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NIAGARA-ON-THE-LAKE HYDRO INC.

Financial Statements

December 31, 2002

NIAGARA-ON-THE-LAKE HYDRO INC.

Financial Statements

December 31, 2002

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AUDITORS' REPORT

To the Board Members and Shareholder
of Niagara-on-the-Lake Hydro Inc.

We have audited the balance sheet of Niagara-on-the-Lake Hydro Inc. as at December 31, 2002 and the statements of operations, 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, 2002 and the results of its operations and its cash flows for the year then ended in accordance with the accounting principles disclosed in note 1 to the financial statements.



Niagara Falls, Ontario
March 7, 2003

CRAWFORD, SMITH AND SWALLOW
CHARTERED ACCOUNTANTS LLP

NIAGARA-ON-THE-LAKE HYDRO INC.

BALANCE SHEET

December 31, 2002

Assets - note 15	2002	2001
	\$	\$
Current Assets		
Accounts receivable	647,499	1,010,811
Rate settlement rebate receivable	825,897	
Unbilled revenue	1,819,679	772,408
Payments in lieu of corporate income taxes refundable		22,842
Inventories	188,123	196,432
Prepaid expenses	58,489	38,360
	3,539,687	2,040,853
Capital Assets		
Land	55,986	55,986
Buildings	820,333	818,675
Transformer stations	104,579	
Distribution stations	271,887	447,673
Distribution overhead lines	8,081,571	7,627,751
Distribution underground lines	7,558,576	7,426,266
Distribution transformers	4,415,650	4,276,002
Distribution meters	848,503	847,844
Equipment	1,920,633	1,576,328
Other	25,038	25,038
	24,102,756	23,101,563
Less accumulated amortization	10,815,354	10,034,659
	13,287,402	13,066,904
Other Assets		
Regulatory assets - note 4	441,120	222,844
Extraordinary event costs - note 5		91,968
Special deposits	114,243	43,313
Long-term investments- note 6	36,000	36,000
	591,363	394,125
	17,418,452	15,501,882

See accompanying notes

NIAGARA-ON-THE-LAKE HYDRO INC.

BALANCE SHEET

December 31, 2002

Liabilities and Shareholder's Equity	2002	2001
	\$	\$
Current Liabilities		
Bank indebtedness	445,781	196,716
Accounts payable		
Trade	309,315	106,377
Independent Market Operator payable	609,708	1,046,525
Hydro One payable	153,528	
Debt retirement payable	134,715	
Interest payable	167,732	
Rebate cheques payable	796,251	
Payments in lieu of corporate income taxes payable	107,706	
Due to affiliated companies - note 2	12,428	15,302
Other current liabilities	238,711	91,461
Note payable		70,000
Current portion of customer deposits		42,000
	2,975,875	1,568,381
Other Liabilities		
Employee future benefits - note 7	380,568	358,785
Customer deposits	114,243	43,313
Accumulated vested sick leave credits	19,361	19,361
Other deposits	46,811	92,900
	560,983	514,359
Long-Term Note Payable - note 8	6,901,333	6,901,333
Contingent Liability - note 13		
Shareholder's Equity		
Share capital - note 9	2,632,307	2,632,307
Paid-up capital	4,269,026	4,269,026
Retained earnings (deficit)	78,928	(383,524)
	6,980,261	6,517,809
	17,418,452	15,501,882

Signed on behalf of the Board:

Director

Director

See accompanying notes

NIAGARA-ON-THE-LAKE HYDRO INC.

