

TORONTO HYDRO CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR THE YEAR ENDED
DECEMBER 31, 2006

The following discussion and analysis should be read in conjunction with the audited consolidated financial statements and accompanying notes of Toronto Hydro Corporation (the "Corporation") as at and for the year ended December 31, 2006 (the "Consolidated Financial Statements"). The Consolidated Financial Statements are prepared in accordance with Canadian generally accepted accounting principles, including accounting principles prescribed by the Ontario Energy Board (the "OEB") and are presented in Canadian dollars.

Business of Toronto Hydro

The Corporation is a holding company, which wholly-owns the following subsidiaries:

- *Toronto Hydro-Electric System Limited* ("LDC") – which distributes electricity;
- *Toronto Hydro Energy Services Inc.* ("TH Energy") – which provides street lighting and expressway lighting services and develops energy efficiency products and services. In 2006, TH Energy also managed a portfolio of electricity contracts (the last of which expired on December 31, 2006), and operated a water heater rental business (the assets comprising the water heater rental business were sold on February 8, 2007). See notes 15, 23 and 26 to the Consolidated Financial Statements; and
- *Toronto Hydro Telecom Inc.* ("Telecom") – which provides fibre optic cable capacity and manages data communications services.

The principal business of the Corporation and its subsidiaries is the distribution of electricity by LDC. LDC owns and operates an electricity distribution system, which delivers electricity to approximately 678,000 customers located in the City of Toronto. LDC is the largest municipal electricity distribution company in Canada and distributes approximately 18% of the electricity consumed in Ontario. The business of LDC is regulated by the OEB which has broad powers relating to licensing, standards of conduct and service and the regulation of rates charged by LDC and other electricity distributors in Ontario.

TH Energy owns and operates street lighting and expressway lighting systems located in the City of Toronto and is engaged in the sale of energy efficiency products and services to commercial and industrial customers.

Telecom is a provider of "dark" fibre optic capacity and data communications services to telecommunications carriers, business customers and large institutions in the City of Toronto. Telecom owns a network of fibre optic cable located in ducts, on poles and in other parts of the electricity distribution system of LDC. The network is currently connected to over 490 buildings located in the City of Toronto.

The sole shareholder of the Corporation is the City of Toronto (the "City").

Electricity Distribution – Industry Overview

On May 1, 2002, the Province opened Ontario’s wholesale and retail markets to competition by providing generators, retailers and consumers with open access to Ontario’s transmission and distribution network (“Open Access”).

Since the commencement of Open Access, LDC and other electricity distributors have been purchasing their electricity from the wholesale market administered by the Independent Electricity System Operator (“IESO”) and recovering the costs of electricity and certain other costs at a later date in accordance with procedures mandated by the OEB.

The OEB has regulatory oversight of electricity matters in the Province of Ontario. The *Ontario Energy Board Act, 1998* sets out the OEB’s authority to issue a distribution licence which must be obtained by owners or operators of a distribution system in Ontario. The OEB prescribes licence requirements and conditions including, among other things, specified accounting records, regulatory accounting principles, separation of accounts for separate businesses and filing process requirements for rate-setting purposes.

The OEB’s authority and responsibilities include the power to approve and fix rates for the transmission and distribution of electricity, the power to provide continued rate protection for rural and remote electricity customers and the responsibility for ensuring that electricity distribution companies fulfil obligations to connect and service customers.

LDC is required to charge its customers for the following amounts (all of which, other than the distribution rate, represent a pass through of amounts payable to third parties):

- *Electricity Price and Related Rebates* – The electricity price and related rebates represent a pass through of the commodity cost of electricity.
- *Distribution Rate* – The distribution rate is designed to recover the costs incurred by LDC in delivering electricity to customers and the OEB-allowed rate of return. Distribution rates are regulated by the OEB and typically comprise a fixed charge and a usage-based (consumption) charge.

The volume of electricity consumed by LDC’s customers during any period is governed by events largely outside LDC’s control (principally, sustained periods of hot or cold weather which increase the consumption of electricity, and sustained periods of moderate weather which decrease the consumption of electricity).

- *Retail Transmission Rate* – The retail transmission rate represents a pass through of wholesale costs incurred by distributors in respect of the transmission of electricity from generating stations to local areas. Retail transmission rates are regulated by the OEB.
- *Wholesale Market Service Charge* – The wholesale market service charge represents a pass through of various wholesale market support costs. Retail rates for the recovery of wholesale market service charges are regulated by the OEB.

