

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

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

**SURREBUTTAL AND CROSS-ANSWERING TESTIMONY
OF
JAMES M. PROCTOR
ON BEHALF OF
THE ADVISORS TO THE
COUNCIL OF THE CITY OF NEW ORLEANS**

APRIL 26, 2019

PUBLIC REDACTED VERSION

**PREPARED SURREBUTTAL AND CROSS-ANSWERING 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 located at 5555 West 6th Street No.
4 G1, 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 surrebuttal testimony on behalf of the Advisors to the Council of the City
10 of New Orleans (“Council” or, Advisors or “CNO”).

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

12 **A.** My surrebuttal testimony will address issues raised in the rebuttal testimony of Entergy
13 New Orleans, LLC (or “ENO” or “Company”). Specifically, I respond to the rebuttal
14 testimony filed by ENO witnesses Robert B. Hevert, Rory L. Roberts, and Joshua B.
15 Thomas. The subject matter I rebut includes the Company’s rebuttal testimony regarding:

16 (a) Return on Equity;

17 (b) Accumulated Deferred Income Taxes;

1 (c) Net Operating Loss Carry-forward;

2 (d) Financial Accounting Standards Board's Interpretation No. 48; and,

3 (e) Pension Asset.

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

6 **A.** In my direct testimony, I present analysis, exhibits and recommendations supporting a cost
7 of equity for ENO of 8.42%. In arriving at this estimate, I applied the capital asset pricing
8 model ("CAPM"), a mathematical model supported by sound economic principles. The
9 CAPM model, among other applications, is commonly used to estimate the cost of equity
10 requirement for setting utility rates.

11 ENO's witness Mr. Hevert criticized the credibility and reliability of the CAPM. However,
12 in my surrebuttal testimony, I point out the flaws in his specific arguments. Also, I
13 demonstrate the reasonableness of my application of the CAPM by explaining Entergy
14 Corporation ("Entergy") previously employed Goldman, Sachs & Company ("Goldman")
15 to estimate Entergy's cost of equity for its transmission utility business and that Goldman
16 used the CAPM to estimate Entergy's cost of equity. My application of the CAPM is
17 consistent with Goldman's application of the model.

18 ENO's witness, Mr. Hevert, criticized my use of the CAPM due to currently low interest
19 rates. In my surrebuttal testimony, I explain the economic literature and mathematical
20 theory deriving the CAPM do not support an argument that application of the CAPM is
21 limited to circumstances when interest rates fall within a specified range.

1 Further, I explain when regulatory bodies rely too much on the return on equity authorized
2 in other jurisdictions to set the cost of equity, it may perpetuate cost of equity findings that
3 are not supported by the current economic setting, sound economic reasoning or the
4 specific risk characteristics of the utility under review.

5 In rebuttal testimony, ENO's witness Mr. Roberts disputes my recommendations regarding
6 the Company's ratemaking treatment for accumulated deferred income taxes ("ADIT")
7 related to its net operating loss carry-forward ("NOLCF") and its application of Financial
8 Accounting Standards Board's Interpretation No. 48 ("FIN 48"). I demonstrate in my
9 surrebuttal testimony that the Company's arguments are dependent, in part, on their false
10 premise that ENO's recording of ADIT creates a cash loan to them from the government.

11 I clearly demonstrate the only cash "loan" received by ENO comes from the ratepayers to
12 them when ENO's cash income tax payment is less than the income tax expense recorded
13 in ENO's financial statements and those additional income taxes are recovered from
14 ratepayers. Under this circumstance, the ratepayers end up pre-paying income tax expense
15 to ENO as customer-supplied capital. Further, I explain ENO's ratemaking approach for
16 FIN 48 does not correctly balance the interest of ratepayers and the Company.

17 ENO's rebuttal witness Mr. Thomas disputes my ratemaking treatment for the Company's
18 Pension Asset. I explain in my surrebuttal testimony the balance of the Pension Asset
19 allowed in rate base should be the amount recommended in Advisor adjustment ADV10
20 discussed in my Direct Testimony and as supported by the five-year average balance of the
21 Pension Asset.

1 **II. REQUIRED RETURN ON EQUITY**

2 **General Overview and Summary for Surrebuttal on Return on Equity:**

3 **Q. PLEASE SUMMARIZE THE ADVISORS' POSITION REGARDING ENO'S**
4 **COST OF EQUITY.**

5 **A.** In my direct testimony, I explain business risk and discuss and evaluate ENO's business
6 risk relative to its proposed ratemaking approach. Then, I discuss the relationship between
7 ENO's business and financial risk to its proposed cost of equity ("COE"). Further, I discuss
8 the return on equity ("ROE") recommendation provided by Advisor Witness Mr. Byron
9 Watson and my support for his analysis and overall recommendation for ENO's ROE to
10 be set at 8.93%, as compared to ENO's proposed ROE of 10.75%.

11 **Q. WHAT DOES RETURN ON EQUITY MEAN?**

12 **A.** Generally, return on equity is the earnings available to common equity holders as a
13 proportion of the *book value* of common equity. However, ROE can also refer to earnings
14 available to common equity holders as a proportion of the *market value* of common equity.
15 Within the context of this proceeding, I refer to ROE regarding *book value* of common
16 equity unless specified otherwise.

17 **Q. WHAT IS MEANT BY DETERMINING A COMPANY'S REQUIRED RETURN**
18 **ON EQUITY?**

19 **A.** As I discussed in my direct testimony, a company's required ROE is equal to the expected
20 return for common equity holders foregone by investing in comparable risk assets or

1 financial securities generally. Expected return can be viewed as the average of possible
2 returns weighted by their individual probabilities.

3 **Q. IS THE TERM “REQUIRED RETURN ON EQUITY” OFTEN REFERRED TO BY**
4 **OTHER NAMES?**

5 **A.** Yes. It is common for financial experts to refer to the required ROE as either cost of equity,
6 opportunity cost of equity, or market capitalization rate. One may refer to the required ROE
7 using these other terms interchangeably. If I do so in my Surrebuttal Testimony, one should
8 assume I am referring to the required ROE.

9 **Q. WHAT ARE THE ADVISORS’ RECOMMENDATION FOR THE RETURN ON**
10 **EQUITY THAT SHOULD BE USED FOR SETTING ENO’S RATES?**

11 **A.** I present direct testimony, analysis, exhibits and recommendations supporting the
12 proposition that ENO’s ROE may be reasonably set at 8.42% based on my application of
13 the CAPM. Mr. Watson presents direct testimony, analysis, exhibits and recommendations
14 supporting the proposition ENO’s required ROE should be 8.93%.

15 Mr. Watson bases his ROE recommendation on multiple factors, including a reasonable
16 application of the DCF methodology. He finds that a reasonable ROE for ENO is 8.93%
17 after accounting for his analyses, my CAPM analyses and the principles established by the
18 Hope and Bluefield US Supreme Court decisions. I agree. Mr. Watson’s findings, based
19 on the DCF, are well within a range of reasonableness established from using my derivation
20 for the cost of equity of 8.42% and his of 8.93%.

1 **Q. HAVE YOU DESCRIBED THE CAPM IN YOUR DIRECT TESTIMONY?**

2 **A.** Yes, the Council should review my direct testimony in this proceeding for a detailed
3 discussion of the CAPM. In short, I describe the mathematics and assumptions supporting
4 the application of the CAPM. Also, I explain the relationship of business risk, financial
5 risk, equity risk and market risk to the opportunity cost of an investment in ENO's equity.

6 **Q. IS THE CAPM WIDELY ACCEPTED AND USED TO ESTIMATE ROE**
7 **REQUIREMENTS?**

8 **A.** Yes, the CAPM is commonly used to estimate the ROE requirement for setting utility rates.
9 But the model has a much wider application. For example, investors use the CAPM to
10 estimate the value of a company's common stock when making investment decisions. Also,
11 the CAPM is used by corporations in the determination of the opportunity cost of equity to
12 be used for discounting cash flow to evaluate the present value of potential investments in
13 complex projects, individual assets and mergers and acquisitions with other companies or
14 subsets of companies. In fact, according to a survey of corporate financial managers
15 approximately 75% of them use the CAPM to estimate the cost of equity.¹

16 **Q. WHAT DOES IT MEAN TO ESTIMATE THE REQUIRED ROE?**

17 **A.** When valuing investments in common stock, complex projects, individual assets and
18 mergers and acquisitions, the required ROE refers to the discount rate which if used to
19 discount expected net incremental cash flows received from the investment, in perpetuity,

¹ See J. R. Graham and C. R. Harvey, "The Theory and Practice of Corporate Finance: Evidence from the Field" *Journal of Finance* 61 (2001), pp. 187-243.

1 provides the net present value of such investment. Again, this discount rate is also referred
2 to as either the cost of equity, opportunity cost of equity or market capitalization rate.

3 **Q. PLEASE USE THE DCF MODEL TO FURTHER EXPLAIN THIS CONCEPT.**

4 **A.** Mr. Watson performed DCF analyses to estimate ENO's cost of equity. In other contexts,
5 I have also used the DCF approach for determining a utility's cost of equity and to
6 determine the present value of cash-flow for other corporate purposes. The DCF model is
7 widely used to estimate the cost of equity. The DCF model is a specific application of a
8 present value formula. That is, the DCF formula is used to discount incremental net cash
9 flows, in perpetuity, for a particular investment by the return that can be earned in the
10 capital market on securities of equivalent risk. That return is the cost of equity, opportunity
11 cost of equity or market capitalization rate for the investment. For this particular purpose,
12 the cost of equity is being estimated by Mr. Watson, specifically, for an investment in
13 ENO's equity, based on the return that can be earned in the capital market on securities of
14 equivalent risk.

15 **Q. IS THE CAPM USED FOR THE SAME PURPOSE AS THE DCF?**

16 **A.** Yes. The CAPM is also used to estimate the discount rate, or cost of equity, for the same
17 valuation purposes as the DCF. The CAPM approaches the problem of estimating discount
18 rates from a different perspective, that is, from evaluating the risk and expected return on
19 investments. I explain the relationship between risk and return as it relates to applications
20 of the CAPM in my direct testimony.

1 **Q. HAVE CERTAIN OF ENO’S WITNESSES CHALLENGED THE CREDIBILITY**
2 **OF THE CAPM FOR DETERMINING THE COST OF EQUITY?**

3 **A.** Yes. ENO’s Witness Mr. Hevert criticized my application of the CAPM. I will point out
4 the flaws in Mr. Hevert’s specific arguments throughout my testimony when discussing his
5 comments. However, part of my discussion in addressing Mr. Hevert’s criticisms will be
6 to demonstrate my application of the CAPM is largely consistent with that of a large
7 investment bank employed previously by Entergy.

8 **Q. HAS ENO’S PARENT COMPANY, ENTERGY, RECENTLY ENGAGED AN**
9 **INTERNATIONALLY RESPECTED INVESTMENT BANKING FIRM TO**
10 **RENDER AN OPINION ON A PROPOSED COMPLEX BUSINESS**
11 **COMBINATION AND, IF SO, DID THAT FIRM EMPLOY THE CAPM IN ITS**
12 **ANALYSIS?**

13 **A.** Yes. In 2011 Entergy, the parent company of ENO, entered an agreement with ITC
14 Holdings, Corp. (“ITC”) to divest Entergy’s transmission utility assets² to ITC; and,
15 Entergy and ITC proposed the transaction to regulators for approval. As part of its due
16 diligence for the transaction Entergy employed Goldman, Sachs & Company (“Goldman”)
17 to evaluate the transaction from a financial point of view and present its analysis and

² I have shown transmission utility assets in underlining and italics to draw the Council’s attention to the fact the cost of equity used by Goldman was in the valuation of Entergy’s regulated transmission utility business and *not* in the valuation of either Entergy’s unregulated non-utility investments or Entergy’s market capitalization as a whole. Goldman’s estimated cost of equity for Entergy’s regulated transmission utility business was used to discount to net present value the net incremental cash flow for the transmission utility under varying assumptions. As explained here in my surrebuttal testimony, the estimated cost of equity for setting ENO’s utility rates is the cost of equity that represents the rate used to discount expected net incremental cash flows from an investment in ENO’s equity used to finance its’ utility business. The discounting of such cash flow in this manner estimates the net present value of such investment in ENO’s equity.

1 recommendations to the Board of Directors of Entergy on December 4, 2011.³ In the
2 course of Goldman’s review of the transaction, it estimated Entergy’s cost of equity for use
3 in discounting incremental net cash flow for the valuation of Entergy’s equity investment
4 in *its transmission utility business*. [REDACTED]

5 [REDACTED]
6 [REDACTED]
7 [REDACTED]

8 **Q. DO YOU BELIEVE IT IS INCONSISTENT FOR ENO WITNESS HEVERT TO**
9 **ARGUE AGAINST THE VALIDITY OF YOUR APPLICATION OF THE CAPM**
10 **IN THIS PROCEEDING?**

11 **A.** Yes. Entergy hired Goldman to value Entergy’s equity investment in *its transmission*
12 *utility business* pre- and post-transaction as part of its due diligence for its merger
13 transaction with ITC. Entergy compensated Goldman handsomely for their expertise and
14 provided Goldman access to Entergy’s Board of Directors to present their valuation of the
15 merger transaction to Entergy’s shareholders. As of October 2012, Entergy had
16 compensated Goldman \$ [REDACTED] for its financial analysis and projected that it would
17 pay \$ [REDACTED] to Goldman through the course of their engagement to analyze the ITC

³ I have attached the Advisors response to ENO’s Discovery Question.: ENO 3-1 as Exhibit No. (JMP-11).
In response to ENO’s discovery the Advisors included a copy of [REDACTED]

4 [REDACTED]

1 transaction.⁵ In its analysis, [REDACTED] to determine the ROE for
2 use in discounting cash flow.

