

TORONTO HYDRO CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR THE INTERIM PERIOD ENDED
SEPTEMBER 30, 2005

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

- the unaudited consolidated financial statements and accompanying notes of Toronto Hydro Corporation (the "Corporation") as at and for the three-month period and the nine-month period ended September 30, 2005 (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, 2004 (the "Annual Consolidated Financial Statements"); and
- management's discussion and analysis of financial condition and results of operations for the year ended December 31, 2004 (including the sections entitled "Electricity Industry", "Restatement of Consolidated Financial Statements", "Quarterly Results of Operations", "Energy Services Retail Contracts", "Liquidity and Capital Resources", "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 SEDAR 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.* ("Energy Services") – which manages an existing portfolio of electricity contracts and provides professional energy management services to help businesses lower their energy consumption and control costs; 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 over 673,000 customers located in the City of Toronto. LDC is the largest municipal electricity distribution company in Canada. 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 Interim Consolidated Financial Statements.

The sole shareholder of the Corporation is the City of Toronto.

Selected Interim Consolidated Financial Data

The selected interim consolidated financial data presented below should be read in conjunction with the Interim Consolidated Financial Statements. See “Restatement of Financial Statements” below for the impact of the restatement on the interim consolidated financial statements as at and for the three-month period and the nine-month period ended September 30, 2004.

	Three months ended Sept 30, (Unaudited)		Nine months ended Sept 30, (Unaudited)	
	2005 \$	2004 \$ (restated)	2005 \$	2004 \$ (restated)
(in thousands of dollars, except for per share amounts)				
Interim Consolidated Statement of Income Data				
Revenues	774,295	543,174	1,976,122	1,680,678
Costs				
Purchased power and other	634,080	411,730	1,560,074	1,250,155
Operating expenses	47,471	42,898	133,134	135,116
Depreciation and amortization	32,799	33,558	101,998	100,490
	<u>714,350</u>	<u>488,186</u>	<u>1,795,206</u>	<u>1,485,761</u>
Income before interest, other and provision for payments in lieu of corporate taxes (“PILs”)	59,945	54,988	180,916	194,917
Interest income	3,108	2,901	9,755	8,826
Interest expense				
Long-term debt	(20,100)	(20,100)	(60,302)	(60,302)
Other interest	(294)	(699)	(1,667)	(2,365)
Other ⁽¹⁾	2,154	387	2,154	589
Income before provision for PILs	44,813	37,477	130,856	141,665
Provision for PILs	25,459	15,373	60,912	54,618
Net income for the period	<u>19,354</u>	<u>22,104</u>	<u>69,944</u>	<u>87,047</u>
Basic and fully diluted net income per share	<u>19,354</u>	<u>22,104</u>	<u>69,944</u>	<u>87,047</u>

	As at September 30, 2005 (Unaudited) \$	As at December 31, 2004 (Unaudited) \$
	(in thousands of dollars)	
Interim Consolidated Balance Sheet Data		
Total assets	<u>2,786,595</u>	<u>2,588,854</u>
Current liabilities	899,017	701,636
Long-term liabilities	1,057,212	1,065,796
Total liabilities	<u>1,956,229</u>	<u>1,767,432</u>
Shareholder’s equity	830,366	821,422
Total liabilities and shareholder’s equity	<u>2,786,595</u>	<u>2,588,854</u>

Note:

(1) Consists of gains on disposals of property, plant and equipment.

Results of Operations

Net Income

Net income for the three months and the nine months ended September 30, 2005 was \$19.4 million and \$69.9 million compared to \$22.1 million and \$87.0 million for the comparable periods in 2004.

The decrease in net income for the three months ended September 30, 2005 was primarily due to increased provision for PILs (\$10.1 million) and increased operating expenses (\$4.6 million) partially offset by increased net revenues (\$8.8 million) and gain on disposals of property, plant and equipment (\$1.8 million) primarily at Telecom.

The decrease in net income for the nine months ended September 30, 2005 was primarily due to decreased net revenues (\$14.5 million) and increased provision for PILs (\$6.3 million) partially offset by decreased operating expenses (\$2.0 million) and gain on disposals of property, plant and equipment (\$1.6 million) primarily at Telecom.

Net Revenues

Net revenues (revenues minus the cost of purchased power and other) for the three months and the nine months ended September 30, 2005 were \$140.2 million and \$416.0 million compared to \$131.4 million and \$430.5 million for the comparable periods in 2004.

