BEFORE THE
ARKANSAS PUBLIC SERVICE COMMISSION

IN THE MATTER OF THE APPLICATION OF ENTERGY ARKANSAS, INC. FOR APPROVAL OF CHANGES IN RATES FOR RETAIL ELECTRIC SERVICE	))))	DOCKET NO. 06-101-U

DIRECT TESTIMONY

OF

HUGH T. MCDONALD

PRESIDENT AND CHIEF EXECUTIVE OFFICER

ENTERGY ARKANSAS, INC.

ON BEHALF OF

ENTERGY ARKANSAS, INC.

AUGUST 15, 2006

I. INTRODUCTION AND BACKGROUND

Q. PLEASE STATE YOUR NAME, TITLE, AND BUSINESS ADDRESS.

A. My name is Hugh T. McDonald. I am employed by Entergy Arkansas, Inc. ("EAI" or the "Company") as President and Chief Executive Officer ("CEO"). My business address is 425 West Capitol Avenue, Little Rock, Arkansas 72201.

Q. ON WHOSE BEHALF ARE YOU TESTIFYING?

A. I am testifying on behalf of EAI.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND PROFESSIONAL EXPERIENCE.

A. I joined Middle South Services, Inc., now Entergy Services, Inc. ("ESI"),[1] in 1982 as an engineer at the Waterford 3 Nuclear Station in Louisiana. In 1989, I was promoted to Executive Assistant to the Chairman and CEO of Louisiana Power & Light Company/New Orleans Public Service Inc. I led Entergy Louisiana's Total Quality initiative until 1993. During Entergy Corporation's merger with Gulf States Utilities Company, I served as the Special Projects Director for the functional integration of the transmission, distribution and customer service organizations.

[1] ESI is subsidiary of Entergy Corp. that provides technical and administrative services to all the Entergy Operating Companies.

In 1994, I held the position of Division Manager of Customer Service for Entergy Mississippi, Inc. In 1995, I was promoted to Director, Regulatory Affairs-Texas, and was responsible for Entergy Gulf States, Inc. rate proceedings, rulemakings and transition to competition activities before the Public Utility Commission of Texas ("PUCT"). I held this position until April 1999. I then led the ESI Retail Operations in New Orleans until June 2000. I was named to my present position, President and CEO of EAI, on June 1, 2000.

I was awarded a Bachelor of Science degree in Construction Management from North Dakota State University in 1980. I earned a Masters in Business Administration degree from the University of New Orleans in 1987.

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE A REGULATORY COMMISSION?

A. Yes. I have testified on fuel, base rate and transition to competition issues in rate proceedings and rulemakings before the PUCT. I also have presented testimony in Docket No. 99-249-U, Docket No. 00-190-U, Docket No. 00-329-U, Docket No. 01-084-U, 04-023-U, and 05-116-U before the Arkansas Public Service Commission ("APSC" or the "Commission").

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. With this filing, the Company is requesting a $150.4 million increase in its base rates, which would be the first base rate increase for the Company since 1985. Our request for a rate increase is driven by several factors:

1. the need to adjust base rates to reflect the increase in the Company's investment in utility facilities and the increased cost of operations;
2. the need for EAI to acquire new generating capacity because it does not own or control enough modern, load-following capacity to meet its customers' needs;
3. the need to put in place new rate mechanisms that reflect the current realities of:
   - the increased role that purchased capacity plays in the Company's resource portfolio, and
   - the order of the Federal Energy Regulatory Commission ("FERC") that will require EAI to make payments to other Entergy Operating Companies[2] because of disparities in the relative total production costs of these utilities.

My testimony provides an overview of the case by introducing the witnesses and the topics addressed in their testimonies. My testimony provides an overview of the Company and its role as an electricity supplier and corporate citizen in Arkansas. In addition, my testimony will explain

[2] The Entergy Operating Companies include EAI; Entergy Gulf States, Inc.; Entergy Louisiana, LLC (formerly Entergy Louisiana, Inc.); Entergy Mississippi, Inc.; and Entergy New Orleans, Inc.

why the Company's investment in utility infrastructure and need for new generating capacity, among other factors, has created the need for a base rate increase of $150.4 million. Further, my testimony explains the overall impact on a typical residential customer's bill over the next year that includes the proposed base rate increase, projected reductions of fuel and purchased energy expense, and the impacts associated with payments EAI will be required to make as a result of the FERC Opinion Nos. 480 and 480-A in FERC Docket No. EL01-88-001 (the "FERC Decision").[3] My testimony also explains why the Company is proposing in this case to recover the cost of new load-following generation capacity it plans to acquire and to implement a new cost recovery mechanism for purchased capacity. Finally, my testimony will explain the alternative methods the Company has proposed to recover payments that EAI will be required to make as a result of the FERC Decision, which will reallocate production costs among the Operating Companies.

Q. WHAT WITNESSES IS EAI SPONSORING IN THIS CASE?

A. In addition to my testimony, the following individuals, and the topics on which they testify, are:

1. Mr. J. David Wright, Director of Regulatory Accounting, will present per book financial information and pro forma adjustments that were

[3] Opinion No. 480, 111 FERC ¶ 61,311, *aff'd* Opinion No. 480-A, 113 FERC ¶ 61,282 (2005).

used to prepare certain Minimum Filing Requirement schedules in support of the Company's request to change its rates.

2. Mr. Phillip B. Gillam, Director of Revenue Requirements and Analyses, will provide the results of the cost-of-service study, will describe the operation of the proposed Capacity Management Rider ("Rider CM"), will describe the operation of the proposed Production Cost Allocation Rider ("Rider PCA"), will address the assignment of capacity that EAI proposed in Docket No. 03-028-U and that was deferred by the Commission to a later docket, and will discuss the effects of the inclusion of the existing Energy Cost Recovery Rider ("Rider ECR") and the proposed Rider PCA costs in base rates.