Market participants (including distributors and retailers) are required to satisfy and maintain prudential requirements with the IESO, which include credit support with respect to outstanding market obligations in the form of letters of credit, cash deposits or guarantees from third parties with prescribed credit ratings.

The Corporation and its subsidiaries are exempt from tax under the *Income Tax Act (Canada)* and the *Corporations Tax Act (Ontario)*, if not less than 90% of the capital of the Corporation is owned by the City and not more than 10% of the income of the Corporation and each of its subsidiaries is derived from activities carried on outside the municipal geographical boundaries of the City.

The Corporation and each of its subsidiaries is a “municipal electricity utility” (“MEU”) for purposes of the payment in lieu of corporate taxes (“PILs”) regime contained in the *Electricity Act, 1998*. The *Electricity Act, 1998* provides that a MEU that is exempt from tax under the *Income Tax Act (Canada)* and the *Corporations Tax Act*

(Ontario) is required to make, for each taxation year, a PILs to the Ontario Electricity Financial Corporation in an amount equal to the tax that it would be liable to pay under the *Income Tax Act (Canada)* and the *Corporations Tax Act (Ontario)* if it were not exempt from tax.

Selected Consolidated Financial Data

The selected consolidated financial data presented below should be read in conjunction with the Consolidated Financial Statements.

Year ended December 31, (in thousands of dollars, except for per share amounts)				
	2006	2005	Change	Change
	\$	\$	\$	%
Consolidated Statement of Operations Data ⁽¹⁾				
Revenues	2,247,008	2,606,272	(359,264)	(13.78%)
Costs				
Purchased power and other	1,705,845	2,059,789	(353,944)	(17.18%)
Operating expenses	194,216	191,185	3,031	1.59%
Depreciation and amortization	137,344	131,595	5,749	4.37%
	<u>2,037,405</u>	<u>2,382,569</u>	<u>(345,164)</u>	<u>(14.49%)</u>
Income before interest, other and provision for PILs	209,603	223,703	(14,100)	(6.30%)
Interest income	17,726	14,116	3,610	25.57%
Interest expense				
Long-term debt	(75,894)	(80,403)	4,509	5.61%
Other interest	(2,902)	(2,700)	(202)	(7.48%)
Other	89	5,040	(4,951)	(98.23%)
Income before provision for PILs	<u>148,622</u>	<u>159,756</u>	<u>(11,134)</u>	<u>(6.97%)</u>
Provision for PILs	58,403	68,839	(10,436)	(15.16%)
Income from continuing operations	90,219	90,917	(698)	(0.77%)
Income from discontinued operations – net of tax ⁽²⁾	2,178	1,528	650	42.54%
Net income	<u>92,397</u>	<u>92,445</u>	<u>(48)</u>	<u>(0.05%)</u>
Basic and fully diluted net income per share from continuing operations	90,219	90,917	(698)	(0.77%)
Basic and fully diluted net income per share from discontinued operations	2,178	1,528	650	42.54%
Basic and fully diluted net income per share	<u>92,397</u>	<u>92,445</u>	<u>(48)</u>	<u>(0.05%)</u>

Notes:

- (1) Amounts reflect reclassification for discontinued operations. See note 23 to the Consolidated Financial Statements.
- (2) Consists of discontinued operations for water heaters. See note 23 to the Consolidated Financial Statements.

**As at December 31,
(in thousands of dollars)**

	2006	2005
	\$	\$
Consolidated Balance Sheet Data ⁽¹⁾		
Total assets	2,591,706	2,819,258
Current liabilities	555,105	941,211
Long-term liabilities	1,144,537	1,032,180
Total liabilities	1,699,642	1,973,391
Shareholder's equity	892,064	845,867
Total liabilities and shareholder's equity	2,591,706	2,819,258

Note:

- (1) Includes discontinued operations. See note 23 to the Consolidated Financial Statements.

Results of Operations

Net Income

Net income was \$92.4 million in 2006 and 2005. Unfavourable variances were noted in net revenues (\$5.3 million), operating expenses (\$3.0 million), depreciation and amortization expense (\$5.7 million) and other (\$5.0 million). These unfavourable variances were offset by decreased net interest expense (\$7.9 million), decreased provision for PILs (\$10.4 million) and increased income from discontinued operations (\$0.7 million).

