



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

For the period ended December 31, 2010

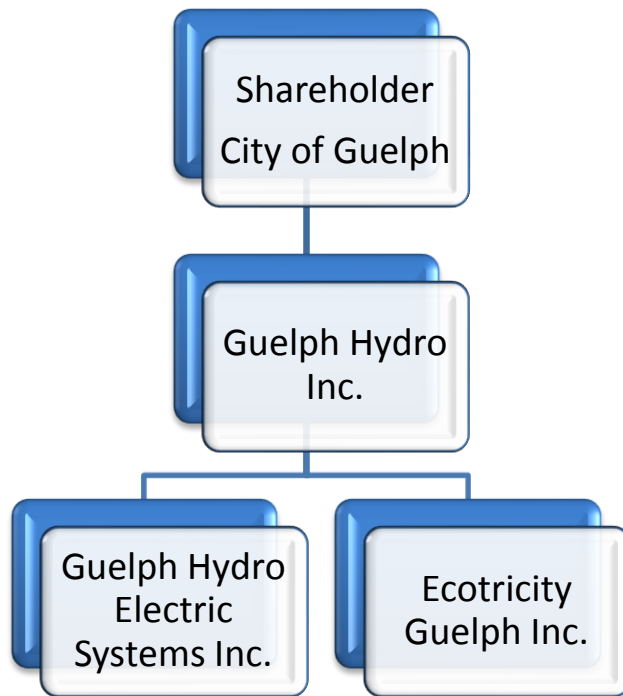
As at April 8, 2011

**MANAGEMENT'S DISCUSSION AND ANALYSIS**  
**For the period ended December 31, 2010**  
**(Amounts in thousands of dollars unless otherwise noted)**

The following discussion and analysis should be read in conjunction with the financial statements of Guelph Hydro Inc. for the period ended December 31, 2010. The financial statements have been prepared in accordance with Canadian generally accepted accounting principles.

**OVERVIEW**

Guelph Hydro Inc. (the "Corporation"), is a holding company with two operating subsidiaries – Guelph Hydro Electric Systems Inc. ("GHESI") and Ecotricity Guelph Inc. ("EGI"). The Corporation is wholly owned by a sole shareholder, the City of Guelph.



**Guelph Hydro Electric Systems Inc.**

GHESI is an electricity distributor for residential and business customers within the municipalities of Guelph and Rockwood; the activities of which are regulated by the Ontario Energy Board ("OEB"), a Crown Corporation of the Province of Ontario. The OEB is the regulator of Ontario's natural gas and electricity industries. The Corporation also provides certain non-regulated water billing and customer care services to the City of Guelph and Village of Rockwood.

GHESI distributes electricity through approximately 1,000 kilometers of a low-voltage distribution system to approximately 50,000 residential and business customers. The distribution system serves all residents and businesses within the borders of Guelph and Rockwood.

GHESI 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, GHESI 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 83% of gross service revenue billed by GHESI. GHESI 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 policies to mitigate such risk.

## **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 GHESI are based on a revenue requirement that provides a regulated Maximum Allowable Return on Equity (“MARE”) on the amount of shareholder’s equity supporting the business of electricity distribution, which is also determined by regulation.

On April 6, 2010, the OEB approved distribution rates for GHESI, effective May 1, 2010. Such distribution rates were effectively adjusted upwards from 2009 levels by an average of 0.45%.

On September 17, 2010, GHESI filed an application under the OEB’s Incentive Regulation Mechanism (IRM) to increase its distribution rates effective May 1, 2011. On March 14, 2011 the OEB released its decision on the application approving a distribution rate increase of 3.72%. Included in this increase is an amount approved by the OEB allowing the Corporation to recover the costs and damages associated with the settlement of a late payment penalties class action lawsuit, of which the Corporation was named as part of the defendant class. The increase also contains an inflationary adjustment of 0.18%

as well as a component to allow for recovery of the Corporation's investments in smart meters and a new transformer station.

GHESI is in the process of preparing a rate rebasing application to the OEB for new distribution rates to be effective on January 1, 2012. This application will allow GHESI to obtain approval for the inclusion of recent significant investments in smart meters and a new transformer station into the rate base for the purposes of determining new distribution rates.

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. GHESI'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. GHESI'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.

### **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, GHESI launched a Smart Meter conversion program in 2009. GHESI has met its regulatory obligations with the completion of approximately 48,000 Smart Meter installations as of the end of December 2010.

### **Ecotricity Guelph Inc.**

EGI develops, owns and operates renewable generation assets in the City of Guelph. EGI's current assets include a 2.8 MW capacity landfill gas generation facility located at the City-owned Eastview landfill site as well as a 100 KW solar photovoltaic facility located on the roof of GHESI's office building at 395 Southgate Drive.

Electricity generated from both of these facilities is fed into GHESI's distribution grid and sold under long term contracts to the Ontario Power Authority ("OPA").

EGI has recently applied under the OPA's Feed-in Tariff program for a total of 15 contracts representing 1.4 MW of rooftop solar photovoltaic generation capacity. The sites are a mix of City-owned buildings and third party commercial properties all located within the City of Guelph.

