



**TEACHERS'**  
PENSION PLAN • RÉGIME DE RETRAITE  
DES ENSEIGNANTES ET DES ENSEIGNANTS

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24 September 2012

Hannah Nixon  
Senior Partner for Distribution  
The Office of Gas and Electricity Markets  
9 Millbank  
London SW1P 3GE

Dear Hannah,

**RIIO-GD1 Initial Proposals (27 July 2012)**

In our previous letter to Ofgem dated 4 February 2011, we noted our concerns over the expectations being set for returns despite the higher risks of the new RIIO regime. Ofgem's Initial Proposals have not alleviated our concerns; we remain worried by the signals being sent to investors.

As a long term investor in a global portfolio of regulated utilities, Ontario Teachers' understands well the balance of risk and return necessary for a healthy regulatory regime. I am writing to highlight some of the areas where we believe real progress is needed to ensure that the final outcome attains that balance, and is consistent with Ofgem's indications early in the RIIO-GD1 process that a good-performing company should be able to earn a double digit RORE.

The overall package proposed to SGN is extremely demanding. Significant cuts have been imposed on our totex submission. The incentive package is weak. In addition, despite presenting the prospect of considerable volatility in returns including over a longer period, the financial package is significantly lower than in previous price control periods.

Beginning with totex, Ofgem's benchmarking and productivity assessment do not reflect regional factors specific to our networks. SGN's two networks operate under very different economic realities. Scotland is exposed to extreme weather. It also has a low population density and has customers that are spread out and further away from bigger cities. The effects of weather and sparsity need to be captured in assessing Scotland's costs against the other networks. Southern operates across London and the South East, where it contends with its own array of regional factors, including higher contractor and labour costs, urban pressures and unique customer expectations. We urge you to carefully consider these material differences in your final totex allowances for the two DNs.

In addition, the incentive package set out in Ofgem's Initial Proposals is disappointing, and we do not believe it will foster the level of innovation contemplated at the outset of RIIO. SGN has established an excellent track record on customer service, health and safety, and innovation. This track record has taken conscious effort to build and sustain. While, as shareholders, we will do our part to ensure that this trend continues, we believe that continued innovation will hinge on Ofgem offering a full suite of incentives with higher targets and greater opportunity to outperform. In order to better motivate and reward, incentives should be further enhanced to accrue fully to the Company over the eight year period by removing them from the IQL mechanism.

Finally, Ofgem's cost of capital proposal will negatively affect SGN's credit ratios, particularly in the short to medium term. We are concerned that the notional gearing proposed by Ofgem combined with increased expected cash flow risk will support only a BBB rating. Ofgem's proposed cost of debt index is inconsistent with this reality. We believe the cost of debt index needs to be based on a BBB rating.

We also reiterate that the cost of equity is inconsistent with the increased volatility of returns, not to mention other recent UK regulatory decisions.

Returns as currently proposed will be significantly lower and lasting over a longer time frame than we have experienced before. During the RII process, Ofgem has stated its willingness to offer real, double-digit returns for high-performing companies. We believe that the current package will not allow a high-performing company to achieve that level of return. In your final analysis, we ask you to please ensure that the overall package is in line with your stated commitment.

Yours sincerely,

A handwritten signature in dark ink, appearing to read 'S. Dowd', enclosed within a large, loopy oval shape.

Stephen Dowd  
SVP, Infrastructure

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