The increase in net revenues for the three months ended September 30, 2005 was primarily due to increased distribution revenue at LDC from higher consumption attributable to weather (\$6.3 million) and the net effect of the third adjustment to achieve a market-based rate of return after deferral for conservation and demand management ("CDM") programs (\$1.4 million).

The decrease in net revenues for the nine months ended September 30, 2005 was primarily due to decreased net revenues at Energy Services (\$32.2 million) partially offset by increased net revenues at LDC (\$15.5 million). At Energy Services, the decrease in net revenues was primarily due to the gain recognized in 2004 related to the exercise of a wholesale electricity purchase contract (\$32.1 million) and decreased net revenues from expired retail contracts (\$18.0 million) partially offset by higher mark-to-market gain from the change in the future value of the existing portfolio in 2005 (\$19.1 million). At LDC, the increase in net revenues was primarily due to increased distribution revenue from higher consumption attributable to weather (\$8.3 million) and the net effect of the third adjustment to achieve a market-based rate of return after deferral for CDM programs (\$6.9 million).

Expenses

Operating expenses for the three months and the nine months ended September 30, 2005 were \$47.5 million and \$133.1 million compared to \$42.9 million and \$135.1 million for the comparable periods in 2004.

The increase in operating expenses for the three months ended September 30, 2005 was primarily due to increased provisions at LDC for property taxes (\$1.8 million) and inventory obsolescence (\$0.8 million) and increased costs for compensation and marketing at Telecom (\$0.8 million).

The decrease in operating expenses for the nine months ended September 30, 2005 was primarily due to the deferral of pension and regulatory costs (see note 3a to the Interim Consolidated Financial Statements) at LDC (\$4.6 million) partially offset by increased costs for compensation and marketing at Telecom (\$1.5 million) and increased provision for property taxes at LDC (\$0.8 million).

Depreciation and amortization expense for the three months and the nine months ended September 30, 2005 was \$32.8 million and \$102.0 million compared to \$33.6 million and \$100.5 million for the comparable periods in 2004. The increase in depreciation and amortization expense for the nine months ended September 30, 2005 was primarily due to investments made in the electricity distribution system of LDC.

Net interest expense for the three months and the nine months ended September 30, 2005 was \$17.3 million and \$52.2 million compared to \$17.9 million and \$53.8 million for the comparable periods in 2004.

Provision for PILs

Provision for PILs for the three months and the nine months ended September 30, 2005 was \$25.5 million and \$60.9 million compared to \$15.4 million and \$54.6 million for the comparable periods in 2004.

The increase in the provision for PILs for the three months ended September 30, 2005 was primarily due to increased temporary differences (\$7.9 million) and an increase in the tax effected change in income (\$2.6 million).

The increase in the provision for PILs for the nine months ended September 30, 2005 was primarily due to increased temporary differences (\$11.2 million) partially offset by a decrease in the tax effected change in income (\$3.9 million).

Liquidity and Capital Resources

The Corporation's primary liquidity and capital resource requirements comprise: the commodity cost of electricity purchased by LDC on behalf of consumers; capital expenditures to maintain and improve the electricity distribution system of LDC; interest expense; prudential requirements; and third party credit support.

The City of Toronto 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 September 30, 2005, the Corporation had issued \$130.0 million of parental guarantees on behalf of Energy Services in support of prudential requirements and obligations under bilateral contracts for the purchase and sale of electricity and had issued a \$90.0 million parental guarantee to the City of Toronto as part of an agreement by the City of Toronto to purchase electricity at a fixed price from Energy Services. See note 13 to the Interim Consolidated Financial Statements.

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

Cash provided by operating activities for the three months and the nine months ended September 30, 2005 was \$51.2 million and \$149.3 million compared to \$81.8 million and \$155.2 million for the comparable periods in 2004.

The decrease in cash provided by operating activities for the three months ended September 30, 2005 was primarily due to negative variances in accounts payable and accruals (\$11.3 million), accounts receivables and unbilled revenue (\$14.0 million) and mark-to-market assets and liabilities (\$11.4 million) partially offset by a positive variance in deferred revenue (\$11.9 million).

The decrease in cash provided by operating activities for the nine months ended September 30, 2005 was primarily due to negative variances in accounts receivables and unbilled revenue (\$68.0 million), net income (\$17.1 million) and other non-cash items and working capital balances (\$8.3 million) partially offset by positive variances in accounts payable and accruals (\$51.0 million), mark-to-market assets and liabilities (\$18.5 million) and deferred revenue (\$18.0 million).

