This interpretation of the affiliate burden of proof is fully consistent with the Austin Court of Appeals' opinion in *Central Power and Light Company, et al. v. Public Utility Commission of Texas, et al.*[191] There the court noted that there is a presumption in Section 36.058(a) that affiliate costs are "*not* included in the rate base" (emphasis in original) but that a utility can overcome this presumption by demonstrating that its affiliate costs are reasonable and necessary pursuant to Section 36.058(b).[192] There is no discussion anywhere in the court's opinion regarding the difficulty of meeting the reasonableness and necessity burden. The court simply stated that the utility must meet the burden of Section 36.058(c)(1) and (2) in order to overcome the presumption of Section 36.058(a) that such costs are presumed to be unreasonable[193] until proven otherwise by the utility.

In Docket No. 14965 and Docket No. 16705, the Commission made clear that affiliate costs would receive careful scrutiny in rate cases. In particular, the Commission stated in both cases that the utility must establish a reasonable relationship between the level of service provided and the charges for the services, and that the burden of proof is particularly heavy because of the requirement that the Commission affirmatively find that the cost is "reasonable and necessary for each item or class of items as determined by the Commission." In neither case did the Commission conclude that the burden is extraordinarily difficult to meet or that it requires greater evidence to prove reasonableness and necessity (as opposed to the no higher than standard) than would be required to meet a non-affiliate expense that is challenged by another party. The emphasis was on the fact that affiliate costs, unlike non-affiliate costs, carry an initial presumption of unreasonableness which must be overcome by the utility with respect to each class of service. To overcome that presumption the utility must set out its affiliate costs by class of service, and prove that the service is reasonable in amount, is necessary to the utility, and its cost is no higher than charges for the same service to other affiliates or non-affiliates. In this regard, the Commission also stated in Docket No. 14965 that "consolidation of functions in the

[191] 36 S.W.2d 547 (Tex. App.—Austin 2000, pet. denied).

[192] *Id.* at 564.

[193] *Application of Central Power and Light Company for Authority to Change Rates*, Docket No. 14965, Second Order on Rehearing at 5 of 112 (Oct. 15, 1997).

service company undoubtedly permits CSW to achieve economies of scale and reduce the cost of performing these functions."[194]

In Docket No. 14965, the Commission disallowed $17 million of TCC's (then Central Power and Light Company) affiliate costs. The Commission's primary concern was that certain factors used did not allocate sufficient costs to unregulated affiliates.[195] In this case, only OPC proposed any adjustments based on the particular allocation factor used and those were limited to $257 thousand.[196]

The Commission followed up on these orders by substantially revising the rate filing package and requiring far more information than in prior filings. The revised package is very specific about what information must be provided, not only in the schedules but in workpapers. The effect of these new filing requirements is to take the guess-work out of what type of information is required and to require enough information for all parties to evaluate the question of which affiliate costs are reasonable and necessary and meet the "no higher than" standard. With the new rate filing package, utilities would no longer have to guess about the type of information required, and the other parties could concentrate on substantive evaluations of affiliate costs.

The Commission has an excellent opportunity in this case to take a fair, balanced, and common sense approach to the affiliate standard. It should fully recognize the additional elements of proof that the statute requires. It should recognize that the statute and sound regulatory policy require scrutiny to ensure that TCC is not discriminated against in the allocation process. It should require that TCC and other utilities present persuasive evidence from knowledgeable individuals about each and every class of affiliate service, using external sources where it makes sense to do so. The Commission, however, should not create a burden which essentially anticipates the disallowance of affiliate costs incurred in providing critically important services, regardless of the quality and completeness of the utility case..

Because of the paucity of discussion about TCC's case (and the limited discussion of some other parties' cases), TCC feels obligated to discuss its and the other parties' cases at some

---

[194] *Application of Central Power and Light Company for Authority to Change Rates*, Docket No. 14965, Second Order on Rehearing at 5 of 112 (Oct. 15, 1997).

[195] *Id.* at 6-7.

[196] PFD at 63.

length in these exceptions. Only by thoroughly focusing on these cases can the Commission separate fact from rhetoric.

TCC's Case

TCC organized its case on affiliate costs fully cognizant of its burden of proof. In order to meet that burden, it presented the direct testimony of Ms. Sandra Bennett, who discussed in detail the AEP accounting system for charging affiliate costs to TCC and other AEP subsidiaries.[197] She further described the allocation process used for charging those costs which cannot be directly billed because they are related to functions or projects benefiting more than one company.[198]

A. AEP's and TCC's Organizational Structure

As discussed throughout the hearing, AEP has a centralized service company, AEPSC, whose primary purpose is to provide a wide variety of services to its electric utility operating companies, including TCC.[199] A basic tenet of the AEP structure is that any employee who provides more than incidental services to more than one company is an AEPSC employee, and thus services provided by that individual are provided by the service company. In the case of TCC, among the services provided by AEPSC are financial, treasury, accounting, audit, regulatory, legal, information technology, supply chain, personnel, fleet management, land and building management, and a wide variety of distribution and transmission service related functions. In short, TCC is managed and operated to a large extent by AEPSC employees. An excellent example of this is a witness in this case, Mr. Harry Gordon. Mr. Gordon is the Vice President-Distribution in the Corpus Christi region, which provides distribution services to both TCC and AEP Texas North Company (TNC). As a result, Mr. Gordon and numerous employees who provide distribution services to TCC and who reside in Texas are AEPSC employees because they also provide services to TNC. This organization results in a highly efficient operation with costs for TCC and TNC being substantially reduced because of the consolidation of their distribution organizations. From a regulatory standpoint, the result is that many of these

---

[197] *Id.*

[198] *Id.* at 16, line 21 through 17, line 7.

[199] While there are 11 traditional electric utilities owned by AEP, a twelfth company, AEP Generating Company, which owns one power plant, is considered AEP's twelfth operating company.

costs are affiliate costs, despite the fact that the vast majority of these individuals provide services to only TCC and TNC.

As discussed by TCC witness Bennett in her direct and rebuttal testimony, AEPSC's accounting system ensures that all costs are captured and allocated appropriately through work orders.[200] Each AEPSC employee is required to complete time sheets for each working day. The individual filling out the time sheets must indicate the work order and activity he or she is working on, the benefiting location for that project, and the FERC account that should be billed. As discussed below, the work order system is simple, understandable, and results in appropriate costs being assigned to the appropriate company under the appropriate FERC account. Information provided by the employee varies slightly depending upon which type of work order is used.

Both the time sheet process and the work order process are subject to the Securities and Exchange Commission's (SEC) jurisdiction over AEP under the Public Utility Company Holding Act.[201] As stated by Ms. Bennett in her testimony, the SEC has thoroughly reviewed and approved the work order system and the time sheet methodology used by AEPSC. A detailed description of the accounting system and work order system is contained in Ms. Bennett's direct testimony.[202]

B. The Rate Filing Package Requirements

Ms. Bennett further described the detailed and substantial requirements of the Rate Filing Package for presenting affiliate costs.[203] Twelve schedules for such costs are required by the Commission. These costs and the associated workpapers demonstrate such information as affiliate expenses by FERC account, adjustments to affiliate expenses, capital projects by affiliate amounts, descriptions of services provided by affiliates, demonstrations of the reasonableness and necessity of the costs, a demonstration of the "no higher than" standard, description of the affiliate allocation process, and a detailed listing of the amounts billed by AEPSC to each affiliate in dollars and percentages. There is no suggestion in any party's testimony in this case that TCC has not met the Rate Filing Package requirements for all 12 of

[200] TCC Exh. 7, Direct Testimony of Sandra Bennett, at 16, line 9 through 17, line 13; TCC Exh. 68, Rebuttal Testimony of Sandra Bennett at 48, line 19 through 49, line 4.

[201] *Id.* at 8, lines 6-26.

[202] *Id.* at 16, line 7 through 31, line 12.

[203] TCC Exh. 68, Rebuttal Testimony of Sandra Bennett, at 10, lines 11-14.

these schedules. As discussed by Ms. Bennett, in order to meet the requirements of the Rate Filing Package, AEP filed 894 pages of schedules and 1,888 pages of workpapers.[204] In Docket No. 14965, TCC's 1995 rate case, the Rate Filing Package required three pages of schedules.[205] There is simply no comparison between the amount of information required today and that required in Docket No. 14965.

C. Witnesses' Testimony

TCC also presented the testimony of ten witnesses, each of whom testified in detail about the particular affiliate services and costs that fell within their area of expertise.[206] The witnesses' testimony demonstrated in detail the need for the particular service, the reasonableness of the costs for that service, and that the costs to TCC were no higher than the costs for the same service to other affiliates or non-affiliates. The latter point is primarily demonstrated through the allocation process. By explaining the reasonableness of the allocation methodology, each witness has demonstrated that TCC has received its fair share of these costs and is paying proportionately no more than any other affiliate or non-affiliate. Further, as Ms. Bennett stated in her direct and rebuttal testimony, the allocation factors and the application of these factors to specific costs were expressly reviewed and approved by the SEC in its most recent audit of AEPSC.[207] Depending on the particular class in question, witnesses also presented varying types of objective indicators of the reasonableness of the level of costs and services provided, including benchmarking, cost trends, cost reduction, process improvements, and increased efficiency shown by reduction in staffing levels. A summary of those witnesses' testimony is attached to these exceptions as Appendix G.

