

TORONTO HYDRO CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR THE INTERIM PERIOD ENDED
MARCH 31, 2007

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 ended March 31, 2007 (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, 2006 (the "Annual Consolidated Financial Statements"); and
- management's discussion and analysis of financial condition and results of operations for the year ended December 31, 2006 (including the sections entitled "Electricity Distribution – Industry Overview", "Liquidity and Capital Resources", "Corporate Developments", "Consumers' Gas Decision", "Share Capital", "Services Provided to the City", "Risks and Uncertainties", "Disclosure and Internal Controls" 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 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 Ontario Energy Board (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 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 provides street lighting and expressway lighting services and energy efficiency products and services. In 2006, TH Energy also operated a water heater rental business (the assets comprising the water heater rental business were sold on February 8, 2007). See notes 1, 4 and 23 to the Annual Consolidated Financial Statements and note 13 to the Interim 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 (the "City"). 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. See note 2 to the Annual Consolidated Financial Statements.

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 Three months ended March 31 (in thousands of dollars, except for per share amounts, unaudited)				
	2007	2006 ⁽¹⁾	Change	Change
	\$	\$	\$	%
Revenues	607,327	564,009	43,318	7.68%
Costs				
Purchased power and other	481,634	431,652	49,982	11.58%
Operating expenses	53,814	43,423	10,391	23.93%
Depreciation and amortization	36,039	33,827	2,212	6.54%
	<u>571,487</u>	<u>508,902</u>	<u>62,585</u>	12.30%
Income before interest and provision for PILs	35,840	55,107	(19,267)	(34.96%)
Interest income	4,402	4,417	(15)	(0.34%)
Interest expense				
Long-term debt	(18,410)	(20,101)	1,691	8.41%
Other interest	(367)	(945)	578	61.16%
	<u>21,465</u>	<u>38,478</u>	<u>(17,013)</u>	(44.21%)
Provision for PILs	8,408	16,231	(7,823)	(48.20%)
Income from continuing operations	13,057	22,247	(9,190)	(41.31%)
Income from discontinued operations – net of tax ⁽²⁾	24,597	312	24,285	7,783.65%
Net income	<u>37,654</u>	<u>22,559</u>	<u>15,095</u>	66.91%
Basic and fully diluted net income per share from continuing operations	13,057	22,247	(9,190)	(41.31%)
Basic and fully diluted net income per share from discontinued operations	24,597	312	24,285	7,783.65%
Basic and fully diluted net income per share	<u>37,654</u>	<u>22,559</u>	<u>15,095</u>	66.91%

Notes:

- (1) Amounts reflect reclassification for discontinued operations. See note 23 to the Annual Consolidated Financial Statements.
- (2) Consists of discontinued operations for water heaters. See note 13 to the Interim Consolidated Financial Statements.

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

	As at March 31, 2007 \$	As at December 31, 2006 \$
Total assets	2,608,858	2,591,706
Current liabilities	547,552	555,105
Long-term liabilities	1,158,788	1,144,537
Total liabilities	1,706,340	1,699,642
Shareholder's equity	902,518	892,064
Total liabilities and shareholder's equity	2,608,858	2,591,706

Results of Operations

Net Income

Net income for the three months ended March 31, 2007 was \$37.7 million compared to \$22.6 million for the comparable period in 2006. The increase was primarily due to the gain on the sale of water heater assets included in income from discontinued operations (\$24.3 million), decreased provision for PILs (\$7.8 million) and decreased net interest expense (\$2.3 million), partially offset by increased operating expenses (\$10.4 million), decreased net revenues (\$6.7 million) and increased depreciation and amortization expense (\$2.2 million).

Net Revenues

Net revenues (revenues minus the cost of purchased power and other) for the three months ended March 31, 2007 were \$125.7 million compared to \$132.4 million for the comparable period in 2006. The decrease was primarily due to decreased net revenues at TH Energy (\$5.6 million), decreased net revenues at LDC (\$2.6 million), partially offset by increased net revenues at Telecom (\$1.4 million).

At TH Energy, the decrease in net revenues was primarily due to the conclusion of the electricity retail business on December 31, 2006.

