OCA Statement No. 2-SR

BEFORE THE PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission, *et. al.*	:	R-2016-2537349, *et al.*
	:	
v.	:	
	:	
Metropolitan Edison Company	:	
Pennsylvania Public Utility Commission, *et. al.*	:	R-2016-2537352, *et al.*
	:	
v.	:	
	:	
Pennsylvania Electric Company	:	
Pennsylvania Public Utility Commission, *et. Al.*.	:	R-2016-2537355, *et. al.*
	:	
v.	:	
	:	
Pennsylvania Power Company	:	
Pennsylvania Public Utility Commission, *et. al.*	:	R-2016-2537359, *et al.*
	:	
v.	:	
	:	
West Penn Power Company	:	

SURREBUTTAL TESTIMONY

OF

DAVID C. PARCELL

ON BEHALF OF
OFFICE OF CONSUMER ADVOCATE

August 31, 2016

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I. INTRODUCTION

Q. PLEASE STATE YOUR NAME, OCCUPATION AND BUSINESS ADDRESS.

A. My name is David C. Parcell. I am President of Technical Associates, Inc. My business address is 1503 Santa Rosa Road, Suite 130, Richmond, VA 23229.

Q. ARE YOU THE SAME DAVID C. PARCELL WHO FILED DIRECT TESTIMONY ON BEHALF OF THE OFFICE OF CONSUMER ADVOCATE ("OCA") ON JULY 22, 2016?

A. Yes, I am.

Q. WHAT IS THE PURPOSE OF YOUR CURRENT TESTIMONY?

A. My present testimony is prepared to respond to the Rebuttal Testimony of Pauline M. Ahern on behalf of Metropolitan Edison Company ("Met-Ed"), Pennsylvania Electric Company ("Penelec"), Pennsylvania Power Company ("Penn Power"), and West Penn Power Company ("West Penn"), collectively, "Companies."

Q. HOW HAVE YOU ORGANIZED YOUR RESPONSES TO MS. AHERN'S REBUTTAL TESTIMONY CONCERNING THE COMMON EQUITY COST RATE?

A. Ms. Ahern's Rebuttal Testimony addresses her criticisms to my applications of three cost of equity models – DCF, CAPM, and CE. Her Rebuttal Testimony also addresses her adjustments for flotation costs, business risk, and credit (financial) risk. Accordingly, my Surrebuttal Testimony addresses each of these concepts in turn.

My Surrebuttal Testimony also incorporates the updated cost of long-term debt for Penn Power, as contained in the Rebuttal Testimony of Joseph Dipre.

Q. HAVE YOU PREPARED AN EXHIBIT IN SUPPORT OF YOUR TESTIMONY?

A. Yes, I have prepared one exhibit, identified as Exhibit DCP-2. This is comprised of 2 schedules.

II. GENERAL COMMENTS

Q. DO YOU HAVE ANY GENERAL COMMENTS ABOUT MS. AHERN'S REBUTTAL TESTIMONY AND RECOMMENDATIONS IN THIS PROCEEDING?

A. Yes, I do. Ms. Ahern, in her Rebuttal Testimony, continues to recommend ROEs for the Companies of 10.9 percent to 11.5 percent. Schedule 1 of Ms. Ahern's Rebuttal Testimony shows the authorized ROEs for several historic utility cases in Pennsylvania. What Ms. Ahern does not show in her Rebuttal Testimony, and neither acknowledges nor disputes, is the trend in authorized ROEs for electric utilities throughout the United States. As I demonstrated on page 13 of my Direct Testimony, which was not disputed by Ms. Ahern, the average authorized ROE for electric utilities has declined over the past several years and most ROEs are now well below 10.0 percent:

Year	ROE
2013	9.94%
2014	9.76%
2015	9.58%
2016 (2Q)	9.52%

Significantly, according to the same source cited by Ms. Ahern on her Schedule 1, not a single U.S. utility has been authorized a ROE as high as 10.9 percent by a state regulatory commission since at least 2013.

Q. HAS MS. AHERN MIS-CHARACTERIZED YOUR TESTIMONY IN HER REBUTTAL TESTIMONY?

A. Yes, she has. On page 3, lines 17-18 of her Rebuttal Testimony, Ms. Ahern states her belief that my "recommended common equity cost rate" is 8.80 percent. This is not correct. As I clearly indicated on page 3, lines 22-23 and page 4, lines 1-2 of my Direct Testimony, my specific ROE recommendation is 9.15 percent, the mid-point of a range of 8.80 percent to 9.50 percent.

