BEFORE THE CORPORATION COMMISSION OF OKLAHOMA

IN THE MATTER OF THE APPLICATION OF OKLAHOMA GAS AND ELECTRIC COMPANY FOR AN ORDER OF THE COMMISSION AUTHORIZING APPLICANT TO MODIFY ITS RATES, CHARGES, AND TARIFFS FOR RETAIL ELECTRIC SERVICE IN OKLAHOMA	))))))	CAUSE NO. PUD 201700496

Rebuttal Testimony

of

Stephen E. Merrill

on behalf of

Oklahoma Gas and Electric Company

May 29, 2018

Q. **Please state your name and business address.**

A. My name is Stephen E. Merrill. My business address is 321 North Harvey, Oklahoma City, Oklahoma 73102.

Q. **Are you the same Stephen E. Merrill who filed direct testimony in this Cause?**

A. Yes.

Q. **What is the purpose of your rebuttal testimony?**

A. The purpose of my testimony is to rebut the positions of Attorney General ("AG") witness Griffing, the Oklahoma Industrial Energy Consumers ("OIEC") and Oklahoma Energy Resources ("OER") witness Parcell and the Public Utility Division ("PUD") witness Rush with regards to OG&E's capital structure and the impact of their recommended ROE on OG&E's cost of capital.

Q. **What is the Company's position in response to the proposals by witnesses Griffing and Parcell urging the Commission to impose a hypothetical capital structure on the Company?**

A. As discussed by Mr. Rowlett in his testimony, the Commission has never taken such action before and such a response would be not only unprecedented but unsupported and damaging both to the financial interests of the Company and to customer interests in keeping rates low.

Q. **Please explain.**

A. The Intervenors' proposal is unsupported by a demonstration of any basis for such drastic action. Dr. Morin explains why the Company's existing capital structure stands within the range of reasonable capital structures for utilities and that most comparable utility companies have capital structures like ours. Intervenors have failed to demonstrate that the Company has financed its business in an unreasonable way, or that the Commission should impose an arbitrary 50/50 equity-to-debt ratio in place of one that routinely exists throughout the utility industry. Second, the imposition of an arbitrary and hypothetical cap structure would likely be viewed by the rating agencies and the investment community as a negative outcome that could place the Company's financial standing further at risk.

Q. **Why does OG&E maintain its current capital structure of 53.3 percent equity and 47.7 percent debt?**

A. The Company's current capital structure is essential to maintain a good credit rating that keeps our cost of capital low for our customers. Credit ratings are an indication of a Company's ability to pay its financial obligations, not an assessment of overall risk. Consequently, and to a very great extent, credit ratings are a function of how a company is capitalized. As a mid-cap company, OG&E needs to demonstrate through its capital structure that it is adequately capitalized with equity so its credit rating can be maintained at its current favorable level. All things being equal, large-cap companies have more flexibility in their capital structure than we do. If OG&E's debt level were to be higher, as Intervenors propose, I have no doubt that OG&E's credit rating would be lower. Consequently, the Company's cost of capital could increase, driving up customer rates.

Q. **What would be the likely effects of the imposition of a hypothetical capital structure?**

A. The primary effect would be the disallowance of the authorized return on equity for a portion of the Company's outstanding equity. Griffing recommends a return on equity of 9.18 percent and Parcell recommends 9.2 percent. Those recommendations, already significantly below that of Dr. Morin at 9.9 percent, are further reduced to an effective allowed return on equity of 8.85 – 8.87 percent[1] when coupled with the hypothetical capital structure they propose at a 50/50 equity-to-debt ratio. All things being equal, this would amount to a revenue reduction of approximately $33 million per year for the Company. Based on my knowledge of the investment community, I am confident that

[1] Calculated by using 50/50 equity-to-debt ratio, the recommended ROEs of 9.18 percent and 9.20 percent respectively and keeping all other assumptions as filed in the Company Application

such a result would cause serious adverse consequences for the Company's cost of capital.

Q. **Is that revenue reduction representative of a lower revenue requirement and thus lower rates for your customers?**

A. No. The Company's cost of capital will rise as the investment community devalues its investment in the Company's stock and increase the cost of borrowing. The notion that regulators can reduce the Company's cost of capital simply by lowering the ROE or by lowering hypothetically the Company's equity ratio is illusory. As Dr. Morin and Dr. Evans demonstrate, the correct analysis is to optimize the allocation of resources to the Company through an allowed ROE that meets the expectations of the financial community.

