PPL ELECTRIC UTILITIES CORPORATION

Appendices A Through I to Accompany

the Direct Testimony

of

Paul R. Moul, Managing Consultant
P. Moul & Associates

Concerning

Cost of Capital

APPENDIX A TO DIRECT TESTIMONY OF PAUL R. MOUL

EDUCATIONAL BACKGROUND, BUSINESS EXPERIENCE AND QUALIFICATIONS

I was awarded a degree of Bachelor of Science in Business Administration by Drexel University in 1971. While at Drexel, I participated in the Cooperative Education Program which included employment, for one year, with American Water Works Service Company, Inc., as an internal auditor, where I was involved in the audits of several operating water companies of the American Water Works System and participated in the preparation of annual reports to regulatory agencies and assisted in other general accounting matters.

Upon graduation from Drexel University, I was employed by American Water Works Service Company, Inc., in the Eastern Regional Treasury Department where my duties included preparation of rate case exhibits for submission to regulatory agencies, as well as responsibility for various treasury functions of the thirteen New England operating subsidiaries.

In 1973, I joined the Municipal Financial Services Department of Betz Environmental Engineers, a consulting engineering firm, where I specialized in financial studies for municipal water and wastewater systems.

In 1974, I joined Associated Utility Services, Inc., now known as AUS Consultants. I held various positions with the Utility Services Group of AUS Consultants, concluding my employment there as a Senior Vice President.

In 1994, I formed P. Moul & Associates, an independent financial and regulatory consulting firm. In my capacity as Managing Consultant and for the past twenty-nine years, I have continuously studied the rate of return requirements for cost of service regulated firms. In this regard, I have supervised the preparation of rate of return studies which were employed in connection with my testimony and in the past for other individuals. I have presented direct

testimony on the subject of fair rate of return, evaluated rate of return testimony of other witnesses, and presented rebuttal testimony.

My studies and prepared direct testimony have been presented before thirty (30) federal, state and municipal regulatory commissions, consisting of: the Federal Energy Regulatory Commission; state public utility commissions in Alabama, Connecticut, Delaware, Florida, Georgia, Hawaii, Illinois, Indiana, Iowa, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, New Hampshire, New Jersey, New York, North Carolina, Ohio, Oklahoma, Tennessee, Pennsylvania, South Carolina, Texas, Virginia, and West Virginia; and the Philadelphia Gas Commission. My testimony has been offered in over 200 rate cases involving electric power, natural gas distribution and transmission, resource recovery, solid waste collection and disposal, telephone, wastewater, and water service utility companies. While my testimony has involved principally fair rate of return and financial matters, I have also testified on capital allocations, capital recovery, cash working capital, income taxes, factoring of accounts receivable, and take-or-pay expense recovery. My testimony has been offered on behalf of municipal and investor-owned public utilities and for the staff of a regulatory commission. I have also testified at an Executive Session of the State of New Jersey Commission of Investigation concerning the BPU regulation of solid waste collection and disposal.

I was a co-author of a verified statement submitted to the Interstate Commerce Commission concerning the 1983 Railroad Cost of Capital (Ex Parte No. 452). I was also co-author of comments submitted to the Federal Energy Regulatory Commission regarding the Generic Determination of Rate of Return on Common Equity for Public Utilities in 1985, 1986 and 1987 (Docket Nos. RM85-19-000, RM86-12-000, RM87-35-000 and RM88-25-000). Further, I have been the consultant to the New York Chapter of the National Association of

Water Companies which represented the water utility group in the Proceeding on Motion of the Commission to Consider Financial Regulatory Policies for New York Utilities (Case 91-M-0509). I have also submitted comments to the Federal Energy Regulatory Commission in its Notice of Proposed Rulemaking (Docket No. RM99-2-000) concerning Regional Transmission Organizations and on behalf of the Edison Electric Institute in its intervention in the case of Southern California Edison Company (Docket No. ER97-2355-000).

In late 1978, I arranged for the private placement of bonds on behalf of an investor-owned public utility. I have assisted in the preparation of a report to the Delaware Public Service Commission relative to the operations of the Lincoln and Ellendale Electric Company. I was also engaged by the Delaware P.S.C. to review and report on the proposed financing and disposition of certain assets of Sussex Shores Water Company (P.S.C. Docket Nos. 24-79 and 47-79). I was a co-author of a Report on Proposed Mandatory Solid Waste Collection Ordinance prepared for the Board of County Commissioners of Collier County, Florida.

I have been a consultant to the Bucks County Water and Sewer Authority concerning rates and charges for wholesale contract service with the City of Philadelphia. My municipal consulting experience also included an assignment for Baltimore County, Maryland, regarding the City/County Water Agreement for Metropolitan District customers (Circuit Court for Baltimore County in Case 34/153/87-CSP-2636).

I am a member of the Society of Utility and Regulatory Financial Analysis (formerly the National Society of Rate of Return Analysts) and have attended several Financial Forums sponsored by the Society. I attended the first National Regulatory Conference at the Marshall-Wythe School of Law, College of William and Mary. I also attended an Executive Seminar sponsored by the Colgate Darden Graduate Business School of the University of Virginia concerning Regulated Utility Cost of Equity and the Capital Asset Pricing Model. In October

1984, I attended a Standard & Poor's Seminar on the Approach to Municipal Utility Ratings, and in May 1985, I attended an S&P Seminar on Telecommunications Ratings.

My lecture and speaking engagements include:

Date	Occasion	Sponsor
April 2001	Thirty-third Financial Forum	Society of Utility & Regulatory Financial Analysts
December 2000	Pennsylvania Public Utility Law Conference: *Non-traditional Players* in the Water Industry	Pennsylvania Bar Institute
July 2000	EEI Member Workshop Developing Incentives Rates: Application and Problems	Edison Electric Institute
February 2000	The Sixth Annual FERC Briefing	Exnet and Bruder, Gentile & Marcoux, LLP
March 1994	Seventh Annual Proceeding	Electric Utility Business Environment Conf.
May 1993	Financial School	New England Gas Assoc.
April 1993	Twenty-Fifth Financial Forum	National Society of Rate of Return Analysts
June 1992	Rate and Charges Subcommittee Annual Conference	American Water Works Association
May 1992	Rates School	New England Gas Assoc.
October 1989	Seventeenth Annual Eastern Utility Rate Seminar	Water Committee of the National Association of Regulatory Utility Commissioners Florida Public Service Commission and University of Utah
October 1988	Sixteenth Annual Eastern Utility Rate Seminar	Water Committee of the National Association of Regulatory Utility Commissioners, Florida Public Service Commission and University of Utah
May 1988	Twentieth Financial Forum	National Society of Rate of Return Analysts
October 1987	Fifteenth Annual Eastern Utility Rate Seminar	Water Committee of the National Association of Regulatory Utility Commissioners, Florida

		Public Service Commission and University of Utah
September 1987	Rate Committee Meeting	American Gas Association
May 1987	Pennsylvania Chapter annual meeting	National Association of Water Companies
October 1986	Eighteenth Financial Forum	National Society of Rate of Return
October 1984	Fifth National on Utility Ratemaking Fundamentals	American Bar Association
March 1984	Management Seminar	New York State Telephone Association
February 1983	The Cost of Capital Seminar	Temple University, School of Business Admin.
May 1982	A Seminar on Regulation and The Cost of Capital	New Mexico State University, Center for Business Research and Services
October 1979	Economics of Regulation	Brown University

APPENDIX B TO DIRECT TESTIMONY OF PAUL R. MOUL

RATESETTING PRINCIPLES

Under traditional cost of service regulation, an agency engaged in ratesetting, such as the Commission, serves as a substitute for competition. In setting rates, a regulatory agency must carefully consider the public's interest in reasonably priced, as well as safe and reliable, service. The level of rates must also provide an opportunity to earn a rate of return for the public utility and its investors that is commensurate with the risk to which the invested capital is exposed so that the public utility has access to the capital required to meet its service responsibilities to its customers. Without an opportunity to earn a fair rate of return, a public utility will be unable to attract sufficient capital required to meet its responsibilities over time.

It is important to remember that regulated firms must compete for capital in a global market with non-regulated firms, as well as municipal, state and federal governments. Traditionally, a public utility has been responsible for providing a particular type of service to its customers within a specific market area. Although this relationship with its customers has been changing, it remains quite different from a non-regulated firm which is free to enter and exit competitive markets in accordance with available business opportunities.

As established by the landmark Bluefield and Hope cases,[1] several tests must be satisfied to demonstrate the fairness or reasonableness of the rate of return. These tests include a determination of whether the rate of return is (i) similar to that of other financially sound businesses having similar or comparable risks, (ii) sufficient to ensure confidence in the financial integrity of the public utility, and (iii) adequate to maintain and support the credit of the utility, thereby enabling it to attract, on a reasonable cost basis, the funds necessary to

[1] Bluefield Water Works & Improvement Co. v. P.S.C. of West Virginia, 262 U.S. 679 (1923) and F.P.C. v. Hope Natural Gas Co., 320 U.S. 591 (1944).

satisfy its capital requirements so that it can meet the obligation to provide adequate and reliable service to the public.

A fair rate of return must not only provide the utility with the ability to attract new capital, it must also be fair to existing investors. An appropriate rate of return which may have been reasonable at one point in time may become too high or too low at a subsequent point in time, based upon changing business risks, economic conditions and alternative investment opportunities. When applying the standards of a fair rate of return, it must be recognized that the end result must provide for the payment of interest on the company's debt, the payment of dividends on the company's stock, the recovery of costs associated with securing capital, the maintenance of reasonable credit quality for the company, and support of the company's financial condition, which today would include those measures of financial performance in the areas of interest coverage and adequate cash flow derived from a reasonable level of earnings.

APPENDIX C TO DIRECT TESTIMONY OF PAUL R. MOUL

EVALUATION OF RISK

The rate of return required by investors is directly linked to the perceived level of risk. The greater the risk of an investment, the higher is the required rate of return necessary to compensate for that risk all else being equal. Because investors will seek the highest rate of return available, considering the risk involved, the rate of return must at least equal the investor-required, market-determined cost of capital if public utilities are to attract the necessary investment capital on reasonable terms.

In the measurement of the cost of capital, it is necessary to assess the risk of a firm. The level of risk for a firm is often defined as the uncertainty of achieving expected performance, and is sometimes viewed as a probability distribution of possible outcomes. Hence, if the uncertainty of achieving an expected outcome is high, the risk is also high. As a consequence, high risk firms must offer investors higher returns than low risk firms which pay less to attract capital from investors. This is because the level of uncertainty, or risk of not realizing expected returns, establishes the compensation required by investors in the capital markets. Of course, the risk of a firm must also be considered in the context of its ability to actually experience adequate earnings which conform with a fair rate of return. Thus, if there is a high probability that a firm will not perform well due to fundamentally poor market conditions, investors will demand a higher return.

The investment risk of a firm is comprised of its business risk and financial risk. Business risk is all risk other than financial risk, and is sometimes defined as the staying power of the market demand for a firm's product or service and the resulting inherent uncertainty of realizing expected pre-tax returns on the firm's assets. Business risk encompasses all operating factors, e.g., productivity, competition, management ability, etc. that bear upon the expected

pre-tax operating income attributed to the fundamental nature of a firm's business. Financial risk results from a firm's use of borrowed funds (or similar sources of capital with fixed payments) in its capital structure, i.e., financial leverage. Thus, if a firm did not employ financial leverage by borrowing any capital, its investment risk would be represented by its business risk.

It is important to note that in evaluating the risk of regulated companies, financial leverage cannot be considered in the same context as it is for non-regulated companies. Financial leverage has a different meaning for regulated firms than for non-regulated companies. For regulated public utilities, the cost of service formula gives the benefits of financial leverage to consumers in the form of lower revenue requirements. For non-regulated companies, all benefits of financial leverage are retained by the common stockholder. Although retaining none of the benefits, regulated firms bear the risk of financial leverage. Therefore, a regulated firm's rate of return on common equity must recognize the greater financial risk shown by the higher leverage typically employed by public utilities.

