

Financial Statements

**Toronto Hydro-Electric System Limited**

DECEMBER 31, 2005

Financial Statements

**Toronto Hydro-Electric System Limited**

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## AUDITORS' REPORT

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To the Shareholder of  
**Toronto Hydro-Electric System Limited**

We have audited the balance sheet of **Toronto Hydro-Electric System Limited** ["THESL"] as at December 31, 2005 and the statements of retained earnings, income and cash flows for the year then ended. These financial statements are the responsibility of the THESL's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of THESL as at December 31, 2005 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

*Ernst & Young LLP*

Toronto, Canada,  
February 17, 2006 [except as to note 22,  
which is as of March 2, 2006].

Chartered Accountants

# Toronto Hydro-Electric System Limited

## BALANCE SHEET

[in thousands of dollars]

As at December 31

	2005	2004
	\$	\$
<b>ASSETS</b>		
<b>Current</b>		
Cash and cash equivalents	310,760	289,125
Accounts receivable, net of allowance for doubtful accounts [notes 4 and 16]	142,451	143,249
Unbilled revenue [note 16]	281,775	233,270
Inventories	18,189	19,373
Prepaid expenses	158	81
<b>Total current assets</b>	<b>753,333</b>	<b>685,098</b>
Property, plant and equipment, net [note 5]	1,532,053	1,518,186
Intangible assets, net [note 6]	40,266	45,329
Regulatory assets [note 7]	63,752	73,883
Other assets [note 8]	4,129	3,685
<b>Total assets</b>	<b>2,393,533</b>	<b>2,326,181</b>
<b>LIABILITIES AND SHAREHOLDER'S EQUITY</b>		
<b>Current</b>		
Accounts payable and accrued liabilities [notes 4 and 16]	374,638	278,186
Current portion of other long-term liabilities [note 9]	38,906	16,557
Deferred revenue	19,637	-
Promissory note payable [note 10]	980,231	980,231
<b>Total current liabilities</b>	<b>1,413,412</b>	<b>1,274,974</b>
<b>Long-term liabilities</b>		
Long-term note payable to related party [note 16]	180,000	180,000
Post-employment benefits [note 11]	114,576	108,397
Regulatory liabilities [note 7]	13,297	2,880
Asset retirement obligations [notes 3[k] and 12]	5,691	4,274
Other long-term liabilities [note 13]	5,547	4,007
Customers' advance deposits and other deposits	2,900	45,967
Long-term deferred revenue	1,580	-
<b>Total long-term liabilities</b>	<b>323,591</b>	<b>345,525</b>
<b>Total liabilities</b>	<b>1,737,003</b>	<b>1,620,499</b>
Commitments and contingencies [notes 11, 12, 17, 19 and 20]		
<b>Shareholder's equity</b>		
Share capital [note 14]	527,817	527,817
Retained earnings	117,322	166,474
Contributed surplus	11,391	11,391
<b>Total shareholder's equity</b>	<b>656,530</b>	<b>705,682</b>
<b>Total liabilities and shareholder's equity</b>	<b>2,393,533</b>	<b>2,326,181</b>

# Toronto Hydro-Electric System Limited

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## STATEMENT OF RETAINED EARNINGS

[in thousands of dollars]

Year ended December 31	2005	2004
	\$	\$
Retained earnings, beginning of year	166,474	155,539
Net income	65,374	60,135
Dividends <i>[notes 14 and 22]</i>	(114,526)	(49,200)
<b>Retained earnings, end of year</b>	<b>117,322</b>	<b>166,474</b>

# Toronto Hydro-Electric System Limited

## STATEMENT OF INCOME

[in thousands of dollars]

Year ended December 31	2005 \$	2004 \$
<b>Revenues [note 16]</b>		
Sale of electricity	2,686,751	2,235,154
Other income	23,068	26,197
	<b>2,709,819</b>	<b>2,261,351</b>
<b>Costs [note 16]</b>		
Purchased power	2,224,034	1,798,008
Operating expenses	167,139	166,617
Depreciation and amortization	124,988	122,526
	<b>2,516,161</b>	<b>2,087,151</b>
<b>Income before interest, other and provision for payments in lieu of corporate taxes</b>		
	<b>193,658</b>	<b>174,200</b>
Interest income	10,485	10,325
Interest expense		
Long-term notes [note 16]	(78,533)	(78,673)
Other interest	(2,087)	(2,935)
Other	2,965	1,043
<b>Income before provision for payments in lieu of corporate taxes</b>		
	<b>126,488</b>	<b>103,960</b>
Provision for payments in lieu of corporate taxes [note 15]	61,114	43,825
<b>Net income</b>	<b>65,374</b>	<b>60,135</b>

# Toronto Hydro-Electric System Limited

## STATEMENT OF CASH FLOWS

[in thousands of dollars]

Year ended December 31

	2005	2004
	\$	\$
<b>OPERATING ACTIVITIES</b>		
Net income	65,374	60,135
Adjustments for non-cash items		
Depreciation and amortization	124,988	122,526
Net change in other assets and liabilities	8,714	3,835
Gains on disposals of property, plant and equipment	(2,965)	(1,043)
Changes in non-cash working capital balances		
Decrease in accounts receivable	798	6,205
Decrease (increase) in unbilled revenue	(48,505)	2,883
Decrease in inventories	1,184	3,118
Decrease (increase) in prepaid expenses	(77)	190
Increase in accounts payable and accrued liabilities	96,452	1,022
Increase in deferred revenue	19,637	-
Increase in current portion of long-term liabilities	1,219	1,717
<b>Net cash provided by operating activities</b>	<b>266,819</b>	<b>200,588</b>
<b>INVESTING ACTIVITIES</b>		
Purchase of property, plant and equipment	(124,236)	(92,894)
Purchase of intangible assets	(8,024)	(6,848)
Net change in regulatory assets and liabilities <i>[note 7]</i>	20,548	15,029
Decrease in long-term loan receivable from related party	-	6,991
Proceeds on disposal of property, plant and equipment	3,001	5,397
<b>Net cash used in investing activities</b>	<b>(108,711)</b>	<b>(72,325)</b>
<b>FINANCING ACTIVITIES</b>		
Increase (decrease) in customers' advance deposits	(20,081)	5,795
Repayment of capital lease liability	(1,866)	(1,891)
Dividends paid <i>[note 14]</i>	(114,526)	(49,200)
<b>Net cash used in financing activities</b>	<b>(136,473)</b>	<b>(45,296)</b>
<b>Net increase in cash and cash equivalents during the year</b>	<b>21,635</b>	<b>82,967</b>
Cash and cash equivalents, beginning of year	289,125	206,158
<b>Cash and cash equivalents, end of year</b>	<b>310,760</b>	<b>289,125</b>
<b>Supplementary cash flow information</b>		
Total interest paid	79,483	79,889
Payments in lieu of corporate taxes	51,837	52,828

## Toronto Hydro-Electric System Limited

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### NOTES TO FINANCIAL STATEMENTS

[all tabular amounts in thousands of dollars]

December 31, 2005

#### 1. INCORPORATION

On June 23, 1999, Toronto Hydro-Electric System Limited ["THESL"] was incorporated under the Business Corporations Act (Ontario) ["BCA"]. THESL is a wholly-owned subsidiary of Toronto Hydro Corporation Inc. ["the Corporation"]. The incorporation was required in accordance with the provincial government's Electricity Act, 1998.

