

TORONTO HYDRO CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR THE YEAR ENDED
DECEMBER 31, 2008

The following discussion and analysis should be read in conjunction with the audited consolidated financial statements and accompanying notes of Toronto Hydro Corporation (the "Corporation") as at and for the year ended December 31, 2008 (the "Consolidated Financial Statements"). The Consolidated Financial Statements are prepared in accordance with Canadian generally accepted accounting principles ("GAAP"), including accounting principles prescribed by the Ontario Energy Board (the "OEB"), and are presented in Canadian dollars.

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 and engages in Conservation and Demand Management ("CDM") activities; and
- *Toronto Hydro Energy Services Inc.* ("TH Energy") - which provides street lighting services and develops energy efficiency products and 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 684,000 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.

TH Energy owns and operates street lighting and expressway lighting assets located in the City and is engaged in the sale of energy efficiency products and services to commercial and industrial customers.

The sole shareholder of the Corporation is the City.

Electricity Distribution – Industry Overview

In April 1999, the government of Ontario initiated a restructuring of Ontario's electricity industry. The restructuring was intended, among other things, to facilitate competition in the generation and sale of electricity, to protect the interests of consumers with respect to prices and the reliability and quality of electricity service and to promote economic efficiency in the generation, transmission and distribution of electricity.

On May 1, 2002, the Province opened Ontario's wholesale and retail markets to competition by providing generators, retailers and consumers with open access to Ontario's transmission and distribution network ("Open Access").

Since the commencement of Open Access, LDC and other electricity distributors have been purchasing their electricity from the wholesale market administered by the Independent Electricity System Operator ("IESO") and recovering the costs of electricity and certain other costs at a later date in accordance with procedures mandated by the OEB.

The OEB has regulatory oversight of electricity matters in the Province of Ontario. The *Ontario Energy Board Act, 1998* sets out the OEB's authority to issue a distribution licence which must be obtained by owners or operators of a distribution system in Ontario. The OEB prescribes licence requirements and conditions including, among other things, specified accounting records, regulatory accounting principles, separation of accounts for separate businesses and filing process requirements for rate-setting purposes.

The OEB's authority and responsibilities include the power to approve and fix rates for the transmission and distribution of electricity, the power to provide continued rate protection for rural and remote electricity customers and the responsibility for ensuring that electricity distribution companies fulfil obligations to connect and service customers.

LDC is required to charge its customers for the following amounts (all of which, other than the distribution rate, represent a pass through of amounts payable to third parties):

- *Distribution Rate* – The distribution rate is designed to recover the costs incurred by LDC in delivering electricity to customers and the OEB-allowed rate of return. Distribution rates are regulated by the OEB and typically comprise a fixed charge and a usage-based (consumption) charge.

The volume of electricity consumed by LDC's customers during any period is governed by events largely outside LDC's control (principally, sustained periods of hot or cold weather which increase the consumption of electricity and sustained periods of moderate weather which decrease the consumption of electricity).

- *Electricity Price and Related Rebates* – The electricity price and related rebates represent a pass through of the commodity cost of electricity.
- *Retail Transmission Rate* – The retail transmission rate represents a pass through of wholesale costs incurred by distributors in respect of the transmission of electricity from generating stations to local areas. Retail transmission rates are regulated by the OEB.
- *Wholesale Market Service Charge* – The wholesale market service charge represents a pass through of various wholesale market support costs. Retail rates for the recovery of wholesale market service charges are regulated by the OEB.

LDC is required to satisfy and maintain prudential requirements with the IESO, which include credit support with respect to outstanding market obligations in the form of letters of credit, cash deposits or guarantees from third parties with prescribed credit ratings.

The Corporation and its subsidiaries are exempt from tax under the *Income Tax Act (Canada)* and the *Corporations Tax Act (Ontario)*, if not less than 90% of the capital of the Corporation is owned by the City and not more than 10% of the income of the Corporation and each of its subsidiaries is derived from activities carried on outside the municipal geographical boundaries of the City.

The Corporation and each of its subsidiaries is a Municipal Electricity Utility ("MEU") for purposes of the Payment In Lieu of Corporate Taxes ("PILs") regime contained in the *Electricity Act, 1998*. The *Electricity Act, 1998* provides that a MEU that is exempt from tax under the *Income Tax Act (Canada)* and the *Corporations Tax Act (Ontario)* is required to make, for each taxation year, a PILs to the Ontario Electricity Financial Corporation in an amount equal to the tax that it would be liable to pay under the *Income Tax Act (Canada)* and the *Corporations Tax Act (Ontario)* if it were not exempt from tax.

Selected Consolidated Financial Data

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

As at December 31, (in thousands of dollars except for per share amounts)					
	2008	2007⁽²⁾	Change	Change	2006⁽²⁾
	\$	\$	\$	%	\$
Revenues	2,382,542	2,351,486	31,056	1.3	2,217,504
Costs					
Purchased power and other	1,884,296	1,853,874	30,422	1.6	1,701,412
Operating expenses	205,472	190,404	15,068	7.9	183,628
Depreciation and amortization	156,347	143,983	12,364	8.6	131,868
	<u>2,246,115</u>	<u>2,188,261</u>	<u>57,854</u>	2.6	<u>2,016,908</u>
Income before interest, impairment, other and provision for PILs	136,427	163,225	(26,798)	(16.4)	200,596
Interest income	12,350	13,949	(1,599)	(11.5)	17,555
Interest expense					
Long-term debt	(71,542)	(75,312)	3,770	5.0	(75,894)
Other interest	(3,212)	1,403	(4,615)	(328.9)	(2,894)
Impairment of investments held to maturity ..	(22,033)	(13,059)	(8,974)	(68.7)	-
Other	-	1,674	(1,674)	(100.0)	589
Income before provision for PILs	51,990	91,880	(39,890)	(43.4)	139,952
Provision for PILs	5,697	37,802	(32,105)	(84.9)	55,040
Income from continuing operations	46,293	54,078	(7,785)	(14.4)	84,912
Income from discontinued operations – net of tax ⁽¹⁾	122,719	28,753	93,966	326.8	7,485
Net income	<u>169,012</u>	<u>82,831</u>	<u>86,181</u>	104.0	<u>92,397</u>
Basic and fully diluted net income per share from continuing operations	46,293	54,078	(7,785)	(14.4)	84,912
Basic and fully diluted net income per share from discontinued operations	122,719	28,753	93,966	326.8	7,485
Basic and fully diluted net income per share	<u>169,012</u>	<u>82,831</u>	<u>86,181</u>	104.0	<u>92,397</u>

Notes:

- (1) Consists of discontinued operations for Toronto Hydro Telecom Inc. (“Telecom”) and for the water heater business. See note 26 to the Consolidated Financial Statements.
- (2) Net income was \$82.8 million in 2007 compared to \$92.4 million in 2006. Unfavourable variances were noted in net revenues (\$18.5 million), impairment provision recorded on investments held to maturity (\$13.1 million), depreciation and amortization expense (\$12.1 million) and operating expenses (\$6.8 million). These unfavourable variances were partially offset by the gain recorded on the sale of the water heater assets included in income from discontinued operations in 2007 (\$21.3 million), lower provision for PILs (\$17.2 million) and decreased net interest expense (\$1.2 million). For further details, see the Corporation’s 2007 Management’s Discussion and Analysis as filed on the System for Electronic Document Analysis and Retrieval (“SEDAR”) website at www.sedar.com.

**As at December 31,
(in thousands of dollars)**

Consolidated Balance Sheet Data	2008⁽¹⁾	2007
	\$	\$
Total assets	2,779,783	2,695,751
Current liabilities	561,414	320,017
Long-term liabilities	1,237,078	1,447,039
Total liabilities	1,798,492	1,767,056
Shareholder's equity	981,291	928,695
Total liabilities and shareholder's equity	2,779,783	2,695,751

Note:

- (1) Amounts include current liabilities from discontinued operations regarding Telecom. See note 26 to the Consolidated Financial Statements.

