

TORONTO HYDRO CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR THE
THREE AND NINE MONTHS ENDED
SEPTEMBER 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 nine-month period ended September 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 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 3 to the Annual Consolidated Financial Statements and in note 3 to the Interim Consolidated Financial Statements.

Business of Toronto Hydro Corporation

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, provides energy efficiency products and services and delivers street lighting and expressway lighting services; 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 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 Three months ended September 30 (in thousands of dollars, except for per share amounts, unaudited)				
	2006	2005	Change	Change
	\$	\$	\$	%
Revenues	600,549	774,295	(173,746)	(22.4%)
Costs				
Purchased power and other	458,872	634,080	(175,208)	(27.6%)
Operating expenses	49,544	47,471	2,073	4.4%
Depreciation and amortization	34,456	32,799	1,657	5.1%
	<u>542,872</u>	<u>714,350</u>	<u>(171,478)</u>	<u>(24.0%)</u>
Income before interest, other and provision for payments in lieu of corporate taxes ("PILs")	57,677	59,945	(2,268)	(3.8%)
Interest income	4,433	3,108	1,325	42.6%
Interest expense				
Long-term debt	(18,410)	(20,100)	1,690	8.4%
Other interest	(645)	(294)	(351)	(119.4%)
Other ⁽¹⁾	606	2,154	(1,548)	(71.9%)
	<u>43,661</u>	<u>44,813</u>	<u>(1,152)</u>	<u>(2.6%)</u>
Income before provision for PILs	43,661	44,813	(1,152)	(2.6%)
Provision for PILs	14,767	25,459	(10,692)	(42.0%)
	<u>28,894</u>	<u>19,354</u>	<u>9,540</u>	<u>49.3%</u>
Net income	28,894	19,354	9,540	49.3%
Basic and diluted net income per share	<u>28,894</u>	<u>19,354</u>	<u>9,540</u>	<u>49.3%</u>

Note:

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

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

	2006 \$	2005 \$	Change \$	Change %
Revenues	1,703,151	1,976,122	(272,971)	(13.8%)
Costs				
Purchased power and other	1,294,456	1,560,074	(265,618)	(17.0%)
Operating expenses	143,107	133,134	9,973	7.5%
Depreciation and amortization	104,096	101,998	2,098	2.1%
	<u>1,541,659</u>	<u>1,795,206</u>	<u>(253,547)</u>	<u>(14.1%)</u>
Income before interest, other and provision for PILs	161,492	180,916	(19,424)	(10.7%)
Interest income	13,283	9,755	3,528	36.2%
Interest expense				
Long-term debt	(57,484)	(60,302)	2,818	4.7%
Other interest	(2,242)	(1,667)	(575)	(34.5%)
Other ⁽¹⁾	606	2,154	(1,548)	(71.9%)
Income before provision for PILs	115,655	130,856	(15,201)	(11.6%)
Provision for PILs	46,041	60,912	(14,871)	(24.4%)
Net income	69,614	<u>69,944</u>	<u>(330)</u>	<u>(0.5%)</u>
Basic and diluted net income per share	<u>69,614</u>	<u>69,944</u>	<u>(330)</u>	<u>(0.5%)</u>

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

	As at September 30, 2006 \$	As at December 31, 2005 \$
Total assets	2,552,365	2,819,258
Current liabilities	297,593	941,211
Long-term liabilities	1,378,491	1,032,180
Total liabilities	1,676,084	1,973,391
Shareholder's equity	876,281	845,867
Total liabilities and shareholder's equity	<u>2,552,365</u>	<u>2,819,258</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, 2006 was \$28.9 million and \$69.6 million compared to \$19.4 million and \$69.9 million for the comparable periods in 2005.

The increase in net income for the three months ended September 30, 2006 was primarily due to decreased provision for PILs (\$10.7 million) and decreased net interest expense (\$2.7 million) partially offset by increased operating expenses (\$2.1 million), increased depreciation expense (\$1.7 million) and decreased gains on disposals of property, plant and equipment (\$1.5 million).

The decrease in net income for the nine months ended September 30, 2006 was primarily due to increased operating expenses (\$10.0 million), decreased net revenues (\$7.4 million), increased depreciation expense (\$2.1 million) and lower gain on disposition of assets (\$1.5 million) partially offset by decreased provision for PILs (\$14.9 million) and decreased net interest expense (\$5.8 million).

Net Revenues

Net revenues (revenues minus the cost of purchased power and other) for the three months and the nine months ended September 30, 2006 were \$141.7 million and \$408.7 million compared to \$140.2 million and \$416.0 million for the comparable periods in 2005.

The increase in net revenues for the three months ended September 30, 2006 was primarily due to increased net revenues at LDC (\$3.0 million) and at Telecom (\$1.9 million) partially offset by decreased net revenues at TH Energy (\$3.0 million).

