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 RESOLUTIONS R-15-194 AND R-17-504 AND FOR RELATED RELIEF)

DOCKET NO. UD-18-07

SURREBUTTLAL 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
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. G1, Lawrence, Kansas 66049.

5 Q. ARE YOU THE SAME JAMES M. PROCTOR WHO PREVIOUSLY FILED 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 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 New Orleans, LLC (or “ENO” or “Company”). Specifically, I respond to the rebuttal testimony filed by ENO witnesses Robert B. Hevert, Rory L. Roberts, and Joshua B. Thomas. The subject matter I rebut includes the Company’s rebuttal testimony regarding:

16 (a) Return on Equity;

17 (b) Accumulated Deferred Income Taxes;
Q. PLEASE SUMMARIZE YOUR TESTIMONY AND MAJOR CONCLUSIONS OR RECOMMENDATIONS.

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

ENO’s witness Mr. Hevert criticized the credibility and reliability of the CAPM. However, in my surrebuttal testimony, I point out the flaws in his specific arguments. ENO’s witness, Mr. Hevert, criticized my use of the CAPM due to currently low interest rates. In my surrebuttal testimony, I explain the economic literature and mathematical theory deriving the CAPM do not support an argument that application of the CAPM is limited to circumstances when interest rates fall within a specified range.
Further, I explain when regulatory bodies rely too much on the return on equity authorized in other jurisdictions to set the cost of equity, it may perpetuate cost of equity findings that are not supported by the current economic setting, sound economic reasoning or the specific risk characteristics of the utility under review.

In rebuttal testimony, ENO’s witness Mr. Roberts disputes my recommendations regarding the Company’s ratemaking treatment for accumulated deferred income taxes (“ADIT”) related to its net operating loss carry-forward (“NOLCF”) and its application of Financial Accounting Standards Board’s Interpretation No. 48 (“FIN 48”). I demonstrate in my surrebuttal testimony that the Company’s arguments are dependent, in part, on their false premise that ENO’s recording of ADIT creates a cash loan to them from the government. I clearly demonstrate the only cash “loan” received by ENO comes from the ratepayers to them when ENO’s cash income tax payment is less than the income tax expense recorded in ENO’s financial statements and those additional income taxes are recovered from ratepayers. Under this circumstance, the ratepayers end up pre-paying income tax expense to ENO as customer-supplied capital. Further, I explain ENO’s ratemaking approach for FIN 48 does not correctly balance the interest of ratepayers and the Company.

ENO’s rebuttal witness Mr. Thomas disputes my ratemaking treatment for the Company’s Pension Asset. I explain in my surrebuttal testimony the balance of the Pension Asset allowed in rate base should be the amount recommended in Advisor adjustment ADV10 discussed in my Direct Testimony and as supported by the five-year average balance of the Pension Asset.
II. REQUIRED RETURN ON EQUITY

General Overview and Summary for Surrebuttal on Return on Equity:

Q. PLEASE SUMMARIZE THE ADVISORS’ POSITION REGARDING ENO’S COST OF EQUITY.

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

Q. WHAT DOES RETURN ON EQUITY MEAN?

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

Q. WHAT IS MEANT BY DETERMINING A COMPANY’S REQUIRED RETURN ON EQUITY?

A. As I discussed in my direct testimony, a company’s required ROE is equal to the expected return for common equity holders foregone by investing in comparable risk assets or
financial securities generally. Expected return can be viewed as the average of possible returns weighted by their individual probabilities.

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

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

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

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

Mr. Watson bases his ROE recommendation on multiple factors, including a reasonable application of the DCF methodology. He finds that a reasonable ROE for ENO is 8.93% after accounting for his analyses, my CAPM analyses and the principles established by the Hope and Bluefield US Supreme Court decisions. I agree. Mr. Watson’s findings, based on the DCF, are well within a range of reasonableness established from using my derivation for the cost of equity of 8.42% and his of 8.93%.
Q. HAVE YOU DESCRIBED THE CAPM IN YOUR DIRECT TESTIMONY?

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

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

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

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

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

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

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

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

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

A. Yes. The CAPM is also used to estimate the discount rate, or cost of equity, for the same
valuation purposes as the DCF. The CAPM approaches the problem of estimating discount
rates from a different perspective, that is, from evaluating the risk and expected return on
investments. I explain the relationship between risk and return as it relates to applications
of the CAPM in my direct testimony.
Q. HAVE CERTAIN OF ENO’S WITNESSES CHALLENGED THE CREDIBILITY OF THE CAPM FOR DETERMINING THE COST OF EQUITY?

