

April 10, 2019

Lora W. Johnson, CMC, LMMC
Clerk of Council
Room 1E09, City Hall
1300 Perdido Street
New Orleans, LA 70112

Re: *Revised Application of Entergy New Orleans, LLC for a Change in Electric and Gas Rates Pursuant to Council Resolutions R-15-194 and R-17-504 and for Related Relief*
Council Docket No. UD-18-07

Dear Ms. Johnson:

On behalf of Entergy New Orleans, LLC ("ENO" or the Company), please find enclosed for your further handling an original and three copies of Entergy New Orleans, LLC's Opposition to the Motion of the Advisor to Strike Portions of Entergy New Orleans, LLC's Rebuttal Testimony, which I would appreciate your filing into the record of this proceeding. Please file an original and two copies into the record in the above referenced matter, and return a date-stamped copy to our courier.

Should you have any questions regarding the above/attached, please do not hesitate to contact me.

With kindest regards, I am

Sincerely,



Alyssa Maurice-Anderson

AMA/amb
Enclosures

cc: Official Service List via email



**BEFORE THE
COUNCIL OF THE CITY OF NEW ORLEANS**

APPLICATION OF)	
ENTERGY NEW ORLEANS, LLC)	
FOR A CHANGE IN ELECTRIC AND)	
GAS RATES PURSUANT TO)	DOCKET NO. UD-18-07
COUNCIL RESOLUTIONS R-15-194)	
AND R-17-504 AND FOR RELATED)	
RELIEF)	

**ENTERGY NEW ORLEANS, LLC’S OPPOSITION TO THE MOTION OF ADVISORS
TO STRIKE PORTIONS OF ENTERGY NEW ORLEANS, LLC’S
REBUTTAL TESTIMONY**

NOW BEFORE THE COUNCIL OF THE CITY OF NEW ORLEANS comes Entergy New Orleans, LLC (“ENO” or the “Company”), through undersigned counsel, and submits its opposition to the motion to strike portions of the Company’s rebuttal testimony (“Motion”) filed by the Advisors to the Council of the City of New Orleans (the “Advisors”). The Advisors’ Motion endeavors to prevent ENO from (i) directly responding to certain erroneous claims and arguments advanced by Advisors’ witnesses in their direct testimony and (ii) updating the models supporting the Company’s return on equity (“ROE”) recommendation so that the Council (which is bound to rule in the public interest) may base its decision in this proceeding on current financial data—a common practice in jurisdictions throughout this country, including the Council.¹ Accordingly, the Advisors’ Motion is improper and should be denied.

I. INTRODUCTION AND BACKGROUND

The Advisor’s Motion focuses on three categories of information included in Rebuttal Testimony and Exhibits of ENO witness Mr. Robert B. Hevert: (1) information concerning an Empirical Capital Asset Pricing Model (“ECAPM”) and associated calculations; (2) a quantitative

¹ See, e.g., Rebuttal Testimony of James Proctor, Council Docket No. UD-08-03.

analysis of the effect of the Tax Cut and Jobs Act (“TCJA”) on utility stock performance; and (3) the Company’s updated analysis of the models used in Mr. Hevert’s Direct Testimony in support of his ROE recommendation in this proceeding. All of this rebuttal testimony is proper and should be allowed.

Advisors base their Motion on the grounds that the Company’s rebuttal testimony cited in their Motion constitutes new analysis and argument that does not directly respond to arguments and evidence presented in the Advisors’ direct testimony and is objectionable. They argue in their Memorandum in Support of Advisors’ Motion to Strike Portions of Entergy New Orleans LLC’s Rebuttal Testimony (“Memorandum”) that rebuttal evidence “should be confined to matters brought out by the opposition”² and cite precedent for the proposition that “rebuttal evidence should be confined to matters raised by defendants.”³

All of the testimony objected to by the Advisors was included in Mr. Hevert’s Rebuttal Testimony to directly respond to arguments advanced by the Advisors in its direct testimony and is therefore proper rebuttal evidence under Louisiana Rule of Evidence art. 611(E). As explained more fully below, the cited portions of Mr. Hevert’s discussion of the ECAPM analysis was in direct response to Mr. Proctor’s Direct Testimony tying risk and return to Beta coefficients and the Capital Asset Pricing Model (“CAPM”). Similarly, Mr. Hevert’s quantitative assessment of the effect of the TCJA on utility stock performance was in direct response to the erroneous claim by Mr. Proctor in his Direct Testimony that any effects of the TCJA were both short-lived and immaterial. Mr. Hevert’s Rebuttal Testimony also responded directly to the 8.93% ROE recommendation of the Advisors, in part by updating the quantitative ROE analysis Mr. Hevert presented in his Direct Testimony to include the effects of more recent market data. For the reasons

² Memorandum at 2.

³ *Id.*

more fully detailed in the discussion below, ENO's rebuttal filing was proper in scope and the Advisors' Motion should be denied.

II. LAW AND ARGUMENT

Pursuant to the Code of the City of New Orleans ("City Code") § 158-476, any evidence that would be admissible under the rules of evidence governing proceedings in matters tried to the bench in state court is admissible before the Council in a rate case such as this. The Louisiana Code of Evidence, which applies to bench trials in state court, gives the plaintiff in a civil case (the party with the burden of proof) the absolute right to rebut evidence offered by its opponents.⁴ Such rebuttal evidence has been described as "that which is offered to explain, repel, counteract or disprove facts given in evidence by the adverse party."⁵ In addition, other evidence may be admitted "if it is at all probative and relevant, provided the substantive rights of all parties are protected."⁶ The Council has great discretion in determining whether testimony is admissible rebuttal evidence.⁷

ENO does not dispute the Advisors' position that rebuttal evidence should be confined to matters raised by Advisors in their direct case. However, the primary case cited by the Advisors does not stand for the proposition that new evidence can never be offered on rebuttal and that to allow it would be an abuse of discretion, as the Advisors argue it does.⁸ In the *Guste* case, the plaintiff alleged that defendant was a public body and offered evidence that the defendant had received public funds to prove that allegation. Defendant provided evidence in its defense that it had returned those funds. Plaintiff sought to offer other evidence on rebuttal that did not in any

⁴ La. Code Evid. art. 611(E).

⁵ *State v. Franklin*, 956 So.2d 823, 837 (La. App. 2d Cir. 2007), writ denied, 972 So.2d 1162; *Robinson v. Healthworks Intern., L.L.C.*, 837 So.2d 714, 720 (La. App. 2d Cir. 2003).

⁶ City Code § 158-476.

⁷ *Robinson*, 837 So.2d at 720.

⁸ *State ex rel. Guste v. Nicholls College Foundation*, 592 So.2d 419 (La. App. 1st Cir. 1991).

way address or pertain to the defendant's evidence that it had returned the funds. The trial court found the unrelated evidence was new evidence that did not rebut matters raised by the defendant.⁹ Unlike the evidence offered in rebuttal in the *Guste* case, and as more fully discussed below, ENO's rebuttal testimony is offered specifically to explain, counteract, and disprove facts raised by the direct testimony of Advisors' witnesses.

A. ECAPM ANALYSIS

To support their move to strike the portion of Mr. Hevert's Rebuttal Testimony that discusses his ECAPM analysis, the Advisors first observe that neither of their two witnesses that offered testimony on the topic of the Company's ROE conducted an ECAPM analysis to support their direct testimony.¹⁰ Advisors note that Mr. Watson's ROE recommendation was based on his discounted cash flow methodology, and that Mr. Proctor conducted a CAPM analysis. Advisors argue that Mr. Hevert's testimony regarding ECAPM is improper because it is "completely new," "distinct" from and "additional" to Mr. Proctor's use of the CAPM.¹¹ According to the Advisors, Mr. Hevert's ECAPM analysis is irrelevant to Mr. Proctor's work and is offered, without criticism of Mr. Proctor's CAPM analysis, as additional modeling that could have been presented in ENO's direct case.¹²

These arguments miss the point and are incorrect. As explained above, the standard for rebuttal is whether it "explains," "counteracts," or "disproves" facts introduced by an adverse party. Therefore, new evidence, or evidence that could have been offered on direct, is proper rebuttal evidence if it counteracts or explains or disproves facts that Advisors brought up in their direct testimony. Mr. Hevert's Rebuttal Testimony regarding his ECAPM directly responds to and

⁹ *Id.* at 422.

¹⁰ Memorandum at 3.

¹¹ *Id.*

¹² *Id.*

counteracts the fallacy in Mr. Proctor's testimony concerning the relationship between Beta coefficients and business risk.

The Advisors seem to understand how precarious their argument is because, in their Memorandum, they resort to arguing that Mr. Hevert's Rebuttal Testimony is "*disguised* as a response to an argument or observation made by Advisor witness Proctor."¹³ The testimony at issue, however, is clearly, as the Advisors seem to concede, in response to Mr. Proctor's arguments and is explicitly offered to disprove Mr. Proctor's testimony – *i.e.*, the ECAPM analysis as counter-argument to Mr. Proctor's position on the effect of low Beta coefficients.

Although the Advisors move to strike testimony beginning on page 44 of Mr. Hevert's Rebuttal Testimony, his discussion of the ECAPM model actually begins earlier, on page 42. There, Mr. Hevert notes that at page 33 of Mr. Proctor's Direct Testimony, he argues that declining Beta coefficients among his proxy group provide "additional evidence business risk is decreasing."¹⁴ Mr. Proctor specifically relies on decreasing Beta coefficients for his proxy group to argue that business risk has declined for electric utilities, stating that "[t]hroughout 2018 the equity beta coefficients for the proxy group used in my CAPM analyses have declined substantially."¹⁵ Additionally, his proposed business risk adjustment for ENO is based entirely on Beta coefficients and the market risk premiums from his CAPM analysis.¹⁶ Ultimately, Mr. Proctor bases his extraordinarily low ROE recommendation, at least in part, on the argument that declining Beta coefficients indicate a decrease in business risk for utilities such as ENO.¹⁷

¹³ *Id.* at 3-4 (emphasis added).

¹⁴ Hevert Rebuttal at 42. Beta coefficients reflect (a) volatility of a company's returns relative to the overall market's return volatility and (b) the correlation in returns between the company and the overall market. *Id.*

¹⁵ Proctor Direct at 32.

¹⁶ *Id.* at 61.

¹⁷ *Id.* It is notable that neither the Advisors' Motion nor its Memorandum in support of the Motion cite to Mr. Hevert's Rebuttal Testimony where he both quotes and specifically refers to the Advisors' Direct Testimony that he is squarely addressing.

Mr. Hevert testifies on rebuttal that Mr. Proctor correctly observed that Beta coefficients have declined. Mr. Hevert then uses the ECAPM to explain why the conclusion Mr. Proctor reaches based on this observation is invalid. At pages 42 – 44 of his Rebuttal Testimony, Mr. Hevert discusses Beta coefficients and why they may have fallen. As a lead-in to the testimony Advisors seek to strike, Mr. Hevert succinctly describes the issue:

The question is whether the currently low Beta coefficients adequately reflect expected systemic risk and, therefore, required returns. As discussed below, published research has found low-Beta coefficient companies (such as utilities) have tended to earn returns greater than those predicted by the CAPM. *Consequently, the relatively low Beta coefficients Mr. Proctor observes likely under-estimate investors' return requirements. One means of addressing Mr. Proctor's observation is the Empirical Capital Asset Pricing Model, discussed below.*¹⁸

In other words, Mr. Proctor's conclusion that declining Beta coefficients necessarily indicate declining business risk rests on an assumption that the CAPM properly measures risk and returns when Beta coefficients are relatively low. However, Mr. Hevert explains on rebuttal that the ECAPM "adjusts for the CAPM's tendency to under-estimate returns for companies that (like utilities) have Beta coefficients less than the market mean of 1.000, and over-estimate returns for relatively high-Beta coefficient stocks."¹⁹ In this way, the ECAPM counteracts Mr. Proctor's observation and disproves Mr. Proctor's opinion that the low Beta coefficients result in lower required returns.

In summary, Mr. Proctor's ROE recommendation is based on his CAPM results. He believes that the relatively low Beta coefficients that drive his ROE result are a sign of lower required investor returns. Mr. Hevert disagrees with Mr. Proctor's opinion as to the meaning of the lower Beta coefficients and offers the ECAPM analysis to directly and specifically rebut Mr.

¹⁸ Hevert Rebuttal at 44 (emphasis added). ENO notes that the Advisors did *not* object to this testimony.

¹⁹ Hevert Rebuttal at 44.

Proctor's conclusion regarding the effect of decreased Beta coefficients on required returns. It is not "disguised" in any way and is not objectionable.

B. TCJA

To support their attempt to strike the portion of Mr. Hevert's Rebuttal Testimony discussing the TCJA's effect on utility stock performance, Advisors claim that Mr. Hevert has introduced new analyses that "could have been included in ENO's direct case but were not timely presented."²⁰ They claim further that the Company has provided "new data and analysis *as opposed to squarely addressing* positions taken in the Advisors' direct testimony."²¹ This too is incorrect.

Again, neither the Advisors' Motion nor its Memorandum cite to Mr. Hevert's Rebuttal Testimony where he both quotes and specifically refers to Mr. Proctor's Direct Testimony that he is "squarely addressing." At page 67 in his Rebuttal Testimony, Mr. Hevert summarizes Mr. Proctor's position regarding the TCJA's effect on the cost of equity. He specifically notes that at page 46 of Mr. Proctor's Direct Testimony, he concludes that "any over-all negative impact from the TCJA of 2017 on ENO's business risk is short-lived and immaterial..."²²

To counter those two claims, Mr. Hevert testifies that an "event study" is commonly used by practitioners to test the effects of events on stock prices over time. He then presents the results of his "event study" based on the TCJA to counteract Mr. Proctor's unsupported claims made in his Direct Testimony. Not surprisingly, Mr. Hevert finds that the empirical evidence supports neither of Mr. Proctor's claims.

²⁰ *Id.* at 4.

²¹ *Id.* (emphasis added).

²² Hevert Rebuttal at 67.

Chart 10 (on page 70 of Mr. Hevert’s Rebuttal Testimony) demonstrates the materiality of the TCJA’s effect on Mr. Watson’s proxy group, through March 2018. Footnote 152 notes that the effect is statistically significant. Those data conclude that the effect of the TCJA on utility stock prices is indeed material, contrary to Mr. Proctor’s unsupported claim.

Similarly, Chart 11 (on page 71 of Mr. Hevert’s Rebuttal Testimony) demonstrates that the TCJA’s negative effect continued over time, through December 2018, and remained statistically significant.²³ Those data also disprove Mr. Proctor’s unsubstantiated statements that the TCJA’s effect is “short-lived” and “immaterial.”

The portion of Mr. Hevert’s Rebuttal Testimony that Advisors seek to strike directly responds to and disproves Mr. Proctor’s claims that the effects of the TCJA are both “short-lived” and “immaterial.” Mr. Hevert concludes that the event study shows “[t]he TCJA has had a strong negative effect on Mr. Proctor’s proxy group; that effect has continued over time. We therefore reasonably can conclude that aside from actions taken by rating agencies, the TCJA meaningfully – and negatively – affected utility stock prices, and should be considered in determining the Company’s ROE.”²⁴ As previously discussed, whether the event study was a new analysis is immaterial, so long as it is offered to disprove or counteract evidence presented by the Advisors. This testimony directly responds to and rebuts Advisors’ direct testimony, and is therefore proper rebuttal testimony that should be allowed.

C. Updating ROE recommendations is proper rebuttal testimony and customary in rate cases.

The Advisors also seek to strike the portions of Mr. Hevert’s Rebuttal Testimony that update the ROE analyses he included in his Revised Direct Testimony. That earlier testimony was

²³ Hevert Rebuttal at n. 153.

²⁴ *Id.* at 71.

filed on September 2018 and was based on market data as of June 15, 2018. Mr. Hevert's Rebuttal Testimony was filed in March 2019. It sought to, in large part, respond directly to the Advisors' unusually low level of equity return.²⁵ Part of what Mr. Hevert did to respond to the Advisors' recommended ROE was to update the results of his various models he used to determine his recommended ROE using market data as of February 28, 2019.²⁶ This updated analyses not only demonstrates how unreasonable the Advisors' recommended ROE is, it has the added benefit of providing the Council with more current information regarding investor preferences so that it can make a more informed decision that is not based on older market data. Moreover, Advisors' witness Mr. Watson based his recommended ROE on market data as of January 2019; Mr. Hevert's rebuttal specifically and directly rebuts Mr. Proctor's opinion using a comparable data set from February 2019.

Advisors offer no argument as to why ENO should not be permitted to update its ROE recommendation using data comparable to the data relied upon by their witnesses in developing Mr. Watson's ROE recommendation. Allowing the Advisors to use market data through January 2019 and restricting the Company to use of market data through June 15, 2018, is unfair and creates an obviously un-level "playing field." Yet the Advisors complain that Mr. Hevert's update is improper and, if upheld, will allow parties to, "submit updated data and new support for their direct case at each and every stage of the proceeding,"²⁷ when they have used "updated" market data as compared to the market data used by Mr. Hevert in his direct testimony.

Furthermore, this claim is surprising and appears disingenuous given a number of factors not addressed in the Advisors' Motion or Memorandum. First, updating ROE analyses in order to

²⁵ As Mr. Hevert points out in his Rebuttal Testimony, the Advisors' recommended ROE is lower than any equity return amount awarded for a fully integrated utility like ENO since at least 1980. Hevert Rebuttal at 6.

²⁶ Hevert Rebuttal at 153.

²⁷ Memorandum at 4.

provide the Council with more current information in aid of its decision has occurred before in Council proceedings. For example, in ENO's 2008 rate case, Advisors' witness Mr. Proctor filed Direct Testimony on November 17, 2008, in which he both updated the May 2008 data used by the company's ROE witness "to account for more current financial information" and performed his own ROE analyses.²⁸ Subsequently, Mr. Proctor filed Redirect Testimony on January 16, 2009, in which he criticized the analysis used by the Company's ROE witness as "outdated" and also updated his own ROE analyses "to incorporate more current financial information."²⁹ When asked why he chose to update the ROE analyses, Mr. Proctor responded that a significant amount of time had passed since the company filed its original testimony in July 2008, and since that time, a number of factors, including stock prices, dividend yields, and interest rates had changed significantly.³⁰ Because those factors can have "dramatic effects" on ROE estimates, Mr. Proctor, representing the Advisors, thought it proper to update the ROE analyses.³¹ Notably, in the instant case, Mr. Hevert's updated analysis was prepared approximately eight months after his original analysis, the same amount of time which had passed when Mr. Proctor previously criticized the Company's witness analysis as "outdated." Also noteworthy regarding Mr. Proctor's 2009 testimony is the fact that his updated analysis did not respond to any updated analysis of the Company's ROE witness, but rather was a function of the passage of time, as is typically the protocol in rate case proceedings, as discussed below.

Second, updating ROE analyses to reflect more current financial data is a common practice in rate cases in virtually every jurisdiction in this country. For example, in Entergy Texas, Inc.'s

²⁸ Council Docket No. UD-08-03, Direct Testimony of James M. Proctor at 13 (Nov. 17, 2008) (Attached as ENO Exhibit 1).

²⁹ Council Docket No. UD-08-03, Redirect Testimony of James M. Proctor at 4-5 (Jan. 16, 2009) (Attached as ENO Exhibit 2).

³⁰ *Id.* at 5.

³¹ *Id.*

last two rate cases, updated ROE information was presented in that company's rebuttal testimony.³² Similarly, in Entergy Arkansas, Inc.'s ("EAI") 2013 rate case, the Arkansas Public Service Commission ("APSC") considered the updated ROE analyses presented by that company in its rebuttal testimony as well as updated ROE analyses presented by the Staff and an intervenor witness in their surrebuttal testimony.³³ Moreover, in 2014, the APSC granted EAI's petition for rehearing for the purpose of considering more current financial data relevant to establishing EAI's ROE that was not available at the time of hearing.³⁴

Further, the practice of updating ROE analyses on rebuttal to provide more current financial information is not limited to Entergy jurisdictions. For example, in a settled case in 2018 involving Duke Energy, the North Carolina Utility Commission cited updated ROE information contained in rebuttal testimony of Duke Energy's ROE witness.³⁵ In a 2018 order involving Atmos Energy Corporation (a gas distribution company), the Kentucky Public Service Commission considered updated ROE information submitted by the company's ROE witness in rebuttal testimony.³⁶ Similarly, in a 2016 case involving Public Service Company of New Mexico, the New Mexico Public Regulation Commission also considered updated model evidence submitted by the utility's ROE witness in rebuttal testimony.³⁷ Additionally, the Florida Public Service

³² In the 2012 rate case, the Administrative Law Judge specifically considered the updated ROE information in forming the ultimate ROE recommendation. PUCT Docket No. 39896, Proposal for Decision at 77, 84 (July 6, 2012). The most recent rate case was settled.

