



**Horizon Utilities Corporation
Auditors' Report to the Shareholders
and Financial Statements
Year Ended December 31, 2006 and
December 31, 2005**



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AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the balance sheet of Horizon Utilities Corporation as at December 31, 2006 and the statement 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 financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2006 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

KPMG LLP

Chartered Accountants

Hamilton, Canada
February 2, 2007



Balance Sheet

(in thousands)

As at December 31,

	2006	2005
ASSETS		
Current assets		
Cash and cash equivalents	\$ 19,616	\$ 35,629
Accounts receivable	79,976	84,309
Inventory	6,480	5,454
Other assets [note 4]	1,340	1,297
	107,412	126,689
Fixed assets [note 5]	274,054	263,550
Future payments in lieu of taxes	4,208	2,397
Goodwill [note 2]	18,923	18,923
Total assets	\$ 404,597	\$ 411,559
LIABILITIES AND SHAREHOLDER'S EQUITY		
Current liabilities		
Accounts payable and accruals	\$ 72,246	\$ 91,260
Credit support for service delivery [note 7]	21,092	19,166
	93,338	110,426
Long-term liabilities		
Long-term borrowings [note 8]	116,000	116,000
Employee future benefits [note 9]	15,602	15,258
Net regulatory liabilities [note 10]	14,902	13,655
	146,504	144,913
Total liabilities	239,842	255,339
Shareholders' equity		
Share capital [note 11]	123,593	123,593
Contributed surplus [note 2]	15,218	15,218
Retained earnings	25,944	17,409
Total shareholders' equity	164,755	156,220
Total liabilities and shareholders' equity	\$ 404,597	\$ 411,559

Commitments and contingencies [note 13]

On behalf of the Board:

Director

Director



Statement of Income and Retained Earnings

(in thousands)

For the year ended December 31,

	2006	2005
Electricity distribution service charges <i>[note 14]</i>	\$ 79,610	\$ 76,815
Other income from operations <i>[note 15]</i>	9,837	7,650
	89,447	84,465
Expenses:		
Operating expenses <i>[note 16]</i>	37,953	39,508
Depreciation and amortization <i>[note 5]</i>	19,945	18,599
	57,898	58,107
Income from operating activities	31,549	26,358
Gain on sale of fixed assets	50	104
Interest income	792	931
Interest expense <i>[notes 8 and 16]</i>	(9,229)	(8,936)
Income before payments in lieu of taxes	23,162	18,457
Payments in lieu of income and large corporations taxes <i>[note 6]</i>	(8,197)	(5,917)
Net income	14,965	12,540
Retained earnings, beginning of year	17,409	29,559
Dividends paid <i>[note 2]</i>	(6,430)	(24,690)
Retained earnings, end of year	\$ 25,944	\$ 17,409



Statement of Cash Flows

(in thousands)

For the year ended December 31,

	2006	2005
OPERATING ACTIVITIES		
Net income for the year	\$ 14,965	\$ 12,540
Add (deduct) non-cash items:		
Depreciation and amortization	20,903	19,562
Future payments in lieu of taxes	(1,811)	(2,061)
Net change in employee future benefits	344	176
Gain on sale of fixed assets	(50)	(104)
Net change in other assets and liabilities	(14,503)	27,490
Cash provided by operating activities	19,848	57,603
INVESTING ACTIVITIES		
Additions to fixed assets	(31,425)	(18,848)
Proceeds received on disposal of fixed assets	68	117
Cash used in investing activities	(31,357)	(18,731)
FINANCING ACTIVITIES		
Repayment of long-term borrowings	-	(29,123)
Net change in credit support for service delivery	1,926	338
Dividends paid in the year	(6,430)	(32,064)
Issuance of Class A common shares for cash	-	2,680
Cash used in financing activities	(4,504)	(58,169)
Net decrease in cash and cash equivalents during the year	(16,013)	(19,297)
Cash and cash equivalents, beginning of year	35,629	54,926
Cash and cash equivalents, end of year	\$ 19,616	\$ 35,629
Supplemental disclosure of cash flow information		
Interest received	\$ 810	\$ 1,026
Interest paid	\$ (8,288)	\$ (8,546)
Taxes paid	\$ (9,791)	\$ (11,998)



Notes to the Financial Statements

December 31, 2006

(\$ in thousands)

1) BUSINESS OF CORPORATION

Horizon Utilities Corporation (the “Corporation”) was created pursuant to an amalgamation, described in Note 2 below, and provides electricity distribution and related services to its commercial and residential customers.

