FINANCIAL POSITION REVIEW

Overview

As at December 31, 2012, Capstone had a consolidated working capital surplus of $30,821 compared with a deficit of $86,694 at December 31, 2011. The improvement of $117,515 primarily reflected debt repayments and refinancing activity during the year. The total comprises$10,123 and $31,041 surpluses for the utilities – water and power segments, respectively, and a deficit of $10,343 at corporate.

Unrestricted cash and equivalents totaled $49,599 on a consolidated basis with the utilities – water and power segments contributing $25,315 and $20,941, respectively.

During 2012, Capstone's debt to capitalization ratio (refer to page 33) improved from71.0% to 62.7% on a fair value basis and from 65.7% to 57.6% on a book value basis. On a fair value basis, the decline was primarily due to a $212,712 decrease in the fair value of debt. This variance was largely attributable to a $110,708 reduction in corporate debt following the repayment of debt incurred to acquire Bristol Water and a $93,305 reduction of the utilities – water segment debt arising from Capstone's reduced ownership interest in Bristol Water, which lowered its proportionate share of the company's debt. As at December 31, 2012, Capstone and its subsidiaries were in compliance with all debt covenants.

Liquidity

Working capital

As at	**Dec 31, 2012**	Dec 31, 2011
Power	**31,041**	(64,566)
Utilities – water	**10,123**	91,864
Corporate	**(10,343)**	(113,992)
Working capital	**30,821**	(86,694)

The working capital surplus of $30,821 increased by $117,515 from December 31, 2011. The improvement at the power segment primarily reflected refinanced debt, which was classified as long term at the end of 2012. For corporate, the reduction was due to repayments during the year. This was partially offset by a $81,741 working capital decrease in the utilities – water segment as available cash was used to fund the capital asset expansion program.

Cash and cash equivalents

As at	**Dec 31, 2012**	Dec 31, 2011
Power	**20,941**	13,972
Utilities – water	**25,315**	35,434
Corporate	**3,343**	8,181
Unrestricted cash and cash equivalents	**49,599**	57,587
Less: cash with access limitations		
Power	**(8,386)**	(10,135)
Utilities – water (1)	**(25,315)**	(35,434)
Cash and cash equivalents available to Capstone	**15,898**	12,018

(1) Cash and cash equivalents is in addition to $6,471 short-term deposits at December 31, 2012 (December 31, 2011 – $82,202). The decrease in short-term deposits was a result of funds used for capital projects.

Unrestricted cash represents funds available for operating activities, capital expenditures and future acquisitions. The $7,988 decrease in cash from December 31, 2011 was primarily attributable to the timing of cash required to fund Bristol Water's capital asset expansion program.

Cash and cash equivalents available to Capstone are funds available for general purposes, including payment of dividends to shareholders. Bristol Water's $25,315 of cash and cash equivalents as at December 31, 2012 are primarily earmarked for capital expenditure projects for the company's five-year asset management plan approved by the regulator. In addition, Bristol Water obtained $111,083 of credit availability during the third quarter to fund the long-term cash requirements of the capital projects. For the power segment, $8,386 is only periodically accessible to Capstone through distributions under the terms of the credit agreements for the hydro facilities, Erie Shores and Amherstburg.

Restricted cash increased by $4,282 from December 31, 2011 to $19,229 at December 31, 2012. The increase was mainly attributable to new debt service and maintenance reserve accounts required by the credit agreement for the hydro facilities. Restricted cash represents reserve accounts of $10,331 and $8,898 at the power segment and Bristol Water, respectively.