Net Revenues

Net revenues (revenues minus the cost of purchased power and other) were \$541.2 million in 2006 compared to \$546.5 million in 2005. The decrease was primarily due to decreased net revenues at TH Energy (\$5.8 million) and LDC (\$5.5 million) partially offset by increased net revenues at Telecom (\$5.4 million).

At TH Energy, the decrease in net revenues was primarily due to lower contributions from the remaining activities of the electricity retail business which concluded on December 31, 2006 (\$17.8 million), partially offset by increased revenue from street lighting and expressway lighting services provided to the City under the terms of a new service agreement entered into as part of the purchase of the street lighting and expressway lighting assets from the City on December 31, 2005 (\$12.1 million).

At LDC, the decrease in net revenues for the year ended December 31, 2006 was mainly due to lower distribution revenue from decreased consumption (26,437 GWh compared to 27,282 GWh) attributable to weather and Conservation and Demand Management ("CDM") programs (\$13.7 million), a decrease in distribution rates following the OEB's decision on LDC's 2006 rate application regarding interest payable to related parties (\$11.8 million), and a reduction of recoverability for PILs related to the elimination of Large Corporation Tax (\$1.7 million). LDC's decrease in net revenues was partially offset by higher revenue recognition from CDM programs in 2006 (\$14.2 million) and changes in allowable cost recovery stemming from the OEB's decision on 2006 rate application (\$7.5 million).

At Telecom, the increase in net revenues was primarily due to increased margin from the sale of data managed services.

Expenses

Operating expenses were \$194.2 million in 2006 compared to \$191.2 million in 2005. The increase in operating expenses was primarily due to higher deferral of pension and regulatory costs at LDC for 2005 prior to inclusion of these costs in distribution rates effective May 1, 2006 stemming from the OEB's decision into LDC's 2006 rate application (\$6.4 million), increased operating spending on CDM programs (\$3.9 million), partially offset by lower property taxes (\$6.7 million) mainly from realized gains on appeals related to 2002 to 2006 assessments.

Depreciation and amortization expense was \$137.3 million in 2006 compared to \$131.6 million in 2005. The increase was primarily due to the depreciation of street lighting and expressway lighting assets purchased from the City by TH Energy at the end of 2005.

Net interest expense was \$61.1 million in 2006 compared to \$69.0 million in 2005. The decrease was primarily due to lower interest expense in respect of the City Promissory Note commencing May 1, 2006 (\$4.5 million) (see "Corporate Developments – Amended and Restated City Note") and higher interest received on short-term investments.

Other

Included in Other are amounts primarily relating to gains on disposals of property, plant and equipment. Other was \$0.1 million in 2006 compared to \$5.0 million in 2005. The decrease was due to gains realized in 2005 on disposals of excess properties at LDC (\$2.4 million) and dark fibre assets at Telecom (\$2.6 million).

Provision for PILs

Provision for PILs was \$58.4 million in 2006 compared to \$68.8 million in 2005. The decrease in the provision for PILs was primarily due to higher earnings before taxes in 2005 and lower temporary differences in LDC resulting from deductions of capital cost allowance and depreciation on fixed assets in LDC.

Discontinued Operations

In November 2006, the Board of Directors of TH Energy approved a plan to sell the water heater business. The results of operations and financial position of this business segment have been segregated and are presented as discontinued operations.

Income from discontinued operations was \$2.2 million in 2006 compared to \$1.5 million in 2005. The increase was primarily due to lower depreciation costs from lower asset book value (\$1.1 million), partially offset by higher operating expenses related to marketing efforts (\$0.5 million).

On February 8, 2007, TH Energy sold its water heater business to Consumers' Waterheater Income Fund for cash consideration of \$40.8 million subject to post closing adjustments and transaction costs. See notes 23 and 26 to the Consolidated Financial Statements.

Quarterly Results of Operations

The tables below present unaudited quarterly consolidated financial information of the Corporation for 2006 and 2005 and reflect discontinued operations relating to water heaters. See note 23 to the Consolidated Financial Statements.

