

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 and six months ended June 30, 2006 to the three and six months ended June 30, 2005.

Revenues

<i>(Canadian dollars in millions)</i>	Three months ended June 30				Six months ended June 30			
	2006	2005	\$ Change	% Change	2006	2005	\$ Change	% Change
Transmission	316	307	9	3	614	635	(21)	(3)
Distribution	757	706	51	7	1,613	1,567	46	3
Other	5	5	-	-	11	10	1	10
	1,078	1,018	60	6	2,238	2,212	26	1
Average Ontario 60-minute peak demand (MW) ¹	22,596	21,502	1,094	5	22,489	22,319	170	1
Distribution - units distributed to customers (TWh) ¹	6.6	6.6	-	-	14.6	15.1	(0.5)	(3)

¹System-related statistics are preliminary

The demand for electricity generally follows normal weather-related variations, and therefore our 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.

Transmission

Transmission revenues predominantly consist 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.

Transmission tariff revenues for the second quarter and for the first six months of 2006 reflect two recent 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 our approved rate of return of 9.88% for the period January 1, 2006 until new rates are set. Consequently, 50% of excess earnings recovered from customers are deferred as a regulatory liability. On December 8, 2005, the OEB decided to adjust revenue allocation factors for all of the Province's electricity transmitters and, as a result, our transmission revenues declined slightly compared to last year. In addition, the Ontario peak demand reached 24,857 MW during May 2006, surpassing the previous May record of 20,327 MW set in 2004, resulting in higher transmission tariffs for the quarter. Our systems performed well during the period, reflecting the investments we have made over the past few years. On a year-to-date basis, the average peak demand was only marginally higher due to mild winter 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 increased in the second quarter and in the first six months of 2006 compared to the same periods last year, primarily as a result of OEB-approved distribution tariff rate increases that were effective May 1, 2006 and April 1, 2005. During April 2006, after reviewing evidence submitted, the OEB approved an increase in our distribution tariff rates, as well as those charged by our subsidiary, Hydro One Brampton Inc. These new rates were effective on May 1, 2006. We also received OEB approval for low-voltage rates for services provided to local distribution companies (LDCs) embedded

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within our service territory. The April 1, 2005 increase was originally scheduled to be effective March 1, 2003, and was subsequently suspended for all LDCs by the *Electricity Pricing Conservation and Supply Act, 2002*. These increases support the maintenance and investment requirements of the distribution system to enable the safe and reliable delivery of electricity to customers throughout Ontario. In addition, our distribution revenues in the quarter increased as a result of recovering higher purchased power costs, as described below under "Purchased Power." The effect of these increases was partially offset by lower year-over-year energy consumption, primarily in the first quarter of 2006.

Other

Other revenues earned by our telecom business were consistent for the second quarter, but increased marginally for the first six months relative to the comparative period.

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's) wholesale market service charges, and transmission charges levied by the IESO. From April 1, 2004 to March 31, 2005, for certain low-volume and designated customers, the commodity price of electricity was based on an interim two-tiered pricing structure. This structure was subsequently replaced by the OEB's Regulated Price Plan (RPP), which consists of a two-tiered pricing structure with threshold amounts adjusted twice annually. Customers who are not eligible for the RPP continue to pay the market price for electricity, adjusted for the difference between market prices and the prices paid to generators under the *Electricity Restructuring Act, 2004*. A summary of the interim pricing plan and RPP is provided below.

Summary of Interim Pricing Plan & RPP

Price Plan	Effective Date	Tier Threshold (kWh)		Tier Rates (cents/kWh)	
		Residential	Non-Residential	First Tier	Second Tier
Interim	April 1, 2004	750	750	4.7	5.5
RPP	April 1, 2005	750	750	5.0	5.8
RPP	November 1, 2005	1,000	750	5.0	5.8
RPP	May 1, 2006	600	750	5.8	6.7

Purchased power costs increased by \$21 million to \$505 million in the second quarter and by \$1 million to \$1,103 million during the first six months compared to last year. These increases primarily reflect rate increases associated with the OEB's RPP for residential and other eligible customers, partially offset by lower wholesale commodity prices for customers who are not eligible for the RPP. On a year-to-date basis, the increase in purchased power costs was further mitigated by the lower year-over-year demand for electricity experienced in the first quarter and lower wholesale market services charges levied by the IESO.

