

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

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

**DIRECT TESTIMONY
AND EXHIBITS
OF
RICHARD A. BAUDINO**

**ON BEHALF OF THE
CRESCENT CITY POWER USERS' GROUP**

**J. KENNEDY AND ASSOCIATES, INC.
ROSWELL, GEORGIA**

FEBRUARY 2019

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DIRECT TESTIMONY OF RICHARD A. BAUDINO

I. QUALIFICATIONS AND SUMMARY

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

2 A. My name is Richard A. Baudino. My business address is J. Kennedy and Associates,
3 Inc. (“Kennedy and Associates”), 570 Colonial Park Drive, Suite 305, Roswell,
4 Georgia 30075.

5 **Q. What is your occupation and by whom are you employed?**

6 A. I am a consultant with Kennedy and Associates.

7 **Q. Please describe your education and professional experience.**

8 A. I received my Master of Arts degree with a major in Economics and a minor in
9 Statistics from New Mexico State University in 1982. I also received my Bachelor of
10 Arts Degree with majors in Economics and English from New Mexico State in 1979.

11

12 I began my professional career with the New Mexico Public Service Commission Staff
13 in October 1982 and was employed there as a Utility Economist. During my
14 employment with the Staff, my responsibilities included the analysis of a broad range

1 of issues in the ratemaking field. Areas in which I testified included cost of service,
2 rate of return, rate design, revenue requirements, analysis of sale/leasebacks of
3 generating plants, utility finance issues, and generating plant phase-ins.

4
5 In October 1989, I joined the utility consulting firm of Kennedy and Associates as a
6 Senior Consultant where my duties and responsibilities covered substantially the same
7 areas as those during my tenure with the New Mexico Public Service Commission
8 Staff. I became Manager in July 1992 and was named Director of Consulting in
9 January 1995. Currently, I am a consultant with Kennedy and Associates.

10
11 Exhibit ____ (RAB-1) summarizes my expert testimony experience.

12 **Q. On whose behalf are you testifying?**

13 A. I am testifying on behalf of the Crescent City Power Users Group (“CCPUG”), a group
14 of commercial and government customers taking electric service at retail from Entergy
15 New Orleans, LLC (“ENO” or “Company”).

16 **Q. What is the purpose of your Direct Testimony?**

17 A. The purpose of my Direct Testimony is to address the allowed return on equity for
18 ENO. I will also respond to the Revised Direct Testimony of Mr. Robert Hevert,
19 witness for the Company.

20
21 In addition to rate of return, I have reviewed the Company’s proposed Gas
22 Infrastructure Replacement Program (“GIRP”) rider, its proposed Reliability Incentive

1 Mechanism (“RIM”), and its proposed Distribution Grid Modernization (“DGM”) rider.
2

3 **Q. Please summarize your conclusions and recommendations.**

4 A. I recommend that the Council adopt a return on equity (“ROE”) of 9.35% for the base
5 electric and gas revenue requirements, as well as for use in the Electric Formula Rate
6 Plan (“EFRP”) and Gas Formula Rate Plan (“GFRP”) if they are adopted. I performed
7 a Discounted Cash Flow (“DCF”) analysis using the same proxy group of companies
8 used by ENO witness Hevert. I also performed two Capital Asset Pricing Model
9 (“CAPM”) analyses, one based on expected returns for the stock market and one based
10 on a risk premium using historical market returns. I relied on the DCF result for my
11 ROE recommendation, although my CAPM analyses support my 9.35%
12 recommendation as being reasonable.

13
14 In Section IV of my testimony I will respond to ENO witness Hevert’s Revised Direct
15 Testimony and his ROE recommendation of 10.75%. I will demonstrate to the Council
16 that Mr. Hevert’s recommended ROE of 10.75% grossly overstates a fair rate of return
17 for ENO and that his recommendation should be rejected.

18
19 In Section V, I recommend that the Council reject the proposed RIM. Given ENO’s
20 recent poor reliability performance, ENO should not be given incentives in its allowed
21 return on equity for performance that New Orleans ratepayers should expect from their
22 regulated provider of electric service.

23

1 In Section VI, I recommend that the Council reject ENO's proposed GIRP and DGM
2 riders. The GIRP and DGM are not needed if the Council adopts CCPUG's
3 recommended EFRP and GFRP.
4

5 II. REVIEW OF ECONOMIC AND FINANCIAL CONDITIONS

6 **Q. Mr. Baudino, what has the trend been in long-term capital costs over the last 10**
7 **years?**

8 A. Since 2007 and 2008, the overall trend in interest rates in the U.S. and the world
9 economy has been sharply lower. This trend was precipitated by the 2007 financial
10 crisis and severe recession that followed in December 2007. In response to this
11 economic crisis, the Federal Reserve ("Fed") undertook an unprecedented series of
12 steps to stabilize the economy, ease credit conditions, and lower unemployment and
13 interest rates. These steps are commonly known as Quantitative Easing ("QE") and
14 were implemented in three distinct stages: QE1, QE2, and QE3. The Fed's stated
15 purpose of QE was "to support the liquidity of financial institutions and foster
16 improved conditions in financial markets."¹

17 **Q. Mr. Baudino, before you continue please provide a brief explanation of how the**
18 **Fed uses interest rates to improve conditions in the financial markets.**

19 A. Generally, the Fed uses monetary policy to implement certain economic goals. The
20 Fed explained its monetary policy as follows:

21 Monetary policy in the United States comprises the Federal Reserve's actions and
22 communications to promote maximum employment, stable prices, and moderate long-

¹ (http://www.federalreserve.gov/monetarypolicy/bst_crisisresponse.htm).

1 term interest rates--the three economic goals the Congress has instructed the Federal
2 Reserve to pursue.

3
4 The Federal Reserve conducts the nation's monetary policy by managing the level of
5 short-term interest rates and influencing the overall availability and cost of credit in
6 the economy.²
7

8 One of the Fed's primary tools for conducting monetary policy is setting the federal
9 funds rate. The federal funds rate is the interest rate set by the Fed that banks and
10 credit unions charge each other for overnight loans of reserve balances. Traditionally
11 the federal funds rate directly influences short-term interest rates, such as the Treasury
12 bill rate and interest rates on savings and checking accounts. The federal funds rate
13 has a more indirect effect on long-term interest rates, such as the 30-Year Treasury
14 bond and private and corporate long-term debt. Long-term interest rates are set more
15 by market forces that influence the supply and demand of loanable funds.

16 **Q. Please continue with your discussion of the Fed's quantitative easing programs.**

17 A. QE1 was implemented from November 2008 through approximately March 2010.
18 During this time, the Fed cut its key Federal Funds Rate to nearly 0% and purchased
19 \$1.25 trillion of mortgage-backed securities and \$175 billion of agency debt
20 purchases. QE2 was implemented in November 2010 with the Fed announcing that it
21 would purchase an additional \$600 billion of Treasury securities by the second quarter
22 of 2011.³ Beginning in September 2011, the Fed initiated a "maturity extension
23 program" in which it sold or redeemed \$667 billion of shorter-term Treasury securities

² From the Federal Reserve's web site and the section entitled "Monetary Policy".

³ (<http://www.federalreserve.gov/newsevents/press/monetary/20101103a.htm>)

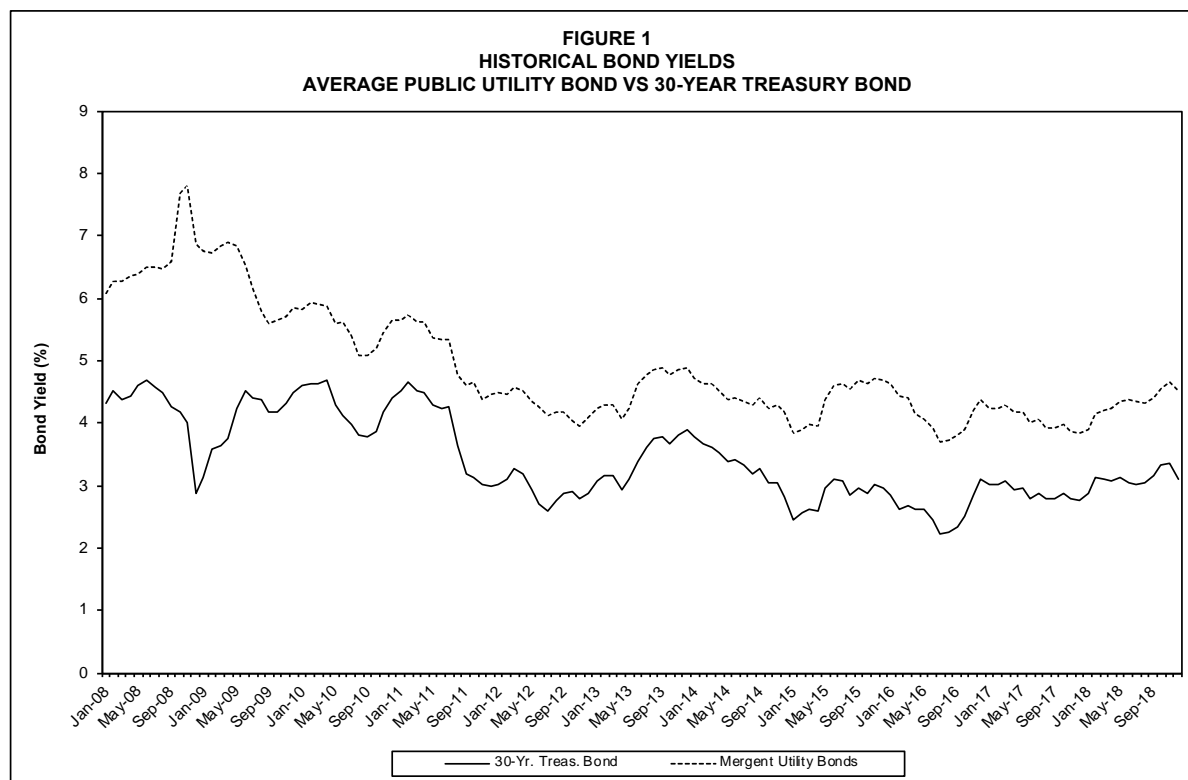
1 and used the proceeds to buy longer-term Treasury securities. This program, also
2 known as "Operation Twist," was designed by the Fed to lower long-term interest rates
3 and support the economic recovery. Finally, QE3 began in September 2012 with the
4 Fed announcing an additional bond purchasing program of \$40 billion per month of
5 agency mortgage backed securities.

6
7 The Fed began to pare back its purchases of securities in the last few years. On January
8 29, 2014 the Fed stated that beginning in February 2014 it would reduce its purchases
9 of long-term Treasury securities to \$35 billion per month. The Fed continued to reduce
10 these purchases throughout the year and in a press release issued October 29, 2014
11 announced that it decided to close this asset purchase program in October.⁴

12
13 Figure 1 below presents a graph that tracks the 30-Year Treasury Bond yield and the
14 Mergent average utility bond yield.

