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MANAGEMENT'S DISCUSSION AND ANALYSIS

Our infrastructure businesses provide essential services for which there is consistent demand throughout the economic cycle. They also operate within contractual frameworks or environments where they benefit from high barriers to entry. Combined, these attributes result in an inherently stable foundation and, accordingly, relatively predictable operating cash flow.

Financial Highlights

	As at and for the year ended December 31		
	2012	2011	2010
Revenue	357,610	215,967	158,512
Net income (loss)	43,724	(3,263)	15,901
Earnings (loss) per share			
Basic and diluted	0.298	(0.108)	0.339
AFFO per share	0.473	0.541	0.693
Cash dividends per share			
Common	0.450	0.660	0.660
Preferred	1.250	0.421	n/a
Total assets	1,652,539	1,697,744	804,134
Total long-term liabilities	1,013,729	928,797	414,480
Total liabilities	1,142,081	1,249,774	540,039

LEGAL NOTICE

Caution Regarding Forward-Looking Statements

Certain of the statements contained within this document are forward-looking and reflect management's expectations regarding the future growth, results of operations, performance and business of Capstone Infrastructure Corporation (the "Corporation") based on information currently available to the Corporation. Forward-looking statements and financial outlook are provided for the purpose of presenting information about management's current expectations and plans relating to the future and readers are cautioned that such statements may not be appropriate for other purposes. These statements and financial outlook use forward-looking words, such as "anticipate", "continue", "could", "expect", "may", "will", "estimate", "plan", "believe" or other similar words, and include, among other things, statements found in "Strategic Overview" and "Results of Operations". These statements and financial outlook are subject to known and unknown risks and uncertainties that may cause actual results or events to differ materially from those expressed or implied by such statements and financial outlook and, accordingly, should not be read as guarantees of future performance or results. The forward-looking statements and financial outlook within this document are based on information currently available and what the Corporation currently believes are reasonable assumptions, including the material assumptions set out in the management's discussion and analysis of the results of operations and the financial condition of the Corporation ("MD&A") for the year ended December 31, 2012 under the heading "Results of Operations", as updated in subsequently filed MD&A of the Corporation (such documents are available under the Corporation's profile on www.sedar.com).

Other material factors or assumptions that were applied in formulating the forward-looking statements and financial outlook contained herein include or relate to the following: that the business and economic conditions affecting the Corporation's operations will continue substantially in their current state, including, with respect to industry conditions, general levels of economic activity, regulations, weather, taxes and interest rates; that the power infrastructure facilities will experience normal wind, hydrological and solar irradiation conditions, and ambient temperature and humidity levels; an effective TCPL gas transportation toll of approximately $1.76 per gigajoule in 2013; that there will be no material change in the level of gas mitigation revenue historically earned by the Cardinal facility; that there will be no material changes to the Corporation's facilities, equipment or contractual arrangements, no material changes in the legislative, regulatory and operating framework for the Corporation's businesses, no delays in obtaining required approvals, no material changes in rate orders or rate structures for the power infrastructure facilities, Värmevärden or Bristol Water, no material changes in environmental regulations for the power infrastructure facilities, Värmevärden or Bristol Water and no significant event occurring outside the ordinary course of business; that the amendments to the regulations governing the mechanism for calculating the Global Adjustment (which affects the calculation of the DCR escalator under the PPA for the Cardinal facility and price escalators under the hydro power facilities located in Ontario) will continue in force; that there will be no material change to the accounting treatment for Bristol Water's business under International Financial Reporting Standards, particularly with respect to accounting for maintenance capital expenditures; that there will be no material change to the amount and timing of capital expenditures by Bristol Water; that there will be no material changes to the Swedish Krona to Canadian dollar and UK pound sterling to Canadian dollar exchange rates; and that Bristol Water will operate and perform in a manner consistent with the regulatory assumptions underlying AMP5, including, among others: real and inflationary increases in Bristol Water's revenue, Bristol Water's expenses increasing in line with inflation, and capital investment, leakage, customer service standards and asset serviceability targets being achieved.

Although the Corporation believes that it has a reasonable basis for the expectations reflected in these forward-looking statements and financial outlook, actual results may differ from those suggested by the forward-looking statements for various reasons, including: risks related to the Corporation's securities (dividends on common shares and preferred shares are not guaranteed; volatile market price for the Corporation's securities; shareholder dilution; and convertible debentures credit risk, subordination and absence of covenant protection); risks related to the Corporation and its businesses (availability of debt and equity financing; default under credit agreements and debt instruments; geographic concentration; foreign currency exchange; acquisitions and development; environmental, health and safety; changes in legislation and administrative policy; and reliance on key personnel); risks related to the Power Infrastructure Facilities (power purchase agreements; operational performance; fuel costs and supply; contract performance; land tenure and related rights; environmental; regulatory environment); risks related to Bristol Water (Ofwat price determinations; failure to deliver capital investment programs; economic conditions; operational performance; failure to deliver water leakage target; SIM and the serviceability assessment; pension plan obligations; regulatory environment; competition; seasonality and climate change; and labour relations); and risks related to Värmevärden (operational performance; fuel costs and availability; industrial and residential contracts; environmental; regulatory environment; and labour relations).

The assumptions, risks and uncertainties described above are not exhaustive and other events and risk factors could cause actual results to differ materially from the results and events discussed in the forward-looking statements and financial outlook. The forward-looking statements and financial outlook within this document reflect current expectations of the Corporation as at the date of this document and speak only as at the date of this document. Except as may be required by applicable law, the Corporation does not undertake any obligation to publicly update or revise any forward-looking statements and financial outlook.

This document is not an offer or invitation for the subscription or purchase of or a recommendation of securities. It does not take into account the investment objectives, financial situation and particular needs of any investors. Before making an investment in the Corporation, an investor or prospective investor should consider whether such an investment is appropriate to their particular investment needs, objectives and financial circumstances and consult an investment adviser if necessary.

INTRODUCTION

Management's discussion and analysis ("MD&A") summarizes Capstone Infrastructure Corporation's (the "Corporation" or "Capstone") consolidated financial position, operating results and cash flows as at and for the years ended December 31, 2012 and 2011.

This MD&A should be read in conjunction with the accompanying audited consolidated financial statements of the Corporation and notes thereto as at and for the years ended December 31, 2012 and 2011. Additional information about the Corporation, including its Annual Information Form ("AIF") for the year ended December 31, 2011, quarterly financial reports of Capstone and other public filings of the Corporation will be available under the Corporation's profile on the Canadian Securities Administrators' System for Electronic Document Analysis and Retrieval ("SEDAR") website at www.sedar.com.

The information contained in this MD&A reflects all material events up to March 7, 2013, the date on which this MD&A was approved by the Corporation's Board of Directors.

BASIS OF PRESENTATION

Financial information in this MD&A is prepared in accordance with International Financial Reporting Standards ("IFRS") and amounts are in Canadian thousands of dollars or thousands of share amounts unless otherwise indicated.

Amounts included in the consolidated financial statements of each entity in the Corporation are measured using the currency of the primary economic environment in which the entity operates ("functional currency"). The consolidated financial statements are presented in Canadian dollars ("presentation currency"), which is Capstone's functional currency. The exchange rates used in the translation to the presentation currency are:

	Swedish krona (SEK)		Pound sterling (£)	
As at and for the year ended	Average	Spot	Average	Spot
Dec 31, 2011	0.1525 (1)	0.1479	1.6076 (2)	1.5799
Dec 31, 2012	**0.1476**	**0.1528**	**1.5840**	**1.6178**

(1) Nine-month period from acquisition on March 31, 2011 to December 31, 2011.

(2) Period from acquisition on October 5, 2011 to December 31, 2011.

CHANGES IN THE BUSINESS

In 2012, Capstone addressed maturing debt and positioned the company for future growth. At the end of 2011, Capstone had $197,375 of debt maturing in 2012, excluding amounts at Bristol Water. Capstone repaid or refinanced this amount through the initiatives described below. In addition, the Corporation implemented a new dividend policy in June 2012 reflecting the expected cash flow profile of the company post-2014, which includes the impact of lower cash flow from Cardinal following expiry of its current power purchase agreement.

Värmevärden Recapitalization

In March 2012, Värmevärden, the district heating business, issued approximately $150,000 (1,000,000 SEK) of senior secured bonds to institutional investors. Värmevärden repaid a portion of the shareholder loans from the bond proceeds. Capstone received $49,400 as partial repayment of its shareholder loan and accrued interest which is its pro rata share resulting from Capstone's one-third interest in Värmevärden. Capstone used these proceeds to repay a portion of its senior debt facility. As a result of the recapitalization, Capstone continues to own a one-third interest in Värmevärden, however its total investment in Värmevärden was reduced to $52,028, comprising $34,336 in loans receivable and $17,692 in equity accounted investment.

Partial Sale of Interest in Bristol Water

On May 10, 2012, Capstone sold to I-Environment Investments Ltd, a subsidiary of ITOCHU Corporation, a 20% indirect interest in Bristol Water plc. I-Environment Investments Ltd acquired a 2/7ths ownership interest in CSE Water UK Limited, which indirectly owns a 70% interest in Bristol Water plc. Capstone received $68,952 of net proceeds from the sale and used the funds to repay the remaining $28,975 on the senior debt facility and $39,000 on the CPC-Cardinal credit facility, retaining cash of $977.

Capstone retains a 50% indirect interest in Bristol Water and continues to consolidate based on retention of control. In accordance with IFRS, Capstone recorded the transaction as a transfer of equity to non-controlling interest holders. The excess net proceeds of $15,694 over the value of equity transferred to the non-controlling interest and $850 of taxes were recorded directly to retained earnings.

Financing of Hydro Facilities

On June 6, 2012, MPT Hydro LP, an indirect wholly-owned subsidiary of Capstone, which owns the Dryden, Hluey Lakes, Sechelt and Wawatay hydro facilities (the "hydro facilities"), completed a $100,621 debt offering to recapitalize the hydro facilities. The debt offering comprised $80,379 of senior secured bonds and $20,242 of subordinated secured bonds.

Proceeds from the offering were used to repay the $27,239 balance of levelization debt at the Wawatay hydro facility and to pay $1,785 of transaction costs, which were capitalized. In addition, Capstone cash funded $3,846 for debt service and maintenance reserve accounts in accordance with the bond indenture and used $67,700 of net proceeds to repay a portion of the CPC-Cardinal credit facility. The remaining balance of $12,300 was subsequently refinanced in September 2012, as part of the new credit facility.

New Dividend Policy

On June 1, 2012, the Board of Directors of the Corporation established a new policy with respect to the timing and amount of its dividend, commencing with the month ended June 2012. Under the new dividend policy, the Corporation intends to pay a quarterly dividend of $0.075 per common share, or $0.30 per common share on an annualized basis. Among other things, the Corporation's dividend policy reflects management's view on current Ontario power market and fiscal dynamics and its expectation for the cash flow the Cardinal facility will generate following the expiry of its current power purchase arrangement at the end of 2014.

The Corporation's dividend policy is determined by the Board of Directors of the Corporation and is based on the Corporation's cash flows, financial requirements, the satisfaction of solvency tests imposed under corporate law for the declaration of dividends and other relevant factors. With the implementation of the new dividend policy, the Corporation expects to retain additional cash that can be reinvested in new growth opportunities.

NON-GAAP AND ADDITIONAL GAAP PERFORMANCE MEASURE DEFINITIONS

While the accompanying consolidated financial statements have been prepared in accordance with IFRS, this MD&A also contains figures that are performance measures not defined by IFRS. These non-GAAP and additional GAAP performance measures do not have any standardized meaning prescribed by IFRS and are, therefore, unlikely to be comparable to similar measures presented by other issuers. The Corporation believes that these indicators are useful since they provide additional information about the Corporation's earnings performance and cash generating capabilities and facilitate comparison of results over different periods. The non-GAAP and additional GAAP measures used in this MD&A are defined below.

Earnings before Interest Expense, Taxes, Depreciation and Amortization ("EBITDA")

EBITDA is net income (loss), including that net income (loss) related to the non-controlling interest ("NCI") and interest income excluding interest expense, income taxes, depreciation and amortization. EBITDA represents Capstone's continuing capacity to generate income from operations before taking into account management's financing decisions and costs of consuming tangible capital assets and intangible assets, which vary according to their vintage, technological currency, and management's estimate of their useful life. EBITDA is presented on the consolidated statement of income.

