

**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

Docket No. R-2010-2161694

PPL Electric Utilities Corporation

Statement No. 12

Direct Testimony of Julie M. Cannell

1 **Direct Testimony of Julie M. Cannell**

2 **Q. Please state your name, employer, and business address.**

3 A. My name is Julie M. Cannell. I am the president of my own advisory firm, J.M.
4 Cannell, Inc. My business address is P.O. Box 199, Purchase, NY 10577.

5
6 **Q. Please describe your professional and educational background.**

7 A. My firm, J.M. Cannell, Inc., provides investor-related advisory services to electric
8 utility companies and other firms and organizations with an interest in the
9 industry. Prior to establishing my firm in February 1997, I was employed by the
10 New York-based investment manager, Lord Abbett & Company, from June 1978
11 to January 31, 1997. During my tenure with Lord Abbett, I was a securities
12 analyst specializing in the electric utility and telecommunications services
13 industries; portfolio manager of America's Utility Fund, an equity utility mutual
14 fund, for which Lord Abbett was a sub-advisor; portfolio manager of numerous
15 institutional equity portfolios; and co-director of Lord Abbett's Equity Research
16 Department.

17 My educational credentials include a B.A. from Mary Baldwin College,
18 M.Ln. from Emory University, and M.B.A. from Columbia University. I am also a
19 Chartered Financial Analyst (C.F.A.).

20 I have been a member of the Wall Street Utility Group, an organization of
21 security and credit rating analysts having an expertise in the utility industry, for
22 over thirty years.

1 **Q. On whose behalf are you providing direct testimony in this proceeding?**

2 A. I am providing Direct Testimony on behalf of PPL Electric Utilities Corporation
3 (“PPL Electric” or the “Company”).
4

5 **Q. Have you submitted testimony previously before any state regulatory
6 agencies?**

7 A. Yes, I have. I have submitted pre-filed testimony on behalf of investor-owned
8 utilities before Public Service or Public Utility Commissions in the states of
9 Arizona, Colorado, Connecticut, Kansas, Massachusetts, Missouri, Nevada, New
10 York, Oklahoma, Rhode Island, South Carolina, Texas, Virginia, Washington,
11 and Wisconsin.
12

13 **Q. Have you ever testified before this Commission?**

14 A. Yes. I have testified on behalf of PPL Electric regarding the Company’s cost of
15 capital before the Pennsylvania Public Utility Commission (“PUC” or
16 “Commission”) twice previously: in 2007, at Docket R-00072155; and in 2004, at
17 Docket R-00049255.
18

19 **Q. Have you had additional regulatory experience?**

20 A. Yes. As a consultant to the Edison Electric Institute, I have been extensively
21 involved since 2004 in an ongoing initiative geared toward fostering and
22 improving communications between state regulators and the investment
23 community. This effort has centered on a series of forums held throughout the

1 United States bringing together these two constituencies, sponsored by the
2 Edison Electric Institute and facilitated by Gee Strategies president Robert Gee,
3 former chairman of the Texas Public Utilities Commission and former assistant
4 secretary for the U.S. Department of Energy. In addition to helping structure
5 these dialogues, my role has been to moderate panel discussions of equity and
6 debt security analysts.

7 I have also conducted several studies of investor perceptions of regulatory
8 issues. Further, I have written articles addressing the implications for utilities and
9 state regulators of various topical issues, including the current electric industry
10 capital expenditure cycle, and, most recently, the financial crisis.

11
12 **Q. What is the scope of your direct testimony in this proceeding?**

13 A. I will address the perspective of investors in regard to the Company's rate
14 proposal and will provide comments on several areas: (1) investors' perspective
15 of risk due to the extensive investment currently being undertaken by electric
16 utilities in general and the Company in particular; (2) investors' perception of risk
17 as impacted by current macroeconomic conditions and reflected in an increase in
18 allowed returns on equity ("ROE"); and (3) investors' expectations for a
19 continuation of the constructive trend of the Pennsylvania regulatory climate to
20 ensure the Company's continued access to the capital markets.

1 **Q. What in your experience allows you to provide testimony about investors’**
2 **perspectives and expectations?**

3 A. As a securities analyst, I specialized in the electric utility industry and the
4 individual companies comprising it. And as a portfolio manager, I applied that
5 knowledge, along with investment fundamentals, in making investment decisions
6 on behalf of institutions and individual investors. My experience has given me
7 familiarity with the information and tools that investors use in making decisions
8 with respect to expected ROEs. Moreover, I have reviewed the various reports
9 of security analysts, which have addressed the Company and its regulatory
10 situation. Further, I have familiarized myself with the Company’s fundamentals
11 and its planned investment levels.

12
13 **Q. As an analyst or portfolio manager, did you follow the Company?**

14 A. Yes, I did. Both Lord Abbett and America’s Utility Fund periodically maintained a
15 holding in the common stock of the Company, which was then named
16 Pennsylvania Power & Light Company.

17
18 **Q. Please describe how your testimony is organized.**

19 A. There are four parts to my testimony.

20 **I. Investors’ Requirements for Increased Returns in Utility Investments.**

21 This section discusses the investment risk of electric utilities; specifically, why the
22 current construction cycle has increased the risk of investing in the industry. It
23 also addresses how regulatory risk has risen due to this higher capital spending.

24 **II. The Macroeconomic Environment.** This section discusses the elevated

1 risk created by the global economic crisis.

2 **III. Investors' Expectations for Returns and Perceptions of the Current**

3 **Proceeding**. This section focuses on how investors actually make their
4 decisions, reviewing the investment community's perceptions of the Company
5 and Pennsylvania regulation. This review is based on a number of recent
6 publications by investment analysts discussing their perceptions of the Company
7 and its regulatory environment.

8 **IV. Investor Expectations for Return on Equity for PPL Electric and PPL**

9 **Corporation**. This section discusses how investors would view the Company's
10 request for an authorized ROE of 11.75%.

11
12 **I. INVESTORS' REQUIREMENTS FOR INCREASED RETURNS IN UTILITY**
13 **INVESTMENTS**
14

15 **Q. Please explain why the investment community's view of an electric utility's**
16 **stock is important to the utility and its customers.**

17 A. Distribution electric utilities are in the business of providing their customers with
18 safe, reliable, and efficient service. This requires extensive investment in
19 distribution and transmission infrastructure, which makes the electric utility
20 business capital-intensive. Investors provide the capital necessary to maintain
21 and expand a utility's infrastructure, which in turn enables utilities like the
22 Company to provide safe, reliable, and efficient service to customers.