2) AMALGAMATION

On March 1, 2005, the former Hamilton Hydro Inc. (“HHI”), a regulated electricity distribution company then wholly-owned by the Corporation, merged with St. Catharines Hydro Utility Services Inc. (“SCHUSI”), also a regulated distribution company then wholly-owned by St. Catharines Hydro Inc. (“SCHI”), by amalgamation under the *Business Corporations Act (Ontario)* and continue as the Corporation.

The amalgamation was completed pursuant to a Merger Co-operation Agreement dated November 25, 2004 between the City of Hamilton, as sole shareholder of Hamilton Utilities Corporation (“HUC”), and The Corporation of The City of St. Catharines, as sole shareholder of SCHI, which acknowledged their approval of the merger of HHI and SCHUSI under terms and conditions set out in a Merger Participation Agreement (the “MPA”), dated November 25, 2004, between HUC, HHI, SCHI and SCHUSI.

The MPA provided that the respective shareholders of HHI and SCHUSI, HUC and SCHI, receive common shares in the Corporation with votes and value in proportion to the respective values of HHI and SCHUSI.

A valuation of HHI and SCHUSI was undertaken by a competent third party and was largely based on projections of capital assets, capital expenditures and operating expenses anticipated to be permitted by regulation administered by the Ontario Energy Board (“OEB”) governing the distribution charges that each respective corporation charges to its customers. The values agreed to by HUC and SCHI (the “Parties”) were as negotiated by the Parties based on such valuation. The results of the negotiation and valuation provide for common share allocations of 78.9% for HUC and 21.1% for SCHI.

In accordance with the MPA, immediately prior to the merger, HHI declared a dividend in specie to HUC consisting of the right to receive any future amounts received by Horizon Utilities that represent the recovery of any regulatory assets in excess of HHI’s book value of such assets as at February 28, 2005. SCHUSI also declared a dividend in specie to SCHI consisting of the right to receive any future amounts received by Horizon Utilities that represent the recovery of any regulatory assets in excess of SCHUSI’s book value of such assets as at February 28, 2005. In April 2006, the OEB approved the Corporation’s application for the recovery of regulatory asset balances as at December 31, 2004, resulting in amounts recoverable by HUC and SCHI under the MPA of \$2,779 and \$2,935 respectively.

On March 1, 2005 the Corporation issued the following shares in exchange for all of the issued and outstanding shares of HHI and SCHUSI:

	<u>No. Shares</u>
Class 1 Common owned by HUC	7,890
Class A Common owned by SCHI	2,110



Notes to the Financial Statements

December 31, 2006

(\$ in thousands)

2) AMALGAMATION (Continued)

This transaction resulted in HUC receiving a controlling interest in the Corporation. Consequently, the Corporation recorded the transaction using the purchase method of accounting. As such, the results of operations and cash flow for 2005 reflect that of Horizon Utilities for the ten months ended December 31, 2005 and HHI for the two months ended February 28, 2005.

The purchase consideration was determined by the fair value of the assets and liabilities assumed as at March 1, 2005 and adjusted for the costs related to the merger, including direct costs associated with the transaction as well as human resource and other integration costs.

The total purchase consideration was allocated to identifiable net assets acquired based on their respective fair values as at the date of amalgamation as follows:

Purchase consideration:	
Issuance of 2,110 Class A common shares at fair value	55,052
Transaction and integration costs	3,545
Total purchase consideration	58,597
Fair value of net assets of SCHUSI acquired:	
Current assets	27,449
Fixed assets	56,498
Other assets	2,068
Current liabilities	(14,151)
Long-term liabilities	(32,190)
Net assets acquired	39,674
Excess purchase consideration over fair value of net assets acquired, allocated to goodwill	18,923

The excess of the fair value of the Class A common shares issued to SCHI over the stated capital of SCHUSI immediately prior to the merger was recorded as contributed surplus on the balance sheet, and that, subsequent to amalgamation, a dividend was paid to SCHI in the amount of \$8,931 of which \$7,374 was charged to contributed surplus.

In addition to transaction and integration costs included as part of the total purchase consideration, the Corporation also incurred \$2,689 in additional costs related to the amalgamation, which have been included in operating expenses. These additional costs included severance costs associated with voluntary retirement and separation programs offered to employees, computer programming and other administrative costs related to the integration of operations.

The merger of HHI and SCHUSI resulted in the third largest municipally owned electricity distribution company in the Province serving approximately 230,000 customers in the municipalities of Hamilton and St. Catharines.