Results of Operations

Net Income

Net income was \$169.0 million in 2008 compared to \$82.8 million in 2007. The increase in net income was primarily due to higher contribution from discontinued operations in 2008 (\$94.0 million) related to the sale of Telecom (see "Discontinued Operations" below) and a favourable variance in provision for PILs (\$32.1 million). These favourable variances were partially offset by higher operating expenses (\$15.1 million), higher depreciation expense (\$12.4 million), higher impairment on investments held to maturity recorded in 2008 (\$9.0 million), higher net interest expense (\$2.4 million), and lower gains on disposition of PP&E (\$1.7 million).

Net Revenues

Net revenues (revenues minus the cost of purchased power and other) were \$498.2 million in 2008 compared to \$497.6 million in 2007. The increase was primarily due to increased net revenues at LDC.

At LDC, the increase in net revenues was primarily due to increased distribution revenue (\$10.5 million), partially offset by lower non-distribution related revenue (\$10.2 million) from lower revenue recognition associated with CDM activities and lower demand billable work in 2008. The increase in distribution revenue was primarily due to higher OEB-approved distribution rates for 2008 arising from projected increase in maintenance programs expenditures and capital expenditures (\$22.9 million) (see "Corporate Developments – Distribution Rates for LDC" below), partially offset by lower contribution from CDM activities in 2008 compared to 2007 (\$7.1 million) and lower consumption in 2008 mainly from weather variances (26,037 GWh compared to 26,679 GWh) (\$7.0 million).

Expenses

Operating expenses were \$205.5 million in 2008 compared to \$190.4 million in 2007. The increase in operating expenses was primarily due to higher payroll costs in LDC mainly from the hiring of new apprentices in the electrical trades and annual general wage increase (\$5.8 million), an adjustment to capital taxes recorded in 2008 in LDC (\$3.2 million), increase in maintenance costs for aging electrical infrastructure at LDC (\$2.5 million), higher support costs for technology infrastructure at LDC (\$1.6 million), and higher cost in TH Energy related to the development of new business activities (\$2.6 million).

Depreciation and amortization expense was \$156.3 million in 2008 compared to \$144.0 million in 2007. The increase in depreciation and amortization expense was primarily due to increased investments in electricity distribution assets of LDC. This increase was consistent with the infrastructure renewal program presented to the

OEB in 2007 and included in the 2008 and 2009 distribution rates (see “Corporate Developments – Distribution Rates for LDC” below).

Net Interest Expense

Net interest expense was \$62.4 million in 2008 compared to \$60.0 million in 2007. The increase in net interest expense was primarily due to lower interest income from lower interest rates on cash balance, higher interest expense on regulatory liabilities, partially offset by lower interest cost on the long-term debt.

Impairment of Investments Held to Maturity

Impairment of investments held to maturity was \$22.0 million in 2008 compared to \$13.1 million in 2007. The provision recorded reflects the estimated market variation in the estimated fair value of the Corporation’s third-party Asset-Backed Commercial Paper (“ABCP”) notes. The impairment provision of \$22.0 million recorded in 2008 reflects the overall deterioration of the credit market and the resulting impact on weighted average discount rates used to value the ABCP notes (See “Investments Held to Maturity” below).

Other

Included in Other are amounts primarily relating to gains on disposals of property, plant and equipment. Other was \$nil in 2008 compared to \$1.7 million in 2007. The unfavorable variance was due to gains recorded on disposal of excess properties at LDC in 2007.

Provision for PILs

Provision for PILs was \$5.7 million in 2008 compared to \$37.8 million in 2007. The \$32.1 million decrease in the provision for PILs was primarily due to the favourable impact of the settlement of the Ministry of Finance income tax audits for prior periods that was recorded in 2008 and lower earnings before tax in 2008 compared to 2007 (See “Corporate Developments - Ministry of Finance Tax Audit” below).

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. In connection with this transaction, the Corporation recorded a net gain of \$24.1 million in 2007. 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.

On July 31, 2008, the Corporation sold all of the shares of Telecom to Cogeco Cable Canada Inc. (“Cogeco”) for cash consideration of \$200.0 million, subject to post closing adjustments and transaction costs. In connection with this transaction, the Corporation recorded a net gain of \$118.7 million. As part of the closing of the transaction, LDC and Cogeco entered into a transition agreement pursuant to which LDC agreed to provide certain back office support services (on the basis and in the manner generally provided by LDC to Telecom immediately prior to the closing of the sale) to Cogeco for a period of up to six months with options for Cogeco to renew for two additional terms of three months each. The first option has been exercised by Cogeco. The results of operations and financial position of Telecom have been segregated and presented as discontinued operations in the Consolidated Financial Statements.

Income from discontinued operations, net of tax, was \$122.7 million in 2008 compared to \$28.8 million in 2007. The increase in income from discontinued operations, net of tax, was primarily due to the sale of Telecom in 2008.

See note 26 to the Consolidated Financial Statements.

Summary of Quarterly Results

The tables below present unaudited quarterly consolidated financial information of the Corporation for 2007 and 2008 and reflect discontinued operations relating to Telecom and the water heater business. See note 26 to the Consolidated Financial Statements.

2008 quarter ended, (in thousands of dollars)				
	December 31	September 30	June 30	March 31
	\$	\$	\$	\$
Revenues	587,243	633,820	568,968	592,511
Costs	556,112	589,252	534,325	566,426
Income from continuing operations	4,709	11,125	9,777	20,682
Net income.....	4,820	126,623	15,077	22,492

2007 quarter ended, (in thousands of dollars)				
	December 31	September 30	June 30	March 31
	\$	\$	\$	\$
Revenues	582,037	619,131	552,046	598,272
Costs	536,617	567,242	519,271	565,131
Income from continuing operations	19,130	9,311	13,867	11,770
Net income.....	19,223	11,045	14,909	37,654

Liquidity and Capital Resources

Sources of Liquidity and Capital Resources

The Corporation's primary sources of liquidity and capital resources are cash provided by operating activities, bank financing, interest income and borrowings from debt capital markets. The Corporation's liquidity and capital resource requirements are mainly for capital expenditures to maintain and improve the electricity distribution system of LDC, purchased power expense, interest expense and prudential requirements.

The Corporation does not believe that equity contributions from the City, its sole shareholder, will constitute a source of capital. In addition, the Corporation is not aware of any plans or decisions by the City to permit the Corporation to sell equity to the public or to other investors.

Liquidity and Capital Resources
Year Ended December 31,
(in thousands of dollars)

	2008 \$	2007 \$
Cash and cash equivalents, beginning of year	216,002	327,524
Net cash provided by operating activities	266,632	214,154
Net cash used in investing activities	(197,603)	(311,576)
Net cash used in financing activities	(112,922)	(43,646)
Net cash provided by discontinued operations ⁽¹⁾	168,383	29,546
Cash and cash equivalents, end of year	340,492	216,002

Note:

- (1) Consists of discontinued operations for the water heater business and Telecom. See note 26 to the Consolidated Financial Statements.

Net Cash Provided by Operating Activities

Net cash provided by operating activities was \$266.6 million in 2008 compared to \$214.2 million in 2007. The increase in net cash provided by operating activities was primarily due to a variance in the aggregate of accounts receivable and unbilled revenue due to the timing of billing and collection activities at LDC and TH Energy (\$24.2 million), a variance in the aggregate of other assets and liabilities at TH Energy and LDC mainly from variance in PILs receivable (\$15.3 million), higher depreciation and amortization (\$12.4 million), and a variance in the impairment provision recorded in connection with the liquidity issues on the Corporation's investments in ABCP notes (\$9.0 million). The increase was partially offset by lower net income from continuing operations (\$7.8 million).