⁴ (<http://www.federalreserve.gov/newsevents/press/monetary/20141029a.htm>)

1



2

3

4

5

6

7

The Fed's QE program and federal funds rate cuts were effective in lowering the long-term cost of borrowing in the United States. The 30-Year Treasury Bond yield declined from 5.11% in July 2007 to a low of 2.59% in July 2012. The average utility bond yield also fell substantially, from 6.28% in July 2007 to 4.12% in July 2012.

8

Q. Has the Fed recently indicated any important changes to its monetary policy?

9

A. Yes. In March 2016, the Fed began to raise its target range for the federal funds rate, increasing it to 1/4% to 1/2% from 0% to 1/4%. Since that time, the Fed increased the federal funds rate several more times, with the most recent increase announced on December 19, 2018. The federal funds rate now stands in the range of 2.25% - 2.50%.

13

In its press release dated December 19, 2018 the Fed stated the following:

1 “Consistent with its statutory mandate, the Committee seeks to foster maximum
2 employment and price stability. The Committee judges that some further gradual
3 increases in the target range for the federal funds rate will be consistent with sustained
4 expansion of economic activity, strong labor market conditions, and inflation near the
5 Committee’s symmetric 2 percent objective over the medium term. The Committee
6 judges that risks to the economic outlook are roughly balanced, but will continue to
7 monitor global economic and financial developments and assess their implications for
8 the economic outlook.
9

10 In view of realized and expected labor market conditions and inflation, the Committee
11 decided to raise the target range for the federal funds rate to 2-1/4 to 2-1/2 percent.
12

13 In determining the timing and size of future adjustments to the target range for the
14 federal funds rate, the Committee will assess realized and expected economic
15 conditions relative to its maximum employment objective and its symmetric 2 percent
16 inflation objective. This assessment will take into account a wide range of information,
17 including measures of labor market conditions, indicators of inflation pressures and
18 inflation expectations, and readings on financial and international developments.”
19

20 The Fed also provided certain economic projections that accompanied its December
21 19, 2018 press release showing the following:

- 22 • Projected federal funds rate of 2.4% for 2018, 2.9% for 2019, 3.1% for 2020,
23 and 2.8% for the longer run.
- 24 • Inflation running at 1.9% for 2018 and 2.0% for 2019 and 2020.

25 The Fed has signaled that it will likely continue increasing the federal funds rate this
26 year.

27 **Q. Mr. Baudino, why is it important to understand the Fed's actions over the last 10**
28 **years?**

29 A. The Fed's monetary policy actions since 2008 were deliberately undertaken to lower
30 interest rates and support economic recovery. Even with several recent increases in
31 the federal funds rate, the U.S. economy is still in a relatively low interest rate
32 environment. This environment has affected the common stocks of regulated utilities,
33 which are interest rate sensitive due to their high concentration of fixed assets. Thus,

1 as interest rates increase in the general economy, the prices of utility common stocks
2 fall and their dividend yields rise. Alternatively, as interest rates fall, the dividend
3 yields on utility common stocks tend to fall as their prices rise.

4 **Q. Are current interest rates indicative of investor expectations regarding the future**
5 **direction of interest rates?**

6 A. Yes. Securities markets are efficient and most likely reflect investors' expectations
7 about future interest rates. As Dr. Roger Morin pointed out in *New Regulatory*
8 *Finance*:

9 "A considerable body of empirical evidence indicates that U.S. capital markets
10 are efficient with respect to a broad set of information, including historical and
11 publicly available information."⁵
12

13 Dr. Morin also noted the following:

14 "There is extensive literature concerning the prediction of interest rates. From
15 this evidence, it appears that the no-change model of interest rates frequently
16 provides the most accurate forecasts of future interest rates while at other
17 times, the experts are more accurate. Naïve extrapolations of current interest
18 rates frequently outperform published forecasts. The literature suggests that on
19 balance, the bond market is very efficient in that it is difficult to consistently
20 forecast interest rates with greater accuracy than a no-change model. The latter
21 model provides similar, and in some cases, superior accuracy than professional
22 forecasts."⁶
23

24 Despite recent increases in the general level of short-term interest rates since the
25 second half of 2016, the U.S. economy continues to operate in a relatively low interest
26 rate environment. It is important to realize that investor expectations of higher future
27 interest rates, if any, are already likely already embodied in current securities prices,
28 which include debt securities and stock prices.

⁵ Morin, Roger A., *New Regulatory Finance*, Public Utilities Reports, Inc. (2006) at 279.

⁶ *Ibid* at 172.

1

2

Moreover, the current low interest rate environment still favors lower risk regulated

3

utilities. Although the Fed anticipates raising the federal funds rate later this year, I

4

still firmly believe that it would not be advisable for utility regulators to raise ROEs

5

in anticipation of higher forecasted long-term interest rates that may or may not occur.

6

Q. How has the increase in the federal funds rate since 2016 affected utility stocks in terms of bond yields and stock prices?

7

8

A. Table 1 shows the federal funds rate, the yield on the 30-Year Treasury bond, the yield

9

on the average utility bond, and the Dow Jones Utility Average from January 2016

10

through December 2018.

TABLE 1
Bond Yields and DJUA

	Federal <u>Funds Rate %</u>	30-Year <u>Treasury %</u>	Avg. Utility <u>Bond %</u>	<u>DJUA</u>
<u>2016</u>				
January	0.34	2.86	4.62	611.35
February	0.38	2.62	4.44	620.70
March	0.36	2.68	4.40	668.57
April	0.37	2.62	4.16	654.44
May	0.37	2.63	4.06	659.44
June	0.38	2.45	3.93	716.52
July	0.39	2.23	3.70	711.42
August	0.40	2.26	3.73	666.87
September	0.40	2.35	3.80	668.13
October	0.40	2.50	3.90	675.23
November	0.41	2.86	4.21	632.67
December	0.54	3.11	4.39	645.86
<u>2017</u>				
January	0.65	3.02	4.24	668.87
February	0.66	3.03	4.25	703.16
March	0.79	3.08	4.30	697.28
April	0.90	2.94	4.19	704.35
May	0.91	2.96	4.19	726.62
June	1.04	2.80	4.01	706.91
July	1.15	2.88	4.06	726.48
August	1.16	2.80	3.92	743.24
September	1.15	2.78	3.93	723.60
October	1.15	2.88	3.97	753.20
November	1.16	2.80	3.88	770.39
December	1.30	2.77	3.85	723.37
<u>2018</u>				
January	1.41	2.88	3.91	699.25
February	1.42	3.13	4.15	668.81
March	1.51	3.09	4.21	692.63
April	1.69	3.07	4.24	707.01
May	1.70	3.13	4.36	695.21
June	1.82	3.05	4.37	711.64
July	1.91	3.01	4.38	724.24
August	1.91	3.04	4.33	726.41
September	1.95	3.15	4.41	720.60
October	2.19	3.34	4.56	733.84
November	2.20	3.36	4.65	741.92
December	2.27	3.10	4.51	712.93

Source: Federal Reserve, Mergent Bond Record, Yahoo! Finance

1 Note that as the federal funds rate rose significantly from January through December
2 2017, the 30-Year Treasury yield declined. The DJUA rose throughout 2017, declined
3 sharply in December and through February 2018, then began to rise again through
4 November 2018. Although the federal funds rate steadily increased from 2016, the
5 30-Year Treasury yield was not much different in December 2018 than it was in
6 January 2017. The average utility bond yield was slightly lower in December 2018
7 (4.51%) than it was in January 2016 (4.62%), despite the steep increases in the federal
8 funds rate.

9 **Q. How does the investment community regard the electric utility industry**
10 **currently?**

11 A. The Value Line Investment Survey's December 14, 2018 report on the Electric Utility
12 (Central) Industry concluded as follows:

13 "Stocks in the Electric Utility Industry have had a mixed performance so far in 2018,
14 but (as a group) have outpaced the broader market averages. *Utility equities attract*
15 *income-oriented investors for their above average dividend yields, and their defensive*
16 *characteristics are appealing to many investors in times of market turbulence. Among*
17 *utility issues reviewed in Issue 5, the prices of OGE Energy and Ameren are up 22%*
18 *and 18%, respectively, year to date. Vectren stock has performed well, too (up 11%),*
19 *thanks to the pending takeover of the company by CenterPoint Energy.*

20
21 Most equities in this Industry have a high valuation. Most are trading within their
22 2021-2023 Target Price Range, and some recent quotations are even near the upper
23 end of this range. The average dividend yield of stocks in the Electric Utility Industry
24 is 3.3%, which is low, by historical standards. Total return potential over the 3- to 5-
25 year period is just 3%, on average." (italics added)

26 **Q. Please provide an overview of the electric utility industry's credit ratings and**
27 **current authorized ROEs.**

1 A. The Edison Electric Institute (“EEI”) assembles and publishes a quarterly credit
 2 ratings and rate review of the electric industry on its web site.⁷ For the third quarter
 3 of 2018, EEI’s analysis showed that for the 47 electric utilities included in its survey
 4 analysis, the average Standard and Poor’s credit rating was BBB+, with 55% of the
 5 companies having credit ratings of BBB+/BBB. Entergy Corporation was one of the
 6 17 companies in the survey with a BBB+ credit rating. Through the third quarter of
 7 2018, 42% of the ratings actions were credit upgrades and 58% were downgrades.
 8 This was a change from 2017, during which 73.6% of ratings actions were upgrades.
 9 However, the average credit rating for the industry was unchanged from the 2017
 10 rating of BBB+.

11
 12 With respect to requested and allowed ROEs, EEI’s rate review reported the following.
 13

TABLE 2		
2018		
QUARTERLY REQUESTED AND ALLOWED ROES		
	<u>Requested</u>	<u>Allowed</u>
Quarter 1	10.02	9.58
Quarter 2	9.86	9.51
Quarter 3	10.25	9.53
Average	10.04	9.54

14

⁷ Please refer to EEI’s web site and the page entitled *Electric Utility Industry Financial Data And Trend Analysis* and the 2018 Q3 – Financial Updates.

1 **Q. What are the current credit ratings and bond ratings for ENO?**

2 A. Standard and Poor's ("S&P") current issuer credit rating for ENO is BBB+, with a
3 senior secured bond rating of A. ENO's issuer credit rating from S&P is consistent
4 with the average electric utility credit rating reported by EEI above. Moody's long
5 term issuer rating for the Company is Ba1, with a first mortgage bond rating of Baa2.
6 Both Moody's and S&P have a stable credit outlook for ENO.

7

8 ENO provided S&P's September 21, 2018 credit rating report in response to discovery
9 in this case.⁸ S&P's report noted the following with respect to ENO's business risk:

- 10 • Low-risk, fully rate-regulated utility concentrated in the city of New Orleans.
11 • Generally stable regulatory framework.
12 • Susceptible to weather-related disasters.
13 • Small customer base with modest growth.
14 • Limited regulatory or business diversity.