3. Mr. Gordon D. Meyer, Senior Staff Rate Analyst, will describe the development of the proposed cost allocation factors, provide an overview of pro forma adjustments to sales revenues and the development of those revenues, and present a description of rate design and the associated tariff sheets.

4. Mr. Greg J. Grillo, Director of Distribution Operations, will describe proposed changes to the Company's lighting services and revisions to the extension of facilities policy and underground policy, and other related tariff changes.

5. Dr. Roger A. Morin, a consultant with Utility Research International, Professor of Finance at the College of Business, Georgia State

University, and Professor of Finance for Regulated Industry at the Center for the Study of Regulated Industry at Georgia State University will present his recommended return on equity and describe his derivation of that figure.

6. Mr. Robert R. Cooper, Manager of Generation Planning and Models, will describe EAI's resource requirements, capabilities, and resource planning process; document the cost associated with new generating capacity that EAI plans to acquire, and present the economic justification for the elimination of the irrigation switch program.

7. Mr. Steven M. Fetter, president of the consulting firm Regulation UnFettered, will discuss public policy considerations that favor recovery of purchased capacity costs through an automatic adjustment rate mechanism such as the Company's proposed Rider CM.

8. Mr. Roger Q Mills, Supervisor of Planning Models and Analysis, will provide a projection of fuel and purchased energy costs for the case pro forma period that would be recovered in base rates should the APSC lawfully terminate Rider ECR.

9. Mr. Michael J. Goin, Manager of Financial Analysis, will support the pro forma adjustment associated with the payments that EAI is expected to be required to make as a result of the FERC Decision in the Entergy System Agreement litigation.

10. Mr. Michael M. Schnitzer, a Director in the consulting firm The NorthBridge Group, Inc., will describe the factors that affect the level of EAI's payments as a result of the FERC Decision and discuss the volatility of these payments year to year.

11. Mr. Paul R. Ford, Manager of Customer Relations, will explain the proposed weatherization program that would provide funds to improve the energy efficiency of residences, similar to the federal Weatherization Assistance Program.

II. OVERVIEW OF ENTERGY ARKANSAS

Q. WHAT IS ENTERGY ARKANSAS?

A. EAI is a public utility that provides electric service to approximately 670,000 customers in Arkansas. It is a wholly owned subsidiary of Entergy Corporation, which also owns other public utilities including Entergy Mississippi, Inc.; Entergy Louisiana, LLC (formerly Entergy Louisiana, Inc.); Entergy New Orleans, Inc.; and Entergy Gulf States, Inc. But EAI is more than a vehicle for producing and delivering safe and reliable electricity to Arkansans. The Company also is a group of individuals who are committed to providing exemplary customer service, being compassionate in dealing with customers experiencing difficulties, protecting the environment, encouraging education, providing civic and business leadership, providing leadership in economic development in the state, and much more.

A. Service Reliability

Q. THE BASIC EXPECTATION THAT CUSTOMERS HAVE OF AN ELECTRIC UTILITY IS RELIABLE SERVICE. HOW DOES EAI STACK UP IN THAT MEASUREMENT?

A. Very well. First and foremost, EAI is committed to a philosophy of workplace safety and continuous improvement in reliability and customer service. Beginning in 1999, EAI hired additional frontline workers, put in place programs that identified and addressed poor-performing electrical circuits, inspected and repaired key equipment, and put in place programs to manage proactively vegetation growth along the 33,747 miles of the Company's distribution lines and 4,800 miles of transmission lines.

Q. WHAT HAS BEEN THE RESULT OF THESE EFFORTS?

A. The result of these efforts has been a dramatic improvement in service reliability. Reliability is typically measured in the utility industry by using two indices: System Average Interruption Frequency Index ("SAIFI") and System Average Interruption Duration Index ("SAIDI"). SAIFI measures how frequently, on average, a customer experiences an outage in a given year, while SAIDI measures the average duration, or number of minutes, a customer is without power over a given year. Table 1 shows that from 1998 to 2005, there has been a 60 percent reduction in the frequency of outages. In 1998, customers experienced an average of 3.62 outages in a year, while by 2005 that incidence rate had dropped to 1.46 outages. This

represents the best performance in eight years and the best SAIFI levels ever recorded at EAI.

Table 1
Outage Frequency (SAIFI)
Average Number of Outages Per Customer

	1998	1999	2000	2001	2002	2003	2004	2005
SAIFI	3.62	2.52	1.96	1.78	1.61	1.49	1.57	1.46

Similarly, Table 2 shows that, on average, customers were without power less than half as long in 2005 as they were in 1998. The average amount of time customers were without power in 2005 was 161.3 minutes, while in 1998 it was 331 minutes.

Table 2
Outage Duration (SAIDI)
Average Number Minutes Per Customer

	1998	1999	2000	2001	2002	2003	2004	2005
SAIDI	331	284	161	148.3	160.8	141.4	169.4	161.3

Q. ARE THERE OTHER MEASURES OF SERVICE RELIABILITY?

A. Yes. EAI has demonstrated that its customers can count on its service personnel when customers need help the most – in times of natural disaster. A prime example occurred in the ice storms of December 2000 and January 2001, which left nearly two-thirds of the Company's customers without electric service. A total of 435,000 homes, businesses

and industrial sites were left without power. The Company assembled a work force of more than 10,000 linemen and servicemen from 24 states who restored service within 11 days of the first ice storm and 9 days of the second storm under very challenging circumstances.

The Company's response to this storm in extremely challenging weather was widely recognized and praised. Arkansas Governor Mike Huckabee praised the Company's efforts throughout the crisis and later publicly thanked EAI's employees and customers. The Edison Electric Institute presents the Emergency Assistance Award each year to a company that provides outstanding assistance to a neighboring utility during a crisis. EEI also presents the Emergency Response Award for excellence in responding to a disaster in one's own territory. The Entergy Operating Companies has received one of these two awards every year for seven years, and, in 2006, received both awards.

