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BEFORE THE CORPORATION COMMISSION OF OKLAHOMA

COURT CLERK'S OFFICE - OKC
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

Direct Testimony

of

Stephen E. Merrill

on behalf of

Oklahoma Gas and Electric Company

January 16, 2018

Stephen E. Merrill
Direct Testimony

1 Q. **Please state your name, position, by whom you are employed, and business address.**

2 A. My name is Stephen Merrill. I am employed by OGE Energy Corp. (“OGE”) and serve
3 as Chief Financial Officer of OGE and its subsidiary, Oklahoma Gas and Electric
4 Company (“OG&E” or “Company”) and my business address is 321 N. Harvey Ave,
5 P.O. Box 321, Oklahoma City, Oklahoma 73101.
6

7 Q. **Please summarize your educational background and professional experience.**

8 A. I earned a Bachelor of Science degree in Accounting from Oklahoma State University. I
9 have served as Chief Financial Officer of OG&E since 2014. Previously, I served as
10 Executive Vice President of Finance and Chief Administrative Officer of Enable
11 Midstream Partners, LP. I held the position of Chief Operating Officer of Enogex LLC,
12 and Vice President of Human Resources of OGE Energy Corporation prior to that.
13 My professional career includes 30 years of diversified experience in the energy industry.
14

15 Q. **Please describe your duties and responsibilities as Chief Financial Officer of OG&E.**

16 A. I am responsible for all aspects of finance, treasury, accounting, internal audit, regulatory
17 affairs and the investor relations function. I also oversee the management of significant
18 resources that are used to provide safe and reliable service to our customers. My
19 responsibilities include setting goals, measuring progress towards achieving those goals,
20 communicating it to the investors, employees and the Board of Directors. A significant
21 portion of my time is spent on communicating with current and potential shareholders,
22 creditors and the credit rating agencies.
23

24 Q. **Have you previously testified before the Oklahoma Corporation Commission or any
25 other regulatory commission?**

26 A. No, I request that my credentials be accepted at this time.

Introduction

Q. **What is the purpose of your testimony in this proceeding?**

A. The purpose of my testimony is to explain how the authorized Return on Equity (“ROE”) granted in this cause will be vitally important to our future operations and to the customers we serve. The ROE decision in this cause is not a choice between what’s good for the Company and what’s good for our customers. I will discuss why the authorized ROE should align the interests of both our customers and our investors.

Q. **How does ROE affect OG&E’s planning, cost of capital, its customers, and the community?**

A. Electric utilities are capital intensive businesses. Significant investment is necessary each year to keep operations current. The financial community’s perception of our ability to earn a fair rate of return drives the cost of funding those capital investments. Uncertainty around earning a reasonable ROE has an adverse impact on the Company’s ability to have a clear long-term capital plan. Also, it can increase our cost of capital, which would compromise OG&E’s financial health and adversely impact customer costs by driving up the cost of debt. Our ability to earn fair and reasonable ROE is directly related to our ability to keep customer bills low.

Q. **Is OG&E guaranteed to earn the ROE authorized by the Commission?**

A. No, the authorized ROE is not a guaranteed ROE. OG&E bears the risk of earning less than the authorized ROE if operating costs and capital project costs increase. The lag on the recovery of our investments also contributes to lower than authorized returns. OG&E’s rates are set based on customer usage during normal weather conditions. The Company bears the risk of abnormal weather, both above and below normal. Over the last several years, weather has been below normal, adversely impacting our earned ROE. Further, our recent large capital spend, largely mandated by federal environmental requirements and the inherent regulatory lag has greatly impacted our ability to earn our allowed return. Equity investors are the last in line to get compensated and therefore absorb all of the volatility of the variability in earnings.

1 Q. **Why is authorized ROE so important to investors?**

2 A. Of course, historic earned ROE is an important consideration for investors. But investors
3 primarily look to the future: and a Commission authorized ROE which signals that
4 OG&E will have the opportunity to provide a fair, timely and predictable return on
5 investments is very important to the market. Investors have many options when it comes
6 to investing their capital, and OG&E must compete with other companies with similar
7 risk profiles for that capital. A reasonable authorized ROE is a key factor in keeping our
8 cost of capital from escalating.

