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PETITION TO INQUIRE INTO THE
REASONABLENESS OF THE RATES
AND SERVICES OF CAP ROCK
ENERGY CORPORATION

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RECEIVED
PUBLIC UTILITY COMMISSION
BEFORE THE STATE OFFICE
OF
ADMINISTRATIVE HEARINGS

**CITY OF GREENVILLE'S RESPONSE
TO CAP ROCK'S MOTION TO STRIKE
THE TESTIMONY OF MICHAEL L. ARNDT**

TO THE HONORABLE PUBLIC UTILITY COMMISSION OF TEXAS:

The City of Greenville ("Greenville") files this response to Cap Rock's Motion to Strike the Testimony of Michael L. Arndt and in support thereof, would show as follows:

I. INTRODUCTION

Cap Rock seeks to strike the testimony of Mr. Michael L. Arndt with regard to Cap Rock's computer costs, catastrophe reserve, surcharges, and layers of management. All of Cap Rock's objections go either to Mr. Arndt's credibility as an expert or to factual issues that must be decided by the Commission. As such, they go to the credibility of the witness as opposed to the admissibility of the evidence.

Mr. Arndt is an expert witness who is exceptionally well qualified both by education and experience. Mr. Arndt is a Certified Public Accountant who has Bachelor's and Master's degrees in Business Administration and who has taken additional graduate level courses in accounting, auditing, economics, finance, and taxation. Since he began his career in 1974, he has testified in over 90 public utility rate proceedings before the Federal Energy Regulatory Commission (FERC) and numerous state regulatory commissions, including the Public Utility Commission of Texas, where he has been recognized as an expert and has had much of his

testimony adopted. His testimony in prior proceedings has involved issues related to the determination of revenue requirements, income taxes, affiliated transactions, depreciation, securitization, ECOM, allocations, and rate design. Additionally, he has participated in various court proceedings involving antitrust, the Modified Final Judgment, breach of contract, utility damage, and telephone directory cases. There is no question that Mr. Arndt is exceptionally well qualified to testify about the issues subject to Cap Rock's motion to strike.

II. REPLY TO OBJECTIONS

1. Computer Costs Adjustment: pages 56, line 1, through page 59, line 18

Cap Rock Objection:

Cap Rock objects to the testimony of Mr. Arndt with regard to computer costs. Cap Rock claims that Mr. Arndt has not demonstrated any expertise in the selection and sizing or useful life of computer systems and that there is no foundation in support of his recommendation.

Response:

In his almost thirty-year career, Mr. Arndt has testified in over 90 cases before the FERC and numerous state regulatory agencies, including the Texas PUC. He has testified as an expert in regard to a broad range of rate making issues, including issues that encompass computer costs. Cap Rock complains that Mr. Arndt has not demonstrated any expertise in the selection and sizing or useful life of the computer systems. However, a reading of Mr. Arndt's objected-to testimony shows that he is not purporting to select and size or determine the useful life of the computer system. Instead, he is addressing issues such as the need to match the computer costs, which are outside of the test year, with matching future changes in investment, revenues, and expenses; the company's failure to eliminate existing costs in the test year,

which will cease once the new computer software system is fully functional; the company's failure to show that the costs of the computer are reasonable, necessary, and prudent whether or not Cap Rock grows as planned; the Company's failure to show how the costs of the new system are reasonable, necessary, and prudent for a utility as small as Cap Rock; and the Company's failure to quantify or adjust for future cost savings, which will result from the future consolidation of multiple computer software applications.¹

It is ironic that Cap Rock criticizes Mr. Arndt for not performing any studies to support his recommendations. The company has the burden of proving that these costs should be included, yet the company's own expert Mr. Crowley, who recommended this adjustment, neither performed a study nor was aware of whether any such study had been performed.²

Cap Rock also argues that there is no basis for Mr. Arndt's opinion that the system is "very expensive." In his testimony, Mr. Arndt sets forth his reasons for stating that the system is very expensive. Mr. Arndt determined that the computer system will cost each customer \$176.³ As an expert with 30 years of experience in the utility field, Mr. Arndt certainly is qualified to make the statement that a computer system that costs each customer \$176 is expensive. This is an issue of fact to be developed during the hearing and decided by the ALJs and ultimately the Commission and goes to the weight to be given to Mr. Arndt's testimony and not the admissibility.