Notes to the Financial Statements

December 31, 2006

(\$ in thousands)

3) 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) 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 Company’s distribution rates are based on a revenue requirement that provides a regulated rate of return on the amount of shareholder’s equity supporting the business of electricity distribution. Distribution rates for 2005 were based on an annual rate of return of 9.88% on the amount of common equity deemed to be allocated to this business, presently regulated at 40% of the Corporation’s investment in electricity distribution assets and related working capital requirements. As mandated by the OEB, the rate increase in 2005 was subject to a financial commitment by the Corporation to invest \$7,071 in conservation and demand management activities over the period September 1, 2005 to September 30, 2007.

On April 12, 2006, the OEB approved the Corporation’s Electricity Distribution Rate Application for 2006 distribution rates, for rates to be effective May 1, 2006. The 2006 distribution rate, in accordance with the OEB filing requirements, provides for a revised rate of return of 9.0%, as compared to 9.88% in previous years.

In accordance with the OEB Report on Cost of Capital and 2nd Generation Incentive Regulation for Ontario’s Electricity Distributors, distribution rates for 2007 will be established based on an OEB approved incentive regulation mechanism model (“the IRM Model”). The IRM Model adjusts base rates for the 2006 Canada Gross Domestic Product Implicit Price Index less a Productivity Factor of 1% as determined by the OEB.

Notes to the Financial Statements

December 31, 2006

(\$ in thousands)

3) SIGNIFICANT ACCOUNTING POLICIES (Continued)

a) Regulation (continued)

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. Specific regulatory assets and liabilities are disclosed in Note 10.

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

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

Smart Meter Initiative

The Province of Ontario has committed to have "Smart Meter" electricity meters installed in 800,000 homes and small businesses by the end of 2007 and 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. *Bill 21, Energy Conservation and Responsibility Act*, provides the legislative framework and regulations to support this initiative.

In support of this initiative, the Corporation launched a Smart Meter pilot program in 2006 as part of its conservation and demand management plan approved by the OEB. The primary purpose of the pilot was to develop and test the processes, tools and network infrastructure to support mass deployment in 2007 to 2010.

Included in distribution rates effective May 1, 2006 is a charge for smart meters of \$0.39 per metered customer per month. Consistent with the OEB's direction and pending further guidance, all smart meter related expenditures and recoveries are currently being deferred in regulatory accounts.



Notes to the Financial Statements

December 31, 2006

(\$ in thousands)

3) SIGNIFICANT ACCOUNTING POLICIES (Continued)

b) 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.

c) 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.

d) Inventory

Inventory consists principally of construction and maintenance materials. Inventory is stated at the lower of cost and replacement value, with cost determined on an average cost basis.

e) 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.



Notes to the Financial Statements

December 31, 2006

(\$ in thousands)

f) Goodwill

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

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

g) 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.

h) 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 are amortized into expense on a straight-line basis over the expected average remaining service life of active employees.



Notes to the Financial Statements

December 31, 2006

(\$ in thousands)

3) SIGNIFICANT ACCOUNTING POLICIES (Continued)

i) 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.

j) Related party transactions

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

k) Payments in Lieu of Taxes (“PILs”)

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

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

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

l) 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.



Notes to the Financial Statements

December 31, 2006

(\$ in thousands)

3) SIGNIFICANT ACCOUNTING POLICIES (Continued)

m) 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.

4) OTHER ASSETS

Other assets comprise:

	2006	2005
Prepaid expenses	1,272	1,229
Other	68	68
Total other assets	1,340	1,297

5) FIXED ASSETS

Fixed assets comprise:

	2006			2005		
	Original Cost	Accumulated Depreciation	Net Book Value	Original Cost	Accumulated Depreciation	Net Book Value
Land	1,493	-	1,493	1,493	-	1,493
Land rights	129	(42)	87	129	(39)	90
Buildings	24,350	(13,663)	10,687	22,987	(12,661)	10,326
Distribution stations	9,624	(6,467)	3,157	9,685	(6,372)	3,313
Distribution lines – overhead and underground	307,846	(125,627)	182,219	294,637	(116,293)	178,344
Distribution transformers	75,740	(32,420)	43,320	70,605	(29,407)	41,198
Distribution meters	28,462	(11,093)	17,369	25,367	(9,829)	15,538
Other fixed assets	37,930	(26,419)	11,511	34,312	(24,890)	9,422
Work in process	4,211	-	4,211	3,826	-	3,826
	489,785	(215,731)	274,054	463,041	(199,491)	263,550

During the year, the Corporation received \$3,603 (2005 - \$2,161) of capital contributions in aid of construction.

