Before the
Oklahoma Corporation Commission

In the Matter of the Application of Oklahoma Gas and Electric Company for an Order of the Commission Authorizing Applicant to Modify its Rates, Charges, and Tariffs for Retail Electric Service in Oklahoma	**)))))))**	**Cause No. PUD 201800140**

Responsive Testimony of Scott Hempling

On Behalf of Sierra Club

April 22, 2019

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I. Purpose and qualifications

Q. What is your name and address, and on whose behalf are you testifying?

A. I am Scott Hempling, President of Scott Hempling, Attorney at Law LLC, 417 St. Lawrence Dr., Silver Spring, Maryland. I am testifying on behalf of Sierra Club.

Q. Describe the background of this proceeding and your testimony's purpose.

A. OG&E's proposed revenue requirement includes the costs of installing scrubbers at the Sooner coal plant (consisting of Sooner Units 1 and 2), as well as the projected costs of operating the scrubbed plant. The proposed revenue requirement also reflects the net revenues OG&E hopes to receive from Sooner's sales into the Southwest Power Pool's energy market. To set just and reasonable rates, the Commission needs to determine (1) whether OG&E's scrubber decisions were prudent, and (2) whether the scrubbers are now used and useful. In the prudence category, there are three distinct questions: (a) whether OG&E's 2014 decision to install the scrubbers was prudent; (b) whether its subsequent failures between 2014 and 2018 to revisit that decision were prudent; and (c) whether OG&E's current intent to continue operating Sooner as a coal plant, rather than converting it to gas, is prudent.

My testimony recommends policy principles for the Commission to apply in making its determinations on prudence and used-and-usefulness. After summarizing my qualifications, this testimony has five remaining parts:

Part II describes the common purpose of the prudence and used-and-useful standards: to make rates just and reasonable by producing performance comparable to competition.

Part III addresses prudence—the standard that regulators use to shield customers from the costs of utility executives' errors.

Part IV addresses the used-and-useful standard—the tool that regulators use to render utilities accountable for the risks they choose to take.

> **Part V** anticipates OG&E's objections that a scrubber cost disallowance will affect the Company's finances. Those objections should not divert the Commission from its essential task: assigning to OG&E the consequences of its discretionary decisions.
>
> **Part VI** urges the Commission to make its prudence and used-and-useful determinations in this case as clear as possible, because OG&E's executives have misconstrued the 2016 Order's discussion of those concepts.[1]

Q. How does your testimony relate to the testimonies of the other Sierra Club witnesses?

A. I recommend a policy framework that, when combined with the testimony of Sierra Club's other two witnesses, gives the Commission a full, coherent picture of the decisions it faces, along with the policy principles, facts, and logic by which it can make those decisions. Specifically, I explain the roles of prudence analysis and used-and-useful analysis in setting just and reasonable rates. For each of prudence and used-and-usefulness, I provide practical criteria that cause a utility to bear appropriate consequences for its decisions. I also provide the logic for translating these standards into specific disallowances.

Using my criteria and logic, Mr. Tyler Comings assesses whether OG&E's scrubber decisions were prudent, and whether the result of those decisions—Sooner with scrubbers—is used and useful to OG&E's customers. Based on those assessments, Mr. Comings recommends disallowances of scrubber costs and associated adjustments to OG&E's proposed revenue requirement.

Mr. Kevin O'Donnell describes how Mr. Comings's disallowances will likely affect OG&E's financial condition. I explain that those financial effects are logically

[1] When I refer to the "2015 Order" I mean the final Order in Cause No. PUD 201400229 (Dec. 2, 2015). When I refer to the "2016 Order" I mean the final Order in Cause No. PUD 201600059 (Apr. 28, 2016).

unrelated to, and therefore should not influence, the Commission's judgments about prudence and used-and-usefulness.

Mr. O'Donnell also calculates that OG&E's choice of scrubber over conversion-to-gas increased OG&E's expected earnings by $138 million (net present value). That fact shows the conflict between OG&E's profit interest and its ratepayers' interest. Due to this conflict, I explain that OG&E's scrubber choice deserves no presumption of prudence.

Q. Describe your employment background, education, and experience.

A. I began my legal career in 1984 at a private law firm, where I represented municipal power systems and others on transmission access, holding company structures, nuclear power plant construction prudence and producer-pipeline gas contracts, among other matters. From 1987 to 1990, I was an attorney at a public interest organization, working on electric utility issues. From 1990 to 2006, I had my own law practice, advising public and private sector clients—primarily state regulatory commissions, and also municipal systems, independent power producers, consumer advocates, public interest organizations, and utilities—with an emphasis on electric utility regulation. For several of those years, I had a consulting relationship with OG&E, although I never appeared on its behalf.

From October 2006 through August 2011, I was Executive Director of the National Regulatory Research Institute (NRRI). Founded by the National Association of Regulatory Utility Commissioners (NARUC), NRRI is a Section 501(c)(3) organization, funded primarily by state utility regulatory commissions to provide research to regulatory decision-makers. As Executive Director, I was responsible for working with commissioners and commission staff at all 51 state-level regulatory agencies to develop and carry out research priorities in electricity, gas, telecommunications, and water. In addition to overseeing the planning and publication of over 80 research papers by NRRI's staff experts and outside consultants, I published my own research papers, advised contract clients (including state commissions, regional transmission organizations, private industry, and international institutions), and wrote monthly essays on effective regulation. For most of my NRRI tenure, OG&E continued its consulting relationship with me, with NRRI receiving the revenues.

In September 2011, I returned to private practice to focus on writing books and research papers, providing expert testimony, advising regulatory agencies and others, and teaching courses and seminars on the law and policy of utility regulation. Since that time, I have taught public utility law (and for three years, regulatory litigation) as an adjunct professor at Georgetown University Law Center.

My book on public utility law, *Regulating Public Utility Performance: The Law of Market Structure, Pricing and Jurisdiction,* was published by the American Bar Association in 2013. This is the first volume of a two-volume treatise, the second of which will address the law of corporate structure, mergers, and acquisitions. My book of essays, *Preside or Lead? The Attributes and Actions of Effective Regulators,* was published by NRRI in 2010. I published a second, expanded edition in 2013. I have written several dozen articles on utility regulation for publication in law journals, trade journals, and books; and have taught utility law seminars to attendees from all fifty states and all industry sectors. Most recently, from January to April 2019, I taught a 12-week, 18-hour webinar on the law of utility regulation to 120 students from all industry sectors.

Internationally, I have taught seminars or presented at industry conferences in Australia, Canada, England, Germany, India, Italy, Jamaica, Mexico, New Zealand, Nigeria, Norway, Peru, and Vanuatu. As a subcontractor to the U.S. Department of State, I have advised the six nations of Central America on the regulatory infrastructure necessary to accommodate and encourage cross-national electricity transactions.

I received a B.A. *cum laude* from Yale University in 1978, where I majored in Economics and Political Science, and in Music. I received a J.D. *magna cum laude* from Georgetown University Law Center in 1984. I am a member of the Bars of the District of Columbia and Maryland.

My resume is attached to this testimony as Exhibit SH-1. More information is available at www.scotthemplinglaw.com.

Q. Before what fora have you presented testimony?

A. I have presented testimony before the state commissions of California, Connecticut, District of Columbia, Hawaii, Illinois, Indiana, Kansas, Louisiana, Maryland, Minnesota, Mississippi, New Jersey, North Carolina, Texas, Vermont, and Wisconsin. I also have submitted testimony to federal district courts in Florida, Minnesota, Montana, and Wisconsin. These proceedings are listed on my resume.

II. The separate standards of prudence and used-and-usefulness carry out regulation's central purpose—to produce performance comparable to competition

Q. How do the standards of prudence and used-and-usefulness relate to the purpose of regulation?

A. OG&E has a legal monopoly over retail electric service. Absent regulatory standards, along with consequences for not meeting those standards, a company with a legal monopoly lacks incentive to perform as cost-effectively as a company subject to competition. "Managements of unregulated business subject to the free interplay of competitive forces have no alternative to efficiency. If they are to remain competitive, they must constantly be on the lookout for cost economies and cost savings. . . . Public utility management, on the other hand, does not have quite the same incentive."[2]

Regulation therefore must replicate the pressures of competition. "[T]he state through its commission takes the place of competition and furnishes the regulation which competition cannot give . . . ."[3] By replicating competition's pressures, regulation causes utilities to comply with their affirmative obligations: to "secure efficiency in the

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[2] *Midwestern Gas Transmission Co. v. E. Tenn. Natural Gas Co.*, 36 FPC 61, 70 (1966), *aff'd sub nom. Midwestern Gas Transmission Co. v. FPC*, 388 F.2d 444 (7th Cir. 1968). The Federal Power Commission later rescinded its decision on unrelated grounds. *Knoxville Utils. Bd. v. E. Tenn. Natural Gas Co.*, 40 FPC 172 (1968).

[3] *Delmarva Power & Light Co. v. Public Service Comm'n of Maryland*, 370 Md. 1, 6 (Md. 2002) (*quoting* Oscar L. Pond, *A Treatise on the Law of Public Utilities* 29-31 § 901 (3d ed.1925)). *See also* Alfred Kahn, *The Economics of Regulation: Principles and Institutions* (1971, 1988), Vol. 2 at 112 (stressing the "importance of making regulation more intelligent and more effective in those circumstances in which competition is simply infeasible").

allocation of resources";[4] to "operate with all reasonable economies";[5] to incur the "lowest feasible cost";[6] and to use "all available cost savings opportunities."[7]

Regulation cannot produce results equivalent to competition, of course. Regulated utilities have a franchise obligation to serve. That obligation includes an obligation to plan to serve, and to be ready to serve, all customers in all foreseeable circumstances; and to carry out whatever additional obligations the commission or legislature imposes lawfully. Companies in competitive markets, in contrast, have only the obligations they accept contractually (along with any imposed by statutes). Because these differences in obligation produce differences in cost, we cannot expect regulation always to produce results comparable to competition. But effective regulation should create pressures comparable to competition, so that the utility achieves results—and its customers experience results—as comparable to competition as possible.

Q. To produce pressures comparable to competition, what consequences must regulation cause utilities to face?

A. To produce pressures comparable to competition, regulation must assign consequences commensurate with performance. It must reward competitive-level performance with competitive-level profit, and penalize suboptimal performance by disallowing excess costs. In competition, companies face financial consequences in two distinct situations:

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[4] *Democratic Cent. Comm. of the D.C. v. Wash. Metro. Area Transit Comm'n*, 485 F.2d 886, 907 (D.C. Cir. 1973).

[5] *El Paso Natural Gas Co. v. FPC,* 281 F.2d 567, 573 (5th Cir. 1960).

[6] *Potomac Elec. Power Co. v. Pub. Serv. Comm'n of the D.C.*, 661 A.2d 131, 137 (D.C. 1995). *See also State of Oklahoma v. Oklahoma Gas & Electric*, 1975 OK 40, 536 P.2d 887, 891 (1975) (requiring Commission to set "lowest reasonable rates consistent with the interests of the public and the utilities").

[7] *Midwestern Gas Transmission Co.,* 36 FPC at 70.

imprudent action or inaction; and conduct that, though prudent, produces uneconomic outcomes. In regulation, these two situations align with the two common prerequisites for cost recovery: prudence and used-and-usefulness.

Imprudent action or inaction: To act prudently is to exercise reasonable care, consistent with industry norms, using all professional tools objectively and competently. If a competitive company acts imprudently (or imprudently fails to act), it incurs costs its competitors don't incur; or, it fails to achieve savings its competitors achieve. The equilibrium market price will reflect the lower costs of the prudent competitors. Because the imprudent seller cannot charge more than the market price without losing customers, that seller cannot recover its excess costs. Knowing of this inevitable consequence, companies in competitive markets strive toward prudence. They "have no alternative to efficiency."[8]

Prudent action but uneconomic outcomes: Not all prudent decisions work out. A competitive company might choose a path prudently, yet produce a product more costly than its competitors' products. If the higher-cost company charges a price reflecting its higher cost, its product will be non-useful to the extent its price exceeds its competitors' lower price, which will reflect their lower cost. And so like the imprudent company, the less successful company, constrained by the lower market price, will not recover its excess costs.

Both situations—imprudence, and prudent actions with uneconomic outcomes—have counterparts in regulatory practice. I explain those counterparts Parts III and IV, respectively.

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[8] *Midwestern Gas Transmission Co.*, 36 FPC at 70.

Competition and regulation have this commonality: When both operate effectively, the shareholder and customer interests align. Customer satisfaction means strong market position and healthy shareholder earnings; shareholder satisfaction means ample investment in the services customers need at the quality they want. Under effective competition and effective regulation, good performance yields good returns; suboptimal performance yields suboptimal returns. Under both competition and regulation, the purpose is performance.

III. Imprudence disallowances shield customers from utility executives' mistakes

Q. Describe the purpose of this Part III.

A. This Commission has defined prudence review as a "comprehensive review that examines as fair, just, and reasonable, a utility's practices, policies, and decisions regarding an investment or expense at the time the investment was made or expense was incurred."[9] This Part III recommends principles for applying this definition to the Sooner scrubber decision and its costs.

First, I describe the three distinct scrubber questions OG&E's rate proposal presents. Second, I explain that prudence analysis assesses and addresses a utility's procedures, decisions, and biases. I specify six screens by which the Commission should evaluate OG&E's decisions. Third, I describe the traditional presumption of prudence, then explain why it is negated by OG&E's conflict of interest—embodied in likely scrubber-related earnings $138 million more (net present value) than the likely earnings from conversion. Fourth, I explain the appropriate method for calculating the disallowance, should the Commission find the scrubber decision imprudent. Fifth, I address the possibility that the Commission does not find imprudence, but does find that OG&E has failed to prove prudence.

A. The Commission faces three prudence issues: OG&E's 2014 scrubber decision, its failures through 2018 to revisit that decision, and its plan not to replace scrubbers with conversion now

Q. In this rate case, what distinct prudence decisions must the Commission make about OG&E's Sooner scrubber investment?

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[9] Okla. Admin. Code § 165:35-1-2.

A. OG&E's proposed revenue requirement includes its costs of installing the Sooner scrubbers and operating the Sooner plant. It also reflects the net revenues OG&E expects to receive from the sales Sooner will make into the Southwest Power Pool (SPP) energy market. Applying the prudence standard to the Sooner costs involves three distinct questions.

1. Was OG&E's initial 2014 scrubber decision prudent? If the answer is no, the Commission must disallow the imprudent costs. It then need not address the remaining prudence questions, or the question of used-and-usefulness.

2. If the initial 2014 decision was prudent, was OG&E's failure to reassess that decision during construction, and then to convert Sooner if changes in facts so required, imprudent? If the answer is yes, the Commission must disallow the imprudent costs resulting from that failure. The Commission would allow recovery of costs incurred prudently prior to the point in time of OG&E's imprudent failure. (But if the Commission finds the scrubber investment not used and useful (see Part IV below), the disallowance resulting from that finding would prevail if it exceeds the disallowance calculated here.)

3. Regardless of whether the pre-2019 decisions were prudent or imprudent, is it prudent for OG&E now to continue operating Sooner with scrubbers, instead of converting Sooner to gas?

I elaborate on each question next.

1. Was OG&E's 2014 scrubber decision prudent? In 2014, OG&E chose the Sooner scrubber option as part of its response to the Environmental Protection Agency's Regional Haze Rule (RHR).[10] That decision caused the Sooner scrubbers cost whose recovery OG&E now seeks. If the 2014 decision was imprudent, the Commission must disallow costs, in amounts determined as described in Part III.D below.

[10] Rowlett Direct Testimony at 7 lines 25-29 ("OG&E is installing Scrubbers on Sooner Units 1 and 2 to comply with the federal Regional Haze Rule ("RHR"), as part of the environmental compliance plan.").

OG&E's 2014 decision actually raises two distinct prudence sub-questions. The first question concerns OG&E's decision-making process: Did that process include the multiple steps that a reasonable utility would take—such as identifying all feasible alternatives and comparing them objectively; and did OG&E carry out those steps with the level of care appropriate for a decision that could cost ratepayers hundreds of millions of dollars over several decades? The second question concerns technical accuracy: In comparing the costs of the scrubber against alternatives, did OG&E properly account for future costs and risks, such as future environmental compliance costs and future risks of SPP revenue shortfalls? If OG&E performed imprudently on either of these two sub-questions—the decision-making process or the cost comparison—then a disallowance is necessary.

If the Commission finds imprudence in the original decision, its inquiry ends here; it need not examine post-2014 decisions or outcomes.

2. Between 2014 and 2018, did OG&E prudently reassess its 2014 decision as the facts underlying that decision changed? Mr. Comings explains that from 2014-2018, OG&E incurred the lion's share of the scrubber installation cost—hundreds of millions of dollars. OG&E admitted that at no point during that period did it reassess its original scrubber decision[11] —even after, as Mr. Comings explains, energy margins in the SPP energy market and gas prices fell below the OG&E projections underlying that decision.

[11] *See, e.g.*, Transcript of February 21, 2019, Hearing before ALJ, Cause No. PUD 201900140, at 36:25 (counsel for OG&E: "OG&E's plan to scrub was made in 2014."); *id.* at 37:5-6 (counsel for OG&E: "The decision to scrub Sooner was made in 2014. is no 2016 decision...."); *id.* at 38:8-9, 23-25 (counsel for OG&E: "Again, there isn't another decision. It's a 2014 decision. . . . . So all of this stuff about how Sooner runs or doesn't run or decision in 2016, or what happened in '15, and why we didn't address it, inapplicable.").

Mr. Comings explains that at multiple points between 2016 and 2018, the knowable likely conversion cost (in net present value revenue requirement—NPVRR) was markedly less than the scrubber cost OG&E had projected. That fact leads to this question: Assuming OG&E's 2014 decision was prudent, was there a point in time when the facts changed, such that continuing with the scrubber rather than choosing conversion became imprudent? To answer that question, one must compare, at various points in the scrubber spending period, two figures: the reasonably knowable prospective NPVRR for the scrubbers, and the reasonably knowable prospective NPVRR for conversion or other alternatives.

The proper comparison is of prospective spending only. Sunk costs, prudent or imprudent, don't count. Why? Because if the scrubber spending prior to each decision point was prudent, ratepayers would bear that prior spending under either the scrubber-continue scenario or the scrubber-conversion scenario. And if the scrubber spending was imprudent, they would not bear the cost—under either scenario. So like any sunk cost, that prior spending becomes irrelevant to the prospective decision. Mr. Comings therefore compares, as of several dates between 2016 and 2018, the NPVRRs of (a) the remaining scrubber capital expenditure plus scrubber operating expenditure minus expected SPP revenues, with (b) the total conversion capital expenditure plus conversion operating expenditure minus expected SPP revenues.

About this gap between the two knowable, prospective NPVRRs, there are again two distinct prudence questions. The first question is whether OG&E should have monitored gas price forecasts to check for deviations from its 2014 assumptions—and if deviations did occur, whether OG&E should have paused to find out why they occurred.

According to Mr. Comings, monitoring is a low-cost, high-benefit activity that a prudent utility would have undertaken, especially given the high dependence of the scrubber decision on gas price forecasts. Mr. Comings describes the type of monitoring that a prudent utility would have performed. The second question is whether, when objective gas price forecasts dropped sharply from those that OG&E relied on, OG&E should have undertaken a new modeling exercise, to produce an updated, detailed cost comparison between scrubbing and converting. Mr. Comings acknowledges that modeling the two options is more time-consuming than monitoring gas price forecasts. But he concludes that a prudent utility, on observing the drop in gas price forecasts, would have re-modeled. (That Mr. Comings did not himself do modeling is beside the point. If OG&E failed to monitor gas price forecasts, and failed to probe the reasons for changes in those forecasts, those failures create serious doubt about its prudence. That serious doubt eliminates any presumption of prudence, leaving OG&E with the burden of production on prudence. I discuss these evidentiary and policy concepts in Part III.E below.)

3. *For 2019 forward, is it prudent for OG&E to continue operating Sooner with scrubbers, instead of converting Sooner to gas?* However the Commission assesses OG&E's original scrubber choice, and however the Commission assesses OG&E's failure to reassess that choice, this rate increase request raises a third, distinct question: Prospectively, which option will cost less—staying with the coal-fired, scrubbed Sooner; or converting it to gas? As I explained in Part II, a utility must, at all times, "operate with all reasonable economies";[12] incur the "lowest feasible cost";[13] and use "all available cost

[12] *El Paso Natural Gas Co.*, 281 F.2d at 573.

