BEFORE THE CORPORATION COMMISSION OF THE STATE OF OKLAHOMA

APPLICATION OF PUBLIC SERVICE COMPANY OF OKLAHOMA FOR A DETERMINATION THAT ADDITIONAL ELECTRIC GENERATING CAPACITY WILL BE USED AND USEFUL	)	CAUSE NO. PUD 200500516
APPLICATION OF PUBLIC SERVICE COMPANY OF OKLAHOMA FOR A DETERMINATION THAT ADDITIONAL BASELOAD ELECTRIC GENERATING CAPACITY WILL BE USED AND USEFUL	)	CAUSE NO. PUD 200600030
IN THE MATTER OF THE APPLICATION OF OKLAHOMA GAS AND ELECTRIC COMPANY FOR AN ORDER OF THE COMMISSION GRANTING PRE-APPROVAL TO CONSTRUCT RED ROCK GENERATING FACILITY AND AUTHORIZING A RECOVERY RIDER	)	CAUSE NO. PUD 200700012 (CONSOLIDATED)

OKLAHOMA GAS AND ELECTRIC COMPANY'S APPEAL TO THE REPORT OF THE ADMINISTRATIVE LAW JUDGE

COMES NOW Oklahoma Gas and Electric Company ("OG&E" or "Company"") and respectfully requests that the Oklahoma Corporation Commission ("Commission") reverse or modify certain portions of the Report of the Administrative Law Judge ("ALJ Report"), filed August 21, 2007, in the above-styled causes. OG&E respectfully submits that the Administrative Law Judge ("ALJ") correctly recommended approval of the Red Rock Construction Rider ("RRCR"), but erred in disallowing recovery through the rider of income taxes which will be paid by the Company as a result of the RRCR collections. In addition, OG&E submits that the ALJ magnified the error if, in fact, the recommendation includes disallowance of Allowance for Funds Used During Construction ("AFUDC") treatment for such income taxes.

INTRODUCTION

It should be understood that this appeal represents an exception to OG&E's general agreement with the ALJ's findings and recommendations. The Company agrees with the ALJ's finding that there is a need for the capacity represented by the Red Rock plant on OG&E's system in the 2012 timeframe. (Report of ALJ, page 10.) OG&E also agrees with the ALJ's conclusion that Red Rock benefits customers and would be used and useful. (Report of ALJ, page 16.) Except as otherwise described herein, OG&E agrees that the RRCR is the appropriate mechanism for recovering financing costs during construction. (Report of ALJ, page 27.) The Company also agrees that OAC 165:35-38-5 is applicable to this Cause and with the ALJ's characterization of hedging issues. (Report of ALJ, page 26 and page 25, respectively.) Also, OG&E agrees with the recommendation that the Company proceed with the Demand Side Management approaches described in Attachment A of the ALJ Report. (Report of ALJ, page 27.)

ARGUMENT AND AUTHORITY FOR REVERSAL OR MODIFICATION

PROPOSITION: The Administrative Law Judge ("ALJ") correctly recommended approval of the RRCR, but erred in disallowing recovery of income taxes which will be paid by the Company as a component of the RRCR.

The ALJ's recommendation at page 27 includes the following:

> "G. OG&E should be permitted to recover a return on the costs of financing the construction of the Red Rock facility, equal to the rate of return authorized by the Commission in its most recent rate case. The proposed Red Rock Construction Rider is an appropriate mechanism for recovery of a return on the financing costs since it contains a true-up mechanism, which will

> ensure the ratepayers pay no more than is paid by OG&E for financing costs. As with PSO, **<u>the rate of return should not be grossed up for taxes</u>**, to reflect the anticipated growth in customers and revenue on OG&E's system, which is the basis for the Commission's determination that additional baseload capacity is required by OG&E." (Emphasis added.)

OG&E believes the RRCR will benefit both customers and the Company. OG&E also identifies three fundamental errors related to the ALJ's recommendation concerning disallowance of the income tax expense. Additionally, the Company believes the recommendation made by the Referee in the recent rate case of Public Service Company of Oklahoma ("PSO") appropriately recognizes that a fully funded rider is in the best interests of utility customers and shareowners.

