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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
Further hearing.	

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Hearing Room 1
State Office Building
Broad and Spring Garden Streets
Philadelphia, Pennsylvania

Wednesday, January 22, 1986

Met, pursuant to notice, at 10:05 a.m.

BEFORE:

JOSEPH MATUSCHAK, Administrative Law Judge

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P R O C E E D I N G S

ADMINISTRATIVE LAW JUDGE JOSEPH MATUSCHAK: The first thing we will have is the oral argument on the motion to strike.

Who wants to proceed first? Do you want to proceed first, Mr. Hall?

MR. HALL: Your Honor, I can proceed first. I would like to reserve time to reply, however, to the arguments of the Staff and the Consumer Advocate.

JUDGE MATUSCHAK: We will give you a chance to reply. You may proceed first.

MR. HALL: Thank you, Your Honor.

Your Honor, we received late yesterday the Commission's order on the Material Question Petition that we had filed and have had a brief chance to review that. As we understand the Commission's order on the material question, the Commission, in its ordering paragraph two, has affirmed Your Honor's ruling of December 20. That ruling provided that evidence related to the issue of reasonableness or unreasonableness of the company's decisions to delay completion of the Limerick plant in 1976 and 1978 would be stricken from the record.

In compliance with that order, Prosecutory Staff on January 3rd filed with Your Honor and the parties a motion to strike five pieces of testimony which had been submitted by the company. We have reviewed those five pieces of testimony and have provided Your Honor with a brief whereby we set forth our view that the majority of this material does not direct itself at all to the question of the reasonableness or unreasonableness of the company's decisions with respect to the construction pace in 1976 and 1978.

Two of the pieces of testimony, principally being that of Mr. Boyer and also that of Dr. Hieronymus, in our view do not address in any respect issues related to whether the company's decisions as made in 1976 and 1978 were reasonable or not reasonable. Mr. Boyer's testimony simply seeks to present to Your Honor data which will assist Your Honor in resolving the quantification issues and assessing whether and to what effect those specific decisions had upon the completion dates of the Limerick plant. Dr. Hieronymus's testimony similarly presents data of that nature to Your Honor.

In our view those two statements clearly contain nothing that could be struck under Your Honor's ruling.

Now, with respect to the other three statements, that of Mr. Paquette and Mr. Abrams and that of Dr. Perl, I think it's useful to divide those by taking Mr. Paquette's and Mr. Abrams' testimony first.

Those statements provide to Your Honor two sets of information, as outlined in the company's brief. First, they provide data which could be used to measure the reasonableness or unreasonableness of the company's decisions. However, they also provide data which in the company's view will assist Your Honor and is intended to assist Your Honor in resolving the quantification issue.

In the company's view, this data will permit Your Honor to determine to what extent financial constraints, cash constraints, upon the company during the construction period required an extension of the time period to complete those units.

JUDGE MATUSCHAK: Didn't the Commission, in imputing the reasonableness, resolve the issue of financial constraints in their investigation? When they found unreasonableness didn't they pass upon that portion of the testimony in the investigation, that is, the financial status of the company?

It would seem to us that that was one of the prime determinations as to whether the matter was reasonable or unreasonable, whether the delays were reasonable or unreasonable; and the Commission, as we recall, seemed to indicate that the company had the financial ability to proceed and not delay.

MR. HALL: Your Honor, I don't read the order to say that. I believe that is not correct.

The Commission, as I read the Commission's order, did say that merely because there was financial constraint that that would not necessarily render the company's decision reasonable. And they did, I believe, indicate that financial or cash constraint would not be a showing that could avoid an unreasonableness finding.

However, there is a very different question at issue here, and that question is the effects of cash constraint as an external force upon the company's ability to complete the plant.

JUDGE MATUSCHAK: We agree, and during the cross-examination of Mr. Abrams I believe we stated, that although some of the evidence would not be admissible on the question of prudency, that same evidence might be admissible on other grounds, on the grounds of quantification. Our problem is where to draw that line.

The trouble with your answer is it's your position -- the company's position has been to dismiss the motion to strike in its entirety; and it seems to us that some of the testimony that you present on the basis of quantification is a rehashing or a relitigation of the issues that the Commission utilized in determining whether the delays were prudent or not.

We are not going to go into the issue of the financial constraints of the company, the load history or planning stages and excess capacity and all that on the grounds of quantification. We think we are way beyond that.

Now, there are some items, we will agree, that are in the testimony that the motion seeks to strike -- well, let me put it this way: we will determine that any of the testimony that the motion to strike refers to, that none of that testimony will be admissible for the purposes of showing prudency because we feel that the Commission has already determined that question, that those delays were imprudent. We are not going to admit the testimony for that.

We will agree with the company's position that just because the testimony is inadmissible for some purposes it may not be inadmissible for all purposes.

One item, for instance, the first item to be stricken, according to the motion, is where Mr. Paquette makes the statement, "Now I will discuss the '74, '76 and '78 delays." The Staff wants to strike the "'76 and '78" out of that testimony. We think that is really going too far, now.

We don't think that the Commission indicated that PECo could not discuss the '76 and '78 delays. The question is they can discuss the '76 and '78 delays as far as quantifying the effect of those delays as they arise out of the decisions of the company.

But I think as far as financial constraints on the company, questions of fear about excess capacity and things of that sort, we think that is beyond.

However, we want to hear the rest. You may proceed.

MR. HALL: Thank you, Your Honor.

Your Honor, the company believes that it understands the Commission's order and Your Honor's ruling on this matter. It is the company's position that the evidence that it has present, that the majority of it can go to the quantification issue or is intended to go to that issue and solely to that issue in many instances. The company seeks that this evidence be admitted into the record to be used for that purpose only.

The company does not feel that Your Honor can go through and strike individual pieces of testimony, individual lines and individual questions and answers, on the grounds that they might not go to quantification.

JUDGE MATUSCHAK: Well, we will say this: that where the testimony definitely does not go to quantification we feel it should be stricken; where the testimony goes to quantification it should not be stricken. But between those two extremes there may be some questions where there is some doubt as to whether it should be stricken and whether it refers to quantification or not, and where there is such doubt we believe we should resolve that doubt in favor of the company.

But we believe that there are some items that the company wishes to retain that definitely refer solely to the prudency of the delays rather than quantification.

Now, what we want to have from both parties here is some help as to further evaluating the dividing point between these two extremes. I think in reading the Staff's motion, the brief in support of the motion, and in reading the company's brief in support of objections to the motion, we think that both sides have gone to the extreme. We think that the Consumer Advocate's brief was more to the point than either of the briefs of the Staff and PECo.

Now, if you want to argue whether the constraints, financial constraints -- how can you agrue that the financial constraints are an element in the quantification, Mr. Hall?

MR. HALL: Your Honor, I believe that the cash constraints and the financial constraints upon the company are externally imposed circumstances; and I think the Commission recognized this in its order.

The Commission's order does find the company's decisions and the announcements that it made arguably unreasonable under the interpretation of that order that Your Honor and the Commission have adopted. However, that does not go to the question of whether or not they may have been effects of those factors which extended the schedule of the plant which should be recognized as quantification.

JUDGE MATUSCHAK: That's what we want to hear and rule on, the effect of the delay decisions. We don't want to know why the decisions were made, what prompted those decisions or what the concerns of the company were in making those decision. We think we are beyond all that.

What we want to know is what the effects of those decisions were on the cost of Limerick 1. Maybe there are some outside NRC ruling or some other elements that may have effected some of that delay.

But as far as the concerns of the company about their financial position, about the market response to continuing with the construction, their concerns about the load, their concerns about excess capacity and all that, I think we are way beyond that and those items, those matters, we think, should not be in the record of this proceeding. We don't think they have anything to do with the quantification.

We want to stress the effects of the company's decisions in ordering the '76 and '78 delays.

MR. HALL: If Your Honor will permit me to speak hypothetically, it seems to me that there are two ways in which cash constraint can affect the length of the Limerick schedule which were not adjudicated by the Commission in the first Limerick investigation.

First, the company's financial position and any effort to try and build the plant to a faster schedule would have required the raising of additional funds. It may be in examining whether the company could raise those funds or not that in point of fact they could not in the markets during the time periods that are at issue. If that is in fact --

JUDGE MATUSCHAK: That may be so. That point was argued before the Commission and the Commission has not accepted that argument. The Commission accepted the argument that the company was financially able to proceed. We are not going to go into that now.

Nor are we going to go -- some of the expert witnesses seems to want to go into the feasibility and the wisdom of constructing Limerick 1 in the first place and the planning of it and all that. That testimony, we could strike it of our own accord but we would prefer it be done in an adversary fashion and we will expect Counsel to call that to our attention.

The Commission found that the original decision to construct Limerick was reasonable, that the '74 delay was reasonable. Now, we go beyond that. The concern here is for the '76 and the '78 delays and not with the motivation of the company, the concerns of the company, the concerns about excess capacity, the concerns about all that. We feel that that has nothing to do with the quantification.

Now, one of the items, for instance, of quantification may be the extent of the delay in construction by NRC requirements. There may be an offsetting claim by the company that if they had proceeded the consumer would have paid an additional increase in rates for the time being due to the fact that it was already in operation. Those are the offsetting things and the costs strictly related to the effects of the decisions of the company, and we are not going to go beyond that.

Now, Mr. Delaney, we will hear you for a few minutes and Mr. Hall may respond.

MR. DELANEY: Your Honor, at this point we have filed two briefs with you. I think Mr. Hall misspoke because the Motion to Strike addresses six pieces of testimony, not five.

JUDGE MATUSCHAK: Well, Mr. Delaney, before we start off on that, you're not contending in this stage of the proceeding that the company is prohibited from discussing the '76 and '78 delays, are you?

MR. DELANEY: It depends on the purpose of the discussion.

JUDGE MATUSCHAK: Well, in Mr. Paquette's testimony the first item you have to strike is where Mr. Paquette says something to this effect: "Now I want to discuss the '74, '76 and '78 delays," and you want to strike the " '76 and '78" out.

Why? Do you mean that he can't talk about the '76 and '78 delays? That's ridiculous.

MR. DELANEY: Mr. Paquette's testimony, Your Honor, is a good example of what I think to be the problem with the company's case. We introduced Mr. Paquette's prior testimony in the Limerick 1 case as Staff Exhibit 15, to my recollection, and I think if you will examine it you will find that it's identical in many respects -- almost all respects -- to the testimony in the present case. Mr. Paquette, it seems to me, to be relitigating a lot of the stuff that he testified to initially and it's immediately obvious, in my view, because if you read the Commission's order and Judge Klovekorn's initial decision you will see much of it comes right from Mr. Paquette's testimony.

I think what his testimony in particular -- in fact he even incorporates as an Appendix A to his testimony -- or maybe it's B -- the prior Limerick testimony. I think what his present testimony indicates is an effort to bolster the company's first position by responding to criticisms in the Commission's prior order. If you get the two and lay them side by side you will see that there are strategic additions to his first testimony that are responsive to criticisms in the Commission's order and findings.

I think of all the people, Mr. Paquette, and to some extent Mr. Boyer, obviously if you read the Commission orders and the initial decision and compare it against what they are testifying to you will see that it's practically the same.

First of all I submit that our motions to strike -- and I would note at this point we filed an Amended Motion to Strike which simply added a couple of sentences in Mr. Paquette's and Mr. Perl's testimony, and we did that because the company said in its brief our motion was inconsistent. So we added a couple of paragraphs.

But we tried to be conservative on what we moved to strike. You will note that we never after all of the testimony of certain witnesses. But I've tried to read it carefully and I think for you to resolve what should be stricken you have to sit and read the entire testimony because I think it's the tenor of the discussion and what the point that's trying to be established in the discussion and in the present testimony that should really be a guide as to what's acceptable and what is not.

In my view, many of the things that we have identified in the Motion to Strike is testimony that goes to suggesting that the Commission mistakenly decided imprudence in the '76 and '78 delays.

JUDGE MATUSCHAK: In your view what are the items of quantification that you think the company is entitled to address?

MR. DELANEY: I would think that the -- I agree with your statement that you made to Mr. Hall that things that examine elements previously examined in the Commission order should not be reviewed in this case. And I, in my reply brief, have quoted language from the Commission's order which says that the evidence that should be admitted in this proceeding is that which measures the increased cost to the ratepayers.

I think the problem, in my view, with the company's presentation in this case is that it is simply re-introducing large amounts of information that was reviewed by Judge Klovekorn and the Commission in the prior proceeding and really should not be re-introduced in this case; and I don't see the nexus that the company has argued that these things immediately go to quantification.

I think that much of Mr. Abrams's testimony, much of Mr. Paquette's testimony, portions of Mr. Boyer's testimony all are designed to go these things and --

JUDGE MATUSCHAK: Let me ask you this: would you agree that the company can refer to the '76 and '78 delays?

MR. DELANEY: Refer to them?

JUDGE MATUSCHAK: Refer to the '76 and '78 delays and to show what, if any, extent the delay in completing construction of Limerick 1 was due to NRC requirements?

MR. DELANEY: That's a good example, Your Honor. If you will note, we did not move to strike any portion of the major NRC witnesses sponsored by the company. Mr. Kemper is not the subject of any motion. The Exhibit 2 we did not address, which is the one that summarizes the NRC effects.

The position that we have taken on this is that things previously examined in the prior proceeding have no purpose in this proceed.

Now, the company has raised these NRC matters as independent -- in effect post-record effects from the '80 investigation. I note that the company suggests that we have striken some of that in some of the people that our motion addresses. But really our intention was, I thought, that when we did hit NRC material on those other witnesses it was in the context of them addressing reasonableness.

I think that the company can introduce evidence that goes to quantification. I think the NRC may be one of those things, and we did not really go after that in our motion.

So I think that they can address some of these things. But, again, the purpose that you have to look for, what you have to guide you, is the purpose of the testimony; and in many of the portions of the testimony that we have moved to strike the witness begins the discussion in that portion of the testimony by answering a question that references the Commission prior decision. Mr. Paquette very straightforwardly says, "I believe that the Commission misunderstood the evidence in the prior proceeding," and then he restates practically all of his old testimony. And those are the types of things that should not be in the record.

JUDGE MATUSCHAK: Any of that testimony that relates to reasonableness, we are not going to consider and we direct

Counsel that they will not refer to that testimony in support of the reasonableness of the company's decisions in '76 and '78. That matter, as far as we are concerned, has been resolved with the Commission.

Any testimony we refuse to strike, we will provide that that testimony is to be admissible solely for the purpose of quantifying the increase in cost of Limerick as a result of those decisions.

MR. DELANEY: Your Honor, if I might say one further thing, the company has developed in its briefs and I think when you begin to read the testimony carefully, sometimes there are elements where a lot of this is addressed simultaneously by the witness.

JUDGE MATUSCHAK: Don't you agree that if there is some question of doubt we should resolve the doubt in favor of admissibility rather than striking it?

MR. DELANEY: Well, that's a matter of discretion, Your Honor. That would have to be a judgement by the person making the decision.

JUDGE MATUSCHAK: Well, if the case goes up won't it be safer to admit it and then determine whether or not we will give any weight to that testimony rather than to strike it and then to have a remand from the Commonwealth Court?

MR. DELANEY: Generally I think that would be correct, Your Honor, but again it would have to be on the particular. Everyone would have to draw a line and see whether it went over it. It's not easy to talk in an abstract sense.

But, again, I would just say that we tried to be conservative in the motion to strike. We recognize, certainly, that the company has the burden in this case and we do not wish to interfere with that unnecessarily. I did make an effort to be careful in what we moved to strike. You will see that there are pages here, pages there. Some of the things identified in the motion are simply lines on a page. It's not a wholesale effort to gut the testimony of any particular witness. We did look at it in the way of trying to narrowly remove certain discussions.

JUDGE MATUSCHAK: I think both you and the company have gone to extremes. You practically want to rule out all of that testimony and the company wants all of it in. I think both of you have reached the extremes.

MR. DELANEY: Well, Your Honor, I would say that all of the things identified in my motion have some connection with discussions of reasonableness, and it's my position that all of the --

JUDGE MATUSCHAK: How are you hurt if we do make an error and determine not to strike some portion of the testimony if it's at the same time ruled that that testimony is not to be relied upon, is not admissible, as to the prudency or imprudency of the '76 and '78 delays? How would anybody be hurt by that?

MR. DELANEY: Well, I see the restriction that you're placing on the evidence as applying only to the Commission proceedings. I think on subsequent appeal the evidence would be used, I'm sure, in the company's brief before the Commonwealth Court.