³³ APSC Docket No. 13-028-U, Order No. 21 at 101-103, 105, 109 (Dec. 30, 2013). A settlement in another recent rate case in Arkansas was approved by the APSC with an agreed ROE based on new and updated financial information provided by the utility on rebuttal. APSC Docket No. 17-071-U, Order No. 6 at 42-43 (Oct. 5, 2018).

³⁴ APSC Docket No. 13-028-U, Order No. 25 at 3 (Feb. 24, 2014) (allowing EAI to introduce into evidence testimony and documents regarding recent ROE awards in other jurisdictions, financial analyst reports commenting on ROE, and credit rating agency reports that were published following the close of the case).

³⁵ *In the Matter of Application of Duke Energy Carolinas, LLC, for Adjustment of Rates and Charges Applicable to Electric Utility Service in North Carolina*, Docket No. E-7, Sub 1146, Order at 39 (n. 10), 44-45, 49 (2018).

³⁶ *Electronic Application of Atmos Energy Corporation for an Adjustment of Rates and Tariff Modifications*, Case No. 2017-00349, Order at 27, 29 (May 8, 2018).

³⁷ *In the Matter of the Application of Public Service Company of New Mexico for Revisions of its Retail Electric Rates Pursuant to Advice Notice No. 513*, Case No. 15-00261-UT, Final Order Partially Adopting Corrected Recommended Decision, at P. 45 (2016).

Commission considered updated ROE analyses presented in the company witness's rebuttal testimony as well as additional financial reports proffered by the witness at hearing in arriving at its ultimate ROE award.³⁸ The Maine Public Utility Commission has determined that evidence offered to update adjustments already proposed by a party and submitted on rebuttal is normally admissible, barring other evidentiary problems.³⁹ In a November 2017 order establishing a revenue requirement for an electric utility, the Massachusetts Department of Public Utilities considered updated ROE analyses from the utility's witnesses provided on rebuttal in determining a reasonable and appropriate ROE.⁴⁰

In a 2013 Minnesota Public Utility Commission case, the ALJ considered both the updated ROE analyses presented by the company in its rebuttal case as well as by an intervenor witness in surrebuttal testimony.⁴¹ In that case, the ALJ adopted the intervenor's ROE recommendation in large part because the updated analyses "are based on more recent information."⁴² In a 2012 Virginia Electric Power Company case, the North Carolina Utilities Commission specifically considered the updated ROE information presented by the company ROE witness in arriving at its ultimate ROE recommendation.⁴³

Moreover, as shown in a 2013 Arizona Corporation Commission proceeding, a company may be criticized for failing to update its ROE analysis on rebuttal.⁴⁴ There, the Commission

³⁸ *Gulf Power Company*, Docket No. 110138-EI, 2012 WL 1144285 at *207, 219 (Fla. P.S.C. April 3, 2012).

³⁹ *Investigation of Central Maine Power Co.'s Credit and Collection Policies and Standard Offer Uncollectible Balances*, Docket No. 2010-327, Procedural Order (Jan. 5, 2012).

⁴⁰ *Petition of NSTAR Electric Company and Western Massachusetts Electric Company d/b/a Eversource Energy for Approval of General Increases in Base Distribution Rates for Electric Service and a Performance Based Ratemaking Mechanism*, D.P.U. 17-05, Order Establishing Eversource's Revenue Requirement at 666-668, 684-685, 694 (Nov. 30, 2017).

⁴¹ *Northern States Power Company*, Docket No. E-022/GR-12-961, 2013 WL 3422902 at *42-51 (Minn. P.U.C. July 3, 2013).

⁴² *Id.* at *51.

⁴³ *Virginia Electric & Power Company, d/b/a Dominion North Carolina Power*, Docket No. E-22, Sub 479, 2012 WL 6643963 at *82 (N.C. U.C. Dec. 21, 2012).

⁴⁴ *Arizona Water Company*, Docket No. W-01445A-11-0310, 2013 WL 750287 (Ariz. C.C. Feb. 20, 2013).

criticized the company's witness for failing to update his ROE analysis: "We find persuasive the criticisms of Dr. Zepp's analysis as outdated because Dr. Zepp opted not to revise his analysis and recommendations based on fresher data after his prefiled direct testimony in this case."⁴⁵

Clearly the common practice in rate cases is for the ROE analyses to be based on the most current information available. This is not surprising given the fact that these jurisdictions are not litigating the rights of "private" litigants in cases where the public is not impacted. Instead, they are bound to rule "in the public interest." This does not mean that current market information is simply ignored because, as the Advisors claim, the Council's regulatory rules and the Louisiana Code of Evidence demand it. That would be an unreasonable result. And, if it were the case, it would leave the Council in the unenviable position as one of a few regulatory jurisdictions in the country that willfully ignores current market data in determining a proper ROE.

III. CONCLUSION

The portions of Mr. Hevert's Rebuttal Testimony objected to by the Advisors have been provided in direct response to the Advisors' direct testimony. This testimony explains, disproves, and/or counteracts evidence and arguments advanced by the Advisors in this proceeding. The Advisors' attack on Mr. Hevert's Rebuttal Testimony is self-serving and contrary to well-established regulatory practice, including that of the Advisors themselves, and therefore must be rejected. Accordingly, the Company respectfully urges that the Advisors' motion to strike certain portions of Mr. Hevert's Rebuttal Testimony and Exhibits be denied.

SIGNATURES ON THE FOLLOWING PAGE

⁴⁵ *Id.* at *36.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that I have this 10th day of April, 2019, served the required number of copies of the foregoing pleading upon all other known parties of this proceeding individually and/or through their attorney of record or other duly designated individual, by: electronic mail, facsimile, hand delivery, and/or by depositing same with overnight mail carrier, or the United States Postal Service, postage prepaid.

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**BEFORE THE
COUNCIL OF THE CITY OF NEW ORLEANS**

**APPLICATION OF)
ENTERGY NEW ORLEANS, INC.)
FOR A CHANGE IN ELECTRIC)
AND GAS RATES PURSUANT TO)
COUNCIL RESOLUTION NO. R-06-459)**

DOCKET NO. UD-08-03

**DIRECT TESTIMONY
OF
JAMES M. PROCTOR
ON BEHALF OF
COUNCIL OF THE CITY OF NEW ORLEANS**

NOVEMBER 17, 2008

**PREPARED DIRECT TESTIMONY
OF**

JAMES M. PROCTOR

1 **I. INTRODUCTION**

2 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

3 **A.** My name is James M. Proctor. My business address is 5555 West 6th Street, No. Q5,
4 Lawrence, Kansas 66049.

5 **Q. BY WHOM ARE YOU EMPLOYED BY IN THIS PROCEEDING AND WHAT IS
6 YOUR TITLE?**

7 **A.** I am an Executive Consultant and Associate with Legend Consulting Group Limited of
8 Denver, Colorado. I have been retained by Legend Consulting Group Limited as a sub-
9 consultant to provide expert analysis and testimony on behalf of the Council of the City
10 of New Orleans (“CNO”) related to all cost of capital matters in the Application of
11 Entergy New Orleans, Inc. (“ENO”) for a Change in Electric and Gas Rates in Council
12 Docket No. UD-08-03.

13 **Q. PLEASE SUMMARIZE YOUR RELEVANT EDUCATIONAL BACKGROUND
14 AND PROFESSIONAL EXPERIENCE.**

15 **A.** Exhibit No. ____ (JMP-2) provides a summary of my relevant educational and
16 professional experience.

17 **Q. HAVE YOU TESTIFIED ON COST OF CAPITAL RELATED MATTERS
18 BEFORE?**

1 A. Yes.

2 **Q. WHAT IS THE SCOPE OF YOUR TESTIMONY?**

3 A. My testimony will cover issues concerning ENO's return on equity ("ROE"), capital
4 structure and rate of return on rate base ("ROR"). Additionally, I provide testimony to
5 help support certain adjustments to ENO's Net Operating Loss ("NOL") carry-forward
6 and NOL carry-back proposed by CNO Witness Mathai.

7 **Q. PLEASE SUMMARIZE YOUR TESTIMONY AND MAJOR CONCLUSIONS OR**
8 **RECOMMENDATIONS.**

9 A. I present testimony, analysis, exhibits and recommendations supporting the proposition
10 that ENO's cost of capital be separately calculated for its natural gas distribution utility
11 business ("gas utility") and its integrated electric utility business ("electric utility"). In
12 doing so, I recommend a combined capital structure for the gas utility and the electric
13 utility. However, because I recommend a separate ROE for the gas utility and the electric
14 utility, the proposed ROR for ENO's gas utility and electric utility will be different.

15 Specifically, I recommend that the ROE and the ROR for ENO's gas utility be
16 10.32% and 8.08%, respectively. Further, I recommend that the ROE and the ROR for
17 ENO's electric utility be 11.07% and 8.45%, respectively. The weighted-average ROE
18 for ENO's total utility investment, based on my separate ROE recommendations for
19 ENO's gas utility and electric utility, is approximately 10.91%. Therefore, if CNO
20 chooses to award ENO the same ROE for the gas utility and the electric utility, it should
21 assign the Company a total utility ROE of 10.91% instead of the 11.75% recommended
22 by Dr. Morin.

1 I am not recommending any current adjustments to ENO's proposed capital
2 structure or its cost of debt and preferred stock. However, if circumstances change
3 during the course of this review, affecting ENO's capital structure, my findings may need
4 to be updated to more current information.

5 I also propose certain adjustments and updating to Dr. Morin's analysis and
6 recommendations that should be adopted by CNO if his proposals are accepted. Because
7 of the recent and significant change in the securities markets, CNO will see that the
8 revisions I made to revise and update the analysis of Dr. Morin have not had a significant
9 affect on his overall recommendations. The most noticeable limiting impact to my
10 revisions to his analysis results from the substantial decline in utility company stock
11 prices in recent weeks. The substantial decline in utility company stock prices has caused
12 the ROE estimates derived from discounted cash flow ("DCF") models to increase
13 significantly.¹ Therefore, even though revising his analysis has in effect decreased his
14 ROE recommendation, updating financial information has largely offset those effects.
15 Finally, if CNO fully adopts Dr. Morin's models for determining a fair and reasonable
16 ROE for ENO, I recommend that the ROE and the ROR for ENO's combined utility
17 businesses be 11.73% and 8.77%, respectively.²

18 **Q. HOW IS YOUR TESTIMONY ORGANIZED?**

19 **A.** My testimony is separated into seven sections. Those sections are as follows.

¹ The DCF model will be explained later in this testimony. However, one component of the DCF model is the expected dividend yield for each company. The dividend yield is calculated by dividing the dividend payment by the stock price. Naturally, when stock prices decrease significantly and dividend estimates are unchanged, the dividend yields increase materially, thus causing the significant increases to the required ROE of each company in the sample.

² ENO's proposed capital structure is presented in Section D, Statement DD-1, page 1 of its filing. Using that capital structure with my revised ROE recommendation for Dr. Morin's analysis results in an ROR for the combined utility of 8.77% [8.77% = weighted cost of debt of 2.83% + weighted cost of preferred equity of 0.23% + weighted cost of equity of 48.66% * 11.73%].

1 **Section I - Dr. Morin's ROE Analysis**

2 I briefly explain the testimony, financial models, assumptions and analysis used by Dr.
3 Morin in developing his findings and recommendation for a ROE for ENO's combined
4 operations.

5 **Section II - Revising and Updating Dr. Morin's ROE Analysis**

6 Using his models, I explain the adjustments necessary to correct and update the analysis
7 and recommendations of Dr. Morin.

8 **Section III - Proposed Base ROE**

9 I explain the financial models, assumptions and analysis used by me in developing
10 findings and recommendations for a base ROE for ENO's gas utility and electric utility,
11 separately.

12 **Section IV - Proposed Risk Adjustment to the Base ROE**

13 I explain the assumptions and analysis used by me in developing findings and
14 recommendations for a risk adjustment to the base ROE for ENO's gas utility and electric
15 utility, separately.

16 **Section V - Proposed Capital Structure and ROR**

17 I present recommendations for: (1) a capital structure for ENO's combined gas utility and
18 electric utility; and, (2) a separate ROR for its gas utility and electric utility.

19 **Section VI - Net Operating Loss Carry-back**

20 I present testimony further supporting CNO Witness Mathai's adjustment to ENO's
21 position concerning NOL carry-back.

22 **Section VII - Net Operating Loss Carry-forward**

1 I present testimony further supporting CNO Witness Mathai's adjustment to ENO's
2 position concerning NOL carry-forward.

3
4 **I - DR. MORIN'S ROE ANALYSIS**

5 **Q. WHAT ARE DR. MORIN'S FUNDAMENTAL ASSUMPTIONS REGARDING**
6 **THE REQUIREMENTS OF AN ADEQUATE ROE?**

7 **A.** Dr. Morin believes that the prevailing economic principles that an adequate cost of equity
8 must satisfy are two-fold. First, the cost of equity must provide an expected return to the
9 supplier of equity capital that is commensurate to the risk being assumed. Second, the
10 cost of equity must be at an appropriate level that allows a firm to continue to invest in
11 assets with the expectation of generating a return that meets the firm's cost of equity.

12 **Q. ACCORDING TO DR. MORIN, HOW ARE THE ABOVE PRINCIPLES USED**
13 **TO DETERMINE A REGULATED COMPANY'S RATES?**

14 **A.** Dr. Morin states that a regulated company's rates should be set to allow the company to
15 recover its costs as well as a fair and reasonable return on its invested capital.
16 Furthermore, he asserts that the appropriate way to determine the regulated ROE is to
17 isolate the portion of the company that performs the regulated activity and evaluate its
18 risk profile separate and apart from a consolidated company that includes non-regulated
19 activities.

20 **Q. IN GENERAL, DO YOU AGREE WITH DR. MORIN'S BELIEF REGARDING**
21 **THE REQUIREMENTS OF AN ADEQUATE ROE AS WELL AS HOW IT**
22 **RELATES TO A REGULATED ENTITY?**

1 **A.** Yes, I generally concur with Dr. Morin's testimony on these issues. However, a
2 regulated utility should not be granted a higher ROE than that for an average risk utility
3 similarly situated, when that utility's risk is higher due to either imprudent or inefficient
4 management. Similarly, if a public utility incurs excessive or imprudent costs or makes
5 imprudent investments, then that utility should not be made financially whole under the
6 premise those business decisions were prudent.

7 **Q. HOW DID DR. MORIN CALCULATE HIS RECOMMENDED ROE FOR ENO?**

8 **A.** Dr. Morin used three different methodologies to separately calculate ENO's required
9 ROE. He then averaged the results from the various methods to determine a single
10 recommendation. The three methodologies Dr. Morin used include the Capital Asset
11 Pricing Model ("CAPM"), Risk Premium analysis and DCF Models. Dr. Morin
12 concludes that ENO's ROE on a "business as usual" basis should be 11.0%. To that
13 amount, he adds a risk premium of 0.75%. Therefore, his overall recommendation is that
14 ENO should be granted an ROE equal to 11.75%.

15 **Q. CAN YOU PLEASE EXPLAIN THE CAPM APPROACH?**

16 **A.** The CAPM basically provides a formula that starts with a basic risk-free investment and
17 assigns additional required return on invested capital as the risk associated with the
18 investment increases. The determination of how much additional risk is required is
19 reflected in an investment's beta. Beta is a measurement of the investment's volatility
20 relative to an investment in the market as a whole.

21 **Q. CAN YOU PLEASE EXPLAIN THE COMPONENTS REQUIRED IN**
22 **PERFORMING CAPM CALCULATIONS?**

1 **A.** The CAPM requires assumptions for the following variables: risk-free rate of return, beta
2 and market risk premium (“MRP”).

3 **Q. WHAT DID DR. MORIN USE TO APPROXIMATE THE RISK-FREE RATE OF**
4 **RETURN?**

5 **A.** Dr. Morin used the current yield of 30-year United States Treasury bonds (“T-Bond”) as
6 the risk-free rate of return. The risk-free rate of return used by Dr. Morin is 4.6%.

7 **Q. WHAT DID DR. MORIN USE TO APPROXIMATE BETA?**

8 **A.** Dr. Morin created two sample groups of publicly-traded utility companies with
9 observable betas and used the average betas of each sample to come up with a single
10 estimate of an estimated beta for ENO. The first group included investment-grade
11 vertically integrated electric utilities. The second group included combination gas and
12 electric utilities. The beta used by Dr. Morin is 0.83.

13 **Q. WHAT DID DR. MORIN USE TO APPROXIMATE THE MRP?**

14 **A.** Dr. Morin took a calculation of the observed historical risk-premium of the broad market
15 of common stocks over the historical returns of the 20-year T-Bond’s income component
16 and averaged it with an estimated prospective market risk premium as calculated by Dr.
17 Morin using a DCF analysis. The MRP employed by Dr. Morin is 7.4%.

18 **Q. WHAT OTHER CALCULATIONS DID DR. MORIN PRESENT AS IT RELATES**
19 **TO HIS CAPM METHOD?**

20 **A.** Dr. Morin argues that the traditional CAPM formula is flawed. He states that observed
21 risk-return tradeoffs are flatter than the CAPM would predict. In other words, the
22 required return on low beta stocks is understated by CAPM and the required return on
23 high beta stocks is overstated by CAPM. Dr. Morin proposes that empirical research

1 supports that adjustments to the regular CAPM approach have to be made to more
2 adequately approximate the required cost of equities actually observed in the market
3 place. He calls this version of the CAPM the Empirical CAPM (“ECAPM”).

4 **Q. WHAT ADDITIONAL STEPS DOES DR. MORIN TAKE TO CREATE HIS**
5 **CAPM ESTIMATE OF ENO’S REQUIRED RETURN ON EQUITY?**

6 **A.** Dr. Morin includes a flotation cost charge to both the CAPM and ECAPM calculation
7 and then averages the two.

8 **Q. CAN YOU PLEASE EXPLAIN THE RISK PREMIUM ANALYSIS PERFORMED**
9 **BY DR. MORIN?**

10 **A.** Dr. Morin used the average of three separate risk premium calculations to determine the
11 Risk Premium estimate of ENO’s ROE. They included two historical utility risk
12 premium estimates and one allowed risk premium estimate. The first historical utility
13 risk premium estimate used an electric utility industry index as a proxy to measure the
14 actual annualized realized return on equity capital in comparison to the annual long-term
15 government bond return for the applicable year. The average of the annual differences
16 provided the first historical utility risk premium estimate. The second historical utility
17 risk premium estimate consisted of the same process only with a natural gas industry
18 index as the chosen proxy. Both historical risk premium estimates are then added to a
19 flotation cost charge. The allowed risk premium estimate consists of taking a ten year
20 average of the actual allowed risk premiums by regulators.

21 **Q. CAN YOU PLEASE EXPLAIN THE DCF MODEL METHODOLOGY?**

22 **A.** The DCF approach states that investors will value a security based upon the net present
23 value of the expected cash flows associated with the security.

1 **Q. CAN YOU PLEASE EXPLAIN THE COMPONENTS REQUIRED IN**
2 **PERFORMING DCF CALCULATIONS?**

3 **A.** The DCF requires assumptions for the following variables: expected dividend yield and
4 expected long-term growth.

5 **Q. HOW DID DR. MORIN CALCULATE HIS DCF ESTIMATE?**

6 **A.** The DCF model approach employed by Dr. Morin consists of taking the average of four
7 separate DCF calculations. The first two calculations use a group of publicly traded
8 vertically integrated electric utility companies as a proxy. Dr. Morin calculated each
9 company's cost of equity and averaged them. The only distinction between the first two
10 calculations was the source that Dr. Morin used for earnings growth estimates. The third
11 and fourth calculations consisted of the same process only with a different group of
12 companies as the proxy. The second proxy consisted of combination gas and electric
13 utility companies. Each DCF calculation was then added to a flotation cost charge before
14 averaging the four together.

