

HYDRO ONE INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS

RESULTS OF OPERATIONS

As used in this section, references to increases and decreases, whether in terms of amounts or percentages, are made by comparison of the three months ended March 31, 2006 to the three months ended March 31, 2005.

Revenues

| <i>Three months ended March 31 (Canadian dollars in millions)</i> | 2006 | 2005 | \$ Change | % Change |
|--|---------------|---------------|------------------|-----------------|
| Transmission | 298 | 328 | (30) | (9) |
| Distribution | 856 | 861 | (5) | (1) |
| Other | 6 | 5 | 1 | 20 |
| | 1,160 | 1,194 | (34) | (3) |
| Average Ontario 60-minute peak demand (MW)¹ | 22,382 | 23,136 | (754) | (3) |
| Distribution - units distributed to customers (TWh)¹ | 8.0 | 8.4 | (0.4) | (5) |

¹system-related statistics are preliminary

The demand for electricity generally follows normal weather-related variations and therefore, our energy-related revenues tend to be higher in the first and third quarters than in the second and fourth quarters.

Transmission

Transmission revenues consist predominantly of our transmission tariff, which is based on the monthly peak demand for electricity across our high-voltage network. The level of peak demand is primarily influenced by weather conditions. The tariff is designed to recover revenues necessary to support a transmission system that has sufficient capacity to accommodate the maximum expected demand. Maximum expected demand is primarily influenced by weather, as well as economic conditions. Transmission revenues also include minor amounts of ancillary revenues which are primarily attributable to maintenance services provided to generators and secondary use of our land rights-of-way.

Our lower transmission tariff revenues for the first quarter reflect two Ontario Energy Board (OEB) decisions. On February 21, 2006, the OEB decided to apply an earnings sharing mechanism to any transmission earnings in excess of the approved return of 9.88% for the period January 1, 2006 until new rates are set for the 2006 to 2008 period. On December 8, 2005, the OEB decided to adjust revenue allocation factors for the Province's electricity transmitters and, as a result, our transmission revenues declined slightly compared to last year. Transmission tariff revenues were also lower this quarter due to the average peak demand being approximately 754 MW lower than last year as a result of mild weather.

Distribution

Distribution revenues include our distribution tariff, which is based on OEB-approved rates, as well as amounts to recover the cost of purchased power used by our customers. Accordingly, distribution revenues are primarily influenced by our distribution rates, the amount of electricity we distribute, and the cost of purchased power. Distribution revenues also include a minor amount of ancillary distribution services revenues, such as fees related to the use of our poles by the telecommunications and cable television industries, and miscellaneous charges such as those for late payments.

Distribution revenues decreased during the first quarter of 2006 compared to the same period last year, primarily due to lower purchased power costs of \$20 million, as described below under "Purchased Power," and lower energy consumption, partially offset by an OEB-approved distribution tariff rate increase, effective April 1, 2005. This increase represented the final installment of a previously deferred rate increase, associated with moving toward our allowable return on equity, that was originally to be effective for all local distribution companies (LDCs) on March 1, 2003. In accordance with the OEB's rate order granting this increase, we have established a conservation and demand management program.

HYDRO ONE INC.
MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

Other

Other revenues increased by \$1 million compared to the same period last year. During the period, our telecom business experienced higher lit service revenues and dark fibre sales. We are currently in the process of assessing our strategy with respect to our telecom operations.

Purchased Power

Purchased power costs incurred by our distribution business represent the cost of electricity delivered to customers within our distribution service territory and consist of the wholesale commodity cost of energy, the Independent Electricity System Operator's (IESO) wholesale market service charges, and transmission charges levied by the IESO. Prior to April 1, 2005, for certain low-volume and designated customers, the commodity price of electricity was based on an interim two-tiered pricing structure of 4.7 cents per kWh for the first 750 kWhs consumed each month and 5.5 cents per kWh for any electricity consumed over this threshold each month. On April 1, 2005, the interim pricing structure was replaced by the OEB's Regulated Price Plan (RPP) which consists of a two-tiered pricing structure with threshold amounts adjusted twice a year. Starting April 1, 2005, RPP customers were charged 5.0 cents per kWh for the first 750 kWh consumed each month and 5.8 cents per kWh for any additional consumption. Effective November 1, 2005, the first 750 kWh threshold was increased to 1,000 kWh during the winter months for residential customers. For the 2006 summer months (May 1 to October 31), the threshold for residential customers will be 600 kWh. Also effective May 1, 2006, the new RPP prices were set at 5.8 cents per kWh for the first tier and 6.7 cents per kWh for the second tier. Customers who are not eligible for the RPP continue to pay the market price for electricity, adjusted for the difference between market price and regulated and contract prices paid to generators under the *Electricity Restructuring Act, 2004*.