The Rate Filing Package contains several suggestions as to how the utility can meet its burden of proving the reasonableness and necessity of affiliate costs. Where applicable, the witnesses have discussed those methods in their testimony. However, those methods are simply suggestions and the Rate Filing Package makes clear that it is up to the utility to put on evidence that meets its burden.

---

[204] *Id.* at 10-16.

[205] *Id.* at 22, line 16.

[206] TCC Exh. 7, Direct Testimony of Sandra Bennett, at Exh. SSB-2; TCC Exh. 68, Rebuttal Testimony of Sandra Bennett at 12, lines 4-6.

[207] *Id.* at 11, lines 6-21.

The combination of the Rate Filing Package, the workpapers, and the testimony of the witnesses provided a roadmap for Intervenors to fully review whether individual categories of affiliate costs are necessary, whether the particular cost itself is reasonable in amount, and whether other affiliates or non-affiliates have been charged less than TCC. The 12 required schedules and supporting workpapers create a comprehensive presentation of affiliate data for Intervenors and Staff to utilize, and in some cases this appears to have led to complaints that TCC did not present the information in the form the Intervenor would have liked. However, as discussed below, this information was presented *exactly* as required by the Rate Filing Package.

Staff's Case

Most notably absent in the ALJs' discussion is the fact that the Commission Staff recommended only one adjustment to TCC's affiliate costs and that was not based on the affiliate standard. (The ALJs did not adopt that recommendation.) Staff's accounting witness, Mary Jacobs, made clear that she had performed a complete analysis of TCC's case and that the Staff revenue requirement recommendation in this case was comprehensive.[208] The fact that the Staff proposed only one disallowance of $582,000[209] and effectively found that TCC had met its burden of proof is a significant factor for the Commission to consider.

OPC's Case

OPC presented witness Dr. Carol Szerszen, who proposed several specific adjustments to TCC's affiliate costs. Dr. Szerszen also complained about the difficulty of analyzing TCC's affiliate costs because of the size of the AEP system and the number of benefiting locations which can be charged with affiliate costs. The ALJs apparently rejected the latter criticism of Dr. Szerszen but recommended adoption of some of her individual disallowances. TCC excepts to the following disallowances by the ALJs:[210]

Technical and Economic Evaluation

The ALJs erred in recommending disallowance of $176,126 of activities related to technical and economic evaluation on the grounds that they "cannot see how that would be required to serve T&D customers."

---

208 Staff Exh. 2, Direct Testimony of Mary Jacobs, at 5, lines 17-19.

209 Staff Exh. 7, Direct Testimony of Mary Jacobs, at 9.

210 Apparently, these disallowances were considered by the ALJs to be included in the $10.3 million disallowance based on Dr. Thomas' recommendation.

Ms. Bennett provided direct and rebuttal testimony on this subject and pointed out that the vast majority of these services were the equivalent of being directly charged to TCC operations only and were related to activities performed specifically for TCC's benefit.[211] These costs are related to research and development , as discussed in Ms. Bennett's direct testimony.[212] As she pointed out in her rebuttal testimony, the company provided work order titles and descriptions of the work performed along with other information. The fact that the work order has in its title "non-power related projects" does not mean that the research is not necessary and beneficial for T&D services.

Dr. Szerszen's criticism of these expenses was related to her claim that the total asset allocation factor is inappropriate and there is no way to determine whether the expenses were reasonably incurred.[213] She did not make the suggestion that the expenses should be disallowed because they were limited to non-power projects. Exhibit SSB-6, page 13, of Ms. Bennett's direct testimony provides a description of these costs.[214]

For these reasons, the ALJ's recommendation should be reversed.

Corporate Existence and Separation Expenses

TCC requested $1.074 million in costs related to corporate separation. As stated by the ALJs, these costs are incurred as a result of legislative and regulatory restructuring requirements. The ALJs recommended disallowance of $671,300 on the grounds that the term "Corporate Separation-General" is insufficiently specific to justify these expenses.[215]

This is an extremely puzzling conclusion. The term "Corporate Separation-General" of which the ALJs complain is simply the title of a work order. Other work orders in *this category* of expense are "Maintain Corporate Existence" and "Corporate Separation-SEC Filings." The purpose of the title of a work order is not to provide a detailed description of the function or service. It is simply developed for purposes of accounting. It is preposterous to disallow expenses based simply on a work order title. Yet that is what the ALJs have done.

---

211 TCC Exh. 68, Rebuttal Testimony of Sandra Bennett, at 52, lines 13-15.

212 TCC Exh. 7, Direct Testimony of Sandra Bennett, at 47, lines 1-13.

213 OPC Exh. 1A, Direct Testimony of Carol Szerszen, at 61, lines 16-20.

214 TCC Exh. 7F, page 13 of 28.

215 PFD at 56.

The reasonableness and necessity of the costs that are included within this work order, along with the other work orders comprising this category of expense, were discussed in Mr. Carpenter's direct and rebuttal testimony.[216] Mr. Carpenter very specifically pointed out that the activities related to Corporate Separation-General were provided in Exhibit DGC-5 of his direct testimony and Exhibit SSB-3 of Ms. Bennett's direct testimony and in Rate Filing Schedule V-K-7-a, lines 425-441. These activities cover SEC filings related to AEP's corporate separation, which is pending before the SEC according to Mr. Carpenter.[217]

For these reasons, this disallowance is based on an erroneous analysis which ignores the evidence in the record and should be reversed.

Public Relations, Community Relations and Customer Communication Expenses

The ALJs recommended disallowance of $515,000 with respect to media relations, community relations, customer communications, and various related activities.[218] The only stated basis for the disallowance was that the ALJs "could not discern which amounts were essential to the public interest and which amounts were simply part of the utility's promotion of its own interests."[219] TCC would note that it provided very specific evidence about these activities, which include education of and communication with the public, TCC providing community service, providing critical information to public officials, and generally maintaining good relations with the communities it serves. The ALJs' analysis seems to impose a new test for recovery of these types of expenses, *i.e.*, a utility must eliminate those expenses which may promote its own interest. TCC would suggest that it obviously promotes TCC's interests to serve its communities, to keep its public officials informed, and to provide information to the public, but it is equally in the interest of all of its customers and its communities for it to do so. The ALJs are suggesting a false distinction by claiming that the two are mutually exclusive and that the utility should not be permitted to recover expenses that benefit itself as well as its communities and customers. This recommendation should be reversed by the Commission.

---

[216] TCC Exh. 4, Direct Testimony of David Carpenter, at 52, lines 3-7; TCC Exh. 66, Rebuttal Testimony of David Carpenter, at 62, lines 14-22; at 63, lines 1-10.

[217] TCC Exh. 66, Rebuttal Testimony of David Carpenter, at 63, lines 8-18.

[218] PFD at 56-57.

[219] PFD at 57.

Strategic Planning, Long-Range Business Plans, and Long-Term Financial Plans

The ALJs recommend disallowances of the following expenses on the very vague ground that they "need greater clarity from the Applicant" in order to recommend that these costs are reasonable and necessary:[220]

Perform strategic planning and analysis	$1,692,895
Develop and administer long-range business plans	491,909
Prepare long-term financial plans	172,517

There is almost no discussion of what evidence TCC put into the record on this subject. There is also no conclusion that these costs are not necessary to the operation of the utility. In any event, the suggestion that the Company did not put on sufficient evidence to justify these costs is wrong.

In actuality, Dr. Szerszen's proposed disallowances of these costs are related primarily to her belief that more of these costs should be directly charged to TCC's T&D operations. Her conclusion was that TCC customers should be charged only for costs which benefit only TCC and not if those costs benefit other AEP business units or subsidiaries as well.

TCC responded to this criticism in the rebuttal testimony of Ms. Bennett. These services are related to forecasting, strategic planning and analysis, budget variance analyses, long-term resource planning, provision of information to rating agencies, forecasting data needed for regulatory proceedings and support for an AEP computerized financial model used for all companies. As Ms. Bennett noted, these activities are performed for TCC exclusively by AEPSC, which allows significant savings.[221] The corporate planning and budgeting staffs of CSW and AEP were reduced by 63 percent as a result of the merger. A significant loss of efficiencies and scale would result if TCC performed the services with its own staff, as Dr. Szerszen seems to prefer. Her suggestion that TCC should be allocated no costs if the activity involves other companies is completely unrealistic. These activities by their nature involve multiple companies, and to exclude TCC from any such allocation where it is one of the companies that benefits makes no sense. Dr. Szerszen's suggestion in essence is that if multiple companies benefit from AEP's financial forecasting, for example, all such costs should be

[220] PFD at 60.

[221] TCC Exh. 7, Direct Testimony of Sandra Bennett, at 38, line 17 through 39, line 2.

charged to the parent company. This approach ignores the obvious facts that the centralized provision of services is a mainstay of large utility organizations today and that costs benefiting more than one company must be allocated in order to ensure their appropriate recovery.

As Ms. Bennett also stated, an asset allocator is clearly appropriate since a larger company will incur more costs related to strategic, financial, and business planning than a smaller company would.[222] It would be illogical to suggest that a company with $1 billion in assets would have costs in these areas similar to a company a quarter that size. The asset allocator thus approximates the costs each benefiting location would incur.

The ALJs are simply wrong when they suggest that the company should have provided "greater clarity" as to why TCC's share of these costs are reasonable.

