ONTARIO'S INDEPENDENT ELECTRICITY SYSTEM OPERATOR

2005 FINANCIAL STATEMENTS

ieso

Power to Ontario. On Demand.

Contents

MANAGEMENT REPORT

Management's Responsibility for Financial Reporting

The accompanying financial statements of the Independent Electricity System Operator are the responsibility of management and have been prepared in accordance with accounting principles generally accepted in Canada. The significant accounting policies followed by the Independent Electricity System Operator are described in the Summary of Significant Accounting Policies contained in Note 2 in the financial statements. The preparation of financial statements necessarily involves the use of estimates based on management's judgment, particularly when transactions affecting the current accounting period cannot be finalized with certainty until future periods. The financial statements have been prepared within reasonable limits of materiality and in light of information available up to February 2, 2006.

Management maintained a system of internal controls designed to provide reasonable assurance that the assets were safeguarded and that reliable information was available on a timely basis. The system included formal policies and procedures and an organizational structure that provided for the appropriate delegation of authority and segregation of responsibilities.

These financial statements have been examined by PricewaterhouseCoopers LLP, a firm of independent external auditors appointed by the Board of Directors. The external auditors' responsibility is to express their opinion on whether the financial statements are fairly presented in accordance with generally accepted accounting principles in Canada. The Auditors' Report, which follows, outlines the scope of their examination and their opinion.

Independent Electricity System Operator

On behalf of management,

Dave Goulding
President and Chief Executive Officer
Toronto, Canada
February 2, 2006

Gary Sherkey
Vice President, Corporate Services,
Chief Financial Officer and Treasurer
Toronto, Canada
February 2, 2006

AUDITORS' REPORT

February 2, 2006

To the Board of Directors of the Independent Electricity System Operator (IESO):

We have audited the statement of financial position of the IESO as at December 31, 2005 and the statements of operations and accumulated surplus and cash flows for the year then ended. These financial statements are the responsibility of the IESO's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements present fairly, in all material respects, the financial position of the IESO as at December 31, 2005 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

PricewaterhouseCoopers LLP

Chartered Accountants

STATEMENT OF OPERATIONS & ACCUMULATED SURPLUS

(in thousands of Canadian dollars)	For the Year Ended December 31, 2005	For the Year Ended December 31, 2004
Revenues		
System fees **(Note 6)**	**$143,273**	$152,438
Other revenue	**4,969**	3,590
Total revenues	**$148,242**	$156,028
Expenses		
Labour	**$ 65,098**	$ 62,155
Computer services, support and equipment	**10,413**	10,816
Contract services and consultants	**8,058**	8,595
Telecommunications	**2,761**	2,395
Other costs	**5,656**	4,915
Amortization	**47,392**	52,001
Total expenses	**$139,378**	$140,877
Net income before interest and investment income	**$ 8,864**	$ 15,151
Interest and investment income	**1,659**	1,131
Interest expense and financing charges	**(9,330)**	(10,613)
Net income for the year	**$ 1,193**	$ 5,669
Accumulated surplus – beginning of the year	**$ 21,307**	$ 15,638
Transfer to Ontario Power Authority **(Note 9)**	**(15,000)**	–
Accumulated surplus – end of year (Note 6)	**$ 7,500**	$ 21,307

See accompanying notes to Financial Statements.

Certain 2004 comparative figures in the statement of operations and accumulated surplus above have been reclassified to conform to the 2005 presentation.