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:

(Canadian dollars in millions)	Three months ended June 30				Six months ended June 30			
	2006	2005	\$ Change	% Change	2006	2005	\$ Change	% Change
Transmission	109	83	26	31	202	170	32	19
Distribution	120	102	18	18	206	188	18	10
Other	5	6	(1)	(17)	11	12	(1)	(8)
	234	191	43	23	419	370	49	13

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Transmission

Operation, maintenance and administration expenditures incurred to sustain our high-voltage transmission stations, lines and rights-of-way increased by \$26 million in the second quarter and by \$32 million on a year-to-date basis compared to the same periods last year. We continue to make the investments necessary to ensure the safe and reliable operation of our installed transmission system with particular focus on the assets that are critical to generation and to the unrestricted supply of electricity to our customers. As a result, higher expenditures were required across a number of our work programs to support our growing transmission asset base. Our expenditures also reflect higher employee benefit costs attributable to a lower discount rate as well as economic increases in materials and fuel. In addition, the increases in expenditure levels were impacted by recoveries in 2005 associated with insurance settlements and bad debts, as well as the effect of last year's labour disruption.

Distribution

Operation, maintenance and administration expenditures necessary to maintain our low-voltage distribution system increased by \$18 million, both in the quarter and on a year-to-date basis. Higher work program expenditures in both periods resulted from increased weather-related trouble calls, meter refurbishments, and tree and brush clearing on our rights-of-way, as well as the impact of last year's labour disruption. We also experienced economic increases across our work program, similar to those in our transmission business. Over the year-to-date period, the impact of higher operation, maintenance and administration expenditures was partially offset by the effect of the OEB's distribution rate decision on our pension costs.

Other

Other operation, maintenance and administration costs decreased by \$1 million in the quarter and over the first six months compared to 2005.

Depreciation and Amortization

Depreciation and amortization expense increased by \$8 million, or 7%, to \$127 million in the second quarter, and by \$4 million, or 2%, to \$245 million in the first six months compared to the same periods last year. These increases primarily reflect increased amortization expense related to regulatory assets resulting from the OEB's April 2006 rate decision. In addition, higher depreciation expense resulted from increases in our fixed assets in service, consistent with investments made to improve the reliability of our electricity delivery network. On a year-to-date basis, the impact of these increases was partially offset by a reduction in fixed asset removal costs.

Financing Charges

Financing charges decreased by \$10 million, or 12%, to \$73 million in the quarter and by \$17 million, or 10%, to \$146 million in the first six months compared to the same periods in 2005. These reductions reflect the combined impact of lower effective interest rates and lower average debt levels. Increased interest capitalization associated with the higher levels of capital construction this year also resulted in a reduction in financing charges. For the six-month period, interest on a refund of prior years' corporate taxes further contributed to lower financing charges.

Provision for Payments in Lieu of Corporate Income Taxes

The provision for payments in lieu of corporate income taxes increased by \$14 million, or 54%, to \$40 million in the quarter, but decreased by \$16 million, or 18% to \$74 million on a year-to-date basis relative to the comparative periods. The second quarter increase was primarily due to the recognition of a \$21 million tax benefit in the corresponding period of 2005 related to the accumulated tax losses of one of our subsidiaries. For the year-to-date period, the impact of last year's second quarter tax benefit was more than offset by the tax benefit recognized in the first quarter of 2006 following the recovery of approximately \$30 million in prior years' payments in lieu of corporate income taxes, combined with the effect of tax changes enacted in the second quarter relating to the elimination of the federal large corporations tax and higher capital cost allowance rates. This favourable impact was partially offset by taxes payable on transmission amounts received but not recognized for accounting purposes, primarily due to the OEB's earnings sharing mechanism.

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Net Income

Net income was lower by \$16 million, or 14%, in the second quarter, but higher by \$5 million, or 2%, in the first six months compared to 2005 results. Net income levels in the quarter and year-to-date periods reflect higher distribution tariff revenues associated with recent OEB-approved tariff rate increases and lower financing charges. These results were partially offset by the impacts of higher expenditures required to operate and maintain our transmission and distribution systems in the second quarter and the impact of the OEB's transmission earnings sharing mechanism in the first quarter. We also experienced a higher effective tax rate in the second quarter, that was more than mitigated on a year-to-date basis by the first quarter recognition of a tax benefit associated with the recovery of prior years' taxes and the enactment of lower tax rates and regulations.