Managing Operational Risk

Last, the ALJs recommend disallowance of $257,000 related to managing risk.[223] The sole basis for this disallowance was their belief that an asset-based allocator should not be used since asset size does not necessarily reflect the degree or size of operational risk of a company. This is simply not correct. This activity is used primarily by AEPSC's legal and risk management departments for the services they provide in analyzing, planning for, and executing the plans to mitigate the risks inherent in operating a large business, specifically electric utility operating companies.[224] As pointed out in Ms. Bennett's rebuttal testimony, it is quite obvious that a large company with a large asset base has more assets at risk than a smaller company.[225] It is difficult to believe that any rational company would spend equal resources in analyzing the risks of a very small company as they would analyzing the risks of a very large company. This is the thrust of Ms. Bennett's testimony and, contrary to the ALJs' conclusion, it provides evidence of a logical correlation between the size of a company and the operational risk inherent in that company.

Cities' Case

Cities presented the testimony of Mr. Gerald Tucker, who recommended the disallowance of $16.6 million in affiliate costs.

---

[222] TCC Exh. 68, Rebuttal Testimony of Sandra Bennett, at 49, lines 17-20.

[223] PFD at 63.

[224] *Id.* at 55-56.

[225] TCC Exh. 68, Rebuttal Testimony of Sandra Bennett, at 56, lines 2-3.

Mr. Tucker's analysis primarily consisted of 14 pages of criticism of the AEPSC work order and time sheet system and the manner in which TCC organized its filing in its direct case.[226] He then provided six sentences of testimony in which he stated that TCC provided insufficient evidence of "competitive bids for the services, no comparison of costs from outside vendors and no significant studies of outsourcing opportunities."[227]

He concluded in general that, TCC did not meet its burden of proof, and he proposed a disallowance of $16.6 million.[228] He calculated this disallowance by assuming that TCC was allowed $43.8 million in affiliate costs in the settlement of its UCOS rate case and that amount should be the maximum level awarded in the current case.[229] This resulted in a $16.6 million reduction from TCC's requested amount.

The ALJs discussed Mr. Tucker's criticisms of the AEPSC work order system and rejected them. Other than describing his criticism of TCC for not having sufficient outsourcing studies, they mention that criticism very briefly as a basis for their conclusion on affiliate costs. They also rejected his proposed disallowance of $16.6 million.[230]

TCC responded at length in its rebuttal testimony to Mr. Tucker's criticisms of the work order system and will not repeat those arguments here, since the ALJs appear to have rejected most of his criticisms and his method of calculating a disallowance. However, TCC urges the Commission to carefully review Mr. Tucker's testimony to see first hand the type of analysis he suggests merits a $16 million disallowance. His criticisms of the TCC work order system and filing approach have no substance. His criticism of TCC's alleged lack of outsourcing or third-party vendor studies consists of nothing other than a statement that TCC should have done more. There was no analysis of whether such studies make sense for any particular services or whether outsourcing is possible or desirable for particular services. In sum, Mr. Tucker's testimony offers no rational basis for any type of disallowance.

---

[226] Cities Exh. 4, Direct Testimony of Gerald Tucker, at 31-44.

[227] *Id.* at 45.

[228] *Id.* at 51, lines 4-10.

[229] *Id.*

[230] PFD at 63-65.

CPL Retail's Case

CPL Retail presented the testimony of Dr. Dennis Thomas, a utility consultant. Dr. Thomas's prefiled direct testimony, which is the apparent basis for the ALJs' proposed disallowance of $10.3 million in affiliate costs, consists of little more than a review of each affiliate witness' testimony and a sentence or two discussing some tests of reasonableness which they did not perform.[231] On this basis alone, he then proposed his disallowance.[232] For example, he was critical of TCC for not providing the amount of affiliate costs currently in rates, despite the fact that TCC and all other parties agreed and the Commission held that the UCOS settlement did not include specific cost items. He was critical of several witnesses for not performing cost trend analyses, despite the fact that the merger in 2000 and company unbundling in 2002 leave very little historical cost data that is comparable to current circumstances. He summarily criticized several witnesses for not doing affiliate cost benchmark studies, despite the fact that almost all utilities are organized differently with respect to the provision of affiliate services, making most such studies very difficult and of little usefulness. He also contended that AEP should perform more outsourcing studies without bothering to take into account the value of a utility maintaining control of a function or determining whether a particular function can be outsourced as a practical matter.

An excellent example of Dr. Thomas' approach to review of TCC's affiliate expenses is his comment on TCC's affiliate expenses related to legal, governmental, and regulatory costs. TCC requested recovery of $5.2 million for these three categories through the testimony of Mr. David Carpenter, who heads up AEPSC's Texas regulatory group.

Mr. Carpenter provided testimony regarding the nature and necessity of the expenses.[233] He described various cost-cutting measures undertaken by AEPSC in each of the three organizations. He discussed the benefits to customers resulting from the services, how the departments have eliminated duplicative activities, and how costs are allocated. He discussed direct charges vis-à-vis allocated charges and how the charges for these services are provided at cost. In short, he provided detailed evidence to demonstrate that TCC's costs for legal,

---

[231] Dr. Thomas addressed the possibility of a $50 million disallowance in his prefiled direct testimony. This proposal was not mentioned in CPL Retail's post-hearing brief, however.

[232] CPL Exh. 1, Direct Testimony of Dennis Thomas, at 13, lines 19 through 49, line 21.

[233] TCC Exh. 4, Direct Testimony of David Carpenter, at 38, line 6 through 53, line 15, and Exh. DGC-5.

regulatory, and governmental services are necessary, are reasonable in amount, have been subject to cost cutting measures as a result of the merger, and are no higher than costs for the same services to other AEP affiliates.

Dr. Thomas responded to this testimony by criticizing Mr. Carpenter for 1) failing to state the amount of the affiliate costs he supports which are in current rates; 2) failing to state the amount of increase requested for those costs; and 3) providing "little external verification" such as cost trends, benchmarking, or comparisons with other utilities.[234] He goes on to state that the Commission has no way of knowing whether "a reduced level of expenses would still allow AEP to perform all necessary activities, or if a 14.7% increase (the overall rate increase proposed by AEP) is absolutely necessary and reasonable."[235] He concludes his analysis by stating that "[a]t a minimum, the Commission should deny any increase in the level of these costs approved in the UCOS decision."[236] His criticism of TCC affiliate witnesses' testimony consisted of a brief recitation of other studies that he contends should have been performed, while acknowledging that TCC provided sufficient information about customer choice and telecommunications costs. He concludes by stating that because TCC did not provide sufficient external verification of all affiliated costs, the Company has not met its burden of proof.

There are numerous flaws in Dr. Thomas' analysis of Mr. Carpenter's and other TCC witnesses' affiliate testimony. First, his criticism of TCC for not providing information about the level of affiliate costs by class in TCC's current rates borders on the absurd. TCC's rates were set in its 2001 UCOS case, Docket No. 22352. That settlement was a black box total revenue settlement, which the parties stipulated would not be broken down on the basis of any level of approved affiliate costs:

> With the exception of certain transmission investments addressed in Article IX below, the above revenue requirement levels are not based on the adoption or rejection of any specific cost or revenue item or adjustment proposed by any Signatory. Rather, the Signatories agree that the revenue requirements are just and reasonable and are consistent with Section 36.051 of PURA only as total amounts and only when considered in context with all other issues resolved in this Agreement.[237]

---

234 CPL Retail Exh. 1, Direct Testimony of Dennis Thomas at 32, line 20 through 35 line 24.

235 CPL Retail Exh. 1, Direct Testimony of Dennis Thomas, at 34, line 23 through 35, line 2.

236 *Id.* At 35, line 15-17.

237 Cities Exh. 13, Docket No. 22352, Stipulation and Agreement at Article II.

The Commission held in Finding of Fact 85:

> 85. The revenue requirements in Finding of Fact No. 84, above *are not based on any specific cost or revenue items*, except as set forth in Finding of Fact No. 100, below.[238]

Thus, Dr. Thomas criticizes Mr. Carpenter and other affiliate witnesses for not doing something they cannot do – state or assume an amount of affiliate costs by class in TCC's existing rates. Certainly one measure of reasonableness is to compare current affiliate costs by class to levels previously approved by the Commission. However, that cannot be done in this case because of the black box nature of the settlement in Docket No. 22352.[239] Dr. Thomas' criticism of Mr. Carpenter and other TCC witnesses for not comparing current costs to previously approved costs simply makes no sense, unless one believes TCC should be penalized for the act of settling its UCOS case (as Entergy Gulf States, Inc. and Texas-New Mexico Power Company did).

Dr. Thomas' criticism of Mr. Carpenter and other witnesses for not providing cost trend information is also flawed. The test year in this case was July 2002 through June 2003. Dr. Thomas ignores the fact that effective January 1, 2002, Central Power and Light Company was functionally unbundled into three separate entities. Up to that time, AEPSC provided services to CPL as a bundled, integrated utility. Thus, only six months of actual cost data are available prior to the test year for comparable services. Comparisons to years prior to unbundling would be meaningless, since services provided in these years included significant generation issues. Dr. Thomas ignores this fact in his criticism.

Similarly, Dr. Thomas' criticism of Mr. Carpenter and others for not performing more industry comparisons or benchmark studies ignores the fact that many affiliate services do not lend themselves to benchmarks or industry comparisons. More importantly, Dr. Thomas ignores or makes little mention of some of those studies done by TCC. He acknowledges that TCC provided ample extrinsic evidence about telecommunications and customer choice costs. He glosses over, however, TCC's benchmark study for distribution costs, which demonstrates that

[238] *Id.*, Interim Order at Finding of Fact 85 (Jun. 4, 2001) (emphasis added). Finding of Fact No. 100 did not involve affiliate costs.