[13] *Potomac Elec. Power Co.*, 661 A.2d at 137.

savings opportunities."[14] Whether scrubbed Sooner satisfies these tests depends on comparing two prospective NPVRRs: (a) the NPVRR of scrubbed Sooner's operating expenditures minus SPP net revenues, and (b) the NPVRR of the capital expenditures to convert Sooner, plus converted Sooner's operating expenditure minus SPP net revenues. Like the other comparisons I discussed, this comparison includes prospective costs only; it excludes the scrubbers' sunk cost. Why? Because if the Commission found the scrubber decision imprudent, the scrubber cost would be excluded from the NPVRR under either option (a) or (b); and if the Commission found the scrubber decision prudent, the scrubber cost would be included in the NPVRR under either option (a) or (b). Regardless of the sunk cost's prudence, that sunk cost is irrelevant to the comparison of prospective costs.

B. Prudence analysis addresses a utility's procedures, decisions, and biases.

Q. Introduce this subpart on procedures, decisions, and biases

A. I have just explained the three prudence questions raised by OG&E' rate increase request. Now I will explain the prudence standard.

Like regulation generally, prudence review substitutes for competitive forces. "If a competitive enterprise tried to impose on its customers costs from imprudent actions, the customers could take their business to a more efficient provider. A utility's ratepayers have no such choice. A utility's motivation to act prudently arises from the prospect that imprudent costs may be disallowed."[15] In this subsection, I explain the prudence

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[14] *Midwestern Gas Transmission Co.*, 36 FPC at 70.

[15] *Gulf States Utilities Co. v. Louisiana Public Service Commission*, 578 So. 2d 71, 85 n.6 (La. 1991) (upholding commission finding that "given the information available at the time, prudent managers would not have chosen in 1979 to construct a

concept. I then list six questions the Commission should ask before deciding whether OG&E's three scrubber decisions were prudent.

1. Prudence principles: Sagacity, skill, and sensitivity

Q. What is the prudence standard, and how does it promote regulation's purpose?

A. The prudence standard requires utilities to behave reasonably, based on industry norms.[16] Prudence requires "sagacity or shrewdness in management of affairs"; and "skill or good judgment in the use of resources."[17] Prudence analysis asks "whether the process leading to the decision was a logical one . . . ."[18] Hindsight is irrelevant, since a reasonable utility can act only on facts known or reasonably knowable at the time of its decision.[19]

Unlike customers of a company in a competitive market, a monopoly utility's customers lack alternatives. If the utility errs, its customers cannot escape. The utility

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nuclear power plant"), *quoting Long Island Lighting Co.*, Case No. 27563, 71 P.U.R.4th 262 (N.Y. Pub. Serv. Comm'n Nov. 16, 1985).

[16] *See, e.g., Appeal of Conservation Law Found., Inc*. 507 A.2d 652, 673 (N.H. 1986) (describing the prudence standard as "essentially apply[ing] an analogue of the common law negligence standard").

[17] *Business & Professional People for the Pub. Interest v. Commerce Comm'n*, 665 N.E.2d 553, 556, 558 (1996).

[18] *Gulf States Utilities Co.*, 578 So. 2d at 85. *See also Cambridge Elec. Light Co.*, D.P.U. 87-2A-1, 86 P.U.R.4th 574 (Mass. Dep't of Pub. Utils. Sept. 3, 1987) (asking whether the utility used "a reasonable decision making process to arrive at a course of action and, given the facts as they were or should have been known at the time, responded in a reasonable manner").

[19] *See, e.g., Boston Edison Co.*, D.P.U. 906, 46 P.U.R.4th 431 (Mass. Dep't of Pub. Utils. Apr. 30, 1982) (prudence analysis must consider "all conditions and circumstances which were known or which reasonably should have been known at the time the decisions were made"), *aff'd sub nom. Att'y Gen. v. Mass. Dep't of Pub. Utils.*, 455 N.E.2d 414 (Mass. 1983). *See also Gulf States Utilities Co.*, 578 So.2d at 85 (upholding commission finding that "given the information available at the time, prudent managers would not have chosen in 1979 to construct a nuclear power plant").

therefore has a continuing responsibility to respond to "changing circumstances or new challenges that arise as a project progresses."[20] Finally, a commission's judgment about whether a utility acted reasonably, and about whether its decision-making process was appropriate, must take into account the consequences of error.[21] When the stake is hundreds of millions of dollars—someone else's dollars—the required level of care is high.

2. The six key questions: From articulating the problem to counteracting bias

Q. In applying the prudence standard, what questions should a commission ask?

A. The prudence principles I've described lead to six key questions.

1. Did the utility understand, and articulate accurately and objectively, the problem it had to solve? OG&E's Mr. Rowlett says the scrubber decision addressed a specific problem: how to comply with the U.S. Environmental Protection Agency's Regional Haze Rule. But a utility's purpose is larger than just complying with federal environmental rules. It must serve its entire territory reliably on a least-cost basis, with each generation, transmission, distribution, and customer service component combining to achieve that purpose. A prudence analysis must address whether OG&E defined the problem too narrowly, thereby making scrubbers the answer to the wrong question.

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[20] *Gulf States Utilities Co.*, 578 So. 2d at 85 (*citing Long Island Lighting Co.*, Case No. 27563, 71 P.U.R.4th 262 (N.Y. Pub. Serv. Comm'n Nov. 16, 1985), and *Central Vermont Public Service Corp.*, Docket No. 5132, 83 P.U.R.4th 532 (Vt. Pub. Serv. Bd. May 15, 1987)).

[21] *Baltimore Gas & Elec. Co.*, Case No. 8520/8520A, 1989 Md. PSC LEXIS 85, at *6-7, *24 (Md. Pub. Serv. Comm'n 1989) (stressing the "high standard of care" required for maintenance practices and procedures at baseload plants, given the "high cost consequences of outages").

2. Did the utility identify all plausible solutions, and explore them with comparable levels of effort, expertise, sophistication, and institutional support? A power supply problem can have multiple possible solutions—such as ways to combine fossil-based, nuclear, renewable, demand response, or energy conservation resources. Each resource poses technical challenges, individually and in combination with others. Each one requires different types of technical expertise, financing methods, and contracting complexities. A prudent utility identifies all plausible options, then uses comparable levels of effort, expertise, sophistication, and institutional support to explore them—at multiple points in time as facts change.[22]

3. Did the utility's technical analysis account appropriately for the probabilities associated with future costs and revenue shortfalls? A major power supply solution can lock in costs and lock out alternatives, for decades. When choosing among solutions, the utility must address multiple uncertainties—including customer loads and consumption, future fuel costs for the selected and rejected options, regional market prices, future environmental rules and the costs of complying with them, and interest rates. Prudence analysis addresses whether the company identified each future cost uncertainty, and then reasonably quantified its effects on alternative outcomes.

4. Did the utility make its decisions at the appropriates times—not too early and not too late? A utility plans a major capital project to meet a time-specific need—like satisfying load growth, replacing a retiring plant, or meeting an environmental deadline.

[22] *See, e.g.*, *Empire District Elec. Co.*, Cause No. PUD 201200170, Order No. 605738, 2012 WL 7170483 (Okla. Corp. Comm. Dec. 20, 2012) (holding that "to meet its burden of proof, Empire must demonstrate that all of its decisions and investments regarding generation, purchased power, and fuel procurement during the review period were reasonable").

Mr. Rowlett argued, for example, that "the next phase of [scrubber] construction needs to begin no later than May 2, 2016" to meet the EPA's Regional Haze Rule compliance deadline of January 2019.[23] Mr. Rowlett's statement appears to rest on two assumptions: that EPA's deadline was unmoveable; and that if it was unmoveable, OGE could not achieve a Sooner conversion by the January 2019 deadline. A prudence analysis should question both assumptions: Should OG&E have considered seeking an EPA extension to accommodate conversion, on the premise that conversion would reduce regional haze at least as effectively as a scrubbed Sooner? And if the deadline remained unchanged, could OG&E have completed conversion in time?

5. Where a utility based its decision on facts that can change, did the utility revisit the facts at appropriate time intervals? Prudence requires making the right choice, based on facts knowable at the time of the choice. But it is not prudent to treat a choice as fixed when its reasonableness depends on facts that are not fixed. If facts central to the decision can change, a prudent decision-maker remains alert to change—by monitoring the facts, then reassessing the original decision as necessary due to changes in facts. Continuous reexamination is especially important for a capital-intensive project with a completion deadline: The sunk spending can bring the project to the point at which its remaining construction cost falls below the alternative's total cost, regardless of the alternative's overall cost-effectiveness. (Even with a completed plant facts can change, such that its prospective operating costs exceed an alternative's full cost. Mr. Comings addresses this possibility when he compares, as of 2019, the prospective NPVRRs for scrubbed Sooner and converted Sooner.)

[23] Rowlett Direct Testimony, Cause PUD 201600059, at 6.

Other commissions have emphasized a utility's obligation to re-examine project decisions. Insisting that Iowa's utilities "maintain surveillance over costs associated with a particular decision," the Iowa Commission declared: "In the real world of competitive enterprise, management officials must continuously rethink prior decisions as new events unfold. Those who fail to stay on top of current events lose out to their competition." [24] And in assessing the Kansas utilities' decision-making around the Wolf Creek Nuclear Plant, the Kansas Commission found that "each of the owners' Wolf Creek economic cost-benefit planning exercises were too infrequent and deficient in design and execution."[25] The Commission added that "[c]ertainly by the end of 1981, applicants should have been acutely aware that the capital costs of Wolf Creek were becoming unreasonably high and that the overall economic benefits were subject to serious question."[26] The Commission blamed, in part, the utilities' "institutional inertia."[27]

A utility's responsibility to reassess its decision does not disappear just because its regulator approved the original decision. With discretion comes responsibility. OG&E told the Oklahoma Supreme Court: "Regardless whether the Commission found OG&E's plan reasonable, it remained OG&E's prerogative to continue or abandon the

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[24] *Iowa Power & Light Co.*, Nos. RPU-78-27, RPU-78-30, RPU-80-36, slip op. at 6-7 (Iowa State Commerce Comm'n Feb. 19, 1982); *quoted in Iowa Pub. Serv. Co.*, 46 P.U.R.4th 339, 368, 1982 WL 993176 (Iowa State Commerce Comm'n 1982).

[25] *Re Wolf Creek Nuclear Generating Facility*, 1985 WL 1205505, 70 P.U.R.4th 475, 526 (Kansas Corp. Comm. Sept. 27, 1985).

[26] *Id at* 533.

[27] "The decision to continue construction of Wolf Creek, especially after 1981, was not based on adequate or realistic analysis and review and appears to have stemmed from institutional inertia." *Id.* at 533.

scrubber plan."[28] Given its obligation to act cost-effectively, a utility must exercise its prerogative by exercising good judgment—especially because, as OG&E also emphasized, the Commission "did not 'substitute its judgment' for OG&E's judgment regarding the 'internal management and control' of the Company."[29] Prerogative, judgment, control—the utility must use those tools responsibly, for its customers' benefit.

6. *Where the utility has a financial interest that could bias its decision against its customers' interest, did the utility create procedures to counteract the bias?* In making the scrubber decision, OG&E had a for-profit interest. Sierra Club Witness Kevin O'Donnell calculates that the NPVRR of earnings for the scrubber option exceeded that for the conversion option by $138 million. This difference in earnings can affect judgment: not because the decision-makers are corrupt or greedy, but because they are human. And in a for-profit utility, executives are legally bound to maximize earnings for the shareholders. So that human tendency is amplified by institutional force—and "institutional inertia."[30]

A prudent decision-maker admits its biases, then protects against those biases with procedures. One procedure is competitive bidding, overseen or judged by an independent entity. To identify and rank ways to satisfy the Regional Haze Rule, OG&E

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[28] Answer Brief of Oklahoma Gas & Electric Company at 16, *Sierra Club and Oklahoma Energy Results v. Corporation Commission of Oklahoma and Oklahoma Gas & Electric Co.*, Sup. Ct. Case No. 115,029 (Jan. 31, 2017).

[29] *Id.*

[30] *See* note 27 above.

could have used competitive bidding, but did not.[31] Then there are standard internal procedures, like creating an internal devil's advocate such as a "red team"—

> an inside group that explicitly challenges a company's strategy, products, and preconceived notions. It frames a problem from the perspective of an adversary or sceptic, to find gaps in plans, and to avoid blunders. Red teams are one way to manage the biggest corporate risk of all: thoughtlessness. . . . [R]ed teams are used to double check important assumptions and overcome groupthink.[32]

A red team causes a

> shift in perspective recognizes the powerful psychological force that exists in all organizations not to challenge the way problems are framed—something that can lead to disaster. . . . A red team is especially useful to review decisions with large scale and complexity. This is because the momentum needed to launch such projects can lead to a feeling that team loyalty requires supporting them, and because the tendency to get lost in the many details leads people to overlook project risks as a whole.[33]

The prudence question is whether OG&E candidly recognized its profit interest, understood it as a factor potentially biasing its decision, and then injected protections like devil's advocacy or red-teaming to prevent that bias.

Q. OG&E says it chose its scrubber contractors competitively, and completed the project under budget. Are these statements relevant to whether its scrubber choice was prudent?

A. No. OG&E has said that it selected scrubber contractors using competitive bidding, and finished the project below the initial direct cost estimate.[34] If the Commission finds the

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[31] OG&E used competitive bidding to choose scrubber contractors, but not to choose solutions to the Regional Haze Rule.

[32] *See* Financial Times, "Definition of red team," available at http://lexicon.ft.com/term?term=red-team.

[33] *Id.*

[34] *See*, in this proceeding, Direct Testimony of Robert R. Burch at 12:20-30, 13:17-22; Direct Testimony of Donald R. Rowlett at 8:15-19.

original scrubber decision prudent, these facts are relevant to whether the cost of carrying out that decision was prudent. But they are not relevant to whether OG&E should have chosen the scrubber option to begin with. That the final scrubber cost fell below its projected cost says nothing about whether that cost was less than the alternatives' knowable cost.

C. OG&E's scrubber decisions deserve no presumption of prudence, because the decision-making process skipped essential steps and because the Company had a conflict of interest

Q. Describe the relationship among burden of proof, burden of production, and the presumption of prudence; then explain how these concepts interact with prudence principles.

A. When proposing rate increases, a utility bears a statutory burden of proof—sometimes called the risk of non-persuasion.[35] It must prove that the increased rate is "just and reasonable." This burden of proving a proposed rate just and reasonable—a burden that always lies with the utility—includes the burden of showing that the underlying costs were prudently incurred.

Some case decisions have lessened this burden of proof by establishing a rebuttable presumption of prudence.[36] That presumption has this effect: If the utility submits evidence sufficient to support its proposed rates, the commission or intervenor

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[35] *See, e.g.*, James Fleming, Jr., *Burdens of Proof*, 47 Va. L. Rev. 51, 51 (1961). The Oklahoma Supreme Court discusses burden of persuasion, and its relation to burden of production, in *Turpen v. Oklahoma Corp. Comm'n*, 1988 OK 126, 769 P.2d 1309, 1323-24 (1988).

[36] *See, e.g.*, *Turpen*, 769 P.2d at 1330 ("Since good faith is presumed on the part of public utility managers, their judgment about prudent outlays, including outlays for capital, should not be overruled unless inefficiency or improvidence on their part is shown.").

has the burden of producing facts on imprudence. Those facts on imprudence rebut the presumption of prudence, thus creating "serious doubt" about the proposed rates' reasonableness.[37] Since the risk of non-persuasion on reasonableness remains with the utility, and since the utility has lost its presumption of prudence, it must then show persuasive evidence of its prudence— or else lose the case.

Q. Should a presumption of prudence apply to OG&E's scrubber decisions?

A. No, a prudence presumption should not apply to OG&E's scrubber decisions, for at least two reasons.

First, OG&E's decision-making process lacked essential indicia of prudence. In rejecting OG&E's proposed Environmental Compliance Plan (ECP—which included the Sooner scrubbers), the Commission's 2015 Order stated (at 10-11):

> "OG&E did not include any other resource options—such as additional wind or other renewables, power purchase agreements, demand-side management options or purchasing existing generation facilities—in its economic analysis." Finding of Fact 14.
>
> "OG&E did not include a carbon tax in the Base Case, but instead ran a single carbon price sensitivity." Finding of Fact 15.
>
> "Carbon was the only future environmental regulation that OG&E analyzed in sensitivity analysis." Finding of Fact 16.
>
> "OG&E did not demonstrate the financial benefit of its selected plan over potential alternatives." Finding of Fact 17.
>
> "[T]he Company did not attempt to quantify the value of fuel diversity in its planning process." The Company's witness "did not know the point at

[37] *See State ex rel. Pub. Counsel v. Pub. Serv. Comm'n of Mo.*, 274 S.W.3d 569, 577-78 (Mo. Ct. App. 2009) (holding that while the utility has burden of proving its rates just and reasonable, "[the] commission properly presumed that [Union Electric] was prudent in its purchase of the [combustion turbine generators], until the State or Public Counsel presented evidence that raised a 'serious doubt' concerning the prudence of its expenditure").

> which fuel diversity favors selection of one portfolio option over another." Finding of Fact 18.
>
> "OG&E's load forecast is based upon information that is two years old." Finding of Fact 20.
>
> "OG&E did not conduct a Request for Proposals for market alternatives to its proposal to either replace, retrofit, or convert the Sooner and Muskogee coal units." Finding of Fact 23.

A decision-making process with so many flaws and omissions—basic ones—cannot enjoy a presumption of prudence.

Second, the scrubber decision had three features that make a presumption of prudence illogical. OG&E (a) has a government-granted, government-protected retail monopoly, so it faces little competitive pressure to gain and retain customers; (b) chose the scrubbers without using competitive bidding to find the most cost-effective solution; and (c) chose an option whose NPVRR earnings would be $138 million more than the conversion solution.[38] In combination, these factors produce a direct conflict between the shareholders' interest and the customers' interest. Where a shareholder-ratepayer conflict exists, and where a company has the power and incentive to resolve that conflict in its shareholders' interest and against its customers' interest, the logical presumption is that the company will do so. "Agencies do not need to conduct experiments in order to rely on the prediction that an unsupported stone will fall."[39] Under these facts, a presumption of prudence contradicts common sense.

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[38] As calculated by Sierra Club witness Kevin O'Donnell.

[39] *Associated Gas Distributors v. FERC*, 824 F.2d 981, 1008 (D.C. Cir. 1987) (holding that the FERC need not conduct a factual hearing to learn that monopolists will act in their self-interest).

D. If OG&E was imprudent, it must absorb the excess of scrubber cost over the cost of the most cost-effective alternative reasonably knowable at the time of imprudence[40]

Q. If the Commission finds that OG&E's scrubber decision was imprudent, how should the Commission calculate the disallowance?

A. Imprudence requires disallowance of excess costs—the excess of actual costs over those of the least-cost prudent decision knowable at the time of the imprudent decision. As I explained in Part III.A, the Commission will need to look at (1) OG&E's initial scrubber choice, (2) its failure to re-assess that choice during the scrubber installation period, and (3) OG&E's continuing decision to operate Sooner with scrubbers rather than converting Sooner to gas. (For purposes of brevity, I will assume here that the least-cost plausible option was Sooner conversion. I do not mean to suggest conversion was the lone alternative.)

OG&E's initial scrubber decision and the failure to re-assess: The Commission will need to identify the date on which it became reasonably knowable that the prospective NPVRR for conversion alternative was less than the prospective NPVRR for the scrubber alternative. (As I have explained, the latter number must exclude sunk costs.) If that point in time was at the initial 2014 decision, preceding any scrubber spending, then the imprudence disallowance applies to the entire excess of scrubber cost over conversion cost. But what if, at the early stages of scrubber spending, the conversion NPVRR was unclear, or the difference between the two NPVRRs was within a reasonable margin of error—such that the imprudence occurred only later when the Company failed to reassess? In that situation, the Commission could treat that early

[40] This Part III.D assumes the Commission finds imprudence. Part III.E below addresses a separate scenario—where the Commissions finds that OG&E failed to prove prudence.

scrubber spending as prudent and recoverable from customers, with the disallowance affecting only those costs incurred after the date OG&E should have reassessed its decision and changed its plans. (This latter point comes with a caveat: Even if the two NPVRRs were close, the scrubber involved more risk. So its cost estimate would be less certain—making the comparison less close and suggesting the scrubber choice was still imprudent.)

OG&E's 2019 intent to continue the scrubbed Sooner as a coal plant, rather than convert it to a gas plant: Independent of OG&E's past decisions is this question: Is OG&E imprudent for failing to convert now? Mr. Comings shows that under certain facts, the NPVRR associated with operating and maintaining the scrubbed Sooner units will exceed the NPVRR of converting and operating the units (both numbers taking into account revenues from the SPP energy market). To preserve the possibility of saving customers money, the Commission should require OG&E to provide the Commission an annual analysis that compares the cost of continuing to operate scrubbed Sooner to the cost of creating and operating alternatives. As described by Mr. Comings, the Company's submissions should contain the detail necessary to allow others to replicate and modify the analysis.