QUARTERLY RESULTS OF OPERATIONS

The following table sets forth unaudited quarterly information for each of the eight quarters ended September 30, 2004 through June 30, 2006. This information has been derived from our unaudited interim Consolidated Financial Statements which, in the opinion of our management, have been prepared on a basis consistent with the audited annual Consolidated Financial Statements and includes all adjustments, consisting only of normal recurring adjustments, necessary for fair presentation of our financial position and results of operations for those periods. These operating results are not necessarily indicative of results for any future period and should not be relied upon to predict our future performance.

<i>(Canadian dollars in millions)</i>	2006			2005			2004	
Quarter ended	Jun. 30	Mar. 31	Dec. 31	Sep. 30	Jun. 30	Mar. 31	Dec. 31	Sep. 30
Total revenue ^{1, 2, 4}	1,078	1,160	1,025	1,179	1,018	1,194	1,074	1,018
Net income ^{1, 2, 3, 4}	99	152	104	133	115	131	186	133
Net income to common shareholder ^{1, 2, 3, 4}	94	148	99	129	110	127	181	129

¹ The demand for electricity generally follows normal weather-related variations, and therefore our electricity-related revenues and profit, all other things being equal, would tend to be higher in the first and third quarters than in the second and fourth quarters.

² Under a regulation issued in October 2005, RPP customers received a one-time *Ontario Price Credit* reflecting a lower cost of power than the fixed commodity price between April 1, 2004 and March 31, 2005. In the fourth quarter of 2005, revenue and cost of power were both reduced by approximately \$140 million. The application of the one-time credit did not result in any adjustment to net income in the period or in previously reported periods.

³ As a result of submitted oral and written evidence, on December 9, 2004 the OEB issued a ruling citing prudence and approving recovery of amounts, previously delayed by the *Electricity Pricing, Conservation and Supply Act, 2002*, relating to regulatory deferral account balances sought in our May 31, 2004 submission. Consequently, net income for the fourth quarter of 2004 includes a regulatory recovery of \$91 million.

⁴ Effective January 1, 2006, the OEB applied an earnings sharing mechanism to any transmission earnings in excess of the approved rate of return of 9.88% until new rates are set.

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.

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Summary of Sources and Uses of Cash	Three months ended		Six months ended	
	June 30		June 30	
(Canadian dollars in millions)	2006	2005	2006	2005
Operating activities	218	227	364	469
Financing activities				
Long-term debt issued	250	500	550	500
Long-term debt retired	(448)	(200)	(448)	(200)
Short-term notes payable	130	(30)	130	(40)
Dividends paid	(64)	(57)	(223)	(146)
Investing activities				
Capital expenditures	(198)	(181)	(375)	(337)
Other financing and investing activities	(3)	(17)	5	(7)
Net change in cash and cash equivalents	(115)	242	3	239

Operating Activities

Net cash from operations decreased by \$9 million to \$218 million in the second quarter and by \$105 million to \$364 million in the first six months compared to 2005 results. The reduction in cash from operations in the quarter primarily reflects our lower net income for the period this year. The reduction for the year-to-date period is principally attributable to higher working capital requirements reflecting the impact of higher electricity prices charged to RPP customers. For the year-to-date period, this impact was combined with the impact of providing RPP customers with the *Ontario Price Credit* in early 2006, pursuant to regulation. Funding for the credit was received from the IESO in early December 2005. In addition, the timing of tax installment payments reduced 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:

(Canadian dollars in millions)	Three months ended June 30				Six months ended June 30			
	2006	2005	\$ Change	% Change	2006	2005	\$ Change	% Change
Transmission	97	87	10	11	197	176	21	12
Distribution	100	94	6	6	175	160	15	9
Other	1	-	1	-	3	1	2	200
	198	181	17	9	375	337	38	11

Transmission

Transmission capital expenditures increased by \$10 million in the second quarter and by \$21 million for the year-to-date compared to the same periods last year. Expenditures made to expand and reinforce the transmission system were higher by \$4 million in the quarter and by \$23 million in the first half of the year. These increased development investments primarily reflect our progress on two critical transmission development projects that are being constructed in the public interest: the Niagara Reinforcement Project, which will reinforce the transmission system in the Niagara region and provide access to new sources of generation when completed, and the Downtown Toronto Cable Project, which will involve the construction of two underground cable circuits to reinforce our electricity transmission facilities. The completion of our Niagara Reinforcement Project has been delayed by an aboriginal land dispute in the Caledonia area. Expenditure increases over the comparative periods also reflect our substantial completion of the Parkway Transformer Station construction and the Cooksville Transformer Station refurbishment projects in 2005, both of which were carried out to accommodate the closure of the Lakeview Generating Station. Compared to last year's levels, our expenditures made to sustain the existing transmission system increased by \$8 million in the quarter but were unchanged over the first six months of the year. The increase in the quarter reflects necessary expenditures to refurbish or replace end-of-life assets in our lines and stations, as well as the impact of last year's labour disruption, partially offset by lower sustainment expenditures on our telecommunications assets in our protection and control systems. Other transmission capital expenditures for the quarter decreased by \$2 million, both in the quarter and over the year-to-date period.

