

BEFORE THE CORPORATION COMMISSION OF THE STATE OF OKLAHOMA

APPLICATION OF OKLAHOMA GAS AND)
ELECTRIC COMPANY FOR DECLARATORY)
ORDER OF THE OKLAHOMA CORPORATION)
COMMISSION DETERMINING APPLICANT'S)
COMPLIANCE WITH ORDER NO. 470044) CAUSE NO. PUD 200300226
ISSUED IN CAUSE NO. PUD 200100455 WITH)
RESPECT TO COMPETITIVE BIDDING FOR)
NATURAL GAS TRANSPORTATION SERVICE)

DIRECT TESTIMONY

OF

MARTIN J. BLAKE

On behalf of

OKLAHOMA GAS AND ELECTRIC COMPANY

March 31, 2004

Direct Testimony
of
Martin J. Blake

1 Q: PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

2 A: My name is Martin J. Blake. My business address is 6435 W. Highway 146, Suite 2,
3 Crestwood, Kentucky 40014.

4 Q: BY WHOM AND IN WHAT CAPACITY ARE YOU EMPLOYED?

5 A: I am a Member and Principal of The Prime Group, LLC. The Prime Group provides
6 consulting services in the areas of marketing, market research, rate and regulatory
7 support, training, and strategic planning for energy industry clients.

8

9

Professional Qualifications & Experience

10 Q: PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND.

11 A: I received my Ph.D. in Agricultural Economics in 1976 from the University of Missouri,
12 Columbia. My doctoral work centered on the areas of marketing and econometrics. I
13 also hold a Master of Arts in Economics from the University of Missouri, Columbia,
14 which I received in 1972. In addition, I received a Bachelor of Arts degree in Economics
15 from Illinois Benedictine College in 1970.

16 Q: IN WHAT AREAS DOES YOUR PRACTICE CONCENTRATE?

17 A: As a member of The Prime Group, I have prepared and filed Order No. 888 and Order
18 No. 889 compliance filings at the Federal Energy Regulatory Commission (“FERC”) for
19 a number of electric utilities as well as Order No. 888 and Order No. 889 waiver requests
20 for other utilities. I have prepared market power analyses in support of market-based rate
21 filings at FERC for utilities and their marketing affiliates, as well as assisting other
22 utilities with their market-based rate filings. I have also assisted several utilities in
23 addressing both FERC and state affiliate transactions concerns and have provided
24 training regarding standards of conduct. I have assisted utilities with developing strategic

1 marketing plans and implementing these plans. I have provided utility clients with
2 assistance regarding regulatory policy, strategy and liaison; state and federal regulatory
3 filing development, testimony and support; cost of service development and support; the
4 development of innovative rates to achieve strategic objectives; the unbundling of rates
5 and the development of menus of rate alternatives for use with customers; performance-
6 based rate and incentive rate development; and energy marketing and brokering
7 capability development. I have made presentations to train account executives in sales
8 and customer negotiation, as well as presentations in ratemaking and utility finance
9 seminars and workshops regarding basic utility marketing. I have provided marketing,
10 market research and marketing support services for utility clients and have assisted them
11 in assessing their marketing capabilities and processes.

12 Q: PLEASE BRIEFLY SUMMARIZE YOUR AREAS OF PROFESSIONAL
13 EXPERIENCE PRIOR TO JOINING THE PRIME GROUP.

14 A: I have professional experience as an economist and professor of economics, as a utility
15 regulator, and as a utility manager and executive.

16 Q: PLEASE DESCRIBE YOUR PROFESSIONAL EXPERIENCE AS AN ECONOMIST.

17 A: From January 1977 to December 1986, I was employed first as an Assistant Professor,
18 then as an Associate Professor, and finally as a Professor of Agricultural Economics at
19 New Mexico State University in Las Cruces, New Mexico ("NMSU"). I was the head of
20 the undergraduate program and taught economics, agricultural economics and
21 econometrics. While at NMSU, I also worked as a consultant for various clients,
22 providing price forecasting, load forecasting, and marketing services. Since 1992, I have
23 taught mathematical economics and econometrics as an Adjunct Professor in the
24 Economics Department at the University of Louisville. Prior to my joining the faculty at
25 NMSU, I served in the U. S. Army as an instructor of economics, statistics, and
26 accounting at the U. S. Army Institute of Administration at Fort Benjamin Harrison,
27 Indianapolis, Indiana.

1 I also have a variety of experience with the application of economics to utility
2 public policy issues. In addition to my experience as a utility regulator and executive,
3 which I describe below, I have, for example, taught retail and wholesale pricing for
4 electric utilities at the NARUC Annual Regulatory Studies Program at Michigan State
5 University since 1993. From May 1983 to August 1983, while on a sabbatical leave from
6 NMSU, I served as a Policy Analyst for the Assistant Secretary for Land and Water at the
7 U. S. Department of Interior.

