BEFORE THE
ARKANSAS PUBLIC SERVICE COMMISSION

IN THE MATTER OF THE APPLICATION	)	
OF OKLAHOMA GAS AND ELECTRIC	)	
COMPANY FOR APPROVAL OF A	)	DOCKET NO. 16-052-U
GENERAL CHANGE IN RATES, CHARGES	)	
AND TARIFFS	)	

SURREBUTTAL TESTIMONY

OF

REGIS POWELL
FINANCIAL ANALYST
FINANCIAL ANALYSIS SECTION

ON BEHALF OF THE GENERAL STAFF
OF THE ARKANSAS PUBLIC SERVICE COMMISSION

MARCH 30, 2017

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INTRODUCTION AND PURPOSE

Q. Please state your name.

A. My name is Regis Powell.

Q. Are you the same Regis Powell who filed Direct Testimony in this Docket on January 31, 2017, on behalf of the General Staff (Staff) of the Arkansas Public Service Commission (Commission)?

A. Yes.

Q. What is the purpose of your Surrebuttal Testimony?

A. The purpose of my Surrebuttal Testimony is to present my updated cost of capital determination results based on my evaluation of the most recent market data and the Rebuttal Minimum Filing Requirement (MFR) Schedules submitted by Oklahoma Gas and Electric Company (OG&E or Company). Additionally, I will address the Rebuttal Testimony of Company witnesses Robert B. Hevert, Donald R. Rowlett, and Gwin Cash as well as the Direct Testimony of the Office of Arkansas Attorney General Leslie Rutledge (AG) witness William Perea Marcus.

COST OF CAPITAL UPDATE

Q. Have you evaluated the Company's Rebuttal testimonies and supporting schedules?

A. Yes, I have.

Q. What are the results of your evaluation?

A. I continue to support the reasonableness of a 9.5% return on equity (ROE) and a hypothetical capital structure based on a sample of market-traded companies of similar risk. My recommendations for the various components of the capital structure afford the Company an opportunity to earn a fair rate of return (ROR).

Q. Have you updated the components of the capital structure to reflect updated information provided by other Staff witnesses?

A. Yes. Staff witness Bill Taylor provided recalculated amounts of current, accrued, and other liabilities (CAOL)[1] and updated accumulated deferred income taxes (ADIT).[2] Mr. Taylor's update consisted of a decrease in ADIT by $64 million as compared to Staff's ADIT estimate in Direct Testimony. The update resulted in a slight increase of the ROR to 5.36% and the weighted cost of debt to 2.04%[3] versus the recommendations made in my Direct Testimony of 5.31% and 2.02%, respectively.[4]

EXTERNAL CAPITAL BALANCES

Q. Do you and the Company agree on any of the external capital balances to be included in the capital structure?

A. Yes. The Company and I are in agreement on the external capital balances of customer deposits and other capital items.

Q. On which external capital balances do you and the Company differ?

A. The Company and I differ on the external capital balances of long-term debt, short-term debt, common equity, and post-1970 accumulated deferred investment tax credits (ADITC). The Company's Rebuttal maintains its

[1] Surrebuttal Testimony of Staff witness Bill Taylor, p. 4, lines 5 - 8.
[2] *Id.*, at p. 5, lines 9 - 11.
[3] Surrebuttal Exhibits RP-1 and RP-4.
[4] The Company's request of 6.01%, provided in its Rebuttal MFR Schedules, remains the same as its request made in its Direct filing.

request to include its *pro forma* projections for these items, whereas, in conforming to Ark. Code Ann. § 23-4-406 and keeping with past practice, I continue to rely on known and measurable balances from the test year-end as of June 30, 2016.

RELATIVE PROPORTIONS OF EXTERNAL CAPITAL COMPONENTS

Q. Have you examined the most recent financial disclosures of the risk-comparable sample companies selected by you and Mr. Hevert?

A. Yes, I have.

Q. What are the average debt-to-equity (DTE) ratios for the sample companies selected by you and Mr. Hevert?

A. The average DTE ratios for the four quarters ending December 31, 2016, for my and Mr. Hevert's risk comparable samples were 52% to 48%[5] and 54% to 46%,[6] respectively.

Q. Do you continue to support the hypothetical capital structure you recommended in your Direct Testimony?

Yes. The most recent financial disclosures further support the reasonableness of the 52% to 48% DTE ratio I recommended in my Direct Testimony. As presented in Surrebuttal Exhibit RP-5, my sample of risk-comparable companies used to derive a hypothetical capital structure is more appropriate because it comprises companies deriving a proportion of their revenues from providing retail electricity that is more comparable with OG&E

[5] Surrebuttal Exhibit RP-2.
[6] Surrebuttal Exhibit RP-3.

than Mr. Hevert's sample of companies.

