London Hydro Inc.

2013 Cost of Service Rate Application (EB-2012-0146/ EB- 2012-0380) Response to Interrogatories

Cost of Capital and Rate of Return (Exhibit 5)

Board Staff Interrogatories Questions:

No questions.

London Properties Management Association (LPMA) Interrogatories Questions:

LPMA #35

Ref: Exhibit 5, Table 5-1 & page 4

As shown in Table 5-1, London Hydro has actual levels of long-term debt that are significantly below the deemed level of 56%.

a) Please update Table 5-1 to reflect actual data for 2012.

b) Please explain why, in a time with historically low long term debt rates, London Hydro is not proposing to bring its actual long-term debt levels more in line with the deemed ratio of 56%.

c) Has London Hydro approached any financial institutions or Infrastructure Ontario about the interest rates available for additional long-term debt instruments in the last 18 months? If not, why not? If yes, please provide the results of those enquiries.

Response LPMA #35

a) As requested, Table 5-1 has been updated to reflect preliminary actual 2012 data (all data in '000's)

	2009 Board Approved Deemed		2009 Actual		2010 Actual		2011 Actual		2012 Actual		2012 Bridge Deemed - CGAAP		2012 Bridge Deemed - IFRS		2013 Test Year Deemed - IFRS	
	Amount	**%**	**Amount**	**%**	**Amount**	**%**	**Amount**	**%**	**Amount**	**%**	**Amount**	**%**	**Amount**	**%**	**Amount**	**%**
Long term debt	126,183	56	70,000	38.4	92,954	43.9	87,650	41.4	85,346	39.8	147,530	56	147,557	56	150,971	56
Short term / unfunded debt	9,013	4	-	0.0	-	0.0	-	0.0	-	0.0	10,538	4	10,540	4	10,783	4
Total debt	135,196	60	70,000	38.4	92,954	43.9	87,650	41.4	85,346	39.8	158,068	60	158,097	60	161,754	60
Common equity	90,130	40	112,133	61.6	118,682	56.1	124,055	58.6	128,858	60.2	105,378	40	105,398	40	107,836	40
Total Rate Base	225,326	100	182,133	100	211,636	100	211,705	100	214,204	100	263,446	100	263,495	100	269,590	100

b) London Hydro is unsure of the reason for this question. Although we agree that the borrowing rates are at an extremely low level, what benefit would be provided with acquiring additional debt? As of this point in time, London Hydro has no need for additional cash to remain on hand. If London Hydro were to borrow additional amounts to increase the debt %, there are three options available.

- Pay out a dividend to the parent company which would reduce the equity levels.
    - The City of London has made the decision to have higher than "deemed" equity levels. This decision provides a lower actual return on equity than would otherwise be permitted when comparing to deemed return on equity. The shareholder is aware of its current equity levels within London Hydro and seems comfortable with the actual returns on the investment that has been provided as no additional dividends are currently requested.
- Keep the cash in the bank
    - London Hydro would be borrowing money at a higher rate than would be received on the cash kept in the bank and therefore London Hydro considers this to be an irresponsible use of cash.
- Reinvest in capital infrastructure.
    - London Hydro has a comprehensive asset sustainment plan and the time may come that in order to continue investing in new infrastructure and the replacement of current infrastructure that London Hydro may need to borrow funds to accomplish these projects, but London Hydro feels that it is an irresponsible use of cash to advance these projects sooner than required based solely on the current debt rates available.

c) London Hydro continues to discuss potential borrowings with various financial organizations and has over the past 18 months. As discussed in the Application, the discussions resulted in the renegotiation of the smart meter loan in June 2012 at a rate of 3.33%.

Although London Hydro is aware of the current rates, as mentioned in part b) above, there were no reasons why additional debt levels seem appropriate at this point in time and therefore London Hydro has not obtained any additional debt during 2012.

