Consolidated Financial Statements

Toronto Hydro Corporation

December 31, 2006

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AUDITORS' REPORT

To the Shareholder of
Toronto Hydro Corporation

We have audited the consolidated balance sheets of **Toronto Hydro Corporation** [the "Corporation"] as at December 31, 2006 and 2005 and the consolidated statements of income, retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Corporation as at December 31, 2006 and 2005 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Ernst & Young LLP

Toronto, Canada,
February 21, 2007 [except as to note 26,
which is as of March 1, 2007].

Chartered Accountants

Toronto Hydro Corporation

CONSOLIDATED BALANCE SHEET

[in thousands of dollars]

As at December 31	2006 $	2005 $
ASSETS		
Current		
Cash and cash equivalents	**327,524**	448,370
Accounts receivable, net of allowance for doubtful accounts	**218,452**	174,499
Unbilled revenue	**216,857**	271,367
Inventories	**22,458**	18,189
Prepaid expenses	**2,277**	2,168
Electricity mark-to-market assets *[note 15]*	**-**	113,297
Future income tax assets *[note 17]*	**791**	33,195
Assets from discontinued operations *[note 23]*	**12,098**	-
Total current assets	**800,457**	1,061,085
Property, plant and equipment, net *[note 5]*	**1,656,868**	1,624,741
Intangible assets, net *[note 6]*	**49,266**	41,926
Regulatory assets *[note 7]*	**66,528**	63,752
Other assets *[note 8]*	**2,578**	5,490
Future income tax assets *[note 17]*	**16,009**	22,264
Total assets	**2,591,706**	2,819,258
LIABILITIES AND SHAREHOLDER'S EQUITY		
Current		
Accounts payable and accrued liabilities	**284,869**	423,780
Current portion of other liabilities *[note 10]*	**16,952**	39,210
Current portion of deferred revenue	**7,320**	20,423
Current portion of promissory note payable *[note 11]*	**245,058**	330,000
Electricity mark-to-market liabilities *[note 15]*	**-**	86,875
Future income tax liabilities *[note 17]*	**-**	40,923
Liabilities from discontinued operations *[note 23]*	**906**	-
Total current liabilities	**555,105**	941,211
Long-term liabilities		
Debentures *[note 11]*	**225,000**	225,000
Promissory note payable *[note 11]*	**735,173**	650,231
Post-employment benefits *[note 12]*	**134,682**	125,415
Regulatory liabilities *[note 7]*	**11,840**	13,297
Other liabilities *[note 13]*	**3,949**	9,077
Asset retirement obligations *[note 14]*	**7,581**	5,691
Customers' advance deposits	**25,944**	2,900
Future income tax liabilities *[note 17]*	**368**	569
Total long-term liabilities	**1,144,537**	1,032,180
Total liabilities	**1,699,642**	1,973,391
Commitments and contingencies *[notes 20 and 21]*		
Shareholder's equity		
Share capital *[note 18]*	**567,817**	567,817
Retained earnings	**324,247**	278,050
Total shareholder's equity	**892,064**	845,867
Total liabilities and shareholder's equity	**2,591,706**	2,819,258

ON BEHALF OF THE BOARD:

Clare R. Copeland, Director

L. Ross Cullingworth, Director

Toronto Hydro Corporation

CONSOLIDATED STATEMENT OF INCOME

[in thousands of dollars, except for per share amounts]

Year ended December 31	**2006** **$**	**2005** **$**
Revenues	**2,247,008**	2,606,272
Costs		
Purchased power and other	**1,705,845**	2,059,789
Operating expenses	**194,216**	191,185
Depreciation and amortization	**137,344**	131,595
	2,037,405	2,382,569
Income before interest, other and provision for payments in lieu of corporate taxes	**209,603**	223,703
Interest income	**17,726**	14,116
Interest expense		
Long-term debt	**(75,894)**	(80,403)
Other interest	**(2,902)**	(2,700)
Other	**89**	5,040
Income before provision for payments in lieu of corporate taxes	**148,622**	159,756
Provision for payments in lieu of corporate taxes *[note 17]*	**58,403**	68,839
Income from continuing operations	**90,219**	90,917
Income from discontinued operations - net of tax *[note 23]*	**2,178**	1,528
Net income	**92,397**	92,445
Basic and fully diluted net income per share from continuing operations *[note 22]*	90,219	90,917
Basic and fully diluted net income per share from discontinued operations *[note 22]*	2,178	1,528
Basic and fully diluted net income per share	**92,397**	92,445

CONSOLIDATED STATEMENT OF RETAINED EARNINGS

[in thousands of dollars]

Year ended December 31	**2006** **$**	**2005** **$**
Retained earnings, beginning of year	**278,050**	253,605
Net income	**92,397**	92,445
Dividends *[note 18]*	**(46,200)**	(68,000)
Retained earnings, end of year	**324,247**	278,050

Toronto Hydro Corporation

CONSOLIDATED STATEMENT OF CASH FLOWS

[in thousands of dollars]

Year ended December 31	2006 $	2005 $
OPERATING ACTIVITIES		
Income from continuing operations	**90,219**	90,917
Adjustments for non-cash items		
Depreciation and amortization	**137,344**	131,595
Net change in other assets and liabilities	**(3,191)**	1,878
Electricity mark-to-market assets and liabilities	**26,422**	1,274
Post-employment benefits	**9,267**	7,298
Future income taxes	**(2,488)**	(3,121)
Gain on disposals of property, plant and equipment	**(89)**	(5,040)
Changes in non-cash working capital balances		
Decrease (increase) in accounts receivable	**(44,003)**	9,080
Decrease (increase) in unbilled revenue	**54,510**	(25,245)
Decrease (increase) in inventories	**(4,269)**	1,719
Decrease (increase) in prepaid expenses	**(60)**	45
Increase (decrease) in accounts payable and accrued liabilities	**(137,787)**	93,045
Increase (decrease) in deferred revenue	**(13,179)**	20,423
Increase in current portion of other liabilities	**32**	1,219
Net cash provided by operating activities	**112,728**	325,087
INVESTING ACTIVITIES		
Purchase of property, plant and equipment	**(166,806)**	(192,241)
Purchase of intangible assets	**(18,501)**	(8,114)
Net change in regulatory assets and liabilities	**(4,233)**	20,548
Proceeds on disposal of property, plant and equipment	**938**	5,085
Net cash used in investing activities	**(188,602)**	(174,722)
FINANCING ACTIVITIES		
Increase (decrease) in customers' advance deposits	**1,835**	(20,081)
Repayment of capital lease liability	**(1,182)**	(1,866)
Dividends paid *[note 18]*	**(46,200)**	(68,000)
Net cash used in financing activities	**(45,547)**	(89,947)
Net cash provided by (used in) continuing operations	**(121,421)**	60,418
Net cash provided by discontinued operations	**575**	1,327
Net increase (decrease) in cash and cash equivalents during the year	**(120,846)**	61,745
Cash and cash equivalents, beginning of year	**448,370**	386,625
Cash and cash equivalents, end of year	**327,524**	448,370
Supplementary cash flow information		
Total interest paid	77,442	81,657
Payments in lieu of corporate income taxes	106,771	74,780

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
[all tabular amounts in thousands of dollars]

December 31, 2006

1. INCORPORATION

On June 23, 1999, Toronto Hydro Corporation [the "Corporation"] was incorporated under the Business Corporations Act (Ontario) along with two wholly-owned subsidiary companies, Toronto Hydro-Electric System Limited ["LDC"] and Toronto Hydro Energy Services Inc. ["TH Energy"]. The incorporation was required in accordance with the provincial government's Electricity Act, 1998.