3 **Q. WHY IS THE GOLDMAN ANALYSIS RELEVANT TO THIS PROCEEDING?**

4 **A.** As established in my direct and surrebuttal testimony, the required ROE, the cost of equity,
5 opportunity cost of equity or market capitalization rate for a particular investment are the
6 same. Also, the cost of equity for an investment in ENO's equity is essentially the same as
7 the cost of equity for an investment in Entergy's transmission utility business. Each
8 investment involves investing in regulated utility assets meaning the risk and return
9 attributes for each investment are very similar. Therefore, it should be obvious to the
10 Council that Goldman's application of the CAPM for determining the net present value of
11 cash flow for Entergy's transmission utility business does illustrate the appropriateness and
12 credibility of my application of the CAPM for estimating the cost of equity for ENO in this
13 electric utility ratemaking proceeding.

14 **Q. WITH RESPECT TO DERIVING COST OF EQUITY, IS THE OBJECTIVE FOR**
15 **GOLDMAN'S FAIRNESS OPINION DIFFERENT THAN FOR THE COUNCIL'S**
16 **REGULATORY PROCEEDING?**

17 **A.** Yes. Goldman's objective for determining the cost of equity was to determine whether the
18 terms of the proposed ITC transaction are fair to Entergy's shareholders from a financial
19 point of view. The Council's objective for authorizing ENO's cost of equity in this rate

⁵ Please see Entergy New Orleans, Inc.'s response to Advisors' 3-44 in Entergy New Orleans Docket No. UD-12-01.

1 proceeding is to determine a fair ROE to include in ENO's cost of capital. That is, a ROE
2 that fairly compensates shareholders for investing funds to finance the utility's operations.

3 Fortunately, the cost of equity is the same for each objective. In my direct testimony I
4 explain a utility's cost of equity, opportunity cost of equity and market capitalization rate
5 are synonymous. Further, ENO's electric utility business and Entergy's transmission utility
6 segment have similar business risks in that each represents utility businesses in which
7 prices and services are regulated by state and federal regulatory bodies. Similarly, ENO's
8 electric utility business and Entergy's transmission utility segment have virtually the same
9 capital structure meaning each has the same financial risk. Therefore, ENO's electric
10 utility business and Entergy's transmission utility segment have approximately the same
11 cost of equity. Hence, [REDACTED]

12 [REDACTED]

13 [REDACTED]

14 **Q. WITH RESPECT TO DERIVING COST OF EQUITY, DOES IT MAKE ANY**
15 **DIFFERENCE THAT ENTERGY AT THE TIME OF THE PROPOSED**
16 **TRANSACTION WAS A HOLDING COMPANY WITH DIVERSE**
17 **OPERATIONS?**

18 **A.** No. That Entergy was a holding company has no relevance in the determination of the cost
19 of equity for either its transmission utility business or ENO's electric utility business. Each
20 provide regulated utility services and Entergy's non-regulated functions at the time of the
21 proposed transaction should not be considered for determining the cost of equity in either

1 case. Remember, Goldman's estimate for the cost of equity was used in financial analysis
2 dealing only with valuing Entergy's transmission assets not Entergy's diverse investment
3 base.

4 If Goldman's CAPM analysis were for Entergy the Holding Company (which it was not),
5 Goldman's cost of equity of [REDACTED] would have been a higher, not lower, cost of equity
6 than for Entergy's transmission utility business. That is the case because an equity
7 investment in Entergy was riskier than an equity investment in its transmission utility
8 business. Therefore, if Goldman would have determined Entergy's cost of equity was
9 [REDACTED], which they did not do so, one should conclude the cost of equity for ENO's electric
10 utility business at the time of the proposed transaction was even lower.

11 **Q. DO YOU AGREE WITH MR. HEVERT'S ASSERTION THAT THE CAPM IS**
12 **NOT CURRENTLY RELIABLE FOR DETERMINING ENO'S COST OF**
13 **EQUITY?**

14 **A.** No. I will discuss his specific comments and point out the flaws in his arguments as they
15 apply to my analysis below in this surrebuttal testimony. However, the economic literature
16 and economic and mathematical theory deriving the CAPM do not support an argument
17 that application of the model is limited to circumstances when interest rates fall within a
18 specified range.
19

20
21 **Surrebuttal of Specific Statements in Hevert's Revised Rebuttal Testimony:**

1 **Q. DOES MR. HEVERT COMMENT ON THE ADVISORS COST OF EQUITY**
2 **RECOMMENDATIONS AS COMPARED TO THOSE APPROVED BY OTHER**
3 **REGULATORY BODIES?**

4 **A.** Yes. On page 16, Lines 6-8 of his Revised Rebuttal Testimony, Mr. Hevert states “Even
5 their 8.93 percent “risk-adjusted” estimate is below every return authorized for a vertically
6 integrated electric utility since at least 1980.” Also, see Pages 49 through 54 of his Revised
7 Rebuttal Testimony with respect to use of vertically integrated electric utility cost of equity
8 decisions in his Bond Yield Plus Risk Premium Approach.

9 **Q. SHOULD REGULATORY COMMISSIONS BASE DECISIONS ON ROE ON**
10 **WHAT OTHER REGULATORS HAVE DONE?**

11 **A.** No. The regulator should base its decision for cost of equity on relevant economic evidence
12 and the business and financial risk of the utility. When a regulatory commission authorizes
13 a ROE consistent with ROEs for other utilities, without having access to credible evidence,
14 that commission may be perpetuating findings based on flawed economic reasoning or
15 negotiated settlements not based on any stated reasoning.

16 **Q. DOES THE TENDENCY TO DO WHAT OTHER REGULATORS HAVE DONE**
17 **EXPLAIN WITNESS HEVERT’S OBSERVATION THAT ALLOWED RETURNS**
18 **BY REGULATORS DO NOT CHANGE BY THE SAME DEGREE AS INTEREST**
19 **RATES?**

20 **A.** Yes, I believe so. Mr. Hevert seems to agree that when interest rates move up or down, so
21 should the cost of equity move up or down, respectively. However, he does dispute my

1 testimony where I explain the degree of the change in the cost of equity is related to the
2 degree of change in short-term treasury bill interest rates. This is a reason he disputes my
3 application of the CAPM.

4 The Council can see a driving factor behind why authorized returns for utilities have not
5 recently changed by the degree which short-term interest rates change is due, in part, to the
6 inclination of regulatory bodies to do the “same thing” as other regulatory bodies. For
7 example, Mr. Watson, in his surrebuttal testimony observes that the North Carolina
8 Utilities Commission (“NCUC”)’s ROE decision cited by Mr. Hevert in his Revised
9 Rebuttal Testimony reflects the reauthorization of the same ROE the NCUC had authorized
10 in two previous ROE proceedings. It is the “safe” decision to make. It is particularly safe
11 when one understands the influence that occurs in the regulatory process and is placed on
12 regulators and their staffs.

13 **Q. WHAT DO YOU MEAN BY INFLUENCE ON THE REGULATORY PROCESS?**

14 **A.** In reviewing Mr. Hevert’s Revised Rebuttal Testimony one finds many examples of the
15 influence and pressures which can be placed on the regulatory process.⁶ For example, when
16 speaking of the Advisors’ recommendation for an 8.93 percent cost of equity, he testifies
17 that “Putting aside the many methodological issues discussed below, there simply is no
18 basis to conclude equity investors would be willing to commit their capital for the
19 opportunity to earn an 8.93 percent “risk-adjusted” return.” He then proceeds to discuss the

⁶ For example, see Mr. Hevert’s Revised Rebuttal Testimony beginning on page 16, line 3 in Docket No. UD-18-07.

1 extent that investor rating agencies place emphasis on authorized returns in their evaluation
2 of regulators.

3 Also, Mr. Hevert states “Mr. Proctor’s 7.57 percent CAPM result, which he argues is based
4 on a more defensible method, is so far removed from the returns investors know to be
5 available elsewhere that investors would not see it as meeting the Hope and Bluefield
6 standards.”⁷ This statement could be imposing to regulators.

7 **Q. DO YOU FIND MR. HEVERT’S TESTIMONY OUT OF PLACE GIVEN**
8 **GOLDMAN’S COST OF EQUITY ANALYSIS?**

9 **A.** Yes. Recall, using the CAPM, [REDACTED]
10 [REDACTED].⁸ The difference
11 between [REDACTED] cost of equity and my current CAPM
12 recommendation is largely due to the increase in interest rates and change in betas since
13 December 2011.

14 The cost of equity for Entergy’s regulated transmission utility business is virtually the same
15 as that for its integrated electric utility business. That is, each has the same financial risk
16 and very similar business risk. Because this proceeding involves ratemaking for ENO, an
17 integrated electric utility business owned by Entergy, it is reasonable to assume Goldman

⁷ See Mr. Hevert’s Revised Rebuttal Testimony page 50, lines 13-16 in Docket No. UD-18-07.

⁸ During December 2011, the 3-month United States Treasury Bill yield ranged between 0% and 0.02%. The 3-month United States Treasury Bill yield used in my CAPM was based on a contemporaneous yield of 2.42%.

1 would have determined ENO's cost of equity to be approximately the same as Entergy's
2 transmission utility business at December 2011.

3 **Q. DOES MR. HEVERT DISCUSS THE RANGE OF HIS ROE ESTIMATES AS**
4 **COMPARED TO THOSE OF MR. WATSON'S DCF ESTIMATES?**

5 **A.** Yes, on page 20, Line 6 of Mr. Hevert's Revised Rebuttal Testimony he states "Mr.
6 Proctor's testimony (at page 49) provides the results of my three methods, which run from
7 a low of 8.37 percent to a high of 12.28 percent, a range of 391 basis points. Although Mr.
8 Proctor is concerned with that variability, Mr. Watson's "two-step" DCF results span from
9 a low of 5.74 percent to a high of 10.64 percent, a range of 490 basis points. That is, the
10 391-basis point range that concerns Mr. Proctor is 99 basis points less than Mr. Watson's
11 range. If my range of results is a "concern" for Mr. Proctor, it seems that concern would
12 extend to Mr. Watson's results."

13 **Q. WHAT IS THE FLAW IN MR. HEVERT'S REASONING?**

14 **A.** Mr. Hevert's ROE results vary from a low of 8.37% using the DCF approach to a high of
15 12.28% using the CAPM approach. These findings concern me because the variance is
16 substantial, particularly since these ROE estimates are not for individual utilities. Instead,
17 these findings are for a proxy group of 22 utilities. Mr. Watson's "two-step" DCF results
18 span from a low of 5.74 percent to a high of 10.64 percent for individual members in his
19 proxy group. It is certainly reasonable for individual sample observations in a proxy group
20 to vary more than means "or averages" of various ROE methodologies.

1 That is, Mr. Hevert used three approaches to derive a ROE estimate for ENO. If one
2 assumes each of the three models are economically, mathematically and statistically sound
3 for estimating the ROE for ENO, and a proxy of 22 sample observations of similarly
4 situated companies were used in the analysis, the “averages” would not have a variance of
5 nearly 400 basis points. Therefore, I believe it should be apparent to the Council that one
6 or more of Hevert’s models is not a sound approach for deriving the ROE; or alternatively,
7 there are flaws in the assumptions and inputs into the models used.

8 Advisors’ ROE estimates based on means or “averages” of individual sample observations
9 of utilities varied much less than Hevert’s estimates. Specifically, I applied the CAPM for
10 deriving an estimate of ENO’s required ROE. The unadjusted estimate derived using the
11 CAPM was 7.57%⁹. Mr. Watson’s unadjusted estimate derived using the DCF approach
12 was 8.09%¹⁰. Therefore, using two different approaches by two different witnesses, the
13 Advisors developed ROE estimates with a range of only 52 basis points.

14 **Q. DID MR. HEVERT MISSTATE YOUR TESTIMONY REGARDING YOUR RISK**
15 **PREMIUM ANALYSIS?**

16 **A.** Yes, on page 30, line 8 of Mr. Hevert’s Revised Rebuttal Testimony, he states “Mr. Proctor
17 provides “Summary Statistics of Annual Total Returns” from 1960 through 2017 for
18 several asset classes, including large (capitalization) stocks, long-term Government bonds,
19 intermediate-term Government bonds, and U.S. Treasury bills.”

⁹ Please see Exhibit No. ___ (JMP-4) attached to my Direct Testimony herein.

¹⁰ Please see Mr. Watson’s Exhibit No. ___ (BSW-4)

1 I present these statistics for 1926 through 2017 as can be confirmed from reviewing Table
2 No. 1 of my Direct Testimony.

3 **Q. HOW DOES MR. HEVERT ADDRESS YOUR POSITION THAT HISTORICAL**
4 **RISKS AND RETURNS SHOULD BE USED IN THE CAPM ANALYSES?**

5 **A.** Mr. Hevert presents a derived regression equation in Chart 5 on page 32 of his Revised
6 Rebuttal Testimony. He concludes based on his regression equation that my CAPM
7 estimates, even adjusted for “business risk,” are insufficient.

