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May 15, 2012

***via RESS e-filing – original to follow by courier***

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge Street, 27th floor
PO Box 2319
Toronto, ON  M4P 1E4

Dear Ms. Walli:

**Re: Application by Toronto Hydro-Electric System Limited (THESL)**
**OEB File No.  EB-2012-0079**

Please find attached THESL's Responding Submissions in respect of its Application for an Accounting Order to establish a deferral account.

Please direct any questions or comments to my attention.

Yours truly,

*[original signed by]*

Amanda Klein
Senior Regulatory Counsel

att.

:AK/km

cc: J. Mark Rodger, Counsel for THESL, by electronic mail only
Intervenors of Record for EB-2011-0144, by electronic mail only

**IN THE MATTER OF** the *Ontario Energy Board Act, 1998*, S.O. 1998, c. 15, (Schedule B);

**AND IN THE MATTER OF** an application an application by Toronto Hydro-Electric System Limited for an accounting order to establish a deferral account.

**RESPONDING WRITTEN SUBMISSIONS OF**
**TORONTO HYDRO-ELECTRIC SYSTEM LIMITED**

## I. BACKGROUND

*(a) Relief Sought*

1. Toronto Hydro-Electric System Limited ("THESL") seeks from the Ontario Energy Board ("OEB") in this proceeding an accounting order to establish a deferral account to record certain accounting differences between Canadian Generally Accepted Accounting Principles ("CGAAP") and United States Generally Accepted Accounting Principles ("USGAAP") effective January 1, 2012 with 2011 comparatives.[1]

2. In particular, THESL seeks a deferral account to record the accounting differences with respect to other post-employment benefits ("OPEB") that arise as a result of THESL transitioning from CGAAP to USGAAP.[2]

3. For the reasons set out below, THESL submits that the evidence demonstrates that THESL's circumstances warrant it being granted an accounting order to establish a deferral account to record the differences that arise as a result of the transition from CGAAP to USGAAP

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[1] Letter from THESL to the OEB dated February 28, 2012 (the "Application Letter"), p.1.
[2] THESL Responses to Interrogatories of Ontario Energy Board Staff ("Board Staff Interrogatories"), Tab 1, Schedule 1, p. 1.

as described above, and that there is no compelling reason to not authorize, or otherwise defer, the establishment of the requested deferral account (the "USGAAP Deferral Account Request").

*(b) Rationale for Relief Sought*

4. As a result of decisions by the Canadian Accounting Standards Board, CGAAP was no longer available to THESL beyond December 31, 2011. THESL was therefore required to transition to a different accounting standard – either IFRS or USGAAP - effective January 1, 2012.[3] Accordingly, THESL applied to the Ontario Securities Commission (the "OSC") for authorization to use USGAAP for external financial reporting and securities filing purposes instead of International Financial Reporting Standards ("IFRS").[4]

5. On July 21, 2011, THESL received a decision from the OSC that effective January 1, 2012, THESL was authorized to use USGAAP for external financial reporting purposes.[5]

6. THESL notified the OEB by letter dated August 19, 2011 that it intended to seek approval to transition to USGAAP for regulatory accounting purposes in its 2012-2014 cost of service application (EB-2011-0144).[6]

7. THESL transitioned from CGAAP to USGAAP effective January 1, 2012 for external financial reporting purposes.[7]

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[3] Similar to many other Canadian utilities who are also public issuers, THESL's decision to convert to USGAAP, rather than IFRS, for external financial reporting purposes was supported by the fact that IFRS does not allow for the recognition of assets and liabilities on the balance sheet for utilities like THESL, whereas USGAAP allows for such recognition. The accounting impact of IFRS would have created significant volatility in earnings for THESL.

[4] Application Letter, p. 1. As noted in THESL Responses to Board Staff Interrogatories, Tab 1, Schedule 4, p. 4, on March 30, 2012, the Accounting Standards Board issued an extension on the use of CGAAP for entities with qualifying rate-regulated activities until January 1, 2013. However, conversion to CGAAP at this time would materially jeopardize THESL's ability to meet its March 31, 2012 OSC external reporting timelines, given that THESL already implemented US GAAP for financial reporting as at January 1, 2012. Further, utilizing the extension of CGAAP would not be a cost effective option as this would require THESL to incur additional costs to unwind the implementation of US GAAP and extend the accounting transition project to another year.

[5] Application Letter, p. 1.

[6] Application Letter, p. 1. THESL's 2012-2014 cost of service application was dismissed by the OEB in January 2012. As THESL has stated in this proceeding, it intends to seek approval to transition to USGAAP for regulatory accounting purposes in its next cost of service application.

[7] Application Letter, p.1.

8. For THESL, the transition from CGAAP to USGAAP creates an approximately $30 million difference in respect of unamortized net actuarial losses and past service costs of THESL's OPEB (the "OPEB Amount"). As at January 1, 2011, the OPEB Amount was unrecognized under CGAAP, but will be recognized on the opening balance sheet under USGAAP.[8]

9. As a result, absent OEB approval of its USGAAP Deferral Account Request, THESL would be required, for external financial reporting purposes, to recognize the OPEB Amount as Accumulated Other Comprehensive Income ("AOCI") in shareholder's equity. This would have a significant negative impact on the shareholder's equity reported in THESL's general purpose financial statements in that the OPEB Amount would be recognized immediately in the statement of profit and loss as an out-of-period cost within operating expenses. It is important to note that for purposes of setting rates, THESL currently defers all unamortized actuarial gains (losses) and prior service costs. The deferred costs that are amortized are accrued as period costs and are included in the calculation of the revenue requirement for each fiscal period when the costs are amortized based on accrual accounting rules.[9]

10. Conversely, establishment of the deferral account would enable THESL to recognize the OPEB Amount as a regulatory asset for external financial reporting purposes and avoid the above-described negative impact on THESL's shareholder's equity, leaving the net equity position on the balance sheet the same under USGAAP as it was under CGAAP. Establishment of an internal tracking account would not be sufficient for THESL to recognize the OPEB Amount as a regulatory asset.[10]

11. Quite apart from the reason that establishment of the requested deferral account will allow THESL to establish a regulatory asset for its external financial reporting, for the reasons outlined

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[8] Application Letter, p. 1-2.
[9] THESL Responses to Board Staff Interrogatories, Tab 1, Schedule 2, p. 1-2.
[10] Application Letter, p. 1; THESL Responses to Board Staff Interrogatories, Tab 1, Schedule 3, p. 1; Tab 1, Schedule 4, p. 3.

in further detail below, THESL submits that the following factors favour the OEB granting THESL's USGAAP Deferral Account Request. In particular, the requested deferral account: [11]

(i) is consistent with OEB policy;

(ii) provides a more transparent method of tracking the effects of THESL's transition and implementation to USGAAP (i.e. the OPEB Amount balance);

(iii) satisfies the criteria of causation, materiality and prudence, as applicable; and

(iv) assists in benchmarking with other utilities that have been granted similar relief by the OEB.

*(b) Chronology of This Proceeding*

12. On the basis that THESL was required to transition to a different accounting standard for external financial reporting purposes, and selected USGAAP, effective January 1, 2012, THESL made its USGAAP Deferral Account Request by letter dated February 28, 2012 (the "Application").

13. The OEB issued a Notice of Application and Hearing and Procedural Order No. 1 in this matter dated March 12, 2012 (the "Notice"). The Notice provided for a written hearing process by which intervening parties could ask interrogatories of THESL and make submissions to the Board.[12]

14. As provided for in the Notice, THESL received interrogatories from Board Staff on March 28, 2012 and responded to those interrogatories on April 10, 2012. THESL received no other interrogatories.

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[11] Application Letter; THESL Responses to Board Staff Interrogatories, Tab 1, Schedule 4, p. 2, and Tab 1, Schedule 3, p 1.
[12] The Notice provided that the OEB adopted as intervenors and observers in this proceeding the intervenors and observers from THESL's electricity distribution rate application for the 2012, 2013 and 2012 (EB-2011-0144).

15. Pursuant to the Notice, Board Staff filed written submissions dated May 1, 2012. In those submissions, Board Staff supported THESL's Application. In particular, Board Staff stated the following at page 7 of its submissions:

> "Board staff submits that the deferral account is appropriate and should be approved by the Board"

16. Pursuant to the Notice, School Energy Coalition ("SEC") also filed written submissions dated May 1, 2012. SEC did not support THESL's Application.

17. THESL makes these responding submissions in accordance with the Notice.

## II. WHY THE RELIEF SOUGHT IS WARRANTED

18. In addition to the reason that establishment of the requested deferral account will allow THESL to record a regulatory asset for its external financial reporting, and as noted above, THESL submits that there are four factors which favour the OEB granting THESL's USGAAP Deferral Account Request. THESL describes these in turn immediately below.

*(a) THESL's Request is Consistent with OEB Policy*

19. In the OEB's Addendum to the Report of the Board Regarding the Implementation of International Financial Reporting Standards (June 13, 2011),[13] the OEB noted that "the option remains for these utilities to seek an individual account if they can demonstrate the likelihood of a large cost impact upon transition to IFRS."[14]

20. As Board Staff noted in their submissions at page 6, THESL's request for the establishment of the deferral account with respect to the large cost impact upon transition from CGAAP to USGAAP is consistent with the guidance provided in the above-noted Addendum.

21. However, while the impact to THESL is large with respect to the creation of unfavourable and unrepresentative decrease in apparent shareholder equity, it is not the case that this impact would be borne by ratepayers. Under THESL's proposal, the periodic costs which are the subject of this application and which enter revenue requirement would continue unchanged from what they would otherwise be. The only purpose of the deferral account is to allow THESL the regulatory pre-requisites needed to recognize these yet-unrealized costs on the asset side of the balance sheet, rather than as an unrepresentative and abrupt reduction in shareholders' equity.

*(b) THESL's Request Aids Financial and Regulatory Transparency*

22. THESL submits that the establishment of the deferral account will aid transparency in that it will clearly record the OPEB amount associated with THESL's transition to USGAAP for

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[13] EB-2008-0408.
[14] Application Letter, p.1

external financial reporting purposes. THESL's need for the deferral account conforms with the specific requirements of USGAAP regulatory accounting for OPEB.[15]

23. The establishment and implementation of the deferral account creates no differential rate impact to ratepayers relative to the use of CGAAP. The future recovery of amounts reflected in the USGAAP deferral account would occur when the actuarial losses and prior service costs are amortized into profit or loss as part of the current services costs of that period. This amortization into profit and loss is consistent with CGAAP.[16]

24. The balance of the deferral account is expected to fluctuate over time based on changes in actuarial assumptions. The fluctuations would occur regardless of the system of accounting in place. Establishment of the deferral account would simply enable THESL to recognize the OPEB Amount as a regulatory asset for external financial reporting purposes, and leave the net equity position on the balance sheet the same under USGAAP as it was under CGAAP.[17]

25. Moreover, in the event that the OEB does approve a later request by THESL to use USGAAP for regulatory accounting purposes (which THESL intends to make in its next cost of service application), establishment of the deferral account eliminates the need for further steps.[18]

*(c) THESL's Request Satisfies the OEB's Criteria*

26. THESL submits that to the extent that the OEB applies the criteria of causation, materiality and prudence to THESL's USGAAP Deferral Account Request, THESL has satisfied those criteria.

27. *Causation*: As a result of decisions by the Canadian Accounting Standards Board, CGAAP was no longer available to THESL beyond December 31, 2011. THESL was therefore required to transition to a different accounting standard effective January 1, 2012.

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[15] Application Letter, p. 1. Board Staff Submissions, p. 6.
[16] Application Letter, p. 2; THESL Responses to Board Staff Interrogatories, Tab 1, Schedule 4, p. 2.
[17] THESL Responses to Board Staff Interrogatories, Tab 1, Schedule 2, p. 2.
[18] As discussed above, THESL notified the OEB by letter dated August 19, 2011 that it intended to seek approval to transition to USGAAP for regulatory accounting purposes in its 2012-2014 cost of service application (EB-2011-0144). That application was dismissed by the OEB in January 2012.

28. *Materiality:* the financial impact of the OPEB Amount of approximately $30 million as at January 1, 2011 is a material amount.

29. *Prudence*: from the ratemaking perspective, the prudence criterion does not engage because there is no differential rate impact arising from the adoption of the requested USGAAP deferral account. In addition to or in the alternative, THESL has satisfied the prudence criterion in that USGAAP has a smaller financial impact than adopting IFRS due to the similarities between USGAAP and CGAAP.[19] Further, USGAAP is expected to result in greater financial stability.

*(d) THESL's Request Assists in Benchmarking*

30. As noted by Board Staff in support of THESL's application, the OEB has approved similar deferral accounts to track differences associated with the transition to USGAAP.[20]

31. THESL submits that accordingly, the granting of THESL's USGAAP Deferral Account Request is not only consistent with OEB past practice, but also assists in benchmarking with other industry entities who have adopted USGAAP for external financial reporting purposes. THESL submits that were it required to recognize the subject costs abruptly through a material reduction in shareholder equity, a distortion in equity-based ratios would result relative to other comparable regulated entities, and that this distortion would impair benchmarking by, for example, requiring ongoing adjustments to published financial results in order to remove the distortion.

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[19] THESL Responses to Board Staff Interrogatories, Tab 1, Schedule 2, p. 3. As noted in this interrogatory response, if THESL were transiting to IFRS, the impact as at January 1, 2011 would be more significant primarily due to the fact that the account would also include the impact for the derecognition of regulatory assets and liabilities.
[20] Board Staff Submissions, p. 5.

## III. SPECIFIC RESPONSES TO SUBMISSIONS OF BOARD STAFF AND SEC

32. To the extent not already addressed above, THESL responds below to other relevant issues raised by Board Staff and SEC.

*(a) Board Staff Submissions*

33. In their submissions, Board Staff raised the concern that the establishment of the deferral account may give rise to an issue of "double recovery". In particular, Board Staff noted: [21]

> "…it would be helpful if THESL could clarify in its reply submission, why if these amounts are being recovered in the current service cost, there would be any need for additional recovery of any amounts which would accumulate in the proposed deferral account."

34. With respect, there is no issue of potential double recovery. THESL is requesting a regulatory asset account in order to recognize the unamortized actuarial losses and past service costs as a regulatory asset on the balance sheet instead of recognizing the balance in shareholder's equity, as USGAAP does not allow these actuarial losses and past service costs to be off-balance sheet.

35. The amounts that would accumulate in the requested deferral account, if approved, would be the same amounts that would accumulate "off-balance-sheet" under CGAAP. These amounts are being amortized into the profit and loss in the same manner under USGAAP as under CGAAP, and it is through the net periodic benefit cost for the current period that the amounts enter revenue requirement either as part of operating costs or as part of return on rate base (for capitalized amounts).

36. Under THESL's proposal, the opening balance of the subject costs would be recognized as a regulatory asset instead of as a reduction to equity. This result follows the basic accounting rule that assets must equal equity plus liabilities. However, there would be no double recovery of any amount because under THESL's proposal, there would be an effective continuation of the

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[21] Board Staff Submissions, p. 5.

existing ratemaking treatment of the periodic costs in question. This treatment is parallel to the treatment of those costs in 2011 when THESL was rebased.

37. To the extent that there are fluctuations in actuarial assumptions or other factors affecting these costs, under THESL's proposal those fluctuations would be treated in exactly the same way as they would otherwise be and would have exactly the same revenue requirement consequences. It is not the presence of the deferral account that gives rise to changes in the levels of those costs, but rather changes in actuarial assumptions or other factors affecting these costs that causes them to change and thus to affect revenue requirement.

38. To summarize, the deferral account would act as a 'holding area' for yet-unrealized OPEB costs. Under THESL's request for the USGAAP deferral account, the total amount in the 'holding area' would never be disposed in a single year. Rather, only the amounts representing current period costs would be charged to revenue requirement, after going through the 'holding area', and these amounts would be no different than those that would occur otherwise in the absence of the deferral account. The essential difference is that the 'holding area' would be recognized as a regulatory asset on the balance sheet (offset by the corresponding obligation), rather than as a reduction to shareholder's equity. As discussed above, THESL submits that if the 'holding area' is not recognized as a regulatory asset, and instead be recorded as a reduction to shareholder's equity, that this would introduce a material distortion THESL's in financial statements.

*(b) SEC Submissions*

39. SEC gives reasons for objecting to the relief that THESL seeks in this application. With respect, THESL addresses and responds to those objections, as they are relevant, in turn directly below.

(i) No Application to Use USGAAP for Regulatory Accounting Purposes

40. SEC notes that there is no application before the OEB from THESL seeking approval to use USGAAP for regulatory accounting purposes. SEC implies that this fact is relevant to whether or not the OEB grants THESL's USGAAP Deferral Account Request.[22]

41. THESL submits that other utilities who have come before the OEB with a request for a USGAAP deferral account faced similar circumstances to THESL's in that upon transitioning to USGAAP for external financial reporting purposes, and in the absence of OEB approval to use USGAAP for regulatory accounting purposes, they sought OEB approval for a deferral account to record certain regulatory assets that arose as a result of the transition to USGAAP.[23]

42. In that context, intervenors submitted similar objections to the relief sought by the utilities. Namely, that the OEB should not grant the requested deferral account because the utility had not yet sought, and had not been authorized by the OEB, to transition to USGAAP for regulatory accounting purposes.

43. In such instances, the OEB determined that the issues of whether a USGAAP deferral account should be granted, versus whether a utility is authorized to use USGAAP for regulatory accounting purposes, are separate and severable. In particular, in such cases, the OEB granted the requested USGAAP deferral accounts in the absence of an application by the utility to use USGAAP for regulatory accounting purposes.[24]

44. THESL recognizes that the issue of whether it is authorized to use USGAAP for regulatory accounting purposes is outside the scope of this proceeding, and THESL does not seek

[22] SEC Submissions, p. 2-3.
[23] See, for example: Decision and Order in Ontario Power Generation's request for a USGAAP deferral account (EB-2011-0432); Partial Decision and Order in Union Gas' request for a USGAAP deferral account (EB-2011-0025).
[24] See, for example: Decision and Order in Ontario Power Generation's request for a USGAAP deferral account (EB-2011-0432); Partial Decision and Order in Union Gas' request for a USGAAP deferral account (EB-2011-0025).

such approval at this time. As noted above, THESL intends to seek approval to use USGAAP for regulatory accounting purposes in the context of its next cost of service application.[25]

45. Consistent with the practice of other utilities and OEB accounting orders regarding same, the relief that THESL seeks in this application is limited only to the establishment of a deferral account to track the differences between CGAAP to USGAAP upon transition and the ongoing fluctuations to the OPEB Amount. THESL is accordingly following what has emerged as a normal practice to obtain approval for the requested deferral account and submits that there is no compelling reason to delay the establishment of the deferral account. SEC's submissions do nothing to suggest that the OEB should depart from its prior decisions granting a USGAAP deferral account for other utilities.

(ii) <u>Other Objections to THESL's Request for a USGAAP Deferral Account</u>

46. SEC argues that THESL's application is flawed because, in identifying the OPEB Amount, it provided an estimated amount, rather than the actual figure, in its application.[26]

47. THESL is not aware of any requirement to provide the precise actual, rather than approximate, initial liability of the accrual account and THESL provided an approximate amount to communicate the order of magnitude of the amount, consistent with the accepted practices of other utilities seeking a USGAAP deferral account.[27] This $30 million is disclosed publicly in Toronto Hydro's Management's Discussion and Analysis ("MD&A") as filed on System for Electronic Document Analysis and Retrieval ("SEDAR") on March 2, 2012, at page 28. In any

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[25] Application Letter. THESL notes that SEC makes further specific submissions on the issue of whether, in SEC's words "Toronto Hydro should be allowed to use USGAAP for regulatory purposes" (SEC Submissions, p. 3). As this is not an issue within the scope of the current proceeding, THESL will reserve response to SEC's arguments on this point until such a time that this issue is before the OEB, to the extent that SEC seeks to maintain its position as stated.
[26] SEC Submission, p. 4.
[27] See, for example, Decision and Order in Ontario Power Generation's request for a USGAAP deferral account, p. 2 and 5 (EB-2011-0432).

event, the precise figure of $30,130,000 is disclosed in note 12(b) of THESL's 2011 Audited Financial Statements filed on SEDAR on March 2, 2012.[28]

48. SEC also argues that THESL only refers to OPEB in its application and "does not deal with any of the other items listed."[29]

49. Contrary to SEC's submission, that THESL only refers to OPEB is neither an error nor a deficiency in its application. OPEB is the only USGAAP related difference that may result in negative impact to equity or profit and loss, absent a regulatory asset. All other USGAAP-related differences are re-classifications of existing balances within the same categories on the balance sheet that do not require consideration within the requested deferral account.

50. SEC also argues that the proposed deferral account does not provide the accounting result that THESL says it would in that it does <u>not</u> satisfy the requirement under USGAAP. In particular, SEC quotes a section of the accounting standard (referred to by THESL in its application and responses to Board Staff Interrogatories) to argue that the requirement under USGAAP is that the utility receive approval from the OEB of both the deferral account, and recovery from ratepayers of the amounts recorded in that deferral account.[30]

51. SEC however, has misconstrued the accounting standard. The language is clear – a utility must only obtain an order that <u>allows for</u>, rather than <u>approves</u> subsequent inclusion of the deferral costs in the utility's rates.

> "…rate order or issued policy statement or generic order…that <u>allows</u> both for the deferral of Subtopic 715-60 cost and for the subsequent inclusion of those deferred costs in the entity's rates."[31] (emphasis added)

[28] In the table that appears at 12(b) of THESL's Audited Financial Statements, the figures of $27,952 (representing unamortized net actuarial losses) and $2,178 (representing past service costs) add up to $30,130,000. For reference, THESL encloses with these submissions both the above-referenced MD&A and Audited Financial Statements as appendices "A" and "B respectively.
[29] SEC Submissions, p. 4.
[30] SEC Submissions, p. 5.
[31] ASC-980-715-25-5. See THESL's Response to Board Staff Interrogatories, Tab 1, Schedule 3, Attachment A.

52. THESL's application is limited only to seeking approval for the establishment of the requested USGAAP deferral account. THESL recognizes that its establishment has no bearing on whether the deferred costs will be eligible for recovery in rates. As also recognized by Board Staff, the establishment of the requested deferral account does in fact conform to the USGAAP accounting standard at issue.

53. SEC also argues that statements in THESL's consolidated financial statements filed two days after this application are inconsistent with the application.[32] In making this assertion, SEC points to the following statement:

> "The Corporation does not believe that the adoption of U.S. GAAP will have a material impact on its consolidated financial statements in the future."

54. To the extent clarification of this statement is required, THESL notes that this statement was intended not to refer to the one-time recognition of the OPEB Amount, but rather to ongoing statements in the future. In the event that the OEB does not grant the deferral account, THESL would recognize the OPEB Amount in AOCI in the next quarter. As discussed above, this would then, at that time, have a material impact to THESL's financial statements.

**ALL OF WHICH IS RESPECTFULLY SUBMITTED**

May 15, 2012

**Toronto Hydro-Electric System Limited**
Amanda Klein
Senior Regulatory Counsel

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Email: aklein@torontohydro.com

[32] SEC Submissions, p. 5.

MANAGEMENT’S DISCUSSION AND ANALYSIS
DECEMBER 31, 2011

**TORONTO HYDRO CORPORATION**

**MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR THE YEAR ENDED
DECEMBER 31, 2011**

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## Forward-Looking Information

Toronto Hydro Corporation (the "Corporation") includes forward-looking information in its Management's Discussion and Analysis ("MD&A") within the meaning of applicable securities laws in Canada ("forward-looking information"). The purpose of the forward-looking information is to provide management's expectations regarding the Corporation's future results of operations, performance, business prospects and opportunities and may not be appropriate for other purposes. All forward-looking information is given pursuant to the "safe harbour" provisions of applicable Canadian securities legislation. The words "anticipates", "believes", "budgets", "could", "estimates", "expects", "forecasts", "intends", "may", "might", "plans", "projects", "schedule", "should", "will", "would" and similar expressions are often intended to identify forward-looking information, although not all forward-looking information contains these identifying words. The forward-looking information reflects management's current beliefs and is based on information currently available to the Corporation's management.

The forward-looking information in the MD&A includes, but is not limited to, statements regarding Toronto Hydro-Electric System Limited's ("LDC") distribution revenue, the outcome of outstanding rate applications and other proceedings before the Ontario Energy Board ("OEB"), the Corporation's plans to borrow funds to repay maturing debentures and to finance the investment in LDC's infrastructure, LDC's Conservation and Demand Management ("CDM") programs, the outcome of outstanding proceedings before the Ministry of Finance of Ontario ("Ministry of Finance"), the expected results of legal proceedings, market volatility on the Corporation's consolidated results of operations, performance, business prospects and opportunities, the effect of changes in interest rates on future revenue requirements, the Corporation's conversion to United States Generally Accepted Accounting Principles ("US GAAP") and the changes in accounting estimates. The statements that make up the forward-looking information are based on assumptions that include, but are not limited to, the future course of the economy and financial markets, the receipt of applicable regulatory approvals and requested rate orders, the receipt of favourable judgments, the level of interest rates, the Corporation's ability to borrow and the expected impact of the conversion to US GAAP on the Corporation's consolidated financial statements.