15 **Q. PLEASE EXPLAIN DR. MORIN'S DESIRE TO INCLUDE A FLOTATION**
16 **COST CHARGE.**

17 **A.** Dr. Morin advises that all common equity capital carries a transaction costs charge that
18 must be compensated in the required ROE, on an on-going basis, in order for investor's
19 to reach a level of return commensurate to their expected risk.

20 **Q. PLEASE SUMMARIZE DR. MORIN'S RESULTS AND RECOMMENDATION.**

21 **A.** Dr. Morin used three categories of methods to create nine total analyses of ENO's
22 required ROE. He states that no one method is foolproof and that his process minimizes
23 the potential flaws of the individual methods in total. Dr. Morin also believes that ENO

1 has a higher risk profile than the average electric utility and assigns a 75 basis point
2 premium to his average calculated ROE of 11.0% for a total recommended ROE of
3 11.75%.

4 **Q. WHAT IS DR. MORIN'S FOUNDATION FOR HIS 75 BASIS POINT RISK**
5 **ADJUSTMENT?**

6 **A.** Dr. Morin justifies the risk adjustment with three considerations: 1) the yield spreads
7 between A-rated and Baa3 rated utility bonds, 2) the beta risk differential between Dr.
8 Morin's estimate of ENO's beta and the average electric utility beta, and 3) the business
9 risk score differentials between ENO and the average-risk integrated electric utility based
10 upon ENO's relative business risks, size, and reduced customer base.

11 **Q. SPECIFICALLY, WHAT IS THE ADJUSTMENT ESTIMATED BY DR. MORIN**
12 **FOR EACH OF THE THREE CONSIDERATIONS?**

13 **A.** Dr. Morin estimates that the adjustment for yield spread is 70 basis points, the adjustment
14 for beta risk differential is 74 basis points, and the adjustment for business risk
15 differentials would be 60-80 basis points. He uses these estimates as a basis to assign the
16 75 basis point premium to ENO's ROE.

17

18 **II - REVISING AND UPDATING DR. MORIN'S ROE ANALYSIS**

19 **Q. DO YOU HAVE CERTAIN OBSERVATIONS ABOUT DR. MORIN'S**
20 **TESTIMONY THAT YOU WANT TO DISCUSS BEFORE RECOMMENDING**
21 **SPECIFIC CHANGES TO IT?**

22 **A.** Yes. Dr. Morin provides certain conclusions regarding ENO's risk environment and the
23 legal principals and precedence that underlie a determination of a fair and reasonable

1 ROE. I generally concur with his testimony on these subjects. However, I believe
2 certain qualifications should be discussed.

3 **Q. PLEASE DISCUSS ENO'S RISK ENVIRONMENT.**

4 **A.** Dr. Morin states that "... ENO's risk environment remains above the industry average
5 due mostly to the negative business climate prevailing in its service territory, and to its
6 recent emergence from bankruptcy..." Based on this observation, Dr. Morin proposes a
7 75 basis point increase to ENO's ROE to account for ENO's "... slightly higher than
8 average risk circumstances..."

9 I agree that ENO has recently been more risky due to circumstances concerning
10 its specific business risk characteristics. There are reasons to believe that ENO's
11 business risk is mitigating, thus that mitigation should be considered by CNO in
12 determining whether the risk adjustment recommended Dr. Morin should be adjusted
13 downward.

14 For example, ENO has demonstrated strong financial performance since emerging
15 from bankruptcy protection in 2007. Its performance has been assisted by the
16 extraordinary political and legislative support ENO received following Hurricane Katrina
17 in 2005. As an illustration of that support, ENO has been allowed by CNO to accumulate
18 up to \$75.0 million in a Storm Reserve Fund over a ten-year period. In addition, ENO's
19 credit metrics are stronger than typical for an electric or gas utility having its current
20 ratings.

21 I will discuss ENO's business risk again when I provide my recommendation for
22 a risk adjustment to the Company's ROE for its gas and electric utilities.

1 **Q. PLEASE DISCUSS DR. MORIN’S POSITION REGARDING THE LEGAL**
2 **PRINCIPALS THAT UNDERLIE A DETERMINATION OF A FAIR AND**
3 **REASONABLE ROE.**

4 **A.** Dr. Morin discusses two United States Supreme Court decisions that provide guidance as
5 to the determination of a fair and reasonable ROE for a public utility. Those decisions
6 relate to: (1) Bluefield Water Works & Improvement Company v. Public Service
7 Commission of West Virginia, 262 U.S. 679 (1923); and, (2) Federal Power Commission
8 v. Hope Natural Gas Company, 320 U.S. 591 (1944).

9 Dr. Morin concludes from these cases that “... Council’s decision should be to
10 allow ENO the opportunity to earn a return on equity that is: (1) commensurate with
11 returns on investments in other firms having corresponding risks, (2) sufficient to assure
12 confidence in the Company’s financial integrity, and (3) sufficient to maintain the
13 Company’s creditworthiness and ability to attract capital on reasonable terms...”

14 **Q. DO YOU BELIEVE THERE IS OTHER CRITERIA A REGULATORY BODY**
15 **SHOULD CONSIDER WHEN DETERMING A FAIR AND REASONABLE ROE**
16 **FOR ANY UTILITY?**

17 **A.** Yes. The criteria mentioned by Dr. Morin assume the business risks facing the utility
18 exist under prudent, competent and efficient management. CNO, or any regulatory body,
19 should also draw conclusions regarding whether the business risk of the regulated utility
20 is greater due to inefficient or uneconomical management. That is, to the extent a
21 regulatory body finds a utility’s business risk is greater because of imprudent or
22 incompetent management, that utility and its shareholders should not be made whole for
23 negative financial ramifications of its management’s deficiencies. This standard should

1 be applied even if the end-result is that the utility does not receive an allowed ROE
2 consistent with its actual business risks.

3 **Q. DO YOU HAVE ANY REASON TO BELIEVE THAT ENO'S BUSINESS RISK IS**
4 **THE RESULT OF MANAGEMENT DEFICIENCIES?**

5 **A.** No. I have not found any evidence that ENO's business risk is greater as a result of
6 imprudent or incompetent management.

7 **Q. WHAT IS YOUR APPROACH TO MAKING REVISIONS TO THE TESTIMONY**
8 **OF DR. MORIN?**

9 **A.** As discussed above in Section I, Dr. Morin has used three models to determine his base
10 recommendation for ENO's ROE. Those models include (1) the CAPM, (2) the Risk
11 Premium and (3) the DCF. Using these models, Dr. Morin develops nine separate
12 estimates of ENO's ROE. He uses these nine estimates to recommend a base ROE of
13 11.0% for ENO. That is, his base ROE recommendation is an ROE required for a
14 combination gas and electric utility of average risk. To that base ROE of 11.0%, he adds
15 a risk premium of 0.75%, thus, his overall recommendation is 11.75%.

16 For purposes of revising his analysis, I have continued to employ the same models
17 used by Dr. Morin. That is, I have simply revised the nine estimates to account for more
18 current financial information and for corrections to his analysis.

19 In Section III of this testimony, I will propose some different approaches to
20 estimating ENO's ROE.

21 **Q. WHAT ARE YOUR REVISIONS TO THE ANALYSIS OF DR. MORIN?**

22 **A.** I have made four revisions to Dr. Morin's analysis. I have also updated his analysis to
23 include financial information through October 24, 2008.

1 The four revisions that I propose to revise Dr. Morin's analysis include:

2 (1) Eliminating the combination natural gas and integrated electric utilities from
3 his sample used for integrated electric utilities in the DCF models and
4 CAPMs;

5 (2) Using the 20-year T-Bond rate as the risk-free rate in the CAPMs and Risk
6 Premium approach instead of his use of the 30-year T-Bond rate;

7 (3) Eliminating his use of the prospective MRP in calculating the MRP for his
8 CAPMs; and

9 (4) Decreasing his estimate of flotation costs of 5.0% to an after tax cost of 2.4%.

10 **Q. WHY DO YOU ELIMINATE THE COMBINATION UTILITIES FROM THE**
11 **SAMPLE OF INTEGRATED ELECTRIC UTILITIES?**

12 **A.** Dr. Morin uses two samples in estimating ENO's ROE under the CAPM and DCF
13 approaches. One sample consists of 29 integrated electric utilities and the other sample
14 consists of 26 combination electric and gas utilities.

15 His sample of integrated electric utilities includes 16 combination electric and gas
16 utilities. That is, these 16 combination electric and gas utilities are in each sample. I
17 believe including them in both samples weights these companies greater than those that
18 are just integrated electric utilities, which are in only one of the samples. To eliminate
19 the excessive influence of the combination electric and gas utilities in his analysis, I have
20 removed them from the sample of integrated electric utilities. Thus, that sample contains
21 13 electric utilities after the revision.

22 **Q. WHY DO YOU USE THE 20-YEAR TREASURY BOND RATE AS THE RISK-**
23 **FREE RATE INSTEAD OF THE 30-YEAR TREASURY BOND RATE?**

1 **A.** I recommend the use of the 20-year T-Bond rate as the risk-free rate in order to properly
2 synchronize the risk-free rate with the historical calculation of the MRP used in Dr.
3 Morin's CAPM. As acknowledged by Dr. Morin, the MRP represents the premium by
4 which the return on common stocks has outperformed the interest component of the 20-
5 year T-Bond from 1926 through 2007.³

6 One should use the same security as the risk-free rate in the CAPM formula as
7 was used for calculating the historical MRP used in the same equation. That is,
8 maintaining consistency is important for applying the CAPM approach. Therefore, I
9 have revised Dr. Morin's ROE analysis to include the 20-year T-Bond as the risk-free
10 rate.

11 **Q. WHY DO YOU ELIMINATE THE PROSPECTIVE MRP IN THE**
12 **CALCULATION OF THE MRP USED IN DR. MORIN'S CAPMS?**

13 **A.** As explained above in Section I, Dr. Morin calculates the expected MRP for his CAPMs
14 by averaging a historical MRP of 7.1% and a prospective MRP of 7.8%. Thus, he uses
15 an MRP of 7.4% in his analysis. The historical MRP of 7.1% should be used in his
16 CAPMs. He should not use the prospective MRP of 7.8% to determine an average, or
17 expected, MRP of 7.4%.

18 Economists and statisticians have not found evidence that the expected MRP has
19 changed over time. Accepting the assumption that the expected MRP is constant over
20 time, one should estimate the expected MRP by using all available historical information.
21 That is the proper way to estimate that expected value statistically.

³ Later in my testimony, I will consider using the 90-day Treasury bill rate as an estimate for the risk-free rate. Here, I am simply correcting the analysis of Dr. Morin.

1 The historical MRP is based on an 81-year average of the difference between
2 returns on equity investments and the 20-year T-Bond. Since that is the longest period
3 for which the data needed for the calculation is available, using all that information
4 should provide the best estimate of the expected MRP. Therefore, the most reliable
5 estimate for the expected MRP, the historical MRP, should be used for Dr. Morin's
6 CAPMs.

7 **Q. WHY IS THE PROSPECTIVE MRP, AS CALCULATED BY DR. MORIN NOT**
8 **ALSO A RELIABLE ESTIMATE OF THE EXPECTED MRP?**

9 **A.** In calculating the prospective MRP of 7.8%, Dr. Morin relied on Value Line's estimate
10 of what the long-term growth rate of dividends for the S&P 500 stock index will be.
11 Obviously, this estimate of growth has not been observed. It is one publication's forecast
12 as to what it expects the long-term growth rate of dividends to be. If using the
13 prospective MRP, based on forecasted information, provides as good of an estimate of
14 the expected MRP as financial information observed over an 81-year period, there would
15 be little need for the time consuming task of gathering and analyzing that historical
16 information. Fortunately, the projections of growth are not reliable or relevant for
17 estimating the true value for the expected MRP.

18 Frankly, I do not understand Dr. Morin's use of the "larger" prospective MRP of
19 7.8% when he stresses the use of historic information in estimating the MRP. Its use
20 unnecessarily increases the ROE for ENO. For example, on pages 26 and 27 of his direct
21 testimony, Dr. Morin states "...A risk premium study should consider the longest
22 possible period for which data are available..." and "...To the extent that the estimated
23 historical equity risk premium follows what is known in statistics as a "random walk",

1 the best estimate of the future risk premium is the historical mean...” He appears to
2 agree the historic mean is the best estimate for the expected MRP. Therefore, he should
3 not average the best estimate for the expected MRP with inferior estimates to arrive at a
4 “water-downed” estimate.

5 **Q. WHAT ARE FLOTATION COSTS?**

6 **A.** As explained by Dr. Morin, flotation costs relate to incremental costs incurred from the
7 issuance of common stock. As calculated by Dr. Morin, these costs include direct
8 expenses such as costs for accounting, marketing, consulting, administrative and legal
9 services incurred for the issuance. He also believes there are indirect costs incurred from
10 issuing the stock. That indirect cost, as alleged by Dr. Morin, includes “...downward
11 pressure on the stock price as a result of the increased supply of stock from the new
12 issue...” He refers to the indirect cost as “market pressure.” Dr. Morin estimates the
13 direct and indirect costs to be about 4% and 1% of the issuance amount, respectively,
14 yielding a total cost of 5.0%.

15 **Q. WHY DO YOU PROPOSE TO DECREASE THE FLOTATION COST FROM**
16 **5.0% TO 2.4%?**

17 **A.** The direct component of flotation costs relates to cash expenditures paid by Entergy for
18 expenses incurred for issuing its common stock.⁴ These cash expenditures are deductible
19 on the company’s income tax return. Therefore, ENO receives a tax benefit for these

⁴ CNO should know that if ENO has historically recovered these direct costs through its cost of service as an operating expense, then those same direct costs should not also be recovered through the ROE. At the time of preparing this testimony, I am unsure whether these direct costs have been previously recovered as an operating expense because there is an outstanding discovery request examining this matter. That discovery request is CNO 35-1, attached as Exhibit No. ____ (JMP-33). I recommend that if ENO historically has recovered these direct costs through its cost of service as an operating expense, the full flotation cost allowance should be removed from Dr. Morin’s recommendation. I will present revisions to my ROE recommendations in rebuttal testimony if ENO’s response to CNO 35-1 confirms flotation costs have been recovered as operating expenses.

1 direct expenses. This means the “after-tax” cost to ENO for these direct expenses is
2 approximately 2.4% of the issuance amount, not 4.0%.

3 If ENO is permitted to increase its allowed ROE to recover an amount of direct
4 costs equal to 4.0% of its issuance proceeds, the company will actually recover an
5 amount equal to about 6.7% of its issuance proceeds through its ROE. ENO will recover
6 through rates, an amount equal to about 6.7% of its issuance proceeds, because the cost of
7 equity is “grossed-up” for income tax expense in the rate making process. Therefore, to
8 limit ENO recovering an amount equal to 4.0% of its issuance proceeds, an “after-tax”
9 cost of 2.4% should be recovered through the ROE component. This is so because after
10 the 2.4% amount is “grossed-up” in the rate making process, an amount equal to 4.0% of
11 its issuance proceeds will be recovered through its utility rates.

12 I propose to eliminate the indirect costs attributed to “market pressure” altogether.
13 Therefore, the flotation costs, for indirect costs in the amount of 1% of the issuance
14 proceeds, should be disallowed, thus decreasing the overall flotation costs to 2.4% of the
15 issuance proceeds.

16 **Q. WHY SHOULD CNO REMOVE INDIRECT COSTS FROM THE FLOTATION**
17 **COST ALLOWANCE?**

18 **A.** Dr. Morin alleges that when new shares of common stock are placed in the market, the
19 stock price should decrease by approximately 1% of the amount of the issuance proceeds
20 due to “market pressure.” I agree that the issuance of new shares into the market could
21 have a downward impact on the stock price. However, if the cash proceeds from the
22 issuance of those shares are invested in assets yielding an expected return at or above the
23 opportunity cost of that investment, then that investment should not negatively impact the

1 stock price in the long-run. In the short-run, there may be some downward pressure on
2 the stock price as investors judge the credibility of how the proceeds are invested, but the
3 initial downward pressure should ultimately be offset if the proceeds are invested wisely.

4 Perhaps, the simplest way to understand the relevance, or lack thereof, of market
5 pressure to the long-term price of stock is to ask the following question. Why would a
6 company issue common stock, for financing a project, if it expected the price of its stock
7 to decline simply because of issuing the stock? Under that scenario, the shareholders
8 would be better off if the project was not undertaken and the stock was not issued, thus
9 avoiding the downward pressure on its current stock price.

10 **Q. AFTER ACCOUNTING FOR YOUR PROPOSED REVISIONS AND UPDATING,**
11 **WHAT IS DR. MORIN'S REVISED ROE RECOMMENDATION?**

12 **A.** CNO can see from reviewing the attached exhibit, Exhibit No. ____ (JMP-3), that Dr.
13 Morin's recommended ROE is 11.73% after accounting for my proposed revisions and
14 updating to his analysis. The impact of my changes to each of his nine estimates of ROE
15 is also presented in Exhibit No. ____ (JMP-3). The supporting calculations used to revise
16 and update each of his nine estimates are presented in the attached exhibits, Exhibit No.
17 ____ (JMP-4) through Exhibit No. ____ (JMP-16).

18

19 **III - PROPOSED BASE ROE**

20 **Q. DO YOU RECOMMEND CNO ADOPT OTHER CHANGES TO DR. MORIN'S**
21 **ROE ANALYSIS?**

22 **A.** Yes. However, the revisions to Dr. Morin's analysis discussed in Section II also apply to
23 the analysis that I recommend be adopted in place of his recommendations. That is, the

1 revisions of: eliminating the combination natural gas and integrated electric utilities from
2 his sample used for integrated electric utilities; using the 20-year T-Bond rate as the risk-
3 free rate instead of his use of the 30-year T-Bond rate; eliminating his use of the
4 prospective MRP in calculating the MRP for his CAPMs; and, decreasing his estimate of
5 flotation costs of 5.0% to an after-tax cost of 2.4%, all apply to my proposed analysis as
6 well. I also update the financial information used in my analysis.

7 **Q. WHAT ARE THE OTHER CHANGES YOU PROPOSE TO THE MODELS AND**
8 **METHODS EMPLOYED BY DR. MORIN?**

9 **A.** I recommend that CNO adopt my analysis of ENO's required ROE. In preparing my
10 analysis and recommendation, I made additional changes to the analysis used by Dr.
11 Morin. Those changes include:

- 12 (1) Replacing Dr. Morin's sample of combinations gas and electric utilities with a
13 sample of natural gas distribution companies;
- 14 (2) using the 13-week United States Treasury Bill ("T-Bill") rate as the risk-free rate in
15 the CAPM analysis in addition to the 20-year T-Bond rate;
- 16 (3) rejecting the ECAPM approach; and
- 17 (4) rejecting the Allowed Risk Premium approach.

18 **Q. WHAT MODELS DID YOU EMPLOY FOR DERIVING YOUR**
19 **RECOMMENDED ROE FOR ENO?**

20 **A.** The models that I used for deriving my recommended ROE are summarized on Exhibit
21 No. ____ (JMP-17). Those models include:

- 22 (1) CAPM separately using 20-year T-Bond and 13-week T-Bill as the risk-free rate;
- 23 (2) Historical Risk Premium; and

1 (3) DCF separately using Value Line Investment Analyzer (“Value Line”) and Zack’s
2 Investment Research, Inc. (“Zacks”) for earnings growth estimates.

3 I have derived an ROE for ENO’s electric utility and gas utility, separately, using each of
4 these models.

5 **Q. WHY ARE YOU PROPOSING A SEPARATE ROE FOR ENO’S GAS UTILITY
6 AND ELECTRIC UTILITY?**

7 **A.** ENO has a gas utility and an electric utility. ENO finances its equity investment at the
8 holding company level and the cost of equity to the holding company is tied to the
9 specific assets being financed with the proceeds of stock issuances. That is, if equity is
10 raised to invest in ENO’s electric utility, the cost of that equity is based on the risks of
11 investing in assets of the electric utility. Similarly, if equity is raised to invest in ENO’s
12 gas utility, the cost of that equity is based on the risks of investing in assets of the gas
13 utility.

