Docket No.ER78-494

SUPPLEMENTAL TESTIMONY OF L. SANFORD REIS
ON BEHALF OF
PENNSYLVANIA ELECTRIC COMPANY

Q. Are you the same L. Sanford Reis who presented testimony on rate of return in this docket in June 1978?

A. Yes.

Q. Has your concept of the required fair rate of return changed since that date?

A. The required fair rate of return has increased considerably in view of the effects on investors of the Three Mile Island Unit 2 accident. After the accident, investors clearly concluded that the risk of investing in GPU common stock had increased dramatically.

Q. What happens when investors perceive an increase in the risk of investing in a particular company?

A. Investors expect a certain level of return on their investment and they bid the market price of the stock to the level which meets their requirement. When they perceive an increase in the risk that the company will actually earn the return which they expect, they naturally increase the level of return which they will require before they invest in that particular company. This increase in the investors' required return increases the cost of common equity capital to the company since it adversely affects the market price and hence the amount of common equity dollars that the company can raise by issuing a given number of common shares.

Q. Why have investors recently perceived GPU stock to be a more risky investment?

A. There is great uncertainty over the financial impact of the TMI-2 accident and the regulatory response to it. In particular, after recent decisions in Pennsylvania and New Jersey removing the entire investment in TMI-2 from rate base and eliminating the operating and maintenance expenses associated with TMI-2 from allowable operating expenses, investors are likely to be concerned over the financial implications of regulatory treatment which would deny a return on GPU's approximate $780,000,000 investment in this plant and such operating and maintenance expenses for some indefinite period of time. Investors are also concerned over the possibility of a writeoff of this investment. I hasten to add that company officials see virtually no chance of writeoff of the unit, but investors can and do consider this possibility in formulating their perception of the risk attaching to investment in GPU common stock.

In addition, of course, investors are aware of GPU's heavy commitment to nuclear power via its Oyster Creek and TMI-1 units and the planned Forked River unit, and the attendant financial risk of such a commitment to nuclear power.

Q. Mr. Reis, in your judgment, has investors' perception of the risk of investing in GPU changed solely because this extraordinary accident has actually happened to GPU rather than to some other utility?

A. No. A portion of the increased risk perception arises as a result of GPU's commitment to nuclear power. This increased risk perception on the part of investors applies to other electric utilities which have made a commitment to nuclear power. The recent market decline of the common stock of companies such as Virginia Electric Power Company and Duke Power Company indicate that investors' risk perceptions have increased even for those companies which did not suffer the TMI-2 accident.

Q. Haven't investors always factored this type of risk into their required return?

A. It is obvious to me that, rightly or wrongly, investors in the past have never seriously weighed the possibility that a major electric utility could, by regulatory action, be entirely denied any return on an investment in the magnitude of $780,000,000 in facilities dedicated to public service. The impact of this regulatory treatment and the financial implication that it entails, has to have a long-term effect on investors' risk perceptions both for the industry in general and for GPU in particular. For the industry in general, of course, it is the risk that the company in question might suffer a similar fate. For GPU in particular, it is this risk plus the financial risk that the company will find it impossible to earn a fair return as a result of the TMI-2 accident and the responsive regulatory treatment.

Q. What has been the result of these increased risk perceptions?

A. Investors now perceive a company which is effectively denied a return on its $780,000,000 investment in this plant. This $780,000,000 represents close to 15% of the total capital of GPU. Denial of <u>any</u> return on this huge block of capital--capital on which the company must continue to meet its fixed preferred dividend and debt interest carrying charges--will clearly make it impossible for the company to earn anything approaching the normal levels of return on book common equity experienced by other electric utilities. In recognition of this risk, investors have bid down the market price of GPU stock to the point where it is impractical for GPU to raise additional common equity capital without severe dilution of existing investment. This is an intolerable situation which should be corrected. A regulatory policy which treats the current situation as acceptable for the long term would violate the capital attraction aspect of a fair rate of return.

Q. What specific evidence is there of the impact of this recent change in risk perception on the cost of GPU and Penelec common equity capital?

A. Exhibit No. ___ (PN-402) updates schedules 26 and 27 to my original exhibit. Updated Schedule 26 shows the market evaluation of the stock of General Public Utilities Corporation over the years 1968-1978 and to date in 1979. For the year 1977 the average market price (average of high and low for the year) was $19.81, for the year 1978 it was $18.88, for the period from January 1, 1979 to March 28, 1979 it ranged from a high of 18 7/8 to a low of 16 1/4. However, from April 1, 1979 to June 22, 1979 it ranged between 15 1/8 and 8 1/4 for an average of 11.69, and currently is 10 1/8. Earnings have fallen from $2.50 per average share in 1977 to $2.30 in 1978 and to $2.25 for the twelve months ending March 31, 1979 and April 30, 1979 (not reflecting any of the costs of the Three Mile Island accident). The price/earnings ratio has fallen from an average of 8.2 times in 1978 to 4.7 times currently. The quarterly dividend for the second quarter was reduced to $.25 from the $.45 paid in previous quarters. The ratio of market value to book value has fallen below 0.50.

Updated Schedule 27 shows that currently the return on common equity necessary to maintain a market price of 120% of book value is 25.8% as compared with an average of 16% over the past five years.

All of these changes definitely indicate a significant increase in the cost of common equity capital.

Q. Is there other evidence by which the recent increase in the cost of Penelec's common equity capital can be measured?

A. Not directly, but an analysis of the cost of secured debt capital for Penelec is instructive. In June 1978 Penelec issued $45 million of first mortgage bonds at an annual cost to the company of 9.66%. In June 1979 Penelec issued $50 million of first mortgage bonds and an estimated (as of June 29) annual cost to the company of 12%--an increase of 2.35%.

