Ontario Electricity Financial Corporation

2001

annual report

Ontario

Ontario Electricity Financial Corporation

Table of Contents

Message from the Chair and Chief Executive Officer

We are pleased to present the second Annual Report of the Ontario Electricity Financial Corporation (OEFC). The report describes the OEFC's objectives and responsibilities, operational highlights and financial results for the year ended March 31, 2001.

As outlined in the *Electricity Act, 1998,* the OEFC's mandate is to ensure that the outstanding debt and derivatives and certain assets and liabilities of the former Ontario Hydro are managed efficiently and prudently and are ultimately retired. The OEFC is also responsible for the administration of the OEFC Pension Plan until its assets and liabilities can be transferred to pension plans of the other successor entities. The Ontario Financing Authority (OFA), Ontario Electricity Pension Services Corporation (OEPSC) and Ministry of Finance provide the OEFC with the staff and expertise needed for its operations and to fulfill its mandate.

For the year ended March 31, 2001, revenues totalled $3,936 million, while expenses totalled $3,692 million. To meet its 2000-01 financing requirements, the Province raised $2,924 million in long-term debt. Total debt outstanding as of March 31, 2001 was $30.6 billion, down $0.8 billion from the previous fiscal year.

During the year, the OEFC retained a contract manager to manage the non-utility generator (NUGs) contracts. Significant progress was also made in renegotiating the 90 power purchase agreements (PPAs) with the NUGs, with the objective of facilitating their integration into the open market.

In April 2001, the government announced that it is committed to opening the electricity market to competition by May 2002, possibly earlier if the necessary conditions for competition are in place.

We are pleased with the operation of the OEFC and look forward to the challenges of the upcoming year.

Bob Christie
Chair

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

Management's Discussion and Analysis

Electricity Industry Financial Structure

The *Energy Competition Act, 1998*, set out the Government of Ontario's plan to restructure Ontario's electricity industry. The plan called for the restructuring of Ontario Hydro and the elimination of its long-standing monopoly on electricity production with the introduction of competition to Ontario's electricity sector.

A key component of this initiative was to introduce a new financial structure for the electricity sector. This structure was announced on April 1, 1999. At this time, Ontario Hydro ceased operations and its assets and liabilities were transferred to five successor corporations and their subsidiaries.

Two commercial companies, Hydro One Inc. (HOI) and Ontario Power Generation Inc. (OPG), together with their subsidiaries, received the majority of Ontario Hydro's assets and in return issued $17.1 billion of debt to the Ontario Electricity Financial Corporation (OEFC), the legal continuation of Ontario Hydro.

To ensure fairness, reliability and safety in the new electricity market, the Independent Electricity Market Operator (IMO) and the Electrical Safety Authority (ESA) were also established. The IMO issued $0.1 billion of debt to the OEFC in return for Ontario Hydro's central market operator and regulatory assets.

To achieve commercially viable capital structures, HOI and OPG entered into debt-for-equity swaps with the Province of Ontario. In exchange for $3.8 billion of equity in HOI and $5.1 billion of equity in OPG, the Province assumed $8.9 billion of the debt issued to the OEFC by the successor corporations. The Province is the sole shareholder of HOI and OPG.

Role of the Ontario Electricity Financial Corporation (OEFC)

As the legal continuation of Ontario Hydro, the OEFC became responsible for ensuring the prudent and efficient management and retirement of $38.1 billion (as of April 1, 1999) in debt and other liabilities of the former Ontario Hydro. The OEFC, an agency of the Province, is a statutory, non-share capital corporation.

The OEFC's Board of Directors is responsible for supervising the OEFC's operations. As the OEFC does not have staff, it retains the Ontario Financing Authority (OFA) and the Ministry of Finance and established the Ontario Electricity Pension Services Corporation (OEPSC) to carry out its daily operations.

The OFA is an agency of the Province of Ontario responsible for provincial borrowing and debt management activities. The OFA manages the OEFC's debt and derivative portfolios, and provides cash management, accounting and other financial services and support to the corporation.

The OEFC relies on a stream of dedicated revenues from the electricity sector to service its outstanding debt obligations. The Ministry of Finance is responsible for the administration and collection of the payments-in-lieu of taxes and the Debt Retirement Charge (DRC), which becomes effective upon market opening, on behalf of the OEFC.