Net Cash Used in Investing Activities

Net cash used in investing activities was \$197.6 million in 2008 compared to \$311.6 million in 2007. The decrease in net cash used in investing activities was primarily due to a variance in investments held to maturity (\$88.0 million), and a decrease in purchases of property, plant and equipment and intangibles, primarily at LDC (\$74.6 million). The decrease was partially offset by a variance in net change in regulatory assets and liabilities at LDC mainly from higher wholesale Market Service charges and delay in implementation of 2008 OEB-approved rates (\$47.4 million).

The decrease in purchases of property, plant and equipment at LDC for 2008 was primarily due to the deferral of 2008 smart meters expenditures to regulatory assets following direction from the OEB (\$28.7 million), higher investment in civil infrastructure in 2007 (\$22.7 million), and higher investment in facilities in 2007 from the relocation of two work centers (\$14.8 million).

The following table summarizes the Corporation's capital expenditures for the years indicated.

Year Ended December 31, (in thousands of dollars)		
	2008	2007
	\$	\$
Capital Expenditures from Continuing Operations		
LDC		
Distribution system	160,256	218,951
Technology assets	30,316	28,279
Other ⁽¹⁾	15,140	33,745
	<u>205,712</u>	<u>280,975</u>
Other ⁽²⁾	9,195	8,527
Total capital expenditures	<u>214,907</u>	<u>289,502</u>

Notes:

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

Net Cash Used In Financing Activities

Net cash used in financing activities was \$112.9 million in 2008 compared to \$43.6 million in 2007. The increase in net cash used in financing activities was primarily due to higher dividends paid in 2008 primarily due to the special dividend of \$75.0 million paid in relation with the sale of the shares of Telecom (See "Dividends" below).

Revolving Credit Facility

The Corporation is a party to a revolving credit facility, scheduled to expire on May 3, 2010, 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 December 31, 2008, no borrowings for working capital were outstanding and letters of credit in the amount of \$45.1 million had been issued to primarily support the prudential requirements of LDC with the IESO. (See note 11 to the Consolidated Financial Statements. See also "Corporate Developments – Shelf Prospectus" below).

Prudential Requirements and Third Party Credit Support

The City 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 purpose of enabling them to carry on their businesses up to an aggregate amount of \$500.0 million.

In recognition that the last of TH Energy's retail electricity contracts expired in December 2006, the board of directors of the Corporation determined in August 2007 to rescind a prior approval authorizing the Corporation to issue parental guarantees on behalf of TH Energy which had been used to enable TH Energy to meet its collateral credit requirements relating to its retailing activities.

Investments Held to Maturity

At December 31, 2008, the Corporation held third-party ABCP notes issued by a number of trusts with an aggregate principal amount of \$88.0 million. On the dates the Corporation purchased these notes, they were rated R1(High), by DBRS Limited (“DBRS”), the highest credit rating issued for commercial paper. These notes matured during the third quarter of 2007 but were not repaid at that time due to liquidity issues in the Canadian ABCP market. The Corporation’s ABCP notes last traded in an active market on or about August 13, 2007 and there are currently no market quotations available. The Corporation has classified its ABCP notes as Investments Held to Maturity, and presented them as long-term assets, after initially classifying them as Cash and Cash Equivalents.

On August 16, 2007, a group representing banks, asset providers and major investors (the “Montreal Committee”) agreed in principle to a long-term proposal and interim arrangements regarding the restructuring of the affected ABCP notes (the “Montreal Proposal”) into long-term Floating Rate Notes (“FRNs”) maturing no earlier than the scheduled maturity of the underlying assets.

On March 17, 2008, a court order was obtained through which the restructuring of the ABCP notes was placed under the protection of the Companies’ Creditors Arrangement Act (“CCAA”). On April 25, 2008, the restructuring proposal put forward by the Montreal Committee was approved by the required majority of the ABCP holders. The plan was sanctioned by the Ontario Superior Court on June 5, 2008.

On June 18, 2008, proceedings were taken by a number of corporate ABCP noteholders in the Ontario Court of Appeal seeking to challenge the Ontario Superior Court of Justice decision that sanctioned the restructuring plan. In a unanimous decision issued on August 18, 2008, the Ontario Court of Appeal dismissed the appeal. On September 2, 2008, a number of the unsuccessful appellants sought leave to appeal the Ontario Court of Appeal decision to the Supreme Court of Canada. On September 19, 2008, the Supreme Court of Canada announced that it would not grant leave to hear the appeal.

On December 24, 2008, the Montreal Committee announced that a final restructuring agreement had been reached on an enhanced and amended plan. The announcement stated that, pursuant to the agreement, the governments of Canada, Quebec, Ontario and Alberta, together with certain participants in the restructuring, agreed to provide, in aggregate, \$4.5 billion of additional margin facilities, which will rank senior to all other margin funding facilities. The final restructuring plan also calls for an 18-month moratorium on margin calls.

Based on the latest information available at December 31, 2008, it is estimated that of the \$88.0 million of ABCP in which the Corporation has invested, \$80.3 million is represented by a combination of leveraged collateralized debt, synthetic assets and traditional securitized assets which will be replaced by senior Class A-1 and Class A-2 and subordinated Class B and Class C long-term FRNs. Upon completion of the restructuring, the Corporation expects to receive replacement notes with par values of \$37.0 million for Class A-1; \$34.6 million for Class A2; \$6.3 million for Class B and \$2.4 million for Class C.

In addition to the above notes, the Corporation also expects to receive \$7.7 million in notes that are represented by assets that have an exposure to U.S. mortgages and sub-prime mortgages, which will be classified as Ineligible Tracking notes.

The valuation technique used by the Corporation to estimate the fair value of its investments in ABCP notes as at December 31, 2008, incorporates a discounted cash flow model considering the best available public information regarding market conditions and other factors that a market participant would consider for such investments and a mark-to-model valuation of the notes. The assumptions used to determine the estimated fair value reflect information contained in documents released by the Montreal Committee to all affected noteholders.

A weighted average interest rate of 1.58% was used to determine interest income on the restructured notes, except for the Ineligible Tracking notes, for which a weighted average interest rate of 2.38% was used. These rates were based on a forecast of 90-day Bankers’ Acceptance (“BA”) rates less 50 basis points from 2009 through 2016. To derive a net present value of the principal and future cash flows, each note class was discounted using an interest rate spread over forecast BA rates ranging from 500 basis points to 1,800 basis points over a period ranging from 4 years to 7 years. On a weighted average basis, the discount rates used for each note class were as follows:

Long-Term FRNs	Discount Rates
Class A-1:	7.08% (ranging from 5.65% to 8.5%)
Class A-2:	7.08% (ranging from 5.65% to 8.5%)
Class B:	7.33% (ranging from 5.90% to 8.75%)
Class C:	7.33% (ranging from 5.90% to 8.75%)
Ineligible Tracking notes:	20.08% (ranging from 18.65% to 21.50%)

As noted above, discount rates vary by each of the different replacement long-term FRNs to be issued as each is expected to have a different risk profile. The discount rates used to value the notes include a risk premium factor that incorporates current indicative credit default swap spreads, an estimated liquidity premium, and a premium for credit losses.

Based on the assumptions described above, the discounted cash flows resulted in an estimated fair value of the Corporation's investment in ABCP notes of \$52.9 million at December 31, 2008, compared to \$74.9 million at December 31, 2007. The decrease in value of \$22.0 million from December 31, 2007 was primarily due to the deterioration of the global credit markets which impacted the recovery assumptions and lead to a change in the methodology for discounting the various classes of notes by using different risk-adjusted discount rates for each note class. The impairment in the fair value of \$35.1 million compared to the maturity value of the ABCP notes was recorded as a reduction of income in the consolidated financial statements.

