BEFORE THE ARKANSAS PUBLIC SERVICE COMMISSION

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

Rebuttal Testimony

of

Donald Rowlett

on behalf of

Oklahoma Gas and Electric Company

I. INTRODUCTION

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

A. My name is Donald Rowlett. My business address is 321 North Harvey Avenue, Oklahoma City, Oklahoma 73101.

Q. **Are you the same Donald Rowlett who filed Direct Testimony in this Docket?**

A. Yes.

Q. **What is the purpose of your Rebuttal Testimony?**

A. I will respond to the Direct Testimony filed by certain intervening parties on January 31, 2017. My Rebuttal Testimony will focus on some of the key themes raised by the responsive witnesses. My failure to address each and every assertion or claim made by other parties in this Docket does not indicate my acquiescence or agreement with such assertion or claim.

II. CAPITAL STRUCTURE

Q. **What is OG&E's capital structure, as filed in this docket?**

A. The filed capital structure is 53.11% equity and 46.89% long-term debt, which reflects the Company's pro-forma year-end capital structure.

Q. **What are the other parties recommendations with regard to capital structure?**

A. The opposing parties recommend the Commission use a hypothetical capital structure based on external measures, such as, an average of peer utility holding companies.

Q. **Do you agree that a hypothetical capital structure is warranted in this case?**

A. No. The best evidence available of the Company's actual costs is its actual data; its actual capital structure. OG&E's Arkansas customers enjoy some of the lowest rates in Arkansas and for some customer classes the lowest electric rates in the country. To some degree these low rates are due to regional advantages but to a significant degree these low rates reflect management's investment, operating and financing decisions. Operating,

investing and financing decisions require coordinated thinking and analysis. If the other elements of the Company's cost of service were also arbitrarily adjusted to average, customer rates would be much higher. Comparison of the Company's actual capital structure to an industry average is a good and useful audit tool to evaluate the reasonableness of the Company's management decisions in financing the Company. OG&E's capital structure is not unusual when compared to the others in the peer group used to estimate the ROE. Unlike ROE, which is not directly observable, OG&E capital structure is observable.

Q. **When would the comparison to the industry warrant a departure from actual?**

A. A hypothetical capital structure may be warranted, if the Company equity level diverged from a level typically seen in the industry or if the equity level contributed to rates being above average. However, OG&E believes that its capital structure is consistent with comparable operating companies and that its rates will continue to be well below average if its actual capital structure is used by the Commission.

Q. **Is OG&E's capital structure reasonable?**

A. Yes. OG&E believes that its current capital structure is appropriate to maintain its current bond ratings and to provide consistency to the investor community. All three agencies (Standard & Poor's ("S&P"), Moody's Investors Service ("Moody's"), and Fitch Ratings ("Fitch")) have all expressed some degree of concern over the Company's credit metrics during the current period of large capital expenditures with uncertain regulatory recovery. Fitch specifically stated that they expect the Company's "credit metrics[1] will weaken" in their August 5, 2016 report on OG&E. In their October 28, 2016 report, Moody's commented that "environmental capex continues to be the primary challenge through 2019" and that "environmental capex will cause a decline in financial metrics until regulatory recovery can be assured." S&P mentions in their September 8, 2016 report that they expect the Company will be "funding its capital needs prudently". Adding a greater proportion of debt at this time would further stress the Company's credit metrics.

[1] Funds from Operations ("FFO") to debt ratio.

Also, as discussed by OG&E Witness Hevert, OG&E's capital structure is within the range of other peer operating utility companies. As stated by Witness Hevert, the peer group average is 51.68% equity with a range of 45.95% to 57.69%.

Q. **Has OG&E increased its equity component relative to the past several years?**

A. No. OG&E has consistently maintained equity capitalization at or higher than the filed level of 53.11% as shown in the table below. OG&E believes that this consistency is valued by the investor community.

In millions	2012	2013	2014	2015	2016	As Filed
LT Debt	$2,050	$2,300	$2,655	$2,639	$2,531	$2,883
Equity	$2,703	$2,829	$3,004	$3,156	$3,252	$3,266
Total	$4,753	$5,129	$5,659	$5,795	$5,783	$6,149
% Equity	56.9%	55.2%	53.1%	54.5%	56.2%	53.1%

Q. **Do you believe comparing OG&E's capital structure to those of other operating companies is more appropriate than to holding companies?**

A. Yes. The operating company is the one issuing debt to finance that specific utility's infrastructure, not the holding company. Therefore those investors' are exposed to the risk of the operating company. Often times, operating companies will have different credit ratings from the holding company indicating a differentiation that investors make.

