



HORIZON HOLDINGS INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS

For the year ended December 31, 2009

and

AUDITORS' REPORT TO THE SHAREHOLDERS AND CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2009 and December 31, 2008

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Management's Discussion and Analysis

For the year ended December 31, 2009
(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 2009 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. ("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. 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.

Horizon Utilities

Horizon Utilities is one of Ontario's largest municipally owned electricity distribution companies. The Corporation distributes electricity through approximately 3,300 kilometres of a low-voltage distribution system to approximately 235,000 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 ("OEFC"). These other non-distribution charges represent "pass-through" charges accruing to these and other electricity industry participants and amounted to approximately 82% (2008 – 83%) 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)* ("OEBA") 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 October 22, 2007, the Corporation filed an application for electricity distribution rates to be effective May 1, 2008 ("2008 EDR 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 2nd 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.

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On October 3, 2008, the OEB issued its decision regarding the 2008 EDR Application. Such decision provided for 2008 service distribution revenue requirement and rate base of \$93,632 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 prudency 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 ("2009 EDR Application") to adjust its electricity distribution rates based on the 3rd Generation Incentive Rate Mechanism ("3G-IRM") of the OEB, applicable to all Ontario electricity distributors. Such adjustments were 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 Gross Domestic Product Implicit Price Index - Final Domestic Demand ("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 2009 EDR Application was 0.4%.

On June 23, 2009, Horizon Utilities submitted an application to the OEB for the recovery of lost revenue and shared savings related to its CDM programs. Such recoveries proceed through prescribed Lost Revenue Adjustment Mechanism ("LRAM") and Shared Savings Mechanism ("SSM") and relate to activities for the years 2007 and 2008. On October 23, 2009, an amount of \$840 was approved to be recovered through a rate rider for the period commencing November 1, 2009 through April 30, 2010.

On November 4, 2009, the Corporation submitted its 2010 electricity distribution rate application ("2010 EDR Application") to adjust its electricity distribution rates based on the 3G-IRM. Such adjustments are to be effective May 1, 2010. The Stretch Factor applicable to the Corporation as of the effective date of the 2010 EDR Application is expected to be determined by the OEB in early 2010.

In December 2009, the OEB concluded a Cost of Capital proceeding with the issuance of a final report. The report principally dealt with the adequacy and determination of the MARE and provided the following adjustments:

- i) acknowledge and incorporate a utility spread off of Canada long-bonds within the Equity Risk Premium ("ERP") to better reflect utility borrowing costs (initially 141.5bps);
- ii) to include a 50bps "transaction cost" component within the ERP to reflect estimated transaction costs related to utility borrowings; and
- iii) reduce MARE volatility from annual changes in the Canada long-bond and i) by reducing the annual adjustment factor from 0.75 to 0.5; and
- iv) reflect a more realistic and "fair" base risk premium for Local Distribution Companies ("LDCs").

The immediate result was an initial rise in MARE to 9.75% (4.25% Canada long-bond + 141.5bps spread between Canada long-bond and A-rated utility bonds + 50bps assumed utility debt issuance costs + 358.5bps base equity premium). The increase in MARE reflects the increased total ERP of 550bps off of an assumed Canada long bond rate of 4.25%. The method of transition to the new MARE is through a Cost of Service Application similar to the 2008 EDR Application. The Corporation anticipates filing such an application in 2010 with an effective date of May 1, 2011.

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 completed its deployment of Smart Meters throughout 2008 and 2009, with 221,000 Smart Meters deployed by the end of 2009. Successful testing with the provincial Meter Data Management Repository ("MDMR") was completed and a pilot migration to Time of Use ("TOU") rates for 10,000 residential customers commenced in January 2010. Under TOU rates, the cost of electricity will vary depending on the time when such is consumed. Rates will vary based on the time of the day, day of the week, and season of the year.

On May 19, 2009, the Corporation submitted an Application to the OEB for the consideration and approval of a Utility-Specific Smart Meter Funding Adder in accordance with the Smart Meter Funding and Cost Recovery Guideline of the OEB. On October 8, 2009, the Application was approved as filed. The Application provided for a new rate adder of \$1.56 per metered customer per month, representing an increase of \$0.74 per customer per month beginning November 1, 2009. Such new rate adder contributes approximately \$4,400 annually towards the Corporation's investment in Smart Meters and operating costs which were \$6,044 and \$1,241, respectively, in 2009 (2008 – \$10,565 and \$659 respectively). As at December 31, 2009, the total unamortized investment in Smart Meters was \$21,960 (2008 – \$17,356).

Green Energy and Green Economy Act

In early 2009, the government tabled the *Green Energy and Green Economy Act* ("GEGEA"). This new legislation makes fundamental changes to the roles and responsibilities of LDCs in the areas of renewable power generation, conservation and demand management delivery, and the development of smart distribution grids.

The GEGEA provides LDCs with the freedom to own and operate a portfolio of renewable power generation. LDCs will also bear added responsibilities to assist and enable consumers to reduce their peak demand and conserve energy in an effort to meet provincial conservation targets. LDCs will also gain new responsibilities in transforming their local distribution networks into smart grids harnessing advanced technologies to facilitate the connection of small-scale generators and the two-way flow of information.

Energy Consumer Protection Act

In December 2009, the government introduced the *Energy Consumer Protection Act, 2009*, ("Bill 235") that would amend several statutes, including the *Ontario Energy Board Act, 1998*; *The Electricity Act, 1998*; *The Consumer Protection Act, 2002*; and the *Residential Tenancies Act, 2006*.

The purpose of the proposed legislation is to provide additional protection for energy consumers and to allow for greater energy conservation through suite metering in multi-residential buildings.

In summary, Bill 235 contains additional measures that are designed to: i) protect consumers from hidden contract costs, excessive cancellation fees and "negative-option" contract renewals; ii) provide greater fairness and transparency for consumers through rate comparisons, and plain language contract disclosure; iii) enhance the ability and rights of consumers to cancel contracts; iv) create a new licensing and training regime that includes mandatory oral disclosure and identification badges for energy retailers; v) enable individual suite metering in apartment buildings; and, vi) grant the OEB more authority to set policies on customer security deposits and termination of electricity procedures by local distribution companies.

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The continuing restructuring of Ontario's electricity industry and other regulatory developments, including current and possible future consultations between the OEB and interested stakeholders, may affect future electricity distribution rates and other permitted regulated recoveries of the Corporation.