8 **Q. DO YOU HAVE CONCERNS ABOUT MR. HEVERT’S REGRESSION**
9 **EQUATION?**

10 **A.** Yes. First, I am concerned that Mr. Hevert does not appear to test any of his derived
11 regression equations presented in Revised Rebuttal Testimony for “Lack of Fit”. I will
12 discuss this observation elsewhere in my surrebuttal testimony regarding certain other
13 regression equations.¹¹ The importance of testing for “lack of fit” of any regression
14 equation is described by N. R. Draper and H. Smith.¹²

15 We have already remarked that the fitted regression equation line is
16 a calculated line based on a certain model or assumption, an
17 assumption we should not blindly accept but should *tentatively*
18 *entertain*. In certain circumstances we can check whether or not the
19 model is correct. First, we can examine the consequences of an
20 incorrect model. (Emphasis Added)

¹¹ I am attaching Advisors 18-4 and Advisors 18-1 as Exhibit No. ____ (JMP-12) and Exhibit No. ____ (JMP-13), respectively, regarding other of Mr. Hevert’s regression equations.

¹² Please see, Section 1.5 Lack of Fit and Pure Error, N. R. Draper and H. Smith, Applied Regression Analysis, Second Edition pages 33-34.

1 The text describes that the regression's residual errors must be tested for "lack of fit".
2 Residual errors are defined as the difference between each observation value of the
3 dependent variable and its corresponding fitted value.¹³ The text discusses basic and
4 complex statistical and graphical tests which may be examined to determine whether the
5 residual errors are: (a) independent; (b) have a zero mean; (c) a constant variance; and, (d)
6 follow a normal distribution.¹⁴ Draper and Smith state on page 141 of the text the following.
7 "Thus if our fitted model is correct, the residuals should exhibit tendencies that tend to
8 confirm the assumptions we have made, or at least, should not exhibit a denial of the
9 assumptions." The residual errors must follow a normal distribution for T-tests and F-tests
10 to be conducted.

11 **Q. WHAT ARE YOUR CONCLUSIONS ABOUT MR. HEVERT'S REGRESSION**
12 **EQUATION?**

13 **A.** Mr. Hevert has not provided any evidence that he has examined the residual errors of his
14 regression equation in Chart 5 on page 32 of his Revised Rebuttal Testimony. Such
15 examination is required to determine whether the residual errors are: (a) independent; (b)
16 have a zero mean; (c) a constant variance; and, (d) follow a normal distribution. As
17 instructed by Draper and Smith above, these tests are necessary to accept, or at least not

¹³ Please see, Chapter 3 The Examination of Residuals, Section 3 Introduction, N. R. Draper and H. Smith, **Applied Regression Analysis**, Second Edition pages 141-142.

¹⁴ Please see, Chapter 3 The Examination of Residuals, N. R. Draper and H. Smith, **Applied Regression Analysis**, Second Edition pages 141-176.

1 reject” assumptions about the variables and one “should not blindly accept” an assumed
2 regression equation.

3 Therefore, I believe the Council should disregard the conclusions Mr. Hevert draws from
4 the regression equation presented in Chart 5. Specifically, the Council should reject Mr.
5 Hevert’s conclusion on page 32 that my CAPM ROE estimates provide too little return in
6 exchange for taking on too much risk.

7 **Q. DID GOLDMAN USE A HISTORICAL RISK PREMIUM IN THE ANALYSIS IT**
8 **CONDUCTED FOR ENTERGY IN DECEMBER 2011?**

9 **A.** Goldman used a historical risk premium in its CAPM analysis as I did. Also, Goldman
10 used the same source that I used for its historical equity risk premium.¹⁵ Goldman used
11 *Ibbotson’s equity risk premium from 1926-2010* for its December 2011 weighted cost of
12 capital analysis for Entergy. Of course, because my CAPM analysis was conducted in
13 December 2018 and January 2019, I was able to use the historical period of 1926 -2017 as
14 discussed above.

15 **Q. DOES MR. HEVERT SAY THE RISK-FREE RATE USED IN THE CAPM**
16 **SHOULD BE BASED ON A LONG-TERM BOND YIELD?**

17 **A.** Yes, on page 32 of his Revised Rebuttal, Mr. Hevert states “the security used as the risk-
18 free rate should match the life of the underlying investment, and referred to utility stocks

¹⁵ Please see page 42 of Exhibit No. ____ (JMP-11).

1 as “long-duration investments”. I do not agree. As explained in my Direct Testimony, the
2 CAPM should use the T-Bill rate as the risk-free rate of interest. However, in Exhibit No.
3 _____(JMP-5), I calculated a return on equity for ENO based on the CAPM using the 30-
4 year T-Bond yield. Using that “risk-free” rate in the CAPM yields a ROE of 6.68% (before
5 a business risk adjustment), an amount less than the ROE of 7.57% (before a business risk
6 adjustment) I determined using the T-Bill rate.

7 **Q. DOES MR. HEVERT CHALLENGE YOUR USE OF BETA IN THE CAPM?**

8 **A.** Yes. Mr. Hevert believes the beta coefficients I used in my CAPM underestimate investors’
9 return requirements.¹⁶ First, recall that Mr. Hevert and I each used Value Line Investment
10 Survey as a source of betas for the proxy companies. Mr. Hevert did not criticize the use
11 of the betas in preparing his Revised Direct Testimony. On the contrary, Mr. Hevert praised
12 his cost of equity estimates derived from his application of the CAPM. He recommended
13 that his CAPM findings were superior to those determined from his discounted cash flow
14 (“DCF”) model.¹⁷

15 **Q. DID GOLDMAN USE AN EQUITY BETA FOR ENTERGY SIMILAR TO THE**
16 **ONE YOU USED IN YOUR CAPM ANALYSIS?**

17 **A.** [REDACTED]
18 [REDACTED] A CAPM

¹⁶ See page 43 of Mr. Hevert’s Revised Rebuttal Testimony in Docket No. UD-18-07.

¹⁷ See page 77, lines 15-18 of Mr. Hevert’s Revised Direct Testimony in Docket No. UD-18-07.

¹⁸ Please see page 42 of Exhibit No. _____ (JMP-11).

1 analysis may employ two different betas in the analysis of risk. The asset beta is a
2 measurement of business risk undertaken by a firm for a capital investment in assets, in
3 this case ENO's assets. The equity beta is a measurement of business and financial risk,
4 undertaken by a firm, in this case ENO's equity. Because we are evaluating the riskiness
5 of an investment in equity here, it is ENO's equity beta we estimate for use in the CAPM.

6 [REDACTED]

7 [REDACTED]

8 [REDACTED] Recall, the equity beta,
9 based on Advisors' proxy group, used in my CAPM analysis was 0.59.¹⁹

10 **Q. DID MR. HEVERT USE A REGRESSION EQUATION IN EVALUATING YOUR**
11 **SELECTION OF BETA COEFFICIENTS?**

12 **A.** Yes. On page 52 of his Revised Rebuttal Testimony, Mr. Hevert claims to have discredited
13 my use of Value Line as a source for beta coefficients using a regression equation. The
14 Advisors submitted data request 18-4, attached as Exhibit No. ____ (JMP-12), to seek any
15 statistical or graphical analyses used to determine whether his regression equation suffered
16 from "lack of fit." ENO did not provide any evidence that Mr. Hevert examined the residual
17 errors of his regression equation and he relied on R-squared.

18 I discussed the importance and necessity of these analyses above. Specifically, Advisors
19 18-4 asked for ENO to provide any tests performed to determine whether the residual errors

¹⁹ Please see Exhibit No. ____ (JMP-9)

1 (the difference between each observation value of the dependent variable and its
2 corresponding fitted value): are independent; have a 0 mean; constant variance; and, follow
3 a normal distribution.

4 According to ENO's response, Mr. Hevert had not performed, or at least ENO was not
5 providing, any statistical or graphical tests regarding the residual errors of his regression
6 equation. The response suggested Mr. Hevert looked at the R-Squared to measure fit. R-
7 Squared does not address the distribution of the residual errors or whether the residual
8 errors are independent; have a 0 mean; constant variance; and, follow a normal distribution.
9 Therefore, R-Squared does not determine fit of a regression equation (please see my above
10 discussion on residual errors and "lack of fit").

11 Instead, R-Squared relates to a comparison of: (a) the difference between the fitted values
12 of the dependent variable and their mean and (b) the difference of the observed values of
13 the dependent variable and their mean. The residual errors relate to the difference between
14 the observed values of the dependent variable and the fitted values of the dependent
15 variable and must be evaluated to determine whether the regression equation can be
16 implemented with confidence.

17 Further, I asked ENO to provide certain basic graphical tests which could be used to
18 determine whether the residual errors are independent; have a 0 mean; constant variance;
19 and, follow a normal distribution. ENO's response to those questions was that "the
20 information in the form requested does not exist." Therefore, the Council should conclude

1 Mr. Hevert's testimony rebutting the credibility of my using Value Line as a source for
2 beta coefficients is not relevant.

3 **Q. DID MR. HEVERT REVISE HIS CAPM COST OF EQUITY ESTIMATES?**

4 **A.** Yes. I criticized Mr. Hevert's CAPM analysis in my Direct Testimony. Among my
5 concerns with his analysis, I explained that his beta coefficients derived from Value Line
6 were outdated and larger than current betas. In response, Mr. Hevert updated his CAPM
7 analysis.²⁰ If one compares the CAPM estimates derived in Mr. Hevert's Revised Direct
8 Testimony²¹ to those in his Revised Rebuttal Testimony, one can see after updating his
9 CAPM analysis the findings for ENO's cost of equity had declined from a midpoint
10 estimate in his Revised Direct Testimony of 11.21% [$11.21\% = (10.13\% + 12.28\%)/2$] to
11 a midpoint estimate in his Revised Rebuttal Testimony of 9.8% [$9.8\% = (8.25\% +$
12 $11.34\%)/2$].

13 **Q. SHOULD THE FACT THAT MR. HEVERT'S ROE ESTIMATES USING THE**
14 **CAPM DECLINED SIGNIFICANTLY IN HIS REVISED REBUTTAL**
15 **TESTIMONY CREATE A CONCERN FOR HIS OVERALL COST OF EQUITY**
16 **RECOMMENDATION?**

17 **A.** Yes. The updated and lower cost of equity midpoint estimate of 9.8% based on Mr.
18 Hevert's CAPM no longer supports ENO being authorized a ROE of 10.75%. Especially
19 so, when you evaluate Mr. Hevert's updated and lower cost of equity midpoint CAPM

²⁰ Please see Table 11 on page 144 of Mr. Hevert's Revised Rebuttal Testimony in Docket No. UD-18-07.

²¹ Please see Table 7 on page 34 of Mr. Hevert's Revised Direct Testimony in Docket No. UD-18-07.

1 estimate of 9.8% together with his updated DCF results presented in Table 11 of his
2 Revised Rebuttal Testimony. The midpoint from Hevert's updated DCF analysis was
3 9.36% [$9.36\% = (8.34\% + 10.38\%)/2$]. Also, keep in mind, Mr. Hevert did not specifically
4 quantify a business risk adjustment to be added to either of the CAPM or DCF findings.

5 **Q. WHAT THOUGHTS DO YOU HAVE REGARDING MR. HEVERT'S EXPECTED**
6 **EARNINGS APPROACH?**

7 A. Mr. Hevert's application of the Expected Earnings Approach "indicates a median Cost of
8 Equity of 10.52 percent..."²² The Expected Earnings Approach is based on examining the
9 "earned" return on common equity projected by Value Line for periods over 2021 through
10 2024. The projected "earned" return on common equity is not the same as deriving a
11 utility's opportunity cost of capital or required return on equity for ratemaking purposes.
12 The "earned" return on common equity is the return that is derived after accounting for all
13 factors affecting a utility's revenues, operating expenses, taxes, investments, capital
14 structure and actual cost of debt. A proper cost of equity analysis focuses on the economic
15 and financial factors affecting the required ROE. Therefore, the Council should give no
16 weight to the method when evaluating ENO's cost of equity in this proceeding.

17 **Q. WHAT HAS MR. HEVERT PROPOSED FOR A BUSINESS RISK ADJUSTMENT**
18 **TO YOUR ROE FINDINGS?**

²² Please see page 54 of Mr. Hevert's Revised Rebuttal Testimony in Docket No. UD-18-07.

1 **A.** Mr. Hevert suggests Advisors’ business risk adjustment should be 321-basis points instead
2 of 81 basis points.²³ Setting aside the extraordinary 240 basis point difference between his
3 recommendation and mine in my Direct Testimony, I note that Mr. Hevert did not (or was
4 unable to) quantify a business risk adjustment to be applied to his cost of equity analysis.
5 Yet, he suggests he can quantify a 321-basis point business risk adjustment for Advisors’
6 cost of equity analysis.

7 Furthermore, he does not reconcile his overall recommendation of 10.75% for ENO’s cost
8 of equity with any of the nineteen models employed nor does he provide any business risk
9 adjustment.

10 **Q.** **DOES IT CONCERN YOU THAT MR. HEVERT HAS NOT DEMONSTRATED**
11 **HOW HE ARRIVES AT HIS ROE RECOMMENDATION IN REVISED**
12 **REBUTTAL TESTIMONY?**

13 **A.** Yes. There does not appear to be any substantial evidence in either of Mr. Hevert’s Revised
14 Direct or Revised Rebuttal Testimony supporting the recommendation that ENO’s cost of
15 equity should be set at 10.75%.