Although no single index or group of indices can precisely quantify the relative investment risk of a firm, financial analysts use a variety of indicators to assess that risk. For example, the creditworthiness of a firm is revealed by its bond ratings. If the stock is traded, the price-earnings multiple, dividend yield, and beta coefficients (a statistical measure of a stock's relative volatility to the rest of the market) provide some gauge of overall risk. Other indicators, which are reflective of business risk, include the variability of the rate of return on equity, which is indicative of the uncertainty of actually achieving the expected earnings; operating ratios (the percentage of revenues consumed by operating expenses, depreciation, and taxes other than income tax), which are indicative of profitability; the quality of earnings,

which considers the degree to which earnings are the product of accounting principles or cost deferrals; and the level of internally generated funds. Similarly, the proportion of senior capital in a company's capitalization is the measure of financial risk which is often analyzed in the context of the equity ratio (i.e., the complement of the debt ratio).

APPENDIX D TO DIRECT TESTIMONY OF PAUL R. MOUL

COST OF EQUITY–GENERAL APPROACH

Through a fundamental financial analysis, the relative risk of a firm must be established prior to the determination of its cost of equity. Any rate of return recommendation which lacks such a basis will inevitably fail to provide a utility with a fair rate of return except by coincidence. With a fundamental risk analysis as a foundation, standard financial models can be employed by using informed judgment. The methods which have been employed to measure the cost of equity include: the Discounted Cash Flow ("DCF") model, the Risk Premium ("RP") approach, the Capital Asset Pricing Models ("CAPM") and the Comparable Earnings ("CE") approach.

The traditional DCF model, while useful in providing some insight into the cost of equity, is not an approach that should be used exclusively. The divergence of stock prices from company-specific fundamentals can provide a misleading cost of equity calculation. As reported in The Wall Street Journal on June 6, 1991, a statistical study published by Goldman Sachs indicated that only 35% of stock price growth in the 1980's could be attributed to earnings and interest rates. Further, 38% of the rise in stock prices during the 1980's was attributed to unknown factors. The Goldman Sachs study highlights the serious limitations of a model, such as DCF, which is founded upon identification of specific variables to explain stock price growth. That is to say, when stock price growth exceeds growth in a company's earnings per share, models such as DCF will misspecify investor expected returns which are comprised of capital gains, as well as dividend receipts. As such, a combination of methods should be used to measure the cost of equity.

The Risk Premium analysis is founded upon the prospective cost of long-term debt, i.e., the yield that the public utility must offer to raise long-term debt capital directly from investors. To that yield must be added a risk premium in recognition of the greater risk of common equity over debt. This additional risk is, of course, attributable to the fact that the payment of interest and principal to creditors has priority over the payment of dividends and return of capital to equity investors. Hence, equity investors require a higher rate of return than the yield on long-term corporate bonds.

The CAPM is a model not unlike the traditional Risk Premium. The CAPM employs the yield on a risk-free interest-bearing obligation plus a premium as compensation for risk. Aside from the reliance on the risk-free rate of return, the CAPM gives specific quantification to systematic (or market) risk as measured by beta.

The Comparable Earnings approach measures the returns expected/experienced by other non-regulated firms and has been used extensively in rate of return analysis for over a half century. However, its popularity diminished in the 1970s and 1980s with the popularization of market-based models. Recently, there has been renewed interest in this approach. Indeed, the financial community has expressed the view that the regulatory process must consider the returns which are being achieved in the non-regulated sector so that public utilities can compete effectively in the capital markets. Indeed, with additional competition being introduced throughout the traditionally regulated public utility industry, returns expected to be realized by *non-regulated firms have become increasing relevant in the ratesetting process.* The Comparable Earnings approach considers directly those requirements and it fits the established standards for a fair rate of return set forth in the Bluefield and Hope decisions. The Hope

decision requires that a fair return for a utility must be equal to that earned by firms of comparable risk.

APPENDIX E TO DIRECT TESTIMONY OF PAUL R. MOUL

DISCOUNTED CASH FLOW ANALYSIS

Discounted Cash Flow ("DCF") theory seeks to explain the value of an economic or financial asset as the present value of future expected cash flows discounted at the appropriate risk-adjusted rate of return. Thus, if $100 is to be received in a single payment 10 years subsequent to the acquisition of an asset, and the appropriate risk-related interest rate is 8%, the present value of the asset would be $46.32 (Value = $100. $(1.08)^{10}$) arising from the discounted future cash flow. Conversely, knowing the present $46.32 price of an asset (where price = value), the $100 future expected cash flow to be received 10 years hence shows an 8% annual rate of return implicit in the price and future cash flows expected to be received.

In its simplest form, the DCF theory considers the number of years from which the cash flow will be derived and the annual compound interest rate which reflects the risk or uncertainty associated with the cash flows. It is appropriate to reiterate that the dollar values to be discounted are future cash flows.

DCF theory is flexible and can be used to estimate value (or price) or the annual required rate of return under a wide variety of conditions. The theory underlying the DCF methodology can be easily illustrated by utilizing the investment horizon associated with a preferred stock not having an annual sinking fund provision. In this case, the investment horizon is infinite, which reflects the perpetuity of a preferred stock. If P represents price, Kp is the required rate of return on a preferred stock, and D is the annual dividend (P and D with time subscripts), the value of a preferred share is equal to the present value of the dividends to be received in the future discounted at the appropriate risk-adjusted interest rate, Kp. In this circumstance:

$$P_0 = \frac{D_1}{(1+Kp)} + \frac{D_2}{(1+Kp)^2} + \frac{D_3}{(1+Kp)^3} + \ldots + \frac{D_n}{(1+Kp)^n}$$

If $D_1 = D_2 = D_3 = \ldots D_n$ as is the case for preferred stock, and n approaches infinity, as is the case for non-callable preferred stock without a sinking fund, then this equation reduces to:

$$P_0 = \frac{D_1}{Kp}$$

This equation can be used to solve for the annual rate of return on a preferred stock when the current price and subsequent annual dividends are known. For example, with D_1 = \$1.00, and P_0 = \$10, then Kp = \$1.00 ÷ \$10, or 10%.

The dividend discount equation, first shown, is the generic DCF valuation model for all equities, both preferred and common. While preferred stock generally pays a constant dividend, permitting the simplification subsequently noted, common stock dividends are not constant. Therefore, absent some other simplifying condition, it is necessary to rely upon the generic form of the DCF. If, however, it is assumed that D_1, D_2, D_3, ...D_n are systematically related to one another by a constant growth rate (g), so that $D_0 (1 + g) = D_1$, $D_1 (1 + g) = D_2$, $D_2 (1 + g) = D_3$ and so on approaching infinity, and if Ks (the required rate of return on a common stock) is greater than g, then the DCF equation can be reduced to:

$$P_0 = \frac{D_1}{Ks - g} \quad or \quad P_0 = \frac{D_0(1+g)}{Ks - g}$$

which is the periodic form of the "Gordon" model.[1] Proof of the DCF equation is found in all modern basic finance textbooks. This DCF equation can be easily solved as:

[1] Although the popular application of the DCF model is often attributed to the work of Myron J. Gordon in the mid-1950's, J. B. Williams exposited the DCF model in its present form nearly two decades earlier.

$$Ks = \frac{D_0(1+g)}{P_0} + g$$

which is the periodic form of the Gordon Model commonly applied in estimating equity rates of return in rate cases. When used for this purpose, *Ks* is the annual rate of return on common equity demanded by investors to induce them to hold a firm's common stock. Therefore, the variables D_0, P_0 and g must be estimated in the context of the market for equities, so that the rate of return, which a public utility is permitted the opportunity to earn, has meaning and reflects the investor-required cost rate.

Application of the Gordon model with market derived variables is straightforward. For example, using the most recent prior annualized dividend (D_0) of $0.80, the current price (P_0) of $10.00, and the investor expected dividend growth rate (g) of 5%, the solution of the DCF formula provides a 13.4% rate of return. The dividend yield component in this instance is 8.4%, and the capital gain component is 5%, which together represent the total 13.4% annual rate of return required by investors. The capital gain component of the total return may be calculated with two adjacent future year prices. For example, in the eleventh year of the holding period, the price per share would be $17.10 as compared with the price per share of $16.29 in the tenth year which demonstrates the 5% annual capital gain yield.

Some DCF devotees believe that it is more appropriate to estimate the required return on equity with a model which permits the use of multiple growth rates. This may be a plausible approach to DCF, where investors expect different dividend growth rates in the near term and long run. If two growth rates, one near term and one long-run, are to be used in the context of a price (P_0) of $10.00, a dividend (D_0) of $0.80, a near-term growth rate of 5.5%, and a long-run

expected growth rate of 5.0% beginning at year 6, the required rate of return is 13.57% solved with a computer by iteration.

Use of DCF in Ratesetting

The DCF method can provide a misleading measure of the cost of equity in the ratesetting process when stock prices diverge from book values by a meaningful margin. When the difference between share values and book values is significant, the results from the DCF can result in a misspecified cost of equity when those results are applied to book value. This is because investor expected returns, as described by the DCF model, are related to the market value of common stock. This discrepancy is shown by the following example. If it is assumed, hypothetically, that investors require a 12.5% return on their common stock investment value (i.e., the market price per share) when share values represent 150% of book value, investors would require a total annual return of $1.50 per share on a $12.00 market value to realize their expectations. If, however, this 12.5% market-determined cost rate is applied to an original cost rate base which is equivalent to the book value of common stock of $8.00 per share, the utility's actual earnings per share would be only $1.00. This would result in a $.50 per share earnings shortfall which would deny the utility the ability to satisfy investor expectations.

As a consequence, a utility could not withstand these DCF results applied in a rate case and also sustain its financial integrity. This is because $1.00 of earnings per share and a 75% dividend payout ratio would provide earnings retention growth of just 3.125% (i.e., $1.00 x .75 = $0.75, and $1.00 - $0.75 = $0.25, $8.00 = 3.125%). In this example, the earnings retention growth rate plus the 6.25% dividend yield ($0.75 $12.00) would equal 9.375% (6.25% + 3.125%) as indicated by the DCF model. This DCF result is the same as the utility's rate of dividend payments on its book value (i.e., $0.75, $8.00 = 9.375%). This situation provides the

utility with no earnings cushion for its dividend payment because the DCF result equals the dividend rate on book value (i.e., both rates are 9.375% in the example). Moreover, if the price employed in my example were higher than 150% of book value, a "negative" earnings cushion would develop and cause the need for a dividend reduction because the DCF result would be less than the dividend rate on book value. For these reasons, the usefulness of the DCF method significantly diminishes as market prices and book values diverge.

Further, there is no reason to expect that investors would necessarily value utility stocks equal to their book value. In fact, it is rare that utility stocks trade at book value. Moreover, high market-to-book ratios may be reflective of general market sentiment. Were regulators to use the results of a DCF model, that fails to produce the required return when applied to an original cost rate base, they would penalize a company with high market-to-book ratios. This clearly would penalize a regulated firm and its investors that purchased the stock at its current price. When investor expectations are not fulfilled, the market price per share will decline and a new, different equity cost rate would be indicated from the lower price per share. This condition suggests that the current price would be subject to disequilibrium and would not allow a reasonable calculation of the cost of equity. This situation would also create a serious disincentive for management initiative and efficiency. Within that framework, a perverse set of goals and rewards would result, i.e., a high authorized rate of return in a rate case would be the reward for poor financial performance; while low rates of return would be the reward for good financial performance. As such, the DCF results should not be used alone to determine the cost of equity, but should be used along with other complementary methods.

APPENDIX E TO DIRECT TESTIMONY OF PAUL R. MOUL

Dividend Yield

The historical annual dividend yields for the Electric Group and the Gas Group are shown on Schedules 3 and 4. The 1998-2002 five-year average dividend yields were 4.8% for the Electric Group and 4.7% for the Gas Group. The monthly dividend yields for the past twelve months are shown graphically on Schedule 6. These dividend yields reflect an adjustment to the month-end closing prices to remove the pro rata accumulation of the quarterly dividend amount since the last ex-dividend date.

The ex-dividend date usually occurs two business days before the record date of the dividend (i.e., the date by which a shareholder must own the shares to be entitled to the dividend payment--usually about two to three weeks prior to the actual payment). During a quarter (here defined as 91 days), the price of a stock moves up ratably by the dividend amount as the ex-dividend date approaches. The stock's price then falls by the amount of the dividend on the ex-dividend date. Therefore, it is necessary to calculate the fraction of the quarterly dividend since the time of the last ex-dividend date and to remove that amount from the price. This adjustment reflects normal recurring pricing of stocks in the market, and establishes a price which will reflect the true yield on a stock.

A six-month average dividend yield has been used to recognize the prospective orientation of the ratesetting process as explained in the direct testimony. For the purpose of a DCF calculation, the average dividend yields must be adjusted to reflect the prospective nature of the dividend payments, i.e., the higher expected dividends for the future rather than the recent dividend payment annualized. An adjustment to the dividend yield component, when computed with annualized dividends, is required based upon investor expectation of quarterly dividend increases.