The forward-looking information is subject to risks, uncertainties and other factors that could cause actual results to differ materially from historical results or results anticipated by the forward-looking information. The factors which could cause results or events to differ from current expectations include, but are not limited to, market liquidity and the quality of the underlying assets and financial instruments, the timing and extent of changes in prevailing interest rates, inflation levels, legislative, judicial and regulatory developments that could affect revenues and the results of borrowing efforts.

All forward-looking information in the MD&A is qualified in its entirety by the above cautionary statements and, except as required by law, the Corporation undertakes no obligation to revise or update any forward-looking information as a result of new information, future events or otherwise after the date hereof.

## Introduction

The following MD&A should be read in conjunction with the audited consolidated financial statements and accompanying notes of the Corporation as at and for the year ended December 31, 2011 (the "Consolidated Financial Statements"). The Consolidated Financial Statements are prepared in accordance with Canadian Generally Accepted Accounting Principles ("GAAP"), including accounting principles prescribed by the OEB, and are presented in Canadian dollars (see "Significant Accounting Policies" below).

## Business of Toronto Hydro

The Corporation is a holding company which wholly-owns two subsidiaries:

- *LDC* - which distributes electricity and engages in CDM activities; and
- *Toronto Hydro Energy Services Inc. ("TH Energy")* - which provides street lighting services.

The principal business of the Corporation and its subsidiaries is the distribution of electricity by LDC. LDC owns and operates an electricity distribution system, which delivers electricity to approximately 709,000 customers located in the City of Toronto (the "City"). LDC is the largest municipal electricity distribution company in Canada and distributes approximately 18% of the electricity consumed in the Province of Ontario ("Ontario"). The business of LDC is regulated by the OEB which has broad powers relating to licensing, standards of conduct and service and the regulation of electricity distribution rates charged by LDC and other electricity distributors in Ontario. See note 2 to the Consolidated Financial Statements.

The sole shareholder of the Corporation is the City.

## Executive Summary

- Net income was $95.9 million in 2011 compared to $66.1 million in 2010;
- capital expenditures were $437.1 million in 2011 compared to $390.8 million in 2010, with the increase primarily related to reinforcing and maintaining the electricity distribution system of LDC;
- LDC was ordered to file its 2012 electricity distribution rate application using the incentive regulation mechanism framework;
- $300.0 million in 10-year senior unsecured debentures were issued primarily to repay the existing senior unsecured debentures which matured on December 30, 2011; and
- plans to commence reporting under US GAAP in its interim consolidated financial statements for the first quarter of 2012.

## Electricity Distribution – Industry Overview

In April 1999, the government of Ontario began restructuring Ontario's electricity industry. Under regulations passed pursuant to the restructuring, LDC and other electricity distributors have been purchasing their electricity from the wholesale market administered by the Independent Electricity System Operator ("IESO") and recovering the costs of electricity and certain other costs at a later date in accordance with procedures mandated by the OEB.

The OEB has regulatory oversight of electricity matters in Ontario. The *Ontario Energy Board Act, 1998* (Ontario) (the "OEB Act") sets out the OEB's authority to issue a distribution licence which must be obtained by owners or operators of an electricity distribution system in Ontario. The OEB prescribes licence requirements and conditions including, among other things, specified accounting records, regulatory accounting principles, separation of accounts for separate businesses and filing process requirements for rate-setting purposes.

The OEB's authority and responsibilities include the power to approve and fix rates for the transmission and distribution of electricity, the power to provide continued rate protection for rural and remote electricity customers and the responsibility for ensuring that electricity distribution companies fulfill their obligations to connect and service customers.

LDC is required to charge its customers for the following amounts (all of which, other than distribution charges, represent a pass through of amounts payable to third parties):

- *Distribution Charges* – Distribution charges are designed to recover the costs incurred by LDC in delivering electricity to customers and the OEB-allowed rate of return. Distribution charges are regulated by the OEB and are comprised of a fixed charge and a usage-based (consumption) charge. The volume of electricity consumed by LDC's customers during any period is governed by events largely outside LDC's control (principally, sustained periods of hot or cold weather which increase the consumption of electricity and sustained periods of moderate weather which decrease the consumption of electricity).

- *Electricity Price and Related Regulated Adjustments* – The electricity price and related regulated adjustments represent a pass through of the commodity cost of electricity.

- *Retail Transmission Rate* – The retail transmission rate represents a pass through of wholesale costs incurred by distributors in respect of the transmission of electricity from generating stations to local areas. Retail transmission rates are regulated by the OEB.

- *Wholesale Market Service Charge* – The wholesale market service charge represents a pass through of various wholesale market support costs. Retail rates for the recovery of wholesale market service charges are regulated by the OEB.

LDC is required to satisfy and maintain prudential requirements with the IESO, which include credit support with respect to outstanding market obligations in the form of letters of credit, cash deposits or guarantees from third parties with prescribed credit ratings.

The Corporation is exempt from tax under the *Income Tax Act* (Canada) ("ITA") if not less than 90% of the capital of the Corporation is owned by the City and not more than 10% of the income of the Corporation is derived from activities carried on outside the municipal geographical boundaries of the City. In addition, the Corporation's subsidiaries are also exempt from tax under the ITA provided that all of their capital is owned by the Corporation and not more than 10% of their respective income is from activities carried on outside the municipal geographical boundaries of the City. A corporation exempt from tax under the ITA is also exempt from tax under the *Taxation Act, 2007* (Ontario) ("TA") and the *Corporations Tax Act* (Ontario) ("CTA").

The Corporation and each of its subsidiaries are Municipal Electricity Utilities ("MEUs") for purposes of the Payment In Lieu of Corporate Taxes ("PILs") regime contained in the *Electricity Act, 1998* (Ontario) ("Electricity Act"). The Electricity Act provides that a MEU that is exempt from tax under the ITA, the CTA and the TA is required to make, for each taxation year, a PILs payment to the Ontario Electricity Financial Corporation in an amount equal to the tax that it would be liable to pay under the ITA and the TA (for years ending after 2008) or the CTA (for years ending prior to 2009) if it were not exempt from tax. The PILs regime came into effect on October 1, 2001, at which time the Corporation and each of its subsidiaries were deemed to have commenced a new taxation year for purposes of determining their respective liabilities for PILs payments.

The *Green Energy and Green Economy Act, 2009* (Ontario) (the "Green Energy Act") came into force on May 14, 2009. The Green Energy Act, among other things, permits electricity distribution companies to own renewable energy generation facilities, obligates electricity distribution companies to provide priority connection access for renewable energy generation facilities, empowers the OEB to set CDM targets for electricity distribution companies as a condition of license and requires electricity distribution companies to accommodate the development and implementation of a smart grid in relation to their systems.

**Selected Consolidated Financial Data**

The selected consolidated financial data presented below should be read in conjunction with the Consolidated Financial Statements.

| **Years ended December 31, (in thousands of dollars except for per share amounts)** | **2011 $** | **2010 $** | **Change $** | **Change %** | **2009 $** |
|---|---|---|---|---|---|
| Revenues | 2,809,258 | 2,611,671 | 197,587 | 7.6 | 2,457,923 |
| Costs | | | | | |
| Purchased power and other | 2,238,500 | 2,062,269 | 176,231 | 8.5 | 1,953,657 |
| Operating expenses | 243,547 | 223,326 | 20,221 | 9.1 | 208,834 |
| Depreciation and amortization | 151,022 | 169,408 | (18,386) | (10.9) | 162,970 |
| | 2,633,069 | 2,455,003 | 178,066 | 7.3 | 2,325,461 |
| Income before the following: | 176,189 | 156,668 | 19,521 | 12.5 | 132,462 |
| Net financing charges | (75,324) | (71,150) | (4,174) | (5.9) | (70,551) |
| Gain on disposals of property, plant and equipment (“PP&E”) | 3,885 | 3,767 | 118 | 3.1 | 1,013 |
| Change in fair value of investments | - | 2,420 | (2,420) | (100.0) | (1,049) |
| Income before provision for PILs | 104,750 | 91,705 | 13,045 | 14.2 | 61,875 |
| Provision for PILs | 8,818 | 25,580 | (16,762) | (65.5) | 19,742 |
| Net income | 95,932 | 66,125 | 29,807 | 45.1 | 42,133 |
| Basic and fully diluted net income per share | 95,932 | 66,125 | 29,807 | 45.1 | 42,133 |

| **As at December 31, (in thousands of dollars)** | **2011 $** | **2010 $** |
|---|---|---|
| **Consolidated Balance Sheet Data** | | |
| Total assets | 3,455,777 | 3,338,614 |
| Current liabilities | 448,061 | 639,751 |
| Long-term liabilities | 1,905,468 | 1,659,484 |
| Total liabilities | 2,353,529 | 2,299,235 |
| Shareholder’s equity | 1,102,248 | 1,039,379 |
| Total liabilities and shareholder’s equity | 3,455,777 | 3,338,614 |

## Results of Operations – 2011 compared to 2010

### *Net Income*

Net income was $95.9 million in 2011 compared to $66.1 million in 2010. The increase in net income was primarily due to higher net revenues ($21.4 million), lower depreciation expense ($18.4 million) and lower provision for PILs ($16.8 million). These favourable variances were partially offset by higher operating expenses ($20.2 million), higher net financing charges ($4.2 million) and a gain recognized in 2010 in relation with the disposition of the Corporation's long-term investments ($2.4 million).

### *Net Revenues*

Net revenues were $570.8 million in 2011 compared to $549.4 million in 2010 (see "Non-GAAP Financial Measures" below). The increase in net revenues was primarily due to higher regulated distribution revenue at LDC ($26.1 million) partially offset by lower other income ($4.7 million). The increase in distribution revenue was primarily due to the approval by the OEB of a higher revenue requirement balance ($23.6 million) for 2011 to fund LDC's infrastructure modernization program, workforce renewal initiative and incremental maintenance costs (see "Corporate Developments – Distribution Rates for LDC" below). The decrease in other income was primarily due to lower margins in connection with Ontario Power Authority ("OPA") programs and lower late payment charges billed to customers in 2011.

### *Expenses*

Operating expenses were $243.5 million in 2011 compared to $223.3 million in 2010. The increase in operating expenses was primarily due to higher operating labour costs resulting from changes in accounting estimates related to burden rates (see "Changes in Accounting Estimates – Property, Plant and Equipment" below) and higher overall compensation costs due to annual general increase in wages and related benefits ($29.6 million), and higher accounting conversion costs following the decision by the OEB to disallow the recovery of a portion of the costs incurred by the Corporation for its initially planned conversion to International Financial Reporting Standards ("IFRS") as it appeared that such costs were included in prior period electricity distribution rates ($3.0 million). These variances were partially offset by the recognition in 2010 of costs relating to the expected settlement of a class action against LDC ($6.0 million) (see "Legal Proceedings – Christian Helm Class Action" below), the recognition in 2010 of a special charge related to the disallowance by the OEB of a portion of the costs related to the contact voltage remediation activities ($3.8 million) (see "Corporate Developments – Contact Voltage" below) and lower Ontario capital tax expense in 2011 following the elimination of such tax in the second quarter of 2010 ($2.2 million).

Depreciation and amortization expense was $151.0 million in 2011 compared to $169.4 million in 2010. The decrease in depreciation and amortization expense was primarily due to changes in accounting estimates related to useful lives of certain items of PP&E (see "Changes in Accounting Estimates – Property, Plant and Equipment" below). This decrease was partially offset by an increase in depreciation related to the renewal of the regulated electricity distribution infrastructure of LDC. Over the past few years, LDC significantly increased its capital expenditures following the approval by the OEB of higher capital programs aimed at modernizing the electricity infrastructure of LDC (see "Liquidity and Capital Resources – Net Cash Used in Investing Activities" below).

### *Net Financing Charges*

Net financing charges were $75.3 million in 2011 compared to $71.2 million in 2010. The increase in net financing charges was primarily due to higher long-term financing charges from the issuance of senior unsecured debentures in 2011 (see "Corporate Developments – Medium-Term Note Program" below).

### *Gain on Disposals of PP&E*

Gain on disposals of PP&E was $3.9 million in 2011 compared to $3.8 million in 2010. The increase in gain on disposals of PP&E was primarily due to the recognition of gains realized in connection with the disposals of surplus properties at LDC. During 2011, LDC recognized $3.9 million in gain on disposals of surplus properties, of which $1.4 million relates to surplus properties for which the OEB reduced electricity distribution rates in 2010. LDC began recognizing the actual gain realized on the sale of these properties over a one-year period from May 1, 2010 to mirror the actual timing of the reduction in 2010 electricity distribution rates.

*Change in Fair Value of Investments*

On October 8, 2010, the Corporation sold all of its long-term investments for cash consideration of $50.4 million. In connection with these investments, the Corporation recognized a gain of $2.4 million in the consolidated statement of income for the year ended December 31, 2010.

*Provision for PILs*

Provision for PILs was $8.8 million in 2011 compared to $25.6 million in 2010. The decrease in the provision for PILs was primarily due to higher deductions for permanent and temporary differences between accounting and tax treatments mainly related to depreciation and capital cost allowance ($18.5 million) and recoveries resulting from favourable resolution of Ministry of Finance PILs audits of LDC for the 2005 and 2006 taxation years ($2.0 million). The decrease in the provision for PILs was partially offset by the effect of higher income in 2011 ($3.7 million).

**Results of Operations – 2010 compared to 2009**

Net income was $66.1 million in 2010 compared to $42.1 million in 2009. The increase in net income was primarily due to higher net revenues ($45.1 million), a favourable variance in the fair value of investments ($3.5 million) and a higher gain on disposals of surplus PP&E ($2.8 million). These favourable variances were partially offset by higher operating expenses ($14.5 million), higher depreciation expense ($6.4 million) and higher provision for PILs ($5.8 million). For further details, see the Corporation's 2010 MD&A as filed on the System for Electronic Document Analysis and Retrieval ("SEDAR") website at www.sedar.com.

**Summary of Quarterly Results**

The tables below present unaudited quarterly consolidated financial information of the Corporation for 2011 and 2010.

| 2011 Quarter Ended, (in thousands of dollars) | December 31 $ | September 30 $ | June 30 $ | March 31 $ |
|---|---|---|---|---|
| Revenues ................................................ | 689,624 | 734,505 | 683,787 | 701,342 |
| Costs ...................................................... | 648,713 | 683,433 | 643,303 | 657,620 |
| Net income............................................. | 17,228 | 28,982 | 24,270 | 25,452 |

| 2010 Quarter Ended, (in thousands of dollars) | December 31 $ | September 30 $ | June 30 $ | March 31 $ |
|---|---|---|---|---|
| Revenues ................................................ | 656,649 | 680,504 | 627,707 | 646,811 |
| Costs ...................................................... | 621,179 | 631,807 | 588,828 | 613,189 |
| Net income............................................. | 10,048 | 27,687 | 15,839 | 12,551 |

The Corporation's quarterly results are impacted by changes in revenues resulting from variations in seasonal weather conditions, the fluctuations in electricity prices, and the timing and recognition of regulatory decisions. The Corporation's revenues tend to be higher in the first and third quarters of a year as a result of higher energy consumption for winter heating in the first quarter and air conditioning and cooling in the third quarter.

**Financial Position**

The following table outlines the significant changes in the consolidated balance sheets between 2011 and 2010.

**Consolidated Balance Sheet Data**
**As at December 31, 2011 compared to December 31, 2010**
**(in thousands of dollars)**

| Balance Sheet Account | Increase (Decrease) $ | Explanation of Significant Change |
|---|---|---|
| Cash and cash equivalents | (175,895) | See "Liquidity and Capital Resources" below. |
| Investments | 34,002 | The increase in investments is due to the investment in two floating rate notes in the amounts of $25.0 million and $9.0 million, the first maturing on October 22, 2012 and the second maturing on February 17, 2012, which are guaranteed by a Canadian Schedule I bank. |
| Accounts receivable, net of allowance for doubtful accounts | 14,284 | The increase in accounts receivable is primarily due to the timing of the Ontario Clean Energy Benefit Rebate from the IESO, which did not exist in 2010 and the timing of billing and collection activities from large customers. |
| Unbilled revenue | (25,835) | The decrease in unbilled revenue is primarily due to lower consumption in December 2011 compared to December 2010 and lower energy prices compared to the previous year. |
| PP&E and intangible assets, net | 297,706 | The increase in PP&E and intangible assets is primarily due to capital expenditures ($437.1 million) offset by depreciation during the year ($151.0 million). |
| Regulatory assets | (7,791) | The decrease in regulatory assets is primarily due to the on-going recoveries of charges from customers, partially offset by increases in the retail settlement balances regulated by the OEB. |
| Future income tax assets | (23,533) | The decrease in future income tax assets is primarily due to a decrease in the net deductible temporary differences between tax and accounting values of PP&E. |
| Accounts payable and accrued liabilities | 38,869 | The increase in accounts payable and accrued liabilities is mainly due to timing differences in the settlement of trade payables and consumption and price variances related to electricity payable to the IESO. |

| Consolidated Balance Sheet Data<br>As at December 31, 2011 compared to December 31, 2010<br>(in thousands of dollars) | | |
|---|---|---|
| **Balance Sheet Account** | **Increase (Decrease) $** | **Explanation of Significant Change** |
| Deferred revenue .................................. | 11,941 | The increase in deferred revenue is primarily due to a significant balance received in advance from the OPA relating to CDM programs for 2011. |
| Debentures............................................ | 53,677 | The increase in debentures is primarily due to the issuance of $300.0 million senior unsecured debentures (see "Corporate Developments – Medium-Term Note Program" below), which is partially offset by the repayment of the Corporation's outstanding $245.1 million senior unsecured debentures which matured on December 30, 2011. |
| Post-employment benefits .................... | 9,644 | The increase in post-employment benefits is primarily due to higher defined benefit costs. |
| Regulatory liabilities ............................ | (63,426) | The decrease in regulatory liabilities is primarily due to the net disposition of retail settlement balances to customers approved by the OEB and a reduction of future income tax assets payable to customers. |
| Other liabilities ..................................... | 10,667 | The increase in other liabilities is primarily due to a capital lease obligation for contact voltage equipment. |
| Customers' advance deposits ............... | (9,532) | The decrease in customers' advance deposits is primarily due to the reimbursement of customer deposits during the period in compliance with OEB rules and regulations. |
| Retained earnings ................................ | 62,869 | The increase in retained earnings is due to net income ($95.9 million) offset by dividends paid ($33.1 million). |

**Liquidity and Capital Resources**

***Sources of Liquidity and Capital Resources***

The Corporation's primary sources of liquidity and capital resources are cash provided by operating activities, bank financing, interest income and borrowings from debt capital markets. The Corporation's liquidity and capital resource requirements are mainly for capital expenditures to maintain and improve the electricity distribution system of LDC, purchased power expense, net financing charges and prudential requirements.

The Corporation does not believe that equity contributions from the City, its sole shareholder, will constitute a source of capital.

| Liquidity and Capital Resources<br>Year Ended December 31,<br>(in thousands of dollars) | | |
|---|---|---|
| | **2011**<br>**$** | **2010**<br>**$** |
| Cash and cash equivalents, beginning of year | 330,151 | 211,370 |
| Net cash provided by operating activities | 310,348 | 280,318 |
| Net cash used in investing activities | (497,859) | (347,584) |
| Net cash provided by financing activities | 11,616 | 186,047 |
| Cash and cash equivalents, end of year | 154,256 | 330,151 |

***Net Cash Provided by Operating Activities***

Net cash provided by operating activities was $310.3 million in 2011 compared to $280.3 million in 2010. The increase in net cash provided by operating activities was primarily due to higher net income ($29.8 million), a variance in the aggregate amount of accounts receivable and unbilled revenue due to the timing of billing and collection activities ($22.0 million) and an increase in deferred revenue relating to a significant balance received in advance from the OPA for CDM programs in 2011 ($13.7 million). These variances were partially offset by a decrease in depreciation and amortization ($18.4 million), a variance in PILs receivable ($13.8 million) and a decrease in net change in other assets and liabilities ($6.4 million).

***Net Cash Used in Investing Activities***

Net cash used in investing activities was $497.9 million in 2011 compared to $347.6 million in 2010. The increase in net cash used in investing activities was primarily due to the net proceeds received in 2010 in connection with the sale of long-term investments ($50.4 million), the net impact of investing excess cash in low-risk floating rate notes ($34.0 million), higher capital expenditures in 2011 ($46.3 million), a higher change in net regulatory assets and liabilities ($15.7 million) primarily related to a higher variance in 2011 of retail settlement balances regulated by the OEB and the impact of the net proceeds received in 2011 on the disposition of surplus properties ($3.9 million).

The increase in regulated capital expenditures at LDC for the year ended December 31, 2011 amounted to $46.3 million. This increase was primarily due to transformer stations ($25.2 million), metering ($10.6 million), customer connections ($9.5 million), and feeders ($2.3 million). These increases were partially offset by a decrease in distribution lines ($4.4 million).

The following table summarizes the Corporation's capital expenditures for the years indicated.

| Capital Expenditures Year Ended December 31, (in thousands of dollars) | 2011 $ | 2010 $ |
|---|---|---|
| LDC | | |
| Distribution system | 361,851 | 311,781 |
| Technology assets | 33,193 | 39,556 |
| Other [1] | 36,139 | 33,575 |
| | 431,183 | 384,912 |
| Other [2] | 5,884 | 5,872 |
| Total Capital Expenditures | 437,067 | 390,784 |

Notes:

(1) Consists of leasehold improvements, vehicles, other work-related equipment, furniture and office equipment.
(2) Includes unregulated capital expenditures primarily related to TH Energy.

The increase in capital expenditures was primarily related to higher investment in electricity distribution assets in connection with LDC's infrastructure renewal program approved by the OEB. For 2011, the OEB approved $378.8 million in regulated capital expenditures for LDC in comparison to $350.0 million for 2010. It should be noted that when considering the changes in accounting estimates implemented prospectively by the Corporation in 2011 (see "Changes in Accounting Estimates – Property, Plant and Equipment" below), the OEB effectively approved an increase of $51.0 million in LDC's regulated capital programs for 2011.

The three most significant capital expenditures incurred by LDC in the current year were related to reinforcing and maintaining the electricity distribution system, primarily by replacing aging assets in order to maintain long-term reliability ($256.6 million in 2011 compared to $246.5 million in 2010), upgrading and investing in new stations to improve supply reliability in the downtown area and to provide capacity for load growth within this area ($32.5 million in 2011 compared to $7.0 million in 2010), and net expenditures related to customer connections primarily due to growth in the condominium market, particularly in the downtown core of the City ($28.4 million in 2011 compared to $18.9 million in 2010).

***Net Cash Provided by Financing Activities***

Net cash provided by financing activities was $11.6 million in 2011 compared to $186.0 million in 2010. The decrease in net cash provided by financing activities was primarily due to the issuance of $200.0 million of senior unsecured debentures to finance the renewal of LDC's electricity infrastructure in 2010, higher reimbursement of customer deposits in 2011 in compliance with OEB rules and regulations ($20.8 million), and a higher dividend paid with respect to net income for the year ended December 31, 2010, which was paid to the City on March 18, 2011 ($8.1 million). The decrease in net cash provided by financing activities was partially offset by the net effect of the net proceeds received in connection with the issuance of $300.0 million of senior unsecured debentures in 2011 and the repayment of $245.1 million of senior unsecured debentures ($54.9 million).

*Summary of Contractual Obligations*

The following table presents a summary of the Corporation's debentures, major contractual obligations and other commitments.

**Summary of Contractual Obligations and Other Commitments**
**As at December 31, 2011**
**(in thousands of dollars)**

| | Total $ | 2012 $ | 2013/2014 $ | 2015/2016 $ | After 2016 $ |
|---|---|---|---|---|---|
| Debentures – principal repayment... | 1,470,057 | – | 470,057 | – | 1,000,000 |
| Debentures – interest payments....... | 631,758 | 74,905 | 105,960 | 91,600 | 359,293 |
| Operating lease obligations and future commitments........................ | 76,199 | 27,715 | 30,934 | 12,795 | 4,755 |
| Capital lease obligations ….............. | 15,277 | 2,454 | 4,849 | 4,594 | 3,380 |
| Asset retirement obligations........... | 5,811 | 1,320 | 511 | 238 | 3,742 |
| Total contractual obligations and other commitments…..................... | 2,199,102 | 106,394 | 612,311 | 109,227 | 1,371,170 |

*Revolving Credit Facility*

The Corporation is a party to a revolving credit facility pursuant to which the Corporation may borrow up to $400.0 million, of which up to $140.0 million is available in the form of letters of credit. Additionally, the Corporation is a party to a bilateral facility for $50.0 million for the purpose of issuing letters of credit mainly to support LDC's prudential requirements with the IESO.

On May 3, 2011, the Corporation extended its revolving credit facility for an additional term, expiring on May 3, 2013. The extension maintained the level of credit available at $400.0 million.

As at December 31, 2011, no amounts had been drawn under the Corporation's revolving credit facility and $45.1 million had been drawn on the bilateral facility.