Q. Is the Company's requested capital structure in agreement with recent Commission practice?

A. No, it is not. As the Commission has previously ruled:

> ....[T]here should be congruence between the estimated cost of equity and the debt-to-equity ratio, whereby a lower debt-to-equity ratio decreases financial risk and decreases the cost of equity…[7]

However, Mr. Hevert creates incongruences between his recommended ROE and his chosen risk-comparable sample companies which remain unresolved.

Mr. Hevert uses market-traded holding companies to calculate what he deems as a range of reasonableness for OG&E's ROE, but then, he ignores those market-traded companies when evaluating the reasonableness of the Company's requested capital structure. The operating subsidiaries of the sample companies Mr. Hevert uses for his capital structure evaluation have lower DTE ratios and thus less financial risk than the market-traded holding companies he uses for his ROE recommendation. As explained in my Direct Testimony,[8] this creates incongruences between risk and return which should have compelled Mr. Hevert to adjust his ROE recommendation downward to reflect the lower risk associated with the lower DTE ratio he advocates. However, he neglected to do so.

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[7] Docket No. 15-011-U, Order No. 10, pp. 13 - 14.
[8] Direct Testimony of Regis Powell, p. 16, line 15 – p. 17, line 20.

Q. Is the Company correct in its assertion that your recommended capital structure will limit OG&E's financial decisions?[9]

A. No, it is not. An imputed capital structure is used only for ratemaking purposes in order to calculate a reasonable ROR to ensure that rates do not reflect excessive equity costs and fairly balance the interests of ratepayers and shareholders. This does not limit OG&E management's ability to make financial decisions. Imputing a capital structure simply means that equity costs above a reasonable level may not be recovered through rates.

Q. Do you continue to support the inclusion of short-term debt in the capital structure?

A. Yes. Short-term borrowings are a necessary source of funds for utilities. To fund day-to-day operations, companies routinely utilize short-term borrowing. OG&E is no exception. As I discuss in my Direct Testimony, because OG&E consistently utilizes short-term debt in its operations,[10] it would violate the principle of fungibility to exclude a source of funds from the capital structure that the Company routinely uses.[11]

Q. Mr. Hevert states that utilities generally do not use short-term debt to fund the long-lived assets included in rate base.[12] Should this have an impact on your recommendation?

A. No. I find the statement unpersuasive on two grounds. First, current assets,

[9] Rebuttal Testimony of Donald Rowlett, p. 4, line 21 – p. 5, line 5.
[10] Direct Testimony of Regis Powell, p. 18, line 16 – p. 19, line 2.
[11] *Id.*, at p. 6, line 14-21 – p. 7, line 20.
[12] Rebuttal Testimony of Robert Hevert, p. 41, lines 3 - 4.

on which the Company earns a return, are included in Staff's recommended jurisdictional rate base ($44 million out of $520 million). Secondly, as explained in OGE Energy Corp's (OGE Energy) latest Form 10-K, short-term debt is being used to finance construction projects.[13]

Q. Is the Company correct in its assertion that you overstated the level of short-term debt?[14]

A. No, it is not. I maintain that 2.9% is an appropriate level of short-term debt for OG&E. For the four quarters ending December 31, 2016, short-term debt comprised on average 2.8% and 3.1%, respectively, of my and Mr. Hevert's sample companies' external capital structures.[15] The most recent financial disclosures for all the sample companies support the reasonableness of the level of short-term debt I am recommending.

EXTERNAL CAPITAL COST RATES

Q. Do you and the Company agree on any external capital cost rates?

A. Yes. The Company and I agree on the appropriate external capital cost rates for customer deposits, other capital items, and short-term debt.[16] While the Company requests a zero balance for short-term debt and I do not, we both agree that the appropriate cost rate for short-term debt should be 0.76%, based on the interest paid on short-term borrowings by its parent company, OGE Energy.

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[13] OGE Energy's Form 10-K for the fiscal year ending December 31, 2016, p. 93.
[14] Rebuttal Testimony of Robert Hevert, p. 41, lines 3 - 4.
[15] Surrebuttal Exhibits RP-2 and RP-3.
[16] Rebuttal MFR Schedule D-1.3, line 9, column 7.

