HYDRO ONE - INERGI OUTSOURCING AGREEMENT

1.0 SUMMARY OF TERMS

- Hydro One Networks Inc. (Networks) entered into an outsourcing agreement with Inergi LP (Inergi) in December 2001 (the "Master Services Agreement" or "MSA").
- Inergi is a wholly owned subsidiary of Capgemini and is not an affiliate of Hydro One Networks Inc.
- "Base Services" refers to the basket of services Inergi assumed provision of as of the commencement date. Inergi committed to providing Base Services for a fee of $122.5 M in contract year one assuming performance remained at historical service levels and volumes remained unchanged, declining in real terms over the term of the agreement by 30%.
- Base Services commenced under the MSA on March 1, 2002 ("commencement date") and includes Customer Service Operations, Supply Management Services, Finance and Accounting, Information Technology, HR Payroll, and Settlements.
- In addition to Base Services and ongoing services added to the arrangement from time to time, Inergi also provides short term "Project" services at predetermined rates. Inergi fees for Base Services actually payable in any year vary according to agreed changes in volume and scope.
- In 2006, Networks expects to pay a fee of $115.6 M for Base Services.
- The arrangement involved the transfer of over 900 Networks' employees to Inergi.
- Networks' owns substantially all assets involved in Inergi's delivery of Base Services.
- Inergi has subcontracted the call centre operations to Vertex Canada (Vertex). Vertex is not an affiliate of Hydro One Networks Inc.

- The MSA provides for benchmarking of fees in contract years 3, 6 and 9 and downward adjustment of pricing in the event the benchmarking exercise determines the bundled pricing of Base Services is not competitive.
- The 10-year term of the MSA expires on February 29, 2012.

2.0 STATEMENT OF WORK SUMMARY

The contract includes the MSA, associated Schedules and Statement of Work (SOW) for each line-of-business which provide details of the Base Services provided. The following table summarizes the current SOW for each line-of-business (LOB).

Line of Business	Domain	Service Description
Information Technology	Infrastructure Operations	Services that facilitate the operation of shared devices and servers on a corporate level and services required to engineer and manage the computing network infrastructure
	End User Support	Help Desk and Desktop Support
	Application Maintenance and Sustainment	Services to maintain technology platform, operational quality assurance and application support customised to the service requirements and needs of the business applications
	Projects	Provides problem definition; requirement definition; business case development; design, development, configuration and testing; and commissioning, (including system enhancements) to meet specific line of business or enterprise needs.
	Cross Functional	Provides Service Management, Account Management, Vendor and Asset Management, and Resource Management to all other IT domains
	Mainframe Operations and Services	Services that facilitate the use of the mainframe computer and associated infrastructure

Line of Business	Domain	Service Description
Customer Care	Inbound Call contact Handling	Provides customer call handling services for billing, customer services, collections, outages and emergencies for Residential and small business segment. Includes corporate switchboard, maintain the day to day operational configuration of the IVR system, and responding to other contacts such as letters and email.
	Bill Production	Issue electricity bills, including bill print, insert delivery to Canada Post and remittance, managing exceptions, accuracy and timely delivery. Maintain accuracy of customer billing records to enable timely and accurate billing and print, envelope and dispatch bills to Canada Post.
	Collections	Manage the collection of outstanding customer debts and negotiate and collect deposits.
	Data Services	Administration and data input of timesheets, work order task packages and service and work orders for field personnel and transmission operations.
	Business Customer Centre	Selection of services for business customers, including inbound call and contact handling, retail settlements, billing exceptions and manual bills.
	Application support	Provide direction and work management for variety of billing systems. ▪ Perform systems/business analysis to define system changes to address bug fixes & enhancements. ▪ User acceptance testing for all code changes
Settlements		Wholesale Settlements - Provide settlement and reconciliation services for power procured from the Independent Electricity System Operator and embedded Retail Generators with due consideration to legislative initiatives for fixed energy prices for low volume customers, transmission revenues and inter-utility load transfers, and cost of power reporting, and Retail Settlements - Provide complex billing for interval meter accounts.
Supply Management	Demand Planning	Preparing Material Requests and capital demand forecasts
	Demand Management and Procurement	Maintaining market intelligence of applicable commodities, processing purchase transactions and inspecting and expediting services to ensure delivery to contract

Line of Business	Domain	Service Description
		commitments
	Sourcing, Vendor Management and Inventory Management	Services to support sourcing all commodities and services which include: managing and developing supply strategies (strategic sourcing), monitoring spend on all commodities and services, managing the size and composition of vendor base, resolving vendor issues, managing inventory levels, and negotiating vendor stocking arrangement.
	Process Development and Data Management	Services supporting the execution of daily transactions including ensuring the operation of automated systems and maintaining catalogue schema
	Transportation	Negotiating and managing transportation contract with logistics providers
	Asset Disposal	Managing the selling and disposal of surplus materials.
Payroll	Pay Operations	Services necessary to calculate all pay cycles
	Payroll Accounting	Services necessary for the distribution of pay and production of back up information for all pay cycles
	Inquiries and Application Support	Services necessary to support the performance of other payroll domains, including technology support and issue resolution
Finance	Accounts Payable	Services required for processing disbursements which include: maintaining Vendor Master Data and CCC Master Data, invoice processing, payments management, AP inquiries support, period end and reconciliations, management reporting and special projects.
	Billing and Accounts Receivable	Services required for processing non-energy miscellaneous billings and AR which include: maintaining AR Master Data, customer billing information, customer invoicing, customer collections support, applying AR payments and adjustments, AR inquiries support, period end and reconciliation, management reporting and special projects
	Fixed Asset and Project Cost Accounting	Provides fixed assets and project costing transaction processing, reconciliation of sub-ledger balances to general ledger accounts, reconciliation of the fixed assets and project costing suspense accounts, transfer of projects to fixed assets and recording sales and retirement of assets

Line of Business	Domain	Service Description
	General Accounting and Planning, Budgeting and Reporting	General Accounting – ensuring financial recognition consistent with corporate requirements, accounting adjustments, processing of transactions and maintenance of the general ledger system account blocks, support of financial systems and modules and interface and support for pay services and management reporting Planning, budgeting and reporting – provide advice, guidance, consultation and project support on routine operating processes and business support initiatives.

3.0 GOVERNANCE MODEL/ORGANIZATION

The parties have established the following committees to manage their relationship in connection with the agreement: Executive Committee, Operations Management Committee, Services Committees (one for each LOB) and a Contract Management Committee. The Executive Committee meets quarterly and is comprised of senior Management of each organization and responsible for oversight and management of the overall relationship between the parties and to address escalated matters. The Operations Management Committee meets monthly and is comprised of the accountable VP and Contract Manager within each organization and is responsible for the ongoing management of all operations including matters escalated from the Services Committees. A separate Services Committee is established for each LOB, includes the Contract Managers and LOB operational leads from each party and meets monthly to review operational performance, change management, business planning and other contact business. The Contract Management Committee includes the Contract Managers and support staff to monitor the change management process and other contract business.

Internally, Networks has established an Inergi Deal Steering Committee comprised of VP's accountable for LOB performance as delivered by Inergi with a mandate to ensuring common vision and purpose in all matters related to Inergi within Networks, setting direction for transformation of the contract, resolving priorities and trade-offs amongst LOB service areas, and approval of material contract changes.

Capgemini's management team has established the Toronto Service Delivery Centre (TSDC) which is organized to provide common leadership to its multi-client base. The Inergi Account Team is dedicated to managing the commercial relationship with Networks. Currently, all service delivery staff providing Base Services to Networks (excluding the operational management team, project group and some specific areas such as data centre operations) are dedicated exclusively to Networks.

4.0 BENEFITS OF OUTSOURCING

The successful implementation of the outsourcing arrangements has resulted in significant cost savings to Networks. Networks has realized other positive business results that have multiplied the value of this business arrangement to the benefit of Networks' ratepayers. These benefits, as described in Section 8 below, are expected to continue throughout the term of the agreement.

Inergi's fees for Base Services have been prudently and reasonably set, consistent with Networks' business plan. The outsourcing arrangements have resulted in lower than historical costs at consistent and stable service quality. Networks has retained proper management control and decision making authority over the outsourcing arrangement to continue the safe, secure and reliable delivery of electricity in the Province of Ontario.

Financial, service quality and intellectual capital benefits in combination with the opportunity for utility management to reduce its focus on outsourced functions were believed to be sufficient to justify the pursuit of an outsource service agreement as further described in the Business Case in Appendix A. The NPV of the financial benefits as compared with the Networks Business Plan was estimated to be $24 million over the life of the agreement and includes savings that Networks will make through guaranteed price reductions, strategic sourcing, growth royalties from Inergi, and is net of all incremental costs associated with the transaction. The Networks Business Plan used for comparison to the outsourcing contract alternatives contained significant savings that had no formal strategies for achieving them. The outsourcing contract not only added additional savings but also removed the risk of achieving the savings already identified in the Business Plan.

5.0 COST OF OUTSOURCING

Table 1 below contains the contracted price for Base Services (by Contract Year) along with adjustments that reconcile to the spend in the calendar year. Also included is the actual project spend with Inergi LP. This section explains the various inputs to fees shown in Table 1. Table 2 shows the amount of total contracted Inergi fees in 2006 allocated to Distribution.

Base Service Fees

The contracted fees for Base Services paid by Networks under the outsource services agreements will decline over time so long as service is maintained at then prevailing service levels and activity volume levels are within the normal range of those for historical periods. The declining price curve reflects Networks and Inergi's expectation that Inergi will obtain cost savings over time as process re-engineering efforts are implemented and refined, and such savings are passed onto Networks as a guaranteed reduction in the fee for Base Services.

Table 1
Summary of Inergi Fees ($ Million)

	Historic			Bridge	Test
Description	**2002**	**2003**	**2004**	**2005**	**2006**
Contracted Fees for Base Services	**94.2**	**102.6**	**95.6**	**91.9**	**89.7**
Market Ready Apps (part of IT)	-	8.2	7.9	7.1	7.8
Settlements	1.9	2.3	2.3	4.3	2.5
COLA, Pension & Benefits	6.0	9.5	10.8	10.5	11.7
Volume, Scope & Other	0.9	0.6	5.5	9.3	4.0
Subtotal Base Services per BP	**103.0**	**123.3**	**122.1**	**123.1**	**115.6**
Project Orders (all LOBs)	6.2	12.4	17.4	-	-
Application Enhancements (IT)	1.3	6.5	10.7	4.7	4.6
Supplier Initiatives (all LOBs)	4.2	9.9	0.8	-	-
In-Flight Projects (IT)	5.7	1.5	-	-	-
Managed Contract Reimbursement (IT)	(9.6)	(19.1)	(6.8)	(6.8)	(6.8)
Networks Contractor Reimbursement (IT	(2.7)	(0.6)	-	-	-
Royalties	(2.0)	(2.0)	(2.0)	(2.0)	(2.0)
Pension Top-up	-	-	-	6.6	7.9
Total Inergi Payments	**106.0**	**131.9**	**142.4**	**125.6**	**119.3**
Minimum IT Project Spend	4.8	5.0	4.9	4.7	4.6
Actual IT Project Spend	4.8	8.5	16.7		

Table 2
Allocation of Inergi Fees to Distribution ($ Million)

	Evidence Reference	2006 Fees Allocated to Distribution
Finance	Exhibit C1-2-6	4.2
HR Pay	Exhibit C1-2-6	1.6
IT	Exhibit C1-2-6	31.1
Supply Management Services	Exhibit C1-5-2	0.1
Settlements	Exhibit C1-2-5	2.1
Customer Service Operations	Exhibit C1-2-5	33.9
Subtotal Fees for Base Services		73.0
Minimum IT Project Spend	Exhibit C1-2-6	1.7
Managed Contract Reimbursement (IT)	Exhibit C1-2-6	(3.3)
Royalties	Exhibit E3-1-1	(0.7)
Pension Top-up	Exhibit C1-4-3	7.9
Total Fees for all Contract Commitments		78.5

Incremental sustainment costs for Market Ready Systems were included in the IT contract pricing for year one at a level of $6.1 M but not for subsequent years as it was contemplated these costs may vary as the electricity market evolves. The parties have now agreed to lock-in these costs for the remainder of contract at a fixed and declining price as shown in Table 1 above. The parties agreed to "cost plus" pricing for the Settlements LOB rather than fixed, declining pricing because Inergi felt that it could not support a guaranteed declining price structure for these new and uncertain business processes and technology which were expanded co-incident with the MSA commencement date.

Base Fees and most other fees are subject to cost-of-living adjustments (COLA). The COLA formula is based upon the Statistics Canada Indices of total wages, salaries, and supplementary labour income in Ontario, and total number of employees in Ontario.

