

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	)	

DIRECT TESTIMONY

OF

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FINANCIAL ANALYST  
FINANCIAL ANALYSIS SECTION

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

JANUARY 31, 2017

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**I. INTRODUCTION**

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

A. My name is Regis Powell. My business address is Arkansas Public Service Commission (Commission), 1000 Center Street, Little Rock, Arkansas, 72201.

**Q. Please describe your current position with the Commission's General Staff (Staff).**

A. I am employed by Staff as a Financial Analyst in the Financial Analysis Section. In that capacity, I perform economic and financial analyses, including the determination of the appropriate relative relationship between debt and equity capital and calculating the cost of debt, preferred stock, and common equity as components for determining the overall required rate of return for jurisdictional utilities. Additionally, I evaluate proposed debt and equity issuances, mergers, and acquisitions pertaining to the Arkansas jurisdiction, and monitor current economic and market trends and their impact on the cost of capital.

**Q. Please describe your educational qualifications.**

A. I hold a Bachelor of Science degree in Economics from Duke University in Durham, North Carolina. Since joining Staff, I have attended the "The Basics" Practical Regulatory Training held by New Mexico State University. I am a member of the Society of Utility and Regulatory Financial Analysts and have attended the Society's Annual Financial Forum.

**II. PURPOSE OF TESTIMONY**

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

A. The purpose of my testimony is to make a recommendation concerning the

1 overall required rate of return (ROR) for Oklahoma Gas and Electric  
2 Company's (OG&E or Company) Application for Approval of a General  
3 Change in Rates, Charges and Tariffs (Application) filed August 25, 2016,  
4 and revised on September 2, 2016. I will address the Company's requested  
5 6.01% ROR by specifically responding to the cost rates and balances on all  
6 external capital components, as well as the relative proportion of the external  
7 capital components.

8 **Q. What are the primary costs of capital issues?**

9 A. There are two primary differences between my recommendation and the  
10 Company's request: the appropriate debt-to-equity ratio (DTE ratio) and the  
11 required return on equity (ROE). In the D Schedules of the Company's  
12 Application the Company requested an overall ROR of 6.01%, which reflects  
13 a 47% to 53% DTE ratio and an ROE of 10.25%.<sup>1</sup> The Company's request is  
14 supported by Company witness Robert B. Hevert. My analysis supports a  
15 52% to 48% DTE ratio and a required ROE of 9.50%. My assessment of the  
16 appropriate cost rates and balances for all capital components produces an  
17 overall ROR recommendation of 5.31% as compared to the Company's  
18 6.01% request. Stated on a pre-tax basis, my recommended ROR is 7.37%  
19 compared to the 8.65% requested by the Company.

20 **III. CORPORATE STRUCTURE**

21 **Q. What is OG&E's corporate structure?**

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<sup>1</sup> See Direct Exhibit RP-1, p. 2.

1 A. The Company's Application states that OG&E is an investor owned  
2 corporation organized under the laws of the State of Oklahoma. OG&E's  
3 property consists of facilities for the generation, transmission, and distribution  
4 of electric power and energy to its retail customers in its service areas in  
5 Oklahoma and Arkansas. OG&E provides electric service to approximately  
6 825,000 total retail customers, of which approximately 66,000, or 8%, of the  
7 total retail customers are located in Arkansas. OG&E is a wholly owned  
8 subsidiary of OGE Energy Corp. (OGE Energy), which also has a significant  
9 interest in the natural gas midstream operations of Enable Midstream  
10 Partners, LP (Enable).

#### 11 IV. OVERVIEW OF APPROACH

12 **Q. Could you provide an overview of your approach in arriving at a fair**  
13 **return?**

14 A. OG&E, as with any regulated utility, is entitled to the opportunity to earn a fair  
15 return on its capital. To determine OG&E's cost of capital, I first identified the  
16 sources of capital supporting its investment. Next, I assessed the  
17 requirements of the providers of that capital. Lender requirements are  
18 contractual and relatively straightforward to calculate. In the case of common  
19 equity, I performed a market-based assessment of the return required by  
20 investors. Because OG&E is not market traded, I relied on a sample  
21 approach to assess the risk of an equity investment in OG&E. I performed  
22 additional analyses, including risk premium and other reasonableness  
23 checks. I further assessed the adequacy of my recommendations compared

1 to commonly used financial ratios to ensure OG&E is afforded the opportunity  
2 to earn a fair return.

3 **V. WEIGHTED COST OF CAPITAL METHODOLOGY**

4 **Q. How did you determine the overall cost of capital for OG&E?**

5 A. I used the weighted cost of capital methodology, wherein the various sources  
6 of capital are weighted by their proportion in the capital structure at their  
7 respective cost rates and then summed.

8 **Q. What sources of financing should be included in OG&E's capital**  
9 **structure for ratemaking purposes?**

10 A. My primary consideration in arriving at the appropriate capital structure for  
11 ratemaking purposes was to include all capital sources available to OG&E. I  
12 included all liabilities and equity capital on the "right side of the balance  
13 sheet" as sources of capital.

14 **Q. Is it appropriate to recognize all liabilities in the capital structure?**

15 A. Yes. It is appropriate to recognize all liabilities in the capital structure with  
16 other funding sources typically considered (e.g., long-term debt and equity)  
17 because these represent fungible sources of money from which all assets are  
18 funded. This treatment is consistent with the concept of fungibility, which this  
19 Commission has repeatedly found reasonable and proper. Further, such  
20 treatment conforms to the standards set forth in Order No. 7, p. 17, Docket  
21 No. 84-199-U, in which this Commission directed Staff to follow the principle

1 of "asset in rate base/liability in capital structure" to every extent possible.<sup>2</sup>

2 Staff has used this approach and the Commission has adopted it in every  
3 rate case proceeding since the Commission's implementation in Docket No.  
4 84-199-U.

5 **Q. Why is it important that sources of capital not be limited to the typical**  
6 **investor-supplied sources?**

7 A. All sources of capital should be considered to accurately calculate an overall  
8 cost of capital. Given that all dollars are fungible, it is impossible to  
9 distinguish dollars supporting Arkansas-jurisdictional rate base from those  
10 supporting rate base for other jurisdictions. Although all sources or types of  
11 funding and their respective amounts are readily distinguishable, the uses of  
12 those funds are not readily traceable. For example, the right side of a utility's  
13 balance sheet presents the amounts of debt, equity, and other capital  
14 components. However, one cannot determine which of these specific  
15 components is funding any specific asset. Thus, it is appropriate to include all  
16 funding sources in the capital structure at their respective costs to obtain a  
17 weighted cost of capital for financing all assets of a company. Applying the  
18 cost of capital to Arkansas-jurisdictional rate base essentially scales down  
19 each component of the capital structure consistent with the funding  
20 proportions for all assets.

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<sup>2</sup> In the Matter of the Motion of Staff of the Arkansas Public Service Commission to Establish a Docket to Determine the Reasonableness of Arkansas Power & Light Company's Rates, Docket No. 84-199-U, Order No. 7, p. 17.

1 **VI. CAPITAL COMPONENTS**

2 **Q. What capital components did OG&E include in its Application?**

3 A. In its Application Schedule D-1.2,<sup>3</sup> the Company included long-term debt,  
4 common equity, accumulated deferred income taxes (ADIT), post-1970  
5 accumulated deferred investment tax credits (post-1970 ADITC), customer  
6 deposits, short-term debt, and current, accrued, and other liabilities (CAOL)  
7 on its books as of the end of the historical test year, June 30, 2016. While  
8 OG&E reflected a short-term debt debit balance<sup>4</sup> on its D-1 schedules at the  
9 end of the test year, the Company proposed an adjustment to exclude short-  
10 term debt for ratemaking purposes.<sup>5</sup> I do not agree with this adjustment and  
11 will address this issue later in my testimony.