Q. MS. AHERN STATES, ON PAGE 2, LINES 11-13 OF HER REBUTTAL TESTIMONY THAT NOTHING IN THE TESTIMONIES OF THE "OPPOSING WITNESSES" HAS CAUSED HER TO CHANGE HER RECOMMENDATIONS AND CONCLUSIONS SHE HAS MADE IN HER DIRECT TESTIMONY. DOES ANYTHING SHE HAS MAINTAINED IN HER REBUTTAL TESTIMONY CAUSE YOU TO CHANGE YOUR RECOMMENDATIONS AND CONCLUSIONS?

A. No. Ms. Ahern's Rebuttal Testimony largely repeats her Direct Testimony, which myself and the other "Opposing Witnesses" have shown to significantly over-state the ROEs for the Companies.

III. DISCOUNTED CASH FLOW MODEL (DCF)

Q. MS. AHERN MAINTAINS IN HER REBUTTAL TESTIMONY ON PAGES 7-10 THAT THE DCF MODEL HAS A TENDENCY TO MIS-SPECIFY INVESTORS' REQUIRED RETURN RATES. SHE ALSO MAINTAINS THE DCF COST OF EQUITY FOR A UTILITY IS UNDERSTATED WHEN THE MARKET PRICE OF UTILITY STOCKS EXCEEDS THE BOOK VALUE. DO YOU AGREE WITH THIS POSITION?

A. No, I do not. Knowledgeable and/or informed investors are well aware of the fact that most utilities have their rates set based on the book value of their assets (i.e., rate base and capital structure). This knowledge is reflected in the prices that investors are willing to pay for stocks and thus is reflected in DCF cost rates. This is clearly an element of the principle of "efficient markets," which Ms. Ahern has long cited in testimony. If one believes that markets are efficient, there is no reason to question the appropriateness of either stock prices or market models that are based on stock prices.

On page 22 of my Direct Testimony, I noted that this Commission has predominately relied on the DCF model in recent years. Ms. Ahern does not acknowledge this in her Rebuttal Testimony and does not dispute this precedent. I also note that Ms. Ahern is being inconsistent and selective in her testimony regarding the Commission's approach. On the one hand, she cites various Commission decisions on

ROE over several past periods (page 3, lines 16-20 and her Schedule 1); on the other hand she does not acknowledge the Commission's use of the DCF method, which she does not currently give significant weight to since its results are less than she desires to recommend.

Q. WHAT ARE THE RESPECTIVE DCF RESULTS OF MS. AHERN, YOURSELF AND THE OTHER ROE WITNESSES IN THIS PROCEEDING?

A. The DCF results of the ROE witnesses in this proceeding are as follows:

Companies	Pauline Ahern	8.80%
OCA	David Parcell	8.2 – 8.8%
Staff	Rachel Maurer	8.46%
IUG	Billie LaConte	8.8%

It is thus apparent that there is relatively little dispute as to the current DCF cost rates for the groups of proxy electric utilities employed in this proceeding. Rather, the meaningful dispute relates to the appropriateness of the DCF model. In this regard, Ms. Ahern is the "outlier" on this issue.

Finally, I note that Ms. Ahern's 10.9 percent or higher ROE recommendations for the Companies are all more than 200 basis points (two percentage points) higher than her DCF conclusions. Clearly, she is giving very little weight to the Commission-preferred DCF methodology in her ROE recommendations in this proceeding.

IV. <u>CAPITAL ASSET PRICING MODEL (CAPM)</u>

Q. WHAT IS THE FIRST POINT MS. AHERN ADDRESSES IN HER REBUTTAL TESTIMONY ON THE CAPM MODEL?

A. Ms. Ahern's first point is to express her disagreement with my position that the CAPM specifically recognizes the risk of a particular company or industry, whereas the simple risk premium does not (per pages 19-20 of her Rebuttal Testimony). Ms. Ahern states her opinion that I am "incorrect" in my position. I disagree with her on this point.