LPMA #36

Ref: Exhibit 5, page 3

a) *Please explain why London Hydro decided to renew the affiliate debt that had an expiry date of October 31, 2010 on September 30, 2009, rather than waiting and renewing the debt at the original expiry date.*

b) *What was the Board approved deemed long-term debt rate as of October 31, 2010.*

Response LPMA #36

a) London Hydro had to renew the note at least 12 months before its due date of Oct 31, 2010 to avoid having the entire $70 million balance on the note shown as a "current" liability in its financial statements. If this were not done prior to November 2009, it would have had a severe impact on the Company's financial ratings and credit rating.

b) With respect to interest rates, the note renewal on September 30, 2009 at 6% was 1.62% less than the OEB's deemed long-term debt rate at that time. The actual approved long term debt rate as at October 31, 2010 was 5.87%. In the context of the information that is available to us today, these rates do not look favorable, but at the time of the note renewal, and at the time the Board established their deemed cost of capital rates, these rates were reflective of market conditions.

Vulnerable Energy Consumers Coalition (VECC) Interrogatories Questions:

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VECC 33.0

Reference: Exhibit 5, pg. 1

a) Please provide the actual and deemed return on equity for each of 2009 through 2012. Please show the calculation for each value.

Response VECC 33.0

Actual	All amounts in ('000's)			
	2009	2010	2011	2012
Net Income	8,327	9,049	7,873	7,802
Equity	112,133	118,682	124,055	128,858
Return on Equity	7.43%	7.62%	6.35%	6.05%

Deemed	2009	2010	2011	2012	
Net Income	8327	9049	7873	7802	
Actual Interest	4248	4896	5386	5189	
Deemed Interest	7,691	7,691	7,691	7,691	Note 1
Difference in Interest	3,443	2,795	2,305	2,502	
Tax Impact on Interest @ 33%	- 1,136	- 922	- 761	- 826	
Deemed Net Income	6,020	7,176	6,329	6,126	
Deemed Equity	90,130	90,130	90,130	90,130	Note 1
Deemed Return on Equity	6.68%	7.96%	7.02%	6.80%	

Note 1 - The deemed interest and equity numbers were not adjusted from 2009 as that is amount the deemed amounts have been based upon

Deemed Interest and Equity Calculations

2009 Rate Base	**225,326**	Allocation	Deemed Rate	Deemed $
Deemed LT Interest	126,183	56%	6%	7,571
Deemed ST Interest	9,013	4%	1.33%	120
Deemed Equity	90,130	40%	8.01%	7,219

Deemed LT Interest + Deemed ST Interest = $7,691.

VECC 34.0

Reference Exhibit 5, pg. 1

a) *Why did London Hydro reduce the promissory note value from $95 million to $70 million in 2009?*

b) *What due diligence did London Hydro do to ensure it was negotiating a competitive rate for a long-term loan with its affiliate? Please provide the analysis and briefing material supplied to the Board of Directors relating the renegotiating this loan.*

Response VECC 34.0

a) London Hydro is unsure where the information from this question was located as the amount owing on the Promissory note has not changed since 2001.

b) There are a number of additional factors impacting the lending arrangement with the City other than strictly the interest rate utilized. As an example, this note has certain terms and conditions that would not be available from a third party lender and as such, are looked upon favorably from a credit agency rating perspective, and provide cashflow relief from a utility operating perspective. From a credit rating agency perspective, this note is more in the nature of preferred shares than it is a debt instrument.

Features such as no principal payment requirements, ability to postpone interest payments under certain conditions and conversion of the debt to paid up capital upon default, are all features that would not be available through a third party lender. These terms and conditions give rise to slightly higher rates than would be available through the external market.

The former CFO who would have been involved in the discussion is no longer working at London Hydro, but internal files indicate that the applicable external interest rate available was 5.43% based on the financial performance at that time.