Total depreciation expense for the year is \$20,903 (2005 - \$19,562) of which \$958 (2005 - \$964) has been allocated to operating expenses and capital.



Notes to the Financial Statements

December 31, 2006

(\$ in thousands)

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:

	2006	2005
Basic rate applied to income before PILs	36.12%	36.12%
Increase (decrease) in PILs resulting from:		
Tax basis of depreciable capital assets and goodwill in excess of accounting basis	(3.31%)	(5.34%)
Revaluation of Future Tax Liability at 2011 statutory rate of 32.50%	2.02%	-
Items not deductible for tax purposes and other	0.67%	0.45%
Provision for payments in lieu of large corporations taxes	(0.11%)	0.82%
Effective rate applied to income before PILs	35.39%	32.06%

At December 31, 2006, based on substantively enacted income tax rates, future income tax assets of \$17,198 (2005 - \$19,869) have not been recorded. Such future income tax assets relate to tax bases of depreciable capital assets and employee future benefits in excess of amounts recorded for accounting purposes. Such future tax assets have not been recorded in the accounts as there is uncertainty as to whether the Corporation will realize the benefits related to these assets which would be realized as relatively modest reductions of future tax liability over many future years.

7) CREDIT SUPPORT FOR SERVICE DELIVERY

Credit support for service delivery comprises:

	2006	2005
Customer deposits	14,256	12,698
Retailer deposits	551	766
Construction deposits	6,285	5,702
Total credit support for service delivery	21,092	19,166

8) LONG-TERM BORROWINGS

Long-term borrowings comprise:

	2006	2005
Promissory note payable to HUC	116,000	116,000

The promissory note payable to HUC bears interest at 7.0% per annum, payable semi-annually on January 30 and July 30. The promissory note is unsecured and matures on July 30, 2012.

The Corporation incurred interest expense in respect of the promissory note payable to shareholder of \$8,120 (2005 - \$8,120).



Notes to the Financial Statements

December 31, 2006

(\$ in thousands)

9) EMPLOYEE FUTURE BENEFITS

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

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

	2006	2005
Accrued benefit liability, beginning of year	15,258	12,014
Fair value of liability assumed on acquisition of SCHUSI	-	3,068
Net benefit expense:		
Current service cost	334	240
Interest cost	966	969
Amortization of net actuarial loss	104	-
Net benefit expense for the year	1,404	1,209
Benefits paid for the year	(1,060)	(1,033)
Accrued benefit liability, end of year	15,602	15,258

An actuarial valuation of the plan obligations was completed as at March 1, 2005 resulting in an unamortized net actuarial loss of \$823. 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 five years. Other medical and dental expenses are assumed to increase at 4% per year.

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

	Accrued Benefit Obligation	Periodic Benefit Cost
1% increase in health care trend rate	2,204	105
1% decrease in health care trend rate	(1,752)	85



Notes to the Financial Statements

December 31, 2006

(\$ in thousands)

9) EMPLOYEE FUTURE BENEFITS (Continued)

b) Interest (discount) rate

The obligations at the period end and the present value of future liabilities were determined using a discount rate of 5.0% representing an estimate of the yield on high quality corporate bonds as at the valuation date.

(c) Salary levels

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

10) NET REGULATORY ASSETS (LIABILITIES)

Net regulatory assets (liabilities) comprise:

	2006	2005
Settlement variances	(8,880)	(23,571)
Regulatory assets recovery account	(2,560)	-
Other	(2,850)	2,714
Smart Meter deferral account	(612)	-
Pre-market opening cost of power variances	-	7,202
Total net regulatory liabilities	(14,902)	(13,655)

Net regulatory assets (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 EA and deferred in anticipation of their future recovery in electricity distribution service charges.

Settlement variances - represent amounts that have accumulated since January 1, 2005 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.

Regulatory asset recovery account – represents approved regulatory asset balances as at December 31, 2004, consisting of transition costs, pre-market opening cost of power variances, settlement variances and associated interest, less amounts recovered up to December 31, 2006. Recoveries in excess of approved amounts will be repaid to customers over a two-year period ending April 30, 2008.



Notes to the Financial Statements

December 31, 2006

(\$ in thousands)

10) NET REGULATORY ASSETS (LIABILITIES)

Pre-market opening cost of power variances - represent the excess of the cost of the commodity electricity to the Corporation over the amount billed to its customers prior to Market Opening. This variance was subsequently approved and included in the regulatory asset recovery account.

