

HYDRO ONE GOVERNANCE FRAMEWORK

1.0 OVERVIEW

The corporate governance structure and Internal Control Framework of Hydro One Inc. provide reasonable assurance regarding Hydro One Distribution's effective and efficient operations, reliable financial reporting and compliance with applicable laws and regulations. In the past few years, federal and provincial governments and regulators have moved decisively to increase the robustness and transparency of corporate governance, as well as expand the requirements for internal control and disclosure. Although the majority of Hydro One Distribution's practices already conform to these requirements, special projects have been undertaken to ensure full compliance. In 2006, the focus was on documenting and testing the controls over financial reporting. Tests of operational effectiveness will continue each year.

2.0 CORPORATE GOVERNANCE

Corporate governance is the mechanism by which a corporation ensures independent oversight of management activities on behalf of the shareholder(s). For Hydro One Inc., the Board of Directors and its associated committees fulfill this role, and provide direction to management through precepts such as ethical management (as established through our Code of Business Conduct), review and/or approval of a stated mission, goals and business objectives, organizational authorities, and business plans.

The company's corporate governance structure is illustrated in Figure 1. Hydro One's Board and Senior Management committees are also described in detail below.

Hydro One Corporate Governance

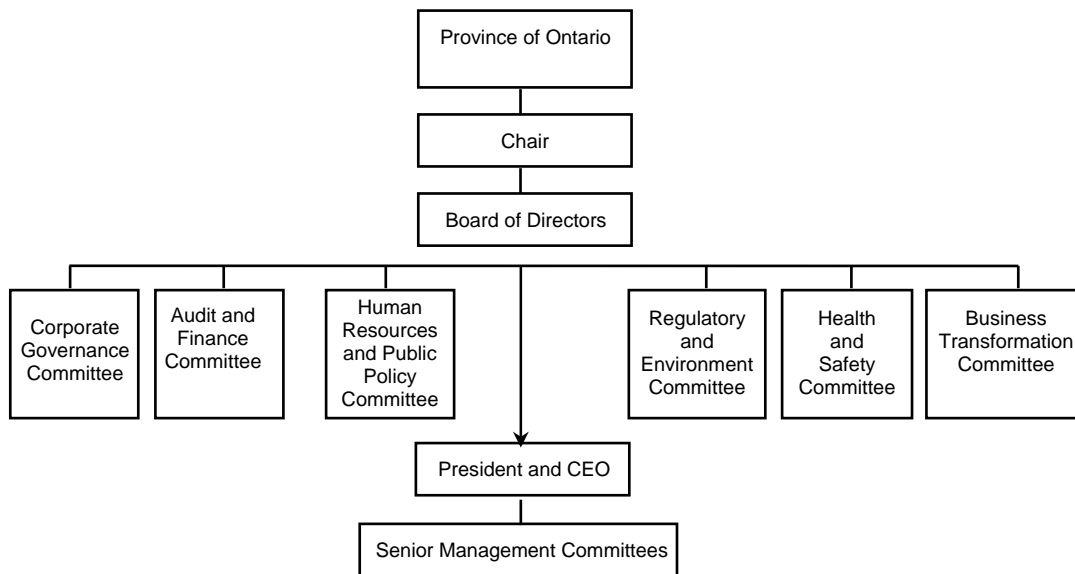


Figure 1

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4 2.1 The Corporate Governance Committee is the Board governance committee of
5 Hydro One Inc. and its subsidiaries. The committee is primarily responsible for
6 carrying out an annual review of the mandates of the Board and each committee
7 of the Board or subsidiary Boards. Other obligations include recommending
8 issues for discussion at Board meetings, monitoring the quality of management's
9 relationship with the Board, recommending suitable nominees to the Board of
10 Directors, conducting the annual Board and individual Director effectiveness
11 evaluations and reviewing all Director compensation.

12
13 2.2 The Audit and Finance Committee is mainly responsible for overseeing the
14 accounting, financial reporting and auditing practices for Hydro One Inc. and its
15 subsidiaries. Specifically, the committee makes recommendations regarding

1 financial objectives and plans, and risk management strategies of the company.
2 It is also accountable for reviewing and recommending to the Board for approval
3 the interim and annual consolidated financial statements, management discussion
4 and analysis disclosures, and financial statements in debt securities offering
5 documents. In addition, the Audit and Finance Committee reviews the internal
6 audit procedures of the company and advises the Board on its auditing practices
7 and procedures, selects and oversees the work of external auditors and obtains
8 assurance that internal controls are adequate. The committee also reviews, at least
9 annually but more frequently if necessary, complaints brought forward under the
10 Code of Business Conduct that relate specifically to inappropriate accounting,
11 internal control or auditing matters. All members of the committee are
12 independent and financially literate as per applicable Canadian securities
13 legislation.

14
15 2.3 The Human Resources and Public Policy Committee is responsible for reviewing
16 the appropriateness of current and future organization structures, succession plans
17 for corporate and divisional officers, the appropriateness of the Code of Business
18 Conduct (including any breaches for the preceding year), and the performance and
19 remuneration of senior executives. Also, the committee identifies, assesses and
20 provides advice to the Board on public affairs issues that have significant impact
21 on the company.

