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COMMONWEALTH OF PENNSYLVANIA ^{KUP}

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PUBLIC UTILITY COMMISSION

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 4 :
 4 Pennsylvania Public Utility Commission :
 4 versus Pennsylvania Power & Light Company :
 5 Investigation into a proposed \$261,000,000 : Docket Nos.
 5 annual rate increase. : R-943271
 6 : R-943271C0001
 6 : through
 7 Further Hearing. : R-943271C00130
 7 :
 8 ----- x

8 Pages 1532 through 1639

Hearing Room No. 2
North Office Building
Harrisburg, Pennsylvania

Friday, April 28, 1995

Met, pursuant to adjournment, at 10:08 a.m.

BEFORE:

ROBERT A. CHRISTIANSON, Administrative Law Judge

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P R O C E E D I N G S

ADMINISTRATIVE LAW JUDGE ROBERT A. CHRISTIANSON:

Let's be on the record. I am Administrative Law Judge Robert Christianson. We are here today for the last day this week, but we have two more days next week of testimony from other parties, so-called. We have at this point a third party with rate of return testimony beyond the traditional Trial Staff and Consumer Advocate, and unless there's something preliminary from counsel, we might as well just go ahead. I'll swear in the witness and Mr. Kleppinger may proceed with him.

MR. KLEPPINGER: Thank you, Your Honor. PP&L Industrial Customer Alliance calls Richard A. Baudino to the stand.

JUDGE CHRISTIANSON: Could you stand and raise your right hand, please?

Whereupon,

RICHARD A. BAUDINO

having been duly sworn, testified as follows:

JUDGE CHRISTIANSON: Fine. Be seated.

Proceed, counsel

DIRECT EXAMINATION

BY MR. KLEPPINGER:

Q. Please state your name and business address for the record.

1 A. My name is Richard A. Baudino. My business
2 address is J. Kennedy and Associates, Incorporated, 35
3 Glenlake Parkway, Suite 475, Atlanta, Georgia.

4 Q. On whose behalf are you appearing here today?

5 A. I am appearing on behalf of the PP&L Industrial
6 Customer Alliance.

7 Q. Mr. Baudino, do you have before you a document
8 which is labeled "Direct Testimony and Exhibits of Richard
9 A. Baudino" consisting of some 57 pages of text and five
10 exhibits labeled RAB-1 through RAB-5?

11 A. Yes.

12 MR. KLEPPINGER: Your Honor, I would like to have
13 marked for identification purposes PPLICA Statement No. 8,
14 the direct testimony and exhibits of Richard A. Baudino.

15 JUDGE CHRISTIANSON: That's right. This is number 8,
16 yes, all your individual people. So identified, number 8.

17 (Whereupon, the documents were marked
18 as PPLICA Statement No. 8 and PPLICA
19 Exhibits Nos. RAB-1 through RAB-5
20 for identification.)

21 BY MR. KLEPPINGER:

22 Q. Mr. Baudino, was PPLICA Statement No. 8 prepared
23 by you or under your supervision?

24 A. It was.

25 Q. Are there any additions or corrections you would

1 like to make to that testimony at this time?

2 A. I do not have any.

3 MR. KLEPPINGER: Your Honor, I would like to note for
4 the record that one mailing of this did go out with April
5 1994 on it. If anyone has one of those dates on the cover
6 sheet, it should be 1995, obviously.

7 JUDGE CHRISTIANSON: Oh, mine has that. I should
8 confess, I just worked on discovery trouble in one case I
9 had, a telephone case, and I had referenced a decision I had
10 written January 10, 1994, which was 1995, and I referenced
11 this in a later decision. The date I used was a year off.

12 MR. KLEPPINGER: The parties who were served by Fed
13 Ex I think had the '94 date, and those that we hand-
14 delivered had '95 corrected on it.

15 JUDGE CHRISTIANSON: I must have had a prior one,
16 yes.

17 MR. KLEPPINGER: I just wanted to make sure.

18 JUDGE CHRISTIANSON: Okay.

19 BY MR. KLEPPINGER:

20 Q. Mr. Baudino, you don't have any other additions
21 or corrections then to your testimony at this time?

22 A. No, I do not.

23 Q. If I were to ask you the questions contained in
24 PPLICA Statement No. 8 today, would your answers be the same
25 as set forth therein?

1 A. Yes.

2 Q. Are those answers true and correct to the best
3 of your knowledge, information and belief?

4 A. Yes.

5 MR. KLEPPINGER: Your Honor, I would like to move for
6 the admission of PPLICA Statement No. 8 at this time.

7 JUDGE CHRISTIANSON: It's accepted into the record
8 under the standard conditions about possible motions on
9 cross.

10 (Whereupon, the documents marked as
11 PPLICA Statement No. 8 and PPLICA
12 Exhibits Nos. RAB-1 through RAB-5
13 were received in evidence.)

14 JUDGE CHRISTIANSON: I should correct myself
15 slightly. The Department of Defense witness did touch on
16 rate of return as well, so it's another party who has
17 addressed rate of return.

18 MR. KLEPPINGER: And the witness is available for
19 cross-examination.

20 JUDGE CHRISTIANSON: Fine. We can proceed with the
21 company.

22 MR. GADSDEN: Thank you, Your Honor.

23 CROSS-EXAMINATION

24 BY MR. GADSDEN:

25 Q. Mr. Baudino, maybe the best place to start is on

1 page 37 of your testimony where you provide us a table which
2 sets forth various components of your weighted cost of
3 capital or rate of return recommendation in this case.

4 As I understand that table, as well as your
5 testimony, you are proposing that the Commission adopt
6 PP&L's historic test year end capital structure; is that
7 correct?

8 A. Yes.

9 Q. Can we agree that the company's historic test
10 year capital structure has more debt and less equity than
11 what we've claimed in terms of the future test year end
12 capital structure?

13 A. Yes.

14 Q. And all other factors being equal, that would
15 lead to an overall lower rate of return, would it not, your
16 recommendation?

17 A. Yes.

18 Q. In the question and answer which begins at the
19 bottom of page 37 and runs over to the top of 38, you note
20 that PP&L is planning to issue a substantial amount of
21 additional common equity financing, and further go on to
22 point out that in your judgment the company hasn't provided
23 a sufficient explanation for doing that. Is that a fair
24 summary?

25 A. Yes.

1 Q. How do you define substantial as you use that
2 term on line 21 of page 37?

3 A. Substantial in a qualitative sense I would
4 define as the end result being, with the company's proposed
5 financing plans, that the common equity ratio increases by
6 one percentage point at a time when the company has filed
7 for a future test period. That would be a qualitative
8 definition of it.

9 Q. Do you have any estimate or do you know what the
10 total capitalization of Pennsylvania Power & Light Company
11 is?

12 A. I can look that up. I don't have it right at
13 the tip of my fingers. I can look it up and give it to you.

14 Q. You don't know off the top of your head what
15 percentage of that total capitalization the \$100 million
16 that the company is planning on issuing this year would
17 represent?

18 A. I haven't calculated it as a percentage.

19 Q. Assuming an adequate explanation were provided
20 by the company, presumably in the rebuttal phase of this
21 case, would it still be your view that the projected capital
22 structure at 9/30/95 should not be utilized?

23 A. Possibly, yes.

24 Q. Do you find those ratios per se unreasonable?

25 A. The projected ratios?

1 Q. Yes.

2 A. I believe they're unreasonable in this case.

3 Q. Are there other reasons why you hold to that
4 view other than those which you expressed in your testimony?

5 A. I believe that the company asked in an
6 interrogatory request to me what the company would have to
7 do in order to justify its request, and I gave several items
8 that I think would have to be satisfied.

9 I believe that in addition to what I presented --
10 what I presented in that response to the interrogatory was
11 more detailed than I've presented in my testimony because
12 the company's question was more direct and detailed and
13 asked for specific items. So to the extent that the answer
14 in my testimony is supplemented by the response to the
15 interrogatory, then that would be it as far as my position
16 on that.

17 Q. Let me ask the question this way then. Assuming
18 that the company presented evidence to your satisfaction
19 that addressed the various concerns that you raise in your
20 response to our Interrogatory Set II, No. 10, under those
21 circumstances would it still be your view that the historic
22 test year end capital structure should be utilized?

23 A. Not necessarily, but then I don't believe that
24 the company's projected capitalization ratios would
25 necessarily be correct either.

1 Q. Why is that?

2 A. I believe that Mr. Kahal raised a point in his
3 direct testimony, which I hadn't considered, regarding the
4 debt ratio and how you reflect the call premiums, so I think
5 there is an issue there that he raised that deserves some
6 attention, and if he's right, the equity ratio on a
7 projected basis would not differ significantly from the
8 equity ratio on an historic basis.

9 Q. The issue that you just alluded to is not
10 addressed in your direct testimony, is it?

11 A. It is not.

12 Q. What is the average equity ratio of your
13 barometer group?

14 A. I haven't calculated it, but -- my comparison
15 group, you mean as opposed to Mr. Moul's barometer group?

16 Q. No. I'm just interested in knowing what the
17 equity ratio of your barometer group is.

18 A. I call it comparison group, so I just wanted to
19 make sure our terminology is --

20 Q. Sure.

21 A. But you're talking about my group versus --

22 Q. The barometer group that you selected.

23 A. Okay. I haven't calculated it, but in reviewing
24 the capital ratios, I believe the equity ratio is higher for
25 that group than it is for PP&L, both on an historic and a

1 projected basis.

2 Q. As an on-the-record data request I would ask
3 that you provide us with the average capital structure
4 ratios for your barometer group, which you characterize as
5 the comparison group, both at the latest available date and
6 as may be projected at year end 1995.

7 A. May I make a statement on that?

8 Q. Certainly.

9 A. I can provide you the '93 actual numbers from
10 Value Line. I don't know that I would be able to provide
11 the '94 numbers. I don't know if we necessarily have all of
12 the annual reports from the companies that were detailed in
13 '94 capital ratios.

14 JUDGE CHRISTIANSON: I guess counsel is worried about
15 '95.

16 MR. GADSDEN: You're right.

17 THE WITNESS: I could present the '94 projected
18 capital ratios from the Value Line sheets that I've got, if
19 that would be sufficient, and I could show the '95
20 projections as well. I just want to make sure that the form
21 I present is adequate.

22 BY MR. GADSDEN:

23 Q. I understand, and I understand that you can't
24 provide us information that you don't have. You understand
25 the request, and just to the extent you can.

1 A. I'll provide what I have.

2 JUDGE CHRISTIANSON: Provide what is reasonably
3 available.

4 MR. GADSDEN: Right.

5 JUDGE CHRISTIANSON: Mr. Kleppinger took notes. I
6 guess he's aware of that request.

7 BY MR. GADSDEN:

8 Q. Mr. Baudino, even though you've utilized PP&L's
9 historic test year end capital structure, am I correct that
10 you have adopted, on Table 4 on page 37 of your testimony,
11 the company's projected future test year end embedded cost
12 rates for long-term debt and preferred stock?

13 A. Yes.

14 Q. And those rates are lower than the comparable
15 figures at the end of the historic test year, are they not?

16 A. Correct.

17 Q. Can we also agree that the future test year end
18 embedded cost rates are based at least in part on issuances
19 of securities, redemptions and satisfaction of sinking fund
20 requirements which are anticipated to take place during the
21 future test year?

22 A. Yes. I believe some of those have actually
23 taken place already as far as the issuance of new debt.

24 Q. Just so the record is clear then, for embedded
25 cost rate purposes, you're effectively recognizing those

1 future test year issuances and redemptions, but for capital
2 structure purposes, at least at this point, you're ignoring
3 them; is that correct?

4 A. I think I would say that I'm imputing a capital
5 structure based on the company's September 30, 1994
6 capitalization ratios.

7 Q. Which does not take into account the issuances,
8 redemptions or sinking fund requirements associated with
9 securities that take place after that historic test year; is
10 that correct?

11 A. As a practical matter that's true, but what I
12 have done is essentially imputed that capital structure as
13 being a reasonable one to use, and essentially it would
14 impute slightly more debt issuance, let's say, than the
15 company had planned in the 1995 test period.

16 Q. At various points in your testimony you, like
17 the other rate of return witnesses in this case, touch upon
18 the issue of relative risk, and I have a couple of questions
19 with respect to that.

20 If I could direct your attention to page 3, and
21 specifically at line 11, --

22 A. Yes.

23 Q. -- you note that PP&L, or at least I interpret
24 that what you say there in the first item, that you believe
25 PP&L is a below average electric utility. Is that your --

1 A. Below average risk.

2 Q. Below average risk electric utility.

3 A. Yes.

4 Q. A minor point, but can I assume that the "3" and
5 "4" should be "2" and "3", or is there an additional item in
6 there that was omitted?

7 A. It should be "2" and "3". Thank you.

8 Q. Is your opinion that PP&L is a below average
9 risk electric utility based on the fact that Value Line has
10 assigned PP&L a 2 rating when it comes to safety risk?

11 A. Yes. And I would just say that it's a safety
12 rank.

13 Q. Sorry.

14 A. That's okay. Which considers the total risk of
15 a stock. So yes, it's based on that.

16 Q. As I understand your response to one of our
17 interrogatories in which you provided us some materials from
18 Value Line, the safety rank represents an average of the
19 utility's price stability rating and its financial condition
20 rating; is that correct?

21 A. May I have a moment?

22 Q. Certainly.

23 (Witness perusing documents.)

24 A. I just wanted to make sure the terminology was
25 correct. Its price stability index and financial strength

1 rating; that's correct.

2 Q. In terms of assigning a safety rank, am I
3 correct that companies are not ranked by Value Line
4 vis-a-vis their peers but rather in terms of all 1700
5 companies that are followed by Value Line?

6 A. Yes.

7 Q. So, in other words, the ranking cuts across
8 industry lines, does it not?

9 A. Yes, it does.

10 Q. I believe I noted that PP&L's financial
11 condition rating according to Value Line was either BBB or
12 BBB+. Do you recall that?

