



Report to the
City of Toronto
Executive Committee

November 5, 2012

Executive Summary

This report summarizes Toronto Hydro's executive compensation policies and practices.

In the past number of years, executive compensation practices have been the focus on much regulatory scrutiny. Within the private sector, there are highly rigorous governance standards and reporting requirements for companies that are public equity or debt issuers. Toronto Hydro, as a public debt issuer, is obligated to fully comply with these regulatory requirements. These requirements include the following:

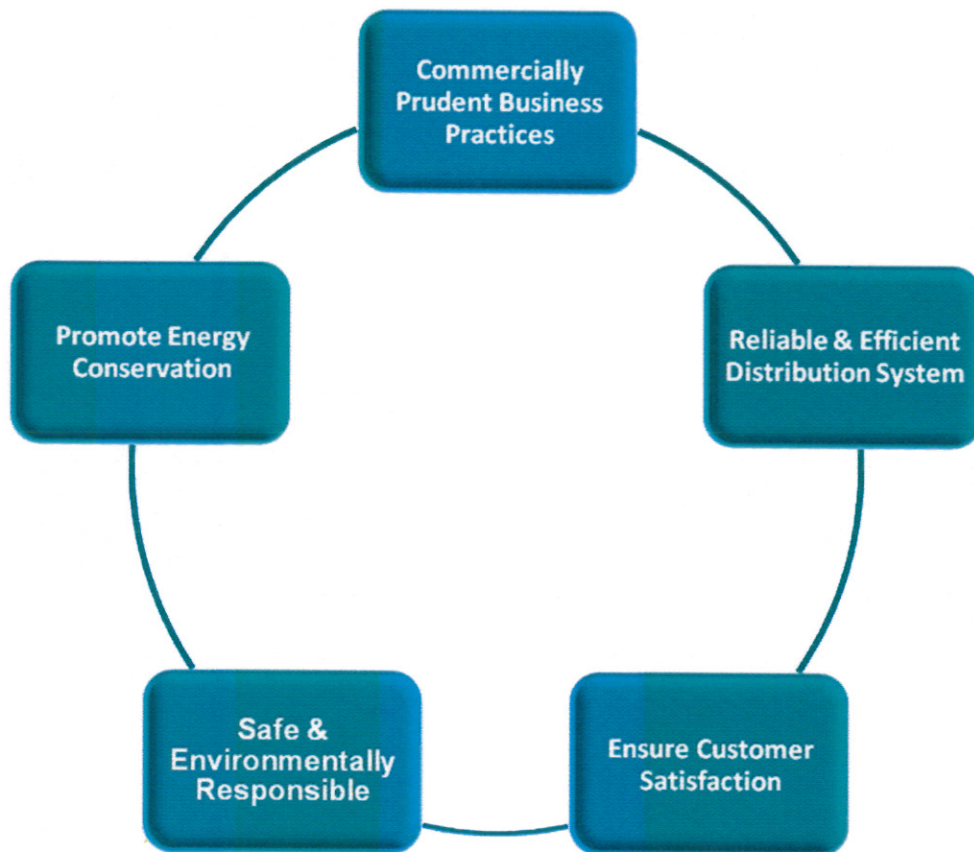
- Compensation recommendations relating to the Chief Executive Officer ("CEO") must be made by a Compensation and Human Resource Committee of the Board consisting entirely of Independent Directors;
- The Committee must have sufficient expertise and experience in these matters;
- The advice to the Committee must be provided by an independent external advisor and that the nature of that advisor's relationship to the firm be fully disclosed; and
- The compensation practices must be fully disclosed

As Toronto Hydro is a regulated utility, it is also required to report to the Ontario Energy Board ("OEB") on the reasonableness of its compensation practices in support of any rate filing. These filings are supported by extensive analysis of the competitiveness of compensation practices at all employee levels and are subject to intervenor scrutiny.

Finally, Toronto Hydro is owned by the City of Toronto and is dedicated to the fulfilling the City's expectations for the corporation. These expectations (derived from the Shareholder Direction Relating to Toronto Hydro Corporation) are summarized below and focus on the effectiveness of the company in meeting the needs of Toronto by ensuring that energy needs are reliable, efficient, safe, environmentally sensitive and delivered in the most cost-effective manner.