8 Q: PLEASE DESCRIBE YOUR PROFESSIONAL EXPERIENCE AS A UTILITY
9 REGULATOR.

10 A: From January 1987 to November 1990, I served as a Commissioner and as the Chairman
11 of the New Mexico Public Service Commission. As a Commissioner, my duties included
12 making policy and adjudicatory decisions regarding rates, terms of service, financing,
13 certificates of public convenience and necessity, and complaints for electric, gas, water,
14 and sewer utilities. As Chairman, I supervised a staff of thirty-two professionals and
15 sixteen support staff. During my tenure on the New Mexico Commission, I also served
16 as Chairman of the Western Conference of Public Service Commissioners Electric
17 Committee and as Chairman of the Committee on Regional Electric Power Cooperation,
18 a group composed of state public service commissioners and representatives from the
19 state energy offices of the thirteen western states.

20 As a Commissioner, I interpreted legislation, reviewed prior Commission cases to
21 determine the precedents that they provided, drafted rules and regulations, wrote Orders,
22 conducted hearings, ruled on motions, and served as an arbitrator in alternative dispute
23 resolution proceedings. Although I do not have a law degree, I performed adjudicatory
24 and regulatory functions for the four years that I served on the Commission.

25 Q: PLEASE DESCRIBE YOUR PROFESSIONAL EXPERIENCE AS A UTILITY
26 MANAGER.

1 A: From December, 1990 to June 1996, I was employed by Louisville Gas and Electric
2 Company ("LG&E"). Initially, I served as LG&E's Director of Regulatory Planning. In
3 this position, I was responsible for coordinating all of LG&E's state and federal
4 regulatory efforts, and prepared and presented testimony to regulators. In performing my
5 duties in the federal regulatory area, I performed the market power analysis in LG&E's
6 original market-based rate filing at the FERC, which was one of the first applications of
7 the "hub and spoke" methodology that the FERC used in assessing generation market
8 dominance in market-based rate filings; supervised the preparation of the market-based
9 rate filings; and served as LG&E's principal witness in this case. I also helped develop
10 the electronic bulletin board that the FERC required as a condition for approving the
11 market-based tariff. Additionally, I helped to develop LG&E's comparable transmission
12 tariff filing, which provided third parties with access to LG&E's transmission system at
13 the same price, terms and conditions as LG&E. This was the first tariff providing
14 comparable transmission service that was filed and approved by the FERC and was filed
15 before Order No. 888 was issued by FERC. In this comparable transmission tariff filing, I
16 served as LG&E's principal witness and negotiated the settlement in this case with FERC
17 staff. When LG&E Power Marketing filed for the ability to charge market-based rates, I
18 helped to develop the codes of conduct that were submitted to the FERC as a part of the
19 filing.

20 My areas of responsibility were expanded in April 1994 to include marketing and
21 strategic planning. As the Director, Marketing, Planning and Regulatory Affairs, I was
22 responsible for coordinating LG&E's retail gas and electric marketing, strategic planning,
23 and state and federal regulatory efforts. I continued to be employed in that capacity at
24 LG&E until June 1996, when I joined the Prime Group as one of its Principals.

25 Q: PLEASE DESCRIBE THE INDUSTRY GROUPS IN WHICH YOU HAVE
26 PARTICIPATED.

1 A: I have served on several regional transmission coordination groups such as the
2 Interregional Transmission Coordination Forum, and the General Agreement on Parallel
3 Paths, as well as the following committees of the Edison Electric Institute ("EEI") --
4 Economics and Public Policy Executive Advisory Committee, Strategic Planning
5 Executive Advisory Committee, Transmission Task Force, and Power Supply Policy
6 Technical Task Force. Recently, I have worked with a group of utilities developing the
7 Midwest ISO and serve as Southern Illinois Power Cooperative's representative on the
8 Transmission Owner Committee and Tariff Committee. I am currently Vice Chairman of
9 the Tariff Committee.

10 Q: HAVE YOU TAUGHT ANY COURSES OR SEMINARS IN THE AREA OF UTILITY
11 RESTRUCTURING?

12 A: Yes. I have taught the following courses at the NARUC Annual Regulatory Studies
13 Program at Michigan State University: 1) retail ratemaking, 2) wholesale pricing, 3) rate
14 of return regulation, 4) competitive market fundamentals, 5) electric industry overview,
15 6) the economics of power production and delivery, 7) electric system technologies, and
16 8) the institutions and organizations of the new electric utility industry. Each year, I also
17 teach and conduct numerous workshops and programs and deliver invited presentations
18 to utility managers and regulators on a variety of subjects including industry
19 restructuring.

20 Q. IN WHICH CASES HAVE YOU PREVIOUSLY TESTIFIED?

21 A. I have testified in numerous proceedings before the Federal Energy Regulatory
22 Commission and various state regulatory bodies. Attached to my Testimony as Exhibit 1
23 is a summary of my testimonial experience.

24 Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

1 A. The purpose of my testimony is to identify the appropriate standards for determining the
2 prudence of the natural gas transportation and storage agreements that OG&E entered
3 into with Enogex and to address the prudence of OG&E entering into these agreements.