STATEMENT OF FINANCIAL POSITION

(in thousands of Canadian dollars)	As at December 31, 2005	As at December 31, 2004
Assets		
Current assets		
Cash & cash equivalents	**$ 9,631**	$ 7,302
Temporary investments	**5,980**	45,841
Prepaid expenses & receivables	**22,621**	20,188
	$ 38,232	$ 73,331
Property & equipment (Note 3)		
In service	**$127,886**	$167,194
Construction-in-progress	**4,027**	2,038
	$131,913	$169,232
Other assets		
Long-term investments **(Note 4)**	**$ 9,912**	$ 8,016
Prepaid pension expense **(Note 8)**	**21,856**	22,097
	$ 31,768	$ 30,113
Total assets	**$201,913**	$272,676
Liabilities		
Current liabilities		
Accounts payable & accrued liabilities **(Note 5)**	**$ 19,894**	$ 17,921
Accrued interest	**1,030**	1,677
Rebates to market participants **(Note 6)**	**13,560**	–
	34,484	19,598
Long-term debt (Note 7)	**128,200**	203,200
Accrual for employee future benefits other than pensions (Note 8)	**31,729**	28,571
Total liabilities	**$194,413**	$251,369
Accumulated surplus (Note 6)	**7,500**	21,307
Total liabilities & accumulated surplus	**$201,913**	$272,676

See accompanying notes to Financial Statements.

On behalf of the Board:

Glenna Carr
Chair
Toronto, Canada
February 2, 2006

James Hinds
Chair, Audit Committee
Toronto, Canada
February 2, 2006

STATEMENT OF CASH FLOWS

(in thousands of Canadian dollars)	For the Year Ended December 31, 2005	For the Year Ended December 31, 2004
Operating activities		
Net income for the year	**$ 1,193**	$ 5,669
Adjustments for non-cash items:		
Amortization	**47,392**	52,001
Decrease in prepaid pension expense	**8,406**	7,495
Increase in accrual for employee future benefits other than pensions	**4,470**	4,054
	61,461	69,219
Changes in non-cash balances related to operations:		
Increase in accounts payable and accrued liabilities	**337**	1,803
Increase in rebates to market participants	**13,560**	–
Increase in prepaid expenses and receivables	**(2,433)**	(843)
	11,464	960
Other:		
Contribution to pension fund	**(8,165)**	(5,027)
Payment of employee future benefits	**(1,312)**	(1,143)
	(9,477)	(6,170)
Cash provided from operating activities	**$ 63,448**	$ 64,009
Investing activities		
Net sale/(purchase) of temporary investments	**$ 39,861**	$(33,399)
Purchase of long-term investments	**(1,896)**	(1,552)
Investment in property & equipment	**(9,084)**	(8,695)
Cash provided from/(used in) investing activities	**$ 28,881**	$(43,646)
Financing activities		
Retirement of long-term debt	**$(75,000)**	$(50,000)
Transfer to Ontario Power Authority **(Note 9)**	**(15,000)**	–
Cash used in financing activities	**$(90,000)**	$(50,000)
Net change in cash & cash equivalents	**$ 2,329**	$(29,637)
Cash & cash equivalents – beginning of year	**7,302**	36,939
Cash & cash equivalents – end of year	**$ 9,631**	$ 7,302

Supplementary information:
(in thousands of Canadian dollars)

Interest paid	**$ 9,698**	$ 10,321

See accompanying notes to Financial Statements.

NOTES TO FINANCIAL STATEMENTS

NOTE 1

Nature of Operations

The Independent Electricity System Operator (IESO), formerly known as the Independent Electricity Market Operator (IMO), is a not-for-profit, non-taxable corporation, created by statute effective on April 1, 1999 pursuant to Part II of the *Electricity Act, 1998*. As set out in the *Electricity Act*, the IESO operates pursuant to a licence granted by the Ontario Energy Board (OEB). The objects of the IESO as contained in the *Electricity Act*, and amended in the *Electricity Restructuring Act, 2004* are as follows:

- to exercise the powers and perform the duties assigned to the IESO under the *Electricity Restructuring Act, 2004*, the market rules and its licence;
- to enter into agreements with transmitters giving the IESO the authority to direct the operation of their transmission systems;
- to direct the operation and maintain the reliability of the IESO-controlled grid to promote the purposes of the *Electricity Restructuring Act, 2004*;
- to participate in the development, by any standards authority, of standards and criteria relating to the reliability of the transmission systems;
- to work with the responsible authorities outside Ontario to co-ordinate the IESO's activities with their activities;
- to collect and provide information to the Ontario Power Authority (OPA) and the public relating to the current and short-term electricity needs of Ontario and the adequacy and reliability of the integrated power system to meet those needs; and
- to operate the IESO-administered markets to promote the purposes of the *Electricity Restructuring Act, 2004*.