¹ Prefiled testimony of Arndt at 56-58.

² Deposition of Crowley dated July 28, 2004 Tr. at 146.

³ Prefiled testimony of Arndt at 58.

2. Layers of Executive Management: page 22, lines 7 through 10

Cap Rock Objection:

Cap Rock objects to Mr. Arndt's testimony with regard to his statement that the company has numerous layers of executive management, claiming that there is no factual basis for the assertion.

Response:

Mr. Arndt has analyzed utility rate cases for the past 30 years and has dealt with issues involving affiliate transactions, executive compensation, and levels of executive management. In his testimony, Mr. Arndt analyzed Cap Rock's executive staffing and compensation at Cap Rock, and based on his expertise, Mr. Arndt has concluded that Cap Rock has numerous layers of executive management.⁴ This is a factual issue in dispute and is for the examiners and ultimately the Commission to determine. Cap Rock's objections to Mr. Arndt's testimony go to the credibility of his opinions, and not the admissibility of his testimony.

3. Catastrophe Reserve Adjustment: page 59, line 1, through page 61, line 21.

Cap Rock Objection:

Cap Rock objects to Mr. Arndt's testimony related to the issue of catastrophe reserve. Cap Rock's asserted basis to strike is threefold, claiming "pure speculation," "reliance on an inapplicable PUC rule," and lack of "basis" for the adjustment under TEX. R. EVID. 705 (c).

Response:

Cap Rock's asserted bases for striking Mr. Arndt's testimony are just plain wrong. First, the catastrophe reserve issue is put into play by Cap Rock's own witness Mr. Larry Crowley. Mr. Crowley made a cost of service adjustment to fund a catastrophe reserve over

⁴ Arndt prefiled testimony at 20-23.

three years.⁵ Cap Rock's claimed stated reason for establishing the catastrophe reserve is to establish a fund to respond to severe storms that occur in the Company's service area.⁶ Moreover, the amount of the Company's proposed catastrophe reserve fund is based on historical storm costs.⁷

Mr. Arndt's testimony takes this issue head on and points out that the Company's proposed fund fails to comply with PUC SUBST. R 25.231(b)(1)(G). While Cap Rock may assert that PUC SUBST. R 25.231(b)(1)(G) does not apply, this is a fact issue that must ultimately be decided. It does not go to the admissibility of the testimony. Cap Rock's conclusionary statement that the PUC rules do not apply to the catastrophe reserve proposal has no bearing on the admissibility of Mr. Arndt's testimony on this issue. Instead, the Company can make such claims in the evidentiary hearing where these facts must be decided.

For the above reasons Cap Rock's motion to strike should be denied.

4. Surcharge Adjustments

a. Introduction

Cap Rock's motion sets forth a discussion of certain legal and evidentiary principles that purport to be relevant to the consideration of Cap Rock's request to strike the testimony of Mr. Arndt. That discussion, however, is largely irrelevant to the consideration of the motion as it applies to Mr. Arndt's testimony on the specific surcharge issues.

Cap Rock seeks to strike the entirety of Mr. Arndt's testimony on these three surcharge issues based on the general assertion that these surcharges are prior period rates and are

⁵ Crowley Direct at page 19, lines 18-19.

⁶ *Id.* at page 19, lines 12-16.

specifically precluded from review in this proceeding based on the Preliminary Order at page 4.⁸ Cap Rock's misplaced reading and reliance on this "prior rate" doctrine leads to further misplaced conclusionary statements that Mr. Arndt's testimony is "irrelevant," beyond the scope of this proceeding," and involves "prior period rates [which] are specifically precluded from this proceeding."⁹

Cap Rock is attempting to rewrite Mr. Arndt's testimony. While Mr. Arndt does in fact adjust test year revenues for each of these surcharges, it is Cap Rock that introduced these issues by removing surcharge revenues from the test year actual revenues.¹⁰ One of the many fact issues that must be decided in this case is the level of present rate revenues, and surcharges which will have a major impact on that determination. PURA § 36.051 requires:

In establishing an electric utility's rates, the regulatory authority shall establish the utility's overall revenues at an amount that will permit the utility a reasonable opportunity to earn a reasonable return on the utility's invested capital used and useful in providing service to the public in excess of the utility's reasonable and necessary operating expenses.