Ms. Ahern's position apparently focuses only on the use of public utility bond yields in her interpretation of the risk premium analysis which she believes properly recognizes the risk of the subject company. This is misleading in terms of its ability to measure risk comparability, since all utilities with the same bond rating are assumed to have the same ROE with her reasoning. My CAPM analysis uses a specific measure of risk (i.e., beta) that reflects the relative stock price variability of specific stocks, or groups of similar-risk stocks. As such, the beta component in a CAPM analysis does specifically recognize the risk of the subject company, unlike the risk premium that essentially assigns the same cost of equity for all utilities with the same bond rating.

Q. MS. AHERN MAINTAINS, ON PAGE 21, LINES 6-11 OF HER REBUTTAL TESTIMONY THAT YOUR USE OF A 20-YEAR U.S. TREASURY BOND RATE IS "INAPPROPRIATE" AS SHE APPARENTLY BELIEVES YOU SHOULD HAVE FOCUSED ON A LONGER-TERM U.S. TREASURY BOND RATE. DO YOU AGREE?

A. No, I do not agree. As I indicated on page 26, lines 25-28 of my Direct Testimony, I used a 20-year U.S. Treasury Bond rate in order to be consistent with the time-frame of the "long-term government bonds" used to develop the risk premium component of the CAPM. The Morningstar/Ibbotson source used both by me and Ms. Ahern uses 20-year U.S. Treasury bonds as the source of long-term government bonds. Thus my use of 20-year bonds is consistent and appropriate.

Q. MS. AHERN STATES HER BELIEF, ON PAGES 21-22 OF HER REBUTTAL TESTIMONY, THAT YOUR USE OF 20-YEAR U.S. TREASURY BONDS IGNORES THE FACT THAT BOTH THE COST OF CAPITAL AND RATEMAKING ARE PROSPECTIVE. DO YOU HAVE ANY COMMENTS ON HER POSITION?

A. Yes, I do. Given that Ms. Ahern's risk premium model relies on historic risk premiums dating back to 1926, I find her statement to be inconsistent with her own analyses, as she is also relying on historic data. Nevertheless, my use of 20 year U.S. Treasury bonds uses the most recent three-month average yields, which is more properly described as "actual yields."

Q. ON PAGES 21 AND 22 OF HER REBUTTAL TESTIMONY, MS. AHERN MAINTAINS THAT YOUR CAPM RISK FREE RATE SHOULD HAVE USED FORECASTED YIELDS ON U.S. TREASURY BONDS RATHER THAN THE CURRENT YIELDS YOU USED. WHAT IS YOUR RESPONSE TO HER ASSERTION?

A. I disagree with Ms. Ahern. It is proper to use the current yield as the risk-free rate in a CAPM context. This is the case since the current yield is known and measurable and reflects investors' collective assessment of all capital market conditions. Prospective interest rates, in contrast, are not measurable and not achievable. For example, if the current yield on 20-year U.S. Treasury Bonds is 2.0 percent, this reflects the rate that investors can actually receive on their investment. Investors cannot receive a prospective yield on their investments since such a yield is not actual but rather speculative.

Use of the current risk-free rate in a CAPM context is similar to using the current yield in a DCF context. Analysts, including Ms. Ahern, do not use prospective stock prices as the basis for the dividend yield in a DCF analysis, as the use of prospective stock prices is speculative. Use of current stock prices is appropriate. Likewise, current levels of interest rates reflect all current information and should be used as the risk-free rate in the CAPM.

Q. MS. AHERN STATES, ON PAGES 23-24 OF HER REBUTTAL TESTIMONY, THAT IT IS IMPROPER TO CONSIDER GEOMETRIC MEAN RETURNS IN THE DETERMINATION OF A RISK PREMIUM AND THAT ONLY ARITHMETIC RETURNS ARE APPROPRIATE. DO YOU AGREE WITH THIS POSITION?

A. No, I do not. It is apparent that investors have access to both types of returns when they make investment decisions. In fact, it is noteworthy that mutual fund investors regularly receive reports on their own funds, as well as prospective funds they are considering investing in, which show only geometric returns. Based on this, I find it difficult to accept Ms. Ahern's position that only arithmetic returns are appropriate.