JUDGE MATUSCHAK: If we admit it solely for the purpose of quantification and we specifically state that any of that statement is not admissible on the question of reasonableness or unreasonableness of the '76 and '78 delays, how could anybody be hurt by it?

MR. DELANEY: Your Honor, that would be an acceptable result to us if you choose to go that way on some of the things that we identified in the motion to strike that you don't agree with.

JUDGE MATUSCHAK: If we feel that you might have gone overboard can't we consider that in the final adjudication?

MR. DELANEY: Well, I would take the position that if there are things that you feel that we have inappropriately identified in the motion to strike -- again I would reiterate my position is that they are all strikeable -- then I think that the appropriate thing for you to do if you choose to let some of it in is to put that kind of restriction on it.

JUDGE MATUSCHAK: Do you also agree that at the conclusion of this rate proceeding if we want to we can go back and strike what we have not striken before as not being related to quantification?

MR. DELANEY: That could be your choice, Your Honor. The concern I'm having is in the first case one of the company's -- it's kind of an interesting aspect to this -- the litigated issue in the first case was how should these things be evaluated by the Commission in judging whether the company was prudent or not, and there was a lot of litigation. What the Commission decided to do was to use what they called a reasonable care standard, and that said looking at all of the circumstances did they act reasonable at the time without trying to judge their actions on the basis of hindsight.

JUDGE MATUSCHAK: The only thing we are trying to prevent here is we are trying to prevent the necessity of the other parties in the case, including the Staff, of responding to some of that testimony and wasting our time and your time and your efforts if it is totally beyond the scope of our proceeding in this case.

MR. DELANEY: Yes, sir, and that was the purpose of our motion.

JUDGE MATUSCHAK: Aside from that, if we satisfy that, aside from that I don't think we could be hurt or anybody would be hurt, especially where there is some doubt about the testimony, by leaving it in with the qualification that that testimony is not to be relied upon and is not admissible for the purpose of showing the reasonableness or unreasonableness of the '76 and '78 delays.

MR. DELANEY: Your Honor, I think that would be a reasonable way to resolve portions of the testimony which you thought we had inappropriately moved to strike. But, again, I would say that I think it's all strikeable.

JUDGE MATUSCHAK: I think we should be concerned mostly with those items which are solely and clearly not related to quantification but are related solely to the question of the prudency of those decisions. I think if you had done that you would have done as much as you can to relieve the other parties from presenting testimony adverse to that testimony.

MR. WERSAN: Your Honor, before Mr. Hall responds may I make a statement?

JUDGE MATUSCHAK: Yes.

MR. WERSAN: The point which the OCA believes is key to understanding how to deal with the testimony submitted by the company is exactly the question of drawing the line. In our opinion I guess the term external factors comes to mind initially.

We have to operate under the assumption that if the Commission that the delays were unreasonable and that those delays were the result of company decisions, then we have to set areas within the company's management discretion or responsibility aside and view other factors which is why in the testimony we have filed of Mr. O'Brien and Dr. Hanauer we have reviewed what we consider critical path factors, NRC requirements, et cetera.

However, the company has referred to the financial constraints as an externally imposed condition and that, I think, is a key area of disagreement, certainly, that we have.

The Commission's decision was made in 1982. They had been aware of the company's financial condition through a number of rate cases --

JUDGE MATUSCHAK: Not only that but that matter was litigated in that investigation and I don't have the decision before me but I believe the Commission determined that the company was able to finance construction as originally planned. We think that clearly is out of the purview of our quantification issue.

MR. WERSAN: Okay. That was my main uncertainty.

The only other thing that I would like to state is that the company in its reply brief --

JUDGE MATUSCHAK: And by the same token, we are not going to recognize any testimony as to the imprudency of any original planning or construction of Limerick. On our own motion we say that if we take the Commission's findings we have to take them all. We have to take the ones where they found prudency and the ones where they didn't find prudency.

Some expert testimony seems to be back and relitigate whether Limerick should have been constructed at all and the wisdom of constructing it and the alternatives to it. That testimony has nothing to do with the quantification and we aren't going to permit that testimony and if the parties don't request that it be stricken we are going to strike it on our own motion.

MR. WERSAN: I don't think the Consumer Advocate's office was relitigated --

JUDGE MATUSCHAK: I don't think the Consumer Advocate has. I think one of the experts for one of the other parties started from scratch. My guess is that they may have presented the same thing in the investigation. I don't know whether they were in it or not. But it certainly is beyond us here in this case and we are not going to rehash that.

MR. WERSAN: Thank you.

There was one other thing that I needed to raise. In the company's reply brief, at page six, they characterize part of the testimony of Mr. O'Brien and discuss it in the context of external forces, such as restrictions upon the company's ability to prudently raise capital and the effects of NRC safety requirement changes is also addressed as part of the quantification issue by the Consumer Advocate. I feel I need to make it clear we did not address financing requirements in our testimony. We did address NRC requirements. I don't want the company's --

JUDGE MATUSCHAK: Let me ask you this: the company also, in some of the testimony that has been asked to be stricken, refers to the average cost of running like nuclear plants, and the company says if that is to be stricken how can the Consumer Advocate come in and use the same kind of testimony. Now, what is your position on that?

MR. WERSAN: So far, to date, as far as I know, in our testimony and our approach to this case where we have used other plants -- for example, we have cited to Susquehanna and LaSalle in Mr. O'Brien's testimony and Dr. Hanauer's testimony -- it was for the purpose of showing similar kinds of reactors that were under the same NRC requirements and restrictions to show that those restrictions would not have prevented earlier completion.

I think that is slightly different from comparing average costs of other plants to Limerick. However, personally I feel I must state a slight disagreement with Mr. Delaney -- and I don't mean to undercut him -- in that I don't particularly have a problem with the company saying their plant is an average cost plant because I don't think that means a whole heck of a lot.

JUDGE MATUSCHAK: What is the position of Counsel as it pertains to the company that even if the decision had not been made with regard to the '76 and '78 delays that because of the lack of manpower those delays may have been required in any event?

MR. WERSAN: Well, the company has stated that and we have responded, in part, in Mr. O'Brien's testimony to that point. So I think it is properly a subject for discussion. For example, we have cited the number of craft labor working on Unit 2 at the same time that there was a shortage on Unit 1. So we do have testimony on that in this case.

JUDGE MATUSCHAK: Well, I think it's quite evident that it appears there are at least three categories that could be discussed here:

First is the cost, the additional cost, of construction of Limerick caused by the delay decisions;

Second, external matters which affected the construction; and

Third, any offsetting matters that could be used in evaluating the cost effect of those decisions.

I think that pretty well covers the categories that we can review. Are there any other categories?

MR. WERSAN: Your Honor, on your third category I would like to note that the Commission did discuss the company's argument in the original Limerick order on the relative economic benefits and detriments to ratepayers and shareholders of earlier versus later plant completion versus delay. So the Commission did discuss whether or not it would save ratepayers money or cost them more money to complete the plant sooner rather than later; and the Commission said they found that argument unpersuasive.

So to that extent, the OCA believes that at least some of those arguments have already been addressed by the Commission.

JUDGE MATUSCHAK: Mr. Hall, do you have anything further?

MR. HALL: Yes, I do, Your Honor. I have two -- really, I think, three -- major things.

First off, simply because the Commission has discussed something in its order does not in my view mean that the Commission has resolved that particular matter relative to quantification. The Commission's order as has been interpretted by the Commission itself yesterday in the order issued yesterday, and by Your Honor, renders a determination on reasonableness or unreasonableness of the company's delay announcements. The Commission explicitly reserves questions of quantification. Therefore, to the extent that there are issues relative to ratepayer benefits or costs of earlier versus later completion, I think that those issues can be addressed to the extent that they deal with quantification;

and thus I believe that Mr. Wersan's last comment is incorrect.

Secondly, Trial Staff, in its argument to Your Honor, consistently mentioned its view that all of the company's evidence which it sought to strike -- or has sought to strike -- addressed in its view the reasonableness question. The company very strongly disagrees with that. In fact, I think we have an issue here that is often a matter of the eye of the beholder, and I would urge Your Honor very strongly not to be overly preclusive in terms of striking evidence.

It's very difficult at this point, it seems to me, what precisely the issue of quantification will contain as we go through the case and as evidence and arguments are presented. Your Honor does not have the full argument before you at this point, as do none of the parties.

JUDGE MATUSCHAK: Well, in response to the Consumer Advocate, we first had our baptism on these delays in 1978 when we had that rate case -- 438, I believe it was -- in which the company first indicated that they would not delay and later on toward the end of the case they changed their mind and decided to delay.

Now, although the Commission may not have considered or not been persuaded that temporary benefits to the consumers would have been some reason for the delays, while that may not have been a reasonable basis for the delay decisions, we think that it might be a subject of inquiry in the quantification because the consumers did benefit to some extent by the delays, at least temporarily, although over the long-run they might have been hurt by it. But at least temporarily and at least up to this time they may have been benefitted. I think that might be a subject that we would like to look into a little further and see whether that might be an offsetting matter against any additional costs of delay.

I think the Commission's ruling and feeling on that matter addressed the reasonableness of the decision rather than whether there was any offset which should be considered in determining the quantification of the cost of delay.

We will look at all portions of it and we will enter a decision.

MR. DELANEY: I would like to say one last thing on your last comment.

The opinion and order that the Commission entered yesterday, on pages seven, eight and nine, quotes at some length the Limerick Nuclear Generating Station Investigation Order of August of 1982, and in my view at least the second paragraph on page eight, which is part of the quote, addresses this idea of -- well, let me just read the first sentence of it:

"PECo's final argument that the relative economic benefits and detriments to ratepayers and shareholders of earlier versus later plant completion favored delay is unpersuasive."

In my view one of the things that's established by this long quote that's on here is that there was an examination and consideration by the Commission of the evidence put before it and a consideration and rejection of some of these points in reaching the conclusion of imprudence, which is what is reached in the final paragraph of the quote. So I would just note that at least in my view this element of the judging, or balancing, of benefits to ratepayers of delay versus the detriment was examined in the prior proceeding.

JUDGE MATUSCHAK: Well, what is your position on this aspect? We are concerned here about the impact on the ratepayers of these delays.

MR. DELANEY: Yes.

JUDGE MATUSCHAK: Now, suppose that as a result of these delays the ratepayers have been spared higher costs that they would have paid since the '76 and '78 delays -- in other words, if the company had completed Limerick 1 at the original dates set after the '74 delay. What is your position on whether there should be some offsetting?

MR. DELANEY: I would admit that that possibly could be relevant to quantification.

JUDGE MATUSCHAK: I'm inclined to think that at least we ought to leave it in the air and see where we come out.

MR. DELANEY: Fine, Your Honor. I just wanted to note that I think that to some extent that was examined.

JUDGE MATUSCHAK: Anything further?

MR. HALL: Your Honor, I only have one last comment, which was that in the company's view -- and following up on my comment that reasonableness and what addresses reasonableness is a very difficult line to draw and one that we think Your Honor should not draw too tightly -- the company very strongly believes that the testimony as presented by Mr. Boyer, by Dr. Perl and Dr. Hieronymus -- especially those latter two gentlemen's testimony -- deals with statistics with regard to nuclear plant costs and with regard to the length of nuclear plant schedules that do not go to reasonableness and are not intended by the company to go to reasonableness.

The testimony there, as the company views it, does go to attempting to quantify and to other issues unrelated to the '76 and '78 delays, and I believe we have stated our reasoning for that in the briefs.

That's the only comment I have.

JUDGE MATUSCHAK: We will look into it further and see if we can draw some reasonable line.

MR. DELANEY: Your Honor, could I ask is it your intention to issue an interim order on this or do you think you might do it at the end of the case?

JUDGE MATUSCHAK: I think I would rather -- I have looked over some of these items but I haven't given it the kind of study that I feel able to render a decision.

We will provide -- and the parties are put on notice -- we will provide that any of that testimony that is requested to be stricken, that none of that testimony is to be utilized or depended upon by the company or is admissible for the purpose of discussing or determining the reasonableness or unreasonableness of the '76 and '78 delays.

MR. DELANEY: Your Honor, I simply raise this because what remains in the record may well require the intervenors, at least, to consider putting on responsive evidence.

JUDGE MATUSCHAK: We will give some indication as to some of the items we feel are strictly not related to the quantification of the costs in this proceeding. You will have to use your judgement until we get a change to review the matter further.

MR. DELANEY: Thank you, Your Honor.

JUDGE MATUSCHAK: I was hoping in this case that we could send the parties back and see if they could come up with another motion and come up with -- amend their motion -- and come up with the items and just to ask to strike those items which are clearly related to prudency. We would have preferred that rather than go over all those items ourself. We are trying to restrict our burden as much as possible.

Our first intention was, Mr. Delaney, to send you back and see if you could amend your motion in accordance with some of the expressions we have here. But rather than cause further delay, we will try to get into it as soon as we can.

MR. DELANEY: Thank you, Your Honor.

JUDGE MATUSCHAK: Thank you.

Let's take a five minute recess.

(Recess.)

JUDGE MATUSCHAK: When the parties are ready we will proceed.

Whereupon,

PHILIP R. WINTER

having been duly sworn, testified as follows:

DIRECT EXAMINATION

BY MS. PITTS:

Q. Mr. Winter, will you please state for the record your full name and business address?

A. Philip R. Winter, and I work for the General Services Administration. That's at 18th and F Streets, Washington, D. C.

Q. Mr. Winter, I refer you to what has been identified as GSA Statement No. 1, "Testimony of Philip

R. Winter, CFA, Cost of Capital, on behalf of the Federal Executive Agencies, General Services Administration," consisting of 50 pages and Appendix A, "Educational and Professional Summary"; and also to Exhibits of Philip R. Winter, Cost of Capital, on behalf of the Federal Executive Agencies, General Services Administration, consisting of Schedules 1 through 13.

Were this testimony and exhibits prepared by you or under your direct supervision and control?

A. Yes.

Q. On January 16, 1986, the General Services Administration forwarded to all parties an errata sheet for the direct testimony of Philip R. Winter. Mr. Winter, does the referenced errata sheet contain the corrections to your testimony and exhibits?

A. Yes, it does.

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

A. Yes. I found one typo that I would like to correct.

On page two, line 24, the "10.74 percent" should be "10.84 percent".

To my knowledge that is the only correction.

JUDGE MATUSCHAK: Which line was that?

THE WITNESS: Line 24.

JUDGE MATUSCHAK: On page two?

THE WITNESS: Yes. Page two, line 24.

JUDGE MATUSCHAK: And what is the correction?

THE WITNESS: The 10.74 percent figure should be changed to 10.84 percent.

BY MS. PITTS:

Q Mr. Winter, with the correction as indicated, if you were asked those questions contained in your testimony would your answers be the same as contained therein?

A Yes.

MS. PITTS: At this time, Your Honor, I move that GSA Statement No. 1 be admitted into evidence.

JUDGE MATUSCHAK: Statement 1 is admitted into evidence subject to exceptions or motions to strike made in a timely fashion.

(Whereupon, the document was marked as GSA Statement No. 1 for identification, and was received in evidence.)

MS. PITTS: Mr. Winter is now tendered for cross-examination.

JUDGE MATUSCHAK: Did you ask the witness whether the statement is true and correct?

MS. PITTS: I asked if his answers would be the same as contained therein in the testimony.

JUDGE MATUSCHAK: Very well.

Mr. MacGregor.

MR. MacGREGOR: Thank you, Your Honor.

Ms. Pitts, first of all, I don't recall receiving a copy of Mr. Winter's errata sheet. If you have an extra one of those could you provide it to me?

MS. PITTS: Certainly.

(Document handed to Counsel MacGregor.)

CROSS-EXAMINATION

BY MR. MacGREGOR:

Q. Mr. Winter, referring first to your errata sheet, would I be correct that none of the changes on this sheet affect your overall 15.6 cost of equity recommendation for Philadelphia Electric Company in this proceeding?

A. Nothing in the errata sheet changed my cost of equity finding for Philadelphia Electric Company.

Q. Mr. Winter, would you first refer briefly to Appendix A in your testimony, which sets forth an educational and professional summary?

Would you agree with me that your academic training is in the field of mathematics?

A. Yes.

Q. And reviewing your employment history, would you agree with me that prior to 1979 none of your job positions involved responsibility for making cost of equity determinations for investor-owned utilities?

A. Not directly, no.

Q. How did they involve such determinations indirectly for investor-owned public utilities?

A. I was thinking of the work I did for the Postal Service, which had to do with cost analyses concerning the deployment of new equipment in which we considered the cost of capital in those analyses. Those were not directly related to public utility firms.

