BEFORE THE CORPORATION COMMISSION OF OKLAHOMA

IN THE MATTER OF THE APPLICATION OF OKLAHOMA GAS AND ELECTRIC COMPANY FOR COMMISSION AUTHORIZATION OF A PLAN TO COMPLY WITH THE FEDERAL CLEAN AIR ACT AND COST RECOVERY; AND FOR APPROVAL OF THE MUSTANG MODERNIZATION AND COST RECOVERY

CAUSE NO. PUD 201400229

FILED
JAN 26 2015
COURT CLERK'S OFFICE - OKC
CORPORATION COMMISSION
OF OKLAHOMA

Rebuttal Testimony

of

Steven M. Fetter

On behalf of

OG&E Shareholders Association

January 26, 2015

PRE-FILED REBUTTAL TESTIMONY OF STEVEN M. FETTER
January 26, 2015

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SECTION I - INTRODUCTION AND BACKGROUND

Q. PLEASE STATE YOUR NAME, POSITION AND BUSINESS ADDRESS.

A. My name is Steven M. Fetter. I am President of Regulation UnFettered. My business address is 1240 West Sims Way, Port Townsend, Washington 98368.

Q. ON WHOSE BEHALF ARE YOU TESTIFYING?

A. I am testifying on behalf of the OG&E Shareholders Association, though my testimony relates to the situation faced by Oklahoma Gas & Electric Co. ("OG&E") in this proceeding before the Oklahoma Corporation Commission ("OCC" or "Commission").

Q. BY WHOM ARE YOU EMPLOYED?

A. I started Regulation UnFettered, a utility advisory firm, in April 2002. Prior to that, I was employed by Fitch, Inc. ("Fitch"), a credit rating agency based in New York and London. Prior to that, I served as Chairman of the Michigan Public Service Commission ("Michigan PSC"). Earlier in my public service in Michigan, I created the Office of Majority General Counsel within the Michigan Senate and served as the first Majority General Counsel.

Q. PLEASE DESCRIBE YOUR ROLE AS PRESIDENT OF REGULATION UNFETTERED.

A. I formed the utility advisory firm to use my financial, regulatory, legislative, and legal expertise to aid the deliberations of regulators, legislative bodies, and the courts, and to assist them in evaluating regulatory issues. My clients include investor-owned and municipal electric, natural gas and water utilities, state public utility commissions and consumer advocates, non-utility energy suppliers, international financial services and consulting firms, and investors.

Q. WHAT IS YOUR EDUCATIONAL BACKGROUND?

A. I graduated with high honors from the University of Michigan with an A.B. in Communications in 1974. I graduated from the University of Michigan Law School with

a J.D. in 1979. I am a member of the New York, Michigan, and U.S. Supreme Court Bars.

Q. PLEASE DESCRIBE YOUR SERVICE ON THE MICHIGAN PUBLIC SERVICE COMMISSION.

A. I was appointed as a Commissioner to the three-member Michigan PSC in October 1987 by Democratic Governor James Blanchard. The Michigan PSC's responsibilities included regulation of Michigan's electric and natural gas companies with regard to rates and their terms and conditions of service for customers within the state.

In January 1991, I was promoted to Chairman by incoming Republican Governor John Engler, who reappointed me in July 1993. During my tenure as Chairman, timeliness of commission processes was a major focus. My colleagues and I achieved the goal of eliminating the agency's case backlog for the first time in 23 years.

While on the Michigan PSC, I also served as Chairman of the Board of the National Regulatory Research Institute ("NRRI"), the research arm of the National Association of Regulatory Utility Commissioners ("NARUC").

After leaving regulatory service, I was appointed to the NRRI Board as a public member. I have also served as a lecturer at Michigan State University's Institute of Public Utilities Annual Regulatory Studies Program ("Camp NARUC") and at NARUC's New Commissioner Regulatory Orientation.

Q. WHAT WAS YOUR ROLE AT FITCH?

A. I was Group Head and Managing Director of the Global Power Group within Fitch. In that role, I served as group manager of the combined 18-person New York and Chicago utility team. I was originally hired to interpret the impact of regulatory and legislative developments on utility credit ratings. I continued that responsibility throughout my tenure at the rating agency.

Q. HOW LONG WERE YOU EMPLOYED BY FITCH?

A. I was employed by Fitch from October 1993 until April 2002. In April 2002, I left Fitch to start Regulation UnFettered. In addition, Fitch retained me as a consultant for a period of approximately six months shortly after I resigned.

Q. HOW DOES YOUR EXPERIENCE RELATE TO YOUR TESTIMONY IN THIS PROCEEDING?

A. My rebuttal testimony will address a number of issues directly related to my past experience as a utility regulator, bond rater, and consultant to regulated utilities, state utility commissions, and state consumer advocates.

In particular, I believe my experience as a Commissioner on the Michigan PSC and my experience with financial analysis and ratings of the U.S. electric and natural gas sectors (whether in jurisdictions involved in restructuring activity or those still following a more traditional regulatory path), is very relevant. It has given me solid insight into the regulator's role in setting rates and also in determining appropriate terms and conditions of service for regulated utilities. These regulatory decisions are among the factors that enter into the process of utility credit analysis and formulation of individual company credit ratings. Utilities must fund very large capital projects. They do so by attracting equity investors and institutional lenders who are comfortable with a utility's ability to meet its financial obligations. It is undeniable that a utility's credit ratings significantly affect the ability of a utility to raise capital on a timely basis and upon reasonable terms.

Q. HOW DOES EXPERIENCE AS MAJORITY GENERAL COUNSEL TO THE MICHIGAN SENATE INFORM YOUR REBUTTAL TESTIMONY IN THIS CASE?

A. A key piece of this contested case relates to the specific text of the controlling Oklahoma statutory language of 17 O.S. § 286. In my role as Majority General Counsel, I was called upon to interpret existing and proposed statutory language on a daily basis. I also often had to draft amendatory language to ensure that the laws that were enacted reflected the intent of the Michigan Legislature. It is that extensive experience with legislative text

that helps me in interpreting 17 O.S. Sections 286(B) and 286(C) as they relate to the issues in contention in this case.

Q. HAVE YOU PREVIOUSLY GIVEN TESTIMONY BEFORE REGULATORY AND LEGISLATIVE BODIES?

A. Since 1990, I have testified before the U.S. Senate, the U.S. House of Representatives, the Federal Energy Regulatory Commission, federal district and bankruptcy courts, and various state and provincial legislative, judicial, and regulatory bodies in more than 100 proceedings, including proceedings in Oklahoma.

Q. ON WHAT TOPICS HAVE YOU TESTIFIED?

A. I have testified on the subjects of credit risk and cost of capital within the utility sector, electric and natural gas utility restructuring, fuel and other energy cost adjustment mechanisms, regulated utility mergers and acquisitions, construction work in progress ("CWIP") and other interim rate recovery structures, utility securitization bonds, and nuclear energy.

Q. HAVE YOUR QUALIFICATIONS BEEN ACCEPTED BY THIS COMMISSION IN OTHER PROCEEDINGS?

A. Yes. I have previously filed testimony before the OCC on behalf of the OG&E Shareholders Association in Cause No. PUD 200700012 (relating to generation pre-approval and CWIP); Cause No. PUD 200800398 (relating to credit quality issues within a rate case); and Cause No. PUD 201100087 (relating to credit quality issues within a rate case). My full educational and professional background is presented in Schedule SMF-1.

SECTION II - PURPOSE AND EXECUTIVE SUMMARY

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. I have reviewed the responsive testimony of Craig R. Roach, Ph.D., Mark E. Garrett, and Steve W. Chriss and will rebut their views related to certain of the subjects they address. In particular, I recommend that:

1. The Commission should continue its history of responsible regulatory treatment of OG&E through this period of high capital expenditures for both federal government imposed environmental compliance and necessary replacement of aged generation equipment to satisfy capacity requirements and enhance reliability. Based on the evidence before it, the Commission should issue an order allowing OG&E to recover, through the proposed periodic rate adjustment mechanism, all of the prudently incurred costs of the Environmental Compliance Plan ("ECP") and Mustang Modernization Plan ("MMP") proposed by OG&E; and, specifically,

2. The Commission should follow the unambiguous language of 17 O.S. § 286(B) which mandates recovery of the prudently incurred costs of the ECP through a periodic rate adjustment mechanism, *at the election of OG&E*, subject to the fairness protection of a subsequent, timely general rate case. And the Commission should reject the contrary recommendations by Messrs. Roach, Garrett and Chriss; and

3. The Commission should exercise its discretion under the permissive terms of 17 O.S. § 286(C) to enter its order that all prudently incurred costs of the MMP, as approved by the Commission, may also be recovered by OG&E through a periodic rate adjustment mechanism, as proposed by OG&E. The Commission may, and I believe on sound policy grounds it should, reject the contrary recommendations by Messrs. Roach, Garrett and Chriss; and

4. The Commission should reject the recommendation by Mr. Garrett that the Company be required to "Finance the Environmental Compliance Plan with Debt."[1] OG&E's cost of capital includes cost of equity capital as well as debt capital. That cost of equity capital is like any other business expense the Company is allowed to recover. Mr. Garrett's recommendation implies the existence of a capital structure with 0% equity, which is plainly wrong, without any evidence the actual capital structure is, instead, the product of management's bad faith, inefficiency or improvidence; and

5. The Commission should reject Mr. Garrett's recommendation to reduce the Company return on equity ("ROE") to 9.75% from the existing approved 10.2%,[2] and

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[1] Responsive Testimony and Exhibits of Mark E. Garrett at page 24; also at page 6.