16 **Q.** **DOES MR. HEVERT MAKE ARGUMENTS SUGGESTING THAT A BUSINESS**
17 **ADJUSTMENT FOR ENO IS UNNECESSARY?**

18 **A.** Yes. On page 63 of his Revised Rebuttal Testimony, Mr. Hevert discusses Modern
19 Portfolio Theory. In that discussion Mr. Hevert states “That is, any reduction in the Cost

²³ Please see page 57 of Mr. Hevert’s Rebuttal Testimony in Docket No. UD-18-07.

1 of Equity depends on the type of risk that is reduced; if the risk assumed to be mitigated
2 by the rate structures is diversifiable, there would be no reduction in the Cost of Equity
3 even if total risk (diversifiable plus non-diversifiable risk) has been reduced.”

4 A corollary to that statement should read that any increase in the cost of equity depends on
5 the type of risk that is increased; if the risk under consideration and examination is
6 diversifiable, there would be no increase in the cost of equity even if total risk (diversifiable
7 plus non-diversifiable risk) has been increased. Based on Mr. Hevert’s discussion of
8 Modern Portfolio Theory as it relates to the CAPM and diversifiable risk, one could argue
9 for denying a business risk adjustment to ENO’s cost of equity.

10 **Q. PLEASE EXPLAIN.**

11 **A.** According to Mr. Hevert’s discussion above, if the risk assumed to be increased for ENO
12 relates to diversifiable company specific business risk, there would be no need for an
13 increase in the Council authorized cost of equity to account for it. For example, the
14 following diversifiable risks discussed by Mr. Hevert as a basis for a business risk
15 adjustment require no cost of equity adjustment based on his application of the Modern
16 Portfolio Theory. Those risks include ENO’s planned capital investment program; ENO’s
17 credit profile; ENO’s geographic risk associated with severe weather; ENO’s risks
18 associated with the lack of customer diversity; and ENO’s small size relative to the proxy
19 group. That is, these diversifiable risks can be diversified by investors through their
20 investing in a diversified portfolio and, therefore, ENO requires no specific business risk
21 adjustment.

1 **Q. DO YOU HAVE ANY REBUTTAL ARGUMENTS CONCERNING MR.**
2 **HEVERT’S UPDATED BOND YIELD PLUS RISK PREMIUM APPROACH?**

3 **A.** Yes, Mr. Hevert updated his regression equation and cost of equity calculation using the
4 Bond Yield Plus Risk Premium (“BYPRP”) Approach. The revised regression equation is
5 discussed on page 52 of Mr. Hevert’s Revised Rebuttal Testimony.

6 First, I want to remind the Council that I provided extensive arguments opposing Mr.
7 Hevert’s BYPRP Approach in my Direct Testimony. I will not repeat those arguments but,
8 they apply also to his updated BYPRP Approach and findings.

9 Second, the Advisors submitted data request 18-1 to ENO, attached as Exhibit No. ____
10 (JMP-13), to seek any statistical or graphical analysis Mr. Hevert undertook to determine
11 whether the updated regression equation and analysis used for his updated BYPRP
12 Approach suffered from “lack of fit”. ENO did not provide any evidence that Mr. Hevert
13 examined the residual errors of the regression equation. Instead, he relied on R-squared.
14 The Council should review my earlier discussions on regression analysis and R-squared
15 and all my arguments from Direct Testimony to conclude Mr. Hevert’s application of the
16 BYPRP Approach does not provide reliable estimates for ENO’s cost of equity.

17 **Q. DOES MR. HEVERT BELIEVE YOU MISREPRESENTED HIS FLOTATION**
18 **COST CALCULATION?**

19 **A.** Yes. On page 64 of his Revised Rebuttal Testimony, Mr. Hevert states “Mr. Proctor agrees
20 an adjustment for flotation costs is reasonable, although he suggests I have calculated the

1 approximately nine basis point adjustment based on flotation costs of 1.12 percent of gross
2 equity issuance proceeds.”

3 **Q. IS MR. HEVERT CORRECT?**

4 **A.** No. Mr. Hevert is incorrect. I do not say or suggest that statement in my testimony. Instead,
5 I say “He calculates the flotation cost associated with the Entergy issuance at 1.12% of the
6 gross equity issuance proceeds.” This flotation cost amount is found at row 8, column L of
7 Mr. Hevert’s Exhibit RBH-12.

8 **Q. DOES MR. HEVERT ARGUE THAT ENO’S FLOTATION COST ADJUSTMENT**
9 **SHOULD BE BASED OVER SEVERAL YEARS AND ACROSS MANY**
10 **COMPANIES?**

11 **A.** Yes. On page 64 of his Revised Rebuttal Testimony, Mr. Hevert states “First, as noted
12 above the appropriate flotation cost rate is 2.525 percent, which represents the weighted
13 average rate over several years and across many companies.”

14 **Q. DO YOU AGREE?**

15 **A.** No. I disagree that the flotation costs incurred by other companies should be the basis of
16 ENO’s flotation cost. It should be based on the expenses incurred by ENO like all other
17 expenses in its cost of service.

18 **Q. DOES MR. HEVERT ASSET THAT FLOTATION COSTS ARE NOT**
19 **RECOVERED IN ENO’S REVENUE REQUIREMENTS?**

1 A. Yes. On page 65 of his Revised Rebuttal Testimony, Mr. Hevert states “Flotation costs are
2 not operating expenses and are not recovered through the Company’s revenue
3 requirement.”

4 Q. **DO YOU AGREE?**

5 A. No. Mr. Hevert is wrong. Flotation costs are operating expenses and can be recoverable
6 through ENO’s revenue requirement as either an expense or part of the return on equity.
7 Flotation costs relate to incremental costs incurred from the issuance of common stock.
8 These costs include incremental direct expenses such as costs for accounting, marketing,
9 consulting, administrative and legal services incurred for the issuance. The costs are
10 legitimately recoverable through utility rates either as a cost of equity or an operating
11 expense.

12 These cash expenditures are deductible on ENO’s income tax return. Therefore, ENO
13 receives a tax benefit for these direct expenses. This means the “after-tax” cost to ENO for
14 these direct expenses is approximately 0.828% [$0.828\% = (1 - 26.08\%) * 1.12\%$] of the
15 issuance amount based on ENO’s marginal corporate tax rate of 26.08%.

16 III. **ACCUMULATED DEFERRED INCOME TAXES**

17 **General Overview and Summary for Surrebuttal on ADIT:**

18 Q. **ON WHAT ISSUES DOES ENO WITNESS ROBERTS PROVIDE REBUTTAL**
19 **TESTIMONY?**

1 A. Mr. Roberts rebuts my testimony concerning accumulated deferred income taxes
2 (“ADIT”), Net Operating Loss Carry-forward (“NOLCF”) and Financial Accounting
3 Standards Board’s Interpretation No. 48 (“FIN 48”) .

4 **Q. HOW IS ACCUMULATED DEFERRED INCOME TAX PRESENTED IN ENO’S**
5 **FINANCIAL STATEMENTS?**

6 A. ADIT is a balance sheet account that usually is a liability, with a credit balance. ADIT can
7 also be an asset, with a debit balance.

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

11 A. Yes. Certain revenue and expense transactions affect net income for financial accounting
12 purposes in different periods than for income tax purposes. These differences are called
13 timing differences. When this happens, the current income tax expense calculated pursuant
14 to income tax law for such transactions differs from the income tax expense recorded in
15 the financial records of the company. The difference between the amount of income tax
16 expense recorded in the financial records of the company and the current income tax
17 expense based on income tax law is reflected in the book entries for deferred income tax
18 expense and ADIT. A company’s income tax expense for financial reporting purposes
19 equals the sum of current and deferred income tax expense, even though the company only
20 makes cash income tax payments with respect to the current component.

1 **Q. WHEN SETTING UTILITY RATES, MUST THE COUNCIL'S RATEMAKING**
2 **DECISIONS FOR DEFERRED INCOME TAX EXPENSE MATCH THE**
3 **FINANCIAL ACCOUNTING TREATMENT?**

4 **A.** No. The Council is not required to follow financial accounting standards for treatment of
5 deferred income tax expense when establishing regulatory rates. I am aware of no
6 regulations or other legal requirements that requires Council to do so. To the contrary, it is
7 standard industry practice not to follow financial accounting standards for the treatment of
8 deferred income tax expense when following such standards would lead to an unreasonable
9 or unjust result in ratemaking.

10 **Q. EXPLAIN HOW THE RECOGNITION OF DEFERRED INCOME TAX EXPENSE**
11 **MAY CREATE A CREDIT OR LIABILITY BALANCE FOR ADIT.**

12 Companies generally are allowed to depreciate assets more rapidly under income tax law
13 than for financial reporting purposes. That is because for financial reporting purposes an
14 asset is depreciated ratably (that is to say, in equal amounts) over its book life, while for
15 income tax purposes the same asset is depreciated on a more accelerated basis, with larger
16 depreciation in the early years of an asset's life and smaller depreciation amounts in later
17 years. By allowing a company to take a greater depreciation expense in the early years of
18 an asset's life, the company has reduced taxable income compared to its taxable income
19 for financial reporting purposes, and correspondingly reduced cash income tax payments
20 relative to those income taxes recorded in its financial statements.

1 The reduction of the tax benefit over time also would lead to a disparity between the tax
2 payments and tax reporting of the company, on the one hand, and the company's balance
3 sheet with its ratable depreciation for the asset, on the other. Therefore, in every year during
4 the depreciable life of an asset, the company debits or credits deferred income tax expense
5 and, correspondingly, credits or debits ADIT for the difference between the amount of
6 current income tax expense determined pursuant to income tax law and the amount of
7 income tax expense recorded in the financial records of a company. That is, the company's
8 total income tax expense, for financial accounting purposes, includes a current provision
9 payable to the government based on income tax law and deferred provision based on
10 financial accounting standards. Throughout the book depreciable life of a depreciable asset,
11 the balance of the related ADIT account is a credit or liability. However, the balance of the
12 ADIT account amortizes over the book life of the asset and eventually reaches a zero
13 balance in the final year.

14 **Q. EXPLAIN HOW THE RECOGNITION OF DEFERRED INCOME TAX EXPENSE**
15 **MAY CREATE A DEBIT OR ASSET BALANCE FOR ADIT.**

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

1 In the year the asset is sold, the current provision for income tax expense on the company's
2 books is initially fully offset by a credit to deferred income tax expense for financial
3 reporting purposes. At the same time, a like amount is debited to an ADIT asset account.
4 Then, for the year of the sale, a ratable portion of deferred income tax expense is recognized
5 for financial reporting purposes. Similarly, for financial reporting purposes, the ADIT asset
6 account is decreased by the same amount.

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

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

1 **Q. DOES MR. ROBERTS' REBUTTAL TESTIMONY PRESENT A FUNDAMENTAL**
2 **MISUNDERSTANDING OF ADIT THAT CAUSES HIS ARGUMENTS**
3 **REGARDING ADIT, NOLCF AND FIN 48 TO ALL FAIL?**

4 **A.** Yes. Mr. Roberts incorrectly characterizes ENO as receiving a cash loan from the
5 government when: (1) it files its' income tax returns according to the income tax law; and,
6 (2) its cash income tax payment to the government for a given tax year is less than the
7 income tax expense recorded in ENO's financial statements for the same year.²⁴ This
8 statement is blatantly false.

9 The only cash "loan" received by ENO comes from the ratepayers when it files income tax
10 returns according to the income tax law and its cash income tax payment is less than the
11 income tax expense recorded in ENO's financial statements. However, that cash "loan"
12 from ratepayers exists if and only if the deferred income tax expense recorded in ENO's
13 financial statements to comply with accounting requirements is also normalized for
14 ratemaking purposes. Remember, the Council and other regulatory bodies need not
15 normalize income tax expense for ratemaking purposes. Simply stated, ENO's recording
16 of deferred income tax expense to meet the accounting normalization requirements does
17 not provide any cash to ENO unless regulatory agencies authorize collection of those
18 deferred income taxes from ratepayers. Finally, ADIT is only recognized as cost-free
19 capital when the Council chooses to normalize income tax expense for ratemaking
20 purposes.

²⁴ See page 9 of Mr. Robert's Rebuttal Testimony filed in Docket No. UD-18-07.

1 Mr. Roberts is incorrect that the mere act of recording deferred income tax expense, and
2 the related ADIT, creates a government loan to ENO. Indeed, ENO's income tax expert
3 witness, Mr. James A. Warren, in a previous rate case before the Council admits that there
4 is no "loan" from the government in any normative sense of the legal concept.²⁵

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

12 To understand the error in Mr. Robert's position, consider the treatment of deferred income
13 tax expense in an unregulated company. For an unregulated company, the amount recorded
14 to deferred income tax expense for financial reporting purposes has no negative or positive
15 cash impacts. The unregulated company does not pay cash to or receive cash from the
16 government when it records deferred income tax expense. Unlike a current provision for
17 income tax expense, recording deferred income tax expense is a non-cash entry. Such an
18 entry is recorded, for financial reporting purposes, only to normalize or "smooth" and
19 "allocate" book income tax expense over the life of a timing difference. The recording has
20 no impact on ENO's cash flow. Since deferred income tax expense is a non-cash expense,

²⁵ See, Warren December 29, 2008 deposition transcript at 26:21-27:21, 46:12-47:18, 49:12-24 in Council Docket No. UD-08-03.

1 the corresponding balances of ADIT cannot be considered to represent a cash loan from
2 the government when it records deferred income tax expense.