12 **VII. CAPITAL COMPONENT BALANCES**

13 **Q. Can you discuss the time frame you relied upon in determining the**  
14 **balances in the capital structure?**

15 A. Consistent with past practice before this Commission, I relied on the  
16 balances at the end of the historical test year with adjustments for known and  
17 measurable activity to arrive at the appropriate proportion of external capital  
18 components (*i.e.*, debt, equity, other capital items) and zero cost capital  
19 before arriving at the appropriate DTE ratio.

20 **Q. What did the Company request for the amount of long-term debt to be**

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<sup>3</sup> See Direct Exhibit RP-2, p. 3.

<sup>4</sup> Money owed to creditors as reflected in liability accounts typically carries a credit balance, not a debit balance.

<sup>5</sup> See Direct Exhibit RP-3, p. 4.



1           **included in the capital structure?**

2    A.    The Company's requested ROR contemplates \$2,833,269,587 in long-term  
3           debt, which is premised on the Company's test year balance with *pro forma*  
4           adjustments to include an anticipated \$350 million debt issuance and to  
5           exclude its Tinker Loans. Employing only known and measurable  
6           assessments, I excluded from the capital structure the Company's  
7           anticipated \$350 million debt issuance. Additionally, in applying the  
8           Commission's principle of fungibility, I included OG&E's Tinker Loans, which  
9           the Company excluded in the *pro forma* year because the funds are directly  
10          assigned to Oklahoma.<sup>6</sup> Despite being assigned outside the Arkansas  
11          jurisdiction, these loans represent fungible sources of capital that fund all of  
12          the Company's assets proportionally on a total company basis, and  
13          consequently, on an Arkansas-jurisdictional basis.

14   **Q.    What do you recommend as the appropriate balance for long-term**  
15          **debt?**

16    A.    After making the necessary adjustments in conformance with past practice  
17           before this Commission as discussed above, I recommend the balance at the  
18           end of the test year, which included \$2,555,298,990 in notes and bonds  
19           outstanding.<sup>7</sup>

20   **Q.    Do you agree with the Company's exclusion of short-term debt in**  
21          **determining the required ROR?**

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<sup>6</sup> See Direct Exhibit RP-4, p. 5.

<sup>7</sup> See Direct Exhibit RP-12, p. 14, column 5, line 18.

1 A. No, I do not. The Company uses short-term debt as a source of funding for  
2 its operations.<sup>8</sup> This is further supported by the use of short-term debt by my  
3 risk comparable sample of electric utilities as further discussed in Section VIII  
4 below.

5 **Q. Did the Company correctly reflect its true short-term debt balance in its**  
6 **Schedule D-1 and supporting workpapers?**

7 A. No, it did not. The Company's Schedule D-1 and supporting workpapers D-  
8 1-1 reflect a short-term debit balance of \$8,173,166 at the end of the test  
9 year.<sup>9</sup> This balance is derived solely from Accounts Payable to Associated  
10 Companies account (APAC).<sup>10</sup> This APAC is currently carrying a debit  
11 balance, as opposed to a typical credit balance, and is interest bearing.

12 **Q. Is it appropriate to use the APAC to determine short-term debt?**

13 A. No. It is not appropriate in this particular instance. By carrying a debit  
14 balance, the APAC, which the Company asserts is interest bearing, is, in  
15 essence, a working capital asset (WCA) that the Company has earned a  
16 return on throughout the test-year with a 13-month average that calculates as  
17 a debit balance of nearly \$38 million.<sup>11</sup> Staff historically, and again in this  
18 docket, excludes any WCA that earns interest from the total revenue  
19 requirement pursuant to the modified balance sheet approach.<sup>12</sup> Ratepayers

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<sup>8</sup> See Direct Exhibit RP-6, p. 7.

<sup>9</sup> See Direct Exhibit RP-9, p. 11.

<sup>10</sup> FERC Account 234.

<sup>11</sup> See Direct Exhibit RP-7, pp. 8-9 and RP-8, p. 10.

<sup>12</sup> See Direct Testimony of Staff witness Bill Taylor, p. 5.

1 should not compensate the Company for investments or assets on which the  
2 Company is already earning a return. Therefore, I excluded the APAC from  
3 my short-term debt calculation.

4 **Q. In your opinion, did the Company make any other errors in computing**  
5 **its short-term debt balance?**

6 A. Yes. The Company utilizes its Notes Payable to Associated Companies  
7 account (NPAC)<sup>13</sup> as a source of short-term debt. In OG&E's Schedule D-1,  
8 the Company appears to have mislabeled the NPAC as a non-interest  
9 bearing account and further reflected a zero balance.<sup>14</sup> As of the end of the  
10 test year,<sup>15</sup> the NPAC reflected a typical credit balance of \$41,043,240.<sup>16</sup>

11 **Q. What do you recommend as the appropriate level for short-term debt?**

12 A. I recommend a balance of \$41,043,240, which only includes the Company's  
13 balance reflected in its NPAC at the end of its test year. This is supported by  
14 the Company's methodology used in calculating the short-term debt  
15 component in its Allowance for Funds Used during Construction (AFUDC)  
16 computations. To determine the appropriate level of short-term debt used in  
17 its AFUDC rates, the Company uses solely the NPAC. The Company  
18 provided its AFUDC calculation in response to Staff Data Request APSC-  
19 029.<sup>17</sup> The short-term debt balance reflected in the Company's worksheet

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<sup>13</sup> FERC Account 233.

<sup>14</sup> See Direct Exhibit RP-9, p. 11.

<sup>15</sup> June 30, 2016.

<sup>16</sup> See Direct Exhibit RP-10, p. 12 and RP-11, p. 13.

<sup>17</sup> See Direct Exhibit RP-5, p. 6.

1 included with its Response to Staff Data Request APSC-029 is a credit  
2 balance of \$41,043,240 which coincides with the amount of short-term debt I  
3 am recommending for inclusion in my cost of capital calculation.<sup>18</sup>

4 **Q. How did you arrive at the appropriate balance for common equity?**

5 A. Employing only known and measurable assessments, I included the actual  
6 test year-end balances of the Company's common equity and excluded the  
7 Company's request to include a \$90 million anticipated increase in retained  
8 earnings through the *pro forma* year. I recommend the test year-end balance  
9 of \$3,175,571,011 as the appropriate balance for inclusion in the capital  
10 structure.<sup>19</sup>

11 **Q. How did you arrive at the appropriate balance for other capital items?**

12 A. For the balance in other capital items, I recommend a *pro forma* balance of  
13 \$8,082,810. The obligations in this account are contractual and therefore  
14 known and measurable, as opposed to the anticipated increase in retained  
15 earnings the Company proposed in its common equity balance.<sup>20</sup> The  
16 Company and I both recommend balances with *pro forma* adjustments.  
17 However, through Staff Data Request APSC-030,<sup>21</sup> I discovered that the  
18 balance of other capital items reflected the addition of accrued interest. It is  
19 inappropriate for shareholders to earn a return on the accrued interest, which

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<sup>18</sup> See Direct Exhibit RP-11, p. 13.

<sup>19</sup> See Direct Exhibit RP-3, p. 4.

<sup>20</sup> The balance in this capital component derives from two contracts: one agreement with the Army Corp of Engineers allowing the Company to use three water storage tanks in Kaw Lake and a second contract with a renewable energy company to develop a phased wind generated energy development project for OG&E.

<sup>21</sup> See Direct Exhibit RP-14, p. 16.

1 the Company carries at zero cost. Therefore, I have removed the accrued  
2 interest from the other capital item balance and provided the appropriate  
3 amount to Staff witness Bill Taylor for inclusion in his CAOL calculation.<sup>22</sup> I  
4 recommend the inclusion of only principal amounts in the *pro forma* balance  
5 of other capital items.

