Veridian Corporation

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RATING

Rating	Trend	Rating Action	Debt Rated
A	Stable	Confirmed	Issuer Rating

RATING HISTORY

	Current	2005	2004	2003	2002	2001
Issuer Rating	A	A	A (low)	A (low)	A	NR

RATING UPDATE

The financial profile of Veridian Corporation (Veridian or the Company) remains strong and continues to support the Company's A-rated Issuer Rating. Fixed charges coverage and cash flow-to-debt improved materially as leverage remained largely unchanged and earnings grew following the acquisition of Gravenhurst Hydro and Scugog Hydro in Q3 2005, favourable customer growth and a minimal increase in operating costs. Debt-to-capital remains favourable at below 50%, which is below the Company's deemed regulatory debt level of 55%. The majority of Veridian's debt is comprised of $60.8 million in convertible subordinated promissory notes payable to its shareholder municipalities, with the remaining $14.5 million as bank debt due on December 16, 2006.

Since 2002, the Company has continued to generated sufficient cash flow from operations to fully fund dividends and capital expenditures. This is expected to continue over the medium term despite an anticipated doubling in capital expenditures to roughly $15 million annually beginning this year, with the increase primarily due to spending on government-mandated conservation initiatives (i.e., smart meters). As such, no new borrowing is anticipated over the near to medium term, and the Company's financial profile is expected to remain well within the "A" rating range, given its stable regulated distribution operations.

On May 1, 2006, new rates became effective for Veridian. This included a lower allowable ROE at 9.00% (down from 9.88% in 2005), which came into effect for all Ontario local distribution companies (LDCs). The impact of this lower ROE on Veridian's earnings and cash flow is expected to be minimal.

The key challenge/uncertainty for regulated distribution companies in Ontario over the medium term is the regulatory framework beyond 2006. However, Dominion Bond Rating Service (DBRS) expects that the Ontario Energy Board (OEB) will maintain a supportive regulatory framework for electricity distributors, which would likely continue to include full cost-of-service recovery, a market-based rate of return, and a performance-based incentive mechanism.

Future acquisitions for Veridian remain uncertain, especially while the transfer tax remains in place. However, should the transfer tax be waived again and an acquisition opportunity become available, the Company has considerable financial flexibility with its cash on hand and the ability to convert the promissory notes into equity (at the option of the shareholders).

RATING CONSIDERATIONS

Strengths

- Regulated electricity distribution provides long-term stability to earnings and cash flows
- Favourable franchise area
- Financially strong and supportive shareholders
- Efficiencies gained from acquisitions/mergers
- Non-regulated operations provide higher margins

Challenges

- Regulatory risk and risk of political intervention
- Low regulatory returns
- Earnings are sensitive to volume of electricity sold
- Lack of access to the public equity markets and small size
- Non-regulated operations have greater operating risks

FINANCIAL INFORMATION

	12 mos. ended	For the year ended December 31				
	Mar. 31, 2006	2005	2004	2003	2002	2001P
Fixed-charges coverage (times)	3.37	3.06	2.45	2.23	1.93	0.28
Gross debt-to-capital	47.3%	48.1%	49.0%	50.0%	53.6%	54.1%
Net debt-to-capital	34.2%	31.2%	38.2%	40.8%	50.3%	48.9%
Cash flow/total debt	32.8%	30.9%	22.7%	24.5%	19.3%	11.5%
Cash flow/capital expenditures (times)	3.45	3.11	2.64	2.81	3.07	0.64
Cash flow from operations ($ millions)	25.0	23.4	17.1	18.4	16.2	9.8
Net income (before extras.) ($ millions)	9.3	7.9	4.6	3.7	3.5	(2.6)
Return on average equity (before extras.)	10.5%	9.2%	5.8%	5.0%	4.8%	(3.6%)
Electricity throughputs (millions kWh)	n/a	2,453	2,278	2,263	2,282	2,232

P = Pro forma of historical data for all seven former municipal utilities. n/a = not applicable.