Cash used in investing activities for the three months and the nine months ended September 30, 2005 was \$35.6 million and \$77.7 million compared to \$23.6 million and \$73.7 million for the comparable periods in 2004. The increases were primarily due to higher capital expenditures at LDC partially offset by decreased regulatory asset balances following recovery approved by the OEB.

Cash used in financing activities for the three months and the nine months ended September 30, 2005 was \$6.2 million and \$83.9 million compared to \$4.0 million and \$35.8 million for the comparable periods in 2004. The increase in cash used in financing activities for the nine months ended September 30, 2005 was primarily due to decreased customer deposits following a new OEB directive (\$26.2 million) and increased dividends paid to the City of Toronto (\$21.8 million).

Restatement of Financial Statements

In May 2004, the IESO informed LDC of a variance in consumption data recorded at the Ellesmere wholesale metering sub-station. In August 2004, LDC received its monthly wholesale power invoice from the IESO, which included a credit in connection with the variance in consumption data for the period of May 1, 2002 to January 31, 2004. Following notification by the IESO of the metering variance, LDC commenced an in-depth review of its revenue, cost of power and regulatory assets calculation model and related market assumptions.

As a result of the findings from this review and the adjustment received from the IESO, the Corporation restated its consolidated financial statements in the fourth quarter of 2004 as at and for the years ended December 31, 2003 and 2002 and its unaudited interim consolidated financial statements as at and for the quarters ended March 31, June 30 and September 30, 2004. See note 4 to the Interim Consolidated Financial Statements.

The effects of the resulting adjustments – increase or (decrease) – to the originally issued unaudited interim consolidated financial statements as at and for the three months and the nine months ended September 30, 2004 were as follows:

	September 30 2004
	\$
	(in thousands of dollars)

Changes in Interim Consolidated Balance Sheet Data

Unbilled revenue	15,340
Regulatory assets	(6,660)
Accounts payable and accrued liabilities	3,135
Retained earnings	5,545

	Three months ended Sept 30, 2004	Nine months ended Sept 30, 2004
	\$	\$
	(in thousands of dollars)	(in thousands of dollars)

Changes in Interim Consolidated Statement of Income Data

Net revenues	1,710	8,223
Interest income	99	457
Provision for PILs	1,045	3,135
Net income	<u>764</u>	<u>5,545</u>

Interim consolidated statement of cash flows:

Operating activities:

Net income for the period	764	5,545
Changes in non-cash working capital balances		
Increase in unbilled revenue	(2,788)	(15,340)
Increase in accounts payable and accrued liabilities	1,045	3,135
Net cash used by operating activities	<u>(979)</u>	<u>(6,660)</u>

Investing activities:

Decrease in regulatory assets	<u>979</u>	<u>6,660</u>
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Dividends

On August 25, 2005, the board of directors of the Corporation declared a dividend in the amount of \$6.0 million in respect of the third quarter of 2005. This dividend was paid on September 30, 2005.

On November 29, 2005, the board of directors of the Corporation declared a dividend in the amount of \$7.0 million in respect of the fourth quarter of 2005. This dividend is payable on December 30, 2005.

See also note 11 and note 20b to the Interim Consolidated Financial Statements.

Corporate Developments

Appointments

On May 13, 2005, the Corporation announced the appointment of Anthony Haines as Chief Administrative Officer of the Corporation and Jean-Sebastien Couillard as Chief Financial Officer of the Corporation. Both appointments were effective May 30, 2005.

On July 20, 2005, the City of Toronto, as sole shareholder of the Corporation, renewed the appointment of the Chair of the board of directors of the Corporation, Clare Copeland, and three of the independent directors, David L. Bumstead, L. Ross Cullingworth and Dr. Frank Frantisak and appointed four new independent directors, Janet Beed, Trish Callon, Brian Chu and Jeffrey G. Marshall. These appointments were effective August 1, 2005 for a three-year term. The new independent directors replaced Peter Atkinson, Dr. Ruth Corbin, Timothy Millard and David Williams whose term of office expired on August 1, 2005. On May 19, 2005, the City of Toronto renewed the appointments of three city councillors, David Shiner, Gerry Altobello and Bill Saundercook, to the board of directors of the Corporation. These appointments were effective June 4, 2005, for an eighteen-month term.