14 **Q. WHY DO YOU PROPOSE USING A SAMPLE OF NATURAL GAS
15 DISTRIBUTION COMPANIES IN YOUR ANALYSIS?**

16 **A.** I propose replacing Dr. Morin’s sample of combination gas and electric utilities with a
17 sample of natural gas distribution companies because doing so provides a basis for
18 deriving a more precise estimate of the required ROE for ENO’s gas utility. It provides a
19 more precise estimate of the required ROE for ENO’s gas utility because a sample of
20 natural gas distribution companies includes utilities that have risk characteristics more
21 consistent with those of ENO’s gas utility.

22 **Q. HOW DID YOU CHOOSE YOUR GAS UTILITY SAMPLE?**

1 **A.** Since it is correct to determine a separate ROE for the gas utility and the electric utility,
2 one should choose separate samples for the respective estimations.

3 To find a sample of companies to use in my analysis of ENO's gas utility, I began
4 by examining natural gas distribution companies analyzed by Value Line. Next, I
5 eliminated companies that had less than 50% of their revenues from natural gas
6 distribution and companies that did not have positive growth estimates. The sample I
7 used to derive an ROE for ENO's gas utility is presented in Exhibit No.____ (JMP-24).

8 **Q. HOW DID YOU CHOOSE YOUR ELECTRIC UTILITY SAMPLE?**

9 **A.** I have used Dr. Morin's sample of integrated electric utilities to estimate an ROE for
10 ENO's electric utility. However, I eliminated combination electric and gas utilities from
11 his sample to derive a sample that has risk characteristics more consistent with ENO's
12 electric utility. I am also not using Dr. Morin's sample of combination gas and electric
13 utilities because that sample contains companies which include mixed risk characteristics.
14 That is, they include some characteristics of a gas utility and some of an electric utility
15 when what we need here is a sample of only electric utilities. My sample of electric
16 utilities is presented in Exhibit No.____ (JMP-25).

17 **Q. WHY DO YOU PROPOSE INCLUDING THE USE OF THE 13-WEEK T-BILL
18 RATE AS A PROXY FOR THE RISK-FREE RATE IN YOUR CAPM
19 ANALYSIS?**

20 **A.** I propose using the 13-week T-Bill rate as the risk-free rate in the CAPM analysis
21 because the return on these T-Bills is more closely representative of a risk-free rate than
22 other treasury issuances. T-Bills are still subject to inflation risks, but as the term of
23 treasury issuances increases, the more the instrument is also subject to interest rate risk.

1 For example, the 20-year and 30-year T-Bond issuances are subject to greater risk than
2 the 13-week T-Bill. Further, the basic CAPM, as theoretically derived, assumes that
3 investors are satisfied in investing in a combination of risk-free investments and the
4 market portfolio. The 13-week T-Bill is the closest proxy for a risk-free rate and, thus,
5 should be considered for CAPM analysis.

6 **Q. DO YOU THINK IT IS ALSO IMPORTANT TO CONSIDER CAPM**
7 **ESTIMATES OF UTILITY RETURN REQUIRMENTS USING THE LONGER**
8 **TERM T-BONDS?**

9 **A.** Yes. I think it is important to also consider longer term T-Bonds in the CAPM analysis
10 when examining ROE requirements for utility investments. This is because of the
11 discreet nature of rate making and the potential for significantly fluctuating T-Bill rates in
12 the short-run.

13 Utility rates are set usually on average every two to four years. There are
14 generally no limitations on a utility filing rate cases, but a regulatory body should strive
15 to set rates which will be appropriate for at least two years. Otherwise, the cost of
16 regulation can become excessive. If T-Bill rates are volatile around the time rates are
17 established, or change significantly shortly thereafter, it is possible for the ROE estimate
18 derived, using T-Bill rates as the risk-free rate in the CAPM, to become either excessive
19 or insufficient.

20 Therefore, even though the 20-year T-Bond is subject to inflation and interest rate
21 risk, and, therefore, is not risk-free, consideration of it in the CAPM analysis can provide
22 a smoothing effect. That is, when considering and averaging CAPM estimates using,

1 separately, T-Bills and T-Bonds as the risk-free rate, one may derive an estimate that is
2 more appropriate for the period for which rates are in effect.

3 **Q. WHY DO YOU RECOMMEND REJECTING THE ECAPM APPROACH FROM**
4 **THE ROE ANALYSIS?**

5 **A.** The CAPM, as traditionally used in ROE analysis for regulated utilities, is derived from
6 basic underpinnings of economic analysis. That is, the CAPM model is derived based on
7 the assumption that investors are satisfied in investing in a combination of risk-free
8 investments and the market portfolio. Any investor's desired combination of these
9 investments coincides with his appetite for risk. If this assumption is true, the CAPM is a
10 reliable tool in estimating the cost of equity.

11 Unlike the theoretical underpinnings of the basic CAPM, the ECAPM depends on
12 empirical research. It also depends on the observation of actual returns, whereas, the
13 CAPM estimates expected returns. Since the evaluation of equity investments are based
14 on expected returns, not observed returns, I recommend the basic CAPM as the relevant
15 model for ROE estimation. Therefore, I recommend not relying on the ECAPM here.

16 **Q. WHY DO YOU RECOMMEND REJECTING THE ALLOWED RISK PREMIUM**
17 **APPROACH IN ESTIMATING ENO'S REQUIRED ROE?**

18 **A.** The allowed risk premium approach, as employed by Dr. Morin, consists of taking a ten-
19 year average of the actual difference between the regulator-allowed ROEs and the yield
20 on long-term T-Bonds. He then adds the resulting risk premium estimate to the current
21 yield on the 30-year T-Bond to derive an ROE estimate.

22 I believe this method is not reliable because there is likely measurement error in
23 matching historic T-Bond rates with the actual timing for the derivation of each separate

1 ROE determination set by regulatory commissions. Measuring these allowed risk
2 premiums over such a short period of time exasperates the likelihood of error. Further,
3 even though regulatory commissions often consider market-based methodologies for
4 setting ROE, it is also common for an ROE finding to be set with the influence of
5 subjectivity. That is, many allowed ROEs may not bear a real resemblance to any
6 underlying estimate derived from using a DCF or CAPM.

7 **Q. WHAT ARE YOUR FINDINGS FROM APPLYING THE FINANCIAL MODELS**
8 **YOU HAVE PROPOSED?**

9 **A.** The results of my ROE analysis for ENO are presented in Exhibit No. ____ (JMP-17).
10 In the first two columns of that exhibit, CNO will find the results of my separate analyses
11 for the gas utility and the electric utility. Those results for the separate utilities include
12 two CAPM analyses, one Historical Risk Premium Analysis and two DCF analyses.

13 To arrive at my base recommendation for the ROE for each of the gas and electric
14 utility, I averaged the two CAPM findings and the two DCF findings, separately. After
15 averaging the CAPM and DCF findings, CNO will see that the exhibit presents an
16 average CAPM estimate, a Historical Risk Premium estimate and an average DCF
17 estimate, separately, for each of the gas and electric utility. I derived my base ROE
18 recommendation for the gas utility and the electric utility, separately, from averaging the
19 estimates from application of the three models. Therefore, I propose a base
20 recommendation for the gas utility and electric utility of 9.98% and 10.49%, respectively.

21 **Q. WHY DO YOU REFER TO THESE ROE RECOMMENDATIONS AS BASE**
22 **RECOMMENDATIONS?**

1 **A.** I believe ENO's gas utility and electric utility are somewhat more risky than the average-
2 risk utility. Further, I believe the greater risk exposure to ENO's utilities is largely
3 outside the direct control of management. That is, its greater risk is attributed to
4 geographic location, small capitalization and the recent exposure to significant hurricane
5 damage to its plant investment and customer base. If these risks were largely controllable
6 by ENO and it had been negligent in limiting exposure to them, I would not be proposing
7 the risk adjustment. Therefore, as did Dr. Morin, I present a risk adjustment to the ROE
8 for each of ENO's utility businesses. However, I have determined my risk adjustment
9 differently than Dr. Morin. I will explain and present the risk adjustment in the next
10 section of my testimony.

11

12 **IV - PROPOSED RISK ADJUSTMENT TO THE BASE ROE**

13 **Q. DO YOU AGREE WITH THE AMOUNT OF THE RISK ADJUSTMENT**
14 **PROPOSED BY DR. MORIN?**

15 **A.** No. I also recommend the risk adjustment for the gas utility and the electric utility be
16 calculated separately.

17 **Q. WHAT IS THE AMOUNT OF THE RISK ADJUSTMENT PROPOSED BY DR.**
18 **MORIN?**

19 **A.** Dr. Morin proposes a risk adjustment of 75 basis points. He bases that adjustment on
20 three separate considerations. Those considerations include: 1) observed bond yield
21 differentials between A-rated and Baa3-rated utility bonds, 2) observed electric utility
22 beta differentials; and, 3) the differential between common equity ratio requirements
23 based on S&P Business Risk Scores.

1 **Q. DO YOU AGREE WITH HIS USE OF BOND YIELD DIFFERENTIALS TO**
2 **CALCULATE THE RISK ADJUSTMENT?**

3 **A.** No. I believe that his use of the observed bond yield differentials, as of June 2008,
4 between A-rated and Baa3-rated utility bonds provides only a “one point” estimate of the
5 bond yield spread. As either ENO’s bond rating of Baa3 or the bond yield differentials
6 between A-rated and Baa3-rated utility bonds change over time, so will Dr. Morin’s
7 calculation of a yield spread. Therefore, any finding of a risk premium based on yield
8 spreads can be too variable. Also, Dr. Morin does not separate the risk premium between
9 the gas utility and the electric utility.

10 **Q. DO YOU AGREE WITH HIS USE OF ELECTRIC UTILITY BETA**
11 **DIFFERENTIALS TO ESTIMATE THE RISK ADJUSTMENT?**

12 **A.** I do not agree with his specific application of utility beta differentials, but the CAPM can
13 be used to estimate a risk adjustment here. That is, because the beta variable in the
14 CAPM can be used to estimate risk differentials among companies, it can be used to
15 estimate a risk adjustment for ENO’s gas and electric utilities.

16 **Q. HOW DO YOU CORRECTLY DERIVE A RISK ADJUSTMENT FOR ENO**
17 **USING BETA AND THE CAPM?**

18 **A.** One needs to calculate risk adjustments for the gas utility and the electric utility
19 separately. In order to accomplish that objective, I evaluated the average beta and
20 standard deviation for my gas utility sample presented in Exhibit No. ____ (JMP-24) and
21 the average beta and standard deviation for my electric utility sample presented in Exhibit
22 No. ____ (JMP-25). As shown in these exhibits, the standard deviation for the beta

1 estimate of the natural gas distribution sample and the integrated electric utility sample
2 are .043 and .074, respectively.

3 Next, I averaged the two MRPs used in my CAPM analyses. Those include the
4 MRP for the 20-year T-Bond and the 13-week T-Bill shown in Exhibit No. ____ (JMP-
5 18) and Exhibit No. ____ (JMP-19), respectively. The MRP for the T-Bond and the T-
6 Bill are 7.1% and 8.5%, respectively, thus the average MRP is 7.8%.

7 Once, I have calculated the average MRP of 7.8% and the standard deviation for
8 the natural gas distribution sample and the integrated electric utility sample of .043 and
9 .074, respectively, I can determine the risk premium adjustment for ENO's gas utility and
10 electric utility. To calculate the risk adjustment for the gas utility, I multiply .043 times
11 7.8% to derive the premium of .34%. To calculate the risk adjustment for the electric
12 utility, I multiply .074 times 7.8% to derive the premium of .58%.

13 **Q. HOW DO YOU USE THESE RISK PREMIUM ADJUSTMENTS TO ARRIVE AT**
14 **A RISK-ADJUSTED ROE FOR ENO'S GAS UTILITY AND ELECTRIC**
15 **UTILITY?**

16 **A.** Recall, I propose a base ROE recommendation for the gas utility and electric utility of
17 9.98% and 10.49%, respectively. To arrive at my recommendation for the risk-adjusted
18 ROE, I simply add the base ROEs of 9.98% and 10.49% for the gas utility and electric
19 utility to the separate risk adjustments of .34% and .58%, respectively. Therefore, the
20 risk-adjusted ROE for the gas utility is 10.32% [10.32% = 9.98% + .34%] and the risk-
21 adjusted ROE for the electric utility is 11.07% [11.07% = 10.49% + .58%].

1 **Q. WHAT IS THE WEIGHTED-AVERAGE ROE FOR ENO GIVEN YOUR**
2 **SEPARATE RECOMMENDATIONS FOR THE GAS UTILITY AND THE**
3 **ELECTRIC UTILITY?**

4 **A.** The weighted-average ROE based on my separate ROE recommendations for ENO's gas
5 utility and electric utility is approximately 10.91%. That is, my recommendation for
6 ENO's risk-adjusted ROE for the gas utility of 10.32% and for the electric utility of
7 11.07%, results in a weighted-average ROE, based on my separate ROE
8 recommendations, of approximately 10.91%.

9 **Q. HOW SHOULD CNO EVALUATE THE FAIRNESS OF YOUR RISK PREMIUM**
10 **ADJUSTMENT?**

11 **A.** I have used the average MRP of the CAPM models, and average beta and standard
12 deviation for the natural gas distribution and integrated electric utility samples,
13 separately, to calculate my adjustments. Because I have increased my recommendation
14 of ENO's base ROE for the gas utility and electric utility to reflect an assumed beta for
15 ENO that is one standard deviation above the sample means for the respective samples, I
16 am in effect concluding that ENO is riskier than approximately 84% of other natural gas
17 distribution and integrated electric utility companies. Based on my evaluation of ENO's
18 credit ratings and risk environment, I believe that is a reasonable assumption.

19 **Q. DO YOU AGREE WITH DR. MORIN'S USE OF S&P BUSINESS RISK SCORES**
20 **TO CALCULATE A RISK ADJUSTMENT?**

21 **A.** No. Dr. Morin calculates a 60 to 80 basis point adjustment to ENO's ROE pursuant to
22 his assumptions of: (1) ROE requirements related to the differential between common
23 equity ratio requirements; and, (2) S&P Business Risk Score rankings. In arriving at this

1 range of 60 to 80 basis points, Dr. Morin makes assumptions that: (1) on a standalone
2 basis ENO would be assigned a two step lower S&P Business Risk Score ranking than
3 the average-risk utility; (2) each one step variance in S&P ranking equates to a 3% to 4%
4 impact on common equity ratio requirements; and, (3) that each 1% change in common
5 equity ratio requirements in the capital structure equates to a 10 basis point adjustment in
6 the ROE requirement.

7 In making these assumptions, Dr. Morin guesses that S&P would award ENO a
8 two steps lower S&P Business Risk Score ranking than the average-risk utility, and
9 rounds and averages theoretical and empirical studies to support his assumption that each
10 1% change in common equity ratio requirements in the capital structure equates to a 10
11 basis point adjustment in the ROE requirement. These assumptions implicitly assume
12 that only common equity ratio requirements affect ROE requirements.

13 In summary, Dr. Morin makes assumptions and calculations that are not reliable
14 enough to support a risk adjustment on the basis of S&P Business Risk Score rankings.

15 **V - PROPOSED CAPITAL STRUCTURE AND ROR**

17 **Q. DO YOU RECOMMEND ANY CHANGES TO THE CAPITAL STRUCTURE OF** 18 **ENO FOR PURPOSES OF THIS RATE CASE?**

19 **A.** I do not currently recommend any changes to the capital structure that ENO proposes be
20 used for determining the ROR for rate making purposes. However, that capital structure
21 was forecasted by ENO prior to ENO's filing of this rate case and, therefore, is
22 necessarily based on its then assumptions about 2008 earnings, capital investments,
23 working capital requirements and debt and equity financings. Naturally, those

1 assumptions about 2008 earnings, capital investments, working capital requirements and
2 debt and equity financings will be different in reality. Therefore, I recommend CNO
3 evaluate ENO's actual capital structure at December 31, 2008 prior to setting rates in this
4 proceeding. If ENO's actual capital structure is substantially different than the projected
5 capital structure, I recommend CNO consider using the actual capital structure for setting
6 rates.

7 **Q. DO YOU BELIEVE THE SAME CAPITAL STRUCTURE SHOULD BE USED**
8 **FOR ENO'S GAS UTILITY AND ITS ELECTRIC UTILITY?**

9 **A.** Yes. I believe the same capital structure should be used for the gas utility and the electric
10 utility. ENO's capital structure is representative of a typical natural gas distribution or
11 electric utility. Further, the source of financing for ENO's gas utility and electric utility
12 is the same.

13 **Q. DO YOUR RECOMMENDED CHANGES TO THE ROE FOR ENO'S GAS AND**
14 **ELECTRIC UTILITIES AFFECT THE RECOMMENDED ROR?**

15 **A.** Yes. First, unlike Dr. Morin, I am recommending a separate ROE for the gas utility and
16 the electric utility. This recommendation also results in a separate ROR for the gas utility
17 and the electric utility. Second, his recommendation of an ROE of 11.75% is different
18 than either of my recommendations for ROE. That is, I recommend an ROE of 10.32 %
19 for the gas utility and 11.07% for the electric utility.

20 I am not, at this time, recommending changes to ENO's capital structure or
21 weighted-cost of debt or preferred equity. However, because I am recommending a
22 different ROE for each of the gas and electric utility, the ROR is affected from that
23 change.

1 Dr. Morin recommends a ROR for ENO of 8.78%. Using ENO's capital structure
2 and my ROE recommendations of 10.32% and 11.07% for the gas utility and electric
3 utility, respectively, results in ROR recommendations of 8.08% and 8.45%.⁵
4

5 **VI - NET OPERATING LOSS CARRY-BACK**

6 **Q. PLEASE EXPLAIN THE CIRCUMSTANCES CREATING THE NOL CARRY-**
7 **BACK ISSUE.**

8 **A.** ENO incurred a net operating loss in 2005 of approximately \$203.1 million as a result of
9 damages suffered from Hurricane Katrina.⁶ Under the provisions of the Gulf Opportunity
10 ("GO") Zone Act of 2005, the Company was permitted to use these operating losses to
11 offset taxable income as far back as 1995. Through offsetting taxable income, ENO
12 received approximately \$71.1 million dollars in income tax refunds during September
13 2005 and April 2006.

14 **Q. WHAT IS THE CORRECT RATE MAKING TREATMENT FOR THESE**
15 **INCOME TAX REFUNDS?**

16 **A.** These income tax refunds should be flowed-back to ENO's ratepayers instead of being
17 retained by ENO's shareholders. The refunds should be provided to ratepayers because
18 the Company's income tax expense since 1995 has been included in ENO's revenue
19 requirements and, thus, paid by ratepayers through their utility rates. Therefore, because

⁵ ENO's proposed capital structure is presented in Section D, Statement DD-1, Page 1 of its filing. Using that capital structure with my ROE recommendations results in an ROR for the gas utility of 8.08% [8.08% = weighted cost of debt of 2.83% + weighted cost of preferred equity of 0.23% + weighted cost of equity of 48.66% * 10.32%] and for the electric utility of 8.45% [8.45% = weighted cost of debt of 2.83% + weighted cost of preferred equity of 0.23% + weighted cost of equity of 48.66% * 11.07%].

⁶ CNO Witness Mathai further discusses this issue in his testimony. CNO Witness Mathai also explains the derivation of an adjustment to provide the benefits from the NOL Carry-back to the ratepayers over a five-year period.

1 the proceeds of the income tax refunds have not previously been distributed to ratepayers
2 through either a refund or rate reduction, the proceeds should now be used to decrease
3 prospective revenue requirements and, thus, rates for ENO's ratepayers in the current rate
4 case.

5 **Q. HOW DO YOU KNOW THAT ENO HAS NOT RETURNED THESE REFUNDS**
6 **TO ITS CUSTOMERS?**

7 **A.** Subsequent to the receipt of the refunds in 2005 and 2006, ENO has not been subject to a
8 regulatory proceeding that culminated in the income tax refunds either being refunded to
9 ratepayers or used to lower their utility rates.