[239] This type of non-cost specific settlement is very typical at the Commission.

TCC ranks 35th out of 65 utilities in expenditures per mile of distribution lines.[240] He also ignores various benchmark studies provided in discovery.[241] Each TCC witness criticized by Dr. Thomas responded in rebuttal regarding the impracticalities of his conclusions.

Dr. Thomas' disallowance ignores the fact that the revenue requirement requested by TCC in Docket No. 22352 was based on a forecasted future test year and not on actual costs. More importantly, it ignores the fact that Docket No. 22352 was filed by TCC prior to the merger of CSW and AEP. As discussed above, a great many organizational changes took place after the merger, such as the combining of TCC's and TNC's transmission and distribution organizations, which led to more employees in Texas becoming AEPSC employees, rather than operating company employees. The result of this and other post-merger changes was that many transmission and distribution costs became affiliate costs, rather than operating company costs. Thus, comparing TCC's current affiliate costs to its pre-merger affiliate costs is an invalid comparison.

As the ALJs state, there is no doubt and almost no disagreement that such post-merger changes have produced "dramatic cost savings in some areas, including affiliate costs" for TCC and its customers.[242] Dr. Thomas offered no disagreement at all to that fact in his testimony. Yet his disallowance penalizes TCC mightily for having made those changes, simply because they resulted in operating costs becoming affiliate costs.

In summary, Dr. Thomas did not find that a single affiliate cost of TCC was unreasonable or higher than was charged to other affiliates and non-affiliates. The sole basis of his criticism was a lack of external studies presented in TCC's case, particularly in the area of outsourcing studies. TCC strongly urges the Commission to reject this sort of analysis of convenience and to look carefully at the testimony and evidence offered by TCC. Adopting Dr. Thomas' approach and requiring such things as multitudes of outsourcing studies, whether outsourcing makes any sense for a particular service, would create plenty of work for consultants such as Dr. Thomas, but would realistically add nothing to the regulatory process.

[240] TCC Exh. 8, Direct Testimony of Harry Gordon, at Exh. HRG-3.

[241] TCC Exh. 72, Rebuttal Testimony of Mark Bailey, at 8-9.

[242] PFD at 69.

The ALJs' Recommendation

In five very brief paragraphs, the ALJs state that TCC's affiliate costs should be reduced by $10.3 million, which is the amount Dr. Thomas recommended, although they suggest they are not necessarily adopting his analysis.[243] Their view is that the $10.3 million figure "fairly reflects the amount and degree to which the Applicant's request should be disallowed for the issues discussed herein."[244] There is no more discussion than that to support the level of recommended disallowance. There are, however, a number of reasons why this disallowance should be rejected by the Commission.

First, the ALJs fully acknowledge that TCC's use of a centralized service company and merger-related activities result in "dramatic cost savings in some areas, including affiliate costs" for customers.[245] As stated by the ALJs, no intervenor challenged this fundamental fact.

Second, the ALJs' disallowance, as best as can be discerned from their brief discussion, seems to center on the fact that TCC depended too heavily on internal witnesses who supported these costs rather than by outside experts and comparative cost data and historical cost data. This analysis seems to assume that it is mandatory that affiliate costs be proven in such a manner. It is not. There is nothing in the statute, the Commission rules, or the rate filing package that requires this type of proof. TCC chose to present the testimony of numerous internal witnesses who had actual management responsibility for the costs they are supporting. There can be no better witness to support these costs than the individuals who are responsible for the services and level of costs. Not surprisingly, Dr. Thomas, a utility consultant, disagrees and believes that individuals such as he should be utilized to perform all manner of studies for the utility. However, in his prefiled direct testimony he provides no indication of how those studies would relate to a particular cost other than to simply conclude that they should have been done. This is not a basis for concluding that TCC's affiliate costs are excessive.

In apparent support for their conclusion the ALJs further mention that in Docket No. 14965, the Commission disallowed $17 million of CPL's affiliate expenses.[246] What they do not discuss is the fact that the Commission went through TCC's affiliate expenses in detail and

[243] *Id.* at 72

[244] *Id.*

[245] Id. at 69.

[246] *Id.* at 70.

disallowed individual cost items in large part because of the allocation factor used. In this case, the ALJs recommended the disallowance of only one affiliate cost item in the amount of $257,310 on the basis of the allocation factor.

While TCC obviously disagreed with the results of the Commission decision in Docket No. 14965, that decision was based on an approach of reviewing individual affiliate costs by class and determining whether TCC met its burden of proving the reasonableness of fuel costs under the affiliate standard. Here the ALJs have concluded on a very generalized basis that TCC did not perform enough external verification studies to justify more than approximately $53 million in affiliate costs in rates. There is no discussion about what evidence TCC did offer on the subject, no suggestion as to why the supposed lack of external verification should be quantified at that level, and no acknowledgement of the fact that many affiliate costs are not subject to meaningful external verification or cannot be meaningfully compared to other utilities.

The rate filing package was set up to allow the parties, the ALJ, and the Commissioners to review individual affiliate costs and determine whether they are reasonable, necessary and no higher than costs to other affiliates or non-affiliates. Some intervenors took this approach. OPC and Staff proposed specific disallowances with a specific rationale. This process will take longer than simply asserting that the company did not meet its burden of proof and pronouncing a large disallowance. When individual affiliate costs are reviewed and proposed for disallowance, the Commission has the opportunity to determine whether those costs should be included in rates under the statutes.

However, the ALJs did not attempt to recommend a result based on that type of analysis. When sweeping judgment about the burden of proof are made the Commission cannot carry out the reasoned, fact-specific decision-making that is necessary to a balanced regulatory process.

Further, the ALJs ignore the enormous amount of detail that is now required for affiliate costs in rate filing packages. As stated previously in these exceptions, the purpose of those requirements is to allow Intervenors and the Staff to undertake a detailed analysis of a utility's affiliate costs with far less difficulty than occurred under previous rate filing packages. Despite this purpose, only one party, OPC, recommended specific disallowances based on the affiliate standard. Dr. Thomas and Cities instead chose across-the-board disallowances on the basis of their vague conclusion that TCC did not meet its burden of proof, whatever that might be.

The ALJs also state they are troubled that TCC has over relied on allocating costs as opposed to direct billed costs.[247] However, this conclusion ignores the fact that while total billings to a combination of only TCC business units, the equivalent of direct billings prior to unbundling, is 14.2 percent, as stated by the ALJs, this tells only part of the story regarding AEPSC's allocation and billing practices. Transmission and distribution billings to benefiting locations which include only TCC and TNC business units amount to an additional 13 percent.[248] A great many of these costs would have been directly charged to TCC prior to unbundling and the combining of the TCC and TNC distribution organizations. In addition, 21 percent of TCC's affiliated costs were allocated to only Texas operating companies (including SWEPCO-Texas).[249] Thus almost 50 percent of TCC's affiliate costs are either directly billed to TCC transmission and distribution or are allocated only to TCC and other Texas companies. These numbers demonstrate that the ALJs' stated concern about direct billings vis-à-vis allocated costs does not tell the whole story.

TCC has met the burden of proof in every possible respect, and the ALJs' recommendation should be reversed.

B. Debt Reacquisition Costs

Exception No. 9

> The ALJs erred in rejecting TCC's request for $12,456,000 in restructuring-related debt reacquisition costs. (FOF 161, 162; COL 30,31)

The settlement agreement and Commission order in the UCOS proceeding allowed the Company to defer restructuring-related debt reacquisition costs for future recovery, and specifically limited the grounds upon which the costs could be challenged in the future. Finding of Fact No. 98 in TCC's final UCOS order[250] captures these terms, stating:

> It is reasonable that the debt refinancing costs incurred to restructure TCC should be deferred and amortized over a 15 year period beginning January 1, 2002, with the unamortized balance included in rate base. Each signatory to the Stipulation and Agreement has expressly retained *the right to challenge the reasonableness of the 15-year period and the amount of the refinancing costs* in a future rate case of

[247] *Id.* at 71.

[248] TCC Exh. 7, Direct Testimony of Sandra Bennett, at 18, lines 18-21; Tr. 1 at 374, line 20.

[249] *Id.* at 19, lines 1-4.

[250] Docket No. 22352.

> TCC. No signatory has waived its right to challenge in future rate cases a decision by the TCC TDU to refinance its debt as discussed in the direct and rebuttal testimony of TCC witness Wendy G. Hargus in Docket No. 22352.[251]

The PFD allows no portion of the costs to be included in rate base, allows no period of amortization, and disallows 100% of the amount of these costs ($12.4 million).[252] Yet the PFD finds no unreasonableness in the amount of the costs, nor did any party challenge the reasonableness of the amount of the costs.

The PFD's recommended treatment violates TCC's rights under the settlement, by changing a right of other parties to challenge the "reasonableness of...the *amount* of the refinancing costs" into a right to challenge "the *allocation* of the refinancing costs."[253] As a result, recovery of the reasonable amount is denied by allocating the reasonable amount in a manner that prevents recovery. While the settlement left open the possibility that TCC's recovery might be reduced, it did not contemplate that there would be an assignment of the reasonable costs to the generation function in a manner that would prevent their recovery.

