

The Company and its partners in certain jointly owned entities have severally as well as jointly and severally guaranteed the financial performance of these entities related primarily to construction projects, redelivery of natural gas, PPA payments and the payment of liabilities. TransCanada's share of the potential exposure under these guarantees was estimated at December 31, 2008 to range from \$688 million to a maximum of \$1.4 billion. For certain of these entities, any payments made by TransCanada under these guarantees in excess of its ownership interest are to be reimbursed by its partners. Deferred Amounts includes \$9 million for the fair value of these joint and several guarantees.

TransCanada has guaranteed a subsidiary's equity undertaking to support the payment, under certain conditions, of principal and interest on US\$43 million of the public debt obligations of TransGas. The Company has a 46.5 per cent interest in TransGas. Under the terms of a shareholder agreement, TransCanada and another major multinational company may be required to severally fund more than their proportionate share of debt obligations of TransGas in the event that the minority shareholders fail to contribute. Any payments made by TransCanada under this agreement would convert into share capital of TransGas. The Company's potential exposure is contingent on the impact any change of law would have on the ability of TransGas to service the debt. There has been no change in applicable law since the issuance of debt in 1995 and, thus, no exposure for TransCanada. The debt matures in 2010. The Company has made no provision related to this guarantee.

## RISK MANAGEMENT AND FINANCIAL INSTRUMENTS

### FINANCIAL RISKS AND FINANCIAL INSTRUMENTS

#### Risk Management Overview

TransCanada has exposure to market risk, counterparty credit risk, and liquidity risk. TransCanada engages in risk management activities with the primary objective being to protect earnings, cash flow and, ultimately, shareholder value.

Risk management strategies, policies and limits are designed to ensure TransCanada's risks and related exposures are in line with the Company's business objectives and risk tolerance. Risks are managed within limits ultimately established by the Company's Board of Directors, implemented by senior management and monitored by risk management and internal audit personnel. The Board of Directors' Audit Committee oversees how management monitors compliance with risk management policies and procedures, and oversees management's review of the adequacy of the risk management framework. Internal audit personnel assist the Audit Committee in its oversight role by performing regular and ad-hoc reviews of risk management controls and procedures, the results of which are reported to the Audit Committee. The Board of Directors also has a Governance Committee that assists in overseeing the risk management activities of TransCanada. The Governance Committee monitors, reviews with management and makes recommendations related to TransCanada's risk management programs and policies on an ongoing basis.

#### Market Risk

The Company constructs and invests in large infrastructure projects, purchases and sells commodities, issues short-term and long-term debt, including amounts in foreign currencies, and invests in foreign operations. These activities expose the Company to market risk from changes in commodity prices, foreign exchange rates and interest rates, which affect the Company's earnings and the value of the financial instruments it holds.

The Company uses derivatives as part of its overall risk management policy to manage exposure to market risk that results from these activities. Derivative contracts used to manage market risk generally consist of the following:

- Forwards and futures contracts – contractual agreements to purchase or sell a specific financial instrument or commodity at a specified price and date in the future. TransCanada enters into foreign exchange and commodity forwards and futures to mitigate the impact of volatility in foreign exchange rates and commodity prices.

- Swaps – contractual agreements between two parties to exchange streams of payments over time according to specified terms. The Company enters into interest rate, cross-currency and commodity swaps to mitigate the impact of changes in interest rates, foreign exchange rates and commodity prices.
- Options – contractual agreements to convey the right, but not the obligation, of the purchaser to buy or sell a specific amount of a financial instrument or commodity at a fixed price, either at a fixed date or at any time within a specified period. The Company enters into option agreements to mitigate the impact of changes in interest rates, foreign exchange rates and commodity prices.

#### ***Commodity Price Risk***

The Company is exposed to commodity price movements as part of its normal business operations, particularly in relation to the prices of electricity, natural gas and oil products. A number of strategies are used to mitigate these exposures, including the following:

- Subject to the Company's overall risk management policies, the Company commits a significant portion of its expected power supply to fixed-price medium-term or long-term sales contracts, while reserving an amount of unsold supply to mitigate price risk in its asset portfolio.
- The Company purchases a portion of the natural gas and oil products required for its power plants or enters into contracts that base the sales price of electricity on the cost of natural gas, effectively locking in a margin. A significant portion of the electricity needed to fulfill the Company's power sales commitments is purchased with contracts or fulfilled through power generation, thereby reducing the Company's exposure to fluctuating commodity prices.
- The Company enters into offsetting or back-to-back positions and derivative financial instruments to manage price risk exposure in power and natural gas commodities created by certain fixed and variable pricing arrangements for different pricing indices and delivery points.