Over the first few years of the agreement, the parties have adjusted the contract to reflect sustained changes in the volume of transactions or scope of services purchased which has resulted in adjustments to the fees for Base Services for the remainder of the agreement. Examples of significant scope and volume changes are as follows:

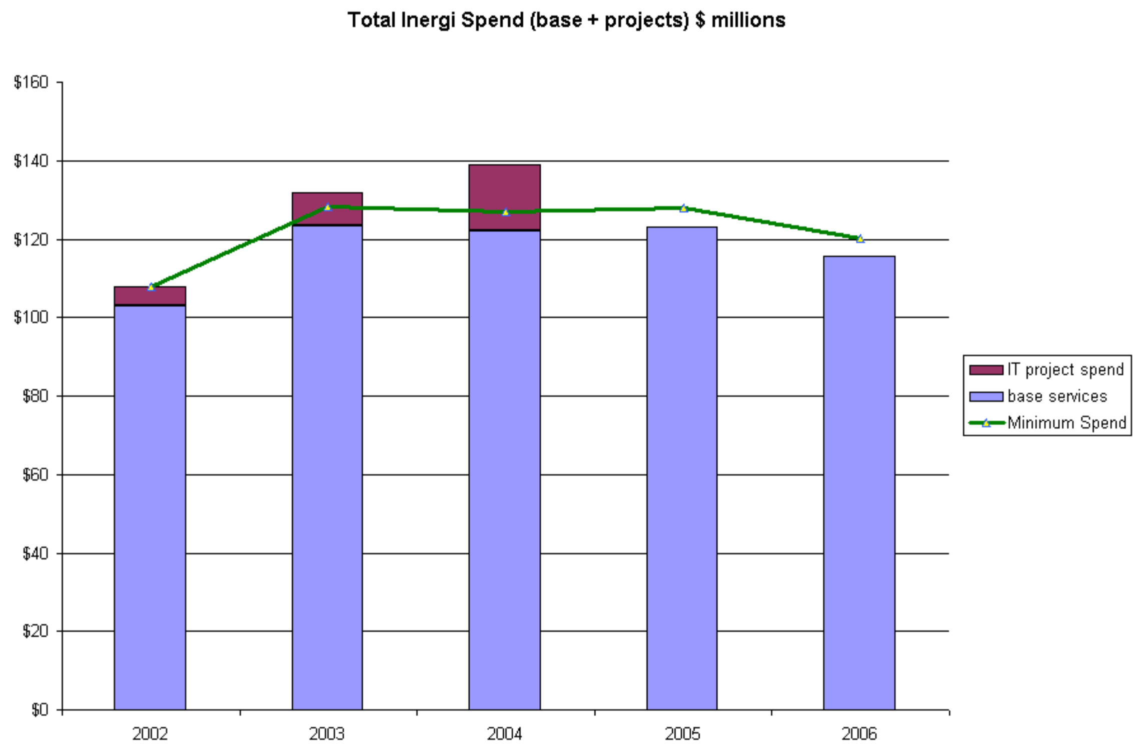
- Scope: In the interest of advancing the transformation of the Supply Chain to meet Networks' future needs, and to achieve an optimal warehouse network, the parties agreed to repatriate Warehouse Operations Services back to Networks resulting in a reduction in Base Fees effective May 2004. The 27 PWU stock-keepers who staff the warehouses and operate the delivery trucks together with three front line managers and one Warehouse Operations Manager returned to Networks. The negotiated price reduction of $3 million per year was based on actual costs that Inergi would avoid as a result of the transfer of staff back to Networks. Networks completed consolidation of its Warehouse Operation in January 2005.

- Volume: The number of new IT applications supporting Networks' operations increased significantly since commencement requiring an increase in volume of IT application support services.

Systems Development Expenditures (Project Orders/Application Enhancements)

The Master Services Agreement sets out Networks' spending commitment to Inergi for IT systems enhancements and other IT project development work for the duration of the agreement as shown in Table 1 above. Although Networks has a contractual obligation to award a minimum annual spend, Networks retains the option to competitively bid individual projects and has awarded several IT projects to other vendors since Commencement.

Graph 1



Over the first three years of the agreement, Networks decided to award to Inergi system enhancements and other IT development work above the contract minimum spend levels as shown in Graph 1 above for the following reasons.

- Inergi's project labour rates are comparable to top tier service providers,
- Inergi's in-depth experience with Networks' IT applications and infrastructure which tends to reduce required project effort and permit completion of projects under tight time constraints such as required by changes in retail billing regulations,
- As the incumbent service provider, Inergi can offer overall savings in implementation of new technologies by delivering both the project work and services to integrate the work with existing applications and/or infrastructures,
- Generally, Networks has experienced high client satisfaction with the delivery of Inergi IT projects, and

- Inergi has the broad skill base and technical and project management capabilities needed to manage large-scale projects.

Inergi assists Networks with assessment work as part of the fee for Base Services, which can range from data collection to the development of project business requirements used to award work. Inergi may choose to decline direct involvement in assessment work in order to be eligible to competitively bid on the resulting project work that Networks has declared to bring to market.

Expenditures Supporting Productivity Improvements (Supplier Initiatives)

Bidders to the outsourcing arrangement anticipated expenditures the first few years of the contract to change processes, technology and people in order to realize cost savings and share those cost savings with Networks in terms of price reductions. The MSA required Networks to provide $5 Million per year for the first three contract years to partially fund "Supplier Initiatives" in return for the promised fee schedule. The $15 Million expenditure is aligned with expenditures Networks estimated it would have made to achieve its business plan savings had it not outsourced Base Services. Although the contract identifies the specific initiatives that Inergi planned to undertake in each line of business, Inergi was unconstrained as to how, or if, the initiatives were implemented as the price reductions were guaranteed. The following describes two of the Supplier Initiatives completed.

<u>Speech Recognition Initiative – Customer Service Operations</u>

This initiative was designed to reduce the number of calls handled by agents through the implementation of self-serve telephony applications using Interactive Voice Response (IVR) and Speech recognition technology. The goal was to understand 85% of customer speech on the first pass in both Canadian English and French.

By integrating Speech Recognition software in the existing IVR and Customer Service System platform, several of the high volume call types were automated freeing the agent to handle more complex and non-automated functions. In addition, Speech Recognition allowed all-speech user experiences for selected services. Speech Recognition technology is expected to improve customer satisfaction and experience.

Accounts Payable Process Improvements - Finance & Accounting

The objective of this initiative was to improve invoice processing and problem resolution processes in Inergi's Accounts Payable Services unit (AP) and improve the overall payment processing process (including cheque printing and distribution). The initiative focussed on rationalization and re-distribution of responsibilities and job duties, elimination of non-value added activities and improvement of and / or leveraging of existing information technology enablers.

In-Flight Projects

In-flight project fees reflect the fees paid to Inergi to complete selected projects which were initiated prior to the commencement date.

Managed Contract Reimbursement

Prior to the commencement date, Networks purchased certain products and services under contracts with third parties. In the context of IT Services, it was contemplated that Inergi would assume the majority of these contracts and provide the related products or services directly as part of the fees for Base Services. The balance of the third party contracts would continue to be held by Networks, and simply 'managed' by Inergi. As of the commencement date, a final determination as to which contracts were to be assumed had not been made. The costs which Networks would otherwise have incurred under all third party IT contracts were included in Base Service fees as of the commencement date, to be adjusted later. However, payments to the third party vendors are made directly by Networks and Inergi reimburses Networks for those payments. Once certain contracts were identified for assumption by Inergi (mostly hardware and software contracts), Networks stopped paying these third party contractors. The actual assumption of these contracts over the first three years is reflected in a reduction of reimbursements and Networks' termination of the data centre agreement with IBM.

Royalty Payments - Business Development

Inergi agreed to make royalty payments to Networks concerning new business to be delivered by TSDC, which Networks assists, Inergi or Capgemini in attracting. The marketing support includes:

- conference and sales support programs as agreed to by both parties,
- hosting site visits and participating in occasional promotional meetings, and
- acting as a reference when required.

Networks' out-of-pocket costs to support Inergi marketing efforts are more than offset by the royalty payments.

Royalty Payments - Asset Usage

In addition to the forgoing, the contract requires Inergi to pay royalties as agreed upon to Networks where Networks permits Inergi to use Networks assets for the benefit of third parties. With the minor exception of the use of 8-10 laptops by Inergi management staff for multiple clients, no such usage has occurred.

Use of Networks Assets by Supplier

Networks provided at the commencement date, all facilities and equipment necessary for Inergi to perform its contracted responsibilities (i.e., office buildings, workstations, partitions, desktop computers, network printers, telephones, servers, telecom equipment, etc.). Inergi's staff are located in Networks' facilities and the cost of those facilities and generally facility overhead costs (communication services, heating, lighting, consumable goods, etc.) are borne by Networks. Personal office tools are provided by Inergi such as cell phones, pagers, PDA's, personal desktop printers and associated cartridges, supplementary desk lighting, etc.

Inergi has not acquired any Networks assets as part of the transaction with the exception of certain third party agreements they have assumed. Ownership of assets remains with Networks and is unchanged as a result of the outsourcing. Networks retains an obligation to refresh those assets through the term of the contract. Upon termination of the contract all assets used to provide service to Networks are returned to Networks.

The outsourcing arrangements were structured in this way because at the time of bid solicitation, the desired services were not sufficiently defined to permit prospective bidders to identify the assets necessary for delivery.

Pension, Supplementary Pension and Post Retirement Benefit Fees

The employment of 913 Networks employees was transferred to the outsource service provider. Of these 913 employees, 569 were represented by the Power Workers Union (the "PWU") and a further 277 were represented by the Society of Energy Professionals (the "Society"). The remaining 67 managers were not represented by a bargaining unit.

Agreement for the transfer of collective bargaining rights to Inergi respecting the outsourced work was obtained from the PWU directly on December 14, 2001 and from the Society by way of arbitration award in December 2001.

In order to simplify bid evaluation Networks requested pricing net of pension, supplementary pension and post retirement benefit costs. During the due diligence and contract negotiation phase of the contracting process with Inergi, it was agreed that Networks would fund these costs on the following terms:

- Inergi would be held harmless for pension (funding) costs and for the Other Post Retirement Benefits (OPRB) accruing due to transferred staff prior to the deal, and
- Inergi would provide benefit plans to transferred employees which would be no less favourable than the Networks' plans in place prior to the transfer.

Inergi set up a pension plan mirroring Networks', to provide benefits accruing to the transferred employees following the commencement date. Networks agreed to transfer assets and liabilities from Networks' pension plan to Inergi’s pension plan, with respect to benefits accruing due to transferred employees prior to the commencement date, on no less than a solvency basis. The pension regulator has not yet approved the transfer.

The current service cost for the pension plan has been calculated using a going concern actuarial valuation basis that produces a going concern liability for transferred employees approximately equal to the solvency liability. The fees for current service cost decline annually, and from Networks perspective, reflect expected reductions in numbers of employees needed to deliver Base Services and inflationary increases in a manner consistent with the escalation of other cost elements of fees for Base Services.

The forgoing arrangement keeps Networks pension plan whole as no more or less than the liability and assets associated with the transferred staff are to be transferred. Actuarial calculations have been used to determine the amount of the transfer and the actuarial calculations have been filed as required and approved by the appropriate regulatory authorities. The asset transfer report has been prepared in accordance with Section 80 of the pension Benefits Act (Ontario).

Networks is obliged to fund over three years, the difference between the solvency liabilities for the transferred employees on the Commencement date and the end of 2004 and a 4% funding cushion, to the extent such amounts are not offset by pension fund performance during the same period. This shortfall has been determined by Networks' actuary to be $23.6M and 1/36th of this amount was added to the monthly outsourcing fee commencing in March 2005. This adjustment is described as "Pension Top-up" in Table 1.

Inergi also set up a supplementary pension plan (SPP) mirroring Networks', to provide benefits accruing to the transferred employees following the Commencement date. Networks pays SPP benefits based on credited service with both Networks and Inergi.

Networks pays a portion of the Other Post Retirements Benefits (OPRB) ultimately payable based on the provisions of Networks' plan as at the commencement date but allowing for dental fee guide increases. Networks' share is based on the proportion of continuous service with Networks, ignoring service under reciprocal agreements.

If Inergi reduces the SPP benefits or OPRB of transferred employees, Networks will pay to Inergi, an amount equal to any resulting reduction in its SPP liabilities and/or OPRB liabilities, determined using Networks' then current accounting methods and assumptions is in exchange for satisfactory indemnities and releases.

Current service costs for the Inergi pension plan, SPP and OPRB are described as 'pension & benefits' in Table 1.

6.0 SUPPLIER PERFORMANCE

Benchmarking

The MSA allows for adjustment of Inergi fees for Base Services on the third, sixth and ninth anniversary of the commencement date in accordance with the findings of a mutually acceptable independent third party engaged for the purpose of benchmarking. The MSA listed a number of industry-recognized benchmarking providers deemed acceptable.

For purposes of the first and second benchmarking study the analysts shall restrict themselves to considering comparable companies that are unionized in the same proportion as that of Inergi relative to the services being reviewed. In the third benchmarking study period the analyst is permitted to consider for comparison purposes a reasonable mixture of unionized and non-unionized companies.