Cash flow

Capstone's consolidated cash and cash equivalents decreased by $7,988 in 2012 compared with a decrease of $70,826 in 2011. Details of the decrease are presented in the consolidated statement of cash flows and are summarized as follows:

For the year ended	**Dec 31, 2012**	Dec 31, 2011
Operating activities	**114,678**	50,881
Investing activities	**(4,949)**	(401,344)
Financing activities (excluding dividends to shareholders)	**(92,503)**	322,782
Dividends paid to shareholders	**(26,131)**	(42,051)
Effect of exchange rate changes on cash and cash equivalents	**917**	(1,094)
Change in cash and cash equivalents	**(7,988)**	(70,826)

Cash flow from operating activities generated $63,797 more cash than in 2011, primarily because Bristol Water contributed $54,282. Capstone's power segment generated $10,596 less cash flow in 2012, primarily due to lower operating income and working capital requirements, partially offset by the commencement of operations at Amherstburg. In addition, corporate operating activities were $21,779 higher in 2012, resulting mainly from internalization costs occurring only in 2011.

Cash flow from investing activities was $396,395 higher in 2012 than in 2011, primarily due to the significant investments in Värmevärden, Bristol Water and Amherstburg occurring in 2011 in addition to the recapitalization of Värmevärden in 2012. The changes in investing activities are summarized as follows:

Värmevärden
- Capstone invested $109,146 in 2011, comprising shareholder loans and equity investment, for a one-third interest in Värmevärden.
- In 2012, Värmevärden repaid $48,943 of the shareholder loans from the bond issue proceeds at Sefyr Värme.

Bristol Water
- Capstone invested $173,989 ($213,476 purchase price less $39,487 of cash at Bristol Water on acquisition) in 2011.
- During 2012, Bristol Water used $72,010 of short-term investments to fund capital expenditures.

Amherstburg
- Capstone invested $94,635 in 2011 to complete construction of Amherstburg.

Cash flow from financing activities was $415,285 lower in 2012 than in the prior year primarily because Capstone repaid $253,311 of debt in 2012 while adding $100,621 of long-term debt for the hydro facilities. This was partially offset by the receipt of $70,274 from ITOCHU for a 20% interest in Bristol Water before transaction costs of $1,322. In 2011, Capstone added $172,328 of long-term debt to finance the Bristol Water investment and to fund the construction of Amherstburg along with raising $72,020 of preferred shares and $71,625 of common shares, net of costs. The remaining difference was due to reduction of principal on debt and common shares issued in 2011 to MGL related to the internalization transaction.

Capital Structure

Capstone considers shareholders' equity and long-term debt (proportionately attributable to Capstone's shareholders), both the current and non-current portions, to be the basis of its capital structure. Capstone measures its capitalization ratio based on the fair values of long-term debt and shareholders' equity. Capstone's capitalization ratio using fair values and carrying values was as follows:

	Dec 31, 2012		Dec 31, 2011	
As at	**Fair Value**	**Carrying Value**	Fair Value	Carrying Value
Long-term debt				
Power	**305,497**	**297,792**	314,196	308,513
Utilities – water (1)	**259,830**	**236,768**	353,135	336,237
Corporate	**44,416**	**40,631**	155,124	152,613
Deferred financing fees	**—**	**(7,328)**	—	(6,421)
	609,743	**567,863**	822,455	790,942
Equity				
Shareholders' equity (2)	**363,248**	**418,848**	335,228	413,520
Total capitalization	**972,991**	**986,711**	1,157,683	1,204,462
Debt to capitalization	**62.7%**	**57.6%**	71.0%	65.7%

(1) Only 50% of the long-term debt at Bristol Water has been included in the calculation to reflect the impact of the non-controlling interest (December 31, 2011 – 70%).

(2) The carrying value of shareholders' equity does not include the amount attributed to the non-controlling interest.