23 The terms on which the Company is able to obtain that capital have a
24 direct and measurable impact on customers and the amounts they pay for

1 electric service. For example, if credit rating agencies such as Moody's Investors
2 Service ("Moody's"), Standard & Poor's ("S&P"), or Fitch Ratings ("Fitch") believe
3 that the utility's revenues will be diminished by adverse business or regulatory
4 decisions, those rating agencies could lower their credit ratings for the utility,
5 which would raise the cost of debt. And, because the cost of debt is a
6 component of the weighted average cost of capital, the increased costs of capital
7 would eventually be passed on to customers in the form of higher rates.

8 The same is true for equity investors. If individual or institutional investors
9 believe that the return they are offered is too low in light of the risk involved, they
10 will either sell their stock or elect not to purchase the stock, which generally
11 drives the stock price down. Although lower stock prices would appear at first
12 blush to be a concern only to investors, they also affect customers. When a
13 utility has to go to the equity markets to obtain capital, a low stock price requires
14 it to issue more shares of stock to obtain the same amount of money than it
15 would have received for fewer shares if the per share price had been higher.
16 The resulting increase in the number of shares outstanding requires more dollars
17 to be expended toward dividends, resulting in less retained earnings for
18 reinvestment in the company.

19 The corollary is that when investors believe that they are investing in a
20 company where regulation is fair, consistent, and provides a reasonable rate of
21 return, those investors charge less for their capital. And when debt and equity
22 investors demand less for their capital, utility rates remain lower and utilities have
23 more ready access to the capital markets. Thus, a utility and its customers have

1 a shared interest in meeting the expectations of investors and credit rating
2 agencies. Regulators share this interest as well, because fair treatment of one
3 utility decreases the costs of capital for all utilities in that regulatory jurisdiction.
4

5 **Q. Are you suggesting that the Commission's decisions should be dictated by**
6 **investors?**

7 A. No. I realize that the Commission must balance the interests of investors and
8 customers. My point is that the Commission's decision on rate of return is not
9 simply a zero-sum game. If the rate of return strikes an appropriate balance
10 between the utility and customers, both benefit. If the rate of return is set too
11 low, both the utility and customers are adversely impacted because the cost of
12 capital increases over the long term.
13

14 **Q. How do investors evaluate an industry sector and specific companies**
15 **within an industry?**

16 A. Investors arrive at investment judgments by essentially a two-step process. First,
17 they make judgments about the benefit of owning stock in particular industry
18 sectors and the investment risks that apply to those sectors as a whole. This
19 step incorporates a consideration of macroeconomic factors. Step two involves
20 examining company-specific risk factors, which are additive to sector risk. In
21 other words, investors first determine the risk involved in investing in a particular
22 sector. They then add to that sector risk the specific risks applicable to individual
23 companies. My evaluation of how investors make decisions concerning investing
24 in PPL Electric bonds and PPL Corporation ("PPL") stock follows this same

1 approach. My evaluation first looks at the risks and benefits of investing in the
2 electric utility sector, then examines the risks specific to investing in PPL Electric
3 and PPL.

4
5 **Q. Please explain how the investment community views utility stocks as**
6 **investments.**

7 A. Historically, electric utilities have been regarded as investment vehicles that
8 provide stable performance through the ups and downs of market cycles and
9 changing economic conditions. Electric utilities historically have earned a
10 reasonable return even when conditions were not favorable for other companies.
11 Accordingly, electric utility stocks have been particularly valuable holdings when
12 conditions were not conducive to investments in more volatile industry sectors.
13 In other words, investors would likely see greater returns from investment in
14 other industries when times were good, but they would lose less on electric utility
15 stocks when times were less favorable.

16 In addition, the reliability of electric utilities' earnings streams historically
17 has permitted most of the companies to continue to pay regular dividends during
18 both good and bad economic cycles. For investors with a need for regular cash
19 income, the prospect of regular dividends has been an important consideration in
20 making a decision to invest in electric utility stocks.

21 Based on these factors, investors traditionally have viewed electric utility
22 stocks as bond substitutes. In other words, electric utility stocks have provided
23 regular cash returns in the form of dividends and the shares themselves were
24 seen to have a stable underlying value. Historically, electric utilities have paid

1 out a large proportion of their earnings as dividends, and their large construction
2 programs have kept them dependent on the capital markets. As a result, electric
3 utility stocks as a group have tended to move closely in line with the direction of
4 interest rates, but in an inverse relationship. That is, utility stock prices rose
5 when interest rates fell, and vice versa. These factors made owning electric
6 utilities a way of balancing the risks in a stock portfolio that included stocks in
7 more volatile industries. However, that historic relationship between utility stock
8 prices and interest rates has not been consistent of late. This is due in part to
9 fundamental concerns that investors have about the major capital expansion
10 program the industry is facing and the amount of capital that will be required to
11 fund it, among other issues.

12

13 **Q. How has the risk of investing in electric utilities changed in recent years?**

14 A. During the past several years, it has become clear to investors and others that
15 the industry is entering into a major new construction cycle. This new
16 construction cycle reflects the need utilities have to replace aging infrastructure;
17 to meet new environmental requirements and expectations; to address the need
18 for grid enhancements, including those associated with interconnecting
19 renewable resources; to provide technological advancements such as smart
20 meters; and to add new base-load and intermediate generation resources to
21 meet growing customer needs. The resulting increase in capital expenditure
22 means that utilities will be more active in capital markets in future years and,
23 therefore, will be more exposed to the risks and uncertainties in those markets.

1 Electric utilities will also be more exposed to regulatory risks, since a significant
2 expansion of capital spending by electric utilities usually results in rate
3 proceedings to recover the costs associated with that capital. As a result,
4 regulatory exposure has become a key focus for investors as utilities face a
5 series of rate cases in order to recover the costs they are incurring to supplement
6 and replace aging infrastructure, to meet environmental requirements, and to
7 meet other costs. These risks are in addition to the other risks posed by the
8 technological, economic, environmental and other policy changes that also affect
9 the industry. It is because of these increased risks that investors no longer
10 perceive electric utilities as a group as being the “safe havens” they once were.