13 A. Did you say you mentioned that?

14 Q. I thought I had noticed it --

15 A. I don't recall you mentioning it.

16 Q. -- in either materials you had provided to us or
17 someone else had.

18 A. I can look that up.

19 (Witness perusing documents.)

20 A. It's B++.

21 Q. B++?

22 A. Yes.

23 Q. How does PP&L fare in terms of Value Line's
24 timeliness rank? Is it above average, below average or
25 average?

1 A. It's below average. Not unlike many electric
2 utilities at this time.

3 Q. How often are these safety ranks reviewed and
4 revised?

5 A. Quarterly. I should say the reports come out
6 quarterly, and I think during that time the analyst will
7 look and see if any revision is required. They wouldn't
8 necessarily be revised quarterly, but any revision would
9 take place on a quarterly basis, if necessary.

10 Q. Mr. Baudino, at page 13, and again later in your
11 testimony, --

12 A. Yes, I have that.

13 Q. -- you assert that PP&L has increased its
14 business risk by proposing what you characterize as an
15 excessive increase for its industrial customers. Do you see
16 that?

17 A. I see that I said it may have increased the
18 business risk.

19 Q. You agree, do you not, that the rates charged
20 interruptible customers should reflect the cost of serving
21 them?

22 A. I think that's correct.

23 Q. Have you, yourself, made any analysis to
24 determine what the cost of service is to interruptible
25 customers?

1 A. No, I have not. Mr. Baron of our firm addresses
2 that.

3 Q. Do you happen to know how the interruptible
4 rates proposed by the company in this case compare to the
5 rates that were charged those same customers ten years ago?

6 A. No.

7 Q. In the same answer you refer to the risk of self
8 generation and bypass. What is your definition of bypass in
9 this context?

10 A. Bypass would refer to essentially bypassing the
11 company's system and using another supplier of electricity.
12 And in this case it would be bypassing perhaps the company's
13 generation.

14 JUDGE CHRISTIANSON: And if they used the PP&L
15 distribution system, probably.

16 THE WITNESS: It depends. They would probably still
17 continue to use it, unless -- I mean there may be other
18 options.

19 BY MR. GADSDEN:

20 Q. Who would these other suppliers be?

21 A. I have not made a study of that. I think the
22 best witness we have that I would refer you to would be Mr.
23 Rooney, for Armstrong, who has actually looked at some self
24 generation and bypass alternatives.

25 Q. Mr. Rooney is the gentleman from Armstrong World

1 Industries?

2 MR. KLEPPINGER: Yes; that's correct.

3 THE WITNESS: Yes.

4 JUDGE CHRISTIANSON: Yes. I think he had testimony
5 about forming a local municipal entity. I was going to say
6 authority, but I don't think authorities can do electric, if
7 I remember correctly.

8 BY MR. GADSDEN:

9 Q. Mr. Baudino, am I correct that for purposes of
10 this proceeding you relied exclusively on the discounted
11 cash flow in developing your equity recommendation?

12 A. Yes.

13 Q. In your response to our Interrogatory Set II,
14 No. 11, you indicated, did you not, that you had utilized
15 the risk premium method in the past but discontinued its use
16 in 1992?

17 A. Yes. That risk premium was actually based on a
18 DCF analysis of a comparison group of companies, the risk
19 premium from which would be applied to the subject company's
20 bond yield.

21 Q. Do you recall participating in a 1993 proceeding
22 regarding Arkansas Louisiana Gas Company?

23 A. Yes.

24 Q. Based on my reading of the order in that case,
25 you also presented a risk premium analysis there. Is the

1 order in error?

2 MR. KLEPPINGER: Mr. Gadsden, would you have the
3 order there?

4 MR. GADSDEN: Certainly.

5 THE WITNESS: I recall the use of a CAPM in '93 in
6 that case. I presented a DCF analysis and a capital asset
7 pricing model, if I correctly recall my testimony in that
8 case.

9 BY MR. GADSDEN:

10 Q. I apologize that I don't have a complete copy of
11 the order, but let me hand you what I do have, and I've
12 highlighted the paragraph that attracted my attention.

13 (Document handed to witness.)

14 A. Thank you.

15 (Witness perusing document.)

16 A. I think I would like to answer that.

17 Q. Sure.

18 A. I need to review the testimony, but as I recall,
19 the risk premium analysis was one which I looked at the
20 resulting risk premium from the DCF analysis and determined
21 that it was reasonable. It wasn't a risk premium analysis
22 as I had presented it in '92 and prior to that.

23 The actual numbers that I presented in that case were
24 for the DCF and the capital asset pricing model, and my
25 recommendation was based on the DCF.

1 Q. Your risk premium study was in effect used as a
2 check?

3 A. Right.

4 Q. Mr. Baudino, you further note in your response
5 to our Interrogatory Set II, No. 11, that you relied
6 primarily on the capital asset pricing model in a 1992
7 Cincinnati Gas & Electric case. Do you recall that?

8 A. Primarily did you say? I relied in part on it.

9 Q. I'm sorry. Partially.

10 A. Yes.

11 Q. Thank you.

12 Am I correct that you have also used the CAPM as a
13 check in subsequent proceedings involving companies such as
14 Minnesota Power & Light, Monongahela Power Company and West
15 Penn Power Company?

16 A. Correct.

17 Q. And all those testimonies were filed in 1994; is
18 that correct?

19 A. Correct.

20 Q. Do you recall testifying in a 1993 Indiana
21 Michigan Power Company case that the CAPM was a basically
22 sound model that was frequently used for purposes of
23 estimating the cost of equity?

24 A. No, I don't recall that.

25 Q. Again, I only have the LEXIS version of this.

1 This is an order issued by the Indiana Utility Regulatory
2 Commission on November 12, 1993 in Cause No. 39314, Re:
3 Indiana Michigan Power Company. Again, I have highlighted
4 the portion of the order that I'm interested in.

5 (Document handed to witness.)

6 (Witness perusing document.)

7 A. It says, "While Mr. Baudino was critical of the
8 CAPM model, he also acknowledges that it was a basically
9 sound model used for the purposes in estimating cost of
10 equity."

11 Did you characterize this as being '93?

12 Q. The order was issued in '93 at least, according
13 to the --

14 A. Right. The testimony was in '92. All I recall
15 from that testimony -- and maybe I could provide you a copy
16 of this -- is that I had a criticism of Mr. Brennan's
17 capital asset pricing model in my testimony. I don't recall
18 that I -- this may be the way the Commission characterized
19 my testimony, but I don't recall saying that it was a
20 basically sound model.

21 JUDGE CHRISTIANSON: You might have said, "It's
22 basically a sound model, but," and then emphasized the "but"
23 part I guess.

24 THE WITNESS: I would need to see the transcript,
25 probably, of my cross-examination, but I don't recall saying

1 that in the direct testimony.

2 BY MR. GADSDEN:

3 Q. Mr. Baudino, as I understand it, you applied the
4 DCF method to data for PP&L, Mr. Moul's barometer group, and
5 a group which you selected based on the criteria that you
6 set forth on page 22 of your testimony; is that correct?

7 A. Yes.

8 Q. And perhaps I missed it, but were those analyses
9 given equal weight or did you focus primarily on the
10 barometer group analyses?

11 A. I gave them equal weight in terms of looking at
12 the results. The actual recommendation was based on an
13 average of the PP&L analysis and the barometer group
14 analysis, and I noted that the recommendation was at the top
15 end of the range of the comparison group that I did.

16 Q. You just indicated in your answer that you gave
17 equal weight to the PP&L analysis and the barometer group
18 analysis.

19 A. In formulating the recommendation, right.

20 Q. Which barometer group are you talking about?

21 A. Mr. Moul's.

22 Q. You did not give any weight to the results of
23 the barometer group analysis of the companies that you
24 selected?

25 A. I noted that it was within the range, at the top

1 end of the range.

2 Q. Now, in selecting your barometer group I gather
3 you did not consider generating mix and specifically the
4 extent to which a utility might rely on nuclear power; is
5 that correct?

6 A. No, I did not do that. The Value Line safety
7 rank tends to be a good way to select companies, and they
8 would tend to look at all risk factors pertaining to a
9 specific company. So the safety rank would tend to include
10 nuclear generation to the extent the investors would
11 consider that an additional risk to consider.

12 Q. There may be some lack of clarity in the record
13 either given my question or your answer, but just so we
14 can -- I understand what you said about the Value Line
15 safety rank. The question we asked in discovery was: did
16 Mr. Baudino consider generating mix, and specifically
17 nuclear generation, in developing the selection criteria?
18 Can we agree that your answer was no?

19 A. Oh, sure, I'll agree to that.

20 Q. On page 23 you indicate that it's been your
21 general practice to use six months of data in calculating an
22 average dividend yield; is that correct?

23 A. Yes.

24 Q. Have there been occasions when you've used more
25 or less than six months?

1 A. Yes.

2 Q. Mr. Baudino, do you have an estimate of the rate
3 of inflation over the next several years?

4 A. The projections I've seen have been between 3
5 and 4 percent over the next couple of years.

6 Q. And the growth rates that you've proposed in
7 this case are slightly less than that; isn't that correct?

8 A. I think if you look at the midpoint of the
9 growth rate range, it would be less than inflation; that's
10 correct.

11 MR. GADSDEN: That's all we have, Your Honor.

12 JUDGE CHRISTIANSON: Then we can probably pause. You
13 might want a couple of minutes with your witness.

14 MR. KLEPPINGER: Yes.

15 JUDGE CHRISTIANSON: Let's take about five minutes.
16 Let's be off the record.

17 (Discussion off the record.)

18 JUDGE CHRISTIANSON: Let's be back on the record.
19 We can proceed then with redirect examination.

20 MR. KLEPPINGER: Thank you, Your Honor.

21 REDIRECT EXAMINATION

22 BY MR. KLEPPINGER:

23 Q. Mr. Baudino, do you recall Mr. Gadsden's
24 questions regarding what criteria you would like to see PP&L
25 meet before assessing the reasonableness of the proposed

1 equity financing in August of 1995?

2 A. Yes.

3 Q. I believe he alluded to an interrogatory
4 response that you had provided at Set II, No. 10; do you
5 recall that?

6 A. Yes.

7 Q. Could you tell us what the criteria were that
8 you listed in that interrogatory answer?

9 A. Yes. I had four criteria. The first was
10 demonstrate that the proposed equity financing is
11 economical; two, demonstrate that the equity financing is
12 unrelated to the creation of the holding company, PP&L
13 Resources; three, demonstrate that the proposed equity
14 issuance is not a temporary timing difference for purposes
15 of inflating the revenue requirement in this proceeding; and
16 four, verify that the proposed equity issuance has actually
17 taken place.

18 MR. KLEPPINGER: Thank you, Mr. Baudino.

19 That's all I have, Your Honor.

20 JUDGE CHRISTIANSON: I would guess there's no follow-
21 up.

22 Anything from the company?

23 MR. GADSDEN: Just one.

24

25

REXCROSS-EXAMINATION

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BY MR. GADSDEN:

Q. Mr. Baudino, your first criterion, demonstrating that the proposed equity financing is economical, what kind of presentation do you anticipate with respect to that one?

A. From the company?

Q. Yes.

A. I don't know.

Q. You don't know what the company would have to present in order to satisfy that criterion?

A. No, I have some ideas of what it could present. I thought your question was what do I anticipate from the company.

Q. No.

A. And I didn't know what the company was --

Q. No. I'm just trying to get a better handle on what your test is.

A. My test would be that the company would show that there is some benefit to the ratepayers and to the company through this equity financing, being savings in the cost of capital, both debt and lower cost of equity; that there would be some benefit for the additional cost, in other words, that the company is asking to include in this case.

MR. GADSDEN: That's fine. Thank you.

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JUDGE CHRISTIANSON: Any follow-up on that?

MR. KLEPPINGER: No, Your Honor.

JUDGE CHRISTIANSON: Then the witness is excused.

(Witness excused.)

JUDGE CHRISTIANSON: We might as well get started
with Mr. Kahal.



1 Whereupon,

2 MATTHEW I. KAHAL

3 having been duly sworn, testified as follows:

4 JUDGE CHRISTIANSON: Proceed, counsel.

5 MS. KENNEY: Your Honor, pursuant to discussions with
6 Mr. Gadsden, it is my understanding Mr. Kahal will be
7 crossed on OCA Statement 1 in the morning and then OCA
8 Statement 2 in the afternoon.

9 Your Honor, at this time I would like to have them
10 both marked for identification.

11 JUDGE CHRISTIANSON: Fine.

12 MS. KENNEY: Your Honor, I would like to have marked
13 for identification as OCA Statement No. 1 the direct
14 testimony of Matthew I. Kahal on fair rate of return and
15 nuclear decommissioning trust fund earnings. Also, I would
16 like to have marked as OCA Statement No. 2 the additional
17 direct testimony of Matthew I. Kahal on capacity issues.

18 I would note for the record that this testimony has
19 been provided in both a proprietary and non-proprietary
20 form. The proprietary form is in a red cover and has been
21 sealed, and the non-proprietary form is in the grey cover,
22 and the majority of the parties were provided with the non-
23 proprietary material.

24 I would note that we have had some discussions with
25 the company about the continuing proprietary nature of the

1 testimony, but at this time we will continue to treat this
2 material as proprietary and we will continue those
3 discussions with the company.

4 (Whereupon, the documents were marked
5 as OCA Statement No. 1 and OCA
6 Statement No. 2 for identification.)

7 DIRECT EXAMINATION

8 BY MS. KENNEY:

9 Q. Mr. Kahal, could you please state your business
10 address for the record?

11 A. It is Exeter Associates, 12510 Prosperity Drive,
12 Silver Spring, Maryland, 20904.

13 Q. Mr. Kahal, do you have before you copies of your
14 prepared, prefiled direct testimony in this case, OCA
15 Statement No. 1 consisting of 60 pages of questions and
16 answers and Schedules MIK-1 through MIK-10 and OCA Statement
17 2 consisting of 30 pages of questions and answers and
18 Schedules MIK-11 through MIK-15?