Power

The composition of the power segment's long-term debt was:

As at			**Dec 31, 2012**		Dec 31, 2011	
	Maturity	Interest Rate	**Fair Value**	**Carrying Value**	Fair Value	Carrying Value
CPC-Cardinal credit facility	2014	4.53%	**12,050**	**12,050**	85,000	85,000
Erie Shores project debt	2016 & 2026	5.28 – 6.15%	**106,538**	**97,703**	108,616	102,933
Amherstburg Solar Park project debt	2016	7.32%	**90,560**	**90,560**	94,267	94,267
Hydro facilities senior secured bonds	2040	4.56%	**76,347**	**77,237**	—	—
Hydro facilities subordinated secured bonds	2041	7.00%	**20,002**	**20,242**	—	—
Wawatay facility's levelization liability	Settled	6.87%	**—**	**—**	26,313	26,313
			305,497	**297,792**	314,196	308,513

On September 17, 2012, Capstone repaid $12,300 of the old CPC-Cardinal credit facility and entered into an amended and restated facility in the aggregate amount of $27,300, comprising a $12,300 term loan and a $15,000 revolving facility. The facility has covenants that include limits on the consolidated debt-to-capitalization ratio and require CPC and certain subsidiaries to maintain a minimum EBITDA.

The $10,721 decrease in the carrying value of power segment's long-term debt is summarized in the following table:

Dec 31, 2011	Unscheduled Repayments(1)	Scheduled Repayments(2)	Debt Proceeds(3)	Other(4)	**Dec 31, 2012**
308,513	(99,672)	(12,331)	100,621	661	**297,792**

(1) Unscheduled debt repayments included $72,700 to settle the power portion of CPC-Cardinal credit facility along with the $27,239 to settle the Wawatay facility's levelization liability. Additionally, a $267 receivable with the OEFC as at June 30, 2012 partially offsets the Wawatay facility's levelization liability repayment.

(2) Scheduled repayments are regular repayments under the credit agreements.

(3) Debt proceeds include the issue of senior and subordinated secured bonds for the hydro facilities, net of deferred financing costs.

(4) Other includes $688 of accrued interest partially offset by a reduction in the Wawatay facility's levelization liability of $27.

Covenant compliance

All of the power segment's long-term debt is subject to financial covenant requirements. The Erie Shores project debt, hydro facilities senior secured and subordinated secured bonds, and Amherstburg project debt are individually required to maintain minimum debt service coverage ratios to allow for distributions to the Corporation. During 2012, Capstone's power segment complied with all covenants.

Utilities – water

The composition of the utilities – water segment's long-term debt was as follows:

As at			**Dec 31, 2012**		Dec 31, 2011	
	Maturity	Interest Rate	**Fair Value**	**Carrying Value**	Fair Value	Carrying Value
Bank loans	2017	1.18%- 5.73%	**31,540**	**31,430**	55,625	54,213
Term loans	2032 – 2041	5.77 – 6.79%(1)	**457,563**	**413,746**	420,242	398,445
Debentures	Irredeemable	3.50 – 4.25%	**2,346**	**2,072**	2,125	2,008
Cumulative preferred shares	Irredeemable	8.75%	**28,211**	**26,289**	26,487	25,673
Consolidated long-term debt			**519,660**	**473,537**	504,479	480,339
Less: non-controlling interest			**(259,830)**	**(236,769)**	(151,344)	(144,102)
Capstone share of long-term debt			**259,830**	**236,768**	353,135	336,237

(1) The interest rate on certain term loans includes an index-linked component to RPI, which was 3.9% after April 1, 2012 (for January 1 to March 31, 2012 – 5%).

Long-term debt for the utilities – water segment was used to fund current and ongoing capital expenditures to improve Bristol Water's network. During the third quarter, Bristol Water repaid a $23,699 bank loan from cash on hand and entered into bank loans of $31,738 and $79,345, maturing August 17, 2015 and 2017, respectively. The new loans are earmarked for long-term cash requirements related to the capital expansion. As at December 31, 2012, Bristol Water has not drawn on these loans. The preferred shares are classified as long-term debt on the basis that they are irredeemable. All Bristol Water debt is non-recourse to Capstone.

Covenant compliance

The principal debt agreements require Bristol Water to comply with covenants relating to the minimum levels of interest coverage and net debt in relation to regulatory capital value. During 2012, Bristol Water complied with all its covenants.