15

16 S&P also noted that ENO had "modestly negative cash flow resulting from tax reform
17 impacts." With respect to the Company's ongoing operating revenues, S&P stated
18 that "[a]bout 80% of operating revenues are from residential and commercial
19 customers, providing a measure of stability to revenue and cash flow."

20

⁸ See ENO response to APC 2-4.

1 Moody's October 13, 2017 credit opinion, also provided by ENO in response to
2 discovery, stated that ENO's "low lying service territory will continue to constrain its
3 credit rating going forward, despite the strength of the credit profile."

4 **Q. Considering the credit reports from Moody's and S&P, what are your**
5 **conclusions and recommendations to the Council with respect to the approach to**
6 **estimating the allowed ROE for ENO in this proceeding?**

7 A. I recommend that the Council approach its allowed ROE using a proxy group of
8 investment grade regulated electric and gas companies. Given that ENO's BBB+ S&P
9 credit rating is equivalent to the average electric industry credit rating, it is reasonable
10 to assume that equity investors would view the Company as having a similar
11 risk/return relationship as the industry in general. For purposes of this case, I have
12 adopted the proxy group used by ENO witness Hevert to estimate the Company's cost
13 of equity in this proceeding.

14 III. DETERMINATION OF FAIR RATE OF RETURN

15 **Q. Please describe the methods you employed in estimating a fair rate of return for**
16 **ENO.**

17 A. I employed a Discounted Cash Flow ("DCF") analysis using the proxy group of 22
18 regulated electric utilities used by Mr. Hevert in the ROE analysis he submitted on
19 behalf of the Company. My DCF analysis is the standard constant growth form of the
20 model that employs four different growth rate forecasts from the Value Line
21 Investment Survey, Yahoo! Finance, and Zacks. I also employed Capital Asset Pricing
22 Model ("CAPM") analyses using both historical and forward-looking data. The results
23 from the CAPM tend to support the reasonableness of my DCF results as well as my
24 ROE recommendation for ENO.

1 **Q. What are the main guidelines to which you adhere in estimating the cost of equity**
2 **for a firm?**

3 A. The estimated cost of equity should be comparable to the returns of other firms with
4 similar risk structures and should be sufficient for the firm to attract capital. These are
5 the basic standards set out by the United States Supreme Court in *Federal Power*
6 *Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) and *Bluefield W.W. & Improv.*
7 *Co. v. Public Service Comm'n*, 262 U.S. 679 (1922).

8
9 From an economist's perspective, the notion of "opportunity cost" plays a vital role in
10 estimating the return on equity. One measures the opportunity cost of an investment
11 equal to what one would have obtained in the next best alternative. For example, let
12 us suppose that an investor decides to purchase the stock of a publicly traded electric
13 utility. That investor made the decision based on the expectation of dividend payments
14 and perhaps some appreciation in the stock's value over time; however, that investor's
15 opportunity cost is measured by what she or he could have invested in as the next best
16 alternative. That alternative could have been another utility stock, a utility bond, a
17 mutual fund, a money market fund, or any other number of investment vehicles.

18
19 The key determinant in deciding whether to invest, however, is based on comparative
20 levels of risk. Our hypothetical investor would not invest in a particular electric
21 company stock if it offered a return lower than other investments of similar risk. The
22 opportunity cost simply would not justify such an investment. Thus, the task for the
23 rate of return analyst is to estimate a return that is equal to the return being offered by
24 other risk-comparable firms.

1 **Q. What are the major types of risk faced by utility companies?**

2 A. In general, risk associated with the holding of common stock can be separated into
3 three major categories: business risk, financial risk, and liquidity risk. Business risk
4 refers to risks inherent in the operation of the business. Volatility of the firm's sales,
5 long-term demand for its product(s), the amount of operating leverage, and quality of
6 management are all factors that affect business risk. The quality of regulation at the
7 state and federal levels also plays an important role in business risk for regulated utility
8 companies.

9

10 Financial risk refers to the impact on a firm's future cash flows from the use of debt in
11 the capital structure. Interest payments to bondholders represent a prior call on the
12 firm's cash flows and must be met before income is available to the common
13 shareholders. Additional debt means additional variability in the firm's earnings,
14 leading to additional risk.

15

16 Liquidity risk refers to the ability of an investor to quickly sell an investment without
17 a substantial price concession. The easier it is for an investor to sell an investment for
18 cash, the lower the liquidity risk will be. Stock markets, such as the New York and
19 American Stock Exchanges, help ease liquidity risk substantially. Investors who own
20 stocks that are traded in these markets know on a daily basis what the market prices of
21 their investments are and that they can sell these investments fairly quickly. Many
22 electric utility stocks are traded on the New York Stock Exchange and are considered
23 liquid investments.

1 **Q. Are there any sources available to investors that quantify the total risk of a**
 2 **company?**

3 A. Bond and credit ratings are tools that investors use to assess the risk comparability of
 4 firms. Bond rating agencies such as Moody's and Standard and Poor's perform
 5 detailed analyses of factors that contribute to the risk of an investment. The result of
 6 their analyses is a bond and/or credit rating that reflect these risks.

7 **Discounted Cash Flow ("DCF") Model**

8 **Q. Please describe the basic DCF approach.**

9 A. The basic DCF approach is rooted in valuation theory. It is based on the premise that
 10 the value of a financial asset is determined by its ability to generate future net cash
 11 flows. In the case of a common stock, those future cash flows generally take the form
 12 of dividends and appreciation in stock price. The value of the stock to investors is the
 13 discounted present value of future cash flows. The general equation then is:

$$14 \quad V = \frac{R}{(1+r)} + \frac{R}{(1+r)^2} + \frac{R}{(1+r)^3} + \dots + \frac{R}{(1+r)^n}$$

15 *Where:* $V = \text{asset value}$
 16 $R = \text{yearly cash flows}$
 17 $r = \text{discount rate}$

18 This is no different from determining the value of any asset from an economic point
 19 of view; however, the commonly employed DCF model makes certain simplifying
 20 assumptions. One is that the stream of income from the equity share is assumed to be
 21 perpetual; that is, there is no salvage or residual value at the end of some maturity date
 22 (as is the case with a bond). Another important assumption is that financial markets
 23 are reasonably efficient; that is, they correctly evaluate the cash flows relative to the
 24 appropriate discount rate, thus rendering the stock price efficient relative to other

1 alternatives. Finally, the model I typically employ also assumes a constant growth rate
2 in dividends. The fundamental relationship employed in the DCF method is described
3 by the formula:

$$k = D_1/P_0 + g$$

4
5 *Where:* $D_1 =$ the next period dividend
6 $P_0 =$ current stock price
7 $g =$ expected growth rate
8 $k =$ investor-required return

9 Under the formula, it is apparent that “k” must reflect the investors’ expected return.
10 Use of the DCF method to determine an investor-required return is complicated by the
11 need to express investors’ expectations relative to dividends, earnings, and book value
12 over an infinite time horizon. Financial theory suggests that stockholders purchase
13 common stock on the assumption that there will be some change in the rate of dividend
14 payments over time. We assume that the rate of growth in dividends is constant over
15 the assumed time horizon, but the model could easily handle varying growth rates if
16 we knew what they were. Finally, the relevant time frame is prospective rather than
17 retrospective.

18 **Q. What was your first step in conducting your DCF analysis for ENO?**

19 A. My first step was to choose a proxy group of companies with a risk profile that is
20 reasonably similar to ENO. For purposes of this case, it is reasonable to proceed with
21 the proxy group of 22 companies shown by Mr. Hevert on page 14, Table 2 of his
22 Revised Direct Testimony.

23 **Q. What was your first step in determining the DCF return on equity for the proxy**
24 **group?**

1 A. I first determined the current dividend yield, D_1/P_0 , from the basic equation. My
2 general practice is to use six months as the most reasonable period over which to
3 estimate the dividend yield. The six-month period I used covered the months from
4 July through December 2018. I obtained historical prices and dividends from Yahoo!
5 Finance. The annualized dividend divided by the average monthly price represents
6 the average dividend yield for each month in the period.

7

8 The resulting average dividend yield for the comparison group is 3.26%. These
9 calculations are shown in Exhibit ____ (RAB-2).

10

11 Exhibit ____ (RAB-2) also shows the monthly dividend yield for the proxy group. The
12 monthly average dividend yield ranged from 3.23% (December) to 3.30% (July), so
13 there was not significant variation in the average proxy group dividend yield over the
14 six-month period.

15 **Q. Having established the average dividend yield, how did you determine the**
16 **investors' expected growth rate for the electric comparison group?**

17 A. The investors' expected growth rate, in theory, correctly forecasts the constant rate of
18 growth in dividends. The dividend growth rate is a function of earnings growth and
19 the payout ratio, neither of which is known precisely for the future. We refer to a
20 perpetual growth rate since the DCF model has no arbitrary cut-off point. We must
21 estimate the investors' expected growth rate because there is no way to know with
22 absolute certainty what investors expect the growth rate to be in the short term, much
23 less in perpetuity.

24

1 For my analysis in this proceeding, I used three major sources of analysts' forecasts
2 for growth. These sources are The Value Line Investment Survey, Zacks, and Yahoo!
3 Finance. These are the sources I typically use for estimating growth for my DCF
4 calculations.

5 **Q. Please briefly describe Value Line, Zacks, and Yahoo! Finance.**

6 A. The Value Line Investment Survey is a widely used and respected source of investor
7 information that covers approximately 1,700 companies in its Standard Edition and
8 several thousand in its Plus Edition. It is updated quarterly and probably represents
9 the most comprehensive of all investment information services. It provides both
10 historical and forecasted information on a number of important data elements. Value
11 Line neither participates in financial markets as a broker nor works for the utility
12 industry in any capacity of which I am aware.

13
14 Zacks gathers opinions from a variety of analysts on earnings growth forecasts for
15 numerous firms including regulated electric utilities. The estimates of the analysts
16 responding are combined to produce consensus average estimates of earnings growth.
17 I obtained Zacks' earnings growth forecasts from its web site.

18
19 Like Zacks, Yahoo! Finance also compiles reports consensus analysts' forecasts of
20 earnings growth.

21 **Q. Why did you rely on analysts' forecasts in your analysis?**

22 A. Return on equity analysis is a forward-looking process. Five-year or ten-year
23 historical growth rates may not accurately represent investor expectations for dividend

1 growth. Analysts' forecasts for earnings and dividend growth provide better proxies
2 for the expected growth component in the DCF model than historical growth rates.
3 Analysts' forecasts are also widely available to investors and one can reasonably
4 assume that they influence investor expectations.

5 **Q. Please explain how you used analysts' dividend and earnings growth forecasts in**
6 **your constant growth DCF analysis.**

7 Q. Page 1, Columns (1) through (4) of Exhibit ____ (RAB-3) shows the forecasted dividend
8 and earnings growth rates from Value Line and the earnings growth forecasts from
9 Zacks and Yahoo! Finance. It is important to include dividend growth forecasts in the
10 DCF model since the model calls for forecasted cash flows received by the investor.
11 Value Line is the only source of which I am aware that forecasts dividend growth and
12 my approach gives this forecast equal weight with the three earnings growth forecasts.

