Public Service Pension Plan Account

AUDITORS' REPORT

To the President of the Treasury Board

We have audited the Balance Sheet of the Public Sector Pension Investment Board — Public Service Pension Plan Account (the "Public Service Pension Plan Account") as at March 31, 2007 and the Statements of Net Income and Accumulated Net Income from Operations and of Changes in Net Assets for the year then ended. These financial statements are the responsibility of the Public Sector Pension Investment Board's ("PSP Investments") management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Public Service Pension Plan Account as at March 31, 2007 and the results of its operations and changes in its net assets for the year then ended in accordance with Canadian generally accepted accounting principles. As required by the *Financial Administration Act*, we report that, in our opinion, these principles have been applied on a basis consistent with that of the preceding year.

Further, in our opinion, the transactions of the Public Service Pension Plan Account that have come to our notice during our audit of the financial statements have, in all significant respects, been in accordance with the applicable provisions of Part X of the *Financial Administration Act*, the *Public Sector Pension Investment Board Act* and regulations and the by-laws of PSP Investments and its wholly-owned subsidiaries.

The financial statements as at March 31, 2006 and for the year then ended were audited solely by Deloitte & Touche LLP who expressed an opinion without reservation on those statements in their report dated April 28, 2006.

Deloitte & Touche s.r.l.

Chartered Accountants
Licensed Public Accountants
Toronto, Canada
April 27, 2007

Sheila Fraser

Sheila Fraser, FCA
Auditor General of Canada
Ottawa, Canada
April 27, 2007

BALANCE SHEET

As at March 31 ($ millions)

	2007	2006
ASSETS		
Investments (Note 3)	**$ 26,156**	$ 20,991
Amounts due from pending trades (Note 3)	**1,185**	1,169
Other assets	**7**	4
Due from the Canadian Forces Pension Plan Account (Note 7 (a))	**2**	3
Due from the Royal Canadian Mounted Police Pension Plan Account (Note 7 (a))	**1**	1
TOTAL ASSETS	**$ 27,351**	$ 22,168
LIABILITIES		
Investment-related liabilities (Note 3)	**$ 1,914**	$ 2,145
Accounts payable and accrued liabilities	**27**	26
	1,941	2,171
NET ASSETS	**$ 25,410**	$ 19,997
Accumulated net income from operations	**$ 7,334**	$ 4,892
Accumulated fund transfers	**18,076**	15,105
NET ASSETS	**$ 25,410**	$ 19,997

Commitments (Note 11)

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

On behalf of the Board of Directors:

Paul Cantor
Chairman

Keith Martell
Director and Chair of the
Audit and Conflicts Committee

Public Service Pension Plan Account

STATEMENT OF NET INCOME AND ACCUMULATED NET INCOME FROM OPERATIONS

For the year ended March 31 ($ millions)

	2007	2006
INVESTMENT INCOME (Note 5)		
Interest and dividends	$ 743	$ 432
Net realized gains	1,597	1,735
Change in unrealized appreciation in value of investments	177	824
	2,517	2,991
EXPENSES		
Operating expenses (Note 7 (b))	38	28
External investment management fees	37	30
	75	58
NET INCOME FROM OPERATIONS	2,442	2,933
Accumulated net income from operations, beginning of year	4,892	1,959
Accumulated net income from operations, end of year	$ 7,334	$ 4,892

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

STATEMENT OF CHANGES IN NET ASSETS

For the year ended March 31 ($ millions)

	2007	2006
NET ASSETS, BEGINNING OF YEAR	$ 19,997	$ 13,976
Fund transfers (Note 4)	2,971	3,088
Net income from operations	2,442	2,933
Increase in net assets for the year	5,413	6,021
NET ASSETS, END OF YEAR	$ 25,410	$ 19,997

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

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2007

ORGANIZATION

The Public Sector Pension Investment Board ("PSP Investments") was formed pursuant to the *Public Sector Pension Investment Board Act* (the "*Act*") with a mandate to invest the contributions of the Public Service, Canadian Forces and Royal Canadian Mounted Police pension plans in financial markets.