In discussing the meaning of another settlement agreement (the ISA from the merger proceeding), the PFD emphasizes that the principal means of determining the intent of such an agreement is by giving its terms "their plain and ordinary meaning."[254] In the case of the debt reacquisition costs, however, the PFD does not apply this rule. First, as Finding of Fact No. 98 shows, the means by which the debt reacquisition costs could be challenged in the future were specifically and expressly laid out: "the reasonableness of the 15-year period," "the reasonableness of the amount of the refinancing costs," the "decision by the [TCC] TDU to refinance its debt" as discussed in Ms. Hargus' UCOS testimony. Nowhere in this specific list is mentioned a reservation of the right to challenge the allocation of the costs. To the contrary, Finding of Fact No. 98 specifically states that the full unamortized balance of the costs is to be included in *TCC's* rate base. A challenge to the "amount" of costs goes to the total quantity. It does not include the issue of allocation, which speaks only to which entity is responsible for the costs.

---

251 TCC Exh. 66, Rebuttal Testimony of David Carpenter, at 40, lines 16-26 (emphasis added).

252 PFD at 72-75.

253 PFD at 73.

254 *Id.* at 25.

The PFD defends its conclusion by pointing to the fact that TCC's UCOS order includes a statement, lifted from the Commission's order in the generic unbundling proceedings that paralleled the various UCOS proceedings,[255] that T&D rates should be allocated the proportionate share of debt restructuring costs that T&D assets bear to the utility's bundled assets as a whole.[256] This general ruling, however, cannot control the specific terms of the CPL UCOS settlement and Finding of Fact No. 98.

Moreover, the terms of the TCC UCOS order, borrowed from Order No. 17 in the PUC generic proceeding for all the UCOS rate cases, show that this ruling does not apply to the debt reacquisition costs in issue. In the quote from Order No. 17 included in the UCOS order referenced in the PFD, the legal/policy issue is framed by the Commission as what cost recovery mechanisms are available "for costs incurred *prior to January 2002....*"[257] This generic ruling, limited to the period before competition began,[258] is in no way inconsistent with TCC's right to recover *post-2002* debt reacquisition costs pursuant to the UCOS settlement and Finding of Fact No. 98. That recovery, and the specific limits on future challenges, are several of many interrelated tradeoffs that the parties in CPL Docket No. 22352 agreed to in order to settle the case. The PFD would deprive TCC of the benefits gained through that settlement, while TCC is still required to comply with numerous other settlement terms, all of which were interdependent.

Even erroneously assuming that the UCOS order allows future challenges to the *allocation* between T&D and generation functions of the debt reacquisition costs, the PFD's recommendation for 100% disallowance of recovery should be rejected. The PFD acknowledges the testimony of Mr. Carpenter explaining that there *has already* been an allocation of these specific debt reacquisition costs between T&D and generation.[259] Mr. Carpenter's testimony ties the previous generation-related allocation to the same pool of debt reacquisition costs now at issue in this case:

---

[255] PUC Docket No. 22344.

[256] PFD at 74.

[257] *Generic Issues Associated with Applications for Approval of Unbundled Cost of Service Rate*, Docket No. 22352, Final Order at 20 (emphasis added).

[258] Order No. 17 at 4; TCC Exh. 66, Rebuttal Testimony of David Carpenter, at 38, lines 14-17. (Debt reacquisition costs incurred the test year).

[259] PFD at 74-75.

Q. WAS A PORTION OF THE COSTS OF REACQUIRING DEBT ALLOCATED TO THE GENERATION FUNCTION?

A. Yes. When the Commission authorized TCC to securitize generation-related regulatory assets, it required TCC to use the proceeds of securitization to reduce common stock equity and long-term debt. Debt reacquisition costs of $22.3 million, per the Issuance Advice Letter, were included in the principal amount of securitization bonds issued. *The debt reacquisition costs requested in T&D revenue in this case includes the July 2002 debt reacquisition costs in excess of the securitization amount plus costs of subsequent debt reacquisition. The generation function has been allocated a reasonable portion of debt reacquisition costs.*[260]

Despite this testimony showing that the same overall debt reacquisition costs have been reasonably allocated between the T&D and generation functions, with 64% being allocated to generation,[261] the ALJ recommended total disallowance of the costs because "how those amounts fit into the allocation method referred to in the [UCOS] final order has not been made clear to the ALJs.[262]

As explained above, the generic allocation method referred to in the UCOS order is inapplicable by its own terms and by the terms of the ultimate UCOS settlement. Assuming, however, that the Commission concludes that the settlement should not control the resolution of this issue, the PFD recommendation is still inconsistent with its handling of other issues where the record lacked apparent clarity. In the context of the consolidated tax adjustment, the ALJs' uncertainty over the merit of TCC's allocation of tax benefits triggered a recommendation that the case be remanded for more evidence.[263] Here, where the lack of clarity results in a complete disallowance of TCC's debt reacquisition costs, the PFD proposes no remedy other than an adverse burden of proof finding. TCC nonetheless reasonably relied on the words of the UCOS settlement in presenting its evidence. Consistency and basic fairness at a minimum call for a

---

[260] TCC Exh. 66, Rebuttal Testimony of David Carpenter, at 41, line 15 through 42, line 2 (emphasis added).

[261] $22.3 million allocated to generation, divided by $34.7 million total ($22.3 + $12.4) debt reacquisition costs = 64%.

[262] PFD at 75. The ALJs erroneously state that TCC initially proposed to allocate 6.08% of the costs to generation. PFD at 72. The discovery response the ALJs cite stated only that TCC's books showed this allocation. *See*, Cities Exh. 28. Moreover, that discovery response was incorrect and TCC submitted a corrected answer explaining that none of the costs were allocated to the generation function on TCC's books. *See*, TCC Exh. 29; Tr. 6 at 1198, line 23 through 1199, line 15.

[263] *Id.* at 103-04.

remand for evidence on the proper allocation, as was the result with regard to the consolidated tax adjustment.

C. Salary Adjustments and Related Taxes

Exception No. 10

> The ALJs erred in rejecting $508,761 in TCC's base payroll expenses on the grounds that those costs were not known and measurable. (COL 44)

TCC proposed to increase its test year base payroll expense by $679,344.[264] As the PFD correctly notes on page 76, this total is composed of three items:

1. $170,583 to reflect the test year end number of employees and raises that went into effect prior to the test year end.

2. $262,456 to reflect the test year end number of employees and the raises that went into effect during the last six months of 2003.

3. $246,305 to reflect the test year end level of employees and raises that have been approved by management and are effective during the first six months of 2004.[265]

The PFD recommended that only the first item—the salaries for employees as of the end of the test year—be recognized in the cost of service. The PFD said that the other two items, totaling $508,761, should not be recovered based upon the Commission's policy in Docket No. 14965.[266] In rejecting the Company's request for these amounts, the PFD ignores a long line of Commission precedent that allows post-test year salary adjustments for test year end level of employees and pay increases that have been approved by management. Instead, the PFD incorrectly relies on precedent that is no longer relevant now that TCC has unbundled.

TCC respectfully submits that the ALJs' recommendation to disallow those costs should be rejected. The two items in question satisfy the known and measurable criteria in P.U.C. SUBST. R. 25.231(b). The amounts associated with the two items in question were developed on an employee-by-employee basis. In other words, the salary of each and every TCC employee was utilized to develop the known and measurable change.[267] By calculating the adjustment on an employee-by-employee basis, the accuracy of the adjustment is certain.

---

[264] TCC Exh. 67, Rebuttal Testimony of Randall Hamlett, at 22, line 21 through 23, line 13.

[265] *Id.*

[266] PFD at 77. Proposed FoF 44 merely states that TCC "failed to meet the legal requirements to recover" the costs of these two items.

[267] TCC Exh. 67, Rebuttal Testimony of Randall Hamlett, at 26, line 13 through 27, line 10.

The $262,456 proposed adjustment reflects the test-year-end number of employees and raises that went into effect in the last six months of 2003. The $246,305 proposed adjustment represents the test-year-end number of employees and raises that have been approved by management and went into effect the first six months of 2004.[268] In other words, as these exceptions are being written, *all* of these changes have already occurred.

The PFD's reasoning that the Commission ruling in Docket No. 14965 only allows post test year salary adjustments in the face of inflation and new additions to a utility's generation fleet is misplaced. This authority has lost its relevance now that TCC has unbundled. In addition, this ruling is an aberration and plainly wrong on its face. Adjusting test year expense levels for test year end employee levels is common Commission practice.[269] For example, a test year end (or later) level of employees was used to determine payroll expense in Docket Nos. 8425, 7195, and 9165.[270]

It is also common for salary adjustments to reflect increases that have been approved and gone into effect. To the extent that an increase has been approved, it is known and measurable. For example, the Commission has reflected salary increases that have been approved by the utility's board of directors in Docket No. 8425;[271] post-test year merit raises approved by the board of directors in Docket No. 9165;[272] and payroll increases that have been reflected in actual payments made following the test year in Docket No. 7195.[273] P.U.C. SUBST. R. 25.231(b) does not decree that known and measurable changes may be made *only if inflation is a factor and*

---

[268] TCC Exh. 5, Direct Testimony of Randall Hamlett, at 22, line 13 through 24, line 2.

[269] In fact, Staff witness Jacobs recommends using an employee count level at November, 2003, which is actually past the test year end. Staff Exh. 2, Direct Testimony of Mary Jacobs, at 13, lines 17-20.' If this employee level were to be used along with the salary increases that have been approved by the Company and are described in Mr. Hamlett's testimony, the base salary adjustment would be approximately $629,000, a decrease of approximately $50,000 from the Company's request.

