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James Veaney
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Dear Mr. Veaney,

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 consultation on the RIIO-2 framework. PPL appreciates the opportunity to express our views on key aspects of the framework that we believe are critical to continue to attract the financing necessary for long-term investment in the U.K. electricity distribution sector. In a separate response, WPD is comprehensively addressing the consultation questions and proposals including important topics such as improving customer engagement, taking a whole system approach, the scope of market competition and the length of the price control.

PPL's Response to Ofgem's Consultation on the RIIO-2 Framework

Like WPD, we believe that RIIO-ED1 has performed well so far and is largely on course to meet its objectives and deliver positive outcomes for consumers. As such, the focus for RIIO-2 should be to build upon and refine the RIIO-ED1 framework where needed. We view the following components as essential for attracting and sustaining the investor financing necessary to fund initiatives that will deliver customer desired outputs.

<u>Cost of Debt</u>

While we agree with the principles Ofgem proposes to guide the cost of debt setting methodology for RIIO-2, we do not believe the cost of debt indexation mechanism adopted for WPD in RIIO-ED1 has been successful. The 10-year trailing average of the benchmark iBoxx index employed in RIIO-ED1 has resulted in an under-recovery of real interest costs that is projected to be in excess of £200M[1] (nominal prices) over the duration of RIIO-ED1. Therefore, we believe a re-calibration of the RIIO-1 indexation policy is needed. If this cannot be done in a manner that successfully meets the objective of allowing companies to recover the cost of

[1] WPD's Response to Ofgem's Consultation on Mid-Period Review, 1 February 2018, Annex 2 - Table A2.2.

financing their activities, then a pass through allowance for debt should be further considered. We also note that RoRE calculations should include the impact of cost of debt recovery because equity returns can be under or over stated based on the effectiveness of the interest recovery mechanism.

Cost of Equity

While we acknowledge RIIO-ED2 does not begin until 2023, and therefore that it is premature to debate specific values for cost of equity assumptions, we have significant concerns over the impact of the currently proposed reduction in the regulatory cost of equity to 3%-5%. We believe that the estimate should be significantly higher because the proposed range understates the baseline return needed to attract and retain equity financing into the sector, and is likely to create financeability issues for regulated companies.

As demonstrated in a report by NERA (included in WPD's response), CEPA understated the total market return and beta components of the Capital Asset Pricing Model ("CAPM") in its calculations of plausible ranges for the real cost of equity based on current market conditions. Understating the cost of equity is likely to cause credit metrics to deteriorate. Moreover, addressing financeability issues by bringing forward cash flows does not resolve the underlying issue and will probably not be recognized by rating agencies. Ofgem should revisit CEPA's analysis on the cost of equity and evaluate the level of notional gearing to ensure industry financeability.

It should be possible to establish a reasonable cost of equity allowance for the duration of the RIIO-ED2 price control period. Doing so would make the indexation of the cost of equity unnecessary and avoid the greater price volatility it would introduce to consumers. While individual components of the cost of equity calculation fluctuate, evidence shows that risk-free rates and equity risk premiums are negatively correlated – resulting in lower volatility for the overall cost of equity. If this and other long-observed evidence and averages will not be taken into account in the cost of equity calculation, and, in particular, if the calculation would assume that negative real risk-free rates persist for the duration of RIIO-ED2, then an indexation mechanism should be further considered.

Incentives

A hallmark of the U.K. regulatory model is setting revenue using incentives and penalties to deliver innovation and outputs that create long-term value for consumers. Performance-based ratemaking is one of the reasons why investors view the U.K. as a premium regulatory jurisdiction and choose to invest capital in the sector – despite the additional risk compared to the cost-of-service model in the United States. We believe the use of incentives in the RIIO-ED1 framework has thus far worked well and has been effective in driving innovation and efficiencies while providing consumers better service at lower costs. RIIO-2 should continue to use incentives to further drive these successful outcomes.

We also believe that incentives should continue to be based on absolute targets set at the beginning of the price control so that companies know exactly what they are working towards. It will be difficult for companies to make effective resource decisions if there is the potential for targets to be recalibrated during the price control. In addition, incorporating adjustment mechanisms to targets would add unnecessary complexity to the U.K. regulatory model – making the regulation more difficult for license holders, consumers and investors.

When setting absolute targets, Ofgem should take into account more than just historical performance. It should establish premier-level performance targets for companies to achieve. Those companies that perform well should be rewarded and those that do not perform well should be penalized.

We disagree with a shift towards incentives based on relative performance, such as a fixed incentive pot or zero-sum incentives. We do not believe that relative incentives provide individual companies with the level of certainty or control needed to make informed business decisions. Companies that are – individually – actually performing well may be penalized when measured relatively, which could dis-incentivize good behavior and possibly lead to financeability issues. Relative performance also exposes all companies to the consequences and risks of errors made in target setting. If companies are being exposed to greater risk through relative targets, then they should be compensated with a higher return which ultimately creates higher costs for consumers.

Fair Returns

Expected returns under RIIO-ED1 are projected to be significantly lower than under DPCR5. Regardless, Ofgem has stated that the returns being earned by DNOs under RIIO-ED1 are higher than expected. These higher returns are generally not the result of forecasting errors; instead, they are being driven by out-performance against targets, which benefits consumers. All DNOs have outperformed their targets in the first two years of RIIO-ED1 and consumers have benefited from fewer and shorter interruptions and improved customer service as a result of these incentives. In those few cases where outperformance is also due to under-spending of Totex, we believe Ofgem has the ability to deal with that issue within the current framework.

We believe many of the proposed schemes to restrict the returns DNO's can earn, (i.e. hard caps and floors, constraining Totex and output incentives, discretionary adjustments, RoRE sharing factor and anchoring returns) would likely increase regulatory risk in an asymmetric manner which would ultimately lead to an increase in the cost of capital. However, we recognize that Ofgem is concerned that errors in forecasting input costs may lead to higher than intended returns. We agree with WPD's assessment that indexing real price effects against credible external cost indices would better serve to alleviate Ofgem's forecasting concerns. However, if concerns remain, we believe the best solution is to establish fully symmetric caps and floors with a RoRE sharing factor applied outside those ranges. This would allow consumers to benefit while still incentivizing companies to continue to improve performance, improve efficiency and focus on innovation.

In conclusion, it is important to establish a framework for RIIO-2 that enables DNOs to continue to attract the capital necessary to deliver the outputs desired by consumers at an efficient cost. We look forward to continuing to engage with you regarding RIIO-2 to achieve the best overall outcome for our customers and our shareowners.

Sincerely,

William H. Spence
Chairman, President and CEO
PPL Corporation