*Prudential Requirements and Third Party Credit Support*

The City has authorized the Corporation to provide financial assistance to its subsidiaries, and LDC to provide financial assistance to other subsidiaries of the Corporation, in the form of letters of credit and guarantees, for the purpose of enabling them to carry on their businesses up to an aggregate amount of $500.0 million.

**Dividends**

The shareholder direction adopted by the City with respect to the Corporation provides that the board of directors of the Corporation will use its best efforts to ensure that the Corporation meets certain financial performance standards, including those relating to the credit rating and dividends. Subject to applicable law, the shareholder direction provides that the Corporation will pay dividends to the City each year amounting to the greater of $25.0 million or 50% of the Corporation's consolidated net income for the year. The dividends are not cumulative and are payable as follows:

- $6.0 million on the last day of each of the first three fiscal quarters during the year;
- $7.0 million on the last day of the fiscal year; and
- the amount, if any, by which 50% of the Corporation's annual consolidated net income for the year exceeds $25.0 million, within ten days after the board of directors of the Corporation approved the Corporation's audited Consolidated Financial Statements for the year.

The board of directors of the Corporation declared and paid dividends totalling $33.1 million in 2011 and $25.0 million in 2010 to the City.

On March 2, 2012, the board of directors of the Corporation declared dividends in the amount of $29.0 million. The dividends are comprised of $23.0 million with respect to net income for the year ended December 31, 2011, payable to the City on March 12, 2012, and $6.0 million with respect to the first quarter of 2012, payable to the City on March 30, 2012.

**Credit Rating**

The Corporation and the debentures issued under its medium-term note program were rated as follows:

| Credit Ratings<br>As at December 31, | |
|---|---|
| | **2011** |
| DBRS Limited | A (high) |
| Standard & Poor's ("S&P") | A |

**Corporate Developments**

***Distribution Rates for LDC***

Regulatory developments in Ontario's electricity industry, including current and possible future consultations between the OEB and interested stakeholders, may affect LDC's electricity distribution rates and other permitted recoveries in the future.

LDC's electricity distribution rates are typically effective from May 1 to April 30 of the following year. Accordingly, LDC's distribution revenue for the first four months of 2011 was based on the electricity distribution rates approved for the May 1, 2010 to April 30, 2011 rate year (the "2010 Rate Year"), and the distribution revenue for the remainder of 2011 and for the first four months of 2012 are and will be based on electricity distribution rates approved for the May 1, 2011 to April 30, 2012 rate year (the "2011 Rate Year").

LDC's electricity distribution rates for the 2010 Rate Year and the 2011 Rate Year were determined through an application under the cost of service framework. The cost of service framework sets electricity distribution rates using a detailed examination of evidence and an assessment of the costs incurred by an electricity distributor to provide its service to its customers.

On April 9, 2010, the OEB issued its decision regarding LDC's electricity distribution rates for the 2010 Rate Year. The decision provided for a distribution revenue requirement and rate base of $518.7 million and $2,140.7 million, respectively. In addition, the decision provided for capital program spending levels and operating, maintenance and administration spending levels of $350.0 million and $204.1 million, respectively.

On July 7, 2011, the OEB issued its decision regarding LDC's electricity distribution rates for the 2011 Rate Year. The decision provided for a distribution revenue requirement and rate base of $522.0 million and $2,298.2 million, respectively. In addition, the decision provided for capital program spending levels and operating, maintenance and administration spending levels of $378.8 million and $238.0 million, respectively.

On August 26, 2011, LDC filed a rate application, following the cost of service framework, with the OEB seeking approval of separate and successive revenue requirements and corresponding electricity distribution rates for three rate years commencing on May 1, 2012, May 1, 2013 and May 1, 2014 (the "2012-2014 Rate Application"). The requested distribution revenue requirements for these rate years were $571.4 million, $639.5 million, and $712.8 million, respectively, and the expected rate bases for these rate years were $2,636.3 million, $3,053.5 million, and $3,503.2 million, respectively.

Pursuant to the incentive regulation mechanism framework, the OEB established, as a preliminary issue in the 2012-2014 Rate Application, that it would consider the question of whether the application filed by LDC was acceptable or whether it should be dismissed. In particular, the OEB established that in order for it to find that LDC's 2012-2014 Rate Application was acceptable, LDC would be required to show why and how LDC cannot adequately manage its resources and financial needs under the incentive regulation mechanism framework. The incentive regulation mechanism framework provides for an annual adjustment to an electricity distributor's rates based on a formulaic calculation with no direct examination of evidence regarding the electricity distributor's actual costs and infrastructure needs.

LDC filed evidence supporting its position for electricity distribution rates to be set under the cost of service framework as part of its 2012-2014 Rate Application. In particular, LDC provided evidence that it cannot adequately manage its resources and financial needs under the incentive regulation mechanism framework. The OEB established a process by which a portion of LDC's evidence was tested during an oral hearing held in November 2011.

On January 5, 2012, the OEB rendered its decision on the preliminary issue and dismissed LDC's cost of service 2012-2014 Rate Application. In its decision, the OEB found that LDC was not permitted to deviate from the standard incentive regulation mechanism framework cycle, and LDC will therefore be required to file its request for electricity distribution rates commencing on May 1, 2012 pursuant to the formulaic adjustment and the incremental capital module provided for under the incentive regulation mechanism framework.

On January 25, 2012, LDC filed with the OEB a motion to review the OEB's January 5, 2012 decision.

On February 6, 2012, LDC filed a notice of appeal with the Ontario Divisional Court regarding the OEB's January 5, 2012 decision.

Pursuant to the OEB's decision of January 5, 2012, LDC is currently preparing an application for electricity distribution rates using the incentive regulation mechanism framework, including the filing of an incremental capital module. The quantum of this application is consistent with the capital program spending levels previously approved by the OEB for the 2011 Rate Year.

Under the incentive regulation mechanism framework, LDC has to significantly reduce its costs structure, and in particular its operating expenses, in order to meet its financial obligations. Accordingly, in the first quarter of 2012, LDC began implementing a restructuring program aimed at reducing its operating costs in the future. The main component of this restructuring program is a workforce reduction plan targeting both union and management employees. As at March 2, 2012, the costs incurred as a result of the restructuring program amounted to approximately $19.3 million, which were mainly related to employee severance and buy-out costs.

The Corporation continues to assess all of the impacts related to the imposition by the OEB of the incentive regulation mechanism framework, which impacts may include additional restructuring costs. The incremental restructuring costs could have a material impact on the Corporation's consolidated financial statements in the future.

***Street Lighting Activities***

On June 15, 2009, the Corporation filed an application with the OEB seeking an electricity distribution licence for a new wholly-owned legal entity to which the Corporation intended to transfer the street lighting assets of TH Energy. Concurrently, the Corporation filed another application with the OEB seeking approval for the merger of LDC and the new legal entity. The main objective of these applications was to transfer the street lighting assets to the regulated electricity distribution activities of LDC to increase the overall safety of the related infrastructure.

On February 11, 2010, the OEB issued its decision in regard to these applications. In its decision, the OEB agreed that, under certain conditions, the treatment of certain types of street lighting assets as regulated assets is justified. The OEB ordered the Corporation to provide a detailed valuation of the street lighting assets and to perform an operational review to determine which street lighting assets could become regulated assets. The Corporation performed a detailed asset operational review and financial valuation of the street lighting assets, which was submitted to the OEB on January 31, 2011.

On August 3, 2011, the OEB issued its final decision allowing the transfer of a portion of the street lighting assets to the new wholly-owned legal entity, and for LDC to amalgamate with the new legal entity.

On January 1, 2012, the Corporation completed the transfer of street lighting assets to LDC for a purchase price of $28.5 million, subject to post closing adjustment and transaction costs.

***Medium-Term Note Program***

On November 18, 2011, the Corporation issued $300.0 million in 10-year senior unsecured debentures ("Series 7") which bear interest at the rate of 3.54% per annum and are payable semi-annually in arrears in equal instalments on May 18 and November 18 of each year. The Series 7 debentures mature on November 18, 2021 and contain covenants which, subject to certain exceptions, restrict the ability of the Corporation and LDC to create security interests, incur additional indebtedness or dispose of all or substantially all of their assets. The net proceeds from this issuance were used to repay the $245.1 million senior unsecured debentures of the Corporation which matured on December 30, 2011 and the balance is expected to be used for general corporate purposes.

***CDM Activities***

On March 31, 2010, the Minister of Energy and Infrastructure of Ontario, under the guidance of sections 27.1 and 27.2 of the OEB Act, directed the OEB to establish CDM targets to be met by electricity distributors. Accordingly, on November 12, 2010, the OEB amended LDC's distribution licence to require LDC, as a condition of its licence, to achieve 1,304 Gigawatt-Hours of energy savings and 286 Megawatts of summer peak demand savings, over the period beginning January 1, 2011 through December 31, 2014.

Effective January 1, 2011, LDC entered into an agreement with the OPA to deliver CDM programs in the amount of approximately $50.0 million extending from January 1, 2011 to December 31, 2014 (the "Master CDM Program Agreement"). As at December 31, 2011, LDC received approximately $19.9 million from the OPA for the delivery of CDM programs under the Master CDM Program Agreement. All programs to be delivered under the Master CDM Program Agreement are fully funded and paid in advance by the OPA. These programs are expected to support the achievement of the mandatory CDM targets described above.

On January 10, 2011, LDC filed an application with the OEB seeking an order granting approval of funding for CDM programs specific to its customer base. LDC requested funding for eight specific CDM programs amounting to $50.7 million. On July 12, 2011, the OEB issued its decision regarding the CDM programs of LDC. In its decision, the OEB approved with modifications two of the eight programs for a total funding of $5.3 million. The modifications directed by the OEB included changes to the term and nature of those two programs. The OEB did not approve the other six programs as it considered them to be duplicative of existing CDM programs already funded by the OPA.

On August 3, 2011, LDC filed a letter with the OEB informing them that, due to the modified terms and nature of the two approved programs, LDC's revised economic assessment showed these two programs to be uneconomic, and that they would not be implemented. Accordingly, LDC expects to continue to work with the OPA to expand the roster of current CDM programs in order to achieve its mandated CDM targets.

***Special Purpose Charge***

On April 9, 2010, the OEB informed electricity distributors of a Special Purpose Charge ("SPC") assessment under Section 26.1 of the OEB Act, for the Ministry of Energy and Infrastructure conservation and renewable energy program costs. The OEB assessed LDC the amount of $9.7 million for its apportioned share of the total provincial amount of the SPC of $53.7 million in accordance with the rules set out in Ontario Regulation 66/10 (the "SPC Regulation"). In accordance with Section 9 of the SPC Regulation, LDC was allowed to recover this balance. The recovery was completed as at April 30, 2011.

***Contact Voltage***

On December 10, 2009, the OEB issued an initial decision in regard to the costs incurred in 2009 for the remediation of safety issues related to contact voltage relating to LDC's electricity distribution infrastructure. The decision provided for the recovery of allowable actual expenditures incurred above the amount deemed as controllable expenses in LDC's 2009 approved electricity distribution rates. At the time of the decision, the Corporation estimated the allowable recovery of costs at $9.1 million.

On October 29, 2010, the OEB issued a second decision in the matter, following further review of costs incurred by LDC. In this decision, the OEB deemed the balance allowable for recovery at $5.3 million. The variance from the Corporation's original estimate is mainly due to the OEB's interpretation of the definition of controllable expenses used to determine the final allowable recovery. In connection with this decision from the OEB, the Corporation revised its recovery estimate for contact voltage costs, resulting in an increase in operating expenses of $3.8 million in 2010. On November 18, 2010, LDC filed a motion to review the decision with the OEB seeking an amendment to allow for recovery in accordance with the initial decision rendered on December 10, 2009. On March 25, 2011, the OEB issued its decision on the LDC motion, denying the requested additional recovery.

***OEB PILs Proceeding***

The OEB conducted a review of the PILs variances accumulated in regulatory variance accounts for the period from October 1, 2001 to April 30, 2006 for certain MEUs. On June 24, 2011, the OEB issued its decision for these MEUs and provided guidelines for the calculation and further disposition of the balances accumulated in the PILs regulatory variance accounts.

LDC has reviewed the balances of its PILs regulatory variance accounts and applied the guidelines provided by the OEB. As at December 31, 2011, LDC estimated its liability at approximately $2.8 million. This balance has been recorded in the Corporation's Consolidated Financial Statements. LDC intends to apply for disposition of this balance in 2012. The amount to be approved by the OEB will be based on the OEB's interpretation and application of its guidelines and the final balance which is yet to be approved by the OEB could differ materially from LDC's estimation of its liability.

***Payments in Lieu of Additional Municipal and School Taxes***

The Ministry of Finance has issued assessments in respect of payments in lieu of additional municipal and school taxes under section 92 of the Electricity Act that are in excess of the amounts LDC believes are payable. The dispute arose as a result of inaccurate information incorporated into Ontario Regulation 224/00. The Corporation has worked with the Ministry of Finance to resolve this issue, and as a result the Ministry of Finance issued Ontario Regulation 423/11 on August 31, 2011. The new regulation revoked Ontario Regulation 224/00 and corrected inaccurate information retroactively to 1999.

The balance assessed by the Ministry of Finance on its most recent statement of account amounts to approximately $10.0 million above the balance accrued by the Corporation. While the Corporation expects that reassessments will be issued as a consequence of the change in regulation, there can be no assurance that the Corporation will not have to pay the full assessed balance in the future.

***Customer Care and Billing System***

On July 6, 2011, LDC implemented a new customer care and billing system for its regulated electricity distribution business. The new system allows for more flexibility for its users and provides better information for the calculation of accounting estimates related to revenue recognition. The system provides an integrated billing platform leveraging the technology of the smart meters installed over the past few years.

***Changes to the Corporation's Board of Directors***

On March 31, 2010, the City, as the sole shareholder of the Corporation, appointed David Williams as an independent director of the Corporation. His appointment is effective to November 30, 2012.

On December 7, 2010, the City, as the sole shareholder of the Corporation, appointed three new councillors, Shelley Carroll, Josh Colle, and Ron Moeser as the City's designates on the board of directors of the Corporation to replace Joe Pantalone, Gordon Perks and Bill Saundercook. Their appointments are effective to November 30, 2012.

Effective December 2, 2010, William Rupert resigned as an independent director of the Corporation.

## Legal Proceedings

In the ordinary course of business, the Corporation is subject to various litigation and claims with customers, suppliers, former employees and other parties. On an ongoing basis, the Corporation assesses the likelihood of any adverse judgments or outcomes as well as potential ranges of probable costs and losses. A determination of the provision required, if any, for these contingencies is made after analysis of each individual issue. The provision may change in the future due to new developments in each matter or changes in approach, such as a change in settlement strategy.

### *Christian Helm Class Action*

On December 6, 2010, a statement of claim in a proposed class action was issued against LDC. The claim seeks general and special damages in the amount of $100.0 million for disgorgement of unjust gains allegedly resulting from the receipt of interest on overdue accounts at a rate exceeding 5% per annum in contravention of the *Interest Act* (Canada) ("Interest Act"). A statement of defence has been filed. Prior to any certification of the action as a class proceeding, cross summary judgment motions were heard in June 2011 to determine whether the Interest Act has been breached. On February 1, 2012, prior to the release of the decisions on the summary judgment motions, the parties reached a settlement of the matter, which settlement now requires court approval. The Settlement Approval Hearing is scheduled for April 30, 2012. If the settlement receives court approval, damages and costs of approximately $6.0 million shall be paid by LDC. In 2010, the Corporation accrued a liability to cover the expected settlement.

If the settlement does not receive court approval, the decision on the cross summary judgment motions will be released. In this event, if the court finds a breach of the Interest Act, subject to appeals, the proceeding will continue, and LDC will rely on other defences. While LDC believes it has a defence to this claim, there is no guarantee that it will be successful in defending the action and therefore, the outcome of this proceeding could have a material impact on the Corporation's consolidated financial statements and results of operations.

### *2 Secord Avenue*

An action was commenced against LDC in September 2008 in the Ontario Superior Court of Justice under the *Class Proceedings Act, 1992* (Ontario) ("Class Proceedings Act") seeking damages in the amount of $30.0 million as compensation for damages allegedly suffered as a result of a fire and explosion in an underground vault at 2 Secord Avenue on July 20, 2008. This action is at a preliminary stage. The statement of claim has been served on LDC, a statement of defence and third party claim have been served by LDC and a third party defence and counterclaim against LDC seeking damages in the amount of $51.0 million have been filed. A certification order has been issued. Affidavits of documents have been produced by LDC to the other parties and examinations for discovery have commenced and are continuing. Given the preliminary status of this action, it is not possible to reasonably quantify the effect, if any, of this action on the financial performance of the Corporation. If damages were awarded, LDC would make a claim under its liability insurance which the Corporation believes would cover any damages which may become payable by LDC in connection with the action.

On December 20, 2010, LDC was served with a statement of claim by the City seeking damages in the amount of $2.0 million as a result of the fire at 2 Secord Avenue. A statement of defence and third party claim have been served. Given the preliminary status of this action, it is not possible to reasonably quantify the effect, if any, of this action on the financial performance of the Corporation. If damages were awarded, LDC would make a claim under its liability insurance which the Corporation believes would cover any damages which may become payable by LDC in connection with the action.

By order of the court, the above actions and a smaller non-class action commenced in April 2009 involving the same incident will be tried at the same time or consecutively.

### *2369 Lakeshore Boulevard West*

A third party action was commenced against LDC in October 2009 in the Ontario Superior Court of Justice under the Class Proceedings Act seeking damages in the amount of $30.0 million as compensation for damages allegedly suffered as a result of a fire in the electrical room at 2369 Lakeshore Boulevard West on March 19, 2009. Subsequently, in March 2010, the plaintiff in the main action amended its statement of claim to add LDC as a defendant. The plaintiff in the main action seeks damages in the amount of $10.0 million from LDC. Both actions are at a preliminary stage and the certification hearing is scheduled for September 2012. Statements of defence to the main action and to the third party claim have not been filed. Accordingly, given the preliminary status of these actions, it is not possible at this time to reasonably quantify the effect, if any, of these actions on the financial performance of the Corporation. If damages were awarded, LDC would make a claim under its liability insurance which the Corporation believes would cover any damages which may become payable by LDC in connection with these actions.

Another third party action was commenced against LDC in October 2009 in the Ontario Superior Court of Justice seeking damages in the amount of $30.0 million as compensation for damages allegedly suffered as a result of the fire at 2369 Lakeshore Boulevard West. Subsequently, in March 2010, the plaintiff in the main action amended its statement of claim to add LDC as a defendant. The plaintiff in the main action seeks damages in the amount of $0.4 million from LDC. LDC has filed a statement of defence, crossclaim and counterclaim. Examinations for discovery have not taken place but are to be completed by February 29, 2012 pursuant to a court ordered timetable. Accordingly, given the preliminary status of these actions, it is not possible at this time to reasonably quantify the effect, if any, of these actions on the financial performance of the Corporation. If damages were awarded, LDC would make a claim under its liability insurance which the Corporation believes would cover any damages which may become payable by LDC in connection with these actions.

On August 29, 2011, LDC was served with a statement of claim by the owner of the building and the property management company for the building seeking damages in the amount of $2.0 million as a result of the fire at 2369 Lakeshore Boulevard West. LDC has filed a statement of defence and counterclaim. Given the preliminary status of this action, it is not possible to reasonably quantify the effect, if any, of this action on the financial performance of the Corporation. If damages were awarded, LDC would make a claim under its liability insurance which the Corporation believes would cover any damages which may become payable by LDC in connection with the action.

***Adamopoulos***

An action was commenced against LDC in November 2004 in the Ontario Superior Court of Justice seeking damages in the amount of $7.8 million as compensation for damages allegedly suffered as a result of a motor vehicle accident involving an LDC vehicle on January 9, 2001. The plaintiff's motion increasing its claim for damages to $23.8 million was granted on July 7, 2010. This matter has been settled and a court order has been issued dismissing the action and all related claims by payment of a total amount of approximately $4.6 million. LDC's liability insurance covered the settlement amount.

## Share Capital

The authorized share capital of the Corporation consists of an unlimited number of common shares of which 1,000 common shares are issued and outstanding as at the date hereof.

## Transactions with Related Parties

The City is the sole shareholder of the Corporation. Subsidiaries of the Corporation provide certain services to the City at commercial and regulated rates, including electricity, street lighting and energy management services. All transactions with the City are conducted at prevailing market prices and normal trade terms. Additional information with respect to related party transactions between the Corporation and its subsidiaries, as applicable, and the City is set out below.

**Transactions with Related Parties Summary**
**Year Ended December 31,**
**(in thousands of dollars)**

| | 2011<br>$ | 2010<br>$ |
|---|---|---|
| Revenues | 147,469 | 147,399 |
| Operating expenses and capital expenditures | 30,582 | 14,068 |
| Net financing charges | - | 7,487 |
| Dividends | 33,063 | 25,000 |

**Transactions with Related Parties Summary**
**As at December 31,**
**(in thousands of dollars)**

| | 2011 $ | 2010 $ |
|---|---|---|
| Accounts receivable, net of allowance for doubtful accounts .................... | 8,412 | 6,711 |
| Unbilled revenue ...................................................................................... | 8,692 | 9,830 |
| Other assets ................................................................................................ | 7,279 | 7,368 |
| Accounts payable and accrued liabilities.................................................... | 25,085 | 12,164 |
| Customers' advance deposits...................................................................... | 8,714 | 10,953 |

Revenues represent amounts charged to the City primarily for electricity and street lighting services. Operating expenses and capital expenditures represent amounts charged by the City for purchased road cut repairs, property taxes and other services. Net financing charges represent interest paid to the City on the promissory note which was monetized on April 1, 2010. Dividends represent dividends paid to the City.

Accounts receivable, net of allowance for doubtful accounts represent receivables from the City primarily for relocation services, sale of electricity and street lighting services. Unbilled revenue represents receivables from the City related to the provision of electricity not yet billed. Other assets represent amounts for prepaid land leases from the City. Accounts payable and accrued liabilities represent amounts payable to the City relating to road cut repairs and other services, as well as funds received from the City for the construction of electricity distribution assets. Customers' advance deposits represent funds received from the City for future expansion projects.

See note 20 to the Consolidated Financial Statements.

## Risk Factors

The financial performance of the Corporation is subject to a variety of risks including those described below:

### *Condition of Distribution Assets*

LDC estimates that approximately one-third of its electricity distribution assets are past their expected useful life. LDC's ability to continue to provide a safe work environment for its employees and a reliable and safe distribution service to its customers and the general public will depend on, among other things, the OEB allowing recovery of costs in respect of LDC's maintenance program and capital expenditure requirements for distribution plant refurbishment and replacement.

### *Regulatory Developments*

Ontario's electricity industry regulatory developments and policy changes may affect the electricity distribution rates charged by LDC and the costs LDC is permitted to recover. This may in turn have a material adverse effect on the financial performance of the Corporation and or in its ability to provide reliable service to its customers. In particular, there can be no assurance that:

- the OEB will approve LDC's electricity distribution rates under the incentive regulation mechanism framework, including the incremental capital module, at levels that will permit LDC to carry out its planned capital work programs required to maintain reliable service to its customers and earn the allowed rate of return on the investment in the business;

- the OEB will not set a lower recovery for LDC's cost of capital;

- the full cost of providing service to distribution customers will be permitted to be recovered through LDC's electricity distribution rates;

- the OEB will not permit competitors to provide distribution services in LDC's licensed area, or permit loads within LDC's service area to become electrically served by a means other than through LDC's electricity distribution system;

- the OEB will allow recovery for revenue lost as a consequence of unanticipated effects of CDM;

- parts of LDC's services will not be separated from LDC and opened to competition; or

- regulatory or other changes will not be made to the PILs regime.

Changes to any of the laws, rules, regulations and policies applicable to the businesses carried on by the Corporation could also have a significant impact on the Corporation. There can be no assurance that the Corporation will be able to comply with applicable future laws, rules, regulations and policies. Failure by the Corporation to comply with applicable laws, rules, regulations and policies may subject the Corporation to civil or regulatory proceedings that may have a material adverse effect on the Corporation.

***Information Technology Infrastructure***

LDC's ability to operate effectively is in part dependent on the development, maintenance and management of complex information technology systems. Computer systems are employed to operate LDC's electricity distribution system, financial and billing systems and business systems to capture data and to produce timely and accurate information. Failures of LDC's financial, business and operating systems could have a material adverse effect on the Corporation's business, operating results, financial condition and prospects.

LDC's electricity distribution infrastructure and technology systems are also potentially vulnerable to damage or interruption from cyber attacks, which could have an adverse impact on its operations, financial conditions, brand and reputation. While LDC has implemented protective measures to monitor the risk of a cyber attack and mitigate its effects, there can be no assurance that such protective measures will be completely effective in protecting LDC's electricity distribution infrastructure or assets from a cyber attack or the effects thereof.

***Labour Relations***

The Corporation's ability to operate successfully in the electricity industry in Ontario will continue to depend in part on its ability to make changes to existing work processes and conditions to adapt to changing circumstances. The Corporation's ability to make such changes, in turn, will continue to depend in part on its relationship with its labour unions and its ability to develop plans and approaches that are acceptable to its labour unions. There can be no assurance that the Corporation will be able to secure the support of its labour unions.