E. If the Commission does not find imprudence, but finds that OG&E has failed to prove prudence, OG&E still must absorb the excess cost

Q. What if the Commission does not find imprudence, but does find that OG&E has failed to prove prudence?

A. In Part III.C I explained that applying a presumption of prudence to OG&E's scrubber decision is illogical. There were two reasons. OG&E's decision-making process had deficiencies; and the Company had a profit bias. If the Commission agrees with these reasons, then the combination of burden of proof and absence of prudence presumption means OG&E will have failed to carry its burden of proving prudence.

So what can the Commission do? The Commission cannot allow a utility to recover the cost of an expenditure whose prudence it has failed to prove. But to disallow the entire scrubber cost would make no sense, because OG&E had to make some expenditure to comply with the Regional Haze Rule. The logical recoverable amount is the cost of the least-cost feasible alternative known or knowable at the time of the scrubber decision. So the disallowance for failing to prove prudence is the same as for being imprudent.

IV. Not-used-and-useful disallowances make utilities accountable for the risks they take

Q. Describe the purpose of this Part IV.

A. Here I describe the used-and-useful standard. In competitive markets, companies do not profit from, or readily recover the costs of, products that are not useful—products that do not benefit customers. Customers go elsewhere. Since a utility monopoly's customers cannot go elsewhere, regulation protects them by applying the used-and-useful standard. That standard—a component of the statutory "just and reasonable" requirement—protects ratepayers from prudent but uneconomical, and thus non-beneficial, decisions for which the utility took the risk.

The level of protection can vary, just as it does in competitive markets. In competitive markets, the buyer and seller can contract to share the risk of uneconomic outcomes. Similarly in regulation, a commission can design a pre-approval order to make ratepayers share some of the risk. But for the Sooner scrubbers, there was neither pre-approval nor risk-sharing; both the 2015 and 2016 Orders explicitly required OG&E to bear the risk of an uneconomic outcome. After explaining the used-and-useful principle, I will show that OG&E both accepted the risk and charged rates that compensated the Company for that risk. If the Commission finds the scrubber investment prudent but non-economic, OG&E must bear the uneconomic portion.

A. Not-used-and-useful disallowances—which assign utilities the consequence of uneconomic outcomes—are distinct from imprudence disallowances

Q. Explain the distinction between prudence disallowance and not-used-and-useful disallowance.

A. Used-and-useful analysis is distinct from prudence analysis. Prudence analysis compares a decision's cost to the cost of alternatives known or knowable at the time of the decision.

The outcome of the imprudent decision reveals the excess cost caused by the imprudence, but the outcome does not determine whether there was imprudence.[41] Used-and-useful analysis is different. The analysis assumes an action's prudence. (If the action were imprudent, the resulting disallowance would make a used-and-useful disallowance unnecessary.) The used-and-useful question is whether the prudent action has produced a used-and-useful outcome. So used-and-usefulness, unlike prudence, does depend on outcome. An outcome is not useful if it does not provide economic benefit to the customer, compared to other options the utility could have chosen.

For nearly a century, regulators and courts have recognized this distinction between prudence and used-and-usefulness. The seminal *Bluefield* case distinguished inefficient performance from uneconomic outcomes: "The return should be reasonable, sufficient to assure confidence in the financial soundness of the utility, and should be adequate, *under efficient and economical management*, to maintain and support its credit and enable it to raise money necessary for the proper discharge of its public duties."[42] By caveating "efficient and economical management," the court makes clear that if the investment is inefficient or turns out to be uneconomical, it deserves no return.[43]

Decades after *Bluefield*, in our own lifetimes, the U.S. Supreme Court held constitutional the Pennsylvania Public Utility Commission's disallowance of prudent costs. The Commission took this action under a statute explicitly requiring disallowance

[41] See Part III.B.1 above.

[42] *Bluefield Water Works & Improvement Co. v. Public Service Comm. of West Virginia*, 262 U.S. 679, 693 (1923) (emphasis added).

[43] *See also Appeal of McCool*, 128 N.H. 124, 139 (1986) (describing the used-and-useful test as a "second limitation on the rate base," distinct from prudence).

of investment that is not used and useful. At stake was $35 million in construction costs for a nuclear plant that Duquesne Light Company had prudently planned, prudently constructed, and prudently abandoned. The state's utilities argued that the Constitution (specifically, the Fifth Amendment's Takings Clause, applied to the states through the Fourteenth Amendment's Due Process Clause) mandates recovery of all prudent investment. The Court disagreed:

> We think that the adoption of any such rule would signal a retreat from 45 years of decisional law in this area which would be as unwarranted as it would be unsettling. *Hope* clearly held that "the Commission was not bound to the use of any single formula or combination of formulae in determining rates."[44]

The 8-1 opinion (the dissent was unrelated to the merits) reaffirmed an unbroken line of cases holding that the Constitution does not insulate a utility from uneconomic outcomes—whether caused by market forces, obsolescence, or bad luck—regardless of prudence.[45]

This Commission has recognized the distinction between imprudence disallowance and not-used-and-useful disallowance. Thus its 2015 Order distinguished Section 286 pre-approval from "historical ratemaking procedures":

> Section 286 must be understood and interpreted in the context of the Commission's historical ratemaking procedures. Utility management still

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[44] *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 315 (1989) (*citing Hope Natural Gas v. Fed. Power Comm'n*, 320 U.S. 591, 602 (1944)).

[45] *See, e.g.*, *Denver Union Stock Yard Co. v. United States*, 304 U.S. 470, 475 (1938) (upholding Agriculture Secretary's exclusion from rate base of "land and improvements used for a stock show and for trackage and facilities for unloading and loading livestock" because they were not "used and useful" for the regulated service); *Market St. Railway v. Railroad Comm'n of Calif.*, 324 U.S.324 U.S. 548, 567 (1945) ("The due process clause has been applied to prevent governmental destruction of existing economic values. It has not and cannot be applied to insure values that have been lost by the operation of economic forces.").

> has the discretion to build whatever it wants, whenever it wants, but in doing so assumes the risk and, when seeking a return on and return of the investment, bears the burden to subsequently prove the investment is used and useful in service to the public and that the costs were prudently incurred.[46]

Absent pre-approval under section 286, the utility bears the risks of its decisions.

This analytical distinction between prudence and used-and-usefulness reflects the distinction between fault and risk. Prudence is about fault: The utility knew or should have known better, so should have performed better. Used-and-useful is about risk: The utility made a prudent decision but bore the risk of an uneconomic outcome.[47]

B. By assigning utilities the consequence of uneconomic outcomes, the used-and-useful standard induces accountability consistent with competitive pressures

Q. Explain how assigning utilities the consequence of uneconomic outcomes relates to inducing accountability consistent with competitive pressures.

A. The risk of uneconomic outcomes needs to land somewhere—with the utility's shareholders, its ratepayers, or some combination. This subpart describes three reasons why logic supports placing the risk with the shareholders. (As I explain in Part IV.D.1 below, the Commission's 2016 Order explicitly assigned the scrubber risk to OG&E. These three reasons show why the Commission was right to do so—and why OG&E now must bear the consequences of the risk the Commission assigned.)

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[46] 2015 Order at 13.

[47] "[T]he problem of risk allocation in this case is not a problem of fault. . . . The Natural Gas Act simply does not guarantee the shareholders of even a prudently managed utility that ratepayers can always be stuck with the bill for supply projects that turn out to be total failures, however praiseworthy the utility's motives for undertaking those projects may have been." *Natural Gas Pipeline of America v. FERC*, 765 F.2d 1155, 1163-64 (D.C. Cir. 1985) (upholding FERC's disallowance of costs associated with an unsuccessful synthetic gas supply projects).

1. Increasing business discipline: Assigning to the utility the risk of uneconomic outcomes induces business discipline comparable to what competitive companies experience. In competitive markets, sellers bear the risk of prudent but unsuccessful outcomes (unless they have contracted that risk to the customer). Market prices reflect the cost structures of sellers who choose the most economic paths. Less economically successful sellers cannot charge higher prices yet keep their customers. With the used-and-useful disallowance tool, regulators aim to produce comparable results.

2. Aligning risk with earnings, to avoid asymmetry of risk and reward: Like any for-profit company, a utility is motivated by earnings. Between the scrubber option and conversion options, the earnings potential differed by at least $138 million (net present value).[48] Since by choosing scrubber over conversion OG&E would increase its earnings, symmetry requires that if scrubber costs more than conversion, OG&E bears the consequence. Otherwise, by choosing the scrubbers, OG&E would be getting for itself extra profit without risking a loss. It would literally be taking risks with other people's money. Neither competition nor regulation allows such heads-I-win, tails-you-lose asymmetry.

3. Aligning risk with expertise and control: In comparing the scrubber and conversion options, OG&E had more information and expertise than the Commission or any other party—certainly more than the ratepayers. That information and expertise exist because ratepayers have paid for it, year after year, as expenses included in OG&E's revenue requirement. So OG&E was the entity best positioned (indeed the only entity

[48] As calculated by Mr. O'Donnell.

positioned) to manage the economic risk—by assessing initially, and continuously, whether scrubbers compared favorably to conversion. And OG&E's shareholders would expect OG&E's executives to perform those assessments, so as to reduce the very risk of disallowance about which the 2015 Order warned. (Ratepayers expected the same care: Unlike shareholders, who can sell their stock when the risk exceeds their tolerance, ratepayers have no alternative to OG&E.) Given OG&E's control of information and decisionmaking, the Company was the logical risk-bearer.

In sum: In competition and regulation, risk-bearing induces discipline and objectivity; and it aligns the company's interest with the customers' interest. Shifting the risk of the company's earnings-enhancing decisions, onto customers having no role in making those decisions, reduces discipline while misaligning risk and reward.

C. The used-and-useful principle has both a physical and an economic dimension

Q. Describe the used-and-useful standard's physical and economic features.

A. The used-and-useful standard applies to both an investment's physical features and its economic features. Examples of used-and-useful disallowances for physical reasons include excess capacity[49] and canceled plant.[50] But the principle applies equally to investments that are used physically but are non-useful economically—non-useful economically because they cost more than alternatives available to the utility, and

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[49] *See, e.g., Re Wolf Creek Nuclear Generating Capacity*, 70 P.U.R.4th at 534 ("In view of the fact that the decision to construct and build Wolf Creek was not supported by a need for physical capacity, a physical excess capacity adjustment is undeniably appropriate.").

[50] *See, e.g., Duquesne Light Co.* (discussed in Part IV.A above); *New England Power Co.*, 8 FERC ¶ 61,054 (1979) (addressing rate treatment of project cancellation), *aff'd sub nom. NEPCO Mun. Rate Comm. v. FERC*, 668 F.2d 1327, 1333 (D.C. Cir. 1981).

therefore do not benefit customers. Capacity is "not economical [if] it has excessive capital costs when compared to alternative types of generating facilities."[51]

Usefulness has an economic feature because what makes an investment useful to customers is its value—its ability to provide customer benefit at least equal to the benefit available from the next best alternative. What makes an investment not useful is the insufficiency of value—its inability to provide customer benefit at least equal to the benefit available from the next best alternative. Economic usefulness is a spectrum. At one end is abandoned plant—it provides no economic value to the customer. Because usefulness is a spectrum, there is no logical reason to limit its application to the physical situations of zero value. An investment can be physically useful but economically unhelpful—the measure of its unhelpfulness being the amount by which its cost exceeds that of the utility's most cost-effective alternative.

Here is another way to understand the point: The used-and-useful standard "is based on the principle that ratepayers should provide shareholders with a return only on so much of the utility's investment that is actually in use and *needed to meet their demands*."[52] An investment is not "needed to meet [customers'] demands" if the customers can meet their demands some other way at some lower cost.

Indeed an abandoned plant—the classic cause of used-and-useful disallowance—has an obvious economic dimension. A plant under construction is abandoned if it is not needed. If the plant is not needed, it is not needed because of economic factors: load has

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[51] *Kansas Gas & Elec. Co. v. State Corp. Comm. of Kansas*, 239 Kan. 483, 510; 720 P.2d 1063 (1986) (Court paraphrasing Kansas Commission decision).

[52] *Iowa Pub. Serv. Co.*, 46 P.U.R.4th 339, 368 (Iowa State Commerce Comm'n 1982) (emphasis added).

dropped; or customers have found more economical ways to serve their needs, such as through demand response, energy conservation, or alternative supplies. What has made the plant unnecessary are economic forces. Elementary economics tells us why. In economics we represent economic forces with demand and supply curves. When structural demand drops, the demand curve shifts to the left, causing it to intersect with the supply curve at a lower level of output—making the plant unnecessary. Now suppose we have two supply options—scrubber and conversion. If the conversion option is lower cost, its curve will reside to the left of the scrubber's curve, thereby intersecting the demand curve at a lower price for a given output. So an investment can be rendered uneconomic either by a reduction in demand (causing plant abandonment), or by a lower-cost supply alternative (such as conversion instead of scrubbers). It would be arbitrary to define not-used-and-useful as occurring only when the economic force that makes a plant unnecessary comes from the demand side but not from the supply side.

Exemplifying the not-used-and-useful disallowance on economic grounds was the Kansas Corporation Commission's treatment of Wolf Creek Nuclear Plant construction costs.[53] The Commission's decision distilled to these points:

Imprudence: The Commission disallowed from rate base 10% of the total Wolf Creek capital expenditure as imprudent. Disallowing those costs from rate base meant denying both recovery and return.

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[53] I will cite to the Kansas Commission's original order of Sept. 27,1985, available at 1985 WL 1205505, 70 P.U.R.4th 475 (1985). An order on rehearing, issued Nov. 15, 1985, 1986 WL 220909 (1985), did not change the substance addressed here—at least as I understand the Kansas Supreme Court's decision, which focused on, and upheld, the Commission's original order. *Kansas Gas and Electric Company v. State Corporation Commission of Kansas*, 239 Kan. 483, 720 P.2d 1063 (1986).

Not used-and-useful—in general: To the remaining 90% of the Wolf Creek capital expenditure, the Commission applied the used-and-useful standard. In separate analyses, it found a portion of that 90% excess physical capacity, and a portion excess economic capacity. For current rates, the Commission allowed recovery of those portions through depreciation expense; but denied rate base treatment, which would have produced a return on the undepreciated (and therefore unrecovered) amounts. The Commission said the utilities could seek to place these portions in rate base if at some future time the capacity became used and useful physically and economically.

Not used-and-useful—excess economic capacity: The Commission defined excess economic capacity as capacity "not economical because it has excessive capital costs when compared to alternative types of generating facilities."[54] Compared to a proxy plant, Wolf Creek's capital costs "were of doubtful economic benefit to the ratepayers."[55] To determine the excess economic capacity disallowance, the Commission compared the final Wolf Creek cost to what a "coal-fired plant meeting the applicant's needs would have cost."[56]

The Commission viewed its economic usefulness disallowance as a "risk-sharing approach."[57] In choosing Wolf Creek Nuclear over other options, the utility owners had

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[54] *Kansas Gas & Electric*, 239 Kan. at 510 (Kansas Supreme Court paraphrasing Commission decision).

[55] *Id*. (describing Commission decision).

[56] *Re Wolf Creek Nuclear Generating Facility*, 70 PUR4th at 536.

[57] *Kansas Gas & Electric*, 239 Kan. at 510 (describing Commission decision).

"accepted enormous risks."[58] The specific risk undertaken was the risk that the plant's capital costs would exceed the costs of available alternatives.[59] Since the owners "continued to assume the risks" even "[f]aced with changing economics of the [plant's] benefit," excluding costs based on physical excess alone was insufficient: "[S]imple exclusion of the physical excess capacity . . . would still result in an unreasonable valuation of property in rate base."[60]

This Commission has recognized the need to assign the risk of economic excess capacity. As I will detail in the next subsection, both the 2015 Order and the 2016 Order assigned OG&E the not-used-and-useful risk explicitly.[61] That risk had no relation to physical capacity, because under both the scrubber and conversion scenarios, Sooner's physical capacity likely would be comparable. So the risk imposed by the Commission was not the risk of physical non-usefulness; it was the risk of economic non-usefulness—the risk that the scrubber choice would cost customers more than OG&E's other choices.

D. If the scrubber is not used and useful, OG&E must bear the consequence because it assumed that risk and was compensated for it

Q. Describe the purpose of this subpart.

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[58] *Re Wolf Creek Nuclear Generating Facility*, 70 PUR4th. at 530.

[59] *Id.* at 536 ("We believe that capital costs above this [coal-fired plant] benchmark were part of the risks accepted by shareholders.").

[60] *Id.* at 533.

[61] 2015 Order at 13 ("Utility management still has the discretion to build whatever it wants, whenever it wants, but in doing so assumes the risk and, when seeking a return on and return of the investment, bears the burden to subsequently prove the investment is used and useful in service to the public and that the costs were prudently incurred."); 2016 Order at 10 (explaining that the Commission's finding of "reasonable" does not "result in a determination that the decision to scrub is deemed 'used and useful and entitled to immediate cost recovery'").

A. For the excess of scrubber final cost over likely conversion cost, who should cover the difference? The facts give us the answer. In this subpart I explain how the Commission explicitly assigned to OG&E the risk of an uneconomic outcome. By then continuing with the scrubber, OG&E accepted that risk. I also explain that under a regulatory policy known as the filed rate doctrine, the Commission today must assume that ratepayers have been paying rates that compensated OG&E for that risk. Because OG&E took the risk of an uneconomic outcome and was compensated for that risk, it now must bear the result.

1. The 2015 and 2016 Orders explicitly assigned OG&E, and OG&E accepted, the risk of an uneconomic outcome

Q. How did the Commission's 2015 and 2016 Orders treat the risk that OG&E's scrubber choice would have an uneconomic outcome?

A. Under Section 286,[62] OG&E sought pre-approval of an Environmental Compliance Plan that included scrubbing Sooner.[63] The Commission denied pre-approval. But it left OG&E free to pursue the scrubber option, as long as OG&E "assumed the risk" of an uneconomic outcome:

> Section 286 must be understood and interpreted in the context of the Commission's historical ratemaking procedures. Utility management still has the discretion to build whatever it wants, whenever it wants, but in doing so assumes the risk and, when seeking a return on and return of the investment, bears the burden to subsequently prove the investment is used and useful in service to the public and that the costs were prudently incurred.[64]

I assume the phrase "historical ratemaking procedures" refers to the Commission's general authority over rates, as created by the Oklahoma Constitution and 17 O.S. § 152.

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[62] 17 O.S. § 286(B).

[63] The Commission docketed OG&E's Application as Cause PUD 201400229.

[64] 2015 Order at 13.

Under the Commission's historical ratemaking procedures, a utility seeking recovery of and return on a capital expenditure must prove both prudence and used-and-usefulness.[65] The risk "assume[d]" is the risk of failing that proof and bearing the consequence. The consequence is no return on or recovery of the investment, to the extent the investment is imprudent or not used and useful.

To anticipate an OG&E argument: The Commission did not say "If the investment turns out to be prudent but non-used-and-useful, the Commission then will decide how to allocate the excess cost between ratepayers and shareholders; it is that uncertainty about how we will allocate the excess that is your risk." The Commission did not say that. The Commission defined the risk precisely. To the extent OG&E failed to prove used-and-usefulness, the Company would bear, on the uneconomic portion, the full consequence: no recovery and no return.

How do we know this? Because the context for the Commission's statement was a pre-approval proceeding. Pre-approval's very purpose is to relieve a utility of disallowance risk—from both imprudence and from an uneconomic outcome. By denying pre-approval, the 2015 Order necessarily left OG&E exposed to both types of disallowance. On receiving that 2015 Order, OG&E could have appealed that decision or submitted a new Section 286 application—one that sought to fill the evidentiary gaps that caused the first application's rejection, one that sought to remove the risks. By

[65] *See, e.g.*, *In Re Pub. Serv. Co. of Okla.*, Order No. 545168, 2007 WL 6081138 (Okla. Corp. Comm'n, Oct. 9, 2007) (holding that "ratepayers pay for only those assets that are used and useful for the provision of utility service. The origins of this fundamental doctrine are grounded in the constitutional prudent investment rule.") (italics omitted).

instead continuing its scrubber spending (as Mr. Comings discusses), OG&E chose to bear the Commission-specified risks. Having accepted those risks then, OG&E cannot avoid their consequences now.

Can OG&E argue that the Commission removed the risk assigned by the 2015 Order, when it found the scrubber "reasonable" in the 2016 Order? No, for two reasons. First, there no longer is a 2016 Order, because Oklahoma Supreme Court vacated it. The Court held that outside of Section 286, the Commission has no authority to pre-approve any investment as "reasonable." Second, even if we view the 2016 Order as alive (and lawful), it actually made no change in the risk assignment of the 2015 Order. The 2016 Order said that the finding of reasonableness "will ***not*** result in an automatic right to recover costs or a determination of used and useful." The 2016 Order also said that the Commission "can take necessary action to disallow any unreasonable and/or imprudent costs associated with scrubbing."[66] By making no commitment in the 2016 Order, the Commission necessarily left in place the risk assigned by its 2015 Order.