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The procedure to adjust the average dividend yield for the expectation of a dividend increase during the initial investment period will be at a rate of one-half the growth component, developed below. The DCF equation, showing the quarterly dividend payments as D_0, may be stated in this fashion:

$$K = \frac{D_0(1+g)^0 + D_0(1+g)^0 + D_0(1+g)^1 + D_0(1+g)^1}{P_0} + g$$

The adjustment factor, based upon one-half the expected growth rate developed in my direct testimony, will be 2.750% (5.50% x .5) for the Electric Group and 3.125% (6.25% x .5) for the Gas Group, which assumes that two dividend payments will be at the expected higher rate during the initial investment period. Using the six-month average dividend yield as a base, the prospective (forward) dividend yield would be 4.74% (4.61% x 1.02750) for the Electric Group and 4.17% (4.04% x 1.03125) for the Gas Group.

Another DCF model that reflects the discrete growth in the quarterly dividend (D_0) is as follows:

$$K = \frac{D_0(1+g)^{.25} + D_0(1+g)^{.50} + D_0(1+g)^{.75} + D_0(1+g)^{1.00}}{P_0} + g$$

This procedure confirms the reasonableness of the forward dividend yield previously calculated. The quarterly discrete adjustment provides a dividend yield of 4.77% (4.61% x 1.03415) for the Electric Group and 4.20% (4.04% x 1.03877) for the Gas Group. The use of an adjustment is required for the periodic form of the DCF in order to properly recognize that dividends grow on a discrete basis.

In either of the preceding DCF dividend yield adjustments, there is no recognition for the compound returns attributed to the quarterly dividend payments. Investors have the opportunity to reinvest quarterly dividend receipts. Recognizing the compounding of the periodic quarterly dividend payments *(D_0)*, results in a third DCF formulation:

$$k = \left[\left(1 + \frac{D_0}{P_0}\right)^4 - 1\right] + g$$

This DCF equation provides no further recognition of growth in the quarterly dividend. Combining discrete quarterly dividend growth with quarterly compounding would provide the following DCF formulation, stating the quarterly dividend payments *(D_0)*:

$$k = \left[\left(1 + \frac{D_0(1+g)^{.25}}{P_0}\right)^4 - 1\right] + g$$

A compounding of the quarterly dividend yield provides another procedure to recognize the necessity for an adjusted dividend yield. The unadjusted average quarterly dividend yield was 1.1525% (4.61% ÷ 4) for the Electric Group and 1.0100% (4.04% ÷ 4) for the Gas Group. The compound dividend yield would be 4.75% (1.011680^4-1) for the Electric Group and 4.17% (1.010254^4-1) for the Gas Group, recognizing quarterly dividend payments in a forward-looking manner. These dividend yields conform with investors' expectations in the context of reinvestment of their cash dividend.

For the Electric Group, a 4.75% forward-looking dividend yield is the average (4.74% + 4.77% + 4.75% = 14.26% ÷ 3) of the adjusted dividend yield using the form D_0/P_0 $(1+.5g)$, the dividend yield recognizing discrete quarterly growth, and the quarterly compound dividend yield with discrete quarterly growth. The forward-looking dividend yield is 4.18% (4.17% + 4.20% + 4.17% = 12.54% ÷ 3) for the Gas Group, using each of the dividend yields discussed previously.

Growth Rate

If viewed in its infinite form, the DCF model is represented by the discounted value of an endless stream of growing dividends. It would, however, require 100 years of future dividend payments so that the discounted value of those payments would equate to the present price so that the discount rate and the rate of return shown by the simplified Gordon form of the DCF model would be about the same. A century of dividend receipts represents an unrealistic investment horizon from almost any perspective. Because stocks are not held by investors forever, the growth in the share value (i.e., capital appreciation, or capital gains yield) is most relevant to investors' total return expectations. Hence, investor expected returns in the equity market are provided by capital appreciation of the investment as well as receipt of dividends. As such, the sale price of a stock can be viewed as a liquidating dividend which can be discounted along with the annual dividend receipts during the investment holding period to arrive at the investor expected return.

In its constant growth form, the DCF assumes that with a constant return on book common equity and constant dividend payout ratio, a firm's earnings per share, dividends per share and book value per share will grow at the same constant rate, absent any external financing by a firm. Because these constant growth assumptions do not actually prevail in the

capital markets, the capital appreciation potential of an equity investment is best measured by the expected growth in earnings per share. Since the traditional form of the DCF assumes no change in the price-earnings multiple, the value of a firm's equity will grow at the same rate as earnings per share. Hence, the capital gains yield is best measured by earnings per share growth using company-specific variables.

Investors consider both historical and projected data in the context of the expected growth rate for a firm. An investor can compute historical growth rates using compound growth rates or growth rate trend lines. Otherwise, an investor can rely upon published growth rates as provided in widely-circulated, influential publications. However, a traditional constant growth DCF analysis that is limited to such inputs suffers from the assumption of no change in the price-earnings multiple, i.e., that the value of a firm's equity will grow at the same rate as earnings. Some of the factors which actually contribute to investors' expectations of earnings growth and which should be considered in assessing those expectations, are: (i) the earnings rate on existing equity, (ii) the portion of earnings not paid out in dividends, (iii) sales of additional common equity, (iv) reacquisition of common stock previously issued, (v) changes in financial leverage, (vi) acquisitions of new business opportunities, (vii) profitable liquidation of assets, and (viii) repositioning of existing assets. The realities of the equity market regarding total return expectations, however, also reflect factors other than these inputs. Therefore, the DCF model contains overly restrictive limitations when the growth component is stated in terms of earnings per share (the basis for the capital gains yield) or dividends per share (the basis for the infinite dividend discount model). In these situations, there is inadequate recognition of the capital gains yields arising from stock price growth which could exceed earnings or dividends growth.

To assess the growth component of the DCF, analysts' projections of future growth influence investor expectations as explained above. One influential publication is The Value Line Investment Survey which contains estimated future projections of growth. The Value Line Investment Survey provides growth estimates which are stated within a common economic environment for the purpose of measuring relative growth potential. The basis for these projections is the Value Line 3 to 5 year hypothetical economy. The Value Line hypothetical economic environment is represented by components and subcomponents of the National Income Accounts which reflect in the aggregate assumptions concerning the unemployment rate, manpower productivity, price inflation, corporate income tax rate, high-grade corporate bond interest rates, and Fed policies. Individual estimates begin with the correlation of sales, earnings and dividends of a company to appropriate components or subcomponents of the future National Income Accounts. These calculations provide a consistent basis for the published forecasts. Value Line's evaluation of a specific company's future prospects are considered in the context of specific operating characteristics that influence the published projections. Of particular importance for regulated firms, Value Line considers the regulatory quality, rates of return recently authorized, the historic ability of the firm to actually experience the authorized rates of return, the firm's budgeted capital spending, the firm's financing forecast, and the dividend payout ratio. The wide circulation of this source and frequent reference to Value Line in financial circles indicate that this publication has an influence on investor judgment with regard to expectations for the future.

There are other sources of earnings growth forecasts. One of these sources is the Institutional Brokers Estimate System ("IBES"), which has been published for many years. The IBES service provided data on consensus earnings per share forecasts and five-year

earnings growth rate estimates. The publisher of IBES has been purchased by Thomson/First Call. The IBES forecasts have been integrated into the First Call consensus growth forecasts. The earnings estimates are obtained from financial analysts at brokerage research departments and from institutions whose securities analysts are projecting earnings for companies in the First Call universe of companies. Other services that tabulate earnings forecasts and publish them are Zacks Investment Research and Market Guide (which is provided over the Internet by Reuters). As with the First Call forecasts, Zacks and Reuters/Market Guide provide consensus forecasts collected from analysts for most publically traded companies.

In each of these publications, forecasts of earnings per share for the current and subsequent year receive prominent coverage. That is to say, Zacks, First Call/Thomson, Reuters/Market Guide, and Value Line show estimates of current-year earnings and projections for the next year. While the DCF model typically focusses upon long-run estimates of growth, stock prices are clearly influenced by current and near-term earnings prospects. Therefore, the near-term earnings per share growth rates should also be factored into a growth rate determination.

Although forecasts of future performance are investor influencing[2], equity investors may also rely upon the observations of past performance. Investors' expectations of future growth rates may be determined, in part, by an analysis of historical growth rates. It is apparent that any serious investor would advise himself/herself of historical performance prior to taking an investment position in a firm. Earnings per share and dividends per share represent the principal financial variables which influence investor growth expectations.

[2] As shown in a National Bureau of Economic Research monograph by John G. Cragg and Burton G. Malkiel, Expectations and the Structure of Share Prices, University of Chicago Press 1982.

Other financial variables are sometimes considered in rate case proceedings. For example, a company's internal growth rate, derived from the return rate on book common equity and the related retention ratio, is sometimes considered. This growth rate measure is represented by the Value Line forecast "*BxR*" shown on Schedule 11. Internal growth rates are often used as a proxy for book value growth. Unfortunately, this measure of growth is often not reflective of investor-expected growth. This is especially important when there is an indication of a prospective change in dividend payout ratio, earned return on book common equity, change in market-to-book ratios or other fundamental changes in the character of the business. Nevertheless, I have also shown the historical and projected growth rates in book value per share and internal growth rates.

Leverage Adjustment

As noted previously, the divergence of stock prices from book values creates a conflict within the DCF model when the results of a market-derived cost of equity are applied to the common equity account measured at book value in the ratesetting context. This is the situation today where the market price of stock exceeds its book value for most companies. This divergence of price and book value also creates a financial risk difference, whereby the capitalization of a utility measured at its market value contains relatively less debt and more equity than the capitalization measured at its book value. It is a well-accepted fact of financial theory that a relatively higher proportion of equity in the capitalization has less financial risk than another capital structure more heavily weighted with debt. This is the situation for the Electric and Gas Groups where the market value of their capitalization contains more equity than is shown by the book capitalization. The following comparison demonstrates this situation where the market capitalization is developed by taking the "Fair Value of Financial

Instruments" (Disclosures about Fair Value of *Financial Instruments* -- Statement of Financial Accounting Standards ("FAS") No. 107) as shown in the annual report for these companies and the market value of the common equity using the price of stock. The comparison of capital structure ratios is:

	Electric Group		Gas Group	
	Market Value	Book Value	Market Value	Book Value
Long-term Debt	46.81%	52.19%	38.85%	50.08%
Preferred Stock	3.39	4.42	2.21	2.89
Common Equity	49.79	43.38	58.94	47.04
Total	100.00%	100.00%	100.00%	100.00%

With regard to the capital structure ratios represented by the carrying amounts shown above, there are some variances from the ratios shown on Schedules 3 and 4. These variances arise from the use of balance sheet values in computing the capital structure ratios shown on Schedules 3 and 4, and the use of the Carrying Amounts of the Financial Instruments according to FAS 107 (the Carrying Amounts were used in the table shown above to be comparable to the Fair Value amounts used in the comparison calculations).

With the capital ratios calculated above, is necessary to first calculate the cost of equity for a firm without any leverage. The cost of equity for an unleveraged firm using the capital structure ratios calculated with market values is:

$ku = ke - (((ku - i)\ 1\text{-}t)\ D / E) - (ku - d)\ P / E$

Electric Group

8.71% = 10.25%-(((8.71%-6.43%) .65) 46.81%/49.79%) - (8.71% - 6.76%) 3.39%/49.79%

Gas Group

9.17% = 10.43%-(((9.17%-6.43%) .65) 38.85%/58.94%) - (9.17% - 6.76%) 2.21%/58.94%

where ku = cost of equity for an all-equity firm, ke = market determined cost equity, i = cost of debt[3], d = dividend rate on preferred stock[4], D = debt ratio, P = preferred stock ratio, and E = common equity ratio. Using the market value of each group's capitalization, the formula shown above indicates that the cost of equity for a firm with 100% equity is 8.71% for the Electric Group and 9.17% for the Gas Group. Having determined that the cost of equity for a firm with 100% equity, the rate of return on common equity associated with the book value capital structure is:

$ke = ku + (((ku - i)\ 1\text{-}t)\ D / E) + (ku - d)\ P / E$

Electric Group

10.69% = 8.71% + (((8.71%-6.43%).65) 52.19%/43.38%) + (8.71% - 6.76%) 4.42%/43.38%

Gas Group

11.22% = 9.17% + (((9.17%-6.43%).65) 50.08%/47.04%) + (9.17% - 6.76%) 2.89%/47.04%

[3] The cost of debt is the six-month average yield on Moody's A rated public utility bonds.