THE COMPANY

Veridian Corporation is a holding company that owns: (1) Veridian Connections Inc. (VCI), a regulated electricity distribution company; and (2) Veridian Energy Inc., which provides: (a) non-regulated billing and management services to VCI and external customers, (b) water heater rentals, and (c) the leasing of fibre-optic cables. Veridian Corporation is 41%-owned by the City of Pickering, 32.1% by the Town of Ajax, 13.6% by the Municipality of Clarington, and 13.3% by the City of Belleville. Along with its service area being an amalgamation of the former municipal electric utilities of the aforementioned municipalities, it has acquired the former utilities of Brock, Port Hope, Uxbridge, Gravenhurst, and Scugog.

Notes:
All figures in Canadian dollars, unless otherwise noted.
Issuer ratings apply to all general senior unsecured obligations of the issuer corporation.

RATING CONSIDERATIONS

Strengths

(1) Almost all of Veridian's operating income (95% of EBIT) is generated from its regulated distribution subsidiary, VCI, which provides stability to earnings and cash flow. VCI receives roughly 40% of its distribution revenues from the fixed monthly connection fee with the remaining 60% from variable volume throughput. The Company divested its interest in higher risk non-regulated retail energy marketing in 2003 and future involvement in non-regulated business is expected to remain limited.

(2) Veridian has a favourable franchise area, with a total combined population of approximately 310,000 and has experienced annual load growth that has averaged around 1.5% since 2000 (excluding acquisitions). Population growth is expected to continue to be strong for the medium term, providing a basis for continued stable earnings growth. Veridian's distribution network has substantial unused capacity, which reduces the amount of capital investment required to accommodate future customer growth. Also, a well diversified, predominately residential and small commercial customer base of 104,400 and limited exposure to larger cyclical industrial customers provide Veridian with a relatively stable and predictable demand load year-over-year, with limited influence from economic cycles.

(3) The four shareholder municipalities are financially strong and have the ability to provide financial support to protect their investment, if necessary. The $60.8 million subordinated promissory note held by the four shareholder municipalities is convertible to equity on or before maturity on November 1, 2006, which could be utilized to provide equity support to the Company's capital structure. However, the shareholders cannot provide formal guarantees to Veridian's debt obligations as the Ontario municipal legislation prohibits municipalities from doing so. Having more than one shareholder, each with a minority interest, reduces the risk of being influenced by the special interests of a single municipal council, although it may make the decision-making process more challenging.

(4) Consolidating the operations of nine former municipal utilities provides an opportunity to significantly reduce operating costs.

(5) Non-regulated operations such as contracted services to LDCs (outsourcing billing and call centre), water heater and sentinel light rentals, and telecommunications (leasing of fibre-optic cable) earn high margins, require minimal capital, and provide a source of earnings growth beyond its regulated distribution subsidiary.

Challenges

(1) The key challenge facing electricity distributors in Ontario is regulatory risk and the risk of political intervention. Regulatory risk is an inherent challenge for any regulated utility given that the regulatory framework essentially dictates the maximum profitability that can be achieved and the degree of protection to bondholders. While some uncertainty exists regarding the regulatory framework beyond 2006, DBRS expects the OEB to remain supportive by continuing to allow full cost of service recovery with a market-based rate of return on regulated distribution operations. The key risk with respect to political intervention would be the imposition of a rate freeze, as was seen in 2002, which was at a time of high electricity prices and near a provincial election. However, DBRS believes the risk of political intervention in the rate-setting process is relatively low under the current provincial government's tenure, in light of its strong commitment to passing along the full cost of power to electricity ratepayers.

(2) The 9.0% ROE for Ontario electricity distributors is low in comparison with similar regulated utilities in the United States. As such, cash flow and coverage ratios for regulated distribution utilities in Ontario will typically be lower than for similarly-regulated distribution utilities in the United States. However, the current regulated ROE for Ontario utilities is in line with the lower ROEs typically granted to regulated utilities in Canada.

