

TORONTO HYDRO CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR THE INTERIM PERIOD ENDED
JUNE 30, 2006

The following discussion and analysis should be read in conjunction with:

- the unaudited interim consolidated financial statements and accompanying notes of Toronto Hydro Corporation (the "Corporation") as at and for the three-month period and the six-month period ended June 30, 2006 (the "Interim Consolidated Financial Statements");
- the audited consolidated financial statements and accompanying notes of the Corporation as at and for the year ended December 31, 2005 (the "Annual Consolidated Financial Statements"); and
- management's discussion and analysis of financial condition and results of operations for the year ended December 31, 2005 (including the sections entitled "Electricity Industry", "Quarterly Results of Operations", "Liquidity and Capital Resources", "Corporate Developments", "Consumers' Gas Decision", "Share Capital", "Services Provided to the City of Toronto", "Risks and Uncertainties", "Risk Management" and "Significant Accounting Policies" which remain substantially unchanged as at the date hereof except as noted below or as updated by the Interim Consolidated Financial Statements).

Copies of these documents are available on the Canadian Securities Administrators' web site at www.sedar.com.

The Interim 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. In preparing the Interim Consolidated Financial Statements, management 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 Interim 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 3 to the Annual Consolidated Financial Statements and in note 3 to the Interim Consolidated Financial Statements.

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 manages an existing portfolio of electricity contracts and provides energy efficiency products and services;
- *Toronto Hydro Telecom Inc.* ("Telecom") - which provides fibre optic cable capacity and manages data communications services; and
- *Toronto Hydro Street Lighting Inc.* ("Street Lighting") - which provides street lighting and expressway lighting 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 677,000 customers located in the City of Toronto (the "City"). LDC is the largest municipal electricity distribution company in Canada and distributes approximately 19% 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.

Selected Interim Consolidated Financial Data

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

Interim Consolidated Statement of Income Data				
Three months ended June 30				
(in thousands of dollars, except for per share amounts, unaudited)				
	2006	2005	Change	Change
	\$	\$	\$	%
Revenues	536,942	589,001	(52,059)	(8.8%)
Costs				
Purchased power and other	403,478	447,823	(44,345)	(9.9%)
Operating expenses	50,227	39,744	10,483	26.4%
Depreciation and amortization	34,961	34,689	272	0.8%
	<u>488,666</u>	<u>522,256</u>	<u>(33,590)</u>	<u>(6.4%)</u>
Income before interest and provision for payments in lieu of corporate taxes ("PILs")	48,276	66,745	(18,469)	(27.7%)
Interest income	4,438	3,243	1,195	36.8%
Interest expense				
Long-term debt	(18,973)	(20,101)	1,128	(5.6%)
Other interest	(652)	(737)	85	(11.5%)
Income before provision for PILs	33,089	49,150	(16,061)	(32.7%)
Provision for PILs	14,928	19,396	(4,468)	(23.0%)
Net income for the period	<u>18,161</u>	<u>29,754</u>	<u>(11,593)</u>	<u>(39.0%)</u>
Basic and diluted net income per share	<u>18,161</u>	<u>29,754</u>	<u>(11,593)</u>	<u>(39.0%)</u>

Interim Consolidated Statement of Income Data
Six months ended June 30
(in thousands of dollars, except for per share amounts, unaudited)

	2006 \$	2005 \$	Change \$	Change %
Revenues	1,102,602	1,201,827	(99,225)	(8.3%)
Costs				
Purchased power and other	835,584	925,994	(90,410)	(9.8%)
Operating expenses	93,563	85,663	7,900	9.2%
Depreciation and amortization	69,640	69,199	441	0.6%
	<u>998,787</u>	<u>1,080,856</u>	<u>(82,069)</u>	<u>(7.6%)</u>
Income before interest and provision for PILs	103,815	120,971	(17,156)	(14.2%)
Interest income	8,850	6,647	2,203	33.1%
Interest expense				
Long-term debt	(39,074)	(40,202)	1,128	(2.8%)
Other interest	(1,597)	(1,373)	(224)	16.3%
Income before provision for PILs	71,994	86,043	(14,049)	(16.3%)
Provision for PILs	31,274	35,453	(4,179)	(11.8%)
Net income for the period	<u>40,720</u>	<u>50,590</u>	<u>(9,870)</u>	<u>(19.5%)</u>
Basic and diluted net income per share	<u>40,720</u>	<u>50,590</u>	<u>(9,870)</u>	<u>(19.5%)</u>