***Natural and Other Unexpected Occurrences***

LDC's operations are exposed to the effects of natural and other unexpected occurrences such as severe or unexpected weather conditions, terrorism and pandemics. Although LDC's facilities and operations are constructed, operated and maintained to withstand such occurrences, there can be no assurance that they will successfully do so in all circumstances. Any major damage to LDC's facilities or interruption of LDC's operations arising from these occurrences could result in lost revenues and repair costs that can be substantial. Although the Corporation has insurance, if it sustained a large uninsured loss caused by natural or other unexpected occurrences, LDC would apply to the OEB for the recovery of the loss. There can be no assurance that the OEB would approve, in whole or in part, such an application.

***Electricity Consumption***

LDC's electricity distribution rates are comprised of a fixed charge and a usage-based (consumption) charge. The volume of electricity consumed by LDC's customers during any period is governed by events largely outside LDC's control (e.g., principally sustained periods of hot or cold weather could increase the consumption of electricity, sustained periods of mild weather could decrease the consumption of electricity, and general economic conditions could affect overall electricity consumption). Accordingly, there can be no assurance that LDC will earn the revenue requirement approved by the OEB.

Economic conditions could also lead to lower overall electricity consumption, particularly in the commercial customer segment, which is estimated to be the most sensitive to economic changes. Lower electricity consumption from commercial customers could negatively impact LDC's revenue. On an annual basis, a decrease of 1% in electricity consumption would reduce net revenue by approximately $3.6 million.

### *Market and Credit Risk*

LDC is subject to credit risk with respect to customer non-payment of electricity bills. LDC is permitted to mitigate the risk of customer non-payment using any means permitted by law, including security deposits (including letters of credit, surety bonds, cash deposits or lock-box arrangements, under terms prescribed by the OEB), late payment penalties, pre-payment, pre-authorized payment, load limiters or disconnection. In the event of an actual payment default and a corresponding bad debt expense incurred by LDC, roughly 80% of the expense would be related to commodity and transmission costs and the remainder to LDC's distribution revenue. While LDC would be liable for the full amount of the default, there can be no assurance that the OEB would allow recovery of the bad debt expense from remaining customers. Established practice in such cases is that the OEB would examine any electricity distributor's application for recovery of extraordinary bad debt expenses on a case-by-case basis.

LDC is also exposed to fluctuations in interest rates as its regulated rate of return is derived using a formulaic approach, which is based in part on a forecast of long-term Government of Canada bond yields and A-rated Canadian utility bond spreads. LDC estimates that a 1% (100 basis point) reduction in long-term Government of Canada bond yields used to determine its regulated rate of return would reduce LDC's net income, as at December 31, 2011, by approximately $4.6 million.

The Corporation is exposed to fluctuations in interest rates for the valuation of its post-employment benefit obligations. The Corporation estimates that a 1% (100 basis point) increase in the discount rate used to value these obligations would decrease the accrued benefit obligation, as at December 31, 2011, by approximately $33.1 million, and a 1% (100 basis point) decrease in the discount rate would increase the accrued benefit obligation, as at December 31, 2011, by approximately $42.9 million.

### *Additional Debt Financing*

Cash generated from operations, after the payment of expected dividends, will not be sufficient to repay existing indebtedness, fund capital expenditures and meet other obligations. The Corporation relies on debt financing through its Medium-Term Note Program or existing credit facilities to repay existing indebtedness and fund capital expenditures. The Corporation's ability to arrange sufficient and cost-effective debt financing could be adversely affected by a number of factors, including financial market conditions, the regulatory environment in Ontario, the Corporation's results of operations and financial condition, the ratings assigned to the Corporation and its debentures by credit rating agencies, the current timing of the Corporation's debentures and general economic conditions.

### *Work Force Renewal*

Over the next decade, a significant portion of LDC's employees will become eligible for retirement, including potential retirements occurring in supervisory, trades and technical positions. Accordingly, LDC will be required to attract, train and retain skilled employees. There can be no assurance that LDC will be able to attract and retain the required workforce.

### *Insurance*

Although the Corporation maintains insurance, there can be no assurance that the Corporation will be able to obtain or maintain adequate insurance in the future at rates it considers reasonable or that insurance will continue to be available. Further, there can be no assurance that available insurance will cover all losses or liabilities that might arise in the conduct of the Corporation's business. The Corporation self-insures against certain risks (e.g., business interruption and physical damage to certain automobiles). The occurrence of a significant uninsured claim or a claim in excess of the insurance coverage limits maintained by the Corporation could have a material adverse effect on the Corporation's results of operations and financial position.

### *Credit Rating*

Should the Corporation's credit rating from both credit rating agencies fall below "A"(minus) (S&P) and "A"(low) (DBRS), the Corporation and its subsidiaries may be required to post additional collateral with the IESO.

*Conflicts of Interest*

The City owns all of the outstanding shares of the Corporation and has the power to determine the composition of the board of directors of the Corporation and influence the Corporation's major business and corporate decisions, including its financing programs and dividend payments. A conflict may arise between the City's role as the sole shareholder of the Corporation and its role as the administrator of the City's budget and other matters for the residents of the City.

*Change of Ownership*

The City may also decide to sell all or part of the Corporation. In the case of such event, depending on the nature of the transaction, the Corporation's credit ratings could be negatively affected.

*Conversion to US GAAP*

The Corporation plans to commence reporting under US GAAP in its first quarterly consolidated financial statements in 2012. The Corporation does not believe that the adoption of US GAAP will have a material impact on its consolidated financial statements. However, given that the decision granted by the Canadian securities regulatory authorities only allows for the option to prepare consolidated financial statements in accordance with US GAAP for fiscal years beginning before January 1, 2015, and the continued uncertainty around the timing, scope and eventual adoption of a rate-regulated accounting ("RRA") standard under IFRS and the potential material impact of RRA on the Corporation's consolidated financial statements, if the Corporation were to adopt the use of IFRS for fiscal years beginning on or after January 1, 2015, it may have an impact on the Corporation's future financial position and results of operations, which cannot be reasonably quantified at this time.

*Real Property Rights*

Certain terminal stations and municipal sub-stations of LDC are located on lands owned by the Province, the City and others. In some cases, LDC does not have and may not be able to obtain formal access agreements with respect to such facilities. Failure to obtain or maintain access agreements could adversely affect LDC's operations.

*LDC Competition*

In the past, there had been one electricity distributor in each region of Ontario. Under the current regulatory regime, a person must obtain a licence from the OEB in order to own and operate an electricity distribution system. LDC has the right to distribute electricity in the City. Although the distribution licence specifies the area in which the distributor is authorized to distribute electricity, unless otherwise provided, the licence does not provide exclusive distribution rights for such area.

The Corporation believes that the complexities and potential inefficiencies that would be created by having multiple electricity distributors authorized to serve a single area are likely to result in the continuation of the practice of having a single electricity distributor authorized to serve a single area. In addition, the Corporation believes that there are significant barriers to entry with respect to the business of electricity distribution in Ontario, including the cost of maintaining an electricity distribution system, OEB regulation of electricity distribution rates and the level of regulatory compliance required to operate an electricity distribution system. However, the Corporation recognizes that more than one distribution licence could be issued for the same area and there is a possibility that in the future some business functions or activities could be separated from LDC and made open to competition from non-regulated business entities, or that defined geographical areas within LDC's service area may be electrically supplied by a means other than through LDC's electricity distribution system.

**Non-GAAP Financial Measures**

The Corporation's MD&A includes "net revenue" which is a non-GAAP financial measure. The definition of net revenues is revenue minus the cost of purchased power and other. This measure does not have any standard meaning prescribed by Canadian GAAP and is not necessarily comparable to similarly titled measures of other companies. The Corporation uses this measure to assess its performance and to further make operating decisions.

**Critical Accounting Estimates**

The preparation of the Corporation's Consolidated Financial Statements in accordance with Canadian GAAP requires management to make estimates and assumptions which affect the reported amounts of assets, liabilities, revenues and costs, and related disclosures of commitments and contingencies. The estimates are based on historical experience, current conditions and various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities as well as identifying and assessing the accounting treatment with respect to commitments and contingencies. Actual results may differ from these estimates and judgments under different assumptions or conditions.

The following critical accounting estimates involve the more significant estimates and judgments used in the preparation of the Consolidated Financial Statements:

***Regulatory Assets and Liabilities***

Regulatory assets as at December 31, 2011, amounted to $77.3 million and primarily relate to the deferral of smart meters expenditures incurred in 2009 and 2008. Regulatory liabilities as at December 31, 2011, amounted to $210.3 million and primarily relate to future income tax assets payable to customers and retail settlement balances to customers approved by the OEB. These assets and liabilities can be recognized for rate-setting and financial reporting purposes only if the OEB directs the relevant regulatory treatment or if future OEB direction is judged to be probable. In the event that the disposition of these balances was no longer deemed to be probable, the balances would be recorded in the Corporation's consolidated statements of income in the period that the assessment is made.

***Environmental Liabilities and Asset Retirement Obligations***

The Corporation recognizes a liability for the future removal and handling costs for contamination in distribution equipment in service and in storage and for the future environmental remediation of certain properties. The estimation of such a liability requires that assumptions be made, such as the number of assets and contamination levels of equipment, and the number of contaminated properties and the extent of contamination. All factors used in deriving the Corporation's environmental liabilities and asset retirement obligations ("ARO") represent management's best estimates based on the planned approach of meeting regulatory requirements. However, it is possible that number of contaminated assets, current cost estimates, inflation assumptions and assumed pattern of annual cash flows may differ significantly from the Corporations' assumptions.

ARO amounted to $4.9 million as at December 31, 2011 compared to $5.0 million as at December 31, 2010. The Corporation estimates the undiscounted amount of cash flows required over the next one to 45 years to settle the ARO is $5.8 million for 2011 compared to $6.6 million for 2010. Discount rates ranging from 1.39% to 6.60% were used to calculate the carrying value of the ARO as at December 31, 2011 and as at December 31, 2010. No assets have been legally restricted for settlement of the liability.

***Employee Future Benefits***

Employee future benefits other than pension provided by the Corporation include medical, dental and life insurance benefits, and accumulated sick leave credits. These plans provide benefits to employees when they are no longer providing active service. The accrued benefit obligations and current service cost are calculated by independent actuaries using the projected benefit method prorated on service and based on assumptions that reflect management's best estimate. The assumptions were determined by management recognizing the recommendations of the Corporation's actuaries. There could be no assurance that actual employee's future benefits cost will not differ significantly from the estimates calculated using management's assumptions.

***Revenue Recognition***

Revenues from the sale of electricity are recorded on a basis of cyclical billings and also include unbilled revenues accrued in respect of electricity delivered but not yet billed. The unbilled revenue accrual at the end of each period is based on the difference between the forecast revenue and the actual amounts billed. The development of the revenue forecast requires estimates of customer growth, economic activity and weather conditions. There can be no assurance that actual unbilled revenue estimates will not differ materially from actual revenue for the period.

**Significant Accounting Policies**

The Consolidated Financial Statements of the Corporation have been prepared in accordance with Canadian GAAP including accounting principles prescribed by the OEB in the handbook "Accounting Procedures Handbook for Electric Distribution Utilities" ("AP Handbook") and are presented in Canadian dollars. In preparing the Consolidated Financial Statements, management makes estimates and assumptions which affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the Consolidated Financial Statements and the reported amounts of revenues and expenses for the year. Actual results could differ from those estimates, including changes as a result of future decisions made by the OEB, the Ministry of Energy, or the Ministry of Finance. The significant accounting policies of the Corporation are summarized in note 3 to the Consolidated Financial Statements.

**Changes in Accounting Estimates**

***Property, Plant and Equipment***

Effective January 1, 2011, the Corporation revised its estimates of useful lives of certain items of PP&E following a detailed review and analysis supported by external third-party evidence. These changes in estimates have been accounted for on a prospective basis in the Consolidated Financial Statements effective January 1, 2011.

Effective January 1, 2011, the Corporation revised its estimates of burden rates of certain items of PP&E following a detailed review and analysis of all the components included in such burden rates. These changes in estimates of burden rates include changes in the allocation of engineering and administration costs, changes in the calculation of standard labour rates, and changes in the calculation of materials handling costs. These changes in estimates have been accounted for on a prospective basis in the Consolidated Financial Statements effective January 1, 2011.

The changes discussed above were reflected in the 2011 electricity distribution rates approved by the OEB on July 7, 2011. Accordingly, these changes decreased distribution revenues by approximately $24.6 million, increased operating expenses by approximately $22.0 million, decreased depreciation expenses by approximately $33.0 million and decreased PILs by approximately $13.6 million for the year ended December 31, 2011 and are expected to impact depreciation expenses proportionately in future periods.

See note 3(f) to the Consolidated Financial Statements.

**Future Accounting Pronouncements**

***Adoption of New Accounting Standards***

Publicly accountable enterprises in Canada were required to adopt IFRS in place of Canadian GAAP for interim and annual reporting purposes for fiscal years beginning on or after January 1, 2011.

Prior to the developments noted below, the Corporation's IFRS conversion project was proceeding as planned to meet the January 1, 2011 conversion date.

*Rate-Regulated Accounting*

In accordance with Canadian GAAP, the Corporation currently follows specific accounting policies unique to a rate-regulated business. Under RRA, the timing and recognition of certain expenses and revenues may differ from those otherwise expected under Canadian GAAP in order to appropriately reflect the economic impact of regulatory decisions regarding the Corporation's regulated revenues and expenditures. These timing differences are recorded as regulatory assets and regulatory liabilities on the Corporation's consolidated balance sheets and represent current rights and obligations regarding cash flows expected to be recovered from or refunded to customers, based on decisions and approvals by the OEB. As at December 31, 2011, the Corporation reported $77.3 million of regulatory assets and $210.3 million of regulatory liabilities.

On July 23, 2009, the International Accounting Standards Board ("IASB") issued an Exposure Draft proposing accounting requirements for rate-regulated activities. The IASB received a significant number of comment letters with diverging opinions. On September 3, 2010, in preparation for the September IASB meetings, the IASB staff issued Agenda Paper 12 outlining the staff's view that regulatory assets and regulatory liabilities did not meet the definitions of an intangible asset under International Accounting Standard ("IAS") 38 – *Intangible Assets*, a financial liability nor a provision under IAS 37 – *Provisions, Contingent Liabilities and Contingent Assets* respectively. The utility industry immediately expressed its concern against the issuance of such a blanket prohibition under IFRS. On September 16, 2010, the IASB held a meeting to discuss Agenda Paper 12 and the overall status of the rate-regulated activities project. The IASB members remained divided on the issue and determined that the matter could not be resolved quickly. As such, the IASB decided to obtain feedback through public consultation as to the next steps that the IASB should take in relation to the rate-regulated activities project. Feedback from constituents was expected to be obtained by early 2011 and next steps for the project were expected to be determined and communicated by the second half of 2011. At this time, no further discussions are planned for this project on the IASB's work plan.

The Canadian Electricity Association ("CEA") wrote a letter to the IASB on September 28, 2010 requesting an interim standard to grandfather previous GAAP accounting practices, such as those in Canada, be developed with respect to accounting for regulatory assets and liabilities. The IASB response indicated that it would further consider an interim standard after public consultation in 2011. To date, the IASB has not approved any temporary exemption or finalized a RRA standard under IFRS.

On September 10, 2010, the Accounting Standards Board ("AcSB") granted an optional one-year deferral for IFRS adoption for entities subject to rate regulation due to the uncertainty created by the IASB in regard to RRA. To date, the IASB has not approved any temporary exemption or finalized a RRA standard under IFRS. The Corporation elected to take the optional one-year deferral of its adoption of IFRS; therefore, it continues to prepare its Consolidated Financial Statements in accordance with Canadian GAAP accounting standards in Part V of the Canadian Institute of Chartered Accountants Handbook in 2011.

On October 13, 2011, the CEA wrote a letter to the AcSB in response to the IASB's Request for Views on Agenda Consultation 2011. The CEA strongly believes that the IASB should give priority to a project on the accounting for RRA. The AcSB has also identified RRA as a key priority on the IASB's future projects agenda.

In the absence of a definitive plan to consider the issuance of a RRA standard by the IASB, the Corporation decided to evaluate the option of adopting US GAAP effective January 1, 2012 as an alternative to IFRS. The Corporation's current application of Canadian GAAP for RRA is generally consistent with US GAAP. Under US GAAP, the Corporation's financial reporting is expected to be more comparable with its current Canadian GAAP results than it would be under IFRS and is expected to facilitate comparability with other large North American utilities.

*Canadian Securities Legislation*

On July 8, 2011, the Corporation filed an application with the applicable Canadian securities regulatory authorities pursuant to section 5.1 of National Instrument 52-107 "Acceptable Accounting Principles and Auditing Standards", to permit the Corporation to prepare its consolidated financial statements in accordance with US GAAP without qualifying as a US Securities and Exchange Commission issuer.

On July 21, 2011, the applicable Canadian securities regulatory authorities issued a decision which gave the Corporation the option to prepare its consolidated financial statements in accordance with US GAAP for its fiscal years beginning on or after January 1, 2012, but before January 1, 2015. The decision is similar to that obtained by other Canadian rate-regulated utilities.

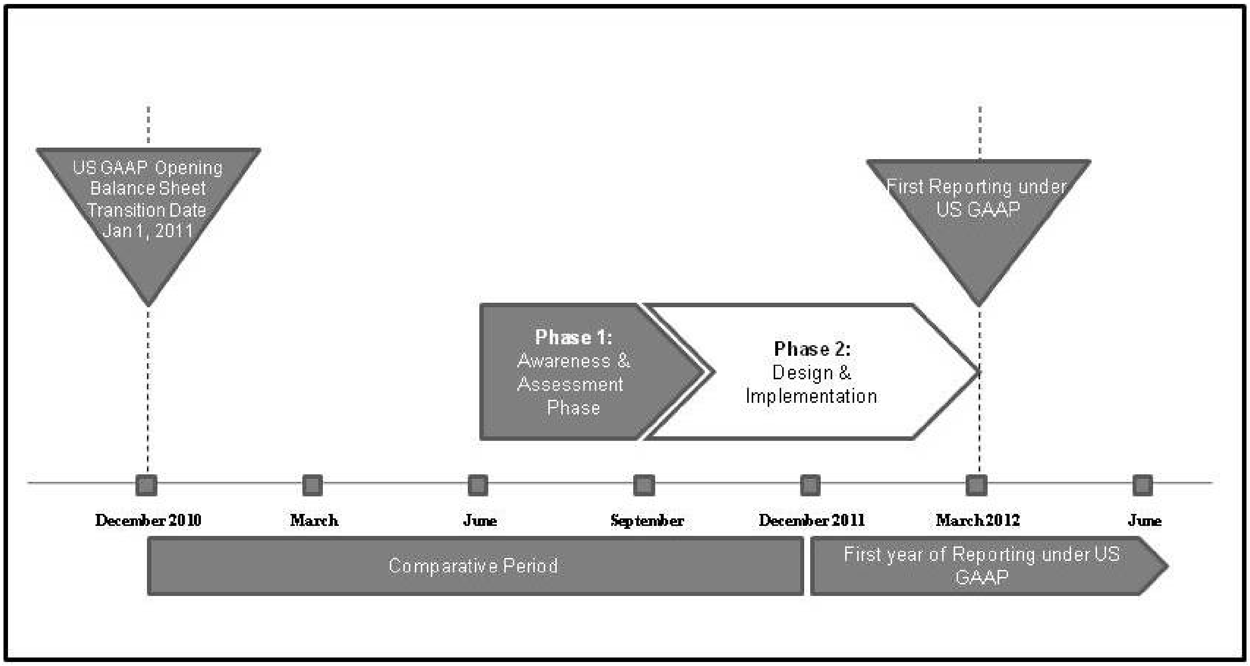
On August 26, 2011, the board of directors of the Corporation approved the adoption of US GAAP for financial reporting purposes for the year beginning on January 1, 2012. Accordingly, the Corporation plans to commence reporting under US GAAP in its first quarterly consolidated financial statements in 2012. As a result of this decision, the Corporation's IFRS conversion project efforts have been reduced. However, the work has been managed in such a way that it can effectively be restarted when a future transition to IFRS is required.

*US GAAP Conversion Project*

The Corporation commenced its US GAAP conversion project and established a formal project governance structure. This structure includes a steering committee consisting of senior levels of management from finance, information technology and operations, among others. External accounting advisors have been engaged to assist the US GAAP conversion project team and to provide technical accounting support as required. Regular progress reports are provided to senior executive management. The Corporation's audit committee receives periodic project updates from senior management and approves all US GAAP accounting policies. The Corporation's board of directors receives periodic project updates from senior executive management.

The Corporation's project consists of two phases:

1) the awareness and assessment phase; and
2) the design phase and implementation phase.




The Corporation has completed its awareness and initial assessment phase. During the initial assessment it was determined that the areas of accounting differences with the highest potential impact to the Corporation's future financial position and results of operations are employee benefits, PILs, financial instruments, and customers' advance deposits. The Corporation has completed its detailed assessment of accounting and disclosure differences. Based on the results of the assessment, no material differences are expected that would impact the consolidated financial statements on the date of transition to US GAAP and post US GAAP implementation. In parallel, a detailed assessment of the impact of the US GAAP conversion on the Corporation's systems, processes and controls as well as other business, regulatory and tax impacts was also conducted. During the awareness and assessment phase, the Corporation established a communication plan and a staff-training plan.

The design and implementation phase of the project is substantially completed. The activities involved in the design phase include establishing issue-specific working groups in each of the identified risk areas. The working groups are comprised of individuals from finance and operations, among others, establish key milestones such as developing recommendations, analyzing financial system and internal control impacts, developing significant accounting policies, and carrying out ongoing discussions with external consultants and auditors, in each area. Based on the outcomes of each working group, the Corporation is currently determining the final impacts of adopting US GAAP on its 2011 comparative consolidated financial statements.