The OEFC is also the administrator of the former Ontario Hydro Pension and Insurance Plan (since renamed the Ontario Electricity Financial Corporation Pension Plan). The OEFC will remain as the administrator until the assets and liabilities of the pension plan are transferred to the pension plans of the four successor corporations. The OEPSC acts as the agent of the OEFC in the administration of the pension plan and management of the pension fund during the transition period.

The *Electricity Act, 1998* requires the OEFC to enter into an agreement with the four successor corporations providing for the division and transfer of the assets and liabilities of the OEFC Pension Plan to the pension plans of the successor corporations. The five companies signed an agreement in principle on January 19, 2001. The final agreement was submitted to the Superintendent of Financial Services, on March 29, 2001, and was subsequently approved on June 6, 2001.

Stranded Debt and Residual Stranded Debt

At April 1st 1999, the OEFC assumed approximately $38.1 billion in total liabilities from the former Ontario Hydro. The OEFC received a total of $17.2 billion represented by notes owing to it from the Province, OPG, HOI, and the IMO. The difference of approximately $20.9 billion represents "stranded debt", which is defined under the *Act* as the amount of debt and other liabilities of the OEFC that cannot reasonably be serviced and retired in a competitive electricity market.

The *Electricity Act, 1998* requires that dedicated electricity revenues must be paid by the successor entities and municipal electric utilities (MEUs) to the OEFC to service stranded debt. As of April 1, 1999, the present value of these revenue streams was estimated at $13.1 billion, resulting in an estimated $7.8 billion of residual stranded debt. The *Electricity Act, 1998* also provides for a Debt Retirement Charge (DRC) to be paid to the OEFC to retire residual stranded debt.

The April 1, 1999 Unfunded Liability (the stranded debt from electricity sector restructuring to be recovered from ratepayers) of $19.4 billion of the OEFC is comprised of the liabilities of $38.1 billion (described above) less notes receivable above of $17.2 billion, less other loans receivable of $200 million, less other assets of $1.3 billion.

Debt Repayment Plan

Pursuant to the *Electricity Act, 1998* and consistent with the principles of electricity sector restructuring, the government has established a long-term plan to retire debt from within the electricity sector. The $38.1 billion in obligations is being repaid from the following sources:

- *Notes receivable* from the Province, OPG, HOI and IMO;
- *Payments-in-lieu* (PILs) of corporate income, capital, and property taxes, made by OPG, HOI and municipal electric utilities (MEUs);
- *A Debt Retirement Charge (DRC),* to be paid by electricity consumers when the market opens to competition; and
- *Electricity Sector Dedicated Income.* Consistent with the government's commitment to keep electricity income in the electricity sector, the combined net incomes of OPG and HOI in excess of the Province's cost of its investment in its electricity subsidiaries is dedicated to the retirement of the OEFC's debt.

The government has committed to opening the electricity market by May 2002, but will work towards the earliest possible date for opening, if all of the necessary conditions are met. These conditions include: consumer protection and choice; a strong business climate with a reliable supply of safe, affordable electricity; environmental protection; and encouraging new ways of doing business and supporting the search for alternative sources of power.

2000-01 In Review

Highlights for the OEFC's second year of operation include:

- Completing long-term public borrowing of almost $3.0 billion;
- Cost-effective management of the debt and derivatives portfolios;
- Retention of an external manager to oversee the day-to-day administration and the sale of power acquired under the power purchase agreements with non-utility generators (NUGs);
- Ensuring the effective administration of the OEFC Pension Plan and Fund and finalizing an agreement on the division and transfer of the assets and liabilities of the OEFC Pension Plan to the pension plans of the four successor corporations to Ontario Hydro.

Financing and Debt

Revenue in 2000-01 totalled $3,936 million, including $1,070 million of interest payments from HOI, OPG, IMO and the Province, $988 million from payments-in-lieu of tax, $408 million in electricity sector dedicated income, $695 million from power sales and $748 million from the revenue pool residual.

Expenses totalled $3,692 million, including $2,671 million in interest on the debt and nuclear funding liability, $146 million of amortization of deferred charges, $695 million for power purchases, $157 million for a debt guarantee fee and $23 million for operating costs.