Interim Consolidated Balance Sheet Data
(in thousands of dollars, unaudited)

	As at June 30, 2006 \$	As at December 31, 2005 \$
Total assets	2,555,805	2,819,258
Current liabilities	326,924	941,211
Long-term liabilities	1,375,494	1,032,180
Total liabilities	<u>1,702,418</u>	<u>1,973,391</u>
Shareholder's equity	853,387	845,867
Total liabilities and shareholder's equity	<u>2,555,805</u>	<u>2,819,258</u>

Results of Operations

Net Income

Net income for the three months and the six months ended June 30, 2006 was \$18.2 million and \$40.7 million compared to \$29.8 million and \$50.6 million for the comparable periods in 2005.

The decrease in net income for the three months ended June 30, 2006 was primarily due to increased operating expenses (\$10.5 million) and decreased net revenues (\$7.7 million) partially offset by decreased provision for PILs (\$4.5 million) and decreased net interest expense (\$2.4 million).

The decrease in net income for the six months ended June 30, 2006 was primarily due to decreased net revenues (\$8.8 million) and increased operating expenses (\$7.9 million) partially offset by decreased provision for PILs (\$4.2 million) and decreased net interest expense (\$3.1 million).

Net Revenues

Net revenues (revenues minus the cost of purchased power and other) for the three months and the six months ended June 30, 2006 were \$133.5 million and \$267.0 million compared to \$141.2 million and \$275.8 million for the comparable periods in 2005.

The decrease in net revenues for the three months ended June 30, 2006 was primarily due to decreased net revenues at TH Energy (\$8.1 million) and at LDC (\$3.5 million) partially offset by increased net revenues at Street Lighting (\$2.8 million) and at Telecom (\$1.1 million).

At LDC, the decrease in net revenues for the three months ended June 30, 2006 was primarily due to lower distribution revenue from decreased consumption attributable to weather (\$5.1 million), a decrease in distribution rates (\$1.5 million) and lower other revenues due to reduction in customer demand work (\$2.3 million) partially offset by higher revenue recognition for conservation and demand management ("CDM") programs (\$5.4 million).

The decrease in net revenues for the six months ended June 30, 2006 was primarily due to decreased net revenues at TH Energy (\$14.5 million) and at LDC (\$2.8 million) partially offset by increased net revenues at Street Lighting (\$5.4 million) and at Telecom (\$2.8 million).

At LDC, the decrease in net revenues for the six months ended June 30, 2006 was primarily due to lower distribution revenue from decreased consumption attributable to weather (\$7.3 million), a decrease in distribution rates (\$1.5 million) and lower other revenues due to reduction in customer demand work (\$3.4 million) partially offset by higher revenue recognition for CDM programs (\$9.4 million).

At TH Energy, the decrease in net revenues for the three months and six months ended June 30, 2006 was primarily related to lower contributions from the remaining activities of the electricity retail business which is scheduled to cease on December 31, 2006.

At Street Lighting, the increase in net revenues for the three months and the six months ended June 30, 2006 was primarily due to additional revenue from services provided to the City (effective January 1, 2006) under the terms of a service agreement entered into as part of the purchase of the street and expressway lighting assets from the City on December 31, 2005.

At Telecom, the increase in net revenues for the three months and the six months ended June 30, 2006 was primarily due to increased sales of data managed services.

Expenses

Operating expenses for the three months and the six months ended June 30, 2006 were \$50.2 million and \$93.6 million compared to \$39.7 million and \$85.7 million for the comparable periods in 2005.

The increase in operating expenses for the three months ended June 30, 2006 was primarily due to lower property taxes in 2005 (\$3.8 million), lower deferral of pension and regulatory costs at LDC (\$3.0 million), higher

compensation and benefit costs (\$2.4 million), increased provisions against the allowance for doubtful accounts (\$1.3 million) and increased spending on CDM programs at LDC (\$1.2 million).