The roll-out of the required changes takes place during the design and implementation phase and involves the development of new accounting policies, development of accounting manuals and the associated training for the finance and operational teams, testing the effectiveness of the changes made to systems, a simulation of the financial reporting process, preparation of opening balance sheet on transition date and related reconciliations and disclosures. Based on these changes, the Corporation updated its internal control processes and documentation. Changes to accounting policies will result in additional controls and procedures to address reporting on transition date as well as ongoing US GAAP reporting requirements. The Corporation developed and implemented the related controls and procedures to ensure the integrity of internal controls over financial reporting and disclosure controls and procedures. The updated controls and procedures will be evaluated to ensure that they are operating effectively. It is expected that the evaluation will be completed in time such that the Corporation's interim consolidated financial statements for the first quarter of 2012 will be prepared in accordance with US GAAP and applied retrospectively to the Corporation's opening US GAAP consolidated balance sheet as at January 1, 2011.

| Key Activities | Current Status |
|---|---|
| Accounting policies & procedures: | |
| • High level review of major differences between Canadian GAAP and US GAAP.<br>• Establish issue-specific working groups in the identified risk areas.<br>• Detailed assessment of accounting and disclosure differences and accounting policy choices available.<br>• Develop recommendations and accounting policies through ongoing discussions with external consultants and auditors.<br>• Finalize new accounting policies and accounting manuals.<br>• Continue to monitor ongoing Financial Accounting Standards Board ("FASB") projects and assess potential impacts. | • Completed the detailed assessment of accounting and disclosure differences.<br>• All accounting policies have been developed.<br>• All accounting policies have been approved by senior management and the audit committee.<br>• Accounting policies and procedure manuals continue to be updated based on the FASB project developments and accounting standard updates. |
| Financial statements preparation: | |
| • Identify Canadian GAAP to US GAAP financial statement presentation differences and design interim and annual financial statement formats and related notes disclosures.<br>• Assess impacts on comparative information.<br>• Simulate the financial reporting process under US GAAP.<br>• Assess ongoing impacts on the US GAAP financial statements and related disclosures. | • Developed interim and annual consolidated financial statement formats.<br>• Substantially completed all journal entries and related account reconciliations for the comparative period.<br>• Testing of systems related modifications are completed. |
| Training & communication: | |
| • Provide training to affected finance and operational teams, management, the board of directors, and relevant committees thereof, including the audit committee.<br>• Develop and execute staff training plan, and roll out communication initiatives.<br>• Continue to update audit committee and senior management for key developments in US GAAP and the potential impacts to the Corporation's consolidated financial statements. | • Completed detailed training for resources directly engaged in the changeover and general awareness training to broader group of finance and operation employees.<br>• Completed topic-specific and relevant training to finance and operational teams on all finalized positions. Key areas include employee benefits, PILs, financial instruments, and customers' advance deposits.<br>• Completed awareness and assessment phase closeout training sessions for all key finance and operational teams.<br>• Continue ongoing, periodic internal and external communications on the Corporation's progress on the US GAAP project and direction.<br>• Knowledge transfer is scheduled to roll-out in the first quarter of 2012. |
| Business impacts: | |
| • Evaluate impacts and implement necessary changes to debt covenants, internal performance measures, contracts and processes. | • Impacts to debt covenants, key financial ratios, regulatory and other business processes were identified and assessed throughout the development of accounting policies.<br>• Amended the trust indenture agreement allowing the use of US GAAP for reporting purposes. |
| Information technology systems: | |
| • Analysis of financial systems to identify required modifications.<br>• Test the effectiveness of the changes made to financial systems.<br>• Ensure solution captures financial information under Canadian GAAP and US GAAP during the year of transition for comparative reporting purposes. | • Completed preliminary assessment of the IT systems impacts to accommodate the adoption of US GAAP.<br>• Completed the implementation and testing of the required modifications to financial systems. |

*US GAAP Differences*

Based on the results of the detailed assessment performed, the following is a summary of the key accounting areas for which significant Canadian GAAP to US GAAP differences were identified:

| Risk Areas | Key Differences Canadian GAAP vs. US GAAP | Potential Key Impacts |
|---|---|---|
| Employee Benefits | US GAAP requires the full obligation (funded or unfunded status) of defined benefit plans to be recognized as a liability on the balance sheet and no adjustments are made for minimum funding requirements.<br><br>Actuarial gains and losses are recognized in Other Comprehensive Income ("OCI") in the period in which they arise and are presented within equity as Accumulated Other Comprehensive Income ("AOCI"). Amounts presented in AOCI are subsequently reclassified to profit or loss, generally using the corridor method.<br><br>Prior service costs are recognized initially in OCI in the period in which they arise and are presented within equity as AOCI.<br><br>The liability for an underfunded plan must be classified as a current liability, a non-current liability or both. The current portion (determined on a plan-by-plan basis) is the amount by which the actuarial present value of benefits included in the benefit payable in the next 12 months exceeds the fair value of plan assets.<br><br>Based on Accounting Standards Update No. 2011-09 on *Disclosures about an Employer's Participation in a Multi-employer Plan*, the Corporation will be required to disclose additional information on its pension plan. | All unamortized actuarial gains and unamortized prior service costs will be recognized on the consolidated balance sheet resulting in an increase of approximately $30.0 million, as at January 1, 2011, to post-employment benefits liability, with a corresponding reduction to equity presented as AOCI on the consolidated balance sheet. No significant impact to the net asset position is expected on the Corporation's consolidated balance sheet. However, given the nature of the Corporation's rate-regulated operations, the amounts presented in AOCI will be reclassified to a regulatory asset.<br><br>Actuarial gains and losses and prior service costs will be recognized in OCI and presented within equity as AOCI. Since the corridor method is used under both Canadian GAAP and US GAAP, no differences will arise with respect to the recognition of actuarial gains and losses and prior service costs in profit or loss in a period.<br><br>A portion of the benefit obligation will be presented as a post-employment benefits current liability on the consolidated balance sheet.<br><br>The measurement date of the actuarial valuation is required to be as of the reporting date of the Corporation, therefore, a reconciliation for the one day difference may be required. |
| PILs | US GAAP requires deferred income taxes to be calculated based on enacted tax rates.<br><br>US GAAP states that the recognition of an investment tax credit ("ITC") as a reduction of income tax expense in the year in which the credit arises is acceptable. US GAAP does not provide specific guidance applicable to government grants. | The calculation of PILs is not expected to be impacted.<br><br>Certain types of ITCs which are government grants that are refundable in nature will continue to be applied as a reduction against the related expense in the profit or loss. Other ITC's which are non-refundable in nature will be recognized as a reduction of income tax expense. |
| Financial Instruments | US GAAP requires financing fees to be reported on the balance sheet as a deferred charge; hence, financing fees are presented on a gross basis. | It is expected that financing fees associated with long-term debt will no longer be netted against the principal balance of the related long-term debt. The impact of this change is an increase of approximately $4.9 million, as at January 1, 2011, to deferred charges with a corresponding increase to long-term debt. |
| Customers' Advance Deposits | Under US GAAP, customers' advance deposits are classified as current liabilities if they are due on demand or will be due on demand within one year from the end of the reporting period. As such, they are classified as a current liability even if refunds of the deposits are not to be expected within that period. | It is expected that there will be a reclassification for customers' advance deposits from non-current to current liability under US GAAP. The impact of this change is an increase of approximately $31.8 million, as at January 1, 2011, to current liabilities with a corresponding decrease to non-current liabilities. |

*OEB Review Process*

On June 13, 2011, the OEB issued an Addendum to Report of the Board: *Implementing International Financial Reporting Standards in an Incentive Rate Mechanism Environment.* Specifically, the OEB addressed the use of US GAAP in rate applications. The OEB is encouraging utilities adopting US GAAP to file a letter in advance of making the rate application, stating the intention to file under US GAAP. The utility must be able to demonstrate its eligibility under the relevant securities legislation to report financial information under US GAAP, and identify the benefits and potential disadvantages of adopting US GAAP for customers.

On August 19, 2011, LDC filed a letter with the OEB stating its intention to adopt US GAAP as the basis for the calculation of electricity distribution rates starting in 2012 in accordance with the guidelines provided by the OEB. In the OEB guidelines, the OEB indicated to Ontario utilities that it would permit the use of US GAAP for the calculation of electricity distribution rates if such utilities receive approval from the Ontario Securities Commission and if it benefits electricity distribution consumers.

On December 21, 2011, the OEB issued a letter requesting comments on the revised AP Handbook. The proposed revisions made in the AP Handbook are primarily to reflect the transition to IFRS. Distributors reporting under an alternative accounting framework will be required to report using the alternative accounting standard, but to also include the accounting procedures or requirements that the OEB has stipulated. On January 30, 2012, LDC provided its comments through a joint submission with the Coalition of Large Distributors as well as its own letter to address its entity-specific issues.

On February 28, 2012, LDC submitted a letter to the OEB requesting a deferral account to record the accounting differences between Canadian GAAP and US GAAP.

To date, there are no formal clear guidelines from the OEB regarding the treatment of the differences between Canadian GAAP and IFRS or US GAAP in the electricity distribution rates application process. However, considering the similarities between Canadian GAAP currently used by LDC to derive electricity distribution rates and US GAAP, the Corporation does not believe that the adoption of US GAAP will have a material impact on LDC's electricity distribution rates.

**Selected Annual Information**

The following table sets forth selected annual financial information of the Corporation for the three years ended December 31, 2011, 2010 and 2009. This information has been derived from the Consolidated Financial Statements.

**Selected Annual Consolidated Financial Information**
**(in thousands of dollars)**

| **Year Ended December 31,**[1] | **2011 $** | **2010 $** | **2009 $** |
|---|---|---|---|
| Net revenues | 570,758 | 549,402 | 504,266 |
| Operating expenses | 243,547 | 223,326 | 208,834 |
| Net income | 95,932 | 66,125 | 42,133 |
| **As at December 31,** | **2011 $** | **2010 $** | **2009 $** |
| Total assets[2] | 3,455,777 | 3,338,614 | 3,059,227 |
| Total debentures[2] [3] | 1,463,514 | 1,409,837 | 720,475 |
| Promissory note payable | - | - | 490,115 |
| Shareholder's equity[2] | 1,102,248 | 1,039,379 | 998,254 |
| Dividends[4] | 33,063 | 25,000 | 25,170 |

Notes:

(1) See "Results of Operations" for further details on net revenues, operating expenses and net income.
(2) See "Financial Position" for further details of significant changes in assets, debentures and shareholder's equity.
(3) Total debentures include current and long-term debentures.
(4) See "Dividends" for further details.

**Additional Information**

Additional information with respect to the Corporation (including its annual information form) is available at www.sedar.com.

Toronto, Canada

March 2, 2012

TORONTO HYDRO Corporation

CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2011

# Consolidated Financial Statements
DECEMBER 31, 2011

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TORONTO HYDRO
Corporation

## MANAGEMENT'S REPORT

The accompanying Consolidated Financial Statements have been prepared by management of Toronto Hydro Corporation (the "Corporation"), who are responsible for the integrity, consistency and reliability of the information presented. The Consolidated Financial Statements have been prepared in accordance with Canadian generally accepted accounting principles and applicable securities legislation.

The preparation of the Consolidated Financial Statements necessarily involves the use of estimates and assumptions based on management's judgments, particularly when transactions affecting the current accounting period cannot be finalized with certainty until future periods. Estimates and assumptions are based on historical experience, current conditions and various other assumptions believed to be reasonable in the circumstances, with critical analysis of the significant accounting policies followed by the Corporation as described in Note 3 to the Consolidated Financial Statements. The preparation of the Consolidated Financial Statements includes information regarding the estimated impact of future events and transactions. Actual results in the future may differ materially from the present assessment of this information because future events and circumstances may not occur as expected. The Consolidated Financial Statements have been prepared within reasonable limits of materiality in light of information available up to March 2, 2012.

In meeting its responsibility for the reliability of financial information, management maintains and relies on a comprehensive system of internal control and internal audit, which is designed to provide reasonable assurance that the financial information is relevant, reliable and accurate, and that the Corporation's assets are safeguarded and transactions are properly authorized and executed. The system includes formal policies and procedures and appropriate delegation of authority and segregation of responsibilities within the organization. An internal audit function evaluates the effectiveness of these internal controls consistent with its annual audit plan and reports its findings to management and the Audit Committee of the Corporation, as required.

The Consolidated Financial Statements have been examined by KPMG LLP, independent external auditors appointed by the Corporation's shareholder. The external auditors' responsibility is to express their opinion on whether the Consolidated Financial Statements are fairly presented in accordance with generally accepted accounting principles in Canada. The attached Independent Auditors' Report outlines the scope of their examination and their opinion.

The Board of Directors, through its Audit Committee, is responsible for overseeing management in the performance of its financial reporting and internal controls. The Audit Committee is composed of independent directors and meets periodically with management, the internal auditors and the external auditors to discuss internal controls over the financial reporting process, auditing matters and financial reporting issues, to satisfy itself that each group has properly discharged its respective responsibility and to review the Consolidated Financial Statements before recommending approval by the Board of Directors. The Audit Committee also considers, for review by the Board of Directors and approval by the shareholder, the appointment of the external auditors. The external auditors have direct and full access to the Audit Committee, with and without the presence of management, to discuss their audit and their findings as to the integrity of the financial reporting and the effectiveness of the system of internal controls.

On behalf of Toronto Hydro Corporation's management:

Anthony Haines
President and Chief Executive Officer

Jean-Sebastien Couillard
Chief Financial Officer

KPMG

**KPMG LLP**
**Chartered Accountants**
Bay Adelaide Centre
333 Bay Street Suite 4600
Toronto ON M5H 2S5

Telephone (416) 777-8500
Fax (416) 777-8818
Internet www.kpmg.ca

## INDEPENDENT AUDITORS' REPORT

To the Shareholder of Toronto Hydro Corporation

We have audited the accompanying consolidated financial statements of Toronto Hydro Corporation, which comprise the consolidated balance sheet as at December 31, 2011, the consolidated statements of income, retained earnings and cash flows for the year then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

*Management's Responsibility for the Consolidated Financial Statements*

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

*Auditors' Responsibility*

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

*Opinion*

In our opinion, the consolidated financial statements present fairly, in all material respects, the consolidated financial position of Toronto Hydro Corporation as at December 31, 2011, and its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with Canadian generally accepted accounting principles**.**

*Other matter*

The consolidated financial statements of Toronto Hydro Corporation as at and for the year ended December 31, 2010 were audited by another auditor who expressed an unmodified opinion on those statements on March 11, 2011.

KPMG LLP

Chartered Accountants, Licensed Public Accountants

Toronto, Canada

March 2, 2012

TORONTO HYDRO Corporation

## CONSOLIDATED BALANCE SHEETS

**[in thousands of dollars]**

| **As at December 31** | **2011** <br> **$** | **2010** <br> **$** |
|---|---|---|
| **ASSETS** | | |
| **Current** | | |
| Cash and cash equivalents | **154,256** | 330,151 |
| Investments | **34,002** | - |
| Accounts receivable, net of allowance for doubtful accounts *[note 16[b]]* | **183,272** | 168,988 |
| Unbilled revenue *[note 16[b]]* | **262,058** | 287,893 |
| Payments in lieu of corporate taxes receivable | **11,312** | 6,729 |
| Inventories *[note 4]* | **6,891** | 7,501 |
| Prepaid expenses | **4,487** | 4,048 |
| **Total current assets** | **656,278** | 805,310 |
| Property, plant and equipment, net *[note 5]* | **2,399,497** | 2,128,777 |
| Intangible assets, net *[note 6]* | **112,982** | 85,996 |
| Regulatory assets *[note 7]* | **77,322** | 85,113 |
| Other assets *[note 8]* | **7,331** | 7,518 |
| Future income tax assets *[note 18]* | **202,367** | 225,900 |
| **Total assets** | **3,455,777** | 3,338,614 |
| **LIABILITIES AND SHAREHOLDER'S EQUITY** | | |
| **Current** | | |
| Accounts payable and accrued liabilities *[note 16[b]]* | **412,412** | 373,543 |
| Other liabilities *[note 10]* | **22,290** | 19,733 |
| Deferred revenue | **13,359** | 1,418 |
| Debentures *[note 11]* | **-** | 245,057 |
| **Total current liabilities** | **448,061** | 639,751 |
| **Long-term liabilities** | | |
| Debentures *[note 11]* | **1,463,514** | 1,164,780 |
| Post-employment benefits *[note 12]* | **179,541** | 169,897 |
| Regulatory liabilities *[note 7]* | **210,280** | 273,706 |
| Other liabilities *[note 13]* | **11,301** | 634 |
| Asset retirement obligations *[note 14]* | **4,902** | 5,005 |
| Customers' advance deposits | **35,930** | 45,462 |
| **Total long-term liabilities** | **1,905,468** | 1,659,484 |
| **Total liabilities** | **2,353,529** | 2,299,235 |
| Commitments, contingencies and subsequent events *[notes 21, 22 and 25]* | | |
| **Shareholder's equity** | | |
| Share capital *[note 19]* | **567,817** | 567,817 |
| Retained earnings | **534,431** | 471,562 |
| **Total shareholder's equity** | **1,102,248** | 1,039,379 |
| **Total liabilities and shareholder's equity** | **3,455,777** | 3,338,614 |

**ON BEHALF OF THE BOARD:**

Clare R. Copeland, Director

Brian Chu, Director

The accompanying notes are an integral part of the consolidated financial statements.

## CONSOLIDATED STATEMENTS OF INCOME

**[in thousands of dollars, except for per share amounts]**

| Year ended December 31 | 2011 $ | 2010 $ |
|---|---|---|
| **Revenues** | **2,809,258** | 2,611,671 |
| **Costs** | | |
| Purchased power and other | **2,238,500** | 2,062,269 |
| Operating expenses | **243,547** | 223,326 |
| Depreciation and amortization | **151,022** | 169,408 |
| | **2,633,069** | 2,455,003 |
| **Income before the following:** | **176,189** | 156,668 |
| Net financing charges | **(75,324)** | (71,150) |
| Gain on disposals of property, plant and equipment *[note 5]* | **3,885** | 3,767 |
| Change in fair value of investments | **-** | 2,420 |
| **Income before provision for payments in lieu of corporate taxes** | **104,750** | 91,705 |
| Provision for payments in lieu of corporate taxes *[note 18]* | **8,818** | 25,580 |
| **Net income** | **95,932** | 66,125 |
| **Basic and fully diluted net income per share** ***[note 23]*** | **95,932** | 66,125 |

## CONSOLIDATED STATEMENTS OF RETAINED EARNINGS

**[in thousands of dollars]**

| Year ended December 31 | 2011 $ | 2010 $ |
|---|---|---|
| **Retained earnings, beginning of year** | **471,562** | 430,437 |
| Net income | **95,932** | 66,125 |
| Dividends *[notes 19 and 20]* | **(33,063)** | (25,000) |
| **Retained earnings, end of year** | **534,431** | 471,562 |

The accompanying notes are an integral part of the consolidated financial statements.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

**[in thousands of dollars]**

| **Year ended December 31** | **2011** **$** | **2010** **$** |
|---|---|---|
| **OPERATING ACTIVITIES** | | |
| Net income | **95,932** | 66,125 |
| Adjustments for non-cash items | | |
| Depreciation and amortization | **151,022** | 169,408 |
| Change in fair value of investments | **-** | (2,420) |
| Net change in other assets and liabilities | **(1,312)** | 5,051 |
| Payments in lieu of corporate taxes | **(4,583)** | 9,203 |
| Post-employment benefits | **9,644** | 8,549 |
| Future income taxes *[note 18]* | **(601)** | 871 |
| Gain on disposals of property, plant and equipment *[note 5]* | **(3,885)** | (3,767) |
| Changes in non-cash working capital balances | | |
| Increase in accounts receivable | **(14,284)** | (18,193) |
| Decrease in unbilled revenue | **25,835** | 7,754 |
| Decrease (increase) in inventories | **610** | (1,277) |
| Increase in prepaid expenses | **(439)** | (717) |
| Increase in accounts payable and accrued liabilities | **39,093** | 40,109 |
| Increase (decrease) in deferred revenue | **13,316** | (378) |
| **Net cash provided by operating activities** | **310,348** | 280,318 |
| **INVESTING ACTIVITIES** | | |
| Purchase of property, plant and equipment *[note 5]* | **(384,262)** | (362,397) |
| Purchase of intangible assets *[note 6]* | **(52,805)** | (28,387) |
| Purchase of investments | **(84,041)** | - |
| Proceeds from investments | **50,000** | 50,350 |
| Net change in regulatory assets and liabilities | **(31,725)** | (16,011) |
| Proceeds on disposals of property, plant and equipment | **4,974** | 8,861 |
| **Net cash used in investing activities** | **(497,859)** | (347,584) |
| **FINANCING ACTIVITIES** | | |
| Dividends paid *[notes 19 and 20]* | **(33,063)** | (25,000) |
| Proceeds from debentures *[note 11]* | **297,950** | 198,493 |
| Repayment of debentures *[note 11]* | **(245,057)** | - |
| Increase (decrease) in customers' advance deposits | **(8,214)** | 12,554 |
| **Net cash provided by financing activities** | **11,616** | 186,047 |
| **Net increase (decrease) in cash and cash equivalents during the year** | **(175,895)** | 118,781 |
| Cash and cash equivalents, beginning of year | **330,151** | 211,370 |
| **Cash and cash equivalents, end of year** | **154,256** | 330,151 |
| **Supplementary cash flow information** | | |
| Total interest paid | **79,552** | 71,248 |
| Payments in lieu of corporate taxes | **10,299** | 15,061 |

The accompanying notes are an integral part of the consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
[all tabular amounts in thousands of dollars]

December 31, 2011

## 1. INCORPORATION

On June 23, 1999, Toronto Hydro Corporation [the "Corporation"] was incorporated under the *Business Corporations Act* (Ontario) [the "OBCA"] and is wholly-owned by the City of Toronto [the "City"]. The incorporation was required in accordance with the provincial government's *Electricity Act*, *1998* (Ontario) ["Electricity Act"].

The Corporation supervises the operations of, and provides corporate, management services and strategic direction to two subsidiaries incorporated under the OBCA and wholly-owned by the Corporation:

[i] Toronto Hydro-Electric System Limited ["LDC"] (incorporated June 23, 1999) – distributes electricity to customers located in the City and is subjected to rate regulation. LDC is also engaged in the delivery of Conservation and Demand Management ["CDM"] activities; and

[ii] Toronto Hydro Energy Services Inc. ["TH Energy"] (incorporated June 23, 1999) – provides street lighting services.

The principal business of the Corporation and its subsidiaries is the distribution of electricity by LDC.

## 2. REGULATION

In April 1999, the government of Ontario began restructuring the Province of Ontario ["Ontario"]'s electricity industry. Under regulations passed pursuant to the restructuring, LDC and other electricity distributors have been purchasing their electricity from the wholesale market administered by the Independent Electricity System Operator ["IESO"] and recovering the costs of electricity and certain other costs at a later date in accordance with procedures mandated by the Ontario Energy Board [the "OEB"].

The OEB has regulatory oversight of electricity matters in Ontario. The *Ontario Energy Board Act, 1998* (Ontario) [the "OEB Act"] sets out the OEB's authority to issue a distribution licence which must be obtained by owners or operators of an electricity distribution system in Ontario. The OEB prescribes licence requirements and conditions including, among other things, specified accounting records, regulatory accounting principles, separation of accounts for separate businesses and filing process requirements for rate-setting purposes.

The OEB's authority and responsibilities include the power to approve and fix rates for the transmission and distribution of electricity, the power to provide continued rate protection for rural and remote electricity customers and the responsibility for ensuring that electricity distribution companies fulfill their obligations to connect and service customers.

Regulatory developments in Ontario's electricity industry, including current and possible future consultations between the OEB and interested stakeholders, may affect LDC's electricity distribution rates and other permitted recoveries in the future.

LDC is required to charge its customers for the following amounts (all of which, other than distribution charges, represent a pass through of amounts payable to third parties):

[i] *Distribution Charges*. Distribution charges are designed to recover the costs incurred by LDC in delivering electricity to customers and the OEB-allowed rate of return. Distribution charges are regulated by the OEB and are comprised of a fixed charge and a usage-based (consumption) charge. The volume of electricity consumed by LDC's customers during any period is governed by events largely outside LDC's control (principally, sustained periods of hot or cold weather which increase the consumption of electricity and sustained periods of moderate weather which decrease the consumption of electricity).

[ii] *Electricity Price and Related Regulated Adjustments*. The electricity price and related regulated adjustments represent a pass through of the commodity cost of electricity.

[iii] *Retail Transmission Rate*. The retail transmission rate represents a pass through of wholesale costs incurred by distributors in respect of the transmission of electricity from generating stations to local areas. Retail transmission rates are regulated by the OEB.

[iv] *Wholesale Market Service Charge*. The wholesale market service charge represents a pass through of various wholesale market support costs. Retail rates for the recovery of wholesale market service charges are regulated by the OEB.

LDC is required to satisfy and maintain prudential requirements with the IESO, which include credit support with respect to outstanding market obligations in the form of letters of credit, cash deposits or guarantees from third parties with prescribed credit ratings.

## *a) Electricity Distribution Rates*

LDC's electricity distribution rates are typically effective from May 1 to April 30 of the following year. Accordingly, LDC's distribution revenue for the first four months of 2011 was based on the electricity distribution rates approved for the May 1, 2010 to April 30, 2011 rate year [the "2010 Rate Year"], and the distribution revenue for the remainder of 2011 and for the first four months of 2012 are and will be based on electricity distribution rates approved for the May 1, 2011 to April 30, 2012 rate year [the "2011 Rate Year"].

LDC's electricity distribution rates for the 2010 Rate Year and the 2011 Rate Year were determined through an application under the cost of service framework. The cost of service framework sets electricity distribution rates using a detailed examination of evidence and an assessment of the costs incurred by an electricity distributor to provide its service to its customers.

On April 9, 2010, the OEB issued its decision regarding LDC's electricity distribution rates for the 2010 Rate Year. The decision provided for a distribution revenue requirement and rate base of $518,700,000 and $2,140,700,000, respectively. In addition, the decision provided for capital program spending levels and operating, maintenance and administration spending levels of $350,000,000 and $204,100,000, respectively.

On July 7, 2011, the OEB issued its decision regarding LDC's electricity distribution rates for the 2011 Rate Year. The decision provided for a distribution revenue requirement and rate base of $522,044,000 and $2,298,227,000, respectively. In addition, the decision provided for capital program spending levels and operating, maintenance and administration spending levels of $378,800,000 and $238,000,000, respectively.

On August 26, 2011, LDC filed a rate application, following the cost of service framework, with the OEB seeking approval of separate and successive revenue requirements and corresponding electricity distribution rates for three rate years commencing on May 1, 2012, May 1, 2013 and May 1, 2014 [the "2012-2014 Rate Application"]. The requested distribution revenue requirements for these rate years were $571,369,000, $639,492,000, and $712,777,000, respectively, and the expected rate bases for these rate years were $2,636,291,000, $3,053,499,000, and $3,503,165,000, respectively.

Pursuant to the incentive regulation mechanism framework, the OEB established, as a preliminary issue in the 2012-2014 Rate Application, that it would consider the question of whether the application filed by LDC was acceptable or whether it should be dismissed. In particular, the OEB established that in order for it to find that LDC's 2012-2014 Rate Application was acceptable, LDC would be required to show why and how LDC cannot adequately manage its resources and financial needs under the incentive regulation mechanism framework. The incentive regulation mechanism framework provides for an annual adjustment to an electricity distributor's rates based on a formulaic calculation with no direct examination of evidence regarding the electricity distributor's actual costs and infrastructure needs.

LDC filed evidence supporting its position for electricity distribution rates to be set under the cost of service framework as part of its 2012-2014 Rate Application. In particular, LDC provided evidence that it cannot adequately manage its resources and financial needs under the incentive regulation mechanism framework. The OEB established a process by which a portion of LDC's evidence was tested during an oral hearing held in November 2011 *[note 25[b]]*.

## *b) Street Lighting Activities*

On June 15, 2009, the Corporation filed an application with the OEB seeking an electricity distribution licence for a new wholly-owned legal entity to which the Corporation intended to transfer the street lighting assets of TH Energy. Concurrently, the Corporation filed another application with the OEB seeking approval for the merger of LDC and the new legal entity. The main objective of these applications was to transfer the street lighting assets to the regulated electricity distribution activities of LDC to increase the overall safety of the related infrastructure.