STATEMENT OF RETAINED EARNINGS

for the year ended December 31, 2002

	2002 \$	2001 \$
Deficit, Beginning of Year	(383,524)	(206,710)
Net Income (Loss) for the Year	462,452	(176,814)
Retained Earnings (Deficit), End of Year	78,928	(383,524)

See accompanying notes

NIAGARA-ON-THE-LAKE HYDRO INC.**STATEMENT OF OPERATIONS**

for the year ended December 31, 2002

	2002 \$	2001 \$
Service Revenue		
Residential energy	5,342,791	5,560,436
General <50 energy	3,295,331	4,070,236
General >50 energy	5,003,565	4,279,148
Street lighting energy	76,054	77,353
Sentinel lighting energy	14,984	11,949
Unbilled revenue	1,709	(156,894)
Sales for retailers	333,865	
Non-competitive charges	1,764,770	
	15,833,069	13,842,228
Cost of Power		
Power purchased	12,406,161	11,366,747
Gross Margin	3,426,908	2,475,481
Other Income		
Administration expense recovery	4,973	50,083
Other revenue	40,879	38,923
Interest income	31,191	34,291
	77,043	123,297
	3,503,951	2,598,778
Other Expenditure		
Distribution operations	573,574	555,011
Billing and collection	316,079	368,708
General administration	495,935	522,407
Financial expense	541,615	490,936
Amortization - note 14(a)	1,003,590	838,530
	2,930,793	2,775,592
Net Income (Loss) Before Payments in Lieu of Corporate Income Taxes	573,158	(176,814)
Payments in Lieu of Corporate Income Taxes	110,706	
Net Income (Loss) for the Year	462,452	(176,814)

See accompanying notes

NIAGARA-ON-THE-LAKE HYDRO INC.**STATEMENT OF CASH FLOWS**

for the year ended December 31, 2002

	2002 \$	2001 \$
Operating Activities		
Net income (loss) for the year	462,452	(176,814)
Amortization - note 14(a)	1,103,897	904,483
Loss on disposal of capital assets	55,492	
Working capital provided by operations	1,621,841	727,669
Changes in non-cash working capital components - note 10 (a)	(298,405)	71,063
Funds provided by operating activities	1,328,436	798,732
Investing Activities		
Additions to capital assets - note 10(b)	(1,379,887)	(639,493)
Increase in regulatory assets - note 4	(218,276)	(147,079)
Decrease (increase) in extraordinary event costs	91,968	(6,217)
Decrease (increase) in special deposits	(70,930)	5,708
Funds used by investing activities	(1,577,125)	(787,081)
Other Activities		
Increase in future employee benefits	21,783	24,484
Increase (decrease) in customer deposits	28,930	(13,708)
Decrease in other deposits	(46,089)	(357,790)
Funds provided (used) by other activities	4,624	(347,014)
Decrease in Cash and Cash Equivalents	(249,065)	(335,363)
Cash and Cash Equivalents, Beginning of Year	(196,716)	138,647
Cash and Cash Equivalents, End of Year	(445,781)	(196,716)

See accompanying notes

NIAGARA-ON-THE-LAKE HYDRO INC.

NOTES TO FINANCIAL STATEMENTS

for the year ended December 31, 2002

Incorporation

On July 1, 2000, Niagara-on-the-Lake Hydro Inc. was incorporated under the Business Corporations Act (Ontario) along with its affiliate companies, Niagara-on-the-Lake Energy Inc. and Energy Services Niagara Inc. The incorporation was pursuant to the provisions of the Energy Competition Act, 1998.

1. Accounting Policies

These financial statements of Niagara-on-the-Lake Hydro Inc. have been prepared in accordance with accounting principles prescribed for electric distribution utilities by the Ontario Energy Board ("the OEB"). The company is a wholly-owned subsidiary of Niagara-on-the-Lake Energy Inc.

Use of estimates

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that effect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses for the year. Actual results could differ from estimates, including changes as a result of future decisions made by the OEB or the Minister of Energy.

Cash and cash equivalents

Cash equivalents are readily convertible investments with maturities of three months or less. Investments are recorded at the lower of cost and market.

Inventories

Inventory is valued at average cost with allowances for obsolete stock.

Capital assets

Capital assets are stated at cost and removed from the accounts when disposed or retired. Costs of assets which are pooled are removed from the accounts at the end of their estimated average service lives. Gains or losses at retirement or disposition of such assets are credited or charged to other income.