[2] Responsive Testimony and Exhibits of Mark E. Garrett at pages 24-26; also at page 6.

reject related concerns expressed by Mr. Chriss.[3] Mr. Garrett's recommendation is not based on substantial evidence and would, in my opinion, exceed the Commission's authority in this proceeding under Oklahoma Const. Art. 9, § 20; and

6. The Commission should apply a proper forward-looking prudence standard in this proceeding. The Commission should not follow Dr. Roach's recommendations to pre-judge the treatment of alleged stranded costs in the event the Sooner coal plants are idled before 2044, or impose prescriptive performance standards as guaranties. The Commission has experience with reasonable mechanisms to deal effectively with whatever concerns develop regarding alleged stranded costs, capital cost overruns, the cost of underperformance, or project delays, if any were to occur; [4] and

7. The Commission should permit the Company to utilize construction work in progress ("CWIP") to help stabilize its cash flow consistent with its current "A" ratings category credit profile. That would mean rejection of opposition to the Company's CWIP proposal, most explicitly stated in the responsive testimony of Mr. Chriss (at pp. 11-16); and

SECTION III – 17 O.S. § 286

Q. WHAT IS THE IMPORTANCE OF 17 O.S. § 286 TO THIS PROCEEDING?

A. 17 O.S. § 286(B) and 17 O.S. § 286(C) are at the heart of OG&E's request for relief in this proceeding. Those sections describe with specificity the Oklahoma Legislature's directive to be applied in this case. The most relevant portions of 17 O.S. § 286 are quoted below. I will refer to this language often.

17 O.S. § 286.

"....

B. An electric utility subject to rate regulation by the Corporation Commission may file an application seeking Commission authorization of a plan by the utility to make capital expenditures for equipment or facilities necessary to comply with the federal Clean Air Act (CAA), the Clean Water Act (CWA), the Comprehensive Environmental Response,

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[3] Responsive Testimony of Steve W. Chriss at pages 8-10.

[4] Responsive Testimony of Craig R. Roach, Ph.D. at page 65, line 14 through page 66, line 7.

Compensation, and Liability Act (CERCLA), the Emergency Planning & Community Right-to-Know Act (EPCRA), the Endangered Species Act (ESA), the National Environmental Policy Act (NEPA), the Occupational Safety and Health Act (OSHA), the Oil Pollution Act (OPA), the Pollution Prevention Act (PPA), the Resource Conservation and Recovery Act (RCRA), the Safe Drinking Water Act (SDWA), the Toxic Substances Control Act (TSCA), all as amended, and, as the Commission may deem appropriate, federal, state, local or tribal environmental requirements which apply to generation facilities. If approved by the Commission, after notice and hearing, the equipment or facilities specified in the approved utility plan are conclusively presumed used and useful. The utility may elect to periodically adjust its rates to recover the costs of the expenditures. The utility shall file a request for a review of its rates pursuant to Section 152 of this title no more than twenty-four (24) months after the utility begins recovering the costs through a periodic rate adjustment mechanism and no more than twenty-four (24) months after the utility begins recovering the costs through any subsequent periodic rate adjustment mechanism. Provided further, that a periodic rate adjustment or adjustments are not intended to prevent a utility from seeking cost recovery of capital expenditures as otherwise may be authorized by the Commission. However, the reasonableness of the costs to be recovered by the utility shall be subject to Commission review and approval. The Commission shall promulgate rules to implement the provisions of this subsection, such rules to be transmitted to the Legislature on or before April 1, 2007.

C. 1. An electric utility subject to rate regulation by the Corporation Commission may elect to file an application seeking approval by the Commission to construct a new electric generating facility, to purchase an existing electric generation facility or enter into a long-term contract for purchased power and capacity and/or energy, subject to the provisions of this subsection. If, and to the extent that, the Commission determines there is a need for construction or purchase of the electric generating facility or long-term purchase power contract, the generating facility or contract shall be considered used and useful and its costs shall be subject to cost recovery rules promulgated by the Commission. The Commission shall enter an order on an application filed pursuant to this subsection within two hundred forty (240) days of the filing of the application, following notice and hearing and after consideration of reasonable alternatives."

Q. WHEN DID SECTION 286 BECOME LAW?

A. The relevant portions of Section 286 are almost ten years old. The statute passed in 2005 with broad support, I understand, including a 96-0 vote in the House of Representatives and 45-0 vote in the Senate. It has been amended several times.

Q. WHAT IS YOUR UNDERSTANDING OF THE PURPOSE OF THE LAW?

A. The intent of 17 O.S. § 286(B) is to allow a utility involved in major federally-mandated environmental compliance construction activities to limit the increase in its operational and financial risks through regulatory pre-approval and the ability to elect periodic rate adjustments to maintain its cash flow, financial stability, and credit ratings for the benefit of both utility customers and investors. Section 286(C) serves the same laudable purpose as Section 286(B) for the types of projects it covers.

Q. DO YOU BELIEVE THE EXISTENCE OF THIS LAW IS OF CONSEQUENCE TO THE CREDIT RATINGS OF OKLAHOMA UTILITIES BY THE RATING AGENCIES?

A. Yes. For the reasons I just stated, the rating agencies view the existence of this law as a significant credit-supportive rating factor, as more fully shown in the statements of the agencies excerpted in my testimony.

SECTION IV – 17 O.S. § 286 AND TRADITIONAL ELECTRICITY RATEMAKING

Q. WHAT IS YOUR UNDERSTANDING OF THE ELECTRICITY RATEMAKING PROCESS IN OKLAHOMA?

A. Electricity rates for utilities like OG&E are ultimately determined by the Oklahoma Corporation Commission. OG&E can only charge those rates for its services that have been approved by an Order of the OCC. The Commission is a constitutional body of state government with legislative, executive and judicial powers and functions. The Commission's basic authority derives from Oklahoma Constitution, Article 9, Section 18, *et seq.* and its power to set electric rates in particular from 17 O.S. §§ 151-154 That is why the Company cited those provisions in its Application at Section III, Legal Authority. OG&E's requests for pre-approval under the provisions of 17 O.S. § 286 and the associated request for implementation of a recovery rider are included in the ratemaking process.

Q. **WHAT TYPE OF GOVERNMENTAL FUNCTION DOES THE COMMISSION EXERCISE WHEN IT SETS RATES?**

A. In most states, including Oklahoma (and also Michigan where I regulated), ratemaking is a legislative function to be accomplished either by the Legislature or the utility commission, with the commission's powers coming through delegation by the Legislature.

For purposes of this proceeding, the designation of ratemaking as a legislative function is important because the Oklahoma Legislature has dictated the right of the utility to elect periodic rate adjustments under the circumstances of this case.

Q. WHAT METHOD HAS THE COMMISSION GENERALLY RELIED UPON TO SET RATES?

A. Like in many other states, the Commission decides "general rate cases" by using what is referred to as the rate base/rate of return/cost of service method to set rates. Over time, that method has developed across the country and in Oklahoma. In this jurisdiction, that method has been somewhat standardized in extensive rules (OAC Rules 165:70-1-1, *et seq.*).[5]

There are two concepts about general rate making that I believe are particularly important to understand when considering the importance of Section 286 to the credit rating community. Those concepts are "used and useful" and "regulatory lag."

Q. WHAT DOES THE TERM "USED AND USEFUL" MEAN?

A. In the utility world, "used and useful" generally refers to plant and equipment that is necessary to provide reliable service (useful) and which is installed and in service (used).