Q. **Should the Commission care about what the investment community thinks about OG&E?**

A. Yes. Our investors determine both the availability and the cost of capital for the Company. We must compete for financial resources in the completive capital markets. These markets are not regulated by utility commissions. On the contrary, investors make their own independent evaluations of an allowed ROE or an approved capital structure. If the evaluation is negative, capital resources available to the Company will be more expensive, less available, or both. The cost and availability of both debt and equity capital we need to build and maintain our system will rise and customer rates will be driven up.

Q. **Mr. Rush testifies that because utility companies earn a return on their rate base, they are less risky and the Commission should accordingly reduce their allowed ROE. Do you agree?**

A. That is only part of the story. First, the Commission sets an allowed return, not a guaranteed return. That allowed return guarantees only an opportunity for us to earn the return that investors who fund the Company expect. Second, the cost of capital is established by the market and the cost of capital will increase unnecessarily if the allowed

ROE is set below opportunity costs and investor expectations. Mr. Rush's testimony displays a bias toward *low* ROE when the correct focus should be on *optimal* ROE.

Q. **Griffing and Parcell contend that OG&E is doing well financially and that the Commission should not be concerned about reducing the Company's ROE and revising its capital structure. Do you agree?**

A. I do not agree with that at all. As I have recounted in my Direct Testimony and as I recount in this Rebuttal Testimony, the investment community has already expressed concern over the regulatory environment in Oklahoma. The response by these Intervenor witnesses is to urge the Commission to ignore the warning signs documented in this case, to make even further reductions in allowed ROE, and to impose an arbitrary and hypothetical reduction in the Company's equity. Mr. Parcell goes so far as to suggest that the Company could be downgraded without adverse effects. As Company witness Morin illustrates in his direct testimony, a downgrade of the Company bonds from single A to BBB could cost the ratepayers $10 million over 20-year period[2]. In my view, this approach is very irresponsible because it would expose the Company to the excessive and unnecessary risk that its cost of capital will actually increase, that the availability of capital to the Company will deteriorate, and that customers will ultimately pay the price.

Q. **Have you recently updated your Chart 3 from your Direct Testimony?**

A. Yes, Chart 3 was presented in my Direct Testimony to demonstrate that OG&E's recommended ROE in this case is near the middle of the band of ROEs awarded to other utilities since December 2015. To show that my point still holds true, I have updated Chart 3 from my Direct Testimony (Rebuttal Chart 1 below) to add allowed ROEs from decisions made between November 6, 2017 and April 26, 2018. I have also added to the chart the ROEs recommended by AG's witness Griffing, OIEC/ OER witness Parcell, PUD's witness Rush and FEA's witness Walters.

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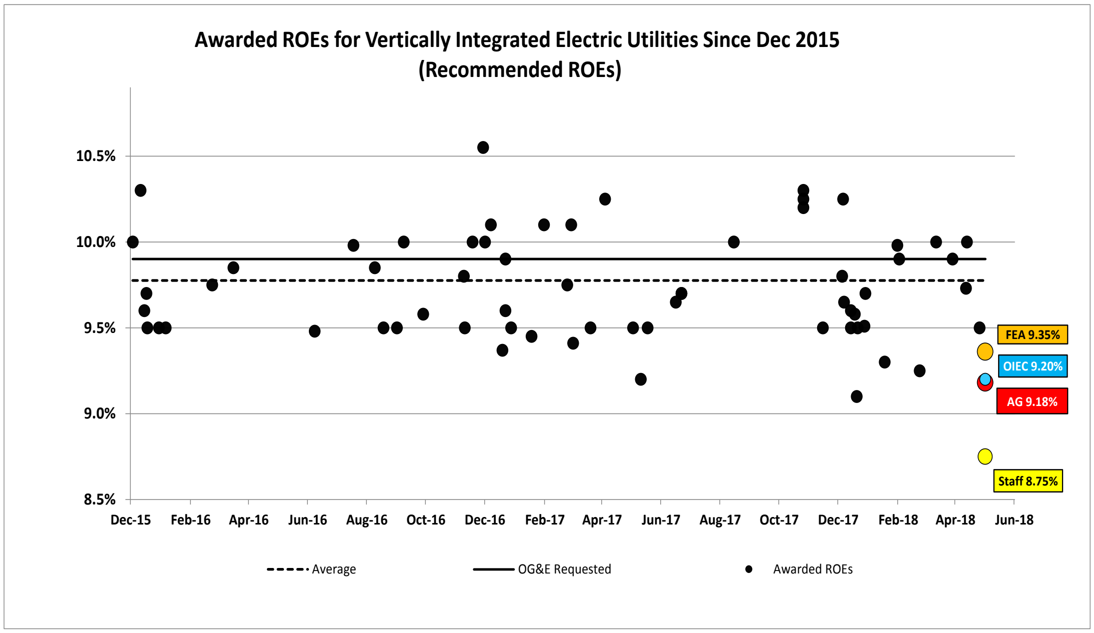
[2] Assumes a 20-year $100 million bond. See Direct Testimony of Roger Morin, PhD, p. 55, lns. 2-19.