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

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

15 **Q. IF ADIT REPRESENTS A “LOAN” FROM THE FEDERAL GOVERNMENT AS**
16 **ARGUED BY MR. ROBERTS, WOULD ENO BE REPAYING THE LOAN TWICE**
17 **AS TIMING DIFFERENCES REVERSE?**

18 **A.** Yes. As I have explained, the amortization of an ADIT liability in rate base provides the
19 income tax benefits of timing differences to ratepayers over time through credits to deferred
20 income tax expense. These credits lower utility rates. That is, the “loan” is from the
21 ratepayers and it is paid back to them through credits as timing differences reverse. If Mr.

1 Roberts were correct, the utility would be repaying the entire amount of the tax benefit
2 twice -- the first time to the ratepayers through the amortizing of ADIT, and the second
3 time to the government. No rational utility would utilize an income tax deduction in its tax
4 reporting if it had to repay it twice.

5 **Q. IS MR. ROBERTS' DISCUSSION OF HIS EXAMPLE 3 AND OF HOW ADIT**
6 **WORKS CORRECT?**

7 **A.** No. Mr. Roberts provides discussion of an example (his "Example 3") in his rebuttal
8 testimony that purportedly demonstrates how an ADIT liability of \$21 represents a
9 government loan to ENO.²⁶ His discussion of the example is wrong. The premise of his
10 argument here is that when ENO records deferred income tax expense, and the related
11 ADIT, the government sends ENO cash that must be paid back to the government as the
12 timing difference reverses.

13 I thoroughly explain above and below that when ENO records deferred income tax
14 expense, and the related ADIT, the Company receives no cash benefit, nor any cash from
15 the government. Specifically, no cash is recognized in ENO's Statement of Cash Flows
16 when accounting for the deferred income tax expense and its related ADIT.

17 ENO receives a cash benefit of \$21 if and only if the Council chooses to allow the deferred
18 income tax expense to be collected from ENO's customers through rates. If the Council
19 chooses to allow the deferred income tax of \$21 to be collected as cash from ENO's

²⁶ See Example Three on page 6; page 8, line 1; and page 9, lines 2-4 of Mr. Roberts' Rebuttal Testimony in Docket No. UD-18-07.

1 customers that Council decision creates customer-supplied cost-free capital for ENO
2 requiring the related ADIT of \$21 to offset rate base.

3 **Q. DO UNREGULATED COMPANIES RECEIVE A LOAN FROM THE**
4 **GOVERNMENT WHEN RECORDING DEFERRED INCOME TAX EXPENSE?**

5 **A.** No. For example, when Ford Motor Company or Boeing record accelerated depreciation,
6 the related deferred income tax expense does not amount to a government loan either.
7 Again, when these companies record deferred income tax expense, there is no
8 accompanying cash loaned by the government to any of these companies for all the reasons
9 explained above. However, unlike for regulated utility companies, there is no legally
10 enforceable mandate by a regulatory body that Ford Motor Company and Boeing be
11 permitted to recover deferred income tax expense amounts from its customers; unlike with
12 ENO, these unregulated companies cannot charge their customers for deferred income tax
13 expenses. Therefore neither the government nor customers provide cost-free capital to
14 unregulated companies by dint of recording deferred income tax expense.

15 A liability balance recorded for ADIT does not represent indebtedness of a company to the
16 government. However, for utility companies, which have their rates established so that
17 deferred income tax expense is recovered from ratepayers, a credit balance of ADIT
18 represents an amount for income tax expense that actually is paid by the customers before
19 it is paid by the utility. The recovery of deferred taxes through rates creates cost-free capital
20 for ENO. In effect, the utility's customers -- not the United States government -- are loaning
21 funds to the utility, because deferred income tax expense is recovered through their rates.

1 Therefore, the amount of otherwise cost-free capital provided ENO through customer paid
2 revenues must be used to decrease ENO's rate base.

3 Now, returning to the treatment of deferred income tax expense for unregulated companies
4 like Ford Motor Company and Boeing, the amount recorded to deferred income tax
5 expense for financial reporting purposes has no negative or positive cash flow impacts for
6 such companies. The unregulated company does not pay cash to or receive cash from the
7 government when it records deferred income tax expense. However, in an efficient market,
8 through competition an unregulated company over time also flows through the cash flow
9 benefit from using accelerated depreciation to its customers, in the form of lower prices for
10 its goods or services. It can try to recover the deferred income tax expense indefinitely in
11 the marketplace, but the marketplace will determine if it is successful. Therefore, if Ford
12 Motor Company and Boeing operate in an efficient competitive market, its customers do
13 not provide them cost-free capital.

14 **Q. DOES MR. ROBERTS SUGGEST THAT YOU BELIEVE INCOME TAX**
15 **NORMALIZATION IS A BURDEN ON CUSTOMERS?**

16 **A.** Yes. On pages 4 and 5 of his Rebuttal Testimony, Mr. Roberts states "James M. Proctor
17 provides a discussion of income tax normalization suggesting that income tax
18 normalization, which the Council as well as the Federal Energy Regulatory Commission
19 ("FERC") requires ENO to use, is a burden to customers, when it is not."

20 I have not stated or suggested that position in my Direct Testimony and Mr. Robert's has
21 not provided a cite of my testimony supporting his assertion.

1 **Q. WHY IS MR. ROBERTS INCORRECT THAT “TIMING DIFFERENCES” DO**
2 **NOT CHANGE THE AMOUNT OF INCOME TAX EXPENSE PAID BY**
3 **CUSTOMERS?**

4 **A.** On page 6 of his Rebuttal Testimony, Mr. Roberts states “These examples show that
5 timing differences for when items of expense and revenue are included in cost of service
6 versus when included on the income tax return do not change the amount of income tax
7 expense paid by customers in rates.”

8 Mr. Roberts’ illustration on page 6 of his Rebuttal Testimony demonstrates one of the
9 fundamental flaws in his and ENO’s position on the deferred income tax and ADIT issues.
10 That is, even though timing differences for when items of expense and revenue are included
11 in cost of service versus when included on the income tax return do not change the amount
12 of income tax expense paid by customers in rates, it does change: (i) the amount of income
13 taxes paid by ENO and (ii) the amount of cost-free capital provided by ratepayers.

14 That is, for example, looking at his Example 3 one can see ENO pays \$42 of current income
15 tax expense to the government but collects \$63 of income taxes from ratepayers. That
16 means the ratepayers have provided ENO \$21 more through its rates than ENO paid in
17 current tax payments. The \$21 represents a “loan” from ratepayers to ENO requiring the
18 amount to be deducted from ENO’s rate base to provide ratepayers a return on ENO’s
19 otherwise cost-free capital.

20 The Council can see here the issue regarding ADIT is a comparison of: (i) the amount of
21 income taxes paid by ENO and (ii) the amount of cost-free capital provided by ratepayers.

1 **Q. IS MR. ROBERTS CORRECT THAT RECORDING DEFERRED INCOME TAX**
2 **EXPENSE REFLECTS A PAYMENT OF CASH?**

3 **A.** No. On page 7 of his Rebuttal Testimony, Mr. Roberts states “Deferred income tax expense
4 is the amount that should be paid to (or received from) the taxing authorities in the future
5 attributable to economic activity in the current period” and “I think Mr. Proctor’s
6 characterization of deferred income tax expense is misleading. Deferred income tax
7 expense does reflect a payment of cash, but the payment will occur in the future.”

8 Mr. Roberts’ above statements demonstrate another of the fundamental flaws in his and
9 ENO’s position. Deferred income tax expense is a non-cash event regardless of whether it
10 is recorded currently or in the future. No cash exchanges between ENO and the government
11 due to the recording of deferred income tax expense, but cash is collected by ENO from
12 ratepayers. The act of recording deferred income tax expense for financial reporting
13 purposes is simply to normalize income tax expense for accounting purposes over the life
14 of a timing difference.

15 Perhaps, the best way to understand that deferred income tax expense is a non-cash item is
16 to examine its treatment in ENO’s Statement of Cash Flows. Deferred income tax expense
17 is removed from expense on a Statement of Cash Flow regardless of whether it is a credit
18 or debit entry because it is neither a receipt of nor payment of a cash expense at any time.
19 Nonetheless, deferred income tax expense is recoverable through rates from ratepayers and
20 is part of ENO’s cost of service studies as filed in the instant proceeding.

21 **Q. WHAT IS WRONG WITH MR. ROBERTS ASSERTION THAT ADIT IS NOT A**
22 **LOAN FROM CUSTOMERS?**

1 **A.** On page 8 of his Rebuttal Testimony, Mr. Roberts states “Since customers pay the same
2 amount in rates regardless of the amount of deferred income taxes, the ADIT is not like a
3 loan from customers.”

4 It is a recurring theme throughout Mr. Roberts’ Rebuttal Testimony that “ADIT is not like
5 a loan from customers”. Mr. Roberts testimony here demonstrates another of the
6 fundamental flaws in his and ENO’s position. That is, when ADIT is credited, the related
7 deferred income tax is collected through rates and does represent a cost-free loan from
8 ratepayers. These taxes are collected from ratepayers even though they are not paid to the
9 government.

10 Perhaps the best way to illustrate this concept relates to a discussion of Excess ADIT
11 created pursuant to the 2017 Tax Act. Excess ADIT is an issue I discuss extensively in my
12 Direct and Surrebuttal Testimony. As of December 31, 2017, Excess ADIT existed on
13 ENO’s books attributable to lower income tax rates pursuant to the 2017 Tax Act. ENO,
14 and other utilities throughout the United States, were required by their regulators to refund
15 Excess ADIT to ratepayers because the amounts were “loaned” to ENO, and the other
16 utilities, from ratepayers.

17 The excess deferred taxes are not paid to the government because the Excess ADIT was
18 not a “loan” from the government to ENO. If it were a “loan” from the government, the
19 Excess ADIT would have been repaid to the government and not provided to ratepayers.

1 **IV. NET OPERATING LOSS CARRY-FORWARD**

2 **Q. IS MR. ROBERTS TESTIMONY RIGHT ABOUT THE CORRECT**
3 **RATEMAKING FOR DEFERRED INCOME TAX EXPENSE AND ADIT WHEN**
4 **HE DISCUSSES NET OPERATING LOSS CARRY-FORWARD?**

5 **A.** No. Mr. Roberts' discussion of NOLCF assumes the incorrect proposition that the reason
6 ENO receives cash benefits through income tax normalization is due to them receiving
7 government loans with respect to recording deferred income tax expense.

8 Clearly, I demonstrate that ADIT balances, whether debit or credit, should be in ENO's
9 rate base if, and only if, the related recorded deferred income tax expense credits and debits
10 have been recognized for ratemaking purposes. With respect to the NOLCF, the debit
11 balances of ADIT that ENO and Mr. Roberts wants in rate base were not offset, when
12 recorded, with corresponding credits to deferred income tax expense through the
13 ratemaking process and, therefore, the ADIT asset should not be in rate base.

14 **Q. PLEASE EXPLAIN THE NET OPERATING LOSS CARRY-FORWARD ISSUE.**

15 **A.** ENO proposes to include \$9,402,024 of ADIT in rate base related to NOLCF as of calendar
16 year ending December 31, 2018.²⁷ This amount is attributed to state and federal operating
17 losses recorded in the previous years that were not used prior to December 31, 2018 to
18 decrease ENO's current income tax expense.

19 The NOLCF ADIT amounts represent a future income tax benefit that ENO may use, as
20 an income tax credit, to decrease future income tax expense. That is why the amounts are

²⁷ Please see the discussion in James M. Proctor's Direct Testimony in Docket No. UD-18-07 regarding the proper ratemaking adjustments necessary for ENO's revisions to the NOLCF and ADIT amounts included in ENO's Revised Direct Testimony. The amount shown above is after accounting for ENO's revisions.

1 recorded in ADIT asset accounts. However, when recorded, these future income tax
2 benefits are not to be considered for ratemaking purposes either as ADIT debits to rate base
3 or deferred income tax expense credits to operating income. That treatment is afforded to
4 the NOLCF because ENO did not record a cash expenditure with respect to the recording
5 of these ADIT assets and, therefore, as explained elsewhere in my direct and surrebuttal
6 testimony, should not receive rate base treatment. By cash expenditure I mean ENO has
7 not paid income taxes upfront and then offset that upfront payment by decreasing (or
8 crediting) deferred income tax expense for ratemaking purposes. ENO records the asset
9 simply to comply with financial accounting standards that call for ENO's books to reflect
10 that ENO has had operating losses that can be used in subsequent years to decrease its
11 income tax liability. Therefore, because ENO did not record a cash expenditure with
12 respect to the recording of these ADIT assets, the ADIT asset should not be allowed to earn
13 a return from including it in ENO's rate base and then collecting the return from ratepayers.

14 **Q. YOU EXPLAIN THAT THE ADIT ASSET BALANCE FOR THE NET**
15 **OPERATING LOSS CARRY-FORWARD SHOULD NOT BE IN RATE BASE.**
16 **ARE ADIT ASSETS SOMETIMES INCLUDED IN RATE BASE?**

17 **A.** When in ratemaking a regulator permits a regulated utility to normalize income tax expense
18 for timing differences, deferred income tax expense will have a cash impact for that utility.
19 For example, under normalization treatment for the income tax paid for the gain on the sale
20 of an asset, a utility records a cash cost from paying income taxes on the gain upfront in
21 the year of the sale; but through ratemaking the utility recovers those tax payments from
22 ratepayers over time. The un-recovered accumulated investment represented by the ADIT

1 asset balance is used to increase the utility's rate base, and the regulator thereby treats the
2 cost recorded by the utility to pay income taxes in the year of the sale as a cash investment
3 to be recovered ratably from ratepayers in future years. Increasing the rate base for the
4 ADIT balance in effect allows the utility to earn a return from the ratepayers on the upfront
5 cash investment.