Under the terms of By-law No. 374-1999 of the City of Toronto made under section 145 of the Electricity Act, 1998 and in accordance with continuity of interest accounting, the former Toronto Hydro-Electric Commission and the City of Toronto [the "City"] transferred, at book value, their assets and liabilities [effective July 1, 1999] and employees [effective January 1, 2000] associated with electricity distribution to THESL in consideration for the issuance of equity securities of THESL and long-term notes payable to the City.

The equity securities of THESL were subsequently transferred by the City to the Corporation in consideration for the issuance of equity securities of the Corporation to the City.

The book value of the assets transferred at July 1, 1999 was \$1,548,048,000.

THESL distributes electricity to customers located in the City.

#### 2. REGULATION

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.

##### *a) Open Access*

On May 1, 2002, the Province of Ontario 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, THESL and other electricity distributors have been purchasing their electricity requirements from the wholesale market administered by the Independent Electricity System Operator [the "IESO"] and recovering the cost of electricity and certain other costs at a later date in accordance with procedures mandated by the Ontario Energy Board [the "OEB"].



## Toronto Hydro-Electric System Limited

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### NOTES TO FINANCIAL STATEMENTS

[all tabular amounts in thousands of dollars]

December 31, 2005

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 fulfill obligations to connect and service customers.

THESL 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):

- [i] *Electricity Price.* The electricity price represents a pass through of the commodity cost of electricity. See "Price protection and rate caps" below.
- [ii] *Distribution Rate.* The distribution rate is designed to recover the costs incurred by THESL 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 THESL's customers during any period is governed by events largely outside THESL'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).

- [iii] *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.
- [iv] *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.

THESL is required to satisfy and maintain prudential requirements with the IESO which include credit support with respect to outstanding market obligations.

## Toronto Hydro-Electric System Limited

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### NOTES TO FINANCIAL STATEMENTS

[all tabular amounts in thousands of dollars]

December 31, 2005

#### ***b) Price protection and rate caps***

In December 2002, the Province the Province passed the *Electricity Pricing, Conservation and Supply Act, 2002* ["Bill 210"] which, among other things:

- [i] fixed the price of electricity payable by consumers of electricity who annually utilize less than 250,000 kWh ["Low Volume Consumers"] and consumers comprised principally of municipalities, universities, schools, hospitals, charities, health and community service organizations, consumers with a demand of 50 kW or less and multi-unit residential buildings ["Designated Consumers"] at 4.3¢ per kWh (retroactive to May 1, 2002);
- [ii] capped distribution rates at current levels and deferred rate increases and certain cost recoveries by electricity distributors (including scheduled third adjustment for market-based rate of return); and
- [iii] deemed certain costs and variance account balances of distributors to be "regulatory assets or liabilities" which are required to be reflected in a distributor's balance sheet until the manner and timing of disposition is determined by the OEB.

In November 2003, the Province:

- [i] announced its intention to increase (effective April 1, 2004) the price of electricity payable by Low Volume Consumers and Designated Consumers from 4.3¢ to 4.7¢ per kWh on the first 750 kWh consumed during a month and 5.5¢ per kWh thereafter;
- [ii] directed the OEB to develop new pricing mechanisms for setting the price of electricity payable by Low Volume Consumers and Designated Consumers; and
- [iii] announced initiatives with respect to the disposition of regulatory assets or liabilities and the third distribution rate adjustment to achieve a market-based rate of return.

During the period that the price protection is in effect, it is expected that electricity distributors will be compensated by the Ontario Electricity Financial Corporation for amounts by which the purchase price of the electricity purchased by them in the IESO-administered wholesale market on behalf of Low Volume Consumers and Designated Consumers is greater than the fixed price per kWh charged to customers.

## Toronto Hydro-Electric System Limited

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### NOTES TO FINANCIAL STATEMENTS

[all tabular amounts in thousands of dollars]

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#### *c) 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 impact on customers. Effective on each of December 1, 2000 and March 1, 2002, the OEB authorized THESL to increase its distribution rates to allow for the recovery of additional annual revenue of \$39.8 million.

In March 2005, THESL received approval from the OEB to increase distribution rates to recover \$39.8 million, representing the third and final adjustments necessary to achieve a market-based rate of return. The rate increase was effective as of April 1, 2005 and subjected THESL to a financial commitment to invest \$39.8 million in Conservation and Demand Management ["CDM"] activities by September 2007.

#### *d) Electricity sector reorganization*

In December 2004, the Province initiated a further restructuring of Ontario's electricity industry with the passage of the *Electricity Restructuring Act, 2004* ["Bill 100"]. The restructuring was intended, among other things, to ensure efficient and effective management of electricity, promote the expansion of new electricity supply and capacity, encourage electricity conservation and renewable energy and regulate prices in parts of the electricity sector.

Bill 100:

- [i] established the Ontario Power Authority [the "OPA"], as an independent, non-profit, self-financed corporation, with a broad mandate to ensure adequate long-term electricity supply in the Province;
- [ii] reorganized the Independent Electricity Market Operator as the IESO, a non-share corporation, which will continue to operate the wholesale market and be responsible for the operation and reliability of the integrated power system; and
- [iii] established a Conservation Bureau within the OPA responsible for assuming a leadership role in planning and coordinating electricity conservation measures and load management in the Province.

Under Bill 100, the commodity cost of electricity for certain customer classes will be regulated by the OEB. Customers who did not wish to or are not eligible to participate in the regulated plan may purchase electricity in the competitive market or through licensed retailers.

## Toronto Hydro-Electric System Limited

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### NOTES TO FINANCIAL STATEMENTS

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December 31, 2005

Effective January 1, 2005, the IESO implemented, pursuant to Bill 100, a new price adjustment applicable to customers not subject to price protection and rate caps. The new price adjustment, referred to as Global Adjustment, is a variable rate calculated by the IESO based on the difference between electricity market prices and the mix of regulated and contract prices paid to electricity generators. This calculation results in positive or negative bill adjustments depending on prevailing electricity market conditions.

The difference between the amount credited to customers and the amount received from the IESO by THESL is being tracked in variance account and is currently reflected as a settlement variance regulatory liability. The disposition of the variance account balance shall be in accordance with the OEB's guidelines for reviewing variance and deferral accounts.