Rebuttal Chart 1



Q. **Do you agree with Dr. Griffing's statement that ROEs from settled cases should be ignored?**

A. No, I don't agree. Investors take into account both settled and fully litigated cases when comparing the return on equity offered by various utilities in the sector.

No regulatory commission will accept a settlement without examining it for reasonableness and consistency with the public interest. No basis exists to assert these are aberrant awards, or to conclude that an order approving a settlement should stand on any different footing than an order approving an ALJ recommendation or a rate decision that is fully litigated.

Q. **What does your updated chart show?**

A. The data on the chart illustrates that 60 out of the 64 recently awarded ROEs are higher than the recommended ROEs by PUD's witness Rush, AG's witness Griffing, OIEC's witness Parcell and FEA's witness Walters. It is clear that the ROEs awarded since December 2015 have stayed within the range of 9.5 percent and 10.5 percent with a handful of outliers. There is no discernible trend of decrease in ROEs as some witnesses claim.

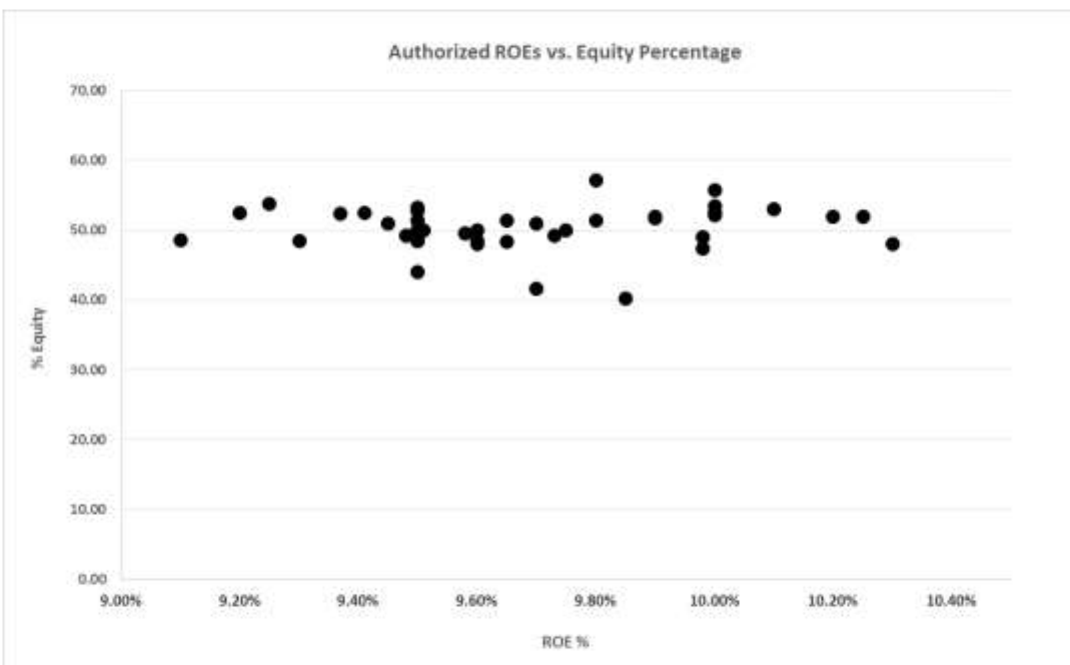
Q. **Have any of the intervenors provided support for their recommendation that the Commission should award OG&E an ROE that's in the bottom 5-6 percent when compared to returns allowed in the last 2-3 years?**

A. No, they have not provided any support for recommending ROEs towards the very bottom of that range.

Q. **Is there a difference between OG&E's capital structure and that of the utilities presented on your chart that could warrant significantly lower allowed ROE for OG&E?**

A. No, the differences in capital structure seem to me to have no effect on the awarded ROEs. Rebuttal Chart 2 below illustrates the complete lack of correlation between awarded ROE and capital structure. The chart uses the same group of vertically integrated utilities and plots their ROEs as measured by the X axis and equity percentages as measured by the Y axis.

