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COMMONWEALTH OF PENNSYLVANIA

PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission, et al. versus Philadelphia Electric Company. Investigation into a requested $660 million annual rate increase.	Docket No. R-850152
Hearing.	

Pages 1 through 126

Hearing Room 3
North Office Building
Harrisburg, Pennsylvania

Tuesday, December 10, 1985

Met, pursuant to notice, at 10:00 a.m.

BEFORE:

JOSEPH MATUSCHAK, Administrative Law Judge

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C O N T E N T S

E X H I B I T S

E X H I B I T S (Continued)

NUMBER	FOR IDENTIFICATION	IN EVIDENCE
Cffice of Consumer Advocate		
Exhibit No. 3 (Excerpt from "New York Times")	84	--
General Services Administration		
Exhibit No. 1 (Response by Brennan to IR-GSA-1-1)	42	42
Exhibit No. 2 (Response by Brennan to IR-GSA-1-2)	42	42
Exhibit No. 3 (Response by Brennan to IR-GSA-1-4)	42	42
Exhibit No. 4 (Response by Brennan to IR-GSA-1-5)	42	42
Exhibit No. 5 (Response by Brennan to IR-GSA-1-8)	42	42
Exhibit No. 6 (Salomon Brothers, Inc. Report: "Valuation Focus," November 11, 1985 - four-page excerpt)	47	--

-0-

P R O C E E D I N G S

ADMINISTRATIVE LAW JUDGE JOSEPH MATUSCHAK: Are there any preliminary matters?

MR. DELANEY: I am Daniel Delaney representing the Trial Staff. I would note concerning the Motion to Eliminate that the Staff filed and there was some discussion at the prehearing conference last week, I would note that the company filed a response on Friday. You indicated at the prehearing conference that we would have the opportunity to reply to it, and I would like to file a reply.

JUDGE MATUSCHAK: In their Answer they submitted New Matter; so you would have a right to reply to the New Matter at any rate.

MR. DELANEY: My calculation of the period for the reply is 10 days under the Commission's Rules and Procedures. So that would make it next Monday.

With your indulgence, I think there are some things that the company raises in the Answer that I would like to have a brief opportunity to argue about before Your Honor. So I would ask that we would have some brief oral argument on this some morning next week after I file my reply to the New Matter.

JUDGE MATUSCHAK: Very well.

MR. MacGREGOR: Your Honor, the company would join the request for oral argument. I'm not particularly familiar s2

with the ten-day rule to which Mr. Delaney referred; but if that is the correct rule, then that is fine.

MR. DELANEY: I don't know if Your Honor would at this time like to schedule such a date, but I would suggest that we could start early one day.

JUDGE MATUSCHAK: You people set that. After you file your reply, we can decide on that.

MR. DELANEY: Thank you, Your Honor.

JUDGE MATUSCHAK: Are there any other preliminary matters?

(No response.)

JUDGE MATUSCHAK: If not, you may proceed.

MR. MacGREGOR: Your Honor, the company will present three witnesses today; Mr. Brennan, Mr. Solecki and Mr. Smith, in that order.

I would call as the company's first witness in this proceeding Mr. Joseph F. Brennan.

Whereupon,

JOSEPH F. BRENNAN

having been duly sworn, testified as follows:

MR. MacGREGOR: Your Honor, I have previously distributed to the court reporter, to all parties, and to Your Honor copies of a document entitled "Philadelphia Electric Company (Electric Division) Direct Testimony of Joseph F. Brennan, President, Associated Utility Services, Inc., Concerning Fair Rate of Return.

I would ask that that document be marked for identification as PECo Statement No. 28.

JUDGE MATUSCHAK: Statement No. 28?

MR. MacGREGOR: Yes, Your Honor.

JUDGE MATUSCHAK: Very well.

(Whereupon, the document was marked as PECo Statement No. 28 for identification.)

MR. MacGREGOR: In addition, Your Honor, I have distributed to all parties, to Your Honor, and to the court reporter copies of the document entitled "Philadelphia Electric Company (Electric Operations) Exhibit to Accompany the Direct Testimony of Joseph F. Brennan, President, Associated Utility Services, Inc." I would ask that that be marked for identification as PECo Exhibit JFB-1.

JUDGE MATUSCHAK: Very well; it is so marked.

(Whereupon, the document was marked as PECo Exhibit No. JFB-1 for identification.)

DIRECT EXAMINATION

BY MR. MacGREGOR:

Q. Mr. Brennan, do you have before you a copy of the document that has been marked for identification as PECo Statement No. 28?

A. Yes.

Q. Is this, in fact, a copy of your direct testimony in this proceeding?

A. Yes.

Q. Was it prepared by you or under your direct supervision?

A. Yes.

Q. Mr. Brennan, do you have any changes or corrections to make to Statement No. 28 at this time?

A. Yes. We submitted an errata sheet, but I gather it wasn't filed.

Q. That's correct.

A. So then I should put into the record what was shown on the errata sheet.

Q. Correct.

A. On page 5, line 11, change "11.9 percent" to "12.0 percent." Page 10, line 3, change "October, 1985" to "May, 1986."

Page 20, line 16, change the words "through 1984" to "to date."

Schedule 6, page 4 of 4, change the words "contract data" to "contract date." Change "September" to "September, 1985." Change the average T-Bill Settled Yield from "11.607" to "11.612."

There is also one on Schedule 6, page 3. At the very bottom of the page, the next to the last line, it says, "July 18," and it should be "June 13."

Schedule 9, under the column "DJU," the year 1975 under the sub-column "Price" toward the bottom of the page where it says, "Market Price Index," it shows "74.55." That should be "79.55." And because of that change, up above opposite the year 1975 in the same column where it says, "97.4," it is "104.0."

JUDGE MATUSCHAK: Would you repeat that for me, please?

THE WITNESS: Sure. The whole thing?

JUDGE MATUSCHAK: Starting with Schedule 9.

THE WITNESS: On Schedule 9, under the column "DJU," and it says, "Market Price Index," all the way down toward the bottom, the next to the last number in the column, you will see something labelled "74.55."

JUDGE MATUSCHAK: Yes.

THE WITNESS: That should be "79.55." Now, because that changes, you have to move up to the next to the last number in the preceding tabulation, which is now shown as "97.4," and it becomes "104.0."

The last one, Schedule 13, page 6, opposite Philadelphia Electric, instead of "23.1," it is "23.4."

Those are the changes that are primarily the product of typographical errors. I intend to update my exhibit and all schedules prior to the close of this record, because subsequent to the time this testimony was filed, the company has redeemed in part three series of bonds and they have issued one series of bonds that wasn't originally contemplat Those changes affect the capital structure ratios and the embedded cost of debt. And I will, as I said, prior to the close of the record update and reflect all changes between the time the testimony was filed and the latest time possibl to file the changes so the Judge has the benefit of the latest facts.

BY MR. MacGREGOR:

Q. Mr. Brennan, with respect to PECo Statement 28, with the corrections that you have just noted, if you were asked the same questions contained in that document again today, would your answers be the same as those contained therein and would they be true and correct to the best of your knowledge?

A. Yes, subject to the caveat that there have been changes in the company's financing plans since the testimony was prepared.

Q. Mr. Brennan, are you also responsible for the preparation of PECo Exhibit JFB-1?

A. Yes.

Q. Is the material contained in that document true and correct to the best of your knowledge?

A. Yes, as just corrected for the record relative to some typographical errors.

MR. MacGREGOR: Your Honor, I would ask that the documents that have been marked for identification as PECo Statement 28 and Exhibit JFB-1 be admitted as evidence in this proceeding subject to cross-examination.

JUDGE MATUSCHAK: They may be admitted into evidence subject to any timely exceptions, objections or any other modifications that might be requested by the parties.

(Whereupon, the documents marked as PECo Statement No. 28 and PECo Exhibit No. JFB-1 were received in evidence.)

MR. MacGREGOR: Thank you, Your Honor. Your Honor, Mr. Brennan is available for cross-examination.

CROSS-EXAMINATION

BY MR. DELANEY:

Q. Good morning, Mr. Brennan. My name is Dan Delaney. I represent the Trial Staff in this matter. I have some questions on your direct testimony.

A. Good morning, Mr. Delaney.

Q. Mr. Brennan, as I understand it, the purpose of your testimony is to make a recommendation on the overall rate of return for the company including a rate of return on common equity; is that correct?

A. Yes.

Q. It is my understanding, Mr. Brennan, that you have testified on this issue for the company in several cases at several times since 1975; is that correct?

A. Yes.

Q. Would it be fair to say that the major factor affecting cost of capital during the '70s and early '80s was the high interest rates caused primarily by rising inflation? Would you agree with that?

A. As a generalization, yes.

Q. Would you agree also as a generalization that your recommendations in prior cases reflected this rising cost of capital due to inflation?

A. And falling; because my recommendations have been higher and lower.

Q. Mr. Brennan, could you briefly describe the methods that you used in developing your recommendation?

A. Are you speaking with respect to the cost rate for equity or the overall rate of return?

Q. If you could describe both briefly, that would be fine.

A. Sure. With respect to the cost rate for common equity capital, I employed primarily two techniques; the discounted cash flow method and a risk spread method. I centered my attention upon money market evidence pertaining to PECo, because that's the company in question in this proceeding.

I also produced a DCF calculation for a barometer group of companies who are similar but obviously not identica in risk to PECo as a check. I also performed a risk spread calculation for both PECo and the barometer group of companies.

I gave equal weight to the DCF calculation and the risk spread calculation in getting the indicated money market-derived cost rate for common equity capital and made a minor adjustment to reflect the fact that there are issuance and selling expenses incurred relative to the sale of new common stock and there is no other place in the regulatory model to reflect recovery of those costs except in the cost of equity, just like issuance and selling expenses with respect to the cost rate for debt and preferred stock are recovered through an adjustment in the cost rate for the debt and preferred stock.

I used the company's estimated capital structure ratios at June 30, 1986, reflective of all known or planned changes at the time I prepared my testimony. Those ratios I feel are well within the range of reasonableness for an operating electric company, and I think management should have the right to choose the way the enterprise is financed so long as its choice is not unduly costly and is within the range of reasonableness.

I employed the composite weighted cost of debt and preferred stock together with the market-derived cost rate for common equity capital, which was the product of giving equal weight to DCF and risk spread calculations primarily for PEC to develop the weighted cost for debt, preferred and common equity, summed the total and obtained a recommended range of 13.15 percent to 13.34 percent overall rate of return opportunity for PECo.

Subsequent, of course, to the time I produced this testimony, the company has changed its financial plans slightly, the end result of which is to have a downward movement in the composite cost of debt from the calculations originally prepared, because since the time I prepared the testimony, the company redeemed in part three series of high coupon bonds and issued one pollution control note that wasn't originally contemplated and has cancelled the propose sale of some first mortgage bonds. The end result of all of these changes is to move downward, undoubtedly, the overall cost of money. But it is impossible at the moment to make the calculation because all of the results of the tender offer for the three high coupon bonds are not yet known.

When they become known, it is my intention to update all of my calculations and provide the Commission and the Judge with the latest calculations prior to the time that the record in this case is closed.

Q Mr. Brennan, I note in your direct testimony and your exhibits, you often cite forecasts from rating agencies Could you describe briefly the role of these agencies in you calculations?

A. I don't mean to quarrel with you. I haven't cited forecasts of rating agencies. I have cited rating agency standards with respect to what they believe is required to command a particular bond rating.

Q. With that correction, would you describe the role that these kinds of standards play in your calculations and recommendations?

A. Well, they don't play a role, per se. What I have attempted to do, after calculating what I believe is the proper overall rate of return opportunity, I have attempted to test that recommendation by observing what coverage would fall out of an achieved return equal to my recommended return to observe whether or not that would comport with the level of coverage necessary to command an investment grade bond rating, and my testing shows it does.

This is particularly critical because in reality the return on equity actually earned provides the margin of protection by which fixed charges are earned more than once. So that if one earns inadequately on equity, over time one will have an insufficient level of coverage to command a a particular bond rating.

The bond rating agencies, if you have a certain level of coverage -- I will be illustrative -- two-and-a-half times, they may say, "Well, for an electric company, that is calculations?

A. I don't mean to quarrel with you. I haven't cited forecasts of rating agencies. I have cited rating agency standards with respect to what they believe is required to command a particular bond rating.

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This is particularly critical because in reality the return on equity actually earned provides the margin of protection by which fixed charges are earned more than once. So that if one earns inadequately on equity, over time one will have an insufficient level of coverage to command a a particular bond rating.

The bond rating agencies, if you have a certain level of coverage -- I will be illustrative -- two-and-a-half times, they may say, "Well, for an electric company, that is sufficient to command a Bbb bond rating; and if you have three-and-a-half times, that might be sufficient to have a strong A rating," and so forth.

One must pay attention to what these folks say for the simple reason that the marketplace does as evidenced by the fact that companies whose bonds are rated Aaa are able to attract capital at a lower cost rate than companies whose bonds are rated Aa, A or Bbb.

So, in reality, the management of the company and the regulator cannot ignore the yardsticks promulgated by rating agencies to assign ratings, because it affects, in fact, the market cost of equity and market cost of debt.

Q. Mr. Brennan, based on your last answer, would you agree that the standards established by these ratings agencies are accepted by the industry in terms of evaluating the financial viability or the financial condition of a utility?

A. I think it is a standard that investors do take into account, as I indicated earlier, as evidenced by the fact that they charge more for companies whose bonds are rated lower and less for companies whose bonds are rated higher.

Q. And the judgment of these rating agencies typically is available through publications that are widely distributed through the country; is that correct?

A. Yes.

Q. In your experience, is it common for representatives of these rating agencies to testify before regulatory bodies in support of a utility's rate increase?

A. To the best of my knowledge, it is not common at all. As a matter of fact, I believe Standard & Poor's has a policy that they do not testify in support or against a rate increase.

Q. In your opinion, would such testimony by the representatives of such an agency raise questions as to their impartiality?

A. I think it might, and that's probably the reason why S&P doesn't do it.

Q. Mr. Brennan, on page 4 of your testimony, you state that, "PECo's financial profile results in an investor judgment that the risk of an investment in PECo is significantly higher compared to the average operating electric company;" is that correct?

A. Yes.

Q. Mr. Brennan, in your judgment, does the barometer group chosen by you present the same perception of risk to potential investors?

A. The barometer group risk appears to be less than PECo?

Q. To your knowledge, do any of the utilities in your barometer group currently have large, solely-owned nuclear plants under construction?