9
10 Q. **Why is the authorized ROE important to customers?**

11 A. Uncertainty around investors' ability to receive fair, timely, and predictable return on
12 their investments will prompt them either to make different investment choices or
13 demand a higher return to invest in OG&E. Because OG&E must raise capital, this will
14 force the Company to pay a higher cost of capital. This translates into a higher revenue
15 requirement and ultimately leads to higher customer rates.

16
17 Q. **Should the interests of the customer and the investors be aligned?**

18 A. Yes, the interests of the customers and the investors should be aligned. In a recent essay,
19 Scott Hempling, a noted regulatory attorney who often advises state utility commissions,
20 observed "Shareholder and ratepayer interests, if legitimate, are not
21 opposites. Shareholders want satisfied customers; customers want healthy companies. In
22 regulating public utilities, the public interest is served when shareholder and ratepayer
23 interests are aligned; that is, when pursuit of the shareholder interest simultaneously
24 advances the consumer interest." Here is what this quote means to me. Customers need
25 and expect reliable service. To provide that service OG&E needs the resources to make
26 that possible. One of those resources is equity investment. Equity and debt investors play
27 a critical role in the financing of utility operations. As stated earlier they experience the
28 variability inherent in business outcomes. In order to attract and retain investment dollars
29 the returns must match investors' market-driven expectations. In the end, customers and
30 investors alike are best served by fair, balanced, and predictable returns.

1 Artificially high returns and unrealistically low returns are equally unsustainable.
2 A fair and reasonable ROE keeps the interests of customers and investors aligned.
3

4 Planning

5 Q. **How do reasonable capital costs allow OG&E planning, investor requirements and**
6 **customer benefits to align?**

7 A. OG&E's ability to earn reasonable ROE allows the Company to develop a solid long
8 term plan and make major investments that would bring value to our customers at a
9 reasonable price.

10 The SmartGrid platform is a great example of an investment that was not
11 mandated or driven by reliability requirements. New technology gave customers control
12 and flexibility over their electricity use, provided greater insight and efficiency into
13 outage restoration, and allowed the seamless integration of wind and solar. OG&E
14 received nationwide recognition for the Smart Hours program and, assuming adequate
15 returns, will continue to offer innovative customer-focused products by investing in new
16 technologies. Another key initiative that has provided value to customers was the
17 Company's investment in its solar program that has met customer demands for additional
18 renewable energy.
19

20 Q. **Are investors and the rating agencies voicing any concerns related to OG&E's**
21 **planning?**

22 A. Yes, investors continue to request more details around the Company's future investments,
23 beyond 2018, and the Company has been hesitant to provide a detailed response without
24 having a clear line of sight to the ROE it can earn. Generally speaking, investors will seek
25 investments that provide steady stream of capital projects because that signals a growing
26 business that provides an opportunity to earn a return on their investment. In fact,
27 investors are very concerned about the direction of ROEs and regulation in Oklahoma.
28 Some of our large investors have vacated the stock since the last rate order. The rating
29 agencies have expressed concern about the trend in allowed rates of depreciation, the
30 trend in OG&E's authorized ROE, the prospect of an imputed hypothetical capital
31 structure, as well as the timelines of recovery and investments. Moody's has put the

1 Company on negative watch and Fitch has similar concerns. In addition, on October 6,
2 2017, Wells Fargo downgraded their recommendation to buy OG&E stock.

3
4 **Q. When authorized ROE does not meet investors' expectations, how are projects**
5 **affected?**

6 A. Unlike the Company's decision to implement investments like SmartGrid and the Utility
7 Solar Pilot Program, the Company is also required to complete projects mandated by state
8 or federal law, including many projects required to maintain reliable service to customers.
9 When investors demand higher return from the Company because of the additional risk
10 they are taking, the customer pays more for those mandated projects. On the other hand,
11 as the cost of capital rises, that additional cost means that the Company may not be able
12 to undertake the projects that, while not required, would enhance the customer
13 experience.

