ONTARIO ELECTRICITY FINANCIAL CORPORATION

ANNUAL REPORT 2004

Ontario

Mandate

The mandate of the Ontario Electricity Financial Corporation (OEFC) includes the following:

- Manage the outstanding debt and derivatives portfolios, financial risks and other liabilities of the former Ontario Hydro;
- Manage the long-term power purchase agreements entered into by the former Ontario Hydro and provide the associated risk management infrastructure;
- Receive payments and administer assets, liabilities, rights and obligations of the Corporation that have not been transferred to other Ontario Hydro successor corporations and dispose of these as it deems appropriate or as directed by the Minister of Finance; and
- Perform any additional functions as required by the Lieutenant-Governor-in-Council, including managing the Electricity Consumer Price Protection Fund (ECPPF).

OEFC retains the services of the Ontario Financing Authority (OFA) and the Ministry of Finance on a cost-recovery basis to carry out its daily operations. The OFA is the agency of the Province of Ontario responsible for provincial borrowing and debt management.

The *Energy Competition Act, 1998*, established the legislative framework for the current electricity market in Ontario. Under the Act, Ontario Hydro was restructured into five new corporations: Ontario Power Generation Inc. (OPG), Hydro One Inc. (Hydro One), the Independent Electricity Market Operator (IMO), the Electrical Safety Authority (ESA) and OEFC.

The *Electricity Act, 1998,* outlines OEFC's objectives. These objectives can be expanded by the Lieutenant-Governor-in-Council. In addition, the regulations to the *Ontario Energy Board Act, 1998*, also define responsibilities for OEFC.

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Message from the Chair and Vice-Chair

The 2004 OEFC Annual Report describes the Corporation's objectives and responsibilities, operational highlights and financial results for the year ended March 31, 2004.

In the year ended March 31, 2004, OEFC's revenues totalled $3,022 million, while expenses totalled $3,389 million, resulting in a deficiency of revenue over expense of $367 million, compared to the prior year's deficiency of revenue over expense of $98 million. The deficiency is partly attributable to lower interest on notes receivable due to the sale of Hydro One notes in 2002-03, lower payments-in-lieu of taxes from OPG and Hydro One and lower power sales as well as the elimination of two revenue sources in the prior year, the electricity sector dedicated income transfer from the Province and the gain on the sale of Hydro One notes.

The Province completed OEFC's 2003-04 borrowing requirements of $5,490 million. OEFC took advantage of historically low interest rates in 2003-04 and successfully funded $1.2 billion of OEFC's nuclear funding liability under the Ontario Nuclear Funds Agreement (ONFA). Through prudent risk management and the strengthening Canadian dollar, OEFC was able to eliminate its foreign exchange exposure on outstanding debt.

OEFC continued to manage approximately 90 power purchase agreements (PPAs) with non-utility generators (NUGs) that were entered into by the former Ontario Hydro to produce additional generating capacity. OEFC reached agreements to revise seven PPAs to facilitate their integration into the competitive electricity market and to reduce costs, bringing the total revised contracts to twenty-three.

In addition, OEFC managed the Electricity Consumer Price Protection Fund (ECPPF) and implemented contracts for 249 megawatts of temporary generation capacity, providing additional back-up resources for the summer and fall of 2003.

The government introduced legislation on June 15, 2004, to implement reforms to the electricity sector that would develop a market structure consisting of a combination of a fully regulated and a competitive electricity market. If legislation is passed in the fall of 2004, the new market structure is expected to be in place in early 2005. Under the proposed reforms, consumers would become responsible for paying the full cost of existing and any new contracts for generation, which would eliminate OEFC's liability for the above-market portion of existing PPAs, expected to be $3.9 billion at that time. In the interim, on April 1, 2004, the government replaced the 4.3 cents per kilowatt-hour price freeze for low volume and designated consumers with a pricing structure that better reflects the true cost of power. This pricing structure also is expected to eliminate the net cost for the ECPPF in 2004-05.

Looking ahead to 2004-05, OEFC will continue to support the implementation of the government's electricity sector initiatives, where those initiatives touch on OEFC's mandate, and monitor the financial performance of the Ontario Hydro successor companies and other policy developments to determine the financial impact on OEFC. OEFC will meet its other priorities of cost-effective borrowing and debt management, in addition to managing the NUG contracts and the ECPPF, while also proceeding with payments to reduce the commitment-in-lieu for the nuclear funding liability.

Colin Andersen
Chair

Gadi Mayman
Chief Executive Officer and Vice-Chair (interim)

Management's Discussion and Analysis

Highlights 2003-04

The 2003 Annual Report outlined OEFC's corporate objectives in 2003-04 as follows:

- Continue to perform borrowing, risk management, cash management, banking and accounting services as required in managing and retiring the outstanding debt and derivative contracts of the former Ontario Hydro;
- Assist in the implementation of the government's electricity policy decisions and coordinate economic and financial issues related to the industry. This includes management of the ECPPF, managing financial relationships with the successor companies of Ontario Hydro (Hydro One, Ontario Power Generation Inc. and the Independent Electricity Market Operator) and assisting the Ministry of Energy and the Ministry of Finance in analyzing and implementing new supply initiatives, such as the temporary generation initiatives for the summer and fall of 2003;
- Continue negotiating revisions to the PPA contracts to ensure that the contracts are consistent with the competitive market. Develop and implement the necessary infrastructure to manage, in a cost-effective and prudent manner, the NUG contracts and related exposures and their integration into the power market administered by the IMO; and
- Discharge OEFC's liability to the nuclear decommissioning fund related to generating stations of the former Ontario Hydro.

OEFC achieved the following results in relation to its objectives:

- Met long-term borrowing requirements of $5,490 million, including the refinancing of maturing debt, in a cost-effective manner.
- Eliminated all foreign exchange exposure on outstanding debt through prudent risk management.
- Managed the ECPPF created under the *Electricity Pricing, Conservation and Supply Act, 2002.*
- Implemented contracts for 249 megawatts of temporary generation capacity, providing additional back-up resources for the summer and fall of 2003.
- Reached agreements for the revision of seven additional PPAs with NUGs, bringing the total revised PPAs to twenty-three.
- Continued to develop the necessary infrastructure to manage the PPAs and related exposures in a competitive market in a cost-effective and prudent manner.
- Negotiated agreements with three NUGs to provide additional NUG capacity.
- Managed the obligation under the ONFA between the Province, OPG and certain OPG subsidiaries. OEFC funded $1.2 billion of the nuclear funding liability of $3 billion, which OEFC assumed as a legacy liability of the former Ontario Hydro.

These results are detailed in the following discussion.

Overview of Financial Results

For the year ended March 31, 2004, revenues totalled $3,022 million, while expenses totalled $3,389 million, resulting in a deficiency of revenue over expense of $367 million, compared to the prior year's deficiency of revenue over expense of $98 million.

OEFC's deficiency of revenue over expense increased by $269 million. The deficiency is partly attributable to lower interest on notes receivable due to the sale of Hydro One notes in 2002-03, lower payments-in-lieu of taxes from OPG and Hydro One and lower power sales as well as the elimination of two revenue sources in the prior year, the electricity sector dedicated income transfer from the Province of $197 million and the gain on sale of Hydro One notes of $206 million.