This increase in interest rate does not reflect all of the cost increases between the two issues. The 1978 issue was in the public markets with a five-year non-refundability feature. The 1979 issue is a private placement with a ten-year non-refundability provision and with specific restraints and limitations not generally found in electric utility financing.

Some of this increase results from the increase in the cost of capital in general, but a significant portion of the increase must be ascribed to the TMI-2 accident and its financial implications. In any event, the cost of debt capital secured by a first mortgage, a relatively safe form of investment, has risen by over 2% for Penelec since I prepared my original testimony. This fact strongly suggests that the cost of common equity capital, which capital must bear the brunt of all the increased risk occasioned by the financial implications of the TMI-2 accident, has risen by at least this much.

Q. What do you conclude with respect to the current fair rate of return for Penelec common equity capital?

A. It is difficult if not impossible to quantify the upper limit of the fair rate of return. In my judgment the recent dramatic market reaction to the increased risk of GPU common stock leads me to conclude that the fair return on Penelec's common equity capital is at least 16%.

Q. Has the embedded cost of debt and preferred stock capital changed since you prepared your testimony in 1978?

A. Yes. Mr. Thomas L. Carroll presents a revised capital structure showing the current embedded cost of preferred stock capital and long-term debt capital for Penelec. A 16% return on common equity, when applied to Mr. Carroll's revised capital structure, produces an overall return requirement of 10.56%.

Q. What is your recommendation?

A. It is my recommendation that Penelec be permitted an overall return of 10.56%.

My recommendation assumes that the company will be afforded an opportunity to earn such return on <u>all</u> of its capital, whether through cash revenues or by the allowance for funds used during construction (if that is appropriate and would be consistent with rate-making treatment) or by a combination thereof. If, and to the extent that, the company is denied an opportunity to earn such return on its total capital--by an exclusion of part of its assets from rate base or otherwise, the return requirement for the remaining capital of the company will be correspondingly increased. The risk attaching to the remaining capital is obviously increased since the earnings permitted on this remaining capital will 1) be reduced by the necessity of meeting the fixed carrying charges on the portion of capital on which no return is permitted and 2) the earnings available for return on the common equity portion of the remaining capital must be shared with the common equity component of the capital on which no return is permitted.

Q. Does this conclude your supplemental testimony?

A. Yes, it does.

UNITED STATES OF AMERICA

BEFORE THE

FEDERAL ENERGY REGULATORY COMMISSION

Pennsylvania Electric Company   Docket No. ___________

ATTESTATION

L. Sanford Reis, being first duly sworn, deposes and says: that he is the President of Reis & Chandler, Inc. and that the statements contained in the foregoing supplemental direct testimony and supporting data on behalf of Pennsylvania Electric Company are true and correct to the best of his knowledge and belief.

L. Sanford Reis

L. Sanford Reis

STATE OF NEW YORK
COUNTY OF NEW YORK

Subscribed and sworn to before me this 28th day of June 1979.

Lucille E. Rogers

Notary Public

My commission expires

LUCILLE E. ROGERS
Notary Public, State of New York
No. [illegible]
Qualified in New York County
[illegible] 1980

POOR ORIGINAL

Exhibit No. (PN-402)
Docket No. ER 78-494

Updated Schedules
26 and 27
June 1979

GENERAL PUBLIC UTILITIES CORPORATION

FINANCIAL DATA

e o.	Year	Average Market Price	Earnings Per Average Share	Price Earnings Ratio	Dividend Paid	Average Yield	Average Book Value	Ratio of Average Market Value to Average Book Value	Line No.
1	1968	$28.63	$2.11	13.6x	$1.57	5.48%	$20.21	1.42x	1
2	1969	27.50	2.00	13.8	1.60	5.82	20.96	1.31	2
3	1970	21.13	1.83	11.5	1.60	7.57	21.08	1.00	3
4	1971	22.94	2.08	11.0	1.60	6.97	21.34	1.07	4
5	1972	22.25	2.21	10.1	1.60	7.19	21.65	1.03	5
6	1973	19.63	2.25	8.7	1.60	8.15	21.72	0.90	6
7	1974	14.88	2.25	6.6	1.68	11.29	21.93	0.68	7
8	1975	13.94	2.00	7.0	1.68	12.05	21.51	0.65	8
9	1976	17.56	2.20	8.0	1.68	9.57	21.10	0.83	9
10	1977	19.81	2.50	7.9	1.70	8.58	21.71	0.91	10
11	1978	18.88	2.30	8.2	1.77	9.37	22.15	0.85	11
12	1979 to 5/31	15.03	2.25	6.7	1.59	10.58	22.26	0.68	12
13	6/22/78	10.63	2.25	4.7	1.00*	9.41	22.43	0.47	13

Current annual rate

GENERAL PUBLIC UTILITIES CORPORATION

RELATIONSHIPS OF MARKET PRICES, BOOK VALUES AND

RETURN ON AVERAGE COMMON EQUITY

Line No.	Year	Return on Average Common Equity	Average Book Value Per Share	Average Market Value Per Share	Average Market to Book Ratio	Return on Equity Necessary to Maintain 120% of Book Value	Line No.
1	1974	10.2%	$21.93	$14.88	0.68x	18.0%	1
2	1975	9.3	21.51	13.94	0.65	17.2	2
3	1976	10.4	21.10	17.56	0.83	15.0	3
4	1977	11.5	21.71	19.81	0.91	15.2	4
5	1978	10.4	22.15	18.88	0.85	14.7	5
6	Current	10.1	22.43	10.63	0.47	25.8	6

Updated 6/22/79