2. If the scrubber is uneconomic, OG&E must bear the consequence because ratepayers have compensated OG&E for its risk

Q. Given the Commission's risk assignment decision, who—as between OG&E and its ratepayers—must bear the consequence if the Commission finds the scrubber decision's outcome uneconomic?

A. OG&E must bear the consequence, because by paying lawful rates, OG&E's customers already have compensated OG&E for the risk. This conclusion follows necessarily from the filed rate doctrine—one of regulation's most important principles.

[66] 2016 Order at 10 (emphasis in original).

A for-profit utility's rates are based on a revenue requirement. That revenue requirement includes an authorized return on equity. That authorized return on equity must compensate a utility for certain "risks and uncertainties."[67] Among the risks is the one OG&E assumed: the risk of absorbing costs associated with an investment that is not used and useful.

During and after the period OG&E spent money on the scrubbers, it charged rates authorized by the Commission. Under the filed rate doctrine, we must presume, conclusively, that those rates were lawful rates.[68] That conclusive presumption applies to rates set by the Commission and rates proposed in a settlement approved by the Commission. The rates on file at the Commission are lawful rates unless a court says otherwise, and no court has.

The preceding two paragraphs produce this conclusion: Ratepayers have compensated OG&E, and continue to compensate OG&E, for bearing the risk of an uneconomic outcome. That conclusion follows from this syllogism:

1. The Commission assigned, and OG&E accepted, the risk of an uneconomic outcome.

2. Throughout the scrubber expenditure period, and currently, OG&E charged lawful rates—which to be lawful had to reflect the risk of an uneconomic outcome.

[67] *Bluefield Water Works & Improvement Co.*, 262 U.S. at 692-93 (holding that a "public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties").

[68] "Unless and until suspended or set aside [by the regulator], this rate is made, for all purposes, the legal rate." *Maislin Industries v. Primary Steel*, 497 U.S. 116, 126 (1990), *quoting Keogh v. Chi. & Nw. Ry. Co.*, 260 U.S. 156, 163 (1922).

3. Therefore, ratepayers have compensated OG&E for the risk of an uneconomic outcome.

To avoid this logic, OG&E would have to show that Oklahoma law removes all economic risk; that it guarantees recovery of all prudent costs, regardless of their economic uselessness. That cannot be true, for two reasons. First, as I have already explained, the Commission expressly assigned OG&E the not-used-and-useful risk—the risk of economic non-usefulness. Second, if Oklahoma law had removed that risk already, then the pre-approval statute would be superfluous: Its very purpose is to give utilities an opportunity to have the Commission remove the risk of post-investment disallowance, including disallowance for non-usefulness. There is no basis, in law or logic, for OG&E to say now that its rates did not reflect the risks it assumed.

To summarize: The Commission assigned to OG&E the risk of an uneconomic outcome. The ratepayers already have been compensating OG&E for that risk. There is no way to unring those two bells. The Commission cannot take back its prior risk-assigning statements; nor can it revise past rates retroactively to refund ratepayers their ROE payments for OG&E's risk.[69] OG&E now must bear the consequences of the risk it accepted.

3. The consequence for a not-used-and-useful result is disallowance of excess cost

Q. If the Commission finds that OG&E’s scrubber investment is not used-and-useful, what disallowance is appropriate?

[69] *See Turpen*, 769 P.2d at 1332 (holding that Commission may not “[a]ccount[]for mistakes in past rates in the setting of future rates”), *citing Southwestern Pub. Serv. Co. v. State*, 637 P.2d 92, 102 (1981).

A. Among regulatory decisions, used-and-useful disallowances vary. They can involve complete disallowances (no recovery and no return); or they can involve risk-sharing (such as amortized recovery through depreciation expense but no return). FERC tends to use the latter approach. In the 1980s and 1990s, FERC sought to increase wholesale gas competition by encouraging, then requiring, gas pipelines to offer nondiscriminatory transportation service unbundled from wholesale sales. Injecting competition left some pipelines with sunk costs unrecoverable through market prices. For those sunk costs, FERC allowed recovery but no return.[70] FERC has provided similar treatment for cancelled electric generation plant.[71] And as I explained in Part IV.C above, the Kansas Commission in the Wolf Creek case applied this "risk-sharing" approach (recovery without return) to the nuclear plant's excess physical capacity and excess economic capacity.

But risk-sharing does not apply here, because this Commission's 2015 Order did not share the risk; it assigned to OG&E the full scrubber risk. To repeat a passage I already quoted:

> Utility management still has the discretion to build whatever it wants, whenever it wants, but in doing so assumes the risk and, when seeking a return on and return of the investment, bears the burden to subsequently

[70] *See, e.g.*, *United Distrib. Cos. v. FERC*, 88 F.3d 1105, 1179-80 (D.C. Cir. 1996). There the court, upholding FERC, quoted other authorities for the proposition that it "would be inappropriate [to] . . . allow[] a return on facilities that are not economically viable"; doing so "may also result in a competitive advantage for the pipeline." Allowing cost amortization, however, "will keep the pipeline whole for the direct cost of its investment in the facilities. . . . Investor interests have not, therefore, been entirely ignored."

[71] *See, e.g.*, *NEPCO Mun. Rate Comm. v. FERC*, 668 F.2d 1327, 1333 (D.C. Cir. 1981) ("FERC's refusal to include project expenditures in the rate base, while allowing their recovery as costs over time, is a valid approach to allocating the risks of project cancellation.").

> prove the investment is used and useful in service to the public and that the costs were prudently incurred.[72]

The risk the Commission assigned—and that OG&E accepted—is the risk of economic non-usefulness: that the scrubber would end up costing more than alternatives.

To ensure that OG&E bears the consequence of its gamble—and conversely, to protect ratepayers from that gamble—the rates should recover no more than the cost of an economic outcome. Achieving this result requires two distinct decisions: (1) How much to disallow in this rate case; and (2) how to adjust that disallowance if the facts change.

For this rate case: The Commission should allow scrubber-related additions to OG&E's rate base, up to the amount required for a prudent conversion. Mr. Comings recommends removing from OG&E's proposed rate base $344.7 million: the amount by which the capital expenditure for scrubbed Sooner Units 1 and 2 exceeds the capital expenditure for converting Muskogee Units 4 and 5 (which he describes as reasonable proxies for a converted Sooner). That removal reduces the proposed annual revenue requirement, he says, by $47.3 million. That figure represents the amount by which the scrubber investment does not benefit consumers, and therefore is not economically useful.

As for operating expense, Mr. Comings does not estimate a scrubbed Sooner-converted Muskogee difference because the necessary information is not available to him. Mr. Comings recommends that the Commission require OG&E to produce that information at year's end. With that information missing now, the Commission's only

[72] 2015 Order at 13.

option for this rate case is to determine a reasonable operating cost, and allow recovery of that amount.

For future adjustments: As I have explained, the used-and-useful standard assigns to the utility the risk of uneconomic outcomes. If the Commission agrees with Mr. Comings that scrubbed Sooner today is not fully used and useful compared to a converted Sooner, to be fair to the Company it should also recognize that facts can change. We won't know whether scrubbed Sooner is ultimately uneconomic, as compared to converted Sooner, until scrubbed Sonner has reached the end of its useful life (assuming OG&E does not convert at some earlier point). In this respect, unused-and-useful disallowance differs from imprudence disallowance. The Commission determines imprudence only once, because imprudence is based on facts reasonably knowable at a specific point in time—the point in time when the utility chose its course. Usefulness is different. A plant that is physically non-useful in Year 1 due to low demand can become physically useful in Year 10 if demand grows. Similarly, a scrubbed Sooner that is not economically useful (compared to a converted Sooner) based on today's gas prices and operating costs could turn out to be economically useful if gas prices rise or scrubbed Sooner's operating costs drop (or Muskogee's prudent operating costs rise).

These factors lead to this result: If the Commission decides in this rate case that OG&E must absorb some scrubber costs due to economic non-usefulness, it should allow OG&E an opportunity to seek a prospective rate change if facts change. The Kansas Commission offered that option to the Wolf Creek utilities, for both physical excess capacity and economic excess capacity, although it expressed both uncertainty and skepticism over whether the facts would change.[73] Depending on how favorable the scrubber choice fares relative to conversion costs, OG&E's opportunity for higher recovery could involve both capital expenditures and operating expenses.

And the facts might move in the other direction. If gas prices go down, converted Muskogee 4 and 5 would have lower operating expenses. The gap between scrubbed Sooner's cost and the more economical conversion option would increase, thereby increasing OG&E's underrecovery of its scrubbed Sooner operating expenses. Symmetry requires that the Commission preserve this possible outcome. For OG&E, though, there could be no downward adjustment in recovery of capital expenditures, because the Commission would have already disallowed the excess of Sooner scrubber capital expenditure over conversion capital expenditure. Any adjustment favoring customers would affect only operating expenses.

Of course, if the Commission finds the scrubber choice imprudent (or not proven prudent), then it never reaches the used-and-useful question because imprudence leads to

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[73] *See Wolf Creek Nuclear Generating Facility,* 1985 WL 1205505 at 535 ("With regard to the Wolf Creek plant excluded today, its value may increase with changes in the comparative economics of coal generating facilities. If, for example, coal transportation costs escalate or "acid rain" concerns cause increased costs for coal generation facilities in the future, the figure adopted today could increase. Absent very compelling evidence, however, we cannot envision that value as being greater than the historical costs. Furthermore, the commission is inclined to believe that valuation of plant included in rate base should not change over time although that need not be addressed today."); *id.* at 538 (stating that "[t]he commission ... is not required to exclude permanently the "carrying and finance charges" associated with physical and economic excess capacity adjustments we make today, although we have the discretion to do so under KSA 1984 Supp 66128b ...."); *id.* at 539 para. 24 (stating that the "exclusions [of amounts from rate base due to physical or economic excess capacity] may well someday be fully in rate base, we are unable to project when that will occur").

a permanent disallowance of the excess of scrubber cost over conversion cost (with the amount of disallowance depending on the point in time the imprudence occurred).

E. If OG&E resists the consequences of its risks, its likely arguments will rest on misunderstandings of regulatory policy

Q. What arguments might OG&E make against a not-used-and-useful disallowance, and how do you respond?

A. I have explained (a) how the use-and-useful principle increases accountability by assigning risk; and (b) why the principle, combined with the Commission's decisions and OG&E's actions, makes OG&E responsible for uneconomic scrubber costs. In this subsection I anticipate three possible OG&E arguments by restating some key principles.

1. A disallowance based on not-used-and-usefulness is neither "Monday morning quarterbacking" nor "regulation-by-hindsight." OG&E might argue that disallowing costs on grounds of non-usefulness is regulation-by-hindsight. But that attack applies only in the context of prudence analysis; specifically, where a regulator treats the utility as having access to facts at the time of its decision, when those facts were not available until after the decision. In that prudence context, the Commission would commit regulation-by-hindsight if: (a) at the time of a necessary decision, the only knowable, feasible option was scrubbers; (b) years later, conversion became a feasible option; and (c) on that basis the Commission found the original scrubber decision imprudent because the Company should have chosen conversion. In the prudence context, regulation-by-hindsight is illogical, and improper, because it assumes the impossible—knowing of the conversion option before it was knowable.

But used-and-useful analysis is not prudence analysis. Used-and-useful analysis does not say, "OG&E was imprudent for choosing scrubber over conversion because now we know that conversion would have cost less." With used-and-useful analysis the

Commission says “OG&E had a choice between conversion and scrubber. It had the expertise to make the decision. It had the management prerogative to make the decision. We alerted OG&E that it would own the decision—that it would take the risk of the decision turning out uneconomically. And now we see that the decision has turned out uneconomically.” Used-and-useful analysis uses the outcome only to determine the consequence of the risk assumed in making the original decision, not to second-guess the prudence of the original decision.

2. Prudence does not guarantee recovery. OG&E might argue that if its decision was prudent, the story ends; recovery is required because there is no basis for non-recovery. That argument has been wrong for nearly a century. As Part IV.A explained, the U.S. Supreme Court has held, multiple times and most recently in the 1989 *Duquesne* case, that the Constitution does not guarantee recovery of prudent costs. A utility has no constitutional right to have ratepayers cover its risks, even when the utility’s decisions are prudent. The very absence of that right is what supports this Commission’s statutory power to say—as it said in its 2015 and 2016 Orders—that it can disallow costs for reasons of prudence *or* non-usefulness.

3. OG&E accepted the risk spelled out by the Commission. OG&E might agree with the prior two points—that assigning risks and applying used-and-useful disallowances do not constitute Monday morning quarterbacking, and that prudence does not guarantee recovery—but then argue that it did not take the risk of an uneconomic outcome. Too late. In its 2015 Order denying pre-approval (a pre-approval which could have insulated OG&E from this risk), the Commission made clear that if OG&E pursued the scrubbers, it bore the risk of disallowance on grounds of both prudence and not-used-and-usefulness. OG&E then proceeded with the scrubbers, rather than try to fill the evidentiary gaps that caused the Commission to reject pre-approval. (I discuss the evidentiary and policy implications of OG&E's gap-filling failure in Part III.E above, relating to the Company's failure to prove prudence.) OG&E's action means that OG&E accepted the risk. And as I have explained, the filed rate doctrine requires the Commission to assume that the rates OG&E charged during the scrubber-spending period have compensated OG&E for that risk. OG&E cannot use hindsight to change the facts.

V. A disallowance's financial effects on OG&E should not deter the Commission from holding the Company accountable

Q. Explain the purpose of this Part V.

A. OG&E might argue that a disallowance will damage it financially. This concern has no logical relevance to the questions before the Commission:

1. Was the scrubber choice imprudent, either in 2014 or later?

2. Is continuing to operate Sooner today as a scrubbed, coal-fired power plant imprudent given the option of converting?

3. Did OG&E bear the risk that the scrubbers would not be economically useful?

4. Is a scrubbed Sooner economically useful?

5. What are the necessary consequences to OG&E of its actions, inactions, and risk-taking?

Accountability can hurt. But reducing a utility's accountability, merely because it hurts, undermines regulation's central purpose: to induce the performance that customers pay for and deserve. In this Part V, I explain that regulatory policy makes no promises about a utility's financial viability; and that insulating a utility from its errors causes harm to customers and to the public interest. Then I describe how OG&E witness Morin's testimony uses phrasing that could distract the Commission from these points.

A. Regulatory policy does not guarantee a utility's financial health

Q. Is a commission obligated to guarantee a utility's financial health?

A. No. On this question, confusion often arises—not because the law is unclear but because some people describe the law unclearly.

To satisfy constitutional and statutory commands, commissions must set rates that give the utility a reasonable opportunity to earn a fair return on capital expenditures, subject to two conditions: prudence and used-and-usefulness. If a utility's investments are imprudent or not-used-and-useful, regulators have no obligation to guarantee that utility's financial success or even its viability. Courts and commissions have said as much, multiple times.[74] Anyone who testifies or argues otherwise misleads this Commission.

This regulatory flexibility does come with four cautions.

First, a utility facing a major disallowance must have an opportunity at hearing to describe the harm.[75] This rate case provides that opportunity. Mr. O'Donnell testifies that Mr. Comings's recommended disallowance will neither render OG&E unable to serve nor leave it unable to raise capital. At hearing OG&E can contest Mr. O'Donnell's conclusions, but if those conclusions are valid OG&E, having had its hearing, cannot contest the Commission's authority to accept them.

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[74] *See, e.g., Covington & Lexington Tpk. Rd. Co. v. Sandford*, 164 U.S. 578, 596–97 (1896) ("If a corporation cannot maintain such a highway and earn dividends for stockholders, it is a misfortune for it and them which the Constitution does not require to be remedied by imposing unjust burdens on the public."); *Market St. Ry. Co. v. R.R. Comm'n of Cal.*, 324 U.S. 548, 567 (1945) ("The due process clause has been applied to prevent governmental destruction of existing economic values. It has not and cannot be applied to insure values or restore values that have been lost by the operation of economic forces."); *Appeal of McCool*, 128 N.H. at 140 (holding that a commission's "obligation to limit the rate base and other revenue-producing factors precludes a guarantee of survival to the utility, and it is no guarantee of freedom from hardship to the customers"); *Consumers Power Co*., Case No. U-7830 Step 3B, 1991 Mich. PSC LEXIS 119, at *133-36 (Mich. Pub. Serv. Comm'n May 7, 1991) ("The [federal and state] constitutions do not guarantee that Consumers [Power] will earn, or have the opportunity to earn, its authorized rate of return if it engages in unreasonable or imprudent activities. Likewise, the constitutions do not require the Commission to establish Consumers' rates based on whether those will permit it to achieve a particular coverage ratio or common equity ratio . . . .").

[75] *Jersey Central Power & Light v. FERC*, 810 F.2d 1168, 1175-82 (D.C. Cir. 1987).

Second, a regulatory decision to "arbitrarily switch back and forth between methodologies in a way which required investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others" will raise constitutional concerns.[76] To eliminate the switching-back-and-forth problem in used-and-useful context, I recommended in Part IV.D.3, and Mr. Comings recommends in his testimony, this protection: If the Commission disallows costs because the scrubber investment is not economically useful, it should allow OG&E to seek recovery of those disallowed costs later, if and when future facts show that its decision turned out to be economically useful.

Third, if the Commission guarantees cost recovery prior to an expenditure, it cannot change its mind after the expenditure. That concern does not apply here, because the Commission had made no guarantee. Its 2015 Order not only rejected OG&E's request for a pre-approval guarantee; it expressly assigned OG&E the risk of disallowances on grounds of both imprudence and not-used-and-usefulness. The Commission made no promises.

Fourth, where the incumbent is the customers' sole possible supplier, then out of desperation a commission might consider forcing customers to pay for the utility's mistakes rather than let the utility become non-viable. That was the Louisiana Supreme Court's interpretation of Louisiana law, when it upheld the state commission's decision

[76] *Duquesne Light Co.*, 488 U.S. at 315. This switching abuse arises only in the used-and-useful context (which the *Duquesne* Court was addressing), not in the prudence context. Why? Because switching involves inconsistency in assigning the risk of uneconomic outcomes. Prudence involves judging performance, not assigning risk of uneconomic outcomes.

to make ratepayers pay for $600 million in imprudent utility costs.[77] That treatment, nearly unprecedented in United States utility regulation, is unnecessary here. As I will explain in the Conclusion, OG&E is neither indispensable nor irreplaceable. Ratepayers have neither obligation nor need to cover for OG&E's errors and risks.

B. Protecting a utility from its errors causes five harms to ratepayers

Q. How would protecting OG&E from its errors affect ratepayers?

A. Reducing OG&E's accountability for imprudent or uneconomic expenditures would cause the public interest at least five distinct harms.

1. Subsidies: The Commission should apply economic efficiency's first principle: Cost-causers must be the cost-bearers. Making ratepayers cover a utility's errors and risks commits the sin of subsidy—someone bears a cost that someone else caused.

2. Dulled motivation: Economic consequences, logically and predictably applied, induce businesses to avoid mistakes and improve performance. Competitive markets induce performance because the seller's choice is stark: Please the customer or lose the customer. In non-competitive markets, the utility can't lose the customer, so to induce performance, we need consequences. Cutting the consequence dulls the inducement.

3. Corrosion of culture: Pleading financial harm to avoid appropriate consequences reflects, and embeds, a culture of entitlement, a sense that the utility is owed its monopoly franchise regardless of performance. The effect is to reverse right and wrong: to insist on accountability is destructive, to resist accountability is

[77] *Gulf States*, 578 So. 2d. at 89, 95-96.

productive. Only if investors feel the natural consequences of their utility's actions will they pressure executives to improve performance. A utility should feel privileged to serve, not entitled to serve. Making ratepayers cover its bets turns that reasoning around.

4. Distraction from the relevant: Framing the question as "What consequence can the company absorb?" distracts from the correct question: "What consequence does the company deserve?" To decide what the company deserves, a commission should ask: What were the harms? What actions or inactions were the cause? What consequences will redress the harms? Beyond redress, what consequences will cause the company to change its ways?

5. Distortion of competition: When government treats some firms as "too big to fail" it lowers their risks. That risk reduction gives them a cost-of-capital advantage over their competitors. That competitive advantage is unrelated to merit; it is unearned. Unearned advantages distort competition on the merits, making customers and citizens worse off. For 30 years, the nation has introduced competition to transform our historically monopolistic electricity, gas, and telecommunications sectors. If we want competition on the merits, we must eliminate unearned advantages. If we protect incumbent utilities from their errors by giving them cost-of-capital advantages, prospective competitors will go away, making too-big-to-fail a self-fulfilling prophecy.