A sensitivity analysis was also conducted to examine the impact of an increase or a decrease in the overall weighted average discount rate. Based on the Corporation's mark-to-model valuation, a variation of 1% (100 basis points) would reduce or increase the estimated fair value of the ABCP notes by \$3.0 million.

The estimation by the Corporation of the fair value of its ABCP notes, as at December 31, 2008, is subject to significant risks and uncertainties, including the timing and amount of future cash flows, market liquidity and the quality of the underlying assets and financial instruments. Accordingly, there can be no assurance that the Corporation's assessment of the estimated fair value of its ABCP notes will not change materially in subsequent periods.

On January 12, 2009, the Ontario Superior Court approved the restructuring plan subject to the modification announced on December 24, 2008. On January 21, 2009, the amended restructuring plan was completed and the Corporation received its replacement notes. The replacement notes received have a face value of \$87.7 million, and DBRS has assigned an "A" credit rating to the Class A-1 and A-2 notes; the Class B, C and Ineligible Tracking notes are unrated. According to the Eighteenth and Nineteenth Reports of the Monitor, released on January 2, 2009, and January 8, 2009, respectively, the "legal final maturity" of the restructured notes is July 15, 2056. However, the expected repayment date for the restructured Class A-1 and Class A-2 notes is January 22, 2017. It should be noted that based on the information contained in the above-mentioned reports, there is no obligation to pay interest on the notes before 2019 and no legal requirement to pay principal until 2056. The distribution by class is listed below:

Master Asset Vehicle II	Amount Received	Percent of Total
Class A-1	\$36.9 million	42.1%
Class A-2	\$34.5 million	39.3%
Class B	\$6.3 million	7.2%
Class C	\$2.4 million	2.7%
Ineligible Tracking notes	\$7.6 million	8.7%

The replacement notes will be measured at fair value on initial recognition and are expected to be classified as held-for-trading under the Corporation's financial instrument policy which would require them to be fair valued at each period end with changes in fair value included in the income statement in the period in which they arise. Until an active market develops for the replacement notes, the fair value will be determined using a discounted cash flow approach based on the maximum use of inputs observed from market conditions on subsequent reporting dates.

As part of the note exchange, the Corporation received a payment of \$2.7 million representing the first installment of its share of the accumulated cash up to August 31, 2008 in the conduit trusts. This amount will be included in the determination of the fair value of the replacement notes as at March 31, 2009.

As there has been no active market for the new notes since closing on January 21, 2009, the Corporation has determined that as at March 10, 2009, there is no material change to the market conditions reported as at December 31, 2008.

The liquidity crisis in the third-party ABCP market has no significant impact on the Corporation's operations. The Corporation has sufficient cash to fund all of its ongoing liquidity and capital expenditure requirements and is in compliance with the financial covenants under the terms of its outstanding indebtedness.

Dividends

The shareholder direction adopted by the City with respect to the Corporation provides that the board of directors of the Corporation will use its best efforts to ensure the Corporation meets certain financial performance standards, including those relating to the credit rating and dividends. Subject to applicable law, the shareholder direction provides that the Corporation will pay dividends to the City each year amounting to the greater of \$25 million or 50% of the Corporation's consolidated net income for the year. The dividends are not cumulative and are payable as follows:

- \$6 million on the last business day of each of the first three fiscal quarters during the year;
- \$7 million on the last business day of the fiscal year; and
- the amount, if any, by which 50% of the Corporation's net income for the year exceeds \$25 million, within ten calendar days after the board of directors of the Corporation approved the Corporation's Consolidated Financial Statements for the year.

The board of directors of the Corporation declared and paid dividends totalling \$116.4 million in 2008 and \$46.2 million in 2007. The 2008 dividend payments include a special dividend of \$75.0 million paid on December 31, 2008, in relation to the sale of all the shares of Telecom.

On March 10, 2009, the board of directors of the Corporation declared dividends in the amount of \$6.2 million. The dividends are comprised of a \$0.2 million payment with respect to net income for the year ended December 31, 2008, payable to the City on March 19, 2009, and a \$6.0 million payment in connection with the first quarter of 2009, payable to the City on March 31, 2009.

Credit Rating

As at December 31, 2008, the Corporation and the Corporation's Debentures were rated "A" by DBRS and Standard & Poor's.

Corporate Developments

Labour Agreement

On December 22, 2008, CUPE Local One ratified collective agreements governing inside and outside employees for a five-year period expiring January 31, 2014. The collective agreements implemented an immediate wage increase of 3.0% and provide for general wage increases of 3.0%, for each of the following four years.

Shelf Prospectus

On December 12, 2008, the Corporation filed under its Medium Term Notes program a new shelf prospectus providing for the issuance of up to \$1.0 billion of debentures during the 25-month period following the date of the prospectus. The net proceeds from the sale of debentures issued under the shelf prospectus will be used by the Corporation for general corporate purposes which may include the repayment of existing indebtedness outstanding to the City under the terms of the "City Promissory Note".

Appointments

On October 30, 2008, the City, as sole shareholder of the Corporation, renewed the appointment of the Chair of the board of directors of the Corporation, Clare Copeland, appointed Patricia Callon as Chair-Designate, reappointed an independent director, Brian Chu and appointed five new independent directors, Derek Cowbourne, Paulette Kennedy, Shoba Khetrapal, Mike Richmond, and Bill Rupert. These appointments were effective December 1, 2008 for a two-year term.

On December 3, 2008, the City, as sole shareholder of the Corporation, renewed the appointments of Councillor Gordon Perks and Councillor Bill Saundercook and appointed Deputy Mayor Joe Pantalone as the City's designates on the board of directors of the Corporation. These appointments were effective January 1, 2009 to November 30, 2010.

Distribution Rates for LDC

On April 12, 2007, the OEB approved an increase in LDC's distribution rates for the period May 1, 2007 to April 30, 2008 representing an estimated revenue increase of approximately \$1.9 million.

On May 15, 2008, the OEB issued its decision regarding LDC's electricity distribution rates application for 2008, 2009 and 2010. In its decision, the OEB provided final approval for 2008 base distribution revenue requirement and rate base of \$473.0 million and \$1,968.9 million, respectively. The allowable market-based rate of return percentage for LDC was set at 8.57% by the OEB for 2008. The OEB's decision also provides for an option for a mechanistic adjustment based on the then-prevailing incentive regulation mechanism, for 2010. It should be noted that the deemed debt to equity structure of LDC was modified to 62.5% debt and 37.5% equity for 2008, and to 60.0% debt and 40.0% equity for 2009 thereafter.

In its decision on LDC's rate application for 2008, 2009 and 2010, the OEB found that 100% of the net after-tax gains on the sale of certain LDC properties should be deducted from the revenue requirement recovered through distribution rates. The OEB deemed this amount to be \$10.3 million (the 'deemed amount'). On June 16, 2008, LDC filed an appeal with the Divisional Court of Ontario (the "Divisional Court") seeking to overturn the gain on sale aspects of the OEB decision and also sought and obtained a stay order with respect to the deduction of the deemed amount from the revenue requirement recovered through rates. LDC expects that the appeal will be heard by the Divisional Court in 2009.

On December 15, 2008, LDC applied to the OEB to refund to customers amounts related to the unanticipated extension for three months of rate riders that were to have expired April 30, 2008. The rate riders were extended by the OEB at LDC's request to avoid rate instability prior to the implementation of 2008 rates as of August 1, 2008. In total, the extension produced excess collection of \$7.7 million, which together with interest is proposed to be refunded to customers commencing May 1, 2009. The balances described above were recorded as regulatory liabilities.