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.

In the absence of rate regulated accounting, generally accepted accounting principles would require the Corporation to reverse the carrying charges recorded, related to the regulatory assets (liabilities) described above, in the operating results for the year in which they are incurred. In 2006, carrying charges of \$360 were recorded in interest expense (2005 – nil).

11) SHARE CAPITAL

	2006	2005
Authorized:		
Unlimited Class 1 Common shares		
Unlimited Class A Common shares		
Issued:		
7,890 Class 1 Common shares	91,133	91,133
2,110 Class A Common shares	32,460	32,460
	123,593	123,593

12) PENSION PLAN

The Corporation participates in the Ontario Municipal Employees Retirement Fund (OMERS), a multi-employer plan, on behalf of its employees. The plan is a contributory defined benefit pension plan. Contributions during the year were 6.5% for employee earnings below the year's maximum pensionable earnings and 9.6% thereafter. Contributions are expected to remain the same in 2007. During 2006, the Corporation expensed contributions totaling \$1,756 (2005 - \$1,416) made to OMERS in respect of the employer's required contributions to the plan.

13) COMMITMENTS AND CONTINGENCIES

Commitments

Contractual Obligation

Pursuant to a Meter Supply and Services Agreement executed on January 30, 2007, the Corporation has committed to purchase Smart Meters and related equipment over a one-year period. The total commitment over the term of the contract is approximately \$5,500.



Notes to the Financial Statements

December 31, 2006

(\$ in thousands)

13) COMMITMENTS AND CONTINGENCIES (Continued)

Leases

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

2007	200
2008	200
2009	200
Total	600

Contingencies

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.

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 tentative settlement of this class action but the settlement is subject to approval by the Ontario Superior Court of Justice. The Court held a hearing in September 2006 to consider the settlement but has not yet issued a ruling.

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

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



Notes to the Financial Statements

December 31, 2006

(\$ in thousands)

13) COMMITMENTS AND CONTINGENCIES (Continued)

Contingencies (continued)

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

14) BILLINGS TO ELECTRICITY DISTRIBUTION CUSTOMERS

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

Electricity distribution services charges comprise:

	2006	2005
Gross customer billings	515,881	548,951
Less: Pass through charges billed by the Corporation		
Electricity charges paid through to generators	(301,908)	(333,823)
Transmission and miscellaneous charges	(62,302)	(66,786)
Market service charges	(34,608)	(34,710)
Debt retirement charges	(37,453)	(36,817)
Total electricity distribution service charges	79,610	76,815

15) OTHER INCOME FROM OPERATIONS

Other income from operations comprises:

	2006	2005
Water and waste water billing and customer care charges	2,901	2,790
Collection and other service charges	2,296	1,192
Miscellaneous	1,625	1,403
Pole and other rental income	1,514	1,079
Late payment charges	873	937
Scrap sales	628	249
Total other income from operations	9,837	7,650



Notes to the Financial Statements

December 31, 2006

(\$ in thousands)

16) RELATED PARTY TRANSACTIONS

Shareholder loans

Pursuant to an Amended Credit Agreement dated January 20, 2006, HUC has made available a revolving line of credit up to \$55,000 to finance general corporate requirements, working capital requirements and prudential obligations. The Amended Credit Agreement matures on January 19, 2009. Interest rates payable on the Amended Credit Agreement are based on a margin above HUC's borrowing rate, as determined by reference to HUC's debt rating.

Revenue

The Corporation provides certain water and wastewater billing and customer care services to the sole shareholder of its parent company, the City of Hamilton. Other income includes \$2,901 (2005 - \$2,790) earned with respect to this agreement. As at the end of the year, accounts payable and accruals include \$8,839 (2005 - \$8,540) owing to the City of Hamilton for amounts collected on behalf of the City of Hamilton pursuant to this agreement.

Operating expenses

Operating expenses include \$218 (2005 - \$1,032) paid to Hamilton Utilities Corporation for certain management and administrative services and \$602 (2005 - \$573) paid to Hamilton Hydro Services Inc., a corporation under common control, for the provision of certain computer maintenance, network and internet services.

17) 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 HUC due to the limited amount of comparable market information available.

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% (2005 - 3%) of revenue. No other single customer in either year would account for revenue in excess of 1% of the respective reported balances.

One customer, the City of Hamilton, accounts for 3% of accounts receivable at year-end. No other single customer accounts for more than 1% of accounts receivable at year-end.

18) COMPARATIVE FIGURES

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