CITY OF HAMILTON

CORPORATE SERVICES
Financial Planning & Policy

TO: Mayor and Members General Issues Committee	**WARD(S) AFFECTED:** CITY WIDE
COMMITTEE DATE: April 18, 2012	
SUBJECT/REPORT NO: Amendments to Horizons Holdings Inc. Dividend Policy and Shareholders Agreement and Hamilton Utilities Corporation Dividend Policy (FCS12030) (City Wide)	
SUBMITTED BY: Roberto Rossini General Manager Finance & Corporate Services Department **SIGNATURE:**	**PREPARED BY:** Adam Smith 905-546-2424 Ext. 1434

RECOMMENDATION

(a) That the amended Horizon Holdings Inc. (HHI) Dividend Policy included as Appendix “A” to Report FCS12030 be approved and replace the existing Dividend Policy contained in the HHI Shareholders Agreement, effective January 1, 2012;

(b) That the Resolution of the Shareholder related to the HHI Dividend Policy change, included as Appendix “B” to Report FCS12030, be approved;

(c) That the amended Hamilton Utilities Corporation (HUC) Dividend Policy, as outlined in Appendix “C” to Report FCS12030, be approved to replace the existing HUC Dividend Policy, effective January 1, 2012;

(d) That the HUC Resolution of the Shareholder, included as Appendix “D” to Report FCS12030, be approved.

EXECUTIVE SUMMARY

Horizon Holdings Inc (HHI) and Hamilton Utilities Corporation (HUC) are both required to transition accounting standards from Canadian Generally Accepted Accounting Principles (CGAAP) to International Financial Reporting Standards (IFRS) beginning January 1, 2012. There are differences between the accounting standards which will result in 'Timing Differences' that could impact the level of the dividends the City receives from year to year.

The 'Timing Differences' referred to are the difference between when HHI receives bills from Hydro One and the Independent Electricity System Operator (IESO), and the amount and when these fees are recovered from customers. These costs are included in the rates approved by the Ontario Energy Board (OEB), and will eventually be fully recovered, but not necessarily in the same calendar and fiscal year that the offsetting revenues through customer billings are received.

Under CGAAP, these 'Timing Differences' were included on and tracked through the balance sheet (as Regulatory Assets or Liabilities), thus not impacting Net Earnings or the dividends calculation. However, under IFRS, these are recorded on the income statement (as Revenue or Contra-Revenue) in the year incurred. As a result, under IFRS net earnings may be volatile from one year to the next and will be dependent on the magnitude of the 'Timing Differences' and when these may be settled with customers through either recoveries or reductions of rates approved by the OEB.

The OEB will be using a 'Modified IFRS' for determining electricity distribution rates, which essentially treats the 'Timing Differences' in the same manner applied under CGAAP.

Through the recommended amendments to the Dividend Policies, HUC and HHI are requesting that the dividend calculation be done on a basis materially consistent with this method used by the OEB for the regulated electricity distribution operations. This will allow for dividends to continue to be calculated similar to how they have been in the past, meaning that they will be more consistent and allow for more accurate projections. It is important to note that these changes are solely to benefit the shareholders, as they have no impact on the business model or economic situation of HUC or HHI. Adapting the recommended changes will help to ensure a stable and more predictable dividend revenue stream from HUC year to year. Under the proposed changes, the City dividend would be 60% of adjusted IFRS net income, versus simply 60% of IFRS net income.

HHI and HUC's external auditors, KPGM LLP, will be providing an audit opinion on the reconciliation from IFRS earnings to the adjusted earnings for the purpose of calculating the dividend.

HUC and HHI have provided a 'Questions and Answers' information pamphlet on the Dividend Policy changes, which is Appendix "E" to Report FCS12030.

Alternatives for Consideration – Not Applicable

FINANCIAL / STAFFING / LEGAL IMPLICATIONS (for Recommendation(s) only)

Financial:
Approval of the revised dividend policy will result in dividends continuing to be calculated in a manner similar to how they've been determined in the past, allow HUC and HHI to better project future dividends, and provide for more consistent dividend payments from year to year.

The impact of the change from CGAAP to IFRS has the potential to result in volatility to the dividends that would be distributed if the Dividend Policy were not changed. The significance of this impact based on 2011 forecasted revenues can be seen in Table 1 of Report FCS12030.

