London Hydro Strategic Refresh

Prepared for:

City of London

June 10, 2013

NAVIGANT CONSULTING

Agenda

London Hydro Strategic Refresh

1. Overview of Ontario Electricity Industry
2. High-level Review of London Hydro's Performance
3. Recent Industry Developments and Key Drivers
4. Review and Discuss Strategic Options / Questions

NAVIGANT

The electricity market in Ontario

Ontario's electricity market is highly regulated and subject to provincial government direction

» The electricity market in Ontario has three main components:

1. Generators that produce electricity
2. Transmission lines that move power from generators to LDCs and large customers
3. Local Distribution Companies or "LDCs" such as London Hydro that take power from the transmission lines and deliver the power to customers in their service territories. There are currently ~80 LDCs serving 4.5 million customers

» LDCs are the point of contact for customers and are responsible for billing and collecting for the cost of all electricity market components

» The Ontario Energy Board ("OEB") is responsible for setting and monitoring customer rates, minimum levels of service and reliability, codes of conduct and the financial stability of distribution utilities in the province, regardless of ownership structure

» The Ontario government has been deeply involved with setting direction and issuing directives for the Ontario electricity industry

NAVIGANT

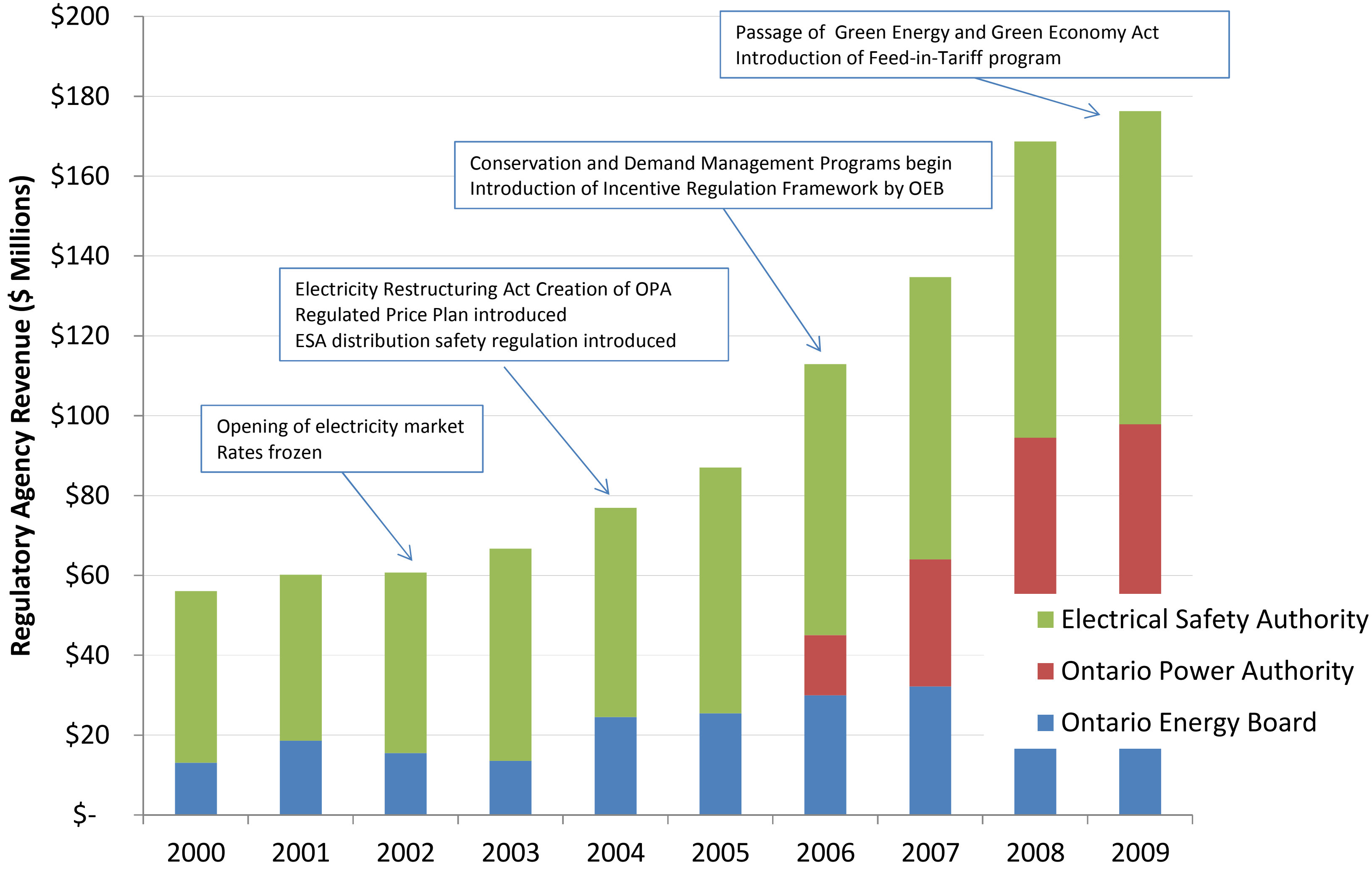
Comparison of regulated utilities in Ontario