The Public Service pension fund was established by amendments to the *Public Service Superannuation Act*, to receive contributions and make benefit payments in respect of member service after April 1, 2000. The net contributions are transferred, by the Public Service pension fund, to PSP Investments – Public Service Pension Plan Account for investment. PSP Investments maintains records of the pension fund's net contributions, as well as the allocation of its investments and the results of its operations in the plan account.

PSP Investments is responsible for managing amounts that are transferred to it in the best interests of the beneficiaries and contributors under the *Public Service Superannuation Act*. The amounts are to be invested with a view of achieving a maximum rate of return, without undue risk of loss, with regards to the funding, policies and requirements of the *Public Service Superannuation Act*.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

These financial statements present the financial position and operations of PSP Investments and its wholly-owned subsidiaries as they pertain to the investment of the net contributions transferred to it from the Public Service fund in respect of member service after April 1, 2000. Accordingly, they do not reflect all of the assets or the details of the pension contributions, payments and liabilities of the Public Service pension fund. The statements have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP") and the requirements of the *Act*.

Comparative figures have been reclassified to conform to the current year's presentation.

Valuation of Investments

Investments for each asset class are recorded as of the trade date and are stated at fair value. Fair value is an estimate of the amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act. Fair value of investments in pooled funds is based on unit values, which reflect the quoted market prices or other generally accepted pricing methodologies for the underlying securities.

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2007

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Valuation of Investments (continued)

Fair values of investments are determined as follows:

(a) Cash equivalent investments are recorded at cost, which, together with accrued interest income, approximates fair value.

(b) Market prices for equities and unit values for pooled funds are used to represent the fair value of these investments. Unit values reflect the quoted market prices of the underlying securities.

(c) Private equity and infrastructure investments, where quoted market prices are not available, are fair-valued annually. The fair value is determined by the external managers, management and/or third party appraisers using acceptable industry valuation methods.

In the first year of ownership, cost is generally considered to be an appropriate estimate of fair value for private equity and infrastructure investments unless there is an indication of permanent impairment of value.

(d) The fair value of investments in real estate is determined at least annually, using acceptable industry valuation methods, such as discounted cash flows and comparable transactions.

In the first year of ownership, cost is generally considered to be an appropriate estimate of fair value for real estate, unless there is an indication of permanent impairment of value.

Management may use the services of a third party appraiser to determine the fair value of real estate investments.

(e) Fixed income securities are valued at quoted market prices at the end of the year, where available. Where quoted market prices are not available, estimated values are calculated using either an appropriate interest rate curve with a spread associated with the credit quality of the issuer or other generally accepted pricing methodologies.

(f) All derivative financial instruments are recorded at fair value using market prices. Where quoted market prices are not available, appropriate valuation techniques are used to determine fair value.

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2007

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Income Recognition

The investment income has been allocated proportionately based on the asset value held by the Public Service Pension Plan Account ("The Plan").

Investment income is recorded on the accrual basis and represents realized gains and losses on the disposal of investments, change in unrealized appreciation (depreciation) on investments held at the end of the year, interest income, dividends and net operating income from private market real estate investments. These income items include the related distributions from pooled funds and limited partnerships.

Translation of Foreign Currencies

Transactions in foreign currencies are recorded at the rates of exchange prevailing on the transaction date. Investments denominated in foreign currencies and held at the end of the year are translated at exchange rates in effect at the year-end date. The resulting realized and unrealized gains and losses on foreign exchange are included in investment income.

Fund Transfers

Amounts received from the Public Service pension fund are recorded in its respective plan account.

Income Taxes

PSP Investments and certain of its subsidiaries are exempt from Part I tax under paragraph 149 (1) (d) of the *Income Tax Act* (Canada).

Use of Estimates

In preparing these financial statements, management must make certain estimates and assumptions which can affect the reported values of assets and liabilities, principally the valuation of investments, related income and expenses and note disclosures. Actual results may differ from estimates.

2. FUTURE ACCOUNTING CHANGES

In January 2005, the Canadian Institute of Chartered Accountants ("CICA") issued Section 3855 — Financial Instruments — Recognition and Measurement which will impact PSP Investments in its 2008 fiscal year.

The standard establishes criteria for the recognition, derecognition, measurement and classification of financial instruments. As an investment company, PSP Investments is largely exempt from this new standard, however, it will be required to measure the fair value of its market quoted securities using the bid price for long positions and the ask price for short positions. In addition, all transaction costs associated with its assets or liabilities are required to be recognized immediately in net income. The implementation of this standard is not expected to have a material impact on PSP Investments' financial statements.

