



## MANAGEMENT'S DISCUSSION AND ANALYSIS

For the year ended December 31, 2007

(amounts in thousands of dollars unless otherwise noted)

The following discussion and analysis should be read in conjunction with the consolidated financial statements and Auditor's Report included in this annual report and any reference to financial statements or related note disclosures in this document refer to the consolidated financial statements and notes. The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles.

### OVERVIEW

Horizon Holdings Inc. (the "Corporation") is an investment holding company that owns 100% of the common equity of each of Horizon Utilities Corporation ("Horizon Utilities") and Horizon Energy Solutions Inc. ("Horizon Energy"). The common shareholdings of the Corporation are owned by Hamilton Utilities Corporation ("HUC") (78.9%) and St. Catharines Hydro Inc. ("SCHI") (21.1%).

The Corporation's principal operating subsidiary, Horizon Utilities, is an electricity distributor for residential and business customers within the municipalities of Hamilton and St. Catharines; the activities of which are regulated by the Ontario Energy Board ("OEB"), a Crown Corporation of the Province of Ontario. The OEB is the regulator of Ontario's natural gas and electricity industries. The *Energy Competition Act (Ontario), 1998* (the "ECA") and its enabling statutes and regulations distinguish and require the separation of regulated electricity businesses from non-regulated business activities. Horizon Utilities also provides certain non-regulated water billing and customer care services to the City of Hamilton.

Other non-regulated energy services provided by the Corporation, including water heater rentals and meter services, are provided through its wholly-owned subsidiary, Horizon Energy Solutions Inc.

### Horizon Utilities

Horizon Utilities is one of Ontario's largest municipally owned electricity distribution companies in Ontario. The Corporation distributes electricity through approximately 3,300 kilometres of a low-voltage distribution system to approximately 232,600 residential and business customers. The distribution system serves all residents and businesses within the borders of Hamilton and St. Catharines with the exception of approximately 25,000 rural customers served by another electricity distributor.

The Corporation earns revenue from this business by charging its customers for the use of the distribution system. Such electricity distribution services charges, or distribution charges, comprise a fixed periodic service charge combined with a variable charge based on electricity consumption. The distribution charges are subject to the approval of the OEB.



Pursuant to industry regulation, the Corporation is required to be the default billing and collecting agent for all electricity related charges for all electricity industry participants, which, in addition to its own distribution charges, include transmission charges accruing to the provincially owned Hydro One Inc., commodity costs for electricity accruing to generators such as the provincially owned Ontario Power Generation Inc. ("OPGI"), service charges for market participants such as the Independent Electricity System Operator ("IESO"), and the "Debt Retirement Charge" which is a provincial charge directed to the repayment of certain debt obligations of the former Ontario Hydro which continue in the provincially owned Ontario Electricity Financial Corporation ("OEFC"). These other non-distribution charges represent "pass-through" charges accruing to these and other electricity industry participants and amounted to approximately 84% (2006 - 85%) of gross annual amounts billed by the Corporation. The Corporation must remit these non-distribution charges to other industry participants, irrespective of whether or not such charges are ultimately collected from customers, thus exposing the Corporation to credit risk well in excess of its own capacity to generate revenue. The Corporation has instituted credit policy to mitigate such risk.

### Horizon Energy

Horizon Energy was incorporated in the latter part of 2006 for the principle purpose of providing non-regulated energy services. On December 31, 2007, pursuant to an Asset Purchase Agreement, Horizon Energy acquired the water heater and sentinel light assets of St. Catharines Hydro Generation Inc., which represents its only business activity as of this date.

### **Electricity Regulation**

The Ontario Energy Board Act, 1998 (Ontario) ("OEB") conferred on the OEB increased powers and responsibilities to regulate the electricity industry in Ontario. These powers and responsibilities include approving or fixing rates for the transmission and distribution of electricity, providing continued rate protection for rural and remote electricity consumers, and ensuring that distribution companies fulfill obligations to connect and service customers. The OEB may also prescribe license requirements and conditions of service to electricity distributors which may include, among other things, record keeping, regulatory accounting principles, separation of accounts for distinct businesses, and filing and process requirements for rate setting purposes.