13 **Q. How did you proceed to determine the DCF return of equity for the comparison**
14 **group?**

15 A. To estimate the expected dividend yield (D_1), the current dividend yield must be
16 moved forward in time to account for dividend increases over the next twelve months.
17 I estimated the expected dividend yield by multiplying the current dividend yield by
18 one plus one-half the expected growth rate.

19
20 Page 2 of Exhibit ____ (RAB-3) presents my standard method of calculating dividend
21 yields, growth rates, and return on equity for the proxy group of companies. The DCF
22 Return on Equity Calculation section shows the application of each of four growth
23 rates I used in my analysis to the current group dividend yield of 3.26% to calculate
24 the expected dividend yield. I then added the expected growth rates to the expected

1 dividend yield. In evaluating investor expected growth rates, I use both the average
2 and the median values for the group under consideration. Method 1 uses the group
3 average expected growth rate and Method 2 uses the group median expected growth
4 rate.

5 **Q. What are the results of your constant growth DCF model?**

6 A. For the average growth rates in Method 1, the results range from 8.71% to 9.36%, with
7 the average of these results being 9.05%. Using the median growth rates in Method 2,
8 the results range from 8.52% to 9.36%, with the average of these results being 8.97%.

9 **Capital Asset Pricing Model**

10 **Q. Briefly summarize the Capital Asset Pricing Model ("CAPM") approach.**

11 A. The theory underlying the CAPM approach is that investors, through diversified
12 portfolios, may combine assets to minimize the total risk of the portfolio.
13 Diversification allows investors to diversify away all risks specific to a particular
14 company and be left only with market risk that affects all companies. Thus, the CAPM
15 theory identifies two types of risks for a security: company-specific risk and market
16 risk. Company-specific risk includes such events as strikes, management errors,
17 marketing failures, lawsuits, and other events that are unique to a particular firm.
18 Market risk includes inflation, business cycles, war, variations in interest rates, and
19 changes in consumer confidence. Market risk tends to affect all stocks and cannot be
20 diversified away. The idea behind the CAPM is that diversified investors are rewarded
21 with returns based on market risk.

22

1 Within the CAPM framework, the expected return on a security is equal to the risk-
 2 free rate of return plus a risk premium that is proportional to the security's market, or
 3 non-diversifiable, risk. Beta is the factor that reflects the inherent market risk of a
 4 security and measures the volatility of a security relative to the overall market for
 5 securities. For example, a stock with a beta of 1.0 indicates that if the market rises by
 6 15%, that stock will also rise by 15%. This stock moves in tandem with movements
 7 in the overall market. Stocks with a beta of 0.5 will only rise or fall 50% as much as
 8 the overall market. So with an increase in the market of 15%, this stock will only rise
 9 7.5%. Stocks with betas greater than 1.0 will rise and fall more than the overall market.
 10 Thus, beta is the measure of the relative risk of individual securities vis-à-vis the
 11 market.

12
 13 Based on the foregoing discussion, the equation for determining the return for a
 14 security in the CAPM framework is:

$$K = Rf + \beta(MRP)$$

15
 16
 17 *Where:* K = Required Return on equity
 18 Rf = Risk-free rate
 19 MRP = Market risk premium
 20 β = Beta

21
 22 This equation tells us about the risk/return relationship posited by the CAPM.
 23 Investors are risk averse and will only accept higher risk if they expect to receive
 24 higher returns. These returns can be determined in relation to a stock's beta and the
 25 market risk premium. The general level of risk aversion in the economy determines

1 the market risk premium. If the risk-free rate of return is 3.0% and the required return
2 on the total market is 15%, then the risk premium is 12%. Any stock's required return
3 can be determined by multiplying its beta by the market risk premium. Stocks with
4 betas greater than 1.0 are considered riskier than the overall market and will have
5 higher required returns. Conversely, stocks with betas less than 1.0 will have required
6 returns lower than the market.

7 **Q. In general, are there concerns regarding the use of the CAPM in estimating the**
8 **return on equity?**

9 A. Yes. There is some controversy surrounding the use of the CAPM.⁹ There is evidence
10 that beta is not the primary factor in determining the risk of a security. For example,
11 Value Line's "Safety Rank" is a measure of total risk, not its calculated beta
12 coefficient. Beta coefficients usually describe only a small amount of total investment
13 risk.

14
15 There is also substantial judgment involved in estimating the required market return.
16 In theory, the CAPM requires an estimate of the return on the total market for
17 investments, including stocks, bonds, real estate, etc. It is nearly impossible for the
18 analyst to estimate such a broad-based return. Often in utility cases, a market return
19 is estimated using the S&P 500 or the return on Value Line's stock market composite.
20 However, these are limited sources of information with respect to estimating the
21 investor's required return for all investments. In practice, the total market return

⁹ For a more complete discussion of some of the controversy surrounding the use of the CAPM, refer to *A Random Walk Down Wall Street* by Burton Malkiel, pp. 219-223, 11th edition.

1 estimate faces significant limitations to its estimation and, ultimately, its usefulness in
2 quantifying the investor required ROE.

3
4 In the final analysis, a considerable amount of judgment must be employed in
5 determining the risk-free rate and market return portions of the CAPM equation. The
6 analyst's application of judgment can significantly influence the results obtained from
7 the CAPM. My experience with the CAPM indicates that it is prudent to use a wide
8 variety of data in estimating investor-required returns. Of course, the range of results
9 may also be wide, indicating the difficulty in obtaining a reliable estimate from the
10 CAPM.

11 **Q. How did you estimate the market return portion of the CAPM?**

12 A. The first source I used was the Value Line Investment Analyzer Plus Edition, for
13 December 27, 2018. This edition covers several thousand stocks. The Value Line
14 Investment Analyzer provides a summary statistical report detailing, among other
15 things, forecasted growth rates for earnings and book value for the companies Value
16 Line follows as well as the projected total annual return over the next 3 to 5 years. I
17 present these growth rates and Value Line's projected annual return on page 2 of
18 Exhibit ____ (RAB-4). I included median earnings and book value growth rates. The
19 estimated market returns using Value Line's market data range from 11.50% to
20 16.00%. The average of these market returns is 13.75%.

21 **Q. Why did you use median growth rate estimates rather than the average growth**
22 **rate estimates for the Value Line companies?**

1 A. Using median growth rates is likely a more accurate approach to estimating the central
2 tendency of Value Line's large data set compared to the average growth rates. Average
3 earnings and book value growth rates may be unduly influenced by very high or very
4 low 3 - 5-year growth rates that are unsustainable in the long run. For example, Value
5 Line's Statistical Summary shows both the highest and lowest value for earnings and
6 book value growth forecasts. For earnings growth, Value Line showed the highest
7 earnings growth forecast to be 93.5% and the lowest growth rate to be -31%. With
8 respect to book value, the highest growth rate was 85.5% and the lowest was a -30%.
9 None of these growth rate projections is compatible with long-run growth prospects
10 for the market as a whole. The median growth rate is not influenced by such extremes
11 because it represents the middle value of a very wide range of earnings growth rates.

12 **Q. Please continue with your market return analysis.**

13 A. I also considered a supplemental check to the Value Line projected market return
14 estimates. Duff and Phelps compiled a study of historical returns on the stock market
15 in its 2018 SBBI Yearbook. Some analysts employ this historical data to estimate the
16 market risk premium of stocks over the risk-free rate. The assumption is that a risk
17 premium calculated over a long period of time is reflective of investor expectations
18 going forward. Exhibit ____ (RAB-5) presents the calculation of the market returns
19 using the historical data.

20 **Q. Please explain how this historical risk premium is calculated.**

21 A. Exhibit ____ (RAB-5) shows both the geometric and arithmetic average of yearly
22 historical stock market returns over the historical period from 1926 - 2017. The
23 average annual income return for 20-year Treasury bond is subtracted from these

1 historical stocks returns to obtain the historical market risk premium of stock returns
2 over long-term Treasury bond income returns. The historical market risk premium
3 range is 5.2% - 7.1%.

4 **Q. Did you add an additional measure of the historical risk premium in this case?**

5 A. Yes. Duff and Phelps reported the results of a study by Dr. Roger Ibbotson and Dr.
6 Peng Chen indicating that the historical risk premium of stock returns over long-term
7 government bond returns has been significantly influenced upward by substantial
8 growth in the price/earnings ("P/E") ratio for stocks from 1980 through 2001.¹⁰ Duff
9 and Phelps noted that this growth in the P/E ratio for stocks was subtracted out of the
10 historical risk premium because "it is not believed that P/E will continue to increase
11 in the future." The adjusted historical arithmetic market risk premium is 6.04%, which
12 I have also included in Exhibit ____ (RAB-5). This risk premium estimate falls near
13 the middle of the market risk premium range.

14 **Q. How did you determine the risk free rate?**

15 A. I used the average yields on the 30-year Treasury bond and five-year Treasury note
16 over the six-month period from July through December 2018. The 30-year Treasury
17 bond is often used by rate of return analysts as the risk-free rate, but it contains a
18 significant amount of interest rate risk. The five-year Treasury note carries less
19 interest rate risk than the 30-year bond and is more stable than short-term Treasury
20 bills. Therefore, I have employed both securities as proxies for the risk-free rate of

¹⁰ 2018 *SBBI Yearbook*, Duff and Phelps, pp. 10-28 through 10-30.

1 return. This approach provides a reasonable range over which the CAPM return on
2 equity may be estimated.

3 **Q. How did you determine the value for beta?**

4 A. I obtained the betas for the companies in the electric company comparison group from
5 most recent Value Line reports. The average of the Value Line betas for the
6 comparison group is 0.60.

7 **Q. Please summarize the CAPM results.**

8 A. From Exhibit ____ (RAB-4), my forward-looking CAPM return on equity estimates
9 are 9.34% - 9.47%. Using historical risk premiums in Exhibit ____ (RAB-5), the
10 CAPM results are 6.26% - 7.39%.

11 **Conclusions and Recommendations**

12 **Q. Please summarize the cost of equity results for your DCF and CAPM analyses.**

13 A. Table 3 below summarizes my return on equity results using the DCF and CAPM for
14 my comparison group of companies.

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**TABLE 3
SUMMARY OF ROE ESTIMATES**

DCF Methodology:	
Average Growth Rates	
- High	9.36%
- Low	8.71%
- Average	9.05%
Median Growth Rates:	
- High	9.36%
- Low	8.52%
- Average	8.97%
CAPM:	
- 5-Year Treasury Bond	9.34%
- 30-Year Treasury Bond	9.47%
- Historical Returns	6.26% - 7.39%

1

2 **Q. What is your recommended return on equity for ENO?**

3 A. My independent analyses of the return on equity for ENO indicate a reasonable
4 investor required return on equity (“ROE”) in the range of 8.70% - 9.35% based on
5 the DCF analyses I performed. My recommended ROE for ENO in this proceeding
6 would be 9.35%. My 9.35% ROE recommendation represents the top of the range of
7 DCF estimates and is also reasonably consistent with my CAPM results as well.