As the OEFC does not have its own credit rating, the Province, through the OFA, borrows on the OEFC's behalf. In turn, the OEFC issues debt to the Province. To meet its 2000-01 financing requirements, the Province raised $2,924 million in long-term debt, while paying down short-term debt by $876 million and pre-borrowing $400 million for fiscal 2001-02. In 2000-01, the Province raised the majority of the OEFC's long-term financing in the Canadian dollar market.

As of March 31, 2001, total debt outstanding was $30.6 billion, decreasing by $0.8 billion from the previous fiscal year. This decrease is primarily due to principal repayments of notes receivable by HOI and OPG totalling $1,533 million.

With maturing debt and planned redemptions of $4.4 billion, along with a projected cash surplus of $0.8 billion in 2001-02, total financing requirements as of March 31, 2001 are projected at $3.6 billion. Total debt outstanding is projected to decrease to $29.4 billion at March 31, 2002.

The increase in Ontario Power Generation's (OPG) wholesale electricity rates, effective June 1, 2001, will improve OEFC's results in 2001-02 by increasing the OEFC's revenues from the revenue pool residual.

Management of Power Purchase Contracts

In the late 1980s and early 1990s, the former Ontario Hydro entered into approximately 90 long-term power purchase agreements (PPAs) with non-utility generators (NUGs) located in Ontario. These PPAs, which expire on various dates until the year 2048, provide for the purchase of power at prices that are expected to exceed the market price. As the continuation of Ontario Hydro, the OEFC is now the purchaser under these contracts.

The OEFC purchases about 1700 megawatts (MW) under the PPAs, representing approximately six per cent of the generating capacity available to meet Ontario's energy requirements.

Currently, the power purchased by the OEFC from the NUGs is resold at cost to the revenue pool managed by OPG. After open access, the power will be sold in the market. The net present value of the liability of the above-market costs resulting from the difference between the purchase price and the selling price over the life of the contracts was estimated at $4.3 billion at April 1, 1999.

In 2000-01, the OEFC issued a Request for Proposals (RFP) to retain a contract manager to manage the NUG contracts. Enron Canada Corporation was selected as the successful respondent to the RFP.

The OEFC is currently in the process of negotiating revisions to the PPAs to facilitate the transition to an open market and to replace certain contract provisions that have become obsolete as a result of the electricity restructuring.

OEFC Pension Plan

The OEFC is the administrator of the OEFC Pension Plan (formerly the Ontario Hydro Pension and Insurance Plan), including the pension fund.

The Ontario Electricity Pension Services Corporation (OEPSC) was established as a subsidiary of the OEFC to act as the OEFC's agent in the administration and day-to-day operations of the OEFC Pension Plan until the assets and liabilities can be transferred to the pension plans of the other Ontario Hydro successor corporations.

The *Electricity Act, 1998* provides for the transfer of assets and liabilities from the OEFC Pension Plan to the successor companies' pension plans in accordance with a transfer agreement to be entered into by the OEFC with the administrators of each successor company pension plan. The OEPSC is responsible for preparing the transfer agreement in accordance with the guidelines set out in the *Electricity Act, 1998* and under the supervision of the OEFC's pension committee and in consultation with the successor corporations. On June 6, 2001, the Superintendent of Financial Services consented in writing to the transfer of assets from the OEFC Pension Plan to the pension plans of the four successor corporations.

Risk Management

The OEFC has a number of policies in place to address the financial risks to which it is exposed through its borrowing and debt management activities.

Market Risk

The market risk policy provides a framework for the management of foreign exchange and interest rate risks to which the OEFC is exposed through the financing and debt management programs.

Foreign Exchange Exposure: The target for unhedged foreign currency exposure by the end of fiscal 2001-02 is five per cent of outstanding debt. When the OFA became responsible for the management of the OEFC's debt portfolio, total debt exposed to fluctuations in foreign currencies was 14.5 per cent. The OFA reduced the OEFC's exposure to 7.1 per cent as of March 31, 2001. The OFA will continue to reduce the level of exposure towards the five per cent target in a prudent manner.

Floating Interest Rate Exposure: The limit on the OEFC's floating interest rate exposure (net of liquid reserves) is 20 per cent of debt outstanding. Actual floating interest rate exposure was 5.7 per cent as of March 31, 2001.