Adjusted EBITDA

Adjusted EBITDA is calculated as revenue less operating and administrative expenses plus interest income and dividends or distributions received from equity accounted investments. Amounts attributed to any non-controlling interest are deducted. Adjusted EBITDA for the investment in Bristol Water is included at Capstone's proportionate ownership interest. For the period from October 5, 2011 to May 10, 2012, Capstone held a 70% ownership interest. This ownership interest was reduced to 50% upon the partial sale of Bristol Water on May 10, 2012. Adjusted EBITDA is reconciled to EBITDA by removing equity accounted income, other gains and losses (net), foreign exchange gains and losses, and adding in dividends or distributions from equity accounted investments.

Adjusted Funds from Operations ("AFFO")

Capstone's definition of AFFO measures cash generated by its infrastructure business investments that is available for dividends and general corporate purposes. For wholly owned businesses, AFFO is equal to Adjusted EBITDA less interest paid, repayment of principal on debt, income, taxes paid and maintenance capital expenditures. For businesses that are not wholly owned, the cash generated by the business is only available to Capstone through periodic dividends. For these businesses, AFFO is equal to distributions received. Also deducted are corporate expenses and dividends on preferred shares.

AFFO is calculated from Adjusted EBITDA by:

Deducting:

- Adjusted EBITDA generated from businesses with significant non-controlling interests

Adding:

- Dividends received from businesses with significant non-controlling interests
- Scheduled repayments of principal on loans receivable from equity accounted investments

Deducting items for businesses without significant non-controlling interests:

- Interest paid
- Income taxes paid
- Dividends paid on the preferred shares included in shareholders' equity
- Maintenance capital expenditure payments
- Scheduled repayments of principal on debt, net of changes to the levelization liability up to repayment on June 6, 2012

Payout Ratio

Payout ratio measures the proportion of AFFO that is paid as dividends to common shareholders. The payout ratio is calculated as dividends declared divided by AFFO.

Reconciliation of Non-GAAP Performance Measures

The following table reconciles Adjusted EBITDA and AFFO to the nearest GAAP measures:

	For the year ended	
	Dec 31, 2012	Dec 31, 2011
EBITDA	**161,091**	32,066
Foreign exchange (gain) loss	**(1,620)**	3,274
Other (gains) and losses, net	**(1,294)**	21,742
Equity accounted (income) loss	**(2,294)**	5,276
Distributions from equity accounted investments	**2,001**	—
Non-controlling interest ("NCI") portion of Adjusted EBITDA	**(37,227)**	(6,685)
Adjusted EBITDA	**120,657**	55,673
Cash flow from operating activities	**114,678**	50,881
Bristol Water cash flow from operating activities	**(76,474)**	(22,192)
Bristol Water dividends paid to Capstone	**8,091**	3,971
Värmevärden dividends paid to Capstone	**2,001**	—
Foreign exchange (gain) loss on loans receivable from Värmevärden	**(415)**	33
Chapais loans receivable principal repayments	**984**	884
Power maintenance capital expenditures	**(5,398)**	(4,129)
Power and corporate scheduled principal repayments	**(12,581)**	(4,688)
Power and corporate working capital changes	**8,427**	(8,287)
Dividends on redeemable preferred shares	**(3,750)**	(1,264)
AFFO	**35,563**	15,209

RESULTS OF OPERATIONS

Overview

Capstone's Adjusted EBITDA and AFFO in 2012 were both higher than in 2011 as reflected in the following table.

	For the year ended	
	Dec 31, 2012	Dec 31, 2011
Revenue	**357,610**	215,967
Expenses	**(206,613)**	(160,052)
Interest income	**4,886**	6,443
Distributions from equity accounted investments	**2,001**	—
Less: non-controlling interest ("NCI")	**(37,227)**	(6,685)
Adjusted EBITDA	**120,657**	55,673
Adjusted EBITDA of consolidated businesses with NCI	**(48,516)**	(15,597)
Dividends from businesses with non-controlling interests	**8,091**	3,971
Principal from loans receivable	**984**	884
Interest paid	**(23,312)**	(19,641)
Dividends paid on Capstone's preferred shares	**(3,750)**	(1,264)
Income taxes (paid) recovery	**(612)**	—
Maintenance capital expenditures	**(5,398)**	(4,129)
Scheduled repayment of debt principal	**(12,581)**	(4,688)
AFFO	**35,563**	15,209
Internalization costs	**—**	19,675
AFFO before internalization costs	**35,563**	34,884
Before internalization costs		
AFFO per share	**0.473**	0.541
Payout ratio (1)	**94.9%**	120.5%
Dividends declared per share	**0.450**	0.660

(1) Capstone's payout ratio for the year ended December 31, 2012 would have been 63.4% if the new dividend policy of $0.30/share had been effective for all of 2012.

Revenue increased by $141,643, or 65.6%, primarily due to full year contributions from businesses acquired or commencing operations during 2011. Bristol Water and Amherstburg contributed $132,797 and $8,582 representing nine and six months, respectively, of additional revenue.

Expenses increased by $46,561, or 29.1%, including internalization costs, and $66,236, or 47.2%, excluding these costs.

- Operating expenses increased by $73,092 or 59.9%, primarily due to a full year of Bristol Water, which added $68,486 during the first nine months of 2012.
- Administrative expenses increased by $1,068, or 10.7%, from 2011, excluding internalization costs, primarily due to the inclusion of a full year of corporate costs such as rent, IT, and staff compensation. Prior to April 15, 2011, such costs were covered by the management fee paid to Macquarie Group Limited ("MGL").
- Project development costs decreased by $7,924, or 95.6%, as Capstone had less business acquisition activity in 2012 as management focused on financing and asset management initiatives.

Interest income decreased by $1,557, or 24.2%, primarily due to Värmevärden repaying $48,100 of the shareholder loan balance from the proceeds of the bond issuance. The reduction in interest income was partially offset by the receipt of an additional quarter of interest from Värmevärden for the first quarter of 2012 compared with the prior year as the business was acquired on March 31, 2011. The remaining difference was attributable to interest income variances on cash balances at Bristol Water and corporate.

Distributions from equity accounted investments increased by $2,001, or 100%, as Värmevärden began paying dividends to Capstone in 2012. The new dividends offset the lower interest income received from Värmevärden.

Interest paid increased by $3,671, or 18.7%, primarily due to additional interest costs at Amherstburg since commencement of operations in June 2011, new long-term debt at the hydro power facilities beginning in June 2012, and interest on the corporate senior debt facility up until May 2012 when it was repaid. Interest paid by Bristol Water is excluded from Capstone's definition of AFFO and is the primary difference between interest expense included in consolidated net income (loss) and interest paid in AFFO. The remaining difference between interest expense and interest paid was attributable to amortization of financing costs and timing differences between accrual and payment basis.

Scheduled debt repayments increased by $7,893, or 168%, primarily due to higher debt service payments at Amherstburg during the first full year of operations, along with new debt for the hydro facilities and a full year of debt amortization in 2012 on tranche C of the Erie Shores project debt.

Maintenance capital expenditures increased by $1,269, or 30.7%, primarily due to Cardinal's scheduled hot gas path inspection, which occurs every three years.

Results by Segment

Capstone's results are segmented into power facilities across Canada, a water utility in Europe and a district heating utility in Europe. All remaining results relate to corporate activities. The power segment includes gas cogeneration, hydro, wind, biomass and solar power, as well as project development. In 2011, Capstone made investments in the utilities segment through the acquisition of an interest in Bristol Water, a regulated water utility in the United Kingdom, and the acquisition of a 33.3% interest in Värmevärden, a district heating business in Sweden. The financial results of Bristol Water are consolidated with Capstone's other businesses before deducting the portion of Adjusted EBITDA attributable to non-controlling interests. Capstone's non-controlling interest in Värmevärden provides interest income and dividends.

Non-GAAP performance measures

Non-GAAP performance measures results for each business segment were as follows:

Adjusted EBITDA	For the year ended		
	Dec 31, 2012	Dec 31, 2011	Change
Power	**78,178**	72,677	5,501
Utilities – water	**48,516**	15,597	32,919
Utilities – district heating	**5,357**	5,024	333
Corporate (1)	**(11,394)**	(17,950)	6,556
Total	**120,657**	75,348	45,309

AFFO	For the year ended		
	Dec 31, 2012	Dec 31, 2011	Change
Power	**43,859**	50,048	(6,189)
Utilities – water	**8,091**	3,971	4,120
Utilities – district heating	**5,357**	5,024	333
Corporate (1)	**(21,744)**	(24,159)	2,415
Total	**35,563**	34,884	679

(1) Excludes internalization costs of $19,675 for 2011.

Power

The following table shows the significant changes in Adjusted EBITDA and AFFO from 2011:

Change	**Explanations**
8,210	Amherstburg contributed an additional six months of Adjusted EBITDA in 2012.
(1,561)	Cardinal's hot gas path inspection required more days of maintenance than the combustion inspection completed in 2011, which resulted in lower revenue and lower operating expenses.
(1,079)	Higher fuel transportation costs at Cardinal as TransCanada Pipelines ("TCPL") tolls increased from $1.64 per GJ to $2.24 per GJ in March 2011.
843	Whitecourt's sales of additional renewable energy credits ("RECs") produced higher revenue.
(912)	Various other changes.
5,501	Change in Adjusted EBITDA.
(5,604)	Amherstburg had an additional six months of debt servicing costs in 2012.
(4,462)	The hydro facilities and Erie Shores had additional debt servicing costs. The increase was due to the recapitalization of the hydro facilities in June 2012 and the refinancing of Erie Shores in April 2011.
(959)	Cardinal's hot gas path inspection resulted in higher maintenance capital expenditures than in 2011.
(665)	Various other changes.
(6,189)	Change in AFFO.

Utilities – water

The following table shows the significant changes in Adjusted EBITDA and AFFO from 2011:

Change	**Explanations**
38,372	Bristol Water contributed nine months of additional Adjusted EBITDA in 2012.
(4,340)	Sale of Bristol Water interest to ITOCHU resulted in less Adjusted EBITDA from Bristol Water in the fourth quarter of 2012.
(1,113)	Various other changes.
32,919	Change in Adjusted EBITDA.
(32,919)	Remove Bristol Water Adjusted EBITDA changes.
4,868	Higher AFFO from a full year of dividends from Bristol Water, which was acquired in October 2011.
(1,135)	Lower dividend to Capstone due to a reduced ownership interest after the sale of a partial interest in Bristol Water.
387	Various other changes.
4,120	Change in AFFO.

Utilities – district heating

The following table shows the significant changes in Adjusted EBITDA and AFFO from 2011:

Change	Explanations
(3,020)	Lower interest income due to repayments of the shareholder loan from proceeds of the refinancing.
2,001	Higher dividends received in 2012.
1,352	Additional quarter of interest income for the first quarter in 2012 because the business was acquired at the end of the first quarter of 2011.
333	Change in Adjusted EBITDA and AFFO.

Corporate

The following table shows the significant changes in Adjusted EBITDA and AFFO from 2011, excluding internalization costs:

Change	Explanations
7,947	Lower business development expenses were incurred in 2012 as Capstone focused on various refinancing and asset management initiatives. In addition, Capstone initiated development capabilities within the power segment. In 2011, Capstone incurred one-time costs for the acquisition of Bristol Water and Värmevärden.
(2,623)	Inclusion of a full year of staffing costs since internalization April 15, 2011.
1,232	Various other changes.
6,556	Change in Adjusted EBITDA.
(3,098)	Preferred share dividends and related taxes were higher in 2012 as the preferred shares were issued on June 30, 2011.
(1,043)	Debt interest was higher in 2012 which was primarily due to the senior debt facility established for the Bristol Water acquisition, which was outstanding from October 2011 to May 2012.
2,415	Change in AFFO.