19 A. Yes, I do.

20 Q. Was this testimony and were these schedules
21 prepared by you or under your direct supervision?

22 A. They were.

23 Q. I would note that OCA Statement No. 2, pages 23
24 through 26 and Schedule MIK-15 have been designated as
25 proprietary. Is that correct?

1 A. That's correct.

2 Q. Do you have any additions, corrections or
3 modifications to make to your testimony or schedules at this
4 time?

5 A. Yes, I do. In OCA Statement No. 1, Schedule
6 MIK-4, page 1, this provides a listing of dividend yields
7 for Mr. Moul's group of companies. The first company is the
8 Allegheny Power System. As of September, 1994, I believe
9 the schedule lists its dividend yield as 27.79 percent.
10 That is a bit of an exaggeration. The dividend yield in
11 fact is 7.79 percent. It is a typographical error.

12 That is the only correction I have.

13 Q. And does that correction make any changes to the
14 conclusions on that schedule?

15 A. No. It is strictly a typographical error. It
16 didn't enter into any of the other calculations.

17 Q. Subject to this correction, are the testimony
18 and schedules in OCA Statements 1 and 2 true and correct to
19 the best of your knowledge, information and belief?

20 A. Yes.

21 Q. If I were to ask you these same questions today
22 under oath, would your answers be the same?

23 A. They would.

24 MS. KENNEY: Your Honor, we ask that Mr. Kahal's
25 testimony marked for identification as OCA Statements 1

1 and 2 and Schedules MIK-1 through MIK-15 be admitted into
2 evidence subject to cross-examination and any timely motions
3 by opposing counsel.

4 JUDGE CHRISTIANSON: Yes. Under the standard
5 conditions, Statement 1 and Statement 2 with the
6 accompanying schedules are now accepted into the record.

7 (Whereupon, the documents marked as
8 OCA Statement No. 1 and OCA
9 Statement No. 2 were received in
10 evidence.)

11 MS. KENNEY: Your Honor, all parties and Your Honor
12 were previously provided with copies of Mr. Kahal's
13 testimony. I would note that only a couple of the parties
14 did receive the proprietary version and I believe Your Honor
15 has also received the proprietary version of that testimony.

16 JUDGE CHRISTIANSON: Yes; and I've broken the seal on
17 my copy.

18 MS. KENNEY: And we have also provided complete
19 copies of Mr. Kahal's testimony to the court reporter. Mr.
20 Kahal is now available for cross-examination.

21 JUDGE CHRISTIANSON: And again, just on Statement 1
22 at this point. And the company may proceed.

23 MS. KENNEY: Oh, Your Honor. I would note, as a
24 housekeeping matter, particularly in OCA Statement No. 2,
25 that at that time Mr. Kahal's testimony noted that

1 supplemental testimony would be filed in response to
2 outstanding data requests and that we are still waiting for
3 the PP&L 10-K for 1994 and 1995 Annual Resource Planning
4 Report. We still have not received that information, so
5 therefore, there still may be a supplement to that
6 testimony.

7 JUDGE CHRISTIANSON: I remember ARPR. That brings
8 back memories of NUG litigation, not fond memories I might
9 add.

10 THE WITNESS: Not for any of us.

11 JUDGE CHRISTIANSON: But that is noted for the
12 record.

13 MR. GADSDEN: And I would simply note for the record
14 that the Annual Resource Planning Report is not due to be
15 filed until Monday, and that as soon as it is, we will make
16 it available to the Consumer Advocate.

17 JUDGE CHRISTIANSON: Okay.

18 MR. GADSDEN: And the other parties.

19 MS. KENNEY: Thank you.

20 CROSS-EXAMINATION

21 BY MR. GADSDEN:

22 Q. Mr. Kahal, like Mr. Baudino, you have not
23 adopted PP&L's proposed capital structure, have you?

24 A. I have made one small modification to that
25 capital structure. Other than that, I have accepted all of

1 the capitalization numbers.

2 Q. As I understand it, your problem lies not with
3 the company's proposed equity issuance provided that it
4 takes place and satisfactory proof of that is submitted, but
5 rather relates to the fact that Mr. Moul deducted
6 approximately \$116 million of unamortized losses on debt
7 reacquisitions from his long-term debt balance in developing
8 his capital structure ratio?

9 A. That's correct. That's my only disagreement.

10 Q. And that is the issue that Mr. Baudino alluded
11 to during his cross-examination; is that correct?

12 A. Yes. I thought he had indicated that he was at
13 least potentially in agreement with that.

14 Q. Whereas Mr. Moul subtracted those dollars out,
15 you would add them back in resulting in a lower equity ratio
16 and a higher debt ratio; is that correct?

17 A. I think that a more accurate characterization is
18 simply that I wouldn't have subtracted the amount in the
19 first place.

20 Q. You would leave them in?

21 A. I would have -- well, it's not a question of
22 leaving them in. I would have simply used the actual debt
23 balance. I would not have adjusted the debt balance.

24 Q. Mr. Kahal, do you know whether this issue has
25 ever been previously addressed by the Commission?

1 A. I believe it has. My recollection was that it
2 was addressed in a National Fuel Gas Distribution case.

3 Q. And you appeared in that case, did you not?

4 A. Yes, I did.

5 Q. Do you recall the outcome of that case?

6 A. There was more than one case, and at this point,
7 we're pushing very hard on memories, but my recollection was
8 in the first case where it was presented I opposed it and it
9 was disallowed. In the -- and I don't know whether this was
10 the very next case or some cases subsequent where it was
11 presented and then it was accepted. So in one case it was
12 not accepted and in another case it was accepted.

13 Q. Did you participate in the case in which it was
14 accepted?

15 A. I participated in -- I believe I participated in
16 one of the cases where it was accepted. You have to
17 understand that National Fuel Gas has had an awful lot of
18 rate cases over the last eight years.

19 Q. Could you as an on-the-record data request
20 provide us the citation to the case in which you believe
21 this adjustment was adopted?

22 A. That is was adopted?

23 Q. Yes.

24 MS. KENNEY: Your Honor, I would think that that
25 information is a matter of public record. It is obviously

1 in a Commission Order, and that would be fully available to
2 Mr. Gadsden, and Mr. Kahal should not necessarily be doing
3 legal research.

4 JUDGE CHRISTIANSON: I agree with that, but maybe he
5 can find it as he sits here. I'm not sure.

6 Can you reach it for the record?

7 THE WITNESS: Actually, let me take a crack at that,
8 because I do have a listing of cases in which I've testified
9 on rate of return in Appendix A.

10 JUDGE CHRISTIANSON: Most witnesses do, yes.

11 THE WITNESS: And my recollection -- this is off the
12 top of my head -- was that it was probably in the second NFG
13 case in which I testified on rate of return.

14 (Witness perusing document.)

15 THE WITNESS: If you have my Appendix A, if you look
16 at page A-4.

17 BY MR. GADSDEN:

18 Q. I do.

19 A. If you'll look at Item No. 56, Docket No.
20 R-901670. I'm not sure I can really do any better than that
21 for you, Mr. Gadsden, because my own records have my own
22 testimony, but I don't really keep all of the old Commission
23 Orders.

24 JUDGE CHRISTIANSON: So you are nominating that case
25 to be the one?

1 THE WITNESS: Yes. If you wanted to search for an
2 Order, I would recommend looking at that case.

3 BY MR. GADSDEN:

4 Q. I have that Order, Mr. Kahal, and I have
5 reviewed it.

6 Did you present testimony in any subsequent National
7 Fuel Gas Distribution cases following your appearance at
8 Docket R-901670?

9 A. I don't know. I testified in some National Fuel
10 Gas Distribution cases on some forecasting issues, that is
11 sales forecasting issues, and that wouldn't be part of
12 Appendix A, so I couldn't tell you off the top of my head.

13 Q. Does Appendix A capture all of your prior
14 appearances in the area of rate of return?

15 A. In rate of return, it does.

16 JUDGE CHRISTIANSON: I've done a couple of NFG cases
17 myself, and 1670 sounds familiar.

18 THE WITNESS: That's the best I can do for right now
19 sitting here.

20 MR. GADSDEN: That's fine.

21 BY MR. GADSDEN:

22 Q. Mr. Kahal, on page 12 of your testimony -- you
23 can tell me when you're there.

24 A. Sure. I'm there.

25 Q. At lines 20 through 21, you indicate that there

1 has been steady improvement so far in 1995 for the electric
2 utility industry; is that correct?

3 A. Yes.

4 Q. Is the evidence of that steady improvement
5 declining dividend yields or are there other factors which
6 you had in mind?

7 A. Primarily, I was referring both to declining
8 interest rates, which obviously are beneficial to the
9 industry, and to declining dividend yields, which is going
10 to be a proxy for rising stock prices.

11 Q. To the best of your knowledge, has PP&L's
12 dividend yield declined in 1995?

13 A. The data that I have available run only through
14 February of this year. If you look at Schedule MIK-4, page
15 2 of 2, as of December, 1994, the dividend yield was 8.54
16 percent. As of February -- and these are averages for the
17 month -- it was 8.14 percent.

18 Q. Do you know where it stands today?

19 A. Where it stands today, no. Keep in mind that I
20 am planning on presenting an update in May at the time of
21 the rebuttal hearings, and I would have data at least
22 extending through April.

23 Q. You haven't followed the course of the stock
24 during the course of this proceeding?

25 A. Not during the course of the proceeding, no. I

1 had planned to do that as part of the updating process.
2 That's probably the most efficient way of looking at it.

3 Q. I apologize for jumping around a bit, Mr. Kahal,
4 but if I could direct you to page 29 of your testimony.

5 A. Yes.

6 Q. Bear with me for a moment.

7 (Pause.)

8 Q. At lines 13 and 14, you note that "increasing
9 wholesale and retail competition may erode earnings to some
10 degree." Do you see that?

11 A. Yes.

12 Q. And in our Interrogatory Set IV, No. 6, if you
13 could locate that, we asked the following question with
14 reference to this particular sentence, and the question was
15 as follows: "To what extent did the prospect of 'increasing
16 wholesale and retail competition' affect Mr. Kahal's
17 determination that 12 percent represented a reasonable
18 expected future earned return on equity from Mr. Moul's
19 barometer group?"

20 Your answer reads as follows: "Increasing
21 competition theoretically might argue for a lower ROE than
22 12 percent. However, Value Line projects an average ROE of
23 12.06 percent, which incorporates Value Line's own
24 perception concerning the impact of competition, if any, on
25 profitability."

1 Attached to that response was Value Line's analysis
2 of the so-called industrial composite for February the 17th,
3 1995; is that correct?

4 A. No. Something got out of order. That was an
5 attachment to some other response, and it might have gotten
6 mislabeled, but it was not part of the response to Set IV,
7 Item 6, because if you look at that response, there is no
8 reference to an attachment.

9 Q. Do you know what the attachment is supposed to
10 be attached to?

11 A. Is it not labeled?

12 Q. It is labeled, "Attachment to Set IV, Item No.
13 6," which is this question and your answer.

14 MS. KENNEY: Your Honor --

15 MR. GADSDEN: We don't need to waste time on the
16 record, Your Honor, if Mr. Kahal could check that during the
17 break and let us know.

18 MS. KENNEY: I think he will need to check with his
19 attorneys, who did the attachments.

20 (Laughter.)

21 THE WITNESS: I'm sure we can resolve this.

22 JUDGE CHRISTIANSON: Do I sense an element of guilt
23 in that sentence?

24 MS. KENNEY: The person is not in this room, Your
25 Honor.

1 (Laughter.)

2 JUDGE CHRISTIANSON: Was this faxed?

3 MR. GADSDEN: We've received hard copies since then.

4 JUDGE CHRISTIANSON: Perhaps it was just a mistake in
5 filing, but then get back to Mr. Gadsden sometime.

6 THE WITNESS: Yes. I think we can easily resolve
7 which interrogatory that is an attachment to.

8 BY MR. GADSDEN:

9 Q. Mr. Kahal, am I correct that like Mr. Baudino
10 and Mr. Deardorff, that you, in developing your equity
11 recommendation, have relied exclusively on the DCF method?

12 A. For the purposes of the recommendation, yes.
13 I've obviously looked at other methodologies as a way of
14 reviewing the company's direct case.

15 Q. Have you also relied exclusively on the DCF
16 method?

17 A. In the manner in which I've just described, yes.
18 I have looked at the other methodologies principally for
19 purposes of evaluating the evidence submitted by others, but
20 those other methodologies did not form the basis of my
21 recommendations.

22 Q. Do you recall testifying in a recent
23 Pennsylvania-American Water Company case that you, quote,
24 "would not encourage the Commission to disregard any
25 evidence that is put before it"?

1 A. Yes. I very much belief that a Commission
2 should give a fair review of all evidence that is submitted
3 before it. That is clearly not the same thing as just
4 taking all of the numbers, adding them up, and dividing by
5 the number of witnesses, though.

6 Q. Given the mathematics of that, we would fully
7 agree.

8 (Laughter.)

9 JUDGE CHRISTIANSON: The company would be
10 outnumbered.

11 MR. GADSDEN: More than slightly.

12 BY MR. GADSDEN:

13 Q. On page 22 of your testimony, you acknowledge
14 the assumptions of the DCF method may appear to be -- and
15 I'll use your phrase -- "rather restrictive," but that in
16 your view the model provides an acceptable approximation of
17 reliability for relatively stable companies.

18 A. Yes.

19 Q. Will increased competition or deregulation in
20 whole or in part increase or decrease the stability that
21 electric utilities have historically enjoyed?

22 A. You mean if it occurs?

23 Q. Yes.

24 A. If large scale deregulation occurs at some point
25 in time in the future such that electric utilities are

1 viewed or operate as competitive firms rather than as
2 regulated monopolies, it is quite likely that that would
3 lead to a reduction in their financial stability, I think,
4 unless they were to offset that by making very large changes
5 to their capital structures.