Purchased power costs decreased by \$20 million, or 3%, to \$598 million compared to the first quarter of 2005. This decrease primarily reflects lower demand for electricity due to mild weather during the winter, a lower wholesale commodity price for customers who are not eligible for the RPP, and a reduction in IESO charges for wholesale market services, partially offset by an increase associated with the implementation of the April 2005 pricing structure for customers who are eligible for the RPP.

Operation, Maintenance and Administration

Our operation, maintenance and administration costs are comprised primarily of labour, material, equipment and purchased services in support of the operation and maintenance of the transmission and distribution systems. These costs also include property taxes and payments in lieu thereof on our transmission and distribution lines, stations and buildings.

Operation, maintenance and administration costs for each of our three business segments were as follows:

| <i>Three months ended March 31 (Canadian dollars in millions)</i> | 2006 | 2005 | \$ Change | % Change |
|---|-------------|-------------|------------------|-----------------|
| Transmission | 93 | 87 | 6 | 7 |
| Distribution | 86 | 86 | - | - |
| Other | 6 | 6 | - | - |
| | 185 | 179 | 6 | 3 |

Transmission

Transmission business operation, maintenance and administration expenditures incurred to sustain our high-voltage transmission stations, lines and rights of way increased by \$6 million in the first quarter of 2006 compared to the same period last year. We continued to make the investments necessary to ensure the safe and reliable operation of our installed transmission system and we focused our work on the assets that are critical to generation and to the unrestricted supply of energy to our customers. On a year-over-year basis, our transmission OM&A is slightly higher across a number of our work programs in support of our growing transmission asset base, as well as reflecting economic increases in materials and fuel costs and higher labour costs attributable to a reduction in the discount rate used to calculate certain employee benefits costs.

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MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

Distribution

Distribution business operation, maintenance and administration expenditures necessary to maintain our low-voltage system were consistent with the comparative quarter last year. Higher work program expenditures resulted from increased weather-related trouble calls, an increase in our meter refurbishment program, and slightly higher line clearing and brush control activities. We also experienced other economic increases across our work program similar to those seen in our transmission business. These higher expenditures were offset by the impact of the OEB's distribution rate decision on our pension costs.

Other

Other operation, maintenance and administration costs for the quarter, primarily incurred by our telecom business, were \$6 million, unchanged from the same period last year.

Depreciation and Amortization

Depreciation and amortization expense decreased by \$4 million, or 3%, to \$118 million. This reduction reflects lower fixed asset removal costs in the first three months of the year compared to the same period in 2005.

Financing Charges

Financing charges declined by \$7 million, or 9%, to \$73 million. This reduction primarily results from lower average interest rates and a slightly lower average level of debt outstanding in the first three months of 2006 compared to the same period last year. Interest earned in the quarter increased due to a higher average level of short-term investments due to the timing of debt issuances and maturities, as well as interest related to a recovery of payments in lieu of corporate income taxes.

Provision for Payments in Lieu of Corporate Income Taxes

The provision for payments in lieu of corporate income taxes decreased by \$30 million, or 47%, to \$34 million, primarily due to the recognition of a tax benefit of approximately \$30 million related to a recovery of payments in lieu of corporate income taxes from prior years. In addition, we experienced lower operating income and other temporary differences. The impact of these reductions in the period was partially offset by taxes payable on transmission rate amounts received but not recognized for accounting purposes, consistent with the OEB's decision to apply a transmission earnings sharing mechanism.

Net Income

Net income of \$152 million for the first quarter was \$21 million, or 16% higher than last year. This increase reflects higher distribution tariff revenues and a reduction in our effective tax rate due to the recognition of a tax benefit in the quarter. Lower financing costs and depreciation expense also contributed to the higher level of net income. These impacts were partially offset by reduced transmission revenues primarily resulting from the implementation of the OEB's transmission earnings sharing mechanism and mild weather.

LIQUIDITY AND CAPITAL RESOURCES

Our primary sources of liquidity and capital resources are funds generated from operations, debt capital market borrowings and bank financing. These resources will be used to satisfy our capital resource requirements, which continue to include capital expenditures, servicing and repayment of our debt, payments related to our outsourcing arrangements, investing activities, and dividends.