Q. **How is OG&E's capital structure treated in its other jurisdictions?**

A. The Oklahoma jurisdiction has utilized OG&E's actual capital structure for rate making purposes. OG&E's FERC jurisdictional transmission formula rate utilizes actual capital structure with a cap of 56% equity.

Q. **How does a hypothetical capital structure limit OG&E's financial decisions?**

A. If OG&E wants to earn its allowed return, a hypothetical capital structure would divest the Company's management of its discretion to address financing constraints that are dynamic in nature and that continually change in response to market conditions. The use of debt by companies is called financial leverage for a reason. It acts as a lever to

magnify the financial impact of the company. In times of market stability, it is a benefit. However, in times of stress it amplifies the risk of the company. The Company must therefore finance the company in a way that strikes a balance between the beneficial use of leverage versus the potentially harmful side effects of leverage in times of stress. A hypothetical capital structure limits the Company's ability to achieve this balance.

Q. **Do you believe it is fair for this Commission to impose a hypothetical capital structure on OG&E when the large majority of its service territory uses an actual capital structure?**

A. No. OG&E believes it is inappropriate for the Arkansas jurisdiction to impose a hypothetical capital structure for OG&E's Arkansas rates (which constitute about 7.5% of OG&E's revenue). OG&E will continue to utilize a capital structure that it deems appropriate to balance the need to finance capital expenditures to provide reliable service with the need to maintain financial strength as expected by the credit rating agencies. Moreover, an actual capital structure is used by both the Oklahoma and FERC jurisdictions for setting OG&E's rates. It is simply unfair to impose a hypothetical capital structure in Arkansas when the Company (i) must have the flexibility to balance its overall cost of capital in response to dynamic market conditions; and (ii) when the other jurisdictions representing approximately 90% of OG&E's rate regulated business allow OG&E this flexibility. This unfair jurisdictional inequity makes it more difficult for the Company to earn its authorized return in Arkansas and penalizes the Company for prudently financing its business. In effect, this inequality has a direct effect upon the allowed ROE and if adopted by the Commission would result in the reduction of approximately 100 basis points to the Company's ROE.

Q. **Could OG&E finance its Arkansas operations separately from its other two jurisdictions?**

A. To do so would be highly inefficient and require the formation of a separate operating company. Issuing debt at this level would require registering a new company with the SEC, preparing separate financial statements, an independent audit and obtaining separate debt ratings from the rating agencies. Financing this dramatically smaller entity would be difficult from a debt perspective. Larger companies enjoy better rates if they can issue

debt in large blocks. Typically, OG&E has issued debt in increments of $250 million which allows the debt to qualify for inclusion in the Bloomberg Barclay's Aggregate Bond index. The result is that there is increased investor demand for bonds that meet this criteria. Earlier this year, it was announced that the index threshold is being increased to $300 million.

Q. **What are your conclusions about imposing a hypothetical capital structure on OG&E?**

A. As stated above, OG&E needs to have the flexibility to address financing constraints that are dynamic in nature and that continually change in response to market conditions. A hypothetical capital structure in Arkansas prevents the Company's management from having the discretion to respond to dynamic market conditions. It also inappropriately prevents the Company from earning its authorized return in Arkansas because OG&E will not manage to the hypothetical capital structure as it exposes the Company to unnecessary financial risks that other jurisdictions recognize by allowing the use of the actual capital structure.

III. RETURN ON EQUITY

Q. **Has OG&E prepared rebuttal testimony with regard to the ROE recommendations of the other parties in this case?**

A. Yes. OG&E Witness Hevert has filed rebuttal testimony in which he addresses the testimony filed by Mr. Regis Powell, on behalf of the General Staff of the Commission ("Staff"); Mr. William P. Marcus, on behalf of the Office of the Arkansas Attorney General ("AG"); and Mr. David J. Garrett, on behalf of the Arkansas River Valley Energy Consumers ("ARVEC"), Wal-Mart Stores Arkansas, LLC, and Sam's West, Inc. ("Opposing ROE Witnesses").