The structure and oversight of Ontario natural gas industry is directly comparable to the electricity industry

	Electricity	**Natural Gas**
Participants	~ 75	Enbridge, Union
Ontario customers	~ 5 million	3 million +
Ownership	Mostly public	Private
Who sets rates?	Ontario Energy Board	Ontario Energy Board
Service quality	Monitored by OEB	Monitored by OEB
Choice of Provider?	No	No
Competition for commodity?	Yes	Yes

NAVIGANT

Increasing Regulatory Burden; Ongoing Government Intervention



How the OEB establishes distribution rates

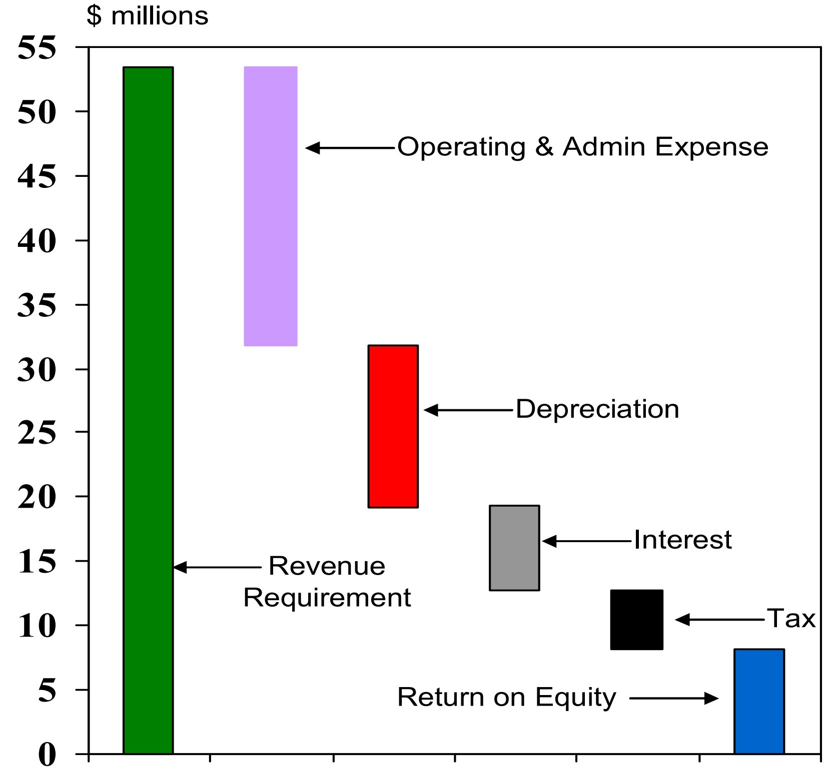
Distribution rates are currently set on a "bottom-up" basis every four years in a "rebasing" process

» The OEB first establishes how much revenue London Hydro requires to cover all its costs. This is referred to as revenue requirement

- Customer rates are then adjusted to achieve this revenue requirement
- This same process is used regardless of who owns the utility

» Once rates are established in the rebasing year, they are allowed to increase by inflation less a specified amount annually until the next rebasing in four or five years

Components of Distribution Rates



NAVIGANT

London Hydro Strategic Refresh

1. Overview of Ontario Electricity Industry
2. **High-level Review of London Hydro's Performance**
3. Recent Industry Developments and Key Drivers
4. Review and Discuss Strategic Options / Questions

Fiscal 2012 Performance: From 2012 AGM

London Hydro provides distributions to the City of London through interest paid on debt and dividends