Under the terms of By-law No. 374-1999 of the City of Toronto ["Transfer By-law"] made under section 145 of the Electricity Act, 1998 and in accordance with continuity of interest accounting, the former Toronto Hydro-Electric Commission and the City of Toronto [the "City"] transferred, at book value, their assets and liabilities [effective July 1, 1999] and employees [effective January 1, 2000] associated with:

[a] electricity distribution to LDC in consideration for the issuance of equity securities of LDC and long-term notes payable to the City; and

[b] electricity generation, co-generation and energy services to TH Energy in consideration for the issuance of equity securities of TH Energy.

The equity securities of LDC and TH Energy were subsequently transferred by the City to the Corporation in consideration for the issuance of equity securities of the Corporation to the City.

Certain surplus real property assets and cash funds were excluded from the transfer and were retained by the City. In addition, the long-term debt incurred by the City on behalf of the former Toronto Hydro-Electric Commission was excluded from the liabilities transferred and was retained by the City.

The book value of the assets transferred at July 1, 1999 was $1,548,048,000. The principal amount of the long-term notes payable to the City was $980,231,000 and the value of the common shares of the Corporation received by the City was $567,817,000.

The Corporation supervises the operations of, and provides corporate and management services and strategic direction to, its subsidiary companies [each of which is listed below, incorporated under the BCA and wholly-owned, directly or indirectly, by the Corporation]:

[a] LDC [incorporated June 23, 1999] – which distributes electricity to customers located in the City and is subjected to rate regulation.

[b] TH Energy [incorporated June 23, 1999] – which owns and operates street lighting and expressway lighting systems located in the City and is engaged in the sale of energy efficiency products and services.

[c] Toronto Hydro Telecom Inc. ["Telecom"] [incorporated September 26, 2000] – which provides fibre optic cable capacity and manages data communications services.

[d] 1455948 Ontario Inc. [incorporated December 21, 2000] – which owns a 50% interest in EBT Express Partnership ["EBT Express"], a joint venture with a wholly-owned subsidiary of Ontario Power Generation Inc. EBT Express owns a 67% controlling interest in The SPi Group, a corporation formed to provide, among other things, centralized electronic data management and transaction services to energy industry participants.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
[all tabular amounts in thousands of dollars]

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The principal business of the Corporation is the regulated distribution of electricity by LDC.

2. REGULATION

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

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

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

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

[i] *Electricity Price and Related Rebates*. The electricity price and related rebates represent a pass through of the commodity cost of electricity.

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

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

[iii] *Retail Transmission Rate*. The retail transmission rate represents a pass through of wholesale costs incurred by distributors in respect of the transmission of electricity from generating stations to local areas. Retail transmission rates are regulated by the OEB.

[iv] *Wholesale Market Service Charge*. The wholesale market service charge represents a pass through of various wholesale market support costs. Retail rates for the recovery of wholesale market service charges are regulated by the OEB.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

[all tabular amounts in thousands of dollars]

December 31, 2006

3. ELECTRICITY DISTRIBUTION RATES

In connection with the restructuring of Ontario's electricity industry in 1999, the OEB had authorized electricity distributors to adjust their distribution rates to incorporate a market-based rate of return of 9.88% on the deemed debt to equity structure of LDC of 65:35. The adjustment was being phased in over three adjustment periods to lessen the rate impact on customers. Effective on each of December 1, 2000 and March 1, 2002, the OEB authorized LDC to increase its distribution rates to allow for the recovery of additional annual revenue of $39.8 million.

In March 2005, LDC received approval from the OEB to increase distribution rates to recover $39.8 million, representing the third and final adjustments necessary to achieve a market-based rate of return of 9.88%. The rate increase was effective as of April 1, 2005 and subjected the LDC to a financial commitment to invest $39.8 million in Conservation and Demand Management ["CDM"] activities by September 2007.

In April 2006, the OEB approved a decrease in the distribution rates of LDC for the period May 1, 2006 to April 30, 2007 representing a revenue reduction of approximately $57,956,000, including the new regulatory treatment for revenues relating to smart meters [see *note 7*]. The methodology used by the OEB to establish the distribution rates was based on, among other things, a rate base of $1.861 billion, a deemed debt to equity structure of 65:35 and an allowed return on deemed equity of 9%. The OEB also allowed for the recovery of regulatory assets related to prior years' pension costs and OEB fees and reduced the allowable interest rate recoverable on related party debt including the outstanding $980,231,000 promissory note between LDC and the Corporation from 6.8% to 5% per annum.

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

4. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

a) Basis of consolidation

The consolidated financial statements include the accounts of the Corporation and its wholly-owned subsidiaries. All significant intercompany balances and transactions have been eliminated.

b) Regulation

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

Regulatory Assets and Liabilities

In accordance with Canadian Institute of Chartered Accountants [“CICA”] Accounting Guideline 19 “Disclosures by Entities Subject to Rate Regulation” [“AcG-19”], certain costs and variance account balances deemed to be “regulatory assets” or “regulatory liabilities” are reflected separately on LDC’s balance sheet until the manner and timing of disposition is determined by the OEB *[note 7]*.

Payments in lieu of corporate taxes

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

The Corporation and each of its subsidiaries is a “municipal electricity utility” [“MEU”] for purposes of the payments in lieu of corporate taxes [“PILs”] regime contained in the Electricity Act, 1998. The Electricity Act, 1998 provides that a MEU that is exempt from tax under the ITA and the *Corporations Tax Act (Ontario)* is required to make, for each taxation year, a PILs, to the Ontario Electricity Financial Corporation in an amount equal to the tax that it would be liable to pay under the ITA and the *Corporations Tax Act (Ontario)* if it were not exempt from tax.

The PILs regime came into effect on October 1, 2001, at which time the Corporation and each of its subsidiaries were deemed to have commenced a new taxation year for purposes of determining the respective liabilities for PILs. Accordingly, the Corporation and its subsidiaries were deemed to have disposed of their assets at their then fair market value and to have re-acquired such assets at the same amount. The differences between the financial statement carrying value and tax basis of assets and liabilities were accounted for by the Corporation as follows:

[a] in the case of the Corporation's unregulated businesses, the liability method of accounting was applied in accordance with recommendations of the CICA; and

[b] in the case of the Corporation’s regulated electricity distribution business, the taxes payable method of accounting was applied in accordance with recommendations of the CICA and the OEB.

Under the liability method, current income taxes payable are recorded based on taxable income. Future income taxes arise from temporary differences in the accounting and tax basis of assets and liabilities. Future tax assets and liabilities are provided based on substantively enacted tax rates that will be in effect when the differences are expected to reverse.

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

The OEB's Electricity Distribution Rate Handbooks, issued in March 2000 and May 2005, provide for the recovery of PILs by LDC through annual distribution rate adjustments as permitted by the OEB. The OEB-approved distribution rate for PILs recoveries is based on estimated consumption volumes. The difference between actual billings that relate to the recovery of PILs and the OEB-approved PILs amount up to April 30, 2006, is tracked by

LDC as a variance amount in accordance with OEB guidelines for regulatory assets and with criteria set out in the AP Handbook. Commencing May 1, 2006, any differences that result from a legislative or regulatory change to the tax rates or rules assumed in the 2006 electricity distribution rate application are tracked by LDC as variance amounts.