Rebuttal Chart 2



Q. **Do you agree with the conclusion of OIEC/ OER witness Parcell that OGE Energy's investment in Enable has negatively impacted OGE Energy's stock price and financial performance?**

A. No. Mr. Parcell has chosen to support his statement with outdated reports and comments made by Value Line in 2015 and 2016.

Q. **On page 17 of his testimony Mr. Parcell (referring to Standard & Poor's rationale for placing OG&E on negative credit watch) concludes, "Clearly, it is not the 'regulatory risk' of OG&E …that is the primary driver in the Company's negative credit watch." Do you agree with Mr. Parcell's conclusion?**

A. No. Mr. Parcell does not tell the whole story. His representation of the Standard & Poor's rationale is incomplete and inaccurate. Here is what Standard & Poor actually said at the beginning of its statement:

> After incorporating revised capital expenditure estimates and its **pending rate case** (reduced by the potential impact of U.S. corporate tax reform) in our forecasts, we expect OGE Energy Corp.'s (OGE) funds from operations (FFO) to debt to be very close to our downgrade trigger of 23 percent.
>
> This combined with **rising regulatory risk in Oklahoma** creates some uncertainty regarding OGE's ability to consistently maintain FFO to debt above 23 percent. [Emphasis added].[3]

Significantly, Mr. Parcell omits any reference to these stated concerns about the regulatory environment in Oklahoma. His conclusion is consequently misleading.

[3] Standard & Poor's, Ratings Direct, *Research Update: OGE Energy Corp. And Subsidiary Outlooks Revised to Negative on Weaker Financial Measures; Ratings Affirmed*, March 5, 2018.

Q. **On page 16 of his testimony Mr. Parcell claims that OG&E's credit ratings are '…clear evidence of a lower level of perceived risk for OG&E relative to the proxy companies.' Do you agree with his statement?**

A. I do not agree with his conclusion. OG&E's relatively higher rating is in part due to financial characteristics including its capital structure. It makes no sense to say that OG&E could have a lower equity ratio because the company has less risk when the capital structure is a key factor in that overall credit rating. Further, the table in Mr. Parcell's testimony ignores the fact that OG&E does not have a stable outlook from Moody's. While the Company's credit ratings are now strong, the rating agencies have issued clear warnings about the future. The Company's financial standing would be placed at risk if the Commission adopts the recommendations by Parcell and Griffing for lowering ROE and revising an approved capital structure to an arbitrary 50/50 ratio. The risk with that cavalier approach is that our cost of capital will increase, driving up rates for our customers.

Q. **On page 28 of his testimony Mr. Parcell claims that the authorized capital structure for A-rated companies was 49.95 percent and the median equity ratio was 50.00 percent. Do you agree?**

A. From his exhibit, I do not agree. His Schedule 8 shows that many of those companies are "split rated". That is one of their ratings is single A and one rating is BBB. Further, many of the companies rated by Moody's are A3 which is two notches lower than OG&E's rating of A1. Mr. Parcell has also failed to exclude from his average the equity ratio of Consumers Energy Co. which for ratemaking purposes incorporates Accumulated Deferred Income Taxes in the capital structure.

Q. **Mr. Parcell responds to your Direct Testimony explaining that on June 29, 2017 Moody's changed both OGE Energy's and OG&E's outlooks from "Stable" to "Negative". How does Moody's define its outlooks?**

A. Moody's defines "outlook" as follows:

> A stable outlook indicates a low likelihood of a rating change over the medium term. A negative, positive or developing outlook

indicates a higher likelihood of a rating change over the medium term.[4]

According to Moody's, a negative outlook is essentially a warning to investors that a company's credit profile has changed and more often than not will require a change in rating sometime in the foreseeable future.

