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DELIVERED

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Re: Hydro One Inc. - Preliminary Prospectus dated March 28, 2002

We are the solicitors for the Communications, Energy and Paperworkers Union of Canada (CEP) and the Canadian Union of Public Employees (CUPE) with respect to this matter.

Collectively, our clients represent in excess of 650,000 Canadians. In Ontario, CEP has 50,000 members and CUPE has 200,000 members. Our clients' members are residential consumers of electricity, and employed by major industrial and commercial users of electricity as well as by companies providing energy transmission and distribution services. As members of pension plans with substantial participation in equity markets, their economic security is closely tied to fair and efficient capital markets.

Our clients have a number of significant concerns with this Initial Public Offering (IPO) and with the preliminary prospectus that Hydro One has filed with the Ontario Securities Commission (Commission). It is our clients' position that a receipt for a prospectus in this

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matter should not be issued under the Ontario Securities Act because it would not be in the public interest to do so.

In addition, a receipt ought not to be issued because, in our view, the preliminary prospectus fails to meet the requirements for full, true and plain disclosure of all material facts relating to this share issue.

This prospectus raises material and novel questions involving the public interest which should be referred to the Commission for determination and for hearing.

Before elaborating on our clients' concerns, we draw your attention to the highly unusual circumstances of this public offering:

- As the Province has noted, this is the largest IPO ever made in Canada by a very wide margin. While the precise value of this share offering has yet to be determined, by all accounts it will be at least 150% larger than the privatization of CN Rail, its nearest rival in terms of scale, value and importance.

- The underlying assets of Hydro One and its subsidiaries are vital to the well-being of every Ontario resident and business. It is no exaggeration to say that there is no other infrastructure that has more importance for Ontario's economy.

- This IPO will end public control of an electricity transmission system that has been in public hands for the past century, and as the prospectus indicates, may ultimately result in effective control of Hydro One being acquired by foreign investors.

- The IPO is taking place amidst significant upheavals in the electricity industry in North America, including the collapse of Enron and California's failed experiment with deregulation for the electricity sector. The economic consequences of policy and market failures in other jurisdictions have had devastating impacts on consumers, workers, and important sectors of the economy. We believe that it is incumbent upon the Commission to take notice of these circumstances, and in keeping with its mandate, ensure that similar consequences not occur in Ontario.

- The government's intention to privatize Hydro One was announced only last December, and has never been the subject of legislative or other hearings, nor has the privatization been submitted to any independent or objective review. Moreover the Hydro One's sole shareholder, the Minister of Energy, Science and Technology had, until recently, repeatedly disavowed any intention to relinquish public control of this natural monopoly.[1]

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[1] Jim Wilson, Minister of Energy, Science and Technology: Hansard for June 17, 1998.

- Available polling results indicate that most Ontario residents oppose privatization, and even a greater majority believe that the government should seek an electoral mandate before proceeding. We believe these polling results offer an important indication of public sentiment with respect to this Provincial initiative.[2]

The Commission's Public Interest Mandate

The Commission is permitted to decline approval of this prospectus if it believes that it is in the public interest to do so. Section 61(1) of the Act, provides that:

> *Subject to subsection (2) of this section and subsection 63(4), the Director shall issue a receipt for a prospectus filed under this Part unless it appears to the Director that it is not in the public interest to do so.*

The Commission has established that it has broad discretion to determine the scope of its public interest jurisdiction. In *Re Canadian Tire Corp.* (1987), 10 O.S.C.B. 857, and *Re H.E.R.O. Industries Ltd.* (1990), 13 O.S.C.B. 3775, the panel noted that it does not need to find a breach of the *Act* or of the Regulations in order to exercise its jurisdiction under section 127. The courts have since confirmed the correctness of this approach.

Moreover, in *Committee for the Equal Treatment of Asbestos Minority Shareholders v. Ontario (Securities Commission)*, [2001] 2 S.C.R. 132, the Supreme Court of Canada described the Commission's public interest jurisdiction as neither remedial nor punitive, but rather protective and preventive.