Contributions in aid of construction

Capital contributions received from outside sources are used to finance additions to property, plant and equipment of LDC. According to the AP Handbook, capital contributions received are treated as a "credit" to property, plant and equipment. The amount is subsequently amortized by a charge to accumulated amortization and a credit to amortization expense at an equivalent rate to that used for the depreciation of the related property, plant and equipment.

Spare transformers

Spare transformers are items that are expected to substitute for original distribution plant transformers when these original plant assets are being repaired and are held and dedicated for the specific purpose of backing up plant in service as opposed to assets available for other uses. According to the criteria set out in the AP Handbook, spare transformers are treated as capital assets *[note 5]*, which would be recorded as inventory under Canadian GAAP for unregulated businesses.

c) Cash and cash equivalents

Effective January 1, 2006, the Corporation changed the terms to maturity in the definition of cash equivalents from five months or less to 90 days or less from the date of acquisition. This change resulted in no impact on the audited consolidated financial statements as at December 31, 2006 and 2005.

d) Inventories

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

e) Property, plant and equipment and depreciation

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

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

[all tabular amounts in thousands of dollars]

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

Buildings	1.7% to 10.0%
Stations	2.9% to 5.0%
Distribution lines	2.5% to 25.0%
Transformers	3.3% to 4.0%
Meters	2.9% to 4.0%
Other capital assets	6.7% to 12.5%
Communications	5.0% to 20.0%
Computer hardware	20.0% to 25.0%
Rolling stock	12.5% to 33.3%
Equipment and tools	10.0%

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

f) Intangible assets

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

Land rights	2.0%
Computer software	14.0% to 33.0%
Capital contributions	4.0%
Leasehold improvements	Over the remaining lease term

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

g) Deferred debt issue costs

In 2003, the Corporation incurred debt issue costs arising from the Corporation's debenture offering *[note 8]*. Deferred debt issue costs are included in "Other assets" and represent the unamortized amounts of debt costs arising from the issuance of debt, and other related costs. Deferred debt issue costs are amortized over the period to maturity of the debt on a straight-line basis.

h) Workplace Safety and Insurance Act

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

i) Revenue recognition and accounting for financial derivative instruments

LDC

Revenue from the sale of electricity is recorded on a basis of cyclical billings and also includes unbilled revenue accrued in respect of electricity delivered but not yet billed.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

Other income, which includes revenues from electricity distribution related services, is recognized as the services are rendered.

TH Energy

TH Energy has entered into contracts to provide electricity at fixed prices. Electricity contracts are contracts with fixed notional volumes at fixed prices. These contracts expose TH Energy to changes in market prices of electricity and consumption. To reduce its exposure to these changes, TH Energy purchases wholesale electricity physical bilateral and financial contracts.

TH Energy accounts for notional block contracts and non-designated purchase contracts using the mark-to-market method of accounting. Under the mark-to-market method of accounting, TH Energy records the fair value of the contracts, less related reserves, as mark-to-market assets or liabilities at the time of contract execution. All transactions are recognized on a net basis as mark-to-market revenue. Mark-to-market revenue includes gains or losses on new transactions at origination, unrealized gains and losses from changes in the fair value of contracts, net gains or losses from realized transactions and changes in reserves.

TH Energy records reserves for counter-party credit risk and on-going operational expense to reflect uncertainties associated with certain estimates inherent in the determination of the fair value of mark-to-market assets and liabilities. To the extent possible, TH Energy utilizes market-based data together with quantitative methods to determine the level of reserves.

As at December 31, 2006, all retail and wholesale electricity contracts have concluded. TH Energy has no outstanding contracts as at December 31, 2006.

Energy efficiency products and services revenue is accounted for under the percentage of completion method, with revenue recognized proportionately with the degree of completion of the services under contract. Losses on contracts are fully recognized when they become evident.

Water heater revenue is accounted for when the service is rendered.

TH Energy provides certain services to the City at commercial rates, including street lighting and expressway lighting services. Street lighting and expressway lighting services are recognized when services are rendered.

Telecom

Fibre leasing and data communications services revenues are recognized as services are rendered.

j) Employee future benefits

Pension plan

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

Employee future benefits other than pension

Employee future benefits other than pension provided by the Corporation include medical and life insurance benefits, accumulated sick leave credits and voluntary exit incentive program liability. These plans provide benefits to employees when they are no longer providing active service. Employee future benefit expense is recognized in the period in which the employees render services on an accrual basis.

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

k) Customers' advance deposits

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

l) Asset retirement obligations

The Corporation recognizes a liability for the future environmental remediation of certain properties and for future removal and handling costs for contamination in distribution equipment and in storage. Initially, the liability is measured at present value and the amount of the liability is added to the carrying amount of the related asset. In subsequent periods, the asset is depreciated and the liability is adjusted quarterly for the discount applied upon initial recognition of the liability [“accretion expense”] and for changes in the underlying assumptions. The liability is recognized when the asset retirement obligation [“ARO”] is incurred and when the fair value is determined.

Effective June 30, 2006, the Corporation adopted Emerging Issues Committee Abstract EIC-159 “Conditional Asset Retirement Obligations” [“EIC-159”]. EIC-159 requires an entity to recognize a liability for the fair value of an ARO even though the timing or method of settlement is conditional on future events. The Corporation has identified

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conditional AROs and recognized the related liability in 2006. The adoption has been accounted for prospectively as information is not available to allow it to be accounted for retroactively. The fair value of the identified AROs and the change from prior period are determined to be not material to the Corporation's result of operations and financial position.

m) Use of estimates

The preparation of the Corporation's consolidated financial statements in accordance with Canadian GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses for the year. Actual results could differ from those estimates, including changes as a result of future decisions made by the OEB, the Minister of Energy or Minister of Finance.

5. PROPERTY, PLANT AND EQUIPMENT, NET

Property, plant and equipment consist of the following:

	2006			2005		
	Cost $	Accumulated depreciation $	Net book value $	Cost $	Accumulated depreciation $	Net book value $
Land	**4,088**	**—**	**4,088**	4,136	—	4,136
Buildings	**145,281**	**44,016**	**101,265**	144,048	43,332	100,716
Stations	**191,833**	**99,988**	**91,845**	183,155	94,179	88,976
Distribution lines	**2,069,674**	**1,024,020**	**1,045,654**	1,982,918	942,109	1,040,809
Transformers	**493,878**	**264,308**	**229,570**	471,562	247,102	224,460
Meters	**131,886**	**80,032**	**51,854**	127,468	75,721	51,747
Other capital assets	**44,077**	**30,127**	**13,950**	57,506	41,722	15,784
Communications	**73,041**	**45,629**	**27,412**	61,241	39,290	21,951
Computer hardware	**39,511**	**35,237**	**4,274**	36,593	33,436	3,157
Rolling stock	**57,237**	**44,243**	**12,994**	51,424	40,990	10,434
Equipment and tools	**33,168**	**23,488**	**9,680**	28,086	22,232	5,854
Construction in progress	**64,282**	**—**	**64,282**	56,717	—	56,717
	3,347,956	**1,691,088**	**1,656,868**	3,204,854	1,580,113	1,624,741

At December 31, 2006, spare transformers with carrying amounts of $5,486,000 [2005 - $4,767,000], are included in "Property, plant and equipment, net" *[note 4[b] "Spare transformers"]*. In the absence of rate regulation, inventory would have been $5,486,000 higher [2005 - $4,767,000].