Do you understand the question?

A. I didn't hear all of it. There was a sneeze in there. I'm sorry.

Q. I will repeat it then.

Do any of the utilities in your barometer group currently have large, solely-owned nuclear plants under construction, to your knowledge?

A. Duquesne Light is involved in nuclear construction.

Bear with me one moment.

(Witness perusing documents.)

A. Detroit does not. New York State Electric and Gas Corporation does. Of course, Ohio Edison is also involved in nuclear construction.

Q. Mr. Brennan, are you aware of whether any of these companies are building solely-owned facilities similar to the situation that PECo faces with Limerick?

A. I don't believe that three of the four companies are building solely-owned. They are participants with other utilities in the construction.

Q. So the answer is no, if I understand your response?

A. Yes.

Q. Yes, it is no?

A. Yes.

Q. Would you agree, Mr. Brennan, that current regulatory problems facing electric utilities with large construction programs have an impact upon investors' expectations?

A. Yes.

Q. I note you have a discussion in your direct testimony concerning perception of risk for Philadelphia Electric. One of the things that you define is the heavy concentration of industrial customers and the company's sales mix. That statement is on page 6.

You go on further there to say that "The risk of serving industrial customers is potentially more risky than the risk of serving residential customers."

Do you have any empirical studies to support that statement, Mr. Brennan?

A. I have prepared a study for the Department of Energy under a grant given to the Delaware Public Service Commission several years ago which addressed that question, and our conclusion was that as a generalization it is more risky to serve industrial customers than it is residential customers.

Q. Were there specific utilities that were the subject of that study, Mr. Brennan, or was it in general?

A. It was electric companies in general.

Q. Would that include Philadlephia Electric Company in that study?

A. I don't remember. I would suspect so, but I can't say for certain. I would have to check.

Q. Do you think you could provide us with a copy of that study?

A. Of the report we made to the Delaware Public Service Commission which was filed with the DOE, yes.

MR. MacGREGOR: We will provide it, Your Honor. One procedural matter with respect to the data request. I was wondering whether it would be possible to ask the parties that where data requests are made, if they could be briefly written out and handed to me at the end of the hearing.

There are two or three reasons why that might help expedite the whole process. We tried this in the Limerick 2 investigation, and it worked well in clarifying the request and it helps us in terms of providing a more timely response. We can take these and call them down to the company and make sure we are communicating accurately among the parties as to what exactly is requested so we don't do work that is not required and yet provide an answer to the question.

JUDGE MATUSCHAK: I think that might be a good idea, because the party making the data request may want to editorialize or correct the phraseology that was asked.

MR. DELANEY: Certainly, Your Honor, we have no objection to that.

JUDGE MATUSCHAK: I would suggest that that procedure be followed. If there is any doubt as to what the request is, the company can make further inquiry.

BY MR. DELANEY:

Q Mr. Brennan, I note on page 16 of your testimony, you describe the company's achieved rate of return on common equity for recent years.

Do you know when the company last achieved its Commission-established rate of return on common equity?

A You are speaking about the retail electric Pennsylvania?

Q Yes.

A No, I don't. It's not in memory.

Q Can you accept that it has been some time since that occurred?

A Yes.

Q Will you agree further that there are other reasons besides the effect of regulation which could prevent a utility from achieving its approved rate of return? What I am thinking of are substantial below-the-line expenses or poor management of the company.

A No, I wouldn't agree. I think we have a semantic problem, possibly.

Q Maybe you can indicate where the confusion is.

A Sure. When you say "achieve its rate of return," I presume you're speaking about on rate base as determined by the Commission. There is quite a difference both in coverage and return on equity between the return on the common equity part of the rate base and the coverage related to rate base debt and return on book common equity and the coverage on total debt outstanding.

That is simply because all of the company's assets are not in the rate base and they earn varying rates of return.

Q. My recollection is on page 16 of your testimony, you are referring to book common equity return.

A. I am citing book common equity figures.

Q. Would you agree that there are possibilities that in the company's operation there may be unanticipated events that would keep it from achieving the kinds of rates of return that the regulatory body would permit them to earn in a rate order, an overall rate of return?

A. Yes. I would agree that there are unanticipated events by both the regulator and the company. For instance, just like an oil embargo in the middle '70s at a time when fuel adjustment clauses were not what they are today, and there were lots of dollars going unrecovered which was right off the bottom line.

Q. Would you agree further that things that would prevent achieving an approved rate of return might be, as you just indicated, below-the-line expenses?

A. No. They are not below-the-line expenses. Fuel costs are above-the-line expenses. The problem is: if the proper fuel cost isn't reflected in the price of service, then obviously you can't earn the fair rate of return, whatever it may be.

Q. You are referring to the regulatory actions that control the company's finances somewhat such as adjustment clauses?

A. Just for clarity, I'm not casting aspersions upon the regulator for setting the price of service without regard to fuel cost. My point is simply that if at the time the custom was to set the rates based on the best estimate of what fuel costs were going to be, but beyond anybody's control fuel costs were higher than they were, obviously even the most efficiently managed company and the most efficiently regulated company won't earn the fair rate of return. It has nothing to do with below-the-line costs.

Q. Would you agree that the quality of management of a utility may have an effect on the kind of result in achieving a fair rate of return?

A. I agree that it can. I have made no management studies. I am not a management study expert.

MR. DELANEY: Excuse me for a second.

(Pause.)

BY MR. DELANEY:

Q. Mr. Brennan, in the current case, you performed a single-stage discount cash flow analysis, which I think you start a discussion of on page 25 of your testimony.

Now, it is my understanding that in developing the dividend yield, you used historic, spot and projected data; is that correct?

A. Not for the yield.

Q. Maybe you can indicate what you used in developing your yield.

A. I used the dividend relative to a 12-month average price and the dividend relative to a current price and obtained a yield and averaged the two.

I also, of course, as have most witnesses, including Staff witnesses, have taken into account the impact on cost occasioned by the next period dividend, since the price of stock reflects the next period dividend.

The starting point of the calculation is the actual dividend relative to the average price of stock for 12 months and the current price of stock, and then I averaged the two, because I don't think one should perform a DCF calculation using spot nor necessarily 12-month averages.

Q. Mr. Brennan, you performed your DCF in September of this year; is that correct?

A. Yes.

Q. What is the projected time period that you examined? One year; would that be correct?

A. The data that I used was the data available in September with respect to the price of stock, the 12 months ended August and the spot price in September.

Q. My question is: for the next period, what did you use?

A. I don't understand the question. Are you speaking about the price of stock I used in getting the yield?

Q. You said you made an adjustment for the next period dividend. That was what my question was to.

A. Okay. I took into account the expectation that the dividend would be increased by one-half the growth rate expected in dividends, which in this instance is just about one percent because there is not too much growth expected or at least there wasn't at that time.

Perhaps there is more growth expected now than there was then as reflected by the fact that the price of stock has since gone up.

Q. I understand that, but your response previously was the "next period." I'm just asking what time period is the next period?

A. The next 12 months.

Q. In developing the growth rate for your DCF, it is my understanding you used both the historic and forecasted growth rates and gave more weight to the forecasted data; is that correct?

A. Yes.

Q. And the periods you examined were the five years back and the five forward?

A. Yes.

Q. And your projected growth rate is 1.7 percent?

A. That's what it was at the time that I prepared that calculation. As I indicated the growth rate is a function of the price of stock, and the price of stock is the function of what investors think. Investors change their minds from time to time.

As a generalization, if they pay more for the stock, perhaps they are expecting higher growth. If they pay less for the stock, then perhaps they expect less growth. So it was 1.7 percent at the time I prepared the calculation. Today the yield would be different and perhaps the growth rate would be different also.

MR. DELANEY: Excuse me.

(Pause.)

BY MR. DELANEY:

Q. Mr. Brennan, are you aware at the time you did this calculation whether any investment services also calculated a projected growth rate for PECo of 1.7 percent?

A. I missed the last part of your question.

Q. At the time you did the calculation, were there any investment services that predicted a similar growth rate for PECo of 1.7 percent?

A. Yes, there were some that predicted, as a matter of fact, higher than that.

Q. Higher is what you said?

A. Higher than 1.7.

Q. How about lower?

A. There were some that predicted lower. I'm aware of about -- and I can't identify them -- about 15 forecasts. The composite of the forecasts using an arithmetic mean was 2.24 percent and the median was 2 percent, which means that, obviously, there are more higher than lower than the number I used.

Q. Moving to your risk spread analysis, Mr. Brennan, you state on page 36 of your testimony that "the yield on long-term public utility bonds captures all elements of cost related to investor-required inflation protection and the bare rent rate; is that correct?

A. Yes.

Q. What kind of a maturity period are you referring to for these bonds?

A. Thirty-year bonds.

Q. So would that be the minimum necessary in your view to have that kind of effect?

A. I would say it's the minimum. If somebody wanted to use a 25-year bond or perhaps even a 20-year bond, it might be sufficient for this purpose, but I don't think one should use a five-year bond.

Q. So a shorter period bond then wouldn't have the kind of effect you would attribute to a longer term bond?

A. Correct. There is a difference in investor requirement relative to the number of years to which its capital is exposed to risk.

If you commit by contract to expose your capital for 30 years, the risk is different than if you're only going to expose your capital, to be illustrative, for one year.

Q. You indicate that your risk spread study is based upon data from the years 1981 to 1984. My understanding of your testimony is you chose those dates because the publication of Merril Lynch's "Quantitative Analysis" did not begin until 1981; is that correct?

A. For the companies that I had available to use, I made calculations for the DCF cost of equity. I wanted to use a growth rate other than just, for instance, Value Line, if I used projections only, which I didn't. I used a very similar methodology, namely projections as well as history.

Well, Merrill Lynch didn't, to the best of my knowledge start publishing for these companies until sometime in '81.

Q. If you would have had similar data available to you for a longer period prior to 1981, would you have used that and extended your analysis?

A. Yes, keeping in mind, of course, that there are other factors besides the availability of Merrill Lynch that determines whether or not a particular time frame is appropriate to employ. But I would have; no question about it.

MR. DELANEY: Excuse me for a minute, Mr. Brennan.

(Pause.)

MR. DELANEY: That's all the questions I have for this witness, Your Honor. Thank you, Mr. Brennan.

JUDGE MATUSCHAK: Who wants to proceed next?

MR. RUBIN: I will go next.

JUDGE MATUSCHAK: Very well.

CROSS-EXAMINATION

BY MR. RUBIN:

Q. Good morning, Mr. Brennan.

A. Good morning.

Q. My name is Scott Rubin. I'm with the Consumer Advocate's office.

First, I would like to pursue something that you just stated to Mr. Delaney, and that was that you had looked at a composite of about 15 growth projections and you gave what the average was and what the median was.

Was the source for that information I/B/E/S?

jl

A. I/B/E/S; yes.

Q. Mr. Brennan, before we get into the details of your analysis, I would like to establish a few basic principles. First, would you agree with me that the dividend yield component of a DCF analysis should reflect investors' expectations for next year's dividend rate?

A. Yes, in the context that we are attempting to find here what is representative of the future for the period of time the rates for service in question in this proceeding will be in effect, since we are trying to match revenues and costs.

Q. Would you agree that generally speaking investors are risk averse?

A. Yes.

Q. As a result of that, all other things being equal, investors will pay relatively less for the stock of a company with a high risk profile than for the stock of a company with a low risk profile; is that right?

A. Yes.

Q. Would you also agree that investors are risk averse because in a higher risk situation investors might not achieve the earnings or dividends that would be achieved in a lower risk situation?

A. I'm not sure I understand the question. If one is compensated adequately, one will take risks. So it is really the return required commensurate with the risk to which the capital is exposed.

Q. Mr. Brennan, I thought the question was fairly straightforward. I'm trying to determine why investors require a higher return on a higher risk investment.

Is it because that with a higher risk investment, investors might not achieve the earnings or dividends that they expect to achieve; there is some risk that they will not get the earnings or dividends?

A. Yes; just like there is some risk that they won't get the lower return on a supposed lower risk investment. But, again, their judgment is the product of relative risk. They want to be compensated for the risk to which their capital is exposed. So it doesn't mean that a supposed high-risk company can't attract capital if the price is right.

MR. RUBIN: I would like to have marked as OCA Exhibit 1 a multi-page document which we have pre-marked in the upper right-hand corner.

JUDGE MATUSCHAK: Very well.

(Whereupon, the document was marked as OCA Exhibit No. 1 for identification.)

BY MR. RUBIN:

Q. Mr. Brennan, OCA Exhibit 1 is your response to OCA Interrogatory Set V, No. 13.

j3

Are you familiar with that document?

A. Yes.

Q. Was the information that is in here prepared or furnished by you?

A. Yes. I responded to the interrogatory.

Q. And this information is true and correct to the best of your knowledge, information and belief?

A. Yes.

Q. Mr. Brennan, could you turn to your Schedule 2? And I am looking at page 1 of that schedule.

A. I have it.

Q. On this page you show, on line III, your recommended cost of equity without recognition of issuance costs, and then on line IV you show your cost of equity with issuance cost; is that correct?

A. That's correct.

Q. So would I be correct then that you are effectively using an allowance of 50 basis points for issuance cost?

A. That's the end result. The answer is: yes; that's the end result of recommending a return on equity which hopefully would command a market price of stock 3 percent above book value.

Q. Now, if you could keep that page in front of you and also turn to pages 21 and 22 of your testimony.

Do you have that?

A. Yes.

Q. You explain here how you arrived at the 3 percent increment to the market to book ratio to account for issuance costs; is that right?

A. That's one of the reasons why I recommend the 3 percent increment. Yes, that's right.

Q. Now, is it correct that you applied this 3 percent allowance to all of the company's common equity?

A. That's correct.

Q. Is it correct that this 3 percent allowance is the reason that you multiplied your cost of equity without issuance costs back on Schedule 2, page 1, by 1.03 to give a cost rate with issuance costs on that schedule?

A. Yes; that's one of the reasons.

Q. Mr. Brennan, does this mean that in order to increase the market to book ratio by 3 percent, you believe it is necessary to increase the earned return on equity by 3 percent?

A. That is the fall-out of the arithmetic in this situation.

Q. So is the answer to the question yes?

A. No; the answer is what I have said. You see, if the cost rate for equity was different than is shown on line III, the fall-out could be different than 50 basis

j5

points. For instance, --

Q Yes; I understand.