Q. Mr. Winter, have you ever been retained by an investor-owned utility to advise it as to the issuance of public securities?

A. No.

Q. You list a number of testimonies and regulatory proceedings in which you have participated on the second page of your Appendix A. In any of those testimonies have you testified on behalf of an investor-owned public utility?

A. No, I have not.

Q. Now, Mr. Winter, in addition to your cost of equity recommendation in this proceeding you have proposed certain adjustments to Mr. Brennan's proposed cost of debt and preferred stock; is that correct?

A. Yes.

Q. And the first of these adjustments is to reflect more recent data as to the likely cost of new issuances of long-term debt and preferred stock in early 1986; is that correct?

A. Yes.

Q. Would you agree with me that those proposed adjustments are more by the way of updates than a fundamental disagreement with Mr. Brennan's methodology?

A. I disagree with Mr. Brennan's approach of relying on -- excuse me -- in which he relied upon yields indicated in the futures market to determine the cost of the floating rate.

Q. But with that exception your other adjustments simply reflect an update to reflect more recent information; is that correct?

A. I believe some of that information may have been available at the time Mr. Brennan prepared his testimony. I would have to go back and check to determine that exactly.

But in some part, at least, it is an update. I would agree with that.

Q. Now, with respect to your adjustment for the cost of the floating rate pollution control notes, Mr. Brennan, as I understand it, employed the actual yields on settled Treasury Bill futures contracts; is that correct?

A. That's my understanding, yes.

Q. And you, as an alternative, propose to use the concensus of forecasted future Treasury Bill yields; is that correct?

A. Yes.

Q. Mr. Winter, do you know whether the method that Mr. Brennan has employed in this case is that same as this which he has used in many prior Philadelphia Electric Company rate proceedings?

A. It's my understanding that he has relied on Treasury Bill futures yields in prior cases.

Q. Is it also your understanding that the Commission has consistently approved that approach?

A. It's not my understanding that they have specifically approved that approach. I believe they have accepted the cost estimates he has made, at least in some cases, for the cost of short-term debt for example.

Q. Now, on page four of your testimony, at lines 17 through 20, am I correct that the figure that you have used based on your methodology is 7.15 percent as compared to the 8.13 percent figure used by Mr. Brennan?

A. That's what I say on that page.

Q. Mr. Winter, have you done any analysis or review to determine what portion of the difference between those figures relates to the difference in the timing of the data employed by Mr. Brennan and employed by you, as opposed to the difference in methodology?

A. I haven't done any specific calculations there, no.

Q Would you agree with me that the information Mr. Brennan relied upon was sometime prior to September 27, 1985, when he filed his testimony, whereas your information was based upon the January 1, 1986, Blue Chip Financial Forecasts?

A. Yes.

Q So would I be correct, Mr. Winter, that you performed no analysis to determine what the difference might be between your method and Mr. Brennan's method if they were developed using data from a consistent time period?

A. I haven't done a specific analysis of that, except there is reason to believe that there could be significant differences between these two approaches.

Q But you have not specifically determined that, have you?

A. No, I have not. I know for a fact that there are differences that exist from time to time between the futures market and what the Blue Chip Financial Forecasts indicates but I can't quantify that for you at this time.

Q Nor have you made any determination as to what that difference might have -- what effect that difference might have on the total cost of capital requirement of Philadelphia Electric Company?

A. You're talking about the difference between the 7.15 and the 8.13 and what impact that difference would have on PECo's --

Q. I'm referring to the difference in the approach you propose and the approach Mr. Brennan has proposed using data from a consistent time period, as to what impact, if any, that would have on the overall cost of capital claim presented by the company in this case.

A. Well, we are talking about -- I'm trying to talk about approaches. I think relying on qualified forecasts of future interest rates, say, on short-term debt, is a more reliable approach than that suggested by Mr. Brennan, which is based upon futures yields.

Q. Am I correct that you have performed no analysis to determine what difference, if any, those two approaches would make employing data from a consistent time period? If you have performed such an analysis please provide it to me.

A. No. I think I answered that question before. I have not quantified the differences that would exist between these approaches at different points in time.

Q. Thank you, Mr. Winter.

Turning to your cost of equity recommendation, am I correct that your recommendation in this proceeding for cost of common equity is 15.6 percent, that being the midpoint of your 15.1 and 16.1 percent range?

A. That's the estimate without the consideration of

Limerick risk.

Q. This recommendation, you would agree, is fairly close to the 15.75 percent which is produced by Philadelphia Electric Company's rate filing as filed in this proceeding?

A. That's a fallout number. The 15.75 is a fallout number in the PECo filing; that's correct. And the difference is relatively small.

Q. Now, the components of your DCF analysis are a dividend yield of 14.5 percent and a short-term growth rate of zero to 1.0 percent and a long-term growth rate range of 1 to 2 percent; is that correct?

A. Yes.

Q. And the determination of the cost of equity that you employ is a multistaged, or two-stage, DCF model; is that correct?

A. Yes.

Q. And to calculate the cost of equity in a two-stage model is an iterative process; is that correct?

A. Yes, it is.

Q. And the calculation is performed on a computer?

A. It is in this case, yes.

Q. Do you have any formula or workpapers that you could provide us to demonstrate how that calculation was performed? We are having some difficulty replicating it.

A. Well, the formula is presented in my testimony.

I can find that for you in just a minute.

(Witness perusing document.)

A. It's on page 26, between lines 18 and 20. That is the equation that would be used.

The iterative approach is one in which a guess is made for k and then dependent upon the value calculated for the right-hand side of that equation using the estimate for k, you move closer and closer to a correct value that works in the equation.

Q. And the 15.1 percent figure, which is your low-end range, I take it the inputs to that are a 14.5 percent dividend yield, a zero percent short-term growth rate and a one percent long-term growth rate; is that correct?

A. That's correct.

Q. And the high end of your range, the 16.1 percent, consists of a dividend yield of 14.5 percent, a short-term growth rate of one percent and a long-term growth rate of two percent?

A. Yes.

Q. Thank you.

Now, Mr. Winter, in establishing your short-term growth rate range of zero percent to one percent, you examined short-term dividend growth rate history and the dividends and earnings growth forecasts of several investment firms; is that correct?

A. Yes. I also look at price growth histories and prospective price growth.

Q. The historic short-term dividend growth rate you reviewed was 2.6 percent for Philadelphia Electric Company; is that correct?

A. What period are you looking at there?

Q. I'm referring to page 29 of your testimony where you state, "For the ten most recent five-year holding periods with December 1 boundaries, dividend growth rates have averaged 2.6 percent."

A. That's correct on page 29. Also, though, you should note that during a similar period price growth for the company was a negative 1.1 percent. You must consider both of those growth rates in your DCF finding.

Q. And as a result of that analysis you rejected reliance on the short-term dividend growth rate in this proceeding -- short-term historic dividend growth rate?

A. I considered it, but it was not a specific data item that I subsituted into the DCF equation.

Q. And that figure, 2.6 percent, is well above your zero to one percent short-term growth rate range?

A. Yes, it is, just as it is above every forecasted short-term dividend growth rate that I reviewed.

Q. Well, let's look at your forecast for a moment on schedule 12 of your testimony. Am I correct that you set forth on that schedule the expected average annual growth rates in dividends and earnings forecast by seven investment firms?

A. Yes.

Q. And the average of the forecast for dividends is 1.0 percent and the average of the forecasts for the earnings is 0.8 percent?

A. That's correct.

Q. And the average of the two would be -- or a midpoint -- would be .9 percent?

A. Yes.

Q. So I take it that you also in part rejected these forecasts? You did not use a .9 percent growth rate but rather you used a range of zero percent to 1.0 percent?

A. I would disagree with that characterization because I did consider those in determining my growth rate ranges. As I pointed out, you must consider prospects for both price and dividend growth. You must have a composite of those two in your equation, otherwise you're very likely to get misleading results.

Q. But you did not employ either the dividends or earnings short-term growth rates forecast by these investment firms on the average in your DCF analysis? Your short-term growth rate was not .9 percent, was it, Mr. Winter?

A. No. I used a range from zero to 1.0 percent, which contains the .9 percent that you're referring to.

Q. You cited two principal reasons for using a lower short-term growth rate than what has been forecast here. One is the potential for a Philadelphia Electric Company dividend cut and the second was a preponderance of forecasted growth rates at or near zero percent; is that correct?

A. That is among the reasons that contributed to my thinking in that area. Once again, you're forgetting about price growth. But I have already answered the question concerning price.

Q. Now, with respect to the potential for a dividend cut, what evidence did you rely on that the company will cut its dividend?

A. There were indications of the potential for a dividend cut in reports to shareholders. There were also indications of the potential for dividend cuts in various reports from the investment community.

Q. What time period of reports did you review in your answer that you just provided?

A. From the investment community there were reports in late 1985. Concerning the shareholder reports, some of them were also in 1985.

Q. In preparing your testimony did you review Value

Line's December 27, 1985, report on Philadelphia Electric Company?

A. I believe that report became available after this testimony was already prepared.

Q. Your testimony was filed on January 3, 1986; is that correct?

A. That's correct, but it was prepared prior to the Christmas holidays.

Q. If I could show you a copy of that report, Mr. Winter, would you agree that in the discussion, in reading the portions of the discussion that appear in bold print, the report states that, "**Regulators have voted to allow completion of the utility's Limerick 2 nuclear plant,**" and proceeding down to the next bold type, "**With the risk of cancellation removed the dividend appears secure but capital needs will remain high through 1990.**" And finally, in the second column, reading the highlighted material, "The current yield has dropped several notches. The PUC's go-ahead for Limerick 2 has eliminated the immediate risk of a dividend cut in our opinion."

Do you see those references?

A. Yes, I do.

Q. And you did not consider this in the preparation of your testimony?

A. No. Also, I didn't consider the lower dividend yield that is currently recorded for PECo and was recorded for PECo at the time this report was prepared.

Q. Nor have you considered any revised forecasted growth rates subsequent to the time you filed your testimony?

A. I have looked at other growth rates that have become available from Merrill Lynch and Salomon Brothers. It's my view of those forecasts that they have not changed from those forecasts that were included in my testimony.

Q. Let's talk about those forecasts for a moment, Mr. Winter. Another reason you cite for the use of the zero to one percent short-term growth rate range is the preponderance of zero percent forecasts by the investment firms that you have examined; is that correct?

A. Yes.

Q. Looking at Schedule 12, and particularly the dividends column first, would you agree that with respect to dividends three of the firms forecast a zero percent growth rate and the three highest firms forecast an average of two percent, that being Value Line, Merrill Lynch and Dean Witter, 2.2 percent, 1.8 percent and 2.0 percent respectively?

A. Yes.

Q. Based on that what is the basis for your conclusion that zero percent predominates in the dividend forecasts?

A. Once again, three of the seven have indicated zero growth. Also, a consideration at that time was the dividend yield that was required by investors on PECo. That yield was among the highest, if not the highest yield, of all major public utilities that are traded. So there were other considerations other than the ones you wish to concentrate on at this time. But there is a preponderance of zero rate forecasts.

Q. Would you agree with me that if you look at the dividends and earnings tables combined that six of the forecasts are at 1.8 percent or higher and six are at zero percent or lower?

A. Six are 1.8 percent or higher?

Q. Correct.

A. Of earnings and dividends?

Q. Yes.

A. No, I wouldn't agree with that.

Q. Would you agree with me in the dividends column, Value Line's dividend is 2.2 percent. Is that value 1.8 percent or higher?

A. Value Line's forecast for both dividends and earnings is in excess -- well, in one case it's 2.2 and in the other 1.4 percent.

Q. I asked about dividends. Is 2.2 percent 1.8 percent or higher?

A. Yes.

Q. With respect to Merrill Lynch, is 1.8 percent 1.8 percent or higher?

A. Yes.

Q. With respect to Dean Witter, is 2.0 percent 1.8 percent or higher?

A. That's three; yes.

Q. In the earnings column, with respect to Dean Witter, is 2.5 percent higher than 1.8 percent?

A. Yes.

Q. For Duff and Phelps is 1.9 percent 1.8 percent or higher?

A. I see the sixth one. Yes. I would agree with your earlier question.

Once again, I would point out that you failed to consider price growth.

Q. I'm not examining price growth, Mr. Winter. I'm examining your statement that zero percent predominates on Schedule 12.

A. As it pertains to dividends, yes.

Q. Mr. Winter, would you agree with me that in some other testimony that you have recently presented that you also considered growth rate forecasts by Argus Research Corporation?

A. Yes.

Q. And would you accept subject to check -- and I have a copy of the document -- that Argus's current forecasted dividend growth rate for Philadelphia Electric Company for the five year period 1986 to 1991 is 3.0 percent?

A. That forecast was not one that was available to me at the time I prepared my testimony.

Q. Was the December, '85, forecast also 3.0 percent? I don't believe it changed in January.

(Pause.)

Q. But in any event, would you agree with me that their current forecasted dividend growth rate for Philadelphia Electric Company is 3.0 percent?

(Pause.)

Q. It's on the last page of the document.

(Witness perusing document.)

A. They have a column entitled "Dividends, estimated average yearly growth, 1986 to 1991," and the figure that they show is three percent; and this is from their January, '86, report. Yes.

Q. Also, I would like to show you a copy of the December, '85, report and ask you if the same growth rate is set forth in that document.

(Witness perusing document.)

A. The same figure appears in a December, '85, report. Again, neither of these reports were available to me at the time I prepared my testimony.

Q. Mr. Winter, you testified in the company's 1985 electric proceeding at Docket No. R-822291; is that correct?

A. Yes.

Q. Would you accept, subject to check, that in that case you examined a group of investment firm forecasted dividends and earnings growth figures consisting of Value Line, Duff and Phelps, Merrill Lynch, Salomon Brothers and Argus?

A. I don't have that testimony here. I know that I have relied upon Argus in the past so it wouldn't surprise me if it did appear.

Q. I would like to show you a copy of pages 22 and 23 of your testimony from that proceedings and ask if you would confirm my listing of the investment firms which you considered in that proceeding.

(Witness perusing document.)

A. Yes. Argus is included in this testimony.

Q. Mr. Winter, would you accept subject to check that if you had used that same group of companies which you relied on in your last testimony before this Commission for Philadelphia Electric Company in this case and used their current growth rate projections that you would have achieved a 1.6 percent dividend forecast average rate, .8 percent for earnings and an average of 1.2 percent?

A. If I had included the December forecast for Argus? Is that your question?

Q. Yes.

A. Well, if you add Argus to the list three percent would appear as one of the growth forecasts for dividends; that's correct.

Q. And if we used the group that you used in the Philadelphia Electric 1983 rate proceeding of Value Line, Duff and Phelps, Merrill Lynch, Salomon Brothers and Argus?

A. Yes? What is the question?

Q. Would you not have achieved an expected average forecasted dividend growth rate of 1.6 percent and earnings growth rate of .8 percent and an average of the two of 1.2 percent?

A. I believe those figures are correct.

I think it's important that you look at what Argus was saying back in October, for example, of 1985, however. This was one report that was available. They were predicting no load and in fact, a decrease in earnings for Philadelphia Electric between 1985 and 1986. In that particular report, however, they did not show a five year growth forecast. So you need to consider that as well.

Q. You also testified in a recent Bell Telephone proceeding in this state, did you not?

A. Yes.

Q. And in that case you used yet a different set of investment firms made up of Value Line, Prudential-Bache, Merrill Lynch, Salomon Brothers, Argus and Dean Witter. Would you accept that subject to check?

A. Again, I think those are an accurate list. I would have to see the testimony.

Q. I can provide you with a copy of the testimony, but if you would accept it subject to check for the moment would you agree that if you used that set of firms in this case you would have forecast an average dividends and earnings growth rate for Philadelphia Electric Company of 1.2 percent?

A. I think that's correct, yes.

Q. You also --

A. Let me point out there that the Duff and Phelps report on Bell Telephone was not available to me. Also, to my knowledge there was no report from E.F. Hutton on Bell Telephone available to me at that time that contained a five year growth forecast.

My approach is to use as many firms as I can, investment firms, as many forecasts from investment firms as I can. In this particular case these were all available to me.

Q. It appears to me, Mr. Winter, that your approach seems to be to use a different set of investment firms every time you file a piece of testimony.

A. Well, that is your opinion. Let me point out, though, again, that I choose those that are available to me. Those that are available to me that contain five year forecasts are not the same from one case to the next.