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6. INTANGIBLE ASSETS, NET

Intangible assets consist of the following:

	2006			2005		
	Cost $	Accumulated amortization $	Net book value $	Cost $	Accumulated amortization $	Net book value $
Land rights	**10,229**	**2,022**	**8,207**	10,074	1,819	8,255
Computer software	**118,861**	**86,070**	**32,791**	97,590	72,840	24,750
Leasehold improvements	**693**	**215**	**478**	1,239	383	856
Capital contributions	**2,043**	**197**	**1,846**	2,043	116	1,927
Software in development	**5,944**	**—**	**5,944**	6,138	—	6,138
	137,770	**88,504**	**49,266**	117,084	75,158	41,926

7. REGULATORY ASSETS AND LIABILITIES

Regulatory assets consist of the following:

	2006 $	2005 $
Regulatory assets recovery account	**37,510**	55,408
Excess of cash pension contributions	**—**	4,785
Excess of OEB annual cost	**—**	3,559
Smart meters	**29,018**	—
	66,528	63,752

Regulatory liabilities consist of the following:

	2006 $	2005 $
Pre-market opening line loss variance	**2,880**	2,880
Settlement variances	**7,990**	10,417
Other	**970**	—
	11,840	13,297

For the year ended December 31, 2006, LDC recovered approved regulatory assets amounts of $26,877,000 through permitted distribution rate adjustments [2005 - $24,563,000]. These recovery amounts are for the recovery of approved regulatory assets recorded in reporting periods prior to January 1, 2005. In accordance with the OEB's direction, the Corporation recorded carrying charges on the recovered amounts of $nil in 2006 [2005 - $1,544,000].

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In the absence of rate regulation, interest income for the year ended December 31, 2006 would have been $nil [2005 - higher by $1,544,000].

For the years ended December 31, 2006 and December 31, 2005, recovery amounts were credited directly to reduce the regulatory assets recovery account. The regulatory assets and liabilities balances of the Corporation are defined as follows:

[a] Regulatory assets recovery account

On March 31, 2005, the OEB ordered that the approved regulatory asset balances be aggregated into a single regulatory account. Approved regulatory assets of $71,465,000 consisted of transition costs of $37,868,000, pre-market opening energy electricity variance of $26,129,000, and settlement variances of $31,852,000, less recoveries of $24,384,000, which were transferred to the "regulatory asset recovery account" ["RARA"]. This approved balance will be recovered over a period ending March 31, 2008. The RARA is credited with recovery amounts and is debited by OEB-prescribed carrying charges. In the absence of rate regulation, interest income in 2006 would have been $1,685,000 lower [2005 - $2,539,000].

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

[i] Transition costs

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

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

[ii] Pre-market opening energy electricity variance

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

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

[b] Excess of cash pension contributions

The OEB has allowed the LDC to defer the incremental OMERS pension expenditures for the fiscal years starting after January 1, 2005 and to end on April 30, 2006. Accordingly, the Corporation has deferred these expenditures in accordance with the criteria set out in the AP Handbook.

Under such regulation, the deferred expenditures would have been expensed under Canadian GAAP for unregulated businesses. In April 2006, the OEB approved the recovery of the deferred amount of $6,510,000. Accordingly, the balance was transferred to the RARA for recovery commencing May 1, 2006 and ending March 31, 2008. In the absence of rate regulation, operating expenses in 2006 would have been $1,725,000 higher [2005 - $4,785,000].

[c] Excess of OEB annual cost

The OEB has allowed the LDC to defer a portion of the OEB annual cost assessments for the fiscal years starting after January 1, 2004 and to end on April 30, 2006. Accordingly, the Corporation has deferred these expenditures in accordance with the criteria set out in the AP Handbook.

Under such regulation, the deferred expenditures would have been expensed under Canadian GAAP for unregulated businesses. In April 2006, the OEB approved the recovery of the deferred amount of $4,345,000. Accordingly, the balance was transferred to the RARA for recovery commencing May 1, 2006 and ending March 31, 2008. In the absence of rate regulation, operating expenses in 2006 would have been $786,000 higher [2005 - $2,166,000].

[d] Smart Meters

Effective May 1, 2006, the OEB has allowed the LDC to defer capital expenditures, operating expenditures, depreciation expense and revenues relating to smart meters. Accordingly, the Corporation has deferred these items in accordance with the criteria set out in the AP Handbook.

Under such regulation, in 2006, smart meter capital expenditures of $30,347,000 [2005 - $nil] were deferred. These expenditures would otherwise have been recorded as property, plant and equipment under Canadian GAAP for unregulated businesses. In the absence of rate regulation, property, plant and equipment in 2006 would have been $30,347,000 higher [2005 - $nil].

In 2006, smart meter operating expenditures of $526,000 [2005 - $nil] were deferred which would be expensed under Canadian GAAP for unregulated businesses., and smart meter depreciation expense of $690,000 [2005 - $nil] was deferred which otherwise would be charged to depreciation expense under Canadian GAAP for unregulated businesses. In the absence of rate regulation, operating expenses and depreciation expense in 2006 would have been $526,000 and $690,000 higher respectively [2005 - $nil and $nil respectively].

In 2006, smart meter customer revenues of $2,966,000 [2005 - $nil] were deferred. In the absence of rate regulation, revenue in 2006 would have been $2,966,000 higher [2005 - $nil].

The deferred balances continue to be calculated and attract carrying charges. In 2006, the Corporation recorded carrying charges of $422,000 [2005 - $nil] on the deferred amounts. In the absence of rate regulation, interest income in 2006 would have been $422,000 lower [2005 - $nil].

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The manner and timing of disposition of these smart meter regulatory assets have not been determined by the OEB at this time.

[e] Pre-market opening line loss variance

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

In the absence of rate regulation, there would have been no impact on the Consolidated Statement of Income for 2006 and 2005. The deferred balance does not attract carrying charges. The manner and timing of disposition of the variance have not been determined by the OEB.

[f] Settlement variances

The OEB has allowed the LDC to defer settlement variances from May 1, 2002 to December 31, 2006. This balance represents the variances between amounts charged by LDC to customers (based on regulated rates) and the corresponding cost of non-competitive electricity service incurred by LDC after May 1, 2002. The settlement variances relate primarily to service charges, non-competitive electricity charges, imported power charges and the global adjustment. Accordingly, the Corporation has deferred these recoveries in accordance with the criteria set out in the AP Handbook.

Settlement variances of $27,980,000, relating to the period from May 1, 2002 to December 31, 2004, were approved for recovery by the OEB and are included in the RARA balance. The remaining balance, representing settlement variances arising after January 1, 2005, is deferred in a regulatory liability account.

In the absence of rate regulation, interest income in 2006 would have been $49,000 lower [2005 - $1,112,000]. The deferred balance for unapproved settlement variances continues to be calculated and attract carrying charges in accordance with the OEB's direction. The manner and timing of disposition of the variance have not been determined by the OEB.