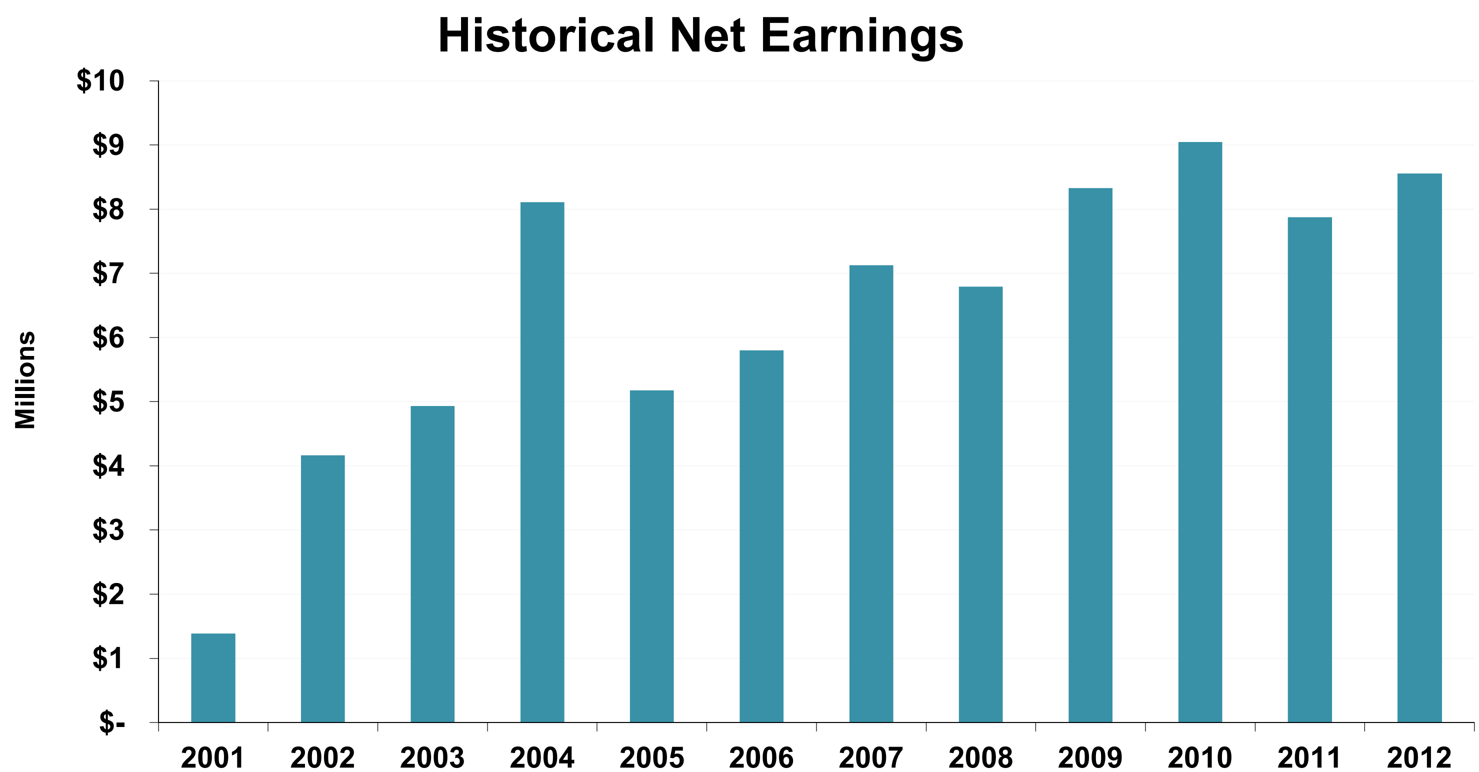
Financial Highlights	2011	($ millions) Planned 2012	Actual 2012	Planned 2013
Energy Quantities Distributed - Gigawatt Hrs	**3,408.4**	**3,488.3**	**3,345.3**	3,473.4
Revenue:				
Energy and distribution	**$ 356.7**	**$ 381.6**	**$ 378.5**	$ 403.6
Cost of power	**$ (297.9)**	**$ (321.5)**	**$ (316.7)**	$ (335.7)
Distribution revenue	**$ 58.8**	**$ 60.1**	**$ 61.8**	$ 67.9
Net earnings	**$ 7.9**	**$ 8.0**	**$ 8.6**	$ 9.5
Average return on shareholder equity	**6.5%**	**6.3%**	**6.6%**	7.0%
Annual investments:				
Capital assets	**$ 28.7**	**$ 30.6**	**$ 27.9**	$ 29.7
Smart Meter Initiative	**$ 3.2**	**$ 0.7**	**$ 0.8**	$ -
Financial Position:				
Total Assets	**$ 300.6**	**$ 308.8**	**$ 308.2**	$ 317.3
Shareholder's equity	**$ 124.1**	**$ 129.1**	**$ 129.6**	$ 136.1
Distributions to the City of London:				
Interest paid	**$ 4.2**	**$ 4.2**	**$ 4.2**	$ 4.2
Dividends declared or paid	**$ 2.5**	**$ 3.0**	**$ 3.0**	$ 3.0
S&P Credit Rating	**A/Stable**	**A/Stable**	**A/Stable**	**A/Stable**

Note: Above financial results and projections are presented using Canadian Generally Accepted Accountng Standards

NAVIGANT

Value to Shareholder: From 2012 AGM

London Hydro's future net earnings are forecast to range between $9 to $10 million; in line with recent trends



NAVIGANT

Non-Financial Performance

London Hydro shows strong performance in many other areas

» High customer satisfaction
  - Rated "A" by customers, compared with average rating of "B+ " for other Ontario LDCs

» Below average distribution rates as compared with other LDCs

» Participation with and contributions to community (eg, UWO, Fanshawe, UTRCA)

» Renewable generation connection

» Provincial leader in energy conservation

» Enhanced customer services (TOU rate portal, bill consolidation for commercial property managers)