22
23 2.4 The Regulatory and Environment Committee maintains an up-to-date
24 understanding of regulatory and environmental compliance risks and seeks to
25 ensure that management is effectively managing those risks. The committee is
26 also responsible for reviewing management's regulatory strategy and proposals for
27 transmission and distribution rate applications, as well as the status of outstanding
28 applications. It also plays an advisory role with respect to changes or additions to

1 environmental policies, standards, accountabilities and programs, and
2 recommends such to the Board for approval.

3

4 2.5 The Health and Safety Committee is responsible for reviewing and ensuring
5 compliance with occupational health and safety legislation, policies, standards,
6 and programs. They annually review the company's state of readiness to respond
7 to crisis situations, as well as reports of any occupational accidents. They may
8 also review such other health and safety matters, including public health and
9 safety, as appropriate.

10

11 2.6 The Business Transformation Committee is responsible for assisting the Board of
12 Directors in its oversight responsibility on matters related to the Enterprise
13 Application Systems Replacement Strategy. The strategy addresses the
14 replacement of existing customized business applications with commercially
15 available software system applications to simplify the information technology
16 infrastructure and improve functionality in business processes.

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18 **3.0 SENIOR MANAGEMENT COMMITTEES**

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20 Prudent decision-making, operational effectiveness and business transparency are
21 supported by four key senior management committees: Executive Committee,
22 Operations Committee, Pension Committee and Disclosure Committee.

23

24 **3.1 Executive Committee**

25

26 This committee is a decision-making body established to review and approve business
27 plans and strategies, capital projects and investments, key operating decisions, regulatory
28 filings, labour strategy, financial and operational performance indicators and other items

1 as required. The Executive Committee also reviews all project approvals prior to going
2 to the Board.

3 4 **3.2 Operations Committee**

5
6 This committee provides business coordination between lines of business, including
7 resourcing strategy, alignment of business plans, health and safety policy, support for
8 regulatory filings and implementation of corporate strategies. They also review and
9 coordinate operational issues and review project and program expenditures. Any
10 required changes to project or program schedules are coordinated across all lines of
11 business.

12 13 **3.3 Pension Committee**

14
15 The Pension Committee is responsible for approving appropriate pension policies,
16 standards and programs. It is also responsible for ensuring compliance with legislation,
17 policies and standards.

18 19 **3.4 Disclosure Committee**

20
21 The Disclosure Committee operates under the principal that communications to the
22 public should be timely, factual and accurate and broadly disseminated in accordance
23 with all applicable legal and regulatory requirements in Canada. The committee meets
24 quarterly to review financial statements and management's discussion and analysis
25 disclosures, offering documents for debt securities, as well as risk assessments prepared
26 for credit rating agencies and government.

1 **4.0 INTERNAL CONTROL FRAMEWORK**

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3 Internal controls ensure the company achieves its mission and goals, by enabling
4 management to deal with rapidly changing economic and competitive environments,
5 customer demands and priorities, and restructuring for future growth. Internal controls
6 promote efficiency, reduce risk of asset loss, and help ensure the reliability of financial
7 statements and compliance with laws and regulations.

8
9 Hydro One Inc.'s Internal Control Framework has five components, including: the
10 Control Environment, Risk Assessment, Control Activities, Information and
11 Communication, and Monitoring. The framework further addresses the appropriate
12 elements of each component at the entity (Board) level, corporate (senior management)
13 level and operational (local) level. The framework is consistent with accepted external
14 standards and control criteria set out by such standard setting bodies as the Canadian
15 Institute of Chartered Accountants and the US Committee of Sponsoring Organizations
16 (COSO criteria, Internal Control-Integrated Framework). Key components of the
17 framework are described in more detail below:

18
19 The "Control Environment" refers to direction and oversight from the top of the
20 organization. The control environment component in the framework captures the notion
21 of ethical and prudent financial management as established by the Board of Directors and
22 senior management (see Section 2.0 above), and sets the tone for all financial and project
23 management policies and practices established at lower levels. Regular education
24 sessions on policies, processes and practices/procedures are also provided.

25
26 Hydro One Inc. has a formal Code of Business Conduct and a Disclosure Policy which
27 have been issued to all staff. The Code of Business Conduct requires all management
28 employees at the director level and above to sign an annual compliance form to document

1 that they have read, understood, and complied with the Code, and that all conflicts or
2 potential conflicts of interest have been disclosed. The Corporate Ethics Officer ensures
3 that this process is performed on a timely basis and that a compliance register is
4 maintained and submitted to the President and CEO of Hydro One Inc. And lastly,
5 individual performance contracts capture the understanding between a manager and a
6 direct report as to the results expected and the means by which such results will be
7 achieved.