TransCanada manages its exposure to seasonal natural gas price spreads in its natural gas storage business by economically hedging storage capacity with a portfolio of third-party storage capacity contracts and proprietary natural gas purchases and sales. TransCanada simultaneously enters into a forward purchase of natural gas for injection into storage and an offsetting forward sale of natural gas for withdrawal at a later period, thereby locking in future positive margins and effectively eliminating exposure to price movements of natural gas. Fair value adjustments recorded each period on proprietary natural gas storage inventory and these forward contracts may not be representative of the amounts that will be realized on settlement.

#### ***Natural Gas Inventory Price Risk***

At December 31, 2008, \$76 million (2007 – \$190 million) of proprietary natural gas inventory was included in Inventories. TransCanada measures its proprietary natural gas inventory held in storage at the one-month forward price for natural gas less selling costs. The Company did not have any proprietary natural gas inventory held in storage prior to April 2007. In 2008, the net change in fair value of proprietary natural gas held in inventory was a net unrealized loss of \$7 million (2007 – nil), which was recorded as a decrease to Revenue and Inventory. In 2008, the net change in fair value of natural gas forward purchases and sales contracts was a net unrealized gain of \$7 million (2007 – \$10 million) which was included in Revenues.

#### ***Foreign Exchange and Interest Rate Risk***

Foreign exchange and interest rate risk is created by fluctuations in the fair value or cash flow of financial instruments due to changes in foreign exchange rates and/or market interest rates.

A portion of TransCanada's earnings from its Pipelines and Energy operations is generated in U.S. dollars and is subject to currency fluctuations. The performance of the Canadian dollar relative to the U.S. dollar can affect TransCanada's earnings. This foreign exchange impact is offset by certain related debt and financing costs being denominated in U.S. dollars and by the Company's hedging activities. Due to its increased U.S. operations, TransCanada has a greater exposure to U.S. currency fluctuations than in prior years.

The Company uses foreign currency and interest rate derivatives to manage the foreign exchange and interest rate risks related to its debt and other U.S. dollar-denominated transactions, and to manage the interest rate exposure of the Canadian Mainline, Alberta System and Foothills operations. Certain of the realized gains and losses on these derivatives are shared with shippers on predetermined terms. These gains and losses are deferred as regulatory assets and liabilities until they are recovered from or paid to the shippers in accordance with the terms of the shipping agreements.

TransCanada has floating interest rate debt, which subjects it to interest rate cash flow risk. The Company uses a combination of forwards, interest rate swaps and options to manage its exposure to this risk.

#### **Net Investment in Self-Sustaining Foreign Operations**

The Company hedges its net investment in self-sustaining foreign operations (on an after-tax basis) with U.S. dollar-denominated debt, forward foreign exchange contracts, cross-currency interest rate swaps and foreign exchange options. At December 31, 2008, the Company had designated as a net investment hedge U.S. dollar-denominated debt with a carrying value of \$7.2 billion (US\$5.9 billion) (2007 – \$4.7 billion (US\$4.7 billion)) and a fair value of \$5.9 billion (US\$4.8 billion) (2007 – \$4.8 billion (US\$4.8 billion)). In January 2009, the Company issued an additional US\$2.0 billion of long-term debt and designated it as a hedge of the net U.S. dollar investment in foreign operations. At December 31, 2008, \$254 million was included in Deferred Amounts for the fair value of the forwards, swaps and options used to hedge the Company's net U.S. dollar investment in foreign operations.