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Distribution

Distribution capital expenditures increased by \$6 million in the quarter and by \$15 million over the first six months, compared to the same periods in 2005. Expenditures made to sustain our low-voltage distribution system increased by \$8 million in the second quarter and by \$12 million over the first half of the year. These increases were primarily due to higher planned replacements of end-of-life assets, combined with increased expenditures for other unplanned asset replacements and line relocations, as well as the impact of last year's labour disruption. Expenditures for the first six months also reflect higher asset replacement expenditures related to storm damage, primarily due to the impact of a significant storm front that was concentrated in north-central Ontario in early February. During the second quarter, we also continued with our deployment of smart meters. Capital expenditures necessary to expand and reinforce our distribution network decreased by \$3 million during the quarter, but increased marginally by \$1 million in the first six months. The increase in the quarter was principally attributable to increased work to connect new customers, while the year-to-date decrease was primarily due to lower asset relocation expenditures within our Brampton service territory. Our other distribution capital expenditures were also slightly higher than last year, increasing by \$2 million for the first six months and by \$1 million in the second quarter.

Other

Other capital expenditures made to enhance our telecom infrastructure increased by \$1 million in the second quarter and by \$2 million in the first six months compared to the same periods in 2005.

Future Capital Expenditures

Capital expenditures are expected to increase significantly over the medium-term and are anticipated to exceed \$1.2 billion in each of 2007 and 2008. These investment levels will address new development and supply enhancement initiatives, including system expansions, generation requirements and load connections, and the needs of our aging transmission system under continued challenging conditions of tight generation supply. Our next transmission rate application, expected to be filed in the third quarter of 2006, will reflect these prudent transmission infrastructure project investments in a secure and reliable transmission system, consistent with the public interest. Within our distribution business, we are planning for the mass deployment of smart meters to begin in 2007.

The Ontario Power Authority (OPA) is responsible for developing the Integrated Power System Plan (IPSP) and submitting it to the OEB for review and approval. The OPA has recently announced it will submit the IPSP to the OEB in early 2007. While we continue to work closely with the OPA, we will proceed with some transmission projects in the short-term because of pressing need, consistent with our transmission rate application. The IPSP is expected to influence the timing and amount of our future capital expenditures.

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 June 30, 2006, we had \$130 million of 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 2007 and which 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 June 30, 2006, \$1,950 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. ¹	R-1 (middle)	A (high)
Moody's Investors Service Inc.	Prime-1	Aa3

¹ On June 23, 2006, Dominion Bond Rating Service raised Hydro One's short-term debt rating to R-1 (middle) from R-1 (low) and long-term debt rating to A (high) from A.

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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 second quarter of 2006, we issued \$250 million in long-term debt under our medium-term note program, repaid \$448 million in maturing long-term debt, and increased our short-term notes by \$130 million. In comparison, during the same period in 2005, we issued \$500 million in long-term debt under our medium term note program, repaid \$200 million in maturing long-term debt and reduced our short-term notes by \$30 million.

During the first six months of 2006, we issued \$550 million in long-term debt under our medium-term note program, repaid \$448 million in maturing long-term debt, and increased our short-term notes by \$130 million. In comparison, during the same period in 2005, we issued \$500 million in long-term debt under our medium term note program, repaid \$200 million in maturing long-term debt and reduced our short-term notes by \$40 million.

In the second quarter of 2006, we paid dividends to the Province of Ontario in the amount of \$64 million, consisting of \$59 million in common dividends and \$5 million in preferred dividends. In the comparative period, we paid common dividends of \$52 million and preferred dividends of \$5 million. Year-to-date, we have paid common and preferred dividends totaling \$223 million, compared to \$146 million in 2005.

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, shareholder expectations, the level of net income and timing.