Fees for the benchmarking are to be borne equally by Networks and Inergi.
The agreement requires the analyst to compare the Inergi fees adjusted for employment costs (i.e. current pension cost, other post retirement benefits and supplementary pension plan costs) and applicable cost of living increases with the market price as determined by the analyst, for Base Services delivered under each statement of work in the MSA. The

fees chargeable under each statement of work are to be adjusted to align with the 50th percentile of the fair market value range identified by the analyst.

An RFP for the benchmarking project was released to the analysts listed in the MSA in June 2004 with the expectation that the benchmarking study would be completed by the end of 2004. No compliant bids were received as none of the bidders were capable of completing the benchmarking work on all lines-of-business. In general, industry analysts involved in price benchmarking work advised Networks that with the exception of IT and certain portions of Customer Care, there is very little maturity in benchmarking work of other lines-of-business. Further pursuit of this work would be based on relatively expensive primary research and involve a limited number of companies with comparable characteristics such as size, type of service, unionization, etc.

A second RFP was released in January 2005 to solicit a benchmarking study for IT Services. IT Services represents over 50% of the total value of the fees for Base Services and it was felt that benchmarking results of this line-of-business provide a general indicator of Inergi's market competitiveness.

P.A. Consulting was awarded the work of completing an IT Services price benchmark study and their report is included in Appendix B of this evidence. The results of this analysis show that Inergi fees for IT Services are $0.514M above the 50th percentile of the Fair Market Value Range established to be $50.341M (that is, within 1.0%). In addition, PA Consulting has identified several intangible factors that could not be presently quantified and could conceivably influence the outcome of the benchmarking results within the Fair Market Value Range slightly above or below the 50th percentile.

Service Performance

As of the end of year three (February 2005) of the agreement Networks can say with confidence that outsourcing objectives are being realized.

- **Delivery of service against defined service levels** is assessed on a monthly and yearly basis. One of the benefits of the outsourcing process was the definition of Base Services, associated roles and responsibilities of client and supplier and establishment of measures of service volume and service performance. Service level performance has been satisfactory to date with overall improvement from the time period before outsourcing.

DELIVERY OF SERVICE AGAINST DEFINED SERVICE LEVELS					
	Number of Service Levels	Number of Service Failures in 2004			
		Severity			
		1	2	3	QSL
1. CSO	20				
2. Supply Management	37			1	
3. HR Payroll Operations	18			1	
4. Inergi Information Technology	35	1	3	12	
5. Finance & Accounting	21				
6. Settlements	11				
Total	142	1	3	14	0

Overall: Inergi met or exceeded 99% of the service level measurements in 2004.
(Tiers 1, 2 and 3 are levels assigned to Service Levels based on criticality, QSL is a quarterly trend failure associated with Tier 2 service levels.)

In the event of a failure by Inergi to achieve any service level, Inergi provides a Cure Plan and service credits to Networks according to severity and frequency of such failures.

Service credits increase as the situation warrants. Termination of individual statements of work or the whole agreement is allowed under defined circumstances.

Inergi's performance to-date has been such that only one minor service credit has been issued; that in connection with IT services in February 2005. A Tier 1 service failure (Passport System restoration failure) occurred but Inergi's response was exemplary and Networks did not invoke its right to collect significant service credits. Networks' agreement not to pursue contractual or other legal remedies arising from the failure to restore Passport were contingent on Inergi i) improving the relationship commensurate with the teamwork shown during the incident, ii) delivering a Cure Plan to ensure restoration of the Passport System can meet the service level and iii) developing system security and business continuity recommendations with Networks. Inergi satisfied these requirements in 2005.

- **Three major utility incidents** occurred and were addressed successfully: a major surge of customer calls to the Call Centre in the spring and summer of 2003 caused an overflow of calls to internal operating units and the government; loss of the power grid throughout Ontario and the North East United States in the summer of 2003 caused loss of critical IT systems; and outage of the computer-based supply chain and work management system (Passport System) in 2004 resulted in data integrity issues and manual processing of transactions. In each case, emergency measures undertaken; restoration efforts and subsequent root cause analysis performed by Inergi were exemplary.
- **Service at lower cost** is being provided as promised. Base Service fees including adjustments for COLA, Pension & Benefits, Settlements and Market Ready Applications are forecast to fall by $12.5 M, or 10.2%, from Contract Year 1 to Year 5 (2002 - 2006).

Other Standards and Measures of Performance

In addition to service level obligations, the MSA requires that Inergi delivery of Base Services meet various other standards and measures of performance. Close oversight ensures that all such commitments are honoured; the result has been full compliance.

Networks Policies & Procedures

Inergi is required to comply with the Networks' policies as amended and Networks routinely advises Inergi of changes to pertinent policies such as Networks Safety and Environment policies or 3rd Party Access to Network Stations.

Inergi has reviewed and assumed applicable Disaster Recovery Plan and Emergency Response Plan (ERP) obligations. No lapses have been observed. Inergi demonstrates on an annual basis that all ERP plans and procedures have been tested and are effective through drills that are coordinated and witnessed by the Networks' Emergency Preparedness Department.

Internal Controls Review

Inergi is required to retain an external auditor to review and report on internal controls as contemplated under Section 5900 of the Handbook of the Canadian Institute of Chartered Accountants. Inergi has provided Networks with its Annual Internal Controls Review report for 2003 and 2004 and has executed plans to address identified control weaknesses.

Audits

Networks itself has the right to audit Inergi's operations exclusive of information related to Inergi's own costs and financial statements). Inergi is required to respond to and bring itself into compliance with any audit findings of material non-compliance with the MSA, generally accepted accounting principles or other requirements for which Inergi has responsibility. Several audits have been completed by Networks "internal audit" department, mostly as part of a larger audit of Networks business processes that are dependent upon Inergi's performance. The parties have addressed all gaps identified through these audits.

Regulations, Codes, Laws

Inergi is required to ensure that all Base Services are provided in accordance with law as law applies to Inergi and Networks. In support of Inergi's responsibilities in this regard, Networks has directed Inergi's attention to new privacy and safety legislation, and relevant proceedings and judgments from the OEB. Inergi has accepted responsibility for staying abreast of electricity marketplace evolution and related regulations.

Code of Conduct and Confidentiality

Inergi is to comply with the requirements of the OEB and applicable law as regards the protection, security and segregation of Networks' confidential information. Capgemini requires its employees and contractors to follow its Code of Conduct with respect to client business information and personal information. The Code of Conduct addresses confidentiality as it applies to proprietary, technical, business, marketing, financial and personal information about Inergi / New Horizon System Solutions / Toronto Service

Delivery Centre and Inergi's clients; disclosure of Networks' sensitive information only on direction from Networks.

Security of Information

Inergi is required to maintain physical or logical separation and security of Networks applications and data from Capgemini's other clients. Applications and data reside on facilities within Networks premises or at the Capgemini Data Centre. No other Inergi or Capgemini client application or data resides on facilities on the Networks premises. Networks applications and data at the Capgemini Data Centre reside on Networks equipment and are physically separated from other clients or, in some cases, utilize equipment shared with Capgemini with logical separation achieved through appropriate security technologies managed by Capgemini. The Data Centre is physically secure and guarded 24x7 hours per day.

Best Practices

Inergi was required to meet the programming criteria of excellence designated as CMM Level 2, by March 2004. This has been accomplished and Inergi is now focused on attaining certification at Level 3. [The Capability Maturity Model (CMM) is a method for evaluating the maturity of the software development process of organizations on a scale of 1 to 5. The CMM was developed by the Software Engineering Institute (SEI) at Carnegie Mellon University. It has been used extensively for avionics software and for government projects since it was created in the mid-1980s.]

With respect to Customer Service Operations (Billing Domain), continued performance to the international standard of ISO 9000 was required of Inergi and met in 2004. Certification for other areas within Customer Service Operations is being pursued by

Inergi. Similarly, Inergi Finance was certified under ISO 9000 standards in 2005. [ISO 9000 has become an international reference for quality management requirements in business-to-business dealings. The ISO 9000 standard is primarily concerned with "quality management". This is what the organization does to fulfil the customer's quality requirements, and applicable regulatory requirements, while aiming to enhance customer satisfaction, and achieve continual improvement of its performance in pursuit of these objectives.]

Operations Procedure Manual

Inergi was to deliver an Operations Procedures Manual by the end of the third contract year and be in a form and substance sufficient to enable Networks, or a successor outsourcer to fully assume the provision of Base Services. Inergi completed this manual for all lines of business in 2005.

Development of a Termination Transition Plan

Inergi is required to prepare termination transition plans laying out the process, effort, schedule and information requirements necessary to enable Networks or a third party to take over provision of Base Services on termination of the contract. The first such plan was completed for IT Services in 2004. The remaining five plans are to be completed in 2005 using the IT template.

Financial Guarantees

Capgemini SA is a publicly listed international consulting and information technology firm with annual worldwide revenues of approximately $9.4 billion. In May 2000, Capgemini (a public company since 1987) and Ernst & Young Consulting Services merged to form the Canadian consulting practice firm now known as Cap Gemini Ernst & Young (CGEY). CGEY was subsequently rebranded to Capgemini in 2004. Capgemini SA operates with more than 50,000 people worldwide, and is a leading management and IT consulting service provider. Capgemini US operates as part of the America's group of Capgemini SA. Inergi LP is a wholly owned subsidiary of Capgemini Canada and is the partnership vehicle created by Capgemini Canada to contract with Networks to provide Base Services. Capgemini US has provided financial and performance guarantees of the MSA.

Client Satisfaction

Inergi surveys Networks relevant business managers and internal users in respect of their satisfaction with performance of the Base Services and projects and is required to address material dissatisfaction revealed by the survey. In some cases, corrective action may require the parties to agree on process changes, incremental investments and/or changes in service levels. The scores of this bi-annual survey have recently been 3.9 out of 5 for Base Services and 4.1 out of 5 for project work.

7.0 BUSINESS RATIONALE FOR OUTSOURCING

The outsourcing solution was selected to resolve a number of business issues that Networks faced. Those business issues were:

- Improving cost competitiveness,
- Addressing a legacy payroll structure,
- Minimizing the requirement for non core capital investment, and
- Improving business focus on operations.

Networks recognized the requirement to become increasingly more cost competitive in a regulated market with external cost pressures. Hampering Networks' ability to become more cost competitive was a legacy payroll and benefit structure, which makes its labour costs higher than most of its competitors. To decrease its per unit labour costs Networks either had to invest in greater process automation or had to invest in business growth to attract additional customers to spread its fixed costs over more transactions and thereby reduce the per unit cost of services. The latter, however, would have drawn management focus away from the core electricity delivery business.

Prior to proceeding with the outsourcing initiative, Networks held discussions with various outsourcing companies. Those discussions confirmed the need to aggressively expand the existing customer base in order to obtain efficiencies of scale in customer service and IT development.

Growth would, as noted, have required either significant capital investment or diversion of senior management attention to the pursuit of new business. General market wisdom held there would only be a few successful market participants who would have sufficient business scale to be successful. To succeed, the focus would have to include all of North America and all utility markets.

Market credibility was a required ingredient to attract these new third party customers. Obtaining credibility would have required the entering into of partnership arrangements with an existing recognized outsource provider or with other companies pursuing similar strategies.

Regardless of how the growth was to be achieved, the pursuit of a growth strategy would have resulted in additional business risk being borne by the Networks business directly or indirectly. Networks management therefore chose to pursue a strategy where the business risk was transferred to a third party and where the desired savings would be guaranteed.

8.0 OBJECTIVES FOR OUTSOURCING

In proceeding with its outsourcing initiative, Networks wished to achieve the following objectives:

- Defined service levels,
- Services at lower cost,
- Access to change management and intellectual knowledge that understands Networks business and can provide benefit to Networks operations,
- Improved career opportunities for transferred Networks employees, and
- Reduced management distraction from operation and maintenance of the Transmission and Distribution system.

The outsourcing objectives as set out above are incorporated in the agreement between Inergi and Networks and serve to provide direction as the contract evolves.

- **Change management and intellectual knowledge** has been demonstrated by Inergi in re-engineering and optimizing Networks business processes in order to meet Inergi's pricing commitments. With Inergi's expertise in the Customer Service Operations, Networks has been able to meet all timetables for changing billing and pricing imposed by Bill 210, Bill 4 and Bill 100 and Inergi has responded with the appropriate resources to address associated increased customer call handling demands. Inergi successfully completed the complex task of migration of Networks' Data Centre operation from IBM without incident and now offer Data Centre services at pricing below IBM's prices to Networks.
- **Improved career opportunities for transferred Networks employees** have resulted from Capgemini US transfer of its own back-office processing to the Markham

Accounting Centre (MAC). Sixty-eight (68) additional jobs have resulted for the PWU membership; Eighty-nine (89) employees are located at the MAC. Of this total, Seventy-seven (77) were employees redundant to Inergi's needs. Capgemini is also in the process of investigating the movement of IT processing workloads from its US work centres to its newly established Data Centre location in Mississauga.