A. -- if that number was 12 percent and we multiplied that by 1.03, the number that falls out of that is 12.36. So 3 percent would produce 36 basis points instead of 50 basis points.

Q I understand that, Mr. Brennan. I'm asking about the 3 percent figure itself, not about the fall-out number which you just explained.

Now, is it your opinion that in order to increase the market to book ratio by 3 percent, that it is necessary to increase the earned return on equity by 3 percent?

A. Yes; it comports completely with the DCF theory, since the DCF theory proceeds from the premise that if the book value -- one of the premises is if book value or earnings or dividends grow over time by a given percentage, the price of stock will grow by an identical percentage.

Q Now, Mr. Brennan, could you turn to page 6 of your testimony?

A. (Witness complying.)

Q You state here that the common stock of Philadelphia Electric Company is higher in risk than the common stock of the barometer group of companies which you relied upon; is that correct?

A. Yes.

j6

Q. Would you also agree that PECo's common stock would be considered riskier than the stock of most other electric utilities?

A. Yes; the answer is yes. I would say that is a fair generalization.

Q. Mr. Brennan, for how long do you believe that PECo's common stock has been perceived by investors to be more risky than the stock of most other electric utilities?

A. For several years.

Q. Could you say how far back that might go?

A. I haven't quantified it, but it has been that way for several years.

Q. Mr. Brennan, turning to your DCF analysis, when you computed a DCF for PECo you used a current dividend yield of $2.20; is that right?

A. No. The yield is not $2.20. The dividend is $2.20. To get the yield you relate the dividend to the price; that gives you the yield.

Q. Yes; I'm sorry. I must have misspoke.

And then you increased that dividend by one-half year's growth; is that right?

A. That's correct.

Q. So you effectively used a dividend of approximately $2.23, something like that; is that right?

A. Yes; it is in that ballpark.

Q. Mr. Brennan, to the best of your knowledge, has Philadelphia Electric Company indicated that it will be increasing its dividend in the near future?

A. No, it hasn't, which is academic in a DCF calculation.

Q. And, in fact, am I correct that PECo's dividend has been at 55 cents per quarter since the first quarter of 1984?

A. That's correct.

Q. Mr. Brennan, in applying your DCF method, you arrived at your growth rate in two different ways. One method was to use a five-year historic growth rate in dividends; is that right?

A. Yes, sir.

Q. And the other method was to use dividend growth rates indicated by certain investment advisory services; is that correct?

A. No; both earnings and dividend growth rates, and by Value Line and Merrill Lynch, because the Commission -- one of the reasons was that the Commission in its last order seemed to be a little critical of using only Value Line, and they mentioned specifically Merrill Lynch; so I used both.

Q. Could you turn to your Schedule 7 now?

A. (Witness complying.)

j8

Q. Would you agree with me that the earned return on equity for Philadelphia Electric has been increasing over the last five years?

A. Yes.

Q. Would you also agree that this schedule shows that the earned return on equity for your barometer group of companies was also increasing over the last five years?

A. Yes. I would note that in neither case did these companies, either PECo or the barometer group, average in any of those years the return authorized.

In other words, notwithstanding the fact that it increased, they still earned less than what was authorized.

Q. Yes; I understand that, Mr. Brennan. Thank you.

Now, in your opinion, does the fact that earned returns on equity have been increasing create any problems for an analyst when using a five-year historic growth rate in dividends as an indicator of future growth?

A. Yes; it may understate, in this instance, the growth rate expectation -- it may understate the growth rate expectation, particularly if during that same period of time, notwithstanding the increasing earned rate of return on common equity, the stock sold at less than book value. Since the intention, as I understand it, of regulation is to permit a price of service intended to produce an opportunity to experience a return that will maintain the integrity of the rate base, and even if you measure it at original or book cost, an achieved earnings rate that results in consistently a price of stock less than book value suggests that it was substandard.

Q. I'm sorry, Mr. Brennan, I don't think you answered the question that I asked. I think you had another question in mind.

I asked: does the fact that earned returns on equity have been increasing create any problems in using five-year historic growth rates in dividends?

A. I could restate, but I thought I said the answer up front and then explained. I said yes, it could be a problem, and then I explained what the problem was.

Q. We will move on I guess.

Mr. Brennan, is it correct that your other method for determining a growth rate was to rely on growth projections for dividends and earnings as reported in the Value Line Investment Survey and in the Merrill Lynch Quantitative Analysis Report; is that correct?

A. Yes.

Q. For how many years into the future does Value Line report growth projections?

A. Approximately, five years.

Q. How far into the future does the Merrill Lynch report go?

j10

A. The same; five years.

Q. Mr. Brennan, did you present an earnings retention analysis as part of your growth rate projection?

A. No.

Q. Mr. Brennan, let's turn to your risk premium analysis. Is it correct that your risk premium analysis concludes with the finding that the proper risk spread for PECo was 4.5 percent over your projected Baa bond yield?

A. It was relative to a forecasted bond yield of 12.5 percent. If the bond yield forecast was different, the risk spread would be different, for reasons explained in my direct testimony.

Q. Yes. And the risk spread for your barometer group was 4 percent over the Baa bond yield; is that right?

A. Correct.

Q. Mr. Brennan, in developing your risk premiums, is it correct that you relied upon your DCF analysis to compute the risk premiums?

A. The answer is yes; that is necessary in order to get a premium in the first place.

Q. Mr. Brennan, are you generally familiar with the generic rate of return orders which the Federal Energy Regulatory Commission has issued for electric utilities?

A. Yes. I was a commenter in the original generic

j11

proceeding last year, and I am a commenter this year on behalf of 15 electric companies.

Q Mr. Brennan, would you accept, subject to check, that as corrected in October of 1985, in May of 1985, FERC found the cost of equity for electric utilities to be 14.44 percent?

A. Yes; for the period, 12 months ended June 30, 1984.

Q And on July 19, 1985, FERC found that rate to have declined to 13.65 percent; would you accept that?

A. No, I would not. FERC didn't find it; it was just simply the operations of the indexing methodology that they adopted for this advisory number, since it is not binding on the FERC, the staff or the companies; and the staff of the FERC now agrees and admits that the indexing methodology was seriously flawed.

Q Would you agree that the 13.65 percent number is the number which FERC reported in July of 1985?

A. Yes; that is the product of applying the flawed indexing methodology.

Q And in October of 1985, FERC reported a rate for electric utilities of 13.68 percent; would you accept that?

A. Yes; and the staff of the FERC in the second generic proceeding I think is recommending 14.5 percent at

j12

the same time for the industry average, notwithstanding the indexing methodology producing something a point lower, thereby apparently proving the point that the indexing method is flawed.

MR. RUBIN: Thank you, Mr. Brennan.

Your Honor, at this time I would like to move into evidence OCA Exhibit No. 1.

MR. MacGREGOR: No objection.

JUDGE MATUSCHAK: OCA Exhibit 1 is admitted into evidence.

(Whereupon, the document marked as OCA Exhibit No. 1 was received in evidence.)

MR. RUBIN: That concludes my examination. Thank you, Your Honor.

MR. MacGREGOR: Your Honor, before we move to the next questioner, I have just one other procedural matter.

On a couple of occasions Mr. Rubin asked the company to accept matters subject to check. I certainly have no problem with that as long as it is not burdensome to check the numbers, and in this case it is not.

What I would like to do is establish some sort of procedure for the company, if it checks on a question and finds out that the premise was wrong, that we can correct that without having to bring the witness back.

What I would like to do, with the consent of Your

Honor and the parties, is to treat a "subject to check" question essentially as a data request; and that if we wish to respond that we don't agree with the premise and the "subject to check," that we would file a data request stating that fact, and would be able to move it into evidence in the record without having to bring the witness back again to authenticate it.

JUDGE MATUSCHAK: Any objections?

MR. RUBIN: No objection, Your Honor.

MR. DELANEY: No objection.

JUDGE MATUSCHAK: Very well.

MR. MacGREGOR: Thank you, Your Honor.

CROSS-EXAMINATION

BY MR. ETTNER:

Q. Good morning, Mr. Brennan.

A. Good morning.

Q. I am Mike Ettner, representing GSA.

Mr. Brennan, do you recall receiving and responding to a number of interrogatories from GSA directed to you in this proceeding?

A. Yes.

MR. ETTNER: Your Honor, before the hearing today I passed out a package of proposed cross-examination exhibits of GSA, and at this time I would like to have marked for identification the following exhibits attached to that package: as GSA Exhibit No. 1, Mr. Brennan's response to Interrogatory GSA-1-1.

JUDGE MATUSCHAK: Would you proceed to authenticate it first by Mr. Brennan?

MR. ETTNER: Whatever is your desire, Your Honor.

BY MR. ETTNER:

Q Mr. Brennan, do you have a copy of that package of proposed exhibits?

A. Yes.

Q Could you look through the first five documents there, which are preliminarily marked as GSA Exhibits Nos. 1 through 5?

A. Yes; I have looked through them.

Q Do they represent your responses to the questions posed in those interrogatories?

A. They represent five of the nine questions that I responded to. The first five that you handed me this morning are identical to five of the questions that I responded to.

There were more questions that you asked me that I responded to that are not contained in this document.

MR. ETTNER: Your Honor, the --

JUDGE MATUSCHAK: Are these responses true and correct?

THE WITNESS: The first five are identical to what

j15

I responded.

BY MR. ETTNER:

Q. And do you adopt them here today as your responses to those questions posed therein?

A. Yes.

MR. MacGREGOR: Your Honor, I might just interject. As a general matter, any interrogatory that the company has answered, we would stipulate to its authenticity for use in the proceeding, if that would save some time.

JUDGE MATUSCHAK: We just want to make sure that we have them properly authenticated.

MR. ETTNER: Your Honor, may those exhibits be marked as identified?

JUDGE MATUSCHAK: Yes; Exhibits 1 through 5 are admitted into evidence.

(Whereupon, the documents were marked as GSA Exhibits Nos. 1 through 5 for identification, and were received in evidence.)

BY MR. ETTNER:

Q. Mr. Brennan, turning to your testimony; starting on page 6 of your testimony you begin a discussion of the risks associated with investing in PECo common stock, and you indicate that there are a number of factors which affect risk. You further specifically identify as one of those factors the uncertainty concerning the regulatory treatment of Limerick investment; is that correct?

A. Yes.

Q. Mr. Brennan, focusing just on that one factor, that uncertainty factor, and keeping all other factors constant, would you agree that if uncertainty decreases, then risk decreases, and, conversely, if uncertainty increases, risk will increase?

A. Yes, as a generalization.

Q. If investors were certain of the regulatory treatment of Limerick investments, would risks associated with investing in PECo be reduced?

A. Yes; I already have that in my testimony.

Q. Is it not a fact, Mr. Brennan, that PECo's stockholders have been informed by management through various means, through annual reports, through company-issued statements -- have those investors been informed that cancellation of the Limerick plant would likely result in a dividend cut?

A. I am unaware that the management has said that cancellation would likely result in a dividend cut. I am unaware of that.

Q. Have you seen any statements from management that discuss that general issue and raised as a possibility a cut in dividend if there were, to PECo's perspective, an adverse ruling on Limerick?

A. I am unaware of any management statement that they would cut the dividends. Obviously, management has to review the earnings and the prospect for earnings every time they declare a dividend, because dividends are only payable when, as and if declared, which is quarterly.

But I can't say that I'm aware of management saying the dividend will be cut.

Q. Do you personally consider that as a possibility?

A. Yes, in the sense that anything is possible. I think it is unlikely, frankly, at -- let me put it this way: it is less likely today, I think investors think -- and I share that view -- than it was a few months ago, as evidenced by the fact that the Commission was initially polled, and then they voted that if PECo wants to finish Limerick II, they can do so, so long as there is a cap of $3.2 billion.

The response from the marketplace to that was an upward movement in the stock, which suggests that investors thought that was favorable and that there was less risk today than there used to be, and possibly more growth.

Q. So there is no discussion in your testimony describing the potential for a cut in PECo's dividend, is there?

A. No. I believe I have words in my testimony which indicates that there is always the possibility of a cut, and I responded -- for any company -- and I responded to an interrogatory which said just that; that some investors may think that there is a possibility of a cut, and other investors may think that there is a possibility of an increase. And both of those views are reflected in the price of stock. That's why we start with the stock price as a starting point to get the cost of equity.

Q. In your DCF analysis you did not model the situation where PECo would cut its dividend, did you, or reduce its dividend in any way?

A. No. I assumed that the present price of stock reflects investor expectation that the dividend will be paid and, in fact, will grow over the long term.

My view on that is not unique; it is shared by others.

Q. Turning to a different area, your risk spread analysis, Mr. Brennan. It is your opinion, is it not, that stocks in general are more risky than bonds?

A. Yes; it comports with the classic theory of finance.

Q. Therefore, it is your opinion that the required return on a company's stock -- that would include PECo's stock, for example -- is greater than that on a company's long-term bonds?

A. The opportunity for return is greater, in order

j19

to motivate people to buy stock. If it was otherwise, they would buy nothing but bonds, and you couldn't sell stock, because the bonds have a first claim on assets and earnings; the stockholder gets whatever, if any, left over. Why would anybody buy stock if you can get a better return, a more assured return and have a first claim on assets? Nobody would buy stock.

Q. Mr. Brennan, however, are you aware that there are recent publications from members of the investment community that have expressed the opinion that bonds are equally as risky as common stock and may even be more risky than common stock? Are you aware of those opinions expressed in investment community publications?

A. I'm aware of one publication, which is authored by a person who has been characterized by staff members of this Commission as perhaps not reliable, that says that there is greater volatility of bond prices than stock prices; and if you use volatility exclusively as the yardstick of relative risk, then bonds are more risky than stock.

Q. Can you tell us who that person is and who he works for, what firm he works for?

A. Salomon Brothers; Luftig. It's in the Duquesne Light Company transcript; and the person who said it is sitting in this room.

Q. Would you agree that Salomon Brothers as an institution is an important voice in the investment community and that they are generally respected in their views?

A. Yes.

Q. Mr. Brennan, could you turn to the next exhibit in the package of exhibits, which has been preliminarily marked as GSA Exhibit No. 6, which represents the Salomon Brothers, Incorporated report entitled "Valuation Focus," and dated November 11, 1985?

MR. ETTNER: I would like to note, Your Honor, that the excerpt that we have is four pages in length. The pages are correctly identified in the upper right-hand corner; however, they have been switched around. Page 3 and 2 were switched around when the package was assembled. So they are correctly identified.