6 For example, if they moved to a very much higher
7 equity ratio, then you might not observe that instability.
8 But if they were to be financed the way they are now, in a
9 deregulated environment I think you would likely see less
10 stability.

11 Q. Mr. Kahal, I have a few questions with respect
12 to your application of the DCF method; and correct me if I'm
13 wrong, but as I understand your testimony, you conducted
14 three DCF analyses in much the same fashion as Mr. Baudino,
15 one involving data for PP&L, one involving data for Mr.
16 Moul's barometer group, and one involving data for a
17 barometer group that you selected.

18 A. Yes.

19 Q. And am I correct that your recommendation in
20 this case is based in effect on an averaging of the results
21 for the two barometer group company analyses?

22 A. Essentially, that's right. Strictly speaking,
23 the mathematics gave a figure of 11.0 or slightly more than
24 11.0 midpoints. I found that if I had given equal weight to
25 the PP&L stand-alone study, that would have resulted in an

1 average of 11.1; and to avoid controversy over whether the
2 PP&L stand-alone study should have been given equal weight,
3 my recommendation is 11.1.

4 I remarked in my testimony that I feel a great deal
5 less comfortable with a stand-alone single company study.

6 Q. Is it your testimony that a DCF analysis of PP&L
7 data should or should not be given equal weight?

8 A. I don't believe it should be given equal weight
9 even though that is consistent with the 11.1 percent
10 recommendation, but generally, I do not believe it rises to
11 the same level of reliability as does a proxy group study.

12 Q. Backing up a bit, Mr. Kahal, to page 7 of your
13 testimony, at page 7 up at the top, you set forth the
14 various criteria that you utilized in assembling your proxy
15 group; is that correct?

16 A. Yes.

17 Q. The first factor noted is that the utility must
18 have, quote, "significant nuclear operations."

19 A. That's correct.

20 Q. Do you have a specific percentage in mind?

21 A. Yes. Generally, I cut that off at about 10
22 percent. If it is less than 10 percent, I would probably
23 not include a company as being a nuclear company. I believe
24 that all of my proxy companies have nuclear operations in
25 excess of 10 percent.

1 Q. Do you believe that investors perceive utilities
2 with significant nuclear operations as more risky than
3 utilities with no nuclear operations?

4 A. I have to answer that in an all else held equal
5 context, if that's all right.

6 Q. Certainly.

7 A. In an all else held equal context, the answer is
8 at least some investors would perceive it as being risky,
9 and therefore, it would be reasonable to consider that as
10 being a risk factor.

11 Q. The second criterion is that the utility must be
12 rated either 2 or 3 for safety by Value Line; is that
13 correct?

14 A. Yes.

15 Q. Can we refer to your Schedule MIK-3, page 3?
16 Can we agree that two of the barometer group companies that
17 you selected, the Southern Company and Union Electric, at
18 least according to your exhibit, are ranked 1 as far as the
19 safety rating?

20 A. Yes. Let me just double-check that.

21 (Witness perusing document.)

22 A. Yes. Those two do have a No. 1 safety rating,
23 and it may have been that they were rated at the 2 level
24 when I initially began to put together the group, so their
25 inclusion is really inadvertent.

1 Q. Can we agree that your barometer group on
2 average employs less leverage than PP&L?

3 A. That my group?

4 Q. Yes.

5 A. I don't want to really quibble with you too
6 much. That may be true. What this shows is that the
7 average equity ratio is 47 percent. This refers to the
8 common equity ratio. Unfortunately, I don't have the
9 preferred stock ratios in here.

10 The PP&L equity ratio is shown as 43.5 percent. At
11 this same point in time for this rate case, it is either 45
12 or 46 percent, so there is a slight difference with PP&L
13 having a slightly lower equity ratio.

14 One of the difficulties is that many analysts also
15 look at off-balance sheet leverage obligations, which is not
16 factored into these Value Line numbers. When you're dealing
17 with a close call like this and you may have left some
18 important things out, it's a little hard to be definitive.
19 The only thing I can say is that it is possible that PP&L
20 may be slightly more leveraged than the average company in
21 this group.

22 Q. Jumping forward to the bottom of page 24 of your
23 testimony, you express some disagreement with Mr. Moul's
24 exclusion of utilities that cut their dividends in the past.
25 Specifically, I'm referring to the sentence which runs over

1 to the top of page 25. Do you see that?

2 A. Yes.

3 Q. And I gather it is your position that, provided
4 the utility did not cut its dividend within the past two
5 years, that it is okay to utilize it for barometer group
6 purposes?

7 A. That's right. I'm suggesting that there ought
8 to be a statute of limitations on dividend reductions.

9 Q. How about a utility that may have cut its
10 dividend in three of the last five years? Do you think that
11 is an appropriate candidate for the barometer group?

12 A. You mean had three cuts within the last five
13 years?

14 Q. Yes.

15 A. It's not obvious to me that if it has not cut
16 its dividend within the past two years that you could not
17 apply the DCF model to such a company, because after all,
18 what you're interested in is what the prospective dividend
19 growth is, so I would not automatically toss out a company
20 if its last dividend reduction took place several years ago,
21 such as three or four years ago; and I believe that has been
22 the position of the Federal Regulatory Commission as well.

23 Q. Do you know whether any of your barometer group
24 companies have cut their dividend three times in the last
25 five years?

1 A. Three cuts in the last five years? No, I don't
2 know that any have. It would take me a few minutes to check
3 that.

4 Q. Do you have a Value Line sheet for Midwest
5 Resources?

6 A. I do.

7 Q. There is a line on the Value Line sheet styled,
8 "Dividend Declared Per Share." Do you see that one?

9 A. Yes.

10 Q. Can we agree that starting in 1989, the figures
11 read \$1.59; 1990, \$1.32; 1991, \$1.56; 1992, \$1.36; 1993,
12 \$1.16; and 1994, again, \$1.16?

13 A. Yes.

14 Q. Is that what it shows?

15 A. Yes. That's an unusual historic pattern.
16 During that time period, Midwest Resources was involved in
17 some merger activity. I don't know whether that accounts
18 for it. One possibility is that there may have been some
19 kind of a special dividend paid out in 1991, and that
20 obviously would be unimportant for prospective purposes.

21 And if that was the case, other than the fact that
22 there was a reduction in the dividend between 1989 and 1990
23 and it appears another small dividend reduction in 1992,
24 there is nothing extraordinary about this that would trouble
25 me for DCF purposes.

1 Q. I understand. Have there been many electric
2 utilities that have cut their dividend three times in the
3 last five years?

4 A. No, there have not, and I'm not saying that
5 Midwest Resources has either. As I said, the figure in 1991
6 may have been a special dividend payment such as a stock
7 dividend to shareholders. So I wouldn't take this as an
8 indication that there have been three cuts in the dividend.

9 Q. Can we agree that your barometer group also
10 includes a company for which Value Line at least is
11 projecting will experience negative earnings growth over the
12 next five years on a normalized basis? I would refer you to
13 Schedule MIK-6, page 5. Is that what it shows for Detroit
14 Edison?

15 A. Yes; and this is a wonderful example of why it
16 is useful to use a fairly large proxy group, because those
17 kinds of aberrations disappear in the averaging when you
18 have a large proxy group.

19 The results for Detroit Edison have very, very little
20 effect on the averages.

21 Q. Mr. Kahal, your recommended equity allowance in
22 this case is 11.1 percent, as you indicated previously; is
23 that correct?

24 A. Yes.

25 Q. What is Value Line projecting that Mr. Moul's

1 barometer group or your barometer group will actually earn
2 on book equity over the next five years? Do you have those
3 figures?

4 A. By over the next five years, I think that you
5 mean five years hence, not the average for the next five
6 years, because the information I have is the earned ROE in
7 the late 1990s.

8 Q. What figure do you have to give me on that?

9 A. For my own proxy group, it is 12.27 percent is
10 the average; and for Mr. Moul's companies, the average is
11 12.06; and I guess to be complete, I would point out that
12 for Pennsylvania Power & Light, it is 11.5 percent.

13 Q. In his direct testimony, Mr. Moul expressed
14 various concerns regarding the DCF method, and you respond
15 to those concerns roughly at pages 38 to 44 of your
16 testimony. I specifically direct you to page 40, where you
17 address Mr. Moul's circularity argument.

18 In the paragraph that begins on line 7, you cite a
19 situation where investors become convinced, to use your
20 phrase, that the utility would receive an adverse regulatory
21 decision. Do you see that?

22 A. Yes.

23 Q. And you indicate that if that happens,
24 presumably investors would bid the price of the stock down,
25 thereby increasing the dividend yield and the indicated DCF

1 cost of equity; is that correct?

2 A. Yes.

3 Q. At what point in the process do you think
4 investors would become convinced that an adverse regulatory
5 decision would take place?

6 A. What process?

7 Q. Ratemaking process.

8 A. At what point in the process?

9 Q. Yes.

10 A. I would say in most cases it would be when a
11 Commission issues a Final Order. That would be the more
12 typical case. There could be cases where they may become
13 convinced before a regulatory order is issued, but that
14 would probably be less typical.

15 Q. So you're not suggesting in this particular
16 example that the falling price stock and the rising dividend
17 yield and the increased DCF cost of equity would somehow get
18 reflected in the Commission's Order itself?

19 JUDGE CHRISTIANSON: You're talking about sort of a
20 self-fulfilling prophecy?

21 THE WITNESS: Well, part of the problem is that I
22 think that the typical application of the DCF model is to
23 proxy companies rather than the subject company itself. So
24 one is going to be looking at data for a whole group of
25 companies that somehow are representative of the operations

1 of the subject utility; and adverse regulatory decisions
2 that might have affected those companies are going to be
3 reflected in the stock prices.

4 BY MR. GADSDEN:

5 Q. But if, for example, investors perceived, for
6 whatever unjustified reason, that PP&L would receive an
7 adverse regulatory decision in this case and bid its price
8 down and its yield up either today, tomorrow or at some
9 point in the next several months, that development would not
10 be reflected in your DCF analysis, would it, to the extent
11 that you've relied on barometer group company data and not
12 PP&L specific data?

13 A. That would be true if you assume that some
14 adverse regulatory decision would make the proxy companies
15 that I have selected or that Mr. Moul has selected no longer
16 representative, if that's the case. In other words, that
17 would suggest that we erred in the selection of our proxy
18 companies.

19 However, I think that the only thing that we can go
20 on are the published and available risk indicators that are
21 available to the investing public such as bond rating, the
22 published beta, something like the Value Line safety
23 ranking.

24 You know, it is true that I think in any rate case on
25 any issue, whether it is rate of return or anything else,

1 we're limited to the record evidence, and it is obviously
2 difficult, if not improper, for the Commission to be basing
3 its position on post-record evidence; and clearly, the
4 Commission, even if it wanted to, couldn't incorporate
5 evidence that became available after it's Order was issued.

6 Q. Quite right. Now, Mr. Kahal, on page 41 of your
7 testimony at lines 4 through 6, you refer to an alleged
8 concern on Mr. Moul's part that the application of the DCF
9 method to an original cost rate base will not sustain the
10 stock price at, quote, "its lofty level." Do you see that?

11 A. Yes.

12 Q. And when we asked you in our Interrogatory Set
13 IV, No. 12 to define what you mean by "lofty level," you
14 referred to a 50 percent premium, did you not?

15 A. I referred to a 50 percent premium as an
16 example. What my interrogatory said is that there is no
17 precise definition of what the term "lofty level" means, and
18 I was not intending to imply that there was a precise
19 definition of the term "lofty."

20 Q. Is it your testimony that PP&L's stock is
21 currently trading at a lofty level?

22 A. If you mean currently today, I don't know what
23 the stock price is today.

24 Q. Do you have a figure which you can give us as to
25 PP&L's book value?

1 A. I have a figure of PP&L's book value -- do you
2 mean per share?

3 Q. Correct.

4 A. -- at December, 1994; and that figure is \$16.55.
5 The estimate for 1995 is \$17.10. So I assume the book value
6 is somewhere between those two figures currently.

7 Q. Would you accept subject to check that PP&L's
8 stock has traded within the last several weeks in the \$18.50
9 range?

10 A. Sure. I would accept that. I think if that is
11 true, that completely undercuts Mr. Moul's argument.

12 Q. Mr. Kahal, is it your position that the proper
13 application of the DCF method will not result in an
14 understatement of a utility's cost of capital?

15 A. Could you repeat that, please?

16 Q. Sure. Is it your position that if the DCF
17 method is properly applied, it will not result in an
18 understatement of a utility's cost of equity capital?

19 A. No. It is my position that the DCF model, if
20 properly applied, will result in a reasonable estimate of
21 the cost of equity, but that's all it ever is is an
22 estimate. It's not a precise measurement.

23 Q. You testified recently in a Commonwealth Edison
24 Company case, did you not?

25 A. Yes.

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Q. Have you had an opportunity to review the Final Order in that case which was issued in January?

A. I have seen the Final Order, yes.

Q. And is it your understanding of that Order that the Illinois Commerce Commission rejected your presentation as well as that of certain other witnesses on the grounds that the DCF analysis understated Commonwealth Edison's cost of equity?

A. What the Commission indicated in its Order is that the DCF estimate that I presented and that the Attorney General presented and a witness for the industrial group presented underestimated what the Commission believed to be the cost of equity. The Commission also stated in that Order that the DCF studies of the company witnesses overstated the cost of equity. You might call this a Goldilocks Order; that it was somewhere in the middle.

The Commission did accept the analysis of the Commission staff in that case. Essentially, the difference between my analysis and that of the Commission staff with regard to DCF is that the Commission staff used a quarterly compounding model which the Illinois Commission accepts, whereas I used I think what would be called the standard model, such as the model that is used by all of the witnesses in this case.