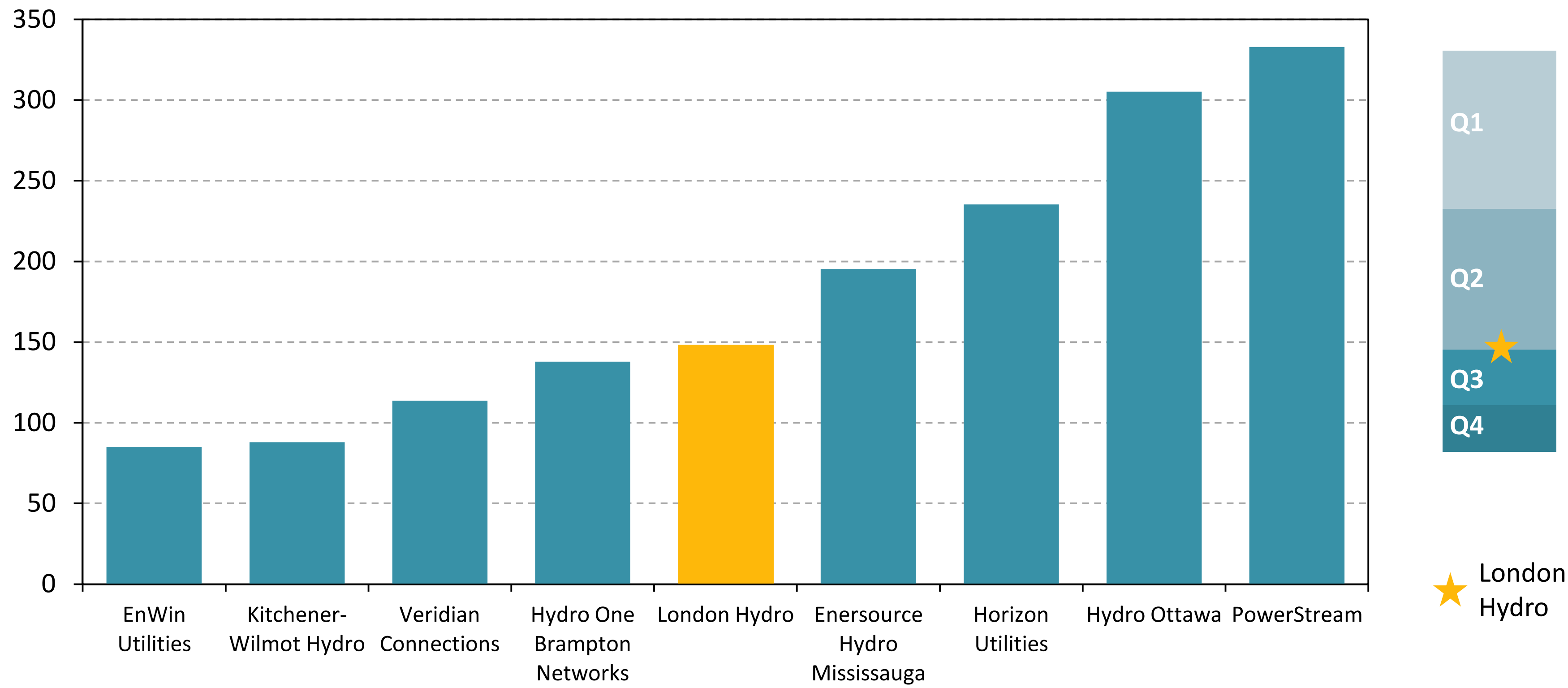
» Improved reliability (fewer and shorter outages)

NAVIGANT

Peer Utilities (from a Size Perspective)

Of the nine largest LDCs (exc. Hydro One and Toronto Hydro), London Hydro is the median utility with ~150k customers