Q. In October of this year, Mr. Winter, did you submit testimony in an El Paso Electric Company case?

A. Yes, I did.

Q. And that is an electric company; is that correct?

A. Yes.

Q. You used a group in that case made up of Value Line, Prudential-Bache, Merrill Lynch, Salomon Brothers, Duff and Phelps and Dean Witter. You again did not include E.F. Hutton; is that correct? Or Argus?

A. You would have to show me the testimony. I think that's reasonable.

Again, I would guess that the E.F. Hutton report was not available to me.

Q. There was no E.F. Hutton report available to you in October of 1985 for El Paso but there was for Philadelphia Electric Company?

A. That contained a five year growth forecast.

Q. And there was for Philadelphia Electric Company but not for El Paso Electric; is that correct?

A. The list that you read to me is correct. E.F. Hutton does not appear in the El Paso case.

Again, I try my best to obtain all of the reports that are available from the investment community in each case that I submit testimony in.

Q Would it surprise you to find, Mr. Winter, that if you used the set of firms you used in the El Paso case that your average of forecasted dividends and earnings growth rates would have been 1.1 percent?

A. You know, we are talking about relatively small differences here. We are talking about a 1.0 percent average for dividends in this case. You pointed out that in an El Paso case if I had added -- excuse me -- you're saying if I did the same as I did in the El Paso case, that is, include E. F. Hutton, you're saying I would have come up with a 1.1 percent average. We are a tenth of a percent off.

Q An interesting point to me, Mr. Winter, is that in each instance if we had used a group that you had used in prior testimony we would have achieved a result that fell outside of your zero to one percent short-term growth rate range; is that correct?

A. No, it's not correct.

Q Well, 1.2 percent is higher than zero to one percent, is it not?

A. Let me explain my --

Q Is 1.2 percent higher than zero to one percent?

MS. PITTS: Please let the witness complete his answer.

MR. MacGREGOR: I've asked him a specific question.

JUDGE MATUSCHAK: Let him answer the question.

A. I just wanted to explain that you're saying that when you compare the average of dividend and growth forecasts from investment firms with the range that I have found reasonable in this case, that depending upon which investment firms you include in your sample you may come up with a dividend growth forecast average that is above, slightly, the upper end of my short-term growth rate range. Okay? I have no problem with that.

The problem that I have is that that growth rate range that I selected is based upon more than just short-term growth forecasts by investment firms. It's based upon history and it's also based upon price growth forecasts. You wish to ignore, in my opinion, the importance of price growth and some of these other factors.

BY MR. MacGREGOR:

Q. Have you provided a schedule that shows projected price growth by these investment firms, Mr. Winter, in this testimony?

A. These firms do not forecast price growth.

Q. I see.

A. However, I have reviewed short-term price growth history and I have included consideration of that in the determination of my growth rate range.

Q Let's look at your long-term growth rate. You use a range of 1.0 to 2.0 percent; is that correct?

A. Yes.

Q And in developing that rate you again looked at both history and forecasts; is that correct?

A. Yes.

Q Would you agree with me that for whatever reason you may wish to offer that your range of 1.0 to 2.0 percent falls below the historic dividend growth rate you examined at 2.3 percent and also below Merrill Lynch's forecasted 2.9 percent long-term growth rate?

A. Yes, and once again the reason for that is that you must consider the prospects for price growth.

Q Mr. Winter, I believe you mentioned earlier that while your recommendation in this case is for a cost of equity of 15.6 percent that that did not reflect the possibility that the Commission would make a rate base adjustment for Limerick 1 in this proceeding; is that correct?

A. I pointed out in my testimony that if the Commission finds that a portion of Limerick should be excluded from rate base, then I think there is justification for selection of a lower cost of equity than the estimate of 15.6 percent that we have been discussing.

Q Is that because of the lower prospective growth rate if that were to occur?

A. No. The company would not -- excuse me -- the ratepayers should be responsible for the added costs associated with these risks that have to do with Limerick in my opinion if the Commission makes its decision of excess capacity.

Q. Would they have to disallow all of Limerick in order to make such an adjustment?

A. No.

Q. You testified in the most recent PP&L rate proceeding involving Susquehanna 2, did you not?

A. Yes.

Q. In that case a number of witnesses proposed major excess capacity adjustments; is that correct?

A. Yes, they did.

Q. Including a GSA witness?

A. Yes.

Q. And the Commission in fact adopted a major excess capacity adjustment. They disallowed all the common equity return on Susquehanna 2; is that correct?

A. Yes.

Q. You testified in that proceeding, did you not?

A. Yes, I did.

Q. Did you make any such proposal in that case?

A. No. However, on hindsight --

Q. Thank you, Mr. Winter.

A. -- I think it would be appropriate.

Q. You also oppose any allowance for flotation costs in this case, do you not?

A. Yes. I recommend that no adjustment be allowed.

Q. Would you agree with me that the last time you testified in a Philadelphia Electric Company rate proceeding before this Commission you did propose an adjustment for flotation costs?

A. In some past cases I have recommended a very small adjustment for flotation costs that would amount to maybe three or four basis points. I have not recommended such an adjustment, however, within the past year and possibly longer than that.

MR. MacGREGOR: Thank you, Mr. Winter.

That's all I have, Your Honor.

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

Mr. Delaney?

MR. DELANEY: Just one or two questions.

CROSS-EXAMINATION

BY MR. DELANEY:

Q. Good morning, Mr. Winter. My name is Dan Delany and I represent the Trial Staff. I just want to ask you a few questions on an answer that begins on page 33 and goes to page 34 of your testimony.

Now, beginning at the bottom of 33 you are asked about the current dividend yield term of your DCF equation and how it was derived. And in the course of responding to that question you talk about the data that you used. You indicate that the yield is computed as the average of the quotients of the end-of-week stock prices and effective annual dividend rates from the most recent 16 week period, and you indicate that the period that you're referring to is one from 8/30/85 to 12/13/85.

Do you see where I'm reading?

A. Yes, I do.

Q. Mr. Winter, are you familiar with what might be the most recent 16 week period for this kind of data? That would be the one ending 1/17/86.

A. I have not made that specific calculation but it would be significantly lower than the 14.5 that I found at the time my testimony was prepared.

Q. Are you familiar with the January 21, 1986, price and yield?

A. Yes. As of the close yesterday I think the yield was 12.4 percent if I recall.

Q. And do you know what the stock price was?

A. Seventeen and three-quarters was the close according to the Wall Street Journal this morning.

MR. DELANEY: That's all the questions I have, Your

Honor.

Thank you, Mr. Winter.

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

MR. RUBIN: Yes. I have just one question.

CROSS-EXAMINATION

BY MR. RUBIN:

Q. Good morning, Mr. Winter. My name is Scott Rubin. I'm with the Consumer Advocate's office.

A. Good morning.

Q. I believe you stated both in your testimony and just a few moments ago when you were being questioned by Mr. MacGregor that your 15.6 percent recommendation does not include any reduction for Limerick-related risk; is that correct?

A. That's correct.

Q. Would I be correct that that is true for risks associated with both Limerick Unit 1 and Limerick Unit 2?

A. Yes. In fact, it's interesting to note that in October when the Commission made its ruling that construction could continue on Limerick PECo's stock price improved considerably and in fact the drop in yield from the 14.5 percent that I found at the time I prepared my testimony to today, which is down around 12.5 percent, a total of 200 basis points, tends to validate the estimate that I made.

I suggested that a minimum of 50 to 100 basis points reduction was appropriate to account for the Limerick risks. If you take into consideration a slight downward trend in interest rates and the impact of that Limerick decision you would come up with a figure that's very close to that 100 basis points that I indicated in my testimony.

MR. RUBIN: Thank you, Mr. Winter.

That's all we have, Your Honor.

MR. MacGREGOR: One follow-up question, Your Honor.

FURTHER CROSS-EXAMINATION

BY MR. MacGREGOR:

Q. Mr. Winter, you said a lot about the change in stock price and dividend yield as a result of the Commission's decision in the Limerick 2 case. Would you agree that that decision also could have an impact on investor's expectations of future earnings and dividends growth rates for Philadelphia Electric Company?

A. It could have, but as I have indicated, there was no change in the Merrill Lynch report or the Salomon Brothers report that has been published subsequent to that decision.

Q. So you think it's appropriate to rely on those reports for that purpose, but not in using their growth rates in your DCF calculation in this testimony?

A. Well, if you want to update it, if you want to update my testimony, to include the current growth forecast you should also update it to reflect current yield requirements.

Q. Correct. You have to update both; is that correct?

A. Yes. Yes.

MR. MacGREGOR: Thank you.

That's all I have, Your Honor.

JUDGE MATUSCHAK: Any redirect?

MS. PITTS: No redirect, Your Honor.

JUDGE MATUSCHAK: Thank you.

(Witness excused.)

JUDGE MATUSCHAK: Let's take a five minute recess.

(Recess.)

JUDGE MATUSCHAK: On the record.

MR. DELANEY: Your Honor, the Staff would call as its first witness Andrew R. O'Donnell.

Whereupon,

ANDREW R. O'DONNELL

having been duly sworn, testified as follows:

JUDGE MATUSCHAK: You may be seated.

DIRECT EXAMINATION

BY MR. DELANEY:

Q. Would you state your name and business address, please?

A. My name is Andrew R. O'Donnell. My business address is P.O. Box 3265, Harrisburg, Pennsylvania.

Q. Can you indicate by whom you are employed and in what capacity?

A. I am employed by the Pennsylvania Public Utility Commission as a Fixed Utility Financial Analyst in the Rate of Return Section of the Bureau of Rates.

Q. Mr. O'Donnell, do you have before you a multipage document previously distributed to the parties and the Administrative Law Judge entitled, Trial Staff Statement ARO-1?

A. That is correct.

Q. Do you also have another multipage document marked Trial Staff Exhibit ARO-1?

k2

A. That is correct.

(Whereupon, the documents were marked Trial Staff Statement ARO-1 and Trial Staff Exhibit ARO-1 for identification.)

Q. Does this Staff Statement and Staff Exhibit constitute the prepared direct testimony that you have prepared to be given in this proceeding?

A. Yes.

Q. Do you have any changes, modifications, additions or corrections which you would care to make to this testimony at this time?

A. Yes. In Statement ARO-1, we can begin at page 2, line 12. After the last word in line 12, "high," should be inserted "grade."

JUDGE MATUSCHAK: Keep your voice up.

BY MR. DELANEY:

Q. Repeat that.

A. On page 2, line 12, at the end of the sentence, insert the word "grade." It should read, "high grade corporate bonds."

On page 5, line 2, the word "to" should be "too."

On page 15, line 18, insert the word "among" between the words "is" and "the."

On page 20 --

JUDGE MATUSCHAK: Just a minute. On line 18, what are you correcting?

THE WITNESS: The statement should read, "which is among the highest." Insert the word "among" on line 18 on page 15.

JUDGE MATUSCHAK: All right.

THE WITNESS: Page 20, line 6, change the number 14.1 to 14.2.

And also on page 20, line 7, change "12.7 to 14.2" to read, "12.5 to 14.1."

In the Exhibit ARO-1, Schedule 5, page 2, down in the source, in the first line, the word "September" is misspelled. It should be S-E-P-T-E-M-B-E-R.

And in the next to the last line of the source, "December 18" should be changed to "December 3."

Also in Exhibit ARO-1, in Schedule 2, the statistics there require some updating. However, the updates won't have any significant meaning as to the testimony.

MR. MacGREGOR: Which schedule is that?

THE WITNESS: Schedule 2.

I have the updates now. However, they are going to be updated in another week, anyhow. A new Value Line investment survey will be out by then, which will make all the updates I make today meaningless. And I don't expect the updates to change anything to any significance.

BY MR. DELANEY:

Q. So it is your intention, Mr. O'Donnell, to update Schedule 2, then?

A. Yes.

Q. When you obtain that information?

A. Yes.

Q. Was this testimony and the accompanying exhibit prepared by you or under your direction?

A. Yes.

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

A. Yes.

Q. If I were to ask you all the questions that are contained in your statement, would your answers be the same as are now contained therein?

A. Yes.

MR. DELANEY: Your Honor, at this time I would move into evidence Trial Staff Statement ARO-1 and Trial Staff Exhibit ARO-1.

JUDGE MATUSCHAK: The motion is granted, subject to any later exceptions or objections.

(Whereupon, the documents marked Trial Staff Statement ARO-1 and Trial Staff Exhibit ARO-1 were received in evidence.)

MR. DELANEY: Mr. O'Donnell is available for cross-examination, Your Honor.

JUDGE MATUSCHAK: You may proceed.

MR. MacGREGOR: Thank you, Your Honor.

CROSS-EXAMINATION

BY MR. MacGREGOR:

Q. Good morning, Mr. O'Donnell.

A. Good morning, Mr. MacGregor.

Q. Am I correct that your Statement ARO-1 states your position as to a fair rate of return for Philadelphia Electric Company in this proceeding?

A. Yes.

Q. Am I also correct that you have not challenged the company's claimed capital structure ratios, embedded cost of debt and preferred stock?

A. That is correct, including the language I stated referring to the revisions of the cost of debt. I also noticed one thing in Mr. Winter's testimony about the cost of preferred stock that I inadvertently missed, and that was relative to the cost of preferred stock, a proposed issuance. And I would have to go back and review that.

But if the proposed May, 1986 issuance is still proposed, I would have to tend to agree with Mr. Winter that the cost rate probably should be lower.

Q. Based on more current data?

A. That is correct. However, it won't significantly affect my rate of return recommendation, since the preferred stock is a minor weighting in capital structure.

Q. So, am I correct that the principal difference, in fact the sole difference between your overall recommendation of a fair rate return of 12.03 percent to 12.42 percent and the 12.7 percent requested by the company relates to a dispute over the cost of common equity capital?

A. That is correct.

Q. And the company's rates as filed produce a fall-out rate of return of 15.75 percent, and you instead propose a range of 14.0 to 15.0 percent?

A. May I have the question repeated?

Q. I am simply asking you if you would agree that the company's rates as filed produce a fallout return on common equity of 15.75 percent, and by comparison your testimony proposes a cost of common equity range of 14.0 to 15.0 percent.

A. That is correct.

Q. Now, at pages 2 and 3 of your testimony, you discuss generally several economic and financial factors that have affected and are expected to affect the cost of equity for electric companies, is that correct?

A. That is correct.

Q. And in general, to summarize that statement, you state that electric utilities have gone through some tough times recently, but as a general matter, things have improved because most utilities have completed their construction programs, and inflation and interest rates are down from previously higher levels.

A. That is correct.

Q. However, you also state that this is not the case for a minority of electric companies, particularly those who still have ongoing nuclear construction programs, is that correct?

A. That is correct.

Q. And Philadelphia Electric Company would fall into that minority group, is that correct?

A. That is correct.

Q. You state on page 3 beginning at line 13 that the news has not been all bad for Pennsylvania electric utilities, is that correct?

A. That is correct.

Q. And one example you list there is the use in Pennsylvania of automatic fuel adjustment clauses which permit escalating energy costs to be passed through to customers without filing a base rate case, is that correct?

A. That is correct.

Q. Are you aware, Mr. O'Donnell, that in response to a Commission Order, the company has filed in this proceeding a revised energy cost rate in which only 80 percent of energy costs would be subject to after-the-fact reconciliation for over/undercollection?

A. Yes, I have read Mr. Brennan's Statement No. 28.

Q. Would you agree that all else equal, this might have some impact on the risk of investment in Philadelphia Electric?

A. Some impact, yes.

Q. Now, continuing on on page 3, you list some other factors which have acted to reduce regulatory lag, is that correct?

A. That is correct.

Q. Now, you would agree with me that these actions have simply reduced regulatory lag, and have not eliminated it entirely?

A. That is correct.

Q. And would you also agree with me that Philadelphia Electric Company and other electric utilities in Pennsylvania continue to have been unable to earn their Commission-allowed returns?

A. That is correct.

Q. Now, turning to page 5 of your testimony, continuing on, am I correct that your cost of equity recommendation in this proceeding is based in part upon analysis of a barometer group of four electric utility companies?

A. Yes. The analysis of the barometer group has entered into my judgment as to the required rate of return for Philadelphia Electric.

Q. Would you agree that it has played a fairly significant role, and that you have calculated a DCF cost of equity specifically for Philadelphia Electric Company in the range of 14.7 to 15.7 percent, with a midpoint of 15.2 percent? Is that correct?

A. Not exactly. What is not correct about it is the statement that you made that the analysis of the barometer group played a significant role in my judgmental 14.0 to 15.0 range for common equity for Philadelphia Electric.

I believe that if you read further in my testimony, you will see that I pretty much summarize what went into my judgment in arriving at that range. I will direct you to the proper place.