2006 quarter ended, (in thousands of dollars)				
	December 31	September 30	June 30	March 31
	\$	\$	\$	\$
Revenues	549,931	598,581	534,930	563,566
Costs	499,836	541,858	487,257	508,454
Income from continuing operations	22,054	28,197	17,721	22,247
Net income.....	22,783	28,894	18,161	22,559

2005 quarter ended, (in thousands of dollars)				
	December 31	September 30	June 30	March 31
	\$	\$	\$	\$
Revenues	636,206	772,121	586,972	610,973
Costs	591,429	713,039	520,859	557,242
Income from continuing operations	22,153	18,842	29,380	20,542
Net income.....	22,501	19,354	29,754	20,836

Liquidity and Capital Resources

Sources of Liquidity and Capital Resources

The Corporation's primary sources of liquidity and capital resources are cash provided by operating activities, short-term bank financing, interest income and debt capital market borrowings.

The Corporation does not believe that equity contributions from the City, its sole shareholder, will constitute a source of capital. In addition, the Corporation is not aware of any plan or decision by the City to permit the Corporation to sell equity to the public or other investors.

Liquidity and Capital Resources Year Ended December 31, (in thousands of dollars)		
	2006	2005
	\$	\$
Cash and cash equivalents, beginning of period	448,370	386,625
Net cash provided by operating activities	112,728	325,087
Net cash used in investing activities	(188,602)	(174,722)
Net cash used in financing activities	(45,547)	(89,947)
Net cash provided by discontinued operations ⁽¹⁾	575	1,327
Cash and cash equivalents, end of period	<u>327,524</u>	<u>448,370</u>

Note:

- (1) Consists of discontinued operations for water heaters. See note 23 to the Consolidated Financial Statements.

Cash Provided by Operating Activities

Cash provided by operating activities was \$112.7 million in 2006 compared to \$325.1 million in 2005. The decrease was primarily due to an unfavourable variance in accounts payable and accrued liabilities at LDC due to the payment in 2006 of rebates received at the end of 2005 (\$174.9 million) and increased payments for PILs in 2006 from revisions to projected tax liabilities (\$45.5 million), an unfavourable variance in the aggregate of accounts receivable and unbilled revenue at TH Energy due to reduced electricity activities (\$39.8 million) and an unfavourable variance in deferred revenue primarily due to increased CDM initiatives at LDC (\$34.6 million).

These variances were partially offset by a favourable variance in the aggregate of accounts receivable and unbilled revenue at LDC due to timing differences in the collection of large commercial customers at the end of 2006 (\$53.8 million) and a favourable variance in electricity mark-to-market assets and liabilities at TH Energy resulting from the expiration of the electricity retail portfolio (\$25.1 million).

Revolving Credit Facility

The Corporation is a party to a revolving credit facility agreement dated May 5, 2005 pursuant to which the Corporation may borrow up to \$500 million, of which up to \$175 million is available in the form of letters of credit. As at December 31, 2006, no borrowings for working capital were outstanding and letters of credit in the amount of \$81.6 million had been issued. See note 9 to the Consolidated Financial Statements.

Operating Liquidity and Capital Resource Requirements

The Corporation's primary liquidity and capital resource requirements are for capital expenditures to maintain and improve the electricity distribution system of LDC, cost of power expense, interest expense and prudential requirements and third party credit support.

Cash Used in Investing Activities

Cash used in investing activities was \$188.6 million in 2006 compared to \$174.7 million in 2005. The increase was primarily due to an increase in regulatory assets from smart meter activities and settlement of variance accounts in LDC (\$24.8 million), an increase in the purchase of property, plant and equipment at LDC to improve electricity distribution assets (\$35.4 million), at TH Energy to improve street lighting and expressway lighting assets (\$4.3 million) and at Telecom for the reinforcement of the core network and the deployment of the new Wi-Fi network (\$3.4 million). These variances were partially offset by the investment of \$60 million made by TH Energy in 2005 for the purchase of the street lighting and expressway lighting assets from the City.

Capital Expenditures

The following table summarizes the Corporation's capital expenditures for the years indicated.

**Year Ended December 31,
(in thousands of dollars)**

	2006	2005
	\$	\$
Capital Expenditures from Continuing Operations		
LDC		
Distribution system	131,389	113,333
Technology assets	21,880	10,119
Other ⁽¹⁾	14,416	8,808
	167,685	132,260
Other ⁽²⁾	17,622	68,095
Total capital expenditures	185,307	200,355
Capital Expenditures from Discontinued Operations		
Water heaters	3,865	3,638

Notes:

- (1) Consists of vehicles, other work-related equipment, furniture and office equipment.
- (2) Includes capital expenditures relating to TH Energy and Telecom.

