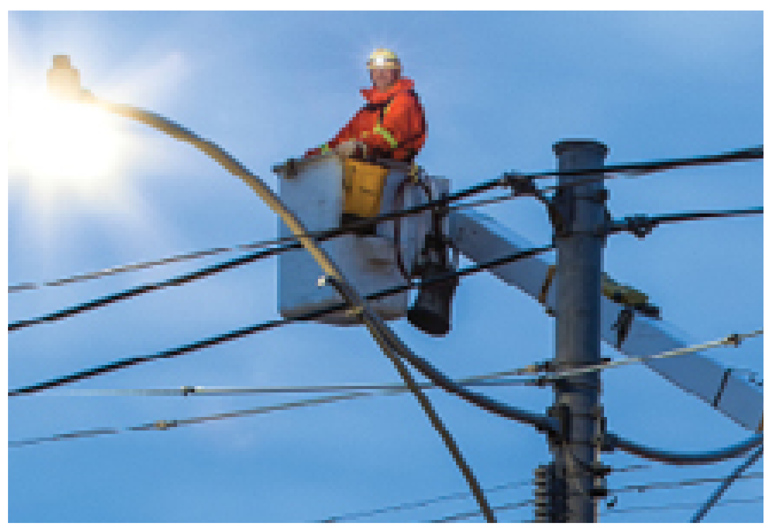
2012 Annual Report

# THE MEASURE OF OUR COMMITMENT



TORONTO HYDRO CORPORATION 2012 ANNUAL REPORT

TORONTO HYDRO Corporation

## MESSAGE FROM THE CHAIRMAN OF THE BOARD

**On June 23, 1999 Toronto Hydro Corporation (the "Corporation") was incorporated under the Ontario Business Corporations Act, by the City of Toronto, its sole shareholder. Changes were happening at a rapid pace across Ontario's electricity sector, and I was asked by the City to assume the Chairmanship of the new Corporation. The amalgamation of the former Metropolitan Toronto electricity utilities had been completed and the company's customer base tripled in size in just 12 months. The company was well-positioned to take a leadership role in the provincial energy industry and I accepted the challenge.**

The City had recruited a slate of eight top business-people with extensive Board experience from a range of commercial enterprises, and City Council had also appointed three Councillors to the inaugural Board of Directors. An experienced management team was in place, and together we began the process of defining and creating a corporate structure that would be the strategic foundation upon which the successful business would be built.

Like most business sectors, the electricity industry has been in a state of continuous change over the past decade. However, the foundation that we laid in 1999 has enabled Toronto Hydro to adapt quickly to the changing business environment and to continually move forward with confidence. The company has always been focussed on delivering excellent customer service, providing a safe and reliable supply of electricity to Toronto, and increasing the value of Toronto Hydro for our shareholder. This focus has enabled us to set our priorities over the years with clear objectives in mind.

In 1999, who could have foreseen what was ahead of us? Ice storms, hurricanes, and the blackout in 2003 that hit the north-eastern United States and Canada, underscoring the importance of investments in critical, aging infrastructure. The launching of innovative conservation and demand management ("CDM") programs

## MESSAGE

to help our customers manage their electricity bills. The introduction of time-of-use rates, smart meters and smart grids. A tough recession that changed the business landscape in Ontario significantly. And our own investments of almost $2 billion to renew Toronto Hydro's distribution grid, so that it will meet the needs of our customers today and for many years to come.

Now, after 14 years at the helm, I am retiring from the Board of Directors with pride in what we have achieved in such a short time. We have established a sound capital structure that is enabling the company to invest in its critical infrastructure assets and addressing systemic service reliability problems. We are growing the company's asset base while maintaining solid investment grade financial performance. We have delivered approximately $2 billion to the City, while increasing productivity and reducing staffing levels significantly. Our workplace safety record is among the best in our industry. We are deeply involved in the community through our support of many social, environmental and educational programs. In just 14 years, we have become recognized as one of the most successful and innovative energy companies in Canada.

I would like to express my sincere thanks to all of the talented and committed business people and City Councillors who have served with me on the Board at Toronto Hydro. Your wise counsel and guidance have helped the company to rise to the challenges that are behind us, and to prepare the company for what lies ahead. Also, to the professional management teams that have worked so well with the Board since those early days, I extend my appreciation for your leadership and best wishes for your future endeavours. The employees who work for Toronto Hydro are dedicated to providing excellent customer service and safety, and they are among the best in the industry.

Finally, I want to thank The Mayor and the Councillors of the City of Toronto for their trust and support as we have written another incredible chapter in the long, proud history of Toronto Hydro.

I am pleased to present this Annual Report containing the highlights of our operational performance in 2012, and our consolidated financial statements for the year.

**Clare R. Copeland**
Chairman

# GOVERNANCE

## CORPORATE GOVERNANCE

The Corporation has developed sound corporate governance practices. The Corporation's Board of Directors and management believe that strong corporate governance is essential for creating shareholder value and maintaining investor confidence.

## BOARD OF DIRECTORS

The Board of Directors of the Corporation is responsible for supervising the business and affairs of the Corporation and providing strategic guidance to management. The Board of Directors of the Corporation is composed of eight independent directors and three city councillors. All directors are appointed by the sole shareholder of the Corporation. The Board of Directors has four regularly scheduled meetings each year but meets as often as is necessary to fulfill its responsibilities to the Corporation.

The Board of Directors has worked to put in place a system of corporate governance that meets the requirements of applicable provincial legislation and Canadian Securities rules. As part of its ongoing commitment to corporate governance, the Board of Directors operates in accordance with a board mandate, and its committees operate in accordance with committee charters, which are all reviewed and approved by the Board of Directors.

The members of the Corporation's Board of Directors as of December 31, 2012 are introduced here. The description indicates committee and subsidiary Board of Directors' participation.

# GOVERNANCE

## BOARD OF DIRECTORS (continued)

Effective January 1, 2013, Councillor Gloria Lindsay Luby was appointed as a Director of the Corporation.

Effective April 15, 2013, David Williams was appointed Chair of the Corporation. Glenna Carr, Sara Gelgor, Colum Bastable and Isabel Meharry were appointed Directors of the Corporation.

## CODE OF BUSINESS CONDUCT AND CORPORATE RESPONSIBILITY

All employees, officers and directors of Toronto Hydro are required to comply with the principles set out in the Code of Business Conduct, which was implemented by the Corporation in 2004 and most recently amended and approved by the Board of Directors in November 2012. The Code provides for the appointment of an Ethics Officer and establishes a direct hotline to the Ethics Officer by which perceived violations of the principles set out in the Code may be reported, anonymously or otherwise. The Ethics Officer reports quarterly to the Audit Committee of the Board on the nature of complaints received including those related to audit and accounting matters. Where the complaint involves the conduct of a director or officer of the Corporation, the Ethics Officer is required to report it to the Chair of the Audit Committee, who oversees the investigation of that complaint. A copy of Toronto Hydro's Code of Business Conduct is available on our website.

## DISCLOSURE

The Board of Directors recognizes the importance of complying with all disclosure requirements applicable by provincial Securities rules and is committed to promoting consistent disclosure practices aimed at accurate and timely disclosure of material information. To ensure consistent and appropriate disclosure practices, the Corporation has adopted a Disclosure Policy to govern the disclosure by its employees, officers and directors of material information about the Corporation and has established a Disclosure Committee composed of senior executives to assist the Chief Executive Officer and the Chief Financial Officer in making accurate, complete and timely disclosure. The composition and operation of the Disclosure Committee are established in the Disclosure Policy.

## COMMITTEES

The Board of Directors believes that its ability to discharge its responsibilities is enhanced by the active participation of committees in the corporate governance process. Currently there are four committees of the Board of Directors: Corporate Governance, Audit, Compensation, and Health and Safety. Each committee meets regularly throughout the year and provides a report at meetings of the Board of Directors on material matters considered by the committee.

# GOVERNANCE

## AUDIT COMMITTEE

The Audit Committee is responsible for overseeing the adequacy and effectiveness of financial reporting, accounting systems and internal controls. The Audit Committee reviews the Corporation's quarterly and annual financial statements as well as financial statements prepared in connection with securities offerings or required by applicable regulatory authorities, reviews the audit plans of the external auditors, oversees the internal audit of the Corporation and recommends the external auditor for appointment by the Corporation's sole shareholder.

## CORPORATE GOVERNANCE COMMITTEE

The Corporate Governance Committee is responsible for considering and making recommendations to the Board with respect to matters relating to the corporate governance of Toronto Hydro, including board and committee composition and mandates, and guidelines for assessing the effectiveness of the Board and its committees and procedures to ensure that the Board functions independently from management.

## COMPENSATION COMMITTEE

The Compensation Committee is responsible for reviewing and assisting the Board in overseeing Toronto Hydro's compensation program, and reviewing and approving executive compensation.

## HEALTH AND SAFETY COMMITTEE

The Health and Safety Committee is responsible for considering and making recommendations to the Board with respect to matters of health and safety.

## BOARD OF DIRECTORS (As of December 31, 2012)

### Clare R. Copeland (Chairman)

- **Chairman**
  Toronto Hydro-Electric System Limited
- **Chairman**
  Toronto Hydro Energy Services Inc.
- **Chief Executive Officer**
  Falls Management Company
- **Former President and CEO**
  Peoples Jewellers Corp.
- **Former Chair**
  Sun Media Corp.
- **Former Chair**
  Ontario Place
- **Former Chair and Executive Officer**
  OSF Inc.

**Committee Membership**
Member, Compensation Committee

(Mr. Copeland ceased to be Chairman and a Director of the Corporation on April 14, 2013)

### Vince Brescia

- **Chief Executive Officer**
  Federation of Rental-Housing Providers of Ontario
- **Director**
  Canadian Federation of Apartment Associations
- **Director**
  Scarboro Golf & Country Club
- **Former Director**
  Municipal Property Assessment Corporation
- **Former Development Promotion Representative**
  Labourers' International Union of North America (LIUNA) Local 183
- **Former Director of Government Relations**
  Greater Toronto Home Builders' Association
- **Former Senior Economist**
  Ontario Ministry of Finance
- **Former Housing Policy Advisor**
  Office of the Minister of Municipal Affairs and Housing
- **Former Senior Treasury Board Analyst**
  Ontario Ministry of Finance
- **Former Senior Policy Advisor**
  Ontario Ministry of Housing
- **Former Senior Research Analyst**
  Clayton Research Associates Ltd.

## BOARD OF DIRECTORS (As of December 31, 2012)

### Patricia Callon

- **Director**
  Toronto Hydro-Electric System Limited
- **Director**
  Toronto Hydro Energy Services Inc.
- **Director**
  Community MicroSkills Development Centre
- **Chief Legal Officer**
  Canadian Securities Transition Office
- **Former Advisor**
  Ontario Securities Commission
- **Former Vice-President and Associate General Counsel**
  Canadian Imperial Bank of Commerce
- **Former Director**
  CIBC Trust Corporation, CIBC Securities Inc., CIBC Life Insurance Company Limited, CIBC Investor Services Inc. and TAL Global Asset Management Inc.

**Committee Memberships**
Chair, Compensation Committee
Member, Health and Safety Committee

(Ms. Callon ceased to be a Director of the Corporation on April 14, 2013)

### Brian Chu

- **Partner**
  Bogart Robertson & Chu
- **Trustee and Vice-Chair**
  The Centennial Centre of Science and Technology (Ontario Science Centre)
- **Former Director and President**
  Laidlaw Foundation
- **Former Director**
  Apparel Industry Development Council
- **Former Chair**
  Ontario College of Art and Design
- **Former Vice-Chair**
  Centennial College of Applied Arts and Technology
- **Former Vice-Chair**
  Chinese Cultural Centre of Greater Toronto

**Committee Memberships**
Chair, Audit Committee
Member, Corporate Governance Committee

(Mr. Chu ceased to be a Director of the Corporation on April 14, 2013)

## BOARD OF DIRECTORS (As of December 31, 2012)

### Derek Cowbourne

- **Former Vice-President and Chief Operating Officer**
  Independent Electricity System Operator
- **Former Chair**
  North American Electric Reliability Corporation (NERC) Operating Committee
- **Former Chair**
  Northeast Power Coordinating Council (NPCC) Reliability Coordinating Committee
- **Member**
  Institute of Corporate Directors, Institute-Certified Director, ICD.D
- **Fellow**
  Institution of Engineering & Technology
- **Member**
  Professional Engineers of Ontario

**Committee Membership**
Chair, Corporate Governance Committee

### Paulette Kennedy

- **Commissioner**
  Ontario Securities Commission
- **Member, Governing Council and Business Board**
  University of Toronto
- **Chair, Audit Committee**
  University of Toronto
- **Member, Pension Committee**
  University of Toronto
- **Member, External Stakeholders Advisory Committee**
  Financial Consumer Agency of Canada
- **Former Chief Auditor and Chief Financial Officer**
  AEGON Canada Inc.
- **Former Senior Vice-President and Chief Internal Auditor**
  Sobeys Inc.
- **Former Chief Auditor, Former Vice-President Finance and Actuarial**
  Sun Life Assurance Company of Canada

**Committee Memberships**
Member, Audit Committee
Member, Corporate Governance Committee

## BOARD OF DIRECTORS (As of December 31, 2012)

### Shoba Khetrapal

- **Director**
  St. Joseph's Health Centre
- **Director**
  Cancer Care Ontario
- **Vice-Chair**
  The Public Accountants Council
- **Former Vice-President and Chief Financial Officer**
  Weekenders International
- **Former Vice-President and Treasurer**
  Moore Corporation Ltd.
- **Former Officer**
  Canadian Pacific Limited
- **Former Advisory Member**
  Canadian Chamber of Commerce Economic Policy Committee
- **Former Director**
  Moore Group Services BVBA – Belgium, Peak Technologies Canada Ltd., Ontario Casino Corporation and other companies

**Committee Memberships**
Member, Audit Committee
Member, Health and Safety Committee

(Ms. Khetrapal ceased to be a Director of the Corporation effective April 14, 2013)

### David Williams

- **Director**
  Shoppers Drug Mart Corporation
- **Director**
  Canadian Apartment Properties REIT
- **Lead Director**
  Mattamy Homes Corp.
- **Lead Director**
  Aastra Technologies Inc.
- **Former Chair**
  Shoppers Drug Mart Corporation
- **Former President and Chief Executive Officer**
  Workplace Safety Insurance Board
- **Former Executive Vice-President**
  George Weston Ltd.
- **Former Executive Vice-President**
  Loblaws Companies Ltd.

**Committee Membership**
Chair, Health and Safety Committee

(Mr. Williams was appointed Chair of the Corporation effective April 15, 2013)

## BOARD OF DIRECTORS (As of December 31, 2012)

### Councillor Shelley Carroll

- **City Councillor**
  Ward 33 (Don Valley East) – since 2003
- **Member**
  North York Community Council
- **Member**
  City of Toronto Audit Committee
- **Member**
  Economic Development Committee
- **Director**
  Foodshare
- **Director**
  Toronto Atmospheric Fund
- **Director**
  Toronto Centre for the Arts
- **Director**
  Invest Toronto
- **Director**
  Hockey Hall of Fame
- **Director**
  Partners in Project Green

### Councillor Josh Colle

- **City Councillor**
  Ward 15 (Eglinton-Lawrence)
- **Member**
  North York Community Council
- **Commissioner**
  Toronto Transit Commission
- **Vice-Chair**
  Planning and Growth Management Committee
- **Director**
  Greater Toronto Marketing Alliance
- **Former Vice-President**
  Bridgepoint Group Limited
- **Former Manager**
  Greater Toronto Airport Authority

## BOARD OF DIRECTORS (As of December 31, 2012)

### Councillor Ron Moeser

- **City Councillor**
  Ward 44 (Scarborough East)
- **Member**
  Scarborough Community Council
- **Member**
  Civic Appointments Committee
- **Member**
  Parks and Environment Committee
- **Former Member**
  Budget Committee 1990–2003
- **Former Chair**
  Scarborough Community Council
- **Former Chair, Finance**
  Committee Toronto Regional Conservation Authority (T.R.C.A.)
- **Former Director**
  Toronto Zoo
- **Former Director**
  Canadian National Exhibition
- **Former Member**
  City of Toronto Seniors Committees
- **Former Director**
  Centenary Hospital
- **Former Commissioner**
  Toronto Transit Commission
- **Former Member**
  Greater Toronto Area Committee
- **Former Member**
  Rouge Park Alliance

(Councillor Moeser ceased to be a Director of the Corporation effective December 31, 2012)

### Colum P. Bastable*

- **Chairman**
  Cushman & Wakefield Ltd.
- **Former President & Chief Executive Officer**
  Cushman & Wakefield LePage Inc.
- **Member, Independent Review Committees**
  Brandes Investment Partners & Co.
- **Member, Board of Trustees**
  Brookfield Office Properties Canada REIT
- **Past Chair, Board of Governors**
  McMaster University
- **Former President & Chief Executive Officer**
  Royal LePage Limited

**Committee Membership**
Member, Compensation Committee

* Member of the Board of Directors, Toronto Hydro-Electric System Limited

(Mr. Bastable was appointed a Director of the Corporation effective April 15, 2013)

## BOARD OF DIRECTORS (As of December 31, 2012)

### Janet Beed*

- **President and Chief Executive Officer**
  Markham Stouffville Hospital
- **Former Chief Operating Officer**
  University Health Network:
  Toronto General Hospital
- **Former Partner**
  Global Consulting Group, Deloitte Consulting
- **Member, Board of Directors**
  ventureLAB Inc., York Region
- **Member, Board of Governors**
  Character Community Foundation of York Region

**Committee Membership**
Member, Compensation Committee

* Member of the Board of Directors,
Toronto Hydro-Electric System Limited

## SENIOR MANAGEMENT TEAM

***Anthony M. Haines**[1]
President and Chief Executive Officer

**Jean-Sebastien Couillard**[1,2]
Chief Financial Officer

**Paul B. Sommerville**[1,2]
Vice-President, Regulatory Affairs and General Counsel

**Ivano Labricciosa**[2]
Vice-President, Asset Management

**Ben LaPianta**[2]
Vice-President, Distribution Grid Management

**Ave Lethbridge**[2]
Vice-President, Organizational Effectiveness and Environment, Health & Safety

**Blair H. Peberdy**[2]
Vice-President, Marketing, Communications and Public Affairs

**Dino Priore**[2]
Vice-President, Distribution Services

**Chris Tyrrell**[2]
Vice-President, Customer Care and Chief Conservation Officer

**Robert Wong**[2]
Vice-President, Information Technology and Strategic Management

* Also President of Toronto Hydro-Electric System Limited

[1] Toronto Hydro Corporation

[2] Toronto Hydro-Electric System Limited

# OVERVIEW


**Toronto Hydro Corporation (the "Corporation") is a holding company which wholly-owns two subsidiaries:**

- **Toronto Hydro-Electric System Limited – which distributes electricity and engages in conservation and demand management ("CDM") activities; and**
- **Toronto Hydro Energy Services Inc. – which provides street lighting services.**

## SERVICES

- Provides policy and strategic direction to its subsidiaries.
- Manages shareholder and key business relationships.