Q. I don't want to interrupt you, Mr. O'Donnell. I have read your testimony. Maybe we could just look at page 20 of your testimony, the table where you provide the results of your three methods, is that correct?

A. That was the page I was going to direct you to.

Q. Thank you.

Was my prior statement correct, that you have calculated a DCF specifically for PECo in a range of 14.7 to 15.7 percent as shown on page 20, line 4?

A. You are correct by that statement. However, you are not correct if you infer that that is the proper DCF required rate of return for Philadelphia Electric.

Q. I understand. That's the product of your calculation --

A. That's correct.

Q. -- in the application of your DCF model to Philadelphia Electric Company market data?

A. In that, you are correct, yes.

Q. And you provide the results of two other methodologies right below that, your result for your four electric company barometer group, 12.6 to 14.2 percent, is that correct?

A. That is correct.

Q. And the results of your risk spread analysis, 12.5 to 14.1 percent?

A. That is correct.

Q. And out of these three methods, plus the consideration of the other factors you list on page 20, you derive a final recommendation of 14.0 to 15.0 percent?

A. That is partially correct. I also considered the inputs to the DCF calculation themselves, and the reasonableness of those inputs.

Q. Mr. O'Donnell, you have testified in a number of recent electric rate proceedings, but I believe this is the first Philadelphia Electric Company electric rate proceeding in which you have testified, is that correct?

A. That is correct.

Q. Do you know whether this Commission has directly relied upon barometer group analyses in establishing a common equity cost rate for Philadelphia Electric Company in recent company rate orders?

A. When you put the word "recent" in there, you throw a curve to me. I'd have to go back and check, but I am sure that the Commission has made recommendations based on statistics that came from barometer group analysis, including from barometer group analyses of the company's own witness, Mr. Brennan.

Q. Do you think the Commission orders from the last two or three rate proceedings of Philadelphia Electric Company reflect that fact? Have you reviewed them, first?

A. I reviewed some past orders of Philadelphia Electric, and I have also reviewed past testimonies of Mr. Brennan in Philadelphia Electric --

Q. I am not asking about Mr. Brennan's testimony. I am asking about Commission orders.

A. Okay, I couldn't tell you what the specifics of the Commission orders are at this time.

Q. Fine.

Now, am I correct that your barometer group in this case is made up of four companies: Ohio Edison, Toledo

Edison, Dayton Power and Light and Duquesne Light Company?

A. That is correct.

Q. Three of these companies are from Ohio, and one is from Pennsylvania?

A. That is correct.

Q. Now, based upon a variety of parameters you have indicated, and particularly the Value Line Safety Rank, you conclude that this group is comparable in total risk to Philadelphia Electric Company, is that correct?

A. Yes.

Q. And therefore, one would expect these companies to have a comparable cost of attracting common equity capital, all else equal?

THE WITNESS: May I have the question repeated, please?

(Whereupon, the reporter read from the record, as requested.)

BY MR. MacGREGOR:

Q. Based upon your conclusion that these companies are approximately equal in total risk, would it not follow that their cost of attracting common equity capital also would be approximately equal?

A. I don't agree that they would be approximately equal. The cost of capital would be within a close range of each other.

Q. In preparing your testimony, Mr. O'Donnell, did you examine the most recent allowed equity cost allowances for the companies in your barometer group?

A. I am aware of the most recently allowed rates of return for these companies, yes. I couldn't give you the specifics, but I am generally aware of where they are.

Q. Are you aware that the most recent allowed return for Ohio Edison Company was 16.65 percent?

A. I am aware that when you look at the allowed rates of return from all the Ohio companies, you are going to find higher allowed rates of return.

I am also aware of differences relative to writeoffs in Ohio that aren't the same as are in Pennsylvania. So, you will have differences and you will have rates of return allowed that might reflect more of a political situation than what is actually required by investors.

Q. And that wouldn't be true in Pennsylvania?

A. It could be.

Q. Just to complete the list, would you agree that the most recent allowed return for Toledo Edison is 17.3 percent, and the most recent allowed return for Dayton Power and Light was 16.46 percent?

A. Yes.

Q. Now, one case in which you recently testified, Mr. O'Donnell, was the Metropolitan Edison and Pennsylvania

Electric Company cases, Docket No. R-842770, is that correct?

A. That is correct.

Q. And in that case, am I correct that you determined the cost of equity for Metropolitan Edison-Pennsylvania Electric Company by reference to a barometer group of four electric companies?

A. Yes, that is correct. Due to the information available to all witnesses in that case, all witnesses were forced to use a barometer group.

Q. And what you did, as I understand it, was first determine the DCF cost of equity for this group, and then apply a risk premium to that result to obtain a common equity cost allowance for Metropolitan Edison and Pennsylvania Electric Company to reflect their perceived greater risk?

A. That is correct. That is identical to the method that I used, the risk spread method that I used in this case.

Q. Now, Philadelphia Electric Company was one of the four companies in your barometer group in the Metropolitan Edison case, is that correct?

A. That is correct.

Q. And in the course of your testimony in that case, you determined a DCF cost of common equity capital for Philadelphia Electric Company in a range of 15.1 to 15.9 percent?

A. At that time, that was a correct figure. That has little to do with what I have calculated using the same methodology today.

The only analogy you can draw using those statistics is that the cost of capital at that time for Philadelphia Electric was much higher than it is now. And I will go along with that.

Q. Mr. O'Donnell, have you had an opportunity to review the Commission's final order in the Met-Ed/Penelec case in which you recently testified?

A. Yes.

Q. Would you agree with me that your barometer group in the Metropolitan Edison case, in addition to Philadelphia Electric Company, included Toledo Edison, Ohio Edison, and Dayton Power and Light?

A. That is correct.

Q. And those three companies are also in your barometer group in this case?

A. That is correct.

Q. And that is the group which you have concluded is at approximately the same total risk as Philadelphia Electric Company?

A. Not only is it correct for Metropolitan Edison and Pennsylvania Electric, but it's also correct for the Duquesne Light case, which I have recently testified in.

The only change is to pull the one company out and add the other company. They are all comparable in risk according to the analysis I performed.

Q. Mr. O'Donnell, have you reviewed page 88 of the Commission's order in the Metropolitan Edison/Pennsylvania Electric Company Electric case, which states as follows: "Trial Staff, by Mr. O'Donnell, selected four companies he considered comparable for equity cost determinations. We agree that Philadelphia Electric Company is considered to have more risk than the other three comparables."

A. May I look at that?

Q. Certainly.

(Document handed to the witness.)

(Witness perusing document.)

A. That says that, and I would suggest that they would probably change their mind if they were writing an order today, and agree that Philadelphia Electric is comparable.

Q. This order was entered October 24, 1985, was it not, Mr. O'Donnell?

A. It was not me that stated that, however. I did not state that Philadelphia Electric was not comparable in risk.

Q. I understand that. I didn't mean to contend you did. It was the Commission that stated that, is that correct?

A. That is what the Commission said.
Q. Thank you.
A. Things changed since October.
Q. Three months, I guess, isn't it?
(No response.)
Q. Mr. O'Donnell, pages 10 to 15 of your testimony, you discuss what you characterize as certain key ratios as a prelude to your DCF calculation, is that correct?
A. Is that on page 15?
Q. Beginning on page 10.
A. That is correct.
Q. And those ratios include the market price index, dividend yield, compound dividend growth rate and dividend payout ratio?
A. That is correct.
Q. At the top of page 11, you define the market price index as being calculated by dividing the average of each year's high and low stock price by a base year's average high/low stock price and multiplying the result by an adjustment factor, is that correct?
A. That is correct.
Q. And you set forth the results of this analysis on Schedule 3, page 1 and page 2, is that correct?
A. That is correct.
Q. And you have provided data in that table and graph

for a period of 1974 to 1985, is that correct?

A. Yes.

Q. Would you agree with me that the 1985 figure that you used is not calculated in the same fashion as the 1974 through 1984 figures?

A. That is clearly a --

Q. It's a spot figure, is it not?

A. -- spot figure at December 17, as indicated on the graph.

Q. And it therefore is not calculated by dividing the average of each year's high and low stock price by a base year's average high and low stock price and multiplying the result by an adjustment factor, is that correct?

A. No. It's a spot price, as indicated on the schedule.

Q. Have you performed a calculation now for 1985?

A. No, I haven't.

Q. Would you agree with me that the high/low stock price or range for Philadelphia Electric Company for the 12 months ended December 31, 1985 is a high stock price of 17 and 5/8ths and a low stock price of 13 and 7/8ths?

A. I will agree with those statistics, and that is precisely why I used six months in my analysis.

Q. And the average of those two would be $15.75?

A. Subject to check, I will accept your figure.

Q. And what is the base stock price for 1974 that you used? Is that $14.44?

A. That sounds correct. Unfortunately, I don't have my workpapers with me right now, and I would have to check that. But that sounds reasonably accurate.

Q. And if we were to do the calculation, would you accept subject to check that it would produce a market price index of 1.09 for 1985 as compared to a 12-17-85 spot number of 1.19?

A. You say 1.09?

Q. I derived that by dividing $15.75 by $14.44.

A. I will accept that subject to check.

Q. The second ratio you examined was dividend yields, is that correct?

A. That is correct.

Q. Would our same discussion apply, that the 1985 figure is a spot number, not an average 1985 number?

A. Yes.

Q. If we applied the company's 1985 dividend of $2.20 to the average stock price of $15.75, we would achieve an average dividend yield for 1985 of 14 percent?

A. That sounds reasonable.

Q. Now, the third ratio you considered, Mr. O'Donnell, was compound dividend growth rate, is that correct?

A. That is correct.

Q. As set forth on Schedule 4, pages 3 and 4 of your testimony?

A. Yes.

Q. Now, since you have employed five and ten year moving averages, would you agree with me that the backup data for the graphs on Schedule 4, page 3 goes back as far as 1970 for the five year compound dividend growth rate moving average, and as far back as 1965 for the ten year compound dividend growth rate moving average?

A. That is correct.

Q. Mr. O'Donnell, can you cite to me any Commission order where the Commission has relied upon growth rates going back 15, 20 years in developing the growth rate in a DCF calculation?

A. I don't know that I can cite any orders. However, the way you stated that, that I developed growth rates using statistics 15, 20 years ago, that's not an accurate statement.

Q. That's not what I said.

A. That's what it sounded like to me.

Q. I asked you if you knew of any order where the Commission had done so.

A. I don't have access to all the orders at this time. I am sure that I could find orders that went back at least 10 years. If you go back to 15 and 20 years, you probably would have some difficulty finding one, but I am not going to say it doesn't exist.

Q. In fact, are there not orders where the Commission has often rejected 10 year data as stale and outdated?

A. I don't recall seeing any. I recall seeing orders where the Commission has accepted 10 year data.

Q. If you could provide me a listing of those, I would appreciate it.

A. I sure will.

Q. Thank you.

At page 14, lines 20 to 22 of your testimony, you state, "There is little doubt that investors expect a lower growth rate for PECo than for the barometer group and/or the Moody's 24," is that correct?

A. That is correct.

Q. Is that determination based upon your comparison of the relative dividend yield as discussed above in that paragraph on page 14?

A. Of course, Philadelphia Electric has a higher dividend yield than the barometer group companies and Moody's 24, so naturally you would expect in a general sense for the company to have lower growth.

Q. Or a higher cost of total capital?

A. I believe that --

Q. One or the other; it could be either, could it not?

A. If you review utility yields over the past 12 months, you will see that investors are fairly generic in their expectations of cost of capital for utilities.

Q. They expect that all electric utilities have the same cost of capital, is that what you're saying?

A. I am not going to go as far as saying that they all have the same cost of capital. However, I have reviewed the movements in dividend yield.

And if you plot the movements in dividend yield of the four electric group with the Moody's 24, you will find them moving together with a spread between the Moody's 24 and the barometer group.

And what you will find for Philadelphia Electric, up until October, is a more erratic type behavior in the yield, however generally moving in the same direction as the industry averages.

Q. So, in your view, Mr. O'Donnell, it is perfectly reasonable to expect that a utility that is rated AA and has no nuclear construction whatsoever would have the same cost of capital as Philadelphia Electric Company?

A. I wouldn't go as far as saying that. What I am saying is, the movements in cost of capital for companies such as the barometer group of four electrics and the Moody's 24 tend to move together.

You will have differences in the required rates of return based on investor perception of risk. However, they tend to move together in a generic sense.

Q. Thank you.

Now, on page 15 of your testimony, on the bottom half of the page, you state that one cannot rule out the possibility of a PECo dividend cut, is that correct?

A. That is correct.

Q. And that Limerick 2 is still a cancellation candidate, is that correct?

A. That is what I stated at the time I prepared the testimony. There might be some revision to that statement in that investor perceived risk of cancellation of Limerick 2 would be somewhat lessened by the fact that the Commission's order on Limerick 2 came out I guess it was December 5, 1985, and the anticipation of that order coming resulted in investor perception of risk being somewhat lower.

Q. Thank you, Mr. O'Donnell.

Now, we asked an interrogatory denominated IR-PECo-Staff-1-7. Do you have a copy of your response to that?

A. Yes, I do.

Q. We asked you to provide your support and backup for that statement we have just been discussing. And in the answer to subpart B, you provide a quote from the September 27, 1985 Value Line Investment Survey, is that correct?

A. That is correct.

Q. I am having a little trouble finding the source of that quote. Perhaps I am looking at the wrong document, or perhaps I am not reading it closely.

I am providing you with a copy of the document that is marked September 27, 1985 Value Line, page 203. And I would ask you if that is the source of your quotation, and if so, could you point out on that report where that quotation appears?

A. Yes, I can point that out. On page 203 of the September 27 issue of Value Line, specific to Philadelphia Electric, if you look in the bottom right hand corner where it starts out, "We're not too worried about dividend cuts, nevertheless these shares are not for the fainthearted. The principal risk is that if the Commission calls for cancellation of Limerick 2, the utility may elect to cut the dividend to ease financial pressures." That's precisely the quote.

Q. Thank you, Mr. O'Donnell.

Now, right above that, does the report also state that, "We believe that PE has sufficient unrestricted retained earnings to maintain the present common dividend even with a punitive writeoff"?

A. It states that. The primary purpose of my statement was to point out the possibility of a dividend cut, not the fact that the dividend would be cut.

Q. Mr. O'Donnell, on page 16 of your testimony, you set forth your formula for your discounted cash flow methodology, is that correct, line 10?

A. What page again, sir?

Q. Page 16, line 10.

A. What was the question?

Q. Does that not set forth the formula which you employ for determining the discounted cash flow cost of common equity capital?

A. In a general sense, that is the formula for computing the DCF.

Q. Am I correct that this is the so-called constant growth format of the DCF model as opposed to a two-stage or multi-stage DCF calculation?

A. Well, it depends on what you characterize "G" as. As you can see, I have put "expected dividend growth." I didn't say constant or non-constant. In a general sense --

Q. Is it constant or non-constant? I want to know which you used, Mr. O'Donnell.

A. I think I provided that for you in response to an interrogatory.

Q. Well, I'd like you to explain it to me again, because I didn't understand your answer.

A. Gladly.

Q. Is the growth constant or non-constant in your model as you employed it?

A. It's more of a non-constant sense in the fact --

Q. Non-constant?

A. -- that I used a range of growth rates.

Q. And it's your testimony that a non-constant DCF model can be calculated without an iteration process and using a computer?

A. Sir, I don't know what you're talking about. Would you please explain that again?

Q. Is it your testimony that simply by using a range of growth rates, you can refer to this formula as a non-constant DCF model?

A. I am just using common sense. If it's not constant, it's non-constant.

Q. I am asking a very simple question. Is it your testimony that by simply using a range of growth rates for the "G" value, you can denominate this a non-constant DCF model, yes or no?

A. I have to answer it, in a word, yes, the range of--

Q. Thank you.

A. -- growth rates indicates that it could be higher or lower, which makes it non-constant.

Q. Thank you, Mr. O'Donnell.

Mr. O'Donnell, looking at your growth rate for a moment, am I correct that you proposed a growth rate range of 1.0 to 2.0 percent?

A. That is correct.

Q. And am I also correct that this growth rate is based primarily upon forecast growth rates by Value Line, Salomon Brothers and Merrill Lynch?

A. That is correct.

Q. Did you give any particular weighting to the three? I noticed that Value Line appears to be the top end, whereas Salomon Brothers and Merrill Lynch appear to be a little bit lower.