11

12 **Q. Have investors’ goals for utility investments changed in response to these**
13 **increased risks?**

14 A. No. Investors’ goals for electric utility investments have not fundamentally
15 changed. They still look to electric utilities primarily as defensive investments,
16 and still look for stable performance and regular dividends as the reason to invest
17 in electric utilities. But investors also understand that the investment risk in
18 electric stocks has risen significantly, and their expectations of returns have
19 changed accordingly.

20 In the end, investors have a very large universe of stocks from which to
21 select; with few exceptions, they have no requirement to own electric utility
22 stocks. To the extent that they do invest within the utility sector, investors must
23 be discriminating in their stock selection. As a result, utilities with strong financial
24 metrics operating in constructive regulatory environments will have stronger

1 investment appeal than utilities with weak metrics and less favorable regulation.

2 **Q. Please expand on how investors view the industry’s current construction**
3 **cycle as a risk.**

4 A. In its annual regulatory study, *Capital Management*, Barclays Capital explores
5 extensively the ramifications of the current construction cycle. The study begins
6 by noting that “[w]e are in the third year of the infrastructure build cycle for
7 regulated utilities that began in 2007. Based on our 2009 capex [capital
8 expenditures] survey, we now anticipate that the industry will proceed with a pre-
9 dividend free cash flow deficit through at least 2013, but likely significantly
10 longer.” Barclays estimated that over the next five years, capital spending in the
11 industry will be double the industry’s annual depreciation and amortization
12 expense, resulting in growth in industry rate base at an average annual pace of
13 6.3%. Barclays concludes that, as was the case in the last major construction
14 cycle in the industry which occurred in 1973-1984, “the risks of this build cycle
15 will offset much of the growth opportunity in share performance through the
16 construction period.” Barclays refers to the risks involved in this construction
17 period as “financial headwinds” which it assesses as follows:

- 18 • The headwinds we forecast will likely come from the dilutive effect of
19 heightened external capital funding requirements, regulatory risk in a
20 rising rate environment and execution risk associated with a significant
21 construction program. The best performing stocks over the cycle will
22 likely be those spending on infrastructure with the highest public policy
23 support, with the highest quality balance sheets, doing business in the
24 best regulatory jurisdictions.
25
- 26 • In the long term, structural headwinds should persist for regulated
27 utilities, owing to risks associated with capital acquisition, construction

1 execution, and regulatory recovery in a rising rate-base environment.
2 The bulk of this report is focused on these long run trends. As a result
3 of these trends, we would be owners of the most constructive
4 regulatory jurisdictions, the strongest balance sheets, and most
5 capable managements.
6

- 7 • In the intermediate term, we are looking for potential catalysts around
8 rate case filings and equity issuance schedules.¹
9

10 **Q. Did Barclays also address the rate case process?**

11 A. Yes. Barclays noted the added problem of regulatory lag caused by the use of
12 historic test years during a time of substantial investments:

13 During periods of rising capital expenditures and rate base as well as
14 rising costs, utilities with historic test years cannot fully recover those
15 rising costs over time. That is, during periods of free cash flow deficits,
16 revenues meant to offset depreciation, capital, and operating costs, for
17 utilities with historic test years are often delayed versus the actual
18 incurrence of these costs due to the review process.² NOTE: We'd
19 discussed striking this entire question, but Mike wanted the material on
20 regulatory lag left in, so I've maintained the first part of the Barclays quote.

21
22 **Q. Are investors concerned about state regulation in the context of mounting
23 risk?**

24 A. Yes. Nationally, in the past several years, rate case filings in the electric industry
25 have become much more frequent. From an investor's perspective, each
26 regulatory proceeding introduces a period of uncertainty for a utility. Among the
27 unknowns are the ROE the company will be allowed to earn, the equity base on
28 which that return can be earned, the extent to which costs—both historical and

¹ Barclays Capital. Capital Management. July 16, 2009.

² Ibid.

1 future—can be recovered, and the degree to which the rate case will prompt a
2 negative regulatory reaction. In other words, the utility's future earnings power is
3 thrown into question until the case is decided. Because that earnings power is
4 the basis for an investment in the company, the stability and constructiveness of
5 state regulatory policies are critical concerns to investors.

6
7 **Q. Please elaborate on the uncertainty surrounding allowed returns on equity.**

8 A. According to data provided by Regulatory Research Associates,³ average
9 allowed ROEs fell from 12.70% in 1990 to 10.36% in 2007. In 2008, however,
10 average ROEs began to increase slightly, to 10.46%, with 2009 rising marginally,
11 to 10.48%. Although the uptick in recent periods is encouraging, it is concerning
12 that the average allowed ROE has been below 11% for the past six years, even
13 as industry risk associated with the major construction cycle and other pressures
14 has begun to mount.

15
16 **Q. You mentioned previously Barclays Capital's concerns regarding rising
17 industry risk associated with the construction cycle. Does the firm provide
18 projections of authorized returns for the industry during the spending
19 cycle?**

20 A. Yes. Barclays projects average allowed ROEs for the industry of 11.16% for

³ Regulatory Research Associates. "Major Rate Case Decisions -- January 2009 - December 2009." January 8, 2010.

1 2010, 10.97% for 2011, 10.79% for 2012, and 10.60% for 2013.⁴ The firm's
2 projections reflect some recognition on the part of state regulators of rising
3 industry risk, but less than is expected by investors.

4
5 **Q. What are the implications for PPL Electric of Barclays analysis?**

6 A. Other things being equal, companies whose authorized returns are consistent
7 with investor requirements will have greater access to capital on more
8 reasonable terms. In the Company's case, it is already dealing with earnings
9 attrition borne of regulatory lag. With a major capex program and attendant
10 capital requirements, coupled with other risk factors, PPL Electric needs an
11 authorized ROE at the upper end of the industry range to ensure continued
12 capital access at reasonable prices.

13
14 **Q. Do investors have additional regulatory concerns?**

15 A. Yes. Many states offer little assurance of cost recovery, especially in the context
16 of a major capital expenditure program, through such mechanisms as
17 construction work in progress in rate base or investment pre-approval.
18 Pennsylvania provides neither. This is a significant deterrent to investors with
19 long memories relative to the last construction cycle, during which billions of
20 investment dollars—especially shareholder equity—were disallowed by state
21 regulators through *ex post* cost deliberations.

22

⁴ Barclays Capital, op. cit.