6 ENO has no such cash investment with respect to the ADIT asset recorded for NOLCF and
7 therefore its balance should not be in rate base.

8 **Q. DOES MR. ROBERTS STATE THAT THE RECORDING OF NOLCF ADIT**
9 **AFFECTS THE AMOUNT OF INCOME TAX EXPENSE PAID BY**
10 **RATEPAYERS?**

11 **A.** No, he does not. On page 10 of his Rebuttal Testimony, Mr. Roberts states for his Example
12 2 "The recording of the NOL ADIT does not affect the amount of income tax expense paid
13 by customers." However, his Example 2 does not depict an example of NOLCF ADIT.

14 Instead, Example 2 depicts a situation when ENO pays \$147 more in current income tax
15 expense than the \$63 collected from ratepayers. Therefore, the resulting \$147 of ADIT
16 asset should be in rate base if it relates to a timing difference for a regulatory cost. I have
17 discussed ADIT assets elsewhere in my testimony with respect to utility asset sales.

18 Example 2 is not an illustration of ENO's NOLCF ADIT asset because the NOLCF ADIT
19 asset on ENO's books does not represent a situation when current income taxes paid by
20 ENO exceed the amount of income taxes collected from ratepayers. That is, instead the
21 NOLCF ADIT recorded by ENO (in dispute here), relates to deferred income tax expense

1 previously collected from ratepayers and should not be used to offset the related ADIT
2 liability.

3 **Q. DOES MR. ROBERTS ARGUE THAT WHEN ENO IS IN A NET OPERATING**
4 **LOSS POSITION, NO COST-FREE CAPITAL IS CREATED THROUGH ADIT**
5 **LIABILITIES?**

6 **A.** Yes. On page 10 of his Rebuttal Testimony, Mr. Roberts states “credit ADIT is included
7 as an offset to rate base because ENO has been able to delay the payment for taxes through
8 accelerated tax depreciation deductions. But, when ENO is in a net operating loss position,
9 no cost-free capital is created because there were no tax payments to delay.”

10 Mr. Roberts’ testimony is incorrect. Cost-free capital was provided by ratepayers even
11 though ENO may have recorded an NOL in the same period. The cost-free capital relates
12 to the deferred income taxes ENO collected through rates. ENO’s collection of deferred
13 income tax expense from ratepayers occurred regardless of whether ENO had an NOL the
14 same year. If ENO did record an NOL, the NOL was less than otherwise because the
15 deferred income tax collected from ratepayers increased its revenues mitigating the NOL
16 amount. If the NOLCF ADIT asset is included in rate base (thus offsetting the ADIT
17 liability) as proposed by ENO, ENO recovers a return on the deferred income taxes (related
18 to the ADIT liability) previously collected from its ratepayers.

19 **Q. DOES MR. ROBERTS ALSO ARGUE THAT THE AMOUNT OF NOLCF ADIT**
20 **ASSETS “ATTRIBUTABLE” TO ACCELERATED DEPRECIATION MUST BE**
21 **IN RATE BASE?**

1 A. Yes. On pages 11 through 12 of his Rebuttal Testimony, Mr. Roberts' states "Internal
2 Revenue Code ("IRC") Section Regulation Section 1.167(1)-1(h)(1)(iii) makes it clear that
3 the amount of a utility's NOL ADIT asset that is attributable to income tax depreciation
4 must be included in rate base." Also, "To do otherwise is a normalization violation because
5 credit ADIT attributable to accelerated tax depreciation deductions would offset rate base
6 for which no cost-free capital was received."

7 IRC Section Regulation Section 1.167(1)-1(h)(1)(iii) does not make it clear that the amount
8 of a utility's NOLCF ADIT asset that is "attributable" to income tax depreciation must be
9 included in rate base. Further, IRC Section Regulation Section 1.167(1)-1(h)(1)(iii) is
10 misunderstood and misapplied by ENO.

11 The ADIT liability "attributable" to accelerated tax depreciation deductions did provide
12 cost-free capital and must not be offset by the NOLCF ADIT asset "attributable" to
13 accelerated tax depreciation deductions.

14 **Q. DOES MR. ROBERTS STATE THAT THE IRS PRIVATE LETTER RULINGS**
15 **ATTACHED TO HIS REBUTTAL TESTIMONY EXPLAIN THAT NOLCF ADIT**
16 **ASSETS MUST BE IN RATE BASE?**

17 A. Yes. On pages 11 through 12 of his Rebuttal Testimony, Mr. Roberts states "Attached as
18 Exhibit RLR-2 are two IRS private letter rulings, PLR Nos. 201438003 and PLR
19 201548017, that explain in detail the income tax normalization rules that require the
20 inclusion in rate base of NOL ADIT attributable to accelerated tax depreciation. Those
21 private letter rulings explain that the NOL ADIT asset must be included in rate base to
22 reduce the credit ADIT by the amount for which no cost-free capital was received."

1 **Q. HOW DO YOU RESPOND TO MR. ROBERTS CONCERNING THE PRIVATE**
2 **LETTER RULINGS?**

3 **A.** I have examined the Private Letter Rulings (“PLRs”) attached to Mr. Roberts’ Rebuttal
4 Testimony. It is apparent to me from reading the PLRs the IRS relied on misinformation
5 provided by the utilities seeking the PLRs. That is, the circumstances described to and
6 relied on by the IRS from the utilities appeared to be biased in favor of the rulings sought
7 from the IRS by the utilities. Furthermore, the IRS private letter rulings, PLR Nos.
8 201438003 and PLR 201548017, attached as Exhibit RLR-2 to Mr. Roberts Rebuttal
9 Testimony include the following language.

10 PLR No. 201438003:

11 This ruling is based on the representations submitted by Taxpayer and is
12 only valid if those representations are accurate. The accuracy of these
13 representations is subject to verification on audit. Except as specifically
14 determined above, no opinion is expressed or implied concerning the
15 Federal income tax consequences of the matters described above. This
16 ruling is directed only to the taxpayer who requested it. Section 6110(k)(3)
17 of the Code provides it may not be used or cited as precedent. In accordance
18 with the power of attorney on file with this office, a copy of this letter is
19 being sent to your authorized representative. (Emphasis Added)

20

21 PLR No. 201548017:

22 Except as specifically determined above, no opinion is expressed or implied
23 concerning the Federal income tax consequences of the matters described
24 above. This ruling is directed only to the taxpayer who requested it. Section
25 6110(k)(3) of the Code provides it may not be used or cited as precedent. In
26 accordance with the power of attorney on file with this office, a copy of this
27 letter is being sent to your authorized representative. (Emphasis Added)

28

1 Therefore, not only do the circumstances relied on by the IRS in issuing these PLRs not
2 explain the circumstances regarding ENO's NOLCF ADIT assets, and the ratemaking
3 treatment sought by ENO for them from the Council, the rulings have no precedence with
4 respect to an IRS PLR which could be sought by ENO.

5 **Q. WHAT IS THE MOST FUNDAMENTAL FACT REGARDING ENO'S NOLCF**
6 **ADIT ASSETS THAT REQUIRE THEIR EXCLUSION FROM RATE BASE?**

7 **A.** The most fundamental reason ENO's NOLCF ADIT assets should not be in rate base is
8 that ENO was provided cost-free capital from the ratepayers with respect to the ADIT
9 liabilities that ENO hopes to offset. This crucial fact is not disputable. I have discussed this
10 fact extensively in each of my Direct and Surrebuttal Testimony.

11 That is, ENO was provided cost-free capital from the ratepayers because in the periods
12 NOLs were recorded, ENO still recovered through rates the deferred income tax expense
13 for the timing difference related to accelerated depreciation. As such, ENO's recovery of
14 the depreciation related deferred income taxes increased ENO's cash revenues by an
15 amount equal to the deferred taxes. These deferred taxes were not paid to the government.
16 Therefore, because these deferred taxes were not paid to the government but recovered
17 from ratepayers, cost-free capital was provided to ENO by ratepayers. The fact that ENO
18 may have had a NOL during the same period is not relevant and does not disprove that cash
19 revenues were received from ratepayers.

20 Furthermore, ENO's cash revenues were greater during the periods its NOLs were recorded
21 due to ENO's recovery from ratepayers of the deferred income tax expense related to
22 accelerated depreciation. That is, the NOL recorded during the previous periods was less

1 than it otherwise would be by an amount equal to the deferred income taxes which were
2 not paid to the government but were collected from ratepayers.

3 Clearly, ENO did receive cost-free capital from its ratepayers for the timing difference
4 related to accelerated depreciation during the periods of ENO's NOLs.

5 **Q. IS THERE ANOTHER FUNDAMENTAL FACT SUPPORTING ADVISORS'**
6 **TREATMENT TO REMOVE ENO'S NOLCF ADIT ASSETS FROM RATE BASE?**

7 **A.** Yes. Mr. Roberts takes the position that part of ENO's NOLCF ADIT assets are directly
8 "attributable" to income tax timing differences with respect to accelerated and straight-line
9 depreciation. For example, on page 10 of his Rebuttal Testimony, Mr. Roberts states "ENO
10 is only including the NOL ADIT attributable to accelerated income tax depreciation in rate
11 base." Yet, none of ENO's NOLCF ADIT assets are directly "attributable" to income tax
12 timing differences.

13 **Q. WHAT IS ACCELERATED INCOME TAX DEPRECIATION?**

14 **A.** Accelerated income tax depreciation is also sometimes referred to as liberalized
15 depreciation. It relates to the depreciation expense that may be deducted by a taxpayer for
16 determining its current income tax liability. With respect to utilities, like ENO, liberalized
17 depreciation may be further divided into two components. That is, it can be divided into an
18 amount based on straight-line depreciation and an amount based on excess depreciation
19 over straight-line. In later years of an asset's depreciable life, excess depreciation is a
20 negative amount. The sum of straight-line depreciation and excess depreciation equal
21 liberalized depreciation. In later years of an asset's depreciable life, liberalized depreciation
22 is less than straight-line depreciation.

1 **Q. WHAT IS A NET OPERATING LOSS?**

2 **A.** I agree with Mr. Roberts definition of a net operating loss, or NOL. On page 9 of his
3 Rebuttal Testimony, Mr. Roberts explains that an NOL is recorded when a company has
4 more income tax deductions than taxable income, the excess of the income tax deductions
5 over taxable income is called a net operating loss (NOL).

6 **Q. WHY IS THE NOLCF ADIT ASSET NOT ATTRIBUTABLE TO ACCELERATED**
7 **DEPRECIATION?**

8 **A.** First, I'd like to point out that cash is fungible. That is, within ENO's corporate structure
9 movements of cash cannot be traced to any specific receipt or expenditure. ENO's witness
10 Mr. Hevert seems to agree with me. In his Rebuttal Testimony, Mr. Hevert claims "it is a
11 long held understanding in corporate finance that cash is fungible and cannot be traced to
12 specific uses."²⁸

13 The NOLCF ADIT asset is not attributable to accelerated depreciation because the NOL
14 cannot be tied to the excess depreciation over straight-line depreciation. That is, when ENO
15 records an NOL, ENO's NOL is caused by the collective effect from all components of its
16 Income Statement. That is, the NOL falls out from ENO's calculation of net income after
17 accounting for its utility service revenues, other operating revenues, all operation &
18 maintenance expenses, regulatory debits and credits, straight-line depreciation expense and
19 excess depreciation expense, taxes other than income taxes and other miscellaneous tax
20 deductions. One cannot simply calculate an NOLCF ADIT asset attributable to solely

²⁸ See Mr. Hevert's Rebuttal Testimony at page 78 in Docket No. UD -18-07.

1 excess depreciation over straight-line depreciation expense when the NOLCF ADIT asset
2 results from the collective effect from all components of the Income Statement discussed
3 above.

4 **Q. HAS AN ENTERGY INCOME TAX EXPERT PREVIOUSLY TESTIFIED IN**
5 **OTHER PROCEEDINGS REGARDING WHETHER AN NOLCF CAN BE**
6 **ATTRIBUTED TO ANY ONE INCOME TAX DEDUCTION?**

7 **A.** Yes. Mr. James A. Warren, discussed above in my surrebuttal testimony, has on behalf
8 of Entergy agreed in other proceedings that an NOLCF position cannot be tied to any one
9 tax deduction. Mr. Warren freely conceded that no one item of expense can be pinpointed
10 as the cause of net operating losses. Indeed, it was Mr. Warren's position that "because all
11 of the Company's tax deductions are subtracted from all revenue to calculate the
12 Company's net taxable income or loss," regulatory bodies "cannot possibly identify" which
13 tax deductions create net operating loss carry-forwards.²⁹

14 **Q. DOES MR. ROBERTS ASSERT THAT YOUR TREATMENT FOR DEFERRED**
15 **INCOME TAX EXPENSE IS A DEPARTURE FROM COUNCIL PRACTICE?**

16 **A.** Yes. On page 13 of his Rebuttal Testimony, Mr. Roberts asserts that my recommendation
17 to decrease deferred income tax expense if the NOLCF ADIT asset is included in rate base
18 is a departure from the Council's practice of normalizing income tax expense for
19 ratemaking purposes. He defends that position by stating "As I showed in my examples
20 above, the creation of an ADIT asset or liability does not affect the amount of income tax

²⁹ Entergy Gulf States, Inc. v. Louisiana Public Service Comm'n, 730 So.2d 890, 909 (La. 1999), adopted by Mr. Warren, Warren December 29, 2008 deposition transcript at 72:5-73:23 in Council Docket No. UD-08-03.