Amortization is provided for capital assets using the straight-line method based on the following estimated service lives:

Buildings	25 to 50 years
Transformer station	25 years
Distribution stations	25 years
Distribution lines	25 years
Distribution transformers and meters	25 years
Other capital assets	3 to 15 years
Intangible assets	Nil

NIAGARA-ON-THE-LAKE HYDRO INC.

NOTES TO FINANCIAL STATEMENTS

for the year ended December 31, 2002

1. Accounting Policies - continued

Other assets

Expenditures made which may benefit future periods are recorded as other assets. See Regulatory Assets, note 4.

Paid-up capital

Paid-up capital reflects the balance of capital contributions received by the former Niagara-on-the-Lake Hydro-Electric Commission prior to January 1, 2000

Revenue recognition

Service revenue is recorded as revenue in the period to which it relates. Service revenue from the sale of electrical energy includes an estimated accrual for power supplied but not billed to customers from the last meter reading date to the year end. The impact of the year end change in this estimated accrual is included in service revenue in the Statement of Operations.

Customer deposits

Customer deposits are cash collections from customers to guarantee the payment of electricity bills. Deposits expected to be refunded to customers within the next fiscal period are classified as a current liability.

Employee future benefits

The company pays certain medical, dental and life insurance benefits on behalf of its retired employees. The company recognizes these post-retirement costs in the period in which the employees rendered the services. See note 7.

Capitalized interest

The company capitalizes an amount of interest which represents an allowance for the use of funds expended during the construction period of capital assets. Interest is also capitalized on all funds expended and deferred as regulatory assets. See note 14(b).

Payments in lieu of corporate income taxes and capital taxes

Under the Electricity Act, 1998, the company is required to make payments in lieu of corporate taxes to Ontario Electricity Financial Corporation (OEFC), commencing October 1, 2001. These payments are calculated in accordance with the rules for computing income and taxable capital and other relevant amounts contained in the Income Tax Act (Canada) and the Corporations Tax Act (Ontario) as modified by the Electricity Act, 1998, and related regulations.

The company provides for payments in lieu of corporate income taxes using the taxes payable method. Under the taxes payable method, no provisions are made for future income taxes as a result of temporary differences between the tax basis of assets and liabilities and their carrying amounts for accounting purposes. When unrecorded future income taxes become payable, it is expected that they will be included in the rates approved by the OEB and recovered from the customers of Niagara-on-the-Lake Hydro Inc.

NIAGARA-ON-THE-LAKE HYDRO INC.

NOTES TO FINANCIAL STATEMENTS

for the year ended December 31, 2002

2. Due To (From) Affiliated Companies

	2002 \$	2001 \$
Niagara-on-the-Lake Energy Inc.	(8,854)	(3,585)
Energy Services Niagara Inc.	21,282	18,887
	12,428	15,302

Balances are non-interest bearing with no fixed terms of repayment.

3. Related Party Transactions

During the period, Niagara-on-the-Lake Hydro Inc. provided operation and administration services to its affiliates in the normal course of business in the following amounts:

	2002 \$	2001 \$
Niagara-on-the-Lake Energy Inc.	368	85
Energy Services Niagara Inc.	81,900	35,018
	82,268	35,103

In the ordinary course of business, the company enters into transactions with the Town of Niagara-on-the-Lake (the "Town") including its boards and agencies. The company derives revenues from the sale of electricity and recovers costs of supplying electrical equipment and distribution system from these related parties. Purchases from related parties take place at fair market value. Account balances resulting from these transactions which are included in the balance sheet are settled in accordance with normal trade terms.

NIAGARA-ON-THE-LAKE HYDRO INC.

NOTES TO FINANCIAL STATEMENTS

for the year ended December 31, 2002

4. Regulatory Assets

The OEB has established in its Electricity Distribution Rate Handbook and its Accounting Procedures Handbook for Electricity Distribution Utilities provisions for recording regulatory assets on company's Balance Sheet.

