

February 16, 2007

### **ONTARIO POWER GENERATION REPORTS 2006 FINANCIAL RESULTS**

[Toronto]: Ontario Power Generation Inc. ("OPG" or the "Company") today reported its financial and operating results for the year ended December 31, 2006. Net income for the year was \$490 million compared to net income of \$366 million for the year ended December 31, 2005.

"OPG's 2006 financial results reflect increased nuclear and hydroelectric production. Although the reliability of our fossil stations continued to improve in 2006, fossil production declined due to significantly lower Ontario electricity demand. In 2007, we expect a continuation of low market prices and slow growth in Ontario electricity demand. These factors, combined with constrained revenues, cost pressures, and an increasing requirement to undertake new generation projects, are expected to result in increased financial pressures. In 2007, OPG will continue to focus on improving operational performance and strengthening safety initiatives while continuing to meet the expectations of our shareholder with respect to new generation projects," said President and CEO Jim Hankinson.

Electricity generated in 2006 of 105.2 terawatt hours (TWh) was lower than 2005 production of 108.5 TWh. Electricity production from OPG's nuclear stations of 46.9 TWh in 2006 increased over 2005 nuclear production of 45.0 TWh. The increase was primarily a result of a full year's production from Unit 1 at the Pickering A nuclear station which returned to service in November 2005. Hydroelectric production of 33.3 TWh was marginally higher than production of 32.6 TWh in 2005. Electricity production from OPG's fossil stations declined to 25.0 TWh in 2006 compared to 30.9 TWh in 2005 mainly as a result of significantly lower Ontario electricity demand.

OPG received an average price of 4.6¢/kilowatt hour (kWh) from the output of all of its generating stations compared to an average price of 4.9¢/kWh in 2005. These average prices reflect regulated prices that OPG receives for production from its nuclear and baseload hydroelectric generating assets as well as spot market prices, subject to a revenue limit, for the majority of its remaining production. The average electricity spot price in Ontario of 4.9¢/kWh in 2006 was affected by lower demand and was significantly lower than the average price in 2005 of 7.2¢/kWh.

Earnings in 2006 were significantly affected by a reduction in gross margin from electricity sales due primarily to lower average sales prices and lower electricity generation compared to 2005, and an increase in pension and other post employment benefit costs mainly as a result of changes in economic assumptions used to measure the costs.

Earnings in 2006 were favourably affected by a decrease in depreciation expense of \$89 million compared to 2005. The decrease in depreciation expense was primarily due to an extension of the service lives, for accounting purposes, of all of the coal-fired generating stations as a result of proposed delays in the plan to replace coal-fired generation. In addition, OPG extended the remaining service lives of the Pickering A and B nuclear generating stations.

In 2005, OPG recorded impairment charges of \$202 million related to its Lennox generating station, and \$63 million related to Units 2 and 3 at the Pickering A nuclear station which contributed to higher earnings in 2006 relative to 2005.

In 2006, OPG initiated and made progress on a number of electricity generation projects aimed at significantly contributing to Ontario's long-term electricity supply requirements. These projects include the following:

- Excavation of a new water diversion tunnel to increase the amount of water flowing to existing turbines at the Sir Adam Beck generating stations in Niagara began in early September;
- Construction of a new 12.5 megawatt (MW) Lac Seul hydroelectric generating station on the English River began during the first quarter of 2006 and is expected to be completed in the fourth quarter of 2007;
- In September, Portlands Energy Centre ("PEC"), a 550 MW gas-fired, combined cycle station that is under construction near downtown Toronto, signed a 20-year Accelerated Clean Energy Supply contract with the Ontario Power Authority. PEC is a limited partnership between OPG and TransCanada Energy Ltd.;
- OPG began an Environmental Assessment ("EA") process as part of its business case study for the potential refurbishment and life extension of its Pickering B nuclear generating station;
- OPG initiated a federal approval process with the Canadian Nuclear Safety Commission in September by filing an Application for a Site Preparation Licence for new nuclear generating units at OPG's Darlington nuclear generating site;
- The definition phase for a 450 MW hydroelectric development, which includes the replacement and expansion of certain hydroelectric generating stations located on the Lower Mattagami River, is proceeding. OPG is engaged in consultations with First Nations stakeholders, and is currently addressing EA requirements and detailing technical project specifications; and
- OPG is exploring the potential development of a gas-fuelled electricity generation station at its Lakeview site and is continuing with the decommissioning and demolition of the Lakeview coal-fired generating station.

"The list of new generation projects that OPG is currently undertaking is extensive. Our Shareholder has asked us to develop these much-needed new sources of electricity supply to help meet Ontario's future electricity needs. Our objective is to effectively manage and deliver these small, medium, and large projects on schedule and within budget," said President and CEO Jim Hankinson.

## FINANCIAL AND OPERATIONAL HIGHLIGHTS

| <i>(millions of dollars – except where noted)</i>                         | <b>2006</b>  | <b>2005</b> |
|---------------------------------------------------------------------------|--------------|-------------|
| <i>Earnings</i>                                                           |              |             |
| Revenue after revenue limit and Market Power Mitigation Agreement rebates | <b>5,564</b> | 5,798       |
| Fuel expense                                                              | <b>1,098</b> | 1,297       |
| Gross margin                                                              | <b>4,466</b> | 4,501       |
| Operations, maintenance and administration                                | <b>2,777</b> | 2,516       |
| Other expenses                                                            | <b>1,091</b> | 1,162       |
| Impairment of long-lived assets                                           | <b>22</b>    | 265         |
| Income tax expenses                                                       | <b>86</b>    | 118         |
| Extraordinary item                                                        | <b>-</b>     | 74          |
| Net income                                                                | <b>490</b>   | 366         |
| <i>Cash flow</i>                                                          |              |             |
| Cash flow provided by operating activities                                | <b>397</b>   | 1,201       |
| <i>Electricity Generation (TWh)</i>                                       |              |             |
| Regulated – Nuclear                                                       | <b>46.9</b>  | 45.0        |
| Regulated – Hydroelectric                                                 | <b>18.3</b>  | 18.5        |
| Unregulated – Hydroelectric                                               | <b>15.0</b>  | 14.1        |
| Unregulated – Fossil-Fuelled                                              | <b>25.0</b>  | 30.9        |
| Total electricity generation                                              | <b>105.2</b> | 108.5       |
| <i>Average electricity sales price<sup>1</sup> (\$/kWh)</i>               |              |             |
| Regulated – Nuclear <sup>2</sup>                                          | <b>4.9</b>   | 4.7         |
| Regulated – Hydroelectric <sup>2</sup>                                    | <b>3.5</b>   | 4.1         |
| Unregulated – Hydroelectric <sup>3</sup>                                  | <b>4.6</b>   | 5.2         |
| Unregulated – Fossil-Fuelled <sup>3</sup>                                 | <b>4.8</b>   | 5.5         |
| OPG's average sales price                                                 | <b>4.6</b>   | 4.9         |
| <i>Nuclear unit capability factor (per cent)</i>                          |              |             |
| Darlington                                                                | <b>88.7</b>  | 90.6        |
| Pickering A                                                               | <b>72.0</b>  | 69.9        |
| Pickering B                                                               | <b>75.2</b>  | 77.7        |
| <i>Equivalent forced outage rate (per cent)</i>                           |              |             |
| Unregulated– Fossil-Fuelled                                               | <b>14.1</b>  | 15.9        |
| <i>Availability (per cent)</i>                                            |              |             |
| Regulated – Hydroelectric                                                 | <b>94.2</b>  | 92.7        |
| Unregulated – Hydroelectric                                               | <b>92.4</b>  | 92.2        |

<sup>1</sup> Prior to the inception of rate regulation on April 1, 2005, OPG's electricity generation received the Ontario spot electricity market price net of the Market Power Mitigation Agreement rebate.

<sup>2</sup> After April 1, 2005, electricity generation from stations in the Regulated – Nuclear segment received a fixed price of 4.95¢/kWh. During the same period, electricity generation from stations in the Regulated – Hydroelectric segment received a fixed price of 3.3¢/kWh for the first 1,900 MWh of generation in any hour, and the Ontario spot electricity market price for generation above this level.

<sup>3</sup> During the period from April 1, 2005 to April 30, 2006, 85 per cent of the electricity generation from unregulated stations, excluding the Lennox generating station and other contract volumes, was subject to a revenue limit based on an average price of 4.7¢/kWh. Starting May 1, 2006, the revenue limit decreased to 4.6¢/kWh.

Ontario Power Generation Inc. is an Ontario-based electricity generation company whose principal business is the generation and sale of electricity in Ontario. Our focus is on the efficient production and sale of electricity from our generation assets, while operating in a safe, open and environmentally responsible manner.

Ontario Power Generation Inc.'s audited consolidated financial statements and Management's Discussion and Analysis as at and for the year ended December 31, 2006, can be accessed on OPG's Web site ([www.opg.com](http://www.opg.com)), the Canadian Securities Administrators' Web site ([www.sedar.com](http://www.sedar.com)), or can be requested from the Company.

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## 2006 REPORT

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## **ONTARIO POWER GENERATION INC. MANAGEMENT'S DISCUSSION AND ANALYSIS**

This Management's Discussion and Analysis ("MD&A") should be read in conjunction with the audited consolidated financial statements and accompanying notes of Ontario Power Generation Inc. ("OPG" or the "Company") as at and for the year ended December 31, 2006. OPG's consolidated financial statements are prepared in accordance with Canadian generally accepted accounting principles ("GAAP") and are presented in Canadian dollars. Certain prior year information has been reclassified to conform to the current year's presentation. This MD&A is dated February 15, 2007.

### **FORWARD-LOOKING STATEMENTS**

The MD&A contains forward-looking statements that reflect OPG's current views regarding certain future events and circumstances. Any statement contained in this document that is not current or historical is a forward-looking statement. OPG generally uses words such as "anticipate", "believe", "foresee", "forecast", "estimate", "expect", "schedule", "intend", "plan", "project", "seek", "target", "goal", "strategy", "may", "will", "should", "could" and other similar words and expressions to indicate forward-looking statements. The absence of any such word or expression does not indicate that a statement is not forward-looking.

All forward-looking statements involve inherent assumptions, risks and uncertainties and, therefore, could be inaccurate to a material degree. In particular, forward-looking statements may contain assumptions such as those relating to OPG's fuel costs and availability, asset performance, nuclear decommissioning and waste management, closure of coal-fired generating stations, refurbishment of existing facilities, development and construction of new facilities, pension and other post employment benefit ("OPEB") obligations, income taxes, spot market electricity prices, the ongoing evolution of the Ontario electricity industry, environmental and other regulatory requirements, and the weather. Accordingly, undue reliance should not be placed on any forward-looking statement. The forward-looking statements included in this MD&A are made only as of the date of this MD&A. OPG does not undertake to publicly update these forward-looking statements to reflect new information, future events or otherwise.

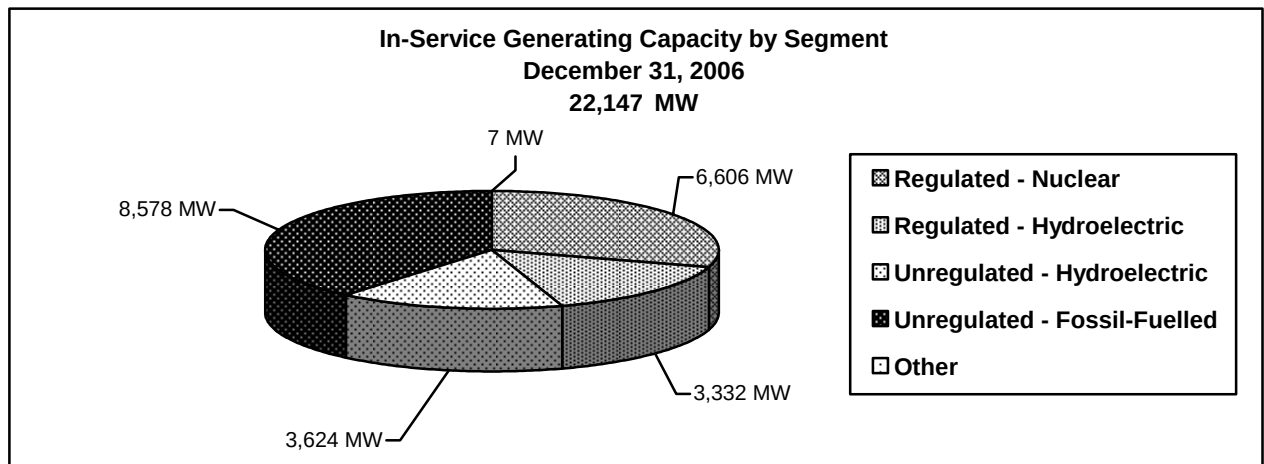
### **THE COMPANY**

OPG is an Ontario-based electricity generation company whose principal business is the generation and sale of electricity in Ontario. OPG's focus is on the efficient production and sale of electricity from its generating assets, while operating in a safe, open and environmentally responsible manner. OPG was created under the *Business Corporations Act* (Ontario) and is wholly owned by the Province of Ontario (the "Province").

At December 31, 2006, OPG's electricity generating portfolio had an in-service capacity of 22,147 megawatts ("MW"). OPG's electricity generating portfolio consists of three nuclear generating stations, five fossil-fuelled generating stations, 64 hydroelectric generating stations and three wind generating stations (which includes a 50 per cent interest in the Huron Wind joint venture). In addition, OPG, ATCO Power Canada Ltd. and ATCO Resources Ltd. co-own the Brighton Beach gas-fired generating station. OPG also owns two other nuclear generating stations, which are leased on a long-term basis to Bruce Power L.P. ("Bruce Power").

Effective April 1, 2005, the output from most of OPG's baseload hydroelectric facilities and all of the nuclear facilities that the company operates became rate regulated. OPG continues to receive the spot market price for the output from its remaining hydroelectric, fossil-fuelled and wind generating stations, subject to a revenue limit on the majority of this output. With the introduction of rate regulation, OPG revised its reportable business segments to separately reflect the regulated and unregulated aspects of its business. Since the second quarter of 2005, OPG reported its business segments as Regulated – Nuclear, Regulated – Hydroelectric, and Unregulated Generation. Beginning in the first quarter of 2006,

OPG separated the Unregulated Generation business segment into two reportable segments, identified as Unregulated – Fossil-Fuelled and Unregulated – Hydroelectric, as a result of changes in the management structure of these segments. Results for the comparative periods have been reclassified accordingly.



#### RATE REGULATION

A regulation was introduced pursuant to the *Electricity Restructuring Act, 2004* (Ontario), which provides that, effective April 1, 2005, OPG receives regulated prices for electricity generated from most of its baseload hydroelectric and all of the nuclear facilities that it operates. This comprises electricity generated from the Sir Adam Beck 1, 2 and Pump generating station, DeCew Falls 1 and 2, and R.H. Saunders hydroelectric facilities, and Pickering A and B and Darlington nuclear facilities.

The regulated price received by OPG for the first 1,900 megawatt hours (“MWh”) of production from the regulated hydroelectric facilities in any hour is \$33.00/MWh (3.3¢/kWh). As an incentive to encourage maximum hydroelectric electricity production during peak demand periods, any production from these regulated hydroelectric facilities above 1,900 MWh in any hour receives the Ontario electricity spot market price. The regulated price received by OPG for production from the nuclear facilities is \$49.50/MWh (4.95¢/kWh). These regulated prices were established by the Province, based on a revenue requirement taking into account a forecast of production volumes and total operating costs, and a return on rate base, which assumed an average five per cent return on equity. Rate base is a regulatory construct that represents the average net level of investment in regulated fixed assets, deferred charges and an allowance for working capital. These initial prices took effect April 1, 2005, and are expected to remain in effect until at least March 31, 2008, at which time it is anticipated that new regulated prices to be established by the Ontario Energy Board (“OEB”) will take effect.

The regulation directed OPG to establish variance accounts for costs incurred and revenues earned or foregone on or after April 1, 2005 due to deviations from the forecast information provided to the Province for the purposes of establishing regulated prices that are associated with differences in hydroelectric electricity production due to differences between forecast and actual water conditions; unforeseen changes to nuclear regulatory requirements or unforeseen technological changes; changes to revenues for ancillary services from the regulated facilities; acts of God (including severe weather events); and transmission outages and transmission restrictions. In addition, the regulation directed OPG to establish a deferral account for non-capital costs incurred on or after January 1, 2005 that are associated with the planned return to service of all units at the Pickering A nuclear generating station.

An amendment to the regulation pursuant to the *Electricity Restructuring Act, 2004* (Ontario) was made in February 2007. The amendment clarified certain aspects of the regulation and directed OPG to establish a deferral account related to certain changes in its liability for nuclear used fuel management and its liability for nuclear decommissioning and low and intermediate level waste management. The amendment directed OPG to establish a deferral account to record, up to the effective date of the OEB's first order establishing regulated prices, the revenue requirement impact, as reflected in OPG's audited consolidated financial statements, of any changes in its nuclear liabilities arising from an Approved Reference Plan, approved after April 1, 2005, in accordance with the terms of the Ontario Nuclear Funds Agreement ("ONFA").

The production from OPG's other generating assets remains unregulated and continues to be sold at the Ontario electricity spot market price. However, 85 per cent of the generation output from OPG's other generating assets, excluding the Lennox generating station and forward sales as of January 1, 2005, is subject to a revenue limit. The output from a generating unit where there has been a fuel conversion and the incremental output from a generating station where there has been a refurbishment or expansion of these assets are also excluded from the output covered by the revenue limit. In addition, until the Transition – Generation Corporation Designated Rate Options ("TRO") expired on April 30, 2006, volumes sold under such options were excluded from the revenue limit rebate. The revenue limit, which was originally established for a period of 13 months ending April 30, 2006, was subsequently extended for an additional three years. Starting May 1, 2006, the revenue limit decreased to 4.6¢/kWh from the previous limit of 4.7¢/kWh. On May 1, 2007, the revenue limit will return to 4.7¢/kWh and increase to 4.8¢/kWh effective May 1, 2008. In addition, beginning May 1, 2006, volumes sold under a Pilot Auction administered by the Ontario Power Authority ("OPA") are subject to a revenue limit that is 0.5¢/kWh higher than the revenue limit applicable to OPG's other generating assets. Revenues above these two revenue limits are returned to the Independent Electricity System Operator ("IESO") for the benefit of consumers.

The implementation of regulated pricing for the generation from most of OPG's baseload hydroelectric stations and the nuclear generating stations that OPG operates, as well as the revenue limit on OPG's unregulated generating assets, replaced OPG's rebate obligations under the Market Power Mitigation Agreement effective April 1, 2005.

From market opening on May 1, 2002, and prior to April 1, 2005, OPG was required under its generation licence issued by the OEB to comply with prescribed market power mitigation measures, including a rebate mechanism. Under the Market Power Mitigation Agreement, OPG had been required to pay a rebate to the IESO equal to the excess, if any, of the average hourly spot energy price over 3.8¢/kWh for the amount of energy sales subject to the rebate mechanism for those generating stations that OPG continued to control. The IESO passed the rebate on to consumers. The amount of energy generated by OPG that was subject to the rebate mechanism was approximately 80 terawatt hours ("TWh") on an annual basis.

## HIGHLIGHTS

### Overview of Results

This section provides an overview of OPG's audited consolidated operating results. A detailed discussion of OPG's performance by reportable business segment is included under the heading, *Discussion of Operating Results by Business Segment*.

| <i>(millions of dollars)</i>                                               | <b>2006</b>  | <b>2005</b> |
|----------------------------------------------------------------------------|--------------|-------------|
| <i>Revenue</i>                                                             |              |             |
| Revenue before revenue limit and Market Power Mitigation Agreement rebates | <b>5,725</b> | 6,949       |
| Revenue limit rebate                                                       | <b>(161)</b> | (739)       |
| Market Power Mitigation Agreement rebate                                   | <b>-</b>     | (412)       |
|                                                                            | <b>5,564</b> | 5,798       |
| <i>Earnings</i>                                                            |              |             |
| Income before the following:                                               | <b>791</b>   | 1,020       |
| Impairment of long-lived assets                                            | <b>22</b>    | 265         |
| Income before interest, income taxes and extraordinary item                | <b>769</b>   | 755         |
| Net interest expense                                                       | <b>193</b>   | 197         |
| Income before income taxes and extraordinary item                          | <b>576</b>   | 558         |
| Income tax expenses                                                        | <b>86</b>    | 118         |
| Income before extraordinary item                                           | <b>490</b>   | 440         |
| Extraordinary item                                                         | <b>-</b>     | 74          |
| Net income                                                                 | <b>490</b>   | 366         |
| <i>Electricity production (TWh)</i>                                        | <b>105.2</b> | 108.5       |
| <i>Cash flow</i>                                                           |              |             |
| Cash flow provided by operating activities                                 | <b>397</b>   | 1,201       |

Net income for the year ended December 31, 2006 was \$490 million compared to \$366 million in 2005, an increase of \$124 million. Income before income taxes for the year ended December 31, 2006 was \$576 million compared to income before taxes and an extraordinary item in 2005 of \$558 million, an increase of \$18 million. During 2005, OPG recorded a one-time extraordinary loss of \$74 million to reflect the impact of adopting rate regulated accounting for income taxes effective April 1, 2005.

The following is a summary of the factors impacting OPG's results for the year ended December 31, 2006 compared to results in 2005, on a before-tax basis:

*(millions of dollars – before tax )*

|                                                                                                                                                                               |              |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------|
| <b>Income before income taxes and extraordinary item for the year ended December 31, 2005</b>                                                                                 | <b>558</b>   |
| Changes in gross margin                                                                                                                                                       |              |
| Decrease in electricity sales prices after revenue limit and Market Power Mitigation Agreement rebates                                                                        | (83)         |
| Change in electricity generation by segment:                                                                                                                                  |              |
| Regulated – Nuclear                                                                                                                                                           | 96           |
| Regulated – Hydroelectric                                                                                                                                                     | (7)          |
| Unregulated – Hydroelectric                                                                                                                                                   | 46           |
| Unregulated – Fossil-Fuelled                                                                                                                                                  | (181)        |
| Trading revenue                                                                                                                                                               | 58           |
| Ancillary revenue                                                                                                                                                             | 64           |
| Other changes in gross margin                                                                                                                                                 | (28)         |
|                                                                                                                                                                               | (35)         |
| Increase in pension and other post employment benefit costs                                                                                                                   | (177)        |
| Increase in maintenance and repairs primarily for the nuclear and fossil-fuelled generating stations                                                                          | (57)         |
| Increase in nuclear planned outages                                                                                                                                           | (46)         |
| Amortization of Pickering A Return to Service deferral account balance                                                                                                        | (21)         |
| Write-off of excess inventory related to Pickering A Units 2 and 3 in 2005                                                                                                    | 57           |
| Decrease in depreciation expense primarily due to extension of service lives of the coal-fired generating stations, Pickering B station and Unit 4 of the Pickering A station | 89           |
| Other changes                                                                                                                                                                 | (35)         |
| <b>Decrease in income before income taxes, excluding impairment of long-lived assets</b>                                                                                      | <b>(225)</b> |
| Impairment of long-lived assets – 2005                                                                                                                                        | 265          |
| Impairment of long-lived assets – 2006                                                                                                                                        | (22)         |
| <b>Income before income taxes for the year ended December 31, 2006</b>                                                                                                        | <b>576</b>   |

Earnings for the year ended December 31, 2006 were significantly affected by a reduction in gross margin from electricity sales due primarily to lower average sales prices and lower electricity generation compared to 2005. The decrease in electricity prices was primarily due to lower average Ontario spot market prices applicable to electricity generation from OPG's unregulated business segments. OPG's lower electricity generation during 2006 was primarily due to lower electricity demand in Ontario and higher generation from non-OPG generating stations, which contributed to reduced generation at OPG's fossil-fuelled stations. The lower generation from the fossil-fuelled generating stations was partially offset by higher generation from OPG's nuclear and unregulated hydroelectric generating stations.

Gross margin in 2006 was favourably affected by an increase in ancillary revenue compared to 2005, primarily due to revenue from the Lennox reliability must-run ("RMR") contract, and a higher margin on trading activities. The RMR contract, which commenced effective October 1, 2005, is a cost-based contract with the IESO that provides for regular payments, which are subject to adjustments for actual costs.

For the year ended December 31, 2006, OM&A expenses were \$2,777 million compared to \$2,516 million in 2005. The higher OM&A expenses were primarily due to an increase in pension and OPEB costs mainly due to changes in economic assumptions used to measure the costs. In 2006, OM&A expenses also included amortization of the Pickering A return to service costs, which were previously deferred in accordance with a regulation pursuant to the *Electricity Restructuring Act, 2004* (Ontario). Amortization commenced late in 2005 with the return to service of Unit 1 at the Pickering A

nuclear generating station. In addition, the nuclear and fossil-fuelled business units incurred higher costs during 2006 as a result of an increase in repairs and maintenance expenditures for both planned and unplanned outages. In 2005, OM&A expenses were affected by a write-off of excess inventory acquired for the anticipated return to service of Units 2 and 3 at the Pickering A nuclear generating station.

Earnings were favourably affected by a decrease in depreciation expense of \$89 million during 2006 compared to 2005. The decrease in depreciation expense was primarily due to a service life extension, for accounting purposes, of the Nanticoke generating station during the third quarter of 2005, and the subsequent extension of the service lives of all of the coal-fired generating stations during the third quarter of 2006, as a result of delays in the plan to replace coal-fired generation. In addition, in late 2005 and early 2006 respectively, OPG extended the remaining service lives of the Pickering A and B nuclear generating stations for purposes of calculating depreciation. This reduction was partially offset by an increase in depreciation expense due to the return to service of Unit 1 at the Pickering A nuclear generating station in November 2005 and other fixed asset additions during 2006.

OPG recognized an impairment loss on the Thunder Bay and Atikokan coal-fired generating stations in 2006 of \$22 million, which represented the carrying amount or net book value of these stations. OPG tested the recoverability of the carrying amounts of the coal-fired stations as a result of changes in circumstance, which included a decrease in forecast Ontario spot market prices and the extension of the lives of the coal-fired stations. It was determined that the Thunder Bay and Atikokan coal-fired generating stations would not be able to recover their operating and capital expenditures and carrying amount, over their remaining service lives.

OPG recorded an impairment charge of \$202 million related to its Lennox generating station in the first quarter of 2005, which contributed to higher earnings in 2006 relative to 2005. It was determined that the Lennox generating station, as a relatively high variable cost plant, would not be able to recover its carrying value from the wholesale electricity market in the future. Earnings were also reduced in 2005 as a result of the impairment charge of \$63 million related to Units 2 and 3 at the Pickering A nuclear generating station. Upon consideration of the scope of the refurbishment work, the costs and the risks related to the return to service of these two units, and the Company's focus on improving the performance of its other nuclear units, OPG's Board of Directors decided that while technically feasible, the return to service of these units was not justified on a commercial basis. The impairment charge represented the carrying value, including construction in progress of these two units.

In 2006, legislation was passed which eliminated the Large Corporations Tax and reduced future income tax rates. The Large Corporations Tax for the year ended December 31, 2005 was \$28 million. During the second quarter of 2006, OPG recorded a \$19 million increase in earnings to reflect the reduction in future income tax rates.

Net income during the year ended December 31, 2006 reflected the impact of accounting for income taxes for the regulated segments of the business using the taxes payable method for the entire year. Net income for the year ended December 31, 2005 reflected the impact of the taxes payable method for only nine months, as this method was adopted upon inception of rate regulation on April 1, 2005. For the year ended December 31, 2006, OPG did not record a future income tax expense of \$89 million, which would have been recorded had OPG accounted for income taxes for the regulated segments using the liability method. Net income for year ended December 31, 2005 reflected the impact of not recording a future income tax expense of \$157 million. In the second quarter of 2005, as part of the transition to rate regulated accounting, OPG eliminated a net future income tax asset balance of \$74 million related to rate regulated segments and recorded a corresponding one-time extraordinary loss.

## Average Sales Prices

The weighted average Ontario spot electricity market price and OPG's average sales prices by reportable business segment, net of the revenue limit rebate for the period from April 1, 2005 to December 31, 2006, and net of the Market Power Mitigation Agreement rebate up to the inception of rate regulation on April 1, 2005, were as follows:

| (¢/kWh)                                                       | 2006 | 2005 |
|---------------------------------------------------------------|------|------|
| Weighted average hourly Ontario spot electricity market price | 4.9  | 7.2  |
| Regulated – Nuclear                                           | 4.9  | 4.7  |
| Regulated – Hydroelectric <sup>1</sup>                        | 3.5  | 4.1  |
| Unregulated – Hydroelectric <sup>2</sup>                      | 4.6  | 5.2  |
| Unregulated – Fossil-Fuelled <sup>2</sup>                     | 4.8  | 5.5  |
| OPG's average sales price                                     | 4.6  | 4.9  |

<sup>1</sup> During the period from April 1, 2005 to December 31, 2006, electricity generated from stations in the Regulated – Hydroelectric segment received a fixed price of 3.3¢/kWh for the first 1,900 MWh of generation in any hour, and the Ontario spot electricity market price for generation above this level.

<sup>2</sup> During the period from April 1, 2005 to December 31, 2006, 85 per cent of the electricity generated from unregulated stations, excluding the Lennox generating station and other contract volumes, was subject to a revenue limit. The revenue limit was based on an average price of 4.7¢/kWh from April 1, 2005 to April 30, 2006, and decreased to 4.6¢/kWh effective May 1, 2006.

OPG's average sales price for the year ended December 31, 2006 was 4.6¢/kWh compared to 4.9¢/kWh for 2005. The decrease in OPG's average sales price was due to lower Ontario spot market prices, partially offset by the impact of the introduction of regulated prices and other related regulatory changes effective April 1, 2005. Ontario spot market prices were considerably lower in 2006 primarily as a result of lower demand, higher production from low marginal cost generation, and lower natural gas prices.

As a result of regulated prices and the revenue limit rebate, OPG's average sales price continued to be lower than the weighted average hourly Ontario spot electricity market price.

## Electricity Generation

Total electricity generation during the year ended December 31, 2006 from OPG's generating stations was 105.2 TWh compared to 108.5 TWh in 2005. Electricity generation from nuclear stations increased primarily as a result of the return to service of Unit 1 at the Pickering A nuclear generating station in November 2005. Also, during the second quarter of 2005, Unit 4 at the Pickering A nuclear generating station was shut down for the duration of the quarter due to the inspection and repair of feeder pipes. OPG's fossil-fuelled generation was impacted by lower electricity demand in Ontario, higher non-OPG generation, and the increase in electricity generation from OPG's nuclear generating stations.

OPG's results are affected by changes in demand resulting from variations in seasonal weather conditions. The following table provides a comparison of Heating and Cooling Degree Days for the years ended December 31:

|                                  | 2006  | 2005  |
|----------------------------------|-------|-------|
| Heating Degree Days <sup>1</sup> |       |       |
| Total for year                   | 3,346 | 3,749 |
| Ten-year average                 | 3,626 | 3,704 |
| Cooling Degree Days <sup>2</sup> |       |       |
| Total for year                   | 391   | 551   |
| Ten-year average                 | 372   | 356   |

<sup>1</sup> Heating Degree Days are recorded on days with an average temperature below 18°C, and represent the aggregate of the differences between the average temperature and 18°C for each day during the period, as measured at Pearson International Airport.

<sup>2</sup> Cooling Degree Days are recorded on days with an average temperature above 18°C, and represent the aggregate of the differences between the average temperature and 18°C for each day during the period, as measured at Pearson International Airport.

Heating Degree Days for 2006 decreased compared to 2005 primarily due to warmer weather in Ontario during the winter, early spring, and December of 2006. The warmer temperature reduced electricity demand in Ontario in 2006.

Cooling Degree Days for 2006 decreased compared to 2005. Ontario experienced lower temperatures during the summer of 2006 compared to the same period in 2005, which also contributed to lower demand for electricity in Ontario in 2006.

### Cash Flow from Operations

Cash flow provided by operating activities for 2006 was \$397 million compared to \$1,201 million during 2005. The decrease in cash flow from operating activities was primarily due to lower revenue before rebates as a result of lower Ontario spot electricity market prices, partially offset by the impact of lower expenditures on fuel and higher non-energy revenue.

### Recent Developments

#### *Appointment of Chief Operating Officer*

In December 2006, OPG announced the appointment of Mr. Pierre Charlebois as Chief Operating Officer. Mr. Charlebois served as OPG's Chief Nuclear Officer from December 2003 to November 2006. The appointment reflects OPG's commitment to improve the operational effectiveness of OPG's nuclear, hydroelectric and fossil-fuelled generating businesses.

#### *Lennox Generating Station*

In January 2007, the OEB issued a decision approving a second RMR contract between OPG and the IESO for the Lennox generating station, for the period from October 1, 2006 to September 30, 2007. RMR contracts are designed to ensure that generating stations remain available to produce electricity when called upon in order to maintain the reliability of the electricity system. In its decision, the OEB deemed it appropriate for OPG to recover the fixed and variable operating costs of the Lennox generating station that are not recovered through market revenues. The RMR contract is a cost-based contract that provides for regular payments, which are subject to adjustments for actual costs.

## **VISION, CORE BUSINESS AND STRATEGY**

OPG's mandate is to cost effectively produce electricity from its diversified generation assets, while operating in a safe, open and environmentally responsible manner. To accomplish its mandate and strategic objectives, OPG is focused on the following four corporate strategies: improving generating asset performance; increasing its generating capacity; achieving financial sustainability; and achieving excellence in corporate governance, safety, social responsibility, corporate citizenship and environmental stewardship.

### **Improving the Performance of Generating Assets**

#### *Nuclear Generating Assets*

OPG's strategic objective is to operate the Darlington and Pickering A and B nuclear generating stations in a safe, efficient and cost effective manner, while undertaking prudent investments to improve their reliability and operating performance. To achieve these objectives, various programs and initiatives have been implemented to improve safety performance, improve the material condition and reliability of the operating units, optimize planned outages, reduce maintenance backlogs, mitigate technological risks through comprehensive inspection and testing programs, focus on production unit energy costs, and continue to address human resource demographic issues.

OPG is in the process of placing Units 2 and 3 at the Pickering A nuclear generating station in a safe state for the remaining life of the station and an additional 30-year period prior to dismantlement. This project involves de-fuelling the reactors, removing all heavy water, and reconfiguring the station, including the control room, as a two unit station. These activities must be conducted while meeting nuclear, radiological, industrial safety, and environmental protection standards.

Pursuant to the direction from the Minister of Energy in June of 2006, OPG has begun a feasibility study on the refurbishment of its Pickering B and Darlington nuclear generating facilities. OPG has initiated an assessment of the feasibility for refurbishing the Pickering B nuclear generating station to support its continued operation beyond 2015. The assessment will be a systematic, thorough review of the safety, environmental, financial and logistical aspects of refurbishment and continued operation of the nuclear generating station. OPG received confirmation from the Canadian Nuclear Safety Commission ("CNSC") that a Federal Environmental Assessment ("EA") is required prior to the refurbishment of the Pickering B nuclear generating station. The CNSC intends to issue draft guidelines outlining issues to be considered and included in the EA. The results of the EA will be documented in an EA study report, which will be publicly available. It is expected that an EA report will be ready in late 2007. OPG plans to make a recommendation to its Board in the first quarter of 2008. Following this, work will begin on the assessment of the business case for refurbishing the Darlington units.

#### *Hydroelectric Generating Assets*

OPG's strategic objective is to improve production from its existing hydroelectric generating assets in a cost effective and efficient manner. To achieve this objective, prudent investments will be made to maintain and/or improve the condition, reliability and efficiency of the hydroelectric generating assets. Programs and initiatives are underway to increase the availability of existing stations by replacing aging and obsolete equipment, accelerating runner upgrades, and enhancing maintenance practices. Performance improvements will be pursued while maintaining OPG's focus on employee and public safety, dam safety, environmental stewardship, and community relations. In 2006, hydroelectric capacity increased by 25 MW as a result of runner upgrades at three unregulated hydroelectric generating stations. In addition, plans are being developed for the conversion of Sir Adam Beck 1, Unit 7 from a 25 to 60 cycle load requirement. The conversion would increase hydroelectric generating capacity by an estimated additional 58 MW, and would be in service for early 2009.

## *Fossil-Fuelled Generating Assets*

OPG's strategic objective is to maintain the productive capability of its coal-fired generating facilities, while continuing to operate in compliance with all applicable laws and regulations. To achieve this objective, various initiatives are in place to address the impacts of increased unit starts and stops, in part due to the role that the fossil-fuelled plants perform as intermediate and peaking facilities. In addition, OPG will ensure continued environmental compliance, and recruit and retain staff to ensure adequate expertise is available to both operate and maintain the units until their closure.

In June 2006, the Ministry of Energy announced that, as a result of additional capacity requirements to maintain system reliability, further delays will be necessary in the plan to replace coal-fired generation by 2009. The Minister directed the OPA to determine how best to replace coal-fired generation in the earliest practical timeframe and recommend options for cost effective measures to reduce air emissions from coal-fired generation. In its November 2006 publication titled "Ontario's Integrated Power System Plan, Discussion Paper 7: Integrating the Elements – A Preliminary Plan", the OPA indicated that coal-fired generation potentially could be replaced by 2011-2012. The report also indicated that reliability considerations suggest, however, retaining the option of maintaining about 3,000 MW of coal capacity until 2014 as insurance against possible delays in acquiring other resources. Plans to reduce the environmental impacts of coal-fired generation that remain in service are currently being evaluated.

Maintenance programs and performance improvement initiatives at OPG's coal-fired generating stations that were appropriate for an earlier shutdown have been re-assessed assuming longer plant operations. Several environmental initiatives have also been undertaken at both the Nanticoke and Lambton generating stations to address a number of key issues such as particulates, heat rates, water temperatures and noise abatement. Deferral of coal-fired plant closures has resulted in a further review of staffing requirements and strategies including focused recruiting efforts to maintain plant operating capability.

### **Increasing OPG's Generating Capacity**

OPG's strategy with respect to increasing its generating capacity is to expand, develop, and/or improve its hydroelectric generating capacity through expansion and redevelopment of its existing sites, as well as the pursuit of new projects where feasible. In addition, OPG, in consultation with its shareholder, plans to increase its generating capacity by exploring and developing, where feasible, natural gas and nuclear opportunities in Ontario. OPG will undertake these investments on its own or through partnerships. OPG is currently involved in the following hydroelectric, natural gas and nuclear generation projects.

#### *Niagara Tunnel*

The Niagara tunnel project will increase the amount of water flowing to existing turbines at OPG's Sir Adam Beck generating stations in Niagara, allowing the stations to utilize available water more effectively. Average annual generation is expected to increase by about 1.6 TWh.

In September 2006, on-site assembly of the tunnel boring machine was completed and excavation of the tunnel commenced. The intake configuration required the replacement of the existing accelerating wall and the installation of a cellular cofferdam, which were completed in 2006. The project is expected to be completed in late 2009.

The project is expected to cost approximately \$985 million. Capital project expenditures for the year ended December 31, 2006 were \$161 million and life-to-date capital expenditures were approximately \$244 million. The project is debt financed through the Ontario Electricity Financial Corporation ("OEFEC").

#### *Lac Seul*

OPG is constructing a new 12.5 MW hydroelectric generating station on the English River. The new Lac Seul generating station will utilize a majority of the spill currently passing the existing Ear Falls generating station, thus increasing the overall efficiency, capacity and energy generated from this location. A design-build contract was awarded and construction started during the first quarter of 2006,

with the in-service date planned for the fourth quarter of 2007. Total project costs are expected to be \$47 million.

In 2006, the water conveyance tunnel, the tailrace channel excavation, and the intake cofferdam were substantially completed. The powerhouse civil foundation and superstructure were completed in January 2007. Major sub-assemblies have been delivered to the site and pre-installation work has started. Capital project expenditures for the year ended December 31, 2006 were approximately \$24 million and life-to-date capital expenditures were approximately \$27 million. OPG has negotiated the project's debt financing with the OEFC and is in discussions with the OPA for a contract for the production from the new facility.

#### *Lower Mattagami*

In May 2006, OPG provided development alternatives to the Province to increase the generating capacity of four hydroelectric generating stations on the Lower Mattagami River. The incremental capacity associated with these alternatives ranged from approximately 140 to 450 MW.

In May 2006, OPG received a letter from the Minister of Energy, which directed OPG to proceed immediately with the definition phase for a 450 MW development which includes the replacement of the Smoky Falls generating station and the expansion of Little Long, Harmon and Kipling generating stations, all of which are located on the Lower Mattagami River. OPG was also directed to initiate discussions with Ministry staff on a power purchase agreement.

During the latter part of 2006, OPG was engaged in consultations with the First Nations stakeholders, identification of EA requirements, discussions with Hydro One regarding transmission upgrades, and detailing the technical specifications of the project. In addition, OPG received and is reviewing pre-qualification documents from three design/build proponents as well as from four water-to-wire suppliers for the supply and installation of the required generating equipment for the project.

#### *Portlands Energy Centre*

OPG entered into a partnership with TransCanada Energy Ltd. ("TransCanada"), through Portlands Energy Centre L.P. ("PEC"), to pursue the development of a 550 MW gas-fired, combined cycle station on the site of the former R.L. Hearn generating station, near downtown Toronto. OPG has a 50 per cent ownership interest in the joint venture.

During the first quarter of 2006, the Province directed the OPA to negotiate an agreement with PEC for the purchase of electricity. PEC signed a 20-year Accelerated Clean Energy Supply ("ACES") contract with the OPA during the third quarter of 2006. PEC entered into an engineer-procure-construct ("EPC") contract to construct the facility, and construction started in 2006. PEC is expected to be operational in simple cycle mode with a capacity of up to 340 MW to meet peak summer demand beginning June 1, 2008. The plant is expected to be completed and fully operational in the second quarter of 2009, providing up to 550 MW of power in combined cycle mode. The capital cost of PEC is estimated to be \$730 million excluding capitalized interest. A significant proportion of this capital cost relates to the EPC contract.

OPG's share of capital project expenditures for the year ended December 31, 2006 was approximately \$97 million. OPG has negotiated financing for its share of the project with the OEFC.

#### *Lakeview Site*

OPG is continuing with decommissioning and demolition of the Lakeview coal-fired generating station, having closed the station in 2005 after more than 40 years of service. OPG is exploring the potential development of a gas-fuelled electricity generating station at the site. The construction of a new plant would proceed only after required approvals and completion of a power purchase agreement.

### *New Nuclear Generating Units*

As directed by the Minister of Energy in June of 2006, OPG initiated a federal approvals process with the CNSC in September of 2006 by filing with the CNSC an Application for a Site Preparation Licence for new nuclear generating units at OPG's Darlington nuclear generating site. The CNSC will review OPG's application and will determine the EA requirements.

### **Achieving Financial Sustainability**

With respect to its strategic financial objectives, OPG's mandate, as agreed with its Shareholder, states that: as an Ontario Business Corporations Act corporation with a commercial mandate, OPG will operate on a financially sustainable basis and maintain the value of its assets for its shareholder, the Province. In addition, as a transition to a sustainable financial model, any significant new generation project approved by the OPG Board of Directors and agreed to or directed by the Shareholder, may receive financial support from the Province, if and as appropriate.

OPG's financial priority, operating as a commercial enterprise, is to achieve a sustainable level of financial performance. Inherent in this priority is the objective of ensuring that sufficient funds are available to achieve OPG's strategic objectives of improving the performance of its generating assets and increasing its generating capacity.

OPG has employed a number of strategies to achieve a level of sustainable financial performance, while maximizing funds from operations. OPG's ability to increase its revenues is constrained as it receives regulated prices for electricity produced from its nuclear generating stations and most of its baseload hydroelectric generating stations, and the majority of the output from its other generating assets is subject to a revenue limit. In light of this constraint, OPG is focused on implementing effective cost management initiatives that include optimizing the management of available resources and identifying and implementing cost reduction programs. These initiatives will be balanced with additional investments required to continue to improve the performance and reliability of OPG's aging generation assets.

To the extent that additional funds, beyond those generated from operations, are required to achieve its strategic objectives of improving the performance of its generating assets and increasing its generating capacity, OPG plans to continue to seek opportunities to diversify its sources of funding and increase its access to cost effective capital. As a result of forecast liquidity constraints in 2007, OPG is in discussions with its Shareholder regarding options to ensure that adequate financing resources are available to fund on-going operational requirements and new generation development. By ensuring access to cost effective funding and maintaining its investment grade credit ratings, OPG will ensure its status as a long term, commercially viable investment.

### **Excellence in Corporate Governance, Safety, Social Responsibility, Corporate Citizenship and Environmental Stewardship**

Another of OPG's strategic objectives within its mandate is to operate in accordance with the highest corporate standards, including, but not limited to, the areas of corporate governance, safety, and sustainable development.

#### *Corporate Governance*

OPG's Board of Directors is made up of individuals with substantial expertise in managing and restructuring large businesses, managing and operating nuclear stations, managing capital intensive companies, and overseeing regulatory, government and public relations. The Board has established a number of committees to focus on areas critical to the success of the Company.

OPG's corporate governance strategy is to continually improve the policies and procedures used to direct and manage the corporation to enhance shareholder value and ensure financial viability. OPG continues to implement initiatives to enhance corporate governance practices in line with existing Ontario Securities Commission ("OSC") regulatory requirements, with the objective of strengthening the organization. These initiatives are described in the *Corporate Governance* section on pages 55 to 64.

## *Safety*

OPG is committed to achieving excellent safety performance and striving for continuous improvement with the goal of minimizing injuries. A primary objective is to achieve excellence in employee and public safety through the development and implementation of formal safety management systems, targeted risk mitigation programs, and a corporate commitment to safety. Continuous oversight and reporting provide management with information on the effectiveness of the safety management efforts, compliance with legal and corporate requirements, and safety performance trends. Oversight activities include internal and external safety management system audits, work protection code audits, and specific operational safety risk reviews. OPG also has a rigorous incident management system, which requires that all incidents, including near misses, be reported and investigated, and that corrective action plans are developed to prevent reoccurrences.

A contractor management program ensures that contractors contribute to OPG's strong safety culture and maintain a level of safety equivalent to that of OPG employees. Initiatives have been implemented to address young worker safety issues within OPG and in the communities where we operate. A commitment to public safety is an important part of the operation of its generating stations, including standards established in the area of public waterways safety.

OPG measures its safety performance primarily through two performance indicators – Accident Severity Rate (“ASR”) and All Injury Rate (“AIR”). The ASR is a measure of the number of days lost due to injuries. In 2006, OPG experienced 5.87 days lost per 200,000 hours worked compared to 2.03 in 2005. Although the number of worker injuries was similar to that of 2005, the injuries were more severe, requiring an increase in recuperation days required prior to the employees returning to work. The AIR provides a measure of the frequency of injuries resulting in lost time or requiring medical treatment. In 2006, OPG experienced 1.30 injuries per 200,000 hours worked compared to 1.33 in 2005.