City of Toronto

Shareholder Direction for Toronto Hydro Corporation

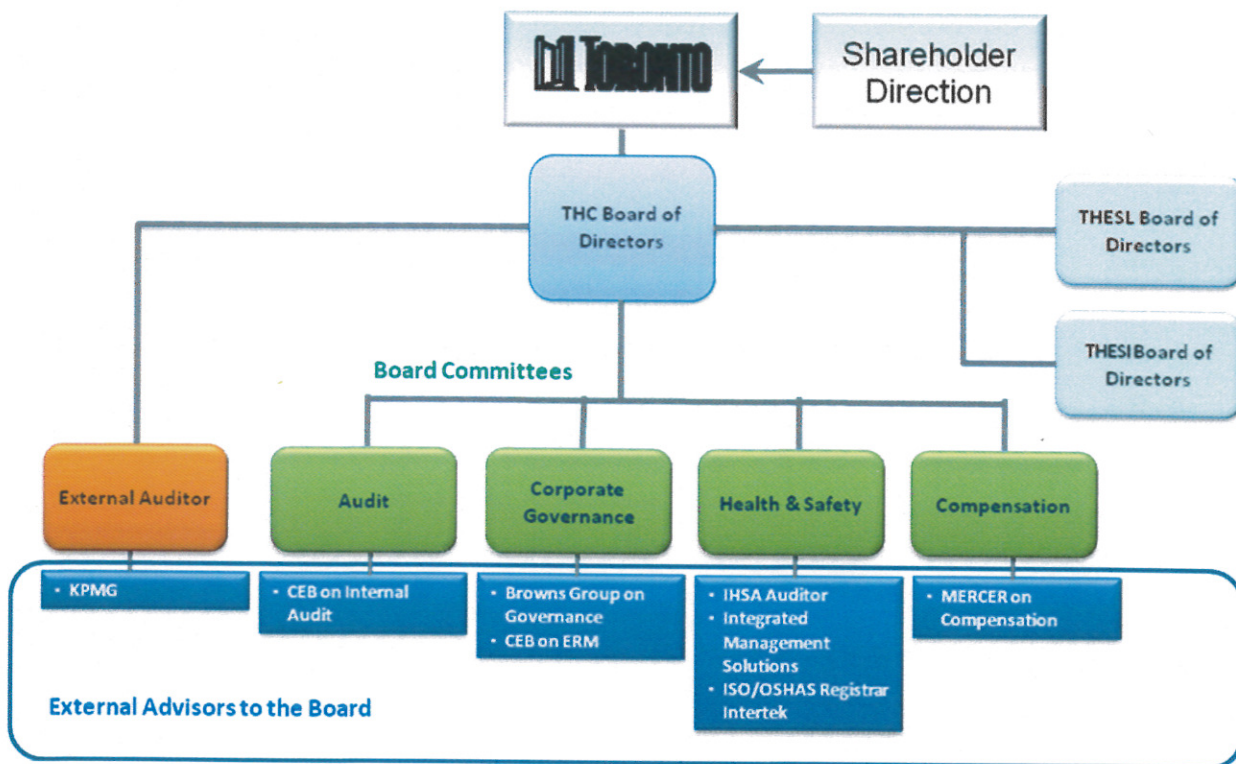


This report provides an overview of Toronto Hydro's executive compensation programs and processes, their full compliance with all regulatory requirements and their alignment with the key outcomes expected by the City.

Governance

Toronto Hydro’s Compensation Committee consists of fully independent directors with significant experience in executive compensation. This committee has a defined charter which describes the scope of its mandate and the expectations of advisors to the Committee. Mercer Canada has been engaged as the advisor to the Committee and is fully compliant with its engagement requirements. Mercer attends all Committee meetings and meets in camera with the Committee to discuss executive compensation issues and recommendations. A summary overview of the overall Board Committee structure and its external advisors is shown below.

Toronto Hydro – Corporate Governance



The Compensation Committee engages Mercer, Canada’s leading compensation experts to assist and to provide updates on the competitiveness of the CEO’s compensation, as well as that of other members of the executive team. This review includes all elements of the

executive compensation arrangement including base salary, annual performance pay and significant perquisites and benefits (including pension). This process and the outcomes are reported in the Annual Information Form filed by Toronto Hydro in compliance with its obligations as a public debt issuer.