TABLE 1 Illustration of CGAAP vs. IFRS	Forecast of Revenues ($MM)		
	CGAAP	IFRS	Difference
Net Electricity Billings Revenue	99.2	91.5	(7.7)
HUC proportionate share (78.9%)	78.3	72.2	(6.1)
Income Taxes on the Difference			1.6
Impact on Net Income			(4.5)
Reduction in Dividends to HUC and City (at 60% DRP)			(2.7)

As illustrated in Table 1 of Report FCS12030, the change in accounting standards could very well result in a decrease or increase of several million dollars to the dividend paid to the City in a given year. Such swings in the amount of dividends received are problematic for the City in terms of planning on how those dividends will be used from year to year.

Staffing:
None

Legal:
The HUC dividend policy amendment requires the approval of the City of Hamilton as its sole shareholder.

The amendments to the HHI dividend policy and shareholders agreement require the approval of the City of Hamilton, the City of St. Catharines, and the Canadian Imperial

Bank of Commerce (CIBC) through an enabling amendment to the credit facility of Horizon Holdings Inc.

HISTORICAL BACKGROUND (Chronology of events)

The City of Hamilton is the sole shareholder of HUC, which owns 78.9% of HHI and 100% of Hamilton Hydro Services Inc. (HHSI). The remaining 21.1% of equity in HHI is held by St. Catharines Hydro Inc. (SCHI). HHI is the holding company for Horizon Utilties and Horizon Energy Solutions. HHI splits its dividend proportionally (based on % of share holdings) between its two shareholders - HUC and SCHI.

Horizon Utilities is a regulated local electricity distribution company serving over 237,000 customers in St. Catharines and Hamilton. As a regulated utility, Horizon Utilities is required to collect charges for the following non-distribution activities:

- Generation and transmission;
- Regulatory charges to support certain regulatory agencies such as the Ontario Power Authority (OPA) and the IESO;
- Debt Retirement Charge;
- Ontario Clean Energy Benefit, Harmonized Sales Tax, and others.

It is important to note that Horizon Utilities does not earn income from these charges. Horizon Utilities must pay the full invoiced charges to the IESO and Hydro One, but rates for these charges are set by the OEB, which means that in a given year, Horizon Utilities could collect more or less than required for these charges. The variance is settled in future years by Horizon Utilities applying to the OEB for revised customer rates.

For accounting purposes, under CGAAP, the difference between what should have been collected and what was actually collected was recorded on the balance sheet as “Regulatory Assets or Liabilities”. As a result, there was no impact on the Income of Horizon Utilities.

Beginning in 2012, HHI and HUC are required to switch accounting standards from CGAAP to IFRS for financial reporting. The new IFRS does not allow for the recording of Regulatory Assets or Liabilities, instead requiring any variance to be consolidated into distribution earnings. In other words, Horizon Utilities (and its parent company on consolidation) must now record non-distribution collections as revenue in the year collected, and the amounts billed to Horizon Utilities by the IESO and Hydro One must now be recorded as costs in the year incurred.

The impact of IFRS on Horizon Utilities net income is that it could be significantly higher or lower than it would have been under CGAAP in any given year – and equally important, net income may be very volatile from one year to the next, depending on the rates approved by the OEB.

In order to have the dividends of HHI and HUC be more consistent and predictable from one year to the next, HHI and HUC have brought forward amendments to their respective dividend policies to adjust the way the dividend is calculated. It is important to note that the volatility is a result of the change to IFRS and that there is no change to the business model or economic situation of HUC and HHI – the suggested changes are solely to benefit the shareholders.

These changes, which are recommended for approval, include that the dividend calculation be based on an adjusted net earnings materially consistent with the method in which the OEB computes income for regulated electricity distributors in Ontario that are subject to IFRS, as well as other housekeeping changes. The OEB uses a 'modified IFRS' that takes into account the timing differences that used to be captured under the regulatory assets and liabilities under CGAAP.

HUC and HHI will be having their external auditors, KPMG LLP, provide and audit opinion on the adjustments made to net earnings for the purpose of calculating the dividends.

