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Standard & Poor's Research

Summary:

Gaz Metro inc.
Gaz Metro L.P.

Primary Credit Analyst:
Gerald F Hannochko, Toronto (1) 416-507-2589; gerald_hannochko@standardandpoors.com

Secondary Contact:
Gavin MacFarlane, Toronto (1) 416-507-2545; gavin_macfarlane@standardandpoors.com

Table Of Contents

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Corporate Credit Rating	A-/Stable/--

Profile Assessments

BUSINESS RISK	EXCELLENT	Vulnerable — Excellent
FINANCIAL RISK	SIGNIFICANT	Highly leveraged — Minimal

Rationale

Business Risk: Excellent

- Standard & Poor's Ratings Services' assessment reflects Gaz Metro inc. (GMi) and Gaz Metro L.P.'s (GMLP) highly stable regulated gas distribution cash flows in Quebec and electricity and gas distribution in Vermont
- There is a supportive regulatory environment in Quebec — we expect a return to incentive-based regulation in 2014
- Offsetting these factors is the low organic growth in its jurisdictions and high degree of dependence on industrial volumes in Quebec, which has a higher degree of variability than residential consumption

Financial Risk: Significant

- Financial metrics reflect a high degree of leverage associated with the regulated capital structure, as well as additional debt at the GMLP level
- Forecast financial metrics improve to the 20% FFO-to-debt range in 2013 and 2014 from a full year of Central Vermont Public Service Corp. (CVPS) operations
- We expect stable dividend policy and moderate capital expenditures

Outlook: Stable

The stable outlook reflects our expectations in the next two years of continued regulatory support in Quebec and Vermont, of some modest synergies from the combination of CVPS and Green Mountain Power Corp. operations, and that Gaz Metro will sustain adjusted funds from operations (AFFO)-to debt of about 20% (consolidated and deconsolidated). We also expect adjusted debt-to-capital to remain below 70%, consistent with its regulatory capital structure and trust indenture limits.

Downside scenario

A downgrade is possible if the company fails to keep consolidated AFFO-to-debt above 16%, which we would expect would be as a result of material non regulatory debt used to finance acquisitions. We believe material changes to the business risk profile resulting in an outlook revision are unlikely, given trust indentures that limit the amount of nonregulatory business contribution to the consolidated entity. Although we don't expect it, any adverse material developments (such as an adverse regulatory decision or additional debt-financed acquisitions) could change our view on the company's business risk and financial risk profiles.

Upside scenario

An outlook revision to positive or an upgrade is not likely without a demonstrated, long-term commitment to a much stronger balance sheet with stronger cash flow metrics (30% AFFO-to-total debt or better).

Standard & Poor's Base-Case Scenario

Our base case assumptions include a jump in EBITDA from a full year of CVPS operations (the acquisition closed in June 2012).

Assumptions

- FFO of approximately C$450 million, with 70% from Quebec and 20% from Vermont
- Cost-of-service methodology for Quebec gas distribution in 2013, with a return to incentive mechanisms in 2014
- Modest synergies from CVPS in 2013
- Return to more normal weather from the warm winter that depressed metrics in 2012

Key Metrics

(%)	2012A	2013E	2014E
EBITDA growth	(4.7)	29	10
FFO-to-debt	16	18-21	19-22
Debt-to-EBITDA (x)	6.6	4.5-5	4-4.5

FFO--Funds from operations. A--Actual. E--Estimate.

Business Risk: Excellent

The excellent business risk profile reflects our view of the high degree of regulated cash flows from its natural gas and electricity distribution activities in Quebec and Vermont. The vast majority of cash flows are from regulated businesses, which we believe provides a high degree of stability. In Quebec, GMLP is operating under a cost of service methodology for 2013, and has recently been given support by the Regie de l'Energie for an approved 8.9% return on equity. It has reapplied for incentive-based regulation for 2014. We view the regulatory environment as supportive in Quebec, with measures such as weather normalization adjustments. While we view the business fundamentals of Vermont-based electricity and gas distribution companies (GMP and CVPS) as not as strong as Quebec, they do not drag down the overall business risk profile. The Seigneurie de Beaupre wind farms are contracted for 20 years with Hydro Quebec, and we expect the segment to be a small contributor to the overall business. Our base-case operating scenario forecasts contribution from U.S.-based distribution at about 20% of FFO, while 70% comes from Quebec.