The fair values and notional or principal amount for the derivatives designated as a net investment hedge were as follows:

<b>Asset/(Liability)</b>	<b>2008</b>		<b>2007</b>	
	<b>Fair Value</b>	<b>Notional or Principal Amount</b>	<b>Fair Value</b>	<b>Notional or Principal Amount</b>
<i>December 31 (millions of dollars)</i>				
U.S. dollar cross-currency swaps (maturing 2009 to 2014)	<b>(218)</b>	<b>U.S. 1,650</b>	77	U.S. 350
U.S. dollar forward foreign exchange contracts (maturing 2009)	<b>(42)</b>	<b>U.S. 2,152</b>	(4)	U.S. 150
U.S. dollar options (maturing 2009)	<b>6</b>	<b>U.S. 300</b>	3	U.S. 600
	<b>(254)</b>	<b>U.S. 4,102</b>	76	U.S. 1,100

#### **Counterparty Credit Risk**

Counterparty credit risk represents the financial loss the Company would experience if a counterparty to a financial instrument failed to meet its obligations in accordance with the terms and conditions of its contracts with the Company.

Counterparty credit risk is managed through established credit management techniques, including conducting financial and other assessments to establish and monitor a counterparty's creditworthiness, setting exposure limits, monitoring exposures against these limits, using master netting arrangements and obtaining financial assurances where warranted. In general, financial assurances include guarantees, letters of credit and cash. The Company monitors and manages its concentration of counterparty credit risk on an ongoing basis. The Company believes these measures minimize its counterparty credit risk but there is no certainty that these processes will protect it against all losses.

TransCanada has significant credit and performance exposures to financial institutions as they provide committed credit lines and cash deposit facilities, critical liquidity in the foreign exchange derivative, interest rate derivative and energy wholesale markets, and letters of credit to mitigate TransCanada's exposure to non-credit worthy counterparties.

During the deterioration of global financial markets in 2008, TransCanada continued to closely monitor and reassess the creditworthiness of its counterparties, including financial institutions. This has resulted in TransCanada reducing or mitigating its exposure to certain counterparties where it is deemed warranted and permitted under contractual terms. As part of its ongoing operations, TransCanada must balance its market risk and counterparty credit risk when making business decisions.

Certain subsidiaries of Calpine filed for bankruptcy protection in both Canada and the U.S. in 2005. Gas Transmission Northwest Corporation (GTNC) and Portland Natural Gas Transmission System (PNGTS) reached agreements with Calpine for allowed unsecured claims in the Calpine bankruptcy. In February 2008, GTNC and PNGTS received initial distributions of 9.4 million common shares and 6.1 million common shares of Calpine, respectively, which represented approximately 85 per cent of their agreed-upon claims. In 2008, these shares were subsequently sold into the open market and resulted in total pre-tax gains of \$279 million. Claims by NOVA Gas Transmission Limited and Foothills Pipe Lines (South B.C.) Ltd. for \$32 million and \$44 million, respectively, were received in cash in January 2008 and will be passed on to shippers on these systems. At December 31, 2008, \$22 million remained in regulatory liabilities for these claims.

### Liquidity Risk

Liquidity risk is the risk that TransCanada will not be able to meet its financial obligations as they fall due. The Company's approach to managing liquidity risk is to ensure that, under both normal and stressed conditions, it always has sufficient cash and credit facilities to meet its obligations when due without incurring unacceptable losses or damage to the Company's reputation.

Management forecasts cash flows for a period of 12 months to identify financing requirements. These requirements are then managed through a combination of committed and demand credit facilities and access to capital markets. The Company's liquidity and cash flow management is also discussed in the "Liquidity and Capital Resources" and "Contractual Obligations" sections of this MD&A.

### Fair Values

The fair value of financial instruments included in Cash and Cash Equivalents, Accounts Receivable, Other Assets, Notes Payable, Accounts Payable, Accrued Interest and Deferred Amounts approximates their carrying amounts due to the nature of the item and/or the short time to maturity. The fair value of foreign exchange and interest rate derivatives has been calculated using year-end market rates. The fair value of power, natural gas and oil products derivatives has been calculated using quoted market prices where available. In the absence of quoted market prices, third-party broker quotes are used. Credit risk has been taken into consideration when calculating fair values.

Valuation techniques that refer to observable market data or estimated market prices may also be used to calculate fair value. These include comparisons with similar instruments that have observable market prices, option pricing models and other valuation techniques commonly used by market participants. Fair values determined using valuation models require the use of assumptions about the amount and timing of estimated future cash flows and discount rates. In making these assumptions, the Company looks primarily to readily observable external market input factors such as interest rate yield curves, currency rates and price and rate volatilities, as applicable.