On February 23, 2005, the Minister of Energy announced a new fixed pricing structure for electricity supplied by OPG. The new pricing structure, effective April 1, 2005 through March 31, 2008, is based on a blended price for electricity supplied by OPG's regulated and unregulated assets.

The new pricing structure had an immediate impact on large industrial and commercial electricity customers who use more than 250,000 kWh per year. While residential, small business and other consumers were not immediately affected by the new pricing structure, the OEB blended the various prices paid to generators into a new fixed price that these consumers now pay under the Regulated Price Plan ["RPP"], which took effect on April 1, 2005.

The OEB has formulated two pricing plans for RPP-eligible customers, depending on how customers' electricity consumption is metered -- that is, a pricing plan for customers without smart meters, and a pricing plan for customers with smart meters. For both plans, prices were effective April 1, 2005.

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, including payments in lieu of corporate taxes ["PILs"] recoveries, that THESL may charge and the costs that THESL may recover, including the balance of its regulatory assets.

## Toronto Hydro-Electric System Limited

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### NOTES TO FINANCIAL STATEMENTS

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#### *e) 2006 Rate Application*

On August 2, 2005, THESL filed with the OEB its Electricity Distribution Rate Application for 2006 distribution rates [the "2006 Rate Application"], for rates to be effective on May 1, 2006. The 2006 Rate Application includes an overall reduction of 6.9% of distribution rates (5.0% including the recovery of regulatory assets). A final decision from the OEB regarding the 2006 Rate Application is expected in April 2006.

### 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The financial statements of THESL have been prepared in accordance with Canadian generally accepted accounting principles ["GAAP"], including accounting principles prescribed by the OEB in the handbook "Accounting Procedures Handbook for Electric Distribution Utilities" ["AP Handbook"] and reflect the significant accounting policies summarized below.

#### *a) Regulation*

The following regulatory treatments have resulted in accounting treatments which differ from Canadian GAAP for enterprises operating in an unregulated environment:

##### *Regulatory Assets and Liabilities*

Effective December 31, 2005, THESL adopted Canadian Institute of Chartered Accountants ["CICA"] Accounting Guideline 19 "Disclosures by Entities Subject to Rate Regulation" ["AcG-19"]. Certain costs and variance account balances are deemed to be "regulatory assets" or "regulatory liabilities" and are reflected in THESL's balance sheet until the manner and timing of disposition is determined by the OEB [note 7].

##### *Business Protection Plan ["BPP"]*

Consumers other than designated consumers who annually utilize more than 250,000 kWh were eligible to receive BPP rebates from the IESO to the extent that electricity prices exceed certain prescribed thresholds. This rebate program was terminated on March 31, 2005, with the enactment of Bill 100.

Under this program, THESL and other electricity distributors were required to pass these rebates through to eligible consumers and other market participants (including retailers). THESL included amounts due from the IESO in accounts receivable and included amounts due to eligible consumers and market participants in accounts payable and accrued liabilities.

## Toronto Hydro-Electric System Limited

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### NOTES TO FINANCIAL STATEMENTS

[all tabular amounts in thousands of dollars]

December 31, 2005

#### *Payments in lieu of corporate taxes*

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

THESL is a "municipal electricity utility" ["MEU"] for purposes of the 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 payment in lieu of corporate taxes, 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.

The PILs regime came into effect on October 1, 2001, at which time THESL was deemed to have commenced a new taxation year for purposes of determining the respective liabilities for PILs. Accordingly, THESL was deemed to have disposed of its assets at their then fair market value and to have re-acquired such assets at the same amount. The differences between the financial statement carrying value and tax bases of assets and liabilities were accounted for by THESL under the taxes payable method of accounting applied in accordance with recommendations of the Canadian Institute of Chartered Accountants ["CICA"] and the OEB.

The OEB's Electricity Distribution Rate Handbooks, issued in March 2000 and May 2005, provides for the recovery of PILs by THESL through annual distribution rate adjustments as permitted by the OEB. The OEB-approved distribution rate for PILs recoveries is based on estimated consumption volumes. The difference between actual billings that relate to the recovery of PILs and the OEB-approved PILs amount is tracked by THESL as a variance amount in accordance with OEB guidelines for regulatory assets and with criteria set out in the AP Handbook.

Under the taxes payable method, no provisions are made for future income taxes as a result of temporary differences between the tax basis of assets and liabilities and their carrying amounts for accounting purposes. When unrecorded future income taxes become payable, it is expected that they will be included in the rates approved by the OEB and recovered from the customers of the regulated business at that time.

## Toronto Hydro-Electric System Limited

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### NOTES TO FINANCIAL STATEMENTS

[all tabular amounts in thousands of dollars]

December 31, 2005

#### *Contributions in aid of construction*

Capital contributions are required contributions received from outside sources used to finance additions to property, plant and equipment. According to the AP Handbook, capital contributions received are treated as a "credit" to property, plant and equipment. The amount is subsequently amortized by a charge to accumulated amortization and a credit to amortization expense at an equivalent rate to that used for the depreciation of the related property, plant and equipment. Canadian GAAP provides no specific guideline on the accounting treatment for this type of contributions.

#### *Spare transformers*

Spare transformers are items that are expected to substitute for original distribution plant transformers when these original plant assets are being repaired and are held and dedicated for the specific purpose of backing up plant in service as opposed to assets available for other uses. According to the criteria set out in the AP Handbook, spare transformers are treated as capital assets [note 5], which would be recorded as inventory under Canadian GAAP for unregulated businesses. In the absence of rate regulation, inventory in 2005 would have been \$4,767,000 higher [2004 - \$4,467,000].

#### *b) Cash and cash equivalents*

Cash equivalents are highly liquid investments with terms to maturity of five months or less from their date of acquisition. Temporary investments are accounted for at the lower of cost and market.

#### *c) Inventories*

Inventories consist primarily of maintenance and construction materials and are stated at the lower of cost and replacement cost, with cost determined on an average cost basis net of the provision for obsolescence.

#### *d) Property, plant and equipment and depreciation*

Property, plant and equipment are stated at cost and are removed from the accounts at the end of their estimated average service lives, except in those instances where specific identification allows their removal at retirement or disposition. Gains or losses at retirement or disposition of such assets are credited or charged to "Other" in the Statement of Income.

## Toronto Hydro-Electric System Limited

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### NOTES TO FINANCIAL STATEMENTS

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In the event that facts and circumstances indicate that property, plant and equipment may be impaired, an evaluation of recoverability is performed. For purposes of such an evaluation, the estimated future undiscounted cash flows associated with the asset are compared to the carrying amount of the asset to determine if a write-down is required. The impairment loss is measured as the amount by which the carrying amount of the asset exceeds its fair value.