At LDC, the increase in net revenues for the three months ended September 30, 2006 was primarily due to higher revenue related to conservation and demand management ("CDM") program incentives (\$7.3 million) partially offset by lower distribution revenue from decreased consumption attributable to weather (\$3.5 million) and a reduction of distribution rates following the 2006 OEB decision effective May 1, 2006 (\$1.6 million).

The decrease in net revenues for the nine months ended September 30, 2006 was primarily due to decreased net revenues at TH Energy (\$12.0 million) partially offset by increased net revenues at Telecom (\$4.7 million).

At TH Energy, the decrease in net revenues for the three months and the nine months ended September 30, 2006 was primarily due to lower contributions from the remaining activities of the electricity retail business which is scheduled to cease on December 31, 2006, offset by the increase in street lighting net revenues 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 nine months ended September 30, 2006 was primarily due to increased sales of data managed services.

At LDC, net revenues for the nine months ended September 30, 2006 amounted to \$363.1 million compared to \$362.9 million for the nine months ended September 30, 2005. The variance was mainly due to higher revenue related to CDM program incentives (\$16.7 million) offset by lower distribution revenue from decreased consumption attributable to weather (\$10.8 million), a reduction in distribution rates following the 2006 OEB decision effective May 1, 2006 (\$3.0 million) and lower income from customer charges other than electricity distribution (\$2.6 million).

Expenses

Operating expenses for the three months and the nine months ended September 30, 2006 were \$49.5 million and \$143.1 million compared to \$47.5 million and \$133.1 million for the comparable periods in 2005.

The increase in operating expenses for the three months ended September 30, 2006 was primarily due to increased spending on CDM programs at LDC (\$4.5 million) and lower deferral of pension and regulatory costs at LDC (\$1.5 million) offset by lower operating costs at LDC (\$4.0 million).

The increase in operating expenses for the nine months ended September 30, 2006 was primarily due to increased spending on CDM programs at LDC (\$5.5 million), higher allowance for doubtful accounts at LDC (\$1.0 million) and lower deferral of pension and regulatory costs at LDC (\$3.6 million) offset by lower property taxes (\$1.9 million) at LDC.

Depreciation and amortization expense for the three months and the nine months ended September 30, 2006 was \$34.5 million and \$104.1 million compared to \$32.8 million and \$102.0 million for the comparable period in 2005. The increase in depreciation expense for the three months and the nine months ended September 30, 2006 was primarily due to higher depreciation from new street lighting assets in TH Energy and capital investment in the LDC.

Net interest expense for the three months and the nine months ended September 30, 2006 was \$14.6 million and \$46.4 million compared to \$17.3 million and \$52.2 million for the comparable periods in 2005. The decrease in net interest expense for the three months and the nine months ended September 30, 2006 was primarily due to higher interest rates received on short-term investments and lower interest expenses in respect of the City Promissory Note commencing May 1, 2006 (see “Corporate Developments – City Promissory Note”).

Provision for PILs

Provision for PILs for the three months and the nine months ended September 30, 2006 was \$14.8 million and \$46.0 million compared to \$25.5 million and \$60.9 million for the comparable periods in 2005. The decrease in the provision for PILs for the three months and the nine months ended September 30, 2006 was primarily due to higher taxable income and lower temporary differences not benefited in LDC.

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 (in thousands of dollars, unaudited)				
	Three months Ended September 30		Nine months Ended September 30	
	2006	2005	2006	2005
	\$	\$	\$	\$
Cash and cash equivalents, beginning of period	316,796	365,095	448,370	386,625
Net cash provided by operating activities	60,638	51,153	62,048	149,337
Net cash used in investing activities	(48,689)	(35,601)	(145,801)	(77,684)
Net cash used in financing activities	(4,268)	(6,240)	(40,140)	(83,871)
Cash and cash equivalents, end of period	<u>324,477</u>	<u>374,407</u>	<u>324,477</u>	<u>374,407</u>

Cash Provided by Operating Activities

Cash provided by operating activities for the three months and the nine months ended September 30, 2006 was \$60.6 million and \$62.0 million compared to \$51.2 million and \$149.3 million for the comparable period in 2005.

The increase in cash provided by operating activities for the three months ended September 30, 2006 was primarily due to increased net income (\$9.5 million), a favourable variance in the aggregate of accounts receivable and unbilled revenue due to lower energy prices and consumption at LDC (\$22.6 million) and a favourable variance in electricity mark-to-market assets and liabilities at TH Energy due to changes in the forward price of electricity and reduction of the electricity retail portfolio (\$11.8 million). This was partially offset by an unfavourable variance in accounts payable and accrued liabilities due to lower energy prices and consumption at LDC and at TH Energy (\$18.8 million) and an unfavourable variance in deferred revenue at LDC due to CDM initiatives (\$17.0 million).