On February 11, 2010, the OEB issued its decision in regard to these applications. In its decision, the OEB agreed that, under certain conditions, the treatment of certain types of street lighting assets as regulated assets is justified. The OEB ordered the Corporation to provide a detailed valuation of the street lighting assets and to perform an operational review to determine which street lighting assets could become regulated assets. The Corporation performed a detailed asset operational review and financial valuation of the street lighting assets, which was submitted to the OEB on January 31, 2011.

On August 3, 2011, the OEB issued its final decision allowing the transfer of a portion of the street lighting assets to the new wholly-owned legal entity, and for LDC to amalgamate with the new legal entity *[note 25[a]]*.

## *c) Conservation and Demand Management Activities*

On March 31, 2010, the Minister of Energy and Infrastructure of Ontario, under the guidance of sections 27.1 and 27.2 of the OEB Act, directed the OEB to establish CDM targets to be met by electricity distributors. Accordingly, on November 12, 2010, the OEB amended LDC's distribution licence to require LDC, as a condition of its licence, to achieve 1,304 Gigawatt-Hours of energy savings and 286 Megawatts of summer peak demand savings, over the period beginning January 1, 2011 through December 31, 2014.

Effective January 1, 2011, LDC entered into an agreement with the Ontario Power Authority [“OPA”] to deliver CDM programs in the amount of approximately $50,000,000 extending from January 1, 2011 to December 31, 2014. As at December 31, 2011, LDC received approximately $19,875,000 from the OPA for the delivery of CDM programs. All programs to be delivered are fully funded and paid in advance by the OPA. These programs are expected to support the achievement of the mandatory CDM targets described above.

On January 10, 2011, LDC filed an application with the OEB seeking an order granting approval of funding for CDM programs specific to its customer base. LDC requested funding for eight specific CDM programs amounting to $50,700,000. On July 12, 2011, the OEB issued its decision regarding the CDM programs of LDC. In its decision, the OEB approved with modifications two of the eight programs for a total funding of $5,320,000. The modifications directed by the OEB included changes to the term and nature of those two programs. The OEB did not approve the other six programs as it considered them to be duplicative of existing CDM programs already funded by the OPA.

On August 3, 2011, LDC filed a letter with the OEB informing them that, due to the modified terms and nature of the two approved programs, LDC’s revised economic assessment showed these two programs to be uneconomic, and that they would not be implemented. Accordingly, LDC expects to continue to work with the OPA to expand the roster of current CDM programs in order to achieve its mandated CDM targets.

### *d) Contact Voltage*

On December 10, 2009, the OEB issued an initial decision in regard to the costs incurred in 2009 for the remediation of safety issues related to contact voltage relating to LDC’s electricity distribution infrastructure. The decision provided for the recovery of allowable actual expenditures incurred above the amount deemed as controllable expenses in LDC’s 2009 approved electricity distribution rates. At the time of the decision, the Corporation estimated the allowable recovery of costs at $9,050,000.

On October 29, 2010, the OEB issued a second decision in the matter, following further review of costs incurred by LDC. In this decision, the OEB deemed the balance allowable for recovery at $5,296,000. The variance from the Corporation’s original estimate is mainly due to the OEB’s interpretation of the definition of controllable expenses used to determine the final allowable recovery. In connection with this decision from the OEB, the Corporation revised its recovery estimate for contact voltage costs, resulting in an increase in operating expenses of $3,754,000 in 2010. On November 18, 2010, LDC filed a motion to review the decision with the OEB seeking an amendment to allow for recovery in accordance with the initial decision rendered on December 10, 2009. On March 25, 2011, the OEB issued its decision on the LDC motion, denying the requested additional recovery.

## 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements of the Corporation have been prepared in accordance with Canadian generally accepted accounting principles [“GAAP”], including accounting principles prescribed by the OEB in the handbook “Accounting Procedures Handbook for Electric Distribution Utilities” [“AP Handbook”], are presented in Canadian dollars and reflect the significant accounting policies summarized below:

### *a) Basis of consolidation*

The consolidated financial statements include the accounts of the Corporation and its wholly-owned subsidiaries. All significant intercompany balances and transactions have been eliminated.

## b) Regulation

The following regulatory treatments have resulted in accounting treatments which differ from Canadian GAAP for enterprises operating in an unregulated environment:

***Regulatory Assets and Liabilities***

In accordance with Canadian GAAP, the Corporation currently follows specific accounting policies unique to a rate-regulated business. Under rate-regulated accounting ["RRA"], the timing and recognition of certain expenses and revenues may differ from those otherwise expected under Canadian GAAP in order to appropriately reflect the economic impact of regulatory decisions regarding the Corporation's regulated revenues and expenditures. These timing differences are recorded as regulatory assets and regulatory liabilities on the Corporation's consolidated balance sheets and represent current rights and obligations regarding cash flows expected to be recovered from or refunded to customers, based on decisions and approvals by the OEB. These assets and liabilities can be recognized for rate-setting and financial reporting purposes only if the OEB directs the relevant regulatory treatment or if future OEB direction is judged to be probable. In the event that the disposition of these balances was assessed to no longer be probable, the balances would be recorded in the Corporation's consolidated statements of income in the period that the assessment is made. The measurement of regulatory assets and liabilities is subject to certain estimates and assumptions, including assumptions made in the interpretation of the regulation and the OEB's decisions.

***Contributions in aid of construction***

Capital contributions received from outside sources are used to finance additions to property, plant and equipment of LDC. According to the AP Handbook, capital contributions received are treated as a "credit" to property, plant and equipment. The amount is subsequently depreciated by a charge to accumulated depreciation and a credit to depreciation expense at an equivalent rate to that used for the depreciation of the related property, plant and equipment.

***Allowance for funds used during construction***

The AP Handbook provides for the inclusion of an Allowance for Funds Used During Construction ["AFUDC"] when capitalizing construction-in-progress assets, until such time as the asset is substantially complete. A concurrent credit of the same amount is made to net financing charges when the allowance is capitalized. The interest rate for capitalization is prescribed by the OEB and modified on a periodic basis, and is applied to the balance of the construction-in-progress assets on a simple interest basis. The interest rate for capitalization, for the period from January 1 to September 30, 2011, was 4.29%, and from October 1, 2011 to December 31, 2011, was 3.92%. AFUDC is included in property, plant and equipment, intangible assets, and construction-in-progress assets for financial reporting purposes, charged to operations through depreciation and amortization expense over the service life of the related assets and recovered through future revenue.

## c) Cash and cash equivalents

Cash and cash equivalents include cash in bank accounts and short-term investments with terms to maturity of 90 days or less from their date of acquisition.

## d) Investments

Investments with terms to maturity of greater than 90 days from their date of acquisition are classified as held to maturity and included in current assets.

## e) Inventories

Inventories consist primarily of small consumable materials mainly related to the maintenance of the electricity distribution infrastructure. The Corporation classifies all major construction related components of its electricity distribution system infrastructure to property, plant and equipment. Once capitalized, these items are not depreciated until they are put into service. Inventories are carried at the lower of cost and net realizable value, with cost determined on an average cost basis net of a provision for obsolescence.

## f) Property, plant and equipment

Property, plant and equipment are stated at cost and are removed from the accounts at the end of their estimated average service lives, except in those instances where specific identification allows their removal at retirement or disposition.

In the event that facts and circumstances indicate that property, plant and equipment may be impaired, an evaluation of recoverability is performed. For purposes of such an evaluation, the estimated future undiscounted cash flows associated with the asset are compared to the carrying amount of the asset to determine if a write-down is required. The impairment loss is measured as the amount by which the carrying amount of the asset exceeds its fair value, which is determined by the estimated future discounted cash flows.

Effective January 1, 2011, the Corporation revised its estimates of useful lives of certain items of property, plant and equipment following a detailed review and analysis supported by external third-party evidence. These changes in estimates have been accounted for on a prospective basis in the consolidated financial statements effective January 1, 2011.

Effective January 1, 2011, the Corporation revised its estimates of burden rates of certain items of property, plant and equipment following a detailed review and analysis of all the components included in such burden rates. These changes in estimates of burden rates include changes in the allocation of engineering and administration costs, changes in the calculation of standard labour rates, and changes in the calculation of materials handling costs. These changes in estimates have been accounted for on a prospective basis in the consolidated financial statements effective January 1, 2011.

The changes discussed above were reflected in the 2011 electricity distribution rates approved by the OEB on July 7, 2011 *[note 2[a]]*. Accordingly, these changes decreased distribution revenues by approximately $24,600,000, increased operating expenses by approximately $22,000,000, decreased depreciation expenses by approximately $33,000,000 and decreased Payments in Lieu of Corporate Taxes ["PILs"] by approximately $13,600,000 for the year ended December 31, 2011 and are expected to impact depreciation expenses proportionately in future periods.

[all tabular amounts in thousands of dollars]

Depreciation is provided on a straight-line basis over the estimated service lives at the following annual rates:

| | 2011 | 2010 |
|---|---|---|
| Distribution lines | 1.7% to 5.0% | 2.5% to 25.0% |
| Transformers | 3.3% to 5.0% | 3.3% to 4.0% |
| Stations | 2.5% to 10.0% | 2.5% to 6.7% |
| Meters | 2.5% to 6.7% | 2.9% to 6.7% |
| Buildings | 1.3% to 5.0% | 2.0% |
| Rolling stock | 12.5% to 25.0% | 12.5% to 33.3% |
| Other capital assets | 4.0% to 20.0% | 4.0% to 20.0% |
| Assets under capital lease | 14.3% to 25.0% | 25.0% |
| Equipment and tools | 10.0% to 16.7% | 10.0% to 16.7% |
| Computer hardware | 16.7% to 25.0% | 20.0% to 25.0% |
| Communications | 10.0% to 20.0% | 10.0% to 20.0% |

Construction in progress relate to assets not currently in use and therefore are not depreciated.

## *g) Intangible assets*

Intangible assets are stated at cost. Amortization is provided on a straight-line basis over their estimated service lives at the following annual rates:

| | 2011 | 2010 |
|---|---|---|
| Computer software | 20.0% to 25.0% | 20.0% |
| Contributions | 4.0% | 4.0% |

Software in development and contributions for work in progress relate to assets not currently in use and therefore are not amortized.

## *h) Deferred debt issue costs*

Debt issue costs arising from the Corporation's debenture offerings are recorded against the principal amount of the debentures. The debentures are accreted back to their face value using the effective interest rate method over the remaining period to maturity.

## *i) Workplace Safety and Insurance Act*

The Corporation is a Schedule 1 employer for workers' compensation under the *Workplace Safety and Insurance Act, 1997* (Ontario) [the "WSIA"]. As a Schedule 1 employer under the WSIA, the Corporation is required to pay annual premiums into an insurance fund established under the WSIA and recognizes expenses based on funding requirements.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
[all tabular amounts in thousands of dollars]

December 31, 2011

## *j) Revenue recognition*

Revenues from the sale of electricity are recorded on a basis of cyclical billings and also include unbilled revenues accrued in respect of electricity delivered but not yet billed.

Other revenues, which include revenues from electricity distribution related services and revenues from the delivery of street lighting services, are recognized as the services are rendered.

## *k) Financial instruments*

At inception, all financial instruments which meet the definition of a financial asset or financial liability are to be recorded at fair value, unless fair value cannot be reliably determined. Gains and losses related to the measurement of financial instruments are reported in the consolidated statements of income. Subsequent measurement of each financial instrument will depend on the balance sheet classification elected by the Corporation. The fair value of a financial instrument is the amount of consideration that would be agreed upon in an arm's length transaction between willing parties.

The following summarizes the accounting classification the Corporation has elected to apply to each of its significant categories of financial instruments:

| | |
|---|---|
| Cash equivalents and short-term investments | Investments Held to Maturity |
| Investments | Investments Held to Maturity |
| Accounts receivable and unbilled revenue | Loans and Receivables |
| Accounts payable and accrued liabilities | Other Financial Liabilities |
| Obligations under capital lease | Other Financial Liabilities |
| Customers' advance deposits | Other Financial Liabilities |
| Debentures | Other Financial Liabilities |

The Corporation uses the following methods and assumptions to estimate the fair value of each class of financial instruments for which carrying amounts are included in the consolidated balance sheet:

- Cash equivalents, comprising short-term investments, are classified as "Investments Held to Maturity" and are measured at amortized cost, which, upon initial recognition, is considered equivalent to fair value. The carrying amounts approximate fair value because of the short maturity of these instruments.
- Investments are classified as "Investments Held to Maturity" and are measured at amortized cost, which, upon initial recognition, is considered equivalent to fair value. The carrying amounts approximate fair value because of the short maturity of these instruments.
- Accounts receivable and unbilled revenue are classified as "Loans and Receivables" and are measured at amortized cost, which, upon initial recognition, are considered equivalent to fair value. Subsequent measurements are recorded at amortized cost using the effective interest rate method. The carrying amounts approximate fair value because of the short maturity of these instruments.
- Accounts payable and accrued liabilities are classified as "Other Financial Liabilities" and are initially measured at their fair value. Subsequent measurements are recorded at amortized cost using the effective interest rate method. The carrying amounts approximate fair value because of the short maturity of these instruments.

- Obligations under capital lease are classified as “Other Financial Liabilities” and are initially measured at their fair value. Subsequent measurements are based on discounted cash flow analysis and approximate their carrying values as management believes that the fixed interest rates are representative of current market rates.
- Customers’ advance deposits are classified as “Other Financial Liabilities” and are initially measured at their fair value. Subsequent measurements are recorded at amortized cost using the effective interest rate method. The carrying amounts approximate fair value because of the short maturity of the current portion, and the discounted long-term portion approximates the carrying value, taking into account interest accrued on the outstanding balance.
- Debentures are classified as “Other Financial Liabilities” and are initially measured at their fair value. The carrying amounts of the debentures are carried at amortized cost, based on an initial fair value as determined at the time using quoted market price for similar debt instruments. The fair value of the debentures is calculated by discounting the related cash flows at the estimated yield to maturity of similar debt instruments *[note 16]*. While the Corporation has the option to redeem some or all of the debentures at its discretion, this option has no value and has not been recorded in the consolidated financial statements.

## *l) Fair value measurements*

The Corporation utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. A fair value hierarchy exists that prioritizes observable and unobservable inputs used to measure fair value. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Corporation’s assumptions with respect to how market participants would price an asset or liability. The fair value hierarchy includes three levels of inputs that may be used to measure fair value:

- Level 1 – Unadjusted quoted prices in active markets for identical assets or liabilities. An active market for the asset or liability is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis;
- Level 2 – Observable inputs other than level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities; and
- Level 3 – Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

## *m) Employee future benefits*

### *Pension plan*

The Corporation provides a pension plan for its full-time employees through the Ontario Municipal Employees Retirement System [“OMERS”]. OMERS is a multi-employer, contributory, defined benefit pension plan established in 1962 by Ontario for employees of municipalities, local boards and school boards. Both participating employers and employees are required to make plan contributions based on participating employees’ contributory earnings. The Corporation recognizes the expense related to this plan as contributions are made.

***Employee future benefits other than pension***

Employee future benefits other than pension provided by the Corporation include medical, dental and life insurance benefits, and accumulated sick leave credits. These plans provide benefits to employees when they are no longer providing active service. Employee future benefit expense is recognized in the period in which the employees render services on an accrual basis.

The accrued benefit obligations and the current service costs are calculated using the projected benefit method prorated on service and based on assumptions that reflect management's best estimate. The current service cost for a period is equal to the actuarial present value of benefits attributed to employees' services rendered in the period. Past service costs arising from plan amendments are amortized on a straight-line basis over the average remaining service period of employees active at the date of amendment. The excess of the net actuarial gains or losses over 10% of the accrued benefit obligation is amortized into expense over the average remaining service period of active employees to full eligibility. The effects of a curtailment gain or loss are recognized in income in the year of the event giving rise to the curtailment. The effects of a settlement gain or loss are recognized in the period in which a settlement occurs.

## n) Asset retirement obligations

The Corporation recognizes a liability for the future removal and handling costs for contamination in distribution equipment in service and in storage and for the future environmental remediation of certain properties. Initially, the liability is measured at present value and the amount of the liability is added to the carrying amount of the related asset. In subsequent periods, the asset is depreciated and the liability is adjusted quarterly for the discount applied upon initial recognition of the liability ["accretion expense"] and for changes in the underlying assumptions. The liability is recognized when the asset retirement obligation ["ARO"] is incurred and when the fair value is determined.

## o) Customers' advance deposits

Customers' advance deposits are cash collections from customers to guarantee the payment of energy bills. The customers' advance deposits liability includes interest credited to the customers' deposit accounts, with the debit charged to net financing charges. Deposits expected to be refunded to customers within the next fiscal year are classified as a current liability.

## p) Payments in lieu of corporate taxes

The Corporation is exempt from tax under the *Income Tax Act* (Canada) ["ITA"] if not less than 90% of the capital of the Corporation is owned by the City and not more than 10% of the income of the Corporation is derived from activities carried on outside the municipal geographical boundaries of the City. In addition, the Corporation's subsidiaries are also exempt from tax under the ITA provided that all of their capital is owned by the Corporation and not more than 10% of their respective income is from activities carried on outside the municipal geographical boundaries of the City. A corporation exempt from tax under the ITA is also exempt from tax under the *Taxation Act, 2007* (Ontario) ["TA"] and the *Corporations Tax Act* (Ontario) ["CTA"].

The Corporation and each of its subsidiaries are Municipal Electricity Utilities ["MEUs"] for purposes of the PILs regime contained in the Electricity Act. The Electricity Act provides that a MEU that is exempt from tax under the ITA, the CTA and the TA is required to make, for each taxation year, a PILs payment to the Ontario Electricity

Financial Corporation in an amount equal to the tax that it would be liable to pay under the ITA and the TA (for years ending after 2008) or the CTA (for years ending prior to 2009) if it were not exempt from tax. The PILs regime came into effect on October 1, 2001, at which time the Corporation and each of its subsidiaries were deemed to have commenced a new taxation year for purposes of determining their respective liabilities for PILs payments.

The Corporation uses the liability method of accounting for income taxes. Under the liability method, future income tax assets and liabilities are determined based on differences between the accounting and tax bases of assets and liabilities and measured using the substantively enacted tax rates and laws that will be in effect when the differences are expected to reverse. The effect on future income tax assets and liabilities of a change in tax rates is included in income in the period the change is substantively enacted. Future income tax assets are evaluated and if realization is not considered more likely than not, a valuation allowance is established. In accordance with the Canadian Institute of Chartered Accountants ["CICA"] Handbook Section 3465 – "Income Taxes", LDC recognizes future income taxes associated with its rate-regulated operations and records an offsetting regulatory asset or liability for the future income taxes that are expected to be recovered or refunded through future regulated prices charged to customers.

## *q) Use of estimates*

The preparation of the Corporation's consolidated financial statements in accordance with Canadian GAAP requires management to make estimates and assumptions which affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses for the year. The estimates are based on historical experience, current conditions and various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities as well as identifying and assessing the accounting treatment with respect to commitments and contingencies. Significant areas requiring the use of management estimates relate to unbilled revenue, regulatory assets and liabilities, environmental liabilities and AROs, employee future benefits, and revenue recognition. Actual results could differ from those estimates, including changes as a result of future decisions made by the OEB, the Ministry of Energy, or the Ministry of Finance of Ontario ["Ministry of Finance"].

## *r) Future Accounting Pronouncements*

### *Adoption of New Accounting Standards*

Publicly accountable enterprises in Canada were required to adopt International Financial Reporting Standards ["IFRS"] in place of Canadian GAAP for interim and annual reporting purposes for fiscal years beginning on or after January 1, 2011. On September 10, 2010, the Accounting Standards Board granted an optional one-year deferral for IFRS adoption for entities subject to rate regulation due to the uncertainty created by the International Accounting Standards Board ["IASB"] in regard to RRA. To date, the IASB has not approved any temporary exemption or finalized a RRA standard under IFRS. The Corporation elected to take the optional one-year deferral of its adoption of IFRS; therefore, it continues to prepare its consolidated financial statements in accordance with Canadian GAAP accounting standards in Part V of the CICA Handbook in 2011.

The Corporation's IFRS conversion project was proceeding as planned to meet the January 1, 2011 conversion date. In the absence of a definitive plan to consider the issuance of a RRA standard by the IASB, the Corporation decided to evaluate the option of adopting United States ["US"] GAAP effective January 1, 2012 as an alternative to IFRS. The Corporation's current application of Canadian GAAP for RRA is generally consistent with US GAAP. Under US GAAP, the Corporation's financial reporting is expected to be more comparable with its current Canadian

[all tabular amounts in thousands of dollars]

GAAP results than it would be under IFRS and is expected to facilitate comparability with other large North American utilities.

On July 8, 2011, the Corporation filed an application with the applicable Canadian securities regulatory authorities pursuant to section 5.1 of National Instrument 52-107 "Acceptable Accounting Principles and Auditing Standards", to permit the Corporation to prepare its consolidated financial statements in accordance with US GAAP without qualifying as a US Securities and Exchange Commission issuer.

On July 21, 2011, the applicable Canadian securities regulatory authorities issued a decision which gave the Corporation the option to prepare its consolidated financial statements in accordance with US GAAP for its fiscal years beginning on or after January 1, 2012 but before January 1, 2015. The decision is similar to that obtained by other Canadian rate-regulated utilities.

On August 19, 2011, LDC filed a letter with the OEB stating its intention to adopt US GAAP as the basis for the calculation of electricity distribution rates starting in 2012 in accordance with the guidelines provided by the OEB. In the OEB guidelines, the OEB indicated to Ontario utilities that it would permit the use of US GAAP for the calculation of electricity distribution rates if such utilities receive approval from the Ontario Securities Commission and if it benefits electricity distribution consumers.

On August 26, 2011, the board of directors of the Corporation approved the adoption of US GAAP for financial reporting purposes for the year beginning on January 1, 2012. Accordingly, the Corporation plans to commence reporting under US GAAP in its first quarterly consolidated financial statements in 2012. As a result of this decision, the Corporation's IFRS conversion project efforts have been reduced. However, the work has been managed in such a way that it can effectively be restarted when a future transition to IFRS is required.

The Corporation's interim consolidated financial statements for the first quarter of 2012 are expected to be prepared in accordance with US GAAP and applied retrospectively to the Corporation's opening US GAAP consolidated balance sheet as at January 1, 2011. Based on the results of the detailed assessment of the differences between US GAAP and Canadian GAAP as it applies to its business, the Corporation does not believe that the adoption of US GAAP will have a material impact on its consolidated financial statements in the future.

## 4. INVENTORIES

Inventories consist of the following:

| | 2011<br>$ | 2010<br>$ |
|---|---|---|
| Consumables, tools and other maintenance items | **1,745** | 2,077 |
| Fuses | **1,625** | 1,731 |
| Drums and reels | **938** | 1,092 |
| Other | **2,583** | 2,601 |
| | **6,891** | 7,501 |

For the year ended December 31, 2011, the Corporation recognized operating expenses of $6,567,000 related to inventory used to service electrical distribution assets [2010 - $4,727,000].

[all tabular amounts in thousands of dollars]

## 5. PROPERTY, PLANT AND EQUIPMENT, NET

Property, plant and equipment consist of the following:

| | 2011 | | | 2010 | | |
|---|---|---|---|---|---|---|
| | **Cost $** | **Accumulated depreciation $** | **Net book value $** | **Cost $** | **Accumulated depreciation $** | **Net book value $** |
| Land | **16,761** | **—** | **16,761** | 9,560 | — | 9,560 |
| Distribution lines | **2,850,401** | **1,441,333** | **1,409,068** | 2,608,555 | 1,384,876 | 1,223,679 |
| Transformers | **652,102** | **360,398** | **291,704** | 609,702 | 341,706 | 267,996 |
| Stations | **277,905** | **137,246** | **140,659** | 259,337 | 128,254 | 131,083 |
| Meters | **238,459** | **124,117** | **114,342** | 214,859 | 114,808 | 100,051 |
| Buildings | **154,932** | **62,403** | **92,529** | 151,543 | 55,609 | 95,934 |
| Rolling stock | **78,016** | **43,154** | **34,862** | 73,749 | 43,208 | 30,541 |
| Other capital assets | **68,802** | **44,108** | **24,694** | 59,049 | 35,462 | 23,587 |
| Assets under capital lease | **14,269** | **1,251** | **13,018** | 886 | 351 | 535 |
| Equipment and tools | **44,208** | **31,785** | **12,423** | 41,604 | 29,732 | 11,872 |
| Computer hardware | **44,625** | **35,602** | **9,023** | 40,634 | 31,228 | 9,406 |
| Communications | **31,537** | **23,912** | **7,625** | 26,818 | 21,013 | 5,805 |
| Construction in progress | **232,789** | **—** | **232,789** | 218,728 | — | 218,728 |
| | **4,704,806** | **2,305,309** | **2,399,497** | 4,315,024 | 2,186,247 | 2,128,777 |

For the year ended December 31, 2011, AFUDC in the amount of $3,786,000 [2010 - $1,850,000] was capitalized to property, plant and equipment and credited to net financing charges.