(Whereupon, the document was marked as GSA Exhibit No. 6 for identification.)

BY MR. ETTNER:

Q. Mr. Brennan, do you have a copy of that?

A. Yes. You provided me with one. I don't normally read these, but I have perused this one.

Q. Mr. Brennan, let me direct your attention to page 3 of 4, what is marked as page 3 of 4 of that document. At the bottom of that page you will see a discussion that is entitled "Should the 'Equity Risk Premium' Be Zero?"

Do you see that?

A. I see that.

Q. Could you turn to page 4 of 4 of Exhibit No. 6? The Salomon Brothers discussion of that issue carries over, and I would like to direct your attention to the -- it looks like the second paragraph on the top of that page. There is a check mark in the right-hand corner, and there is a statement made by Salomon Brothers there beginning with the words "Bond markets."

Would you read that and then express your opinion on that statement?

A. Do you want me to read the whole paragraph? Where do you want me to start reading from?

Q. At the check mark, the conclusory statement beginning with the words "Bond markets."

A. Okay. "Bond markets have become so jumpy that their risk reaches or exceeds that of stocks."

Now you want me to comment on it?

Q. Yes. I assume that you disagree with that.

A. Yes, I do. I could produce an identical type of calculation using stock prices and bond prices that proves the exact opposite conclusion.

If you used the S&P 40 utilities' stock prices and the S&P bond prices, you can demonstrate -- I could demonstrate that the volatility of bonds is greater than stocks, and if volatility is used as the sole, single criteria to determine relative risk, by my studies, bonds are less risky than stock.

Frankly, I don't think one should draw a conclusion based exclusively upon volatility of bond prices or stock prices over a very relatively short period of time, because investors in both have time horizons -- or some investors in both have time horizons far in excess of, for instance, the years '81 through '84, as is covered by the Salomon Brothers report you had me read.

MR. ETTNER: Thank you, Mr. Brennan. That's all the cross-examination questions I have.

Your Honor, may I request that we also be provided with a copy of the report that Mr. Brennan is going to provide to Staff as a result of a request this morning?

JUDGE MATUSCHAK: Copies of the report should go to all active parties in the proceeding.

MR. ETTNER: Thank you.

Your Honor, also as a final matter, I would like to move the admission of GSA Exhibits 1 through 6.

MR. MacGREGOR: I would object to No. 6, Your Honor. Mr. Brennan, as he stated today, has not even read the report.

If Mr. Ettner plans to put on a rate of return witness, he can do so, and his witness can sponsor it; and I would have the opportunity to cross-examine his witness as to whatever reliance he might make on No. 6.

JUDGE MATUSCHAK: Yes. We have already admitted 1 through 5. I think this isn't the proper time to offer 6 as an exhibit. You may offer it again if you have someone sponsor it.

Do you have anybody to sponsor that exhibit?

MR. ETTNER: I believe that Mr. Brennan indicated that normally he does not read Salomon Brothers reports, but that he did have a chance to peruse this particular document; and he was given an adequate opportunity to fully respond to the statement.

JUDGE MATUSCHAK: Are you going to have anybody testify to that in your direct case?

MR. ETTNER: We will have a witness whose attention will be directed to the same subject matter; but I think this kind of publication is normally accepted, provided the witness has been given an opportunity to comment on it and to offer contrary views, and that has occurred.

The report exists and should be introduced and admitted for no other reason than the fact that it does establish that there is an investment firm out there by the name of Salomon Brothers which has made such a statement indicating that the risk of bonds may exceed that of stock, common stock.

MR. MacGREGOR: Your Honor, the company would disagree strongly. The fact that this is proper as a tool for cross-examination and can be marked for identification and Mr. Brennan can be asked his opinion on it certainly doesn't mean that Mr. Brennan can sponsor this exhibit.

If Mr. Ettner is going to present a witness on rate of return, if he wishes to draw some conclusion from that report, then I would have an opportunity to cross-examine that witness and to delve into the reasons why he has reached that conclusion; but I can't see how this can be admitted into evidence at this time.

JUDGE MATUSCHAK: I don't think it is the proper time to admit it either. I sustain the objection of the company.

You may offer it again after you submit your testimony.

MR. ETTNER: Thank you, Your Honor.

CROSS-EXAMINATION

BY MR. RAINEY:

Q. Good morning, Mr. Brennan.

A. Good morning.

Q. My name is Charles Rainey. I am appearing on behalf of the City of Philadelphia

Mr. Brennan, I would like to direct your attention to pages 5 and 6 of your testimony, specifically the bottom of page 5 and the top of page 6.

There you state that PECo's construction work in progress is about 145 percent of book common equity; is that correct?

A. Yes.

Q. Mr. Brennan, can you tell us what percentage of book common equity will CWIP be after the inclusion of Limerick in rate base?

MR. MacGREGOR: One point of clarification: Limerick I and II, or just Limerick I?

MR. RAINEY: Well, he can tell us if he knows for Limerick I, and if he knows for Limerick II, he can tell us that as well.

THE WITNESS: I would have to make the precise -- first, the answer is lower, obviously. Second, since Limerick II I think has been reported in the press as being something in the magnitude of $900 million at the moment, CWIP, after Limerick I it would be significantly lower.

But I would have to literally make the calculation, and I would rather not speculate on the precise number; but it would be significantly lower.

BY MR. RAINEY:

Q. Would you make that calculation for us? I will put that in the form of an oral data request.

A. Sure. Based on the facts as known at the moment, how much is in CWIP at the moment with respect to Limerick II and with respect to Limerick I.

Q. That's correct.

A. Okay.

Q. But you are stating even with inclusion of Limerick I solely, there would be a significant drop in the percentage of CWIP as compared to common equity?

A. Yes. If Limerick I went into rate base and was taken out of -- went into plant in service and was allowed in rate base, obviously, the CWIP expressed as a percent of book common equity would decline from the 145 percent number cited in my testimony.

Q. And you would also agree that the company's cash flow would improve significantly with the inclusion of Limerick I in rate base?

A. Yes, assuming, of course, they earn what the Commission intends.

Q. And you would agree that the company would stop accruing AFUDC; is that correct?

A. Absolutely.

Q. And that the company would also begin collecting depreciation expense on the plant; is that correct?

A. Yes.

Q. And the company would also receive deferred tax expense; is that correct?

A. What was the last one?

Q. Deferred tax expense, expenses for deferred taxes.

A. Do you mean: would there still be deferred income taxes? The answer is yes, to the extent there are continuing timing differences between book and tax depreciation and no tax laws change.

Based on the tax law proposed, it is going to be reduced from whatever it is at the moment, apparently.

Q. Mr. Brennan, you have determined PECo's required return on equity in the historic test year and in the future test year to be 16.9 and 17.4 percent; is that correct?

A. Yes, based on the evidence, the facts, at the time I prepared the study. Quite frankly, it would be slightly lower today because the market has changed.

Q. And you have utilized a comparable group of four companies in making that determination; is that correct?

A. No. The 16.9 to 17.4 number is exclusively the product of PECo data; but I did perform identical calculations derived from information pertaining to a barometer group of four electrics used as a check. But the 16.9 to 17.4 was the product of PECo data.

Q. So you used a barometer group to support your recommendation, in other words?

A. As I indicated in my testimony, the barometer group data suggests a lower cost rate than PECo, because I believe the market thinks that PECo is more risky than the average barometer company.

Q. Mr. Brennan, do you know what the standard of confidence is in using only four comparable companies as a check for your recommendation on common equity in this case?

A. I missed the first word of your question, the standard --

Q. What the standard of confidence is?

A. No.

Q. I would like to reference Schedule 7.

A. I have it.

Q. There it shows the barometer four earned return on equity, spot 1985, as 14.8 percent; is that correct?

A. At that time, yes; that's correct.

Q. And you would also agree, Mr. Brennan, that your barometer group companies have never earned a return on equity as high as 16.9 to 17.4 percent; is that correct?

A. That's right. And if you look at the next schedule, Schedule 8, you will see that as a result of that the price of stock was consistently less than book value for the last several years, and, on average, for the last five and ten years, which means the achieved rate on earnings was rejected as inadequate by the money market.

MR. RAINEY: I have no further questions for this witness, Your Honor.

CROSS-EXAMINATION

BY MS. FERKIN:

Q. Mr. Brennan, good morning; my name is Zori Ferkin. I represent the Governor's Energy Council in this proceeding.

A. Good morning.

Q. Would you turn for a moment to page 9 of your testimony?

A. I have it.

Q. In lines 16 and 17 there, Mr. Brennan, you refer to a planned sale of first mortgage bonds for November 1, 1985; is that correct?

A. That's correct.

Q. Do you know whether that sale took place?

A. No, the sale did not take place; that is, specifically, the $100 million sale. That sale has been canceled, and instead the company has a revised financing plan whereby they sold two issues aggregating $400 million, the proceeds of which were used in part to redeem three issues of high coupon bonds -- I shouldn't say redeem. They purchased at the market portions of three issues of high coupon bonds.

Q. With respect to the $400 million sale that you

j30

just mentioned, Mr. Brennan, do you know what the interest rate was with respect to that sale?

A. Yes. On the long-term piece, that is the 29-year obligation, the coupon rate was 11.75 percent.

Q. How much of the sale was at the 11.75 percent rate, what percentage of the total sale? Do you know?

A. You mean of the $400 million?

Q. Yes.

A. I'll tell you the precise figures on that. One was $250 million, the other was $150 million.

The 11.75 percent series due the year 2014 was $250 million.

The other one was a $150 million issue that had a coupon rate of 10-7/8.

I might say for clarification that the cost rate to the company to maturity for both issues is significantly higher than either the 12.75 or 10-7/8 percent.

Q. Can you tell me why that is, Mr. Brennan?

A. Because in part the proceeds were used to redeem three series of bonds by buying them at the market at a market premium to avoid paying a composite interest rate of -- continuing to pay a composite interest rate of 18 percent. So in developing the cost rate for these issues, one needs to take into account the premium paid to get rid of the approximate 18 percent interest rates on the three

j31

series retired in part, as well as the issuance and selling expenses on the new issue, and the unamortized issuance and selling expense related to that portion of those three other issues that were retired early to avoid continuing to pay 18 percent.

When you take all of those factors into account, the cost to the company was considerably higher than is the coupon rate on either of those two issues.

Q. Mr. Brennan, you mentioned that the proceeds of the $400 million sale were used in part to offset -- or with respect to bonds or high interest bonds that the company has made a tender offer to redeem; is that correct?

A. Correct.

Q. Could you turn to Schedule 4 of your exhibit?

A. I have it.

Q. You do have it?

A. Right; yes.

Q. Would I be correct that the bond series that the company has offered to redeem are the bonds listed at 17-5/8 percent, 18-3/4 percent and 18 percent?

A. Yes.

Q. Mr. Brennan, do you see -- again, referring to Schedule 4, do you see in the listing of first mortgage bonds various series that are at rates higher than 11-3/4 percent?

j32

A. Yes.

Q. Do you know whether the company has any plans to redeem any of the bonds in those series?

A. Specifically, the -- I don't know which series it is off the top of the head. Most first mortgage bonds, including these high coupon rate bonds, were sold with a so-called "five-year no-call" provision, and so one is precluded by contractual obligation from calling them as technically as such until the five years expires.

There is one series that has a no-call expiration in June of 1986, and I would expect the company will call that in.

In addition, one can, on occasion, avoid the no-call provision by paying at the marketplace a premium -- if the money market is 12 percent and a bond has an 18 percent coupon, typically it sells at a premium -- redeem at the marketplace -- I should say buy at the marketplace and redeem bonds that way.

One has to then calculate the real cost rate. When you pay a premium to buy something with a higher coupon rate, in the new issuance and selling expenses one has to make the calculation of whether or not to avoid paying a 15 percent interest rate on a bond that was issued several years ago; when you take all of the costs associated with raising new money to replace the old money and the premium

j33

you have to pay to do it, and the issuance and selling expenses you have to incur to do it, and the recovery of the unamortized balance of issuance and selling expenses related to the old issue, it is a never-ending computation. And I am sure this company, just as it has recently demonstrated, is watching that very carefully and will take every measure to minimize the composite cost of debt.

MS. FERKIN: Mr. MacGregor, could I make a data request that I will detail for you: it's a sample of one of the contractual agreements relating to one of these high interest bond series that we have just been discussing.

MR. MacGREGOR: Sure.

MS. FERKIN: I will detail that for you.

That's all the questions I have.

Thank you, Mr. Brennan.

THE WITNESS: You're welcome.

JUDGE MATUSCHAK: Is there any other cross-examination of this witness?

(No response.)

JUDGE MATUSCHAK: If not, we'll take a ten-minute recess.

(Recess.)

JUDGE MATUSCHAK: Do you have any redirect?

MR. MacGREGOR: I have no redirect for Mr. Brennan, Your Honor, so we are ready to proceed to the next witness.

(Witness excused.)

JUDGE MATUSCHAK: Do you have another witness?

MR. MacGREGOR: The company's next witness is Mr. Albert J. Solecki, who is manager of the Budget and Control Division, Philadelphia Electric Company.

Whereupon,

ALBERT J. SOLECKI

having been duly sworn, testified as follows:

JUDGE MATUSCHAK: You may take a seat.

MR. MacGREGOR: Your Honor, I have previously distributed to the court reporter and to all parties and to Your Honor copies of the document entitled, "Pennsylvania Public Utility Commission versus Philadelphia Electric Company, Docket No. R-850152, Direct Testimony of Albert J. Solecki, Explanation of the Budget Process and Inflation Rate Assumptions." I would ask that it be marked for identification as PECo Statement No. 19.

JUDGE MATUSCHAK: So marked.

(Whereupon, the document was marked PECo Statement No. 19 for identification.)

DIRECT EXAMINATION

BY MR. MacGREGOR:

Q. Mr. Solecki, do you have before you a copy of the document that has been marked as PECo Statement No. 19?

A. Yes, I do.

Q. Is this in fact a copy of your direct testimony in this proceeding?

A. Yes, it is.

Q. Do you have any changes, corrections or additions to make to your testimony at this time?

A. One typographical error correction that was submitted with the errata on page 7, on page 7, line 16, the spelling of the word "review" in "U.S. long term review." Other than that, there were no changes.

Q. Mr. Solecki, with that change, if you were asked the same questions contained in PECo Statement No. 19 again today, would your answers be true and correct to the best of your knowledge?