Cash Used in Financing Activities

Cash used in financing activities was \$45.5 million in 2006 compared to \$89.9 million in 2005. The decrease was primarily due to a decrease in dividends paid (\$21.8 million) and the reclassification of a large portion of customer deposits to long-term assets in 2006 (\$21.9 million).

Prudential Requirements and Third Party Credit Support

In order to mitigate the risk of payment default, wholesale market participants are required to provide credit support for their obligations to the IESO in the form of letters of credit, cash deposits or guarantees from third parties with prescribed credit ratings. A market participant's prudential requirements are determined by the IESO based on the participant's "maximum net exposure", subject to permitted reductions resulting from, among other things, good payment history, credit rating or, in the case of distributors, prudential support collected from retailers or customers.

In addition to prudential requirements, counterparties under bilateral contracts for the purchase and sale of electricity contracts may require parental guarantees or other forms of credit support. Also, electricity distributors may require retailers to maintain security arrangements (including letters of credit, surety bonds, cash deposits or lock-box arrangements) under terms prescribed by the OEB to protect against credit risk.

The City has authorized the Corporation to provide financial assistance to its subsidiaries, and LDC to provide financial assistance to other subsidiaries of the Corporation, in the form of letters of credit and guarantees, for the purposes of enabling them to carry on their businesses up to an aggregate amount of \$500 million.

As at December 31, 2006, the Corporation had issued \$56.5 million of parental guarantees on behalf of TH Energy in support of prudential requirements and obligations under bilateral contracts for the purchase and sale of electricity. The Corporation has also issued a parental guarantee to the City as part of an agreement by the City to purchase electricity at a fixed price from TH Energy. The value of the parental guarantee to the City was nil at December 31, 2006. See note 16 to the Consolidated Financial Statements.

Dividends

The shareholder direction adopted by the City with respect to the Corporation provides that the board of directors of the Corporation will use its best efforts to ensure the Corporation meets certain financial performance standards, including those relating to credit rating and dividends. Subject to applicable law, the shareholder direction provides that the Corporation will pay dividends to the City each year equal to the greater of \$25 million or 50% of the Corporation's net income for the year. The dividends are not cumulative and are payable as follows:

- \$6 million on the last business day of each of the first three fiscal quarters during the year;
- \$7 million on the last business day of the fiscal year; and
- the amount, if any, by which 50% of the Corporation's net income for the year exceeds \$25 million, within ten calendar days after the board of directors of the Corporation approves the Corporation's Consolidated Financial Statements for the year.

The board of directors of the Corporation declared and paid dividends totalling \$46.2 million in 2006 and \$68.0 million in 2005.

On March 1, 2007, the board of directors of the Corporation declared dividends in the amount of \$27.2 million. The dividends are comprised of a \$21.2 million payment for 2006 net income, payable to the City on March 9, 2007, and a \$6.0 million payment in connection with the first quarter of 2007, payable to the City on March 30, 2007.

Corporate Developments

Appointments

On November 29, 2006, Anthony Haines was appointed President of LDC.

On December 6, 2006, Gordon Perks was appointed as a Director of the Corporation and David Shiner and Bill Saundercook were reappointed as Directors of the Corporation, each for a term of office that shall end on December 31, 2008.

Changes in Business

TH Energy operated a water heater rental business until February 8, 2007, at which time the business was sold to The Consumers' Waterheater Income Fund. See notes 23 and 26 to the Consolidated Financial Statements.

In December 2002, TH Energy ceased electricity retailing activities in respect of new customers following the implementation of price protection under the *Electricity Pricing, Conservation and Supply Act, 2002*. Remaining contracts and portfolio obligations were managed to expiration on December 31, 2006. See note 15 to the Consolidated Financial Statements.

Medium-Term Note Program

On January 13, 2006, the Corporation filed a short form base shelf prospectus in connection with the establishment of a medium-term note program ("MTN Program"). Under the terms of the MTN Program, the Corporation may offer and issue, from time to time, unsecured debentures in one or more series in an aggregate principal amount of up to \$1 billion during the twenty-five months following the date of the prospectus. The debentures issuable under the MTN Program have been assigned a rating of "A" with a stable trend by DBRS and a preliminary rating of "A-" by S&P. As at December 31, 2006, no debentures had been issued under the MTN Program.