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[5] Chapter 70. Minimum Standard Filing Requirements In Support Of A Request By A Public Utility Doing Business in Oklahoma For A Proposed General Rate Change.

It is a term of art identifying assets that are properly included in rate base[6] for ratemaking purposes. In the traditional general rate case approach, once installed and in service, and therefore providing benefits to customers, the prudently incurred costs are included in rates in the next rate case, but not before that time.

Q. WHAT IS REGULATORY LAG?

A. Regulatory lag refers to the length of time between when an asset begins providing benefit to customers and when new rates go into effect that allow the utility to be compensated for the cost of buying or constructing that asset. The term is frequently utilized to describe the length of time between general rate cases.

Q. PLEASE EXPLAIN THE RISK ASSOCIATED WITH REGULATORY LAG BETWEEN RATE CASES.

A. Utility rates are intended to fairly compensate a utility's owners for all the costs they incur to provide electric service to customers. In a general rate case, those rates are set based on representative costs and defined sales volumes. Over time, rates set in a general rate case can become stale and unrepresentative of the actual costs of the provision of utility service and/or the sales volumes, and thus unfair to either the utility or its ratepayers. In a period of increasing costs and/or declining sales after one general rate case, the stale rates result in "under recovery" for the utility. Because the utility has a duty to serve, it must incur those costs notwithstanding that it is being denied recovery of that money because the incremental increase in costs is not covered by the then current rates. This scenario is considered unfair to the utility's shareholders. Of course, the opposite, or so-called "over recovery," would occur if there is a period when costs are declining and/or sales growth is increasing and the prudently incurred costs are less than the amount of revenue returned to the Company charging current rates. In such a declining cost and/or rising revenue environment, continued collection, year after year, of

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6 *Turpen v. Oklahoma Corporation Commission*, 1988 OK 126, 769 P2d 1309, 1320, fn. 25 (The rate base in Oklahoma is founded "upon the value of property used and useful in [the utility's] public service business at the time the inquiry was made." *Southwestern Public Service Co. v. State, supra* note 7 at 97. Also see, *Okmulgee Gas Co. v. Corporation Commission,* 95 Okl. 213, 220 P. 28 [1923].)

the then current rates is considered unfair to the ratepayer. Thus, regulating the time period between cases to determine the proper level of "reasonable and just" rates, or, in the alternative, some interim regulatory mechanism to keep costs and revenues in relative balance, is a sensible fairness safeguard that may protect either the utility or the ratepayer.

Q. WHY NOT REQUIRE FREQUENT GENERAL RATE CASES?

A. Rate cases are complex, time consuming and expensive for all interested participants. Very frequent general rate cases are simply impractical and unnecessary because, on balance, most costs under most circumstances are not large enough and do not fluctuate enough within a short time to make refreshing rates in a comprehensive review of all costs a reasonable exercise. Instead, Commissions have come to understand that periodic rate adjustment mechanisms—sometimes called "riders"—are more efficient and effective than frequent rate cases.

Moreover, it is thought that general rate cases are not well suited to the special circumstances presented in this case regarding the costs imposed by the government, like the federal EPA Clean Air Act rules. Consequently, OAC Rule 165:70-1-2, in the definition of "General Rate Change" to which Chapter 70 applies, specifically exempts: "A change mandated by regulation or legislation, a change in the terms and conditions of service, a request for special contract, or a request for a new and/or optional service does not constitute a general rate change." (Emphasis added.)

Q. DOES OKLAHOMA ALLOW PRUDENTLY INCURRED COSTS THAT ARE NOT INCLUDED IN CURRENT BASE RATES TO BE RECOVERED BY PERIODIC RATE ADJUSTMENTS?

A. Yes. A prime example is the periodic rate adjustment mechanism known as the fuel adjustment clause under 17 O.S. § 251, *et seq*. Today, OG&E's cost of fuel and purchased power (approximately 50% of all of a utility's costs) is recovered only through the fuel adjustment clause and shown as a line item on every customer's monthly bill. OG&E currently has in effect multiple periodic rate adjustment mechanisms approved by

the Commission. Section 286 is another example of a periodic rate adjustment mechanism created by the Legislature and included in the Commission's rules.

Q. WHY IS IT IMPORTANT IN THIS CASE TO RECOGNIZE THAT RATEMAKING IS ESSENTIALLY A LEGISLATIVE FUNCTION?

A. By enacting 17 O.S. § 286(B), the Legislature has made a fundamental policy choice in favor of an electric utility's right to elect to periodically adjust its rates to recover the costs of expenditures to comply with the Clean Air Act and other federal environmental statutes. The power to make this legislative policy choice resides first with the Legislature as a part of its legislative ratemaking power. While utility regulators have delegated power to make rules, that power does not include the ability to legislate rules that are contrary to a statute. In this proceeding, I believe it is critical that the Commission weigh certain recommendations by the parties with that understanding firmly in mind.

Proper respect for the Legislature's choice to allow a predetermination of "used and useful" and to permit the utility to elect periodic adjustment of its rates requires rejection of the recommendations put forward by various parties, especially the PUD Staff and the OIEC, to defer review and cost recovery for Clean Air Act compliance costs into a future general rate case or other circumstance. I believe those recommendations are inconsistent with the plain language of Section 286(B).

Q. WHAT LANGUAGE OF THE STATUTE PROVIDES THE LEGISLATURE'S DIRECTIVE REGARDING PREAPPROVAL OF ASSETS ELIGIBLE FOR RECOVERY THOUGH A PERIODIC ADJUSTMENT?

A. In Section 286(B), the sentence immediately preceding the right to elect periodic adjustment of rates provides, **"If approved by the Commission, after notice and hearing, the equipment or facilities specified in the approved utility plan are conclusively presumed used and useful."** (Emphasis added.)

Until the Legislature enacted Section 286, except for the FAC, the Commission generally did not support recovery of large capital costs through periodic rate adjustments until the

project was constructed and placed into service, or "used and useful." Section 286(B) and also Section 286(C), with the process for an earlier prudence decision and allowance of cost recovery through a rider, represent a supportive paradigm shift. That shift is referred to as "pre-approval," not just in Oklahoma but also in other states.

Q. WHAT IS THE SIGNIFICANCE OF THE LEGISLATURE SAYING IN SECTION 286(B) "CONCLUSIVELY PRESUMED USED AND USEFUL"?

A. As I discussed above, "used and useful" is a term of art in Oklahoma and around the country relating to the constitutional "reasonable and just" standard. The Section 286(B) conclusive presumption of being "used and useful" (that derives from Commission approval of the compliance plan) means the utility has a right to recover the prudently incurred costs consistent with the plan, through the elected periodic adjustment of rates.

Objection that such an election is unfair or unreasonable to ratepayers should be rejected. Stated another way, a utility must be allowed to recover a fair return on that which is "used and useful". A rate which provides a fair return upon the fair value of the utility's "used and useful" property in supplying the service furnished cannot be unreasonable or unjust to the ratepayer.

Q. WHAT LANGUAGE IN 17 O.S. § 286(B) REFLECTS THE LEGISLATURE'S DECISION TO PERMIT THE UTILITY TO ELECT PERIODIC ADJUSTMENT OF ITS RATES IN THESE CIRCUMSTANCES?

A. The utility faced with Clean Air Act compliance expenditures is authorized to file an application seeking Commission authorization of its compliance plan. That is what OG&E has done. If the Commission authorizes a compliance plan, Section 286(B) provides: **"The utility may elect to periodically adjust its rates to recover the costs of the expenditures."** The utility has a clear and unambiguous right to implement a periodic rate adjustment; and the only question is whether the utility chooses to ask for implementation of that recovery mechanism. In this proceeding, OG&E has made that election. The text of that specific provision is at odds with the cost recovery deferral recommendations by the PUD Staff and OIEC, among others, and those recommendations should not be accepted.

Q. DOES SECTION 286(B) INDICATE WHEN AND HOW THOSE PRUDENTLY INCURRED COSTS ARE TO BE RECOVERED?

A. Yes. I understand the combination of the utility's right to elect periodic rate adjustment and the conclusive presumption of "used and useful" to mean that, upon Commission approval of the plan, recovery of prudently incurred costs may not be deferred until a general rate case but must be recoverable via periodic rate adjustments if elected by the utility, as in this case. In my mind, there is no other fair reading of the unambiguous text of Section 286(B). The actual text of Section 286(B) is a mandate and a full rebuttal to critics like Dr. Roach, Mr. Garrett, and Mr. Chriss, who say fairness requires deferral to a general rate case. In short, the Legislature has conclusively decided that policy question exactly to the contrary. I believe Dr. Roach's, Mr. Garrett's and Mr. Chriss' recommendations to defer cost recovery to a general rate case should be rejected.