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 2008 EDR 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.

Effective January 1, 2009, the Corporation adopted amended Canadian Institute of Chartered Accountants ("CICA") Handbook Section 1100, Generally Accepted Accounting Principles ("Handbook Section 1100"), Handbook Section 3465, Income Taxes ("Handbook Section 3465"), and Accounting Guideline 19, Disclosures by Entities Subject to Rate Regulation. These amended standards remove a temporary exemption in Handbook Section 1100 pertaining to the application of that section to the recognition and measurement of assets and liabilities arising from rate regulation, require the recognition of future income tax liabilities and assets in accordance with Handbook Section 3465 as well as a separate regulatory asset or liability balance for the amount of future income taxes expected to be included in future rates and recovered from or paid to customers, and retain existing requirements to disclose the effects of rate regulation. The revised standards are effective for interim and annual financial statements for the fiscal years beginning on or after January 1, 2009.

Following the removal of the temporary exemption for rate-regulated operations included in Handbook Section 1100, the Corporation developed accounting policies for its assets and liabilities arising from rate regulation using professional judgment and other sources issued by bodies authorized to issue accounting standards in other jurisdictions. Upon final assessment and in accordance with Handbook Section 1100, the Corporation has determined that its assets and liabilities arising from rate-regulated activities qualify for recognition under Canadian GAAP and this recognition is consistent with U.S. Statement of Financial Accounting Standards No. 71, Accounting for the Effects of Certain Types of Regulation. Accordingly, the removal of the temporary exemption had no effect on the Corporation's results of operations as of December 31, 2009.

Amendments to Handbook Section 3465 remove the choice to record or not record future income tax liabilities and assets in accordance with Handbook Section 3465. The section requires recognition of a separate regulatory asset or liability balance for the amount of future income taxes expected to be included in future rates and recovered from or paid to customers. Existing requirements to disclose the effects of rate regulation have been retained. The revised standards are effective for fiscal years beginning on or after January 1, 2009.

The impact to the Corporation of the amendment to Handbook Section 3465 requires the recognition of regulatory liabilities and assets for the amount of future income taxes expected to be refunded to, or recovered from, customers in future electricity rates, applied on a retroactive basis without prior period restatement. As a result of the implementation of the changes in Handbook Section 3465, the Corporation has recognized

a regulatory liability relating to the difference between the accounting value of property, plant and equipment and their tax values. At December 31, 2009, the Corporation has recorded a regulatory liability of \$6,997 of which \$5,997 reduced retained earnings and \$1,000 increased future payments in lieu of taxes. The Corporation has reassessed a valuation allowance previously recognized for the future tax asset relating to employee future benefits and has adjusted the allowance at January 1, 2008, increasing both opening retained earnings and future payments in lieu of taxes by \$4,078.

On July 28, 2009, the OEB issued its Report of the Board – Transition to IFRS, which contains recommendations on how regulatory reporting requirements should change in response to IFRS (note 20). The OEB has now initiated a second phase in its transition project, which involves amending certain regulatory instruments. The Corporation continues to evaluate the potential impacts of the recommendations contained in the Report of the Board on both the activities of Corporation and its IFRS transition plan.

Results of Operations

Year Ended December 31, 2009 compared to Year Ended December 31, 2008

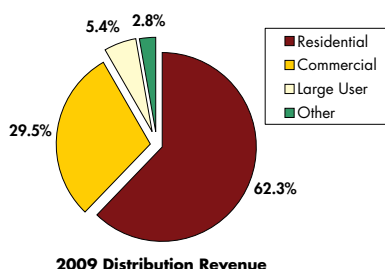
Net Income

Net income for the year of \$13,521 was lower by \$1,584 or 10.5% compared to \$15,105 in the prior year, primarily reflecting lower income from operating activities; increased income taxes to reflect an adjustment to future taxes as a result of proposed changes to corporate income tax rates; partially offset by lower net financing costs.

Revenues

	<u>2009</u>	<u>2008</u>
<i>Electricity distribution services charges</i>	\$88,583	\$88,335

Distribution revenue for the year increased only marginally over 2008. While distribution rates increased by approximately 1% effective May 1, 2009, electricity consumption declined significantly in the year. Distribution revenue for the year includes the recovery of \$840 (2008 – \$868) in recoveries of lost revenue and shared savings related to the Corporation’s CDM programs.



The Corporation has experienced a significant and general decline in load (and associated revenue) across its Large User and General Service > 50 kW classes through the persisting general decline in the economy. Commercial customer consumption has decreased by approximately 12% over the prior year resulting in a revenue shortfall of approximately \$3,500.

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(amounts in thousands of dollars unless otherwise noted)

	2009	2008
<i>Other income from operations</i>	\$10,369	\$10,090

Other income from operations comprises income from regulated services as well as non-regulated services.

Regulated services include rate charges to customers for connection, reconnection, pole attachment charges, late payment charges and other ancillary service charges. Regulated services revenue declined by approximately \$601 or 11% in 2009.

Non-regulated services include water billing and customer care services provided to the City of Hamilton, management and other incentive fees earned for the delivery of conservation and demand management programs through programs funded by the Ontario Power Authority ("OPA"), water heater rentals and meter services revenue. Non-regulated services revenue increased by approximately \$880 or 20% in 2009, primarily reflecting an increase in incentive fees earned from the OPA funded programs.

Expenses

	2009	2008
<i>Operating expenses</i>	\$44,855	\$43,997

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 \$858, or 2.0% in 2009. The increase primarily reflects costs related to the implementation of Smart Meters, including communication and other costs to enable TOU rates to customers, and general wage and price inflation. In response to the persisting decline in commercial customer electricity consumption in 2009 and 2008, the Corporation deferred approximately \$2,000 in planned operating expenditures for the year in order to partially mitigate the financial impact of related foregone distribution revenue. Such expenditures included business and operational improvement initiatives, human resources, facilities, and other maintenance expenditures.

	2009	2008
<i>Depreciation and amortization</i>	\$25,012	\$23,481

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. In 2009, the electricity distribution business invested approximately \$44,775 in capital assets, as compared to approximately \$42,045 in 2008 and \$39,253 in 2007. The increase primarily reflects the Corporation's incremental investments supporting its regulated electricity distribution system. The Corporation has applied consistent amortization rates to its capital assets throughout the reporting period.