B. Customer Service

Q. PLEASE DESCRIBE YOUR APPROACH TO CUSTOMER SERVICE.

A. We understand that electricity is an essential service to our customers. We also know that energy costs in general have escalated greatly in the past few years. In response, EAI has been proactive in finding bill payment solutions for our customers. Some of these efforts include:

- Pick-A-Date - customers can select the date on which their electric bills will be due every month;

- Levelized Billing - allows customers to budget their electric bill by paying roughly the same amount each month;
- Draw Draft – allows customers to deduct automatically their payment from their checking account each month;
- Other payment options - EAI allows customers to view bills and pay through the internet, and to pay bills by telephone, credit card, or check.

Customer service also means we help customers who are having difficulty paying their electric bills. These are some programs and policies we have implemented to support customers in that situation:

- Project Deserve – a fund supported by Entergy stockholders, customers and employees and administered by a third party to help elderly and handicapped customers pay their electric bills.
- LIHEAP Referrals – Company personnel connect needy customers with this federal program that provides money to local community action agencies to help with expenses such as electric bills and weatherizing homes. When a customer qualifies for assistance from a LIHEAP agency, the Company will continue service or reconnect based on that agency's promise to pay. The Company has also spent considerable resources lobbying Congress and obtaining support from Arkansas' Congressional delegation and the Governor to ensure Arkansas receives a greater allocation of LIHEAP and U.S. Department of Energy Weatherization Assistance Program

funding. The most recent allocation allotted $23,336,283 to Arkansas, an increase of $9,968,972 as of March 2006.[4]

- Bill Payment Arrangements - Qualifying customers can have their due date extended up to four days through the Company's automated telephone answering system and longer through deferred payment arrangement via our customer service representatives.

In addition, Company representatives have scheduled numerous meetings with low-income advocates in the state to attempt to address the needs of these customers better. EAI's advocacy for low-income customers has included distributing fans to customers who cannot afford air conditioning, organizing more than 100 projects where employee and community volunteers weatherize homes of low-income customers; and providing monetary support over the past five years for low-income weatherization projects through Community Action Agencies ("CAAs"), for the Foundation for the Mid-South and Habitat for Humanity, and many more non-profit organizations that serve our low-income customers.

Q. DOES EAI PROPOSE TO IMPLEMENT A LONG-TERM SOLUTION FOR INCREASING THE EFFICIENT USE OF ELECTRICITY FOR ITS CUSTOMERS?

[4] Source: http://www.neada.org/appropriations/2006-03-23_table.pdf.

A. Yes. To further address the need for more efficient use of our product, EAI proposes to implement a program to provide weatherization services to its residential customers by contracting with the CAAs operating in our service territory. The program would be similar to the U.S. Department of Energy Weatherization Assistance Program, except no income guidelines will be utilized to determine eligibility. Eligibility will be determined by an assessment of the residence utilizing the National Energy Audit Tool, a software tool that determines the cost effectiveness of individual weatherization measures for that residence. Low income customers typically live in older, low-cost housing that is very energy inefficient and are expected to be the major beneficiaries of the program.

In addition to weatherization services, EAI proposes in this case to fund a customer education program, administered by the CAAs, to educate customers on the use of easy-to-install energy-efficiency and safety items. CAA representatives would provide energy-efficiency/ education kits to identified households and discuss the installation and use of the items included in the kits. The kits include compact fluorescent bulbs, low-flow shower heads, refrigerator and hot water thermometer cards, battery-powered smoke detectors, and energy savings literature, among other items. Mr. Ford describes the Company's propose in more detail in his Direct Testimony.

Q. IN WHAT OTHER WAYS DOES EAI SUPPORT ITS CUSTOMERS AND THEIR COMMUNITIES?

A. As a public utility that provides electric service within a fixed service territory in Arkansas, our employees are active volunteers who give back to their respective communities. We also have a very keen interest in the economic development of the state. Our nine-person economic development group supports our state's and communities' efforts in business recruitment, retention and expansion, community development, marketing, and research. This group has been recognized four times in the last eight years by *Site Selection*, a magazine aimed at facility managers and corporate real estate officers, as being among the top utility economic development organizations in the country.

III. OVERVIEW OF FACTORS REQUIRING BASE RATE INCREASE

Q. HOW MUCH INCREASE IN ANNUAL BASE RATE RECOVERY IS THE COMPANY REQUESTING?

A. Approximately $150 million. As explained in detail by Messrs. Wright and Gillam, EAI has an annual base rate revenue requirement of $1.054 billion, but current rates generate annual base rate revenues $150.4 million less than this requirement. Therefore, EAI is requesting an increase of $150.4 million in annual base rate revenues, including a rate of return on common equity of 11.25 percent. Dr. Morin's testimony explains in his testimony why this level of return on common equity is appropriate.

The impact of the requested increase on the level of base rates for each rate class and the total retail business are shown in Table 3 below.

Table 3

Rate Class	Base Rate Revenues $ millions	Base Rate Increase $ millions	% Increase on Base Rev
Residential	432.8	50.0	11.6
Small General Service	207.9	40.9	19.7
Large General Service	242.7	52.8	21.7
Lighting	20.1	6.7	33.5
Total Retail	903.6	150.4	16.6