14
15 **Q. Is there any evidence that OG&E's cost of equity has increased?**

16 A. Yes. The Price Earnings ratio or PE ratio provides the clearest evidence that the public
17 equity markets have raised OG&E's cost of equity.

18
19 **Q. How does the PE ratio indicate that OG&E's cost of equity has increased?**

20 A. The PE ratio expresses the current stock price as a ratio of one year worth of earnings.
21 OG&E's equity value is trading at a PE multiple of approximately 18 while electric
22 utilities on average are trading at a PE multiple of approximately 21¹. This means
23 investors are willing to pay \$18 for \$1 of OG&E earnings while they are willing to pay
24 \$21 for \$1 of earnings for the average utility. Another way of saying this is that a dollar
25 of earnings collected from customers for the average utility supports \$21 of investment.
26 The same dollar collected from OG&E's customers supports only \$18 of investment.

¹ Source: FactSet as of December 15, 2017
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1 Q. **Does the Commission determine the cost of equity?**

2 A. No. The Commission determines the Company's authorized ROE. The authorized ROE is
3 used to calculate OG&E's allowed revenue requirement. OG&E's actual cost of equity is
4 determined on a daily basis by the capital markets. The fairness, balance and
5 predictability of Commission orders has a significant influence on the market's
6 assessment of risk that is translated into the cost of equity.

7
8 Q. **Does lower than average authorized ROE impact OG&E's cost of capital?**

9 A. Yes. This is a result of the Company's capital requirements being driven by the
10 obligation to serve customers, which may force OG&E to access capital markets during
11 market downturns and fund projects on unfavorable terms. Also, there are times when the
12 capital markets are in distress and only financially stable companies with excellent credit
13 ratings have access to capital. For example, during the financial crisis in 2008, it was
14 extremely difficult to raise capital for many well established companies, especially for
15 companies with lower than average credit ratings.

16
17 Q. **Why should customers care about OG&E's allowed ROE?**

18 A. Unreasonably low allowed ROE may cause the credit agencies to downgrade the utility
19 credit rating. This in turn would increase OG&E's directly observable borrowing costs
20 which are included in customers' costs. This is more important than ever given the most
21 recent analysts' expectations that the Federal Reserve would raise interest rates three
22 times in 2018.

23
24 **Customer and Community Impact**

25 Q. **How does a financially strong utility benefit customers?**

26 A. Financially strong utilities are able to invest in key initiatives and new technologies that
27 provide benefit to customers, while also keeping their cost of capital and customer bills
28 low. It is important that OG&E be a financially strong utility so that it can remain
29 focused on its customers through its continued development of automation solutions for
30 OG&E's customers through the Smart Grid platform, renewable energy resources, and
31 investing for the future.

1 **Q. How does a financially strong utility benefit the communities in which its customers**
2 **live and work?**

3 A. Public service is core to our values and underlines efforts to grow the 276 cities in our
4 service territory. Each year, our ad valorem payments benefit our schools and
5 communities, OG&E is one of the largest ad valorem taxpayers in the state of Oklahoma,
6 paying approximately \$75 million in ad valorem taxes per year. The OG&E Foundation
7 and employees donate about \$4 million dollars to the United Way and other worthy
8 causes. Members also spend 20,000 hours volunteering their time and energy to a number
9 of nonprofit and civic organizations.

10 OG&E also funds a variety of programs that serve students throughout Oklahoma.
11 Annually, the Company provides grants to public school teachers (pre-K through 12) to
12 fund projects in the areas of reading, science, mathematics, technology, energy and the
13 environment. In 2017 alone, the Company funded 182 projects, benefitting 17,780
14 students in our service territory. Also in 2017, the Company helped fund close to 100
15 educational programs including Junior Achievement, school career fairs, field days and
16 assemblies. One project of note is ScienceFest Oklahoma. OG&E has
17 sponsored ScienceFest Oklahoma since 2002. Each May, about 5,000 4th and 5th
18 graders from across Oklahoma gather together for interactive learning on alternative
19 energy and environmental conservation. In addition to financial support, the Company
20 provides about 75 employee volunteers who keep the day organized and safe or who
21 participate in an environmental education hands-on activity station for the visiting
22 students.