Expenses were down in 2003-04 as a result of lower interest costs and the lower cost of the ECPPF, partially offset by the costs incurred from contracts implemented for temporary generation capacity.

Revenues

OEFC's total revenues for 2003-04 were $3,022 million, a decrease of $775 million from 2002-03. Revenues included $1,000 million from the Debt Retirement Charge, $627 million in payments-in-lieu of tax, $771 million in interest income from the Province, OPG, Hydro One, and the IMO, and $510 million in power sales under the PPAs.

Expenses

OEFC's total expenses for 2003-04 were $3,389 million, a decrease of $506 million from 2002-03. OEFC's expenses included interest payments on short- and long-term debt of $1,890 million, power purchases of $797 million and interest on the nuclear funding liability of $142 million.

OEFC's expenses for 2003-04 also include the ECPPF. The ECPPF receives a large proportion of its funding from the portion of the Market Power Mitigation Agreement rebate paid by OPG that is attributable to the low volume and designated consumers covered under the ECPPF. After taking this rebate into account, the electricity price freeze was delivered through OEFC at a net cost of $253 million in 2003-04, down from $665 million in 2002-03.

Borrowing Program

In 2003-04, the Province completed OEFC's long-term public borrowing requirements of $5.5 billion. This amount includes the refinancing of $2.3 billion of long-term debt maturities, $1.2 billion to refinance maturities in transactions to fix interest rates on short-term debt, $1.2 billion to fund the nuclear funding liability under ONFA and $1.0 billion to meet OEFC's total obligation to the ECPPF, offset by $0.7 billion in principal repayment of notes receivable by Hydro One.

These requirements were $1.0 billion higher than the $4.5 billion forecast at the time of the 2003 Ontario Economic Outlook and Fiscal Review due to a decision to extend the term of some of OEFC's debt to lock in more attractive long-term financing. This increase was offset by an identical decrease in short-term borrowing.

Long-term public borrowing was completed primarily in the Canadian domestic market. However, the Province also was successful in issuing two Euro Medium Term Notes, including one issued in Swiss Francs, for a Canadian dollar equivalent of $465 million, and one U.S. dollar global issue, for a Canadian dollar equivalent $739 million.

Nuclear Funds

The Province, OPG and certain OPG subsidiaries entered into ONFA in March 2002. The agreement came into force on July 24, 2003. Its main objective is to ensure sufficient funds are available to pay for future costs of nuclear waste management and nuclear station decommissioning.

OEFC's obligation represents unfunded nuclear decommissioning and nuclear waste management liabilities accumulated by the former Ontario Hydro. Under ONFA, OEFC has an obligation to make payments to fund this legacy nuclear funding liability. This liability has been reported in OEFC's financial statements as part of the liabilities of the former Ontario Hydro.

On July 24, 2003, OEFC paid $1.2 billion and delivered a written commitment to pay (commitment-in-lieu) approximately $1.9 billion to the segregated fund for decommissioning in satisfaction of its ONFA obligation. The OEFC Board has committed to fund the commitment-in-lieu no later than the end of fiscal 2006-07.

Risk Management

OEFC has risk management policies and procedures in place to address the management of OEFC's market, credit and operational risk exposures, primarily pertaining to OEFC's debt, derivatives and NUG portfolios and related capital markets transactions.

OEFC's foreign exchange and floating rate exposures have remained within policy limits in 2003-04.

- Floating interest rate exposure was eight percent at March 31, 2004, within the OEFC's limit of 20 percent.
- Foreign exchange exposure was zero percent at March 31, 2004, within the OEFC's limit of five percent.

An appreciation of the Canadian dollar in 2003 provided OEFC with an opportunity to reduce the policy limit of its unhedged foreign exchange exposure to five per cent of outstanding debt from 20 per cent. Through the use of derivative instruments, OEFC reduced its U.S. dollar exposure by U.S.$1.1 billion, thereby eliminating all of OEFC's remaining foreign exchange exposure. This will eliminate the sensitivity of OEFC's annual financing charges to movements in the Canadian dollar/U.S. dollar exchange rate.

In addition, when issuing new debt, the Province, on behalf of OEFC, aims for a smooth debt maturity profile to diversify the interest rate risk inherent in refinancing maturing and floating rate debt.

A description of OEFC's risk management policies can be found in the Corporate Policies section.

Debt and Unfunded Liability

OEFC assumed approximately $38.1 billion in total debt and other liabilities from the former Ontario Hydro upon the restructuring of Ontario's electricity sector on April 1, 1999. As part of the restructuring, OEFC received a total of $17.2 billion in notes owing from the Province, OPG, Hydro One and the IMO. The difference of approximately $20.9 billion represented "stranded debt," which is defined under the *Electricity Act, 1998,* as the amount of debt and other liabilities of OEFC that cannot reasonably be serviced and retired by commercial companies in a competitive electricity market.

OEFC's unfunded liability is the net deficiency of OEFC's assets over its liabilities. Unfunded liability represents the stranded debt adjusted for $1.5 billion of additional assets transferred to OEFC. On April 1, 1999, unfunded liability was $19.4 billion. As of March 31, 2004, OEFC's unfunded liability was $20.6 billion.

The *Electricity Act, 1998,* requires that payments-in-lieu of taxes must be paid by the successor entities and municipal electric utilities to OEFC to service stranded debt. As of April 1, 1999, the present value of these dedicated revenues and Electricity Sector Dedicated Income was estimated at $13.1 billion, which, when subtracted from the $20.9 billion stranded debt, resulted in an estimated $7.8 billion of residual stranded debt. *The Electricity Act, 1998* provided for a Debt Retirement Charge to be paid by consumers until the residual stranded debt is retired.

OEFC's total debt outstanding, which includes short and long-term debt, was $27.6 billion as of March 31, 2004, an increase of $0.8 billion from the previous fiscal year, primarily due to a $1.2 billion payment towards the nuclear funding liability. Since the $1.2 billion already was included as other liabilities of the former Ontario Hydro, total debt and other liabilities is not affected by this transaction.

Debt Repayment Plan

OEFC's mandate is to service and retire the debt and other liabilities of the former Ontario Hydro from within the electricity sector. As the legal continuation of the former Ontario Hydro, OEFC services and retires the debt and other liabilities through revenues and cashflows from the following sources:

- Outstanding notes receivable from the Province, OPG and IMO;
- Payments-in-lieu (PILs) of corporate income, capital and property taxes, made by OPG, Hydro One and municipal electric utilities;
- Debt Retirement Charge paid by electricity consumers; and
- Electricity sector dedicated income: the Province's combined net incomes from OPG and Hydro One in excess of the Province's interest cost of its investment in these electricity subsidiaries.

For more information on debt and other liabilities, see Notes 7 to 10 to the Financial Statements.

Management of Power Purchase Agreements

In the late 1980s and early 1990s, the former Ontario Hydro entered into approximately 90 long-term PPAs with NUGs. These PPAs, which expire on various dates until 2048, represent approximately 1,700 megawatts of generating capacity. Power purchases by OEFC under the PPAs in 2003-04 amounted to $797 million. The PPAs account for about six to eight per cent of the generating capacity available to meet Ontario's energy requirements.

As the legal continuation of Ontario Hydro, OEFC is responsible for these contracts. The PPA liability had been valued at $4,286 million on a discounted cash-flow basis as of April 1, 1999, the date Ontario Hydro was continued as OEFC. Details are set out in Note 9 to the Financial Statements.