8. OTHER ASSETS

Other assets consist of the following:

	2006 $	2005 $
Deferred debt issue costs, net of accumulated amortization of $1,412,000 [2005 - $1,025,000]	**2,457**	2,843
Long-term advances and deposits	**—**	1,566
Other	**121**	1,081
	2,578	5,490

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December 31, 2006

9. BANK INDEBTEDNESS AND BANKERS' ACCEPTANCES

On May 5, 2005, the Corporation extended its revolving credit facility with a syndicate of Canadian banks [the "Revolving Credit Facility"] for a three-year period to May 4, 2008. Under the terms of the revolving credit facility, the Corporation may borrow up to $500,000,000, of which:

[a] $500,000,000 less the amount utilized under [b] is available for working capital purposes in the form of prime rate loans in Canadian dollars and bankers' acceptances; and

[b] up to $175,000,000 is available in the form of letters of credit to support the prudential requirements of LDC and TH Energy and general credit requirements of the Corporation and its subsidiaries.

The facility contains a negative pledge, customary covenants and events of default.

At December 31, 2006, $81,620,000 [December 31, 2005 - $90,174,000] had been utilized under the revolving credit facility in the form of letters of credit to support the prudential requirements of LDC [$80,000,000] [2005 - $80,000,000], TH Energy [$780,000] [2005 - $9,194,000] and Telecom [$840,000] [2005 - $980,000]. At December 31, 2006, no amounts had been drawn for working capital purposes [December 31, 2005 - $nil].

The Corporation also has a bilateral demand line of credit for $20,000,000 with a Canadian chartered bank. The line of credit bears interest at the bank's prime rate [December 31, 2006 – 6%]. At December 31, 2006, no amounts had been drawn on the line of credit [December 31, 2005 - $nil].

10. CURRENT PORTION OF OTHER LONG-TERM LIABILITIES

Current portion of other long-term liabilities consist of the following:

	2006 $	2005 $
Current portion of obligations under capital leases *[note 20]*	**733**	1,877
Customers' advance deposits	**15,904**	37,029
Other	**315**	304
	16,952	39,210

11. LONG-TERM DEBT

Long-term debt consists of the following:

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[all tabular amounts in thousands of dollars]

December 31, 2006

	2006 $	2005 $
Senior unsecured debentures	**225,000**	225,000
Promissory note payable to the City	**980,231**	980,231
	1,205,231	1,205,231
Less: Current portion of promissory note payable to the City	**245,058**	330,000
Long-term debt	**960,173**	875,231
Comprising:		
Debentures	**225,000**	225,000
Promissory note payable to the City	**735,173**	650,231

All debt of the Corporation ranks equally.

a) Senior unsecured debentures

On May 7, 2003, the Corporation issued $225,000,000 10-year senior unsecured debentures. The Corporation's 10-year senior unsecured debentures in the amount of $225,000,000, as at December 31, 2006, [December 31, 2005 - $225,000,000] bear interest at a rate of 6.11% per annum, payable semi-annually in arrears in equal instalments on May 7 and November 7 of each year. The debentures mature on May 7, 2013.

The Corporation may redeem some or all of the debentures at any time prior to maturity at a price equal to the greater of the Canada Yield Price (determined in accordance with the terms of the debentures) and par, plus accrued and unpaid interest up to but excluding the date fixed for redemption. Also, the Corporation may, at any time and from time to time, purchase debentures for cancellation, in the open market, by tender or by private contract, at any price. The debentures have the benefit of certain covenants which, subject to certain exceptions, restrict the ability of the Corporation and LDC to create security interests, incur additional indebtedness or dispose of all or substantially all of their assets.

b) Promissory note payable to the City of Toronto

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

Concurrent with the closing of the debenture offering on May 7, 2003, the City transferred the Replacement Note to the Corporation in consideration for the issue by the Corporation to the City of a new promissory note in the principal amount of $980,231,000 [2005 – $980,231,000] [the "City Note"]. At December 31, 2005 the principal amount of the City Note, together with accrued interest thereon, was payable:

[a] on demand on not less than 90 days written notice until May 7, 2006; and

[b] in accordance with a payment schedule to be delivered by the City at least 90 days before May 7, 2006;

provided that the Corporation will not be required to pay more than $330,000,000 of the principal amount of the City Note during any twelve-month period. Accordingly, $330,000,000 of the principal amount outstanding under the City Note was classified as a current liability. In 2005 the maximum term of the City Note was ten years.

On September 5, 2006, the Corporation announced that it and the City had amended and restated the City Note effective May 1, 2006 by fixing the interest rate at 6.11% and establishing an agreed repayment schedule. The Corporation is required to pay the principal amount of the note as follows: $245,058,000 on the last business day before each of December 31, 2007, December 31, 2009, December 31, 2011 and on May 6, 2013. Accordingly, $245,058,000 of the principal amount outstanding under the City Note is classified as a short-term liability, with the remainder being classified as a long-term liability. Interest is calculated and payable quarterly in arrears on the last business day of March, June, September and December of each year.

12. EMPLOYEE FUTURE BENEFITS

Pension

For the year ended December 31, 2006, the Corporation's OMERS current service pension costs were $10,343,000 [2005 - $8,965,000].

Employee future benefits other than pension

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

The Corporation measures its accrued benefits obligation for accounting purposes as at December 31 of each year. The latest actuarial valuation was performed as at January 1, 2005. The December 31, 2006 year-end accrued benefit obligation reflects a December 31, 2006 discount rate. This result was achieved by updating the January 1, 2005 actuarial valuation using the December 31, 2006 discount rate of 5.3% while keeping all other assumptions constant.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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December 31, 2006

[a] Accrued benefit obligation

	2006 $	2005 $
Balance at beginning of year	**167,013**	139,468
Experience gain at beginning of year	**—**	(1,446)
Current service cost	**3,907**	3,152
Interest cost	**8,412**	8,178
Benefits paid	**(5,372)**	(4,988)
Actuarial (gains) losses	**(6,499)**	22,649
Balance at end of year	**167,461**	167,013

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

	2006 $	2005 $
Accrued benefit obligation	**167,461**	167,013
Unamortized net actuarial loss	**(26,593)**	(34,427)
Unamortized past service costs	**(6,186)**	(7,171)
Post-employment benefits liability	**134,682**	125,415

[c] Components for net periodic defined benefit costs

	2006 $	2005 $
Current service cost	**3,907**	3,152
Interest cost	**8,412**	8,178
Actuarial (gains) losses	**(6,499)**	21,203
Cost incurred in the year	**5,820**	32,533
Differences between costs incurred and costs recognized in the year in respect of:		
Actuarial loss (gain)	**7,789**	(21,230)
Past service costs	**985**	983
	8,774	(20,247)
Defined benefit costs recognized	**14,594**	12,286
Capitalized as part of property, plant and equipment	**6,385**	3,672
Charged to operations	**8,209**	8,614

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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[d[Significant assumptions

	2006 %	2005 %
Accrued benefit obligation as of December 31:		
Discount rate	**5.3**	5.0
Rate of compensation increase	**4.0**	4.0
Benefit costs for years ended December 31:		
Discount rate	**5.0**	5.9
Rate of compensation increase	**4.0**	4.0
Assumed health care cost trend rates at December 31:		
Rate of increase in dental costs	**4.5**	4.5

For December 31, 2006 and 2005, medical costs are assumed to increase at 10.5% graded down by 1.0% annual decrements to 4.5% in 2011 and thereafter.