23
24 **Q. Does the Oklahoma economy benefit from a financially strong locally**
25 **headquartered electric utility?**

26 A. Yes, as estimated by Company witness Dr. Russell Evans, OG&E's capital investments
27 create a spillover effect in the state by supporting over 7,600 Oklahoma jobs and creating
28 \$578 million in gross state product.

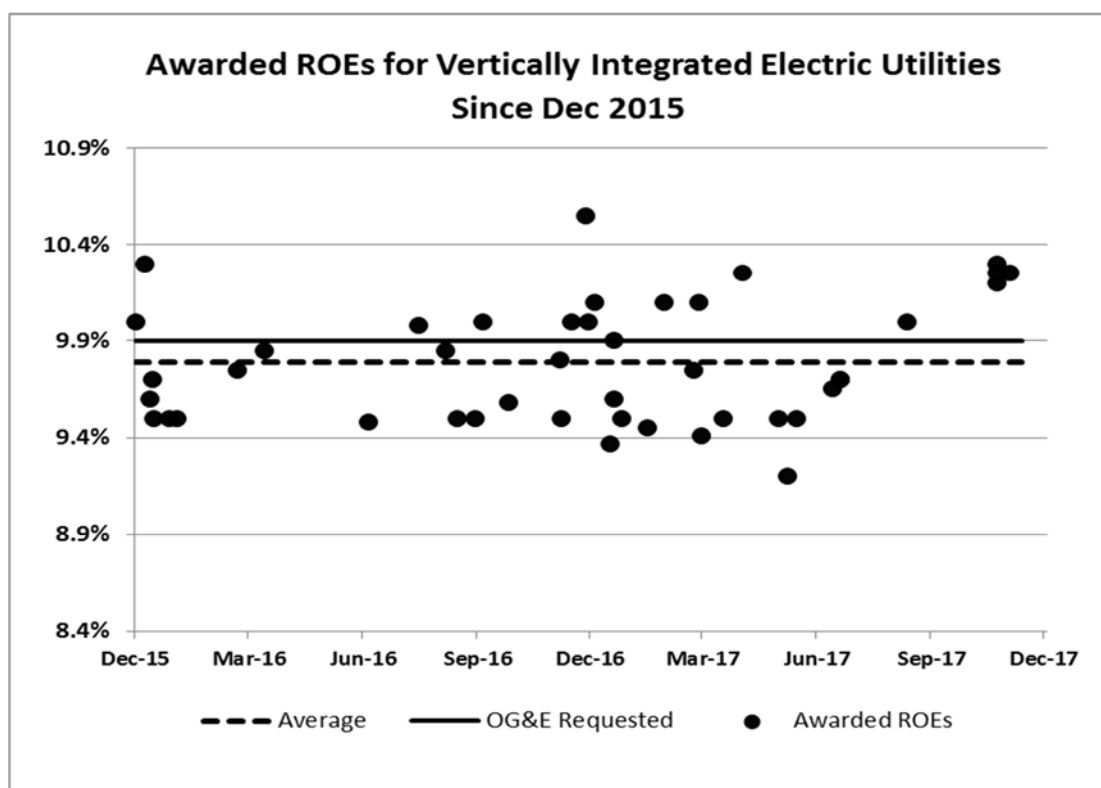
Conclusion

Q. Do you believe the ROE recommended by Dr. Morin align the interests of investors and customers?

A. Yes, considering the data presented by Chart 3 it appears that Dr. Morin's recommendation of 9.9% ROE is in line with ROEs recently awarded by other state commissions and it will be perceived as fair and balanced by the investment community

I believe that the ROE recommended by Dr. Morin will align with customer expectations because it will result in the lowest reasonable cost of capital being included in the rates paid by our customers for OG&E services.

Chart 3



1 Q. **Do you have any concluding remarks?**

2 A. I certainly recognize the need for a balanced approach to meet the needs of all of our
3 Stakeholders. A financially healthy and stable utility, that is able to have clear line of
4 sight to returns, and is able to increase investment in the state, while maintaining low
5 customer rates, certainly achieves that balance.

6

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

8 A. Yes.