A determination of whether these three surcharges are to be reflected in test year revenues is a major issue in this proceeding in determining Cap Rock's rates.

Cap Rock's argument that these surcharges are prior rates and are not subject to this proceeding is misplaced. The test year in this case is October 1, 2002 through September 30, 2003. All revenues in this test year before September 1, 2003 (PUCT Jurisdiction) are "prior

⁷ *Id.* at page 19, lines 16.

⁸ Cap Rock Motion to Strike Greenville Witness Arndt at 2, 3, 4, and 5.

⁹ *Id.*

¹⁰ Arndt Direct Testimony at page 37, lines 11-13, page 39, lines 8-10, page 40, lines 16-18.

rates” under Cap Rock’s argument, but the Commission must consider the entire test year to satisfy the requirements of PURA § 36.051.

Mr. Arndt’s testimony on these surcharge issues, while criticizing the Company’s collection and test year treatment of these surcharges, provides a basis for reversing the Company’s exclusion of these surcharge amounts from the test year revenue base. In other words, Mr. Arndt’s treatment of the surcharge revenues does not rely solely on the propriety of these charges as asserted by Cap Rock. For example, at page 38, lines 4 through 7, Mr. Arndt states, “the CCN transfer benefits Cap Rock’s stockholders and has not been shown to benefit ratepayers. Ratepayers should not be charged for costs which are designed to meet the Company’s future expansion goals.” Thus, as to the regulatory surcharge adjustment, Mr. Arndt’s testimony is supported by a benefits/burden test and not a propriety of the surcharge rate as explained by Cap Rock.

The basis for Mr. Arndt’s true-up surcharge adjustment is found at page 39, lines 14 through 16 of his direct testimony where he states:

Recovery of 1995 to 2001 over/under collections constitutes retroactive ratemaking and cannot be allowed. . . As for the hedging losses, there has been no showing that these losses were prudent.

Again, Mr. Arndt is attempting to calculate a memorialized test year revenue base that eliminates impermissible retroactive rate adjustments and imprudent conduct.

b. Regulatory Surcharge Adjustment: page 36, line 15, through page 38, line 13

Cap Rock Objection:

Cap Rock objects to the testimony of Mr. Arndt with regard to the regulatory surcharge. Cap Rock claims that the testimony is irrelevant and beyond the scope of the proceeding, claiming that it deals with a prior cost of service or rate.

Response:

Cap Rock asserts that Mr. Arndt's testimony on the topic of regulatory surcharge is irrelevant because such testimony deals only with a prior cost of service or rate. Specifically, Cap Rock has objected and moved to strike Mr. Arndt's testimony at page 36, line 15 through page 38, line 13.

This regulatory surcharge issue is a fact issue that is raised in the direct testimony of Company witness Crowley.¹¹ Greenville witness Arndt has responded to this issue by proposing the current ratemaking treatment for these surcharge collections.¹² Mr. Arndt's testimony reverses the Company's proposed test year regulatory surcharge amount of \$1,845,767¹³ and Mr. Arndt makes an additional post test year adjustment for \$511,480 of regulatory surcharges for the period October 2003 through February 2004.¹⁴

The fact issue is whether Cap Rock's test year revenues should be reduced for these regulatory surcharges. Cap Rock claims a reduction in revenues should occur because such surcharges are non-recurring.¹⁵ Mr. Arndt challenges this test year revenue adjustment and

¹¹ Crowley Direct at page 21, lines 4-10.

¹² Arndt Direct at page 36, line 16 through page 38, line 13.

¹³ Arndt Direct at page 36, lines 21-22.

¹⁴ *Id.* at page 37, lines 3-5.

¹⁵ Crowley Direct at page 21, lines 11.

recommends such amounts should lower test year cost of service in the favor of refund and rate base reductions.¹⁶

Cap Rock relies on the claim that Mr. Arndt's testimony is beyond the scope of this proceeding by asserting Mr. Arndt relies on the propriety of a prior cost of service or rate in violation of the Preliminary Order at page 4. First, every dollar of test year revenues in this case is based on a "prior rate." Second, a reading of Mr. Arndt's testimony at page 37, line 72 through page 38, lines 1-7 provides reasons why these test year and post test year regulatory surcharge revenues should offset cost of service in this case. In other words, "[r]atepayers should not be charged for costs which are designed to meet the Company's future expansion goals."¹⁷ This is an equity argument in cost of service determination — the propriety of the regulatory surcharge need not be determined in deciding this fact issue.