## 2012 ACHIEVEMENTS

- Named one of **Canada's Top 100 Employers** as selected by editors of the Canada's Top 100 Employers project, organized by Mediacorp Canada Inc.; one of **Greater Toronto's Top Employers**, one of **Canada's Top Family-Friendly Employers** and one of **Canada's Greenest Employers**, all of which are also organized by Mediacorp Canada Inc. and featured in *The Globe and Mail*.
- Received an honourable mention in Canada's Outstanding Employers by The Learning Partnership for its participation in the Take Our Kids to Work™ program.
- Raised more than $380,000 for charities and community causes including United Way Toronto. Our United Way employee campaign raised approximately $335,000.

# OVERVIEW


## 2012 ACHIEVEMENTS (continued)

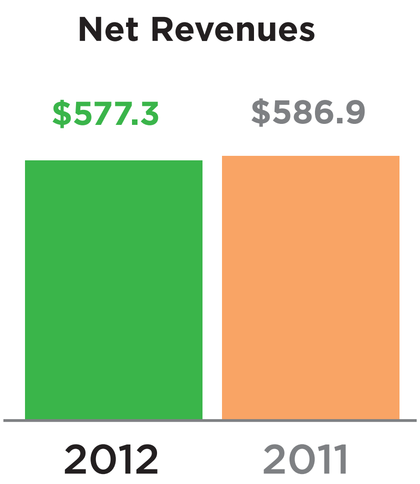
- Recognized by Green Living Enterprises for Excellence in Corporate Responsibility for the company's dedication towards creating sustainable and ethical practices within a business framework.
- Recognized by PR News for Corporate Social Responsibility ("CSR") and Stakeholder Engagement efforts.
- Supported the City's Urban Forest campaign, Ontario Forestry Association and Local Enhancement and Appreciation of Forests through tree planting initiatives and forestry education programs for youth.
- Provided a consistent and fair return in line with the Corporation's shareholder direction.
- As at December 31, 2012, the debentures issued under the Corporation's medium-term note program were rated "A (high)" by DBRS Limited and "A" by Standard & Poor's.

## 2013 OBJECTIVES

- Conduct business with a skilled, safe and productive workforce.
- Improve reliability by rebuilding the existing aging infrastructure.
- Strive to be the best utility in customer service.
- Achieve consistent financial performance.

## FACTS & FIGURES


**(in millions of dollars)**





# FACTS & FIGURES

## Toronto Hydro-Electric System Limited

**System Average Interruption Duration Index (SAIDI)**

**1.03 hours**

**System Average Interruption Frequency Index (SAIFI)**

**1.40 interruptions**

**Customer Average Interruption Duration Index (CAIDI)**

**0.74 hours**

**Peak Load**

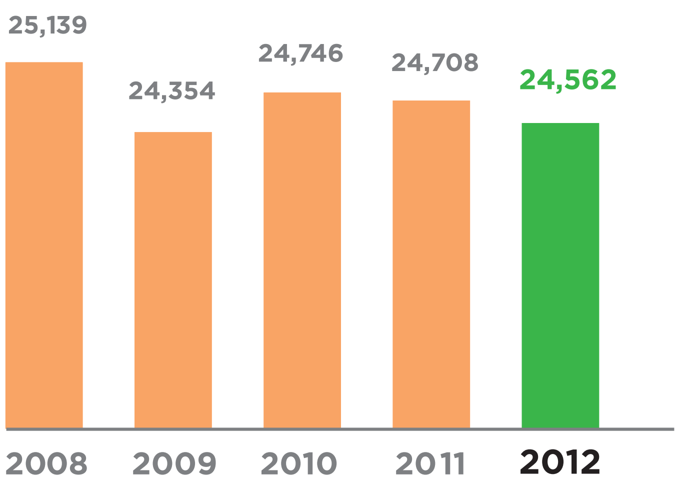
**4,830 megawatts**
on July 17, 2012 representing approximately

**19%** of the provincial demand

## FACTS & FIGURES

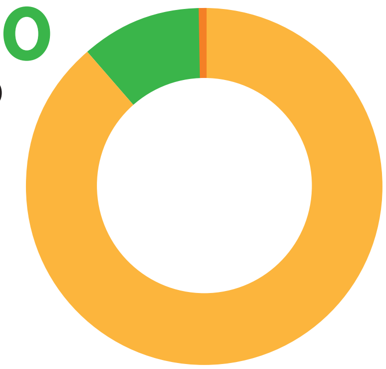
### Electricity Delivered (GWh)

**2012 — 24,562 GWh**




### Total Number of Customers

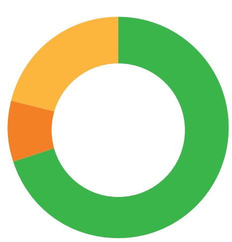
**719,000**
(approximate)



| | |
|---|---|
| Residential Service | 637,910 |
| General Service with monthly demand of 0-5,000 kW | 80,699 |
| Large Users with monthly demand over 5,000 kW | 52 |

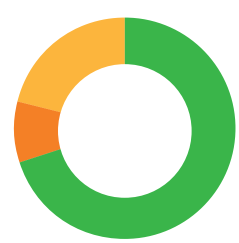
### Electricity Distributed by Class (GWh)
(approximate)

| | |
|---|---|
| Residential | 5,174 |
| General Service | 17,206 |
| Large Users | 2,182 |



### Electricity Distributed by Class (%)
(approximate)

| | |
|---|---|
| Residential | 21% |
| General Service | 70% |
| Large Users | 9% |



TORONTO HYDRO

## FACTS & FIGURES

**Number of Employees** (as of December 31, 2012) **1,540** (approximate)

### Toronto Hydro Corporation 2012 Capital Expenditures
**(in millions of dollars)**

| | |
|---|---|
| Distribution System | **$257.4** |
| Information Technology | **22.8** |
| Other | **9.5** |
| Non-regulated | **0.7** |
| TOTAL | **$290.4** |

### Distribution System is serviced from:
**(approximate)**

| | |
|---|---|
| **35** | Terminal Stations |
| **20,400** | Primary Switches |
| **60,650** | Distribution Transformers |
| **169** | In-service Municipal Substations |
| **15,100** | Kilometres of overhead wires supported by **174,700** poles and approximately **10,800** kilometres of underground wires |
| **1** | Control Centre |
| **7** | Operations Centres |

## 2012 Annual Report Glossary

**Conservation and Demand Management ("CDM")**

**Customer Average Interruption Duration Index ("CAIDI")**
A measure (in hours) of the average duration of interruptions experienced by customers, not including Major Event Days ("MED") as defined by the Institute of Electrical and Electronic Engineers Inc. specification 1366. CAIDI represents the quotient obtained by dividing the System Average Interruption Duration Index (SAIDI) by the System Average Interruption Frequency Index (SAIFI). See below for more explanation.

**Gigawatt-Hour ("GWh")**
A standard unit for measuring electrical energy produced or consumed over time. A GWh is equal to one million kilowatt-hours.

**International Organization for Standardization ("ISO")**

**Kilovolt**
Equals 1,000 volts

**Kilowatt ("kW")**
A common measure of electrical power equal to 1,000 watts.

**Kilowatt-Hour ("kWh")**
A standard unit for measuring electrical energy produced or consumed over time. One kWh is the amount of electricity consumed by 10 - 100 watt light bulbs burning for one hour.

**Megawatt ("MW")**
A common measure of electrical power equal to one million watts.

**Megawatt-Hour ("MWh")**
A megawatt-hour is equal to 1,000 kilowatt-hours.

**Occupational Health and Safety Management System ("OHSAS")**

**Peak Load**
The maximum demand for power, measured in megawatts, that occurs within a stated period of time. Toronto Hydro's peak system load (or peak demand) normally occurs in the summer because of power demands from air conditioning.

## 2012 Annual Report Glossary

**System Average Interruption Duration Index ("SAIDI")**
A measure (in hours) of the annual system average interruption duration for customers served, not including MED. SAIDI represents the quotient obtained by dividing the total customer hours of interruptions longer than one minute by the number of customers served.

**System Average Interruption Frequency Index ("SAIFI")**
A measure of the frequency of service interruptions for customers served, not including MED. SAIFI represents the quotient obtained by dividing the total number of customer interruptions longer than one minute by the number of customers served.

**Watt**
A common measure of electrical power. One watt equals the power used when one ampere of current flows through an electrical circuit with a potential of one volt.

**Watt-Hour**
A measure of energy production or consumption equal to one watt produced or consumed for one hour.

# TORONTO HYDRO-ELECTRIC SYSTEM LIMITED

**Toronto Hydro-Electric System Limited owns and operates $2.6 billion of capital assets comprised primarily of an electricity distribution system, which delivers electricity to approximately 719,000 customers located in the City of Toronto. It is the largest municipal electricity distribution company in Canada and distributes approximately 19% of the electricity consumed in the Province of Ontario.**

## SERVICES

- Delivers safe, reliable and cost-effective electrical power to approximately 719,000 residential, commercial and industrial customers in the City of Toronto, which has a population base of approximately 2.8 million.
- Plans, maintains and operates the City of Toronto's electrical distribution system infrastructure efficiently and in an environmentally responsible manner.
- Provides consistent, high-quality customer service.
- Designs and delivers electricity CDM programs.

## 2012 ACHIEVEMENTS

- Among the leading local distribution companies in the delivery of CDM programs to help customers conserve energy, save money and help the environment.
- Achieved savings of 116,900 MWh in its conservation portfolio in 2012, for a total cumulative savings of 462,700 MWh since 2011.
- Unveiled the first energy storage system installed directly in an urban community, which will allow Toronto Hydro-Electric System Limited to monitor and validate the benefits of this technology on the grid.
- Recognized by Infrastructure Health & Safety Association for achieving three million hours without a lost time injury.

## TORONTO HYDRO-ELECTRIC SYSTEM LIMITED

### 2012 ACHIEVEMENTS (continued)

- Passed audit towards certification for ISO 14001 (Environmental Management System) and OHSAS 18001 (Occupational Health and Safety Management System) international standards.
- Introduced My TorontoHydro™, a new fully automated online customer service portal available for customers to complete account transactions 24/7.
- Launched ***peaksaver* PLUS**®, a demand response program, which provides participants with an energy information display and load control devices.
- Launched the Electric Vehicle (EV) Connections Program and currently collecting EV data from charging stations located in residential homes, and industrial and commercial areas throughout the city, in an effort to create charging profiles and provide insight on how the grid is handling the additional growth.
- Supported training programs at Georgian College to help drive recruitment in the electricity industry.
- Supported the Mowat Centre for Policy Innovation, School of Public Policy & Governance, University of Toronto for research on energy technology policy.
- Participated in the Centre for Urban Energy at Ryerson University, a research and technology demonstration centre devoted to the discovery and commercialization of innovative solutions to urban energy issues.
- Continued a public consultation for the new Toronto Hydro Transformer Station and cable tunnel in the south-central downtown core of Toronto to help increase electricity capacity.
- Increased stakeholder outreach and met with a wide range of stakeholders to hear what is most valued by our community.

## TORONTO HYDRO-ELECTRIC SYSTEM LIMITED

### 2012 ACHIEVEMENTS (continued)

- Continued to work with Hydro One Inc. to refurbish the existing 115 kilovolt transmission infrastructure serving midtown to help improve service reliability.
- Prepared for the Pan Am Games by relocating and upgrading infrastructure to help with additional electricity demand.
- Relocated and upgraded aging infrastructure as part of Waterfront Toronto's initiative to transform the waterfront into a world-class showpiece for Toronto.
- Continued public safety campaign to remind public of electrical hazards on the street and around the home.
- Launched first annual pet safety week with Toronto Humane Society, which takes place during the third week in October.
- Recognized by Toronto City Council and Ontario Ministry of Energy for Hurricane Sandy power restoration efforts in Toronto and in the United States.
- Launched a solar photovoltaic (PV) project with City of Toronto to install 8,800 solar PV panels on 10 city-owned buildings.
- Introduced new Key Accounts Management initiative to provide 24/7 service to Toronto Hydro's largest commercial and industrial customers in the event of emergencies.
- Teamed up with Toronto Real Estate Board and created a new *Homeowners Kit*, which provides REALTORS® and their clients with information about key programs and services available through Toronto Hydro.

# TORONTO HYDRO ENERGY SERVICES INC.

## 2012 ACHIEVEMENTS

- Continued to provide reliable street lighting services to the City of Toronto.

MANAGEMENT'S DISCUSSION AND ANALYSIS
DECEMBER 31, 2012

**TORONTO HYDRO CORPORATION**

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR THE THREE MONTHS AND YEAR ENDED DECEMBER 31, 2012**

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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 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 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 and the Corporation's ability to borrow.

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, 2012 (the "Consolidated Financial Statements");

Effective January 1, 2012, the Corporation's annual and interim consolidated financial statements have been prepared in accordance with United States Generally Accepted Accounting Principles ("US GAAP") and are presented in Canadian dollars (see "Significant Accounting Policies" below). The Corporation's annual and interim consolidated financial statements were prepared in accordance with Part V of Canadian Generally Accepted Accounting Principles ("Canadian GAAP") until December 31, 2011. Comparative consolidated financial statements for 2011 have been adjusted retroactively from the consolidated financial statements previously presented to conform to the presentation of the Corporation's 2012 consolidated financial statements prepared in accordance with US GAAP.

**Business of Toronto Hydro Corporation**

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 719,000 customers located in the City of Toronto (the "City"). LDC is the largest municipal electricity distribution company in Canada and distributes approximately 19% of the electricity consumed in 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 3 to the Consolidated Financial Statements.

The sole shareholder of the Corporation is the City.

**Executive Summary**

- Net income for the three months and year ended December 31, 2012 was $22.8 million and $86.0 million, compared to net income of $17.2 million and $95.9 million for the comparable periods in 2011;
- capital expenditures were $107.8 million and $290.4 million for the three months and year ended December 31, 2012, compared to $130.3 million and $437.1 million for the comparable periods in 2011, with the decrease primarily related to uncertainty regarding the electricity distribution rates of LDC for 2012;

- on May 10, 2012, LDC filed an application for electricity distribution rates for 2012, 2013 and 2014 using the Incentive Regulation Mechanism ("IRM") framework, including the filing of an Incremental Capital Module ("ICM") application (the "IRM/ICM Application");
- on October 31, 2012, an update to the IRM/ICM Application was submitted by LDC modifying the requested amounts for 2012 and 2013, respectively, and requesting that consideration for 2014 be deferred until LDC has received a decision from the OEB in respect of the 2012 and 2013 rate years; and
- effective January 1, 2012, the Corporation's consolidated financial statements have been prepared in accordance with US GAAP.

**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 that 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 Regulated Adjustments* – The electricity price and regulated adjustments represent the pass through of the commodity and other costs 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").

The Corporation and each of its subsidiaries are Municipal Electricity Utilities ("MEUs") for purposes of the Payments 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 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 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 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.

**Corporate Strategy**

The Corporation's vision is to maximize customer and stakeholder satisfaction by providing safe and reliable service in an environmentally responsible way. The Corporation's corporate strategy is based on this vision and is focused on the following four pillars:

- *Health & Safety* – To conduct business with a skilled, safe and productive workforce;
- *Asset Modernization* – Improve reliability and strive to meet the objectives of the Green Energy Act by rebuilding the existing aging infrastructure in keeping with leading technology;
- *Customer Service* – Strive to be the best utility in customer service; and
- *Financial Strength* – Achieve consistent financial performance.

**Selected Consolidated Financial Data**

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

**Consolidated Statements of Net Income and Comprehensive Income**
**Three months ended December 31**
**(in thousands of Canadian dollars, except for per share amounts, unaudited)**

| | 2012 $ | 2011[1] $ | Change $ | Change % | 2010[1] $ |
|---|---|---|---|---|---|
| Revenues | 692,222 | 694,284 | (2,062) | (0.3) | 656,649 |
| Costs | | | | | |
| Purchased power | 551,267 | 542,510 | 8,757 | 1.6 | 515,336 |
| Operating expenses | 65,107 | 66,880 | (1,773) | (2.7) | 57,702 |
| Depreciation and amortization | 35,900 | 43,984 | (8,084) | (18.4) | 48,141 |
| | 652,274 | 653,374 | (1,100) | (0.2) | 621,179 |
| Income before the following: | 39,948 | 40,910 | (962) | (2.4) | 35,470 |
| Net financing charges | (18,640) | (19,506) | 866 | (4.4) | (18,478) |
| Gain (loss) on disposals of property, plant and equipment ("PP&E") | 1,430 | (1,135) | 2,565 | (226.0) | 1,094 |
| Income before income taxes | 22,738 | 20,269 | 2,469 | 12.2 | 18,086 |
| Income tax expense (recovery) | (104) | 3,041 | (3,145) | (103.4) | 8,038 |
| Net income and comprehensive income | 22,842 | 17,228 | 5,614 | 32.6 | 10,048 |
| Basic and fully diluted net income per share | 22,842 | 17,228 | 5,614 | 32.6 | 10,048 |

Note:

(1) The Corporation's consolidated financial statements were prepared in accordance with Part V of Canadian GAAP until December 31, 2011. Selected financial information from comparative consolidated financial statements for 2011 have been adjusted retroactively from the consolidated financial statements previously filed to conform to the presentation of the Corporation's 2012 consolidated financial statements prepared in accordance with US GAAP.

**Consolidated Statements of Net Income and Comprehensive Income**
**Year ended December 31**
**(in thousands of Canadian dollars, except for per share amounts)**

| | 2012 $ | 2011[(1)] $ | Change $ | Change % | 2010[(1)] $ |
|---|---|---|---|---|---|
| Revenues | 2,852,477 | 2,823,470 | 29,007 | 1.0 | 2,611,671 |
| Costs | | | | | |
| Purchased power | 2,275,209 | 2,236,541 | 38,668 | 1.7 | 2,062,269 |
| Operating expenses | 245,173 | 262,241 | (17,068) | (6.5) | 223,326 |
| Depreciation and amortization | 141,572 | 151,022 | (9,450) | (6.3) | 169,408 |
| | 2,661,954 | 2,649,804 | 12,150 | 0.5 | 2,455,003 |
| Income before the following: | 190,523 | 173,666 | 16,857 | 9.7 | 156,668 |
| Net financing charges | (73,977) | (75,324) | 1,347 | (1.8) | (71,150) |
| Gain (loss) on disposals of PP&E | 1,805 | 3,885 | (2,080) | (53.5) | 3,767 |
| Restructuring costs | (27,796) | - | (27,796) | 100.0 | - |
| Change in fair value of investments | - | - | - | - | 2,420 |
| Income before income taxes | 90,555 | 102,227 | (11,672) | (11.4) | 91,705 |
| Income tax expense (recovery) | 4,565 | 6,295 | (1,730) | (27.5) | 25,580 |
| Net income and comprehensive income | 85,990 | 95,932 | (9,942) | (10.4) | 66,125 |
| Basic and fully diluted net income per share | 85,990 | 95,932 | (9,942) | (10.4) | 66,125 |

Note:

(1) The Corporation's consolidated financial statements were prepared in accordance with Part V of Canadian GAAP until December 31, 2011. Selected financial information from comparative consolidated financial statements for 2011 have been adjusted retroactively from the consolidated financial statements previously filed to conform to the presentation of the Corporation's 2012 consolidated financial statements prepared in accordance with US GAAP.

| Condensed Consolidated Balance Sheets Data (in thousands of Canadian dollars) | | |
|---|---|---|
| | **As at December 31 2012 $** | **As at December 31 2011 $** |
| Total assets | 3,539,354 | 3,527,507 |
| Current liabilities | 937,514 | 483,399 |
| Long-term liabilities | 1,461,568 | 1,941,860 |
| Total liabilities | 2,399,082 | 2,425,259 |
| Shareholder's equity | 1,140,272 | 1,102,248 |
| Total liabilities and shareholder's equity | 3,539,354 | 3,527,507 |

**Results of Operations – 2012 compared to 2011**

***Net Income***

Net income for the three months and year ended December 31, 2012 was $22.8 million and $86.0 million compared to net income of $17.2 million and $95.9 million for the comparable periods in 2011.