EGI is also in the process of assessing the viability of a number of potential combined heat and power / district energy opportunities within the City of Guelph for possible future investments.

In 2010 EGI was notified by a U.K. company with a similar name that it was not compliant with trademark legislation. An agreement was subsequently arrived at whereby EGI has up until August of 2012 to change its name.

**RESULTS OF OPERATIONS**

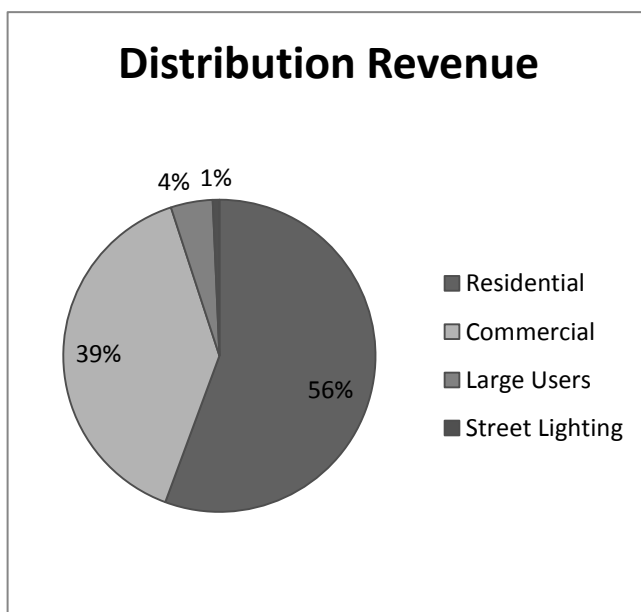
**Twelve Month Period Ended December 31, 2010 compared to Period Ended December 31, 2009**

*Net income*

Net income for the twelve months was \$2,812 compared to a loss of \$558 in the prior year. The net loss incurred in 2009 was caused in large part by a \$2,984 write down on the value of EGI’s landfill gas generation assets. This write down was based on recognition that the remaining supply of gas from the landfill site would be insufficient to generate enough revenue over the remaining life of the asset to recover the original investment.

<b>Revenues</b>	<b><u>2010</u></b>	<b><u>2009</u></b>
<i>Electricity Sales</i>	\$141,549	\$120,171
<i>Other services</i>	<u>1,057</u>	<u>1,100</u>
	<b><u>\$142,606</u></b>	<b><u>\$121,271</u></b>

Revenue from electricity sales originating from GHESI’s operations account for over 99% of the Corporation’s consolidated revenue. Approximately 83% of this revenue represents revenue collected on behalf of other electricity market participants including generators, transmitters, retailers, and regulatory agencies. GHESI’s portion of the revenue for its distribution services was \$23,892 in 2010 (\$23,410 in 2009). The following chart shows a breakdown of GHESI’s distribution revenue by customer category:



Revenues from other services originate from EGI’s generation and sale of electricity. In 2010 and 2009 all revenue was derived from EGI’s land fill gas generation facility in Guelph.

Revenues for the period ending December 31, 2010 increased 17.6% compared to the same period in 2009. This growth was primarily driven by an increase in electricity related charges (transmission charges, commodity costs) which are reflected as cost of sales with an equal offsetting amount being recognized in electricity sales. The growth was also driven by an increase in megawatt hour sales which were about 7.0% higher than in 2009.

	<u>2010</u>	<u>2009</u>
<i>Other income from operations</i>	\$2,611	\$2,270

Other income from operations primarily comprises regulated service rate charges to customers, non-regulated water billing and customer care services provided to the City of Guelph, late payment charges, pole attachment charges, and miscellaneous other income. Other income increased by 15.0% relative to 2009 primarily due to an amount (\$207) approved by the OEB for the recovery of costs and damages associated with a late payment penalty class action lawsuit of which the Corporation was named as part of the defendant class, and an increase in the rate charged for water billing (\$87).

#### **Expenses**

	<u>2010</u>	<u>2009</u>
<i>Operating expenses</i>	\$13,173	\$12,255

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 \$918 or 7.5% in 2010. The increase was caused primarily by higher general administrative costs (\$1,226) due to a restructuring, credit rating fees associated with GHESI's re-financing, and hiring of several new management positions in both GHESI and GHI. The additional positions were required to meet the company's ongoing regulatory activities and support the growth of GHI's business. This increase was partially offset by lower costs in operations and maintenance (\$308) due primarily to Scientific Research and Experimental Development and apprentice tax credits received in 2010 as well as recovery of bad debt from a commercial customer of GHESI.

	<u>2010</u>	<u>2009</u>
<i>Depreciation and amortization</i>	\$7,548	\$6,798

The increase in depreciation reflects an increase in capital investments over the past two years, particularly with respect to GHESI's investment in Smart Meters. For the twelve month period ended December 31, 2010, the electricity distribution business invested \$15,557 in capital assets, as compared to \$12,142 in 2009. The increase primarily reflects GHESI's investment in Smart Meters and the purchase of land for a new transformer station. The Corporation has applied consistent amortization rates to its capital assets throughout the reporting period.

