DERIVATIVE FINANCIAL INSTRUMENTS

Capstone has exposure to market, credit and liquidity risks from its use of financial instruments as described in notes 9 (Financial Instruments) and 10 (Financial Risk Management) in the consolidated financial statements for the year ended December 31, 2012. These notes contain further details on the implicit risks and valuation methodology employed for Capstone's financial instruments.

To manage the risks inherent in the business, Capstone enters into derivative contracts to mitigate the economic impact of the fluctuations in interest rates and foreign exchange rates. The fair values of these contracts, as reported in Capstone's consolidated statements of financial position, were:

As at	**Dec 31, 2012**	Dec 31, 2011
Derivative contract assets	**2,021**	3,144
Derivative contract liabilities	**(30,651)**	(34,143)
Net derivative contract liabilities	**(28,630)**	(30,999)

The composition of derivative contracts in 2012 is consistent with 2011, aside from the expiry of the gas swap and certain interest rate swaps during 2012. The $2,369 decrease in the net derivative contract liabilities is included in the $2,605 gain as a part of other gains and losses in the consolidated statement of income for the year ended December 31, 2012. The unrealized gain (loss) on derivatives on the consolidated statements of income and comprehensive income comprised:

	Year ended	
	Dec 31, 2012	Dec 31, 2011
Interest rate swap contracts	**(100)**	(8,128)
Gas swap contracts	**—**	(1,918)
Foreign currency option contracts	**(975)**	(644)
Embedded derivative	**3,680**	(11,052)
Unrealized gain (losses) on derivatives in net income	**2,605**	(21,742)
Interest rate swap contracts in OCI	**(642)**	(60)
Unrealized gain (losses) on derivatives in comprehensive income	**1,963**	(21,802)

Gains on derivatives for the year ended December 31, 2012 were primarily attributable to the change in value of the embedded derivative at Cardinal, partially offset by losses on the foreign currency contracts.

The embedded derivative gain was primarily due to a decrease in the forecasted Direct Customer Rate ("DCR") and the passage of time. The liability portion of the embedded derivative is calculated by discounting Capstone's expected cash flows from Cardinal's fuel supply agreement. Cardinal may swap gas mitigation payments at DCR for a fixed rate, which means that declines in forecasted DCR reduce the fair value of the liability. Additionally, as time passes, fewer net payments are included in the calculation and the liability declines.

The loss on foreign currency contracts was due to the net depreciation of the Swedish krona and UK pound sterling forward-looking rates relative to the fixed Canadian dollar conversion rate.

FOREIGN EXCHANGE

The foreign exchange gains (losses) were primarily due to translation of Capstone's SEK-denominated shareholder loan receivable with Värmevärden. Capstone recorded a $1,620 foreign exchange gain in 2012 compared with a $3,274 loss in 2011. In 2012, the Swedish krona appreciated against the Canadian dollar thereby increasing the carrying value of the loans in Canadian dollars, compared with a deprecation in 2011. The 2012 gain was also mitigated by the repayment of more than half of the shareholder loan, reducing the impact of Swedish krona appreciation.

Capstone hedges the interest payments from Värmevärden, but not the outstanding loan receivable.