Depreciation is provided on a straight-line basis over the estimated service lives at the following annual rates:

Buildings	1.7% to 10.0%
Distribution stations	2.9% to 5.0%
Distribution lines - overhead and underground	2.5% to 4.0%
Distribution transformers	3.3% to 4.0%
Distribution meters	2.9% to 4.0%
Other capital assets	6.7% to 12.5%
Communications	10% to 20.0%
Computer hardware	20.0% to 25.0%
Rolling stock	12.5% to 20.0%
Equipment and tools	10.0%

Construction in progress includes assets not currently in use which are not depreciated.

#### *e) Intangible assets*

Intangible assets, which lack physical substance, are stated at cost. Amortization is provided on a straight-line basis over their estimated useful service lives at the following annual rates:

Land rights	2.0%
Computer software	14.0% to 33.0%
Capital contributions paid	4.0%

Software in development includes assets not currently in use which are not amortized.

#### *f) Deferred debt issue costs*

During 2003, THESL incurred debt issue costs arising from the issuance of long-term notes payable to the Corporation, with the funds raised through the Corporation's debenture offering [note 8]. Deferred debt issue costs are included in "Other assets" and represent the unamortized amounts of debt costs arising from the issuance of debt, and other related costs. Deferred debt issue costs are amortized over the period to maturity of the debt on a straight-line basis.



## Toronto Hydro-Electric System Limited

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### NOTES TO FINANCIAL STATEMENTS

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#### *g) Workplace Safety and Insurance Act*

THESL is a Schedule 1 employer for workers' compensation under the Workplace Safety and Insurance Act ["WSIA"]. As a Schedule 1 employer, THESL is required to pay annual premiums into an insurance fund established under the WSIA and recognizes expenses based on funding requirements.

#### *h) 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.

In March 2005, THESL received approval from the OEB to increase distribution rates to recover \$39,800,000. The rate increase was effective as of April 1, 2005 and is subject to a financial commitment by THESL to use \$39,800,000 in CDM activities by September 2007. The revenue of \$39,800,000 is being billed to customers over an approximate 11-month period commencing April 1, 2005. At each reporting date, on a life-to-date basis, to the extent the earned customer revenue exceeds the CDM activity spending, the difference is recorded on the balance sheet as "Deferred revenue".

Other income revenues, which include revenues from electricity distribution services, pole attachment, duct rentals, customer demand work and other miscellaneous revenues, are recognized as the service activity is performed.

#### *i) Employee future benefits*

##### *Pension plan*

THESL provides a pension plan for its full-time employees through Ontario Municipal Employees Retirement System ["OMERS"]. OMERS is a multi-employer, contributory, defined benefit pension plan established in 1962 by the Province for employees of municipalities, local boards and school boards in Ontario. Both participating employers and employees are required to make plan contributions based on participating employees' contributory earnings. THESL recognizes the expense related to this plan as contributions are made.

##### *Employee future benefits other than pension*

Employee future benefits other than pension provided by THESL include medical and life insurance benefits, accumulated sick leave credits and voluntary exit incentive program liability. These plans provide benefits to employees when they are no longer providing active service.

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### NOTES TO FINANCIAL STATEMENTS

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Employee future benefit expense is recognized in the period in which the employees render services on an accrual basis. The accrued benefit obligations and current service cost are calculated using the projected benefit method prorated on service and based on assumptions that reflect management's best estimate. The current service cost for a period is equal to the actuarial present value of benefits attributed to employees' services rendered in the period. Past service costs from plan amendments are amortized on a straight-line basis over the average remaining service period of employees active at the date of amendment. The excess of the net actuarial gains (losses) over 10% of the accrued benefit obligation are amortized into expense on a straight-line basis over the average remaining service period of active employees to full eligibility. The effects of a curtailment gain or loss are recognized in income in the year of the event giving rise to the curtailment. The effects of a settlement gain or loss are recognized in income for the period in which a settlement occurs.

#### *j) Customers' advance deposits*

Customers' advance deposits are cash collections from customers to guarantee the payment of energy bills. The customers' advance deposits liability includes interest credited to the customers' deposit accounts, with the debit charged to interest expense. Deposits expected to be refunded to customers within the next fiscal year are classified as a current liability.

#### *k) Asset retirement obligations*

Effective January 1, 2004, THESL adopted the CICA standard for accounting for asset retirement obligations ["ARO"]. Under this standard, THESL recognizes a liability for the future environmental remediation of certain properties and for future removal and handling costs for contamination in distribution equipment and in storage. Initially, the liability is measured at present value and the amount of the liability is added to the carrying amount of the related asset. In subsequent periods, the asset is depreciated and the liability is adjusted quarterly for the discount applied upon initial recognition of the liability ["accretion expense"] and for changes in the underlying assumptions. The liability is recognized when the ARO is incurred.

#### *l) Use of estimates*

The preparation of THESL's financial statements in accordance with Canadian GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses for the year. 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.

## Toronto Hydro-Electric System Limited

### NOTES TO FINANCIAL STATEMENTS

[all tabular amounts in thousands of dollars]

December 31, 2005

#### 4. BUSINESS PROTECTION PLAN REBATES

At December 31, 2005, "Accounts receivable, net of allowance for doubtful accounts" include \$nil [2004 - \$44,739,000] receivable from the IESO regarding the BPP rebates and "Accounts payable and accrued liabilities" include \$nil [2004 - \$33,609,000] payable to customers, electricity retailers and wholesale suppliers in connection with BPP rebates.

#### 5. PROPERTY, PLANT AND EQUIPMENT, NET

Property, plant and equipment consist of the following:

	2005			2004		
	Cost \$	Accumulated Depreciation \$	Net Book value \$	Cost \$	Accumulated Depreciation \$	Net Book value \$
Land	4,136	—	4,136	4,153	—	4,153
Buildings	144,048	43,332	100,716	140,635	40,107	100,528
Distribution stations	183,155	94,179	88,976	177,362	88,364	88,998
Distribution lines – overhead and underground	1,922,918	942,109	980,809	1,877,718	868,982	1,008,736
Distribution transformers	471,562	247,102	224,460	451,328	230,665	220,663
Distribution meters	127,468	75,721	51,747	123,007	71,585	51,422
Other capital assets	33,665	28,554	5,111	32,672	27,312	5,360
Communications	21,345	19,680	1,665	21,280	17,909	3,371
Computer hardware	36,578	33,436	3,142	35,560	31,566	3,994
Rolling stock	51,439	40,990	10,449	48,912	38,309	10,603
Equipment and Tools	28,086	22,232	5,854	25,603	21,157	4,446
Construction in progress	54,988	—	54,988	15,912	—	15,912
	<b>3,079,388</b>	<b>1,547,335</b>	<b>1,532,053</b>	<b>2,954,142</b>	<b>1,435,956</b>	<b>1,518,186</b>

At December 31, 2005, spare transformers with carrying amounts of \$4,767,000 [2004 - \$4,467,000], are included in "Property, plant and equipment, net" [note 3[a] "Spare transformers"].