4 Q. PLEASE SUMMARIZE YOUR FINDINGS.

5 A. I recommend that the Commission recognize that the firm no-notice, load following gas
6 transportation and storage services that OG&E purchases from Enogex are prudent
7 expenditures that allow OG&E to operate its gas-fired generation assets on a fully
8 integrated basis. This integrated operation of its gas-fired generating assets provides a
9 benefit to customers both in terms of reliability and in terms of cost effectiveness. The
10 reliability benefit is a result of OG&E's ability to start and stop its gas-fired generation
11 whenever it is needed by customers. The firm, no-notice, load following gas
12 transportation and storage services assure that the lack of gas availability does not
13 constrain the operation of these gas-fired generation units in any manner. It also assures
14 that any surplus gas that was scheduled for OG&E's gas-fired generating units could be
15 stored until it was needed and would not require the backing down of any coal plants.
16 The cost effectiveness is a result of OG&E being able to maximize the utilization of its
17 coal units which produce electric energy at a relatively low variable cost per unit
18 compared to OG&E's gas-fired generation. If its gas supply were not flexible enough to
19 accommodate integrated system operation, the coal plants would be cycled while the gas
20 plants were run in accordance with the gas supply to which they had committed. The
21 testimony of Dr. Zimmerman in Cause No. PUD 200100455 and the testimony of Mr.
22 Coffman and Mr. Crowley in this proceeding adequately support this conclusion that
23 OG&E's payments to Enogex for firm, no-notice, load following gas transportation and

1 storage services are not excessive for the kind of service that is being provided. Because
2 natural gas transportation and storage service that permits OG&E to operate its gas-fired
3 generating units is a necessary function for providing reliable service to customers and
4 because the cost of these services is not excessive, OG&E's purchase of natural gas
5 transportation and storage services from Enogex are prudent expenditures.

6 Q. WHY IS THE PRUDENCE OF OG&E'S PURCHASE OF NATURAL GAS
7 TRANSPORTATION AND STORAGE SERVICE FROM ENOGEX AN ISSUE IN
8 THIS PROCEEDING?

9 A. Paragraph 5 of the Joint Stipulation and Settlement Agreement ("Stipulation") in Cause
10 No. PUD 200100455 stated that OG&E agreed to include competitive bidding as an
11 option when analyzing the extension or renewal of the Enogex Gas Transportation
12 Service Agreement for providing natural gas transportation service to OG&E's current
13 gas-fired generation facilities prior to the expiration of the current Agreement with
14 Enogex that will terminate in April 2004. Paragraph 5 of the Stipulation went on to state
15 that:

16 if OG&E chooses not to utilize competitive bidding to obtain all natural gas
17 transportation services to the Current Generation Facilities (after April 1, 2004)
18 and the New Generation Facilities, OG&E will provide Staff and the Attorney
19 General's office all data and information upon which those decisions were based,
20 and the renewed or new contracts for natural gas transportation services or supply
21 services shall be subject to a prudency review by the Commission.

22
23 OG&E has decided not to pursue competitive bidding to secure the natural gas
24 transportation and storage services to meet the needs of its gas-fired generating facilities,
25 and thus the Agreements with Enogex to provide natural gas transportation and storage
26 services are subject to a prudency review.

27 Q. DID PARAGRAPH 5 OF THE STIPULATION SPECIFY CRITERIA FOR
28 CONDUCTING COMPETITIVE BIDDING IF OG&E SELECTED THE
29 COMPETITIVE BIDDING OPTION?

1 A. Yes. Paragraph 5(d) of the Stipulation required that:

2 such competitive bid package shall not include the right of any party to match the
3 lowest bid submitted by any other bidder, and each generation facility shall be bid
4 separately for the services required. A competitive bidder may submit a bid for a
5 combination of generation facilities in response to such competitive bid package,
6 only if such bidder shall also submit or include a bid to serve those same plants
7 individually. (emphasis added)

8
9 Webster's Dictionary defines "shall" as "used in laws, regulations or directives to express
10 what is mandatory". Thus, this language in the Stipulation is very restrictive and requires
11 that certain specifications or criteria would be included in any competitive solicitation.
12 This language precludes OG&E from requiring that the natural gas transportation and
13 storage services that it is seeking would allow OG&E to operate its natural gas-fired
14 generation assets on a fully integrated basis. The competitive bidding criteria specified in
15 the stipulation requires that entities to be allowed to bid on natural gas transportation to
16 just one or a subset of OG&E's natural gas-fired generating plants. If different generating
17 plants were served by different pipelines, OG&E would lose the benefit of integrated
18 operation of its natural gas supply to all of its gas-fired generating units. Thus, under the
19 Stipulation, OG&E did not have an option of seeking competitive bids for the kind of
20 natural gas transportation and storage service that it preferred; namely service that would
21 allow the integrated operation of its gas-fired generating units. Furthermore, if providing
22 natural gas transportation and storage service that permitted integrated operation of
23 OG&E's gas-fired generating facilities was not included as a criteria in the solicitation of
24 competitive bids, it would be difficult for OG&E to use this criteria in selecting a higher
25 priced bid that provided the ability to operate on an integrated basis over a lower priced
26 bid that did not provide the ability to operate on an integrated basis. Such a selection of a
27 higher priced bid that provided the ability to operate on an integrated basis could be

1 challenged as arbitrary under the criteria set forth in the solicitation, as this criteria would
2 not have been included in the solicitation under the terms of the Stipulation.