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>June 30, 2006 (Canadian dollars in millions)</i>	Total	2006¹	2007/2008	2009/2010	After 2010
Contractual Obligations (due by year)					
Long-term debt	5,186	141	895	800	3,350
Inergi LP outsourcing agreement ²	545	56	205	182	102
Operating lease commitments	16	3	9	4	-
Total Contractual Obligations	5,747	200	1,109	986	3,452
Other Commercial Commitments (by year of expiry)					
Bank line ³	750	-	750	-	-
Letters of credit ⁴	95	85	10	-	-
Guarantees ⁴	275	275	-	-	-
Pension ⁵	45	37	8	-	-
Total Other Commercial Commitments	1,165	397	768	-	-

¹ The amounts disclosed represent the balance due over the period July 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 2007, 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 \$10 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 based 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

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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 Rate Application

We continued to prepare a transmission rate application for filing with the OEB in the third quarter of 2006. Stakeholder consultation sessions were held and we introduced our proposed revenue requirements for 2007 and 2008, representing transmission rate increases of approximately 4.3% and 2.7%, respectively. The average annual increase on total customer bills of less than 0.5% supports increased transmission system infrastructure investments in the public interest, reflecting the needs of our aging transmission system and additions to support new generation consistent with government policy.

Supply Mix Plan and IPSP

On June 13, 2006, the Ministry of Energy responded to the OPA to proceed with its recommended 20-year electricity supply mix plan, with some revisions. The plan proposes moving away from coal in favour of new nuclear power, renewable energy and conservation. In particular, the plan emphasizes the need to expand the transmission capacity from Bruce County and surrounding area, to facilitate the transmission of electricity from several new wind farms and the refurbishment of the Bruce facility to Ontario homes and businesses. If we receive approval to construct a new transmission line from Bruce to our Essa Transformer Station, we anticipate spending in the range of \$600 million over the period 2007 to 2011. Now that the Ministry of Energy has issued its policy direction to the OPA on the future supply mix for Ontario, the OPA will begin to develop the IPSP. On June 29, 2006, the OPA issued a discussion paper in respect of the scope and overview of the IPSP.

Hydro-Quebec Interconnection

Once the Provinces of Ontario and Quebec reach agreement on a power purchase agreement, we will work with Hydro-Quebec to build a new high capacity tie between our two systems. This line, which already has regulatory approval, will maintain service reliability and quality and expand Ontario's access to external sources of generation. The interconnection will consist of upgrading and installing new equipment at Hawthorne Transformer Station, replacing the existing 115kV and 230kV single circuit transmission lines with a new 230kV double circuit transmission line, and constructing an additional 230kV double circuit line.

Smart Meter Project

On June 13, 2006, the Government issued draft regulations clarifying the technical details of advanced metering infrastructure and data management. In support of the Government's decision to install smart meters throughout Ontario by 2010, we have re-launched our smart meter project. Our project will aim for the installation of approximately 45,000 meters by the end of 2006 and will focus on developing and testing the processes, tools, and network infrastructure to support the mass deployment of meters in the 2007 to 2010 period.

On May 1, 2006, we implemented new distribution rates which included a charge for smart meters of \$0.30 per month for each residential customer. Consistent with the OEB's direction and pending its further guidance, all of our smart meter-related expenditures and recoveries are currently being deferred in regulatory accounts.

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Cat Lake Power Utility Limited

On July 21, 2006 the OEB issued a decision, order and interim licence for us to assume operational responsibility for the Cat Lake Power distribution system and transmission assets by August 14, 2006 and to track revenues and costs in a regulatory account for review in a future rate proceeding.

OEB Proposals

Multi-year Electricity Rate Setting Plan – On June 19, 2006, the OEB issued a draft proposal concerning both the distribution cost of capital and the development of a second generation incentive regulation mechanism (IRM). We responded to the draft with concerns over the proposed common capital structure, as well as the low proposed return on equity. On July 25, 2006, the OEB issued its final proposal which included a proposed return on equity in the range of 8.37% for the existing rate base as of 2006 and the possibility of 9.87% as an incentive for new infrastructure investment added to rate base in 2007 and beyond. A 1% change in the return on deemed common equity of the distribution business would affect our net income by about \$13 million. We will continue to take an active role in this process, the next steps of which are expected to be the filing of expert evidence and an OEB technical conference in the third quarter of this year.

Minimum Filing Requirements for Transmission and Distribution Rate Applications and Leave to Construct Projects – On July 17, 2006, the OEB proposed minimum information requirements for cost of service filings for rate adjustments, second generation IRM and leave to construct filings. We are currently preparing a response to the proposals.

Interest Rates for Regulatory Accounts of Utilities – On May 26, 2006, the OEB issued a proposal regarding an interest rate methodology that reflects market rates and is responsive to changes in market conditions for distribution regulatory accounts. We have responded to the proposals and do not currently anticipate the outcome of this proposal to have a material impact to our net income.