In addition to the benchmarking review, Mercer also reviews the performance pay process including the selection of performance measures and targets, the assessment of performance and the determination of appropriate performance pay awards. In addition, actual results are subject to review by the Audit Committee of the Board.

Performance

Mercer assisted Toronto Hydro in the development of its performance management process and the design of its performance pay program. These programs helped enable Toronto Hydro's transition to a performance-based culture which is essential to its ability to continuously improve and deliver on its mandate.

A key element of this process is the annual performance pay program. Toronto Hydro was one of the first LDC's (Local Distribution Companies) in Ontario to develop a rigorous performance pay system and it has served as a template for other LDC's in the province as they have adopted similar practices. This program ensures that all non-bargaining employees have a portion of their annual total compensation at risk for performance. All employees are accountable for overall business performance, the performance of their business unit, and their individual contribution to it -- with the relative importance of each varying with the level of employee and their ability to impact outcomes.

This process ensures that there is clear accountability for the achievement of all key business expectations throughout the organization. As Mercer describes it, "the THC performance measurement process is one of the most effective performance measurement systems seen in any industry." The effectiveness of the program is evident in the performance results. As the chart below illustrates, Toronto Hydro's distribution costs declined as a percentage of overall hydro rates.

Distribution Bill -- Residential (800 kWh/Month)

	2005	2011	Compound Annual Average
Toronto Hydro Distribution	29.72	29.50	-0.12%
Transmission	8.63	10.09	2.64%
Regulated Charges	11.00	11.25	0.37%
Commodity	41.50	66.57	8.19%
GST/HST	6.36	15.26	15.71%
Total Bill before OCEB	\$97.21	\$132.67	5.32%
Ontario Clean Energy Benefit		\$13.27	
Net Total Bill	\$97.21	\$119.41	3.49%

Since amalgamation, Toronto Hydro's performance has been truly outstanding. Over this period, Toronto Hydro has...

- Paid out \$2 billion to the City of Toronto in interest and dividend payments
- Raised \$1.5 billion in debenture bonds
- Reduced staff levels by 42% (from 2,688 in 1996 to 1,562 in 2012)
- Reduced executive staff levels by 50% (from 20 in 2005 to 10 in 2012)
- Achieved accolades in safety performance (IHSA President's Award for 3,000,000 hrs worked without incurring a compensable injury)
- Maintained a high standard of reliability for rate payers and users of electricity in Toronto
- Led Ontario in the deployment of Smart Meters and Time of Use billing

All while...

- Increasing our number of customers served
- Increasing capital investments by approximately 190% (from \$132 million in 2005 to \$380 million in 2011)

This success in large measures the results of outstanding leadership and rigorous performance measurement and monitoring systems tied directly to the compensation practice.

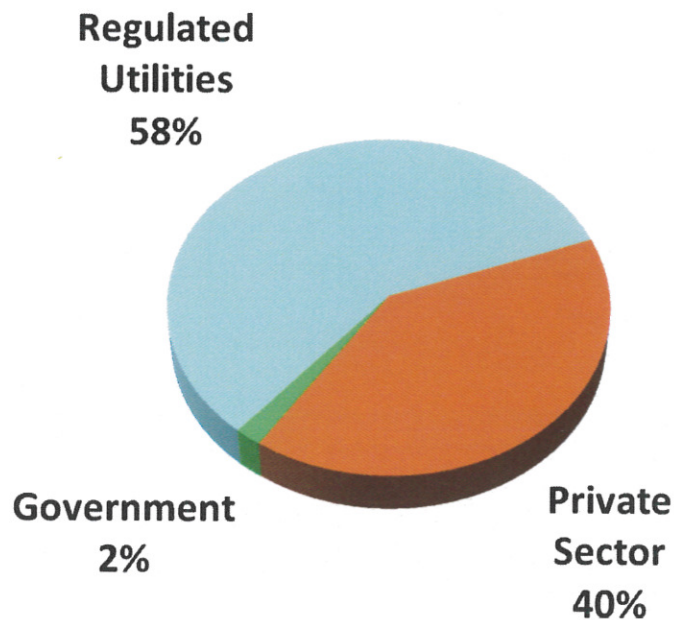
Compensation

As indicated above, the Compensation Committee asks Mercer to review the competitiveness of the current compensation practices at Toronto Hydro. In conducting this analysis, Mercer reviews the compensation practices of other companies in the market for employees performing similar roles.