Q. On which external capital cost rates do you and the Company differ?

A. The Company and I differ on the appropriate external capital cost rates for long-term debt, common equity, and post-1970 ADITC. Concerning the cost rate on long-term debt, I continue to recommend the cost rate presently reflected on the Company's books. OG&E's requested long-term debt cost rate is based on unsubstantiated *pro forma* projections and as such, runs counter to Ark. Code Ann. § 23-4-406. The differences in the Company's request and my recommendation for the external capital costs rates of common equity and long-term debt consequently lead to the differences in the cost rates applied to the apportioned components of post-1970 ADITC.

UPDATED COST OF EQUITY ANALYSIS

Q. Did you update your Discounted Cash Flow (DCF) analysis to a more recent timeframe to assess the continued reasonableness of your ROE recommendation?

A. Yes. I updated the DCF analysis that was provided in my Direct Testimony[17] to incorporate the following issues of *The Value Line Investment Survey* (Value Line):

Value Line Issue Date	Region of U.S.
October 28, 2016	West
November 18, 2016	East
December 16, 2016	Central

The updated price, current annual dividend, and calculated dividend yield for

[17] Direct Testimony of Regis Powell, p. 21, line 14 – p. 31, line 16.

each of the companies in my risk-comparable sample are shown on Surrebuttal Exhibit RP-6. The updated growth rates for each of the companies in my risk-comparable sample are presented on Surrebuttal Exhibit RP-7.

Q. What are the updated ROE estimates for your risk-comparable sample?

A. As shown on Surrebuttal Exhibit RP-8, the five updated risk-comparable sample ROE estimates are 8.7%, 9.3%, 9.4%, 9.9%, and 10.2%, which results in a midpoint of 9.5%.

Q. Should Staff's DCF analysis be given less weight because of current and expected economic conditions?

A. No, it should not. My DCF analysis uses the most current stock prices, which embody all of the information currently available to rational investors, including expected economic conditions. Thus, my DCF analysis reasonably "prices in" current and expected trends.

Q. Did you perform an update of your Capital Asset Pricing Model (CAPM) analysis to assess the continued reasonableness of your ROE recommendation?

A. Yes. The updated Value Line issues I employed in my DCF analysis maintain the same average beta for my sample companies as the figure previously used in my Direct Testimony.[18] In this proceeding, I accept Mr. Hevert's comments concerning my market risk premium (MRP) and have adopted the

[18] Direct Exhibit RP-28, p. 35.

index dividend yield Mr. Hevert provides in his Rebuttal Testimony.[19]

I take a conservative approach and use both the geometric and arithmetic means to evaluate a fair ROE in my CAPM analysis. As shown in Table 1 below, incorporating this index dividend yield into my CAPM analysis produces updated ROE estimates of 9.4% and 9.7%. Both of these updated estimates help form my range of reasonableness and further support my ROE recommendation of 9.5%.

TABLE 1: CAPM Results

	Beta (1)	**Market Risk Premium** (2)	**Risk Free Rate** (3)	**ROE Estimate** (1)x(2)+(3)
Geometric	0.67	7.83%	4.10%	9.4%
Arithmetic	0.67	8.28%	4.10%	9.7%

Q. Do you still maintain your criticisms of Mr. Hevert's CAPM?

A. Yes. The source of my concern regarding his CAPM model is the discrepancy in the betas used in his analysis.[20]

Table 7 in Mr. Hevert's Rebuttal Testimony is straightforward in explaining that betas, which measure the relative movement between an individual stock price and the market, should be similar in value for the same company despite the index used in the betas' derivation.[21] My Surrebuttal Exhibit RP-10 includes an excerpt from Duff & Phelps' *2016 Valuation Handbook* that further supports this expectation. However, a beta can be

[19] Robert Hevert's Rebuttal Exhibit RBH-11.
[20] Surrebuttal Exhibit RP-9.
[21] Rebuttal Testimony of Robert Hevert, p. 30, Table 7.

unstable and have differing values depending on if you measure it using two, four, or six years of historical data. Mr. Hevert's analysis contains these beta discrepancies. This is problematic because beta is the sole measure of risk in the general CAPM model.

