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03/14/2019

Ofgem
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Ladies and gentlemen of Ofgem:

Zimmer Partners, LP is among the largest dedicated utility investors in the world. We have been long-time investors in the UK Regional Electricity Companies beginning with the early 1990s privatization. We are currently among the largest investors in four UK RECs, Midlands, East Midlands, South Wales, and South West through WPD's parent PPL. In addition, we own stakes in National Grid, and SSE. We have grave concerns about the shape that RIIO 2 is taking and felt that it would be appropriate to voice those concerns to you, and to inform you that if these measures were implemented as drafted we would likely be forced pull our capital out of UK Utilities and reinvest the capital in different countries with supportive regulation. We recognize that the proposals that have been released thus far do not impact distribution companies, but for the investment community, past is often prologue. The outcome of the transmission and gas cases will ultimately send a strong signal to the markets of how we should expect distribution to be treated.

The proposed returns in the transmission and gas cases appear far too low to justify further investment in your country.

In the United States and Europe, there are many options to invest capital in a stable regulatory framework that allows companies to earn 9%+ regulated returns. We view 9% as the minimum acceptable return threshold for us to keep our capital in the UK. Anything below 9% and we will begin an active campaign to stop PPL from investing further into its UK distribution assets. It simply does not make sense for PPL to employ capital into a 5-7% return regime when its implied cost of equity exceeds 9%, especially given that all the saber rattling about tighter price controls and nationalization that we are forced to endure so many years before the review even takes place. In the United States, the Constitution protects investors from a government seizing control of investments or unfairly cutting regulated returns on the basis of the shift in political winds. No such protection exists in the UK, which makes the UK an inherently risker place to do business, implying it needs higher gross ROEs than what regulators authorize for utilities in the US. Furthermore we find it alarming that the proposed return for the energy sector is roughly in line with what is proposed by OFWAT for water utilities which objectively have a considerably lower risk profile.

We are only halfway through the regulatory period but the constant noise about punishing investors with lower returns has significantly increased the cost of capital of UK Networks operators.

Investing in a utility is unique relative to most other stocks. It requires not just faith in management and a strategic vision, but also in the institutions that govern the regulation. For many years, we viewed UK regulation as a constructive framework. We felt that it offered a fair balance of incentives for top performing distribution companies to earn above average returns by outperforming their peers. However, there is no point in having a multi-year regulatory cycle if halfway through the cycle you disrupt the perception of the framework by communicating that you intend to upend the entire regulatory regime in the future. Public markets have low tolerance for uncertainty and therefore price capital accordingly. The noise has significantly damaged the cost of capital for the utilities that you regulate.

Brexit uncertainty has made the UK capital markets one of the least attractive capital markets in the world right now.

We understand there is little that can be done about this from Ofgem's perspective, but flag it as a risk that weighs on the minds of investors before they consider allocating capital to your regime. Risk must be commensurate with reward. If returns are below average on top of a bad macro backdrop, many UK utility investors will simply find another place to put their money.

Labour Party's threat of nationalization of utilities has significantly increased the risk of investing in UK Utilities .

The potential for nationalization of utilities is a terrifying prospect for investors. Unlike our investments in the United States, there is not a well-established constitutional protection in the United Kingdom that necessarily prevents government from seizing assets without paying fair market based compensation for those assets. If this is not something that you have considered in your assessment of the risk of investing in your regime, we would encourage you to do so. It is our belief that this risk has been one of the key drivers of pushing up the real cost of capital for these companies. There have been countless broker research notes on the topic and it weighs heavily on the minds of investors. The threat of nationalization is one of the key considerations for many investors who have chosen to avoid investing in these companies. It is already choking off access to certain pools of capital. Once again, this is an example of why UK nominal ROEs should be higher than those of the US, not lower.

The less predictable nature of the incentives and penalty structures in the UK make the return framework more volatile than in other jurisdictions .

The Ofgem return framework is also highly unpredictable. Investors have no way of forecasting the incentive pools of revenue or how their companies are performing through the regulatory period as it stands. Investors are now in the terrible position of trying to understand exactly how you intend to start cutting those pools of revenue many years from now. While we applaud the framework's ability to incentivize value added behavior and recognize that most companies outperformed, a tightening of the incentives for these frameworks coupled with the unpredictable nature of the results make it impossible for investors to properly price the value of these frameworks. This results in less transparency of future returns, and therefore more expensive capital for UK operators. In the

UK water sector, the path to incentive awards is a lot less opaque and the upside opportunity is largely uncapped motivating companies to strive for the best quality of service for customers.

Pushing companies to the cusp on their credit ratings is harmful to cost of capital

The entire concept of backstopping the debt with a government guarantee in exchange for slashing cash flow to equity is one of the most egregiously punitive and misguided regulatory mechanisms we have seen proposed in our three decades in this business. S&P and Moody's will probably agree with this if you ask them. Whenever a regulator puts a mechanism in place that appears to be there simply to ensure they can inflict the maximum amount of punishment to a company without sending the ratings to sub investment grade, it betrays just how punitive the regulatory compact is (we are currently observing a similar proposal in California and S&P shared this view). If you were to move ahead with such a proposal, it would undoubtedly harm the cost of capital of your regulated companies.

We hope these points will be received as constructive feedback, so you may consider the point of view of the investors capitalizing your countries utility industry. We would like to continue to support UK energy infrastructure through a mutually beneficial regulatory compact and understand that the role of a good regulator is to balance the interests of all interested parties.

Thank you for your time and consideration,

Sincerely,

Stuart J. Zimmer
CEO
Zimmer Partners, LP