In addition to comparing the external and internal rates, the favorable terms and conditions, the other external factor is the impact that having the shareholder loan classified as short term on our books. If the decision was made that London Hydro would rather seek external funding rather than renew the agreement with the City, the 2009 financial statements would have recorded the entire $70M debt as a current liability which would have resulted in a very unfavourable liquidity ratio. That ratio may have resulted in a poor credit rating with S&P which would have resulted in higher borrowing costs and potentially a higher interest rate.

Many utilities have shareholder loans that extend into perpetuity (although have a callable function usually with 367 days notice) where the interest rate is set at a variable rate (adjusted yearly) based on market conditions. The City of London and London Hydro have a slightly different strategy which is done for planning purposes. The strategy involves having a shorter term horizon (usually about 5 years) but having a fixed rate of interest. This rate of interest is set based on the market conditions at the time the agreement is renewed. This allows both organizations to budget the actual cash expenditures or income over that time horizon while locking in the rates during the term of the agreement.

All of these factors need to be taken into account when contemplating the loan renegotiation.

VECC 35.0

Reference Exhibit 5, pg. 13

What was London Hydro`s interest coverage ratio in each of the years 2007 through 2011

Response VECC 35.0

Year	2007	2008	2009	2010	2011
Net Earnings before taxes	11,860	9,666	11,212	11,402	9,400
Interest	4,498	4,439	4,664	4,896	5,386
Net Earnings before Interest and Taxes	16,358	14,105	15,876	16,298	14,786
Interest	4,498	4,439	4,664	4,896	5,386
Interest Coverage Ratio	3.6	3.2	3.4	3.3	2.7

All amounts were taken directly from the Audited Financial Statements.

School Energy Coalition (SEC) Interrogatories Questions:

SEC #36

Ex 5, p.13.

Please provide details on all actions taken by the Applicant to obtain debt rates lower than 6% as an alternative to the extension of the City's promissory note in 2009, and all actions subsequently to either renegotiate the terms, or replace the debt with lower cost debt.

Response SEC #36

London Hydro entered into a 5 year agreement with the City of London to borrow funds at a fixed rate of interest. At the time the agreement was entered into, the Board approved rate was significantly higher than the rate agreed by the two parties. There are no terms in the agreement that allows London Hydro to walk away or to re-negotiate the debt. The City of London has provided no indication that it is interested in renegotiating the terms (including the interest rate) at this point in time until the note becomes closer to the maturity date.

SEC #37

Ex 5, p. 11

Please provide all revised promissory notes with the City, or other bills of exchange affecting changes to the original promissory note, since the issuance of the original interest-free promissory note in 2000.

Response SEC #37

The promissory note contained in Appendix 5A of the Cost of Service Application provides the most recent amendment to the promissory note which includes all amendments since the initial note was issued in 2000.

Energy Probe (EP) Interrogatories Questions:

Energy Probe – 23

Ref: Exhibit 5, Table 5-1

a) *In Table 5-1 please explain why the Capitalization/Rate Base differs between the Deemed and Actual amounts for 2009.*

b) *Please add a column to Table 5-1 to show 2013 forecast "actual" cost of debt.*

c) *Calculate the 2013 Cost of debt on a deemed and "actual basis and comment on the difference in cost.*

Response Energy Probe - 23

a) The first column represents the numbers that were deemed (and applied for in the 2009 cost of service), while the second column represents the actual values in 2009 representative of the actual capital structure at London Hydro.

b)