	<u>2010</u>	<u>2009</u>
<i>Financial and other expenses</i>	\$2,028	\$1,755

The increase of financial and other expenses of \$273 over the prior year is primarily due to a small increase in interest expense as a result of GHESI's issuance of \$65,000 of 5.264% Senior Unsecured Debentures in December of 2010 and a reduction of interest income in 2010 due to lower outstanding cash balances.

	<u>2010</u>	<u>2009</u>
<i>Payments in lieu of income and large corporations taxes</i>	\$1,947	\$3,488

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 Electricity Act, 1998, the Corporation is required to compute taxes under the Tax Acts and remit such amounts to OEFC to be applied against certain stranded debt obligations of the former Ontario Hydro continuing in Ontario Electricity Financial Corporation.

The tax basis of the Corporation's assets was valued at fair value pursuant to the provisions of the Tax Acts as at the date the Corporation became subject to Payments in Lieu of Income Taxes ("PILs"). This results in a long-term favorable 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 Corporation's provision for PILs decreased by \$1,541 in 2010 primarily due to the fact that the provision for 2009 included an adjustment of \$1,173 relating to a future income tax asset write down as a result of changes in future tax rates.

## **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 \$12,850 in 2010, as compared to \$13,013 in 2009.

#### *Financing activities*

The Corporation's subsidiary, GHESI, re-financed its debt on December 6, 2010 with a private placement of Series A 5.264% Senior Unsecured Debentures in the amount of \$65,000. The Debentures are due on December 6, 2030 and interest is calculated and payable semi-annually on June 6 and December 6. A portion of the proceeds from the financing were used to repay a \$12,558 note to

GHESI's parent company (Guelph Hydro Inc.) and a \$30,000 note to the City of Guelph. The remaining proceeds will be used by GHESI to fund ongoing capital investments.

## Requirements for liquidity and capital resources

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

## Capital Expenditures

### *Distribution system*

The electricity distribution system operates within a moderate growth service area resulting in a predictable capital program that is largely based on the expansion of distribution assets to service new customers.

Table 1: Capital Expenditures	December 31	
	<u>2010</u>	<u>2009</u>
Distribution system	\$ 5,641	5,596
Smart meters	6,026	3,362
Transformer station	770	1,697
Land	1,874	-
Other	1,246	1,487
Construction in process	429	-
Total	15,986	12,142

### *Smart Meters*

GHESI completed its mass deployment program in 2010 with approximately 48,000 installations, representing a total capital investment of approximately \$9,500.

### *Transformer Station*

GHESI is in the process of constructing a new transformer station to accommodate customer growth in the south end of the City. The total cost of the transformer station is anticipated to be \$13,000 to \$14,000 by the time it is in service in the fall of 2011.

### *Other*

Other capital expenditures include facilities, transportation equipment, furniture and office equipment and other work-related equipment.

### *Dividend requirements*

The Corporation paid dividends in the amount of \$1,500 in 2010 to its shareholder, compared to \$2,250 paid in 2009. 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 50% 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 Finance and Audit 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 Chief Executive Officer has ultimate accountability for risk management and the Chief Financial Officer is responsible to the Chief Executive Officer for the ongoing monitoring and review of the risk profile, policies and practices of the Corporation and ensuring that the risk management program is an integral part of business strategy and planning. Significant risk factors affecting the businesses of the Corporation include:

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

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

### **Credit Risk**

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

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

Management has implemented credit and collection policies in accordance with the OEB regulation to mitigate the exposure of the Corporation to credit risk.

As of December 31, 2010, one customer accounted for approximately 7% of accounts receivable (including all pass through charges). This customer has an excellent payment history with the Corporation and is considered a low credit risk.

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 68% of the Corporation's employees are represented by the International Brotherhood of Electrical Workers Union ("IBEW"). The existing collective agreement with the IBEW expires March 31, 2013. The Corporation bears financial risk related to the ability to negotiate a collective agreement consistent with its rate orders. In the event of a labour dispute, the Corporation could face some degree of operational risk related to continued compliance with its license requirements of providing service to customers.

### **Condition of Distribution Assets**

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

### **Environmental Regulation**

The Corporation is subject to Canadian federal, provincial and municipal environmental regulation. Failure to comply with environmental regulation could subject the Corporation to fines and other penalties. In addition, releases of hazardous substances now or in the past on or from properties owned, leased, occupied or used by the Corporation, or as a result of Corporation's operations could lead to governmental orders requiring investigation, control and/or remediation of releases. The presence or release of hazardous substances could also lead to claims by third parties for harm as a result of the existence of these substances. In addition, new approvals or permits or renewals of existing approvals and permits may require environmental assessment and/or result in the imposition of conditions which may result in compliance costs.

### **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.

### **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 Canadian Accounting Standards Board has recently approved an option to rate regulated entities to defer reporting under IFRS by one year to January 1, 2012. The company has elected, however, to begin IFRS reporting as originally contemplated from January 1, 2011 onward.

## **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 April 8, 2011.