



## **HORIZON HOLDINGS INC.**

### **MANAGEMENT'S DISCUSSION AND ANALYSIS**

For the year ended December 31, 2008

and

### **AUDITORS' REPORT TO THE SHAREHOLDERS**

And Consolidated Financial Statements

Year Ended December 31, 2008 and

December 31, 2007

**MANAGEMENT'S DISCUSSION AND ANALYSIS**  
**For the year ended December 31, 2008**  
**(amounts in thousands of dollars unless otherwise noted)**

The following discussion and analysis should be read in conjunction with the consolidated financial statements of Horizon Holdings Inc. for the year ended 2008 and accompanying Auditor's 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. ("SCH") (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. 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 234,000 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 located in Hamilton, which are 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 volumetric 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 Networks Inc., commodity costs for electricity payable to the Independent Electricity System Operator (“IESO”) and accruing to generators such as the provincially owned Ontario Power Generation Inc. (“OPGI”), service charges for market participants such as the IESO, and the “Debt Retirement Charge” which is a provincial charge directed to the repayment of certain stranded debt obligations of the former Ontario Hydro which continue in the provincially owned Ontario Electricity Financial Corporation (“OEFCE”). These other non-distribution charges represent “pass-through” charges accruing to these and other electricity industry participants and amounted to approximately 83% (2007 - 84%) 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 provides non-regulated energy services of water heater and sentinel light rentals and maintenance, and meter services. On July 31, 2008, pursuant to an Asset Purchase Agreement, Horizon Energy acquired a meter services business and related customer contracts from its affiliate, Horizon Utilities.

### **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 residential 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, which is also determined by regulation.

On April 12, 2006, the OEB approved distribution rates for the Corporation, effective May 1, 2006 to April 30, 2007. 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 from 2006 levels by 1.92%, representing the Gross Domestic Product Inflationary Price Index for Final Domestic Demand (“GDP IPI-FDD”) 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 ("2008EDR Application"). Such application based distribution rates on a 2008 forecast of the amount of operating and capital expenses, debt, and shareholder's equity required to support the business of electricity distribution. The distribution rates applied for further included provision for the cost of debt capital, payments in lieu of corporate taxes, and the MARE.

On March 7, 2008, and in accordance with its report on Cost of Capital and 2<sup>nd</sup> Generation Incentive Regulation for Electricity Distributors, the OEB revised the MARE from 9.00% to 8.57% and deemed short-term debt rate from 4.77% to 4.47%. This change was effective May 1, 2008.

On October 3, 2008, the OEB issued its decision regarding the 2008EDR Application. Such decision provided for 2008 base distribution revenue requirement and rate base of \$86,662 and \$346,420, respectively. Such amounts do not include provision for the investment of the Corporation in the Smart Meter Initiative, further elaborated below. This decision did, however, provide for the Corporation to file a separate application for a rate adder to recover its ongoing investment in Smart Meters and related expenses including financing charges and MARE, which are recorded in a deferral account and will be subjected to a future prudence review of the OEB. This decision also provided for the recovery of \$868 of lost revenue and shared provincial savings related to certain conservation and demand management ("CDM") programs of the Corporation delivered in 2005 and 2006.

On November 17, 2008, the Corporation submitted its 2009 electricity distribution rate application ("2009EDR Application") to adjust its electricity distribution rates based on the 3<sup>rd</sup> Generation Incentive Rate Mechanism ("3G-IRM") of the OEB, applicable to all Ontario electricity distributors. Such adjustments are to be effective May 1, 2009. The 3G-IRM provides for a formulaic adjustment to electricity distribution rates. Such adjustment includes, among other components, an increase in distribution rates for the annual change in the GDP IPI-FDD net of a productivity factor of 1% and a "Stretch Factor" determined by the relative efficiency of an electricity distributor. The Stretch Factor applicable to the Corporation as of the effective date of the 2009EDR Application is 0.4%.

### *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 recent OEB decision on the 2008EDR Application provided for the disposition of \$7,373 of the Corporation's net regulatory liabilities over a twenty-nine month period ending April 30, 2011.

*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.

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 has installed approximately 140,000 Smart Meters as of the end of 2008 and anticipates having installed a total of 236,000 Smart Meters upon completion of its mass deployment.

**RESULTS OF OPERATIONS**

**Year Ended December 31, 2008 compared to Year Ended December 31, 2007**

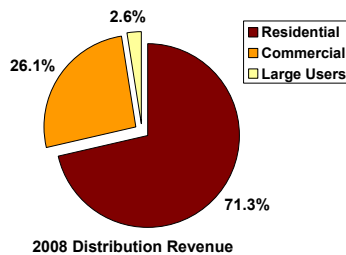
*Net income*

Net income for the year was \$15,105 compared to \$14,745 in the prior year, reflecting a decrease in income from operating activities, gains on sales of fixed assets, and interest income and expense, net of lower income taxes.

**Revenues**

	<u>2008</u>	<u>2007</u>
<i>Electricity distribution services charges</i>	\$88,335	\$84,797

The increase of \$3,538 was primarily due to the outcome of the 2008EDR Application which provided for average increases in distribution rates, one-time recoveries of certain regulatory costs, and recoveries of lost revenue and shared savings related to the Corporation’s CDM programs, partially offset by a decrease in electricity consumption during the year.



	<u>2008</u>	<u>2007</u>
<i>Other income from operations</i>	\$10,090	\$9,792

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 charges, water heater rentals, meter services revenue, and miscellaneous other income. Other income increased modestly by 3% relative to 2007, representing modest increases in water billing and water heater rentals net of lower meter services revenue.

### Expenses

	<u>2008</u>	<u>2007</u>
<i>Operating expenses</i>	\$43,997	\$41,687

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 \$2,310, or 5.5% in 2008. The increase is primarily due to an increase in vegetation management near electricity lines and poles (\$800); various asset management and process improvement initiatives (\$500); and expenses related to the development of a merger opportunity that was unsuccessful (\$630); and general wage and price inflation.

	<u>2008</u>	<u>2007</u>
<i>Depreciation and amortization</i>	\$23,481	\$21,174

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 2008, the electricity distribution business invested approximately \$42,045 in capital assets, as compared to approximately \$39,253 in 2007. The increase primarily reflects the Corporation's investment in Smart Meters and new enterprise resource planning software. The Corporation has applied consistent amortization rates to its capital assets throughout the reporting period.

	<u>2008</u>	<u>2007</u>
<i>Interest income</i>	\$ (312)	\$ (642)
<i>Interest expense</i>	\$9,558	\$9,584

The modest increase in net interest expense over the prior year primarily reflects lower average cash balances throughout the year and lower rates of interest in 2008 on cash balances, credit support for service delivery, and net regulatory liabilities.

	<u>2008</u>	<u>2007</u>
<i>Payments in lieu of income and large corporations taxes</i>	\$6,641	\$8,425

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 stranded debt obligations of the former Ontario Hydro continuing in Ontario Electricity Financial Corporation.