Q. WHY IS THIS INCREASE IN BASE RATES NEEDED?

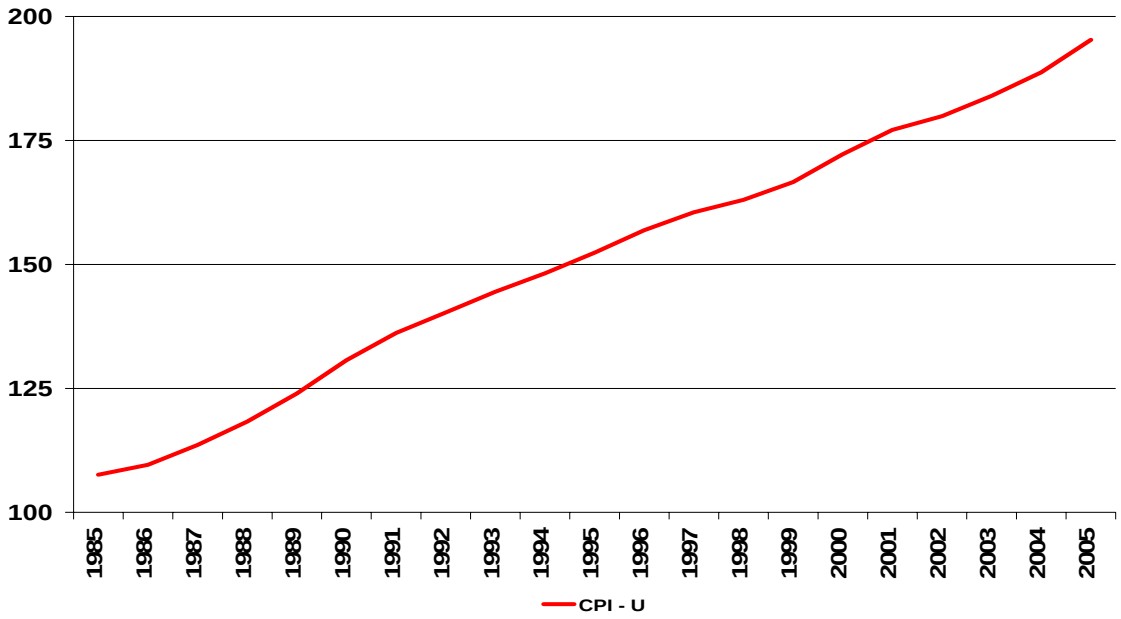
A. EAI has made significant investment in the infrastructure used to provide service to its retail customers since its last change in base rates, which was based upon 1995 test year data and resulted in a $17 million reduction in base rates. Since that time, the Company has made significant investment in its infrastructure, resulting in a more than $440 million increase in the net plant balance for its distribution facilities and an almost $250 million increase in the net plant balance for transmission facilities.[5] These significant investments are not reflected in the Company's current base rates. In addition, the Company has experience an increase in its general cost of operations and maintenance since 1995.

[5] Source: FERC Form 1 data from 2005 and 1995.

Q. HAVE CONSUMER PRICES FOR OTHER GOODS CHANGED SINCE EAI'S LAST BASE RATE INCREASE?

A. Yes, significantly. Since the Company's last base rate increase in 1985, the prices paid by consumers for a representative basket of goods and services in 2005 have increased 82 percent from their levels in 1985 as measured by the Consumer Price Index ("CPI"), which increased from an annual indexed level of 107.6 in 1985 to 195.3 for 2005.[6] Chart 1 below shows this change in the price of goods as reflected in the CPI index.

Chart 1



Q. PLEASE EXPLAIN HOW THE CPI-U IS DEVELOPED AND GIVE SOME EXAMPLES OF CHANGES IN PRICES OVER THE LAST TWENTY YEARS.

[6] CPI-U Base period is 1982-1984 = 100.

A. The CPI is a measure of the average change over time in the prices paid by urban consumers for a standardized set of sample consumer goods and services. The CPI reflects spending patterns for each of two population groups: all urban consumers and urban wage-earners and clerical workers. The all-urban consumers group represents about 87 percent of the total U.S. population. The U.S. Department of Labor's Bureau of Labor Statistics classifies expenditure items into more than 200 categories, arranged into eight major groups: food and beverages, housing, apparel, transportation, medical care, recreation, education and communication, and other goods and services.

Since EAI's last base rate increase in 1985 through the end of 2005, medical care costs have increased 185 percent, housing prices have increased 82 percent, food prices have increased 81 percent and the price of regular gasoline increased 91 percent.

Q. BASE RATES ARE ONLY A PART OF A CUSTOMER'S ELECTRIC BILL. HOW HAS THE LEVEL OF AN EAI RESIDENTIAL CUSTOMER'S TOTAL BILL CHANGED OVER TIME?

A. The price of electricity, as measured by a typical bill for an EAI residential customer using 1,000 kWh a month, has varied over time. A typical bill includes all costs for electric service -- base rates, fuel and purchased energy expense, and purchased power from the Grand Gulf Nuclear Station. Typical bills increased in the 1980s as construction of nuclear

and coal plants were completed and the cost of these plants were reflected in bills. When the Company's last base rate increase was implemented in September 1985, a typical residential bill was $86.22. The typical bill peaked in 1992 at $101.21 and then declined in the late 1990s as bills reflected the decline in the cost of purchased power from the Grand Gulf Nuclear Station, the end of the deferral plan for those purchases, and the $17 million reduction from the Company's last base rate adjustment beginning in January 1998. Since then, typical bills reflected the general increase in natural gas costs through increased fuel and purchased energy expenses in 2000 and 2001 and their subsequent decline, only to increase again with the significant increase in natural gas costs in 2005 and 2006 that drove up purchased power costs. The current typical residential bill is $102.77, a level comparable to that in 1992 in real terms.