8

9 ENO’s S&P credit rating of BBB+ is consistent with the average credit rating for
10 regulated electric utilities at this time. Given recent concerns with increasing interest
11 rates near the end of 2018 and for this year as well, I chose to place my recommended
12 ROE at the top of the DCF range for purposes of this case. Moreover, given ENO’s
13 split credit rating from S&P and Moody’s, it is my view that placing my recommended

1 ROE at the top of the DCF range more than compensates for Moody's lower credit
2 rating.

3 **Q. On page 44, lines 10 through 14 of his Revised Direct Testimony Mr. Hevert**
4 **testified that S&P's BBB+ rating reflects ENO's affiliation with Entergy**
5 **Corporation and that its stand-alone credit rating would be two notches lower**
6 **(BBB-). Is this a valid reason for setting ENO's allowed ROE higher than the**
7 **proxy group average in this proceeding?**

8 A. No. ENO's lower stand-alone credit rating does not justify a higher ROE than the
9 proxy group average ROE. ENO's credit and risk profiles benefit from its affiliation
10 with Entergy Corporation and its ROE should fully reflect that relationship. ENO is
11 not, in fact, a stand-alone entity and should not be treated as such for purposes of the
12 Council's allowed ROE in this proceeding.

13 **Q. Did you review ENO's requested cost of long-term debt?**

14 A. Yes. I reviewed the components of ENO's requested long-term debt cost and find that
15 ENO's requested cost of debt is reasonable and should be adopted by the Council.

16 **Q. Did you address the Company's requested capital structure?**

17 A. No. Mr. Kollen addresses ENO's capital structure and the inclusion of short-term debt
18 in his Direct Testimony. Mr. Kollen also quantifies the effect of including short-term
19 debt in ENO's capital structure and the revenue requirement impact of my
20 recommended 9.35% ROE.

21 **IV. RESPONSE TO ENO ROE TESTIMONY**

22 **Q. Have you reviewed the Revised Direct Testimony of Mr. Robert Hevert?**

23 A. Yes.

1 **Q. Please summarize Mr. Hevert's testimony and approach to return on equity.**

2 A. Mr. Hevert employed four methods to estimate the investor required rate of return for
3 ENO: (1) the constant growth DCF model, (2) two multi-stage DCF models, (3) the
4 CAPM, and (4) the bond yield plus risk premium model.

5

6 For his constant growth DCF approach, he used Value Line, First Call, and Zacks for
7 the investor expected growth rate. For the proxy group, Mr. Hevert's mean growth
8 rate ROE results ranged from 9.16% to 9.29%.

9

10 Regarding his multi-stage DCF analyses, Mr. Hevert's models are comprised of three
11 distinct stages with assumptions regarding growth rates and payout ratio changes. Mr.
12 Hevert used his own forecast of growth in nominal Gross Domestic Product ("GDP")
13 for his long-term growth rate. The mean ROE results for Mr. Hevert's multi-stage
14 DCF methods ranged from 9.67% to 10.02%.

15

16 With respect to the CAPM, Mr. Hevert utilized a current and projected yield on the
17 30-Year Treasury bond for his risk-free rate. He also used beta values from both Value
18 Line and Bloomberg. Using the current Treasury bond yield of 3.11%, his CAPM
19 results ranged from 10.13% to 11.91%. Using the near-term projected Treasury yield
20 of 3.48%, his CAPM results ranged from 10.5% to 12.28%.

21

22 Finally, Mr. Hevert's bond yield plus risk premium analyses employed current and
23 long-term projected 30-Year Treasury bond yields ranging from 3.11% to 4.30% and

1 commission authorized returns on equity from January 1980 through June 15, 2018.
2 Mr. Hevert's ROE results using this method were 9.96% - 10.28%.

3 **Q. Before you proceed to the particulars of your review of Mr. Hevert's testimony,**
4 **what is your overall conclusion with respect to Mr. Hevert's recommended ROE**
5 **range?**

6 A. Mr. Hevert's recommended ROE range of 10.25% - 11.00% fails to reflect the full
7 range of results from his analyses. His mean DCF results, which are fairly consistent
8 with mine, were completely excluded from his range of recommendations. This means
9 that Mr. Hevert rejected the results from two of his four ROE methodologies, choosing
10 instead to mainly rely on the results from the CAPM. To put this another way, consider
11 the following:

- 12 • Mr. Hevert effectively rejected the average (mean) results from the constant
13 growth DCF in total.
- 14 • Mr. Hevert effectively rejected the mean results from his multi-stage DCF
15 models in total.
- 16 • Mr. Hevert effectively rejected two of the three bond yield plus risk premium
17 results (9.96% - 10.03%).

18
19 Mr. Hevert also apparently rejected the CAPM results that used the average Value
20 Line beta, which ranged from 11.66% - 12.28%. Indeed, these results are so
21 unreasonably high that they should be rejected out of hand. Mr. Hevert's own
22 historical data presented in his Exhibit RBH-7 show that more recent allowed returns
23 are far below these calculated returns, making them extreme outliers. I will explain
24 this in more detail later in my response to Mr. Hevert.

1

2

What we are left with to understand the basis for Mr. Hevert's ROE range, then, is the CAPM results from the average Bloomberg beta (10.13% - 10.71%) and the upper end of the bond yield plus risk premium result of 10.28% using a forecasted Treasury bond yield. I was not able to determine how he obtained the 11.0% high end of his recommended ROE range. Mr. Hevert's recommended ROE of 10.75% for ENO is slightly higher than the upper bound of his CAPM results using the Bloomberg beta.

3

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9

In conclusion, although Mr. Hevert presented four different approaches to ROE analysis, he primarily relied on the results of one method, the CAPM.

10

11

Q. Is it appropriate for Mr. Hevert to reject the mean results from his constant growth and multi-stage DCF analyses?

12

13

A. No, definitely not. It is incorrect for Mr. Hevert to exclude the mean results of all of the DCF models in his recommended ROE for ENO. The constant growth DCF model utilizes verifiable public information with respect to investor return requirements for electric utilities. Current stock prices are the best indicators we have of investor expectations and analysts' earnings and dividend growth forecasts may reasonably be assumed to influence investors' required ROEs. Simply discarding this important publicly available information, as Mr. Hevert has done, serves to significantly overstate his recommended investor required return for the average regulated utility company. The DCF model currently shows that investor required returns are considerably lower for utility stocks given their safety and security relative to the stock market as a whole.

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1 **Q. Is using the high mean results from the DCF models appropriate?**

2 A. No. Mr. Hevert's high mean results simply use the highest ROE for each company in
3 the proxy group, which is driven by the highest expected growth rate. There is no
4 basis for assuming that investors are more likely to expect the highest growth rate from
5 the three sources used by Mr. Hevert. The average of the three sources is a far more
6 likely and reasonable assumption. Further, the proxy group high mean is unduly
7 influenced by Avangrid, which has a high ROE result of over 16%.

8

9 Referring to Mr. Hevert's Tables 3 and 4, there is not one DCF mean ROE result that
10 supports the low end of Mr. Hevert's recommended range of 10.25%. In addition, the
11 high mean results for Mr. Hevert's multi-stage DCF models cannot be used because
12 they are greatly overstated due to an excessively high GDP growth forecast that Mr.
13 Hevert developed himself. I will address this in more detail later in my testimony.

14 **Q. On page 23 of his Revised Direct Testimony, Mr. Hevert described two DCF**
15 **model assumptions that he claimed "are not consistent with current market**
16 **conditions." Please summarize the assumptions addressed by Mr. Hevert.**

17 A. Mr. Hevert addressed the following assumptions:

- 18
- 19 • A constant payout ratio
 - 20 • A constant price/earnings ("P/E") ratio
 - 21 • Constant required return on equity

22 These are three of the basic assumptions that underlie the DCF model. The payout
23 ratio refers to the percentage of earnings that are paid out in dividends. For example,
if a utility company earns \$1.00 per share and pays out \$0.80 per share in dividends,

1 then the payout ratio is 0.80. The constant growth DCF analysis assumes that this ratio
2 is constant over time and is a very reasonable simplifying assumption.

3
4 The DCF model also assumes that the investor has a constant required return on equity
5 over time. This is a logical assumption given that investors base their investment
6 decisions on assessing expectations of the future outcomes using a current market
7 required return on equity.

8 **Q. Did Mr. Hevert provide sufficient basis for the Council to question the DCF**
9 **results?**

10 A. No, he did not. Before I proceed to a more detailed response to Mr. Hevert's criticisms
11 of the DCF model's assumptions, it is important to realize that none of the models Mr.
12 Hevert and I use to estimate the investor required ROE strictly adhere to their
13 underlying assumptions 100% of the time. The DCF, CAPM, and risk premium
14 models all operate with certain simplifying assumptions. Earlier in my testimony I
15 pointed out the limitations of the CAPM that must be considered in assessing its
16 effectiveness relative to the DCF model. One of those limitations is estimating the
17 market required rate of return. Estimating the market required rate of return requires
18 considerable judgment on the part of the analyst, judgment that may result in a wide
19 range of possible returns. And in fact, Mr. Hevert and I used very different estimates
20 of the market rate of return that caused our CAPM results to differ considerably. I
21 will address the serious underlying problems with Mr. Hevert's CAPM later in my
22 testimony.

23

1 I suggest that the Council keep in mind that no ROE estimation model strictly adheres
2 to its underlying assumptions all the time.

3 **Q. Please continue with your response to Mr. Hevert's criticism of the DCF model's**
4 **assumptions.**

5 A. With respect to the assumption of a constant payout ratio, simply because the industry's
6 current payout ratio may be above or below the long-term average payout ratio does
7 not mean that the DCF results based on current data are questionable and should be
8 thrown out completely. This is also the case with respect to the industry's
9 price/earnings ("P/E") ratio and the assumption of a constant expected future return.
10 As I have stated previously in my testimony, capital markets are efficient and can be
11 assumed to reflect investor preferences in the prices they are willing and able to pay
12 for a regulated utility's common stock. This includes publicly available information
13 to which investors have access including payout and P/E ratios. The current stock
14 price, then, is reflective of the discounted future cash flows to the investor in the form
15 of dividends as well as the expected price of the stock when it is sold. It does not make
16 sense for a rational investor to expect a capital loss in the future based on the price that
17 investor pays today. What this means is that it is reasonable to assume that current
18 stock prices are reflective of investors' required ROE and that the DCF model can
19 provide valid information to the Council in its determination of the allowed ROE for
20 regulated utilities generally. Similarly, payout ratios will also vary around their long-
21 term historical averages based on current market conditions, but this by no means
22 invalidates the DCF model results.