For information purposes, below is the HUC dividend over the last few years:

($ 000's)	2008	2009	2010	2011	2012
Regular Dividends from Operations	8,555	7,259	6,654	6,838	9,216
Regular Dividends from One Time Event	-	-	-	-	2,586
Special Dividends	10,000	-	646	462	-
Total Dividends	18,555	7,259	7,300	7,300	11,802

Notes:
- 2008 Special Dividend in respect of sale of FibreWired at the end of 2007.
- 2010 & 2011 Special Dividend from HUC retained earnings to stabilize dividend to City during rate application period
- 2012 Regular Dividend to include dividend from one time net after tax gain on sale of water heater rental services operation (Total 2012 regular dividends of $11.802 million)

It should be noted that for 2012, the City is budgeting $7.3 million in HUC dividends; $5.3 million in operating and $2.0 million in capital.

POLICY IMPLICATIONS

Approval of the recommendations to Report FCS12030 will see the dividend policy for HUC updated with the new wording as found in Appendix "C" to Report FCS12030, and the dividend policy for HHI will be updated with the new wording as found in Appendix "A" to Report FCS12030, subject to the approval of the City of St. Catharines and CIBC.

RELEVANT CONSULTATION

Katie Mills – CFO, Hamilton Utilities Corporation
Provided recommended changes to HUC dividend policy, and provided background with respect to the recommended changes.

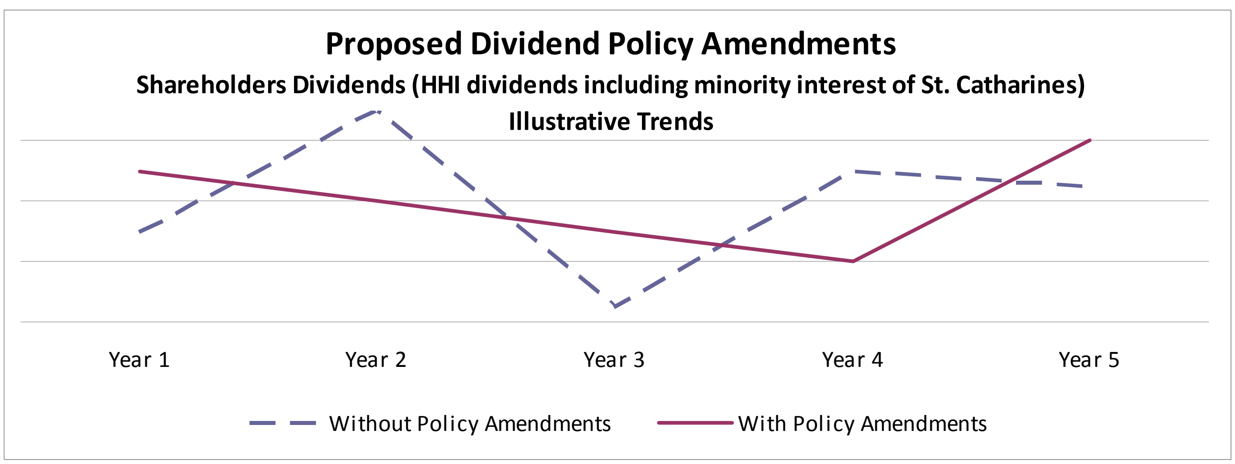
Max Cananzi – President and CEO, and John G. Basilio – Senior Vice-President and CFO, Horizon Holdings Inc.
Provided recommended changes to HHI dividend policy and shareholders agreement, as well as background with respect to the recommended changes.

ANALYSIS / RATIONALE FOR RECOMMENDATION

(include Performance Measurement/Benchmarking Data, if applicable)

<u>Impacts of Proposed Policy Amendments</u>

CHART 1



Explanation of "With Policy Amendments" Trend Line in Chart 1 of Report FCS12030 (for illustrative purposes only – illustrating 100% of HHI dividend including minority interests of St. Catharines)**:**
The solid line illustrates the expected and more predictable trend based on the dividend policy amendments and the 4-year regulated rate cycle of Horizon Utilities.

The rate cycle of Horizon Utilities commences in Year 1 with a Cost of Service Application that, under the Modified IFRS approach of the OEB, will result in expected dividends based on the regulated rate of return. The Cost of Service Application includes all costs, expenditures, etc., for Horizon Utilities and is fully reviewed by the OEB and intervener stakeholder groups. The OEB then renders a decision on the application based on the strength of its evidence and with consideration for customer rate impacts.