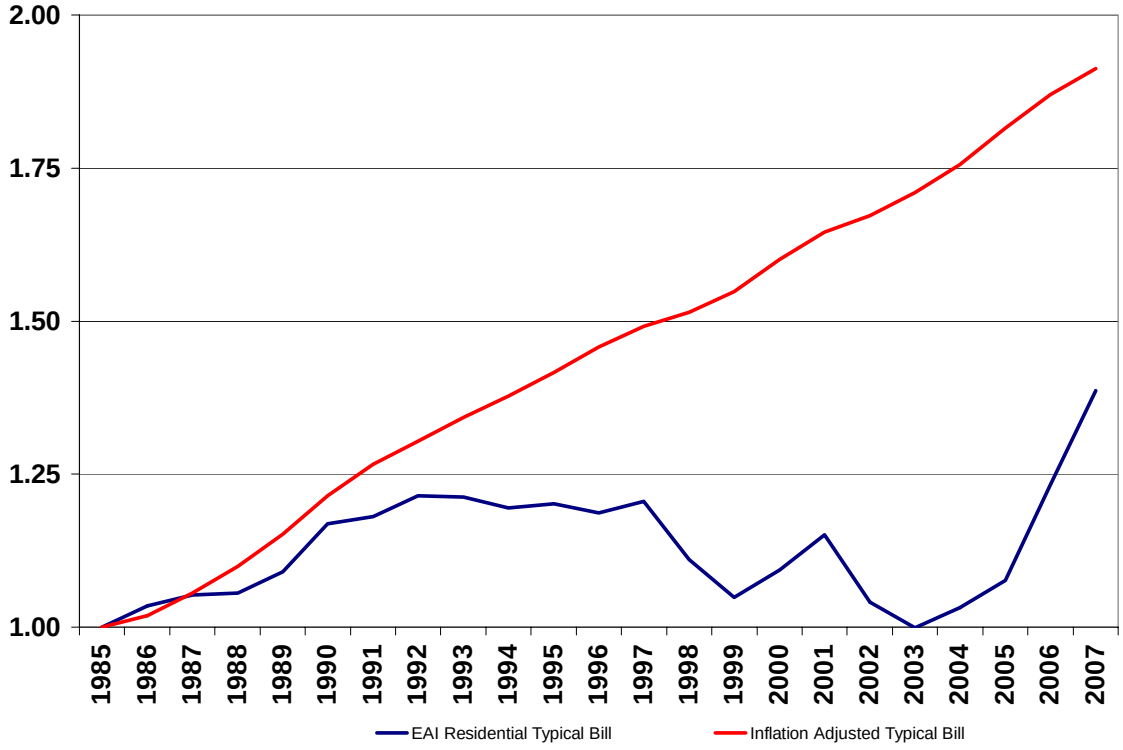
Q. WHAT WOULD BE THE IMPACT OF THE REQUESTED BASE RATE INCREASE ON A TYPICAL RESIDENTIAL BILL?

A. To answer that, I have to address all the cost elements that will affect bills over the next year – base rates, Grand Gulf purchased power costs, fuel and purchased energy expense, and the new category of costs – production costs allocated to EAI as a result of the FERC Decision. The average effect of the proposed increase in base rates on the residential rate class would result in a $7.68 increase in a typical residential bill.

Grand Gulf purchased power costs have remained stable or trended downward for several years, and this trend is expected to continue. As for fuel and purchased energy expense, absent any major events that would disrupt our generation or cause significant upheavals in fuel supplies, current estimates indicate that the Rider ECR Energy Cost Rate will decline significantly when the next annual update of the Energy Cost Rate is filed March 15, 2007, to be effective with the first billing cycle of April 2007. While that Energy Cost Rate will be calculated based upon actual revenues and expenses through the end of this year, we currently project the Energy Cost Rate that would be effective in April 2007 to be approximately $0.0175/kWh based on current projections of fuel and purchased energy expenses. This estimated reduction from the current rate level of $0.02827/kWh would represent a $10.77 reduction in the typical bill. Further, as Mr. Gillam describes in his testimony, we expect the retail portion of the initial payment EAI will be required to make beginning in mid-2007 as a result of the FERC Decision to be $265 million, which would increase a typical residential bill by $12.62. Given these projected rate changes, the reduction in fuel and purchased energy expenses will offset entirely the base rate increase and offset a portion of the increase due to the FERC allocated payments. The net effect of all these factors would be to raise a typical residential bill from the current level of $102.77 to $112.30, a 9.3 percent increase.

Chart 2 below shows how a typical EAI residential bill has varied over time, using 1985 as the base year, compared to the increase of an inflation adjusted typical bill as measured by the CPI, again using 1985 as the base year. While inflation is projected to increase 91 percent from 1985 to 2007, EAI's typical residential bill would have increased 30 percent from September 1985 to July 2007.