HYDRO ONE INC.
MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

Summary of Sources and Uses of Cash

| <i>Three months ended March 31 (Canadian dollars in millions)</i> | 2006 | 2005 |
|---|-------------|-------------|
| Operating activities | 146 | 236 |
| Financing activities | | |
| Long-term debt issued | 300 | - |
| Short-term notes payable | - | (10) |
| Dividends paid | (159) | (89) |
| Investing activities | | |
| Capital expenditures | (177) | (156) |
| Other financing and investing activities | 8 | 16 |
| Net change in cash and cash equivalents | 118 | (3) |

Operating Activities

Net cash generated from operating activities for the first three months of 2006 was \$146 million, compared with \$236 million in 2005. This \$90 million reduction in cash from operations was attributable to higher working capital requirements reflecting the impact of issuing the *Ontario Price Credit* to RPP customers in early 2006 pursuant to regulation. Funding for the credit was received from the IESO in early December 2005. In addition, the impact of commencing construction of our Niagara Reinforcement Project and the timing of tax installment payments increased our working capital requirements in the quarter.

Investing Activities

Cash used for investing activities primarily represents capital expenditures for each of our three business segments as follows:

| <i>Three months ended March 31 (Canadian dollars in millions)</i> | 2006 | 2005 | \$ Change | % Change |
|---|-------------|-------------|------------------|-----------------|
| Transmission | 100 | 89 | 11 | 12 |
| Distribution | 75 | 66 | 9 | 14 |
| Other | 2 | 1 | 1 | 100 |
| | 177 | 156 | 21 | 13 |

Transmission

Total capital expenditures made by our transmission business in the first quarter of 2006 increased by \$11 million to \$100 million, compared to the first quarter of 2005. Expenditures made to expand and reinforce the transmission system increased by \$19 million to \$54 million. This increase in development investment reflects higher demand for load and generation customer connections and our progress in two critical transmission development projects in the public interest; the Niagara Reinforcement Project, which is on track to be in service late in the second quarter of this year, and our downtown Toronto Cable Project. Expenditures to sustain our existing transmission system decreased by \$7 million to \$40 million in the quarter compared to the same period in the previous year. This reduction primarily resulted from the completion of last year's Cooksville transmission station refurbishment project that was carried out to accommodate the closure of the Lakeview Generating Station. Other transmission capital expenditures remained relatively constant at \$6 million in the quarter.

Distribution

Total distribution business capital expenditures made during the first three months of this year were \$75 million, representing a \$9 million increase over the same period last year. Expenditures to sustain our distribution system increased in the quarter by \$4 million to \$35 million. This increase was primarily due to a higher level of equipment replacements caused by a significant storm front that was concentrated in north-central Ontario in early February. Capital expenditures necessary to expand and reinforce our distribution network were \$33 million, a \$3 million increase compared to the first quarter of 2005. This increase was attributable to moderate increases in customer connection work and necessary distribution station meter

HYDRO ONE INC. MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

purchases. We have also begun installing smart meters at the premises of our residential customers. Our other distribution capital expenditures increased slightly over the comparative period in the prior year to \$7 million.

Other

Other capital expenditures increased from \$1 million in the first quarter of 2005 to \$2 million in 2006. This increase was attributable to an earlier commencement of capital work within our telecom business.

Financing Activities

Short-term liquidity is provided through funds from operations and our commercial paper program, under which we are authorized to issue up to \$1 billion in short-term notes with a term to maturity of less than 365 days. As at March 31, 2006, we had no short-term notes outstanding. The commercial paper program is supported by a \$750 million committed revolving credit facility with a syndicate of banks which matures in August 2006 and has a two-year extension option. The short-term liquidity under this program and anticipated levels of funds from operations should be sufficient to fund our normal operating requirements. Long-term financing is provided by our access to the debt markets, including our medium-term note program. Our notes and debentures mature between 2006 and 2043. We currently plan to refinance maturing debt principally through our medium-term note program. The maximum authorized principal amount of medium-term notes issuable under this program is \$2,500 million. As at March 31, 2006, \$2,200 million remained available until July 2007.

| Rating Agency | Rating | |
|--|------------------------|-----------------------|
| | Short-term Debt | Long-term Debt |
| Standard & Poor's Rating Services Inc. | A-1 | A |
| Dominion Bond Rating Service Inc. | R-1 (low) | A |
| Moody's Investors Service Inc. | Prime-1 | Aa3 |

We have customary covenants normally associated with long-term debt. Among other things, our long-term debt covenants limit our permissible debt as a percentage of our total capitalization, limit our ability to sell assets and impose a negative pledge provision, subject to customary exceptions. The credit agreement related to our \$750 million credit facility has no material adverse change clauses that could trigger default. However, the credit agreement requires that we provide notice to the lenders of any material adverse change within three business days of the occurrence. The agreement also provides limitations that debt cannot exceed 75% of total capitalization and that debt issued by our subsidiaries cannot exceed 10% of the total book value of our assets. We are in compliance with all of these covenants and limitations.