### *Rate Setting*

The distribution rates of the Corporation are based on a revenue requirement that provides a regulated Maximum Allowable Return on Equity ("MARE") on the amount of shareholder's equity supporting the business of electricity distribution.

On April 12, 2006, the OEB approved distribution rates for the Corporation, effective May 1, 2006. Such distribution rates provided for a revised MARE of 9.0% on the amount of shareholder's equity supporting the business of electricity distribution as at December 31, 2004. In prior years, such MARE was 9.88%.

On April 12, 2007, the OEB approved distribution rates for the Corporation, effective May 1, 2007. Such distribution rates were effectively adjusted upwards by 1.92% representing the Gross Domestic Product Inflationary Price Index net of an industry productivity expectation of 1%; for a net increase of 0.92%.

On October 22, 2007, the Corporation filed an application for electricity distribution rates to be effective May 1, 2008. It is anticipated that the regulated MARE may decline to a level between 8.5% and 8.9% based on the methodology prescribed by the OEB for determining such. Such application based distribution rates on a 2008 forecast of the amount of shareholder's equity required to support the business of electricity distribution.

### *Regulatory Accounting*

In its capacity to approve or set rates, the OEB has the authority to specify regulatory accounting treatments that may differ from Canadian generally accepted accounting principles for enterprises operating in a non-rate regulated environment. The OEB has the general power to include or exclude costs, revenues, losses or gains in the rates of a specific period, resulting in a change in the timing of accounting recognition from that which would have applied in an unregulated company. Such change in timing involves the application of rate regulated accounting, giving rise to the recognition of regulatory assets and liabilities. The Corporation's regulatory assets represent certain amounts receivable from future customers and costs that have been deferred for accounting purposes because it is probable that they will be recovered in future rates. The Corporation's regulatory liabilities represent costs with respect to non-distribution market related charges and variances in recoveries that are expected to be settled in future periods.

### *The Electricity Restructuring Act (Ontario), 2004 (the "ERA")*

On December 9, 2004, the Province enacted the ERA, which provides for a restructuring of Ontario's electricity sector to promote the expansion of electricity supply and capacity, alternative and renewable energy sources, and conservation and demand management. Under the ERA, the commodity cost of electricity for certain customer classes will be determined by the OEB on an annual basis and based on a combination of regulated, contract and competitive market prices for electricity. There are few provisions in the ERA that apply to electricity distributors.

### *Smart Meter Initiative*

The Province of Ontario has committed to have "Smart Meter" electricity meters installed in all homes and small businesses throughout Ontario by the end of 2010. Smart Meters permit consumption to be recorded within specific time intervals and specific tariffs to be levied within such intervals. The *Energy Conservation and Responsibility Act*, provides the legislative framework and regulations to support this initiative.

In support of this initiative, the Corporation launched a Smart Meter pilot program in 2006 as part of its conservation and demand management plan approved by the OEB. The primary purpose of the pilot was to develop and test the processes, tools, and network infrastructure to support mass deployment in 2007 to 2010. The Corporation commenced a mass deployment of Smart Meters in 2007, with the installation of 53,217 Smart Meters within that year. The Corporation has installed a total of 60,944 Smart Meters as of the end of 2007.

Included in distribution rates effective May 1, 2006 was a charge for Smart Meters of \$0.39 per metered customer per month. Effective May 1, 2007, such charge was increased to \$0.82 per metered customer per month. On August 8, 2007, the OEB issued its decision approving the prudence of costs associated with Smart Meter activities by the Corporation for minimum Smart Meter infrastructure functionality. The current and outstanding rate applications of the Corporation include provision for the recovery of costs and MARE to support its mass deployment of Smart Meters in 2008. The Corporation anticipates that its distribution rates will continue to be adjusted annually for incremental investments related to its mass deployment plan for Smart Meters, which has been filed with the OEB.