10 **Q. IS ENO FLOWING BACK THESE REFUNDS TO RATEPAYERS THROUGH**
11 **THIS CURRENT PROCEEDING?**

12 **A.** ENO's cost of service, used for determining its revenue requirements in this rate
13 proceeding, does not make ratepayers whole for the income tax refunds. The ratepayers
14 are receiving a partial benefit through ENO's current filing. CNO Witness Mathai is
15 proposing an adjustment to provide the full benefit of the \$71.1 million refund to
16 ratepayers over a five-year period.

17 **Q. WHY DO YOU SAY THE RATEPAYERS ARE RECEIVING A PARTIAL**
18 **BENEFIT?**

19 **A.** ENO responded to data request CNO 21-3, attached as Exhibit No. _____ (JMP-34), that
20 in 2005 it recorded the income tax refunds as credits among Account No. 190161,
21 Account No. 283531 and Account No. 282111. The Company contends that by recording
22 the refunds in these accounts, and using the related balances as rate base offsets in the
23 current case, results in the ratepayers receiving the benefits.

1 I acknowledge that if the full amount of the \$71.1 million refund is currently
2 recorded in those accounts with accrued interest, and the balances thereof are used to
3 decrease rate base and income tax expense through amortization, the ratepayers are
4 receiving the full benefit. However, that scenario is not consistent with ENO's filing.
5 That is, ENO's filing does not provide the aforementioned treatment for ratepayers.
6 CNO Witness Mathai will specify, and take into account the partial benefit ENO
7 proposes to flow to ratepayers, in the proposed adjustment explained in his testimony.

8 **Q. HOW DID YOU TRY TO DETERMINE WHETHER THE RATEPAYERS**
9 **RECEIVED THE BENEFITS?**

10 **A.** CNO 32-1 was submitted to ENO, attached as Exhibit No. ____ (JMP-35). In that data
11 request, it was asked in part (c) and part (d) for the rate base and expense treatment,
12 respectively, afforded the \$71.1 million refund in the current rate case. The Company did
13 not respond concerning the current regulatory treatment as requested. Instead, the
14 Company referred to an accounting entry made for the refund in 2005 and, specifically,
15 did not address how much, if any, of that amount was included to decrease rate base and
16 income tax expense in the current case.

17 **Q. HOW DO YOU PROPOSE TO ADDRESS THE INCOME TAX REFUND IN THIS**
18 **CASE?**

19 **A.** CNO Witness Mathai submitted data requests CNO 38-1 and CNO 38-2, attached as
20 Exhibit No. ____ (JMP-36) and Exhibit No. ____ (JMP-37), respectively. These requests
21 were written to ascertain the Company's ratemaking treatment for the refunds. ENO's
22 responses to these requests were received late in the afternoon on November 14, 2008.
23 CNO Witness Mathai has taken the information the Company provided in its response to

1 data request CNO 38-1 and CNO 38-2 and quantified an adjustment to ENO's cost of
2 service to incorporate the full benefit of the tax refund for ratepayers.

3
4 **VII - NET OPERATING LOSS CARRY-FORWARD**

5 **Q. PLEASE EXPLAIN THE CIRCUMSTANCES CREATING THE NOL CARRY-**
6 **FORWARD ISSUE.**

7 **A.** ENO has included approximately \$46.8 million of NOL Carry-forward in rate base for
8 the test year ending December 31, 2008. This amount is attributed to state and federal
9 operating losses incurred in previous years that are not expected to be used prior to
10 December 31, 2008 to decrease ENO's current income tax expense. The expected
11 balance for NOL Carry-forward for state and federal, separately, is approximately \$19.9
12 million and \$26.9 million, respectively, at December 31, 2008. For purposes of the
13 forecasted test year, these amounts are recorded in Account No. 190882 and Account No.
14 190881, respectively, and the total amount is included in ENO's filed rate base.

15 The NOL Carry-forward amounts represent a future income tax benefit that ENO
16 may use, as an income tax credit, to decrease future income tax expense. That is why the
17 amounts are recorded in asset accounts. However, ENO did not incur cash expenditures
18 with respect to the recording of these assets and, therefore, should not be allowed to earn
19 a return on the asset balances from including them in rate base and, in effect, collecting
20 this amount from ratepayers.

21 **Q. HAS ENO INCLUDED ANY RELATED ADIT CREDIT BALANCES IN RATE**
22 **BASE THAT OFFSET THE NOL CARRY-FORWARD BALANCES?**

1 A. In response to data request CNO 32-3 (e), attached as Exhibit No. ____ (JMP-38), ENO
2 acknowledges that it has included the NOL Carry-forward balances in rate base. ENO
3 also indicates that the NOL Carry-forward balances are offset by ADIT credit balances.

4 However, they did not provide the ADIT accounts, and balances thereof,
5 offsetting rate base as of December 31, 2008. Therefore, CNO Witness Mathai submitted
6 data request CNO 38-3, attached as Exhibit No. ____ (JMP-39) to confirm whether
7 ENO has indeed included any related ADIT offsets in rate base.

8 **Q. HOW DO YOU PROPOSE ADDRESSING THE NOL CARRY-FORWARD ISSUE**
9 **IN THIS RATE CASE?**

10 A. ENO's response to CNO 38-3 was received late in the afternoon on November 14, 2008.
11 The Company did not identify or provide any ADIT credit balances that related
12 specifically to its recording of the NOL Carry-forward asset. Therefore, CNO Witness
13 Mathai has quantified an adjustment to ENO's cost of service to incorporate the removal
14 of the \$46.8 million in NOL Carry-forward from rate base for the test year ending
15 December 31, 2008. His adjustment necessarily assumes that none of the \$46.8 million
16 of the NOL Carry-forward balance is offset by ADIT credit balances that related directly
17 to that NOL asset in ENO's rate base.

18 **Q. DO YOU HAVE ANY OTHER OBSERVATIONS RELATIVE TO THE NOL**
19 **CARRY-FORWARD ISSUE?**

20 A. Yes. The fact that the NOL Carry-forward should not be included in rate base is not the
21 only observation CNO should consider here. The \$46.8 million balance of the NOL
22 Carry-forward included in rate base, for the test year ending December 31, 2008, was
23 based on an estimate derived by ENO prior to filing its rate case in July 2008. According

1 to ENO's response to data request CNO 32-3 (c), attached as Exhibit No. ____ (JMP-
2 38), the Company's estimate, as of November 3, for the balance of the NOL Carry-
3 forward at December 31, 2008 is \$33.4 million [\$33.4 million = \$24.5 million (federal
4 balance) + \$8.9 million (state balance)]. Further, the Company's current estimate for the
5 balances of the NOL Carry-forward at December 31, 2009 and December 31, 2010 are
6 \$3.6 million [\$3.6 million = \$0.0 million (federal balance) + \$3.6 million (state balance)]
7 and \$0.0 million (federal and state balances each equal \$0.0 million), respectively.

8 The NOL Carry-forward balance ENO seeks to include in rate base for the test
9 year ending December 31, 2008 is \$46.8 million. Even if this were an asset that should be
10 included in rate base, which it is not, ENO could not support including that amount. That
11 is, ENO now expects the balance of the NOL Carry-forward to be only \$33.4 million at
12 test year end and only \$3.6 million one year later on December 31, 2009. This means
13 that less than one year after new rates are in place, after this rate case, the asset balance is
14 expected to be just \$3.6 million. Based on these expectations as to the NOL Carry-
15 forward balance, ENO cannot justify earning a return on a \$46.8 million asset in rate
16 base. If allowed to do so, the Company would earn that return level until the next rate
17 case which could be several years into the future.

18 **Q. DOES THAT CONCLUDE YOUR TESTIMONY?**

19 **A.** Yes, it does.

20

21

22

**BEFORE THE
COUNCIL OF THE CITY OF NEW ORLEANS**

**APPLICATION OF)
ENTERGY NEW ORLEANS, INC.)
FOR A CHANGE IN ELECTRIC)
AND GAS RATES PURSUANT TO)
COUNCIL RESOLUTION NO. R-06-459)**

DOCKET NO. UD-08-03

**REDIRECT TESTIMONY
OF
JAMES M. PROCTOR
ON BEHALF OF
THE ADVISORS TO
THE COUNCIL OF THE CITY OF NEW ORLEANS**

JANUARY 16, 2009

PREPARED REDIRECT TESTIMONY

OF

JAMES M. PROCTOR

1 **I. INTRODUCTION**

2 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

3 **A.** My name is James M. Proctor. My business address is 5555 West 6th Street, No. Q5,
4 Lawrence, Kansas 66049.

5 **Q. ARE YOU THE SAME JAMES M. PROCTOR WHO PREVIOUSLY FILED**
6 **DIRECT TESTIMONY IN THIS PROCEEDING?**

7 **A.** Yes, I am.

8 **Q. ON WHOSE BEHALF DO YOU APPEAR IN THIS PROCEEDING?**

9 **A.** I am presenting testimony on behalf of the Advisors to the Council of the City of New
10 Orleans (“Council” or “CNO”).

11 **Q. WHAT IS THE SCOPE OF YOUR REDIRECT TESTIMONY?**

12 **A.** My redirect testimony will address issues raised by Entergy New Orleans, Inc. (“ENO”)
13 Witness Dr. Roger Morin concerning ENO’s return on equity (“ROE”), capital structure
14 and rate of return on rate base (“ROR”) and provide updated findings and conclusions
15 concerning ENO’s ROE. Additionally, I provide redirect testimony to address issues

1 raised by ENO's Witnesses Messrs. Brian Caldwell, Rory Roberts and James Warren
2 concerning the Net Operating Loss ("NOL") carryforward and NOL carryback
3 adjustments proposed by CNO Witness Mathai.

4 **Q. PLEASE SUMMARIZE YOUR TESTIMONY AND MAJOR CONCLUSIONS OR**
5 **RECOMMENDATIONS.**

6 **A. Return on Equity Conclusions and Recommendations:**

7 I have found, when updating the ROE analysis performed by Dr. Morin, that his
8 recommendation for ENO's ROE is 10.84%. This compares to Dr. Morin's filed
9 recommendation of 11.75% based on his outdated analysis. Further, my updated analysis
10 and findings for ROEs for ENO's gas utility and electric utility are 9.25% and 9.93%,
11 respectively. The updated weighted-average ROE, based on Advisors' rate base, for
12 ENO's combined utility business is 9.79%.

13 My recommendations for ROE for ENO's gas utility and electric utility as filed
14 November 17, 2008 are 10.32% and 11.07 %, respectively. In that filing, the weighted-
15 average ROE for ENO's combined utility business is 10.91%. Based on the findings
16 from updating the filed ROE analyses of Dr. Morin and myself, I believe that my
17 previous ROE recommendations for ENO's gas utility and electric utility of 10.32% and
18 11.07 %, respectively, and the weighted-average ROE for ENO's combined utility
19 business of 10.91%, are all extremely reasonable and generous. That is, even the findings
20 from updating Dr. Morin's analysis result in an ROE of 10.84%, which is lower than the

1 weighted-average ROE for ENO's combined utility business of 10.91% based on my
2 November 17, 2008 analysis.

3 However, I believe CNO should find that choosing an ROE for ENO's gas utility
4 and electric utility, or the weighted-average for the combined utility, within the ranges
5 established with my previous and updated findings is certainly reasonable. Those ranges
6 for the gas utility, electric utility and combined utility are 9.25% to 10.32%; 9.93% to
7 11.07%; and 9.79% to 10.91%, respectively.

8 **NOL Carryback Conclusions and Recommendations:**

9 I believe CNO should accept CNO Witness Mathai's proposed modified adjustment with
10 respect to ENO's NOL carryback. That adjustment is discussed and supported in both his
11 and my redirect testimony. The arguments proposed in our redirect testimonies fully
12 support rejecting the rebuttal contentions of ENO's witnesses concerning this issue.

13 **NOL Carryforward Conclusions and Recommendations:**

14 I believe CNO should accept the adjustment with respect to ENO's NOL carryforward as
15 proposed in both my direct testimony and that of CNO Witness Mathai. The arguments
16 proposed in our direct and redirect testimonies fully support rejecting the rebuttal
17 contentions of ENO's witnesses concerning this issue.

18 **Q. HOW IS YOUR TESTIMONY ORGANIZED?**

19 **A.** My testimony is separated into four sections. Those sections are as follows.

1 **Section I - Updating the ROE Analyses and Recommendations**

2 I have completely updated the ROE analysis performed by Dr. Morin and myself to
3 incorporate more current financial information. In doing so, I used the same financial
4 models that he and I used in our testimonies filed on July 31, 2008 and November 17,
5 2008, respectively.

6 **Section II - Response to Arguments of Dr. Morin**

7 I respond to several arguments in Dr. Morin's rebuttal testimony that are either not
8 accurate statements about my direct testimony or include flawed content.

9 **Section III –Treatment of the \$71 Million GO Zone Tax Refund**

10 I provide additional explanation of the reasoning for the Advisors' proposed rate making
11 treatment of the Gulf Opportunity Zone ("GO Zone") Tax Refund. I explain the
12 reasoning supporting the Advisors' modifications to the NOL carryback adjustment. I
13 discuss the accounting and rate making for deferred income tax expense to rebut the
14 contentions of ENO's Witnesses and to support the adjustments proposed by the Advisors
15 for the NOL carryback and NOL carryforward. I also rebut the arguments of ENO's
16 Witnesses regarding the Advisors' NOL carryback adjustment.

17 **Section IV – Response to ENO's NOL Carryforward Arguments**

18 I rebut the arguments of ENO's Witnesses regarding the Advisors' NOL carryforward
19 adjustment.

1 **I - UPDATING THE RETURN ON EQUITY (“ROE”) ANALYSES AND**
2 **RECOMMENDATIONS**

3 **Q. WHAT REVISIONS HAVE YOU MADE TO THE VARIOUS ROE**
4 **CALCULATIONS PREVIOUSLY PERFORMED IN THIS PROCEEDING?**

5 **A.** I have completely updated the ROE analyses performed by Dr. Morin and myself in this
6 proceeding to incorporate more current financial information. In doing so, I used the
7 same financial models that we used in our respective direct testimonies and simply input
8 current interest rates, stock betas, dividend yields and earnings-growth estimates, all of
9 which are updated through January 2, 2009. Further, I used the same data sources each
10 of us used in our respective ROE analyses, such as Zack’s Investment Research and
11 Value Line Investment Service.

12 **Q. WHY DID YOU CHOOSE TO UPDATE THE ROE ANALYSES?**

13 **A.** A significant amount of time has passed since Dr. Morin filed his ROE analysis on July
14 31, 2008. Since that time, stock prices, dividend yields and interest rates have changed
15 significantly as a result of the current global economic crisis. In addition, natural gas and
16 electric utility betas have decreased due to the general stability of utility company stock
17 prices in relation to the stock market. All of these factors have had rather dramatic
18 effects on the ROE estimates both Dr. Morin and I derived using the Capital Asset
19 Pricing Model (“CAPM”), Risk Premium and Discounted Cash Flow (“DCF”) Models.

1 **Q. WHAT WERE THE RESULTS FROM UPDATING DR. MORIN'S ROE**
2 **ANALYSIS THROUGH JANUARY 2, 2009?**

3 **A.** I have presented my findings from updating Dr. Morin's ROE analysis in Exhibit No.
4 ____ (JMP-R2). On page 1 of that exhibit, I provide the results of updating the average
5 CAPM, Risk Premium and DCF analyses to 8.94%, 8.70% and 12.63%, respectively.
6 Using these updated findings, the average ROE under Dr. Morin's analysis is 10.09%
7 without his proposed risk adjustment. With his proposed risk adjustment of 0.75%, Dr.
8 Morin's updated ROE estimate is 10.84%. It is worth noting that this updated estimate of
9 ENO's ROE under Dr. Morin's analysis is considerably lower than Dr. Morin's
10 recommended ROE of 11.75% (which reflects his risk adjustment).

11 **Q. IN YOUR NOVEMBER 17, 2008 DIRECT TESTIMONY, YOU MADE CERTAIN**
12 **CORRECTIONS TO DR. MORIN'S ROE ANALYSIS BEFORE PROPOSING**
13 **YOUR RECOMMENDED ROE. WHAT WERE THOSE CORRECTIONS?**

14 **A.** In my direct testimony, I made (and explained) the following four revisions to Dr.
15 Morin's analysis:

16 (1) Removed the combination natural gas and integrated electric utilities from the
17 proxy group he used for integrated electric utilities in the DCF Models and
18 CAPMs;

19 (2) Used the yield on the 20-year Treasury Bond as the risk-free rate in the
20 CAPM and Risk Premium models instead of the 30-year Treasury Bond rate
21 used by Dr. Morin;

1 (3) Eliminated the prospective Market Risk Premium (“MRP”) from the
2 calculation of the MRP in the CAPMs; and

3 (4) Decreased his flotation-costs estimate from 5.0% to an after-tax cost of 2.4%.

4 **Q. WHAT WOULD BE THE REQUIRED ROE FOR ENO IF YOU MAKE THESE**
5 **CORRECTIONS TO DR. MORIN’S ANALYSIS AND UPDATE HIS ANALYSIS**
6 **THROUGH JANUARY 2, 2009?**

7 **A.** Exhibit No. _____(JMP-R3) contains the results of correcting and updating Dr.
8 Morin’s ROE analysis. In that exhibit, I show that Dr. Morin’s updated ROE analysis
9 produces an average CAPM of 8.63%, an average Risk Premium of 8.70% and an
10 average DCF of 11.84%. Based on these corrected and updated analyses, the average
11 ROE is 9.72% without Dr. Morin’s .75% risk adjustment and 10.47% with it.

12 **Q. IN YOUR DIRECT TESTIMONY, YOU PROPOSED AN ROE FOR ENO BASED**
13 **ON YOUR RECOMMENDED METHODOLOGY. HOW DID YOUR**
14 **METHODOLOGY DIFFER FROM DR. MORIN’S ROE ANALYSIS?**

15 **A.** In my direct testimony, I recommended that the Council adopt my ROE analysis -- which
16 reflected my proposed corrections to Dr. Morin’s analysis mentioned above as well as the
17 following additional changes:

18 (1) Replace Dr. Morin’s sample of combination gas and electric utilities with
19 a sample of natural gas distribution companies;

- 1 (2) Use both the 13-week Treasury Bill rate and the yield on the 20-year
2 Treasury Bond as the risk-free rate in the CAPM;
- 3 (3) Reject the Empirical CAPM (“ECAPM”) approach; and
- 4 (4) Reject the Allowed Risk Premium approach.

5 **Q. WHAT WOULD BE YOUR PROPOSED ROE IF YOU ALSO UPDATE YOUR**
6 **ANALYSIS THROUGH JANUARY 2, 2009?**

7 **A.** Exhibit No. _____ (JMP-R17) contains the results from updating my previously-filed
8 ROE analysis. As reflected therein, my updated ROE analysis would result in ROEs of
9 8.81% and 9.21% for ENO’s gas and electric utilities, respectively. These updated
10 findings are based on my analysis before considering risk adjustments of 0.44% and
11 0.72% for ENO’s gas and electric utilities, respectively. If you include these risk
12 adjustments, the ROEs would be 9.25% and 9.93% for ENO’s gas and electric utilities,
13 respectively. Based on the Advisors’ recommended rate base, the weighted-average ROE
14 for ENO’s combined utility businesses is 9.79% { $9.79\% = [(\$287,495,000)(9.93\%) +$
15 $(\$71,992,000)(9.25\%)] \div [\$359,487,000]$ }.

16 **Q. WHAT ROE DID YOU RECOMMEND IN YOUR DIRECT TESTIMONY FOR**
17 **ENO’S GAS AND ELECTRIC UTILITIES?**

18 **A.** In my direct testimony, I recommend an ROE of 10.32% for ENO’s gas utility and
19 11.07% for its electric utility. The weighted-average ROE for ENO’s combined gas and
20 electric utility businesses is 10.91%.

1 **Q. PLEASE SUMMARIZE YOUR FINDINGS WITH RESPECT TO UPDATING**
2 **YOUR AND DR. MORIN'S ROE ANALYSES AND RECOMMENDATIONS?**

3 **A.** Updating the ROE analysis contained in Dr. Morin's direct testimony results in a 10.84%
4 ROE for ENO, which is significantly lower than his recommended ROE of 11.75%.
5 Updating my analysis and findings results in ROEs of 9.25% and 9.93% for ENO's gas
6 and electric utilities, respectively. Using the Advisors' recommended rate base, the
7 updated, weighted-average ROE would be 9.79%.