The increase in net income for the three months ended December 31, 2012 was primarily due to lower depreciation and amortization expense ($8.1 million), lower income tax expense ($3.1 million), higher gain on disposals of PP&E ($2.6 million), lower operating expenses ($1.8 million) and lower net financing charges ($0.9 million). These favourable variances were partially offset by lower net revenues ($10.8 million).

The decrease in net income for the year ended December 31, 2012 was primarily due to restructuring costs incurred in conjunction with cost reduction initiatives at LDC recognized in the first quarter of 2012 (see "Restructuring Costs" below) ($27.8 million), lower net revenues ($9.6 million) and lower gain on disposals of PP&E ($2.1 million). These unfavourable variances were partially offset by lower operating expenses ($17.1 million), lower depreciation and amortization expense ($9.5 million), lower income tax expense ($1.7 million) and lower net financing charges ($1.3 million).

***Net Revenues***

Net revenues for the three months and year ended December 31, 2012 were $141.0 million and $577.3 million compared to $151.8 million and $586.9 million for the comparable periods in 2011 (see "Non-GAAP Financial Measures" below).

The decrease in net revenues for the three months ended December 31, 2012 was primarily due to lower regulated distribution revenue at LDC ($8.8 million) and lower other income ($2.0 million). The decrease in distribution revenue was primarily due to a revenue adjustment recorded in 2011 for a large commercial customer ($6.9 million) and a reduction of the Lost Revenue Adjustment Mechanism ("LRAM") receivable reflecting recent decisions rendered by the OEB ($1.3 million).

The decrease in net revenues for the year ended December 31, 2012 was primarily due to lower regulated distribution revenue at LDC ($6.0 million) and lower other income ($3.7 million). The decrease in distribution revenue was primarily due to a revenue adjustment recorded in 2011 for a large commercial customer ($6.9 million), adjustments recorded in 2012 for future taxes payable to customers ($3.8 million), and a reduction of the LRAM receivable reflecting recent decisions rendered by the OEB ($2.5 million). These variances were partially offset by higher electricity distribution rates in the first four months of 2012 compared to 2011 ($3.3 million) and higher consumption ($3.0 million) as a result of higher demand from large customers. The decrease in other income was primarily due to lower regulated customer connection work performed in 2012.

***Expenses***

Operating expenses for the three months and year ended December 31, 2012 were $65.1 million and $245.2 million compared to $66.9 million and $262.2 million for the comparable periods in 2011.

The decrease in operating expenses for the three months ended December 31, 2012 was primarily due to lower compensation costs resulting mainly from a workforce restructuring program implemented in 2012 ($4.8 million) (see "Restructuring Costs" below) partially offset by higher contractor costs related to an increase in operational and reactive maintenance program work in the fourth quarter of 2012 ($3.5 million) primarily related to lower capital programs at LDC.

The decrease in operating expenses for the year ended December 31, 2012 was primarily due to a favourable reassessment by the Ministry of Finance of Ontario ("Ministry of Finance") for payments in lieu of additional municipal and school taxes recorded in the second quarter of 2012 following a change in regulation related to prior periods ($8.7 million) (see "Corporate Developments – Payments in Lieu of Additional Municipal and School Taxes" below), lower compensation costs resulting mainly from a workforce restructuring program implemented in 2012 ($7.8 million) (see "Restructuring Costs" below), a one-time charge recorded in 2011 related to the decision by the OEB to disallow the recovery of a portion of the costs incurred by the Corporation related to the International Financial Reporting Standards ("IFRS") conversion project ($3.0 million), and reduced bad debt expense ($2.3 million) from improved collection initiatives. These variances were partially offset by higher operational maintenance and contractor costs primarily related to an increase in operational and reactive maintenance program work and lower capital programs at LDC in 2012 ($6.3 million).

Depreciation and amortization expense for the three months and year ended December 31, 2012 was $35.9 million and $141.6 million compared to $44.0 million and $151.0 million for the comparable periods in 2011.

The decrease in depreciation and amortization expense for the three months ended December 31, 2012 was primarily due to certain assets being fully depreciated ($15.0 million) partially offset by an increase in depreciation related to new additions in-service ($6.4 million).

The decrease in depreciation and amortization expense for the year ended December 31, 2012 was primarily due to certain assets being fully depreciated ($23.8 million) and changes in useful life estimates of certain assets ($3.1 million). This decrease was partially offset by an increase in the depreciation related to new additions in-service ($18.3 million).

***Net Financing Charges***

Net financing charges for the three months and the year ended December 31, 2012 were $18.6 million and $74.0 million compared to $19.5 million and $75.3 million for the comparable periods in 2011.

The decrease in net financing charges for the three months and year ended December 31, 2012 was primarily due to the rollover of maturing debentures at a lower interest rate in late 2011, partially offset by lower interest capitalized in relation to allowance of funds used during construction due to lower capital spending in 2012 and lower interest income on cash and investments.

***Gain (loss) on Disposals of PP&E***

Gain (loss) on disposals of PP&E for the three months and year ended December 31, 2012 was $1.4 million and $1.8 million compared to ($1.1) million and $3.9 million for the comparable periods in 2011.

The increase in gain on disposals of PP&E for the three months ended December 31, 2012 was primarily due to higher gains realized in connection with the disposals of surplus properties at LDC in the fourth quarter of 2012.

The decrease in gain on disposals of PP&E for the year ended December 31, 2012 was primarily due to lower gains realized as a result of fewer disposals of surplus properties at LDC in 2012. During 2011, LDC recognized $3.9 million in gain on disposals of surplus properties, of which $1.4 million related to surplus properties for which the OEB reduced electricity distribution rates in 2010.

### *Restructuring Costs*

In the first quarter of 2012, the Corporation's Board of Directors approved a workforce restructuring program aimed at reducing operating expenditures for LDC. The program was approved following the decision by the OEB to deny the request of LDC to set its electricity distribution rates for 2012, 2013 and 2014 under the Cost of Service ("COS") framework. In preparing its revised application using the IRM framework, LDC concluded that significant cost reductions were necessary to manage its business within the confines of the expected allowed electricity distribution rates provided by the IRM framework. The main component of these operating cost reduction initiatives was a workforce restructuring program, which included the severance of management employees and a voluntary exit incentive program for targeted unionized positions. See "Corporate Developments – Distribution Rates for LDC" below.

Restructuring costs for the year ended December 31, 2012 were $27.8 million compared to $nil for the comparable period in 2011. This balance was comprised of ongoing termination charges of $23.7 million and one-time termination incentive charges of $4.1 million, of which $12.0 million remains unpaid as at December 31, 2012.

### *Income Tax Expense (Recovery)*

Income tax expense (recovery) for the three months and year ended December 31, 2012 was ($0.1) million and $4.6 million compared to $3.0 million and $6.3 million for the comparable periods in 2011.

The decrease in the income tax expense for the three months ended December 31, 2012 was primarily due to higher deductions for permanent and temporary differences between accounting and tax treatments ($3.8 million) partially offset by higher earnings before taxes ($0.7 million).

The decrease in the income tax expense for the year ended December 31, 2012 was primarily due to lower earnings before taxes ($3.1 million) offset by lower deductions for permanent and temporary differences between accounting and tax treatments ($1.4 million).

## Results of Operations – 2011 compared to 2010

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 ($37.5 million), lower income tax expense ($19.3 million), and lower depreciation expense ($18.4 million). These favourable variances were partially offset by higher operating expenses ($38.9 million), higher net financing charges ($4.2 million), and a change in fair value of investments ($2.4 million) in 2010. For further details, see "Selected Consolidated Financial Data" above and the Corporation's 2011 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 2012 and 2011, which was prepared in accordance with US GAAP.

| 2012 Quarter Ended, (in thousands of Canadian dollars, unaudited) | | | | |
|---|---|---|---|---|
| | **December 31 $** | **September 30 $** | **June 30 $** | **March 31 $** |
| Revenues | 692,222 | 751,168 | 709,519 | 699,568 |
| Costs | 652,274 | 693,809 | 649,831 | 666,040 |
| Net income | 22,842 | 34,436 | 41,538 | (12,826) |

| 2011 Quarter Ended, (in thousands of Canadian dollars, unaudited) | | | | |
|---|---|---|---|---|
| | December 31 $ | September 30 $ | June 30 $ | March 31 $ |
| Revenues | 694,284 | 738,352 | 686,646 | 704,188 |
| Costs | 653,374 | 687,279 | 648,685 | 660,466 |
| Net income | 17,228 | 28,982 | 24,270 | 25,452 |

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/cooling in the third quarter.

**Financial Position**

The following table outlines the significant changes in the consolidated balance sheets between 2012 and 2011.

| Consolidated Balance Sheets Data (in thousands of Canadian dollars) | | |
|---|---|---|
| **Balance Sheet Account** | **Increase (Decrease) $** | **Explanation of Significant Change** |
| **Assets** | | |
| Cash and cash equivalents | (77,664) | See "Liquidity and Capital Resources" below. |
| Investments | (34,002) | The decrease in investments is due to the sale and maturity of two floating rate notes in the amounts of $25.0 million and $9.0 million, the first was sold on February 15, 2012 and the second matured on February 17, 2012. |
| Accounts receivable, net of allowance for doubtful accounts | (8,113) | The decrease in accounts receivable is primarily due to the timing of billing and collection activities ($6.6 million) and the timing of billings and recoveries from the Ontario Power Authority ("OPA") for CDM programs ($2.9 million). |
| Unbilled revenue | 16,028 | The increase in unbilled revenue is primarily due to higher energy prices as at December 2012 compared to December 2011 and the timing of billing activities. |
| PP&E and intangible assets, net | 148,267 | The increase in PP&E and intangible assets is primarily due to capital expenditures ($290.4 million), partially offset by depreciation during the period ($141.6 million). |

| Consolidated Balance Sheets Data (in thousands of Canadian dollars) | | |
|---|---|---|
| **Balance Sheet Account** | **Increase (Decrease) $** | **Explanation of Significant Change** |
| Regulatory assets ................................ | (21,824) | The decrease in regulatory assets is primarily due to a decrease in the retail settlement balances regulated by the OEB, lower smart meter recoveries for the year and lower balances related to the accounting policy change upon adoption of US GAAP. |
| Deferred income tax assets .................. | (8,049) | The decrease in deferred income tax assets is due to a decrease in the net deductible temporary differences between tax and accounting values of PP&E. |
| **Liabilities and Shareholder's Equity** | | |
| Accounts payable and accrued liabilities ............................................... | (29,041) | The decrease in accounts payable and accrued liabilities is mainly due to the reduction in capital programs ($13.7 million), a decrease in customer refunds ($5.2 million), the settlement of prior year's PILs property tax reserve ($4.9 million), and lower cost of power accrual for December 2012. |
| Restructuring accrual........................... | 11,954 | The restructuring accrual is due to the workforce restructuring program initiated by the Corporation in the first quarter of 2012 (see "Results of Operations – Restructuring Costs" above). |
| Deferred conservation credit ............... | 6,957 | The increase in deferred conservation credit is due to the timing in delivery of CDM programs and advances from the OPA. |
| Post-retirement benefits........................ | 9,564 | The increase in post-retirement benefits is due to additional accruals for the current service provided by active employees, partially offset by benefits paid during the period. |
| Regulatory liabilities ............................ | (14,403) | The decrease in regulatory liabilities is due to the net disposition of retail settlement balances to customers approved by the OEB and a reduction of deferred income tax assets payable to customers. |
| Customers' advance deposits ............... | (9,200) | The decrease in customers' advance deposits is due to the reimbursement of residential customer deposits during the period. |
| Retained earnings ................................ | 38,024 | The increase in retained earnings is due to net income for the year ($86.0 million), partially offset by dividends paid ($48.0 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, 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, to purchase power, to meet financing obligations and for prudential requirements.

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

**Consolidated Statement of Cash Flows**
**(in thousands of Canadian dollars)**

| | Three months Ended December 31 | | Year Ended December 31 | |
|---|---|---|---|---|
| | **2012** **$** | **2011** **$** | **2012** **$** | **2011** **$** |
| Cash and cash equivalents, beginning of period ... | 137,323 | 153,953 | 154,256 | 330,151 |
| Net cash provided by operating activities ........... | 43,396 | 109,928 | 220,429 | 345,996 |
| Net cash used in investing activities .................... | (93,420) | (152,921) | (239,132) | (532,513) |
| Net cash provided by (used in) financing activities ............................................................ | (10,707) | 43,296 | (58,961) | 10,622 |
| Cash and cash equivalents, end of period ............ | 76,592 | 154,256 | 76,592 | 154,256 |

### *Net Cash Provided by Operating Activities*

Net cash provided by operating activities for the three months and year ended December 31, 2012 was $43.4 million and $220.4 million compared to $109.9 million and $346.0 million for the comparable periods in 2011.

The decrease in net cash provided by operating activities for the three months ended December 31, 2012 was primarily due to a higher variance in accounts payable and accrued liabilities primarily related to timing of payments to suppliers and reduction in capital programs ($50.1 million), a decrease in post-retirement benefits in 2012 ($8.1 million), a decrease in depreciation expense ($8.1 million), and a decrease in the restructuring accrual established in 2012 (see "Results of Operations – Restructuring Costs" above) ($2.9 million). These variances were partially offset by an increase in net income ($5.6 million).

The decrease in net cash provided by operating activities for the year ended December 31, 2012 was primarily due to a higher variance in accounts payable and accrued liabilities primarily due to timing of payments to suppliers and reduction in capital programs ($68.1 million), a lower increase in post-retirement benefit liability in 2012 ($34.7 million), a variance in the aggregate amount of accounts receivable and unbilled revenue due to the timing of billing and collection activities ($19.5 million), a decrease in net income ($9.9 million), and a decrease in depreciation expense ($9.5 million). These variances were partially offset by the recognition of a restructuring accrual in 2012 (see "Results of Operations – Restructuring Costs" above) ($12.0 million) and a variance in income tax receivable ($8.0 million) from lower instalments in 2012.

### *Net Cash Used in Investing Activities*

Net cash used in investing activities for the three months and year ended December 31, 2012 was $93.4 million and $239.1 million compared to $152.9 million and $532.5 million for the comparable periods in 2011.

The decrease in net cash used in investing activities for the three months ended December 31, 2012 was primarily due to a change in net regulatory assets and liabilities ($36.0 million) and lower capital expenditures in 2012 ($22.5 million). The change in net regulatory assets and liabilities was primarily related to a higher variance in 2012 of retail settlement balances regulated by the OEB ($12.4 million), lower regulatory asset recovery accounts approved by the OEB for disposition ($10.8 million), and lower balances due to the accounting policy change upon adoption of US GAAP ($8.9 million).

The decrease in net cash used in investing activities for the year ended December 31, 2012 was primarily due to lower capital expenditures in 2012 ($146.7 million), a change in net regulatory assets and liabilities ($81.0 million) and a variance related to short-term investment activities ($68.0 million). The change in net regulatory assets and liabilities was primarily related to lower balances due to the accounting policy change upon adoption of US GAAP ($37.9 million), a higher variance in 2012 of retail settlement balances regulated by the OEB ($29.4 million), and lower regulatory asset recovery accounts approved by the OEB for disposition ($25.1 million). The variances related to the net regulatory assets and liabilities were partially offset by changes due to the late payment penalties settlement ($7.8 million) and the reduction of deferred IFRS project expenditures ($6.0 million).

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

**Capital Expenditures**
**(in thousands of Canadian dollars)**

| | Three months Ended December 31 | | Year Ended December 31 | |
|---|---|---|---|---|
| | **2012 $** | **2011 $** | **2012 $** | **2011 $** |
| LDC | | | | |
| Distribution system | 96,675 | 96,824 | 257,408 | 361,851 |
| Technology assets | 7,421 | 11,293 | 22,752 | 33,193 |
| Other [1] | 3,539 | 20,401 | 9,530 | 36,139 |
| | 107,635 | 128,518 | 289,690 | 431,183 |
| Other [2] | 146 | 1,753 | 688 | 5,884 |
| Total Capital Expenditures | 107,781 | 130,271 | 290,378 | 437,067 |

Notes:

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

Under the current electricity distribution rates of LDC, the OEB approved regulated capital expenditures amounted to approximately $140.0 million for 2012. For 2011, the OEB approved $378.8 million in regulated capital expenditures for LDC. On May 10, 2012, LDC filed the IRM/ICM Application. While the IRM/ICM Application proposed by LDC has been under consideration by the OEB, capital spending in 2012 has been maintained at a reduced amount (see "Corporate Developments – Distribution Rates for LDC" below).

The decrease in regulated capital expenditures at LDC for the three months and year ended December 31, 2012 amounted to $20.9 million and $141.5 million, respectively. The decrease was primarily due to the uncertainty surrounding LDC's capital work program as a result of the OEB's decision to impose the IRM framework for 2012.

For the year ended December 31, 2012, the decrease in regulated capital expenditures was primarily related to distribution lines ($64.0 million), fleet & facilities ($29.4 million), feeders ($13.0 million), metering ($10.1 million), and technology assets ($9.1 million).

The most significant areas for regulated capital expenditures incurred by LDC in 2012 were related to rebuilding and maintaining the reliability of the electricity distribution system, primarily by replacing aging assets ($170.5 million), expenditures related to upgrades to stations ($26.7 million) and expenditures related to customer connections ($21.8 million).

***Net Cash Provided by (Used in) Financing Activities***

Net cash provided by (used in) financing activities for the three months and year ended December 31, 2012 was ($10.7) million and ($59.0) million compared to $43.3 million and $10.6 million for the comparable periods in 2011.

The increase in net cash used in financing activities for the three months ended December 31, 2012 compared to the same period in 2011 was primarily due to the net effect of the proceeds received in connection with the issuance of $300.0 million of senior unsecured debentures and the repayment of $245.1 million of senior unsecured debentures in 2011 ($52.9 million).

The increase in net cash used in financing activities for the year ended December 31, 2012 compared to the same period in 2011 was primarily due to the net effect of the proceeds received in connection with the issuance of $300.0 million of senior unsecured debentures, the repayment of $245.1 million of senior unsecured debentures in 2011 ($52.9 million) and a higher dividend paid to the City ($14.9 million).

