Hydro Ottawa Holding Inc.

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RATING

Rating	Trend	Rating Action	Debt Rated
A (low)	Stable	Confirmation	Senior Unsecured Debt

(All figures in Canadian dollars, unless otherwise noted.)

RATING HISTORY

	Current	2005	2004	2003	2002	2001	2000
Senior Unsecured Debt	A (low)	A (low)	A (low)	A (low)	A	NR	NR

Ratings prior to 2005 reflect Hydro Ottawa Holding Inc.'s Issuer Rating.

RATING UPDATE

The financial profile of Hydro Ottawa Holding Inc. (Hydro Ottawa or the Company) improved significantly in 2005, the result of: (1) a recapitalization of $37.8 million in debt by the City of Ottawa (the City) on December 31, 2004; (2) a lower interest rate of 4.93% on the $200 million in long-term debt that was issued in February 2005 to repay a 6.9% promissory note to the City; and (3) growth in both the Company's franchise area and rate base. Furthermore, the Company's business profile remains stable, as close to 90% of the Company's consolidated EBIT continues to be derived from regulated electricity distribution operations in the City. In addition, the Company's non-regulated subsidiary, Energy Ottawa, provides some earnings diversification.

Over the next five years, however, leverage is expected to increase, from the current level to approximately 60%, as the Company's large capital expenditures program, expected to average approximately $100 million per year during this period, will continue to result in free cash flow deficits. These will in turn be financed through drawings under the Company's bank facility. This debt financing, when combined with the Company's dividend policy (which began in 2006), may limit financial flexibility.

Overall, Hydro Ottawa's earnings and cash flows from operations should continue to demonstrate improvement from the Company's favourable, and growing, franchise area; the establishment of new distribution rates via the Ontario Energy Board's (OEB) April 12, 2006, decision, which led to an overall rate increase of 1.9%; and the Company's contracted power generating operations. While the Company will have its financial profile tested in the coming years as a result of expenditures on system reliability and improvements, Dominion Bond Rating Service (DBRS) is of the opinion that the earnings and coverage ratios will remain in a range that continues to support the rating.

RATING CONSIDERATIONS

Strengths

- Regulated electricity distribution operations provide a degree of stability to earnings and cash flows
- Favourable franchise area with high density population and diversified customer base
- Financially strong and supportive parent
- Higher earnings growth potential from non-regulated operations

Challenges

- Political uncertainty and regulatory risk
- Further free cash flow deficits expected
- Low regulated returns
- Earnings sensitive to volumes sold and customer growth
- Non-regulated operations have higher business risks
- Lack of access to public equity markets

FINANCIAL INFORMATION

	For the year ended December 31				
	2005	2004	2003	2002	2001
Fixed-charges coverage (times)(2)	2.68	1.60	1.35	1.92	n.m.
% debt in capital structure (1)	45.4%	49.9%	58.7%	58.7%	56.6%
Cash flow/total debt (times)	23.9%	16.0%	11.1%	12.5%	10.1%
Cash flow/capital expenditures (times)	0.78	0.53	0.36	1.09	0.62
Net income (bef. extras.) ($ millions)	14.5	8.1	0.9	7.8	0.9
Cash flow from operations ($ millions)	50.5	36.9	27.3	30.5	24.0
Return on average equity (before extras.)	6.0%	4.0%	0.5%	4.4%	0.5%
Electricity throughputs (GWh)	7,663	7,515	7,483	7,471	7,351

(1) The conversion of $37.8 million of debt into equity by the City of Ottawa on December 31, 2004, resulted in a decline to 50%. n.m. = not meaningful. (2) Increase due to lower interest expense on refinanced debt (4.93%).

THE COMPANY

Hydro Ottawa Holding Inc. is a holding company with the following subsidiaries: (1) Hydro Ottawa Limited (the local distribution company or Hydro LDC), a regulated electricity distributor and the Company's primary business. (2) Energy Ottawa Inc., a non-regulated company involved in electricity generation (two hydroelectric facilities with 15 MW of capacity plus development of a 5 MW landfill gas recovery) and energy management services. (3) Telecom Ottawa Holding Inc., which is involved in fibre-optic leasing and is an Internet Service Provider, virtual network provider and data local exchange carrier. Hydro Ottawa's sole shareholder is the City of Ottawa, currently rated AA (high) with a Stable trend by DBRS.