## *Sustainable Development*

OPG's objective is to become a sustainable development company by balancing financial growth, social responsibility and environmental leadership. OPG is committed to minimizing its impact on the environment; operating its facilities safely, reliably and responsibly; and being an engaged and productive member of its host communities. OPG's sustainable development activities can be divided into two categories: Environmental Stewardship, and Social and Corporate Responsibility.

### Environmental Stewardship

OPG's Environmental Policy states that “OPG will strive to continually improve its environmental performance” and that the Environmental Policy is an important part of OPG's commitment to Sustainable Development. This policy further commits OPG to meet all legal requirements and voluntary commitments, with the objective of exceeding those standards where appropriate and feasible. Other goals include integrating environmental factors into business planning and decision-making and maintaining environmental management systems (“EMSs”) at its generating facilities consistent with the ISO 14001 standard. More information on OPG's emissions into the environment and compliance with environmental laws is included within the *Risk Management – Environmental Risk* section.

OPG utilizes a number of performance indicators to monitor environmental performance, including sulphur dioxide (“SO<sub>2</sub>”) and nitrogen oxides (“NO<sub>x</sub>”). Acid gas (SO<sub>2</sub> and NO<sub>x</sub>) emissions were 118 gigagrams (Gg) in 2006 compared to 153 Gg in 2005. The reduction in emissions was primarily a result of lower fossil production in 2006 primarily due to lower Ontario electricity demand, improved performance from the selective catalytic reduction equipment installed at OPG's Nanticoke and Lambton fossil-fuelled generation stations and the use of lower sulphur fuels at OPG's fossil-fuelled stations.

### Social and Corporate Responsibility

Contributing to the quality of life in communities where companies operate is a corporate responsibility as well as a societal expectation. OPG is committed to being an active and good corporate citizen by strengthening relationships with the communities that host OPG's generating facilities. At the corporate level, as well as through the actions of employees, OPG plays a significant role in local communities by

donating time and resources. OPG's Corporate Citizenship Program provides financial and in-kind support to registered charities and not-for-profit environmental, educational and community organizations whose initiatives reflect OPG's values. Employees donate funds through an annual charity campaign and their time, expertise and energy through numerous personal acts of volunteerism.

OPG is committed to openness and transparency in its reporting to the broader community. This includes operational and financial reports that are prepared in a manner that users can easily understand and distributed in a timely manner.

## **CAPABILITY TO DELIVER RESULTS**

### **Liquidity and Capital Resources**

OPG's financial condition remained stable throughout 2006 following implementation of the regulatory changes which were introduced in 2005. During the year, OPG repaid \$806 million of its maturing long-term debt. In addition, new committed debt financing was secured for OPG's interest in the Portlands Energy Centre and Lac Seul generating station projects from the OEFC in the form of long-term debt, on commercial terms and rates.

Liquidity requirements are primarily supported by a bank syndicated credit facility under which OPG issues commercial paper to fund its short-term requirements, and a number of financing arrangements held with the OEFC. As a result of forecast liquidity constraints in 2007, OPG is in discussions with its Shareholder and the OEFC regarding options to ensure that adequate financing resources are available to fund ongoing operational requirements and new generation development.

### **Generating Assets**

OPG has increased the productive capacity of its hydroelectric stations, extended their service lives and invested significant capital for the replacement of aging equipment, upgrades to runners and station automation, and enhanced maintenance practices. Programs are in place to further improve the hydroelectric stations, which already operate with high efficiency and availability.

OPG continues to implement initiatives to improve the reliability and predictability of each of the nuclear generating stations. These initiatives are designed to address the specific technology requirements and risks at each of OPG's nuclear generating stations. The Darlington nuclear generating station is the most recently constructed station in OPG's nuclear fleet and operates with the highest reliability. The two operating units at the Pickering A nuclear generating station have recently been refurbished and are in good material condition. Programs are underway at the Pickering B nuclear generating station to mitigate technological risks and to improve its condition and performance.

OPG will continue to maintain the reliability and productive capacity of its coal-fired generating stations until their scheduled closure dates.

OPG has a number of potential sites for new generating asset development in Ontario. The completion of the decommissioning activity at OPG's Lakeview generating station will provide a brownfield site with the potential for development of additional generating capacity in the Greater Toronto Area.

In addition to the discussion in this section, OPG's capability to deliver results is affected by factors discussed in the *Risk Management* section.

### **Skilled Workforce**

As of December 31, 2006, OPG had approximately 11,500 regular employees. OPG has considerable experience in operating and maintaining generating stations through its trained and qualified technical employees. Due to an aging workforce, OPG's challenge is to attract and retain a skilled workforce to replace retiring employees. Approximately 35 per cent of OPG's workforce was over the age of 50 at December 31, 2006. OPG has initiated a comprehensive resource and succession planning program to

address demographic issues related to a high percentage of employees that are eligible for retirement over the next five years, as well as those staffing issues associated with the closure of the coal-fired generating stations.

The Company's collective agreement with the Power Workers' Union runs through March 31, 2009 and the labour agreement with The Society of Energy Professionals runs through December 31, 2010. As of December 31, 2006, the Company had approximately 90 per cent of its regular labour force represented by collective bargaining agreements.

## **ONTARIO ELECTRICITY MARKET TRENDS**

Ontario's IESO reported that energy consumed in Ontario was 151 TWh in 2006, which represented a decrease of 3.8 per cent from 157 TWh consumed in 2005. OPG's electricity generating facilities produced 70 per cent of Ontario's 2006 electricity consumption. The combination of increased electricity supply and lower electricity demand in Ontario during 2006 contributed to the lowest annual weighted average hourly Ontario spot electricity market price since the electricity market opened in 2002. The weighted average price for 2006 was 4.9 ¢/kWh, which was a decrease of over 30 per cent when compared to 7.2 ¢/kWh in 2005.

Ontario set a new all-time record for electricity demand of 27,005 MW on August 1, 2006. This record demand exceeded the previous peak set in 2006 of 26,160 MW. However, despite the record peak in 2006, total electricity consumed declined in 2006 compared to 2005. The IESO reported that Ontario's nuclear generating facilities increased their output by three per cent to 84 TWh and provided 54 per cent of Ontario's electricity supply. Hydroelectric generating production remained steady at 22 per cent, or 35 TWh. Electricity generation from coal-fired generating facilities declined three per cent from 2005, which represented 16 per cent of all Ontario electricity generation or 25 TWh. Other fuels, including oil, gas and alternative sources, supplied the remaining eight per cent of Ontario's electricity consumption.

In the IESO's 18-Month Outlook published on December 21, 2006, the IESO indicated that Ontario's existing installed electricity generating capacity was 31,189 MW, an increase of 558 MW when compared to 2005. OPG's in-service electricity generating capacity at the end of 2006 was 22,147 MW or 71 per cent of Ontario's capacity. The expected peak electricity demand in the summer of 2007, under normal weather conditions, is forecast to be 25,658 MW. The IESO reported that over the next 18 months, the outlook for Ontario's supply/demand balance remains positive as a result of a combination of an additional 1,000 MW of electricity generating capacity and a lower forecast for growth in energy consumption and peak electricity demand. New electricity supply includes two gas-fired electricity generating facilities that will contribute to maintaining reliability in and around the Greater Toronto Area. Phase One of the Goreway Station natural gas-fired electricity generating facility is expected to come into service before the summer of 2007, and Phase One of the Portlands Energy Centre is planned to come into service before the summer of 2008.

The IESO's forecast of energy consumption in 2007 is 155 TWh, which represents an increase of approximately 2.5 per cent over consumption in 2006. Significantly lower average electricity sales prices in 2006 had a material impact on OPG's revenues. Electricity prices are forecast to not materially increase in 2007 compared to 2006.

Fuel prices can have a significant impact on revenue and gross margin, both in terms of the underlying commodity price and the United States dollar ("USD") to Canadian dollar exchange rate. During 2006, spot prices for Appalachian and Powder River Basin coal, natural gas, and oil experienced slight decreases to modest increases. OPG has a fuel hedging program, which includes fixed price and indexed contracts for fossil and nuclear fuels, as well as commodity derivatives. Foreign exchange derivatives are used to manage exposure to anticipated USD denominated purchases.

In March 2007, Ontario's Integrated Power System Plan ("IPSP"), being prepared by the OPA, will be submitted to the OEB for their review and approval. The plan will identify the conservation, generation, and transmission investments that are needed in the next three to five years, indicate the preparatory

work required for the subsequent five years, and chart broad directions for the development of the electricity system for the balance of the planning period.

## **BUSINESS SEGMENTS**

Prior to the introduction of rate regulation, OPG had two reportable business segments: Generation and Energy Marketing. A separate category, Non-Energy and Other, included revenue and certain costs not allocated to its business segments.

With the introduction of rate regulation, OPG revised its reportable business segments to separately reflect the regulated and unregulated aspects of its business. Since the second quarter of 2005, OPG reported its business segments as Regulated – Nuclear, Regulated – Hydroelectric, and Unregulated Generation. Beginning in the first quarter of 2006, OPG separated the Unregulated Generation business segment into two reportable segments identified as Unregulated – Fossil-Fuelled and Unregulated – Hydroelectric, as a result of changes in the management structure of these segments. Results for the comparative periods were reclassified to reflect the revised disclosure.

OPG has entered into various energy and related sales contracts with its customers to hedge commodity price exposure to changes in electricity prices associated with the spot market for electricity in Ontario. Contracts that are designated as hedges of OPG's generation revenues are included with electricity production revenues in each segment up to March 31, 2005, and in the Unregulated – Hydroelectric and Unregulated – Fossil-Fuelled generation segments after that date. Gains or losses in these hedging transactions are recognized in revenue over the terms of the contract when the underlying transaction occurs.

### **Regulated – Nuclear Segment**

OPG's Regulated – Nuclear business segment operates in Ontario, generating and selling electricity from the nuclear generating stations that it owns and operates. The business segment includes electricity generated by the Pickering A and B, and Darlington nuclear generating stations. This business segment also includes revenue under the terms of a lease arrangement with Bruce Power related to the Bruce nuclear generating stations. This arrangement includes lease revenue and revenue from engineering analysis and design, technical and other services. Revenue is also earned from isotope sales and ancillary services. Ancillary revenues are earned through voltage control/reactive support.

### **Regulated – Hydroelectric Segment**

OPG's Regulated – Hydroelectric business segment operates in Ontario, generating and selling electricity from most of its baseload hydroelectric generating stations. The business segment is comprised of electricity generated by the Sir Adam Beck 1, 2 and Pump generating station, DeCew Falls 1 and 2, and the R.H. Saunders hydroelectric facilities. The Regulated – Hydroelectric business segment also includes ancillary revenues related to these stations earned through offering available generating capacity as operating reserve and through the supply of other ancillary services including voltage control/reactive support, certified black start facilities and automatic generation control.

### **Unregulated – Hydroelectric Segment**

The Unregulated – Hydroelectric business segment operates in Ontario, generating and selling electricity from its hydroelectric generating stations that are not subject to rate regulation. The Unregulated – Hydroelectric business segment also includes ancillary revenues earned through offering available generating capacity as operating reserve, and through the supply of other ancillary services including voltage control/reactive support, certified black start facilities and automatic generation control, and revenues from other services.

## **Unregulated – Fossil-Fuelled Segment**

The Unregulated – Fossil-Fuelled business segment operates in Ontario, generating and selling electricity from its fossil-fuelled generating stations, which are not subject to rate regulation. The Unregulated – Fossil-Fuelled business segment also includes ancillary revenues earned through offering available generating capacity as operating reserve, and through the supply of other ancillary services including voltage control/reactive support and automatic generation control, and revenues from other services.

## **Other**

The Other category includes revenue that OPG earns from its 50 per cent joint venture share of the Brighton Beach Power Limited Partnership (“Brighton Beach”) related to an energy conversion agreement between Brighton Beach and Coral Energy Canada Inc. (“Coral”). The revenue and expenses related to OPG’s trading and other non-hedging activities are also included in the Other category. As part of these activities, OPG transacts with counterparties in Ontario and neighbouring energy markets in predominantly short-term trading activities of typically one year or less in duration. These activities relate primarily to physical energy that is purchased and sold at the Ontario border, sales of financial risk management products and sales of energy-related products. All contracts that are not designated as hedges are recorded as assets or liabilities at fair value, with changes in fair value recorded in other revenue as gains or losses. In addition, the Other category includes revenue from real estate rentals.

## **KEY GENERATION AND FINANCIAL PERFORMANCE INDICATORS**

Key performance indicators that directly pertain to OPG’s mandate and corporate strategies are measures of production efficiency, cost effectiveness, and environmental performance. OPG evaluates the performance of its generating stations using a number of key performance indicators, which vary depending on the generating technology. These indicators are defined in this section and are discussed in the *Discussion of Operating Results by Business Segment* section.

### **Nuclear Unit Capability Factor**

OPG’s nuclear stations operate as baseload facilities as they have low marginal costs and are not designed for fluctuating production levels to meet peaking demand. The nuclear unit capability factor is a key measure of nuclear station performance. It is the amount of energy that the unit(s) generated over a period of time, adjusted for externally imposed constraints such as transmission or demand limitations, as a percentage of the amount of energy that would have been produced over the same period had the unit(s) produced maximum generation. Capability factors are primarily affected by planned and unplanned outages. Capability factors by industry definition exclude grid-related unavailability.

### **Fossil-Fuelled and Hydroelectric Equivalent Forced Outage Rate (“EFOR”)**

OPG’s fossil-fuelled stations provide a flexible source of energy and operate as baseload, intermediate and peaking facilities, depending on the characteristics of the particular stations. OPG’s hydroelectric stations operate primarily as baseload facilities and provide a reliable and low-cost source of renewable energy. A key measure of the reliability of the fossil-fuelled and hydroelectric stations is their ability to be available to produce electricity when called upon. EFOR is an index of the reliability of the generating unit measured by the ratio of time a generating unit is forced out of service, including any forced deratings, compared to the amount of time the generating unit was available to operate.

### **Hydroelectric Availability**

Hydroelectric availability is a measure of the reliability of a hydroelectric generating unit represented by the percentage of time the generating unit is capable of providing service, whether or not it is actually in-service, compared to the total time for a respective period.

**Nuclear Production Unit Energy Cost (“PUEC”)**

Nuclear PUEC is used to measure the operations-related costs of production of OPG's nuclear generating assets. Nuclear PUEC is defined as nuclear fuel, OM&A expenses including allocated corporate costs, and variable costs related to used fuel disposal and the disposal of low and intermediate level radioactive waste materials, divided by total energy produced.

**Hydroelectric OM&A Expense per MWh**

Hydroelectric OM&A expense per MWh is used to measure the cost effectiveness of the hydroelectric generating stations. It is defined as total hydroelectric OM&A expenses, including allocated corporate costs, divided by hydroelectric electricity generation.

**Fossil-Fuelled OM&A Expense per MW**

Since fossil-fuelled generating stations are primarily employed during periods of intermediate and peak demand, the cost effectiveness of these stations is measured by their total OM&A expenses, including allocated corporate costs, divided by total station nameplate capacity.

**Other Key Indicators**

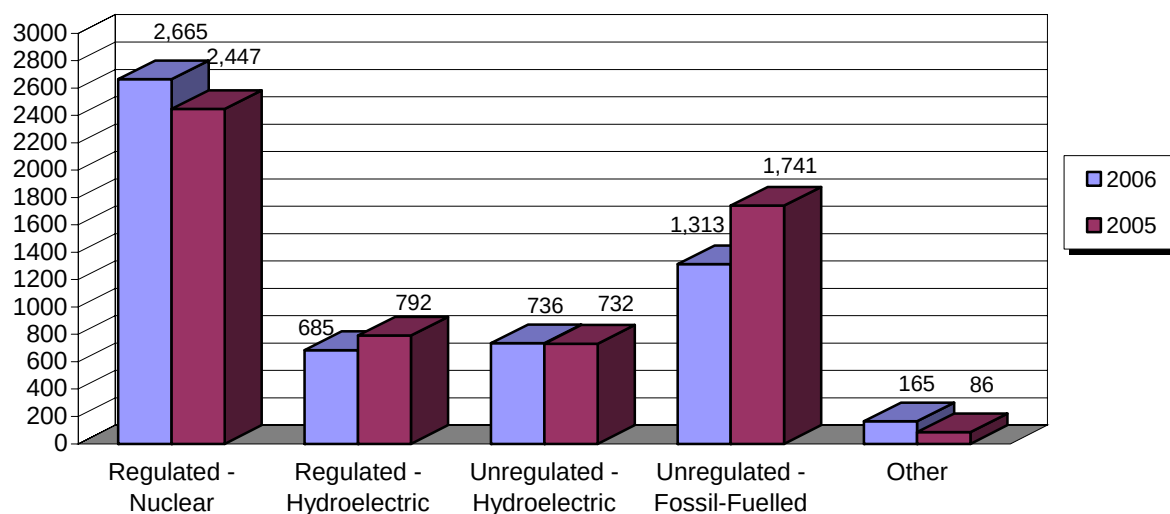
In addition to performance and cost effectiveness indicators, OPG has identified certain environmental indicators. These indicators are discussed under the heading, *Risk Management*.

## DISCUSSION OF OPERATING RESULTS BY BUSINESS SEGMENT

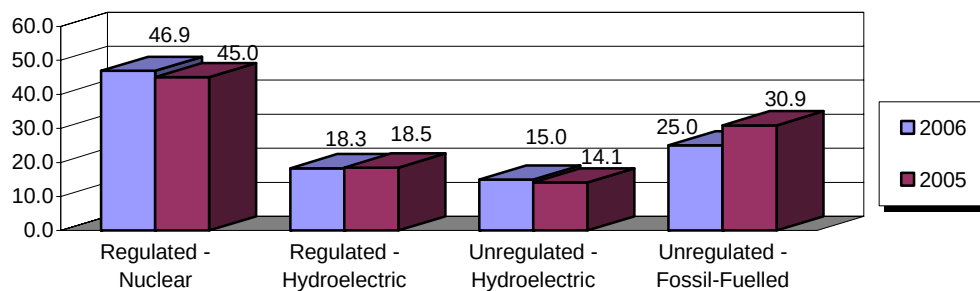
This section summarizes OPG's key results by segment for the years ended December 31, 2006 and 2005. Although the regulation pursuant to the *Electricity Restructuring Act, 2004* (Ontario) became effective commencing April 1, 2005, results for the entire 2005 year were reclassified according to the business segment definitions. The operating results for the first quarter of 2005 prior to rate regulation reflect a significantly different economic environment from that introduced by rate regulation. The following table provides a summary of revenue, earnings and key generation and financial performance indicators by business segment:

| <i>(millions of dollars)</i>                                                       | <b>2006</b>  | <b>2005</b> |
|------------------------------------------------------------------------------------|--------------|-------------|
| <i>Revenue, net of revenue limit and Market Power Mitigation Agreement rebates</i> |              |             |
| Regulated – Nuclear                                                                | <b>2,665</b> | 2,447       |
| Regulated – Hydroelectric                                                          | <b>685</b>   | 792         |
| Unregulated – Hydroelectric                                                        | <b>736</b>   | 732         |
| Unregulated – Fossil-Fuelled                                                       | <b>1,313</b> | 1,741       |
| Other                                                                              | <b>165</b>   | 86          |
|                                                                                    | <b>5,564</b> | 5,798       |
| <i>Income (loss) before interest, income taxes and extraordinary item</i>          |              |             |
| Regulated – Nuclear                                                                | <b>70</b>    | (10)        |
| Regulated – Hydroelectric                                                          | <b>264</b>   | 375         |
| Unregulated – Hydroelectric                                                        | <b>375</b>   | 423         |
| Unregulated – Fossil-Fuelled                                                       | <b>(37)</b>  | (17)        |
| Other                                                                              | <b>97</b>    | (16)        |
|                                                                                    | <b>769</b>   | 755         |
| <i>Electricity Generation (TWh)</i>                                                |              |             |
| Regulated – Nuclear                                                                | <b>46.9</b>  | 45.0        |
| Regulated – Hydroelectric                                                          | <b>18.3</b>  | 18.5        |
| Unregulated – Hydroelectric                                                        | <b>15.0</b>  | 14.1        |
| Unregulated – Fossil-Fuelled                                                       | <b>25.0</b>  | 30.9        |
| Total electricity generation                                                       | <b>105.2</b> | 108.5       |
| <i>Nuclear unit capability factor (per cent)</i>                                   |              |             |
| Darlington                                                                         | <b>88.7</b>  | 90.6        |
| Pickering A                                                                        | <b>72.0</b>  | 69.9        |
| Pickering B                                                                        | <b>75.2</b>  | 77.7        |
| <i>Equivalent forced outage rate (per cent)</i>                                    |              |             |
| Regulated – Hydroelectric                                                          | <b>1.5</b>   | 1.2         |
| Unregulated – Hydroelectric                                                        | <b>1.9</b>   | 1.4         |
| Unregulated – Fossil-Fuelled                                                       | <b>14.1</b>  | 15.9        |
| <i>Availability (per cent)</i>                                                     |              |             |
| Regulated – Hydroelectric                                                          | <b>94.2</b>  | 92.7        |
| Unregulated – Hydroelectric                                                        | <b>92.4</b>  | 92.2        |
| <i>Nuclear PUEC (\$/MWh)</i>                                                       | <b>42.87</b> | 40.24       |
| <i>Regulated – Hydroelectric OM&amp;A expense per MWh (\$/MWh)</i>                 | <b>5.01</b>  | 4.23        |
| <i>Unregulated – Hydroelectric OM&amp;A expense per MWh (\$/MWh)</i>               | <b>12.63</b> | 10.55       |
| <i>Unregulated – Fossil-Fuelled OM&amp;A expense per MW (\$000/MW)</i>             | <b>61.1</b>  | 53.0        |

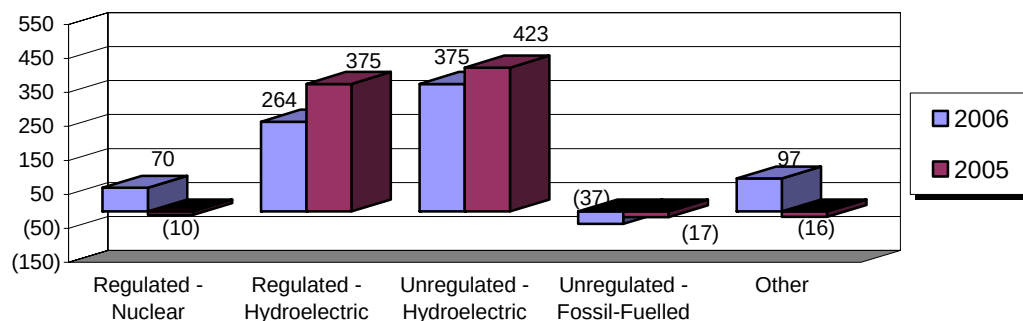
**Revenue, Net of Revenue Limit and Market Power Mitigation Agreement Rebates  
by Segment  
Year Ended December 31  
(millions of dollars)**



**Electricity Production by Segment  
Year Ended December 31  
(TWh)**



**Income (Loss) Before Interest, Income Taxes and Extraordinary Item by Segment  
Year Ended December 31  
(millions of dollars)**



## Regulated – Nuclear Segment

| <i>(millions of dollars)</i>                                               | <b>2006</b>  | <b>2005</b> |
|----------------------------------------------------------------------------|--------------|-------------|
| Revenue net of Market Power Mitigation Agreement rebate                    | <b>2,665</b> | 2,447       |
| Fuel expense                                                               | <b>122</b>   | 115         |
| Gross margin                                                               | <b>2,543</b> | 2,332       |
| Operations, maintenance and administration                                 | <b>1,967</b> | 1,804       |
| Depreciation and amortization                                              | <b>343</b>   | 359         |
| Accretion on fixed asset removal and nuclear waste management liabilities  | <b>490</b>   | 467         |
| Earnings on nuclear fixed asset removal and nuclear waste management funds | <b>(371)</b> | (381)       |
| Property and capital taxes                                                 | <b>44</b>    | 30          |
| Income (loss) before impairment of long-lived asset                        | <b>70</b>    | 53          |
| Impairment of long-lived asset                                             | <b>-</b>     | 63          |
| Income (loss) before interest and income taxes                             | <b>70</b>    | (10)        |

### Revenue

| <i>(millions of dollars)</i>                  | <b>2006</b>  | <b>2005</b> |
|-----------------------------------------------|--------------|-------------|
| Regulated generation sales                    | <b>2,312</b> | 1,621       |
| Spot market sales, net of hedging instruments | <b>-</b>     | 662         |
| Market Power Mitigation Agreement rebate      | <b>-</b>     | (160)       |
| Variance account                              | <b>1</b>     | (1)         |
| Other                                         | <b>352</b>   | 325         |
| Total revenue                                 | <b>2,665</b> | 2,447       |

Regulated – Nuclear revenue was \$2,665 million for the year ended December 31, 2006 compared to \$2,447 million in 2005. The increase in revenue was primarily due to higher electricity generation of 1.9 TWh in 2006 compared to 2005, and higher sales prices related to the introduction of regulated prices effective April 1, 2005.

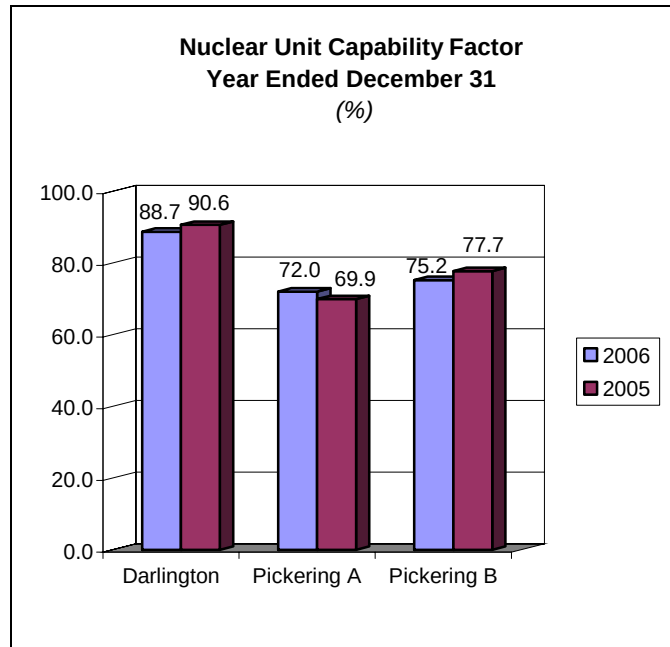
### Electricity Prices

Electricity generation from stations in the Regulated – Nuclear segment have received a fixed price of 4.95¢/kWh since the introduction of rate regulation effective April 1, 2005. For the year ended December 31, 2005, OPG's Regulated – Nuclear sales price was 4.7¢/kWh, after taking into account the regulated price for the last three quarters of 2005, and the spot market sales price, net of the Market Power Mitigation Agreement rebate for the first quarter of 2005.

## Volume

Electricity generation from stations in the Regulated – Nuclear segment for the year ended December 31, 2006 was 46.9 TWh compared to 45.0 TWh in 2005. The increase in volume was mainly due to the return to service of Unit 1 at the Pickering A nuclear generating station in the fourth quarter of 2005. Also, in the second quarter of 2005, Unit 4 at the Pickering A nuclear generating station was shut down for the duration of the quarter due to the inspection and repair of feeder pipes. Electricity generation from the Darlington and Pickering B nuclear generating stations decreased in 2006 compared to 2005 due to an increase in unplanned outage days.

The Darlington nuclear generating station's unit capability factor for the year ended December 31, 2006 was 88.7 per cent compared to 90.6 per cent in 2005. The decrease was a result of higher unplanned outage days in 2006.



The Pickering A nuclear generating station's unit capability factor improved to 72.0 per cent for the year ended December 31, 2006 compared to 69.9 per cent in 2005. The increase was primarily due to lower unplanned outage days in 2006 compared to 2005, related to the shutdown of Unit 4 in 2005 for feeder inspection and repair.

The Pickering B nuclear generating station's unit capability factor was 75.2 per cent compared to 77.7 per cent in 2005. The decrease was primarily due to an increase in unplanned outage days in 2006 compared to 2005.

## Fuel Expense

Fuel expense for the year ended December 31, 2006 was \$122 million compared to \$115 million in 2005. Fuel expense was moderately affected by incremental nuclear generation in 2006 compared to 2005, due to the low marginal cost of nuclear generation.

## Operations, Maintenance and Administration

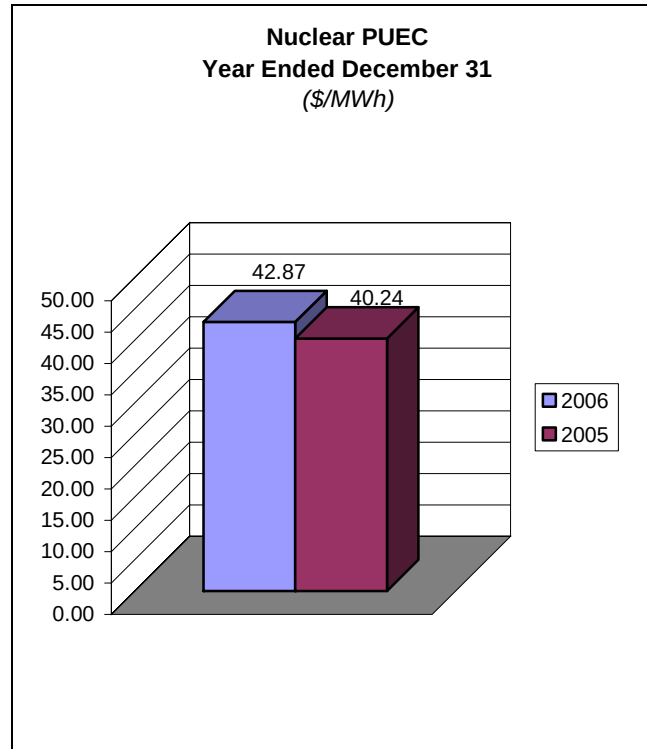
OM&A expenses for the year ended December 31, 2006 were \$1,967 million compared to \$1,804 million in 2005. The increase of \$163 million in OM&A expenses in 2006 compared to 2005 was primarily due to higher pension and OPEB costs of \$133 million mainly due to changes in economic assumptions and higher costs of \$62 million related to nuclear outages and projects to improve the performance of the nuclear generating stations. In addition, OM&A expenses for the year ended December 31, 2006 included amortization of \$25 million related to Pickering A nuclear generating station return to service costs, which were previously deferred. In 2005, OM&A expenses were affected by a write-off of excess inventory of \$57 million acquired for the anticipated return to service of Units 2 and 3 at the Pickering A nuclear generating station.

Effective January 1, 2005, in accordance with a regulation pursuant to the *Electricity Restructuring Act, 2004* (Ontario), OPG established a balance sheet deferral account for non-capital costs associated with the planned return to service of all units at the Pickering A nuclear generating station. The deferred costs are charged to operations in accordance with the terms of the regulation. Amortization of this deferral account commenced in the fourth quarter of 2005 following the return to commercial service of Unit 1 of the Pickering A nuclear generating station.

Nuclear PUEC increased to \$42.87/MWh for 2006 compared to \$40.24/MWh during 2005. The increase during the year ended December 31, 2006 was mainly due to higher pension and OPEB costs of \$133 million, and other changes in OM&A expenses, partially offset by higher generation in 2006 compared

#### *Depreciation and Amortization*

Depreciation and amortization expense for the year ended December 31, 2006 was \$343 million compared to \$359 million in 2005. The decrease was primarily due to the impact of an extension of the remaining service lives of the Pickering B nuclear generating station and Unit 4 of the Pickering A nuclear generating station, for purposes of calculating depreciation. The reduction in depreciation related to the service life extension was partially offset by the impact of the return to commercial service of Unit 1 at the Pickering A station and fixed asset additions. to 2005.



#### *Accretion*

Accretion expense relating to future costs for fixed asset removal and nuclear waste management was \$490 million for the year ended December 31, 2006 compared to \$467 million in 2005. The increase in the accretion expense in 2006 was due to the higher liability balance compared to last year primarily as a result of the increase in the present value of the liability due to the passage of time.

#### *Earnings on the Nuclear Fixed Asset Removal and Nuclear Waste Management Funds*

OPG realized earnings of \$371 million on the nuclear fixed asset removal and nuclear waste management funds in 2006, compared to \$381 million in 2005. The decrease was due primarily to the impact of a lower Ontario Consumer Price Index on the Used Fuel Segregated Fund ("Used Fuel Fund") earnings when compared to 2005, and a decrease in earnings from the Decommissioning Segregated Fund ("Decommissioning Fund"). Used Fuel Fund earnings are guaranteed by the Province at 3.25 per cent plus the change in the Ontario Consumer Price Index. The decrease was partially offset by the effect of an increase in earnings as a result of a higher asset base in 2006. Starting January 1, 2007, the recognition of earnings on the nuclear fixed asset removal and nuclear waste management funds are affected by the adoption of new Canadian Institute of Chartered Accountants ("CICA") handbook sections as described under the heading *Nuclear Fixed Asset Removal and Nuclear Waste Management Funds* in the *Balance Sheet Highlights* section.

#### *Impairment of Long-Lived Assets*

During the second quarter of 2005, OPG completed an assessment of the scope of the refurbishment work, the cost and the risks related to the return to service of Units 2 and 3 at the Pickering A nuclear generating station. OPG's Board of Directors decided that, while technically feasible, the return to service of these units was not justified on a commercial basis. As a result, the Company recorded an impairment loss of \$63 million related to the carrying amount of these two units, including construction in progress.

## Regulated – Hydroelectric Segment

| <i>(millions of dollars)</i>                             | <b>2006</b> | <b>2005</b> |
|----------------------------------------------------------|-------------|-------------|
| Revenue, net of Market Power Mitigation Agreement rebate | <b>685</b>  | 792         |
| Fuel expense                                             | <b>245</b>  | 254         |
| Gross margin                                             | <b>440</b>  | 538         |
| Operations, maintenance and administration               | <b>92</b>   | 78          |
| Depreciation and amortization                            | <b>66</b>   | 67          |
| Property and capital taxes                               | <b>18</b>   | 18          |
| Income before interest and income taxes                  | <b>264</b>  | 375         |

### Revenue

| <i>(millions of dollars)</i>                  | <b>2006</b> | <b>2005</b> |
|-----------------------------------------------|-------------|-------------|
| Regulated generation sales <sup>1</sup>       | <b>635</b>  | 558         |
| Spot market sales, net of hedging instruments | -           | 260         |
| Market Power Mitigation Agreement rebate      | -           | (65)        |
| Variance accounts                             | <b>(4)</b>  | 2           |
| Other                                         | <b>54</b>   | 37          |
| Total revenue                                 | <b>685</b>  | 792         |

<sup>1</sup> Regulated generation sales included revenue of \$169 million and \$210 million that OPG received at the Ontario spot market price for generation over 1,900 MWh in any hour during the year ended December 31, 2006 and 2005, respectively.

Regulated – Hydroelectric revenue was \$685 million for the year ended December 31, 2006 compared to \$792 million in 2005. The decrease in revenue was mainly due to lower sales prices related to the introduction of regulated prices effective April 1, 2005, lower average spot market prices during 2006 compared to 2005 that affected revenues in excess of 1,900 MWh in any hour, and lower sales volume in 2006 compared to 2005.

### Electricity Prices

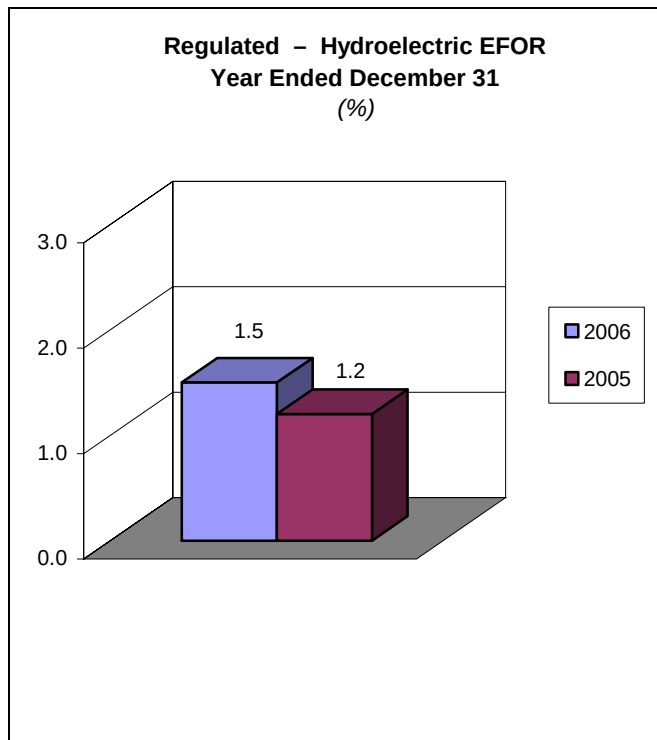
The average price for the year ended December 31, 2006 was 3.5¢/kWh compared to 4.1¢/kWh in 2005. The average price in 2005 reflected the regulated price for the last three quarters of 2005 and OPG's average spot market sales price net of the Market Power Mitigation Agreement rebate for the first quarter of 2005.

## Volume

Electricity sales volume for the year ended December 31, 2006 decreased to 18.3 TWh compared to 18.5 TWh in 2005. During 2006, electricity generation of 3.4 TWh related to production levels above 1,900 MWh in any hour. For 2005, electricity generation of 2.8 TWh related to production levels above 1,900 MWh in any hour during the last three quarters of 2005. The decrease in electricity sales volume in 2006 compared to 2005 was primarily due to lower water levels.

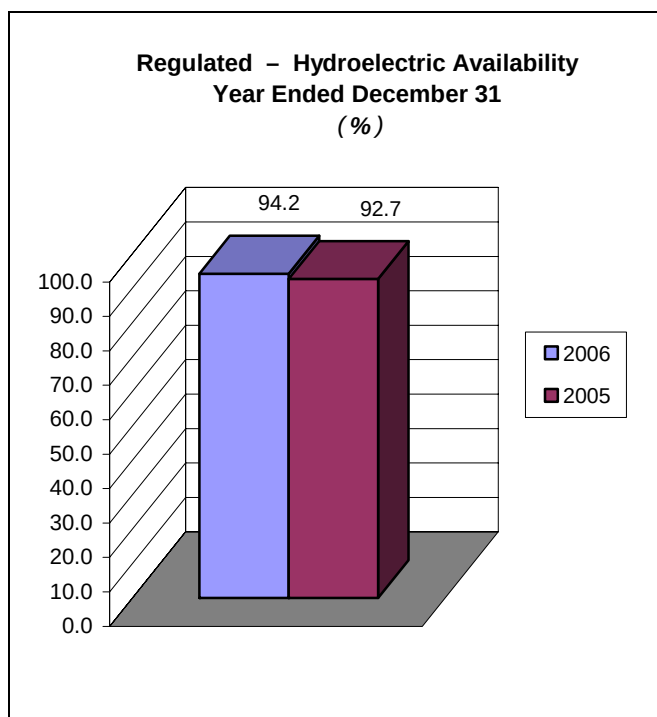
The equivalent forced outage rate for the Regulated – Hydroelectric stations was 1.5 per cent for the year ended December 31, 2006 compared to 1.2 per cent in 2005.

The availability for the Regulated – Hydroelectric stations was 94.2 per cent for the year ended December 31, 2006 compared to 92.7 per cent in 2005. The high availability and low equivalent forced outage rate reflect the continuing strong performance of these generating stations.



## Variance Accounts

OPG is required, under a regulation pursuant to the *Electricity Restructuring Act, 2004* (Ontario), to establish variance accounts to capture the impact of differences in hydroelectric electricity production due to differences between forecast and actual water conditions and differences between assumed and actual revenues for ancillary services. During 2006, OPG recorded a reduction in revenue of \$4 million, reflecting ancillary services revenue that was favourable compared to the forecast for 2006 provided to the Province for the purposes of establishing regulated prices.



### *Fuel Expense*

OPG pays charges to the Province and the OEFC on gross revenue derived from the annual generation of electricity from its hydroelectric generating assets. The gross revenue charge ("GRC") includes a fixed percentage charge applied to the annual hydroelectric generation derived from stations located on provincial Crown lands, in addition to graduated rate charges applicable to all hydroelectric stations. GRC costs are included in fuel expense. Fuel expense for the year ended December 31, 2006 was \$245 million compared to \$254 million in 2005. The decrease in fuel expense was due to lower generation and lower marginal GRC rates as a result of lower generation from rate regulated hydroelectric stations.

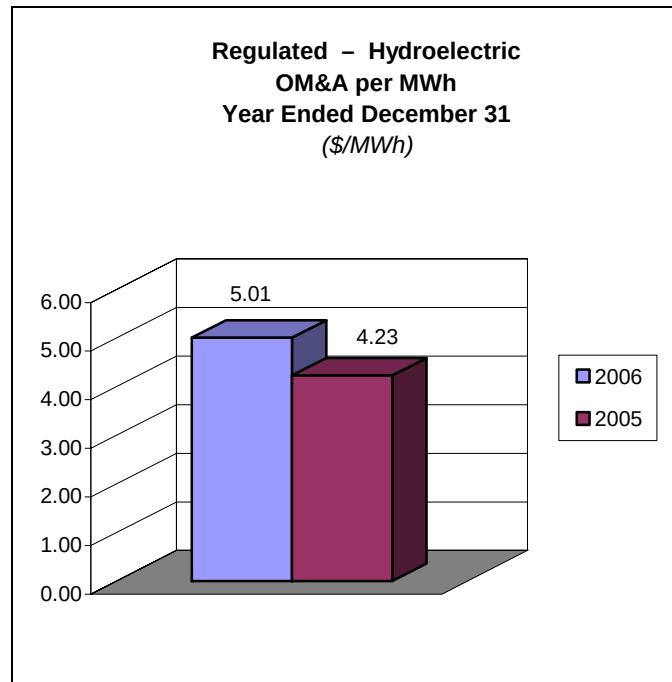
### *Operations, Maintenance and Administration*

OM&A expenses for the year ended December 31, 2006 were \$92 million compared to \$78 million in 2005. The increase in OM&A expenses in 2006 was primarily due to higher pension and OPEB costs.

OM&A expense per MWh for the regulated hydroelectric stations increased to \$5.01/MWh in 2006 compared to \$4.23/MWh in 2005. The increase in 2006 compared to 2005 mainly reflected higher OM&A expenses combined with lower generation.

### *Depreciation and Amortization*

Depreciation expense for the year ended December 31, 2006 was \$66 million compared to \$67 million in 2005.



### **Unregulated – Hydroelectric Segment**

| <i>(millions of dollars)</i>                                                | 2006 | 2005 |
|-----------------------------------------------------------------------------|------|------|
| Revenue, net of revenue limit and Market Power Mitigation Agreement rebates | 736  | 732  |
| Fuel expense                                                                | 88   | 82   |
| Gross margin                                                                | 648  | 650  |
| Operations, maintenance and administration                                  | 189  | 148  |
| Depreciation and amortization                                               | 69   | 64   |
| Property and capital taxes                                                  | 15   | 15   |
| Income before interest and income taxes                                     | 375  | 423  |

## Revenue

| <i>(millions of dollars)</i>                  | <b>2006</b> | <b>2005</b> |
|-----------------------------------------------|-------------|-------------|
| Spot market sales, net of hedging instruments | <b>746</b>  | 962         |
| Revenue limit rebate                          | <b>(44)</b> | (210)       |
| Market Power Mitigation Agreement rebate      | -           | (58)        |
| Other                                         | <b>34</b>   | 38          |
| <b>Total revenue</b>                          | <b>736</b>  | 732         |

Unregulated – Hydroelectric revenue was \$736 million for the year ended 2006 compared to \$732 million in 2005. The marginal increase was due to higher electricity generation of 0.9 TWh, largely offset by the impact of lower Ontario spot market prices during 2006 compared to 2005.

## Electricity Prices

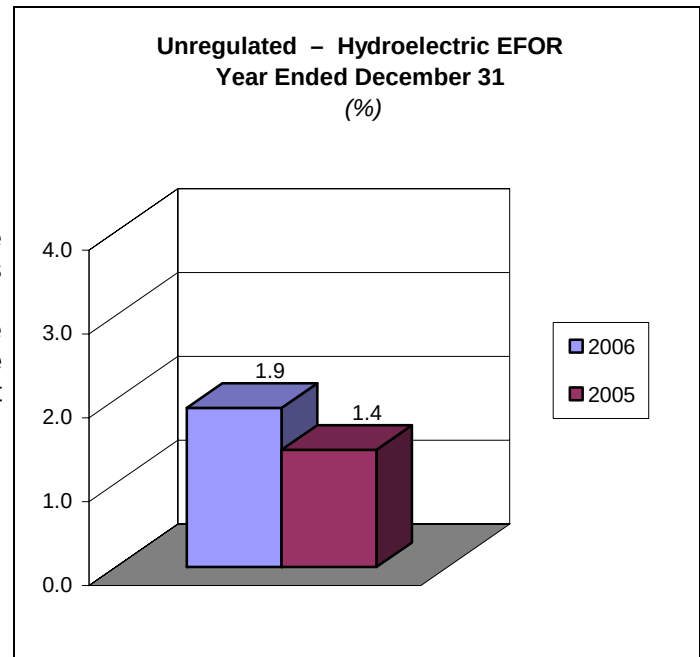
Eighty-five per cent of the generation output from OPG's unregulated generation assets, excluding the Lennox generating station, TRO volumes and forward sales as of January 1, 2005, was subject to the revenue limit based on an average price of 4.7¢/kWh commencing April 1, 2005. Effective May 1, 2006, the revenue limit decreased to 4.6¢/kWh.

OPG's average sales price for its unregulated hydroelectric generation for the year ended December 31, 2006 was 4.6¢/kWh compared to 5.2¢/kWh in 2005. The decrease was primarily due to lower average Ontario spot market prices, partly offset by the favourable impact of the replacement of the Market Power Mitigation Agreement rebate with the revenue limit rebate effective April 1, 2005.

## Volume

Electricity sales volume for the year ended December 31, 2006 was 15.0 TWh compared to 14.1 TWh in 2005. The increase in volume in 2006 was primarily due to higher water levels in Eastern Ontario during 2006 compared to 2005.

The equivalent forced outage rate for the Unregulated – Hydroelectric stations was 1.9 per cent for the year ended December 31, 2006 compared to 1.4 per cent during the same period in 2005. The increase in EFOR was due to equipment repairs and forced outages at certain stations.



The availability for the Unregulated – Hydroelectric stations was 92.4 per cent for the year ended December 31, 2006 compared to 92.2 per cent for the year ended December 31, 2005. The availability and the equivalent forced outage rate during 2006 continue to reflect the strong performance of the unregulated hydroelectric generating assets.

#### *Fuel Expense*

Fuel expense was \$88 million for the year ended December 31, 2006, compared to \$82 million in 2005. The increase in fuel expense was primarily due to higher electricity generation. Generating stations within this segment are subject to the GRC.