A. There's obviously no weighting. It's a range of the numbers, dividend growth rate numbers that I have reported.

Q. You didn't give them any particular weight?

A. That's what I said.

Q. But you would agree with me, referring to Schedule 5, page 2, that the Value Line forecasts are somewhat higher than the Salomon Brothers and Merrill Lynch, is that correct?

A. That is correct. And I think you can find, if you read further into the Value Line forecast and you read the writeups they have, you have involved in there other possibilities.

For instance, in the September 27 Value Line, they use a 2 percent dividend growth rate. However, in the writeup, they refer to the possibility of a dividend cut.

Now, in the December 27, you will see the same

2 percent growth rate forecasted for dividends. However, in the writeup, Value Line says, "The immediate risk of a dividend cut has been eliminated."

That still does not mean that there is not a risk of a dividend cut, or a risk of a cancellation. What it means is, the immediate risk of a dividend cut has been eliminated.

Q. So, you think Value Line might be a little less reliable in this instance?

A. That is not what I am saying. What I am saying is, you wouldn't want to fall into the trap of weighting growth rates, because they could be reliable; then again, you will find that even Value Line, that's an independent rater of growth rates, is not quite sure about what is going to happen.

Q. Am I correct, Mr. O'Donnell, that you presented testimony in the most recent Duquesne Light proceeding?

A. That is correct.

Q. I would like to show you a portion of your cross-examination from that proceeding, and ask you to go over it for a moment, if you could.

A. (Witness perusing document.)

Q Would you agree with me that you testified at 1669 of the transcript in that proceeding, "I do not consider Salomon Brother projections as reliable as Value Line"?

A Yes.

Q And that was because certain employees of Salomon Brothers testifying in electric utility rate proceedings from time to time?

A Yes. What I was referring to was Value line is more of an independent agency than Salomon Brothers. However --

Q And the same is true for Merrill Lynch; is that correct?

A I'm not saying that the estimates are right or wrong for Salomon Brothers or Merrill Lynch. All I'm saying is you have to be able to use a little bit of common sense in looking at these growth rate estimates, and when you realize you have witnesses testifying for the electric utilities who are also analyzing growth rates you have to be a little bit suspicious. But that doesn't mean that their estimates are right or wrong.

Q I see. Would you agree with me then that on page 1671 you stated as follows, "All I said was that the 2.5" percent "Value Line is projecting and Value Line being an agency that's not selling stocks or testifying in rate of return such as Salomon Brothers --"?

A That is correct.

Q And then referring to page 1672 to the cross-examination, you are asked a question by Judge Casey. Question: "You are indicating they have no ax to grind. That they are not in the same type of business as Salomon Brothers --"

Your answer: "That's right.

Judge Casey continuing, "-- which actually underwrites the markets, securities and --"

And then you continue your answer stating, "Well not only that. They have someone who works in the utility section of the company, Mark Luftig, who testifies for electric utilities. There is all kinds of possibilities that do exist as to why those growth rates -- why they are. I'm a little suspect at certain times. But Value Line I'm not suspect of."

Is that correct?

A Yes, and I would like to add that subsequent to that testimony in the Duquesne case Salomon Brothers was projecting a 3 percent growth rate, and the next month the growth rate was 1.5. That's what I was trying to point out. I was suspicious of that growth rate being too high in that case, and evidently Salomon Brothers has seen the light and has agreed with me.

Q Now that they have reduced the growth rate they are okay, aren't they, Mr. O'Donnell?

A I think so.

Q But when they were a little higher it was a problem for you, wasn't it?

A Yes, it was.

Q Finally, at page 1673 --

A Because there were indications in that case that the growth rates were overstated. Even Value Line's growth rates were overstated.

Q Finally, Mr. O'Donnell, would you agree that on page 1673 you expressed a similar concern with respect to Merrill Lynch stating as follows, "That's correct, and Merrill Lynch has the same situation. Mr. Kamosa (phonetic) testifies and he has people under him who testify for the electric utilities. Value Line does not to my knowledge in that situation"?

A That is correct; I stated that.

JUDGE MATUSCHAK: When you come to a reasonable place for a break we will recess for lunch.

MR. MacGREGOR: Your Honor, I can finish in about ten minutes and then we can break for lunch at that time.

BY MR. MacGREGOR:

Q Mr. O'Donnell, you also employed a risk spread approach in this case, did you not?

A That is correct.

Q I understand that what you did is you looked at the DCF result for your barometer group of 12.6 to 14.2 percent and tried to determine how you would adjust that to reflect any difference in risk between Philadelphia Electric Company and that barometer group; is that a fair summary?

A Yes.

Q What you did to determine that risk differential is to compare the current yields to maturity for the six months ended November 30, 1985 on a PECo bond and similar bonds for companies in the barometer group?

A Yes.

Q Am I correct that the results of this analysis are set forth on page 18 of your testimony?

A Yes.

Q Am I correct that your risk spread results indicated that PECo was slightly less risky than the barometer group, and you, therefore, reduced your DCF for your barometer group by ten basis points to reflect that lesser risk of Philadelphia Electric Company; is that correct?

A Yes. I could perhaps not even have performed that operation at all. I'm not going to get excited over ten basis points. What I was trying to point out was that in a similar situation it appears as if Philadelphia Electric is similar in risk to the barometer group.

If you look on pages 3 and 4 of Schedule 6 you will see slight differences in the maturity dates and the nominal interest rates. Those slight differences could amount to ten basis points.

Q But you did make the adjustment in your testimony and you presented the risk spread as a separate analysis on page 27, showing a different range of results; isn't that correct?

A I take the range of results there and made a calculation, but that does not necessarily mean that that had a significant effect on my judgment as to the required rate of return for Philadelphia Electric Company.

Q And in fact, as stated on page 20 at lines 9 through 11, you "believe the DCF result should be viewed as a more credible method than the risk spread;" is that correct?

A Absolutely, and I think you'll find prior Commission orders over the past two years to support that, that the risk spread method is pretty much DCF-dependent; and I don't think the Commission gives the risk spread method as much weight as the DCF method either.

Q Finally, Mr. O'Donnell, turning to your coverage calculations at the end of your testimony, am I correct that in developing your coverage calculations you employed an effective tax rate of 40 percent?

A Yes. That was based on an industry average type analysis and also an analysis of Philadelphia Electric's effective tax rate at June 30, 1985.

Q Is there any particular reason why you chose June 30, 1985; is that the end of the company's fiscal year?

A That was the latest statistic I had available to me from Salomon Brothers in "The Electric Utility Quality Measurements" dated October 14, 1985.

Q Did you perform any independent determination of the effective tax rate, yourself?

A No. I stated --

Q Do you know how to calculate an effective tax rate?

A Absolutely.

Q But you did not in this case?

A I didn't need to. Salomon Brothers calculated it for me.

Q Would you agree with me that the Value Line publication,which you referred to, on September 27, 1985 shows an average effective tax rate for Philadelphia Electric Company for the 1980-84 period, the last five years for which there is actual data, of 21.44 percent?

A I agree with that. Things have a way of changing too.

Q Would you agree with me that Value Line forecasted an effective tax rate for 1986 for Philadelphia Electric Company of 24 percent?

Yes or no.

I'll show you a copy of that.

A I agree with you. I agree with you.

Q Thank you, Mr. O'Donnell.

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

MR. RUBIN: Your Honor, I think I can finish my cross within ten minutes if you would like to do that before we break for lunch.

JUDGE MATUSCHAK: Very well.

CROSS-EXAMINATION

BY MR. RUBIN:

Q Mr. O'Donnell, on pages 20 and 21 of your testimony you discuss a number of the factors which lead you to the conclusion that PECo's cost of equity is between 14 and 15 percent. In reaching that conclusion did you attempt to remove any risks which are currently reflected in the price of PECo's common equity?

A Yes. It is pretty obvious that although I calculated a DCF required rate of return for Philadelphia Electric in the range of 14.7 to 15.7 eprcent, I specifically stated that I felt that one of the inputs to my rate of return calculation, the six months average dividend yield of 14.7 percent, appeared to be based on undervalued prices; and I stick by that statement. Subsequent to the preparation of my testimony -- well, I should say at the time I prepared my final draft the yield was 12.8 percent, and risk has in fact been somewhat removed from Philadelphia Electric's valuation, and that is the risk that they -- they are now permitted to construct Unit No. 2, however with cost of capital.

So some uncertainty has been eliminated from investors' minds as it is reflected in the price of stock. That is reflected.

Q But that slightly lower risk is reflected in the current market price of PECo stock; is that correct?

A Yes.

Q So you have not attempted to remove any risks for ratemaking purposes that investors might perceive currently in the stock market for PECo?

A May I have the question repeated?

Q Perhaps I should try to restate it. Would you agree with me that there are a whole series of risks which investors would perceive today for Philadelphia Electric Company?

A Yes.

Q And have you for ratemaking purposes attempted to remove any of those risks in determining a fair rate of return for Philadelphia Electric Company?

A No.

Q I believe you referred earlier under your examination by Mr. MacGregor to allowed rates of return for Ohio Edison, Toledo Edison and Dayton Power and Light. Would you know when those allowed rates of return were determined by the Ohio Commission?

A No.

Q Would you know if they would have been very recent, say within the last two to three months?

A I'd have to look that information up. I'm generally aware that the rates of return were in the 17 percent range, and of course I'm generally aware that the Ohio Commission is trying to soften the effect of their law that requires that these utilities are not permitted to write off their costs associated with cancelling power plants.

Q I believe you also referred to the testimony which you submitted in the Metroplitan Edison and Pennsylvania Electric Company cases at Docket Numbers R-842770 and 842771. Do you know when your testimony in those cases was prepared, approximately?

A I think it was probably the first quarter of 1984, somewhere around there. I'm sorry; 1985.

I have to go back; I'm sorry. In the previous response that I gave I said that the Ohio utilities are not permitted to write off their costs. What I meant was they will be able to write them off, but they are not permitted revenues to recover those write-offs. I want to make sure that the record is clear on that.

Q I'm sorry; you said that your Met-Ed and Penelec testimony was prepared in, you think, the first quarter of 1985?

A Will you give me when the decision date was in that case?

Q I believe it was October of 1985.

A I'll say in the early part of 1985 it was prepared. I'd have to go back and get that date for sure, but I recall still having to deal with the so-called nuclear power shock in the stock market with not being able to use 12-month yields because they included improper valuations of stock. I'll just say around the early part of 1985; it could have been as late as April, I guess.

Q I think you also referred to the fact that Salomon Brothers and Merrill Lynch have individuals who testify for electric utilities. Would that fact tend to understate or overstate their growth rate estimates?

A It could do either. In the case of Duquesne Light Company it was clear that with all of the knowledge I have of what was going on in that case that the growth rate that Salomon Brothers was using was grossly understated. It didn't take Salomon Brothers long to agree with me.

Now as far as Merrill Lynch went in that case, Merrill Lynch didn't even provide a growth rate in Duquesne Light.

But as to the statement you made about if it over or understates the growth rate, any agency, including Value Line, any security analyst has a line of thinking that goes into forecasting those growth rates. And, of course, as we have seen in the case of Salomon Brothers, they could be wrong. I've seen it happen in Value Line.

I testified in an Equitable Gas case back in 1980, I believe it was, and Value Line was talking about a 23 percent growth rate, and in the very next supplement that came out for the same company, Equitable Gas, it was 13 percent. So they have a way of being wrong.

Q Thank you, Mr. O'Donnell.

MR. RUBIN: That's all we have, Your Honor. Thank you, Your Honor.

MR. MacGREGOR: Your Honor, I think Mr. Rubin's examination of Mr. O'Donnell was clearly in the nature of redirect examination. I would like the record to reflect that it was so, as opposed to cross-examination.

JUDGE MATUSCHAK: Do you say you have further cross-examination?

MR. MacGREGOR: No, Your Honor. I was just saying that Mr. Rubin's cross-examination appeared to me to be simply redirect examination; I would like to state that.

JUDGE MATUSCHAK: Be it as it may, call it by any other name.

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

JUDGE MATUSCHAK: Very well. We will reconvene at 1:50.

(Whereupon, at 12:50 p.m. the hearing was adjourned to be reconvened at 1:50 p.m. this same day.)

sl:T2b

AFTERNOON SESSION

(1:55 p.m.)

JUDGE MATUSCHAK: We can begin.

Whereupon,

JAMES A. ROTHSCHILD

having been duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. RUBIN:

Q. Mr. Rothschild, could you please state your full name and business address for the record?

A. Yes. My name is James A. Rothschild. My business address is 115 Scarlet Oak Drive, Wilton, Connecticut.

MR. RUBIN: Your Honor, I would like to have marked for identification as OCA Statement No. 3 a multi-page document which is the testimony of James A. Rothschild in this proceeding.

JUDGE MATUSCHAK: It will be so marked.

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

BY MR. RUBIN:

Q. Mr. Rothschild, do you have before you a copy of what has been marked as OCA Statement No. 3?

A. Yes.

Q. And is this your prepared direct testimony in this proceeding?

A. Yes, it is.

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

A. Yes.

Q. Do you have any corrections to make to OCA Statement No. 3 at this time?

A. Yes, I do have one change to the text, which will be on page 5 at line 4. Between the next-to-the-last and the last word on that line where it says "the Moody's," insert in there "the non-nuclear construction Moody's."

JUDGE MATUSCHAK: What is the correction?

THE WITNESS: I want to add the words "non-nuclear construction" between the words "the" and "Moody's" on line 4 of page 5.

JUDGE MATUSCHAK: So it will read "the non-nuclear construction Moody's 24 electrics"?

THE WITNESS: Yes.

BY MR. RUBIN:

Q. And attached to OCA Statement No. 3 are a series of schedules. Were these also prepared by you or under your direction and supervision?

A. Yes.

Q. Do you have any corrections to make to those schedules at this time?

A. Yes. On Schedule 1, page 2, the highest number on the page is the 13.54 percent. That should just be deleted. Footnote A associated with that number should be used to reference the 13.65 percent right below it.

JUDGE MATUSCHAK: I didn't get that.

THE WITNESS: On Schedule 1, page 2, the first column of numbers, the first number in that column is the 13.54 percent. That should just be deleted.

JUDGE MATUSCHAK: That should be deleted?

THE WITNESS: Yes.

JUDGE MATUSCHAK: All right.

THE WITNESS: The Footnote A should make reference to the 13.65 percent just under it in the next column.

JUDGE MATUSCHAK: All right.

THE WITNESS: On Schedule 2, page 1, on the line entitled "Non-nuclear Construction Electrics," the "13.60 percent" should read "13.65 percent."

Right next to it, the "8.72 percent" should read "8.71 percent."

In the last line, the "11.28 percent" should read "11.66 percent." And the "14.12 percent" should read "13.74 percent."

On Schedule 4, page 3, the number on line 5 should be "$5,864,000."

That completes the changes.

BY MR. RUBIN:

Q. With those changes, is the testimony and schedules which appear in OCA Statement No. 3 true and correct to the best of your knowledge, information and belief?

A. Yes.

Q. If I were to ask you those same questions today, would your answers be the same as contained in OCA Statement No. 3?

A. Yes.

MR. RUBIN: Your Honor, at this time, I would like to move into evidence, subject to any motions to strike made in a timely fashion, OCA Statement No. 3.

JUDGE MATUSCHAK: Under those conditions, the motion is granted.

MR. RUBIN: Thank you, Your Honor. Mr. Rothschild is available for cross-examination.

(Whereupon, the document marked as OCA Statement No. 3 was received in evidence.)

JUDGE MATUSCHAK: Mr. MacGregor?

MR. MacGREGOR: Thank you, Your Honor.

CROSS-EXAMINATION

BY MR. MacGREGOR:

Q. Good afternoon, Mr. Rothschild.

A. Good afternoon.

Q. Continuing with your schedules for a moment, refer for a moment to Schedule 6, page 2.

A. Yes.

Q. With reference to Footnote A, "Schedule 6, page 4," would you agree with me that there is no Schedule 6, page 4, at least not in the copy of the testimony that was provided?

A. That is correct. I believe that was provided to you in response to an interrogatory request.

MR. MacGREGOR: Do you intend, Counsel, to include that as part of the testimony?

MR. RUBIN: I don't think it is necessary to do so. Certainly, Mr. MacGregor, if you would like to include that in the record, as Mr. Rothschild just said, you've been provided with a --

MR. MacGREGOR: If you want to leave the testimony in the record that says "Schedule 6, page 4," as a source for the document and not provide the schedule, that's fine with me.

BY MR. MacGREGOR:

Q. Is the same true of Footnote E; there is no Schedule 6, page 6 provided in the testimony as submitted?

A. No. It was intended in order to simplify the filing to treat those schedules as workpapers and will be made available upon your request. They simply support the derivation of the numbers on the schedule.