During 2003-04, OEFC negotiated revisions to seven additional NUG contracts to facilitate their integration into the competitive electricity market and reduce above-market costs. This brings the total revised NUG contracts to twenty-three. OEFC also completed three incremental power agreements with existing NUGs, providing 46 megawatts of additional NUG capacity during 2003. In addition, OEFC completed five paid-to-produce agreements. These arrangements increased OEFC's ability to manage NUG costs and exposures effectively and maximize NUG output during periods of tight electricity supply.

Temporary Generation

In March of 2003, OEFC was directed by the government to contract for the provision of 200 to 400 megawatts of short-term temporary generation to support Ontario's electricity reserves during the summer and fall of 2003.

Through a competitive bid process, OEFC successfully completed negotiations with three counterparties who completed the installation of 249 megawatts of gas-fired generation by August 2003. The temporary generation was located at five sites in southern Ontario. It was in place to support the Ontario grid during the week following the blackout in August 2003, producing a total of 24,659 megawatt hours. All of the contracts matured on December 31, 2003.

The total cost to OEFC for this temporary generation was $70 million in 2003-04.

Outlook for 2004-05

Implications of Electricity Sector Reforms for OEFC

The government introduced legislation on June 15, 2004 to implement its vision for reforming the electricity sector, and if the legislation is passed in the fall of 2004, the new market structure is expected to be in place early in 2005.

The proposed reforms would result in a combination of a fully regulated and competitive electricity sector, with different electricity generators receiving prices set through a variety of mechanisms. Electricity generated from OPG's nuclear and baseload hydro generation assets would receive regulated prices and electricity from those generators with existing or new contracts would receive prices as determined by their contracts. A competitive market would set the price received by other generation.

Under the proposed plan, consumers would pay bills that reflect a blend of these costs, including the pass-through of regulated rates for OPG-regulated plants, the full costs for existing and new contracts for generation and market prices for other plants. For residential and small business consumers, the Ontario Energy Board (OEB) would implement a new standard rate plan in early 2005 that would reflect these blended costs. The standard rate plan would provide more stable prices to consumers, with periodic adjustments to ensure people pay the true cost of electricity over time.

OEFC will continue to support the implementation of the government's electricity sector initiatives, where those initiatives touch on OEFC's mandate and monitor the financial performance of the successor companies and other policy developments to determine the impact on OEFC. If legislation to implement reforms to the electricity sector is passed, it would have a significant financial impact on OEFC.

For example, under the new market structure, the above-market portion of the existing power purchase agreements with the non-utility generators would be passed on to the electricity consumer over the life of the contracts. OEFC anticipates that this would eliminate the liability for above-market costs under its power purchase agreements, expected to be about $3.9 billion at that time.

Other Corporate Objectives

OEFC's activities in 2004-05 will focus on the following objectives:

- Provide borrowing, risk management, cash management, banking, accounting and forecasting services as required in managing and retiring the outstanding debt and derivative contracts of the former Ontario Hydro.
- Proceed with payments to reduce the commitment-in-lieu for nuclear liabilities associated with the financial restructuring of the former Ontario Hydro.
- Develop and implement the necessary infrastructure to manage, in a cost-effective and prudent manner, the NUG contracts and related exposures and their integration into the power market.
- Negotiate revisions to the NUG contracts to ensure that the contracts are consistent with the electricity sector as it develops.
- Manage the ECPPF to ensure accuracy of claims under the interim pricing structure, which is expected to be in place until 2005. This pricing structure, which charges consumers 4.7 cents per kilowatt-hour for the first 750 kilowatt-hours of consumption per month and 5.5 cents per kilowatt-hour for additional volumes, better reflects the true cost of power and is expected to result in no net cost for the ECPPF in 2004-05.

Financial Statements

Responsibility for Financial Reporting

The accompanying financial statements of the Ontario Electricity Financial Corporation have been prepared in accordance with accounting principles recommended for governments by the Canadian Institute of Chartered Accountants and are the responsibility of management. 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 properly prepared within reasonable limits of materiality and in light of information available up to June 4, 2004.

Management maintains a system of internal controls designed to provide reasonable assurance that the assets are safeguarded and that reliable financial information is available on a timely basis. The system includes formal policies and procedures and an organizational structure that provides for appropriate delegation of authority and segregation of responsibilities. Internal Audit Services of the Ministry of Finance independently evaluates the effectiveness of these internal controls on an ongoing basis and reports its findings to management and the Audit Committee of the Board of Directors.

The Board of Directors, through the Audit Committee, is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal controls. The Audit Committee meets periodically with management, the internal auditors and the external auditor to deal with issues raised by them and to review the financial statements before recommending approval by the Board of Directors.

The financial statements have been audited by the Provincial Auditor. The Provincial Auditor's responsibility is to express an opinion on whether the financial statements are fairly presented in accordance with accounting principles recommended for governments by the Canadian Institute of Chartered Accountants. The Auditor's Report, which appears on the following page, outlines the scope of the Auditor's examination and his opinion.

On behalf of Management:

Gadi Mayman

Chief Executive Officer and Vice-Chair (interim)

Office of the Provincial Auditor of Ontario

Bureau du vérificateur provincial de l'Ontario

AUDI ALTERAM PARTEM

Box 105, 15th Floor, 20 Dundas Street West, Toronto, Ontario M5G 2C2
B.P. 105, 15e étage, 20, rue Dundas ouest, Toronto (Ontario) M5G 2C2
(416) 327-2381 Fax: (416) 327-9862

Auditor's Report

To the Ontario Electricity Financial Corporation
and to the Minister of Finance

I have audited the statement of financial position of the Ontario Electricity Financial Corporation as at March 31, 2004 and the statements of revenue, expense and unfunded liability and cash flow for the year then ended. These financial statements are the responsibility of the Corporation's management. My responsibility is to express an opinion on these financial statements based on my audit.

I conducted my audit in accordance with Canadian generally accepted auditing standards. Those standards require that I 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 accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In my opinion, these financial statements present fairly, in all material respects, the financial position of the Corporation as at March 31, 2004 and the results of its operations and its cash flow for the year then ended, in accordance with the accounting principles recommended for governments by the Canadian Institute of Chartered Accountants.