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. This results in a long-term favourable impact on effective tax rates, resulting from a tax basis of depreciable capital property and eligible capital expenditure in excess of the book basis.

The effective rate of PILs expense in 2008 was 30.53% (2007 – 36.36%) versus the statutory rate of 33.50% (2007 – 36.12%). The favourable effective rate in 2008, relative to the statutory rate, primarily reflects a tax basis of depreciable capital property and eligible capital expenditure in excess of the book basis, as noted above. The effective tax rate in 2007 was adversely impacted by an adjustment to future PILs of \$697 to reflect an anticipated reduction in the future effective tax rate to 29.0% by 2012.

## **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 \$39,852 in 2008, as compared to \$41,306 in 2007. The modest decrease in 2008 was primarily the result of a relatively flat change in other assets and liabilities during 2008 versus a decrease in 2007, somewhat offset by an increase in depreciation. The decrease in 2007 other assets and liabilities was due to 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.

#### *Financing activities*

Short-term and long-term liquidity was available to the Corporation throughout the year through a \$55,000 (2007 - \$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, 2010. 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, which is A+/stable as of the date of the Auditor's Report accompanying the financial statements.

### **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 shareholders.

*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>2008</u>	<u>2007</u>
Distribution system	\$23,456	\$22,039
Smart meters	10,419	6,557
Enterprise resource planning	3,567	2,244
Conservation and demand management	-	1,645
Other	4,603	6,768
<b>Total</b>	<b>\$42,045</b>	<b>\$39,253</b>

Smart Meters

The Corporation will continue its mass deployment program in 2009 with an anticipated 86,000 of additional installations, representing a capital investment of approximately \$8,500. The Corporation anticipates completing its mass deployment in 2010 with a final addition in that year of approximately 10,000 Smart Meters at an estimated cost of \$3,400. The total investment by the Corporation in Smart Meters and enabling technology through to 2010 is estimated at \$31,000. Such future incremental investment will be financed by adjustments to future electricity distribution rates.

Enterprise Resource Planning

In 2008, the Corporation completed its 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 \$8,700 investment that includes business process mapping, solution design and implementation, and organizational change management. In 2008, the Corporation incurred approximately \$4,796 in costs related to the ERP implementation, including \$1,229 in operating expenditures related to business process design and documentation and change management initiatives and \$3,567 in capital related to software development and implementation costs. ERP expenditures of a capital nature are recorded in Table 1.

Other

Other capital expenditures include facilities, transportation equipment, furniture and office equipment and other work-related equipment. Additional non-recurring capital investments of approximately \$2,000 are anticipated over the next three years.

*Dividend requirements*

The Corporation paid dividends in the amount of \$8,847 in 2008 to its shareholders, compared to \$10,451 paid in 2007. 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 regular 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% (2007 – 3%) of revenue. No other single customer in either year would account for revenue in excess of 1% of the respective reported balances.

No single customer accounts for more than 1% of accounts receivable at year-end. In 2007, one customer, the City of Hamilton, accounted for 4% of accounts receivable.

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, 2011. The Corporation bears 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 OEB for rate increases to recover costs incurred as a result of extraordinary circumstances impacting the electricity distribution system.

## **SIGNIFICANT ACCOUNTING POLICIES**

### **Changes in Accounting Standards**

#### *Capital Disclosures*

Effective January 1, 2008, the Corporation adopted CICA Handbook Section 1535 Capital Disclosures, which establishes new accounting standards regarding capital disclosures. Under Section 1535, an entity is required to disclose information regarding its objectives, policies and processes for managing capital as well as its compliance with any external capital requirements. This standard did not have any impact on the Financial Statements.

### *Financial Instruments*

Effective January 1, 2008, the Corporation adopted CICA Handbook Sections 3862 Financial Instruments Disclosures and 3863 Financial Instruments Presentation. The adoption of the new standard requires the disclosure of qualitative and quantitative information about the Corporation's risks associated with recognized and unrecognized financial instruments. The adoption of the new standard on presentation carried forward unchanged the presentation requirements from Section 3861 Financial Instruments Disclosure and Presentation, and therefore did not have any impact on the Financial Statements.

### *Inventories*

Effective January 1, 2008, the Corporation adopted Canadian Institute of Chartered Accountant's (CICA) Handbook Section 3031 Inventories. Under the new standard, inventories are required to be measured at the lower of cost and net realizable value and any items considered to be major future components of property, plant and equipment are to be transferred to fixed assets. This new standard also provides updated guidance on the appropriate methods of determining cost and the impact of any write-downs to net realizable value. The implementation of this standard did not have any impact on the Corporation's results of operations.

## **Future Accounting Pronouncements**

### *Rate-Regulated Operations*

In August 2007, the Canadian Accounting Standards Board (AcSB) issued a decision, effective January 1, 2009, to withdraw the temporary exemption in CICA Handbook Section 1100 Generally Accepted Accounting Principles, which permits the recognition and measurement of assets and liabilities arising from rate regulation. Further, CICA Handbook Section 3465 Income Taxes was amended to require the recognition of future income tax liabilities and assets for regulated enterprises that were previously not subject these provisions. Consequently, the Company will be required to reflect on its Consolidated Balance Sheet, the effect of applying the liability method when accounting for payments in lieu of corporate income taxes and a corresponding regulatory asset. The Company is currently assessing the impact of the AcSB's decision on its Consolidated Balance Sheet.

### *Goodwill and Intangibles*

In January 2008, the CICA issued Handbook Section 3064 Goodwill and Intangible Assets, and amended Handbook Section 1000 Financial Statement Concepts, and Accounting Guideline 11 Enterprises in the Development Stage and withdrew Handbook Section 3450 Research and Development Costs. Handbook Section 3064 clarifies that costs may only be deferred when they relate to an item that meets the definition of an asset. The concept of matching revenues and expenses remains appropriate for allocating the cost of an asset that is consumed in general revenue over multiple reporting periods. Handbook Sections 3064 replaces Handbook Section 3062 and provides extensive guidance on when expenditures qualify for recognition as intangible assets. These changes are effective for fiscal years beginning on or after October 1, 2008. The Corporation is currently in the process of evaluating the potential impact of these standards on its financial statements.

### *International Financial Reporting Standards (“IFRS”)*

On February 13, 2008, the AcSB announced that publicly accountable enterprises will be required to adopt IFRS effective January 1, 2011. Some of these standards will be implemented in Canada during a transition period towards IFRS, with the remaining standards adopted at the date such standards become effective.

The Corporation has launched an IFRS conversion project, which consists of four phases: (1) initial assessment; (2) detailed assessment; (3) design; and (4) testing and implementation. The IFRS conversion project has a formal governance structure, including an Executive Sponsor, Steering Committee, and Project Management. The Corporation has also engaged experienced external advisors to assist with this project.