Debt Maturity Profile: When issuing new debt, the OFA, on behalf of the OEFC, will aim for a smooth debt maturity profile to diversify the interest rate risk for the refinancing of maturing and floating rate debt. The maturity profile can be found in Note 8 to the Financial Statements.

Credit Risk

Credit risk is the risk that a counterparty does not meet, or defaults, on its obligations. Credit risk arises when the OEFC undertakes financial and derivatives transactions. The minimum credit rating of a counterparty is A- and R1-mid for money market investments. However, for a new swap transaction the OEFC typically deals with AA- or better credit. The resulting exposure is capped at mark-to-market limits, depending on the counterparty's credit rating.

Risk Management Reporting

At its regular quarterly meetings, the OEFC Board of Directors is kept informed of the OEFC's activities, positions and risk 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 financing and debt management plan, staffing and other administrative and operational matters. The CEO also reports on the OEFC's compliance with applicable government directives, and OFA Legal Counsel reports on compliance with applicable laws.

The Director of Risk Control, OFA, reports additional details on the OEFC's exposures and performance.

Exception reports are provided to the Board of Directors immediately when required.

OFA Management is kept informed of the OEFC's risk exposures and positions on a daily basis. The OEFC's Annual Financing and Debt Management Plan, which shows how the OFA will ensure that risk exposures and losses remain within the approved exposure and loss limits, is approved by the Board of Directors.

Use of Financial Instruments and Derivatives

New instruments can be used only after approval by the OEFC Board of Directors and if their use is authorized under the OEFC's by-laws, which are approved by the Minister of Finance. All instruments are used only to advance the OEFC's objective of managing the OEFC's debt and its financing and liquidity requirements in a prudent and cost-effective manner.

Derivatives and financial instruments can be used only if the OFA can price and value them and quantify their risks. Furthermore, risks that arise with the use of derivatives are identified, evaluated, reported, monitored and managed prudently.

Corporate Governance and Board of Directors

Appointed by the Lieutenant Governor in Council, the Board of Directors is responsible for supervising the OEFC's operations, which are carried out by the Ontario Financing Authority, Ministry of Finance and Ontario Electricity Pension Services Corporation on a day-to-day basis. The Board of Directors meets at least quarterly.

The OEFC Audit Committee supports the Board of Directors with the review and recommendation for approval of the 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.

The OEFC Pension Committee is a committee of the Board of Directors that makes decisions concerning the OEFC Pension Plan and oversees the activities of the OEPSC.

Board of Directors

- **Bob Christie** — Chair and Deputy Minister of Finance.
- **Gadi Mayman** — CEO and Vice-Chair, CEO and Vice-Chair of the Ontario Financing Authority (Interim).
- **Bryne Purchase** — Deputy Minister, Energy, Science and Technology.
- **Brian FitzGerald** — Fellow of the Canadian Institute of Actuaries, Chair, OEFC Pension Committee.
- **Bruce Macnaughton** — Director, Pension and Income Security Policy Branch, Ministry of Finance.
- **Tom Sweeting** — Assistant Deputy Minister, Office of the Budget and Taxation, Ministry of Finance, Chair, OEFC Audit Committee.

OEFC Financial Statements

Responsibility for Financial Reporting

The accompanying financial statements of the Ontario Electricity Financial Corporation have been prepared in accordance with accounting principles generally accepted in Canada 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 1, 2001.

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. An internal audit function 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 generally accepted accounting principles. 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
Vice-Chair and
Chief Executive Officer (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 consolidated balance sheet of the Ontario Electricity Financial Corporation as at March 31, 2001 and the consolidated statements of revenue, expense and unfunded liability and of cash flows 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, 2001 and the results of its operations and its cash flows for the year then ended, in accordance with Canadian generally accepted accounting principles.