1 **Q. Please address how investors assess the specific risks the Company is**
2 **facing in relation to the new capital investment cycle.**

3 A. Investors understand that PPL Electric is involved in the industry-wide
4 construction and capital investment cycle in a significant way. During 2007-2009,
5 the Company invested \$859 million in its utility distribution system. From 2010
6 through 2012, the current expectation is that it will spend a total of \$1.7 billion of
7 new capital for the electric system, moving from \$423 million in 2010 to \$559
8 million in 2011, and then rising to \$673 million in 2012. During the 2010-2012
9 period, the Company will need to access the equity and debt markets, sometimes
10 requiring funding from both sources in the same year. The Company (and its
11 parent, which supplies it with equity) will thus be exposed to market vicissitudes
12 and pricing levels.

13
14 **Q. Does the Company face further risks?**

15 A. Yes. With its major planned capital spending, it is clear that PPL Electric will face
16 regular rate cases. Recovery of the substantial costs of maintaining, renewing
17 and replacing a mature utility infrastructure is likely to require base rate cases
18 routinely during the coming years.

19
20 **Q. What implication does regulatory lag, as highlighted in the Barclays’**
21 **analysis, have for PPL Electric?**

22 A. As noted by Regulatory Research Associates (“RRA”), Pennsylvania regulatory
23 practice utilizes a depreciated original-cost year end rate base for a forecast test

1 year.⁵ While this is clearly preferable to employment of an historical test year,
2 the test period in reality is historical by the time a rate case is decided.
3 Therefore, the Company is not kept fully whole. As a result, investors will have
4 questions about the timing and certainty of the utility's cash recovery of costs. It
5 is thus reasonable to expect investors to increase somewhat the risk premiums
6 they would require to supply the Company with capital, given this regulatory
7 structure.

8
9 **Q. Does PPL Electric face additional risks in the market for energy?**

10 A. Yes, it does. A major risk is rising environmental requirements such as
11 renewable portfolio standards or renewable energy standards, mandated DSM
12 expenditures, and various forms of carbon regulation, coupled with a significantly
13 heightened public concern around climate issues. While utilities have long faced
14 environmental compliance costs, such expenditures are likely to rise to a new
15 level under the Obama Administration. Even though the Company does not own
16 generation, it would bear the expenses associated with environmental
17 compliance through the costs it pays for purchased power, which would factor in
18 higher environmental-related power production expenses. These
19 environmentally-related costs will more likely put pressure on total electricity
20 costs, and thus make it more difficult for the public to accept rate increases
21 required to recover other necessary expenses.

⁵ Regulatory Research Associates. "Pennsylvania Public Utility Commission." Cited section updated 4/7/09.

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24

Q. What further risks might PPL Electric encounter?

A. PPL Electric was required under Act 129, which became effective in Nov. 2008, to create and adopt an energy efficiency and conservation program. Near term, the plan must reduce electric consumption by 1% by the end of May 2011, and by 3% by May 31, 2013. Act 129 also incorporates peak load reduction targets, which along with the electricity consumption reduction targets, extend through May 2013. In its plan, PPL Electric addressed the uncertainties associated with its ability to achieve the prescribed targets of the statute, which are aggressive compared to those of standards in other states. Beyond that, recovery of revenues lost due to conservation between rate cases cannot be recovered.

Q. You've discussed the mounting risks you see the Company facing. Do those risks have the potential to reduce its earnings and cash flow streams and increase their volatility?

A. Yes, they could, due to the fact that the foregoing factors are in large part beyond PPL Electric's control. Where risk factors are more clearly within the Company's control, investors can evaluate the importance and effect of those risks based on their assessment of the strength of the Company's management, and guidance about how the Company plans to mitigate or avoid the risks in question. In this case, the nature of the risk is such that the Company's investors have little guidance and more uncertainty. Uncertainty leads to investor concern and demands for higher investment returns.

1 regulators will be unwilling to let utilities recover their increased costs.

2 In this environment, set in the context of rising capital expenditures for the
3 industry at large and the Company specifically, it is important that the
4 Commission recognize that investors require a level of return that reflects the
5 increased level of risk.

6

7 **Q. What additional implications does the financial crisis hold for utilities?**

8 A. The current environment presents a distinct challenge to the industry. At a time
9 when utilities are starting major expansion initiatives, access to the capital
10 markets has become more questionable. As the financial crisis unfolded in the
11 2008-2009 period, utility companies learned that they could not count on being
12 able to finance their capital needs precisely on demand. Instead, at times market
13 access was limited, volatile, and very expensive. While the markets are now
14 open and the cost of access has dropped from the crisis peak, industry leaders,
15 investors and other participants in the market understand that such instability
16 could return again. Importantly, the industry must retain access to capital on
17 reasonable terms during this period of market uncertainty in order to provide safe
18 and reliable service to customers. This will require balanced and consistent
19 regulation. During this period, it will be imperative for electric utilities and
20 regulators to communicate effectively and work together to find the right balance
21 in satisfying the needs of all constituencies in this challenging environment.
22 Maintaining a solid regulatory compact will be critical.

23

24

1 **Q. What do you mean by a solid regulatory compact?**

2 A. The regulatory compact means that utilities will take the risk to invest in the
3 infrastructure and assets needed to provide safe, reliable, and efficient electric
4 service, and that regulators will support that investment by providing timely
5 recovery of costs, reasonable returns on prudently invested capital, and
6 regulatory treatment that, in general, is fair, predictable and balanced. It does
7 not involve favoring any one group of interested parties in the regulatory process
8 over others, but recognizes the key relationship between investment of capital by
9 the utility, and the need for recovery of operating costs, capital and returns to
10 support prudent investment.

11

12 **Q. Does the Company's financial health and investment grade credit rating**
13 **guarantee it easy access in the credit markets?**

14 A. No. As previously discussed, the turmoil in the financial markets has resulted in
15 no company—no matter how financially strong—having carte blanche access to
16 debt and equity financing. The stronger the company, the better the odds that
17 financing would be available, but there are no guarantees.