Q. PLEASE DEFINE THE CONCEPTS OF ARITHMETIC MEAN AND GEOMETRIC MEAN AND DESCRIBE WHY BOTH ARE RELEVANT TO INVESTORS.

A. The arithmetic mean is the average of period (e.g., annual) changes in a statistic, such as investor returns. The geometric mean is a compound return of a period. The example below describes each for a sample period:

Period	Value	Return
1	$10	
2	$11	10% ($1 return on $10 base)
3	$12	9% ($1 return on $11 base)
4	$11	-8% (-$1 loss on $12 base)
5	$12	9% ($1 return on $11 base)

In this example, the arithmetic return is the average of the annual "Return" figures, which is 5 percent (i.e., 10% +9% - 8% + 9% divided by 4). The arithmetic return thus gives consideration to the return level for each period.

The geometric return is the compound return over the four year period, in which the value increased from $10 to $12, which is 20 percent over a four-year period, or 4.66 percent. The geometric mean thus is concerned with the total return over the period without consideration of individual period averages.

Arithmetic returns are always higher than geometric returns. This is the case since the individual period returns in an arithmetic sense are not "compounded" which, in an arithmetic sense, requires that to be higher. Both types of returns are relevant to investors and both are reported to investors. Investors are concerned with period returns, but over a given period of time it is the geometric return that indicates their actual gain or loss. As a result, I consider both in my analyses of the risk premium component.

Q. DOES MS. AHERN USE VALUE LINE INFORMATION IN HER COST OF CAPITAL ANALYSES?

A. Yes, she does. She has in fact cited Value Line reports on her electric utility proxy utilities on her Exhibit PMA-1, Schedule 4.

Q. DO THE VALUE LINE REPORTS SHOW HISTORIC AND PROSPECTIVE GROWTH RATES FOR THE ELECTRIC PROXY UTILITIES?

A. Yes, they do.

Q. DO THESE VALUE LINE REPORTS SHOW HISTORIC AND PROSPECTIVE RETURNS ON AN ARITHMETIC BASIS?

A. No, they do not.

Q. DO THE VALUE LINE REPORTS SHOW HISTORIC AND PROSPECTIVE RETURNS ON A GEOMETRIC, OR COMPOUND GROWTH RATE BASIS?

A. Yes, they do. See Exhibit DCP-2, Schedule 1, which describes Value Line's method of calculating growth rates. As a result, any investor reviewing Value Line, as Ms. Ahern does, would be using geometric growth rates.

Q. IS IT YOUR POSITION THAT ONLY GEOMETRIC GROWTH RATES SHOULD BE USED?

A. No. I believe that both arithmetic and geometric growth rates should be used as I have done in my Direct Testimony on page 27 and Exhibit DCP-1, Schedule 14. This is the case because investors have access to both and presumably use both.

Q. ON PAGE 22, MS. AHERN ALSO TAKES ISSUE WITH YOUR USE OF ACHIEVED RATES OF RETURN ON BOOK EQUITY IN DERIVING THE EQUITY RISK PREMIUM IN YOUR CAPM ANALYSIS. WHAT IS YOUR RESPONSE TO THIS?

A. I disagree with Ms. Ahern. As I indicate on pages 26-27 of my Direct Testimony, I used measures of both book returns and market returns in developing my CAPM market risk premium components. The rates (i.e., prices) of public utilities are set based upon the book values of their rate base and capital structures, as well as the book levels of expenses and revenues. As such, it is appropriate to consider the level of return on book equity in the determination of the cost of equity (which is applied to the book level of common equity). I also note that the risk premium I derive from my use of book rates of return is the highest of the three risk premiums I considered in my CAPM analyses.

Q. MS. AHERN CRITICIZES YOU FOR USING "TOTAL RETURNS" ON U.S. LONG-TERM BONDS IN DEVELOPING YOUR CAPM RISK PREMIUM, RATHER THAN ONLY "INCOME RETURNS" AS SHE PROPOSES. WHAT IS YOUR RESPONSE TO THIS?

A. I disagree. In my CAPM risk premium, I am comparing total returns for stocks (as does Ms. Ahern) with total returns for bonds (she only considers income returns). This stock return includes both income (dividends) and capital gains. Any true and relevant comparison for bonds should also include income (interest) and capital gains for bonds. I have consistently done this and Ms. Ahern has not.