Corporate

The composition of Capstone's corporate long-term debt was as follows:

			Dec 31, 2012		Dec 31, 2011	
As at	Maturity	Interest Rate	Fair Value	Carrying Value	Fair Value	Carrying Value
Senior debt facility	Settled	6.73%	—	—	78,375	78,375
CPC-Cardinal credit facility	2014	4.53%	—	—	34,000	34,000
Convertible debentures	2016	6.50%	44,416	40,631	42,749	40,238
			44,416	40,631	155,124	152,613

Long-term debt decreased by $111,982 in the first year of 2012. Capstone repaid the full $78,375 of the senior debt facility and $34,000 of the CPC-Cardinal credit facility using funds received from the Värmevärden recapitalization, sale proceeds from the Bristol Water partial sale and financing proceeds from the hydro facilities.

Covenant compliance

During 2012, Capstone complied with all covenants.

Shareholders' equity

Shareholders' equity comprised:

As at	Dec 31, 2012	Dec 31, 2011
Common shares	632,474	626,861
Class B exchangeable units	26,710	26,710
Preferred shares	72,020	72,020
	731,204	725,591
Equity portion of convertible debentures	9,284	9,284
Accumulated other comprehensive income (loss)	(809)	(6,729)
Retained earnings (deficit)	(320,831)	(314,626)
Equity to Capstone shareholders	418,848	413,520
Non-controlling interests	91,610	34,450
Total shareholders' equity	510,458	447,970

Capstone is authorized to issue an unlimited number of common shares as well as a limited number of preferred shares equal to 50% of the outstanding common shares. The increase in common shares outstanding was as follows:

	Year ended Dec 31, 2012		Year ended Dec 31, 2011	
($000s and 000s of shares)	Shares	Amount	Shares	Amount
Opening balance	70,957	626,861	56,352	536,278
Shares issued(1)	—	(89)	12,856	77,526
Dividend reinvestment plan (DRIP)	1,488	5,702	253	1,238
Conversion of convertible debentures	—	—	1,496	11,819
Ending balance	72,445	632,474	70,957	626,861

(1) During 2012, additional transaction costs of $89 were included in share capital in relation to the November 10, 2011 common share offering.

The composition of fair value for shareholders' equity was as follows:

As at	Dec 31, 2012			Dec 31, 2011		
($000s, except per share amounts)	Market Price per Share	Outstanding Amount	Fair Value	Market Price per Share	Outstanding Amount	Fair Value
Common shares	$4.03	72,445	291,955	$3.81	70,957	270,348
Class B units	$4.03	3,249	13,093	$3.81	3,249	12,380
Preferred shares	$19.40	3,000	58,200	$17.50	3,000	52,500
			363,248			335,228

Retained earnings (deficit) reflects the aggregate of Capstone's net income (loss) since formation of the Corporation less cumulative dividends paid to shareholders and cumulative distributions paid to Class B exchangeable unitholders.

Contractual Obligations

As at December 31, 2012, Capstone's outstanding contractual obligations are due in the following periods:

	Within one year	One year to five years	Beyond five years	Total
Long-term debt	14,977	180,087	619,014	814,078
Finance lease obligations	3,528	2,689	2,572	8,789
Operating leases	939	3,765	8,443	13,147
Asset retirement obligations	—	—	5,657	5,657
Purchase obligations	67,393	107,453	7,189	182,035
Total contractual obligations	86,837	293,994	642,875	1,023,706

Long-term debt

Long-term debt is discussed as a part of the Capital Structure section on page 33 of this MD&A.

Leases

Cardinal leases the site on which it is located from Ingredion Canada Incorporated ("Ingredion"), formerly Casco Inc. Under the lease, Cardinal pays nominal rent. The lease extends to 2016 and expires concurrently with the energy savings agreement between Ingredion and Cardinal.