The fair value of the Company's Long-Term Debt was estimated based on quoted market prices for the same or similar debt instruments and, when such information was not available, was estimated by discounting future payments of interest and principal at estimated interest rates that were made available to the Company.

### Non-Derivative Financial Instruments Summary

The carrying and fair values of non-derivative financial instruments were as follows:

<i>December 31 (millions of dollars)</i>	2008		2007	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<b>Financial Assets<sup>(1)</sup></b>				
Cash and cash equivalents	1,308	1,308	504	504
Accounts receivable and other assets <sup>(2)(3)</sup>	1,404	1,404	1,231	1,231
Available-for-sale assets <sup>(2)</sup>	27	27	17	17
	<b>2,739</b>	<b>2,739</b>	1,752	1,752
<b>Financial Liabilities<sup>(1)(3)</sup></b>				
Notes payable	1,702	1,702	421	421
Accounts payable and deferred amounts <sup>(4)</sup>	1,372	1,372	1,193	1,193
Accrued interest	359	359	261	261
Long-term debt and junior subordinated notes	17,367	16,152	13,908	15,334
Long-term debt of joint ventures	1,076	1,052	903	937
Other long-term liabilities of joint ventures <sup>(4)</sup>	–	–	60	60
	<b>21,876</b>	<b>20,637</b>	16,746	18,206

<sup>(1)</sup> Consolidated Net Income in 2008 and 2007 included unrealized gains or losses of nil for the fair value adjustments to each of these financial instruments.

<sup>(2)</sup> At December 31, 2008, the Consolidated Balance Sheet included financial assets of \$1,257 million (2007 – \$1,018 million) in Accounts Receivable and \$174 million (2007 – \$230 million) in Other Assets.

<sup>(3)</sup> Recorded at amortized cost, except for certain Long-Term Debt which is adjusted to fair value.

<sup>(4)</sup> At December 31, 2008, the Consolidated Balance Sheet included financial liabilities of \$1,350 million (2007 – \$1,175 million) in Accounts Payable and \$22 million (2007 – \$78 million) in Deferred Amounts.

**Derivative Financial Instruments Summary**

Information for the Company's derivative financial instruments is as follows:

<i>December 31</i> <i>(all amounts in millions unless otherwise indicated)</i>	2008				
	Power	Natural Gas	Oil Products	Foreign Exchange	Interest
<b>Derivative Financial Instruments Held for Trading</b>					
Fair Values <sup>(1)</sup>					
Assets	\$132	\$144	\$10	\$41	\$57
Liabilities	\$(82)	\$(150)	\$(10)	\$(55)	\$(117)
Notional Values					
Volumes <sup>(2)</sup>					
Purchases	4,035	172	410	—	—
Sales	5,491	162	252	—	—
Canadian dollars	—	—	—	—	1,016
U.S. dollars	—	—	—	U.S. 479	U.S. 1,575
Japanese yen (in billions)	—	—	—	JPY 4.3	—
Cross-currency	—	—	—	227/U.S. 157	—
Net unrealized gains/(losses) in the year <sup>(3)</sup>	\$24	\$(23)	\$1	\$(9)	\$(61)
Net realized gains/(losses) in the year <sup>(3)</sup>	\$23	\$(2)	\$1	\$6	\$13
Maturity dates	2009-2014	2009-2011	2009	2009-2012	2009-2018
<b>Derivative Financial Instruments in Hedging Relationships<sup>(4)(5)</sup></b>					
Fair Values <sup>(1)</sup>					
Assets	\$115	\$—	\$—	\$2	\$8
Liabilities	\$(160)	\$(18)	\$—	\$(24)	\$(122)
Notional Values					
Volumes <sup>(2)</sup>					
Purchases	8,926	9	—	—	—
Sales	13,113	—	—	—	—
Canadian dollars	—	—	—	—	50
U.S. dollars	—	—	—	U.S. 15	U.S. 1,475
Cross-currency	—	—	—	136/U.S. 100	—
Net realized (losses)/gains in the year <sup>(3)</sup>	\$(56)	\$15	\$—	\$—	\$(10)
Maturity dates	2009-2014	2009-2011	—	2009-2013	2009-2019

<sup>(1)</sup> Fair value is equal to the carrying value of these derivatives.