**RESULTS OF OPERATIONS**

**Year Ended December 31, 2007 compared to Year Ended December 31, 2006**

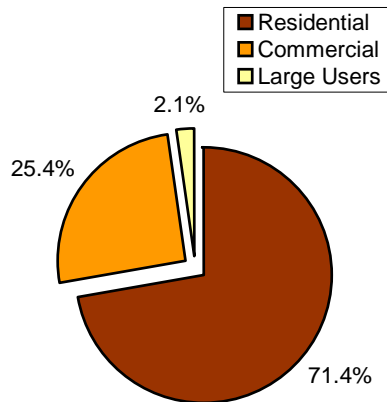
*Net income*

Net income for the year was \$14,745 compared to \$14,918 in the prior year, reflecting an increase in income from operating activities and gain on sale of fixed assets, partially offset by higher income taxes.

**Revenues**

	<u>2007</u>	<u>2006</u>
<i>Electricity distribution services charges</i>	\$84,797	\$79,610

Electricity distribution services charges for the year ended December 31, 2007 were \$84,797 compared to \$79,610 in 2006. The increase of \$5,187 was primarily due to increases in distribution rates to support the regulated annual rate of return, partially offset by a decrease in electricity consumption.



**2007 Distribution Revenue**

	<u>2007</u>	<u>2006</u>
<i>Other income from operations</i>	\$9,792	\$9,837

Other income from operations primarily comprises regulated service rate charges to customers, non-regulated water billing and customer care services provided to the City of Hamilton, late payment charges, pole attachment and other rental income, and miscellaneous other income. Other income decreased by less than 0.5% or \$45, reflecting lower rental income and other support services fees.

**Expenses**

	<u>2007</u>	<u>2006</u>
<i>Operating expenses</i>	\$41,687	\$38,027

Operating expenses include labour, material, equipment, and other third party service costs in support of the operation and maintenance of the distribution system; billing and collection; and general administration costs. Operating expenses increased by \$3,660, or 9.6% in 2007 primarily due to expenditures related to the selection, business process design, and implementation of an Enterprise Resource Planning software solution (\$1,700), increased credit losses (\$630), higher wages and benefits reflecting negotiated wage increases as well as an increase in staff complement, and professional fees associated with the Corporation's 2008 Electricity Distribution Rate Application (\$470).



	<u>2007</u>	<u>2006</u>
<i>Depreciation and amortization</i>	\$21,174	\$19,945

The increase in depreciation reflects an increase in capital investments over the past two years, particularly with respect to the Corporation's investment in Smart Meters and regulated conservation and demand management programs. In 2007, the electricity distribution business invested approximately \$38,601 in capital assets, as compared to approximately \$31,426 in 2006. The increase primarily reflects the Corporation's investment in Smart Meters. The Corporation has applied consistent amortization rates to its capital assets throughout the reporting period.

	<u>2007</u>	<u>2006</u>
<i>Interest income</i>	\$(642)	\$(792)
<i>Interest expense</i>	\$9,584	\$9,229

The net increase in interest income and expense over the prior year primarily reflects carrying charges realized on regulatory liabilities, as well as lower average cash balances throughout the year.

	<u>2007</u>	<u>2006</u>
<i>Payments in lieu of income and large corporations taxes</i>	\$8,425	\$8,170

The Corporation is currently exempt from taxes under the *Income Tax Act (Canada)* and the *Ontario Corporations Tax Act* (collectively referred to as the "Tax Acts").

Commencing October 1, 2001 and pursuant to the ECA, the Corporation is required to compute taxes under the Tax Acts and remit such amounts to OEFC to be applied against certain debt obligations of the former Ontario Hydro continuing in Ontario Electricity Financial Corporation.