The Corporation completed Phase 1 of the IFRS conversion project in December 2008 and is currently in the process of evaluating the potential impact of the conversion to IFRS on its financial statements. Based on the initial assessment, the Corporation has determined that the areas of accounting differences with the highest potential impact to the Corporation are accounting for property, plant and equipment, rate regulated accounting, as well as initial adoption of IFRS under the provisions of IFRS 1, First-Time Adoption of IFRS. The Corporation is presently in Phase 2 of the project, which involves a detailed assessment and gap analyses of accounting and disclosure differences between Canadian GAAP and IFRS, and conducting an analysis of the available accounting choices to be made to address these differences and options available under IFRS 1.

### **OUTLOOK**

In 2009, the Corporation will continue to focus on the delivery of safe, reliable, and cost-effective electricity distribution services, providing excellent 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 performing utility, being easy to do business with, financial excellence, and being a great place to work for its employees. Certain supporting initiatives in 2009 to meet these objectives include pursuing mergers, the transformation of business processes and practices through the recent implementation of a new Enterprise Resource Planning software solution, investment in capital infrastructure renewal, deployment of Smart Meters, and conservation and demand management.

A general decline in the economy, such as that presently experienced in Ontario, often results in an increase in customer payment defaults and some reduction in energy consumption as business and residential customers seek to reduce their energy costs. These conditions may have an adverse impact on the Corporation’s revenues and credit losses. The Corporation may be able to mitigate some of these adverse impacts as noted under the Risk Factors section above.

The Corporation has conservative levels of debt capitalization that strongly support its debt servicing obligations.

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, 2009.

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**Horizon Holdings Inc.  
Auditors' Report to the Shareholders  
and Consolidated Financial Statements  
Year Ended December 31, 2008 and  
December 31, 2007**



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## AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the consolidated balance sheet of Horizon Holdings Inc. as at December 31, 2008 and the consolidated statements of income and retained earnings and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2008 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

A handwritten signature in black ink that reads 'KPMG LLP'. The signature is written in a cursive, slightly slanted style. Below the signature is a horizontal line that starts under the 'K' and ends under the 'P'.

Chartered Accountants, Licensed Public Accountants

Hamilton, Canada  
February 6, 2009

**Consolidated Balance Sheet**  
(in thousands)

As at December 31, 2008

	2008	2007
<b>ASSETS</b>		
<b>Current assets</b>		
Cash and cash equivalents .....	\$ 4,355	\$ 14,406
Accounts receivable .....	88,631	81,402
Inventory [note 3] .....	5,940	6,378
Other assets [note 4] .....	1,645	1,875
	<b>100,571</b>	104,061
<b>Fixed assets [note 5] .....</b>	<b>308,277</b>	291,050
<b>Future payments in lieu of taxes .....</b>	<b>5,192</b>	4,750
<b>Goodwill .....</b>	<b>18,923</b>	18,923
<b>Total assets .....</b>	<b>\$ 432,923</b>	\$ 418,784
<b>LIABILITIES AND SHAREHOLDER'S EQUITY</b>		
<b>Current liabilities</b>		
Accounts payable and accruals .....	\$ 59,702	\$ 53,589
Accounts payable to corporations under common control .....	12,245	17,879
Credit support for service delivery [note 7] .....	24,792	23,848
	<b>96,739</b>	95,316
<b>Long-term liabilities</b>		
Long-term borrowings [note 8] .....	116,000	116,000
Employee future benefits [note 9] .....	16,294	15,964
Net regulatory liabilities [note 10] .....	28,629	22,501
	<b>160,923</b>	154,465
<b>Total liabilities .....</b>	<b>257,662</b>	249,781
<b>Shareholders' equity</b>		
Share capital [note 11] .....	123,594	123,594
Contributed surplus .....	15,218	15,218
Retained earnings .....	36,449	30,191
<b>Total shareholders' equity .....</b>	<b>175,261</b>	169,003
<b>Total liabilities and shareholders' equity .....</b>	<b>\$ 432,923</b>	\$ 418,784

**Commitments and contingencies [note 13]**

On behalf of the Board:



Director



Director

## Consolidated Statement of Income and Retained Earnings

(in thousands)

For the year ended December 31, 2008

	2008	2007
Electricity distribution service charges <i>[note 14]</i> .....	\$ 88,335	\$ 84,797
Other income from operations <i>[note 15]</i> .....	10,090	9,792
	<b>98,425</b>	94,589
Expenses:		
Operating expenses <i>[note 17]</i> .....	43,997	41,687
Depreciation and amortization <i>[note 5]</i> .....	23,481	21,174
	<b>67,478</b>	62,861
<b>Income from operating activities</b> .....	<b>30,947</b>	31,728
Gain on sale of assets .....	45	384
Interest income .....	312	642
Interest expense <i>[note 8]</i> .....	<b>(9,558)</b>	(9,584)
<b>Income before payments in lieu of taxes</b> .....	<b>21,746</b>	23,170
Payments in lieu of income and large corporations taxes <i>[note 6]</i> .....	<b>(6,641)</b>	(8,425)
<b>Net income</b> .....	<b>15,105</b>	14,745
<b>Retained earnings, beginning of year</b> .....	<b>30,191</b>	25,897
Dividends paid .....	<b>(8,847)</b>	(10,451)
<b>Retained earnings, end of year</b> .....	<b>\$ 36,449</b>	\$ 30,191

## Consolidated Statement of Cash Flows

(in thousands)

For the year ended December 31, 2008

	2008	2007
<b>OPERATING ACTIVITIES</b>		
Net income .....	\$ 15,105	\$ 14,745
Add (deduct) non-cash items:		
Depreciation and amortization .....	24,818	22,209
Future payments in lieu of taxes .....	(402)	(542)
Net change in employee future benefits .....	330	362
Gain on sale of assets .....	(45)	(384)
Net change in other assets and liabilities .....	46	4,916
<b>Cash provided by operating activities</b> .....	<b>39,852</b>	<b>41,306</b>
<b>INVESTING ACTIVITIES</b>		
Additions to fixed assets .....	(42,045)	(39,253)
Proceeds received on sale of fixed assets .....	45	432
<b>Cash used in investing activities</b> .....	<b>(42,000)</b>	<b>(38,821)</b>
<b>FINANCING ACTIVITIES</b>		
Net change in credit support for service delivery .....	944	2,756
Dividends paid in the year .....	(8,847)	(10,451)
<b>Cash used in financing activities</b> .....	<b>(7,903)</b>	<b>(7,695)</b>
<b>Net decrease in cash and cash equivalents</b>		
<b>during the year</b> .....	<b>(10,051)</b>	<b>(5,210)</b>
<b>Cash and cash equivalents, beginning of year</b> .....	<b>14,406</b>	<b>19,616</b>
<b>Cash and cash equivalents, end of year</b> .....	<b>\$ 4,355</b>	<b>\$ 14,406</b>
<b>Supplemental disclosure of cash flow information</b>		
Interest received .....	\$ 372	\$ 654
Interest paid .....	\$ (9,060)	\$ (8,997)
Taxes paid .....	\$ (9,630)	\$ (10,163)

## **1) BUSINESS OF CORPORATION**

On October 18, 2006, Horizon Holdings Inc. (the "Corporation") was incorporated under the Business Corporations Act (Ontario). The Corporation is an investment holding company with a 100% ownership interest in 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%).