***Summary of Contractual Obligations and Other Commitments***

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, 2012**
**(in thousands of Canadian dollars)**

| | Total $ | 2013 $ | 2014/2015 $ | 2016/2017 $ | After 2017 $ |
|---|---|---|---|---|---|
| Debentures – principal repayment... | 1,470,057 | 470,057 | - | 250,000 | 750,000 |
| Debentures – interest payments....... | 557,590 | 60,160 | 91,600 | 91,600 | 314,230 |
| Operating lease obligations and other ……………………………… | 34,800 | 9,091 | 17,051 | 8,658 | - |
| Future capital commitments [(1)].......... | 15,278 | 15,278 | - | - | - |
| Capital lease obligations…………. | 12,766 | 2,338 | 4,651 | 4,620 | 1,157 |
| Asset retirement obligations........... | 5,983 | 1,285 | 246 | 359 | 4,093 |
| Total contractual obligations and other commitments…..................... | 2,096,474 | 558,209 | 113,548 | 355,237 | 1,069,480 |

Note:

(1) Reflect estimated capital contributions payable to Hydro One Networks Inc. under the Toronto Midtown Transmission Reinforcement Project.

***Credit Facilities and Shelf Prospectus***

The Corporation is a party to a credit agreement with a syndicate of Canadian chartered banks which establishes a revolving credit facility ("Revolving Credit Facility"). On October 10, 2012, the credit agreement was amended and restated to increase the amount the Corporation may borrow under the Revolving Credit Facility from $400.0 million to $600.0 million and to extend the Revolving Credit Facility's maturity date from May 3, 2013 to October 10, 2017. An amount up to $210.0 million (formerly $140.0 million) is available in the form of letters of credit. The Revolving Credit Facility may be used for general corporate purposes, letter of credit requirements and financing capital expenditures of LDC. As at December 31, 2012, refinancing costs of $1.1 million related to the renewal have been recorded as deferred financing cost.

Additionally, the Corporation is a party to:

- a demand facility with a Canadian chartered bank for $75.0 million (increased from $50.0 million on October 10, 2012) for the purpose of issuing letters of credit mainly to support LDC's prudential requirements with the IESO ("Prudential Facility"); and
- a demand facility with a second Canadian chartered bank for $20.0 million for the purpose of working capital management ("Working Capital Facility").

As at December 31, 2012, no amounts had been drawn under either the Revolving Credit Facility or the Working Capital Facility. As at December 31, 2012, $49.2 million had been drawn on the Prudential Facility.

The Corporation filed a base shelf prospectus dated December 10, 2012 with the securities commissions or similar regulatory authorities in each of the provinces of Canada. These filings allow the Corporation to make offerings of unsecured debt securities of up to $1.5 billion during the following 25-month period.

***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. As at December 31, 2012, the Corporation had drawn letters of credit in the amount of $49.2 million on its Prudential Facility in respect of the operations of LDC.

**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 approval of the Corporation's audited Consolidated Financial Statements for the year by the Board of Directors of the Corporation.

For the year ended December 31, 2012, the Board of Directors of the Corporation declared and paid dividends totalling $48.0 million to the City.

On February 28, 2013, the Board of Directors of the Corporation declared dividends in the amount of $24.0 million. The dividends are comprised of $18.0 million with respect to net income for the year ended December 31, 2012, payable to the City on March 8, 2013, and $6.0 million with respect to the first quarter of 2013, payable to the City on March 28, 2013.

**Credit Rating**

Maintaining an investment grade credit rating is essential for corporate liquidity and future capital market access. The cost and availability of financing are influenced by credit ratings, which are an indicator of the creditworthiness of a particular company, security or obligation. Lower ratings generally result in higher borrowing costs as well as reduced access to capital markets.

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

**Credit Ratings**
**As at December 31, 2012**

| | Rating |
|---|---|
| DBRS | A (high) |
| Standard & Poor's | 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 for 2011 were determined through an application under the COS framework. The COS framework sets electricity distribution rates using a detailed examination of evidence and an assessment of the costs incurred by an electricity distributor to provide services to its customers.

On July 7, 2011, the OEB issued its decision regarding LDC's electricity distribution rates for 2011. 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 COS framework, with the OEB seeking approval of separate and successive revenue requirements and corresponding electricity distribution rates for 2012, 2013 and 2014. Pursuant to the IRM framework, the OEB established, as a preliminary issue in this application, that it would consider the question of whether the application filed by LDC under the COS framework was acceptable or whether it should be dismissed. The IRM framework provides for a standard adjustment to an electricity distributor's rates based on a formulaic calculation with the possibility to request an ICM to address specific capital expenditure needs that occur during the IRM term, and are not otherwise funded by the formulaic calculation. In order to determine whether a distributor is eligible for the ICM, the OEB conducts a review of the application by way of a detailed examination of a distributor's evidence and consideration of a number of criteria, such as materiality, need and prudence.

LDC filed evidence supporting its position for electricity distribution rates to be set under the COS framework for 2012, 2013 and 2014. 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 COS framework application for 2012, 2013 and 2014. In its decision, the OEB found that LDC was not permitted to deviate from the standard IRM framework cycle. Accordingly, LDC was required to file its request for electricity distribution rates for 2012, 2013, and 2014 pursuant to the IRM framework and to use the ICM to request the capital needed for infrastructure renewal.

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

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

On May 10, 2012, LDC filed the IRM/ICM Application. The formulaic adjustment, requested by LDC, follows the guidelines provided by the OEB and seeks to increase the current revenue requirement by 0.68% to $525.5 million for 2012, $529.1 million for 2013 and $532.7 million for 2014. The 2013 and 2014 formulaic adjustment may be subject to change depending on future inflation and market data.

The IRM/ICM Application proposed by LDC requests rate riders to enable the recovery of capital expenditures. Accordingly, the amount of capital expenditures included in LDC's proposed IRM/ICM Application amounts to $448.7 million for 2012, $534.5 million for 2013 and $439.5 million for 2014.

On August 16, 2012, the OEB issued its decision on the issues list for the application filed May 10, 2012. In that decision, the OEB stated that further procedural steps would be determined pending LDC's response to the OEB as to whether LDC would continue to pursue the Motion and the Appeal. On August 20, 2012, LDC filed a notice of abandonment with the Ontario Divisional Court thereby terminating the Appeal. On the same date, LDC advised the OEB that it would withdraw its Motion for review.

While the IRM/ICM Application proposed by LDC has been under consideration by the OEB, capital spending in 2012 has been maintained at a reduced amount. As it was no longer practical to achieve the previously requested capital spending of $448.7 million in 2012, an update to the IRM/ICM Application was submitted by LDC on October 31, 2012 modifying the requested capital expenditures for 2012 and 2013 to $283.0 million and $579.1 million, respectively, and requesting that consideration for 2014 be deferred to a second phase of the proceeding, once LDC has received a decision from the OEB in respect of phase one. On November 3, 2012, the OEB accepted LDC's request for a two-phase proceeding: phase one comprising LDC's 2012 and 2013 work program proposals and phase two comprising LDC's 2014 work program proposal.

The current application is expected to be subject to an in-depth review by the OEB. There can be no assurance that the OEB will allow for the total or partial recovery of the capital expenditure balances requested in the current application. The financial effect of the OEB decision will be recorded in the period it becomes known and could be material to the Corporation's financial performance.

On October 18, 2012, the OEB released its report, Renewed Regulatory Framework for Electricity Distributors: A Performance-Based Approach ("RRFE"), which will guide the OEB in setting rates for electricity distributors. The OEB is currently developing the necessary regulatory instruments and expects such instruments to be largely finalized and implemented in time for setting distribution rates beginning May 2014. The RRFE is designed to support the cost-effective planning and operation of the electricity distribution network.

The RRFE identifies three rate-setting methods to provide choices for distributors with varying capital requirements: a Fourth Generation Incentive Rate-setting method, which builds on the current Third Generation Incentive Rate-setting method; a Custom Incentive Rate-setting method, through which rates are set based on a five year forecast of a distributor's revenue requirement and sales volumes; and an Annual Incentive Rate-setting Index method, which involves adjustment of rates by a simple price cap index formula. Each distributor may select the rate-setting method that best meets its needs and circumstances. The RRFE also requires distributors to file five-year capital plans to support their rate applications, and to report annually on their key performance outcomes. Within the scope of the information currently available, the Corporation is currently assessing the rate-setting methods available and other implications resulting from the RRFE.

***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 (1798594 Ontario Inc.), and for LDC to amalgamate with the new legal entity. On January 1, 2012, the Corporation completed the asset transfer and amalgamation. The purchase price for such assets, including a post-closing adjustment, was $42.5 million, subject to transaction costs.

***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 GWh 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 in the amount of approximately $50.0 million to deliver CDM programs extending from January 1, 2011 to December 31, 2014 (the "Master CDM Program Agreement"). As at December 31, 2012, LDC received approximately $35.4 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. Amounts received but not yet spent are presented under current liabilities as deferred conservation credit. Upon the expiration of the Master CDM Program Agreement, LDC is required to repay to the OPA any excess funding received for program administration less any cost efficiency incentives. These programs are expected to support the achievement of the mandatory CDM targets described above.

On December 21, 2012, the Minister of Energy of Ontario issued a direction to the OPA under subsection 25.32(4.1) of the Electricity Act to extend the funding time period for OPA-contracted province-wide CDM initiatives under the Green Energy Act framework to December 31, 2015.

***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. Subsequent to this decision, the OEB issued interrogatories and decisions for other MEUs.

LDC has reviewed the balances of its PILs regulatory variance accounts and applied the guidelines provided by the OEB. As at December 31, 2012, LDC estimated its liability at approximately $7.0 million. This balance has been recorded in the Corporation's Consolidated Financial Statements. LDC has applied for disposition of the balance as part of its pending IRM/ICM Application filed on May 10, 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 had issued assessments in respect of payments in lieu of additional municipal and school taxes under section 92 of the Electricity Act that were in excess of the amounts LDC believed were payable. The dispute arose as a result of inaccurate information incorporated into Ontario Regulation 224/00. The Corporation 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.

In May 2012, the Ministry of Finance completed its reassessment as a consequence of the change in regulation. The impact of the reassessment issued was favourable to the Corporation.

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

On July 12, 2012, the City, as the sole shareholder of the Corporation, appointed Vincent Brescia on the Board of Directors as an independent director of the Corporation. This appointment was effective immediately for a term ending November 30, 2012, or until a successor is appointed.

Effective as of January 1, 2013, the City, as the sole shareholder of the Corporation, appointed councilor Gloria Lindsay Luby as the City's designates on the Board of Directors of the Corporation to replace councilor Ron Moeser and also re-appointed councilor Josh Colle as the Mayor's designate and councilor Shelley Carroll as the City's designates on the Board of Directors of the Corporation. Their appointments are effective to November 30, 2014.

**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 an 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 sought 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 in contravention of the *Interest Act* (Canada). On April 30, 2012, a settlement reached by the parties was approved by Order of the Ontario Superior Court of Justice. Pursuant to the terms of the Order, LDC was required to pay the amount of $5.8 million plus costs in settlement of all claims, substantially all of which had been paid as at December 31, 2012. The Corporation accrued a liability to cover the expected settlement in 2010. The action has been dismissed, and the claims by all class members have been released.

***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) 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 a 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 dated January 24, 2012, 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, 1992* (Ontario) 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 has yet to occur. 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 sought 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, notwithstanding a court ordered timetable to have them completed by February 29, 2012. By order dated December 5, 2012, these actions were dismissed by the court for delay.

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.

**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 other 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**
**(in thousands of Canadian dollars)**

| | Three months Ended December 31 | | Year Ended December 31 | |
|---|---|---|---|---|
| | 2012 $ | 2011 $ | 2012 $ | 2011 $ |
| Revenues | 53,075 | 54,290 | 222,032 | 210,449 |
| Operating expenses and capital expenditures | 9,798 | 15,069 | 26,259 | 30,582 |
| Dividends | 7,000 | 7,000 | 47,966 | 33,063 |

**Transactions with Related Parties Summary**
**(in thousands of Canadian dollars)**

| | As at December 31 2012 $ | As at December 31 2011 $ |
|---|---|---|
| Accounts receivable | 7,810 | 8,412 |
| Unbilled revenue | 17,018 | 12,439 |
| Other assets | 7,279 | 7,279 |
| Accounts payable and accrued liabilities | 38,020 | 25,085 |
| Advance deposits | 8,926 | 8,714 |

Revenues represent amounts charged to the City primarily for electricity, street lighting, and ancillary services. Operating expenses and capital expenditures represent amounts charged by the City for purchased road cut repairs, property taxes and other services. Dividends represent dividends paid to the City.

Accounts receivable represent receivables from the City primarily for electricity, street lighting and ancillary services. Unbilled revenue represents receivables from the City related to the provision of electricity and other services provided and not yet billed. Other assets represent amounts primarily 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. Advance deposits represent funds received from the City for future expansion projects.

See note 20 to the Consolidated Financial Statements.

**Risk Factors**

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

***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 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 IRM framework, including the ICM, at levels that will permit LDC to carry out its planned capital work programs required to maintain safe and reliable service to its customers and earn the allowed rate of return on the investment in the business;
- the regulatory instruments that arise from the RRFE will be sufficient to address LDC's operations, needs and circumstances in respect of future applications for electricity distribution rates;
- 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.

Any future regulatory decision to disallow or limit the recovery of costs would lead to potential asset impairment and charges to results from operations, which could have a material adverse effect.

***Condition of Distribution Assets***

LDC estimates that approximately one-third of its electricity distribution assets are past their expected useful lives. 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.

LDC is focused on overcoming the above challenges and executing its maintenance program. However, if LDC is unable to carry out these plans in a timely and optimal manner, equipment performance will degrade which may compromise the reliability of distribution assets, the ability to deliver sufficient electricity and/or customer supply security and increase the costs of operating and maintaining these assets.

***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 and financial, billing and business systems to capture data and to produce timely and accurate information. Failures of any one of the financial, business and operating systems could have a material adverse effect on the Corporation's business, operating results, financial condition and prospects. The Corporation mitigates this risk through various methods including the use of security event management tools on its distribution and business systems, by separating the electricity distribution system from the business systems and by providing company-wide awareness training to personnel.

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 preventative measures to monitor and protect against cyber attacks and mitigate their effects, there can be no assurance that such 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 related to the electricity distribution system. 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 customers could negatively impact LDC's revenue. On an annual basis, the Corporation estimates that 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, approximately 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.

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, 2012, by approximately $39.4 million, and a 1% (100 basis point) decrease in the discount rate would increase the accrued benefit obligation, as at December 31, 2012, by approximately $48.3 million.

As at December 31, 2012, the Corporation has limited exposure to interest rate risk since its significant obligations are either non-interest bearing or bear fixed interest rates, its financial assets are predominately short-term in nature and mostly non-interest bearing, and its revenue is governed by a specified rate of return pricing structure set by the OEB. The Corporation estimates that a 100 basis point increase (decrease) in short-term interest rates, with all other variables held constant, would result in a decrease (increase) of approximately $0.3 million per annum to net financing charges.

***Additional Debt Financing and Credit Rating***

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 debentures issued under the Corporation's medium-term note program by credit rating agencies, the current timing to maturity of the Corporation's debentures and general economic conditions. See note 13 to the Consolidated Financial Statements.

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

***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. In addition, 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.

***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.

### *Accounting Policies*

Given that the decision granted by the Canadian securities regulatory authorities allows 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 IFRS, 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 references to "net revenues", which is a non-GAAP financial measure. The definition of net revenues is revenue minus the cost of purchased power. This measure does not have any standard meaning prescribed by US 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. Users of the MD&A utilize this measure to assess the Corporation's financial performance from ongoing operations.

## Critical Accounting Estimates

The preparation of the Corporation's Consolidated Financial Statements in accordance with US 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. 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:

***Revenue Recognition***

Revenue from the sale of electricity is recorded on the basis of cyclical billings and includes an estimated amount for electricity delivered and not yet billed, the amount of which is impacted by energy demand, customer class usage patterns and composition, and weather conditions. Other revenues, which include revenues from electricity distribution related services, revenues from the delivery of street lighting services and revenues from demand billable activities, are recognized as the services are rendered.

***Regulatory Assets and Liabilities***

As at December 31, 2012, regulatory assets amounted to $121.2 million and were primarily related to the accounting policy changes upon the adoption of US GAAP and the deferral of smart meter expenditures incurred in 2008, 2009 and 2010. As at December 31, 2012, regulatory liabilities amounted to $196.8 million and were primarily related to future income tax assets payable to customers. 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 be no longer probable, the balances would be recorded in the Corporation's consolidated statements of net income and comprehensive 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.

***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 obligation and net periodic benefit cost are calculated by independent actuaries using the projected unit credit method 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 future benefits cost will not differ significantly from the estimates calculated using management's assumptions.

***Asset Retirement Obligations***

The Corporation recognizes a liability for the future removal and handling costs for contamination in distribution equipment and for the future environmental remediation of certain properties. Asset retirement obligations amounted to $5.1 million as at December 31, 2012 compared to $4.9 million as at December 31, 2011. See notes 4 (p) and 15 to the Consolidated Financial Statements.

**Significant Accounting Policies**

The Consolidated Financial Statements of the Corporation have been prepared in accordance with US GAAP 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 of Ontario, or the Ministry of Finance. The significant accounting policies of the Corporation are summarized in note 4 to the Consolidated Financial Statements.

**Changes in Accounting Estimates**

***Intangible Assets***

Effective January 1, 2012, the Corporation revised its estimate of useful life of its Customer Care and Billing Customer Information System from five years to ten years as a result of an analysis completed related to the useful life assessment. This change has been accounted for on a prospective basis in the Consolidated Financial Statements effective January 1, 2012. The change in estimate reduced amortization expense by approximately $4.0 million for the year ended December 31, 2012 with an offsetting increase in the carrying value of intangible assets.

The change in estimate will decrease future amortization expense by $4.0 million per year over the term of the original useful life with no impact to the final year of the original useful life, and thereafter increase future amortization expense by $4.0 million per year. See note 4(h) to the Consolidated Financial Statements.

**Future Accounting Pronouncements**

A number of new standards and interpretations are not yet effective for the year ended December 31, 2012, and have not been applied in preparing these Consolidated Financial Statements. The Corporation continues to analyze these standards and had initially determined that the following could have a significant effect on the Consolidated Financial Statements.

In December 2011, the Financial Accounting Standards Board issued Accounting Standards Update ("ASU") No. 2011-11, "Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities" ("ASU 2011-11"). The amendments require an entity to disclose both gross and net information about financial instruments and transactions eligible for offset in the consolidated balance sheets. ASU 2011-11 is effective for fiscal years, and interim periods within those years, beginning on or after January 1, 2013. Retrospective application is required. The ASU No. 2013-01, "Balance Sheet (Topic 210): Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities", was issued in January 2013 to amend the scope of ASU 2011-11 to clarify that the disclosure requirements are limited to derivatives, repurchase and reverse repurchase agreements, and securities borrowing and lending transactions that are either offset in the consolidated balance sheets or subject to enforceable master netting arrangements or similar agreements. Based on the Corporation's analysis, the adoption of these amendments are not expected to have an impact on the Corporation's consolidated balance sheets or significantly impact disclosures.

**US GAAP Transition**

Publicly accountable enterprises in Canada were required to adopt IFRS 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. The Corporation elected to take the optional one-year deferral of its adoption of IFRS. In the absence of a definitive plan to consider the issuance of a rate-regulated accounting standard by the International Accounting Standards Board ("IASB"), the Corporation decided to evaluate the option of adopting US GAAP effective January 1, 2012 as an alternative to IFRS. On July 21, 2011, the Ontario Securities Commission granted the Corporation an exemption to allow the Corporation to file financial statements under US GAAP for the years commencing on or after January 1, 2012 but before January 1, 2015. 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.