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2007

3. INVESTMENTS

(a) Investment Portfolio

The investment portfolio, as at March 31, is as follows:

($ millions)	2007		2006	
Asset Class	**Fair Value**	**Cost**	Fair Value	Cost
Developed World Equity				
Canadian Equity	**$ 7,583**	**$ 6,589**	$ 6,893	$ 5,956
US Large Cap Equity	**1,653**	**1,513**	1,902	1,761
EAFE Large Cap Equity	**1,251**	**1,020**	2,340	1,894
Small Cap Developed World Equity	**2,143**	**1,946**	1,450	1,314
Emerging Markets Equity	**1,819**	**1,549**	1,407	1,105
Private Equity	**1,213**	**1,207**	218	222
Nominal Fixed Income				
Cash Equivalents	**281**	**281**	284	284
World Government Bonds	**1,217**	**1,241**	-	-
Canadian Fixed Income	**3,945**	**3,964**	3,799	3,849
Real Return Assets				
World Inflation-linked Bonds	**1,257**	**1,257**	305	279
Real Estate	**2,979**	**2,618**	1,413	1,345
Infrastructure	**348**	**334**	-	-
Absolute Return	**467**	**384**	980	891
INVESTMENTS	**$ 26,156**	**$ 23,903**	$ 20,991	$ 18,900
Investment-Related Assets				
Amounts due from pending trades	**$ 1,185**	**$ 1,166**	$ 1,169	$ 1,168
Investment-Related Liabilities				
Amounts payable from pending trades	**(1,020)**	**(1,019)**	(1,538)	(1,538)
Capital debt financing (Note 8)	**(365)**	**(365)**	(253)	(253)
Securities sold short	**(386)**	**(394)**	(225)	(223)
Derivative-related liabilities	**(143)**	**(43)**	(129)	(42)
Total investment-related liabilities	**(1,914)**	**(1,821)**	(2,145)	(2,056)
NET INVESTMENTS	**$ 25,427**	**$ 23,248**	$ 20,015	$ 18,012

Direct investments and derivative contracts are classified by asset-mix category based on the intent of the investment strategies of the underlying portfolio of PSP Investments.

In addition to the different asset classes outlined in the asset mix policy, PSP Investments employs a number of absolute return strategies to enhance returns by changing the investment asset mix, enhancing equity and fixed income portfolio returns and managing foreign currency exposures.

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2007

3. INVESTMENTS (continued)

(b) Derivative Financial Instruments

Derivative financial instruments are financial contracts, the value of which is derived from changes in underlying assets, interest or exchange rates. PSP Investments uses derivative financial instruments to enhance returns or to replicate investments synthetically. Derivatives are also used to reduce the risk associated with existing investments.

Notional values are not recorded as assets and liabilities as they represent the face amount of the contract to which a rate or price is applied in order to calculate the exchange of cash flows. Notional values do not represent the potential gain or loss associated with the market or credit risk of such transactions. Rather, it serves as the basis upon which the returns from, and the fair value of the contracts, are determined.

PSP Investments writes credit default derivatives and, hence, indirectly guarantees the underlying reference obligations. The maximum potential exposure is the notional amount of written credit default derivatives as shown in the table below. No payments related to written credit default derivatives have been made to date.

The following table summarizes the derivatives portfolio as at March 31:

($ millions)		**2007**		2006	
INVESTMENTS		**Notional Value**	**Fair Value**	Notional Value	Fair Value
Equity Derivatives					
Futures		**$ 1,252**	**$ 4**	$ 701	$ 9
Swaps		**3,148**	**37**	1,613	34
Warrants		**33**	**5**	-	-
Options:	Listed-purchased	**69**	**1**	-	-
	Listed-written	**89**	**(2)**	16	(2)
	OTC-purchased [1]	**534**	**53**	737	189
	OTC-written	**80**	**(2)**	460	(15)
Variance Swaps		**499**	**(2)**	493	(1)
Currency Derivatives					
Forwards		**8,133**	**-**	3,352	(23)
Swaps		**526**	**(9)**	-	-
Options:	OTC-purchased	**633**	**6**	242	3
	OTC-written	**99**	**-**	105	(2)
Interest Rate Derivatives					
Bond forwards		**1,553**	**6**	2,490	-
Futures		**425**	**-**	1,237	1
Swaps		**1,410**	**5**	5,155	2
Swaptions		**-**	**-**	2,269	(3)
Options:	Listed-purchased	**369**	**2**	2,586	6
	Listed-written	**369**	**(2)**	6,127	(3)
Inflation Swaps		**142**	**-**	-	-
Total Return Swaps		**1,760**	**(12)**	-	-
Credit Default Derivatives					
Swaps:	Purchased	**50**	**6**	50	19
	Written	**1,071**	**(23)**	2,188	(20)
		$ 22,244	**$ 73**	$ 29,821	$ 194