The IESO is required to submit its proposed expenditures, revenue requirements, and fees for the coming year to the OEB for review. The submission may be made only with the approval of the Minister of Energy (Minister).

On May 24, 2005 the OEB approved the IESO's requested expenditures, revenue requirements and fees for fiscal 2005. In addition, a component of the IESO's application was a Settlement Agreement, which was accepted by the OEB on March 18, 2005 and stipulates that any amount accumulated in the IESO's approved regulatory deferral account that exceeds $5.0 million at the end of any fiscal year will be returned to market participants in the form of a rebate of system fees in the following year.

For its 2006 application, the IESO obtained permission of the Minister to submit its proposed 2006 expenditures, revenue requirements, and fees to the OEB on October 21, 2005. The IESO filed its submission for review with the OEB on October 27, 2005. The OEB has not yet completed its review of the IESO's requested 2006 expenditures, revenue requirements, and fees.

NOTE 2 Summary of Significant Accounting Policies

a) Basis of financial statement preparation
The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in Canada.

b) Revenue recognition
System fees earned by the IESO are based on approved rates for each megawatt of electricity withdrawn from the IESO-controlled grid, including exports. System fees are recognized as revenue at the same time as the electricity is withdrawn. Rebates are recognized in the year in which the approved regulatory deferral account before such rebates exceeds regulated limits.

These financial statements do not include the financial transactions of market participants within the IESO-administered markets.

Other revenue represents amounts that accrue to the IESO relating to interest on funds passing through market settlement accounts, as well as fines and penalties passing through the market adjustment account. Such revenue is recognized as it accrues.

c) Cash and cash equivalents
Cash and cash equivalents comprise cash, term deposits and other short-term investments with original maturity dates of less than 90 days.

d) Temporary investments
Short-term money market investments with original maturities of 90 days or longer are classified as temporary investments and valued at amortized cost. Premiums and discounts are amortized to income using the constant yield method over the period to maturity.

e) Construction-in-progress
Construction-in-progress generally relates to the costs of physical facilities, hardware and software, and includes costs paid to vendors, internal and external labour, consultants, an applicable share of overhead, and an allocation of interest related to funds borrowed to finance the project. Costs relating to construction-in-progress are transferred to property and equipment in service when the asset under construction is deemed to be ready for use.

f) Property and equipment in service
Property and equipment are capitalized at cost, which comprises materials, labour, external support, overheads, and interest applicable to capital activities.

g) Amortization
The capital cost of property and equipment in service is amortized on a straight-line basis over their estimated service lives.

The estimated service lives in years, from the date the assets were transferred from Ontario Hydro or subsequently acquired, are:

Class	Estimated Average Service Life
Facilities	40
Market Systems and Applications	4 to 7
Infrastructure and Other Assets	3 to 10

Gains and losses on sales of property and equipment and losses on premature retirements are charged to operations as adjustments to amortization expense. Removal costs are charged to amortization expense as incurred.

The estimated service lives of property and equipment and the significant assumptions underlying the estimates of removal costs are subject to periodic review. The impacts of changes in the estimated lives of property and equipment are amortized on a prospective basis. The most recent review was completed in fiscal 2005.

h) Long-term investments
Portfolio investments are carried at cost less any provision for other than temporary losses.

i) Pension and other post-employment benefits
The IESO's post-employment benefit programs include pension, group life insurance, health care, long-term disability and workers' compensation benefits.

The IESO accrues obligations under pension and other post-employment benefit ("OPEB") plans and the related costs, net of plan assets. Pension and OPEB expenses and obligations are determined annually by independent actuaries using the projected benefit method and management's best estimate of expected return on plan assets, salary escalation, retirement ages of employees, mortality and expected health-care costs. The discount rate used to value liabilities is based on market rates as at the measurement date of September 30.