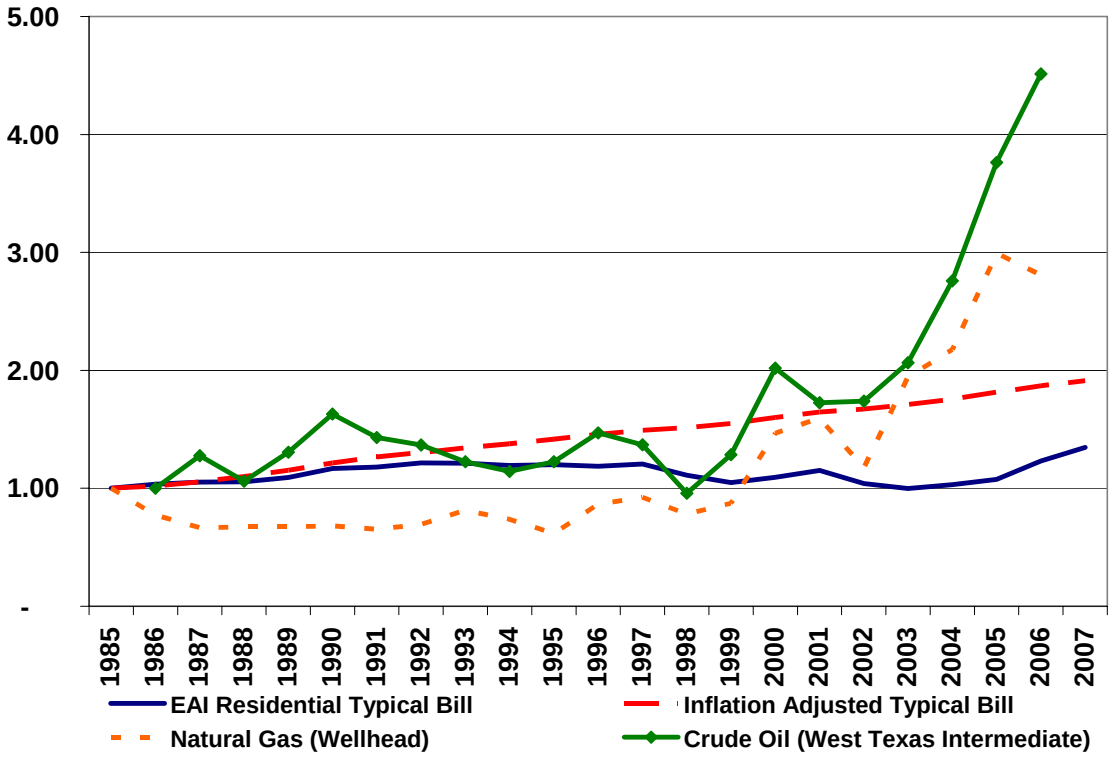
Chart 2



Q. HOW HAVE THE PRICES OF PRODUCTS IN THE ENERGY SECTOR CHANGED OVER THIS SAME TIME PERIOD?

A. The oil and natural gas commodity markets are commonly used in comparing the price of energy products. Through mid-year 2006, natural gas prices have increased 181 percent since 1985 and oil prices have increased 351 percent since 1986.[7] Chart 3 below adds the indexed prices of oil and natural gas to the CPI and inflation adjusted typical bill shown in Chart 2.

Chart 3



[7] Source: U.S. Department of Energy - Energy Information Administration

IV. CAPACITY ACQUISITION AND CAPACITY MANAGEMENT RIDER

Q. WHY IS THE COMPANY REQUESTING THE COMMISSION APPROVE COST RECOVERY OF NEW GENERATING CAPACITY?

A. As explained in more detail in Mr. Cooper's testimony, EAI is projected to have a capacity deficit of approximately 1,000 MW in 2007, comparing its peak usage plus reserves to the level of capacity that it owns or controls. While the Company has sufficient base load capacity with its coal and nuclear generating capacity, it has no modern load-following capacity. In response to this need, ESI on behalf of the Company issued a Request for Proposal in the fall of 2005 soliciting bids for this type of capacity. We expect to complete the transaction to acquire capacity – either by purchasing a Combined Cycle Combustion Turbine or entering into a long-term Power Purchase Agreement -- before the completion of this case and are requesting that the cost of this capacity be reflected in the Company's base rates. Or, in the alternative, the cost of this capacity would be recovered through Rider CM if the transaction for some reason is not concluded by the end of the pro forma period.

Q. WILL THE COMPANY BE MAKING A SEPARATE APPLICATION TO THE APSC FOR APPROVAL TO PURCHASE THIS CAPACITY?

A. Yes. The Company will enter into a letter of intent to acquire capacity, subject to appropriate regulatory approvals, later this year. When that

occurs, we will file a petition with the APSC asking it to approve this transaction.

Q. IF THE COMPANY IS GOING TO ACQUIRE LONG-TERM, LOAD-FOLLOWING CAPACITY, WHY ARE YOU REQUESTING THE COMMISSION TO APPROVE A RATE MECHANISM THAT WOULD ADJUST ANNUALLY THE LEVEL OF PURCHASED CAPACITY IN THE COMPANY'S RATES?

A. Even after the long-term acquisition of capacity, EAI will continue to have to rely on additional capacity purchases from the wholesale market to meet growing customer demand and reliability requirements. The development of the wholesale generating market has provided EAI with another source of capacity in addition to its owned resources and the capacity reserves that EAI can currently draw upon from the other Operating Companies through the Entergy Electric System.[8] As described in more detail by Mr. Cooper in his testimony, purchased capacity has been a significant supply source for EAI and will continue to be so even after the purchase of the load-following capacity I described above. The amount of capacity that is needed, the term, and its price can fluctuate significantly over time. As explained by Mr. Fetter in his testimony, these

[8] The Entergy Electric System includes the Operating Companies' generation and bulk transmission system, which are operated as a single, integrated electric system. However, EAI gave notice on December 18, 2005 that it is terminating its participation in the Entergy System Agreement after the required 96-month notice period.

characteristics make the cost of purchased capacity more appropriate to recover in a rate mechanism that is adjusted more frequently than are base rates in order to maximize the opportunity for EAI to take advantage of such purchases on behalf of its 670,000 retail customers. Approval of a flexible mechanism for recovering the costs of purchased capacity, such as Rider CM, is necessary to assure that the Company will have a reasonable opportunity to recover these costs.

V. FERC ALLOCATED COSTS AND PRODUCTION COST ALLOCATION RIDER

A. History of System Agreement Litigation

Q. PLEASE DESCRIBE THE BACKGROUND OF THE CASE AT FERC THAT YOU MENTIONED ABOVE.

A. The Louisiana Public Service Commission ("LPSC") and the Council for the City of New Orleans ("CNO") filed a complaint at FERC in June 2001 alleging that rough production cost equalization among the Entergy Operating Companies required by the FERC had been disrupted by changed circumstances.[9] Among other things, the LPSC and CNO requested that FERC amend the System Agreement to achieve full production cost equalization or to restore rough production cost equalization. ESI, on behalf of all the Operating Companies, filed a common response to the complaint in July 2001 denying the allegations of the LPSC and the CNO. The APSC and the Mississippi Public Service Commission ("MPSC") also filed responses opposing the relief sought by the LPSC and the CNO.

In February 2002, the FERC set the matter for hearing. Pursuant to a settlement agreement approved by the CNO in May 2003, CNO withdrew as a complainant in the proceeding.