A. Yes. ENO’s Witness Mr. Hevert criticized my application of the CAPM. I will point out the flaws in Mr. Hevert’s specific arguments throughout my testimony when discussing his comments.
Q. DO YOU AGREE WITH MR. HEVERT’S ASSERTION THAT THE CAPM IS NOT CURRENTLY RELIABLE FOR DETERMINING ENO’S COST OF EQUITY?

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

Surrebuttal of Specific Statements in Hevert’s Revised Rebuttal Testimony:
Q. DOES MR. HEVERT COMMENT ON THE ADVISORS COST OF EQUITY RECOMMENDATIONS AS COMPARED TO THOSE APPROVED BY OTHER REGULATORY BODIES?

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

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

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

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

A. Yes, I believe so. Mr. Hevert seems to agree that when interest rates move up or down, so should the cost of equity move up or down, respectively. However, he does dispute my
testimony where I explain the degree of the change in the cost of equity is related to the
degree of change in short-term treasury bill interest rates. This is a reason he disputes my
application of the CAPM.

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

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

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

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For example, see Mr. Hevert’s Revised Rebuttal Testimony beginning on page 16, line 3 in Docket No. UD-18-07.
extent that investor rating agencies place emphasis on authorized returns in their evaluation of regulators.

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

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7 See Mr. Hevert’s Revised Rebuttal Testimony page 50, lines 13-16 in Docket No. UD-18-07.
Q. DOES MR. HEVERT DISCUSS THE RANGE OF HIS ROE ESTIMATES AS COMPARED TO THOSE OF MR. WATSON’S DCF ESTIMATES?

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

Q. WHAT IS THE FLAW IN MR. HEVERT’S REASONING?

A. Mr. Hevert’s ROE results vary from a low of 8.37% using the DCF approach to a high of 12.28% using the CAPM approach. These findings concern me because the variance is substantial, particularly since these ROE estimates are not for individual utilities. Instead, these findings are for a proxy group of 22 utilities. Mr. Watson’s “two-step” DCF results span from a low of 5.74 percent to a high of 10.64 percent for individual members in his proxy group. It is certainly reasonable for individual sample observations in a proxy group to vary more than means “or averages” of various ROE methodologies.
That is, Mr. Hevert used three approaches to derive a ROE estimate for ENO. If one assumes each of the three models are economically, mathematically and statistically sound for estimating the ROE for ENO, and a proxy of 22 sample observations of similarly situated companies were used in the analysis, the “averages” would not have a variance of nearly 400 basis points. Therefore, I believe it should be apparent to the Council that one or more of Hevert’s models is not a sound approach for deriving the ROE; or alternatively, there are flaws in the assumptions and inputs into the models used.

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

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

A. Yes, on page 30, line 8 of Mr. Hevert’s Revised Rebuttal Testimony, he states “Mr. Proctor provides “Summary Statistics of Annual Total Returns” from 1960 through 2017 for several asset classes, including large (capitalization) stocks, long-term Government bonds, 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)
I present these statistics for 1926 through 2017 as can be confirmed from reviewing Table No. 1 of my Direct Testimony.

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

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

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

**A.** Yes. First, I am concerned that Mr. Hevert does not appear to test any of his derived regression equations presented in Revised Rebuttal Testimony for “Lack of Fit”. I will discuss this observation elsewhere in my surrebuttal testimony regarding certain other regression equations. The importance of testing for “lack of fit” of any regression equation is described by N. R. Draper and H. Smith.\(^1^2\)

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\(^{11}\) 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.

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

Q. WHAT ARE YOUR CONCLUSIONS ABOUT MR. HEVERT’S REGRESSION EQUATION?

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

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

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

Of course, because my CAPM analysis was conducted in December 2018 and January 2019, I was able to use the historical period of 1926-2017 as discussed above.

Q. DOES MR. HEVERT SAY THE RISK-FREE RATE USED IN THE CAPM SHOULD BE BASED ON A LONG-TERM BOND YIELD?
A. Yes, on page 32 of his Revised Rebuttal, Mr. Hevert states “the security used as the risk-free rate should match the life of the underlying investment, and referred to utility stocks

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15 Please see page 42 of Exhibit No. ____ (JMP-11).
as “long-duration investments”. I do not agree. As explained in my Direct Testimony, the CAPM should use the T-Bill rate as the risk-free rate of interest. However, in Exhibit No. _____(JMP-5), I calculated a return on equity for ENO based on the CAPM using the 30-year T-Bond yield. Using that “risk-free” rate in the CAPM yields a ROE of 6.68% (before a business risk adjustment), an amount less than the ROE of 7.57% (before a business risk adjustment) I determined using the T-Bill rate.

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

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

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

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

I discussed the importance and necessity of these analyses above. Specifically, Advisors 18-4 asked for ENO to provide any tests performed to determine whether the residual errors
(the difference between each observation value of the dependent variable and its corresponding fitted value): are independent; have a 0 mean; constant variance; and, follow a normal distribution.