[270] *Application of HL&P to Change Rates and Petition of HL&P for a Final Reconciliation of Fuel Costs*, Docket Nos. 8425 and 8431, 16 P.U.C. BULL. 2199, 2359 (June 20, 1990); *Application of Gulf States Utilities Company for Authority to Change Rates and Inquiry of the PUC into the Prudence and Efficiency of the Planning and Management of the River Bend Nuclear Generating Station*, Consolidated Docket Nos. 7195 and 6755, 14 P.U.C. BULL. 1943, 2195 (May 16, 1988); *Application of El Paso Electric Company for Authority to Change Rates*, Docket No. 9165, 16 P.U.C. BULL. 605 (August 22, 1990).

[271] 16 P.U.C. BULL. at 2579.

[272] 16 P.U.C. BULL. at 717.

[273] 14 P.U.C. BULL. at 2195.

generating plants are to be added. In fact, in this unbundled environment, no ERCOT investor-owned utilities will be adding generation.[274]

Consequently, TCC should be allowed to recover its recommended adjustment of $679,344 to base payroll expense.

D. Incentive Compensation

Exception No. 11

The ALJs erred in rejecting $2.92 million of TCC's employee incentive payments. (FOF 170; COL 45)

TCC's employee compensation includes both base and incentive payments. The test year incentive payments were $4.42 million, with 66% of the incentives being paid for meeting certain financial measures and 34% for meeting certain operating measures. The PFD recommends that TCC not recover the financial measures incentives (or $2.92 million). The PFD's rationale is that those payments are not in the public interest, do not directly benefit customers and are not reasonable and necessary to provide T&D service.[275] TCC submits that the PFD reflects an unduly narrow and erroneous view of the public interest and engages in unwarranted micromanagement regarding the structure of the compensation package the Company designed to attract and retain skilled employees.

TCC starts from the fundamental proposition that, in order to render adequate service, it must hire and retain skilled personnel in a competitive marketplace. To achieve this goal, the compensation package must be adequate and competitive. As long as the total compensation package is not excessive and incentives are not designed to result in unnecessary costs to customers or provide poor service (which no party argued in this case), then the package itself is in the public interest and satisfies the just and reasonable standard. TCC also submits that it should be afforded reasonable discretion to design a compensation package that it believes will satisfy these objectives.

TCC's compensation regime was designed to follow these criteria. The compensation package the Company offers its employees includes both a base and an incentive compensation amount. As TCC witness Mr. Jolley testified, both pieces are necessary to offer an employee a

[274] The PFD itself undermines the Docket No. 14965 precedent it cites when it recommends that TCC's test year salary level be adjusted by $170,583.

[275] PFD at 81; FoF 170.

package that is designed to be competitive from a market perspective in order to allow the Company to attract and retain qualified employees.[276]

Neither the PFD nor any party contended that TCC could hire and retain skilled employees if it kept its base salary structure but removed the incentives. They do not claim that the total compensation (base and incentive) is higher than what is necessary for this employment purpose. Nor could they have made a credible case if they had tried. Mr. Jolley carefully explained that the Company designs its compensation package so that only the *entire* amount, including both the base and incentive portions, produces an adequate level of compensation that is designed to attract and retain qualified employees.[277] He also described how the *overall* level of an employee's compensation (base and incentive) is designed to reflect the nationwide industry median level. It is this level that allows the Company to attract and maintain qualified individuals.[278] TCC submits that a compensation structure based on the industry median level is not excessive.

In addition, the PFD wrongly concludes that the portion of incentive compensation based on Financial Measures is not in the public interest because it does not *directly* benefit ratepayers. Indeed, the Financial Measures work together with Operational Measures to promote the financial integrity of and low cost service by TCC. As TCC witness Mr. Jolley explained, customers' interests are furthered "when we control costs and run our company effectively and efficiently from a financial perspective."[279] In addition, to the extent that financial targets are more consistently met, the need for rate relief is lessened. In the long run, all these measures benefit customers.

As the chart on page 78 of the PFD shows, 25% of the Financial Measures incentive compensation was for the "Corporate Component"—which was earnings per share for AEP as a whole. Higher earnings are the result of or translate into stronger financial integrity and stability,

---

[276] TCC Exh. 87, Rebuttal Testimony of David Jolley at 6, line 16 through 7, line 3. The Commission has long approved the inclusion of incentive compensation in rates. *Application of HL&P to Change Rates*, Docket No. 8425, 16. P.U.C. BULL. 2199, 2580 (Jun. 20, 1990) (FoF No. 140), and in Docket No. 6200 the Commission found that such expenses are "normal costs of doing business and increase productivity to the benefit of customers." *Petition of Southwestern Bell Telephone Company for Authority to Change Rates*, Docket No. 6200, 14. P.U.C. BULL. 490, 582 (Sept. 24, 1986) (FoF No. 100).

[277] TCC Exh. 87, Rebuttal Testimony of David Jolley at 6, line 19 through 7, line 3.

[278] TCC Exh. 19, Direct Testimony of David Jolley, at 5, line 21, through 6, line 3.

[279] Tr. 14 at 3070, lines 5-17.

access to the capital markets on lower cost terms, lower cost of service and fewer rate cases over time. All of the other four Financial Measures also translate into lower rates and costs over time. Twenty percent of the incentive compensation was within the measure "O&M Expense"—which is whether AEP performs under the O&M budget- and 15% was within the measure "Capital Expenditures"—which is whether AEP performs under its capital expenditure budget. Surely customers benefit by company policies designed to ensure fiscal discipline, which tends to make the cost of service lower than it would be otherwise. In truth, the O&M and Capital measures benefit both shareholders and customers because their interests are aligned.

The same is true of the measure "3rd Party Margins"—which is a variety of categories, including revenues for joint use of utility poles, line extension fees, litigation recoveries"—and "Transmission Revenues"—which is wheeling revenues. The revenues from these items reduce the Company's cost of service. For example, revenues from the joint use of utility poles are credited to the cost of service under the "other services" rule in P.U.C. SUBST. R. 25.342(f)(l)(D)(ii)(III). Line extension fees are likewise credited to the cost of service.

The ALJs appear to be influenced by the mandate in PURA § 36.062 that requires the disallowance of any "executive salary... [that the Commission finds] to be unreasonable, unnecessary or not in the public interest."[280] Yet in the context of this case, this provision must be interpreted to mean one of two things. On the one hand, it may be read to prohibit the recovery of an excessive salary. But no one claims that the total compensation is excessive and, as stated above, TCC keeps overall compensation in line with the industry median level. On the other hand, it could be read to prohibit an incentive payment that is designed to work against the interests of customers by unnecessarily raising costs or harming service quality. But none of TCC's incentives can be classified this way.

The ALJs' analysis fails to accord management with the proper discretion in how to structure compensation packages that, in total, no one has claimed are excessive. The PFD includes no explanation of how TCC could provide a competitive salary if it eliminated the incentive compensation in the manner suggested by the PFD. By the PFD's reasoning, costs attributable to employee vacation and sick time could just as easily be disallowed, because they do not *directly* benefit customers. TCC's incentive compensation is designed to meet the long-

280 PFD at 80.

term interests of both shareholders and customers. Accordingly, TCC should be allowed to recover all of its incentive compensation costs.

E. Pension Expenses

Exception No. 12

> The PFD erred in not allowing TCC to recover its Requested Pension Expense of $6,796,788. (FOF 172, 173; COL 46)

Whereas TCC proposed a pension expense of $6,796,788 in its cost of service, the PFD recommends allowing only $30,812 in pension expense[281] on the basis that the Company's proposed increase is not "known and measurable." The PFD not only incorrectly applies the "known and measurable" standard, it also ignores the broader context of an issue that has grave consequences for the lives and welfare of so many people. The pervasive under-funding of pensions affects the national interest, cutting across industries and geography. It is no exaggeration to say that pension funds which appeared adequate and healthy just a few years ago have since been devastated by the decline in the value of stock markets and interest rates. Now companies both large and small are grappling to restore their pension funds to levels on which employees can depend. TCC is no exception.

As indicated above, the PFD's rationale for rejecting TCC's proposed adjustment to its test year expense is that it does not satisfy the known and measurable criteria. Specifically, the PFD found that TCC's adjustment is based upon "forecasts that are highly dependent on changes in stock market prices and market interest rates," but that "future stock market prices and market interest rates are not within the category of known and measurable changes."[282]

Specifically, the PFD observes that Company witness Turk could not predict with "reasonable certainty" future stock prices or interest rates which affect future actuarial pension funding. Therefore, the PFD reasons, "[t]he Applicant may not use expert testimony for the purpose of measuring the stock and bond markets' performance as the basis for a 'known and measurable change.'"[283] However, neither the Company nor its witness was trying to measure the stock and bond markets' performance. Mr. Turk was testifying as to the rate year level of

[281] By "expense" TCC means the funding level, not the expense recorded in TCC's books.

[282] PFD at FoF 172-173.

[283] PFD at 84.

pension expense. This amount, while not known with absolute precision, is known with reasonable certainty. The reason is that the performance of the bond and stock markets is only one of many factors which affect rate year pension expense.