Q. ON PAGE 25 OF HER REBUTTAL TESTIMONY, MS. AHERN MAINTAINS YOU SHOULD HAVE INCORPORATED AN EMPIRICAL CAPM IN YOUR ANALYSES. DO YOU AGREE?

A. No, I do not agree. Ms. Ahern advocates what she describes as an "empirical" CAPM analysis. This form of the CAPM assumes that beta for an industry understates the industry's volatility and thus risk, and it is necessary to substitute the overall market's beta (i.e., 1.0) for one-fourth of the industry's actual beta. Ms. Ahern assumes that the appropriate beta in a CAPM analysis is a combination of the actual industry beta with a 75 percent weight and a beta of 1 with a 25 percent weight.

The use of an empirical CAPM overstates the cost of equity for companies with betas below that of the market. What the empirical CAPM actually does is inflate the CAPM cost for the selected company or industry on one-fourth of its equity and assumes that one-fourth of the company has the risk of the overall market. This is not appropriate for the Companies or for other utilities.

Q. DO YOU AGREE WITH MS. AHERN'S RECALCULATION OF YOUR CAPM ANALYSES, ON PAGE 27 AND SCHEDULE 16 OF HER REBUTTAL TESTIMONY, IN WHICH SHE HAS RE-DONE YOUR CAPM ANALYSES?

A. No, I do not. For the same reasons I have previously indicated in this Surrebuttal Testimony, her proposed manipulations of my CAPM analyses are not appropriate.

V. <u>COMPARABLE EARNINGS (CE) METHOD</u>

Q. ON PAGES 27-28 OF HER REBUTTAL TESTIMONY, MS. AHERN INDICATES HER BELIEF THAT YOUR ASSOCIATION OF MARKET-TO-BOOK RATIOS AND RETURNS ON EQUITY ARE "NOT SUPPORTED BY EITHER THE ACADEMIC LITERATURE NOR BY A HISTORICAL ANALYSIS OF THE EXPERIENCE OF UNREGULATED COMPANIES." WHAT IS YOUR RESPONSE TO THIS?

A. I disagree with Ms. Ahern on this point. Clearly, public utilities have their rates regulated (i.e., set) based upon their book value of rate base and capital structure. Investors are aware of this relationship (i.e., efficient market hypothesis, to again quote Ms. Ahern). Any reference to the experience of unregulated companies, as is evident in Ms. Ahern's rebuttal testimony, simply misses the point of public utility regulation.

Q. ON PAGES 28-30 OF HER REBUTTAL TESTIMONY, MS. AHERN STATES THAT SHE HAS "PERFORMED AN ANALYSIS TO DETERMINE THE EXISTENCE OF A DIRECT RELATIONSHIP BETWEEN THE MARKET-TO-BOOK RATIOS OF UNREGULATED COMPANIES AND THEIR EARNED RATES OF RETURN ON BOOK COMMON EQUITY." IS HER STUDY RELEVANT FOR PUBLIC UTILITIES?

A. No, it is not. Ms. Ahern's study applies to the S&P 500, which is predominately made up of unregulated firms. Many unregulated firms, such as energy producing companies and technology-related companies, have book values that do not reflect the actual value of their underlying assets. As a result, the market values of their stock may not be related to the book value of their assets.

Utilities, in contrast, have their rates established based upon the book values of their assets (i.e., rate base) and liabilities/common equity (i.e., capital structure). As a result, book value is very relevant for utilities.

Q. MS. AHERN STATES, ON PAGES 30-31 OF HER REBUTTAL TESTIMONY, THAT ANY PROXY GROUP SELECTED FOR A CE ANALYSIS SHOULD BE "BROAD BASED" AND NOT INCLUDE OTHER UTILITIES. DO YOU AGREE?

A. No, I do not. Ms. Ahern maintains that a proxy group selected for use in a CE analysis "should exclude utilities to avoid circularity since the achieved returns on book common equity of utilities, being a function of the regulatory process, are substantially influenced by regulatory awards." In reality, this is the reason that utility returns should be considered in a CE analysis.

I do not regard the use of utility returns as being circular. In contrast, use of utility returns is necessary and appropriate in order to conform to the "relative risk" dictates of the <u>Bluefield</u> and <u>Hope</u> decisions cited in my Direct Testimony. Contrary to Ms. Ahern's position, it is appropriate to consider the impact of regulatory awards since these reflect the same types of analyses (i.e., DCF, CAPM, and CE) that should be utilized in the current proceeding.