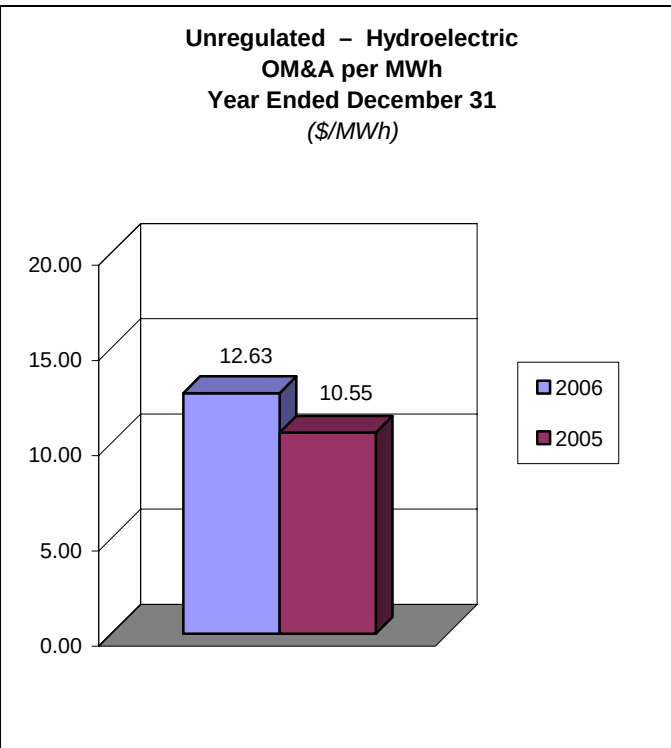
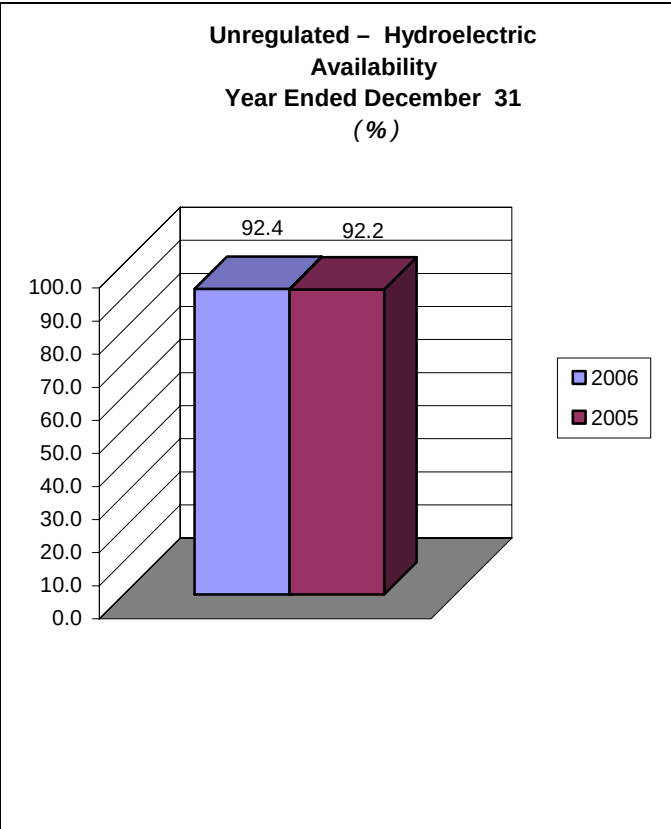
#### *Operations, Maintenance and Administration*

OM&A expenses for the year ended December 31, 2006 were \$189 million compared to \$148 million in 2005. The increase in OM&A expense in 2006 was primarily due to higher expenses for plant improvement projects and higher pension and OPEB costs.

OM&A expense per MWh for the unregulated hydroelectric stations increased to \$12.63/MWh for the year ended December 31, 2006 from \$10.55/MWh in 2005. The increases in 2006 compared to 2005 reflect higher OM&A expenses, partially offset by higher generation.

#### *Depreciation and Amortization*

Depreciation expense for the year ended December 31, 2006 was \$69 million compared to \$64 million in 2005.



## Unregulated – Fossil-Fuelled Segment

| <i>(millions of dollars)</i>                                                | <b>2006</b>  | <b>2005</b> |
|-----------------------------------------------------------------------------|--------------|-------------|
| Revenue, net of revenue limit and Market Power Mitigation Agreement rebates | <b>1,313</b> | 1,741       |
| Fuel expense                                                                | <b>643</b>   | 846         |
| Gross margin                                                                | <b>670</b>   | 895         |
| Operations, maintenance and administration                                  | <b>524</b>   | 455         |
| Depreciation and amortization                                               | <b>133</b>   | 203         |
| Accretion on fixed asset removal                                            | <b>9</b>     | 9           |
| Property and capital taxes                                                  | <b>19</b>    | 39          |
| Restructuring                                                               | <b>-</b>     | 4           |
| (Loss) income before impairment of long-lived assets                        | <b>(15)</b>  | 185         |
| Impairment of long-lived assets                                             | <b>22</b>    | 202         |
| (Loss) income before interest and income taxes                              | <b>(37)</b>  | (17)        |

### Revenue

| <i>(millions of dollars)</i>                  | <b>2006</b>  | <b>2005</b> |
|-----------------------------------------------|--------------|-------------|
| Spot market sales, net of hedging instruments | <b>1,323</b> | 2,293       |
| Revenue limit rebate                          | <b>(117)</b> | (529)       |
| Market Power Mitigation Agreement rebate      | <b>-</b>     | (129)       |
| Other                                         | <b>107</b>   | 106         |
| Total revenue                                 | <b>1,313</b> | 1,741       |

Unregulated – Fossil-Fuelled revenue was \$1,313 million for the year ended December 31, 2006, a decrease of \$428 million compared to \$1,741 million in 2005. The decrease in revenue in 2006 compared to 2005 was primarily due to lower electricity generation of 5.9 TWh in 2006 and lower average sales prices when compared to 2005. These impacts were partially offset by revenue from the Lennox RMR contract. The RMR contract, which commenced effective October 1, 2005, is a one year cost-based contract with the IESO that provides for regular payments, which are subject to adjustments for actual costs. OPG and the IESO negotiated an agreement in July 2006 for a subsequent one year cost-based contract. This agreement was approved in January 2007 by the Ontario Energy Board.

### Electricity Prices

OPG's average sales price for its unregulated fossil-fuelled generation for the year ended December 31, 2006 was 4.8¢/kWh compared to 5.5¢/kWh in 2005. The decrease was primarily due to lower average Ontario spot market prices in 2006, partially offset by the favourable impact of the replacement of the Market Power Mitigation Agreement rebate with the revenue limit rebate effective April 1, 2005.

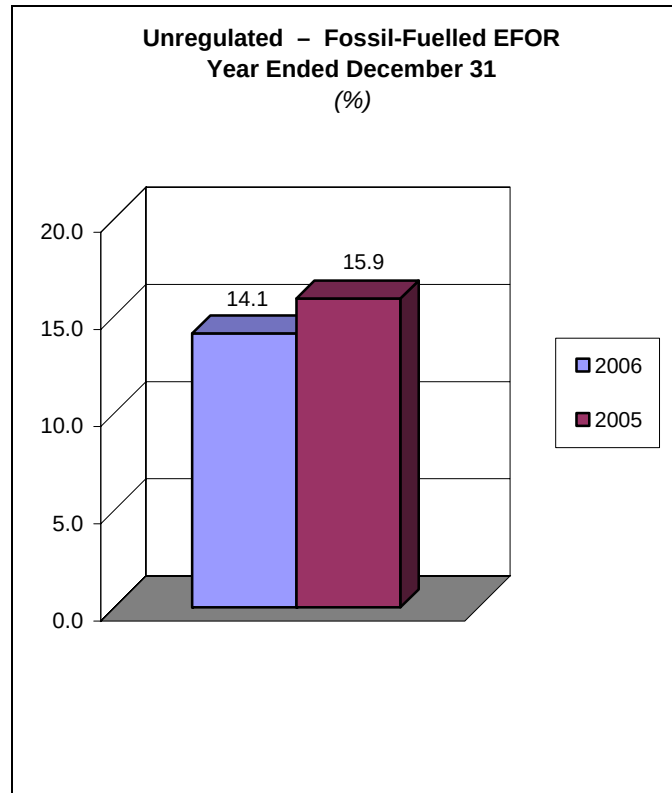
### Volume

Electricity sales volume decreased to 25.0 TWh compared to 30.9 TWh in 2005. The decrease of 5.9 TWh was primarily due to lower overall electricity market demand in Ontario and higher nuclear generation.

The equivalent forced outage rate for the fossil-fuelled generating stations was 14.1 per cent for the year ended December 31, 2006 compared to 15.9 per cent in 2005. EFOR decreased in 2006 primarily due to the impact of closing the Lakeview generating station in April 2005 and improved equipment reliability of the fossil-fuelled generating stations.

### Fuel Expense

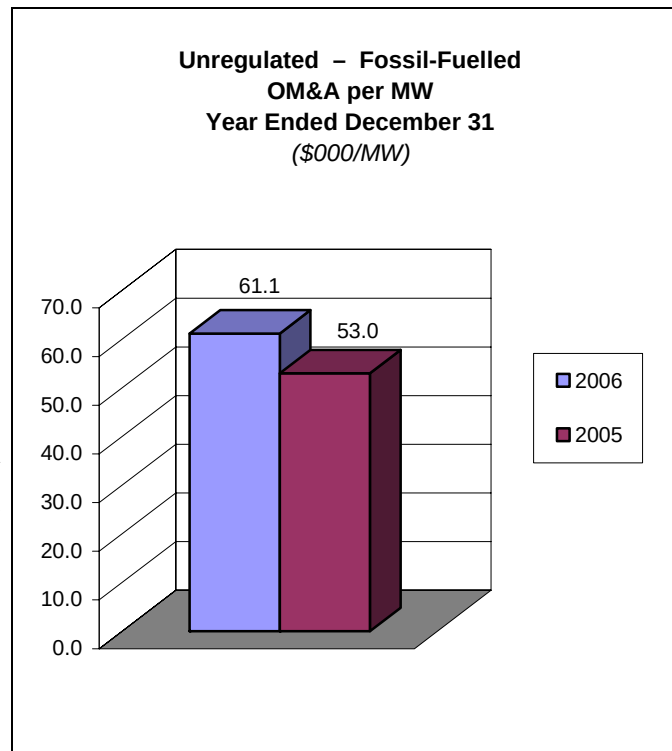
Fuel expense decreased to \$643 million for the year ended December 31, 2006 compared to \$846 million in 2005. The decrease of \$203 million in 2006 compared to 2005 was due to lower generation and a higher blend of lower cost Powder River Basin coal at the Nanticoke fossil-fuelled generating station, partly offset by higher average coal prices.



### Operations, Maintenance and Administration

OM&A expenses for the year ended December 31, 2006 were \$524 million compared to \$455 million in 2005. OM&A expenses increased in 2006 mainly due to higher pension and OPEB costs, the write-off of unrecoverable costs related to the Thunder Bay generating station gas conversion project, and higher expenditures on maintenance for the Nanticoke and Lambton generating stations.

OM&A expense per MW (\$/MW) for the unregulated fossil-fuelled stations increased to \$61,100/MW for the year ended December 31, 2006 compared to \$53,000/MW in 2005. The increase in 2006 reflected higher OM&A expenses, and the impact of lower generation capacity due to the closure of the Lakeview generating station in April 2005.



### *Depreciation and Amortization*

Depreciation expense for the year ended December 31, 2006 was \$133 million compared to \$203 million in 2005. The decrease in depreciation expense in 2006 was mainly due to the extension of the service life of all coal-fired generating stations, for purposes of calculating depreciation, due to the delay in the Province's coal replacement program. Furthermore, depreciation expense decreased due to a lower asset base, which resulted from the impairment charge on the Lennox generating station, which was recorded in 2005.

In the third quarter of 2005, OPG had extended, for purposes of calculating depreciation, the remaining service life of the Nanticoke generating station by one year, from 2007 to 2008, based on further details provided by the Province with respect to its coal replacement program at that time. The estimated service life for all of the coal-fired generating stations as at June 30, 2006, for purposes of calculating depreciation, was December 31, 2007, with the exception of the Nanticoke generating station. As a result of an announcement in June 2006 of delays in the plan to replace coal-fired generation, OPG extended, effective July 1, 2006, the service life for all of the coal-fired generating stations, for the purpose of calculating depreciation, to December 31, 2012. OPG will continue to assess the service life of the coal-fired stations upon submission of the IPSP, and as subsequently approved by the OEB, and other available information.

### *Impairment of Long-Lived Assets*

OPG recognized an impairment loss on the Thunder Bay and Atikokan coal-fired generating stations in 2006 of \$22 million, which represented the carrying amount or net book value of these stations. OPG tested the recoverability of the carrying amounts of the coal-fired stations as a result of changes in circumstance, which included a decrease in forecast Ontario spot market prices and the extension of the lives of the coal-fired stations. The fair value of the coal-fired generating stations, which was determined using a discounted cash flow method, was compared to the carrying value of the generating assets to determine the impairment loss. It was determined that the Thunder Bay and Atikokan coal-fired generating stations would not be able to recover their operating and capital expenditures and carrying amount, over their remaining service lives.

In 2005, OPG recorded an impairment charge of \$202 million, which was the carrying value of the Lennox generating station. OPG was advised by the Province that it would not support an arrangement that would allow for the recovery of costs related to the carrying value of the Lennox generating station.

### **Other**

| <i>(millions of dollars)</i>                   | <b>2006</b> | <b>2005</b> |
|------------------------------------------------|-------------|-------------|
| Revenue                                        | <b>165</b>  | 86          |
| Operations, maintenance and administration     | <b>5</b>    | 31          |
| Depreciation and amortization                  | <b>53</b>   | 60          |
| Property and capital taxes                     | <b>10</b>   | 5           |
| Restructuring                                  | -           | 6           |
| Income (loss) before interest and income taxes | <b>97</b>   | (16)        |

Other revenue for the year ended December 31, 2006 was \$165 million compared to \$86 million in 2005. The increase of \$79 million was primarily due to revenue from trading activities. During 2006, OPG had an increase in mark-to-market gains on interconnected sales contracts and higher margins on interconnected sales compared to 2005.

OM&A expenses of the generation business segments include an inter-segment service fee for the use of certain property, plant and equipment of the Other category. The total service fee is recorded as a reduction to the Other category's OM&A expenses. For the year ended December 31, 2006, the service fee was \$25 million for Regulated – Nuclear, \$2 million for Regulated – Hydroelectric, \$3 million for

Unregulated – Hydroelectric and \$9 million for Unregulated – Fossil-Fuelled, with a corresponding reduction in OM&A expenses of \$39 million for the Other category. Results of the 2005 comparative year have been reclassified to reflect the service fee. The decrease in OM&A expenses of the Other category in 2006 compared to 2005 was partly due to reduced activity in the Energy Markets business and an increase in the service fee.

Interconnected purchases and sales (including those to be physically settled) and mark-to-market gains and losses (realized and unrealized) on energy trading contracts are disclosed on a net basis in the consolidated statements of income. If disclosed on a gross basis, revenue and power purchases for the year ended December 31, 2006 would have increased by \$163 million (2005 – \$228 million), with no impact on net income.

The carrying amounts and notional quantities of derivative instruments not designated for hedging purposes are disclosed in Note 12 in the audited consolidated financial statements as at December 31, 2006.

### **Income Tax**

OPG follows the liability method of tax accounting for its unregulated operations. Under the liability method, future tax assets and liabilities are determined based on differences between the accounting and tax bases of assets and liabilities and measured using the substantively enacted tax rates and laws that will be in effect when the differences are expected to reverse. Commencing April 1, 2005, with the introduction of rate regulation, OPG accounts for income taxes relating to the rate regulated segments of its business using the taxes payable method. Under the taxes payable method, OPG does not recognize future income taxes relating to the rate regulated segments of its business to the extent those future income taxes are expected to be recovered in future regulated prices charged to customers.

Income tax expense for the year ended December 31, 2006 reflected the impact of accounting for income taxes for the regulated segments of the business using the taxes payable method. Income tax expense for 2005 reflected the impact of the taxes payable method for the last three quarters, as this method was adopted upon inception of the rate regulation on April 1, 2005.

Income tax expense for the year ended December 31, 2006 was \$86 million compared to \$118 million in 2005. The elimination of the Large Corporations Tax and the reduction in the future income tax rates enacted in 2006 reduced income tax expense in the year. In 2005, OPG recorded an income tax charge of \$50 million to provide for a change in income tax liabilities related to certain income tax positions that the Company had taken in prior years. During the years ended December 31, 2006 and 2005, the income tax expense was lower than what would otherwise have been recorded had OPG accounted for income tax for the regulated segment using the liability method by \$89 million and \$157 million, respectively.

During 2005, as a result of the adoption of the taxes payable method for the rate regulated segments on April 1, 2005, OPG eliminated the net future income tax asset balance of \$74 million related to the rate regulated segments and recognized the amount as a one-time extraordinary loss in determining net income.

In the third quarter of 2006, OPG received a preliminary communication from the Provincial Tax Auditors (“Tax Auditors”) with respect to their initial findings from their audit of OPG’s 1999 taxation year. Many of the issues raised through the audit are unique to OPG and relate either to start-up matters and positions taken on April 1, 1999 upon commencement of operations, or matters that were not adequately addressed through the *Electricity Act, 1998*. OPG has estimated that the proposed adjustments could result in additional taxes payable for the 1999 taxation year in excess of \$200 million. Although OPG has subsequently resolved some of these issues, there is uncertainty as to how the remaining issues will be resolved.

OPG expects to receive a reassessment for its 1999 taxation year. The Company would defend its position through the tax appeals process. The potential increase in taxes payable related to these issues for 1999 and subsequent taxation years could be material. Because OPG uses the taxes payable

method to account for income taxes in the regulated business segments and the liability method for the unregulated business segments, the impact of any potential adjustments on future income tax expense could vary significantly, depending on the resolution of these issues.

OPG has previously recorded income tax charges related to certain income tax positions that the Company has taken in prior years that may be disallowed. Given the uncertainty as to how these income tax matters will be resolved, OPG has not adjusted its income tax liabilities. Should the ultimate outcome materially differ from OPG's recorded income tax liabilities, the Company's effective tax rate and its net income could be affected positively or negatively in the period in which the matters are resolved.

## LIQUIDITY AND CAPITAL RESOURCES

OPG's primary sources of liquidity and capital are funds generated from operations, bank financing, and credit facilities provided by OPG's Shareholder. These resources are required for continued investment in plant and technologies, and to meet other significant funding obligations including contributions to the pension fund, the Used Fuel Fund and Decommissioning Fund (together, the "Nuclear Funds"), and to service and repay long-term debt and revenue limit rebate obligations.

| <i>(millions of dollars)</i>                         | <b>2006</b>  | <b>2005</b> |
|------------------------------------------------------|--------------|-------------|
| Cash and cash equivalents, beginning of the year     | <b>908</b>   | 2           |
| Cash flow provided by operating activities           | <b>397</b>   | 1,201       |
| Cash flow (used in) investing activities             | <b>(650)</b> | (760)       |
| Cash flow (used in) provided by financing activities | <b>(649)</b> | 465         |
| Net (decrease) increase                              | <b>(902)</b> | 906         |
| Cash and cash equivalents, end of the year           | <b>6</b>     | 908         |

### Operating Activities

Cash flow provided by operating activities for 2006 was \$397 million compared to \$1,201 million during 2005. The decrease in cash flow from operating activities was primarily due to lower revenue before rebates as a result of lower Ontario spot electricity market prices, partially offset by the impact of lower expenditures on fuel and higher non-energy revenue.

OPG made quarterly revenue limit payments during 2006 of \$860 million, of which \$739 million relates to the period of April to December, 2005. The revenue limit payments in 2006 contributed to the decrease in the operating cash flows.

Further, the expenditures on fixed asset removal and nuclear waste management for 2006 were \$164 million as compared to \$90 million in 2005. The increase of \$74 million in 2006 was mostly due to increased expenditures relating to the safe storage of Units 2 and 3 at the Pickering A nuclear generating station. OPG is in the process of submitting a request to the Province to approve reimbursements from the Nuclear Funds to cover the expenditures relating to the safe storage program of Units 2 and 3 at the Pickering A nuclear generating station.

### Investing Activities

OPG is in a capital-intensive business that requires continued investment in plant and technologies to improve operating efficiencies, increase generating capacity of its existing stations, invest in new generating stations and to maintain and improve service, reliability, safety and environmental performance.

Investment in fixed assets during the year ended December 31, 2006 was \$637 million compared with \$494 million in 2005. The increase in capital expenditures of \$143 million was primarily due to OPG's increased investment in the Niagara Tunnel project, Portlands Energy Centre, the Lac Seul project and the Pickering B nuclear generating station auxiliary power system. The impact of these investments was largely offset by a lower investment at the Pickering A nuclear generating station in 2006 compared to 2005, with the return to service of Unit 1 in November 2005.

OPG's anticipated capital expenditures for 2007 are approximately \$1 billion, which include amounts for the Niagara Tunnel project, Portlands Energy Centre, Lac Seul project and the Lower Mattagami project.

Included in the investing activities are increases in OPG's regulatory assets of \$13 million for the year ended December 31, 2006 compared to \$265 million in 2005. The lower investment in regulatory assets during 2006 was primarily due to the return to service of Unit 1 at the Pickering A nuclear generating station in 2005.

### **Financing Activities**

OPG maintains a \$1 billion revolving committed bank credit facility which is divided into two tranches – a \$500 million 364-day term tranche maturing May 22, 2007 and a \$500 million three-year term tranche maturing May 22, 2009. The total credit facility will continue to be used primarily as credit support for notes issued under OPG's commercial paper program. OPG has recently borrowed under its commercial paper program, and as at December 31, 2006, \$15 million of commercial paper was outstanding. OPG had no other outstanding borrowings under the bank credit facility.

OPG also maintains \$26 million (2005 – \$26 million) in short-term uncommitted overdraft facilities as well as \$240 million (2005 – \$215 million) of short-term uncommitted credit facilities, which support the issuance of Letters of Credit. OPG uses Letters of Credit to support the supplementary pension plans, and is required to post Letters of Credit as collateral with Local Distribution Companies ("LDCs") as prescribed by the OEB's Retail Settlement Code. At December 31, 2006, there were a total of \$185 million (2005 – \$157 million) of Letters of Credit issued, which includes \$159 million for the supplementary pension plans and \$16 million related to the construction of the Portlands Energy Centre.

To finance the Niagara Tunnel project, OPG negotiated an agreement with the OEFC to finance the project for up to \$1 billion over the duration of the project. The funding will be advanced in the form of 10-year notes, on commercial terms and conditions. Advances under this facility commenced in October 2006, and amounted to \$160 million as at December 31, 2006. Similarly, debt financing has been negotiated with the OEFC for OPG's interest in the Portlands Energy Centre and Lac Seul projects for up to \$400 million and \$50 million, respectively. Advances under these facilities commenced in December 2006, and totalled \$90 million for the Portlands Energy Centre and \$20 million for the Lac Seul projects, as at December 31, 2006.

During 2006, OPG's Board of Directors approved the payment of a dividend to its Shareholder, the Province. The declared dividend of \$128 million represents 35 per cent of OPG's 2005 net income and was paid in November 2006.

As at December 31, 2006, OPG's long-term debt outstanding with the OEFC was approximately \$3.2 billion. Although the new financing added in 2006 has extended the maturity profile, approximately \$2.5 billion of long-term debt must be repaid or refinanced within the next five years. OPG's liquidity outlook for 2007 is forecast to be constrained due to electricity prices that are forecast to remain at relatively low levels, revenues that are subject to regulated prices and a revenue limit, increasing pension and other post employment benefit costs, debt repayment obligations, and significant funding requirements for ongoing operations and new generation project development. To ensure that adequate financing resources are available beyond its \$1 billion commercial paper program backed by the bank credit facility, OPG is in discussions with its Shareholder and the OEFC regarding a new financial agreement that would provide for longer term financial support.

## Contractual and Commercial Commitments

The Company's contractual obligations and other significant commercial commitments as at December 31, 2006, are as follows:

| <i>(millions of dollars)</i>              | 2007         | 2008         | 2009         | 2010         | 2011         | Thereafter   | Total         |
|-------------------------------------------|--------------|--------------|--------------|--------------|--------------|--------------|---------------|
| Contractual obligations:                  |              |              |              |              |              |              |               |
| Fuel supply agreements                    | 670          | 514          | 202          | 153          | 167          | 351          | 2,057         |
| Contributions under the ONFA <sup>1</sup> | 454          | 679          | 350          | 350          | 350          | 1,053        | 3,236         |
| Long-term debt repayment                  | 400          | 400          | 350          | 970          | 375          | 670          | 3,165         |
| Interest on long-term debt                | 181          | 158          | 135          | 103          | 55           | 80           | 712           |
| Unconditional purchase obligations        | 25           | 20           | 17           | 15           | 12           | 194          | 283           |
| Long-term accounts payable                | 28           | 9            | -            | -            | -            | -            | 37            |
| Operating lease obligations               | 10           | 9            | 11           | 10           | 10           | 123          | 173           |
| Operating licence                         | 16           | 17           | 17           | 17           | 18           | -            | 85            |
| Pension contributions <sup>2</sup>        | 268          | -            | -            | -            | -            | -            | 268           |
| Other                                     | 144          | 30           | 26           | 28           | 24           | 26           | 278           |
| Significant commercial commitments:       |              |              |              |              |              |              |               |
| Niagara Tunnel                            | 167          | 178          | 132          | 2            | -            | -            | 479           |
| Lac Seul                                  | 24           | -            | -            | -            | -            | -            | 24            |
| Portlands Energy Centre                   | 155          | 63           | 22           | 2            | 1            | 24           | 267           |
| <b>Total</b>                              | <b>2,542</b> | <b>2,077</b> | <b>1,262</b> | <b>1,650</b> | <b>1,012</b> | <b>2,521</b> | <b>11,064</b> |

<sup>1</sup> Contributions under ONFA are subject to adjustment due to the 2006 approved ONFA Reference Plan.

<sup>2</sup> The pension contributions include additional funding requirements towards the deficit and ongoing funding requirements in accordance with the actuarial valuation as at January 1, 2005, as well as a voluntary contribution of approximately \$20 million. The contributions are affected by various factors including market performance, changes in actuarial assumptions, plan experience, and the timing of funding valuations. Funding requirements after 2007 are excluded due to significant variability in the assumptions required to project the timing of future cash flows.

## Credit Ratings

Maintaining an investment grade credit rating is essential for corporate liquidity and future capital market access. The cost and availability of financing is influenced by credit ratings, which are intended to be an indicator of the creditworthiness of a particular company, security or obligation. Lower ratings generally result in higher borrowing costs as well as reduced access to capital markets.

At December 2006, OPG has a long-term credit rating of BBB+ by Standards & Poor's ('S&P') and 'A (low)' by Dominion Bond Rating Service ("DBRS"). In May 2006, S&P issued a press release expressing their recognition of OPG's improving performance and prospects and announcing that they had upgraded the Company's short-term Canadian scale Commercial Paper debt rating to 'A-1(Low)' from 'A-2'. The outlook on OPG's long-term credit rating is positive. In August 2006, DBRS issued a rating report confirming OPG's long-term debt rating and short-term Commercial Paper rating of 'A (low)' and 'R-1(low)', respectively, with a stable outlook.

## CRITICAL ACCOUNTING POLICIES AND ESTIMATES

OPG's significant accounting policies, including the impact of future accounting pronouncements, are outlined in Note 3 to the consolidated financial statements as at and for the year ended December 31, 2006. Certain of these policies are recognized as critical accounting policies by virtue of the subjective and complex judgments and estimates required around matters that are inherently uncertain and could result in materially different amounts being reported under different conditions or assumptions. The critical accounting policies and estimates that affect OPG's consolidated financial statements, the likelihood that materially different amounts would be reported under varied conditions and estimates and the impact of changes in certain conditions or assumptions, are highlighted below.

## Rate Regulated Accounting

A regulation made pursuant to the *Electricity Restructuring Act, 2004* (Ontario) prescribes that most of OPG's baseload hydroelectric facilities and all of the nuclear facilities that OPG operates receive regulated prices for their output. Under this regulation, OPG is required to establish a deferral account in connection with non-capital costs incurred on or after January 1, 2005, that are associated with the planned return to service of all units at the Pickering A nuclear generating station. As at December 31, 2006, the deferral account balance was \$249 million, consisting of non-capital costs of \$232 million related to Unit 1, \$19 million related to Units 2 and 3, \$20 million of general return to service costs, interest of \$7 million applied at the annual rate of six per cent, as prescribed by the regulation, and accumulated amortization of \$29 million. As at December 31, 2005, the deferral account balance was \$261 million, consisting of non-capital costs of \$228 million related to Unit 1, \$19 million related to Units 2 and 3, \$11 million of general return to service costs, interest of \$7 million applied at the annual rate of six per cent, and accumulated amortization of \$4 million. OPG commenced the amortization of the deferral account associated with Unit 1 of the Pickering A nuclear generating station when the unit was returned to service in November 2005. The amortization of \$25 million was charged to OM&A expense in 2006 (2005 – \$4 million). Upon OPG becoming subject to regulated prices established by the OEB, which is expected in 2008, the OEB is directed by the regulation to ensure that OPG recovers any balance in the deferral account through future prices charged to customers on a straight-line basis, over a period not to exceed 15 years.

In addition, under the regulation, OPG is required to establish a variance account to record certain costs incurred on or after April 1, 2005, due to deviations from the forecast information provided to the Province for the purposes of establishing regulated prices, associated with a number of predefined circumstances. Under the terms of the regulation, the OEB is directed to ensure that OPG either recovers or returns those amounts through future regulated prices charged to customers over a period not to exceed three years, to the extent that the OEB is satisfied that the costs were prudently incurred and are accurately recorded. As at December 31, 2006, the balance was nil (2005 – \$5 million) in the variance account related to revenues for ancillary services that were below the forecast provided to the Province for the purposes of establishing regulated prices. As at December 31, 2006 and 2005, OPG recorded a regulatory liability of \$4 million in a variance account reflecting water conditions that were favourable to those forecasted. Further, as of December 31, 2006, OPG recorded a regulatory asset of \$2 million reflecting lower generation sales caused by transmission outages and transmission restrictions. Other regulatory liability includes a portion of non-regulated revenue earned by OPG's regulated assets, which may result in a reduction of future regulated prices to be established by the OEB. The measurement of regulatory assets and liabilities is subject to certain estimates and assumptions including assumptions made in the interpretation of the regulation.

In February 2007 the Province amended the regulation pursuant to the *Electricity Restructuring Act, 2004* (Ontario) to clarify certain sections of the regulation and to require OPG to establish a deferral account in connection with certain changes to its liability for nuclear used fuel management and its liability for nuclear decommissioning and low and intermediate level waste management. The deferral account requires OPG to record a regulatory asset or liability representing the revenue requirement impact associated with the changes in these nuclear liabilities arising from an Approved Reference Plan, approved after April 1, 2005, in accordance with the terms of the ONFA. On December 31, 2006, OPG recorded an increase of \$1,386 million in these nuclear liabilities arising from the 2006 Approved Reference Plan.

Commencing in the first quarter of 2007 and up to the effective date of the OEB's first order establishing regulated prices, which is expected to be after March 31, 2008, OPG will record a regulatory asset associated with the increase in the nuclear liabilities arising from the 2006 Approved Reference Plan. The OEB is directed by the regulation to ensure that OPG recovers the balance recorded in the deferral account on a straight line basis over a period not to exceed three years, to the extent that the OEB is satisfied that the revenue requirement impacts are accurately recorded.

## Income Taxes

OPG is exempt from tax under the *Income Tax Act* (Canada). However, under the *Electricity Act, 1998*, OPG is required to make payments in lieu of corporate income and capital taxes to the OEFC. These payments are calculated in accordance with the *Income Tax Act* (Canada) and the *Corporations Tax Act* (Ontario), and are modified by regulations made under the *Electricity Act, 1998*.

OPG's operations are complex and the computation of the provision for income taxes involves interpretation of the various tax statutes and regulations. The *Income Tax Act* (Canada) and the *Corporations Tax Act* (Ontario) have a large body of technical interpretations and case law to help determine the Company's filing position. However, the *Electricity Act, 1998* and tax related regulations are relatively new and it has therefore been necessary for OPG, since its inception, to take certain filing positions in calculating the amount of its income tax provision. Certain filing positions may be challenged on audit and some of them possibly disallowed, resulting in a potential significant change in OPG's tax provision upon reassessment.

OPG uses the liability method of accounting for income taxes for the unregulated segment of the business and provides future income taxes for income tax temporary differences. The process involves an estimate of OPG's actual current tax liability and an assessment of the Company's future income taxes as a result of temporary differences arising from the difference between the tax basis of an asset or liability and its carrying value on the consolidated balance sheet. In addition, OPG has to assess whether the future tax assets can be realized and to the extent that recovery is not considered likely, a valuation allowance must be established. Judgment is required in determining the provision for income taxes, future income tax assets and liabilities and any related valuation allowance. To the extent a valuation allowance is created or revised, current period earnings will be affected.

Commencing April 1, 2005, OPG accounts for income taxes related to the rate regulated segments of its business in accordance with paragraphs 102 to 104 inclusive of the CICA handbook, Section 3465 – Income Taxes. Accordingly, OPG does not recognize future income taxes related to the rate regulated segments of its business to the extent that these income taxes are expected to be recovered in future regulated prices charged to customers.

Future tax assets of \$228 million (2005 – \$269 million) have been recorded on the consolidated balance sheet at December 31, 2006. The Company believes there will be sufficient future taxable income and capital gains that will permit the use of these deductions and carry-forwards. Because of the adoption of rate regulated accounting, OPG did not record future tax assets of \$3,514 million (2005 – \$3,297 million), which it would have recorded under the liability method, resulting primarily from temporary differences related to the nuclear fixed asset removal and nuclear waste management provisions.

Future tax liabilities of \$477 million (2005 – \$492 million) have been recorded on the consolidated balance sheet at December 31, 2006. Because of the adoption of rate regulated accounting, OPG did not record future tax liabilities of \$3,686 million (December 31, 2005 – \$3,380 million), which it would have recorded under the liability method, resulting primarily from temporary differences related to the nuclear fixed asset removal and nuclear waste management fund.

## Fixed Assets

OPG's business is capital intensive and requires significant investment in property, plant and equipment, and at December 31, 2006, the net book value of OPG's fixed assets was \$12,761 million.

Property, plant and equipment are tested for recoverability whenever events or changes in circumstances indicate that the carrying amounts may not be recoverable. Recoverability of property, plant and equipment is determined by comparing the carrying amount of an asset to the undiscounted future net cash flows expected to be generated from the asset over its estimated useful life. In cases where the undiscounted expected future cash flows are less than the carrying amounts, an impairment loss is recognized equal to the amount by which the carrying amount exceeds the fair value, or discounted cash flows.

Various assumptions and accounting estimates are required to determine whether an impairment loss should be recognized and, if so, the value of such loss. This includes factors such as short-term and long-term forecasts of the future market price of electricity, the demand for and supply of electricity, the in-service dates of new and laid-up generating stations, inflation, fuel prices, capital expenditures and station lives. The amount of the future net cash flow that OPG expects to receive from its fixed assets could differ materially from the net book values recorded in OPG's consolidated financial statements.

The accounting estimates related to asset depreciation require significant management judgment to assess the appropriate useful lives of OPG's long-lived assets, including consideration of various technological and other factors. The Province has accepted the advice of the IESO in their June 2006 report that indicates a need for 2,500 to 3,000 MW of additional capacity to maintain system reliability. Therefore, further delays will be necessary in the plan to replace coal-fired generation by 2009. As a result of these delays, effective July 1, 2006, OPG extended the life for all of the coal-fired generating stations, for purposes of calculating depreciation, to December 31, 2012. The extension will reduce depreciation expense by \$126 million in 2007 and \$46 million in 2008. From 2009 to 2012, the depreciation expense will increase by \$59 million in each year. OPG will reassess the service life of the coal-fired stations upon submission of the IPSP, and as subsequently approved by the OEB. Any change to the estimated service life of the coal-fired generating stations, for purposes of calculating depreciation, could have a material impact on OPG's consolidated financial statements.

During 2006, OPG extended the remaining service life of the Pickering B nuclear generating station to 2014 for depreciation purposes after a review of the life limiting components, taking into account recent station capacity factors. The extension reduced depreciation expense by \$36 million in 2006. OPG will continue to review the estimated useful lives of its generating stations, including the Darlington and Bruce nuclear generating units. Any changes resulting from the review will be reflected in 2007.

### **Pension and Other Post Employment Benefits**

OPG's accounting for pension and other post employment benefits are dependent on management's accounting policies and assumptions used in calculating such amounts.

#### *Accounting Policy*

In accordance with Canadian generally accepted accounting principles, actual results that differ from the assumptions used, as well as adjustments resulting from changes in assumptions, are accumulated and amortized over future periods and therefore generally affect recognized expense and the recorded obligation in future periods.

Under OPG's policy on accounting for pension and OPEB, certain actuarial gains and losses have not been charged to expense and are therefore not reflected in OPG's pension and OPEB obligations as a result of the following:

- Pension fund assets are valued using market-related values for purposes of determining actuarial gains or losses and the expected return on plan assets. The market-related value recognizes gains and losses on equity assets relative to a six per cent assumed real return over a five-year period.
- For pension and OPEB, the excess of the net cumulative unamortized gain or loss, over 10 per cent of the greater of the benefit obligation and the market-related value of the plan assets (the "corridor"), is amortized over the expected average remaining service life.

In addition, past service costs arising from pension and OPEB plan amendments are amortized over future periods and therefore affect recognized expense and the recorded obligation in future periods.

At December 31, 2006, the unamortized net actuarial loss and unamortized past service costs for the pension plan and other post employment benefits amounted to \$1,937 million (2005 – \$2,760 million). Details of the unamortized net actuarial loss and total unamortized past service costs at December 31, 2006 and 2005 are as follows:

|                                                                                          | <b>Registered Pension Plan</b> |             | <b>Supplementary Pension Plans</b> |             | <b>Other Post Employment Benefits</b> |             |
|------------------------------------------------------------------------------------------|--------------------------------|-------------|------------------------------------|-------------|---------------------------------------|-------------|
| <i>(millions of dollars)</i>                                                             | <b>2006</b>                    | <b>2005</b> | <b>2006</b>                        | <b>2005</b> | <b>2006</b>                           | <b>2005</b> |
| Net actuarial (gain) not yet subject to amortization due to use of market-related values | <b>(677)</b>                   | (48)        | -                                  | -           | -                                     | -           |
| Net actuarial loss not subject to amortization due to use of corridor                    | <b>931</b>                     | 910         | <b>15</b>                          | 14          | <b>207</b>                            | 207         |
| Net actuarial loss subject to amortization                                               | <b>854</b>                     | 875         | <b>5</b>                           | 4           | <b>492</b>                            | 678         |
| Unamortized net actuarial loss                                                           | <b>1,108</b>                   | 1,737       | <b>20</b>                          | 18          | <b>699</b>                            | 885         |
| Unamortized past service costs                                                           | <b>82</b>                      | 100         | <b>3</b>                           | 4           | <b>25</b>                             | 16          |

#### *Accounting Assumptions*

Assumptions used in determining projected benefit obligations and the costs for the Company's employee benefit plans are evaluated periodically by management in consultation with an independent actuary. Critical assumptions, such as the discount rate used to measure the Company's benefit obligations, the expected long-term rate of return on plan assets and health care cost projections, are evaluated and updated annually. The discount rates used by OPG in determining projected benefit obligations and the costs for the Company's employee benefit plans are based on representative AA corporate bond yields.

A change in these assumptions, holding all other assumptions constant, would increase (decrease) 2006 costs, excluding amortization components, as follows:

|                                   | <b>Registered Pension Plan</b> | <b>Supplementary Pension Plans</b> | <b>Other Post Employment Benefits</b> |
|-----------------------------------|--------------------------------|------------------------------------|---------------------------------------|
| <i>(millions of dollars)</i>      |                                |                                    |                                       |
| Expected long-term rate of return |                                |                                    |                                       |
| 0.25% increase                    | (20)                           | Na                                 | na                                    |
| 0.25% decrease                    | 20                             | Na                                 | na                                    |
| Discount rate                     |                                |                                    |                                       |
| 0.25% increase                    | (11)                           | -                                  | (3)                                   |
| 0.25% decrease                    | 12                             | -                                  | 3                                     |
| Inflation                         |                                |                                    |                                       |
| 0.25% increase                    | 36                             | 1                                  | -                                     |
| 0.25% decrease                    | (34)                           | (1)                                | -                                     |
| Salary increases                  |                                |                                    |                                       |
| 0.25% increase                    | 10                             | 1                                  | -                                     |
| 0.25% decrease                    | (10)                           | (1)                                | -                                     |
| Health care cost trend rate       |                                |                                    |                                       |
| 1% increase                       | Na                             | Na                                 | 34                                    |
| 1% decrease                       | Na                             | na                                 | (26)                                  |

na – change in assumption not applicable.

## **Asset Retirement Obligations**

OPG's asset retirement obligations are comprised of liabilities for nuclear fixed asset removal and nuclear waste management costs and non-nuclear fixed asset removal costs related to the decommissioning of fossil-fuelled generating stations. The liabilities associated with decommissioning the nuclear generating stations and long-term used nuclear fuel management comprise the most significant amounts of the total obligation. The estimates of the nuclear liabilities are reviewed on an annual basis as part of the ongoing, overall nuclear waste management program. Changes in the nuclear liabilities resulting from changes in assumptions or estimates that impact the amount of the originally estimated undiscounted cash flows are recorded as an adjustment to the liabilities, with a corresponding change in the related asset retirement cost capitalized as part of the carrying amount of fixed assets.

The estimates of nuclear fixed asset removal and nuclear waste management costs require significant assumptions in the calculations since the programs run for many years. Significant assumptions underlying operational and technical factors are used in the calculation of the accrued liabilities and are subject to periodic review. Changes to these assumptions, including changes in the timing of programs, technology employed, inflation rate, and discount rate, could result in significant changes in the value of the accrued liabilities.

During the fourth quarter of 2006, OPG reviewed and updated the cost estimates under the ONFA Reference Plan. The Approved Reference Plan (the 2006 Reference Plan) under the ONFA resulted in a \$1,386 million increase in OPG's liability for nuclear waste management and decommissioning, and a corresponding increase in the carrying value of the nuclear generating stations to which this liability relates. Changes to the reference plan and cost estimates are mainly due to a change in economic indices, recent industry experience in decommissioning reactors, and additional used fuel and waste quantities resulting from service life extensions.

The increment in the amount of the undiscounted estimated cash flows for OPG's liability for nuclear waste management and decommissioning was discounted using the current credit-adjusted risk-free rate of 4.6 per cent. A ten basis points (0.1 per cent) change in this discount rate would impact the carrying value of the asset retirement obligations by approximately \$100 million.

## **Future Changes in Accounting Policies and Estimates**

In 2005, the Canadian Institute of Chartered Accountants issued three new accounting standards: Financial Instruments – Recognition and Measurement, Hedges, and Comprehensive Income. These standards provide guidance on the recognition and measurement of financial assets, financial liabilities and non-financial derivatives. They also provide guidance on the classification of financial instruments and hedge accounting.

These standards are effective for OPG beginning in 2007. OPG has completed assessing the impact of these standards on its consolidated financial statements. The impact of implementing these new standards on OPG's consolidated financial statements is summarized below under the heading *Impact of Adoption*. The following provides further information on each of the three new accounting standards as they relate to OPG.

### ***Comprehensive Income***

As a result of adopting these standards, a new category, accumulated other comprehensive income, will be added to shareholder's equity on the consolidated balance sheets. Major components for this category will include unrealized gains and losses on financial assets classified as available-for-sale, unrealized foreign currency translation amounts, net of hedging, and changes in the fair value of the effective portion of cash flow hedging instruments. These amounts will be recorded in the statement of other comprehensive income until the criteria for recognition in the consolidated statement of income are met.

## *Financial Instruments – Recognition and Measurement*

Under the new standard, for accounting purposes, financial assets will be classified as one of the following: held-to-maturity, loans and receivables, held-for-trading or available-for-sale, and financial liabilities will be classified as held-for-trading or other than held-for-trading. Financial assets and liabilities held-for-trading will be measured at fair value with gains and losses recognized in net income. Financial assets held-to-maturity, loans and receivables and financial liabilities other than those held-for-trading, will be measured at amortized cost. Available-for-sale instruments will be measured at fair value with unrealized gains and losses recognized in other comprehensive income. The standard also permits designation of any financial instrument as held-for-trading upon initial recognition. All derivatives, including embedded derivatives that must be separately accounted for, generally must be classified as held-for-trading and recorded at fair value in the consolidated balance sheets.

## *Hedges*

This new standard specifies the criteria under which hedge accounting can be applied and how hedge accounting is to be executed for each of the permitted hedging strategies: fair value hedges, cash flow hedges and hedges of a foreign currency exposure of a net investment in a self-sustaining foreign operation. In a fair value hedging relationship, the carrying value of the hedged item is adjusted by gains or losses attributable to the hedged risk and recognized in net income. This change in fair value of the hedged item, to the extent that the hedging relationship is effective, is offset by changes in the fair value of the derivative. In a cash flow hedging relationship, the effective portion of the change in the fair value of the hedging derivative will be recognized in other comprehensive income. The ineffective portion will be recognized in net income. The amounts recognized in accumulated other comprehensive income will be reclassified to net income in the periods in which net income is affected by the variability in the cash flows of the hedged item. In hedging a foreign currency exposure of a net investment in a self-sustaining foreign operation, foreign exchange gains and losses on the hedging instruments will be recognized in other comprehensive income.

## *Impact of Adoption*

Upon adoption of the financial instruments accounting standards, the assets in the Nuclear Funds that have been carried at amortized cost until the end of 2006, will be classified as held-for-trading in 2007 and reported at fair value. Prior to January 1, 2007, OPG valued securities in the Nuclear Funds based on the closing price of the securities. Starting January 1, 2007, OPG will apply bid pricing, however, the change in the pricing methodology is not expected to have a significant impact to the Nuclear Funds balance on the consolidated balance sheets.

The transition adjustment related to the change in accounting for the funds will be recognized in the opening balance of retained earnings as at January 1, 2007. The transition adjustment for embedded derivatives within long-term contracts will also be recognized in the opening balance of retained earnings as at January 1, 2007. The fair value of hedging instruments designated as cash flow hedges will be recognized in the opening accumulated other comprehensive income on a net of tax basis. The fair values of these hedges are disclosed in Note 12 to the audited consolidated financial statements.