Financial Risk: Significant

We view the financial risk profile as significant, because a high degree of allowed leverage for regulatory purposes (54% in Quebec) compounds additional nonregulatory debt at the GMLP level. We expect capital expenditures to be about C$140 million in Quebec. We also expect distributions from the GMLP level to be flat year-over-year. We expect financial metrics will be generally stable, although they will improve slightly in 2014 with additional synergies from CVPS and an expected return to incentive-based regulation.

Liquidity: Adequate

We view the company's liquidity as adequate, with sources exceeding uses by more than 1.2x, and sources less uses being positive over the next 12 months.

Principal Liquidity Sources	Principal Liquidity Uses
• FFO of approximately C$450 million • Cash of C$55 million as of Dec 31, 2012 • Committed credit facility of C$600 million, of which approximately C$290 million was available at Dec 31, 2012	• Capital expenditures of C$450 million-C$500 million • Distributions to owners of approximately C$150 million

Recovery Analysis

We assign recovery ratings to secured utility bonds (SUBs) that utilities issue, which can result in issue ratings being above our corporate credit rating (CCR) on the company, depending on the CCR category and the extent of the collateral coverage. Under our recovery criteria, we consider the amount of SUB's outstanding relative to the regulated capital value (Net property plant and equipment exclusive of construction work in progress). Our ratings on these bonds can exceed the CCR on the issuing utility up to one notch in the 'A' category, two notches in the 'BBB' category, and three notches in speculative-grade categories.

Securing GMi's SUBs (the company issues first mortgage bonds) are a trust deed that contains a hypothec on the universality of present and future movable and immovable property of GMi and GMLP located in the Province of Quebec. The creditors are also covered by a first immovable hypothec on GMLP's present and future pipelines and natural gas system. The FMBs comprise several individual debt issues, with maturities ranging from fiscal years 2013-2036. Standard & Poor's believes that if GMi were to default, it would continue to operate as part of a reorganized entity because of the business' essential service nature. The recovery estimate compares the level of collateral to existing amount of secured debt. Collateral coverage of greater than 1.5x supports a '1+' recovery rating and an issue rating one notch above the CCR on Gaz Metro.

Related Criteria And Research

- Collateral Coverage And Issue Notching Rules For '1+' And '1' Recovery Ratings On Senior Bonds Secured By Utility Real Property, Feb. 14, 2013
- Methodology: Business Risk/Financial Risk Matrix Expanded, Sept. 18, 2012
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008

Business And Financial Risk Matrix

	Financial Risk					
Business Risk	Minimal	Modest	Intermediate	Significant	Aggressive	Highly Leveraged
Excellent	AAA/AA+	AA	A	A-	BBB	--
Strong	AA	A	A-	BBB	BB	BB-
Satisfactory	A-	BBB+	BBB	BB+	BB-	B+
Fair	--	BBB-	BB+	BB	BB-	B
Weak	--	--	BB	BB-	B+	B-
Vulnerable	--	--	--	B+	B	B- or below

Note: These rating outcomes are shown for guidance purposes only. The ratings indicated in each cell of the matrix are the midpoints of the likely rating possibilities. There can be small positives and negatives that would lead to an outcome of one notch higher or lower than the typical matrix outcome. Moreover, there will be exceptions that go beyond a one-notch divergence. For example, the matrix does not address the lowest rungs of the credit spectrum (i.e., the 'CCC' category and lower). Other rating outcomes that are more than one notch off the matrix may occur for companies that have liquidity that we judge as "less than adequate" or "weak" under our criteria, or companies with "satisfactory" or better business risk profiles that have extreme debt burdens due to leveraged buyouts or other reasons. For government-related entities (GREs), the indicated rating would apply to the standalone credit profile, before giving any credit for potential government support.