

Q5. DOES THE TRANSACTION PROVIDE SUBSTANTIAL CONCRETE BENEFITS SUCH THAT THE TRANSACTION IS IN THE PUBLIC INTEREST?

A. Yes, the transaction provides substantial concrete benefits for Arkansas customers and is in the public interest. Staff witness Mr. Peaco's testimony highlights the fact that the Commission "is not opposed to independent transmission companies or independent transmission construction and, in fact, it strongly supports the improvement of the transmission system in this state and region as a means to lower energy costs for Arkansas ratepayers."¹ Mr. Peaco interprets the Commission's order in the SWEPCO Transco case to express a standard of substantial evidence of concrete benefits for ratepayers. While ITC does not believe the Commission has clearly adopted a standard to be applied in considering the Application submitted in this docket, I disagree with how Mr. Peaco has chosen to apply the standard he recites with respect to several unquantified qualitative benefits which this transaction brings to Arkansas ratepayers. In Docket No. 11-050-U the Commission did not say that "concrete benefits" must be quantified, yet Mr. Peaco's report gives little weight to or simply disregards ITC's testimony and responses to discovery requests regarding these unquantified benefits in determining whether the transaction is consistent with the public interest.

This is an unusual transaction in that it is driven primarily by qualitative benefits. The nature of the benefits stemming from the transaction reflect the fact that the ultimate outcome will be far more than simply the transfer of ownership of transmission facilities, but rather a significant strategic realignment that will better position the region to meet its energy challenges for the future. Analyzing this transaction only from the perspective of

¹ Peaco Direct Testimony at 8 (citing Docket No. 11-050-U. Order No. 6 at 21).

quantitative benefits versus quantifiable costs really misses the point of the transaction, to the detriment of customers in Arkansas.

By not limiting concrete benefits to quantifiable benefits in Docket No. 11-050-U, the Commission had the wisdom to recognize that the assessment of the public interest is far more than a simple endeavor that can be whittled down to quantifiable costs and benefits. Consequently, I must respectfully disagree with Mr. Peaco who reaches the exact opposite conclusion. The qualitative benefits of the transaction, which are set forth in my Direct Testimony and in the testimony of other ITC and Entergy witnesses, provide real, substantial and concrete benefits for Arkansas customers that will more than offset the incremental costs of the transaction. These benefits cannot be ignored. When they are considered, the Commission can and should find this transaction to be in the public interest.

Q6. CAN YOU DISCUSS SOME OF THE SUBSTANTIAL CONCRETE BENEFITS WHICH THIS TRANSACTION WILL PROVIDE FOR CUSTOMERS IN ARKANSAS?

- A.** Yes, to begin with, independence is an immediate, substantial and concrete benefit and it is important to this Commission. As stated in our Application, the Commission has expressed concerns regarding the transparency and independence of the Entergy Operating Companies' planning process under the Independent Coordinator of Transmission ("ICT") arrangement approved by FERC in 2006. The Commission stated:

Notwithstanding the improvements in transparency resulting from the ICT planning process, this lack of transparency in what the Operating Companies "decide" to build raises serious questions as to the independence of the Entergy Transmission from influence by the Entergy

System over what transmission is constructed in the Entergy footprint and why.²

In response to APSC 22-1 which asked ITC to “identify all ways in which the transaction will enhance independence of Entergy’s transmission system that are not achievable under Entergy ownership and MISO operation and planning” ITC responded as follows:

Independence will be enhanced because the transmission system will be owned by an independent entity that does not also own generation or distribution assets which would not be the case under Entergy's ownership or MISO operation and planning. As addressed in great detail in the Direct Testimony of Joseph Welch, ITC's independent business model is structured with a singular focus on transmission, which means that all financial and other company resources are utilized to build, operate, and maintain best in class transmission that provides access to the lowest cost generation available. All of ITC's decisions are made based on the needs of customers and the system. ITC's track record of making investments to improve reliability and provide greater access to wholesale energy markets is outlined throughout the case filing. MISO membership alone does not lead to the same results, because the individual transmission owner continues to play a critical role in the RTO planning process which is largely derived from projects submitted by the transmission owner. Therefore, the owner's approach to transmission development affects what will ultimately be built. ITC's broader, regional approach to transmission development provides more robust and effective regional transmission projects than might otherwise be considered. In addition, as stated on page 54 of Mr. Welch's Direct Testimony, the RTO "does not perform local operations, fund or perform maintenance on the system, fund or build capital projects or generator interconnections, or respond to customer needs or concerns on the ground." As such, independent ownership is the best model to provide the focus and financial capability to achieve the most effective transmission system.