At LDC, the decrease in net revenues was primarily due to a decrease in distribution revenue (\$5.0 million) partially offset by higher non-distribution income (\$2.4 million) from gains on disposals of assets and higher customer service charges. The decrease in distribution revenue was mainly related to a decrease in distribution rates following the OEB's decision on LDC's 2006 rate application regarding interest payable to related parties (\$4.4 million) and lower revenue recognition from lower delivery of CDM programs in 2007 (\$1.8 million). LDC's decrease in distribution revenue was partially offset by increased consumption attributable to colder weather (\$1.2 million) in the first three months of 2007 compared to 2006 (6,880 GWh compared to 6,732 GWh).

At Telecom, the increase in net revenues was primarily due to increased sales of data services.

Expenses

Operating expenses for the three months ended March 31, 2007 were \$53.8 million compared to \$43.4 million for the comparable period in 2006. The increase was primarily due to higher compensation costs at LDC (\$3.5 million) attributable to increased headcount and increased benefits and pension costs, higher costs for operations and maintenance programs at LDC (\$2.6 million) partially attributable to a severe storm that occurred in March 2007, higher costs for facilities at LDC (\$1.0 million), higher regulatory costs at LDC (\$0.8 million) in

connection with increased fees from the OEB and higher operating costs at Telecom (\$1.1 million) mainly from increased sales efforts. These variances were partially offset by lower CDM expenditures (\$1.1 million).

Depreciation and amortization expense for the three months ended March 31, 2007 was \$36.0 million compared to \$33.8 million for the comparable period in 2006. The increase in depreciation is due to higher net book value for fixed assets and intangible assets in service. The increase in net book value is mainly due to increased investment in distribution assets of LDC (2006 - \$167.7 million; 2005 - \$132.3 million).

Net interest expense for the three months ended March 31, 2007 was \$14.4 million compared to \$16.6 million for the comparable period in 2006. The decrease was primarily due to lower interest expenses in respect of the City Promissory Note commencing May 1, 2006. See note 6b to the Interim Consolidated Financial Statements.

Provision for PILs

Provision for PILs for the three months ended March 31, 2007 was \$8.4 million compared to \$16.2 million for the comparable period in 2006. The decrease was primarily due to a decrease in income (\$6.1 million) and lower temporary differences not benefited in LDC (\$1.4 million).

Discontinued Operations

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. The results of operations and financial position of the water heater business have been segregated and presented as discontinued operations in the accompanying financial statements. See note 13 to the Interim Consolidated Financial Statements.

The water heater sale agreement includes a six-month purchase price adjustment period commencing April 2, 2007. At the end of the adjustment period, the purchase price will be adjusted to reflect an increase or decrease in the number of active customers used in the purchase price calculation.

Income from discontinued operations for the three months ended March 31, 2007 was \$24.6 million in 2007 compared to \$0.3 million for the comparable period in 2006. The increase was primarily due to the sale of the water heater business.

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.

Liquidity and Capital Resources		
Three months ended March 31		
(in thousands of dollars, unaudited)		
	2007	2006
	\$	\$
Cash and cash equivalents, beginning of period	327,524	448,370
Net cash provided by (used in) operating activities	51,740	(29,553)
Net cash used in investing activities	(27,885)	(50,802)
Net cash used in financing activities	(33,605)	(32,406)
Net cash provided by (used in) discontinued operations ⁽¹⁾	40,032	(515)
Cash and cash equivalents, end of period	<u>357,806</u>	<u>335,094</u>

Note: (1) Consists of discontinued operations for water heaters. See note 13 to the Interim Consolidated Financial Statements.

Cash Provided by Operating Activities

Cash provided by operating activities for the three months ended March 31, 2007 was \$51.7 million compared to cash used in operating activities of \$29.6 million for the comparable period in 2006. The increase was primarily due to the payment of electricity rebates and PILs liabilities in 2006 at LDC (\$51.5 million) and a favourable variance in the aggregate of accounts receivable and unbilled revenue due to the timing of billing and collection activities at LDC (\$22.9 million). These variances were partially offset by an unfavourable variance in Telecom (\$7.7 million) mainly due to the payment in 2007 of access fees to the City relating to 2003 to 2006 and an unfavourable variance in TH Energy (\$5.7 million) principally attributable to the conclusion of the electricity retail activities at the end of 2006.