[1] The fair value of certain options excludes all cash, if any, that may have been deposited with a counterparty.

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2007

3. INVESTMENTS (continued)

(b) Derivative Financial Instruments (continued)

The fair value of derivative contracts, as at March 31, is represented by:

($ millions)	2007	2006
Derivative-related receivables	$ 216	$ 323
Derivative-related liabilities	(143)	(129)
	$ 73	$ 194

The derivative-related receivables are included as part of the fair value of each respective asset class in the investment portfolio.

The term to maturity based on notional value for the derivatives is as follows:

($ millions)	2007	2006
Under 1 year	$ 17,678	$ 19,094
1 to 5 years	3,362	8,063
Over 5 years	1,204	2,664
	$ 22,244	$ 29,821

(c) Investment Asset Mix

PSP Investments has established a Statement of Investment Policies, Standards and Procedures (“SIP&P”). The SIP&P sets out the manner in which the assets shall be invested for the Plan.

The investment asset mix, as set out in the SIP&P, as at March 31, is as follows:

	2007		2006	
	Actual Asset Mix	Policy Portfolio	Actual Asset Mix	Policy Portfolio
Equities	61.9 %	62.0 %	70.2 %	62.0 %
Fixed Income	21.6	15.0	22.4	15.0
Real Return Assets	16.5	23.0	7.4	23.0
	100.0 %	100.0 %	100.0 %	100.0 %

Differences between the actual asset mix and the policy portfolio targets are due principally to target weights of certain asset classes which have yet to be attained. For instance, real return assets include infrastructure assets with a policy portfolio target weight of 8.0% and an actual asset weight of only 1.4%.

NOTES TO THE FINANCIAL STATEMENTS
For the year ended March 31, 2007

3. INVESTMENTS (continued)

(d) Foreign Currency Risk
PSP Investments and its subsidiaries are exposed to currency risk through holdings of securities, units in pooled funds and units in limited partnerships of non-Canadian assets where investment values will fluctuate due to changes in foreign exchange rates. To mitigate this risk, PSP Investments may take, through derivative contracts, positions in foreign currencies.

The underlying net foreign currency exposures, as at March 31, were as follows:

	2007		2006	
Currency	**Fair Value**	**% of Total**	Fair Value	% of Total
(in Canadian $)	($ millions)		($ millions)	
US Dollar	**$ 4,529**	**53.7 %**	$ 4,201	57.0 %
Euro	**1,479**	**17.5**	1,141	15.4
British Pound	**585**	**6.9**	487	6.6
Yen	**512**	**6.1**	669	9.1
Australian Dollar	**314**	**3.7**	228	3.1
Korean Won	**241**	**2.8**	128	1.7
Other	**782**	**9.3**	523	7.1
	$ 8,442	**100.0 %**	$ 7,377	100.0 %

PSP Investments and its subsidiaries also have commitments, denominated in foreign currencies, in real estate, private equity and infrastructure investments for an amount of $4,214 million ($2,391 million US, €885 million and £43 million) which are not included in the foreign currency exposure table above.

(e) Credit Risk
PSP Investments is exposed to the risk that a debt securities issuer could be unable to meet its financial obligation or that a derivative counterparty could default or become insolvent.

As at March 31, 2007, the Plan's highest concentration of credit risk is with the Government of Canada through holdings of $1.5 billion of Government of Canada issued securities. In order to minimize derivative contract credit risk, PSP Investments deals only with counterparties that are major financial institutions with a minimum credit rating of "A", as supported by a recognized credit rating agency.