6 **Q. Are certain capital component balances addressed by other Staff**  
7 **witnesses?**

8 A. Yes. Staff witness Taylor supports the appropriate balances of ADIT and  
9 CAOL for inclusion in the capital structure.<sup>23</sup>

10 **Q. Were accrued interest payable and common stock dividends payable**  
11 **included in Staff's CAOL balance?**

12 A. Yes.

13 **Q. What is the rationale for including accrued interest payable and**  
14 **common stock dividends payable?**

15 A. As discussed previously, the right side of a utility's balance sheet presents all  
16 sources of capital which fund the assets listed on the left side. The right side  
17 represents the amounts of equity, debt, and other capital components.  
18 Although the sources or types of funding and the respective amounts of each  
19 are readily distinguishable, the uses of those funds are not as readily  
20 traceable. For this reason, it is essential that all funding sources be included  
21 in the capital structure at their respective balances and cost rates to obtain

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<sup>22</sup> See Direct Testimony of Staff witness Bill Taylor, p. 6-7.

<sup>23</sup> *Id.*, p. 6-9.

1 the weighted cost of capital for financing all assets of a company. Failure to  
2 include all funding sources will result in an improper weighting of capital  
3 sources and, thus, an improper cost of capital or overall ROR.

4 **Q. Could you please explain further how not including all funding sources**  
5 **will result in an improper cost of capital?**

6 A. A utility receives, through rates, compensation for these accrued interest  
7 payable and common stock dividends payable daily. However, these  
8 liabilities are not paid out daily. Typically, utility companies pay bond interest  
9 semi-annually and dividends quarterly. Both debt and equity investors realize  
10 there will be a lag before they receive these payments. Interest payments are  
11 a contractual agreement between a company and its debtors. The debt  
12 holders have agreed to advance principal to the company for a stated return  
13 on stated dates. The company's obligation is to pay the agreed-upon interest  
14 at the stated intervals, and debt holders do not expect to be paid anything  
15 except the agreed-upon interest payments at the stated intervals. Debt  
16 holders realize they will not be able to reinvest their interest proceeds until  
17 they are received. Thus, interest rates on debt are slightly higher to reflect  
18 this lag time than if there were none.

19 A market-based cost of equity analysis implicitly incorporates a  
20 premium for the quarterly dividend payment time lag, making it appropriate  
21 for an analyst to consider this component as a zero-cost current liability. In  
22 fact, not including common stock dividends payable as a zero-cost  
23 component would allow the stockholders the opportunity to earn two returns

1 associated with this payment lag. First, the stockholder could earn a higher  
2 return through the return on equity itself because the lag is an intrinsic  
3 assumption in the price of the security. Second, the stockholder could earn a  
4 higher return as a result of an artificially inflated overall cost of capital. If the  
5 analysis is market-based the cost associated with the lag-time disbursement  
6 of common stock dividends is incorporated in the cost of equity.

7 **Q. How did you arrive at the balances for each of the remaining**  
8 **components included in the capital structure you recommend?**

9 A. I included the test year-end, June 30, 2016, balances of customer deposits  
10 and post-1970 ADITC.

11 **VIII. RELATIVE PROPORTIONS OF EXTERNAL CAPITAL COMPONENTS**

12 **Q. What has been the nature of the Company's capital structure since its**  
13 **last rate case?**

14 A. As presented in Direct Exhibit RP-16, page 20, OG&E's capital structure  
15 since its last rate case, Docket No. 10-067-U, has been relatively static in  
16 comparison to its parent company, OGE Energy, which has substantially  
17 reduced the debt reflected on its balance sheet since the deconsolidation of  
18 Enogex, a natural gas subsidiary, whose assets were placed into Enable.  
19 OGE Energy continues to have a significant stake in the gathering and  
20 transporting of natural gas, but the financial reporting for OGE Energy's

1 interest in Enable differs from its prior interest in Enable.<sup>24</sup>

2 **Q. Do you agree with the Company's requested capital structure?**

3 A. No, I do not. Company witness Hevert's analysis does not support the  
4 Company's requested capital structure. He purportedly calculates an average  
5 DTE ratio for his risk comparable sample of 48.32% to 51.68%.<sup>25</sup> His capital  
6 structure analysis, however, only includes the utility operations of the market-  
7 traded companies in his sample.<sup>26</sup> Additionally, his analysis is void of any  
8 discussion of the appropriate level of short-term debt for inclusion in the  
9 capital structure.

10 **Q. Did you perform a revised calculation of the DTE ratio that would result**  
11 **had Mr. Hevert included both regulated and unregulated operations of**  
12 **his sample companies?**

13 A. Yes. Including both regulated and unregulated operations in his analysis, Mr.  
14 Hevert's sample produces an average DTE ratio of 53% to 47%, with 2.9%  
15 short-term debt.<sup>27</sup> As I will further explain, by using only the regulated  
16 operations of his sample companies, Mr. Hevert creates incongruences  
17 between his sample companies included in his analyses and his  
18 recommended ROE. These incongruences should compel him to adjust  
19 downward his recommended ROE from one of two different perspectives—

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<sup>24</sup> With neither CenterPoint Energy nor OGE Energy having majority control of Enable, OGE Energy accounts for its investment in Enable under the equity method of accounting.

<sup>25</sup> Direct Testimony of Robert B. Hevert, p. 65, lines 14 – 15.

<sup>26</sup> *Id.*, p. 65, lines 12 – 14.

<sup>27</sup> See Direct Exhibit RP-18, p. 22.



1 lowered business risk or lowered financial risk. Mr. Hevert proposes no such  
2 adjustment.

3 **Q. Why would lowered business risk require lower returns on equity?**

4 A. Credit rating agencies identify companies' regulated operations as having  
5 lower business risk than the unregulated operations. If the regulated  
6 operating companies that Company witness Hevert analyzed were market  
7 traded, investors would view these companies as having less business risk  
8 than the market-traded companies presently in Mr. Hevert's sample. Less  
9 business risk would equate to investors requiring lower returns on equity,  
10 which should be reflected in Mr. Hevert's cost of equity analysis.

11 **Q. Why should lowered financial risk result in a downward adjusted ROE?**

12 A. Financial risk is determined by a company's ability to meet its fixed  
13 obligations -- generally the interest on its debt and payments on its long-term  
14 leases. Generally, higher debt and thus higher financial risk results in a  
15 higher required ROE to compensate investors for the elevated risk. In  
16 recommending less debt than the average market-traded company in his  
17 sample, Mr. Hevert's ROE recommendation is premised on a higher average  
18 financial risk associated with his sample companies than what is present in  
19 his OG&E capital structure recommendation, and thus, his recommended  
20 ROE should be adjusted downward.

21 **Q. What DTE ratio does your risk comparable group support?**

22 A. My risk comparable group supports, and I accordingly recommend, an

1 imputed DTE ratio of 52% to 48%.<sup>28</sup>

2 **Q. What is the basis for imputing a reasonable capital structure for**  
3 **ratemaking purposes?**

4 A. As the Commission has previously ruled:<sup>29</sup>

5 ....[T]here should be congruence between the estimated cost of  
6 equity and the debt-to-equity ratio, whereby a lower debt-to-  
7 equity ratio decreases financial risk and decreases the cost of  
8 equity. The evidence of record supports imputing the average  
9 capital structure of companies with comparable risk...

10 This position has been upheld by the Arkansas Court of Appeals,  
11 which held that in instances where the utility's capital structure is unsound or  
12 out of step with industry standards, especially those of comparable  
13 companies, a regulatory commission may calculate the cost of capital based  
14 not on the utility's actual capital structure but on a hypothetical capital  
15 structure.<sup>30</sup>

16 **Q. How did you determine a reasonable level of short-term debt?**

17 A. While the utility persistently uses short-term debt, OG&E generally keeps a  
18 minimal level of short-term debt on its balance sheet. As detailed in the  
19 response to Staff Data Request APSC-001.12,<sup>31</sup> OG&E and OGE Energy's  
20 working capital requirements are aggregated, and when there is a necessity  
21 for those requirements to be met with external capital, OGE Energy accesses

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<sup>28</sup> See Direct Exhibit RP-17, p. 21.