	2009	2008
<i>Interest income</i>	\$ (24)	\$ (312)
<i>Interest expense</i>	\$9,209	\$9,558

Net interest expense of \$9,185 in the current year was slightly favourable to net interest expense of \$9,246 in the prior year and primarily reflects lower interest rates in 2009 on short-term sources of working capital financing, including credit support for service delivery, and net regulatory liabilities.

	2009	2008
<i>Payments in lieu of income and large corporations taxes ("PILs")</i>	\$6,471	\$6,641

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 *Energy Competition Act ("ECA")*, the Corporation is required to compute taxes under the Tax Acts and remit such amounts to OEFEC to be applied against certain stranded debt obligations of the former Ontario Hydro continuing in OEFEC.

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 2009 was 32.37% (2008 – 30.53%) versus the statutory rate of 33.00% (2008 – 33.50%). The favourable effective tax rate in 2009, relative to the statutory rate, reflects the tax basis of depreciable capital assets and goodwill in excess of the accounting basis, partially offset by an adverse adjustment to future PILs to reflect an anticipated reduction in the future effective tax rates by 4% by July 1, 2013. The 2009 effective tax rate also reflects the recognition of future income tax liabilities and assets in accordance with Handbook Section 3465 for the amount of future income taxes expected to be included in future rates and recovered from or paid to customers.

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 \$27,715 in 2009, as compared to \$39,852 in 2008. The decrease in 2009 was primarily the result of the decline in income from operations, as well as a significant decrease in other assets and liabilities during 2009 versus 2008. The decrease in 2009 other assets and liabilities was due to an increase in working capital, including timing differences between collections realized from customer receivables, decreases in accounts payable, and a reduction in regulatory liabilities to reflect the approved disposition of approximately \$7,373 of the Corporation's net regulatory liabilities over the period December 1, 2008 to April 30, 2011.

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Financing Activities

Short-term and long-term liquidity was available to the Corporation throughout the year through a \$80,000 (2008 – \$55,000) credit facility. Pursuant to an Amended Credit Agreement dated August 31, 2009, HUC has made available a revolving line of credit up to \$80,000 to finance general corporate and working capital requirements. The Amended Credit Agreement matures on July 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 was 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.

Table 1: Capital Expenditures

	2009	2008
Distribution system	\$33,188	\$23,456
Smart meters	6,044	10,419
Enterprise resource planning	-	3,567
Other	5,543	4,603
Total	\$44,775	\$42,045

Capital Expenditures

Total capital expenditures for 2009 were \$44,775 and increased \$2,730 over the prior year primarily reflecting higher distribution system capital.

Capital expenditures for 2010 are budgeted at \$38,600, reflecting distribution system capital expenditures of \$30,100, Smart Meter expenditures of \$800, and other capital expenditures of \$7,700.

Distribution System

Distribution system capital expenditures increased by \$9,732 in 2009. The increase was primarily attributable to substation renewal projects, increased capacity projects, as well as an increase in customer demand projects. Substation renewal projects included the continuation and commencement of multi-year upgrades to substations that are nearing end of useful life. Capacity projects in the year included a \$2,100 contribution towards the upgrade of a transformer station in St. Catharines.

Distribution capital expenditures for 2010 reflect investments required to expand, refurbish or replace distribution infrastructure consistent with government policy, local area supply requirements and the preventive and corrective maintenance needs to manage an aging asset infrastructure in order to ensure an adequate and reliable supply of electricity to our customers.

Smart Meters

The Corporation completed its mass deployment of Smart Meters to all residential and small businesses in 2009. The Corporation has installed approximately 221,000 Smart Meters representing a total cumulative capital investment outlay of approximately \$24,000. In the latter part of 2009, the Corporation also commenced the installation of Smart Meters on all General Service > 50 kW customers. The Corporation expects the installation of the majority of the meters in this customer class to be completed by 2012 at a total investment of \$2,900.

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 a \$9,300 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 \$3,000 are anticipated in 2010.

Dividend Requirements

The Corporation paid dividends in the amount of \$9,063 in 2009 to its shareholders, compared to \$8,847 paid in 2008. 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:

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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% (2008 – 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.

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 continually monitors the condition and age of its distribution assets. The Corporation's capital and maintenance programs have been increasing to maintain the performance and replacement of a mature distribution system. 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.

Economic Conditions

The persisting general decline in the economy has impacted, and may continue to impact, overall electricity consumption; particularly in the commercial customer segments, which is the most sensitive to changing economic conditions.

Lower electricity consumption from commercial customers may continue to negatively impact the Corporation's revenue.

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.

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Significant Accounting Policies

Changes in Accounting Standards

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 to these provisions.

The effect of these changes was as noted previously under "Regulatory Accounting" [see pg. 6].

Goodwill and Intangibles

Effective January 1, 2009, the Corporation retrospectively adopted CICA Handbook Section 3064, Goodwill and Intangible Assets. Handbook Section 3064 replaces Handbook Section 3062, Goodwill and Other Intangible Assets and Handbook Section 3450, Research and Development Costs. The new Section establishes standards for the recognition, measurement, presentation and disclosure of goodwill and other intangible assets.

As a result of this new section, the Corporation reclassified computer applications software, previously classified as fixed assets, to intangible assets.

Financial Instruments

Effective January 1, 2009, the CICA issued Emerging Issues Committee Abstract 173 ("EIC-173"), Credit Risk and the Fair Value of Financial Assets and Financial Liabilities. EIC-173 provides further information on the determination of the fair value of financial assets and financial liabilities under Handbook Section 3855, Financial Instruments – Recognition and Measurement. Such provides that an entity's own credit risk and counterparty credit risks should be evaluated in determining the fair value of financial assets and financial liabilities, including derivative instruments. The adoption of this standard did not have any impact on the Corporation's results of operations or financial position.

Effective for the 2009 annual reporting period, the Corporation adopted the amended CICA Handbook Section 3862, Financial Instruments Disclosures, which provide new financial instrument fair value measurement and liquidity risk management. The amendments require an entity to classify fair value measurements using a fair value hierarchy in levels ranging from 1 to 3 that reflects the significance of the inputs used in making these measurements. The amendments also provide required liquidity risk disclosures. The adoption of these amendments to disclosures carried forward unchanged the disclosures previously provided in the Corporation's 2008 Consolidated Financial Statements.