The effective rate of PILs expense in 2007 was 36.36% (2006 – 35.39%) versus the statutory rate of 36.12% (2006 – 36.12%). The unfavourable effective rate primarily reflects an adjustment to future PILS to reflect an anticipated reduction in the future effective tax rate to 29.0% by 2012. The Federal Government received Royal Assent on December 14<sup>th</sup> for its Economic Statement of October 30, 2007 which provided for further reductions in the Federal Corporate Tax rate, in addition to those previously announced in its last budget. The Combined Federal and Corporate Income Tax Rate will decline from its present level of 36.12% to 29.00% by 2012. These changes resulted in a \$697 impairment in the Future PILs asset of the Corporation, reflecting a reduction in value of certain future tax deductions. Partially offsetting this unfavourable effective tax rate was a tax basis of depreciable capital property and eligible capital expenditure in excess of the book basis. The tax basis of the Corporation's assets was valued at fair value pursuant to the provisions of the Tax Acts as at the date the Corporation became subject to PILs.

## **LIQUIDITY AND CAPITAL RESOURCES**

### **Sources of liquidity and capital resources**

The principal sources of liquidity and capital resources comprise funds generated from operations and financing through lines of credit.

*Funds generated from operating activities*

Cash provided from operations was \$41,268 in 2007, as compared to \$19,848 in 2006. The increase was primarily due an increase in working capital, including timing differences between collections realized from customer receivables, amounts paid to third-parties with respect to non-distribution charges and decreases in accounts payable. Also, reflected in the prior year was the payment of approximately \$21,000 in Ontario Pricing Credits, which represents a refund to residential and small business electricity customers, schools, hospitals, and other customers covered by the Regulated Pricing Plan (“RPP”). Under the RPP, the OEB sets electricity prices based on a two-tiered structure with seasonal consumption thresholds. Electricity prices are reviewed at least annually, at which time refunds or price adjustments are made to reflect the actual cost of providing electricity.

*Financing activities*

Short-term and long-term liquidity was available to the Corporation throughout the year through a \$55,000 (2006 - \$55,000) credit facility. Pursuant to an Amended Credit Agreement dated January 20, 2006, HUC has made available a revolving line of credit up to \$55,000 to finance general corporate and working capital requirements. The Amended Credit Agreement matures on January 19, 2009. Interest rates payable on the Amended Credit Agreement are based on a margin above HUC’s borrowing rate, as determined by reference to HUC’s debt rating.

**Requirements for liquidity and capital resources**

The Corporation’s principal liquidity and capital resource requirements comprise its ongoing commitment to maintain, improve and expand its distribution and other infrastructure assets on a sustainable basis and in accordance with governing statutes and regulations; working capital requirements, including cost of power expense; the servicing and repayment of debt obligations; and the payment of dividends to its shareholder.

*Capital Expenditures*

Table 1: Capital Expenditures

Distribution system

The electricity distribution business operates within a mature and low-growth service area resulting in a predictable capital program that is largely based on routine replacement of aging infrastructure.

	<u>2007</u>	<u>2006</u>
Distribution system	\$22,039	\$25,465
Smart meters	6,557	-
Enterprise resource planning	2,244	-
Conservation and demand management	1,645	1,912
Other	6,730	4,048
<b>Total</b>	<b>\$39,215</b>	<b>\$31,425</b>

Smart Meters

The Province of Ontario has committed to have “Smart Meter” electricity meters installed in all homes and small businesses throughout Ontario by the end of 2010. Smart Meters permit consumption to be recorded within specific time intervals and specific tariffs to be levied within such intervals. The *Energy Conservation and Responsibility Act*, provides the legislative framework and regulations to support this initiative.