The transition amounts that will be recorded in the opening retained earnings or in the opening accumulated other comprehensive income balance on January 1, 2007 are as follows:

| <i>(millions of dollars)</i>            | At Cost             | At Fair Value     | Transition Amounts – January 1, 2007 |                                                         |
|-----------------------------------------|---------------------|-------------------|--------------------------------------|---------------------------------------------------------|
|                                         | December 31<br>2006 | January 1<br>2007 | Opening<br>Retained<br>Earnings      | Opening<br>Accumulated Other<br>Comprehensive<br>Income |
| Nuclear funds balance <sup>1</sup>      | 7,694               | 9,041             | 1,347                                | -                                                       |
| Due to Province                         | (100)               | (928)             | (828)                                | -                                                       |
|                                         | 7,594               | 8,113             | 519                                  | -                                                       |
| Accounts receivable and other<br>assets | 325                 | 372               | -                                    | 47                                                      |
| Accounts payable and accrued<br>charges | (989)               | (1,005)           | (6)                                  | (10)                                                    |
| Net future income tax liability         | (249)               | (265)             | -                                    | (16)                                                    |
| Transition Adjustments                  |                     |                   | 513                                  | 21                                                      |

<sup>1</sup> OPG applied bid pricing for securities in the Nuclear Funds. As a result, the fair value of the Nuclear Funds above is lower than that reported under Note 9 of the financial statements. The change in pricing methodology does not have any impact to the overall balance on the consolidated balance sheets because the reduction in fair value is offset by the corresponding change in the due to Province balance.

## BALANCE SHEET HIGHLIGHTS

The following section provides highlights of OPG's audited consolidated financial position using selected balance sheet data:

| Selected balance sheet data<br><i>(millions of dollars)</i>                           | As at December 31 |        |
|---------------------------------------------------------------------------------------|-------------------|--------|
|                                                                                       | 2006              | 2005   |
| Assets                                                                                |                   |        |
| Accounts receivable                                                                   | 256               | 538    |
| Property, plant and equipment – net                                                   | 12,761            | 11,412 |
| Nuclear fixed asset removal and nuclear waste management funds                        | 7,594             | 6,788  |
| Regulatory assets                                                                     | 251               | 266    |
| Liabilities                                                                           |                   |        |
| Accounts payable and accrued charges                                                  | 989               | 958    |
| Revenue limit rebate payable                                                          | 40                | 739    |
| Fixed asset removal and nuclear waste management                                      | 10,520            | 8,759  |
| Other post employment benefits and supplementary pension plans<br>(long-term portion) | 1,396             | 1,212  |

## Accounts Receivable

As at December 31, 2006, accounts receivable were \$256 million compared to \$538 million as at December 31, 2005. The decrease of \$282 million was primarily due to lower electricity generation volume as a result of unseasonably warm weather in December 2006 compared to December 2005.

## **Property, Plant and Equipment – Net**

Net property, plant and equipment as at December 31, 2006 was \$12,761 million compared to \$11,412 million as at December 31, 2005, an increase of \$1,349 million. The increase was primarily due to the change in the estimate for the liability for nuclear fixed asset removal and nuclear waste management of \$1,386 million and the corresponding required adjustment to fixed assets. These changes are depreciated over the remaining useful life of the related fixed assets.

## **Nuclear Fixed Asset Removal and Nuclear Waste Management Funds**

OPG is responsible for the ongoing long-term management and disposal of radioactive waste materials and used fuel resulting from operations and future decommissioning of its nuclear generating stations. OPG's obligations relate to the Pickering and Darlington nuclear generating stations that are operated by OPG, as well as the Bruce A and B nuclear generating stations that are leased by OPG to Bruce Power.

In order to fund these liabilities, OPG established and manages, jointly with the Province, a Used Fuel Fund and a Decommissioning Fund, which are funded by OPG in accordance with the ONFA. The Used Fuel Fund is primarily intended to fund future expenditures associated with the disposal of highly radioactive used nuclear fuel bundles. The Decommissioning Fund was established to fund future expenditures associated with nuclear fixed asset removal and the disposal of low and intermediate level nuclear waste materials. OPG maintains the Nuclear Funds in third party custodial accounts that are segregated from the rest of OPG's assets.

Assets in the Nuclear Funds are invested in fixed income and equity securities, which OPG has been recording as long-term investments at their amortized cost. Therefore, gains and losses are recognized only upon the sale of an underlying security. As such, there may be unrealized gains and losses associated with the investments in the Nuclear Funds, which OPG has not recognized in its consolidated financial statements. The Nuclear Funds are referred to as the nuclear fixed asset removal and nuclear waste management funds in OPG's consolidated financial statements. As at December 31, 2006, the value of the Nuclear Funds on an amortized cost basis were \$7,594 million compared to \$6,788 million as at December 31, 2005.

Under the ONFA, the Province guarantees OPG's annual return in the Used Fuel Fund at 3.25 per cent plus the change in the Ontario Consumer Price Index ("committed return") for funding related to the first 2.23 million used fuel bundles. OPG recognizes the committed return on the Used Fuel Fund and includes it in earnings on the nuclear fixed asset removal and nuclear waste management funds. The difference between the committed return on the Used Fuel Fund and the actual market return, based on the fair value of the assets, which includes realized and unrealized returns, is due to or from the Province. Since OPG accounts for the investments in the Nuclear Funds on an amortized cost basis at December 31, 2006, the amount due to or due from the Province recorded in the consolidated financial statements is the difference between the committed return and the actual return based on realized returns only. At December 31, 2006, the Used Fuel Fund included an amount due to the Province of \$100 million (December 31, 2005 – \$4 million). The Used Fuel Fund asset value, after taking into account the committed return and the related amount due to the Province, was \$3,238 million at December 31, 2006 (December 31, 2005 – \$2,689 million). If the investments in the Used Fuel Fund were accounted for at fair market value in the audited consolidated financial statements at December 31, 2006, there would be an amount due to the Province of \$641 million (December 31, 2005 – \$306 million). In addition, under the ONFA, the Province is entitled to any surplus in the Used Fuel Fund, subject to a threshold funded ratio of 110 per cent compared to the value of the associated liabilities.

Under the ONFA, the Decommissioning Fund initially had a long-term target rate of return of 5.75 per cent per annum. Under the 2006 Approved Reference Plan, this rate was revised to 5.15 per cent. OPG bears the risk and liability for cost estimate increases and fund earnings associated with the Decommissioning Fund. According to the ONFA, the Province has a right to any excess funding in the Decommissioning Fund, which is the excess of the fair market value of the Decommissioning Fund over the estimated completion costs, approved under the ONFA Reference Plan. At December 31, 2006, based on the estimate of costs to complete under the 2006 Reference Plan, the Decommissioning Fund was fully funded on a market value basis, and underfunded on an amortized cost basis. When the

Decommissioning Fund is overfunded on an amortized cost basis, OPG limits the earnings it recognizes in its consolidated financial statements, through a charge to the Decommissioning Fund with a corresponding payable to the Province, such that the amortized cost balance of the Decommissioning Fund would equal the cost estimate of the liability based on the 2006 Reference Plan. The payable to the Province could be reduced in subsequent periods in the event that the Decommissioning Fund earns less than its target rate of return or in the event that a new reference plan is approved with a higher estimated decommissioning liability.

At December 31, 2006, the Decommissioning Fund asset value on an amortized cost basis was \$4,356 million compared to a market value of \$5,169 million, the difference representing net unrealized gains of \$813 million. Under the ONFA, if there is a surplus in the Decommissioning Fund, such that the liabilities, as defined by the 1999 and 2006 ONFA Reference Plans, are at least 120 per cent funded, OPG may direct up to 50 per cent of the surplus over 120 per cent to be treated as a contribution to the Used Fuel Fund, and the OEFC is entitled to a distribution of an equal amount.

Effective January 1, 2007, OPG adopted the CICA Handbook section 3855, Financial Instruments – Recognition and Measurement. As a result of the adoption, the investments in the Nuclear Funds and the corresponding payables to the Province will be classified as held-for-trading and will be measured at fair value with gains and losses recognized in OPG's consolidated financial statements. As a result of the initial adoption of the standard on January 1, 2007, OPG recorded a transition adjustment of \$519 million to opening retained earnings, to adjust the investments in the Nuclear Funds, and the related payables to fair value.

The Province guarantees OPG's annual return in the Used Fuel Fund related to the initial 2.23 million used fuel bundles at the committed return, such that any difference between the committed return and the actual return based on fair value would be offset by the change in the related payable or receivable to the Province in the Used Fuel Fund. Therefore, the new accounting standard does not impact the earnings from the Used Fuel Fund in 2007.

On January 1, 2007, the fair value of the investments in the Decommissioning Fund exceeded the estimated completion costs under the 2006 Approved ONFA Reference Plan. Accordingly, the Decommissioning Fund balance was reduced by a payable to the Province, as the Decommissioning Fund balance is capped at the estimated completion costs under the 2006 Approved ONFA Reference Plan. When the Decommissioning Fund is overfunded, the earnings from the Decommissioning Fund would be equal to the long-term target rate of return, which is currently 5.15 per cent. If the Decommissioning Fund were underfunded, the earnings for the Decommissioning Fund would reflect actual fund returns at market value.

### **Regulatory Assets**

As at December 31, 2006, regulatory assets were \$251 million compared to \$266 million as at December 31, 2005. The change in regulatory assets during 2006 was mainly due to the amortization of \$25 million of the deferred Pickering A return to service costs, partially offset by \$13 million of additional costs that were deferred.

As a result of the change in the Approved Reference Plan, commencing in 2007, OPG will recognize additional expenses including accretion on the fixed asset removal and nuclear waste management liabilities and depreciation of the carrying value of the related fixed assets. The impact of these additional expenses will be reduced by the recognition of a regulatory asset to be recovered through future prices charged to customers, as prescribed by the amended regulation pursuant to the *Electricity Restructuring Act, 2004* (Ontario).

### **Accounts Payable and Accrued Charges**

Accounts payable and accrued charges as at December 31, 2006 were \$989 million compared to \$958 million as at December 31, 2005. The increase of \$31 million was partly due to the timing of nuclear fuel purchases and payroll expenditures at year end. The increase was partially offset by a decrease in payables due to the timing of coal purchases and a reduced property tax payable balance.

## **Revenue Limit Rebate Payable**

The revenue limit rebate payable as at December 31, 2006 was \$40 million compared to \$739 million as at December 31, 2005. During 2006, payments of \$860 million were made. The balance of \$40 million as at December 31, 2006 represents the revenue limit rebate payable for the period of August 1, 2006 to December 31, 2006. The decrease in the revenue limit rebate payable was partly due to timing, since the \$40 million payable at December 31, 2006 represented a period of five months compared to the period of eight months as at December 31, 2005. Furthermore, the revenue limit rebate payable at December 31, 2006 reflected lower electricity prices and generation volume from OPG's unregulated businesses.

## **Fixed Asset Removal and Nuclear Waste Management**

The liability for fixed asset removal (for nuclear and fossil-fuelled generating stations) and nuclear waste management as at December 31, 2006 was \$10,520 million compared to \$8,759 million as at December 31, 2005. The increase was primarily due to the change in the estimate for the liability for nuclear fixed asset removal and nuclear waste management of \$1,386 million resulting from the Approved Reference Plan in accordance with the terms of the ONFA.

## **OPEB and Supplementary Pension Plans**

The long-term portion of the liability for OPEB and supplementary pension plans was \$1,396 million as at December 31, 2006 compared to \$1,212 million as at December 31, 2005. The increase of \$184 million was mainly due to costs recognized in 2006, net of benefit payments.

## **Off-Balance Sheet Arrangements**

In the normal course of operations, OPG engages in a variety of transactions that, under Canadian GAAP, are either not recorded in the Company's consolidated financial statements or are recorded on the Company's consolidated financial statements in amounts that differ from the full contract amounts. Principal off-balance sheet activities that OPG undertakes include securitization of certain accounts receivable agreements, guarantees which provide financial or performance assurance to third parties on behalf of certain subsidiaries, and certain derivative instruments and long-term fixed price contracts.

### *Securitization*

In October 2003, OPG completed a revolving securitization agreement with an independent trust. The independent trust is not controlled by OPG, nor is OPG the primary beneficiary. As such, the results of the trust are not consolidated. The securitization provides OPG with an opportunity to obtain an alternative source of cost effective funding. For the year ended December 31, 2006, the average all-in cost of funds was 4.4 per cent and the pre-tax charges on sales to the trust were \$13 million. The current securitization agreement extends to August 2009. Refer to Notes 3 and 4 of OPG's 2006 annual audited consolidated financial statements for additional information.

### *Guarantees*

As part of normal business, OPG and certain of its subsidiaries and joint ventures enter into various agreements providing financial or performance assurance to third parties on behalf of certain subsidiaries and joint ventures. Such agreements include guarantees, stand-by Letters of Credit and surety bonds.

### *Derivative Instruments*

The majority of OPG's derivative instruments are treated as hedges, with gains or losses recognized upon settlement when the underlying transactions occur. OPG holds financial commodity derivatives primarily to hedge the commodity price exposure associated with changes in the price of electricity. Foreign exchange derivative instruments are used to hedge the exposure to anticipated USD denominated purchases. When such a derivative instrument ceases to exist or when designation of a hedging relationship is terminated, any associated deferred gains or losses are carried forward to be recognized in income in the same period as the corresponding gains or losses associated with the hedged item. When a hedged item ceases to exist, any associated deferred gains or losses are

recognized in the current period's consolidated statement of income. The deferred gain on electricity derivative instruments and interest rate hedges was \$41 million as at December 31, 2006, compared to a deferred loss of \$130 million as at December 31, 2005. For additional information, refer to Note 12 of OPG's audited consolidated financial statements as at and for the year ended December 31, 2006.

All contracts not designated as hedges are recorded as assets or liabilities at fair value with changes in fair value recorded in Other revenue.

Effective January 1, 2007, OPG adopted the CICA Handbook section 3865 – Hedges. Hedging instruments designated as cash flow hedges will be recognized in opening accumulated other comprehensive income. Adjustments arising due to hedging instruments designated as cash flow hedges will be recognized in the opening balance of accumulated other comprehensive income on a net of tax basis.

## **RISK MANAGEMENT**

OPG's portfolio of generation assets and its electricity trading and marketing operations are subject to inherent risks, including financial, operational, and strategic risks. To manage these risks, OPG's Board of Directors and management have implemented a risk management framework for the governance, identification, measurement, monitoring and reporting of risk across all of OPG and its business operations. Implementation and coordination of risk management activities are undertaken through a centralized risk management group, separate and independent from operational management. Risk information from the business units is independently assessed and aggregated by the Risk Services Group, and is reported by the Chief Risk Officer to the Audit/Risk Committee of the Board of Directors. Risk factors are incorporated into business planning to support the Company's sustainability and achievement of its stated objectives.

While OPG believes it is pursuing appropriate risk management strategies, there can be no assurance that one or more of the risks outlined or other risk factors will not have a material adverse impact on OPG. In particular, the *Electricity Restructuring Act, 2004* (Ontario) and related regulations, the imposition of a revenue limit on the non-regulated assets, and changes in the future mandate of the Company in the Ontario electricity marketplace could have a material impact on OPG.

## **Risk Classification**

OPG's operations face numerous complex risks. For purposes of this discussion, these risks have been grouped together into the following three categories:

- **Operational Risk:** The risk of loss resulting from external events or inadequate internal processes, equipment and systems. Operational risk can also arise from unexpected or poor human performance involving any key process or function.
- **Financial Risk:** The risk of financial loss caused by external market factors resulting in unexpected movements in credit, foreign exchange, interest rate, and commodity markets.
- **Strategic Risk:** The risk that adverse events or conditions in OPG's regulatory, economic, political and social environment will prevent OPG from achieving its objectives. These include risks from adverse regulatory changes or onerous existing regulations; risks from unexpected economic conditions; the risk of financial loss or damaged reputation resulting from unexpected political actions; and the risk inherent in succession planning.

## **Operational Risks**

OPG is exposed to the financial impacts of uncertain output from its generating units. The amount of electricity generated by OPG is affected by fuel supply, equipment malfunction, maintenance requirements, and regulatory and environmental constraints. There is also a risk that an unexpected deterioration of equipment could result in extensive repairs and additional remedial measures. The primary impacts of this risk are increased cost of operations, and the potential derating of a generating unit below its normal level of output.

### *Nuclear Segment Generation Risks*

The uncertainty around the electricity generated by OPG's nuclear generating plants arises from various degradation or aging processes affecting three key types of components: steam generators, fuel channels, and feeders. Generation risks also arise from other structures, components or systems in the nuclear generating stations such as cooling water systems, turbines and reactor structures and components. While OPG has extensive life cycle plans to govern maintenance of the most critical plant life limiting equipment, the depth of coverage does not extend to many other parts of the plant.

OPG maintains a program of preemptive maintenance, which involves inspection and testing to monitor and continue safe operations. When an exposure is suspected or indicated, a specific monitoring program is established. If an exposure is materialized, a resolution program is initiated. Both types of programs usually result in increased operating costs and normally maintain or restore generating capability. One such resolution program currently used is the replacement of piping components, known as feeders. Feeders are part of the system that transports heat from the reactors to the steam generators that feed the turbines producing electricity. Certain feeders have shown degradation beyond expectations, and will be replaced under the current feeder replacement program. Based on the program's success, the program will be extended if necessary.

OPG's management programs with respect to technology risk and plant conditions impacting operations and safety, involve sharing of operating experience and information with other nuclear operators, and participating in industry-wide or shared research programs as well as the development of investigation methods and remediation tools or methods.

### *Regulatory Uncertainty*

An additional element of technology risks is their impact on nuclear regulation and the changes they bring to technical codes. Operating experience around the world also contributes new knowledge and understanding of both nuclear operations and safety issues, resulting in continually evolving regulatory rules and refining of safety measurements and assessments. Keeping up with these changes adds to cost of operations and in some instances, it may result in a reduction in the productive capacity of a plant, or the premature replacement of a plant component. The divergence of views as to the suitability or depth of safety assessments could result in the imposition of costly remediation measures or curtailment of production.

OPG manages regulatory uncertainty risk by maintaining close contacts with the regulator and issuers of standards/codes. Together with other industry members, OPG is promoting a risk-based mode of regulation.

### *Hydroelectric Segment Generation Risks*

OPG's hydroelectric generating performance is partially dependent on the availability of water, which can vary from year to year due in large part to the weather. The inherent uncertainty in forecasting water levels introduces a significant degree of uncertainty in the capability of hydroelectric generation. OPG manages the risk with production forecasting models, which consider unit efficiency characteristics, water flow conditions and outage plans. Water flows and outage conditions are assessed and monitored on an ongoing basis.

The hydroelectric generating stations vary in age from 14 to 108 years, with an average age of over 71 years. Over 75 per cent of the hydroelectric generating capacity is over 50 years old. Due to the variability and age of the equipment and civil components, there is a risk that some facilities will require significant work and funding to sustain their reliability. OPG manages the reliability risks by conducting ongoing maintenance of critical components, engineering reviews, plant condition assessments, and inspections to identify future work necessary to sustain and, if necessary, upgrade the plant and its equipment. The success of the program is monitored through the measurement of risk reduction and reliability improvements.

The hydroelectric business segment operates 232 dams across the province. To mitigate and manage the risks associated with the operation of these dams, OPG has a dam safety program that performs ongoing maintenance, upgrades and rehabilitation work. OPG also undertakes ongoing dam safety reviews and monitoring, and ad hoc peer reviews. Emergency preparedness and response plans have been established for all facilities to mitigate losses in the event of a dam failure or uncontrolled release of water.

#### *Unregulated – Fossil-Fuelled Segment Risks*

The fossil-fuelled generation units can be interrupted by plant and equipment failures. OPG manages and mitigates the risks associated with its fossil-fuelled stations by performing ongoing maintenance and undertaking engineering reviews, condition assessments and critical reviews of maintenance processes. OPG uses the results of these reviews and assessments to make changes to inspection, maintenance, and capital project programs. The risks associated with plant and equipment failures and outages at OPG's fossil generating stations are measured by their availability to produce electricity when called upon.

#### *Major Project Risk*

OPG is involved with several major development projects, including: the Niagara Tunnel, Lac Seul, Portlands Energy Centre, other projects supporting operating units, hydroelectric development projects, and the potential refurbishment of existing nuclear generation, and the consideration of new nuclear units at OPG's Darlington nuclear generation site. There is a risk that OPG will have insufficient resources and ability to implement several large projects concurrently. This risk is especially critical given the complexity, long project timelines, and inherent risks related to these projects.

OPG has taken many steps that address the unique challenges relating to the various development projects. OPG utilizes Owner's Representative services to acquire the necessary technical expertise to monitor and control projects. Also, major projects have been contracted on a "design and build" basis, which provides OPG with greater certainty over costs.

For nuclear related projects, OPG has established a new division that has a specific mandate to evaluate the viability of refurbishment of existing nuclear facilities in order to extend their life. The activities of this division include completing plant condition and environmental assessments, developing appropriate project infrastructures and confirming various industry regulatory requirements.

#### *Human Resources Risk*

The availability of qualified human resources needed to support existing facilities and complete all the major development projects once they have commenced operations presents a significant risk to OPG. This risk is exacerbated by the increasing number of existing staff who are approaching early retirement dates. While in the past, the planned shutdown of the coal-fired generating stations alleviated some of these needs, the recent delay in the Province's coal replacement program has increased the quantum of this risk.

The business units have processes to monitor and track demographics and identify potential workforce gaps in critical functions, which support their recruitment activities. Other mitigation measures include enhancements to staff development, succession planning, and training and development programs. OPG also has implemented mentoring programs, and has formed partnerships with various labour groups to market the electricity sector.

#### *Environmental Risk*

OPG's Environmental Policy commits OPG to meet all legal requirements and voluntary environmental commitments, integrate environmental factors into business planning and decision-making, and contribute to environmental protection, pollution prevention and energy and resource use efficiency. This policy also commits OPG to maintain comprehensive environmental management systems ("EMSs") at its generating facilities consistent with the ISO 14001 standard.

OPG monitors emissions into the air and water and regularly reports the results to various regulators, including the Ministry of the Environment, Environment Canada and the Canadian Nuclear Safety Commission. The public also receives ongoing communications regarding OPG's environmental performance through community-based advisory groups, annual environmental reports, community newsletters, open houses and OPG's Web site. OPG has developed and implemented internal monitoring, assessment and reporting programs to manage environmental risks such as air and water emissions, discharges, spills, the treatment of radioactive emissions and radioactive wastes. OPG also continues to address historical land contamination through its voluntary land assessment and remediation program.

OPG's emissions of SO<sub>2</sub> and NO<sub>x</sub> are managed through the installation of specialized equipment such as scrubbers, low NO<sub>x</sub> burners, and selective catalytic reduction equipment. OPG also purchases low sulphur fuel and utilizes a regulatory approved emissions trading program to manage emission levels within regulatory limits. The Province has directed the OPA to develop a plan to phase out coal-fired generation in the earliest possible timeframe with the assurance that there is an adequate supply of electricity during the phase-out period. Consideration is also being given to emission control technology improvements to mitigate the environmental impacts of generation from coal while these facilities continue to operate. In the interim, OPG will operate its coal-fired facilities in accordance with all regulatory requirements and will implement continuous improvement measures that are consistent with the remaining in-service requirements for these facilities.

OPG's emissions of greenhouse gases ("GHG") have been managed on a voluntary basis, primarily through improvements in energy efficiency and the purchase of GHG emission reduction credits. In October 2006, the Federal Government introduced the *Clean Air Act* as well as the Notice of Intent to Develop and Implement Regulations and Other Measures to Reduce Air Emissions. The Government proposes to regulate CO<sub>2</sub> emissions from certain large emitters and is currently consulting with stakeholders, including OPG. The Government intends to release its proposed regulatory framework in the spring of 2007 and more detailed sector-specific regulations in the spring of 2008. It is possible that OPG could be required to reduce the CO<sub>2</sub> intensity of its fossil stations in the period of 2010 to 2015, most likely through the purchase of CO<sub>2</sub> offsets.

Changes to environmental laws or delays in implementing the current timetable of the Province's coal replacement policy could create compliance risks that may be addressed by the installation of additional equipment or control technologies, the purchase of additional emission reduction credits, or by constraining production from the fossil-fuelled fleet. In addition, a failure to comply with applicable environmental laws may result in enforcement actions, including the potential for orders or charges. Further, some of OPG's activities have the potential to cause contamination to land or water that may require remediation. The potential liability associated with any of these events could have a material adverse effect on the business.

## **Financial Risk**

### *Commodity Price Risk*

Commodity price risk (the risk of changes in the market price of electricity or of the fuels used to produce electricity) will adversely impact OPG's earnings and cash flow from operations. To manage this risk, the Company seeks to maintain a balance between the commodity price risk inherent in its electricity production and plant fuel portfolios to the extent that trading liquidity in the relevant commodities markets provides the economic opportunity to do so. To manage the input risk, OPG has a fuel hedging program, which includes fixed price and indexed contracts for fossil and nuclear fuels, as well as commodity derivatives.

Through a regulation passed pursuant to the *Electricity Restructuring Act, 2004* (Ontario) OPG receives regulated prices for most of its baseload hydroelectric facilities and all of the nuclear facilities that it operates (approximately 60 per cent of OPG generation) from April 1, 2005. These prices are expected to remain in effect until the later of March 31, 2008 and such time that new regulated prices established by the OEB will come into effect. Eighty-five per cent of the remaining unregulated OPG electricity generation, excluding generation from the Lennox generating station and volumes relating to existing

contracts, is subject to a revenue limit. To the extent that Ontario spot electricity market prices are below this limit, OPG will assess the recoverability of rebates against future payment amounts.

While a significant portion of OPG's revenue is either fixed or subject to the revenue limit, OPG's revenue is affected by changes in the price of electricity. A \$1/MWh increase in the spot price of electricity above the revenue limit rebate threshold would increase OPG's gross margin by approximately \$16 million while a \$1/MWh decrease below the revenue limit rebate threshold would decrease gross margin by approximately \$25 million.

Increases and decreases in the price of electricity result from changes in other factors such as increases and decreases in the supply and demand for electricity. Therefore, the impact of these other factors together with the impact of the revenue limit rebate mechanism results in an asymmetrical impact on gross margin when the price of electricity increases and decreases.

The percentages of OPG's expected generation, emission requirements and fuel requirements hedged are shown below:

|                                                                                       | 2007 | 2008 | 2009 |
|---------------------------------------------------------------------------------------|------|------|------|
| Estimated generation output hedged <sup>1</sup>                                       | 93%  | 91%  | 70%  |
| Estimated fuel requirements hedged <sup>2</sup>                                       | 99%  | 96%  | 92%  |
| Estimated nitric oxide (NO) emission requirement hedged <sup>3</sup>                  | 100% | 100% | 100% |
| Estimated sulphur dioxide (SO <sub>2</sub> ) emission requirement hedged <sup>3</sup> | 100% | 100% | 100% |

<sup>1</sup> Represents the portion of megawatt hours of expected future generation production, including power purchases, for which the Company has sales commitments and contracts including the obligations under regulated pricing commitments, agreements with the IESO, OPA auction sales and the revenue limit on OPG's non-prescribed assets.

<sup>2</sup> Represents the approximate portion of megawatt hours of expected generation production (and fossil year-end inventory target) from all types of facilities (fossil, nuclear and hydroelectric) for which OPG has entered into some form of contractual arrangements or obligations in order to secure either the expected availability and/or price of fuel and/or fuel related services. Excess fuel in inventories in a given year is attributed to the next year for the purpose of measuring hedge ratios. Since production from hydroelectric facilities is primarily influenced by expected weather and weather patterns, fuel hedge ratios for hydroelectric facilities are assumed to be 100 per cent.

<sup>3</sup> Represents the approximate portion of megawatt hours of expected fossil production for which OPG has purchased, been allocated or granted emission allowances and Emission Reduction Credits to meet OPG's obligations under Ontario Environmental Regulations 397/01.

### *Trading Risk*

Open trading positions are subject to measurement against Value at Risk ("VaR") limits. For a given portfolio, VaR measures the possible future loss (in terms of market value) which, under normal market conditions, will not be exceeded within a defined probability and time period. VaR utilization ranged between \$1.2 million and \$3.4 million during the year ended December 31, 2006, compared to \$0.7 million and \$3.0 million during the year ended December 31, 2005. VaR utilization is closely monitored in order to ensure compliance with approved limits.

Trading liquidity continues to be constrained in Ontario and interconnected markets due to broader energy market fundamentals. In addition, the revenue limit reduces customer exposure to electricity spot market prices and further limits trading activity.

### *Liquidity Risk*

OPG operates in a capital intensive business. Significant financial resources are required to fund capital improvement projects and related maintenance programs at generating stations. In addition, the Company has other significant disbursement requirements including investment in new generating capacity, rebate payments associated with the revenue limit, annual funding obligations under the ONFA, pension funding and continuing debt maturities with the OEFC. A discussion of corporate liquidity is included in the *Liquidity and Capital Resources* section.

## Foreign Exchange and Interest Rate Risk

OPG's foreign exchange exposure is attributable to two primary factors: USD denominated transactions such as the purchase of fossil fuels; and the influence of USD denominated commodity prices on Ontario electricity spot market prices. The magnitude and direction of the exposure to the USD is affected by generation reliability and the price volatility of USD denominated commodities. OPG currently manages its exposure using forwards and various derivative products to periodically hedge its anticipated USD exposures according to approved risk management policies.

OPG has interest rate exposure on its short-term borrowings and investment programs. The majority of OPG's existing debt is at fixed interest rates. Interest rate risk arises with the need to undertake new financing and with the potential addition of variable rate debt. Interest rate risk may be hedged using derivative instruments. The management of these risks is undertaken by hedging the exposure in accordance with corporate risk management policies.

## Credit Risk

For OPG, credit risk exposure is comprised of two major components: the first is derived from its sales of electricity and the second is derived from its purchases of services and products. As the majority of OPG's sales are derived through the IESO administered spot market, OPG management accepts this credit risk due to the IESO's primary role in the Ontario electricity market. This confidence is based on the IESO's own credit risk management policies and practices, which require all spot market participants to meet specific standards for creditworthiness. Additionally, in the event of a participant default, the loss is shared on a pro-rata basis among all participants thus reducing the specific exposure to OPG.

The following table provides information on credit risk from energy sales and trading activities as at December 31, 2006:

| Credit Rating <sup>1</sup> | Number of Counterparties <sup>2</sup> | Potential Exposure for Largest Counterparties            |                          |                                                |
|----------------------------|---------------------------------------|----------------------------------------------------------|--------------------------|------------------------------------------------|
|                            |                                       | Potential Exposure <sup>3</sup><br>(millions of dollars) | Number of Counterparties | Counterparty Exposure<br>(millions of dollars) |
| Investment grade           | 173                                   | 139                                                      | 8                        | 112                                            |
| Below investment grade     | 57                                    | 20                                                       | 2                        | 12                                             |
| IESO <sup>4</sup>          | 1                                     | 385                                                      | 1                        | 385                                            |
| Total                      | 231                                   | 544                                                      | 11                       | 509                                            |

<sup>1</sup> Credit ratings are based on OPG's own analysis, taking into consideration external rating agency analysis where available, as well as recognizing explicit credit support provided through guarantees and letters of credit or other security.

<sup>2</sup> OPG Counterparties are defined by each Master Agreement.

<sup>3</sup> Potential exposure is OPG's assessment of maximum exposure over the life of each transaction at 95 per cent confidence.

<sup>4</sup> Credit exposure to the IESO peaked at \$1,029 million during the year ended December 31, 2006 and at \$1,146 million during the year ended December 31, 2005.

OPG's second element of credit risk relates to the exposures created by companies ("counterparties") who are contracted to provide services or products. OPG manages this risk using a comprehensive credit risk management function that independently evaluates all major counterparties and provides continuous input to business units who acquire these services.

## Strategic Risks

### Regulatory Risk

Effective April 1, 2005, resulting from a regulation passed pursuant to the *Electricity Restructuring Act, 2004* (Ontario) OPG receives regulated prices for most of its baseload hydroelectric facilities and all of the

nuclear facilities that it operates. These prices are expected to remain in effect until at least March 31, 2008. If there are changes to the fundamental assumptions on which these regulated prices were developed, the Province may amend them.

Effective some time after March 31, 2008, the OEB is expected to establish new regulated prices. The process of setting new regulated prices is inherently uncertain. The new prices established by the OEB may not provide for recovery of all of OPG's costs, including an appropriate rate of return. Despite the fact that some costs may not be included within the new prices, these expenditures may still be necessary to maintain the reliability and safety of OPG's regulated generating assets.

The regulation pursuant to the *Electricity Restructuring Act, 2004* (Ontario) also directed OPG to establish variance accounts for capital and non-capital costs incurred and revenues earned or foregone on or after April 1, 2005 that are associated with certain unforeseen circumstances. In addition, the regulation directed OPG to establish a deferral account for non-capital costs incurred on or after January 1, 2005 that are associated with the planned return to service of all units at the Pickering A nuclear generating station, and to establish a deferral account related to certain changes in its liability for nuclear used fuel management and its liability for nuclear decommissioning and low and intermediate level waste management. The accuracy and prudence of any variance account balances that OPG seeks to recover must be demonstrated to the OEB as part of the process to establish new regulated prices expected to be effective after March 31, 2008. The accuracy of recording any deferral account balance related to the changes in the nuclear liabilities that OPG seeks to recover must also be demonstrated to the OEB. In the event that some of the amounts recorded in the variance or deferral accounts are disallowed by the OEB at a future date, the amounts disallowed would be reflected in results of operations in the period that the OEB decision occurs.

Following a consultation process throughout 2006, the OEB has concluded that a limited cost of service form of regulation for OPG is appropriate for establishing prices to be effective on or after April 1, 2008. Under cost of service regulation, a rate application process leads to the implementation of new prices based on the total revenue requirement and forecast production.

The OEB has concluded that the first proceeding to establish new prices should focus on a limited set of issues, specifically the appropriate level of OM&A costs for the regulated facilities, the appropriate rate of return on equity, the recovery of balances in the deferral and variance accounts established under the regulation pursuant to the *Electricity Restructuring Act, 2004* (Ontario), the potential to establish a mechanism to maximize the efficient use of the regulated nuclear facilities operated by OPG, and the impact of the capital expenditures for the Niagara Tunnel project. The OEB has also concluded that while a portion of OPG's production from the regulated hydroelectric facilities will continue to receive the Ontario electricity spot market price as an incentive to encourage the efficient use of these assets, it will review the current threshold of 1,900 MWh in any hour above which spot market prices are received by OPG.

The OEB has stated that its first order for prices is expected to be in effect until December 31, 2009, assuming that the OEB's review of OPG's financial and cost data will accommodate this timeframe. OPG expects to file an application for new prices during 2007. The prices established by the OEB can have significant implications on OPG's future financial performance and operating plans.

The exact timing for establishing new prices to be effective after March 31, 2008 remains uncertain at this time. A delay in the effective date of new prices beyond April 1, 2008 would result in a continuation of current prices. The current prices were established by the Province prior to April 1, 2005, based on financial information available at that time. To the extent that these prices do not reflect current costs and operating plans, this could result in deteriorating financial performance.

#### *Risk to Reputation*

Loss of a company's reputation is a significant risk, and any of the circumstances outlined could affect OPG's reputation. To mitigate this risk, the Company builds goodwill, uses best practices, is committed to sustainability, ensures transparency, practices leading edge corporate governance and communicates

continually with stakeholders. OPG strives to have “no surprises” for stakeholders in order to support its reputation, which is key to achieving the company’s strategies and objectives.

## Other

OPG’s operations are subject to government regulation and direction that may change. Matters that are subject to regulation include: structure of the electricity market, nuclear operations including regulation pursuant to the *Nuclear Safety and Control Act* (Canada), the *Nuclear Liability Act* (Canada) and the *Emergency Plans Act* (Ontario), nuclear waste management and decommissioning, water rentals, environmental matters including air emissions, and proxy tax payments. Because legal requirements can change and are subject to interpretation, OPG is unable to predict the impact of such changes on the Company and its operations.

## RELATED PARTY TRANSACTIONS

Given that the Province owns all of the shares of OPG, related parties include the Province, the other successor entities of Ontario Hydro, including Hydro One Inc. (“Hydro One”), the IESO, and the OEFC. OPG also enters into related party transactions with its joint ventures. The transactions between OPG and related parties are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

These transactions are summarized below:

| <i>(millions of dollars)</i>             | Revenue | Expenses | Revenue | Expenses |
|------------------------------------------|---------|----------|---------|----------|
|                                          | 2006    |          | 2005    |          |
| Hydro One                                |         |          |         |          |
| Electricity sales                        | 34      | -        | 40      | -        |
| Services                                 | -       | 13       | -       | 12       |
| Settlement Transactions                  | -       | -        | -       | 27       |
| Province of Ontario                      |         |          |         |          |
| GRC water rentals and land tax           | -       | 132      | -       | 132      |
| Guarantee fee                            | -       | 8        | -       | 8        |
| Used Fuel Fund rate of return guarantee  | -       | 96       | -       | -        |
| Decommissioning Fund excess funding      | -       | (7)      | -       | 7        |
| OEFC                                     |         |          |         |          |
| GRC and proxy property tax               | -       | 205      | -       | 207      |
| Interest income on receivable            | -       | (29)     | -       | (75)     |
| Interest expense on long-term notes      | -       | 203      | -       | 211      |
| Capital tax                              | -       | 51       | -       | 51       |
| Income taxes                             | -       | 86       | -       | 192      |
| Indemnity fees                           | -       | 2        | -       | 5        |
| IESO                                     |         |          |         |          |
| Electricity sales                        | 5,029   | 146      | 6,517   | 329      |
| Market Power Mitigation Agreement rebate | -       | -        | (412)   | -        |
| Revenue limit rebate                     | (161)   | -        | (739)   | -        |
| Ancillary services                       | 132     | -        | 68      | -        |
| Other                                    | 1       | 1        | -       | -        |
|                                          | 5,035   | 907      | 5,474   | 1,106    |

At December 31, 2006, accounts receivable included \$8 million (2005 – \$14 million) due from Hydro One and \$71 million (2005 – \$324 million) due from the IESO. Accounts payable and accrued charges at December 31, 2006 included \$2 million (2005 – \$2 million) due to Hydro One.

## **CORPORATE GOVERNANCE**

National Instrument 58-101 – Disclosure of Corporate Governance Practices has been implemented by Canadian securities regulatory authorities to provide greater transparency for the marketplace regarding issuers' corporate governance practices.

### **Board of Directors and Directorships**

OPG's Board of Directors is made up of individuals with substantial expertise in managing and restructuring large businesses, managing and operating nuclear stations, managing capital intensive companies, and overseeing regulatory, government and public relations. The Board exercises its independent supervision over management as follows: the majority of members of the Board are independent of the Company; meetings of the Board are held at least six times a year; a formal Charter for the Board and for each Board Committee has been adopted; each Board Committee is chaired by an independent director; and a portion of each Board and Committee meeting is reserved for directors to meet without management present.

The following are the directors of OPG as at December 31, 2006.

#### *Jake Epp*

Calgary, Alberta, Canada

Jake Epp was appointed as Chairman of Ontario Power Generation Inc. in April 2004. He held the position of interim Chairman from December 2003 until his current appointment. Jake Epp was a member of the provincial government's review committee that was created in December 2003 and headed by John Manley to look at OPG's future role in the province's electricity market; examine its corporate and management structure; and decide whether OPG should go ahead with refurbishing three more nuclear reactors at the Pickering A nuclear power plant. The committee's report was presented to the government in March 2004. In May 2003, he was appointed by the Ontario government to lead a panel to review the delays and cost overruns at the Pickering A nuclear generating station. The findings of the report were released in December 2003. He is also certified by the Institute of Corporate Directors.

Mr. Epp's principal occupation is the Chairman of the Board of Directors of Ontario Power Generation Inc., and he serves as a director of QHR Technologies Inc., which is a reporting issuer.

#### *James F. Hankinson*

Toronto, Ontario, Canada

James Hankinson was appointed as President and Chief Executive Officer of Ontario Power Generation in May 2005. He has broad management experience in energy, transportation, resource and manufacturing-based businesses. He served as President and Chief Executive Officer of New Brunswick Power Corporation from 1996 to 2002, and during that time had a significant impact on improving the operational and financial position of the company. In 1973, he joined Canadian Pacific Limited, and served as Chief Operating Officer from 1990 to 1995. A chartered accountant, Mr. Hankinson has a Master of Business Administration from McMaster University, and an Honourary Doctor of Laws degree from Mount Allison University. He also sits on the boards of CAE Inc. and Maple Leaf Foods Inc.

Mr. Hankinson's principal occupation is President and Chief Executive Officer, Ontario Power Generation Inc., and he serves as a director for the two reporting issuers CAE Inc. and Maple Leaf Foods Inc.

#### *Donald Hintz*

Punta Gorda, Florida, U.S.A.

Donald Hintz is the retired President of Entergy Corporation, where he was responsible for Entergy's 30,000 megawatts of generating assets, including 10 nuclear plants. Prior to his appointment as President he spent seven years as President and CEO of Entergy Operations Inc. where he oversaw the improvement of Entergy's nuclear operations to top quartile performance. Mr. Hintz currently serves on the Board of Entergy Corp. He has a Bachelor of Science in Chemical Engineering from the University of

Wisconsin, and has completed the Utility Executive Program and the Advanced Management Program at the University of Michigan and the Harvard Business School, respectively.

Mr. Hintz's principal occupation is retired President of Entergy Corporation and he serves as a director of Entergy Corporation, which is a reporting issuer.

*Gary Kugler*  
Burlington, Ontario, Canada

Dr. Gary Kugler is the retired Senior Vice President, Nuclear Products and Services of Atomic Energy of Canada, Limited (AECL), where he was responsible for all of AECL's commercial operations, including nuclear power plant sales and services worldwide. During his 34 years with AECL, he also held various technical, project management, and business development positions. Prior to joining AECL, he served as a pilot in the Canadian Air Force. Dr. Kugler currently serves as Chairman of the Nuclear Waste Management Organization's Board of Directors. He holds a Bachelor of Science degree in honours physics and a Ph.D. in nuclear physics from McMaster University.

Dr. Kugler's principal occupation is Chairman, Nuclear Waste Management Organization.

*M. George Lewis*  
Toronto, Ontario, Canada

George Lewis is Chairman and Chief Executive Officer of RBC Asset Management Inc. Mr. Lewis is also Executive Vice President, Wealth Management for the Personal and Business Canada division of RBC FG, Canada's largest bank. Formerly he was Managing Director, Head of Institutional Equity Sales, Trading and Research with RBC Capital Markets and was Canada's top-rated analyst for three consecutive years. He has extensive experience in the investment industry and has a Master of Business Administration degree with distinction from Harvard University, a Bachelor of Commerce degree with high distinction from Trinity College at the University of Toronto and is a chartered financial analyst and chartered accountant. He has also been certified by the Institute of Corporate Directors.

Mr. Lewis' principal occupation is Chairman and Chief Executive Officer of RBC Asset Management Inc.

*David J. MacMillan*  
Barnes, London, United Kingdom

David MacMillan is Non-Executive Director of InterGen N.V., and has extensive international experience in power projects and financing. He is also a former Director of Killingholme Power Limited. Mr. MacMillan holds a Bachelor of Arts and a Master of Arts in Economics from McGill University.

Mr. MacMillan's principal occupation is Financial Advisor.

*Corbin A. McNeill Jr.*  
Jackson, Wyoming, U.S.A.

Corbin McNeill is the retired Chairman and Co-Chief Executive Officer of Exelon Corporation, which was formed by the merger of PECO Energy and Unicom Corp. He joined PECO in 1988 as Executive Vice President, Nuclear and went on to become Chairman, President and CEO. Prior to PECO, he oversaw nuclear operations at the Public Service Electric and Gas Company and the New York Power Authority. Mr. McNeill currently serves as a Director of Owens-Illinois, Inc. and Portland General Electric. He has a Bachelor of Science degree from the U.S. Naval Academy and has completed the Executive Management Program at Stanford University.

Mr. McNeill's principal occupation is retired Chairman and Co-Chief Executive Officer of Exelon Corporation, and he serves as a director for the two reporting issuers Owens-Illinois, Inc. and Portland General Electric Company.

*Peggy Mulligan*  
Mississauga, Ontario, Canada

Peggy Mulligan is Executive Vice President and Chief Financial Officer of Linamar Corporation. Prior to her current appointment, Mrs. Mulligan was with the Bank of Nova Scotia for eleven years as Executive Vice President, Systems and Operations and Senior Vice President, Audit and Chief Inspector. Before joining Scotiabank, she was an Audit Partner with PricewaterhouseCoopers in Toronto. Mrs. Mulligan holds a Bachelor of Mathematics (Honours) from the University of Waterloo. She was named an FCA by the Institute of Chartered Accountants of Ontario in 2003.

Mrs. Mulligan's principal occupation is Chief Financial Officer, Linamar Corporation, and she serves as a director of Resolve Business Outsourcing Income Fund, which is a reporting issuer.

*C. Ian Ross*  
Collingwood, Ontario, Canada

Ian Ross served at the Richard Ivey School of Business at the University of Western Ontario from 1997 to September 2003. Most recently he held the position of Senior Director, Administration in the Dean's Office, and was also Executive in Residence for the School's Institute for Entrepreneurship, Innovation and Growth. He has served as Governor and President and CEO of Ortech Corporation; Chairman, President and CEO of Provincial Papers Inc.; and President and CEO of Paperbound Industries Corp. Mr. Ross currently serves as a Director for a number of corporations including World Heart Corporation, GrowthWorks Canadian Fund Ltd., PetValu Canada Inc., Comcare Health Services and eJust Systems (formerly Praeda Managements Systems). He is also a member of the Law Society of Upper Canada.

Mr. Ross's principal occupation is Chairman of GrowthWorks Canadian Fund Ltd. and he serves as a director for the following reporting issuers: GrowthWorks Canadian Fund Ltd., PetValu Canada Inc., and World Heart Corporation.

*Marie C. Rounding*  
Toronto, Ontario, Canada

Marie Rounding is a lawyer with Gowling Lafleur Henderson LLP. She is the former President and Chief Executive Officer of the Canadian Gas Association (CGA) and served as Chair of the Ontario Energy Board (OEB) from 1992 to 1998. She has extensive background in regulatory and administrative law, and as a leading regulator she was involved in the deregulation of the natural gas markets and the early restructuring of the electricity sector in Ontario. Ms. Rounding is a graduate of the University of Western Ontario and Osgoode Hall Law School.

Ms. Rounding's principal occupation is Counsel of Gowling Lafleur Henderson LLP.

*William Sheffield*  
Toronto, Ontario, Canada

William Sheffield is the former Chief Executive Officer of Sappi Fine Paper plc., and a former Executive Vice President of International Operations and Corporate Development at Abitibi Consolidated. He has experience in operating large international industries. Mr. Sheffield also spent 17 years with Stelco. He currently serves on the Boards of Velan Inc., Canada Post, Houston Wire & Cable Company and Corby Distilleries. Mr. Sheffield has a Bachelor of Science in Chemistry from Carleton University, a Master of Business Administration from McMaster University, completed the Advanced Management Program at INSEAD School of Business, France and is certified by the Institute of Corporate Directors.