Rate Application

On August 2, 2005, LDC filed with the OEB its Electricity Distribution Rate Application for 2006 distribution rates for rates to be effective on May 1, 2006. The LDC application includes a 1.7% reduction in rates. In accordance with the procedural orders received from the OEB in November, 2005, LDC will commence an alternate dispute resolution process to settle 2006 distribution rate application issues, with any unsettled issues to undergo an oral hearing in the first quarter of 2006.

Financial Guarantees

Effective November 3, 2005, the Corporation increased the amount of parental guarantees issued on behalf of Energy Services by \$20.0 million with respect to security for obligations under wholesale electricity sale contracts.

Potential Acquisition

Toronto Hydro Street Lighting Inc., a wholly-owned subsidiary of the Corporation, which provides street lighting and maintenance services to the City of Toronto and other clients, has entered into discussions with the City with respect to the acquisition of the City's street lighting assets. There can be no assurance that these discussions will lead to an agreement or that an agreement, if reached, will be consummated. The Corporation does not expect that the acquisition under discussion, if consummated, would constitute a "significant acquisition" under applicable Canadian securities laws.

Regulatory Assets

Electricity distributors are required to reflect certain prescribed costs as regulatory assets on their balance sheet until the manner and timing of disposition is determined by the OEB. See note 2 to the Interim Consolidated Financial Statements.

In November 2003, the OEB announced its intention to permit LDC and other electricity distributors to make rate applications to the OEB for the recovery of regulatory asset balances as at December 31, 2003. The recovery of these balances is being phased in over a four-year period commencing in March 2004.

In July 2005, the OEB issued final approval for LDC's recovery of the regulatory asset balances as at December 31, 2003.

Guidelines for Reviewing Variances and Deferral Accounts

In September 2005, the OEB issued guidelines for reviewing electricity commodity-related and other variance and deferral accounts maintained by electricity distributors. The guidelines propose quarterly reviews for commodity account balances and annual reviews for non-commodity account balances. Once the OEB decides on a full or partial disposition of the account balances, it will commence a proceeding to set new rates for LDC. The OEB's guidelines indicate that the first quarterly review of the commodity account balances will cover the first two quarters of 2005. The OEB will determine whether and how the annual reviews of non-commodity account balances will be integrated with other annual rate processes.

Market-Based Rate of Return

Before the introduction of rate caps in December 2002, the OEB had authorized electricity distributors to adjust their distribution rates to incorporate a market-based rate of return. The adjustment was being phased in over three adjustment periods (2001, 2002 and 2003) to lessen the rate impact on customers. Effective on each of December 1, 2000 and March 1, 2002, the OEB authorized LDC to increase its distribution rates to allow for the recovery of additional annual revenue of \$39.8 million.

In March 2005, LDC received approval from the OEB to increase distribution rates to recover \$39.8 million, representing the third adjustment necessary to achieve a market-based rate of return. The rate increase was effective as of April 1, 2005 and is subject to a financial commitment by LDC to invest \$39.8 million in CDM activities over the next two years.

Global Adjustment

Effective January 1, 2005, the Independent Electricity System Operator ("IESO") implemented, pursuant to the *Electricity Restructuring Act, 2004*, a new price adjustment applicable to customers not subject to price protection and rate caps. This new price adjustment, referred to as Global Adjustment, is a variable rate calculated by the IESO based on the difference between electricity market prices and the mix of regulated and contract prices paid to electricity generators. This calculation will result in positive or negative bill adjustments depending on prevailing electricity market conditions. LDC expects that a daily variable Global Adjustment rate will take effect later this year.

In the interim, LDC has been directed by the IESO to credit eligible customers using fixed interim adjustment rates. Concurrently, LDC receives from the IESO a credit based on the variable Global Adjustment rate in respect of the electricity consumed by these customers. The difference between the amount credited to customers and the amount received from the IESO by LDC (\$27.3 million as at September 30, 2005) is being tracked in a variance account and reflected as a regulatory asset. The disposition of the variance account balance shall be in accordance with the OEB's guidelines for reviewing variance and deferral accounts.

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 (the "Supreme Court") 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 Corporation 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.

The first is an action commenced against a predecessor of LDC and other Ontario municipal electric utilities under the Class Proceedings Act, 1992 seeking \$500.0 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 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 \$64.0 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.

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 SEDAR web site at www.sedar.com.

Toronto, Canada

November 29, 2005