Horizon Utilities is one of Ontario's largest municipally owned electricity distribution companies in Ontario, delivering electricity and related utility services to more than 234,000 residential and commercial customers in Hamilton and St. Catharines.

Horizon Energy was incorporated to provide non-regulated energy services, including water heater rentals and meter services.

## **2) SIGNIFICANT ACCOUNTING POLICIES**

The financial statements have been prepared in accordance with generally accepted accounting principles in Canada consistently applied. The more significant accounting policies are summarized below:

### **a) Basis of consolidation**

The consolidated balance sheet as at December 31, 2007 includes the accounts of the Corporation, Horizon Utilities, and Horizon Energy.

On December 31, 2007, pursuant to Share and Note Transfer Agreements between the Corporation, HUC and SCHI, the Corporation purchased 100 percent of the Class 1 and Class A Common Shares of Horizon Utilities in exchange for 7,101 Class 1 Common Shares and 1,899 Class A Common Shares of the Corporation. These transactions were with related parties and did not result in any substantive change in the beneficial ownership of Horizon Utilities. As such, the consolidated financial statements include the operating results and financial position of Horizon Utilities on a comparative basis.

All significant inter-company accounts and transactions have been eliminated.

### **b) Regulation**

The Ontario Energy Board Act, 1998 (Ontario) ("OEBA") conferred on the Ontario Energy Board ("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.

## 2) SIGNIFICANT ACCOUNTING POLICIES (Continued)

### b) Regulation (continued)

#### *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, which is also determined by regulation.

On April 12, 2006, the OEB approved distribution rates for the Corporation, effective May 1, 2006 to April 30, 2007. 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 from 2006 levels by 1.92%, representing the Gross Domestic Product Inflationary Price Index for Final Domestic Demand ("GDP IPI-FDD") 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 ("2008EDR Application"). Such application based distribution rates on a 2008 forecast of the amount of operating and capital expenses, debt, and shareholder's equity required to support the business of electricity distribution. The distribution rates applied for further included provision for the cost of debt capital, payments in lieu of corporate taxes, and the MARE.

On March 7, 2008, and in accordance with its report on Cost of Capital and 2<sup>nd</sup> Generation Incentive Regulation for Electricity Distributors, the OEB revised the MARE from 9.00% to 8.57% and deemed short-term debt rate from 4.77% to 4.47%. This change was effective May 1, 2008.

On October 3, 2008, the OEB issued its decision regarding the 2008EDR Application. Such decision provided for 2008 base distribution revenue requirement and rate base of \$86,662 and \$346,420, respectively. Such amounts do not include provision for the investment by the Corporation in the Smart Meter Initiative, further elaborated below. This decision did, however, provide for the Corporation to file a separate application for a rate adder to recover its ongoing investment in Smart Meters and related expenses including financing charges and MARE, which are recorded in a deferral account and will be subject to a future prudence review of the OEB. This decision also provided for the recovery of \$868 of lost revenue and shared provincial savings related to certain conservation and demand management ("CDM") programs of the Corporation delivered in 2005 and 2006.

## 2) SIGNIFICANT ACCOUNTING POLICIES (Continued)

### b) Regulation (continued)

On November 17, 2008, the Corporation submitted its 2009 electricity distribution rate application (“2009EDR Application”) to adjust its electricity distribution rates based on the 3<sup>rd</sup> Generation Incentive Rate Mechanism (“3G-IRM”) of the OEB, applicable to all Ontario electricity distributors. Such adjustments are to be effective May 1, 2009. The 3G-IRM provides for a formulaic adjustment to electricity distribution rates. Such adjustment includes, among other components, an increase in distribution rates for the annual change in the GDP IPI-FDD net of a productivity factor of 1% and a “Stretch Factor” determined by the relative efficiency of an electricity distributor. The Stretch Factor applicable to the Corporation as of the effective date of the 2009EDR Application was 0.4%.

#### *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 recent OEB decision on the 2008EDR Application provided for the disposition of \$7,373 of the Corporation’s net regulatory liabilities over a twenty-nine month period ending April 30, 2011.

Specific regulatory assets and liabilities are disclosed in Note 10.

#### *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.

## 2) SIGNIFICANT ACCOUNTING POLICIES (Continued)

### b) Regulation (continued)

#### *Smart Meter Initiative*

The Province of Ontario has committed to have “Smart Meter” electricity meters installed in 800,000 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 Corporation has installed approximately 140,000 Smart Meters as of the end of 2008 and anticipates having installed a total of 236,000 Smart Meters upon completion of its mass deployment.

### c) Financial instruments

On January 1, 2007, the Corporation adopted CICA Handbook Section 3855 Financial Instruments – Recognition and Measurement and Section 3861 Financial Instruments – Disclosure and Presentation. These standards provide accounting guidelines for the recognition and measurement of financial assets and financial liabilities and related disclosures.

Under these standards, all financial assets are classified as held-for-trading, held-to-maturity, loans and receivables, or available-for-sale and all financial liabilities must be classified as held-for-trading or other financial liabilities.

All financial instruments are carried on the balance sheet at fair value except for loans and receivables, held-to-maturity investments and other liabilities, which are measured at amortized cost.

The Corporation has classified its financial instruments as follows:

Cash and cash equivalents	Held-for-trading
Accounts receivable	Loans and receivables
Accounts payable and accruals	Other liabilities
Credit support for service delivery	Other liabilities
Long-term borrowings	Other liabilities

Effective January 1, 2008, the Corporation adopted CICA Handbook Sections 3862 Financial Instruments Disclosures and 3863 Financial Instruments Presentation. The adoption of the new standard requires the disclosure of qualitative and quantitative information about the Corporation’s risks associated with recognized and unrecognized financial instruments. The adoption of the new standard on presentation carried forward unchanged the presentation requirements from Section 3861, Financial Instruments Disclosure and Presentation, and therefore did not have any impact on the Financial Statements.

## 2) SIGNIFICANT ACCOUNTING POLICIES (Continued)

### d) Measurement uncertainty

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and note disclosures related thereto. Due to the inherent uncertainty in making estimates, actual results could differ from estimates recorded in preparing these financial statements, including changes as a result of future regulatory decisions.

Accounts receivable and regulatory assets are stated after evaluation of amounts expected to be collected and an appropriate allowance for doubtful accounts. Inventory is recorded net of provisions for obsolescence. Amounts recorded for depreciation and amortization of equipment are based on estimates of useful service life. Employee future benefits are based on certain assumptions, including interest (discount) rate, salary escalation, the average retirement age of employees, employee turnover and expected health and dental care costs.