Cost Allocation Review – On June 28, 2006, the OEB issued a proposal on principles and methodologies to be included in the cost allocation model and filing for all distributors. We have responded with our comments to the OEB and do not anticipate the outcome of this proposal to have a material impact to our net income.

SELECTED FINANCIAL HIGHLIGHTS AND RATIOS

<i>(Canadian dollars in millions) (except as otherwise noted)</i>	Three months ended		Six months ended	
	June 30		June 30	
	2006	2005	2006	2005
Net income	99	115	251	246
Net cash from operations	218	227	364	469
Capital expenditures	198	181	375	337
Earnings per common share <i>(Canadian dollars)</i>	943	1,107	2,417	2,368
Earnings coverage ratio ¹			2.71	2.85
Net asset coverage on long-term debt ²			1.92	1.93
Total debt to capitalization ³			53%	52%

¹The earnings coverage ratio has been presented for the twelve months ended June 30, 2006 and June 30, 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 June 30, 2005, excluding the impact of the \$91 million regulatory recovery recognized in 2004 as a result of the OEB's December 9, 2004 rate decision, was 2.60.

²The net asset coverage on long-term debt ratio has been presented as at June 30, 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.

³Total debt to capitalization ratio has been presented as at June 30, 2006 and December 31, 2005 and has been calculated as total debt divided by total debt plus total shareholder's equity.

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

FORWARD LOOKING STATEMENTS AND OTHER INFORMATION

Our oral and written public communications, including this Management Discussion and Analysis (MD&A), often contain forward looking statements that are based on current expectations, estimates, forecasts and projections about our business and the industry in which we operate and include beliefs and assumptions made by the management of our company. Such statements include, but are not limited to words such as “expect,” “anticipate,” “intend,” “attempt,” “may,” “plan,” “will”, “believe,” “seek,” “estimate,” and variations of such words and similar expressions are intended to identify such forward looking statements. These statements are not guarantees of future performance and involve assumptions and risks and uncertainties that are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed, implied or forecasted in such forward looking statements. We do not intend, and we disclaim any obligation to update any forward looking statements, whether written or oral, or whether as a result of new information, future events or otherwise.

These forward looking statements are based on a variety of factors and assumptions including, but not limited to the following:

- Our forecasted future capital expenditures of \$1.2 billion in each of 2007 and 2008 could be affected by approvals required from several regulatory bodies. Any such delays could also affect the reliability and quality of our services.
- We have estimated that a new transmission line from Bruce to Essa Transformer Station would cost approximately \$600 million. This estimate could be affected by the timing of approvals, potential plan or scope changes, changes in future interest and inflation rates, as well as other construction contingency factors that can affect major projects, such as specific design changes, uncertain soil conditions and the effects of weather.
- We could face reductions in the allowable return on common equity of our regulated businesses. A lower return on common equity could affect our credit ratings and ability to attract necessary capital.
- We have forecasted \$100 million in contributions to our defined benefit pension plan for 2007. These contributions could be affected by, but not limited to, the expected return on pension assets, future interest rates and inflation.

These assumptions are based on information currently available to us, including information obtained from third-party industry analysts. Actual results may differ materially from those predicted by such forward looking statements. While we do not know what impact any of these differences may have, our business, results of operations, financial condition and our credit stability may be materially adversely affected.

We caution the reader that the above list of factors is not exhaustive.

This MD&A is dated as at August 11, 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>(Canadian dollars in millions)</i>	Three months ended		Six months ended	
	June 30		June 30	
	2006	2005	2006	2005
Revenues				
Transmission <i>(Note 3)</i>	316	307	614	635
Distribution <i>(Note 4)</i>	757	706	1,613	1,567
Other	5	5	11	10
	1,078	1,018	2,238	2,212
Costs				
Purchased power	505	484	1,103	1,102
Operation, maintenance and administration	234	191	419	370
Depreciation and amortization	127	119	245	241
	866	794	1,767	1,713
Income before financing charges and provision for payments in lieu of corporate income taxes	212	224	471	499
Financing charges	73	83	146	163
Income before provision for payments in lieu of corporate income taxes	139	141	325	336
Provision for payments in lieu of corporate income taxes <i>(Note 5)</i>	40	26	74	90
Net income	99	115	251	246
Basic and fully diluted earnings per common share (Canadian dollars)	943	1,107	2,417	2,368

CONSOLIDATED STATEMENTS OF RETAINED EARNINGS (unaudited)

<i>(Canadian dollars in millions)</i>	Three months ended		Six months ended	
	June 30		June 30	
	2006	2005	2006	2005
Retained earnings, beginning of period	1,072	929	1,079	887
Net income	99	115	251	246
Dividends <i>(Note 6)</i>	(64)	(57)	(223)	(146)
Retained earnings, end of period	1,107	987	1,107	987

See accompanying notes to Consolidated Financial Statements.