<sup>29</sup> See, Docket No. 06-101-U, Order No. 10, page 44, and further emphasized in Docket No. 15-011-U, Order No. 10, page 13-14.

<sup>30</sup> *Entergy Arkansas, Inc. v. Arkansas Pub. Serv. Comm'n*, 104 Ark. App. 147, 165, 289 S.W.3d 513, 527 (2008).

<sup>31</sup> See Direct Exhibit RP-19, pp. 23-24.

1 its commercial paper program. The incurred short-term debt remains on the  
2 balance sheet at the parent company level.

3 To determine the appropriate level of short-term debt, I evaluated the  
4 short-term debt proportions of the capital structures of my risk-comparable  
5 sample average and that of OGE Energy by evaluating the most recent  
6 financial disclosures available prior to Staff's Direct Filing. The external  
7 capital structures of OGE Energy reflected short-term debt of 2.8%<sup>32</sup> and for  
8 my risk-comparable sample average, short-term debt of 2.9%.<sup>33</sup> Additionally,  
9 my revised calculation of Mr. Hevert's sample using both regulated and  
10 unregulated operations yielded an average short-term debt ratio of 2.9%.  
11 Therefore, I recommend 2.9% as the appropriate proportion of short-term  
12 debt for inclusion in OG&E's capital structure.

13 **Q. Which OG&E cost rates do you agree with?**

14 A. Since the Arkansas-jurisdictional cost rate on customer deposits remains  
15 unchanged in 2017 from that approved in 2016,<sup>34</sup> I agree with the Company's  
16 requested 1.47% cost rate on customer deposits.<sup>35</sup> During my Surrebuttal  
17 Testimony, I will reevaluate the Oklahoma customer deposit components to  
18 assess if the cost rate should undergo any adjustment.

19 I also agree with the Company's cost rates on its short-term and long-  
20 term debt. The Company's short-term debt cost rate of 0.76% was derived by

<sup>32</sup> See Direct Exhibit RP-20, p. 25.

<sup>33</sup> See Direct Exhibit RP-17, p. 21.

<sup>34</sup> Docket No. 16-088-U, Order No. 3.

<sup>35</sup> See Direct Exhibit RP-21, p. 26.

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1 evaluating the interest incurred during the last month of the test year on OGE  
2 Energy's commercial paper.<sup>36</sup> The Company's long-term debt cost rate of  
3 5.68%, as presented in Direct Exhibit RP-12, page 14 is an embedded cost  
4 rate.

5 I also agree with the Company's cost rates of zero for ADIT and CAOL.  
6 ADIT represents funds owed to the IRS at some future date for which the IRS  
7 does not impose interest or other carrying costs. Thus, there is no cost to the  
8 Company and this source of capital is appropriately set at zero for  
9 ratemaking purposes. CAOL is largely creditor-supplied capital which the  
10 Company may use at no carrying charge. Thus, ratepayers should not be  
11 required to pay any cost for these funds.

12 **Q. Which cost rates in your recommendation differ from the Company's?**

13 A. My cost recommendations are different for other capital items, common  
14 equity, and post-1970 ADITC.

15 **Q. Which cost rate do you recommend for other capital items?**

16 A. As explained earlier in my testimony and detailed in Direct Exhibit RP-15.1,  
17 page 17, I recommend a cost rate of 8.53% versus the Company's 7.38%.<sup>37</sup>

18 **Q. What do you recommend as the cost rate for post-1970 ADITC?**

19 A. Pursuant to IRS regulations, post-1970 ADITC included in the capital  
20 structure should be divided into the appropriate external capital amounts (*i.e.*,  
21 short-term debt, long-term debt, and common equity) and costed at the

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<sup>36</sup> See Direct Exhibit RP-22, p. 27.

<sup>37</sup> See Direct exhibit RP-13, p. 15.

1 applicable cost rate for each component of external capital. Therefore, my  
2 recommended proportions of external capital components and respective  
3 cost rates were used to cost post-1970 ADITC. Because the Company and I  
4 differ on the inclusion of short-term debt in the capital structure, the relative  
5 proportions of total debt and equity, and the cost rates for long-term debt and  
6 common equity, our cost of post-1970 ADITC differs.

7 **Q. How does your cost of equity recommendation compare to the**  
8 **Company's?**

9 A. The Company is requesting an ROE of 10.25%. After evaluating Company  
10 witness Hevert's analysis and conducting market-based analyses of a risk-  
11 comparable sample of electric utilities, as well as other checks on my  
12 analyses, I conclude that the required ROE for OG&E is in the range of 8.9%  
13 to 10.1%, with a mid-point recommendation of 9.5%.

14 **IX. DISCOUNTED CASH FLOW METHODOLOGY**

15 **Q. What primary methodology did you use to determine a fair return on an**  
16 **equity investment in OG&E?**

17 A. The primary methodology I used was the Discounted Cash Flow (DCF)  
18 methodology. For nearly two-and-a-half decades, this Commission has  
19 consistently embraced the DCF methodology as its preferred method for

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1 estimating a company's cost of equity or ROE.<sup>38</sup> Additionally, the DCF  
2 methodology is the most widely employed model by other state commissions.

3 Nationwide, investors in common stock are primarily concerned with  
4 the cash flows they expect to receive from the ownership of that stock. For  
5 the individual investor, these cash flows consist of expected future dividends  
6 and expected capital gains or losses from liquidating the stock at some future  
7 time. However, for investors taken as a whole and from the firm's  
8 perspective, expected cash flows are made up of future dividends only.  
9 Capital gains result from stock price appreciation, and stock price  
10 appreciation is a consequence of rising dividends and expected dividend  
11 growth. There is no theoretical difference between those two interpretations  
12 of the stream of cash flows.

13 The market price of the stock embodies investors' expectations about  
14 the stream of future dividends. However, a dividend received in the future is  
15 not valued as highly as that same dividend received today. The investor  
16 implicitly imputes a discount to future dividends. The further in the future the  
17 dividend is to be received, the greater is the discount. This value or per share  
18 price that investors impute to that share is the present value of the expected  
19 stream of dividends to be received by them. These future dividends are

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<sup>38</sup> See Docket No. 91-093-U, Order No.18 (September 25, 1992); Docket No. 92-260-U, Order No. 38 (January 27, 1994); Docket No. 93-081-U, Order No. 13 (February 9, 1994); Docket No. 97-091-U, Order No. 5 (October 14, 1997); Docket No. 04-121-U, Order No. 16 (September 19, 2005); Docket No. 04-176-U, Order No. 6 (October 31, 2005); Docket No. 05-006-U, Order No. 7 (December 1, 2005); and Docket No. 06-101-U, Order No. 10 (June 15, 2007). Numerous other orders have approved settlements which incorporated a return on equity referencing Staff's analysis, which relied primarily on the DCF Methodology.

1 discounted by an amount dependent upon the discount rate (*i.e.*, the cost of  
2 equity). This relationship is stated in Equation (1) below where "P" represents  
3 the current market price of the stock, "D" is the current dividend, "k" is the  
4 cost of equity capital, and "g" is the expected growth rate:

5 Equation (1) 
$$P = D/(k-g)$$

6 Equation (1) demonstrates that the DCF method is a market-based  
7 approach. Any changes in the investors' discount rate, current dividend, or  
8 expected growth rate in dividends are accurately captured by changes in the  
9 market price of the stock. For example, other things being equal, if the cost of  
10 equity increases, investors will bid the market price down.