Amended and Restated City Note

On September 5, 2006, the Corporation announced that it and the City had amended and restated the outstanding \$980.2 million promissory note between the Corporation and the City (the "City Note") effective

May 1, 2006 by fixing the interest rate at 6.11% (the same interest rate payable on the Corporation's outstanding senior unsecured debentures) and establishing an agreed repayment schedule (\$245.1 million on the last business day before each of December 31, 2007, December 31, 2009 and December 31, 2011 and on May 6, 2013). Interest is calculated and payable quarterly in arrears on the last business day of March, June, September and December of each year. A copy of the amended and restated City Note is available at www.sedar.com. See note 11 to the Consolidated Financial Statements.

Ministry of Finance Tax Audit

The Ministry of Finance is currently carrying out a tax audit of the Corporation and its subsidiaries. Certain filing positions for PILs taken by the Corporation and its subsidiaries may be challenged on the audit. This may result in a material increase in the Corporation's reported tax obligations upon reassessment. As the audit has not yet been completed, management is not able to determine the impact, if any, of the audit on the Consolidated Financial Statements or the Corporation's tax reserves. The Corporation adjusts its tax reserves when there is sufficient information available, or when an event occurs requiring a change to the reserves.

Distribution Rates

In March 2005, LDC received approval from the OEB to increase distribution rates to recover \$39.8 million, representing the third and final adjustments necessary to achieve a market-based rate of return of 9.88%. The rate increase was effective as of April 1, 2005 and subjected the LDC to a financial commitment to invest \$39.8 million in CDM activities by September 2007.

In April 2006, the OEB approved a decrease in distribution rates of LDC for the period May 1, 2006 to April 30, 2007 representing a revenue reduction of approximately \$58.0 million. The methodology used by the OEB to establish the distribution rates was based on, among other things, a rate base of \$1.861 billion, a deemed debt to equity structure of 65:35 and an allowed return on equity of 9%. The OEB also allowed for the recovery of regulatory assets related to prior years' pension costs and OEB fees and reduced the allowable interest rate recoverable on related party debt including the outstanding \$980.2 million promissory note between LDC and the Corporation from 6.8% to 5% per annum.

On January 26, 2007, LDC filed an Annual Rate Adjustment Application for 2007 Rates as directed to by the OEB. In accordance with the OEB's Incentive Regulation Model, LDC has sought authorization to increase its distribution rates by 0.4% on May 1, 2007.

Smart Meters

On June 13, 2006, the Province issued draft regulations clarifying the technical details of advanced metering infrastructure and data management. In support of the Province's decision to install smart meters throughout Ontario by 2010, LDC launched its smart meter project in 2006. The project objective is to install 711,000 smart meters and the supporting infrastructure by the end of 2009. LDC had installed 193,000 meters at December 31, 2006 and will use the experience gained from this initiative as an opportunity to further develop and test the new tools, processes, and network infrastructure to support the mass deployment of these smart meters.

On May 1, 2006, LDC implemented new distribution rates which included charges for smart meters of \$0.47 per month for each residential customer and \$1.04 per month for all other customers. The charges are the first part of the funding for LDC's smart meter program. Consistent with the OEB's direction, LDC has deferred capital expenditures, operating expenditures, and revenues relating to smart meters in regulatory asset accounts. When LDC files its application to clear the 2006 smart meter balances, the \$0.47 and \$1.04 riders will be removed (and replaced by new rate riders, if approved by the OEB). See note 7 to the Consolidated Financial Statements.

OEB Proposals for Multi-Year Electricity Rate Setting Plan

On June 19 and July 25, 2006, the OEB began a generic licence amendment proceeding that was intended to effect changes to the allowable cost of capital and to effect a multi-year electricity distribution rate setting plan via incentive regulation mechanisms for distributors. LDC responded to both proposals in writing, and participated in technical conferences held in August and September. In December 2006, in the interests of implementing

distribution rate changes for 2007 in a timely manner, the OEB discontinued its examination into LDCs' allowable cost of capital and second-generation incentive regulation mechanism.

Consumers' Gas Decision

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 The Consumers' Gas Company ("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 a determination of the plaintiffs' damages. The parties reached a settlement of this class action. The Ontario Superior Court of Justice has approved this settlement. However, the representative plaintiff, Mr. Garland, is appealing the settlement approval order in an attempt to increase the fees to which he is entitled for having acted as representative plaintiff and to receive lawyer's fees in connection with such efforts. Mr. Garland's appeal is pending.

