EX15.4.2

COMMENTS ON THE OCTOBER 18, 2011 REPORT ON MONETIZATION POTENTIAL OF CITY ASSETS BY THE CITY OF TORONTO'S DEPUTY CITY MANAGER AND CHIEF FINANCIAL OFFICER

Prepared for
Canadian Union of Public Employees Local One
(Toronto Hydro Workers)

Prepared by
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Authors

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Summary

On October 18, 2011, the Deputy City Manager and Chief Financial Officer (DCM/CFO) of the City of Toronto wrote a report titled "Monetization Potential of City Assets." The report recommended preparing an initial public offering of up to 10% of Toronto Hydro Corporation shares, and allocating the proceeds to the Capital Reserve Fund to offset further debt issuance.

We believe selling 10% of Toronto Hydro would result in a net loss of $5.378 million in income per year for the City. In June 2011, we authored a report titled "Why the City of Toronto Should Not Sell Part of Toronto Hydro" in which we examined a scenario where the City sells sufficient shares through a private placement to net the city $100 million.[1] Using the same model and making adjustments for the decline in debt costs[2] and the higher issuance costs for IPOs vs. private placements, we extrapolated our numbers to analyze the staff recommendation to sell 10% of Toronto Hydro shares. Our conclusions are as follows.

- The City of Toronto's investment in Toronto Hydro has provided an average return of 9.42% per year (which included a dividend yield of 4.26% and appreciation in the value of its investment). This return is more than twice the City of Toronto's cost of debt financing.
- The sale of 10% Toronto Hydro's stock would reduce the City of Toronto's revenues by $10 million per year, and reduce the City of Toronto's interest expense by $4.622 million, causing a net loss of $5.378 million in annual income.
- The City's cost of debt is very low at the present time, and thus, now is a good time for the City to invest in assets, not to sell assets.

TABLE 1: Analysis of Selling 10% of Toronto Hydro Stock Through an IPO	
Proceeds from selling 10% of Toronto Hydro stock	
Gross proceeds from 10% of Toronto Hydro stock (based on investors requiring a return on investment of 8.5%)	$118,000,000
Issuance costs for an initial public offering	10,000,000
Net proceeds from selling 10% of Toronto Hydro stock	$108,000,000
Impact on the City of Toronto's annual income	
Annual loss in revenue given to new shareholders	($10,000,000)
Savings in annual interest costs avoided	4,622,000
City's net loss in annual income	($5,378,000)

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[1] The $100 million private placement we examined would have represented the sale of about 8.7% of Toronto Hydro shares based on a prospective income of $100 million

[2] In our June 2011 report, we estimated the city's cost of long-0term debt to be 4.73%. As of November 29, 2011, we estimate the city's cost of long-term debt to be 4.28%.

An initial public offering could easily cost $10 million in underwriting costs and other issuance costs. We also believe that it would be impractical to have the initial public offering targeted specifically to Toronto residents.

In 2010, City Council decided that the sale of any part of Toronto Hydro was not in the City of Toronto's best interest. We believe that City Council made the correct decision in 2010. We believe that today a full analysis still shows it is not in the best interest of the City of Toronto to sell part of Toronto Hydro.

Lack of Information to Support 10% sale of Toronto Hydro

If the City of Toronto is to sell up to 10% of Toronto Hydro Corporation, there should be a thorough analysis done of the financial consequences of the sale. This analysis should include:

(a) determining the proceeds from the sale,
(b) determining how much income would be given away to the new shareholders in future years,[3]
c) determining the issuance costs of the initial public offering (which are likely to be very substantial)
(d) determine the City of Toronto's cost of debt financing, and
(e) compare the income that will be lost in future years as a result of the sale to the reduction in annual interest costs.

The only one of the 5 above items that is covered in the report is the city's cost of debt financing.[4] The report states the average interest on its debt to be currently around 4%.[5] The DCM/CFO is asking City Council to make a decision without providing adequate financial analysis to support such a decision. We believe that City Council should know what the expected proceeds of the sale are likely to be before being asked to approve such a sale.

Our report did examine all of these issues and the result of our analysis is as follows:

- Our analysis found that investors are likely to require a return of 8.5% on an investment in Toronto Hydro shares. Assuming that Toronto Hydro's prospective income is $100 million, investors would value the company's entire stock at approximately $1.18 billion and would be willing to pay $118 million for 10% of the stock.[6] The net proceeds after issuance costs would likely be about $108 million through an initial public offering.

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[3] To calculate, one needs to predict Toronto Hydro's prospective income and proceeds from stock issuance.
[4] Some of the other 4 items may have been covered in the confidential attachment, which was not available to us.
[5] "Monetization Potential of City Assets," Report by the Deputy City Manager and Chief Financial Officer, October 18, 2011, page 6.
[6] A $100 million perpetuity discounted at 8.5% is worth $1.18 billion.

- Our analysis found that the City of Toronto would be giving up $10,000,00 in income if they sold 10% of the shares (based on a prospective income for Toronto Hydro of $100 million).
- Our earlier analysis looked at an issuance cost of 2% of proceeds for a private placement. We believe that underwriting fees for a public offering would be more like 6% (or $7 million) if there was an initial public offering and would increase if investment bankers were asked to target Toronto residents. Total issuance costs (including fees paid to lawyers and accountants, and various other costs) might amount to $10 million.
- As of November 29, 2011, the cost of long-term debt for Toronto Hydro was 4.28%.[7]
- Our analysis found that a sale of 10% of Toronto Hydro shares would cause the City of Toronto to lose $10,000,000 in annual revenue but only reduce annual interest expenses by $4,622,000. Thus, the annual income of the city would decrease by $5,378,000.

[illegible]ublic Offering to Toronto Residents is Impractical

Re[illegible]mendation #5 of the report directs the Toronto Hydro Corporation [illegible] to [illegible]gn an initial public offering (IPO) that allocates the maximum portion of s[illegible] Toronto residents without adversely affecting the proceeds of sale. [illegible]dation is impractical.

[illegible], investment banking firms try to sell new stock issues quickly to investors [illegible] are willing to pay the issue price. Investment banking firms typically [illegible]al investors in IPOs. Investment bankers would find it difficult to [illegible]'s request to target Toronto residents as buyers and it would [illegible]ance costs since the effort required to sell IPOs to retail investors is [illegible]er. After a stock is sold in an IPO, the stock can be traded on an exc[illegible] Even if stock is initially sold to Toronto residents, there is no reason to bel[illegible]at it will continue to be held by Toronto residents.

Proceeds from Sale of Assets for Debt Servicing is Unnecessary

The report by the DCM/CFO discusses the city's debt service ratio is approaching a self-imposed limit of 15%. The Province of Ontario prohibits municipalities from exceeding a debt service ratio of 25%. The debt service ratio is a ratio of the sum of interest and principal payments to the size of the operating budget. There is no business rationale for the city's self-imposed debt service ratio ceiling. If the City of Toronto were to sell off profitable assets in order to reduce its debt service ratio, it is unlikely that bond rating agencies would respond positively and raise the city's bond rating. Bond rating agencies

[7] This calculated based on a yield quote of 4.17% plus amortization of 2% issuance costs for the City of Toronto's bonds maturing in 2040. At the time of our June 2011 report, the cost was 4.73%.