Toronto, Ontario
June 4, 2004

J.R. McCarter, CA
Assistant Provincial Auditor

Ontario Electricity Financial Corporation
Statement of Financial Position
as at March 31, 2004
($ Millions)

	2004	2003
ASSETS		
Current Assets		
Cash and cash equivalents (Note 4)	**$ 8**	$ 3
Accounts receivable	**355**	248
Interest receivable	**12**	31
Current portion of notes receivable (Note 6)	**250**	651
	625	933
Payments-in-lieu of tax receivable (Note 11)	**248**	218
Due from Province of Ontario (Notes 5, 11)	**351**	351
Notes and loans receivable (Note 6)	**12,080**	12,337
Deferred debt costs	**451**	673
	$ 13,755	$ 14,512
LIABILITIES		
Current Liabilities		
Accounts payable	**$ 250**	$ 210
Interest payable	**563**	556
Short-term notes payable (Note 7)	**1,177**	3,413
Current portion of long-term debt (Note 7)	**3,945**	1,665
	5,935	5,844
Long-term debt (Note 7)	**22,433**	21,752
Power purchase contracts (Notes 9, 16)	**4,021**	4,125
Nuclear funding liability (Note 10)	**1,916**	2,974
	34,305	34,695
Contingencies and guarantees (Note 14)		
UNFUNDED LIABILITY (Notes 1, 3, 11)	**(20,550)**	(20,183)
	$ 13,755	$ 14,512

Approved on behalf of the Board of Directors:

Colin Andersen
Chair

Gadi Mayman
Vice-Chair (interim)

See accompanying notes to financial statements

Ontario Electricity Financial Corporation
Statement of Revenue, Expense and Unfunded Liability
for the Year Ended March 31, 2004
($ Millions)

	2004	2003
REVENUE		
Debt retirement charge (Note 1)	**$ 1,000**	$ 889
Revenue pool residual (Note 1)	**-**	24
Payments-in-lieu of tax (Note 11)	**627**	711
Interest	**771**	964
Power sales (Note 9)	**510**	635
Net reduction of power purchase contracts (Note 9)	**104**	161
Electricity sector dedicated income (Notes 5, 11)	**-**	197
Gain on sale of Hydro One notes (Note 6)	**-**	206
Other	**10**	10
Total Revenue	**3,022**	3,797
EXPENSE		
Interest - short-term debt	**78**	147
- long-term debt	**1,812**	1,867
Interest on nuclear funding liability (Note 10)	**142**	162
Amortization of deferred charges	**91**	105
Electricity Consumer Price Protection Fund (Note 12)	**253**	665
Power purchases (Note 9)	**797**	786
Temporary generation supply (Note 13)	**70**	-
Debt guarantee fee	**134**	147
Operating	**12**	16
Total Expense	**3,389**	3,895
Deficiency of revenue over expense	**367**	98
Unfunded Liability, beginning of year	**20,183**	20,085
Unfunded Liability, end of year	**$ 20,550**	$ 20,183

See accompanying notes to financial statements.

Ontario Electricity Financial Corporation

Statement of Cash Flow
for the Year Ended March 31, 2004
($ Millions)

	2004	2003
CASH FLOWS USED IN OPERATING ACTIVITIES		
Deficiency of revenue over expense	**$ 367**	$ 98
Adjustments for:		
Amortization of deferred charges	**(91)**	(105)
Net reduction of power purchase contracts (Note 9)	**104**	161
Interest on nuclear funding liability (Note 10)	**(142)**	(162)
Payments-in-lieu of tax receivable	**30**	(18)
Other items	**163**	69
Cash required by operations	**431**	43
CASH FLOWS FROM FINANCING ACTIVITIES		
Long-term debt issues	**5,490**	967
Less long-term debt retired	**2,279**	2,775
Long-term debt issued (retired), net	**3,211**	(1,808)
Short-term debt issued (retired), net	**(2,236)**	(583)
Payment towards nuclear funding liability (Note 10)	**(1,200)**	-
Sale of notes receivable (Note 6)	**-**	1,878
Repayment of notes receivable	**661**	536
Cash provided from financing activities	**436**	23
Increase (decrease) in cash and cash equivalents	**5**	(20)
Cash and cash equivalents, beginning of year	**3**	23
Cash and cash equivalents, end of year	**$ 8**	$ 3
Interest paid during the year and included in deficiency of revenue over expense	**$ 1,883**	$ 2,117

See accompanying notes to financial statements.

Notes to Financial Statements

1) Restructuring of the Ontario Electricity Industry

Effective April 1, 1999, pursuant to the *Electricity Act, 1998,* Ontario Hydro was continued as a corporation without share capital under the name Ontario Electricity Financial Corporation (OEFC). It is exempt from federal and provincial income taxes under paragraph 149(1)(d) of the Income Tax Act of Canada. OEFC is a Crown agency created to manage the debt and administer the assets, liabilities, rights and obligations of Ontario Hydro not transferred to other successor entities. These other successor entities include:

- Ontario Power Generation Inc. (OPG), an electricity generation company;
- Hydro One Inc. (Hydro One), a regulated electricity transmission and distribution business;
- Independent Electricity Market Operator (IMO), the regulated centralized independent system co-ordinator responsible for directing system operations and operating the electricity market; and
- Electrical Safety Authority (ESA), which performs a regulatory function related to electrical inspections.

On April 1, 1999, the respective business units, including assets, liabilities, employees, rights and obligations of the former Ontario Hydro, were transferred to OPG and Hydro One (and their subsidiaries) and the IMO for $8.5 billion, $8.6 billion and $78 million respectively in exchange for debt payable to OEFC. On the same day, the Province exchanged equity of $5,126 million and $3,759 million in OPG and Hydro One respectively for debt payable to OEFC.

OEFC debt, liabilities and associated financing costs will be repaid from interest on notes receivable from the Province and successor entities, and, as provided under the *Energy Competition Act, 1998,* from dedicated electricity revenues in the form of payments-in-lieu (PILs) of corporate income, capital and property taxes made by the successor entities and municipal electric utilities. Residual debt is serviced through a Debt Retirement Charge (DRC) paid by electricity consumers at a rate of 0.7 cents per kilowatt-hour for most Ontario consumers. Until open access on May 1, 2002, OEFC continued to be a party to a revenue-allocation agreement among successor entities and was entitled to the forecast residual amount in the revenue pool after allocations to OPG, Hydro One and the IMO were paid.

2) Summary of Significant Accounting Policies

Basis of Accounting

As OEFC is a government organization, these financial statements are prepared in accordance with the recommendations of the Public Sector Accounting Board (PSAB) of the Canadian Institute of Chartered Accountants.

Measurement Uncertainty

Uncertainty in the determination of the amount at which an item is recognized in the financial statements is known as measurement uncertainty. Such uncertainty exists when it is reasonably possible that there could be a material variance between the recognized amount and another reasonably possible amount, as there is whenever estimates are used. Measurement uncertainty in these financial statements exists in the estimated amount for the Electricity Consumer Price Protection Fund, the valuation of the power purchase contracts and the estimated defeasance date for OEFC's obligations. Estimates are based on the best information available at the time of preparation of the financial statements and will be updated annually to reflect new information as it becomes available.

Deferred Debt Costs

Deferred debt costs includes the unamortized amounts related to unrealized foreign exchange gains or losses resulting from the translation of long-term debt issued in foreign currencies and discounts, premiums or commissions arising from the issuance of debt or the acquisition of debt prior to maturity. These costs are amortized to operations over the life of the underlying debt.

Revenue Recognition

Revenues are recognized in the period in which they are earned.

Foreign Currency Translation

Debt is composed of short-, medium- and long-term bonds, notes and debentures. Debt denominated in foreign currencies that has been hedged is recorded at the Canadian dollar equivalent using the rates of exchange established by the terms of the hedge agreements. Other foreign currency debt, liabilities and assets are translated to Canadian dollars at year-end rates of exchange and any exchange gains or losses are deferred and amortized over the remaining term to maturity.

Power Purchase Contracts

The power purchase contracts liability is valued on a discounted cash-flow (DCF) basis. Periodic revaluations of this liability will give rise to changes in the estimated cost of the contracts and will be amortized to operations over a maximum ten-year period.