3 Q. DID PARAGRAPH 5 OF THE STIPULATION REQUIRE OG&E TO UTILIZE
4 COMPETITIVE BIDDING TO ACQUIRE THE NATURAL GAS TRANSPORTATION
5 AND STORAGE SERVICES TO MEET THE NEEDS OF ITS GAS-FIRED
6 GENERATING UNITS?

7 A. No. Paragraph 5 of the Stipulation required OG&E "to include competitive bidding as an
8 option" when analyzing the extension or renewal of the Enogex Gas Transportation
9 Service Agreement. This is an option that OG&E chose not to pursue after analyzing this
10 alternative. It is clear that Paragraph 5 of the Stipulation does not require competitive
11 bidding as the only means of procuring natural gas transportation and storage services
12 that OG&E needs for its gas-fired generating facilities. If competitive bidding were
13 required, there would be no need for the language in Paragraph 5(c) that describes what
14 will take place if OG&E did not pursue the competitive bidding option. As stated above,
15 because OG&E did not choose to pursue the competitive bidding option after analyzing
16 this option, the natural gas transportation and storage agreements with Enogex are subject
17 to a prudency review in this proceeding.

18 Q. IS OG&E'S DECISION NOT TO PURSUE COMPETITIVE BIDDING
19 INCONSISTENT WITH THE TERMS OF THE STIPULATION?

20 A. No. OG&E reached a decision that the form of competitive bidding specified in the
21 Stipulation may not result in the ability to operate its gas-fired generating units on an
22 integrated basis. OG&E considered the ability to operate its gas-fired generating units on
23 an integrated basis as essential to providing safe, reliable, cost effective service to its

1 customers. Thus, OG&E's choice boiled down to pursuing an alternative that was certain
2 to provide the ability to operate its gas-fired generating units on an integrated basis
3 (namely entering into an agreement with Enogex) versus an alternative that may not
4 provide the ability to operate its gas-fired generating units on an integrated basis (the
5 form of competitive bidding specified in the Stipulation). OG&E pursued reliability as its
6 primary goal and chose certainty over uncertainty, which is definitely a reasonable thing
7 to do as long as the price of obtaining certainty is not excessive. I will demonstrate later
8 in my testimony, using testimony presented by Dr. Zimmerman in OG&E's last rate
9 proceeding, that the cost of obtaining this certainty was not excessive. Thus, entering into
10 the natural gas transportation and storage agreements with Enogex was a reasonable and
11 prudent action by OG&E.

12 Q. HAS THE U.S. SUPREME COURT PROVIDED GUIDANCE REGARDING THE
13 CONCEPT OF PRUDENCE?

14 A. Yes. The foundational description of prudence was set forth in a footnote to the
15 concurring opinion in *State of Missouri ex. rel. Southwestern Bell Telephone Co. v.*
16 *Public Service Commission of Missouri, et al.*, wherein Justice Brandeis stated that:

17 The term prudent investment is not used in a critical sense. There should not be
18 excluded from the finding of the base, investments which, under ordinary
19 circumstances, would be deemed reasonable. The term is applied for the purpose
20 of excluding what might be found to be dishonest or obviously wasteful or
21 imprudent expenditures. Every investment may be assumed to have been made in
22 the exercise of reasonable judgment, unless the contrary is shown. (emphasis
23 added) *State of Missouri ex. rel. Southwestern Bell Telephone Co. v. Public*
24 *Service Commission of Missouri, et al.*, 262 U.S. 276 (1923)

25 In *Acker v. U.S.*, 298 U.S. 426, 431 (1936), the Court held that regulation cannot be
26 frustrated by requiring a rate to compensate for extravagant or unnecessary costs.

27 Moreover, in *West Ohio Gas Co. v. Public Utilities Commission of Ohio*, 294 U.S. 63, 72

1 (1935), the Court held that good faith is presumed on the part of the utility absent a
2 showing of inefficiency or improvidence. Therefore, upon this guidance from the U.S.
3 Supreme Court, the concepts of "wasteful", "dishonest", "extravagant", "unnecessary",
4 "inefficient" and "improvident" would seem to be good concepts to apply in determining
5 whether an action is prudent. Along the same lines, Bonbright defines a prudent
6 investment as:

7 The original historical cost minus any fraudulent, unwise, or extravagant
8 outlays that should not be a burden on ratepayers. (Principles of Public
9 Utility Rates, James C. Bonbright, Albert L. Danielsen and David R.
10 Kamerschen, Public Utility Reports, Inc., 1988, p. 223)
11

12 These concepts can be summarized in two key questions for addressing the issue of
13 prudence: 1) is the action or function in question necessary to provide safe, reliable
14 service to customers and 2) is the cost of performing this action or function excessive.
15

16 Q. PLEASE SUMMARIZE THE APPROPRIATE STANDARDS FOR PRUDENCE AND
17 THE CONTEXT IN WHICH THEY SHOULD BE CONSIDERED IN THIS
18 PROCEEDING.