A. <u>The record in this Cause demonstrates that full recovery of Red Rock financing costs through the RRCR will materially benefit both customers and the Company.</u>

Use of the RRCR will allow the Company to improve its position in the capital markets (Hatfield Direct at p. 14 and Motley Direct at p.2); support the maintenance of its BBB+ debt ratings (Graves Direct at pp. 23-24); and minimize interest expense on new or refinanced debt (Hatfield Direct at p. 27). These benefits ultimately flow-through to customers as lower utility rates (Hatfield Transcript 7-30-07 at p. 22 and Motley Transcript 7-30-07 at pp. 151 and 158). Because OG&E will file a rate case in 2009 and anticipates filing a rate case in 2011, these interest cost savings will be flowed through expeditiously.

There is no detriment to customers from implementation of the RRCR. The evidence shows that the present value of revenue requirements is the same whether OG&E recovers its construction financing costs through the RRCR or by the amortization of AFUDC balances over the depreciable life of Red Rock (Graves Direct at pp. 6-7). Revenues recovered through the RRCR do not create additional earnings for OG&E because Red Rock rider revenues are offset by negative AFUDC booked to recognize the current recovery of construction financing costs. The Red Rock rider revenues simply offset the related financing costs, no more, and therefore do not create any incremental margin or profit.

The ALJ, however, has recommended that the RRCR "not be grossed up for income taxes, to reflect the anticipated growth in customers and revenue on OG&E's system....". (Report of ALJ, page 27.) If this language contemplates total disallowance of recovery of income tax expense, it would reduce the effective return on equity to 6.59%.[1] The adoption of such an approach would not allow the Company to move forward with the construction of the Red Rock plant.

If, in fact, the intent is to disallow current recovery through the RRCR, but allow the accrual of the income tax expense for future recovery, the negative impact from adoption of that recommendation would result in the Company reconsidering its options for meeting future customer requirements. Given the Company's six-year construction budget, such a modification of the RRCR will likely offer inadequate support for maintaining the Company's BBB+ rating and impair the Company's ability to make needed infrastructure and reliability expenditures.

As apparently recognized by the ALJ, implementing a recovery rider facilitates lower interest expense costs prospectively. However, the benefits of lower debt costs for the Company and its' customers are undercut by disallowing current recovery for the income taxes to be paid on the cash flow generated by the RRCR.[2]

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[1]A disallowance of the recovery of income tax expense does not permit OG&E to recover its' Commission authorized return on equity for equity funds used to finance the construction of Red Rock. Specifically, without recovery of the income tax component of the financing costs, OG&E will only receive approximately a 6.59% [(1 - 0.387 = 0.613) * (10.75%) = 6.59%] return on equity instead of the 10.75% authorized by the Commission.

[2] The disallowance for the recovery of the income tax expense component of the Rider decreases OG&E's *cash flow* during the construction of Red Rock. It is unclear from the ALJ's recommendation whether the intent is to also disallow recovery for the income tax expense component, as AFUDC, over the depreciable life of Red Rock. If that is the case, the *earnings* during construction of Red Rock and *cash flow* over the depreciable life of Red Rock are also less.

B. <u>The ALJ's recommendation concerning disallowance of the income tax expense is inconsistent with Referee Jackie Miller's recommendations.</u>

In Cause No. PUD 200600285, involving the utility rates for PSO, Referee Miller recognizes the potential benefit to customers of the proposed RRCR approach. She recommends a rider be authorized for PSO that *includes* recovery of income tax expense,[3] noting:

> *The Referee finds that there may be benefits to setting in place a process that would allow for the more timely recovery of construction costs in a more efficient manner than the typical rate case process. Exhibit 183, Mathai Rebuttal at p. 10, 1. 15-28.* ***Because of the magnitude of PSO's proposed construction plan, the ability of PSO to recover its costs will be critical to the investment community and could result in lower costs to customers.*** *The Referee finds that the process offered by Staff's proposed NGTR would result in substantially less time and resources for all parties as compared to a sequence of traditional rate cases. Furthermore, there may be other benefits to customers according to PSO, by allowing return on CWIP, the nominal first year benefit to customers is $41.2 million (Exhibits 13, 14, Sartin Direct at p. 8) in contrast to accruing AFUDC. By allowing a return on CWIP, the ultimate total rate increase associated with the plant will be 10.0% instead of 13.2%. Exhibits 13, 14, Sartin Direct at p. 8. See also Exhibit 183, Mathai Rebuttal at Rebuttal Exhibit GM-2. However, the Referee also directs to the Commission's attention the exhibits of the OIEC Exhibit MG-1 for consideration of this issue.* (Emphasis added.)