8 In my direct testimony, I recommend ROEs for ENO's gas and electric utilities of
9 10.32% and 11.07%, respectively -- which would result in a 10.91% weighted-average
10 ROE for ENO's combined gas and electric utility businesses. Based on the results from
11 updating both my and Dr. Morin's ROE analyses, I believe my previous ROE
12 recommendations for ENO's gas utility and electric utility of 10.32% and 11.07%,
13 respectively, and the weighted-average ROE for ENO's combined utility businesses of
14 10.91% are all extremely reasonable and generous. In fact, Dr. Morin's updated analysis
15 would result in a weighted-average ROE of 10.84%, which is lower than my 10.91%
16 weighted-average ROE. Accordingly, I believe the Council could reasonably choose an
17 ROE for ENO's gas utility and electric utility, or a weighted-average ROE for the
18 combined utility, from the range of ROEs established from those recommended in my
19 direct testimony and updated ROE analysis. The resulting ROE ranges are 9.25% to
20 10.32% for ENO's gas utility, 9.93% to 11.07% for ENO's electric utility, and 9.79% to
21 10.91% for ENO's combined gas and electric utilities.

1 **II - RESPONSE TO ARGUMENTS OF DR. MORIN**

2 **Q. HOW DO YOU RESPOND TO ARGUMENTS MADE BY DR. MORIN IN HIS**
3 **REBUTTAL TESTIMONY?**

4 **A.** Several of the arguments put forth in Dr. Morin's rebuttal testimony are either inaccurate
5 statements about my direct testimony or are flawed. In addition, many of his arguments
6 are simply a reprise of the arguments included in his July 31, 2008 direct testimony,
7 which I addressed in my November 17, 2008 direct testimony. Therefore, for purposes of
8 efficiency I will not specifically respond to all the arguments offered in his rebuttal
9 testimony with which I disagree. Instead, to the extent I do not specifically address Dr.
10 Morin's remonstrations I will rely on the arguments put forth in my direct testimony.

11 **Q. WHAT CONCERNS DID DR. MORIN HAVE WITH THE**
12 **RECOMMENDATIONS PUT FORTH IN YOUR DIRECT TESTIMONY?**

13 **A.** According to Dr. Morin, my ROE recommendation understates an appropriate ROE for
14 ENO for the following reasons:

- 15 • Using the 13-week Treasury Bill yields instead of 30-year Treasury Bond yields
16 understates the CAPM estimates;
- 17 • Relying on CAPM alone, as opposed to both CAPM and ECAPM, results in
18 understated return requirements for low-beta firms, such as ENO;
- 19 • Eliminating the market-pressure component of flotation costs results in the under
20 recovery of legitimate costs;

- 1 • Limiting ENO’s recoverable direct flotation costs to its after-tax costs results in
2 an inappropriate tax treatment for these costs;
- 3 • Using beta to determine ENO’s risk-premium adjustment is inappropriate; and
- 4 • Developing separate ROEs for ENO’s gas and electric utilities produces an
5 understated gas ROE for ENO.

6 **Q. WHICH OF DR. MORIN’S CONCERNS DO YOU INTEND TO RESPOND TO IN**
7 **YOUR REDIRECT TESTIMONY?**

8 **A.** I will respond to each of the above-enumerated concerns expressed in Dr. Morin’s
9 rebuttal testimony.

10 **Q. WHY DID YOU USE THE 13-WEEK TREASURY-BILL YIELD AS ONE OF**
11 **THE TWO PROXIES FOR THE RISK-FREE RATE IN THE CAPM ANALYSIS?**

12 **A.** I used the 13-week Treasury-Bill yield as the risk-free rate in the CAPM analysis because
13 the return on this short-term security more closely represents a risk-free rate than the
14 returns on long-term treasury issuances.

1 **Q. DOES DR. MORIN AGREE WITH YOUR OPINION THAT THE YIELD ON**
2 **THE 13-WEEK TREASURY BILL IS THE CLOSEST APPROXIMATION OF**
3 **THE RISK-FREE RATE?**

4 **A.** Yes. In his rebuttal testimony, Dr. Morin readily acknowledges that “the yield on 90-day
5 Treasury Bills is virtually riskless.”¹ However, he attempts to blunt the significance of
6 this acknowledgement by also contending that yields on 13-week Treasury Bills may
7 fluctuate widely and therefore produce unreliable ROE returns.

8 **Q. DO YOU AGREE THAT THE YIELDS ON 13-WEEK TREASURY BILLS CAN**
9 **BE SUBJECT TO FLUCTUATIONS?**

10 **A.** Yes. I agree that the short-term nature of these securities makes them susceptible to
11 fluctuations. In fact, it is for this very reason that I did not use the yield on the 13-week
12 Treasury Bill as the sole proxy for the risk-free rate in the CAPM analysis.

13 **Q. PLEASE EXPLAIN.**

14 **A.** As stated in my direct testimony, I used two proxies for the risk-free rate in the CAPM
15 analysis: the yield on the 13-week Treasury Bill and the yield on the 20-year Treasury
16 Bond. I used the yield on the 13-week Treasury Bill as one of the proxies because it most
17 closely approximates the risk-free rate, and, due to its short-term nature, is subject to little
18 or no interest rate risk. However, because the yield is susceptible to fluctuation, using it
19 as the sole proxy for the risk-free rate in the CAPM analysis could result in excessive or

¹ Morin Rebuttal Testimony at 7:20.

1 insufficient ROE estimates for rate making if it changes significantly after the time rates
2 are established.

3 Consequently, in an attempt to capture the risk-free characteristics of the 13-week
4 Treasury Bill but yet counteract its vulnerability to fluctuations, I employed the yield on
5 the 20-year Treasury Bond as a second proxy for the risk-free rate in the CAPM analysis.

6 **Q. WHY DID YOU NOT SIMPLY USE THE YIELD ON THE 20-YEAR TREASURY**
7 **BOND AS THE RISK-FREE RATE FOR THE CAPM?**

8 **A.** I did not simply use the yield on the 20-year Treasury Bond because it is subject to
9 inflation and interest-rate risk. Therefore, it is not risk-free. However, when it is
10 averaged with the yield on the 13-week Treasury Bill, averaging helps to eliminate the
11 deficiencies captured in the these yields when used separately.

12 **Q. DR. MORIN SUGGESTS THAT YOUR USE OF THE 13-WEEK TREASURY**
13 **BILL RATE AS ONE OF YOUR PROXIES FOR THE RISK-FREE RATE**
14 **SHOULD BE REJECTED BECAUSE THE RESULTS OF THAT ANALYSIS**
15 **REPRESENT OUTLIERS. HOW DO YOU RESPOND TO THAT ARGUMENT?**

16 **A.** As I explained above, use of the yield on the 13-week Treasury-Bill is perfectly sound.
17 Dr. Morin's remonstrations are unfounded. Presumably, he believes just because the
18 results from using the yield on the 13-week Treasury Bill are lower than the other
19 models, one should assume those results have no meaningful input into the ROE analysis.
20 However, that is not a legitimate basis for rejecting results derived using a theoretically
21 sound model.

1 It is worth noting that if Dr. Morin's rationale were applied to his updated ROE
2 analysis, his updated DCF results would have to be rejected as outliers. As mentioned
3 previously in Section I of my redirect testimony, I have updated the financial inputs to
4 Dr. Morin's ROE calculations through January 2, 2009. When allowing for flotation
5 costs, as proposed by Dr. Morin, updating his analyses through January 2, 2009 produces
6 the following results:²

- 7 1) Average CAPM results of 8.94%;
- 8 2) Average Risk Premium Model results of 8.70%;
- 9 3) Average DCF Model results of 12.63%; and,
- 10 4) Overall Average ROE results of 10.09%.

11 Accordingly, based on Dr. Morin's rationale, the results from his DCF model
12 would have to be rejected as outliers.

13 **Q. WHAT COMMENTS DO YOU HAVE WITH RESPECT TO DR. MORIN'S**
14 **STATEMENTS CONCERNING YOUR USE OF THE CAPM?**

15 **A.** On page 9, lines 14-15, of Dr. Morin's rebuttal testimony, he says that he disagrees with
16 my using the "plain vanilla" CAPM for estimating the cost of capital. I found this
17 statement confounding because Dr. Morin used the "plain vanilla" CAPM in his analysis
18 of ENO's cost of capital.

² The results here are before considering Dr. Morin's recommendation for a 75 basis point risk adjustment. With his risk adjustment, the overall updated ROE is 10.84%.

1 **Q. WHAT ARE FLOTATION COSTS?**

2 **A.** Flotation costs relate to incremental costs incurred from the issuance of common stock.
3 These costs include direct expenses -- such as costs for accounting, marketing,
4 consulting, administrative and legal services -- incurred from the issuance. Dr. Morin
5 believes flotation costs also have an indirect component, representing “downward
6 pressure on the stock price as a result of the increased supply of stock from the new
7 issue.”³ He refers to this indirect cost as “market pressure.”

8 **Q. WHAT ARE YOUR RECOMMENDATIONS WITH RESPECT TO FLOTATION**
9 **COSTS?**

10 **A.** I agree that the direct component of flotation costs relates to cash expenditures paid by
11 Entergy for expenses incurred for issuing its common stock. These cash expenditures are
12 deductible on the income tax return as operating expenses. As a result, Entergy receives
13 a tax benefit for these direct expenses. When this tax benefit is taken into account, the
14 “after-tax” cost to ENO for these direct expenses is approximately 2.4% of the issuance
15 amount, not 4.0% as claimed by Dr. Morin.

16 There is a possibility that ENO has recovered some or all of these direct costs (*i.e.*, if they
17 were allocated to them by Entergy) as an operating expense through its cost of service. If
18 so, those same direct costs should not also be recovered through its ROE. As of the
19 preparation of my redirect testimony, I am unsure whether these direct costs have indeed
20 been recovered previously by ENO as an operating expense. However, I am currently

³ Morin direct testimony at 49:7-8.

1 awaiting ENO's response to an Advisors' data request CNO-48-4, which should provide
2 the answer.⁴

3 If ENO has historically recovered these direct costs as an operating expense
4 through its cost of service, I recommend that the full flotation cost allowance referenced
5 in Dr. Morin's direct testimony be disallowed. In the event ENO's response to CNO-48-
6 4 confirms that floatation costs have been recovered as operating expenses, I will present
7 revisions to my ROE recommendations. Further, I propose to eliminate the indirect costs
8 attributed to "market pressure" altogether.

9 **Q. HOW DO YOU RESPOND TO DR. MORIN'S COMMENTS CONCERNING**
10 **YOUR ELIMINATION OF THE INDIRECT COMPONENT OF FLOTATION**
11 **COSTS?**

12 **A.** Dr. Morin alleges that when new shares of common stock are placed in the market, the
13 stock price should decrease by approximately 1% of the amount of the issuance proceeds
14 due to "market pressure." I agree that the issuance of new shares into the market could
15 have a downward impact on the stock price. However, if the cash proceeds from the
16 issuance of those shares are invested in assets yielding an expected return at or above the
17 opportunity cost of that investment, then that investment should not negatively impact the
18 stock price in the long-run. In the short-run, there may be some downward pressure on
19 the stock price as investors judge the credibility of how the proceeds are invested, but the
20 initial downward pressure should ultimately be offset if the proceeds are invested wisely.

⁴ CNO data request CNO-48-4 is attached hereto as Exhibit No. _____ (JMP-R34).

1 Perhaps, the simplest way to understand the relevance, or lack thereof, of market
2 pressure to the long-term price of stock is to ask the following question -- Why would a
3 company issue common stock for financing a project if it expected the price of its stock
4 to decline as a result of the issuance? Under that scenario, the shareholders would be
5 better off if the project was not undertaken and the stock was not issued, thus avoiding
6 the downward pressure on its current stock price.

7 **Q. WHAT IS YOUR RESPONSE TO DR. MORIN'S ARGUMENT THAT**
8 **FLOTATION COSTS ARE NEITHER EXPENSED ON THE INCOME**
9 **STATEMENT NOR DEDUCTED FOR INCOME TAX PURPOSES?**

10 **A.** I find this statement perplexing given ENO's response to CNO-35-1, which is attached
11 hereto as Exhibit No. ____ (JMP-R33). Specifically, in response to CNO-35-1 (ii),
12 ENO clearly states that costs for issuing common stock include costs for marketing
13 services, consulting services, accounting services, legal services, investment banking
14 services and miscellaneous expenses. Those costs are all expensed on an income
15 statement and deducted for income tax purposes.

16 **Q. DID DR. MORIN MISREPRESENT THE BETA YOU USED IN CALCULATING**
17 **YOUR RISK ADJUSTMENT?**

18 **A.** Yes. On page 17, line 1 of his rebuttal testimony, Dr. Morin alleged that I used Entergy's
19 beta to calculate my risk adjustment. This statement is patently false. As stated on page
20 27, lines 18 through 22 of my direct testimony, I calculated my risk adjustment by
21 evaluating the average beta and standard deviation for my gas utility sample and the

1 average beta and standard deviation for my electric utility sample. I did not use
2 Entergy's beta.

3 **Q. DR. MORIN CRITICIZES YOUR DEVELOPMENT OF SEPARATE ROES FOR**
4 **ENO'S GAS AND ELECTRIC UTILITIES. DO YOU HAVE ANY GENERAL**
5 **COMMENTS ABOUT HIS ARGUMENTS?**

6 **A.** Yes. Dr. Morin seems to believe that the cost of equity for a natural gas utility and an
7 electric utility are interchangeable because, in his opinion, their risks are virtually the
8 same. As a result, he claims it was inappropriate for me to develop separate ROEs for
9 ENO's gas and electric utilities, respectively. However, if, as he claims, both electric and
10 gas utilities have virtually equal risk, Dr. Morin fails to explain how establishing separate
11 ROE analyses for ENO's gas and electric utilities, respectively, yielded materially
12 different results. That is, my use of a sample of natural gas utilities to determine an ROE
13 for ENO's gas utility business and a sample of electric utilities to determine an ROE for
14 ENO's electric utility business yielded ROEs of 10.32% and 11.07% for ENO's gas and
15 electric utilities, respectively.

16 To further examine his argument, let us assume instead of undertaking an ROE
17 analysis for ENO, one did an ROE analysis for any of the natural gas utilities in my
18 sample of natural gas utilities. If that analysis were completed, the ROE determined
19 under my models and that sample would be 10.32%. Yet, let's assume a cost of capital
20 analyst adopted Dr. Morin's apparent opinion that the cost of equity for a natural gas
21 utility and an electric utility are interchangeable and, therefore, used that conclusion to

1 recommend that the natural gas utility be awarded an ROE of 11.07% based on a sample
2 of electric utilities. I do not believe that analyst's testimony would be well received by a
3 regulatory body.

4 **III - TREATMENT OF THE \$71 MILLION GO ZONE TAX REFUND**

5 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY REGARDING THE**
6 **TREATMENT OF THE \$71 MILLION TAX REFUND?**

7 **A.** The purpose of this testimony is to respond to testimony given by Rory Roberts and
8 James Warren on behalf of ENO regarding the treatment of the \$71 million tax refund
9 received by ENO as a result of the Gulf Opportunity ("GO") Zone Act of 2005. As has
10 been discussed in prior testimony by myself and others in this proceeding, ENO incurred
11 a net operating loss in 2005 of approximately \$203.1 million as a result of damages
12 suffered from Hurricane Katrina. Under the provisions of the GO Zone act, ENO was
13 permitted to use these operating losses to offset taxable income as far back as 1995. By
14 offsetting taxable income in earlier years with tax deductions for Katrina casualty losses,
15 repairs deduction and additional accelerated depreciation, ENO received approximately
16 \$71.1 million in income tax refunds in September, 2005 and April, 2006.

17 CNO Witness Mathai and I have proposed a rate making treatment for this \$71
18 million income tax refund. Messrs. Roberts and Warren contend that tax and financial
19 reporting requirements make our proposal ill-advised. I give this testimony to explain
20 why the proposal made by CNO Witness Mathai and me is the appropriate treatment,
21 why Messrs. Roberts and Warren's criticisms of our proposal reflect a misunderstanding

1 of rate making and are without merit, and why ENO's proposed treatment of the GO
2 Zone tax refund is unreasonable and unfair to the citizens and ratepayers of New Orleans.

3 **Q. WHAT DO MESSRS. ROBERTS AND WARREN SAY ABOUT ENO'S**
4 **PROPOSAL FOR THE \$71 MILLION GO-ZONE TAX REFUND?**

5 **A.** Messrs. Warren and Roberts claim that the refunds should not be returned to ratepayers,
6 and instead that ENO should retain all of the \$71 million tax refund. Messrs. Warren and
7 Roberts propose that ENO offset rate base by the amount it considers cost-free capital
8 from the refund. However, and as we explain below, Mr. Warren at least does not appear
9 to recognize that ENO's proposal also flows the refund back to the ratepayers (just over a
10 longer period of time than the advisors' proposal). (Mr. Roberts' testimony on the point
11 is conflicting).

12 **Q. DO YOU AGREE WITH ENO'S PROPOSED RATE MAKING TREATMENT OF**
13 **THE \$71 MILLION GO-ZONE TAX REFUND?**

14 **A.** No.

15 **Q. WHY DO YOU DISAGREE, AND WHAT DO YOU PROPOSE AS THE PROPER**
16 **RATE MAKING TREATMENT OF THE \$71 MILLION GO-ZONE TAX**
17 **REFUND?**

18 **A.** These income tax refunds should be flowed back to ENO's ratepayers instead of being
19 retained by ENO's shareholders. The refunds should be provided to ratepayers because
20 the Company's income tax expense since 1995 has been included in ENO's revenue

1 requirements and thus has been paid by ratepayers through their utility rates. The only
2 fair treatment of the refund is to return to the ratepayers the taxes they already have paid.
3 Therefore, because the proceeds of the income tax refunds previously have not been
4 distributed to ratepayers either through a refund or a rate reduction, the proceeds should
5 now be used to decrease prospective revenue requirements and thus decrease the rates for
6 ENO's ratepayers in the current rate case.

7 As the Council considers the two proposals, it is important to bear in mind that,
8 despite the protests of their witnesses, ENO's proposal would in fact also flow back to the
9 ratepayers the amount of the refund, a point that I explain in detail below. The issue is
10 not, then, as presented by ENO's witnesses, whether or not to flow back the refund to the
11 ratepayers; the issue is how long it will take ENO to flow it back. CNO Witness Mathai
12 and I have proposed that ten (10) years is reasonable. ENO would like to do it over 40-
13 48 years, by which time the ratepayers who originally paid the taxes will have moved
14 away, or died, or closed their businesses. ENO seeks to justify the self-serving snail's
15 pace of its proposed return on the theory that the refund should be returned over the life
16 of the timing differences that gave rise to the refund. But even Mr. Roberts concedes that
17 at this point in time ENO has not even been able to determine the period of time over
18 which the biggest component of the refund, the repair costs, will amortize (the tax benefit
19 was valued at December 31, 2008 as approximately \$29,125,372). (Roberts December
20 30, 2008 deposition transcript at 34:17-24). Indeed, over half of the repair cost
21 amortization may already have turned around. (*Id.* at 38:9-40:4).

1 There is no legal rule or regulatory principle that requires ENO to take half a
2 lifetime to return the GO Zone refund to its customers. There is no legal rule or
3 regulatory principle that requires ENO to flow the portion of the refund attributable to
4 casualty losses and repair costs back to its customers consistent with the life of timing
5 differences related to those costs. ENO is simply voluntarily choosing to propose to do
6 so, perhaps so that it can retain much of the benefit of the refund for its shareholders.
7 This choice is not reasonable. The citizens and businesses that originally paid the taxes
8 in 1995-2004 through their utility rates should enjoy the benefit of the return of those
9 taxes -- not whom ever may be an ENO customer at mid-century. The ratepayers who
10 already paid these taxes should receive their refund over a period of time no longer than
11 the period over which they paid the taxes in the first place.

12 **Q. HOW DO YOU KNOW THAT ENO HAS NOT RETURNED THESE FUNDS TO**
13 **ITS CUSTOMERS?**

14 **A.** Subsequent to the receipt of the refunds in 2005 and 2006, ENO has not been subject to a
15 regulatory proceeding that culminated in the income tax refunds either being refunded to
16 ratepayers or being used to lower their utility rates.