19 A. In answering these two questions regarding prudence that are posed above, the standards
20 for determining the prudence of an action can be summarized as:

- 21 • What a reasonable person would have done under the circumstances that
22 prevailed when the action was taken, knowing the information available at the
23 time that the decision was made.
- 24 • The appropriate standard for determining prudence is not perfection.
- 25 • The application of hindsight is always inappropriate.

- It is inappropriate to use a standard of “what I would have done in similar circumstances”.

Q. COULD YOU ELABORATE ON WHY YOU BELIEVE THAT THESE STANDARDS FOR DETERMINING PRUDENCE ARE APPROPRIATE?

A. The Federal Energy Regulatory Commission and state regulatory commissions have recognized that the appropriate standard for assessing prudence is what a reasonable person would do based on the facts available at the time the decision was made. Additionally, the application of hindsight is always inappropriate in assessing the prudence of an action. State regulatory agencies have recognized that the use of hindsight is an inappropriate standard for determining the prudence of an action. For example, the Pennsylvania Public Utility Commission stated that:

Prudence is that standard of care which a reasonable person would be expected to exercise under the same circumstances encountered by utility management at the time decisions had to be made. In determining whether a judgment was prudently made, only those facts available at the time judgment was exercised can be considered. Hindsight review is impermissible. *Re Salem Nuclear Generating Station*, 70 PUR 4th 568,574 (Pa. PUC 1985).

Along the same lines, Bonbright notes that:

"Prudent" imports the requirement that the investment, in order to gain recognition in rate base, must have been prudently incurred in the light of foresight rather than hindsight. (Principles of Public Utility Rates, James C. Bonbright, Albert L. Danielsen and David R. Kamerschen, Public Utility Reports, Inc., 1988, p. 238)

This guidance regarding the inappropriateness of using hindsight is difficult trap to avoid because the determination of the prudence of an action generally occurs well after the decision is made. With the ready availability of historical data, it is easy to determine

1 how an action turned out, and there is a strong inclination to ascribe imprudence to
2 decisions that did not turn out well.

3 It is inappropriate for regulators to use a standard of “what I would have done in similar
4 circumstances”. Direction in this regard has been provided by the U.S. Supreme Court
5 which stated that:

6 The Commission is not the financial manager of the corporation and it is
7 not empowered to substitute its judgment for that of the directors of the
8 corporation; nor can it ignore items charged by the utility as operating
9 expenses unless there is an abuse of discretion in that regard by the
10 corporate officers. *State of Missouri ex rel. Southwestern Bell Telephone*
11 *Company v. Public Service Commission of Missouri, et al.* (262 U.S. 276,
12 1923)

13
14 Prudence does not require that a utility try to anticipate the decision that regulators would
15 prefer. Although regulators may prefer a certain decision to the one made by the utility,
16 the prudence of a decision is determined based on whether the utility's decision was
17 reasonable based on the facts know at that point in time.

18 Furthermore, the appropriate standard for determining prudence is not perfection. No
19 company will make the right decision every time. A proper assessment of the prudence of
20 an action should focus on the appropriateness and reasonableness of the decision based
21 on information that utility management knew or should have known at the time that the
22 action was taken.

23 Q. HAS THE FEDERAL ENERGY REGULATORY COMMISSION PROVIDED
24 GUIDANCE REGARDING PRUDENCE?

25 A. Yes. In Opinion No. 231 issued in *New England Power Company*, 31 FERC ¶ 61,047, the
26 FERC discussed the concept of prudence and established a standard for determining
27 prudence. The standard adopted by the FERC is as follows:

1 Consistent with the cases discussed herein, we reiterate that managers of a utility
2 have broad discretion in conducting their business affairs and in incurring costs
3 necessary to provide services to their customers. In performing our duty to
4 determine the prudence of specific costs, the appropriate test to be used is whether
5 they are costs which a reasonable utility management (or that of another
6 jurisdictional entity) would have made, in good faith, under the same
7 circumstances, and at the relevant point in time. We note that while in hindsight it
8 may be clear that a management decision was wrong, our task is to review the
9 prudence of the utility's actions and the costs resulting there from based on the
10 particular circumstances existing either at the time the challenged costs were
11 actually incurred, or the time the utility became committed to incur those
12 expenses. *New England Power Company*, 31 FERC ¶ 61,047 (emphasis added)

13
14 This FERC standard does a good job of summarizing the two key issues regarding
15 prudence that were raised above; namely 1) is the action or function in question necessary
16 to provide safe, reliable service to customers and 2) is the cost of performing this action
17 or function excessive.