The expected return on plan assets is based on management's long-term best estimate using a market-related value of plan assets. The market-related value of plan assets is determined using market-related values for equities (whereby fund assets are calculated using the smoothed value of assets over five years) and market values for fixed income securities, as at the measurement date of September 30.

Pension and OPEB expenses are recorded during the year in which employees render services. Pension and OPEB expenses consist of current service costs, interest expense on liabilities, expected return on plan assets and the amortization of plan amendments on a straight-line basis over the expected average remaining service life of the employees covered by the plan. Actuarial gains (losses) arise from, amongst other things, the difference between the actual rate of return on plan assets for a period and the expected long-term rate of return on plan assets for that period or from changes in actuarial assumptions used to determine the accrued benefit obligations. The excess, if any, of the cumulative unamortized net actuarial gain or loss over 10% of the greater of the projected benefit obligation and the market-related value of plan assets is also amortized over the expected average remaining service life of the employees covered by the plan.

The expected average remaining service life of employees covered by the pension and OPEB plans is 11 years (2004: 12 years).

j) Fair value of financial instruments

The carrying amounts reported in the balance sheet for financial instruments, comprising current assets and current liabilities, approximate to their fair values. The fair value of long term investments is disclosed in Note 4. The fair value of the long-term debt is not readily available.

k) Derivative financial instruments

The IESO enters into foreign exchange forward contracts, for risk management purposes. Foreign exchange forward contracts are commitments to purchase foreign currencies for delivery at a specified date in the future at a fixed rate. The IESO enters into such contracts only for known or anticipated transactions that will require settlement in foreign currency, and does not use any other derivative instruments.

The IESO is exposed to changes in the value of such contracts prior to their settlement as a result of movements in the underlying foreign exchange rates. Senior management responsible for cash management manages this risk.

Where such forward contracts meet the criteria for hedge accounting, changes in their values resulting from exchange rate movements are not reflected in the financial statements. Where such contracts do not meet the criteria for hedge accounting, they are recorded at their fair value at the balance sheet date, with changes in their value recognized in the statement of operations.

l) Foreign exchange

Transactions denominated in foreign currencies are translated into Canadian dollars at the rate of exchange prevailing on the date of the transaction. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are translated in Canadian dollars at the rate prevailing at that date. Exchange gains and losses arising on settlement of foreign exchange transactions are reported in the statement of operations at the date at which the transactions are settled.

m) Use of estimates

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

NOTE 3 Property and Equipment

(in thousands of Canadian dollars)	Cost	Accumulated Amortization	As at December 31, 2005 Net Book Value	As at December 31, 2004 Net Book Value
Property and equipment in service				
Facilities	**$ 48,810**	**$ 7,992**	**$ 40,818**	$ 41,680
Market Systems and Applications	**193,798**	**119,785**	**74,013**	108,173
Infrastructure and Other Assets	**92,710**	**79,655**	**13,055**	17,341
	335,318	**207,432**	**127,886**	167,194
Construction-in-progress	**4,027**	**–**	**4,027**	2,038
	$339,345	**$207,432**	**$131,913**	$169,232

In 2005 no adjustments were made to management's estimates of remaining asset service lives. In 2004 the impact of changes in estimates was an increase in amortization expense of $2,390,495 in the year.

Interest capitalized to construction-in-progress during 2005 was $nil (2004 - $24,047).

NOTE 4 Long-Term Investments

Long-term investments represent a balanced portfolio of pooled funds. The market value of these investments was $11,365,515 as at December 31, 2005.

As at December 31, 2004, the long-term investments represented an investment in a balanced pooled fund and had a market value of $8,916,508.