17 **Q. BASED ON NEW INFORMATION, ARE YOU NOW RECOMMENDING**
18 **CHANGES TO THE NOL CARRYBACK ADJUSTMENT PROPOSED IN THE**
19 **ADVISORS DIRECT TESTIMONY FILED ON NOVEMBER 17, 2008?**

20 **A.** Yes. CNO Witness Mathai has re-calculated the recommended adjustment based on new
21 information provided: (1) by ENO one business day before CNO Witness Mathai and I

1 filed our direct testimony, which we accordingly were not able to completely digest and
2 incorporate in our original testimony; (2) in ENO's rebuttal testimony; and (3) in
3 subsequent depositions of ENO's witnesses. CNO Witness Mathai explains in his
4 redirect testimony the extent to which ENO has amended information, corrected
5 information and provided important information in a piecemeal manner since September
6 9, 2008, thereby significantly hindering our ability to evaluate this matter and ENO's
7 proposals.

8 **Q. WILL YOU PLEASE SUMMARIZE YOUR MODIFICATIONS TO THE**
9 **ADJUSTMENT?**

10 **A.** After reviewing all the newly provided information and performing further analysis, I am
11 proposing the following modifications to the recommendations to the NOL Carryback
12 adjustment made in the testimony provided by CNO Witness Mathai and me on
13 November 17, 2008:

- 14 1) Removing the interest-related component of the refunded amount;
- 15 2) Removing the portion of the refunded amount related to liberalized
16 depreciation;
- 17 3) Providing for a 10-year amortization for the payback of the
18 remainder of the income tax refund instead of the initially
19 proposed five (5) year period;
- 20 4) Using a mid-year convention in calculating the average un-
21 refunded balance; and,
- 22 5) Adjusting the starting ADIT liability balance to the Company's
23 corrected balance for December 31, 2008.

1 **Q. WHY ARE YOU PROPOSING TO REMOVE THE INTEREST COMPONENT?**

2 **A.** In the adjustment originally proposed, the Advisors added an interest component to the
3 refunded amount to be flowed back to the ratepayers. The intent was to make the
4 ratepayers whole for the time value of the full amount of the refund during the period
5 between ENO's receipt of the \$71 million from the government and its eventual return of
6 these funds through utility rates, to the customers who originally paid these taxes through
7 their utility rates.

8 Subsequent to filing our direct testimony, CNO Witness Mathai and I received
9 significant additional information from ENO. This included the belated production by
10 ENO of significant information in discovery, the rebuttal testimony of ENO's witnesses,
11 and the deposition testimony of those witnesses. From this new information -- much of
12 which could have and should have been provided well before our initial November 17,
13 2008 testimony -- CNO Witness Mathai and I have determined that ENO appears to be
14 treating the income tax refund properly for financial accounting purposes. We also have
15 determined that, as explained above, ENO's proposal would in fact also flow back to the
16 ratepayers the amount of the refund, just over a longer period of time. With ENO now
17 having clarified that its proposed treatment also flows the refund back to the ratepayers,
18 CNO Witness Mathai and I now have decided that our original proposed interest
19 component is no longer necessary to make the ratepayers whole.

1 **Q. WHY HAVE YOU REMOVED THE AMOUNT RELATED TO LIBERALIZED**
2 **GO ZONE DEPRECIATION?**

3 **A.** Under the provisions of the GO Zone Act, ENO was permitted to apply operating losses
4 to offset taxable income as far back as 1995. ENO received approximately \$71.1 million
5 dollars in income tax refunds during September 2005 and April 2006, and credited that
6 amount to an ADIT liability account. After making corrections and removing previous
7 years' amortizations of that balance, I have determined through discovery and ENO's
8 rebuttal testimony that the estimated balance for the ADIT liability at December 31, 2008
9 is approximately \$60.7 million.

10 Out of the balance for the ADIT liability at December 31, 2008 of approximately
11 \$60.7 million, approximately \$2.6 million pertains to the additional accelerated
12 (liberalized) depreciation to be carried back to previous income tax years pursuant to the
13 GO Zone Act.

14 Generally, the Internal Revenue Code requires timing differences related to
15 accelerated depreciation to be reversed over the life of the book-tax timing difference.
16 Otherwise, the Internal Revenue Service could deny a taxpayer use of liberalized
17 depreciation for income tax purposes, prospectively. Although I am not convinced that
18 this rule applies to the specific circumstances of the GO Zone income tax refund, out of
19 an abundance of caution I am proposing to eliminate the portion of the adjustment related
20 to the book-tax timing differences for depreciation.

1 **Q. WHY HAVE YOU INCREASED THE AMORTIZATION PERIOD FROM FIVE**
2 **(5) YEARS TO TEN (10) YEARS?**

3 **A.** The two reasonable choices for a period of time over which to return to the ratepayers the
4 taxes they had previously paid through their utility rates in 1995-2004 would be the two
5 carryback periods provided in the GO Zone legislation: five (5) years (for NOL resulting
6 from Katrina repairs and liberalized depreciation) or ten (10) years (for NOL resulting
7 from Katrina casualty losses). The ten (10) year period has the additional justification of
8 being the same period over which the underlying taxes now being refunded were paid by
9 the ratepayers through their rates. Plainly the 40-48 year flow back proposed by ENO is
10 grossly unfair to the ratepayers of New Orleans, and would guarantee that almost all of
11 the ratepayers who paid these taxes in 1995-2004, through their utility payments, would
12 never be fully reimbursed. Therefore we initially proposed five (5) years because it was
13 reasonable, would be equitable to the ratepayers and impose no hardship on ENO and, I
14 am advised, is in accord with analogous case-law authority. In response, ENO has
15 contended that a five (5) year flow back would leave ENO without a reasonable rate of
16 return. Therefore we have determined to relax the advisors' proposal to a ten (10) year
17 flow back, in order not to unduly burden ENO's cash flows. I note that, at least as a
18 matter of theory, the present value of the benefit to ratepayers under a five (5) year
19 amortization period is the same as for a ten (10) year amortization, because CNO Witness
20 Mathai and I also propose to decrease rate base by the average balance of the
21 unamortized liability during the amortization period. Because rate making is a discrete

1 rather than a continuous process, the present value benefit for ratepayers under the two
2 methods, while not identical, is reasonably close.

3 However, using the five (5) year amortization period may create a cash flow
4 impact to ENO that is not necessary to treat ratepayers fairly. Therefore, the Advisors
5 make this concession to help sustain ENO's cash flow in the near term.

6 **Q. WHY ARE YOU NOW PROPOSING TO USE THE MID-YEAR CONVENTION**
7 **FOR COMPUTING THE AVERAGE UNAMORTIZED BALANCE OF THE**
8 **LIABILITY?**

9 **A.** In direct testimony, the Advisors calculated the average balance for the unamortized
10 liability portion of the refund, without including the ending balance after year five (5) in
11 the calculation. CNO Witness Mathai has included the ending balance of year ten in his
12 currently proposed adjustment. CNO Witness Mathai and I each believe this revision to
13 the calculation provides a more reasonable amount to be subtracted from rate base.

14 **Q. WHY ARE YOU NOW REVISING THE BEGINNING BALANCE FOR THE**
15 **ADIT LIABILITY?**

16 **A.** The balance for the ADIT liability at December 31, 2008 is now estimated at
17 approximately \$60.7 million. In arriving at this amount, CNO Witness Mathai modified
18 his calculations based on new information provided by: (a) ENO, one business day before
19 CNO Witness Mathai and I filed our direct testimony; (b) ENO's rebuttal testimony; and
20 (c) subsequent deposition testimony of ENO witnesses.

1 **Q. MESSRS. ROBERTS AND WARREN CRITICIZE THE ADVISORS FOR**
2 **PROPOSING TO GIVE THE RATEPAYERS THE BENEFIT OF THE \$71**
3 **MILLION GO-ZONE TAX REFUND. IS THAT CRITICISM FAIR?**

4 **A.** No, it is not fair to suggest that it is improper to give the ratepayers the benefit of the \$71
5 million tax refund. This criticism reflects a lack of understanding of rate making by
6 Messrs. Warren and Roberts. After all, ENO proposes to deduct the remaining portion of
7 the refund from its rate base, and to amortize the reduction over varying periods of time:
8 forty (40) years for the casualty loss portion of the NOL carryback, which at December
9 31, 2008 had a balance of about \$28,901,323; forty (40) years for the electric property
10 liberalized depreciation, which at December 31, 2008 had a balance of about \$1,783,708;
11 forty-eight (48) years for the gas property liberalized depreciation, which at December
12 31, 2008 had a balance of about \$865,377; and an indeterminate period for the GO Zone
13 repair deduction, which at December 31, 2008 had the largest balance of all, about
14 \$29,125,372. (Roberts December 12, 2008 at page 18; Exhibit ENO BWC-16 at page 5).
15 Therefore, as even Mr. Roberts concedes, the ratepayers will receive the benefit, via
16 reduced rates, over those periods of time. (Roberts December 15, 2008 testimony at page
17 18). While Mr. Warren was adamant at his deposition that it would be improper to give
18 the ratepayers the benefit of the tax refund, he did not seem to grasp that ENO's approach
19 does just that, simply over a longer period of time: 40-48 years, as opposed to ten (10).

20 To understand why the advisors' proposal is more appropriate and fair to all
21 parties, we need to understand and properly apply deferred income tax expense.

1 **Q. WHAT IS DEFERRED INCOME TAX EXPENSE?**

2 **A.** Deferred income tax expense is an income statement account included in determining the
3 net income of a company. This is true whether the company is a utility or not. Deferred
4 income tax expense is also a concept that is used in rate making. However, it is used
5 differently for rate making and financial reporting purposes. These differences are
6 important for the City Council's assessment of the proposals before it for the treatment of
7 the \$71 million GO Zone tax refund.

8 **Q. WHICH TREATMENT OF DEFERRED INCOME TAX EXPENSE SHOULD**
9 **THE COUNCIL USE HERE?**

10 **A.** This is a rate making proceeding. Therefore, the treatment of deferred income tax
11 expense that matters here is its treatment for rate making purposes.

12 **Q. WHEN SETTING UTILITY RATES, IS THE COUNCIL CONSTRAINED BY**
13 **FINANCIAL ACCOUNTING TREATMENTS OF DEFERRED INCOME TAX**
14 **EXPENSE?**

15 **A.** No. The Council is not required to follow financial accounting standards for the
16 treatment of deferred income tax expense when establishing regulatory rates. I am aware
17 of no regulations or other legal requirements that CNO do so. To the contrary, it is
18 standard industry practice not to follow financial accounting standards for the treatment
19 of deferred income tax expense when following such standards would lead to an
20 unreasonable or unjust result in rate making. I note that Messrs. Warren, Roberts and
21 Caldwell were unable in their depositions to identify any legal requirement that the

1 council follow financial accounting standards for the treatment of deferred income tax
2 expense when rate-making.⁵

3 **Q. WHAT IS ACCUMULATED DEFERRED INCOME TAX?**

4 **A.** Accumulated deferred income tax (“ADIT”) is a balance sheet account that usually is a
5 liability, with a credit balance. ADIT can also be an asset, with a debit balance. That is
6 to say, when an entry is made on the income statement for deferred income tax expenses,
7 a corresponding entry is recorded in ADIT for the same amount.

8 **Q. ARE THERE DIFFERENCES IN THE TREATMENT OF ADIT FOR RATE**
9 **MAKING AS OPPOSED TO FINANCIAL REPORTING PURPOSES THAT ARE**
10 **SIGNIFICANT HERE?**

11 **A.** Yes.

12 **Q. WHAT ARE THESE DIFFERENCES?**

13 **A.** Certain revenue and expense transactions affect net income for financial accounting
14 purposes in different periods than for income tax purposes. These differences are called
15 timing differences. When this happens, the current income tax expense calculated
16 pursuant to income tax law for such transactions differs from the income tax expense
17 recorded in the financial records of the company. The difference between the amount of
18 income tax expense recorded in the financial records of the company and the current

⁵ Warren December 29, 2008 deposition transcript at 89:12-91:1; Roberts December 30, 2008 deposition transcript at 24-27; Caldwell December 29, 2008 deposition transcript at 216-218.

1 income tax expense based on income tax law is reflected in the book entries for deferred
2 income tax expense and ADIT. A company's income tax expense for financial reporting
3 purposes equals the sum of current and deferred income tax expense, even though the
4 company only makes cash payments with respect to the current component.

5 **Q. WILL YOU PROVIDE AN EXAMPLE OF HOW THE RECOGNITION OF**
6 **DEFERRED INCOME TAX EXPENSE CREATES A CREDIT OR LIABILITY**
7 **BALANCE FOR ADIT?**

8 Yes. Companies generally are allowed to depreciate assets more rapidly under income
9 tax law than for financial reporting purposes. That is because for financial reporting
10 purposes an asset is depreciated ratably (that is to say, in equal amounts) over its book
11 life, while for income tax purposes the same asset is depreciated on a more accelerated
12 basis, with larger depreciation in the early years of an asset's life and smaller
13 depreciation amounts in later years. By allowing a company to take a greater
14 depreciation expense in the early years of an asset's life, the tax code thereby gives the
15 company the benefit of a reduced taxable income, and correspondingly reduced tax
16 payments.

17 The reduction of the tax benefit over time also would lead to a disparity between
18 the tax payments and tax reporting of the company, on the one hand, and the company's
19 balance sheet with its ratable depreciation for the asset, on the other. Therefore, in every
20 year during the depreciable life of an asset, the company debits or credits deferred
21 income tax expense and, correspondingly, credits or debits ADIT for the difference

1 between the amount of current income tax expense determined pursuant to income tax
2 law and the amount of income tax expense recorded in the financial records of a
3 company. That is, the company's total income tax expense, for financial accounting
4 purposes, includes a current provision based on income tax law and deferred provision
5 based on financial accounting standards. Throughout the book depreciable life of a
6 depreciable asset, the balance of the related ADIT account is a credit or liability.
7 However, the balance of the ADIT account amortizes over the book life of the asset and
8 eventually reaches a zero balance in the final year.

9 **Q. WILL YOU PROVIDE AN EXAMPLE OF HOW THE RECOGNITION OF**
10 **DEFERRED INCOME TAX EXPENSE CREATES A DEBIT OR ASSET**
11 **BALANCE FOR ADIT?**

12 Consider the gain on the sale of an asset. When a company sells a valuable asset, such as
13 utility plant, it must pay the full income tax expense on the gain, based on income tax
14 law, in the year of the sale. However, for financial reporting purposes, the gain on the
15 sale and the income tax expense for that gain are recognized ratably over some future
16 specified period of years. Frequently, for utility plant, that period would be the
17 remaining depreciable life of the asset sold.

18 In the year the asset is sold, the current provision for income tax expense on the
19 company's books is initially fully offset by a credit to deferred income tax expense for
20 financial reporting purposes. At the same time, a like amount is debited to an ADIT asset
21 account. Then, for the year of the sale, a ratable portion of deferred income tax expense

1 is recognized for financial reporting purposes. Similarly, for financial reporting
2 purposes, the ADIT asset account is decreased by the same amount.

3 The net effect of these entries is that, for the year of the sale, the current income
4 tax expense for the company is completely offset by deferred income tax expense, except
5 for the first ratable portion from amortization of ADIT. Following the year of the sale,
6 for every year during the specified amortization period for the gain, the company debits
7 deferred income tax expense and, correspondingly, credits ADIT.

8 The deferred income tax expense thus represents the difference between the
9 amount of current income tax expense determined pursuant to income tax law and the
10 amount of income tax expense recorded in the financial records of a company. That is,
11 the company's total income tax expense, for financial accounting purposes, includes a
12 current provision based on income tax law and deferred provision based on financial
13 accounting standards. Throughout the amortization period of the gain, the balance of the
14 related ADIT account is a debit balance or asset. However, the balance of the ADIT asset
15 account amortizes, over the amortization period, and eventually reaches a zero balance in
16 the final year.

1 **Q. ENO WITNESS JAMES WARREN SAYS THAT WHEN ADIT HAS A CREDIT**
2 **BALANCE, THAT BALANCE REPRESENTS A GOVERNMENTAL LOAN TO**
3 **THE UTILITY COMPANY RECORDING THE LIABILITY. IS MR. WARREN**
4 **CORRECT?**

5 **A.** Mr. Warren is incorrect. Indeed, he admits that there is no “loan” from the government
6 in any normative sense of the legal concept. (*See, e.g., Warren December 29, 2008*
7 *deposition transcript at 26:21-27:21, 46:12-47:18, 49:12-24.*)

8 A liability balance recorded for ADIT does not represent indebtedness of a
9 company to the government. However, for utility companies, which have their rates
10 established so that deferred income tax expense is recovered from ratepayers, a credit
11 balance of ADIT represents an amount for income tax expense that actually is paid by the
12 customers before it is paid by the utility. In effect, the utility’s customers -- not the
13 United States government -- are loaning funds to the utility, because deferred income tax
14 expense is recovered through their rates.

15 To understand the flaw in Mr. Warren’s analogy, consider the treatment of
16 deferred income tax expense in an unregulated company. For an unregulated company,
17 the amount recorded to deferred income tax expense for financial reporting purposes has
18 no negative or positive cash impacts. The unregulated company does not pay cash to or
19 receive cash from the government when it records deferred income tax expense. Unlike a
20 current provision for income tax expense, recording deferred income tax expense is a
21 non-cash entry. Such an entry is recorded, for financial reporting purposes, only to

1 normalize or “smooth” and “allocate” book income tax expense over the life of a timing
2 difference. Since deferred income tax expense is a non-cash expense, the corresponding
3 balances of ADIT cannot be considered to represent a cash loan from the government
4 when it records deferred income tax expense.

5 A regulated utility is no different. A regulated utility, be it ENO or any other,
6 does not pay cash to or receive cash from the government by dint of recording deferred
7 income tax expense. Thus they cannot be considered to have received some sort of
8 “loan” from the government.

9 Another way to understand the error in Mr. Warren’s premise that ADIT
10 represents a loan from the government is to consider the manner in which a company’s
11 Statement of Cash Flows is prepared. Deferred income tax expense is eliminated as a
12 non-cash expense when determining operating cash flow in preparing a Statement of
13 Cash Flows. ENO makes such adjustments in its Statement of Cash Flows, and thereby
14 acknowledges that deferred income tax expense is a non-cash event. Further, ENO does
15 not include the liability balance of ADIT in its Statement of Cash Flows as a source of
16 financing like it does for debt and equity issuances. If ADIT really represented a
17 government loan, ENO would include the cash loaned to it in its Statement of Cash Flows
18 as a source of financing.

19 Further reflecting that ADIT is not a government loan, prominent financial
20 analysts, including Moody’s Investor Service, add ADIT liability balances to equity when
21 determining credit metrics to evaluate a company’s financial viability. If the balance of

1 ADIT represented a company's indebtedness to the government, as touted by Mr.
2 Warren, Moodys would not reverse ADIT from a liability balance to an equity balance
3 when evaluating the financial viability of a company.

4 **Q. CAN IT BE SAID THAT ADIT REPRESENTS A "LOAN" FROM THE**
5 **FEDERAL GOVERNMENT IN THE SENSE THAT THE UTILITY GETS THE**
6 **USE OF FUNDS, FOR A PERIOD OF TIME, WHICH OTHERWISE WOULD**
7 **HAVE BEEN PAID AS TAXES, BUT IN RETURN THE COMPANY**
8 **ULTIMATELY MUST PAY HIGHER TAX LIABILITIES TO THE**
9 **GOVERNMENT WHEN THE TAX DEPRECIATION "RUNS OUT"?**

10 **A.** No. As we have explained above, the ADIT amortization in the rate base flows the
11 benefits of accelerated depreciation to ratepayers over time through credits to deferred
12 income tax. The "loan," if any, is from the ratepayers. If Mr. Warren were correct, the
13 utility would be repaying the entire amount of the tax benefit twice -- the first time to the
14 ratepayers through the amortizing of ADIT, and the second time to the government. No
15 rational utility would utilize an accelerated depreciation deduction in its tax reporting if it
16 had to repay it twice.