On February 24, 2009, the OEB issued the allowed return on equity for LDC. The 2009 percentage was set at 8.01%. Using approved 2009 distribution expenses and capital expenditures, LDC has estimated the 2009 base distribution revenue requirement and rate base at \$483.8 million and \$2,035.0 million, respectively.

The continuing restructuring of Ontario's electricity industry and other regulatory developments, including current and possible future consultations between the OEB and interested stakeholders, may affect the distribution rates and other permitted recoveries.

Smart Meters

In support of the Province of Ontario'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 approximately 587,000 meters as at December 31, 2008.

On August 8, 2007, the OEB issued its decision approving costs associated with smart metering activities incurred by LDC for minimum smart meter infrastructure functionality. In its decision, the OEB approved the disposition of the balance relating to 2006 in the smart meter deferral account and the addition of the 2006 smart meter assets to the rate base.

The OEB's decision issued on May 15, 2008 regarding the electricity distribution rates application of LDC provided directions regarding the accounting treatment of smart meters expenditures incurred in 2007 and 2008. In its decision, the OEB directed LDC to record to property, plant and equipment all capital expenditures incurred prior to December 31, 2007 and to record to a deferral account all expenditures incurred after January 1, 2008. The recovery of expenditures incurred after January 1, 2008 will be subjected to a prudence review by the OEB in the near future. The decision rendered by the OEB also allowed the LDC to keep in its rate base the net book value of the stranded meters related to the deployment of smart meters in property, plant and equipment.

Lost Revenue Adjustment Mechanism ("LRAM") and Shared Savings Mechanism ("SSM")

On September 11, 2007, LDC received approval from the OEB to recover \$2.9 million for LRAM which represents the loss revenue from CDM programs and \$4.3 million for SSM which represents its share of provincial savings related to these programs delivered in 2005 and 2006. LDC recovered the approved amounts over the period commencing on November 1, 2007, and ending July 31, 2008.

On December 15, 2008, LDC applied to the OEB to recover LRAM and SSM amounts related to CDM programs undertaken in 2007. The total of the recovery sought is \$3.7 million.

CDM Agreements

In May 2007, LDC entered into agreements with the Ontario Power Authority ("OPA") to deliver OPA-funded CDM programs in the amount of approximately \$60.0 million during the years from 2007 to 2010. All programs are fully funded by the OPA with any advance payments recorded on the Consolidated Balance Sheet as a deferred liability.

Since the launch of these programs in 2007, LDC has spent a total of \$30.7 million on OPA programs (\$20.7 million in 2007 and \$10.0 million in 2008) and recognized \$8.1 million in margin related to such programs (\$6.2 million in 2007 and \$1.9 million in 2008).

Ministry of Finance Tax Audit

The Ministry of Finance completed its income tax audits of LDC for the years 2001, 2002, 2003, and 2004. The impact of the completed audits was recorded in the financial statements and resulted in a reduction to the income tax provision in 2008.

Legal Proceedings

Late Payment Charges Class Action

On April 22, 2004, in a decision in a class action commenced against The Consumers' Gas Company Limited (now Enbridge Gas Distribution Inc.), (hereinafter referred to as "Enbridge"), the Supreme Court of Canada (the "Supreme Court") ruled that Enbridge 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 Enbridge 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.

On February 4, 2008, the OEB, in response to an application filed by Enbridge, ruled that all of Enbridge's costs related to settlement of the class action lawsuit, including legal costs, settlement costs and interest, are recoverable from ratepayers. The representative plaintiff in the class action lawsuit has made a petition to the Lieutenant Governor in Council (Cabinet) under subsection 34(1) of the *Ontario Energy Board Act, 1998*, S.O. 1998, c. 15, Schedule B. for an order that the matter be submitted back to the OEB for reconsideration. A decision by Cabinet on the petition is pending.

LDC is not a party to the Enbridge 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 Enbridge 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 \$64.0 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 Enbridge 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 Enbridge class action.

LDC may have defences available to it in these actions that were not disposed of by the Supreme Court in the Enbridge class action.

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. Also, decisions of the OEB are fact specific in each circumstance and the decision of the OEB in respect of Enbridge's application for recovery of costs related to the settlement is not necessarily determinative of the outcome of any similar application which LDC may make to the OEB in the future. Accordingly, given the preliminary status of these actions, it is not possible at this time to reasonably quantify the effect, if any, of the Enbridge decision on these actions or of these actions on the financial performance of the Corporation.

2 Secord Avenue

An action was commenced against LDC in October, 2008 under the *Class Proceedings Act, 1992* seeking damages in the amount of \$30.0 million as compensation for damages allegedly suffered as a result of a fire and explosion in an underground vault at 2 Secord Avenue on July 20, 2008. This action is at preliminary stage. The statement of claim has been served on LDC, but a statement of defence has not been filed. Accordingly, given the preliminary status of this action, it is not possible at this time to reasonably quantify the effect, if any, of this class action on the financial performance of the Corporation. If damages were awarded, LDC would make a claim under its liability insurance which the Corporation believes would cover any damages which may become payable by LDC in connection with the action.

An action was commenced against LDC in February, 2009 seeking damages in the amount of \$20.0 million as compensation for damages allegedly suffered as a result of a fire and explosion in an underground vault at 2 Secord Avenue on July 20, 2008. This action is at a preliminary stage. The statement of claim has been served on LDC, but a statement of defence has not been filed. Accordingly, given the preliminary status of this action, it is not possible at this time to reasonably quantify the effect, if any, of this action on the financial performance of the

Corporation. If damages were awarded, LDC would make a claim under its liability insurance which the Corporation believes would cover any damages which may become payable by LDC in connection with the action.

Share Capital

The authorized capital of the Corporation consists of an unlimited number of common shares of which 1,000 common shares are issued and outstanding as at the date hereof.

Transactions with Related Parties

The City is the sole shareholder of the Corporation. Subsidiaries of the Corporation provide certain services to the City at commercial and regulated rates, including electricity, street lighting and maintenance services. In addition, the City and its agencies have entered into energy management contracts with TH Energy. All transactions with the City are conducted at prevailing market prices and normal trade terms. Additional information with respect to related party transactions between the Corporation and its subsidiaries, as applicable, and the City is set out below.

LDC provided electricity to the City in the amount of \$97.6 million at prevailing market prices and normal trade terms in 2008, compared to \$96.2 million in 2007. Included in "Unbilled revenue", as at December 31, 2008, is a balance amounting to \$9.1 million receivable from the City related to the provision of electricity for the previous months, compared to \$8.3 million as at December 31, 2007.

LDC provided relocation services related to the City in the amount of \$1.0 million in 2008, compared to \$1.3 million in 2007. Included in LDC's "Accounts receivable, net of allowance for doubtful accounts", as at December 31, 2008, is \$4.1 million receivable from the City related to these services and other construction activities compared to \$2.6 million as at December 31, 2007.

TH Energy provided energy efficiency products and services, street lighting services and consolidated billing services to the City amounting to \$19.9 million in 2008, compared to \$19.5 million in 2007. Included in TH Energy's "Accounts receivable, net of allowance for doubtful accounts", as at December 31, 2008, is \$4.9 million receivable from the City related to these services compared to \$6.7 million as at December 31, 2007.

LDC purchased road cut and other services of \$4.9 million from the City in 2008, compared to \$6.9 million in 2007. Included in LDC's "Accounts payable and Accrued liabilities", as at December 31, 2008, is \$4.5 million payable to the City related to services received from the City compared to \$3.4 million as at December 31, 2007.

LDC and TH Energy paid property tax expenses to the City of \$6.5 million in 2008, compared to \$6.4 million in 2007.

At December 31, 2008, the outstanding principal in respect of the City Promissory Note was \$735.2 million compared to \$735.2 million as at December 31, 2007. As a result of the next scheduled payment for December 31, 2009, \$245.1 million of the principal amount outstanding under the City Promissory Note is classified as a short-term liability, with the remainder being classified as a long-term liability. The Corporation paid interest of \$44.9 million on the City Promissory Note in 2008, compared to \$59.9 million in 2007.