Future Accounting Pronouncements

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. Phase 2 was completed in March 2009 and identified the areas of accounting differences with the highest potential impact to the Corporation, including rate regulated accounting, property, plant and equipment, as well as initial adoption of IFRS under the provisions of IFRS 1, First-Time Adoption of IFRS. The Corporation is nearing the completion of Phase 3, the design phase, and has commenced Phase 4, testing and implementation. The Corporation’s current focus is on the selection of accounting policies and related recommendations, including detailed analysis of the financial impacts of such recommendations, modifications to the Corporations’ business processes and related information systems, the development of financial reports, and additional training for key stakeholders.

Consolidated Financial Statements and Non-controlling Interests

In January 2009, the CICA issued Handbook Section 1601, Consolidated Financial Statements. This section, along with the new Handbook Section 1602, Non-controlling Interests, replace Handbook Section 1600, Consolidated Financial Statements and establish standards for the preparation of consolidated financial statements. These standards apply to interim and annual consolidated financial statements relating to fiscal years beginning on or after January 1, 2011. Earlier application is permitted as of the beginning of a fiscal year. The Corporation has determined that these standards will have no impact on the classification or valuation of its consolidated financial statements.

Comprehensive Revaluation of Assets and Liabilities

In August 2009, the CICA amended Handbook Section 1625, Comprehensive Revaluation of Assets and Liabilities to be consistent with Handbook Section 1582, Business Combinations, Handbook Section 1601 and Handbook Section 1602, which were issued in January 2009. The amendments apply prospectively to comprehensive revaluations of assets and liabilities occurring in fiscal years beginning on or after January 1, 2011. Earlier adoption is permitted as of the beginning of a fiscal year. The Corporation is currently in the process of evaluating the potential impact of these amendments on its financial statements.

Impaired Loans

In August 2009, the CICA amended Handbook Section 3025, Impaired Loans to include held-to-maturity investments and to conform the definition of a loan to that in amended Handbook Section 3855. These amendments apply to annual financial statements relating to fiscal years beginning on or after November 1, 2008. The Corporation is currently in the process of evaluating the potential impact, if any, of these amendments on its financial statements.

Management's Discussion and Analysis

For the year ended December 31, 2009

(amounts in thousands of dollars unless otherwise noted)

Outlook

The Corporation continues its principal 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. In 2010, the Corporation will commence planning for the delivery of new regulated requirements for delivering a Smart Grid and deploying conservation and demand management within its licensed service territory.

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 2010 to meet these objectives include business processes and employee engagement initiatives, investment in capital infrastructure renewal, enabling Smart Meters through TOU rates, and conservation and demand management.

While the overall financial position and prospects of the Corporation remain strong, the current economic climate continues to expose the Corporation to material revenue risk related to electricity consumption. Although the nature of electricity distribution costs are largely fixed, regulated electricity distribution revenues are disproportionately weighted towards electricity consumption. In order to proactively address this risk and ensure sustained profits and cash flows, the Corporation intends to file a cost-of-service electricity distribution application in 2010 for revised rates effective May 1, 2011. The principle objective of such rate application, in addition to the ongoing recovery of prudently incurred electricity distribution costs, will be to revise its electricity consumption forecast to reflect more current and expected future realization.

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

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 5, 2010.

Management's Responsibility for Financial Reporting

The accompanying Consolidated Financial Statements of Horizon Holdings Inc. (the "Corporation") are the responsibility of management and have been approved by the Board of Directors. In management's opinion, the Consolidated Financial Statements have been prepared in accordance with Canadian generally accepted accounting principles. The significant accounting principles are disclosed in note 2 to the Consolidated Financial Statements. The preparation of financial statements necessarily requires judgement and estimation when events affecting the current year depend on determinations to be made in the future. Management has exercised careful judgement where estimates were required, and these Consolidated Financial Statements reflect all information available to February 5, 2010.

Management maintains systems of internal controls designed to provide assurance that the assets of the Corporation are safeguarded, that transactions are properly authorized and that reliable financial information is relevant, accurate and available on a timely basis. The internal control systems include formal policies and procedures and an organizational structure that provides for a proper delegation of authority and segregation of incompatible responsibilities. The internal control systems are monitored by management which reports regularly to the Audit and Risk Committee of the Board of Directors.

The Consolidated Financial Statements have been examined by KPMG LLP, the external auditors of the Corporation. The responsibility of the external auditors is to express their opinion on whether the Consolidated Financial Statements are fairly presented in accordance with Canadian generally accepted accounting principles. The Auditor's Report, which appears on the following page, outlines the scope of their audit examination and states their opinion.

The Board of Directors, through the Audit and Risk Committee, is responsible for ensuring that management fulfills its responsibility for financial reporting and internal controls. The Audit Committee, which is comprised of independent directors, meets regularly with management and the external auditors to satisfy itself that each group is discharging its responsibilities with respect to internal controls and financial reporting. The Audit and Risk Committee reviews the Consolidated Financial Statements and recommends their approval to the Board of Directors. The external auditors have full and open access to the Audit and Risk Committee, with and without the presence of management.

On behalf of the management of Horizon Holdings Inc.:



Max Cananzi
President and Chief Executive Officer



John G. Basilio
Senior Vice President and Chief Financial Officer

February 5, 2010

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Horizon Holdings Inc.

Auditors' Report to the Shareholders and Consolidated Financial Statements

Years Ended December 31, 2009 and December 31, 2008



KPMG LLP
Chartered Accountants
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21 King Street West Suite 700
Hamilton ON L8N 3R1

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www.kpmg.ca

AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the consolidated balance sheet of Horizon Holdings Inc. as at December 31, 2009 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, 2009 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 single horizontal line that underlines the text.

Chartered Accountants, Licensed Public Accountants

Hamilton, Canada
February 5, 2010

Consolidated Balance Sheet

(\$ in thousands)

As at December 31, 2009

	2009	2008
ASSETS		
Current assets		
Cash and cash equivalents	\$ -	\$ 4,355
Accounts receivable	89,801	88,631
Inventory [note 3]	6,341	5,940
Other assets [note 4]	1,730	1,645
	97,872	100,571
Fixed assets [note 5]	321,595	302,850
Future payments in lieu of taxes [notes 2 and 6]	9,939	9,230
Intangible assets [note 7]	5,064	5,427
Goodwill	18,923	18,923
Total assets	\$ 453,393	\$ 437,001
LIABILITIES AND SHAREHOLDER'S EQUITY		
Current liabilities		
Bank indebtedness	\$ 23,967	\$ -
Accounts payable and accruals	55,233	59,702
Accounts payable to corporations under common control	12,364	12,245
Credit support for service delivery [note 8]	22,451	24,792
	114,015	96,739
Long-term liabilities		
Long-term borrowings [note 9]	116,000	116,000
Employee future benefits [note 10]	16,421	16,294
Net regulatory liabilities [note 11]	29,157	28,629
	161,578	160,923
Total liabilities	275,593	257,662
Shareholders' equity		
Share capital [note 12]	123,594	123,594
Contributed surplus	15,218	15,218
Retained earnings	38,988	40,527
Total shareholders' equity	177,800	179,339
Total liabilities and shareholders' equity	\$ 453,393	\$ 437,001