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

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

Further, I asked ENO to provide certain basic graphical tests which could be used to determine whether the residual errors are independent; have a 0 mean; constant variance; and, follow a normal distribution. ENO’s response to those questions was that “the information in the form requested does not exist.” Therefore, the Council should conclude
Mr. Hevert’s testimony rebutting the credibility of my using Value Line as a source for beta coefficients is not relevant.

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

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

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

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

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

Q. WHAT THOUGHTS DO YOU HAVE REGARDING MR. HEVERT’S EXPECTED EARNINGS APPROACH?

A. Mr. Hevert’s application of the Expected Earnings Approach “indicates a median Cost of Equity of 10.52 percent…”\(^{22}\) The Expected Earnings Approach is based on examining the “earned” return on common equity projected by Value Line for periods over 2021 through 2024. The projected “earned” return on common equity is not the same as deriving a utility’s opportunity cost of capital or required return on equity for ratemaking purposes. The “earned” return on common equity is the return that is derived after accounting for all factors affecting a utility’s revenues, operating expenses, taxes, investments, capital structure and actual cost of debt. A proper cost of equity analysis focuses on the economic and financial factors affecting the required ROE. Therefore, the Council should give no weight to the method when evaluating ENO’s cost of equity in this proceeding.

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

\(^{22}\) Please see page 54 of Mr. Hevert’s Revised Rebuttal Testimony in Docket No. UD-18-07.
A. Mr. Hevert suggests Advisors’ business risk adjustment should be 321-basis points instead of 81 basis points. Setting aside the extraordinary 240 basis point difference between his recommendation and mine in my Direct Testimony, I note that Mr. Hevert did not (or was unable to) quantify a business risk adjustment to be applied to his cost of equity analysis. Yet, he suggests he can quantify a 321-basis point business risk adjustment for Advisors’ cost of equity analysis.

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

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

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

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

A. Yes. On page 63 of his Revised Rebuttal Testimony, Mr. Hevert discusses Modern 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.
of Equity depends on the type of risk that is reduced; if the risk assumed to be mitigated by the rate structures is diversifiable, there would be no reduction in the Cost of Equity even if total risk (diversifiable plus non-diversifiable risk) has been reduced.”

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

Q. PLEASE EXPLAIN.

A. According to Mr. Hevert’s discussion above, if the risk assumed to be increased for ENO relates to diversifiable company specific business risk, there would be no need for an increase in the Council authorized cost of equity to account for it. For example, the following diversifiable risks discussed by Mr. Hevert as a basis for a business risk adjustment require no cost of equity adjustment based on his application of the Modern Portfolio Theory. Those risks include ENO’s planned capital investment program; ENO’s credit profile; ENO’s geographic risk associated with severe weather; ENO’s risks associated with the lack of customer diversity; and ENO’s small size relative to the proxy group. That is, these diversifiable risks can be diversified by investors through their investing in a diversified portfolio and, therefore, ENO requires no specific business risk adjustment.
Q. **DO YOU HAVE ANY REBUTTAL ARGUMENTS CONCERNING MR. HEVERT’S UPDATED BOND YIELD PLUS RISK PREMIUM APPROACH?**

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

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

Second, the Advisors submitted data request 18-1 to ENO, attached as Exhibit No. ____ (JMP-13), to seek any statistical or graphical analysis Mr. Hevert undertook to determine whether the updated regression equation and analysis used for his updated BYPRP Approach suffered from “lack of fit”. ENO did not provide any evidence that Mr. Hevert examined the residual errors of the regression equation. Instead, he relied on R-squared.

The Council should review my earlier discussions on regression analysis and R-squared and all my arguments from Direct Testimony to conclude Mr. Hevert’s application of the BYPRP Approach does not provide reliable estimates for ENO’s cost of equity.

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

A. Yes. On page 64 of his Revised Rebuttal Testimony, Mr. Hevert states “Mr. Proctor agrees an adjustment for flotation costs is reasonable, although he suggests I have calculated the
approximately nine basis point adjustment based on flotation costs of 1.12 percent of gross equity issuance proceeds.”

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

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

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

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

Q.  **DO YOU AGREE?**

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

Q.  **DOES MR. HEVERT ASSET THAT FLOTATION COSTS ARE NOT RECOVERED IN ENO’S REVENUE REQUIREMENTS?**
A. Yes. On page 65 of his Revised Rebuttal Testimony, Mr. Hevert states “Flotation costs are not operating expenses and are not recovered through the Company’s revenue requirement.”

