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5 – Cost of Capital and Rate of Return

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OVERVIEW:

The purpose of this evidence is to summarize the method and cost of financing the capital requirements for the 2013 Test Year.

CAPITAL STRUCTURE AND COST OF CAPITAL

CAPITAL STRUCTURE

Goderich Hydro has used the Ontario Energy Board's (the "**Board**") deemed capital structure of 56% long-term debt, 4% short-term debt and 40% common equity for the purpose of this Cost of Service Application. The weighted average cost of capital is 6.20% on a capital amount of \$10,370,699 for a capital cost of \$643,066. This is consistent with the structure set out in the *Report of the Board on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors* ("**Board Report on CoC and IRM**") dated December 20, 2006 and it is also consistent with Goderich Hydro's past and current practices. The actual total debt to equity ratio is approximately 64.44%/35.56%.

Since the 2009 cost of service rate application, EB-2008-0248, there are a number of changes that have occurred to change the capital structure and the cost of capital. Pressure from the F3 Tornado and its ongoing costs have increased the actual debt from 40% to 64.44% and increased the actual cost. The applied for short term debt is 2.08% as compared to 1.33% in EB-2008-0248 and an applied for rate of 4.41% for long-term debt as compared to 7.62%.

Upward pressure on the cost of capital has resulted from the increase from 8.01% to 9.12% in the deemed return on equity set by the Board on the 40% equity component. In addition, the total capital already spent due to the Tornado; the additional capital assets that we required over the next several years to meet the basic system requirements will increase this requirement.

Table 6-1 – Comparison of Summary of Capital Structure and Rates

	EB-2008-0248 Board Approved	2013 Application	EB-2008-0248 Rate	Application Rate
Long Term Debt	52.7%	56%	7.62%	4.41%
Total	100%	100%	7.52%	6.20%

COST OF DEBT

Short Term Debt Goderich Hydro has bank facilities with an unrelated major financial institution. For the purposes of the cost of service application test year, Goderich Hydro has used a forecast of 2.08% for the short term debt rate based on the deemed short term debt rate for 2013 cost of service applications as communicated in the March 2, 2012 letter from the Board. It is recognized that this rate will be updated, if necessary, at the time of the rate decision to reflect the current rate in effect as per the calculations and terms outlined in the December 11, 2009 *“Report of the Board on the Cost of Capital for Ontario’s Regulated Utilities”*.

Long Term Debt Goderich Hydro is using the Board’s deemed long-term debt rate of 4.41% as set out in the March 2, 2012 letter. Long term debt is comprised of unrelated and related party debt and long-term capital leases.

The related long-term debt represents amounts, totaling \$4,862,500, owing to the municipal shareholder and the Bank. The actual rate of interest is currently 7.25% on the Note (\$974,454) payable to the Shareholder and is set by the Board of Directors, from time to time. The balance is currently being negotiated with a financial institution and the rate has not been determined. There are no fixed repayment terms associated with the principle outstanding and no principal amounts are anticipated to be paid over the next twelve months. The current note is secured by a first position General Security Agreement covering accounts receivable, inventory and equipment, including motor vehicles.

Preference Shares Goderich Hydro does not currently have any preference shares issued nor has it forecast for any issuance for the test year.

Common Equity

For the purposes of the Cost of Service Application test year, Goderich Hydro has used the deemed return on equity for 2012 cost of service applications of 9.12% as communicated in the March 2, 2012 letter from the Board. It is recognized that this rate will be updated at the time of the rate decision to reflect the current rate in effect as per the calculations and terms outlined in the December 11, 2009 “*Report of the Board on 13 the Cost of Capital for Ontario’s Regulated Utilities*”.

EB-2008-0248

In EB-2008-0248, Board approved a capital structure of 43.3% equity with a deemed return of 8.01%; short-term debt of 4% at a rate of 1.33%; and long-term debt of 52.7% at 7.62%. This resulted in an overall cost of capital of 7.52%.

Table 6-2 - EB-2008-0248 Board Approved

Board-approved 2009 Capital Structure and Cost of Capital Component	% of Total Capital Structure	Cost (%)
Short-Term Debt	4%	1.33%
Long-Term Debt	52.7%	7.62%
Equity	43.3%	8.01%
Preference Shares		
Total	100.0	7.52%