23 **Q. On page 23 of his Revised Direct Testimony, Mr. Hevert testified that the**
24 **"Federal Reserve's process of policy normalization, including the uncertainty**

1 **surrounding the “unwinding” of the approximately \$4 trillion of assets put on its**
2 **balance sheet during its “Quantitative Easing” initiative introduce a degree of**
3 **risk and a likelihood of increasing interest rates not present in the current**
4 **market.” Do you agree with this statement?**

5 A. No. Instead, it is more likely than not that investors have taken this information into
6 account since it is already public knowledge given the Federal Reserve's statements
7 regarding its plans for unwinding its Quantitative Easing program and increasing
8 short-term interest rates. In fact, Mr. Hevert referred to these statements on page 72
9 of his Revised Direct Testimony.

10 **Q. On pages 23 and 24 of his Revised Direct Testimony, Mr. Hevert testified that**
11 **since 1980 only eight utility rate cases included an authorized ROE of less than**
12 **9.0% and that for vertically integrated utilities there were no authorized ROEs**
13 **less than 9.0%. Please respond to Mr. Hevert's testimony on this point.**

14 A. Including rate cases since 1980 is, quite frankly, an irrelevant exercise because it
15 places too much emphasis on stale data. In the 1980s and 1990s interest rates and
16 allowed ROEs were far higher than they have been in the last few years. Consider the
17 following information I developed using the information in Mr. Hevert's Exhibit RBH-
18 7:

- 19 • From 1980 through 1989, the average awarded ROE was 14.80% and the
20 average 30-Year Treasury bond yield was 11.35%.
- 21 • From 1990 through 1999, the average awarded ROE was 11.91% and the
22 average 30-Year Treasury bond yield was 7.51%.
- 23 • From 2000 through 2009, the average awarded ROE was 10.62% and the
24 average 30-Year Treasury bond yield was 4.81%.

25 Note that this data includes all ROE awards since 1980, not just those for vertically
26 integrated companies. Nonetheless, these averages give the Council a general picture

1 of the interest rate and ROE levels from the 1980s, 1990s, and 2000s and represent
2 1,218 of the 1,556 observations in Mr. Hevert's data set in Exhibit RBH-7. They are
3 in no way indicative of investor required returns today given how much higher interest
4 rates were during these prior periods. According to Mr. Hevert's data, since January
5 2016 the average awarded ROE was 9.63% and in 2018 the average allowed ROE was
6 9.58%. These more recent ROE awards show how grossly overstated Mr. Hevert's
7 10.75% ROE recommendation is in today's environment.

8 **Q. Considering the foregoing discussion, please summarize your conclusions with**
9 **respect to Mr. Hevert's recommended ROE range and his ROE recommendation**
10 **for ENO.**

11 A. I strongly recommend that the Council reject Mr. Hevert's recommended ROE range
12 and his recommended ROE of 10.75%. Mr. Hevert's ROE range omits critically
13 important information from the DCF model and, as a result, greatly overstates the
14 investor required ROE for investment grade regulated electric utilities.

15 **Q. Would Mr. Hevert's recommended ROE of 10.75% harm New Orleans**
16 **ratepayers?**

17 A. Yes, it certainly would. Although Entergy, Corporation shareholders would benefit
18 from the excessive ROE of 10.75%, New Orleans ratepayers would have to shoulder
19 the burden of an excessive revenue requirement to support it. Mr. Kollen calculated
20 that lowering the Company's extreme ROE request to 9.35% would provide \$6.268
21 million per year of rate relief to New Orleans customers.

22
23 **Multi-stage DCF Model**

24 **Q. Please summarize the components of Mr. Hevert's multi-stage DCF model.**

1 A. Mr. Hevert described the structure and the inputs for his multi-stage DCF model on
2 pages 25 through 28 of his Revised Direct Testimony. The main elements of Mr.
3 Hevert's multi-stage DCF analyses are as follows:

- 4 • 30, 90, and 180 average stock prices.
- 5 • First stage of growth based on the average earnings growth rates from Value
6 Line, Zacks, and First Call.
- 7 • A transition period from near-term to long-term growth.
- 8 • Long-term growth estimated using GDP growth based on historical real GDP
9 growth from 1929 through 2017 (3.21%) and a forecasted inflation rate. The
10 total nominal GDP growth rate was 5.45%.
- 11 • Expected dividend in the final year divided by solved cost of equity less long-
12 term growth rate.
- 13 • Payout ratio assumptions based on Value Line for the first stage, a transition
14 period, and a long-term expected payout ratio.

15 **Q. In your opinion, did Mr. Hevert overstate expected GDP growth?**

16 A. Yes. There are two publicly available forecasts of GDP growth that have been relied
17 upon by the Federal Energy Regulatory Commission ("FERC") in the determination
18 of the second stage of the two-stage growth rate in its DCF return on equity formula.
19 These forecasts come from the Energy Information Administration ("EIA"), and the
20 Social Security Administration's ("SSA") Trustees Report.¹¹ The latest EIA GDP

¹¹ Please see the Energy Information Administration, *Annual Energy Outlook 2018* and Social Security Administration, 2018 OASDI Trustees Report, Table VI.G6 - Selected Economic Variables.

1 forecast shows expected growth in nominal GDP of 4.39%. The SSA Report forecasts
2 nominal growth in GDP of 4.38%. I included the calculation of these two GDP growth
3 rates on Exhibit ____ (RAB-6). My calculations are based on my understanding of
4 how the FERC Staff used the data contained in the EIA and SSA documents to
5 calculate long-term GDP growth for the second stage of its two-stage DCF model.

6
7 These independent sources are forecasting nominal GDP growth to be substantially
8 lower than the forecast developed by Mr. Hevert (4.38% vs. Mr. Hevert's forecast of
9 5.45%). In conclusion, Mr. Hevert's GDP forecast contributes to a significant
10 overstatement of his multi-stage DCF results.

11 **Q. Did you recalculate Mr. Hevert's multi-stage DCF model with the lower GDP**
12 **forecasts from EAI and the SSA?**

13 A. Yes. Exhibit ____ (RAB-7), pages 1 and 2 show the revised results from Mr. Hevert's
14 multi-stage DCF models using the 180-day average prices and a long-term GDP
15 growth forecast of 4.4%, which is the rounded average of the GDP forecasts from EAI
16 and the SSA. *The revised mean results from the two multi-stage DCF methods are*
17 *8.28% and 9.15%.*

18
19 If the Council considers a multi-stage DCF approach in this case, then it should use
20 the publicly available independent GDP forecasts I have provided, not the one
21 developed by Mr. Hevert.

22
23 **CAPM**

1 **Q. Briefly summarize the main elements of Mr. Hevert's CAPM approach.**

2 A. On page 32 of his Direct Testimony, Mr. Hevert testified that he used two different
3 measures of the risk-free interest rate: the current 30-day average yield on the 30-year
4 Treasury bond (3.11%) and a projected 30-year Treasury bond yield (3.48%). Mr.
5 Hevert did not consider any shorter maturity bonds, such as the 5-year Treasury note.

6

7 Mr. Hevert then calculated ex-ante measures of total market returns using data from
8 Bloomberg and Value Line. Total market returns from these two sources were 15.73%
9 using Bloomberg data and a 16.10% return using Value Line data. Mr. Hevert also
10 used two different estimates for beta from Bloomberg and Value Line.

11 **Q. Is it appropriate to use forecasted or projected bond yields in the CAPM?**

12 A. No. Current interest rates and bond yields embody all the relevant market data and
13 expectations of investors, including expectations of changing future interest rates. The
14 forecasted bond yield used by Mr. Hevert is speculative at best and may never come
15 to pass. Current interest rates provide tangible and verifiable market evidence of
16 investor return requirements today, and these are the interest rates and bond yields that
17 should be used in both the CAPM and in the bond yield plus risk premium analyses.
18 To the extent that investors give forecasted interest rates any weight at all, they are
19 already incorporated in current securities prices.

20 **Q. You noted earlier that Mr. Hevert used a forecasted 30-year Treasury bond yield**
21 **of 3.48%, while the current yield was 3.11%. What does this suggest with respect**
22 **to investors currently holding 30-year treasury bonds?**

1 A. It suggests that investors today should expect to incur huge losses in the value of their
2 investments in long-term Treasury bonds, which suggests economic irrationality on
3 their part. There is no sound basis for such an assumption.

4
5 The price of a bond moves in the opposite direction of its yield. In other words, given
6 a certain current bond coupon and price, if the required yield on that bond increases
7 then the price of the bond goes down. Alternatively, if the required yield declines then
8 the price of the bond increases. This relationship can be illustrated with the following
9 simplified example. Assume a current 30-year Treasury bond has a coupon of \$3.00
10 and a price of \$100, resulting in a current yield of 3.00%. If interest rates were to rise
11 in the economy such that the required yield on the 30-year Treasury increased to
12 3.50%, then the price of our existing 30-year Treasury bond would fall to \$85.71 from
13 \$100, given the coupon of \$3.00. This represents a loss to our current bond investor
14 of 14.30%.

15
16 The point here is that if investors were certain that there would soon be a substantial
17 increase in interest rates, the rational response would be to immediately discount what
18 they were willing to pay currently for the 30-year Treasury bond rather than pay \$100
19 and suffer certain significant losses to the value of their bonds.

20 **Q. Should Mr. Hevert have considered shorter-term Treasury yields in his CAPM**
21 **analyses?**

22 A. Yes. In theory, the risk-free rate should have no interest rate risk. 30-year Treasury
23 bonds do tend to face interest rate risk, which is the risk that interest rates could rise
24 in the future and lead to a capital loss for the bondholder. Typically, the longer the

1 duration of the bond, the greater the interest rate risk. The 5-year Treasury note has
2 much less interest rate risk than the 30-year Treasury bond and may be considered one
3 reasonable proxy for a risk-free security.

4 **Q. Please comment on Mr. Hevert's use of Bloomberg and Value Line earnings**
5 **growth estimates for the S&P 500.**

6 A. Mr. Hevert used earnings growth estimates from these two sources to estimate the
7 expected market return for his CAPM. According to the data contained in Exhibit
8 RBH-4, the average Value Line growth rate is 11.79% and the average Bloomberg
9 growth rate is 12.33%. These are by no means long-run sustainable growth rates.
10 They are well over double the long-term GDP forecast of 5.45% that Mr. Hevert used
11 in his multi-stage DCF analysis. If forecasted GDP growth were used as the long-term
12 growth rate for the S&P 500, then both Mr. Hevert's and my own market return
13 estimates would fall significantly.

14 **Q. HOW DO MR. HEVERT'S ESTIMATES OF THE OVERALL MARKET**
15 **RETURN COMPARE TO YOURS?**

16 A. My estimates of the market required return are as follows:

- 17 • Value Line 3-5 Year Total Return: 16.0%
- 18 • Value Line Growth Rates: 11.50%
- 19 • S&P Average Historical Returns: 10.2% - 12.1%

20 Mr. Hevert's market returns of 15.73% - 16.10% are extraordinarily high compared to
21 historical norms. I recommend that the Council give Mr. Hevert's inflated market
22 returns very little weight in this proceeding.