## Toronto Hydro-Electric System Limited

### NOTES TO FINANCIAL STATEMENTS

[all tabular amounts in thousands of dollars]

December 31, 2005

#### 6. INTANGIBLE ASSETS, NET

Intangible assets consist of the following:

	2005			2004		
	Cost \$	Accumulated Amortization \$	Net Book value \$	Cost \$	Accumulated Amortization \$	Net Book value \$
Land rights	9,946	1,813	8,133	9,946	1,615	8,331
Computer software	91,731	67,663	24,068	88,318	54,859	33,459
Capital contributions paid	2,043	116	1,927	2,043	34	2,009
Software in development	6,138	—	6,138	1,530	—	1,530
	<b>109,858</b>	<b>69,592</b>	<b>40,266</b>	<b>101,837</b>	<b>56,508</b>	<b>45,329</b>

#### 7. REGULATORY ASSETS AND LIABILITIES

Regulatory assets consist of the following:

	2005 \$	2004 \$
Regulatory assets recovery account	55,408	—
Transition costs	—	37,310
Pre-market opening energy electricity variance	—	25,759
Settlement variances	—	9,421
Deferral account for cash pension contributions	4,785	—
Deferral account for OEB annual cost assessments	3,559	1,393
	<b>63,752</b>	<b>73,883</b>

Regulatory liabilities consist of the following:

	2005 \$	2004 \$
Pre-market opening line loss variance	2,880	2,880
Settlement variances	10,417	—
	<b>13,297</b>	<b>2,880</b>

## Toronto Hydro-Electric System Limited

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### NOTES TO FINANCIAL STATEMENTS

[all tabular amounts in thousands of dollars]

December 31, 2005

For the year ended December 31, 2005, THESL recovered approved regulatory assets amounts of \$24,563,000 through permitted distribution rate adjustments [2004 - \$17,701,000]. These recovery amounts are for the recovery of approved regulatory assets recorded in reporting periods prior to January 1, 2004. In the absence of rate regulation, revenue in 2005 would have been \$24,563,000 higher [2004 - \$17,701,000]. In accordance with the OEB's direction, THESL recorded carrying charges on the recovered amounts of \$1,544,000 in 2005 [2004 - \$399,000]. In the absence of rate regulation, interest income in 2005 would have been \$1,544,000 higher [2004 - \$399,000]. The regulatory assets and liabilities balances of THESL are defined as follows:

**[a] Regulatory assets recovery account:**

On March 31, 2005, the OEB ordered that the approved regulatory asset balances be aggregated into a single regulatory account. Approved regulatory assets of \$71,465,000 consisted of transition costs of \$37,868,000, pre-market opening energy electricity variance of \$26,129,000, and settlement variances of \$31,852,000, less recoveries of \$24,384,000, which were transferred to the "regulatory asset recovery account" ["RARA"]. This approved balance will be recovered over a 3-year period ending March 31, 2008. The RARA is credited with recovery amounts and is debited by the OEB prescribed carrying charges. In the absence of rate regulation, interest income in 2005 would have been \$2,539,000 lower [2004 - \$nil].

The transition costs and pre-market opening energy electricity variance are defined as follows:

**[i] Transition costs:**

The OEB has allowed THESL to defer the costs incurred to align systems and practices with the requirements of the competitive electricity market in Ontario in accordance with the *Ontario Energy Board Act, 1998*. Accordingly, THESL has deferred these expenditures in accordance with the criteria set out in the OEB's Electricity Distribution Rate Handbook and the AP Handbook.

Under such regulation, expenditures were allowed to be deferred during the period January 1, 2000 to December 31, 2002, which would be capitalized or expensed under Canadian GAAP for unregulated businesses. For the period January 1, 2003 to March 31, 2005, transition costs were increased for carrying charges in accordance with the OEB's direction. In the absence of rate regulation, interest income in 2005 would have been \$558,000 lower [2004 - \$2,233,000].

## Toronto Hydro-Electric System Limited

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### NOTES TO FINANCIAL STATEMENTS

[all tabular amounts in thousands of dollars]

December 31, 2005

**[ii] Pre-market opening energy electricity variance:**

The OEB has allowed THESL to recognize the pre-market opening energy electricity variance for the period January 1, 2001 to April 30, 2002, the date of market opening. The pre-market opening energy variance represented the difference between THESL's cost of power purchased based upon time-of-use ["TOU"] rates and the amounts billed for the cost of power to non-TOU customers at an average rate for the same period. Accordingly, THESL has deferred these expenditures in accordance with the criteria set out in the AP Handbook.

Under such regulations, expenditures were allowed to be deferred which would be expensed under Canadian GAAP for unregulated businesses. For the period January 1, 2001 to March 31, 2005, the pre-market opening energy electricity variance was increased for carrying charges in accordance with the OEB's direction. In the absence of rate regulation, interest income in 2005 would have been \$370,000 lower [2004 - \$1,479,000].

**[b] Deferral account for cash pension contributions:**

The OEB has allowed THESL to defer the incremental OMERS pension expenditures for the fiscal years starting after January 1, 2005. Accordingly, THESL has deferred these expenditures in accordance with the criteria set out in the AP Handbook.

Under such regulations, expenditures are allowed to be deferred which would be expensed under Canadian GAAP for unregulated businesses. The deferred balance continues to be calculated and attract carrying charges in accordance with the OEB's direction. In the absence of rate regulation, operating expenses in 2005 would have been \$4,785,000 higher [2004 - \$nil]. The OEB has allowed THESL to apply for the recovery of the deferred amounts beginning in 2006 and THESL has included such balance in its 2006 Rate Application.

**[c] Deferral account for OEB annual cost assessments:**

The OEB has allowed THESL to defer the OEB annual cost assessments for the fiscal years starting after January 1, 2004. Accordingly, THESL has deferred these expenditures in accordance with the criteria set out in the AP Handbook.

Under such regulation, expenditures are allowed to be deferred which would be expensed under Canadian GAAP for unregulated businesses. The deferred balance continues to be calculated and attract carrying charges in accordance with the OEB's direction. In the absence of rate regulation, operating expenses in 2005 would have been \$2,166,000 higher [2004 - \$1,393,000]. The OEB has allowed THESL to apply for the recovery of the deferred amounts beginning in 2006 and THESL has included such balance in its 2006 Rate Application.

## Toronto Hydro-Electric System Limited

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### NOTES TO FINANCIAL STATEMENTS

[all tabular amounts in thousands of dollars]

December 31, 2005

**[d] Pre-market opening line loss variance:**

The OEB has allowed THESL to defer the pre-market opening line loss variance for the period June 1, 2001 to April 30, 2002. This balance represents the variance between amounts charged by THESL to customers for the OEB-approved loss adjustment factor and THESL actual loss adjustment factor. Accordingly, THESL has deferred this variance in accordance with the OEB's direction.