Q. **Does Mr. Parcell accurately describe this "Negative" outlook from Moody's?**

A. No. Mr. Parcell dismisses this warning as something that "simply [describes] where within the ratings category the subject company resides." He is incorrect. He has confused a ratings modifier with a rating outlook. The correct analysis requires a consideration of Moody's own definition[5], which I set out above. Clearly, the Moody's outlook is a warning about a potential downgrade. Moreover, what my contacts in the rating agencies tell me about their concerns with the Oklahoma regulatory environment is much more strident than what they write in their reports. I believe that the Company would be at risk of adverse financial consequences if the recommendations of Parcell and Griffing were adopted by this Commission.

Q. **If the rating agencies downgrade OG&E's credit rating would it be easy to recover and achieve an upgrade?**

A. No. It is very difficult for a company to upgrade its credit rating. Once a strong credit rating is achieved, the financial effects are beneficial to customers because rates will reflect the favorable cost of capital. But once achieved, a strong credit rating can easily be lost if irresponsible recommendations like those Parcell and Griffing propose here are adopted as regulatory policy.

A credit rating is dependent upon more than meeting certain criteria at any given point in time. The agencies look for trends to confirm their views. Therefore, just an immediate fix of whatever conditions led to a downgrade would not lead to a corresponding immediate upgrade in the rating. Rather, the agencies tend to take a

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[4] Moody's Investors Service, *Rating Symbols and Definitions,* July 2007.
[5] *Ibid*.

skeptical view and look for long-term confirmation that the underlying variables have in fact changed.

Q. **What is the impact on your customers in an event of credit rating downgrade?**

A. If OG&E's credit rating deteriorates it could lead to increase in cost of capital and limited access to capital in the event of financial or economic crisis which will increase the customers' bills. The impact on our customers is very tangible as illustrated by Company witness Morin:

> [f]or every $100 million of bonds issued by the company, the cost to ratepayers of being a BBB company instead of being a single A company is $10 million.[6]

Q. **Mr. Parcell describes the Company's credit rating as "top notch." What is your view?**

A. The top of the single A rated category should not be confused with the highest rating possible. The Company has a good, strong credit rating, but it is not unreasonably high as Parcell suggests. Rather, it is high enough for OG&E to attract reasonably priced capital that helps keep rates down.

Q. **If OG&E enjoys a strong credit rating, why are you worried about possible downgrade?**

A. First of all, my concern arises because the rating agencies have themselves told us a downgrade is possible if their concerns about the regulatory environment are not alleviated. Moreover, it is never a good time to be downgraded, but now is an especially bad time because of the pressure created by the Tax Cut and Jobs Act (TCJA) on cash flow. Lowering the tax rate from 35 percent to 21 percent doesn't benefit the Company because the cost reduction will be reflected in customers' rates. And any unpaid deferred taxes will be accrued by the Company and returned to the customers over time. The speed at which the unpaid deferred taxes are returned to customers can have significant negative cash flow effect on OG&E.

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[6] Direct Testimony of Roger Morin, PhD, p. 55, lns. 14-16.

Earlier this year Moody's reacted to the TCJA by changing its outlook on 25 regulated utilities from stable to negative[7]. In a report dated January 24, 2018 S&P outlined the credit implications of the tax reform on U.S. utilities and advised that

> Regulators must also recognize that tax reform is a strain on utility credit quality, and we expect companies to request stronger capital structures and other means to offset some of the negative impact. [8]

Q. **Do you agree with Mr. Parcell's statement that "OG&E's currently authorized ROE of 9.5 percent is consistent with the most recently authorized ROE for other utilities"?**

A. I do not agree. First, Parcell's point that a 9.5 percent ROE is "consistent" with that of other utilities is contrary to his own recommendation that ROE must be lowered further. Second, based on the data presented on my Rebuttal Chart 1, the average of the ROEs authorized since December 3, 2015 is 9.8 percent and 56 of the 64 of those ROEs are at or above 9.5 percent. Two thirds of the authorized ROEs are above 9.5 percent. If by "consistent" Mr. Parcell means within the wide range of awarded ROEs, he is correct, but clearly the 9.5 percent ROE that is currently –authorized ROE is in the bottom third of those authorized since 2015.

Third, the currently – authorized ROE was awarded in our last rate case filed in December 2015. The yield on 10-year and 30-year Treasuries as well as market volatility, as illustrated by Rebuttal Charts 3 and 4 below, have increased since then driving higher return expectations by equity investors, and are forecasted to increase further[9].