That was really the only material difference in our

FORM 2

1 DCF results.

2 Q. Just for my curiosity, could you explain to me
3 the reference to a Goldilocks decision?

4 A. Yes. By Goldilocks decision means some of the
5 numbers are too high, some of the numbers are too low, and
6 the one in the middle is just right.

7 Q. Ah, the three bears?

8 A. The three bears, yes.

9 Q. Okay. Mr. Kahal, beginning at page 45 of your
10 testimony, you offer various criticisms in Mr. Moul's
11 analysis, and more specifically, at pages 47 to 48, you
12 describe an alternative form of risk premium analysis which
13 you performed; is that correct?

14 A. Yes.

15 Q. And as I understand, that alternative approach
16 starts with a DCF-derived equity cost rate and subtracts out
17 contemporaneous bond yields to derive a risk premium.

18 A. Yes.

19 Q. In what respects is this particular approach
20 different, if you know, than those that were presented to
21 and consistently rejected by the Commission in the late
22 1970s and early 1980s?

23 A. I would say that the main difference is twofold.
24 One is that a number of the risk premium studies that have
25 been rejected by this Commission have been analyses or risk

1 premium analyses that have been based upon historic, after-
2 the-fact realized returns and encountering the problem that
3 returns realized after the fact are not the same thing as
4 required returns.

5 I believe another problem is that some of the risk
6 premium studies that have been presented and rejected have
7 encountered the problem of just using very old data or in
8 fact even non-utility data. Even the studies that don't
9 rely on required returns very often are based upon
10 information from the '60s or '70s or perhaps even the early
11 '80s.

12 This study I think is much more current than most
13 that have been presented, and it is based exclusively on
14 electric utility data. I think those are the major
15 differences.

16 Q. Are you aware that in the early to mid '80s,
17 this Commission time after time repeatedly rejected risk
18 premium studies that used a DCF-derived cost of equity as
19 the starting point?

20 A. I don't know that much really about electric
21 utility rate decisions, rate of return decisions during that
22 time period. That was somewhat before my time, but I think
23 it is important to keep in mind, Mr. Gadsden, that I'm not
24 advocating this either. I think that the DCF evidence is
25 superior to this risk premium study that is shown on

1 page 48.

2 Q. I understand, Mr. Kahal. You've made that
3 perfectly clear.

4 Now, your starting point is the benchmark or generic
5 equity return rate fixed by FERC during the period 1985 to
6 '91; is that correct?

7 A. Yes.

8 Q. Are you aware of any case adjudicated during
9 that six-year period in which FERC's equity allowance was
10 actually set at the benchmark rate?

11 A. Exactly at the benchmark rate?

12 Q. Yes.

13 A. No, but I really haven't followed very many
14 electric rate of return cases at FERC. The few that I've
15 been involved in involved the presentation of new evidence,
16 new DCF evidence.

17 The only thing I can tell you is that the FERC has
18 consistently relied on the DCF method for making rate of
19 return determinations.

20 Q. So sitting here today, you can't cite us a case
21 in which the benchmark rate was actually utilized or where
22 the equity allowance was actually set at the benchmark rate?

23 A. Yeah. I don't know whether that is the case or
24 not. The only thing that I can tell you is that the FERC
25 believes in rate cases it is proper to take into account

1 individual company risk characteristics. The benchmark is
2 an industry-wide figure and therefore obviously does not.

3 Q. At pages 49 through 53, you discuss Mr. Moul's
4 CAPM analysis, and at page 52, you make reference to the
5 industrial composite and indicate that this group includes
6 three-fourths of all industries covered by Value Line.

7 A. Yes.

8 Q. Can we agree that the industrial composite also
9 encompasses less than one-half of the companies covered by
10 Value Line?

11 A. I don't know if it is less. I think it is on
12 the order of about one-half. It certainly accounts for the
13 vast majority of assets. I think it is fair to describe the
14 industrial composite as being corporate America excluding
15 the utility sector and the financial services sector.

16 Q. Returning to the infamous Set IV, No. 6, where
17 you did provide us the industrial composite write-up, can we
18 confirm that at least that indicates that the composite
19 consists of 810 companies?

20 A. Yes.

21 Q. Value Line covers or follows approximately 1700;
22 is that correct?

23 A. Yes; and the exclusions are as I've described in
24 my testimony.

25 Q. Mr. Kahal, you have offered testimony and

1 continue to offer testimony in rate cases involving a
2 variety of different types of fixed utilities; is that
3 correct?

4 A. Yes.

5 Q. How would you rank the different fixed utility
6 groups in terms of relative risk or cost of equity?

7 A. Any response I'd have to give you would be a
8 generalization.

9 Q. I'm happy with that answer.

10 A. As a generalization, I would rank them as water
11 utilities being the least risky. Traditionally, next would
12 come electric utilities, and then, following that, gas
13 distribution utilities. However, at the present time I
14 don't know if I can make a distinction between electric and
15 gas distribution. That may be too close to call.

16 Following that would be gas pipeline companies, and
17 then, following that, telephone utilities.

18 MR. GADSDEN: I think that's all we have for Mr.
19 Kahal, Your Honor.

20 JUDGE CHRISTIANSON: Okay. Then let's be off the
21 record for a little bit.

22 (Recess.)
23
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1 JUDGE CHRISTIANSON: Let's be back on the record,
2 then. I understand there is some redirect, and counsel may
3 proceed.

4 MS. KENNEY: Thank you, Your Honor.

5 REDIRECT EXAMINATION

6 BY MS. KENNEY:

7 Q. Mr. Kahal, you may recall at the beginning of
8 the cross, there was some confusion over an attachment that
9 had been marked as an attachment to OCA Set IV, No. 6.

10 During the recess, were you able to determine what
11 interrogatory that package should have been attached to?

12 JUDGE CHRISTIANSON: With the able assistance of
13 counsel, I suspect.

14 THE WITNESS: That's absolutely correct. With the
15 able assistance of counsel, the two of us were able to solve
16 the mystery.

17 That attachment goes to Set III, Item 6. So it was
18 inadvertently marked as Set IV rather than Set III.

19 BY MS. KENNEY:

20 Q. Also, Mr. Kahal, Mr. Gadsden had asked you to
21 generally, as I recall, give a ranking of utilities in terms
22 of risk, and you did provide such a ranking.

23 What was the basis for the ranking that you provided?

24 A. When I provided that ranking to Mr. Gadsden,
25 what I was specifically referring to were business risk

1 rankings.

2 And I believe that at least as a gross
3 generalization, that's a reasonable ranking of those types
4 of utilities with respect to business risk.

5 The qualification I would make is that in some
6 instances, there could be differences in capital structure
7 that might offset those business risk differences.

8 For example, there are some pipelines that have
9 relatively high business risk that also have high equity
10 ratios offsetting that, and the same thing is true for some
11 telephone companies. So that's a business risk ranking.

12 MS. KENNEY: Your Honor, we have no further
13 questions.

14 JUDGE CHRISTIANSON: Okay, then we can pause, if you
15 need anything about the discovery matter.

16 MR. GADSDEN: No. I appreciate the clarification,
17 and we have no recross.

18 JUDGE CHRISTIANSON: Then we seem to be done with the
19 witness and the witness is partially excused.

20 MR. GADSDEN: Excused for lunch.

21 JUDGE CHRISTIANSON: Yes, and we can be off the
22 record then.

23 (Witness temporarily excused.)

24 (Whereupon, at 11:55 a.m., the hearing was adjourned,
25 to be reconvened at 2:00 p.m., this same day.)

AFTERNOON SESSION

(2:05 p.m.)

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2
3 JUDGE CHRISTIANSON: Let's be back on the record,
4 then. The witness is obviously under oath from this
5 morning. I remind him that he continues to be under oath.
6 Whereupon,

MATTHEW I. KAHAL

7
8 having previously been duly sworn, testified further as
9 follows:

10 JUDGE CHRISTIANSON: Go ahead and introduce the
11 witness again -- well, you've already got his testimony in.

12 MS. KENNEY: Yes, Your Honor. This afternoon, we are
13 presenting Matthew Kahal and I believe there will be cross-
14 examination on OCA Statement No. 2, which addresses capacity
15 issues in this proceeding.

16 JUDGE CHRISTIANSON: And is already of record from
17 this morning.

18 MS. KENNEY: Yes. His testimony has already been
19 identified.

20 JUDGE CHRISTIANSON: Fine. Then go ahead. The
21 company might as well just start cross.

22 MR. GADSDEN: Thank you, Your Honor.

23 I might just state at the outset that the cross-
24 examination will not get into areas of Mr. Kahal's testimony
25 which have been designated as proprietary.

1 JUDGE CHRISTIANSON: Okay. That will help the court
2 reporter out. We probably wouldn't have to clear the
3 courtroom, but we might have to think about it.

4 MR. GADSDEN: It may be empty by the time we get
5 through, anyway.

6 JUDGE CHRISTIANSON: I was counting the other day.
7 There were like 30 people here. There were more people here
8 than at some public input sessions held in the case.

9 FURTHER CROSS-EXAMINATION

10 BY MR. GADSDEN:

11 Q. Okay, Mr. Kahal, let's talk about OCA Statement
12 No. 2. By way of overview, the ultimate proposal that you
13 advance is that PP&L be denied an equity return on its
14 claimed jurisdictional investment in Susquehanna Unit No. 2;
15 is that correct?

16 A. Yes.

17 Q. And as I read your testimony, that proposal is
18 based on the following two principal findings: Number one,
19 your conclusion that PP&L presently has somewhere between
20 400 and 800 megawatts of excess generating capacity when
21 viewed from a physical reliability standpoint; and number
22 two, your conclusion that Susquehanna Unit No. 2 represents
23 economic excess capacity when measured against the market
24 cost of power. Is that a fair summary?

25 A. Yes.

1 Q. Mr. Kahal, before we get into the real meat of
2 your testimony, I have a few preliminary questions, the
3 first of which is directed to a statement you make at the
4 bottom of page 2, lines 21 through 25, specifically at lines
5 23 through 25 where you discuss the company's long-term
6 capacity sale to Atlantic Electric.

7 And you indicate that we are proposing to terminate
8 the current practice of flowing through to customers the
9 revenues that we receive from that sale.

10 We can agree, can we not, that in lieu of that
11 particular ratemaking device, we are in effect recommending
12 a different method of treating that capacity sale in which
13 the costs and revenues would be allocated out of
14 jurisdictional rates?

15 A. Yes, that's my understanding from my review of
16 the cost of service study, that is instead of including the
17 cost of the capacity serving Atlantic in rates and crediting
18 the revenues, you all would simply allocate the cost of the
19 plant associated with serving Atlantic Electric out of the
20 retail jurisdiction.

21 Q. And I assume, based on your response to one of
22 our interrogatories, that you do not object to that
23 proposal?

24 A. Right.

25 Q. Turning now to page 4, specifically line 23, you

1 refer to a high capacity factor. Could you indicate for the
2 record what you had in mind with respect to a high capacity
3 factor as you used it in that context?

4 A. The high capacity factor that I was using refers
5 to the company's own projections of its output from the
6 Susquehanna plant that were presented and published in the
7 1994 Annual Resource Planning Report.

8 And that capacity factor approximates about 80
9 percent, maybe slightly less than that in years in which
10 there are refueling outages.

11 Q. And can we agree that historically, the
12 Susquehanna has operated at a 75 to 80 percent capacity
13 factor?

14 A. Well, not necessarily in every year, but that's
15 a reasonable characterization I think of its history. And
16 for a nuclear plant, that's a relatively high capacity
17 factor.

18 Q. So the plant has run pretty well, at least in
19 your judgment?

20 A. Yes, it has. In that regard, I think the plant
21 has been successful.

22 Q. At page 6 at lines 9 and 10, you state, quote,
23 "In an unregulated, competitive market, shareholders would
24 absorb 100 percent of uneconomic costs."

25 Does that imply an immediate transition from

1 regulation to competition?

2 A. No. That statement doesn't have any
3 implications with regard to a transition from regulation to
4 competition. It's simply a general statement that refers to
5 the way competitive markets work in general, that is any
6 industry. This wasn't even a specific reference to the
7 electric utility industry.

8 Q. So we should not take this statement to offer or
9 have any implications with respect to your position or the
10 position of the Office of Consumer Advocate with respect to
11 the recovery of what are called stranded investment costs?

12 A. That wasn't the intention of this statement.
13 That's certainly true. The OCA's position on stranded cost
14 recovery I think is likely to be expressed at other places,
15 but this was simply a statement of general economic
16 principles. It's not a policy recommendation in any way.

17 Q. Fine. Mr. Kahal, let's turn to page 7. And
18 beginning at line 13, you state that with reference to the
19 company's last base rate proceeding in 1984 and 1985, that
20 the addition of Susquehanna Unit 2 at that time was the
21 direct cause of excess capacity. Do you see that?

22 A. Yes.

23 Q. Why was Susquehanna Unit No. 2 perceived to be
24 the direct cause of excess capacity in the Unit 2 case?

25 A. Because Susquehanna 1 had already been excluded

1 from rate base. And although I may not be completely sure
2 of the timing, following the exclusion of Susquehanna Unit 1
3 from rate base, the company concluded a slice of system sale
4 with Jersey Central Power and Light that essentially
5 absorbed Susquehanna 1, thereby removing the amount of
6 capacity represented by Susquehanna 1 as the proximate cause
7 of the excess capacity.

8 Consequently, when Susquehanna Unit 2 came on line,
9 that added 945 megawatts approximately to the company's
10 generating capacity, which immediately had the effect of
11 substantially increasing reserves above the minimum planning
12 levels.

13 Q. In other words, it was perceived as the direct
14 cause of the excess capacity because it was the latest
15 capacity added to the system?

16 A. Well, that's right. It was simply the event
17 that was occurring at that time that resulted in a change in
18 the amount of capacity reserves.

19 That's not to say that there weren't other things
20 going on at that time. For example, if loads had been
21 higher, I suppose that also would have resulted in less
22 excess capacity.