Under such direction, the variance is allowed to be deferred which would be recorded as revenue under Canadian GAAP for unregulated businesses. In the absence of rate regulation, there would have been no impact on the Consolidated Statement of Income for 2005 and 2004. The deferred balance does not attract carrying charges. The manner and timing of disposition of the variance has not been determined by the OEB.

**[e] Settlement variances:**

The OEB has allowed THESL to defer settlement variances from May 1, 2002 to December 31, 2005. This balance represents the variances between amounts charged by THESL to customers (based on regulated rates) and the corresponding cost of non-competitive electricity service incurred by it in the wholesale market administered by the IESO after May 1, 2002. The settlement variances relate primarily to service charges, non-competitive electricity charges, imported power charges and the global adjustment. Accordingly, THESL has deferred these recoveries in accordance with the criteria set out in the AP Handbook.

Settlement variances of \$31,852,000, relating to the period from May 1, 2002 to December 31, 2003, were approved for recovery in July 2005 and are included in the RARA balance. The remaining balance, representing settlement variances arising after January 1, 2004, is deferred in a regulatory liability account.

Under such regulation, the variances are allowed to be deferred which would be recorded as revenue when incurred under Canadian GAAP for unregulated businesses. In the absence of rate regulation, revenues in 2005 would have been \$5,971,000 higher [2004 - \$3,739,000] and interest income in 2005 would have been \$1,112,000 lower [2004 - \$1,705,000]. The deferred balance for unapproved settlement variances continues to be calculated and attract carrying charges in accordance with the OEB's direction. The manner and timing of disposition of the variance has not been determined by the OEB.

## Toronto Hydro-Electric System Limited

### NOTES TO FINANCIAL STATEMENTS

[all tabular amounts in thousands of dollars]

December 31, 2005

#### 8. OTHER ASSETS

Other assets consist of the following:

	2005	2004
	\$	\$
Deferred debt issue costs, net of accumulated amortization of \$792,000 [2004 - \$493,000]	2,197	2,496
Long-term advances and deposits	1,566	744
Other	366	445
	<b>4,129</b>	<b>3,685</b>

#### 9. CURRENT PORTION OF OTHER LONG-TERM LIABILITIES

	2005	2004
	\$	\$
Current portion of obligations under capital leases [note 17]	1,877	2,514
Customers' advance deposits	37,029	14,043
	<b>38,906</b>	<b>16,557</b>

#### 10. PROMISSORY NOTE PAYABLE

On July 1, 1999, THESL issued a promissory note to the City ["Initial Note"] in the principal amount of \$947,000,000 in partial consideration for the assets in respect of the electricity distribution system transferred by the Toronto Hydro-Electric Commission and the City to THESL effective July 1, 1999. The Initial Note was non-interest bearing until December 31, 1999 and interest bearing thereafter at the rate of 6% per annum. As authorized under the Transfer By-law, to reflect regulatory changes made by the OEB, the principal amount of the Initial Note was adjusted effective January 1, 2000 to \$980,231,000 to reflect the deemed debt/common equity structure of THESL [65:35] permitted by the OEB. At the same time, the Initial Note was replaced by a promissory note ["Replacement Note"] issued by THESL, which was interest bearing at the rate of 6.8% per annum. At December 31, 2002, the Replacement Note was payable on the earlier of demand and December 31, 2003.



## **Toronto Hydro-Electric System Limited**

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### **NOTES TO FINANCIAL STATEMENTS**

[all tabular amounts in thousands of dollars]

December 31, 2005

Concurrent with the closing of the Corporation's debenture offering on May 7, 2003, the City transferred the Replacement Note to the Corporation in consideration for the issuance by the Corporation to the City of a new promissory note in the principal amount of \$980,231,000. Following the issuance of the new promissory note to the City, on May 7, 2003, THESL issued a promissory note to the Corporation in the principal amount of \$980,231,000.

THESL's promissory note is payable to the Corporation on demand and is bearing interest at the Debt Cost Rate ["DCR"] plus 5 basis points. Interest is calculated and payable quarterly in arrears on the last business day of March, June, September and December. The DCR refers to the rate of interest per annum that at all time is equal to the DCR prescribed from time to time by the OEB in its Electricity Distribution Rate Handbook. The DCR at December 31, 2005 was 6.8% [2004 - 6.8%].

#### **11. EMPLOYEE FUTURE BENEFITS**

##### **Pension**

For the year ended December 31, 2004, THESL's current service pension costs payable to OMERS were \$6,674,000 [2004 - \$5,848,000].

##### **Employee future benefits other than pension**

THESL has a number of unfunded benefit plans providing retirement and post-employment benefits [excluding pension] to most of its employees. THESL pays certain medical and life insurance benefits under unfunded defined benefit plans on behalf of its retired employees. THESL pays accumulated sick leave credits, up to certain established limits based on service, in the event of retirement, termination or death of certain employees.

In October 1994, the former Toronto Hydro-Electric Commission introduced the voluntary exit incentive program for eligible employees. Under the terms of the program, certain employees receive a retirement supplement payment over the term of their retirement and the life of any surviving spouse.

THESL measures its accrued benefits obligation for accounting purposes as at December 31 of each year. The latest actuarial valuation was performed as at January 1, 2005.

## Toronto Hydro-Electric System Limited

### NOTES TO FINANCIAL STATEMENTS

[all tabular amounts in thousands of dollars]

December 31, 2005

#### [a] Accrued benefit obligation:

	2005 \$	2004 \$
Balance at beginning of year	128,303	113,188
Experience loss at beginning of year	423	—
Current service cost	2,694	1,897
Interest cost	7,603	7,308
Benefits paid	(4,948)	(5,230)
Actuarial losses	20,468	11,140
<b>Balance at end of year</b>	<b>154,543</b>	<b>128,303</b>

#### [b] Reconciliation of the accrued benefit obligation to the balance sheet accrued benefits liability:

	2005 \$	2004 \$
Accrued benefit obligation	154,543	128,303
Unamortized net actuarial loss	(34,527)	(13,721)
Unamortized past service costs	(5,440)	(6,185)
<b>Post-employment benefits liability</b>	<b>114,576</b>	<b>108,397</b>

#### [c] Components for net periodic defined benefit costs:

	2005 \$	2004 \$
Current service cost	2,694	1,897
Interest cost	7,603	7,308
Actuarial losses	20,891	11,140
<b>Cost incurred in the period</b>	<b>31,188</b>	<b>20,345</b>
<b>Differences between costs incurred and costs recognized in the period in respect of:</b>		
Actuarial gain	(20,806)	(11,140)
Past service costs	745	745
	<b>(20,061)</b>	<b>(10,395)</b>
<b>Defined benefit costs recognized</b>	<b>11,127</b>	<b>9,950</b>
Capitalized as part of property, plant and equipment	3,672	2,985
<b>Charged to operations</b>	<b>7,455</b>	<b>6,965</b>