Cash Used in Investing Activities

Cash used in investing activities for the three months ended March 31, 2007 was \$27.9 million compared to \$50.8 million for the comparable period in 2006. The favourable variance was primarily due to a decrease in regulatory assets and liabilities (\$21.5 million) due to lower global adjustment variances.

Capital Expenditures Three months ended March 31 (in thousands of dollars, unaudited)		
	2007	2006
	\$	\$
Capital Expenditures from Continuing Operations		
LDC		
Distribution System	32,525	33,909
Technology assets	3,129	5,635
Other ⁽¹⁾	4,196	3,203
	39,850	42,747
Other ⁽²⁾	3,809	1,535
Total Capital Expenditures	43,659	44,282
Capital Expenditures from Discontinued Operations		
Water heaters	283	820

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 for the three months ended March 31, 2007 was \$33.6 million compared to \$32.4 million for the comparable period in 2006. The increase was primarily due to an increase in customer advance deposits at LDC.

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 March 31, 2007, no borrowings for working capital were outstanding and letters of credit in the amount of \$80.2 million had been issued. See note 5 to the Interim Consolidated Financial Statements.

Dividends

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, which was paid on March 9, 2007 and a \$6.0 million payment in connection with the first quarter of 2007, which was paid on March 30, 2007.

On May 28, 2007, the board of directors of the Corporation declared a dividend in the amount of \$6.0 million in respect of the second quarter of 2007, payable on June 29, 2007.

Corporate Developments

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 note 13 to the Interim 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 Annual Consolidated Financial Statements.

Distribution Rates

On January 26, 2007, LDC filed an Annual Rate Adjustment Application for 2007 Rates as directed by the OEB. In accordance with the OEB's Incentive Regulation Model, LDC sought authorization to increase rates effective May 1, 2007. On April 12, 2007, the OEB approved LDC's rates which provided for a 0.9% increase in base distribution rates for all customer classes. After adjustment for the removal for the Large Corporations Tax and changes in the Smart Meter rate riders, the impact on an average residential customer is approximately \$0.35 per month or \$4.20 per year.

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 2010. LDC had installed over 254,000 meters at March 31, 2007.

Consistent with the OEB's direction, LDC has deferred capital expenditures, operating and depreciation expenses and revenues relating to smart meters in regulatory asset accounts. On May 1, 2006, LDC implemented new distribution rates which included charges for smart meters of \$0.47 per 30 days for each residential customer and \$1.04 per 30 days for all other customers. Effective May 1, 2007, the OEB-approved charges for smart meters were changed to \$0.68 per 30 days for all metered customers.

On March 23, 2007, LDC submitted an application to the OEB for disposition of the 2006 balance in the smart meter deferral account and an adjustment to rate base to reflect 2006 smart meter assets. On March 27, 2007, the OEB advised LDC that it would consider the smart meter deferral account and the adjustment to rate base in a "generic" proceeding that will commence after May 1, 2007. See note 2 to the Interim Consolidated Financial Statements.

Shared Savings Mechanism and Lost Revenue Adjustment Mechanism

On March 23, 2007, LDC submitted an application to the OEB for recovery of \$10.4 million associated with LDC's CDM programs. Authorization to apply for recovery of these amounts was granted by the OEB in its decision on CDM programs funding on May 11, 2005. On March 27, 2007, the OEB acknowledged receipt of the application and indicated that the application will proceed later in 2007. See note 2 to the Interim Consolidated Financial Statements.

OEB Proposals for Multi-Year Electricity Rate Setting Plan

In June 2006, the OEB began a generic licence amendment proceeding that was intended to effect changes to the allowable cost of capital and was intended to effect a multi-year electricity distribution rate setting plan via incentive regulation mechanisms for distributors. LDC responded to the OEB's proposals and participated in technical conferences.