Q. **DO YOU AGREE?**

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

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

### III. ACCUMULATED DEFERRED INCOME TAXES

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

**Q.** **ON WHAT ISSUES DOES ENO WITNESS ROBERTS PROVIDE REBUTTAL TESTIMONY?**
A. Mr. Roberts rebuts my testimony concerning accumulated deferred income taxes ("ADIT"), Net Operating Loss Carry-forward ("NOLCF") and Financial Accounting Standards Board’s Interpretation No. 48 ("FIN 48").

Q. HOW IS ACCUMULATED DEFERRED INCOME TAX PRESENTED IN ENO'S FINANCIAL STATEMENTS?

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

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

A. Yes. Certain revenue and expense transactions affect net income for financial accounting purposes in different periods than for income tax purposes. These differences are called timing differences. When this happens, the current income tax expense calculated pursuant to income tax law for such transactions differs from the income tax expense recorded in the financial records of the company. The difference between the amount of income tax expense recorded in the financial records of the company and the current income tax expense based on income tax law is reflected in the book entries for deferred income tax expense and ADIT. A company’s income tax expense for financial reporting purposes equals the sum of current and deferred income tax expense, even though the company only makes cash income tax payments with respect to the current component.
Q. WHEN SETTING UTILITY RATES, MUST THE COUNCIL’S RATEMAKING DECISIONS FOR DEFERRED INCOME TAX EXPENSE MATCH THE FINANCIAL ACCOUNTING TREATMENT?

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

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

Companies generally are allowed to depreciate assets more rapidly under income tax law than for financial reporting purposes. That is because for financial reporting purposes an asset is depreciated ratably (that is to say, in equal amounts) over its book life, while for income tax purposes the same asset is depreciated on a more accelerated basis, with larger depreciation in the early years of an asset’s life and smaller depreciation amounts in later years. By allowing a company to take a greater depreciation expense in the early years of an asset’s life, the company has reduced taxable income compared to its taxable income for financial reporting purposes, and correspondingly reduced cash income tax payments relative to those income taxes recorded in its financial statements.
The reduction of the tax benefit over time also would lead to a disparity between the tax payments and tax reporting of the company, on the one hand, and the company’s balance sheet with its ratable depreciation for the asset, on the other. Therefore, in every year during the depreciable life of an asset, the company debits or credits deferred income tax expense and, correspondingly, credits or debits ADIT for the difference between the amount of current income tax expense determined pursuant to income tax law and the amount of income tax expense recorded in the financial records of a company. That is, the company’s total income tax expense, for financial accounting purposes, includes a current provision payable to the government based on income tax law and deferred provision based on financial accounting standards. Throughout the book depreciable life of a depreciable asset, the balance of the related ADIT account is a credit or liability. However, the balance of the ADIT account amortizes over the book life of the asset and eventually reaches a zero balance in the final year.

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

Consider the gain on the sale of an asset. When a company sells a valuable asset, such as utility plant, it must pay the full income tax expense on the gain, based on income tax law, in the year of the sale. However, for financial reporting purposes, the gain on the sale and the income tax expense for that gain are recognized ratably over some future specified period of years. Frequently, for utility plant, that period would be the remaining depreciable life of the asset sold.
In the year the asset is sold, the current provision for income tax expense on the company’s books is initially fully offset by a credit to deferred income tax expense for financial reporting purposes. At the same time, a like amount is debited to an ADIT asset account. Then, for the year of the sale, a ratable portion of deferred income tax expense is recognized for financial reporting purposes. Similarly, for financial reporting purposes, the ADIT asset account is decreased by the same amount.

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

The deferred income tax expense thus represents the difference between the amount of current income tax expense determined pursuant to income tax law and the amount of income tax expense recorded in the financial records of a company. That is, the company’s total income tax expense, for financial accounting purposes, includes a current provision payable to the government based on income tax law and a deferred provision based on financial accounting standards. Throughout the amortization period of the gain, the balance of the related ADIT account is a debit balance or asset. However, the balance of the ADIT asset account amortizes, over the amortization period, and eventually reaches a zero balance in the final year.
Q. DOES MR. ROBERTS’ REBUTTAL TESTIMONY PRESENT A FUNDAMENTAL MISUNDERSTANDING OF ADIT THAT CAUSES HIS ARGUMENTS REGARDING ADIT, NOLCF AND FIN 48 TO ALL FAIL?

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

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

24 See page 9 of Mr. Robert’s Rebuttal Testimony filed in Docket No. UD-18-07.
Mr. Roberts is incorrect that the mere act of recording deferred income tax expense, and
the related ADIT, creates a government loan to ENO. Indeed, ENO’s income tax expert
witness, Mr. James A. Warren, in a previous rate case before the Council admits that there
is no “loan” from the government in any normative sense of the legal concept.25

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

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

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No. UD-08-03.
the corresponding balances of ADIT cannot be considered to represent a cash loan from
the government when it records deferred income tax expense.