- **Improving business focus** on Networks operations has been achieved with the reduction of Networks management time spent on monitoring and controlling transactions, labour management and operational direction with a commensurate increase in time spent on core T&D business. To effectively manage the outsource service provider and the delivery of service under the contracts Networks has established small scale vendor management resources within each line of business and a centralized team of contract management professionals that carry out overall management of the contract, contract amendments, formal governance, remedies, fees and the relationship. Across Networks and including functional support from Finance, Law, Procurement, HR, etc., the full time equivalent of sixteen Networks staff are engaged in contract management, representing about 1.4% of the contract value.

(The 2004 World Outsourcing Conference reports average outsourcing contract management costs ranging from 3% to 6% of contract value.)

9.0 OUTSOURCING PROCUREMENT PROCESS

In November 2000, Networks considered options to reduce costs for non-core functions through various discussions with potential partners. These discussions progressed over the next 8 months with a variety of potential partners and outsource service providers. Networks identified two qualified candidates, Accenture and CGEY. Inergi LP is the partnership vehicle originally created by CGEY to contract with Networks to provide Base Services.

In the late Spring and Summer of 2001 Accenture and CGEY conducted due diligence on the potential of providing a range of internal services to Networks through an outsource arrangement. The due diligence period took place over 60 days during which each proponent revised and re-crafted their proposals. Accenture and CGEY were provided with due diligence packages consisting of financial and staff information on which to base their business proposals. The two companies were asked to provide competitive bids and to respond in a predetermined format. Networks developed a request for proposal format that permitted it to evaluate proposals on a comparable basis. Both parties were requested to provide their responses in accordance with the requested formats. Both companies were aware they were competing in a competitive process against the other.

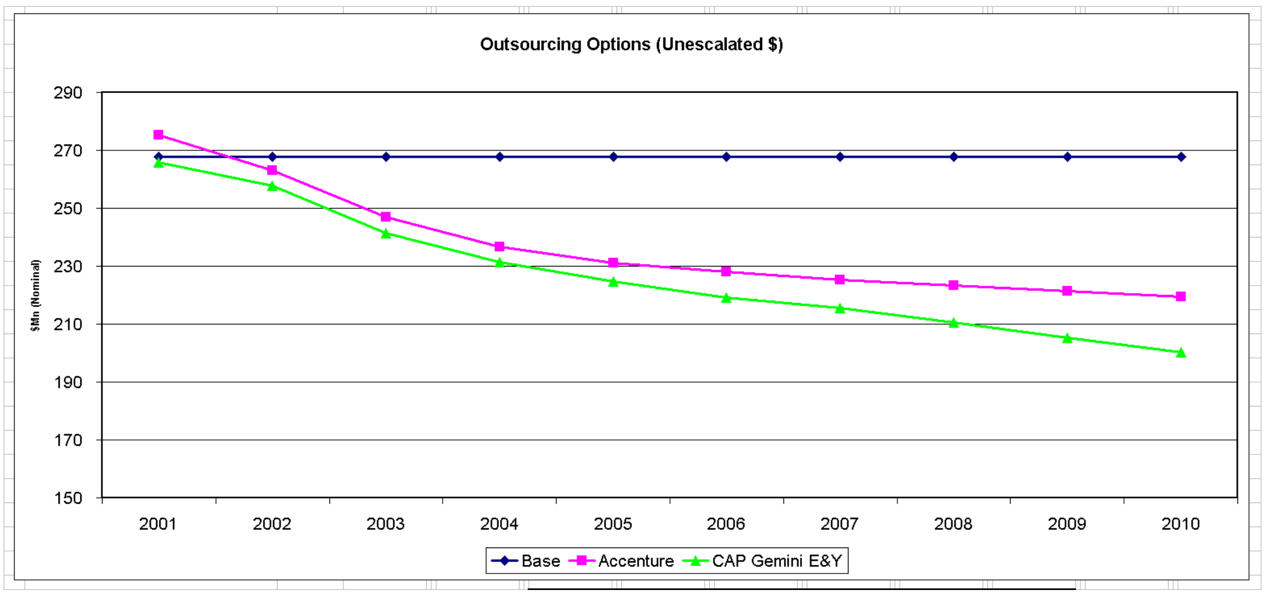
Both parties spent a significant amount of time talking with the various Networks service line managers who potentially would be in receipt of their services, discussing organization structure, operations and performance requirements and developing a detailed understanding of the business.

Both Accenture and CGEY presented their confidential and proprietary business proposals to Senior Networks management. On the basis of these bids (which were to be confirmed through a next phase of due diligence and through the negotiation of binding agreements) it was concluded that savings could be realized. Senior Networks team members who would be the service recipients provided an independent assessment of the two proposals based on the merits of the proposals.

The graph below shows the financial analysis of the two bidders proposals compared against one another and shows the CGEY proposal to be lower than Accenture. Both proposals exclude procurement savings as a result of Strategic Sourcing.

Graph 2

Comparative Financial Analysis



On the basis of the written proposals and other discussions with the two proponents it was concluded that Networks would undertake negotiations with CGEY for the provision of services in the following areas:

- Customer care, including billing , call handling, accounts receivable and collections,
- Settlements,
- Information technology services, including desk top support, application development, system operations,
- Finance, accounting and accounts payable,
- Payroll,
- Inventory management, and

- The management of hazardous waste.

In addition the company undertook the negotiation of a consulting assignment with CGEY respecting the implementation of Strategic Procurement processes that would have the impact of reducing the cost of procured goods and services.

Networks decided that in addition to price reductions, service quality would be maintained at defined service levels at or better than historic service levels. By contracting with a party that had aspirations to maintain these functions as a core to their outsource service business Networks could gain access to best outsourcing practices and intellectual capital it might otherwise not have available to it.

Management recommended to the Board of Directors that Networks engage in a second phase of due diligence and enter contract negotiations for outsourced service arrangements with CGEY. The proposal from CGEY was deemed superior, in summary, due to (a) experience with the Networks unions; (b) instant benefits of scale and employment opportunities from the Markham Accounting Centre proposal to incorporate CGEY's own North American back office services within the Work; (c) the strong credibility of the proposed Call Centre subcontractor Vertex; (d) better economic returns flowing from the Strategic Procurement proposal.

The internal business case to move forward with the outsourcing arrangements is described more fully in Appendix A.

CGEY has specifically recognized the unique nature of providing service to a unionized and regulated business and has committed to implement any requirements of the OEB and applicable laws. CGEY has also agreed during the life of the agreement to allow Networks, its internal or external auditors, or any applicable governmental authority the right to verify the compliance with all applicable laws including OEB standards and requirements. The knowledge, understanding and willingness to comply with OEB standards provides additional confidence that CGEY is a knowledgeable provider of services and recognizes the rules under which its operating behavior must be governed.

In order to address concerns that it did not have sufficient outsource service experience with customer care and call centre operations, CGEY has retained Vertex Customer Management (Canada) Limited, a wholly owned subsidiary of Vertex a UK based business process outsourcing company owned by United Utilities (85%) and CGEY (15%, since divested). Vertex is a large customer relationship management and call centre operation in the UK handling 14 million client customers annually and 106 million calls, printing and sending out 36 millions bills and processing 93 million payment transactions to a value of over £6 billion. Vertex Canada has entered into a separate sub contractor agreement with CGEY to provide management expertise for customer relationship management, including call centre outsourcing operations, for Networks.

On October 12, 2001 the Hydro One Board of Directors approved management's recommendation that Networks proceed to a second phase of due diligence with CGEY and that negotiations commence respecting outsource service agreements.

To undertake this task, negotiation and due diligence teams were established that would lead the process of confirming in detail:

- Services that would be outsourced,
- Service levels that would be provided,
- The current cost associated with the provision of those services,
- The employment positions and employees associated with services that would be outsourced and retained,

- Issues pertaining to pension, benefit and post retirement benefit obligations retained by Networks or assumed by the outsource service provider including obligations for past service periods,
- The interaction that would exist between outsourced and retained services, and
- The many contract terms and conditions that would apply through the future contractual relationship.

Negotiations took place between October 2001 and January 2002. An agreement in principle was reached on December 28, 2001 and a Master Services Agreement, Statements of Work and supporting schedule, were signed on February 8, 2002.

Outsourcing Process

To assist Networks in the development of an outsourcing agreement, Networks retained various experienced outsourcing consultants and practitioners to develop the material needed to assist in the preparation of proper service agreements. The process undertaken included identifying the services to be provided in each functional area, describing the services requirements, assessing the current performance measurement criteria, the service target levels, the base line performance, cost drivers, the performance drivers and identifying existing opportunities for improvement. These documents were used extensively in the preparation of the Statements of Work and as the basis for further documentation prepared during the Transition period.

The external consultants also provided input into the negotiation process and helped in developing the contract sections covering performance remedies, cost adjustments, change management and benchmarking.

Networks retained experienced external legal counsel from Osler Harcourt & Hoskins and consultants from Pricewaterhouse Coopers to assist in the above work.

10.0 Contract Summary

Overview:

In 2002, Networks entered into a 10-year Outsourcing arrangement with CGEY to provide business process and information technology services. The service contract was predicated on "same service/volumes for a declining price for Base Services in each of the agreed service areas."

Document Objective:

This document provides a summary of the Master Services Agreement (MSA) signed on December 28, 2001 between Hydro One Networks Inc. and Inergi LP. This document outlines the structure and sections of the MSA and its schedules and highlights the intent and requirements of various sections.

The MSA covers the 10-year, approximately $1Billion outsourcing agreement between the Networks and Inergi. The outsourcing agreement covers the following service areas (referred to as Statements of Work (SOW):

- SOW 1: Customer care or Customer Service Operations (CSO)
- SOW 2: Supply Chain or Supply Management Service (SMS)
- SOW 3: Human Resources & Payroll (HR Pay)
- SOW 4: Information Technology or Inergi Information Technology (IIT)
- SOW 5: Finance & Accounting (F&A)
- SOW 6: Settlements

Base Services under these SOW's were largely performed by Networks prior to the MSA. Each SOW describes 'what' service Inergi delivers and Networks expects. Each SOW is further broken down into Domains to describe detailed functional services.

Structure of the MSA:

The MSA is structured as follows:

- MSA
- Schedules to the MSA, which include exhibits and tables
- Statement of Works

Master Services Agreement (MSA):

The MSA is organized into segments called Articles, which outline the details of the outsourcing agreement.

General Articles:

The initial Articles deal with various terms of transition, which were carried out in 2002. This section also calls for the development of an Operations Procedure Manual (OPM) by the 3rd anniversary to guide the parties in their relationship. It also covers topics like Networks assets and restrictions on use, consents regarding Networks assets, replenishment of assets, client service area - access and renovations, assumed and managed contracts, data centre contract, shared service centre and equitable adjustments. Inergi is required to set up a Shared Service Center in Toronto at no cost to Networks.

Services:

This article covers aspects like Scope of services, participation agreement, participation and affiliation, policies and guidelines, emergency and disaster plans, and exclusivity. Inergi provides all the services as noted in Statement of Works that were not retained by Networks and that were provided by transferred employees during their normal course of employment for the 12 month preceding the agreement. Inergi is required to comply with all Networks' policies and guidelines and to assume both the emergency response plan and the disaster recovery plan. Inergi was required to develop a termination transition plan for an orderly, cost efficient and timely wind down and transition of services for each SOW.

Service Levels:

This article covers the intent on service levels and provisions around service level reporting and failures, customer satisfaction surveys, and planning and improvements to service levels. They contain the measurable level of service Inergi provides to Networks against a defined volume. Service levels describe measurable events specific to each Domain (e.g. average speed of answer by the Help Desk). Each Service Level has a Remedy Point. Performance worse than the Remedy Point results in development of a cure plan and/or a penalty. Service Levels within each Domain are organized into 3 Tiers with Tier 1 having the highest level of importance. Each SOW contains a number of volumetric measurements called Resource Units to measure, and adjust if required the volume of service.

Governance:

This article describes the governance structure between the parties for the outsourcing deal including procedures for dispute escalation and resolution. The following are the main governing committees:

- Executive committee: comprised of 3 managers (2 Networks, 1 Inergi) with responsibility for oversight and management of overall relationship between the parties
- Steering committee: comprised of minimum 6 managers (3 Networks, 3 Inergi) with responsibility for oversight and planning for services and service changes
- Operations Management committee: comprised of 2 managers (1 Networks, 1 Inergi) with responsibility for overall and ongoing management of the operations

General Articles:

There is an article that covers various aspects around Intellectual Property. In it the parties grant each other a non-exclusive, non-transferable right and license during the contract term for the sole purpose of providing services and fulfilling obligations under this agreement. There is further an article which details the rights and obligations of the parties concerning audits, the rights to audit, compliance and insurance. The MSA contains an article in which the rights and requirements related to confidential information is detailed. This article includes the obligation of Inergi to with the laws and requirements of the OEB as relates to confidential information. There are also articles which cover such standard deal issues as Fees and Charges, Warranties and Covenants, Indemnities and Limitations of Liability.