HYDRO ONE INC.
CONSOLIDATED BALANCE SHEETS (unaudited)

<i>(Canadian dollars in millions)</i>	June 30, 2006	December 31, 2005
Assets		
Current assets		
Short-term investments	3	-
Accounts receivable (net of allowance for doubtful accounts)	722	622
Materials and supplies	62	56
Other	13	12
	800	690
Fixed assets		
Fixed assets in service	15,754	15,553
Less: accumulated depreciation	5,998	5,818
	9,756	9,735
Construction in progress	540	381
	10,296	10,116
Long-term assets		
Deferred pension asset	416	449
Regulatory assets	364	430
Goodwill	133	133
Deferred debt costs	24	23
Other	10	10
	947	1,045
Total assets	12,043	11,851
Liabilities		
Current liabilities		
Bank indebtedness	9	9
Accounts payable and accrued charges	619	700
Accrued interest	45	43
Short-term notes payable	130	-
Long-term debt payable within one year (Note 7)	463	589
	1,266	1,341
Long-term debt (Note 7)	4,711	4,466
Other long-term liabilities		
Employee future benefits other than pension (Note 8)	761	716
Regulatory liabilities (Note 3)	482	525
Environmental liabilities	59	64
Long-term accounts payable and accrued charges	20	23
	1,322	1,328
Total liabilities	7,299	7,135
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	1,107	1,079
Total shareholder's equity	4,744	4,716
Total liabilities and shareholder's equity	12,043	11,851

See accompanying notes to Consolidated Financial Statements.

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

<i>(Canadian dollars in millions)</i>	Three months ended		Six months ended	
	June 30		June 30	
	2006	2005	2006	2005
Operating activities				
Net income	99	115	251	246
Adjustments for non-cash items:				
Depreciation and amortization (net of removal costs)	118	111	227	220
Transmission earnings sharing mechanism	3	-	18	-
Amortization of discount	7	15	18	30
Retail settlement variance accounts	3	18	6	22
Low-voltage services	(2)	-	(8)	-
	228	259	512	518
Changes in non-cash balances related to operations	(10)	(32)	(148)	(49)
Net cash from operations	218	227	364	469
Financing activities				
Long-term debt issued	250	500	550	500
Long-term debt retired	(448)	(200)	(448)	(200)
Short-term notes payable	130	(30)	130	(40)
Dividends paid	(64)	(57)	(223)	(146)
Termination of forward sale	-	(10)	-	(10)
Other	(4)	(2)	(4)	(1)
Net cash (used in) from financing activities	(136)	201	5	103
Investing activities				
Fixed assets	(198)	(181)	(375)	(337)
Other assets	1	(5)	9	4
Net cash used in investing activities	(197)	(186)	(366)	(333)
Net change in cash and cash equivalents	(115)	242	3	239
Cash and cash equivalents, beginning of period	109	(12)	(9)	(9)
Cash and cash equivalents, end of period	(6)	230	(6)	230

See accompanying notes to Consolidated Financial Statements.

HYDRO ONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

1. BASIS OF PRESENTATION

These 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. CONDITIONAL ASSET RETIREMENT OBLIGATIONS

Effective April 1, 2006, Hydro One adopted the new accounting recommendations for "Conditional Asset Retirement Obligations" issued by the Emerging Issues Committee of the Canadian Institute of Chartered Accountants. Although Hydro One has identified several conditional asset retirement obligations, the Company expects to use the majority of the related assets for an indefinite period. As such, a removal date cannot be determined and a reasonable estimate of the fair value of related asset retirement obligations cannot be made at this time. The Company did determine that there is an immaterial liability associated with the disposal of treated wood utility poles. If at some future date, it becomes possible to estimate the fair value of the cost of disposing the other assets that the Company is legally required to dispose of, a related asset retirement obligation will be recognized at that time.

3. 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 revenue requirements 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 its 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. As at June 30, 2006, \$18 million had been recorded in the regulatory liability account, inclusive of interest.