23 **Q. How do the Value Line beta values used by Mr. Hevert compare to those you used**
24 **in your CAPM analyses?**

1 A. My updated Value Line betas are generally lower than the dated beta values in Mr.
2 Hevert's Exhibit RBH-5. His average proxy group beta was 0.667, while my updated
3 proxy group beta is 0.60. Using the updated beta value in Mr. Hevert's CAPM analysis
4 would lower the results to the range of 10.69% - 11.27%. However, these revised
5 results are still excessively high and should be rejected by the Council.

6

7 **Risk Premium**

8 **Q. Please summarize Mr. Hevert's risk premium approach.**

9 A. Mr. Hevert developed a historical risk premium using Commission-allowed returns
10 for regulated electric utility companies and 30-year Treasury bond yields from January
11 1980 through June 15, 2018. He used regression analysis to estimate the value of the
12 inverse relationship between interest rates and risk premiums during that period.
13 Applying the regression coefficients to the average risk premium and using current
14 and projected 30-year Treasury yields I discussed earlier, Mr. Hevert's risk premium
15 ROE estimate range is 9.96% - 10.28%.

16 **Q. Please respond to Mr. Hevert's risk premium analysis.**

17 A. First, the bond yield plus risk premium approach is imprecise and can only provide
18 very general guidance on the current authorized ROE for a regulated electric utility.
19 Risk premiums can change substantially over time. As such, this approach is a "blunt
20 instrument," if you will, for estimating the ROE in regulated proceedings. In my view,
21 a properly formulated DCF model using current stock prices and growth forecasts is
22 far more reliable and accurate than the bond yield plus risk premium approach, which
23 relies on a historical risk premium analysis over a certain period of time.

1

2

Second, I recommend that the Council reject the use of the forecasted Treasury bond

3

yield for the same reasons I described in my response to Mr. Hevert's CAPM

4

approach. Using a forecasted Treasury bond yield, rather than the current yield, will

5

overestimate the investor required return.

6

7

Business Risks and Other Considerations

8

Q. Beginning on page 38 of his Revised Direct Testimony, Mr. Hevert presented a discussion of business risks and other considerations that informed his judgement regarding his recommended ROE range. Please summarize your understanding of these considerations.

9

10

11

12

A. On page 38 of his Revised Direct Testimony, Mr. Hevert presented the risks and other

13

considerations that he believes should be taken into account in setting the allowed cost

14

of equity for ENO. These considerations include:

15

- Planned capital expenditure program

16

- ENO's credit profile

17

- Geographic risk associated with severe weather

18

- Lack of customer diversity

19

- ENO's small size relative to the proxy group

20

- Flotation costs

21

- Effect of the Tax Cut and Jobs Act ("TCJA")

22

Q. Were many of these risks considered by the credit rating agencies in the reports on ENO that you reviewed?

23

1 A. Based on my reading of the credit reports, I believe they were. Moody's and S&P
2 mentioned these risks in various places in the reports I reviewed. These reports
3 evaluated ENO's credit profile, its risk associated with severe weather, its small size,
4 and the effect of the TCJA. Regarding customer diversity, the S&P report I cited
5 earlier noted that ENO's customer mix was a credit strength, not a weakness.

6

7 After assessing these risks, as well as credit strengths possessed by ENO, S&P
8 assigned credit ratings to ENO that were consistent with the proxy group and with the
9 electric utility industry in general. From this perspective, I do not recommend any
10 additional risk premium for ENO relative to the proxy group.

11 **Q. Mr. Hevert presented a 101 basis point small size premium for ENO on page 54**
12 **of his Revised Direct Testimony. Should the Council consider a size premium for**
13 **ENO in its determination of the allowed ROE in this proceeding?**

14 A. No, definitely not. The data that Mr. Hevert relied on to quantify this adjustment came
15 from the *2018 Cost of Capital: Annual U.S. Guidance and Examples* by Duff and
16 Phelps. The group of companies from which Mr. Hevert calculated this significant
17 upward adjustment more likely than not contains many small unregulated companies.
18 Mr. Hevert thus assumes, without any foundation whatsoever, that a return premium
19 for higher risk unregulated companies would apply to ENO. Given the fact that the
20 Company engages in low-risk regulated electric and gas operations, it is incorrect to
21 assume that ENO would be as risky as a group of unregulated companies simply on
22 the basis of its size. Mr. Hevert's small size premium should be rejected.

23 **Q. Will CCPUG's proposed Formula Rate Plans ("FRP") reduce ENO's risk with**
24 **respect to recouping costs associated with its future capital expenditure**
25 **program?**

1 A. Yes, it will. I have not evaluated the reasonableness or prudence of ENO's proposed
2 capital expenditure program, including the level of yearly investments. Nevertheless,
3 ENO currently operates without the benefit of a FRP for its regulated electric and gas
4 operations. CCPUG witness Kollen supports the adoption of a 3-year FRP for both
5 electric and gas operations. The FRPs will enable ENO to collect its yearly prudently
6 incurred investments associated with its capital expenditure program that have closed
7 to plant-in-service without the regulatory lag associated with traditional rate cases.
8 This will be an ongoing future benefit to ENO and will be supportive to its credit
9 profile.

10 **Q. Mr. Hevert provided a detailed discussion of his concerns relating to the TCJA**
11 **on pages 58 through 66 of his Revised Direct Testimony. What is your response**
12 **to Mr. Hevert's testimony regarding the TCJA as it affects ENO?**

13 A. The effect of the TCJA on ENO has already been settled and implemented by the
14 Council. ENO's Tax Reform Plan and its associated benefits was described by ENO
15 witness Joshua Thomas on pages 31 and 32 of his Revised Direct Testimony. ENO's
16 stable credit outlook from S&P and Moody's already reflects the implementation of
17 this plan and warrants no further consideration in determining ENO allowed ROE in
18 this proceeding.

19 **Q. Beginning on page 55 of his Direct Testimony Mr. Hevert discusses flotation costs.**
20 **Please respond to Mr. Hevert's testimony on this issue.**

21 A. In my opinion, it is likely that flotation costs are already accounted for in current stock
22 prices and that adding an adjustment for flotation costs amounts to double counting.
23 A DCF model using current stock prices should already account for investor
24 expectations regarding the collection of flotation costs. Multiplying the dividend yield
25 by a 4% flotation cost adjustment, for example, essentially assumes that the current

1 stock price is wrong and that it must be adjusted downward to increase the dividend
2 yield and the resulting cost of equity. I do not believe that this is an appropriate
3 assumption. Current stock prices most likely already account for flotation costs, to the
4 extent that such costs are even accounted for by investors.

5 **V. ENO PROPOSED RELIABILITY INCENTIVE MECHANISM (RIM) PLAN**

6 **Q. Briefly summarize ENO's proposed RIM Plan.**

7 A. The mechanics of the Company's proposed RIM Plan were presented in the Revised
8 Direct Testimony of Mr. Joshua B. Thomas beginning on page 23. Mr. Thomas
9 testified that the goal of the RIM Plan "is to align the earnings component of ENO's
10 base rates to its distribution reliability performance." The primary components of the
11 proposed RIM Plan are:

- 12 • The adjusted ROE in the Electric FRP would be the sum of the baseline ROE
13 approved in this case plus a reliability adjustment in the range of +/- 25 basis
14 points (0.25%).
- 15 • The electric base revenue requirement in this proceeding would include Mr.
16 Hevert's recommended ROE of 10.75% less a downward 0.25% adjustment
17 for an adjusted ROE of 10.50%.
- 18 • ENO would need to demonstrate an improvement in its service reliability to
19 achieve rates through the operation of the Electric FRP to achieve the 10.75%
20 ROE.
- 21 • Reliability performance would be measured by the System Average
22 Interruption Frequency Index ("SAIFI"). If ENO's SAIFI improves to 1.24,
23 then the Reliability Adjustment is zero, and the baseline ROE is unaffected. If

1 ENO's SAIFI is more than 1.24, the Reliability Adjustment reduces the
2 baseline ROE, and at a SAIFI of 1.40 or greater, the Reliability Adjustment
3 reduces the baseline ROE by the maximum 25 basis points. If ENO's SAIFI is
4 less than 1.24, the Reliability Adjustment increases the baseline ROE, and at a
5 SAIFI of 1.05 or less, the Reliability Adjustment increases the baseline ROE
6 by the maximum 25 basis points.

7 **Q. Should the proposed RIM Plan be approved by the Council?**

8 A. No. The proposed RIM should be rejected by the Council.

9 **Q. Please explain why the RIM Plan should be rejected.**

10 A. Given ENO's unacceptably poor electric system reliability over the last few years, the
11 Council should not under any circumstances approve a regulatory incentive
12 mechanism that provides the possibility of ENO earning a higher ROE for improved
13 system reliability. Reliable service is part and parcel of every utility company's duty,
14 including ENO, under the Regulatory Compact. In other words, in return for its
15 monopoly status and the absence of competition, its power of eminent domain, and the
16 opportunity to earn an almost guaranteed rate of return, the utility's service must be
17 reliable.

18
19 Company witnesses admitted problems with ENO's system reliability. Mr. Thomas
20 stated: "The Company is proposing the RIM Plan because the Company recognizes
21 that its reliability performance has not met the expectations of ENO, its customers,
22 and the Council." Thomas Revised Direct Testimony, page 23, lines 4 through 6.
23 Likewise, Ms. Melonie Stewart testified: "While ENO's reliability performance

1 metrics, which I discuss later, reflect reasonably reliable service during the early
 2 portion of the last five years, those performance metrics began to decline over the last
 3 couple of years.” Steward Revised Direct Testimony, page 9, lines 19 through 22.

4 **Q. Please summarize ENO’s reliability performance metrics over the last few years.**

5 A. Table 4 presents System Average Interruption Frequency Index (“SAIFI”) and the
 6 System Average Interruption Duration Index (“SAIDI”) statistics from Ms. Stewart’s
 7 Revised Direct Testimony as well as ENO’s earned ROEs that were provided in
 8 response to a discovery request from CCPUG. SAIDI is a measure of the length of
 9 time (duration) during a year that the average customer experienced an outage. SAIFI
 10 is a measure of how frequently customers were interrupted during the year. Table 4
 11 below presents ENO’s SAIDI and SAIFI values for the years 2013- 2017 and the 3-
 12 year average for the period 2013 - 2015.

TABLE 4						
ENO SAIFI, SAIDI, And Earned ROE						
	<u>2013</u>	<u>2014</u>	<u>2015</u>	<u>2016</u>	<u>2017</u>	<u>Avg. 2013 - 2015</u>
SAIFI	1.04	1.209	1.234	1.61	1.584	1.161
SAIDI	92	121.3	128	167.9	179.8	113.767
Earned ROE	5.64%	13.18%	12.56%	11.22%	10.52%	
Earned ROE Source: ENO response to CCPUG 1-13						

14
 15 For 2017, ENO's SAIDI was 179.8, which means that the average customer
 16 experienced 179.8 minutes of interrupted service during the year. For 2017, ENO's
 17 SAIFI was 1.584, meaning that the average customer was interrupted 1.584 times

1 during 2017. Lower SAIDI and SAIFI number indicate interruptions of shorter
2 duration and fewer interruptions, respectively.