Mr. Sheffield's principal occupation is Corporate Director, and he serves as a director for the following reporting issuers: Corby Distilleries Ltd., Houston Wire & Cable Company and Velan Inc.

David G. Unruh  
Vancouver, British Columbia, Canada

David Unruh is a retired lawyer and energy business executive, currently serving as a director of Westcoast Energy Inc. and Union Gas Limited, both Duke Energy companies. Mr. Unruh is also a director of Catalyst Paper Corporation, Pacific Northern Gas Inc., Corriente Resources Inc., The Wawanesa Mutual Insurance Company, and Canada Line Rapid Transit Inc. Prior to this, Mr. Unruh served as Vice Chairman of Westcoast Energy Inc. and Union Gas Limited, before that as Senior Vice President and General Counsel for Houston-based Duke Energy Gas Transmission and before that as Senior Vice President, Law and Corporate Secretary of Westcoast Energy Inc. Mr. Unruh practiced corporate and commercial law in Winnipeg, Manitoba before joining Westcoast Energy Inc. in Vancouver, British Columbia in 1993.

Mr. Unruh's principal occupation is Corporate Director, and he serves as a director for the following reporting issuers: Catalyst Paper Corporation, Union Gas Limited, Corriente Resources Inc., Westcoast Energy Inc., and Pacific Northern Gas Ltd.

The following lists the membership duration on the Board and Board Committees for each director of OPG. Each director's corresponding attendance at Board and Board Committee meetings for 2006 is disclosed:

| Director           | Board and Board Committees membership                                                                                                                       | 2006 Attendance |      |
|--------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------|------|
| Jake Epp           | Board<br>(since December 2003)                                                                                                                              | 10/10           | 100% |
|                    | Compensation and Human Resources Committee<br>(since November 2004)                                                                                         | 6/6             | 100% |
|                    | Governance and Nominating Committee<br>(since August 2005)                                                                                                  | 6/6             | 100% |
|                    | Nuclear Generation Projects Committee<br>(since November 2006)                                                                                              | 1/1             | 100% |
|                    | The Board Chair is invited to attend all other<br>committee meetings                                                                                        | 22/22           | 100% |
| James F. Hankinson | Board<br>(since December 2003)                                                                                                                              | 9/10            | 90%  |
|                    | The President and CEO is invited to attend all<br>committee meetings with the exception of select<br>Compensation and Human Resources Committee<br>meetings | 31/34           | 91%  |
| Donald Hintz       | Board<br>(since October 2004)                                                                                                                               | 8/10            | 80%  |
|                    | Compensation and Human Resources Committee<br>(since November 2004)                                                                                         | 5/6             | 83%  |
|                    | Nuclear Operations Committee*<br>(since November 2004)                                                                                                      | 6/6             | 100% |
|                    | Nuclear Generation Projects Committee<br>(since November 2006)                                                                                              | 1/1             | 100% |

| Director              | Board and Board Committees membership                           | 2006 Attendance |      |
|-----------------------|-----------------------------------------------------------------|-----------------|------|
| Gary Kugler           | Board<br>(since September 2004)                                 | 10/10           | 100% |
|                       | Audit/Risk Committee<br>(since November 2004)                   | 6/6             | 100% |
|                       | Governance and Nominating Committee<br>(since August 2005)      | 6/6             | 100% |
|                       | Nuclear Operations Committee<br>(since November 2004)           | 6/6             | 100% |
|                       | Nuclear Generation Projects Committee<br>(since November 2006)  | 1/1             | 100% |
|                       |                                                                 |                 |      |
| M. George Lewis       | Board<br>(since February 2005)                                  | 9/10            | 90%  |
|                       | Audit/Risk Committee*<br>(since February 2005)                  | 6/6             | 100% |
|                       | Investment Funds Oversight Committee*<br>(since March 2005)     | 2/2             | 100% |
|                       |                                                                 |                 |      |
| David J. MacMillan    | Board<br>(since September 2004)                                 | 10/10           | 100% |
|                       | Nuclear Operations Committee<br>(since November 2004)           | 6/6             | 100% |
|                       | Major Projects Committee*<br>(since November 2004)              | 8/8             | 100% |
|                       |                                                                 |                 |      |
| Corbin A. McNeill Jr. | Board<br>(since October 2004)                                   | 10/10           | 100% |
|                       | Governance and Nominating Committee*<br>(since August 2005)     | 5/6             | 83%  |
|                       | Investment Funds Oversight Committee<br>(since May 2005)        | 2/2             | 100% |
|                       | Nuclear Operations Committee<br>(since November 2004)           | 6/6             | 100% |
|                       | Nuclear Generation Projects Committee*<br>(since November 2006) | 1/1             | 100% |
|                       |                                                                 |                 |      |
| Peggy Mulligan        | Board<br>(since December 2005)                                  | 8/10            | 80%  |
|                       | Audit/Risk Committee<br>(since February 2006)                   | 5/6             | 83%  |
|                       |                                                                 |                 |      |
| C. Ian Ross           | Board<br>(since December 2003)                                  | 10/10           | 100% |
|                       | Audit/Risk Committee<br>(since November 2004)                   | 6/6             | 100% |
|                       | Governance and Nominating Committee<br>(since August 2005)      | 6/6             | 100% |
|                       | Major Projects Committee<br>(since November 2004)               | 8/8             | 100% |
|                       | Nuclear Generation Projects Committee<br>(since November 2006)  | 1/1             | 100% |
|                       |                                                                 |                 |      |

| Director          | Board and Board Committees membership                               | 2006 Attendance |      |
|-------------------|---------------------------------------------------------------------|-----------------|------|
| Marie C. Rounding | Board<br>(since September 2004)                                     | 10/10           | 100% |
|                   | Compensation and Human Resources Committee<br>(since November 2004) | 6/6             | 100% |
|                   | Investment Funds Committee<br>(since May 2005)                      | 2/2             | 100% |
|                   | Major Project Committee<br>(since November 2004)                    | 8/8             | 100% |
|                   |                                                                     |                 |      |
| William Sheffield | Board<br>(since September 2004)                                     | 10/10           | 100% |
|                   | Compensation and Human Resources Committee*                         | 6/6             | 100% |
|                   | Investment Funds Oversight Committee<br>(since February 2005)       | 2/2             | 100% |
|                   | Major Projects Committee<br>(since November 2004)                   | 8/8             | 100% |
|                   |                                                                     |                 |      |
| David G. Unruh    | Board<br>(since September 2004)                                     | 10/10           | 100% |
|                   | Compensation and Human Resources Committee<br>(since November 2004) | 6/6             | 100% |
|                   | Audit/Risk Committee<br>(since November 2004)                       | 6/6             | 100% |
|                   | Major Projects Committee<br>(since December 2004)                   | 8/8             | 100% |
|                   |                                                                     |                 |      |

\* Chair of Committee

All directors listed are independent within the meaning of section 1.4 of Multilateral Instrument 52-110 ("MI 52-110") except for James F. Hankinson who is the President and Chief Executive Officer ("CEO") of OPG and Gary Kugler who is the Chairman of the Nuclear Waste Management Organization.

### Orientation and Continuing Education

Directors participate in a range of orientation initiatives when they join the OPG Board:

- Directors receive an overview of relevant documentation arising from a new director's election to the Board;
- Directors are provided a Director's Handbook, which provides an overview of the Board's constitution and governance practices, including Shareholder Agreements, Board and Committee Charters, Director roles and responsibilities, Board and Committee chair position descriptions, Board approved corporate policies and Code of Conduct, Director and Officer indemnities and insurance, Board and Committee evaluations, and recent Board activity;
- Directors attend a comprehensive introductory briefing session on OPG's operations and business; and
- Plant tours are provided of OPG generating facilities.

The Board supports the continuing education of directors, in both the business of OPG and their duties as directors, in a number of ways:

- Special presentations are made to the Board or a Committee on specific or unique aspects of OPG's operations, for example, OPG hedging activities and controls, and nuclear waste management;

- Approximately every other Board meeting is preceded by a Board education session. Suggestions for director education sessions are submitted to the Chair of the Governance and Nominating Committee;
- Plant tours to major facilities are arranged in conjunction with director orientation sessions as well as the holding of Board meetings at OPG facilities;
- OPG sponsors director attendance at the Institute of Corporate Directors/Rotman Business School Director College, or equivalent; and
- OPG also provides support to directors for attendance at conferences related to OPG's business or continuing education sessions related to their responsibilities as directors.

### **Ethical Business Conduct**

OPG has a policy for ethical business behaviour and a Code of Business Conduct, which is approved by the Board. The Audit/Risk Committee Charter expressly includes regular reporting by Management on the Code of Business Conduct, including reports on substantiated cases of fraud and the disposition of such cases including disciplinary action. The Audit/Risk Committee also receives an annual report on the Code of Business Conduct in order to satisfy itself that appropriate codes of conduct and compliance programs are in place and are being enforced and remedial action is being taken. A copy of OPG's Code of Business Conduct has been filed on SEDAR ([www.sedar.com](http://www.sedar.com)). The Audit/Risk Committee has also established procedures for the receipt, retention and treatment of complaints received pertaining to internal accounting controls or auditing; matters and the confidential anonymous submission by employees concerning such matters.

The Board has adopted an annual process of written disclosure by directors of information in order to: (i) identify potential conflicts of interest for the purposes of complying with the Ontario Business Corporations Act; (ii) validate their independence and financial literacy for the purposes of complying with securities regulations related to Boards and Audit Committees; and (iii) satisfy other disclosures and filings.

### **Nomination of Directors**

The Governance and Nominating Committee's responsibilities are to: (i) develop and maintain a list of optimum skills which the Board should collectively possess; (ii) recommend a process to identify director candidates; (iii) recommend selection criteria; (iv) identify director candidates to the Board; and (v) recommend to the Board the candidates to stand for election. The Board submits recommended candidates to the Shareholder. Nominations of directors by the Shareholder are also reviewed by the Governance and Nominating Committee.

The Board consists of 12 directors.

### **Compensation**

#### *Director Compensation*

In the spring of 2005, the Compensation and Human Resources Committee of the Board retained an independent advisor to benchmark OPG director compensation against companies of similar size, business complexity and risk profile. The Compensation and Human Resources Committee submitted its recommendations for director compensation to the Board for approval. The Board Chair subsequently informed the Shareholder. For 2006, the Governance and Nominating Committee assumed responsibility for annually monitoring and reviewing the level and nature of compensation of directors. Based on the extensive review in 2005 and updated benchmarking, the Governance and Nominating Committee recommended that no change be made to the compensation of directors, with the exception of an increase in the annual retainer for the Audit/Risk Committee chair to ensure that it is both appropriate to the responsibilities and risks assumed, and competitive with other comparable organizations.

Each director who is not an employee of OPG receives an annual retainer of \$25,000. Directors also receive a \$3,000 annual retainer to chair committees and for each committee that they are a member of. In recognition of the increased duties and responsibilities placed upon the chair of the Audit/Risk Committee as a result of recent regulatory initiatives in North America, the annual retainer for the Audit/Risk Committee chair is \$8,000.

Directors are compensated for each meeting that they attend and receive a fee of \$1,500 or \$750, as determined by the board or committee chair.

In order to retain national and international expertise, non-resident directors are compensated in USDs exchanged at par and directors who travel long distances receive a travel fee to cover travel time related to board and committee meetings they attend.

Directors are also reimbursed for travel and other expenses they incur to attend meetings or to perform other duties in their role as a director.

The chair of the board in his role as non-executive chair receives an all-inclusive annual fee of \$150,000 and is reimbursed for out of pocket expenses including travel and other expenses.

### *CEO Compensation*

The Compensation and Human Resources Committee of the Board oversees, on behalf of the Board, the setting of the CEO's annual goals and objectives and the annual review of the CEO's performance, and makes recommendations to the Board with respect to the CEO's compensation. The Compensation and Human Resources Committee seeks input from an independent advisor with regard to monitoring and benchmarking compensation developments.

During 2006, the Compensation and Human Resources Committee of the Board retained an independent advisor from Mercer Human Resource Consulting, to benchmark the compensation package for the President and CEO and to confirm that the compensation package is appropriate given the nature, complexity and risk profile of OPG's business. The Compensation and Human Resources Committee submitted its recommendation to the Board for approval. The Board Chair subsequently informed the Shareholder.

OPG is subject to the *Public Sector Salary Disclosure Act* and is obligated to report salaries over \$100,000. For purposes of applying the Act, salaries include bonuses and taxable benefits actually received during that year as reported for personal income tax purposes. Consistent with this reporting requirement, the President and Chief Executive Officer received compensation of \$1,488,123, including taxable income and taxable benefits during 2006.

### **Board Committees**

The Board has established seven committees to focus on areas critical to the Company:

#### *Audit/Risk Committee*

The Committee is responsible for reviewing the Company's regulatory filings including financial statements, MD&A, and press releases prior to their disclosures to the public. The Committee is also responsible for overseeing the internal audit function, the work of external auditors including their nomination and compensation, that the Company has adequate controls in the financial reporting process and the risk management process, and is in compliance with regulatory and internal policies. The Committee is also responsible for overseeing OPG's policy on ethical behaviour and the Code of Business Conduct, including reports on compliance programs, substantiated cases of fraud and the disposition of such cases including disciplinary action.

### *Compensation and Human Resources Committee*

This Committee focuses on human resources related areas including compensation practices, CEO objectives and compensation, disclosure on compensation and human resources matters, leadership talent review including succession planning, human resources policies related to employee complaints, diversity and pay equity, organizational design, labour relations, pension plans and policies, and Board compensation, education and evaluation programs.

### *Governance and Nominating Committee*

The Committee develops governance principles for OPG that are consistent with high standards of corporate governance and reviewing and assessing on an ongoing basis OPG's system of corporate governance with a view to maintaining these high standards. The Committee identifies and recommends candidates for election or appointment to the Board to be put before the Shareholder in the event of a vacancy on the Board. Finally, the Committee reviews and recommends OPG's processes for director orientation, assessment, and compensation.

### *Investment Funds Oversight Committee*

This Committee assists the Board in fulfilling its responsibilities for the OPG Pension Fund and the Used Fuel Fund and Decommissioning Fund. The Committee provides oversight of the investment of assets, investment-related liabilities and the management of any surplus (deficit) of the funds. Specifically the Committee: reviews the investment policies, risks and the asset mix; approves annual performance objectives for the investment portfolios; and monitors the performance of the funds.

### *Major Projects Committee*

This Committee assists the Board in providing oversight of major non-nuclear electricity supply projects, including project development, contracting, financing, and construction monitoring.

### *Nuclear Generation Projects Committee*

This Committee was formed in 2006 following direction from the Shareholder to: (i) begin feasibility studies on refurbishing its existing nuclear units; and (ii) begin a federal approvals process, including an environmental assessment, for new nuclear units at an existing site. This Committee assists the Board in providing oversight of the new nuclear plant projects and the refurbishment and life extension projects for existing nuclear plants.

### *Nuclear Operations Committee*

This Committee is responsible for oversight of safe and efficient operations of OPG's nuclear business, regulatory compliance of OPG's nuclear facilities, review of reports from independent oversight of OPG's nuclear operations, reviews of OPG's nuclear management and organization matters, security of OPG's nuclear facilities and substances, and oversight of OPG's nuclear waste and decommissioning liabilities and management.

## **Assessments**

The annual Board & Committee Evaluation is based upon the completion of confidential questionnaires regarding assessment of its performance and the compliance with the Board and Committee Charters. In October 2006, the Governance and Nominating Committee began the process for evaluating Board performance, in addition to Committee Evaluations. The annual process is overseen by the Chair of the Governance and Nominating Committee, who reports the results and recommendations for enhancing oversight to the Board. The Board will begin to assess individual directors in the 2007 evaluation process.

## **Further Information on OPG Governance**

OPG provides additional information on OPG's governance on its Web site ([www.opg.com](http://www.opg.com)) including:

- Memorandum of Understanding
- Shareholder Directives
- Board and Committee Charters
- Board and Committee Chair Position Descriptions
- Code of Business Conduct Policy
- Disclosure Policy

## **AUDIT/RISK COMMITTEE INFORMATION**

MI 52-110 has been implemented by Canadian securities regulatory authorities to encourage reporting issuers to establish and maintain strong, effective and independent audit committees, which enhance the quality of financial disclosure and ultimately foster increased investor confidence in Canada's capital markets. Information on OPG's Audit/Risk Committee, which includes the text of the Audit/Risk Committee Charter, updated during 2006, is as follows:

### **Audit/Risk Committee Charter**

#### *Purpose*

The purpose of the Audit/Risk Committee (the "Committee") is to assist the Board in fulfilling its oversight responsibilities by reviewing, advising and making recommendations to the Board on:

- The integrity, quality and transparency of the Company's financial information;
- The adequacy of the financial reporting process;
- The systems of internal controls and risk management, and the Company's related principles, policies and procedures which Management have established;
- The performance of the Company's internal audit function and the external auditors;
- The external auditors' qualifications and independence;
- The Company's compliance with related legal and regulatory requirements and internal policies; and
- The promotion of a culture of ethical business conduct and compliance with OPG's Code of Business Conduct.

The function of the Audit/Risk Committee is oversight. Management is responsible for the preparation, presentation and integrity of the consolidated financial statements of the Company. Management of the Company is responsible for maintaining appropriate accounting and financial reporting principles and policy and internal controls and procedures that provide for compliance with accounting standards and applicable laws and regulations.

#### *Organization*

#### Members

The Audit/Risk Committee shall consist of three or more independent directors appointed by the Board of Directors, none of whom shall be employees of the Company or any of the Company's affiliates. A majority of the members of the Committee, but not less than two, will constitute a quorum. As a venture issuer, OPG is exempt from the statutory requirements of MI 52-110 requiring members of Audit Committees to be independent. However, OPG considers such independence to be "best practice" and, therefore, each of the members of the Audit/Risk Committee shall satisfy the applicable independence and financial literacy requirements of the laws and regulations governing the Company.

The Board of Directors shall designate one member of the Audit/Risk Committee as the Committee Chair. Members of the Audit/Risk Committee shall serve at the pleasure of the Board of Directors for such term or terms as the Board of Directors may determine. The Board of Directors shall confirm that each member of the Audit/Risk Committee is financially literate as such qualification is interpreted by the Board of Directors in its business judgment and in compliance with MI 52-110 and its Companion Policy.

#### Meetings

The Committee will meet at least quarterly or more frequently as circumstances require and at any time at the request of a member. The Committee will meet regularly and at least annually with the external auditors, the internal auditors and Management in separate sessions to discuss any matters that the Committee believes should be discussed and to provide a forum for any relevant issues to be raised.

#### Reports

The Committee will report its activities and actions to the Board of Directors with recommendations, as the Committee deems appropriate.

The Committee will provide for inclusion in the Company's financial information or regulatory filings any report from the Audit/Risk Committee required by applicable laws and regulations and stating among other things whether the Audit/Risk Committee has:

- Reviewed and discussed the audited consolidated financial statements with Management;
- Discussed pertinent matters with the internal and external auditors;
- Received disclosures from the external auditors regarding the auditors' independence and discussed with the auditors their independence; and
- Recommended to the Board of Directors that the audited consolidated financial statements be included in the Company's Annual Report.

#### *Authority*

While the Audit/Risk Committee has the responsibilities and powers set forth in this Charter, it is not the duty of the Audit/Risk Committee to plan or conduct audits or risk assessments, or to determine that the Company's consolidated financial statements and disclosures are complete and accurate and are in accordance with generally accepted accounting principles and applicable rules and regulations. These are the responsibility of Management.

In carrying out its oversight responsibilities, the Audit/Risk Committee and the Board will necessarily rely on the expertise, knowledge and integrity of the Company's Management, and internal and external auditors.

The Audit/Risk Committee shall have the authority to set and pay the compensation for any advisors employed by the Committee.

The Audit/Risk Committee shall have the authority to communicate directly with the internal and external auditors.

#### Delegation of Authority

The Committee may delegate to any employee of OPG or a sub-committee the authority to: (i) execute or carry out any decision of the Committee; and/or (ii) exercise any right, power or function of the Committee on such terms and conditions and within such limits as the Committee may establish, except that the Committee may not delegate its oversight responsibilities.

### Access to Management and Outside Advisors

The Audit/Risk Committee shall have unrestricted access to members of Management and relevant information. The Audit/Risk Committee may retain independent counsel, accountants or other advisors to assist it in the conduct of any investigation, as it determines necessary to carry out its duties.

### *Committee Responsibilities and Duties*

The Committee shall:

#### General

- Conduct or authorize investigations into any matters within the Committee's scope of responsibilities;
- Review and recommend approval to the Board, the appointment or replacement of the CFO and the CRO.

#### Risk Management and Internal Controls

- Review and evaluate the Company's policies and processes for assessing significant risks or exposures and the steps Management has taken to monitor and control such risks to the Company, including the organizational structure and the adequacy of resources;
- Consider and review with the CRO and Management the critical risks to the Company, the potential impact of such risks, and related mitigation;
- Ascertain whether the Company has an effective process for determining risks and exposure from actual and potential litigation and claims relating to non-compliance with laws and regulations;
- Review with Management, reports demonstrating compliance with risk management policies;
- Review with the Company's General Counsel and others any legal, tax, or regulatory matters that may have a material impact on Company operations and the financial statements, including, but not limited to, violations of securities law or breaches of fiduciary duty;
- Review with Management, internal audit, and the external auditors, the scope of review of internal control over financial reporting, significant findings, recommendations and Management's responses for implementation of actions to correct weaknesses in internal controls;
- Review disclosures made by the CEO and CFO during the certification process regarding significant deficiencies in the design or operation of internal controls or any fraud that involves Management or other employees who have a significant role in the Company's internal controls; and
- Review the expenses of the Chairman, Board, President and the President's direct reports on a semi-annual basis, and of any other senior officers and employees the Committee considers appropriate.

#### Internal Audit

- Evaluate the internal audit process and define expectations in establishing the annual internal audit plan and the focus on risk, including the organizational structure and the adequacy of resources;
- Approve the Charter of the internal audit function annually;
- Evaluate the audit scope and role of internal audit; and
- Consider and review with the CRO and Management:
  - Significant findings and Management's response including the timetable for implementation of Management Actions to correct weaknesses;
  - Any difficulties encountered in the course of their audit (such as restrictions on the scope of their work or access to information);
  - Any changes required in the planned scope of the audit plan; and
  - The internal audit budget.

### External Auditor

- Recommend to the Board of Directors the external auditor to be nominated for the purpose of preparing or issuing an auditor's report or performing other audit, review or attest services for the Company, and the compensation of the external auditor;
- Oversee the work of the external auditor engaged for the purpose of preparing or issuing an auditor's report or performing other audit, review or attest services for the Company, including the resolution of disagreements between Management and the external auditor regarding financial reporting;
- Review the independence and qualifications of the external auditor;
- At least annually, obtain and review a report by the external auditor describing the auditing firm's internal quality control procedures, any material issues raised by the most recent internal quality control review or peer review of the auditing firm or by any inquiry or investigation by governmental or professional authorities within the preceding five years respecting one or more independent audits carried out by the external auditor and any steps taken to deal with any such issues and all relationships between the external auditors and the Company;
- Review the scope and approach of the annual audit plan with the external auditors;
- Discuss with the external auditor the quality and acceptability of the Company's accounting principles including all critical accounting policies and practices used, any alternative treatments that have been discussed with Management as well as any other material communications with Management;
- Assess the external auditor's process for identifying and responding to key audit and internal control risks;
- Ensure the rotation of the lead audit partner every five years and other audit partners every seven years, and consider regular rotation of the audit firm;
- Evaluate the performance of the external auditor annually and present its findings to the Board of Directors;
- Determine which non-audit services the external auditor is prohibited by law or regulation, or as determined by the Audit/Risk Committee, from providing and pre-approve all services provided by the external auditors. The Committee may delegate such pre-approval authority to a member of the Committee. The decision of any Committee member to whom pre-approval authority is delegated must be presented to the full Audit/Risk Committee at its next scheduled meeting;
- Review and approve all related party transactions; and
- Review and approve the Company's hiring policies regarding partners, employees and former partners and employees of the present and former external auditor of the Company.

### Financial Reporting

- Review with Management and the external auditors the Company's interim financial information and disclosures under MD&A and earnings press release, prior to filing;
- Satisfy itself that adequate procedures are in place for the review of the Company's public disclosure of financial information extracted or derived from the Company's consolidated financial statements, other than the public disclosure referred to above, and periodically assess the adequacy of those procedures;
- Review with Management and the external auditors, at the completion of the annual audit:
  - The Company's annual financial statements, MD&A, related footnotes and any documentation required by the Securities Act to be prepared and filed by the Company or that the Company otherwise files with the OSC;
  - The external auditors' audit of the consolidated financial statements and their report;
  - Any significant changes required in the external auditors' audit plan;
  - Any difficulties or disputes with Management encountered during the audit;
  - The Company's accounting principles; and
  - Other matters related to conduct, which should be communicated to the Committee under generally accepted auditing standards.
- Review significant accounting and reporting issues and understand their impact on the consolidated financial statements. These include complex or unusual transactions and highly judgmental areas; major issues regarding accounting principles and financial presentations, including significant changes in the Company's selection or application of accounting principles; and the effect of

regulatory and accounting initiatives, as well as off-balance sheet arrangements, on the consolidated financial statements of the Company;

- Review analysis prepared by Management and/or the external auditor detailing financial reporting issues and judgments made in connection with the preparation of financial information, including analysis of the effects of alternative Generally Accepted Accounting Principles methods; and
- Advise Management, based upon the Audit/Risk Committee's review and discussion, whether anything has come to the Committee's attention that causes it to believe that the consolidated financial statements contain an untrue statement of material fact or omit to state a necessary material fact.

#### Compliance with Code of Business Conduct

- Review the administration of and compliance with the Company's Code of Business Conduct to ensure that appropriate codes of conduct and compliance programs are in place, are being enforced and remedial action is being taken, as well as the process for communicating the Code of Business Conduct to Company personnel; and
- Monitor through regular updates from Management regarding compliance matters.

#### Treatment of Complaints

- Establish procedures for the receipt, recording and treatment of complaints received by the Company regarding accounting, internal accounting controls, or auditing matters; and
- Establish procedures for the confidential and anonymous submission by employees of concerns regarding accounting or auditing matters of the Company.

#### *Annual Review and Assessment*

The Committee shall conduct an annual review and assessment of its performance, including a review of its compliance with this Charter, in accordance with the evaluation process approved by the Board.

The Committee shall also review and assess the adequacy of this Charter on an annual basis taking into account all legislative and regulatory requirements applicable to the Committee as well as any best practice guidelines recommended by regulators with whom OPG has a reporting relationship, and if appropriate, shall recommend changes to the Board.

#### **Composition of the Audit/Risk Committee**

OPG's Audit/Risk Committee consists of George Lewis, Dr. Gary Kugler, Peggy Mulligan, Ian Ross, and David Unruh. As a venture issuer, OPG is exempt from the provisions of securities regulations, which require that members of an Audit Committee be independent and financially literate. OPG's Board of Directors has, however, decided that, in keeping with best practice, each member of OPG's Audit/Risk Committee should meet the independence and financial literacy requirements in accordance with the requirements of the securities regulations known as MI 52-110. The Board of Directors has concluded that all of the members of OPG's Audit/Risk Committee are financially literate and that four of the five members of the Committee are independent of OPG and its subsidiaries, within the meaning of MI 52-110.

Dr. Kugler does not meet the statutory definition of being independent as a result of being the Chairman of the Nuclear Waste Management Organization (the "NWMO"), a not-for-profit organization of which New Brunswick Power, Hydro-Québec and OPG are members. Dr. Kugler was appointed to the NWMO Board by OPG and was subsequently appointed Chairman by the NWMO Board. The NWMO has been established under the *Nuclear Fuel Waste Act* to investigate approaches for managing Canada's used nuclear fuel and implement the approach that is selected by the government. OPG plays a significant role in the funding and leadership of the NWMO, which results in Dr. Kugler no longer being independent of OPG, according to MI 52-110. The Board of Directors believes that Dr. Kugler's service as NWMO Chairman is in the best interests of OPG, the NWMO, and OPG's stakeholders, in view of his experience and extensive knowledge of the Canadian nuclear industry, and that his involvement with the NWMO does not affect his ability to exercise impartial judgment and fulfill his responsibilities as a member of the

OPG Audit/Risk Committee. In view of OPG's nuclear operations and related financial and waste management obligations, Dr. Kugler's experience and knowledge is also considered a key input to the planning and risk management components of the Committee's mandate. As a result, OPG's Board of Directors has determined that it is appropriate for Dr. Kugler to serve as a non-independent member of that Committee, in accordance with section 3.3(2) of MI 52-110.

#### *Relevant Education and Experience*

Financially literate means having the ability to read and understand the accounting principles used by OPG to prepare its consolidated financial statements, and the ability to address the breadth and level of complex accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by OPG's consolidated financial statements. Each member had an understanding of internal controls and procedures for financial reporting. The education and experience of each Audit/Risk Committee member that are relevant to his or her performance as an audit committee member may be found in the Corporate Governance section.

#### **Audit/Risk Committee Oversight**

There have been no recommendations of OPG's Audit/Risk Committee to nominate or compensate an external auditor which have not been adopted by its Board of Directors.

#### **External Auditor Service Fees**

The following fees were billed by Ernst & Young LLP:

| <i>(thousands of dollars)</i> | <b>2006</b>  | <b>2005</b> |
|-------------------------------|--------------|-------------|
| Audit Fees                    | <b>1,250</b> | 1,251       |
| Audit-Related Fees            | <b>335</b>   | 277         |
| Tax Fees and Other            | <b>300</b>   | 320         |

#### *Audit Fees*

These fees included the audit of OPG's consolidated financial statements, quarterly reviews of the financial statements, and the pension fund audits.

#### *Audit-Related Fees*

These fees included work with respect to internal controls, accounting assistance, French translation of consolidated financial statements and MD&A, and special audits and reviews. During 2006, OPG has employed the services of other professional advisers, particularly in the areas of internal controls and accounting assistance.

#### *Tax Fees and Other*

These fees included tax services related to assistance with matters raised by the Tax Auditors for the 1999 taxation year and a United States state tax review.

## **INTERNAL CONTROLS OVER FINANCIAL REPORTING AND DISCLOSURE CONTROLS**

Management, including the President and CEO and Chief Financial Officer (CFO), are responsible for maintaining disclosure controls and procedures and internal control over financial reporting. Disclosure controls and procedures are designed to provide reasonable assurance that all relevant information is gathered and reported to senior management, including the President and CEO and the CFO, on a timely basis so that appropriate decisions can be made regarding public disclosure. Internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the financial statements in accordance with GAAP.

An evaluation of the effectiveness of design and operation of OPG's disclosure controls and procedures was conducted as of December 31, 2006. Management, including the President and the CEO and the CFO, has evaluated the effectiveness of OPG's disclosure controls and procedures (as defined in Multilateral Instrument 52-109 - *Certification of Disclosure in Issuers' Annual and Interim Filings*, of the Canadian Securities Administrators) as of December 31, 2006. Management has concluded that, as of December 31, 2006, OPG's disclosure controls and procedures were effective to provide reasonable assurance that material information relating to OPG and its consolidated subsidiaries and interests in jointly controlled entities would be made known to them by others within those entities, particularly during the period in which this report was being prepared.

Management has designed internal controls over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP and has concluded, as of December 31, 2006, that the design of internal controls over financial reporting was effective.

There were no changes in internal control over financial reporting that have materially affected or are reasonably likely to materially affect OPG's internal control over financial reporting.

## FOURTH QUARTER

### Overview of Results

Net loss for the three months ended December 31, 2006 was \$19 million compared to net income of \$160 million for the same period in 2005. Loss before income taxes for the three months ended December 31, 2006 was \$82 million compared to income before income taxes of \$192 million for the same period in 2005.

The following is a summary of the factors impacting OPG's results for the three months ended December 31, 2006 compared to results for the same period in 2005, on a before-tax basis:

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*(millions of dollars – before tax) (unaudited)*

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|                                                                                                                                                                               |              |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------|
| <b>Income before income taxes for the three months ended December 31, 2005</b>                                                                                                | <b>192</b>   |
| Changes in gross margin                                                                                                                                                       |              |
| Decrease in electricity sales prices after revenue limit rebate                                                                                                               | (74)         |
| Change in electricity generation by segment:                                                                                                                                  |              |
| Regulated – Nuclear                                                                                                                                                           | (75)         |
| Regulated – Hydroelectric                                                                                                                                                     | 8            |
| Unregulated – Hydroelectric                                                                                                                                                   | 6            |
| Unregulated – Fossil-Fuelled                                                                                                                                                  | (46)         |
| Other changes in gross margin                                                                                                                                                 | 8            |
|                                                                                                                                                                               | (173)        |
| Increase in pension and other post employment benefit costs                                                                                                                   | (47)         |
| Increase in nuclear maintenance and repairs                                                                                                                                   | (36)         |
| Increase in nuclear outages                                                                                                                                                   | (55)         |
| Write-off of excess inventory related to Pickering A Units 2 and 3 in 2005                                                                                                    | 35           |
| Decrease in depreciation expense primarily due to extension of service lives of the coal-fired generating stations, Pickering B station and Unit 4 of the Pickering A station | 27           |
| Other changes                                                                                                                                                                 | (3)          |
| <b>Decrease in income before income taxes, excluding impairment of long-lived assets</b>                                                                                      | <b>(252)</b> |
| Impairment of long-lived assets                                                                                                                                               | (22)         |
| <b>Loss before income taxes for the three months ended December 31, 2006</b>                                                                                                  | <b>(82)</b>  |

Earnings for the three months ended December 31, 2006 were significantly affected by a reduction in gross margin from electricity sales due primarily to lower average sales prices and lower electricity generation compared to the same period in 2005. The decrease in electricity prices was primarily due to lower average Ontario spot market prices applicable to electricity generation from OPG's unregulated business segments. The lower electricity generation in the fourth quarter of 2006 compared to the same period in 2005 was primarily due to extended planned and unplanned outages at OPG's nuclear generating stations and lower Ontario demand which continued to unfavourably impact the fossil-fuelled generating stations.

For the three months ended December 31, 2006, OM&A expenses were \$810 million compared to \$686 million in the same period in 2005. The increase of \$124 million was primarily due to higher pension and OPEB costs mainly due to changes in economic assumptions used to measure the costs and an increase in maintenance and repairs on OPG's nuclear and fossil-fuelled generating stations, which reflected OPG's continued objective of maintaining the reliability of the stations. In addition, an increase in unplanned outages at certain nuclear generating stations unfavourably affected earnings in the fourth quarter of 2006 compared to the same period in 2005. During the three months ended December 31, 2005, OPG wrote off excess inventory of \$35 million acquired for the anticipated return to service of Units 2 and 3 at the Pickering A nuclear generating station, which did not reoccur in 2006.

Earnings were favourably affected by a decrease in depreciation expense of \$27 million during the three months ended December 31, 2006 compared to the same period in 2005. The decrease was primarily due to the extension of the service lives of all of the coal-fired generating stations, as a result of delays in the plan to replace coal-fired generation.

OPG recognized an impairment loss on the Thunder Bay and Atikokan coal-fired generating stations in the three months ended December 31, 2006 of \$22 million, which represented the carrying amount or net book value of these stations. OPG tested the recoverability of the carrying amounts of the coal-fired stations as a result of changes in circumstance, which included a decrease in forecast Ontario spot market prices and the extension of the lives of the coal-fired stations. It was determined that the Thunder Bay and Atikokan coal-fired generating stations would not be able to recover their operating and capital expenditures and carrying amount, over their remaining service lives.

Commencing April 1, 2005, with the introduction of rate regulation, OPG accounts for income taxes relating to the rate regulated segments of its business using the taxes payable method. Under this method, future income tax assets and liabilities associated with these segments are not recognized where those future income taxes are expected to be recovered in the regulated prices charged to customers in the future. As a result, OPG did not record a future tax expense of \$47 million and \$46 million for the rate regulated segments during the three months ended December 31, 2006 and 2005, respectively, which would have been recorded had OPG accounted for income taxes for the regulated segments using the liability method.

## Discussion of Operating Results

| <i>(millions of dollars)</i> (unaudited)                                    | 2006  | 2005  |
|-----------------------------------------------------------------------------|-------|-------|
| Revenue, net of revenue limit and Market Power Mitigation Agreement rebates | 1,276 | 1,496 |
| Fuel expense                                                                | 267   | 314   |
| Gross margin                                                                | 1,009 | 1,182 |
| Operations, maintenance and administration                                  | 810   | 686   |
| Depreciation and amortization                                               | 160   | 187   |
| Accretion on fixed asset removal                                            | 124   | 118   |
| Earnings on nuclear fixed asset removal and nuclear waste management funds  | (97)  | (102) |
| Property and capital taxes                                                  | 24    | 43    |
| Restructuring                                                               | -     | 4     |
| (Loss) income before impairment of long-lived assets                        | (12)  | 246   |
| Impairment of long-lived assets                                             | 22    | -     |
| (Loss) income before interest and income taxes                              | (34)  | 246   |

## Revenue

| <i>(millions of dollars)</i> (unaudited)      | 2006  | 2005  |
|-----------------------------------------------|-------|-------|
| Regulated generation sales <sup>1</sup>       | 665   | 751   |
| Spot market sales, net of hedging instruments | 453   | 841   |
| Revenue limit rebate                          | (13)  | (262) |
| Variance accounts                             | (4)   | 1     |
| Other                                         | 175   | 165   |
| Total revenue                                 | 1,276 | 1,496 |

<sup>1</sup> Regulated generation sales included revenue of \$46 million and \$65 million that OPG received at the Ontario spot market price for Regulated—Hydroelectric generation over 1,900 MWh in any hour during the fourth quarter of 2006 and 2005, respectively.

## *Revenue*

Revenue was \$1,276 million for the three months ended December 31, 2006 compared to \$1,496 million during the same period in 2005. The decrease of \$220 million was primarily due to lower average spot electricity prices impacting OPG's unregulated business segments combined with lower nuclear and fossil-fuelled generation of 3.2 TWh compared to the same period in 2005.

## *Electricity Prices*

OPG's average sales price for the three months ended December 31, 2006 was 4.5¢/kWh compared to 5.0¢/kWh for the same period in 2005. The decrease was primarily due to lower average Ontario spot market prices in the fourth quarter of 2006, which significantly affected OPG's unregulated business segments.

## *Fuel Expense*

Fuel expense was \$267 million for the three months ended December 31, 2006 compared to \$314 million during the same period in 2005. The decrease of \$47 million was primarily due to lower generation from the fossil-fuelled stations compared to the same period in 2005.

## *Operations, Maintenance and Administration*

OM&A expenses for the three months ended December 31, 2006 were \$810 million compared to \$686 million during the same period in 2005. The increase of \$124 million in OM&A expenses was primarily due to higher pension and other post employment benefit costs and an increase in repairs and maintenance for the nuclear generating stations.

## *Property and Capital Taxes*

Property and capital taxes for the three months ended December 31, 2006 was \$24 million, compared to \$43 million during the same period in 2005. The \$19 million decrease was primarily due to additional municipal property tax assessments for OPG's fossil-fuelled generating station received in the fourth quarter of 2005, which did not occur in 2006.

## **Average Sales Prices**

The weighted average Ontario spot electricity market price and OPG's average sales prices by reportable business segment, net of the revenue limit rebate for the three months ended December 31, 2006 and 2005, were as follows:

| <i>(¢/kWh)</i>                                                | <b>Three Months Ended<br/>December 31</b> |             |
|---------------------------------------------------------------|-------------------------------------------|-------------|
|                                                               | <b>2006</b>                               | <b>2005</b> |
| Weighted average hourly Ontario spot electricity market price | <b>4.5</b>                                | <b>7.5</b>  |
| Regulated – Nuclear                                           | <b>4.9</b>                                | <b>4.9</b>  |
| Regulated – Hydroelectric                                     | <b>3.5</b>                                | <b>3.9</b>  |
| Unregulated – Hydroelectric                                   | <b>4.5</b>                                | <b>5.5</b>  |
| Unregulated – Fossil-Fuelled                                  | <b>4.6</b>                                | <b>5.6</b>  |
| OPG's average sales price                                     | <b>4.5</b>                                | <b>5.0</b>  |

The continued decrease in Ontario's spot electricity market price significantly contributed to the decline in OPG's average sales price for the three months ended December 31, 2006 compared to the same period in 2005.

## **Electricity Generation**

Total electricity sales volume for the three months ended December 31, 2006 was 24.3 TWh compared to 27.1 TWh during the same period in 2005. The decrease was primarily due to lower nuclear generation due to higher planned and unplanned outage days and a decrease in generation from the fossil-fuelled stations due to lower Ontario demand.

## **Liquidity and Capital Resources**

Cash flow provided by operating activities during the three months ended December 31, 2006 was \$91 million compared to \$446 million for the three months ended December 31, 2005. The unfavourable change in cash flow was primarily due to lower revenue before rebates as a result of lower Ontario spot market prices and lower volumes. A revenue limit rebate payment of \$58 million was made in the three months ended December 31, 2006, which did not occur in the three months ended December 31, 2005.

Investment in fixed assets during the three months ended December 31, 2006 was \$215 million compared with \$141 million during the same period in 2005. The increase in capital expenditures of \$74 million was primarily due to increased investment in the Portlands Energy Centre, the Niagara Tunnel project, and the Lac Seul project.

OPG negotiated agreements with the OEFC to finance the Niagara Tunnel project, the Portlands Energy Centre and the Lac Seul project. Advances under these credit arrangements commenced during the fourth quarter and amounted to \$160 million for the Niagara Tunnel, \$90 million for the Portlands Energy Centre and \$20 million for the Lac Seul project.

## QUARTERLY FINANCIAL HIGHLIGHTS

The following tables set out selected financial information from OPG's unaudited interim consolidated financial statements for each of the twelve most recently completed quarters. This financial information has been prepared in accordance with Canadian GAAP.

| <i>(millions of dollars)</i><br><i>(unaudited)</i> | 2006 Quarters Ended |                 |            |             | Total  |
|----------------------------------------------------|---------------------|-----------------|------------|-------------|--------|
|                                                    | December<br>31      | September<br>30 | June<br>30 | March<br>31 |        |
| Revenue after revenue limit rebate                 | 1,276               | 1,435           | 1,345      | 1,508       | 5,564  |
| Net (loss) income                                  | (19)                | 167             | 143        | 199         | 490    |
| Net (loss) income per share                        | \$(0.08)            | \$0.65          | \$0.56     | \$0.78      | \$1.91 |

| <i>(millions of dollars)</i><br><i>(unaudited)</i>                        | 2005 Quarters Ended |                 |            |             | Total  |
|---------------------------------------------------------------------------|---------------------|-----------------|------------|-------------|--------|
|                                                                           | December<br>31      | September<br>30 | June<br>30 | March<br>31 |        |
| Revenue after revenue limit and Market Power Mitigation Agreement rebates | 1,496               | 1,571           | 1,373      | 1,358       | 5,798  |
| Income (loss) before extraordinary item                                   | 160                 | 181             | 137        | (38)        | 440    |
| Income (loss) before extraordinary item per share                         | \$0.62              | \$0.71          | \$0.53     | \$(0.15)    | \$1.71 |
| Net income (loss)                                                         | 160                 | 181             | 63         | (38)        | 366    |
| Net income (loss) per share                                               | \$0.62              | \$0.71          | \$0.25     | \$(0.15)    | \$1.43 |

| <i>(millions of dollars)</i><br><i>(unaudited)</i>     | 2004 Quarters Ended |                 |            |             | Total  |
|--------------------------------------------------------|---------------------|-----------------|------------|-------------|--------|
|                                                        | December<br>31      | September<br>30 | June<br>30 | March<br>31 |        |
| Revenue after Market Power Mitigation Agreement rebate | 1,215               | 1,212           | 1,141      | 1,350       | 4,918  |
| Net income (loss)                                      | 34                  | (15)            | (41)       | 64          | 42     |
| Net income (loss) per share                            | \$0.13              | \$(0.06)        | \$(0.16)   | \$0.25      | \$0.16 |

**Balance Sheet as at December 31**

| <i>(millions of dollars)</i>                      | <b>2006</b> | <b>2005</b> | <b>2004</b> |
|---------------------------------------------------|-------------|-------------|-------------|
| Total assets                                      | 22,750      | 21,623      | 19,830      |
| Total long-term liabilities                       | 15,408      | 13,640      | 13,366      |
| Cash dividend declared per share <i>(dollars)</i> | \$0.50      | -           | -           |
| Common shares outstanding <i>(millions)</i>       | 256.3       | 256.3       | 256.3       |

OPG's quarterly results are affected by changes in demand primarily resulting from variations in seasonal weather conditions. Historically, OPG's revenues are higher in the first and third quarters of a fiscal year as a result of winter heating demands in the first quarter and air conditioning/cooling demands in the third quarter. Since April 1, 2005, revenue has increased due to the introduction of regulated prices for most of OPG's baseload hydroelectric and all of the nuclear facilities that it operates and other related regulatory changes. The revenue limit and the Market Power Mitigation Agreement rebates, regulated prices, and OPG's hedging strategies significantly reduced the impact of seasonal price fluctuations on the results of operations.

Additional items which affected net income in certain quarters above include the following:

- Increase in depreciation expense in 2004 due to the planned early shutdown of coal-fired generating stations and an increase in fixed assets in service;
- Tax benefit of \$93 million recorded during the fourth quarter of 2004 related to the elimination of a valuation allowance due to the introduction of rate regulation;
- Lower OM&A expenses due to the deferral of non-capital costs related to the planned return to service of all units at the Pickering A nuclear generating station units return to service project, beginning January 1, 2005, as required by a regulation pursuant to the *Electricity Restructuring Act, 2004* (Ontario);
- Impairment loss on the Lennox generating station of \$202 million recorded during the first quarter of 2005, reflecting the amount of the carrying value of the station;
- Higher revenues as a result of a reliability must-run contract between OPG and the IESO for the Lennox generating station, for the period October 1, 2005 to September 30, 2006;
- Lower income tax expense due to the use of the taxes payable method for the regulated segments commencing April 1, 2005;
- Impairment loss of \$63 million related to Units 2 and 3 of the Pickering A nuclear generating station, recorded in the second quarter of 2005;
- One-time extraordinary loss of \$74 million recorded in the second quarter of 2005, resulting from the adoption of rate regulated accounting and the corresponding use of the taxes payable method;
- Write-off of \$22 million and \$35 million of excess inventory as a result of not returning Pickering A nuclear generating station Units 2 and 3 to service recorded in the third and fourth quarters of 2005 respectively;
- Higher depreciation expense related to the return to service of Unit 1 at the Pickering A generating station in the fourth quarter of 2005;
- Decrease in depreciation expense primarily due to extension of service lives, for accounting purposes, of the Nanticoke station in the third quarter of 2005, and the Pickering B nuclear generating station and Unit 4 of the Pickering A nuclear generating station beginning in the first quarter of 2006;
- Higher pension and OPEB costs from 2004 to 2006 mainly due to changes in economic assumptions used to measure the costs; and
- Decrease in depreciation expense primarily due to extension of the service life, for accounting purposes, of all coal-fired generating stations to December 31, 2012, beginning in the third quarter of 2006.