The PFD acknowledges that the Commission has the discretion to include in rates amounts outside of the test year "which can be anticipated with reasonable certainty."[284] Because most of the factors that affect pension expense are known (*e.g.*, past investment gains and losses, whose effects must be recognized over time, current asset values in the trust, the actuarial liabilities and current interest rates) the level of rate year pension expense can be anticipated with reasonable certainty. However, the PFD is silent on this fact. It focuses on only one small factor affecting pension expense and never acknowledges that the vast majority of factors affecting pension expense are known with reasonable certainty.

This issue should also be viewed using basic common sense. The large stock market declines of recent years are historical facts. They are both known and measurable and, because of the requirement to phase-in the effects of losses over time, will impact companies' pension expense for a number of years. AEP is not alone in this regard. The combination of declines in long-term interest rates and equity markets have resulted in significant increases in required contributions for qualified pension plans throughout the country.[285] As detailed in the Company's filing, the Company has an unfunded minimum pension liability of $73,124,749.[286] Based on the PFD's recommended funding level of $30,812, it will take the Company 2,373 years to fund this liability. Obviously, the PFD's recommendation regarding pension expense is beyond any consideration of a reasonable view of what the Company and employees need to have for a viable pension trust when they retire.

Under the PFD's rationale, there would never be any change in pension expense from test year levels because these data are not "known and measurable." The questions the Commission should ask itself are has the stock market declined, and is the Company's request for pensions reasonable based on the assets held in the pension trust? The answer to both questions is an indisputable "yes."

---

[284] PFD at 83.

[285] TCC Exh. 20, Direct Testimony of Michael Turk, at 12, lines 6-13.

[286] TCC Exh. 5, Direct Testimony of Randall Hamlett at 28, line 21 through 29, line 8; TCC Exh. 2.1 Schedule II-C-2.1, p. 2 of 2 (line 4 under column entitled "06-30-03 Per Books").

If TCC's adjustment is rejected because the actuarial data commonly relied upon to establish pension contributions is not known and measurable, then consistency demands that the same result obtain for post employment benefits.[287] TCC's proposed changes to the test year levels of pension, OPEB and post employment benefits were all made on the same basis—an actuarial determinations of costs. The adjustments to pension and OPEB expenses were increases. However, the adjustment to post employment benefits was a decrease. Of all the intervenor witnesses on these issues, only CCR witness Blumenthal was consistent in recommending the rejection of all three adjustments.[288] If the Commission disallows the Company's requested adjustments to test year levels of pension and OPEB expense (which the PFD recommends), then it should also adopt Ms. Blumenthal's rejection of the Company's proposed decrease to post employment benefits on the same grounds (on which the PFD is silent).[289] This would increase TCC's cost of service by $1,630,943.[290]

Finally, if the PFD's recommendation is adopted, then the adjustment to the Company's filing needs to be properly calculated. In the Company's filing, its pension costs totaled $6,796,788, not $7.2 million as indicated on page 84 of the PFD.[291]

F. OPEB (Post-retirement Expenses Other Than Pensions)

Exception No. 13

> The ALJs erred in rejecting TCC's proposal to increase its OPEB test year expense by $365,000. (FOF 176; COL 47)

TCC proposed to increase its $4,874,149 test year expense related to post retirement benefits other than pensions (OPEBs) by $365,000 in order to reflect the actuarial amounts that it

---

[287] OPEBs refer to employment benefits other than pensions and may include health and dental benefits. Post-employment benefits, on the other hand, refer to benefits granted to retirees.

[288] CCR Exh. 1, Direct Testimony of Ellen Blumenthal, at 16-18 (what she refers to as SFAS 87, 106 and 112 expense). Note that post employment benefits are what Ms. Blumenthal means when she refers to SFAS 112 expense.

[289] TCC Exh. 67, Rebuttal Testimony of Randall Hamlett, at 33, lines 7-14.

[290] *Id.*, lines 3-16; TCC Exh. 2.1 (Schedule II-D-2, Attachment page 6 of 12).

[291] TCC Exh. 3.2 (WP/Schedule II-D-2-1; Line Titled "Projected Cash Funding to Trust-Expense Portion.").

will fund during the rate year (July 2004 through June 2005).[292] Again, just as with pension expense, the Company's request is based on an actuarial determination of rate year costs. The evidence submitted by the Company indicated that the requested adjustment to test year expense levels were based on increased health costs, lower interest rates, and current asset values, and, just as with pension expense, were known and measurable and should be allowed.

However, the PFD's rejection of the Company's requested level of OPEB expense was based not on a reasoned application of post-test year cost principles, but instead on an incorrect reading of P.U.C. SUBST. R. 25.231(b)(1)(H)(i).

P.U.C. SUBST. R. 25.231(b)(1)(H)(i) states that, "OPEB expense shall be included in an electric utility's cost of service for ratemaking purposes based on actual payments made." The PFD rejects the Company's requested adjustment to OPEB expense on the grounds that it is not based on "actual payments made." This is incorrect. This provision must be read along with the rest of the rule, while also keeping in mind the accounting distinction between a paid cost and an accrued cost. P.U.C. SUBST. R. 25.231(b)(1)(H)(ii)-(vi) describe the circumstances in which a utility can include its current OPEB expense in cost of service for ratemaking purposes "on an *accrual basis*..." (emphasis added). The other method, the one TCC uses, is one based upon actual payments made. This rule indicates that a company may include in cost of service payments made to a funded trust. Thus, the rule is intended to distinguish the accounting convention to be used for this item, not to prohibit a post-test year known and measurable adjustment. TCC's proposed adjustment is intended to reflect rate year contributions to its OPEB trust, and does not violate the rule.

Known and measurable changes to OPEB expense is also supported by the Commission's rate filing package. The instructions for Schedule II-D-3.9 require that the utility's filing, "Present costs (expensed and capitalized) per GAAP and actual funded amounts by function for each of the three most recent years' OPEBs." This information must be updated "if actuarial information or actual payments for OPEBs change subsequent to the test year." (Instructions 3 and 5) The instructions would not require this information to be updated for post-test year information, including actuarial information, if post-test year adjustments to the cost of service were, as the PFD contends, categorically prohibited. TCC's proposed adjustment to test year

[292] The Company's total OPEB expense for 2004 and 2005 (including capital and O&M costs) is expected to be $9,100,000 and $8,800,000, respectively. TCC Exh. 20, Direct Testimony of Michael Turk, at 22, lines 5-6. Only the O&M piece is included in cost of service.

OPEB expense of $395,000 does represent amounts to be funded to its OPEB trust. It complies with P.U.C. SUBST. R. 25.231(b)(1)(H), is known and measurable, and should be allowed.

G. Group Insurance Expense

Exception No. 14

> The ALJs erred in rejecting TCC's proposal to increase its test year group insurance expense by $908,833. (FOF 179; COL 48)

TCC's group insurance (medical, dental, *etc.*) test year costs were $3,741,039. The PFD rejects TCC's request to increase the cost of service amount by $908,833 (to $4,649,872) to reflect expenses that will be incurred when rates go into effect. Just as with pension and OPEB expense, group insurance costs included in rates are based on actuarially determined amounts. They are properly-determined post-test year adjustments to test-year amounts and, like the Company's pension and OPEB requests, should be allowed.

However, the PFD's rejection of TCC's proposal rests not on any alleged failure to meet the known and measurable standard, but instead on what the PFD claims is a lack of information in the record (that is, their inability to locate the test year cost data and TCC's requested expense amount or the underlying actuarial study).[293] But this claim is unfounded. First, test year cost data on group insurance is located on TCC Exh. 3.2, WP/Schedule II-D-2-10.[294] In addition, the requested amount was supported by record evidence, and the fact that the study on which those amounts are based was never introduced into evidence is not proper grounds to deny the adjustment.

TCC's request satisfies the "known and measurable" standard for a post-test year adjustment, and there is sufficient record evidence supporting TCC's request. However, the PFD simply ignores TCC's evidence.

First, an actuarial study *was* performed to determine what costs would be incurred in 2004.[295] Towers Perrin assisted the Company in calculating 2004 health care rates, based on an annual health care study that it undertakes in order to analyze current trends in the group medical

[293] PFD at 87.

[294] *See* line entitled "Net Test Year Expense" under column labeled "Total T&D."

[295] TCC Exh. 20, Direct Testimony of Michael J. Turk, at 4, lines 2-8.

insurance markets.[296] As Company witness Mr. Turk testified in his rebuttal testimony, this most recent study indicated that group medical insurance (the largest component of group insurance expense) will increase on average 12% over 2003 levels.[297]

The fact that the underlying actuarial study itself was not introduced into the record is no basis for concluding, as the ALJs do, that this issue should be resolved as if there were no study at all. It is common in Commission proceedings for expert witnesses to testify about the results of a study to support their conclusions.[298] Other parties then have the right to seek the underlying study through discovery to determine whether the expert's conclusions are indeed supported by the study.[299] Indeed, under Texas Rule of Evidence 705, an expert may give the reasons for his or her opinion or inference "without prior disclosure of the underlying facts or data, unless the court requires otherwise. The expert may in any event disclose on direct examination, or be required to disclose on cross-examination, the underlying facts or data." As noted above, Mr. Turk did provide the underlying facts or data (that is, the results of the actuarial study) in his testimony, satisfying the rules of evidence. It is significant here that the only party to contest TCC's request, the Staff, did not complain about the lack of the study. Staff's position was merely that the Company's request did not satisfy the known and measurable standard.[300]

In addition, as TCC witness Mr. Hamlett testified on rebuttal, TCC's actual contribution to the group medical plan for 2004 is higher than its requested amount by approximately $250,000.[301] TCC's requested amount satisfies the known and measurable standard. In fact, the evidence indicates that the Company's requested amount is *less* than what TCC is paying for

---

[296] TCC Exh. 76, Rebuttal Testimony of Michael J. Turk, at 11, lines 14-16.