3) Going Concern

OEFC is dependent on the Province to borrow to finance maturing debt and to cover any cash shortfalls in the Corporation. It is also dependent on the government's long-term plan to defease the unfunded liability described in Note 11.

4) Cash and Cash Equivalents

Cash and cash equivalents includes cash on deposit and highly liquid investments with maturities of less than three months. They are recorded at cost, which approximates current market value.

5) Due from Province of Ontario

The Province has committed to dedicate the combined net income of OPG and Hydro One in excess of the Province's interest cost of its investment in its electricity subsidiaries to OEFC. For the year ended March 31, 2004, the aggregate earnings of the subsidiaries did not exceed the Province's financing cost. Consequently, no dedicated income transfer has been reflected (March 2003 - $197 million).

6) Notes and Loans Receivable

($ millions)

	Maturity date	Interest rate	Interest payable	March 31, 2004	March 31, 2003
Province of Ontario	2039 - 2041	5.85	Monthly	$ 8,885	$ 8,885
OPG	2005 - 2011	5.44 to 6.65	Semi-annually	3,200	3,200
Hydro One		5.4 to 13.50	Semi-annually	—	651
IMO	2009	7.90	Semi-annually	78	78
				12,163	12,814
Less: Current portion of notes receivable				250	651
				11,913	12,163
Add: Loans receivable from non-utility generators (NUGs) (See Note 9)				167	174
				$ 12,080	**$ 12,337**

OEFC has agreed with OPG, Hydro One and IMO not to sell notes owing from these successor entities without their prior approval.

On March 5, 2003, with the prior approval of Hydro One, OEFC completed the sale of $1,878 million (face value) of Hydro One notes. OEFC realized a gain of $206 million on the sale as interest rates payable on the notes were above market interest rates.

In 2002, OEFC had agreed with OPG to defer principal payments of $200 million originally due in March and September 2002 until December 2004. These maturities totaling $200 million have been further deferred until December 2006. In addition, OEFC has agreed with OPG to defer principal repayments totaling $500 million originally due in the period March 2003 to September 2004. The new maturity dates on these notes have been extended until March 2005 to September 2006.

7) Debt

Debt at March 31, 2004 is set out below by maturity and by currency of repayment, expressed in Canadian dollars.

($ millions) Currency	Canadian Dollar	U.S. Dollar	Swiss Franc	2004 Total	2003 Total
Maturing in:					
1 year	4,563	559	—	5,122	5,078
2 years	1,131	425	—	1,556	3,250
3 years	2,074	739	—	2,813	1,425
4 years	528	1,053	—	1,581	119
5 years	3,095	388	—	3,483	1,959
1-5 years	11,391	3,164	—	14,555	11,831
6-10 years	4,375	1,026	307	5,708	7,667
11-15 years	648	—	—	648	648
16-20 years	3,678	—	—	3,678	3,678
21-25 years	2,116	—	—	2,116	2,077
26-50 years	850	—	—	850	929
Total	**$23,058**	**$4,190**	**$307**	**$27,555**	**$26,830**

The effective rate of interest on the debt portfolio is 6.54 per cent (March 2003 - 6.78 per cent) after considering the effect of derivative instruments used to manage interest rate risk. The longest term to maturity is to October 17, 2031. Total foreign currency-denominated debt at March 31, 2004 was $4.5 billion (March 2003 - $3.8 billion), 100 % of which (March 2003 - $2.6 billion or 67.7 per cent) was fully hedged to Canadian funds. Bonds and notes payable are either held, or guaranteed as to principal and interest, by the Province as set out below:

	March 31, 2004			March 31, 2003		
($ millions)	Held by the Province	Guaranteed by the Province	**Total**	Held by the Province	Guaranteed by the Province	**Total**
Short term debt	1,177	—	1,177	3,413	—	3,413
Current portion of long term debt	3,697	248	3,945	350	1,315	1,665
Long term debt	11,520	10,913	22,433	9,791	11,961	21,752
	$16,394	$11,161	$27,555	$13,554	$13,276	$26,830

Fair value of debt issued approximates amounts at which debt instruments could be exchanged in a current transaction between willing parties. In valuing the OEFC's debt, fair value is estimated using discounted cash flows and other valuation techniques and is compared to public market quotations where available. These estimates are affected by the assumptions made concerning discount rates and the amount and timing of future cash flows.

The estimated fair value of OEFC debt at March 31, 2004 is $32.2 billion (March 2003 - $31.2 billion). This is higher than the book value of $27.6 billion (March 2003 - $26.8 billion) because current interest rates are generally lower than the interest rates at which the debt was issued and because of exchange rate movements. The fair value of debt does not reflect the effect of related derivative contracts.

8) Risk Management and Derivative Financial Instruments

OEFC employs various risk management strategies and operates within strict risk exposure limits to ensure exposure to risk is managed in a prudent and cost-effective manner. A variety of strategies are used, including the use of derivative financial instruments ("derivatives"). Derivatives are financial contracts, the value of which is derived from underlying instruments. OEFC uses derivatives for the purpose of hedging and to minimize interest costs. Hedges are created primarily through swaps, which are legal arrangements under which OEFC agrees with another party to exchange cash flows based upon one or more notional amounts during a specified period. This allows OEFC to offset its existing obligations and thereby effectively convert them into obligations with more desirable characteristics. Other derivative instruments used by OEFC include forward foreign exchange contracts, forward rate agreements, futures and options.

Foreign exchange or currency risk is the risk that foreign currency debt principal and interest payments and foreign currency transactions will vary in Canadian dollar terms due to fluctuations in foreign exchange rates. To manage currency risk, OEFC uses derivative contracts to convert foreign currency cash flows into Canadian dollar denominated cash flows. The current policy allows unhedged foreign currency debt principal payments and foreign currency transactions to reach a maximum of 5 per cent of total debt, reduced from 20 per cent at March 31, 2003. At March 31, 2004, the actual unhedged level was 0.1 per cent (March 2003 - 6.3 per cent) of total debt, with all the currency exposure to US dollars.

Floating rate risk is the exposure of OEFC to changes in short-term interest rates over a 12-month period. OEFC reduces its exposure to rate changes by entering into derivative contracts that convert floating interest payments to fixed interest payments. The current policy allows unhedged floating rate debt, net of liquid reserves, to reach a maximum of 20 per cent of total debt. At March 31, 2004, OEFC's floating rate debt as a percentage of total debt was 8.0 per cent (March 2003 - 13.5 per cent).

Liquidity risk is the risk that OEFC will not be able to meet its current short-term financial obligations. As explained in Note 3, OEFC is dependent on the Province to finance maturing debt and to cover any cash shortfalls in the Corporation.

The table below presents a maturity schedule of OEFC's derivatives, by type, outstanding at March 31, 2004, based on the notional amounts of the contracts. Notional amounts represent the volume of outstanding derivative contracts and are not indicative of credit risk, market risk or actual cash flows.

Derivative Portfolio Notional Value ($ millions)

As at March 31, 2004

Maturity in Fiscal Year	2005	2006	2007	2008	2009	6-10 Years	Over 10 Years	TOTAL 2004	TOTAL 2003
Cross-currency swaps	-	425	739	496	388	1,309	-	3,357	2,355
Interest rate swaps	292	1,488	1,826	1,272	588	1,446	1,436	8,348	7,043
Forward foreign exchange contracts	1,578	-	-	-	-	-	-	1,578	720
Other [1]	112	-	-	-	-	-	-	112	50
Total	$ 1,982	1,913	2,565	1,768	976	2,755	1,436	$ 13,395	$ 10,168

(1) Other includes options and futures.