## SUPPLEMENTAL EARNINGS MEASURES

In addition to providing net income in accordance with Canadian GAAP, OPG's MD&A, audited consolidated financial statements as at and for the year ended December 31, 2006 and 2005 and the notes thereto, present certain non-GAAP financial measures. These financial measures do not have standard definitions prescribed by Canadian GAAP and therefore may not be comparable to similar measures disclosed by other companies. OPG utilizes these measures in making operating decisions and assessing its performance. Readers of the MD&A, consolidated financial statements and notes thereto utilize these measures in assessing the Company's financial performance from ongoing operations. These non-GAAP financial measures have not been presented as an alternative to net income in accordance with Canadian GAAP as an indicator of operating performance. The definitions of the non-GAAP financial measures are as follows:

- (1) **Gross margin** is defined as revenue less revenue limit and Market Power Mitigation Agreement rebates and fuel expense.
- (2) **Earnings** is defined as net income.

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## **STATEMENT OF MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL INFORMATION**

Ontario Power Generation Inc.'s ("OPG") management is responsible for presentation and preparation of the annual consolidated financial statements and Management's Discussion and Analysis ("MD&A").

The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP") and the requirements of the Ontario Securities Commission ("OSC"), as applicable. The MD&A has been prepared in accordance with the requirements of securities regulators, including National Instrument 51-102 of the Canadian Securities Administrators and its related published requirements.

The consolidated financial statements and information in the MD&A necessarily include amounts based on informed judgments and estimates of the expected effects of current events and transactions with appropriate consideration to materiality. Something is considered material if it is reasonably expected to have a significant impact on the Company's earnings, cash flow, value of an asset or liability, or reputation. In addition, in preparing the financial information we must interpret the requirements described above, make determinations as to the relevancy of information to be included, and make estimates and assumptions that affect reported information. The MD&A also includes information regarding the impact of current transactions and events, sources of liquidity and capital resources, operating trends, risks and uncertainties. Actual results in the future may differ materially from our present assessment of this information because future events and circumstances may not occur as expected.

In meeting our responsibility for the reliability of financial information, we maintain and rely on a comprehensive system of internal control and internal audit, including organizational and procedural controls and internal controls over financial reporting. Our system of internal controls includes written communication of our policies and procedures governing corporate conduct and risk management; comprehensive business planning; effective segregation of duties; delegation of authority and personal accountability; careful selection and training of personnel; and sound and conservative accounting policies, which we regularly update. This structure ensures appropriate internal control over transactions, assets and records. We also regularly audit internal controls. These controls and audits are designed to provide us with reasonable assurance that the financial records are reliable for preparing financial statements and other financial information, assets are safeguarded against unauthorized use or disposition, liabilities are recognized, and we are in compliance with all regulatory requirements.

Management, including the President and Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of OPG's disclosure controls and procedures (as defined in Multilateral Instrument 52-109 of the Canadian Securities Administrators) as of December 31, 2006. Management concluded that, as of December 31, 2006, OPG's disclosure controls and procedures were effective to provide reasonable assurance that material information relating to OPG and its consolidated subsidiaries and interests in jointly controlled entities would be made known to them by others within those entities, particularly during the period in which this report was being prepared.

Management has designed internal controls over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP.

Accordingly, we, as OPG's Chief Executive Officer and Chief Financial Officer, will certify OPG's annual disclosure documents filed with the OSC, which includes attesting to the design and effectiveness of OPG's disclosure controls and procedures and the design of internal control over financial reporting.

The Board of Directors, based on recommendations from its Audit and Risk Committee, reviews and approves the consolidated financial statements and the MD&A, and oversees management's responsibilities for the presentation and preparation of financial information, maintenance of appropriate internal controls, management and control of major risk areas and assessment of significant and related party transactions.

The consolidated financial statements have been audited by Ernst & Young LLP, independent external auditors appointed by the Board of Directors. The Auditors' Report outlines the auditors' responsibilities and the scope of their examination and their opinion on OPG's consolidated financial statements. The independent external auditors, as confirmed by the Audit and Risk Committee, had direct and full access to the Audit and Risk Committee, with and without the presence of management, to discuss their audit and their findings therefrom, as to the integrity of OPG's financial reporting and the effectiveness of the system of internal controls.

**Jim Hankinson (signed)**  
*President and Chief Executive Officer*

**Donn W. J. Hanbidge (signed)**  
*Chief Financial Officer*

February 14, 2007

## **AUDITORS' REPORT**

### **To the Shareholder of Ontario Power Generation Inc.**

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

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

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

**ERNST & YOUNG LLP (signed)**  
**Chartered Accountants**  
Toronto, Canada  
February 14, 2007

## CONSOLIDATED STATEMENTS OF INCOME

### Years Ended December 31

(millions of dollars except where noted)

|                                                                                      | 2006         | 2005         |
|--------------------------------------------------------------------------------------|--------------|--------------|
| <b>Revenue</b> (Note 19)                                                             |              |              |
| Revenue before revenue limit and Market Power Mitigation Agreement rebates           | 5,725        | 6,949        |
| Revenue limit rebate (Note 16)                                                       | (161)        | (739)        |
| Market Power Mitigation Agreement rebate (Note 17)                                   | -            | (412)        |
|                                                                                      | <b>5,564</b> | <b>5,798</b> |
| Fuel expense                                                                         | 1,098        | 1,297        |
| <b>Gross margin</b>                                                                  | <b>4,466</b> | <b>4,501</b> |
| <b>Expenses</b> (Note 19)                                                            |              |              |
| Operations, maintenance and administration                                           | 2,777        | 2,516        |
| Depreciation and amortization (Note 5)                                               | 664          | 753          |
| Accretion on fixed asset removal and nuclear waste management liabilities (Note 9)   | 499          | 476          |
| Earnings on nuclear fixed asset removal and nuclear waste management funds (Note 9)  | (371)        | (381)        |
| Property and capital taxes                                                           | 106          | 107          |
| Restructuring                                                                        | -            | 10           |
|                                                                                      | <b>3,675</b> | <b>3,481</b> |
| <b>Income before the following:</b>                                                  | <b>791</b>   | <b>1,020</b> |
| Impairment of long-lived assets (Note 5)                                             | 22           | 265          |
| <b>Income before interest, income taxes and extraordinary item</b>                   | <b>769</b>   | <b>755</b>   |
| Net interest expense                                                                 | 193          | 197          |
| <b>Income before income taxes and extraordinary item</b>                             | <b>576</b>   | <b>558</b>   |
| Income tax expense (Note 10)                                                         |              |              |
| Current                                                                              | 60           | 80           |
| Future                                                                               | 26           | 38           |
|                                                                                      | <b>86</b>    | <b>118</b>   |
| <b>Income before extraordinary item</b>                                              | <b>490</b>   | <b>440</b>   |
| <b>Extraordinary item</b> (Note 10)                                                  | <b>-</b>     | <b>74</b>    |
| <b>Net income</b>                                                                    | <b>490</b>   | <b>366</b>   |
| <b>Basic and diluted income per common share before extraordinary item</b> (dollars) | <b>1.91</b>  | <b>1.72</b>  |
| <b>Basic and diluted income per common share</b> (dollars)                           | <b>1.91</b>  | <b>1.43</b>  |
| <b>Common shares outstanding</b> (millions)                                          | <b>256.3</b> | <b>256.3</b> |

See accompanying notes to the consolidated financial statements

## CONSOLIDATED STATEMENTS OF RETAINED EARNINGS

### Years Ended December 31

*(millions of dollars)*

|                                                       | 2006         | 2005  |
|-------------------------------------------------------|--------------|-------|
| <b>Retained earnings (deficit), beginning of year</b> | <b>261</b>   | (105) |
| Net income                                            | <b>490</b>   | 366   |
| Dividend <i>(Note 19)</i>                             | <b>(128)</b> | -     |
| <b>Retained earnings, end of year</b>                 | <b>623</b>   | 261   |

*See accompanying notes to the consolidated financial statements*

## CONSOLIDATED STATEMENTS OF CASH FLOWS

Years Ended December 31

(millions of dollars)

### Operating activities

|                                                                                                    | 2006         | 2005         |
|----------------------------------------------------------------------------------------------------|--------------|--------------|
| Net income                                                                                         | 490          | 366          |
| Adjust for non-cash items:                                                                         |              |              |
| Depreciation and amortization (Note 5)                                                             | 664          | 753          |
| Accretion on fixed asset removal and nuclear waste management liabilities (Note 9)                 | 499          | 476          |
| Earnings on nuclear fixed asset removal and nuclear waste management funds (Note 9)                | (371)        | (381)        |
| Pension cost (Note 11)                                                                             | 218          | 115          |
| Other post employment benefits and supplementary pension plans (Note 11)                           | 255          | 181          |
| Future income taxes                                                                                | 26           | 38           |
| Transition rate option contracts (Note 15)                                                         | (12)         | (36)         |
| Provision for restructuring                                                                        | -            | 10           |
| Mark-to-market adjustment on energy contracts                                                      | (29)         | 23           |
| Provision for used nuclear fuel                                                                    | 33           | 28           |
| Impairment of long-lived assets (Note 5)                                                           | 22           | 265          |
| Excess inventory write-off                                                                         | -            | 57           |
| Regulatory assets and liabilities (Note 6)                                                         | 27           | 11           |
| Extraordinary item (Note 10)                                                                       | -            | 74           |
| Other                                                                                              | (11)         | 18           |
|                                                                                                    | <b>1,811</b> | <b>1,998</b> |
| Contributions to nuclear fixed asset removal and nuclear waste management funds (Note 9)           | (454)        | (454)        |
| Expenditures on fixed asset removal and nuclear waste management (Note 9)                          | (164)        | (90)         |
| Reimbursement of expenditures on nuclear fixed asset removal and nuclear waste management (Note 9) | 19           | 23           |
| Contributions to pension fund (Note 11)                                                            | (261)        | (254)        |
| Expenditures on other post employment benefits and supplementary pension plans (Note 11)           | (69)         | (65)         |
| Revenue limit rebate (Note 16)                                                                     | (860)        | -            |
| Market Power Mitigation Agreement rebate (Note 17)                                                 | -            | (851)        |
| Expenditures on restructuring                                                                      | (8)          | (18)         |
| Net changes to other long-term assets and liabilities                                              | (94)         | (92)         |
| Changes in non-cash working capital balances (Note 23)                                             | 477          | 1,004        |
| <b>Cash flow provided by operating activities</b>                                                  | <b>397</b>   | <b>1,201</b> |
| <b>Investing activities</b>                                                                        |              |              |
| Increase in regulatory assets (Note 6)                                                             | (13)         | (265)        |
| Investment in fixed assets (Notes 5 and 18)                                                        | (637)        | (494)        |
| Proceeds on sale of other fixed assets                                                             | -            | 3            |
| Net proceeds from purchase of long-term investments                                                | -            | (4)          |
| <b>Cash flow used in investing activities</b>                                                      | <b>(650)</b> | <b>(760)</b> |
| <b>Financing activities</b>                                                                        |              |              |
| Issuance of long-term debt (Note 8)                                                                | 270          | 495          |
| Repayment of long-term debt (Note 8)                                                               | (806)        | (4)          |
| Dividend paid                                                                                      | (128)        | -            |
| Net increase (decrease) in short-term notes (Note 7)                                               | 15           | (26)         |
| <b>Cash flow (used in) provided by financing activities</b>                                        | <b>(649)</b> | <b>465</b>   |
| <b>Net (decrease) increase in cash and cash equivalents</b>                                        | <b>(902)</b> | <b>906</b>   |
| <b>Cash and cash equivalents, beginning of year</b>                                                | <b>908</b>   | <b>2</b>     |
| <b>Cash and cash equivalents, end of year</b>                                                      | <b>6</b>     | <b>908</b>   |

See accompanying notes to the consolidated financial statements

## CONSOLIDATED BALANCE SHEETS

**As at December 31**

*(millions of dollars)*

### Assets

#### Current assets

|                                             |              |              |
|---------------------------------------------|--------------|--------------|
| Cash and cash equivalents                   | 6            | 908          |
| Accounts receivable <i>(Notes 4 and 19)</i> | 256          | 538          |
| Future income taxes <i>(Note 10)</i>        | -            | 18           |
| Fuel inventory <i>(Note 18)</i>             | 669          | 581          |
| Materials and supplies <i>(Note 18)</i>     | 112          | 115          |
|                                             | <b>1,043</b> | <b>2,160</b> |

#### Fixed assets *(Notes 5 and 18)*

|                                |               |               |
|--------------------------------|---------------|---------------|
| Property, plant and equipment  | 17,136        | 15,172        |
| Less: accumulated depreciation | 4,375         | 3,760         |
|                                | <b>12,761</b> | <b>11,412</b> |

#### Other long-term assets

|                                                                                |               |               |
|--------------------------------------------------------------------------------|---------------|---------------|
| Deferred pension asset <i>(Note 11)</i>                                        | 706           | 663           |
| Nuclear fixed asset removal and nuclear waste management funds <i>(Note 9)</i> | 7,594         | 6,788         |
| Long-term materials and supplies <i>(Note 18)</i>                              | 326           | 273           |
| Regulatory assets <i>(Note 6)</i>                                              | 251           | 266           |
| Long-term accounts receivable and other assets                                 | 69            | 61            |
|                                                                                | <b>8,946</b>  | <b>8,051</b>  |
|                                                                                | <b>22,750</b> | <b>21,623</b> |

*See accompanying notes to the consolidated financial statements*

## CONSOLIDATED BALANCE SHEETS

**As at December 31**  
(millions of dollars)

|                                                                          | <b>2006</b>   | <b>2005</b> |
|--------------------------------------------------------------------------|---------------|-------------|
| <b>Liabilities</b>                                                       |               |             |
| <b>Current liabilities</b>                                               |               |             |
| Accounts payable and accrued charges (Notes 11, 15, and 19)              | <b>989</b>    | 958         |
| Revenue limit rebate payable (Note 16)                                   | <b>40</b>     | 739         |
| Short-term notes payable (Note 7)                                        | <b>15</b>     | -           |
| Long-term debt due within one year (Note 8)                              | <b>406</b>    | 806         |
| Future income taxes (Note 10)                                            | <b>3</b>      | -           |
| Deferred revenue due within one year                                     | <b>12</b>     | 12          |
| Income and capital taxes payable (Note 10)                               | <b>128</b>    | 81          |
|                                                                          | <b>1,593</b>  | 2,596       |
| <b>Long-term debt (Note 8)</b>                                           | <b>2,953</b>  | 3,089       |
| <b>Other long-term liabilities</b>                                       |               |             |
| Fixed asset removal and nuclear waste management (Note 9)                | <b>10,520</b> | 8,759       |
| Other post employment benefits and supplementary pension plans (Note 11) | <b>1,396</b>  | 1,212       |
| Long-term accounts payable and accrued charges                           | <b>150</b>    | 183         |
| Deferred revenue                                                         | <b>132</b>    | 144         |
| Future income taxes (Note 10)                                            | <b>246</b>    | 241         |
| Regulatory liabilities (Note 6)                                          | <b>11</b>     | 12          |
|                                                                          | <b>12,455</b> | 10,551      |
| <b>Shareholder's equity</b>                                              |               |             |
| Common shares (Note 13)                                                  | <b>5,126</b>  | 5,126       |
| Retained earnings                                                        | <b>623</b>    | 261         |
|                                                                          | <b>5,749</b>  | 5,387       |
|                                                                          | <b>22,750</b> | 21,623      |

Commitments and Contingencies (Notes 2, 5, 7, 8, 9, 10, 12, 14 and 18)

See accompanying notes to the consolidated financial statements

On behalf of the Board of Directors:

**Honourable Jake Epp (signed)**  
Chairman

**M. George Lewis (signed)**  
Director

## **NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005**

### **1. DESCRIPTION OF BUSINESS**

Ontario Power Generation Inc. was incorporated on December 1, 1998 pursuant to the *Business Corporations Act* (Ontario). As part of the reorganization of Ontario Hydro, under the *Electricity Act, 1998* and the related restructuring of the electricity industry in Ontario, Ontario Power Generation Inc. and its subsidiaries (collectively "OPG" or the "Company") purchased and assumed certain assets, liabilities, employees, rights and obligations of the electricity generation business of Ontario Hydro on April 1, 1999 and commenced operations on that date. Ontario Hydro has continued as Ontario Electricity Financial Corporation ("OEFEC"), responsible for managing and retiring Ontario Hydro's outstanding debt and other obligations.

### **2. BASIS OF PRESENTATION**

These consolidated financial statements were prepared in accordance with Canadian generally accepted accounting principles. The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and the disclosure of contingent assets and liabilities. Actual results could differ from those estimates.

The consolidated financial statements include the accounts of OPG and its subsidiaries. OPG accounts for its interests in jointly controlled entities using the proportionate consolidation method. All significant intercompany transactions have been eliminated on consolidation.

Certain of the 2005 comparative amounts have been reclassified from financial statements previously presented to conform to the 2006 financial statement presentation.

### **3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

#### **Cash and Cash Equivalents and Short-Term Investments**

Cash and cash equivalents include cash on deposit and money market securities with a maturity of less than 90 days on the date of purchase. All other money market securities with a maturity on the date of purchase that is greater than 90 days, but less than one year, are recorded as short-term investments. These securities are valued at the lower of cost or market.

Interest earned on cash and cash equivalents and short-term investments of \$21 million (2005 – \$13 million) at an average effective rate of 4.0 per cent (2005 – 2.8 per cent) is offset against interest expense in the consolidated statements of income.

#### **Sales of Accounts Receivable**

Asset securitization involves selling assets such as accounts receivable to independent entities or trusts, which buy the receivables and then issue interests in them to investors. These transactions are accounted for as sales, given that control has been surrendered over these assets in return for net cash consideration. For each transfer, the excess of the carrying value of the receivables transferred over the estimated fair value of the proceeds received is reflected as a loss on the date of the transfer, and is included in net interest expense. The carrying value of the interests transferred is allocated to accounts receivable sold or interests retained according to their relative fair values on the day the transfer is made.

Fair value is determined based on the present value of future cash flows. Cash flows are projected using OPG's best estimates of key assumptions, such as discount rates, weighted average life of accounts receivable and credit loss ratios.

As part of the sales of accounts receivable, certain financial assets are retained and consist of interests in the receivables transferred. Any retained interests held in the receivables are accounted for at cost. The receivables are transferred on a fully serviced basis and do not create a servicing asset or liability.

## **Inventories**

Fuel inventory is valued at weighted average cost.

Materials and supplies are valued at the lower of average cost or net realizable value with the exception of critical replacement parts that are unique to OPG's generating stations. The cost of the critical replacement parts inventory is charged to operations on a straight-line basis over the remaining life of the related facilities and is classified in long-term assets.

## **Fixed Assets and Depreciation**

Property, plant and equipment are recorded at cost. Interest costs incurred during construction are capitalized as part of the cost of the asset based on the interest rate on OPG's long-term debt. Expenditures for replacements of major components are capitalized.

Depreciation rates for the various classes of assets are based on their estimated service lives. Any asset removal costs that have not been specifically provided for in current or previous periods are also charged to depreciation expense. Repairs and maintenance are expensed when incurred.

Fixed assets are depreciated on a straight-line basis except for computers, and transport and work equipment, which are depreciated on a declining balance basis as noted below:

|                                                                        |                             |
|------------------------------------------------------------------------|-----------------------------|
| Nuclear generating stations and major components                       | 15 to 49 years <sup>1</sup> |
| Fossil generating stations and major components                        | 25 to 40 years <sup>2</sup> |
| Hydroelectric generating stations and major components                 | 25 to 100 years             |
| Administration and service facilities                                  | 10 to 50 years              |
| Computers, and transport and work equipment assets – declining balance | 9% to 40% per year          |
| Major application software                                             | 5 years                     |
| Service equipment                                                      | 5 to 10 years               |

<sup>1</sup> The end of station life for depreciation purposes for the Darlington, Pickering A, Pickering B, and Bruce B nuclear generating stations ranges between 2012 and 2021. Major components are depreciated over the lesser of the station life and the life of the components. The Bruce A nuclear generating station was fully depreciated in 2003. Bruce Power decided to refurbish the Bruce A generating station contributing to an increase in the asset retirement obligation at December 31, 2006 and an increase in the carrying value of the Bruce A station. The station will now be depreciated over the period to 2030.

<sup>2</sup> Commencing July 1, 2006, the end of station life for depreciation purposes for the coal-fired generating stations was changed to 2012, due to the expected shutdown of these stations by the end of 2012. The Lennox generating station is depreciated to 2016.

## **Impairment of Fixed Assets**

OPG evaluates its property, plant and equipment for impairment whenever conditions indicate that estimated undiscounted future net cash flows may be less than the net carrying amount of assets. In cases where the undiscounted expected future cash flows are less than the carrying amount, an impairment loss is recognized equal to the amount by which the carrying amount exceeds the fair value. Fair value is determined using expected discounted cash flows when quoted market prices are not available.

## **Rate Regulated Accounting**

In December 2004, the *Electricity Restructuring Act, 2004* (Ontario) received royal assent. A regulation made pursuant to that statute provides that OPG receives regulated prices beginning April 1, 2005 for most of its baseload hydroelectric facilities and all of the nuclear facilities that it operates. This includes electricity generated by Sir Adam Beck 1, 2 and Pump generating station, DeCew Falls 1 and 2, and R.H. Saunders hydroelectric facilities, and the Pickering A and B, and Darlington nuclear generating stations. The regulation was amended in February 2007. The amendment clarified certain aspects of the regulation and directed OPG to establish a deferral account related to certain changes in its liability for nuclear used fuel management and its liability for nuclear decommissioning and low and intermediate level waste management.

OPG's regulated prices were established by the Province of Ontario (the "Province") based on a forecast of production volumes and total operating costs, and a return on rate base, which assumed an average five per cent return on equity. Rate base is a regulatory construct that represents the average net level of investment in regulated fixed assets, deferred charges, and an allowance for working capital. The initial prices took effect April 1, 2005, and are expected to remain in effect until at least March 31, 2008, at which time it is anticipated that new regulated prices to be established by the Ontario Energy Board ("OEB") will take effect. If there are changes to the fundamental assumptions on which the initial prices were developed, the Province may amend these initial prices.

The OEB is a self-funding Crown corporation. Its mandate and authority come from the *Ontario Energy Board Act, 1998*, the *Electricity Act, 1998*, and a number of other provincial statutes. The OEB is an independent, quasi-judicial tribunal that reports to the Legislature of the Province through the Minister of Energy. It regulates the Province's natural gas and electricity industries and carries out its regulatory functions through public hearings and other more informal processes such as consultations.

Accounting standards recognize that rate regulation can create economic benefits and obligations, which are reported in the consolidated financial statements as regulatory assets and liabilities. When the regulation provides sufficient assurance that incurred costs will be recovered in the future, then OPG may defer those costs and report them as a regulatory asset. If current recovery is provided for costs expected to be incurred in the future, then OPG reports a regulatory liability. Also, if the regulation provides for lesser or greater than planned revenue to be received or returned by OPG through future regulated prices, then OPG recognizes and reports a regulatory asset or liability, respectively. The measurement of such regulatory assets and liabilities is subject to certain estimates and assumptions, including assumptions made in the interpretation of the regulation. See the Company's revenue recognition policy and Notes 6 and 10 to the consolidated financial statements for additional disclosures required under rate regulated accounting.

## **Long-Term Portfolio Investments**

Long-term portfolio investments, other than investments owned by the Company's wholly owned subsidiary OPG Ventures Inc. ("OPGV"), are stated at amortized cost and include the nuclear fixed asset removal and nuclear waste management funds. Gains and losses on long-term investments are recognized in other income when investments are sold. When a decline in the value of investments occurs, which is considered to be other than temporary, a provision for loss is established.

In accordance with Accounting Guideline 18, Investment Companies ("AcG-18"), investments owned by OPGV are recorded at fair value, and changes to the fair value of the investments are included in revenue in the period in which the change occurs. The fair values of these investments are estimated based on readily available market information or using estimation techniques based on historical performance.

## **Fixed Asset Removal and Nuclear Waste Management Liability**

OPG recognizes asset retirement obligations for fixed asset removal and nuclear waste management, discounted for the time value of money. OPG has estimated both the amount and timing of future cash expenditures based on current plans for fixed asset removal and nuclear waste management. The liabilities are initially recorded at their estimated fair value, which is based on a discounted value of the expected costs to be paid.

On an ongoing basis, the liability is increased by the present value of the variable cost portion of the nuclear waste generated each year, with the corresponding amounts charged to operating expenses. Expenses relating to low and intermediate level waste are charged to depreciation and amortization expense. Expenses relating to the disposal or storage of nuclear used fuel are charged to fuel expense. The liability may also be adjusted due to any changes in the estimated amount or timing of the underlying future cash flows. Upon settlement of the liability, a gain or loss would be recorded.

Accretion arises because liabilities for fixed asset removal and nuclear waste management are reported on a net present value basis. Accretion expense is the increase in the carrying amount of the liabilities due to the passage of time. The resulting expense is included in operating expenses.

The asset retirement cost is capitalized by increasing the carrying value of the related fixed assets. The capitalized cost is depreciated over the remaining useful life of the related fixed assets and is included in depreciation expense.

### **Nuclear Fixed Asset Removal and Nuclear Waste Management Funds**

Pursuant to the Ontario Nuclear Funds Agreement (“ONFA”) between OPG and the Province of Ontario, OPG established a Used Fuel Fund and a Decommissioning Fund (together the “Nuclear Funds”). The Used Fuel Fund is intended to fund expenditures associated with the disposal of highly radioactive used nuclear fuel bundles, while the Decommissioning Fund was established to fund expenditures associated with nuclear fixed asset removal and the disposal of low and intermediate level nuclear waste materials. OPG maintains the Nuclear Funds in third party custodial accounts that are segregated from the rest of OPG’s assets.

The Nuclear Funds are invested in fixed income and equity securities, which OPG records as long-term investments and accounts for at their amortized cost value. Therefore, gains and losses are recognized only upon the sale of an underlying security. As such, there may be unrealized gains and losses associated with the investments in the Nuclear Funds, which OPG has not recognized in its consolidated financial statements. After applying the Canadian Institute of Chartered Accountants (“CICA”) Handbook Section 3855, Financial Instruments – Recognition and Measurement in 2007, the Nuclear Funds will be measured at fair value with gains and losses recognized in net income. More detail on the impact of the new accounting standards is provided in the Future Accounting Changes section.

### **Revenue Recognition**

All of OPG’s electricity generation is sold into the real-time energy spot market administered by the Independent Electricity System Operator (“IESO”). Prior to April 1, 2005, revenue was recorded as electricity was generated and metered based on the spot market sales price, net of the Market Power Mitigation Agreement rebate and hedging activities. At each balance sheet date, OPG computed the average spot energy price that prevailed since the beginning of the current settlement period and recognized a Market Power Mitigation Agreement rebate if the average price exceeded 3.8¢/kilowatt hour (“kWh”), based on the amount of energy subject to the rebate.

Effective April 1, 2005, the generation from most of OPG’s baseload hydroelectric facilities and all of the nuclear facilities that OPG operates became rate regulated. As a result, energy revenue generated from the nuclear facilities is recognized based on a regulated price of 4.95¢/kWh. The regulated price received by OPG for the first 1,900 megawatt hours (MWh) of production from the regulated hydroelectric facilities in any hour is 3.3¢/kWh. Any production from these regulated hydroelectric facilities above 1,900 MWh in any hour receives the Ontario electricity spot market price.

The production from OPG’s remaining hydroelectric, fossil-fuelled and wind generating stations remains unregulated and continues to be sold at the Ontario electricity spot market price. However, 85 per cent of the generation output from these other generating assets, excluding the Lennox generating station and forward sales as of January 1, 2005, is subject to a revenue limit. The output from a generating unit where there has been a fuel conversion and the incremental output from a generating station where there has been a refurbishment or expansion of these assets are also excluded from the output covered by the revenue limit. In addition, until the Transition – Generation Corporation Designated Rate Options (“TRO”)

expired on April 30, 2006, volumes sold under such options were also excluded from the revenue limit rebate. This revenue limit, which was originally established for a period of 13 months ending April 30, 2006, was subsequently extended for an additional three years. Starting May 1, 2006, the revenue limit decreased to 4.6¢/kWh from the previous limit of 4.7¢/kWh. On May 1, 2007, the revenue limit will return to 4.7¢/kWh and increase to 4.8¢/kWh effective May 1, 2008. In addition, beginning May 1, 2006, volumes sold under a Pilot Auction administered by the Ontario Power Authority ("OPA") are subject to a revenue limit that is 0.5¢/kWh higher than the revenue limit applicable to OPG's other generating assets. Revenues above these two revenue limits are returned to the IESO for the benefit of consumers.

OPG also sells into, and purchases from, interconnected markets of other provinces and the U.S. northeast and midwest. All contracts that are not designated as hedges are recorded in the consolidated balance sheets at market value with gains or losses recorded in the consolidated statements of income. Gains and losses on energy trading contracts (including those to be physically settled) are recorded on a net basis in the consolidated statements of income. Accordingly, power purchases of \$163 million in 2006 and \$228 million in 2005 were netted against revenue.

OPG derives non-energy revenue under the terms of a lease arrangement with Bruce Power L.P. ("Bruce Power") related to the Bruce nuclear generating stations. This includes lease revenues, interest income and revenues for engineering analysis and design, technical and ancillary services. OPG also earns revenue from its joint venture share of the Brighton Beach Power Limited Partnership ("Brighton Beach") related to an energy conversion agreement between Brighton Beach and Coral Energy Canada Inc. ("Coral"). In addition, non-energy revenue includes isotope sales to the medical industry and real estate rentals. Revenues from these activities are recognized as services are provided or as products are delivered.

#### *Accounting for Certain Leases*

OPG accounts for certain lease revenues relating to the regulated business using the cash basis of accounting. Under the cash basis of accounting, OPG recognizes lease income as stipulated in the lease agreement to the extent that the lease payments are expected to be included in future regulated prices charged to customers.

If OPG did not apply the cash basis of accounting for leases and the taxes payable method for the related income tax accounting in 2006, the revenue and the related future income tax expense would have increased by \$21 million (2005 – \$15 million) and \$6 million (2005 – \$5 million) respectively.

As of December 31, 2006, had OPG accounted for the leases related to the regulated business using a straight-line basis and the related income taxes using the liability method, OPG would have reported a deferred lease receivable of \$36 million (2005 – \$15 million) and a related future income tax liability of \$11 million (2005 – \$5 million).

#### **Derivatives**

OPG is exposed to changes in electricity prices associated with a wholesale spot market for electricity in Ontario. To hedge the commodity price risk exposure associated with changes in the wholesale price of electricity, OPG enters into various energy and related sales contracts. These contracts are expected to be effective as hedges of the commodity price exposure on OPG's generation portfolio. Gains or losses on hedging instruments are recognized in income over the term of the contract when the underlying hedged transactions occur. These gains or losses are included in unregulated revenue and are not recorded on the consolidated balance sheets. All contracts not designated as hedges are recorded as assets or liabilities at fair value with changes in fair value recorded in other revenue.

OPG also enters into derivative contracts with major financial institutions to manage the Company's exposure to foreign currency movements. Foreign exchange translation gains and losses on these foreign currency denominated derivative contracts are recognized as an adjustment to the purchase price of the commodity or goods received.

OPG is exposed to changes in market interest rates on debt expected to be issued in the future. OPG uses interest rate derivative contracts to hedge this exposure. Gains and losses on interest rate hedges are recorded as an adjustment to interest expense for the debt being hedged. Gains and losses that do not meet the effectiveness criteria are recorded through net income in the period incurred.

OPG utilizes emission reduction credits ("ERCs") and allowances to manage emissions within the prescribed regulatory limits. ERCs are purchased from trading partners in Canada and the United States. Emission allowances are obtained from the Province and purchased from trading partners in Ontario. The cost of ERCs and allowances are held in inventory and charged to OPG's operations at average cost as part of fuel expense as required. Options to purchase ERCs are accounted for as derivatives and are recorded at estimated market value.

Hedge accounting is applied when the derivative instrument is designated as a hedge and is expected to be effective throughout the life of the hedged item. When such derivative instrument ceases to exist or be effective as a hedge, or when designation of a hedging relationship is terminated, any associated deferred gains or losses are carried forward to be recognized in income in the same period as the corresponding gains or losses associated with the hedged item. When a hedged item ceases to exist, any associated deferred gains or losses are recognized in the current period's consolidated statement of income.

### **Foreign Currency Translation**

Monetary assets and liabilities denominated in foreign currencies are translated into Canadian currency at year-end exchange rates. Any resulting gain or loss is reflected in other revenue.

### **Research and Development**

Research and development costs are charged to operations in the year incurred. Research and development costs incurred to discharge long-term obligations such as the nuclear waste management liabilities, for which specific provisions have already been made, are charged to the related liability.

### **Pension and Other Post Employment Benefits**

OPG's post employment benefit programs include a contributory defined benefit registered pension plan, a defined benefit supplementary pension plan, group life insurance, health care and long-term disability benefits. OPG accrues its obligations under pension and other post employment benefit ("OPEB") plans. The obligations for pension and other post retirement benefit costs are determined using the projected benefit method pro-rated on service. The obligation for long-term disability benefits is determined using the projected benefit method on a terminal basis. The obligations are affected by salary levels, inflation, and cost escalation. Pension and OPEB costs and obligations are determined annually by independent actuaries using management's best estimate assumptions. The discount rates used by OPG in determining projected benefit obligations and the costs for the Company's employee benefit plans are based on representative AA corporate bond yields.

Pension fund assets are valued using market-related values for purposes of determining actuarial gains or losses and the expected return on plan assets. The market-related value recognizes gains and losses on equity assets relative to a six per cent assumed real return over a five-year period.

Pension and OPEB costs include current service costs, interest costs on the obligations, the expected return on pension plan assets, adjustments for plan amendments and adjustments for actuarial gains or losses, which result from changes in assumptions and experience gains and losses. Past service costs arising from pension and OPEB plan amendments are amortized on a straight-line basis over the expected average remaining service life of the employees covered by the plan, since OPG will realize the economic benefit over that period. Due to the long-term nature of post-employment liabilities, the excess of the net cumulative unamortized gain or loss, over 10 per cent of the greater of the benefit obligation and the market-related value of the plan assets, is also amortized over the expected average remaining service life.

When the recognition of the transfer of employees and employee-related benefits gives rise to both a curtailment and a settlement, the curtailment is accounted for prior to the settlement. A curtailment is the loss by employees of the right to earn future benefits under the plan. A settlement is the discharge of a plan's liability.

## **Taxes**

Under the *Electricity Act, 1998*, OPG is responsible for making payments in lieu of corporate income and capital taxes to the OEFC. These payments are calculated in accordance with the *Income Tax Act* (Canada) and the *Corporations Tax Act* (Ontario), and are modified by the *Electricity Act, 1998* and related regulations. This effectively results in OPG paying taxes similar to what would be imposed under the federal and Ontario tax acts.

OPG follows the liability method of accounting for income taxes of its unregulated operations. Under the liability method, future tax assets and liabilities are determined based on differences between the accounting and tax bases of assets and liabilities and measured using the substantively enacted tax rates and laws that will be in effect when the differences are expected to reverse. The effect on future income tax assets and liabilities of a change in tax rates is included in income in the period the change is substantively enacted. Future income tax assets are evaluated and if realization is not considered more likely than not, a valuation allowance is established.

Commencing April 1, 2005, with the introduction of rate regulation, OPG accounts for income taxes relating to the rate regulated segments of its business using the taxes payable method. Under the taxes payable method, OPG does not recognize future income taxes relating to the rate regulated segments of its business to the extent those future income taxes are expected to be recovered in future regulated prices charged to customers.

OPG makes payments in lieu of property tax on its nuclear and fossil-fuelled generating assets to the OEFC, and also pays property taxes to municipalities.

OPG pays charges on gross revenue derived from the annual generation of electricity from its hydroelectric generating assets. The gross revenue charge ("GRC") includes a fixed percentage charge applied to the annual hydroelectric generation derived from stations located on provincial Crown lands, in addition to graduated rate charges applicable to all hydroelectric stations. GRC costs are included in fuel expense.

## **Changes in Accounting Policies and Estimates**

### *Depreciation of Long-Lived Assets*

The accounting estimates related to the depreciation of long-lived assets require significant management judgment to assess the appropriate useful lives of OPG's long-lived assets, including consideration of various technological and other factors.

Effective January 1, 2006, following the completion of a review of the life limiting components of the Pickering B nuclear generating station, OPG revised and extended, for the purpose of calculating depreciation, the estimated remaining service life of the Pickering B nuclear generating station to 2014 from 2009. The extension reduced depreciation expense by \$36 million in 2006.

The Province has accepted the advice of the IESO in their June 2006 report that indicates a need for 2,500 to 3,000 MW of additional capacity to maintain system reliability. Therefore, further delays will be necessary in the Province's plan to replace coal-fired generation by 2009. As a result of these delays, effective July 1, 2006, OPG extended the life for all of the coal-fired generating stations, for purposes of calculating depreciation, to December 31, 2012. The extension reduces depreciation expense by \$64 million in 2006, \$126 million in 2007, and \$46 million in 2008. From 2009 to 2012, the depreciation expense will increase by \$59 million in each year. OPG will reassess the service life of the coal-fired stations upon release of the submitted Integrated Power System Plan, and as subsequently approved by the OEB. Any change to the estimated service life of the coal-fired generating stations, for purposes of calculating depreciation, could have a material impact on OPG's consolidated financial statements.

OPG will continue to review the estimated useful lives of its generating stations including the Darlington and Bruce nuclear generating units. Any changes resulting from the review would be reflected in 2007.

### *Reportable Segments*

As noted in Note 18, effective April 1, 2005, the output from most of OPG's baseload hydroelectric facilities and all of the nuclear facilities that OPG operates became rate regulated. OPG continues to receive the spot market price for the output from its other generating stations, subject to a revenue limit on the majority of this output. With the introduction of rate regulation, OPG revised its reportable business segments to separately reflect the regulated and unregulated aspects of its business. Since the second quarter of 2005, OPG reported its business segments as Regulated – Nuclear, Regulated – Hydroelectric, and Unregulated Generation. Commencing in the first quarter of 2006, OPG separated the Unregulated Generation business segment into two reportable segments, identified as Unregulated – Fossil-Fuelled and Unregulated – Hydroelectric, as a result of changes in the management structure of these segments. Results for the comparative periods have been reclassified to reflect the revised disclosure.

### **Future Accounting Changes**

In 2005, the CICA issued three new accounting standards: Handbook Section 1530, Comprehensive Income; Handbook Section 3855, Financial Instruments – Recognition and Measurement; and Handbook Section 3865, Hedges. These standards apply to interim and annual financial statements relating to fiscal years beginning on or after October 1, 2006.

These standards are effective for OPG beginning in 2007. OPG has completed assessing the impact of these standards on its consolidated financial statements. The impact of implementing these new standards on OPG's consolidated financial statements is summarized below under the heading Impact of Adoption. The following provides further information on each of the three new accounting standards as they relate to OPG.

#### *Comprehensive Income*

As a result of adopting these standards, a new category, accumulated other comprehensive income, will be added to shareholder's equity in the consolidated balance sheets. Major components for this category will include unrealized gains and losses on financial assets classified as available-for-sale, changes in the fair value of the effective portion of cash flow hedging instruments, and unrealized foreign currency translation amounts, net of hedging, arising from self-sustaining foreign operations. These amounts will be recorded in the statement of other comprehensive income until the criteria for recognition in the consolidated statement of income are met.

#### *Financial Instruments – Recognition and Measurement*

Under the new standard, for accounting purposes, financial assets will be classified as one of the following: held-to-maturity, loans and receivables, held-for-trading or available-for-sale, and financial liabilities will be classified as held-for-trading or other than held-for-trading. Financial assets and liabilities held-for-trading will be measured at fair value with gains and losses recognized in net income. Financial assets held-to-maturity, loans and receivables and financial liabilities other than those held-for-trading, will be measured at amortized cost. Available-for-sale instruments will be measured at fair value with unrealized gains and losses recognized in other comprehensive income. The standard also permits designation of any financial instrument as held-for-trading upon initial recognition. All derivatives, including embedded derivatives that must be separately accounted for, generally must be classified as held-for-trading and recorded at fair value in the consolidated balance sheets.

## Hedges

This new standard specifies the criteria under which hedge accounting can be applied and how hedge accounting is to be executed for each of the permitted hedging strategies: fair value hedges, cash flow hedges and hedges of a foreign currency exposure of a net investment in a self-sustaining foreign operation. In a fair value hedging relationship, the carrying value of the hedged item is adjusted by gains or losses attributable to the hedged risk and recognized in net income. This change in fair value of the hedged item, to the extent that the hedging relationship is effective, is offset by changes in the fair value of the derivative. In a cash flow hedging relationship, the effective portion of the change in the fair value of the hedging derivative will be recognized in other comprehensive income. The ineffective portion will be recognized in net income. The amounts recognized in accumulated other comprehensive income will be reclassified to net income in the periods in which net income is affected by the variability in the cash flows of the hedged item. In hedging a foreign currency exposure of a net investment in a self-sustaining foreign operation, foreign exchange gains and losses on the hedging instruments will be recognized in other comprehensive income.

## Impact of Adoption

Upon adoption of the financial instruments accounting standards, the assets in the Nuclear Funds that have been carried at amortized cost until the end of 2006, will be classified as held-for-trading in 2007 and reported at fair value. The transition adjustment related to the change in accounting for the funds will be recognized in the opening balance of retained earnings as at January 1, 2007. The transition adjustment for embedded derivatives within long-term contracts will also be recognized in the opening balance of retained earnings as at January 1, 2007. Prior to January 1, 2007, OPG valued securities in the Nuclear Funds based on the closing price of the securities. Starting January 1, 2007, OPG will apply bid pricing, however, the change in the pricing methodology is not expected to have a significant impact to the Nuclear Funds balance on the consolidated balance sheets. The fair value of hedging instruments designated as cash flow hedges will be recognized in the opening accumulated other comprehensive income on a net of tax basis. The fair values of these hedges are disclosed in Note 12 to the audited consolidated financial statements.

The transition amounts that will be recorded in the opening retained earnings or in the opening accumulated other comprehensive income balance on January 1, 2007 are as follows:

|                                         | At Cost<br>December 31<br>2006 | At Fair Value<br>January 1<br>2007 | Transition Amounts – January 1, 2007 |                                                         |
|-----------------------------------------|--------------------------------|------------------------------------|--------------------------------------|---------------------------------------------------------|
|                                         |                                |                                    | Opening<br>Retained<br>Earnings      | Opening<br>Accumulated Other<br>Comprehensive<br>Income |
| <i>(millions of dollars)</i>            |                                |                                    |                                      |                                                         |
| Nuclear funds balance <sup>1</sup>      | 7,694                          | 9,041                              | 1,347                                | -                                                       |
| Due to Province                         | (100)                          | (928)                              | (828)                                | -                                                       |
|                                         | 7,594                          | 8,113                              | 519                                  | -                                                       |
| Accounts receivable and other<br>assets | 325                            | 372                                | -                                    | 47                                                      |
| Accounts payable and accrued<br>charges | (989)                          | (1,005)                            | (6)                                  | (10)                                                    |
| Net future income tax liability         | (249)                          | (265)                              | -                                    | (16)                                                    |
| Transition adjustments                  |                                |                                    | 513                                  | 21                                                      |

<sup>1</sup> OPG applied bid pricing for securities in the Nuclear Funds. As a result, the fair value of the Nuclear Funds above is lower than that reported under Note 9 of the financial statements. The change in pricing methodology does not have any impact to the overall balance on the consolidated balance sheets because the reduction in fair value is offset by the corresponding change in the due to Province balance.

#### 4. SALE OF ACCOUNTS RECEIVABLE

On October 1, 2003, the Company signed an agreement to sell an undivided co-ownership interest in its current and future accounts receivable (the "receivables") to an independent trust. The Company also retains an undivided co-ownership interest in the receivables sold to the trust. Under the agreement, OPG continues to service the receivables. The transfer provides the trust with ownership of a share of the payments generated by the receivables, computed on a monthly basis. The trust's recourse to the Company is generally limited to its income earned on the receivables. In December 2005, the Company extended this agreement to August 2009.

OPG reflected the initial transfer to the trust of the co-ownership interest, and subsequent transfers required by the revolving nature of the securitization, as sales in accordance with CICA Accounting Guideline 12, *Transfer of Receivables*. In accordance with this Guideline, the proceeds of each sale to the trust were deemed to be the cash received from the trust net of the undivided co-ownership interest retained by the Company. For 2006, OPG has recognized pre-tax charges of \$13 million (2005 – \$9 million) on such sales at an average cost of funds of 4.4 per cent (2005 – 3.1 per cent). As at December 31, 2006, OPG had sold receivables of \$300 million from its total portfolio of \$392 million.

The accounts receivable reported and securitized by the Company are as follows:

| <i>(millions of dollars)</i>             | Principal amount of receivables<br>as at December 31 |      | Average balance of receivables<br>for year ended December 31 |      |
|------------------------------------------|------------------------------------------------------|------|--------------------------------------------------------------|------|
|                                          | 2006                                                 | 2005 | 2006                                                         | 2005 |
| Total receivables portfolio <sup>1</sup> | <b>392</b>                                           | 668  | <b>445</b>                                                   | 559  |
| Receivables sold                         | <b>300</b>                                           | 300  | <b>300</b>                                                   | 300  |
| Receivables retained                     | <b>92</b>                                            | 368  | <b>145</b>                                                   | 259  |
| Average cost of funds                    |                                                      |      | <b>4.4%</b>                                                  | 3.1% |

<sup>1</sup> Amount represents receivables outstanding, including receivables that have been securitized, which the Company continues to service.

An immediate 10 per cent or 20 per cent adverse change in the discount rate would not have a material effect on the current fair value of the retained interest. There were no credit losses for the year ended December 31, 2006 and 2005.

Details of cash flows from securitizations for the years ended December 31, 2006 and 2005 are as follows:

| <i>(millions of dollars)</i>                           | 2006         | 2005  |
|--------------------------------------------------------|--------------|-------|
| Collections reinvested in revolving sales <sup>1</sup> | <b>3,600</b> | 3,600 |
| Cash flows from retained interest                      | <b>2,020</b> | 2,927 |

<sup>1</sup> Given the revolving nature of the securitization, the cash collections received on the receivables securitized are immediately reinvested in additional receivables resulting in no further cash proceeds to the Company over and above the initial cash amount of \$300 million. The amounts reflect the total of 12 monthly amounts.