### e) Cash and cash equivalents

Cash equivalents comprise overnight deposits in an investment account with a Schedule A bank. Investments are carried at cost, which approximates fair value.

### f) Inventory

Effective January 1, 2008, the Corporation adopted Canadian Institute of Chartered Accountant's (CICA) Handbook Section 3031, Inventories. Under the new standard, inventories are required to be measured at the lower of cost and net realizable value and any items considered to be major future components of property, plant and equipment are to be transferred to fixed assets. This new standard also provides updated guidance on the appropriate methods of determining cost and the impact of any write-downs to net realizable value. The implementation of this standard did not have any impact on the Corporations' results of operations.

### g) Fixed assets and depreciation

Fixed assets are recorded at cost, including the cost of work in process, and are removed from the accounts at the end of their estimated service lives, except in those instances where specific identification allows their removal at retirement or disposition. For specifically identifiable assets, gains or losses at retirement or on disposition are credited or charged to other income, otherwise, no gain or loss is recognized unless a sale has occurred.

## 2) SIGNIFICANT ACCOUNTING POLICIES (Continued)

### g) Fixed assets and depreciation (continued)

Depreciation is calculated on a straight-line basis over the estimated service life of fixed assets as follows:

Land rights	50 years
Buildings	25-30 years
Distribution stations	30 years
Distribution lines – overhead and underground	25 years
Distribution transformers	25 years
Distribution meters	25 years
Other fixed assets	3-15 years

Work in process reflects the cost of construction materials and applied labour and overheads consumed in partially completed capital projects, and is not depreciated.

### h) Goodwill

Goodwill represents the amount by which the purchase price of an acquired business exceeds the fair value of the net identifiable assets purchased.

Goodwill is not amortized and is evaluated for impairment on an annual basis, or more frequently if circumstances require, with any write-down of the carrying value of goodwill being charged against the results of operations. Goodwill impairment is assessed based on a comparison of the fair value of the reporting unit to the underlying carrying value of the reporting unit's net assets, including goodwill.

### i) Credit support for service delivery

Credit support for service delivery represents cash deposits from electricity distribution customers and retailers, as well as construction deposits.

Deposits from electricity distribution customers are applied against any unpaid portion of individual customer accounts. Customer deposits in excess of unpaid account balances are refundable to individual customers upon termination of their electricity distribution service.

Customer deposits are also refundable to residential electricity distribution customers demonstrating an acceptable level of credit risk, as determined by the Corporation.

## **2) SIGNIFICANT ACCOUNTING POLICIES (Continued)**

### **i) Credit support for service delivery (continued)**

Pursuant to the Ontario Energy Board retail settlement code, the Corporation is entitled to security from retailers to guarantee the payment of the difference between the market price for electricity and the retailer's average contract price.

Construction deposits represent cash prepayments for the estimated cost of capital projects recoverable from customers and developers. Upon completion of the capital project, these deposits are transferred to capital contributions in aid of construction.

### **j) Employee future benefits**

The Corporation pays certain health, dental and life insurance benefits, under unfunded defined benefit plans, on behalf of its retired employees.

Employee future benefits are recorded on an accrual basis. The accrued benefit obligations and current service cost are calculated using the projected benefit method pro rated on service and reflect management's best estimate of certain underlying assumptions. The current service cost for a period is equal to the actuarial present value of benefits attributed to that period in which employees rendered their services. Past service costs from plan amendments are amortized on a straight-line basis over the average remaining service period of employees active at the date of the amendment. The excess of actuarial gains (losses) over 10% of the accrued benefit obligation is amortized into expense on a straight-line basis over the expected average remaining service life of active employees.

### **k) Pension plan**

The Corporation provides a pension plan for its employees through the Ontario Municipal Employees Retirement System ("OMERS"). OMERS is a multi-employer pension plan which operates as the Ontario Municipal Employees Retirement Fund ("the Fund"), and provides pensions for employees of Ontario municipalities, local boards, public utilities and school boards. The fund is a contributory defined benefit pension plan. The Corporation records the required contributions as an expense in the period they accrue.

### **l) Related party transactions**

Transactions with related parties represent the culmination of the earnings process and are measured at the exchange amount.

## 2) SIGNIFICANT ACCOUNTING POLICIES (Continued)

### m) Payments in Lieu of Taxes (“PILs”)

The Corporation is currently exempt from taxes under the Income Tax Act (Canada) (“ITA”) and the Ontario Corporations Tax Act (“OCTA”).

Commencing October 1, 2001 and pursuant to the *Energy Competition Act* (“ECA”), the Corporation is required to compute taxes under the ITA and OCTA and remit such amounts thereunder to the Ontario Electricity Financial Corporation (“OEFC”). These amounts, referred to as PILs under the ECA, are applied to reduce certain debt obligations of the former Ontario Hydro continuing in OEFC.

The Corporation provides for PILs using the asset and liability method. Under this method, future tax assets and liabilities are recognized, to the extent such are determined likely to be realized, for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future tax assets and liabilities are measured using enacted or substantively enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the date of enactment or substantive enactment.

### n) Capital contributions in aid of construction

Capital contributions arise from development charges which are provided and paid by developers and used to finance additions to fixed assets. Capital contributions received are treated as a “credit” contra account and are included in fixed assets. These amounts are subsequently amortized by a charge to accumulated amortization and a credit to amortization expense at an equivalent rate to that used for the depreciation of the related fixed asset.

### o) Revenue recognition

Electricity distribution services charges comprise charges to customers for use of the Corporation’s electricity distribution system. These charges are recorded when the related services are performed.

## 3) INVENTORY

Inventory, which consists of parts and supplies acquired for internal construction, consumption, or recoverable work, is valued at the lower of cost and net realizable value. Cost is determined on a weighted average basis. Net realizable value is determined by replacement cost.

The amount of inventories consumed by the Corporation and recognized as an expense during 2008 was \$840 (2007 - \$838).

#### 4) OTHER ASSETS

Other assets comprise:

	2008	2007
Prepaid expenses	1,639	1,614
Other	6	261
<b>Total other assets</b>	<b>1,645</b>	<b>1,875</b>

#### 5) FIXED ASSETS

Fixed assets comprise:

	2008			2007		
	Original Cost	Accumulated Depreciation	Net Book Value	Original Cost	Accumulated Depreciation	Net Book Value
Land	1,483	-	1,483	1,483	-	1,483
Land rights	146	(49)	97	142	(45)	97
Buildings	26,988	(15,980)	11,008	26,426	(14,725)	11,701
Distribution stations	9,724	(7,102)	2,622	9,706	(6,784)	2,922
Distribution lines – overhead and underground	332,416	(148,412)	184,004	319,813	(136,963)	182,850
Distribution transformers	81,772	(37,565)	44,207	79,002	(35,618)	43,384
Distribution meters	52,992	(14,527)	38,465	37,170	(12,498)	24,672
Other fixed assets	52,609	(31,590)	21,019	43,613	(28,297)	15,316
Work in process	5,372	-	5,372	8,625	-	8,625
	<b>563,502</b>	<b>(255,225)</b>	<b>308,277</b>	<b>525,980</b>	<b>(234,930)</b>	<b>291,050</b>

During the year, the Corporation received \$6,198 (2007 - \$3,402) of capital contributions in aid of construction.