<sup>(2)</sup> Volumes for power, natural gas and oil products derivatives are in gigawatt hours, billion cubic feet and thousands of barrels, respectively.

<sup>(3)</sup> All power, natural gas and oil products realized and unrealized gains and losses are included in Revenues. All interest rate and foreign exchange realized and unrealized gains and losses are included in Financial Charges and Interest Income and Other, respectively. Realized gains and losses are included in Net Income upon settlement of the financial instrument.

<sup>(4)</sup> All hedging relationships are designated as cash flow hedges except for interest-rate derivative financial instruments designated as fair value hedges with a fair value of \$8 million. In 2008, the Company did not record any amounts in Net Income related to ineffectiveness for fair value hedges.

<sup>(5)</sup> In 2008, Net Income included losses of \$6 million for the changes in fair value of power and natural gas cash flow hedges that were ineffective in offsetting the change in fair value of their related underlying positions. In 2008, there were no gains or losses included in Net Income for discontinued cash flow hedges.

The anticipated timing of settlement of the derivative contracts assumes no changes in commodity prices, interest rates and foreign exchange rates from December 31, 2008. Actual settlements will vary based on changes in these factors. The anticipated timing of settlement of these contracts is as follows:

<i>(millions of dollars)</i>	Total	2009	2010 and 2011	2012 and 2013	2014 and Thereafter
Derivative financial instruments held for trading	(30)	38	(46)	(14)	(8)
Derivative financial instruments in hedging relationships	(199)	(68)	(65)	(43)	(23)
	(229)	(30)	(111)	(57)	(31)

### **Derivative Financial Instruments Summary**

Information for the Company's derivative financial instruments is as follows:

<i>December 31</i> <i>(all amounts in millions unless otherwise indicated)</i>	2007			
	Power	Natural Gas	Foreign Exchange	Interest
<b>Derivative Financial Instruments Held for Trading</b>				
Fair Values <sup>(1)</sup>				
Assets	\$55	\$43	\$11	\$23
Liabilities	\$(44)	\$(19)	\$(79)	\$(18)
Notional Values				
Volumes <sup>(2)</sup>				
Purchases	3,774	47	–	–
Sales	4,469	64	–	–
Canadian dollars	–	–	–	615
U.S. dollars	–	–	U.S. 484	U.S. 550
Japanese yen (in billions)	–	–	JPY 9.7	–
Cross-currency	–	–	227/U.S. 157	–
Net unrealized gains/(losses) in the year <sup>(3)</sup>	\$16	\$(10)	\$8	\$(5)
Net realized (losses)/gains in the year <sup>(3)</sup>	\$(8)	\$47	\$39	\$5
Maturity dates	2008-2016	2008-2010	2008-2012	2008-2016
<b>Derivative Financial Instruments in Hedging Relationships<sup>(4)(5)</sup></b>				
Fair Values <sup>(1)</sup>				
Assets	\$135	\$19	\$–	\$2
Liabilities	\$(104)	\$(7)	\$(62)	\$(16)
Notional Values				
Volumes <sup>(2)</sup>				
Purchases	7,362	28	–	–
Sales	16,367	4	–	–
Canadian dollars	–	–	–	150
U.S. dollars	–	–	U.S. 113	U.S. 875
Cross-currency	–	–	136/U.S. 100	–
Net realized (losses)/gains in the year <sup>(3)</sup>	\$(29)	\$18	\$–	\$3
Maturity dates	2008-2013	2008-2010	2008-2013	2008-2013

- (1) Fair value is equal to the carrying value of these derivatives.
- (2) Volumes for power and natural gas derivatives are in gigawatt hours and billion cubic feet, respectively.
- (3) All power and natural gas realized and unrealized gains and losses are included in Revenues. All interest rate and foreign exchange realized and unrealized gains and losses are included in Financial Charges and Interest Income and Other, respectively. Realized gains and losses are included in Net Income upon settlement of the financial instrument.
- (4) All hedging relationships are designated as cash flow hedges except for interest rate derivative financial instruments designated as fair value hedges with a fair value of \$2 million. In 2007, the Company did not record any amounts in Net Income related to ineffectiveness for fair value hedges.
- (5) In 2007, Net Income included gains of \$7 million for the changes in fair value of power and natural gas cash flow hedges that were ineffective in offsetting the change in fair value of their related underlying positions. In 2007, Net Income included a loss of \$4 million for the changes in fair value of an interest-rate cash flow hedge that was reclassified as a result of discontinuance of cash flow hedge accounting when the anticipated transaction was not likely to occur by the end of the originally specified time period.