C. Dr. Morin's imprecise language implies that ratepayers should cover OG&E's mistakes and risks

Q. Does Dr. Morin's return-on-equity testimony provide the Commission with objective principles?

A. In important ways, no. Dr. Morin uses language suggesting that the Commission make ratepayers OG&E's protectors. His message conflicts with two principles on which responsible regulation rests. First, costs arising from utility errors or utility risk-taking are not the ratepayers' responsibility. Second, so-called "supportive regulation" must support prudent performance and economical risk-taking, not utility imprudence or inefficient risk-shifting. Dr. Morin's omissions and imprecisions—about rating agency reactions, "regulatory environment," and "supportive regulation"—should not divert the Commission from its mission: compensating utilities based on their performance, while holding them accountable for that performance.

1. Costs arising from utilities' imprudence or their risk-taking are not the ratepayers' responsibility

Q. Does Dr. Morin describe a regulator's rate-setting responsibilities accurately?

A. No. He states: "Under the traditional regulatory process, a regulated company's rates should be set so that the company recovers its costs, including taxes and depreciation, plus a fair and reasonable return on its invested capital."[78] This statement makes three obvious errors. First, lawful rates provide only an opportunity to recover costs and a fair return; recovery is not guaranteed.[79] Second, the "costs" that receive this opportunity are only reasonable costs—costs that are prudent, and associated with assets that are used and useful, physically and economically. So third, the "fair and reasonable return" is available only for prudent invested capital, and only when that capital yields an asset that is used and useful. These errors are not minor wording glitches; they are fundamental mischaracterizations of regulatory principles that the regulatory profession, commissions, and courts have applied for a century.

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[78] Morin Direct Testimony at 9, lines 13-15.

[79] *See* Part V.A above.

Dr. Morin errs again when testifying that the consequences of a bond downgrade "include a substantial increase in ratepayer burden."[80] This statement's certainty makes it a falsity. If the downgrade's source is either the utility's poor performance or the uneconomic outcomes of the risks it accepted, cost responsibility for the downgrade lies with shareholders, not ratepayers. Regulatory professionals do not debate this point.

My four corrections to Dr. Morin's testimony make the difference between a utility that is accountable for performance and one whose profitability is indifferent to performance. And they align with the very *Bluefield* opinion he cites. The *Bluefield* Court stated: "The return should be reasonable, sufficient to assure confidence in the financial soundness of the utility, and should be adequate, *under efficient and economical management*, to maintain and support its credit and enable it to raise money necessary for the proper discharge of its public duties."[81] The phrase "efficient and economical management" makes clear that ratepayers don't pay for inefficient or uneconomical management.

Prudence and risk-taking therefore are limits on investors' (including bondholders') expectations for regulatory outcomes. Dr. Morin insists that the "allowed rate of return must necessarily reflect the ... investors' return requirements."[82] If by "allowed" he means "authorized," and if by "requirements" he refers to the authorized rate of return necessary to match the return available from investments of comparable

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[80] Morin Direct Testimony at 7, lines 20-23.

[81] *Id.* at 692 (quoted by Dr. Morin, Direct Testimony at 10) (emphasis added).

[82] Morin Direct Testimony at 9, lines 15-17.

risk, he is correct. The term "must" implies a legal requirement—also correct. Dr. Morin therefore must agree with my explanation in Part IV.D, that:

1. because the filed rate doctrine requires us to treat existing rates as lawful rates; and

2. because those lawful rates reflected "investors' return requirements"; and

3. because those return requirements embedded in the Commission-set rates reflected the risk, imposed by the Commission, of investing non-Commission-approved dollars in scrubbers that could be uneconomical; then

4. investors already have been compensated for the risk of an uneconomical outcome.

So, if the Commission finds that the scrubbers were either imprudent or not used-and-useful, the Commission must marry risk compensation with cost consequence by disallowing the excess cost. Dr. Morin also must agree with something he does not say: that "investors' return requirements" do not include being compensated, through the authorized return on equity, for the risk that the Commission will find imprudence. Otherwise, he would be saying that the Commission must satisfy investors' "requirements" whatever they are. Saying that would ignore nearly a century of precedent, beginning with the *Bluefield* opinion he cites, but describes inaccurately. The regulatory duty is to satisfy only legitimate investor expectations, not all investor expectations. Investors' legitimate expectation—their legally protected expectation—is for the utility to have a reasonable opportunity to earn a fair return on investment that is prudent and used and useful, and to recover only those costs incurred "under efficient and economical management."

2. "Supportive regulation" must support prudent performance and economical risk-taking

Q. Does Dr. Morin discuss the need for regulatory "support" objectively?

A. No. Dr. Morin insists on regulatory "support" six different times.[83] But mantras are not principles; repetition is not persuasion. As with his discussion of "required return" and "bond downgrading," he divorces his insistence from OG&E's performance. Illustrating the problem is his quote from Fitch: "Fitch believes that the regulatory environment in Oklahoma has become challenging underscored by the unfavorable rate case outcomes in 2017 and 2018 and the uncertain treatment of environmental compliance investment resulting in higher operating risks and weaker financial metrics . . . ."[84] On each of these outcomes—the two rate cases and the environmental compliance investment—Fitch omits the context and Dr. Morin fails to provide it. But candor requires context. Consider:

The 2017 Rate Order:[85] Fitch nowhere mentions how the Commission described OG&E witness Hevert's recommended return on equity: as "excessive in that each of his methods and the inputs he used appear to have been biased upward, resulting in a significantly inflated recommendation."[86] Nor does Fitch note the Commission's concern that OG&E's capital structure overemphasizes equity.[87] Nor does Fitch mention

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[83] See Morin Direct Testimony at 7, line 25; 9, line 7; 52, line 1; 54, line 23; 55, line 29; 55, line 30.

[84] Morin Direct at 55, lines 9-12 (quoting Fitch communication of Aug. 1, 2018).

[85] The Commission issued the 2017 Rate Order, Order No. 662059, in Cause No. PUD 201500273 on March 20, 2017. The Commission there rejected the return on equity proposed by OG&E witness Hevert, 10.25 percent. Instead, the Commission adopted a return on equity of 9.50 percent, which it described as within the range of values proposed by various intervenor witnesses. 2017 Rate Order at 4-5.

[86] 2017 Rate Order at 5.

[87] *Id.*

that OG&E failed to provide "sufficient support" for its proposed short-term incentive compensation of $14 million.[88] Nor does Fitch mention the Commission's finding that OG&E had no persuasive evidence for making ratepayers pay for 25% of long-term incentive compensation.[89] Dr. Morin severs Fitch's bare, under-informing quote from the factual context he omits. By doing so, he attaches himself to Fitch's apparent view that "regulatory support" is disconnected from regulatory responsibility.

The 2018 Rate Order:[90] The 2018 Rate Order, also complained of by Fitch (as quoted by Dr. Morin) adopted a stipulation that OG&E itself signed. Dr. Morin and Fitch omit that fact. It is illogical to attack as lacking "regulatory support" a rate outcome sought by the utility.

The treatment of environmental compliance investment: About the "uncertain treatment of environmental compliance investment," who's to blame? Missing from Fitch's statement, and missing from Dr. Morin's testimonial passage that copies that statement, is the long list of Commission dissatisfactions, listed in the 2015 Order, addressing that very environmental compliance investment. The Commission there found that OG&E had—

> failed to "model non-emitting wind energy as an alternative energy source to maintain the Company's desired diversity in fuel portfolio when considering compliance with EPA regulations," Finding of Fact 11;

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[88] *Id.* at 7.

[89] *Id.* at 7.

[90] The Commission issued the 2018 Rate Order, Order No. 679358, in Cause No. PUD 201700496 on June 19, 2018. The 2018 Order approved a stipulation among the parties. According to the stipulation, OG&E agreed to reduce its Oklahoma revenue by $64 million. This new revenue requirement included an authorized full return component "calculated using 1) the last Commission approved ROE before this Cause; and 2) the Company's capital structure and cost of debt, as filed in the Direct Testimony and Application Package in this Cause." Exhibit A to the 2018 Order at 9-10.

failed to “include any other resource options-such as additional wind or other renewables, power purchase agreements, demand-side management options or purchasing existing generation facilities-in its economic analysis,” Finding of Fact 14;

failed to “include a carbon tax in the Base Case, but instead ran a single carbon price sensitivity,” Finding of Fact 15;

failed to “demonstrate the financial benefit of its selected plan over potential alternatives.,” Finding of Fact 17;

failed to “attempt to quantify the value of fuel diversity in its planning process,” Finding of Fact 18;

failed to have sufficient knowledge about “the point at which fuel diversity favors selection of one portfolio option over another,” Finding of Fact 18;

failed to update its load forecast, which was “based upon information that is two years old,” Finding of Fact 20; and

failed to “conduct a Request for Proposals for market alternatives to its proposal to either replace, retrofit, or convert the Sooner and Muskogee coal units,” Finding of Fact 23.

I agree with Fitch—the “treatment of environmental compliance investment” remains “uncertain”—not only because of the above-listed deficiencies, but also because the Commission’s 2016 order evaporated when the Oklahoma Supreme Court found lawless the legal argument advanced by OG&E.[91] And so on the question of environmental investment uncertainty, and the lack of “regulatory support,” who’s to blame?

In short, the “challenging” environment and “uncertain” treatment Fitch complains of, and that Dr. Morin relies on unconditionally, have a single common source: OG&E’s failures and decisions—its failure to provide sufficient evidence in its request

[91] *Sierra Club v. Okla. Corp. Comm’n*, 2018 OK 31, 417 P.3d 1196, 1205 (Ok. 2018) (holding that Commission cannot grant pre-approval outside of section 286, and cannot “grant pre-approval in a way completely untethered from the project’s effect on ratepayers”).

for pre-approval under Section 286; its failure to use a lawful theory to get approval under 17 O.S. § 152; and its decision to keep spending on scrubbers—after failing to get any regulatory commitment to cost recovery, after failing to monitor gas price forecasts, and after changes in plant operation reduced SPP revenues. For Dr. Morin to blame these uncertainties on a lack of "regulatory support," then to insist the Commission resolve them in OG&E's favor, is to divorce regulation from performance.

Having pointed his blame-finger at the Commission instead of OG&E (using Fitch as his pointer), Dr. Morin offers this: "[A] decision in this cause can relieve apprehension over the Company's risk profile and financial metrics."[92] But as I explained in Part IV.D.2 above, the existing rates already compensate OG&E's investors for legitimate uncertainties. The Commission's job is to set just and reasonable rates—rates that reflect efficient performance. OG&E's job is to achieve that performance. If both entities do their jobs, Dr. Morin's apprehension will be relieved.

Q. What are your concluding comments on Dr. Morin's treatment of rate-setting principles and "supportive" regulation?

A. Dr. Morin's imprecisions and omissions, on case law and on facts, are not random. They all line up on one side of the ledger: Investor returns should be independent of utility performance. Perhaps his rebuttal will take offense, asserting that I've twisted his words or taken them from context. Let him clarify his words and describe the context. Let him upgrade his testimonial boilerplate so that it helps the Commission carry out its public interest mission—establishing rates that induce the utility performance that Oklahomans deserve.

[92] Morin Direct Testimony at 55, lines 27-28.

VI. Clear rulings on prudence and used-and-usefulness will help OG&E's executives to cease misconstruing the 2016 Order

Q. Explain the importance to Oklahoma of the Commission making clear rulings on prudence and used-and-usefulness.

A. Certain features of the 2016 Order have caused OG&E's top executives to create incorrect impressions of its effects. I agree with Dr. Morin that investors react to regulatory signals. By making those signals clear, and by insisting that utility executives understand those signals and describe them forthrightly, the Commission will promote one of regulation's main purposes: causing appropriate amounts of capital to flow to Oklahoma's utilities at appropriate prices.

Q. Explain your concerns about how OG&E's executives discussed the 2016 Order.

A. To recap the essential background: The 2015 Order rejected OG&E's bid for pre-approval of its Environmental Compliance Plan (which included the possibility of scrubbers at Sooner). Several months later, OG&E initiated the proceeding leading to the 2016 Order. In that proceeding, OG&E sought "only approval of [its] decision" to install scrubbers at Sooner. OG&E said it was "not seeking any determination on the reasonableness or recovery of the costs of the scrubbers at this time."[93] The Commission's 2016 Order then found that "the decision to scrub the Sooner Plant is—no more or no less—reasonable."[94]

Despite finding the scrubber decision "reasonable," the 2016 Order said the Commission would "examine the prudency" of the scrubber decision in the next rate

[93] 2016 Order at 9.

[94] *Id.* at 10.
[95] *Id.*

case.[95] Doing so, the Commission said, would enable it to "take necessary action to disallow any unreasonable and/or imprudent costs associated with scrubbing."[96]

Given the Commission's express intent to examine the scrubber decision later, "any" unreasonable or imprudent costs includes costs arising not only from implementing the scrubber decision but from the decision itself.

Q. How did OG&E's top executives describe the 2016 Order?

A. In earnings calls, OG&E's executives ignored the tension between two features of the 2016 Order: the Commission deeming the scrubber decision "reasonable," while reserving full authority to question the decision's prudence and its outcome's usefulness. Normally, a finding of reasonableness constrains future regulatory actions, but the 2016 Order's language leaves the Commission fully unconstrained. The communications I next describe omit this absence of constraint.

Consider first how Sean Trauschke, OG&E's Chief Executive Officer, characterized the 2016 Order on two earnings calls:

> 5-5-16 (2016 Q1): "We were pleased that the Oklahoma commission has approved our application, seeking approval to install the scrubbers at the Sooner plant. . . .I want to thank all the parties, including the OG&E members, the OCC staff, the commissioners, the Attorney General's office and the Oklahoma Industrial Group for working diligently to bring this cause to a conclusion."
>
> 5-3-18 (2018 Q1): [Referring to the Oklahoma Supreme Court decision] ". . . . [L]ast week a ruling was issued against the OCC, finding they did not have the authority to grant pre-approval of our scrubbers at Sooner under the statue used. This does not change the intent or the unanimous

[95] *Id.*

[96] *Id.*

[97] I attach relevant excerpts from these earnings calls as Exhibit SH-2.

approval of the commission to the reasonableness of our plan, and we'll work with the commission to resolve this in our filing later this year."[97]

Anyone relying on Mr. Trauschke's statements as a substitute for reading the 2016 Order, and for reading the Supreme Court's opinion vacating that Order, would deserve forgiveness for understanding him to imply certainty of recovering the scrubber investment and earning a return on that investment. Specifically:

The 5-5-16 call: When you are risking $400-500 million on a project, telling financial analysts you are "pleased" with a regulatory order implies that the order removed the risk; that cost recovery and earnings will follow. In that same conversational context, saying that your application was "approved" has to mean approval of what is important to the company financially—cost recovery of and earnings on the investment. But the Commission explicitly left all its decisions—the prudence and usefulness of the scrubber itself and all the associated costs and earnings—unconstrained. And "thanking" the parties means thanking them for something of value received. But the only thing of value OG&E could have received from the 2016 Order was a commitment to cost recovery and profit—both of which, again, the Commission declined to provide. As for "[b]ringing the cause to a conclusion," the emphasis on "conclusion" necessarily means "successful" conclusion; *i.e.*, a Commission decision removing OG&E's risk—which the Commission expressly did not do. If the conference call were a call with engineers trying to solve an environmental compliance problem, then perhaps the word "conclusion" could refer to overcoming an obstacle to construction progress. But this conference call was an earnings call, a call with people who communicate with

[97] I attach relevant excerpts from these earnings calls as Exhibit SH-2.

investors, so the subject was money. The only possible conclusion Mr. Trauschke could have been referring to was the conclusion of cost recovery and earnings.

It gets worse. In this same 5-5-16 call the first questioner said: "[C]ongratulations, you finally—or the commission and OG&E finally got together on the scrubbers." The phrase "finally got together," and the "congratulations," coming from a financial analyst, had to mean "came to an understanding on cost recovery and earnings," and "Congratulations—you're getting your money." Yet neither Mr. Trauschke nor Chief Financial Officer Stephen Merrill (who also was on the call) corrected this misimpression; neither man informed the questioner that the 2016 Order provide no "getting together" on "any" cost—that it provided no cause for congratulations because the Commission left open the possibility of disallowing every single dollar of the scrubber investment to the extent the scrubber decision was imprudent or turned out to be non-useful. Even worse, when next asked about the rate case schedule, Mr. Merrill said there would be a "general rate case towards the end of '18, which would pick up on the scrubbers when they finally go into service." In the context of the CEO announcing an "approval" of the scrubbers, and a financial analyst congratulating him on the Commission and OG&E "finally getting together on the scrubbers," the phrase "pick up on the scrubbers" had to mean "include their full cost in rate base." What else could "pick up on the scrubbers" mean? "Debate their prudence and usefulness, with the possibility of full disallowance?" Hardly.

Anyone listening to this call or reviewing this transcript, and not having read the 2016 Order and the Supreme Court order vacating it, would reasonably conclude that the Commission had promised cost recovery and return.

The 5-3-18 call: A similar tendency to under-inform occurred in the 5-3-18 call. Mr. Trauschke referred to the Commission's "intent" about the "reasonableness of our [scrubber] plan." The word "intent" refers to the future. The only thing left for the Commission to do in the future is award cost recovery and profit—the very thing the Commission's 2016 Order explicitly denied any specific intent to do.

Q. Should the OG&E executives' statements influence how the Commission decides the scrubber issue now?

A. No. The Commission should feel no obligation to approve cost recovery and return just because Mr. Trauschke and Mr. Merrill, or the financial analysts they spoke to, might have led OG&E's investors to expect recovery and return. Doing so would place the penalty for these communications on the ratepayers. The ratepayers are blameless. Should stock or bond prices fall because the Commission's rate decision disappoints investors, the blame belongs with OG&E and its executives. OG&E failed to produce useful evidence for the 2015 Order. OG&E offered the law-ignoring theory that led to the evaporation of the 2016 Order. OG&E's executives omitted in earnings calls the key caveats that made cost recovery and earnings uncertain—uncertainty that the Commission explicitly intended. If the Commission's decisions in this case disappoint investors, they must direct their disappointment at OG&E's executives. This Commission's responsibility is to put the 2016 Order aside and ask the central questions anew: Was OG&E prudent? Is this investment used and useful?

Q. Does the combination of the 2016 Order's language and the Supreme Court's opinion have any other implication?

A. Yes. Given the 2016 Order's unexplained juxtaposition of (a) a finding that the scrubber is "reasonable" and (b) a reservation of authority to find the scrubber imprudent or non-used-and-useful, and given the Supreme Court's opinion vacating the Order, the

Commission has no choice but to treat the eight findings favorable to the scrubbers[98] as never having been made. These findings lack validity for two reasons: They were based on the same factual record that the Commission held inadequate in its 2015 Order, and they were based on an incorrect legal theory that purported to make cost and ratepayer impact irrelevant. Findings that were "untethered from [a] project's effect on ratepayers"[99] cannot form the basis for a decision on prudence or usefulness. Given the confusion and misconstructions that have arisen from the 2016 Order, the Commission's surest path to credibility—one that avoids any risk that its invalidated 2016 Order prejudged the instant case—is to assess, afresh, whether the facts show imprudence or non-usefulness; or whether, alternatively, the facts OG&E has offered fail to prove prudence.

[98] 2016 Order at 10-12.

[99] *Sierra Club v. Okla. Corp. Comm'n*, at ¶ 29.

Conclusion

Q. Summarize your testimony.

A. I have provided principles and criteria by which the Commission should apply the prudence and used-and-useful standards to OG&E's actions and inactions. Prudence review protects ratepayers from a utility's departures from reasonable utility practices. Used-and-useful review makes utilities accountable for the risks they take. Used-and-useful review has both a physical dimension and an economic dimension. The economic dimension, part of regulatory law and policy for nearly a century, is triggered when a utility has taken the risk that a prudent choice produces results less desirable than other available choices.

Regulation owes utilities a reasonable opportunity to earn a fair return on investment that is both prudent and used and useful. So a disallowance's effect on a utility's financial condition should not deter a commission from causing a utility to live with its decisions' consequences. To do otherwise would create a moral hazard, where the bigger the utility's chosen risks and the bigger its mistakes, the more likely ratepayers end up covering the consequences.

Mr. O'Donnell shows that the disallowance will leave OG&E able to serve and able to raise capital. His analysis aside, OG&E is not irreplaceable. It is not a "systemic" bank whose failure could bring down the economy. A bank's value is its assets. Its assets are financial. When its money disappears, the assets are gone. A utility is different. Its finances may fail, but its assets—its generators, its transmission network, its distribution system, its wholesale contracts—all survive. And customers—the ones who loyally pay monthly the money needed to finance and operate these assets—also will survive. So the necessary funds will flow—under FERC regulation for wholesale sales and under state regulation for retail sales. The utility's successor can step into its role, take over the assets, hire the predecessor's employees, service the contracts, and supply the customers. Over the past 30 years, nearly 100 acquisitions of utilities prove that should an opportunity arise to take over OG&E's government-protected franchise, there will be takers.[100] OG&E is neither indispensable nor irreplaceable.