Regulatory assets primarily represent costs that have been deferred in anticipation of future cost recoveries as determined by the OEB. The costs include transition costs to prepare the utility for the competitive electricity market, pre and post market opening settlement variances related to the supply of energy to retailers and standard supply service customers, deferred payments in lieu taxes (PILS) representing the difference between PILS revenue entitlements and PILS collections, retailer cost variances and extraordinary event losses.

Bill 210, the Electricity Pricing, Conservation and Supply Act enacted by the Province of Ontario limits the opportunity to recover such regulatory assets during the rate cap period continuing to April 2006. Rate applications can be made to the OEB during this period with the written authorization of the Minister of Energy. Bill 210 also provides for the continuation of deferral accounts for these regulatory assets. In addition, the Minister of Energy has indicated, in a January 23, 2003 letter to distributors, that he will ask the OEB to complete, no later than December 31, 2003 a review of applications by distributors for the recovery of the amounts that Bill 210 deems to be regulatory.

All such costs will be deferred until the OEB requests submissions on how the utility plans to recover these costs from applicable ratepayers. The ultimate recovery of these costs is subject to the review and approval of the OEB. Upon review of the company's submission, the OEB may conclude that certain costs are not eligible for recovery from distribution utility ratepayers. The OEB may then prescribe the accounting treatment of any costs deemed to be ineligible. Failing this, any ineligible costs related to capital expenditures would be transferred to capital assets and be amortized in accordance with the appropriate rate for the capital asset class. Any ineligible costs of an operational nature would be recorded as an expense on the statement of operations in the year they become ineligible.

As at December 31, 2002, the company has accumulated \$ 441,120 (\$ 222,844 - 2001) in regulatory assets on the balance sheet as other assets. It is management's belief that these assets are consistent with the OEB's deferral criteria.

	2002 \$	2001 \$
Qualifying Transition Costs	362,442	252,915
Pre-Market Opening Variances	135,139	(30,071)
Deferred PILS Variances	238,583	
RSVA & RCVA Variances	(304,780)	
Other Deferred Variances	9,736	
	441,120	222,844

NIAGARA-ON-THE-LAKE HYDRO INC.

NOTES TO FINANCIAL STATEMENTS

for the year ended December 31, 2002

5. Extraordinary Event Costs

In May, 2000, certain properties within the municipal boundaries of the Town were subject to a type of storm known as a "downburst". The damage throughout the Town was extensive and therefore required resources of the company previously unbudgeted. The OEB had established in its Electricity Distribution Handbook criteria, which if met, authorized a distribution utility to defer certain costs incurred which relate to an extraordinary event. Such costs were deferred until the OEB reviewed the submission on how the utility planned to recover these costs from electricity distribution ratepayers. The recovery of these costs were denied by the OEB in May, 2002, therefore since the costs were capital in nature, they were reclassified to distribution lines within capital assets.

6. Long-Term Investments

The company has committed \$ 36,000 to a partnership known as the ENERconnect Limited Partnership as a limited partner. This partnership will carry on the business of procuring power on behalf of, and providing services relating to power procurement to limited partners and other third parties who are not.

7. Employee Future Benefits

Defined Benefit Plan Information

	2002 \$	2001 \$
Employee benefit plan assets		
Employee benefit plan liabilities	380,568	358,785
Employee benefit plan deficit	380,568	358,785
	2002 \$	2001 \$
Accrued benefit obligation, beginning of year	358,785	334,301
Expense for the year	35,266	33,924
Benefits paid during the year	(13,483)	(9,440)
Accrued benefit obligation, end of year	380,568	358,785

NIAGARA-ON-THE-LAKE HYDRO INC.

NOTES TO FINANCIAL STATEMENTS

for the year ended December 31, 2002

7. Employee Future Benefits - continued

The main actuarial assumptions employed for the valuation are as follows:

General Inflation - Future general inflation levels, as measured by changes in the Consumer Price Index (CPI), were assumed at 3.5% in 2000 and thereafter.