NOTE 5 Accounts Payable and Accrued Liabilities

(in thousands of Canadian dollars)	As at December 31, 2005	As at December 31, 2004
Relating to property and equipment	**$ 3,270**	$ 2,281
Relating to operations	**16,624**	15,640
	$19,894	$17,921

NOTE 6 Accumulated Surplus And Rebates To Market Participants

During 2005 the IESO recognized rebates to market participants of system fees of $13,560,242 representing amounts previously accumulated in the IESO's approved regulatory deferral account in excess of $5.0 million. As at December 31 the components of the IESO's Accumulated Surplus were as follows:

(in thousands of Canadian dollars)	As at December 31, 2005	As at December 31, 2004
Approved regulatory deferral account	**$5,000**	$18,906
Accumulated market penalties and fines	**2,500**	2,401
	$7,500	$21,307

NOTE 7 **Long-Term Debt**

(in thousands of Canadian dollars)	As at December 31, 2005	As at December 31, 2004
Notes payable to:		
Ontario Electricity Financial Corporation (OEFC)	**$ 78,200**	$ 78,200
The Province of Ontario	**50,000**	125,000
	$128,200	$203,200

Note payable to OEFC
The long-term note payable to the Ontario Electricity Financial Corporation (OEFC) is unsecured, bears interest at 7.9% per annum and is repayable in full on May 1, 2009. Interest accrues daily and is payable in arrears, in equal semi-annual payments on May 1 and November 1 of each year.

Note payable to Province of Ontario
The long-term note payable to the Province of Ontario is unsecured.

The repayment date is the earliest of March 30, 2007 or six months after which a credit rating is received by the IESO or revised to a specific level.

Interest accrues daily at an interest rate equal to the three-month floating Bankers' Acceptance rate plus 50 basis points during this period. At December 31, 2005, the interest rate was 3.53%. The loan agreement provides the right for the IESO to make prepayments on the outstanding principal at three-month intervals, in multiples of $5.0 million, co-incident with the payment of interest. On each of February 3, 2005, June 30, 2005 and December 30, 2005, the IESO prepaid $25.0 million, for a total prepayment in 2005 of $75.0 million.

Credit facility
The IESO has an unsecured, committed, and extendible 364-day revolving credit facility agreement with a Canadian chartered bank, under which the bank will make available to the IESO an amount up to $10.0 million. This amount was revised on July 22, 2005 from $20.0 million. As at December 31, 2005 and 2004, no balance was drawn on the credit facility. Advances under this facility are available in Canadian dollars by way of prime rate loans or relevant Bankers' Acceptances rates. Unused portions of this credit facility are subject to a commitment fee of 10 basis points per annum and a Stamping Fee of 30 basis points per annum upon acceptance of each Bankers' Acceptance.

The IESO also has an unsecured, committed, and extendible 364-day revolving credit facility agreement with a Canadian chartered bank, under which the bank will make available to the IESO an amount up to $100.0 million. This agreement was with a banking syndicate until July 22, 2005. As at December 31, 2005 $0.9 million was drawn on this credit facility (December 31, 2004 no balance was drawn). Advances under this facility are available in Canadian dollars by way of prime rate loans or relevant Bankers' Acceptances rates. Unused portions of this credit facility are subject to a commitment fee of 10 basis points per annum and a Stamping Fee of 30 basis points per annum upon acceptance of each Bankers' Acceptance. This facility will mainly be used to fund shortfalls in amounts owed to the IESO by Market Participants for payment to other Market Participants prior to their recovery under the provisions of the market rules.

NOTE 8

Post-Employment Benefit Plans

The IESO provides pension and other employee post-employment benefits, comprising group life insurance, long-term disability and group medical and dental plans, for the benefit of current and retired employees.

Pension plans
The IESO provides a contributory defined benefit, indexed, registered pension plan. In addition to the funded registered pension plan, the IESO provides certain non-registered defined benefit pensions through an unfunded, indexed, non-registered plan.

Other employee future benefits
The group life insurance, long-term disability and group medical and dental benefits are provided through unfunded, non-registered defined benefit plans.