Mr. Peaco’s report summarily dismisses this response presumably because ITC does not quantify the magnitude of this incremental benefit.³ The concrete benefits of the ITC independent transmission model may be difficult to quantify, but, as evidenced by the Direct Testimonies of Richard P. Sergel and Joseph L. Welch and ITC’s responses to data

² Docket No. 08-136-U, Order No. 10 at 8.

³ See Peaco Testimony Exhibit DEP-2 at 23.

requests, and as recognized by this Commission, independence benefits are concrete benefits nevertheless.

Improved reliability through a properly planned transmission system is another substantial concrete benefit that ITC has delivered to its other transmission systems and will deliver in Arkansas. This Commission has recognized the importance of a reliable and efficient transmission system and its benefits:

The Commission recognizes that a reliable and efficient electric transmission system is necessary to transfer electrical power within Arkansas and between Arkansas and other regions. A properly designed transmission system provides the state's electric utilities improved access to additional generation resources, increases reliability of service, reduces reserve requirements, reduces or delays the need for new generation facilities and may facilitate the provision of electric service at lower production costs.⁴

ITC witness Jon E. Jipping discusses the value of reliability improvements on the transmission system. His testimony demonstrates how ITC's singular focus on transmission has enabled it to achieve top performance in terms of transmission availability and the tangible economic benefit to customers of realizing this high level of service quality.

Other quantitative and qualitative concrete benefits are described by various EAI and ITC witnesses supporting the transaction application. ITC rebuttal witness Mr. Christopher Kapfer quantifies the economies of scope and scale that may be realized in the Entergy region as a result of the transaction. In addition to the immediate quantified debt cost savings described in my Direct Testimony and the Direct Testimony of EAI witness Jay A. Lewis, Mr. Lewis also explains that the Entergy Operating Companies ("EOCs")

⁴ Docket No. 08-136-U, Order No. 1 at 1.

benefit from increased financial flexibility from alleviating the need for them to invest in required transmission infrastructure going forward, which results in improved free cash flow generation and lower debt balances for the EOCs. This improves Entergy's ability to address both planned and unplanned investment requirements in generation and distribution going forward in a cost-effective manner. ITC witnesses Johannes P. Pfeifenberger and Thomas Vitez describe the benefits of an independent, regional approach to transmission planning. Mr. Pfeifenberger's testimony documents the substantial benefits of ITC's broader, independent planning model. My Direct Testimony further illustrates how this model has resulted in substantial investment in needed transmission.

Regarding transmission service, while the transmission assets may be the same initially, stewardship, service and development of these assets will be significantly enhanced through ITC's ownership. This will lead to not only heightened reliability, which is an economic benefit to customers, but also to a more economically efficient system that allows customers to benefit from a lower delivered cost of energy. These are concrete benefits of the independent transmission model that will flow from the transaction.

More specifically, ITC offers concentrated expertise and focus in the transmission function, allowing for enhanced performance at reduced costs, as explained in Mr. Jipping's testimony. As Mr. Jipping and ITC witness Thomas H. Wrenbeck explain, ITC will have dedicated personnel to serve customer and other stakeholder needs surrounding new and existing transmission lines. As Mr. Pfeifenberger's Direct Testimony explains (p. 11), "[h]aving an independent transmission company like ITC plan the Entergy transmission system and collaborate with stakeholders and regulators will accelerate the

identification and pursuit of beneficial infrastructure projects in the Entergy Region that go beyond addressing traditional transmission planning needs, such as reliability needs, load serving needs, or certain economic projects.” Furthermore, as Mr. Lewis explains in his Direct Testimony, the spinoff of Entergy's transmission business allows for Entergy's increased focus and capital spending on generation and distribution lines and operations, potentially increasing the performance of both.

In conclusion, when all the benefits flowing from this transaction are considered, both quantitative and qualitative, the modest estimated increase in retail rates will be more than offset by the substantial benefits resulting from ITC's broader, independent planning model, track record of significant investment in needed transmission, and singular focus on transmission producing top performance in transmission availability and reliability. As such, this transaction is in the public interest.