Interest (Discount) Rate - The present value of future liabilities and the expense were determined using a discount rate of 6.0%. This corresponds to the assumed CPI rate plus an assumed real rate of return of 2.5%.

Salary Levels - Future general salary and wage levels were assumed to increase at 2.0% per annum.

Medical Costs - Medical costs were assumed to increase at the CPI rate plus a further increase of 11.5% in 2000 graded down to 6.5% in 2009 and thereafter.

Dental Costs - Dental costs were assumed to increase at the CPI rate plus a further increase of 3.5% in 2000 and graded down to the CPI rate in 2009 and thereafter.

8. Long-Term Note Payable

On November 1, 2000, Niagara-on-the-Lake Hydro Inc. incurred a long-term note payable to the Town of Niagara-on-the-Lake in the amount of \$ 6,901,333. Pursuant to the transfer by-law, the long-term note payable was issued as a non-interest bearing instrument pending the establishment of permanent terms. There is no intent to redeem the long-term note payable.

Effective March 1, 2001, interest is payable at 7.25% and amounts paid and accrued for the year amounted to \$ 500,347 (\$ 458,651 - 2001).

9. Share Capital

Authorized

Unlimited number of common shares

Issued

1,001 common shares

2002	2001
\$	\$
2,632,307	2,632,307

NIAGARA-ON-THE-LAKE HYDRO INC.

NOTES TO FINANCIAL STATEMENTS

for the year ended December 31, 2002

10. Statement of Cash Flows

(a) Changes in working capital components include:

	2002 \$	2001 \$
Marketable securities		30,730
Accounts receivable	363,312	61,307
Rate settlement rebate receivable	(825,897)	
Unbilled revenue	(1,047,271)	244,761
Inventories	8,309	130,069
Prepaid expenses	(20,129)	7,952
Accounts payable	1,018,347	(23,542)
Payments in lieu of corporate income taxes payable	130,548	(22,842)
Due to affiliated companies	(2,874)	17,881
Other current liabilities	147,250	(207,253)
Note payable	(70,000)	(168,000)
	(298,405)	71,063

(b) Acquisition of capital assets

During the period, capital assets were acquired in the amount of \$ 1,652,856. Capital contributions received from third parties amounted to \$ 272,969. Cash payments of \$ 1,379,887 were made to purchase capital assets.

(c) Interest and payments in lieu of corporate income taxes

	2002 \$	2001 \$
Interest received	510	19,816
Interest paid	406,964	480,945
Payments in lieu of corporate income taxes paid	5,686	33,092

11. Pension Agreement

The company makes contributions to the Ontario Municipal Employees Retirement Systems (OMERS), which is a multi-employer plan, on behalf of approximately 20 members of its staff. The plan is a defined benefit plan which specifies the amount of the retirement benefit to be received by the employees based on the length of service and rates of pay.

As a result of OMERS waiving pension funding requirements, the amount contributed to OMERS for the year ending December 31, 2002 was nil for current service.

NIAGARA-ON-THE-LAKE HYDRO INC.

NOTES TO FINANCIAL STATEMENTS

for the year ended December 31, 2002

12. General Liability Insurance

The company is a member of the Municipal Electric Association Reciprocal Insurance Exchange (MEARIE) which is a pooling of general liability insurance risks. Members of MEARIE would be assessed, on a pro-rata basis, based on the total of their respective deposit premiums should losses be experienced by MEARIE, in excess of reserves and supplementary insurance, for the years in which the company or the former Niagara-on-the-Lake Hydro-Electric Commission was a member. To December 31, 2002, the company has not been made aware of any additional assessments. Participation in MEARIE covers a three year underwriting period which expires January 1, 2004.

13. Contingent Liability

Class Action

A class action claiming \$ 500 million in restitutionary payments plus interest was served on the former Toronto Hydro-Electric Commission 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 in Ontario which have charged late payment charges on overdue utility bills at any time after April 1, 1981.

The claim is based on the premise that late payment penalties result in the 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.

