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Dear Akshay,

I am writing on behalf of PPL Corporation ("PPL"), the ultimate parent of the four Western Power Distribution ("WPD") electricity distribution network operators ("DNOs"), in response to Ofgem's 6 August 2019, RIIO-ED2 Open Letter Consultation. While none of our previously expressed views[1] have changed, PPL appreciates the opportunity to respond to Ofgem's first RIIO-2 consultation centered solely on electricity distribution. WPD, as the network operator, is comprehensively responding to the consultation questions in a separate correspondence.

PPL's Response to Ofgem's Open Letter Consultation on approach to setting the next electricity distribution price control (RIIO-ED2)

The next electricity distribution price control will commence at a time when the energy sector is experiencing revolutionary changes as the U.K. moves toward a more sustainable, low carbon energy system that supports clean economic growth. PPL and WPD welcome the opportunity to support these initiatives as DNOs are essential in helping transition the U.K. to a net-zero carbon emitting economy.

PPL believes that there is strong evidence that RIIO-ED1 has performed well to date and is largely on course to meet its objectives. Consumers are receiving high levels of service and performance in RIIO-ED1. Ofgem's 2017-2018 Annual Report highlights that during the first three years of RIIO-ED1, DNOs have continued to invest in their networks and have improved reliability to around 99.99% with an average 11% decrease in the number of customer interruptions and a 9% reduction in the duration of interruptions[2]. Furthermore, DNOs have improved customer service, earning an industry average score of 8.7 out of 10[3]. These results have led to incentive rewards and are the primary driver for DNO's outperformance above base returns. This is in contrast to the gas distribution and electric transmission sectors, whose overall RIIO-1 outperformance above base returns is largely driven by Totex underspend (12%

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[1] PPL's Response to Ofgem's Consultation on the RIIO-2 Framework, 2 May 2018; PPL's Response to Ofgem's RIIO-2 Sector Specific Methodology Consultation, 14 March 2019
[2] "RIIO-ED1 Annual Report 2017-2018", *Ofgem*, March 2019, para 2.7
[3] "RIIO-ED1 Annual Report 2017-2018", *Ofgem*, March 2019, para 2.13

and 10%, respectively[4]). DNOs are currently projecting to underspend their Totex allowances by 5%[4]. However, this level of underspend is largely driven by UKPN. When excluding UKPN, total expenditure across all DNOs is only 2%[4] below allowed expenditures. This demonstrates that improvements were already incorporated into the RIIO-ED1 framework, which included significant stakeholder engagement, and, as such, the focus on RIIO-ED2 should be to build upon and refine the RIIO-ED1 framework where needed.

In order to fund the electrification initiatives that will play a crucial role in achieving the government's target of net-zero carbon emissions by 2050, it is critical that the next electricity distribution price control attracts and sustains the necessary investor financing by offering fair returns. Ofgem has a statutory duty to ensure license holders are able to finance their regulated activities and recover efficiently incurred costs. However, after the publication of the RIIO-ED2 Open Letter, our concerns around financeability remain. These concerns were also echoed recently by Moody's Investor Services[5].

WPD has seen significant under performance to date against the RIIO-ED1 cost of debt allowance, based on the 10-year trailing iBoxx index, and expects this to continue for the remainder of the price control period. In order to prevent this under recovery from reoccurring in RIIO-ED2, Ofgem should utilize a trailing average period, which is reflective of efficiently issued historical debt. Additionally, Ofgem should be mindful of the weightings they use between the iBoxx non-financials A and non-financials BBB bond indices, with greater weighting to the BBB index, if the RIIO-ED2 settlement causes financeability issues and negatively impacts credit ratings, as Moody's Investor Services has indicated is a possibility[5]. In a well calibrated price control there should not be over/under recovery of prudent and efficiently issued debt financing costs.

The cost of equity is a forward-looking concept and must appropriately capture all measures of risk borne by investors. Like Ofgem, PPL and WPD expect that the electricity distribution networks will see the greatest impact out of all the energy sectors arising from the forces of decarbonization and electrification, decentralization and digitalization[6]. These impacts increase uncertainty and put DNOs at a higher risk of volatility due to government policy; therefore, it is inappropriate to assume the same financing parameters being proposed in the impending gas distribution and electricity and gas transmission sectors' price controls. Since Ofgem has been emphasizing the volatility of the rapidly changing energy sector, it should account for this changing risk profile and reward/incentivize DNOs accordingly when setting allowed returns. Additionally, the continued uncertainty of Brexit and the Labour Party's plans to renationalize the energy sector have resulted in a higher risk exposure for investors. Ofgem's base allowed cost of equity and targeted RoRE ranges must provide adequate risk adjusted compensation in order to attract the sector-required equity investment needed to meet consumer needs and to achieve government net-zero carbon emissions initiatives.