A subsidiary of Capstone has lease agreements with the Provinces of Ontario and British Columbia with respect to certain lands, lands under water and water rights necessary for the operation of its hydro power facilities. The payments with respect to these agreements vary based on actual power production. The terms of the lease agreements extend between 2023 and 2042.

Amherstburg leases the land on which its operating facilities are located. The terms of the lease agreements extend to 2032.

Erie Shores has lease and easement agreements with local landowners, municipalities and other parties with respect to certain lands for the operation of the wind farm. The payments above a minimum level with respect to these agreements vary based on actual power production. The terms of the lease agreements extend to 2025, with a 20-year renewal option.

The Corporation has an operating lease for premises, which has a term to 2018 with an option to extend to 2023. Capstone also has finance leases for certain equipment and vehicles.

Asset retirement obligations

Commitments associated with our asset retirement obligations are expected to occur principally over the next 30 years for our power infrastructure facilities.

Purchase obligations

Capstone enters into contractual commitments in the normal course of business. These contracts include energy savings agreements, wood waste supply agreements, natural gas purchase contracts, operations and maintenance agreements, capital commitments and guarantees.

Energy savings agreement

Under the terms of an energy savings agreement between Cardinal and Ingredion, Cardinal is required to sell up to 723 million pounds of steam per year to Ingredion for its manufacturing operations. The energy savings agreement matures on December 31, 2014 but may be extended by up to two years at Cardinal's option.

Wood waste supply agreement

Whitecourt has a long-term agreement with Millar Western to ensure an adequate supply of wood waste. The agreement expires in June 2016.

Gas purchase contract

Cardinal has a long-term purchase agreement for natural gas that expires on May 1, 2015. The minimum purchase commitment for natural gas under the agreement is 9,289,104 MMBtu per year through to expiration in 2015, which is equivalent to 80% of the contract maximum.

Operations and management agreements

Capstone has an O&M agreement with Regional Power OPCO Inc. ("Regional") to operate and maintain the hydro power facilities, expiring on November 15, 2016 with an automatic renewal term. Regional is paid a monthly management fee and is eligible for an annual incentive fee.

Capstone has an O&M agreement with SunPower Energy Systems Canada Corporation to operate and maintain Amherstburg, expiring on June 30, 2031. Capstone has the ability to terminate the agreement during the term of the contract.

Capstone has an O&M agreement with Agbar to provide management support to Bristol Water, with an initial five-year term, which automatically extends indefinitely. Capstone has the ability to terminate the contract.

Capital commitments

Bristol Water has commitments for capital expenditures at December 31, 2012 of which $33,300 were contracted for but not accrued.

Guarantees

Capstone also provides three guarantees relating to Clean Power Income Fund's legacy obligations. As at December 31, 2012, no claims had been made on these guarantees.

There have been no other significant changes to the specified contractual obligations that are outside the ordinary course of business. Capstone is not engaged in any off-balance sheet financing transactions.

Equity Accounted Investments

See discussion in the results of operations on page 30 of this MD&A for a detailed discussion on Capstone's equity accounted investment in Värmevärden.

For Capstone's equity interest in Chapais, no income has been recorded on the investment since its acquisition in 2007. Capstone does not expect to earn any future equity accounted income from this investment. Additionally, Capstone's investment in MLTCLP had no significant activity during the year ended December 31, 2012.

Capital Expenditure Program

Capstone incurred $146,073 in capital expenditures during the year. Below is the breakdown of the investment by operating segment:

	For the year ended	
	Dec 31, 2012	Dec 31, 2011
Power	**5,432**	87,451
Utilities – water	**140,555**	22,962
Corporate	**86**	638
	146,073	111,051

Capital expenditures for the power segment in 2012 were in the normal course of operations and primarily related to the Cardinal, Whitecourt, Erie Shores and the hydro facilities as they completed scheduled outages in the second and third quarters of 2012. In 2011, the capital expenditures primarily related to the construction of the Amherstburg facility. For the utilities – water segment, expenditures included both growth and maintenance initiatives as outlined in Bristol Water's regulatory capital expenditures program. In aggregate, Bristol Water's capital expenditure program spans the five-year AMP5 period. Overall, Bristol Water's expenditures to date are behind the five-year plan but are expected to catch up before the end of AMP5 in March 2015.