Q. Does OG&E have reason to seek to suppress your testimony as legal analysis?

A. No, because I offer no legal interpretations of Oklahoma law. That's the attorneys' job. I don't describe the boundaries of the Commission's legal discretion; rather, I present policy principles for the Commission to use when it exercises that legal discretion. OG&E has no cause to suppress my testimony because every principle I present provides the Company an objective opportunity to seek recovery and return.

Where useful, I have provided examples of how other commissions applied these policy principles, along with court decisions that have upheld those principles. That other bodies have used, and courts have upheld, the principles I recommend does not convert my policy recommendations into legal analysis. These references let the Commission know that each of my recommendations fits within the mainstream of regulatory practice. Without them, this document would be less useful to the Commission. And if my testimony omitted these precedents, OG&E then might mis-describe recommendations it dislikes as "unprecedented."

[100] For a long list of many of those acquisitions, and some reasons why they occur, *see* Hempling, "Inconsistent with the Public Interest: FERC's Three Decades of Deference to Electricity Consolidation," *Energy Law Journal* (Fall 2018), available at https://www.eba-net.org/assets/1/6/15-233-312-Hempling_[FINAL]1.pdf.

Rate of return witnesses like Dr. Morin routinely cite cases like *Bluefield* and *Hope*. They do so to show that the principles they espouse fall within legal boundaries (although as I explained in Part V.C, Dr. Morin's citations, and his use of them, lack evenhandedness). That I am licensed as a lawyer and he is not should not cause a difference in whether our submissions are received. In any event, opposing counsel are free to cross-examine me, as a policy witness, on each of my recommendations and their consistency with other bodies' decisions. The resulting dialogue between witness and opposing attorney, on the foundations and principles of regulatory practice, will assist the Commission's decision-making. There is no public interest in preventing it.

OG&E has already consumed much of the Commission's and the parties' time with an evidence-lacking submission in Cause PUD 201400229 and a law-ignoring application in Cause PUD 201600059. I hope the Company now will welcome my submission as an opportunity to discuss and use clear regulatory policies, thereby producing a Commission decision that the Oklahoma Supreme Court will uphold.

Q. Does this conclude your Responsive Testimony?

A. Yes.

Exhibit SH-1: Resume of Scott Hempling

Scott Hempling, Attorney at Law

Scott Hempling is an attorney, expert witness and teacher. As an attorney, he has assisted clients from all industry sectors—regulators, utilities, consumer organizations, independent competitors and environmental organizations. As an expert witness, he has testified numerous times before state commissions and before committees of the United States Congress and the legislatures of Arkansas, California, Maryland, Minnesota, Nevada, North Carolina, South Carolina, Vermont, and Virginia. As a teacher and seminar presenter, he has taught public utility law and policy to a generation of regulators and practitioners, appearing throughout the United States and in Canada, Central America, Germany, India, Italy, Jamaica, Mexico, New Zealand, Nigeria and Peru.

The first volume of his legal treatise, *Regulating Public Utility Performance: The Law of Market Structure, Pricing and Jurisdiction*, was published by the American Bar Association in 2013. It has been described as a "comprehensive regulatory treatise [that] warrants comparison with Kahn and Phillips." The second volume will address the law of corporate structure, mergers and acquisitions. His book of essays, *Preside or Lead? The Attributes and Actions of Effective Regulators*, has been described as "matchless" and "timeless"; a Spanish translation has circulated throughout Latin America, through the auspices of the Asociación Iberoamericana de Entidades Reguladoras de la Energía, REGULATEL (an association of telecommunications regulators from Europe and Latin America) and the World Energy Forum. The essays continue monthly at www.scotthemplinglaw.com.

His articles have appeared in the *Energy Bar Journal*, the *Electricity Journal*, *Energy Regulation Quarterly*, *Public Utilities Fortnightly*, *ElectricityPolicy.com*, publications of the American Bar Association, and other professional publications. These articles cover such topics as mergers and acquisitions, the introduction of competition into formerly monopolistic markets, corporate restructuring, ratemaking, utility investments in nonutility businesses, transmission planning, renewable energy and state–federal jurisdictional issues. From 2006 to 2011, he was the Executive Director of the National Regulatory Research Institute.

Hempling is an adjunct professor at the Georgetown University Law Center, where he teaches public utility law and has taught regulatory litigation. He received a B.A. *cum laude* in (1) Economics and Political Science and (2) Music from Yale University, where he was awarded a Continental Grain Fellowship and a Patterson research grant. He received a J.D. *magna cum laude* from Georgetown University Law Center, where he was the recipient of an *American Jurisprudence* award for Constitutional Law. He is a member of the District of Columbia and Maryland Bars. More detail is available at www.scotthemplinglaw.com.

Education

B.A. *cum laude*, Yale University (two majors: Economics and Political Science, Music), 1978. Recipient of a Continental Grain Fellowship and a Patterson Research grant.

J.D. *magna cum laude*, Georgetown University Law Center, 1984. Recipient of *American Jurisprudence* award for Constitutional Law; editor of *Law and Policy in International Business*; instructor, legal research and writing.

Professional Experience

President, Scott Hempling, Attorney at Law LLC (2011–present).

Adjunct Professor, Georgetown University Law Center (2011–present).

Executive Director, National Regulatory Research Institute (2006–2011).

Founder and President, Law Offices of Scott Hempling, P.C. (1990–2006).

Attorney, Environmental Action Foundation (1987–1990).

Associate, Spiegel and McDiarmid (1984–1987).

Past Clients

Independent Power Producers and Marketers

California Wind Energy Association, Cannon Power Company, Electric Power Supply Association, EnerTran Technology Company, National Independent Power Producers, SmartEnergy.com, U.S. Wind Force.

Investor-Owned Utilities

Madison Gas & Electric, Oklahoma Gas & Electric.

Legislative Bodies

Vermont Legislature, South Carolina Senate.

Municipalities and Counties

American Public Power Association; Connecticut Municipal Electric Energy Cooperative; Iowa Association of Municipal Utilities; City of Jacksonville, Florida; Montgomery County, Maryland; Texas Cities; City of Winter Park, Florida.

Public Interest Organizations

Alliance for Affordable Energy, American Association of Retired Persons, Consumer Federation of America, Energy Foundation, Environmental Action Foundation, GRID2.0

(Washington, D.C.), D.C. Consumer Utility Board, Illinois Citizens Utility Board, Union of Concerned Scientists.

Regulatory Commissions and Consumer Agencies

Arkansas Public Service Commission, Arizona Corporation Commission, British Columbia's Office of the Auditor General, Connecticut Department of Public Utility Control, Connecticut Office of Consumer Counsel, Delaware Public Service Commission, Hawai'i Public Utilities Commission, Hawai'i Office of Planning, Indiana Utility Regulatory Commission, Kansas Corporation Commission, State of Maryland, Maryland Energy Administration, Maryland Attorney General, Maryland Office of People's Counsel, Massachusetts Attorney General, Massachusetts Department of Public Utilities, Mexico's Comisión Reguladora de Energía, Minnesota Public Utilities Commission, Mississippi Public Service Commission, Mississippi Public Utilities Staff, Missouri Public Service Commission, Montana Public Service Commission, National Association of Regulatory Utility Commissioners, Nevada Consumer Advocate, Nevada Public Service Commission, New Hampshire Public Utilities Commission, New Jersey Division of Ratepayer Advocate, North Carolina Utilities Commission, Ohio Public Utilities Commission, Oklahoma Corporation Commission, Pennsylvania Office of Consumer Advocate, Puerto Rico Energy Commission, South Carolina Public Service Commission, Texas Office of Public Utility Counsel, Vermont Department of Public Service, Virginia State Corporation Commission, Wisconsin Attorney General.

Testimony Before Legislative Bodies

United States Senate

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United States House of Representatives

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Subcommittee on Energy and Power, Sept. 1988 (discussing "independent power producers" and PUHCA).

State Legislatures

Judiciary Committee, South Carolina Senate (2000) (discussing options for introducing retail electricity competition).

Commerce Committee, Arkansas General Assembly (1999) (discussing legislation to introduce retail electricity competition).

Health Access Oversight Committee, Vermont General Assembly (1999) (discussing options for state regulation of prescription drug pricing).

Electricity Restructuring Task Force, Virginia General Assembly (1999) (discussing options for introducing retail electricity competition).

Study Committee, North Carolina Legislature (1999) (discussing legislation to introduce retail electricity competition).

Committees on General Affairs, Finance, Vermont Senate (February-March 1997) (discussing options for structuring the electric industry).

Task Force to Study Retail Electric Competition, Maryland General Assembly (1997) (discussing options for introducing retail electricity competition).

Interim Committee on Electric Restructuring, Nevada Legislature (1995-97) (discussing options for structuring the electric industry).

Committee on Energy and Public Utilities, California Senate (December 1989) (discussing relationships between electric utilities and their non-regulated affiliates).

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District of Columbia Public Service Commission: Canadian holding company acquisition of retail natural gas company (2017).

Maryland Public Service Commission: Canadian holding company acquisition of retail natural gas company (2017).

Kansas Corporation Commission: Utility holding company acquisition of utility holding company (2016-2017).

U.S. District Court for Middle District of Florida: Effect of disaffiliation, mandated by Public Utility Holding Company Act, on corporation's liability under the Comprehensive Environmental Response, Compensation, and Liability Act (2016).

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Vermont Public Service Board: Cost allocation and interaffiliate pricing between service company and utility affiliates (1990).

Publications

Books

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Preside or Lead? The Attributes and Actions of Effective Regulators (2d edition 2013).

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"Inconsistent with the Public Interest: FERC's Three Decades of Deference to Electricity Consolidation," *Energy Law Journal* (Fall 2018), available at https://www.eba-net.org/assets/1/6/15-233-312-Hempling_[FINAL]1.pdf.

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"Depolarizing the Debate: Can Retail Wheeling Coexist with Integrated Resource Planning?" *The Electricity Journal* (Apr. 1994).

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"Making Competition Work," *The Electricity Journal* (June 1993).

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"The Retail Ratepayer's Stake in Wholesale Transmission Access," *Public Utilities Fortnightly* (July 19, 1990).

"Preserving Fair Competition: The Case for the Public Utility Holding Company Act," *The Electricity Journal* (Jan./Feb. 1990).

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"The Legal Standard of 'Prudent Utility Practices' in the Context of Joint Construction Projects," *NRECA/APPA Newsletter Legal Reporting Service* (Dec. 1984/Jan. 1985) (co-author).

Speaker and Lecturer

United States: American Antitrust Institute; American Association of Retired Persons; American Bar Association; American Power Conference; American Public Power Association; American Wind Energy Association; Chicago Bar Association (Energy Section); Columbia University Institute for Tele-Information; Electric Cooperatives of South Carolina; Electric Power Research Institute; *Electric Utility Week;* Electricity Consumers Resource Council; Energy Bureau; *Energy Daily;* Executive Enterprises; Exnet; Federal Energy Bar Association; Harvard Electricity Policy Group; Indiana State Bar Association; Infocast; King Abdullah Petroleum Studies and Research Center; Louisiana Energy Bar; Management Exchange; Maryland Resiliency Through Microgrids Task Force; MIT Energy Initiative; Michigan State University Public Utilities Institute; Mid-America Association of Regulatory Commissioners; MidAtlantic Demand Resources Initiative; Mid-Atlantic Conference of Regulatory Utility Commissioners; National Association of Regulatory Utility Commissioners; National Association of State Utility Consumer Advocates; National Conference of Regulatory Attorneys; National Governors Association; National Independent Energy Producers; New England Conference of Public Utility Commissioners; New England Public Power Association; New Mexico State University Regulatory Studies Program; New York Bar Association (Energy Section); North Carolina Electric Membership Corporation; Pennsylvania Bar Institute; Puerto Rico Energy Center; Puerto Rico Institute of Public Policy; Regulatory Studies programs at

Michigan State University, New Mexico State University and University of Idaho; Society of American Military Engineers; Society of Utility and Regulatory Financial Analysts; Southeastern Association of Regulatory Utility Commissioners; Universidad del Turabo (Puerto Rico); United Nations Association at Georgetown Law; U.S. Department of Energy Forum on Electricity Issues; U.S. Department of Energy Solar Energies Technology Office; U.S. Environmental Protection Agency; Western Interstate Energy Board; Wisconsin Public Utilities Institute; Wisconsin Bar-Public Utilities Section; Yale Alumni in Energy; Yale School of Forestry and Environmental Studies.

International: Australian Competition and Consumer Commission; Australian Energy Regulator; Bergen Center for Competition Law & Economics, University of Bergen (Norway); British Columbia Utilities Commission; Canadian Association of Members of Utility Tribunals; Canadian Energy Law Forum; Central Electric Regulatory Commission (India); Comisión Reguladora de Energía (Mexico); The Energy and Resources Institute (India); Government & Policy Think Tank, Sharif University Institute of Technology (Iran); Independent Power Producers Association of India; India Institute of Technology at Kanpur; Ludwig-Maximilians-Universitat (Munich, Germany); Management Development Institute (Gurgaon, India); National Association of Water Utility Regulators (Rome, Italy); New Zealand Electricity Authority; New Zealand Commerce Commission; Nigeria Electric Regulatory Commission; Office of Utility Regulation of Jamaica; OSIPTEL (the Peruvian Telecom Regulator) Training Program on Regulation for University Students; Petroleum and Natural Gas Regulatory Board (India); Regulatel (an international forum of telecommunications regulators); Regulatory Policy Institute (Cambridge, England); Utilities Regulatory Authority of Vanuatu; World Regulatory Forum.

Community Activities

Member, PEPCO Work Group, appointed by County Executive of Montgomery County, Maryland (2010–2011).

Sunday School teacher, Temple Emanuel, Kensington, Maryland (2002–2006, 2008).

Board of Trustees, Temple Emanuel (2005–2006).

Musical performer (cello): Riderwood Village Retirement Community (2003-present); St. Paul Episcopal Church (Centreville, MD).

Exhibit SH-2: Excerpts from OG&E earnings calls

S&P Capital IQ

CONTENTS

OGE Energy Corp. NYSE:OGE

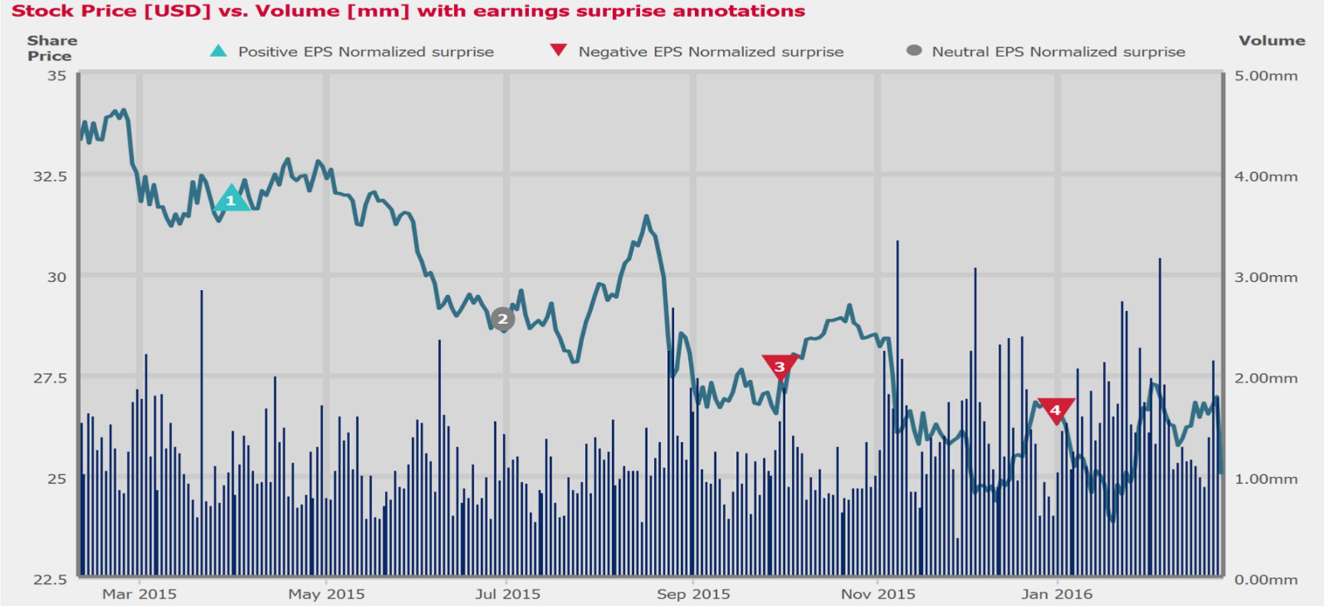
FQ1 2016 Earnings Call Transcripts

Thursday, May 05, 2016 1:00 PM GMT

S&P Capital IQ Estimates

	-FQ1 2016-			-FQ2 2016-	-FY 2016-	-FY 2017-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.13	0.13	0.00	0.40	1.76	1.87
Revenue (mm)	-	-	-	-	2402.70	2480.43

Currency: USD
Consensus as of Apr-22-2016 6:00 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ1 2015	0.16	0.22	37.50 %
FQ2 2015	0.44	0.44	0.00 %
FQ3 2015	0.91	0.90	(1.10 %)
FQ4 2015	0.22	0.15	(31.82 %)

Call Participants

EXECUTIVES

R. Sean Trauschke
Chairman, CEO & President

Stephen E. Merrill
Chief Financial Officer

Todd Tidwell
Director of Investor Relations

ANALYSTS

Anthony Christopher Crowdell
Jefferies LLC, Research Division

Brian J. Russo
Ladenburg Thalmann & Co. Inc., Research Division

Charles J. Fishman
Morningstar Inc., Research Division

Paul Thomas Ridzon
KeyBanc Capital Markets Inc., Research Division

Sarah Elizabeth Akers
Wells Fargo Securities, LLC, Research Division

Presentation

Operator

Good day, ladies and gentlemen and welcome to the First Quarter 2016 OGE Energy Earnings Conference Call. [Operator Instructions] As a reminder, this conference is being recorded.

I would like to introduce your host for today's conference Mr. Todd Tidwell. Sir, please begin.

Todd Tidwell
Director of Investor Relations

Thank you, operator. Good morning, everyone, and welcome to OGE Energy Corp.'s First Quarter 2016 Earnings Call. I'm Todd Tidwell, Director of Investor Relations. And with me today, I have Sean Trauschke, Chairman, President and CEO of OGE Energy Corp.; and Steve Merrill, CFO of OGE Energy Corp. In terms of the call today, we will first hear from Sean, followed by an explanation from Steve of first quarter results, and finally, as always, we will answer your questions. I would like to remind you that this conference is being webcast, and you may follow along on our website at oge.com. In addition, the conference call and accompanying slides will be archived following the call on that same website.

Before we begin the presentation, I would like to direct your attention to the safe harbor statement regarding forward-looking statements. This is an SEC requirement for financial statements and simply states that we cannot guarantee forward-looking financial results, but this is our best estimate to date. I would also like to remind you that there is a Regulation G reconciliation for gross margin and ongoing earnings in the appendix, along with projected capital expenditures.

I will now turn the call over to Sean for his opening comments. Sean?

R. Sean Trauschke
Chairman, CEO & President

Thank you, Todd. Good morning, everyone, and thank you for joining us on the call morning this morning. This morning, we reported first quarter consulted earnings of $0.13 --

[Audio Gap]

-- $0.03 per share, and Enable contributed --

[Audio Gap]

We have received approximately $35 million in distributions from Enable year-to-date, and I'll speak more about Enable a bit later and then Steve will provide a little more detail on our financial results for the quarter.

Quickly turning to the utility. We continue to see our historical growth rate of 1%, as we've added an additional 10,000 customers compared to the first quarter 2015. The majority of these customers are in the residential and commercial sectors. As you know, Oklahoma's been impacted by the downturn in energy prices, which contributed to a moderate decrease in oil field sales. The latest economic statistics put Oklahoma's unemployment rate at 4.4%, with Oklahoma city just under 4%. Both of these compared to 5% nationally. The new customer gross margin was just under $1 million for the quarter, it is consistent with our projections. We will continue to monitor the impact of low energy prices on the state economy, and we'll keep you updated if and when we begin to see a significant change in our sales growth. Our operations team continued a great job of maintaining the fleet and the grid this quarter and this quarter was no exception. We've already had 2 significant storms with tornadoes this year and the majority of outages were returned to service within 24 hours. Our combined cycle plants performed well, and with the continued record low natural gas prices, our capacity factors were exceedingly high. In fact, our McClain power plant reached record production levels in the first quarter.