The CAPM is a useful tool in establishing the range of reasonableness, but my criticism highlights a major short-coming of the model: beta is derived from historical data and can't be reliably forecasted. As this Commission has stated:

> A major advantage of the DCF methodology is that it is more directly market-based. A key component of the DCF formula is the price term. The price term, if correctly calculated, is *forward-looking* and directly embodies the market consensus of a utility's risk, the time value of money, and the opportunity cost of money. As can easily be seen from the DCF formula, K = D/P + g, if risk increases, P decreases, and K increases. If the time value of money increases, P decreases, and K increases. If the opportunity cost of money increases, P decreases, and K increases. All of these results illustrate the simplicity of the DCF methodology. None of the other methodologies employ such a simple and direct market-based measure. Instead they all are *backward-looking*, relying upon a vast array of historical data, which may or may not be applicable in the future.[22]

No matter how forward looking Mr. Hevert's or any other's MRP could be, the sole determinant of risk in the general CAPM model is based on years of historical data. Years of stale historical data may not reflect current investor sentiment going forward. This is better captured by the DCF which incorporates the most recent stock prices in its analysis.

[22] Docket No. 06-101-U, Order No. 10, p. 26.

Q. Did you perform an update of your risk premium analysis to assess if your ROE recommendation is in line with returns authorized for vertically integrated electric utilities in the same general part of the country?

A. Yes. As shown in Table 2, updating for the most current yields on 30-year treasuries and public utility debt produces two estimates: 9.2% and 9.3%.

TABLE 2: Risk Premium Analysis of Surrounding Jurisdictions

	Risk Premium Observed on Respective Debt in Surrounding Jurisdictions (1)	Average Yield Since the Co.'s Filed Application (8/25/2016) (2)	Result (1) + (2)
Public Utility Bond Yields	4.7%	4.5%	9.2%
30-Year Treasuries	6.5%	2.8%	9.3%

My risk premium analysis also helped form my range of reasonableness from which I developed my recommended ROE of 9.5%.

Q. Is your risk premium analysis lacking in using projected information?

A. No. Mr. Hevert argues that I should have evaluated projected interest rates and produced a forward-looking risk premium.[23] This is unnecessary because my analysis is consistent with Act 725 and thus gives more clarity to the information the Company provided concerning recent returns in the same general part of the country.

Looking at decisions only within the most recent year or two doesn't

[23] Rebuttal Testimony of Robert Hevert, p. 32, line 8 – p. 35, line 3.

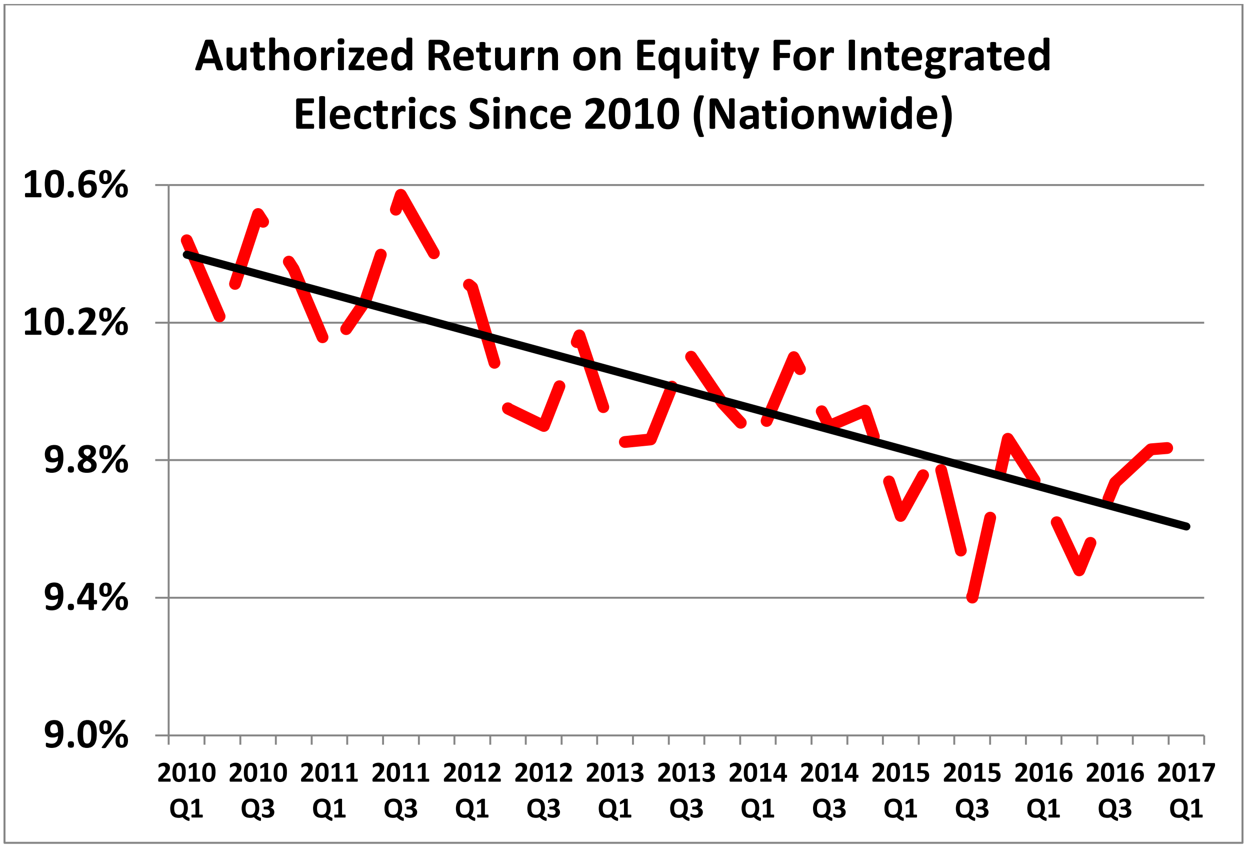
draw a large enough sample to be confident that potential aberrant rate cases are not creating a distorted picture. Keeping my evaluation period within the same business cycle limits the effects of inflation, tax policy, economic productivity, etc. In the analysis, the yields on public utility debt and 30-year treasuries help inform the prevailing opportunity costs to investors during the pendency of the individual rate cases. What future ROE authorizations in the surrounding states might be in the upcoming years is outside the scope of my analysis.