Q Thank you.

Mr. Rothschild, am I correct that you have not challenged the company's proposed capital structure ratios or embedded cost of preferred stock or long-term debt?

A. I have not challenged the capital structure ratios, and I have talked about -- I wouldn't necessarily call it challenged the embedded cost of debt.

My understanding is that Mr. Brennan does plan to update the embedded cost of debt and the embedded cost of preferred stock to reflect the market realities that have occurred since the original filing.

Assuming, I believe, if that is done correctly, then I would suspect that I would not oppose it.

Q Is it correct that the proposed common equity cost rate which you set forth in your testimony for Philadelphia Electric Company in this case is 14.0 percent?

A. I have recommended a fair return on equity for Philadelphia Electric in this case of 14.0.

Q Am I correct that this recommendation is based primarily on the results of your DCF analysis with a few other methods used as a check on that?

A. Yes.

Q Am I also correct that the form of the DCF model you've used is a single-stage constant growth model, what is commonly referred to as that?

A. It is correct that my final analysis was done using the single-stage approach, but it wasn't done without forethought and without discussion, which is in my testimony, where I believe it is applicable in this case.

Q. Is it correct in a single-stage DCF model that assumes a constant growth rate that the analyst also assumes no change in the dividend payout ratio in the period of analysis?

A. No. I don't think it is fair to say that anybody ever expects no change in anything, but --

Q. The model itself -- I understand that, but the model itself at least in theory assumes a constant payout ratio, a constant earnings to book value ratio, a constant price/earnings multiple, does it not, the formula itself?

A. The strict mathematical derivation of the formula does assume that all of these things are being held constant; however --

Q. And we all recognize that that really isn't the case in the real world.

A. It is not the case in the real world, and it is not necessary to believe that these things will remain exactly the same over time in order for it to make sense to use the simplified version of the DCF formula.

Q. Is it necessary to assume that they will remain relatively stable over time?

A. No. It is only necessary to assume that in the first place there is no more reason to expect an upward bias than a downward bias and that what you are reflecting is a reasonable reflection of a long-term average.

Q. Would you agree that referring to page 16 of your testimony, the question and answer beginning on line 5-- the question states: "Why do you believe it is generally possible to use the simplified version of the DCF method in public utility rate proceedings?"

Your answer begins: "For most electric utilities, business conditions are relatively stable. Earnings fluctuate to a certain degree based upon local economic conditions, certain extraordinary events and the timing of rate cases. However, results generally tend to be brought back to a reasonable profit allowance based upon Commission rate increase awards."

Is that correct?

A. Yes.

Q. And this is an important reason in your view, I take it, that allows you to use this form of the DCF model in forecasting the cost of common equity in electric rate proceedings?

A. That is one of the important considerations, yes.

Q. Would you agree with me, Mr. Rothschild, that the issue in this case is to determine the common equity cost rate for Philadelphia Electric Company?

A. The purpose is to determine the fair rate of return which Philadelphia Electric should be afforded at this point in time.

Q. Am I correct that your 14 percent recommendation is based upon a DCF calculation for those members of Moody's 24 electric companies who you believe do not have ongoing nuclear construction programs?

A. Yes, it is. The reason is explained in this testimony. It is my intent to arrive at the non-nuclear risk cost.

Q. So your recommendation for PECo in this case as to a fair rate of return is established as though PECo did not have an ongoing nuclear construction program?

A. Yes. The cost of equity for Philadelphia Electric at least as of the time this testimony was prepared is somewhat higher than the 14 percent; but nevertheless, I feel the 14 is the appropriate return to allow.

Q. And you're not testifying that the risk in investing in Philadelphia Electric Company stock is the same as the group of non-nuclear utilities that you analyzed as part of Moody's 24?

A. That is correct; I am not saying that the risk is the same. I believe the risk is somewhat higher for Philadelphia Electric.

Q. And, in fact, as indicated by your own testimony, you performed a separate DCF calculation specifically for Philadelphia Electric Company and found that cost rate to be 14.75 percent; is that correct?

A. Yes, based upon the analysis of both Philadelphia Electric and in viewing the analysis of the Moody's nuclear construction group.

Q. Mr. Rothschild, are you aware that the Office of Consumer Advocate and the City of Philadelphia proposed a similar methodology in the company's last electric rate proceeding which was decided by the Commission in January of 1985?

A. I am aware that there was a proposal to consider a nuclear risk segmentation at that time. I think there are a lot of things that have changed since then. I'm also aware that the Commission did not use that approach at that time. But I think in view of the fact that Limerick 1 is scheduled to go commercial shortly and has already been operating under test power, as we look to the future, we're looking at a company that should have significantly diminishing nuclear risk, and that would be one reason why looking at the non-nuclear risk would be more indicative of what the not so far out future will show for Philadelphia Electric.

The other reason is, as I've explained in my testimony, the decision of this Commission to permit the company, if it should choose, to continue construction of Limerick 2 is one, at least as I read the decision, that says the Commission wants to keep the risks and the costs of that the responsibility of management and the stockholders to the extent that a specified cap level is exceeded. And I think to fully segment that, I'm continuing with what the Commission's most recent wishes are.

Q. Other than the general quotation on page 4 of your testimony from the Commission's order, can you point to me anywhere in the Commission's Limerick 2 order where the Commission specifically said that as part of the cost containment program it adopted that the Commission would make adjustments to the company's common equity cost rate in future rate proceedings to remove the risk associated with Limerick 2?

A. There is no place in the decision where the cost of common equity is specifically discussed.

Q. The Commission ordered --

A. The order does not talk about the cost of equity. That wasn't the purpose of that order. I'm just suggesting that to me, it is consistent with the statement in that decision and a logical extension of my reading of the intent. The Commission is going to know its intent better than I can know it. But at least to what I believe is consistent with what the Commission is now saying, this approach is appropriate

Q. But you're not stating in any way that the Commission's order requires that or states that that is what the Commission plans to do? There is no statement at all about making adjustments to common equity cost rates, is there?

A. Common equity cost rates, to the best of my recollection, are not mentioned in that decision at all. However --

MR. MacGREGOR: Your Honor, I believe the witness has answered my question.

JUDGE MATUSCHAK: We will let him finish.

THE WITNESS: As I read the decision, it is a logical extension of what the Commission has already said. Of course, the same Commission will be making the decision in this case and it should know very well what it intended.

BY MR. MacGREGOR:

Q. Would you agree with me that the Commission order is fairly specific about the cost program? It establishes a specific cap on the total construction cost of Limerick, is that correct, of about $3.2 billion?

A. There is a specific cap right around that, yes.

Q. And they also established a specific limitation on capital additions after the plant is placed in service; is that correct?

A. To my recollection, yes.

Q. And the order also established a specific operating performance standard for the Limerick 2 plant; is that correct?

A. Yes; I believe within a range.

Q. Mr. Rothschild, looking at your growth rate analysis which you used in the DCF calculation for your group of non-nuclear companies, you employed, as I understand it, three growth rate indicators. You looked at the 1984 achieved returns on book equity, the Value Line projected return on book equity, and the I/B/E/S projected returns as well; is that correct?

A. Yes.

Q. Now, at page 16 of your testimony, line 18, you state "One common mistake that must be avoided in the implementation of the DCF method for public utilities is to compute a compound annual growth rate from some historic period as a starting point and to apply that "g" to the simplified D/P + g formulation." Is that correct?

A. Yes.

Q. Would you agree with me, Mr. Rothschild, that this Commission has often employed historic earnings and dividend growth rates in establishing a DCF cost of equity, if you know?

A. I believe it has done so sometimes. I really would hate to say whether it is appropriate to categorize it as often or not.

Q Have you in any prior testimonies ever relied on historic growth rates as a starting point for your analysis?

A. I never have.

Q You state above -- and I think we went over this before -- on page 16 that one reason why it is possible to use the DCF method in public utility rate proceedings is that for most electrics, business conditions are relatively stable; is that correct? That is lines 8 and 9 on page 16.

A. Yes.

Q If for most electric utilities business conditions are relatively stable, why isn't it reasonable to use historic growth rates as a forecast of the future if they are going to be relatively stable?

A. Business conditions can be relatively stable and indeed are, but general economic conditions change in less predictable ways.

What is important to recognize is that, for instance, we've had over the last five years or so a general up trend in the earned returns that were achieved by electric utilities, and that kind of an increase is a response to a general change in economic conditions and inputs that develop through a maturity phase that can occur in a historic period. But as we look to the future, we estimate what we think can happen. We're looking at a best expectation of reasonable stability.

I haven't heard anybody talking about electric energy becoming obsolete. It is still a very important part of our society. The best way to provide that service is still through a major electric utility that can build large plants to serve the general population.

Q. So as I understand it, conditions are stable enough to use the DCF model, but they are not stable enough to look at the historic earnings and dividends growth rate; is that correct?

A. The historic period has an identifiable, non-repeatable function in it; and if you rely on the historic numbers, you will be making an inference about the future which is unfair to extrapolate from the past.

Q. All right. Would you agree with me that what we are trying to establish here is investor expectations of future growth?

A. Yes.

Q. And we really don't know to what extent investors rely on history versus forecasts in making their investment decisions; is that correct? Or perhaps you do know.

A. I can't tell you exactly what percentage of investors do what. It is safe to say that there are at least some investors that would fall into a pretty wide array of factors.

I think it's safe to say that if there are a number of investors relying on historic growth indicators as what they expect for the future, then the result is the stock prices would become illogically distorted. So that those investors who have their act together who are preparing a more thought-out and detailed analysis will bid the price -- put more dollars in and bid the price back to its appropriate level.

It's simply not rational to expect a continuation of earned return on equity growth particularly at this juncture when we had a period as we go back three, four, five years ago when electric utilities were under-earning. As most people would agree, market-to-book ratios of .7 were inadequate and there was a recovery from that inadequate level to adequate or in many cases today above adequate earning levels combined with general interest rate declines and inflation being lower. As we move to the future, it just wouldn't make sense for earned returns on equity to continue to increase.

You can see this not only by looking at the comparison between historic earned return on equity and what Value Line says and what I/B/E/S says, but you can see the same kind of discussions coming out from FERC, and we're seeing more and more in terms of current allowed returns on equity.

Q You mentioned I/B/E/S in your answer. If you would look at page 35 of your testimony, beginning at line 9, you state, "It provides a helpful balance to the historical earned return study and the shorter-term return on equity estimates presented in I/B/E/S;" is that correct?

A. That's in the discussion of how I/B/E/S compares to the forecast in Value Line.

Q. Am I correct that I/B/E/S does not forecast returns on equity; it forecasts earnings growth rates?

A. I/B/E/S forecasts earnings per share.

Q. It does not forecast return on equity estimates; is that correct?

A. There is no place I am specifically aware of in which I/B/E/S expresses its earnings per share in terms of return on equity. It is merely a question of how to express the numbers. Because to obtain return on equity all one has to do is take the earnings per share and divide it by book value.

Q. You have to project the value, do you not?

A. You have to project book value, that is correct; but book value is essentially equal to the prior period book value plus earnings minus dividends. So you can project book value with a reasonable degree of accuracy.

The only appropriate way to interpret the earnings per share forecast as published in I/B/E/S is to convert that number to the mathematical number you need to implement the DCF method.

Q. On page 36 of your testimony beginning at line 19, you say, "In the case of I/B/E/S, the actual period for growth is not stated;" is that correct?

A. Yes. It is not specifically stated.

Q. Do you subscribe to I/B/E/S?

A. No, I am not a subscriber to I/B/E/S.

Q. Doesn't I/B/E/S state the projected five-year growth rates?

A. The source which I obtained the numbers from did not state that, no. I was using a -- it was approximately a one-year growth rate period, but it will vary somewhat, because what I/B/E/S is is a composite average of essentially all of the generally followed analysts on Wall Street, and there are going to be slightly different time periods from one to the other.

Q. In addition to your non-nuclear group of electrics, you also examined data for the nuclear group in Moody's 24; is that correct?

A. Yes.

Q. And for that group you also, in establishing your growth rate, looked at 1984 returns on book equity and Value Line and I/B/E/S forecasts; is that correct?

A. Yes.

Q. And Philadelphia Electric Company is included in that group, is it not?

A. Yes, it is.

Q. And you provided and relied upon certain data for Philadelphia Electric Company as part of your nuclear company analysis as shown on Schedule 5, page 3; is that correct? And specifically columns 9, 11 and 12 show an achieved return on book equity for Philadelphia Electric for 12/31/1984 of 15.08 percent, a Value Line forecast of 14 percent, and an I/B/E/S estimate of 14.54 percent; is that correct?

A. Yes, that is correct.

Q. You used those figures in your nuclear analysis, but when you went to develop your DCF cost of equity for PECo, you made certain adjustments to those numbers; is that correct?

A. I did make adjustments to those numbers; that is correct.

Q. And you didn't use the 1984 return on book equity figures at all, as I understand it; is that correct?

A. That is correct; I did not.

Q. And then you took the I/B/E/S and the Value Line numbers, 14 and 14.5 percent, found the mid-point of that as being 14.25 percent, and then made certain adjustments to that number to reflect either a $500 million or a $1 billion rate base allowance for Limerick 1; is that correct?

A. Disallowance.

Q. Disallowance.

A. That is correct.

Q. And the $500 million rate base disallowance produced a projected return on book equity of 13.25 percent, and the $1 billion disallowance produced a 12.25 percent number; is that correct?

A. Yes.

Q. Mr. Rothschild, did you calculate what the return on equity would have been for PECo had you employed the average of the three figures shown on Schedule 5, page 3?

A. No, I did not, because I don't think it would be appropriate.

Q. Would you accept, subject to check, that the figure would be 16.5 percent?

A. It might be. I want to stress that there would be no meaning to that. If I could, I would be happy to explain.

Q. No, I don't think we need an explanation.

Now, if we look on Schedule 4, page 1, am I correct that this shows the backup calculations for your DCF calculation for PECo?

A. Yes, that is correct.

Q. Correct me if I am wrong, but as I understand it, the left-hand side of the calculations is the result using a 13.25 percent projected return on equity and the right-hand is the result using a 12.25 percent projected return on equity; is that correct?

A. Yes, that is correct.

Q. And what you did was to average the 13.25 and 12.25 results at December 31, 1984 with the 13.25 and 12.25 results at November 30, 1985, is that correct, and then added floatation costs to achieve your 14.75 percent number? It is explained in your testimony. I am just taking it from there.

A. Yes.

Q. As we previously indicated, the 12.25 and 13.25 percent figures assume a rate base disallowance associated with Limerick 1; is that correct?

A. Specifically what it assumes is an estimate of what investors would expect for disallowance.

Q. And what you're doing is you reduced the Value Line and I/B/E/S forecasts to reflect that possibility; is that correct?

A. Yes, that is correct.

Q. Do you know, Mr. Rothschild, whether and to what extent the Value Line and I/B/E/S forecasts have already taken into account the potential rate base disallowance for Limerick 1?

A. Yes. At least with regard to the Value Line forecast, if you look on the Value Line sheet in the lower right-hand column, you will see the initials "PL", and that stands for Peter Lin. Mr. Lin is the analyst who prepared the Philadelphia Electric Value Line sheet.

I did talk to Mr. Lin and asked him whether or not he factored in the possibility of any disallowance for Limerick 1 investment and he said, no, that he did not; that the 14 percent was before consideration of the possible disallowance.

In the case of I/B/E/S, because it is an aggregate result of a bunch of analysts, it wouldn't be feasible to call them all and ask them, but it is simply a question of looking at all of the other inputs and all of the other numbers and realizing, indeed, what makes sense.

Q. You made an adjustment here to your growth rate to reflect the potential of the Limerick 1 disallowance; is that correct?

A. Yes, which is conceptually -- if I've done it right, and I realize that numbers like this are of their nature imprecise -- I can't tell you exactly what investors expect on average for a write-off for Limerick 1. But if the $500 million to $1 billion range is correct of what investors expect on average, then that has to be taken into consideration of what impact it will have for future cash flows that the company will be able to generate.

Q. If the Commission makes such an adjustment at the end of this rate case, Mr. Rothschild, do you have any projection of what might happen to the company's stock price?

A. If you tell me hypothetically what the disallowance would be. $750 million?

Q. Correct.

A. If it was $750 million --

Q. Would the stock price go up or down?

A. It would slightly go up at that level, to my best estimate. The reason is as follows: if the expectation of $750 million is correct, then that per se would leave the stock price unchanged; but because an uncertainty will have become history, the relieving of an uncertainty has a slight reduction in risk and that would make the stock price go up a little bit.