Q. DID THE COMMISSION ADOPT RULES TO IMPLEMENT SECTION 286(B)?

A. Yes, the Commission adopted OAC Rules 165: 35-38-1, 165:35-38-2, and 165:35-38-4 which by their terms apply to capital expenditures to meet environmental requirements under the Clean Air Act, pursuant to Section 286 (B).

Q. WHAT IS THE LIMITATION ON THE COMMISSION'S RULE MAKING AUTHORITY?

A. It is my understanding that the Commission may not adopt or interpret, and may not enforce, any rule that is inconsistent with the provisions of the Oklahoma Constitution or any statute as enacted by the Legislature. The same is true, I believe, if a rule that is valid on its face is applied in a way that is inconsistent with the statute.

Q. ARE THE RULES ADOPTED BY THE OCC CONSISTENT WITH THE STATUTORY LANGUAGE IN SECTION 286(B)?

A. Those rules are, as I read them, consistent with Section 286(B) in that the text of the rules does not expressly contradict the text of Section 286(B). However, I believe those rules are being misconstrued or ignored by some parties. The Commission is being encouraged to deny OG&E's right to elect a periodic rate adjustment and to defer cost

recovery for used and useful assets until they are the subject of a general rate case. Specifically, Dr. Roach for the PUD Staff urges the Commission to defer cost recovery of expenditures for the ECP (and the MMP under Section 286(C)) until a general rate case, citing a portion of Section 286(B) and OAC Rule 165:35-38-4(d)[7]. Mr. Garrett makes the same recommendation and cites OAC Rule 165:35-38-4.[8] Mr. Chriss makes the same recommendation, but does not cite any authority. As I have noted, those recommendations are not consistent with the express provisions of Section 286(B) which allow for a utility election of a periodic rate adjustment to begin recovery of related costs before any general rate case.

Q IS SECTION 286(C) ALSO A PRE-APPROVAL STATUTE LIKE SECTION 286(B)?

A. Yes. Section 286(C), which applies to the consideration of the Mustang Modernization Plan ("MMP"), is also a "pre-approval" type statute. It is, however, different from those types of externally imposed capital expenditure programs that are addressed in the special cases mentioned in Section 286(A) or in Section 286(B). Because compliance with Section 286(C) and the applicable rules of the Commission should result in a determination that a plant not yet in service is nevertheless "used and useful", under Section 286(C), I view it as a tool for the Commission to grant permissively a periodic rate adjustment mechanism to recover all prudently incurred costs.

I think it is fair to say the projects that are addressed in Section 286(C) are more common resource planning decisions, and ones that are regularly within the utility's integrated resource planning process. It is, however, my view that any near-term project like MMP ought to be considered in the same proceeding as ECP and addressed comprehensively precisely because projects under Section 286(B) are imposed by the federal government, and superimposed upon normal capital expenditures, and therefore disrupt the normal or predictable resource planning process.

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7 Responsive Testimony of Craig R. Roach, Ph.D. at pp. 14-16.

8 Responsive Testimony and Exhibits of Mark E. Garrett at pages 38-39.

Moreover, the same public policy reasons that support pre-approval of a Section 286(B) project apply to any Section 286(C) project. After all, capital expenditure is capital expenditure, and all prudently incurred costs for those projects must be recovered in rates in order to support long-term system reliability and financial stability. From an administrative efficiency perspective, it makes sense for the Commission to consider both the 286(B) and 286(C) matters in the same proceeding, as opposed to processing a separate application for the Mustang Modernization project.

Q. IN YOUR OPINION, WHAT WOULD BE THE FINANCIAL MARKET RAMIFICATIONS IF THE RECOMMENDATIONS OF OPPOSING PARTIES WERE IMPLEMENTED?

A. The financial community has an expectation that the Commission will respect the legislative mandate with regard to pre-approval and the ability of OG&E to elect to maintain its financial stability through periodic rate adjustments. The OCC has a reputation for carrying out constructive regulatory policies, ones that are financially-supportive of the state's regulated utilities, which in turn has a positive impact on customer rates and investor interest in providing necessary funds to the utilities. Failure by the OCC to follow the letter of the law would be viewed as a setback by the financial community, with likely negative consequences for the Company and its customers and investors.

SECTION V - ALTERNATIVES LIKE SECTION 286 ARE SOUND PUBLIC POLICY

Q. DO OTHER JURISDICTIONS USE ALTERNATIVE FORMS OF REGULATION LIKE SECTION 286 INSTEAD OF A TRADITIONAL "GENERAL RATE CASE" IN APPROPRIATE CIRCUMSTANCES?

A. Yes, as I indicated earlier, many and a growing number of states use, in addition to fuel adjustment clauses, some other form of alternative regulation like Section 286, often to decrease the risk of major utility investment projects, or provide financial assistance along the progress of a major project (such as through use of CWIP, which I will discuss below). Both of these steps secure a utility's financial stability while exhibiting

regulatory support on an ongoing basis. Such support serves as a strongly positive rating factor in the eyes of the rating agencies.

Q. HOW MANY STATES USE SOME FORM OF ALTERNATIVE REGULATION IN APPROPRIATE CIRCUMSTANCES INSTEAD OF A GENERAL RATE CASE?

A. On June 6, 2013, Regulatory Research Associates published a listing of alternative regulation provisions in all 53 jurisdictions it covers (all 50 states, plus D.C., and two authorities in both Louisiana and Texas). By my count of that listing, there are fuel adjustment clauses, in some fashion, in every state. Alternative regulation for RTO - related transmission costs, like Section 286(A), exist in approximately 16 states; environmental compliance alternative regulation provisions, like Section 286(B), exist in approximately 31 states; and new capital investment alternative regulation provisions, like Section 286(C), exist in approximately 28 states.

Q. DO YOU BELIEVE THAT THESE ALTERNATIVE REGULATION METHODS, INCLUDING PRE-APPROVAL UNDER 17 O.S. § 286, REPRESENT SOUND PUBLIC POLICY?

A. Yes I do. I strongly agree that Section 286(B), as well as Section 286(C), are based on sound public policy. As a former utility commissioner, I was charged with following the laws as enacted whether I agreed with them or not, including in unpopular cases involving rate increases. That is often very difficult, but is not the case here. To me, as a former regulator, I see a very positive purpose and benefit to both Section 286(B) and Section 286(C).

Q. WHY DO YOU BELIEVE THAT SECTION 286(B) AND SECTION 286(C) REPRESENT SOUND PUBLIC POLICY?

A. At the heart of the matter, it is in the long-term public interest for the regulator to support policies and practices that are supportive of utility management's efforts to provide reliable service at the lowest reasonable cost. Section 286(B) supports management's efforts in this regard by assuring timely recovery of all of the utility's prudently incurred

costs. The Legislature determined that the best way to accomplish this goal was to allow the utility a right to elect periodic rate adjustments, upon the condition that actual recovery of costs under that election would be followed reasonably promptly by a general rate case as a fairness safeguard against regulatory lag. I find that to be a reasonable approach. Similarly, Section 286(C) provides the benefits of a used and useful determination for major capital expenditure projects, differing from 286(B) in that the option for a periodic rate adjustment is at the Commission's discretion.

SECTION VI – CONTINUED REGULATORY SUPPORT IS NEEDED

Q. PLEASE EXPLAIN HOW SECTION 286 ACCOMPLISHES THAT WHICH WAITING FOR A GENERAL RATE CASE WOULD NOT?

A. The Edison Electric Institute published an Alternative Regulation Survey in 2013 that identifies the problem as "The Problem of Financial Attrition Under Traditional Cost of Service Regulation." It states:

> The underlying problem they face is a tendency of cost to grow more rapidly than the billing determinants (*e.g.* kWh of use) that determine revenue growth between rate cases. . . .
>
> Traditional approaches to utility regulation can fail to provide timely rate relief for such conditions. . . . Financial attrition undoubtedly has been a factor in the long-term decline of average credit ratings among investor-owned electric utilities. . . . Higher risk raises financing costs and can discourage needed investments.
>
> Alternative approaches to regulation have been developed which handle today's business conditions better. [9]

Of course, the additional costs of plant and equipment and operating expenses for the ECP and the MMP are new costs. Those costs are not now in the rate base nor in rates. The ECP costs are necessary costs imposed by the federal government. By any measure, those costs are substantial and hold out the potential to impact OG&E's financial profile. Here the ECP capital cost is more than $700 million, which alone would represent approximately 35% of the utility's production plant. Even Mr. Garrett observed that

[9] Edison Electric Institute, "Alternative Regulation for Evolving Utility Challenges: An Updated Survey," January 2013, at Introduction, page 1.

these ECP costs, at least, are the type of large expenses which are beyond the control of the Company and therefore qualify for treatment under Section 286(B).[10]

The MMP capital cost is required largely because of the age of the plants, which are among the oldest in the country, and the capacity reserve requirements imposed by the SPP. The MMP costs are more than $400 million, representing another 20% of production plant. Combined, the capital expenditures required to be made over the next 5 years for ECP and MMP total approximately 55% of production plant.[11]

That amount of capital investment expenditure is incremental to the amount needed for normal plant replacement, which is also substantial at approximately $325 million on average per year from 2014-2018.