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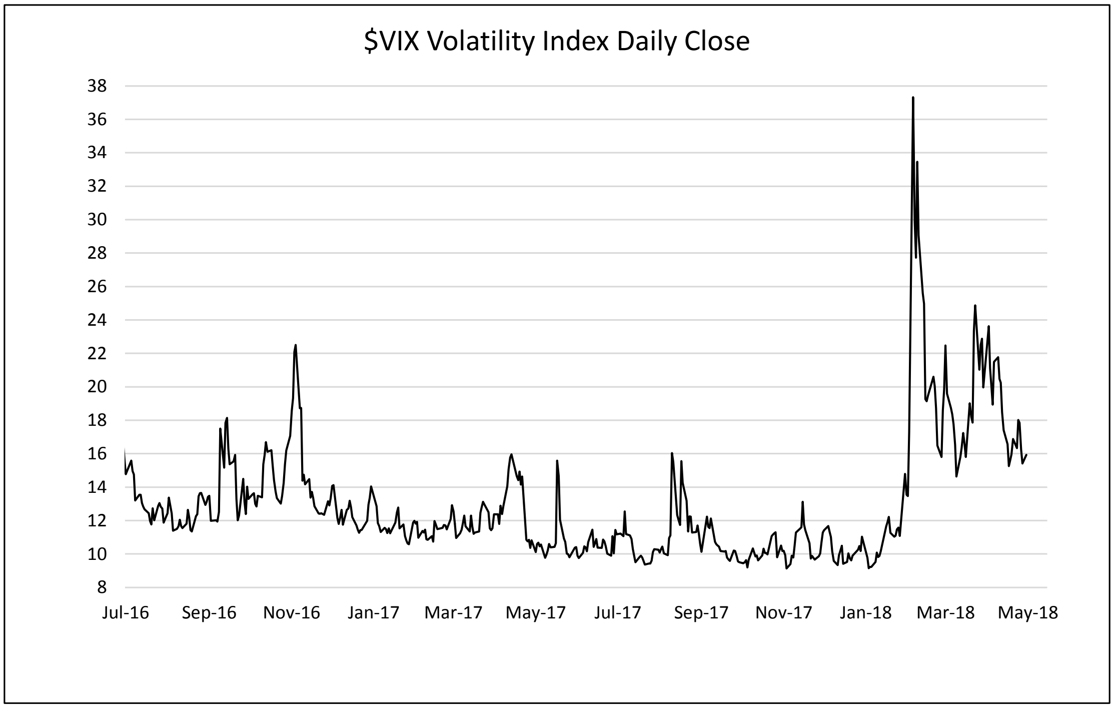
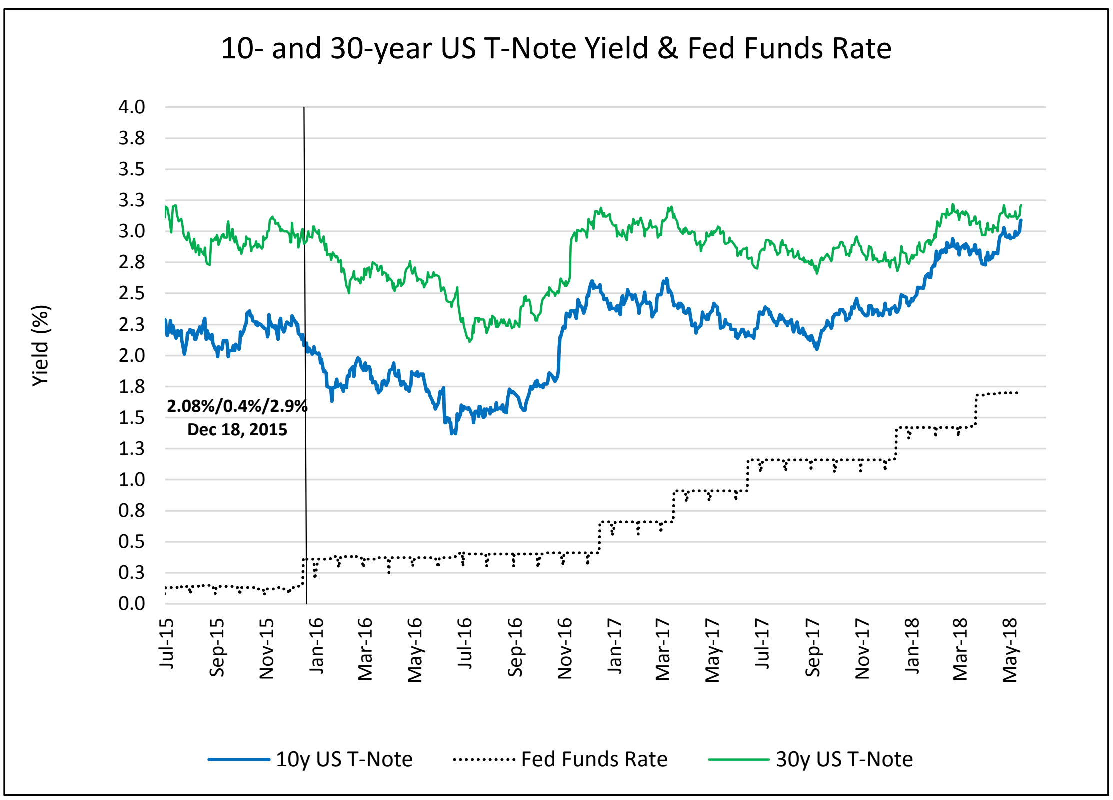
[7] Moody's Investors Service-Global Credit Research , *Rating Action:Moody's changes outlook on 25 US regulated utilities primarily impacted by tax report*, 19 Jan 2018.
[8] S&P Global Ratings, *U.S. Tax Reform: For Utilities'Credit Quality, Challenges Abound*, January 24, 2018, p. 5.
[9] For forecast yield on 30-year U.S. Treasury bonds see Direct Testimony of Roger Morin, PhD, Table 2, p.31.