Net income (loss)

Net income (loss) for each business segment was as follows:

Net Income (loss)	For the year ended	
	Dec 31, 2012	Dec 31, 2011
Power	**19,788**	27,757
Utilities – water	**38,805**	5,002
Utilities – district heating	**7,936**	(3,541)
Corporate	**(22,805)**	(32,481)
Total	**43,724**	(3,263)

Capstone's net income (loss) comprises cash measures included in Adjusted EBITDA and non-cash measures required by IFRS. The major items are summarized below:

	For the year ended	
	Dec 31, 2012	Dec 31, 2011
Adjusted EBITDA	**120,657**	55,673 (1)
Adjustment of Värmevärden distributions to equity accounted income	**293**	(5,276)
NCI portion of Adjusted EBITDA	**37,227**	6,685
Other gains and (losses), net	**1,294**	(21,742)
Foreign exchange gain (loss)	**1,620**	(3,274)
Interest expense	**(49,707)**	(31,668)
Depreciation and amortization	**(57,552)**	(39,419)
Income tax recovery (expense)	**(10,108)**	35,758
Net Income (loss)	**43,724**	(3,263)

(1) Includes internalization costs of $19,675 for 2011.

Infrastructure – Power

Capstone's power facilities produce electricity from gas cogeneration, wind, biomass, hydro and solar and are located in Ontario, Alberta, British Columbia and Quebec. Results from these facilities were:

4.8%

Percentage of total installed wind capacity in Ontario currently represented by Erie Shores.

11%

Percentage increase in Adjusted EBITDA at Whitecourt primarily due to $843 in additional revenue from the sale of renewable energy credits.

4,000

Approximate number of households capable of being powered by Amherstburg's green electricity each year.

For the year ended December 31, 2012

	Gas	Wind	Biomass[1]	Hydro	Solar	Development	Total
Power generated (GWh)	**1,231.9**	**233.4**	**197.0**	**157.0**	**39.5**	**n/a**	**1,858.8**
Capacity factor	**92.9%**	**26.8%**	**95.3%**	**50.1%**	**22.5%**	**n/a**	**n.m.f**
Availability	**95.0%**	**97.9%**	**95.9%**	**98.5%**	**97.4%**	**n/a**	**n.m.f**
Revenue	110,926	22,876	15,202	13,826	16,388	—	179,218
Expenses	(84,088)	(4,265)	(8,890)	(3,289)	(1,246)	(23)	(101,801)
Interest income	64	54	588	22	33	—	761
Adjusted EBITDA	26,902	18,665	6,900	10,559	15,175	(23)	78,178
Principal from loans receivable	—	—	984	—	—	n/a	984
Interest paid	(672)	(6,065)	(5)	(3,778)	(6,804)	n/a	(17,324)
Income taxes (paid) recovery	—	—	—	—	—	n/a	—
Maintenance capital expenditures	(2,576)	(536)	(1,130)	(1,156)	—	—	(5,398)
Scheduled repayment of debt principal	(250)	(5,231)	(128)	(3,265)	(3,707)	—	(12,581)
AFFO	23,404	6,833	6,621	2,360	4,664	(23)	43,859

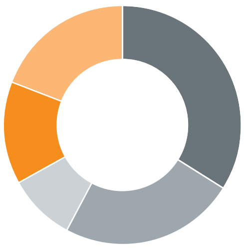
For the year ended December 31, 2011

	Gas	Wind	Biomass[1]	Hydro	Solar	Development	Total
Power generated (GWh)	**1,256.1**	**236.7**	**202.4**	**161.6**	**17.6**	**n/a**	**1,874.4**
Capacity factor	**95.0%**	**27.2%**	**95.9%**	**51.4%**	**19.9%**	**n/a**	**n.m.f**
Availability	**97.6%**	**96.9%**	**96.6%**	**98.8%**	**95.6%**	**n/a**	**n.m.f**
Revenue	114,311	23,093	14,217	13,497	7,289	—	172,407
Expenses	(84,185)	(3,409)	(8,559)	(3,326)	(1,038)	—	(100,517)
Interest income	87	7	547	—	146	—	787
Adjusted EBITDA	30,213	19,691	6,205	10,171	6,397	—	72,677
Principal from loans receivable	—	—	884	—	—	—	884
Interest paid	(1,027)	(6,315)	(14)	(3,966)	(3,374)	—	(14,696)
Income taxes (paid) recovery	—	—	—	—	—	—	—
Maintenance capital expenditures	(1,749)	(347)	(969)	(1,064)	—	—	(4,129)
Scheduled repayment of debt principal	—	(4,129)	—	974	(1,533)	—	(4,688)
AFFO	27,437	8,900	6,106	6,115	1,490	—	50,048

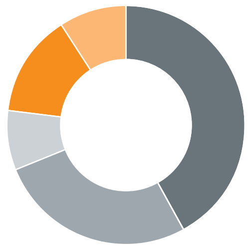
(1) Includes receipts from interest and loan receivable on Capstone's 31.3% equity interest in the Chapais facility. Statistics for power generated, capacity factors and availability do not include the Chapais facility.

The following charts show the composition of the power segment's Adjusted EBITDA and AFFO for the years ended December 31, 2012 and 2011:

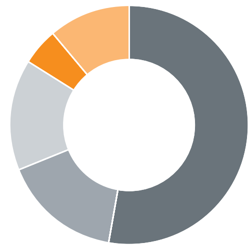
ADJUSTED EBITDA 2012



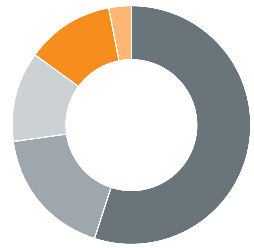
ADJUSTED EBITDA 2011



AFFO 2012



AFFO 2011



Revenue was $6,811, or 4.0%, higher compared with 2011, primarily due to the inclusion of $8,582 from an additional six months of operations at Amherstburg. In addition, Whitecourt increased revenue by $985 over 2011, primarily due to the increased sale of renewable energy credits. Lower revenue of $3,385 at Cardinal partially offset these gains.

The $3,385, or 3.0%, decrease at Cardinal was primarily attributable to lower power generation, which decreased electricity sales by $1,318, and a $2,151 decline in gas sales as Cardinal had previously entered into gas swaps at higher prices, with the last one expiring in 2011. Cardinal's power generation was lower by 24.2 GWh, or 1.9%, reflecting the impact of the scheduled hot gas path inspection in the second quarter, which occurs every three years and requires more time than other annual outages. In addition, power production was reduced as a result of higher ambient temperatures in 2012.

Expenses increased by $1,284, or 1.3%, over 2011. Excluding Amherstburg, the increase was primarily attributable to repairs and maintenance expenditures at Erie Shores and Whitecourt, which contributed a combined increase of $1,187. The remaining expenses at Cardinal and hydro facilities were consistent with 2011. In December 2012, Capstone established a power development subsidiary focused on developing and acquiring renewable and clean electricity generation projects in western Canada and the United States.

Interest paid was $2,628, or 17.9%, higher than in 2011, primarily due to Amherstburg, which paid $3,430 more in interest in 2012. Higher interest paid during 2012 was partially offset by $355 less interest on the CPC-Cardinal credit facility, which had a lower average balance in 2012, and a $250 decline at Erie Shores due to a lower debt balance following scheduled debt repayment.

Maintenance capital expenditures increased by $1,269 over 2011, primarily due to the hot gas path inspection at Cardinal.

Scheduled repayments of debt principal were $7,893, or 168%, higher than in 2011. The increase was primarily due to:

- A $2,174 increase in debt payments at Amherstburg, reflecting a full year of repayments compared with six months in 2011;
- Hydro debt repayments of $4,239 beginning in June 2012; and
- An increase of $1,102 in debt repayments at Erie Shores as the Tranche C debt became fully amortizing in the second quarter of 2011.

Seasonality

Results for Capstone's power segment fluctuate during the year due to seasonal factors that affect quarterly production at each facility. These factors include scheduled maintenance, seasonal electricity demands and environmental factors such as water flows, sunlight, wind speeds and density, ambient temperature and humidity, which affect the amount of electricity generated. In aggregate, these factors have historically resulted in higher electricity production during the first and fourth quarters as shown in the following table:

			Actual	Average long-term production (GWh) (1)				
Type	Facility	PPA Expiry	**2012**	Q1	Q2	Q3	Q4	Annual
Gas	Cardinal	2014	**1,231.9**	342.9	278.1	303.5	333.3	1,257.8
Wind	Erie Shores	2026	**233.4**	76.3	52.5	34.0	76.9	239.7
Biomass	Whitecourt	2014	**197.0**	50.3	45.3	50.1	49.3	195.0
Hydro	Various	2017 – 2042	**157.0**	32.2	57.1	29.0	40.9	159.2
Solar	Amherstburg	2031	**39.5**	6.8	13.7	12.5	5.9	38.9
Total			**1,858.8**	508.5	446.7	429.1	506.3	1,890.6

(1) Average long-term production is from March 2005 to December 31, 2012, except for Erie Shores, which is from June 2006, and Amherstburg, which is from July 2011.

Outlook

In 2013, Capstone expects slightly higher revenue from higher power production, which will be partially offset by increased development costs.

Capstone's power facilities are expected to perform consistently with long-term average production, subject to variations in wind, water flows, ambient temperatures and sunlight.

Capstone expects Cardinal's production to return to its long-term average and that the facility will incur lower average fuel transportation costs due to:

- Higher power generation reflecting less maintenance time planned in 2013; and
- A lower average effective gas transportation rate in 2013 of $1.76 per GJ compared with $2.24 per GJ in 2012, based on the expected outcome from the National Energy Board.

Capstone's new power development subsidiary is expected to increase costs within the power segment related to the pursuit and development of new business opportunities.

Overall, Capstone expects the net impact of these factors to result in a slightly higher Adjusted EBITDA for the power segment in 2013 compared with 2012.

Infrastructure – Utilities

Water

Capstone's water utilities segment includes a 50% investment in Bristol Water, which is located in the United Kingdom. Capstone initially acquired a 70% interest on October 5, 2011, prior to which no results were reported in Capstone's comparative figures. On May 10, 2012, Capstone sold a 20% indirect interest in Bristol Water to a subsidiary of ITOCHU Corporation while retaining the remaining 50%.

	For the year ended (2)	
	Dec 31, 2012	Dec 31, 2011
Water supplied (megalitres)	**81,245**	19,700
Revenue	**178,392**	43,560
Operating expenses	**(93,400)**	(21,569)
Interest income	**751**	291
Less: non-controlling interest(1)	**(37,227)**	(6,685)
Adjusted EBITDA	**48,516**	15,597
Adjusted EBITDA of consolidated businesses with non-controlling interests	**(48,516)**	(15,597)
Dividends from businesses with non-controlling interests	**8,091**	3,971
AFFO	**8,091**	3,971

(1) Starting from May 10, 2012, the non-controlling interest increased to 50% from 30%.
(2) 2011 only includes three months of activity from the date of acquisition.

Revenue was $134,832, or 310%, higher compared with 2011, due to receiving a full year of contribution in 2012 versus one quarter in 2011. Bristol Water derived over 97% of its revenue during the year from the sale of water, consistent with 2011.

Operating expenses increased by $71,831, or 333%, primarily due to a full year of inclusion in Capstone's result. Approximately $77,455 of operating expenses related to raw materials, consumables, bad debts and other charges less recoveries. Labour costs to maintain the network and deliver water services to retail and commercial customers represented $15,945. Additionally, increases in the capital expansion program contributed to the higher proportion of operating expenses to revenue compared with 2011.

Non-controlling interest was increased on May 10, 2012 to reflect the partial sale of Bristol Water. Capstone's Adjusted EBITDA is reduced for Agbar's 30% interest over the entire period and ITOCHU's 20% interest beginning May 10, 2012.

Capital expenditures

The approved and planned capital expenditures for the current asset management plan ("AMP5") period, which concludes in March 2015, is approximately $441,000, or £276,000 (base price of £261,000 adjusted for inflation for new regulatory fiscal year). As at December 31, 2012, the cumulative capital expenditure incurred for AMP5 was $224,000, which was $50,000 less than planned. The shortfall was primarily the result of delays at the start of AMP5 as commencement of expenditures was dependent on a Competition Commission ruling. Bristol Water expects its expenditures over the remainder of AMP5 to achieve the cumulative approved capital expenditure. Bristol Water made $140,555 in capital expenditures in 2012 as detailed on page 37 of this MD&A.