4. DISTRIBUTION RATE DECISION

On April 12, 2006, the OEB announced its decision regarding the Company's rate application in respect of the distribution business of Hydro One Networks Inc. On the basis of the written and oral evidence submitted, the OEB approved the requested increase in the revenue requirement based on a reduction in the approved rate of return, from 9.88% to 9.00%, effective May 1, 2006.

5. 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. Future income taxes related to the regulated businesses are accounted for using the taxes payable method and have not been recorded in the accounts as they are expected to be recovered through future revenues. In the absence of rate regulated accounting, in the second quarter of 2006 Hydro One would have recorded a future income tax benefit of \$27 million related to the reduction in substantively enacted federal tax rates. As at June 30, 2006, after taking into account the reduction in the substantively enacted tax rates and additional temporary differences incurred throughout the period, unrecognized future income tax liabilities amounted to approximately \$281 million (December 31, 2005 - \$265 million).

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

6. DIVIDENDS

During the six months ended June 30, 2006, preferred dividends in the amount of \$9 million (2005 - \$9 million) and common dividends in the amount of \$214 million (2005 - \$137 million) were declared.

7. LONG-TERM DEBT

On March 3, 2006, Hydro One issued notes under the Company's Medium Term Note (MTN) 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.

On April 24, 2006, the Company issued \$250 million of 30-year notes under its MTN 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.

On June 27, 2006, the maturity date of the Company's \$750 million standby revolving credit facility was extended to August 10, 2007.

8. EMPLOYEE FUTURE BENEFITS

Total benefit costs are as follows:

<i>(Canadian dollars in millions)</i>	Three months ended		Six months ended	
	June 30	2005	June 30	2005
	2006	2005	2006	2005
Pension				
Net period benefit costs	39	44	77	87
Pension fund contribution	22	23	44	43
Less: Portion attributable to labour and capitalized as part of the cost of fixed assets	9	8	17	16
Portion attributable to regulatory assets	3	7	11	14
Charged to results of operations	10	8	16	13
Employee Future Benefits Other than Pension				
Net periodic benefit cost	31	24	61	48
Less: Portion attributable to labour and capitalized as part of the cost of fixed assets	9	7	19	16
Charged to results of operations	22	17	42	32

9. 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.

HYDRO ONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (continued)

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 June 30 (Canadian dollars in millions)</i>	Transmission	Distribution	Other	Consolidated
2006				
Segment profit				
Revenues	316	757	5	1,078
Purchased power	-	505	-	505
Operation, maintenance and administration	109	120	5	234
Depreciation and amortization	61	64	2	127
Income (loss) before financing charges and provision for payments in lieu of corporate income taxes	146	68	(2)	212
Financing charges				73
Income before provision for payments in lieu of corporate income taxes				139
Capital expenditures	97	100	1	198
2005				
Segment profit				
Revenues	307	706	5	1,018
Purchased power	-	484	-	484
Operation, maintenance and administration	83	102	6	191
Depreciation and amortization	59	59	1	119
Income (loss) before financing charges and provision for payments in lieu of corporate income taxes	165	61	(2)	224
Financing charges				83
Income before provision for payments in lieu of corporate income taxes				141
Capital expenditures	87	94	-	181
<i>Six months ended June 30 (Canadian dollars in millions)</i>				
2006				
Segment profit				
Revenues	614	1,613	11	2,238
Purchased power	-	1,103	-	1,103
Operation, maintenance and administration	202	206	11	419
Depreciation and amortization	120	122	3	245
Income (loss) before financing charges and provision for payments in lieu of corporate income taxes	292	182	(3)	471
Financing charges				146
Income before provision for payments in lieu of corporate income taxes				325
Capital expenditures	197	175	3	375
2005				
Segment profit				
Revenues	635	1,567	10	2,212
Purchased power	-	1,102	-	1,102
Operation, maintenance and administration	170	188	12	370
Depreciation and amortization	123	116	2	241
Income (loss) before financing charges and provision for payments in lieu of corporate income taxes	342	161	(4)	499
Financing charges				163
Income before provision for payments in lieu of corporate income taxes				336
Capital expenditures	176	160	1	337

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

<i>(Canadian dollars in millions)</i>	June 30, 2006	December 31, 2005
Total assets		
Transmission	6,892	6,833
Distribution	5,061	4,926
Other	90	92
	12,043	11,851

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

10. COMPARATIVE FIGURES

The comparative Consolidated Financial Statements have been reclassified from statements previously presented to conform to the presentation of the June 30, 2006 Consolidated Financial Statements.