Rebuttal Chart 3



Rebuttal Chart 4



Q. **Would you comment on Mr. Parcell's statement that 'the OCC is generally regarded as an "average regulatory climate"?**

A. Mr. Parcell is incorrect again. He completely ignores recent statements referring to a declining regulatory environment in Oklahoma published by Regulatory Research Associates, Fitch and Moody's and quoted in the Direct Testimony of Company witness Morin. Instead of presenting these mainline evaluations, Parcell relies on a single Value Line report. His conclusion is accordingly an incorrect and misleading representation of the "general" opinion in the industry.

Q. **Would you comment on Mr. Parcell's statement that current riders and adjustment clauses reduce the risk of OG&E?**

A. This statement is also misleading. While riders and adjustment clauses provide mechanism for more timely cost recovery they do not necessarily reduce OG&E's risk relative to other utilities. In setting ROE, the Commission should evaluate the Company relative to enterprises of comparable risk. OG&E does not utilize more riders than other vertically integrated utilities. On the contrary, some jurisdictions have even stronger risk-reducing regulatory mechanisms such as formula rate plans/ riders. In contrast, for example, OG&E's request for approval for its Environmental Compliance Rider was denied in Cause PUD 201400229. Additionally, the PTC rider requested in this Cause has not received support from the Intervening Parties.

Q. **Do you agree with Mr. Parcell's statement that the Company management was "non-responsive" to the Commissions concern expressed in Order No. 662059 in OG&E's last rate proceeding in regards to OG&E's capital structure?**

A. No, I do not agree with this statement. The Company Management didn't ignore the Commissions concern but evaluated it in the context of the current market environment. Since the issuance of Order 662059, OG&E's cash flow has been eroded in part due to the allowed ROE and depreciation impact determined in that order. As a result, OG&E has been put on negative outlook by Moody's and S&P. Further, the Company faces cash flow headwinds from the Tax Cuts and Jobs Act. My testimony sets forth the reasons why I believe that its capital structure should be maintained intact so as to maintain the Company's credit rating. We need capital to provide safe and reliable service. The Company's current capital structure is optimal for achieving that result.

Q. **Please summarize your testimony.**

A. The recommended hypothetical 50/50 capital structure and the recommended ROE are not fair and reasonable given the current environment. Since the last order of the Commission, in Cause No. 201500273, interest rates have gone up, market volatility is elevated, S&P and Moody's have issued negative outlook on OG&E and the Tax Cut and Jobs Act is applying additional pressure on the Company's cash flows. Further degradation in ROE will result in diminished cash flow profile for the company, reduced credit quality and increased costs to customers that will be difficult to reverse in the near term.

Q. **Does this conclude your testimony?**

A. Yes.