1 **Q. YOU HAVE TESTIFIED THAT DEFERRED INCOME TAX EXPENSE AND**
2 **THE RELATED BALANCE OF ADIT SHOULD BE, AND IS, UNDERSTOOD**
3 **DIFFERENTLY FOR RATE MAKING THAN FOR FINANCIAL REPORTING**
4 **PURPOSES. IS THAT TRUE WHETHER ADIT IS A LIABILITY OR AN**
5 **ASSET?**

6 **A.** Yes.

7 **Q. WHY IS THAT THE CASE?**

8 **A.** The difference with respect to interpreting deferred income tax expense for rate making
9 and financial reporting purposes, when the related ADIT account is a liability, can be
10 illustrated using the earlier example involving accelerated depreciation. I mentioned
11 above that for an unregulated company, the amount recorded to deferred income tax
12 expense, for financial reporting purposes, does not have a negative or positive cash
13 impact to the company making those book entries because the company does not pay
14 cash to or receive cash from the government when it makes the book entries. However,
15 through competition an unregulated company also flows through the cash flow benefit
16 from using accelerated depreciation to its customers, in the form of lower prices for its
17 goods or services.

18 Similarly, since deferred income tax expense is a non-cash expense for an
19 unregulated company, all corresponding balances of ADIT also do not represent a cash
20 loan from the government or its customers. But unlike an unregulated company, the
21 amount recorded to deferred income tax expense for a regulated utility can, through the

1 rate making process, have a direct cash impact to the utility. When a regulatory body
2 permits a regulated utility to normalize income tax expense for rate making purposes for
3 some or all of the utility's timing differences, deferred income tax expense has a cash
4 impact on revenues because, under normalization methods, the utility includes deferred
5 income tax expense (recorded for financial reporting purposes) as a recoverable amount
6 from ratepayers -- even though the utility makes no actual cash expenditure for it.
7 Regulatory bodies, including the Council, permit normalization accounting for rate
8 making purposes to allow the utility to initially retain the cash benefit. This treatment of
9 deferred income tax expense means that the utility's cash flow benefit from accelerated
10 depreciation is not flowed through immediately to its customers, as happens with
11 unregulated enterprises in competitive, non-monopolistic marketplaces. Instead, the cash
12 benefit here from accelerated depreciation is flowed through to ratepayers over the book
13 depreciable life of the utility.

14 Thus under normalization treatment for accelerated depreciation, a utility receives
15 -- through the rates it is permitted to charge its customers -- a direct cash flow benefit
16 from those customers for the deferred income tax expense on its books. Therefore,
17 regulatory bodies treat this cash benefit for the regulated utility *as a cost free loan from*
18 *the ratepayers*. Therefore the accumulated cash benefit recorded in the ADIT liability
19 balance decreases the utility's rate base. Decreasing the rate base for the ADIT balance
20 in effect allows the ratepayers to earn a return on the cost free capital provided to the
21 utility. That is, the ratepayers receive a return on the cost-free capital they have given to
22 the utility through the utility's deferred income tax expense collections through rates.

1 **Q. DOES THE NOL CARRYBACK ISSUE ALSO PROVIDE AN ILLUSTRATION**
2 **OF ADIT AS A LIABILITY BALANCE?**

3 **A.** Yes. As in the illustration above of accelerated depreciation deductions, for rate making
4 and financial reporting purposes ENO deferred the refund's benefit by recording deferred
5 income tax expense in 2005, thereby offsetting the current income tax benefit. Under
6 ENO's proposed rate making treatment for the refund, the cash benefit is flowed back to
7 ratepayers in subsequent years over the life of the timing differences for Katrina casualty
8 losses, repairs deductions and the additional accelerated depreciation. In the meantime,
9 while the cash benefit is flowed back to ratepayers through amortization of the ADIT
10 liability, the unamortized ADIT balance is treated as cost free capital for rate making
11 purposes -- just as it was in the illustration above involving accelerated depreciation.

12 **Q. DOES ENO'S ACCOUNTING TREATMENT FOR THE NOL CARRYBACK**
13 **COMPLY WITH FINANCIAL ACCOUNTING STANDARDS?**

14 **A.** Yes, I believe it does. However, as explained by CNO Witness Mathai, it has been an
15 extensive and time consuming process receiving sufficient information from ENO to
16 make this determination. For example, please review Exhibit No. ____ (JMP-R35)
17 attached to my testimony. In Advisors' 3-1, ENO was asked to "please provide a
18 schedule by year quantifying the Net Operating Loss ("NOL") for ENO related to
19 Hurricane Katrina and Rita, and its treatment for tax purposes as of today" and "provide a
20 schedule showing the actual journal entries booked to reflect the financial impact in
21 ENO's books, since the NOL of 2005.

1 In response, ENO provided only three journal entries whose net effect to its
2 financial statements was to debit “Cash” \$71.1 million and credit “Current Income Tax
3 Expense” \$71.1 million. The combined net effect from these entries for the years 2005
4 and 2006 are that the asset and equity balances of ENO’s balance sheets for 2005 and
5 2006 are, in total, each increased by \$71.1 million; and, the net income in ENO’s Income
6 Statement for 2005 is increased by \$71.1 million.

7 These three journal entries provided by ENO did not indicate that it had deferred
8 income tax expense, as required by Financial Accounting Standards. Because ENO did
9 not provide entries here demonstrating it had debited deferred income tax expense and
10 credited ADIT, it conveyed the perception that ENO had included the tax refund in its
11 earnings and, therefore had not set up an ADIT balance. In addition to violating
12 Financial Accounting Standards, not establishing an ADIT balance for the timing
13 difference also does not provide for the correct rate making treatment, as explained
14 herein.

15 **Q. DOES ENO’S ACCOUNTING TREATMENT FOR THE NOL CARRYBACK**
16 **SATISFY RATE MAKING REQUIREMENTS?**

17 **A.** Only in part. I first observe that it has been an extensive and time consuming process to
18 obtain adequate information from ENO to make this determination with respect to the
19 rate making treatment at all.

20 Part of ENO’s proposed rate making treatment for the NOL carryback, relating to
21 the portions attributable to casualty losses and liberalized depreciation, appears not to

1 violate ratemaking requirements, as it provides for the NOL carryback cash benefit
2 attributable to casualty losses and liberalized depreciation to be flowed back to ratepayers
3 over the life of the timing differences, while in the meantime the unamortized ADIT
4 balance is treated by ENO as cost free capital for rate making purposes. While ENO's
5 treatment of these portions of the refund does not violate rate making requirements;
6 however, it also is not required by them. More importantly, for the reasons detailed
7 herein the advisors' recommendations also comply with ratemaking requirements, but
8 have the added advantage of being more reasonable and more fair to all concerned,
9 including the citizens of New Orleans.

10 However, with respect to the largest portion of the NOL carryback, which is
11 attributable to repair losses, ENO's accounting treatment does not satisfy rate making
12 requirements. Mr. Roberts conceded that there is no general measurable "life" of timing
13 differences which result from repair costs, and despite that GO Zone was passed in 2005,
14 the company has not yet identified for which assets the basis will be reduced. (Roberts
15 December 30, 2008 deposition transcript at 34-35). Moreover, the timing differences for
16 around half of the repair loss carryback will have turned around by the end of last year.
17 (Roberts December 30, 2008 deposition transcript at 40 ("Q. It's greater than 15 million?
18 A. Maybe.")). Because a large portion of the repair allowance already has been fully
19 amortized before these rates will be set, under ENO's proposed methodology potentially
20 over \$15,000,000 will be retained by the shareholders and never returned to the
21 ratepayers. Moreover, Mr. Warren concedes that "I don't think repairs are subject to
22 normalization rules." (Warren December 29, 2008 deposition transcript at 91:24-25.

1 Thus in significant part ENO's accounting treatment does not satisfy rate making
2 requirements.

3 **Q. SHOULD THE COUNCIL ADOPT ENO'S PROPOSAL, AT LEAST IN PART?**

4 **A.** Only with respect to the GO Zone additional accelerated depreciation. Otherwise, as
5 explained above and as explained by CNO Witness Mathai in his direct testimony, we
6 believe the cash benefit from the income tax refund should be flowed to ratepayers over a
7 shorter period of time than the life of the timing differences. CNO Witness Mathai
8 believes, for rate making purposes, that it is more reasonable to flow the cash benefit
9 from the income tax refund to ratepayers over a ten year period.

10 There is no legal rule or regulatory principle that requires ENO to take half a
11 lifetime to return the GO Zone refund to its customers. There is no legal rule or
12 regulatory principle that requires ENO to flow the portion of the refund attributable to
13 casualty losses and repair costs back to its customers consistent with the life of timing
14 differences related to those costs. ENO is simply voluntarily choosing to do so, perhaps
15 so that it can retain much of the benefit of the refund for its shareholders for decades --
16 and approximately half of the benefit related to the repair allowance permanently. This
17 choice is not reasonable. The citizens and businesses that originally paid the taxes in
18 1995-2004 through their utility rates should enjoy the benefit of the return of those taxes -
19 - not whom ever may be an ENO customer at mid-century. The ratepayers who already
20 paid these taxes should receive their refund over a period of time no longer than the
21 period over which they paid the taxes in the first place.

1 **Q. YOU ASSERT THAT DEFERRED INCOME TAX EXPENSE AND THE**
2 **RELATED BALANCE OF ADIT SHOULD BE INTERPRETED DIFFERENTLY**
3 **FOR RATE MAKING THAN FOR FINANCIAL REPORTING PURPOSES.**
4 **WILL YOU PROVIDE AN ILLUSTRATION OF THAT CONCEPT FOR WHEN**
5 **ADIT IS AN ASSET?**

6 **A.** Yes. The difference in interpreting deferred income tax expense for rate making and
7 financial reporting purposes when the related ADIT account is an asset can be illustrated
8 using the earlier example involving the gain on the sale of an asset. As I discuss above,
9 for an unregulated company the amount recorded to deferred income tax expense for
10 financial reporting purposes does not have a negative or positive cash impact to the
11 company, because it does not thereby pay cash to or receive cash from the government.
12 However, an unregulated company hopes to pass the cash flow cost to its customers over
13 time. Yet just because an unregulated company establishes an ADIT asset for financial
14 reporting purposes does not mean the company actually will be able to recover deferred
15 income tax expense in the future from amortizing the ADIT asset. It can try to recover
16 the expense in the marketplace, but the marketplace will determine if it is successful.
17 Either way, for an unregulated company balances of an ADIT asset generated from
18 credits to deferred income tax expense do not represent indebtedness from the
19 government, or from the company's customers, to the company.

20 However, as I also explained above, when in rate making a regulator permits a
21 regulated utility to normalize income tax expense for timing differences, deferred income
22 tax expense will have a cash impact for that utility. Under normalization treatment for

1 the income tax paid for the gain on the sale of an asset, a utility incurs a cash cost from
2 paying income taxes on the gain in the year of the sale; but through rate making the
3 utility recovers those tax payments from ratepayers. The un-recovered accumulated
4 investment represented by the ADIT asset balance is used to increase the utility's rate
5 base, and the regulator thereby treats the cost incurred by the utility to pay income taxes
6 in the year of the sale as a cash investment to be recovered ratably from ratepayers in
7 future years. Increasing the rate base for the ADIT balance in effect allows the utility to
8 earn a return from the ratepayers on the investment.

9 **Q. MESSRS. ROBERTS AND WARREN ASSERT THAT THE ADVISORS'**
10 **PROPOSAL WOULD VIOLATE IRS "NORMALIZATION" REQUIREMENTS**
11 **AND THREATEN ENO'S FUTURE ABILITY TO RECEIVE THE TAX**
12 **BENEFITS OF DEFERRED INCOME TAX EXPENSE. ARE THEY RIGHT?**

13 **A.** They are wrong, albeit for different reasons with respect to the casualty loss carryback
14 (with an approximately \$28.9 million value) and the repair loss carryback (with an
15 approximately \$29.1 million value). With respect to the liberalized depreciation
16 permitted by GO Zone (with an approximately \$2.6 million value), by contrast, Messrs.
17 Roberts and Warren have a colorable concern. Therefore, to assuage their concern and
18 remove any threat of an adverse IRS action, however slight it may be, the advisors have
19 removed this approximately \$2.6 million portion of the GO Zone refund from our
20 proposed flow back to ENO's customers.

1 **Q. PLEASE EXPLAIN WHY MESSRS. ROBERTS AND WARREN ARE WRONG**
2 **WITH RESPECT TO THE CASUALTY LOSS CARRYBACK.**

3 **A.** Messrs. Roberts and Warren are unable to identify any authority for the proposition that a
4 casualty loss must be normalized in order to comply with the tax code, IRS rules or
5 regulations, or any other rule or regulation. (Warren December 29, 2008 deposition
6 transcript at 89:12-91:1; Roberts December 30, 2008 deposition transcript at 27). I too
7 am aware of no authority for the proposition that a casualty loss must be normalized in
8 order to comply with the tax code, IRS rules or regulations, or any other rule or
9 regulation.

10 **Q. IS IT LOGICAL THAT A CASUALTY LOSS SHOULD BE “NORMALIZED”**
11 **LIKE ACCELERATED DEPRECIATION EXPENSE?**

12 **A.** No.

13 **Q. WHY NOT?**

14 **A.** As explained by Mr. Warren, the “casualty loss itself is not a depreciation deduction.”
15 (Warren December 29, 2008 deposition transcript at 90:21-23). “I can certainly, you
16 know, make an argument, the same argument that you are propounding now, that it
17 shouldn’t be subject to the normalization rules.” (Id. at 90:23-91:1). That is to say, the
18 IRS does not require normalization of casualty losses, and although you could draw some
19 analogies between casualty loss and accelerated depreciation, they are not the same. In
20 addition, the underlying premise of requiring normalization of accelerated depreciation

1 timing differences -- to incentivize utilities to invest in their plant -- is not present with
2 respect to casualty losses.

3 **Q. WHAT ABOUT THE REPAIR COSTS DEPRECIATION BENEFIT?**

4 **A.** Mr. Warren concedes that repair costs are not subject to normalization requirements.
5 (Warren December 29, 2008 deposition transcript at 91:24-92:2).

6 **IV - RESPONSE TO ENO'S NOL CARRYFORWARD ARGUMENTS**

7 **Q. PLEASE DESCRIBE THE NOL CARRYFORWARD ISSUE.**

8 **A.** ENO has included approximately \$46.8 million of NOL carryforward in an ADIT asset
9 account for the test year ending December 31, 2008. ENO also includes the NOL
10 carryforward balance in rate base for rate making purposes. When it filed its rate case,
11 ENO attributed this amount to state and federal operating losses incurred in previous
12 years that ENO claimed it did not expect to use prior to December 31, 2008 to decrease
13 ENO's income tax expense.

14 **Q. WAS ENO'S ESTIMATE OF THE NOL CARRYFORWARD AMOUNT**
15 **ACCURATE?**

16 **A.** Not even close. As of November 3, 2008, ENO was estimating that the actual
17 carryforward would be only about \$33.4 million by year's end, and that by the end of
18 2009 it would be only about \$3.5 million. (Warren Exhibit 5, ENO's Response to
19 Advisors 32-3, page 2 at ¶ c).

1 **Q. SHOULD THE COUNCIL ADOPT ENO'S PROPOSED TREATMENT FOR THE**
2 **NOL CARRYFORWARD?**

3 **A.** Absolutely not.

4 **Q. WHY NOT?**

5 **A.** First, the \$46.8 million estimate number used in the rate filing is not a reasonable
6 estimate. An estimate for rate base purposes has to be a reasonable estimate, even when a
7 forecast test year is being used. (Roberts December 30, 2008 deposition transcript at 78).
8 ENO is not considering a pro forma adjustment. (*Id.* at 83).

9 Second, an entirely contingent potential asset should not be included in a rate
10 base. As proven by the \$13.5 million dip in the value of the carryforward in the first two
11 months after the estimate, the amount of the carryforward not only does not reduce
12 ratably, but is unpredictable. (Warren December 29, 2008 deposition transcript at
13 122:18-25). Rather, ENO concedes that it is "volatile." (Roberts December 30, 2008
14 deposition transcript at 74-75). Yet this contingent, volatile amount, already worth only
15 two thirds of its September estimate, should form a part of the rate base return level for
16 ENO until the next rate case is filed. (Warren December 29, 2008 deposition transcript at
17 123:1-8).

18 Third, rate base is properly comprised of the investor supplied plant facilities and
19 the other investments required to supply utility service to customers. (Roberts December
20 30, 2008 deposition transcript at 70:19-71:15). The NOL carryforward does not fit
21 within these items permitted to be included in rate base.

1 Fourth, ENO did not incur a cash investment with respect to recording the ADIT
2 asset for the NOL carryforward and, therefore, should not be allowed to earn a return on
3 that asset balance by including it in rate base.⁶ ENO records the NOL carryforward as an
4 asset simply to comply with financial accounting standards that want the books to reflect
5 that ENO has had operating losses that can be used in subsequent years to decrease its
6 income tax liability.

7 Fifth, it is not fair to require the ratepayers of New Orleans to pay an annual
8 return on an estimated \$48 million asset when everybody, including ENO first of all,
9 knows that by the end of the first year under the new rates the asset will be worth only
10 \$3.5 million.

11 **Q. WAS ENO'S INABILITY TO COLLECT DEFERRED INCOME TAX EXPENSE**
12 **THROUGH RATES WHEN LOSSES FIRST OCCURRED THE CAUSE OF THE**
13 **NET OPERATING LOSSES THAT ARE NOW BEING CARRIED FORWARD?**

14 **A.** ENO contends in its rebuttal testimony that because it had operating losses that generated
15 the NOL Carryforward asset, those operating losses should be attributed to its inability to
16 collect deferred income tax expense through rates during the year in which the losses
17 were incurred. But Messrs. Warren and Roberts both freely conceded that no one item of
18 expense can be pinpointed as the cause of net operating losses. Indeed, it is Entergy's

⁶ Earlier, I explained that a utility incurs a cash cost when paying income taxes on the gain in the year of the sale of an asset and, therefore, regulatory bodies treat the cash cost incurred by the regulated utility, for that payment of income taxes in the year of the sale, as a cash investment to be ratably recovered from its customers in subsequent years. Further, because the cost for the regulated utility is a cash investment, the un-recovered accumulated amount recorded in the ADIT asset balance is used to increase the utility's rate base. Increasing the rate base for the ADIT balance in effect allows the utility to earn a return on the investment, provided by the utility, from its ratepayers.

1 and Mr. Warren's position that "because all of the Company's tax deductions are
2 subtracted from all revenue to calculate the Company's net taxable income or loss,"
3 regulatory bodies "cannot possibly identify" which tax deductions create net operating
4 loss carryforwards. *Entergy Gulf States, Inc. v. Louisiana Public Service Comm'n*, 730
5 So.2d 890, 909 (La. 1999), adopted by Mr. Warren, Warren December 29, 2008
6 deposition transcript at 72:5-73:23. In point of fact, the NOL carryforward at issue was
7 generated because "the totality of tax deductions [expenses] exceeded the taxable
8 revenues." Roberts December 30, 2008 deposition transcript at 70:6-18.

9 **Q. LET US SUPPOSE, FOR DISCUSSION PUPOSES ONLY, THAT THE NOL**
10 **CARRYFORWARD COULD BE ATTRIBUTED SOLELY TO ENO NOT**
11 **COLLECTING DEFERRED INCOME TAX EXPENSE THROUGH RATES IN**
12 **PREVIOUS TAX YEARS. IF THAT WERE THE CASE, WOULD ENO HAVE A**
13 **BASIS FOR INCLUDING THE NOL CARRYFORWARD IN RATE BASE?**

14 **A.** No. The NOL carryforward was caused by operating income losses in years prior to the
15 2008 test year for this rate case. If it could be shown, which it cannot be, that the NOL
16 carryforward resulted from ENO's revenues not being large enough to allow for it to
17 recover deferred income tax expense through then-established rates, that still would not
18 permit ENO to recover those expenses in a subsequent rate case. If ENO were allowed to
19 place the NOL carryforward balance in rate base now, it would be granted authority to
20 retroactively recover from current customers for losses in the past. Rate making does not,
21 and should not, facilitate such retroactive treatment.

1 **Q. DOES THAT CONCLUDE YOUR REDIRECT TESTIMONY?**

2 **A.** Yes, it does. However, I reserve the right to amend or revise my testimony based on
3 additional information that may become available before the hearing in this Docket.