(3) Earnings and cash flow for distribution companies are partially dependent on the volume of electricity sold. Seasonality, economic cyclicality, and year-over-year changes in weather patterns directly impact the volume of electricity sold, and hence revenue earned from electricity sales and interest coverage ratios. In addition, economic growth impacts customer growth. However, Veridian's well diversified and growing customer base helps mitigate most of these risks, as does its fixed monthly connection fee.

(4) Veridian does not have access to the capital markets for common equity, this along with its small size limits its financial flexibility, especially its ability to make a strategic acquisition or invest in a significant capital project. Veridian's equity base is limited to internal earnings growth, a reduction of dividends to shareholders, or increases in equity from the conversion of subordinated debt into equity. However, DBRS expects that Veridian will continue to seek out strategic investments in additional LDCs in Ontario to continue to grow its asset base, as it has in the past.

(5) Non-regulated operations have greater operating risk than regulated electricity distribution, which may affect the stability of consolidated earnings and cash flow. However, it is expected that non-regulated operations will continue to comprise only a minor segment of Veridian's consolidated operations over the longer term (roughly 5% of consolidated EBIT in 2005). Veridian has taken a conservative approach to these operations through Veridian Energy Inc.: (a) Earnings from electric water heater rentals are relatively stable. The key risk associated with this operation is competition from natural gas water heaters. (b) With telecommunications, long-term contracts with anchor tenants, largely in the MUSH (municipalities, universities, schools, and hospitals) sector, are secured prior to investing capital. This business is dependent on the creditworthiness of the anchor tenants. (c) Investment in electricity generation will likely be as a minority equity owner.

REGULATION

Veridian's electricity distribution operations are regulated by the OEB under the *Electricity Act, 1998* (the Electricity Act), with the following noteworthy amendments:

- The *Electricity Pricing, Conservation and Supply Act, 2002* (Bill 210) – December 9, 2002.
- The *Ontario Energy Board Amendment Act (Electricity Pricing), 2003* (Bill 4) – December 18, 2003.
- The *Electricity Restructuring Act, 2004* (Bill 100) – December 9, 2004.

Summary

- Veridian's current deemed debt/equity is 55/45.
- On November 11, 2005, the OEB set the allowable ROE for all Ontario LDCs at 9.00% (down from 9.88% in 2005).
- On April 12, 2006, the OEB issued its rate decision on Veridian's 2006 distribution rate application, with new distribution rates becoming effective on May 1, 2006. The following are highlights of this rate decision:
  - An approved rate base for distribution operations of $144.1 million (including Scugog and Gravenhurst). This represents the first rate base adjustment since the Electricity Act was implemented, which was set based on a 1999 rate base equivalent to $145 million ($155.7 million including Scugog and Gravenhurst).
  - An approved debt rate of 7.6% for the promissory notes.
- A $0.30 charge per residential customer per month as a result of the OEB's generic decision on Smart Metering.
- A total approved revenue requirement of $44 million.

Generic Cost of Capital

- On April 27, 2006, the OEB indicated its intent to establish a multi-year electricity distribution rate-setting plan for all LDCs in Ontario, which will include:
  - A generic cost of capital to be used in adjusting annual revenue requirements for 2007 and beyond.
  - A mechanistic incentive rate adjustment for the period.
- The initial term of the multi-year plan will be three years, beginning with the 2007 rate adjustment.
- On June 26, 2006, the OEB posted on its website a draft report of Board staff containing staff's initial proposals for both the cost of capital and the second generation incentive regulation mechanism. A subsequent Board staff proposal was posted on the OEB's website on July 25, 2006, which incorporated stakeholder comments on its June 26 proposal. DBRS notes that the following Board staff proposals, if implemented, would have a negative impact on earnings and cash flow for LDCs like Veridian: (1) A proposed allowed ROE of less than 9.0%, based on Board staff's view of the equity risk premium and current forecast interest rates, and (2) a deemed equity thickness of 40%, versus Veridian's current deemed equity thickness of 45%. However, it is too early to determine the impact on Veridian's credit metrics until the consultation and review process is completed and a final decision is made.