1 expense paid by customers in rates. Therefore, Mr. Proctor's recommendation is
2 inappropriate and unsupported."

3 **Q. HOW DO YOU RESPOND TO MR. ROBERTS' STATEMENT ON COUNCIL**
4 **PRACTICES?**

5 **A.** Mr. Roberts is wrong that "the creation of an ADIT asset or liability does not affect the
6 amount of income tax expense paid by customers in rates." That scenario only exists when
7 income tax expense is not correctly normalized for ratemaking purposes.

8 Specifically, when an ADIT asset or ADIT liability is entered in ENO's books, ENO also
9 enters a credit or debit entry, respectively, for an equal amount to deferred income tax
10 expense. The deferred income tax expense should be included in ENO's operating expenses
11 recoverable from ENO's ratepayers when the corresponding entry to either an ADIT asset
12 or ADIT liability is included in ENO's rate base. This allows for consistency between rate
13 base and operating expenses and correctly normalizes income taxes for ratemaking
14 purposes.

15 Including deferred income tax expense in ENO's operating expenses, and therefore
16 revenue requirements, allows ENO to either collect more revenues (as with an ADIT
17 liability entry) or less revenues (as with an ADIT asset entry) for income taxes than the
18 current income tax paid by the company.

19 The ADIT liability or ADIT asset is included in rate base because the inclusion of the
20 related deferred income tax expense in ENO's revenue requirements provides an otherwise
21 cost-free loan (as with an ADIT liability entry) from ratepayers or additional cash
22 investment (as with an ADIT asset entry) on behalf of ratepayers. Mr. Roberts' table on

1 page 6 of his Rebuttal Testimony can be used to illustrate these scenarios for ADIT asset
2 and ADIT liability entries to rate base.

3 Example 2 of Mr. Roberts' table illustrates the ADIT asset scenario. In that example the
4 company pays \$210 income tax expense to the government. However, only \$63 of that
5 amount is collected currently from ratepayers. The difference of \$147 establishes an ADIT
6 asset account for inclusion in rate base and a credit of \$147 to deferred income tax expense,
7 thus lowering the amount of tax expense recovered currently from ratepayers by \$147
8 [$\$147 = (\$210 - \$63)$]. The \$147 entered as an ADIT asset represents an additional cash
9 investment on behalf of ratepayers, and thus, rate base increases by \$147 to recognize ENO
10 paid \$147 of income taxes not yet collected from ratepayers.

11 Example 3 of Mr. Roberts' table illustrates the ADIT liability scenario. In that example,
12 ENO pays \$42 of income tax expense to the government. However, ENO recovers \$63 of
13 income tax expense currently from ratepayers. The difference of \$21 establishes an ADIT
14 liability for inclusion in ENO's rate base and a debit of \$21 to ENO's deferred income tax
15 expense, thus increasing the amount of tax expense recovered currently from ENO's
16 ratepayers by \$21 [$\$21 = (\$63 - \$42)$]. The \$21 entered as an ADIT liability represents an
17 otherwise cost-free loan from ratepayers. Thus, rate base is decreased by \$21 to recognize
18 ENO paid \$21 less in income taxes than it collected from ratepayers.

19 Finally, as explained and illustrated above, if rate base increases from ENO's inclusion of
20 an NOLCF ADIT asset (as with Example 2 above) in rate base, the Council must decrease
21 operating expenses by an equal amount for deferred income tax expense in order to
22 properly normalize income tax expense for ratemaking purposes.

1 So, the Council can see that the Advisors' recommendation to decrease deferred income
2 tax expense if the related NOLCF ADIT asset is included in rate base is consistent with
3 proper ratemaking and Council practice regarding income tax normalization.

4 **Q. DOES MR. ROBERTS ASSERT THAT THE ADVISORS REMOVED A DEBIT TO**
5 **DEFERRED INCOME TAX?**

6 **A.** Yes. On page 13 of his Rebuttal Testimony, Mr. Roberts asserts "The Advisor's proposal
7 to remove the debit to deferred tax expense without removing the offsetting credit amount
8 in current income tax expense is a departure from normalizing income tax expense in
9 ratemaking."

10 **Q. HOW DO YOU RESPOND TO MR. ROBERTS' STATEMENT?**

11 **A.** Mr. Roberts is wrong. First, the Advisors did not remove a debit previously entered to
12 deferred income tax expense. The Advisors are merely recommending crediting deferred
13 income tax expense by an amount corresponding to the NOLCF ADIT asset entry to rate
14 base. To do otherwise, is a normalization and ratemaking violation as explained and
15 illustrated above.

16 Second, ENO's NOLCF ADIT asset entry does not require a corresponding entry to current
17 income tax expense as suggested by Mr. Roberts. Instead, it requires the corresponding
18 credit entry to deferred income tax expense as discussed above.

19 Finally, the Council should bear in mind that my recommendation to decrease deferred
20 income tax expense is only necessary here when the corresponding NOLCF ADIT asset
21 entry is included in rate base as requested by ENO. The Advisors do not recommend the

1 NOLCF ADIT asset be included in rate base, therefore, if the Council approves the
2 Advisors' recommendation, the deferred income tax expense adjustment discussed here is
3 not needed to properly normalize income tax expense.

4 **Q. DOES MR. ROBERTS SUGGEST THAT THE ADVISORS' PROPOSED CREDIT**
5 **TO DEFERRED INCOME TAX EXPENSE DISCUSSED ABOVE CAUSES A**
6 **NORMALIZATION VIOLATION?**

7 **A.** Yes. On page 14 of his Rebuttal Testimony, Mr. Roberts states "The normalization rules
8 require consistency between tax expense, depreciation expense, ADIT, and rate base. The
9 Advisors' proposal to credit or decrease deferred income tax expense by \$9,402,024 is a
10 normalization violation because it ignores the offsetting \$9,402,024 that was included in
11 current tax expense. The Advisors' proposal is nothing more than flow-through accounting.
12 Flow-through accounting creates a normalization violation when applied to accelerated tax
13 depreciation."

14 The Advisors' recommendation does provide for consistency in ratemaking treatment for
15 tax expense, depreciation expense, ADIT, and rate base. It is ENO's ratemaking treatment
16 of the NOLCF ADIT asset and its related deferred income tax expense that creates
17 inconsistency with respect to tax expense, depreciation expense, ADIT, and rate base.

18 The Advisors' proposal to credit or decrease deferred income tax expense by \$9,402,024
19 is not a normalization violation because there exists no offsetting entry of \$9,402,024 to
20 current tax expense for ENO's NOLCF ADIT asset. As I explained in detail above, the
21 corresponding, and offsetting entry for ENO's NOLCF ADIT asset, is a credit to deferred

1 income tax expense of \$9,402,024. Without the entry to credit deferred income tax expense
2 by \$9,402,024 ENO would not be correctly normalizing income tax expense.

3 Again, though, the Council should bear in mind my recommendation to decrease, or credit,
4 deferred income tax expense by \$9,402,024 is only necessary here when the corresponding
5 NOLCF ADIT asset entry is included in rate base. The Advisors do not recommend the
6 NOLCF ADIT asset be included in rate base, therefore, with that outcome the deferred
7 income tax expense adjustment is not needed.

8 **Q. DO YOU BELIEVE THE COUNCIL SHOULD ORDER ENO AND THE**
9 **ADVISORS TO JOINTLY PREPARE A REQUEST FOR AN IRS PRIVATE**
10 **LETTER RULING REGARDING RATEMAKING TREATMENT FOR NOLCF**
11 **ADIT ASSETS?**

12 **A.** I believe the Council should adopt the Advisors' recommendations for the correct
13 ratemaking treatment for ENO's NOLCF ADIT assets and the related deferred income tax
14 expense. However, if the Council is concerned about doing so without assurance from the
15 IRS that Advisor's recommendations do not violate its normalization requirements, I
16 support the Council asking the Advisors and ENO to jointly prepare a letter for Council
17 approval requesting an IRS PLR.

18 **V. FINANCIAL ACCOUNTING STANDARDS BOARD INTERPRETATION NO. 48**

19 **Q. DOES MR. ROBERTS DISPUTE YOUR ADJUSTMENT REGARDING ADIT**
20 **ISSUES RELATED TO FINANCIAL ACCOUNTING STANDARDS BOARD**
21 **INTERPRETATION NO. 48?**

1 A. Yes.³⁰

2 **Q. WILL YOU PLEASE EXPLAIN FIN 48 IN ORDER FOR THE COUNCIL TO**
3 **UNDERSTAND THE FLAWS IN MR. ROBERTS' POSITION?**

4 A. Yes. The FASB's FIN 48 provides an interpretation of FAS No. 109 regarding the
5 accounting for uncertainty in income taxes recognized in financial statements. In applying
6 FIN 48, a determination is made by the taxpayer for specific transactions as to whether it
7 is more likely than not that a tax position will be sustained upon examination, including
8 resolution of appeals or litigation processes, based on the technical merits of the position.
9 Then the tax position is measured at the largest amount of benefit that is greater than 50
10 percent likely to be realized upon ultimate settlement. Differences between tax positions
11 taken in a tax return and the tax amounts recognized in financial statements result in either:
12 (1) an increase in a liability for income taxes payable or a reduction of an income tax refund
13 receivable, or (2) a reduction in a deferred tax asset or an increase in a deferred tax liability,
14 or both. As a result of applying FIN 48, the amount of taxes recognized in financial
15 statements may differ from the amount actually reflected in a tax return. To reflect the
16 differences on the books, a liability is created which represents an enterprise's potential
17 future obligation to the taxing authority for a tax position that ultimately is not recognized
18 pursuant to FIN 48. In this particular case, the liability created is an ADIT liability.³¹

19 **Q. ON WHAT CRITERIA DID YOU EVALUATE THE ISSUE REGARDING FIN 48?**

³⁰ See page 17 of Mr. Roberts' Rebuttal Testimony.

³¹ Financial Accounting Series No. 281-B, June 2006, FASB Interpretation No. 48 of the FASB of the Financial Accounting Foundation.

1 **A.** Two important FIN 48 issues were addressed in my analysis: (1) how is the financial risk
2 shared between ratepayers and shareholders with respect to the uncertainty of the income
3 tax position taken by ENO; and (2) making the correct adjustment required for ratemaking
4 purposes.

5 **Q. DO YOU AGREE WITH MR. ROBERTS' POSITION ON ENO'S ADJUSTMENT**
6 **TO ELIMINATE THE EFFECT OF FIN 48 ON ADIT?**

7 **A.** No. I disagree with Mr. Roberts' position on ENO's adjustment to eliminate the effect of
8 FIN 48 timing differences from the ADIT balances at December 31, 2018. Mr. Roberts'
9 approach does not balance the interest of ratepayers and the Company. When deferred
10 income tax expense and the related ADIT liability comply with FIN 48, and the Company
11 eliminates the ADIT for ratemaking purposes, the risk of ENO's not achieving the
12 aggressive tax filing position is placed entirely on the ratepayers, not the Company. If the
13 Company removes the ADIT liability from rate base, as it has done here, a balanced
14 ratemaking approach requires ENO must also eliminate the related deferred income tax
15 expense it recovered from ratepayers through their rates. ENO did not eliminate the related
16 deferred income tax expense when it removed the ADIT liability from rate base therefore
17 it should not have removed the ADIT liability either.

18 **Q. WILL YOU PLEASE ELABORATE ON MR. ROBERTS' UNBALANCED**
19 **APPROACH TO RATEMAKING?**

20 **A.** ENO, through complying with FIN 48, effectively records deferred income tax expense
21 that may ultimately not be fully paid, yet the deferred income tax expense is part of ENO's

1 cost of service and, therefore, is recoverable in utility rates. ENO's practice of recording
2 deferred income tax and including it in the cost of service provides them a cost-free loan
3 from the customers requiring that the related ADIT not be eliminated as proposed by ENO.

4 **Q. WHAT IS THE RATEMAKING TREATMENT FOR FIN 48 THAT MR.**
5 **ROBERTS OPPOSES?**

6 **A.** Mr. Roberts argues for ENO's elimination of their recorded FIN 48 ADIT amounts for
7 certain ADIT accounts. I recommend reversing ENO's elimination adjustment because it
8 did not also remove the related deferred income tax expense previously recorded to
9 operating expense. Mr. Roberts opposes my recommendation.

10 **Q. UNDER YOUR APPROACH, WHAT HAPPENS IF ENO LOSES ITS FIN 48 TAX**
11 **POSITION?**

12 **A.** Under my approach, if ENO loses its FIN 48 tax position to an IRS determination (that
13 ENO's position was not correct), ENO simply pays the additional income tax expense
14 owed and then the related ADIT no longer decreases ENO's rate base. That is, since the
15 deferred income taxes that had been previously recovered from the ratepayers in cash are
16 then paid to the government, the ADIT is eliminated and no longer subtracted from rate
17 base as customer provided capital.

18 **Q. UNDER ENO'S APPROACH, WHAT HAPPENS IF ENO WINS ITS FIN 48 TAX**
19 **POSITION?**

1 **A.** Should the Council adopt ENO’s position on its FIN 48 tax position, with a favorable IRS
2 determination (that ENO’s position was correct), ENO pays no additional income tax
3 expense and the related ADIT then begins to decrease rate base until the timing difference
4 turns around.