11 Equation (1) may be restated and expressed as shown below to solve  
12 for the cost of equity:

13 Equation (2) 
$$k = (D/P) + g$$

14 **Risk-Comparable Sample Approach**

15 **Q. How did you use the DCF methodology to estimate OG&E's required**  
16 **cost of equity?**

17 A. I employed the DCF model to estimate the average cost of equity for a group  
18 of firms comparable in risk to OG&E. Using a risk-comparable sample  
19 minimizes the possibility of error associated with the estimation of the growth  
20 rate and the resulting cost of equity in the DCF approach. Therefore, it is  
21 desirable to undertake a risk-comparable sample approach, even when a  
22 company-specific DCF estimate is possible. Company witness Hevert also

relies on a sample approach in estimating his recommended ROE.<sup>39</sup>

**Q. What were the criteria you applied in selecting a risk-comparable sample?**

A. I used an approach similar to what Staff has employed in previous rate cases for OG&E and other electric utilities. I applied the following criteria to obtain a sample of market-traded electric utilities sufficiently comparable to OG&E:

1. Listed in *The Value Line Investment Survey* (Value Line);<sup>40</sup>
2. At least 70% of operating revenues from retail electric operations;
3. S&P investment grade corporate credit rating of at least BBB;
4. Stable or increasing dividend history;
5. Not involved in merger activity; and
6. Positive earnings per share projections by Value Line.

I began the sample selection process with firms listed in *Value Line*. These firms are market traded and information is readily available in widely circulated and recognized sources. I focused on the 41 companies included in the following Value Line issues relating to the electric utility industry:

<u>Value Line Issue Date</u>	<u>Region of U.S.</u>
August 19, 2016	East
September 16, 2016	Central
July 29, 2016	West

My primary focus was to ensure that the sample included only those

<sup>39</sup> Direct Testimony of Robert B. Hevert, p. 15, line 15 – p. 20 line 13.

<sup>40</sup> *The Value Line Investment Survey* is one of the most widely read investment services in the world. It is an in-depth source of information and advice on approximately 1,700 stocks in over 90 industry sectors.



1 firms primarily engaged in electric utility operations. Ideally, the sample would  
2 consist of companies that derive 100% of their revenues from retail electricity  
3 to accurately measure the risk of only electric utility operations. It is  
4 commonly recognized that investors do not perceive the same risk exposure  
5 for regulated operations as compared to non-regulated operations. Including  
6 firms which are basically in the same line of business as OG&E was  
7 paramount in arriving at a risk-comparable sample. There has been a  
8 significant unbundling in the electric utility industry in recent decades.  
9 Increased competition and frequent merger activity have left fewer publicly  
10 traded electric companies with 100% regulated electric revenues than in  
11 years past.<sup>41</sup> Therefore, of necessity, I relaxed the percent operating revenue  
12 criterion to provide an adequate sample size recognizing that doing so could  
13 likely bias upward the cost of equity results.<sup>42</sup> It is preferable to have as large  
14 a sample size as possible to average variations in the data that may be  
15 attributable to one or a few companies.

16 Next, I included firms with an S&P investment grade corporate credit  
17 rating (*i.e.* at least BBB rating). The S&P rating process considers numerous  
18 qualitative and quantitative evaluations. S&P research is commonly used by  
19 investment professionals when making decisions about the business and  
20 financial risks affecting many companies. Therefore, using S&P rating criteria

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<sup>41</sup> FERC Order No. 888 and the Public Utility Holding Company Act of 2005 being significant factors driving consolidation in the industry.

<sup>42</sup> See Direct Exhibit RP-23, p. 28.

1 provides another form of assurance that the sample firms are comparable in  
2 risk to the Company. Further, a stable or increasing dividend is necessary in  
3 the application of the DCF for determining the cost of equity. Any firm that  
4 has reduced its dividend in the last five-year time frame or does not pay cash  
5 dividends was excluded from the sample.

6 Finally, firms reported by *SNL Financial* as being involved in significant  
7 merger and acquisition activity throughout the 13 weeks after the Value Line  
8 issue date were not included in the sample to remove any effects a distortive  
9 stock price would have on cost of equity results.

10 Application of these criteria produced a fifteen-company risk-  
11 comparable sample. Although the companies included in my sample are not  
12 identical to OG&E, all of the firms in my sample group share comparable risk-  
13 related characteristics with OG&E and can reasonably serve as a proxy in an  
14 objective determination of a fair ROE for this rate case.

15 **Price Term in DCF**

16 **Q. How did you determine the appropriate price term in implementing the**  
17 **DCF procedure for your risk-comparable approach?**

18 A. In the DCF methodology, it is important to use a price term that is fairly  
19 current, because it will embody all of the information currently available to  
20 rational investors. Additionally, it should be averaged to eliminate the  
21 influence of random stock market fluctuations. Some analysts argue that a  
22 single day's price is appropriate as a price term in the DCF formula because  
23 that price reflects all of the information available about a given stock on that

1 particular day. However, that price also has that day's cost of equity implicitly  
2 embodied in it. The next day's price and cost of equity will likely be relatively  
3 different. The utility's rates are set for a longer period of time than just one  
4 day. During the period of time in which rates will be in effect, the cost of  
5 equity for the utility will change daily. A properly allowed ROE will give the  
6 utility the opportunity to earn a fair return on its equity over time. Thus, to  
7 eliminate the possibility of an aberrant price, I used an average price over a  
8 fairly recent time period, as discussed below.

9 For the stock price to accurately reflect investor expectations for  
10 growth, the time frame selected for the stock price determination must be  
11 after the pronouncement of the growth expectations. As reflected on Direct  
12 Exhibit RP-24, page 29, I calculated the average stock prices for each of the  
13 sample companies for the thirteen weeks after the applicable date of the  
14 Value Line issue in which the data was reported.

15 **Dividend Term in the DCF**

16 **Q. What dividend term did you select?**

17 A. Consistent with the time frame for the stock price data discussed above, I  
18 used the annualized dividend levels reported by *SNL Financial* on the date of  
19 the last measured stock price. Because the companies in my risk comparable  
20 sample are at various points in their dividend payment cycle, I used the half-  
21 growth convention (or mid-year convention), which results in the equation:

22 Equation (3) 
$$K = \frac{D(1+g/2)}{P}$$

1           The dividend terms used for the companies in the sample are shown in  
2           my Direct Exhibit RP-24, page 29. By dividing the current annual dividend by  
3           the current average stock price, I calculated a current dividend yield for each  
4           of the companies in the sample, as presented on the same exhibit.

## 5 Growth Term in the DCF

6 Q. How is growth considered in your DCF formula?

A. The second key element in the DCF formula is the investor-expected, long-term growth rate in dividends per share. Theoretically, the growth rate in the DCF methodology is one that is expected to persist to infinity. Practically, the appropriate DCF growth rate is inherently long-term. In the context of the DCF methodology, the appropriate "g" term represents long-term sustainable growth in dividends, or the investors' inherent expectation of a positive growth rate for their long-term investments.

4 Company witness Hevert supports the exclusive use of analyst  
5 earnings per share projections in lieu of growth rates derived from historic  
6 information.<sup>43</sup> It is important to recognize that individual investors have  
7 different expectations and consider alternative indicators in deriving their  
8 expectations. A wide array of techniques exists for estimating the growth  
9 expectations of investors. There is no evidence that there is a single indicator  
10 of growth exclusively relied upon by investors as a whole. The  
11 reasonableness of forecasted estimates, whether on an exclusive basis or in

<sup>43</sup> Direct Testimony of Robert B. Hevert, p. 26, line 11 – p. 28, line 6.

1 conjunction with historically derived estimates, has been disputed among  
2 academics and cost of capital witnesses for years. Therefore, I took a  
3 conservative approach to represent investor expectations and used both  
4 projected and historic information to arrive at the appropriate growth rates.

5 **Q, How did you conduct your assessment of the appropriate growth rates?**

6 A. I began by reviewing Value Line data for each company in the sample. I  
7 reviewed the historical and projected estimates of growth for earnings per  
8 share (EPS), dividends declared per share, book value per share, and other  
9 financial values and ratios. In addition to Value Line's projected EPS growth  
10 estimates, I considered the estimated long-term EPS growth rates reported  
11 by Zacks Investment Research (Zacks) and *Yahoo! Finance* (Yahoo)  
12 contemporaneous with the time frame of the Value Line issues.