18 Q. SHOULD THE LOWER OF COST OR MARKET BE USED AS A CRITERIA FOR
19 DETERMINING PRUDENCE?

20 A. No. Cost of service regulation has been used by regulatory commissions to ensure that
21 utilities are not unduly exercising market power and over-earning when a market for the
22 service provided by the utility does not exist. In cost of service regulation, a regulatory
23 commission allows a utility to recover its cost of providing service, which includes a fair
24 rate of return on the capital that the utility has invested to meet the needs of customers. If
25 a utility is earning significantly less than its allowed rate of return, it can file for an
26 increase in rates. This results in utilities that are regulated on a cost of service basis
27 earning a rate of return that falls within a fairly narrow, positive range.

28 By contrast, a market price is determined by the interaction of supply and demand for a
29 service or commodity. A market price has little to do with the full embedded cost of
30 providing a service or commodity. It is through price variation that a market sends it

1 signals to market participants. A high price signals providers of the commodity or service
2 to increase supply and signals buyers to decrease their demand. A low price signals
3 providers of the commodity or service to decrease supply and signals buyers to increase
4 their demand. Hopefully, the profits that a firm makes during high price periods will
5 offset the losses that it experiences when prices are low. However, there is no guarantee
6 that this will be the case. In competitive markets, firms may experience excess profits or
7 losses. If firms experience losses for a long enough period of time, they will exit the
8 business and no longer supply the service or commodity. On the other hand, excess
9 profits attract additional suppliers to the industry. A good example of the price variability
10 that can occur in a market is the price for electricity in the California markets since 1998.
11 At times, the market price of electric energy was below full embedded cost, while at
12 other times, such as June 2000 through early 2001, the market price was well in excess of
13 full embedded cost.

14 If the lower of cost or market were used as a criteria for prudence, a utility would be
15 guaranteed to under-earn, which would be inconsistent with the U.S. Supreme Court
16 guidance in the Hope and Bluefield cases. If the lower of cost or market were used as a
17 criteria for prudence, the highest rate of return that the utility could earn would be the fair
18 rate of return used in determining cost based rates. The utility would experience low or
19 negative earnings during periods of low market prices. Being stuck with the low side of
20 market-based pricing is only fair if you can also benefit from the high prices that occur in
21 properly functioning markets. Using a standard of the lower of cost or market for
22 determining prudence would assure that the utility would not have a chance of earning

1 the return on shareholder equity that a regulatory commission had determined to be fair.
2 This would not be prudence, it would be confiscation.

3 Q. IS IT NECESSARY TO ISSUE COMPETITIVE BIDS FOR A RESOURCE TO
4 DETERMINE WHETHER THE ACQUISITION OF THE RESOURCE WAS
5 PRUDENT?

6 A. No, it is not necessary to competitively bid for a resource to determine whether the
7 acquisition of the resource was prudent. This is especially true if competitive bidding
8 may not result in the kind of service that a utility believes that it needs to provide safe
9 reliable service to customers, as is the case here. In his Direct Testimony, Mr. Coffman
10 testified that Enogex provides firm no-notice, load following gas transportation service at
11 a fixed rate, and that service has allowed OG&E to operate its generation assets on a fully
12 integrated basis. Fully integrated operations have permitted OG&E to recognize changes
13 in load, unit availability, weather conditions and other operational conditions while
14 simultaneously providing the customers with the lowest possible cost for electric energy.
15 (Coffman Direct Testimony, p. 7, lines 5-11). Because competitive bidding may not have
16 provided the natural gas transportation and storage services necessary to operate OG&E's
17 gas-fired generating units on a fully integrated basis, OG&E rejected the competitive
18 bidding option as an alternative for procuring the natural gas transportation and storage
19 services that it needed in favor of an alternative that was certain to provide such service.
20 The fact that competitive bidding as defined in the Stipulation may not have satisfied
21 OG&E's reliability requirements does not preclude the Commission from determining
22 whether the price that OG&E is now paying for natural gas transportation and storage
23 service from Enogex is reasonable based on prices for other gas transportation and

1 storage services offered in the market. Based on the testimony of Mr. Crowley, Mr.
2 Coffman and Dr. Zimmerman, it appears that OG&E is paying a price that is similar to
3 the price of other natural gas transportation and storage services that are available in the
4 market, yet OG&E is receiving a service that is superior to these services that are
5 available in the market. Thus, the cost of the services that OG&E has procured from
6 Enogex is clearly in the best interest of OG&E's customers and cannot be considered
7 excessive.

8 Q. IF OG&E HAD ISSUED AN RFP THAT SPECIFIED THAT THE SUCCESSFUL
9 BIDDER MUST SUPPLY FIRM, NO-NOTICE, LOAD FOLLOWING GAS
10 TRANSPORTATION SERVICE THAT PERMITTED INTEGRATED OPERATION
11 OF OG&E'S GAS-FIRED GENERATING PLANTS, WOULD THIS SPECIFICATION
12 BE CONSISTENT WITH THE PROVISIONS OF PARAGRAPH 5(d) OF THE
13 STIPULATION?