In 2006, as part of its conservation and demand management programs, the Corporation launched a Smart Meter pilot program to install 7,500 Smart Meters. The primary purpose of the pilot was to develop and test the processes, tools, and network infrastructure to support mass deployment in 2007 to 2010. The Corporation commenced a mass deployment of Smart Meters in 2007, with the installation of 53,217 Smart Meters within that year. The Corporation will continue its mass deployment program in 2008 with an anticipated 82,000 of additional installations, representing a capital investment of approximately \$11,000. The estimated total investment by the Corporation through to 2010 is \$35,000 - \$40,000. Such investment is anticipated to be supported by adjustments to future electricity distribution rates.

#### Enterprise Resource Planning

In 2007, the Corporation commenced the implementation of a new Enterprise Resource Planning ("ERP") software solution to support a migration towards leading and contemporary business processes in the areas of asset, work order, financial, human resources, and supply chain management. The project represents an \$8,000 - \$9,000 investment that includes business process mapping, solution design and implementation, and organizational change management. In 2007, the Corporation incurred approximately \$3,944 in costs related to the ERP implementation, including \$1,700 in operating expenditures related to business process design and documentation and change management initiatives and \$2,244 in work in progress related to software development and implementation costs. The ERP solution implementation is expected to be complete in 2008.

#### Other

Other capital expenditures include facilities, transportation equipment, furniture and office equipment and other work-related equipment. Additional non-recurring capital investments of approximately \$3,000 are anticipated over the next three years.

#### *Dividend requirements*

The Corporation paid dividends in the amount of \$10,451 in 2007 to its shareholders, compared to \$6,430 paid in 2006. Dividends on common shares are declared at the discretion of the Board of Directors, based on its approved dividend policy and recommendations of management. The dividend policy of the Corporation targets dividends of up to 60% of annual consolidated net earnings, subject to certain prudential considerations including statutory and contractual compliance, financial prudence, and providing for sustainable investment in electricity distribution infrastructure.

#### **RISK FACTORS**

The Audit and Risk Management Committee of the Board of Directors has adopted a mandate to identify the principal control risks in the business of the Corporation and to verify that effective control systems are in place to manage and mitigate these risks. The President and Chief Executive Officer has ultimate accountability for risk management and the Senior Vice-President and Chief Financial Officer is responsible to the President and Chief Executive Officer for the ongoing monitoring and review of the risk profile, policies and practices of the Corporation and ensuring that the risk management program is an integral part of business strategy and planning.

Significant risk factors affecting the businesses of the Corporation include:

### **Regulatory risk related to the electricity distribution business**

Regulatory risk is the risk that the Province and its regulator, the OEB, could establish a regulatory regime that imposes conditions that restrict the electricity distribution business from achieving an acceptable rate of return that permits financial sustainability of its operations including the recovery of expenses incurred for the benefit of other market participants in the electricity industry such as transition costs and other regulatory assets. All requests for changes in electricity distribution charges require the approval of the OEB.

### **Credit Risk**

Credit risk is the risk that one party to a financial instrument will fail to discharge an obligation and cause the other party to incur a financial loss.

The principal source of credit risk for the Corporation relates to the realization of its customer receivables. The legislation governing the operation of Ontario's electricity industry exposes the Corporation, through its electricity distribution operations, to credit risk of several multiples of its means to generate revenue. Pursuant to Provincial regulation, electricity distribution companies in Ontario are required to act as the billing agent for all industry participants and must remit billed amounts accruing to these participants irrespective of whether such amounts are ultimately collected. With the exception of the debt retirement charge, electricity distribution companies are exposed to losses for entire amounts billed to customers. Electricity distribution companies are not compensated for assuming this level of risk nor is there a clear and mechanistic regulatory means to recover losses for non-distribution charges.

Management has implemented credit and collection policies in accordance with the OEB regulation to mitigate the exposure of the Corporation to credit risk. Such policies have significantly improved credit loss experience with respect to residential customers. However, OEB regulation continues to impose certain restrictions on credit policy that exposes electricity distribution corporations to unmitigated and uncompensated credit risk of several multiples of their means to generate revenue.