Q. ON PAGE 28, MS. AHERN ASSERTS HER BELIEF THAT THERE IS NO DIRECT RELATIONSHIP BETWEEN MARKET-TO-BOOK RATIOS AND RETURNS ON EQUITY. WHAT IS YOUR RESPONSE TO THIS?

A. Ms. Ahern is essentially stating that there is no relationship between earnings and stock prices. She is incorrect. Clearly, ROE (earnings) and M/B are related. This is the case since the book value is an element in both ROE and M/B (i.e., EPS/BVPS and P/BVPS). This contradicts her logic that EPS and stock prices are not related. This, of course, also runs counter to her DCF analyses that only consider EPS growth.

VI. <u>MS. AHERN'S "CORRECTED CONCLUSION OF MR. PARCELL'S COST OF COMMON EQUITY"</u>

Q. ON PAGES 27, 31, 32 AND 46-47 OF HER REBUTTAL TESTIMONY, MS. AHERN PRESENTS WHAT SHE DESCRIBES AS "CORRECTIONS" TO YOUR DCF, CAPM AND CE RESULTS. DO YOU AGREE WITH THESE "CORRECTIONS?"

A. No, I do not. In fact, her analyses are not "corrections" at all, but rather reflect her criticisms of my Direct Testimony and the substitution of her model inputs for my inputs. As I have described above, her criticisms and "corrections" are without merit and do not reflect proper implementations of the DCF, CAPM and CE analyses.

Q. BASED UPON YOUR REVIEW OF MS. AHERN'S REBUTTAL TESTIMONY, DO YOU STILL RECOMMEND A ROE FOR THE COMPANIES OF 9.15 PERCENT?

A. Yes, I do. There is nothing in Ms. Ahern's Rebuttal Testimony that causes me to change my analyses, data sources or recommendations.

VII. <u>FLOTATION COST ADJUSTMENT PROPOSED BY MS. AHERN</u>

Q. ON PAGE 33, LINES 4-5 OF HER REBUTTAL TESTIMONY, MS. AHERN STATES "FLOTATION COSTS ARE VERY REAL COSTS…" HAS MS. AHERN IDENTIFIED ANY "REAL COSTS" THAT FIRSTENERGY HAS INCURRED IN RECENT YEARS OR PROSPECTIVELY IN CONNECTION WITH THE SALE OF FIRSTENERGY COMMON STOCK FOR THE PURPOSE OF FUNDING THE COMMON EQUITY OF THE COMPANIES?

A. No, she has not. Neither Ms. Ahern nor other Companies' witnesses have identified any "real costs" that FirstEnergy has incurred or is expected to incur. In reality, Ms. Ahern's flotation costs should be described as "fictional costs" rather than "real costs."

Q. ON PAGE 34, LINES 10-11 OF HER REBUTTAL TESTIMONY, MS. AHERN STATES THAT YOU HAVE NOT "DEMONSTRATED THAT FIRSTENERGY'S HISTORICAL FLOTATION COSTS HAVE BEEN RECOVERED." HAS MS. AHERN DEMONSTRATED THAT FIRSTENERGY HAS ACTUALLY INCURRED ANY FLOTATION COSTS FOR USE IN FUNDING THE COMPANIES?

A. No, she has not.

VIII. <u>BUSINESS RISKS ADJUSTMENT PROPOSED BY MS. AHERN</u>

Q. MS. AHERN MAINTAINS, ON PAGES 57-58 OF HER REBUTTAL TESTIMONY, THAT THE COMPANIES ARE "SMALL" AND THEIR OWN SIZE IMPLIES THEY SHOULD BE REWARDED WITH A HIGHER RATE OF RETURN. DO YOU HAVE ANY RESPONSE TO THIS?

A. Yes, I do. As I have noted in my Direct Testimony on page 38, the Companies do not access equity markets for new common equity. The Companies' equity is provided by its parent company. As a result, the perceived "small size" of the Companies should not be considered as a factor in establishing their cost of equity.

Q. IS IT PROPER TO COMPARE THE SIZE OF THE COMPANIES TO THE PROXY COMPANIES AND MAKE RISK COMPARISONS BASED UPON THE SIZE DIFFERENTIALS BETWEEN THEM?

