

**TORONTO HYDRO CORPORATION**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS**  
**OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR THE INTERIM PERIOD ENDED**  
**MARCH 31, 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 ended March 31, 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", "Dividends", "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](http://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 engages in the development and sale of energy efficiency products and 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 over 673,000 customers located in the City of Toronto. LDC is the largest municipal electricity distribution company in Canada and distributes approximately 18% of the electricity consumed in Ontario. The business of LDC is regulated by the OEB which has broad powers relating to licensing, standards of conduct and service and the regulation of rates charged by LDC and other electricity distributors in Ontario. 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 for the three months ended March 31, 2004.

	<b>Three months ended March 31, (Unaudited)</b>	
	<b>2005</b> \$	<b>2004</b> \$ <b>(Restated)</b>
	(in thousands of dollars, except for per share amounts)	
<b>Interim Consolidated Statement of Income Data</b>		
Revenues .....	612,826	598,220
Costs		
Purchased power and other .....	478,171	463,284
Operating expenses .....	45,919	44,337
Depreciation and amortization .....	34,510	33,372
	<u>558,600</u>	<u>540,993</u>
Income before interest and provision for payments in lieu of corporate taxes (“PILs”) .....	54,226	57,227
Interest income .....	3,404	3,123
Interest expense		
Long-term debt .....	(20,101)	(20,101)
Other interest .....	(636)	(690)
	<u>36,893</u>	<u>39,559</u>
Income before provision for PILs .....	36,893	39,559
Provision for PILs .....	16,057	15,290
Net income for the period .....	<u>20,836</u>	<u>24,269</u>
Basic and fully diluted net income per share .....	<u>20,836</u>	<u>24,269</u>
	<b>As at March 31, 2005 (Unaudited) \$</b>	<b>As at December 31, 2004 (Unaudited) \$</b>
	(in thousands of dollars)	
<b>Interim Consolidated Balance Sheet Data</b>		
Total assets .....	<u>2,560,960</u>	<u>2,588,854</u>
Current liabilities .....	731,260	701,636
Long-term liabilities .....	1,036,442	1,065,796
Total liabilities .....	<u>1,767,702</u>	<u>1,767,432</u>
Shareholder’s equity .....	793,258	821,422
Total liabilities and shareholder’s equity .....	<u>2,560,960</u>	<u>2,588,854</u>

## **Results of Operations**

### ***Net Income***

Net income for the three months ended March 31, 2005 was \$20.8 million compared to \$24.3 million for the comparable period in 2004. The decrease was primarily due to increased operating expenses (\$1.6 million), increased depreciation and amortization expense (\$1.1 million) and increased provision for PILs (\$0.8 million).

### ***Net Revenues***

Net revenues (revenues minus the cost of purchased power and other) for the three months ended March 31, 2005 were \$134.7 million compared to \$134.9 million for the comparable period in 2004. The decrease was primarily due to decreased net revenues at LDC (\$2.8 million) partially offset by increased net revenues at Energy Services (\$2.3 million).

At LDC, the decrease in net revenues was primarily due to decreased contribution from other income resulting from reduced work performed for customers (\$1.5 million) and lower electricity consumption (\$1.3 million).

At Energy Services, the increase in net revenues was primarily due to an increased realized gain from the mark-to-market valuation of retail and designated wholesale electricity contracts (\$4.4 million) and an increased gain in future value of the electricity portfolio (\$0.5 million) partially offset by lower consumption due to expired retail electricity contracts (\$1.4 million) and decreased contribution from business protection plan rebates (\$1.2 million).

### ***Expenses***

Operating expenses for the three months ended March 31, 2005 were \$45.9 million compared to \$44.3 million for the comparable period in 2004. The increase was primarily due to increased property taxes at LDC (\$3.4 million) partially offset by restructuring costs incurred at Energy Services in 2004 resulting from the cessation of electricity retailing activities (\$1.3 million).

Depreciation and amortization expense for the three months ended March 31, 2005 was \$34.5 million compared to \$33.4 million for the comparable period in 2004.

Net interest expense for the three months ended March 31, 2005 was \$17.3 million compared to \$17.7 million for the comparable period in 2004.