	2009 Board Approved Deemed		2009 Actual		2010 Actual		2011 Actual		2012 Bridge Deemed - CGAAP		2012 Bridge Deemed - IFRS		2013 Test Year Deemed - IFRS		2013 Test Year Forecast - IFRS	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Long term debt	126,182,546	56.0%	70,000,000	38.4%	92,954,000	43.9%	87,650,000	41.4%	147,529,633	56.0%	147,557,160	56.0%	150,970,544	56.0%	83,042,000	38.2%
Short term / unfunded debt	9,013,039	4.0%	-	0.0%	-	0.0%	-	0.0%	10,537,831	4.0%	10,539,797	4.0%	10,783,610	4.0%	-	0.0%
Total debt	135,195,587	60.0%	70,000,000	38.4%	92,954,000	43.9%	87,650,000	41.4%	158,067,464	60.0%	158,096,957	60.0%	161,754,155	60.0%	83,042,000	38.2%
Common equity	90,130,392	40.0%	112,133,000	61.6%	118,682,000	56.1%	124,055,000	58.6%	105,378,310	40.0%	105,397,972	40.0%	107,836,103	40.0%	134,264,000	61.8%
Total Rate Base	225,325,979	100.0%	182,133,000	100.0%	211,636,000	100.0%	211,705,000	100.0%	263,445,774	100.0%	263,494,929	100.0%	269,590,258	100.0%	217,306,000	100.0%

c) Due to the fact that the actual debts costs are utilized to determine the "cost of debt" as shown in the Application under table 5-2, there is no change to the "cost of debt" calculations for long-term debt as calculated at 5.58% for either the actual debt % or the deemed debt %.

As there is no forecasted short-term debt, the actual cost of debt would be 0%, while 2.08% was the cost of debt for the deemed calculation.

Energy Probe-24

Ref: Exhibit 5, Table 5-2 and 5-3

Please provide a complete cost of Capital Schedule in the format below for 2009 and forecast 2013 showing the deemed and actual amounts:

Response Energy Probe - 24

2009 Actual

Cost of Capital Components	Principal $Millions	Component %	Cost Rate %	Return %	Return $
Long-term debt	70	38.5%	6.00%	6.00%	4.20
Short-term debt	-	0.0%	0%	0.00%	-
Common equity	112	61.5%	7.40%	7.40%	8.29
Total	182	100.0%	6.86%	6.86%	12.49

2009 Deemed

Cost of Capital Components	Principal $Millions	Component %	Cost Rate %	Return %	Return $
Long-term debt	126	56.0%	6.00%	6.00%	7.56
Short-term debt	9	4.0%	1.33%	1.33%	0.12
Common equity	90	40.0%	8.01%	8.01%	7.21
Total **(Rate base)**	225	100.0%	6.62%	6.62%	14.89

2013 Forecast

Cost of Capital Components	Principal $Millions	Component %	Cost Rate %	Return %	Return $
Long-term debt	83	38.2%	5.58%	5.58%	4.63
Short-term debt	-	0.0%	0%	0.00%	-
Common equity	134	61.8%	7.25%	7.25%	9.72
Total	217	100.0%	6.58%	6.58%	14.35

2013 Deemed

Cost of Capital Components	Principal $Millions	Component %	Cost Rate %	Return %	Return $
Long-term debt	151	56.0%	5.58%	5.58%	8.42
Short-term debt	11	4.0%	2%	2.08%	0.22
Common equity	108	40.0%	9.12%	9.12%	9.83
Total **(Rate base)**	270	100.0%	6.86%	6.86%	18.48

Please note that London Hydro was unsure what was meant by the Return % column as the Cost Rate % and the return % were interpreted to be the same.

Energy Probe – 25

Ref: Exhibit 5, Table 5-2 and 5-3

a) Please provide a Version of Table 5-3 that shows columns for 2009 Actual and 2013 forecast "actual". Include the approved/forecast rate for each component and the Total Weighted Average Cost of Capital (WACC) for each year.

b) Please provide a summary schedule that shows the 2013 cost of capital ($ Million) and the impact on 2013 rates on a deemed and actual basis.