The use of derivatives introduces credit risk, which is the risk of a counterparty defaulting on contractual derivative obligations in which OEFC has an unrealized gain. The table below presents the credit risk associated with the derivative financial instrument portfolio, measured through the replacement value of derivative contracts, at March 31, 2004.

Credit Risk Exposure ($ millions)	**March 31, 2004**	**March 31, 2003**
Gross credit risk exposure[(1)]	5,398	4,167
Less: Netting[(2)]	(5,787)	(4,293)
Net credit risk exposure[(3)]	$ (389)	$ (126)

Notes:

(1) Gross credit risk exposure includes credit exposure on swaps, forward foreign exchange agreements, options and futures.

(2) Master agreements provide for close out netting as contracts do not have coterminous settlement dates.

(3) Total exposure to counterparties with positive exposure (meaning that counterparties owed OEFC) was $130 million (March 2003 - $202 million) and the total exposure to counterparties with negative exposure (meaning that OEFC owed the counterparties) was $519 million (March 2003 - $328 million) for a total net credit exposure of $(389) million (March 2003 - ($126) million).

OEFC manages its credit risk exposure from derivatives by, among other things, dealing only with high credit quality counterparties and regularly monitoring compliance to credit limits. In addition, OEFC enters into contractual agreements (master agreements) that provide for termination netting and, if applicable, payment netting with virtually all of its counterparties. Gross credit risk exposure represents the loss OEFC would incur if every counterparty to which OEFC had credit risk exposure were to default at the same time and the contracted netting provisions were not exercised or could not be enforced. Net credit risk exposure is the loss including the mitigating impact of these netting provisions.

As at March 31, 2004, OEFC's most significant concentrations of credit risk were with an A+ rated counterparty, which represented more than 10 per cent of the Net Credit Risk Exposure. The net cost to OEFC, if it had to replace all of the swap contracts with this counterparty would be $60 million.

9) Power Purchase Contracts

Power purchase contracts and related loan agreements were entered into by Ontario Hydro with non-utility generators (NUGs) located in Ontario. As the legal continuation of Ontario Hydro, OEFC is the counterparty to these contracts. These contracts, expiring on various dates to 2048, provide for the purchase of power at prices that are expected to be in excess of the market price. Since open access on May 1, 2002, this power has been sold at market prices that generally have been less than cost. Prior to open access, power purchased from NUGs was resold at cost to the revenue pool managed by OPG.

During the year, OEFC purchased power in the amount of $797 million (2003 - $786 million) and sold this power for $510 million (2003 - $635 million). Effective April 18, 2002, the NUG Contract Management Agreement between Enron Canada Corporation and OEFC was assigned to UBS Warburg Energy (Canada) Ltd. Annual fees include both a fixed fee of approximately $750,000 plus a variable fee based on performance in minimizing losses under NUG power purchase agreements that amounted to $6.8 million (2002 - $10 million).

The NUG liability had been valued at $4,286 million on a discounted cash-flow (DCF) basis since Ontario Hydro was continued as OEFC on April 1, 1999. As the electricity market was opened in May 2002, the DCF model was updated as of March 31, 2003 which reduced the estimated liability from $4.286 billion to $3.745 billion. The revaluation change is being amortized to operations over a ten year period. In addition, each year, interest at the DCF rate is added to the liability and the estimated in-year loss in the DCF model is deducted from the liability as set out below:

Statement of NUG Liability ($ millions)

As at March 31, 2004

	2004	2003
NUG Liability, beginning of year	$ 3,745	$ 4,286
Interest charged during the year	221	253
Deduct estimated in-year loss	(283)	(372)
Revaluation as of March 31, 2003		(422)
Subtotal	3,683	3,745
Add: Unamortized Revaluation Changes		
Gross Revaluation	422	422
Accumulated Amortization	(84)	(42)
	338	380
	$ 4,021	**$ 4,125**

Loans to NUGs decreased during the period by a net $7 million to $167 million at March 31, 2004 (2003 - $174 million), primarily due to principal repayments.

10) Nuclear Funding Liability

OEFC as the continued Ontario Hydro assumed a liability in the amount of $2,378 million representing nuclear waste management and asset removal liabilities that were incurred prior to April 1, 1999. In March 2002, the Province and OPG entered into the Ontario Nuclear Funds Agreement (ONFA) to establish, fund and manage segregated funds to ensure that sufficient funds are available to pay for costs of nuclear waste management and station decommissioning.

The Board of Directors of OEFC approved the funding of the Decommissioning Segregated Fund, established by OPG, over the next four years, thus discharging the nuclear funding liability. OEFC contributed $1,200 million towards the fund liability on July 24, 2003.

Interest is accrued at a rate equal to the Ontario Consumer Price Index plus 3.25 per cent in accordance with the terms of ONFA which were finalized on July 24, 2003. Previously, interest had been accrued at an estimated rate of 5.75%. The liability has been adjusted to reflect the finalized rate. A commitment-in-lieu of $1,916 million as at March 31, 2004 (March 2003 - $2,974 million) has been provided to the Decommissioning Segregated Fund.

11) Unfunded Liability

The opening unfunded liability of $19.4 billion at April 1, 1999, was composed of $38.1 billion in liabilities assumed from old Ontario Hydro less the value of assets transferred to OEFC at April 1, 1999 including $17.2 billion in notes receivable and $1.5 billion in loans receivable and other assets. Pursuant to the Electricity Act, 1998, and consistent with the principles of electricity restructuring, the government has a long-term plan in place to retire OEFC liabilities from within the electricity sector. The plan includes revenues and cash flows from the following sources as at **April 1, 1999**:

- **Notes receivable** from the Province of $8.9 billion, OPG of $3.4 billion, Hydro One of $4.8 billion and IMO for $0.1 billion for a total of $17.2 billion as a result of the transfer of assets to successor companies;
- **Payments-in-lieu** of corporate income, capital and property taxes made by OPG, Hydro One and municipal electric utilities;
- **Debt Retirement Charge** to be paid by ratepayers based on the consumption of electricity; and
- **Electricity Sector Dedicated Income** - Consistent with the Government's commitment to keep electricity income in the electricity sector, the combined net income of OPG and Hydro One in excess of the Province's interest cost of its investment in its electricity subsidiaries will be allocated to the retirement of OEFC's debt.

The long-term plan supports estimates that OEFC's obligations will likely be defeased in the years ranging from 2012 to 2020. Key assumptions underlying the range include the passage of proposed legislation, which would reform the electricity industry (see Note 16). These reforms would include the requirement that consumers pay the full cost of existing and any new contracts for generation, which OEFC anticipates would eliminate the liability for above market costs for power purchases. In addition, OPG's nuclear and baseload hydroelectric generation would receive regulated prices designed to recover approved costs, including the costs of capital. Other key assumptions include the shutdown of OPG's coal-fired generating stations at the end of 2007.