Q.7 MR. PEACO CONCLUDES (p. 10) THAT THE TRANSACTION DOES NOT YIELD SIGNIFICANT BENEFITS INCREMENTAL TO EAI MEMBERSHIP IN MISO. PLEASE RESPOND.

- A.** EAI's membership in MISO will not be sufficient to achieve the benefits the transaction offers. The planning functions provided through MISO membership in no way resolve the financial challenges faced by EAI, as explained in Mr. Lewis' Direct Testimony. MISO does not build or finance transmission. It does not own or maintain any transmission assets. Regardless of whether a company is participating in an RTO or not, the burden to invest and properly maintain transmission systems to ensure high reliability of service and economic efficiency rests with the transmission owner. Simply joining an RTO does not change this fundamental fact.

Q8. DO YOU AGREE WITH MR. PEACO THAT THE REVERSE MORRIS TRUST (“RMT”) STRUCTURE IS NOT A BENEFIT FOR CUSTOMERS AND IS RISKIER THAN OTHER POTENTIAL TRANSACTION STRUCTURES?

- A.** No. The RMT structure offers substantial concrete benefits compared to other divestiture alternatives. As detailed in the Application filed in this Docket, Entergy has been trying to exit the transmission business for 14 years and believes that independent ownership of its transmission business is the right model. Given that Entergy wants to exit this business, the RMT structure is the most efficient way to do so from a tax perspective relative to other divestiture alternatives (e.g., cash sale). Under a taxable transaction, the tax basis of Entergy’s transmission assets would be reset and Accumulated Deferred Income Taxes (“ADIT”) would be re-measured, resulting in lower balances of ADIT. Because ADIT reduces rate base (as opposed to being a zero-cost component of capital under APSC ratemaking), transmission rates for ITC Arkansas and the other new ITC Operating Companies would be higher in a taxable transaction than they will be in this transaction, absent consideration of any other transaction impacts. As a result of the RMT transaction structure, Entergy’s transmission assets will have the same tax basis once merged into ITC as they had under Entergy ownership immediately prior to the transaction. Accordingly, the negative rate effects for customers that otherwise would have resulted from a change in tax basis under a taxable transaction are avoided. With respect to Mr. Peaco’s concerns that the RMT requires assets of all the EOCs to be included, thereby creating a risk if one state regulator fails to approve the transaction, such a risk is present in any type of transaction structure designed to accomplish the same

result. A transaction is structured on the assumption that every element will be implemented. If that is not the case, the transaction must be reassessed.

Q13. IS THE RATE IMPACT ANALYSIS UNDERSTATED BECAUSE ITC MAY BE ELIGIBLE FOR AN INCENTIVE ROE, AS ASSERTED BY SOME WITNESSES?

- A. No it is not. ITC has not asked for an incentive ROE for ITC Arkansas or any of the other ITC Midsouth Operating Companies. As reflected in our application at FERC we have asked for the standard ROE of 12.38% that FERC has approved for all MISO transmission owners and that is what the rate impact analysis reflects. This is no different than what EAI has applied for at FERC as a transmission owner in MISO. Accordingly, 12.38% is the appropriate ROE for purposes of the rate impact analysis.

Q14. IS THE COMPARISON BETWEEN THE INTEREST RATE ITC ARKANSAS CAN OBTAIN AND THE EMBEDDED COST OF DEBT AT ENTERGY ARKANSAS, INC. THE PROPER MEASURE OF THE DEBT COST SAVINGS THAT WILL RESULT FROM THE TRANSACTION?

- A. Yes. The interest expense savings analysis was based on a comparison of embedded debt costs that are reflected in current rates for EAI and the estimated debt cost to be incurred by ITC Arkansas which will be a component of its rates going forward (and thus, its new embedded cost post-closing the transaction). This analysis quantifies the impacts of the debt costs that customers are paying currently versus what they would pay with the transmission facilities under ITC ownership.

This comparison is appropriate because the issuance of new debt is only relevant to the extent that it affects overall embedded debt costs built into current rates. EAI's current

rates include the existing embedded cost of EAI's debt. Rates under ITC ownership will be based on the debt costs ITC Arkansas is expected to incur as part of the transaction. As this debt will be issued in conjunction with the transaction, the debt costs that are expected to be incurred will be, by nature, "marginal" debt costs when the debt is issued and then immediately become the "embedded" debt cost of ITC Arkansas. Accordingly, in contrast to assertions by some witnesses, the analyses Mr. Lewis and I performed represent the accurate way to quantify the rate effects of the debt savings resulting from the transaction.