EARNINGS AND OUTLOOK

	12 mos. ended	For the year ended December 31				
($ millions)	Mar. 31, 2006	2005	2004	2003	2002	2001P
Net electricity distribution revenues	41.0	38.5	32.6	32.5	32.7	18.6
Ancillary revenues	5.1	4.9	5.5	5.0	3.3	1.8
Net operating revenues	46.1	43.4	38.1	37.5	36.1	20.4
Operating costs	25.7	24.6	24.3	24.9	24.7	19.1
EBITDA	30.3	28.6	23.3	22.0	20.8	9.5
EBIT	20.3	18.8	13.8	12.6	11.4	1.3
Net income (before extras.)	9.3	7.9	4.6	3.7	3.5	(2.6)
Extraordinary items	-	-	(0.1)	(0.4)	(1.7)	-
Net income	9.3	7.9	4.5	3.3	1.8	(2.6)

P = Pro forma of historical statements for seven former municipal utilities.

Summary

- Key factors contributing to the 36% increase in EBIT in 2005 include the following:
  - The acquisition of Gravenhurst Hydro and Scugog Hydro in 2005 increased Veridian's customer base by approximately 9%.
  - Favourable customer growth of about 4% (excluding the acquisitions).
  - A minimal increase in operating costs as a result of continued efficiency improvements.

Outlook

- Annual EBIT will experience a modest increase again in 2006, as this will be the first full year with the inclusion of Gravenhurst Hydro and Scugog Hydro.
- Beyond 2006, EBIT will depend on the outcome of the OEB's multi-year rate plan discussed above.
- However, the Company's regulated electricity distribution operations at VCI, together with its strong franchise area, will continue to provide a high degree of certainty to revenues and stability to consolidated earnings and cash flow over the longer term. Regulated distribution operations will likely continue to comprise over 95% of consolidated EBIT.

FINANCIAL PROFILE AND OUTLOOK

Cash Flow Statement	12 mos. ended	For the year ended December 31				
($ millions)	Mar. 2006	2005	2004	2003	2002	2001P
Net income (before extras.)	9.3	7.9	4.6	3.7	3.5	(2.6)
Depreciation & amortization	10.0	9.8	9.5	9.4	9.5	8.2
Other non-cash adjustments	5.8	5.8	3.0	5.3	3.2	4.2
Cash Flow From Operations	25.0	23.4	17.1	18.4	16.2	9.8
Dividends paid	(3.0)	(4.8)	(1.1)	(0.6)	(1.0)	-
Capex (net of capital contributions)	(7.3)	(7.5)	(6.5)	(6.6)	(5.3)	(15.2)
Free Cash Flow Bef. Work. Cap. Changes	14.8	11.1	9.6	11.3	9.9	(5.5)
Changes in working capital	2.5	16.1	(5.9)	9.3	(11.9)	3.9
Net Free Cash Flow	17.3	27.2	3.7	20.6	(1.9)	(1.5)
Acquisitions/divestitures	(14.1)	(14.1)	-	-	(2.2)	(9.0)
Other	(1.3)	(1.3)	(0.2)	1.0	(0.1)	2.9
Cash flow before financing	1.9	11.8	3.4	21.7	(4.2)	(7.6)
Net change in equity	-	-	-	-	-	-
Net change in debt: new/(repay.)	-	-	-	(8.6)	(1.3)	21.5
Change in Net Cash	1.9	11.8	3.4	13.1	(5.5)	13.9
Key Figures and Ratios						
Total debt in capital structure	76.2	75.7	75.6	75.3	83.9	85.2
Total debt-to-capital	47.3%	48.1%	49.0%	50.0%	53.6%	54.1%
EBITDA interest coverage (times)	5.02	4.66	4.12	3.90	3.54	2.07
EBIT interest coverage (times)	3.37	3.06	2.45	2.23	1.93	0.28
Cash flow/total adjusted debt	32.8%	30.9%	22.7%	24.5%	19.3%	11.5%

P = Pro forma of historical data for all seven former utilities.