C. <u>In addition, the Company believes the ALJ's recommendation in this Cause to disallow recovery of income tax expense through the RRCR is in error because:</u>

1) Disallowance of recovery for income tax expense through the RRCR is not based on any evidence in the case record;

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[3] Cause No. PUD 200600285, Report of Referee at page 152 and Hearing Exhibit 181.

2) If the ALJ's intent is to disallow recovery for income tax expense as a component of AFUDC over the depreciable life of Red Rock, such disallowance is not justified based on evidence in the case record and would constitute an unlawful taking;[4] and,

3) Disallowance for income tax expense based on expectations for revenues from customer growth on OG&E's system is not justified based on the evidence in the record for this Cause.

1. There is no basis to disallow recovery for the income tax expense through the RRCR.

The ALJ's decision to not allow for income tax expense recovery through the RRCR has no evidentiary support in the record. OG&E clearly demonstrates that financing costs include interest expense, return on equity and related income tax expense. No party to the case advocated otherwise. Further, no party specifically advocated that the income tax expense component of the financing costs should not be recovered from customers.

2. There is no basis to further disallow recovery for the income tax expense as a component of AFUDC and such disallowance would be unlawful.[5]

It is not clear from the ALJ's recommendation whether she is recommending a permanent disallowance of the income tax expense related to the equity return component of the Red Rock financing costs. As a matter of policy, the Commission should reverse any interpretation of the

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[4] *Southwestern Public Service Co. v. State* outlines the constitutional safeguard afforded to a utility wherein *Alabama Public Service Com. v. South Cent. Bell Tel. Co.*,[Ala., 348 So.2d 443.] summarizes as follows: "The just compensation safeguarded to a utility by the 14th Am. to the U.S. Const. is a reasonable return on the value of the property used at the time that is being used for the public service, and rates not sufficient to yield that return are confiscatory.["]. *Southwestern Public Service Co. v. State*, 1981 OK 136, ¶ 7, 637 P.2d 92, 96. (*citing Southwestern Bell Tel. Co. v. State*, 204 Okl. 225, 230 P.2d 260 (1951); *Application of Southwestern Bell Tel. Co.*, Okl., 575 P.2d 624 (1978); *Wiley v. Oklahoma Natural Gas Company*, Okl., 429 P.2d 957 (1967); *Bluefield Waterworks & Improv. Co. v. Public Service Com'n of W. Va.*, 262 U.S. 679, 43 S.Ct. 675, 67 L.Ed. 1176 (1923); *Federal Power Com'n v. Hope Natural Gas Co.*, 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 333 (1944).

[5] See Footnote 4.

ALJ's recommendation that does not correctly allow for the current recovery of total financing costs including the related income tax expense. Moreover, in no circumstance should OG&E be denied the right to defer and capitalize any unrecovered expense related to financing costs. To make OG&E whole for its costs, any such deferral must be capitalized and subsequently recovered over the depreciable life of Red Rock in order to avoid an unlawful taking.[6]

In Schedule 1 attached hereto, OG&E demonstrates the significance of the potential disallowance for the recovery of income tax expense. OG&E calculates that, based on the estimated financing costs for Red Rock, OG&E would not be compensated for financing costs of $106.9 million related to income tax expense.[7]

As illustrated above, if OG&E recovers its full financing costs, it will pay an estimated $106.9 million in cash to the state and federal governments for income tax expense related to the equity return component of the Red Rock construction financing costs. The income tax expense paid on revenues recovered through utility rates is considered a prudent cost of providing service. Prudently incurred costs necessary for providing utility service should be recovered from customers. Because there is no finding by the ALJ that the equity financing costs, and the related income tax expense, would be imprudent, as a matter of regulatory practice and law, OG&E should be authorized to recover those costs. To deny recovery of income tax expense only allows OG&E to recover a 6.59% return on the equity funds used to finance the construction of Red Rock. This return on equity is substantially less than the Commission authorized return on equity of 10.75%. Moreover, there is no evidence in the record supporting such recommendation.

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[6] See Footnote 4.

