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Please see
attached letter
for information
cc
Andrew
Colin G
from
Joanna - Duncan

November 06, 2006

Joanna Whittington
Director, Gas Distribution
Ofgem
9 Millbank
London SW1P 3GE

Dear Joanna,

We are writing in response to the Report of the Cost of Capital provided to Ofgem by Smithers and Co. ("Smithers") dated September 1, 2006, Ofgem's Updated Proposals for the Transmission Price Control (the "TPCR Updated Proposals") dated September 26, 2006 and the implications of these publications on the cost of capital as it relates to the next Gas Distribution Price Control Review.

Teachers' was initially attracted to the U.K. because of its mature, stable and transparent regulatory regime. In fact, in many of our discussions with officials in other jurisdictions, we pointed to the UK as an example of how, in an era of mobile capital, regulation can promote disciplined investment in the sector while still protecting and providing benefits to the customer. Since we are a true long-term holder of these assets (hopefully 20+ years), we appreciated the sensible view that Ofgem had adopted in regulating and governing the industry. Your recent approach to the cost of capital as it relates to the Transmission Price Control review has given us pause and some concern.

The TPCR Updated Proposals state that Ofgem's decision on cost of capital will take into account a range of factors such as the investment focus of the review, your financeability assessments, the overall balance of risk the companies will face, your consultants' work on this issue, and the consistency with past regulatory decisions, given the importance of providing stability in allowed returns. However, your current modeling assumption of 4.2% real, post tax is supported mainly by references to mathematical models and the work undertaken by Smithers.

Our main comment with the Smithers report is that it is very academic and the conclusions do not reflect the risk adjusted return expectations of long term investors who support these types of businesses. While the report provides a very robust analysis of the various elements of the CAPM model, we believe that relying on a mathematical approach to determine the cost of capital has a number of shortcomings.

On the cost of equity and specifically, on the calculation of beta, we are concerned that sophisticated mathematical techniques such as the Kalman Filter imply that it is possible to forecast an accurate beta and in turn an accurate cost of equity. In our opinion, there is no reasonable degree of certainty to the results produced by such models and they do nothing to explain how investors truly behave. The wide ranges given by the authors on their estimates of beta are proof that estimating a cost of equity is not an exact science. Indeed, while Smithers' report recognizes the volatility in historical betas, it does not explicitly state how useful the models discussed would have been at predicting the wide swings in equity pricing for regulated business in the UK over the past two years. If Ofgem is truly trying to attract long term capital, it needs to move away from using scientific models based on historical data and limited sample sizes and attempt to consider and measure factors such as:

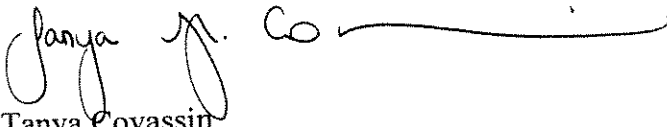
- The significant capital expenditures required over the next price control review. The planned capex programmes imply incremental risk. It is our view that investors should be compensated for this risk and the risk arising from the amount of RAV which could be exposed to regulatory decisions after the current price review;
- The importance of a consistent risk-adjusted cost of capital across not only different regulated industries in the UK but also globally;
- The need to encourage long-term, patient capital in these businesses. It is our view that the recent phenomenon of a large amount of equity being attracted to these businesses is not sustainable and that volatility in regulatory decisions relating to the cost of capital will exacerbate the already frothy markets for mature regulated businesses; and
- The importance of balancing the immediate interests of customers and facilitating efficient investment in the DN businesses.

With regards to gearing, the cost of debt and their impact on the cost of capital, we have the following comments:

- While we acknowledge the Smithers evidence that higher gearing does not lead to higher equity risk premiums, we do not believe it is an accurate representation of how large infrastructure investors measure risk and return from leverage. We do ascribe incremental risk for more highly geared investments and we do expect them to earn incremental return;
- We agree with the use of 2.5% for the real risk-free rate; and
- We do not believe that the current cost of debt is sustainable. Debt capital market pundits predict a correction in the credit markets which will put an end to the historic lows enjoyed by borrowers of debt instruments. Given this eventuality, we do not believe that it is prudent to ascribe a debt premium figure as low as the 1.1% the Smithers report suggests.

In conclusion, your work on the TPCR Update Proposals leads us to believe that you will be relying primarily on mathematical models for the purpose of determining the cost of capital. We believe that these models provide a simplistic assessment of the risks of the business and should therefore serve only as a starting point for any discussion on cost of capital. We are of the strong belief that a regulatory determination is compelled to take into account a fulsome assessment of all the long term risks associated with these complex businesses.

Regards,

A handwritten signature in black ink, appearing to read 'Tanya M. Co', followed by a long horizontal flourish.

Tanya Covassin
Director, Scotia Gas Networks

c.c. Peter Bucks, Senior Financial Adviser
David Gray, Managing Director, Networks