[9] The FERC ruled in its Opinion 234 in 1985 that the rough equalization of production costs among the Operating Companies had been disrupted by the large and unexpected costs associated with the Grand Gulf Nuclear Station and the Waterford 3 nuclear unit. The FERC ruled that the combination of the revisions proposed in the 1982 System Agreement and the revised allocations of purchased power from the Grand Gulf order by FERC Administrative Law Judge Liebman in a prior decision on review by FERC would produce just and reasonable rates.

After the submission of several rounds of testimony, a lengthy hearing conducted by a FERC Administrative Law Judge ("ALJ") in the summer of 2003, and the submission of post-hearing briefs, the ALJ issued an Initial Decision in the case on February 6, 2004.

Q. WHAT WAS THE RESULT IN THE INITIAL DECISION?

A. Although the ALJ rejected the LPSC's argument for full production cost equalization of the Operating Companies' production costs, the ALJ found that the rough equalization standard previously required by the FERC to ensure just and reasonable rates had been disrupted, and the ALJ imposed a remedy containing provisions that would have been catastrophic in their impact on EAI's retail customers.

Q. WHAT ACTIONS DID THE COMPANY TAKE IN RESPONSE TO THE INITIAL DECISON OF THE ALJ?

A. ESI, on behalf of EAI and the other Operating Companies, filed briefs opposing the objectionable provisions of the Initial Decision, as did the APSC and the Arkansas Electric Energy Consumers, Inc. ("AEEC"). The Operating Companies' brief took many exceptions to the ALJ's Initial Decision, including arguing that:

1. the practical effect of the Initial Decision was to impose full production cost equalization, a remedy that had been rejected in the Initial Decision and previously had been rejected by the FERC;

2. resource planning for the Operating Companies as an integrated electric system would be impeded if the Initial Decision were adopted;
3. the remedy in the Initial Decision was inconsistent with the history, structure, and precedent regarding the System Agreement;
4. the Initial Decision's remedy ignored the historical pattern of production cost disparities on the Entergy Electric System and would result in substantial, sudden transfers of costs between groups of Operating Company customers;
5. the numerical standards proposed in the Initial Decision were arbitrary and so complex that they would be difficult to implement;
6. the Initial Decision improperly rejected ESI's resource planning remedy; and
7. the Initial Decision erroneously determined that the full costs of the Catalyst Old River Hydroelectric Generating Facility in Vidalia, Louisiana (the "Vidalia Plant"), should be included in Entergy Louisiana's production costs for purposes of calculating relative production costs.

Q. WHAT ACTION DID FERC TAKE IN RESPONSE TO THE BRIEFS ON EXCEPTION FILED BY THE VARIOUS PARTIES IN THE CASE?

A. While the FERC agreed with the ALJ that the rough production cost equalization standard was not met and therefore some remedy was

required, in its Opinion No. 480 issued June 1, 2005, and in its Opinion No. 480-A rehearing order, the FERC affirmed the rejection of its ALJ of full production cost equalization and overturned or significantly modified the remedy proposed in the ALJ's Initial Decision and many of the more onerous provisions in that decision. While the Initial Decision would have imposed a +/- 7.5 percent annual bandwidth and a +/- 5 percent three-year rolling average bandwidth as a remedy to ensure "rough equalization" of production costs among the Operating Companies, the FERC imposed a broader, annual bandwidth remedy of +/- 11 percent.

A second key improvement was the timetable for implementation of the FERC remedy. Where the ALJ Initial Decision would have made the remedy effective in 2003, the FERC Decision instead made the remedy effective for production costs incurred during calendar year 2006, with the initial remedy payment, if any, to be made in 2007. Further, the FERC affirmed that EAI and its customers will face no refund liability.

Another significant improvement related to which costs would be included in the calculation of relative production costs. The ALJ Initial Decision adopted the argument of the LPSC that production costs of the Vidalia Plant should be included in the calculation of the production costs of Entergy Louisiana, LLC. This would have had the effect of indirectly shifting costs from that very expensive power plant to EAI's retail customers. The FERC agreed with the arguments of the Operating Companies and the APSC that the Vidalia plant was built for the exclusive

benefit of Louisiana and the costs should be paid by customers in Louisiana.

Q. DID PARTIES IN THE LITIGATION SEEK REHEARING OF THE FERC DECISION?

A. Yes. Parties in the case sought rehearing of a number of issues, but the FERC upheld its prior decision in Opinion 480-A issued December 19, 2005.

Q. WHAT ACTION DID EAI TAKE IN RESPONSE TO THE FERC DECISION?

A. We took steps to terminate EAI's participation in the System Agreement. Because the FERC Opinion No. 480-A included a bandwidth remedy that could have a significant, adverse effect on EAI's customers due to the potential cost transfers and the perverse resource planning incentives created by the bandwidth, EAI sent notice the same day to representatives of the other Operating Companies that it was terminating its participation in the System Agreement pursuant to the eight-year notice provision in the agreement.[10] Therefore, EAI's participation in the System Agreement will end no later than December 18, 2013.

[10] *See* Direct Testimony of Hugh T. McDonald in APSC Docket No. 04-023-U, March 29, 2004 at 7-9.

Q. WHAT IS THE STATUS OF THE CASE NOW?

A. The FERC Decision is on appeal to the U.S. Court of Appeals in the District of Columbia Circuit. Also, as required by the FERC, ESI, on behalf of the Operating Companies, made a compliance filing on April 10, 2006, in FERC Docket No. 01-88-004 that would implement the FERC Decision ("Compliance Filing"). Several parties in the case have filed protests or comments to the Compliance Filing, including the APSC, LPSC, and the AEEC.