During the first quarter of 2006, we issued \$300 million in long-term debt under our medium-term note program, but we had no maturities during the period. Our next maturity is scheduled for repayment in April 2006, in the amount of \$280 million. At the end of the first quarter in 2006, no short-term notes were outstanding. In comparison, during the same period in 2005, we did not issue or retire any long-term debt and we repaid \$10 million in short-term notes.

In the first quarter of 2006, we paid dividends to the Province of Ontario in the amount of \$159 million, consisting of \$155 million in common dividends and \$4 million in preferred dividends. In the comparative period in 2005, we paid common dividends of \$85 million and preferred dividends of \$4 million.

Common dividends are declared at the sole discretion of our Board of Directors and are recommended by management based on results of operations, financial condition, cash requirements and other relevant factors such as industry practice and shareholder expectations. As a result, the level of dividend payments in the quarter was impacted by various factors, including the level of net income and timing.

HYDRO ONE INC.
MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

Summary of Contractual Obligations and Other Commercial Commitments

The following table presents a summary of our debt and other major contractual obligations as well as other major commercial commitments.

| <i>March 31, 2006 (Canadian dollars in millions)</i> | Total | 2006¹ | 2007/2008 | 2009/2010 | After 2010 |
|---|--------------|-------------------------|------------------|------------------|-------------------|
| Contractual Obligations (due by year) | | | | | |
| Long-term debt | 5,384 | 589 | 895 | 800 | 3,100 |
| Inergi LP outsourcing agreement ² | 564 | 82 | 202 | 179 | 101 |
| Operating lease commitments | 16 | 4 | 8 | 4 | - |
| Total Contractual Obligations | 5,964 | 675 | 1,105 | 983 | 3,201 |
| Other Commercial Commitments (by year of expiry) | | | | | |
| Bank line ³ | 750 | 750 | - | - | - |
| Letters of credit ⁴ | 102 | 85 | 17 | - | - |
| Guarantees ⁴ | 275 | 275 | - | - | - |
| Pension ⁵ | 67 | 59 | 8 | - | - |
| Total Other Commercial Commitments | 1,194 | 1,169 | 25 | - | - |

¹ The amounts disclosed represent the balance due over the period April 1, 2006 to December 31, 2006.

² On March 1, 2002, Inergi LP began providing a range of services to us for a 10-year period, including information technology, customer care, supply chain and certain human resources and finance services.

³ As a backstop to our commercial paper program, we have a \$750 million, 364-day revolving standby credit facility with a syndicate of banks that matures in August 2006, with a two-year extension option.

⁴ We currently have bank letters of credit of \$82 million outstanding relating to retirement compensation arrangements. We have also provided prudential support to the IESO as required by the Market Rules, using a combination of bank letters of credit of \$16 million and parental guarantees of \$275 million. The amount of prudential support that we provide in the form of bank letters of credit to the IESO is on our highest long-term credit rating which is in the "Aa" category. The amount of bank letters of credit provided would need to increase if our highest credit rating deteriorated. For example, if our credit rating declined to "A" category, the amount of bank letters of credit required to meet our prudential support obligation would be 1.7 times our current amount, and if our credit rating declined to "BBB" category, the amount of bank letters of credit required to meet our prudential support obligation would be 3.3 times the current amount. The remaining letters of credit pertain to operating letters of credit and to surety bonds.

⁵ Contributions to the pension fund are made one-month in arrears. Contributions after 2006 will be based on an actuarial valuation no later than December 31, 2006 and will depend on future investment returns, changes in benefits or actuarial assumptions. Based on current factors, we currently estimate annual pension contributions for 2007 and beyond to be in the range of \$100 million.