While the public interest jurisdiction of the OSC is not unlimited, and while the Commission may be reluctant to engage in the broad public interest inquiry which the government has avoided to date, the improprieties and weakness in the offering under review represent a magnitude of risk to investors that make it imperative that the OSC convene a hearing. This is particularly so, given the size of the offering, and because of the Crown's exemption from certain provisions of the Securities Act, the absence of the ordinary statutory remedies of damages and rescission for investors. The irregularities set out below may significantly undermine the public's confidence in the capital markets.

This IPO sets the stage for successful shareholder law suits challenging agreements entered into between Hydro One and its current shareholder concerning the place of incorporation for Hydro One, the location of its head office, its willingness to moderate rate

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[2] Globe and Mail, Tuesday February 5, 2002 - *Ontarians oppose hydro sale, poll shows.*

increases, and a "non-binding" agreement to grant the Province the right to use transmission corridors and other property for public purposes.

Moreover, we invite the Commission to consider and act on our clients concerns about the much broader public interest that is at stake in this matter, which affects not only the interests of prospective shareholders but also those of its current shareholders, which the Minister of Energy, Science and Technology has correctly described as the people of Ontario.[3]

The Acquisition of Common Shares by Non-Canadian Investors

The IPO indicates that no restriction will be placed on the ability of non-Canadian investors to acquire the common shares of Hydro One. The prospectus offers this explanation for the decision not to impose such restrictions:

> *We have not placed explicit restrictions on the ability of non-Canadians to acquire our common shares as a means of ensuring compliance with these rules because these restrictions may limit the ability of non-Canadian investors to acquire our common shares and, as such, violate investment provisions of the North American Free Trade Agreement and other international trade agreements to which Canada is a party.*

This statement misrepresents Canada's obligations under the NAFTA. To begin with, as a matter of constitutional law, the province is not bound by the international commitments that may have been made by Canada concerning matters of property and civil rights, which are exclusively reserved to provincial governments under our constitution. The *Business Corporations Act (Ontario)* explicitly allows constrained share offerings.

In *Pfizer Inc. v. Canada (T.D.)*, [1999] F.C.J. 1122, appeal dismissed, [1999] F.C.J. 1598, the Federal Court held that, to be binding under Canadian law, Canada's international trade obligations must be incorporated by statute. For the purposes of implementing the commitments that it made by virtue of NAFTA, there were a number of consequential amendments made to domestic law when the federal government passed the *North American Free Trade Implementation Act*. We are aware of no such amendments to Ontario corporations law. Accordingly, the constraints imposed by NAFTA investment disciplines, even were they to apply in this case, have not been incorporated into Ontario law.

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[3] Note 1.

More importantly, the issuer is simply wrong in its assertion that NAFTA constrains the capacity of the Province or Hydro One to restrict this share offering to Canadians. The right of the Province to restrict, or even deny foreign investors the right to acquire shares in Hydro One is specifically reserved under NAFTA. Under Canada's Schedule to Annex I of the NAFTA, the following reservation is listed for obligations to provide *National Treatment* (Article1102) to foreign investors and from restrictions on government measures concerning *Senior Management and Boards of Directors* (Article1107):

> *Canada or any province, when selling or disposing of its equity interests in, or the assets of, an existing state enterprise or an existing governmental entity, may prohibit or impose limitations on the ownership of such interests or assets, and on the ability of owners of such interests or assets to control any resulting enterprise, by investors of another Party or of a non-Party or their investments. With respect to such a sale or other disposition, Canada or any province may adopt or maintain any measure relating to the nationality of senior management or members of the board of directors.*

For purposes of this reservation:

> *(a) any measure maintained or adopted after the date of entry into force of this Agreement that, at the time of sale or other disposition, prohibits or imposes limitations on the ownership of equity interests or assets or imposes nationality requirements described in this reservation shall be deemed to be an existing measure; and*
>
> *(b) "state enterprise" means an enterprise owned or controlled through ownership interests by Canada or a province and includes an enterprise established after the date of entry into force of this Agreement solely for the purposes of selling or disposing of equity interests in, or the assets of, an existing state enterprise or governmental entity.*

That is, and contrary to the representation in the preliminary prospectus, the issuer in this case can restrict foreign ownership in the common shares it is offering.