Q. **Would you please provide an overview of Mr. Hevert's testimony?**

A. Yes. Mr. Hevert's testimony provides a thorough rebuttal of the Opposing ROE Witnesses. He discusses a number of methodological, theoretical, and practical reasons why the Company believes the Opposing ROE Witnesses' recommendations are unduly low. Mr. Hevert concludes that making reasonable adjustments to the Opposing ROE

Witnesses' analyses results in ROE values much closer to Mr. Hevert's range. Mr. Hevert ultimately concludes that his analyses and data continue to support his recommended range of 10.00 percent to 10.75 percent.

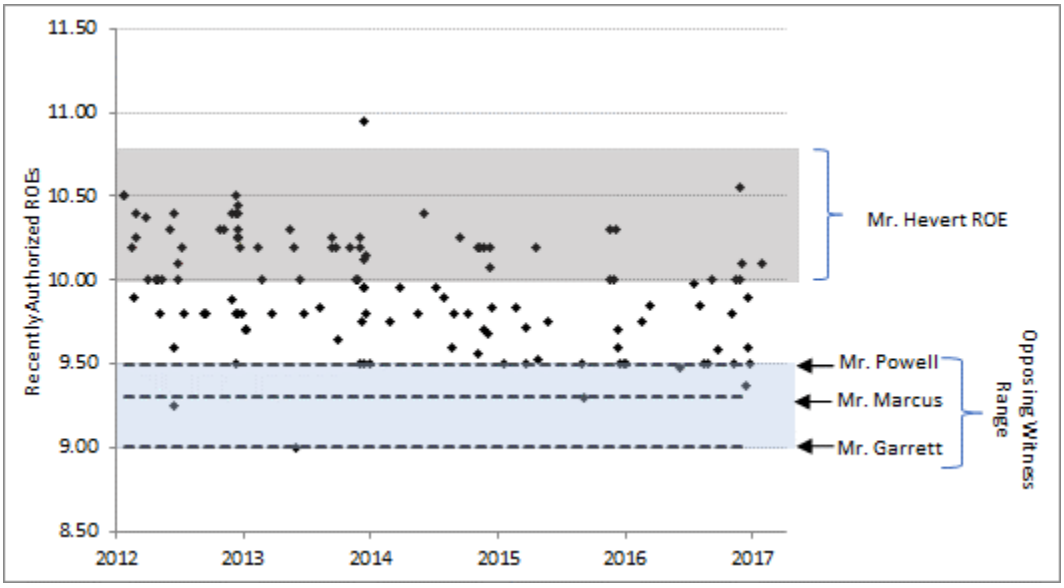
Q. **Is it important to put ROE witness analyses into context?**

A. Yes. ROE witness analyses are quite complicated and making reasonable changes in certain assumptions can often significantly change a witnesses' ROE values. Therefore, one of the most important things to consider when weighing the various ROE recommendations is whether they are comparable to what other Commissions have recently authorized in other states. In fact, the Arkansas Legislature directed the Commission in Act 725 to consider such evidence of other Commission authorized ROEs in rate proceedings like this. As discussed by Mr. Hevert, considering recent authorized returns in other states shows that a reasonable ROE should be in the range of 9.90 percent to 10.10 percent. Such a range is closer to Mr. Hevert's recommended range than any of the Opposing ROE Witnesses and, in fact, overlaps with his recommended range.

Q. **Is there any portion of Mr. Hevert's testimony that you would like emphasize?**

A. Yes. Mr. Hevert includes a chart that effectively demonstrates why the recommendations of the Opposing ROE Witnesses are unrealistic and out of step from the conclusions reached by regulators in other jurisdictions recently around the country. Below is that chart, which shows how all three Opposing ROE Witnesses are recommending ROEs that are far below the decisions coming from Commissions across the United States:

Chart 3: ROE Witness Recommendations vs. Authorized Vertically Integrated Electric ROEs[2]



Q. **Should some of the ROE recommendations offered by the Opposing ROE Witnesses be discounted as being altogether wrong?**

A. Yes. In my opinion, Mr. D. Garrett's recommendation simply makes no sense. His recommendation does not even comport with his own analysis. His flawed analysis results in an overall ROE of 7.5% and then he recommends an ROE of 9%. Mr. D. Garrett's recommendation, which is 140 basis points higher than the results of his DCF model and 190 basis points higher than his CAPM model results, is indicative of a lack of confidence in his own analysis. There is, quite literally, no support for Mr. D. Garrett's arguments. Mr. D. Garrett's recommendation is wholly unsupported by *any* of his calculations. See Garrett Testimony at p. 49, line 2-3.