18

19 **Q. What factors suggest that improvement may still be slow to come in the**
20 **economy, with attendant negative implications for the markets?**

21 A. News sources contain articles on almost a daily basis conveying that the
22 economy is still fragile and the opportunity for additional shocks to the system
23 exists. For example, the Federal Reserve Board has signaled that it would cease
24 its program of Treasury bond purchases in coming months, which will remove an

1 important stabilizing feature from the markets. The Federal Reserve Board has
2 also acknowledged that it will be faced with a delicate balancing act of
3 maintaining a weak but rebounding economy while not fueling inflationary
4 pressures in the process. Another major problematic area is commercial real
5 estate, which has billions of dollars of loans coming due and limited prospects of
6 repayment. A crisis here could exacerbate ongoing problems in the already
7 weak banking sector. And the possibility of markets being disrupted by
8 unanticipated events from around the world always exists. For example, the
9 liquidity problems that surfaced in November 2009 at Dubai's government-owned
10 investment company rattled capital markets globally; the possibility was real that
11 those problems could have put the global economy back into the turmoil and
12 dysfunction that existed in late 2008. Had the Dubai liquidity problems not
13 resolved themselves quickly, the impact on the financial markets could have
14 been very destructive. The latest concern is over the sovereign debt of Greece
15 and Spain, and whether the Euro market will survive. In short, given the unstable
16 economic backdrop that still exists globally, there are numerous possibilities for
17 circumstances and/or events that could plunge the financial markets back into a
18 crisis mode. In short, risks are heightened.

19
20 **III. INVESTORS' EXPECTATIONS FOR RETURNS AND PERCEPTIONS OF THE**
21 **CURRENT PROCEEDING**
22

23 **Q. Why is the perception of regulatory climate of such importance to**
24 **investors?**

1 A. Equity investors today still seek companies that can offer stability in earnings and
2 dividends. Fixed income investors look for stable and adequate cash flows to
3 ensure payment of principal and interest when due, as indicated by stable credit
4 ratings. The ability to pay dividends and sustain credit ratings is directly related
5 to the consistency and sufficiency of a utility's earnings, which depend in large
6 part on how the utility is regulated and managed. If there is uncertainty about
7 whether regulation will allow a utility the opportunity to earn a reasonable return
8 in future years, then that uncertainty will lead investors to avoid holding
9 investment positions in the utility, all other things being equal.

10 As a result, investors selecting electric utility stocks today place a very
11 high value on consistent and constructive regulation. And, with a new round of
12 base rate case filings underway in the industry, the quality of regulation is
13 receiving increased investor attention.

14
15 **Q. In your experience as an analyst and portfolio manager, could a perceived
16 change in a company's regulatory climate affect your investment opinion?**

17 A. Absolutely. During my tenure as an institutional investor, a utility's regulatory
18 environment was a critical factor in my assessment of its investment
19 attractiveness. An adverse regulatory decision could be a key determinant in my
20 recommendation or decision to sell a stock already owned or not to make an
21 investment in one under consideration.

22
23
24

1 **Q. How have you gauged investors' perceptions of the issues in this**
2 **proceeding?**

3 A. To supplement my own knowledge of the industry, I have reviewed various
4 reports related to the Company and its parent written by investment analysts. A
5 clear picture of investors' perceptions emerges from these reports, which is in
6 keeping with my own views.

7
8 **Q. Have investors offered evaluations of Pennsylvania regulation relative to**
9 **other state commissions?**

10 A. Yes. Regulatory Research Associates has ranked the PUC from an investor
11 perspective. In its most recent quarterly evaluation of state regulatory
12 commissions, RRA accorded Pennsylvania regulation an "Average-3" rating.⁶
13 There are three tiers to RRA's ranking scheme: Above Average, Average, and
14 Below Average, with a numeric designation of 1, 2, or 3 (with 1 being the
15 strongest) within the principal rating category employed to indicate relative
16 strength therein. The regulatory firm notes:

17 The evaluations are assigned from an investor perspective and indicate
18 the relative regulatory risk associated with the ownership of securities
19 issued by the jurisdiction's electric, gas, and telephone utilities. Each
20 evaluation is based upon our studies of the numerous factors affecting the
21 regulatory process in the state, and is changed as major events occur that
22 cause us to modify our view of the regulatory risk accruing to the
23 ownership of utility securities in that individual jurisdiction.⁷

24
25 In its profile of the Pennsylvania PUC, RRA stated:

⁶ Regulatory Research Associates. "State Regulatory Evaluations," op. cit.

⁷ Ibid.

1 Over the past several years, the Pennsylvania regulatory climate has been
2 relatively stable, as the major utilities in the state have been operating
3 under relatively constructive electric industry restructuring plans. As the
4 transition periods have begun to expire, the PUC has adopted successor
5 provider-of-last-resort plans that provide for market-based pricing and
6 allow the utilities to fully recover wholesale power prices. However, due to
7 the impact on customers of recent relatively severe power price increases,
8 the PUC and General Assembly have begun to examine alternative
9 market structures, and it is unclear what the post-transition market will
10 look like in the state. In fact, during 2008 certain legislators advocated
11 extending the rate caps. However, it appears that this danger has, for the
12 most part, passed, as the companies and the PUC have proactively
13 sought to implement price mitigation (i.e., rate phase-in) plans for
14 residential and small-volume commercial customers. We continue to
15 accord Pennsylvania regulation an Average/3 rating.⁸
16

17 **Q. In addition to RRA, have other firms provided rankings of state**
18 **commissions?**

19 A. Yes. Barclays Capital, in the firm's previously-referenced annual regulatory
20 study, includes an evaluation of state utility commissions from an investor
21 perspective.⁹ Tier 1 is deemed "Lowest Cost of Capital" and Tier 5, "Highest
22 Cost of Capital." Barclays bases its rankings on six criteria: 1) elected versus
23 appointed commissions; 2) mechanisms for more consistent, timely, and
24 transparent regulation, or not; 3) allowed ROEs; 4) settlements versus litigation;
25 5) rate levels; and 6) a subjective investor friendliness rating. In its July 2009
26 assessment, the investment firm ranked Pennsylvania in "Tier 4" on this scale.¹⁰
27 This ranking indicates that the perception of the Pennsylvania regulatory

⁸ Regulatory Research Associates. "Pennsylvania Public Utility Commission." Quoted section updated 4/7/09.

⁹ The Barclays Capital utility analytical team was previously domiciled at Lehman Brothers. The team has authored the annual regulatory study since 2004.

¹⁰ Barclays Capital, Capital Management, op. cit.

1 environment is one that affords a cost of capital environment that is somewhat
2 more expensive relative to others states.