A. No, it is not proper. Most of the proxy electric utilities have multiple subsidiaries that operate in different jurisdictions. Following Ms. Ahern's reasoning, each of the subsidiaries of the proxy utility utilities should be considered as more risky than the proxy group since, by definition, they would have to be smaller. This reasoning is flawed, since these individual company subsidiaries do not raise their equity capital directly from investors, but rather do so as a consolidated entity.

Q. DO YOU AGREE WITH THE PROPOSITION THAT THE COMPANIES SHOULD BE ENTITLED TO A SIZE OR CREDIT RISK ADJUSTMENT?

A. No, I do not. As I indicated on pages 13-14 of my Direct Testimony, the Companies are subsidiaries of FirstEnergy. The Companies do not have publicly-traded common stock and correspondingly do not have have published risk factors such as beta, Safety or financial strength from publications such as Value Line.

As a result, the Companies' ratepayers should not be charged electric rates which reflect in incremental return to reflect the size of the Company. Such an increment is not justified and not appropriate.

IX. <u>CREDIT RISKS ADJUSTMENT PROPOSED BY MS. AHERN</u>

Q. MS. AHERN CONTINUES TO PROPOSE A CREDIT RISK ADJUSTMENT FOR THE COMPANIES TO REFLECT HER PERCEPTION OF HIGHER RISK FACED BY THESE COMPANIES DUE TO THEIR RELATIVELY LOWER CREDIT RATINGS IN COMPARISON TO THE PROXY GROUPS. IS SHE CORRECT?

A. No, she is not. As I indicated on pages 15-16 and 41 of my Direct Testimony, the relatively lower security ratings of the Companies, in relation to those of the proxy companies, are largely due to the lower credit risk and higher risk of the unregulated operations of their parent FirstEnergy. In particular, Standard & Poor's, which assigns a "family" rating tied to the risk of the ultimate parent(s) gives the Companies lower ratings. Standard & Poor's specifically states this is tied to the higher risk of FirstEnergy's unregulated operations (as I quoted on pages 15-16 of my Direct Testimony). Moody's, in contrast, assigns higher ratings to the Companies and these ratings are not generally lower than other electric utilities, as I indicated on page 15 of my Direct Testimony.

Q. DOES MS. AHERN ACKNOWLEDGE THIS IN HER REBUTTAL TESTIMONY?

A. She purports to address this on page 60 of her Rebuttal Testimony, but she fails to properly recognize that, absent the downward influence of FirstEnergy on the

Companies' ratings, they would not be lower than the proxy companies and no adjustment is either proper or required.

X. UPDATE OF PENN POWER'S COST OF DEBT

Q. HAVE ANY OF THE COMPANIES MADE CHANGES TO THE COST OF DEBT?

A. Yes. Penn Power has updated its cost of long-term debt. This is described in the Rebuttal Testimony of Joseph Dipre. The updated cost of long-term debt is now 5.6606 percent, a reduction from the 5.8846 percent level contained in the original filing.

Q. HAVE YOU UPDATED YOUR COC CALCULATION FOR PENN POWER TO REFLECT THIS UPDATE?

A. Yes, I have. Exhibit DCP-2, Schedule 2 shows my updated COC for Penn Power, reflecting the updated cost of debt. The resulting COC is 7.23 percent to 7.58 percent, with a mid-point of 7.41 percent. My recommended COC for Penn Power is now 7.41 percent.

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A. Yes, it does.

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OF

DAVID C. PARCELL

ON BEHALF OF
OFFICE OF CONSUMER ADVOCATE

August 31, 2016

HOW TO INVEST IN COMMON STOCKS

A Guide to Using
THE VALUE LINE INVESTMENT SURVEY

GLOSSARY

Aaa Corporate Bond Rate—the average yield on corporate bonds rated Aaa by Moody's Investors Service. Bonds that are rated Aaa are judged to be of the best quality.

Accrual Accounting—a method of matching income and expenses in the period they are actually applicable, regardless of the date of collection or payment.

Adjustable-Rate Mortgage Loans (ARMs) (Bank and Thrift Industries)—mortgage loans on which the interest rate charged by the lender is adjusted in accordance with a stipulated, publicly available cost-of-funds index, such as the yield on one-year Treasury bills. (*See **Fixed-Rate Mortgage Loans.***)

After market—the market for replacement parts and accessories for a product or group of products. The Auto Parts (Replacement) Industry participates in the automotive after market.