5 **Q. DOES MR. ROBERTS SPECIFICALLY ALLEGE FIN 48 PROVIDES ENO NO**
6 **COST-FREE CAPITAL?**

7 **A.** Yes. On page 16 and page 18 of his Rebuttal Testimony, Mr. Roberts states “ENO has
8 removed from its rate base the portion of various ADIT liabilities that is unlikely to produce
9 cost-free capital due to the aggressive tax position taken by ENO in its filings with Federal
10 and State tax authorities.” He further states “The FIN 48 amounts represent amounts
11 associated with aggressive tax positions that the Company and its auditors expect ENO to
12 ultimately lose. This means that ENO and its auditors expect ENO to pay the FIN 48
13 amounts to the Federal and State taxing authorities with interest. As a result, these amounts
14 do not represent cost-free capital to the Company.”

15 **Q. DO YOU AGREE THAT FIN 48 PROVIDES NO COST-FREE CAPITAL FOR**
16 **ENO?**

17 **A.** Mr. Roberts is wrong that the recording of these FIN 48 ADIT liabilities have not provided
18 ENO cost-free capital. The recording of these FIN 48 ADIT liabilities have provided ENO
19 cost-free capital. That is, when a FIN 48 ADIT liability is entered in ENO’s books there is
20 a corresponding entry in their books debiting, or increasing, deferred income tax expense
21 for an equal amount. The FIN 48 related deferred income tax expense component is

1 included in ENO's operating expenses. Including the FIN 48 related deferred income tax
2 expense in ENO's operating expense allows ENO to collect cash revenues for such deferred
3 income tax.

4 The ratemaking treatment proscribed for deferred income tax is the reason the FIN 48
5 ADIT liability must not be removed from rate base as proposed by ENO. Specifically, the
6 FIN 48 ADIT liability is included in rate base because the inclusion of deferred income tax
7 expense in ENO's revenue requirements provides an otherwise cost-free loan from
8 ratepayers.

9 **Q. DOES MR. ROBERTS DISCUSS INTEREST PAYMENTS FOR**
10 **UNDERPAYMENT OF TAXES?**

11 **A.** Yes. On page 19 of his Rebuttal Testimony, Mr. Roberts explains ENO will have to pay
12 interest on all amounts of tax underpayments paid to the federal government.

13 **Q. HOW DO YOU RESPOND TO ENO'S INTEREST PAYMENTS FOR**
14 **UNDERPAYMENT OF TAXES?**

15 **A.** The Advisors support ENO's recovering prudently incurred interest expense attributed to
16 ENO paying interest for tax underpayments to the federal government related to prudent
17 FIN 48 positions it takes. The interest costs incurred by ENO should be audited for
18 inclusion in their rates during periodic ratemaking proceedings.

19 **Q. DOES MR. ROBERTS DISCUSS AN ERROR IN YOUR DIRECT TESTIMONY?**

1 A. Yes, on page 20 of his Rebuttal Testimony, Mr. Roberts states [REDACTED]
2 [REDACTED]
3 [REDACTED] I agree, the [REDACTED]
4 [REDACTED]
5 [REDACTED]

6 VI. PENSION ASSET

7 Q. DOES ENO DISAGREE WITH YOUR ADJUSTMENT TO THE PENSION
8 ASSET?

9 A. Yes. Mr. Joshua B. Thomas rebuts my Pension Asset adjustment.³² Mr. Thomas states
10 ENO’s Pension Asset, based on actual 2018 year-end data, for electric and gas operations
11 is \$36,806,484 and \$8,633,620, respectively. Mr. Thomas further believes my estimates
12 discussed below would understate ENO’s rate base.

13 Q. PLEASE EXPLAIN THE ADJUSTMENT YOU PROPOSED IN YOUR DIRECT
14 TESTIMONY?

15 A. In anticipation of receipt of the information requested in discovery requests CNO 12-2 and
16 12-3, I estimated in my Direct Testimony that ENO’s adjusted Period II Pension Asset is
17 approximately \$ [REDACTED]. This amount of Pension Asset is allocated to ENO’s electric
18 and gas businesses in the amounts of \$ [REDACTED] and \$ [REDACTED], respectively. Based on
19 this estimate, and subject to revision upon receipt of the related requested information, I

³² See page 49 of Mr. Thomas’ Rebuttal Testimony in Docket No. UD-18-07.

1 proposed adjustment ADV10 to decrease ENO's Period II rate base for ENO's electric and
2 gas businesses in the amounts of \$ [REDACTED] and \$ [REDACTED], respectively.

3 **Q. DO YOU PROPOSE TO CHANGE THE AMOUNT OF YOUR ADJUSTMENT?**

4 **A.** No. However, the basis and support for my proposed adjustment is different than discussed
5 in my Direct Testimony. The basis and support are now different due to the late receipt of
6 ENO's responses to discovery requests CNO 12-2 and CNO 12-3 on March 1, 2019 and
7 February 27, 2019, respectively. These two discovery requests had been delivered to ENO
8 on December 26, 2018. The information sought in discovery requests CNO 12-2 and CNO
9 12-3 is important to my recommendations for the Pension Asset. Because my Direct
10 Testimony was filed on February 1, 2019, I did not have access to the information in the
11 responses to CNO 12-2 and CNO 12-3 until after my testimony was filed.

12 **Q. WHAT DID YOU FIND FROM THESE DISCOVERY RESPONSES?**

13 **A.** I found that ENO's actual funded status of its pension funds at December 31, 2018 was
14 significantly less than the amount forecasted by Entergy's actuaries, AON Hewitt. Also,
15 ENO's actual balance for its benefit obligations regulatory asset at December 31, 2018 was
16 significantly larger than the amount forecasted by AON Hewitt. Further, AON Hewitt's
17 overestimated funded status for ENO's pension funds and underestimated balance for
18 ENO's benefit obligations regulatory asset at December 31, 2018, respectively, offset one
19 another. After accounting for rounding, ENO's forecasted balance, as determined by AON

1 Hewitt, and actual balance for the Pension Asset at December 31, 2018 remained the
2 same.³³

3 **Q. WHAT IMPACT DID THIS INFORMATION HAVE ON THE BALANCE OF THE**
4 **BENEFIT OBLIGATIONS REGULATORY ASSET?**

5 **A.** The benefit obligations regulatory asset was increased for the difference between the
6 expected positive return on the invested plan assets and the actual negative return on
7 invested plan assets. Also, the benefit obligations regulatory asset was decreased by the
8 difference between AON Hewitt's projected actuarial gain on the projected benefit
9 obligations and the actual larger actuarial gain on the projected benefit obligations.

10 **Q. WHAT IMPACT DID THE BALANCE OF THE BENEFIT OBLIGATIONS**
11 **REGULATORY ASSET HAVE ON ENO' PENSION ASSET?**

12 **A.** The benefit obligations regulatory asset in effect acts as a true-up mechanism regarding
13 changes to projected gains and losses to projected benefit obligations and changes to
14 expected and actual gains and losses to returns on ENO's pension funds. Therefore, as a
15 result of this netting process discussed above, ENO's Pension Asset remains unaffected
16 from differences between estimated and actual net gains and losses.

17 **Q. WHAT IS THE FIVE-YEAR AVERAGE OF THE PENSION ASSET'S YEAR-**
18 **ENDING BALANCES FOR DECEMBER 31, 2014 THROUGH DECEMBER 31,**
19 **2018?**

³³ Please see ENO's response to Advisors 12-3 and ENO's workpapers for its adjustment AJ09-Pension.

1 **A.** The five-year average actual balance for the Pension Asset over the period of December
2 31, 2014 through December 31, 2018 is \$39,084,850.³⁴ Therefore, the five-year average
3 actual balance for ENO’s Pension Asset of \$39,084,850 is less than the estimated amount
4 of \$ [REDACTED] presented in my Direct testimony.

5 **Q.** **WHAT WERE THE TOTAL CONTRIBUTIONS TO THE QUALIFIED PENSION**
6 **FUNDS FOR THE YEARS 2014 THROUGH 2018?**

7 **A.** Entergy contributed \$49,263,446 to ENO’s qualified pension plan fund during the years
8 2014 through 2018.³⁵

9 **Q.** **HOW DID THESE CONTRIBUTION AMOUNTS COMPARE TO**
10 **CONTRIBUTION LEVELS REQUIRED BY ERISA OF 1974?**

11 **A.** Entergy could have satisfied the funding requirements set forth by ERISA of 1974 from
12 contributing \$ [REDACTED] to ENO’s qualified pension plan fund during the years 2014
13 through 2018. Therefore, over the five years, Entergy contributed \$ [REDACTED]
14 (\$ [REDACTED] = \$49,263,446 - \$ [REDACTED]) [REDACTED] than required by ERISA of 1974.

15 **Q.** **DO YOU BELIEVE ENTERGY’S LEVEL OF FUNDING TO ENO’S PENSION**
16 **PLANS OVER THE YEARS 2104 THROUGH 2018 IS NECESSARY GIVEN THE**
17 **BALANCES OF ITS PENSION ASSET OVER THE SAME TIME SPAN?**

³⁴ Please see Exhibit No. ____ (JMP-14).

³⁵ Please see ENO’s response to Advisors 16-2.

³⁶ Please see ENO’s response to Advisors 16-2.

1 **A.** No. ENO's Pension Asset has consistently increased over the period 2014 through 2018.
2 The increase is largely due to the abnormally impressive performance of asset markets over
3 the period and Entergy's larger than necessary contributions to ENO's pension funds.

4 **Q. DO ENERGY AND ENO HAVE FINANCIAL INCENTIVES TO GENEROUSLY**
5 **FUND PENSION PLANS WHEN THE COUNCIL INCLUDES THE FULL**
6 **BALANCE OF THE BENEFIT OBLIGATIONS REGULATORY ASSET IN RATE**
7 **BASE?**

8 **A.** Yes. If Entergy and ENO believe the full balance for the benefit obligations regulatory
9 asset will be included in ENO's rate base, a financial incentive exists for Entergy to
10 generously fund its pension funds increasing the Pension Asset. That is, when the full
11 balance of the regulatory asset is included in ENO's rate base, ENO receives the Council
12 authorized return on its investment in the Pension Asset even though the risk of that
13 investment is less than other rate-based investments.

14 **Q. WHAT IS THE LEVEL OF RISK FOR ENERGY AND ENO'S**
15 **CONTRIBUTIONS TO PENSION FUNDS COMPARED TO OTHER RATE BASE**
16 **INVESTMENTS?**

17 **A.** I explain above the benefit obligations regulatory asset acts as a true-up mechanism
18 regarding changes to projected gains and losses to projected benefit obligations and
19 changes to expected and actual gains and losses to returns on ENO's pension funds. That
20 is, ENO's Pension Asset remains unaffected from differences between estimated and actual
21 net gains and losses. Thus, the risk-return relationship for ENO's investment through

1 Entergy's contributions to the pension funds is favorable to its other investments in utility
2 assets which not all have true-up mechanisms.

3 **Q. DOES ENO RECOVER ITS FULL BENEFIT OBLIGATIONS REGULATORY**
4 **ASSET THROUGH ITS RATES EVEN THOUGH THE FULL BALANCE MAY**
5 **NOT BE IN ITS RATE BASE?**

6 **A.** Yes. ENO's benefit obligations regulatory asset over time is fully recovered through its
7 rates as a component of its net periodic pension cost. The Advisors are not proposing
8 limiting recovery for the amortization of the regulatory asset.

9 **Q. PLEASE EXPLAIN WHY YOUR PENSION ASSET ADJUSTMENT IS**
10 **REASONABLE BASED ON NORMALIZATION OF A RATE BASE**
11 **COMPONENT?**

12 **A.** Regulatory agencies should be careful not to create incentives for utilities to excessively
13 fund pension plans in order to increase rate base. To evaluate the Pension Asset for
14 inclusion in rate base, it is necessary to consider the corresponding level of pension asset
15 funding through periodic contributions which is reasonable given the projected benefit
16 obligations and the fair value of pension fund investment assets. In my judgment, ENO's
17 forecasted December 31, 2018 Pension Asset balance does not fairly represent the balance
18 that should be included in ENO's rate base. I believe the balance is greater than normal,
19 and necessary, due in part to financial market conditions in recent years and the amount of
20 Entergy's contributions to the pension fund.

1 Therefore, I believe my recommendation to set ENO's adjusted Period II Pension Asset at
2 approximately [REDACTED] for rate base purposes is supported by the lower five-year
3 average actual balance of \$39,084,850 and the other reasons discussed above. Finally, I
4 believe adjustment ADV10 to decrease ENO's Period II rate base for ENO's electric and
5 gas businesses in the amounts of \$ [REDACTED] and \$ [REDACTED], respectively, based on the
6 Pension Asset balance of \$ [REDACTED] is reasonable.

7 **Q. DOES AN ADJUSTMENT NEED TO BE MADE TO ADIT?**

8 **A.** No. ENO's pension-related ADIT balance at December 31, 2018 should not be adjusted if
9 the Council adopts the Advisors' recommendation for the Pension Asset.

10 The ADIT balance, as it relates to the Pension Asset, represents the accumulated balance
11 for deferred income tax expense recorded in ENO's accounting records and collected
12 through rates from ratepayers. That is, over the years which the ADIT balance has
13 accumulated, ENO has not been denied recovery of deferred income tax expense related to
14 the Pension Asset. Because the deferred income tax expense is collected from the
15 ratepayers, and such collections represent a source of ratepayer funded capital, the book
16 balance of ADIT must be used to offset rate base to adhere to proper ratemaking treatment
17 and to allow ratepayers a return on their investment in ENO's otherwise cost-free capital.

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

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