The accompanying Consolidated Financial Statements are the Corporation's first annual financial statements prepared in accordance with US GAAP. The accounting policies set out in note 4 to the Consolidated Financial Statements have been applied consistently in preparing the Consolidated Financial Statements for the current and the comparative periods.

The quantification and reconciliation of the Corporation's consolidated balance sheet as at December 31, 2011, prepared in accordance with US GAAP as compared to Canadian GAAP is an increase to both total assets and total liabilities of approximately $71.7 million. The increase is primarily due to the recognition of unamortized actuarial losses and prior service costs and the reclassification of debt issuance costs in accordance with US GAAP. With respect to the consolidated statement of income and comprehensive income for the period ended December 31, 2011, net income was not impacted due to the Corporation's continued ability to apply rate-regulated accounting policies. Based on the detailed assessment of the key accounting areas for which significant Canadian GAAP and US GAAP differences were identified, there was no impact to equity and net earnings from those previously reported in the interim and annual consolidated financial statements.

The Corporation has adjusted amounts reported previously in its consolidated financial statements prepared in accordance with Part V of Canadian GAAP. For reporting purposes, the transition date to US GAAP is January 1, 2011, which is the commencement of the 2011 comparative period to the Corporation's 2012 Consolidated Financial Statements. A reconciliation of the transition from Part V of Canadian GAAP to US GAAP from January 1, 2011 and December 31, 2011 is provided in note 25 to the Consolidated Financial Statements. Due to the limited differences between Part V of Canadian GAAP and US GAAP, the Corporation's compliance with its debt covenants was not impacted by the conversion to US GAAP.

As a result of the transition to US GAAP, there was no significant impact on the Corporation's internal controls, information technology systems and financial reporting expertise requirements. The Corporation has completed topic-specific and relevant training to affected finance and operational teams on all key differences between Canadian GAAP and US GAAP, including management, the Board of Directors, and relevant committees thereof, including the audit committee. The Corporation will continue to focus on training for any key developments in US GAAP and the potential impacts to the Corporation's consolidated financial statements.

On February 28, 2012, LDC submitted a letter to the OEB requesting an accounting order establishing a deferral account to record the accounting differences between Canadian GAAP and US GAAP. On June 7, 2012, the OEB approved the establishment of the accounting policy changes account to record the expected electricity distribution charges to customers arising from timing differences in the recognition of actuarial gains and losses and prior service costs related to other post-retirement benefits. The OEB's approval of this account does not constitute a decision with respect to the Corporation's use of US GAAP for regulatory reporting purposes and LDC intends to seek this approval in its next electricity distribution rate rebasing application.

**IFRS**

As a result of the Corporation's 2011 decision to adopt US GAAP, the conversion of the Corporation's general purpose financial statements to IFRS was suspended. The Corporation's IFRS conversion project included separate awareness and assessment, design and implementation phases. As well, it involved among other initiatives, a detailed assessment of the effects of IFRS on its financial statements, an update of information systems to meet IFRS requirements, and assessment of internal controls over financial reporting and disclosure controls and processes, as well as training of key finance and operations staff.

*Rate-Regulated Accounting*

In accordance with US 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 US 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 sheet 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, 2012, the Corporation reported $121.2 million of regulatory assets and $196.8 million of regulatory liabilities.

On July 23, 2009, the IASB issued an Exposure Draft proposing accounting requirements for rate-regulated activities. The IASB received a significant number of comment letters with diverging opinions. After much deliberation into the various issues raised, the IASB members remained divided and determined that the matter could not be resolved quickly. The RRA project was suspended in 2010, awaiting the outcome of the Agenda consultation.

On May 21, 2012, the IASB expressed its support for a standards level project on RRA. On September 20, 2012, the IASB decided that the RRA project would be restarted with the development of a Discussion Paper ("DP"). In preparation for the December IASB meetings, the IASB staff issued Agenda Paper 6 outlining the staff's view of the issues to be addressed in the DP, a proposed project plan and timeline and issues to consider when deciding whether or not to publish an interim standard. On December 17, 2012, the IASB tentatively decided that the DP would be published in September 2013. The IASB also tentatively decided to develop an Exposure Draft for an interim standard that would permit grandfathering of existing recognition and measurement policies for those entities that currently recognize regulatory assets and liabilities in accordance with their local accounting requirements.

The Canadian Securities Administrators ("CSA") wrote a letter to the IASB on December 10, 2012 in response to the RRA project. The CSA fully supports the initiatives taken by the IASB to address the accounting for rate-regulated activities and strongly encourages the IASB to develop an interim standard which would allow Canadian issuers with rate-regulated activities to also adopt IFRS.

In the absence of an interim or final RRA standard by the IASB, the Corporation intends to continue to use the Ontario Securities Commission's exemption to report under US GAAP up to December 31, 2014. The Corporation is actively monitoring developments by the IASB on rate-regulated accounting should a future IFRS conversion be required. Although the conversion of the Corporation's general purpose financial statements to IFRS was suspended in 2011, the IFRS conversion work is being managed in such a way that if a future transition to IFRS is required, it can be effectively accomplished.

### Selected Annual Information

The following table sets forth selected annual financial information of the Corporation for the three years ended December 31, 2012, 2011 and 2010. This information has been derived from the Consolidated Financial Statements.

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

| Year Ended December 31, | 2012 $ | 2011[(1)] $ | 2010[(1)] $ |
|---|---|---|---|
| Net revenues[(2)] | 577,268 | 586,929 | 549,402 |
| Operating expenses[(2)] | 245,173 | 262,241 | 223,326 |
| Net income[(2)] | 85,990 | 95,932 | 66,125 |
| Capital expenditures[(3)] | 290,378 | 437,067 | 390,784 |
| **As at December 31,** | **2012 $** | **2011[(1)] $** | **2010[(1)] $** |
| Total assets[(4)] | 3,539,354 | 3,527,507 | 3,338,614 |
| Total debentures[(4) (5)] | 1,469,590 | 1,469,527 | 1,409,837 |
| Other non-current financial liabilities[(6)] | 16,175 | 27,101 | 45,831 |
| Shareholder's equity[(4)] | 1,140,272 | 1,102,248 | 1,039,379 |
| Dividends[(7)] | 47,966 | 33,063 | 25,000 |

Notes:

(1) The Corporation's consolidated financial statements were prepared in accordance with Part V of Canadian GAAP until December 31, 2011. Selected financial information from comparative consolidated financial statements for 2011 have been adjusted retroactively from the consolidated financial statements previously filed to conform to the presentation of the Corporation's 2012 consolidated financial statements prepared in accordance with US GAAP.
(2) See "Results of Operations" for further details on net revenues, operating expenses and net income.
(3) See "Liquidity and Capital Resources" for further details on capital expenditures.
(4) See "Financial Position" for further details of significant changes in assets, debentures and shareholder's equity.
(5) Total debentures include current and long-term debentures.
(6) Other non-current financial liabilities include non-current obligations under capital lease and non-current customers' advance deposits. Under US GAAP, deposits that are due or will be due on demand within one year from the end of the reporting period have been reclassified to other current financial liabilities.
(7) 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

February 28, 2013

TORONTO HYDRO Corporation

CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2012

TORONTO HYDRO Corporation

# Consolidated Financial Statements

DECEMBER 31, 2012

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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 United States 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 4 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 February 28, 2013.

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 and reports its findings to management and the Audit Committee of the Corporation, as required.

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.

The Consolidated Financial Statements were reviewed by the Audit Committee, and on their recommendation, were approved by the Board of Directors. 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 United States Generally Accepted Accounting Principles. The attached Independent Auditors' Report outlines the scope of their examination and their opinion.

On behalf of Toronto Hydro Corporation's management:

| | |
|---|---|
| Anthony Haines<br>President and Chief Executive Officer | Jean-Sebastien Couillard<br>Chief Financial Officer |

**KPMG LLP**
**Chartered Accountants**
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# 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 sheets as at December 31, 2012 and December 31, 2011, the consolidated statements of net income and comprehensive income, shareholder's equity and cash flows for the years ended December 31, 2012 and December 31, 2011, 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 United States 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 audits. We conducted our audits 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 in our audits 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, 2012 and December 31, 2011 and its consolidated statements of net income and comprehensive income, shareholder's equity and cash flows for the years ended December 31, 2012 and December 31, 2011 in accordance with United States Generally Accepted Accounting Principles**.**

KPMG LLP

Chartered Accountants, Licensed Public Accountants
Toronto, Canada
February 28, 2013

TORONTO HYDRO Corporation

## CONSOLIDATED BALANCE SHEETS

**[in thousands of Canadian dollars]**

| As at December 31 | 2012<br>$ | 2011<br>$ |
|---|---|---|
| | | *[note 25]* |
| **ASSETS** | | |
| **Current** | | |
| Cash and cash equivalents | **76,592** | 154,256 |
| Investments | **-** | 34,002 |
| Accounts receivable, net of allowance for doubtful accounts *[note 16[b]]* | **175,159** | 183,272 |
| Unbilled revenue *[note 16[b]]* | **278,086** | 262,058 |
| Income tax receivable | **7,879** | 11,312 |
| Inventories *[note 5]* | **7,555** | 6,891 |
| Regulatory assets *[note 9]* | **1,658** | - |
| Other assets *[note 6]* | **5,363** | 5,409 |
| **Total current assets** | **552,292** | 657,200 |
| Property, plant and equipment, net *[note 7]* | **2,526,666** | 2,399,497 |
| Intangible assets, net *[note 8]* | **134,080** | 112,982 |
| Regulatory assets *[note 9]* | **119,556** | 143,038 |
| Other assets *[note 10]* | **12,442** | 12,423 |
| Deferred income tax assets *[note 18]* | **194,318** | 202,367 |
| **Total assets** | **3,539,354** | 3,527,507 |
| | | |
| **LIABILITIES AND SHAREHOLDER'S EQUITY** | | |
| **Current** | | |
| Accounts payable and accrued liabilities *[note 16[b]]* | **383,371** | 412,412 |
| Restructuring accrual *[note 12]* | **11,954** | - |
| Customers' advance deposits | **40,048** | 40,238 |
| Deferred conservation credit | **20,316** | 13,359 |
| Debentures *[note 13]* | **470,050** | - |
| Post-retirement benefits *[note 14]* | **9,925** | 7,915 |
| Other liabilities *[note 21]* | **1,850** | 2,182 |
| Regulatory liabilities *[note 9]* | **-** | 7,293 |
| **Total current liabilities** | **937,514** | 483,399 |
| Customers' advance deposits | **6,790** | 15,800 |
| Debentures *[note 13]* | **999,540** | 1,469,527 |
| Post-retirement benefits *[note 14]* | **243,965** | 236,411 |
| Other liabilities *[note 21]* | **9,385** | 11,301 |
| Regulatory liabilities *[note 9]* | **196,809** | 203,919 |
| Asset retirement obligations *[note 15]* | **5,079** | 4,902 |
| **Total liabilities** | **2,399,082** | 2,425,259 |
| | | |
| Commitments, contingencies and subsequent events *[notes 2, 21 and 22]* | | |
| | | |
| **Shareholder's equity** | | |
| Share capital *[note 19]* | **567,817** | 567,817 |
| Retained earnings | **572,455** | 534,431 |
| **Total shareholder's equity** | **1,140,272** | 1,102,248 |
| **Total liabilities and shareholder's equity** | **3,539,354** | 3,527,507 |

**ON BEHALF OF THE BOARD:**

CR Copeland

Clare R. Copeland, Director

Brian Chu

Brian Chu, Director

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

## CONSOLIDATED STATEMENTS OF NET INCOME AND COMPREHENSIVE INCOME

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

| **Year ended December 31** | **2012** **$** | **2011** **$** |
|---|---|---|
| | | *[note 25]* |
| **Revenues** | **2,852,477** | 2,823,470 |
| **Costs** | | |
| Purchased power | **2,275,209** | 2,236,541 |
| Operating expenses | **245,173** | 262,241 |
| Depreciation and amortization | **141,572** | 151,022 |
| | **2,661,954** | 2,649,804 |
| **Income before the following:** | **190,523** | 173,666 |
| Net financing charges | **(73,977)** | (75,324) |
| Gain on disposals of property, plant and equipment | **1,805** | 3,885 |
| Restructuring costs *[note 12]* | **(27,796)** | - |
| **Income before income taxes** | **90,555** | 102,227 |
| Income tax expense *[note 18]* | **4,565** | 6,295 |
| **Net income and comprehensive income** | **85,990** | 95,932 |
| **Basic and fully diluted net income per share** *[note 23]* | **85,990** | 95,932 |

## CONSOLIDATED STATEMENTS OF SHAREHOLDER'S EQUITY

**[in thousands of Canadian dollars]**

| **Year ended December 31** | **2012** **$** | **2011** **$** |
|---|---|---|
| **Share capital** ***[note 19]*** | **567,817** | 567,817 |
| **Retained earnings, beginning of year** | **534,431** | 471,562 |
| Net income | **85,990** | 95,932 |
| Dividends *[notes 19 and 20]* | **(47,966)** | (33,063) |
| **Retained earnings, end of year** | **572,455** | 534,431 |
| **Total shareholder's equity** | **1,140,272** | 1,102,248 |

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

## CONSOLIDATED STATEMENTS OF CASH FLOWS

**[in thousands of Canadian dollars]**

| **Year ended December 31** | **2012**<br>**$** | **2011**<br>**$**<br>*[note 25]* |
|---|---|---|
| **OPERATING ACTIVITIES** | | |
| Net income | **85,990** | 95,932 |
| Adjustments for non-cash items | | |
| Depreciation and amortization | **141,572** | 151,022 |
| Change in other non-current assets | **(17)** | 1,166 |
| Change in other non-current liabilities | **(202)** | (792) |
| Post-retirement benefits | **9,564** | 44,299 |
| Deferred income taxes *[note 18]* | **889** | (601) |
| Gain on disposals of property, plant and equipment | **(1,805)** | (3,885) |
| Changes in non-cash working capital balances *[note 24]* | **(15,562)** | 58,855 |
| **Net cash provided by operating activities** | **220,429** | 345,996 |
| **INVESTING ACTIVITIES** | | |
| Purchase of property, plant and equipment *[note 7]* | **(248,321)** | (384,262) |
| Purchase of intangible assets *[note 8]* | **(42,057)** | (52,805) |
| Purchase of investments | **-** | (84,041) |
| Proceeds from investments | **34,000** | 50,000 |
| Net change in regulatory assets and liabilities | **14,581** | (66,379) |
| Proceeds on disposals of property, plant and equipment | **2,665** | 4,974 |
| **Net cash used in investing activities** | **(239,132)** | (532,513) |
| **FINANCING ACTIVITIES** | | |
| Dividends paid *[notes 19 and 20]* | **(47,966)** | (33,063) |
| Decrease in customers' advance deposits | **(9,200)** | (8,214) |
| Proceeds from debentures | **-** | 299,850 |
| Increase in debt issuance costs | **-** | (1,900) |
| Repayment of debentures | **-** | (245,057) |
| Repayment of capital lease liability | **(1,795)** | (994) |
| **Net cash provided by (used in) financing activities** | **(58,961)** | 10,622 |
| **Net decrease in cash and cash equivalents during the year** | **(77,664)** | (175,895) |
| Cash and cash equivalents, beginning of year | **154,256** | 330,151 |
| **Cash and cash equivalents, end of year** | **76,592** | 154,256 |
| **Supplementary cash flow information** | | |
| Total interest paid | **75,520** | 79,552 |
| Total income taxes paid (recovered) | **(598)** | 10,299 |

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

## 1. INCORPORATION

On June 23, 1999, Toronto Hydro Corporation [the "Corporation"] was incorporated under the *Business Corporations Act* (Ontario), 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 and provides corporate, management services and strategic direction to two subsidiaries incorporated under the *Business Corporations Act* (Ontario) 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 subject 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. BASIS OF PRESENTATION

These audited consolidated financial statements of the Corporation have been prepared in accordance with United States ["US"] Generally Accepted Accounting Principles ["GAAP"] with respect to the preparation of annual financial information, and are presented in Canadian dollars. These are the Corporation's first US GAAP annual consolidated financial statements. The Corporation's consolidated financial statements were prepared in accordance with Part V of Canadian GAAP until December 31, 2011. The comparative consolidated financial statements have been adjusted retroactively from the consolidated financial statements previously presented to conform to the presentation of the Corporation's 2012 consolidated financial statements prepared in accordance with US GAAP.

A reconciliation of the consolidated balance sheets between Canadian GAAP and US GAAP as at January 1, 2011 and December 31, 2011 and a reconciliation of net income for the year ended December 31, 2011 accompany the consolidated financial statements *[note 25]*.

The Corporation has evaluated the events and transactions occurring after the consolidated balance sheet date through February 28, 2013 when the Corporation's consolidated financial statements were available to be issued after the approval by the Corporation's Board of Directors, and identified the events and transactions which required recognition in the consolidated financial statements and/or disclosure in the notes to the consolidated financial statements *[note 19]*.

## 3. REGULATION

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 Ontario Energy Board [the "OEB"].

The OEB has regulatory oversight of electricity matters in Ontario. The *Ontario Energy Board Act, 1998* (Ontario) sets out the OEB's authority to issue a distribution licence that 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):

[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 Regulated Adjustments*. The electricity price and regulated adjustments represent the pass through of the commodity and other costs 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*

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 for 2011 were determined through an application under the Cost of Service ["COS"] framework. The COS framework sets electricity distribution rates using a detailed examination of evidence and an assessment of the costs incurred by an electricity distributor to provide services to its customers.

On July 7, 2011, the OEB issued its decision regarding LDC's electricity distribution rates for 2011. 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 COS framework, with the OEB seeking approval of separate and successive revenue requirements and corresponding electricity distribution rates for 2012, 2013 and

2014. Pursuant to the Incentive Regulation Mechanism ["IRM"] framework, the OEB established, as a preliminary issue in this application, that it would consider the question of whether the application filed by LDC under the COS framework was acceptable or whether it should be dismissed. The IRM framework provides for a standard adjustment to an electricity distributor's rates based on a formulaic calculation with the possibility to request an Incremental Capital Module ["ICM"] to address specific capital expenditure needs that occur during the IRM term, and are not otherwise funded by the formulaic calculation. In order to determine whether a distributor is eligible for the ICM, the OEB conducts a review of the application by way of a detailed examination of a distributor's evidence and consideration of a number of criteria, such as materiality, need and prudence.

LDC filed evidence supporting its position for electricity distribution rates to be set under the COS framework for 2012, 2013 and 2014. 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 COS framework application for 2012, 2013 and 2014. In its decision, the OEB found that LDC was not permitted to deviate from the standard IRM framework cycle. Accordingly, LDC was required to file its request for electricity distribution rates for 2012, 2013, and 2014 pursuant to the IRM framework and to use the ICM to request the capital needed for infrastructure renewal.