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

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

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

A. Yes. As I have explained, the amortization of an ADIT liability in rate base provides the
income tax benefits of timing differences to ratepayers over time through credits to deferred
income tax expense. These credits lower utility rates. That is, the “loan” is from the
ratepayers and it is paid back to them through credits as timing differences reverse. If Mr.
Roberts were correct, the utility would be repaying the entire amount of the tax benefit twice -- the first time to the ratepayers through the amortizing of ADIT, and the second time to the government. No rational utility would utilize an income tax deduction in its tax reporting if it had to repay it twice.

Q. IS MR. ROBERTS’ DISCUSSION OF HIS EXAMPLE 3 AND OF HOW ADIT WORKS CORRECT?

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

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

ENO receives a cash benefit of $21 if and only if the Council chooses to allow the deferred income tax expense to be collected from ENO’s customers through rates. If the Council chooses to allow the deferred income tax of $21 to be collected as cash from ENO’s customers, then the Council must repay the $21 to ENO.

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

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

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

A liability balance recorded for ADIT does not represent indebtedness of a company to the government. However, for utility companies, which have their rates established so that deferred income tax expense is recovered from ratepayers, a credit balance of ADIT represents an amount for income tax expense that actually is paid by the customers before it is paid by the utility. The recovery of deferred taxes through rates creates cost-free capital for ENO. In effect, the utility’s customers -- not the United States government -- are loaning funds to the utility, because deferred income tax expense is recovered through their rates.
Therefore, the amount of otherwise cost-free capital provided ENO through customer paid
revenues must be used to decrease ENO’s rate base.

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

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

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

I have not stated or suggested that position in my Direct Testimony and Mr. Robert’s has
not provided a cite of my testimony supporting his assertion.
Q. WHY IS MR. ROBERTS INCORRECT THAT “TIMING DIFFERENCES” DO NOT CHANGE THE AMOUNT OF INCOME TAX EXPENSE PAID BY CUSTOMERS?

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

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

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

The Council can see here the issue regarding ADIT is a comparison of: (i) the amount of income taxes paid by ENO and (ii) the amount of cost-free capital provided by ratepayers.
Q. IS MR. ROBERTS CORRECT THAT RECORDING DEFERRED INCOME TAX EXPENSE REFLECTS A PAYMENT OF CASH?

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

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

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

Q. WHAT IS WRONG WITH MR. ROBERTS ASSERTION THAT ADIT IS NOT A LOAN FROM CUSTOMERS?
A. On page 8 of his Rebuttal Testimony, Mr. Roberts states “Since customers pay the same amount in rates regardless of the amount of deferred income taxes, the ADIT is not like a loan from customers.”

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

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

The excess deferred taxes are not paid to the government because the Excess ADIT was not a “loan” from the government to ENO. If it were a “loan” from the government, the Excess ADIT would have been repaid to the government and not provided to ratepayers.
IV. NET OPERATING LOSS CARRY-FORWARD

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

A. No. Mr. Roberts’ discussion of NOLCF assumes the incorrect proposition that the reason ENO receives cash benefits through income tax normalization is due to them receiving government loans with respect to recording deferred income tax expense. Clearly, I demonstrate that ADIT balances, whether debit or credit, should be in ENO’s rate base if, and only if, the related recorded deferred income tax expense credits and debits have been recognized for ratemaking purposes. With respect to the NOLCF, the debit balances of ADIT that ENO and Mr. Roberts wants in rate base were not offset, when recorded, with corresponding credits to deferred income tax expense through the ratemaking process and, therefore, the ADIT asset should not be in rate base.

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

A. ENO proposes to include $9,402,024 of ADIT in rate base related to NOLCF as of calendar year ending December 31, 2018. This amount is attributed to state and federal operating losses recorded in the previous years that were not used prior to December 31, 2018 to decrease ENO’s current income tax expense. The NOLCF ADIT amounts represent a future income tax benefit that ENO may use, as an income tax credit, to decrease future income tax expense. That is why the amounts are

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

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

A. When in ratemaking a regulator permits a regulated utility to normalize income tax expense
for timing differences, deferred income tax expense will have a cash impact for that utility.
For example, under normalization treatment for the income tax paid for the gain on the sale
of an asset, a utility records a cash cost from paying income taxes on the gain upfront in
the year of the sale; but through ratemaking the utility recovers those tax payments from
ratepayers over time. The un-recovered accumulated investment represented by the ADIT
asset balance is used to increase the utility’s rate base, and the regulator thereby treats the
cost recorded by the utility to pay income taxes in the year of the sale as a cash investment
to be recovered ratably from ratepayers in future years. Increasing the rate base for the
ADIT balance in effect allows the utility to earn a return from the ratepayers on the upfront
cash investment.