Total depreciation expense for the year is \$24,818 (2007- \$22,209) of which \$1,373 (2007- \$1,035) has been allocated to operating expenses and capital.

## 6) PAYMENTS IN LIEU OF TAXES

The provision for PILs varies from amounts which would be computed by applying the Corporation's combined statutory income tax rate as follows:

	<b>2008</b>	<b>2007</b>
Basic rate applied to income before PILs	<b>33.50%</b>	36.12%
Increase (decrease) in PILs resulting from:		
Tax basis of depreciable capital assets and goodwill in excess of accounting basis	<b>(3.99%)</b>	(2.64%)
Revaluation of Future Tax Liability at 2012 statutory rate of 29.0%	<b>0.30%</b>	3.00%
Items not deductible for tax purposes and other	<b>0.72%</b>	(0.12%)
<b>Effective rate applied to income before PILs</b>	<b>30.53%</b>	36.36%

At December 31, 2008, based on substantively enacted income tax rates, future income tax assets of \$14,255 (2007 - \$14,782) have not been recorded. Such future income tax assets relate to tax bases of depreciable capital assets and employee future benefits in excess of amounts recorded for accounting purposes. Such future tax assets have not been recorded in the accounts as there is uncertainty as to whether the Corporation will realize the benefits related to these assets which would be realized as relatively modest reductions of future tax liability over many future years.

## 7) CREDIT SUPPORT FOR SERVICE DELIVERY

Credit support for service delivery comprises:

	<b>2008</b>	<b>2007</b>
Customer deposits	<b>15,303</b>	15,112
Construction deposits	<b>9,489</b>	8,736
<b>Total credit support for service delivery</b>	<b>24,792</b>	23,848

## 8) LONG-TERM BORROWINGS

Long-term borrowings comprise a \$116,000 Promissory Note Payable to HUC (2007 - \$116,000) bearing interest at 7.0% per annum (2007 - 7.0%), and payable semi-annually on January 30 and July 30. Such promissory note is unsecured and matures on July 30, 2012.

The Corporation incurred interest expense in respect of the promissory note payable to HUC of \$8,120 (2007 - \$8,120).

## 9) EMPLOYEE FUTURE BENEFITS

The Corporation pays certain health, dental and life insurance benefits on behalf of its retired employees. The Corporation accrues the cost of these employee future benefits over the periods in which the employees earn the benefits. The cost of employee future benefits earned by employees is actuarially determined applying the projected benefit method pro rated on length of service. Significant assumptions underlying the valuation include management's best estimate of the interest (discount) rate, salary escalation, the average retirement age of employees, employee turnover and expected health and dental care costs.

Information about the Corporation's defined benefit plan is as follows:

	2008	2007
Accrued benefit liability, beginning of year	15,964	15,602
Net benefit expense:		
Current service cost	335	374
Interest cost	1,010	969
Amortization of net actuarial loss	99	138
Net benefit expense for the year	1,444	1,481
Benefits paid for the year	(1,114)	(1,119)
<b>Accrued benefit liability, end of year</b>	<b>16,294</b>	<b>15,964</b>

An actuarial valuation of the plan obligations was completed as at December 31, 2008 resulting in an unamortized net actuarial loss of \$1,467. The Corporation has adopted the corridor method of accounting for the actuarially determined experience gains (losses). The excess of actuarial gains (losses) over 10% of the accrued benefit obligation is amortized into expense on a straight-line basis over the expected average remaining service life of active employees.

The main actuarial assumptions underlying the valuation are as follows:

### a) General inflation

The health care cost trend for prescription drugs is estimated to increase at a declining rate from 8% to 4% over five years. Other medical and dental expenses are assumed to increase at 4% per year.

The approximate effect on the accrued benefit obligation and the estimated net benefit expense if the health care trend rate assumption was increased or decreased by 1% is as follows:

	Accrued Benefit Obligation	Periodic Benefit Cost
1% increase in health care trend rate	1,364	163
1% decrease in health care trend rate	(1,114)	(156)

## 9) EMPLOYEE FUTURE BENEFITS (Continued)

### b) Interest (discount) rate

The obligations at the period end and the present value of future liabilities were determined using a discount rate of 7.3% representing an estimate of the yield on high quality corporate bonds as at the valuation date.

### (c) Salary levels

Future general salary and wage levels were assumed to increase at 4% per year.

## 10) NET REGULATORY LIABILITIES

Net regulatory liabilities comprise:

	2008	2007
Settlement variances	19,457	18,803
Smart Meter deferral account	1,998	1,699
Regulatory assets recovery account	6,901	1,024
Other	273	975
<b>Total net regulatory liabilities</b>	<b>28,629</b>	<b>22,501</b>

Net regulatory liabilities represent costs incurred by the Corporation and settlement variances with other participants in the electricity market, less recoveries, for the purpose of supporting the deregulation of the electricity industry in Ontario. These amounts have been accumulated pursuant to regulation underlying the *Electricity Act, 1998 (Ontario)* and deferred in anticipation of their future recovery in electricity distribution service charges.

**Settlement variances** - represent amounts that have accumulated since January 1, 2007 and have not yet been approved in rates by the OEB and comprise:

- i) variances between amounts charged by the Independent Electricity System Operator (“IESO”) for the operation of the wholesale electricity market and grid, various wholesale market settlement charges and transmission charges, and the amounts billed to customers by the Corporation based on the OEB approved wholesale market service rate; and,
- ii) variances between the amounts charged by the IESO to allow for purchases of imported electricity and the amounts billed to customers by the Corporation based on OEB approved rates.

**Smart Meter deferral account** – represents the deferral of operating expenditures, capital expenditures and revenues related to Smart Meters in accordance with the direction set out by the OEB.

**Regulatory asset recovery account** – represents approved regulatory asset balances as at January 1, 2005, consisting of settlement variances and associated interest, less amounts recovered up to December 31, 2006. The recent OEB decision on the 2008EDR Application provided for the disposition of \$7,373 of the Corporation’s net regulatory liabilities over a twenty-nine month period ending April 30, 2011.

## 11) SHARE CAPITAL

Share capital comprises:

	<b>2008</b>	<b>2007</b>
Authorized:		
Unlimited Class 1 Common shares		
Unlimited Class A Common shares		
Issued:		
7,890 Class 1 Common shares	<b>91,134</b>	91,134
2,110 Class A Common shares	<b>32,460</b>	32,460
	<b>123,594</b>	123,594

On December 31, 2007, the Corporation issued 7,101 Class 1 Common Shares and 1,899 Class A Common Shares in exchange for a 100% ownership interest in Horizon Utilities [note 3]. The legal stated capital of the Class 1 and Class A Common Shares was at fair value. As the transactions were with related parties and there was no substantive change in the beneficial ownership of Horizon Utilities, the consolidated financial statements include the operating results and financial position of Horizon Utilities on a comparative basis.