Those new ECP and MMP costs must be paid by the Company as incurred. Some have already been incurred and paid. Others will be paid, even as the case proceeds.

Accordingly, unless the Section 286 alternative periodic adjustment of rates is employed, regulatory lag will delay recovery of prudently incurred costs until the completion of the general rate case next following the completion and in service date of any of these projects – far past the time that the expenditures are made. Given the magnitude of the costs, it is predictable that the cumulative impact of regulatory lag may be unfair to the Company and counterproductive for ratepayers. Oklahoma law is written to avoid that result.

Moreover, the deferral and partial denial of cost recovery would impair the Company's cash flow and could adversely affect its credit ratings. Even Dr. Roach concedes that the result would be an increase in the Company's borrowing costs.[12] That of course will have upward pressure on future customer rates, more so because OG&E's cost of equity would likely be pressured upward as well. If so, these projects (and all other projects)

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10 Responsive Testimony of Mark Garrett, page 30. (In discussing his views on the proper use of riders, Mr. Garrett wrote, "Another example could be mandated environmental compliance costs.")

11 OG&E's Response to AG's DR 1-6; Direct Testimony of Sheri Richard, page 2, lines 16-26; Exhibit SDR-4.

12 Responsive Testimony of Dr. Craig Roach, page 55, lines 1-13.

would ultimately cost ratepayers more than they would have under the cash flow supportive practices required by Section 286(B), and at least allowed and encouraged under Section 286(C).

Q. DO YOU SHARE THE CONCERN EXPRESSED IN THE EEI SURVEY REGARDING THE LONG-TERM DECLINE IN UTILITY COMPANY CREDIT RATINGS?

A. Yes, definitely. As I have testified before this Commission in the past, I believe the Commission should strive to support the Company so that its credit ratings remain in the "A" rating category where they stand today. That level should ensure that OG&E will be able to access the capital markets when needed, even if another global or national financial crisis were to occur. OG&E is now a company with a long history of reliable outstanding service at reasonable rates. It has a strong balance sheet and credit ratings. Section 286 was enacted to help keep it that way.

Q. WHAT ARE THE COMPANY'S CURRENT CREDIT RATINGS FROM THE MAJOR CREDIT RATING AGENCIES?

A. Those ratings for Oklahoma Gas and Electric Company currently are:[13]

	Moody's	S&P	Fitch	Outlook
OG&E	A1	A-	A+	Stable

Q. HAVE THE PAST DECISIONS AND PRACTICES OF THE COMMISSION BEEN PERCEIVED AS A SUPPORTIVE REGULATORY ENVIRONMENT, AS YOU ADVOCATE?

A. Yes, that has been recognized in the national financial community, with S&P placing Oklahoma in the top third of its state commission rankings.[14] In my opinion, proper implementation of Section 286(B) and Section 286(C) as requested in this case will help

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[13] OG&E SEC Filing Form FWP 12/08/2014.

[14] S&P Research: "Utility Regulatory Assessments for U.S. Investor-Owned Utilities," January 7, 2014.

to ensure that the Company remains financially strong and that its current strong credit ratings are maintained.

Q. HAVE THE RATING AGENCIES FOCUSED ON THE IMPORTANCE OF OG&E RECEIVING TIMELY RECOVERY FOR ITS SUBSTANTIAL INVESTMENT PLANS, INCLUDING THE UNDERLYING LEGISLATIVE FRAMEWORK?

A. Yes they have, as shown by the following statements:

> **Moody's**: "We view the regulatory environment in Oklahoma to be a credit positive, since OG&E has been successful in maintaining regulatory relationships with interveners and consumer advocates, which yield credit supportive rate case outcomes. For example, in OG&E's latest rate case (2012), the settlement included an allowed ROE of 10.2% and key riders or tracking mechanisms which facilitate quicker recovery of costs, in addition to a small revenue increase. The tracking mechanisms associated with the last rate case include enhanced recovery for certain transmission projects, smart grid implementation, and the construction of renewable generation resources."
>
> "Oklahoma's state legislature has also proved to be supportive to cost recovery, particularly through House Bill 1910 (HB 1910), which enables the OCC to allow for the pre-approval of qualifying state or federally mandated environmental costs. This bill and ongoing support for infrastructure cost recovery will be increasingly important as OG&E looks to spend around $1.1 billion in environmental upgrades through 2019, the bulk of which is spent through 2018."[15]
>
> **Fitch**: "OGE and OG&E's rating stability depends on continued regulatory support for both growth investments and environmental capex. Oklahoma legislation allows utilities to recover environmental capex incurred to meet both state and federal mandates, and OG&E has several years to comply. However, the amount, timing and mechanism of recovery remain uncertain for what Fitch expects to be a large capex program. Fitch has incorporated $1.2 billion of environmental cost in its projections. To the extent that the final environmental compliance capex is substantially higher or an extended lag in recovery occurs, the ratings and Outlook at both OGE and OG&E could be pressured."[16]

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15 Moody's Research: "OGE Energy Corp.," November 26, 2014.

16 Fitch Research: "Fitch Affirms OGE and Oklahoma Gas & Electric; Outlook Stable," March 18, 2014.

> **S&P**: "Rate surcharge available to recover mandated environmental expenditures . . . . Conservative financing, constructive regulatory outcomes in Oklahoma and Arkansas, and credit-supportive actions by management will be essential to support key financial measures at levels suitable for the current ratings. Notably, construction of sizable pollution-control equipment will require ongoing and timely recovery of capital spending to maintain credit-supportive operating cash flow measures."[17]

Accordingly, if the Commission were to issue a decision departing from those past financially-supportive legislative policies, I believe the rating agencies would be concerned because:

- OG&E is a well-respected utility among US regulated utilities;
- After extensive litigation, the Company is required to move forward with a substantial investment plan related to environmental compliance, along with a modernization plan to ensure reliable service to customers; and
- The Legislature and the Commission have put into place policies supportive of utilities planning significant investment projects.

A Commission choice not to authorize OG&E to utilize Section 286(B) and Section 286(C), whether lawful or not, would be inconsistent with the OCC's current positive regulatory reputation.

SECTION VII - ALLOWANCE OF CONSTRUCTION WORK IN PROGRESS ("CWIP")

Q. YOU ALSO REFER TO MR. CHRISS' CALL FOR DENIAL OF CWIP. CAN YOU PROVIDE SOME BACKGROUND ABOUT CWIP?

A. Yes. CWIP provides for the collection of financing costs incurred during a capital investment period, but not the actual cost of "bricks and mortar." CWIP is the method that the Company is proposing as preferred in its Application in this proceeding. On a present value basis, CWIP and accrual of financing costs through allowance for funds used during the capital investment program ("AFUDC" or deferral and later collection of the financing costs over the life of the projects) should end up costing virtually the same

[17] S&P Research: "Oklahoma Gas & Electric Co.," May 8, 2014.

amount – but that is true *only if* a downgrade were not to occur. If a downgrade were to occur, AFUDC would be more expensive than CWIP.

CWIP provides one benefit to ratepayers and another benefit to the utility. By phasing in rate increases over time, rather than in one large increase, customers are better able to budget for the changing rate levels, rather than face "rate shock" when the AFUDC accrual is flowed into rates along with the commencement of depreciation of the asset. The benefit on the utility side is that CWIP can provide the earlier receipt of cash flow by a utility during its construction cycle, thus likely preventing even the possibility that a credit rating downgrade might occur – a negative event which eventually would be felt by customers as well. This is consistent with my strongly-held view that, due to the utility sector's ongoing need for substantial amounts of investor capital, utilities operating within today's still uncertain economic climate and their regulatory authorities should strive to minimize less supportive regulatory policies that could negatively affect a utility's financial profile, its credit ratings, and thus its access to capital.