Regulation

Hydro Ottawa's electricity distribution operations are regulated by the OEB under the *Energy Competition Act*, 1998 (the Energy Act), with the following noteworthy amendments:

- The *Electricity Pricing, Conservation and Supply Act, 2002* (Bill 210) – December 9, 2002.
- The *Ontario Energy Board Amendment Act (Electricity Pricing), 2003* (Bill 4) – December 18, 2003.
- The *Electricity Restructuring Act, 2004* (Bill 100) – December 9, 2004.

- Effective March 1, 2005, the Hydro LDC was entitled to recover the third and final phase of its rate increase to earn the full ROE of 9.88%, which was equivalent to approximately $9.3 million per year for Hydro Ottawa:
  - However, in accordance with Bill 4, revenues earned during the first year of this rate increase (2005) must be utilized for conservation demand management (CDM), or energy conservation, programs.
- On April 12, 2006, the OEB issued its rate decision with respect to Hydro Ottawa's 2006 rate application, with new rates coming into effect May 1, 2006. The result is an overall average rate increase of 1.9%. Highlights of this rate decision are:
  - Approved rate base of $504 million for 2006 compared with the previous rate base of $380 (both rate base amounts include working capital);
  - Debt/equity remains at 60%/40%;
  - The allowable ROE for 2006 is set at 9.00%, down from 9.88% in 2005;
  - The approved debt rate is 5.25%.

Generic Cost of Capital

- On April 27, 2006, the OEB indicated its intent to establish a multi-year electricity distribution rate-setting plan for all LDCs in Ontario, which will include the following:
  - A generic cost of capital to be used in adjusting annual revenue requirements for 2007 and beyond.
  - A mechanistic incentive rate adjustment for the period.
- The initial term of the multi-year plan will be three years, beginning with the 2007 rate adjustment.
- On June 26, 2006, the OEB posted on its website a draft report of Board staff containing initial proposals for both the cost of capital and the second generation incentive regulation mechanism. While Board staff have proposed an allowed ROE of less than 9.0%, based on the view of the equity risk premium and current forecast interest rates, it is too early to determine the impact on Hydro Ottawa's credit metrics until the consultation and review process is completed and a final decision is made.

Rating Considerations

Strengths

(1) Approximately 90% of Hydro Ottawa's earnings are generated from its distribution operations (Hydro Ottawa Limited), which provides stability to earnings and cash flow over the long term.

(2) Hydro Ottawa's service area has a population of about 840,000 and its franchise area comprises the most densely populated areas within Ottawa and the Village of Casselman, while Hydro One Inc. (Hydro One) serves the more rural areas of Ottawa. The Hydro LDC's customer base is made up largely of residential customers, the federal government, and the MUSH sector (municipal, universities, schools, and hospitals). As a result, it has very stable demand and is less sensitive to economic cycles compared with a customer base consisting of a greater proportion of large industrial customers. Furthermore, the population of Hydro Ottawa's service area has experienced steady growth of 1.0% to 2.0% per year over the past ten years and it is expected to continue to grow at a similar pace, which should lead to favourable customer and electricity throughput growth over the medium to long term.

(3) The Company has a financially strong parent in the City [currently rated AA (high) with a Stable trend by DBRS]. As the sole shareholder of the Company, the City can be expected to both protect and support its investment; this was evidenced by the conversion of $37.8 million of City-owned debt into equity in December 2004. However, the City does not provide a formal guarantee to Hydro Ottawa's debt obligations as the Ontario municipal legislation prohibits municipalities from doing so. While the Company previously enjoyed a zero dividend policy (instituted by the City) which allowed the Company to keep all of its surplus cash for debt repayment or future growth opportunities, the City has now instituted a targeted dividend payout ratio of 60% of the previous year's net income, with the first payment made in April 2006. While the previous arrangement did afford the Company greater financial flexibility, DBRS notes that future dividend payments should be considered in relation to the Company's reliance on debt financing to fund their capital expenditure program; such reliance on debt financing will otherwise have negative consequences for their improving credit metrics.