As at December 31, 2011, the net book value of stranded meters related to the deployment of smart meters amounting to $20,366,000 [December 31, 2010 - $23,120,000] was included in property, plant and equipment. In the absence of rate regulation, property, plant and equipment would have been $20,366,000 lower as at December 31, 2011 [December 31, 2010 - $23,120,000 lower].

For the year ended December 31, 2011, the Corporation recognized a gain of $3,885,000 [2010 - $3,767,000] on disposals of surplus properties, of which $1,375,000 [2010 - $2,750,000] relates to surplus properties for which the OEB reduced electricity distribution rates in 2010. LDC began recognizing the actual gain realized on the sale of these properties over a one-year period from May 1, 2010 to mirror the actual timing of the reduction in 2010 electricity distribution rates.

For the year ended December 31, 2011, the Corporation recorded depreciation expense of $125,210,000 [2010 - $153,189,000] of which $1,177,000 [2010 - $204,000] related to assets under capital lease.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
[all tabular amounts in thousands of dollars]

December 31, 2011

## 6. INTANGIBLE ASSETS, NET

Intangible assets consist of the following:

| | 2011 | | | 2010 | | |
|---|---|---|---|---|---|---|
| | Cost $ | Accumulated amortization $ | Net book value $ | Cost $ | Accumulated amortization $ | Net book value $ |
| Computer software | **222,598** | **154,186** | **68,412** | 172,709 | 129,301 | 43,408 |
| Contributions | **14,059** | **1,440** | **12,619** | 2,043 | 524 | 1,519 |
| Software in development | **3,582** | — | **3,582** | 39,191 | — | 39,191 |
| Contributions for work in progress | **28,369** | — | **28,369** | 1,878 | — | 1,878 |
| | **268,608** | **155,626** | **112,982** | 215,821 | 129,825 | 85,996 |

For the year ended December 31, 2011, the Corporation acquired $52,805,000 of intangible assets [2010 - $28,387,000]. All intangible assets are subject to amortization when they become available for use. Software in development and contributions for work in progress relate to assets not currently available for use and therefore are not amortized.

For the year ended December 31, 2011, $49,907,000 of software in development were transferred to computer software [2010 - $29,266,000].

For the year ended December 31, 2011, AFUDC in the amount of $1,419,000 [2010 - $1,658,000] was capitalized to intangible assets and credited to net financing charges.

For the year ended December 31, 2011, the Corporation recorded amortization expense on intangible assets of $25,812,000 [2010 - $16,219,000].

## 7. REGULATORY ASSETS AND LIABILITIES

Regulatory assets consist of the following:

| | 2011 $ | 2010 $ |
|---|---|---|
| Smart meters | **61,422** | 67,719 |
| Late payment penalties settlement | — | 7,750 |
| IFRS conversion project | — | 6,089 |
| Settlement variances | **14,119** | — |
| Special purpose charge variance | **572** | 3,555 |
| Other | **1,209** | — |
| | **77,322** | 85,113 |

[all tabular amounts in thousands of dollars]

Regulatory liabilities consist of the following:

| | 2011<br>$ | 2010<br>$ |
|---|---|---|
| Future income taxes | **200,436** | 224,570 |
| Regulatory assets recovery account | **6,361** | 40,275 |
| PILs variances | **2,365** | 5,675 |
| Settlement variances | **—** | 2,277 |
| Other | **1,118** | 909 |
| | **210,280** | 273,706 |

For the year ended December 31, 2011, LDC disposed of approved net regulatory liabilities amounting to $34,528,000 through permitted distribution rate adjustments [2010 - $23,003,000].

The regulatory assets and liabilities of the Corporation are as follows:

### *a) Smart Meters*

The smart meters regulatory asset account relates to Ontario's decision to install smart meters throughout Ontario. LDC substantially completed its smart meter project as at December 31, 2010. In connection with this initiative, the OEB ordered LDC to record all expenditures and related revenues from 2008 to 2010 to a regulatory asset account and allowed LDC to keep the net book value of the stranded meters in property, plant and equipment. Starting on January 1, 2011, LDC began recording smart meter costs in property, plant and equipment and intangible assets as a regular distribution activity as directed by the OEB. LDC expects to apply to the OEB to transfer the 2008 to 2010 smart meter costs from regulatory assets to property, plant and equipment and intangible assets, as well as to transfer the net book value of the stranded meters from property, plant and equipment to regulatory assets in 2012.

The Corporation incurred smart meter capital expenditures amounting to $nil for the year ended December 31, 2011 [2010 - $19,799,000]. As at December 31, 2011, smart meter capital expenditures, net of accumulated depreciation, totalling $59,227,000 were recorded to regulatory assets [December 31, 2010 - $65,588,000]. These expenditures would otherwise have been recorded as property, plant and equipment and intangible assets under Canadian GAAP for unregulated businesses. In the absence of rate regulation, property, plant and equipment and intangible assets would have been $54,825,000 and $4,402,000 higher, respectively, as at December 31, 2011 [December 31, 2010 - $59,416,000 and $6,172,000 higher, respectively].

For the year ended December 31, 2011, deferred smart meter operating expenses were reduced by $490,000 which would have reduced expenses under Canadian GAAP for unregulated businesses [2010 – were increased by $3,109,000]. For the year ended December 31, 2011, smart meter depreciation expense of $6,361,000 [2010 - $5,357,000] were deferred which would have been expensed under Canadian GAAP for unregulated businesses. In the absence of rate regulation, for the year ended December 31, 2011, operating expenses would have been $490,000 lower [2010 - $3,109,000 higher], and depreciation expense would have been $6,361,000 higher [2010 - $5,357,000 higher].

For the year ended December 31, 2011, smart meter customer revenues of $5,866,000 were deferred [2010 - $5,774,000]. In the absence of rate regulation, for the year ended December 31, 2011, revenue would have been $5,866,000 higher [2010 - $5,774,000 higher].

### *b) Late Payment Penalties Settlement*

The late payment penalties settlement regulatory asset account was related to the settlement costs associated with the late payment charges class action. All of the MEUs involved in the settlement, including LDC, requested an order from the OEB allowing for the future recovery from customers of all costs related to the settlement. On February 22, 2011, the OEB approved the recovery of the costs of $7,526,000. The recovery is occurring over a 21-month period which commenced on August 1, 2011. Accordingly, the balance approved for recovery was transferred to the Regulatory Assets Recovery Account ["RARA"].

### *c) IFRS Conversion Project*

This regulatory asset account included the incremental costs incurred by LDC for its initially planned conversion to IFRS. On July 7, 2011, the OEB reduced the allowable recoverable costs from $6,134,000 to $3,050,000 as it appeared that a portion of the costs claimed for recovery by LDC were included in prior period electricity distribution rates. In connection with this decision from the OEB, the Corporation revised its estimate for IFRS conversion costs recovery, resulting in an increase in operating expenses of $3,017,000 in the second quarter of 2011. The remaining regulatory asset balance of $3,050,000, which included carrying charges, was transferred to the RARA and is being recovered over a nine-month period which commenced on August 1, 2011. Under Canadian GAAP for unregulated businesses, these costs would have been recorded to operating expenses. In the absence of rate regulation, for the year ended December 31, 2011, operating expenses would have been $3,017,000 lower [2010 - $3,108,000 higher].

### *d) Settlement Variances*

This account is comprised of the variances between amounts charged by LDC to customers, based on regulated rates, and the corresponding cost of non-competitive electricity service incurred by LDC. The settlement variances relate primarily to service charges, non-competitive electricity charges, imported power charges and the global adjustment. Accordingly, LDC has deferred the variances between the costs incurred and the related recoveries in accordance with the criteria set out in the accounting principles prescribed by the OEB in the AP Handbook.

The balance for settlement variances continues to be calculated and attract carrying charges in accordance with the OEB's direction. For the year ended December 31, 2011, settlement variances of $34,938,000 were disposed through rate adjustments [2010 - $20,016,000].

### *e) Special Purpose Charge Variance*

On April 9, 2010, the OEB informed electricity distributors of a Special Purpose Charge ["SPC"] assessment under Section 26.1 of the OEB Act, for the Ministry of Energy and Infrastructure conservation and renewable energy program costs. The OEB assessed LDC the amount of $9,698,000 for its apportioned share of the total provincial amount of the SPC of $53,695,000 in accordance with the rules set out in Ontario Regulation 66/10 [the "SPC Regulation"]. In accordance with Section 9 of the SPC Regulation, LDC was allowed to recover this balance. The recovery was completed as at April 30, 2011.

As at December 31, 2011, the balance in the account consists of LDC's assessment of $9,698,000 less the recoveries received from customers. In the absence of rate regulation, revenue for the year ended December 31, 2011, would have been $3,050,000 higher [2010 - $6,123,000 higher] and operating expenses for the year ended December 31, 2011 would have $nil impact [2010 - $9,698,000 higher].

## *f) Future Income Taxes*

This regulatory liability account relates to the expected future electricity distribution rate reduction for customers arising from timing differences in the recognition of future tax assets *[note 3[p]]*.

As at December 31, 2011, LDC recorded a future income tax asset and a corresponding regulatory liability of $200,436,000 [December 31, 2010 - $224,570,000] with respect to its rate-regulated activities. The future income tax asset and the corresponding regulatory liability as at December 31, 2010, have been recast, to reflect an adjustment of $30,247,000 resulting from a change in methodology used to determine the timing differences between the tax value and book value of the assets for accounting purposes.

## *g) Regulatory Assets Recovery Account*

The RARA consists of balances of regulatory assets or regulatory liabilities approved for disposition by the OEB through rate riders. The RARA is subject to carrying charges following the OEB prescribed methodology and related rates.

On April 16, 2009, the OEB approved the disposition of regulatory liabilities of $7,582,000, for amounts arising from the extended effectiveness of certain rate riders into the 2008 rate year, over a one-year period commencing on May 1, 2009 and ending on April 30, 2010.

On April 9, 2010, the OEB approved the disposition of net regulatory liabilities of $68,140,000, consisting of credit balances for settlement variances and PILs variances of $58,225,000 and $11,900,000, respectively, and intangible assets debit balance of $1,985,000, over a two-year period commencing on May 1, 2010 and ending on April 30, 2012.

On October 29, 2010, the OEB approved the disposition of regulatory assets of $5,296,000, for amounts in connection with the contact voltage remediation activities, for the period commencing on November 1, 2010 and ending on April 30, 2012 *[note 2[d]]*.

On February 22, 2011, the OEB approved the disposition of the Late Payment Penalties Settlement regulatory asset of $7,526,000, over a 21-month period commencing on August 1, 2011 and ending on April 30, 2013.

On July 7, 2011, the OEB approved the disposition of net regulatory liabilities of $8,572,000, consisting of credit balances for settlement variances, PILs variances and 2008 RARA residual of $7,460,000, $3,373,000, and $789,000, respectively, and an IFRS cost debit balance of $3,050,000, over a nine-month period commencing on August 1, 2011 and ending on April 30, 2012.

## *h) PILs Variances*

The PILs variances regulatory liability account relates to the differences that have resulted from a legislative or regulatory change to the tax rates or rules assumed in the rate adjustment model. As at December 31, 2011, the balance in this account consisted of an over-recovery from customers of $2,365,000 [December 31, 2010 - $5,675,000].

[all tabular amounts in thousands of dollars]

## 8. OTHER ASSETS

Other assets consist of the following:

| | 2011<br>$ | 2010<br>$ |
|---|---|---|
| Prepaid leases | **7,279** | 7,368 |
| Other | **52** | 150 |
| | **7,331** | 7,518 |

## 9. CREDIT FACILITIES

On May 3, 2011, the Corporation extended its revolving credit facility [“Revolving Credit Facility”] for an additional term, expiring on May 3, 2013. Under the terms of the Revolving Credit Facility, the Corporation may borrow up to $400,000,000, of which:

[i] $400,000,000 less the amount utilized under [ii] is available for working capital and LDC capital expenditure purposes in the form of prime rate loans in Canadian dollars and Bankers’ Acceptance [“BAs”]; and

[ii] up to $140,000,000 is available in the form of letters of credit to support the prudential requirements of LDC and TH Energy and general credit requirements of the Corporation and its subsidiaries.

The fee payable for BAs and letters of credit is based on a margin determined by reference to the Corporation’s credit rating. The Revolving Credit Facility contains a negative pledge, customary covenants and events of default.

As at December 31, 2011, no amounts had been drawn under the Corporation’s Revolving Credit Facility [December 31, 2010 - $nil]. As at December 31, 2011, no amounts had been drawn for working capital purposes [December 31, 2010 - $nil].

Additionally, the Corporation is a party to a bilateral facility for $50,000,000 for the purpose of issuing letters of credit mainly to support LDC’s prudential requirements with the IESO. As at December 31, 2011, $45,077,000 had been drawn on the bilateral facility [December 31, 2010 - $46,077,000].

## 10. CURRENT PORTION OF OTHER LIABILITIES

Current portion of other liabilities consist of the following:

| | 2011<br>$ | 2010<br>$ |
|---|---|---|
| Customers’ advance deposits | **20,108** | 18,790 |
| Obligations under capital lease *[note 21]* | **1,871** | 182 |
| Other | **311** | 761 |
| | **22,290** | 19,733 |

[all tabular amounts in thousands of dollars]

## 11. DEBENTURES

Debentures consist of the following:

| | 2011<br>$ | 2010<br>$ |
|---|---|---|
| Senior unsecured debentures | | |
| Series 1 – 6.11% due May 7, 2013 | **224,298** | 223,838 |
| Series 2 – 5.15% due November 14, 2017 | **248,941** | 248,793 |
| Series 3 – 4.49% due November 12, 2019 | **248,682** | 248,546 |
| Series 4 – 6.11% due December 30, 2011 | **—** | 245,057 |
| Series 5 – 6.11% due May 6, 2013 | **245,057** | 245,057 |
| Series 6 – 5.54% due May 21, 2040 | **198,566** | 198,546 |
| Series 7 – 3.54% due November 18, 2021 | **297,970** | — |
| **Total debentures** | **1,463,514** | 1,409,837 |
| Less: Current portion of debentures | **—** | 245,057 |
| Long-term portion of debentures | **1,463,514** | 1,164,780 |

All debentures of the Corporation rank equally.

On May 7, 2003, the Corporation issued $225,000,000 in 10-year senior unsecured debentures [“Series 1”]. The Series 1 debentures bear interest at the rate of 6.11% per annum, payable semi-annually in arrears in equal instalments on May 7 and November 7 of each year. The Series 1 debentures mature on May 7, 2013.

On November 14, 2007, the Corporation issued $250,000,000 in 10-year senior unsecured debentures [“Series 2”]. The Series 2 debentures bear interest at the rate of 5.15% per annum, payable semi-annually in arrears in equal instalments on May 14 and November 14 of each year. The Series 2 debentures mature on November 14, 2017.

On November 12, 2009, the Corporation issued $250,000,000 in 10-year senior unsecured debentures [“Series 3”]. The Series 3 debentures bear interest at the rate of 4.49% per annum, payable semi-annually in arrears in equal instalments on May 12 and November 12 of each year. The Series 3 debentures mature on November 12, 2019.

On April 1, 2010, the Corporation issued $245,057,000 senior unsecured debentures [“Series 4”]. The Series 4 debentures bear interest at the rate of 6.11% per annum, payable semi-annually in arrears in equal instalments on June 30 and December 30 of each year and on the maturity date. The Series 4 debentures matured on December 30, 2011.

On April 1, 2010, the Corporation issued $245,057,000 senior unsecured debentures [“Series 5”]. The Series 5 debentures bear interest at the rate of 6.11% per annum, payable semi-annually in arrears in equal instalments on May 6 and November 6 of each year and on the maturity date. The Series 5 debentures mature on May 6, 2013.

On May 20, 2010, the Corporation issued $200,000,000 in 30-year senior unsecured debentures [“Series 6”]. The Series 6 debentures bear interest at the rate of 5.54% per annum, payable semi-annually in arrears in equal instalments on May 21 and November 21 of each year. The Series 6 debentures mature on May 21, 2040.

[all tabular amounts in thousands of dollars]

On November 18, 2011, the Corporation issued $300,000,000 in 10-year senior unsecured debentures [“Series 7”]. The Series 7 debentures bear interest at the rate of 3.54% per annum, payable semi-annually in arrears in equal instalments on May 18 and November 18 of each year. The Series 7 debentures mature on November 18, 2021.

The Corporation may redeem some or all of the debentures at any time prior to maturity at a price equal to the greater of the Canada Yield Price (determined in accordance with the terms of the debentures) and par, plus accrued and unpaid interest up to but excluding the date fixed for redemption. Also, the Corporation may, at any time and from time to time, purchase debentures for cancellation, in the open market, by tender or by private contract, at any price. The debentures contain certain covenants which, subject to certain exceptions, restrict the ability of the Corporation and LDC to create security interests, incur additional indebtedness or dispose of all or substantially all of their assets.

## 12. EMPLOYEE FUTURE BENEFITS

### *Pension*

For the year ended December 31, 2011, the Corporation’s OMERS current service pension costs were $14,115,000 [2010 - $12,024,000]. For the year ended December 31, 2011, OMERS contribution rates were 7.4% up to the year’s maximum pensionable earnings [“YMPE”] and 10.7% over YMPE for normal retirement age [“NRA”] of 65 [December 31, 2010 - 6.4% up to YMPE and 9.7% over YMPE for NRA of 65].

### *Employee future benefits other than pension*

The Corporation has a number of unfunded benefit plans providing retirement and post-employment benefits (excluding pension) to most of its employees. The Corporation pays certain medical, dental and life insurance benefits under unfunded defined benefit plans on behalf of its retired employees. The Corporation pays accumulated sick leave credits, up to certain established limits based on service, in the event of retirement, termination or death of certain employees.

The Corporation measures its accrued benefits obligation for accounting purposes as at December 31 of each year. The latest actuarial valuation was performed as at January 1, 2010.

### *a) Accrued benefit obligation*

| | 2011<br>$ | 2010<br>$ |
|---|---|---|
| Balance, beginning of year | **200,027** | 177,144 |
| Experience loss at beginning of year | — | 8,013 |
| Current service cost | **3,908** | 3,485 |
| Interest cost | **11,507** | 11,102 |
| Benefits paid | **(7,495)** | (7,197) |
| Actuarial losses | **36,379** | 7,480 |
| **Balance, end of year** | **244,326** | 200,027 |

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

[all tabular amounts in thousands of dollars]

December 31, 2011

### *b) Reconciliation of the accrued benefit obligation to the balance sheet accrued benefit liability*

| | 2011 $ | 2010 $ |
|---|---|---|
| Accrued benefit obligation | **244,326** | 200,027 |
| Unamortized net actuarial losses | **(63,698)** | (27,952) |
| Unamortized past service costs | **(1,087)** | (2,178) |
| **Post-employment benefits liability** | **179,541** | 169,897 |

### *c) Components for net periodic defined benefit costs*

| | 2011 $ | 2010 $ |
|---|---|---|
| Current service cost | **3,908** | 3,485 |
| Interest cost | **11,507** | 11,102 |
| Actuarial losses | **36,379** | 15,493 |
| Cost incurred in the year | **51,794** | 30,080 |
| **Differences between costs incurred and costs recognized in the year in respect of:** | | |
| Actuarial gains | **(35,746)** | (15,298) |
| Past service costs | **1,091** | 964 |
| | **(34,655)** | (14,334) |
| **Defined benefit costs recognized** | **17,139** | 15,746 |
| Capitalized as part of property, plant and equipment | **6,758** | 7,388 |
| **Charged to operations** | **10,381** | 8,358 |

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

[all tabular amounts in thousands of dollars]

December 31, 2011

## *d) Significant assumptions*

| | 2011<br>% | 2010<br>% |
|---|---|---|
| **Accrued benefit obligation as at December 31:** | | |
| Discount rate | **4.8** | 5.8 |
| Rate of compensation increase | **4.0** | 4.0 |
| **Benefit costs for years ended December 31:** | | |
| Discount rate | **5.8** | 6.0 |
| Rate of compensation increase | **4.0** | 4.0 |
| **Assumed health care cost trend rates as at December 31:** | | |
| Rate of increase in dental costs | **4.0** | 4.0 |

For December 31, 2011, medical costs are assumed to increase at 7.0% [2010 - 7.5%] graded down by 0.5% [2010 - 0.5%] annual decrements to 5.0% [2010 - 5.0%] in 2016 and thereafter.

## *e) Sensitivity analysis*

Assumed health and dental care cost trend rates have a significant effect on the amounts reported for health and dental care plans. A one-percentage-point change in assumed health and dental care cost trend rates would have the following effects for 2011:

| | Increase<br>$ | Decrease<br>$ |
|---|---|---|
| Total of current service and interest cost (at 5.8%) | **2,733** | **(1,880)** |
| Accrued benefit obligation as at December 31, 2011 (at 4.8%) | **36,933** | **(28,417)** |

Assumed interest rates have a significant effect on the amounts reported for the total accrued benefit obligation and expense. A one-percentage-point change in assumed interest rates would have the following effects for 2011:

| | Increase<br>$ | Decrease<br>$ |
|---|---|---|
| Accrued benefit obligation as at December 31, 2011 | **(33,098)** | **42,923** |
| Estimated expense for fiscal 2012 | **(3,030)** | **3,449** |

[all tabular amounts in thousands of dollars]

## 13. OTHER LIABILITIES

Other long-term liabilities consist of the following:

| | 2011<br>$ | 2010<br>$ |
|---|---|---|
| Obligations under capital lease *[note 21]* | **11,301** | 369 |
| Other | **—** | 265 |
| | **11,301** | 634 |

For the year ended December 31, 2011, the Corporation acquired property, plant and equipment through capital lease transactions totalling $13,717,000 [2010 - $176,000]. These non-cash transactions have been excluded from the consolidated statements of cash flows.

## 14. ASSET RETIREMENT OBLIGATIONS

Reconciliation between the opening and closing ARO liability balances is as follows:

| | 2011<br>$ | 2010<br>$ |
|---|---|---|
| Balance, beginning of year | **5,005** | 7,552 |
| ARO liabilities settled in the year | **(688)** | (2,290) |
| Accretion expense | **173** | 194 |
| Revision in estimated cash flows | **412** | (451) |
| **Balance, end of year** | **4,902** | 5,005 |

As at December 31, 2011, the Corporation estimates the undiscounted amount of cash flows required over the next one to 45 years to settle the ARO liabilities is $5,811,000 [December 31, 2010 - $6,560,000]. Discount rates ranging from 1.39% to 6.60% [December 31, 2010 - 1.39% to 6.60%] were used to calculate the carrying value of the ARO liabilities. No assets have been legally restricted for settlement of the liability.

## 15. CAPITAL DISCLOSURES

The Corporation's main objectives when managing capital are to:

- ensure ongoing access to funding to maintain and refurbish the electricity distribution system of LDC;
- ensure compliance with covenants related to its credit facilities and senior unsecured debentures;
- maintain at least an A- credit rating as required under its shareholder direction; and
- align its capital structure for regulated activities of LDC with the deemed debt to equity structure set by the OEB.

As at December 31, 2011, the Corporation's definition of capital includes long-term debt and obligations under capital lease, including the current portion thereof, and shareholder's equity, and has remained unchanged from

[all tabular amounts in thousands of dollars]

December 31, 2010. As at December 31, 2011, shareholder's equity amounted to $1,102,248,000 [December 31, 2010 - $1,039,379,000] and long-term debt, including the current portion thereof, amounted to $1,476,686,000 [December 31, 2010 - $1,409,837,000]. The Corporation's capital structure as at December 31, 2011 was 57% debt and 43% equity [December 31, 2010 - 58% debt and 42% equity]. There were no changes in the Corporation's approach to capital management during the year.

As at December 31, 2011, the Corporation is subject to debt agreements that contain various covenants. The Corporation's unsecured debentures limit consolidated funded indebtedness to a maximum of 75% of total consolidated capitalization. As at December 31, 2011, the consolidated funded indebtedness to consolidated capitalization ratio was 57% [December 31, 2010 - 57%].

The Corporation's Revolving Credit Facility limits the debt to capitalization ratio to a maximum of 75%. As at December 31, 2011, the debt to capitalization ratio was 58% [December 31, 2010 - 58%].

The Corporation's long-term debt agreements also include negative covenants such as limitations on funded indebtedness, limitations on designated subsidiary indebtedness, and restrictions on mergers and dispositions of designated subsidiaries. As at December 31, 2011 and as at December 31, 2010, the Corporation was in compliance with all covenants included in its long-term debt agreements and short-term Revolving Credit Facility.