[4] The cost of preferred is the six-month average yield on Moody's "a" rated preferred stock.

APPENDIX F TO DIRECT TESTIMONY OF PAUL R. MOUL

INTEREST RATES

Interest rates can be viewed in their traditional nominal terms (i.e., the stated rate of interest) and in real terms (i.e., the stated rate of interest less the expected rate of inflation). Absent consideration of inflation, the real rate of interest is determined generally by supply factors which are influenced by investors willingness to forego current consumption (i.e., to save) and demand factors that are influenced by the opportunities to derive income from productive investments. Added to the real rate of interest is compensation required by investors for the inflationary impact of the declining purchasing power of their income received in the future. While interest rates are clearly influenced by the changing annual rate of inflation, it is important to note that the expected rate of inflation, that is reflected in current interest rates, may be quite different than the prevailing rate of inflation.

Rates of interest also vary by the type of interest bearing instrument. Investors require compensation for the risk associated with the term of the investment and the risk of default. The risk associated with the term of the investment is usually shown by the yield curve, i.e., the difference in rates across maturities. The typical structure is represented by a positive yield curve which provides progressively higher interest rates as the maturities are lengthened. Flat (i.e., relatively level rates across maturities) or inverted (i.e., higher short-term rates than long-term rates) yield curves occur less frequently.

The risk of default is typically associated with the creditworthiness of the borrower. Differences in interest rates can be traced to the credit quality ratings assigned by the bond rating agencies, such as Moody's Investors Service, Inc. and Standard & Poor's Corporation. Obligations of the United States Treasury are usually considered to be free of default risk, and

hence reflect only the real rate of interest, compensation for expected inflation, and maturity risk. The Treasury has been issuing inflation-indexed notes which automatically provide compensation to investors for future inflation, thereby providing a lower current yield on these issues.

Interest Rate Environment

Federal Reserve Board ("Fed") policy actions which impact directly short-term interest rates also substantially affect investor sentiment in long-term fixed-income securities markets. In this regard, the Fed has often pursued policies designed to build investor confidence in the fixed-income securities market. Formative Fed policy has had a long history, as exemplified by the historic 1951 Treasury-Federal Reserve Accord, and more recently, deregulation within the financial system which increased the level and volatility of interest rates. The Fed has indicated that it will follow a monetary policy designed to promote noninflationary economic growth.

As background to the recent levels of interest rates, history shows that the Open Market Committee of the Federal Reserve board ("FOMC") began a series of moves toward lower short-term interest rates in mid-1990 -- at the outset of the previous recession. Monetary policy was influenced at that time by (i) steps taken to reduce the federal budget deficit, (ii) slowing economic growth, (iii) rising unemployment, and (iv) measures intended to avoid a credit crunch. Thereafter, the Federal government initiated several bold proposals to deal with future borrowings by the Treasury. With lower expected federal budget deficits and reduced Treasury borrowings, together with limitations on the supply of new 30-year Treasury bonds, long-term interest rates declined to a twenty-year low, reaching a trough of 5.78% in October 1993.

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On February 4, 1994, the FOMC began a series of increases in the Fed Funds rate (i.e., the interest rate on excess overnight bank reserves). The initial increase represented the first rise in short-term interest rates in five years. The series of seven increases doubled the Fed Funds rate to 6%. The increases in short-term interest rates also caused long-term rates to move up, continuing a trend which began in the fourth quarter of 1993. The cyclical peak in long-term interest rates was reached on November 7 and 14, 1994 when 30-year Treasury bonds attained an 8.16% yield. Thereafter, long-term Treasury bond yields generally declined.

Beginning in mid-February 1996, long-term interest rates moved upward from their previous lows. After initially reaching a level of 6.75% on March 15, 1996, long-term interest rates continued to climb and reached a peak of 7.19% on July 5 and 8, 1996. For the period leading up to the 1996 Presidential election, long-term Treasury bonds generally traded within this range. After the election, interest rates moderated, returning to a level somewhat below the previous trading range. Thereafter, in December 1996, interest rates returned to a range of 6.5% to 7.0% which existed for much of 1996.

On March 25, 1997, the FOMC decided to tighten monetary conditions through a one-quarter percentage point increase in the Fed Funds rate. This tightening increased the Fed Funds rate to 5.5%. In making this move, the FOMC stated that it was concerned by persistent strength of demand in the economy, which it feared would increase the risk of inflationary imbalances that could eventually interfere with the long economic expansion.

In the fourth quarter of 1997, the yields on Treasury bonds began to decline rapidly in response to an increase in demand for Treasury securities caused by a flight to safety triggered by the currency and stock market crisis in Asia. Liquidity provided by the Treasury market makes these bonds an attractive investment in times of crisis. This is because Treasury

securities encompass a very large market which provides ease of trading and carry a premium for safety. During the fourth quarter of 1997, Treasury bond yields pierced the psychologically important 6% level for the first time since 1993.

Through the first half of 1998, the yields on long-term Treasury bonds fluctuated within a range of about 5.6% to 6.1% reflecting their attractiveness and safety. In the third quarter of 1998, there was further deterioration of investor confidence in global financial markets. This loss of confidence followed the moratorium (i.e., default) by Russia on its sovereign debt and fears associated with problems in Latin America. While not significant to the global economy in the aggregate, the August 17 default by Russia had a significant negative impact on investor confidence, following earlier discontent surrounding the crisis in Asia. These events subsequently led to a general pull back of risk-taking as displayed by banks growing reluctance to lend, worries of an expanding credit crunch, lower stock prices, and higher yields on bonds of riskier companies. These events contributed to the failure of the hedge fund, Long-Term Capital Management.

In response to these events, the FOMC cut the Fed Funds rate just prior to the mid-term Congressional elections. The FOMC's action was based upon concerns over how increasing weakness in foreign economies would affect the U.S. economy. As recently as July 1998, the FOMC had been more concerned about fighting inflation than the state of the economy. The initial rate cut was the first of three reductions by the FOMC. Thereafter, the yield on long-term Treasury bonds reached a 30-year low of 4.70% on October 5, 1998. Long-term Treasury yields below 5% had not been seen since 1967. Unlike the first rate cut that was widely anticipated, the second rate reduction by the FOMC was a surprise to the markets. A third

reduction in short-term interest rates occurred in November 1998 when the FOMC reduced the Fed Funds rate to 4.75%.

All of these events prompted an increase in the prices for Treasury bonds which lead to the low yields described above. Another factor that contributed to the decline in yields on long-term Treasury bonds was a reduction in the supply of new Treasury issues coming to market due to the Federal budget surplus -- the first in nearly 30 years. The dollar amount of Treasury bonds being issued declined by 30% in two years thus resulting in higher prices and lower yields. In addition, rumors of some struggling hedge funds unwinding their positions further added to the gains in Treasury bond prices.

The financial crisis that spread from Asia to Russia and to Latin America pushed nervous investors from stocks into Treasury bonds, thus increasing demand for bonds, just when supply was shrinking. There was also a move from corporate bonds to Treasury bonds to take advantage of appreciation in the Treasury market. This resulted in a certain amount of exuberance for Treasury bond investments that formerly was reserved for the stock market. Moreover, yields in the fourth quarter of 1998 became extremely volatile as shown by Treasury yields that fell from 5.10% on September 29 to 4.70 percent on October 5, and thereafter returned to 5.10% on October 13. A decline and rebound of 40 basis points in Treasury yields in a two-week time frame is remarkable.

Beginning in mid-1999, the FOMC raised interest rates on six occasions reversing its actions in the fall of 1998. On June 30, 1999, August 24, 1999, November 16, 1999, February 2, 2000, March 21, 2000, and May 16, 2000, the FOMC raised the Fed Funds rate to 6.50%. This brought the Fed Funds rate to its highest level since 1991, and was 175 basis points higher than the level that occurred at the height of the Asian currency and stock market crisis. At the

time, these actions were taken in response to more normally functioning financial markets, tight labor markets, and a reversal of the monetary ease that was required earlier in response to the global financial market turmoil.

As the year 2000 drew to a close, economic activity slowed and consumer confidence began to weaken. In two steps at the beginning and at the end of January 2001, the FOMC reduced the Fed Funds rate by one percentage point. These actions brought the Fed Funds rate to 5.50%. The FOMC described its actions as "a rapid and forceful response of monetary policy" to eroding consumer and business confidence exemplified by weaker retail sales and business spending on capital equipment and cut backs in manufacturing production. Subsequently, on March 20, 2001, April 18, 2001, May 15, 2001, June 27, 2001, and August 21, 2001, the FOMC lowered the Fed Funds in steps consisting of three 50 basis points decrements followed by two 25 basis points decrements. These actions took the Fed Funds rate to 3.50%. The FOMC observed on August 21, 2001:

> "Household demand has been sustained, but business profits and capital spending continue to weaken and growth abroad is slowing, weighing on the U.S. economy. The associated easing of pressures on labor and product markets is expected to keep inflation contained.
>
> Although long-term prospects for productivity growth and the economy remain favorable, the Committee continues to believe that against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the risks are weighted mainly toward conditions that may generate economic weakness in the foreseeable future."

After the terrorist attack on September 11, 2001, the FOMC made two additional 50 basis points reductions in the Fed Funds rate. The first reduction occurred on September 17, 2001

and followed the four-day closure of the financial markets following the terrorist attacks. The second reduction occurred at the October 2 meeting of the FOMC where it observed:

> "The terrorist attacks have significantly heightened uncertainty in an economy that was already weak. Business and household spending as a consequence are being further damped. Nonetheless, the long-term prospects for productivity growth and the economy remain favorable and should become evident once the unusual forces restraining demand abate."

Afterward, the FOMC reduced the Fed Funds rate by 50 basis points on November 6, 2001 and by 25 basis points on December 11, 2001. In total, short-term interest rates were reduced by the FOMC eleven (11) times during the year 2001. These actions cut the Fed Funds rate by 4.75% and resulted in 1.75% for the Fed Funds rate.

In an attempt to deal with weakening fundamentals in the economy recovering from the recession that began in March 2001, the FOMC provided a psychologically important one-half percentage point reduction in the federal funds rate. The rate cut was twice as large as the market expected, and brought the fed funds rate to 1.25% on November 6, 2002. The FOMC stated that:

> "The Committee continues to believe that an accommodative stance of monetary policy, coupled with still-robust underlying growth in productivity, is providing important ongoing support to economic activity. However, incoming economic data have tended to confirm that greater uncertainty, in part attributable to heightened geopolitical risks, is currently inhibiting spending, production, and employment. Inflation and inflation expectations remain well contained.
>
> In these circumstances, the Committee believes that today's additional monetary easing should prove helpful as the economy works its way through this current soft spot. With this action, the Committee believes that, against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the risks are balanced with respect to the prospects for both goals in the foreseeable future."

As 2003 unfolded, there was a continuing expectation of lower yields on Treasury securities. In fact, the yield on ten-year Treasury notes reached a 45-year low near the end of the second quarter of 2003. For long-term Treasury bonds, those yields culminated with a 4.24% yield on June 13, 2003. Soon thereafter, the FOMC reduced the Fed Funds rate by 25 basis points on June 25, 2003. In announcing its action, the FOMC stated:

> "The Committee continues to believe that an accommodative stance of monetary policy, coupled with still robust underlying growth in productivity, is providing important ongoing support to economic activity. Recent signs point to a firming in spending, markedly improved financial conditions, and labor and product markets that are stabilizing. The economy, nonetheless, has yet to exhibit sustainable growth. With inflationary expectations subdued, the Committee judged that a slightly more expansive monetary policy would add further support for an economy which it expects to improve over time."

Thereafter, intermediate and long-term Treasury yields moved marketedly higher. Higher yields on long-term Treasury bonds, which exceeded 5.00% can be traced to: (i) the market's disappointment that the Fed Funds rate was not reduced below 1.00%, (ii) an indication that the Fed will not use unconventional methods for implementing monetary policy, (iii) growing confidence in a strengthening economy, and (iv) a Federal budget deficit that is projected to be $455 billion in 2003 (reported subsequently, the actual deficit was $374 billion) and $475 billion in 2004 (revised subsequently, the estimated deficit is $500 billion in 2004). All these factors significantly changed the seniment in the bond market.