Horizon Utilities' rates in Years 2 through 4 are adjusted mechanistically through an "Incentive Regulatory Mechanism" or IRM. The IRM effectively adjusts prior year rates by inflation less an expected productivity factor. The result has typically been an adjustment of about 1% or less. The rate adjustment does not cover real utility wage/ price inflation (about 3% annually) or real growth in the infrastructure renewal program of Horizon Utilities. As a result, Horizon Utilities expects some profit and dividend erosion in the IRM period, which explains the modestly declining trend in Years 2 through 4.

Year 5 represents the start of a new rate cycle commencing with a new Cost of Service Application. As Horizon Utilities investments grow through the previous IRM period, it would expect a higher level of return/ profitability and related dividends in successive rate cycles. This pattern is reasonably predictable and, over time, results in modestly increasing dividends that correspond to modest growth in Horizon Utilities.

Ultimately, this average should be the same as that for the trend not reflecting the dividend policy amendments as the volatility between the two, over the long term, are timing differences.

Explanation of "Without Policy Amendments" Trend Line in Chart 1 of Report FCS12030 (for illustrative purposes only – illustrating 100% of HHI dividend, including minority interests of St. Catharines)**:**
This line is best characterized as unpredictable and the line could be reflected in many different ways.

It is difficult to predict dividends under a pure IFRS approach to earnings as a basis for such.

Over this period, shareholders receive the same quantum of dividends but, without the policy amendments, dividends will be difficult to predict. As well, it could take two or three rate cycles for average dividends under both approaches to converge.

ALTERNATIVES FOR CONSIDERATION

(include Financial, Staffing, Legal and Policy Implications and pros and cons for each alternative)

Not Applicable.

CORPORATE STRATEGIC PLAN (Linkage to Desired End Results)

Focus Areas: 1. Skilled, Innovative and Respectful Organization, 2. Financial Sustainability, 3. Intergovernmental Relationships, 4. Growing Our Economy, 5. Social Development, 6. Environmental Stewardship, 7. Healthy Community

Skilled, Innovative & Respectful Organization

- Council and SMT are recognized for their leadership and integrity

Financial Sustainability

- Financially Sustainable City by 2020
- Delivery of municipal services and management capital assets/liabilities in a sustainable, innovative and cost effective manner
- Address infrastructure deficiencies and unfunded liabilities

Intergovernmental Relationships

- Maintain effective relationships with other public agencies

APPENDICES / SCHEDULES

Appendix “A” to Report FCS12030 – Amended HHI Dividend Policy
Appendix “B” to Report FCS12030 – HHI Resolution of the Shareholder
Appendix “C” to Report FCS12030 – Amended HUC Dividend Policy
Appendix “D” to Report FCS12030 – HUC Resolution of the Shareholder
Appendix “E” to Report FCS12030 – HUC Questions and Answers on Dividend Policy Changes

HORIZON HOLDINGS INC.
Dividend Policy

(effective [January 1, 2012])

The dividend policy of Horizon Holdings Inc. (Horizon Holdings) and its subsidiaries is predicated on the mandate of the Board of Directors which includes maximizing shareholder value. Such value is generally realized by the shareholder through dividends or the appreciation of shareholder investment. It is the intention of the Board of Directors of Horizon Holdings to use its best efforts to declare and pay dividends from available earnings and cash flow, subject to certain conditions precedent outlined below, as follows:

(a) <u>Regular Dividends</u> at a target dividend payment rate (DPR) of up to 60% of annual net earnings adjusted, in the case of net earnings contributed from regulated electricity distribution operations, on a basis materially consistent with the method by which the Ontario Energy Board computes income for regulated electricity distributors in Ontario that are subject to International Financial Reporting Standards;

(b) <u>Special Dividend</u> of periodic payments, to maintain the approved capital structure of Horizon Holdings[*].

<u>Conditions Precedent to the Payment of Dividends</u>

Dividends will be paid to the extent that such would not otherwise cause:

(i) non-compliance with relevant statutes and regulations;

(ii) a breach of contract or the immediate or anticipated failure to otherwise meet the terms of financing arrangements;

(iii) an impairment in the operations and maintenance of electricity distribution infrastructure;

(iv) an impairment in financial prudence including capital investment in electricity distribution infrastructure to sustain reliability;

(v) a deterioration in the credit rating of Horizon Holdings or otherwise not support an "A" range or equivalent rating from credit rating agencies that rate Horizon Holdings and/ or its securities;

(vi) an impairment in the maintenance and growth of approved businesses, or logical extensions of existing or related businesses, in line with a Board approved business plan.