Term and Termination:

This article talks about the term and aspects around renewal, and termination under different circumstances. Key provisions are:

- Term is for 10 years, unless terminated early
- Termination for cause of a SOW or SOW's can be invoked by the parties in case of a material breach by the other party
- Termination of a Service Domain or SOW in case Inergi is in a service level default situation as a consequence of failure to achieve Service Levels
- Parties will work towards mitigating all termination costs and undertake an orderly termination

11.0 APPENDICES

Appendix A: Outsourcing Business Case Summary - January 2002
Appendix B: IT Benchmarking Study - PA Consulting - July 2005

OUTSOURCING BUSINESS CASE SUMMARY

JANUARY 2002

APPENDIX A

BUSINESS CASE SUMMARY (BCS)

January 31, 2002

Project Name: Project Excel – E Business Outsourcing Project

Information Update

Hydro One has completed negotiations with Cap Gemini Ernst & Young (CGEY) in respect to the outsourcing to Inergi LP, a wholly owned subsidiary of CGEY, of the following services:

- Call Handling and Customer Care
- Billing
- Supply Chain
- E-Enabled transactions including ETS supported functions
- Back office – Payroll and Finance

The agreement reflects in all material respects the agreement in principal reached with CGEY December 28th, 2001

Agreement Terms

The contract has a term of 10 years. At the end of the term Hydro One' may renew for a further 3 years.

The contract has a nominal value of $1.2 billion.

If after the 3rd year Hydro One decides to exit the contract before term it may do so on payment of certain penalties.

Agreement in principle was reached with CGEY on December 28, 2001 and the contract commencement date is March 1, 2002.

Inergi LP will assume 921 (812 full time and 109 part time employees) unionized and non unionized Hydro One staff (21% of Hydro One's existing staff complement). Hydro One will retain the assets and systems required to operate the outsourced services.

A summary of the terms of the agreement is attached in Exhibit A.

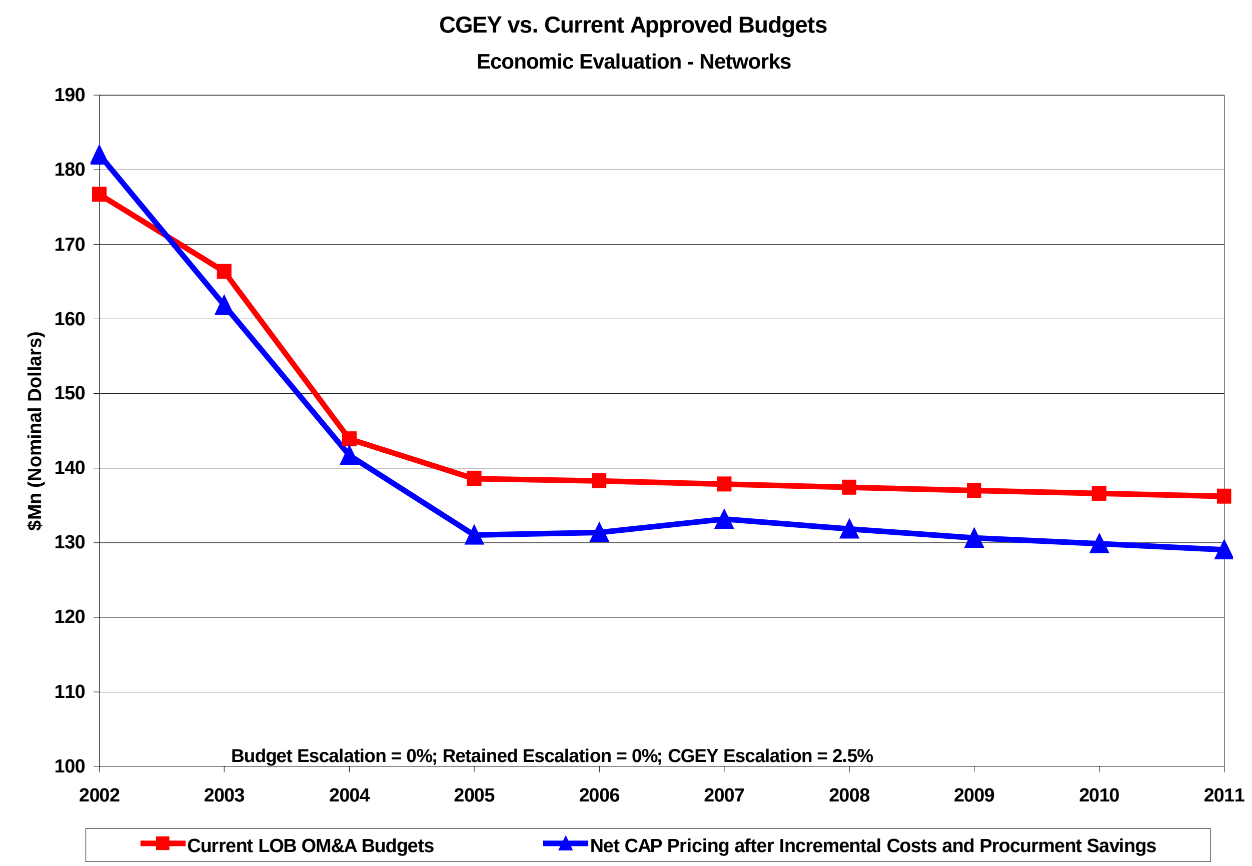
Results to be Delivered

Hydro One will receive:

- Defined service levels and performance measurement.
- A lower overall cost of service.
- Access to state of the art processes, change management and intellectual knowledge.
- Enhanced career opportunities within CGEY for transferred employees.
- Allow Hydro One to focus on core business skills relating to operating and maintaining Transmission and Distribution.

Background

The decision to proceed to outsource these functions to CGEY was made after an extensive process which included discussions with Onex, IBM, CGI, and Customerworks and Accenture regarding various options including partnership and the outsourcing of one or more elements of the in-scope services. CGEY was selected following a competitive bidding process with Accenture. CGEY was selected on the basis of its business proposal, including service provision, labour guarantees, technical skill, risk mitigation, and pricing. The selection of CGEY was made by senior Hydro One management based on the evaluation and recommendations of the line management who will be responsible for the areas that CGEY will provide the services for. The comments of PWU and Society union representatives were also considered. Since October 17th Hydro One and CGEY have been involved in contract negotiations, the completion of extensive contract documentation, and in the development of detailed statements of work for the services being provided.



Financial

The agreement has the following financial impact to Hydro One Networks Inc.

- The NPV of the guaranteed benefit is $24 million over the life of the agreement. This includes savings that HONI will make through strategic sourcing, guaranteed growth royalties from CGEY, and is net of incremental costs associated with the transaction.

- The original CGEY proposal as compared to the original Accenture proposal provides better financial results through lower OM&A costs and higher financial guarantees for supply chain savings. The overall NPV of the original CGEY proposal exceeded the Accenture proposal by approximately $30 million. Since October 5th CGEY has reaffirmed its OM&A pricing which has remained effectively unchanged from its original proposal. CGEY will assume the business risk and responsibility for achieving the cost savings.

- The Line of Business budget for HONI above is presented in comparison to the projected budget including pricing from CGEY. The CGEY pricing assumes inflation at the rate of 2.5% over the life of the agreement. The current HONI budget assumes that all inflation is absorbed against improved productivity. The CGEY proposal assumes that cost reductions are obtained through business process efficiencies and redeployment of staff to other clients. The HONI budget does not include any amount for severance.

- The incremental cash costs associated with the contract amount is $10.4 million in 2002, $10.7 million in 2003 and approximately $2 million per year thereafter. The net present value of these incremental costs is $28.8 million over the life of the contract. The costs for 2002 and 2003, which relate primarily to pension costs associated with the transfer of staff, will be charged to operations in 2001 as a one-time charge associated with exiting the business. As a result of splitting the pension plan, HONI will incur pension charges in 2002 and 2003 which it would not have otherwise incurred had the pension plan remained whole and the pension holiday been available to the transferred employees.

- CGEY has guaranteed the savings related to the strategic sourcing procurement process of $65 million (NPV $40 million). Hydro One expects that it can achieve total, organization-wide procurement savings of $110 million (NPV $62 million) through leveraging the CGEY team based buying approach. CGEY will also guarantee royalty payments to HONI associated with the growth of Inergi LP in the amount of $17.5 million (NPV $11 million). In total, the forecast procurement savings and royalty payments have an NPV of $73 million.

- Inergi LP has provided a competitive IT project consulting fee schedule for Hydro One IT projects

- Hydro One and CGEY have agreed to the structure and calculation of marginal cost increases and decreases resulting from changes in service levels or material volume changes.

- Hydro One will bear the financial risk associated with using an inflationary index based on the Ontario Labour index. Over 10 years this index exceeds CPI annually by approximately 0.5%.

Even with the guaranteed savings from the Inergi LP contract, HONI's budgeted operating costs may exceed the business plan in 2004 and 2005. In order to meet its budget HONI may require access to the Hydro One contingency amount for those years.

Qualitative Factors

In addition to the financial factors above the agreement includes certain qualitative factors. These include:

Guarantee of Cap Gemini Ernst & Young US

- CGEY US has guaranteed the performance of Inergi LP during the 24 months after the commencement date and at the end of term.
- CGEY US has provided a financial guarantee equivalent to 12 months fees to a maximum of $125 million throughout the term of the agreement.

Provision of New Work (Merlot)

- CGEY has legally committed to move a shared service centre to the GTA providing not less than 150 persons of similar full-time work, which is currently being performed for CGEY by Ernst & Young

(Merlot Commitment). An additional 150 persons of work may also be transferred to the shared service centre during term of the agreement, however CGEY is not legally bound to create these jobs. Redundant staff from Inergi LP will be eligible for positions in the shared service centre. The Merlot Commitment was highly regarded by both unions

Service commitment by CGEY to Hydro One

- CGEY has stated that a core business service will be to provide outsourcing services to utility companies. Hydro One with OPG and Bruce Power (New Horizons) are keystones to the development of this market presence in North America. A failure to obtain a significant market share and volume of business may reduce CGEY's enthusiasm to support these services in the event that Inergi LP proves to be unprofitable.
- The services agreement includes certain performance remedies, escalating service failure penalties which could lead to Hydro One terminating the contract. While this option exists it is unlikely that Hydro One would take this action
- CGEY has committed to provide existing service levels in accordance with certain performance metrics that will be more fully defined, subject to changes requested by Hydro One. In the transition period CGEY will provide services on a business as usual basis as both service levels and metrics are better defined.
- Employees providing services to Hydro One after the commencement date will be the same employees that had previously provided the same services to Hydro One. Similarly, Management staff will be the existing staff who had provided supervisory and management direction before the commencement date.

Migration of services to CGEY/Inergi LP

- CGEY has had experience migrating similar services in the Ontario utility environment with both the Society and PWU. The experience gained by CGEY with OPG reduces the risk with transferring operating services from Hydro One to CGEY.
- CGEY has received the acceptance and support of the PWU and the Society to proceed with the outsourcing. The approval should lead to a smooth transition of unionized staff to Inergi LP. It is expected that the majority of transferred management staff will accept their transfer, however if less than 97.5% of transferred staff accept then either CGEY or Hydro One may terminate the agreement.
- Staff providing the functions to Hydro One will be knowledgeable Hydro One staff managed by Hydro One management staff, working for CGEY, as supplemented by CGEY staff.
- CGEY has developed an extensive migration plan that has been reviewed and agreed to by Hydro One line management.
- CGEY has developed and Hydro One management has approved transition principles applicable to the first 6-12 months of the contract. A complete transition plan will be developed within 60 days of the contract commencement. During the transition period Hydro One and CGEY will work to better define service levels, performance metrics and marginal costs associated with each line of business. At the commencement of the contract certain metrics and data will exist for each line of business which will be verified.

Regulatory/ Benchmarking

- CGEY will, in years 3, 6 and 9, benchmark service costs to ensure cost competitiveness of similar 3rd party services. The benchmarking is a one way process that will reduce service costs which are in excess of market prices. At issue will be the ability of a third party benchmarker to obtain proper comparisons to the services provided for comparable sized companies with unionized employees.
- CGEY is committed to work with Hydro One to address any regulatory changes specifically identified by the OEB or to work with Hydro One to reduce costs in accordance with general regulatory reductions imposed by the OEB.

CGEY's knowledge of Hydro One's Systems

- CGEY's prime subcontractor for the customer call centre is Vertex (owned 13% by CGEY). Vertex, a UK based company, has extensive utility call centre operations experience and is familiar with the Customer 1 billing system being operated by Hydro One.
- CGEY has worked with Hydro One on a variety of IT related and business process assignments and as a result CGEY knows the management and staff that it will be managing.
- CGEY understands the Ontario electricity market and the issues surrounding market opening.