Commitments and contingencies [note 14]

On behalf of the Board:



Director



Director

Consolidated Statement of Income and Retained Earnings

(\$ in thousands)

For the year ended December 31, 2009

	2009	2008
Electricity distribution service charges <i>[note 15]</i>	\$ 88,583	\$ 88,335
Other income from operations <i>[note 16]</i>	10,369	10,090
	98,952	98,425
Expenses:		
Operating expenses	44,855	43,997
Depreciation and amortization <i>[note 5]</i>	25,012	23,481
	69,867	67,478
Income from operating activities	29,085	30,947
Gain on sale of assets	92	45
Interest income	24	312
Interest expense <i>[note 9]</i>	(9,209)	(9,558)
Income before payments in lieu of taxes	19,992	21,746
Payments in lieu of income taxes <i>[note 6]</i>	(6,471)	(6,641)
Net income	13,521	15,105
Retained earnings, beginning of year		
As previously reported	36,449	30,191
Change in accounting policy for the recognition of future tax assets and liabilities <i>[note 2]</i>	(1,919)	4,078
As restated	34,530	34,269
Dividends paid	(9,063)	(8,847)
Retained earnings, end of year	\$ 38,988	\$ 40,527

Consolidated Statement of Cash Flows

(\$ in thousands)

For the year ended December 31, 2009

	2009	2008
OPERATING ACTIVITIES		
Net income	\$ 13,521	\$ 15,105
Add (deduct) non-cash items:		
Depreciation and amortization	26,344	24,818
Future payments in lieu of taxes	(1,628)	(402)
Net change in employee future benefits	127	330
Gain on sale of assets	(92)	(45)
Net change in other assets and liabilities	(10,557)	46
Cash provided by operating activities	27,715	39,852
INVESTING ACTIVITIES		
Additions to fixed assets	(44,775)	(42,045)
Proceeds received on sale of fixed assets	142	45
Cash used in investing activities	(44,633)	(42,000)
FINANCING ACTIVITIES		
Net change in credit support for service delivery	(2,341)	944
Dividends paid in the year	(9,063)	(8,847)
Cash used in financing activities	(11,404)	(7,903)
Net decrease in cash and cash equivalents during the year	(28,322)	(10,051)
Cash and cash equivalents, beginning of year	4,355	14,406
Cash and cash equivalents (bank indebtedness), end of year	\$ (23,967)	\$ 4,355
Supplemental disclosure of cash flow information		
Interest received	\$ 39	\$ 372
Interest paid	\$ (9,186)	\$ (9,060)
Taxes paid	\$ (8,420)	\$ (9,630)

Notes to the Consolidated Financial Statements

December 31, 2009
(\$ in thousands)

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, delivering electricity and related utility services to more than 235,000 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 financial statements include the accounts of the corporation and its wholly owned subsidiaries. The principal operating companies are as follows:

Horizon Utilities Corporation
Horizon Energy Solutions Inc.

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.

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 October 22, 2007, the Corporation filed an application for electricity distribution rates to be effective May 1, 2008 ("2008 EDR 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 2nd 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 2008 EDR Application. Such decision provided for service distribution revenue requirement and rate base of \$93,632 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 ("2009 EDR Application") to adjust its electricity distribution rates based on the 3rd Generation Incentive Rate Mechanism ("3G-IRM") of the OEB, applicable to all Ontario electricity distributors. Such adjustments were 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 Gross Domestic Product Implicit Price Index - Final Domestic Demand ("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 2009 EDR Application is 0.4%.

On June 23, 2009, Horizon Utilities submitted an application to the OEB for the recovery of lost revenue and shared savings related to its CDM programs. Such recoveries proceed through prescribed Lost Revenue Adjustment Mechanism ("LRAM") and Shared Savings Mechanism ("SSM") and relate to activities for the years 2007 and 2008. On October 23, 2009, an amount of \$840 was approved to be recovered through a rate rider for the period commencing November 1, 2009 through April 30, 2010.

On November 4, 2009, the Corporation submitted its 2010 electricity distribution rate application ("2010 EDR Application") to adjust its electricity distribution rates based on the 3G-IRM of the OEB, applicable to all Ontario electricity distributors. Such adjustments are to be effective May 1, 2010. 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 2010 EDR Application is expected to be determined by the OEB early in 2010.

Notes to the Consolidated Financial Statements

December 31, 2009

(\$ in thousands)

In December 2009, the OEB concluded a Cost of Capital proceeding with the issuance of a final report. The report principally dealt with the adequacy and determination of the MARE. The Board has acknowledged that it needs to refine and reset its current formula for determining MARE to:

- i) acknowledge and incorporate a utility spread off of Canada long-bonds within the Equity Risk Premium ("ERP") to better reflect utility borrowing costs (initially 141.5bps);
- ii) to include a 50bps "transaction cost" component within the ERP to reflect estimated transaction costs related to utility borrowings; and
- iii) reduce MARE volatility from annual changes in the Canada long-bond and by reducing the annual adjustment factor from 0.75 to 0.5; and
- iv) reflect a more realistic and "fair" base risk premium for Local Distribution Companies ("LDCs").

The short-term result is an initial rise in MARE to 9.75% (4.25% Canada long-bond + 141.5bps spread between Canada long-bond and A-rated utility bonds + 50bps assumed utility debt issuance costs + 358.5bps base equity premium). The increase in MARE reflects the increased total ERP of 550bps off of an assumed Canada long bond rate of 4.25%. The method of transition to the new MARE is through a Cost of Service Application similar to the 2008 EDR Application. The Corporation anticipates filing such an application in 2010 with an effective date of May 1, 2011.

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 completed its deployment of Smart Meters throughout 2008 and 2009, with 221,000 Smart Meters deployed by the end of 2009. Successful testing with the provincial Meter Data Management Repository ("MDMR") was completed and a pilot migration to Time of Use ("TOU") rates for 10,000 residential customers commenced in January 2010.