[*] approved by the Board of Directors as of February 25, 2010 at up to 60% of debt in total financial capitalization.

Payment of Dividends

Regular Dividends

Each year, at its meeting to approve the annual budget for the next fiscal year, the Board of Directors will forecast the annual dividend for the next fiscal year based on budgeted annual net earnings computed on the same basis provided for Regular Dividends. Quarterly dividends will, subject to meeting the above criteria, be targeted at up to \$1.5MM and paid March 1st (or shortly following the approval of the annual audited financial statements of the preceding year), June 1st, September 1st, and December 1st. The first dividend paid in the fiscal year, targeted for payment on March 1st, will include the quarterly dividend in respect of the fourth quarter of the preceding year and any adjustment to bring the total annual dividend for the preceding year to up to the full DPR level.

The payment of Regular Dividends is subject, in each instance, to the review and approval of the Board of Directors in accordance with this policy and subject to the Conditions Precedent noted above.

Special Dividends

Each year, at its meeting to approve the annual audited financial statements, the Board of Directors will review the current and forecast shareholder equity requirements of Horizon Holdings and compare such to the approved capital structure of Horizon Holdings. Subject to the Conditions Precedent, the Board of Directors shall declare and pay a dividend, if any, equal to the excess of actual shareholder equity over that required to support the approved capital structure of Horizon Holdings. Where a Special Dividend has been declared, the Board of Directors will endeavour to pay such dividend on March 1st of the year in which the audited financial statements of the preceding year have been approved.

Reporting to Shareholders

In the event that the Board of Directors does not approve a payment of a Regular Dividend, the Board will promptly report the circumstances underlying the non-payment to the shareholders and, thereafter, provide progress reports on a quarterly basis until such time as the payment of Regular Dividends resumes.

HAMILTON UTILITIES CORPORATION

RESOLUTION OF THE SHAREHOLDER

Dividend Policy Change

WHEREAS:

A. The City of Hamilton is the sole shareholder of Hamilton Utilities Corporation ("HUC") and the City of St. Catharines is the sole shareholder of St. Catharines Hydro Inc ("SCHI").

B. HUC, SCHI, and Horizon Holdings Inc. ("HHI") are parties to a shareholders agreement dated as of November 1, 2006 (the "HHI Shareholders Agreement") which governs the affairs of HHI and its subsidiaries, including Horizon Utilities Corporation.

C. Schedule B to the HHI Shareholders Agreement sets out the dividend policy (the "Current Dividend Policy") for HHI and its subsidiaries.

D. The HHI Shareholders Agreement provides that:

   i. any change to the Current Dividend Policy must be approved by the respective Council for each of Hamilton and St. Catharines; and

   ii. any amendment to the HHI Shareholders Agreement must be set forth in writing and duly executed by all of the parties to the HHI Shareholders Agreement.

E. Commencing January 1, 2012, HHI and its subsidiaries are required to prepare their financial statements in accordance with International Financial Reporting Standards ("IFRS"), which may result in material variability in net earnings used as the basis for determining the annual amount of dividends that are calculated and paid to shareholders;

F. The revised dividend policy, which has been laid before the meeting and which will be attached to this resolution (the "Revised Dividend Policy"), will reduce the propensity for material variability in the annual amount of dividends that are calculated and paid to shareholders, which results from the transition of the preparation of financial statements of HHI to IFRS;

G. A corresponding amendment to a credit facility between HHI and Canadian Imperial Bank of Commerce dated June 30, 2010 (“CIBC Credit Facility”) is required to permit the payment of regular dividends under the Revised Dividend Policy;

RESOLVED THAT, conditional on the City of St. Catharines approving the Revised Dividend Policy and the corresponding amendment to the CIBC Credit Facility:

1. The Current Dividend Policy is replaced by the Revised Dividend Policy, effective January 1, 2012; and

2. HUC is hereby authorized to execute an agreement amending the HHI Shareholders Agreement by deleting the Current Dividend Policy which appears as Schedule B thereto, and substituting therefor as Schedule B the Revised Dividend Policy.