(f) Market Risk
Market risk is the risk that the value of an investment will fluctuate as a result of changes in market prices, whether those changes are caused by factors specific to the individual investment or factors affecting all securities traded in the market. PSP Investments has a diversification strategy to mitigate this risk whereby it invests in a diversified portfolio of investments based on the criteria established in its SIP&P and uses derivative financial instruments to mitigate the impact of market risk.

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2007

3. INVESTMENTS (continued)

(g) Interest Rate Risk

Interest rate risk refers to the effect on the market value of PSP Investments' net asset value due to fluctuations in interest rates. Changes in interest rates will directly affect the fair value of PSP Investments' assets.

As at March 31, 2007, the fixed income asset class was managed with an average duration of 5.7 years. An increase of 1% in interest rates would result in a decline in the value of the fixed income securities of 5.7%, or $227 million.

The terms to maturity of the bonds held in the Canadian fixed income asset class, as at March 31, 2007, are as follows:

	TERMS TO MATURITY					
($ millions)	Within 1 Year	1 to 5 Years	6 to 10 Years	Over 10 Years	2007 Total	2006 Total
Government of Canada bonds	$ 181	$ 751	$ 295	$ 372	$ 1,599	$ 1,306
Provincial and Territorial bonds	1	418	232	462	1,113	954
Municipal bonds	9	46	9	5	69	69
Corporate bonds	33	509	392	230	1,164	1,494
Total	$ 224	$1,724	$ 928	$1,069	$ 3,945	$ 3,823

(h) Securities Lending

The Plan participates in securities lending programs whereby it lends securities in order to enhance portfolio returns. Any such securities lending requires collateral in cash, high quality debt instruments or shares securities with a fair value equal to no less than 102% of the value of the securities lent. As at March 31, 2007, securities with an estimated fair value of $3,075 million (2006 – $2,164 million) were loaned out, while securities contractually receivable as collateral had an estimated fair value of $3,213 million (2006 – $2,281 million).

(i) Securities Collateral

The Plan deposited or pledged securities with a fair value of $71 million as collateral (2006 – $64 million) with various financial institutions. Securities with a fair value of $342 million (2006 – nil) have been received from various financial institutions as collateral.

3. INVESTMENTS (continued)

(j) Private Market Investments

PSP Investments' Real Estate asset class is comprised of investments which are owned by either PSP Investments or its wholly-owned subsidiaries and managed by general partners or external advisors. The underlying investments comprise a diversified portfolio of income-producing properties, third party loans and public and private funds. The real estate asset class is accounted for in the investment portfolio net of all financings. The fair market value of financings in the real estate portfolio generally will not exceed 50% of the gross fair market value of the portfolio.

PSP Investments' Private Equity asset class is comprised of interests in limited partnerships and in funds which are managed by general partners and investments which are owned by either PSP Investments or its wholly-owned subsidiaries. The underlying investments represent equity ownerships or investments with the risk and return characteristics of equity.

PSP Investments' Infrastructure asset class is comprised of investments which are owned by either PSP Investments or its wholly-owned subsidiaries and managed by general partners or external advisors. The underlying investments comprise a diversified portfolio of infrastructure assets and publicly-traded securities. Investment management and performance incentive fees are generally incurred for the above private market investments and are paid through capital contributions or investment income.

Investment management fees in private market investments generally vary between 0.2% and 5.5% of the total invested amount. During the year ended March 31, 2007, management and performance incentive fees of $177 million (2006 – $48 million) were recorded as part of the cost of the private market investments or against investment income.

The carrying values of these investments, as disclosed in Note 1, are reviewed annually and any resulting adjustments are reflected as unrealized gains or losses in investment income.

4. FUND TRANSFERS

During the year, PSP Investments received fund transfers of $2,971 million (2006 – $3,088 million) from the Public Service pension fund. The transfers received are comprised of net employer and employee contributions to the Public Service pension plan in respect of member service after April 1, 2000.