It is not appropriate to consider the "available" cost of debt for EAI and the other EOCs to compare debt cost savings. Entergy has not executed a refinancing of this magnitude to date and has not apprised us of any plans to do so outside of the transaction. . Thus the only valid comparison is to the embedded cost of debt that customers pay now.

Nor is it possible to confine the analysis to only "transmission debt." EAI does not have debt issuances secured solely by transmission assets. EAI debt issuances are secured by all of its assets in a comingled fashion. As such, the proceeds of EAI's debt issuances are shared across its three primary lines of business (generation, distribution and transmission). Therefore, absent the transaction, transmission revenue requirements under Entergy ownership would reflect the "embedded" cost of debt which is issued to fund the entire business.

Q15. CAN THE PROJECTED DEBT INTEREST RATE SAVINGS BE REALIZED BY EAI OR THE OTHER EOCs AS VARIOUS WITNESSES CONTEND?

- A. No. As an initial matter, Entergy has not executed a refinancing of this magnitude to date, and has not apprised us of any plans to do so outside of the transaction. Testimony of the witnesses represent sheer speculation, as Mr. Lewis discusses in his rebuttal testimony.

Regardless of whether or not Entergy were to seek to refinance this magnitude of debt outside of the transaction, any refinancing of Entergy's debt would likely be at higher interest rates than what ITC Arkansas and the other ITC Midsouth Operating Companies are expected to obtain due to the EOC's credit ratings.⁵ Because the EOC's credit ratings are lower than the expected credit ratings for ITC Arkansas and the other ITC Midsouth Operating Companies, their marginal cost of debt would be higher than that expected for ITC Arkansas and the other ITC Midsouth Operating Companies.

Even if EAI would refinance some debt, not only would it be at a higher cost than ITC would obtain, but it would result in very little change in the overall embedded cost of debt, demonstrating the reasonableness of ITC's debt savings analysis.

In summary, the anticipated interest rates savings are correctly calculated and are directly related to the transaction.

Q18. DOES THE RATE IMPACT ANALYSIS OVERSTATE EAI'S COST OF DEBT?

- A. No. My analysis relied on the embedded cost of debt projections provided by Entergy which range from 5.29% in 2014 to 5.78% in 2018. As Mr. Lewis explains in rebuttal testimony, Mr. Peaco's assertion,⁶ that EAI's current cost of debt is 4.88% is inaccurate.

⁵ Mr. Lewis' rebuttal testimony discusses a number of factors that the witnesses' hypothetical analyses of Entergy's ability to refinance its current debt fail to consider.

⁶ See Peaco testimony Exhibit DEP-2 at 18 (citing EAI's Response to Staff Data Request APSC 21-5).

Q19. HAVE YOU CALCULATED THE DEBT COST SAVINGS IN THE CURRENT MARKET?

- A. Yes. As I discussed above, in today's market, ITC could refinance the initial \$1.2 billion debt at approximately 2.7%⁷ rather than the 3.5% interest rate assumed in my Direct Testimony. The embedded cost of debt provided to me by Mr. Lewis for 2014 is 5.29%. Therefore, in today's market, the cost of debt differential between EAI and ITC Arkansas is approximately 259 basis points, wider than the 179 basis point differential assumed in my Direct Testimony.

Q20. COULD YOU ADDRESS MR. PEACO'S CLAIMS THAT THE RATE IMPACT ANALYSIS DOES NOT INCORPORATE SEVERAL ZERO COST COMPONENTS IN EAI'S WEIGHTED AVERAGE COST OF CAPITAL ("WACC")?

- A. As I stated in my Direct Testimony my rate impact analysis relied on data provided by Mr. Lewis. Mr. Peaco appears to be relying on a June 2010 APSC order.⁸ The 5.04% WACC included in this order is a blended pre-tax and after-tax cost of capital. Presumably the tax gross up effects of the after-tax components of the cost of capital would be included as "income taxes" elsewhere in the revenue requirement build-up. The calculated WACC for EAI is based on cost of capital components provided to ITC by EAI and included the tax gross up on the equity and preferred stock components of the return. In addition, the 5.04% WACC included in the APSC order assumed ADIT at a

⁷ Current interest rate projection for initial refinancing reflects 10-year treasury rate of 193 basis points as of May 15, 2013 plus current spread for ITC's operating companies of 75 basis points provided by JPMorgan as of May 2013.