For the remainder of 2003, the FOMC continued with its balanced monetary policy, thereby retaining the 1% Fed Funds rate. However, in 2004, it appears that its policy may be in transition, when on January 28, 2004 the FOMC stated:

> "The Committee continues to believe that an accommodative stance of monetary policy, coupled with robust underlying growth in productivity,

> is providing important ongoing support to economic activity. The evidence accumulated over the intermeeting period confirms that output is expanding briskly. Although new hiring remains subdued, other indicators suggest an improvement in the labor market. Increases in core consumer prices are muted and expected to remain low.
>
> The Committee perceives that the upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal. The probability of an unwelcome fall in inflation has diminished in recent months and now appears almost equal to that of a rise in inflation. With inflation quite low and resource use slack, the Committed believes that it can be patient in removing its policy accommodation."

Public Utility Bond Yields

The Risk Premium analysis of the cost of equity is represented by the combination of a firm's borrowing rate for long-term debt capital plus a premium that is required to reflect the additional risk associated with the equity of a firm as explained in Appendix G. Due to the senior nature of the long-term debt of a firm, its cost is lower than the cost of equity due to the prior claim which lenders have on the earnings and assets of a corporation.

As a generalization, all interest rates track to varying degrees of the benchmark yields established by the market for Treasury securities. Public utility bond yields usually reflect the underlying Treasury yield associated with a given maturity plus a spread to reflect the specific credit quality of the issuing public utility. Market sentiment can also have an influence on the spreads as described below. The spread in the yields on public utility bonds and Treasury bonds varies with market conditions, as does the relative level of interest rates at varying maturities shown by the yield curve.

Pages 1 and 2 of Schedule 12 provide the recent history of long-term (i.e., maturities as close as possible to 30 years) public utility bond yields for each of the "investment grades" (i.e., Aaa, Aa, A and Baa). The top four rating categories shown on Schedule 12 are generally

regarded as eligible for bank investments under commercial banking regulations. These investment grades are distinguished from "junk" bonds which have ratings of Ba and below.

A relatively long history of the spread between the yields on long-term A rated public utility bonds and long-term Treasury bonds are shown on page 3 of Schedule 12. There, it is shown that the spread in these yields declined after the 1987 stock market crash. Those spreads stabilized at about the one percentage point level for the years 1992 through 1997. With the aversion to risk and flight to quality described earlier, a significant widening of the spread in the yields between corporate (e.g., public utility) and Treasury bonds developed in 1998, after an initial widening of the spread that began in the fourth quarter of 1997. The significant widening of spreads in 1998 was unexpected by some technically savvy investors, as shown by the debacle at the Long-Term Capital Management hedge fund. When Russia defaulted its debt on August 17, some investors had to cover short positions when Treasury prices spiked upward. Short covering by investors that guessed wrong on the relationship between corporate and Treasury bonds also contributed to run-up in Treasury bond prices by increasing the demand for them. This helped to contribute to a widening of the spreads between corporate and Treasury bonds.

As indicated by the dynamics described earlier, there has been a disconnection from the previous relationship between the yields on corporate debt and Treasury bonds. As shown on page 3 of Schedule 12, the spread in yields between A rated public utility bonds and long-term Treasury bonds widened from about one percentage point prior to 1998 to 1.46% in 1998, 1.75% in 1999, 2.30% in 2000, 2.27% in 2001, 1.95% in 2002 and 1.56% in 2003. In essence, the cost of corporate debt and equity has disconnected from the yields on long-term Treasury bonds due to a general aversion to risk and the shrinking supply of long-term Treasury bonds.

As shown by the monthly data presented on pages 4 and 5 of Schedule 12, the interest rate spread between the yields on long-term Treasury bonds and A rated public utility bonds was 1.49 percentage points for the twelve-months ended January 2004. For the six- and three-month periods ending January 2004, the yield spread was 1.21% and 1.13%, respectively. This situation continues to point to the high cost of corporate capital vis-à-vis the yield on Treasury obligations.

Risk-Free Rate of Return in the CAPM

Regarding the risk-free rate of return (see Appendix H), pages 2 and 3 of Schedule 14 provide the yields on the broad spectrum of Treasury Notes and Bonds. Some practitioners of the CAPM would advocate the use of short-term treasury yields (and some would argue for the yields on 91-day Treasury Bills). Other advocates of the CAPM would advocate the use of longer-term treasury yields as the best measure of a risk-free rate of return. As Ibbotson has indicated:

> The Cost of Capital in a Regulatory Environment. When discounting cash flows projected over a long period, it is necessary to discount them by a long-term cost of capital. Additionally, regulatory processes for setting rates often specify or suggest that the desired rate of return for a regulated firm is that which would allow the firm to attract and retain debt and equity capital over the long term. Thus, the long-term cost of capital is typically the appropriate cost of capital to use in regulated ratesetting. (Stocks, Bonds, Bills and Inflation - 1992 Yearbook, pages 118-119)

As indicated above, long-term Treasury bond yields represent the correct measure of the risk-free rate of return in the traditional CAPM. Very short term yields on Treasury bills should be avoided for several reasons. First, rates should be set on the basis of financial conditions that will exist during the effective period of the proposed rates. Second, 91-day Treasury bill yields are more volatile than longer-term yields and are greatly influenced by FOMC monetary policy,

political, and economic situations. Moreover, Treasury bill yields have been shown to be empirically inadequate for the CAPM. Some advocates of the theory would argue that the risk-free rate of return in the CAPM should be derived from quality long-term corporate bonds.

APPENDIX G TO DIRECT TESTIMONY OF PAUL R. MOUL

RISK PREMIUM ANALYSIS

The cost of equity requires recognition of the risk premium required by common equities over long-term corporate bond yields. In the case of senior capital, a company contracts for the use of long-term debt capital at a stated coupon rate for a specific period of time and in the case of preferred stock capital at a stated dividend rate, usually with provision for redemption through sinking fund requirements. In the case of senior capital, the cost rate is known with a high degree of certainty because the payment for use of this capital is a contractual obligation, and the future schedule of payments is known. In essence, the investor-expected cost of senior capital is equal to the realized return over the entire term of the issue, absent default.

The cost of equity, on the other hand, is not fixed, but rather varies with investor perception of the risk associated with the common stock. Because no precise measurement exists as to the cost of equity, informed judgment must be exercised through a study of various market factors which motivate investors to purchase common stock. In the case of common equity, the realized return rate may vary significantly from the expected cost rate due to the uncertainty associated with earnings on common equity. This uncertainty highlights the added risk of a common equity investment.

As one would expect from traditional risk and return relationships, the cost of equity is affected by expected interest rates. As noted in Appendix F, yields on long-term corporate bonds traditionally consist of a real rate of return without regard to inflation, an increment to reflect investor perception of expected future inflation, the investment horizon shown by the term of the issue until maturity, and the credit risk associated with each rating category.

The Risk Premium approach recognizes the required compensation for the more risky common equity over the less risky secured debt position of a lender. The cost of equity stated in terms of the familiar risk premium approach is:

$$k=i+RP$$

where, the cost of equity *("k")* is equal to the interest rate on long-term corporate debt *("i")*, plus an equity risk premium *("RP")* which represents the additional compensation for the riskier common equity.

Equity Risk Premium

The equity risk premium is determined as the difference in the rate of return on debt capital and the rate of return on common equity. Because the common equity holder has only a residual claim on earnings and assets, there is no assurance that achieved returns on common equities will equal expected returns. This is quite different from returns on bonds, where the investor realizes the expected return during the entire holding period, absent default. It is for this reason that common equities are always more risky than senior debt securities. There are investment strategies available to bond portfolio managers that immunize bond returns against fluctuations in interest rates because bonds are redeemed through sinking funds or at maturity, whereas no such redemption is mandated for public utility common equities.

It is well recognized that the expected return on more risky investments will exceed the required yield on less risky investments. Neither the possibility of default on a bond nor the maturity risk detracts from the risk analysis, because the common equity risk rate differential (i.e., the investor-required risk premium) is always greater than the return components on a bond. It should also be noted that the investment horizon is typically long-run for both

corporate debt and equity, and that the risk of default (i.e., corporate bankruptcy) is a concern to both debt and equity investors. Thus, the required yield on a bond provides a benchmark or starting point with which to track and measure the cost rate of common equity capital. There is no need to segment the bond yield according to its components, because it is the total return demanded by investors that is important for determining the risk rate differential for common equity. This is because the complete bond yield provides the basis to determine the differential, and as such, consistency requires that the computed differential must be applied to the complete bond yield when applying the risk premium approach. To apply the risk rate differential to a partial bond yield would result in a misspecification of the cost of equity because the computed differential was initially determined by reference to the entire bond return.

The risk rate differential between the cost of equity and the yield on long-term corporate bonds can be determined by reference to a comparison of holding period returns (here defined as one year) computed over long time spans. This analysis assumes that over long periods of time investors' expectations are on average consistent with rates of return actually achieved. Accordingly, historical holding period returns must not be analyzed over an unduly short period because near-term realized results may not have fulfilled investors' expectations. Moreover, specific past period results may not be representative of investment fundamentals expected for the future. This is especially apparent when the holding period returns include negative returns which are not representative of either investor requirements of the past or investor expectations for the future. The short-run phenomenon of unexpected returns (either positive or negative) demonstrates that an unduly short historical period would not adequately support a risk premium analysis. It is important to distinguish between investors' motivation to invest, which

encompass positive return expectations, and the knowledge that losses can occur. No rational investor would forego payment for the use of capital, or expect loss of principal, as a basis for investing. Investors will hold cash rather than invest with the expectation of a loss.

Within these constraints, page 1 of Schedule 13 provides the historical holding period returns for the S&P Public Utility Index which has been independently computed and the historical holding period returns for the S&P Composite Index which have been reported in Stocks, Bonds, Bills and Inflation published by Ibbotson & Associates. The tabulation begins with 1928 because January 1928 is the earliest monthly dividend yield for the S&P Public Utility Index. I have considered all reliable data for this study to avoid the introduction of a particular bias to the results. The measurement of the common equity return rate differential is based upon actual capital market performance using realized results. As a consequence, the underlying data for this risk premium approach can be analyzed with a high degree of precision. Informed professional judgment is required only to interpret the results of this study, but not to quantify the component variables.

The risk rate differentials for all equities, as measured by the S&P Composite, are established by reference to long-term corporate bonds. For public utilities, the risk rate differentials are computed with the S&P Public Utilities as compared with public utility bonds.

The measurement procedure used to identify the risk rate differentials consisted of arithmetic means, geometric means, and medians for each series. Measures of central tendency of the results from the historical periods provide the best indication of representative rates of return. In regulated ratesetting, the correct measure of the equity risk premium is the arithmetic mean because a utility must expect to earn its cost of capital in each year in order to provide

investors with their long-term expectations. In other contexts, such as pension determinations, compound rates of return, as shown by the geometric means, may be appropriate. The median returns are also appropriate in ratesetting because they are a measure of the central tendency of a single period rate of return. Median values have also been considered in this analysis because they provide a return which divides the entire series of annual returns in half and are representative of a return that symbolizes, in a meaningful way, the central tendency of all annual returns contained within the analysis period. Medians are regularly included in many investor-influencing publications.

As previously noted, the arithmetic mean provides the appropriate point estimate of the risk premium. As further explained in Appendix H, the long-term cost of capital in rate cases requires the use of the arithmetic means. To supplement my analysis, I have also used the rates of return taken from the geometric mean and median for each series to provide the bounds of the range to measure the risk rate differentials. This further analysis shows that when selecting the midpoint from a range established with the geometric means and medians, the arithmetic mean is indeed a reasonable measure for the long-term cost of capital. For the years 1928 through 2003, the risk premiums for each class of equity are:

	S&P Composite	S&P Public Utilities
Arithmetic Mean	5.91%	4.98%
Geometric Mean	4.24%	2.85%
Median	11.29%	6.71%
Midpoint of Range	7.77%	4.78%
Average	6.84%	4.88%

The empirical evidence suggests that the common equity risk premium is higher for the S&P Composite Index compared to the S&P Public Utilities.

If, however, specific historical periods were also analyzed in order to match more closely historical fundamentals with current expectations, the results provided on page 2 of Schedule 13 should also be considered. One of these sub-periods included the 52-year period, 1952-2003. These years follow the historic 1951 Treasury-Federal Reserve Accord which affected monetary policy and the market for government securities.