The amounts in the above table under long-term debt are not charged to our results of operations, but are reflected on our balance sheet and statement of cash flows. Interest associated with this debt is recorded under financing charges on our statement of operations or in our capital programs, but these financing charges are not reflected in the above table. Payments in respect of operating leases and our outsourcing agreement with Inergi LP are recorded under operation, maintenance and administration costs on our statement of operations or in our capital programs.

RECENT DEVELOPMENTS

Transmission Earnings Sharing Mechanism

On October 26, 2005, the OEB commenced a proceeding on its own motion to determine whether the rates of our transmission business are just and reasonable, and to approve or fix just and reasonable rates for the transmission of electricity for the years 2006, 2007 and 2008. On February 21, 2006, the OEB announced a decision to apply an earnings sharing mechanism to equally share, between our shareholder and customers, any transmission earnings in excess of the approved return of 9.88%, for the period January 1, 2006 until new transmission rates are set. A transmission rate filing is under preparation. A 1% change in the return on deemed common equity of the transmission business would affect our net income by about \$22 million.

HYDRO ONE INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

Hydro One Networks' Distribution Business Rate Decision

On April 12, 2006, the OEB announced its decision regarding our August 2005 distribution rate application associated with Hydro One Networks Inc. As a result of our comprehensive oral and written evidence and testimony, the requested \$160 million increase in revenue requirement for 2006 was approved. This decision is expected to provide the foundation for maintaining and supporting the safe and reliable operation of the distribution system. Revised customer rates reflecting the OEB decision were approved by the OEB for implementation on May 1, 2006.

Hydro One Brampton Networks Rate Decision

On April 12, 2006, the OEB also released its decision regarding the 2005 rate submission made by our regulated subsidiary, Hydro One Brampton Networks Inc. The OEB approved the requested revenue requirement for this subsidiary and revised rates were approved for implementation effective May 1, 2006.

Customer Bill Credits

In April 2006, we received \$54 million related to payments provided by Ontario Power Generation Inc. (OPG) for the purpose of adjusting commodity prices for customers who pay market prices by the difference between the market price and the revenue limit on OPG for 85 per cent of most of the generation output of its non-price regulated generating facilities. These payments relate to the period April 1, 2005 to December 31, 2005 and were applied as a credit to the accounts of qualifying electricity customers by the end of April 2006. In addition, during the first quarter, we applied the *Ontario Price Credit* to the bills of RPP customers. Including the amounts paid in late 2005, we have passed through \$140 million in credits.

OEB Generic Hearing Decision and Smart Metering

On March 21, 2006, the OEB issued a decision regarding a number of common or generic matters affecting all LDCs. As part of this decision, the OEB determined that an amount in respect of smart meters equal to \$0.30 for each residential customer per month should be included in 2006 rates commencing May 1, 2006 and that regulatory deferral accounts should be established to track the difference between these received amounts and actual expenditures made by the LDC. Each LDC is required to file its plan for smart meter investment with the OEB within a 90 day period following the OEB's March 21 decision.

Debt Issue

On April 24, 2006, we issued \$250 million of 30-year notes under our Medium Term Note Program at a coupon rate of 5.36%, a maturity date of May 20, 2036, and at a yield of 5.412%. This issue is a re-opening of the notes originally issued in May 2005.

Ministerial Review of Executive Compensation Matters

Following an announcement from the Minister of Energy that executive compensation processes for Hydro One and all other government-owned electricity companies and agencies would be reviewed, the Minister requested such a review of our executive compensation arrangements on April 5, 2006. On May 3, 2006, the Chair and Human Resources and Public Policy Committee of the Board of Directors provided a comprehensive briefing, which included a detailed explanation of the manner in which executive salary levels, bonuses and benefits are determined.

Acquisition or Divestiture of Distribution Assets

In a letter dated May 4, 2006, the Minister of Energy advised that while the moratorium on the acquisition or divestiture of distribution assets continues, an exception should be made in the case of any asset transfers from Terrace Bay Superior Wires Inc. to our company.

HYDRO ONE INC.
MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

SELECTED FINANCIAL HIGHLIGHTS AND RATIOS

| <i>Three months ended March 31 (Canadian dollars in millions) (except as otherwise noted)</i> | 2006 | 2005 |
|---|-------------|-------------|
| Net income | 152 | 131 |
| Net cash from operations | 146 | 236 |
| Capital expenditures | 177 | 156 |
| Earnings per common share (<i>Canadian dollars</i>) | 1,474 | 1,261 |
| Earnings coverage ratio ¹ | 2.69 | 2.75 |
| Net asset coverage on long-term debt ratio ² | 1.87 | 1.93 |
| Total debt to capitalization ratio ³ | 53% | 52% |

¹ The earnings coverage ratio has been presented for the twelve months ended March 31, 2006 and March 31, 2005, respectively and has been calculated as the sum of net income, provision for payments in lieu of corporate income taxes and financing charges divided by the sum of financing charges, capitalized interest and cumulative preferred dividends. The earnings coverage ratio for the twelve months ended March 31, 2005, excluding the impact of the \$91 million regulatory recovery recognized as a result of the OEB's December 9, 2004 rate decision, was 2.51.