Erik Peters

Toronto, Ontario
June 1, 2001

Erik Peters, FCA
Provincial Auditor

Ontario Electricity Financial Corporation

Consolidated Balance Sheet as at March 31, 2001

(with comparative figures at March 31, 2000)

($ Millions)

	March 31 2001	March 31 2000
ASSETS		
Current Assets		
Cash and cash equivalents (Note 5)	$ 399	$ 2
Accounts receivable	293	134
Interest receivable	112	119
Current portion of notes receivable (Note 7)	640	1,533
	1,444	1,788
Payments-in-lieu of tax receivable (Note 11)	284	—
Electricity sector dedicated income due from Province (Note 6)	791	383
Notes and loans receivable (Note 7)	15,279	15,894
Deferred debt costs	983	914
	$ 18,781	$ 18,979
LIABILITIES		
Current Liabilities		
Accounts payable	$ 326	$ 101
Interest payable	734	726
Short-term notes payable (Note 8)	2,570	3,446
Current portion of long-term debt (Note 8)	2,774	2,226
	6,404	6,499
Long-term debt (Note 8)	25,222	25,666
Power purchase contracts (Note 9)	4,286	4,286
Nuclear funding liability (Note 9)	2,659	2,515
	38,571	38,966
Guarantees (Note 13)		
UNFUNDED LIABILITY (Note 4, 11)	(19,790)	(19,987)
	$ 18,781	$ 18,979

Approved on behalf of the Board of Directors:

Bob Christie
Chair

Gadi Mayman
Vice-Chair

See accompanying notes to financial statements.

Ontario Electricity Financial Corporation
Consolidated Statement of Revenue, Expense and Unfunded Liability
for the Year Ended March 31, 2001
(with comparative figures for 2000)
($ Millions)

	March 31 2001	March 31 2000
REVENUE		
Revenue pool residual (Note 10)	$ 748	$ 172
Payments-in-lieu of tax	988	889
Interest	1,070	1,118
Power sales (Note 9)	695	741
Electricity sector dedicated income (Note 6)	408	383
Other	27	27
Total Revenue	3,936	3,330
EXPENSE		
Interest - short-term debt	166	158
- long-term debt	2,361	2,490
Interest on nuclear funding liability	144	137
Amortization of deferred charges	146	180
Power purchases (Note 9)	695	741
Debt guarantee fee	157	156
Operating	23	22
Total Expense	3,692	3,884
Excess (deficiency) of revenue over expense	244	(554)
Unfunded Liability (Note 11)	20,034	19,433
Unfunded Liability, end of year	$ 19,790	$ 19,987

See accompanying notes to financial statements.

Ontario Electricity Financial Corporation

Consolidated Statement of Cash Flows

for the Year Ended March 31, 2001

(with comparative figures for 2000)

($ Millions)

	March 31 2001	March 31 2000
CASH FLOWS USED IN OPERATING ACTIVITIES		
Excess (deficiency) of revenue over expense	$ 244	$ (554)
Adjustments for:		
Amortization of deferred debt costs	146	180
Interest on nuclear funding liability	144	137
Electricity sector dedicated income due from Province	(408)	(383)
Payments-in-lieu of tax receivable	(284)	—
Net change in other balance sheet accounts	(18)	(249)
Net cash used in operations	(176)	(869)
CASH FLOWS FROM FINANCING ACTIVITIES		
Long-term debt issues	2,924	1,827
Less long-term debt retired	3,008	1,670
Long-term debt issued (retired), net	(84)	157
Short-term debt issued (retired), net	(876)	695
Payment from notes receivable	1,533	—
Net cash provided by financing activities	573	852
Increase (decrease) in cash and cash equivalents	397	(17)
Cash and cash equivalents, beginning of year	2	19
Cash and cash equivalents, end of year	$ 399	$ 2
Interest paid during the year and included in excess (deficiency) of revenue over expense	$ 2,575	$ 2,685

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). OEFC is a corporation established under the laws of Ontario. 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. (HOI), a regulated electricity transmission and distribution business that operates certain energy service businesses in an unregulated, competitive environment;
- 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 HOI (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 HOI 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. Any residual debt will be serviced through a Debt Retirement Charge (DRC) to be paid by electricity consumers after open access. Until open access, OEFC will continue to be a party to a revenue-allocation agreement among successor entities and is entitled to the forecast residual amount in the revenue pool after allocations to OPG, HOI and the IMO are paid.

2. Summary of Significant Accounting Policies

Basis of Accounting

These financial statements are prepared in accordance with Canadian generally accepted accounting principles (GAAP) as recommended in the Handbook 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 liability for power purchase agreements (see Note 9 for additional details). In addition, the amount of the nuclear funding liability is dependent on an agreement currently under negotiation between the Province and OPG. Estimates are based on the best information available at the time of preparation of the financial statements and will be adjusted annually to reflect new information as it becomes available.