See note 13 and note 22 to the Consolidated Financial Statements.

Risk Factors

The financial performance of the Corporation is subject to a variety of risks including those described below:

Regulatory Developments

Ontario's electricity industry regulatory developments may affect the distribution rates charged by LDC and the costs LDC is permitted to recover. This may in turn have a material adverse effect on the financial performance of the Corporation. In particular, there can be no assurance that:

- the OEB may not set a lower recovery for LDC's cost of capital;

- the full cost of providing service to distribution customers will be permitted to be recovered through distribution rates;
- the OEB will not permit competitors to provide distribution services in a distributor's licensed area, or loads within LDC's service area to become electrically served by a means other than through LDC's system;
- the OEB will allow recovery for revenue lost as a consequence of the emergence and adoption of new technologies such as distributed generation, or unanticipated effects of conservation and demand management;
- parts of LDC's services will not be separated from LDC and opened to competition; or
- regulatory or other changes will not be made to the PILs regime.

Condition of Distribution Assets

LDC's ability to continue to maintain and operate the distribution system reliably and safely in the future will depend on, among other things, the OEB allowing recovery of costs in respect of LDC's maintenance program and capital expenditure requirements for distribution plant refurbishment and replacement.

Electricity Consumption

LDC's distribution rates typically comprise a fixed charge and a usage-based (consumption) charge. The volume of electricity consumed by LDC's customers during any period is governed by events largely outside LDC's control (principally sustained periods of hot or cold weather which increase the consumption of electricity, and sustained periods of moderate weather which decrease the consumption of electricity). Accordingly, there can be no assurance that LDC will earn the revenue requirement approved by the OEB.

Market and Credit Risk

LDC is subject to credit risk with respect to customer non-payment. LDC is permitted to mitigate the risk of customer non-payment using any means permitted by law, including security deposits (including letters of credit, surety bonds, cash deposits or lock-box arrangements, under terms prescribed by the OEB), late payment penalties, pre-payment, pre-authorized payment, load limiters or disconnection. In the event of an actual payment default and attendant bad debt expense incurred by LDC, roughly 80 percent of the expense would be related to commodity and transmission costs and the remainder to LDC's distribution revenue. While LDC would be liable for the full amount of the default, there can be no assurance that the OEB would allow recovery of the bad debt expense from remaining customers. Established practice in such cases is that the OEB would examine any utility's application for recovery of extraordinary bad debt expenses on a case-by-case basis.

LDC is exposed to fluctuations in interest rates as its regulated rate of return is derived using a formulaic approach, which is based in part on a forecast of long-term Government of Canada bond yields coupled with an equity risk premium. LDC estimates that a 1% (100 basis points) reduction in long-term Government of Canada bond yields used in determining its regulated rate of return would reduce LDC's net income by approximately \$4.7 million.

The Corporation is also exposed to fluctuation in interest rates for the valuation of its post-employment benefit obligations. The Corporation estimates that a 1% (100 basis points) increase in the discount rate used to value these obligations would decrease the accrued benefit obligation, as at December 31, 2008, by \$15.8 million, and a 1% (100 basis points) decrease in the discount rate would increase the accrued benefit obligation, as at December 31, 2008, by \$19.8 million.

Additional Debt Financing

The Corporation expects to borrow to repay the Amended and Restated City Note when required to do so under the terms of the Amended and Restated City Note. The Corporation's ability to arrange sufficient and cost-effective debt financing to repay the Amended and Restated City Note and for general corporate purposes could be adversely affected by a number of factors, including financial market conditions, the regulatory environment in

Ontario, the Corporation's results of operations and financial condition, the ratings assigned to the Corporation and its debt securities by credit rating agencies, the current timing of debt maturities and general economic conditions.

Work Force Renewal

Over the next nine years, approximately 600 LDC employees will be eligible for retirement. This number represents approximately 40% of LDC's workforce (with a significant number of potential retirements occurring in supervisory trades and technical positions). Accordingly, LDC will be required to attract and retain skilled employees. There can be no assurance that LDC will be able to attract and retain the required workforce.

Natural and Other Unexpected Occurrences

The facilities of LDC are exposed to the effects of natural and other unexpected occurrences. Although LDC's facilities are constructed, operated and maintained to withstand severe weather conditions, there can be no assurance that they will successfully do so in all circumstances. For example, an ice storm in January 1998 caused significant damage to transmission and distribution facilities in Ontario, Québec and the north-eastern United States. Any major damage to LDC's facilities could result in lost revenues and repair costs that are substantial in amount. If it sustained a large uninsured loss caused by natural or other unexpected occurrences, LDC would apply to the OEB for the recovery of the loss. There can be no assurance that the OEB would approve, in whole or in part, such an application.

Insurance

Although the Corporation maintains insurance, there can be no assurance that the Corporation will be able to obtain or maintain adequate insurance in the future at rates it considers reasonable or that insurance will continue to be available in the future. Further, there can be no assurance that available insurance will cover all losses or liabilities that might arise in the conduct of the Corporation's business. The Corporation self-insures against certain risks (e.g., business interruption and physical damage to certain automobiles). The occurrence of a significant uninsured claim or a claim in excess of the insurance coverage limits maintained by the Corporation could have a material adverse effect on the Consolidated Financial Statements.

Environmental Regulation

LDC is subject to Canadian federal, provincial and municipal environmental regulation. Failure to comply with environmental regulation could subject LDC to fines and other penalties. In addition, releases of hazardous substances now or in the past on or from properties owned, leased, occupied or used by LDC, or as a result of LDC's operations could lead to governmental orders requiring investigation, control and/or remediation of releases. The presence or release of hazardous substances could also lead to claims by third parties for harm as a result of the existence of these substances.

Changes in environmental regulation or enforcement may impose material additional costs on LDC. In addition, new approvals or permits or renewals of existing approvals and permits may require environmental assessment and/or result in the imposition of conditions which may result in significant compliance costs. The process for obtaining environmental permits and approvals, including any necessary environmental assessment, can be lengthy, contentious and expensive.

Investment in Third-Party (Non-Bank) Asset Backed Commercial Paper

At December 31, 2008, the Corporation held third-party ABCP notes issued by a number of trusts with an aggregate principal amount of \$88.0 million. These notes matured during the third quarter of 2007 but were not repaid at that time due to liquidity issues in the Canadian ABCP market.

The estimation by the Corporation of the fair value of its ABCP notes is subject to significant risks and uncertainties, including the timing and amount of future cash flows, market liquidity and the quality of the underlying assets and financial instruments. Accordingly, there can be no assurance that the Corporation's assessment of the estimated fair value of its ABCP notes will not change materially in subsequent periods.

Credit Rating

Should the Corporation's credit rating from both credit rating agencies fall below A – (S&P) and A-low (DBRS), LDC may be required to post additional collateral with the IESO.

Labour Relations

The Corporation's ability to operate successfully in the restructured electricity industry in Ontario will depend in part on its ability to make changes to existing work practices and procedures to adapt to changing circumstances. The Corporation's ability to make these changes will depend in part on its ability to develop plans and approaches that are acceptable to its labour unions. There can be no assurance that the Corporation will be able to secure the support of its labour unions in this regard.

Conflicts of Interest and Change of Ownership

The City owns all of the outstanding shares of the Corporation and has the power to determine the composition of the board of directors of the Corporation and influence major business and corporate decisions, including its financing programs and dividend payments. A conflict may arise between the City's role as the sole shareholder and major debt holder of the Corporation and its role as the administrator of the City budget and other matters for the residents of the City. The City may decide to sell all or part of the Corporation. In this event, depending on the nature of the transaction, the Corporation's credit ratings may be negatively affected.