### ***Balance Sheet Presentation of Derivative Financial Instruments***

The fair value of the derivative financial instruments in the Company's Balance Sheet was as follows:

<i>December 31 (millions of dollars)</i>	<b>2008</b>	<b>2007</b>
<b>Current</b>		
Other current assets	<b>318</b>	160
Accounts payable	<b>(298)</b>	(144)
<b>Long-term</b>		
Other assets	<b>191</b>	204
Deferred amounts	<b>(694)</b>	(205)

## **OTHER RISKS**

### ***Development Projects and Acquisitions***

TransCanada continues to focus on growing its Pipelines and Energy operations through greenfield development projects and acquisitions. TransCanada capitalizes costs incurred on certain of its projects during the development period prior to construction when the project meets specific criteria and is expected to proceed through to completion. The related capital costs of a project that does not proceed through to completion would be expensed at the time it is discontinued. There is a risk with respect to TransCanada's acquisition of assets and operations that certain commercial opportunities and operational synergies may not materialize as expected and would subsequently be subject to an impairment writedown.

### ***Health, Safety and Environment Risk Management***

Health, safety and environment (HS&E) is a priority in all of TransCanada's operations and is guided by the Company's HS&E Commitment Statement. The Commitment Statement outlines guiding principles for a safe and healthy environment for TransCanada's employees, contractors and the public, and that strive to protect the environment. All employees are held responsible and accountable for HS&E performance. The Company is committed to being an industry leader in conducting its business so that it meets or exceeds all applicable laws and regulations, and minimizes risk to people and the environment. The Company is committed to tracking and improving its HS&E performance, and to promoting safety on and off the job in the belief that all occupational injuries and illnesses are preventable. TransCanada endeavours to do business with companies and contractors that share its perspective on HS&E performance and to influence them to improve their collective performance. TransCanada is committed to respecting the diverse environments and cultures in which it operates and to supporting open communication with the public, policy makers, scientists and public interest groups with whom it shares stewardship of the world it inhabits.

TransCanada is committed to ensuring compliance with its internal policies and regulated requirements. The HS&E Committee of TransCanada's Board of Directors monitors compliance with the Company's HS&E corporate policy

through regular reporting. TransCanada's HS&E management system is modeled on the International Organization of Standardization's (ISO) standard for environmental management systems, ISO 14001, and focuses resources on the areas of significant risk to the organization's HS&E business activities. Management is informed regularly of all important HS&E operational issues and initiatives through formal reporting processes. TransCanada's HS&E management system and performance are assessed by an independent outside firm every three years. The most recent assessment occurred in November 2006. The HS&E management system also is subject to ongoing internal review to ensure that it remains effective as circumstances change.

In 2008, employee and contractor health and safety performance continued to be a top priority. TransCanada's assets were highly reliable and there were no incidents that were material to TransCanada's operations.

The safety and integrity of the Company's pipelines is a top priority. The Company expects to spend approximately \$185 million in 2009 for pipeline integrity on its wholly owned pipelines, which is higher than the amount spent in 2008 primarily due to increased levels of in-line pipeline inspection on all systems. Under the approved regulatory models in Canada, pipeline integrity expenditures on NEB- and AUC-regulated pipelines are treated on a flow-through basis and, as a result, have no impact on TransCanada's earnings. Expenditures on the GTN System are also recovered through a cost recovery mechanism in its rates. Pipeline safety in 2008 continued to be very good, as TransCanada experienced only one small-diameter pipeline failure in a remote part of east central Alberta. The break resulted in minimal impact with no injuries or property damage. Spending associated with public safety on the Energy assets is focused primarily on the Company's hydro dams and associated equipment, and is consistent with previous years.