⁸ See Peaco testimony Exhibit DEP-2 at 14 (citing Docket No. 09-084-U, Order No. 20).

0% cost. The WACC components provided to ITC by EAI did not include ADIT. Rather, ADIT was included as a reduction to rate base, consistent with MISO's Attachment O rate-making. Including ADIT in WACC versus including it as a reduction to rate base has no impact on the resulting return on rate base or revenue requirement.

Q21. DO YOU AGREE WITH ASSERTIONS THAT USE OF THE FORWARD TEST YEAR INCREASES THE REVENUE REQUIREMENT EVERY YEAR?

- A. No I do not. The forward test year has only a timing effect on revenue requirement. The total amount of the revenue requirement that is collected over the life of an asset is not affected. Only the timing of the collection changes. The true-up adjustment assures that the revenue requirement collected ultimately will equal the actual revenue requirement, no more, no less. For these reasons, the use of the forward test year should not be included when measuring the rate effects of the transaction.

Nor is it accurate that there will continue to be effects of the use of the forward test year. After the conversion to the use of the forward test year, the transmission revenue requirement will be collected sooner than it would be under an historical test year, but the actual total revenue requirement collected will not change. When rate base is increasing, use of a forward test year does result in higher revenue requirements than would have been collected using a historical test year. However, when rate base is declining, use of a forward test year results in lower revenue requirements than otherwise would have been collected using a historical test year. Regardless, the same amount is collected over the life of the asset in either scenario.

Q22. WHAT ARE THE BENEFITS OF USING A FORWARD TEST YEAR AND TRUE UP COMPARED TO THE USE OF A HISTORIC TEST YEAR METHODOLOGY?

- A.** In a historic test year methodology, both customers and the utility are at risk due to the existence of regulatory lag. Customers have the risk that the utility will over- recover, while the utility has the risk that it will under- recover. These risks for customers and the utility are reduced through the use of the forward test year methodology, which minimizes recovery lag by better matching cost incurrence and cost collection. The true-up adjustment protects both customers and ITC by accounting for the difference between forecasted and actual results and incorporating this difference, including interest, in rates assessed two years later. The true-up ensures that customers are not harmed if the actual revenue requirement is less than the forecast. Conversely, the true-up also protects ITC if the actual revenue requirement is more than forecast. This allows for ITC's operating companies, including ITC Arkansas, to recover their revenue requirements – no more, no less – on a timely basis.

Minimizing regulatory lag is particularly important because the capital needs of the ITC Midsouth Operating Companies are expected to outpace cash flow generated by the transmission business significantly. Use of a forward test year does improve cash flow generation and, therefore, promotes credit quality and the ability to make the significant and sustained level of capital investment required. This is why FERC has found repeatedly that formula rates using a forward test year are just and reasonable. Also please see Mr. Pfeifenberger's rebuttal testimony.

Q24. SHOULD THE ESTIMATES OF RATE EFFECTS REFLECT INCREASES IN RATEBASE DUE TO ADDED TRANSMISSION INVESTMENT?

- A.** No. For purposes of this analysis we assumed the same level of expected capital investments as EAI has forecasted over the five-year period in order to identify and focus on the effects of ITC's regulatory construct on rates. Until ITC owns and operates EAI's transmission assets, it is not possible to project with any accuracy what levels of capital investments will be required above the EAI forecast, if any, until ITC has experience with the system. As discussed in the Direct Testimony of ITC witness Thomas W. Vitez, participation in the MTEP process ensures that projects are consistent with the needs of existing and emerging energy markets in the EOC footprint and are vetted in an open and transparent process. As discussed in the Direct Testimony of ITC witness Thomas H. Wrenbeck, once the transaction closes, ITC Arkansas will engage regulators and stakeholders to help us determine the future needs of the transmission system. ITC's sole focus on transmission and complete independence from market participants allows ITC to objectively identify projects that reduce congestion across a broad region, strengthen reliability, and facilitate wholesale electric competition through greater market access and transparency for customers. This in turn results in more economic dispatch of generation, ultimately reducing energy costs to end-use customers.