12) Electricity Consumer Price Protection Fund

On November 11, 2002, the Province announced a program designed to provide electricity to low volume and designated consumers at a fixed price of 4.3 cents per kilowatt-hour (kWh) until at least 2006, retroactive to May 1, 2002. Power generators continue to receive the competitive market price as set in the IMO electricity market. The program is administered through the Electricity Consumer Price Protection Fund (ECPPF) managed by OEFC.

On December 18, 2003, the *Ontario Energy Board Amendment Act (Electricity Pricing), 2003,* was passed into law to remove, effective April 1, 2004, the 4.3 cents per kWh price freeze in favour of a pricing structure that better reflects the true cost of electricity, including a strong incentive to conserve energy. Effective April 1, 2004, an interim pricing plan was introduced whereby the first 750 kWh consumed in any month is priced at 4.7 cents per kWh and consumption above that level is priced at 5.5 cents per kWh. This pricing plan will stay in place until the Ontario Energy Board develops a mechanism for setting prices no later than May 1, 2005.

Expenditures from the Fund during the year amounting to $643 million (March 2003 - $1,461 million) have been reduced by a portion of the rebate from OPG due under the Market Power Mitigation Agreement (MPMA) in the amount of $390 million (March 2003 - $796 million) leaving a net cost in OEFC of $253 million (March 2003 - $665 million).

13) Temporary Generation Supply

In April of 2003, OEFC was directed to undertake a project to install 200 to 400 megawatts of temporary generation to provide support to Ontario's electricity reserves during the summer and fall of 2003.

OEFC arranged for the installation of 249 megawatts of gas-fired generation by the summer of 2003 at a cost of $70 million. All of the contracts expired on December 31, 2003.

14) Contingencies and Guarantees

OEFC is involved in various legal actions arising out of the ordinary course and conduct of business, some of which relate to the former Ontario Hydro prior to the establishment of OEFC on April 1, 1999. Under the terms of the April 1, 1999 restructuring of Ontario Hydro, each successor entity (OPG, Hydro One, ESA and IMO and their respective subsidiaries) is responsible for any liabilities relating to those operations of the former Ontario Hydro that were transferred to it. In the event any such liabilities remained with OEFC, the successor entity is also required to indemnify OEFC. With respect to legal actions relating to operations of Ontario Hydro that were retained by OEFC, the outcome and ultimate disposition of these legal actions is not determinable at this time. Accordingly, no provision for the above actions is reflected in the financial statements. Settlements of these contingencies, if any, will be reflected in the period in which settlement occurs.

Subject to a $10 million and $20 million deductible respectively, OEFC has agreed to indemnify Hydro One and OPG with respect to any adverse claim to title to any asset, right or thing transferred or intended to be transferred to the companies at April 1, 1999 and any failure of the transfer order to transfer such assets, rights or things and with respect to payment to or from or other dealing with any equity account of Ontario Hydro, including certain related litigation. The Province of Ontario has guaranteed any liability arising from these indemnifications.

OEFC is contingently liable under guarantees given to third parties that have provided long-term financing to certain independent power producers in connection with the power purchase contracts described in Note 9. These guarantees total approximately $102 million at March 31, 2004 (March 2003 - $113 million).

15) Ontario Electricity Pension Services Corporation

OEFC was the administrator of the Ontario Electricity Financial Corporation Pension Plan and Fund. It was responsible for negotiating an agreement with each of the successor corporations for the division and transfer of the assets and liabilities of the OEFC pension plan to the pension plans of the successor corporations. The Ontario Electricity Pension Services Corporation (OEPSC), a wholly owned subsidiary of OEFC, acted as agent for OEFC to carry out the required administrative, investment and other responsibilities of the OEFC Pension Plan and Fund.

OEPSC made application to the Superintendent of Financial Services for Ontario for approval to transfer all of the assets of the OEFC Pension Plan to the pension plans of the four successor operating entities. The Superintendent agreed to the transfer on June 6, 2001. With the exception of certain records and assets of nominal value, all pension fund assets were transferred to the pension plans of successor corporations on June 29, 2001. As OEPSC's functions have been completed, OEFC is in process of winding up the company.

16) Subsequent Event

On April 15th, 2004, the government released its proposals to reform the electricity sector. Legislation proposed to be introduced in June would, if passed by the Legislature, result in a combination of a fully regulated and competitive electricity sector with different generators receiving prices set through a variety of mechanisms. Electricity generated from OPG's nuclear and baseload hydro generation assets would receive regulated prices and electricity from those generators with existing or new contracts would receive prices as determined by their contracts. Consumers would pay a blend of these costs including the pass-through of regulated rates for OPG-regulated plants, the full costs for existing and new contracts for generation and market prices for other generation facilities.

If the legislation is passed by the Legislature, and when the reformed market becomes operational, OEFC would begin to receive actual contract prices for the power and would no longer incur above-market costs on the power purchase contracts with non-utility generators. Since the power purchase contracts liability on the balance sheet represents the net present value of the estimated above-market costs incurred under these contracts, OEFC anticipates that the estimated $3.9 billion liability at the time of implementation would be eliminated. OEFC will ensure that all implications of electricity sector reform are accounted for appropriately in the books of OEFC for the period in which those changes become effective.

Governance

Board of Directors

Colin Andersen	Chair and Deputy Minister of Finance [Appointed from March 2004 to March 2007]
Gadi Mayman	Vice-Chair and Chief Executive Officer, (interim) [Appointed from November 2003 to November 2004]
Brian FitzGerald	Fellow of the Canadian Institute of Actuaries [Appointed from April 2001 to July 2004]
Bryne Purchase	Deputy Minister, Ministry of Energy [Appointed from April 2001 to March 2004]
Tom Sweeting	Assistant Deputy Minister, Office of the Budget and Taxation, Ministry of Finance [Appointed from April 2001 to July 2004]
Bruce Macnaughton	Director, Pension and Income Security Policy Branch, Ministry of Finance [Appointed from April 2001 to July 2004]
Robert Siddall	Chair, OEFC Audit Committee, Provincial Controller, Ministry of Finance [Appointed from November 2002 to November 2005]
Karen Sadlier-Brown	Assistant Deputy Minister, Corporate and Electricity Finance Division, Ontario Financing Authority [Appointed from July 2003 to July 2006]
Bob Christie	Chair and Deputy Minister of Finance [Appointed from September 2000 to February 2004]
Michael Gourley	Vice-Chair and Chief Executive Officer [Appointed from July 2002 to November 2003]

Corporate Governance

Appointed by the Lieutenant Governor in Council, the Board of Directors is responsible for supervising OEFC's business. The Board of Directors reports to the Minister of Finance through the Chair of OEFC, who is also the Deputy Minister of Finance. OEFC retains services from the Ontario Financing Authority (OFA) and the Ministry of Finance to carry out its daily operations. The Chief Executive Officer of OEFC is responsible for day-to-day operations, and is accountable to the OEFC Board of Directors.

The Board of Directors meets at least quarterly. It monitors OEFC's financial performance and approves OEFC's financial policies and its annual corporate plan, which contains short and long-term objectives and reports on accomplishments for the preceding year.

The Minister of Finance reviews and approves OEFC's annual business plan. In keeping with the government's Agency Establishment and Accountability Directive, the Minister of Finance recommends the OEFC business plan to Management Board of Cabinet for approval once every three years.