THE FOREGOING RESOLUTION is hereby consented to by the sole shareholder of the Corporation pursuant to the provision of the Business Corporation Act (Ontario).

DATED the 18th day of April 2012.

CITY OF HAMILTON

Per: ________________________
[Name]
[City Clerk, Shareholder Representative]

HAMILTON UTILITIES CORPORATION
Dividend Policy
(effective January 1, 2012)

The dividend policy of Hamilton Utilities Corporation (HUC) is predicated on the mandate of the Board of Directors to maximize shareholder value. Such value is generally realized by the shareholder through dividends or the appreciation of shareholder investment. It is the intention of the Board of Directors of HUC to use its best efforts to declare and pay dividends from available earnings and cash flow, subject to certain conditions precedent outlined below, as follows:

(a) Regular Dividends at a target dividend payment rate (DPR) of up to 60% of consolidated annual net earnings, in the case of net earnings contributed from regulated electricity distribution operations, adjusted on a basis materially consistent with the method by which the Ontario Energy Board computes income for regulated electricity distributors in Ontario that are subject to International Financial Reporting Standards (“IFRS”); and,

(b) Special Dividend periodic payments to maintain the approved capital structure of HUC. ✶

Conditions Precedent to the Payment of Dividends

Dividends will be paid to the extent that such would not otherwise cause:

(i) non-compliance with relevant statutes and regulations;

(ii) a breach of contract or the immediate or anticipated failure to otherwise meet the terms of financing arrangements;

(iii) an impairment in the maintenance of financial prudence including the sustainability and reliability of electricity distribution infrastructure investments;

(iv) a deterioration in the credit rating of HUC or otherwise not supporting an “A” range or equivalent rating from credit rating agencies that rate HUC and/ or its securities;

(v) an impairment in the maintenance and growth of approved businesses, or logical extensions of existing or related businesses, in line with a Board approved business plan.

Payment of Dividends

Regular Dividends

Each year, at its meeting to approve the annual budget for the next fiscal year, the Board of Directors will forecast the annual dividend for the next fiscal year based on budgeted annual net earnings computed on the same basis provided for Regular Dividends as specified above. Quarterly dividends will be targeted at up to $1.25MM and paid March 1st (or shortly following the approval of the annual audited financial statements of the preceding year), June 1st, September 1st and December 1st. The first dividend of the fiscal year, targeted for payment on March 1st, will also include any adjustment to bring the total annual dividend for the preceding year up to the full DPR level.

The payment of Regular Dividends is subject, in each instance, to the review and approval of the Board of Directors in accordance with this policy and subject to the Conditions Precedent noted above.

✶ *Up to 60% of debt in total financial capitalization approved by the Board of Directors on February 23, 2012.*

HAMILTON UTILITIES CORPORATION
Dividend Policy (continued)
(effective January 1, 2012)

Special Dividends

Each year, at its meeting to approve the annual audited financial statements, the Board of Directors will review the current and forecast shareholder equity requirements of HUC and compare such to the approved capital structure of HUC. Subject to the Conditions Precedent, the Board shall declare and pay a dividend, if any, equal to the excess of actual shareholder equity over that required to support the approved capital structure of HUC. Where a Special Dividend has been declared, the Board of Directors will endeavour to pay such dividend on March 1st of the year in which the audited financial statements of the preceding year have been approved.

Reporting to Shareholder

In the event that the Board of Directors does not approve a payment of a Regular Dividend, the Board will promptly report the circumstances underlying the non-payment to the shareholder and, thereafter, provide progress reports on a quarterly basis until such time as the payment of Regular Dividends resumes.

HAMILTON UTILITIES CORPORATION
(the "Corporation")

RESOLUTION OF THE SHAREHOLDER

Dividend Policy Change

WHEREAS:

A. The City of Hamilton is the sole shareholder of Hamilton Utilities Corporation (the "Corporation").

B. The City of Hamilton adopted as of November 1, 2005, a dividend policy that provided for the payment of a dividend on the common shares of the Corporation which policy was amended as of January 1, 2006, and February 27, 2007 (the "Current Dividend Policy").

C. Commencing January 1, 2012, the Corporation is required to prepare its financial statements in accordance with International Financial Reporting Standards ("IFRS"), which may result in volatility in the amount of dividends that are calculated and paid to its shareholder.