### ***Provision for PILs***

Provision for PILs for the three months ended March 31, 2005 was \$16.1 million compared to \$15.3 million for the comparable period in 2004. The increase was primarily due to increased effective PILs rate at LDC resulting from unfavourable impact of temporary differences.

## **Corporate Developments**

### ***Extension of Short Term Revolving Credit Facility***

Effective May 3, 2005, the Corporation extended its existing \$500 million committed short term revolving credit facility, placed with a syndicate of five Schedule I chartered banks, to May 2008.

### ***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 of these appointments are effective May 30, 2005.

## **Liquidity and Capital Resources**

The Corporation's primary liquidity and capital resource requirements are for power purchases from the Independent Electricity System Operator ("IESO"), 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 March 31, 2005, the Corporation had issued \$166.5 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 an \$11.3 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 are 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 ended March 31, 2005 was \$47.1 million compared to \$2.1 million for the comparable period in 2004. The increase was primarily due to a positive variance in accounts payable and accrued liabilities (\$80.9 million) resulting from increased electricity trade payables at LDC and Energy Services, partially offset by a negative variance in accounts receivable (\$34.1 million) due to higher collection of accounts receivable prior to December 31, 2004.

Cash used in investing activities for the three months ended March 31, 2005 was \$21.7 million compared to \$25.5 million for the comparable period in 2004. The decrease was primarily due to lower capital expenditures at LDC.

Cash used in financing activities for the three months ended March 31, 2005 was \$75.2 million compared to \$28.7 million for the comparable period in 2004. The increase was primarily due to decreased customer deposits following a new OEB directive requiring the earlier return of customer deposits (\$26.7 million) and increased dividends in relation to prior year financial results (\$19.8 million).

## **Dividends**

On March 31, 2005, the board of directors of the Corporation declared dividends payable to the City of Toronto in the amount of \$49.0 million. The dividends were comprised of a \$23.7 million payment in respect of 2004 net income, a \$6.0 million payment in respect of the first quarter of 2005 and a \$19.3 million one-time extraordinary dividend payment. These dividends were paid on March 31, 2005.

On May 27, 2005, the board of directors of the Corporation declared a dividend in the amount of \$6.0 million in respect of the second quarter of 2005. This dividend is payable on June 30, 2005.

## **Regulatory Assets**

As a result of *The Electricity Pricing, Conservation and Supply Act, 2002*, 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 electricity distributors to make rate applications to the OEB with respect to the recovery of regulatory assets. The recoveries are being phased in over a four-year period which commenced in March 2004.

In September 2004, a public hearing was held to review LDC's regulatory assets for prudence and to make a final determination of the amounts to be recovered. In December 2004, the OEB approved the recovery of the remaining regulatory assets as at December 31, 2003. In March 2005, the OEB approved LDC's rate application for

the recovery of the approved regulatory assets subject to a final review of the 2004 audited financial statements of LDC.

### **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 is effective as of April 1, 2005 and is subject to a financial commitment by LDC to invest \$39.8 million in conservation and demand management activities over the next three years.

### **Global Adjustment**

Effective January 1, 2005, the OEB implemented 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 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 the prevailing conditions. This 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 a fixed interim adjustment rate of \$0.10 per MWh. Concurrently, LDC paid the IESO a rate of \$1.40, \$2.80 and \$2.00 per MWh for the consumption of these customers, for the months of January, February and March 2005, respectively. The difference between the amount credited to customers and the amount paid to the IESO by LDC is being tracked in a variance account and reflected as a regulatory asset pending the OEB's direction with respect to recovery.

### **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 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 MEU's 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.

### 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 following table summarizes the impact – increase or (decrease) – to the originally issued unaudited interim consolidated financial statements as at and for the three months ended March 31, 2004:

	<b>Three months ended March 31, 2004</b>
	<b>\$</b>
	(in thousands of dollars)
<b>Changes in Interim Consolidated Statement of Income Data</b>	
Net revenues .....	1,445
Interest income .....	211
Provision for PILs .....	1,045
Net income .....	611
<b>Changes in Interim Consolidated Balance Sheet Data</b>	
Unbilled revenue .....	3,130
Regulatory assets .....	(1,474)
Accounts payable and accrued liabilities .....	1,045
Retained earnings .....	611

## **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](http://www.sedar.com).

Toronto, Canada

May 27, 2005