2011 Customers ('000) **Quartiles**



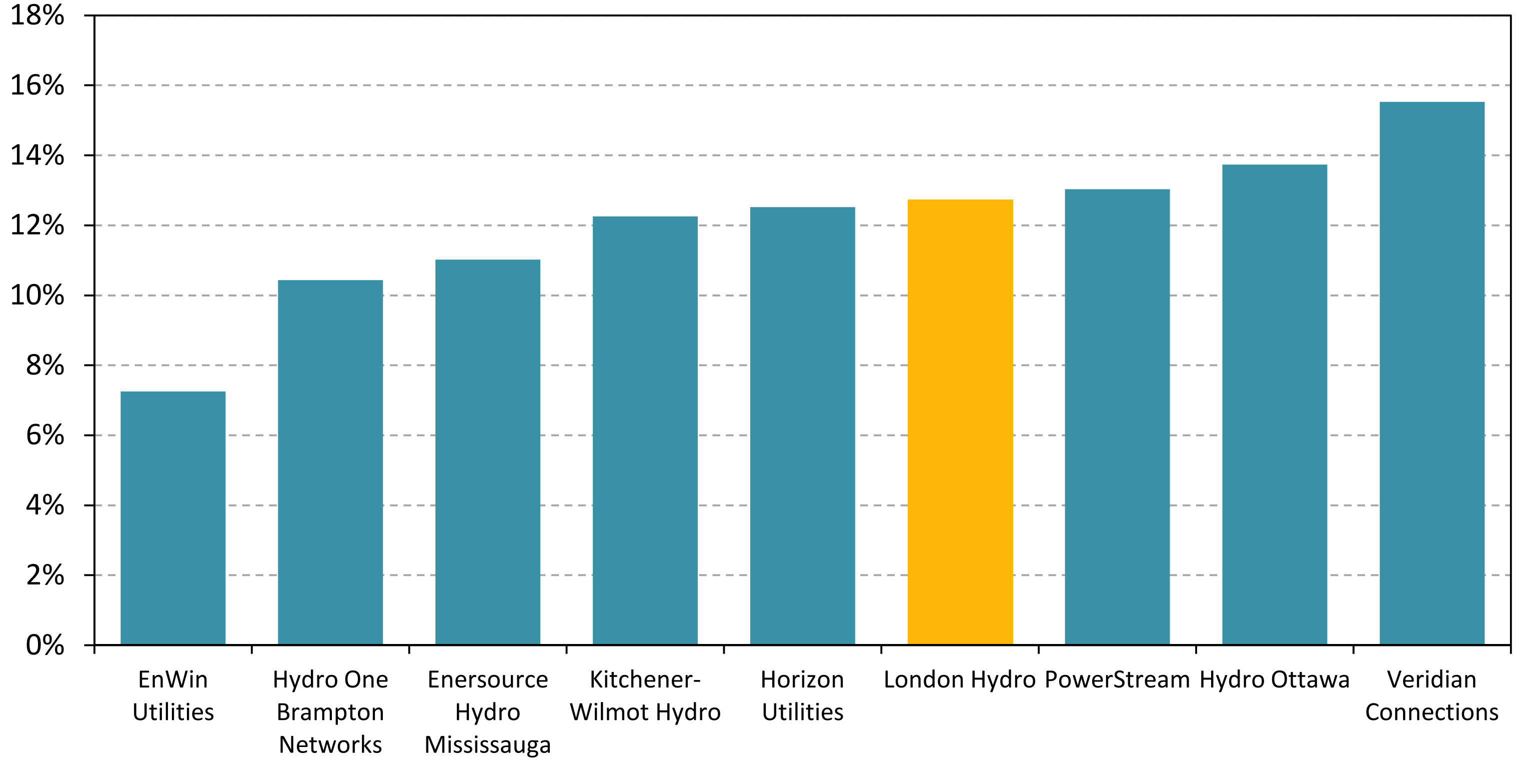
Source: Ontario Energy Board (OEB) Reporting and Record Keeping Requirements; Navigant analysis

NAVIGANT

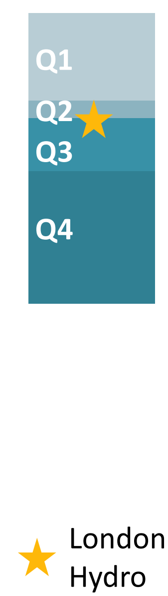
Peer Utilities (Level of Capital Investments)

On average, London Hydro has made annual capital investments roughly in line with its peer LDCs

Annual Capital Additions as Percentage of Regulated Asset Base (2006-2010, inclusive)



Quartiles



Source: OEB Reporting and Record Keeping Requirements; Navigant analysis

NAVIGANT

London Hydro Strategic Refresh

1. Overview of Ontario Electricity Industry
2. High-level Review of London Hydro's Performance
3. **Recent Industry Developments and Key Drivers**
4. Review and Discuss Strategic Options / Questions

NAVIGANT

Where are we now?

Ontario's LDCs have significantly lifted their game from 2005

» Distribution sector development has occurred concurrently with larger, more significant changes in other areas of Ontario's electricity industry

» Provincial government focus since 2004 has been on securing necessary generation to accommodate coal phase-out objectives and address long-term supply requirements

» Relative lack of government policy and direction for distribution sector does not mean government is satisfied with the current situation, merely that they have had higher priority issues to deal with

Recent Ontario LDC Transactions

Recent transactions at attractive multiples of book value

» Collus Power sale of 50% equity to PowerStream for $15 million to form Collus PowerStream
  - Collus PowerStream continues to operate as a separate company
  - Implied Enterprise Value ~ $34 million (inclusive of debt)
  - **Sale Price ~1.5 x book value**

» Norfolk Power sale to Hydro One for $93 million
  - As part of the transaction, Hydro One will
    - Apply for 1% rate reduction and freeze rates for 5 years
    - Transfer all Norfolk Power employees to Hydro One
    - Create 30 new jobs in Norfolk County
    - Maintain Norfolk Power office for three years
  - Enterprise Value ~$59 million
  - **Sale Price ~ 1.6 x book value**