The ultimate determination of Cap Rock's test year revenues is a fact issue that must be decided by the Examiner. One part of the test year revenues determination is a decision on whether to exclude regulatory surcharge revenues from the test year revenue base. Mr. Arndt's testimony is relevant to such a determination, and Cap Rock's request to strike his testimony should be denied.

¹⁶ Arndt Direct at page 38, lines 9-13.

¹⁷ Arndt Direct at page 38, lines 6-7.

c. True-Up and Prior Period Surcharge Adjustments: page 38, line 14, through page 40, line 5 or alternatively, page 39, lines 18 through 19; and page 40, line 20, through page 41, line 9.

Cap Rock Objection:

Cap Rock objects to the testimony of Mr. Arndt with regard to the true-up adjustment testimony. Cap Rock claims that Mr. Arndt's testimony is irrelevant and beyond the scope of the proceeding, claiming that it deals with prior rates. Furthermore, Cap Rock argues that Mr. Arndt's recommendation lacks sufficient basis. Alternatively, Cap Rock argues that page 39, lines 18 and 19 should be stricken as speculation, lacking a sufficient basis.

Cap Rock also objects to Mr. Arndt's testimony regarding the prior period surcharge. Cap Rock claims that the testimony is irrelevant and beyond the scope of the proceeding, claiming that it deals with a prior rate.

Response:

As discussed above, Mr. Arndt's testimony on these two surcharge issues is neither irrelevant nor beyond the scope of these proceedings. Instead, Mr. Arndt is attempting to provide the Commission the test year revenue base as a starting point for the rate determination of this case.

Moreover, Mr. Arndt's testimony is responsive to Cap Rock witness Crowley's proposal to remove these surcharge revenues from the test year revenue base. More importantly, Mr. Arndt's adjustments prevent the Company's removal of the same revenues twice. In other words, it appears that Mr. Crowley has removed the same surcharge revenues two times resulting in a distortion of the test year revenue base for this case.

Mr. Crowley's double dip can be seen by comparing the true-up surcharge adjustment of \$4,363,793 (Arndt Direct at page 38, line 18) less the hedging losses of \$1,506,910 (Arndt Direct at page 39, line 1) resulting in a net true-up surcharge of \$2,856,883. This \$2,856,883 is the Company's claimed true-up surcharge without the hedging losses. This is exactly the

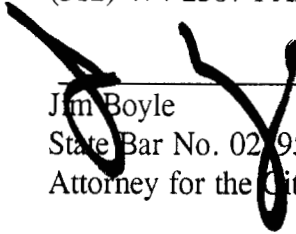
same value the Company claims is the prior period surcharge of \$2,856,883 as shown in Mr. Arndt's direct testimony at page 40 line 10.¹⁸ It would appear that Cap Rock has removed the same surcharge revenues twice under the guise of two different claimed surcharge adjustments.

While, Cap Rock may differ on the facts, these surcharge issues are fact issues rather than issues of admissibility. The controversy regarding surcharges and the appropriate test year revenue base should be resolved through the hearing process where Cap Rock will have every opportunity to examine Mr. Arndt and his proposals.

PRAYER

WHEREFORE, for all the foregoing reasons, the Motion to Strike the testimony of Mr. Michael L. Arndt should in all respects be denied.

Respectfully submitted,
LAW OFFICES OF JIM BOYLE, PLLC
1005 Congress Avenue, Suite 550
Austin, Texas 78701
(512) 474-1492
(512) 474-2507 FAX



Jim Boyle
State Bar No. 0295000
Attorney for the City of Greenville

¹⁸ See Company response to Greenville's RFI 9-25.

CERTIFICATE OF SERVICE

I hereby certify that I have served a copy of the foregoing document upon all known parties of record by fax and/or first class mail on this the 13th day of September 2004.



Jim Boyle