Flexibility

- The agreement has been structured to allow for growth or reduction in services as needed over the 10 yr. Life and provides operational flexibility through a defined change management process. While this flexibility exists for the growth or divestiture of the various business units there are, however, financial costs and additional complexities associated with divestitures or business changes that significantly change service levels.

CGEY Commitments

- CGEY will assume the operating risk associated with Hydro One back office operations and the management of 921 transferred employees.
- CGEY will assume the financial risk for obtaining the efficiencies required to meet the operating savings provided to Hydro One.
- CGEY is responsible for providing defined service levels and will incur defined penalties for performance failure. While CGEY may be penalized for performance failure, customers will still perceive the failure to be as a result of Hydro One's actions.
- CGEY will adhere to Hydro One's Emergency Response Program.
- CGEY will continue to provide services in the event of a strike and has provided a work around plan to do so. There is no certainty, however, that the work plan will ensure that service to Hydro One is not significantly impacted in the event of a labour disruption.

Best In Class

- Outsourcing represents a significant milestone towards a demonstration of Hydro One management's objective of moving to best in class performance.

Specific Risk Analysis and Mitigation

IPO

- Performance issues will be magnified due to IPO attention. CGEY has committed to enabling Hydro One to meet its IPO needs. Failure by CGEY to perform the contracted services will reflect badly on CGEY's ability to obtain new 3rd party client work. Inadequate performance by CGEY will also negate CGEY being awarded further consulting work by Hydro One. Regardless, however, Hydro One will be at greater risk during this period.

Market Opening

- Hydro One is unable to operate at market opening due to a failure by CGEY. This would reflect badly on Hydro One and could delay market opening. CGEY staff providing services to Hydro One comprises the existing Hydro One staff who understand the electricity business and Hydro One's operations and customers. CGEY has committed to leaving IT systems "as are" for a period of 30 days prior to and 60 days after market opening. Existing plans with respect to market opening, developed by Hydro One, will be implemented by CGEY.

Financial Risk associated with Inergi LP business plan

- Inergi LP's business plan for the Hydro One services forecasts a reduction in head count due to technology improvement and change management. Redundant staff would be employed on new client work or in the Merlot Commitment. The Merlot work enhances the economic viability of the

Inergi LP business plan. As noted above, the Hydro One contract is being guaranteed by CGEY US and CGEY Canada.

Structuring of the agreements

- Hydro One staff is responsible for daily operations. The teams have built heavily on the expertise of internal staff recruited from outside the organization who have experience in an outsourcing environment and in the development of the required contracts. Hydro One teams have been supplemented as required by outside experts who have knowledge working in an outsourced environment. These teams have been developing performance data and were actively involved in assessing and developing the individual Statements of Work and in the contract negotiations.

Contract Evolution

- The agreements will evolve over the term of the contract and will undergo significant change. While mechanisms and governance exists to track those changes, managing the contract and Inergi LP are crucial to obtaining the identified savings and performance. Much of the success of the contract to Hydro One is dependent on successful change management wherein Hydro One moves to become a smart buyer of services previously provided internally.

Involvement of Hydro One in obtaining savings

- Achievement of additional savings identified in the supply procurement area are dependent on Hydro One adopting and adhering to the team based buying approach being proposed by CGEY. Hydro One management responsible for this function will be measured against the achievement of those savings. However, there is the risk that the additional savings identified, in excess of the CGEY guaranteed savings, will not be achieved.
- Additionally, the deal relies on the realization of efficiency savings in the retained portions of the out-sourced departments.

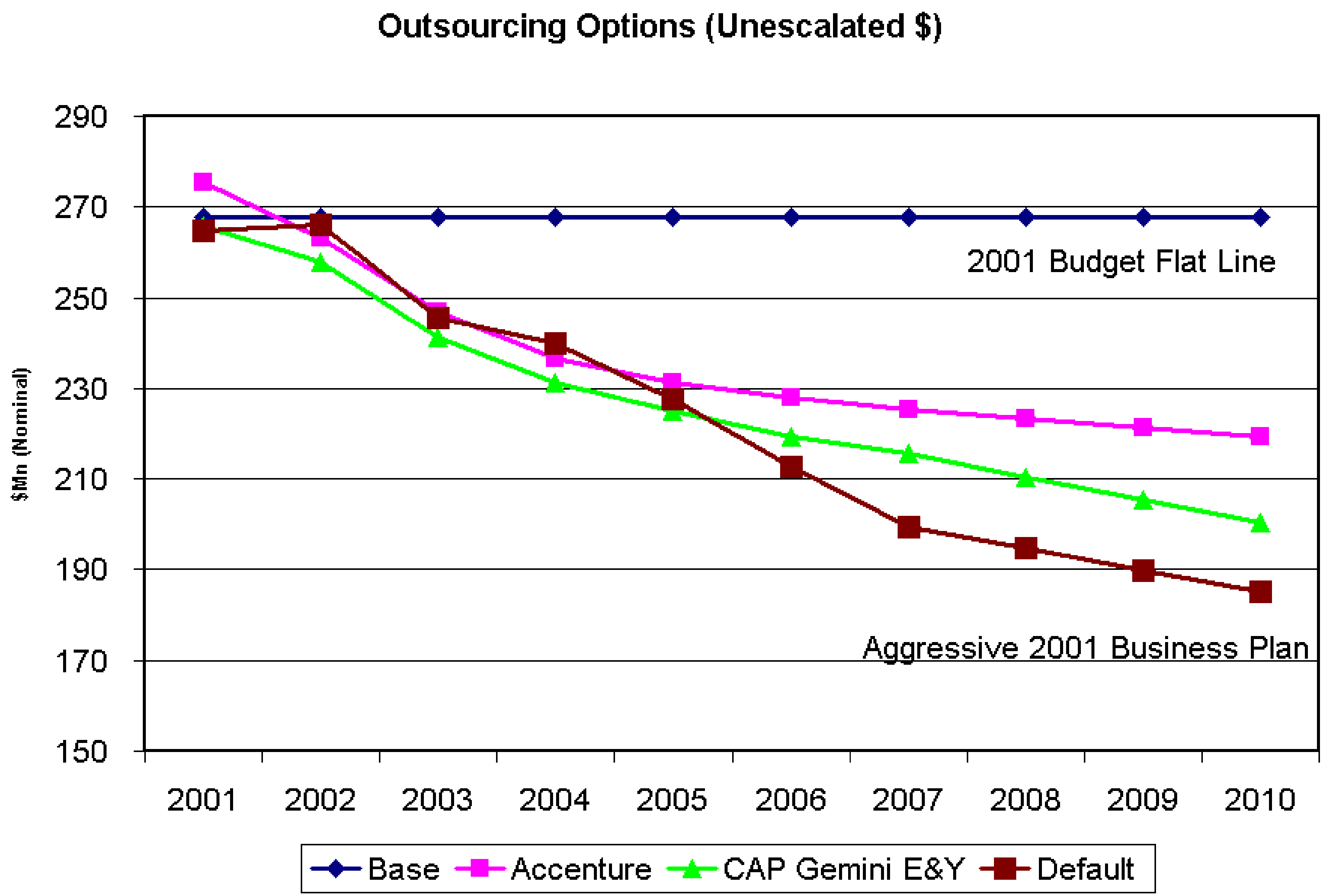
Exhibit A

	CGEY
Term	• 10 years, benchmark price check at year 3,6,& 9
Scope	• IT, SMS, CSO, Finance, HR • CSO managed by Vertex for CGEY • In use assets to be retained by Hydro One. Hydro One and CGEY will determine best approach for ownership of assets refreshed
Management	• Hydro One team supplemented in selected areas. Senior members join Inergi LP
Unions	• 2-year job guarantee. No anticipated downsizing due to Merlot project • Collective agreements go as is • Automatic transfer of PWU and Society to Inergi LP • MCP staff to be offered employment on the same conditions
Pension	• Transfer on solvency basis with potential top up in yr. 3 • Hydro One funds actual annual cost $7.3 M: Yr. 1-3 then reset
Financial	• In scope OM&A Yr. 1 - $ 133M: Yr. 10 - $89 before CPI and PST. Total costs including In scope and Out of Scope costs reduce from Yr. 1- $185M to Yr. 10- $122M • Separate agreement covers Strategic Sourcing Project • Average wage index for Ontario to be applied as Inflation index applicable to CGEY service fees
Regulatory Risk	• Inergi LP assumes market price risk except for risk on market ready asset costs and commits to work with Hydro One on other regulatory decisions
Service Levels	• Maintain at existing levels with defined remedies for performance failure
Ownership	• New entity to provide services will be 100% owned by CGEY – Financial guarantee provided by CGEY US

Hydro One Inc - Project Excel

Amalgamated Summary

(all numbers in $Mn)		2001 Base	2002 Forecast	2003 Forecast	2004 Forecast	2005 Forecast	2006 Forecast	2007 Forecast	2008 Forecast	2009 Forecast	2010 Forecast
Extrapolated Base Case (no savings)		**268**	**268**	**268**	**268**	**268**	**268**	**268**	**268**	**268**	**268**
Default (Internal Hydro One) Case ($Mn)											
Estimated Default Costs		265	255	241	232	217	203	197	192	188	183
Estimated Severance Required		-	12	5	8	10	10	2	2	2	2
Total		**265**	**266**	**246**	**240**	**228**	**213**	**200**	**195**	**190**	**185**
Benefit of Default vs. Base Case		**3**	**1**	**22**	**28**	**40**	**55**	**68**	**73**	**78**	**83**
Accenture ($Mn)											
Revised Partner Costs (Partner Revenue)		158	155	141	133	131	131	131	131	131	131
Remaining Hydro One Costs		117	108	106	103	100	97	94	92	90	88
Extraordinary Pension Costs		-				-	-	-	-	-	-
Gross Total Costs		**275**	**263**	**247**	**237**	**231**	**228**	**225**	**223**	**221**	**219**
Benefit of Accenture vs. Base Case		**(8)**	**5**	**21**	**31**	**37**	**40**	**42**	**44**	**46**	**48**
Benefit of Accenture versus Default Business Plan		**(11)**	**3**	**(1)**	**3**	**(4)**	**(15)**	**(26)**	**(29)**	**(31)**	**(34)**
	$183										
CAP Gemini E&Y ($Mn)											
Revised Partner Costs (Partner Revenue)		136	135	123	116	113	111	110	108	105	102
Remaining Hydro One Costs		130	123	118	115	112	108	105	103	101	98
Extraordinary Pension Costs		-	-	-	-	-	-	-	-	-	-
Gross Total Costs		**266**	**258**	**241**	**231**	**225**	**219**	**216**	**211**	**205**	**200**
Benefit of CAP vs. Base Case		**2**	**10**	**26**	**36**	**43**	**49**	**52**	**57**	**62**	**67**
Benefit of CAP versus Default Business Plan		**(1)**	**8**	**4**	**9**	**3**	**(6)**	**(16)**	**(16)**	**(16)**	**(15)**
	$229										


Outsourcing Options (Unescalated $)
$Mn (Nominal)
290
270
250
230
210
190
170
150
2001 Budget Flat Line
Aggressive 2001 Business Plan
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
Base
Accenture
CAP Gemini E&Y
Default

IT BENCHMARKING REPORT

PA CONSULTING

APPENDIX B

Appendix B

Exhibit C1 Tab 3 Schedule 1

IT Benchmarking Report

A Review of the Hydro One-Inergi Information Technology Pricing

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8/10/05

FOREWORD

This report was completed in response to a request from Hydro One and Inergi to conduct price benchmarking of its Information Technology Statement of Work (SOW) within the outsourcing arrangement. The SOW covers the operations and support of the IT infrastructure, end user services and ongoing sustainment of existing applications that were outsourced to Inergi. Contractual obligations allow that the prices be benchmarked periodically to validate their adherence to market prices.

This report presents the results of a customized benchmarking. The project consisted of development of data input instrument and soliciting participation of entities with similar arrangements in the North America, and consolidation and analysis of the results. Additionally, existing ancillary data, both government and private were used to normalize participant data and to make like-for-like comparisons. The participant data was used to develop the Fair Market Value range and average price to which Hydro One prices were compared. Ultimately, the IT outsourcing financial arrangements were benchmarked and evaluated.

PA is a multi-disciplinary consultancy operating primarily in North America and in Europe both in private markets and government space. PA Consulting is a sixty year old, employee-owned, global consultancy and our position in the consulting market is based on independent advice.

Our competence to provide benchmarking evaluation is based on the following:

- Multi-level expertise in the development, negotiation and evaluation of outsourcing arrangements between clients and suppliers
- Extensive benchmarking experience of the utility industry in North America and Europe during the past 15 years
- Ability to organize a benchmarking survey to collect and successfully analyze appropriate data
- Experience in performing the Information Technology audits
- Experience in the regulatory and litigation processes assisting either utilities or regulatory commissions
- Deep knowledge of the utility industry and the Information Technology space
- Practical experience in performing a wide variety of projects both within the utility industry and IT
- Multi-disciplinary team of seasoned consultants who participated in the development of this report

Specific references can be provided on request.