[7] The estimated disallowance for income tax expense calculated in the attached schedule is derived from evidence presented by OG&E Witness Motley through his direct testimony (Motley Direct p.3, Chart 1). Based on that testimony and OG&E's authorized rate of return, the Rider as recommended by the ALJ does not provide for approximately 26.8% of the financing costs.

3. **<u>There is no basis to justify disallowance for the income tax expense on expectations for revenues from customer growth.</u>**

The ALJ justifies not grossing up the equity return for income tax expense because of anticipated revenues from customer growth on OG&E's system. Such a conclusion requires a showing that expected customer growth generates a net revenue increase equal to or greater than the income tax expense proposed to be excluded from the RRCR. There is nothing in the record of this Cause which supports such a calculation.

Even though OG&E expects customer growth, the record does not quantify the revenues associated with that growth. Nor does the record of this Cause provide a basis to quantify the other components that will significantly increase OG&E's costs. First, customer load growth will require OG&E to make additional plant investments and incur additional operations and maintenance expenses for new or increased usage by customers. Also, besides normal increases in costs from inflation and other factors, the record does show that the six-year construction program being undertaken by OG&E is expected to cost $3.0 billion, or more than twice the capital investment expended in the previous six years (Hatfield Direct at p. 14 and Hatfield Rebuttal at pp. 14-15). There is nothing in the record of this Cause which suggests revenues from load growth will begin to approach those additional costs.

Finally, OG&E's proposed RRCR would recover the financing costs on only the Red Rock project, a small portion (approximately 26%) of the financing costs on the $3.0 billion capital expenditures. Even if the cash-flow from growth in electricity sales were to somehow cover the increase in operating costs, it would be expected to mitigate only a small portion of the regulatory lag resulting from the remaining $2.2 billion of anticipated capital expenditures.

The record reflects that it is more likely the Company will fail to earn its' authorized rate of return on equity during the construction of Red Rock. OG&E Witness Hatfield testified that he expects the Company would earn less than a ten percent return on equity during the construction of Red Rock, even with full recovery of the RRCR (Hatfield Transcript 7-30-07 at pp. 6-7). Also, the record demonstrates the revenues recovered through the RRCR do not create additional earnings for OG&E (Motley Transcript 7-30-07 at pp. 158-159 and 233).

CONCLUSION

For the reasons stated herein, OG&E believes the best interests of customers and the Company are served by reversing the ALJ's recommendation regarding the disallowance of recovery through the RRCR of income taxes which will be paid by the Company.

Respectfully submitted,

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Oklahoma Gas Electric Company
Cause No. PUD 200700012
Schedule 1

Calculation of Total Proposed Cost Disallowance Over Red Rock Construction Period

Line	RRCR Increment (grossed up for income taxes)[1]	2007	2008	2009	2010	2011	2012	Total
2	2007	3.0	3.0	3.0	3.0	3.0	3.0	
3	2008		24.0	24.0	24.0	24.0	24.0	
4	2009			37.0	37.0	37.0	37.0	
5	2010				22.0	22.0	22.0	
6	2011					8.0	8.0	
7	2012						40.0	
8	RRCR net cash flow	3.0	27.0	64.0	86.0	94.0	134.0	408.0
9	RRCR reduce by 26.8% to reflect disallowance of income tax gross up							
10	Net of income taxes							
11	2007	2.2	2.2	2.2	2.2	2.2	2.2	
12	2008		17.6	17.6	17.6	17.6	17.6	
13	2009			27.1	27.1	27.1	27.1	
14	2010				16.1	16.1	16.1	
15	2011					5.9	8.0	
16	2012						29.3	
17	ALJ proposed rider net cash flow	2.2	19.8	46.9	63.0	68.9	100.3	301.1
18	Disallowance	(0.8)	(7.2)	(17.1)	(23.0)	(25.1)	(33.7)	(106.9)

[1] Motley Direct Testimony p. 3 Chart 1

Note: The amounts reflected on lines 2 through 7 come from Howard Motley's Direct Testimony page 3 Chart 1. The amounts reflected in Motley's Chart 1 show the annual increase in OG&E's revenue requirement from the RRCR for Red Rock financing costs including debt financing, common equity financing and the related income tax expense. Each year's increase is added to the increase for the preceding years to compute the annual RRCR revenue requirement. The amounts on lines 11 through 16 are the same as those derived from Chart 1 but exclude the related income tax expense. The amounts on line 18 shows the annual income tax expense disallowed.