Seasonality

Bristol Water experiences little seasonal variation in demand, resulting in stable revenues throughout the year. Operating expenses vary during the year depending on the availability of water from Bristol Water's various sources and the quantity of water requiring treatment as a result of dry weather and pipe bursts, which are more common in periods when freezing and thawing occur.

Regulatory

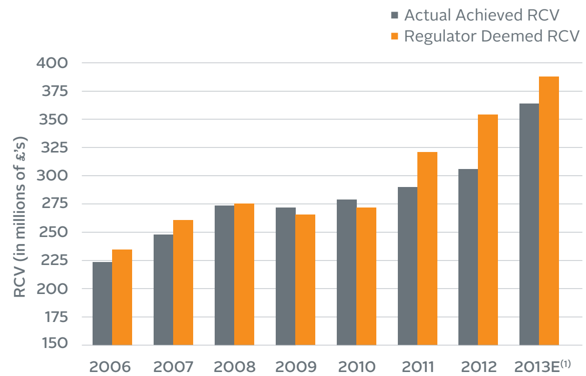
Bristol Water is a regulated business subject to supervision by the Water Services Regulation Authority ("Ofwat").

Bristol Water completed the second year of AMP5 as at March 31, 2012. Management has started planning for the company's regulatory submission for Price Review 14 ("PR14"), during which Ofwat will approve Bristol Water's capital program and set the prices Bristol Water may charge customers in the five-year AMP6 period commencing in April 2015. Bristol Water has agreed to Ofwat's proposed licence changes, which were devised as part of the introduction of competition within the retail business for non-household customers. This change affects less than 3% of Bristol Water's business.

Management continues to focus on achieving key regulatory output targets, including leakage of less than 50 million litres of water per day ("Ml/d") in 2012/2013, and is striving for a top quartile ranking in Ofwat's Service Incentive Mechanism ("SIM") customer service measure. Strong performance on the SIM, which is measured through customer satisfaction surveys and quantitative data related to complaints, can result in an increased revenue allowance for Bristol Water in the next regulatory period.

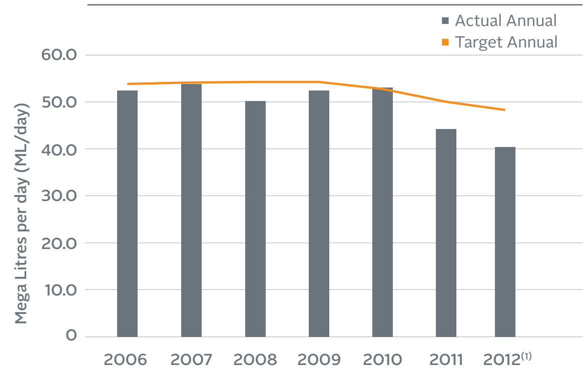
For the regulatory year ended March 31, 2012, Bristol Water achieved leakage levels of 43 Ml/d due to a mild winter, and had a SIM score of 85, which ranked second overall in the industry. For the nine months ended December 31, 2012 of the current regulatory year, which is a seasonally low period for pipe bursts, Bristol Water had leakage levels of 40 Ml/d and is currently ranked eight based on year-to-date SIM survey scores.

GROWTH IN REGULATED CAPITAL VALUE



(1) Expected position as at March 31, 2013.

WATER LEAKAGE VERSUS TARGET



(1) For the year ended December 31, 2012.

Outlook

In 2013, Capstone's results will reflect a 50% interest in Bristol Water for the full year following the partial sale of Capstone's previous 70% interest in May 2012.

Bristol Water is expected to continue its strong operational performance, which will generate cash flow for dividends and for reinvestment in the capital expenditure program. Bristol Water expects to:

- Achieve increased revenue due to an approximately 6.9% rise in the regulated water tariff from April 1 2013;
- Complete capital expenditures of approximately $115,000 (£72,000). Capstone expects between 5% and 6% growth in Ofwat's deemed regulated capital value ("RCV") in 2013, which is expected to lead to future revenue growth; and
- Incur additional expenses in preparation for the coming price review.

Bristol Water's capital program is aimed at improving and expanding Bristol Water's network of reservoirs, treatment facilities, water mains and pipes in order to continue providing high quality water to customers, reducing the amount of water lost to leakage, and positioning Bristol Water to effectively serve a growing population.

Overall, Capstone expects the net impact of these factors, primarily the reduction in ownership interest, to result in lower Adjusted EBITDA for the utilities-water segment in 2013 compared with 2012.

Infrastructure – Utilities

District heating

Capstone's district heating utilities segment includes a 33.3% interest in Värmevärden, located in Sweden, which was acquired on March 31, 2011.

During 2012, Värmevärden focused on maintaining strong customer relationships, managing fuel costs and recapitalizing its business, which led to a portion of the shareholder loans being repaid.

During the year, Värmevärden successfully renewed contracts with industrial customers. In addition, Värmevärden adjusted prices for 2013 for the majority of residential customers with increases in excess of inflation. Management has also enhanced plant availability, thereby minimizing the use of more expensive fuel.

	For the year ended (1)	
	Dec 31, 2012	Dec 31, 2011
Heat and steam production (GWh)	**1,078**	712
Equity accounted income (loss)	**2,315**	(5,270)
Interest income	**3,356**	5,024
Dividends	**2,001**	—
Adjusted EBITDA and AFFO	**5,357**	5,024

(1) 2011 only includes nine months of activity from the date of acquisition.

Interest income

Interest is earned on the outstanding balance of the shareholder loan receivable from Värmevärden. Värmevärden used the bond issuance proceeds in early 2012 to reduce the shareholder loan by $48,100 and pay accrued interest, resulting in lower interest income for Capstone for the remainder of the year. For further details, refer to the changes in the business section on page 19 of this MD&A. In 2012, Capstone received $3,356 in interest income from Värmevärden.

Dividends

In 2012, Värmevärden paid Capstone a $983 dividend in June and a $1,018 dividend in December. No dividends were paid to Capstone in 2011, the year of acquisition.

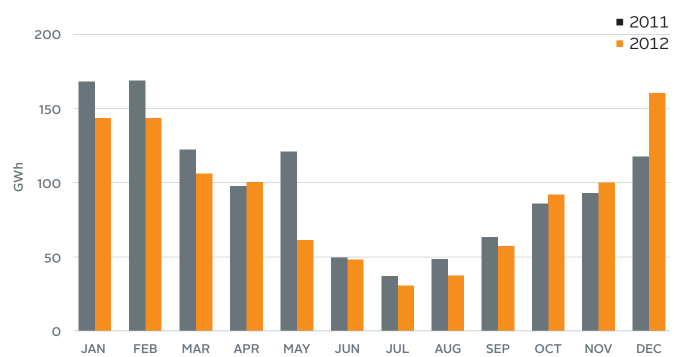
Equity accounted income

Värmevärden contributed $2,315 of equity accounted income in 2012 versus a loss of $5,270 for 2011. The loss in 2011, primarily reflected $2,414 of acquisition costs. Additionally, Capstone did not benefit from the seasonally high first quarter, as this was prior to acquisition.

Seasonality

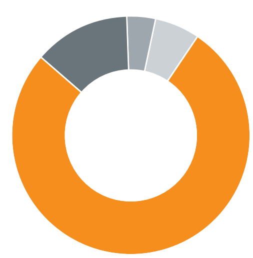
Heat production is typically highest during the first quarter of the year, which represents the coldest months of the year. The first and fourth quarters combined have historically accounted for approximately 65% of Värmevärden's annual revenue.

HEAT AND STEAM PRODUCTION



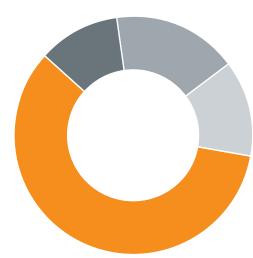
Heat production for Värmevärden before March 31, 2011 is not included in Capstone's result.

FUEL MIX BREAKDOWN BY MWh – 2012



- 4% Electricity
- 6% Fossil Fuel
- 77% Bio and Waste Fuel
- 13% Industrial Heat

FUEL MIX BREAKDOWN BY COST (SEK) – 2012



- 17% Electricity
- 13% Fossil Fuel
- 59% Bio and Waste Fuel
- 11% Industrial Heat

Outlook

In 2013, Värmevärden's performance is expected to continue to support fixed interest payments on Capstone's loan receivable and dividends on Capstone's equity investment.

Interest income from shareholder loans receivable is expected to be lower due to a reduction in the receivable balance in the second quarter of 2012.

As a result, Capstone expects lower Adjusted EBITDA from the district heating segment compared with 2012.

Corporate

Corporate activities primarily comprise growth initiatives, capital structure expenses not specifically attributed to the businesses, and costs to manage, oversee and report on the businesses.

	For the year ended	
	Dec 31, 2012	Dec 31, 2011
Administrative expenses	**(11,070)**	(29,677)
Project development costs	**(342)**	(8,289)
Interest income	**18**	341
Adjusted EBITDA	**(11,394)**	(37,625)
Interest paid	**(5,988)**	(4,945)
Dividends paid on Capstone's preferred shares	**(3,750)**	(1,264)
Income taxes (paid) recovery	**(612)**	—
AFFO	**(21,744)**	(43,834)
Internalization costs	**—**	19,675
AFFO before internalization costs	**(21,744)**	(24,159)

Administrative expenses

	For the year ended	
	Dec 31, 2012	Dec 31, 2011
Internalization expenses and manager fees	**—**	21,500
Staff costs	**6,749**	4,126
Other administrative expenses	**4,321**	4,051
	11,070	29,677

Staff costs reflect amounts paid or accrued for corporate employees beginning April 15, 2011, following the internalization of management. Staff costs were $2,623, or 63.6%, higher than in 2011, primarily reflecting three and a half additional months in 2012. Internalization expenses represented amounts paid for professional fees and other administrative costs along with the termination fee for the management contracts with MGL. Accordingly, Capstone did not incur any internalization expenses or fees to MGL in 2012.

Other administrative expenses were $270, or 6.7%, higher compared with 2011, primarily due to office administration and premises costs required post internalization. Other administrative expenses include audit fees, investor relations costs, office administration and premises costs and professional fees other than for business development.

Project development costs within corporate relate to business acquisition activities. For 2012. these costs were $7,947, or 95.9%, lower compared with 2011. This variance reflected lower business acquisition activity as the corporate focus was on completing various refinancing and asset management initiatives in 2012. In 2011, Capstone closed the acquisition of Bristol Water and Värmevärden, which incurred closing costs that did not recur in 2012.

Interest income is primarily earned on surplus cash balances. Interest income was $323, or 94.7%, lower than in 2011 reflecting lower average cash balances in 2012.

Interest paid was $1,043, or 21.1%, higher compared with 2011 due to higher balances on the CPC-Cardinal credit facility and the senior debt facility following the acquisition of Bristol Water. The debt to acquire Bristol Water was repaid in the second quarter of 2012. In addition, the average balance on the convertible debentures was lower in 2012 due to conversions during 2011 reducing the balance outstanding leading to less interest paid on the convertible debentures.

Preferred share dividends paid and taxes paid

On June 30, 2011, Capstone issued preferred shares that pay $938 of dividends quarterly at a fixed rate of 5.0% per year. Taxes paid relate to preferred share dividends and are available to offset future tax of the Corporation.

Outlook

In 2013, Capstone expects business development and marketing efforts to return to a more normal level, while maintaining staffing levels

Capstone's staff costs are expected to increase due to the accrual of an additional year of grants under the long-term incentive plan.

Overall, Capstone expects these variables to result in higher corporate expenses compared with 2012.

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:

As at	Maturity	Interest Rate	Dec 31, 2012 Fair Value	Dec 31, 2012 Carrying Value	Dec 31, 2011 Fair Value	Dec 31, 2011 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:

($000s and 000s of shares)	Year ended Dec 31, 2012 Shares	Year ended Dec 31, 2012 Amount	Year ended Dec 31, 2011 Shares	Year ended Dec 31, 2011 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 ($000s, except per share amounts)	Dec 31, 2012 Market Price per Share	Dec 31, 2012 Outstanding Amount	Dec 31, 2012 Fair Value	Dec 31, 2011 Market Price per Share	Dec 31, 2011 Outstanding Amount	Dec 31, 2011 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.