It is important -- it is really important, I should say, to note that these achievements were made, while achieving best-in-class safety performance. For the first quarter, the utility was #2 in the southeast electric exchange for safety performance. I'm proud of our members for working safely, watching out for themselves and others day-in and day-out. On the cost side, we continue to focus on controlling costs and increasing efficiency. And as a point of reference, and I know I've said before, but I think it's worth noting. Our O&M cost per customer today are lower today than it was in 2011. We remained focused on enhancing the value of our product for the benefit of our customers. Our Smart Grid deployment was just the beginning of the transformation of our grid, enabling customer facing products and services, but also operational efficiencies. We believe that enhanced products and services, along with our low rates are the best way to attract new businesses to our service territory. 2 recent examples of new loads of the Commercial Metals company, which will build a 40-megawatt micro mill in Durant, Oklahoma, the mill is expected to be commissioned by the fall of 2017. We actually had the ground breaking just last week on this facility. The second is a 15-megawatt specialty paper mill being constructed by Glatfelter in Fort Smith, Arkansas, and this project should be completed by early in 2018. All-in-all, a solid start to the year.

Turning to the regulatory events in Oklahoma and Arkansas. We were pleased that the Oklahoma commission has approved our application, seeking approval to install the scrubbers at the Sooner plant. This support allows us to move forward with our environmental compliance plan with much more certainty. We believe, and I firmly believe, this is the right decision for not only our customers and our state and our company, but also provides a fuel diversity for our fleet for many years to come. Project construction on the scrubbers has resumed, and despite the delays, we are confident the project will be completed by our compliance deadline.

I want to thank all the parties, including the OGE members, the OCC staff, the commissioners, the Attorney General's office and the Oklahoma Industrial Group for working diligently to bring this cause to a conclusion.

We've also received approval for a solar tariff, making our solar farm the first one available to Oklahoma customers. As you may recall, we filed a general rate case in December with a test year-ending June 30, 2015, and those hearings have started this week. I will tell you, I think this case is a straightforward as they come. We've invested $1.6 billion in the system to improve reliability, to provide more functionality to our customers and to ensure long-lasting service to our customers. Since our -- and this is all since our last rate case. And there has not been any opposition to this plan and service. I believe this is a testament to our planning process that delivers low-cost energy to our customers.

Our rates are more than 20% below the national average, and we have extremely high customer satisfaction ratings. The real issues in the case have really been around ROE and depreciation. ROE is always up for debate, and we'll work through that issue. Some of the intervenors are proposing extending depreciable life of assets. The issue with this idea is that when you kick the cane down the road, you are really burdening future generations for assets beyond their useful life. I believe we'll be able to work through both these items for a positive resolution.

Overall, I believe we have a good working relationships with the Oklahoma Commissioners and the Commission as a whole. I firmly believe it's in the best interest of our customers, our company and the state as a whole that we have a strong working relationship with the commission. That's why I'm committed to always working to continually improve that. I want that relationship to be based on credibility and trust, but backed up by our performance. And as I stated earlier, our reliability's extremely high, our customer satisfaction's extremely high, as evidenced by our numerous J.D. Power awards. Our community involvement, our engagement in making our community stronger is second to none and our environmental record is strong. So if we're judged by their performance, I believe we will always come out on the right side.

And these principles apply to Arkansas as well. In Arkansas, we do plan to file a general rate case this summer. We intend to utilize the recently passed legislation in the state, allowing formula rates. Our dialogue with the commission in Arkansas has been positive, and we believe our filing will be a major step towards future investments in Arkansas.

Moving on to Enable's financial results, you know on their earnings call yesterday, they reported strong results for the first quarter, considering current commodity price environment. Processing volumes were up 6% and crude volumes -- crude gathering volumes in the Bakken were high as well. They also announced 2 additional rigs have been moved into the SCOOP-STACK play, reinforcing the significant acreage dedications Enable possesses in that prolific basin.

Another key item was lower O&M cost, which decreased 12%. So as a sponsor of Enable, I was very pleased with that, and clearly, they're focused on the right issues. We are -- we were very pleased with the first quarter, and I have to tell you I'm excited about the significant for that business as commodities cycle continues to improve.

Before closing, I did want to speak for a moment regarding our investment in Enable. While we are disappointed with the Enable's current trading price, although, improving, we're still not satisfied. Remember, our investment provides OGE with strong cash flow that helps support our dividend, capital needs, balance sheet and credit profile. It is doing exactly what we designed it to do when we established Enable a few years ago. Enable is a much larger and more resilient company today compared to when we owned 100% of Enogex a few years ago, and it is strong enough to manage through this cycle.

As you know, CenterPoint has announced their reviewing strategic alternatives as it pertains to their interest in Enable. Their review does not pertain to Enable or OGE's interest in Enable. We are committed to our investment in Enable and are focused on helping position the partnership for growth, as the MLP sector emerges from the current commodity cycle. We believe the value associated with our investment in Enable, including our 60% share in the IDRs will be realized in the market, as commodity prices continued to improve. We are focused on creating that long-term value for all of our shareholders.

So in summary, we continue to believe our businesses are strong and well positioned for long-term growth and value creation. We're on a plan to achieve our utility long-term growth rate of 3% to 5%, and continue to grow our dividend at an industry-leading rate of 10% through 2019.

So now I'll turn it over to Steve to review the financial results.

Stephen E. Merrill
Chief Financial Officer

Thank you, Sean, and good morning, everyone. For the first quarter, we reported net income of $25 million or $0.13 per share as compared to net income of $43 million or $0.22 per share in 2015. The contribution by business unit on a comparative basis is listed on the slide.

At OG&E, net income for the quarter was $6 million or $0.03 per share as compared to net income of $17 million or $0.09 per share in 2015. First quarter gross margin at the utility decreased approximately $13 million, which I will discuss on the next slide.

Now looking at other key drivers, first quarter O&M had a variance of -- it was $2 million higher, just a modest increase over 2015 and is consistent with our focused efforts on controlling our cost. Depreciation increased $3 million, primarily due to additional plant in service, including the low NOx and ACI environmental compliance assets. Other income increased $2 million, primarily due to increased margin from the Guaranteed Flat Bill Program. Income tax expense decreased $4 million due to lower earnings.

Turning to the first quarter gross margin. Utility margins decreased approximately $13 million in the first quarter of 2016 compared to 2015. The primary drivers for the reduction in gross margin were as follows. The expiration of our wholesale contract last summer has reduced margin this quarter by approximately $5 million. As we have said before, this item has been included in the current Oklahoma general rate case. Weather translated into $2 million of lower gross margin as compared to the first quarter of 2015. Weather for the quarter was flat compared to normal. Finally, lower demand revenues and lower wholesale transmission revenues combined to reduce margin $3 million as compared to the first quarter of 2015. Partially offsetting those reductions was growth from new customers contributing $1 million in gross margin. We added nearly 10,000 new customers to the system compared to the first quarter 2015.

Moving on to environmental and Mustang modernization investments. Investments for 2016 are largely comprised of Sooner scrubbers and Mustang CTs. There's a small amount of low NOx as 5 of the 7 of those units have been completed today and are now in service. The Muskogee natural gas conversion project spending will begin in 2017. As we have said before, we plan to run those coal units as long as we can for the benefit of our customers.

Turning to our investment in Enable. For the first quarter of 2016, Enable made cash distributions of approximately $35 million to OGE compared to $34 million in the first quarter of 2015, and contributed earnings of $18 million or $0.09 per share compared to $23 million or $0.11 per share last year. The decrease reflects lower commodity prices in addition to higher depreciation and interest expense, offset by lower O&M expense. Turning to the 2016 outlook, as you know, the majority of utility earnings occur in the second and third quarters, and assuming normal weather, we are comfortable with our current guidance. That concludes our prepared remarks this morning. We'll now answer your questions.

Question and Answer

Operator

[Operator Instructions] Our first question will come from the line of Anthony Crowdell from Jefferies.

Anthony Christopher Crowdell
Jefferies LLC, Research Division

So I have a first question just more on -- congratulations, you finally -- or the commission and OGE finally got together on the scrubbers. What's the rate case filing schedule look like for the next couple of years now?

R. Sean Trauschke
Chairman, CEO & President

Well, Steve, do you want to come and run through the schedule there?

Stephen E. Merrill
Chief Financial Officer

Sure. Anthony, what we're looking at, as you know, we're currently in a rate case with Oklahoma. We will file sometime in August an Arkansas general rate case, and that will take a little bit of time. And then when the -- we will time our next Oklahoma general rate case associated with when the Mustang plant goes into service, the CTs, and we'll use our 6-month forward look to really minimize any impact of that going into service. So look for that towards the end of 2017, and then really -- and then there would be a follow-on Oklahoma general rate case towards the end of '18, which would pick up the scrubbers when they finally go into service.

Anthony Christopher Crowdell
Jefferies LLC, Research Division

So in Oklahoma, you currently have a case going on now, and that should get you new rates, I guess, in 2016, then another filing for Mustang CT end of '17 and then another filing end of '18?

R. Sean Trauschke
Chairman, CEO & President

That's correct, Anthony.

Anthony Christopher Crowdell
Jefferies LLC, Research Division

Okay. And just if -- and I don't want to take up too much time on the call. I think there's is an issue going on in the case right now of how the PTC, whether the PTC is put in base rates or the PTC gets put through the fuel adjustment clause. Could you just walk us through -- I'm just struggling to understand the differences there, like what's one side versus the other?

R. Sean Trauschke
Chairman, CEO & President

Yes. I think, Anthony, so the issue there is when we commissioned that first wind farm we had PTCs and we flowed all that back to customers. And so now as the PTCs are expiring, there's an increase in the revenue requirement. And what we recommended was really flowing all those through the fuel clause, but if you want to put in base rates, that's fine too. I don't think there's an issue. I think the better issue was let's capture all of the energy cost -- the variable cost components around energy in the fuel clause. It just seems to makes more sense. That will be an annual review. I'm not sure what the real distinction is.

Anthony Christopher Crowdell
Jefferies LLC, Research Division

So now these assets are -- now that the PTC has expired, these assets are going to earn a regulated return off them, and that regulated return, because you were previously refunding customers through the fuel clause, the utility's filing was to get this returned via the fuel clause.

R. Sean Trauschke
Chairman, CEO & President

Yes, and just so -- it's a recovery. It's --

Anthony Christopher Crowdell
Jefferies LLC, Research Division

Recovery?

R. Sean Trauschke
Chairman, CEO & President

Yes. Just -- there's a return of that component. It's more of an expense.

Operator

Our next question will come from the line of Charles Fishman from MorningStar.

Charles J. Fishman
Morningstar Inc., Research Division

The only question I had was I just want to confirm, the movement in capital expenditures between '16 and '17 from the fourth quarter. Is just the Sooner -- the delay in the Sooner project or more capital being pushed into '17 than '16, is that correct?

Stephen E. Merrill
Chief Financial Officer

Yes. That's correct. It's really because we suspended that project for the first quarter while we tried to get this resolved at the commission. That effectively is going to push about $50 million out of '16 and into '17.

Charles J. Fishman
Morningstar Inc., Research Division

Everything else stay the same?

Stephen E. Merrill
Chief Financial Officer

That's correct.

Charles J. Fishman
Morningstar Inc., Research Division

Okay. And tell you what, can I ask a second question? Just -- I was looking at the CapEx chart when you were talking about guidance. You can -- reaffirmed '16. Now that the Sooner scrubber issue is behind you, did you give a long-term earnings growth for OG&E or beyond '16 anything?

R. Sean Trauschke
Chairman, CEO & President

Yes, 3% to 5%.

Operator

Our next question will come from the line of Sarah Akers from Wells Fargo.

Sarah Elizabeth Akers
Wells Fargo Securities, LLC, Research Division

So now that there's clarity on the CapEx outlook, can you just comment on the parent credit metrics and any opportunity you're seeing to utilize the balance sheet after the 2 big spending years here?

Stephen E. Merrill
Chief Financial Officer

Sure. I mean, obviously, our credit metrics, we go into this very strong. We're in a good position with regard to free cash flow to debt, and it's something that we certainly are always looking at. As far as deploying capital, we'll be firming those plans up over the coming months, and we certainly have some work to do on the back half of our 5-year outlook. If you recall, our cash taxes will ultimately increase, not in the near term with bonus depreciation, but we do become a full cash taxpayer in 2021 at this point.

Sarah Elizabeth Akers
Wells Fargo Securities, LLC, Research Division

Got it. And then on the rate case, are there any formal settlement conferences scheduled or what's -- what are the next key milestones in the process there?

R. Sean Trauschke
Chairman, CEO & President

Yes. As part of the procedural schedule, there was -- there'll be preliminary settlement discussions, like I mentioned, in my comments there. There was really not a lot of disagreement when you look at the intervener testimony on the plant in service, kind of the 2 gating items really seem to be around ROE and kind of the depreciable life of assets. And so we'll continue to have discussions, but there's no scheduled settlement proceeding from this point forward.

Operator

Our next question will come from the line of Paul Ridzon from KeyBanc.

Paul Thomas Ridzon
KeyBanc Capital Markets Inc., Research Division

Just I think you already answered this in Charles' question, but did the delay at Sooner affect cost at all?

R. Sean Trauschke
Chairman, CEO & President

No, we don't believe so. That was an important point that we made when we made this filing with the commission. We negotiated with all of our suppliers for a delay that would not impact schedule or cost, and so we don't believe there'll be any cost impact to this.

Operator

Your next question will come from the line of Brian Russo from Ladenburg Thalmann.

Brian J. Russo
Ladenburg Thalmann & Co. Inc., Research Division

Just on the Sooner environmental CapEx, just in terms of kind of the trend in quarter, should we just kind of assume that you'll spend an equal amount in the next -- in 2Q through 4Q or is it -- is it kind of -- does it kind of ramp up as we move through the year?

R. Sean Trauschke
Chairman, CEO & President

It will ramp up a little bit. I would say, the largest part would be third and fourth quarter, as we kind of get cranked back up and then the majority of our spend will be in 2017 associated with the scrubbers.

Brian J. Russo
Ladenburg Thalmann & Co. Inc., Research Division

Okay, great. And then just on the 3% to 5% utility EPS CAGR. Are we now kind of at the high-end of that range, given the scrubber installation?

R. Sean Trauschke
Chairman, CEO & President

We're pretty comfortable with the 3% to 5%, Brian. And we've got a few years left to go, but we're very confident in both that and the dividend growth.

Brian J. Russo
Ladenburg Thalmann & Co. Inc., Research Division

Okay. Great. And then just lastly, you guys have witnessed some pretty good customer growth for the last several years despite the commodity cycle. What's driving the residential and commercial customer growth?

R. Sean Trauschke
Chairman, CEO & President

Brian, could you repeat that, I didn't get that.

Brian J. Russo
Ladenburg Thalmann & Co. Inc., Research Division

The 1% customer growth that you've been experiencing the last 3 years, what's driving the residential compared to commercial side?

R. Sean Trauschke
Chairman, CEO & President

I think, it's -- there's a lot more to the Oklahoma economy than oil field. That's a big component, but there's a lot more to that, and we're seeing a lot of growth at the Tinker Air Force Base, and so Boeing has relocated a number of people here, and those high-paying jobs that have come in to the service territory. I think we just announced these 2 other developments that are going to bring multiples hundreds of jobs to the area. So I think it's a combination probably of we have a workforce here that's available, and so it's unfortunate that there has been a downturn in commodity cycles and there's been maybe a pullback in the oilfield sector, but it's created an opportunity for others looking to relocate here because of our low-energy rates to utilize that workforce, that skilled workforce. And so that's really probably why we haven't seen a decrease because while we've seen some companies pull back, unemployment hasn't really changed. So people have been able to find jobs, and I think that's been a real testament to the economy, and I think it's prime for when the market does -- the commodity cycle does turn, and we know it will. The state and the city are really primed for a lot of growth.

Operator

At this time, I'm showing no further questions. I would like to turn the call back over to Sean Trauschke for any closing remarks.

R. Sean Trauschke
Chairman, CEO & President

Thank you. Thank you, everyone, for joining us today and for your continued support to the company. We appreciate it, and we look forward to visiting with you soon. Have a great day.

Operator
Ladies and gentlemen, thank you for participating in today's conference. This concludes the program. You may now disconnect. Everyone, have a great day.

S&P Capital IQ

CONTENTS

OGE Energy Corp. NYSE:OGE

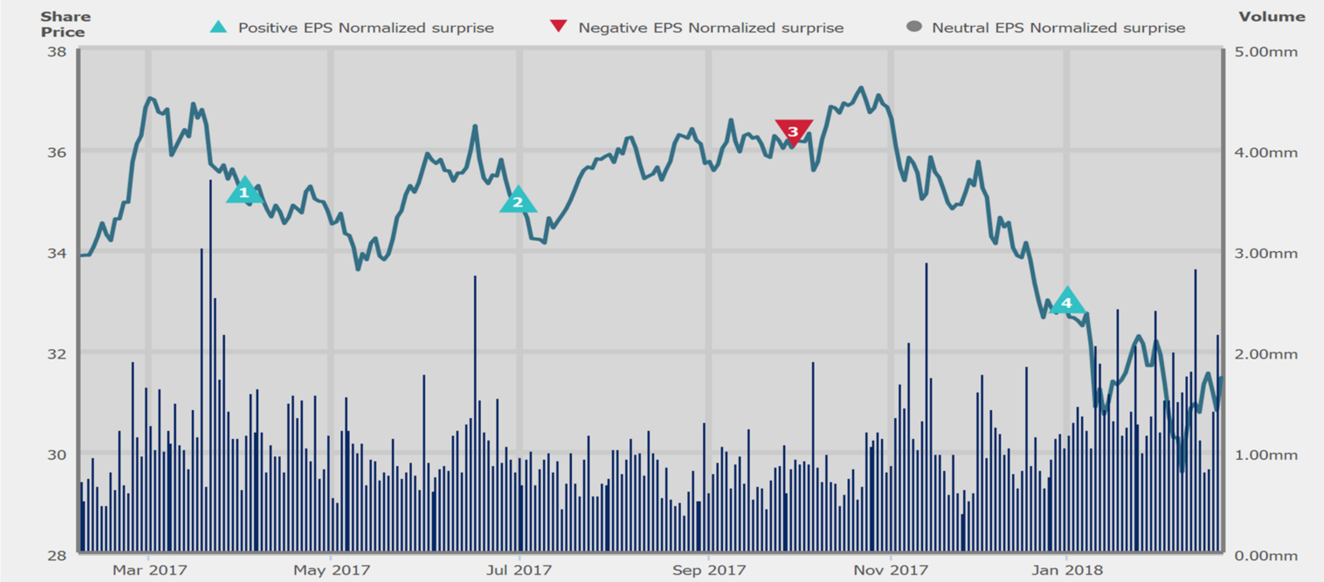
FQ1 2018 Earnings Call Transcripts

Thursday, May 03, 2018 1:00 PM GMT

S&P Capital IQ Estimates

	-FQ1 2018-			-FQ2 2018-	-FY 2018-	-FY 2019-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.16	0.27	▲68.75	0.50	2.00	2.10
Revenue	-	-	▲4.68	-	-	-
Revenue (mm)	470.69	492.70	-	604.16	2316.17	2452.11

Currency: USD
Consensus as of May-02-2018 4:30 PM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ1 2017	0.16	0.18	▲1 12.50 %
FQ2 2017	0.47	0.52	▲2 10.64 %
FQ3 2017	0.94	0.92	▼3 (2.13 %)
FQ4 2017	0.28	0.30	▲4 7.14 %

Call Participants

EXECUTIVES

Robert Sean Trauschke
Chairman, President & CEO

Stephen E. Merrill
Chief Financial Officer

Todd Tidwell
Director of Investor Relations

ANALYSTS

Andrew Levi
Caris & Company, Inc., Research Division

Josephine Moore
BofA Merrill Lynch, Research Division

Paul Thomas Ridzon
KeyBanc Capital Markets Inc., Research Division

Shahriar Pourreza
Guggenheim Securities, LLC, Research Division

Unknown Analyst

Presentation

Operator

Good day, ladies and gentlemen, and welcome to the OGE Energy's First Quarter 2018 Earnings Conference Call. [Operator Instructions] As a reminder, this conference call is being recorded.

I would now like to introduce your host for today's conference, Todd Tidwell, please go ahead.

Todd Tidwell
Director of Investor Relations

Thank you, Abigail. Good morning, everyone, and welcome to OGE Energy Corp's First Quarter 2018 Earnings Call. I'm Todd Tidwell, Director of Investor Relations. And with me today I have Sean Trauschke, Chairman, President and CEO of OGE Energy Corp.; and Steve Merrill, CFO of OGE Energy Corp.

In terms of the call today, we will first hear from Sean, followed by an explanation from Steve of first quarter results and finally, as always, we will answer your questions. I would like to remind you that this conference is being webcast and you may follow along on our website at oge.com. In addition, the conference call and accompanying slides will be archived following the call on that same website.

Before we begin the presentation, I would like to direct your attention to the safe harbor statement regarding forward-looking statements. This is an SEC requirement for financial statements and simply states that we cannot guarantee forward-looking financial results, but this is our best estimate to date.

I would also like to remind you that there is a Regulation G reconciliation for gross margin in the Appendix.