## 16. FINANCIAL INSTRUMENTS

### *a) Recognition and measurement*

The carrying value and fair value of the Corporation's financial instruments consist of the following:

| | 2011<br>$ | | 2010<br>$ | |
|---|---|---|---|---|
| | **Carrying value** | **Fair value** | **Carrying value** | **Fair value** |
| Cash and cash equivalents | **154,256** | **154,256** | 330,151 | 330,151 |
| Investments | **34,002** | **34,002** | — | — |
| Accounts receivable, net of allowance for doubtful accounts | **183,272** | **183,272** | 168,988 | 168,988 |
| Unbilled revenue | **262,058** | **262,058** | 287,893 | 287,893 |
| Accounts payable and accrued liabilities | **412,412** | **412,412** | 373,543 | 373,543 |
| Obligations under capital lease | **13,172** | **13,172** | 505 | 505 |
| Customers' advance deposits | **56,038** | **56,038** | 64,252 | 64,252 |
| Senior unsecured debentures | | | | |
| Series 1 – 6.11% due May 7, 2013 | **224,298** | **238,359** | 223,838 | 245,310 |
| Series 2 – 5.15% due November 14, 2017 | **248,941** | **284,126** | 248,793 | 273,725 |
| Series 3 – 4.49% due November 12, 2019 | **248,682** | **275,575** | 248,546 | 259,777 |
| Series 4 – 6.11% due December 30, 2011 | — | — | 245,057 | 255,199 |
| Series 5 – 6.11% due May 6, 2013 | **245,057** | **259,578** | 245,057 | 267,177 |
| Series 6 – 5.54% due May 21, 2040 | **198,566** | **245,096** | 198,546 | 217,188 |
| Series 7 – 3.54% due November 18, 2021 | **297,970** | **306,696** | — | — |

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

[all tabular amounts in thousands of dollars]

December 31, 2011

## *b) Risk Factors*

The following is a discussion of risks and related mitigation strategies that have been identified by the Corporation for financial instruments. This is not an exhaustive list of all risks, nor will the mitigation strategies eliminate all risks listed.

The Corporation's activities provide for a variety of financial risks, particularly credit risk, interest rate risk and liquidity risk.

***Credit risk***

The Corporation is exposed to credit risk from financial instruments as a result of the risk of counterparties defaulting on their obligations. The Corporation monitors and limits its exposure to credit risk on a continuous basis.

The Corporation's credit risk associated with accounts receivable is primarily related to electricity bill payments from LDC customers. LDC has approximately 709,000 customers, the majority of which are residential. LDC collects security deposits from customers in accordance with direction provided by the OEB. As at December 31, 2011, LDC held security deposits in the amount of $56,038,000 [December 31, 2010 - $64,252,000].

The carrying amount of accounts receivable is reduced through an allowance for doubtful accounts and the amount of the related impairment loss is recognized in the consolidated statements of income. Subsequent recoveries of receivables previously provisioned are credited to the consolidated statements of income.

Credit risk associated with accounts receivable is as follows:

| | 2011<br>$ | 2010<br>$ |
|---|---|---|
| Total accounts receivable | **196,259** | 180,900 |
| Less: Allowance for doubtful accounts | **(12,987)** | (11,912) |
| **Total accounts receivable, net** | **183,272** | 168,988 |
| Of which: | | |
| Outstanding for not more than 30 days | **155,274** | 147,457 |
| Outstanding for more than 30 days but not more than 120 days | **24,777** | 21,635 |
| Outstanding for more than 120 days | **16,208** | 11,808 |
| Less: Allowance for doubtful accounts | **(12,987)** | (11,912) |
| **Total accounts receivable, net** | **183,272** | 168,988 |

[all tabular amounts in thousands of dollars]

Reconciliation between the opening and closing allowance for doubtful accounts balances is as follows:

| | 2011 $ | 2010 $ |
|---|---|---|
| Balance, beginning of year | **(11,912)** | (12,580) |
| Provision for doubtful accounts | **(10,272)** | (6,998) |
| Write-offs | **9,854** | 9,273 |
| Recoveries | **(657)** | (1,607) |
| **Balance, end of year** | **(12,987)** | (11,912) |

Unbilled revenue represents amounts for which the Corporation has a contractual right to receive cash through future billings but are unbilled at period-end. As at December 31, 2011, total unbilled revenue was $262,058,000 [December 31, 2010 - $287,893,000]. Unbilled revenue is considered current.

As at December 31, 2011, there were no significant concentrations of credit risk with respect to any class of financial assets or counterparties. The Corporation's maximum exposure to credit risk is equal to the carrying value of its financial assets.

***Interest rate risk***

The Corporation is exposed to interest rate risk through holding certain financial instruments, and short-term borrowings under the Corporation's Revolving Credit Facility *[note 9]* which may expose the Corporation to fluctuations in short-term interest rates (borrowings in the form of prime rate loans in Canadian dollars and BAs and letters of credit). The Corporation attempts to minimize interest rate risk by issuing long-term fixed rate debt, and by extending or shortening the term of its short-term money market investments by assessing the monetary policy stance of the Bank of Canada, while ensuring that all payment obligations are met on an ongoing basis.

Cash balances, which are not required to meet day-to-day obligations of the Corporation, are either held in bank accounts or invested in Canadian money market instruments, exposing the Corporation to fluctuations in short-term interest rates. These fluctuations could impact the level of interest income earned by the Corporation.

LDC is exposed to fluctuations in interest rates as its regulated rate of return is derived using a formulaic approach, which is based in part on a forecast of long-term Government of Canada bond yields and A-rated Canadian utility bond spreads. LDC estimates that a 1% (100 basis point) reduction in long-term Government of Canada bond yields, used in determining its regulated rate of return would reduce LDC's annual net income, as at December 31, 2011, by approximately $4,600,000.

The Corporation is also exposed to fluctuations in interest rates for the valuation of its post-employment benefit obligations *[note 12[e]]*.

***Liquidity risk***

The Corporation is exposed to liquidity risk related to commitments associated with financial instruments. The Corporation monitors and manages its liquidity risk to ensure access to sufficient funds to meet operational and investing requirements. The Corporation's objective is to ensure that sufficient liquidity is on hand to meet obligations as they fall due while minimizing net financing charges. The Corporation has access to credit facilities and monitors cash balances daily to ensure that sufficient levels of liquidity are on hand to meet financial commitments as they come due. Liquidity risks associated with financial commitments are as follows:

[all tabular amounts in thousands of dollars]

| December 31, 2011 | | | |
|---|---|---|---|
| | **Due within 1 year $** | **Due between 1 year and 5 years $** | **Due after 5 years $** |
| **Financial liabilities** | | | |
| Accounts payable and accrued liabilities | **412,412** | **—** | **—** |
| Obligations under capital lease | **1,871** | **8,042** | **3,259** |
| Senior unsecured debentures | | | |
| Series 1 – 6.11% due May 7, 2013 | **—** | **225,000** | **—** |
| Series 2 – 5.15% due November 14, 2017 | **—** | **—** | **250,000** |
| Series 3 – 4.49% due November 12, 2019 | **—** | **—** | **250,000** |
| Series 5 – 6.11% due May 6, 2013 | **—** | **245,057** | **—** |
| Series 6 – 5.54% due May 21, 2040 | **—** | **—** | **200,000** |
| Series 7 – 3.54% due November 18, 2021 | **—** | **—** | **300,000** |
| Interest payments on debentures | **74,905** | **197,560** | **359,293** |
| | **489,188** | **675,659** | **1,362,552** |

***Hedging and Derivative risk***

As at December 31, 2011 and December 31, 2010, the Corporation had not entered into hedging and derivative financial instruments.

***Foreign exchange risk***

As at December 31, 2011, the Corporation had limited exposure to the changing values of foreign currencies. While the Corporation purchases goods and services which are payable in US dollars, and purchases US currency to meet the related payables commitments when required, the impact of these transactions is not material to the consolidated financial statements.

## 17. FINANCIAL GUARANTEES

The City has authorized the Corporation to provide financial assistance to its subsidiaries, and LDC to provide financial assistance to other subsidiaries of the Corporation, in the form of letters of credit and guarantees, for the purpose of enabling them to carry on their businesses up to an aggregate amount of $500,000,000.

[all tabular amounts in thousands of dollars]

## 18. PAYMENTS IN LIEU OF CORPORATE TAXES

The provision for PILs differs from the amount that would have been recorded using the combined Canadian federal and Ontario statutory income tax rate. Reconciliation between the statutory and effective tax rates is set out below:

***Consolidated Statements of Income***

| | 2011<br>$ | 2010<br>$ |
|---|---|---|
| **Rate reconciliation** | | |
| Income before PILs | **104,750** | 91,705 |
| Consolidated Statutory Canadian federal and provincial income tax rate | **28.25%** | 31.00% |
| Expected provision for PILs | **29,592** | 28,429 |
| Temporary differences not benefited | **(16,032)** | (1,303) |
| Other | **(4,742)** | (1,546) |
| **Provision for PILs** | **8,818** | 25,580 |
| **Effective tax rate** | **8.42%** | 27.89% |
| **Components of provision for PILs** | | |
| Current tax provision | **9,419** | 24,709 |
| Future income tax provision related to the origination and reversal of temporary differences | **(601)** | 871 |
| **Provision for PILs** | **8,818** | 25,580 |

***Consolidated Balance Sheets***

Significant components of the Corporation's future income tax assets and liabilities are as follows:

| | 2011<br>$ | 2010<br>$ |
|---|---|---|
| Property, plant and equipment and intangible assets | **110,161** | 131,232 |
| Regulatory adjustments | **50,109** | 56,142 |
| Post-employment benefits liability | **44,885** | 42,474 |
| Other taxable temporary differences | **6,482** | 6,583 |
| Capital loss carryforwards | **5,147** | 4,840 |
| Non-capital loss carryforwards | **503** | 509 |
| Valuation allowance | **(14,920)** | (15,880) |
| **Future income tax assets** | **202,367** | 225,900 |

As at December 31, 2011, the Corporation accumulated non-capital losses for PILs purposes of approximately $2,011,000 [December 31, 2010 - $2,037,000], which are available to reduce taxable income in future years. As at December 31, 2011, the Corporation also accumulated taxable capital losses of $19,698,000 [December 31, 2010 -

[all tabular amounts in thousands of dollars]

$19,359,000] which are available to offset capital gains in future years. If not utilized, $500,000 of non-capital losses will expire in 2014 and 2015, and $1,511,000 of non-capital losses will expire in or after 2026.

## 19. SHARE CAPITAL

Share capital consists of the following:

| | 2011<br>$ | 2010<br>$ |
|---|---|---|
| **Authorized** | | |
| The authorized share capital of the Corporation consists of an unlimited number of common shares | | |
| **Issued and outstanding** | | |
| 1,000 common shares | **567,817** | 567,817 |

***Dividends***

The shareholder direction adopted by the City with respect to the Corporation provides that the board of directors of the Corporation will use its best efforts to ensure that the Corporation meets certain financial performance standards, including those relating to the credit rating and dividends.

Subject to applicable law, the shareholder direction provides that the Corporation will pay dividends to the City each year amounting to the greater of $25,000,000 or 50% of the Corporation's consolidated net income for the year. The dividends are not cumulative and are payable as follows:

[i] $6,000,000 on the last day of each of the first three fiscal quarters during the year;

[ii] $7,000,000 on the last day of the fiscal year; and

[iii] the amount, if any, by which 50% of the Corporation's annual consolidated net income for the year exceeds $25,000,000, within ten days after the board of directors of the Corporation approved the Corporation's audited consolidated financial statements for the year.

During 2011, the board of directors of the Corporation declared and paid dividends totalling $33,063,000 [2010 - $25,000,000] to the City.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
[all tabular amounts in thousands of dollars]

December 31, 2011

## 20. RELATED PARTIES

For the Corporation, transactions with related parties include transactions with the City. All transactions with the City are conducted at prevailing market prices and normal trade terms.

| Transactions with Related Parties Summary | 2011 $ | 2010 $ |
|---|---|---|
| Revenues | **147,469** | 147,399 |
| Operating expenses and capital expenditures | **30,582** | 14,068 |
| Net financing charges | **—** | 7,487 |
| Dividends | **33,063** | 25,000 |

| Transactions with Related Parties Summary | 2011 $ | 2010 $ |
|---|---|---|
| Accounts receivable, net of allowance for doubtful accounts | **8,412** | 6,711 |
| Unbilled revenue | **8,692** | 9,830 |
| Other assets | **7,279** | 7,368 |
| Accounts payable and accrued liabilities | **25,085** | 12,164 |
| Customers' advance deposits | **8,714** | 10,953 |

Revenues represent amounts charged to the City primarily for electricity and street lighting services. Operating expenses and capital expenditures represent amounts charged by the City for purchased road cut repairs, property taxes and other services. Net financing charges represent interest paid to the City on the promissory note which was monetized on April 1, 2010. Dividends represent dividends paid to the City *[note 19]*.

Accounts receivable, net of allowance for doubtful accounts represent receivables from the City primarily for relocation services, sale of electricity and street lighting services. Unbilled revenue represents receivables from the City related to the provision of electricity not yet billed. Other assets represent amounts for prepaid land leases from the City. Accounts payable and accrued liabilities represent amounts payable to the City relating to road cut repairs and other services, as well as funds received from the City for the construction of electricity distribution assets. Customers' advance deposits represent funds received from the City for future expansion projects.

## 21. COMMITMENTS

### *Operating lease obligations and future commitments*

As at December 31, 2011, the future minimum annual lease payments under property operating leases and future commitments with remaining terms from one to five years and thereafter were as follows:

[all tabular amounts in thousands of dollars]

December 31, 2011

| | $ |
|---|---|
| 2012 | **27,715** |
| 2013 | **23,442** |
| 2014 | **7,492** |
| 2015 | **6,487** |
| 2016 | **6,308** |
| Thereafter | **4,755** |
| Total amount of future minimum payments | **76,199** |

During the first quarter of 2011, LDC entered into an agreement with Hydro One Networks Inc. to reinforce the 115 kilovolt transmission system between Leaside Transformer Station ["TS"] and Bridgman TS under the Toronto Midtown Transmission Reinforcement Project, which terminates on the 25th anniversary of the in service date. LDC is expected to pay the estimated capital contributions and work chargeable by making progress payments based on various payment milestone dates, with $17,600,000 and $15,278,000 payable in 2012 and 2013, respectively, and any difference from the estimated costs to be settled at a later date. These commitments have been reflected in the table above.

## *Capital lease obligations*

As at December 31, 2011, the future minimum annual lease payments under capital leases with remaining lease terms from one to five years and thereafter were as follows:

| | $ |
|---|---|
| 2012 | **2,454** |
| 2013 | **2,445** |
| 2014 | **2,404** |
| 2015 | **2,327** |
| 2016 | **2,267** |
| Thereafter | **3,380** |
| Total amount of future minimum payments | **15,277** |
| Less interest and executory costs | **2,105** |
| | **13,172** |
| Current portion *[note 10]* | **1,871** |
| Long-term portion *[note 13]* | **11,301** |

Included in the capital lease obligations is an equipment lease entered into by the Corporation in the third quarter of 2011 which expires in June 2018 and bears interest at a rate of 4.7%.

## 22. CONTINGENCIES

### *a) Legal Proceedings*

In the ordinary course of business, the Corporation is subject to various litigation and claims with customers, suppliers, former employees and other parties. On an ongoing basis, the Corporation assesses the likelihood of any adverse judgments or outcomes as well as potential ranges of probable costs and losses. A determination of the provision required, if any, for these contingencies is made after analysis of each individual issue. The provision may change in the future due to new developments in each matter or changes in approach, such as a change in settlement strategy. The Corporation and its subsidiaries are subject to various legal actions that arise in the normal course of business and if damages were awarded under these actions, the Corporation and its subsidiaries would make a claim under their liability insurance which the Corporation believes would cover any damages which may become payable by the Corporation and its subsidiaries in connection with these actions.

***Christian Helm Class Action***

On December 6, 2010, a statement of claim in a proposed class action was issued against LDC. The claim seeks general and special damages in the amount of $100,000,000 for disgorgement of unjust gains allegedly resulting from the receipt of interest on overdue accounts at a rate exceeding 5% per annum in contravention of the *Interest Act* (Canada) ["Interest Act"]. A statement of defence has been filed. Prior to any certification of the action as a class proceeding, cross summary judgment motions were heard in June 2011 to determine whether the Interest Act has been breached *[note 25[c]]*.

***2 Secord Avenue***

An action was commenced against LDC in September 2008 in the Ontario Superior Court of Justice under the *Class Proceedings Act, 1992* (Ontario) ["Class Proceedings Act"] seeking damages in the amount of $30,000,000 as compensation for damages allegedly suffered as a result of a fire and explosion in an underground vault at 2 Secord Avenue on July 20, 2008. This action is at a preliminary stage. The statement of claim has been served on LDC, a statement of defence and third party claim have been served by LDC and a third party defence and counterclaim against LDC seeking damages in the amount of $51,000,000 have been filed. A certification order has been issued. Affidavits of documents have been produced by LDC to the other parties and examinations for discovery have commenced and are continuing. Given the preliminary status of this action, it is not possible to reasonably quantify the effect, if any, of this action on the financial performance of the Corporation. If damages were awarded, LDC would make a claim under its liability insurance which the Corporation believes would cover any damages which may become payable by LDC in connection with the action.

On December 20, 2010, LDC was served with a statement of claim by the City seeking damages in the amount of $2,000,000 as a result of the fire at 2 Secord Avenue. A statement of defence and third party claim have been served. Given the preliminary status of this action, it is not possible to reasonably quantify the effect, if any, of this action on the financial performance of the Corporation. If damages were awarded, LDC would make a claim under its liability insurance which the Corporation believes would cover any damages which may become payable by LDC in connection with the action.

By order of the court, the above actions and a smaller non-class action commenced in April 2009 involving the same incident will be tried at the same time or consecutively.

***2369 Lakeshore Boulevard West***

A third party action was commenced against LDC in October 2009 in the Ontario Superior Court of Justice under the Class Proceedings Act seeking damages in the amount of $30,000,000 as compensation for damages allegedly suffered as a result of a fire in the electrical room at 2369 Lakeshore Boulevard West on March 19, 2009. Subsequently, in March 2010, the plaintiff in the main action amended its statement of claim to add LDC as a defendant. The plaintiff in the main action seeks damages in the amount of $10,000,000 from LDC. Both actions are at a preliminary stage and the certification hearing is scheduled for September 2012. Statements of defence to the main action and to the third party claim have not been filed. Accordingly, given the preliminary status of these actions, it is not possible at this time to reasonably quantify the effect, if any, of these actions on the financial performance of the Corporation. If damages were awarded, LDC would make a claim under its liability insurance which the Corporation believes would cover any damages which may become payable by LDC in connection with these actions.

Another third party action was commenced against LDC in October 2009 in the Ontario Superior Court of Justice seeking damages in the amount of $30,000,000 as compensation for damages allegedly suffered as a result of the fire at 2369 Lakeshore Boulevard West. Subsequently, in March 2010, the plaintiff in the main action amended its statement of claim to add LDC as a defendant. The plaintiff in the main action seeks damages in the amount of $400,000 from LDC. LDC has filed a statement of defence, crossclaim and counterclaim. Examinations for discovery have not taken place but are to be completed by February 29, 2012 pursuant to a court ordered timetable. Accordingly, given the preliminary status of these actions, it is not possible at this time to reasonably quantify the effect, if any, of these actions on the financial performance of the Corporation. If damages were awarded, LDC would make a claim under its liability insurance which the Corporation believes would cover any damages which may become payable by LDC in connection with these actions.

On August 29, 2011, LDC was served with a statement of claim by the owner of the building and the property management company for the building seeking damages in the amount of $2,000,000 as a result of the fire at 2369 Lakeshore Boulevard West. LDC has filed a statement of defence and counterclaim. Given the preliminary status of this action, it is not possible to reasonably quantify the effect, if any, of this action on the financial performance of the Corporation. If damages were awarded, LDC would make a claim under its liability insurance which the Corporation believes would cover any damages which may become payable by LDC in connection with the action.

***Adamopoulos***

An action was commenced against LDC in November 2004 in the Ontario Superior Court of Justice seeking damages in the amount of $7,750,000 as compensation for damages allegedly suffered as a result of a motor vehicle accident involving an LDC vehicle on January 9, 2001. The plaintiff's motion increasing its claim for damages to $23,790,000 was granted on July 7, 2010. This matter has been settled and a court order has been issued dismissing the action and all related claims by payment of a total amount of approximately $4,550,000. LDC's liability insurance covered the settlement amount.

## *b) OEB PILs Proceeding*

The OEB conducted a review of the PILs variances accumulated in regulatory variance accounts for the period from October 1, 2001 to April 30, 2006 for certain MEUs. On June 24, 2011, the OEB issued its decision for these MEUs and provided guidelines for the calculation and further disposition of the balances accumulated in the PILs regulatory variance accounts.

LDC has reviewed the balances of its PILs regulatory variance accounts and applied the guidelines provided by the OEB. As at December 31, 2011, LDC estimated its liability at approximately $2,779,000. This balance has been recorded in the Corporation's consolidated financial statements. LDC intends to apply for disposition of this balance in 2012. The amount to be approved by the OEB will be based on the OEB's interpretation and application of its guidelines and the final balance which is yet to be approved by the OEB could differ materially from LDC's estimation of its liability.

### *c) Payments in Lieu of Additional Municipal and School Taxes*

The Ministry of Finance has issued assessments in respect of payments in lieu of additional municipal and school taxes under section 92 of the Electricity Act that are in excess of the amounts LDC believes are payable. The dispute arose as a result of inaccurate information incorporated into Ontario Regulation 224/00. The Corporation has worked with the Ministry of Finance to resolve this issue, and as a result the Ministry of Finance issued Ontario Regulation 423/11 on August 31, 2011. The new regulation revoked Ontario Regulation 224/00 and corrected inaccurate information retroactively to 1999.

The balance assessed by the Ministry of Finance on its most recent statement of account amounts to approximately $10,043,000 above the balance accrued by the Corporation. While the Corporation expects that reassessments will be issued as a consequence of the change in regulation, there can be no assurance that the Corporation will not have to pay the full assessed balance in the future.

## 23. NET INCOME PER SHARE

The weighted daily average number of shares outstanding as at December 31, 2011 was 1,000 [December 31, 2010 - 1,000]. Basic and fully diluted net income per share was determined by dividing the net income for the year by the weighted daily average number of shares outstanding.

## 24. COMPARATIVE CONSOLIDATED FINANCIAL STATEMENTS

Certain comparative amounts of the consolidated financial statements have been reclassified from statements previously presented to conform to the presentation of the 2011 consolidated financial statements.

## 25. SUBSEQUENT EVENTS

### *a) Street Lighting Activities*

On January 1, 2012, the Corporation completed the transfer of street lighting assets to LDC for a purchase price of $28,460,000, subject to post closing adjustment and transaction costs *[note 2[b]]*.

### *b) Electricity Distribution Rates*

On January 5, 2012, the OEB rendered its decision on the preliminary issue and dismissed LDC's cost of service 2012-2014 Rate Application. In its decision, the OEB found that LDC was not permitted to deviate from the standard incentive regulation mechanism framework cycle, and LDC will therefore be required to file its request for electricity distribution rates commencing on May 1, 2012 pursuant to the formulaic adjustment and the incremental capital module provided for under the incentive regulation mechanism framework *[note 2[a]]*.

On January 25, 2012, LDC filed with the OEB a motion to review the OEB's January 5, 2012 decision.

On February 6, 2012, LDC filed a notice of appeal with the Ontario Divisional Court regarding the OEB's January 5, 2012 decision.

Pursuant to the OEB's decision of January 5, 2012, LDC is currently preparing an application for electricity distribution rates using the incentive regulation mechanism framework, including the filing of an incremental capital module. The quantum of this application is consistent with the capital program spending levels previously approved by the OEB for the 2011 Rate Year.

Under the incentive regulation mechanism framework, LDC has to significantly reduce its costs structure, and in particular its operating expenses, in order to meet its financial obligations. Accordingly, in the first quarter of 2012, LDC began implementing a restructuring program aimed at reducing its operating costs in the future. The main component of this restructuring program is a workforce reduction plan targeting both union and management employees. As at March 2, 2012, the costs incurred as a result of the restructuring program amounted to approximately $19,300,000, which were mainly related to employee severance and buy-out costs.

The Corporation continues to assess all of the impacts related to the imposition by the OEB of the incentive regulation mechanism framework, which impacts may include additional restructuring costs. The incremental restructuring costs could have a material impact on the Corporation's consolidated financial statements in the future.

## *c) Christian Helm Class Action*

On February 1, 2012, prior to the release of the decisions on the summary judgment motions, the parties reached a settlement of the matter, which settlement now requires court approval. The Settlement Approval Hearing is scheduled for April 30, 2012. If the settlement receives court approval, damages and costs of approximately $6,000,000 shall be paid by LDC. In 2010, the Corporation accrued a liability to cover the expected settlement.

If the settlement does not receive court approval, the decision on the cross summary judgment motions will be released. In this event, if the court finds a breach of the Interest Act, subject to appeals, the proceeding will continue, and LDC will rely on other defences. While LDC believes it has a defence to this claim, there is no guarantee that it will be successful in defending the action and therefore, the outcome of this proceeding could have a material impact on the Corporation's consolidated financial statements and results of operations *[note 22[a]]*.

## *d) Dividends*

On March 2, 2012, the board of directors of the Corporation declared dividends in the amount of $28,966,000. The dividends are comprised of $22,966,000 with respect to net income for the year ended December 31, 2011, payable to the City on March 12, 2012, and $6,000,000 with respect to the first quarter of 2012, payable to the City on March 30, 2012 *[note 19]*.