Q. UNDER THE TERMS OF THE COMPLIANCE FILING, WHEN WOULD EAI MAKE ITS FIRST PAYMENT?

A. ESI's Compliance Filing before the FERC would have the first payments or receipts booked in the Operating Companies' accounting records in June 2007, and EAI would be billed by the fifth business day in July 2007 and be required to make its first payment by the fifteenth calendar day of that month. However, the LPSC has argued that the tariff should provide for payments to begin in January 2007 or for the entire payment to be made immediately.

B. Cost Recovery Options

Q. HOW WOULD EAI RECOVER THE RETAIL PORTION OF THE FERC ALLOCATED COSTS?

A. We've identified three options: Rider ECR; a new exact recovery rider, the Production Cost Allocation Rider that is introduced and proposed in this case; and base rates.

Q. IS RECOVERY THROUGH RIDER ECR YOUR PREFERRED METHOD?

A. Yes. Recovery of these costs through Rider ECR is appropriate because the Compliance Filing on review before FERC would use an existing FERC tariff, Service Schedule MSS-3: Exchange of Electric Energy Among the Companies ("MSS-3"), as the mechanism to allocate the required amount of dollars among the Operating Companies to achieve the FERC's directive that all the Operating Companies' production costs be within +/-11 percent of the System average. Energy costs that are allocated to EAI through MSS-3 are recovered from the Company's retail customers in the normal operation of Rider ECR.[11]

Q. WHY THEN HAVE YOU PROPOSED RIDER PCA IN THIS DOCKET?

[11] In its Petition to Intervene and Protest in this FERC proceeding, AEEC acknowledged that if the FERC approves the Compliance Tariff as filed, then these FERC allocated costs would be included along with other energy costs in MSS-3, which would then be included in setting the retail Energy Cost Rate as part of the normal working of Rider ECR. AEEC's Petition to Intervene and Protest, FERC Docket No. EL01-88-004, March 31, 2006 at 7.

A. The Commission has given notice that it is considering the prospective elimination of Rider ECR.[12] Thus, it is appropriate for EAI to propose an alternative to Rider ECR for recovery of these FERC allocated costs. In the event the APSC lawfully terminates Rider ECR, these costs should be recovered through another exact recovery rider, Rider PCA. Mr. Gillam describes in his Direct Testimony the structure and operation of this proposed rider.

Q. WHY IS IT APPROPRIATE FOR EAI TO RECOVER THESE COSTS THROUGH AN EXACT RECOVERY RIDER?

A. A separate rate rider, as contrasted with base rate recovery, is important to match customer usage with recovery of the FERC allocated costs and to achieve timely and accurate recovery of these costs. An exact recovery rider would ensure recovery of only the amount of money that FERC has determined is necessary to place EAI within the rough production cost equalization standard as described in the FERC Decision – no more and no less. In addition, the FERC Decision is on appeal in the federal court. Should this appeal be successful, an exact recovery rider, unlike base rate recovery, would facilitate returning money to customers that had previously been collected.

[12] Order No. 7, Docket No. 05-116-U and Order No. 2, Docket No. 06-055-U at 3.

Q. IS RECOVERY OF THESE COSTS THROUGH EAI'S BASE RATES APPROPRIATE?

A. In my view, no. It could be done, but customers could pay more than necessary, and the Company may not have a reasonable opportunity to recover all its costs. The remedy mandated by the FERC and implemented through wholesale compliance tariffs filed by ESI at the FERC, will result in a calculation each year of the level of payments that are required under the FERC remedy to maintain rough production cost equalization among the Operating Companies. These amounts will vary, perhaps significantly, from year to year depending upon factors such as the then-current cost of natural gas, the price of electricity in the wholesale market, and incremental generation resource acquisitions by any of the Operating Companies. Mr. Schnitzer addresses this topic in greater detail in his Direct Testimony. Building a level of FERC allocated costs into base rates that could remain fixed for several years may result in a higher level of cost recovery than appropriate, or a level of under recovery, until base rates could be adjusted. That process may take from 18 to 24 months from the planning of a case until new base rates are put into effect and costs hundreds of thousands of dollars, if not more than a million dollars.

The level of base rates for a utility generally is set to recover the non-fuel costs of a utility's operations for a typical year, which tend to be relatively stable. That is why fuel and purchased energy are typically

recovered in a separate mechanism because these costs tend to be volatile and change frequently. Base rates typically do not change frequently, unless there are significant changes to a utility's cost structure, such as the addition of a significant, new generating capacity. EAI has experienced very few base rate changes over the last two decades. The last two changes in the level of EAI's base rates occurred on September 9, 1985 and January 1, 1998, and given the time it will take to complete the current base rate case, a change in the Company's base rates will occur in mid-2007. That means EAI's base rates have changed an average of about once every 10 years over the last approximately 20 years.

Recovering these FERC allocated costs through base rates, although feasible, is clearly not the most desirable alternative. Instead, the most appropriate way to recover these FERC allocated costs is through Rider ECR or, should it be lawfully terminated by the Commission, through Rider PCA, which would exactly recover these costs on an ongoing and timely basis. For these same reasons, the APSC determined that Grand Gulf purchased power costs should be recovered through an exact recovery rider rather than through a fixed amount embedded in base rates. These same considerations would lead to a similar result in this case.

Q. ARE THERE OTHER RATE IMPACTS THAT MUST BE ADDRESSED IN THIS CASE SHOULD THE APSC TERMINATE RIDER ECR?

A. Yes. Rider ECR is the rate mechanism that EAI uses to recover fuel and purchased energy expense. Should the APSC lawfully terminate Rider ECR, these costs must be recovered through another rate mechanism. While base rate recovery for these volatile costs is not the Company's recommended method, a level of fuel and purchased energy expense must be included in base rates if no other, more appropriate, recovery mechanism is provided. Therefore, Mr. Gillam has provided a level of cost that should be included in base rates in that event.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes.

CERTIFICATE OF SERVICE

I, Steven K. Strickland, do hereby certify that a copy of the foregoing has been served upon all parties of record this 15th day of August 2006.

/ S /

Steven K. Strickland