3
4 **Q. Are there additional inferences to be drawn from investors' general views**
5 **of regulation?**

6 A. Yes. One of the key factors analysts use to evaluate the quality of a regulatory
7 climate is the consistency of a commission's decisions. Investors value certainty
8 and predictability; a lack of consistency in a commission's actions or decisions
9 serves to increase the investment risk associated with a utility. Where there is a
10 predictable track record of regulatory decisions and actions, investors are able to
11 anticipate reliably the future actions of a commission. That reduces risk and
12 supports reasonable valuations—i.e., the market supports a higher price for the
13 Company's stock and a lower interest rate on bonds, which decreases a
14 company's cost of capital. In a study I prepared in 2005 for the Edison Electric
15 Institute on investors' perceptions of state regulation, respondents were asked to
16 cite the regulatory factors they felt characterized a constructive environment, as
17 well as those that characterize a non-constructive environment. On the positive
18 side of the ledger, one of the most important considerations for investors was a
19 regulatory climate that is "fair, stable, predictable, and consistent."

20 On the other hand, actions that indicate that regulatory decision making
21 may no longer be predictable or fair, lead to the opposite result. Actions that
22 indicate to investors that regulation is no longer fair, stable, predictable, and
23 consistent can have a dramatic impact on a utility's cost of capital and access to

1 capital markets on reasonable terms—and, ultimately, the cost of service to
2 customers.

3
4 **Q. What bearing does the investor regulatory rankings you've referenced have**
5 **on the current proceeding?**

6 A. While RRA's opinion of Pennsylvania regulation is that it is reasonably
7 constructive, Barclays' comparative analysis suggests that the Pennsylvania
8 regulatory climate results in costs of capital levels above those in other states.
9 One of the factors analysts value most in assessing a potential investment is
10 consistency and predictability; the state regulatory perception study I conducted
11 for the Edison Electric Institute confirmed that fact.

12 This is a precarious time for the electric utility industry. With companies—
13 PPL Electric among them—facing increasing construction, and other costs, and
14 requiring reasonable access to the capital markets to fund those requirements,
15 constructive regulation is critical. The Commission is viewed as having provided
16 such consistent and fair regulation historically, leading investors to expect a
17 continuation of a constructive regulatory environment in the state prospectively.

18
19 **Q. Turn now, please to the viewpoint of credit rating agencies. Please**
20 **comment on how the agencies perceive the Company and its regulatory**
21 **situation.**

22 A. PPL Electric continues to be rated investment grade, although the agencies are
23 mixed in their ratings. S&P's corporate credit rating on the Company is A-;

1 Moody's is Baa1; and Fitch's is BBB. Of note is the fact that both S&P and
2 Moody's changed their outlook on the rating from stable to negative last year,
3 while Fitch's outlook remains stable.

4
5 **Q. Please elaborate on S&P's and Moody's alteration of their ratings outlook**
6 **on the Company.**

7 A. On January 27, 2009, S&P moved to a negative outlook on PPL Electric. The
8 agency's rationale was two-fold: a negative outlook revision on parent PPL Corp.
9 (S&P links its ratings within a corporate family), and an expectation that the
10 Company's stand-alone credit profile would weaken at the end of 2009. S&P
11 further indicated that the Company's ratings reflect its insulation from its parent,
12 an excellent business risk profile, and an aggressive financial risk profile.¹¹

13 Moody's, which went to a negative outlook on May 11, 2009 stated:

14 The negative outlook for PPL Electric reflects our expectation that beyond
15 2009, as PPL Electric implements market rates for generation, and begins
16 to incur significant capital expenditures in support of its distribution and
17 transmission infrastructure, its financial metrics will deteriorate significantly
18 and will remain below levels demonstrated by electric utilities with senior
19 unsecured ratings of Baa1 for the foreseeable future. The negative
20 outlook also considers the potential for additional pressure on cash flows if
21 measures to avoid rate shock are taken that result in significant deferrals
22 of purchased power costs or if regulatory support for capital investment is
23 reduced or delayed.¹²

24
25 The agency is worried about the potential for the Company's financial strength to
26 decline, coupled with the robust level of prospective capex (capital expenditures)

¹¹ Standard & Poor's. "PPL Electric Corp. Outlook Revised to Negative, 'A-' Credit Rating Affirmed." January 27, 2009.

1 that lies ahead. Moody's also expresses its unease that inadequate or delayed
2 regulatory support for PPL Electric's planned high level of capital spending could
3 also weaken financial metrics well below levels appropriate for the rating.

4 **Q. You noted that Fitch has maintained a stable outlook on the Company. Is it**
5 **accurate to say that it doesn't share the other agencies' concerns?**

6 A. No, that is not accurate. It is important to note at the outset that Fitch's BBB
7 rating on PPL Electric, which was affirmed on October 30, 2009, is lower than
8 either S&P's or Moody's. As part of its ratings rationale on the Company, the
9 agency said that its ratings consider both the anticipated weakening in financial
10 measures as well as the large capex program. Fitch also stated explicitly how
11 imperative supportive regulation is to the Company's ratings: "The ability to
12 receive adequate tariff adjustments during a period of economic weakness and
13 rising power procurement costs is the primary credit concern." Indeed, the
14 agency noted among the key rating drivers for the Company:

15 The ability to receive adequate rate treatment from state regulators for its
16 electric distribution business, particularly in light of large increases in
17 power procurement costs, is a key ratings factor.¹³
18

19 **Q. Did S&P's discussions on the Company address Pennsylvania regulation?**

20 A. They did so only in an indirect way. For example, the agency pointed to "timely
21 recovery of power and transmission costs" as a "Strength" among Major Ratings
22 Factors. An attendant "Weakness" listed was "recovery of higher generation

¹² Moody's Investors Service. "Moody's changes outlook for PPL and PPL Electric to negative; Approximately \$2.5 billion of securities affected." May 11, 2009.

¹³ Fitch Ratings. "PPL Electric Utilities Corp." November 18, 2009.