² The net asset coverage on long-term debt ratio has been presented as at March 31, 2006 and December 31, 2005 and has been calculated as total assets minus total liabilities excluding long-term debt (including current portion) divided by long-term debt including current portion.

³ Total debt to capitalization ratio has been presented as at March 31, 2006 and December 31, 2005 and has been calculated as total debt divided by total debt plus total shareholder's equity.

FORWARD-LOOKING STATEMENTS AND INFORMATION

We have included forward-looking statements in this report that are subject to risks, uncertainties and assumptions. Such information represents our current views based on information as at the date of this report. Any statement contained in this document that is not current or historical is a forward-looking statement. We have based these forward-looking statements on historical experience, current conditions and various assumptions believed to be reasonable in the circumstances. Actual results could differ materially from those projected in the forward-looking statements. Because of these risks, uncertainties and assumptions, undue reliance should not be placed on these forward-looking statements. Except to the extent required by applicable securities laws and regulations, we undertake no obligation to update or revise any of these forward-looking statements, whether to reflect new information, future events or otherwise.

This management's discussion and analysis is dated as at May 10, 2006. Additional information about our company, including our annual information form, is available on SEDAR at www.sedar.com.

HYDRO ONE INC.
CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)

| <i>Three months ended March 31 (Canadian dollars in millions)</i> | 2006 | 2005 |
|---|--------------|--------------|
| Revenues | | |
| Transmission (Note 2) | 298 | 328 |
| Distribution | 856 | 861 |
| Other | 6 | 5 |
| | <u>1,160</u> | <u>1,194</u> |
| Costs | | |
| Purchased power | 598 | 618 |
| Operation, maintenance and administration | 185 | 179 |
| Depreciation and amortization | 118 | 122 |
| | <u>901</u> | <u>919</u> |
| Income before financing charges and provision for payments in lieu of corporate income taxes | 259 | 275 |
| Financing charges | 73 | 80 |
| Income before provision for payments in lieu of corporate income taxes | 186 | 195 |
| Provision for payments in lieu of corporate income taxes (Note 5) | 34 | 64 |
| Net income | <u>152</u> | <u>131</u> |
| Basic and fully diluted earnings per common share (Canadian dollars) | <u>1,474</u> | <u>1,261</u> |

CONSOLIDATED STATEMENTS OF RETAINED EARNINGS (unaudited)

| <i>Three months ended March 31 (Canadian dollars in millions)</i> | 2006 | 2005 |
|---|--------------|-------------|
| Retained earnings, beginning of period | 1,079 | 887 |
| Net income | 152 | 131 |
| Dividends (Note 3) | (159) | (89) |
| Retained earnings, end of period | <u>1,072</u> | <u>929</u> |

See accompanying notes to Consolidated Financial Statements.

HYDRO ONE INC.
CONSOLIDATED BALANCE SHEETS (unaudited)