8
9 "Risk Assessment" involves the identification and analysis by management of the key
10 risks to achieving the company's business objectives. Such an assessment is performed,
11 at minimum, annually, and provides the basis for business planning decisions. Programs
12 that mitigate existing risks to acceptable residual levels, or provide mitigation for
13 emerging risks, are captured in business plans. Risk assessment extends to individual
14 investment decisions through the Work Program Prioritization process (see Exhibit A,
15 Tab 14, Schedule 5). This process assesses whether any proposed solutions for a specific
16 operational need will achieve a level of residual risk acceptable to senior management
17 and our shareholder. Projects and programs underway are regularly assessed for new and
18 changing risks. Moreover, at the operational level, extensive emergency and contingency
19 plans exist and are regularly tested and updated.

20
21 "Control Activities" refers to the systems, policies and procedures that ensure
22 management's objectives are achieved and risk mitigation plans are carried out. Sets of
23 policies and procedures exist to govern annual, monthly and day to day operations at the
24 business unit and local levels. Many of these policies were imported from Ontario
25 Hydro, and revised to focus on the core activities of transmission and distribution. Each
26 revised policy has an issue date and expected review date. In many locations, policies
27 and procedures are available on internal web sites. More information on Hydro One's
28 policies may be found in Exhibit A, Tab 12, Schedule 1.

1 One of the foundations of good control is the establishment of appropriate levels of
2 authority for spending and other business decisions. The delegation and exercise of all
3 authorities are governed by 'Guiding Principles', the Code of Business Conduct, and
4 policies and procedures. Authorities are reviewed by Audit and Finance Committee.
5 Business plans, budgets and business cases establish overall spending of the company.

6

7 The budgeting and business planning process is also a critical element of effective
8 internal controls. Annually a budget and business plan are prepared and submitted to the
9 Board for approval. The budget and business plan sets the parameters of the company's
10 activities for a specific fiscal period. More information on our planning process may be
11 found in Exhibit A, Tab 14, Schedule 1. Information on our Project and Program
12 approval process and our Work Program Prioritization process may be found in Exhibit
13 A, Tab 14, Schedule 4 and Exhibit A, Tab 14, Schedule 5, respectively.

14

15 The Executive Authorities Register (EAR) delegates authorities from the Board to senior
16 management. Organizational Authority Registers (OAR's) exist at subsidiary and
17 business unit levels to delegate authorities from senior management to business unit and
18 local levels.

19

20 The Inergi outsourcing agreement further provides approvals assigned by Hydro One to
21 Inergi LP for specific transactions and levels of spending.

22

23 "Information and Communication" supports all other control components. Pertinent
24 information must be identified, captured and communicated in a form and timeframe that
25 enables staff to carry out their responsibilities. Regular communication occurs to all staff
26 from the Chief Financial Officer and from the Corporate Controller with respect to new
27 or changed policies and procedures. Presentations on various internal control matters

1 also occur regularly. And, as noted previously, policies and procedures can be found in
2 many locations on internal websites.

3
4 "Monitoring" covers the oversight of internal controls by management or independent
5 parties outside the process; or the application of independent methodologies, such as
6 customized procedures or standard checklists, by employees within a process.
7 Monitoring also includes assessing the quality of internal controls over time and
8 implementing required changes.

9
10 Quarterly letters of representation and disclosure prepared and submitted by Vice-
11 Presidents provide both assurance and communication with respect to internal controls
12 and validity of financial statements. The Letter of Disclosure addresses issues such as
13 legal claims; changes in accounting policies, practices, systems, and procedures that have
14 occurred in the period; and financial accounting matters that could have a significant
15 impact on financial statements. The Letter of Representation provides assurance that
16 internal control systems, policies and procedures are in place and functioning properly
17 and financial statements are a true representation of the business.

18
19 Every month, each line of business is required to conduct a detailed review of financial
20 results by comparing operating results to budgets and responding to discrepancies.
21 Project details with major accounts are reconciled monthly to source sub-systems and
22 suspense accounts are also explained and reconciled. Monthly control reports related to
23 key aspects of operations financial and project activity are prepared centrally and
24 delivered to managers for review and follow-up action as appropriate. A month-end
25 close schedule is established to ensure timely production of financial statements. In
26 addition, annual compliance testing of key financial activities are performed locally by
27 line of business staff.

1 Compliance monitoring with respect to codes and policies is performed by multiple
2 groups. Regulatory compliance is monitored by Regulatory Affairs (e.g. Affiliate
3 Relationships Code; see Exhibit A, Tab 8, Schedule 3). Internal Audit performs
4 compliance audits and uses a risk-based audit approach for prioritizing such audits.
5 Internal controls are reviewed on a recurring cycle, again linked to level of risk.
6 Furthermore, regular review of all outstanding items from past audits is performed.
7 Annual year-end audits are also conducted by the external auditor.

8

9 The outsourcing contract with Inergi LP requires that Inergi conduct an independent
10 confirmation of the integrity of financial controls for all Hydro One transactions, and
11 allows for auditing of processes and systems by Hydro One Internal Audit. Such audits
12 are designed to assess the appropriate occurrence, proper measurement, completeness and
13 accuracy of transactions and whether they were classified, described and disclosed in
14 accordance with generally accepted accounting principles.

15