1 rates could have regulatory risk.”¹⁴ However, S&P recently released its
2 assessment of state regulatory environments. In those rankings, which evaluate
3 state commissions from a credit supportiveness standpoint, the agency placed
4 Pennsylvania in the third of five categories, which it describes as “Credit
5 Supportive.” [S&P designates the rankings above that middle tier as being “most
6 credit supportive” and “more credit supportive;” the rankings below the middle tier
7 are “less credit supportive” and “least credit supportive.”]¹⁵

8
9 **Q. What inferences do you draw from the rating agencies’ views of PPL
10 Electric?**

11 A. All three agencies are acutely aware of the changed circumstances that threaten
12 to weaken the Company’s financial profile. The utility’s capital spending is
13 ramping up significantly. Due to this factor, as well as other pressures on
14 financial metrics, both S&P and Moody’s last year moved to a negative outlook
15 on the Company; Fitch, while maintaining its stable outlook, did so from the
16 perspective of a lower rating relative to its sister agencies. The significance of
17 S&P’s and Moody’s respective actions is that a supportive regulatory
18 environment—always important—has become even more critical prospectively,
19 particularly in light of the Company’s ratings now carrying a negative outlook.
20 Moody’s expresses concern that a lack of timely or adequate regulatory support
21 could further pressure PPL Electric’s cash flows. Fitch, which already rates the

¹⁴ Standard and Poor’s, op.cit.

1 Company lower than the other two agencies, states explicitly that the utility's
2 ability to receive sufficient rate relief is a primary credit concern. While S&P
3 addresses regulatory issues related to the Company in a more general fashion,
4 the agency's opinion of the Pennsylvania regulatory environment at the present
5 time is that it represents only average credit supportiveness. Taken together, the
6 agencies' respective views on PPL Electric suggest that it is more critical than
7 ever for the Commission to accord the Company supportive treatment, including
8 authorizing a return on equity level that will help shore up weakening financial
9 metrics.

10
11 **Q. Please turn your attention now to the opinions of equity investors. How do**
12 **they view the Company?**

13 A. Because it is undertaking a major infrastructure improvement program, PPL
14 Electric is becoming a more significant factor prospectively in equity investors'
15 consideration of an investment in the stock of PPL Corp. Bank of America/Merrill
16 Lynch signaled this shift last year:

17 **Shift of focus on PA utility operations**

18 After de-emphasizing the domestic utility in context of the market upside of
19 the Supply segment over the last couple years, management has begun to
20 address opportunities at the utility. In particular, PPL estimates that the
21 Pennsylvania utility rate base could grow by 50% over 2008 levels by
22 2013. Half of the growth will come from transmission investments (subject
23 to FERC incentive regulation) and the remaining to come from distribution
24 system investment. Roughly speaking, a 50% increase in rate base could
25 be work \$0.20-\$0.25/sh of incremental EPS over the next four years.¹⁶

¹⁵ Standard & Poor's. "Standard & Poor's Updates Its U.S. Utility Regulatory Assessments." March 12, 2010.

¹⁶ Bank of America/Merrill Lynch. "PPL Corp.: Strong Q1 driven by UK." May 3, 2009.

1
2 More recently, the firm (with coverage of PPL by a new analyst) stated:

3 **Outsized regulated earnings growth:** We believe that PPL is poised for
4 meaningful earnings growth at its U.S. and U.K. regulated utility
5 businesses.¹⁷
6

7 The ramifications of that new focus is that PPL Electric's outlook and the
8 regulatory environment in which it operates will take on a heightened importance
9 to and will come under increased scrutiny by investors.

10
11 **Q. Please elaborate.**

12 A. Equity analysts are aware that the Company's capex will begin to rise
13 significantly in 2010. For example, a recent report by Barclays Capital provided
14 historic and updated capex numbers by segment, including Pennsylvania
15 Delivery. Beginning this year, the firm pointed to projected spending levels that
16 approach doubling, then more than double levels of recent years.¹⁸ Wachovia
17 also noted the anticipated rise in capex: "Post-2010, the utility should be a
18 source of EPS growth driven by infrastructure investment, including a \$500mm
19 transmission project."¹⁹ On the one hand, this capex will serve to increase rate
20 base (and thus earnings) growth for the Company. On the other, the
21 infrastructure spending will also prompt the need for more frequent rate cases,

¹⁷ Bank of America/Merrill Lynch. "PPL Corporation: Attractive on many fronts."
February 7, 2010.

¹⁸ Barclays Capital. "PPL Corporation: 4Q Beat; 2010 Guidance Reiterated." February
5, 2010.

¹⁹ Wachovia. "PPL Corporation: '10 Looks Increasingly Like Peak Earnings Year;
Lowering Our '10 & '11 Estimates." May 1, 2009.

1 which, as described previously, raises uncertainty associated with an investment
2 stake in the parent.

3
4 **Q. Are investors aware of the current proceeding?**

5 A. Yes, they are. Numerous analyst reports addressed the prospect of PPL
6 Electric's filing a rate case in the March-April 2010 timeframe. In that context,
7 frequent mention was made of the fact that the utility is significantly
8 underearning, and the expectation expressed that earned returns should improve
9 as a result of the case. For example, Soleil Securities noted:

10 The major offset [to PPL Corp.'s earnings from lower power prices] at this
11 point would appear to be a potential base rate increase at the PA
12 regulated utility, which management said is currently earning only a 7.5%
13 ROE, vs. 10-11% for many regulated utilities. This is an overhang as well
14 as an opportunity.²⁰

15
16 Bank of America/Merrill Lynch also addressed the rate case:

17
18 PPL's Pennsylvania distribution business is expected to generate a 6%
19 return on equity in 2010, which will likely improve following the company's
20 planned 2010 distribution rate case.²¹

21
22 Barclays Capital provided additional thinking on the proceeding:

23 This rate case could include, in our view, proposed higher capex levels
24 than currently represented in the company's forecast and tracking
25 mechanism proposals to recover[y—sic] said higher spending on a more
26 real time basis. This would allow the company to potentially ramp up
27 much needed infrastructure spending on the distribution side, create/retain
28 jobs, and potentially drive higher earnings growth at the segment as they
29 would be able to earn closer to their allowed ROE.²²

²⁰ Soleil Securities. "PPL Corp.: Quarter Beats, Raising O9E Slightly." October 30, 2009.

²¹ Bank of America/Merrill Lynch, February 7, 2010, op.cit.

²² Barclays Capital, February 5, 2010, op. cit.

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21

Q. Investors clearly are optimistic that the Company’s earned returns could improve as a result of the case. Do they also envision risks associated with the filing?