Q. In addition to your Limerick 1 adjustment, you have also proposed an adjustment for new financing growth on line 4; is that correct?

A. Yes.

Q. This adjustment is negative for Philadelphia Electric Company. Does this indicate that your expectation of the company's new issuance of common equity will sell below book value?

A. As of the time this was prepared, the market-to-book ratio for Philadelphia Electric was .88. So that at that point in time, given the fact that Philadelphia Electric was still faced with the possibility at least of an ongoing construction program for Limerick 2, the result of the ongoing construction would be external financing, and external financing at a 88 percent market-to-book would result in dilution.

Of course, right now the stock price has gone up; so that market-to-book is about 1. So that redoing the analysis today would, of course, lower the dividend yield and it would also eliminate the necessity to make a new financing growth adjustment at this point in time.

Q. So you would not make such an adjustment today if you were redoing your testimony; is that what you're saying?

A. I would make the adjustment; however, the adjustment would be zero. I always like to make the computation. But you've got to use that with the current dividend yield.

Q. Looking at your numbers as they are calculated on Schedule 4, page 1, if you remove the new financing growth adjustment, I would calculate an equity cost rate of 15.2 percent, just as a calculation. Would you accept that subject to check?

A. I'm not sure what meaning the number has.

Q. I'm not asking you if it has any meaning. Just accept the calculation.

A. If you take -- depending, of course, which column we're looking at -- if you take the November 30th computation, it is true that the impact on growth of the new financing growth adjustment is a negative .41 percent.

Q. What I did was remove .59, the .41, performed your calculation the same way, and added floatation costs, and I got 15.2 instead of 14.75.

A. Arithmetidally, that could be correct. The only thing I want to point out, if you're going to do that even though I disagree, you would at least do that, which would also be incorrect, with regard to the non-nuclear construction companies. In the non-nuclear construction companies, the market-to-book is above 1, and that factor is an increment to growth.

Q. I understand that. I'm trying to get at a little different point.

If you establish a 15.2 percent cost of common equity in this case, is it your view that that would result in the company, all other things equal in your analysis, issuing common equity at above or below the book value or at book value?

A. 15.2 in this marketplace would produce a book value fairly substantially above 1.

Q. So it is your negative new financing growth adjustment that would cause the sale of stock below book value?

A. No, no. You said a couple different things.

If you allow a return on equity higher than appropriate, then the market-to-book will be above 1. The dividend yield will be lower, but the market-to-book will end up at above 1.

Sure, at that point in time the new financing growth adjustment will change from a negative to a positive because the dividend yield change will somewhat overstate change in the cost of equity. So you have to look at the two terms together. As it turns out, the dividend yield term moves a lot faster than the new financing growth term.

Q. I'm not talking about updating. I'm just looking at the numbers on this schedule.

A. Okay; but once you take a new earned return on equity and plug it into the formula to see what would happen, you're talking about an updating.

Q. I'm trying to see what's causing the stock to sell below book value in your analysis as shown on this sheet.

Is it already going to sell below book value and so that's why you make the adjustment here, or is it going to sell at book value if you don't make the adjustment?

A. Neither. What is causing --

Q. Neither?

A. To simplify the discussion if it's all right, hopefully to make it easier to follow, if we just look at the November 30th, 1985 line and for the moment just look at the column where the return on equity expectation is 13.25, what is driving the market-to-book ratio of 88 percent is not the expectation of a cost of equity of 14.53 as shown here, but what is driving it is an investor expected earned return of 13.25.

So what you're saying to me is now if you change your recommendation so that investors expect the company would earn something higher than 13.25, would that result in a higher market price; and the answer is yes, it would.

How much it would take to get the market-to-book to 1, the answer is 14.53, just for the moment concentrating the analysis on that one column.

Q Will the forecasted return on book equity also depend on the cost of common equity allowance made by the Commission in this case?

A. In part, yes.

Q And if you recommend a lower allowance, that will reduce future earnings and tend to increase the possibility of sales of stock below book value; is that correct?

A. If I recommend an allowance lower than 13.25, I would expect that the stock price would drop, yes.

If the Commission sets rates so that this company will earn 13.25 or between 12.25 and 13.25, the stock price will remain unchanged. That would be, in my opinion, an allowance which is below the fair return on equity for Philadelphia Electric. I'm not recommending 12.25 to 13.25 here.

Q Mr. Rothschild, would you agree with the following quotation? "In summary, the appropriate cost of equity for purposes of rate regulation is the earned rate of return which would allow the markeplace valuation of a company's used and useful net assets to equal the total book value of the common stock. In this way, the rate of return potential of an investor's funds ensures neither an increase nor a decrease when those funds are invested in used and useful utility assets. Economic confiscation is avoided and ratepayers are not overcharged.

"If the allowed return resulted in a market-to-book ratio of less than 1.0, management would likely resist making new capital investments in the business because earnings retained and used to purchase new assets would be worth less than if paid out as dividends.

"Conversely, a market-to-book ratio above 1.0 derived from the authorized return is also undesirable in a regulated industry because it would give management an incentive to invest in unneeded new assets.

"Therefore, if regulation permits a utility to increase its profits merely by purchasing new assets, a potential risk exists that management will purchase more assets than are needed to provide safe and adequate service.

"The above principles are important both because they establish the appropriate goal for a regulatory agency with regard to return on equity, and because they help provide an understanding of the proper mechanism for computing the cost of equity.

It is necessary to determine the return on equity required to allow the market-to-book ratio of a regulated company to equal to 1.0. Once investors perceive that the cost of equity can be achieved, on average, in the future, then the market price will be equal to the book value."

A. Yes. That's exactly what I explained here in the discussion which you're talking about.

Q. Thank you.

A. I also think there is a piece probably in there which is also mentioned and I don't think you read, and that is what we're talking about is an assumption that the full amount of the used and useful assets are determined to be appropriate for inclusion in rate base; and if the Commission should determine that there should be a disallowance from rate base of a certain item, then you would expect a market-to-book something below 1.

Conversely, it would also be true if you happen to have a utility company that is in an unregulated business that might be earning a return which is higher than -- or maybe even a lot higher than would be appropriate for regulation, that that might result in a market-to-book above 1, and that's okay, too.

Q. Finally, Mr. Rothschild, at page 5 of your testimony, lines 17 through 19, just by way of update, you state, "Also, in its ongoing generic analysis of the cost of equity for electric utilities, the FERC found in its most recently issued quarterly report that the cost of equity for an average electric utility is 13.68 percent;" is that correct?

A. Yes.

Q. Are you aware that on December 26, 1985, the FERC issued an updated order which determined the cost of equity for average electric utilities of 15.36 percent?

A. What you are saying is literally true. I think taken out of context it could be misinterpreted. FERC did issue an order, which in terms of the date of its issuance is more recent than the number discussed on page 5 of my testimony; however, the time period which was referenced in that decision, which was more of a theoretical update, if you will, of the Order 420 discussed in my testimony, is related to a period which is earlier than the December, 1985 -- earlier than the date associated with the 13.68 percent.

Furthermore, in terms of what that decision said with regard to the appropriate allowed return on equity for regulatory purposes, the number it found was not 15.36 but was 14-point -- I don't remember exactly -- 14.27.

Q. 14.37.

A. 14.37; thank you.

Q. They adjusted the 15.36 to the 14.37 to reflect the particular rate base that is used in FERC regulation; is that correct?

A. Yes. It was to reflect the use of a 13-month average rate base. In this case we're using a year-end rate base; so that the downward adjustment would be larger should we follow through with the principles as expressed in that FERC decision.

Q. You're using different years, different test years, when you refer to that.

A. Furthermore, the FERC decision is using a dividend yield and it was responding to a period ending June 30, 1985.

Q. I understand that.

A. And FERC has as part of what it says is appropriate from its decision to update the dividend yield. So that if we take the dividend yield and update it to current conditions, even if you take the 15.36 you're going to be at or below my recommendation in this case leaving aside the adjustment that FERC also recommends for regulatory purposes.

Q. Do you agree with me that there is another difference in the test years used in Pennsylvania versus those used by FERC? FERC uses a fully projected test year that begins at the approximate effective date of the rates and runs for the first 12 months the rates are going to be effective. Is that correct; yes or no? Is that the FERC rate base for electric utilities?

A. Yes, but in FERC's discussion of this adjustment, it simply talks about the mechanism used for rate base, not its time relationship to the issuance of the decision.

Q. The FERC order doesn't mention the fact that they use the fully projected test year?

A. The FERC order doesn't specifically mention that, but what it talks about is -- it says in here that if you're going to use a different rate base -- to not need this adjustment, you have to use a beginning of year rate base. The adjustment will become larger if you use an end of year rate base.

Q. If fact, what Pennsylvania really does do is use a beginning of the year rate base of the year the rates are going to be in effect? The test year in this case ends at approximately the time the new rates go into effect; is that true?

A. It is true that the test year ends at the approximate time that the rates go into effect, but what the FERC procedure is doing is talking about a matching of the relationship between the earnings on one hand and the return on equity on another.

It has to do with the time relationship between the two, the two being the computation of rate base and the computation of earnings.

So, if you will, instead of annualizing the rate base to bring everything up to year-end and annualizing income and this and that, they're doing this in steps.

MR. MacGREGOR: Thank you, Mr. Rothschild.

That's all I have, Your Honor.

JUDGE MATUSCHAK: Mr. Delaney?

MR. DELANEY: I have no questions for this witness.

JUDGE MATUSCHAK: Then let's take a five-minute recess.

(Recess.)

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JUDGE MATUSCHAK: When you are ready.

MR. MacGREGOR: Your Honor, if it is all right, I have just two more questions that I would like to take care of. I apologize.

JUDGE MATUSCHAK: Go ahead.

BY MR. MacGREGOR:

Q Mr. Rothschild, on Schedule 4, page 1 you have provided certain cost of equity calculations for PECo at December 31, 1984; is that correct?

A Yes.

Q And it is 15.11 percent assuming a 13.25 percent return on equity and a 14.04 percent figure assuming a 12.25 percent forecasted return on book equity?

A Expected return by investors, yes, that is correct.

Q And the mid-point of those would be about 14.5 percent or a little higher?

A Yes.

Q Is that in fact what your calculation derived as the cost of common equity capital for PECo at December 31, 1984?

A At December 31, 1984, yes, but my recommendation of course for the PECo analysis and all the others is subject --

Q Are you aware of what --

A -- to more current conditions, conditions reflected at the end of 1985.

Q Are you aware that in the company's last rate order by the Commission, entered in January of 1985, shortly after December 31, 1984, they determined then the cost of equity capital at 16.75 percent?

A I'm aware that there was a decision of that level around that time, but there is always a lag between the time the Commission is looking at data and when the decision comes out; so I don'tthink it would be appropriate to compare those two without looking at the same time period.

Q What was the test year in that rate case; was it 12 months ending December of 1984?

A I don't know, but that isn't the question. The question is: what was the data used by the rate of return witnesses in the case?

Q On the question of the Limerick 2 order and the Commission's cap, the $3.2 billion cap on the total construction costs, do you know what forecast that was based upon, what figures were used to derive that figure?

A No, I do not know where the $3.2 billion cap came from.

Q Do you know whether the AFUDC component included any addition to reflect your proposal,that rather than currently earned return on Limerick 2 risk that it be added as AFUDC to the cost of the plant?

A I am not aware of any such specific increment for that.

Q So all other things being equal, if we adopted your proposal and added that increment to the AFUDC, the company would not be able to meet the cost cap?

A All other things being equal, which of course they never are, then yes, that's correct. The -- well, it is but it isn't, because the appropriate cost of equity now is lower than the Commission most probably used in determining that AFUDC rate.

Q Thank you.

A So we could actually lower the cap and get it back that way.

Q Thank you.

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

JUDGE MATUSCHAK: Is there any redirect?

MR. RUBIN: Yes. Thank you, Your Honor.

REDIRECT EXAMINATION

BY MR. RUBIN:

Q Mr. Rothschild, do you recall being questioned concerning your exclusion of the December 31, 1984 equity return for Philadelphia Electric Company in your PECo-specific DCF analysis?

A Yes. There was discussion with regard to the computation of the DCF cost of equity as indicated for the Moody's 24 nuclear construction companies and a comparison of the inputs with regard to Philadelphia Electric in that analysis versus those that I used in the company-specific detailed analysis for Philadelphia Electric Company.

Q Could you tell us why those two analyses differ?

A Yes. The analysis that is done for the group of companies is, by nature, done to keep the detailed analysis and discretion to a minimum because we are looking at a large group of companies and it would be impractical or impossible to go through company by company and study it in enough detail to make a meaningful judgment as to how much of a disallowance investors might be expecting on a company-by-company basis for a future -- for the nuclear construction activities.

In looking at the numbers for the nuclear construction companies, I am aware that the earned return on equity I used is overstated for the group, and I am aware in interpreting that number that indeed my result accordingly is conservatively high. But when looking at the company-specific -- in this case Philadelphia Electric -- to do my job the best that I can of informing the Commission and giving the Commission the benefit of my analysis, I think it is appropriate to go further and look at the more difficult to quantify aspects that require an even more detailed look at each of the companies; and that's why there is a difference. The numbers that are used for Philadelphia Electric would be more accurate when using the company-alone basis than being looked at for the group.

Q Thank you, Mr. Rothschild.

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

JUDGE MATUSCHAK: Do you have anything further, Mr. Delaney?

MR. DELANEY: I have nothing, Your Honor.

JUDGE MATUSCHAK: Mr. MacGregor?

RECROSS-EXAMINATION

BY MR. MacGREGOR:

Q Mr. Rothschild, just by way of clarification of the explanation you just gave, the net result of not looking at the '84 return on book equity is to produce a lower figure than otherwise would have been produced for the cost of equity for Philadelphia Electric Company; is that correct?

A Well, I looked at the number.

Q But if you had used the number in your calculation, that is my question.

A If I had found reason to determine the anticipated return on equity for Philadelphia Electric was higher than the 12.25 to 13.25 range, for whatever reasons, my resultant recommendation would have been higher.

Q Thank you.

JUDGE MATUSCHAK: If there is nothing further we will conclude this hearing.

MR. MacGREGOR: Your Honor, one item; I would like to note by way of housekeeping that we have our next hearing scheduled for next Tuesday, I believe January 28th. That day has been set aside for cross-examination of the company's witnesses on the ECR 80/20 revision. One of the company's witnesses, Mr Brennan, who submitted supplemental direct testimony on those issues, went into the hospital on January 6th for hip replacement surgery. He's still in the hospital and will be in the hospital at least through January.

The company will be presenting another person from A.U.S., Mr. Brennan's firm, to sponsor his testimony, and I'll be sending out a list of that witness's experience, qualifications, etcetera to all the parties so they will have that beforehand, and if it is necessary for Mr. Brennan to answer specific questions that this witness can't then he could provide those answers in some other way.

JUDGE MATUSCHAK: Very well. Tomorrow we have a public hearing at Media. Which counsel will be present?

Will Philadelphia Electric be present?

MR. MacGREGOR: Yes, Your Honor. I will be there with two representatives from the company.

JUDGE MATUSCHAK: Mr. Rubin?

MR. RUBIN: I will not be personally present, but we will have two attorneys there.

MR. DELANEY: I will be there personally.

JUDGE MATUSCHAK: Very well. We will adjourn for the public input hearing tomorrow, and then the next set of hearings will begin on the 28th.

I might note that there is a pending Motion to Compel. You haven't filed an answer yet, have you?

MR. MacGREGOR: Yes, sir, I have filed an answer. It was done last Friday. Have you not received it?

JUDGE MATUSCHAK: I haven't received it.

MR. MacGREGOR: I will hand you a copy tomorrow at the public input hearing.

JUDGE MATUSCHAK: Very well. I won't make any decision on that until I review that. At the next session on the week of the 28th we will take that up at that time.

MR. MacGREGOR: I would just note, Your Honor, that we have answered all of the interrogatories related to the Motion to Compel. I think they still want an extension of time to file their testimony. That's the issue at this point.

JUDGE MATUSCHAK: We can discuss that at the January 28th hearing.

We are adjourned.

(Whereupon, at 3:13 p.m. the hearing was adjourned, to be reconvened at 10:00 a.m. on Tuesday, January 28, 1986 in Harrisburg, Pennsylvania.)

C E R T I F I C A T E

We hereby certify, as the stenographic reporters, that the foregoing proceedings were reported stenographically by us, and thereafter reduced to typewriting by us or under our supervison, and that this transcript is a true and accurate record to the best of our ability.

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