Response Energy Probe - 25

a)
Deemed:

	2009 Board Approved		2013 Test Year	
	Amount	%	Amount	%
Total Rate Base	225,325,979		269,590,258	
Long term debt	126,182,548	56%	150,970,544	56%
Short term debt	9,013,039	4%	10,783,610	4%
Common equity	90,130,392	40%	107,836,103	40%
	225,325,979		269,590,258	
Interest on long term debt	7,570,953	6.00%	8,424,156	5.58%
Interest on short term debt	119,873	1.33%	224,299	2.08%
Return on common equity	7,219,444	8.01%	9,834,653	9.12%
Return on Rate Base	14,910,271	6.62%	18,483,108	6.86%

	Actual		Forecast	
	2009 Board Approved Amount	%	2013 Test Year Amount	%
Total Rate Base	223,629,710		269,590,258	
Long term debt	70,000,000	38%	83,042,000	38%
Short term debt	-	0%	-	0%
Common equity	112,133,000	62%	134,264,000	62%
	182,133,000		217,306,000	
Interest on long term debt	4,200,000	6.00%	4,633,744	5.58%
Interest on short term debt	-	1.33%	-	0.00%
Return on common equity	8,327,000	7.43%	12,785,466	9.52%
Return on Rate Base	12,527,000	6.88%	17,419,209	8.02%

(Note the forecasted return on equity assumes a simple 26.5% income tax expense over what has already been calculated within the application.)

b)

Summary	**2009**	**2013**
Deemed Interest	7,690,826	8,648,455
Actual/Forecasted Interest	4,248,000	4,633,744
Difference	3,442,826	4,014,712
Deemed Return on Equity	7,219,444	9,834,653
Entitled Return on Equity	8,981,853	12,244,877
Difference	- 1,762,409	- 2,410,224
Total received over deemed	1,680,417	1,604,488

The above table indicates that, based on the actual debt/equity structure utilized by London Hydro, the Company is entitled to receive approximately $1.6 million dollars more than it would if the actual structure was in line with the deemed structure of all distribution companies.

This information is irrelevant though as it fails to include the impacts of other items such as the actual rate base (asset base + working capital allowance), but merely considers the amounts provided for actual interest costs and the actual return on equity numbers.

There is approximately ($41M in 2009 and $52M in 2013) of rate base costs that have been excluded from the “actual” analysis based on the OEB prescribed templates. Even if a cost of capital of 4% had been applied to these funds, the analysis would change from an “overcollection” of funds under this analysis, to an “undercollection” of funds. The reason for this is that London Hydro has a greater equity investment than the deemed structure. The shareholder is only compensated at the higher return value for the first 40% under the deemed structure, whereas all other returns are based on the weighted average cost of borrowing. Therefore the actual returns received by the shareholder under the existing structure are lower than they would be if using the OEB approved deemed calculations.

Energy Probe – 26

Ref: Exhibit 5, Page 13 Promissory Note

a) *Please explain why the City of London Promissory note does not contain a market rate adjustment clause*

b) *What is the significance to the reference in paragraph 8 to the OEB rate for Common Equity of 6.58%? Please explain.*

c) *Please provide a schedule that shows City of London Senior Debt issues 2009-2012 – Date, Amount, effective rate and maturity.*

Response Energy Probe - 26

a) London Hydro and the City of London entered into a five year fixed rate agreement at a prescribed interest rate. London Hydro prefers fixed rate vehicles in order to accurately predict cash flow requirements and as such all of the financing vehicles utilized which have maturity dates greater than one year are fixed rate contracts. (As an example, the Smart Meter loan was entered into by using a SWAP so that no matter what market conditions changed in the future, London Hydro knew the interest rate that would be paid during the time of the agreement.) London Hydro is in the Utility business and as such does not try to predict what will happen with future rates.

b) London Hydro is unable to comment on the significance of the wording which has carried forward from previous amendments as to the reason for the inclusion, but the purpose of the inclusion is so that if the OEB deemed equity rate drops below 6.58%, then the potential exists for the terms and conditions of the note to be modified.

c) As market conditions change on an ongoing basis, the only debt issuance that would be relevant to the interest rate available to the City at the time London Hydro signed the promissory note extension would be any debt issued in around the same period of the extension in 2009.

London Hydro contacted the City of London and asked for the information requested for any debt issued during 2009 and was informed that the City of London did not issue any debt during that year.