Summary of accrued benefit obligations and plan assets

(in thousands of Canadian dollars)	2005 Pension Benefits	2004 Pension Benefits	2005 Other Benefits	2004 Other Benefits
Accrued benefit obligation	**$363,776**	$284,265	**$ 55,342**	$ 38,104
Fair value of plan assets	**282,313**	242,065	**–**	–
Funded status	**(81,463)**	(42,200)	**(55,342)**	(38,104)
Employer contribution after measurement date	**23**	7	**305**	283
Unamortized past service costs	**5,115**	5,813	**549**	628
Unamortized net actuarial loss	**98,181**	58,477	**22,759**	8,622
Prepaid (accrued) benefit cost recognized in the statements of financial position	**$ 21,856**	$ 22,097	**$(31,729)**	$(28,571)

Prepaid benefit cost is shown net of valuation allowance of $nil (2004: $nil).

Registered pension plan assets

	2005	2004
Equity securities	**59.1%**	57.8%
Debt securities	**38.5%**	40.0%
Cash equivalents	**2.4%**	2.2%
	100.0%	100.0%

As at the measurement date of September 30, registered pension plan assets were split by market value between the following categories:

Summary of principal assumptions used to calculate benefit obligations

	2005 Pension Benefits	2004 Pension Benefits	2005 Other Benefits	2004 Other Benefits
Discount rate at end of the period	**5.1%**	6.25%	**5.1%**	6.25%
Rate of compensation increase	**3.5%**	3.5%	**3.5%**	3.5%

The assumed hospital and drug cost increase rate for the next year is 9.0%. The rate is assumed to begin decreasing gradually in 2007 to a rate of 5.0% in the year 2014 and remain at that level thereafter.

Dental costs are assumed to increase by 6.0% per annum and to begin decreasing in 2007 to a rate of 4.5% in 2009.

Summary of benefit costs and plan contributions

(in thousands of Canadian dollars)	2005 Pension Benefits	2004 Pension Benefits	2005 Other Benefits	2004 Other Benefits
Benefit cost	**$8,406**	$7,495	**$4,470**	$4,054
Employer contributions	**8,149**	9,392	**1,290**	1,134
Plan participants' contributions	**1,962**	1,901	**–**	–
Benefits paid	**9,598**	8,298	**1,290**	1,134

The most recent actuarial valuation of the registered pension plan for funding purposes was at January 1, 2005, and the date of the next required valuation is January 1, 2008.

Summary of principal assumptions used to calculate benefit costs

	2005 Pension Benefits	2004 Pension Benefits	2005 Other Benefits	2004 Other Benefits
Discount rate at the beginning of the period	**6.25%**	6.1%	**6.25%**	6.1%
Expected return on plan assets	**7.0%**	7.25%	**–**	–
Rate of compensation increase	**3.5%**	3.5%	**3.5%**	3.5%
Rate of indexing of pension benefits	**2.5%**	2.5%	**–**	–

NOTE 9 Transfer to Ontario Power Authority

On February 18, 2005, the Government of Ontario issued Ontario Regulation 47/05 to transfer $15.0 million of the IESO's accumulated surplus to the Ontario Power Authority. Accordingly, in 2005, the IESO transferred $15.0 million to the Ontario Power Authority.

NOTE 10 Segmented Information

The IESO consists of a single business engaged in the operation of the wholesale electricity system in Ontario.

NOTE 11 Commitments

Operating commitments

The obligations of the IESO with respect to non-cancellable operating leases over the next five years are as follows:

(in thousands of Canadian dollars)	
2006	$1,915
2007	1,635
2008	1,215
2009	609
2010	609

Power to Ontario. On Demand.

Independent Electricity System Operator

655 Bay Street, Suite 410
P.O. Box 1
Toronto, Ontario M5G 2K4
Reception: 905.855.6100
Media inquiries: 416.506.2823

IESO Customer Relations

Phone: 905.403.6900
Toll-free: 1.888.448.7777
E-mail: customer.relations@ieso.ca

www.ieso.ca