LDC is not a party to the Consumers' Gas class action. It is, however, subject to the two class actions described below and in the Corporation's annual information form, in which the issues are analogous.

The first is an action commenced against a predecessor of LDC and other Ontario MEU's under the Class Proceedings Act, 1992 seeking \$500.0 million in restitution for late payment charges collected by them from their customers that were in excess of the interest limit stipulated in section 347 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. After the release by the Supreme Court of Canada of its 2004 decision in the Consumers' Gas case, the plaintiffs in this proposed class action indicated their intentions to proceed with the litigation, but no formal steps have been taken.

The second is an action commenced against a predecessor of LDC under the *Class Proceedings Act, 1992* seeking \$64.0 million in restitution for 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. This action is also at a preliminary stage. Pleadings have closed and examinations for discovery have been conducted but, as in the first action, the classes have not been certified as the parties were awaiting the outcome of the Consumers' Gas class action.

The claims made against LDC and the definitions of the plaintiff classes are identical in both actions. As a result, any damages payable by LDC in the first action would reduce the damages payable by LDC in the second action, and vice versa.

It is anticipated that the first action will now proceed for determination in light of the reasons of the Supreme Court in the Consumers' Gas class action.

LDC may have defences available to it in these actions 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 LDC from its customers were in excess of the interest limit stipulated in section 347 of the Criminal Code is fact specific in each circumstance. Accordingly, given the preliminary status of these actions, it is not possible at this time to reasonably quantify the effect, if any, of the Consumers' Gas decision on these actions or of these actions on the financial performance of the Corporation.

Share Capital

The authorized capital of the Corporation consists of an unlimited number of common shares of which 1,000 common shares are issued and outstanding as at the date hereof.

Services Provided to the City

Subsidiaries of the Corporation provide certain services to the City at commercial rates, including street lighting and maintenance services. In addition, the City and its agencies have entered into energy management contracts with TH Energy. See note 19 to the Consolidated Financial Statements.

Risks and Uncertainties

The financial performance of the Corporation is subject to a variety of risks and uncertainties including those described below:

Regulatory Uncertainty

The OEB regularly conducts consultations with interested stakeholders with respect to a number of areas which may affect electricity distributors.

The continuing restructuring of Ontario's electricity industry and other regulatory developments may affect the distribution rates charged by LDC and the costs LDC is permitted to recover. This may in turn have a material adverse effect on the financial performance of the Corporation. In particular, there can be no assurance that:

- the OEB may not set a lower recovery for LDC's cost of capital;
- the full cost of providing service to distribution customers will be permitted to be recovered through distribution rates;
- the OEB will not permit competitors to provide distribution services in a distributor's licensed area;
- the OEB will allow recovery for revenue lost as a consequence of the emergence and adoption of new technologies such as distributed generation, or unanticipated effects of conservation and demand management;
- parts of the LDC's services will not be separated from LDC and opened to competition; or
- regulatory or other changes will not be made to the PILs regime.

Changes to any of the laws, rules, regulations or policies applicable to the businesses carried on by the Corporation could have a significant impact on the Corporation. There can be no assurance that the Corporation will be able to comply with applicable future laws, rules, regulations and policies. Failure by the Corporation to comply with applicable laws, rules, regulations and policies may subject the Corporation to civil or regulatory proceedings which may have a material adverse effect on the Corporation.

Additional Debt Financing

The Corporation expects to borrow to repay the City Note when required to do so under the terms of the City Note. See note 11 to the Consolidated Financial Statements. The Corporation's ability to arrange sufficient and cost-effective debt financing to repay the City Note and for general corporate purposes (including credit support for prudential requirements) could be adversely affected by a number of factors, including the regulatory environment in Ontario, the Corporation's results of operations and financial condition, financial market conditions, the ratings assigned to the Corporation and its debt securities by credit rating agencies, the current timing of debt maturities, and general economic conditions.

Electricity Consumption

LDC's distribution rates typically comprise a fixed charge and a usage-based (consumption) charge. The volume of electricity consumed by LDC's customers during any period is governed by events largely outside LDC's control (principally sustained periods of hot or cold weather which increase the consumption of electricity, and sustained periods of moderate weather which decrease the consumption of electricity).