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.

RISKS AND UNCERTAINTIES

Introduction

Risk is an inevitable aspect of operating a business. Decisions that balance risk exposure with intended financial rewards within risk tolerances are the responsibility of the Corporation's management under the supervision of the Board of Directors. When a risk exposure exceeds the Corporation's risk tolerance, the Corporation will take steps to eliminate, avoid, reduce or transfer such risk.

The Corporation recognizes the importance and benefits of timely identification, assessment and management of risks that may impact the Corporation's ability to achieve its strategic objectives. In this respect, the Corporation is committed to prudent risk management practices within the context of an enterprise risk management ("ERM") framework. The Corporation undertakes an annual comprehensive review of its ERM framework and, in 2012, engaged external advisors to further refine and strengthen its risk management practices and implement an outsourced internal audit function.

What follows is a description of the Corporation's key risk governance and risk processes to support achievement of strategic performance objectives.

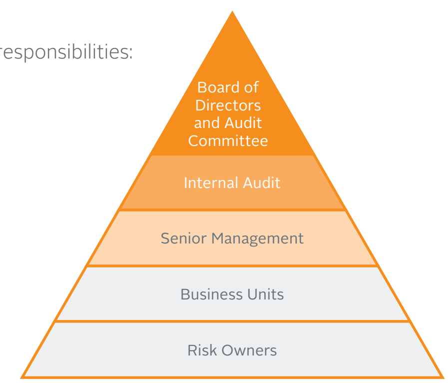
Risk Management Principles and Governance

The Corporation's ERM framework is based on five core principles which establish the culture and tone that guide risk management decisions:

- Risk management is everyone's responsibility
- Risk management is about decision making
- Risk management is embedded within existing management routines
- Risk management is about people and culture
- Risk management is specific to each business unit

The Corporation's implementation of the ERM framework includes the following hierarchy of responsibilities:

- **Board of Directors and Audit Committee** have overall governance responsibility for overseeing management's implementation of the risk management policy.
- **Internal Audit** is responsible for reviewing management's practices to manage risk and reporting to the Audit Committee.
- **Senior Management** is responsible for ensuring the implementation of the ERM framework to all applicable activities and reporting to the Audit Committee.
- **Business Units** are responsible for ensuring the application of a risk management framework to identify, monitor and report risk.
- **Risk Owners** are responsible for the identification and day-to-day management and oversight of risks in their assigned area.

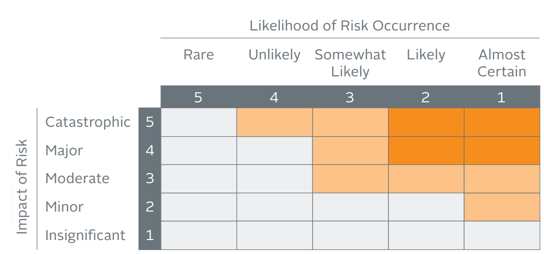


Risk Management Processes

The Corporation's framework relies on the following six key ERM processes to integrate risk management activities with strategic and operational planning, decision-making and day-to-day oversight of business activities.

- **Risk identification** is the process of identifying and categorizing risks that could impact the Corporation's objectives.
- **Risk assessment** is the process of determining the likelihood and impact of the risk. The Corporation uses a five point rating scale for likelihood and impact.
- **Risk prioritization** is the process of ranking risks as high, medium or low based on the net risk rating as described in the diagram below.
- **Risk management** responses are measures taken to optimize the Corporation's net risk exposure within overall tolerance to achieve the desired risk reward balance.
- **Monitoring and reporting** are the processes of assessing the effectiveness of risk management responses.
- **Training and support** ensure that personnel tasked with risk management responsibilities have sufficient knowledge and experience to complete their risk management obligations.

The Corporation's risk management approach is comprehensive and proactive. It combines the experience and specialized knowledge of individual business segments and the corporate oversight functions as well as various analytic tools and methodologies, including a risk matrix (see chart to the right), to assist the Corporation in regularly assessing and updating the net exposure (including mitigants) of each known material risk facing the Corporation in the following four risk categories: operational, strategic, financial and legal and regulatory. The Corporation's assessment process results in prioritization of risks.



Managing Risk

The Corporation requires that risk assessments (which encompass operational, strategic, financial and legal and regulatory risks) be performed at each business unit and at the corporate level (which takes into consideration the business unit risks that are significant to the consolidated organization). The Corporation has identified and defined the following four broad risk categories:

- Risks related to the Corporation on a consolidated basis include: risks related to the variability of dividends on the Corporation's common shares; risks related to the availability of debt and equity financing; risks arising from default under credit agreements and debt instruments;; risks related to geographic concentration; foreign currency exchange risk; risks related to acquisitions; risks related to derivatives; risks related to environmental, health and safety matters; risk of adverse changes in legislation and administrative policy; risks related to insurance; and risks arising from the reliance on key personnel;
- Risks related to the power infrastructure facilities include: operational performance risk; risks related to expiry of Power Purchase Agreements; risk related to fuel costs and supply; contract counterparty performance risk; risk related to land tenure and related rights; environmental risks; and risks related to the regulatory environment;
- Risks related to Bristol Water include: risks related to Ofwat price determinations; the risk of failure to deliver capital investment programs; the risk of failure to deliver water leakage target; risks related to Ofwat's service incentive mechanism and the serviceability assessment; risks related to economic conditions; risks related to pension plan obligations; risks related to the regulatory environment; operational performance risk; risk of competition; risks related to seasonality and climate change; and risks related to labour relations; and
- Risks related to Värmevärden include: general risks inherent in the district heating sector; risks related to fuel costs and availability; risks related to industrial and residential contracts; environmental risks; risks related to the regulatory environment; and risks related to labour relations.

In addition to the risks described in this "Managing Risk" section, there are numerous other risk factors, many of which are beyond the Corporation's control and the effects of which can be difficult to predict, that could be material to investors or cause our results to differ significantly from our plans, objectives and estimates. For a more comprehensive list and description of the risks affecting the Corporation, its power infrastructure facilities, Bristol Water and Värmevärden, please refer to the "Risk Factor" section of the Corporation's most recently filed Annual Information Form, as supplemented by risk factors contained in any of the following documents filed by the Corporation with securities commissions or similar authorities in Canada after the date of this annual MD&A, which are available on SEDAR at www.sedar.com: material change reports; business acquisition reports; interim financial statements; interim management's discussion and analysis; and information circulars.

Risks Related to the Corporation's Securities

Dividends on Common Shares and Preferred Shares are not Guaranteed

Although the Board of Directors of the Corporation has adopted a policy of paying a quarterly dividend on its common shares, and holders of preferred shares are entitled to receive annual fixed, cumulative, preferential dividends of $1.25 per share, payable quarterly, the declaration of common and preferred share dividends is at the discretion of the Board of Directors and may vary in the future based upon numerous factors.

Volatile Market Price for the Corporation's Securities

A publicly-traded company will not necessarily trade at values determined by reference to the underlying value of its business or its results of operations or financial performance. The prices at which the Corporation's securities will trade cannot be predicted. The market price for the Corporation's securities may be subject to significant fluctuations in response to numerous factors, many of which are beyond the Corporation's control.

Shareholder Dilution

The Corporation's constating documents permit the issuance of an unlimited number of common shares and a limited number of preferred shares issuable in series on such terms as the Directors determine without the approval of shareholders, who have no pre-emptive rights in connection with such issuances. In addition, the Corporation is required to issue common shares upon the conversion of its outstanding convertible debentures in accordance with their terms and the Corporation may, in certain circumstances, issue common shares to redeem or pay outstanding principal or interest amounts under the convertible debentures or issue common shares under the DRIP. Accordingly, holders of common shares may suffer dilution.

Convertible Debentures Credit Risk, Subordination and Absence of Covenant Protection

The likelihood that holders of the Corporation's convertible debentures will receive payments of interest and principal owing to them depends on the cash flows of the Corporation. In addition, the convertible debentures are unsecured obligations of the Corporation and are subordinate in right of payment to all the Corporation's existing and future senior indebtedness. The convertible debentures do not contain any covenants restricting future leveraged transactions involving the Corporation.

Risks Related to the Corporation and its Businesses

Availability of Debt and Equity Financing

There can be no assurance that debt or equity financing will be available or, together with internally-generated funds, will be sufficient to meet or satisfy the Corporation's objectives or requirements or be available on acceptable terms. In particular, Bristol Water is expected to continue to require access to the capital markets in connection with its capital investment program so the inability to raise debt or equity financing could have a material adverse effect on its business. The inability of the Corporation to access sufficient capital on acceptable terms could have a material adverse effect on the Corporation's ability to meet its other objectives or requirements.

Default under Credit Agreements and Debt Instruments

The Corporation and various of its subsidiaries and investees, as applicable, are parties to various credit agreements and debt instruments. A failure to comply with the obligations under the applicable credit agreement or debt instrument could result in a default, which, if not cured or waived, could result in the termination of distributions generated by the applicable entity and permit acceleration of the relevant indebtedness. Further, if the indebtedness under any of the credit agreements or debt instruments were to be accelerated, there could be no assurance that the assets of the applicable borrower, or the applicable guarantors, would be sufficient to repay that indebtedness in full. A portion of the cash flow of each applicable subsidiary or investee is devoted to servicing its debt and there can be no assurance that such entity will continue to generate sufficient cash flows from operations to meet the required interest and principal payments on its credit facility or debt instruments. If such an entity were unable to meet such interest or principal payments, it could be required to seek renegotiation of such payments or obtain additional equity, debt or other financing. Although many of the credit agreements related to the power infrastructure facilities are fully amortizing, there can also be no assurance that the Corporation, its subsidiaries or its investees could refinance these credit agreements or debt instruments or obtain additional financing on commercially reasonable terms, if at all. Borrowings under certain credit agreements and debt instruments may be at variable rates of interest, which, in the absence of effective hedges, expose the Corporation to the risk of increased interest rates. This factor may increase the sensitivity of the Corporation's cash flows to interest rate variations.

Geographic Concentration

Approximately 53.0% of the Corporation's Adjusted EBITDA is derived from those power infrastructure facilities that are located in Ontario. In addition, Bristol Water's operations are all located in the Bristol area of the UK and Värmevärden's heat production facilities and distribution networks are all located in certain municipalities in Sweden. Accordingly, the Corporation, its subsidiaries and investees, as applicable, are subject to risks associated with if any of Ontario, Bristol, UK or the applicable municipalities in Sweden were to experience adverse changes in local or regional economic conditions or adverse changes to the regulatory environment in Ontario, Bristol, UK or certain municipalities in Sweden, as applicable.

Foreign Currency Exchange

Through its investments in Bristol Water and Värmevärden, the Corporation is exposed to foreign currency exchange risk through exchange rate movements as the revenue generated by and the assets of Bristol Water and Värmevärden are denominated in UK pound sterling and Swedish krona, respectively. The Corporation's foreign currency exchange hedging strategy focus on reducing foreign currency exchange risk primarily in relation to expected future dividends from and interest paid by Bristol Water and Värmevärden, as applicable. However, the Corporation could be exposed to losses by undertaking hedging activities.

Acquisitions and Development

The Corporation's strategy includes growth through identifying suitable acquisition and development opportunities, pursuing such opportunities, consummating acquisitions, constructing development projects and effectively integrating and operating (or contracting for the operation of) such businesses. The Corporation competes for acquisitions and development opportunities and so there is a risk that the Corporation may not be successful in acquiring or developing such opportunities. Further, if the Corporation is unable to identify, pursue, integrate or manage acquisition or development projects, this could have an adverse impact upon its strategy. As well, in pursuing development opportunities, the Corporation may be required to make material capital expenditures with no guarantee that the development project will achieve commercial operation.