23 Q. Now, in our Interrogatory Set II, No. 13, we
24 asked you to what you attributed PP&L's alleged current
25 excess capacity.

1 Am I correct that you pointed to a variety of
2 potential factors including but not limited to the addition
3 of the Susquehanna units, the failure of native load to grow
4 more rapidly, the addition of QF capacity and the failure of
5 PP&L to sell more capacity off-system?

6 A. Yes. Excess capacity is simply the result of
7 the relationship between capacity resources and load. And
8 obviously, anything that affects capacity resources and
9 anything that affects load can be considered a cause of
10 excess capacity.

11 Q. At page 8 of your testimony at lines 10 through
12 13, you allude to the Commission's order in the Unit 2 case,
13 and offer your interpretation of that order.

14 I assume you read the Commission's order in that
15 case?

16 A. The portion of the order relating to the excess
17 capacity issue, yes.

18 Q. And can we agree that what the Commission
19 determined in that case was that the continuation of the
20 excess capacity adjustment would be contingent upon either
21 one of two things happening: One being PP&L's ability to
22 show that Susquehanna 2's net economic benefits had begun to
23 outweigh its net costs; or that the power was needed from a
24 reliability standpoint?

25 A. Well, you're paraphrasing, of course, but what

1 the Commission indicated --

2 Q. Would you like to review the order?

3 MS. KENNEY: Could we have a cite, please, so that we
4 could give Mr. Kahal a copy of the order?

5 MR. GADSDEN: I'd be happy to pass it out, page 22 of
6 the Commission's order.

7 (Document handed to the witness.)

8 MS. KENNEY: May I approach the witness, Your Honor?

9 JUDGE CHRISTIANSON: Yes, go ahead.

10 MS. KENNEY: Here's a full copy of the order.

11 (Document handed to the witness.)

12 THE WITNESS: Now I've got three copies.

13 MR. KLEPPINGER: Hopefully they're all the same.

14 JUDGE CHRISTIANSON: If there are discrepancies, let
15 us know.

16 MR. GADSDEN: Mine is yellow.

17 THE WITNESS: Not surprisingly, I'm turning to my own
18 copy.

19 The Commission said something I think very similar to
20 what you just said. It's not quite exactly that. What the
21 Commission indicated was that if the company came back and
22 presented evidence either that the plant was needed for
23 reliability or that the plant would provide I suppose one
24 might say imminent net economic benefits for ratepayers,
25 then the Commission would essentially reconsider its

1 adjustment.

2 I want to make it clear that I don't read this order
3 as saying that the Commission commits to reversing the
4 excess capacity adjustment, and this of course is only
5 prospectively.

6 The Commission merely said that if either one of
7 those events took place, it would then reconsider what the
8 appropriate action is at that point.

9 So I think that we're very close, Mr. Gadsden, but I
10 think that there are some important subtleties of language
11 in that order.

12 BY MR. GADSDEN:

13 Q. Now, Mr. Kahal, on that same page, in the answer
14 which begins on line 16, you indicate that it is your
15 understanding based on advice of counsel that Section 1323
16 of the Public Utility Code applies to this case; is that
17 correct?

18 A. That's correct.

19 Q. And I assume that you took the opportunity to
20 review that particular statutory provision?

21 A. Yes.

22 Q. And can we agree that Section 1323 specifically
23 refers to units being claimed in rates for the first time?

24 A. Yes, it does. And I think that there's a fair
25 amount of Commission precedent regarding what that means.

1 Q. Now, to the best of your knowledge, has it ever
2 been applied to a generating facility that was already
3 reflected in rates?

4 A. To the best of my knowledge, no, but I would
5 have to point out that that also would be true of
6 Susquehanna 2 since Susquehanna 2 is only partially in
7 rates, that is there is not full recognition in rates of
8 Susquehanna 2, the Commission having denied the equity
9 return and that continuing to this day.

10 Q. Has it ever been applied to a generating
11 facility that was placed in service prior to the enactment
12 of the statute, to the best of your knowledge?

13 A. I'm sorry, has what been applied?

14 Q. Section 1323. Has it ever been applied to a
15 generating facility that was placed in service prior to the
16 date of enactment of that statute?

17 A. I don't know whether I'm missing something, but
18 unless I'm misunderstanding, I think you're asking me
19 whether a statute was applied before that statute was even
20 enacted.

21 Q. I'm asking you if 1323 has ever been applied to
22 a generating facility that was placed in service prior to
23 the date of enactment of the statutory provision.

24 A. Oh, I'm sorry. You're referring to when the
25 generating unit entered service, not when the Commission

1 decision was rendered.

2 JUDGE CHRISTIANSON: Actually, the Susquehanna 2 was
3 '85 and the statute is '86.

4 THE WITNESS: Right.

5 I don't know the answer to that. I think that the
6 first actual application after the statute was passed may
7 have been with Duquesne Light.

8 JUDGE CHRISTIANSON: One minor point. The beginning
9 of 1323 starts, "Whenever a public utility claims the cost
10 for the first time," which is different from necessarily
11 being allowed in. But again, that's just the language.

12 I think I worried about that at the time. It was not
13 yet out in '85, and we worried about it shortly after that.
14 But go ahead with your development.

15 MR. GADSDEN: Thank you.

16 BY MR. GADSDEN:

17 Q. Mr. Kahal, at page 8, at lines 21 and 22, you
18 offer your interpretation of Section 1323 and state that on
19 the reliability side that the utility must demonstrate that
20 the addition of the unit does not create excess capacity,
21 i.e. capacity in excess of what is needed to meet an
22 appropriate reliability standard.

23 As a preliminary matter, can we agree that what the
24 statute speaks to is a reasonable reserve margin?

25 A. Yes.

1 Q. Do you draw any distinction between what may be
2 required for reliability purposes and what might be
3 reasonable for ratemaking purposes?

4 A. I draw a small distinction, Mr. Gadsden, and I
5 think that that small distinction arises in the context of
6 the reserve requirement range that I discuss later in my
7 testimony.

8 And that is, for a PJM utility, I believe that it
9 would be reasonable for the PJM utility to utilize the
10 reserve margin associated with the prescribed capacity
11 obligation.

12 For example, in the case of PP&L, that would be 12
13 percent. In the case of another utility I'm familiar with,
14 PEPCO, that would be 16 percent. That prescribed reserve
15 margin, then, is a minimum reserve margin target for
16 planning purposes.

17 To me, based upon my knowledge of planning, one can
18 never hit targets or rarely hit targets for planning right
19 on the nose. Hopefully, if you have a good planning
20 process, you're going to come close, but you're not going to
21 hit it right on the nose.

22 Consequently, if a utility had experienced a reserve
23 margin that was slightly higher than its minimum target --
24 let's say in the case of PP&L it was 12.5 percent, whereas
25 the target is 12.0 percent -- in my opinion, that would not

1 warrant an excess capacity adjustment. It would simply be
2 too small of a difference.

3 And in this case, what I suggested is something like
4 three percentage points, going from 12 percent to 15
5 percent, based upon my knowledge of utility planning, would
6 provide a zone of reasonableness, given that you just can't
7 hit these things right on the nose.

8 Q. Let's turn to page 11. At line 4, you refer to
9 numerous factors and operational parameters that enter into
10 an analysis of whether a utility is experiencing excess
11 capacity.

12 And in the next sentence, you list three factors,
13 "and so forth." What is "and so forth"? Do you have any
14 other factors in mind?

15 A. Yes. The "so forth" could include load shape.
16 It could include the unit configuration, that is unit sizes.
17 It could include the characteristics of interconnections.
18 Those are the factors that come to mind.

19 Q. Okay. Now, on page 12 of your testimony, you
20 explain why in your view NUG generation or power from
21 qualifying facilities should be counted in reserve margin
22 calculations.

23 And you state at lines 10 and 11 that an excess
24 capacity adjustment deals with the fact of excess capacity
25 and not whether the utility has acted imprudently.

1 Is it your opinion that regulators should be
2 indifferent to the cause of excess capacity?

3 A. No. I think that I answered that in a data
4 response. The cause of excess capacity may have an
5 influence on the specific remedy, the ratemaking remedy for
6 the excess capacity.

7 For example, if it is due to utility imprudence, then
8 certainly the regulator would be justified in disallowing
9 imprudently incurred costs.

10 Q. Now, on page 12 a little further down at lines
11 16 and 17, you indicate again on advice of counsel that the
12 issue of inclusion of QF capacity in reserve margin
13 calculations is addressed in Section 1323(c). Do you see
14 that?

15 A. Yes.

16 Q. Was it the advice of counsel that this section
17 required the recognition of QF capacity under the
18 circumstances as are presented in this case, or that such
19 determination was left to the discretion of the Commission?

20 A. I don't think that I ever discussed that
21 specific distinction with counsel. I think that the way
22 that our discussions --

23 MS. KENNEY: Your Honor, at this time, I want to just
24 impose an objection about inquiring into inquiring into
25 attorney-client or attorney-witness privilege, that those

1 discussions necessarily are part of an attorney work
2 product.

3 JUDGE CHRISTIANSON: Yes. In this particular
4 instance, he said he didn't talk about it, but I acknowledge
5 your problem, and bring it up again if you have it again.

6 Then he went on. The witness is about to give his
7 own opinion, I think. Go ahead, and maybe ask him a
8 question.

9 BY MR. GADSDEN:

10 Q. Well, putting aside what your counsel may or may
11 not have advised you, is it your recommendation that Section
12 1323(c) be interpreted as mandating that QF power be taken
13 into account in reserve margin calculations?

14 MS. KENNEY: Your Honor, I have an objection that Mr.
15 Gadsden is asking for a legal interpretation and Mr. Kahal
16 is not here as an attorney.

17 JUDGE CHRISTIANSON: Let's ask the witness, do you
18 have an opinion?

19 THE WITNESS: I have an opinion, and it may not be
20 the opinion to the question exactly the way Mr. Gadsden has
21 stated it.

22 But my perspective on this is simply that I believe
23 that this section provides clear guidance regarding
24 legislative intent.

25 I really don't know whether this is a legal mandate

1 or not, but I think it's a clear expression of legislative
2 intent, even if it isn't a mandate.

3 BY MR. GADSDEN:

4 Q. Well, speaking of legislative intent, did your
5 counsel draw your attention to Section 523 of the Public
6 Utility Code?

7 A. No. This may exhaust my legal training.

8 JUDGE CHRISTIANSON: Again, I'll allow some probing,
9 because a lot of this stuff is a mixed matter of expertise
10 and law. But if you like, we can turn to 523. Just for the
11 record, 523 shows up as performance factor considerations.

12 MR. GADSDEN: Factors that the Commission should take
13 into consideration in setting rates, one of which is the
14 encouragement of cost effective cogeneration.

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1 BY MR. GADSDEN:

2 Q. Mr. Kahal, again, not asking you to offer a
3 legal opinion, but let me ask you this: have you read any
4 Commission orders or Commonwealth Court decisions which may
5 have addressed this particular issue, or at least discussed
6 it?

7 A. I'm not sure which issue we're talking about.
8 Do you mean excess capacity or do you mean --

9 Q. Well, we're still on the issue of QF capacity
10 and the extent to which it should or should not be taken
11 into account in reserve margin calculations, and if so,
12 under what circumstances.

13 Did you review any decisions that may have touched on
14 that subject?

15 A. No.

16 Q. Mr. Kahal, can we agree that required reserve
17 margins can change over time as system conditions change?

18 A. Yes, and in particular as PJM conditions change.

19 Q. Can we agree that a utility might need a higher
20 reserve margin if it experienced increases in forced outage
21 rates as existing units aged?

22 A. Yes; that's correct. From what I can tell from
23 industry experience generally, the trend has been the other
24 way; that is, industry planning reserve margins have gone
25 down and part of the explanation for that is that generating

1 unit reliability has improved over time.

2 Q. Would another factor be the possible degradation
3 of reliability from increased reliance on load management
4 and QF capacity?

5 A. You mean as a theoretical matter or as a factual
6 matter?

7 Q. As a theoretical matter.

8 A. As a theoretical matter, if the addition of QF
9 capacity had the effect of reducing reliability, then that
10 could cause a reassessment of reserve margins, possibly
11 leading to higher target reserve margins. As a practical
12 matter, I believe the experience has been the other way;
13 that is that QFs and NUGs have proven to be extremely
14 reliable, perhaps even more reliable than utility-owned
15 units, and if anything have created a possible opportunity
16 for reducing target reserve margins.

17 Q. Would you characterize the company's
18 interruptible tariff offerings as a load management program?

19 A. Yes.

20 Q. Am I correct that you did not review the
21 company's interruptible tariffs prior to submitting your
22 testimony to determine what limitations might exist on the
23 availability to PP&L of those capacity resources?

24 A. I didn't specifically review that because what
25 is important here and what matters here is what PJM accepts;

1 that is, does PJM accept this as a capacity resource, and
2 the answer is yes. I simply have a general knowledge of the
3 subject of interruptible tariffs, and interruptible tariffs
4 almost always have limitations; that is, I don't know of any
5 interruptible tariff that would allow a utility to interrupt
6 a customer 8,760 hours a year.

7 Q. Now, I gather you haven't performed any analysis
8 to determine the extent to which interruptible customers may
9 or may not have actually curtailed their load when requested
10 to do so, at least in the case of Pennsylvania Power & Light
11 Company?

12 A. No. And as I indicated, that's the sort of
13 issue that really needs to be evaluated by PJM, and if PJM
14 finds that the interruptible load does not meet the proper
15 standards of reliability, then PJM would undertake to
16 de-rate that interruptible load, and probably should.

17 Q. Mr. Kahal, have you ever testified that
18 curtailable load should be treated as firm load for purposes
19 of assessing an electric utility's need for generating
20 capacity?