Consolidation

These financial statements include the accounts of OEFC's wholly owned subsidiary, Ontario Electricity Pension Services Corporation (see Note 3).

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 or premiums arising from the issuance of debt or the acquisition of debt prior to maturity.

Revenue Recognition

Revenues are recognized in the period in which they are earned. Amounts received prior to being earned are reflected as deferred revenues.

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 period-end rates of exchange and any exchange gains or losses are deferred and amortized over the remaining term to maturity.

3. Ontario Electricity Pension Services Corporation

OEFC is the administrator of the Ontario Electricity Financial Corporation Pension Plan and Fund. It is 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, acts as agent for OEFC to carry out the required administrative, investment and other responsibilities of the OEFC Pension Plan and Fund. Costs associated with the administration of the OEFC Pension Plan and Fund amounting to approximately $17 million in calendar 2000 (calendar 1999 - $17 million) are charged to and payable by the pension fund.

OEPSC has 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.

4. Economic Dependence

OEFC does not have its own credit rating and is, therefore, dependent on the Province to borrow and on-lend the funds required to refinance maturing debt and to cover any cash shortfalls in the Corporation. It is also dependent on the long-term plan to defease the unfunded liability described in Note 11. Based on the Province's support in refinancing maturing debt and the long-term plan, OEFC is considered a going concern.

5. 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.

6. Electricity Sector Dedicated Income

The Province has committed to dedicate the combined net income of OPG and HOI in excess of the Province's cost of its investment in its electricity subsidiaries to OEFC. In the year ended March 31, 2001, OPG and HOI earned an aggregate amount of $928 million ($903 million for 2000) i.e., $408 million ($383 million for 2000) in excess of the Province's $520 million interest cost of the equity investments in those companies. The $408 million amount has been reflected as income in OEFC and as an increase in the receivable from the Province.

7. Notes and Loans Receivable

($ millions)

	Interest rate	Interest payable	March 31, 2001	Maturity date	March 31, 2000
Province of Ontario	5.85	Monthly	$ 8,885	2039 - 2041	$ 8,885
OPG	5.3 to 6.65	Semi-annually	3,300	2002 - 2011	3,400
HOI	5.4 to 14.3	Semi-annually	3,412	2001 - 2007	4,845
IMO	7.90	Semi-annually	78	2009	78
			15,675		17,208
Less: current portion of notes receivable			640		1,533
			15,035		15,675
Loans receivable from non-utility generators (NUGs) (See Note 9)			244		219
			$ 15,279		$ 15,894

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

8. Debt

Debt at March 31, 2001 is set out below by maturity and by original currency of issue.

($ millions) Currency	Canadian Dollar	U.S. Dollar	Japanese Yen	2001 Total	2000 Total
Maturing before:					
March 31, 2001	—	—	—	—	5,672
March 31, 2002	4,203	1,141	—	5,344	2,708
March 31, 2003	2,548	—	—	2,548	2,848
March 31, 2004	1,748	—	65	1,813	1,813
March 31, 2005	2,700	—	—	2,700	2,000
March 31, 2006	1,000	—	—	1,000	—
1-5 years	12,199	1,141	65	13,405	15,041
6-10 years	7,124	1,530	—	8,654	6,787
11-15 years	648	1,183	—	1,831	2,876
16-20 years	1,078	—	—	1,078	500
21-25 years	3,558	—	—	3,558	3,133
26-50 years	2,040	—	—	2,040	3,001
Total	**$ 26,647**	**$ 3,854**	**$ 65**	**$ 30,566**	**$ 31,338**

The effective rate of interest on the debt portfolio is 7.85% before considering the effect of derivative instruments used to manage interest rate risk. As at March 31, 2001, $2.2 billion of the $3.9 billion foreign debt is hedged. Bonds and notes payable are either held, or guaranteed as to principal and interest, by the Province as set out below:

	March 31, 2001			March 31, 2000		
($ millions)	Held by the Province	Guaranteed by the Province	Total	Held by the Province	Guaranteed by the Province	Total
Short-term debt	2,570	—	2,570	3,446	—	3,446
Current portion of long-term debt	569	2,205	2,774	500	1,726	2,226
Long-term debt	8,056	17,166	25,222	5,701	19,965	25,666
Total	**$ 11,195**	**$ 19,371**	**$ 30,566**	**$ 9,647**	**$ 21,691**	**$ 31,338**

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, 2001 is $34.4 billion (March 31, 2000 - $35.4 billion). This is higher than the book value of $30.6 billion (March 31, 2000 - $31.3 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.