IV. RIDERS

Q. **Will the Company need to update its proposed Formula Rate Plan ("FRP") Rider in the event the Riders contained in original filing package are added or removed?**

A. Yes. In the event that the Company's proposed Large Capital Additions ("LCA") Rider and Storm Damage Recovery ("SDR") Rider are not approved, the Company will need to

[2] Source: SNL Financial. Excludes limited-issue riders.

amend Attachment A-1of the FRP Rider to remove these riders from the proposed FRP Rider. Further, should the Commission approve adding any riders between now and each FRP Rider filing, Attachment A-1 would need to be updated at that time.

V. ACCUMULATED DEPRECIATION

Q. **In its direct testimony, did the Company recommend a change to accumulated depreciation balances?**

A. Yes. In its direct case, filed on August 25, 2016, OG&E witness Scott Forbes made two recommendations regarding accumulated depreciation rates. First, an error perpetrated during the 1986-2006 timeframe is corrected to reflect the correct depreciation balances (adjustment RB-5, an increase in accumulated depreciation of $31,657,965). Second, the Company proposed rates used to calculate accumulated depreciation align with the rates used in Oklahoma, so that no book differences exist (adjustment RB-7, a decrease in accumulated depreciation of $97,093,177). The Company recommended the amortization of the net accumulated depreciation balance differences over 10 years.

Q. **Did Staff accept these recommendations?**

A. Not entirely, no. Staff witness Wolfe recommends that adjustment RB-5 be an increase of $66,927,191,[3] and that adjustment RB-7 be a decrease of $87,067,532.[4] Witness Wolfe also recommends no further amortization, rather recognizing the amount over the remaining useful life of the asset utilizing the correct depreciation balances as calculated by Wolfe.

Q. **Does the Company accept the recommendations of Staff witness Wolfe?**

A. Yes. The Company believes that the Staff's proposed adjustment is a fair and reasonable way to reflect the accumulated depreciation balance.

[3] Wolfe Direct, pg. 21, ln. 9 – pg. 22 ln. 16.
[4] *Ibid*. pg. 23, lns. 5-20.

VI. VEGETATION MANAGEMENT

Q. **Do you agree with Staff witness Eggleton's analysis and recommendations regarding vegetation management?**

A. Yes. Mr. Eggleton recognizes the implementation of a 4 year cycle to maintain OG&E's distribution lines is "optimal when compared to other cycle lengths.[5]" Furthermore, Mr. Eggleton recognizes the intent of the cycle to proactively maintain the system and the need to support additional miles of line.[6]

Q. **Do you agree with Mr. Eggleton's reduction in the Company's proposed pro forma adjustment?**

A. Yes. Mr. Eggleton took the Company's request, reduced it by the actual test year expense and recommended the level of expense that will be in place by the end of the pro forma year. While the overall figure, $874,927, is correct, I would like to clarify that the increase is not only for the proposed 4-year cycle expense on distribution lines, but also supports OG&E's request for transmission and substation components as well. The Company believes this is a fair and reasonable adjustment and representative of its forward looking expenses, utilizing a 4-year cycle.

Q. **Would you care to respond to ARVEC witness M. Garrett's recommendations?**

A. I would only point out that witness M. Garrett's testimony is replete with errors and incorrect information. First, the Company has not requested "catch up" expense for what M. Garrett calls foregone maintenance.[7] Second, while the Company believes that a 4-year cycle is generally the optimal cycle length, witness M. Garrett is incorrect in suggesting there is a cycle requirement in Arkansas that the Company has neglected. As explained in the Direct Testimony of Company witness Cassada, the distribution system is managed by prioritizing work based on reliability.[8] Finally, witness M. Garrett fails to recognize that increases in vegetation management costs have been driven by a 24% increase in distribution line miles on the OG&E system, a 20% increase in contractor

[5] Eggleton Direct, pg. 10, lns. 11-12.
[6] *Ibid.* pg. 10, lns. 5-15
[7] M. Garrett Direct, pg. 41, lns. 12-16.
[8] Direct Testimony of Jarod Cassada, pg. 8, lns. 13-19.

costs, and increasing numbers of customer call outs which all serve to increase the cost of cycle maintenance.

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

A. Yes.