The Municipal Electric Association is undertaking the defence of this class action. At this time, it is not possible to quantify the effect, if any, on the financial statements of the company.

NIAGARA-ON-THE-LAKE HYDRO INC.

NOTES TO FINANCIAL STATEMENTS

for the year ended December 31, 2002

14. Other Information

(a) Amortization

	2002 \$	2001 \$
Amortization of capital assets charged to operations	1,003,590	838,530
Amortization of capital assets charged to operating assets	100,307	65,953
	1,103,897	904,483

(b) Capitalized Interest

	2002 \$	2001 \$
Capitalized interest	34,887	15,280

15. Financial Instruments

Credit Risk

The company in the normal course of business monitors the financial condition of its customers and reviews the credit history of new customers. The company is currently holding customer deposits on hand in the amount of \$ 114,243 (\$ 85,313 - 2001) and is reflected on the balance sheet. Allowances are also maintained for potential credit losses. Management believes that it has adequately provided for any exposure to normal customer credit risk.

Operating Line of Credit

As at December 31, 2002, the company had a line of credit of \$ 2,000,000 of which NIL had been drawn down. The line of credit is revolving operating and term facilities that bear interest at prime rate minus 0.25% and are secured by all assets of the company. There are unlimited guarantees provided by Niagara-on-the-Lake Energy Inc. and Energy Services Niagara Inc. The company is to maintain a current ratio not less than 1.2:1.

Letters of Credit/Guarantees

The company had arranged for a total letter of credit or guarantee in the amount of \$ 1,500,000. As at December 31, 2002, \$ 1,051,306 is available to the Independent Market Operator (the "IMO") of which NIL had been drawn upon. This is to provide a prudential letter of credit in support of the purchase of electrical power from the IMO. Any draw under this facility will be converted into a capital loan facility with a monthly repayment program to be negotiated.

NIAGARA-ON-THE-LAKE HYDRO INC.

NOTES TO FINANCIAL STATEMENTS

for the year ended December 31, 2002

16. Payments in Lieu of Corporate Income Taxes

Future income taxes relating to this regulated business have not been recorded in the accounts as they are expected to be recovered through future revenues. As at December 31, 2002, future income tax assets of \$ 1,235,922 (\$ 1,389,319 - 2001), based on substantively enacted income tax rates, have not been recorded. The company was not subject to payments in lieu of corporate income taxes prior to October 1, 2001.

Temporary differences and carryforwards which give rise to future income tax assets and liabilities are as follows:

	2002 \$	2001 \$
Future income tax assets		
Capital assets	1,267,436	1,252,883
Employee future benefits	114,627	108,066
Regulatory assets	(146,141)	
Tax loss carryforwards		28,370
	1,235,922	1,389,319

An independent valuation was completed effective October 1, 2001 in order to determine the fair market value of the company for the purpose of calculating payments in lieu of corporate income taxes under s. 93 of the Electricity Act. The valuation resulted in a fair market value of approximately \$ 17,219,000 of tangible capital assets, an increase of approximately \$ 4,116,022 over net book value as at October 1, 2001. This valuation was performed for the purposes of calculating payments in lieu of corporate income taxes only and has not been reflected as an adjustment to net book value for accounting purposes.

The reconciliation of the company's effective income tax rate for payments in lieu of corporate income taxes is as follows:

	2002 %	2001 %
Federal income tax rate	29.12	
Provincial income taxes, net of federal abatement	12.50	
Applicable tax rate	41.62	
Losses of prior years recognized in the year	(3.69)	
Reduction relating to general rate reduction	(1.64)	
Reduction relating to small business	(3.82)	
Surtax and large corporations tax	1.43	
Tax effect of expenses that are not deductible for income tax purposes	(2.10)	
Capital cost allowance	(12.48)	
	19.32	

NIAGARA-ON-THE-LAKE HYDRO INC.

NOTES TO FINANCIAL STATEMENTS

for the year ended December 31, 2002

17. Comparative Figures

Certain comparative figures have been restated to conform with the current years presentation.