On May 19, 2009, the Corporation submitted an application to the OEB for the consideration and approval of a Utility-Specific Smart Meter Funding Adder in accordance with the Smart Meter Funding and Cost Recovery Guideline of the OEB. On October 8, 2009, the Application was approved as filed. The Application provided for a new rate adder of \$1.56 per metered customer per month, representing an increase of \$0.74 per customer per month beginning November 1, 2009. Such new rate adder contributes approximately \$4,400 annually towards the Corporation's investment in Smart Meters and operating costs which were \$6,044 and \$1,241, respectively, in 2009.

Green Energy and Green Economy Act

In early 2009, the government tabled the *Green Energy and Green Economy Act* ("GEGEA"). This new legislation makes fundamental changes to the roles and responsibilities of LDCs in the areas of renewable power generation, conservation and demand management delivery, and the development of smart distribution grids.

The GEGEA provides LDCs with the freedom to own and operate a portfolio of renewable power generation and will permit them to provide district heating services in their communities through co-generation. LDCs will also bear added responsibilities to assist and enable consumers to reduce their peak demand and conserve energy in an effort to meet provincial conservation

targets. LDCs will also gain new responsibilities in transforming their local distribution networks into smart grids harnessing advanced technologies to facilitate the connection of small-scale generators and the two-way flow of information.

Energy Consumer Protection Act

In December 2009, the government introduced the *Energy Consumer Protection Act, 2009*, ("Bill 235") that would amend several statutes, including the *Ontario Energy Board Act, 1998*; *The Electricity Act, 1998*; *The Consumer Protection Act, 2002*; and the *Residential Tenancies Act, 2006*.

The purpose of the proposed legislation is to provide additional protection for energy consumers and to allow for greater energy conservation through suite metering in multi-residential buildings.

In summary, Bill 235 contains additional measures that are designed to: i) protect consumers from hidden contract costs, excessive cancellation fees and "negative-option" contract renewals; ii) provide greater fairness and transparency for consumers through rate comparisons, and plain language contract disclosure; iii) enhance the ability and rights of consumers to cancel contracts; iv) create a new licensing and training regime that includes mandatory oral disclosure and identification badges for energy retailers; v) enable individual suite metering in apartment buildings; and, vi) grant the OEB more authority to set policies on customer security deposits and termination of electricity procedures by local distribution companies.

The continuing restructuring of Ontario's electricity industry and other regulatory developments, including current and possible future consultations between the OEB and interested stakeholders, may affect future electricity distribution rates and other permitted regulatory recoveries of the Corporation.

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 2008 EDR 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.

Effective January 1, 2009, the Corporation adopted amended Canadian Institute of Chartered Accountants ("CICA") Handbook Section 1100, Generally Accepted Accounting Principles ("Handbook Section 1100"), Handbook Section 3465, Income Taxes ("Handbook Section 3465"), and Accounting Guideline 19, Disclosures by Entities Subject to Rate Regulation. These amended standards remove a temporary exemption in Handbook Section 1100 pertaining to the application of that section to the recognition and measurement of assets and liabilities arising from rate regulation.

Notes to the Consolidated Financial Statements

December 31, 2009

(\$ in thousands)

Following the removal of the temporary exemption for rate-regulated operations included in Handbook Section 1100, the Corporation developed accounting policies for its assets and liabilities arising from rate regulation using professional judgment and other sources issued by bodies authorized to issue accounting standards in other jurisdictions. Upon final assessment and in accordance with Handbook Section 1100, the Corporation has determined that its assets and liabilities arising from rate-regulated activities qualify for recognition under Canadian GAAP and this recognition is consistent with U.S. Statement of Financial Accounting Standards No. 71, Accounting for the Effects of Certain Types of Regulation. Accordingly, the removal of the temporary exemption had no effect on the Corporation's results of operations as of December 31, 2009.

Amendments to Handbook Section 3465 remove the choice to record or not record future income tax liabilities and assets in accordance with Handbook Section 3465. The section requires recognition of a separate regulatory asset or liability balance for the amount of future income taxes expected to be included in future rates and recovered from or paid to customers. Existing requirements to disclose the effects of rate regulation have been retained. The revised standards are effective for fiscal years beginning on or after January 1, 2009.

The impact to the Corporation of the amendment to Handbook Section 3465 requires the recognition of regulatory liabilities and assets for the amount of future income taxes expected to be refunded to, or recovered from, customers in future electricity rates, applied on a retroactive basis without prior period restatement. As a result of the implementation of the changes in Handbook Section 3465, the Corporation has recognized a regulatory liability relating to the difference between the accounting value of property, plant and equipment and their tax values. At December 31, 2009, the Corporation has recorded a regulatory liability of \$6,997 of which \$5,997 reduced retained earnings and \$1,000 increased future payments in lieu of taxes. The Corporation has reassessed the valuation allowance previously recognized for the future tax asset relating to employee future benefits and has adjusted the allowance at January 1, 2008, increasing both opening retained earnings and future payments in lieu of taxes by \$4,078. The valuation allowance for the tax bases of depreciable capital assets in excess of amounts recorded for accounting purposes has been maintained.

On July 28, 2009, the OEB issued its Report of the Board – Transition to IFRS, which contains recommendations on how regulatory reporting requirements should change in response to International Financial Reporting Standards ("IFRS") [note 20]. The OEB has now initiated a second phase in its transition project, which involves amending certain regulatory instruments. The Corporation continues to evaluate the potential impacts of the recommendations contained in the Report of the Board on both the activities of Corporation and its IFRS transition plan.

c) Financial Instruments

Under CICA Handbook Section 3855, Financial Instruments – Recognition and Measurement and Section 3861, Financial Instruments – Disclosure and Presentation 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
Bank indebtedness	Held-for-trading
Accounts receivable	Loans and receivables
Accounts payable and accruals	Other liabilities
Accounts payable and accruals to corporations under common control	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.

Effective January 1, 2009, the CICA issued Emerging Issues Committee Abstract 173 ("EIC-173"), Credit Risk and the Fair Value of Financial Assets and Financial Liabilities. EIC-173 provides further information on the determination of the fair value of financial assets and financial liabilities under Handbook Section 3855, Financial Instruments – Recognition and Measurement. It states that an entity's own credit and the credit risk of the counterparty should be taken into account in determining the fair value of financial assets and financial liabilities, including derivative instruments. The adoption of this standard did not have any impact on the Corporation's results of operations or financial position.