LIMITATIONS

Disclaimer

While every effort has been made to ensure that the data enclosed in this report is correct and accurate, PA Consulting is not responsible for any omissions and inaccuracies. Proper care must be undertaken when interpreting and using any of the data as well as findings included in this report.

Caveats

The data provided in this report has been obtained based on responses from surveyed companies providing certain type of Information Technology (IT) services in North America. The surveyed companies do not constitute a statistically (in a strict sense of the word) valid sample based on size, type, and company location.

However, the data is deemed useful and representative of IT offerings received by clients in North America due to the design of the data input form, the number of data points and auxiliary reports and comparisons to PA Consulting group experience. The data is most useful to provide ranges of values rather than be a guide for exact values.

All findings were based on the data available at the time of analysis.

All pricing is in Canadian dollars. Any data from U.S. participants was converted using a factor of $1 CDN equals $0.8065 US based on *2005 Q2 Corporate Exchange Rates* as published by PA's Corporate Tax and Treasury department.

Confidentiality

PA Consulting Group served as an impartial third party for the purpose of assimilating and collating the data. All results are presented anonymously to preserve the confidentiality of the participants. ALL PARTICIPANT DATA WAS HELD IN STRICT CONFIDENCE AND AT NO TIME WAS THE IDENTITY OR DATA OF ONE PARTICIPANT SHARED WITH ANOTHER, INCLUDING HYDRO ONE AND INERGI DATA.

Legal Advice

While PA Consulting Group is well qualified to comment on typical IT outsourcing arrangements and make observations on issues of benchmarking from the perspective of what is currently in use in the industry, PA Consulting Group is not qualified to render legal advice. For any legal questions, the readers are encouraged to engage appropriate counsel to review any contractual issues.

TABLE OF CONTENTS

1. EXECUTIVE SUMMARY

Introduction

PA Consulting ("PA") was asked to perform an Information Technology ("IT") Benchmarking Survey Project ("Project") by Hydro One ("Client"), a regulated utility operating transmission and distribution networks in Canada and by Inergi ("Supplier"), the service provider engaged in delivering IT services to Hydro One under the outsourcing agreement. The Client outsourced selected IT services for a 10-year agreement. The contract allows parties to benchmark charges at the three, six and nine year points in the agreement. The benchmarked pricing is intended to be an estimate of the Fair Market Value ("FMV") range charged for such services. PA was asked to design and conduct the benchmarking to determine the Supplier pricing in relation to the 50th percentile of the estimated FMV range.

The Client and the Supplier established contractual conditions to conduct this benchmarking and subjected this process to several conditions. The scope of services provided by the Supplier to the Client included the following domains:

- Application Support and Maintenance
- Infrastructure including the following services: Mainframe, Unix and Wintel Servers, Storage, and Database
- End User Services including the following services: Personal Computer support (PCs): Installs, Moves, Adds and Changes (IMACs); and Help Desk
- Cross-Functional services and charges including the following: 3rd party contract management, managed contracts, assumed contracts, and fixed labour
- Projects

The first three domains were benchmarked; the last two were deemed too specific to each company to be comparable and were not benchmarked.

Project Approach

The approach to benchmarking was to create a customized data input form and use it to gather data from a set of qualified participants.

To identify participants, PA conducted a survey of known IT outsourcing arrangements. A best effort was made to select participants that had characteristics of their outsourcing that were the closest match to the Client's. Ultimately, there were ten participants in the benchmarking sample including the Client. Four data points were from Canada and six from the U.S.; altogether two were unionized. Data was collected from participants using a structured form and follow up interviews. All data were normalized to the Client's environment.

Requested data were defined within each form so that participants had clarity regarding the meaning of each data point. In addition, PA Consulting held a dialogue with each of the participants to get more in-depth understanding of their data and to ensure consistency.

PA then compiled results while maintaining the anonymity of all the participants. The data was used to determine the FMV for an IT outsourcing of the same size and scope as the Client's. In this report the 50th percentile of the FMV was defined as the average of those data points collected in the marketplace.

The participant prices were normalized to the Client environment to the extent that the factors were known or could be estimated. There were some additional intangible factors that affected and influenced uncertainty about price ranges. These latter factors and their potential impacts on prices were discussed, but no adjustments were made using them.

Findings

There were three distinct steps in the data analysis process for the Client and each participant:

- Development of normalized monthly unit prices within each service domain
- Development of the annual FMV price range for each service domain
- Development of the overall annual FMV range for all service domains

Results from the last step are summarized below.

Table 3.1 Overview of IT Services Provided to the Client			
Domain	**Service**	**Fair Market Value (C$)**	
IT Outsourcing Services	**Annual Price to Hydro One (C$)**	**Range (+/- 1S.D.)**	**50% Percentile**
Total	**$50,855,770**	**$44,417,865 to $56,264,242**	**$50,341,054**

The Client base figure is fully loaded and includes the base fees (year 4 of the contract with agreed changes as of April 1, 2005), the associated pension and benefits costs, the monthly volume adjustments (ARCs/RRCs), COLA adjustments, and costs for those incremental applications still in interim sustainment

Regarding the Client –Supplier contract benchmarking distribution:

- The benchmarked services represented 58.3% value of the Client's contract
- Not benchmarked pass through of contract costs represented 28.9% of the contract.
- Other not benchmarked services represented 12.8% value of the contract.

Overall, the annual prices paid by the Client were close to C$50.86M and they were C$0.51M above the 50th percentile.

2. *INTRODUCTION*

Overview

This project was undertaken during the period of April-July 2005 on behalf of Hydro One and Inergi to benchmark the IT outsourcing contract against other contracts in the marketplace. Specifically, the Client wished for a comparison of its IT outsourcing contract prices against the Fair Market Value ("FMV") of such services provided in the marketplace.

To make equitable comparisons, it was necessary to normalize prices for services observed in the market place as acceptable proxies for FMV through the use of factors. It was also to account for material differences in the IT outsourcing contracts. There are both quantifiable and intangible factors that affect FMV and these are discussed in detail later in this report.

The development of the overall FMV range for IT outsourcing services and comparison to the Client's prices involved several tasks, which are listed below:

- Development of the project approach -- PA proposed a targeted benchmarking project that would rely on identifying and soliciting participation from entities with IT outsourcing arrangements already in the marketplace
- Identification of participants out of the potential participant pool -- the participating companies were solicited based on their relative comparable status in identified criteria
- Identification of IT services provided by the Supplier to the Client – this served to define services, their groupings and scope
- Development of the data input form to collect data -- it reflected the Client's current operations and was to adequately capture each participant outsourcing arrangements, while keeping the data general to accommodate the greatest number of participants
- Development of the normalization approach -- since each participants had different contract arrangements, the raw participant data has to be normalized over a number of different factors to arrive at comparable pricing
- Participant data analysis -- after participant data was compiled and normalized, the analysis phase began; service domain values for each participant were subjected to analysis
- Report development -- this report is a structured representation of key activities that took place in the course of the project

3. METHODOLOGY

3.1 DATA GATHERING

This section describes the overall approach to the data gathering and includes a discussion of the following details of the process:

- Establishment of the baseline
- Participant qualification
- Data form design
- Participant response
- Documents analyzed

3.1.1 Establishment of the Baseline

The IT service components were categorized and prices were grouped as presented in the table below. First three domains were benchmarked; the last two were deemed too specific to each participant to be comparable and were not benchmarked. The benchmarking covered a broad range of IT services delivered to the Client in domains summarized in the table below[1]:

Table 3.1 Overview of IT Services Provided to the Client

Domain	Service	Description / Definitions	Representative Units of Measure	Approach to Benchmarking	Scope / Discussion
Application Maintenance and Support	Application Maintenance and Support	Ongoing support and maintenance of installed applications.	Total $	Compared to market salary data and IT surveys	Ongoing sustainment and maintenance of business applications, excluding new development.
Infrastructure Management	Mainframe Operations	Batch and on line processing	Millions of Instructions per Second (MIPS)	Compared to participant data	Ongoing management and operation of the infrastructure services indicated.
	UNIX Server Operations	Unix servers	Server instances		
	Wintel Server Operations	Wintel servers	Server instances		
	Database Management	Mainframe and non-mainframe database support (quantity)	Number of production and development databases		
	Storage	SAN disk storage (GB)	Gigabytes (GB)		
	Tape Operations	Tape storage and manual tape mounts	Manual tape transactions (mounts)		

[1] The data provided by the Client and Supplier

Table 3.1 Overview of IT Services Provided to the Client					
Domain	**Service**	**Description / Definitions**	**Representative Units of Measure**	**Approach to Benchmarking**	**Scope / Discussion**
End-user Services	PC Support	Desktop and laptop support (quantity)	Physical devices (PCs) supported	Compared to participant data	Daily support and management of the end user services indicated.
	IMAC (combined with PC support in findings)	Service tickets (quantity)	Service tickets processed		
	Help Desk	Help desk support (quantity)	Contacts to the Help Desk		
Cross-Functional	Third party contract management	Management of vendors and 3rd party contracts	N/A	Not benchmarked	These charges are pass-through of hardware and software contract costs, dedicated resources. These were outside the scope of services that were benchmarked
	Managed contracts	Pass through of contract costs	N/A		
	Assumed contracts	Pass through of contract costs	N/A		
	Fixed Labour	Dedicated labour for special requests	N/A		
Projects	Projects	Project work on an as requested basis.	N/A	Not benchmarked	Each project is unique and the project mix varies from year to year making these charges not comparable

The Client's conditions of service delivery were used to develop the baseline for equitable comparison of services received by participants. Those service delivery conditions affected ultimate contract prices; the same was true for other contracts as each was different. For example, space and facilities were provided to the Supplier at no price. When other suppliers had to make payments for the same, their circumstances were adjusted to match this contract (i.e., such prices were excluded from considerations). The establishment of baseline conditions and other normalizations enabled pricing comparisons between participants, which are discussed later in the report.

3.1.2 Participant Qualification

An original pool of over 250 potential recent outsourcing arrangements[2] was screened to identify potential candidates for the benchmarking. The participating companies were solicited based on their following characteristics:

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[2] *Customer Needs and Strategies, IDC's Top 100 Outsourcing Deals of 2002, IDC's Top 100 Outsourcing Deals of 2003*, internal research and contacts, ongoing monitoring of outsourcing news and announcements by PA.

- Service domains – targeting contract arrangements that included domains of interest to the Client
- Industry – Outsourcing engagements in regulated and unregulated industries
- Size – comparable to the Client's circumstances
- Union representation – targeting of industries with union representation in their work force

PA identified approximately twenty-five arrangements as meeting the initial considerations. Ultimately, there were eleven participants in the sample with a variety of arrangements and scopes of service.

The outsourcing arrangements of the participants included the top suppliers or their unionized subsidiaries. In all there were six different suppliers. Where the supplier workforce was unionized, they established subsidiaries around the collective bargaining unit. This diversity of suppliers ensures there was a fair representation of a variety of deal structures and delivery models in determining the market value. There was difficulty locating unionized participants due to their limited number.

Confidentiality was a necessary condition for securing the participation of other companies; their identities were kept secret. The raw data was normalized to a number of factors that provided comparability. The table below details the industries of the eleven participants in the study.

Table3.2 Project Participants by Industry	
Industry	**Number (Total=10)**
Retail	1
Financial Services	2
Government	2
Utility	4
High Technology	1

In general participants bundled services in a manner similar to the Client; the only difference was that end user services (PC support, IMAC and Help desk) were sometimes bundled together. No participant had the same portfolio of service domains as the Client. Typically, participants' service domain represented smaller or larger subset of the Client outsourcing portfolio.