I will now turn the call over to Sean for his opening comments. Sean?

Robert Sean Trauschke
Chairman, President & CEO

Thank you, Todd, and good morning, everyone, and thank you for joining us on today's call. Well, it is May in Oklahoma and that usually means storms and extreme weather. And yesterday and through the night our service territory expands tornadoes and rain, hail, high winds just the full complement. But our crews did a great job, as usual, working through the night and I'm happy to report all customers will be back in service this morning.

So turning to the quarter. Earlier this morning, we reported first quarter consolidated earnings of $0.27 per share. And both businesses performed well and accomplished a great deal. So we're off to a great start and certainly on plan for the year.

At the utility, revenues benefited from positive whether and the impact of rate design from last year's Oklahoma rate award. Steve will discuss the details in a moment. But right now, I want to highlight our first quarter achievements. Our new state-of-the-art Mustang Energy Center is in operation serving our customers. We're proud to usher in a new era of generation technology at a location that's been powering our communities and facilitating a critical role in the region's growth and economic development. The Mustang Energy Center is more efficient, more sustainable and more responsive, and it maintains its legacy of providing affordable and reliable power to our communities. The new units with their staggered market availability dates have already seen close to 500 starts and produced more megawatts through the first four months of this year than the legacy units did all of last year. From an emission standpoint with the new units, we are experiencing a 62% decrease in our NOx emission rates. This further validates their importance in the SPP footprint. This was a project of substantial scale that required numerous contractors, hundreds of workers and more than 1.4 million work hours. As testament to the hard work and commitment, the project was executed on time, under budget and incident and injury free. It doesn't get any better than this.

Our service territory continues to grow with 7,200 new customers over the last year. And we are growing near our historical average of 1%. I should note, quarter-over-quarter, we experienced a 4% increase in oilfield sales and a 5% increase in industrial sales. The latest economic statistics put Oklahoma's unemployment rate at 4.1%, which is on par with the national average. Our largest load center, Oklahoma City, is below the national average, all signifying an improving economic outlook.

On the operations front, the start of 2018 has continued our success. Our combined cycle and call units have had their best availability to the market this quarter since we entered the SPP integrated market in 2014. This is important because it demonstrates that we've been flexible, reliable and adaptable to both market and commodity changes, and how our units are utilized in the market. [Safety] for the quarter saw 20% improvement over the first quarter of 2017. Our Covington solar farm is in service. The Sooner Scrubbers project is 82% complete, on time and on budget. And we're currently setting record performance in safety results, going 209 days without an incident, excellent performance.

I have to be honest, it feels good to have the first quarter behind us with a positive benefit from weather. Albeit small, it's the first time in a number of years that we have begun the year with positive weather. Further to that point, it had been 5 years since we've had benefit from favorable weather. I say that only to make the point that weather changes and it is not something you control. What does not change is our execution and focus on getting better. Another quarter of solid execution by everyone here at the company.

This year, we will restart our focus on grid modernization. We plan to begin significant deployment in Arkansas with Oklahoma following in 2019. Grid modernization is the next step in our smart grid deployment, this initiative will focus on improving, replacing existing distribution infrastructure, as well as upgrading systems that allow us to respond to outages more quickly and seamlessly connect with new energy technologies in the future. We'll be able to improve the reliability and resiliency of our grid as well as reduce cost for our customers and more efficient response in operation. As we move forward, we will optimize ideas and applications across our service territory that improve reliability and provide the most benefit to our system and to our customers. This will enable us to meet customer demands and to position our infrastructure for the future.

Turning to regulatory. As you know, we filed a general rate review with the Oklahoma Commission in January. The primary purpose of that filing is recovery of the Mustang Energy Center. And we'll make her first Arkansas Formula Rate filing in October. We will then file another case in Oklahoma at the end of 2018 for the recovery of the Sooner Scrubbers. We anticipate the first scrubber to be in service in June, and in fact, the work to tie in that first scrubber is currently underway. Finally, last week a ruling was issued against the OCC, finding they did not have the authority to grant preapproval of our scrubbers at Sooner under the statue used. This does not change the intent or the unanimous approval of the commission to the reasonableness of our plan, and we'll work with the commission to resolve this in our filing later this year.

Moving on to Enable. On their call yesterday, they reported strong results for the first quarter. They reported all-time high quarterly natural gas gathered volumes and processed volumes, supported by strong rig activity in the Ark-La-Tex and Anadarko basins. As you know, volumes are the key to this business. Quarter-over-quarter, natural gas gathered volumes increased 30% and processed volumes increased nearly 19%. Year-to-date, they have contracted or re-contracted multiple transportation agreements with over 375,000 dekatherms a day of capacity. They've also updated their outlook to reflect an even stronger 2018. So as a sponsor of Enable, we continue to be pleased with their performance and what the Enable team is building. Last, but not least, the Enable Board approved a quarterly distribution this week of $35 -- of which $35 million will be distributed to OGE. This will make distributions received by OGE since the formation of Enable totaling more than $800 million. This unencumbered cash has kept us out of the equity markets and supported our CapEx and dividend growth.

In closing, I want to reiterate how pleased I am with the performance of both businesses. We have a long-term utility growth rate of 4% to 6% and continue to grow our dividend at an industry-leading rate of 10% a year through 2019. As a management team, we're committed to executing on our strategy to continue growing our business, growing our communities and creating long-term shareholder value for all of our shareholders.

Thank you, and I'll now turn the call over to Steve to review our financial results for the quarter. Steve?

Stephen E. Merrill
Chief Financial Officer

Thank you, Sean, and good morning. For the first quarter, we reported net income of $55 million or $0.27 per share as compared to net income of $36 million or $0.18 per share in 2017. The contribution by business unit on a comparative basis is listed on the slide. At OG&E, net income for the quarter was $31 million or $0.16 per share as compared to net income of $16 million or $0.08 per share in 2017. First quarter gross margin at the utility increased approximately $35 million, which I will discuss on the next slide. Looking at other key drivers, first quarter O&M expense decreased $5 million, primarily due to the timing of plant maintenance. O&M expense for the year is on plan. Depreciation increased $24 million. The primary driver for the variance is timing related to last March's Oklahoma rate order.

As you will recall, we booked 6 months of 2016's depreciation adjustment, approximately $20 million, in the first quarter of 2017. Interest expense increased approximately $4 million due to the additional long-term debt issued in March and August of 2017. Income tax expense decreased $4 million due to the reduction of the corporate federal tax rate and an increase in state tax credits generated, partially offset by higher pretax income.

Turning to the first quarter gross margin. Utility margins increased approximately $35 million in the first quarter of 2018 compared to 2017. There are 2 main drivers for the increase. First is the impact of the Oklahoma rate order. You'll recall that we implemented new rates in May of 2017, therefore, margins in the first quarter of 2017 were under the old rates. Under the new rate design methodology, more revenue was shifted into the first quarter. Another way to say this is the small smoothing of our annual revenue curve. This change accounted for $19 million of margin or $0.07 per share.

The other main driver was weather. 80 degree days were 36% above last year and this accounted for $14.6 million of margin or $0.05 per share as well. There have been impacts from the 2017 rate order for the comparative periods, but the bottom line is that we anticipated this and we're on plan for the year.

Turning to our investment in Enable. For the first quarter of 2018, Enable made cash distributions of approximately $35 million, the same amount received in the first quarter of 2017. Enable also contributed earnings of $24 million or $0.11 per share, compared to $20 million or $0.10 per share in 2017. Enable had a solid first quarter and their financial metrics are strong. Enable set all-time quarterly records for gathering and processing volumes. Adjusted EBITDA increased by $36 million and DCF increased $25 million compared to the first quarter of 2017. They ended the quarter with a distribution coverage ratio of 1.4x. Enable increased their guidance for the year, which points to continued execution of the business in recovery and commodities. Enable remains focused on controlling costs and deploying capital effectively.

Turning to 2018 outlook. As you know, the majority of utility earnings occur in the second and third quarters and assuming normal weather, we're comfortable with our current guidance. In the Appendix, we have updated the guidance assumptions for this year following the revenue recognition and pension accounting changes. These are income statement reclassifications and do not affect our initial guidance ranges.
This concludes our prepared remarks, and we'll now answer your questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes from the line of Josephine Moore with Bank of America Merrill Lynch.

Josephine Moore
BofA Merrill Lynch, Research Division

I just -- you mentioned strong sales growth on the industrial side. I was just curious, is that temporary? Or could we see that continue?

Robert Sean Trauschke
Chairman, President & CEO

I think this is a good inflection point for an improving economic outlook here in our service territory. We saw an increase in oilfield sales, Todd and Steve both mentioned about the rig count at Enable. They have a lot of pipeline assets in our service territory. And we have mentioned for a number of quarters the -- some of the new businesses have been relocating to our service territory. Just last Friday, we commissioned and had the groundbreaking for a new steel company that relocated who is manufacturing rebar in the southern part of our service territory. So we're hopeful that there'll be more to come. But I think this is a very good inflection point for an improving economy.

Josephine Moore
BofA Merrill Lynch, Research Division

Great. I mean with that, the strong weather in the first quarter and then Enable's strong guidance for the last quarter, do you feel comfortable coming in maybe towards the high-end of the guidance?

Robert Sean Trauschke
Chairman, President & CEO

Yes, as Steve mentioned, the majority of our earnings, specifically at the utility, come in the second and third quarter. And while the weather benefit was favorable in the first quarter, it was still pretty small. And -- where the weather benefit will really occur to the extent that it is favorable will be in the second and third quarter. So we'll get through those quarters before we make any pronouncements about guidance. But we feel very confident that we're on plan.

Josephine Moore
BofA Merrill Lynch, Research Division

And then just 1 last question. On the rate case underway in Oklahoma, any updates you can give us there?

Robert Sean Trauschke
Chairman, President & CEO

Really no updates at this point. The intervenor testimony was due last night, so we will certainly go through that and evaluate that and proceed accordingly.

Operator

Our next question comes from the line of Paul Ridzon with KeyBanc.

Paul Thomas Ridzon
KeyBanc Capital Markets Inc., Research Division

What was the impact of -- I think last year you were booking interim rates for '16, what was the impact of that rolling off?

Stephen E. Merrill
Chief Financial Officer

In the first quarter, we booked about $0.06 related to 2016 and 2017. So that all kind of pretty much flushed through the first quarter.

Paul Thomas Ridzon
KeyBanc Capital Markets Inc., Research Division

And it looks as though one of the things you called out was lower taxes -- but are you reserved against that? Is that -- if I read the queue properly?

Stephen E. Merrill
Chief Financial Officer

Well, we certainly have to refund currently because we're in the middle of a rate case, we're over-collecting from where tax rates are now. So we're reserving that over-collection to begin to give that back once we get an order from the commission. We don't have a mechanism to do that until they give an order to do so.

Paul Thomas Ridzon
KeyBanc Capital Markets Inc., Research Division

But you did not benefit from lower taxes in the quarter because you reserved against it?

Stephen E. Merrill
Chief Financial Officer

That's correct. That's correct.

Robert Sean Trauschke
Chairman, President & CEO

There's no P&L impact for us.

Operator

Our next question comes from the line of Shar Pourreza with Guggenheim Partners.

Shahriar Pourreza
Guggenheim Securities, LLC, Research Division

Can you hear me?

Stephen E. Merrill
Chief Financial Officer

Yes.

Shahriar Pourreza
Guggenheim Securities, LLC, Research Division

Sorry about that, it's -- this was [addressed], there're a couple of calls going on this morning. Just on sort of your grid mod filings. Can you just remind us -- it's a big piece of, sort of, your CapEx when you think about '19 and beyond. What sort of the podium as far as how you're thinking about recovery? Is it within the FRP that's, sort of, happening in Arkansas? Would it necessitate another filing in Oklahoma. And sort of, I guess, more importantly, how's the educational process going on, especially on grid mod in Oklahoma?

Robert Sean Trauschke
Chairman, President & CEO

So a really good question. And I think you kind of laid out our game plan. In Arkansas, we will use the FRP. We'll be making those filings on an annual basis and so that's how we'll recover that. And we'll begin as we restart this program. Remember, we, kind of, delayed it as we were going through this environmental compliance plan because of the federal requirement. But -- and we'll begin this in Arkansas, we'll pick this up after the Mustang and Sooner projects are complete in Oklahoma. And you're exactly right, we will probably have a lot of dialogue and discussion with the Oklahoma commissioners and staff to make sure that they recognize the full benefits of that. And then see if we can't develop a constructive pathway to see that recovery, whether that includes a rider, whether that includes formal rate-making process, we'll cross that bridge when we get there. But I think your point is exactly right. It's our job to make sure that we educate them beforehand.

Shahriar Pourreza
Guggenheim Securities, LLC, Research Division

Got it, that's helpful. And then just on Oklahoma's, sort of, construct, right. Is there any sort of updates on how the focus groups and everything is going as far as looking in and potentially revisiting how the Oklahoma or the OCC sort of accounts for their regulatory proceedings? Is there any status there? And then just looking at the rate case that we have with interim rates that are -- should be, I guess, implemented sometime in the middle of this year. What is sort of your viewpoint as far as a potential settlement?

Robert Sean Trauschke
Chairman, President & CEO

Sure. So good question. So as it relates to the task force that was initiated by the Governor last year, I know they're conducting interviews and I think the plan is they're going to release the interim report this summer and then, I think, their final report is due the 8th-or-so of November after the elections. And so we'll see where that comes out at. So I think that process is proceeding. As far as this case we have before us on Mustang, you're right, I guess you're referring to the 180-day timeframe that we could implement rates this summer, that's exactly right. I would be hopeful that we would not get to that point. As you recall, we delayed the filing of this Mustang case to incorporate the benefits of tax reform. There is going to be no impact for this investment to our residential or industrial customers. And so we think this is teed up very nicely to get resolved. And I'm hopeful that it can get done before we have to implement rates.

Shahriar Pourreza
Guggenheim Securities, LLC, Research Division

And that just leads me to just 1 last question. On the upcoming rate filing as far as the -- from the Scrubbers and the conversion, is there -- do you have any indication preliminary of what the impact could be from a retail rate perspective there?

Robert Sean Trauschke
Chairman, President & CEO

You're talking about on the Scrubbers?

Shahriar Pourreza
Guggenheim Securities, LLC, Research Division

Correct.

Robert Sean Trauschke
Chairman, President & CEO

So we're working through that right now. And it's probably a bit premature to, kind of, put that number out there too soon. But I do not view that as a large impact.

Operator

And your next question comes from the line of Greg Gordon with Evercore ISI.

Unknown Analyst

This is actually [indiscernible] on for Greg. So my questions on the rate case you guys have already answered. Just on the dividend, so target is 10% through '19. Is that -- when does that get reviewed?

Stephen E. Merrill
Chief Financial Officer

I mean, we're already taking a look at that, but we certainly want to get through the Mustang filing, have some early indications on Sooner and then it would be something we would address sometime next year.

Unknown Analyst

Perfect. And then just on the -- so you guys increased your CapEx in the last call. Just wanted to get an understanding at a high level, where does that put you in terms of either CFO-to-debt metric? And what are you targeting? So I'm trying to get to how much excess balance sheet capacity you may have now that you've increased your CapEx?

Stephen E. Merrill
Chief Financial Officer

Sure. I think what you'd see with that CapEx is our FFO-to-debt staying in line with where we've been historically, strong investment rate. We would look to that not to have any impact on our credit metrics and that's kind of how we manage the company to -- keep a strong FFO to debt consistent with where we've been. Yes, obviously, north of 20%. Last year was kind of our highest CapEx, so that put a little stress on our FFO-to-debt, and we'll be working through that as we start to get recovery for these assets we've put in service.

Unknown Analyst

It goes north of 20%?

Stephen E. Merrill
Chief Financial Officer

Yes.

Unknown Analyst

And that's through your CapEx forecast period? Or through 2020?

Stephen E. Merrill
Chief Financial Officer

No, through the CapEx forecast period.

Operator

Our next question comes from the line of Joe Zhou with Avon Capital Advisers.

Andrew Levi
Caris & Company, Inc., Research Division

It's Andy Levi. Just two questions. Just on Enable and CenterPoint's bid -- not bid, but the acquisition of Vectren. Just any thoughts on how that may or may not affect Enable? And also your thinking on Enable?

Robert Sean Trauschke
Chairman, President & CEO

Well, it doesn't change our thinking on Enable. We are very comfortable with Enable, we like that business, we understand that business, so it doesn't change our thinking on Enable. I think in fairness, Andy, I do agree with you. It probably does bring back to the forefront the exposure to CenterPoint's process with regard to the Enable units. But as far as what actually happens there, you need to ask CenterPoint. That's their decision, and it's their responsibility to communicate that.

Andrew Levi
Caris & Company, Inc., Research Division

Okay. And then just on the current rate case, so you said last night intervenor testimony was filed, does that include staff as well or just intervenor?

Robert Sean Trauschke
Chairman, President & CEO

Yes, yes, so it was all -- as soon as it's made public, we'll go through it all and figure out what happens, what everyone said. But yes, that was the deadline was late yesterday afternoon and so I think they're loading it and putting it on the system right now.

Andrew Levi
Caris & Company, Inc., Research Division

Okay, and that again -- that includes the staff?

Robert Sean Trauschke
Chairman, President & CEO

Yes, yes, it does.

Andrew Levi
Caris & Company, Inc., Research Division

And so just to understand the process from here, I guess settlement conference takes place in the first week of June or something like that?

Robert Sean Trauschke
Chairman, President & CEO

That's correct. It's set for June 8. But Andy that's the procedural schedule, that doesn't -- we'll evaluate where everything comes in at and to the extent that there is an opportunity to have productive discussions, we will.

Andrew Levi
Caris & Company, Inc., Research Division

Before June 7, you're talking?

Robert Sean Trauschke
Chairman, President & CEO

Yes.

Andrew Levi
Caris & Company, Inc., Research Division

I understand, that makes sense. Okay, so basically now since the testimony has been filed and everyone knows each other's positions for no better way to put it, it's a good time if the parties want to, to sit down and talk, is that fair?

Robert Sean Trauschke
Chairman, President & CEO

Yes.

Andrew Levi

Caris & Company, Inc., Research Division

Okay. And I guess we're fairly optimistic hopefully that you guys will settle something.

Robert Sean Trauschke
Chairman, President & CEO

No, no, I agree, keep going.

Operator

And we have a follow-up from the line of Paul Ridzon with KeyBanc.

Paul Thomas Ridzon
KeyBanc Capital Markets Inc., Research Division

Just wanted to go back to the interim rates. So does that imply that we really saw the $0.07 you mentioned plus the $0.06 of rate design shifting throughout the year?

Stephen E. Merrill
Chief Financial Officer

Well, the $0.06 was in the first quarter of 2017. You did see the impact of rate design in this current quarter.

Paul Thomas Ridzon
KeyBanc Capital Markets Inc., Research Division

I got it. This is a normal quarter and last year was [indiscernible].

Stephen E. Merrill
Chief Financial Officer

Yes, that's right, that's exactly right.

Paul Thomas Ridzon
KeyBanc Capital Markets Inc., Research Division

Okay, okay, got it. And how do you see that $0.07 kind of reversing out over the course of the year?

Stephen E. Merrill
Chief Financial Officer

I mean it really will be -- AFUDC will kind of play out through the year. But you really wouldn't need to adjust probably what you have for second, third and fourth quarters, this is just a slight shifting into the first quarter.

Paul Thomas Ridzon
KeyBanc Capital Markets Inc., Research Division

Okay, so a couple of pennies each quarter?

Stephen E. Merrill
Chief Financial Officer

That's probably not too far off, yes.

Operator

[Operator Instructions] We have a follow-up from the line of Josephine Moore with Bank of America Merrill Lynch.

Josephine Moore
BofA Merrill Lynch, Research Division

Just one very quick follow-up on here. On a run rate basis, your O&M seems to come in pretty -- or your total OpEx comes in below guidance. Are we expecting a meaningful uptick there in the later quarters or...?

Stephen E. Merrill
Chief Financial Officer

Yes, it's really just a timing issue. We're actually on plan with what we put out for guidance, it's really just timing of expenditures, particularly plant maintenance. Your outages tend to occur in the summer months and in the fall.

Josephine Moore
BofA Merrill Lynch, Research Division

Got it. And then Sooner coming online too, is that also a driver there?

Stephen E. Merrill
Chief Financial Officer

Sure. Yes, absolutely.

Robert Sean Trauschke
Chairman, President & CEO

There will be some OpEx associated with that.

Operator

At this time, I'm showing no further questions. I would like to turn the call back to Sean Trauschke for closing remarks.

Robert Sean Trauschke
Chairman, President & CEO

Thank you, Abigail. And thank you all for your interest in OGE Energy Corp. and for being on the call today. Have a great day.

Operator
Ladies and gentlemen, thank you for your participation in today's conference. This concludes the program and you may now disconnect. Have a great day.