Effective for the 2009 annual reporting period, the Corporation adopted the amended CICA Handbook Section 3862, Financial Instruments Disclosures, which improve financial instrument fair value measurement and liquidity risk management disclosures. The amendments require an entity to classify fair value measurements using a fair value hierarchy in levels ranging from 1 to 3 that reflects the significance of the inputs used in making these measurements. The amendments also provide clarification about the required liquidity risk disclosures. The adoption of these amendments to disclosures carried forward unchanged the disclosures previously provided in the Corporation's 2008 Consolidated Financial Statements.

In August 2009, the CICA amended Handbook Section 3855, Financial Instruments – Recognition and Measurement to add guidance concerning the assessment of embedded derivatives upon reclassification of a financial asset out of the held-for-trading category. These amendments apply prospectively to reclassifications made on or after July 1, 2009. Earlier adoption is permitted. The application of these amendments did not have any impact on the Corporation's results of operations or financial position since there has not been any financial assets reclassified out of the held-for-trading category.

Notes to the Consolidated Financial Statements

December 31, 2009

(\$ in thousands)

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 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.

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) Intangible Assets and Amortization

Intangible assets include intangible software costs which are stated at cost less accumulated amortization. Amortization of intangible software costs are recorded on a straight-line basis over the estimated service life of 3 years.

i) Goodwill

Effective January 1, 2009, the Corporation retrospectively adopted CICA Handbook Section 3064, Goodwill and Intangible Assets. Handbook Section 3064 replaces Handbook Section 3062, Goodwill and Other Intangible Assets and Handbook Section 3450, Research and Development Costs. The new Section establishes standards for the recognition, measurement, presentation and disclosure of goodwill and other intangible assets.

As a result of this new section, the Corporation reclassified computer applications software, previously classified as fixed assets to intangible assets.

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.

j) 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.

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.

Notes to the Consolidated Financial Statements

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(\$ in thousands)

k) 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.

l) 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.

m) Related Party Transactions

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

n) 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 the period that includes the date of enactment or substantive enactment.

o) 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.

p) 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 2009 was \$783 (2008 – \$840).

4) OTHER ASSETS

Other assets comprise:

	2009	2008
Prepaid expenses	1,716	1,639
Other	14	6
	1,730	1,645

Notes to the Consolidated Financial Statements

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(\$ in thousands)

5) FIXED ASSETS

Fixed assets comprise:

	2009			2008		
	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	147	(53)	94	146	(49)	97
Buildings	27,612	(17,250)	10,362	26,988	(15,980)	11,008
Distribution stations	10,030	(7,371)	2,659	9,724	(7,102)	2,622
Distribution lines overhead and underground	348,293	(157,308)	190,985	332,416	(148,412)	184,004
Distribution transformers	89,462	(39,382)	50,080	81,772	(37,565)	44,207
Distribution meters	59,750	(16,565)	43,185	52,992	(14,527)	38,465
Other fixed assets	44,049	(27,618)	16,431	41,908	(26,316)	15,592
Work in process	6,316	-	6,316	5,372	-	5,372
	587,142	(265,547)	321,595	552,801	(249,951)	302,850

During the year, the Corporation received \$7,963 (2008 – \$6,198) of capital contributions in aid of construction.

Total depreciation expense for the year is \$26,344 (2008 – \$24,818) of which \$1,332 (2008 – \$1,337) 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:

	2009	2008
Basic rate applied to income before PILs	33.00%	33.50%
Increase (decrease) in PILs resulting from:		
Tax basis of depreciable capital assets and goodwill in excess of accounting basis	(4.21%)	(3.99%)
Revaluation of Future Tax Liability at 2014 statutory rate of 25.0%	3.03%	0.30%
Items not deductible for tax purposes and other	0.55%	0.72%
Effective rate applied to income before PILs	32.37%	30.53%

At December 31, 2009, based on substantively enacted income tax rates, future income tax assets of \$11,867 (2008 – \$14,255) have not been recorded. Such future income tax assets relate to tax bases of depreciable capital assets in excess of amounts recorded for accounting purposes at October 1, 2001 (2008 – future income tax assets related to tax basis 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) INTANGIBLE ASSETS

Intangible assets comprise:

	2009	2008
Intangible software costs	11,740	10,699
Less: accumulated amortization	(6,676)	(5,272)
	5,064	5,427

8) CREDIT SUPPORT FOR SERVICE DELIVERY

Credit support for service delivery comprises:

	2009	2008
Customer deposits	15,381	15,303
Construction deposits	7,070	9,489
	22,451	24,792

9) LONG-TERM BORROWINGS

Long-term borrowings comprise a \$116,000 Promissory Note Payable to HUC (2008 – \$116,000) bearing interest at 7.0% per annum (2008 – 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 (2008 – \$8,120).

10) 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.

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(\$ in thousands)

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

	2009	2008
Accrued benefit liability, beginning of year	16,294	15,964
Net benefit expense:		
Current service cost	222	335
Interest cost	1,059	1,010
Amortization of net actuarial loss	-	99
Net benefit expense for the year	1,281	1,444
Benefits paid for the year	(1,154)	(1,114)
Accrued benefit liability, end of year	16,421	16,294

An actuarial valuation of the plan obligations was completed as at December 31, 2009 resulting in an unamortized net actuarial loss of \$245. 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 7% to 4% over three 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	1,678	149
1% decrease in health care trend rate	(1,358)	(120)

b) Interest (Discount) Rate

The obligations at the period end and the present value of future liabilities were determined using a discount rate of 6.4% (2008 – 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 3% (2008 – 4%) per year.

11) NET REGULATORY LIABILITIES

Net regulatory liabilities (assets) comprise:

	2009	2008
Settlement variances	16,790	19,457
Future payments in lieu of taxes	7,677	680
Regulatory assets recovery account	4,444	6,901
Smart Meter deferral account	837	1,998
IFRS transition costs	(561)	-
Other	(30)	(407)
	29,157	28,629

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 or repayment 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.

Future payments in lieu of taxes – represents the amount of future income taxes expected to be included in future rates and recovered from or paid to customers through the rate setting process.

Regulatory assets 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 2008 EDR 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.

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.

IFRS transition costs – represents the incremental costs incurred in relation to the transition from current compliance with Canadian Generally Accepted Accounting Principles to future compliance with IFRS. The OEB decision of July 28, 2009 provided for the deferral of these costs.