Any invitation to the public to subscribe for shares of the Corporation is prohibited.

## 12) PENSION PLAN

The Corporation participates in the Ontario Municipal Employees Retirement Fund (OMERS), a multi-employer plan, on behalf of its employees. The plan is a contributory defined benefit pension plan. Contributions during the year were 6.5% for employee earnings below the year's maximum pensionable earnings and 9.6% thereafter. Contributions are expected to remain the same in 2008. During 2008, the Corporation expensed contributions totaling \$1,802 (2007 - \$1,809) made to OMERS in respect of the employer's required contributions to the plan.

## 13) COMMITMENTS AND CONTINGENCIES

### Commitments

#### Contractual Obligations

Pursuant to the terms of a Connection and Cost Recovery Agreement dated December 10, 2008, the Corporation has committed to upgrade the capacity of one of its transformer stations. The total commitment over a three year period is approximately \$7,278 and the remaining commitment at year-end is approximately \$4,876.

#### Leases

The Corporation has entered into operating leases for certain computer equipment. Minimum annual lease payments required are as follows:

2009	206
<b>Total</b>	<b>206</b>

### 13) COMMITMENTS AND CONTINGENCIES (Continued)

#### Contingencies

##### *General*

From time to time, the Corporation is involved in various litigation matters arising in the ordinary course of its business. The Corporation has no reason to believe that the disposition of any such current matters could reasonably be expected to have a materially adverse impact on its financial position, results of operations, or its ability to carry on any of its business activities.

##### *Class Action*

A class action claiming \$500,000 in restitutionary payments plus interest was served on the former Toronto Hydro-Electric Commission, continuing as Toronto Hydro Corporation, on November 18, 1998. The action was initiated against the former Toronto Hydro-Electric Commission as the representative of the Defendant Class consisting of all municipal electric utilities ("MEU") in Ontario, of which the Corporation is a successor MEU, which have charged Late Payment charges on overdue utility bills at any time after April 1, 1981.

The claim is that late payment penalties result in municipal electric utilities receiving interest at effective rates in excess of 60% per year, which is illegal under Section 347(1)(b) of the Criminal Code. This action is at a preliminary stage. Pleadings have closed but examinations for discovery have not been conducted and the classes have not been certified. The Electricity Distributors Association is undertaking the defense of this class action on behalf of the Defendant Class. It is anticipated that the action will now proceed for determination in light of the reasons of the Supreme Court in the Enbridge class action.

On April 22, 2004, in a decision in a class action commenced against The Consumers' Gas Company Limited (now Enbridge Gas Distribution Inc.), the Supreme Court of Canada ruled that Consumers' Gas was required to repay that portion of certain late payment charges collected by it from its customers that were in excess of the interest limit stipulated in section 347 of the Criminal Code. Although the claim related to charges collected by Consumers' Gas after the enactment of section 347 of the Criminal Code in 1981, the Supreme Court limited recovery to charges collected after the action was initiated in 1994. The Supreme Court remitted the matter back to the Ontario Superior Court of Justice for determination of the damages. The parties have reached a settlement of this class action and the settlement has been approved by the Ontario Superior Court of Justice.

On February 4, 2008, the OEB, in response to an application filed by Enbridge, ruled that all of Enbridge's costs related to settlements of the class action lawsuits, including legal costs, settlement cost and interest, are recoverable from ratepayers. The OEB's decision allows Enbridge to recover all amounts over a five year period commencing in 2008.

In May 2008, the representative plaintiff in the class action made a petition to the Lieutenant Governor in Council of Ontario (LGiC) in which he asked the LGiC to require the OEB to reconsider its decision of February 4, 2008 and potentially re-hear the matter. Interested parties have made their submission to the LGiC. It is not clear when the LGiC will make its decision regarding the petition.

### 13) COMMITMENTS AND CONTINGENCIES (Continued)

#### Contingencies (Continued)

##### *Class Action (continued)*

The Corporation is not a party to the Consumers' Gas class action, however, it is anticipated that the above noted class action will now proceed for determination in light of the reasons of the Supreme Court in the Consumers' Gas class action.

The Defendant Class may have defences available to it in this action that were not disposed of by the Supreme Court in the Consumers' Gas class action. Also, the determination of whether the late payment charges collected by the Corporation from its customers were in excess of the interest limit stipulated in section 347 of the Criminal Code is fact specific in each circumstance.

At this time, given the preliminary status of this action, it is not possible to quantify the effect, if any, on the financial statements of the Corporation. Consequently, no provision has been made in these financial statements with respect to any possible losses that may arise as a result of this matter.

### 14) BILLINGS TO ELECTRICITY DISTRIBUTION CUSTOMERS

The Corporation is licensed by the OEB to distribute electricity. As a licensed distributor, the Corporation is responsible for billing customers for electricity generated by third parties and the related costs of providing electricity service, such as transmission services and other services provided by third parties. The Corporation is required, pursuant to regulation, to remit such amounts to these third parties, irrespective of whether the Corporation ultimately collects these amounts from customers. The Corporation may file to recover uncollected debt retirement charges from OEFC once each year. Otherwise, the Corporation is unable to recover uncollected amounts formerly remitted to these third parties. The Corporation retains only its electricity distribution services charge that is regulated by the OEB.

Electricity distribution services charges comprise:

	<b>2008</b>	<b>2007</b>
Gross customer billings	<b>508,963</b>	523,360
Less: Pass through charges billed by the Corporation		
Electricity charges paid through to generators	<b>(295,462)</b>	(307,041)
Transmission and miscellaneous charges	<b>(57,066)</b>	(59,849)
Market service charges	<b>(32,895)</b>	(34,408)
Debt retirement charges	<b>(35,205)</b>	(37,265)
<b>Total electricity distribution service charges</b>	<b>88,335</b>	84,797

## 15) OTHER INCOME FROM OPERATIONS

Other income from operations comprises:

	2008	2007
Water and waste water billing and customer care charges	3,262	3,076
Collection and other service charges	1,917	2,382
Pole and other rental income	1,325	1,358
Water heater rental income	323	-
Management and other support services	520	859
Late payment charges	1,134	1,023
Scrap sales	569	571
Miscellaneous	1,040	523
<b>Total other income from operations</b>	<b>10,090</b>	<b>9,792</b>

## 16) CAPITAL DISCLOSURES

The main objectives of the Corporation when managing capital are to ensure ongoing access to funding to maintain and improve the electricity distribution system, compliance with covenants related to its credit facilities, prudent management of its capital structure with regard for recoveries of financing charges permitted by the OEB on its regulated electricity distribution business, and to deliver the appropriate financial returns.