13 As investors are concerned primarily with the growth of dividends,  
14 which are ultimately paid out of earnings, I focused on estimates pertaining to  
15 growth in earnings and dividends. The specific growth rates I relied upon for  
16 estimating the cost of equity for OG&E are presented on Direct Exhibit RP-  
17 25, page 31 and summarized below:

- 18 (1) **g1-** One-third weighting applied to the projected EPS growth  
19 estimates from (a) Value Line, (b) Zacks, and (c) Yahoo;  
20 (2) **g2-** Value Line's projected five-year dividend growth;  
21 (3) **g3-** Value Line's five-year historic EPS growth;  
22 (4) **g4-** Value Line's ten-year historic dividend growth;  
23 (5) **g5-** Value Line's ten-year historic EPS growth;

1           This combination of growth rates reflects reasonable and  
2           representative information from which to estimate investor expectations of  
3           sustainable dividend growth for the groups of market-traded risk-comparable  
4           companies. These growth indicators reflect the type of information that  
5           investors consider in making their investment decisions, recognizing  
6           investors have an array of information available to them, all of which can  
7           affect their decision-making process.

8                           **Staff's DCF Cost of Equity Results**

9   **Q.   What are the cost-of-equity rates resulting from your risk-comparable**  
10 **sample analysis?**

11 A.   As shown in Direct Exhibit RP-26, page 31, I applied Equation (3) to each  
12 company in the risk-comparable sample for each growth rate, and removed  
13 any outlier results, which produced five estimates of investor expectations of  
14 the cost of equity for the sample. The five risk-comparable sample cost-of-  
15 equity estimates are 8.9%, 9.2%, 10.1%, 9.2% and 10.1%, with a midpoint of  
16 9.5%.

17 **Q.   What is your recommendation based on your DCF analysis?**

18 A.   My recommended range reflects my DCF analysis of my risk-comparable  
19 sample, which produces a range of 8.9% to 10.1%, with a midpoint of 9.5%.  
20 As Staff has consistently asserted, the DCF has a distinct and superior  
21 quality in rate setting. The DCF analysis comprises data obtained from  
22 companies with financial and business risk characteristics that are similar to  
23 the company under review. The DCF model is the most company-specific

1 model. Furthermore, the DCF is the most forward looking of the models used  
2 by Mr. Hevert and myself. Beta, which is used in the capital asset pricing  
3 model and measures systematic risk, cannot be measured, *ex ante*, *i.e.*,  
4 projected forward. Additionally, risk premiums used in other models cannot  
5 be measured *ex ante* without actively surveying financial experts or utilizing  
6 the DCF model, which Mr. Hevert does,<sup>44</sup> further supporting the DCF's  
7 forward-looking nature. Furthermore, financial literature asserts that the DCF  
8 methodology is well suited to estimate the expected returns for dividend-  
9 paying companies, such as utilities, that are relatively insensitive to the  
10 business cycle and in a mature growth phase. While Mr. Hevert goes into  
11 great detail on the limitations of the constant growth DCF model that Staff  
12 utilizes, he admits all the models being used in this proceeding are  
13 abstractions and thus have tradeoffs<sup>45</sup> which are set forth in my Direct Exhibit  
14 RP-27, page 32 to 33. Overall the DCF methodology is the best suited for  
15 evaluating a utility's cost of equity and conforms to this Commission's long-  
16 standing preference.

17 **X. CAPITAL ASSET PRICING MODEL (CAPM)**

18 **Q. In developing your ROE recommendation, did you perform a CAPM**  
19 **analysis?**

20 **A.** Yes, I did. Risk premium approaches like the CAPM are based on the risk-  
21 reward trade off. Overall, the CAPM is based on the idea that investors

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<sup>44</sup> Direct Testimony of Robert B. Hevert, p. 36, lines 1 – 15.

<sup>45</sup> *Id.*, p. 5, line 2 – p. 7, line 22.

1 through diversifying their security holdings can eliminate non-systematic risk  
2 but will require a premium over the risk-free rate commensurate with their  
3 holdings' market or systematic risk as measured by beta.

4 The most general form of the CAPM is shown in Equation (4) below:

5 Equation (4) 
$$K = R_F + \beta (R_M - R_F)$$

6 Where:

7 **R<sub>M</sub>** is the market return. Specifically, the return an  
8 investor would receive for holding the market portfolio,  
9 which includes every available asset in the world financial  
10 market. A true market portfolio in practice is unobservable  
11 and must be estimated by proxy by using a broad-based  
12 index, such as the S&P 500 Index, the Nasdaq  
13 Composite, or the New York Stock Exchange Composite  
14 (NYSE).

15 **Beta (β)** is the sensitivity of a stock to changes in  
16 the market return, which is caused by systematic risk, *i.e.*,  
17 risk that affects the entire market or economy. Systematic  
18 risk is non-diversifiable and can be affected by the  
19 business cycle, inflation, changes in interest rates,  
20 politics, or natural calamities. These events affect the  
21 entire market, and there is no way to diversify away their  
22 effects. Non-Systematic risk is risk limited to a particular  
23 firm and can be eliminated or reduced by investors in a  
24 well-diversified portfolio. Beta measures solely a stocks  
25 relationship with systematic risk.

26 **R<sub>F</sub>** is the return on a risk-free asset, which is taken  
27 in this context to mean default risk. The return on a risk-  
28 free asset is commonly the yield on treasuries because of  
29 the improbability of United States government defaulting  
30 given its ability to tax and print money.

31 **Q. What are the results of your CAPM analysis?**

32 **A.** I produced two estimates: a geometrically derived estimate of 9.09% and an



1 arithmetically derived estimate of 9.39%.<sup>46</sup> The arithmetic mean is thought to  
2 be a better estimate of the expected single-period return, but the geometric  
3 mean is thought to better reflect the growth rate over multiple periods. The  
4 issue of whether arithmetic or geometric rates better depicts investor  
5 expectation is frequently in dispute in risk premium studies. Therefore, I  
6 produced both.

7 **Q. How did you derive the beta used in your CAPM analysis?**

8 A. For beta, I used the average beta for my risk comparable sample as provided  
9 by Value Line.

10 **Q. How did you derive the market risk premium, ( $R_M - R_F$ ), used in your**  
11 **analysis?**

12 A. To calculate  $R_M$ , I evaluated the last five years of returns on the NYSE, which  
13 is the same index and time frame Value Line uses to develop its betas.  
14 Because the index, as reported by Yahoo, is a price-return index as opposed  
15 to a total return index, it doesn't capture the total return from dividend  
16 reinvestments. Therefore, I used Value Line's median dividend yield for the  
17 universe of stocks it covers to derive the correct total return and thus the  
18 correct  $R_M$ .

19 To calculate  $R_F$ , I evaluated the average yield on 30-year treasuries  
20 during the same five-year time frame. Subtracting the average yield on 30-  
21 year treasuries from the average return on the NYSE produced a reasonable

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<sup>46</sup> See Direct Exhibit RP-29, pp. 35-36.

1 market risk premium. To make sure my model was appropriately forward  
2 looking, I summed this market risk premium with Value Line's anticipated  
3 yields on future 30-year treasuries.

4 **Q. Did Mr. Hevert perform a CAPM analysis?**

5 A. Yes. His CAPM analysis produced a range of cost of equity estimates from  
6 8.84% to 11.40%.<sup>47</sup>

7 **Q. What are your criticisms or short-comings of his model?**

8 A. Mr. Hevert uses two sets of betas: (1) Value Line betas and (2) Bloomberg  
9 Professional (Bloomberg) betas. I disagree with Mr. Hevert's matching of  
10 Value Line betas with the S&P 500 index. He produces an *ex ante*  $R_M$  from  
11 the companies listed in the S&P 500 by using the DCF methodology, which  
12 as I noted earlier, lends support to the DCF's superiority as a forward looking  
13 model. While the Bloomberg betas are appropriately matched with the S&P  
14 500, the Value Line betas, based on the NYSE, are not.