9. Long-Term Liabilities

Power purchase contracts and related loan agreements were entered into by Ontario Hydro with non-utility generators (NUGs) located in Ontario. 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. This liability has been valued at $4,286 million on a discounted cash-flow basis. As the continued Ontario Hydro, OEFC is the counterparty to these contracts. Currently, the power purchased from NUGs is resold at cost to the power grid managed by OPG. However, after open access, this power will be sold at market prices that may be greater or less than cost.

During the year, OEFC purchased power in the amount of $695 million (March 31, 2000 - $741 million) and sold this power to the power grid for the same amount. HOI manages the NUG power purchase contracts and the related loans on behalf of OEFC for an annual fee of $3 million (March 31, 2000 - $3 million), partially offset by a recovery of $2 million (March 31, 2000 - Nil) of transmission expansion costs originally paid by Ontario Hydro, which net cost is included in operating expense. Loans to NUGs increased during the year by $25 million to $244 million at March 31, 2001 (March 31, 2000 - $219 million), primarily due to interest revenue during the year which has been added to the principal balance.

Nuclear funding liability - OEFC as the continued Ontario Hydro received 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. Interest has been accrued at an estimated 5.75 per cent and is included in the total value of $2,659 million as at March 31, 2001 (March 31, 2000 - $2,515 million). The interest rate is still under negotiation with the Province and is subject to change. The impact of the finalization of the interest rate for the fiscal year is not expected to result in a material difference to the liability balance.

10. Revenue Pool Residual

As explained in Note 1, OEFC is the beneficial owner of the forecast residual of the revenue pool, managed by OPG, which collects revenues from electricity consumers and allocates revenues to OPG, Hydro One and the IMO. The forecast residual of the revenue pool is cyclical in nature due to seasonal variations in pricing. As a result, the residual, while positive in the first and fourth quarters of the calendar year, is negative in the second and third quarters.

It was agreed by OEFC and OPG that OEFC would receive an average payment per month which would eliminate the seasonal variation in the pool residual and ensure that OEFC would never need to borrow cash to make up the shortfall. In the accounts, this revenue stream was recorded as received, adjusted for the one month accrual at each year-end.

These interim arrangements were to remain in effect until open access at which time the revenue pool would cease to operate and the Debt Retirement Charge (DRC) would be collected direct from electricity consumers. Open access was originally announced for November 2000 and OEFC's forecast residual for calendar 2000 was calculated over the ten months ended October in anticipation of the November opening. Once open access was delayed past November, it became apparent that the term over which the average should be calculated was unknown. Consequently, beginning in

November 2000, OEFC began to receive the forecast residual as earned each month and reflected this stream as revenue in the accounts. The revenue in OEFC in fiscal 2000-01 has benefitted by including both the increased revenue over the summer of 2000 and the real earnings in the pool over the winter of 2000-01.

11. Unfunded Liability

In the previous year, PILs revenue was recognized on a cash basis and reflected only cash received during the year. For fiscal 2000-01, OEFC has changed its accounting policy to recognize PILs revenue on an accrual basis. The change was made to conform with accounting policies of the Province. Therefore, PILs earned during the year will now include deferred taxes, regardless of when those taxes will be paid.

The previously unrecognized $200 million accrual of PILs revenue has been added to the balance of the opening unfunded liability. In addition, the opening unfunded liability has also been adjusted to account for working capital adjustments in successor companies in the amount of $247 million. The effect of these adjustments is as follows:

Unfunded Liability, March 31, 2000	$ 19,987
Adjustments during the year:	
Accrual for PILs revenue	(200)
Working capital for OPG and HOI	247
Balance after adjustments	$ 20,034

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 industry. The Plan includes 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, HOI 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, property and capital taxes made by OPG, HOI and municipal electric utilities.

A **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 HOI in excess of the Province's cost of its investment in its electricity subsidiaries will be set aside for the retirement of OEFC's debt.

The long-term plan supports estimates that OEFC's obligations will be defeased in the years ranging from 2010 to 2017.