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

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

On May 10, 2012, LDC filed an application for electricity distribution rates for 2012, 2013, and 2014 using the IRM framework, including the filing of an ICM application [the "IRM/ICM Application"]. The formulaic adjustment, requested by LDC, follows the guidelines provided by the OEB and seeks to increase the current revenue requirement by 0.68% to $525,500,000 for 2012, $529,100,000 for 2013 and $532,700,000 for 2014. The 2013 and 2014 formulaic adjustment may be subject to change depending on future inflation and market data.

The IRM/ICM Application proposed by LDC requests rate riders to enable the recovery of capital expenditures. Accordingly, the amount of capital expenditures included in LDC's proposed IRM/ICM Application amounts to $448,700,000 for 2012, $534,500,000 for 2013 and $439,500,000 for 2014.

On August 16, 2012, the OEB issued its decision on the issues list for the application filed May 10, 2012. In that decision, the OEB stated that further procedural steps would be determined pending LDC's response to the OEB as to whether LDC would continue to pursue the Motion and the Appeal. On August 20, 2012, LDC filed a notice of abandonment with the Ontario Divisional Court thereby terminating the Appeal. On the same date, LDC advised the OEB that it would withdraw its Motion for review.

While the IRM/ICM Application proposed by LDC has been under consideration by the OEB, capital spending in 2012 has been maintained at a reduced amount. As it was no longer practical to achieve the previously requested capital spending of $448,700,000 in 2012, an update to the IRM/ICM Application was submitted by LDC on October 31, 2012 modifying the requested capital expenditures for 2012 and 2013 to $283,000,000 and $579,100,000, respectively, and requesting that consideration for 2014 be deferred to a second phase of the proceeding, once LDC has received a decision from the OEB in respect of phase one. On November 3, 2012, the OEB accepted LDC's request for a two-phase proceeding: phase one comprising LDC's 2012 and 2013 work program proposals and phase two comprising LDC's 2014 work program proposal.

The current application is expected to be subject to an in-depth review by the OEB. There can be no assurance that the OEB will allow for the total or partial recovery of the capital expenditure balances requested in the current application. The financial effect of the OEB decision will be recorded in the period it becomes known and could be material to the Corporation's financial performance.

### *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 (1798594 Ontario Inc.), and for LDC to amalgamate with the new legal entity. On January 1, 2012, the Corporation completed the asset transfer and amalgamation.

### *c) 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 *Ontario Energy Board Act, 1998* (Ontario), 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"] in the amount of approximately $50,000,000 to deliver CDM programs extending from January 1, 2011 to December 31, 2014. As at December 31, 2012, LDC received approximately $35,366,000 [December 31, 2011 - $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. Amounts received but not yet spent are presented under current liabilities as deferred conservation credit. Upon the expiration of the agreement, LDC is required to repay to the OPA any excess funding received for program administration less any cost efficiency incentives. These programs are expected to support the achievement of the mandatory CDM targets described above.

On December 21, 2012, the Minister of Energy of Ontario issued a direction to the OPA under subsection 25.32(4.1) of the Electricity Act to extend the funding time period for OPA-contracted province-wide CDM initiatives under the *Green Energy Act, 2009* (Ontario) framework to December 31, 2015.

# 4. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

## *a) Basis of consolidation*

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

## *b) Regulation*

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

***Regulatory Assets and Liabilities***

The Corporation has determined that its assets and liabilities arising from rate-regulated activities qualify for the application of regulatory accounting treatment in accordance with Financial Accounting Standards Board Accounting Standards Codification 980 – "Regulated Operations" ["ASC 980"], which includes accounting principles prescribed by the OEB in the "Accounting Procedures Handbook for Electricity Distributors". Under rate-regulated accounting, the timing and recognition of certain expenses and revenues may differ from those otherwise expected under US 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 existing rights and obligations regarding cash flows expected to be recovered from or refunded to customers, based on decisions and approvals by the OEB. Regulatory 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 net income and comprehensive 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.

Regulatory assets and liabilities are classified as current if they are expected to be recovered from, or refunded to, customers within 12 months after each reporting period. All other regulatory asset and liability balances are classified as long-term on the consolidated balance sheets.

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

The OEB 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, 2012 to March 31, 2012 was 3.92%, from April 1, 2012 to September 30, 2012 was 3.51%, and from October 1, 2012 to December 31, 2012 was 3.23% [January 1, 2011 to September 30, 2011 - 4.29%; October 1, 2011 to December 31, 2011 - 3.92%]. AFUDC is included in property, plant and equipment and intangible assets for financial reporting purposes, charged to operations through depreciation and amortization expense over the useful lives 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, included in current assets and carried at cost.

## *e) Accounts receivable*

Accounts receivable are recorded at the invoiced amount and overdue amounts bear interest at OEB-approved rates. 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 net income and comprehensive income. Subsequent recoveries of receivables previously provisioned and written off are credited to the consolidated statements of net income and comprehensive income. Management estimates uncollectible accounts receivable after considering historical loss experience and the characteristics of existing accounts.

## *f) 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 market, with cost determined on an average cost basis net of a provision for obsolescence.

## *g) 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 useful lives, except in those instances where specific identification allows their removal at retirement or disposition. The cost of property, plant and equipment represents the original cost, consisting of direct materials and labour, contracted services, AFUDC, and overhead directly attributable to the capital project.

Capital contributions received are used to finance additions to property, plant and equipment of LDC. According to the accounting principles prescribed by the OEB, 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.

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.

[all tabular amounts in thousands of Canadian dollars]

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

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

Construction in progress relates to assets not currently in use and therefore is not depreciated.

## h) Intangible assets

Effective January 1, 2012, the Corporation revised its estimate of useful life of its Customer Care and Billing Customer Information System from five years to ten years as a result of an analysis completed related to the useful life assessment. This change has been accounted for on a prospective basis in the consolidated financial statements effective January 1, 2012. The change in estimate reduced amortization expense by approximately $4,000,000 for the year ended December 31, 2012 with an offsetting increase in the carrying value of intangible assets. The change in estimate will decrease future amortization expense by $4,000,000 per year over the term of the original useful life with no impact to the final year of the original useful life, and thereafter increase future amortization expense by $4,000,000 per year.

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

| | |
|---|---|
| Computer software | 10.0% to 25.0% |
| Contributions | 4.0% |

Software in development and contributions for work in progress relate to assets not currently available for use and therefore are not amortized. Contributions represent payments made to Hydro One Networks Inc. for dedicated infrastructure pursuant to an agreement in order to receive connections to transmission facilities.

## i) Deferred financing costs

One-time costs incurred in relation to the Corporation's debenture offerings and costs of arranging the Corporation's revolving credit facilities are capitalized within other assets on the consolidated balance sheets. Debt issuance costs are amortized over the term of the related debentures, using the effective interest method of amortization, and are included in net financing charges. Financing costs relating to revolving credit facilities are amortized on a straight-line basis over the term of the facility, and are included in net financing charges. Transaction costs are expensed as incurred for financial instruments classified as held for trading.

## j) Restructuring

Restructuring charges are recorded based upon planned employee termination dates, site closure and consolidation plans, and contract terminations. Restructuring charges can include severance costs to eliminate a specified number of employee positions, infrastructure charges to vacate facilities and consolidate operations, and contract cancellation costs. The timing of associated cash payments is dependent upon the type of restructuring charge and can extend over a multi-year period.

## k) 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.

## l) Revenue recognition

Revenue from the sale of electricity is recorded on the basis of cyclical billings and includes an estimated amount for electricity delivered and not yet billed, the amount of which is impacted by energy demand, customer class usage patterns and composition, and weather conditions.

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

In the course of its operations, the Corporation collects Harmonized Sales Tax ["HST"] from its customers. When customers are billed, a current liability for HST is recognized which corresponds to the revenue derived from the services provided by the Corporation. When expenses are incurred by the Corporation, a current asset for HST is recorded which corresponds to the expenditures derived from the goods or services received by the Corporation. The Corporation's revenues and expenses exclude HST. This net asset or liability is settled with the appropriate government authority.

## m) Financial instruments

At inception, all financial instruments which meet the definition of a financial asset or financial liability are 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 net income and comprehensive income. Subsequent measurement of each financial instrument will depend on the consolidated 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 | Held for Trading |
| 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 sheets:

- Cash equivalents, comprising short-term investments, are classified as “Held for Trading” and are measured at fair value. The carrying amounts approximate fair value because of the short maturity of these instruments.

- Investments are classified as “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 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 fair value. Subsequent measurements are based on a discounted cash flow analysis and approximate the carrying value 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 fair value. Subsequent measurements are recorded at cost plus accrued interest. The carrying amounts approximate fair value because of the short maturity of the current portion, and the 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 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 a 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[a]]*. 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.

## *n) 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: Other than quoted prices included within Level 1 that are observable for the assets or liabilities, either directly or indirectly; and

- Level 3: Unobservable inputs, supported by little or no market activity, used to measure the fair value of the assets or liabilities to the extent that observable inputs are not available.

## *o) Employee future benefits*

***Multi-employer 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 OMERS plan is accounted for as a defined contribution plan where the Corporation recognizes the expense related to this plan as contributions are made, since it is not practicable to determine the Corporation’s portion of pension obligations or the fair value of plan assets. The Corporation is not responsible for any other contractual obligations other than the contributions.

***Post-retirement benefits other than pension***

The Corporation has a number of unfunded benefit plans providing post-retirement benefits (other than pension) to 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 periodically measures its accumulated benefit obligation for accounting purposes as at December 31 of the applicable year. The latest actuarial valuation was performed as at January 1, 2012.

The cost of providing benefits under the defined benefit plans is determined using the projected unit credit method and based on assumptions that reflect management’s best estimate. All actuarial gains and losses and prior service costs are recognized in other comprehensive income [“OCI”] as they arise and subsequently reclassified to a regulatory asset on the consolidated balance sheets. This results in the full recognition of the benefit obligation as a liability on the consolidated balance sheets.

Actuarial gains or losses are amortized into net periodic benefit cost for the current period when the net cumulative unrecognized actuarial gains or losses in the regulatory asset at the end of the previous reporting period exceed 10% of the accumulated benefit obligation at that date. These gains or losses are recognized over the expected average remaining service period of active employees participating in the plans.

The prior service costs in the regulatory asset are recognized as an expense on a straight-line basis over the average remaining service period of employees active at the date of amendment.

The effects of a curtailment loss are recognized in the consolidated statements of net income and comprehensive income when its occurrence is probable and reasonably estimable. The effects of a curtailment gain are recognized in the consolidated statements of net income and comprehensive income when the related employees terminate or the plan suspension or amendment is adopted. The effects of a settlement gain or loss are recognized in the consolidated statements of net income and comprehensive income in the period in which a settlement occurs.

## *p) Asset retirement obligations*

The Corporation recognizes a liability for the future removal and handling costs for contamination in distribution equipment 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 capitalized amount is depreciated over the useful life of the related asset 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 can be reasonably estimated.

The Corporation has not recorded a liability related to certain AROs as a reasonable estimate of fair value could not be made. The Corporation does not recognize an ARO for active properties which support LDC's distribution operations since it cannot reasonably determine the amount of any remediation costs related to possible contamination, and a reliable estimate cannot be made until environmental site assessments have been completed. The Corporation expects to use the majority of its installed assets in perpetuity. If, at some future date, a particular asset is shown not to meet the perpetuity assumption, it will be reviewed to determine if an ARO exists.

## *q) Customers' advance deposits*

Security deposits from electricity customers are cash collections to guarantee the payment of electricity bills. The electricity customer security deposits liability includes related interest amounts owed to the customers with the debit charged to net financing charges. Deposits that are refundable upon demand are classified as a current liability.

Security deposits on Offers to Connect are cash collections from specific customers to guarantee the payment of additional costs relating to expansion projects. This liability includes related interest amounts owed to the customers with the debit charged to net financing charges. Deposits are classified as a current liability when the Corporation no longer has an unconditional right to defer payment of the liability for at least 12 months after the reporting period.

## *r) Income Taxes*

Under the Electricity Act, the Corporation is required to make Payments In Lieu of Corporate Taxes ["PILs"] to the Ontario Electricity Financial Corporation. These payments are calculated in accordance with the *Income Tax Act* (Canada) and the *Taxation Act, 2007* (Ontario) as modified by regulations made under the Electricity Act and related regulations. This effectively results in the Corporation paying taxes similar to what would be imposed under the Federal and Ontario Tax Acts.

The Corporation uses the liability method of accounting for income taxes. Under the liability method, current income taxes payable are recorded based on taxable income. The Corporation recognizes deferred income tax assets and liabilities for the future tax consequences of events that have been included in the consolidated financial statements or income tax returns. Deferred income tax assets and liabilities are determined based on the difference between the carrying value of assets and liabilities on the consolidated balance sheets and their respective tax basis using the enacted tax rates by the consolidated balance sheet date in effect for the year in which the differences are expected to reverse. Tax benefits associated with income tax positions taken, or expected to be taken, in a tax return are recorded only when it is more likely than not that they will be realized, and are measured at the largest amount of the benefit that has a likelihood greater than 50 percent of being realized upon settlement. Deferred income tax assets are evaluated and unless realization is considered more likely than not, a valuation allowance is established.

ASC 980 requires the recognition of deferred income tax assets and liabilities and related regulatory liabilities and assets for the amount of deferred income taxes expected to be refunded to, or recovered from, customers in future electricity distribution rates. As at December 31, 2012, LDC recorded a deferred income tax asset and a corresponding regulatory liability of $193,276,000 with respect to its rate-regulated activities that will be included in the rate-setting process *[note 9]*. These amounts include a gross up to reflect the income tax benefits associated with reduced revenues resulting from the realization of deferred tax assets. Deferred income taxes that are not included in the rate-setting process are charged or credited to the consolidated statements of net income and comprehensive income.

The benefits of the refundable apprenticeship and co-operative investment tax credits [“ITCs”] are credited against the related expense in the consolidated statements of net income and comprehensive income. All other types of ITCs are recorded as a reduction to income tax expense in the current period to the extent that realization of such benefit is more likely than not.

## *s) Use of estimates*

The preparation of the Corporation’s consolidated financial statements in accordance with US 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, income taxes (including deferred income taxes), 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 of Ontario, or the Ministry of Finance of Ontario [“Ministry of Finance”].

## *t) Future Accounting Pronouncements*

A number of new standards and interpretations are not yet effective for the year ended December 31, 2012, and have not been applied in preparing these consolidated financial statements. The Corporation continues to analyze these standards and had initially determined that the following could have a significant effect on the consolidated financial statements.

In December 2011, the Financial Accounting Standards Board issued Accounting Standards Update [“ASU”] No. 2011-11, “Balance Sheet (Topic 210): *Disclosures about Offsetting Assets and Liabilities*” [“ASU 2011-11”]. The amendments require an entity to disclose both gross and net information about financial instruments and transactions eligible for offset in the consolidated balance sheets. ASU 2011-11 is effective for fiscal years, and interim periods within those years, beginning on or after January 1, 2013. Retrospective application is required. The ASU No. 2013-01, “Balance Sheet (Topic 210): *Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities*”, was issued in January 2013 to amend the scope of ASU 2011-11 to clarify that the disclosure requirements are limited to derivatives, repurchase and reverse repurchase agreements, and securities borrowing and lending transactions that are either offset in the consolidated balance sheets or subject to enforceable master netting arrangements or similar agreements. Based on the Corporation’s analysis, the adoption of these amendments are not expected to have an impact on the Corporation’s consolidated balance sheets or significantly impact disclosures.

[all tabular amounts in thousands of Canadian dollars]

## 5. INVENTORIES

Inventories consist of the following:

| | 2012<br>$ | 2011<br>$ |
|---|---|---|
| Fuses | **2,137** | 1,625 |
| Consumables, tools and other maintenance items | **1,968** | 1,745 |
| Drums and reels | **1,115** | 938 |
| Other | **2,335** | 2,583 |
| | **7,555** | 6,891 |

For the year ended December 31, 2012, the Corporation recognized operating expenses of $6,934,000 related to inventory used to service electrical distribution assets [2011 - $9,196,000].

## 6. CURRENT PORTION OF OTHER ASSETS

Current portion of other assets consists of the following:

| | 2012<br>$ | 2011<br>$ |
|---|---|---|
| Prepaid expenses | **4,382** | 4,089 |
| Deferred financing costs | **981** | 1,320 |
| | **5,363** | 5,409 |

[all tabular amounts in thousands of Canadian dollars]

## 7. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consist of the following:

| | 2012 | | | 2011 | | |
|---|---|---|---|---|---|---|
| | Cost $ | Accumulated depreciation $ | Net book value $ | Cost $ | Accumulated depreciation $ | Net book value $ |
| Land | **16,747** | **—** | **16,747** | 16,761 | — | 16,761 |
| Distribution lines | **2,978,511** | **1,488,060** | **1,490,451** | 2,850,401 | 1,441,333 | 1,409,068 |
| Transformers | **672,981** | **377,900** | **295,081** | 652,102 | 360,398 | 291,704 |
| Stations | **286,229** | **145,601** | **140,628** | 277,905 | 137,246 | 140,659 |
| Meters | **243,152** | **133,789** | **109,363** | 238,459 | 124,117 | 114,342 |
| Buildings | **160,368** | **69,248** | **91,120** | 154,932 | 62,403 | 92,529 |
| Rolling stock | **73,239** | **43,834** | **29,405** | 78,016 | 43,154 | 34,862 |
| Other capital assets | **70,850** | **47,889** | **22,961** | 68,802 | 44,108 | 24,694 |
| Equipment and tools | **45,613** | **33,936** | **11,677** | 44,208 | 31,785 | 12,423 |
| Assets under capital lease | **13,538** | **2,948** | **10,590** | 14,269 | 1,251 | 13,018 |
| Computer hardware | **50,511** | **40,003** | **10,508** | 44,625 | 35,602 | 9,023 |
| Communications | **32,082** | **26,597** | **5,485** | 31,537 | 23,912 | 7,625 |
| Construction in progress | **292,650** | **—** | **292,650** | 232,789 | — | 232,789 |
| | **4,936,471** | **2,409,805** | **2,526,666** | 4,704,806 | 2,305,309 | 2,399,497 |

For the year ended December 31, 2012, AFUDC in the amount of $994,000 [2011 - $3,786,000] was capitalized to property, plant and equipment and credited to net financing charges.

As at December 31, 2012, the net book value of stranded meters related to the deployment of smart meters amounting to $17,647,000 [December 31, 2011 - $20,366,000] was included in property, plant and equipment. In the absence of rate regulation, property, plant and equipment would have been $17,647,000 lower as at December 31, 2012 [December 31, 2011 - $20,366,000 lower].

For the year ended December 31, 2012, capital contributions in the amount of $22,061,000 [2011 - $36,381,000] were credited to property, plant and equipment.

For the year ended December 31, 2012, the Corporation recorded depreciation expense of $120,613,000 [2011 - $125,210,000] of which $1,985,000 [2011 - $1,177,000] related to assets under capital lease.