Q. SO WHEN DR. ROACH DESCRIBES CWIP AS THE EQUIVALENT OF A "ZERO INTEREST LOAN" FROM RATEPAYERS, IS HE RIGHT?

A. No, I do not agree. In my opinion, his analysis is faulty. CWIP does not represent a zero interest loan from ratepayers. Rather, money is expended by the utility – and while the utility does not begin recovery of those construction expenditures prior to commercial operation, it does receive the financing costs of those expended funds, either when that money is spent (through CWIP) or through accrual and deferral of those financing costs with collection later during the life of the asset (through AFUDC). The present value of the amount recovered under either means is equal, unless a downgrade were to occur – in which case, CWIP would then be more beneficial for ratepayers.

Q. WOULD PROVISION OF CWIP BE CONSISTENT WITH ACTIONS BY STATE REGULATORS IN OTHER JURISDICTIONS?

A. Yes, very much so. In 2009, Georgia enacted Senate Bill 31 providing for CWIP to be recovered for regulated utilities constructing a new nuclear plant that has been certified

by the Georgia Public Service Commission.[18] A month earlier, prior to the new law, the Georgia Commission had determined that CWIP was appropriate for Georgia Power Company's construction of nuclear units 3 and 4 at the existing Vogtle nuclear plant site.[19]

Also in 2009, Idaho enacted Senate Bill 1123 ("SB 1123") that permits utilities to seek binding ratemaking treatment from Idaho's utility regulators for costs related to new power generation or transmission facilities. Such pre-construction commitments as specified in SB 1123 may include a cash return on CWIP or other "nontraditional ratemaking treatments or nontraditional cost recovery mechanisms . . . [which] shall be binding in any subsequent commission proceedings regarding the proposed facility."[20]

In 2011, the South Carolina Public Service Commission authorized South Carolina Electric & Gas ("SCE&G") to increase rates by $53 million, representing a cash return on CWIP associated with V.C. Summer 2 and 3, two nuclear plants under construction.[21] The rate increase follows upon legislation enacted in 2007, the Base Load Review Act,[22] which permits a utility to request a cash return on the current level of CWIP related to nuclear plant construction. The South Carolina Commission's decision represents SCE&G's fourth approved request for CWIP during the V.C. Summer plants' construction cycle.

Also, in 2008, the Mississippi Legislature enacted the Baseload Act which allows for the inclusion of CWIP in rate base for retail related generation construction prior to commercial operation of certain types of nuclear and large coal generating facilities. Specifically the new law authorizes the Mississippi Commission:

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18 Section 46-2-25 (c.1), Georgia Code, effective April 21, 2009.

19 Press Release, "PSC Approves Agreement to Allow Construction of New Units at Vogtle Nuclear Power Generation Plant; Approves Conversion of Plant Mitchell to Biomass," Georgia Public Service Commission, March 17, 2009.

20 Section 61-541, Idaho Code, Effective July 1, 2009.

21 South Carolina Public Service Commission, Docket No. 2011-207-E, September 30, 2011.

22 South Carolina General Assembly, 2007-2008 Session, Act 16 (May 3, 2007).

> [T]o include in an electric public utility's rate base and rates, as used and useful components of furnishing electric service, all expenditures determined to be prudently-incurred, pre-construction, construction, operating and related costs that the utility incurs in connection with a generating facility (including but not limited to all such costs contained in the utility's "Construction Work in Progress" or "CWIP" accounts), whether or not the construction of any generating facility is ever commenced or completed, or the generating facility is placed into commercial operation."[23]

There are many other instances of proactive regulatory support for a utility's financial standing during a period of significant capital investment, but I think those examples provide a good sense of the recent trend.

Q. HOW DO THE RATING AGENCIES VIEW REGULATORY SUPPORT DURING UTILITY CONSTRUCTION AND THE AUTHORIZING OF CWIP RATEMAKING TREATMENT TO SUSTAIN A UTILITY'S FINANCIAL STABILITY?

A. Very positively. S&P, in a November 3, 2006 report[24] stated:

> Uncertainty regarding future cost recovery and associated rate of return can make it difficult to assess the strength and stability of a company's future cash flows. This uncertainty can add to a utility's business risk and ultimately lead to lower credit ratings.
>
> To provide greater certainty to the review process and to spur construction of in-state generation, several states have enacted laws that allow utilities to seek regulatory decisions that effectively preapprove the costs of new generation facilities and specify the rate-making principles that a commission will apply when the facility is placed in a utility's rate base, including the authorized rate of return on equity and the economic life of a proposed plant.[25]

In that same report, S&P discussed the stabilizing effects of CWIP on both utility financing costs and also customer rates:

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[23] Miss. Code Ann. § 77-3-105.

[24] S&P Research: "Regulatory Support is Key for U.S. Utilities Building New Coal-Fired Power Plants."

[25] *Id.* at page 2.

> A utility's financial measures may weaken during the construction period unless regulatory support is available to help strengthen cash flows. When a plant is not yet in-service and the commission does not permit [CWIP] in rate base (and subsequently does not allow the company to earn a cash return on CWIP), companies must capitalize their financing costs by booking an allowance for funds used during construction (AFUDC) . . . . During construction, however, utilities that may only accrue AFUDC on CWIP can experience a serious cash drain as large financing costs are paid and no cash is collected from ratepayers . . . .
>
> When regulators authorize utilities to include all or a portion of CWIP in rate base, they provide utilities with the opportunity to generate higher and more stable cash flows during construction, which may lower external financing needs. By allowing utilities to earn a return on CWIP, regulators also reduce the likelihood of rate shock once the plant is in service . . . ."[26]

S&P reaffirmed its support for CWIP in rate base in a 2008 utility industry criteria report:

> Especially during upswings in the capital expenditure cycle, such as we are experiencing now, a jurisdiction's willingness to support large capital projects with cash during the construction phase is an important aspect of our analysis. This is especially true for ventures with big budgets and long lead times, such as baseload coal-fired or nuclear power plants and high-voltage transmission lines that are susceptible to construction delays. **Allowance of a cash return on construction work-in-progress or similar ratemaking methods historically were considered extraordinary measures for use in unusual circumstances, but in today's environment of rising construction costs and possible inflationary pressures, cash flow support could be crucial in maintaining credit quality through the spending program.** [Emphasis supplied.][27]

Q. IS THERE OTHER RATING AGENCY AGREEMENT ABOUT THE VALUE OF CWIP?

A. Similarly, Fitch has stated:

"The timing and amount of cost recovery for capital spending is a key factor in credit ratings. Construction work in progress (CWIP) for financing costs of multi-year projects reduces rate shock on the in-service date and limits stress on credit during the

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[26] *Id.* at page 3.

[27] S&P Research: "Assessing U.S. Utility Regulatory Environments," November 7, 2007, at page 6.

construction period."[28] Avoidance of rate shock allows a smoother rate level transition for customers.

SECTION VIII – REJECTION OF INAPPROPRIATE CONDITIONS

Q. WHAT COMMENTS DO YOU HAVE ABOUT DR. ROACH'S CONCLUSIONS AND RECOMMENDATIONS?

A. While I am comfortable with Dr. Roach's recommendation that the Commission approve the OG&E proposed *Scrub/Convert* environmental alternative, I cannot support his suggested conditions on cost recovery.[29] As Dr. Roach concedes[30], the standard approach to minimizing identifiable risks is to diversify. That is precisely what OG&E has done. Approving for implementation the *Scrub/Convert* alternative is the prudent choice for the Commission to make now. However, the Commission should allow full recovery of all prudently incurred costs to implement the *Scrub/Convert* alternative, instead of imposing the conditions Dr. Roach suggests, as I have earlier explained.

Q. WHY SHOULD THE COMMISSION REJECT THE COST RECOVERY CONDITIONS RECOMMENDED BY DR. ROACH?

A. The basic reason is that those costs are necessary to supply safe reliable electricity in compliance with the substantial environmental mandates of the EPA under the Clean Air Act through OG&E moving forward on the preferred *Scrub/Convert* alternative. As such, the Company is entitled to recover all prudently incurred costs.

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28 Fitch Research: "Electric Utility Capital Spending: The Show Will Go On," October 14, 2009, at page 2.

29 Responsive Testimony of Craig R. Roach, Ph.D. at pages 64-66.

30 On page 65 and earlier on page 11.

a. **Coal Plant Stranded Investment**

Q. DO YOU AGREE THAT THE COMPANY SHOULD NOW BE PROHIBITED FROM RECOVERING ANY STRANDED INVESTMENT FOR THE TWO SCRUBBED COAL UNITS AT SOONER IF THOSE UNITS ARE SHUT DOWN AT ANY TIME BEFORE 2044?