(4) Non-regulated operations, such as Energy Ottawa, provide both earnings growth and diversification opportunities. Energy Ottawa employs strategies to minimize business risks, such as entering into long-term contracts, prior to making a capital investment. For instance, the Company secured a 20-year Ontario Power Authority (OPA) contract to produce 37 GWh/year from its Trail Road landfill methane-gas recovery generating facility. The Company will only develop generating projects with a long-term power purchase agreement in place. However, DBRS does not foresee the growth in this area as being significant.

Challenges

(1) One of the challenges facing electricity distributors in Ontario is regulatory risk and the risk of political intervention. While some uncertainty exists regarding the regulatory framework beyond 2006, DBRS expects the OEB to remain supportive by continuing to allow full cost of service recovery with a market-based rate of return on regulated distribution operations. The key risk with respect to political intervention would be the imposition of a rate freeze, as was seen in 2002, which was at a time of high electricity prices and near a provincial election. However, DBRS believes the risk of political intervention in the rate-setting process is relatively low under the current provincial government's tenure, as this government has made a strong commitment to passing along the full cost of power to electricity ratepayers.

(2) Hydro Ottawa's near-term earnings and cash flow from operations will not be sufficient to fund the projected high levels of capital expenditures over the medium term. This will continue to result in free cash flow deficits that will be substantially debt financed, pressuring the Company's balance sheet. It is expected that the Company's debt/capitalization will increase over the medium term to roughly 60% and pressure cash flow/total debt and fixed-charges ratios.

(3) The approved 9.00% ROE for 2006 is low compared with regulated utilities in the U.S. having similar business risk profiles (typically in the 10% to 12% range). As such, cash flow and coverage ratios for Hydro Ottawa will typically be lower than for similar regulated utilities in the United States. However, Hydro Ottawa's ROE is in line with low rates of return typically granted to regulated LDCs in Canada.

(4) Hydro Ottawa's earnings and cash flows are sensitive to changes in electricity throughputs from one year to the next and to customer growth. Seasonality, economic cyclicality, and year-over-year changes in weather patterns directly impact the volume of electricity sold, while economic growth impacts customer growth. Conservation efforts, which may have an effect on total volumes sold, should have a neutral effect on Hydro Ottawa's earnings as the impact of these efforts should be fully recovered through the regulatory process.

(5) Non-regulated operations (telecommunication and electricity generation) are higher risk than regulated electricity distribution. For instance, the Company created Telecom Ottawa in 2001 with an investment of $11.3 million, but only began to recoup this investment during 2004. While electricity generation is also higher risk due to commodity price risk, the Company's low-cost hydroelectric power (and green credits), as well as long-term contracts for the new generation that it is building, mitigates these challenges.

(6) Hydro Ottawa does not have access to the capital markets for common equity. This limits the Company's financial flexibility, especially its ability to make a strategic acquisition or invest in a significant capital project. As a result, the Company's reliance on debt financing to fund a relatively large capital expenditure program over the next three to five years, combined with the lack of access to equity markets and its proposed dividend policy of 60% of the previous year's net income, may pressure the Company's balance sheet.

Earnings, Financial Profile and Outlook

	For the year ended December 31				
($ millions)	2005	2004	2003	2002	2001
Net distribution revenues	97.9	89.8	94.6	87.7	47.1
Other revenues	24.3	22.2	18.3	9.2	11.4
Net revenues	122.3	112.0	112.8	97.0	58.6
Operating expenses	90.2	84.4	89.7	76.6	60.8
EBITDA	66.3	57.3	50.2	45.6	20.9
EBIT	32.1	27.6	23.1	20.4	(2.3)
Gross interest expense	11.9	17.2	17.1	11.0	0.0
Net interest expense	11.7	16.5	19.5	10.0	(3.2)
Payments in lieu of taxes (incl. capital taxes)	5.9	3.0	2.6	2.6	0.0
Net income bef. extra./non-recurring items	14.5	8.1	0.9	7.8	0.9
Extraordinary/non-recurring items (1)	8.1	11.6	1.7	(20.4)	2.3
Net income	22.6	19.7	2.6	(12.6)	3.2

(1) Reflects recovery of provisions taken for regulatory assets.

For year ended December 31, 2005, includes $7.62 million in regulatory asset recovery.