A. Yes, they would.

Q. Would those answers be the same as those contained in Statement No. 19?

A. Yes.

JUDGE MATUSCHAK: On what page was that correction?

THE WITNESS: On page 7, Your Honor, line 16.

MR. MacGREGOR: Your Honor, I would ask that PECo Statement No. 19 be admitted as evidence in this proceeding.

JUDGE MATUSCHAK: PECo Statement No. 19 is admitted to evidence, subject to timely objections, questions or motions to strike.

(Whereupon, the document marked PECo Statement No. 19 was received in evidence.)

MR. MacGREGOR: Thank you, Your Honor. Mr. Solecki is available for cross-examination.

JUDGE MATUSCHAK: Is Staff ready?

MR. SMITH: Your Honor, we are ready.

CROSS-EXAMINATION

BY MR. SMITH:

Q. Good morning, Mr. Solecki.

A. Good morning.

Q. I am Veronica Smith, and I represent the Commission Trial Staff. I have very brief cross for you. With respect to your budget process at PECo, am I correct that generally what happens is, a preliminary budget is prepared by your division using a historical level, and then inflating that by the company's inflation factors, and is then presented to the bureaus or responsibility areas for review and variance?

A. For items of recurring cost, what we do is apply an inflation factor. That is established, what we call for the budget process, as the goal. And what the goal represents to the responsibility areas is a level about which they are to explain variances.

Q. So, they generally get what the company deems as the goals, and if there are any variances, that is what they make note of to the company?

A. What the responsible areas must do is review the dollar levels that are reported for each of the individual responsible accounts, and indicate whether or not they should be increased or decreased. Increases or decreases in the budget process then are required to be explained relative to that goal that has been established.

Q. Are the explanations required of significant deviations, or is there is a range that is acceptable?

A. With the on-line budget system, there is a range that has been established, and that is 10 percent and $10,000. However, the individual -- that's in order to get the budget data process.

In other words, if the budget data you are submitting is over or under in those areas of variation, then the system itself requires an explanation to be entered before the budget will be accepted.

However, in the review process that is done, there is no $10,000 or 10 percent limit. In other words, in terms of the explanation of an individual responsible area, whatever that responsible area -- and what we do is use a reasonable man approach or a reasonable person approach in reviewing the budget.

Basically that involves my staff reviewing each of the budgets on a responsibility basis and indicating whether or not a reasonable person would question the increase or decrease in a particular budget area.

Q. Let me just ask for clarification, the 10 percent that you are talking about, 10 percent or $10,000, is that over and above the historic plus inflation factor, or is that just 10 percent over?

A. The budget is reviewed two ways. It is reviewed relative to the prior year, and relative to goal. So, that applies to both, the prior year and the goal that has been established.

Q. For the 1985 budget, when was it prepared?

A. Actually, the overall budget process begins in July, in terms of reviewing departmental objectives and personnel requirements. If you are referring to the budget process where the actual dollar values are reflected, that process is usually -- around September is usually the heaviest period of time.

The budget goes through various reviews and then finally is finalized in January of the budget year.

Q. Now, when are the inflation factors generally determined by the company?

A. The inflation factors are generally determined around August. I think the budget instruction letter goes out in August. Yes, the budget instruction letter is dated August 1, and that instruction letter included what our estimates of the inflation factors were.

Q. And that letter that goes out, what was the inflation factor cited as --

A. The initial letter, the one that was dated August 1, the inflation rate was 6.75 for 1985. That was subsequently adjusted --

Q. Go ahead.

A. -- down to 5.25 for 1985.

Q. What date was that adjusted?

A. The adjustment was made in November.

Q. For the historic test year in this proceeding, what was the inflation factor that was employed and how was it developed? Well, let me preface that. Your budget is done on a calendar year basis, is that correct?

A. Yes, that is correct.

Q. But the test year in this proceeding is not on a calendar year basis, isn't that also correct?

A. That is right.

Q. How was the inflation factor for purposes of the rate filing determined?

A. The rate filing was composed of a part year of 1985 and a part year of 1986. So, the inflation factor on the 1985 piece would have been 5.25, and on the 1986 piece would have been 6.4 percent.

Q. So, it was a composite of those two?

A. Yes.

Q. Let me understand that --

JUDGE MATUSCHAK: Excuse me. What was that for 1985?

THE WITNESS: The 1985 was 5.25, Your Honor.

JUDGE MATUSCHAK: And for 1986?

THE WITNESS: 6.4 percent.

BY MS. SMITH:

Q. So, in the historic test year, the actual inflation factor that's employed is the average of those two numbers?

A. No, that's not correct. The inflation factor that was present for the 1985 budget was 5.25 percent, and for the 1986 budget -- we budget on a 24-month basis -- was 6.4 percent.

For the test year ending June of 1986, you would have had six months of the 1986 budget, and six months of the 1985 budget.

Q. Okay, you didn't do an averaging? You merely applied it on a six months basis?

A. That's correct. And in terms of the inflation factor, the inflation factor, as indicated in the instruction letter, is again only a guide to be used in the absence of known cost changes. It's in effect --

JUDGE MATUSCHAK: What was the final test year inflation rate?

THE WITNESS: It was made up of two pieces, Your Honor. The 1986 piece had a 6.4 percent inflation rate in it, and the 1985 piece had a 5.25 percent inflation rate.

BY MS. SMITH:

Q. Are individual responsibility areas allowed any leeway with respect to inflation adjustments?

A. Oh, absolutely.

Q. They are?

A. The instructions to the individual responsibility areas are to give the best possible estimate of cost in that particular category. They are not bound in any way, shape or form to accept the inflation rate. They are not bound to use a goal.

Basically all they are told is, we want your best estimate of cost. Given what your past experience has been, an inflation rate applied to that will arrive at this number

That is not to be just accepted as a valid budget number, but it is a number that has to be reviewed for its accuracy and its applicability.

Q. If an individual responsible for the budget in one of the particular areas had deviated from the company's estimate that is provided by your office, the 6.75 and the

5.25, is that specific inflation rate quantified by that individual when he submits his budget estimates, the variances?

A. The reason for the variance is explained, up or down.

Q. And they give you the actual number they used and the basis for it?

A. The numbers may have absolutely nothing to do with what the inflation percentage is.

Q. Granted, as far as the numbers that they --

A. We get a variety of explanations, okay, in terms of why a particular number is up or down relative to goal and relative to the prior year, which is the basis upon which the budget is evaluated.

Q. My question goes more towards, in those instances where there is deviation from the inflation rate, is there an explanation given as to what the deviation is and why they have deviated, that is less or more?

A. If the deviation -- what we are explaining is the dollar deviation, not an inflation rate deviation, okay? So, if part of that explanation is an assumption on their part of an inflation rate other than what the corporate rate is, then yes, that would be part of the explanation, up or down.

MS. SMITH: Your Honor, I believe in the initial proceeding part of the case, you had requested that any discovery responses be given to you in writing, is that correct?

(No response.)

MS. SMITH: I will have one. Do you need to have me read it into the record?

JUDGE MATUSCHAK: I didn't hear you.

MS. SMITH: I'm sorry. I have a data request, and I have it in written form rather than request it on the record. If that would satisfy Mr. MacGregor, then I don't have to --

JUDGE MATUSCHAK: We had agreed a short time ago that you could make your data request orally on the record and also submit it in written form.

So, you can do both, so that in case we are reading the transcript, we will have it.

BY MS. SMITH:

Q Mr. Solecki, on page 4 of your testimony, you talk about the budgeting process, and I'm on line 16. The budgeting process begins with the development of objectives, initial personnel requirements, et cetera.

Would you explain how the initial personnel requirements are developed for the budget?

A Basically what happens is that the personnel requirements are developed on a responsibility basis. They are reviewed with each one of the vice-presidents in terms of personnel levels, and then each departmental vice-president sits down with the chairman of the board and the president of the company and reviews their corporate objectives, or their departmental objectives, which in fact are corporate objectives, and their requested personnel levels.

Those personnel levels, whatever gets approved as a result of that particular review meeting, are the personnel levels which each department is permitted to include in the budget.

MS. SMITH: Then as my data request, I would ask that the company provide a copy of its payroll estimate form and its association expense form. If you need the forms, I have the numbers.

MR. MacGREGOR: That will be fine.

MS. SMITH: Okay, thank you. That's all I have, Your Honor.

JUDGE MATUSCHAK: Consumer Advocate?

MR. RUBIN: Thank you, Your Honor.

CROSS-EXAMINATION

BY MR. RUBIN:

Q. Good morning, Mr. Solecki.

A. Good morning.

Q. My name is Scott Rubin. I am with the Consumer Advocate's Office. Initially, I believe you just stated under cross-examination by Ms. Smith that the inflation estimates which are used by the company in this proceeding were actually developed back in November of 1984, is that right?

A. That's correct.

Q. Could you tell us when it was decided that the same inflation rates would be used in this proceeding as had been developed by the company back in November of 1984?

A. The basis for the rate filing, to the best of my knowledge, is the 1985-86 budget. And that particular budget period is the period for which the data was available.

Q. So that, you made no attempt to recast the budget in any way to take account of perhaps a more current inflation estimate?

A. No, sir, we did not.

Q. Mr. Solecki, in developing your inflation estimate, did you look at estimates for the GNP deflator?

A. Yes. The inflation estimate is provided by the economist's office, and I believe in my direct testimony I indicated that there are a number of documents that that office uses in arriving at what the inflation rate is.

Q. Do you also look at estimates for the producer price index and the consumer price index, among others?

A. I believe that they are included, yes.

MR. RUBIN: Your Honor, I would like to have marked for identification as OCA Exhibit No. 2 a multipage document which is so marked in the upper right hand corner of the first page.

JUDGE MATUSCHAK: Very well, so marked.

(Whereupon, the document was marked OCA Exhibit No. 2 for identification.)

BY MR. RUBIN:

Q Mr. Solecki, OCA Exhibit No. 2 is a portion of the company's response to OCA Interrogatory, Set X, No. 1, specifically the attachment. We have only included the second and third attachments to that response, primarily because of the voluminous nature of the other attachments.

Are you the witness who is responsible for providing us with this information?

A. Yes, it was provided under my direction.

Q And is this information true and correct to the best of your knowledge, information and belief?

A. The information that was provided, as you'll note, the dates on the Statistical Bulletin are March of 1985, and that was after the determination of the inflation rate. The same is true with the Economics Department Report of Fidelity Bank, again, March 25, 1985.

These documents were submitted as representative of the kind of documents that were used to prepare the inflation rate. The only current document in terms of the preparation of the inflation rate is the document that you have excluded from this exhibit.

Q. Yes, Mr. Solecki, I am aware of that, and I was perhaps puzzled in your response to this interrogatory where you said that the attachment provides copies of some of these documents that were considered in developing the inflation factor.

Now, are you stating that the two documents which I have attached here were not in fact considered by you in developing your inflation factor for this case?

A. That is correct. The economists' office develops the inflation factor. These two documents, by the nature of being dated March of 1985, with an inflation rate determined in 1984, obviously were not considered. Documents similar to them were.

Q. Now, the documents which I have attached to OCA Exhibit No. 2 and which you have provided to us, were those available to you prior to the time when this rate proceeding was filed by the company?

A. Yes, they would have been.

Q. Mr. Solecki, could we turn to the first attachment in OCA Exhibit No. 2, and that's the Statistical Bulletin published by the Conference Board.

A. Yes.

Q. Could you turn to pages 8 and 9 of that report?

A. Yes, sir, I have it.

Q. Would you agree with me that the eight forecasts shown on these pages estimate changes in the GNP deflator for 1985 which range from 2.7 to 5.0 percent?

MR. MacGREGOR: For which time period, Mr. Rubin?

MR. RUBIN: For 1985.

THE WITNESS: Are you talking on an annual basis or a quarterly basis?

BY MR. RUBIN:

Q. Well, I believe the only information given here is annual numbers but presented on a quarter by quarter basis. I am just looking for the highest and lowest numbers in any quarter for 1985, and I think 2.7 is the low end and 5 percent is the high end.

A. Yes, that is correct.

Q. And looking at this information in the same way for the GNP deflator for 1986, would you agree that the range is from 3.3 percent to 5 percent?

A. Yes.

Q. Now, Mr. Solecki, the next document in OCA Exhibit No. 2 is the quarterly table as published by Fidelity Bank. Could you turn to page 12B of that report?

A. Yes, I have it.

Q. Would you agree with me that back in March of this year, Fidelity Bank was projecting a GNP deflator of

4.0 percent for 1985, and 4.9 percent for 1986?

A. Could you repeat those numbers, please?

Q. Yes, 4.0 percent for 1985, 4.9 percent for 1986. I am looking at, it would be the last two columns on the page, which give the annual figures as opposed to the quarterly numbers.

A. Yes, that's correct.

Q. Now, Mr. Solecki, in developing your inflation estimate for budget purposes, would you have the opportunity to examine the inflation estimate of the Value Line Investment Survey?

A. I can't answer definitively that that was one of the services that was utilized.

Q. Do you have with you a copy -- let me provide you with a copy of what has been marked in this proceeding as OCA Exhibit No. 1, which was just marked earlier this morning.

Now, in response to an Office of Consumer Advocate interrogatory, Mr. Brennan provided us with a copy of the Value Line Investment Survey's forecast dated August 9, 1985, and this appears as page 2 of 11 of the attachment in OCA Exhibit No. 1. Do you have that before you?

A. Yes, I do.

Q. And am I correct that this document dated August 9, 1985 would have been available to the company prior to the time when this rate proceeding was filed?

A. Yes, it would have.

Q. And am I also correct that this was not used by you in developing the inflation estimate which appears on the record of this proceeding?

A. I believe I answered that I could not be sure whether or not this particular report was utilized in the inflation factor determination by the economist's office.

From the date of it, it obviously was available.

Q. But this is not something which would have been available in November of 1984 when your inflation estimate was made?

A. No, that's correct.

Q. Fine. Could you turn to page 4 of 11 of the attachment, page 628 from the Value Line report?

A. Yes, sir, I have it.

Q. Would you agree with me that Value Line is projecting an implicit price deflator of 3.8 percent for 1985, and 4.0 percent for 1986?

A. Yes.

Q. And are they also projecting an increase in the consumer price index of 3.5 percent for 1985, and 4.2 percent for 1986?