[all tabular amounts in thousands of Canadian dollars]

## 8. INTANGIBLE ASSETS

Intangible assets consist of the following:

| | 2012 | | | 2011 | | |
|---|---|---|---|---|---|---|
| | Cost $ | Accumulated amortization $ | Net book value $ | Cost $ | Accumulated amortization $ | Net book value $ |
| Computer software | **242,254** | **174,410** | **67,844** | 222,598 | 154,186 | 68,412 |
| Contributions | **19,649** | **2,175** | **17,474** | 14,059 | 1,440 | 12,619 |
| Software in development | **14,210** | — | **14,210** | 15,598 | — | 15,598 |
| Contributions for work in progress | **34,552** | — | **34,552** | 16,353 | — | 16,353 |
| | **310,665** | **176,585** | **134,080** | 268,608 | 155,626 | 112,982 |

For the year ended December 31, 2012, the Corporation acquired $42,057,000 of intangible assets [2011 - $52,805,000]. Contributions for work in progress relate to payments for connection projects to increase electricity distribution system capacity. 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, 2012, $19,656,000 of software in development was transferred to computer software [2011 - $49,907,000].

For the year ended December 31, 2012, AFUDC in the amount of $1,331,000 [2011 - $1,419,000] was capitalized to intangible assets and credited to net financing charges.

For the year ended December 31, 2012, the Corporation recorded amortization expense on intangible assets of $20,959,000 [2011 - $25,812,000].

As at December 31, 2012, estimated future amortization expense related to intangible assets is as follows:

| | $ |
|---|---|
| 2013 | 17,940 |
| 2014 | 17,741 |
| 2015 | 16,815 |
| 2016 | 13,850 |
| 2017 | 11,481 |

[all tabular amounts in thousands of Canadian dollars]

## 9. REGULATORY ASSETS AND LIABILITIES

Regulatory assets consist of the following:

| | 2012<br>$ | 2011<br>$<br>*[note 25]* |
|---|---|---|
| Accounting policy changes | **61,499** | 64,785 |
| Smart meters | **55,599** | 61,422 |
| Regulatory assets recovery account | **2,466** | 931 |
| Settlement variances | **1,071** | 14,119 |
| Other | **579** | 1,781 |
| Total regulatory assets | **121,214** | 143,038 |
| Less: Current portion of regulatory assets | **1,658** | — |
| Long-term portion of regulatory assets | **119,556** | 143,038 |

Regulatory liabilities consist of the following:

| | 2012<br>$ | 2011<br>$<br>*[note 25]* |
|---|---|---|
| Deferred income taxes | **193,276** | 200,436 |
| Income and other taxes variance account | **2,398** | 2,365 |
| Regulatory assets recovery account | **—** | 7,293 |
| Other | **1,135** | 1,118 |
| Total regulatory liabilities | **196,809** | 211,212 |
| Less: Current portion of regulatory liabilities | **—** | 7,293 |
| Long-term portion of regulatory liabilities | **196,809** | 203,919 |

For the year ended December 31, 2012, LDC disposed of approved net regulatory liabilities amounting to $8,838,000 through permitted distribution rate adjustments [2011 - $34,528,000].

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

### *a) Accounting Policy Changes*

This regulatory asset account relates to the accounting policy changes upon adoption of US GAAP, primarily related to the expected future electricity distribution charges to customers arising from timing differences in the recognition of actuarial losses and prior service costs of other post-retirement benefits *[note 25]*. The amount is amortized over the same period as the corresponding actuarial losses and prior service costs. The period in which recovery is expected cannot be determined at this time.

### *b) 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. Effective January 1, 2011, LDC has recorded 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 in the future for both the transfer of the 2008 to 2010 smart meter costs from regulatory assets to property, plant and equipment and intangible assets, and the transfer of the net book value of the stranded meters from property, plant and equipment to regulatory assets.

As at December 31, 2012, smart meter capital expenditures, net of accumulated depreciation, totalling $52,865,000 were recorded to regulatory assets [December 31, 2011 - $59,227,000]. These expenditures would otherwise have been recorded as property, plant and equipment and intangible assets under US GAAP for unregulated businesses. In the absence of rate regulation, property, plant and equipment and intangible assets would have been $50,234,000 and $2,631,000 higher, respectively, as at December 31, 2012 [December 31, 2011 - $54,825,000 and $4,402,000 higher, respectively].

For the year ended December 31, 2012, smart meter depreciation expense of $6,361,000 [2011 - $6,361,000] were deferred which would have been expensed under US GAAP for unregulated businesses. In the absence of rate regulation, for the year ended December 31, 2012, depreciation expense would have been $6,361,000 higher [2011 - $6,361,000 higher].

For the year ended December 31, 2012, smart meter customer revenues of $5,889,000 were deferred [2011 - $5,866,000]. In the absence of rate regulation, for the year ended December 31, 2012, revenue would have been $5,889,000 higher [2011 - $5,866,000 higher].

### *c) Regulatory Assets Recovery Account*

The Regulatory Assets Recovery Account [“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 9, 2010, the OEB approved the disposition of net regulatory liabilities of $68,140,000, consisting of credit balances for settlement variances and income and other taxes 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.

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, income and other taxes variances and 2008 RARA residual of $7,460,000, $3,373,000, and $789,000, respectively, and an International Financial Reporting Standards [“IFRS”] cost debit balance of $3,050,000, over a nine-month period commencing on August 1, 2011 and ending on April 30, 2012.

### *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 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.

[all tabular amounts in thousands of Canadian dollars]

The balance for settlement variances continues to be calculated and attracts carrying charges in accordance with the OEB's direction. For the year ended December 31, 2012, settlement variances of $12,249,000 were disposed through rate adjustments [2011 - $34,938,000].

### *e) Deferred 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 deferred income tax assets *[note 4[r]]*.

As at December 31, 2012, LDC recorded a deferred income tax asset and a corresponding regulatory liability of $193,276,000 [December 31, 2011 - $200,436,000] with respect to its rate-regulated activities that will be included in the rate-setting process.

### *f) Income and Other Taxes Variance Account*

The income and other taxes variance 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, 2012, the balance in this account consisted of an over-recovery from customers of $2,398,000 [December 31, 2011 - $2,365,000].

## 10. OTHER ASSETS

Other long-term assets consist of the following:

| | 2012<br>$ | 2011<br>$ |
|---|---|---|
| Prepaid expenses | **7,191** | 7,279 |
| Deferred financing costs | **5,251** | 5,144 |
| | **12,442** | 12,423 |

## 11. CREDIT FACILITIES AND SHELF PROSPECTUS

The Corporation is a party to a credit agreement with a syndicate of Canadian chartered banks which establishes a revolving credit facility ["Revolving Credit Facility"]. On October 10, 2012, the credit agreement was amended and restated to increase the amount the Corporation may borrow under the Revolving Credit Facility from $400,000,000 to $600,000,000 and to extend the Revolving Credit Facility's maturity date from May 3, 2013 to October 10, 2017. An amount up to $210,000,000 (formerly $140,000,000) is available in the form of letters of credit. The Revolving Credit Facility may be used for general corporate purposes, letter of credit requirements and financing capital expenditures of LDC. As at December 31, 2012, refinancing costs of $1,148,000 related to the renewal have been recorded as deferred financing cost. Borrowings under the credit agreement bear interest at short-term floating rates with reference to the Corporation's credit rating.

The Revolving Credit Facility contains a negative pledge, customary covenants and events of default. The Corporation's Revolving Credit Facility also limits the debt to capitalization ratio to a maximum of 75%. As at December 31, 2012, the Corporation was in compliance with all covenants included in its Revolving Credit Facility.

Additionally, the Corporation is a party to:

- a demand facility with a Canadian chartered bank for $75,000,000 (increased from $50,000,000 on October 10, 2012) for the purpose of issuing letters of credit mainly to support LDC's prudential requirements with the IESO ["Prudential Facility"]; and
- a demand facility with a second Canadian chartered bank for $20,000,000 for the purpose of working capital management ["Working Capital Facility"].

As at December 31, 2012, no amounts had been drawn under either the Revolving Credit Facility or the Working Capital Facility [December 31, 2011 - $nil]. As at December 31, 2012, $49,227,000 had been drawn on the Prudential Facility [December 31, 2011 - $45,077,000].

The Corporation filed a base shelf prospectus dated December 10, 2012 with the securities commissions or similar regulatory authorities in each of the provinces of Canada. These filings allow the Corporation to make offerings of unsecured debt securities of up to $1,500,000,000 during the following 25-month period *[note 13]*.

## 12. RESTRUCTURING

In the first quarter of 2012, the Corporation's Board of Directors approved a workforce restructuring program aimed at reducing operating expenditures for LDC. The program was approved following the decision by the OEB to deny the request of LDC to set its electricity distribution rates for 2012, 2013 and 2014 under the COS framework. In preparing its revised application using the IRM framework, LDC concluded that significant cost reductions were necessary to manage its business within the confines of the expected allowed electricity distribution rates provided by the IRM framework *[note 3[a]]*. The main component of these operating cost reduction initiatives was a workforce restructuring program, which included the severance of management employees and a voluntary exit incentive program for targeted unionized positions.

For the year ended December 31, 2012, the costs incurred as a result of these operating cost reduction initiatives amounted to $27,796,000 and were comprised of ongoing termination charges of $23,668,000 and one-time termination incentive charges of $4,128,000, of which $11,954,000 remains unpaid as at December 31, 2012.

[all tabular amounts in thousands of Canadian dollars]

## 13. DEBENTURES

Debentures consist of the following:

| | 2012 $ | 2011 $ |
|---|---|---|
| Senior unsecured debentures | | |
| Series 1 – 6.11% due May 7, 2013 | **224,993** | 224,976 |
| Series 2 – 5.15% due November 14, 2017 | **249,861** | 249,835 |
| Series 3 – 4.49% due November 12, 2019 | **249,956** | 249,951 |
| Series 5 – 6.11% due May 6, 2013 | **245,057** | 245,057 |
| Series 6 – 5.54% due May 21, 2040 | **199,859** | 199,857 |
| Series 7 – 3.54% due November 18, 2021 | **299,864** | 299,851 |
| **Total debentures** | **1,469,590** | 1,469,527 |
| Less: Current portion of debentures | **470,050** | — |
| **Long-term portion of debentures** | **999,540** | 1,469,527 |

All debentures of the Corporation rank equally.

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 and 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. The Corporation's unsecured debentures limit consolidated funded indebtedness to a maximum of 75% of total consolidated capitalization. As at December 31, 2012, the Corporation was in compliance with its covenants.

## 14. EMPLOYEE FUTURE BENEFITS

### *Pension*

The Corporation provides a pension plan for its full-time employees through OMERS. Details of the plan are as follows:

| Pension Plan | Funded Status as at December 31, 2012 | Contributions | |
|---|---|---|---|
| | | 2012 $ | 2011 $ |
| OMERS | 86% | **16,718** | 14,115 |

The OMERS plan assets are pooled together to provide benefits to plan participants and the plan assets are not segregated in separate accounts for each member entity. As at December 31, 2012, the OMERS plan financial statements disclosed an actuarial deficit of approximately $9,900,000,000, which is being addressed through increases in contribution rates for participating employers and employees. For the year ended December 31, 2012, the total contributions of all participating employers and employees were approximately $3,200,000,000. The Corporation's contributions represent less than five percent of total contributions to the plan.

[all tabular amounts in thousands of Canadian dollars]

For 2012, OMERS contribution rates were 8.3% up to the year's maximum pensionable earnings ["YMPE"] and 12.8% over YMPE for normal retirement age of 65 [2011 - 7.4% up to YMPE and 10.7% over YMPE for normal retirement age of 65].

As at December 31, 2012, OMERS had approximately 266,000 active members, of which approximately 1,700 members had a current relationship with the Corporation.

## *Post-retirement benefits other than pension*

### *a) Benefit Obligations*

| | 2012<br>$ | 2011<br>$ |
|---|---|---|
| Balance, beginning of year | **244,326** | 200,027 |
| Service cost | **5,151** | 3,908 |
| Interest cost | **11,657** | 11,507 |
| Benefits paid | **(8,069)** | (7,495) |
| Actuarial loss | **825** | 36,379 |
| **Balance, end of year** | **253,890** | 244,326 |

### *b) Amounts recognized in regulatory assets*

| | 2012<br>$ | 2011<br>$ |
|---|---|---|
| Net actuarial loss | **61,477** | 63,698 |
| Prior service cost | **22** | 1,087 |
| **Total recognized in regulatory assets *[note 9]*** | **61,499** | 64,785 |

As at December 31, 2012, the estimated net actuarial loss and prior service cost that are expected to be amortized from regulatory asset to net periodic benefit cost in 2013 are $2,026,000 and $8,000, respectively.

[all tabular amounts in thousands of Canadian dollars]

## c) Components of net periodic benefit costs

| | 2012 $ | 2011 $ |
|---|---|---|
| Service cost | **5,151** | 3,908 |
| Interest cost | **11,657** | 11,507 |
| Amortization of net actuarial loss | **3,046** | 633 |
| Amortization of prior service cost | **1,065** | 1,091 |
| **Net periodic benefit cost** | **20,919** | 17,139 |
| Capitalized as part of property, plant and equipment | **7,305** | 6,758 |
| Charged to operations | **13,614** | 10,381 |

## d) Expected benefit payments

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid over the next five years, and in the aggregate for the five fiscal years thereafter:

| | Post-retirement Benefits $ |
|---|---|
| 2013 | **10,134** |
| 2014 | **8,183** |
| 2015 | **8,392** |
| 2016 | **9,076** |
| 2017 | **9,524** |
| 2018-2022 | **55,912** |

[all tabular amounts in thousands of Canadian dollars]

## *e) Significant assumptions*

| | 2012<br>% | 2011<br>% |
|---|---|---|
| **Accrued benefit obligation as at December 31:** | | |
| Discount rate | **4.25** | 4.75 |
| Rate of compensation increase | **4.00** | 4.00 |
| **Benefit costs for years ended December 31:** | | |
| Discount rate | **4.75** | 5.75 |
| Rate of compensation increase | **4.00** | 4.00 |
| **Assumed health care cost trend rates as at December 31:** | | |
| Rate of increase in dental costs assumed for next year | **4.00** | 4.00 |
| Rate of increase in medical costs assumed for next year | | |
| For pre July 2000 retirements | **6.50** | 7.00 |
| For other retirements | **8.00** | 8.50 |
| Rate that medical cost trend rate gradually declines to | | |
| For pre July 2000 retirements | **5.00** | 5.00 |
| For other retirements | **5.00** | 5.00 |
| Year that the medical cost trend rate reaches the ultimate trend rate | | |
| For pre July 2000 retirements | **2016** | 2016 |
| For other retirements | **2019** | 2019 |

## *f) 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 2012:

| | Increase<br>$ | Decrease<br>$ |
|---|---|---|
| Total of current service and interest cost (at 4.75%) | **2,534** | **(2,223)** |
| Accrued benefit obligation as at December 31, 2012 (at 4.25%) | **32,347** | **(28,380)** |

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:

| | Increase<br>$ | Decrease<br>$ |
|---|---|---|
| Accrued benefit obligation as at December 31, 2012 | **(39,382)** | **48,344** |
| Estimated net periodic benefit cost for fiscal 2013 | **(2,653)** | **4,719** |

[all tabular amounts in thousands of Canadian dollars]

## 15. ASSET RETIREMENT OBLIGATIONS

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

| | 2012<br>$ | 2011<br>$ |
|---|---|---|
| Balance, beginning of year | **4,902** | 5,005 |
| ARO liabilities settled in the year | **(313)** | (688) |
| Accretion expense | **174** | 173 |
| Revision in estimated cash flows | **316** | 412 |
| **Balance, end of year** | **5,079** | 4,902 |

## 16. FINANCIAL INSTRUMENTS

### *a) Recognition and measurement*

The fair values of cash and cash equivalents, short-term investments, net accounts receivable, unbilled revenue, accounts payable and accrued liabilities, and customers' advance deposits approximate their carrying values as at December 31, 2012 and December 31, 2011 *[note 4[m]]*.

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

| | 2012<br>$ | | 2011<br>$ | |
|---|---|---|---|---|
| | **Carrying value** | **Fair value (1)** | **Carrying value** | **Fair value (1)** |
| Obligations under capital lease | **11,235** | **11,235** | 13,172 | 13,172 |
| Senior unsecured debentures | | | | |
| Series 1 – 6.11% due May 7, 2013 | **224,993** | **228,749** | 224,976 | 238,359 |
| Series 2 – 5.15% due November 14, 2017 | **249,861** | **283,971** | 249,835 | 284,126 |
| Series 3 – 4.49% due November 12, 2019 | **249,956** | **280,381** | 249,951 | 275,575 |
| Series 5 – 6.11% due May 6, 2013 | **245,057** | **249,108** | 245,057 | 259,578 |
| Series 6 – 5.54% due May 21, 2040 | **199,859** | **256,678** | 199,857 | 245,096 |
| Series 7 – 3.54% due November 18, 2021 | **299,864** | **316,973** | 299,851 | 306,696 |

(1) The fair value measurement of financial instruments for which the fair value has been disclosed is included in Level 2 of the fair value hierarchy.

### *b) Financial Risks*

The following is a discussion of financial 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 financial activities provide for a variety of financial risks, particularly credit risk, interest rate risk and liquidity risk.

[all tabular amounts in thousands of Canadian dollars]

***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 719,000 customers, the majority of which are residential. LDC collects security deposits from certain customers in accordance with direction provided by the OEB. As at December 31, 2012, LDC held security deposits in the amount of $46,838,000 [December 31, 2011 - $56,038,000], of which $25,666,000 [December 31, 2011 - $22,700,000] were related to security deposits on Offers to Connect to guarantee the payment of additional costs relating to expansion projects.

The Corporation did not have any single customer that generated more than 10% of total consolidated revenues for the years ended December 31, 2012 and December 31, 2011.

Credit risk associated with accounts receivable is as follows:

| | 2012<br>$ | 2011<br>$ |
|---|---|---|
| Total accounts receivable | **185,857** | 196,259 |
| Less: Allowance for doubtful accounts | **(10,698)** | (12,987) |
| **Total accounts receivable, net** | **175,159** | 183,272 |
| Of which: | | |
| Outstanding for not more than 30 days | **153,513** | 155,274 |
| Outstanding for more than 30 days and not more than 120 days | **18,231** | 24,777 |
| Outstanding for more than 120 days | **14,113** | 16,208 |
| Less: Allowance for doubtful accounts | **(10,698)** | (12,987) |
| **Total accounts receivable, net** | **175,159** | 183,272 |

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

| | 2012<br>$ | 2011<br>$ |
|---|---|---|
| Balance, beginning of year | **(12,987)** | (11,912) |
| Provision for doubtful accounts | **(6,586)** | (10,272) |
| Write-offs | **9,285** | 9,854 |
| Recoveries | **(410)** | (657) |
| **Balance, end of year** | **(10,698)** | (12,987) |

Unbilled revenue represents amounts for which the Corporation has a contractual right to receive cash through future billings and are unbilled at period-end. As at December 31, 2012, total unbilled revenue was $278,086,000 [December 31, 2011 - $262,058,000]. Unbilled revenue is considered current.

As at December 31, 2012, 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 11]* may expose the Corporation to fluctuations in short-term interest rates. 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.

As at December 31, 2012, the Corporation has limited exposure to interest rate risk since its significant obligations are either non-interest bearing or bear fixed interest rates, its financial assets are predominately short-term in nature and mostly non-interest bearing, and its revenue is governed by a specified rate of return pricing structure set by the OEB. The Corporation estimates that a 100 basis point increase (decrease) in short-term interest rates, with all other variables held constant, would result in a decrease (increase) of approximately $300,000 per annum to net financing charges.