For the CEO, this means Mercer only compares the compensation of the Toronto Hydro CEO to other CEO's in the market. Best practice suggests that the markets selected should be reflective of the markets where the organization attracts talent from or loses talent to. In this case, that includes both the broader energy sector as well as the general market. It typically does not include the public sector. The following is a breakdown of the actual recruitment results of our senior management talent at Toronto Hydro.

Senior Management Sector / Industry Background

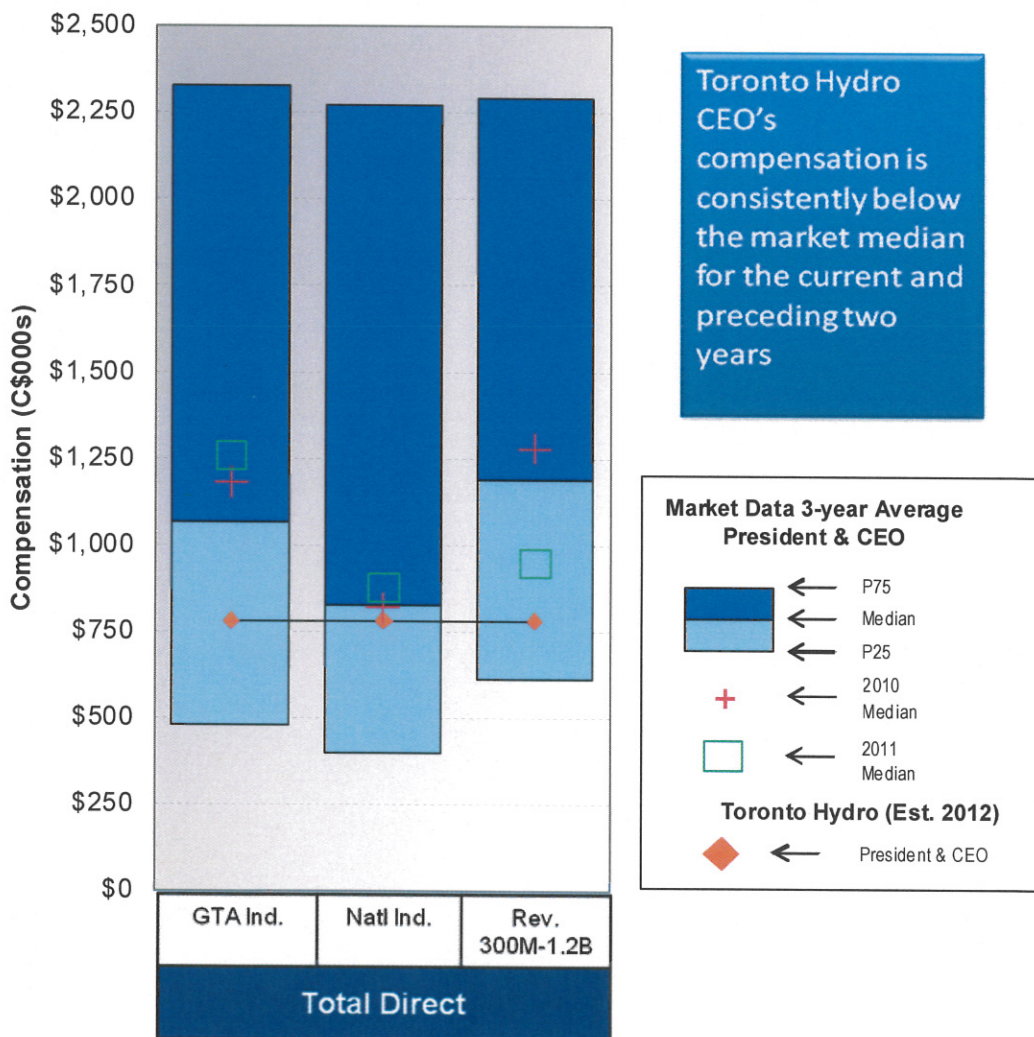
Where did our Executives and Managers come from?



However, to ensure that no one market biases the results, Mercer provides a comparison of compensation against different segments of the market to ensure the Compensation Committee is fully aware of differences including, where permitted, the disclosure of actual pay practices of those specific comparators where public disclosure of compensation is available.