[e] Sensitivity analysis

Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A one-percentage-point change in assumed health care cost trend rates have the following effects for 2006:

	Increase $	Decrease $
Net periodic benefit cost (at 5.0%)	**2,282**	**(1,699)**
Accrued benefit obligation at December 31, 2006 (at 5.3%)	**27,682**	**(21,182)**

13. OTHER LONG-TERM LIABILITIES

Other long-term liabilities consist of the following:

	2006 $	2005 $
Obligations under capital leases *[note 20]*	**1,033**	2,063
Security deposits	**1,575**	3,277
Lease liability – long-term	**—**	285
Other	**1,341**	3,452
	3,949	9,077

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During 2006, the Corporation acquired “Property, plant and equipment” through capital lease transactions totaling $556,000 [2005 - $43,000]. These non-cash transactions have been excluded from the Consolidated Statement of Cash Flows.

14. ASSET RETIREMENT OBLIGATIONS

A reconciliation between the opening and closing ARO liability balances is as follows:

	2006 $	2005 $
Balance, beginning of year	**5,691**	4,274
ARO liabilities incurred in the year	**2,039**	1,525
ARO liabilities settled in the year	**(509)**	(351)
Accretion expense	**360**	243
Balance, end of year	**7,581**	5,691

At December 31, 2006, the Corporation estimates the undiscounted amount of cash flows required over the next ten years to settle the ARO is $11,372,000 [2005 - $6,836,000]. Discount rates ranging from 4.3% to 6.0% were used to calculate the carrying value of the ARO liabilities. No assets have been legally restricted for settlement of the liability.

15. FINANCIAL INSTRUMENTS

Electricity retailing commitments

In December 2002, TH Energy ceased new electricity retailing activities in respect of new customers as a result of the price freeze implemented under Bill 210. TH Energy managed the remaining portfolio of electricity contracts comprised primarily of fixed notional volume contracts, wholesale financial fixed notional volume fixed-for-floating and floating-for-fixed swaps and fixed notional volume physical bilateral contracts. The contracts are derivative contracts for accounting purposes. The electricity contracts had varying maturity dates throughout the period ending December 31, 2006.

At December 31, 2006, TH Energy had floating-for-fixed electricity contracts that had an aggregate expected contract volume and value of nil MWh and $nil [2005 – 3,124,000 MWh and $171,270,000].

To hedge the volume and price risk inherent in retailing electricity, TH Energy entered into financial fixed notional volume fixed-for-floating swaps and fixed notional physical bilateral contracts with generators and marketers. At December 31, 2006, the aggregate notional volume and value of these contracts were nil MWh and $nil [2005 – 3,614,000 MWh and $154,396,000].

For the year ended December 31, 2006, “Revenues” include $20,661,000 of electricity mark-to-market revenues [2005 - $34,309,000].

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Credit risk

Financial instruments result in exposure to credit risk stemming from the risk of the counter-party defaulting on its obligations. TH Energy monitors and limits its exposure to counter-parties with lower credit ratings and evaluates its counter-party credit exposure on a continuous basis. TH Energy obtains collateral from some counter-parties and seeks to deal only with counter-parties with investment-grade credit ratings. TH Energy had five wholesale counter-parties as at December 31, 2006 for its electricity supply portfolio. In addition, TH Energy provides reserves for credit risks based on the financial condition and short and long-term exposures to counter-parties. The largest single credit exposure at December 31, 2006 is estimated at $12,382,389, which is the December 2006 invoice of power sold to one counter party [2005 - $137,170,000].

For retail customers, credit losses are generally low across the sector. LDC, TH Energy and Telecom provide for an allowance for doubtful accounts to absorb credit losses. At December 31, 2006, there were no significant concentrations of credit risk with respect to any class of financial assets other than the risk mentioned above.

Interest rate risk

The Corporation is exposed to interest rate risk for certain of its financial assets and liabilities. Under the Corporation's Revolving Credit Facility *[note 9]*, the Corporation may have short-term borrowings for working capital purposes. These borrowings would expose the Corporation to fluctuations in short-term interest rates [borrowings in the form of prime rate loans in Canadian dollars and bankers' acceptances and letters of credit]. The fee payable for bankers' acceptances and letters of credit is based on a margin determined by reference to the Corporation's credit rating.

Certain cash balances of the Corporation is invested in Canadian money market instruments, with terms of one day to 90 days, exposing the Corporation to fluctuations in short-term interest rates. These fluctuations could impact the level of interest income earned by the Corporation.

Fair value of financial instruments

The carrying value of cash and cash equivalents, accounts receivable, unbilled revenue, and accounts payable and accrued liabilities approximates their fair value due to the immediate or short-term maturity of these financial instruments.

At December 31, 2006, the fair values of the City Note [$980,231,000] and the senior unsecured debentures [$225,000,000] are $1,034,640,000 and $247,515,000 [2005 - $1,120,405,000 and $251,415,000]. These fair values have been calculated by discounting the future cash flow of the respective long-term debt at the estimated yield to maturity of similar debt instruments *[note 11].*

The fair value of hedging derivative financial instruments is the estimated amount the Corporation would receive (pay) to terminate the contracts. The value is based on market prices or management's best estimates if there is no organized market and/or if the market is illiquid.

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All retail fixed notional volume fixed price contracts and all undesignated wholesale fixed notional volume fixed-for-floating swaps and fixed notional volume physical bilateral contracts are accounted for using the mark-to-market method of accounting. The following are the primary sources of the change in the net mark-to-market assets:

	2006 $	2005 $
Net mark-to-market assets		
Fair value, beginning of year	**26,422**	27,696
Unrealized change in fair value during the period	**(4,431)**	16,342
Realization of contracts for the period	**(21,991)**	(17,616)
Fair value of net mark-to-market assets, end of year	**—**	26,422

16. FINANCIAL GUARANTEES

Participants [including LDC and TH Energy] in the wholesale market for electricity are required to satisfy prescribed prudential requirements. In addition, counter-parties under contracts for the purchase and sale of electricity and customers under purchase contracts may require parental financial guarantees or other forms of credit support.

The City has authorized the Corporation to provide up to $500,000,000 in financial support [including guarantees] with respect to prudential requirements and as security for obligations under third party contracts.

At December 31, 2006, the Corporation's board of directors had approved $386,000,000 in parental guarantees on behalf of TH Energy, of which $56,500,000 has been issued to unrelated parties [2005 - $86,500,000].

The Corporation has issued a parental guarantee to the City as part of an agreement to purchase electricity at a fixed price from TH Energy. The fair value of the parental guarantee was $nil at December 31, 2006 [2005 - $56,417,000]

17. PAYMENTS IN LIEU OF CORPORATE TAXES

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

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Consolidated Statement of income

	2006 $	2005 $
Rate reconciliation		
Income before PILs	**148,622**	159,756
Consolidated Statutory Canadian federal and provincial income tax rate	**36.12%**	36.12%
Expected provision for PILs	**53,682**	57,704
Increase in income taxes resulting from large corporations tax net of surtax	**—**	1,655
Temporary differences not benefited	**3,482**	10,630
Valuation allowance	**1,150**	(2,056)
Decrease in federal future tax rates	**2,215**	—
Other	**(2,126)**	906
Provision for PILs	**58,403**	68,839
Effective tax rate	**39.30%**	43.09%
Components of provision for PILs		
Current tax provision	**60,890**	71,960
Future income tax recovery related to the origination and reversal of temporary differences	**(2,487)**	(3,121)
Provision for PILs	**58,403**	68,839