### Environment

TransCanada's facilities are subject to various federal, provincial, state and local statutes and regulations, including requirements to establish compliance and remediation obligations. Compliance obligations can result in significant costs associated with installing and maintaining pollution controls, fines and penalties resulting from any failure to comply, and potential limitations on operations. Remediation obligations can result in significant costs associated with the investigation and remediation of contaminated properties, some of which have been designated as Superfund sites by the U.S. Environmental Protection Agency under the *Comprehensive Environmental Response, Compensation and Liability Act*, and with damage claims arising out of the contamination of properties or impact on natural resources. It is not possible for the Company to estimate exactly the amount and timing of all future expenditures related to environmental matters due to:

- uncertainties in estimating pollution control and clean-up costs, including sites where only preliminary site investigation or agreements have been completed;
- the potential discovery of new sites or additional information at existing sites;
- the uncertainty in quantifying liability under environmental laws that impose joint and several liability on all potentially responsible parties;
- the evolving nature of environmental laws and regulations, including the interpretation and enforcement thereof; and
- the potential for litigation on existing or discontinued assets.

Environmental risks from TransCanada's operating facilities typically include: air emissions, such as nitrogen oxides, particulate matter and greenhouse gases; potential impacts on land, including land reclamation or restoration following construction; the use, storage or release of chemicals or hydrocarbons; the generation, handling and disposal of wastes and hazardous wastes; and water impacts such as uncontrolled water discharge. Environmental controls including physical design, programs, procedures and processes are in place to effectively manage these risks. TransCanada has ongoing inspection programs designed to keep all of its facilities in compliance with environmental requirements and the Company is confident that its systems are in material compliance with the applicable requirements.

In 2008, TransCanada conducted environmental risk assessments and remediation work, resulting in total costs of approximately \$7 million and US\$6 million for work conducted on TransCanada's Canadian and U.S. facilities, respectively. TransCanada also conducted various retirement, reclamation and restoration work in 2008, which resulted

in total costs of approximately \$7 million. At December 31, 2008, TransCanada had recorded liabilities of approximately \$86 million for compliance and remediation obligations. The Company believes it has considered all necessary contingencies and established appropriate reserves for environmental liabilities, however, there is the risk that unforeseen matters may arise requiring the Company to set aside additional amounts.

TransCanada is not aware of any material outstanding orders, claims or lawsuits against the Company in relation to the release or discharge of any material into the environment or in connection with environmental protection.

North American climate change policy continues to evolve at regional and national levels. While recent political and economic events may significantly affect the scope and timing of new measures that are put in place, TransCanada anticipates that most of the company's facilities in Canada and the U.S. will be captured under future regional and/or federal climate change regulations to manage industrial greenhouse gas (GHG) emissions.

In 2008, the Company owned assets in three regions affected by climate change policy measures related to industrial emissions. In Alberta, the Specified Gas Emitters Regulation, which came into effect in 2007, requires industrial facilities to reduce GHG emissions intensities by 12 per cent. TransCanada's Alberta-based pipeline and power facilities are subject to this regulation, as are the Sundance and Sheerness coal-fired power facilities with which TransCanada has commercial arrangements. The Company's total cost of compliance incurred by the Alberta-based facilities for the period from July 2007 to December 2007 was approximately \$12 million. Costs for 2008 compliance are estimated to be \$28 million and will be finalized when compliance reports are submitted in March 2009. Compliance costs of the Alberta System are recovered through tolls paid by customers. Recovery of compliance costs for the Company's power generation facilities and interests in Alberta is partially achieved through contracts and the impact of increased operating costs on Alberta power market prices.

The hydrocarbon royalty in Québec is collected by the natural gas distributor on behalf of the Québec government via a green fund contribution charge on gas consumed. In 2008, the cost pertaining to the Bécancour facility arising from the hydrocarbon royalty was less than \$1 million as a result of an agreement between TransCanada and Hydro-Québec to temporarily suspend the facility's power generation. The cost is expected to increase when the plant returns to service in 2010.

B.C.'s carbon tax, which came into effect in mid-2008, applies to carbon dioxide (CO<sub>2</sub>) emissions arising from fossil fuel combustion. Compliance costs for fuel combustion at the Company's compressor and meter stations in B.C. are recovered through tolls paid by customers. Costs related to the carbon tax for 2008 were \$1 million. This cost is expected to increase over the next four years as the tax charge per tonne of CO<sub>2</sub> increases by \$5 per tonne annually from the initial tax rate of \$10 per tonne.