After-Tax Corporate Profits—*see **Corporate Profits.***

AFUDC—*see **Allowance for Funds Used During Construction.***

Allowance for Funds Used During Construction (Electric Utility Industries)—a non cash credit to income consisting of equity and debt components. This non cash income results from construction work in progress and is expected to be converted into cash income at a future date.

American Depository Receipts (ADRs)—since most other nations do not allow stock certificates to leave the country, a foreign company will arrange for a trustee (typically a large bank) to issue ADRs (sometimes called American Depositary Shares, or ADSs) representing the actual, or underlying, shares. Each ADR is equivalent to a specified number of shares (the ratio is shown in a footnote on the Value Line page).

American Stock Exchange Composite—a market-capitalization weighted index of the prices of the stocks traded on the American Stock Exchange.

Annual Change D-J Industrials (Investment Companies)—the annual change from year end to year end in the Dow Jones Industrial Average, expressed as a percentage.

Annual Change in Net Asset Value (Investment Companies)—the change in percentage terms of the net asset value per share at the end of any given year from what it was at the end of the preceding year, adjusted for any capital gains distributions made during the year.

Annual Rates of Change (Per Share)—compounded annual rates of change of per-share sales, cash flow, earnings, dividends, and book value (or other industry-specific per-share figures) over the past ten years and five years and estimated over the coming three to five years. All forecasted rates of change are computed from the average figure for the past three-year period to an average for a future three-year period. If data for a three-year base period are not available, a two- or one-year base may be used.

Annual Total Return—the capital gain or loss plus the sum of dividend disbursements expected over the next three to five years, all divided by the recent price and expressed as an average annual rate.

Arbitrage—the simultaneous purchase of an asset in one market and sale of the same asset, or assets equivalent to the asset purchased, in another market. Often referred to as "classical arbitrage," this type of transaction should result in a risk-free profit. Risk Arbitrage refers to transactions in stocks involved in takeover activity.

Arbitrageur—a person or organization that engages in arbitrage activity.

Arithmetic Average—a simple mean. Items to be averaged are added and their sum is divided by the number of items. The result is an arithmetic, or simple, average (or mean).

ARM—*see **Adjustable-Rate Mortgage Loans.***

Exhibit DCP-2
Schedule 2

PENNSYLVANIA POWER COMPANY
TOTAL COST OF CAPITAL
AS OF DECEMBER 31, 2017
($000)

Item	Amount 1/	Percent	Cost	Weighted Cost
Long-term Debt	$151,981	49.93%	5.6606% 2/	2.83%
Common Equity	$152,390	50.07%	8.80% 9.15% 9.50%	4.41% 4.58% 4.76%
Total	$304,371	100.00%		7.23% 7.41% 7.58%

1/ Estimated Test Year December 31, 2017 amounts and percents as contained in Penn Power Exhibit JD-24.

2/ Updated cost of long-term debt , as shown on PPExhibit JD-26.

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission, *et. al.*	:	R-2016-2537349, *et al.*
	:	
v.	:	
	:	
Metropolitan Edison Company	:	
Pennsylvania Public Utility Commission, *et. al.*	:	R-2016-2537352, *et al.*
	:	
v.	:	
	:	
Pennsylvania Electric Company	:	
Pennsylvania Public Utility Commission, *et. at.*	:	R-2016-2537355, *et. al.*
	:	
v.	:	
	:	
Pennsylvania Power Company	:	
Pennsylvania Public Utility Commission, *et. al.*	:	R-2016-2537359, *et al.*
	:	
v.	:	
	:	
West Penn Power Company	:	

VERIFICATION

I, David C. Parcell, hereby state that the facts above set forth in my Surrebuttal Testimony, OCA Statement No. 2-SR, are true and correct and that I expect to be able to prove the same at a hearing held in this matter. I understand that the statements herein are made subject to the penalties of 18 Pa.C.S. § 4904 (relating to unsworn falsification to authorities).

Signature: David C. Parcell
David C. Parcell

Consultant Address: Technical Associates, Inc.
1503 Santa Rosa Road, Suite 130
Richmond, Virginia 23229

DATED: August 31, 2016