## Toronto Hydro-Electric System Limited

### NOTES TO FINANCIAL STATEMENTS

[all tabular amounts in thousands of dollars]

December 31, 2005

#### [d] Significant assumptions:

	2005 %	2004 %
<b>Accrued benefit obligation as of December 31:</b>		
Discount rate	5.0	5.9
Rate of compensation increase	4.0	3.3
<b>Benefit costs for years ended December 31:</b>		
Discount rate	5.9	6.5
Rate of compensation increase	4.0	3.3
<b>Assumed health care cost trend rates at December 31:</b>		
Rate of increase in dental costs	4.5	4.5

For December 31, 2005, medical costs are assumed to increase at 10.5% graded down by 1.0% annual decrements to 4.5% in 2011 and thereafter.

For December 31, 2004, medical costs are assumed to increase at 10.5% graded down by 1.0% annual decrements to 4.5% in 2009 and thereafter.

#### [e] Sensitivity analysis:

Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A one-percentage-point change in assumed health care cost trend rates have the following effects for 2005:

	Increase \$	Decrease \$
Net periodic benefit cost (at 5.9%)	1,649	(1,252)
Accrued benefit obligation at December 31, 2005 (at 5.0%)	24,324	(18,597)

## Toronto Hydro-Electric System Limited

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### NOTES TO FINANCIAL STATEMENTS

[all tabular amounts in thousands of dollars]

December 31, 2005

### 12. ASSET RETIREMENT OBLIGATIONS

Effective January 1, 2004, the Corporation adopted the new CICA Standard for accounting for ARO [note 3[k]]. A reconciliation between the opening and closing ARO liability balances is provided below:

	2005	2004
	\$	\$
Balance, beginning of year	4,274	4,040
ARO liabilities incurred in the year	1,525	139
ARO liabilities settled in the year	(351)	(140)
Accretion expense	243	235
Balance, end of year	5,691	4,274

At December 31, 2005, THESL estimates the undiscounted amount of cash flows required over the next ten years to settle the ARO is \$6,836,000 [December 31, 2004 - \$5,278,000]. Discount rates ranging from 4.35% to 5.93% were used to calculate the carrying value of the ARO liabilities. No assets have been legally restricted for settlement of the liability.

### 13. OTHER LONG-TERM LIABILITIES

	2005	2004
	\$	\$
Obligations under capital leases [note 17]	2,063	3,802
Security deposits	3,277	—
Other	207	205
	5,547	4,007

During 2005, THESL acquired "Property, plant and equipment" through capital lease transactions totaling \$43,000 [2004 - \$1,615,000]. These non-cash transactions have been excluded from the statement of cash flows.

## Toronto Hydro-Electric System Limited

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### NOTES TO FINANCIAL STATEMENTS

[all tabular amounts in thousands of dollars]

December 31, 2005

#### 14. SHARE CAPITAL

Share capital consists of the following:

	2005	2004
	\$	\$
<b>Authorized</b>		
The authorized share capital of THESL consists of an unlimited number of common shares. Any invitation to the public to subscribe for securities is prohibited.		
<b>Issued and outstanding</b>		
1,000 common shares	<b>527,817</b>	<b>527,817</b>

#### Dividends

During 2005, the board of directors of THESL declared and paid dividends totaling \$114,526,000 to the Corporation [2004 - \$49,200,000].

## Toronto Hydro-Electric System Limited

### NOTES TO FINANCIAL STATEMENTS

[all tabular amounts in thousands of dollars]

December 31, 2005

#### 15. PAYMENTS IN LIEU OF CORPORATE TAXES

The provision for PILs differs from the amount that would have been recorded using the combined Canadian federal and Ontario statutory income tax rate. Reconciliation between the statutory and effective tax rates is provided as follows:

##### Statement of income

	2005	2004
	\$	\$
<b>Rate reconciliation</b>		
Income before PILs	126,488	103,960
Statutory Canadian federal and provincial income tax rate	36.12%	36.12%
Expected taxes on income	45,688	37,550
Increase (decrease) in income taxes resulting from		
Large corporations tax net of surtax	1,468	2,806
Utilization of temporary differences previously not benefited	11,158	(96)
Other	2,800	3,565
<b>Provision for PILs</b>	<b>61,114</b>	<b>43,825</b>
<b>Effective tax rate</b>	<b>48.32%</b>	<b>42.16%</b>
<b>Components of provision for PILs</b>		
Current tax provision	61,114	43,825
<b>Provision for PILs</b>	<b>61,114</b>	<b>43,825</b>

##### Balance sheet

Future income taxes relating to THESL have not been recorded in the accounts as they are expected to be recovered through future revenues. As at December 31, 2005, future income tax assets of \$251,704,000 [2004 - \$243,841,000], based on substantively enacted income tax rates, have not been recorded. In the absence of rate regulated accounting, THESL's provision for PILs would have been recognized using the liability method rather than the taxes payable method. As a result, the provision for PILs in 2005 would have been \$7,863,000 lower [2004 - \$4,962,000 higher].

As at December 31, 2005, THESL has accumulated a deferred PILs amount, representing the difference between actual billings that relate to the recovery of PILs and the OEB-approved PILs, totaling an under-recovery of \$4,948,000 [2004 - \$13,489,000]. Cumulative interest included in the amount was calculated following OEB direction and totaled \$2,858,000 [2004 - \$2,313,000].

## Toronto Hydro-Electric System Limited

### NOTES TO FINANCIAL STATEMENTS

[all tabular amounts in thousands of dollars]

December 31, 2005

#### 16. RELATED PARTIES

Toronto Hydro Energy Services Inc. ["TH Energy"], Toronto Hydro Telecom Inc ["THTI"] and Toronto Hydro Street Lighting Inc. ["THSLI"] are wholly-owned subsidiaries of the Corporation. The Corporation is wholly owned by the City.

	2005 \$	2004 \$
<b>Long-term note payable to the Corporation</b>	<b>180,000</b>	<b>180,000</b>

The long-term note payable to the Corporation bears interest at a rate of 6.16% per annum, with a maturity date of May 6, 2013, extendable upon mutual consent. At December 31, 2005, the fair value of the long-term note payable is \$200,173,000 [2004 - \$196,529,000], which has been calculated by discounting the future cash flow of the long-term note payable at the estimated yield to maturity of a similar debt instrument.