NAVIGANT

Distribution Sector Review Panel

Panel report recommends significant consolidation of Ontario's distribution sector driven by changing customer needs

» Panel recognized growing and changing needs of customers as driving fundamental change in the distribution sector. Changes include:
  - Smart Grid (and "Smart Homes")
  - Increased penetration of electric vehicles and distributed generation

» Will require new ways of doing business and new services

» Panel recommends consolidation of Ontario's ~80 LDCs into 8 – 12 regional LDCs through voluntary efforts initially, followed by legislation to force consolidation among LDCs that have not progressed voluntarily

» Provincial government has not adopted the recommendations of the Panel; stating it prefers to let industry sort things out voluntarily

NAVIGANT

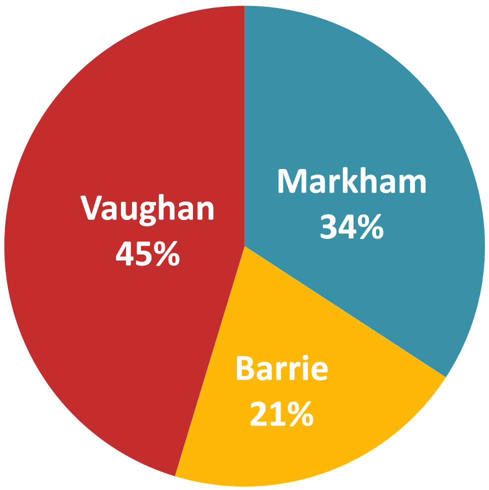
Retaining control in a voluntary merger ("Veto" Rights)

PowerStream Shareholder Agreement reflective of a voluntary merger among roughly equal partners

All shareholders must agree to any of the following (partial list only) activities:

- Entering into a new business (other than distribution)
- Entering a Transaction that is not a Board-Approved Transaction (lower level transactions can be approved by the Board of Directors)
- Admission of a new shareholder
- Sale, lease, exchange or disposition of assets representing more than 5% of the ratebase
- Change to the dividend policy
- Significant capital expenditures
- Establishing a subsidiary other than through a Board-Approved Transaction
- Approval of Strategic Plan (initial plan, then every 3 years)

Municipal Ownership In PowerStream



NAVIGANT

Future Direction (Where are we going?)

Pace of change in Ontario's distribution sector is unlikely to slacken

» As Ontario's generation supply sector issues get addressed expect government to turn its attention to the distribution sector

- Although OEB is an independent agency, government can direct OEB to serve as instrument of change for distribution sector
- Establishment of Distribution Sector Review Panel evidence of government's ongoing interest in the LDC sector

» Four factors are expected to drive change in the future

1. Continuing cost pressure on distribution sector
2. Increasing shareholder expectations re: financial returns
3. Continuing pressure for enhanced sector capabilities
4. Appearance of private capital and well-capitalized private utilities

NAVIGANT

Key Driver 1: Continuing Cost Pressure on LDCs

Diversity of LDC sector has limited OEB's ability to put increased cost pressure on LDCs

» Incentive regulation mechanism (IRM) has brought increased complexity to and scrutiny on rate applications

» Other pressing matters and a lack of accurate and consistent data regarding LDC costs have been a barrier in further refinement of the OEB's IRM

» OEB is now offering three regulatory options for LDCs under the Renewed Regulatory Framework for Electricity (RRFE)

1. Custom IR – involving 5 year capital and O&M spending plans
2. Extension of previous IRM to five year rebasing cycle
3. Annual increase (CPI - productivity factor) without rebasing

» Most LDCs are expected to pursue option #2, since it is well understood (even though it will increase cost pressure on LDCs)

NAVIGANT

Key Driver 2:
Increasing Shareholder Expectations re: Financial Returns

Municipalities are becoming increasingly dependent on their LDC as a source of municipal funds

» Growing recognition that the OEB controls rates, service quality and other key aspects of the LDC's business

» Growing desire for dividends and interest on shareholder notes conflicts with regulatory pressure on rates (and returns) and need for capital expenditures

» Might expect that some shareholders would be unwilling to accept poor performance, but limited sale or merger activity suggests they are satisfied (for now)

NAVIGANT

Key Driver 3:
Continuing Pressure for Greater Sector Capabilities

Government likely sees LDC consolidation as a critical enabler of enhanced sector capability, but has not done much about it

» Government has been primarily focused on addressing Ontario electricity supply needs over the past five to seven years

» Distribution sector has largely been ignored, but several initiatives – such as Conservation, Smart Grid and Distributed Generation – involving LDCs sector are becoming increasingly important

- Each of these initiatives can provide greater value to customers and potentially greater rewards to shareholders.