A. Yes.

Q. And a producer price index increase of 0.9 percen for 1985 and 2.2 percent for 1986, is that correct?

A. Yes, that's correct.

Q. Now, Mr. Solecki, Mr. Brennan also provided us with a copy of a publication, part of a publication called "Trends and Projections," which is published by Standard & Poor's. That begins on page 5 of the attachments to OCA Exhibit No. 1. Again, is this document something that you think the company would look at in preparing inflation estimates, a Standard & Poor's publication like this one?

A. That's entirely possible.

Q. And again, would I be correct that from the date of this publication, June 13, 1985, this obviously was not incorporated in your inflation estimate of this case?

A. That's correct.

Q. Mr. Solecki, could you turn to what is labeled as page 6 of 11 of the attachment, it looks like it's page 6 of the Trends and Projections publication by Standard & Poor's.

Would you agree with me that Standard & Poor's back in June of this year was estimating that the GNP deflator for 1985 would be 3.7, and for 1986 would be 3.6 percent?

A. Yes.

Q. And would you also agree with me that Standard & Poor's back in June was estimating that the consumer price index would go up by 3.6 percent in 1985 and by 3.9 percent in 1986, is that right?

MR. MacGREGOR: Excuse me, what page are we on?

MR. RUBIN: That's on page 6 of 11.

THE WITNESS: I see the 3.6.

BY MR. RUBIN:

Q. Did you find the consumer price index entry, Mr. Solecki?

A. Yes.

Q. I'm sorry, did you agree with the numbers that I have read?

A. 3.6, I agree with.

Q. And 3.9 for 1986?

A. I don't see that number. Can you tell me specifically which column you're referring to?

Q. I'm looking at the top of the page, the third column, it says E, which I assume is estimate, 1986, and then in the next to last major heading on the page, "Prices and Interest Rates, Percent," the first entry, consumer price index, I believe is 3.9 percent under the 1986 column.

A. I'm seeing 4 percent on the right hand side, page 6 of 11.

MR. RUBIN: Could we go off the record a minute, Your Honor?

JUDGE MATUSCHAK: Yes.

(Discussion off the record.)

JUDGE MATUSCHAK: On the record.

BY MR. RUBIN:

Q. Do you have that number, Mr. Solecki?

A. Yes, I do.

Q. Mr. Solecki, the next attachment in OCA Exhibit No. 1 as provided by Mr. Brennan is a September 10, 1985 report from Blue Chip Economic Indicators. Again, do you believe that this type of report is something that would go into the development of the company-wide inflation factor?

A. This type of report, yes.

Q. But again, this particular report would not have been used in developing the inflation estimate for this case?

A. That's correct.

Q. Could you look at what's marked page 8 of 11 of the attachment, page 2 of the Blue Chip Economic Indicators report?

A. Right.

Q. Here there is a list of I think there is approximately 50 economic forecasting firms, do you see that?

A. Yes.

Q. Mr. Solecki, could you give us an idea of which of the firms on this page you would tend to rely on in preparing your inflation forecast?

A. I would have to provide that information. Off the top of my head, I don't know.

Q. If you could provide us with that, I would appreciate it.

Now, to try to pin down some of this while we are here today, I believe you have listed a number of the sources on page 7 of your testimony, is that correct?

A. Yes, I did.

Q. And among those sources were the Conference Board, is that right?

A. That's right.

Q. And would you accept that on this page from Blue Chip in September, 1985, that the Conference Board is projecting a 1985 GNP deflator of 3.7 percent?

A. Yes.

Q. And a 1985 consumer price index increase of 3.5 percent?

A. Yes.

Q. And I believe you also listed Chemical Bank on page 7 of your testimony as a source, is that right?

A. That is correct.

Q. And would you accept that in this summary from Blue Chip Economic Indicators, Chemical Bank is showing a 1985 GNP deflator of 3.1 percent?

A. Yes.

Q. And a 1985 change in the consumer price index of 3.2 percent?

A. Yes.

Q. Did you also list Morgan Stanley as a source you rely on?

A. Yes.

Q. Could you tell us what Morgan Stanley shows for the GNP deflator and consumer price index for 1985?

A. 3.8 percent and 3.8 percent.

Q. Could you do the same for Morgan Guaranty Trust and for Merrill Lynch, both of which I believe you listed on page 7 of your testimony?

A. Morgan Guaranty is 3.6 for the GNP and 3.5 for the consumer price index. What was the other?

Q. Merrill Lynch.

A. Merrill Lynch was 3.7 and 3.7.

Q. Mr. Solecki, would you agree with me that for these 50 or so forecasters, I believe the summary is shown at the bottom of the page, that their estimates range from a high of 4.1 percent to a low of 2.7 percent inflation, and that is looking at both the GNP deflator and the consumer price index for 1985?

A. Subject to check of all those numbers, yes.

Q. And would you believe the Blue Chip Economic Indicators has calculated the average inflation forecast for these 50-some firms to be 3.6 or 3.7 percent?

A. 3.7.

Q. And that's for the GNP deflator?

A. That's right.

Q. And it's 3.6 for the consumer price index?

A. That is correct.

Q. Now, Mr. Solecki, over on the next page of the attachment to OCA Exhibit No. 1, labeled page 9 of 11, there are estimates given which were made by various econometric services. Do you see those?

A. Yes.

Q. Do you believe that when Philadelphia Electric develops an inflation forecast, that it relies on projections made by various econometric services?

A. Yes, I believe it does.

Q. And would you know in particular which services the company might rely on?

A. Data Resources obviously is one; the econometric model from Fidelity Bank as I indicated in my direct testimony. Beyond these, in terms of specifics, I do not know.

Q. Now, Mr. Solecki, on page 9 of 11 of the attachment to OCA Exhibit No. 1, would you agree with me that these various econometric services are projecting inflation rates between roughly 3.5 and 3.9 percent for 1985?

A. Yes.

Q. And would you agree that for 1986, they are projecting changes in the GNP deflator or the consumer price index ranging between roughly 2.7 and 5.0 percent?

A. Yes.

MR. RUBIN: I would like to have marked as OCA Exhibit No. 3 a two-page document which we premarked in the upper right-hand corner.

JUDGE MATUSCHAK: Very well.

(Whereupon, the document was marked OCA Exhibit No. 3 for identification.)

BY MR. RUBIN:

Q. Mr. Solecki, OCA Exhibit No. 3 was taken from this past Sunday's New York Times. The date is a little fuzzy at the top, but it is December 8, 1985.

If you could look down toward the bottom of the page, underneath the main heading, "Prices," could you tell us what is shown for the GNP price deflator for the second and third quarters of 1985?

A. The third quarter of 1985 was 2.3 percent. The second quarter was 2.6 percent.

Q. Am I correct that those are annual rates of change in the price deflator?

A. That's correct.

Q. And for the consumer price index, again, the annual rate of change, if you look over in the last column, it says 12 months. Could you tell me what that rate was?

A. 3.2 percent.

Q. And looking down at the next entry, the producer price index, could you tell me what that has been for the last 12 months?

A. 1.1.

Q. Thank you, Mr. Solecki.

MR. RUBIN: Your Honor, that concludes my examination of this witness. At this time, I would like to move into evidence OCA Exhibits Nos. 2 and 3.

MR. MacGREGOR: I object to No. 3, Your Honor.

JUDGE MATUSCHAK: Yes. No. 2 is admitted in evidence.

(Whereupon, the document marked OCA Exhibit No. 2 was received in evidence.)

JUDGE MATUSCHAK: No. 3, you can defer that until you submit your direct testimony.

MR. RUBIN: Thank you, Your Honor.

CROSS-EXAMINATION

BY MR. ETTNER:

Q. Good afternoon, Mr. Solecki. I'm Mike Ettner, representing GSA. Let me ask you first to turn to page 7 of your prefiled testimony.

A. I have it.

Q. Starting at line 12 on that page, you indicate that the company's inflation factors that you are using in this case were developed in conjunction with the company's consultants. There are two companies, one Putnam, Hayes & Bartlett, and secondly, National Economic Research

Associates, is that correct?

A. That's correct.

Q. Mr. Solecki, could you describe for us what those consultants provided the company with, what exactly did they do for you in conjunction with development of inflation estimates?

A. I cannot answer that question. I do not have the knowledge as to their direct input into the determination of the inflation rates.

MR. ETTNER: Your Honor, could I inquire if there will be a witness among the PECo witnesses who could answer that question?

MR. MacGREGOR: We would be happy to provide the information. I don't know right now if there is a specific witness who could answer that question or not. I can get back to you on that.

MR. ETTNER: If that could be provided, thank you.

BY MR. ETTNER:

Q. Then I take it, Mr. Solecki, you could not answer the question as to why PECo felt it was necessary to hire these consultants to assist the company in development of such factors?

A. I was not part of the decision process that resulted in their hiring, so no, I don't know.

MR. ETTNER: As part of the response, I would also like to have answered the question, why the company felt it was necessary to use those consultants to assist the company in developing the inflation factors.

MR. MacGREGOR: We will provide that information.

BY MR. ETTNER:

Q. Mr. Solecki, also on page 7, a bit further down, you mention the firm Data Resources, Incorporated. Do you see that?

A. Yes.

Q. And you indicate that the inflation estimates that you are using in this case were roughly in line with those provided by Data Resources, Incorporated, is that correct?

A. That is correct.

Q. Are you aware of whether DRI forecasts are relatively high or low in comparison with econometric forecasting services?

A. No, I am not.

Q. As a general proposition, would you agree that there is some variability in the forecasts provided by different forecasters?

A. Oh, absolutely.

Q. So, would you further agree with me, Mr. Solecki, that it would be more reasonable to use an average of the forecasts of several forecasting services rather than to use the forecast of a single forecasting service?

A. We do not use the forecast of a single forecasting service. The statement in the testimony indicates that it is in line with the estimates provided by this forecasting service.

I also believe my direct testimony indicates that there are a number of sources that are utilized in the determination of that inflation factor, which is then used as a guide for the budget process.

Q. Would you agree that it would be more reasonable to use an average than to select any one particular forecasting service's results, as a general proposition?

A. In general, yes, I would agree with that.

Q. Let me direct your attention next to page 8 of your testimony. At the top of that page, you have set forth the company's inflation estimates to be used in this case, is that correct?

A. That is correct.

Q. The company's proposal represents an average of two different rates, namely the GNP deflator and a rate for wages, is that correct?

A. That is correct.

Q. Is that the same method used by PECo or proposed by PECo in the last rate case?

A. Yes, sir, I believe it is.

Q. Are you aware of the Commission's decision on that particular issue as to how to select an inflation rate in PECo's last rate case?

A. I know there was an inflation adjustment in the last rate case.

Q. What is your understanding of the Commission's decision with respect to which inflation rate to use, which process to use?

A. I was not aware of any Commission decision relative to the process of determining an inflation rate to be used as a guide for PE Company's budget, no.

Q. It is not your understanding that the Commission determined that the GNP implicit price deflator should be used?

MR. MacGREGOR: Objection, Your Honor. I believe the Commission Order speaks for itself. The parties can rely on it as they wish in their testimony.

JUDGE MATUSCHAK: Yes, I think that's a matter of argument.

MR. ETTNER: Your Honor, what I wanted to ask the witness was, if he understood that to be the Commission's Order, why is he making his particular proposal in this particular case.

JUDGE MATUSCHAK: We'll overrule the objection, if that's what you're seeking.

THE WITNESS: I was not aware that the Commission specifically prescribed to Philadelphia Electric Company how they should determine their inflation rates for the purposes of using that as a guide in preparation of their budget.

BY MR. ETTNER:

Q. Mr. Solecki, do you have with you a copy of the company's -- this would be part of the company's initial filing, Volumes I and II, or could you be provided that by your counsel?

MR. MacGREGOR: We will provide it.

(Documents handed to the witness.)

THE WITNESS: I have it.

BY MR. ETTNER:

Q. I wanted to ask you a few questions, since you are the witness testifying on the development of the company's inflation factors and how they are used in the budgeting process, I wanted to ask you how that information is reflected in this document.

Let me ask you to turn to a page which is labeled "Attachment II-D-1b." Have you found that?

A. Yes.

Q. What does that represent, Mr. Solecki?

A. That's a statement of electric operations for the 12 months ended June of 1985 and 1985, comparative statement.

Q. Sheets 2 through 6 of that attachment, what information is contained there?

A. Their explanations of the variations in the various accounts.

Q. Some of those variations can be explained because of an inflation factor being assigned to the base amount, is that correct?

A. Some of those variations are explained with inflation as being part of that variation explanation.

Q. What I wanted to know, Mr. Solecki, is: was the same inflation percentage applied to each and every item found in sheets 2 through 6?

A. I --

Q. Did you apply to each account the same inflation percentage, or was there some variation?

A. With the budget process?

Q. Yes, as part of the budget process.

A. The budget process, the inflation factor is not applied to a FERC account. It is applied to individual responsibility accounts, primarily departmental expenses, which ultimately clear to FERC accounts.

Q. Let me take an example, for example Account 500, which is balance sheet 2 of 6. The total variation is about $1.5 million, is it not?

A. Right.

Q. And in the narrative description under that category, it is indicated that part of the variation, namely $834,000, can be attributed to inflation, is that correct?

A. That is correct.

Q. What inflation factor is reflected in that inflation increase?

A. I don't know. I believe Mr. Carroll or Mr. Hill will support that explanation.

MR. MacGREGOR: That is correct, Mr. Ettner. This attachment was prepared by Mr. Hill and Mr. Carroll and Mr. Sileo, and they would be available to answer questions on that.

BY MR. ETTNER:

Q. Mr. Solecki, can you answer the question as to whether or not the inflation estimates that PECo is presenting are used as part of this rate case for any other purpose other than as is reflected in Attachment II-D-Ib?

A. Could you repeat that, please?

Q. With respect to the inflation estimates that you sponsor in your testimony, to what purposes are they put in this rate case other than --

A. The rate case is based on the 1985-86 budget. The inflation factors were developed as guides for responsible area people in preparing their budget for that year. They were guidelines around which various explanations should be provided.

The inflation rates per se were used as a budgeting tool in terms of providing a responsible area with a level of cost above or below which they should provide explanation.

Q. To your knowledge, are the inflation estimates that you developed used by the company for any purpose other than a budgeting purpose?

A. To my knowledge, no.

Q. Finally, Mr. Solecki, is it not correct that in August, 1985, PECo granted a general wage increase of 5.4 percent?

A. That is correct.

Q. And referring back to your testimony, page 8, the table at the top of page 8, is that 5.4 actual general wage increase reflected in your estimate for wage increase in 1986 of 6.8 percent?