D. The revised dividend policy which has been laid before this meeting of the City of Hamilton Council and which will be attached to this resolution (the "Revised Dividend Policy") will reduce the volatility which results from this change in accounting policy.

RESOLVED THAT, the Current Dividend Policy is replaced by the Revised Dividend Policy effective January 1, 2012.

* * *

THE FOREGOING RESOLUTION is hereby consented to by the sole shareholder of the Corporation pursuant to the provision of the Business Corporation Act (Ontario).

DATED the [date] day of [month] 2012

CITY OF HAMILTON

Per: ________________________
Rose Caterini
City Clerk, Shareholder Representative

Hamilton Utilities Corporation®
The Business of Public Service™

QUESTIONS AND ANSWERS –
DIVIDEND POLICY CHANGES

1. *What is the Hamilton Utilities Corporation Dividend Policy?*

The Hamilton Utilities Corporation ("HUC") Dividend Policy is a policy that provides for dividends to its shareholder, the City of Hamilton. At the discretion of the HUC Board of Directors and based on other terms and conditions, HUC may pay its shareholder up to 60% of its annual net earnings as Regular Dividends.

HUC's annual net earnings include HUC's proportionate share of consolidated net earnings from Horizon Holdings Inc. (78.9%) and Hamilton Hydro Services Inc. (100%).

2. *Who are the Shareholders of Horizon Holdings Inc.?*

Horizon Holdings Inc. ("Horizon Holdings") has two shareholders:

- HUC (which is wholly owned by the City of Hamilton) is the majority shareholder with a 78.9% common equity interest in HHI;
- St. Catharines Hydro Inc. ("SCHI") (wholly owned by the City of St. Catharines) is the minority shareholder with a 21.2% common equity interest in HHI.

HHI has its own separate Board of Directors and Dividend Policy. The terms of the HHI Dividend Policy mirror that of the HUC Dividend Policy.

3. *Does the City Receive Dividends from HHI?*

Yes. The City receives dividends through HUC. HUC consolidates the net income of all operation in proportion to the share ownership. HUC includes in its net earnings 78.9% of the net earnings of Horizon Holdings and 100% of that of Hamilton Hydro Services Inc. ("HHSI").

4. *How is Dividend Policy Determined and Who Approves This Policy?*

The HUC Dividend Policy is recommended by the Management and Board of Directors of HUC. The dividend policy of HUC, and any changes, must be approved in advance by the City of Hamilton.

Similarly, the HHI Dividend Policy is determined by its Management and Board of Directors. The HHI Dividend Policy, and any changes, must be approved in advance by HUC, SCHI, and both of the Cities of Hamilton and St. Catharines.

5. *Why is HUC Proposing to Amend its Dividend Policy and that of HHI?*

The rules used to calculate and report annual net income for Canadian companies has changed. As a result, HUC and its subsidiary companies must calculate and report their income under new rules effective for years beginning January 1, 2012. Unless HUC and HHI amend their respective dividend policies, these new rules could significantly impact the amount and stability of dividends paid each year to the City.

6. *What Accounting Rules Changed?*

HUC (and its subsidiaries) used to compute net income under "Canadian generally accepted accounting principles" or CGAAP. CGAAP has traditionally been determined in Canada by the Accounting Standards Board ("AcSB") of the Canadian Institute of Chartered Accountants.

Many countries have been migrating to a global standard of financial reporting, or International Financial Reporting Standards ("IFRS"). IFRS are determined by an International Accounting Standards Board ("IASB"). The benefits of adopting a common global standard are comparability of financial results for businesses that use the same accounting rules.

The AcSB has determined that Canada will transition to and adopt IFRS. Like most Canadian corporations, HUC must adopt IFRS – it does not have any choice.

7. ***What is the Impact of New Accounting Rules on HUC?***

HUC owns 78.9% of HHI which in turn owns 100% of Horizon Utilities, the regulated local electricity distribution business.

The new IFRS rules will result in a very significant change to the manner in which Horizon Utilities computes its net income for purposes of financial statement reporting. The new IFRS rules have virtually no impact on the determination of net income for the other 'non-regulated' businesses of HUC.

Over many years, Horizon Utilities' net income will not be affected by this change as the differences between CGAAP and IFRS rules are "timing differences" with respect to reporting elements that make up net income – such as revenue and costs. However, in any given year, Horizon Utilities' net income could be significantly higher or lower under the new IFRS rules, than the former CGAAP rules.