The decrease in cash provided by operating activities for the nine months ended September 30, 2006 was primarily due to an unfavourable variance in accounts payable and accrued liabilities at LDC mainly due to payment of rebate programs received in 2005 (\$165.4 million), an unfavourable variance in deferred revenue at LDC due to CDM initiatives (\$25.3 million), an unfavourable variance in accounts payable and accrued liabilities at TH Energy due to reduced retail electricity activities (\$21.1 million) and an unfavourable variance in future income taxes due to changes in the electricity retail portfolio at TH Energy (\$6.2 million). This was partially offset by a favourable variance in the aggregate of accounts receivable and unbilled revenue due to lower energy prices and consumption at LDC (\$88.8 million) and a favourable variance in electricity mark-to-market assets and liabilities at TH Energy due to changes in the forward price of electricity and reduction of the electricity retail portfolio (\$31.8 million).

Cash Used in Investing Activities

Cash used in investing activities for the three months and the nine months ended September 30, 2006 was \$48.9 million and \$145.8 million compared to \$35.6 million and \$77.7 million for the comparable periods in 2005.

The increase in cash used in investing activities for the three months ended September 30, 2006 was primarily due to an increase in regulatory assets (\$7.1 million) and an increase in the purchase of property, plant and equipment at LDC (\$4.2 million).

The increase in cash used in investing activities for the nine months ended September 30, 2006 was primarily due to an increase in regulatory assets (\$38.8 million), an increase in the purchase of property, plant, equipment and intangible assets at LDC (\$24.8 million) and TH Energy (\$2.5 million).

Cash Used in Financing Activities

Cash used in financing activities for the three months and the nine months ended September 30, 2006 was \$4.3 million and \$40.1 million compared to \$6.2 million and \$83.9 million for the comparable periods in 2005.

The decrease in cash used in financing activities for the three months ended September 30, 2006 was primarily due to an increase in customers' advance deposits at LDC.

The decrease in cash used in financing activities for the nine months ended September 30, 2006 was primarily due to a decrease in dividends paid (\$21.8 million) and an increase in customers' advance deposits at LDC (\$21.5 million).

Capital Expenditures
(in thousands of dollars, unaudited)

	Three months		Nine months	
	Ended September 30		Ended September 30	
	2006	2005	2006	2005
	\$	\$	\$	\$
LDC				
Distribution System	32,276	30,587	97,215	81,169
Technology assets	3,437	3,334	13,575	8,062
Other ⁽¹⁾	2,302	2,442	7,283	4,541
	38,015	36,363	118,073	93,772
Other ⁽²⁾	5,138	2,525	11,633	7,966
Total Capital Expenditures	43,153	38,888	129,706	101,738

Notes:

- (1) Consists of vehicles, other work-related equipment, furniture and office equipment.
- (2) Includes capital expenditures relating to TH Energy 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 September 30, 2006, no borrowings for working capital were outstanding and letters of credit in the amount of \$82.5 million had been issued. See note 5 to the Interim Consolidated Financial Statements.

Prudential Requirements and Third Party Credit Support

As at September 30, 2006, the Corporation has 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. The Corporation has also issued parental guarantees 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 guarantees to the City was nil as at September 30, 2006 as the market price of power was below the contract price. See note 10 to the Interim Consolidated Financial Statements.

Dividends

On March 2, 2006, the board of directors of the Corporation declared dividends aggregating \$27.2 million: \$21.2 million in connection with 2005 net income, which was paid on March 10, 2006, and \$6.0 million 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, which 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, which was paid on September 29, 2006.

On November 29, 2006, the board of directors of the Corporation declared a dividend in the amount of \$7.0 million in connection with the fourth quarter of 2006, which is payable on December 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. 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.

Smart Meters

On June 13, 2006, the Government issued draft regulations clarifying the technical details of advanced metering infrastructure and data management. In support of the Government's decision to install smart meters throughout Ontario by 2010, LDC has launched its smart meter project in 2006. The project objective is to install 695,000 smart meters and the supporting infrastructure by the end of 2009. LDC has installed 122,000 meters at September 30, 2006 and will use its experience 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. See note 4 to the Interim Consolidated Financial Statements.

OEB Proposals for Multi-Year Electricity Rate Setting Plan

On June 19 and July 25, 2006, the OEB issued draft proposals regarding the distribution allowable cost of capital and the development of a second-generation incentive regulation mechanism. LDC responded to both proposals in writing, and participated in technical conferences held in August and September. LDC will continue to participate in the further development of the OEB's final proposal.

City Promissory Note

On September 5, 2006, the Corporation announced that it 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). A copy of the amended and restated City Note is available at www.sedar.com. See note 6b) to the Interim 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 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 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 held a hearing in September 2006 to consider the settlement but has not yet issued a ruling. 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. The Corporation has identified conditional AROs and recognized a liability amounting to \$1,642,000 in this quarter. The change has been accounted for prospectively as information is not available to allow it to be accounted for retrospectively.

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

November 29, 2006