($ millions)	For the year ended December 31 2005	2004	2003	2002	2001
EBITDA	66.3	57.3	50.2	45.6	20.9
Net income before extraordinary items	14.5	8.1	0.9	7.8	0.9
Depreciation	34.2	29.8	27.2	25.2	23.2
Other non-cash adjustments	1.8	(1.0)	(0.8)	(2.5)	(0.1)
Cash Flow From Operations	50.5	36.9	27.3	30.5	24.0
Capital expenditures	(64.5)	(69.8)	(75.6)	(27.9)	(38.5)
Total dividends paid	-	-	-	-	-
Free Cash Flow Before Working Capital Changes	(14.0)	(33.0)	(48.3)	2.6	(14.5)
Working capital changes	29.3	(7.1)	43.9	(56.8)	0.3
Net Free Cash Flow	15.3	(40.1)	(4.4)	(54.2)	(14.3)
Other investments/acquisitions	(1.0)	(0.0)	(1.2)	(1.5)	0.0
Divestitures	0.8	0.2	0.5	-	-
Regulatory assets (1)	7.6	7.9	0.2	(18.0)	0.0
Cash flow before financing	22.7	(32.0)	(4.9)	(73.7)	(14.3)
Net change in debt	(18.8)	21.2	3.4	5.3	0.0
Net other financing (2)	(3.7)	(0.4)	0.8	3.3	1.4
Net change in cash	0.1	(11.2)	(0.7)	(65.1)	(12.9)
Key Financial Ratios					
Cash flow/capital expenditures (times)	0.78	0.53	0.36	1.09	0.62
Cash flow/total debt (%)	23.9%	16.0%	11.1%	12.5%	10.1%
% debt in the capital structure	45.4%	49.9%	58.7%	58.7%	56.6%
Fixed-charges coverage (times)	2.68	1.60	1.35	1.92	nmf

(1) In 2003, includes provision for regulatory asset recovery of $0.16 million. In 2002, includes writedown of $18.0 million in regulatory assets. For year ended December 31, 2005, includes recovery of $7.62 million in regulatory assets that the Company records as a cost recovery in O&M. (2) Includes, among other items, net increase (decrease) in customer deposits.

Summary

- The key factors contributing to the higher EBIT and net income for the year ended December 31, 2005, were higher residential and commercial demand and contributions from the Company's Energy Ottawa segment.
- Despite the significant improvement in cash flows from operations, it remained insufficient to fully fund capital expenditures.

Outlook

- EBIT and earnings are expected to demonstrate moderate growth over the medium term, primarily driven by the following:
  - The rate increase effective May 1, 2006, takes into account the rate base additions since 1999, which were not previously included in rates.
  - Continuing growth in the Company's franchise area.
- Increased contributions are expected from Energy Ottawa.
  - Energy Ottawa has completed refurbishment of its existing low-cost run-of-river hydroelectric facilities, which has increased its annual generating output.
  - It is also nearing completion of a 5 MW methane recovery and electrical generation facility, expected to be operational by year-end 2006, and which will sell all power under a 20-year PPA with the OPA.
- Over the longer term, DBRS expects relatively stable growth in Hydro Ottawa's earnings and cash flow, given the current regulatory framework and continued growth in the Company's franchise area, as well as from continued contributions from Energy Ottawa.
  - Non-regulated earnings are expected to remain less than 10% of the Company's total earnings over the near term, potentially rising to about 15% by 2010.
- Despite the improvement in cash flows, the Company will continue to record free cash flow deficits over the medium term as a result of continued large capital expenditures.
  - The Company anticipates capital expenditures of approximately $100 million per year between 2006 and 2010, with about $90 million related to the regulated distribution business and split fairly evenly between improving system reliability and meeting growth demands.
  - The remainder, or roughly $10 million per year, are expenditures related to small power generation projects which would only be undertaken with long-term power sales contracts in place, and to the existing fibre-optic network.
- The adoption of the dividend policy, whereby the Company will target a payout of 60% of the previous year's net income, beginning with payment of its first dividend in 2006, will exacerbate the free cash flow deficits. However, DBRS expects that the City will provide the Company flexibility in managing its dividend payments in order to maintain a capital structure that supports the existing rating.