A. Yes, they do. As discussed previously, rate cases are emblematic of heightened risk for a utility, and investors are acutely aware of this risk. Many analyst reports point to regulatory risk as a key one for PPL Corp. For example, Wells Fargo Securities said: “Risks to our valuation include earnings sensitivity to power prices, PA regulatory/political risks and generation-related operating risks.”²³ Soleil Securities indicated its projected price target on PPL Corp. could be vulnerable on both the upside and downside due to more positive or worse than expected rate case results.

Q. You noted earlier the RRA and Barclays Capital evaluations of the Commission. Have equity analysts also opined on the PUC in the context of this proceeding?

A. Yes. Deutsche Bank, in addressing the current rate proceeding, expressed a positive view of the Commission:

PA political risk could come back with high gas prices, rate cases ... Further, with the utility’s plans to begin filing frequent distribution rate cases, it could attract political attention. Despite the political risk potential

²³ Wells Fargo Securities. “PPL Corporation: PPL: 2010 Outlook Reaffirmed—Lowering 2012 Estimate.” February 5, 2010.

1 in Pennsylvania, we note that the Pennsylvania PUC has been generally
2 constructive in its approach to the utilities' market transition plans.²⁴
3

4 The investment firm's implication is that the constructive tone that has
5 characterized the state's regulatory environment historically can be hoped to
6 continue prospectively.
7

8 **Q. Beyond regulatory risk, have investors noted additional areas of concern**
9 **regarding the Company?**

10 A. Two additional factors bear mention. Deutsche Bank noted the ramifications of
11 heightened attention by the credit rating agencies: "In addition, rating agency
12 related scrutiny in the short-term could negatively impact its financing costs."²⁵
13 This statement highlights the linkage that exists between credit ratings and
14 earned equity returns, and reflects the investment firm's awareness of the
15 potential impact that S&P's and Moody's negative outlooks could have on PPL
16 Electric. A second area of concern to investors is the impact of Act 129. As Citi
17 noted recently: "Other issues to watch going forward—impact of demand
18 response and efficiency mandates in Pennsylvania..."²⁶
19
20

²⁴ Deutsche Bank. "PPL Corp.: Initiating coverage with Hold rating and \$33 price target." March 19, 2010.

²⁵ Deutsche Bank. "PPL Corp.: 2010 guidance reaffirmed, stock still appears cheap." May 4, 2009.

²⁶ Citi. "PPL Corp.: Solid 4Q09 Results; 210 Guidance Range Intact." February 5, 2010.

1 **Q. Please expand on Citi's concern.**

2 A. As was discussed previously, PPL Electric was required under Act 129 to create
3 and adopt an energy efficiency and conservation program. Specific to Citi's
4 concerns, recovery of revenues lost due to conservation between rate cases
5 cannot be recovered. The Company is permitted to adjust its sales volumes in a
6 base rate case to reflect lower volumes for setting rates for the future, but what
7 was lost previously is gone permanently.

8 **Q. Please summarize the views of equity investors as they pertain to the**
9 **Company.**

10 A. Investors understand that PPL Electric, though a major capital expansion
11 program, will become a more significant factor prospectively in the parent's
12 business mix. While the capital spending will be a propellant for earnings growth,
13 it also will require more frequent rate cases, which raises investment risk.
14 Investors are aware of this proceeding, and will follow its progress carefully. With
15 the very low returns that PPL Electric is currently earning, they anticipate an
16 improvement, particularly because of the Commission's constructive treatment of
17 the Company historically. In addition to the regulatory environment and its
18 attendant risks, investors are aware of the potential for revenue loss related to
19 conservation and energy efficiency programs. They are also mindful that credit
20 rating agencies currently are scrutinizing the Company, which could result in
21 added cost pressures if a downgrade occurs.

22

23

1 **IV. INVESTORS' EXPECTATIONS FOR RETURN ON EQUITY FOR PPL**
2 **ELECTRIC**
3

4 **Q. How do you believe that the Company's request for an 11.75% return on**
5 **equity comports with investors' perceptions?**

6 A. Investors will evaluate any ROE authorized by the Commission in light of a
7 number of factors including such things as the overall amount of the requested
8 increase that is granted, which bears on the Company's ability to earn the
9 allowed ROE, and whether or not there is a settlement in the case. The fact that
10 an ROE is arrived at through settlement is often seen as a positive factor for
11 investors. In this case, the Company has filed its application seeking an 11.75%
12 ROE, which is higher than the current authorized ROE level of 10.6%,
13 established in 2004. This filing reflects the rising risk levels in the
14 macroeconomic and capital market environments, as well as recognition on the
15 part of both credit rating agencies and investors that company-specific risks are
16 increasing. Most importantly, an 11.75% authorized ROE would represent a
17 continuation of the constructive regulatory trend which investors believe
18 characterizes Pennsylvania regulation, help maintain the Company's financial
19 health, and assist in maintaining access to the debt and equity capital markets.

20
21 **Q. Could a return on equity award that is consistent with investor**
22 **expectations also be expected to provide benefits to the Company's**
23 **customers?**

24 A. Absolutely. A higher ROE permits the realization of a stronger earnings stream.
25 In turn, that can improve a company's stock's valuation prospects, which results

1 in a higher stock price. Thus, when a company needs to tap the equity markets
2 for capital required to meet customer needs, it can get more for its money. Said
3 another way, each share sold brings more equity into a company with the same
4 commitment by the company to generate earnings and pay dividends to support
5 the value of that share. In regard to debt financing, a higher ROE awarded to the
6 Company would be viewed as a sign of constructive regulation and would be
7 positive for the Company's credit rating, as strengthened financial metrics would
8 help support the existing credit ratings. Importantly, customers' rates will
9 eventually reflect this lower cost of capital.

11 **CONCLUSION**

12 **Q. Please summarize what bearing the opinion and expectations of investors**
13 **have on the current proceeding.**

14 A. This is a precarious time for the electric utility industry. With companies—PPL
15 Electric among them—facing continued high levels of construction,
16 environmental, and other costs, and requiring reasonable access to the capital
17 markets to fund those requirements, supportive regulation is critical. Investors
18 are aware of these factors, and expect the Commission to make decisions in light
19 of them that will enable the Company to meet its investment and other
20 requirements. Current market conditions, current trends in ROE awards, and
21 PPL Electric's increased risks support an increase in the last allowed ROE.

1 Q. Does this conclude your testimony?

2 A. Yes.

3