Real Property Rights

Certain terminal stations and municipal substations of LDC are located on lands owned by the Province, the City and others. In some cases, LDC does not have and may not be able to obtain formal access agreements with respect to such facilities. Failure to obtain or maintain access agreements could adversely affect LDC.

LDC Competition

In the past, there had been one electricity distributor in each region of Ontario. Under the current regulatory regime, a person must obtain a licence from the OEB in order to own and operate a distribution system. LDC has the right to distribute electricity in the City. Although the distribution licence does specify the area in which the distributor is authorized to distribute electricity, unless otherwise provided, the licence does not provide exclusive distribution rights for such area.

The Corporation believes that the complexities and potential inefficiencies that would be created by having multiple electricity distributors authorized to serve a single area are likely to result in the continuation of the practice of having a single electricity distributor authorized to serve a single area. In addition, the Corporation believes that there are significant barriers to entry with respect to the business of electricity distribution in Ontario, including the cost of maintaining a distribution system, OEB regulation of distribution rates and the level of regulatory compliance required to operate a distribution system. However, the Corporation recognizes that more than one distribution licence could be issued for the same area and there is a possibility that in the future some business functions or activities could be separated from LDC and made open to competition from non-regulated business entities, or that defined geographical areas within LDC's service area may be electrically supplied by a means other than through LDC's system.

Considerations of Current Economic Conditions

Electricity Consumption

The current economic downturn could lead to lower overall electricity consumption, specifically in the large users customer segment. This segment is the most sensitive to economic changes but has the least share of LDC's total load at 10.0%. The lower electricity consumption from our large users customers could negatively impact LDC's revenue. On average, a 1% reduction in Gross Domestic Product for Toronto is estimated to result in only a 0.10% reduction in load.

Interest Rates

Changes in interest rates will impact the calculation of LDC's revenue requirements filed with the OEB. The first component impacted by interest rates is the return on rate-base. The OEB approved adjustment formula for calculating return on rate-base will increase or decrease by 75% of the change between the current Long Canada Bond Forecast and the risk free rate established at 5.5%. The Corporation estimates that a 1% (100 basis points) decrease in the forecast long-term Government of Canada bond yield used in the current OEB formula to determine the LDC's rate of return on rate-base would reduce net income by approximately \$4.7 million.

The second component of revenue requirement which would be impacted by interest rates is the recovery of financing costs. The difference between actual interest rates on new debt issuances and those approved by the OEB would impact the Corporation's results of operations.

Debt Financing

Cash generated from operations, after the payment of expected dividends, will not be sufficient to repay existing indebtedness, fund capital expenditures and meet other obligations. The Corporation relies on debt financing through a Medium-Term Note Program or its revolving credit facility to repay existing indebtedness and fund capital expenditures. Despite the turmoil in the credit markets and onset of current economic conditions, the Corporation has been able to arrange sufficient cost-effective debt financing to fund these requirements. However, there can be no assurance that the Corporation will be able to arrange such financing facilities with similar terms in the future.

Critical Accounting Estimates

The preparation of the Corporation's Consolidated Financial Statements in accordance with GAAP requires estimates and judgements that affect the reported amounts of assets, liabilities, revenues and costs, and related disclosures of commitments and contingencies. The estimates are based on judgements on historical experience, current conditions and various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgements about the carrying values of assets and liabilities as well as identifying and assessing the accounting treatment with respect to commitments and contingencies. Actual results may differ from these estimates and judgements under different assumptions or conditions.

The following critical accounting estimates involve the more significant estimates and judgements used in the preparation of the Consolidated Financial Statements:

Regulatory Assets and Liabilities

Regulatory assets as at December 31, 2008, amounted to \$26.2 million and primarily relate to the deferral of smart meters expenditures incurred in 2008. Regulatory liabilities as at December 31, 2008, amounted to \$83.5 million and primarily relate to settlement variances and PILs variances. These assets and liabilities can be recognized for rate-setting and financial reporting purposes only if the OEB directs the relevant regulatory treatment or if future OEB direction is judged to be probable. In the event that the disposition of these balances was no longer deemed to be probable, the balances would be recorded in the consolidated income statement.

Environmental Liabilities

The Corporation recognizes a liability for the future environmental remediation of certain properties and for future removal and handling costs for contamination in distribution equipment in service and in storage. The estimation of such a liability requires that assumptions be made, such as the number of contaminated properties and the extent of contamination, the number of assets and contamination levels of equipment. All factors used in deriving the Corporation's environmental liabilities represents management's best estimates based on planned approach of meeting regulatory requirements. However, it is possible that numbers of contaminated assets, current cost estimates, inflation assumptions and assumed pattern of annual cash flows may differ significantly from the Corporations' assumptions.

Employee Future Benefits

Employee future benefits other than pension provided by the Corporation include medical and life insurance benefits, and accumulated sick leave credits. These plans provide benefits to employees when they are no longer providing active service. The accrued benefit obligations and current service cost are calculated by independent actuaries using the projected benefit method prorated on service and based on assumptions that reflect management's best estimate. The assumptions were determined by management recognizing the recommendations of our actuaries. There could be no assurance that actual employee's future benefits cost will not differ significantly from the estimates calculated using management's assumptions.

Fair Value of Investments held to Maturity

The estimation by the Corporation of the fair value of its ABCP notes, as at December 31, 2008, is subject to significant risks and uncertainties, including the timing and amount of future cash flows, market liquidity and the quality of the underlying assets and financial instruments. Accordingly, there can be no assurance that the Corporation's assessment of the estimated fair value of its ABCP notes will not change materially in subsequent periods.

Revenue Recognition

Revenue from the sale of electricity is recorded on a basis of cyclical billings and also includes unbilled revenue accrued in respect of electricity delivered but not yet billed. The unbilled revenue accrual at the end of each period is based on the difference between the forecast revenue and the actual amounts billed. The development of the revenue forecast requires estimates of customer growth, economic activity and weather conditions. There can be no assurance that actual unbilled revenue estimates will not differ materially from actual revenue for the period.

Significant Accounting Policies

The Consolidated Financial Statements have been prepared in accordance with Canadian generally accepted accounting principles, including accounting principles prescribed by the OEB, and are presented in Canadian dollars. In preparing the Consolidated Financial Statements, management of the Corporation 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 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 4 to the Consolidated Financial Statements.

Changes in Accounting Standards

Capital Disclosures: Effective January 1, 2008, the Corporation adopted CICA Handbook Section 1535 – “Capital Disclosures”, which 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. This standard does not have any impact on the classification or valuation of the Corporation's Consolidated Financial Statements. See notes 4 and 17 to the Consolidated Financial Statements.

Financial Instruments – Disclosure and Presentation: Effective January 1, 2008, the Corporation adopted CICA Handbook Sections 3862 – “Financial Instruments – Disclosure” and 3863 – “Financial Instruments – Presentation”, which require increased disclosure about the risks associated with both recognized and unrecognized financial instruments and the management of those risks. These standards do not have any impact on the classification or valuation of the Corporation's Consolidated Financial Statements. See notes 4 and 18 to the Consolidated Financial Statements.

Inventories: Effective January 1, 2008, the Corporation retroactively adopted CICA Handbook Section 3031 – “Inventories”, which replaced existing CICA Handbook Section 3030. Under the new section, inventories are required to be measured at the lower of cost and net realizable value and any items considered to be major spare parts are required to be transferred to property, plant and equipment. The section also provides updated guidance on the appropriate methods of determining cost and the impact of any write-downs to net realizable value. See note 4 and 5 to the Consolidated Financial Statements.