The table below shows a summary of one such analysis for the CEO position.

Market Compensation Levels (president & CEO)¹



¹ Mercer, March 2012

This chart shows the compensation of the CEO compared to three different views of the general industrial market: GTA industrials which reflects the compensation practices of industrial organizations in the GTA, national industrials which captures similar practices of companies across Canada including those of other energy companies, and a group that includes only companies of similar size to Toronto Hydro.

This last comparator group follows market best practice and only includes companies that have revenue between half and two times that of Toronto Hydro (generally accepted as a reasonable range for comparability). However, this comparison is a CONSERVATIVE estimate because revenue excludes the flow through cost of power and focuses only on the operating revenue within the control of Toronto Hydro. Given the OEB's focus on effectiveness, this conservative approach was adopted by the Compensation Committee as a baseline for establishing compensation.

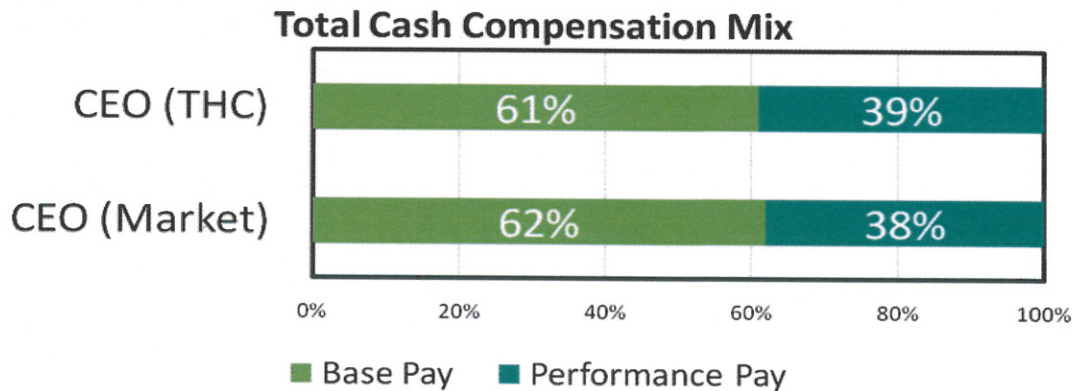
In addition, this analysis looks at compensation levels over the current and preceding 2 years to ensure that changes in any one year do not bias the Committee's view of typical market practice.

Finally, this analysis includes a view of each element of compensation -- Base Salary; Annual Total Cash, which includes actual performance pay earned; and Total Direct Compensation, which includes the value of long term incentives provided in the market.

As you can see from the data, Toronto Hydro's annual Total Direct Compensation is below the median of CEO's in organizations of similar size. Toronto Hydro targets annual Total Cash Compensation at the market median with actual earned compensation above or below this level based on delivered performance results.

Mercer has also looked at the mix of base pay and performance pay for the CEO and other executives relative to the practices of other publicly disclosed energy companies. As can be seen in the chart below, the mix of compensation offered at Toronto Hydro is consistent with market practice. Toronto Hydro does not offer long term incentives provided by some other energy and industrial companies.

Total Cash (Base + Short-term) Compensation Design²



Finally, in addition to a review of cash compensation, the Committee has asked Mercer to review all aspects of our compensation model and system including the competitiveness of perquisites and benefits including the pension arrangement (OMERS). Mercer's findings concluded that the executives perquisites are appropriate and below industry practice and that the pension arrangement, although generally competitive historically, is now declining in competitiveness given OMERS's proposed increases in contribution rates and reductions in the allowable pensionable income.

² Mercer, August 9, 2012

Conclusions

Compensation programs for executives at Toronto Hydro are performance-based and supported by rigorous evaluations of pay competitiveness and achieved results. Most importantly, the governance of these decisions meets best practice governance standards and is fully compliant with all regulatory requirements. These processes ensure that compensation decisions reflect the needs of the Corporation and the interests of the public. For this reason, executive compensation programs at Toronto Hydro:

- Are performance-based and supported by a highly effective performance measurement system;
- Are targeted to not exceed the median of the market;
- Do not include excessive or inappropriate perquisites;
- Are subject to the review and approval of the Compensation Committee and the Board of Directors; and
- Have caps on the total opportunity that can be earned in any year.