3
4 Compare the 2017 SAIFI and SAIDI values with the 3-year average from 2013 – 2015.
5 The average SAIFI during this period was 1.161 and the average SAIDI was 113.767.
6 Table 4 clearly shows the significant deterioration of system reliability for New
7 Orleans customers over the last two years.

8
9 Finally, it is useful to examine ENO's earned ROEs over the 5-year period covered in
10 Table 4. ENO earned healthy, even excessive ROE's during this period, including
11 2016 and 2017 when service had markedly declined.

12 **Q. How do you recommend that the Council move forward regarding ENO's**
13 **accountability for improving service quality to the ratepayers of New Orleans?**

14 A. First, ENO needs to demonstrate a track record of improved service quality as
15 measured by significant improvements to its SAIFI and SAIDI numbers. The
16 Company should in no way be rewarded with an excessive ROE for providing safe
17 and reliable service that customers are entitled to expect from their regulated
18 monopoly provider of electric service.

19
20 Second, the Council should set base level performance attainment levels for ENO in
21 this proceeding. I recommend that these base levels be set at the 3-year average SAIFI
22 and SAIDI levels for the 2013 – 2015 period shown in my Table 4. These base service
23 levels would be 1.16 for SAIFI and 113.8 for SAIDI.

24

1 ENO should be required to report its yearly SAIFI and SAIDI levels with its yearly
2 Electric FRP filings. If ENO falls below either of the base service level SAIFI or
3 SAIDI values, the Council should consider a penalty of a 25 basis point reduction in
4 the baseline ROE approved by the Council in this case. Mr. Thomas indicated in his
5 Revised Direct Testimony that ENO's expected SAIFI for 2018 is 1.65. Therefore, I
6 also recommend that the Council waive the 25 basis point penalty in the first year of
7 the Electric FRP to allow ENO to continue making investments in its system to enable
8 its service reliability to catch up with the 2013 – 2015 average SAIFI and SAIDI
9 values.

10 **Q. Is your service reliability proposal fair to both ENO and its ratepayers?**

11 A. Yes. My service reliability proposal is a fair balancing of the interests between ENO
12 and its ratepayers. It bears repeating that ENO should not be allowed to earn an extra
13 incentive ROE for making investments in its system to improve its poor reliability.
14 Instead, the Council should reaffirm ENO's obligation under the Regulatory Company
15 I mentioned earlier to improve its service quality measures to levels that reflects the
16 safe and reliable service to which New Orleans customers are entitled.

17 **Q. Has ENO increased spending to improve reliability in recent years?**

18 A. Yes. Ms. Stewart provided the additional spending undertaken by ENO to address
19 system reliability in Figures 5 and 6 of her Direct Testimony. In 2017, for example,
20 the Company increased its spending on routine reliability to \$7.3 million from \$3.363
21 million in 2016. Reliability Blitz and Storm Hardening spending were increased from
22 \$10.47 million in 2016 to \$15.68 million in 2017. CCPUG does not oppose the costs
23 included in the historic test year to improve ENO's electric system reliability.

1 However, CCPUG is vigorously opposed to any ROE bonuses for making system
2 reliability improvements.

3 **VI. ENO'S PROPOSED GRID MODERNIZATION AND GIRP RIDERS**

4 **Q. Please describe the Grid Modernization Rider.**

5 A. The mechanics of the Grid Modernization Rider were provided in the Revised Direct
6 Testimony of Mr. Gillam beginning of page 52. Mr. Gillam testified that Rider DGM
7 was proposed by the Company “in order to recover the capital investment costs
8 associated with Council-approved grid modernization projects not recovered in base
9 rates from this proceeding ...” Rider DGM functions in a similar fashion to Rider
10 GIRP in that it would initially collect costs associated with these projects that are
11 placed into service from January 1, 2020 through March 31, 2020 assuming the
12 Council includes plant in service through December 31, 2019 in the electric base
13 revenue requirement. Otherwise the Initial Service Period will depend on the plant in
14 service date approved in this rate case. The proposed Rider DGM includes quarterly
15 filings with quarterly rate redeterminations as additional plant in service is added to
16 accumulated plant included in Rider DGM. Rider DGM also includes an annual
17 reconciliation of the difference between the revenue requirement and actual revenue
18 collected through the rider. The proposed term of Rider DGM would be until the next
19 base rate case filing unless it is terminated by order of the Council.

20 **Q. Please summarize the proposed GIRP Rider.**

21 A. The mechanics of the GIRP are described by Mr. Phillip Gillam beginning on page 48
22 of his Revised Direct Testimony. Rider GIRP was proposed by the Company “in order
23 to recover the costs associated with replacing aging infrastructure to improve the safety

1 and reliability of the gas distribution system.” Gillam Revised Direct Testimony, page
2 48, lines 8 through 9.

3
4 Rider GIRP would initially collect costs associated with these projects that are placed
5 into service from January 1, 2020 through March 31, 2020 assuming the Council
6 includes plant in service through December 31, 2019 in the gas base revenue
7 requirement. Otherwise the Initial Service Period will depend on the plant in service
8 date approved in this rate case. The proposed Rider GIRP includes quarterly filings
9 with quarterly rate redeterminations as additional plant in service is added to
10 accumulated plant included in Rider GIRP. Rider GIRP also includes an annual
11 reconciliation of the difference between the revenue requirement and actual revenue
12 collected through the rider. The proposed term of Rider DGM would be until the next
13 base rate case filing unless it is terminated by order of the Council.

14
15 **Q. What is the Company’s policy justification for proposed Riders GIRP and DGM?**

16 A. Mr. Thomas provided the policy reasons for approval of the GIRP and DGM riders
17 beginning on page 53 of his Revised Direct Testimony. One of the main reasons cited
18 by Mr. Thomas is: “A regulatory environment that provides for contemporaneous cost
19 recovery of large investments outside of the traditional rate case provides the utility
20 the necessary opportunity to earn its allowed return while continuing to invest in the
21 system and mitigate operational risks.” Mr. Thomas also noted the Council’s prior
22 approval of contemporaneous cost recovery for Ninemile 6 and Union Power Block 1
23 and testified that customers’ “contemporaneous receipt of benefits further justified

1 contemporaneous cost recovery in those instances.” Mr. Thomas also asserted that
2 absent the recovery afforded to the Company from the proposed riders “ENO’s cash
3 flow will deteriorate and capital will be lost and will not be available for reinvestment
4 in investment in improvements in the Company’s infrastructure at a time when cash
5 flow and capital is critical to the Company.”

6 **Q. Should the Council approve ENO’s proposed Riders DGM and GIRP?**

7 A. No. The Council should reject ENO’s proposed Riders DGM and GIRP.

8 **Q. Please explain why the Council should reject these proposed riders.**

9 A. The primary reason for rejecting these riders is that they overlap with the proposed
10 EFRP and GFRP. There is no reason to carve out certain electric and gas plant costs
11 and include them in separate riders when these costs can be included in and recovered
12 through the EFRP and GFRP along with all other and in the same manner as all other
13 prudently incurred costs. These FRPs will provide ENO the opportunity to collect its
14 increased costs and investments in plant in service, including grid modernization and
15 gas infrastructure replacement and improvements, using an historic 12-month period.
16 The FRP approach is similar to a regular base rate case that employs an historical test
17 year, but will eliminate much of the regulatory lag and the expenses associated with
18 filing a full base rate proceeding. The Electric and Gas FRP will provide ENO an
19 enhanced opportunity for increased cash flow and return on new plant in service to
20 serve New Orleans customers. It will also provide for a reasonable review process for
21 the Council to ensure just and reasonable rates.

22

1 ENO's proposed Riders GIRP and DGM would carve out certain electric and gas plant
2 costs and provide accelerated and increased recovery through the use of a forecast test
3 year instead of including these costs in the EFRP and GFRP on a historic test year
4 basis. It is unnecessary and inequitable to provide these forms of recovery when the
5 EFRP and GFRP are specifically designed to provide timely rate relief to the Company
6 after rates are reset in this proceeding. It would be a far better balancing of the interests
7 of ENO and its customers to have these proposed eligible investments collected
8 through the FRPs. Note that the FRPs would include the following:

- 9 • Seventy-five day review period.
- 10 • Three-year term.
- 11 • Specified dispute resolution procedure.

12 These terms provide additional protections to ratepayers and additional assurance to
13 the Council and intervenors that costs being passed through the FRPs are reasonable
14 and prudently incurred. The proposed Riders GIRP and DGM do not contain these
15 provisions.

16 **Q. On page 55, lines 3 through 7 of his Revised Direct Testimony Mr. Thomas**
17 **testified that if “customers receive benefits contemporaneous with the placing of**
18 **assets in service, it is reasonable and equitable for the Council to permit**
19 **contemporaneous recovery of the costs incurred to provide those benefits.”**
20 **Should the Council accept this statement as a sound basis for ratemaking?**

21 **A.** No. Mr. Thomas' statement suggests a process that is neither reasonable nor equitable.
22 I believe that Mr. Thomas' reasoning would result in the elimination of regulatory lag
23 and any sort of review of the prudence and reasonableness of costs being collected
24 from New Orleans customers. Taken to its logical end, contemporaneous cost
25 recovery would eliminate rate cases as well as Council and intervenor review of a

1 utility's revenue requirement. Indeed, it would eliminate a utility company's burden
2 of proving that its costs are just and reasonable. I strongly recommend that the Council
3 reject Mr. Thomas' statement in support of contemporaneous cost recovery.

4 **Q. Does this complete your Direct Testimony?**

5 **A. Yes.**

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

**REVISED APPLICATION OF ENTERGY)
NEW ORLEANS, LLC FOR A CHANGE)
IN ELECTRIC AND GAS RATES)
PURSUANT TO COUNCIL RESOLUTIONS)
R-15-194 AND R-17-504 AND)
FOR RELATED RELIEF)**

DOCKET NO. UD-18-07

<p>EXHIBITS OF RICHARD A. BAUDINO</p>
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**ON BEHALF OF THE
CRESCENT CITY POWER USERS' GROUP**

**J. KENNEDY AND ASSOCIATES, INC.
ROSWELL, GEORGIA**


FEBRUARY 2019

AFFIDAVIT

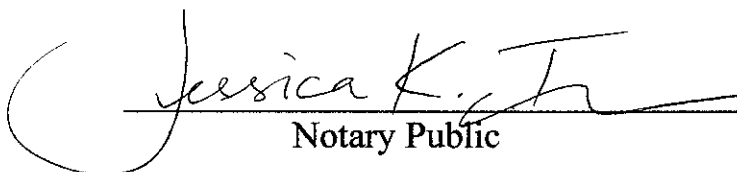
STATE OF GEORGIA)

COUNTY OF FULTON)

RICHARD A. BAUDINO, being duly sworn, deposes and states: that the attached is his sworn testimony and that the statements contained are true and correct to the best of his knowledge, information and belief.


Richard A. Baudino

Sworn to and subscribed before me on this
1st day of February 2019.


Notary Public