Consolidated Balance sheet

Significant components of the Corporation's future income tax assets and liabilities are as follows:

	2006 $	2005 $
Non-capital loss carryforwards	**576**	2,785
Property, plant and equipment and intangible assets	**27,968**	32,153
Other taxable temporary differences	**4,735**	(4,998)
Valuation allowance	**(16,847)**	(15,973)
	16,432	13,967

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Presented on the consolidated balance sheet as follows:

	2006 $	2005 $
Future income tax assets, current	**791**	33,195
Future income tax assets, long-term	**16,009**	22,264
Future income tax liabilities, current	**—**	(40,923)
Future income tax liabilities, long-term	**(368)**	(569)
	16,432	13,967

Under the taxes payable method applicable to LDC, no adjustments are made for differences between the financial statement carrying values and the tax basis of assets and liabilities. As at December 31, 2006, future income tax assets of $234,217,000 [2005 - $249,838,000], based on substantively enacted income tax rates, have not been recorded. In the absence of rate regulated accounting, the Corporation's provision for PILs would have been recognized using the liability method rather than the taxes payable method. As a result, the provision for PILs in 2006 would have been $3,482,000 lower [2005 – $7,863,000 lower][*note 4 [b]*].

As at December 31, 2006, the Corporation has accumulated tax losses for PILs purposes of approximately $1,744,000, which are available to reduce future years' taxable income. These loss carryforwards begin to expire in 2008.

As at December 31, 2006, LDC has accumulated a PILs variance amount, representing the difference between actual billings that relate to the recovery of PILs and the OEB-approved PILs, totaling an under-recovery of $10,286,000 [2005 -$4,948,000]. LDC has also accumulated a PILs variance amount representing differences that have resulted from a legislative or regulatory change to the tax rates or rules assumed in the 2006 electricity distribution rate application totalling an over-recovery of $1,702,000 [2005 - $ nil]. Cumulative interest included in the amounts was calculated following OEB direction and totaled $3,004,000 [2005 - $2,858,000].

18. SHARE CAPITAL

Share capital consists of the following:

	2006 $	2005 $
Authorized		
The authorized share capital of the Corporation consists of an unlimited number of common shares		
Issued and outstanding		
1,000 common shares	**567,817**	567,817

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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December 31, 2006

Dividends

The shareholder direction adopted by the City with respect to the Corporation provided that the Corporation's board of directors would use its best efforts to ensure that the Corporation met certain financial performance standards, including those relating to credit rating and dividends. Subject to applicable law, the shareholder direction provided that the Corporation would pay dividends to the City each year.

Subject to applicable law and the shareholder direction, the amount of the annual dividends payable by the Corporation to the City is to be the greater of $25,000,000 or 50% of the Corporation's annual consolidated net income. The dividends are not cumulative and are payable as follows:

[a] $6,000,000 on the last day of each of the first three fiscal quarters in each year;

[b] $7,000,000 on the last day of the fiscal year; and

[c] the amount, if any, by which 50% of the Corporation's annual consolidated net income for the year exceeds $25,000,000 within ten days after the board of directors of the Corporation approves the Corporation's audited consolidated financial statements for the year.

During 2006, the board of directors of the Corporation declared and paid dividends totaling $46,200,000 to the City [2005 - $68,000,000].

19. RELATED PARTIES

For the Corporation, transactions with related parties include transactions with the City. All transactions with the City are conducted at prevailing market prices and normal trade terms.

For the year ended December 31, 2006, LDC provided street lighting electricity to the City in the amount of $9,281,000 [2005 - $11,089,000].

For the year ended December 31, 2006, TH Energy invoiced the City for electricity for $102,771,000 [2005 - $107,450,000]. At December 31, 2006, included in "Accounts receivable, net of allowance for doubtful accounts" are $5,905,000 [2005 - $1,257,000] receivable from the City related to these electricity billing activities.

For the year ended December 31, 2006, TH Energy provided energy efficiency products and services to the City amounting to $2,010,000 [2005 - $1,927,000].

On December 31, 2005, TH Energy acquired the street lighting and expressway lighting assets from the City for cash consideration of $60,000,000. The transaction was recorded at the exchange amount, which is reflective of the fair market value, as an increase in property, plant and equipment. The acquisition of these assets was recorded at the exchange amount since the carrying value of the assets in the City's records was not determinable. The purchase price was supported by an independent valuation of the fair market value of the acquired assets. The acquired assets are being depreciated over their estimated remaining service lives.

Concurrently with the transaction, the Corporation entered into a service agreement with the City to provide street lighting and expressway lighting services to the City for a period of 30 years commencing January 1, 2006. During

[all tabular amounts in thousands of dollars]

2006, TH Energy provided street and expressway lighting services to the City totalling $15,287,000 [2005 - $4,712,000].

For the year ended December 31, 2006, LDC incurred property taxes payable to the City of $7,306,000 [2005 - $7,030,000].

At December 31, 2006, a promissory note in the amount of $980,231,000 [2005 - $980,231,000] was payable to the City. For the year ended December 31, 2006, interest expense of $59,892,000 [2005 - $66,656,000], on the promissory note was paid to the City *[note 11]*.

20. LEASE COMMITMENTS

Operating lease obligations

As at December 31, 2006, the future minimum annual lease payments under property and computer hardware operating leases with remaining lease terms from one to five years are as follows:

	$
2007	**4,646**
2008	**5,793**
2009	**5,567**
2010	**5,498**
2011	**5,018**
Thereafter	**2,953**
Total minimum lease payments	**29,475**

Capital lease obligations

As at December 31, 2006, the future minimum annual lease payments under vehicle capital leases with remaining lease terms from one to five years are as follows:

	$
2007	**733**
2008	**562**
2009	**552**
2010	**160**
Thereafter	**11**
Total amount of future minimum lease payments	**2,018**
Less interest	**252**
	1,766
Current portion *[note 10]*	**733**
Long-term portion *[note 13]*	**1,033**

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December 31, 2006

21. CONTINGENCIES

a) Ministry of Finance Tax Audit

The Ministry of Finance is currently carrying out a tax audit on the Corporation and its subsidiaries. Certain filing positions for PILs taken by the Corporation and its subsidiaries may be challenged on the audit. This may result in a material increase in the Corporation's reported tax obligations upon reassessment. As the audit has not yet been completed, management is not able to determine the impact, if any, of the audit on the consolidated financial statements or the Corporation's tax reserves. The Corporation adjusts its tax reserves when there is sufficient information available, or when an event occurs requiring a change to the reserves.

b) Consumers' Gas Decision

On April 22, 2004, in a decision in a class action commenced against The Consumers' Gas Company Limited (now Enbridge Gas Distribution Inc.), the Supreme Court of Canada [the "Supreme Court"] ruled that The Consumers' Gas Company ["Consumers' Gas"] was required to repay the portion of certain late payment charges collected by it from its customers that were in excess of the interest limit stipulated in section 347 of the *Criminal Code*. Although the claim related to charges collected by Consumers' Gas after the enactment of section 347 of the *Criminal Code* in 1981, the Supreme Court limited recovery to charges collected after the action was initiated in 1994. The Supreme Court remitted the matter back to the Ontario Superior Court of Justice for a determination of the plaintiffs' damages. The parties reached a settlement of this class action. The Ontario Superior Court of Justice has approved this settlement, however, the representative plaintiff, Mr. Garland, is appealing the settlement approval order in an attempt to increase the fees to which he is entitled for having acted as representative plaintiff, and to receive lawyer's fees in connection with that effort. Mr. Garland's appeal is pending.