| <i>(Canadian dollars in millions)</i> | March 31, 2006 | December 31, 2005 |
|--|---------------------------|------------------------------|
| Assets | | |
| Current assets | | |
| Short-term investments | 119 | - |
| Accounts receivable (net of allowance for doubtful accounts) | 724 | 622 |
| Materials and supplies | 62 | 56 |
| | 905 | 678 |
| Fixed assets | | |
| Fixed assets in service | 15,612 | 15,553 |
| Less: accumulated depreciation | 5,910 | 5,818 |
| | 9,702 | 9,735 |
| Construction in progress | 495 | 381 |
| | 10,197 | 10,116 |
| Other long-term assets | | |
| Deferred pension asset | 433 | 449 |
| Regulatory assets | 426 | 430 |
| Goodwill | 133 | 133 |
| Deferred debt costs | 23 | 23 |
| Long-term accounts receivable and other assets | 12 | 20 |
| | 1,027 | 1,055 |
| Total assets | 12,129 | 11,849 |
| Liabilities | | |
| Current liabilities | | |
| Bank indebtedness | 10 | 9 |
| Accounts payable and accrued charges | 598 | 700 |
| Accrued interest | 93 | 43 |
| Long-term debt payable within one year | 589 | 589 |
| | 1,290 | 1,341 |
| Long-term debt (Note 4) | | |
| | 4,778 | 4,466 |
| Other long-term liabilities | | |
| Regulatory liabilities (Note 2) | 533 | 525 |
| Employee future benefits other than pension (Note 6) | 739 | 716 |
| Environmental liabilities | 61 | 64 |
| Long-term accounts payable and other liabilities | 19 | 21 |
| | 1,352 | 1,326 |
| Total liabilities | 7,420 | 7,133 |
| Shareholder's equity | | |
| Preferred shares (authorized: unlimited; issued: 12,920,000) | 323 | 323 |
| Common shares (authorized: unlimited; issued: 100,000) | 3,314 | 3,314 |
| Retained earnings | 1,072 | 1,079 |
| Total shareholder's equity | 4,709 | 4,716 |
| Total liabilities and shareholder's equity | 12,129 | 11,849 |

See accompanying notes to Consolidated Financial Statements.

HYDRO ONE INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)

| <i>Three months ended March 31 (Canadian dollars in millions)</i> | 2006 | 2005 |
|---|-------------|-------------|
| Operating activities | | |
| Net income | 152 | 131 |
| Adjustments for non-cash items: | | |
| Depreciation and amortization (net of removal costs) | 109 | 109 |
| Amortization of discount | 11 | 15 |
| Low-voltage services | (6) | (6) |
| Retail settlement variance accounts | 3 | 4 |
| | 269 | 253 |
| Changes in non-cash balances related to operations | (123) | (17) |
| Net cash from operating activities | 146 | 236 |
| Financing activities | | |
| Long-term debt issued | 300 | - |
| Short-term notes payable | - | (10) |
| Dividends paid | (159) | (89) |
| Deferred debt costs | - | 1 |
| Net cash from (used in) financing activities | 141 | (98) |
| Investing activities | | |
| Fixed assets | (177) | (156) |
| Other assets | 8 | 15 |
| Net cash used in investing activities | (169) | (141) |
| Net change in cash and cash equivalents | 118 | (3) |
| Cash and cash equivalents, beginning of period | (9) | (9) |
| Cash and cash equivalents, end of period | 109 | (12) |

See accompanying notes to Consolidated Financial Statements.

HYDRO ONE INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

1. BASIS OF PRESENTATION

The interim Consolidated Financial Statements do not conform in all respects to the disclosure requirements of Canadian generally accepted accounting principles for annual financial statements and should, therefore, be read in conjunction with the annual Consolidated Financial Statements of Hydro One Inc. (Hydro One or the Company) which includes information necessary or useful to understanding the Company's business and financial statement presentation. In particular, the Company's significant accounting policies and practices are presented as Note 2 to the annual Consolidated Financial Statements, and have been consistently applied in the preparation of these interim Consolidated Financial Statements.

The demand for electricity generally follows normal weather-related variations, and therefore the Company's energy-related revenues, all other things being equal, will tend to be higher in the first and third quarters than in the second and fourth quarters.

2. TRANSMISSION EXCESS EARNINGS SHARING MECHANISM

On October 26, 2005, the Ontario Energy Board (OEB) commenced a proceeding on its own motion to determine whether the rates of Hydro One's transmission business are just and reasonable, and to approve or fix just and reasonable rates for the transmission of electricity for the years 2006, 2007 and 2008. On February 21, 2006, the OEB announced a decision to apply an earnings sharing mechanism to equally share, between Hydro One's shareholder and customers, any transmission earnings in excess of the approved return of 9.88%, for the period January 1, 2006 until new transmission rates are set. The earnings sharing amount will be based on the Company's audited transmission financial statements and will be held in a regulatory deferral account until disposed of by the OEB. In the first quarter of 2006, \$15 million, inclusive of interest, was recorded in this deferral account.

3. DIVIDENDS

During the three months ended March 31, 2006, preferred dividends in the amount of \$4 million (2005 - \$4 million) and common dividends in the amount of \$155 million (2005 - \$85 million) were declared.

4. LONG-TERM DEBT

On March 3, 2006, Hydro One issued notes under the Company's medium term note program. The issue was comprised of medium term notes with a principal amount of \$300 million having a 10-year term with a coupon rate of 4.64%. The notes are due March 3, 2016.