  - A dividend of $12 million was paid on April 18, 2006.
- Given the Company's lack of access to the equity markets, the free cash flow deficits will be debt financed.
  - The Company's debt ratio is expected to begin increasing over the medium term, but will remain within the 60% target debt/capitalization structure.
- In addition, DBRS expects that the OEB will maintain a supportive regulatory regime and include full cost of service recovery, a market-based rate of return on equity, and performance-based incentive mechanisms where applicable.
  - Yearly rate applications by the Company to recover its cost of service should reduce the magnitude of its free cash flow deficits and continued satisfactory operating performance should be sufficient to support the current rating.

LONG-TERM DEBT MATURITIES AND BANK LINES

- Hydro Ottawa's previous long-term debt was entirely in the form of a 6.9% demand promissory note to its shareholder, the City.
  - The original amount outstanding was $237.8 million. However, on December 31, 2004, $37.8 million was converted by the City into equity in Hydro Ottawa in order to allow the Company to rebalance its capital structure.
  - The Company drew down on its short-term bridge facility in January 2005 and repaid the $200 million remaining amount on the promissory note, then refinanced this drawing with a ten-year, 4.93%, $200 million debt issue maturing February 9, 2015.
- Hydro Ottawa's credit facilities include:
  - A $150 million, three-year extendible revolving credit facility expiring January 6, 2008, of which $54.4 million was outstanding [which included $22.4 million posted as letters of credit to the Independent Electric System Operator (IESO) in Ontario] at June 30, 2006.
  - The Company also has a $25 million, 364-day revolving credit facility with $13.8 million drawn at June 30, 2006.

Hydro Ottawa Holding Inc.

Balance Sheet
($ millions)

Assets	2005	2004	2003
	As at December 31		
Cash & s.t. investments	-	-	-
Accounts receivable	48.2	49.8	46.6
Unbilled revenue	96.0	81.0	77.0
Inventories	6.7	8.6	10.6
Other	1.7	1.2	6.7
Current Assets	152.6	140.5	141.0
Regulatory assets (net)	6.6	5.5	5.8
Net fixed assets	470.3	440.1	399.2
Other assets	4.4	1.8	1.2
Total	633.8	587.9	547.2

Liabilities & Equity	2005	2004	2003
	As at December 31		
Short-term debt	11.1	29.9	8.7
A/P + accr'ds	137.4	109.0	107.2
L.t.d. due in one yr.	-	200	-
Current Liabilities	148.5	338.9	115.9
Customer deposits	6.3	3.5	9.4
Regulatory liability	16.3	9.6	7.0
Other liabilities	8.2	4.7	3.3
Long-term debt	200.4	0.0	237.8
Shareholders' equity	254.2	231.3	173.7
Total	633.8	587.9	547.2

Ratio Analysis

	For the year ended December 31				
Liquidity Ratios	2005	2004	2003	2002	2001
Current ratio	1.03	0.41	1.22	1.72	1.86
Accumulated deprec./gross fixed assets	46.8%	46.3%	47.4%	49.0%	47.6%
% debt in capital structure	45.4%	49.9%	58.7%	58.7%	56.6%
Cash flow/total debt	23.9%	16.0%	11.1%	12.5%	10.1%
Debt/EBITDA	3.20	4.01	4.90	5.24	9.86
Cash flow/capital expenditures (1)	0.78	0.53	0.36	1.09	0.62
Average coupon on long-term debt	4.9%	6.9%	6.9%	6.9%	-
Deemed equity	40%	40%	40%	40%	40%
Common dividend payout	0.0%	0.0%	0.0%	0.0%	0.0%
Coverage Ratios					
EBIT interest coverage	2.68	1.60	1.35	1.92	n.m.
EBITDA interest coverage	5.57	3.33	2.94	4.21	n.m.
Fixed-charges coverage	2.68	1.60	1.35	1.92	n.m.
Profitability/Operating Efficiency					
Operating margin	26.3%	24.6%	20.5%	21.0%	(3.9%)
Net margin (before extras.)	11.8%	7.2%	0.8%	8.1%	1.6%
Return on avg. common equity (bef. extras)	6.0%	4.0%	0.5%	4.4%	0.5%
GWh sold/employee	15.6	15.9	15.2	16.0	14.7
Customers/employee	567	581	546	565	518
Customers/distribution lines	53	54	56	55	54
Operating costs (2)/avg. customer ($)	324	308	333	289	235
Rate base ($ millions)	380	380	380	380	380
Electricity Throughputs					
Residential	2,358	2,267	2,241	2,255	2,192
Commercial	4,642	4,590	4,554	4,512	4,435
Large users > 5 MW	626	621	651	665	690
Street lighting	37	37	36	38	34
Total (GWh)	7,663	7,515	7,483	7,471	7,351
Growth in electricity throughputs	2.0%	0.4%	0.2%	1.6%	4.9%
Peak demand (MW)	1,465	1,405	1,420	1,445	1,412
Generation capacity (MW)	15	15	15	15	15
Gross electricity generated (MWh)	103,900	82,000	111,171	92,749	n/a
Number of Customers					
Residential	252,268	247,790	242,370	237,755	232,319
Commercial	26,303	26,240	26,810	26,754	26,320
Large users > 5 MW	10	10	11	11	12
Total	278,581	274,040	269,191	264,520	258,651
Growth of customer base	1.7%	1.8%	1.8%	2.3%	1.8%