Public Service Pension Plan Account

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2007

5. INVESTMENT INCOME

(a) Investment Income

Investment income, before allocating net realized and unrealized gains on investments, is as follows:

($ millions)	2007	2006
Interest income	$ 333	$ 200
Dividend income	220	152
Other income	186	78
Security lending income	4	2
	743	432
Net realized gains	1,597	1,735
Net unrealized gains	177	824
Net investment income	$ 2,517	$ 2,991

(b) Investment Income by Asset Mix

Investment income by asset mix, after allocating net realized and unrealized gains and losses on investments, is as follows:

($ millions)	2007	2006
Developed World Equity		
Canadian Equity	$ 943	$ 1,504
US Large Cap Equity	166	163
EAFE Large Cap Equity	343	393
Small Cap Developed World	95	160
Emerging Markets Equity	283	357
Private Equity	(3)	1
Nominal Fixed Income		
Cash Equivalents	16	6
World Government Bonds	(32)	-
Canadian Fixed Income	206	166
Real Return Assets		
World Inflation-linked Bonds	(20)	26
Real Estate	473	155
Infrastructure	13	-
Absolute Return	34	60
Net investment income	$ 2,517	$ 2,991

Investment income includes a foreign currency realized loss of $95 million (2006 – $2 million) and a foreign currency unrealized gain of $322 million (2006 – $36 million).

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2007

6. INVESTMENT PERFORMANCE

Portfolio and benchmark returns, for the year ended March 31, are as follows:

	2007		2006	
	Portfolio Returns	**Benchmark Returns**	Portfolio Returns	Benchmark Returns
Developed World Equity				
Canadian Equity	**14.3 %**	**14.2 %**	28.8 %	28.7 %
US Large Cap Equity	**8.7 %**	**10.6 %**	9.5 %	7.7 %
EAFE Large Cap Equity	**16.6 %**	**18.9 %**	20.8 %	20.0 %
Small Cap Developed World	**5.5 %**	**6.1 %**	18.6 %	19.3 %
Emerging Markets Equity	**18.8 %**	**19.3 %**	39.6 %	42.6 %
Private Equity	**(0.6) %**	**(0.6) %**	0.6 %	0.6 %
Nominal Fixed Income				
Cash Equivalents	**4.2 %**	**4.2 %**	2.7 %	2.8 %
World Government Bonds	**(1.5) %**	**(1.5) %**	n.a.	n.a.
Canadian Fixed Income	**5.4 %**	**5.5 %**	4.7 %	4.9 %
Real Return Assets				
World Inflation-linked Bonds	**(1.4) %**	**(1.6) %**	10.9 %	11.8 %
Real Estate	**36.5 %**	**6.7 %**	21.6 %	8.3 %
Infrastructure	**5.5 %**	**5.5 %**	n.a.	n.a.
Total Return	**11.3 %**	**10.1 %**	19.1 %	18.0 %

Returns have been calculated in accordance with the performance calculation methodology recommended by the CFA Institute.

PSP Investments has identified relevant benchmarking for each asset class. The asset class benchmark returns are used in evaluating the relative performance of each asset class.

The total benchmark return aggregates the asset class benchmark returns according to the weights under the actual asset mix. The return of the private equity and infrastructure asset class is not being measured against any benchmark during the ramp-up period as disclosed in PSP Investments' SIP&P. However, for purposes of calculating the total 2007 and 2006 benchmark returns, the actual private equity portfolio returns of (0.6)% and 0.6%, respectively, are used. Similarly, the actual infrastructure portfolio return of 5.5% was used in calculating the total 2007 benchmark return.

The total portfolio return includes the performance impact of absolute return strategies. Hedging investment returns are either netted against the return of the respective hedged assets, as is the case with private asset classes, or included in total return, as in the case of public markets.

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2007

7. EXPENSES

(a) Allocation of Expenses

The *Act* requires that the costs of operation of PSP Investments be charged to the three plans for which it provides investment services. Under section 4(3) of the *Act*, the President of the Treasury Board shall determine to which plan account these costs will be charged, in consultation with the Minister of National Defence and the Minister of Public Safety. An allocation policy has been developed which allocates the direct costs of investment activities, such as external investment management fees and custodial fees, to each plan account, based upon the asset value of each plan account at the time the expense was incurred.