3.1.3 Data Form Design

Each participant filled out the data input form consisting of the following sections:

- Cover – front page
- Introduction – detailed explanations of the purpose of the data form
- General Information – questions about the Client and Supplier
- Volume – questions regarding consumed units of services or quantities

- Charges – questions regarding prices of the above services or quantities
- Price Composition – questions regarding on-shore and off-shore labour components
- Asset Ownership – questions regarding percentages of ownership by each asset
- Performance – questions regarding service levels
- Scope Map – questions regarding the split of tasks between a client and a supplier

Key points about selected sections to indicate data collection intricacies and reasons for approaches to data collection:

- Volume
  - Service quantities across domains were collected in basic units (servers – number of instances, IMACs – number of service tickets, help desk – number of contacts, etc.) selected to capture representative differences such as availability, service levels, equipment locations
  - Application Support and Maintenance was requested in terms of FTE per month to obtain the broadest possible common denominator
  - Projects data was collected to capture effort associated with any non-recurring work
  - Administration and Other Support volumes were collected to capture effort associated with administration of third party, software license, asset and account management
- Charges
  - Charges associated with the above services or quantities were collected on a fully loaded, current year (2005) basis.
  - Charges were presented in terms of monthly fees per service in each domain
- Price Composition
  - A percentage breakdown of charges into on-shore, off-shore labour and non-labour components was collected to appropriately normalize the data
- Asset Ownership
  - The percentages of ownership by each asset type was also collected to insure all appropriately adjust value of the contract
- Performance
  - Representative performance targets for each service were requested to enable normalization on quality of service.
- Scope Map
  - Identification of types of tasks within each service domain and whether completed by the Client or the Supplier

3.1.4 Documents Analyzed

PA used the following documents in preparation of this report:

- Selected portions of the agreement between the Client and the Supplier (relevant to this project scope)

- IT budget spreadsheet provided by the Client
- Data input forms filled out and provided by the survey participants and the Client
- PA confidential data representing data related to IT outsourced arrangements
- External data sources (government reports, industry reports, and published articles)

3.2 DATA ANALYSIS

This section describes the overall approach to the data gathering and includes the discussion of the following details of the process:

- Fair Market Value discussion
- Normalization
- Application analysis
- Unit price comparison

3.2.1 Fair Market Value Discussion

The FMV is a useful concept and it is meant to identify price ranges at which willing buyers and seller enter into commercial relationships. FMV can have different meaning to different people and it can also vary depending on a number of factors. Usually, FMV is not represented by a single discrete price point for services or goods, but rather is represented by a range of values.

There are different definitions of FMV, but they essentially amount to stating the prices that an interested but not desperate buyer would be willing to pay and an interested but not desperate seller would be willing to accept on the open market assuming a reasonable negotiating period of time [3].

In order to develop or deconstruct FMV, it is first necessary to compare prices over the same type and quantities of services to perform like-for-like comparisons. Contracts covering delivery of IT services have similarities and differences; the differences make it necessary to perform adjustments or normalizations.

For the purposes of this project, the FMV range was defined as that which represented all transactions that was used consistently for all participant data.

The adjustment of physical quantities in each of participant's arrangements to the same baseline allowed for the development of comparable financial values. The normalization process involved multiple factors to adjust for discrete characteristics of each contract. Factors affecting FMV fell into both quantifiable and intangible categories.

The following approach was used to ultimately compare participant data points:

- Development of unit prices for each service domain
- Development of FMV for each service domain; including average FMV with a range of values

[3] No single, scientific FMV definition was identified during background search in this project; many organizations use a similar one or a variation that is without a distinction.

- Development of overall FMV for the whole contract

3.2.2 Normalization

Normalization of the data was an essential task to enable like-for-like comparisons. Due to differences in contracts between participants, reporting of raw volume and price data would be improper for comparing participant operations. For data comparability to exist, it is necessary that the raw data be appropriately adjusted to account for differences in both contractual arrangements between participants and their suppliers and objective factors such as exchange rates.

Quantifiable adjustment factors were applied to the raw data:

- Location cost index (place all costs in the same market location using a cost index)
- Exchange rates (presentation in the same currency)
- Geographic diversity (the relative spread of services between central, local and remote locations)
- Offshore component (% of labour provided offshore)
- Pension (treatment of benefit payments)
- Scope (composition of HW and labour)
- Scale (number of servers)
- Service levels (availability, time to respond, etc.)
- Unionization (% of unionized workforce)
- Workweek duration (35 hours versus 40 hour workweek)

Each of these adjustments is discussed below in more detail to provide their context and definitions were applicable:

- Cost Index [4]
    - There are differences in relative costs of doing business in each of the participant cities; the Client's city was set at 100 and using established comparative cost index appropriate adjustments were made to all other locations. The KPMG survey is explicitly a measure of the "relative costs of doing business" for each service, which is distinct from a price index such as CPI.
- Exchange Rates[5]
    - Any data from U.S. participants was converted using a factor of $1 CDN equals $0.8065 US based on *2005 Q2 Corporate Exchange Rates* as published by PA's Corporate Tax and Treasury department
- Geographic Diversity [6]

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[4] *KPMG Alternative Study 2004*, Industry: software design, Operation: advanced software; this cost index was normalized to 100 for Toronto.

[5] *2005 Q2 Corporate Exchange Rates* as published by PA's Corporate Tax and Treasury department.

  - The costs of providing a service in a centralized data center or office facility is usually less than local or remote sites due to the availability of on-site resources and higher utilization due to the density of units. In remote locations, support may involve additional costs associated with travel and lost time getting to and from the support location. Since each participant has a different mix of these geographies, an adjustment was made to reflect the same mix at that of the Client.
- Offshore Component[7]
  - Any service that was provided by offshore labour was adjusted to the basis that all labour was on-shore. The cost of the off shore labour averaged 25% below the domestic markets.
- Pension (treatment of payments)[8]
  - Pension costs are part of the labour costs paid by the Client. This separate pension payment was spread to component charges. All participant costs were set at a fully loaded basis.
- Service Levels (availability, time to respond, etc.)[9]
  - Services delivered at different service levels would entail different unit prices; experiential data was used to make adjustments to the Client service levels.
- Scope[10]
  - Both mainframe and server prices can be composed of hardware and labour prices, depending on who owns the hardware
- Scale[11]
  - The scale discussion relates to economies of scale based on the number of units – operations with fewer units will be more expensive on a per unit basis than operations with a larger number of units. Different adjustments were made to various towers reflecting the expected economies in that service.
- Unionization[12],[13],[14]

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[6] Cost adjustments were based on the Clients contractual ARC/RRC differentials and PA internal experience.

[7] Cost adjustments were based on the PA internal experience.

[8] Based on the review of the Client agreement and participant data.

[9] Cost adjustments were based on the PA internal experience.

[10] Based on the Client and participant agreement details.

[11] Cost adjustments were based on the PA internal experience.

[12] The U.S. government web site (Bureau of Labor Statistics) was used to estimate direct wage differential between union and non-union jobs, http://www.bls.gov/news.release/union2.t04.htm.

[13] For the development of a differential between union and non-union benefits (health care and pension) a document "Economic Bytes: Union wage premium continues 15 year decline" from Employment Policy

- Both U.S. and Canadian reports and sources were used to make comparisons between union and non-union labour. Overall a 14% adjustment was made to account to the difference between direct wages, health care and pension.

- Workweek duration[15]
  - The union agreement covering this outsourcing arrangement mandates a 35-hour workweek. Other participants were adjusted to a 35-hour workweek basis (by 12.5%).

These normalizations allowed for a comparison of the data between participants. Normalizations were made to each service using the above quantifiable factors where relevant and available.

In addition to the above factors, there are certain intangible factors-- those that could not be obtained, were not obtainable due to confidentiality clauses, or were difficult to estimate. These factors were listed in the table below.

Table 3.3 Intangible Factors

Factor Type	Discussion
Actual versus contracted service levels	There is a strong positive correlation between service levels and price of services. In some cases reported prices were provided without specific actual service levels achieved, making it difficult to judge how comparable the prices were.
Application diversity, complexity and volume	Differing applications require various amounts of labour because of their complexity, age, and a host of other factors. There will be large amounts of variability between clients and from year to year due to a number of factors that were not captured in this study. These factors included the exact set of applications under management, their versions, levels of customization, level of documentation, level of competence of staff, etc.
Detailed operational knowledge	There is a trade-off between the study response rate and the depth of information requested. Gaining detailed operational information was beyond the scope of this study.
Exact scope of services delivered	There are varying amounts of knowledge about each participant's scope of services and the resulting impact on their price structure
Economic and business cycles and conditions at contract finalization	Economic and business cycles may have an impact on pricing of contracts. The individual business conditions of participants at the time of contracting may also have an impact on pricing and terms, and that was not captured in this study. In weak markets, vendors often lower their prices to get the deal while in a tight market they strive for higher margins.
Job type mix, non-compensation prices,	The combination of these characteristics affects ultimate

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Foundation was used. Additionally, writings by the following academic authors were consulted: Barry Hirsch, Richard Vedder, Leo Troy (the U.S. experts on labor and union) and the National Right to Work Organization.

[14] Tony Fang and Anil Verma, "Union Wage Premium," Statistics Canada - Catalogue no. 75-001-XPE, Winter 2002 PERSPECTIVES / 17

[15] Based on the participants' data.

Table 3.3 Intangible Factors	
Factor Type	**Discussion**
supplier margins, prices at remote locations	prices and this information is difficult to obtain for each participant
Manual versus automatic administration of operations	Manual operations are expected to be more expensive on a recurring basis; automatic require larger up-front investment; participants are on different equipment cycles
Overall contract size (IT plus other areas)	IT outsourcing alone is likely to have different prices than IT outsourcing plus other areas contracted to a supplier
Penalties and gain-sharing	Total contract prices are affected by these two components and these details are often not available
Ability to leverage/share assets across multiple clients	Typically, an ability to spread services over several clients from a common location would tend to reduce unit costs

For each of the intangible factors listed in the table above, there is a potential for price impact. Taken together, these impacts could be significant, or cancel each other out, depending on specific arrangements between a client and a supplier. The precise impact of each factor within participants' prices was not easily quantifiable and therefore there was uncertainty regarding the FMV range.

3.2.3 Application Sustainment Analysis

Unlike the benchmarking of infrastructure or end user services, the benchmarking of applications sustainment proved to be more complicated and the same approach could not be used. Participants either did not or could not provide the necessary information; there was no clear and objective method to do so.

PA benchmarked applications using two approaches. The two approaches helped to answer the FMV questions from two angles. Overall, PA finds that Client spends more on application sustainment than similar organizations. However, the effective labour rate charged by Supplier for application sustainment is a fair market value. The higher spending is accounted for by the Client's volume resulting from its extensive use of IT and the unique demands of its open market software and is not the result of Supplier's rate.

The first analysis takes both rate and volume into consideration by comparing Supplier price vs. spend on application sustainment of other electric utilities. PA used published data[16] to determine that a sample of North American electric utilities spends approximately 9% of IT operating budget on application sustainment while Client spends approximately 13% of IT operating budget on sustainment with Supplier. This can be due to various reasons: a) open market applications that other participants may not have, b) extensive use of technology etc. PA also found that Client's Open Market software accounts for the 4% difference between Client's spend and that of the sample of North American electric utilities; this software is a unique requirement in Client's application environment.

The second analysis investigated labour rates for performing application sustainment against a normalized Toronto market price to determine if rates were responsible for the greater expenditure.

[16] Based on a combination of public and private sources.

The data were normalized to Supplier pricing to adjust for unionized wages, benefits, and a shorter workweek. The finding is that Supplier's labour rate is only slightly different than an adjusted market labour rate for Toronto and essentially Fair Market Value.

The third analysis investigated the possibility that unique circumstances of the Client's business are driving greater volumes of applications sustainment. PA found that while the Client spends more on IT as a percent of revenue it spends much less per employee on IT than similar organizations. This finding suggests that Client is driving more efficiency through technology than similar organizations.

3.2.4 Unit Price Comparison

The subject agreement between the Client and the Supplier is not based on unit prices across all service domains, unlike most of the participants. Indeed, the contract is essentially set for a lump sum amount for a defined scope of work. This total amount is scheduled to decrease from year to year with partial offsetting factors due to cost of living adjustments and additions to the scope.

In order to make comparisons between this outsourcing agreement and those of other participants, it was necessary to determine the effective unit prices for each of the domains. The component contract amounts and associated volumes were assigned to each of the service domains. For the Client, this was also established by the contractual terms for scope adjustments using additional resource costs (ARCs) and reduced resource credits (RRCs). The prices for each service were fully loaded and an effective unit price developed.

These surrogate prices based on the assigned costs are representative of the services being provided and are a fair basis for comparison among the participants. All normalization and other adjustments were made on this effective unit price basis.

4. RESULTS

There were three distinct steps in the data analysis process for the Client and each participant:

- Development of normalized monthly unit prices within each service domain
- Development of the annual FMV price range for each service domain
- Development of the overall annual FMV range for all service domains

Results from the last step are summarized below.

Table 3.1 Overview of IT Services Provided to the Client			
Domain	**Service**	**Fair Market Value (C$)**	
IT Outsourcing Services	**Annual Price to Hydro One (C$)**	**Range (+/- 1S.D.)**	**50% Percentile**
Total	**$50,855,770**	**$44,417,865 to $56,264,242**	**$50,341,054**

The Client base figure is fully loaded and includes the base fees (year 4 of the contract with agreed changes as of April 1, 2005), the associated pension and benefits costs, the monthly volume adjustments (ARCs/RRCs), COLA adjustments, and costs for those incremental applications still in interim sustainment

Regarding the Client –Supplier contract benchmarking distribution:

- The benchmarked services represented 58.3% value of the Client's contract
- Not benchmarked pass through of contract costs represented 28.9% of the contract.
- Other not benchmarked services represented 12.8% value of the contract.

Overall, the annual prices paid by the Client were close to C$50.86M and they were C$0.51M above the 50th percentile.