The net income of Horizon Utilities comprises most of the net income of HUC as the most significant holdings of HUC.

The impact of the new IFRS rules on HUC annual net income will have a direct impact on its annual dividends and may cause dividends to be much lower one year and then much higher the next, or vice versa.

8. ***Describe the "Timing Differences" that Result In Changes to the Computation of HUC Annual Net Income Each Year?***

Horizon Utilities is the local electricity distribution company serving Hamilton and St. Catharines, and charges customers based on its electricity distribution rates. However, Horizon Utilities is required by regulation for all elements of providing them with electricity including:

- Generation and transmission;
- Regulatory charges to support certain regulatory agencies such as the Ontario Power Authority and the Independent Electricity System Operator ("IESO");
- Debt Retirement Charge;
- Ontario Clean Energy Benefit, Harmonized Sales Tax, and other.

Horizon Utilities does not earn income from these non-distribution activities.

Horizon Utilities is charged for these non-distribution items by entities such as the IESO for electricity and both the IESO and Hydro One for use of the transmission network.

Horizon Utilities pays the IESO and Hydro One based on their full invoiced charges for their services. However, Horizon Utilities may only pass through these charges to customers based on rates approved by the Ontario Energy Board ("OEB"); regulator of Ontario's electricity companies. Horizon Utilities eventually recovers all of the IESO and Hydro One charges, but not at the same rate in any given year from customers. This results in "timing differences" between amounts Horizon Utilities is charged and recovers for these non-distribution services.

These timing differences are referred to as "Regulatory Assets and Liabilities" which may be settled with customers by applying to the OEB for revised customer rates.

Under CGAAP, Regulatory Assets and Liabilities and related changes were not reported as a component of Horizon Utilities' net income. Under CGAAP, these represented "Assets" or "Liabilities" on the Balance Sheet of Horizon Utilities.

Under IFRS, Regulatory Assets and Liabilities no longer exist such that the full amounts billed to Horizon Utilities by the IESO and Hydro One now represents a "cost". Similarly, the recoveries in rates represent "revenue".

These costs and recoveries represent millions of dollars and differences between the two resulting from timing differences in any given year, may have a very significant impact on net income under the new IFRS rules.

9. Do These New Accounting Rules Have Any Real Impact on the Business Prospects of HUC or HHI?

No. The new accounting rules just affect the calculation of income, not the amount of cash that is generated from customer rates.

In fact, the OEB, which approves the electricity distribution rates for Horizon Utilities, is not changing rates as a result of the change in accounting for the "timing differences" described in point 8 above. In response to the change in accounting rules, the OEB has adopted a "Modified IFRS" basis for determining electricity distribution rates. The Modified IFRS basis adopted by the OEB differs from IFRS as it does not recognize these timing differences as revenue or costs.

10. What Amendments to the Dividend Policy are being proposed by HUC?

HUC is proposing to modify its dividend policy for the payment of Regular Dividends.

The modification proposed would change the current policy of:

> *"Regular Dividends at a target dividend payment rate (DPR) of up to 60% of annual net earnings"*

to the following:

> *"Regular Dividends at a target dividend payment rate (DPR) of up to 60% of annual net earnings adjusted on a basis materially consistent with the method in which the Ontario Energy Board computes income for regulated electricity distributors in Ontario that are subject to International Financial Reporting Standards"*

HUC is also proposing certain other housekeeping amendments.

11. What Will These Amendments to the HUC Dividend Policy Accomplish?

The amendments will accomplish the following:

- Are in the best interest of the shareholder;
- Eliminate volatility in dividend payments arising from changes in accounting/reporting standards;
- Does not affect the total $ amount of dividends paid over time to the City of Hamilton; and,
- Dividends will be computed on the same "Modified IFRS" method that the OEB uses to determine the amount of net income electricity distributors should be able to earn.

12. When Will This Change Take Place and What is the Process?

The change needs to take place for Fiscal 2012.

Required approvals are as follows:

- For HUC, the City of Hamilton (as shareholder of HUC).
- For HHI,
  - The City of Hamilton (as shareholder of HUC);
  - The City of St. Catharines (as shareholder of SCHI);
  - CIBC; and
  - Potentially Standard & Poor's.