12. Risk Management and Derivative Financial Instruments

OEFC employs prudent risk management strategies and operates within strict risk exposure limits to ensure exposure to risk is well managed. 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 assets. 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 of debt servicing costs and principal payments varying due to fluctuations in foreign exchange rates. To minimize 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 cash flows to reach a maximum of 20 per cent of total debt. At year end, 7.1 per cent of this debt was unhedged, with most of the currency exposure to US dollars.

Interest rate risk is the risk of debt servicing costs varying due to changes in interest rates. 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 year end, OEFC's floating rate debt as a percentage of total debt was 5.7 per cent.

The table below presents a maturity schedule of OEFC's derivatives, by type, outstanding at March 31, 2001, based on the notional amounts of the contracts. Notional amounts represent the volume of outstanding derivative contracts and are not indicative of credit or market risk. Notional amounts are not representative of actual cash flows.

Derivative Portfolio Notional Value
($ millions)
As at March 31, 2001

Maturity in Fiscal Year	2002	2003	2004	2005	2006	6-10 Years	Over 10 Years	Total	2000
Cross-currency swaps	284	-	638	-	-	884	-	1,806	1,307
Interest rate swaps	797	505	1,814	292	730	1,235	1,520	6,893	6,179
Forward foreign exchange contracts	1,171	-	-	-	-	-	-	1,171	1,151
Other	662	-	-	-	-	-	-	662	1,445
Total	$ 2,914	505	2,452	292	730	2,119	1,520	10,532	10,082

Entering into derivatives contracts results in 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, 2001.

Credit Risk Exposure ($ millions)	March 31, 2001	March 31, 2000
Gross credit risk exposure	5,437	4,850
Less: Netting agreements	(5,519)	(5,019)
Net credit risk exposure	$ (82)	$ (169)

Note:
Contracts do not have coterminous settlement dates. Netting agreements use generally accepted forms and terms developed by the International Swaps and Derivatives Association (ISDA). Based on ISDA definitions, total exposure to counterparties with positive exposure was $210 million (meaning that counterparties owed OEFC) and total exposure to counterparties with negative exposure was $292 million (meaning that OEFC owed counterparties) for a total net credit exposure to ($82) million on March 31, 2001.

OEFC manages its credit risk exposure through daily monitoring compliance with credit limits and by dealing with counterparties with good credit ratings of A- or higher. Counterparties for money market and other short-term transactions must have at least an R1-mid rating by Dominion Bond Rating Service or an A-1 or P-1 rating by Standard and Poor's or Moody's respectively.

OEFC also limits its credit risk exposure on derivatives by entering into contractual netting agreements with virtually all of its counterparties, which enables it to settle derivative contracts on a net basis in the event of a counterparty default. The gross credit risk exposure represents the amount of loss that OEFC would suffer if every counterparty to which OEFC was exposed were to default at the same time and no netting of negative exposures was allowed. The net credit risk exposure includes the mitigating impact of these netting agreements.

13. Guarantees

Subject to a $10 million and $20 million deductible respectively, OEFC has agreed to indemnify HOI and OPG in respect of any adverse claim to title to any asset, right or thing transferred or intended to be transferred to the companies at April 1, 1999, 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 agreements described in Note 9. These guarantees total approximately $135 million at March 31, 2001 (March 31, 2000 - $146 million).

14. Comparative Figures

Prior year's figures have been re-classified where necessary to conform with the current year's presentation.

Sources of Additional Information

Internet:

Ontario Electricity Financial Corporation: www.oefc.on.ca

- Provides information on the OEFC's debt, pension plan, board of directors and contains publications pertaining to the OEFC.

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 Science and Technology :	www.est.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

Contact Addresses and Numbers:

General Information:
Investor Relations, Capital Markets Division
Telephone: 416-325-0918
e-mail: investor@oefc.on.ca

OEFC Pension Plan:
Telephone: 1-888-336-6629
Monday to Friday, 8:00 a.m. to 6:00 p.m.
e-mail: pension@oefc.on.ca

For additional copies of this annual report, please contact:
Ontario Electricity Financial Corporation
1 Dundas Street West, Suite 1400
Toronto, Ontario, Canada M7A 1Y7
Telephone: 416-325-8000

ISSN 1492-7543