A further investigation was undertaken to determine whether realignment has taken place subsequent to the historic 1973 Arab Oil embargo and during the deregulation of the financial markets. In each case, the public utility risk premiums were computed by using the arithmetic mean, and the geometric means and medians to establish the range shown by those values. The time periods covering the more recent periods 1974 through 2003 and 1979 through 2003 contain events subsequent to the initial oil shock and the advent of monetarism as Fed policy, respectively. For the 52-year, 30-year and 25-year periods, the public utility risk premiums were 5.52%, 4.49%, and 4.47% respectively, as shown by the average of the specific point-estimates and the midpoint of the ranges provided on page 2 of Schedule 13.

APPENDIX H TO DIRECT TESTIMONY OF PAUL R. MOUL

CAPITAL ASSET PRICING MODEL

Modern portfolio theory provides a theoretical explanation of expected returns on portfolios of securities. The Capital Asset Pricing Model ("CAPM") attempts to describe the way prices of individual securities are determined in efficient markets where information is freely available and is reflected instantaneously in security prices. The CAPM states that the expected rate of return on a security is determined by a risk-free rate of return plus a risk premium which is proportional to the non-diversifiable (or systematic) risk of a security.

The CAPM theory has several unique assumptions that are not common to most other methods used to measure the cost of equity. As with other market-based approaches, the CAPM is an expectational concept. There has been significant academic research conducted that found that the empirical market line, based upon historical data, has a less steep slope and higher intercept than the theoretical market line of the CAPM. For equities with a beta less than 1.0, such as utility common stocks, the CAPM theoretical market line will underestimate the realistic expectation of investors in comparison with the empirical market line which shows that the CAPM may potentially misspecify investors' required return.

The CAPM considers changing market fundamentals in a portfolio context. The balance of the investment risk, or that characterized as unsystematic, must be diversified. Some argue that diversifiable (unsystematic) risk is unimportant to investors. But this contention is not completely justified because the business and financial risk of an individual company, including regulatory risk, are widely discussed within the investment community and therefore influence investors in regulated firms. In addition, I note that the CAPM assumes that through portfolio diversification, investors will minimize the effect of the unsystematic

(diversifiable) component of investment risk. Because it is not known whether the average investor holds a well-diversified portfolio, the CAPM must also be used with other models of the cost of equity.

To apply the traditional CAPM theory, three inputs are required: the beta coefficient *("β")*, a risk-free rate of return *("Rf")*, and a market premium *("Rm - Rf")*. The cost of equity stated in terms of the CAPM is:

$$k = Rf + \beta\,(Rm - Rf)$$

As previously indicated, it is important to recognize that the academic research has shown that the security market line was flatter than that predicted by the CAPM theory and it had a higher intercept than the risk-free rate. These tests indicated that for portfolios with betas less than 1.0, the traditional CAPM would understate the return for such stocks. Likewise, for portfolios with betas above 1.0, these companies had lower returns than indicated by the traditional CAPM theory. Once again, CAPM assumes that through portfolio diversification investors will minimize the effect of the unsystematic (diversifiable) component of investment risk. Therefore, the CAPM must also be used with other models of the cost of equity, especially when it is not known whether the average public utility investor holds a well-diversified portfolio.

Beta

The beta coefficient is a statistical measure which attempts to identify the non-diversifiable (systematic) risk of an individual security and measures the sensitivity of rates of return on a particular security with general market movements. Under the CAPM theory, a security that has a beta of 1.0 should theoretically provide a rate of return equal to the return

rate provided by the market. When employing stock price changes in the derivation of beta, a stock with a beta of 1.0 should exhibit a movement in price which would track the movements in the overall market prices of stocks. Hence, if a particular investment has a beta of 1.0, a one percent increase in the return on the market will result, on average, in a one percent increase in the return on the particular investment. An investment which has a beta less than 1.0 is considered to be less risky than the market.

The beta coefficient *("β")*, the one input in the CAPM application which specifically applies to an individual firm, is derived from a statistical application which regresses the returns on an individual security (dependent variable) with the returns on the market as a whole (independent variable). The beta coefficients for utility companies typically describe a small proportion of the total investment risk because the coefficients of determination (R^2) are low.

Page 1 of Schedule 14 provides the betas published by Value Line. By way of explanation, the Value Line beta coefficient is derived from a "straight regression" based upon the percentage change in the weekly price of common stock and the percentage change weekly of the New York Stock Exchange Composite average using a five-year period. The raw historical beta is adjusted by Value Line for the measurement effect resulting in overestimates in high beta stocks and underestimates in low beta stocks. Value Line then rounds its betas to the nearest .05 increment. Value Line does not consider dividends in the computation of its betas.

Market Premium

The final element necessary to apply the CAPM is the market premium. The market premium by definition is the rate of return on the total market less the risk-free rate of return

("Rm - Rf"). In this regard, the market premium in the CAPM has been calculated from the total return on the market of equities using forecast and historical data. The future market return is established with forecasts by Value Line using estimated dividend yields and capital appreciation potential.

With regard to the forecast data, I have relied upon the Value Line forecasts of capital appreciation and the dividend yield on the 1,700 stocks in the Value Line Survey. According to the February 13, 2004, edition of The Value Line Investment Survey Summary and Index, (see page 5 of Schedule 14) the total return on the universe of Value Line equities is:

	Dividend Yield	+	Median Appreciation Potential	=	Median Total Return
As of February 13, 2004	1.7%	+	8.78%[1]	=	10.48%

The tabulation shown above provides the dividend yield and capital gains yield of the companies followed by Value Line. With the 10.48% forecast market return and the 5.75% risk-free rate of return, a 4.73% (10.48% - 5.75%) market premium would be indicated using forecast market data.

With regard to the historical data, I provided the rates of return from long-term historical time periods that have been widely circulated among the investment and academic community over the past several years, as shown on page 6 of Schedule 12. These data are published by Ibbotson Associates in its Stocks, Bonds, Bills and Inflation ("SBBI"). From the data provided on page 6 of Schedule 14, I calculate a market premium using the common stock arithmetic mean returns of 12.4% less government bond arithmetic mean returns of 5.8%. For

[1] The estimated median appreciation potential is forecast to be 40% for 3 to 5 years hence. The annual capital gains yield at the midpoint of the forecast period is 8.78% (i.e., $1.40^{.25}$ - 1).

the period 1926-2002, the market premium was 6.6% (12.4% - 5.8%).

I should note that the arithmetic mean must be used in the CAPM because it is a single period model. It is further confirmed by Ibbotson who has indicated:

> *Arithmetic Versus Geometric Differences*
> For use as the expected equity risk premium in the CAPM, the *arithmetic* or *simple difference* of the *arithmetic* means of stock market returns and riskless rates is the relevant number. This is because the CAPM is an additive model where the cost of capital is the sum of its parts. Therefore, the CAPM expected equity risk premium must be derived by arithmetic, *not geometric*, subtraction.
>
> *Arithmetic Versus Geometric Means*
> The expected equity risk premium should always be calculated using the arithmetic mean. The arithmetic mean is the rate of return which, when compounded over multiple periods, gives the mean of the probability distribution of ending wealth values. This makes the arithmetic mean return appropriate for computing the cost of capital. The discount rate that equates expected (mean) future values with the present value of an investment is that investment's cost of capital. The logic of using the discount rate as the cost of capital is reinforced by noting that investors will discount their (mean) ending wealth values from an investment back to the present using the arithmetic mean, for the reason given above. They will therefore require such an expected (mean) return prospectively (that is, in the present looking toward the future) to commit their capital to the investment. (Stocks, Bonds, Bills and Inflation - 1996 Yearbook, pages 153-154)

For the CAPM, a market premium of 5.67% (6.6% + 4.73% = 11.33% ÷ 2) would be reasonable which is the average of the 6.6% using historical data and a market premium of 4.73% using forecasts.

APPENDIX I TO DIRECT TESTIMONY OF PAUL R. MOUL

COMPARABLE EARNINGS APPROACH

Value Line's analysis of the companies that it follows includes a wide range of financial and market variables, including nine items that provide ratings for each company. From these nine items, one category has been removed dealing with industry performance because, under approach employed, the particular business type is not significant. In addition, two categories have been ignored that deal with estimates of current earnings and dividends because they are not useful for comparative purposes. The remaining six categories provide relevant measures to establish comparability. The definitions for each of the six criteria (from the Value Line Investment Survey - Subscriber Guide) follow:

Timeliness Rank

> The rank for a stock's probable relative market performance in the year ahead. Stocks ranked 1 (Highest) or 2 (Above Average) are likely to outpace the year-ahead market. Those ranked 4 (Below Average) or 5 (Lowest) are not expected to outperform most stocks over the next 12 months. Stocks ranked 3 (Average) will probably advance or decline with the market in the year ahead. Investors should try to limit purchases to stocks ranked 1 (Highest) or 2 (Above Average) for Timeliness.

Safety Rank

> A measure of potential risk associated with individual common stocks rather than large diversified portfolios (for which Beta is good risk measure). Safety is based on the stability of price, which includes sensitivity to the market (see Beta) as well as the stock's inherent volatility, adjusted for trend and other factors including company size, the penetration of its markets, product market volatility, the degree of financial leverage, the earnings quality, and the overall condition of the balance sheet. Safety Ranks range from 1 (Highest) to 5 (Lowest). Conservative investors should try to limit purchases to equities ranked 1 (Highest) or 2 (Above Average) for Safety.

Financial Strength

The financial strength of each of the more than 1,600 companies in the VS II data base is rated relative to all the others. The ratings range from A++ to C in nine steps. (For screening purposes, think of an A rating as "greater than" a B). Companies that have the best relative financial strength are given an A++ rating, indicating an ability to weather hard times better than the vast majority of other companies. Those who don't quite merit the top rating are given an A+ grade, and so on. A rating as low as C++ is considered satisfactory. A rating of C+ is well below average, and C is reserved for companies with very serious financial problems. The ratings are based upon a computer analysis of a number of key variables that determine (a) financial leverage, (b) business risk, and (c) company size, plus the judgment of Value Line's analysts and senior editors regarding factors that cannot be quantified across-the-board for companies. The primary variables that are indexed and studied include equity coverage of debt, equity coverage of intangibles, "quick ratio", accounting methods, variability of return, fixed charge coverage, stock price stability, and company size.

Price Stability Index

An index based upon a ranking of the weekly percent changes in the price of the stock over the last five years. The lower the standard deviation of the changes, the more stable the stock. Stocks ranking in the top 5% (lowest standard deviations) carry a Price Stability Index of 100; the next 5%, 95; and so on down to 5. One standard deviation is the range around the average weekly percent change in the price that encompasses about two thirds of all the weekly percent change figures over the last five years. When the range is wide, the standard deviation is high and the stock's Price Stability Index is low.

Beta

A measure of the sensitivity of the stock's price to overall fluctuations in the New York Stock Exchange Composite Average. A Beta of 1.50 indicates that a stock tends to rise (or fall) 50% more than the New York Stock Exchange Composite Average. Use Beta to measure the stock market risk inherent in any diversified portfolio of, say, 15 or more companies. Otherwise, use the Safety Rank, which measures total risk inherent in an equity, including that portion attributable to market fluctuations. Beta is derived from a least squares regression

analysis between weekly percent changes in the price of a stock and weekly percent changes in the NYSE Average over a period of five years. In the case of shorter price histories, a smaller time period is used, but two years is the minimum. The Betas are periodically adjusted for their long-term tendency to regress toward 1.00.

Technical Rank

A prediction of relative price movement, primarily over the next three to six months. It is a function of price action relative to all stocks followed by Value Line. Stocks ranked 1 (Highest) or 2 (Above Average) are likely to outpace the market. Those ranked 4 (Below Average) or 5 (Lowest) are not expected to outperform most stocks over the next six months. Stocks ranked 3 (Average) will probably advance or decline with the market. Investors should use the Technical and Timeliness Ranks as complements to one another.

BEFORE THE

PENNSYLVANIA PUBLIC UTILITY COMMISSION

Docket No. R-00049255

PPL Electric Utilities Corporation

Statement No. 10

Direct Testimony of Julie M. Cannell

DIRECT TESTIMONY OF JULIE M. CANNELL

Q. Please state your name and business affiliation.

A. My name is Julie M. Cannell. I am president of J.M. Cannell, Inc., which provides advisory services to electric utility companies and other types of firms and organizations with an interest in the industry. Prior to establishing my firm in February 1997, I was employed by the New York-based investment manager, Lord Abbett & Company, from June 1978 to January 31, 1997, as well as the summer of 1977. During my tenure with Lord Abbett, I was a securities analyst specializing in the electric utility and telecommunications services industries; portfolio manager of America's Utility Fund, an equity utility mutual fund; portfolio manager of numerous institutional equity portfolios, and co-director of Lord Abbett's Equity Research Department. Further information on my background and experience can be found in Appendix A.