The increase in operating expenses for the six months ended June 30, 2006 was primarily due to lower deferral of pension and regulatory costs at LDC (\$2.8 million), increased spending on CDM programs at LDC (\$1.6 million), increased marketing and product development costs at Telecom (\$1.4 million) and higher compensation and benefit costs (\$1.4 million).

Depreciation and amortization expense for the three months and the six months ended June 30, 2006 was \$35.0 million and \$69.6 million compared to \$34.7 million and \$69.2 million for the comparable period in 2005.

Net interest expense for the three months and the six months ended June 30, 2006 was \$15.2 million and \$31.8 million compared to \$17.6 million and \$34.9 million for the comparable periods in 2005. The decrease in net interest expense for the three months and six months ended June 30, 2006 was primarily due to higher average cash balance and lower interest costs in respect of the City Promissory Note commencing May 1, 2006 following the OEB decision described below under "Corporate Developments – Electricity Distribution Rates". The interest rate of 6.11% used by the Corporation, effective May 1, 2006, represents management's best estimate with respect to the outcome of the process currently underway with the City regarding the amendment of the City Promissory Note.

Provision for PILs

Provision for PILs for the three months and the six months ended June 30, 2006 was \$14.9 million and \$31.3 million compared to \$19.4 million and \$35.5 million for the comparable periods in 2005. The decrease in the provision for PILs for the three months and the six months ended June 30, 2006 was primarily due to a decrease in income.

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

Capital Resources and Liquidity (in thousands of dollars, unaudited)				
	Three months Ended June 30		Six months Ended June 30	
	2006 \$	2005 \$	2006 \$	2005 \$
Cash and cash equivalents, beginning of period	335,094	336,717	448,370	386,625
Net cash provided by operating activities	30,730	51,123	1,410	98,184
Net cash used in investing activities	(45,562)	(20,362)	(97,112)	(42,083)
Net cash used in financing activities	(3,466)	(2,393)	(35,872)	(77,631)
Cash and cash equivalents, end of period	<u>316,796</u>	<u>365,095</u>	<u>316,796</u>	<u>365,095</u>

Cash Provided by Operating Activities

Cash provided by operating activities for the three months and the six months ended June 30, 2006 was \$30.7 million and \$1.4 million compared to \$51.1 million and \$98.2 million for the comparable period in 2005.

The decrease in cash provided by operating activities for the three months ended June 30, 2006 was primarily due to unfavourable variances in accounts payable and accrued liabilities (\$58.2 million) resulting from decreased electricity payables at LDC and lower net income (\$11.6 million) partially offset by favourable variances in accounts receivables and unbilled revenue (\$56.0 million) due to decreased receivables at LDC.

The decrease in cash provided by operating activities for the six months ended June 30, 2006 was primarily due to unfavourable variances in accounts payable and accrued liabilities (\$157.6 million) resulting from decreased electricity payables at LDC and lower net income (\$9.9 million) partially offset by favourable variances in accounts receivables and unbilled revenue (\$66.1 million) due to decreased receivables at LDC.

Cash Used in Investing Activities

Cash used in investing activities for the three months and the six months ended June 30, 2006 was \$45.6 million and \$97.1 million compared to \$20.4 million and \$42.1 million for the comparable periods in 2005.

The increase in cash used in investing activities for the three months ended June 30, 2006 was primarily due to increased regulatory assets and liabilities variance resulting from the new Global Adjustment at LDC.

The increase in cash used in investing activities for the six months ended June 30, 2006 was primarily due to increased regulatory assets and liabilities variance (\$31.7 million) resulting from the new Global Adjustment at LDC and to increased capital expenditures at LDC (\$22.6 million).

Cash Used in Financing Activities

Cash used in financing activities for the three months and the six months ended June 30, 2006 was \$3.5 million and \$35.9 million compared to \$2.4 million and \$77.6 million for the comparable periods in 2005.

The increase in cash used in financing activities for the three months ended June 30, 2006 was primarily due to a variance in customers' advance deposits.

The decrease in cash used in financing activities for the six months ended June 30, 2006 was primarily due to lower dividends paid in 2006 (\$21.8 million) and reduction in customers' advance deposits in 2005 (\$19.7 million).