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

Q. DOES MR. ROBERTS STATE THAT THE RECORDING OF NOLCF ADIT
AFFECTS THE AMOUNT OF INCOME TAX EXPENSE PAID BY
RTEPAYERS?

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

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

Example 2 is not an illustration of ENO’s NOLCF ADIT asset because the NOLCF ADIT
asset on ENO’s books does not represent a situation when current income taxes paid by
ENO exceed the amount of income taxes collected from ratepayers. That is, instead the
NOLCF ADIT recorded by ENO (in dispute here), relates to deferred income tax expense
previously collected from ratepayers and should not be used to offset the related ADIT liability.

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

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

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

Q. DOES MR. ROBERTS ALSO ARGUE THAT THE AMOUNT OF NOLCF ADIT ASSETS “ATTRIBUTABLE” TO ACCELERATED DEPRECIATION MUST BE IN RATE BASE?
A. Yes. On pages 11 through 12 of his Rebuttal Testimony, Mr. Roberts’ states “Internal Revenue Code (“IRC”) Section Regulation Section 1.167(1)-1(h)(1)(iii) makes it clear that the amount of a utility’s NOL ADIT asset that is attributable to income tax depreciation must be included in rate base.” Also, “To do otherwise is a normalization violation because credit ADIT attributable to accelerated tax depreciation deductions would offset rate base for which no cost-free capital was received.”

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

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

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

A. Yes. On pages 11 through 12 of his Rebuttal Testimony, Mr. Roberts states “Attached as Exhibit RLR-2 are two IRS private letter rulings, PLR Nos. 201438003 and PLR 201548017, that explain in detail the income tax normalization rules that require the inclusion in rate base of NOL ADIT attributable to accelerated tax depreciation. Those private letter rulings explain that the NOL ADIT asset must be included in rate base to reduce the credit ADIT by the amount for which no cost-free capital was received.”
Q. HOW DO YOU RESPOND TO MR. ROBERTS CONCERNING THE PRIVATE LETTER RULINGS?

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

PLR No. 201438003:

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

PLR No. 201548017:

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above. This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. (Emphasis Added)
Therefore, not only do the circumstances relied on by the IRS in issuing these PLRs not explain the circumstances regarding ENO’s NOLCF ADIT assets, and the ratemaking treatment sought by ENO for them from the Council, the rulings have no precedence with respect to an IRS PLR which could be sought by ENO.

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

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

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

Furthermore, ENO’s cash revenues were greater during the periods its NOLs were recorded due to ENO’s recovery from ratepayers of the deferred income tax expense related to accelerated depreciation. That is, the NOL recorded during the previous periods was less
than it otherwise would be by an amount equal to the deferred income taxes which were
not paid to the government but were collected from ratepayers.

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

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

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

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

A.  Accelerated income tax depreciation is also sometimes referred to as liberalized
depreciation. It relates to the depreciation expense that may be deducted by a taxpayer for
determining its current income tax liability. With respect to utilities, like ENO, liberalized
depreciation may be further divided into two components. That is, it can be divided into an
amount based on straight-line depreciation and an amount based on excess depreciation
over straight-line. In later years of an asset’s depreciable life, excess depreciation is a
negative amount. The sum of straight-line depreciation and excess depreciation equal
liberalized depreciation. In later years of an asset’s depreciable life, liberalized depreciation
is less than straight-line depreciation.
Q. **WHAT IS A NET OPERATING LOSS?**

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

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

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

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

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28 See Mr. Hevert’s Rebuttal Testimony at page 78 in Docket No. UD -18-07.
excess depreciation over straight-line depreciation expense when the NOLCF ADIT asset results from the collective effect from all components of the Income Statement discussed above.

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

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

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

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

expense paid by customers in rates. Therefore, Mr. Proctor’s recommendation is inappropriate and unsupportable.”

Q. **HOW DO YOU RESPOND TO MR. ROBERTS’ STATEMENT ON COUNCIL PRACTICES?**

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

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

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

The ADIT liability or ADIT asset is included in rate base because the inclusion of the related deferred income tax expense in ENO’s revenue requirements provides an otherwise cost-free loan (as with an ADIT liability entry) from ratepayers or additional cash investment (as with an ADIT asset entry) on behalf of ratepayers. Mr. Roberts’ table on
page 6 of his Rebuttal Testimony can be used to illustrate these scenarios for ADIT asset
and ADIT liability entries to rate base.