5. RECOVERY OF PAYMENTS IN LIEU OF CORPORATE INCOME TAXES

In the first quarter of 2006, Hydro One recognized a tax benefit of approximately \$30 million in respect of a recovery of payments in lieu of corporate income taxes from prior years.

HYDRO ONE INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (continued)

6. EMPLOYEE FUTURE BENEFITS

Total benefit costs are as follows:

| <i>Three months ended March 31 (Canadian dollars in millions)</i> | 2006 | 2005 |
|---|-------------|-------------|
| Pension | | |
| Net periodic benefit cost | 38 | 43 |
| Pension fund contribution | 22 | 20 |
| Less: Portion attributable to labour and capitalized as part of the cost of fixed assets | 8 | 8 |
| Portion attributable to regulatory assets | 8 | 7 |
| Charged to results of operations | 6 | 5 |
| Employee Future Benefits Other than Pension | | |
| Net periodic benefit cost | 30 | 24 |
| Less: Portion attributable to labour and capitalized as part of the cost of fixed assets | 10 | 9 |
| Charged to results of operations | 20 | 15 |

7. SEGMENTED REPORTING

Hydro One has three reportable segments:

- The transmission business, which comprises the core business of providing transportation and connection services, is responsible for transmitting electricity throughout the Ontario electricity grid;
- The distribution business, which comprises the core business of delivering and selling electricity to customers; and
- An "other" segment primarily consisting of telecommunication. The Company is currently in the process of assessing its strategy with respect to these operations.

The designation of segments has been based on a combination of regulatory status and the nature of the products and services provided. Segment information on the above basis is as follows:

| <i>Three months ended March 31 (Canadian dollars in millions)</i> | Transmission | Distribution | Other | Consolidated |
|---|---------------------|---------------------|--------------|---------------------|
| 2006 | | | | |
| Segment profit | | | | |
| Revenues | 298 | 856 | 6 | 1,160 |
| Purchased power | - | 598 | - | 598 |
| Operation, maintenance and administration | 93 | 86 | 6 | 185 |
| Depreciation and amortization | 59 | 58 | 1 | 118 |
| Income (loss) before financing charges and provision for payments in lieu of corporate income taxes | 146 | 114 | (1) | 259 |
| Financing charges | | | | 73 |
| Income before provision for payments in lieu of corporate income taxes | | | | 186 |
| Capital expenditures | 100 | 75 | 2 | 177 |

HYDRO ONE INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (continued)

Three months ended March 31
(Canadian dollars in millions)

| | Transmission | Distribution | Other | Consolidated |
|---|---------------------|---------------------|--------------|---------------------|
| 2005 | | | | |
| Segment profit | | | | |
| Revenues | 328 | 861 | 5 | 1,194 |
| Purchased power | - | 618 | - | 618 |
| Operation, maintenance and administration | 87 | 86 | 6 | 179 |
| Depreciation and amortization | 64 | 57 | 1 | 122 |
| Income (loss) before financing charges and provision for payments in lieu of corporate income taxes | 177 | 100 | (2) | 275 |
| Financing charges | | | | 80 |
| Income before provision for payments in lieu of corporate income taxes | | | | 195 |
| Capital expenditures | 89 | 66 | 1 | 156 |

| <i>(Canadian dollars in millions)</i> | March 31, 2006 | December 31, 2005 |
|---------------------------------------|---------------------------|------------------------------|
| Total assets | | |
| Transmission | 6,893 | 6,832 |
| Distribution | 5,037 | 4,925 |
| Other | 199 | 92 |
| | 12,129 | 11,849 |

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

8. SUBSEQUENT EVENTS

On April 12, 2006, the OEB announced its decisions regarding the Company's rate applications in respect of the distribution businesses of Hydro One Networks Inc. and Hydro One Brampton Inc. On the basis of the written and oral evidence submitted, the OEB approved the requested increases in revenue requirements for 2006. Hydro One will develop revised customer rates reflecting the details included in the OEB decision for implementation May 1, 2006.

On April 24, 2006, Hydro One issued additional notes under the Company's medium term note program. The issue was comprised of medium term notes with a principal amount of \$250 million having a 30-year term with a coupon rate of 5.36%. The notes are due May 20, 2036.

9. COMPARATIVE FIGURES

The comparative Consolidated Financial Statements have been reclassified from statements previously presented to conform to the presentation of the March 31, 2006 Consolidated Financial Statements.