14 A. No. Paragraph 5(d) of the Stipulation requires that each generation facility shall be bid
15 separately for the services required. This would preclude a requirement that gas
16 transportation service would support the integrated operation of OG&E's gas-fired
17 generating plants. Thus, a specification of service consistent with Paragraph 5(d) of the
18 Stipulation would not provide the kind of service that OG&E believes is necessary to
19 provide reliable, cost effective service to its customers. This raises the important issue of
20 whether the integrated operation of OG&E's gas-fired generating plants is necessary or
21 whether separate gas transportation for each generating facility would be adequate.

1 Q. IS INTEGRATED OPERATION OF THE NATURAL GAS SUPPLY TO OG&E'S
2 GAS-FIRED GENERATING UNITS SUPERIOR TO PROVIDING THE NATURAL
3 GAS SUPPLY TO EACH PLANT INDEPENDENTLY?

4 A. Yes. Integrated operation of the natural gas supply to all of OG&E's gas-fired generating
5 units permits gas that is not needed at one unit to be shifted to another unit. It permits gas
6 that is not needed at any of the gas-fired generating facilities to be injected into storage. It
7 also allows gas needed to operate generating units that is in excess of the amount that
8 OG&E has previously scheduled to be withdrawn from storage. With this flexibility,
9 OG&E can flatten its purchase load factor and reduce the price that it pays for the gas
10 commodity.

11 The ability to provide a gas supply that allows OG&E's fleet of gas-fired generation to be
12 started whenever they are needed and to be shut down when they are not needed provides
13 OG&E with the flexibility to maximize the use of its coal-fired generating resources,
14 which typically have a much lower variable cost of production than natural gas. Reducing
15 the variable cost of production is clearly a benefit to customers. If its gas supply were not
16 flexible enough to accommodate integrated system operation, the coal plants would need
17 to be cycled while the gas plants would run in accordance with the gas supply to which
18 they had committed. This would cause generating units with a higher variable cost per
19 unit to be run rather than generating units with lower variable cost per unit. It would also
20 likely result in higher operations and maintenance cost on OG&E's coal-fired generating
21 units because of the increased cycling of these units.

22 Flexible operation of OG&E's natural gas-fired generating units is beneficial in providing
23 reliable and cost effective service to customers. Reliability is enhanced by a flexible

1 natural gas supply because OG&E's gas-fired units can be started whenever necessary to
2 meet customer needs. The ability of these units to run, or to stop running, is not limited
3 by the characteristics of the gas transportation used to supply these plants. Cost
4 effectiveness is achieved by maximizing the ability to utilize OG&E's coal-fired
5 generating resources. Thus, in answering the first question regarding prudence that I
6 posed above, I believe that procuring natural gas transportation and storage service that
7 permits integrated operation of OG&E's gas-fired generating plants is a necessary
8 function for providing safe reliable service to customers. The second issue that needs to
9 be addressed is whether the cost of providing these natural gas transportation and storage
10 services is excessive.

11 Q. HAS DR. ZIMMERMAN ALREADY ADDRESSED THE PRUDENCE OF MOST OF
12 THE NATURAL GAS TRANSPORTATION COSTS AT ISSUE IN THIS
13 PROCEEDING?

14 A. Yes, I believe that he has. Based on *Bluefield Waterworks and Improvement Co. v. West*
15 *Virginia Public Service Commission* (262 U.S. 679, 1923) and *Federal Power*
16 *Commission v. Hope Natural Gas Company* (320 U.S. 391, 1944), a utility has the right
17 to recover its prudently incurred expenses and earn a fair return on its investments of
18 capital used to provide service to ratepayers. Based on this guidance from the U.S.
19 Supreme Court, each element in the revenue requirement must be judged in the light of
20 prudence. In order to disallow an expenditure, there must be a finding that the
21 expenditure was imprudent or unreasonable. Similarly, in order to recommend that an
22 expenditure be recovered by including it in rates, it is necessary that the expenditure be

1 found to be prudent. It would be improper and contrary to existing regulatory precedent
2 to recommend recovery of an expenditure if the expenditure were not prudent.

3 In his Testimony in Cause No. PUD 200100455, Dr. Zimmerman analyzed the natural
4 gas transportation and storage services that Enogex provided for OG&E. He found that
5 the cost of providing these services was reasonable and recommended that OG&E be
6 allowed to recover these expenditures. Specifically, Dr. Zimmerman recommended the
7 recovery of the \$32,300,000 that OG&E agreed to pay Enogex for natural gas
8 transportation service. Dr. Zimmerman could not have recommended the recovery of this
9 expenditure without finding that it was prudent. To have done so would be contrary to
10 existing regulatory precedent and practice regarding prudence.