The OEFC Audit Committee supports the Board of Directors with the review and recommendation for approval of OEFC's financial statements. The Audit Committee also recommends the annual internal audit plan and reviews the findings of the internal auditors regarding the adequacy of internal controls.

Corporate Policies

Overview and Structure

Board of Directors

- Reviews and approves key risk management policies and the annual financing and debt management plans for OEFC.
- Supervises the management of the OEFC's debt portfolio and NUG power sales.

Audit Committee

- Oversees the financial reporting process on behalf of the Board of Directors.
- Reviews key risk management policies, internal audit reports and the financial statements.

Management Committees

Risk Management Committee

- Reviews market updates and outlook.
- Reviews current borrowing, investing and debt management positions and strategies.

Borrowing Strategy Committee

- Reviews economic conditions, fiscal plan and capital markets outlook.
- Reviews borrowing and debt management activities and management reports, cash flows and the annual financing charge forecast.
- Reviews operational limits and procedures related to financial operations.
- Approves amendments and exceptions to approved risk management policies and procedures.
- Approves risk management policies for recommendation to the Board of Directors.

Annual Financing and Debt Management Plan

The annual financing and debt management plan indicates how the OFA will satisfy OEFC's financing requirements, manage OEFC's debt and exposures from NUG contracts while ensuring that risk exposures and losses remain within the approved exposure and loss limits. The plan is approved by the Board of Directors each year and the Board regularly receives progress reports on its implementation.

Overview of Risk Management Policies and Procedures

OEFC risk management policies and procedures provide for the management of risk exposures created by capital market activities. Current policies and procedures address market, credit and operational risk exposure, primarily as they pertain to OEFC's debt and derivatives portfolios and capital markets transactions.

These policies were developed following the guidelines and directives of regulatory bodies, such as the Office of the Superintendent of Financial Institutions of Canada, the Bank for International Settlements (BIS) and consultations with Canadian bank representatives on their risk management practices.

OEFC's Board of Directors approves risk management policies based on recommendations from the OFA's Borrowing Strategy Committee. The Risk Control Division monitors and reports on compliance with the policies.

Risk Management Policies and Procedures

Market Risk Policy

- Market Risk is the risk of financial loss attributable to changes in interest rates, foreign exchange rates and market liquidity. This policy provides a framework for borrowing and integrates several aspects dealing with the management of market risk.
- Foreign Exchange Exposure - OEFC's exposure to unhedged foreign currencies is limited to five per cent of outstanding debt. Foreign exchange exposures are limited to Group of Seven currencies and the Swiss franc or the equivalent currencies (e.g. the Euro).
- Floating Rate Exposure - OEFC is limited to a maximum floating rate exposure of 20 per cent of debt.
- Risk Management Loss Limits - The total amount of financial losses resulting from market risk and the default of counterparties shall not exceed a debt cost loss limit specified by the Board of Directors. Additionally, the CEO establishes a debt management trigger level to ensure that losses will not reach the debt cost loss limit. The trigger level is included in the annual financing and debt management plan.
- Risk Measurement - OEFC identifies and quantifies exposures to market risk in its annual financing and debt management plan to ensure that risk exposures and losses remain within the approved exposure and loss limits. Exposure to market, credit and liquidity risk is measured daily.
- Debt Maturity Profile - When issuing new debt on behalf of OEFC, the OFA will aim for a smooth debt maturity profile to diversify the interest rate risk for the refinancing of maturing and floating rate debt.

Credit Risk Policy

Credit risk is the risk that a counterparty defaults on its obligations. Credit risk arises when the OFA undertakes financial and derivative transactions on behalf of OEFC. The minimum credit rating of a counterparty for a financial agreement or transaction is A- and R1-mid for money market investments. The resulting exposure is capped at mark-to-market limits depending on the counterparty's credit rating and capital base.

Operational Risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people, systems or external events. OEFC manages operational risk through procedures that deal with model risk, legal risk, settlement risk and information systems risks. In addition, OEFC manages operational risk by ensuring that adequate staff levels exist and enhancing staff skills through appropriate training.

OEFC improves the control of operational risks by reducing the likelihood of errors and breakdowns in controls, ensuring that risk monitoring systems are in place prior to the adoption of new products or lines of business. This is achieved through ongoing periodic reviews of policies and procedures, documentation requirements, data processing systems, pricing algorithms, contingency plans and other operating practices.

- Model Risk - OEFC regularly reviews its pricing models for accuracy and compliance with industry standards. It also regularly reviews the valuation of financial instruments.
- Legal Risk - OEFC has established procedures and standards to ensure that documentation of debt issues, debt management and money market transactions meet industry standards and are enforceable.

- Settlement Risk - OEFC has established internal control procedures and systems, which involve external service providers and training its staff to ensure that transactions are settled correctly and in a timely manner, are recorded accurately, and that service providers are appropriately involved.
- Information Systems Risk - On behalf of OEFC, the OFA has introduced measures to protect computer systems and the offices of the OFA. These measures include access controls to the building, monitoring of the computer room environment, the establishment of an improved back-up power source, regular data back-ups, off-site storage, firewalls and intrusion detection systems to protect against unauthorized network intrusions and computer virus scanning. Security is reviewed periodically and when major changes occur. The Business Continuity Plan is regularly updated to allow the continuation of essential operational functions with a minimum of disruption in the event of an emergency.

Policy on the Use of Derivatives

Derivatives are used solely to provide OEFC's financing and liquidity requirements in a sound and cost-effective manner. Derivatives are used to manage exposures arising from existing and planned debt and in a manner consistent with the annual financing and debt management plan. Risks arising from the use of derivatives are identified, monitored, evaluated and managed prudently.

Policy on Risk Management Reporting

At its regular quarterly meetings, the OEFC Board of Directors is informed of OEFC's activities and exposures through three types of reports:

- CEO's report;
- Exposure and performance report; and
- Exception report provided by the Director of Risk Control, OFA.

The CEO provides the Board of Directors with a progress report on the implementation of the annual financing and debt management plan, staffing and other administrative and operational matters. The CEO also reports on OEFC's compliance with applicable government directives, and OFA Legal Counsel reports on compliance with applicable laws. In addition, OFA management is kept informed of OEFC's risk exposures and positions on a daily basis.

Additional Sources of Information

Internet

Ontario Electricity Financial Corporation www.oefc.on.ca

Provides information on OEFC's debt, the Board of Directors and contains other related publications.

Ontario Financing Authority (OFA) www.ofina.on.ca

Provides a description of the OFA's activities, Ontario debt issues and retail products and contains publications from the OFA and the Ontario Ministry of Finance.

Other Links

Ministry of Finance	www.fin.gov.on.ca
Ministry of Energy	www.energy.gov.on.ca
Ontario Power Generation Inc.	www.opg.com
Hydro One Inc.	www.hydroone.com
Ontario Electrical Safety Authority	www.esainspection.net
Independent Electricity Market Operator	www.iemo.com

Inquiries

For general information and additional copies of this annual report, please contact:

Investor Relations, Capital Markets Division

Telephone: (416) 325-8000

E-mail: investor@oefc.on.ca

Ontario Electricity Financial Corporation
1 Dundas Street West, Suite 1400
Toronto, Ontario
M7A 1Y7
Canada
Telephone: 416-325-8000
investor@oefc.on.ca
www.oefc.on.ca

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