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

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

Finally, as explained and illustrated above, if rate base increases from ENO’s inclusion of an NOLCF ADIT asset (as with Example 2 above) in rate base, the Council must decrease operating expenses by an equal amount for deferred income tax expense in order to properly normalize income tax expense for ratemaking purposes.
So, the Council can see that the Advisors’ recommendation to decrease deferred income tax expense if the related NOLCF ADIT asset is included in rate base is consistent with proper ratemaking and Council practice regarding income tax normalization.

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

A. Yes. On page 13 of his Rebuttal Testimony, Mr. Roberts asserts “The Advisor’s proposal to remove the debit to deferred tax expense without removing the offsetting credit amount in current income tax expense is a departure from normalizing income tax expense in ratemaking.”

Q. HOW DO YOU RESPOND TO MR. ROBERTS’ STATEMENT?

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

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

Finally, the Council should bear in mind that my recommendation to decrease deferred income tax expense is only necessary here when the corresponding NOLCF ADIT asset entry is included in rate base as requested by ENO. The Advisors do not recommend the
NOLCF ADIT asset be included in rate base, therefore, if the Council approves the
Advisors’ recommendation, the deferred income tax expense adjustment discussed here is
not needed to properly normalize income tax expense.

Q. DOES MR. ROBERTS SUGGEST THAT THE ADVISORS’ PROPOSED CREDIT
to deferred income tax expense discussed above causes a
normalization violation?

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

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

The Advisors’ proposal to credit or decrease deferred income tax expense by $9,402,024
is not a normalization violation because there exists no offsetting entry of $9,402,024 to
current tax expense for ENO’s NOLCF ADIT asset. As I explained in detail above, the
corresponding, and offsetting entry for ENO’s NOLCF ADIT asset, is a credit to deferred
income tax expense of $9,402,024. Without the entry to credit deferred income tax expense by $9,402,024 ENO would not be correctly normalizing income tax expense.

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

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

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

V. FINANCIAL ACCOUNTING STANDARDS BOARD INTERPRETATION NO. 48

Q. DOES MR. ROBERTS DISPUTE YOUR ADJUSTMENT REGARDING ADIT ISSUES RELATED TO FINANCIAL ACCOUNTING STANDARDS BOARD INTERPRETATION NO. 48?
Q. WILL YOU PLEASE EXPLAIN FIN 48 IN ORDER FOR THE COUNCIL TO UNDERSTAND THE FLAWS IN MR. ROBERTS’ POSITION?

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

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

30 See page 17 of Mr. Roberts’ Rebuttal Testimony.
A. Two important FIN 48 issues were addressed in my analysis: (1) how is the financial risk shared between ratepayers and shareholders with respect to the uncertainty of the income tax position taken by ENO; and (2) making the correct adjustment required for ratemaking purposes.

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

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

Q. WILL YOU PLEASE ELABORATE ON MR. ROBERTS’ UNBALANCED APPROACH TO RATEMAKING?

A. ENO, through complying with FIN 48, effectively records deferred income tax expense that may ultimately not be fully paid, yet the deferred income tax expense is part of ENO’s
cost of service and, therefore, is recoverable in utility rates. ENO’s practice of recording
defered income tax and including it in the cost of service provides them a cost-free loan
from the customers requiring that the related ADIT not be eliminated as proposed by ENO.

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

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

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

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

Q. UNDER ENO’S APPROACH, WHAT HAPPENS IF ENO WINS ITS FIN 48 TAX POSITION?
A. Should the Council adopt ENO’s position on its FIN 48 tax position, with a favorable IRS
determination (that ENO’s position was correct), ENO pays no additional income tax
expense and the related ADIT then begins to decrease rate base until the timing difference
turns around.

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

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

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

A. Mr. Roberts is wrong that the recording of these FIN 48 ADIT liabilities have not provided
ENO cost-free capital. The recording of these FIN 48 ADIT liabilities have provided ENO
cost-free capital. That is, when a FIN 48 ADIT liability is entered in ENO’s books there is
a corresponding entry in their books debiting, or increasing, deferred income tax expense
for an equal amount. The FIN 48 related deferred income tax expense component is
included in ENO’s operating expenses. Including the FIN 48 related deferred income tax expense in ENO’s operating expense allows ENO to collect cash revenues for such deferred income tax.

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

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

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

Q. HOW DO YOU RESPOND TO ENO’S INTEREST PAYMENTS FOR UNDERPAYMENT OF TAXES?

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

Q. DOES MR. ROBERTS DISCUSS AN ERROR IN YOUR DIRECT TESTIMONY?
A. Yes, on page 20 of his Rebuttal Testimony, Mr. Roberts states

B. I agree, the

C. I agree, the

VI. PENSION ASSET

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

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

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

A. In anticipation of receipt of the information requested in discovery requests CNO 12-2 and 12-3, I estimated in my Direct Testimony that ENO’s adjusted Period II Pension Asset is approximately $[redacted]. This amount of Pension Asset is allocated to ENO’s electric and gas businesses in the amounts of $[redacted] and $[redacted], respectively. Based on 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.
proposed adjustment ADV10 to decrease ENO’s Period II rate base for ENO’s electric and
gas businesses in the amounts of $[redacted] and $[redacted], respectively.