When equity investors commit their capital, they are seeking risk adjusted returns on their investments. However, Ofgem's proposal to assume 50-basis points of outperformance will

[4] Supporting data file to "Regulatory financial performance annex to RIIO-1 Annual Reports - 2017-18, *Ofgem*, 8 March 2019
[5] "Regulated water utilities & energy networks – UK, Rock of low returns meets hard place of covenants", *Moody's Investors Service*, 8 October 2019
[6] "RIIO-ED2 Open Letter", *Ofgem*, 6 August 2019, pp. 5

result in setting the base allowed return on equity below required returns thus increasing the investment risk and in turn the return requirement. The rationale for this adjustment seems to be based on historical outperformance and concerns about companies earning outsized returns, but several of Ofgem's currently proposed positions (shortening the price control, indexation of the cost of equity and uncertain costs, treatment of anticipatory investments, the Totex Incentive mechanism, setting incentive rates using a confidence-dependent incentive rate approach, return adjustment mechanisms, etc.) are aimed at preventing this. Therefore, including an arbitrary adjustment that sets the allowed base rate return below the investors hurdle rate disrupts the risk return balance.

We do not believe that outperformance driven by incentive rewards should be viewed negatively as all stakeholders' benefit. RIIO-ED1 incentives continue to deliver service quality improvements as customers are receiving high levels of service and performance. As such, RIIO-ED2 should build on the success of RIIO-ED1. Like WPD, we have significant concerns with Ofgem's current incentive package proposals because it currently lacks detail and appears to be weighted toward the downside. As mentioned in our previous responses, it is imperative that the incentive scheme in RIIO-ED2 drives both innovation and outputs that create long-term value for consumers and enables frontier performers to earn strong RoREs for that frontier performance. RIIO-ED1 has been effective, overall, in achieving these results.

As discussed in our prior response to the gas and transmission subsector consultation[7], we continue to engage regularly with investors regarding regulatory developments across all of our operating jurisdictions. The narrative from investors has not changed significantly since our last formal response in March. These investors continue to highlight the increased perceived risk to U.K. networks under the currently proposed framework for the electricity transmission and gas network companies and the RIIO-ED2 Open Letter, as well as the current political environment. There is clear evidence of these concerns when comparing the stock price performance of companies with significant U.K. network ownership to alternative infrastructure investments in more stable regulatory jurisdictions. For example, stocks predominantly weighted in U.K. utilities have underperformed U.S. utility stocks on average by about ten percent to date in 2019.

We continue to hear from investors that the proposed U.K. regulatory scheme for RIIO-2 has introduced incremental risks for investors, including often pointing out the additional risk created by the proposal to adopt a subjective wedge between expected and allowed returns. Investors also highlight that current proposals lack a clear signal of what return potential exists for top performing companies and that U.K. investments are less stable given the current political and regulatory climate. They note that these risks are not being adequately reflected or recognized in the proposed returns, particularly when considering the incremental risks associated with the investment required to enable the future development of the U.K.'s evolving electricity infrastructure.

We have continued to relay Ofgem's message that investors should not "read through" to what is being reflected in the other subsector reviews for electricity distribution; however, that message continues to be disregarded in large part, as evidenced by PPL's relative stock

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[7] PPL's Response to Ofgem's RIIO-2 Sector Specific Methodology Consultation, 14 March 2019

performance. Investors note that there are a number of investment alternatives with higher and more transparent returns than the current RIIO-2 proposals. As such, investors continue to suggest that we consider reallocating capital to our other business segments in the event that the RIIO-ED2 outcome does not meet their return requirements. As we have discussed with Ofgem, we will deliver on our commitments as we have always done, including providing best-in-class reliability, customer service and innovation to deliver the U.K.'s decarbonization initiatives.

PPL and WPD want to help lead the U.K.'s effort in transitioning to a low carbon economy in a way that is still affordable to consumers and provides fair and reasonable returns for the sector. It is our belief that Ofgem can achieve these results with minor adjustments to RIIO-ED1. We continue to look forward to our ongoing engagement as we strive to achieve the best outcome for all stakeholders in RIIO-ED2.

Sincerely,

William H. Spence
PPL Chairman and CEO