## 5. FIXED ASSETS

Depreciation and amortization expense consists of the following:

| <i>(millions of dollars)</i>   | <b>2006</b> | <b>2005</b> |
|--------------------------------|-------------|-------------|
| Depreciation and amortization  | <b>659</b>  | 748         |
| Nuclear waste management costs | <b>5</b>    | 5           |
|                                | <b>664</b>  | 753         |

Fixed assets consist of the following:

| <i>(millions of dollars)</i>                  | <b>2006</b>   | <b>2005</b> |
|-----------------------------------------------|---------------|-------------|
| Property, plant and equipment                 |               |             |
| Nuclear generating stations                   | <b>6,275</b>  | 4,754       |
| Regulated Hydroelectric generating stations   | <b>4,384</b>  | 4,379       |
| Unregulated Hydroelectric generating stations | <b>3,481</b>  | 3,447       |
| Fossil-Fuelled generating stations            | <b>1,465</b>  | 1,411       |
| Other fixed assets                            | <b>854</b>    | 833         |
| Construction in progress                      | <b>677</b>    | 348         |
|                                               | <b>17,136</b> | 15,172      |
| Less: accumulated depreciation                |               |             |
| Generating stations                           | <b>4,066</b>  | 3,497       |
| Other fixed assets                            | <b>309</b>    | 263         |
|                                               | <b>4,375</b>  | 3,760       |
|                                               | <b>12,761</b> | 11,412      |

Interest capitalized to construction in progress at 6.0 per cent during the years ended December 31, 2006 and 2005 was \$21 million and \$27 million, respectively.

### Impairment of Long-Lived Assets

The accounting estimates related to asset impairment require significant management judgment to identify factors such as short and long-term forecasts for future sales prices, the supply of electricity in Ontario, inflation, fuel prices, and station lives. The amount of the future cash flow that OPG will ultimately realize with respect to these assets could differ materially from the carrying values recorded in the consolidated financial statements.

#### *Pickering A Nuclear Generating Station Units 2 and 3*

OPG completed, in the second quarter of 2005, an assessment of the cost, schedule and risks related to the return to service of Units 2 and 3 at the Pickering A nuclear generating station. The assessment considered results from inspection programs with respect to feeder pipe and steam generator degradation mechanisms, and potential degradation of the calandria vault components, all of which could impact the future capability factor, operating costs and the life of the units. Upon consideration of the scope of the refurbishment work, the costs and the risks related to the return to service of these two units, OPG determined that the return to service of these two units was not justified on a commercial basis even though technically feasible. OPG recorded an impairment loss of \$63 million in the second quarter of 2005 related to the carrying amount of these two units including construction in progress. In addition to the impairment loss for these two units, OPG recorded OM&A expenses of \$57 million related to the write-off of inventory identified as excess or unusable, as a result of not returning Units 2 and 3 to service.

OPG expects to recover the amounts recorded in the deferral account established under a regulation pursuant to the *Electricity Restructuring Act, 2004* (Ontario) relating to non-capital costs incurred on or after January 1, 2005 associated with the return to service of Units 2 and 3. The deferred costs relating to Units 2 and 3 are disclosed in Note 6 to the audited consolidated financial statements.

#### *Lennox Generating Station*

As a result of the Government's "Request for Information/Request for Proposal for 2,500 MW of New Clean Generation and Demand Side Management Projects" released in September 2004 and the related contractual arrangements, future wholesale electricity market revenue is expected to be lower than previously anticipated. As a relatively high variable cost generating station, the Lennox generating station will not be able to recover its fixed operating costs and its carrying value from the wholesale electricity market in the future. Given these factors, OPG had initiated discussions with the Province, with the expectation of entering into a contractual arrangement for the recovery of the annual fixed operating costs and the carrying value of the Lennox generating station. In March 2005, OPG was advised by the Province that it would continue to support OPG in negotiating an arrangement that would allow for the recovery of fixed operating costs, but that the Province would not support an arrangement that would allow for the recovery of the carrying value of the Lennox generating station. As a result of this change in circumstance, OPG recorded the impairment loss of \$202 million in the first quarter of 2005.

In March 2006, the OEB issued a decision approving a reliability must-run ("RMR") contract between OPG and the Independent Electricity System Operator ("IESO") for the Lennox generating station, for the period October 1, 2005 to September 30, 2006. Reliability must-run contracts are designed to ensure that generating stations remain available to maintain the reliability of the electricity system. In its decision, the OEB found it appropriate for OPG to recover the fixed and variable operating costs of the Lennox generating station that are not recovered through market revenues. As a result of the decision, OPG recorded \$59 million in revenue in 2006. The RMR contract is a cost-based contract that provides for regular payments, which are subject to adjustments for actual costs. OPG negotiated a similar contract with the IESO for the period October 1, 2006 to September 30, 2007. The contract was approved by the OEB in January 2007.

#### *Thunder Bay and Atikokan Generating Stations*

OPG recognized an impairment loss on the Thunder Bay and Atikokan coal-fired generating stations in 2006 of \$22 million, which represented the carrying amount or net book value of these stations. OPG tested the recoverability of the carrying amounts of the coal-fired stations as a result of changes in circumstance, which included a decrease in forecast Ontario spot market prices and the extension of the lives of the coal-fired stations. The fair value of the coal-fired generating stations, which was determined using a discounted cash flow method, was compared to the carrying value of the generating assets to determine the impairment loss. It was determined that the Thunder Bay and Atikokan coal-fired generating stations would not be able to recover their operating and capital expenditures and carrying amount, over their remaining service lives.

## 6. REGULATORY ASSETS AND LIABILITIES

The regulatory assets and liabilities as at December 31, 2006 and 2005 are as follows:

| <i>(millions of dollars)</i>                                | <b>2006</b> | <b>2005</b> |
|-------------------------------------------------------------|-------------|-------------|
| Regulatory assets                                           |             |             |
| Pickering A generating station return to service costs      | <b>249</b>  | 261         |
| Ancillary service revenue variance                          | -           | 5           |
| Transmission outages and transmission restrictions variance | <b>2</b>    | -           |
| <b>Total regulatory assets</b>                              | <b>251</b>  | 266         |
| Regulatory liabilities                                      |             |             |
| Hydroelectric production variance                           | <b>4</b>    | 4           |
| Other                                                       | <b>7</b>    | 8           |
| <b>Total regulatory liabilities</b>                         | <b>11</b>   | 12          |

The changes in the regulatory assets and liabilities for 2006 and 2005 are as follows:

| <i>(millions of dollars)</i>                          | <b>Pickering A<br/>Return to<br/>Service Costs</b> | <b>Ancillary<br/>Service<br/>Revenue<br/>Variance</b> | <b>Hydro-<br/>electric<br/>Production<br/>Variance</b> | <b>Transmission<br/>Outages and<br/>Transmission<br/>Restrictions<br/>Variance</b> | <b>Other</b> |
|-------------------------------------------------------|----------------------------------------------------|-------------------------------------------------------|--------------------------------------------------------|------------------------------------------------------------------------------------|--------------|
| Regulatory assets (liabilities),<br>January 1, 2005   | -                                                  | -                                                     | -                                                      | -                                                                                  | -            |
| Increase (decrease) during the<br>year                | 265                                                | 5                                                     | (4)                                                    | -                                                                                  | (8)          |
| Amortization during the year                          | (4)                                                | -                                                     | -                                                      | -                                                                                  | -            |
| Regulatory assets (liabilities),<br>December 31, 2005 | 261                                                | 5                                                     | (4)                                                    | -                                                                                  | (8)          |
| Increase (decrease) during the<br>year                | 13                                                 | (5)                                                   | -                                                      | 2                                                                                  | 1            |
| Amortization during the year                          | (25)                                               | -                                                     | -                                                      | -                                                                                  | -            |
| Regulatory assets (liabilities),<br>December 31, 2006 | <b>249</b>                                         | -                                                     | <b>(4)</b>                                             | <b>2</b>                                                                           | <b>(7)</b>   |

### Pickering A Return to Service Costs

Effective January 1, 2005, in accordance with a regulation made under the *Electricity Restructuring Act, 2004* (Ontario), OPG was required to establish a deferral account in connection with non-capital costs incurred on or after January 1, 2005 that are associated with the planned return to service of all units at the Pickering A nuclear generating station. As a result, the change in accounting was prospectively adopted on January 1, 2005. As at December 31, 2006, the deferral account was \$249 million, consisting of non-capital costs of \$232 million relating to Unit 1, \$19 million relating to Units 2 and 3, \$20 million of general return to service costs, interest of \$7 million, and accumulated amortization of \$29 million.

As at December 31, 2005, the deferral account was \$261 million, consisting of non-capital costs of \$228 million relating to Unit 1, \$19 million relating to Units 2 and 3, \$11 million of general return to service costs, interest of \$7 million, and accumulated amortization of \$4 million.

Under the regulation, the OEB is directed to ensure that OPG recovers any balance in the deferral account on a straight-line basis over a period not to exceed 15 years.

Had OPG not charged costs to the deferral account as required by the regulation, OM&A expenses would have been reduced by \$12 million (2005 – would have been increased by \$254 million). Further, the net interest expense would have been \$7 million higher in 2005.

### **Variance Accounts and Other Regulatory Balances**

Effective April 1, 2005, in accordance with a regulation made under the *Electricity Restructuring Act, 2004* (Ontario), OPG was directed to establish variance accounts for capital and non-capital costs incurred and revenues earned or foregone on or after April 1, 2005 due to deviations from the forecast information provided to the Province for the purposes of establishing regulated prices that are associated with differences in hydroelectric electricity production due to differences between forecast and actual water conditions, unforeseen changes to nuclear regulatory requirements or unforeseen technological changes, changes to revenues for ancillary services from the regulated facilities, acts of God (including severe weather events), and transmission outages and transmission restrictions. OPG recorded a reduction in revenue during 2006 of \$5 million, reflecting ancillary services revenue that was favourable compared to the forecast for 2006 provided to the Province for the purposes of establishing regulated prices. OPG recorded revenue during 2006 of \$2 million reflecting lower generation sales caused by transmission outages and transmission restrictions in 2006.

OPG recorded revenue during 2005 of \$5 million, reflecting ancillary services revenue that was unfavourable compared to that forecasted for 2005. OPG recorded a reduction in revenue during 2005 of \$4 million, reflecting water conditions that were favourable compared to those forecasted for 2005.

The OEB is directed by the regulation to ensure recovery of amounts recorded in the variance accounts to the extent that the OEB is satisfied that the revenues recorded in the accounts were earned or foregone, that the costs recorded in the accounts were prudently incurred, and that both revenues and costs are accurately recorded. Any balances approved by the OEB will be amortized over a period not to exceed three years. The amortization will commence when OPG starts to recover the balances through new prices that will be set by the OEB. Any balances in the account disallowed by the OEB will be reflected in results of operations in the period that the OEB decision occurs.

The other regulatory liability includes a portion of non-regulated revenue earned by OPG's regulated assets, which may result in a reduction of future regulated prices to be established by the OEB.

Had OPG not accounted for the variance accounts and other regulatory balances as regulatory assets and liabilities, revenue for 2006 would have been higher by \$2 million (2005 – lower by \$1 million).

### **Liability for Nuclear Used Fuel Management and Liability for Nuclear Decommissioning and Low and Intermediate Level Waste Management**

In February 2007 the Province amended a regulation pursuant to the *Electricity Restructuring Act, 2004* (Ontario) to require OPG to establish a deferral account in connection with certain changes to its liability for nuclear used fuel management and its liability for nuclear decommissioning and low and intermediate level waste management. The deferral account requires OPG to record a regulatory asset or liability representing the revenue requirement impact associated with the changes in these nuclear liabilities arising from an Approved Reference Plan, approved after April 1, 2005, in accordance with the terms of the ONFA. Revenue requirement is a regulatory construct, which represents all costs and a return on rate base at an allowed rate of return that the regulator determines to be appropriate. On December 31, 2006, OPG recorded an increase of \$1,386 million in these nuclear liabilities arising from the 2006 Approved Reference Plan.

Commencing on January 1, 2007 and up to the effective date of the OEB's first order establishing regulated prices, which is expected to be after March 31, 2008, OPG will record a regulatory asset associated with the increase in the nuclear liabilities arising from the 2006 Approved Reference Plan. The OEB is directed by the regulation to ensure that OPG recovers the balance recorded in the deferral account on a straight line basis over a period not to exceed three years, to the extent that the OEB is satisfied that the revenue requirement impacts are accurately recorded.

## 7. SHORT-TERM CREDIT FACILITIES

OPG's \$1 billion revolving committed bank credit facility is divided into two tranches – a \$500 million 364-day term tranche maturing May 22, 2007, and a \$500 million three-year term tranche maturing May 22, 2009. The total credit facility will be used primarily as support for notes issued under OPG's commercial paper program. As of December 31, 2006, there was \$15 million of commercial paper outstanding (2005 – \$ nil). OPG had no other outstanding borrowing under its bank credit facility in 2006 and 2005.

OPG also maintains \$26 million (2005 – \$26 million) in short-term uncommitted overdraft facilities as well as \$240 million (2005 – \$215 million) of short-term uncommitted credit facilities, which support the issuance of Letters of Credit. OPG uses Letters of Credit to support the supplementary pension plans and is required to post Letters of Credit as collateral with Local Distribution Companies ("LDCs") as prescribed by the OEB's Retail Settlement Code. At December 31, 2006, there was a total of \$185 million (2005 – \$157 million) of Letters of Credit issued, which included \$159 million relating to the supplementary pension plans (2005 – \$138 million) and \$16 million (2005 – \$ nil) relating to the construction of the Portlands Energy Centre.

## 8. LONG-TERM DEBT

Long-term debt consists of the following:

| <i>(millions of dollars)</i>                   | <b>2006</b>  | <b>2005</b> |
|------------------------------------------------|--------------|-------------|
| Notes payable to the OEFC                      | <b>3,165</b> | 3,695       |
| Share of non-recourse limited partnership debt | <b>194</b>   | 200         |
|                                                | <b>3,359</b> | 3,895       |
| Less: due within one year                      |              |             |
| Notes payable to the OEFC                      | <b>400</b>   | 800         |
| Share of limited partnership debt              | <b>6</b>     | 6           |
|                                                | <b>406</b>   | 806         |
| Long-term debt                                 | <b>2,953</b> | 3,089       |

Holders of the senior debt are entitled to receive, in full, amounts owing in respect of the senior debt before holders of the subordinated debt are entitled to receive any payments. The OEFC currently holds all of OPG's outstanding senior and subordinated notes.

The maturity dates as at December 31, 2006 for notes payable to the OEFC are as follows:

| <b>Year of Maturity</b> | <b>Interest Rate (%)</b> | <b>Principal Outstanding (millions of dollars)</b> |                           | <b>Total</b> |
|-------------------------|--------------------------|----------------------------------------------------|---------------------------|--------------|
|                         |                          | <b>Senior Notes</b>                                | <b>Subordinated Notes</b> |              |
| 2007                    | 5.85                     | 400                                                | -                         | 400          |
| 2008                    | 5.90                     | 400                                                | -                         | 400          |
| 2009                    | 6.01                     | 350                                                | -                         | 350          |
| 2010                    | 6.00                     | 595                                                | 375                       | 970          |
| 2011                    | 6.65                     | -                                                  | 375                       | 375          |
| 2012                    | 5.72                     | 400                                                | -                         | 400          |
| 2016                    | 4.91                     | 270                                                | -                         | 270          |
|                         |                          | <b>2,415</b>                                       | <b>750</b>                | <b>3,165</b> |

In March 2005, the Company reached an agreement with the OEFC to obtain additional financing up to \$600 million until March 31, 2006. In April 2005, \$400 million was drawn under this facility, with a seven-year term.

In September 2005, OPG reached an agreement with the OEFC to provide debt financing for the Niagara Tunnel project. The funding, which is up to \$1 billion over the duration of the project, will be in the form of 10-year notes, which will be issued quarterly to meet the project's obligations. Interest will be fixed for each note issued at the time of advance at a rate equal to the prevailing Benchmark Government of Canada 10-Year Bond, plus a credit spread determined by the OEFC based on a survey of market rates. In October 2006, OPG issued \$160 million against this facility.

In October 2005, OPG reached a similar agreement with the OEFC to provide debt financing for the Thunder Bay Gas Conversion project. Under this credit facility, up to \$95 million was available to OPG and could be drawn as needed over the construction period. In light of the directive to the OPA to determine how best to replace coal-fired generation, the Province determined that it was no longer advisable to continue with the conversion of the Thunder Bay generating station to run on natural gas. On July 12, 2006, OPG received a Shareholder Declaration revoking the October 2005 Shareholder Declaration, effectively cancelling the project.

In December 2006, OPG reached an agreement with the OEFC to provide debt financing for the Lac Seul Hydroelectric Generating Station and the Portlands Energy Centre projects. There will be up to \$50 million available for the Lac Seul project and up to \$400 million available for the Portlands Energy Centre project under each credit facility. The credit facilities will be drawn as needed to fund the respective projects over the construction period. The funding will be in the form of 10-year notes with interest rates fixed for each note issued at the time of advance at a rate equal to the prevailing Benchmark Government of Canada 10-Year Bond, plus a credit spread determined by the OEFC based on a survey of market rates. In December, OPG issued \$20 million and \$90 million against the Lac Seul project credit facility and the Portlands Energy Centre credit facility respectively.

Interest paid in 2006 was \$248 million (2005 – \$235 million), of which \$229 million relates to interest paid on long-term debt (2005 – \$220 million).

## 9. FIXED ASSET REMOVAL AND NUCLEAR WASTE MANAGEMENT

The liabilities for fixed asset removal and nuclear waste management on a present value basis consist of the following:

| <i>(millions of dollars)</i>                                                          | <b>2006</b>   | <b>2005</b> |
|---------------------------------------------------------------------------------------|---------------|-------------|
| Liability for nuclear used fuel management                                            | <b>5,669</b>  | 4,940       |
| Liability for nuclear decommissioning and low and intermediate level waste management | <b>4,659</b>  | 3,627       |
| Liability for non-nuclear fixed asset removal                                         | <b>192</b>    | 192         |
| <b>Fixed asset removal and nuclear waste management liabilities</b>                   | <b>10,520</b> | 8,759       |

The changes in the fixed asset removal and nuclear waste management liability for the years ended December 31, 2006 and 2005 are as follows:

| <i>(millions of dollars)</i>                                                                                                                                                                     | <b>2006</b>   | <b>2005</b> |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------|-------------|
| Liabilities, beginning of year                                                                                                                                                                   | <b>8,759</b>  | 8,339       |
| Increase in liabilities due to accretion                                                                                                                                                         | <b>499</b>    | 476         |
| Increase in liabilities due to nuclear used fuel and nuclear waste management variable expenses                                                                                                  | <b>38</b>     | 34          |
| Liabilities settled by expenditures on waste management                                                                                                                                          | <b>(164)</b>  | (90)        |
| Increase in the liability for non-nuclear fixed asset removal                                                                                                                                    | <b>2</b>      | -           |
| Increase in the liability for nuclear used fuel management and the liability for nuclear decommissioning and low and intermediate level waste management to reflect the change in cost estimates | <b>1,386</b>  | -           |
| <b>Liabilities, end of year</b>                                                                                                                                                                  | <b>10,520</b> | 8,759       |

OPG's fixed asset removal and nuclear waste management liabilities are comprised of expected costs to be incurred up to and upon termination of operations and the closure of nuclear and fossil-fuelled generating plant facilities. Costs will be incurred for activities such as dismantling, demolition and disposal of facilities and equipment, remediation and restoration of sites and the ongoing and long-term management of nuclear used fuel and low and intermediate level waste material.

The following costs are recognized as a liability:

- The present value of the costs of dismantling the nuclear and fossil-fuelled production facilities at the end of their useful lives;
- The present value of the fixed cost portion of any nuclear waste management programs that are required based on the total volume of waste expected to be generated over the assumed life of the stations;
- The present value of the variable cost portion of any nuclear waste management program to take into account actual waste volumes incurred to date.

The determination of the accrual for fixed asset removal and nuclear waste management costs requires significant assumptions, since these programs run for many years. As at December 31, 2006, OPG updated the estimates for the nuclear used fuel management and nuclear decommissioning and low and intermediate level waste management liabilities. The resulting updated Reference Plan ("2006 Approved Reference Plan") was approved by the Province in accordance with the terms of the ONFA. The increase in cost estimates reflected in the Approved Reference Plan is mainly due to additional used fuel and waste quantities resulting from station life extension, recent experience in decommissioning reactors, and changes in economic indices. The increase is partially offset by the deferral of some station decommissioning dates.

As a result of the approval of the new Reference Plan, OPG will recognize additional expenses including accretion on the fixed asset removal and nuclear waste management liabilities and depreciation of the carrying value of the related fixed assets. The impact of these additional expenses will be reduced by the recognition of a regulatory asset to be recovered through future prices charged to customers, as prescribed by the amended regulation pursuant to the *Electricity Restructuring Act, 2004* (Ontario) discussed in Note 6 to the consolidated financial statements.

Nuclear and fossil-fuelled plant closures are projected to occur over the next six to 33 years. The updated Reference Plan includes cash flow estimates to 2073 for decommissioning nuclear stations and to approximately 2159 for nuclear used fuel management. The undiscounted amount of estimated cash flows associated with the liabilities expected to be incurred up to and upon closure of generating stations is approximately \$24 billion. The discount rate used to calculate the present value of the liabilities was 5.75 per cent for liabilities established prior to December 31, 2006. The upward revision in the amount of

the undiscounted estimated cash flows for OPG's liability for nuclear waste management and decommissioning was discounted at 4.6 per cent. The cost escalation rates ranged from 1.8 per cent to 3.6 per cent. Under the terms of the lease agreement with Bruce Power, OPG continues to be responsible for the nuclear fixed asset removal and nuclear waste management liabilities associated with the Bruce nuclear generating stations.

The significant assumptions underlying operational and technical factors used in the calculation of the accrued liabilities are subject to periodic review. Changes to these assumptions, including changes to assumptions on the timing of the programs, financial indicators or the technology employed may result in significant changes to the value of the accrued liabilities. With programs of this duration and the evolving technology to handle the nuclear waste, there is a significant degree of uncertainty surrounding the measurement accuracy of the costs for these programs, which may increase or decrease over time.

### **Liability for Nuclear Used Fuel Management Costs**

The liability for nuclear used fuel management represents the cost of managing the highly radioactive used nuclear fuel bundles. The current assumptions that have been used to establish the accrued used fuel costs include long-term management of the spent fuel bundles through deep geological disposal; an in-service date of 2035 for used nuclear fuel disposal facilities; and an average transportation distance of 1,000 kilometres between nuclear generating facilities and the disposal facilities. Alternatives to deep geological disposal have been studied by Canadian nuclear utilities via the Nuclear Waste Management Organization as part of the options study required by the federal *Nuclear Fuel Waste Act* (Canada) ("NFWA"). The options study was submitted to the federal government in November 2005. The federal government will decide which management alternative should be followed. The pending decision could have a significant impact on OPG's estimate of the liability.

### *Liability for Nuclear Decommissioning and Low and Intermediate Level Waste Management Costs*

The liability for nuclear decommissioning and low and intermediate level waste management represents the estimated costs of decommissioning nuclear generating stations after the end of their service lives, as well as the cost of managing low and intermediate level radioactive wastes generated by the nuclear stations. The significant assumptions used in estimating future nuclear fixed asset removal costs include decommissioning of nuclear generating stations on a deferred dismantlement basis where the reactors will remain in a safe storage state for a 30-year period prior to a 10-year dismantlement period.

The life cycle costs of low and intermediate level waste management include the costs of processing and storage of such radioactive wastes during and following the operation of the nuclear stations, as well as the costs of ultimate long-term disposal of these wastes. The current assumptions used to establish the accrued low and intermediate level waste management costs include a disposal facility for low and intermediate level waste with an in-service date of 2017. The option has been approved by the Municipality of Kincardine and the Environmental Assessment ("EA") process is now underway.

### *Liability for Non-Nuclear Fixed Asset Removal Costs*

The liability for non-nuclear fixed asset removal is based on third-party cost estimates after an in-depth review of active plant sites and an assessment of required clean-up and restoration activities. This liability represents the estimated costs of decommissioning fossil-fuelled generating stations at the end of their service lives. The estimated retirement date of these stations is between 2012 and 2039.

In addition to the \$103 million liability for active sites, OPG also has an asset retirement obligation liability of \$89 million for decommissioning and restoration costs associated with plant sites that have been divested or are no longer in use.

OPG has no legal obligation associated with the decommissioning of its hydroelectric generating facilities. Also, the costs cannot be reasonably estimated because of the long service life of these assets. With either maintenance efforts or rebuilding, the water control structures are assumed to be used for the foreseeable future. Accordingly, OPG has not recognized a liability for the decommissioning of its hydroelectric generating facilities.

### **Ontario Nuclear Funds Agreement**

OPG sets aside funds to be used specifically for discharging its nuclear fixed asset removal and nuclear waste management liabilities. In July 2003, OPG and the Province completed arrangements, pursuant to the ONFA. To comply with the ONFA, OPG established the Nuclear Funds. OPG jointly oversees the investment management of the Nuclear Funds with the Province. The assets of the Nuclear Funds are maintained in third party custodian accounts that are segregated from the rest of OPG's assets.

The Decommissioning Fund will be used to fund the future costs of nuclear fixed asset removal and long-term low and intermediate level nuclear waste management and a portion of used fuel storage costs after station life. The initial funding of the Decommissioning Fund was intended to be sufficient to fully discharge the 1999 estimate of the liability. OPG bears the risk and liability for cost estimate increases and fund earnings in the Decommissioning Fund.

The Used Fuel Fund will be used to fund future costs of long-term nuclear used fuel waste management. OPG is responsible for the risk and liability for cost increases for used fuel waste management, subject to graduated liability thresholds specified in the ONFA, which limit OPG's total financial exposure at approximately \$6.0 billion, a present value amount at April 1, 1999 (approximately \$9.1 billion in 2006 dollars) based on used fuel bundle projections of 2.23 million bundles consistent with the station lives included within the initial financial reference plan. The graduated liability thresholds do not apply to additional used fuel bundles as projected in the 2006 Approved ONFA Reference Plan. OPG makes quarterly payments to the Used Fuel Fund over the life of its nuclear generating stations, as specified in the ONFA. Required funding for 2006 under the ONFA was \$454 million, including a contribution to The Ontario NFWA Trust (the "Trust") of \$50 million.

The NFWA was proclaimed into force in November 2002. In accordance with the NFWA, the Nuclear Waste Management Organization was formed to prepare and review alternatives, and to provide recommendations to the federal government for long-term management of nuclear fuel waste by November 2005. The federal government will select the option for dealing with the long-term management of nuclear fuel waste based on submitted plans. As required under the NFWA, OPG made an initial deposit of \$500 million into the Trust in November 2002. The NFWA also requires OPG to make annual contributions of \$100 million to the Trust, to be deposited into the Trust no later than the November anniversary of the NFWA. To comply with this requirement, OPG contributed \$150 million to the Trust in 2005 (\$50 million of the funding was part of OPG's funding requirement for 2006), and \$50 million in 2006 to complete the 2006 funding requirement. Under the NFWA, OPG must continue to deposit \$100 million annually into the Trust until the federal government has approved a long-term plan. Future contributions to the Trust beyond 2006 will be dependent on the direction chosen by the federal government based on the recommendations submitted in November 2005. Given that the Trust forms part of the Used Fuel Fund, contributions to the Trust, as required by the NFWA, are applied towards the ONFA payment obligations.

As required by the *Nuclear Safety and Control Act* (Canada), and under the terms of the ONFA, the Province issued a guarantee to the Canadian Nuclear Safety Commission ("CNSC"), on behalf of OPG, for up to \$1,510 million. This is a guarantee that there will be sufficient funds available to discharge the current nuclear decommissioning and waste management liabilities. The provincial guarantee will supplement the Used Fuel Fund and the Decommissioning Fund until they have accumulated sufficient funds to cover the accumulated liabilities for nuclear decommissioning and waste management. The guarantee, taken together with the Used Fuel Fund and Decommissioning Fund, was in satisfaction of OPG's nuclear licensing requirements with the CNSC. OPG pays the Province an annual guarantee fee of 0.5 per cent of the amount guaranteed by the Province. OPG paid the annual guarantee fee for 2006 of \$8 million in 2006 (2005 – \$8 million).

Under the ONFA, the Province guarantees OPG's annual return in the Used Fuel Fund at 3.25 per cent plus the change in the Ontario Consumer Price Index ("committed return"), but only for the Used Fuel Fund relating to the liability associated with the first 2.23 million used fuel bundles. The difference between the committed return on the Used Fuel Fund and the actual market return, based on the fair value of fund assets, which includes realized and unrealized returns, is due to or due from the Province. Since OPG accounts, up to December 31, 2006, for the investments in the segregated funds on an amortized cost basis, the amount due to or due from the Province recorded in the consolidated financial statements is the difference between the committed return and the actual return based on realized returns only. At December 31, 2006, the Used Fuel Fund accounts included an amount due to the Province of \$100 million (2005 – \$4 million). If the investments in the Used Fuel Fund were accounted for at fair market value in the consolidated financial statements, at December 31, 2006, there would be an amount due to the Province of \$641 million (2005 – \$306 million).

Under the ONFA, the Decommissioning Fund had a long-term target rate of return of 5.75 per cent per annum. Under the 2006 Approved Reference Plan, the rate was revised to 5.15 per cent. The target rate of return is subject to future changes in the ONFA Reference Plan. If the rate of return deviates from 5.15 per cent, or if the estimate of the liabilities changes under the current approved ONFA Reference Plan, the Decommissioning Fund may become over or underfunded. Under the ONFA, if there is a surplus in the Decommissioning Fund such that the liabilities, as defined by the Current Approved ONFA Reference Plan, are at least 120 per cent funded, OPG may direct up to 50 per cent of the surplus over 120 per cent as a contribution to the Used Fuel Fund, and the OEFC is entitled to a distribution of an equal amount. In addition, upon termination of the ONFA, the Province has a right to any excess funds, which is the extent to which the fair market value of the Decommissioning Fund exceeds the estimated completion costs approved under the Current Approved ONFA Reference Plan. As at December 31, 2006, the Decommissioning Fund became underfunded on an amortized cost basis as a result of the approval of the 2006 Approved ONFA Reference Plan. Accordingly, no excess adjustment was reported in the Decommissioning Fund as at December 31, 2006. At December 31, 2005, the Decommissioning Fund exceeded the estimated completion cost under the previous ONFA Reference Plan approved in 1999 on an amortized cost basis. OPG reported an excess of \$7 million due to the Province on an amortized cost basis in 2005. If the investments in the Decommissioning Fund were accounted for at fair market value in the consolidated financial statements at December 31, 2006, and the Decommissioning Fund was terminated under the ONFA, there would be an amount due to the Province of \$294 million (2005 – \$484 million).

The nuclear fixed asset removal and nuclear waste management funds as at December 31, 2006 and 2005, consist of the following:

| <i>(millions of dollars)</i>           | <b>Amortized Cost Basis</b> |             | <b>Fair Value</b> |             |
|----------------------------------------|-----------------------------|-------------|-------------------|-------------|
|                                        | <b>2006</b>                 | <b>2005</b> | <b>2006</b>       | <b>2005</b> |
| Decommissioning Fund                   | <b>4,356</b>                | 4,106       | <b>5,169</b>      | 4,583       |
| Due to Province – Decommissioning Fund | -                           | (7)         | <b>(294)</b>      | (484)       |
|                                        | <b>4,356</b>                | 4,099       | <b>4,875</b>      | 4,099       |
| Used Fuel Fund <sup>1</sup>            | <b>3,338</b>                | 2,693       | <b>3,879</b>      | 2,995       |
| Due to Province – Used Fuel Fund       | <b>(100)</b>                | (4)         | <b>(641)</b>      | (306)       |
|                                        | <b>3,238</b>                | 2,689       | <b>3,238</b>      | 2,689       |
|                                        | <b>7,594</b>                | 6,788       | <b>8,113</b>      | 6,788       |

<sup>1</sup> The Ontario NFWA Trust represents \$1,102 million as at December 31, 2006 (December 31, 2005 – \$1,003 million) of the Used Fuel Fund on an amortized cost basis.

The amortized cost and fair value of the securities invested in the segregated funds, which include the Used Fuel Fund and Decommissioning Fund, as at December 31, 2006 and 2005 are as follows:

| <i>(millions of dollars)</i>                         | <b>Amortized Cost Basis</b> |             | <b>Fair Value</b> |             |
|------------------------------------------------------|-----------------------------|-------------|-------------------|-------------|
|                                                      | <b>2006</b>                 | <b>2005</b> | <b>2006</b>       | <b>2005</b> |
| Cash and cash equivalents and short-term investments | <b>556</b>                  | 516         | <b>553</b>        | 515         |
| Marketable equity securities                         | <b>4,250</b>                | 3,772       | <b>5,608</b>      | 4,547       |
| Bonds and debentures                                 | <b>2,306</b>                | 1,757       | <b>2,305</b>      | 1,762       |
| Receivable from the OEFC                             | <b>588</b>                  | 759         | <b>588</b>        | 759         |
| Administrative expense payable                       | <b>(6)</b>                  | (5)         | <b>(6)</b>        | (5)         |
|                                                      | <b>7,694</b>                | 6,799       | <b>9,048</b>      | 7,578       |
| Due to Province – Decommissioning Fund               | -                           | (7)         | <b>(294)</b>      | (484)       |
| Due to Province – Used Fuel Fund                     | <b>(100)</b>                | (4)         | <b>(641)</b>      | (306)       |
| <b>Total</b>                                         | <b>7,594</b>                | 6,788       | <b>8,113</b>      | 6,788       |

The bonds and debentures held in the Used Fuel Fund and the Decommissioning Fund as at December 31, 2006 and 2005 mature according to the following schedule:

| <i>(millions of dollars)</i>               | <b>Fair Value</b> |             |
|--------------------------------------------|-------------------|-------------|
|                                            | <b>2006</b>       | <b>2005</b> |
| Less than 1 year                           | -                 | -           |
| 1 - 5 years                                | <b>1,167</b>      | 769         |
| 5 - 10 years                               | <b>467</b>        | 485         |
| More than 10 years                         | <b>671</b>        | 508         |
| <b>Total maturities of debt securities</b> | <b>2,305</b>      | 1,762       |
| <b>Average yield</b>                       | <b>4.5%</b>       | 4.3%        |

The receivable of \$588 million (2005 – \$759 million) from the OEFC does not have a specified maturity date. The effective rate of interest on the OEFC receivable was 3.9 per cent in 2006 (2005 – 5.8 per cent).

The change in the Nuclear Funds for the years ended December 31, 2006 and 2005 are as follows:

| <i>(millions of dollars)</i>                          | <b>Amortized Cost Basis</b> |             | <b>Fair Value</b> |             |
|-------------------------------------------------------|-----------------------------|-------------|-------------------|-------------|
|                                                       | <b>2006</b>                 | <b>2005</b> | <b>2006</b>       | <b>2005</b> |
| Decommissioning Fund, beginning of year               | <b>4,099</b>                | 3,858       | <b>4,099</b>      | 3,882       |
| Increase in fund due to return on investments         | <b>256</b>                  | 255         | <b>592</b>        | 459         |
| Decrease in fund due to reimbursement of expenditures | <b>(6)</b>                  | (7)         | <b>(6)</b>        | (7)         |
| Decrease (increase) in Due to Province                | <b>7</b>                    | (7)         | <b>190</b>        | (235)       |
| Decommissioning Fund, end of year                     | <b>4,356</b>                | 4,099       | <b>4,875</b>      | 4,099       |
| Used Fuel Fund, beginning of year                     | <b>2,689</b>                | 2,118       | <b>2,689</b>      | 2,118       |
| Increase in fund due to contributions made            | <b>454</b>                  | 454         | <b>454</b>        | 454         |
| Increase in fund due to return on investments         | <b>204</b>                  | 133         | <b>443</b>        | 283         |
| Decrease in fund due to reimbursement of expenditures | <b>(13)</b>                 | (16)        | <b>(13)</b>       | (16)        |
| (Increase) decrease in Due to Province                | <b>(96)</b>                 | -           | <b>(335)</b>      | (150)       |
| Used Fuel Fund, end of year                           | <b>3,238</b>                | 2,689       | <b>3,238</b>      | 2,689       |

## 10. INCOME TAXES

Commencing April 1, 2005, OPG accounts for income taxes related to the rate regulated segments of its business using the taxes payable method. Under the taxes payable method, OPG does not recognize future income taxes related to the rate regulated segments of its business to the extent that the future income taxes are expected to be recovered in future regulated prices charged to customers. As part of the transition, on April 1, 2005, OPG reversed the net future income tax asset balance of \$74 million relating to the rate regulated segments of its business, and recognized the amount as an extraordinary loss in determining net income. The extraordinary item reduced basic and diluted earnings per share for the year ended December 31, 2005 by \$0.29 per share.

A reconciliation between the statutory and the effective rate of income taxes is as follows:

| <i>(millions of dollars)</i>                                                          | <b>2006</b>  | <b>2005</b> |
|---------------------------------------------------------------------------------------|--------------|-------------|
| Income before income taxes                                                            | <b>576</b>   | 558         |
| Combined Canadian federal and provincial statutory income tax rates, including surtax | <b>36.1%</b> | 36.1%       |
| Statutory income tax rates applied to accounting income                               | <b>208</b>   | 202         |
| Increase (decrease) in income taxes resulting from:                                   |              |             |
| Large corporations tax in excess of surtax                                            | -            | 28          |
| Lower future tax rate on temporary differences                                        | <b>(4)</b>   | (12)        |
| Non-taxable income items                                                              | <b>(5)</b>   | 7           |
| Unrecorded future income tax related to regulated operations                          | <b>(89)</b>  | (157)       |
| Change in income tax positions                                                        | <b>10</b>    | 50          |
| Other changes in future tax rate                                                      | <b>(34)</b>  | -           |
|                                                                                       | <b>(122)</b> | (84)        |
| Income tax expense                                                                    | <b>86</b>    | 118         |
| Effective rate of income taxes                                                        | <b>14.9%</b> | 21.1%       |

The Company has revised its future income tax assets and liabilities to reflect the lower federal income tax rates recently enacted.

In the third quarter of 2006, OPG received a preliminary communication from the Provincial Tax Auditors ("Tax Auditors") with respect to their initial findings from their audit of OPG's 1999 taxation year. Many of the issues raised through the audit are unique to OPG and relate either to start-up matters and positions taken on April 1, 1999 upon commencement of operations, or matters that were not adequately addressed through the *Electricity Act, 1998*. OPG has estimated that the proposed adjustments could result in additional taxes payable for the 1999 taxation year in excess of \$200 million. Although OPG has subsequently resolved some of these issues, there is uncertainty as to how the remaining issues will be resolved.

OPG expects to receive a reassessment for its 1999 taxation year. The Company would defend its position through the tax appeals process. The potential increase in taxes payable related to these issues for 1999 and subsequent taxation years could be material. Because OPG uses the taxes payable method to account for income taxes in the regulated business segments and the liability method for the unregulated business segments, the impact of any potential adjustments on future income tax expense could vary significantly, depending on the resolution of these issues.

OPG has previously recorded income tax charges related to certain income tax positions that the Company has taken in prior years that may be disallowed. Given the uncertainty as to how these income tax matters will be resolved, OPG has not adjusted its income tax liabilities. Should the ultimate outcome materially differ from OPG's recorded income tax liabilities, the Company's effective tax rate and its earnings could be affected positively or negatively in the period in which the matters are resolved.

Significant components of the provision for income tax expense are presented in the table below:

| <i>(millions of dollars)</i>          | <b>2006</b> | <b>2005</b> |
|---------------------------------------|-------------|-------------|
| Current income tax expense            | <b>60</b>   | 80          |
| Future income tax expense (benefits): |             |             |
| Change in temporary differences       | -           | (51)        |
| Non-capital loss carry-forward        | <b>52</b>   | 88          |
| Other                                 | <b>(26)</b> | 1           |
|                                       | <b>26</b>   | 38          |
| Income tax expense                    | <b>86</b>   | 118         |

The income tax effects of temporary differences that give rise to future income tax assets and liabilities are presented in the table below:

| <i>(millions of dollars)</i>                                 | <b>2006</b> | <b>2005</b> |
|--------------------------------------------------------------|-------------|-------------|
| Future income tax assets:                                    |             |             |
| Fixed asset removal and nuclear waste management liabilities | <b>29</b>   | 27          |
| Other liabilities and assets                                 | <b>107</b>  | 107         |
| Non-capital loss carry-forward                               | <b>28</b>   | 98          |
| Future recoverable Ontario minimum tax                       | <b>64</b>   | 37          |
|                                                              | <b>228</b>  | 269         |
| Future income tax liabilities:                               |             |             |
| Fixed assets                                                 | <b>332</b>  | 351         |
| Other liabilities and assets                                 | <b>145</b>  | 141         |
|                                                              | <b>477</b>  | 492         |
| Net future income tax liabilities                            | <b>249</b>  | 223         |
| Represented by:                                              |             |             |
| Current portion liability (asset)                            | <b>3</b>    | (18)        |
| Long-term portion                                            | <b>246</b>  | 241         |
|                                                              | <b>249</b>  | 223         |

The following table summarizes the difference in the balance sheet amounts under the taxes payable method used by the Company to account for income taxes compared to what would have been reported had OPG applied the liability method for the regulated business as at December 31, 2006 and 2005:

|                                                  | <b>2006</b>      |                                      | <b>2005</b>      |                                      |
|--------------------------------------------------|------------------|--------------------------------------|------------------|--------------------------------------|
| <i>(millions of dollars)</i>                     | <b>As Stated</b> | <b>Liability Method <sup>1</sup></b> | <b>As Stated</b> | <b>Liability Method <sup>1</sup></b> |
| Future income tax (liabilities) assets – current | <b>(3)</b>       | <b>(4)</b>                           | 18               | 38                                   |
| Long-term future income tax liabilities          | <b>(246)</b>     | <b>(417)</b>                         | (241)            | (344)                                |

<sup>1</sup> As discussed in note 3, OPG accounts for certain lease revenues relating to the regulated business using the cash basis of accounting. The related future income tax impact disclosed in note 3 is excluded from the above.

The following table summarizes the difference in the income statement amounts under the method used by the Company to account for income taxes compared to what would have been reported had OPG applied the liability method for the regulated business for the years ended December 31, 2006 and 2005:

| <i>(millions of dollars)</i> | <b>2006</b>      |                                      | <b>2005</b>      |                                      |
|------------------------------|------------------|--------------------------------------|------------------|--------------------------------------|
|                              | <b>As Stated</b> | <b>Liability Method <sup>1</sup></b> | <b>As Stated</b> | <b>Liability Method <sup>1</sup></b> |
| Extraordinary item           | -                | -                                    | <b>74</b>        | -                                    |
| Future income tax expense    | <b>26</b>        | 115                                  | <b>38</b>        | 195                                  |

<sup>1</sup> As discussed in note 3, OPG accounts for certain lease revenues relating to the regulated business using the cash basis of accounting. The related future income tax impact disclosed in note 3 is excluded from the above.

As at December 31, 2006, OPG had available approximately \$308 million (2005 – \$236 million) of non-capital loss carry-forwards for Ontario income tax purposes. The non-capital loss carry-forward for the purpose of calculating Ontario income taxes is related to the following taxation years:

| <i>(millions of dollars)</i> | <b>Ontario Loss-Carry Forward</b> | <b>Expiry Date <sup>1</sup></b> |
|------------------------------|-----------------------------------|---------------------------------|
| 2004                         | 236                               | 2014                            |
| 2006                         | 72                                | 2026                            |

<sup>1</sup> The Province of Ontario recently introduced legislation in anticipation of the Ontario Corporate tax harmonization whereby these losses would be replaced by a special tax credit which would expire in 2011.

The amount of cash income taxes paid during 2006 was \$24 million (2005 – \$20 million).

## 11. BENEFIT PLANS

The post employment benefit programs include pension, group life insurance, health care and long-term disability benefits. The registered pension plan is a contributory defined benefit plan covering most employees and retirees. Pension fund assets include equity securities and corporate and government debt securities, real estate and other investments which are managed by professional investment managers. The fund does not invest in equity or debt securities issued by OPG. The supplementary pension plans are defined benefit plans covering certain employees and retirees.