21 A. That interruptible load should be treated as
22 firm load for determining need for capacity?

23 Q. Yes.

24 A. Not that I recall.

25 Q. Do you recall testifying in a case involving

1 Public Service Company of Oklahoma?

2 A. Yes.

3 Q. And you performed a review of Public Service of
4 Oklahoma's official forecast and made certain adjustments to
5 it, did you not?

6 A. That's right.

7 Q. Am I correct that for purposes of your analysis
8 in that case, you did not recognize load management?

9 A. I did no analysis of load management in that
10 case. That was done by another witness, who testified, I
11 believe, that the load management, because of its
12 characteristics, or for whatever reason, did not have
13 capacity value. And I simply incorporated that witness'
14 finding. I did no analysis of my own in that case of
15 interruptible load.

16 Q. And your client in that case was the Smith
17 Cogeneration Management Company?

18 A. That's right.

19 Q. Mr. Kahal, your analysis of PP&L's reserve
20 margins ignores so-called capacity credit sales; is that
21 correct?

22 A. Of reserve margins? That's correct. It's not
23 part of either the resources or the load, it's something
24 separate.

25 Q. Can a utility that purchases capacity credits

1 choose to buy energy on the basis of that purchase?

2 A. No. The capacity credits are sometimes referred
3 to as being paper capacity. It doesn't involve real
4 capacity resources. It is simply an accounting issue of how
5 dollars are spread around.

6 Q. So it's your testimony that a utility that
7 purchased capacity credits cannot exercise those capacity
8 credits and buy power on the basis of them? Is that what
9 you testified to?

10 A. The capacity credits are unrelated to energy. A
11 utility that's a member of PJM certainly has the right to
12 buy energy on the pool, but that's irrespective of the
13 capacity credits. In other words, that's independent of the
14 capacity credits. The capacity credits themselves do not
15 carry with them a specific energy entitlement.

16 Q. Have you ever characterized capacity credit
17 purchases as an available resource?

18 A. It's not an available resource in the physical
19 sense. It can be used as a method that a utility can use to
20 meet its capacity obligation. It has no effect on
21 reliability one way or the other, because reliability is
22 determined at the level of the PJM power pool.

23 Q. Is it a factor that should be taken into
24 consideration in evaluating whether a utility may need to
25 construct additional capacity?

1 A. In the following sense it might; that is, if a
2 utility is able -- let me back up a second. Let's first
3 assume that a utility is looking ahead to a capacity need;
4 that is, during the planning period, that utility does not
5 project itself based upon existing resources as being
6 excess. Therefore, that utility must make a decision as to
7 what kind of resources to acquire in order to meet its
8 capacity target.

9 It is quite possible that capacity credits may be one
10 option that that utility has. That utility then would need
11 to look at both the availability of the capacity credits and
12 the cost of those capacity credits compared to other
13 options; and if the utility is convinced that those capacity
14 credits will be available for purchase and represent the
15 most economic option, then the utility should go ahead,
16 purchase those credits as its least cost option and meet its
17 capacity obligation that way. That, of course, means that
18 it has no effect on reliability per se, because that's
19 determined by the PJM pool. The capacity credits can only
20 exist if reliability is already adequate in the PJM pool.

21 Q. Mr. Kahal, what is your understanding of how
22 capacity credit sales are handled for rate purposes at the
23 present time?

24 A. My understanding at the present time, there was
25 a settlement -- it's governed by a settlement which took

1 place I believe it was in 1993. Under that settlement there
2 is a one-third flow-through of the capacity credit sales
3 revenues to customers and the company retains the other two-
4 thirds.

5 Q. What is your understanding of the company's
6 proposal in this case?

7 A. My understanding is that it's the company's
8 proposal in this case to flow through the full amount of any
9 capacity credit sales if the company's proposal with regard
10 to what I would call the flow-through of the JCP&L returning
11 capacity is accepted; that is, the company has offered to
12 flow the credits through, but it is tied to the Commission
13 accepting the company's treatment that capacity costs
14 related to terminating off-system contracts get flowed
15 through the ECR.

16 Q. Mr. Kahal, your reserve margin recommendation,
17 as you indicated earlier, is 15 percent, is it not?

18 A. It's a range of 12 percent to 15 percent.

19 Q. Your adjustment is based on 15 percent?
20 Actually, your adjustment is based on economic excess
21 capacity; is that right?

22 A. That's correct. My adjustment relates to the
23 entire jurisdictional portion of Susquehanna Unit 2.

24 Q. As you indicated earlier, the 15 percent figure
25 was derived by taking PP&L's installed capacity obligation

1 of 12 percent and adding to it approximately 200 megawatts?

2 A. Yes, or three percentage points. I think in the
3 context of the way utilities do planning these days, a
4 cushion of 3 percent is completely adequate.

5 Q. In fact, in your testimony you characterize it
6 as generous; is that correct?

7 A. I think in the case of PP&L it's generous
8 because I don't see PP&L, over its planning horizon, even
9 adding any resources.

10 Q. Now, are you aware of any case in which this
11 Commission has set a reserve margin as low as 12 to 15
12 percent?

13 A. You mean for excess capacity purposes?

14 Q. Yes.

15 A. No.

16 Q. In a response to our Interrogatory Set II,
17 No. 15, you noted that the basis for the 3 percent cushion
18 was that utility generating unit additions normally fall in
19 the range of 100 to 300 megawatts; is that correct?

20 A. Yes.

21 Q. And you indicated a minute ago, did you not,
22 that to the best of your knowledge PP&L is not planning to
23 add any new generating units in the foreseeable future?

24 A. Yes.

25 Q. Can we agree that the average size of PP&L's

1 existing generating line-up excluding CTs is substantially
2 greater than 200 megawatts?

3 A. Yes. That's -- excuse me. I have to say I
4 haven't done that calculation. If you want me to accept
5 that subject to check, that's fine.

6 Q. Sure. I'll ask you to accept that subject to
7 check.

8 A. There has been, certainly, a pronounced trend
9 over at least the last decade to move toward smaller
10 generating units that match load growth more precisely than
11 may have existed in the past, going back ten, 20 years.

12 Q. Mr. Kahal, in response to our Interrogatory Set
13 IV, No. 24, you provided a copy of a paper which you
14 prepared last October entitled "An Economic Perspective on
15 Competition and the Electric Utility Industry." Do you
16 recall that?

17 A. Yes.

18 Q. I would like to read a couple sentences from
19 that report and see whether you still agree with the
20 positions that you expressed last fall. These both appear
21 on Roman V, which I guess is the Executive Summary or
22 introductory section -- actually, it's styled "Executive
23 Summary."

24 The first sentence is, and I quote, "Under a full
25 retail competition world, existing power pools and

1 longstanding cooperation among utilities in management of
2 regional grids are likely to break down."

3 Do you still believe that?

4 A. If we're talking about power pools as we know
5 them now, the answer is yes, they will change substantially.
6 In fact, I recently had the opportunity to review the
7 comments that were submitted by PJM in the FERC's
8 rulemaking, or inquiry, really, on power pooling, and PJM is
9 proposing some major changes. If we were in a fully
10 deregulated world, I think there would be more changes, and
11 it would be very much open to question whether PJM could
12 survive as an institution.

13 Q. The second sentence, which is on the same page,
14 is, and I quote, "The potential for degradation of service
15 and the loss of coordination economies must be viewed as
16 important risks."

17 Again, is that something that you still subscribe to?

18 A. I think that we need to clarify that, Mr.
19 Gadsden. That was written in the context if we went to a
20 fully deregulated, not just in the wholesale sense, but
21 fully deregulated retail market --

22 Q. I understand.

23 A. -- where retail loads would be served by
24 numerous individual generating companies. And in that case,
25 in my opinion, unless there were certain institutional

1 changes introduced to accompany that change, then there
2 would be real questions about reliability. The problem
3 being that in a completely unregulated competitive market,
4 no one would have the economic incentive to oversee and
5 insure that there would be grid integrity. And I think that
6 this is the source of the various Poolco proposals that have
7 been set forth by some who feel that institutions like that
8 must accompany deregulation.

9 Q. Mr. Kahal, just a few questions with respect to
10 economic excess capacity.

11 A. Sure.

12 Q. I gather that it is your view that an excess
13 capacity adjustment should be made for uneconomic generating
14 capacity even if there is a demonstrated need for that
15 capacity from a reliability standpoint?

16 A. Well, in that case they wouldn't be independent.
17 Reliability can be translated into dollars, and the dollar
18 value of that reliability would then affect the economic
19 assessment. But if it turned out that the cost of that
20 capacity is so high, that is the full revenue requirement
21 cost of that capacity was so high that it exceeded the sum
22 of both the energy value and the reliability value, then it
23 would be proper to deem that as being excess capacity. And
24 I think the reason for that is because if the capacity is
25 that expensive, as we've been discussing in this question

1 and answer, then clearly there are much cheaper ways of
2 meeting that same reliability. It's not a question of do
3 you have reliability or don't you. The assumption is you
4 are going to have reliability. It's simply what do you have
5 to spend to get it.

6 Q. Well, rather than speak in the abstract, let's
7 get a little more specific. If the Commission were to
8 disagree with you and reject your proposed finding that the
9 company has physical excess capacity, is it your
10 recommendation that the Commission nonetheless deny PP&L an
11 equity return on its investment in Susquehanna 2?

12 A. Yes. I believe that the company must meet both
13 the reliability need test and the economic excess capacity
14 test or criteria under Section 1323. I believe that's what
15 that statute states.

16 Q. Do you believe that the need for the capacity is
17 a factor which the Commission should take into consideration
18 in determining whether to adopt an adjustment, or
19 alternatively, what type of adjustment might be appropriate
20 under the circumstances?

21 A. I think you mean "need" in the reliability
22 sense?

23 Q. Yes.

24 A. Of course, they should take that into account.
25 That's why I presented both the physical and economic excess

1 capacity analyses. In other words, the two analyses I think
2 are reinforcing.

3 Q. As you note on page 17, at line 16, Section 1323
4 refers to economic benefits being expected within a
5 reasonable period of time. Based on your review of prior
6 Commission orders, what is your understanding of how that
7 phrase has been interpreted to date?

8 A. It has not been interpreted with anything that
9 one might consider to be precision. That is, I don't think
10 that the Commission has really come up with a precise
11 definition of what a reasonable time period is. I think
12 it's more a matter of the Commission knows a reasonable time
13 period when it sees one.

14 This issue was discussed in the last PP&L case back
15 in its 1985 order, and at that time the Commission simply
16 found that although there was evidence that the unit might
17 eventually become cost effective, that the timing was so far
18 out in the future as not to be meaningful. There was a
19 similar finding with regard to Limerick and Pennsylvania
20 Power & Light Company -- I'm sorry; Philadelphia Electric,
21 as it was called back then.

22 The Commission has never come up with a precise
23 definition of what a reasonable time period is. It has
24 never said it's exactly five years or exactly three years or
25 anything like that.

1 Q. But it has addressed the subject in several
2 cases, has it not?

3 A. Yes, it has.

4 Q. On page 17 you explain that you evaluated the
5 economics of Susquehanna 2 by reference to the market price
6 of power at the wholesale level; is that correct?

7 A. Yes.

8 Q. Are you aware of any case in which the
9 Commission has applied Section 1323's economic benefit test
10 in that fashion?

11 A. No. I don't think that the Commission has ever
12 found it necessary to look at that. One of the reasons why
13 I think is that in the prior cases that I'm aware of, which
14 are generally during, say, the 1980 to 1990 time frame, the
15 concept of a wholly competitive generation market really
16 wasn't very well developed.

17 Q. Do you know whether a market-based economic
18 benefits test has ever been proposed as the appropriate
19 method for applying Section 1323's economic benefits test?

20 A. No. I don't think that anyone has ever found it
21 necessary to use that. I think that the assumption is that
22 the kind of planning studies that were done either by the
23 utility or the OCA -- those are generally the two parties
24 that submitted these economic studies -- were in a sense
25 attempting to mimic the market in the sense that the studies

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that were presented were purported to be least cost planning studies. Least cost simply means that you take the resource that has the lowest cost, and that's either a resource that you can add yourself or the purchase. So I think that the assumption is that new resources that a utility itself would build, whether it's a peaking unit or a combined cycle unit, would themselves reflect the cost of obtaining something equivalent in the market.

1 Q. Are you aware of any other Commission which has
2 applied the approach you've proposed to disallow a return on
3 an existing generating unit?

4 A. No. I really haven't studied the matter to tell
5 you what other Commissions have done.

6 Q. Are you aware of any nuclear generating facility
7 constructed in the last 20 years that could pass your
8 market-based economic benefits test today?

9 A. I really don't know. I'm not aware of any.

10 Q. That's fine.

11 A. But --

12 Q. That's fine.

13 A. I think it's generally understood that recent
14 vintage nuclear plants are uneconomic. It's an unfortunate
15 fact of life.

16 Q. Now, Mr. Kahal at page 18, line 14, you refer to
17 early year cost penalties. What do you have in mind there?

18 A. I'm sorry. Which line is that?

19 Q. Fourteen, page 18.

20 A. There what I was referring to was the remaining
21 life of Susquehanna. The remaining life of Susquehanna is
22 approximately 30 years. Consequently, if we had a scenario
23 whereby there was an equity return disallowance -- excuse
24 me. What I'm referring to here is the fact that if we're
25 looking at the remaining life of the Susquehanna Unit 2,

1 which is approximately 30 years, the early year cost
2 penalties simply refer to the fact that in the near term,
3 let's say the next approximately ten years, that the full
4 revenue requirement cost is above market price, and that may
5 not be true in the later years. That is, in the later years
6 the full revenue requirement cost may be below market price.
7 But the penalty that I was referring to here simply referred
8 to in the near term, the full revenue requirement cost would
9 be above market.

10 Q. So you are not testifying that PP&L customers
11 have been required to pay early year cost penalties during
12 the first ten years of operations of Susquehanna Unit No. 2;
13 you're simply looking on a prospective basis?

14 A. That's what that statement means. I believe
15 that Pennsylvania ratepayers in fact have probably paid an
16 economic penalty on Susquehanna Unit 2, yes.