Summary

- Veridian continues to generate sufficient cash flow from operations to fully fund capital expenditures and dividends.
- Debt-to-capital improved modestly in 2005 as debt levels remained constant and the Company's equity base increased.
- Stronger cash flow from operations led to significantly stronger cash flow-to-debt and interest coverage ratios, which continue to support the Company's "A" rating given its regulated distribution operations.

Outlook

- Despite higher forecast capital expenditures, cash flow from operations is expected to remain adequate to fully fund capital expenditures and dividends over the medium term.
  - Capital expenditures are expected to double, from about $7.5 million in 2005 to about $15 million annually over the next five years, with the increase primarily due to spending on government-mandated conservation initiatives (i.e., smart meters), which will ultimately be added to the rate base.
- Any borrowing requirements over the medium term would be to fund working capital requirements.
- Veridian's debt-to-capital is expected to remain below 50% over the medium term. As such, cash flow-to-debt and interest coverage ratios are expected to remain strong.

LONG-TERM DEBT MATURITIES AND BANK LINES

Long-Term Debt

- Veridian's long-term debt consists of subordinated promissory notes payable to its shareholder municipalities of $60.8 million, convertible to equity (only at the option of the noteholders) prior to expiry on November 1, 2006. It is expected that these notes will be extended for a three-year term. DBRS notes that $44.6 million of these notes are issued at VCI and $17.21 million are issued at Veridian (see tables below). Veridian's Issuer Rating assumes that all senior unsecured obligations of the Company rank ahead of the subordinated notes. DBRS notes that although the subordinated notes are not contractually subordinated to senior unsecured obligations, they are effectively subordinated due to the terms of the Company's inter-creditor agreement. Furthermore, DBRS is of the view that the owner municipalities would refrain from taking actions on their subordinated notes that would impair Veridian's ability to meet its senior unsecured obligations.

Subordinated Notes Payable at VCI

Municipality Lender	Amount
Pickering	$17.97 million
Ajax	$14.06 million
Clarington	$5.97 million
Belleville	$5.59 million
Total	$44.59 million

Subordinated Notes Payable at Veridian

Municipality Lender	Amount
Pickering	$7.10 million
Ajax	$5.55 million
Clarington	$2.35 million
Belleville	$2.21 million
Total	17.21 million

Bank Lines

- Veridian currently has two separate credit facilities totalling $58 million, as follows:
  - A five-year term loan facility (maturing December 16, 2006) in the amount of $48 million to be used for refinancing of acquisitions, capital expenditures and funding new investments. DBRS expects that this term facility will be extended prior to maturity.
  - A 364-day term renewable revolving letter of credit facility of $10 million for Independent Electricity Market Operator (IESO) prudential support for its regulated distribution business.
- At December 31, 2005, Veridian had borrowed $14.5 million (noted above) against the loan facility and utilized $5.6 million of the letter of credit facility for IMO prudential requirements.

Veridian Corporation

Balance Sheet

($ millions)	As at	As at Dec. 31			As at	As at Dec. 31	
Assets	Mar. 2006	2005	2004	**Liabilities & Equity**	Mar. 2006	2005	2004
Cash	32.1	38.6	26.8	Short-term debt	61.0	61.2	0.3
Accounts receivable + unbilled revenue	38.4	49.3	40.8	A/P + accr'ds	28.5	50.4	26.6
Inventories	1.3	1.3	1.1	Regulatory liab.	-	2.2	0.6
Prepaids & other, current portion reg.	3.0	3.2	2.0	Customer deposits	-	1.7	0.3
Current Assets	74.8	92.3	70.7	**Current Liabilities**	89.5	115.5	27.7
Net fixed assets	122.8	124.0	117.4	Customer deposits	-	0.6	0.8
Deferred charges	0.28	0.3	0.4	Long-term debt	0.7	-	60.8
Regulatory assets	1.34	1.6	1.4	Other	18.9	14.9	11.2
Other assets	9.2	9.2	4.0	Shareholders' equity	84.9	81.8	78.8
Total	208.4	227.4	193.9	**Total**	193.9	212.9	179.4