n.m. = not meaningful. n/a = not applicable.
(1) Net of customer contributions.
* DBRS-derived figures from actual results provided by Company.

	For the year ended December 31				
Unit Revenues & Costs (cents per kWh)	2005	2004	2003	2002	2001
Residential	9.33	11.88	8.93	9.03	8.27
Commercial	9.19	6.24	7.25	7.38	7.06
Industrial	9.26	6.69	7.89	6.53	6.41
Street lighting	12.32	9.77	5.99	7.13	6.35
Average gross electricity revenues	9.25	8.00	7.80	7.80	7.36
Purchased power costs	7.97	6.80	6.54	6.63	6.72
Net distribution revenues	1.28	1.19	1.26	1.17	0.64
Ancillary revenues	0.32	0.30	0.24	0.12	0.16
Variable costs (OM&A + income taxes)	0.81	0.77	0.87	0.72	0.51
Fixed costs (deprec. interest, gov't levies)	0.60	0.62	0.62	0.47	0.27
Net margin (before extras.)	0.19	0.11	0.01	0.10	0.01
Total costs	1.41	1.38	1.50	1.19	0.78
Interest income	(0.00)	0.00	0.00	0.01	0.04

Income Statement	For the year ended December 31				
($ millions)	2005	2004	2003	2002R	2001
Residential	220.085	269.307	200.108	203.645	181.232
Commercial	426.411	286.382	330.410	333.077	313.299
Large users > 5 MW	57.979	41.571	51.363	43.437	44.249
Street lighting/other	4.559	3.615	2.164	2.704	2.157
Gross distribution revenues incl. power recovery^^	709.034	600.876	584.045	582.863	540.937
Power purchases^^	611.094	511.098	489.495	495.133	493.813
Net distribution revenues	97.940	89.778	94.550	87.730	47.124
Communication services & products	11.550	11.548	5.679	3.033	
Other revenues	12.783	10.684	12.590	6.208	11.430
Net operating revenues	122.273	112.010	112.819	96.971	58.554
Expenses:					
Operating + maintenance	55.943	54.677	62.580	51.397	37.637
Depreciation & amortization	34.219	29.760	27.165	25.168	23.177
Total operating expenses	90.162	84.437	89.745	76.565	60.814
Operating income	32.111	27.573	23.074	20.406	(2.260)
Gross interest expense	11.853	17.230	17.102	11.029	0.000
Non-cash financial charges	(0.491)	(0.660)	2.475	(0.256)	0.000
Other (income)/expense	0.342	(0.046)	(0.052)	(0.808)	(3.196)
Net interest expense	11.704	16.524	19.525	9.965	(3.196)
Pre-tax income	20.407	11.049	3.549	10.441	0.936
Income taxes (incl. prov. capital tax)	5.946	2.964	2.606	2.630	0.000
Net income bef. extras./non-recurring	14.461	8.085	0.943	7.811	0.936
Minority interest	0				
Net income bef. extras./non-recurring	14.468				
Extraordinary/non-recurring items^	8.097	11.615	1.656	(20.414)	2.310
Net income	22.565	19.700	2.599	(12.603)	3.246

^ Regulatory recovery of accounts that the Company is now recovering, but had previously written off.

^^ Gross distribution revenues and power purchases overstated by amount of Global Adjustment that were not allocated to particular classes as of time of publishing annual results. DBRS has adjusted accordingly.