17 In other words, Susquehanna Unit 2 has been
18 uneconomic, and I believe that burden has been shared
19 between shareholders and ratepayers under the Commission's
20 1985 decision.

21 Q. You said you thought that that was the case.
22 Have you done any analysis to determine whether it is or
23 not?

24 A. Well, the only analysis that I have done is the
25 analysis that estimates what the revenue requirement cost of

1 Susquehanna is with and without the equity return
2 disallowance, and with the equity return disallowance, the
3 cost is on the order of 5 cents a kilowatt-hour; and I think
4 5 cents a kilowatt-hour has been above market price during
5 the last ten years.

6 Q. Is it your understanding that if we did the same
7 analysis based on the rates which are currently in effect
8 and reflected the equity allowance that was adopted in the
9 Unit 2 case that we would also come to the 5-cent per
10 kilowatt figure?

11 A. You went a little too fast for me. Could you
12 try that again?

13 Q. The numbers you gave me, as I understand it,
14 were based on your analysis of the revenue requirements
15 associated with Susquehanna 2 as presented in this case.

16 A. That's correct.

17 Q. And my question is: again, with reference to
18 the rates that have been in effect for the last ten years,
19 is it your testimony that one would come up with the same
20 5-cent figure per KWH based on those rates? And if you
21 don't know, that's fine.

22 A. I haven't done a calculation, but I have every
23 reason to believe it would be a higher number, the reason
24 being that the -- let me refer to a specific schedule so we
25 can follow this through.

1 Q. Mr. Kahal, if you haven't made the analysis, I
2 don't want to speculate as to what you think the answer may
3 be.

4 MS. KENNEY: Your Honor --

5 MR. GADSDEN: No.

6 BY MR. GADSDEN:

7 Q. You indicated you hadn't made the analysis, and
8 that was my only question. I'd like to move on.

9 MS. KENNEY: Your Honor, I believe that Mr. Kahal has
10 been trying to answer Mr. Gadsden's question.

11 MR. GADSDEN: He has answered it. He indicated he
12 hadn't done the analysis.

13 JUDGE CHRISTIANSON: Yes. I'll allow counsel to
14 control him, and then we'll worry later if Consumer Advocate
15 counsel wants to bring it out on redirect and address the
16 issue at that point, but I'll allow counsel to curtail the
17 response.

18 MR. GADSDEN: Thank you, Your Honor.

19 BY MR. GADSDEN:

20 Q. Mr. Kahal, just a few more. In our
21 Interrogatory Set II, No. 21, we asked you whether you
22 believe rates should be set on the basis of the lesser of
23 full cost of service and market value; and am I correct that
24 your response was, quote, "As a broad generalization, the
25 answer is no"? Is that your answer?

1 A. If you give me the reference again.

2 Q. Set II, No. 21. Did I read your answer
3 correctly?

4 A. Right. I would not adopt that as a regulatory
5 principle, as a general regulatory principle that rates
6 should be set at the lesser of full cost of service and
7 market value, and I certainly haven't done that in my
8 testimony here.

9 Q. Mr. Kahal, putting your market-based test aside
10 for the moment, can we agree that there are other ways that
11 one might assess the economic benefits of generating
12 capacity?

13 A. There are other ways. They should reach the
14 same answer.

15 Q. And what would some of those ways be?

16 A. You could use the avoided costs that you file
17 with the Commission. To me, that would give you a similar
18 result. You could use some combination of the avoided costs
19 and new generating units such as the cost of power from
20 let's say a combined cycle unit. In fact, I looked at that.
21 I looked at these various things, and they all seem to point
22 to the same thing.

23 The market price is the price at which a company such
24 as PP&L can sell power or buy power. Therefore, the
25 company's own costs at the margin should be brought in line

1 with the market.

2 Q. You referred to the cost of other generating
3 facilities that might be constructed in lieu of the unit in
4 question, and you have performed analyses in the past which
5 have looked at the cost of so-called proxy units, have you
6 not?

7 A. Yes.

8 Q. Mr. Kahal, you note on page 19 at line 6 that
9 you determined the revenue requirement cost of Susquehanna
10 as claimed by PP&L to be approximately 6 cents per KWH. Do
11 you see that?

12 A. Yes.

13 Q. Do you know what PP&L is currently paying its QF
14 suppliers?

15 A. Something pretty close to that is my
16 understanding. Maybe a little bit higher than 6 cents.

17 Q. Finally, in the sentence which precedes -- well,
18 I guess it is that same sentence, which reads, "Using a
19 range of cost parameters for possible disputed items such as
20 rate of return and depreciation, I find the cost at this
21 time to be roughly 6 cents per KWH."

22 Did you run a series of calculations inputting
23 different assumptions in preparing this portion of your
24 testimony?

25 A. Do you mean with regard to cost?

1 Q. Yes.

2 A. Only the ones that are shown on Schedule 12. I
3 mean, that's it. This seemed to provide a reasonable range
4 to look at the cost of Susquehanna; and when I came up with
5 these results, it also seemed to be roughly consistent with
6 the company's own estimates of the cost of power from
7 Susquehanna, which is fine. It assured me that I really
8 didn't need to go any further.

9 Q. Just for my edification, looking at Schedule
10 MIK-12, page 1, the rate of return reflects on the low side
11 the effect of your rate of return proposal on a pre-tax
12 basis and the high number assumes adoption of Mr. Moul's
13 proposal?

14 A. Yes, that's correct.

15 Q. And how about the spread in decommissioning
16 costs; is that the difference between what the company has
17 claimed and what the OCA is proposing in this case?

18 A. I don't know. I think it is probably close.
19 The 30 million is the company's proposal it is my
20 understanding on a total company basis. At the time that I
21 prepared this, I didn't have the OCA's figure on
22 decommissioning. In fact, I still don't know what it is.

23 Q. Would the same be true with respect to
24 depreciation?

25 A. Not exactly. Depreciation, my understanding of

1 this range, the high end of the range is the company's
2 proposal. That is right out of the cost of service study.

3 The 147 million, as I understand it -- and this is
4 based on discussions with Dr. Johnson -- is an approximation
5 of what depreciation expense would be under the continuation
6 of modified sinking fund.

7 Q. So that number was provided to you by Dr.
8 Johnson?

9 A. That's right.

10 Q. And if we have any questions with respect to its
11 derivation, they should be addressed to him?

12 A. Yes. I don't think that there is much involved
13 in deriving it. I think it is a company number. There are
14 different philosophies on depreciation.

15 MR. GADSDEN: That's all we have, Your Honor.

16 JUDGE CHRISTIANSON: Then I guess there is no other
17 cross type examination. Let's go ahead and be off the
18 record for a few minutes.

19 (Recess.)
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1 JUDGE CHRISTIANSON: Let's be back on the record,
2 then. I understand there is some redirect, and rather than
3 continue these background conversations on other topics, we
4 might as well go ahead and close out this record.

5 You may proceed.

6 MS. KENNEY: Thank you, Your Honor.

7 FURTHER REDIRECT EXAMINATION

8 BY MS. KENNEY:

9 Q. Mr. Kahal, you were asked several questions by
10 Mr. Gadsden, and he was using as a reference the copy of the
11 article, or document, that you had prepared in response to
12 OCA -- excuse me, PP&L Interrogatory Set 4, Number 24.

13 He asked you a number of questions regarding
14 reliability in the future relating to power pulls and what
15 would happen possibly in the future relating to power pulls
16 and reliability.

17 How is that relevant to your physical excess capacity
18 adjustment in this proceeding?

19 A. It really has no bearing on it. I believe that
20 the subject that Mr. Gadsden and I were discussing is what
21 might happen to system reliability in the future, and
22 consequently appropriate reserve margins under a fully
23 deregulated, and I'm including retail deregulated
24 environment.

25 And that's a very interesting question, but it's also

1 highly speculative as to what might happen. In fact, if
2 there was full deregulation, we don't even know if there
3 would be an obligation to serve, for example, and therefore
4 whether planning reserve margins would even have any meaning
5 other than through customer contacts.

6 But it really has nothing to do with the physical
7 excess capacity analysis in this case, because I based my
8 physical excess capacity analysis based upon reserve margin
9 and reliability criteria during the test year and the year
10 following.

11 That's the standard that the Commission has followed
12 and that's the standard prescribed by Section 1323. What
13 might happen many years into the future if and when there's
14 deregulation is really completely irrelevant to the
15 determination of physical excess capacity in this case.

16 Q. You were also asked some questions about whether
17 you knew whether ratepayers had paid a price or a penalty, a
18 price above market price during the last 10 years. Do you
19 have any opinion as to that?

20 A. Yes, I do. I present the calculation of the cost
21 of power for Susquehanna Unit 2 with and without the excess
22 capacity penalty. And at the present time, without the
23 penalty it would be around 6 cents, and with the penalty it
24 would be around 5 cents.

25 And of course, the penalty has been in effect during

1 this time period. However, the costs that ratepayers are
2 currently paying and have paid over the last ten years for
3 Susquehanna Unit 2 are not based upon what the rate base
4 value of Susquehanna 2 is right now.

5 It's based upon the rate base value of Susquehanna 2
6 at the time that that plant went into service in 1995. And
7 that rate base value in 1995 is substantially higher than
8 the rate base value at the present time because of
9 accumulated depreciation and deferred taxes.

10 In addition to that, the company also received at
11 least the debt and preferred stock return on Susquehanna
12 Unit 2. That debt and preferred stock return was a much
13 higher number back in 1985 than it is today.

14 Q. Mr. Kahal, just for clarification, twice when you
15 were referring to a year, you said "1995" and then you
16 mentioned today. Would I be correct that when you mentioned
17 "1995," you actually meant 1985 when the Commission's order
18 when into effect?

19 A. Yes, that's right. In other words, the rates
20 that ratepayers are paying today and that ratepayers have
21 paid over the last ten years are based upon the rate base
22 value of Susquehanna Unit 2 back in 1985 when the plant went
23 into service at that time. And that was a much, much higher
24 figure.

25 Q. What is the basis for your opinion?

1 A. Well, the rate base value of Susquehanna Unit 2
2 was mentioned in the Commission's order. In addition to
3 that, the company in an interrogatory response provided me
4 with the original plant in service for the plant.

5 And accumulated depreciation over the last ten years
6 and accumulated balance of deferred taxes, both of which are
7 offsets for the current -- that is, in this case -- rate
8 base value of Susquehanna Unit 2 are much, much larger than
9 the capital additions that are taking place.

10 MS. KENNEY: Thank you.

11 Your Honor, I have no further questions.

12 MR. GADSDEN: Just a few, Your Honor.

13 REXCROSS-EXAMINATION

14 BY MR. GADSDEN:

15 Q. Mr. Kahal, we've been doing a lot of dancing
16 around on the second issue that you discussed.

17 MS. KENNEY: Your Honor, I'm going to object to Mr.
18 Gadsden's characterization. I would ask him to rephrase.

19 BY MR. GADSDEN:

20 Q. Well, I'm not sure that the responses either in
21 redirect were responsive to my cross-examination or even to
22 your counsel's questioning.

23 But let's focus again on page 18 and the phrase,
24 "early year cost penalties." My question is simple. When
25 you refer to early year cost penalties, are you referring to

1 the period 1985 to 1995 or are you referring to some period
2 other than that?

3 A. My testimony's purely prospective, that is I'm
4 talking about from here forward. I was trying to respond to
5 your question a little earlier that went to, "Gee, did
6 ratepayers pay above market for Susquehanna Unit 2 in
7 earlier years?"

8 And my answer is -- although I didn't do that
9 calculation -- all the information that I would have would
10 lead me to the conclusion that yes, they have.

11 Q. And by "market," how do you define "market"
12 during the period of 1985 to 1995?

13 A. Market is simply the cost at which PP&L could
14 have bought or sold power during that time period. It might
15 be represented by the avoided cost calculations that the
16 company did during that time period.

17 Q. And do you know --

18 A. Not the projected ones, but what the actual ones
19 were. It might be represented by the PJM transactions
20 prices.

21 Q. Do you know what the company's avoided cost
22 calculation showed in 1985?

23 A. I don't have that information. I've been
24 involved, of course, in many, many planning studies during
25 that time, so I'm generally aware of what the PJM

1 transactions were during the last ten years.

2 Q. Do you know whether the price that the company is
3 currently paying its qualifying facilities was based on
4 avoided cost calculations?

5 A. They were based upon projections. They weren't
6 based upon actuals. I'm referring to the actuals.
7 Obviously, the projections turned out to be wrong, and I
8 think that, you know, PP&L is no different than anyone else
9 in overestimating long term projections of avoided cost.

10 Q. And in fact, in a Central Maine Power case, you
11 indicated that that problem was almost universal within the
12 electric utility industry.

13 A. I can't think of any exceptions, so I guess that
14 makes it universal. Just about everybody overprojected
15 where avoided costs were going to go in the long term.

16 MR. GADSDEN: That's all we have, Your Honor.

17 JUDGE CHRISTIANSON: Fine. That perhaps does clarify
18 it. Any follow-up?

19 MS. KENNEY: No, Your Honor. I have no further
20 questions.

21 JUDGE CHRISTIANSON: Grudgingly, no follow-up.

22 MS. KENNEY: It could go on forever, but we'll end it
23 here.

24 JUDGE CHRISTIANSON: For the present time, we'll be
25 done. Thank you.

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(Witness excused.)

JUDGE CHRISTIANSON: Then we seem to be done with this phase. We have two days next week. And we can be done for the record this afternoon.

(Whereupon, at 3:33 p.m., the proceedings were concluded.)

FORM 2

C E R T I F I C A T E

I hereby certify, as the stenographic reporter, that the foregoing proceedings were taken stenographically by me and thereafter reduced to typewriting by me or under my direction, and that this transcript is a true and accurate record to the best of my ability.

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By: John A. Kelly

John A. Kelly,
Certified Verbatim Reporter

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FORM 2

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