» To successfully pursue these initiatives, LDCs will require significant resources, expertise and scale (as noted by Distribution Sector Review Panel)

» Large number of small LDCs could be seen as impediment to these initiatives

NAVIGANT

Key Driver 4:
Appearance of Private capital & Well-Capitalized Private Utilities

Tension between desire for dividends and need for capital investment could be addressed by private capital

» Prior to market restructuring, several large US utilities were aggressively pursuing Ontario LDCs. They withdrew from the market given issues "at home" and unfavourable Ontario government policy changes

» Transfer tax on sale to private utilities now a barrier, but government could change policy. Even without policy change, transfer tax will eventually decline to zero through credit on cumulative payments-in-lieu of taxes by LDCs

» With greater stability in the Ontario market, expect private utilities to become more active in Ontario

- For example, Fortis purchase of Great Lakes Power distribution business (Fortis also purchased Terasen Gas distribution business in B.C. and Aquila Networks distribution assets in B.C. and Alberta)

NAVIGANT

London Hydro Strategic Refresh

1. Overview of Ontario Electricity Industry
2. High-level Review of London Hydro's Performance
3. Recent Industry Developments and Key Drivers
4. **Review and Discuss Strategic Options / Questions**

NAVIGANT

London Hydro Strategic Review

Ultimate objective is to increase corporate value; strategic options fall into three broad categories: hold; buy; and sell (or a combination)

Strategic Options

1. Status quo
2. Achieve economies of scale/scope through merger or acquisition
3. Partial or full divestiture

Internal / External Factors

- Provincial government direction?
- Desired outcomes for City of London?
- Changes in regulation?

Goal/Objective

Increase Corporate Value

NAVIGANT

Option 1: Status Quo

Distributions from London Hydro to the City of London are expected to continue under the status quo

- London Hydro has shown strong performance in the past. This is expected to continue
- Interest on debt from London Hydro to City currently $4.2 million annually (will be renegotiated by end of 2013)
- London Hydro's future net earnings are forecast to range between $9 to $10 million; some of which needs to be re-invested to maintain reliability and service quality
- Annual dividends to the City of London are expected to continue in the $3 million range. Likely difficult to materially increase dividends given other cost pressures on London Hydro.

NAVIGANT

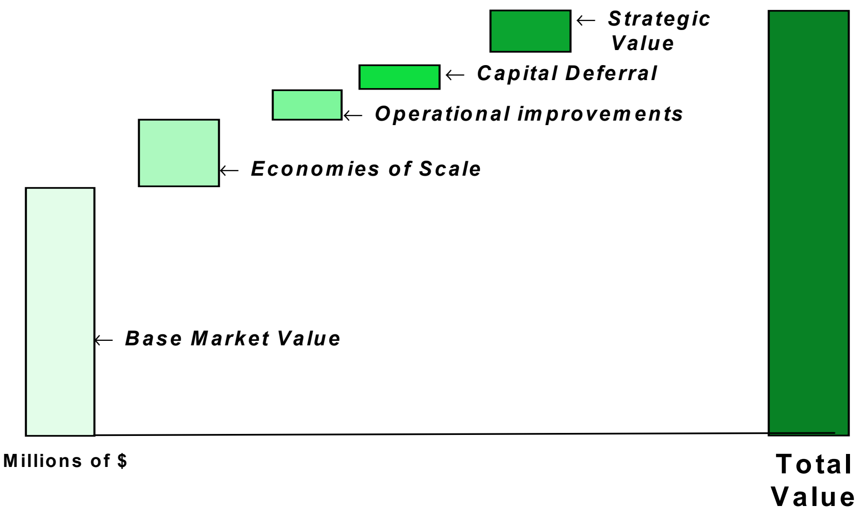
Option 2(a): Merger

Magnitude of gains from merger largely driven by relative efficiency of the standalone utilities and aggressiveness of cost reductions

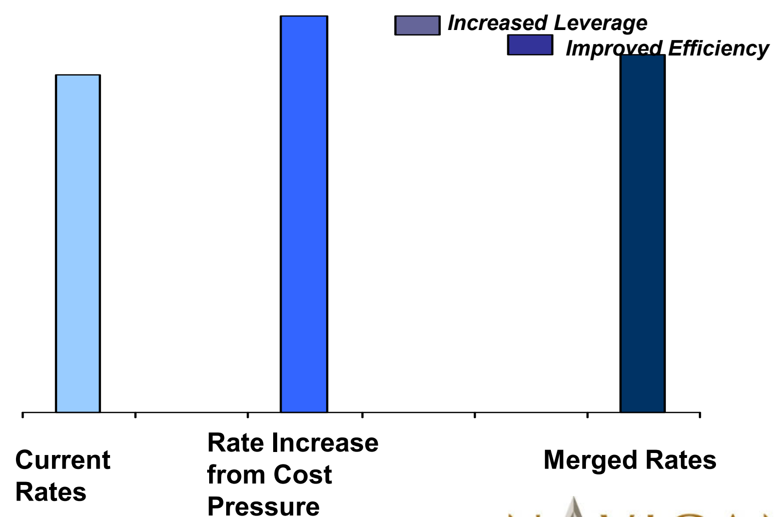
» A merger, with the right partner and properly evaluated, is a relatively low risk method of protecting or enhancing shareholder value while improving operating flexibility and efficiency