Credit Risk

LDC is subject to credit risk with respect to customer non-payment. LDC is permitted to mitigate the risk of customer non-payment using any means permitted by law, including security deposits (including letters of credit, surety bonds, cash deposits or lock-box arrangements, under terms prescribed by the OEB) under terms prescribed by the OEB), late payment penalties, pre-payment, pre-authorized payment, load limiters or disconnection.

In the event of an actual payment default and attendant bad debt expense incurred by LDC, roughly 80% of the expense would be related to commodity and transmission costs, and the remainder to LDC's distribution revenue. Accordingly, while LDC will be liable for the full amount of the default, there can be no assurance that the OEB will allow recovery of the bad debt expense from remaining customers. Rather, it is expected that the OEB will examine LDC's application for claiming bad debt expenses on a case-by-case basis. See note 15 to the Consolidated Financial Statements.

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 LDC's maintenance program and capital expenditure requirements for distribution plant refurbishment and replacement.

Refer to the Corporation's annual information form for more details on risks and uncertainties.

Disclosure and Internal Controls

The President and Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") of the Corporation, together with management, have established and maintained disclosure controls and procedures of the Corporation in order to provide reasonable assurance that material information relating to the Corporation is made known to them in a timely manner, particularly during the period in which the annual filings are being prepared. These officers evaluated the effectiveness of the design and operation of disclosure controls and procedures as of December 31, 2006 and, based on that evaluation, have concluded that these controls are effective in providing such reasonable assurance.

The CEO and CFO, together with management, have also evaluated the design of internal controls over financial reporting of the Corporation as of December 31, 2006 in order to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements. Based on that evaluation, these officers have concluded that the design of these controls is effective to provide such reasonable assurance.

During the quarter ending December 31, 2006, there were no changes to the Corporation's internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, its internal control over financial reporting.

Significant Accounting Policies

The Consolidated Financial Statements have been prepared in accordance with Canadian generally accepted accounting principles, including accounting principles prescribed by the OEB, and are presented in Canadian dollars. In preparing the Consolidated Financial Statements, management of the Corporation makes estimates and assumptions which affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the dates of the Consolidated Financial Statements and the reported amounts of revenues and expenses for the periods covered thereby. Actual results could differ from those estimates, including changes as a result of future decisions made by the OEB, the Minister of Energy or the Minister of Finance. The significant accounting policies of the Corporation are summarized in note 4 to the Consolidated Financial Statements.

Effective June 30, 2006, the Corporation adopted Emerging Issue Committee Abstract EIC-159 - "Conditional Asset Retirement Obligations" ["EIC-159"]. EIC-159 requires an entity to recognize a liability for the fair value of an asset retirement obligation ["ARO"] even though the timing or method of settlement is conditional on future events. The Corporation has identified conditional AROs and recognized a liability amounting to \$1.6

million at year-end. The change has been accounted for prospectively as information is not available to allow it to be accounted for retrospectively. See note 4 to the Consolidated Financial Statements.

In April 2005, the Canadian Institute of Chartered Accountants released three Handbook Sections relating to financial instruments: 1530 – “Comprehensive Income”, 3855 – “Financial Instruments – Recognition and Measurement” and 3865 – “Hedges” effective for annual and interim periods beginning on or after October 1, 2006. These new Sections establish standards for the recognition and measurement of financial instruments. The Corporation is currently evaluating the impact of these standards on its financial statements.

In December 2006, the Canadian Accounting Standards Board announced that as of March 31, 2008, they will be making a final decision on the date in which publicly accountable enterprises will be required to change over to International Financial Reporting Standards (“IFRS”). At this time, it is anticipated that by 2011 Canadian GAAP will be substantially the same as IFRS. Until the change over is finalized, companies will continue to describe their basis of reporting as Canadian GAAP.

Forward-Looking Information

Certain information included herein constitutes “forward-looking information”. Forward-looking information means disclosure regarding possible events, conditions or results that is 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”, “budget”, “continue” or the negative of these terms or other comparable terminology. In addition, certain information included herein may contain forward-looking information attributable to third parties. 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, the ratings assigned to the Corporation and its debt securities by rating agencies, 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.

Additional Information

The information included herein reflects material events up to March 1, 2007, the date on which Consolidated Financial Statements of the Corporation were approved by the Corporation’s board of directors.

Additional information with respect to the Corporation (including its annual information form and annual report) is available on the Canadian Securities Administrators’ web-site at www.sedar.com.

Toronto, Canada

March 1, 2007