Capital Expenditures (in thousands of dollars, unaudited)				
	Three months Ended June 30		Six months Ended June 30	
	2006	2005	2006	2005
	\$	\$	\$	\$
LDC				
Distribution System	31,030	31,715	64,939	50,582
Technology assets	4,503	3,996	10,138	4,728
Other ⁽¹⁾	1,778	1,989	4,981	2,009
	37,311	37,700	80,058	57,319
Other ⁽²⁾	4,212	3,500	6,495	5,441
Total Capital Expenditures	41,523	41,200	86,553	62,760

Notes:

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

Revolving Credit Facility

The Corporation is a party to a credit agreement with respect to a revolving credit facility dated May 5, 2005 pursuant to which the Corporation may borrow up to \$500.0 million, of which up to \$175.0 million is available in the form of letters of credit. As at June 30, 2006, no borrowings for working capital were outstanding and letters

of credit in the amount of \$84.3 million had been issued. See note 5 to the Interim Consolidated Financial Statements.

Prudential Requirements and Third Party Credit Support

As at June 30, 2006, the Corporation had issued \$56.5 million of parental guarantees on behalf of TH Energy in support of prudential requirements to third parties for the purchase and sale of electricity and had issued \$7.9 million of parental guarantees to the City as part of an agreement by the City to purchase electricity at a fixed price from TH Energy. See note 10 to the Interim Consolidated Financial Statements.

Dividends

On March 2, 2006, 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 2005 net income, which was paid on March 10, 2006 and a \$6.0 million payment in connection with the first quarter of 2006, which was paid on March 31, 2006.

On May 29, 2006, the board of directors of the Corporation declared a dividend in the amount of \$6.0 million in connection with the second quarter of 2006. The dividend was paid on June 30, 2006.

On August 24, 2006, the board of directors of the Corporation declared a dividend in the amount of \$6.0 million in connection with the third quarter of 2006. The dividend is payable on September 29, 2006.

Corporate Developments

Electricity Distribution Rates

On April 12, 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, including the new regulatory treatment for revenues relating to smart meters. 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 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 on the existing related party debt instrument from 6.8% to 5% per annum. LDC currently has a promissory note in the principal amount of \$980.2 million payable to the Corporation.

City Promissory Note

The Corporation currently has a promissory note in the principal amount of \$980.2 million payable to the City ("City Note"). See note 6b) to the Interim Consolidated Financial Statements. A copy of the City Note is available at www.sedar.com. The Corporation is currently evaluating the impact on the City Note of the decrease in the allowable affiliate debt rate included in the 2006 distribution rate decision received from the OEB for LDC as discussed above in "Electricity Distribution Rates". The Corporation is currently in discussions with the City with respect to the amendments of the City Note.

Ministry of Finance Tax Audit

Certain filing positions for PILs were taken by the Corporation and its subsidiaries that may be challenged on audit. This may result in a material increase in the Corporation's reported tax obligations upon reassessment. As the current PILs audit has not yet been completed, management is not able to determine the impact of this uncertainty on the Interim Consolidated Financial Statements or the Corporation's tax reserves. The range and level of the Corporation's tax reserves are adjusted when there is sufficient information available, or when an event occurs requiring a change to the reserves.

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 have reached a tentative settlement of this class action but the settlement is subject to approval by the Ontario Superior Court of Justice. The Court has scheduled a hearing on September 6, 2006 to consider the settlement. The Corporation is not a party to the Consumers’ Gas class action. It is, however, subject to the two class actions described below in which the issues are analogous.

The first is an action commenced against a predecessor of LDC and other Ontario municipal electric utilities under the Class Proceedings Act, 1992 seeking \$500 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 as the parties were awaiting the outcome of the Consumers’ Gas class action.

The second is an action commenced against a predecessor of LDC under the *Class Proceedings Act, 1992* seeking \$64 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.

Significant Accounting Policy

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. Although the Corporation has identified conditional AROs, no amounts have been recorded as the fair value of related AROs has been determined to be not material to the Corporation’s results of operations and financial position.

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

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

Toronto, Canada

August 24, 2006