Environmental, Health and Safety

The power infrastructure facilities, Bristol Water and Värmevärden are each subject to a complex and stringent environmental, health and safety regulatory regime. As such, the operation of these businesses carries an inherent risk of environmental, health and safety liabilities (including potential civil actions, compliance or remediation orders, fines and other penalties) and may result in the applicable business being involved from time to time in administrative and judicial proceedings related to such matters. Changes in regulations, or more aggressive enforcement of existing regulations, could lead to material increases in unanticipated liabilities or expenditures for investigation, assessment, remediation or prevention, capital expenditures, restrictions or delays in the business' activities, the extent of which cannot be predicted. To mitigate the risk of administrative sanctions and to minimize safety risks to employees and contractors, the Corporation works continuously with all employees and contractors to ensure the development and implementation of a progressive, proactive safety culture within all operations. The Corporation has safety committees operating within each operating unit to ensure existing safety programs are continuously improved.

Changes in Legislation and Administrative Policy

There can be no assurance that certain laws applicable to the Corporation, its subsidiaries and its investees, including tax laws, will not be changed in a manner which could adversely affect the value of the Corporation. In addition, there can be no assurance that the administrative policies and assessing practices of the Canada Revenue Agency will not be changed in a manner which adversely affects the holders of the Corporation's securities.

Reliance on Key Personnel

The Corporation's success depends heavily on its ability to attract, retain and motivate key employees, including its senior management, individuals with operational experience in industries related to the power infrastructure facilities and the management of Bristol Water and Värmevärden. If the Corporation loses the services of any of these key personnel and cannot replace them in a timely manner, its business and prospects may be adversely affected.

Risks Related to the Power Infrastructure Facilities

Power Purchase Agreements

Most of the electricity that is generated by the power infrastructure facilities is sold to large utilities or creditworthy customers under fixed-term PPAs. In particular, the first automatic one-year renewal following the initial 20-year term of the Cardinal PPA ends on December 31, 2014. As PPAs expire or are terminated, there can be no assurance that the applicable facility will be able to renegotiate or enter into a power supply contract on terms that are commercially reasonable, if at all, and it is possible that the price received for power under subsequent arrangements may be reduced significantly. It is also possible that subsequent PPAs may not be available at prices that permit the operation of a facility on a profitable basis. With respect to the Cardinal facility, which contributed approximately 22.3% of the Corporation's Adjusted EBITDA and approximately 65.8% of its AFFO in 2012, the Corporation expects that the price that the OPA will be willing to pay for electricity under any new PPA for the Cardinal facility will be less than the price paid under its current PPA. In addition, excess power currently generated by certain of the facilities may be sold in the open market and, upon expiry or termination of its PPA, a facility may choose to sell all of the power it produces on the open market. In such circumstances, the price received for power sold will depend on market conditions at the time and there can be no assurance that the market price received for the electricity so offered will exceed the facility's marginal cost of operation.

Operational Performance

The operational performance of Erie Shores, the hydro power facilities and Amherstburg Solar Park are dependent upon wind speed and density, water flows and the availability and constancy of solar insolation, respectively. The weather-related risk at the hydro power facilities is partially offset by their geographic diversification in the three different watersheds. All of the power infrastructure facilities are subject to risks related to premature wear or failure, defects in design, material or workmanship and longer than anticipated down times for maintenance and repair, including grid outages and curtailment. These risks are partially mitigated by the proven nature of the technologies employed at each facility, regular maintenance and the design of each facility. While much of the technology utilized at the power infrastructure facilities has a history of reliable performance at similar facilities throughout Canada, some of the components of Amherstburg Solar Park have not previously been used in operations in Canada for extended periods of time. The Corporation has attempted to mitigate some of these risks by obtaining manufacturers' warranties and a weather-adjusted performance guarantee and having all operations and maintenance services required for the facility provided by SunPower Corporation, which built the facility.

Fuel Costs and Supply

The supply of natural gas required by the Cardinal facility is contracted under a gas purchase agreement, which expires on May 1, 2015. The Whitecourt facility has a contract with a substantial forest products company to supply a majority of its wood waste fuel requirements. Upon the expiry of each of these supply agreements, the Corporation will have to renegotiate the agreement or enter into a new supply agreement or buy fuel in the open market, where available. There can be no assurance that such agreements will be able to be renegotiated, or new supply agreements be entered into, on terms that are similar to the existing agreements, if at all. Furthermore, there can be no assurance as to the supply or price of natural gas or wood waste available on the open market or at the time of the expiry of the supply agreements. Accordingly, there is the risk that, at the time of the expiry of a particular supply agreement, the price of natural gas or wood waste, as applicable, available to the relevant facility may be in excess of the price available under the current supply arrangements or such fuel may not be available in the quantities required. Furthermore, each of these facilities is also dependent on the supply of fuel to it. There is the risk that there could be an interruption in the supply of fuel (as a result of transportation or otherwise) or increases in fuel transportation costs. In particular, the natural gas used at the Cardinal facility is transported to the facility through a number of pipelines, including the TCPL Canadian Mainline pipeline. The tolls on the TCPL Canadian Mainline pipeline are regulated by the National Energy Board and have increased significantly in the past few years.

Contract Performance

To a large extent, the Corporation's cash flows are dependent upon the parties to the various material supply, purchase and operations and management agreements relating to the power infrastructure facilities fulfilling their contractual obligations, As such, there is the risk of the inability or failure by any such party to meet its contractual commitments.

Land Tenure and Related Rights

The power infrastructure facilities have various land tenure and resource access rights upon which they depend for their operations. There can be no assurance that these rights will not be challenged, and, if challenged, whether such challenge will be successful. Furthermore, there can be no assurance that such rights will be able to be renegotiated or extended on commercially reasonable terms, if at all. At such time as any of these rights are successfully challenged or expire and cannot be renewed or renegotiated upon acceptable terms, the affected power infrastructure facility will likely be unable to continue to operate. In addition, in these circumstances, there can be no assurance that the Corporation or its subsidiaries will have the necessary financial resources or will be able to obtain the necessary financial resources to fund or cause to be funded any required restoration and remediation works.

Environmental

The primary environmental risks associated with the operation of the Cardinal facility and the Whitecourt facility include potential air quality and emissions issues, soil and water contamination resulting from oil spills, issues around the storage and handling of chemicals used in normal operations and, in the case of the Whitecourt facility, storage of wood waste fuel on site. The Corporation has procedures in place to prevent and minimize any impact of the foregoing, which procedures meet generally acceptable industry practices. The primary environmental risks associated with the operation of the hydro power facilities include possible dam failure which results in upstream or downstream flooding, and equipment failure which results in oil or other lubricants being spilled into the waterway. In addition, the operation of a hydro power facility may cause the water in the associated waterway to flow faster, or slower, which could result in water flow issues which could impact fish population, water quality and potential increases in soil erosion around a dam facility. In order to monitor and mitigate these risks, the Corporation completes facility inspections and ensures each of its facilities are in compliance with the appropriate regulatory requirements. The primary environmental risks associated with the operation of the Erie Shores Wind Farm include potential harm to the local migratory bird population, harm to the local bat population as well as concerns over sound levels and visual "harm" to the scenic environment around the facility. In order to monitor and mitigate these risks, the Corporation completes facility inspections and ensures its facilities are in compliance with the appropriate regulatory requirements. However, in the event of sound complaints or impacts, the Corporation could be subject to claims, costs and/or enforcement actions.

Regulatory Environment

The Corporation's power infrastructure facilities are highly regulated and must abide by the relevant market rules as administered by the system operators in each local jurisdiction. The performance of these facilities depends in part on a favourable regulatory climate and on the ability to obtain, maintain, comply with or renew all material licences, permits or government approvals. While these facilities are currently compliant with all material regulatory requirements, the Corporation could incur significant expense to achieve or maintain compliance with any new laws, rules or regulations that are introduced or with any modifications to their necessary licences, permits or government approvals. If the Corporation is unable to comply with applicable regulations and standards, or material licences, permits or government approvals, it could become subject to claims, costs or enforcement actions.

Risks Related to Bristol Water

Ofwat Price Determinations

The price determinations periodically made by Ofwat limit the prices Bristol Water can charge its customers. The conditions of Bristol Water's Instrument of Appointment, including any condition relating to the prices Bristol Water can charge its customers, can be modified by Ofwat either with Bristol Water's agreement or, following reference to the UK Competition Commission, on public interest grounds. Implicit within the most recent price limits set by Ofwat) are assumptions concerning Bristol Water's future operating expenditures and the achievement of operating cost savings. If these efficiencies are not achieved, this may be reflected in less favourable outcomes in future profitability and cash flows or in Ofwat's future price determinations. During 2013, Ofwat obtained the consent of all UK water companies (including Bristol Water) to certain amendments to their Instruments of Appointment which will enable Ofwat to set different price limits for different parts of each water company's business. While these changes do not impact the RPI+/-K formula for price controls on a water company's "wholesale" activities, there is no certainty that Ofwat will retain in future price reviews the RPI+/-K form of price control for "retail" activities related to the provision of goods or services directly to non-domestic customers.

Failure to Deliver Capital Investment Programs

Bristol Water is expected to continue to be required to undertake significant capital expenditures in its business, particularly in relation to new and replacement plant and equipment for water distribution networks and treatment facilities. There can be no assurance that operating cash flows will not decline or that external debt financing and other sources of capital will be available or at similar cost to that assumed by Ofwat in order to meet future capital expenditure requirements. Delivery of capital investment programs could also be affected by a number of factors and may affect Bristol Water's ability to meet regulatory and other environmental performance standards, which may result in sanctions being imposed against Bristol Water. In addition, the failure by Bristol Water to successfully complete its capital investment programs could adversely impact future calculations of Bristol Water's RCV, which could adversely impact Ofwat's determination of future price limits for Bristol Water.

Economic Conditions

Bristol Water's RCV is adjusted annually for inflation so, if RPI decreases, the RCV would be adjusted downward to reflect this decrease. Further, generally unfavourable economic conditions may also adversely influence Ofwat's determination of future price limits. Given the significant investments Bristol Water is set to undertake over the remainder of AMP5, it faces risks arising from any adverse changes in RPI.

Operational Performance

Bristol Water controls and operates a large water network and maintains the associated assets with the objective of providing high quality drinking water on a continuous basis. However, its facilities are subject to risks related to premature wear or failure, defects in design, material or workmanship, longer than anticipated down times for maintenance and repair, energy shortages, malicious intervention, failure by a supplier, pollution or contamination, human error, unavailability of access to critical sites or key staff, labour disputes, pollution or contamination and other events. These risks are partially mitigated by the proven nature of the technologies employed at each facility, regular maintenance and the design of each facility. Management also has limited control over future energy or chemical costs, abstraction charges, levels of customer bad debt or taxes. In particular, since 2000, domestic customers cannot be disconnected from their water supply for failure to pay their bill, although. an allowance for bad debts is included when Ofwat sets price limits, which partially mitigates the risk of such bad debts.

Failure to Deliver Water Leakage Target

Bristol Water is required to meet an annual target for water leakage. If Bristol Water fails to achieve the leakage target by a significant margin in any one year or by a small margin over a number of years, Ofwat may impose various sanctions, including a reduced revenue allowance at the next review of price limits. In addition, if performance were to decline, Bristol Water may incur additional operating or capital expenditure to restore performance.

SIM and the Serviceability Assessment

For the 2010-2015 period, Ofwat introduced the service incentive mechanism (the "SIM",) which compares water companies' performance in terms of the quality of service that is delivered to customers. The SIM comprises both a quantitative measure of complaints and unwanted contacts, and a qualitative measure, based on survey evidence, that looks at how satisfied customers are with the quality of service that they receive. Depending upon Bristol Water's relative performance under the SIM, it could receive a reduced or increased revenue allowance when price limits are next reset in 2014. In addition, Bristol Water is required to maintain the serviceability of its water assets, ensuring they continue to deliver a level of service and performance at least as good as in the past. Where serviceability falls below required reference levels of performance, Ofwat may impose a reduced revenue allowance at the next price review. In addition, if performance were to decline, Bristol Water may incur additional operating or capital expenditure to restore performance.

Pension Plan Obligations

Bristol Water operates both defined benefit and defined contribution pension arrangements. Since 2002, all new employees have been offered membership only in the defined contribution pension plan. Estimates of the amount and timing of future funding for Bristol Water's defined benefit plan are based on various actuarial assumptions and other factors, which may require Bristol Water to make additional contributions to its pension plan which may not be recoverable under the regulatory price determination process.