Foreign ownership has a material bearing on the value of shares being offered. As the issuer notes in the preliminary prospectus, the eligibility of Hydro One's telecommunications subsidiaries to operate under the *Telecommunications Act* (Canada) will be put at risk if foreign ownership exceeds 33 1/3%. Hydro One's plan to "monitor" foreign ownership is meaningless if it lacks the power to prevent transfers to foreigners from occurring after this IPO proceeds. This misrepresentation is one that precludes the issuance of a receipt under Section 61(2) of the Act.

Apart from misrepresenting the issuer's ability to restrict foreign ownership generally, it is noteworthy that the issuer's approach to this question is inconsistent. The right to purchase common shares through installment receipts is being made available only to eligible residents of Ontario. If the issuer is correct that NAFTA disciplines preclude restrictions which discriminate against non-residents, then the same constraint would apply to instalment receipts, (unless installment receipts were distinguished under NAFTA rules, which they are not). If the view expressed by the prospectus is correct, then the preferential treatment accorded "eligible Ontario residents" in violation of NAFTA disciplines would be vulnerable to trade challenge and foreign investor claims.

Thus, even if the issuer's view of NAFTA is correct, which it is not, it has failed to disclose that the proposal to issue some shares by way of installment receipts may run afoul of NAFTA. This is a material fact which, if true, should be disclosed by the prospectus.

The Special Share

The prospectus indicates that if the over allotment option is exercised, the Province would be left holding no common shares in Hydro One. However, it would be the holder of one Special Share which is described this way:

> *Concurrently with the share split and issuance of common shares to the Province, we will issue to the Province the special share, which may only be held by it. The special share will entitle the Province to vote on any proposal for amendment of our articles of incorporation to relocate our head office outside of Ontario, to change our jurisdiction of incorporation or to alter the rights attached to the special share. The effect of this vote by the Province, if cast against one of these proposals, will be to preclude us from carrying out the proposal, regardless of whether our directors or common shareholders have voted in favour of the proposal. No other voting rights attach to the special share, and the special share does not entitle the Province to dividends or amounts in the event of our liquidation, dissolution or winding up in excess of $1.*

We believe that the extraordinary features of this Special Share, when viewed in light of the nominal consideration given for these rights, raise concerns about its legality.

The rights attached to this special share are extremely unusual, if not unprecedented. They would, for that reason, be difficult to value. Nevertheless, it is inconceivable that, at $1, the value assigned to this share would be deemed reasonable for the highly unusual veto power it accords its holder. Given that the directors of Hydro One have or will be bargaining away a significant management right, it is entirely foreseeable that future shareholders will challenge the issuance of the Special Share, if this privatization proceeds. Their argument would be that because this share was issued to serve the interest of the

controlling shareholder, and not for any valid corporate purpose, it is oppressive and/or violates the fiduciary duty of the directors of Hydro One. Accordingly, the prospectus is deficient in failing to disclose the risk that the Special Share will be the subject of future attack on the grounds that its valuation cannot be supported on any rational or economic basis.

Furthermore, we believe the rights reserved to the Province by the Special Share may not be compliant with Canada's obligations under NAFTA investment and services rules with respect to the location of corporate head offices. Moreover, the right to insist that Hydro One remain incorporated under the laws of Ontario, must not, under NAFTA, impair foreign investor rights or nullify the benefits the Treaty accords.