Q. Is your recommendation consistent with recent ROE authorizations nationwide?

A. Yes. I evaluated the workpapers Mr. Hevert used to produce Chart 3 in his Rebuttal Testimony.[24] Since the beginning of 2016, 20 out of 21 authorized ROEs for vertically integrated electric utilities fell within my recommended range. Only 6 out of 21 were in Mr. Hevert's range. As explained in my Direct Testimony,[25] the Company has not supported any significant, identifiable risks that justify moving away from the midpoint of my recommended range. Furthermore, the midpoint of my range, 9.5%, is consistent with the trend in ROE authorizations in recent years. (See Graph 1 below.)

[24] *Id.*, at p. 14.
[25] Direct Testimony of Regis Powell, p. 38, line 10 – p. 41, line 17.

GRAPH 1

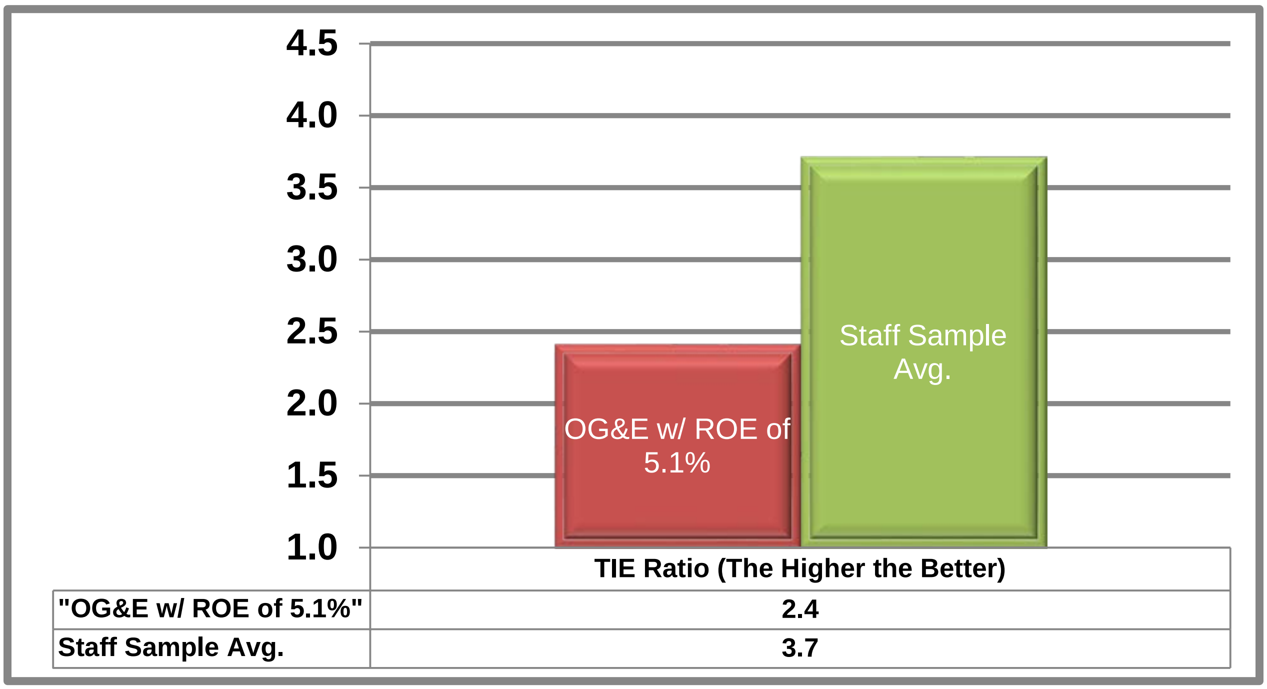


PRO FORMA FINANCIAL RATIO ANALYSIS

Q. Does Mr. Hevert criticize your analysis of the *pro forma* financial ratios produced by Staff's hypothetical capital structure and ROE recommendations?