The Corporation's definition of capital includes shareholder's equity and long-term debt and such definition has remained unchanged from December 31, 2007. As at December 31, 2008 shareholder's equity amounts to \$36,449 (2007 – \$30,262) and long-term debt amounts to \$116,000 (2007 - \$116,000).

The OEB regulates the amount of interest on debt and MARE that may be recovered by the Corporation, through its electricity distribution rates, in respect of its regulated electricity distribution business. The OEB permits such recoveries on the basis of a deemed capital structure represented by 60% debt and 40% equity. The actual capital structure for the Corporation may differ from the OEB deemed structure.

The Corporation has customary covenants typically associated with long-term debt. The Corporation is in compliance with all credit agreement covenants and limitations associated with its long-term debt.

## 17) RELATED PARTY TRANSACTIONS

### Shareholder loans

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 requirements, working capital requirements and prudential obligations. The Amended Credit Agreement matures on January 19, 2010. 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.

## 17) RELATED PARTY TRANSACTIONS (Continued)

### Revenue

The Corporation provides certain water and wastewater billing and customer care services to the sole shareholder of its ultimate parent company, the City of Hamilton. Other income includes \$3,262 (2007 - \$3,076) earned with respect to this agreement. As at the end of the year, accounts payable and accruals include \$9,443 (2007 - \$10,214) owing to the City of Hamilton for amounts collected on behalf of the City of Hamilton pursuant to this agreement.

The Corporation provides certain management and administrative services to Hamilton Hydro Services Inc., a corporation under common control. Other income includes \$352 (2007 - \$353) earned with respect to this agreement.

### Operating expenses

Operating expenses include \$nil (2007 - \$329) paid to Hamilton Utilities Corporation for certain management and administrative services and \$nil (2007 - \$753) paid to Hamilton Hydro Services Inc. for the provision of certain computer maintenance, telephone services, network and internet services.

### Accounts payable

As at the end of the year, accounts payable and accruals include \$nil (2007 - \$5,749) due to Hamilton Utilities Corporation and \$nil (2007 - \$1,366) due to St. Catharines Hydro Inc.

## 18) FINANCIAL INSTRUMENTS

The carrying values of cash and cash equivalents, accounts receivable, credit support for service delivery and accounts payable and accruals approximate fair values because of the short maturity of these instruments.

It is not practicable to determine the fair value of the long-term borrowings from Horizon Holdings due to the limited amount of comparable market information available.

### Risk Factors

The Corporation's activities provide for a variety of financial risks, particularly credit risk, market risk and liquidity risk.

#### *i) Credit risk*

Financial Assets carry credit risk that a counter-party will fail to discharge an obligation which would result in a financial loss. Financial assets held by the Corporation, such as accounts receivable, expose it to credit risk. 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% (2007 - 3%) of revenue. No other single customer in either year would account for revenue in excess of 1% of the respective reported balances.

## 18) FINANCIAL INSTRUMENTS (Continued)

### Risk Factors (continued)

#### *i) Credit risk (continued)*

The carrying amount of accounts receivable is reduced through the use of an allowance for doubtful accounts and the amount of the related impairment loss is recognized in the income statement. Subsequent recoveries of receivables previously provisioned are credited to the income statement. The balance of the allowance for doubtful accounts at December 31, 2008 is \$1,000. No single customer accounts for more than 1% of accounts receivable at year-end.

The Corporation's credit risk associated with accounts receivable is primarily related to payments from Horizon Utilities customers. At December 31, 2008, approximately \$709 is considered 60 days past due. Horizon Utilities has approximately 230,000 customers, the majority of which are residential. Credit risk is managed through collection of security deposits from customers in accordance with directions provided by the OEB. As at December 31, 2008, Horizon Utilities holds security deposits in the amount of \$24,792 (2007 - \$23,848).

#### *ii) Market Risk*

Market risks primarily refer to the risk of loss that results from changes in commodity prices, foreign exchange rates, and interest rates. The Corporation currently does not have commodity or foreign exchange risk. Horizon Utilities is exposed to fluctuations in interest rates as the regulated rate of return for the Corporation's distribution business is derived using a complex formulaic approach which is in part based on the forecast for long-term Government of Canada bond yields. This rate of return is approved by the OEB as part of the approval of distribution rates.

#### *iii) Liquidity risk*

The Corporation monitors its liquidity risk to ensure access to sufficient funds to meet operational and investing requirements. The Corporation's objective is to ensure that sufficient liquidity is on hand to meet obligations as they fall due while minimizing interest expense. The Corporation has access to a line of credit and monitors cash balances to ensure that sufficient levels of liquidity are on hand to meet financial commitments as they come due.

Most accounts payable, as reported on the financial statements, are due within 60 days.

## 19) EMERGING ACCOUNTING CHANGES

### Rate Regulated Entities

In August 2007, the Canadian Accounting Standards Board (AcSB) issued a decision, effective January 1, 2009, to withdraw the temporary exemption in CICA Handbook Section 1100, Generally Accepted Accounting Principles, which permits the recognition and measurement of assets and liabilities arising from rate regulation. Further, CICA Handbook Section 3465, Income Taxes, was amended to require the recognition of future income tax liabilities and assets for regulated enterprises that were previously not subject these provisions. Consequently, the Company will be required to reflect on its Consolidated Balance Sheet, the effect of applying the liability method when accounting for payments in lieu of corporate income taxes and a corresponding regulatory asset. The Company is currently assessing the impact of the AcSB's decision on its Consolidated Balance Sheet.

### Goodwill and Intangible Assets and Other Standards

In January 2008, the CICA issued Handbook Section 3064, Goodwill and Intangible Assets, and amended Handbook Section 1000, Financial Statement Concepts, and Accounting Guideline 11 Enterprises in the Development Stage and withdrew Handbook Section 3450, Research and Development Costs. Handbook Section 3064 clarifies that costs may only be deferred when they relate to an item that meets the definition of an asset. The concept of matching revenues and expenses remains appropriate for allocating the cost of an asset that is consumed in general revenue over multiple reporting periods. Handbook Sections 3064 replaces Handbook Section 3062 and provides extensive guidance on when expenditures qualify for recognition as intangible assets. These changes are effective for fiscal years beginning on or after October 1, 2008. The Corporation is currently in the process of evaluating the potential impact of these standards on its financial statements.

### International Financial Reporting Standards ("IFRS")

On February 13, 2008, the AcSB announced that publicly accountable enterprises will be required to change over to IFRS effective January 1, 2011. Some of the converged standards will be implemented in Canada during the transition period with the remaining standards adopted at the change over date. The Corporation has launched an internal initiative to govern the conversion process and is currently in the process of evaluating the potential impact of the conversion to IFRS on its financial statements.

## 20) COMPARATIVE FIGURES

Certain comparative data have been reclassified to conform with the presentation of the current year.

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