Agreement To Moderate Price Expectations

At page 26 the preliminary prospectus indicates that:

> *Following discussions with our shareholder, which requested us to mitigate the transition [of] higher costs of electricity for our customers, we applied for lower distribution revenues than we had originally requested, with this mitigation to be partially phased out over a three-year period. The Ontario Energy Board issued an interim approval of the first phased increase, effective October 1, 2001; and the second phased increase, effective March 1, 2002. We have requested that the third phased increase be effective March 31, 2003. The Ontario Energy Board is expected to make a final determination with respect to the approval of these increases in mid-2002.*

This agreement between Hydro One and the Province is also vulnerable to challenge on the grounds that the directors breached their fiduciary obligations. In particular, the agreement to reduce the stream of revenue over a period of several years, apparently entered into as a matter of political expediency and not with a view to maximizing profit, can easily be characterized as "oppressive or unfairly prejudicial to ... the interests" of Hydro One's new shareholders, should this IPO proceed. This is because the Board of Directors cannot take instructions from a shareholder, even if that shareholder owns all of the issued shares of the corporation, where those instructions are not in the best interests of the corporation.

The prospectus is deficient in failing to advise that the present value of the shares is artificially reduced by virtue of this agreement.

Term Sheet Agreement Concerning the Transmission Corridors

This is another variation of an agreement, albeit non-binding, that would also be vulnerable to the remedy for oppression. The preliminary prospectus indicates:

> *We have entered into a non-binding term sheet with the Province providing for the grant to the Province of an option to acquire interests in the owned lands underlying our transmission system, which are referred to as our "transmission corridors", for public uses consisting of transportation, recreation, infrastructure and related facilities. The acquisition of any part of our transmission corridors by the Province could reduce the value of our regulated assets, which may reduce our net income. The public uses of any part of the transmission corridors may reduce the ultimate disposal value of our remaining interest in the acquired lands. Revenues from current and future third party uses of the transmission corridors may be affected adversely by the granting of this option. Although we retain the right to use the transmission corridors acquired by the Province for the purposes of our transmission, distribution and telecommunications systems, the public uses may limit our ability to expand our systems in the future. Other uses of the transmission corridors, whether by the Province pursuant to the term sheet or by others, in conjunction with the operation of our transmission, distribution or telecommunications systems may increase safety or environmental risks.*

The characterization of this term sheet provides insufficient information about the status of this agreement; the character of the option that may be granted to the Province; the nature of the interests that would be conveyed with respect to this land; or finally, the consideration that might be given for it. The prospectus concedes, as is obvious, that the term sheet is material to the value of the common shares that would be offered for sale. In our view, the failure of the prospectus to disclose more information about this term sheet fails to represent the full, true and plain disclosure of all material facts, required under the Act.

Finally on this point, the question of proper consideration, again raises the prospect that any agreement negotiated with Province conveying an option to acquire interests in the transmission corridors might be vulnerable to challenge under the law of Ontario, or other jurisdictions in which these shares are being offered for sale.

The questions of valuation and share subscription.

The preliminary prospectus fails to disclose what is arguably the most important fact about

this IPO - the price at which the common shares and instalments receipts will be offered. Nor does the prospectus even indicate a range of values for this share offering.

We gather that Hydro One may not make this critical information available before the final prospectus is submitted to the Commission. Moreover, we also understand that very little time may elapse between the submission of the final prospectus and issuance of receipt by the Commission. Whether this is the customary procedure or not, we believe that it is sorely out of place in the current context. Where the Province is the seller, in our view it is essential to the public interest that the price at which shares will be issued be made known. In our view therefore, it is incumbent on the Commission to ensure that this vital information is made available in a timely manner in order to allow sufficient opportunity for those interested and potentially effected by this proposed sale to make their views known to you.

Sincerely

Steven Shrybman
SS/sd

cc. McCarthy, Tétrault LLP
Solicitors for the Province of Ontario

Osler, Hoskin & Harcourt LLP
Solicitors for Hydro One Inc.

Blake, Cassels & Graydon LLP
Solicitors for the Underwriters