Ratio Analysis	12 mos. ended	For the year ended December 31						
Liquidity Ratios	Mar. 31, 2006	2005	2004	2003	2002	2001P	2000P	1999P
Current ratio	0.72	0.71	2.55	2.42	1.63	1.08	1.09	1.37
Accumulated depr./gross fixed assets	45.8%	49.8%	49.8%	47.1%	44.5%	41.3%	41.7%	40.3%
Total gross debt-to-capital (1)	47.3%	48.1%	49.0%	50.0%	53.6%	54.1%	52.2%	52.4%
Net debt-to-capital	34.2%	31.2%	38.2%	40.8%	50.3%	48.9%	49.8%	46.2%
Senior debt-to-capital	9.4%	9.2%	9.4%	9.6%	14.7%	14.7%	9.5%	10.1%
Cash flow/total debt	32.8%	30.9%	22.7%	24.5%	19.3%	11.5%	9.0%	7.7%
Debt/EBITDA	2.51	2.65	3.24	3.42	4.03	8.96	10.50	14.14
Cash flow/capital expenditures (2)	3.45	3.11	2.64	2.81	3.07	0.64	0.85	0.62
Average coupon on long-term debt	-	7.21%	7.21%	7.21%	7.21%	7.60%	7.60%	-
Common dividend payout	-	61.0%	23.0%	15.0%	28.5%	-	-	-
Deemed equity in the capital structure	45%	45%	45%	45%	45%	45%	-	-
Coverage Ratios (3)								
EBIT interest coverage	3.37	3.06	2.45	2.23	1.93	0.28	0.18	-0.70
EBITDA interest coverage	5.02	4.66	4.12	3.90	3.54	2.07	5.14	8.52
Fixed-charges coverage	3.37	3.06	2.45	2.23	1.93	0.28	0.18	-0.70

Note: Interest for 2003 was prepaid in previous years, hence interest for 2003 will be a non-cash payment.

Profitability/Operating Efficiency								
Operating margin	44.1%	43.3%	36.3%	33.7%	31.5%	6.2%	(2.2%)	(8.0%)
Net margin (before extras.)	20.1%	18.1%	12.2%	9.8%	9.7%	(12.9%)	(6.3%)	(6.8%)
Return on avg. common equity (bef. extras.)	10.5%	9.2%	5.8%	5.0%	4.8%	(3.6%)	(1.8%)	(1.3%)
GWh sold/employee	-	16.1	15.0	14.9	15.0	14.7	14.2	14.0
Customers/employee	-	687	616	598	599	598	538	498
OM&A/customer ($)	-	142.0	158.1	170.1	167.5	122.0	154.8	171.1
Rate base		145	145	145	145	145		

Electricity Throughputs	2005								
Residential	37%		911.5	831.0	827.1	865.6	817.5	790.5	766.0
Commercial	54%		1,327.1	1,248.6	1,263.3	1,257.6	1,268.3	1253.6	1192.8
Large users	9%		214.1	184.7	156.3	158.8	145.9	115.6	164.6
Street lighting	0%			13.6	16.1	-	-	-	-
Total (GWh)		0.0	2,452.7	2,277.9	2,262.8	2,282.0	2,231.7	2,159.7	2,123.4

Number of Customers	2005								
Residential	90.4%		94,342	84,662	82,018	82,807	80,992	n/a	n/a
Commercial	9.6%		10,045	8,968	8,845	8,232	8,179	n/a	n/a
Large users	0.0%		5	4	4	4	4	n/a	n/a
Street lighting	0.0%		7	7	7	-	-	n/a	n/a
Total		0	104,399	93,641	90,874	91,043	89,175	88,760	86,202

P = Pro forma of historical data for all seven former municipal utilities. n/a = not applicable.

(1) Subordinated convertible notes given 100% debt treatment. (2) Net of customer contributions.

(3) EBIT includes interest income, interest expense excludes capitalized interest, AFUDC, and debt amortizations.