Regulatory Environment

Bristol Water is subject to and must ensure its compliance with various laws and regulations of the UK and the EU. Failure to comply with these laws and regulations could expose Bristol Water to regulatory and other proceedings and, in the most extreme case, lead to revocation of Bristol Water's Instrument of Appointment or the appointment of an administrator to manage the affairs, business and property of the company. Furthermore, the impact of future changes in laws or regulations or the introduction of new laws or regulations that affect the business cannot always be predicted and, from time to time, interpretation of existing laws or regulations may also change or the approach to their enforcement may become more rigorous.

Competition

Recently, legislation has been proposed in the UK that could eventually expand the competitive market allowing retail competition for all non-household customers as an initial step in opening markets to competition. Ofwat and the UK Environment Agency are also considering the introduction of reforms to the regulation of water abstraction licences that would allow the trading of licences. Ofwat is also examining the scope for upstream competition in treated water supply and has recently commenced consultations on future price limits. Ofwat has taken steps to introduce competition into the water supply market through inset appointments and the water supply licensing regime. One inset appointment is pending and further inset appointments may be made in the future, resulting in increased competition. In addition, Ofwat or the UK government may take steps that lead to other changes in the structure of the water industry with potentially adverse consequences to Bristol Water.

Seasonality and Climate Change

Although there is little seasonal variation in demand, the proportion of water used from each type of Bristol Water's sources of water varies on a daily and seasonal basis according to the availability of water, the relative costs and other operational constraints, and the quantity of treated water supplies fluctuates owing to a variety of seasonal factors, such as dry weather and burst pipes due to freeze/thaw cycles affecting the ground during winter months. In addition, climate or weather pattern changes may adversely affect the availability of water resources or the demand by customers. As with other UK water companies, Bristol Water is dependent upon suitable weather conditions supplying raw water as inflow for its abstraction points and it has a drought contingency plan in place should there be a lack of such rainfall.

Labour Relations

Approximately 33% of Bristol Water's employees are represented by unions. While Bristol Water has traditionally maintained positive labour relations, there can be no assurance that it will not, either in connection with a renegotiation process or otherwise, experience strikes, labour stoppages or any other type of conflict with unions or employees in the future.

Risks Related to Värmevärden

Operational Performance

Värmevärden controls and operates several district heating networks and maintains the associated assets with the objective of providing heat to its customers on a continuous basis. However, its facilities are subject to risks related to premature wear or failure, defects in design, material or workmanship, longer than anticipated down times for maintenance and repair, energy shortages, malicious intervention, failure by a supplier, pollution or contamination, human error, unavailability of access to critical sites or key staff, labour disputes, pollution or contamination and other events. These risks are partially mitigated by the proven nature of the technologies employed at each facility, regular maintenance and the design of each facility. In addition, Värmevärden's revenue and costs are also affected by the demand for heat, which varies with weather conditions. Unusually cold weather may result in Värmevärden's marginal cost of production exceeding its marginal revenue. Warmer weather may also lead to a decrease in demand for heat which could result in lower revenue.

Fuel Costs and Availability

Värmevärden purchases most of its fuel on a rolling basis and is therefore exposed to market price fluctuations. Although Värmevärden has the ability to pass on fuel price increases on an annual basis to its customers, this ability is limited in the short term. Additionally, price increases may make alternative heating technologies, such as pellet boilers and geothermal pumps, more competitive with the district heating service provided by Värmevärden. Further, Värmevärden could be materially and negatively affected if the supply of fuel, particularly biomass which comprises a majority of its fuel mixture, is interrupted or if there is an increase in the costs to transport the fuel to the district heating facilities. There can be no assurance as to the supply or price of fuel (or alternative fuel sources) available on the open market. As a result, Värmevärden is subject to the risk of significant increases in fuel costs or unavailability of fuel.

Industrial and Residential Contracts

Värmevärden has entered into a number of contracts with large industrial consumers for the supply of heat and/or steam which account for a material amount of Värmevärden's total revenue. Värmevärden is subject to counterparty credit risk and risk of reduction in demand from such industrial customers. Certain of the contracts also include termination and/or buyback options. Värmevärden enjoys a relatively stable base of residential customers as a result of the large majority of the Swedish population residing in multi-unit residential buildings, the majority of which derive their heat from district heating operations. However, residential customers are able to cancel their contracts with Värmevärden at any time upon short notice. As its industrial and residential contracts expire, there is a risk that Värmevärden may not be able to renegotiate or enter into new contracts or do so on commercially reasonable terms which, in some cases, could adversely impact upon the business, operating results and financial condition of Värmevärden and could, in turn, adversely affect the Corporation's cash flows and the likelihood that holders of securities of the Corporation will receive payments, whether of interest or dividends or upon redemption or maturity, as applicable.

Environmental

The primary environmental risks associated with Värmevärden operations include potential air quality and emissions issues, soil contamination resulting from oil spills, issues around the storage and handling of chemicals used in normal operations and the storage of fuel on site. Värmevärden's procedures, in place to prevent and minimize any impact of the foregoing, meet generally acceptable industry practices.

Regulatory Environment

Värmevärden is subject to regulation under legislation governing the district heating industry as well as under consumer protection and other legislation and regulations of general application. Värmevärden's business is presently not subject to price regulation or third-party access ("TPA") regulations. However, there is the risk that price regulation or TPA could occur in the future. Värmevärden's operations, including its heat production and distribution activities, require numerous licences and permits from various governmental authorities and such operations are subject to laws and regulations governing production, taxes, labour standards, occupation health, waste disposal, toxic substances, land use, environmental protection, project safety and other matters. Värmevärden may experience increased costs and delays in the production and distribution of district heating as a result of complying with applicable laws, regulations, licences and permits. While Värmevärden is currently compliant with all material regulations and standards, Värmevärden could incur significant expenses to achieve or maintain compliance with any new laws or regulations that are introduced. If Värmevärden is unable to comply with applicable regulations and standards, it could become subject to claims, costs and enforcement actions.

Labour Relations

Approximately 80% of Värmevärden's employees are represented by unions. While Värmevärden has traditionally maintained positive labour relations, there can be no assurance that it will not in the future, whether in connection with a renegotiation process or otherwise, experience strikes, labour stoppages or any other type of conflict with unions or employees. Such risks may be partially mitigated by Swedish legislation that prohibits labour disruptions in the provision of essential services, such as district heating.

ENVIRONMENTAL, HEALTH AND SAFETY REGULATION

Capstone's Canadian power facilities and the water distribution and district heating businesses, respectively, operated by Bristol Water and Värmevärden (collectively the "Facilities") hold all material permits and approvals required for their operations and are managed to comply with environmental, health and safety laws.

The Facilities are subject to complex and stringent environmental, health and safety regulatory regimes, which primarily focus on:

- air emissions;
- taking of water, and discharges into water;
- the storage, handling, use, transportation and distribution of dangerous goods and hazardous materials;
- the prevention of releases of hazardous materials into the environment;
- the prevention, presence and remediation of hazardous materials in soil and ground water, both on and off site;
- workers' health and safety; and
- sound regulation.

Due to the nature of their operations, the Facilities are not subject to any material contingent environment liabilities or environmental remediation costs upon the retirement of assets.

Greenhouse Gases and other Air Pollutants

Certain of the Facilities have an impact on the environment, particularly the Cardinal and Whitecourt facilities, which both emit greenhouse gases ("GHGs"), such as carbon dioxide ("CO_2") and nitrous oxides ("NOx"). All Facilities comply in all material respects, with the applicable Canadian, UK, Swedish and European Union legislation and guidelines regarding GHGs and other emissions. There are a number of draft proposals in respect of changes to such legislation and guidelines (including proposed limits on GHG emissions) – in various stages of development. However, it is difficult to predict how these changes may apply to the Facilities.

Capstone mitigates the potential impact of future changes to environmental legislation and guidelines by remaining diligent in the operation of the Facilities, including stringent policies and procedures to prevent the improper discharge of emissions or other pollutants. Capstone's environmental footprint is also mitigated by the renewable profile of its wind, hydro, biomass and solar power facilities, which could generate GHG offset credits, where eligible.

Cardinal

There is currently no limit on the amount of CO_2 that the Cardinal facility may emit, although the facility is required to report its CO_2 emissions under various federal and provincial regulations. Environmental regulations in Ontario also provide for, among other things, the reporting, allocation and retirement of NOx emissions. Under this system, applicable facilities receive a maximum yearly emission compliance limit, which may be achieved by controlling or reducing source emissions, or by trading NOx allowances. For 2012, Cardinal received 1,094 tonnes of NOx allowances based on actual generation in 2010. Cardinal expects to retire 375 tonnes of NOx allowances for 2012, leaving a cumulative allowance balance of 7,678 tonnes. NOx emissions from Cardinal's generating equipment are lower than the levels mandated by legislation.

Whitecourt

The Whitecourt Facility uses biomass combustion technology to convert the energy content in wood waste into electricity. Biomass is generally considered to be "carbon-neutral" as the amount of CO_2 arising from combustion is equal to what would be emitted if the biomass were to decompose naturally. As a result, electricity generated from biomass is regarded as an environmentally-friendly form of power generation. The Whitecourt facility is subject to limits governing the emissions of carbon monoxide, NOx and particulates in accordance with the facility's Environmental Approval. Average annual emission levels at the Whitecourt facility are below the levels of permitted emissions for the facility. The Whitecourt Facility is also subject to certain federal and provincial GHG reporting requirements and is in compliance with these requirements.

Hydro Facilities

Capstone's hydro facilities do not produce GHGs. However, their operations are governed by water management plans, which specify the hydrological conditions during which production may occur.

Erie Shores Wind Farm

Erie Shores does not produce GHGs, but is subject to regulations and/or approvals relating to birds, mammals, other animals, and to sound.

Amherstburg Solar Park

The operation of the Amherstburg does not generate GHGs and the primary environmental regulation relates to potential sound emissions issues.

Värmevärden

In 2007, the European Union adopted a long-term climate change target, commonly referred to as 20-20-20. The goal of the target is for member states (including Sweden) to reduce energy use by 20%, reduce CO_2 emissions by 20%, and increase their proportion of renewable energy by 20%, all by 2020. The government of Sweden has subscribed to the 20-20-20 targets and has made biomass-fired and waste-fired heating facilities an important component in its overall plan to meet its CO_2 reduction commitments.

Bristol Water

Energy use in water treatment and other activities carried out by Bristol Water results in indirect emissions of GHGs. Bristol Water is subject to the UK Climate Change Levy, although the forecast cost for 2012-2013 is an immaterial amount due to credits arising from Bristol Water's purchase of green energy. Bristol Water is also subject to the CRC Energy Efficiency Scheme, a mandatory UK carbon emissions reduction plan for significant consumers of energy; costs for 2012-2013 are projected to be an immaterial amount.

Further information regarding Environmental, Safety and Health Regulations matters is contained in the Corporation's Annual Information Form (which is available under the Corporation's profile on www.sedar.com).

RELATED PARTY TRANSACTIONS

Capstone's related party transactions in 2012 comprise compensation to key management, which commenced after the internalization of management on April 15, 2011.

In 2011, Capstone terminated its management and administration agreements with MGL, which established the related party relationship between Capstone and MGL. The 2011 transactions with MGL and MPML are described in note 26 (Related Party Transactions) in the consolidated financial statements for the year ended December 31, 2012.

Compensation of Key Management

Key management includes the Corporation's directors, Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"). Compensation awarded to key management consisted of salaries, directors' fees and short-term employee benefits, which include fees paid to directors. Eligible directors and senior management of the Corporation also receive forms of stock-based compensation. Key management compensation is described in note 26 (Related Party Transactions) in the consolidated financial statements for the year ended December 31, 2012.

Prior to April 15, 2011, the Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") of Capstone and other employees were employed by MGL. Accordingly, employee compensation disclosure only includes executive compensation since the internalization of management.

Linking Management Compensation to Performance

Compensation plays an important role in achieving short- and long-term business objectives that ultimately drive the Corporation's business success in alignment with long-term shareholder goals. The objectives of the Corporation's compensation program are to:

- attract and retain highly qualified employees with a history of proven success;
- align the interests of employees with shareholders' interests and with the execution of the Corporation's business strategy;
- establish performance goals that, if met, are expected to improve long-term shareholder value; and
- tie compensation to those goals and provide meaningful rewards for achieving them.