Included in "Accounts receivable, net of allowance for doubtful accounts" are amounts due from related parties as follows:

	2005 \$	2004 \$
Due from THTI	—	472
Due from THSLI	225	148
Due from TH Energy	90	—
	<b>315</b>	<b>620</b>

Included in "Accounts payable and accrued liabilities" are amounts due to related parties as follows:

	2005 \$	2004 \$
Due to the Corporation	9,334	13,259
Due to THTI	2,388	—
Due to TH Energy	—	11,168
	<b>11,722</b>	<b>24,427</b>

## Toronto Hydro-Electric System Limited

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### NOTES TO FINANCIAL STATEMENTS

[all tabular amounts in thousands of dollars]

December 31, 2005

At December 31, 2005, the promissory note of \$980,231,000 was payable to the Corporation [2004 - \$980,231,000]. For the year ended December 31, 2005, interest expense was paid to the Corporation in the amount of \$67,146,000 [2004 - \$67,255,000] *[note 10]*.

For the year ended December 31, 2005, THESL provided street lighting electricity to the City in the amounts of \$11,089,000 [2004 - \$9,590,000].

During 2005, THESL purchased corporate and management services from the Corporation totaling \$52,275,000 [2004 - \$80,324,000] in the ordinary course of business, with these services charged to operating expenses and measured at their exchange amounts.

During 2005, THESL provided water heater services to TH Energy totaling \$5,274,000 [2004 - \$4,624,000], with the recovery of these services charged to operating expenses and measured at their exchange amounts.

During 2005, THESL provided procurement and fleet services to THTI, the Corporation and THSLI in the amounts of \$235,000, \$704,000 and \$517,000, respectively, in the ordinary course of business and measured at their exchange amounts. [2004 - \$84,000, \$1,815,000 and \$405,000, respectively]

For the year ended December 31, 2005, THESL incurred property taxes payable to the City of \$7,030,000 [2004 - \$7,825,000].

For the year ended December 31, 2005, THESL billed THTI pole attachment and duct rental services totaling \$2,225,000 [2004 - \$4,854,000] at prevailing market prices and normal trade terms.

During 2005, THESL purchased project management services from TH Energy for \$73,000 [2004 - \$569,000].

During 2005, THESL purchased electricity of \$403,000 [2004 - \$1,065,000] from TH Energy. At December 31, 2005, included in "Accounts payable and accrued liabilities" is \$nil [2004 - \$277,000].



## Toronto Hydro-Electric System Limited

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### NOTES TO FINANCIAL STATEMENTS

[all tabular amounts in thousands of dollars]

December 31, 2005

For the year ended December 31, 2005, THESL earned electricity revenues of \$204,248,000 [2004 - \$230,518,000] from TH Energy. At December 31, 2005, included in "Unbilled revenue" is \$21,793,000 [2004 - \$22,412,000] of unbilled revenue due from TH Energy related to electricity revenues.

For the year ended December 31, 2005, THESL billed building occupancy charges to TH Energy, the Corporation and THSLI in the amounts of \$254,000, \$1,270,000 and \$161,000, respectively, in the ordinary course of business and measured at their exchange amounts [2004 - \$nil, \$nil and \$nil, respectively].

### 17. LEASE COMMITMENTS

#### Operating lease obligations

As at December 31, 2005, the future minimum annual lease payments under property and computer hardware operating leases with remaining lease terms from one to five years are as follows:

	\$
2006	844
2007	467
2008	145
2009	21
2010	15
<b>Total minimum lease payments</b>	<b>1,492</b>

## Toronto Hydro-Electric System Limited

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### NOTES TO FINANCIAL STATEMENTS

[all tabular amounts in thousands of dollars]

December 31, 2005

#### Capital lease obligations

As at December 31, 2005, the future minimum annual lease payments under vehicle capital leases with remaining lease terms from one to six years are as follows:

	\$
2006	1,877
2007	1,481
2008	578
2009	346
Thereafter	106
Total amount of future minimum lease payments	4,388
Less interest	448
	3,940
Current portion <i>[note 9]</i>	1,877
Long-term portion <i>[note 13]</i>	2,063

## 18. FINANCIAL INSTRUMENTS

### Credit risk

Financial assets expose THESL to credit risk. Credit risk is the loss from non-performance by suppliers, customers or financial counter-parties. At December 31, 2005, there are no significant concentrations of credit risk with respect to any class of financial assets.

### Fair value of financial instruments

The carrying value of cash and cash equivalents, accounts receivable, loan receivable from related party, accounts payable and accrued liabilities and promissory note payable approximates their fair value due to the immediate or short-term maturity of these financial instruments.

## Toronto Hydro-Electric System Limited

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### NOTES TO FINANCIAL STATEMENTS

[all tabular amounts in thousands of dollars]

December 31, 2005

#### 19. FINANCIAL GUARANTEES

Participants in the wholesale market for electricity that is administered by the IESO are required to satisfy prescribed prudential requirements. In addition, counter-parties under contracts for the purchase and sale of electricity and customers under purchase contracts may require parental financial guarantees or other forms of credit support.

The City has authorized the Corporation to provide up to \$500,000,000 in financial support [including guarantees] with respect to prudential requirements and as security for obligations under third party contracts. At December 31, 2005, no parental guarantees have been issued on behalf of THESL [2004 - \$nil].

At December 31, 2005, \$80,000,000 [2004 - \$80,000,000] was utilized under the Corporation's revolving credit facility in the form of letters of credit to support the prudential requirements of THESL.

#### 20. CONTINGENCIES

##### Consumers' Gas Decision

On April 22, 2004, in a decision in a class action commenced against The Consumers' Gas Company Limited (now Enbridge Gas Distribution Inc.), the Supreme Court of Canada [the "Supreme Court"] ruled that Consumers' Gas Company ["Consumers' Gas"] was required to repay the 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. THESL is not a party to the Consumers' Gas class action. It is, however, subject to the two class actions described below in which the issues are analogous.

The first is an action commenced against a predecessor of THESL and other Ontario municipal electric utilities under the Class Proceedings Act, 1992 seeking \$500,000,000 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.

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[all tabular amounts in thousands of dollars]

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The second is an action commenced against a predecessor of THESL under the Class Proceedings Act, 1992 seeking \$64,000,000 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 the 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 THESL and the definitions of the plaintiff classes are identical in both actions. As a result, any damages payable by THESL in the first action would reduce the damages payable by THESL 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.

THESL 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 THESL 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 quantify the effect, if any, of the Consumers' Gas decision on these actions or of these actions on the financial performance of the Corporation.

### 21. COMPARATIVE FINANCIAL STATEMENTS

The comparative financial statements have been reclassified from statements previously presented to conform to the presentation of the 2005 financial statements.

### 22. SUBSEQUENT EVENTS

#### *Dividends*

On March 2, 2006, the board of directors of THESL declared dividends in the amount of \$47,800,000. The dividends will be paid on March 10, 2006.