A. That wage increase for 1986 stands on its own. In other words, the projection at the time the budget was prepared was for an increase in wages of 5.5 percent. The actual increase in wages was 5.4 percent.

The projection was for a 6.8 percent increase in 1986.

Q. Here today, are you predicting a 6.8 percent wage increase for 1986?

A. I have no basis to make a prediction on what that wage increase will be today.

Q. Thank you, Mr. Solecki.

MR. ETTNER: That's all I have, Your Honor.

CROSS-EXAMINATION

BY MR. RAINEY:

Q. Good afternoon, Mr. Solecki.

A. Good afternoon.

Q. My name is Charles Rainey, appearing on behalf of the City of Philadelphia. Mr. Solecki, you had stated that the inflation factors which were chosen for the years 1985, 1986, and also you show on page 8 1987 and beyond, were determined after review of several sources of forecast data, is that correct?

A. Yes.

Q. Mr. Solecki, can you provide for us, for each of those years, a range, with a lower bound and an upper bound, based on the forecast data which was reviewed?

A. I don't even know whether we have that information.

MR. RAINEY: I'd like to put that in the form of a data request, if that information is available. I would like that to be provided.

MR. MacGREGOR: We will provide whatever information is available.

BY MR. RAINEY:

Q. Mr. Solecki, in preparing the budget in this particular case, did you look at customer growth?

A. That is one of the factors that is considered, yes.

Q. And in looking at customer growths for the years 1985, 1986, and 1987 and beyond, what was the percentage of growth that you found?

A. I don't have that number. I believe Mr. Hoch will address sales growth and customer growth in his testimony.

MR. RAINEY: Mr. Hoch, is that correct, counselor?

MR. MacGREGOR: What's the precise number you want?

MR. RAINEY: The percentage of customer growth for the year 1985, 1986, and 1987 and beyond, what the source of that information is.

MR. MacGREGOR: Number of customers?

MR. RAINEY: Number of customers over present customers that was used in the budget process.

MR. MacGREGOR: We can provide that information.

BY MR. RAINEY:

Q. Also in the preparation of the budget, do you look at growth in customer usage, Mr. Solecki?

A. Yes.

Q. And would you be able to provide the percentage increases for the years with respect to that area?

A. In terms of total electric sales?

MR. RAINEY: I will put that also in the data request, and also ask for the source of that information.

BY MR. RAINEY:

Q. Would you tell us, Mr. Solecki, whether or not you considered growth in the Philadelphia economy in your presentation of the budget?

A. Economic conditions in our service territory are part and parcel of projection of sales for the budget process.

MR. RAINEY: I have no further questions, Your Honor.

MS. FERKIN: Your Honor, I have no questions.

JUDGE MATUSCHAK: Any further cross-examination of this witness?

(No response.)

JUDGE MATUSCHAK: Is there any redirect?

MR. MacGREGOR: Your Honor, I would have a couple of questions on redirect, if I could have about five minutes.

JUDGE MATUSCHAK: All right.

(Recess.)

JUDGE MATUSCHAK: Are you ready?

MR. MacGREGOR: Yes.

REDIRECT EXAMINATION

BY MR. MacGREGOR:

Q. Mr. Solecki, during your cross-examination by Mr. Rubin from the Consumer Advocate's Office, you were referenced to several national projections of the GNP deflator and the CPI, and recent projections of those inflation figures.

Are those national projections of inflation rates the sole basis upon which the company develops an inflation rate for budget purposes?

A. No, absolutely not. Obviously, our objective is not to forecast what a national inflation rate is going to be, but it has got to be more specific to our service territory.

In fact, as is in my testimony, the computation of the inflation rate includes a wage rate in the determination of that inflation rate.

Q. Why does the company rely on a wage projection figure in developing an inflation rate for the budget process?

MR. RUBIN: I object, Your Honor. I think that was fully developed in Mr. Solecki's testimony, and it was not questioned by any party on cross-examination as to why that was done.

MR. MacGREGOR: Your Honor, there was extensive questioning about the company's forecast of the inflation rate for use in the budget process. I think I am entitled on redirect to ask Mr. Solecki what role these national factors versus a projection of PECo wage rates have in the development of the inflation factor used by the company.

JUDGE MATUSCHAK: We'll overrule the objection.

THE WITNESS: The labor rate, as you can see from my direct testimony, is part and parcel of the computation of the inflation rate. In fact, it's an average of our forecast of the GNP and our forecast of what the labor rate is. That's how we arrive at the inflation factor, labor being a large portion of our costs.

MR. MacGREGOR: Thank you, Mr. Solecki.

That's all I have, Your Honor.

JUDGE MATUSCHAK: Anything further of this witness?

(No response.)

JUDGE MATUSCHAK: If not, the witness is excused.

(Witness excused.)

JUDGE MATUSCHAK: I have about 20 minutes to 1:00. Would this be a good time to recess?

MR. RUBIN: Could we go off the record a moment?

JUDGE MATUSCHAK: Yes.

(Discussion off the record.)

JUDGE MATUSCHAK: We will recess until 1:45 p.m.

(Whereupon, at 12:40 p.m., the hearing was adjourned, to reconvene at 1:45 p.m., this same day.)

AFTERNOON SESSION

(1:48 p.m.)

JUDGE MATUSCHAK: Are you ready to begin?

MR. MacGREGOR: Yes, Your Honor. The company's next witness today is Mr. Warren H, Smith, who is Manager of the Plant Accounting Division.

Whereupon,

WARREN H. SMITH

having been duly sworn, testified as follows:

JUDGE MATUSCHAK: You may be seated.

MR. MacGREGOR: Your Honor, I have previously distributed to the parties, to the court reporter and to Your Honor copies of a document entitled "Pennsylvania Public Utility Commission v. Philadelphia Electric Company, Docket No. R-850152, Direct Testimony of Warren H. Smith, Plant in Service Accounting Procedures and Controls."

I would ask that this be marked for identification purposes as PECo Statement Number 25.

JUDGE MATUSCHAK: It will be so marked.

(Whereupon, the document was marked as PECo Statement No. 25 for identification.)

DIRECT EXAMINATION

BY MR. MacGREGOR:

Q Mr. Smith, do you have before you a copy of the document that has been marked for identification as PECo

Statement No. 25?

A Yes, I do.

Q Is this in fact a copy of your direct testimony in this proceeding?

A It is.

Q Mr. Smith, if you were asked the same questions contained in PECo Statement No. 25 again today, would your answers be the same as those contained therein?

A Yes.

Q And would they be true and correct to the best of your knowledge?

A Yes.

MR. MacGREGOR: Your Honor, I would ask that PECo Statement No. 25 be admitted as evidence to this proceeding.

JUDGE MATUSCHAK: The motion is granted, subject to timely exceptions, objections and motions to strike.

(Whereupon, the document marked as PECo Statement No. 25 was received in evidence.

MR. MacGREGOR: Thank you, Your Honor.

The witness is available for cross-examination.

JUDGE MATUSCHAK: Staff?

CROSS-EXAMINATION

BY MS. SMITH:

Q Good afternoon, Mr. Smith. I'm Ms. Smith.

A Good afternoon.

Q In your testimony on page 8 you reference the CPR audit which was conducted by the PUC staff recently. Am I correct that the company has already received the results of that audit?

A Yes, we have.

Q And am I also correct that a number of changes have been suggested by the PUC staff?

A Yes.

Q And am I further correct that some of these items have been agreed to by Mr. Paquette from the company?

A Yes.

Q Have these changes yet been made on the company's books?

A No. The changes that we are not objecting to, which are all of the entries except 4, 9 and 13, we will record the correcting entries in the month of December.

Q With respect to the rate proceeding, will these items remain and be incorporated into the company's rate case?

A I would expect they should be, yes.

MR. MacGREGOR: Mr. Hill can provide the answer to that when he is cross-examined.

MS. SMITH: I assume that will be in the final accounting exhibit.

MR. MacGREGOR: Yes.

BY MS. SMITH:

Q Mr. Smith, on page 4 you indicate that the company follows the Uniform System of Accounts in keeping its records; is that correct?

A Yes.

Q Am I correct that the Uniform System of Accounts mandated by FERC and the Pennsylvania PUC, to which the company's plant records conform, provide certain criteria and guides concerning the classification of incurred costs of capital and maintenance?

A Yes.

Q Am I also correct that the Unified System of Accounts prescribes general and specific minimal listings of property items; for example, retirement units, additions to retirements the replacement of which must be acounted for in the utility's plant records?

A Yes.

Q Would the purchase, construction, replacement or removal of an item of property considered a retirement unit be generally classified as a capital cost?

A Yes.

Q And provided that a utility's practice is consistent in this area, does the Uniform System of Accounts allow utilities an option of using units of property smaller than the described retirement units in its property records?

A Yes, it does.

Q And if a utility opted to use smaller units of property, would the classification of costs for purchases, construction, replacement and removal generally follow those specified for retirement units listed in the Uniform System of Accounts?

A If the utility elected to use smaller units?

Q Yes.

A We would follow the smaller ones, which are on file with FERC and the PUC.

Q Am I correct that the Uniform System of Accounts considers all property other than retirement units as minor items of property?

A Yes.

Q Would you, therefore, agree that for a utility that has decided to use smaller than Uniform System of Accounts-prescribed retirement units in its plant records, minor items of properties then would consist of that property which does not constitute a smaller unit selected?

A No. The smaller units as defined by the company, which would be on file with FERC and the PUC, become the retirement units of the company, and they are smaller than those prescribed by FERC, and they would followed consistently.

Q Those units though which get smaller than your selected small units that are on file, would they be considered minor items?

A Yes.

Q Do PECo's plant records indicate retirement units smaller than those prescribed by the Uniform System of accounts?

A Yes, they do.

Q Am I correct that PECo has developed and compiled a list of retirement units included in its plant in service record for nuclear production facilities owned and operated?

A Yes. The retirement units are -- all but 322 account, reactor plant equipment -- the same as those employed in steam production, because the equipment is similar; but on the reactor plant we developed retirement units for the reactor plant, filed them with FERC, and just recently compared them to the retirement units which were issued by FERC for that primary account and found ours to be either equivalent to or smaller than those that were prescribed by FERC. So we are in compliance.

Q With the --

A With the Uniform System of Accounts.

Q Then the answer to my question is that PECo has developed and compiled a list of retirement units included in its plant in service record for nuclear production facilities owned and operated; the answer is yes?

A That is right.

Q Are these facilities subject to operational licensing by the NRC?

A No.

Q What is the percentage of ownership for PECo of the Salem Nuclear Generating Station?

A One is 42.49 and the other is 42.59; I forget which is which.

Q Would you accept 42.59?

A Yes.

Q Thank you. And the operation is done by PSE&G; is that correct?

A For Salem, yes.

Q Am I correct that PECo's plant records include the company's share of the cost of Salem?

A Yes.

Q Am I also correct that as the operator of Salem PSE&G has the primary resonsibility for classifying plant and related operating costs according to the Uniform System of Accounts prescribed by FERC?

A Yes.

Q Mr. Smith, am I correct that in 1979 and 1980 PECo and PSE&G, respectively, were required by the NRC to review, test, inspect, reevaluate and modify where necessary the safety-related piping system and masonry wall design at Peach Bottom and Salem?

A That is correct.

Q Am I also correct that the costs incurred for these undertakings or projects were generally capitalized in the plant in service account?

A Yes.

Q Is it true that the costs so capitalized by PSE&G for Salem will subsequently be reclassified to an unrecovered plant and regulatory study cost account, and that all related AFUDC accrued and accumulated depreciation taken will reverse as a result of the FERC audit of that company?

A Yes.

Q And that would be the audit that was conducted -- the four-year audit ended in 1982?

A Right. 1983.

Q Am I also correct that in about 1980 a problem of intergranular distress corrosion cracking was identified in the cooling pipes at Peach Bottom?

A Yes.

Q Is it true that during the following several years PECo endeavored to mitigate this problem?

A Yes.

Q And then am I also correct that the costs incurred to reweld these pipes using a then newly developed process was capitalized to plant in service account?

A No, the pipes were not rewelded. What was done was there was a process developed in Japan by General Electric, and it's called -- like you, I have to get this -- the induction heat stress improvement process. Basically what it is is the exterior of the pipe is rapidly heated while the interior of the pipe is kept cool. When the pipe then cools the granular structure around the weld areas becomes more dense, and it mitigates further cracking. You don't fix cracks with this process; you mitigate further cracking. There was no rewelding done.

We did do some weld overlays as a temporary fix, but that was all charged to maintenance.

Q Thank you. On the Commission audit of the property records the company had three areas in which they were in disagreement; is that correct?

A Yes.

Q And that was entry numbers 4, 9 and 13?

A Yes.

Q With respect to item number 4, am I correct that in February 1969 PECo initiated a project to install a new system operation of its computer system?

A Yes.

Q Am I also correct that the costs incurred were ultimately included in the plant in service account?

A Yes.

Q Furthermore, am I correct that as a result of the quality of the integrated curcuit cards and the electronic circuits supplied to the company, and because of an inadequate performance by the prime contractor, PECo incurred approximately $801,000 in increased testing and engineering costs?

A What you are talking about is a part of the $801,000 in question. We also had to, on our own, improve the manuals that were supplied to us for future maintenance. They tended to be inadequate for operating personnel to repair the units. This is a very high complex load dispatching automated system, and at the time it was on there were no standards in the industry. It was a leading edge type project, and we designed the system with the assistance of consulting firms. The system was tested out at 40 remote control locations, and what we experienced was significant travel time in recalibrating the instruments. We experienced failure with some of the instruments, and then we had to prepare all this additional documentation. That's the bulk of the $801,000.

Q But included in the $801,000 was the cost of revising the manuals?

A Yes.

Q What portion of the $801,000 was a direct result of the problems with the performance by the contractor or the quality of the circuit cards?

A I don't have that information with me. I could supply it.

Q Would you please?

A Yes.

Q Thank you.

Am I correct that PECo has made no attempt to recover these additional costs from the contractor?

A That is correct. The contract was a contract, I believe, let with the Rockwell Corporation. They, in turn, subcontracted it to many subcontractors, and our Legal Department reviewed the equipment that failed and they determined that it was not going to be a cost benefit to try and go after and sue these subcontractors; so basically what I'm saying is it would cost more to get it in legal fees than what you would get in return. I don't mean that --

Q We'll let that speak for itself.

With respect to entry number 9, Mr. Smith, I have some confusion as to that. The total amount was approximately $15 million that was involved. How much of that has the company disagreed with?