In December 2006, in the interests of implementing distribution rate changes for 2007 in a timely manner, the OEB maintained its current methodology for determining LDC's allowable cost of capital but proceeded with its multi-year incentive regulation mechanism ("IRM") which incorporates changes to LDC's capital structure as well as an incentive mechanism that adjusts distribution rates by inflation less a productivity factor between rebasing periods. The capital structure change will see LDC's current deemed debt-to-equity structure of 65% debt-to-35% equity change to 60% debt-to-40% equity over a two-year period beginning on May 1, 2008. The capital structure change is estimated to increase LDC's return on rate base by about 20 basis points by 2009.

CDM Agreements

In May 2007, LDC entered into agreements with Ontario Power Authority ["OPA"] to deliver OPA funded CDM programs in the amount of \$59.0 million during the years from 2007 to 2010.

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 Interim 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.

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 that effort. Mr. Garland's appeal is pending.

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. 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 intention 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 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 Policies

Effective January 1, 2007, the Corporation adopted the Canadian Institute of Chartered Accountants ["CICA"] Handbook Sections 3855 - "Financial Instruments – Recognition and Measurement", 3861 - "Financial Instruments – Disclosure and Presentation", 1530 - "Comprehensive Income", 3865 - "Hedges" and the revised CICA Handbook Section 3251 - "Equity" [the "Handbook Sections"]. These Handbook Sections require that all financial instruments, which meet the definition of an asset or liability, be recognized in the financial statements at their fair value, unless fair value cannot be reliably determined. Although the Corporation has identified financial instruments to be reported at fair value, no amounts have been recorded as the fair value of the related financial instruments has been determined to not be material to the Corporation's results of operations and financial position. See note 3 to the Interim Consolidated Financial Statements.

Commencing January 1, 2007, LDC prospectively adopted Article 410 of the Accounting Procedures ["AP"] Handbook, which provides for the inclusion of an allowance for funds used during construction ["AFUDC"] when capitalizing construction in progress assets, until such time as the asset is substantially complete. A concurrent credit of the same amount is made to the interest expense account when the allowance is capitalized. For the three months ended March 31, 2007, \$0.3 million was capitalized in the construction in progress account and was credited to interest expense. See note 3 to the Interim Consolidated Financial Statements.

In December 2006, the Canadian Accounting Standards Board ["AcSB"] 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, the AcSB anticipates a five-year transition period ending around 2011. Some of the converged standards will be implemented in Canada during the transition period with the remaining standards adopted at the change over date. Until the change over is finalized, companies will continue to describe their basis of reporting using Canadian GAAP. Management is currently in the process of evaluating the potential impact of the conversion from Canadian GAAP to IFRS on the Corporation's financial statements.

In December 2006, the AcSB released CICA Handbook Section 1535 - "Capital Disclosures" effective for fiscal years beginning on or after October 1, 2007. This section establishes new accounting standards regarding capital disclosures. Under Section 1535, an entity is required to disclose information regarding its objectives, policies and processes for managing capital as well as its compliance with any external capital requirements. The Corporation is currently in the process of evaluating the potential impact of this standard on its financial statements.

The AcSB issued two new accounting standards surrounding financial instrument presentation and disclosure. CICA Handbook Sections 3862 - "Financial Instruments – Disclosure" and 3863 - "Financial Instruments – Presentation" are effective for fiscal years beginning on or after October 1, 2007. Both sections improve upon the financial instrument disclosure requirements existing under CICA Handbook Section 3861 - "Financial Instruments – Disclosure and Presentation". The Corporation is currently in the process of evaluating the potential impact of these standards on its financial statements.

In March 2007, the AcSB approved CICA Handbook Section 3031 – “Inventories”, which will replace the existing CICA Handbook Section 3030. The new Handbook Section will be effective for fiscal periods beginning on or after January 1, 2008. Under the new section, inventories are required to be measured at the lower of cost and net realizable value. The section also provides updated guidance on the appropriate methods of determining cost and the impact of any write-downs to net realizable value. The Corporation is currently in the process of evaluating the potential impact of this standard on its financial statements.

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

May 28, 2007