Notes to the Consolidated Financial Statements

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(\$ in thousands)

12) SHARE CAPITAL

Share capital comprises:

	2009	2008
Authorized:		
Unlimited Class 1 Common Shares		
Unlimited Class A Common Shares		
Issued:		
7,890 Class 1 Common Shares	91,134	91,134
2,110 Class A Common Shares	32,460	32,460
	123,594	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. 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.

13) PENSION PLAN

The Corporation participates in the 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 2010. During 2009, the Corporation expensed contributions totaling \$2,014 (2008 – \$1,802) made to OMERS in respect of the employer's required contributions to the plan.

14) 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 \$2,426.

Leases

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

2010	330
2011	330
2012	330
	<hr/>
	990

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.

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(\$ in thousands)

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. On December 1, 2008, the LGiC issued an Order in Council confirming that the OEB's decision of February 4, 2008 will stand. There is no possible appeal or review of the LGiC's decision.

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 defenses 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.

15) 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:

	2009	2008
Gross customer billings	485,814	508,963
Less: Pass through charges billed by the Corporation		
Electricity charges paid through to generators	(286,387)	(295,462)
Transmission and miscellaneous charges	(48,351)	(57,066)
Market service charges	(30,564)	(32,895)
Debt retirement charges	(31,929)	(35,205)
	88,583	88,335

16) OTHER INCOME FROM OPERATIONS

Other income from operations comprises:

	2009	2008
Water and waste water billing and customer care charges	3,429	3,262
Collection and other service charges	1,618	1,917
Pole and other rental income	1,415	1,325
Conservation and demand management programs	1,185	215
Late payment charges	1,168	1,134
Scrap sales	434	569
Management and other support services	360	604
Water heater rental income	310	323
Miscellaneous	450	741
	10,369	10,090

17) 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, 2008. As at December 31, 2009 shareholder's equity amounts to \$38,988 (2008 – \$40,527) and long-term debt amounts to \$116,000 (2008 – \$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.

18) 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 \$80,000 to finance general corporate requirements, working capital requirements and prudential obligations. The Amended Credit Agreement matures on July 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.

Notes to the Consolidated Financial Statements

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(\$ in thousands)

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 \$3,428 (2008 – \$3,262) earned with respect to this agreement. As at the end of the year, accounts payable and accruals include \$9,790 (2008 – \$9,443) 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 \$173 (2008 – \$352) earned with respect to this agreement.

19) 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% (2008 – 3%) of revenue. No other single customer in either year would account for revenue in excess of 1% of the respective reported balances.

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, 2009 is \$1,150 (2008 – \$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, 2009, approximately \$793 (2008 – \$709) is considered 60 days past due. Horizon Utilities has approximately 235,000 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, 2009, Horizon Utilities holds security deposits in the amount of \$22,451 (2008 – \$24,792).

ii) *Market Risk*

Market risks primarily refer to the risk of loss resulting 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.

20) EMERGING ACCOUNTING CHANGES

International Financial Reporting Standards ("IFRS")

On February 13, 2008, the Accounting Standards Board of Canada ("AcSB") confirmed that publicly accountable enterprises will be required to adopt IFRS in place of Canadian GAAP for interim and annual reporting purposes for fiscal years beginning on or after January 1, 2011. On October 14, 2009, the Public Sector Accounting Board released a decision summary confirming that government organizations following commercial practices adhere to standards for publicly accountable entities after January 1, 2011. As such, the Corporation will apply IFRS to its financial statements ending December 31, 2011 with restatement of the amounts recorded on the opening IFRS balance sheet as at January 1, 2010, for comparative purposes.

A limited number of converged or IFRS-based standards will be incorporated into Canadian GAAP prior to 2011, with the remaining standards to be adopted at the change over date.

The International Accounting Standards Board ("IASB") issued an exposure draft on rate regulated activities in July 2009. The IASB staff has postponed presenting their analysis of the responses to the IASB until February 2010. This presentation may include options for the next steps of the rate regulated activities project. It is unclear at this time what the outcome of the Board's deliberations will be and how that will impact the Corporation's reporting under IFRS.

The Corporation has 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 consolidated financial statements. Although the impact of the adoption of IFRS on the Corporation's financial position and results of operations is not yet reasonably determinable or estimable, the Corporation does expect a significant increase in financial statement disclosure requirements resulting from the adoption of IFRS, and is designing the systems and related processes changes, which will be required in order to provide the additional information required to make these disclosures.

Notes to the Consolidated Financial Statements

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(\$ in thousands)

In July 2009, the IASB issued an exposure draft on rate regulated activities. The IASB staff has postponed presenting their analysis of the responses to the IASB until February 2010. This presentation may include options for the next steps of the rate regulated activities project. It is unclear at this time what the outcome of the IASB's deliberations will be and how that will impact the Corporation's reporting under IFRS.

The Corporation continues to assess the impact of conversion to IFRS on its results of operations.

Consolidated Financial Statements and Non-controlling Interests

In January 2009, the CICA issued Handbook Section 1601, Consolidated Financial Statements. This section along with the new Handbook Section 1602, Non-controlling Interests replace Handbook Section 1600, Consolidated Financial Statements and establish standards for the preparation of consolidated financial statements. These standards apply to interim and annual consolidated financial statements relating to fiscal years beginning on or after January 1, 2011. Earlier application is permitted as of the beginning of a fiscal year. The Corporation has determined that these standards will have no impact on the classification or valuation of its consolidated financial statements.

Comprehensive Revaluation of Assets and Liabilities

In August 2009, the CICA amended Handbook Section 1625, Comprehensive Revaluation of Assets and Liabilities to be consistent with Handbook Section 1582, Business Combinations, Handbook Section 1601 and Handbook Section 1602, which were issued in January 2009. The amendments apply prospectively to comprehensive revaluations of assets and liabilities occurring in fiscal years beginning on or after January 1, 2011. Earlier adoption is permitted as of the beginning of a fiscal year. The Corporation is currently in the process of evaluating the potential impact of these amendments on its financial statements.

Impaired Loans

In August 2009, the CICA amended Handbook Section 3025, Impaired Loans to include held-to-maturity investments and to conform the definition of a loan to that in amended Handbook Section 3855. These amendments apply to annual financial statements relating to fiscal years beginning on or after November 1, 2008. The Corporation is currently in the process of evaluating the potential impact, if any, of these amendments on its financial statements.

21) COMPARATIVE FIGURES

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

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