Future Accounting Pronouncements

Rate-Regulated Operations: During 2007, the Accounting Standards Board (“AcSB”) issued an exposure draft proposing to remove all specific references to rate regulated accounting from the Canadian Institute of Chartered Accountants (“CICA”) Handbook. In August 2007, the AcSB decided to remove a temporary exemption in CICA Handbook Section 1100 “Generally Accepted Accounting Principles”, retain existing references to rate regulated accounting in the CICA Handbook, amend CICA Handbook Section 3465 “Income Taxes” to require the recognition of future income tax liabilities and assets as well as a corresponding regulatory asset or liability and

retain existing requirements to disclose the effects of rate regulation per Accounting Guideline 19 “Disclosures by Entities Subject to Rate Regulation”. The new rules will apply prospectively to interim and annual financial statements relating to fiscal years beginning on or after January 1, 2009.

Currently, LDC uses the taxes payable method of accounting for income taxes. The estimated effect on the Corporation’s consolidated financial statements, if it had adopted amended CICA Handbook Section 3465 as at December 31, 2008, would have been an increase in future income tax assets of \$298.5 million, including an amount associated with income taxes that will become payable on future revenues as they are collected from customers when the tax timing differences reverse. There would also be a corresponding increase in regulatory liabilities of \$298.5 million. There is no impact to opening retained earnings expected upon adoption of these amendments on January 1, 2009. The Corporation is continuing to assess and monitor any additional implications on its financial statements.

Goodwill and Intangibles: In January 2008, the CICA issued Handbook Section 3064, “Goodwill and Intangible Assets”, and amended Handbook Section 1000, “Financial Statement Concepts”, and Accounting Guideline 11 “Enterprises in the Development Stage” and withdrew Handbook Section 3450, “Research and Development Costs”. Handbook Section 3064 clarifies that costs may only be deferred when they relate to an item that meets the definition of an asset. The concept of matching revenues and expenses remains appropriate for allocating the cost of an asset that is consumed in general revenue over multiple reporting periods. Handbook Sections 3064 replaces Handbook Section 3062 and provides extensive guidance on when expenditures qualify for recognition as intangible assets. These changes are effective for fiscal years beginning on or after October 1, 2008. The Corporation is currently in the process of evaluating the potential impact of these standards on its financial statements.

International Financial Reporting Standards (“IFRS”): On February 13, 2008, the AcSB confirmed that publicly accountable enterprises will be required to adopt IFRS in place of Canadian GAAP for interim and annual reporting purposes for fiscal years beginning on or after January 1, 2011. A limited number of converged or IFRS-based standards will be incorporated into Canadian GAAP prior to 2011, with the remaining standards to be adopted at the change over date. The Corporation has an internal initiative to govern the conversion process and is currently in the process of evaluating the potential impact of the conversion to IFRS on its financial statements. At this time, the impact on the Corporation’s future financial position and results of operations is not reasonably determinable or estimable.

The Corporation commenced its IFRS conversion project in 2007 and has established a formal project governance structure. This structure includes a steering committee consisting of senior levels of management from finance, information technology, treasury and operations, among others. Regular progress reports are provided to senior executive management and to the audit committee of the Corporation’s board of directors. An external expert advisor has been engaged to assist in the IFRS conversion.

The Corporation’s project consists of 3 phases: (1) awareness and assessment; (2) design; and (3) implementation. The Corporation completed the awareness and initial assessment phase, during the second quarter of 2008, which involved a high level review of the major differences between current Canadian GAAP and IFRS. Currently, it has been determined that the areas of accounting differences with the highest potential impact to the Corporation are rate regulated accounting, accounting for property, plant and equipment, PILs, employee future benefits, as well as initial adoption of IFRS under the provisions of IFRS 1, *First-Time Adoption of IFRS*. The Corporation is in the final stages of completing the detailed assessment which involves a detailed systematic gap analyses of accounting and disclosure differences between Canadian GAAP and IFRS, and conducting an analysis of the available accounting choices to be made to address these differences and options available under IFRS 1. In parallel, a detailed assessment of the impact of IFRS conversion of the Corporation’s systems, processes and controls as well as other business, regulatory and tax impacts is also being conducted. During the awareness and assessment phase, the Corporation established a communication plan and a staff-training plan.

The Corporation has proceeded to the design phase, which involves establishing issue-specific working groups to focus on generating options and making recommendations in the identified risk areas. Subsequent to carrying out this work at the consolidated level, the Corporation will also focus on the specific impacts on various subsidiaries and regulated businesses that may affect their unconsolidated financial statements.

The OEB has also begun its own IFRS project to determine the nature of any changes that should be made in regulatory accounting requirements in response to IFRS. On May 8, 2008, the OEB announced the creation of an

IFRS Consultation which provides an opportunity to work with industry participants to identify transition issues and suggest how those issues might be addressed. The Corporation has participated in each of the consultation meetings.

In December 2008, the International Accounting Standards Board (“IASB”) unanimously voted to add the regulatory assets and regulatory liabilities project to their active agenda, with a preliminary exposure draft to be issued in May 2009. The Corporation is closely monitoring IASB activities, with the potential to impact rate regulated accounting under IFRS and will participate in any related processes, as appropriate. Furthermore, the Corporation is monitoring ongoing IASB projects that will result in changes to other IFRSs.

In September 2008, the IASB issued an Exposure Draft setting out proposed amendments to IFRS 1. One of the proposed amendments allows an entity subject to rate regulation to elect for an item of property, plant and equipment to use the Canadian GAAP carrying amount of the item at the date of transition to IFRS as its deemed cost at that date (subject to an impairment test), if certain conditions are met. The Corporation will closely monitor these developments.

Forward-Looking Information

The Corporation includes forward-looking information in the MD&A within the meaning of applicable securities laws in Canada (“forward-looking information”). The purpose of the forward-looking information is to provide management’s expectations regarding the Corporation’s future results of operations, performance, business prospects and opportunities and may not be appropriate for other purposes. All forward-looking information is given pursuant to the “safe harbour” provisions of applicable Canadian securities legislation. The words “anticipates”, “believes”, “budgets”, “could”, “estimates”, “expects”, “forecasts”, “intends”, “may”, “might”, “plans”, “projects”, “schedule”, “should”, “will”, “would” and similar expressions are often intended to identify forward-looking information, although not all forward-looking information contains these identifying words. The forward-looking information reflects management’s current beliefs and is based on information currently available to the Corporation’s management.

The forward-looking information in the MD&A includes, but is not limited to, statements regarding LDC’s 2009 base distribution revenue, the Corporation’s plans to borrow to repay the Amended and Restated City Note, the impact of current economic conditions and financial market volatility on the Corporation’s results of operations, performance, business prospects and opportunities, and the estimated fair value of the Corporation’s ABCP notes. The forecasts and projections that make up the forward-looking information are based on assumptions that include, but are not limited to, the future course of the economy and financial markets, the receipt of applicable regulatory approvals and requested rate orders, the receipt of favourable judgments, the level of interest rates, the Corporation’s ability to borrow, and the fair market value of the replacement notes that replace the ABCP Notes.

The forward-looking information is subject to risks, uncertainties and other factors that could cause actual results to differ materially from historical results or results anticipated by the forward-looking information. The factors which could cause results or events to differ from current expectations include, but are not limited to, the timing and amount of future cash flows generated by the replacement notes, market liquidity and the quality of the underlying assets and financial instruments, the timing and extent of changes in prevailing interest rates, inflation levels, legislative, judicial and regulatory developments that could affect revenues, and the results of borrowing efforts.

All forward-looking information in the MD&A is qualified in its entirety by the above cautionary statements and, except as required by law, the Corporation undertakes no obligation to revise or update any forward-looking information as a result of new information, future events or otherwise after the date hereof.

Additional Information

Additional information with respect to the Corporation (including its annual information form) is available at www.sedar.com.

Toronto, Canada

March 10, 2009