A Almost the whole thing. We have agreed to minor portions of it, and that will be corrected in December, but the portion associated with the safety-related piping problems and the heat or the cracking in the RHR piping we disagree with. The reason we disagree with it is that the work was done in 1979 and 1980 and added to plant in service at that time. In 1984 the FERC issued Order Number 390, which stated that regulatory studies of that type which produced little or no construction should be charged to a new account, 182.2, Regulatory Studies and Abandoned Plant.

It was our position that our accounting at the time in the year 1980 and in 1979 was proper because we had no guidance from any regulatory body along these lines, and that the cost of the work performed had none of the characteristics of maintenance, that it did have a life because if you didn't do the studies the license would be revoked for the station, and that the high cost of it, plus the fact that there were additions to the piping systems for supports, bolts and base plates, of which they are a part of the piping system, added a significant substantial addition to the already existing system, and it was then added to the cost of pipe. If I might add, Order 390 provides that -- and I'll quote, "This rule does not preclude a regulated company from accounting for unrecovered plant and regulatory study costs in accordance with rate proceedings."

We have had this in rate base since 1980; it's been depreciated for both book and tax purposes. What we would like to do is just leave it where it is and in the future account for these costs in accordance with the new rule.

MS. SMITH: I have two requests, one that we will be able -- he mentioned that it has been in rate base since 1980; if we could get the amount that has been depreciated already and the amount currently being depreciated.

THE WITNESS: Would that be for both book and tax purposes?

MS. SMITH: Both.

The other matter is I checked in that Mr. Paquette provided a response to the audit report, and we are missing two pages from that. I have reviewed Mr. Smith's papers and I have checked elsewhere, and two additional pages on item number 9 are not included in the packet to the Commission. There was an oversight of some sort, so if we could have those?

MR. MacGREGOR: They were not in your copies, or they were not provided to the Commission?

MS. SMITH: They were not in our copies, and I got a copy of the original that was sent to the Commission.

MR. MacGREGOR: I will hand you this document, and so I will answer that data request immediately.

MS. SMITH: Thank you.

BY MS. SMITH:

Q With respect to item number 13, am I correct that in 1976 PECo initiated a project to construct a two-mile 138 kV line from Callowhill to Delaware Substation?

A Yes.

Q Am I correct that this project is incomplete?

A Pardon me.

Q Is that project still incomplete?

A No, it's in service.

Q Is that item currently included in the rate base claim?

A Yes.

MS. SMITH: Your Honor, that's all I have for Mr. Smith. Thank you.

JUDGE MATUSCHAK: Mr. Rubin?

MR. RUBIN: Thank you, Your Honor.

CROSS-EXAMINATION

BY MR. RUBIN:

Q Good afternoon.

A Good afternoon.

Q My name is Scott Rubin. I'm an attorney with the Consumer Advocate's office.

Can we start by having you turn to page 4 of your testimony?

A I have it.

Q I am looking in particular at lines 8 through 13. Here you state that you oversee the accounting for capital expenditures which would be included in Accounts 101, 106 and 107; is that correct?

A Yes.

Q Do you also oversee the accounting treatment for land?

A Yes.

Q Under which account would land held for future use be reported?

A Account 105.

Q When would land be transferred out of Account 105 and into either Account 101 or 106?

A When the project which was being constructed on that piece of land was placed in service.

Q Is land ever transferred out of Account 105 into Account 107, Construction Work in Progress?

A No.

Q So even though construction is taking place the land, if you will, underneath the construction project or associated with the construction project is still classified as land held for future use in Account 105?

A Yes.

Q Could you turn to page 9, and I am looking at roughly lines 23 through 25. Here you state that capital authorizations which are open past their expected completion date must be explained by the responsible division; is that right?

A That is correct.

Q How far past the expected completion date must a capital authorization be open before it has to be explained by the division?

A It can't be very long because when we reach an estimated completion date, my division reports to the responsible vice-president that his capital authorization has gone past its estimated completion date. He then must either extend it or close it. And this report is reviewed quarterly by the President and the Chairman of the Board with the vice-presidents.

Q So would it be a matter of a week or two; or some time longer than that?

A I don't --

Q Well, I'm looking -- say hypothetically there is a capital project that had an estimated completion date of January 1st. And January 1st comes along and the project is not completed. You said that you would then report to the responsible vice-president; is that right?

A Yes.

Q And what sort of paperwork would you get back from that vice-president, or from his division?

A I would get a letter signed by him requesting that the completion date be extended, and a reason for it. If I don't get that letter, what I get is a signed off copy of the authorization, that it is in fact complete.

Q Within what time period would you get either of those documents back?

A It could take two or three months.

Q So that once the completion date has been reached, the estimated completion date, within two or three months you would get back a report -- let's say the project will continue, so you will then have a new completion date, and that could trigger the whole process again?

A Yes.

Q Mr. Smith, approximately how many times, say in an average month, would a project reach its estimated completion date without being completed, so that this process would be triggered?

A That's difficult to answer. We have several hundred open work orders, and the only ones that we report to the responsible vice-presidents are those that have gone past their estimated completion dates. He is allowed to extend that twice on his own authority. The third time he must write a supplementary authorization and run it through the approval process, where he and the other responsible vice-presidents and the President and Chairman, if necesssary, based on dollar values, review it and have to approve that extension.

Q Would you be able to estimate for us -- I'm just looking for a ballpark estimate -- how many projects in an average month or an average quarter might be reported to a vice-president because they are past their expected completion date?

A It depends on which vice-president we are talking about. Some of them write more authorizations than others. If you are looking at the company as a whole --

Q Yes, I am.

A -- it varies. I would have to tabulate that for you and report back. Maybe 20 -- maybe.

Q Is that a monthly figure?

A A monthly figure.

Q Why don't we treat that as subject to check, and if that turns out to be very inaccurate let us know.

Mr. Smith, would you have any way for estimating for us the dollar value which might be involved in those 20 or so construction projects each month which are delayed?

A No.

Q Is there some dollar amount to a project below which now this process would come into play?

A The process I'm describing right now applies to all authorizations that have an estimated cost of $20,000 or more. The same process is applied to authorizations which are commonly referred to as blanket orders under which you write job numbers every six months, so that we are continually checking to see if projects are completed; and if not, why not?

Q Mr. Smith, turning over to page 12 of your testimony -- and the reference here is roughly lines 3 through 20; you have described here some of the -- you state here that there are some special procedures which are used for monitoring large construction projects; is that right?

A Yes.

Q Could you tell us approximately how large a project has to be in order to fall under these special procedures?

Q You are saying where plant accounting does not get involved?

Q Yes.

A They would be projects where the company personnel is really not the constructor. We have hired an architect/engineer. Limerick is an example of that.

Q Would there be -- would you know of any other projects currently being undertaken by the company other than Limerick where an outside architect/engineer has been employed?

A That are not in service or completed?

Q Yes.

A None to my knowledge.

Q So this procedure which you describe where plant accounting doesn't get involved in the construction process, itself, really only applies to Limerick; is that correct?

A To very large projects, additions of generating units, major transmission line work that would be done by an outside contractor; but you are talking very, very large projects.

Q And I believe you stated that the only project like that presently under construction would be Limerick; is that correct?

A Yes, I believe so.

Q Mr. Smith, when a project is under construction what amounts are recorded in Account 107 as construction work in progress?

A All costs on that project, all capital costs.

Q How often would those amounts be recorded on the books of the company?

A Every month.

Q So if at any given time, for example, I were to come to you and ask for the book balance in Account 107 for a particular project you would be able to give me the actual expenditures as of the close of the previous month?

A Yes.

Q And is there anywhere on the books of the company where the estimated total cost of a project which is still under construction would be reported?

A It's not recorded on the books of the company; it's on the face of the capital authorization that was written to approve that construction project.

Q Then the capital authorization form would contain an estimated total cost, but the books of the company would just show actual expenditures; is that correct?

A That's right, but we have a report that we prepare each month. That is called the Construction and Retirement report, and it is distributed to all responsible areas where authorized cost is shown, the cost for current month, the cost to date, and the amount available to them.

Q Thank you, Mr. Smith.

MR. RUBIN: Thank you, Your Honor. That concludes our examination.

CROSS-EXAMINATION

BY MR. ETTNER:

Q Good afternoon, Mr. Smith.

A Good afternoon.

Q I'm Mike Ettner, representing the GSA.

I also had some questions about the bookkeeping process involved as described in your testimony. Mr. Smith, starting at page 4 of your testimony, there is an extended discussion of the bookkeeping process involved in a construction project. Basically, if I understand this correctly, the process begins with Account 107 where construction work in progress is accounted for, and then would move to Account 106 upon completion of the unit, and then would move to Account 101 upon classification of the project?

A Yes.

Q Absent from your description was any description of time values, and I wanted to ask you: on average, how long does a large project, a large construction project, remain in Account 106 before it moves to Account 101?

A That is difficult to say because you have completion work on a project after it is placed in service. When it is placed in service it moves from 107 to 106. It is then considered plant in service once the Engineering Department closes the work order to us. Then we can start what we call the unitization process; and, depending on the size of the project, it can take anywheres from three months to two years to unitize that project.

Peach Bottom, for instance, took four man years to unitize.

Q What do you estimate for Limerick?

A Much quicker. We're prepared for Limerick. We have an automated unitization system in hand. We are working with Bechtel to assure that costs that they are reporting are coming in to the proper field cost codes, which in turn become retirement units; and I would expect -- my goal is one year after date in service.

Q Now, a project is moved into Account 106 when it is completed; is that correct?

A Either in service or ready for service.
Normally it is the in-service date.
Q Are all of the construction projects in Account 106 placed in service immediately upon completion?
A Normally it is when they are energized.
Q So the answer to my question is yes?
A Yes.
Q Was that the experience with Salem 2, for example; or was there not a lag between the time that Salem 2 was completed and the time it was placed in service?
A No, but the generating station -- a responsible vice-president, normally the vice-president in charge of constructing the project, will declare the unit in commercial operation. There is a difference on a generating station from synchronization to date of commercial operation. Synchronization means you are now tied into the transmission system. Date of commercial operation means that the Electric Production Department is willing to accept it as a base load plant.
Q Is there not a further distinction between a plant being in service in the sense of putting out kWs for the system, and the plant being available for service?
A I think I just explained that. With a large base load plant you have a period of time from when it is synchronized and actually producing kilowatt hours of electricity

to the point where it is declared in commercial operation. This happens on all large generating plants. During that period of time any power generated by the unit, the value of that energy will be used to reduce the cost of the plant, and any fuel consumed will be added to the capital cost of plant.

Q When a plant is retired and no longer used and useful, the remaining undepreciated amount associated with that plant in Account 101 is deleted from rate base; is that correct?

A If it were retired either on or after it terminal date, yes. If it were not, you would have an unrecovered cost that would probably have to be recovered over some period of time.

Q Mr. Smith, in your capacity as the company's accounting expert, would you agree that a plant that is not used and useful should not be included in Account 101?

A Not necessarily, no.

Q Could you explain please?

A You have spare equipment. We have at some of our generating stations spare spindles, which are high cost items that are kept for continuity of service. You just can't call up a supplier and order one of these things. They take years to build. We have equipment like that in the generating stations.

Q Finally, Mr. Smith, are there ever times within your division with respect to major generating and major construction projects that a concern arises on your part as to whether or not a plant is properly within a given account, be it Account 101, 106 or 107? Are there times when a decision has been made to move it into one account and then later a concern arises that perhaps it is not in the proper account and maybe it should be moved back; has such an instance ever arisen?

A Do you mean from construction work in progress to plant in service and back again?

Q Yes.

A No, not to my knowledge.

Q The decision to place a given plant within one of these three accounts, is that a decision of your division?

A Yes.

Q A decision that you make?

A It's more a function of data that is reported to us. Once the Operating Department or the Engineering Department reports that a plant has been placed in service, we then move it from Account 107 to 106, start up the depreciation and stop the accrual of AFUDC. When we finish unitizing that construction project, which is breaking it up into all of the various retirement units, we then set that up in Account 101 and reverse the costs out of Account 106.

Q And again, in recent years, in the recent experience of Philadelphia Electric Company with respect to bringing into actual service nuclear power plants, has that ever caused concern from your accounting perspective with respect to whether that plant is properly within a given account?

A No.

Q In other words, those engineering type problems do not have any effect on your accounting area?

A The engineering type problems that you are describing are resolved by the Engineering Department and the station operating people, and the station operating people -- if you had big problems like that, they would not accept it as a base load plant, and we would not be notified that it was placed in commercial operation.

The notification of placed in commercial operation is going to move it from work in progress to completed construction.

Q Thank you, Mr. Smith.

MR. ETTNER: That's all I have, Your Honor.

MR. RAINEY: I have no questions for this witness, Your Honor.

JUDGE MATUSCHAK: Is there any other cross-examination of this witness?

(No response.)

JUDGE MATUSCHAK: Is there any redirect?

MR. MacGREGOR: Could I have a short break?

JUDGE MATUSCHAK: Yes.

(Recess.)

JUDGE MATUSCHAK: On the record.

MR. MacGREGOR: I have no redirect, Your Honor.

JUDGE MATUSCHAK: Thank you.

(Witness excused.)

JUDGE MATUSCHAK: Do you have another witness?

MR. MacGREGOR: No, Your Honor. That completes the witnesses that we have for today. We have three witnesses for tomorrow, Dr. McLeod, Mr. Wright and Mr. Wroblewski; and Mr. Hill will also be available to the extent that we have time to get to him either Wednesday, Thursday or Friday.

MS. SMITH: I would prefer Thursday or Friday.

JUDGE MATUSCHAK: Perhaps some other parties could do their cross.

MS. SMITH: Other parties could go ahead if that is their wish, if they want to go forward with Mr. Hill tomorrow.

MR. MacGREGOR: Is there any sense of how much cross there will be for the witnesses tomorrow?

MS. SMITH: I have none for Mr. Wroblewski.

MR. RUBIN: Could we go off the record?

JUDGE MATUSCHAK: Yes.

(Discussion off the record.)

JUDGE MATUSCHAK: On the record.

It appears that all of the testimony has been submitted at this hearing, and we will adjourn until tomorrow morning at 10:00.

(Whereupon, at 2:30 p.m. the hearing was adjourned, to be reconvened at 10:00 a.m. on Wednesday, December 11, 1985 in Harrisburg, Pennsylvania.)

C E R T I F I C A T E

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

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