TransCanada has assets located in Ontario and Manitoba, where the provincial governments have announced climate change strategies that will impact industrial sources of GHG emissions. The details of these programs and how they will align with the Canadian government's climate change policies are still uncertain.

The Canadian government has expressed interest in pursuing the development of a North American cap and trade system for GHG emissions. In April 2007, the Government of Canada released the Regulatory Framework for Air Emissions (Framework). The Framework outlines short-, medium- and long-term objectives for managing both GHG emissions and air pollutants in Canada. TransCanada expects a number of its facilities will be affected by pending federal climate change regulations that will be put in place to meet the Framework's objectives. It is not known at this time whether the impacts from the pending regulations will be material as the draft regulations have not yet been released. It is uncertain how the Framework will fit within a North American cap and trade system and what the specific requirements for industrial emitters will be.

Climate change is a strategic issue for the new U.S. government administration and federal policy to manage domestic GHG emissions is expected to be a priority. Seven western states and four Canadian provinces are focused on the implementation of a cap and trade program under the Western Climate Initiative (WCI). Northeastern states that are members of the Regional Greenhouse Gas Initiative (RGGI) implemented a CO<sub>2</sub> cap and trade program for electricity

generators effective January 1, 2009. Participants in the Midwestern Greenhouse Gas Reduction Accord, which involves six states and one province, are developing a regional strategy for reducing members' GHG emissions that will include a multi-sector cap and trade mechanism.

The Company anticipates a number of its facilities will be affected by these legislative initiatives. Under the RGGI, both the Ravenswood and OSP facilities will be required to submit allowances by December 31, 2011. It is expected that the costs will be recovered from the market and the net impact to TransCanada will be minimal. Company assets located in regions affected by the WCI and Midwestern Greenhouse Gas Reduction Accord and in California are most likely to be covered by GHG reduction measures put in place, however, the level of impact is uncertain as key policy details remain outstanding.

TransCanada monitors climate change policy developments and, when warranted, participates in policy discussions in jurisdictions where the Company has operations. The Company is also continuing its programs to manage GHG emissions from its facilities and to evaluate new processes and technologies that result in improved efficiencies and lower GHG emission rates.

## **CONTROLS AND PROCEDURES**

### ***Evaluation of Disclosure Controls and Procedures***

Disclosure controls and procedures are designed to provide reasonable assurance that information required to be disclosed in reports filed with, or submitted to, securities regulatory authorities is recorded, processed, summarized and reported within the time periods specified under Canadian and U.S. securities laws. The information is accumulated and communicated to management, including the President and Chief Executive Officer and the Chief Financial Officer, to allow timely decisions regarding required disclosure.

As at December 31, 2008, an evaluation of the effectiveness of TransCanada's disclosure controls and procedures as defined under the rules adopted by the Canadian securities regulatory authorities and by the SEC was carried out under the supervision and with the participation of management, including the President and Chief Executive Officer and the Chief Financial Officer. Based on this evaluation, the President and Chief Executive Officer and the Chief Financial Officer concluded that the design and operation of TransCanada's disclosure controls and procedures were effective as at December 31, 2008.

### ***Management's Annual Report on Internal Control over Financial Reporting***

Internal control over financial reporting is a process designed by or under the supervision of senior management and effected by the Board of Directors, management and other personnel to provide reasonable assurance regarding the reliability of financial reporting and preparation of consolidated financial statements for external purposes in accordance with Canadian GAAP, including a reconciliation to U.S. GAAP.

Management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting, no matter how well designed, has inherent limitations and can only provide reasonable assurance with respect to the preparation and fair presentation of published financial statements. Under the supervision and with the participation of the President and Chief Executive Officer and the Chief Financial Officer, management conducted an evaluation of the effectiveness of its internal control over financial reporting based on the framework in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company acquired Ravenswood in August 2008 and began consolidating the operations of Ravenswood from that date. Management has excluded this business from its evaluation of the effectiveness of the Company's internal control over financial reporting as of December 31, 2008. The net income attributable to this business represented less than one per cent of the Company's consolidated net income for the year ended December 31, 2008, and its aggregate total assets represented approximately nine per cent of the Company's consolidated total assets as at December 31, 2008.