The Corporation is also exposed to fluctuations in interest rates for the valuation of its post-retirement benefit obligations *[note 14[f]]*.

***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 debt capital markets and monitors cash balances daily to ensure that sufficient levels of liquidity are on hand to meet financial commitments as they come due.

[all tabular amounts in thousands of Canadian dollars]

Liquidity risks associated with financial commitments are as follows:

| | December 31, 2012 | | | | | |
|---|---|---|---|---|---|---|
| | 2013 $ | 2014 $ | 2015 $ | 2016 $ | 2017 $ | Due after 5 years $ |
| **Financial liabilities** | | | | | | |
| Accounts payable and accrued liabilities | 383,371 | — | — | — | — | — |
| Obligations under capital lease | 2,338 | 2,329 | 2,322 | 2,310 | 2,310 | 1,157 |
| 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 | 60,160 | 45,800 | 45,800 | 45,800 | 45,800 | 314,230 |
| | 915,926 | 48,129 | 48,122 | 48,110 | 298,110 | 1,065,387 |

***Hedging and Derivative risk***

As at December 31, 2012 and December 31, 2011, the Corporation had not entered into hedging and derivative financial instruments.

***Foreign exchange risk***

As at December 31, 2012, 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. As at December 31, 2012, the Corporation had drawn letters of credit in the amount of $49,227,000 *[note 11]* on its Prudential Facility in respect of the operations of LDC.

[all tabular amounts in thousands of Canadian dollars]

## 18. INCOME TAXES

The Corporation's effective tax rate for the year ended December 31, 2012 was 5.04% [2011 – 6.16%]. Income tax expense for the year ended December 31, 2012 was $4,565,000 [2011 - $6,295,000]. The effective tax rate and income tax expense for the year ended December 31, 2012 was lower than the year ended December 31, 2011 due to a reduction in the statutory tax rate from 28.25% to 26.50% and changes in permanent and temporary differences between accounting and tax treatments.

Income tax expense differs from the amount that would have been recorded using the combined statutory Canadian federal and Ontario income tax rate. Reconciliation of income tax expense computed at the statutory income tax rate to the income tax provision is set out below:

***Consolidated Statements of Net Income and Comprehensive Income***

| | 2012<br>$ | 2011<br>$ |
|---|---|---|
| **Rate reconciliation** | | |
| Income before income taxes | **90,555** | 102,227 |
| Statutory Canadian federal and provincial income tax rate | **26.50%** | 28.25% |
| Expected income tax expense | **23,997** | 28,879 |
| Temporary differences not benefited in LDC | **(16,133)** | (16,032) |
| Impact of change in expected future tax rate on existing deferred income tax balances | **(1,803)** | — |
| Other | **(1,496)** | (6,552) |
| **Income tax expense** | **4,565** | 6,295 |
| **Effective tax rate** | **5.04%** | 6.16% |
| **Components of income tax expense** | | |
| Current tax | **6,322** | 9,419 |
| Deferred income tax related to the origination and reversal of temporary differences | **889** | (601) |
| Non-refundable ITCs | **(2,646)** | (2,523) |
| **Income tax expense** | **4,565** | 6,295 |

[all tabular amounts in thousands of Canadian dollars]

***Consolidated Balance Sheets***

Significant components of the Corporation's deferred tax assets are as follows:

| | 2012<br>$ | 2011<br>$ |
|---|---|---|
| Property, plant and equipment and intangible assets | **91,818** | 110,161 |
| Regulatory adjustments | **51,218** | 50,109 |
| Post-retirement benefits liability | **50,667** | 44,885 |
| Other taxable temporary differences | **9,932** | 6,482 |
| Capital loss carryforwards | **5,220** | 5,147 |
| Non-capital loss carryforwards | **7** | 503 |
| Valuation allowance | **(14,544)** | (14,920) |
| **Deferred income tax assets** | **194,318** | 202,367 |

Realization of the Corporation's deferred tax assets is considered more likely than not other than for certain capital loss carryforwards and allowed tax depreciation, for which a valuation allowance has been established.

As at December 31, 2012, the Corporation accumulated non-capital losses for income tax purposes of approximately $28,000 [December 31, 2011 - $2,011,000], which are available to reduce taxable income in future years. As at December 31, 2012, the Corporation also accumulated taxable capital losses of $19,698,000 [December 31, 2011 - $19,698,000] which are available to offset capital gains in future years.

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

| | 2012<br>$ | 2011<br>$ |
|---|---|---|
| Balance, beginning of year | **7,004** | (449) |
| Increases for tax positions taken in the current year | **248** | 374 |
| Increases for tax positions taken in prior years | **—** | 6,633 |
| Decreases for tax positions taken in prior years | **(39)** | — |
| Settlements with tax authorities | **(1,939)** | 446 |
| Reductions resulting from the expiry of limitation periods | **—** | — |
| **Balance, end of year** | **5,274** | 7,004 |

As at December 31, 2012, $5,274,000 of unrecognized tax benefits [December 31, 2011 - $7,004,000] would have a favourable effect on the effective tax rate, if recognized. No interests and penalties have been accrued, since the Corporation is of the view that none are expected to be payable. During the next 12 months, unrecognized tax benefits are not expected to significantly change.

As at December 31, 2012, the Corporation's tax years still open to examination by taxing authorities include 2007 and subsequent years. Other than in respect of the fair market revaluation of the Corporation's assets on October 1, 2001 pursuant to Section 7 of Ontario Regulation 162/01 of the Electricity Act, tax years prior to 2007 are closed to further examination.

[all tabular amounts in thousands of Canadian dollars]

## 19. SHARE CAPITAL

Share capital consists of the following:

| | 2012<br>$ | 2011<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 approval of the Corporation's audited consolidated financial statements for the year by the Board of Directors of the Corporation.

For the year ended December 31, 2012, the Board of Directors of the Corporation declared and paid dividends totalling $47,966,000 [2011 - $33,063,000] to the City.

On February 28, 2013, the Board of Directors of the Corporation declared dividends in the amount of $23,995,000. The dividends are comprised of $17,995,000 with respect to net income for the year ended December 31, 2012, payable to the City on March 8, 2013, and $6,000,000 with respect to the first quarter of 2013, payable to the City on March 28, 2013.

[all tabular amounts in thousands of Canadian dollars]

## 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 | 2012<br>$ | 2011<br>$ |
|---|---|---|
| Revenues | **222,032** | 210,449 |
| Operating expenses and capital expenditures | **26,259** | 30,582 |
| Dividends | **47,966** | 33,063 |

| Transactions with Related Parties Summary | 2012<br>$ | 2011<br>$ |
|---|---|---|
| Accounts receivable | **7,810** | 8,412 |
| Unbilled revenue | **17,018** | 12,439 |
| Other assets | **7,279** | 7,279 |
| Accounts payable and accrued liabilities | **38,020** | 25,085 |
| Advance deposits | **8,926** | 8,714 |

Revenues represent amounts charged to the City primarily for electricity, street lighting and ancillary services. Operating expenses and capital expenditures represent amounts charged by the City for purchased road cut repairs, property taxes and other services. Dividends represent dividends paid to the City *[note 19]*.

Accounts receivable represent receivables from the City primarily for electricity, street lighting and ancillary services. Unbilled revenue represents receivables from the City related to the provision of electricity and other services provided and not yet billed. Other assets represent amounts primarily 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. Advance deposits represent funds received from the City for future expansion projects.

[all tabular amounts in thousands of Canadian dollars]

## 21. COMMITMENTS

### *Future capital commitments and operating lease obligations*

As at December 31, 2012, 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:

| | Future capital commitments (2) $ | Operating lease obligations and other $ |
|---|---|---|
| 2013 | **15,278** | **9,091** |
| 2014 | **—** | **8,999** |
| 2015 | **—** | **8,052** |
| 2016 | **—** | **6,666** |
| 2017 | **—** | **1,992** |
| Thereafter | **—** | **—** |
| **Total amount of future minimum payments (1)** | **15,278** | **34,800** |

(1) Refer to note 16 for repayments of senior unsecured debentures excluded from the table above.
(2) Reflect estimated capital contributions payable to Hydro One Networks Inc. under the Toronto Midtown Transmission Reinforcement Project.

The Corporation has the option to renew its two major property operating leases at the end of the current lease term for an additional five years at the then fair rental value.

Operating lease expense for the year ended December 31, 2012 was $6,547,000 [2011 - $5,271,000].

[all tabular amounts in thousands of Canadian dollars]

### *Capital lease obligations*

As at December 31, 2012, the future minimum annual lease payments under capital leases with remaining lease terms from one to five years and thereafter were as follows:

| | $ |
|---|---|
| 2013 | **2,338** |
| 2014 | **2,329** |
| 2015 | **2,322** |
| 2016 | **2,310** |
| 2017 | **2,310** |
| Thereafter | **1,157** |
| Total amount of future minimum lease payments | **12,766** |
| Less: interest and executory costs | **1,531** |
| | **11,235** |
| Current portion included in Other liabilities | **1,850** |
| Long-term portion included in Other liabilities | **9,385** |

## 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 an 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 sought 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 in contravention of the *Interest Act* (Canada). On April 30, 2012, a settlement reached by the parties was approved by Order of the Ontario Superior Court of Justice. Pursuant to the terms of the Order, LDC was required to pay the amount of $5,836,000 plus costs in settlement of all claims, substantially all of which had been paid as at December 31, 2012. The Corporation accrued a liability to cover the expected settlement in 2010. The action has been dismissed, and the claims by all class members have been released.

***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) 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 a 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 dated January 24, 2012, 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, 1992* (Ontario) 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 has yet to occur. 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 sought 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, notwithstanding a court ordered timetable to have them completed by February 29, 2012. By order dated December 5, 2012, these actions were dismissed by the court for delay.

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.

### *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 Municipal Electricity Utilities ["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. Subsequent to this decision, the OEB issued interrogatories and decisions for other MEUs.

LDC has reviewed the balances of its PILs regulatory variance accounts and applied the guidelines provided by the OEB. As at December 31, 2012, LDC estimated its liability at approximately $7,048,000. This balance has been recorded in the Corporation's consolidated financial statements. LDC has applied for disposition of the balance as part of its pending IRM/ICM Application filed on May 10, 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 had issued assessments in respect of payments in lieu of additional municipal and school taxes under section 92 of the Electricity Act that were in excess of the amounts LDC believed were payable. The dispute arose as a result of inaccurate information incorporated into Ontario Regulation 224/00. The Corporation 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.

In May 2012, the Ministry of Finance completed its reassessment as a consequence of the change in regulation. The impact of the reassessment issued was favourable to the Corporation.

## 23. NET INCOME PER SHARE

The weighted daily average number of shares outstanding for the year ended December 31, 2012 was 1,000 [2011 - 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.

[all tabular amounts in thousands of Canadian dollars]

## 24. NON-CASH WORKING CAPITAL BALANCES

Changes in non-cash working capital provided (used) cash as follows:

| | 2012<br>$ | 2011<br>$ |
|---|---|---|
| Accounts receivable | **8,113** | (14,284) |
| Unbilled revenue | **(16,028)** | 25,835 |
| Income tax receivable | **3,433** | (4,583) |
| Inventories | **(664)** | 610 |
| Other current assets | **46** | (643) |
| Accounts payable and accrued liabilities | **(29,041)** | 39,093 |
| Restructuring accrual | **11,954** | — |
| Deferred conservation credit | **6,957** | 13,316 |
| Other current liabilities | **(332)** | (489) |
| | **(15,562)** | 58,855 |

## 25. US GAAP TRANSITION

Publicly accountable enterprises in Canada were required to adopt IFRS 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. The Corporation elected to take the optional one-year deferral of its adoption of IFRS. In the absence of a definitive plan to consider the issuance of a rate-regulated accounting standard by the International Accounting Standards Board, the Corporation decided to evaluate the option of adopting US GAAP effective January 1, 2012 as an alternative to IFRS. On July 21, 2011, the Ontario Securities Commission granted the Corporation an exemption to allow the Corporation to file financial statements under US GAAP for the years commencing on or after January 1, 2012 but before January 1, 2015. 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.

These are the Corporation's first annual consolidated financial statements prepared in accordance with US GAAP. The accounting policies set out in note 4 have been applied consistently in preparing the consolidated financial statements for the year ended December 31, 2012 and the comparative periods.

The Corporation has adjusted amounts reported previously in its consolidated financial statements prepared in accordance with Canadian GAAP. For reporting purposes, the transition date to US GAAP is January 1, 2011, which is the commencement of the 2011 comparative period to the Corporation's 2012 consolidated financial statements. An explanation of how the transition from Canadian GAAP to US GAAP has affected the Corporation's consolidated financial statements is set out in the following tables and accompanying notes.

Given the Corporation's exemption to file under US GAAP up to December 31, 2014 by the Ontario Securities Commission, the Corporation is actively monitoring developments by the International Accounting Standards Board on rate-regulated accounting should a future IFRS conversion be required. Although the conversion of the Corporation's general purpose financial statements to IFRS was suspended in 2011, the IFRS conversion work is being managed in such a way that if a future transition to IFRS is required, it can be effectively accomplished.

The reconciliation of the January 1, 2011 consolidated balance sheet from Canadian GAAP to US GAAP is as follows:

## CONSOLIDATED BALANCE SHEET

**[in thousands of Canadian dollars]**

| **As at January 1, 2011** | **Notes** | **Canadian GAAP $** | **Transitional Adjustments $** | **US GAAP $** |
|---|---|---|---|---|
| **ASSETS** | | | | |
| **Current** | | | | |
| Regulatory assets | A | — | 3,555 | **3,555** |
| Other | B | 805,310 | 718 | **806,028** |
| **Total current assets** | | 805,310 | 4,273 | **809,583** |
| Regulatory assets | A | 85,113 | 29,224 | **114,337** |
| Other | B | 2,448,191 | 4,132 | **2,452,323** |
| **Total assets** | | 3,338,614 | 37,629 | **3,376,243** |
| **LIABILITIES AND SHAREHOLDER'S EQUITY** | | | | |
| **Current** | | | | |
| Customers' advance deposits | C | — | 50,630 | **50,630** |
| Post-retirement benefits | A | — | 7,415 | **7,415** |
| Regulatory liabilities | A | — | 36,654 | **36,654** |
| Other | C | 639,751 | (18,790) | **620,961** |
| **Total current liabilities** | | 639,751 | 75,909 | **715,660** |
| Customers' advance deposits | C | 45,462 | (31,840) | **13,622** |
| Debentures | B | 1,164,780 | 4,850 | **1,169,630** |
| Post-retirement benefits | A | 169,897 | 22,715 | **192,612** |
| Regulatory liabilities | A | 273,706 | (34,005) | **239,701** |
| Other | | 5,639 | — | **5,639** |
| **Total liabilities** | | 2,299,235 | 37,629 | **2,336,864** |
| **Total shareholder's equity** | | 1,039,379 | — | **1,039,379** |
| **Total liabilities and shareholder's equity** | | 3,338,614 | 37,629 | **3,376,243** |

The reconciliation of the December 31, 2011 consolidated balance sheet from Canadian GAAP to US GAAP is as follows:

**CONSOLIDATED BALANCE SHEET**

**[in thousands of Canadian dollars]**

| As at December 31, 2011 | Notes | Canadian GAAP $ | Transitional Adjustments $ | US GAAP $ |
|---|---|---|---|---|
| **ASSETS** | | | | |
| **Current** | | | | |
| Other | B | 656,278 | 922 | **657,200** |
| **Total current assets** | | 656,278 | 922 | **657,200** |
| Regulatory assets | A | 77,322 | 65,716 | **143,038** |
| Other | B | 2,722,177 | 5,092 | **2,727,269** |
| **Total assets** | | 3,455,777 | 71,730 | **3,527,507** |
| **LIABILITIES AND SHAREHOLDER'S EQUITY** | | | | |
| **Current** | | | | |
| Customers' advance deposits | C | — | 40,238 | **40,238** |
| Post-retirement benefits | A | — | 7,915 | **7,915** |
| Regulatory liabilities | A | — | 7,293 | **7,293** |
| Other | C | 448,061 | (20,108) | **427,953** |
| **Total current liabilities** | | 448,061 | 35,338 | **483,399** |
| Customers' advance deposits | C | 35,930 | (20,130) | **15,800** |
| Debentures | B | 1,463,514 | 6,013 | **1,469,527** |
| Post-retirement benefits | A | 179,541 | 56,870 | **236,411** |
| Regulatory liabilities | A | 210,280 | (6,361) | **203,919** |
| Other | | 16,203 | — | **16,203** |
| **Total liabilities** | | 2,353,529 | 71,730 | **2,425,259** |
| **Total shareholder's equity** | | 1,102,248 | — | **1,102,248** |
| **Total liabilities and shareholder's equity** | | 3,455,777 | 71,730 | **3,527,507** |

The reconciliation of net income from Canadian GAAP to US GAAP for the year ended December 31, 2011 is as follows:

**RECONCILIATION OF NET INCOME FROM CANADIAN GAAP TO US GAAP**

**[in thousands of Canadian dollars]**

| | **Notes** | **2011 $** |
|---|---|---|
| Net income, Canadian GAAP | | 95,932 |
| Revenues | D | 14,212 |
| Purchased power and other | D | 1,959 |
| Operating expenses | D, E | (18,694) |
| Income tax recovery | E | 2,523 |
| **Net income, US GAAP** | | **95,932** |

## Notes to the transitional adjustments

### *A. Post-retirement benefits*

Under Canadian GAAP, unamortized actuarial gains and losses and unamortized prior service costs are not recorded on the consolidated balance sheets. Under US GAAP, all actuarial gains and losses and prior service costs are fully recognized in OCI in the period in which they arise and are presented within equity as Accumulated Other Comprehensive Income [“AOCI”]. Due to the rate-regulated nature of the Corporation’s business, the impact to AOCI on transition and the impact to OCI on a go-forward basis will be reclassified to a regulatory asset account *[note 9[a]]*. This reclassification results in the full recognition of the benefit obligation as a liability on the Corporation’s consolidated balance sheets and no balance reported in OCI and AOCI. A portion of the benefit obligation will also be presented as a current liability on the consolidated balance sheets. The current portion is the amount of the actuarial present value of benefits included in the benefit obligation which is expected to be paid in the next 12 months.

### *B. Debt issuance costs*

Under Canadian GAAP, debt issuance costs are netted against the principal balance of the related debenture. Under US GAAP, debt issuance costs are recognized as deferred charges. This presentation difference results in an increase in other current assets and other assets and an offsetting increase to debentures.

### *C. Customers’ advance deposits*

Under US GAAP, deposits that are due on demand or will be due on demand within one year from the end of the reporting period have been reclassified as current liabilities.

## *D. Demand billable income and expenses*

Under US GAAP, associated costs related to demand billable income have been reclassified on the consolidated statements of net income and comprehensive income. There is no impact to the overall net income.

## *E. Income tax recovery*

Under Canadian GAAP, all ITCs are recognized as a reduction of the related expenditure. Under US GAAP, the benefits of the refundable apprenticeship and co-operative ITCs are recognized as a reduction of the related expenditure. All other ITCs are recorded as a reduction of income tax expense in the current period to the extent that realization of such benefits is more likely than not.