All other operating expenses, excluding the direct cost of investment activities listed above, for the year ended March 31, have been allocated as follows:

	2007	2006
Public Service Pension Plan Account	**72.4 %**	72.2 %
Canadian Forces Pension Plan Account	**20.4**	20.5
Royal Canadian Mounted Police Pension Plan Account	**7.2**	7.3
	100.0 %	100.0 %

Expenses are financed by the Public Service Pension Plan Account which is reimbursed by the other plan accounts on a quarterly basis.

(b) Operating Expenses

Operating expenses consist of the following:

($ thousands)	**2007**	2006
Salaries and benefits	**$ 20,576**	$ 16,328
Professional and consulting fees	**6,533**	3,971
Office supplies and equipment	**4,120**	2,661
Other operating expenses	**2,219**	2,072
Occupancy costs	**1,313**	905
Custodial fees	**1,189**	1,041
Depreciation of fixed assets	**1,101**	755
Remuneration earned by Directors	**520**	422
Travel and related expenses for Directors	**127**	92
Communication expenses	**86**	99
	$ 37,784	$ 28,346

8. PSP CAPITAL INC.

As of March 31, 2007, PSP Capital Inc., a wholly-owned subsidiary of PSP Investments, has $503 million of short-term promissory notes outstanding with maturity dates within 60 to 90 days of issuance of which $365 million has been allocated to the Plan and included in Note 3 (a) as an investment-related liability. The capital raised was used primarily to finance real estate investments and is unconditionally and irrevocably guaranteed by PSP Investments.

Interest expense on short-term promissory notes was $17 million for the year ended March 31, 2007 (2006 – $3 million).

The operating expenses incurred by PSP Capital Inc. were allocated to each plan account as described in Note 7 (a) and include interest expense on the short-term promissory notes of $13 million.

9. SIGNIFICANT REAL ESTATE ACQUISITION

In the last quarter of the fiscal year, PSP Investments, through its wholly-owned subsidiary PSPIB Destiny Inc., acquired all of the issued and outstanding units of Retirement Residences Real Estate Investments Trust ("Retirement REIT") for a total cash consideration of $795 million. Subsequently, PSP Investments advanced an amount of $445 million to refinance the debt of Retirement REIT.

The estimated fair value of assets and liabilities, as at March 31, 2007, allocated to the Plan, is as follows:

($ millions)

Fair value of assets	
Properties	$ 1,950
Other assets	574
	2,524
Less fair value of liabilities	
Current liabilities	(220)
Mortgages payable and other long term liabilities	(1,411)
	(1,631)
Net investments in Retirement REIT	**$ 893**

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2007

10. GUARANTEES AND INDEMNITY

PSP Investments provides indemnification to its Directors. As a result, PSP Investments may be required to compensate, without limitation but subject to the *Act*, these parties for costs incurred, such as claims, actions or litigations. This indemnity is explicitly declared to be in excess and in addition to any indemnity of any policy of insurance purchased and maintained by PSP Investments under subsection 18(1) of the *Act*. To date, PSP Investments has not received any claims nor made any payment for such indemnity.

In 2007, as part of an investment transaction, PSP Investments guaranteed a letter of credit facility. The beneficiaries of this letter of credit facility have the ability to draw against this facility to the extent that the contractual obligations, as defined in the related agreement, are not met. As at March 31, 2007, the maximum exposure of the Plan was $9 million.

During the fiscal year, PSP Investments agreed to guarantee, as part of an investment transaction, a non-revolving term loan. In the event of a default, the Plan would assume the obligation up to $294 million plus interest and other related costs. PSP Investments also unconditionally and irrevocably guarantees all short-term promissory notes issued by its wholly-owned subsidiary, PSP Capital Inc.

11. COMMITMENTS

PSP Investments and its subsidiaries have committed to enter into investments transactions, which will be funded over the next several years in accordance with agreed terms and conditions. As of March 31, 2007, the outstanding commitments in private equity-related, real estate-related and infrastructure-related investments allocable to the Plan amounted to $4,465 million ($3,626 million for private equity investments, $677 million for real estate related investments and $162 million for infrastructure investments).

During 2007, PSP Investments entered into a Purchase and Sale agreement (the "Agreement") to acquire an investment for $585 million. The amount that will be allocated to the Plan will approximate $427 million. As at March 31, 2007 completion of the transaction was pending satisfaction of certain conditions in the Agreement, which included receiving consent from regulatory authorities. The transaction is expected to be completed in fiscal year 2008.