15 **Q. Why should the betas be matched to the correct index?**

16 A. As noted earlier, because of the absence of a true market portfolio, market  
17 participants use proxies to estimate  $R_M$ . Generally most broad-based indexes  
18 are nearly perfectly correlated at 1, which gives analysts latitude to select  
19 among several indexes to develop risk premiums.<sup>48</sup> The NYSE, where the  
20 betas from Value Line are derived, has deviated slightly from perfect  
21 correlation with other broad-based indexes over the last five years, which is

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<sup>47</sup> Direct Testimony of Robert B. Hevert, p. 37, Table 6.

<sup>48</sup> See Duff & Phelps' excerpt in Direct Exhibit RP-28, p. 34.

1 the time frame Value Line evaluates.<sup>49</sup> If the proxy indexes materially vary, it  
2 can generate betas that will in-turn, generate different return estimates for the  
3 same asset, which is impermissible in the CAPM. This is why it is best  
4 practice for an analyst to develop his or her own betas by regressing a  
5 company's stock price against the returns on a chosen broad-based index.  
6 Even when betas are appropriately matched with the correct index, the  
7 CAPM model is further complicated by the time frame used. As explained in  
8 Direct Exhibit RP-28, page 34, beta and risk premiums can vary depending  
9 on the look back period, whether the horizon chosen is two, five, or seven  
10 years. Therefore, the model demands precision.

11 **Q. What are Company witness Hevert's results using only the**  
12 **appropriately matched Bloomberg betas?**

13 A. Using only the appropriately matched Bloomberg betas, Mr. Hevert's results  
14 have a range from 8.84% to 9.89%, which produces a midpoint estimate of  
15 9.37%.

#### 16 **XI. BOND YIELD PLUS RISK PREMIUM MODEL (RPM)**

17 **Q. Did Company witness Hevert produce an RPM analysis to evaluate the**  
18 **required ROE for OG&E?**

19 A. Yes. Mr. Hevert produced an RPM, which yielded results of 10.03%, 10.06%,  
20 and 10.39%.<sup>50</sup>

21 **Q. Do you have any criticisms of the model?**

<sup>49</sup> See Direct Exhibit RP-28, p. 34.

<sup>50</sup> Direct Testimony of Robert B. Hevert, p. 41, Table 7.

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1 A. Yes. Mr. Hevert is correct that there generally is an inverse relationship between  
2 the equity risk premium and nominal interest rates. But the analysis, already  
3 heavily quantitative, considers as its sole independent variable, proportional  
4 changes in 30 year-treasury yields, whereas there is a significant amount of  
5 research that suggests inflation and its volatility also significantly impact risk  
6 premiums.<sup>51</sup>

7 **Q. Does Company witness Hevert offer evidence that his ROE**  
8 **recommendation is consistent with authorized ROEs in nearby**  
9 **jurisdictions?**

10 A. Yes, he does.<sup>52</sup> But Mr. Hevert's analysis fails to provide appropriate  
11 comparisons to prevailing interest rates at the time the ROEs were approved.  
12 The ROE produced at a point in time should be compared to the prevailing  
13 opportunity costs (or economic conditions) at the time an ROE was authorized.  
14 Otherwise, there is no basis on which to determine how much shareholders  
15 should have been generally compensated for assuming the risk in ownership of  
16 equity in nearby utilities at the various times that the ROEs were approved.

17 **Q. Did you perform an RPM analysis to evaluate the compensation**  
18 **shareholders in nearby jurisdictions have received for assuming risk in**  
19 **equity investments in utilities in a recent historical timeframe?**

20 A. Yes, I did. I performed an RPM analysis that considered the contemporaneous

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<sup>51</sup> Society of Utility and Regulatory Financial Analysts (SURFA), *Cost of Capital—A Practitioner's Guide*, pp. 175-176 as shown on Direct Exhibit RP-37, pp. 45 – 46.

<sup>52</sup> Direct Testimony of Robert B. Hevert, p. 62, line 12 – p. 64, line 5.

1 economic conditions at the time recent nearby ROEs were authorized. I  
2 evaluated the authorized returns in surrounding states from twenty rate cases,  
3 going back to July 2009,<sup>53</sup> the beginning of the current business cycle. To assess  
4 the compensation shareholders received on average in those rate cases, I  
5 evaluated the average daily yield on 30-year treasuries and the monthly yield on  
6 public utility debt from the date a utility filed its application in the rate case, to the  
7 date that rate case was completed.

8 **Q. What were your results?**

9 A. As seen on Direct Exhibit RP-30.1, page 37, my RPM analysis results are  
10 9.2% and 9.1%, when using prevailing interest rates.

11 **XI. BUSINESS RISKS AND OTHER CONSIDERATIONS**

12 **Q. Does Company witness Hevert believe the general results from a risk-**  
13 **comparable sample are enough to provide the Company with a fair**  
14 **return?**

15 A. No. Mr. Hevert states:

16 Q. Do the mean DCF, CAPM, and Risk Premium results for the proxy  
17 group provide an appropriate estimate for the Cost of Equity for  
18 OG&E?

19 A. No, the mean results do not necessarily provide an appropriate  
20 estimate of OG&E's Cost of Equity. In my view, there are additional  
21 factors that must be taken into consideration when determining where  
22 OG&E's Cost of Equity falls within the range of results...<sup>54</sup>

23 **Q. Does Company witness Hevert believe that the Company's capital**

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<sup>53</sup> See Direct Exhibit RP-30.2, p 38.

<sup>54</sup> Direct Testimony of Robert B. Hevert, p. 41, lines 1-6.

1 **expenditure program, which includes its environmental compliance**  
2 **plan, should be considered in setting an ROE above the mean average**  
3 **of a group of risk-comparable companies?**

4 A. Yes. Mr. Hevert asserts that the uncertainty associated with the Company's  
5 ability to recover, in a timely manner, the costs associated with environmental  
6 compliance, plant modernization, and additional infrastructure investments as  
7 well as the overall size of the expenditures puts pressure on the Company's  
8 financial metrics and thus increases the risk faced by shareholders and  
9 therefore increases the Company's required ROE.<sup>55</sup>

10 **Q. Do you agree with Mr. Hevert that the Company's capital expenditure**  
11 **program should be given consideration in setting the ROE?**

12 A. No. I do not. Mr. Hevert details the Company's recent history of filings with  
13 the Oklahoma Corporation Commission, but he doesn't provide any evidence  
14 that specifically affirms that OG&E faces materially more uncertainty,  
15 inadequacy, or lag in recovery of its expenditures on upgrades, maintenance,  
16 or environmental compliance than his risk comparable group or any basket of  
17 utilities similar to OG&E. As Company witness Donald R. Rowlett asserts, the  
18 Formula Rate Plan Rider (FRP Rider) the Company is requesting will ensure  
19 that the Company's rates charged to Arkansas ratepayers are closely aligned  
20 with the costs the Company incurs providing safe, reliable, environmentally

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<sup>55</sup> Direct Testimony of Robert B. Hevert, p. 43, line 12 – p. 48, line 4.

1 compliant service to those ratepayers.<sup>56</sup>

2 Mr. Hevert not only doesn't demonstrate untimely recovery by  
3 Arkansas ratepayers, he doesn't demonstrate that the Company's  
4 expenditures are more sizable than his risk comparable group. Mr. Hevert  
5 highlights OG&E's capital expenditure program as significant and an  
6 important concern for investors.<sup>57</sup> However, the Company's expenditures on  
7 upgrades, maintenance, and environmental compliance will crest in the *pro*  
8 *forma* year and fall for years afterward as discussed below.<sup>58</sup>

9 **Q. How does OG&E's projected capital expenditures compare with those**  
10 **of your risk-comparable sample?**

11 A. My analysis of my risk-comparable sample suggests the Company's  
12 projected capital expenditures are typical of an electric utility. I evaluated the  
13 projected capital expenditures of the companies in my risk comparable  
14 sample as well as OGE Energy, on a consolidated basis. I analyzed the  
15 sample companies' own projections in their respective Form 10-Ks and  
16 S&P's Capital IQ projections. The Company's capital expenditure program is  
17 in line with the expenditures of my risk comparable sample.<sup>59</sup> Additionally,  
18 S&P Global presents data that shows the Company's capital expenditure

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<sup>56</sup> Direct Testimony of Donald R. Rowlett, p. 7, lines 13 – 15.