Retirement Benefit Plans

Bristol Water has a defined benefit plan and there are defined contribution plans for the employees of Bristol Water and Cardinal.

Bristol Water's defined benefit plan is for current and former employees. The defined benefit plan is closed to new employees, who are allowed to join Bristol Water's defined contribution plan.

As at	**Dec 31, 2012**	Dec 31, 2011
Fair value of assets	**271,650**	267,114
Present value of defined benefit obligation	**(234,075)**	(207,010)
	37,575	60,104

As at December 31, 2012, the defined benefit plan was in a $37,575 surplus position for accounting purposes. The surplus is subject to a number of critical accounting estimates which can materially impact the balances. The fair values included in the surplus are calculated with the assistance of an actuary and assumptions used are considered to be reasonable by management.

For 2013, Bristol Water expects to make employer contributions of $3,348 compared with actual contributions of $3,725 for the year ended December 31, 2012. The expense is incurred entirely at Bristol Water.

The total defined contribution pension expense recorded in the consolidated statement of income for the year ended December 31, 2012 was $1,319. The expense comprised $1,135 for Bristol Water and $184 for Cardinal.

Income Taxes

Current income tax recovery was $239 for 2012. This was primarily attributable to Bristol Water resolving prior year tax recoveries.

Deferred income tax assets and liabilities are recognized on Capstone's consolidated statement of financial position based on temporary differences between the accounting and tax bases of existing assets and liabilities.

As at	**Dec 31, 2012**	Dec 31, 2011
Deferred income tax assets	**28,719**	32,897
Deferred income tax liabilities	**(181,176)**	(178,201)
	(152,457)	(145,304)

The following table summarizes Capstone's tax loss carry forwards recognized and unrecognized as part of the deferred income tax assets:

	Recognized	Unrecognized	Total
Canadian – capital losses	—	84,610	84,610
Canadian – non-capital losses	13,572	59,908	73,480
US – non-capital losses	—	14,385	14,385
UK – capital losses	—	4,633	4,633
UK – advanced corporation tax	—	6,345	6,345
	13,572	169,881	183,453

Capstone's total deferred income tax assets include $14,517 ($16,924 at December 31, 2011) attributable to the Canadian entities and $14,202 ($15,973 at December 31, 2011) for Bristol Water. Deferred income tax assets primarily relate to financial instruments fair value adjustments and differences in the amortization of deferred financing costs for tax and accounting purposes.

Deferred income tax liabilities of $64,704 ($60,286 at December 31, 2011) were attributable to Capstone's Canadian entities while $116,472 ($117,915 at December 31, 2011) was attributable to Bristol Water. Deferred income tax liabilities primarily relate to the defined benefit pension plan and differences in the amortization of intangible and capital assets for tax and accounting purposes.

Capstone's net deferred income tax liability increased by $7,153 in 2012. The increase was primarily attributable to the difference between accounting and tax depreciation. In addition, a substantively enacted tax rate reduction in the United Kingdom from 25% to 24% effective March 1, 2012, with an additional rate reduction from 24% to 23%, effective July 1, 2012, resulted in a recovery of $7,021. The decrease in the deferred income tax liability not attributable to the deferred income tax expense relates to amounts recorded to other comprehensive income.

The income tax recovery of $35,945 for the year ended December 31, 2011 was primarily attributable to Capstone's conversion to a corporation. As a trust in 2010, IFRS required Capstone to use an "undistributed" tax rate to determine deferred taxes. Upon conversion to a corporation, Capstone recognized the recovery from changing tax rates from 46%, the trust rate, to 25%, the general corporate rate.