A. No, I do not agree. That condition is unreasonable and does not rationally relate to any notion of "risk of incompleteness" in the OG&E's analysis of alternatives, as claimed by Dr. Roach. That condition rests on Dr. Roach's observation that out until 2044, the *Convert* alternative is the least cost alternative, although only slightly. (See Table Two on page 37 of his testimony.)

Q. WHY IS THE CONDITION OF COMPLETE DISALLOWANCE NOW OF STRANDED INVESTMENT UNREASONABLE?

A. Nobody in this proceeding can predict the future. It is unreasonable to impose on the Company an obligation to guaranty against future events that are certainly both unknown and unknowable. No manner of due diligence or prudence can change that fact. Prudence determinations are forward looking assessments, not Monday-morning quarterbacking. OAC Rule 165:35-1-2 defines a "prudence review" as "a comprehensive review that examines as fair, just, and reasonable, a utility's practices, policies, and decisions regarding an investment or expense at the time the investment was made or expense was incurred; including direct or indirect maximization of its positive impacts and mitigation of adverse impact upon its ratepayers, without consideration of its ultimate used and useful nature." (Emphasis added.) See, also, OAC Rule 165:35-35-1. Neither of these rules authorizes the type of second guessing proposed by Dr. Roach.

Such a condition prejudges the matter and finds the utility imprudent. It penalizes the Company for moving forward with what is considered a prudent decision today. If for some reason which only becomes apparent sometime in the future, leading to the shutdown of the scrubbed Sooner units before 2044, through no fault of the Company or today's OCC, it would be patently unfair to place the blame on a blameless utility.

Moreover, the amount of the guaranty would equal the stranded investment without regard to whether the same or other future events would have intervened and had similar defeating effects on the *Convert* alternative. In my opinion, that condition departs unacceptably from the mainstream regulatory policy of not punishing a utility whose much earlier action was without fault. Dr. Roach's stranded investment condition is both unreasonable and unfair and should be rejected.

b. Debt Cost Financing Restriction

Q. DO YOU AGREE WITH MR. GARRETT'S RECOMMENDATION THAT IN ORDER TO LIMIT THE RATE INCREASE IMPACT OF THE ECP THE COMMISSION SHOULD LIMIT COST RECOVERY TO OG&E'S COST OF LONG-TERM DEBT?

A. No, I do not agree with that recommendation by Mr. Garrett[31]. As I have explained earlier, the Commission should allow recovery by OG&E of all prudently incurred costs. OG&E's cost of capital is a combination of its cost of debt and its cost of equity. There is no reason to deny the Company its actual cost of financing its activities in this instance or for any other expenditures it makes in carrying out its obligation to serve its customers.

Q. WHAT DOES MR. GARRETT'S RECOMMENDATION IMPLY?

A. His recommendation for cost recovery for the ECP only at debt cost levels implies there is no equity, and hence no cost for equity capital, which is clearly wrong. According to OG&E's most recent Form 424B2 filed 12/09/2014 with the SEC, the capital structure is approximately 54% equity and 46% debt.

Q. DO YOU AGREE WITH MR. GARRETT'S RECOMMENDATION OF DEBT FINANCING ONLY?

A. No. Mr. Garrett's recommendation is artificial and not sound public policy. To ignore actual equity costs is a gimmick to reach his desired result of a lower short-term rate increase. It is a rebuke to OG&E investors who have supported the Company and its

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31 Pre-filed Responsive Testimony and Exhibits of Mark E. Garrett, page 6 at ¶¶ 6 and 7; page 24 at ¶ 4.

customers by providing in excess of $1 billion since the last rate case (a period of June 30, 2011 through September 30, 2014). Mr. Garrett proposes that the Commission impute, in effect, a hypothetical capital structure of 0% equity and 100% debt for the purpose of calculating the revenue requirement for the ECP. However, Mr. Garrett has made no attempt to demonstrate that the Company's actual capital structure at approximately 54% equity and 46% debt is the product of bad faith, inefficiency or improvidence under the prevailing legal standard of *Turpen v. Oklahoma Corporation Commission*, 1988 OK 126, 769 P.2d 1309, 1329-30 ("There is, in essence, no difference between capital costs and operating expenses. Each is a necessary cost of supplying the service and must be paid out of current income. Since good faith is presumed on the part of public utility managers, their judgment about prudent outlays, including outlays for capital, should not be overruled unless inefficiency or improvidence on their part is shown."). In addition, the Commission's ratemaking power is to deal with the rate impact of utility decisions that rest within the authority of company management (like selection of generating plants and financing of construction). The Commission cannot dictate that management finance a project with all debt – nor, as I discuss below, should the Commission set rates based upon an all-debt scenario regardless of what OG&E management decides to do.

Q. WOULD IT BE PRUDENT IN YOUR OPINION FOR THE COMPANY TO FINANCE THE ECP (WITH OR WITHOUT THE MMP COST) WITH ALL DEBT?

A. Certainly not, and the Commission should not take action that would encourage such emphasis on unbalanced debt financing leverage.

Q. HOW WOULD FOLLOWING MR. GARRETT'S RECOMMENDATION OF ALLOWING ONLY A DEBT RECOVERY ENCOURAGE MANAGEMENT TO INCREASE LEVERAGE?

A. There exists no reason for any entity to invest equity in an enterprise without a fair return on that investment. Accordingly, Mr. Garrett, and the Commission were it to adopt his flawed reasoning, would be placing pressure on the Company to substantially increase its

debt borrowing at the expense of raising equity. The result: greater financial risk, lower credit ratings, higher debt costs, uncertainty with regard to raising future equity, and higher costs for ratepayers.

Q. YOU INDICATE THAT A HIGHER DEBT LOAD WOULD INCREASE OG&E'S FINANCIAL RISK PROFILE. CAN YOU SHARE YOUR THOUGHTS ON WHY IS IT ESPECIALLY IMPORTANT TODAY FOR A REGULATED UTILITY TO MAINTAIN ITS FINANCIAL STABILITY?

A. The global financial crisis six years ago remains in the minds of equity and debt investors. The utility business is capital intensive, even when other businesses are curtailing their investments due to economic uncertainty. There exists an ongoing need for significant investments just to maintain adequate levels of service and reliability, not to mention the huge call on expenditures to meet current and future environmental modifications mandated by the various levels of government. I admitted earlier that nobody can predict the future, but I am willing to go out on a limb and predict that additional environmental compliance requirements will be enacted in the future, though I would not dare try to predict their nature, extent, expense or timing. The high growth rate of electricity sales that fueled past expansion is not present today for OG&E. Per OG&E's most recent integrated resource plan, electricity sales growth is projected to have average annual growth of about 1.4% over the next five years and 1.1% over the next ten years.[32] In addition, competition for retail electricity sales and interest in alternatives -- distributed generation for example -- is high and growing. Energy efficiency and demand response programs are improving and expanding. While general economic conditions have slowly improved, the sharp decline in oil prices over the past 6 months has already had a negative effect on regional economic activity. Now is not the time for utilities to be encouraged to increase their financial risk.

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[32] OG&E 2014 IRP Update, Appendix A - OG&E 2013 Load Forecast, pages 13 and 14.

c. **Reduction on Return on Equity**

Q. DO YOU AGREE WITH MR. GARRETT'S RECOMMENDATION TO REDUCE THE ROE?

A. No. I do not. As a regulator (especially as a lawyer), I was always mindful of the concept of due process. Accordingly, I was surprised to see Mr. Garrett propose here the idea that the Company's authorized ROE should be reduced now from its current authorized 10.2% to 9.75% based only on his aim to save ratepayers $13.7 million. Due process dictates that this issue should not be litigated here, but rather it should be a subject in the Company's next rate case, where a full record will be developed by all stakeholders. It will be on that record that Mr. Garrett will have the opportunity to make his arguments related to OG&E's authorized ROE.

Q. DID MR. GARRETT OFFER SUBSTANTIAL EVIDENCE IN SUPPORT OF HIS 9.75% RECOMMENDATION?

A. No, not in any way. Nor has Mr. Chriss. Far from meeting a substantial evidence standard, they have offered no evidence attempting to relate cost of equity to OG&E or even relatively comparable companies with any specificity. Under such circumstances, it would not be lawful for the Commission, in my opinion, to now lower the Company's currently authorized ROE. To do so based upon Mr. Garrett's or Mr. Chriss' speculation and conjecture would be an arbitrary and capricious determination that bears no relation to the constitutional concept of due process or substantial evidence.