LDC is not a party to the Consumers' Gas class action. It is, however, subject to the two class actions described below in which the issues are analogous.

The first is an action commenced against a predecessor of LDC and other Ontario municipal electric utilities under the Class Proceedings Act, 1992 seeking $500,000,000 in restitution for late payment charges collected by them from their customers that were in excess of the interest limit stipulated in section 347 of the *Criminal Code*. This action is at a preliminary stage. Pleadings have closed but examinations for discovery have not been conducted and the classes have not been certified. After the release by the Supreme Court of Canada of its 2004 decision in the Consumers' Gas case, the plaintiffs in this proposed class action indicated their intention to proceed with the litigation, but no formal steps have been taken.

The second is an action commenced against a predecessor of LDC under the Class Proceedings Act, 1992 seeking $64,000,000 in restitution for late payment charges collected by it from its customers that were in excess of the interest limit stipulated in section 347 of the *Criminal Code*. This action is also at the preliminary stage. Pleadings have closed and examinations for discovery have been conducted but, as in the first action, the classes have not been certified as the parties were awaiting the outcome of the Consumers' Gas class action.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

[all tabular amounts in thousands of dollars]

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The claims made against LDC and the definitions of the plaintiff classes are identical in both actions. As a result, any damages payable by LDC in the first action would reduce the damages payable by LDC in the second action, and vice versa.

It is anticipated that the first action will now proceed for determination in light of the reasons of the Supreme Court in the Consumers' Gas class action.

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

Also, the determination of whether the late payment charges collected by LDC from its customers were in excess of the interest limit stipulated in section 347 of the *Criminal Code* is fact specific in each circumstance. Accordingly, given the preliminary status of these actions, it is not possible at this time to quantify the effect, if any, of the Consumers' Gas decision on these actions or of these actions on the financial performance of the Corporation.

22. NET INCOME PER SHARE

The weighted daily average numbers of shares outstanding were 1,000 as at December 31, 2006 and 2005, for purposes of determining basic and fully diluted net income per share for continuing and discontinued operations. Basic and fully diluted net income per share for continuing and discontinued operations were determined by dividing the net income for the year by the weighted daily average number of shares outstanding.

23. DISCONTINUED OPERATIONS

In November 2006, the Board of Directors of TH Energy approved a plan to sell the water heater assets and to exit this business segment. Accordingly, the results of operations and financial position of the water heater business have been segregated and presented as discontinued operations in the accompanying financial statements. As at December 31, 2006, the net assets of the water heater business have been measured and presented at the lower of the carrying amount or fair value less cost to sell. The net assets held for sale are as follows:

	$
Current assets held for sale:	
Property, plant and equipment	**12,098**
	12,098
Current liabilities held for sale:	
Accounts payable	**103**
Future income tax liabilities	**803**
	906

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

[all tabular amounts in thousands of dollars]

December 31, 2006

For the year ended December 31, 2006 and 2005, the following revenue and expenses of the water heater business have been reclassified from continuing operations to discontinued operations:

	2006 $	2005 $
Sales	**8,085**	8,147
Expenses		
Purchased power and other	**1,820**	1,753
Operating expenses	**879**	319
Depreciation and amortization	**2,405**	3,498
	5,104	5,570
Provision of payments in lieu of corporate taxes	**803**	1,049
Income from discontinued operations	**2,178**	1,528

24. SEGMENT REPORTING

The designation of the segments has been based on a combination of the regulatory status and the nature of products and services provided. The Corporation has two reportable segments:

[a] Electricity Distribution:
the regulated business which consists of the electricity distribution business of LDC; and

[b] Non-regulated:
the non-regulated business of TH Energy which consist primarily of the delivery of street lighting and expressway lighting services, the sale of energy management services, and up until December 31, 2006, the management of a portfolio of electricity contracts. The non-regulated business of Telecom which consists of the provision of fibre optic capacity and data communications services to telecommunications carriers, business customers and large institutions.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
[all tabular amounts in thousands of dollars]

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Segment information on the above basis is as follows:

	2006 $	2005 $
Electricity Distribution		
Revenues	**2,264,469**	2,709,819
Purchased power and other	**1,784,144**	2,224,034
Depreciation and amortization	**124,560**	124,988
Interest income	**11,225**	10,485
Interest expense	**76,537**	80,620
Segment profit before interest, other items and provision for payments in lieu of corporate taxes	**186,701**	193,658
Payment in lieu of corporate taxes	**46,001**	61,114
Non-regulated		
Revenues	**75,530**	103,434
Purchased power and other	**14,654**	42,331
Depreciation and amortization	**12,784**	6,607
Interest income	**84,520**	81,865
Interest expense	**80,278**	80,717
Segment profit before interest, other items and provision for payments in lieu of corporate taxes	**22,902**	30,045
Payment in lieu of corporate taxes	**12,402**	7,725
Intersegment eliminations		
Revenues	**(92,991)**	(206,981)
Purchased power and other	**(92,953)**	(206,576)
Interest income	**(78,019)**	(78,234)
Interest expense	**(78,019)**	(78,234)

	2006 $	2005 $
Total		
Revenues	**2,247,008**	2,606,272
Purchased power and other	**1,705,845**	2,059,789
Depreciation and amortization	**137,344**	131,595
Interest income	**17,726**	14,116
Interest expense	**78,796**	83,103
Income before interest, other items and provision for payments in lieu of corporate taxes	**209,603**	223,703
Payment in lieu of corporate taxes	**58,403**	68,839

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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	2006 $	2005 $
Expenditures on property, plant and equipment and intangible assets		
Electricity Distribution	**167,685**	132,260
Non-regulated	**22,934**	68,095
Intersegment eliminations	**(5,312)**	—
Total	**185,307**	200,355

	2006 $	2005 $
Assets		
Electricity Distribution	**2,280,811**	2,393,533
Non-regulated	**1,505,987**	1,619,790
Intersegment eliminations	**(1,207,190)**	(1,194,065)
Discontinued operations	**12,098**	—
Total	**2,591,706**	2,819,258

All revenues, costs and assets, as the case may be, are earned, incurred or held in Canada.

25. COMPARATIVE CONSOLIDATED FINANCIAL STATEMENTS

The comparative consolidated financial statements have been reclassified from statements previously presented to conform to the presentation of the 2006 consolidated financial statements.

26. SUBSEQUENT EVENTS

Regulatory Affairs

On January 26, 2007, LDC filed an Annual Rate Adjustment Application for 2007 Rates as directed to by the OEB. In accordance with the OEB's Incentive Regulation Model, LDC has sought authorization to increase its rates by 0.4% on May 1, 2007.

Sale of water heater business

On February 8, 2007, TH Energy sold its water heater business to Consumers' Waterheater Income Fund for cash consideration of $40,800,000 subject to post closing adjustments and transaction costs. This transaction will be recorded in the financial statements in 2007.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

[all tabular amounts in thousands of dollars]

December 31, 2006

Dividends

On March 1, 2007, the board of directors of the Corporation declared a dividend in the amount of $27,199,000. The dividends are comprised of a $21,199,000 payment for 2006 net income, payable to the City on March 9, 2007 and a $6,000,000 payment in connection with the first quarter of 2007, payable to the City on March 30, 2007.