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

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

Q. WHAT DID YOU FIND FROM THESE DISCOVERY RESPONSES?

A. I found that ENO’s actual funded status of its pension funds at December 31, 2018 was significantly less than the amount forecasted by Entergy’s actuaries, AON Hewitt. Also, ENO’s actual balance for its benefit obligations regulatory asset at December 31, 2018 was significantly larger than the amount forecasted by AON Hewitt. Further, AON Hewitt’s overestimated funded status for ENO’s pension funds and underestimated balance for ENO’s benefit obligations regulatory asset at December 31, 2018, respectively, offset one another. After accounting for rounding, ENO’s forecasted balance, as determined by AON
Hewitt, and actual balance for the Pension Asset at December 31, 2018 remained the same.33

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

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

Q. WHAT IMPACT DID THE BALANCE OF THE BENEFIT OBLIGATIONS REGULATORY ASSET HAVE ON ENO’ PENSION ASSET?

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

Q. WHAT IS THE FIVE-YEAR AVERAGE OF THE PENSION ASSET’S YEAR-ENDING BALANCES FOR DECEMBER 31, 2014 THROUGH DECEMBER 31, 2018?

33 Please see ENO’s response to Advisors 12-3 and ENO’s workpapers for its adjustment AJ09-Pension.
A. The five-year average actual balance for the Pension Asset over the period of December 31, 2014 through December 31, 2018 is $39,084,850.\(^3^4\) Therefore, the five-year average actual balance for ENO’s Pension Asset of $39,084,850 is less than the estimated amount of $ presented in my Direct testimony.

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

A. Entergy contributed $49,263,446 to ENO’s qualified pension plan fund during the years 2014 through 2018.\(^3^5\)

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

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

Q. DO YOU BELIEVE ENTERGY’S LEVEL OF FUNDING TO ENO’S PENSION PLANS OVER THE YEARS 2014 THROUGH 2018 IS NECESSARY GIVEN THE BALANCES OF ITS PENSION ASSET OVER THE SAME TIME SPAN?

\(^3^4\) Please see Exhibit No. ____ (JMP-14).

\(^3^5\) Please see ENO’s response to Advisors 16-2.

\(^3^6\) Please see ENO’s response to Advisors 16-2.
No. ENO’s Pension Asset has consistently increased over the period 2014 through 2018. The increase is largely due to the abnormally impressive performance of asset markets over the period and Entergy’s larger than necessary contributions to ENO’s pension funds.

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

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

Q. WHAT IS THE LEVEL OF RISK FOR ENTERGY AND ENO'S CONTRIBUTIONS TO PENSION FUNDS COMPARED TO OTHER RATE BASE INVESTMENTS?

A. I explain above the benefit obligations regulatory asset acts as a true-up mechanism regarding changes to projected gains and losses to projected benefit obligations and changes to expected and actual gains and losses to returns on ENO’s pension funds. That is, ENO’s Pension Asset remains unaffected from differences between estimated and actual net gains and losses. Thus, the risk-return relationship for ENO’s investment through
Entergy’s contributions to the pension funds is favorable to its other investments in utility assets which not all have true-up mechanisms.

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

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

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

A. Regulatory agencies should be careful not to create incentives for utilities to excessively fund pension plans in order to increase rate base. To evaluate the Pension Asset for inclusion in rate base, it is necessary to consider the corresponding level of pension asset funding through periodic contributions which is reasonable given the projected benefit obligations and the fair value of pension fund investment assets. In my judgment, ENO’s forecasted December 31, 2018 Pension Asset balance does not fairly represent the balance that should be included in ENO’s rate base. I believe the balance is greater than normal, and necessary, due in part to financial market conditions in recent years and the amount of Entergy’s contributions to the pension fund.
Therefore, I believe my recommendation to set ENO’s adjusted Period II Pension Asset at
approximately [REDacted] for rate base purposes is supported by the lower five-year
average actual balance of $39,084,850 and the other reasons discussed above. Finally, I
believe adjustment ADV10 to decrease ENO’s Period II rate base for ENO’s electric and
gas businesses in the amounts of $[REDacted] and $[REDacted], respectively, based on the
Pension Asset balance of $[REDacted] is reasonable.

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

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

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

Q. DOES THAT CONCLUDE YOUR SURREBUTTAL TESTIMONY?

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