Q. What is the purpose of your testimony in this proceeding?

A. I have been asked by PPL Electric Utilities Corporation ("PPL Electric" or "Company") to explain investors' perceptions of electric utility risk in a post-restructured environment; to discuss how investors determine their expected returns and evaluate their achieved returns on electric utility equities; and to evaluate Paul Moul's recommended allowed return on equity and proposed financial return in terms of the market return expected by investors.

Q. Please summarize your experience that allows you to provide testimony about the viewpoint of investors.

A. As a securities analyst, I specialized in the electric utility industry and the individual companies comprising it. As a portfolio manager, I applied that knowledge, along with investment fundamentals, toward investment decisions on behalf of institutions and individual investors. And, as an advisor to the industry, a great deal of my work has dealt with investors and their perceptions.

Q. As an analyst or portfolio manager, did you follow PPL Corporation?

A. Yes, I did. Both Lord Abbett and America's Utility Fund periodically maintained a holding in the common stock of PPL Corporation ("PPL"), which was then named Pennsylvania Power & Light Company.

Q. Please summarize the key points of your testimony.

A. The risk of investing in the electric utility industry has risen substantially in recent years on an industry-wide basis. Any company-specific risks are additive. Equity investors today are seeking companies that can offer stability in terms of their outlook for earnings and dividends. Fixed income investors look for stable and adequate cash flows to ensure payment of principal and interest when due. Essential to providing that stability is a regulatory environment that is constructive; in other words, one that

provides return levels sufficient to compensate the investor for the risk assumed in making an investment. Because the ability to pay dividends is directly related to a company's earnings power, an investor demands an allowed return sufficient to provide earnings that will allow an appropriate dividend.

Credit issues have also become critically important not only to fixed income investors, but also to equity investors. While credit downgrades initially impacted only the most troubled companies, rating agencies are now scrutinizing all utilities more carefully and changing ratings more frequently. When a regulatory climate is perceived not to provide a supportive financial framework for a utility, the agencies can be expected to downgrade the company's securities.

The Company's debt ratings were downgraded last year by Standard & Poor's Corporation. Deteriorating credit quality increases the cost of capital for a utility, which then further stresses its financial condition. Thus, as industry fundamentals continue to change and evolve, it is increasingly important that stability be present in an investment, and that any risk be assessed on a prospective basis. The issue of a strong financial profile is critically important to investors given both their experiences in the market in recent years and uncertainties about electricity utility fundamentals in the post-restructuring period. Investors and rating agencies will be looking particularly closely at the results of rate cases following expiration of rate caps.

Q. Please provide the Commission with a historical perspective of investing in utilities.

A. Electric utilities historically have been regarded as defensive investment vehicles. The industry's monopoly character insulated it somewhat from the fluctuations of economic cycles. Even when the economy was slowing, utilities typically earned a reasonable profit – unlike some industrial companies, whose earnings levels could be quite negatively impacted in the same environment. The reliability of earnings streams for utilities also permitted most utilities to continue to pay dividends during both good and bad economic cycles. Because they historically paid out a large proportion of their earnings as dividends, and because their large construction programs kept them dependent on the capital markets, utility stocks were traditionally viewed as bond substitutes. This caused utility stocks to move closely in line with the direction of interest rates, but in an inverse relationship. That is, utility stock prices rose when interest rates fell, and vice versa. These factors made utilities a preferred investment during economic slowdowns or recessions.

Q. Have the recent changes in the industry increased the risk of investing in electric utilities?

A. Yes. Just as the industry is in transition, so are investors evolving in how they approach making investments in utilities. Put in the simplest terms,

investors understand that the predictability of the industry's earnings stream has been undermined by electric industry restructuring together with technological, economic and policy changes. There is uncertainty regarding the pace at which customers will choose third party electric suppliers; whether legislatures/regulators will continue electric utilities' provider of last resort obligations and how electric utilities will recover the cost of such obligations; whether legislatures/regulators will permit, or continue to permit, customers who chose other suppliers to return as utility generation customers; how transmission ownership and transmission charges will change through the development of regional transmission organizations (RTOs); and whether state and federal policy promoting distributed generation will promote customer bypass of utilities. This all means that investors no longer perceive electric utilities as "safe havens." Investment risk has risen, and investors now require a higher return for investing in the electric utility industry.

Q. Does PPL Electric face additional risks?

A. Yes, I believe it does. When the Company was an integrated utility involved in the broad provision of generation, transmission, and distribution services, PPL Electric was able to spread the risks involved in any of those businesses across a broader base. However, as a distribution company now focusing on energy delivery, PPL Electric has all of its assets concentrated in a single line of business and thus is fully exposed

to any risks, including those pertaining to size and scope, that may impact its core business. In addition, PPL Electric can no longer control the ultimate cost to the customer because of the loss of integration. This creates a greater risk that it will not be able to respond to competition.

Q. Please discuss the earnings risk of being concentrated in a single line of business.

A. A single-business company would face financial exposures with which an integrated company would not necessarily have to contend. One segment of the business would typically be able to tap the broader financial resources of the corporation when facing financial difficulty. The distribution utility may still face public and political scrutiny for generation-related problems that are now beyond the utility's control. The distribution utility, if it continues to have any retail generation supply obligations, is more reliant on the suppliers of that power than it was when it owned and operated its own generating facilities. The loss of a major supplier of generation services could pose a real financial threat to the distribution utility that an integrated company, with a much broader base of revenues and resources, would be in a better position to manage.

A related risk is the uncertainty surrounding price recovery of power supplies connected to default service obligations. In the absence of rules governing such recovery, the distribution company, which is still required to serve as a provider of last resort, could face extreme financial distress.

An additional risk is heightened economic sensitivity due to geographic concentration. As an integrated company, the Company owned generation assets. During a recessionary period in Pennsylvania, PPL Electric could face a decrease in load growth, or even a decline in distribution revenues. If the Company still owned generation, it might have been able to offset some of that shortfall by selling power into the wholesale market. As a distribution company, PPL Electric would be exposed to the economic situation with no potential to offset it.

Q. Are there other risks involving single line of business concentration?

A. Yes. Another set of risks pertains to advances in technology. One such issue is distributed generation, which is a technology that permits power to be generated on small-scale machines that can be sited near a manufacturing facility, in a commercial business or even a residence. Distributed generation potentially can have a serious adverse impact on a utility's delivery system because distributed generation can facilitate bypass of the system. To the extent that customers see distributed generation as a means of controlling their reliability and power quality, even in areas where the utility (such as PPL Electric) provides high reliability and quality, they may choose distributed generation in an effort to take more of their operations under their own control. The extent of the risk depends largely on factors beyond the utility's control (economics of production and installation of distributed generation, and the extent of governmental

support, for example), and it is unknown how many customers will choose bypass or when the loss will occur. However, in light of an event such as the massive blackout of August 14, 2003 and the attendant widespread concerns about system reliability, the bypass risk has likely increased.

Q. What other risks do you see technology posing to distribution utilities?

A. The advances in technology have made some industries less dependent on geography. There will be continuing pressure to retain customers who can relocate out of the utility's service area or who can take actions that are equivalent to relocation. Manufacturers and commercial businesses can choose to relocate to other parts of a state, or to other states or regions. Bypass may increasingly become economic for these customers as well as customers who do not wish to or cannot move. There will be pressure to discount prices to retain these customers. PPL Electric no longer controls the cost of power and may not be able to discount enough to compete. Furthermore, the effect of lost customers is exacerbated for companies such as PPL Electric. PPL Electric is a much smaller company after generation divestiture and no longer has the balance sheet of an integrated company on which to fall back, so its financial strength could be stretched by customer loss. The Company simply has fewer units over which to spread its fixed costs.

Q. You've discussed the mounting risks you see a distribution company facing. Do those risks have the potential to reduce the company's earnings and cash flow stream and increase their volatility?

A. Yes. A single line of business increases exposures to enterprise credit risk, operating issues, prospective new costs, and technology issues, all of which can have negative financial ramifications. Moreover, since these factors are in large part beyond a company's control, the company's investors have little guidance and more uncertainty. Uncertainty leads to investor concern.

Q. How do institutional investors analyze their decisions whether to invest in electric utilities?

A. Investors have a very large universe of stocks from which to select; with few exceptions, they have no requirement to own electric utility stocks. Institutional investors – financial institutions such as mutual funds, investment companies, insurance companies, commercial and investment banks, and various types of public retirement funds – approach the investment selection process from the standpoint of a portfolio. An investment portfolio is a collection of stocks selected to achieve the highest possible return within a commensurate level of risk. Therefore, institutional investors only keep electric utilities in their portfolios when such stocks contribute to achieving that risk/return relationship.

Q. How do individual investors make their investment decisions?

A. Individual investors typically seek stocks that will appreciate in value and/or will provide dividend income. These investors frequently need dividend income in anticipation of or actually funding retirement. Consequently, the income aspect is particularly important to individual investors of utility stocks, who comprise approximately 39% of PPL's shareholders.

Q. Why do institutional investors matter to PPL?

A. Institutional investors matter for three reasons. First, institutions, because of the sheer size of their investment positions, can effectively direct the course of individual securities, if not the market as a whole. So, as an investor group, institutions warrant significant attention. Second, some of the outstanding shares of PPL's common stock is held in "street name." That is, the stock is registered in the name of a brokerage house, which manages accounts for individuals or for organizations, such as public retirement funds. "Street name" accounts are instances in which an investment institution is directly transacting for individuals or an organization serving individuals' financial interests. Third, it should be remembered that the customers of institutional investors are individuals. Anyone who has a stake in a retirement plan, owns a mutual fund, or has a trust fund, for example, is directly or indirectly a client of an institutional investor. Ultimately, it is the interests of individuals whom institutional investors seek to serve.

Q. Why do investors, and in particular institutional investors, matter in a consideration of a utility's rate of return?

A. A company's ability to raise capital in the financial markets impacts its ability to do business. When the value of its stock – its currency – is considered to be low, its cost of capital is increased. Investors are constantly assessing the fundamentals of companies. When they perceive a diminishment in a company's fundamentals – or even the potential for one – they begin to require more compensation for the greater risk present in their investment. Generally, this results in a lower stock price that, with an unchanged dividend rate, provides a higher yield. The effect of the reduced stock price on the company is a higher cost of capital. The authorized return on equity is also one determinant of the Company's free cash flow. This in turn is a determinant of the Company's credit ratings, which will affect the Company's cost of borrowing. PPL Electric will face substantial expenditures to expand and upgrade its distribution infrastructure over the next few years. If the Company's debt ratings were to deteriorate, PPL Electric would face a higher cost for those borrowings.

Q. Why might an institutional investor choose not to invest in a particular electric utility?

A. Several factors might be drivers. First, institutional investors have fiduciary responsibilities. For example, managers of pension assets are overseen by the ERISA law, which mandates that a portfolio manager behave as a so-called "prudent man." That is to say, he or she is expected not to make investment decisions that are unduly risky. Or in the case of mutual funds, boards of directors are charged with ensuring that the funds' investment charters are met. Second, institutional investors have performance pressures. It is not enough for stocks in a portfolio simply to increase in value. Rather, relative performance is what counts. Investment performance is gauged against a market proxy (such as the Standard & Poor's 500 Index) or a peer group of investors (i.e., investors with a similar style, such as value, growth, growth & income, small cap, etc.). Organizations such as Morningstar track and publicize the relative performance for mutual funds, and various pension consultants perform the same service for their client organizations.

Q. What happens when an institutional investor underperforms?

A. The results can vary, but eventually, underperformance is likely to result in lost business. Mutual fund shareholders can sell their fund shares. A pension plan sponsor can fire the professional investor or reduce the assets under the investor's management. And, of course, poor performance also disadvantages the individual, who has entrusted his monies to the institution for management.

Q. How long a period does an institutional investor have before performance becomes an issue?

A. Again, it can vary. But there is little argument that institutional investors no longer have the luxury of a long time horizon in which to show performance. Investors want results. And with the public visibility that investment results now have (through the auspices of such organizations as Morningstar and the various pension consultants) and the resulting performance pressure, most investment organizations are now operating with a much shorter time horizon than in years past. Generally speaking, a long investment time horizon today can be as short as 12-18 months. So, a stock that is unlikely to perform within the prescribed time horizon is usually not attractive for purchase or continued investment by an institutional investor.