A. Yes. Mr. Hevert raises doubt on the usefulness of my analysis of the *pro forma* financial ratios produced by Staff's recommendations for OG&E. Mr. Hevert asserts that my analysis isn't meaningful because a speculative ROE of 5.10% would inappropriately show financial parity between OG&E and my sample companies.[26] I disagree. The Times Interest Earned Ratio (TIE Ratio) evaluates the number of times a company can pay the interest on its debt with pre-tax income. In Chart 1 below, my analysis shows that an ROE of 5.10% clearly would not achieve parity with my sample companies. My sample companies would have on average, a TIE Ratio 54% greater than OG&E.

CHART 1



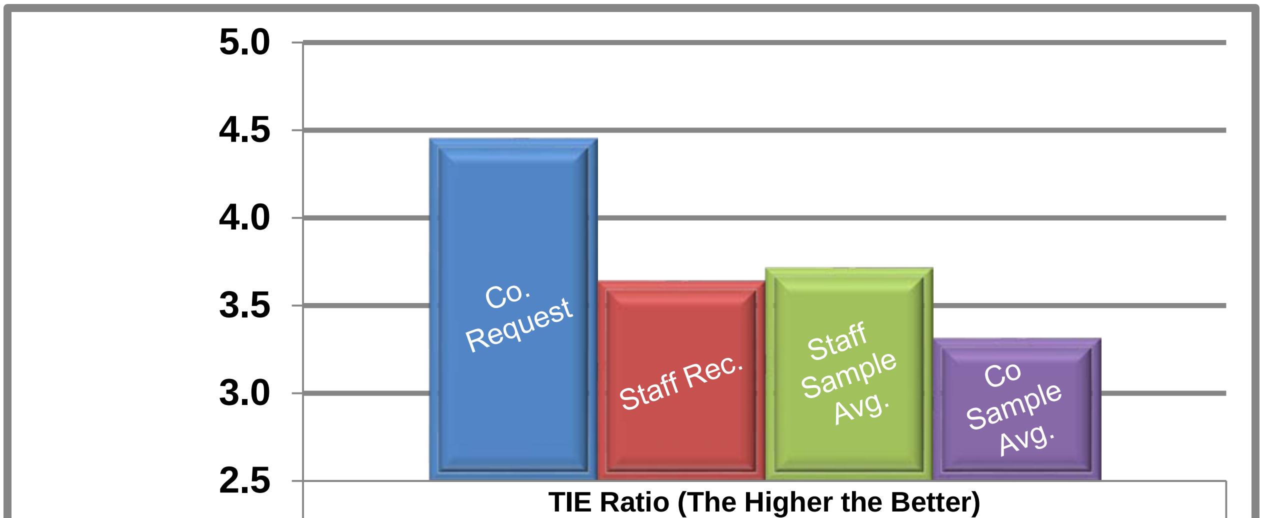
Q. Have you evaluated OG&E's *pro forma* financial ratios produced by the Company's request versus the ratios produced by your cost of capital determination?

A. Yes. The resulting *pro forma* financial ratios support my recommendation as more consistent with setting just and reasonable rates that balance the

[26] Rebuttal Testimony of Robert Hevert, p. 39, lines 1 – 12.