Pension and OPEB obligations are impacted by factors including interest rates, adjustments arising from plan amendments, changes in assumptions and experience gains or losses. The pension and OPEB obligations, and the pension fund assets, are measured at December 31, 2006.

|                                                                      | <b>Registered and Supplementary Pension Plans</b> |             | <b>Other Post Employment Benefits</b> |             |
|----------------------------------------------------------------------|---------------------------------------------------|-------------|---------------------------------------|-------------|
|                                                                      | <b>2006</b>                                       | <b>2005</b> | <b>2006</b>                           | <b>2005</b> |
| <i>Weighted Average Assumptions – Benefit Obligation at Year End</i> |                                                   |             |                                       |             |
| Rate used to discount future benefits                                | <b>5.25%</b>                                      | 5.00%       | <b>5.22%</b>                          | 4.97%       |
| Salary schedule escalation rate                                      | <b>3.00%</b>                                      | 3.00%       | -                                     | -           |
| Rate of cost of living increase to pensions                          | <b>2.00%</b>                                      | 2.00%       | -                                     | -           |
| Initial health care trend rate                                       | -                                                 | -           | <b>7.34%</b>                          | 7.76%       |
| Ultimate health care trend rate                                      | -                                                 | -           | <b>4.68%</b>                          | 4.68%       |
| Year ultimate rate reached                                           | -                                                 | -           | <b>2014</b>                           | 2014        |
| Rate of increase in disability benefits                              | -                                                 | -           | <b>2.00%</b>                          | 2.00%       |

|                                                         | Registered and<br>Supplementary Pension<br>Plans |       | Other Post Employment<br>Benefits |       |
|---------------------------------------------------------|--------------------------------------------------|-------|-----------------------------------|-------|
|                                                         | 2006                                             | 2005  | 2006                              | 2005  |
| <i>Weighted Average Assumptions – Cost for the Year</i> |                                                  |       |                                   |       |
| Expected return on plan assets net of expenses          | <b>7.00%</b>                                     | 7.00% | -                                 | -     |
| Rate used to discount future benefits                   | <b>5.00%</b>                                     | 6.00% | <b>4.97%</b>                      | 5.88% |
| Salary schedule escalation rate                         | <b>3.00%</b>                                     | 3.25% | -                                 | -     |
| Rate of cost of living increase to pensions             | <b>2.00%</b>                                     | 2.25% | -                                 | -     |
| Initial health care trend rate                          | -                                                | -     | <b>7.76%</b>                      | 7.03% |
| Ultimate health care trend rate                         | -                                                | -     | <b>4.68%</b>                      | 4.46% |
| Year ultimate rate reached                              | -                                                | -     | <b>2014</b>                       | 2014  |
| Rate of increase in disability benefits                 | -                                                | -     | <b>2.00%</b>                      | 2.25% |
| Average remaining service life for employees (years)    | <b>11</b>                                        | 11    | <b>11</b>                         | 11    |

|                                                   | Registered<br>Pension Plan |         | Supplementary<br>Pension Plans |       | Other Post<br>Employment<br>Benefits |         |
|---------------------------------------------------|----------------------------|---------|--------------------------------|-------|--------------------------------------|---------|
|                                                   | 2006                       | 2005    | 2006                           | 2005  | 2006                                 | 2005    |
| <i>(millions of dollars)</i>                      |                            |         |                                |       |                                      |         |
| <i>Changes in Plan Assets</i>                     |                            |         |                                |       |                                      |         |
| Fair value of plan assets at beginning of year    | <b>7,921</b>               | 7,056   | -                              | -     | -                                    | -       |
| Contributions by employer                         | <b>261</b>                 | 254     | <b>7</b>                       | 7     | <b>62</b>                            | 58      |
| Contributions by employees                        | <b>61</b>                  | 56      | -                              | -     | -                                    | -       |
| Actual return on plan assets net of expenses      | <b>945</b>                 | 858     | -                              | -     | -                                    | -       |
| Settlements                                       | -                          | (2)     | -                              | -     | -                                    | -       |
| Benefit payments                                  | <b>(359)</b>               | (301)   | <b>(7)</b>                     | (7)   | <b>(62)</b>                          | (58)    |
| Fair value of plan assets at end of year          | <b>8,829</b>               | 7,921   | -                              | -     | -                                    | -       |
| <i>Changes in Projected Benefit Obligation</i>    |                            |         |                                |       |                                      |         |
| Projected benefit obligation at beginning of year | <b>9,095</b>               | 7,663   | <b>144</b>                     | 144   | <b>2,065</b>                         | 1,499   |
| Employer current service costs                    | <b>212</b>                 | 163     | <b>6</b>                       | 7     | <b>71</b>                            | 47      |
| Contributions by employees                        | <b>61</b>                  | 56      | -                              | -     | -                                    | -       |
| Interest on projected benefit obligation          | <b>459</b>                 | 461     | <b>7</b>                       | 9     | <b>104</b>                           | 88      |
| Past service costs                                | -                          | -       | -                              | -     | <b>13</b>                            | 1       |
| Settlement gain                                   | -                          | (2)     | -                              | -     | -                                    | -       |
| Benefit payments                                  | <b>(359)</b>               | (301)   | <b>(7)</b>                     | (7)   | <b>(62)</b>                          | (58)    |
| Net actuarial loss (gain)                         | <b>(155)</b>               | 1,055   | <b>2</b>                       | (9)   | <b>(124)</b>                         | 488     |
| Projected benefit obligation at end of year       | <b>9,313</b>               | 9,095   | <b>152</b>                     | 144   | <b>2,067</b>                         | 2,065   |
| Funded Status – Deficit at end of year            | <b>(484)</b>               | (1,174) | <b>(152)</b>                   | (144) | <b>(2,067)</b>                       | (2,065) |

The assets of the OPG pension fund are allocated among three principal investment categories. Furthermore, equity investments are diversified across Canadian, U.S. and non-North American stocks. The fund also has a small real estate portfolio that is less than one per cent of plan assets.

|                                                          | 2006 | 2005 |
|----------------------------------------------------------|------|------|
| Registered pension plan fund asset investment categories |      |      |
| Equities                                                 | 67%  | 64%  |
| Fixed income                                             | 30%  | 33%  |
| Cash and short-term                                      | 3%   | 3%   |
| Total                                                    | 100% | 100% |

Based on the most recently filed actuarial valuation, as at January 1, 2005, there was an unfunded liability on a going-concern basis of \$465 million and a deficiency on a wind-up basis of \$1,979 million. The deficit disclosed in the next filed funding valuation, which must have an effective date no later than January 1, 2008, could be significantly different.

The supplementary plans are not funded, but are secured by Letters of Credit totalling \$159 million (2005 – \$138 million).

|                                                                             | Registered Pension Plan |         | Supplementary Pension Plans |       | Other Post Employment Benefits |         |
|-----------------------------------------------------------------------------|-------------------------|---------|-----------------------------|-------|--------------------------------|---------|
| (millions of dollars)                                                       | 2006                    | 2005    | 2006                        | 2005  | 2006                           | 2005    |
| <i>Reconciliation of Funded Status to Accrued Benefit Asset (Liability)</i> |                         |         |                             |       |                                |         |
| Funded status – deficit at end of year                                      | (484)                   | (1,174) | (152)                       | (144) | (2,067)                        | (2,065) |
| Unamortized net actuarial loss                                              | 1,108                   | 1,737   | 20                          | 18    | 699                            | 885     |
| Unamortized past service costs                                              | 82                      | 100     | 3                           | 4     | 25                             | 16      |
| Accrued benefit asset (liability) at end of year                            | 706                     | 663     | (129)                       | (122) | (1,343)                        | (1,164) |
| Short-term portion                                                          | -                       | -       | (6)                         | (7)   | (70)                           | (67)    |
| Long-term portion                                                           | 706                     | 663     | (123)                       | (115) | (1,273)                        | (1,097) |

|                                                | Registered Pension Plan |       | Supplementary Pension Plans |      | Other Post Employment Benefits |      |
|------------------------------------------------|-------------------------|-------|-----------------------------|------|--------------------------------|------|
| (millions of dollars)                          | 2006                    | 2005  | 2006                        | 2005 | 2006                           | 2005 |
| <i>Components of Cost Recognized</i>           |                         |       |                             |      |                                |      |
| Current service costs                          | 212                     | 163   | 6                           | 7    | 71                             | 47   |
| Interest on projected benefit obligation       | 459                     | 461   | 7                           | 9    | 104                            | 88   |
| Expected return on plan assets net of expenses | (551)                   | (527) | -                           | -    | -                              | -    |
| Amortization of past service costs             | 18                      | 18    | 1                           | 1    | 4                              | 3    |
| Amortization of net actuarial loss             | 80                      | -     | -                           | 1    | 62                             | 25   |
| Cost recognized                                | 218                     | 115   | 14                          | 18   | 241                            | 163  |

|                                                                  | Registered Pension Plan |         | Supplementary Pension Plans |      | Other Post Employment Benefits |       |
|------------------------------------------------------------------|-------------------------|---------|-----------------------------|------|--------------------------------|-------|
| <i>(millions of dollars)</i>                                     | 2006                    | 2005    | 2006                        | 2005 | 2006                           | 2005  |
| <i>Components of Cost Incurred and Recognized</i>                |                         |         |                             |      |                                |       |
| Current service costs                                            | <b>212</b>              | 163     | <b>6</b>                    | 7    | <b>71</b>                      | 47    |
| Interest on projected benefit obligation                         | <b>459</b>              | 461     | <b>7</b>                    | 9    | <b>104</b>                     | 88    |
| Actual return on plan assets net of expenses                     | <b>(945)</b>            | (858)   | -                           | -    | -                              | -     |
| Past service costs                                               | -                       | -       | -                           | -    | <b>13</b>                      | 1     |
| Net actuarial loss (gain)                                        | <b>(155)</b>            | 1,055   | <b>2</b>                    | (9)  | <b>(124)</b>                   | 488   |
| Cost incurred in year                                            | <b>(429)</b>            | 821     | <b>15</b>                   | 7    | <b>64</b>                      | 624   |
| Differences between costs incurred and recognized in respect of: |                         |         |                             |      |                                |       |
| Actual return on plan assets net of expenses                     | <b>394</b>              | 331     | -                           | -    | -                              | -     |
| Past service costs                                               | <b>18</b>               | 18      | <b>1</b>                    | 1    | <b>(9)</b>                     | 2     |
| Net actuarial (gain) loss                                        | <b>235</b>              | (1,055) | <b>(2)</b>                  | 10   | <b>186</b>                     | (463) |
| Cost recognized                                                  | <b>218</b>              | 115     | <b>14</b>                   | 18   | <b>241</b>                     | 163   |

A one per cent increase or decrease in the health care trend rate would result in an increase in the service and interest components of the 2006 OPEB cost recognized of \$34 million (2005 – \$26 million) or a decrease in the service and interest components of the 2006 OPEB cost recognized of \$26 million (2005 – \$20 million), respectively. A one per cent increase or decrease in the health care trend rate would result in an increase in the projected OPEB obligation at December 31, 2006 of \$342 million (2005 – \$343 million) or a decrease in the projected OPEB obligation at December 31, 2006 of \$265 million (2005 – \$266 million).

## 12. FINANCIAL INSTRUMENTS

Contracts for all trading transactions are carried on the consolidated balance sheet as assets or liabilities at fair value, with changes in fair value recorded in trading revenue as gains or losses.

Fair values of derivative instruments have been estimated by reference to quoted market prices for actual or similar instruments where available. Where quoted market prices are not available, OPG considers various factors to estimate forward prices, including market prices and price volatility in neighbouring electricity markets, market prices for fuel, and other factors.

Forward pricing information is inherently uncertain so that fair values of the derivative instruments may not accurately represent the cost to enter into these positions. To address the impact of some of this uncertainty on trading positions, OPG established liquidity reserves against the mark-to-market gains or losses of these positions. During 2006, the liquidity reserve increased trading revenue by \$1 million (2005 – \$4 million).

### Derivative Instruments Used for Hedging Purposes

The following table provides the estimated fair value of derivative instruments designated as hedges. The majority of OPG's derivative instruments are treated as hedges, with gains or losses recognized upon settlement when the underlying transactions occur. OPG holds financial commodity derivatives primarily to hedge the commodity price exposure associated with changes in the price of electricity.

| <i>(millions of dollars except where noted)</i> | <b>Notional Quantity</b> | <b>Terms</b>    | <b>Fair Value</b> | <b>Notional Quantity</b> | <b>Terms</b> | <b>Fair Value</b> |
|-------------------------------------------------|--------------------------|-----------------|-------------------|--------------------------|--------------|-------------------|
|                                                 |                          | <b>2006</b>     |                   |                          | <b>2005</b>  |                   |
| Gain (loss)                                     |                          |                 |                   |                          |              |                   |
| Electricity derivative instruments              | <b>4.3 TWh</b>           | <b>1-4 yrs</b>  | <b>51</b>         | 4.1 TWh                  | 1-2 yrs      | (125)             |
| Foreign exchange derivative instruments         | <b>U.S. \$2</b>          | <b>Jan/07</b>   | <b>-</b>          | U.S. \$15                | Jan/06       | -                 |
| Floating to fixed interest rate hedges          | <b>45</b>                | <b>1-12 yrs</b> | <b>(3)</b>        | 47                       | 1-13 yrs     | (3)               |
| Forward start interest rate hedges              | <b>622</b>               | <b>1-14 yrs</b> | <b>(9)</b>        | 400                      | 1-15 yrs     | (7)               |

Foreign exchange derivative instruments are used to hedge the exposure to anticipated U.S. dollar denominated purchases. The weighted average fixed exchange rate for contracts outstanding at December 31, 2006 was U.S. \$0.87 (2005 – U.S. \$0.87) for every Canadian dollar.

One of the Company's joint ventures is exposed to changes in interest rates. The joint venture entered into an interest rate swap to manage the risk arising from fluctuations in interest rates by swapping the short-term floating interest rate with a fixed rate of 5.33 per cent. OPG's proportionate interest in the swap is 50 per cent and is accounted for as a hedge.

OPG entered into a number of forward start interest rate swap agreements to hedge against the effect of future interest rate movement based on the anticipated future borrowing requirement for the Niagara Tunnel and the Portlands Energy Centre projects. These transactions are accounted for as hedges.

### Derivative Instruments Not Used for Hedging Purposes

The carrying amount (fair value) of derivative instruments not designated for hedging purposes is as follows:

| <i>(millions of dollars except where noted)</i> | <b>Notional Quantity</b> | <b>Fair Value</b> | <b>Notional Quantity</b> | <b>Fair Value</b> |
|-------------------------------------------------|--------------------------|-------------------|--------------------------|-------------------|
|                                                 | <b>2006</b>              |                   | <b>2005</b>              |                   |
| Foreign exchange derivative                     | -                        | -                 | U.S. \$3                 | -                 |
| Commodity derivative instruments                |                          |                   |                          |                   |
| Assets                                          | <b>3.9 TWh</b>           | <b>25</b>         | 3.3 TWh                  | 13                |
| Liabilities                                     | <b>2.6 TWh</b>           | <b>(25)</b>       | 1.1 TWh                  | (37)              |
| Liquidity reserve                               |                          | <b>-</b>          |                          | (24)              |
|                                                 |                          | <b>(2)</b>        |                          | (3)               |
| Total                                           |                          | <b>(2)</b>        |                          | (27)              |

Foreign exchange derivative instruments that were not designated as hedges had a weighted average exchange rate of U.S. \$0.85 as at December 31, 2005.

## Fair Value of Other Financial Instruments

The carrying values of cash and cash equivalents, accounts receivable, accounts payable and accrued charges, Market Power Mitigation Agreement rebate payable, and short-term notes payable approximate their fair values due to the immediate or short-term maturity of these financial instruments. Fair values for other financial instruments have been estimated by reference to quoted market prices for actual or similar instruments where available.

The carrying values and fair values of these other financial instruments are as follows:

| <i>(millions of dollars)</i>                                   | <b>Carrying<br/>Value<br/>2006</b> | <b>Fair<br/>Value</b> | <b>Carrying<br/>Value<br/>2005</b> | <b>Fair<br/>Value</b> |
|----------------------------------------------------------------|------------------------------------|-----------------------|------------------------------------|-----------------------|
| Financial Assets                                               |                                    |                       |                                    |                       |
| Nuclear fixed asset removal and nuclear waste management funds | <b>7,594</b>                       | <b>8,113</b>          | 6,788                              | 6,788                 |
| Long-term accounts receivable and other assets                 | <b>69</b>                          | <b>69</b>             | 61                                 | 61                    |
| Financial Liabilities                                          |                                    |                       |                                    |                       |
| Long-term debt due within one year                             | <b>406</b>                         | <b>409</b>            | 806                                | 814                   |
| Long-term debt                                                 | <b>2,953</b>                       | <b>3,082</b>          | 3,089                              | 3,267                 |
| Long-term accounts payable and accrued charges                 | <b>150</b>                         | <b>150</b>            | 183                                | 183                   |

## Credit Risk

Credit risk is the financial risk of non-performance by contractual counterparties. Credit risk excludes any operational risk resulting from a third party failing to deliver a product or service as expected. The majority of OPG revenues are derived from sales through the IESO administered spot market. However, OPG also derives revenue from several other sources including the sale of energy products and financial risk management products to third parties.

Credit exposure to the IESO fluctuates based on spot prices and the volume of rate regulated and unregulated generation, and is reduced each month upon settlement of the accounts. Credit exposure to the IESO peaked at \$1,029 million during the year ended December 31, 2006 and at \$1,146 million during the year ended December 31, 2005.

## 13. COMMON SHARES

As at December 31, 2006 and 2005, OPG had 256,300,010 common shares issued and outstanding at a stated value of \$5,126 million. OPG is authorized to issue an unlimited number of common shares without nominal or par value.

## 14. COMMITMENTS AND CONTINGENCIES

### Litigation

Various legal proceedings are pending against OPG or its subsidiaries covering a wide range of matters that arise in the ordinary course of its business activities.

In July 2004, OPG and two individual OPG employees were each charged with criminal negligence causing death and criminal negligence causing bodily harm in relation to a 2002 drowning accident at Barrett Chute. Further to a recent summary application by all three, OPG was acquitted of all charges on November 14, 2006. On December 18, 2006, the two employees were acquitted of all the remaining charges. The appeal period expired on January 18, 2007. Since no appeal was filed, the acquittals of OPG and its employees are considered final.

Certain First Nations have commenced actions for interference with reserve and traditional land rights. The claims by some of these First Nations total approximately \$50 million and claims by others are for unspecified amounts.

On August 9, 2006, a Notice of Action and Statement of Claim in the amount of \$500 million (the "Claim") was served on OPG and Bruce Power L.P. by British Energy Limited and British Energy International Holdings Limited ("British Energy"), claiming that OPG is liable to them for breach of contract and negligence. OPG leased the Bruce nuclear generating stations to Bruce Power L.P. in 2001. British Energy was an investor in Bruce Power L.P. In 2003, British Energy sold its interest in Bruce Power L.P. to a group of investors (the "Purchasers"). The Purchasers are claiming that British Energy is liable to them with respect to this purchase transaction. Their claim is currently the subject of an arbitration proceeding (the "Arbitration"). British Energy is therefore suing OPG in order to preserve any similar claim it may have against OPG pursuant to the 2001 lease transaction. British Energy has indicated that it does not require OPG to actively defend the Claim at this point in time as British Energy is defending the Arbitration commenced by the Purchasers. The Arbitration may narrow or eliminate the claims or damages British Energy has, so as to narrow or eliminate the need to continue the Claim against OPG. British Energy has reserved the right to require OPG to defend the Claim prior to the conclusion of the Arbitration should British Energy at some point believe there is some advantage of doing so.

Each of these matters is subject to various uncertainties. Some of these matters may be resolved unfavourably with respect to OPG and could have a significant effect on OPG's financial position. Management has provided for contingencies that are determined to be likely and are reasonably measurable.

### **Environmental**

OPG was required to assume certain environmental obligations from Ontario Hydro. A provision of \$76 million was established as at April 1, 1999 for such obligations. During the year ended December 31, 2006, expenditures of \$4 million (2005 – \$4 million) were recorded against the provision. As at December 31, 2006, the remaining provision was \$52 million (December 31, 2005 – \$56 million).

Current operations are subject to regulation with respect to air, soil and water quality and other environmental matters by federal, provincial and local authorities. The cost of obligations associated with current operations is provided for on an ongoing basis. Management believes it has made adequate provision in its consolidated financial statements to meet OPG's current environmental obligations.

### **Guarantees**

As part of normal business, OPG and certain of its subsidiaries and joint ventures enter into various agreements providing financial or performance assurance to third parties on behalf of certain subsidiaries. Such agreements include guarantees, standby Letters of Credit and surety bonds.

## Contractual and Commercial Commitments

The Company's contractual obligations and other significant commercial commitments as at December 31, 2006 are as follows:

| <i>(millions of dollars)</i>              | 2007         | 2008         | 2009         | 2010         | 2011         | Thereafter   | Total         |
|-------------------------------------------|--------------|--------------|--------------|--------------|--------------|--------------|---------------|
| Contractual obligations:                  |              |              |              |              |              |              |               |
| Fuel supply agreements                    | 670          | 514          | 202          | 153          | 167          | 351          | 2,057         |
| Contributions under the ONFA <sup>1</sup> | 454          | 679          | 350          | 350          | 350          | 1,053        | 3,236         |
| Long-term debt repayment                  | 400          | 400          | 350          | 970          | 375          | 670          | 3,165         |
| Interest on long-term debt                | 181          | 158          | 135          | 103          | 55           | 80           | 712           |
| Unconditional purchase obligations        | 25           | 20           | 17           | 15           | 12           | 194          | 283           |
| Long-term accounts payable                | 28           | 9            | -            | -            | -            | -            | 37            |
| Operating lease obligations               | 10           | 9            | 11           | 10           | 10           | 123          | 173           |
| Operating licence                         | 16           | 17           | 17           | 17           | 18           | -            | 85            |
| Pension contributions <sup>2</sup>        | 268          | -            | -            | -            | -            | -            | 268           |
| Other                                     | 144          | 30           | 26           | 28           | 24           | 26           | 278           |
| Significant commercial commitments:       |              |              |              |              |              |              |               |
| Niagara Tunnel                            | 167          | 178          | 132          | 2            | -            | -            | 479           |
| Lac Seul                                  | 24           | -            | -            | -            | -            | -            | 24            |
| Portlands Energy Centre                   | 155          | 63           | 22           | 2            | 1            | 24           | 267           |
| <b>Total</b>                              | <b>2,542</b> | <b>2,077</b> | <b>1,262</b> | <b>1,650</b> | <b>1,012</b> | <b>2,521</b> | <b>11,064</b> |

<sup>1</sup> Contributions under ONFA are subject to adjustment due to the 2006 approved Reference Plan.

<sup>2</sup> The pension contributions include additional funding requirements towards the deficit and ongoing funding requirements in accordance with the actuarial valuation as at January 1, 2005, as well as a voluntary contribution of approximately \$20 million. The contributions are affected by various factors including market performance, changes in actuarial assumptions, plan experience, and the timing of funding valuations. Funding requirements after 2007 are excluded due to significant variability in the assumptions required to project the timing of future cash flows.

The Niagara Tunnel project will increase the amount of water flowing to existing turbines at OPG's Sir Adam Beck generating stations in Niagara, allowing the stations to utilize available water more effectively. On-site assembly of the tunnel boring machine was completed in September 2006 and boring of the tunnel commenced during the month. The intake configuration required the replacement of the existing accelerating wall and the installation of a cellular cofferdam, which were completed in 2006. Capital project expenditures for the year ended December 31, 2006 were \$161 million and life-to-date capital expenditures were approximately \$244 million. The project is debt financed through the Ontario Electricity Financial Corporation ("OEFC").

OPG is constructing a new 12.5 MW hydroelectric generating station on the English River. The new Lac Seul generating station will utilize a majority of the spill currently passing the existing Ear Falls generating station, thus increasing the overall efficiency, capacity and energy generated from this location. A design-build contract was awarded and construction started during the first quarter of 2006. In 2006, the water conveyance tunnel, the tailrace channel excavation, and the intake cofferdam were completed. The powerhouse civil foundation and envelope was completed in January 2007. Major sub-assemblies have been delivered to the site and pre-installation work has started. Capital project expenditures for the year ended December 31, 2006 were approximately \$24 million and life-to-date capital expenditures were approximately \$27 million. OPG has negotiated the project's debt financing with the OEFC.

OPG entered into a partnership with TransCanada Energy Ltd. ("TransCanada"), called Portlands Energy Centre L.P. ("PEC"), to pursue the development of a 550 MW gas-fired, combined cycle station on the site of the former R.L. Hearn generating station, near downtown Toronto. During the first quarter of 2006, the Province directed the OPA to negotiate an agreement with PEC for the purchase of electricity. PEC signed a 20-year Accelerated Clean Energy Supply ("ACES") contract with the OPA during the third quarter of 2006. PEC entered into a design-build contract for the construction of the facility, and

construction started in 2006. A significant proportion of the capital cost relates to this contract. OPG's share of capital project expenditures for the year ended December 31, 2006 as approximately \$97 million. OPG has negotiated financing for its share of the project with the OEFC.

#### *Other Commitments*

In addition to the above commitments, the Company has the following commitments:

The Company maintains labour agreements with the Power Workers' Union and The Society of Energy Professionals; the agreements are effective until March 31, 2009 and December 31, 2010, respectively. As of December 31, 2006, OPG had approximately 11,500 regular employees and approximately 90 per cent of its regular labour force is covered by the collective bargaining agreements.

Contractual and commercial commitments above exclude certain purchase orders as they represent purchase authorizations rather than legally binding contracts and are subject to change without significant penalties.

#### **Proxy Property Taxes**

In November 2005, OPG received a letter from the Ministry of Finance indicating its intent to recommend to the Minister of Finance that an Ontario regulation covering proxy property taxes be updated retroactive to April 1, 1999 to reflect reassessments and appeal settlements of certain OPG properties since that date. OPG continues to discuss resolution to this issue with the Ministry of Finance as updates to the regulation may not occur for several years. OPG has not recorded any amounts relating to this anticipated regulation change.

### **15. TRANSITION RATE OPTION CONTRACTS**

Under a regulation known as Transition – Generation Corporation Designated Rate Options ("TRO"), OPG was required to provide transitional price relief since market opening to certain power customers for up to four years based on the consumption and average price paid by each customer during a reference period of July 1, 1999 to June 30, 2000. The TRO was treated as a hedge of generation revenue. The maximum anticipated volume subject to the transitional price relief was approximately 5.4 TWh in the first year after market opening and 3.6 TWh in the second year. The maximum anticipated volume in each of the third and fourth years is 1.8 TWh. The maximum length of the program was four years, which expired April 30, 2006.

The change in the TRO contracts provision for the years ended December 31, 2006 and 2005 is as follows:

| <i>(millions of dollars)</i>          | <b>2006</b> | <b>2005</b> |
|---------------------------------------|-------------|-------------|
| Provision, beginning of year          | <b>12</b>   | 48          |
| Decrease of provision during the year | <b>(12)</b> | (36)        |
| Provision, end of year                | -           | 12          |

### **16. REVENUE LIMIT REBATE**

Eighty-five per cent of the generation output from OPG's unregulated generation assets, excluding the Lennox generating station and forward sales as of January 1, 2005, is subject to a revenue limit. The output from a generating unit where there has been a fuel conversion and the incremental output from a generating station where there has been a refurbishment or expansion of these assets is also excluded

from the output covered by the revenue limit. In addition, until the TRO contracts expired on April 30, 2006, volumes sold under such options were also excluded from the revenue limit rebate.

The revenue limit, which was originally established for a period of 13 months ending April 30, 2006, was subsequently extended for an additional three years. Starting May 1, 2006, the revenue limit decreased to 4.6¢/kWh from the previous limit of 4.7¢/kWh. On May 1, 2007, the revenue limit will return to 4.7¢/kWh and increase to 4.8¢/kWh effective May 1, 2008. In addition, beginning May 1, 2006, volumes sold under a Pilot Auction administered by the Ontario Power Authority ("OPA") are subject to a revenue limit that is 0.5¢/kWh higher than the revenue limit applicable to OPG's other generating assets. Revenues above these two revenue limits are returned to the IESO for the benefit of consumers.

The changes in the revenue limit rebate liability for the years ended December 31, 2006 and 2005 are as follows:

| <i>(millions of dollars)</i>          | <b>2006</b>  | <b>2005</b> |
|---------------------------------------|--------------|-------------|
| Liability, beginning of the year      | <b>739</b>   | -           |
| Increase to provision during the year | <b>161</b>   | 739         |
| Payments made during the year         | <b>(860)</b> | -           |
| Liability, end of year                | <b>40</b>    | 739         |

#### **17. MARKET POWER MITIGATION AGREEMENT REBATE**

Until April 1, 2005, OPG was required under its generating licence to comply with prescribed market power mitigation measures to address the potential for OPG to exercise market power in Ontario. The market power mitigation measures included both a rebate mechanism and the requirement to decontrol generating capacity. Under the rebate mechanism, a majority of OPG's expected energy sales in Ontario were subject to an average annual revenue cap of 3.8¢/kWh. During the term of the Market Power Mitigation Agreement, OPG was required to pay a rebate to the Independent Electricity System Operator equal to the excess, if any, of the average hourly spot energy price over 3.8¢/kWh for a 12-month settlement period, multiplied by the amount of energy subject to the rebate mechanism. The Market Power Mitigation Agreement was replaced effective April 1, 2005 by regulated prices for the output from most of OPG's baseload hydroelectric facilities and all of the nuclear facilities operated by OPG, and a revenue limit that applies to OPG's unregulated generation assets.

In accordance with the Market Power Mitigation Agreement, the rebate was calculated after taking into account the amount of energy sales subject to the rebate mechanism for only those generating stations that OPG continues to control. Since the average hourly spot price during the three months ended March 31, 2005, when the rebate mechanism ended, exceeded the 3.8¢/kWh revenue cap, OPG provided \$412 million in 2005 as a Market Power Mitigation Agreement rebate.

The change in the Market Power Mitigation Agreement rebate liability for the year ended December 31, 2005 is as follows:

| <i>(millions of dollars)</i>          | <b>2005</b> |
|---------------------------------------|-------------|
| Liability, beginning of year          | 439         |
| Increase to provision during the year | 412         |
| Payments                              | (851)       |
| Liability, end of year                | -           |

## **18. BUSINESS SEGMENTS**

With the introduction of rate regulation effective April 1, 2005, OPG revised its reportable business segments to separately reflect the regulated and unregulated aspects of its business. In the first quarter of 2006, OPG separated the Unregulated Generation business segment into two reportable segments identified as Unregulated – Fossil-Fuelled and Unregulated – Hydroelectric, as a result of changes in the management structure of these segments. Results for the comparative periods have been reclassified to reflect the revised disclosure.

### **Regulated – Nuclear Segment**

OPG's Regulated – Nuclear business segment operates in Ontario, generating and selling electricity from the nuclear generating stations that OPG owns and operates. The business segment includes electricity generated by the Pickering A and B, and Darlington nuclear generating stations.

OPG's Regulated – Nuclear business segment includes revenue under the terms of a lease arrangement with Bruce Power related to the Bruce nuclear generating stations. The arrangement includes lease revenue, interest income and revenue from engineering analysis and design, technical and other services. The Regulated – Nuclear business segment also includes revenue earned from isotope sales and ancillary services. Ancillary revenues are earned through voltage control/reactive support. These earnings are included in the Regulated – Nuclear business segment since they were included in determining the regulated price for production from the nuclear facilities operated by OPG.

#### *Bruce Nuclear Generating Stations*

In May 2001, the Company leased its Bruce A and Bruce B nuclear generating stations to Bruce Power until 2018, with options to renew for up to 25 years.

Under the terms of the lease, OPG agreed to transfer certain fuel and material inventory to Bruce Power, in addition to certain fixed assets. Pension assets and liabilities related to the approximately 3,000 employees were transferred to Bruce Power. Bruce Power assumed the liability for other post employment benefits for these employees. OPG makes payments to Bruce Power in respect of other post employment benefits of approximately \$2.3 million per month over a 72-month period, ending in 2008.

As part of the closing, OPG recorded deferred revenue to reflect the initial payments of \$595 million less net assets transferred to Bruce Power under the lease agreement. The deferred revenue is being amortized over the initial lease term of approximately 18 years and is recorded as revenue.

In December 2002, British Energy plc. entered into an agreement to dispose of its entire 82.4 per cent interest in Bruce Power. The transaction was completed in February 2003 and a consortium of Canadian companies assumed the lease of the Bruce A and Bruce B nuclear generating stations that was formerly held by British Energy plc. The Bruce facilities will continue to be operated by Bruce Power. Upon closing of the transaction, the \$225 million note receivable was paid to OPG, and lease payments commenced to be paid monthly. Proceeds from the note are to be applied by March 2008 against OPG's funding requirements with respect to the nuclear fixed asset removal and nuclear waste management liabilities.

As part of the agreement reached in October 2005 between the Province and Bruce Power, OPG received a Shareholder Declaration from the Province instructing OPG's Board of Directors to accept certain amendments to the lease agreement. These amendments included a change to the provisions regarding the transfer of Bruce Power's interest in the site and included a reduction of the annual lease payment for three of the four refurbished Bruce A units to \$5.5 million per unit (in 2002 dollars, escalated at CPI), that will affect the three Bruce A units to be refurbished, once the planned future refurbishments are completed. These changes to the lease agreement will affect OPG when Units 1 and 2 of the Bruce A nuclear generating station are returned to service, and when Unit 3 is refurbished at the end of its current operational life. Other changes to the existing arrangements were made to address Cameco Corporation's decision not to participate in the refurbishment of the Bruce A nuclear generating station.

For 2004 through 2008, minimum payments under the lease are \$190 million annually, subject to limited exceptions. The lease revenue of \$251 million (2005 – \$244 million) was recorded in revenue. The remaining terms of the operating lease agreement will remain substantially unchanged until the planned future refurbishments are completed.

The net book value of fixed assets on lease to Bruce Power at December 31, 2006 was \$1,273 million (2005 – \$492 million). The net book value at December 31, 2006 includes the impact of the increase in the nuclear fixed asset removal and nuclear waste management liabilities relating to the Bruce units as a result of the new Reference Plan described in Note 9.

### **Regulated – Hydroelectric Segment**

OPG's Regulated – Hydroelectric business segment operates in Ontario, generating and selling electricity from most of OPG's baseload hydroelectric generating stations. The business segment is comprised of electricity generated by the Sir Adam Beck 1, 2 and Pump generating station, DeCew Falls 1 and 2, and the R.H. Saunders hydroelectric facilities. The Regulated – Hydroelectric business segment also includes ancillary revenues related to these stations earned through offering available generating capacity as operating reserve and through the supply of other ancillary services including voltage control/reactive support, certified black start facilities and automatic generation control.

### **Unregulated – Hydroelectric Segment**

The Unregulated – Hydroelectric business segment operates in Ontario, generating and selling electricity from its hydroelectric generating stations that are not subject to rate regulation. The Unregulated – Hydroelectric business segment also includes ancillary revenues earned through offering available generating capacity as operating reserve, and through the supply of other ancillary services including voltage control/reactive support, certified black start facilities and automatic generation control, and revenues from other services.

### **Unregulated – Fossil-Fuelled Segment**

The Unregulated – Fossil-Fuelled business segment operates in Ontario, generating and selling electricity from its fossil-fuelled generating stations, which are not subject to rate regulation. The Unregulated – Fossil-Fuelled business segment also includes ancillary revenues earned through offering available generating capacity as operating reserve, and through the supply of other ancillary services including voltage control/reactive support, automatic generation control, and revenues from other services.

### **Other**

OPG earns revenue from its joint venture share of the Brighton Beach related to an energy conversion agreement between Brighton Beach and Coral. In addition, the Other category includes revenue from real estate rentals.

The revenue and expenses related to OPG's trading and other non-hedging activities are also included in the Other category. As part of these activities, OPG transacts with counterparties in Ontario and neighbouring energy markets in predominantly short-term trading activities of typically one year or less in duration. These activities relate primarily to physical energy that is purchased and sold at the Ontario border, sales of financial risk management products and sales of energy-related products. All contracts that are not designated as hedges are recorded as assets or liabilities at fair value, with changes in fair value recorded in other revenue as gains or losses.

Operations, maintenance and administration ("OM&A") expenses of the generation business segments include an intersegment service fee for the use of certain property, plant and equipment of the Other category. The total service fee is recorded as a reduction to the Other category's OM&A expenses. For the year ended December 31, 2006, the service fee was \$25 million for Regulated – Nuclear, \$2 million for Regulated – Hydroelectric, \$3 million for Unregulated – Hydroelectric and \$9 million for Unregulated – Fossil-Fuelled, with a corresponding reduction in OM&A expenses of \$39 million for the Other category. Results of the comparative periods have been reclassified to reflect the service fee.

| <b>Segment Income (Loss) for the Year Ended December 31, 2006</b><br><i>(millions of dollars)</i> | <b>Regulated</b> |                       | <b>Unregulated</b>    |                       |              | <b>Total</b> |
|---------------------------------------------------------------------------------------------------|------------------|-----------------------|-----------------------|-----------------------|--------------|--------------|
|                                                                                                   | <b>Nuclear</b>   | <b>Hydro-electric</b> | <b>Hydro-electric</b> | <b>Fossil-Fuelled</b> | <b>Other</b> |              |
| Revenue before revenue limit rebate                                                               | 2,665            | 685                   | 780                   | 1,430                 | 165          | 5,725        |
| Revenue limit rebate                                                                              | -                | -                     | (44)                  | (117)                 | -            | (161)        |
|                                                                                                   | 2,665            | 685                   | 736                   | 1,313                 | 165          | 5,564        |
| Fuel expense                                                                                      | 122              | 245                   | 88                    | 643                   | -            | 1,098        |
| Gross margin                                                                                      | 2,543            | 440                   | 648                   | 670                   | 165          | 4,466        |
| Operations, maintenance and administration                                                        | 1,967            | 92                    | 189                   | 524                   | 5            | 2,777        |
| Depreciation and amortization                                                                     | 343              | 66                    | 69                    | 133                   | 53           | 664          |
| Accretion on fixed asset removal and nuclear waste management liabilities                         | 490              | -                     | -                     | 9                     | -            | 499          |
| Earnings on nuclear fixed asset removal and nuclear waste management funds                        | (371)            | -                     | -                     | -                     | -            | (371)        |
| Property and capital taxes                                                                        | 44               | 18                    | 15                    | 19                    | 10           | 106          |
| Income (loss) before impairment of long-lived assets                                              | 70               | 264                   | 375                   | (15)                  | 97           | 791          |
| Impairment of long-lived assets                                                                   | -                | -                     | -                     | 22                    | -            | 22           |
| Income (loss) before interest, income taxes and extraordinary item                                | 70               | 264                   | 375                   | (37)                  | 97           | 769          |

| <b>Segment (Loss) Income for the Year Ended December 31, 2005</b><br><i>(millions of dollars)</i> | <b>Regulated</b> |                       | <b>Unregulated</b>    |                       |              | <b>Total</b> |
|---------------------------------------------------------------------------------------------------|------------------|-----------------------|-----------------------|-----------------------|--------------|--------------|
|                                                                                                   | <b>Nuclear</b>   | <b>Hydro-electric</b> | <b>Hydro-electric</b> | <b>Fossil-Fuelled</b> | <b>Other</b> |              |
| Revenue before revenue limit and Market Power Mitigation Agreement rebates                        | 2,607            | 857                   | 1,000                 | 2,399                 | 86           | 6,949        |
| Revenue limit rebate                                                                              | -                | -                     | (210)                 | (529)                 | -            | (739)        |
| Market Power Mitigation Agreement rebate                                                          | (160)            | (65)                  | (58)                  | (129)                 | -            | (412)        |
|                                                                                                   | 2,447            | 792                   | 732                   | 1,741                 | 86           | 5,798        |
| Fuel expense                                                                                      | 115              | 254                   | 82                    | 846                   | -            | 1,297        |
| Gross margin                                                                                      | 2,332            | 538                   | 650                   | 895                   | 86           | 4,501        |
| Operations, maintenance and administration                                                        | 1,804            | 78                    | 148                   | 455                   | 31           | 2,516        |
| Depreciation and amortization                                                                     | 359              | 67                    | 64                    | 203                   | 60           | 753          |
| Accretion on fixed asset removal and nuclear waste management liabilities                         | 467              | -                     | -                     | 9                     | -            | 476          |
| Earnings on nuclear fixed asset removal and nuclear waste management funds                        | (381)            | -                     | -                     | -                     | -            | (381)        |
| Property and capital taxes                                                                        | 30               | 18                    | 15                    | 39                    | 5            | 107          |
| Restructuring                                                                                     | -                | -                     | -                     | 4                     | 6            | 10           |
| Income (loss) before impairment of long-lived assets                                              | 53               | 375                   | 423                   | 185                   | (16)         | 1,020        |
| Impairment of long-lived assets                                                                   | 63               | -                     | -                     | 202                   | -            | 265          |
| (Loss) income before interest, income taxes and extraordinary item                                | (10)             | 375                   | 423                   | (17)                  | (16)         | 755          |

| <i>(millions of dollars)</i>                               | Regulated<br>Nuclear | Hydro-<br>electric | Unregulated<br>Hydro-<br>electric | Fossil-<br>Fuelled | Other      | Total         |
|------------------------------------------------------------|----------------------|--------------------|-----------------------------------|--------------------|------------|---------------|
| <b>Selected Balance Sheet Information</b>                  |                      |                    |                                   |                    |            |               |
| As at December 31, 2006                                    |                      |                    |                                   |                    |            |               |
| Segment fixed assets in service, net                       | <b>4,213</b>         | <b>3,907</b>       | <b>3,012</b>                      | <b>408</b>         | <b>544</b> | <b>12,084</b> |
| Segment construction work in progress                      | <b>165</b>           | <b>252</b>         | <b>78</b>                         | <b>49</b>          | <b>133</b> | <b>677</b>    |
| Segment property, plant and equipment, net                 | <b>4,378</b>         | <b>4,159</b>       | <b>3,090</b>                      | <b>457</b>         | <b>677</b> | <b>12,761</b> |
| Segment materials and supplies inventory, net:             |                      |                    |                                   |                    |            |               |
| Short term                                                 | <b>63</b>            | <b>1</b>           | <b>-</b>                          | <b>48</b>          | <b>-</b>   | <b>112</b>    |
| Long term                                                  | <b>320</b>           | <b>-</b>           | <b>3</b>                          | <b>3</b>           | <b>-</b>   | <b>326</b>    |
| Segment fuel inventory                                     | <b>183</b>           | <b>-</b>           | <b>-</b>                          | <b>486</b>         | <b>-</b>   | <b>669</b>    |
| As at December 31, 2005                                    |                      |                    |                                   |                    |            |               |
| Segment fixed assets in service, net                       | 3,016                | 3,963              | 3,031                             | 484                | 570        | 11,064        |
| Segment construction work in progress                      | 140                  | 91                 | 45                                | 47                 | 25         | 348           |
| Segment property, plant and equipment, net                 | 3,156                | 4,054              | 3,076                             | 531                | 595        | 11,412        |
| Segment materials and supplies inventory, net:             |                      |                    |                                   |                    |            |               |
| Short term                                                 | 72                   | -                  | -                                 | 43                 | -          | 115           |
| Long term                                                  | 268                  | -                  | 4                                 | 1                  | -          | 273           |
| Segment fuel inventory                                     | 158                  | -                  | -                                 | 423                | -          | 581           |
| <b>Selected Cash Flow Information</b>                      |                      |                    |                                   |                    |            |               |
| Year ended December 31, 2006<br>Investment in fixed assets | <b>173</b>           | <b>171</b>         | <b>81</b>                         | <b>71</b>          | <b>141</b> | <b>637</b>    |
| Year ended December 31, 2005<br>Investment in fixed assets | 273                  | 101                | 44                                | 46                 | 30         | 494           |

## 19. RELATED PARTY TRANSACTIONS

Given that the Province owns all of the shares of OPG, related parties include the Province, the other successor entities of Ontario Hydro, including Hydro One Inc. ("Hydro One"), the IESO, and the OEFC. OPG also enters into related party transactions with its joint ventures. The transactions between OPG and related parties are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

These transactions are summarized below:

| <i>(millions of dollars)</i>                | Revenue<br>2006 | Expenses | Revenue<br>2005 | Expenses |
|---------------------------------------------|-----------------|----------|-----------------|----------|
| Hydro One                                   |                 |          |                 |          |
| Electricity sales                           | 34              | -        | 40              | -        |
| Services                                    | -               | 13       | -               | 12       |
| Settlement Transactions                     | -               | -        | -               | 27       |
| Province of Ontario                         |                 |          |                 |          |
| GRC water rentals and land tax              | -               | 132      | -               | 132      |
| Guarantee fee                               | -               | 8        | -               | 8        |
| Used Fuel Fund rate of return<br>guarantee  | -               | 96       | -               | -        |
| Decommissioning Fund excess<br>funding      | -               | (7)      | -               | 7        |
| OEFC                                        |                 |          |                 |          |
| GRC and proxy property tax                  | -               | 205      | -               | 207      |
| Interest income on receivable               | -               | (29)     | -               | (75)     |
| Interest expense on long-term notes         | -               | 203      | -               | 211      |
| Capital tax                                 | -               | 51       | -               | 51       |
| Income taxes                                | -               | 86       | -               | 192      |
| Indemnity fees                              | -               | 2        | -               | 5        |
| IESO                                        |                 |          |                 |          |
| Electricity sales                           | 5,029           | 146      | 6,517           | 329      |
| Market Power Mitigation Agreement<br>rebate | -               | -        | (412)           | -        |
| Revenue limit rebate                        | (161)           | -        | (739)           | -        |
| Ancillary services                          | 132             | -        | 68              | -        |
| Other                                       | 1               | 1        | -               | -        |
|                                             | 5,035           | 907      | 5,474           | 1,106    |

During 2006, OPG's Board of Directors approved the payment of a dividend to its shareholder, the Province. The declared dividend of \$128 million represents 35 per cent of OPG's 2005 net income and was paid in November 2006.

At December 31, 2006, accounts receivable included \$8 million (2005 – \$14 million) due from Hydro One and \$71 million (2005 – \$324 million) due from the IESO. Accounts payable and accrued charges at December 31, 2006 included \$2 million (2005 – \$2 million) due to Hydro One.

## 20. JOINT VENTURES

Significant joint ventures include Brighton Beach and PEC, which are 50 per cent owned by OPG (2005 – 50 per cent).

The following condensed information from the consolidated statements of operations, cash flows and balance sheets detail the Company's share of its investment in joint ventures and partnerships that has been proportionately consolidated:

| <i>(millions of dollars)</i>                      | <b>2006</b>  | <b>2005</b> |
|---------------------------------------------------|--------------|-------------|
| <b>Proportionate joint venture operations</b>     |              |             |
| Operating revenue                                 | <b>39</b>    | 46          |
| Operating expenses                                | <b>(19)</b>  | (36)        |
| Net income                                        | <b>20</b>    | 10          |
| <b>Proportionate joint venture cash flows</b>     |              |             |
| Operating activities                              | <b>17</b>    | 21          |
| Investing activities                              | <b>(109)</b> | (2)         |
| Financing activities                              | <b>(6)</b>   | (4)         |
| Share of increase in cash                         | <b>(98)</b>  | 15          |
| <b>Proportionate joint venture balance sheets</b> |              |             |
| Current assets                                    | <b>25</b>    | 26          |
| Long-term assets                                  | <b>379</b>   | 279         |
| Current liabilities                               | <b>(25)</b>  | (11)        |
| Long-term liabilities                             | <b>(191)</b> | (199)       |
| Share of net assets                               | <b>188</b>   | 95          |

## 21. INVESTMENT COMPANY

The Company applied AcG-18 for all investments owned by OPGV. OPGV is a wholly owned subsidiary of the Company and its results are consolidated into the Company's financial statements. Since OPGV is the only enterprise in the group that satisfies the criteria set out in AcG-18, all other investments made by OPG and its subsidiaries, partnerships or joint ventures continue to be carried at amortized cost. The carrying amount of OPGV's investments was \$32 million (2005 – \$29 million) and the amount was included as long-term accounts receivable and other assets on the consolidated balance sheets.

As a result of the application of this policy, the Company's net income and other assets for 2006 increased by \$2 million (2005 – decreased by \$11 million). The net realized gains and losses for OPGV was \$1 million (2005 – \$ nil).

The gross unrealized gains and losses on the investment held by OPGV as at December 31, 2006 were \$5 million and \$14 million respectively. The gross unrealized gains and losses on the investment held by OPGV as at December 31, 2005 were \$2 million and \$13 million respectively.

## 22. RESEARCH AND DEVELOPMENT

For the year ended December 31, 2006, \$16 million (2005 – \$19 million) of research and development expenses were charged to operations.

**23. CHANGES IN NON-CASH WORKING CAPITAL BALANCES**

| <i>(millions of dollars)</i>                     | <b>2006</b> | <b>2005</b> |
|--------------------------------------------------|-------------|-------------|
| Accounts receivable                              | <b>303</b>  | (191)       |
| Fuel inventory                                   | <b>(88)</b> | (12)        |
| Materials and supplies                           | -           | (23)        |
| Market Power Mitigation Agreement rebate payable | -           | 412         |
| Revenue limit rebate payable                     | <b>161</b>  | 739         |
| Accounts payable and accrued charges             | <b>54</b>   | 10          |
| Income and capital taxes payable                 | <b>47</b>   | 69          |
|                                                  | <b>477</b>  | 1,004       |