Q. Do all institutional investors function within the time frames you describe?

A. No. There is a type of institutional investor called a hedge fund that frequently buys and sells the same stock during the course of a day.

Q. With that kind of investment behavior, what impact do hedge funds have on the market in general and stocks in particular?

A. Their impact can be dramatic. Hedge funds are well known for trading in information; their actions are frequently event-driven. Sometimes that

information is factual and other times it falls into the category of rumor. Because investors at these funds have wide information networks and are in frequent communication with companies and a broad range of other investors, they have the ability and the power to create volatility, which in turn impacts the movement of stock prices. And because the number of hedge funds participating in the market as well as the funds' assets have grown exponentially in recent years – recent estimates put the numbers at over 5300 firms with assets of $619 billion during the first quarter of 2003, up from 610 firms with $39 billion in assets in 1990 – they have become a very strong force both in the market and in stocks in which they are interested. When they like an industry group or a stock, hedge funds can provide substantial support to stock prices. But conversely, when they become disenchanted, their tendency is to sell quickly and without remorse. Although their focus is not on contributing to orderly markets, hedge funds are a formidable presence in the market place and must be reckoned with.

Q. Can you give an example of how hedge funds might traffic in PPL's stock?

A. Yes. In 2003, PPL announced its intention to file the current rate case. Hedge funds assuredly made assumptions about the details of the case, including its resolution, prior to the filing. If, when the Commission's decision is ultimately announced, the details fall short of those expectations, the hedge funds could put significant pressure on the stock

either through outright sales, or short-selling, i.e., selling stock that is borrowed.

Q. What is the significance for regulators in Pennsylvania and elsewhere of the reduced time horizons for valuing stocks now used by institutional investors and hedge funds?

A. The increased rapidity with which institutional investors and hedge funds make investment decisions means their judgments will immediately reflect actions by utility regulators that are perceived to have a short-term or long-term impact on the utility's financial performance. Thus, for example, a rate order that contains a lower than expected allowed return on equity could be viewed as a reason to sell the utility's stock due to the impact on earnings. Similarly, institutional investors and hedge funds are not likely to act to purchase or to hold the stock of a utility that has received a regulatory order that promises only the uncertainty of "future" benefits. In sum, the presence of institutional investors and hedge funds whose relatively short time horizons are significant factors in the liquidity of utility common stocks means that regulatory orders are likely to have an immediate impact on the price of those stocks.

Q. Have any institutional investors recently expressed opinions regarding PPL Electric's Pennsylvania rate filing?

A. Yes, they have. Goldman Sachs wrote:

> "PPL has pending rate proceedings that will reset rates for its Pennsylvania distribution business beginning 1/1/2005 and its UK distribution business beginning 4/1/2005. Management intends to submit its Pennsylvania rate application by the end of Q1 2004. Earnings upside from the rate review could be substantial, with approval of even a low 10.5% ROE potentially adding $0.45 to earnings.
>
> January 28, 2004 report: "PPL (OP/N): Stock Still attractive at current levels"

And Merrill Lynch offered an opinion, as well:

> "In Spring 2004, PPL will file a rate case in Pennsylvania. The utility has been earning a low single digit ROE. Rate relief to earn a reasonable 10-12% ROE would add $0.30/sh to EPS. New rates go into effect on 1/1/2005.
>
> January 29, 2004 report: "PPL Corp.: Visible Growth Beyond "2004."

And Morgan Stanley also weighed in:

> "PA utility earning less than 5% ROE – But assuming rate relief is granted that will allow at least a 10% ROE, we calculate incremental EPS of $0.30 in 2005. PPL plans to file its rate case 3/31, with new rates effective 1/05."
>
> February 2, 2004 report: "PPL Corp.: Solid Earnings, Raising Target; 2004 Rate Case Year"

Q. What conclusions do you draw from these comments about institutional investors' perceptions regarding PPL Electric's rate filing?

A. I believe investors are expecting the Company to be granted a ROE in a range of 10-12%, with the bias toward the upper end of that range, as

evidenced by Merrill Lynch's expectation of a ROE range of 10-12% and Goldman Sachs' reference to "even a low 10.5% ROE."

Q. In the current low interest rate environment, do you consider investor expectations regarding the Company's prospective ROE award to be reasonable?

A. Yes, I do. Although interest rates are at historically low levels, that factor is not the only one that investors are taking into account. I believe that because of the greater risks that the industry in general and distribution companies in particular are facing, investors are requiring a greater risk premium on their utility investments. Thus, I think that the broader interest rate environment should not be considered in isolation in terms of establishing ROEs for utility companies.

Q. Are there additional factors regarding investors' expectations regarding the Company's prospective ROE award?

A. Yes. Investors have a high opinion of the quality of Pennsylvania regulation. In a recent report, Lehman Brothers provided a ranking of state utility commissions from an investor perspective. The firm ranked Pennsylvania "Tier 2" on a 5-tiered scale, with Tier 1 being "Most Shareholder Oriented" and Tier 5 being "Most Consumer Oriented." It bears mention that only 7 other states appeared in the Tier 2 level, and 6 states in the Tier 1 ranking. Lehman's rankings were based on 6 criteria:

"1) elected versus appointed commissions; 2) PBR mechanism or not; 3) allowed ROEs; 4) *Settle vs. Litigate*; 5) rate levels; and 6) a *subjective investor friendless rating.*"

March 5, 2004 report: "They're Back! Twenty-Six Rate Cases This Year Give Rise to the Regulators"

A disappointing ROE in the Company's rate case could signal a change in the positive regulatory environment enjoyed in Pennsylvania, and investors' opinions would be altered accordingly.

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

A. Absolutely. During my tenure as an active investor, the quality of a company's regulatory environment was a critical factor in my assessment of its investment attractiveness. An adverse regulatory decision could be a key determinant in my recommendation or decision to sell a stock already owned or to not make an investment in one under consideration. I believe that investors selecting stocks today still place a very high value on constructive regulation. And with a new round of base rate case filings underway in the industry, I think it likely that the quality of regulation will receive renewed investor attention.

Q. What role do credit agencies play in investors' expectations?

A. In the wake of financial disasters, bankruptcies, and the ensuing severe erosion in investor confidence in the past few years, credit issues have

become critically important not only to fixed income investors, but also to equity investors. While credit downgrades initially impacted only the most troubled companies, a spillover effect soon was seen on healthy utilities. Part of this was due to the fact that the rating agencies, responding to harsh criticism that they had failed to catch problems early enough in companies such as Enron Corp., began to heighten their scrutiny of all entities under their watch and became far more proactive in making rating changes. As well, "headline risk" began to come into play, as investors worried that any company could be vulnerable to a downgrade. Thus, equity investors now watch closely the actions of the credit agencies, because any change in ratings can have a significant impact on a company's stock price.

Q. What happens when a credit downgrade occurs?

A. In the simplest terms, it becomes more expensive for a company to raise money in the capital markets because a downgrade raises a company's risk profile and consequently increases the cost of debt. And because of the increased linkage these days between ratings and stock prices, the price frequently reacts – sometimes quite strongly – to a downgrade. For example, Moody's Investors Service cut the ratings of Allegheny Energy and its subsidiaries to "junk," or below investment-grade, status on October 1, 2002. The prior day, September 30, Allegheny's stock price closed at $13.10. By October 8, when the company announced that it was

in technical default with creditors due to its inability to meet higher collateral requirements prompted by the downgrade, the stock closed at $3.80. Thus, in the space of a week, Allegheny's stock price – and the value of a shareholder's investment – lost 71% of its value.

Q. How do the rating agencies view PPL Electric, and in particular, the rate case?

A. A recent written report on the company came from Standard & Poor's, which rates the Company A-, with a negative outlook. At the end of last year, the agency wrote:

> "The company has announced its intention of filing for a rate increase by April 2004 for the post-2004 period. However, the outcome of such a rate case is uncertain. Ratings are predicated on its ability to maintain cash flow coverages and debt-to-capital ratios at levels of about 3.0x to 3.1x and 53% to 55%, respectively, and also on the outcome of the imminent rate case before the PUC. If the PUC does not allow any rate increase, PPLEU's ratings will be lower. PPLEU's credit metrics are weaker than estimated for 2003 and are likely to be weak through 2004 due to the rate cap.
>
> The negative outlook also reflects PPLEU's need to improve its returns to maintain its financial position."
>
> --December 30, 2003 report: "Summary: PPL Electric Utilities Corp."

Q. Please elaborate on why the earnings stream is important in stock selection.

A. Earnings growth is an important component of what will drive stock price appreciation and dividend income. A company with a higher growth rate will typically warrant a higher price/earnings (P/E) ratio than other

companies. The reverse also holds true. In the end, an institutional investor wants to select the optimal choices for inclusion in a portfolio, so the concept of relative valuation is very important. Stocks are always viewed in terms of how well they stack up against other investment alternatives, including holding cash. And another reason why earnings are important is that they underpin the dividend. Without earnings growth, the dividend cannot grow.

Q. Do you believe that an ROE of 11.50% for PPL Electric is consistent with investors' expectations?

A. Yes, I do. As noted in the previous discussion on institutional investors' current views of the company, I believe that investors are expecting PPL Electric to be granted a ROE in a range of 10%-12%, with the bias toward the upper end of that range. Investment risk in the electric utility industry is higher than it has been, and investors are requiring higher compensation to assume that added risk. As an input in valuation models, earnings levels logically translate into the attractiveness of a stock, other factors being equal. A reasonable ROE award should sustain the Company's earnings power and affect the potential for future dividend growth. Conversely, a lower ROE could potentially undermine investors' expectations for ongoing dividend growth. Further, an 11.5% ROE would be consistent with recent awards in electric utility rate cases. As Lehman Brothers' March 5 report, "They're Back!" details, the average ROE

granted in 2003 within the industry was 10.96%. By quarters, the figures were 11.49% (1Q), 11.16% (2Q), 9.95% (3Q), and 11.48% (4Q).

Q. Turn now, please, to the testimony filed by Paul Moul. Would you please comment on his ROE recommendation?

A. Mr. Moul recommends that PPL Electric be granted an 11.5% ROE. His conclusion was based on a variety of well-established financial models as well as comparative peer group assessment. His finding of an 11.5% ROE is consistent with investor expectations.

Q. Does this complete your testimony?

A. Yes.

APPENDIX A

JULIE M. CANNELL
P.O. Box 199
Purchase, New York 10577

BUSINESS EXPERIENCE:

1997- J.M. CANNELL, INC.

President of firm providing advisory services specializing in the electric utility industry.

1977 - 1997 LORD ABBETT & COMPANY, New York, New York

1995 - 1997 Equity Portfolio Manager. Responsibility for management and client servicing of ten institutional equity portfolios with total assets in excess of $700M. Actively and successfully involved in new institutional business marketing effort.

1994-1996 Associate Director of Equity Research. Provided oversight of departmental activities, including supervision of analysts' research efforts and support staff functions.

1992-1995 Portfolio Manager, America's Utility Fund. Full portfolio management responsibility for the fund since its May 1992 inception.

1978-1995 Securities Analyst. Sole responsibility for analysis of and stock recommendations for the electric utility and telecommunications industries. Other areas of coverage previously included housing (2 years) and pollution control (1 year).

Summer 1977 Research Assistant in Utilities.

1973-1976 UNIVERSITY OF COLORADO. Colorado Springs, Colorado.

Public Services Librarian
Instructor in Bibliography to undergraduate and M.B.A. students

1971-1973 CAMERON COLLEGE, Lawton, Oklahoma.

Reference Librarian

EDUCATION:

1978	COLUMBIA UNIVERSITY, MBA - Finance
1971	EMORY UNIVERSITY, M.Ln. - Librarianship
1970	MARY BALDWIN COLLEGE, B.A. - English

MEMBERSHIPS:

Chartered Financial Analyst (C.F.A.)
New York Society of Security Analysts
Association of Investment Management & Research
Wall Street Utility Group

ORIGINAL

THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

PPL Electric Utilities Corporation Supplement No. 38 to Tariff - Electric Pa. P.U.C. No. 201	: : :	Docket No. R-00049255

CERTIFICATION OF SERVICE

I hereby certify that I have this day served a true copy of the foregoing documents upon the participant(s), listed below, in accordance with the requirements of §1.54 (relating to service by a participant):

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Dated: March 29, 2004

Paul E. Russell