<sup>57</sup> Direct Testimony of Robert B. Hevert, p. 46, line 8.

<sup>58</sup> See Direct Exhibit RP-31, p. 39.

<sup>59</sup> See Direct Exhibit RP-32, p. 40.

1 program, presented on a consolidated basis, declines by 0.5%<sup>60</sup> through  
2 2018 while a sample of thirty-two electric utilities increases on average by  
3 0.5%.<sup>61</sup>

4 **Q. What are flotation costs?**

5 A. Flotation costs are the expenses (underwriting, legal, and registration fees) a  
6 Company bears when it raises new, external equity capital.

7 **Q. Why does Company witness Hevert believe flotation costs should be**  
8 **contemplated in the ROE?**

9 A. Mr. Hevert argues that, "To the extent that a company is denied the  
10 opportunity to recover prudently incurred flotation costs, actual returns will fall  
11 short of expected (or required) returns, thereby diminishing its ability to  
12 attract adequate capital on reasonable terms."<sup>62</sup>

13 **Q. Do you agree with Mr. Hevert that floatation costs should be**  
14 **contemplated in the ROE?**

15 A. No, I do not. The Company did not issue equity in the test year and does not  
16 anticipate issuing new equity in the *pro forma* year. Mr. Hevert argues that  
17 flotation cost incurred 13 years prior to the test year, remain part of the  
18 Company's cost structure that exists during the test year and beyond and  
19 should be recognized for ratemaking. The practice of flotation costs being

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<sup>60</sup> This is inclusive of a 2018 in-service date for the \$190 million Windspeed 2 investment originally projected to be put in service in 2021.

<sup>61</sup> S&P Global's *Financial Focus*. "Capital Expenditure Update." October 27, 2016. See Direct Exhibit RP-33, p. 41.

<sup>62</sup> Direct Testimony of Robert B. Hevert, p. 50, lines 10 - 13.



1 embedded in cost rates for equity is controversial. Mr. Hevert highlights a  
2 case where an implicit, not explicit adjustment was made.<sup>63</sup> But since that  
3 case, numerous companies have requested recovery of flotation costs in the  
4 ROE and no explicit or implicit adjustment has been made through litigation  
5 or settlement.<sup>64</sup>

6 **Q. Does Company witness Hevert propose an explicit adjustment to his**  
7 **recommended ROE as a means of allowing Company shareholders to**  
8 **recover flotation costs?**

9 A. No. Mr. Hevert doesn't make an explicit adjustment to his ROE  
10 recommendation, but he does calculate the magnitude of flotation costs to  
11 have an impact of 0.11%, or 11 basis points, on the ROE.<sup>65</sup> By adjusting the  
12 ROE upwards by this amount, ratepayers could significantly over -  
13 compensate shareholders for an expense that happens very infrequently.  
14 Therefore, such costs, if incurred in the test year, could be normalized and  
15 recovered as an expense adjustment. This approach would be more  
16 equitable. Ratepayers pay and shareholders receive recovery on the  
17 appropriate level of expenses.

## 18 **XII. COST OF CAPITAL SUMMARY**

19 **Q. What is your recommended ROE?**

20 A. I support as reasonable an ROE of 9.5%, which is midpoint of my range of

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<sup>63</sup> Docket No. 04-176-U, In The Matter of the Application of Arkansas Western Gas Company for Rates and Tariffs.

<sup>64</sup> Docket Nos. 06-101-U, 06-124-U, 06-161-U, 09-130-U, 15-011-U, 15-015-U, 15-098-U.

<sup>65</sup> Direct Testimony of Robert B. Hevert, p. 53, lines 4 - 13.

1 8.9% to 10.1%. My CAPM model, my analysis of authorized ROEs in nearby  
2 jurisdictions, as well as Company witness Hevert's analysis helped inform my  
3 recommended ROE as reasonable. A comparison of the results of Mr. Hevert's  
4 and my analysis are provided in Direct Exhibit RP-36, on page 44.

5 **Q. What is your recommended overall cost of capital for OG&E?**

6 A. A cost of equity rate of 9.5% in conjunction with the previously discussed capital  
7 structure component balances and cost rates yields an after-tax ROR of 5.31%  
8 for OG&E, as presented on Direct Exhibit RP-34, page 42.

9 **Q. Did you calculate OG&E's weighted cost of debt?**

10 A. Yes. I calculated a weighted cost of debt for OG&E at 2.02%, as can be seen  
11 on Direct Exhibit RP-35, page 43. This result was provided to Staff witness  
12 Taylor for use in his income tax calculations.

13 **XII. ADEQUACY OF STAFF'S OVERALL RECOMMENDATION**

14 **Q. Did you evaluate the adequacy of your overall cost of capital**  
15 **recommendation?**

16 A. Yes. I evaluated the adequacy of my recommendation compared to  
17 commonly used financial ratios to ensure OG&E is afforded the opportunity to  
18 earn a fair return on its invested capital. As evidenced in Table 1 below, the  
19 ratios I evaluated specific to OG&E using the ROE results from my  
20 recommended range are reasonable when compared to the average ratios of  
21 the companies in my risk-comparable sample. My evaluation is based on my  
22 calculation of (1) earnings before interest, taxes, depreciation and  
23 amortization (EBITDA) to interest; (2) times interest earned (TIE) ratio; and

(3) total debt to EBITDA. I assessed the adequacy of my recommendations using the low end of my recommended range, 8.9%.

**TABLE 1: Adequacy Checks**

	EBITDA/Interest (1)	TIE Ratio (2)	Debt/EBITDA (2)
<b>Bottom – 8.9%</b>	6.6	3.5	3.3
<b>Sample Average</b>	5.9	3.5	4.0

(1) Higher value is better.

(2) Lower value is better.

**Q. Do you believe your recommended ROE and overall ROR meet the standards set forth in the Bluefield<sup>66</sup> and Hope<sup>67</sup> decisions regarding what constitutes a reasonable rate of return?**

A. Yes. These generally accepted, landmark decisions serve as guidelines for such a determination. My analysis considers the current economic and financial climate including debt costs.

### **XIII. FRP Capital Structure**

**Q. What are your recommendations regarding the FRP Rider requested by the Company?**

A. I recommend the Company's annual FRP Rider filings maintain a forward-looking DTE ratio consistent with the DTE ratio I recommend in this docket,

<sup>66</sup> *Bluefield Waterworks and Improvement Co. v. Public Service Commission of the State of West Virginia*, 262 U.S. 679 (1923).

<sup>67</sup> *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944).

1 including my recommended proportion of short-term debt.

2 **XIV. SUMMARY OF RECOMMENDATIONS**

3 **Q. Please summarize your recommendations to the Commission.**

4 A. My recommended total DTE ratio for OG&E is 52% to 48%, with 2.9% short-  
5 term debt. My capital structure recommendation in conjunction with my ROE  
6 recommendation of 9.5% produces an overall rate of return of 5.31%. This  
7 return is derived using the various capital components and cost rates  
8 presented on Direct Exhibit RP-34, page 42. Lastly, in balancing the interest  
9 of ratepayers and shareholders, I recommend the external capital structure  
10 requested by the Company in its future FRP filings be fixed at my  
11 recommended proportions of 52% to 48%, including short-term debt of 2.9%.

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

13 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 31<sup>st</sup> day of January, 2017.

/s/ Justin A. Hinton  
Justin A. Hinton