Financial performance targets are set each year to provide management with an incentivize to improve upon yearly budgeted financial results and are therefore aligned with shareholder interests.

The following table summarizes the link between the Corporation's executive and senior officer forms of compensation and performance:

	Salary	Short-term incentive plan ("STIP")	Long-term incentive plan ("LTIP")
Description	Salary is a fixed component of compensation that provides income certainty by establishing a base level of compensation for executives fulfilling their roles and responsibilities.	The STIP provides the possibility of an additional annual cash award based on the achievement of corporate and individual goals.	The LTIP provides the possibility of an additional award linked to the Corporation's common shares. This award is paid in cash or common shares purchased on the open market after meeting certain vesting conditions.
Purpose	To attract and retain qualified executives.	To motivate, attract and retain qualified executives.	To reward long-term performance and align interests of executives with security holders.
Link to performance	No direct link.	A significant portion of this award is based on actual business performance against Capstone's non-GAAP performance measures, Adjusted EBITDA and AFFO.	A significant portion of this award is directly linked to the performance of the Corporation's shares over the vesting period, as well as the total shareholder return relative to a comparator group.

For a comprehensive understanding of Capstone's compensation program please refer to the "Compensation Discussion and Analysis" section of the Corporation's most recently filed information circular.

SUMMARY OF QUARTERLY RESULTS

The following table provides a summary of the previous eight quarters of Capstone's financial performance.

	2012				2011			
($000s, except for per share amounts)	Q4	Q3	Q2	Q1	Q4 (1)	Q3	Q2 (2, 3)	Q1
Revenue	**94,654**	**84,951**	**85,849**	**92,156**	91,663	40,361	37,028	46,915
Net income (loss)(4)	**12,612**	**5,553**	**(4,568)**	**13,381**	(4,891)	(11,783)	(30,370)	41,332
Adjusted EBITDA	**31,139**	**24,618**	**27,605**	**37,295**	31,120	13,253	(6,569)	17,869
AFFO	**13,560**	**3,381**	**3,707**	**14,915**	9,722	5,891	(13,888)	13,484
Common dividends(5)	**5,579**	**5,655**	**10,231**	**12,299**	11,569	10,225	10,217	10,015
Preferred dividends	**938**	**938**	**938**	**938**	1,264	—	—	—
Earnings Per Share – Basic	**0.144**	**0.061**	**(0.073)**	**0.167**	(0.086)	(0.190)	(0.492)	0.685
Earnings Per Share – Diluted	**0.139** (6)	**0.061**	**(0.073)**	**0.161** (6)	(0.086)	(0.190)	(0.492)	0.625 (6)
AFFO per share	**0.179**	**0.045**	**0.049**	**0.200**	0.136	0.096	(0.225)	0.223
Dividends declared per common share	**0.075**	**0.075**	**0.135**	**0.165**	0.165	0.165	0.165	0.165

(1) AFFO and AFFO per share have been adjusted to conform to the Corporation's revised definition of AFFO; refer to page 20 of this MD&A.

(2) Net loss, Adjusted EBITDA, AFFO, Earnings Per Share, and AFFO per share were significantly impacted by $18,611 of internalization costs incurred during the second quarter.

(3) Net loss has been adjusted by $2,409 for acquisition costs on Capstone's investment in Värmevärden.

(4) Net income (loss) attributable to the shareholders of Capstone.

(5) Common dividends include amounts declared for both the common shares of the Corporation and the Class B exchangeable units.

(6) Convertible debentures were dilutive during the period.

FOURTH QUARTER 2012 HIGHLIGHTS

	Three months ended	
	Dec 31, 2012	Dec 31, 2011
Revenue	**94,654**	91,663
Operating expenses	**(51,533)**	(48,598)
Administrative expenses	**(3,037)**	(3,074)
Project development costs	**(279)**	(4,309)
Equity accounted income (loss)	**3,596**	320
Interest income	**893**	2,123
Other gains and (losses), net	**(378)**	(7,918)
Foreign exchange gain (loss)	**676**	(2,735)
Earnings before, interest, taxes, depreciation and amortization	**44,592**	27,472
Interest expense	**(11,184)**	(15,377)
Depreciation of capital assets	**(12,194)**	(11,912)
Amortization of intangible assets	**(2,582)**	(2,478)
Income (loss) before income taxes	**18,632**	(2,295)
Income tax recovery (expense)		
Current	**1,237**	(179)
Deferred	**(3,533)**	32
Total income tax recovery (expense)	**(2,296)**	(147)
Net income	**16,336**	(2,442)
Net income attributable to:		
Shareholders of Capstone	**12,612**	(4,891)
Non-controlling interest	**3,724**	2,449
	16,336	(2,442)

Capstone's EBITDA was $17,120, or 62.3%, higher compared with the fourth quarter of 2011.

Revenue was $2,991, or 3.3%, higher compared with 2011, primarily due to increases of $2,035 from Bristol Water and $956 from the power segment. Bristol Water's revenue increased primarily due to regulated increases in the water tariff charged to customers, which adjusts annually on April 1. The power segment increase was primarily due to increased power generation of 9.9 GwH, or 34.3%, at the hydro facilities, contributing $1,373. In addition, Cardinal contributed $773 due to higher power rates and increased production. Lower power generation at Erie Shores partially offset revenues by $1,165 due to poor wind conditions.

Expenses were $1,132, or 2.0%, lower compared with 2011.

- **Operating expenses** increased $2,935, primarily related to Bristol Water. Bristol Water's operating expenses increased primarily due to $1,080 of increased repairs and maintenance expenditures coinciding with the capital program, $670 of higher consultancy fees for the capital program and $350 of higher bad debts, as a result of collection experience.
- **Administrative expenses** were consistent with the fourth quarter of 2011.
- **Project development costs** declined by $4,030 as Capstone incurred costs in 2011 for the acquisition of Bristol Water.

Equity accounted income (loss) was $3,276, or 1,024%, higher than in 2011, due to higher earnings reported by Värmevärden.

Interest income was $1,230, or 57.9%, lower than in 2011, due to lower interest on the loan receivable with Värmevärden as a result of the partial repayment in the first quarter of 2011.

Other losses were $7,540, or 95%, lower compared with 2011. The change was primarily attributable to $7,931 greater reduction in the 2011 fair value of Capstone's financial instruments, primarily for interest rate swap contracts which expired in 2011.

Foreign exchange gain (loss) in 2012 was $3,411 favourable to 2011. The favourable change was attributable to the loan receivable with Värmevärden in Sweden. During the fourth quarter of 2012, the Swedish krona appreciated marginally against the Canadian dollar.

Interest expense was $4,193, or 27.3%, higher in 2011, due to additional interest on the senior debt facility used to acquire Bristol Water in 2011. The senior debt facility was repaid in the second quarter of 2012.

Income tax provision was a net **expense** in both years. The current portion income tax provision was a $1,237 recovery in 2012 due to Bristol Water which achieved recoveries from prior year tax return refilings. The deferred portion of the income tax provision was an expense in 2012 primarily attributable to fair value adjustment and the difference between accounting and income tax depreciation for financial instruments.

ACCOUNTING POLICIES AND INTERNAL CONTROL

Significant Changes in Accounting Standards

The consolidated financial statements have been prepared in accordance with IFRS.

Future Accounting Changes

A number of new standards, amendments to standards and interpretations are effective for annual periods beginning after January 1, 2013 and 2015, and have not been applied in preparing these consolidated financial statements. Those which may be relevant to Capstone are set out below. Capstone does not plan to adopt these standards early.

Title of the New IFRS (1)	Impact to Capstone
IFRS 9, Jan 1, 2015 Financial Instruments	Capstone's assessment of the impact of this standard is ongoing.
IFRS 10, 11 and 12, Jan 1, 2013 Consolidated Financial Statements, Joint Arrangements and Disclosure of Interests in Other Entities	Capstone will adopt IFRS 10, 11 and 12 for the annual period beginning on January 1, 2013. Implementation of these standards will have no material impact on Capstone's consolidated financial statements, but will increase disclosure of interests in other entities.
IFRS 13, Jan 1, 2013 Fair Value Measurement	Capstone will adopt IFRS 13 prospectively beginning on January 1, 2013. Implementation of this standard will have no material impact on Capstone's consolidated financial statements.
IAS 19, Jan 1, 2013 Employee Benefits	Capstone will adopt the amendment to IAS 19 retrospectively as a change in accounting policy for the annual period beginning on January 1, 2013. Implementation of this amendment is limited to Bristol Water which has a defined benefit pension plan. The impact on Capstone's consolidated financial statements is: i) The expected return on plan assets must be calculated using the same discount rate as the pension obligation, which will affect interest expense and net income, and is then offset in comprehensive income. ii) Certain costs will be required to be recognized as period costs and will be reclassified from net interest in the statement of income to current service costs which are included in operating expenses.
IAS 27, Jan 1, 2013 Separate Financial Statements	Capstone will adopt the amendment to IAS 27 for the annual period beginning on January 1, 2013. Implementation will have no material impact on Capstone's consolidated financial statements.
IAS 28, Jan 1, 2013 Investments in Associates and Joint Ventures	Capstone will adopt the amendment to IAS 28 for the annual period beginning on January 1, 2013. Implementation will have no material impact on Capstone's consolidated financial statements.

(1) See the note 2 to the consolidated financial statement for the year ended December 31, 2012 for further detail about the nature of these future accounting changes.

Accounting Estimates

The consolidated financial statements are prepared in accordance with IFRS, which require the use of estimates and judgment in reporting assets, liabilities, revenues, expenses and contingencies.

The following accounting estimates included in the preparation of the consolidated financial statements are based on significant estimates and judgments, which are summarized as follows:

Area of significant estimate	Assumptions and judgements
• Purchase price allocations	• Initial fair value of net assets
• Depreciation on capital assets	• Estimated useful lives and residual value
• Amortization on intangible assets	• Estimated useful lives
• Asset retirement obligations	• Expected settlement date, amount and discount rate
• Impairment of trade receivables	• Probability of failing to recover amounts when they fall into arrears
• Derivative financial instruments	• Interest rate, natural gas price, and direct consumer rate
• Retirement benefits	• Future cash flows and discount rate
• Income taxes	• Timing of reversal of temporary differences, tax rates and current and future taxable income
• Impairment assessments of capital, assets, intangibles and goodwill	• Future cash flows and discount rate

Management's estimates are based on historical experience, current trends and various other assumptions that are believed to be reasonable under the circumstances. Actual results could materially differ from those estimates.

Internal Controls over Financial Reporting and Disclosure Controls and Procedures

Capstone's CEO and CFO are required by the various provincial securities regulators to certify annually that they have designed, or caused to be designed, Capstone's disclosure controls and procedures, as defined in the Canadian Securities Administrators' National Instrument 52-109 ("NI 52-109"), and that they have evaluated the effectiveness of these controls and procedures in the applicable period. Disclosure controls are those controls and other procedures that are designed to provide reasonable assurance that the relevant information that Capstone is required to disclose is recorded, processed and reported within the timeframes specified by such securities regulators.

Capstone's management, under the supervision of and with the participation of the CEO and CFO, has designed internal controls over financial reporting, as defined in NI 52-109. The purpose of internal controls over financial reporting is to provide reasonable assurance regarding the reliability of Capstone's financial reporting, in accordance with IFRS, focusing in particular on controls over information contained in the audited annual and unaudited interim consolidated financial statements. The internal controls are not expected to prevent and detect all misstatements due to error or fraud.

During 2012, Capstone continued to improve internal control over financial reporting by adding a third-party internal audit function to objectively evaluate and advise management and the Board of Directors.

The CEO and CFO have concluded that Capstone's disclosure controls and procedures were effective as at December 31, 2012 to ensure that information required to be disclosed in reports that Capstone files or submits under Canadian securities legislation is recorded, processed, summarized and reported within applicable time periods.

As at December 31, 2012, Capstone's management had assessed the effectiveness of Capstone's internal control over financial reporting using the criteria set forth by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission in Internal Control – Integrated Framework. Based on this assessment, management has determined that Capstone's internal control over financial reporting was effective as at December 31, 2012.