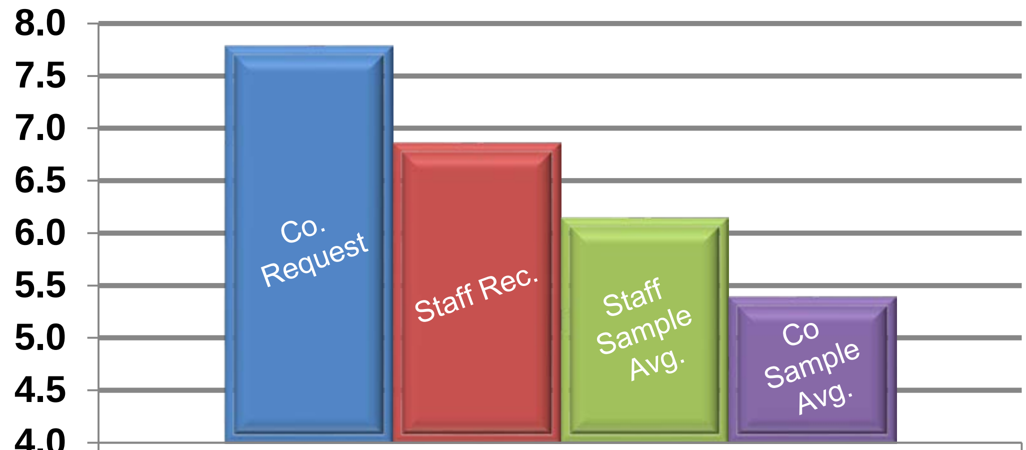
interests of both ratepayers and the Company's shareholders. Charts 2 through 4 below, reveal that the Company's request is not supported by the sample companies used by Mr. Hevert or myself. In every chart, the Company's request far exceeds the sample averages. Additionally, the charts show that my recommendation is not confiscatory to OG&E's shareholders.

CHART 2



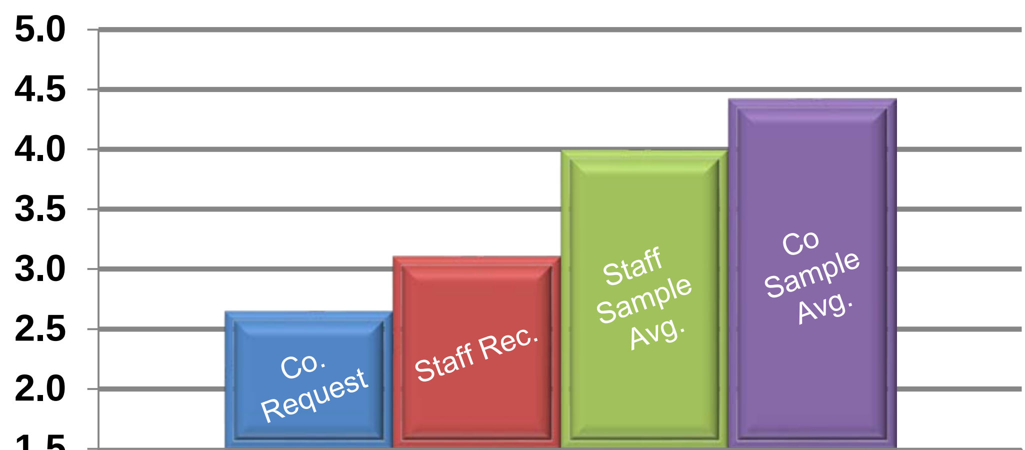
	TIE Ratio (The Higher the Better)
Co. Request	4.5
Staff Rec.	3.6
Staff Sample Avg.	3.7
Co Sample Avg.	3.3

CHART 3



	EBITDA / Interest Coverage (The Higher the Better)
Co. Request	7.8
Staff Rec.	6.9
Staff Sample Avg.	6.2
Co Sample Avg.	5.4

CHART 4



	EBITDA/Debt (The Lower the Better)
Co. Request	2.7
Staff Rec.	3.1
Staff Sample Avg.	4.0
Co Sample Avg.	4.4

REBUTTAL OF AG WITNESS MARCUS

Q. Does AG witness Marcus recommend a basis point reduction in the ROE if the Formula Rate Plan (FRP) Rider is approved?

A. Yes. In his Direct Testimony, Mr. Marcus states:

> If the Formula Rate Plan (FRP) Rider were to be adopted, I would recommend a 25-basis point further reduction to 9.05%, because the FRP Rider and OG&E's other riders will make sure there is little or no regulatory lag and greatly reduce the Company's business risk.[27]

Q. Do you agree with Mr. Marcus' recommendation?

A. No. Mr. Marcus' recommended 25 basis point reduction to the approved ROE raises two questions that must be answered:

1. Is it appropriate to make an adjustment due to the perceived reduction in business risk?
2. How large in magnitude, if warranted, should the adjustment be?

Mr. Marcus has not provided any analysis that such an adjustment is warranted nor has he provided any analysis to quantify the magnitude of such an adjustment.