11 Q. WOULD YOU PLEASE EXPLAIN HOW DR. ZIMMERMAN'S
12 RECOMMENDATIONS OF RECOVERY IN THE LAST RATE CASE RELATE TO
13 THE PRUDENCE OF THE NATURAL GAS TRANSPORTATION SERVICES THAT
14 ENOGEX WILL PROVIDE FOR OG&E THAT ARE AN ISSUE IN THIS RATE
15 CASE?

16 A. The Testimony that Dr. Zimmerman filed on June 11, 2002 in Cause No. PUD
17 200100455 concluded that the \$32,300,000 that OG&E agreed to pay Enogex for natural
18 gas transportation service was reasonable and that the rate that OG&E was paying for this
19 transportation service was market based. (Zimmerman Testimony, p. 18). This
20 \$32,300,000 expenditure for natural gas transportation service is the same amount that
21 OG&E is seeking to recover in this proceeding for the level of transportation service
22 established in the Binding Letter Agreement that OG&E signed with Enogex. On pages
23 27 and 28 of his testimony in the last rate proceeding, Dr. Zimmerman recommends that

1 this \$32,300,000 "should be recovered through base rate tariffs." Such a recommendation
2 would not have been possible if Dr. Zimmerman regarded this expenditure as imprudent.
3 If he were to now find that this expenditure was imprudent in this proceeding, there
4 would be a major inconsistency between such a finding of imprudence and his testimony
5 in the last rate case. Such an inconsistency would need to be carefully examined by the
6 Commission to assure that hindsight, which is not permitted in determining the prudence
7 of an action, did not play a role in changing his recommendation.

8 Dr. Zimmerman's recommendation regarding natural gas transportation service in the last
9 rate proceeding also applies indirectly to the additional transportation service that OG&E
10 procured for its generation facilities at Muskogee, Enid, and Woodward during the winter
11 months. The incremental cost of this additional gas transportation service of \$1,820,940
12 per year was determined by multiplying the same prices used in determining the
13 \$32,300,000 charge by the increased quantity of natural gas transportation service needed
14 for these generating facilities. Because the same pricing, which Dr. Zimmerman found to
15 be reasonable and market based in the last rate proceeding, was used in determining this
16 incremental cost, the second question posed above regarding the prudence of this
17 additional expenditure has been answered. Based on Dr. Zimmerman's testimony in the
18 last rate proceeding, the cost of performing this additional service should be regarded as
19 reasonable and not excessive.

20 The only question that remains is whether this additional gas transportation service is
21 necessary. As Mr. Coffman testifies, this additional gas transportation service is
22 necessary to provide reliable service to customers based on OG&E's experience during
23 the January 2002 ice storm. During this storm, it became apparent that additional

1 transportation service was needed for OG&E's generation facilities at Muskogee, Enid,
2 and Woodward during the winter months, as those stations were used heavily following
3 the ice storm to provide power to Western Oklahoma while the Company's transmission
4 system in that region was being restored. This additional gas transportation service
5 assures that OG&E's customers in Western Oklahoma will receive reliable service even if
6 there is a major transmission outage. Thus, the \$1,820,940 expenditure for additional gas
7 transportation service is prudent because the function is necessary to provide reliable
8 service to customers and the cost of providing this function is not excessive.

9 Q. WHAT DO YOU RECOMMEND?

10 A. I recommend that the Commission find that the firm no-notice, load following gas
11 transportation and storage services that OG&E purchases from Enogex are prudent
12 expenditures that allow OG&E to operate its gas-fired generation assets on a fully
13 integrated basis. This integrated operation of its gas-fired generating assets provides a
14 benefit to customers both in terms of reliability and in terms of cost effectiveness. The
15 reliability benefit is a result of OG&E's ability to start and stop its gas-fired generation
16 whenever it is needed by customers. The firm, no-notice, load following gas
17 transportation and storage services assure that the lack of gas availability does not
18 constrain the operation of these gas-fired generation units in any manner. The cost
19 effectiveness is a result of OG&E being able to maximize the utilization of its coal units
20 which produce electric energy at a relatively low variable cost per unit compared to gas.
21 If its gas supply were not flexible enough to accommodate integrated system operation,
22 the coal plants would be cycled while the gas plants were run in accordance with the gas
23 supply to which they had committed. The testimony of Dr. Zimmerman in Cause No.

1 PUD 200100455 and the testimony of Mr. Coffman and Mr. Crowley in this proceeding
2 adequately support this conclusion that OG&E's payments to Enogex for no-notice, load
3 following gas transportation and storage services are not excessive for the kind of service
4 that is being provided. Because natural gas transportation and storage service that permits
5 OG&E to operate its gas-fired generating units is a necessary function for providing
6 reliable service to customers and because the cost of these services is not excessive,
7 OG&E's purchase of natural gas transportation and storage services from Enogex are
8 prudent expenditures.

9 Q. DOES THIS CONCLUDE YOUR TESTIMONY?

10 A. Yes.