SECTION IX - CONCLUSION

Q. DO YOU HAVE CONCLUDING THOUGHTS?

A. Yes. The OCC has a track record of properly supportive regulation, referred to by some rating agencies as "constructive regulation". The Oklahoma Legislature through Sections 286(B) and 286(C) has shown an appreciation of the financial pressures faced by a utility undertaking substantial investment projects. All of that positive support would be undercut if the OCC were to adopt the proposals of opposing parties, including denial of CWIP treatment as recommended by Mr. Chriss, implementation of stranded cost conditions recommended by Dr. Roach, reduction in ROE and/or permitting only a

debt recovery as recommended by Mr. Garrett, or deferral until a general rate case as recommended by several witnesses.. All of these proposals are objectionable either because they are contrary to Section 286 or requirements to act only upon substantial evidence, are not supportive of the current positive financial strength of the Company, promote unfairness through regulatory lag, and would tend to increase the ultimate cost of these necessary projects, to the detriment of both ratepayers and investors. The Commission should reject those recommendations and, instead, implement the periodic rate adjustments elected by the Company to recover all prudently incurred costs in order to maintain a financially-strong utility able to maintain its reliable system of electricity generation and distribution at reasonable rates.

CERTIFICATE OF SERVICE

I hereby certify that on the 26th day of January 2015, a true and correct copy of the above and foregoing document was sent via electronic mail and/or regular U.S. Postal Service, postage fully prepaid thereon to the following interested parties:

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Education University of Michigan Law School, J.D. 1979
Bar Memberships: U.S. Supreme Court, New York, Michigan
University of Michigan, A.B. Media (Communications) 1974

April 2002 – Present
President - Regulation UnFettered - Port Townsend, Washington

Founder of advisory firm providing regulatory, legislative, financial, legal and strategic planning advisory services for the energy, water and telecommunications sectors, including public utility commissions and consumer advocates; federal and state testimony; credit rating advisory services; negotiation, arbitration and mediation services; skills training in ethics, negotiation, and management efficiency.

Service on Boards of Directors of: Central Hudson (Fortis Inc. subsidiary) (Chairman, Governance and Human Resources Committee); and Previously CH Energy Group (Lead Independent Director; Chairman, Audit Committee, Compensation Committee, and Governance and Nominating Committee); National Regulatory Research Institute (Chairman); Keystone Energy Board; and Regulatory Information Technology Consortium; Member, Wall Street Utility Group; Participant, Keystone Center Dialogues on RTOs and on Financial Trading and Energy Markets.

October 1993 – April 2002
Group Head and Managing Director; Senior Director -- Global Power Group, Fitch IBCA Duff & Phelps -- New York / Chicago

Manager of 18-employee ($15 million revenue) group responsible for credit research and rating of fixed income securities of U.S. and foreign electric and natural gas companies and project finance; Member, Fitch Utility Securitization Team.

Led an effort to restructure the global power group that in three years' time resulted in 75% new personnel and over 100% increase in revenues, transforming a group operating at a substantial deficit into a team-oriented profit center through a combination of revenue growth and expense reduction.

Achieved national recognition as a speaker and commentator evaluating the effects of regulatory developments on the financial condition of the utility sector and individual companies; Cited by Institutional Investor (9/97) as one of top utility analysts at rating agencies; Frequently quoted in national newspapers and trade publications including The New York Times, The Wall Street Journal, International Herald Tribune, Los Angeles Times, Atlanta Journal-Constitution, Forbes and Energy Daily; Featured speaker at conferences sponsored by Edison Electric Institute, Nuclear Energy Institute, American Gas Assn., Natural Gas Supply Assn., National Assn. of Regulatory Utility Commissioners (NARUC), Canadian Electricity Assn.; Frequent invitations to testify before U.S. Senate (on C-Span) and House of Representatives, and state legislatures and utility commissions.

Participant, Keystone Center Dialogue on Regional Transmission Organizations; Member, International Advisory Council, Eisenhower Fellowships; Author, "A Rating Agency's Perspective on Regulatory Reform," book chapter published by Public Utilities Reports, Summer 1995; Advisory Committee, Public Utilities Fortnightly.

March 1994 – April 2002
Consultant -- NYNEX -- New York, Ameritech -- Chicago, Weatherwise USA -- Pittsburgh

Provided testimony before the Federal Communications Commission and state public utility commissions; Formulated and taught specialized ethics and negotiation skills training program for employees in positions of a sensitive nature due to responsibilities involving interface with government officials, marketing, sales or purchasing; Developed amendments to NYNEX Code of Business Conduct.

October 1987 - October 1993
Chairman; Commissioner -- Michigan Public Service Commission -- Lansing

Administrator of $15-million agency responsible for regulating Michigan's public utilities, telecommunications services, and intrastate trucking, and establishing an effective state energy policy; Appointed by Democratic Governor James Blanchard; Promoted to Chairman by Republican Governor John Engler (1991) and reappointed (1993).

Initiated case-handling guideline that eliminated agency backlog for first time in 23 years while reorganizing to downsize agency from 240 employees to 205 and eliminate top tier of management; MPSC received national recognition for fashioning incentive plans in all regulated industries based on performance, service quality, and infrastructure improvement.

Closely involved in formulation and passage of regulatory reform law (Michigan Telecommunications Act of 1991) that has served as a model for other states; rejuvenated dormant twelve-year effort and successfully lobbied the Michigan Legislature to exempt the Commission from the Open Meetings Act, a controversial step that shifted power from the career staff to the three commissioners.

Elected Chairman of the Board of the National Regulatory Research Institute (at Ohio State University); Adjunct Professor of Legislation, American University's Washington College of Law and Thomas M. Cooley Law School; Member of NARUC Executive, Gas, and International Relations Committees, Steering Committee of U.S. Environmental Protection Agency/State of Michigan Relative Risk Analysis Project, and Federal Energy Regulatory Commission Task Force on Natural Gas Deliverability; Eisenhower Exchange Fellow to Japan and NARUC Fellow to the Kennedy School of Government; Ethics Lecturer for NARUC.

August 1985 - October 1987
Acting Associate Deputy Under Secretary of Labor; Executive Assistant to the Deputy Under Secretary -- U.S. Department of Labor -- Washington DC

Member of three-person management team directing the activities of 60-employee agency responsible for promoting use of labor-management cooperation programs. Supervised a legal team in a study of the effects of U.S. labor laws on labor-management cooperation that has received national recognition and been frequently cited in law reviews (U.S. Labor Law and the Future of Labor-Management Cooperation, w/S. Schlossberg, 1986).

January 1983 - August 1985
Senate Majority General Counsel; Chief Republican Counsel -- Michigan Senate -- Lansing

Legal Advisor to the Majority Republican Caucus and Secretary of the Senate; Created and directed 7-employee Office of Majority General Counsel; Counsel, Senate Rules and Ethics Committees; Appointed to the Michigan Criminal Justice Commission, Ann Arbor Human Rights Commission and Washtenaw County Consumer Mediation Committee.

March 1982 - January 1983
Assistant Legal Counsel -- Michigan Governor William Milliken -- Lansing

Legal and Labor Advisor (member of collective bargaining team); Director, Extradition and Clemency; Appointed to Michigan Supreme Court Sentencing Guidelines Committee, Prison Overcrowding Project, Coordination of Law Enforcement Services Task Force.

October 1979 - March 1982
Appellate Litigation Attorney -- National Labor Relations Board -- Washington DC

Other Significant Speeches and Publications

1. The "A" Rating (Edison Electric Institute Perspectives, May/June 2009).

2. Perspective: Don't Fence Me Out (Public Utilities Fortnightly, October 2004).

3. Climate Change and the Electric Power Sector: What Role for the Global Financial Community (during Fourth Session of UN Framework Convention on Climate Change Conference of Parties, Buenos Aires, Argentina, November 3, 1998).(unpublished).

4. Regulation UnFettered: The Fray By the Bay, Revisited (National Regulatory Research Institute Quarterly Bulletin, December 1997).

5. The Feds Can Lead . . . By Getting Out of the Way (Public Utilities Fortnightly, June 1, 1996).

6. Ethical Considerations Within Utility Regulation, w/M. Cummins (National Regulatory Research Institute Quarterly Bulletin, December 1993).

7. Legal Challenges to Employee Participation Programs (American Bar Association, Atlanta, Georgia, August 1991) (unpublished).

8. Proprietary Information, Confidentiality, and Regulation's Continuing Information Needs: A State Commissioner's Perspective (Washington Legal Foundation, July 1990).