Q. Has an adjustment to ROE previously been approved by this Commission because of the adoption of a FRP rider?

A. No. To date, the Commission has approved two FRP Riders for use with regulated utilities in Arkansas.[28] In neither of these two instances has the Commission approved an ROE reduction as the result of the implementation

[27] Direct Testimony of William Marcus, p. 17, lines 18 – 22.
[28] Docket Nos. 15-015-U and 15-098-U.

of an FRP Rider.

Q. Is the FRP Rider a form of a revenue stabilization mechanism?

A. The FRP Rider has characteristics similar to a revenue decoupling mechanism.

Q. Are rate stabilization mechanisms, revenue decoupling mechanisms, and capital recovery riders such as the FRP Rider prevalent across the country?

A. Yes. Decoupling mechanisms, rate stabilization mechanisms, and capital recovery riders are prevalent among regulated electric and gas utilities across the country. As such, many of the companies included in my risk comparable sample utilized in my DCF analysis are and have been operating for some time under a wide array of decoupling mechanisms, other forms of alternative ratemaking, and capital recovery mechanisms. All of these mechanisms operate to reduce regulatory lag.

Q. Do the companies in your risk comparable sample have approved revenue decoupling mechanisms; and capital recovery riders?

A. Yes. The companies in my risk comparable sample have approved revenue decoupling mechanisms; and capital recovery riders. As a result, my recommended ROE encompasses the effects of such rate mechanisms.

Q. Has Staff previously argued that it is inappropriate to make a downward adjustment to its recommended ROE due to the implementation of an FRP Rider?

A. Yes. Staff has argued that although an FRP rider could potentially reduce regulatory lag and may reduce the frequency of general rate cases, an adjustment to the recommended ROE is not necessary.[29] It is inappropriate to isolate a single element of business or financial risk for the purpose of proposing a discrete risk adjustment to the ROE derived from the DCF model. The results of my ROE analyses have comprehended the business and financial risks confronting the risk comparable sample, including the effects of a wide array of riders and rate adjustment mechanisms. Consequently, no further adjustment is needed.

Q. Has any other state utility commission examined the impact of revenue decoupling mechanisms and other forms of alternative ratemaking on the ROE and whether risk adjustment was warranted?

A. Yes. Public Utility Commission of Texas and the staff of the Mississippi Public Utilities engaged Christensen Associates Energy Consulting (Christensen Associates) to examine alternative ratemaking and the resulting impacts on cost of service. Christensen Associates found that a significant majority of state commission decisions do not reduce the ROE with the adoption of decoupling mechanisms.[30]

FORMULA RATE PLAN RIDER RECOMMENDATION

Q. Does the Company disagree with Staff's recommendation to fix the DTE ratio in the FRP Rider to your recommended hypothetical capital

[29] Surrebuttal Testimony of Kim O. Davis, Docket No. 15-015-U, p. 16, lines 5 - 17 and Surrebuttal Testimony of Jerry Keever, Docket No. 15-098-U, p. 19, lines 1 - 7.
[30] *See* https://eepartnership.org/wp-content/uploads/2016/10/Alternative-Ratemaking-Mechanisms-160525.pdf, p. 21.

structure?

A. Yes.[31]

Q. Do you continue to recommend that a fixed DTE ratio for use in the FRP Rider is appropriate?

A. Yes. As supported earlier in my Surrebuttal Testimony, there must be congruence between the ROE and the DTE ratio. This is consistent with the FRP implementation for CenterPoint Energy Arkansas Gas (CEA) in Docket No. 15-098-U.

SUMMARY OF RECOMMENDATIONS

Q. Could you please summarize your recommendations to the Commission?

A. Based on my updated evaluation, I continue to recommend that the Commission:

- Approve my recommendation for a DTE ratio of 52% to 48% with 2.9% short-term debt, and authorize a 9.5% ROE, which produces an overall ROR of 5.36%;
- Deny AG witness Marcus's recommendation for a 25 basis point reduction of the approved ROE based on the Commission's approval of OG&E's FRP Rider; and
- Approved a fixed capital structure for use in the FRP Rider filings at the DTE ratio approved herein until such time as the Company requests a

[31] Rebuttal Testimony of Gwin Cash, p. 3, lines 16 - 20.

general change in base rates.

Q. Does this conclude your testimony?

A. Yes, it does.

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing has been served on all parties of record by electronic mail via the Commission's Electronic Filing System this 30th day of March, 2017.

/s/ Justin A. Hinton
Justin A. Hinton