The Corporation earns its revenue from a broad base of customers located in the City of Hamilton and the City of St. Catharines. One customer, the City of Hamilton, accounts for 3% (2006 – 3%) of revenue. No other single customer in either year would account for revenue in excess of 1% of the respective reported balances.

One customer, the City of Hamilton, accounts for 4% of accounts receivable at year-end. No other single customer accounts for more than 1% of accounts receivable at year-end.

Management actively monitors and manages its exposure to credit risk, within regulatory constraints, and records credit losses in the period in which, in management's opinion, the collection of related receivables becomes doubtful.

### **Labour Relations Risk**

Approximately 77% of the Corporation's employees are represented by the International Brotherhood of Electrical Workers Union ("IBEW"). The existing collective agreement with the IBEW expires on May 31, 2008. The Corporation faces financial risk related to the ability to negotiate a collective agreement consistent with its rate orders. In the event of a labour dispute, the Corporation could face some degree of operational risk related to continued compliance with its license requirements of providing service to customers.



### **Condition of Distribution Assets**

The Corporation's ability to continue to maintain and operate the distribution system reliably and safely in the future will depend on, among other things, the OEB allowing recovery of costs in respect of the Corporation's maintenance program and capital expenditure requirements for distribution plant refurbishment and replacement.

### **Extraordinary event risk**

Unforeseen extraordinary events could disrupt the ability of the electricity distribution business to deliver electricity to all or some of its customers. These risks include weather disasters, major accidents or other involuntary events that may affect the electricity distribution system.

The Corporation has no obligation to deliver an uninterrupted supply of electricity due to extraordinary events, thereby avoiding third party liability concerns.

The Corporation may make application to the Ministry of Energy for rate increases to recover costs incurred as a result of extraordinary circumstances impacting the electricity distribution system.

### **OUTLOOK**

In 2008, the Corporation will continue to focus on the delivery of safe, reliable, and cost-effective electricity distribution services, providing unparalleled customer value, and helping to create a culture of energy conservation in Ontario.

The Corporation remains committed to meeting its strategic objectives of being the best managed utility, being easy to do business with, financial excellence, and being a great place to work for its employees. Certain supporting initiatives in 2008 to meet these objectives include pursuing merger strategy, and the transformation of business processes and practices through the implementation of a new Enterprise Resource Planning software solution.

With respect to its merger strategy, the Corporation signed a Memorandum of Understanding with Guelph Hydro Electric Systems Inc. in August 2007 to develop a business case for a strategic merger. The business case will establish the terms and conditions that could result in a merger agreement. Management expects to complete the business case and seek approval from its respective shareholders in the first half of 2008. Management believes that this merger, if completed, will deliver savings through economies of scale, lower distribution rates, and improved financial position to maintain and improve electricity distribution systems.

Overall, management believes that the Corporation is well positioned to meet its strategic objectives while continuing to maintain a healthy financial condition and earn its regulated returns.



## **FORWARD LOOKING STATEMENTS AND INFORMATION**

Certain information included herein constitutes “forward looking information”. Forward looking information means disclosures regarding possible events, conditions or results that are based on assumptions about future economic conditions and courses of action. In some cases, forward looking information can be identified by terminology such as “may”, “will”, “should”, “expect”, “anticipate”, “believe”, “estimate”, “predict”, “potential”, “continue” or the negative of these terms or other comparable terminology. Although the Corporation believes that it has a reasonable basis for the forward looking information included herein, such information is subject to a number of risks and uncertainties that may cause actual events, conditions or results to differ materially from those contemplated by the forward looking information. Some of the factors that could cause such differences include legislative or regulatory developments, financial market conditions, general economic conditions and weather. The Corporation does not undertake any obligation to update publicly or to revise any of the forward looking information included herein after the date hereof, whether as a result of new information, future events or otherwise.

This management’s discussion and analysis is dated as at February 6, 2008.