» Ratepayers stand to benefit through lower rates or reduced rate increases resulting from the efficiency and financing gains available

Potential for Increased Shareholder Value



Decreased Pressure on Rate Increases



Option 2(b): Acquisition

Acquisitions can provide greater upside than mergers, but also have greater risks

» Compared to mergers, acquisitions are attractive due to the cohesive governance structure of one management team and one shareholder

» This should lead to greater expense reductions in the long term as business decisions are made based on the utility operations only

» However, greater upside comes with greater risk

- In a merger, the risk of failed synergies is shared between the partners
- However, in an acquisition some of the expected value of these synergies has been given away through the purchase price (for example, if expect $3 million of savings, may "share" $1.5 million of this with the seller)
- If expected synergies are not realized, the acquirer will have lost value from the transaction

NAVIGANT

Option 3: Partial or Full Divestiture

Expect significant industry interest in the partial or full acquisition of London Hydro

- London Hydro's rates, service levels and reliability will be regulated by the OEB in exactly the same manner regardless of whether it is owned by the City, another municipality or a private utility
- In recognition of its strong performance and favourable location, Navigant expects there would be significant buyer interest in the partial or full acquisition of London Hydro from both publicly-owned and private sector entities
- Although proceeds from any sale of >10% of London Hydro's value to private sector entities would be subject to a 33% transfer tax, the government has implemented transfer tax waiver periods in the past and could do so in the future
- Partial or full divestiture of London Hydro would help monetize the City of London's value in London Hydro and could generate incremental value for the City of London that might not otherwise be realized under the status quo

NAVIGANT

What are the desired outcomes for the City of London?

If considering options other than Status Quo…

- While the OEB controls rates and service levels, the City of London can maintain control in a merger through specification of unanimous consent items (similar to the “veto” rights presented earlier for PowerStream’s three municipal shareholders)
- Similar unanimous consent items could be developed for partial divestiture
- Other provisions, such as those negotiated in the sale of Norfolk Power to Hydro One, could be established for full divestiture
- Important to recognize that limiting control or otherwise tying the hands of the purchaser could result in decreased sale proceeds. “Control premiums” paid for publicly traded companies have reportedly been in the range of 30% to 50%

NAVIGANT

(Simplified) Comparison of Strategic Options

	1. Status Quo	2 (a). Merger	2 (b). Acquisition	3. Full or Partial Divestiture
Benefits	• Ongoing dividends and interest on debt • Maintain control	• Ongoing dividends and interest on debt • Control through “veto” rights	• Ongoing dividends and interest on debt • Maintain control	• Cash proceeds • If partial, ongoing dividends and interest; could maintain some control (“veto” rights)
Risks	• Government legislation • OEB regulation (e.g., lower Return on Equity) • Growth in distributed generation or other technological change	• Same as status quo	• Same as status quo, PLUS • Failure to achieve expected synergies	• If partial, same as status quo • If full, NONE
Ratepayer Impact	• Will depend on London Hydro’s costs and OEB’s regulatory regime • Consider as the “base” for comparison with other options	• Possibly lower given economies of scale • Potential for improved reliability and service		• If partial, could be similar to other options • If full, would depend on acquirer’s operating costs

NAVIGANT

Recommended course of action

That should the Municipal Council wish to pursue the sale or partial sale of London Hydro Inc., given current favourable market conditions:

» the Board of Directors of London Hydro Inc. BE DIRECTED, by the Shareholder, to issue a competitive proposal process for the sale or partial sale of London Hydro Inc.; and

» the Board of Directors of London Hydro Inc. BE DIRECTED to report back in October 2013 with the results and recommendations arising from the competitive proposal process, for the consideration of the Shareholder.

NAVIGANT

Key CONTACTS

Todd Williams
Managing Director
Toronto, Ontario
(647) 288-5204
TWilliams@Navigant.com

NAVIGANT
ENERGY

Glossary

Divestiture =	Sale
IR =	Incentive Regulation used by regulators to "mimic" effects of competition on regulated utilities
IRM =	Incentive Regulation Mechanism used by the Ontario Energy Board to set rates for LDCs. After being set to allow an LDC to earn the target Return on Equity, rates are allowed to increase by CPI – productivity factor – stretch factor for subsequent years until rates are rebased again
LDC =	Local Distribution Company
O&M =	Operating and Maintenance
Rebasing =	Process used to determine rates at the beginning of an IRM period in which rates are set to provide the allowable return on equity based on the utility's costs as approved by the regulator

NAVIGANT