[297] *Id.*

[298] In the TXU unbundling case, the ALJs observed that a number of studies that supported various affiliate costs were not in evidence. This was not considered a basis on which to deny the costs. *Application of TXU Electric Co. for Approval of Unbundled Cost of Service Rate Pursuant to PURA § 39.201*, Docket No. 22350, Proposal for Decision (Mar. 14, 2001) at 122-23.

[299] Rule 194(f)(4)(A) of the TEX. R. CIV. PROC. allow discovery of all documents, reports or data compilations "that have been provided to, reviewed by, or prepared by or for the expert in anticipation of the expert's testimony."

[300] It is also significant that Staff, unlike the ALJs, did not complain that they could not find TCC's requested amount, which was clearly stated in Ms. Jacob's testimony. Staff Exh. 2, Direct Testimony of Mary Jacobs, at 15, line 9. Staff would surely be in a position to state the costs in issue because it was Staff, and only Staff, that contested these costs. It is often true that the specifics of a particular item become clarified through discovery and the course of Intervenor/Staff testimony and then company rebuttal; that is, once the item becomes a point of contention. This is the process that occurred here.

[301] TCC Exh. 67, Rebuttal Testimony of Randall Hamlett, at 36, lines 1-7.

group insurance benefits in 2004. Consequently, the record supports TCC's request for its group insurance expense of $4,649,872.

H. Catastrophe Reserve

Exception No. 15

> The ALJs erred in rejecting TCC's proposal to increase its depleted catastrophe reserve by $2.6 million annually and to increase the upper limit of its catastrophe reserve from $5.4 million to $13.5 million. (FoF 181)

PURA § 36.064 and P.U.C. SUBST. R. 25.231(b)(l)(G) specifically authorize a utility to recover in its cost of service the expenses (accruals) for a self-insurance plan to cover catastrophic property loss. TCC has had such plan and a corresponding catastrophe reserve. However, because of the damage from two hurricanes in the last five years, the reserve is essentially depleted.[302] Accordingly, in this case TCC seeks to fund the reserve at approximately $2.6 million annually and to increase the upper limit of its catastrophe reserve from $5,353,563 to $13,544,000.[303] The requested annual funding level would allow the reserve to reach its maximum limit in five years (assuming that the Company suffers no intervening losses).

TCC supplied all of the evidence to justify its request under PURA § 36.064 and P.U.C. SUBST. R. 25.231(b)(l)(G). Yet the PFD ignores the elements of the statute and rule, rejects TCC's proposal, and adopts a finding that is contrary to the statute and rule. The essence of the PFD's reasoning is that TCC is not limited to the two options of funding the self-insurance expense or obtaining commercial insurance. Instead, TCC "has another option: seeking a rate increase to fund the additional O&M costs incurred following an unanticipated catastrophic expense."[304] The issue is what level of self-insurance did TCC justify under the self insurance rule, not whether PURA and the Commission's own rule should be ignored. The purpose of the self-insurance rule is to allow a means of recovery for this type of extraordinary expense *without* the necessity and regulatory inefficiency of filing a rate case. TCC respectfully submits that the PFD failed to honor the intent of both the Legislature and the Commission.

---

302 TCC Exh. 22, Direct Testimony of Marshal Nadel, at 6, lines 12-15.

303 *Id.* at 37, line 16 through 38, line 2.

304 PFD at 90.

The PFD refers to the self insurance rule only twice and briefly at that. The PFD opines that "the rule requires the reserve to be in the public interest."[305] The PFD goes on to state that the rule requires a cost-benefit analysis demonstrating that "with consideration of all costs, self-insurance is a lower-cost alternative than commercial insurance and the ratepayers will receive the benefits of the insurance plan."[306] It is after this latter mention of the rule, with its cost benefit analysis requirement, that the PFD creates a third alternative to be imposed on TCC—that it can simply file another rate case to fund additional O&M costs following a catastrophe.

It bears reviewing the entirety of the self insurance rule in P.U.C. SUBST. R. 25.231(b)(l)(G):

> (1) Accruals credited to reserve accounts for self-insurance under a plan requested by an electric utility and approved by the commission. The commission shall consider approval of a self insurance plan in a rate case in which expenses or rate base treatment are requested for such a plan.s [*sic*] be credited to reserve accounts. The reserve accounts are to be charged with property and liability losses which occur, and which could not have been reasonably anticipated and included in operating and maintenance expenses, and are not paid or reimbursed by commercial insurance.
>
> (2) The commission will approve a self insurance plan to the extent it finds it to be in the public interest.
>
> (i) In order to establish that the plan is in the public interest, the electric utility must present a cost benefit analysis performed by a qualified independent insurance consultant who demonstrates that, with consideration of all costs, self-insurance is a lower-cost alternative than commercial insurance and the ratepayers will receive the benefits of the self insurance plan. The cost benefit analysis shall present a detailed analysis of the appropriate limits of self insurance, an analysis of the appropriate annual accruals to build a reserve account for self insurance, and the level at which further accruals should be decreased or terminated.

The first thing to note is that nowhere does the rule even remotely suggest that the alternative of a rate case is to be categorically set against the options of purchasing insurance or self insuring. It is true, as the PFD says, that this rule requires the self-insurance plan to be "in the public interest." However, the rule also specifies the information a utility must present "in order to establish that the plan is in the public interest."

[305] PFD at 87.

[306] PFD at 90.

The record establishes that TCC provided all the evidence it needed to "establish that its plan is in the public interest:"

- "A cost benefit analysis performed by a qualified independent insurance consultant." TCC witness Marshall Nadel, a qualified independent insurance consultant, performed this analysis. [307]
- "Who demonstrates that, with consideration of all costs, self-insurance is a lower-cost alternative than commercial insurance." Mr. Nadel's analysis demonstrated this.[308]
- "The ratepayers will receive the benefits of the self-insurance plan." As Mr. Nadel testified, "TCC's customers will benefit from the significantly lower costs of the self insurance plan."[309]
- "The cost benefit analysis shall present a detailed analysis of the appropriate limits of self-insurance." Mr. Nadel described how commercial insurance is not available to TCC on a reasonable or economic basis and he recommended a reasonable amount of self insurance for TCC.[310]
- "The cost benefit analysis shall present...an analysis of the appropriate annual accruals to build a reserve account for self insurance." Mr. Nadel explained how his forecasting model resulted in an average total annual catastrophe loss to TCC of $5.6 million. TCC's experience has been that approximately 50% of this amount is associated with incremental storm-related O&M expenses, resulting in an annual contribution of approximately $2.6 million.[311]
- "The cost benefit analysis shall present...the level at which further accruals should be decreased or terminated." Mr. Nadel explained how the accruals should be terminated when it reaches $13,544,380.[312]

The record demonstrates that TCC complied with all the criteria in the rule. But this was of no account whatsoever to the ALJs. Instead, the PFD blindly, and with no discussion of pertinent issues, adopts the Commission's 1997 decision on this same subject in TCC's last bundled rate case, Docket No. 14965. Ironically, the PFD acknowledges that TCC's request in

[307] TCC Exh. 22, Direct Testimony of Marshall Nadel, at 3, line 16 through 5, line 5 (qualifications); 5, lines 7–20 (cost-benefit analysis).

[308] *Id.* at 9, line 5–10, line 7.

[309] *Id.* at 12, lines 1–2.

[310] *Id.* at 9, line 10 through 10, line 7; 11, lines 3–17.

[311] *Id.* at 10, line 11 through 11, line 17.

[312] *Id.* at 12, lines 3–17.

1997 was "prior to the damage caused by the two recent hurricanes."[313] The passages from Docket No. 14965 on which the ALJs rely merely show that it was the ALJs in that case who emphasized the rate case option. The Commission ruled only that the $5.4 million catastrophe reserve was adequate (seven years ago) to cover likely damages.[314]

It is more than a legal stretch to say that the evidence presented in this pending rate case can be disregarded on the basis of what the Commission thought was an adequate reserve in an opinion from seven years ago. The PFD does not even attempt to compare the particular facts and evidence in this case and Docket No. 14965, including TCC's experience in the intervening years and what the expert evidence shows in this case.

What the ALJs have effectively decided is that an examination of the facts in this case is unnecessary because TCC can always file another rate case, which is the same thing as saying that such a rate case is TCC's insurance. But this is completely contrary to the regime established by PURA and the Commission rules, which require that a self insurance plan be evaluated on its own merits under the criteria in the rule. TCC complied with this rule. In fact, it was the only party that considered the rule's requirements. The PFD's recommendation ignores the Commission's self-insurance rule. TCC's proposal complied with that rule and it should therefore be adopted.

I. DSM Costs

Exception No. 16

> The ALJs erred in rejecting both of TCC's alternative proposals to recover its DSM costs through a cost recovery factor or through a base rate amount equal to the average of its Year 2003-2005 costs ($7.1 million). (FOF 182; COL 49)

The PFD recommends that TCC recover its test year energy efficiency (or DSM) costs of $6,082,450. In doing so, the PFD rejected TCC's proposals: (1) to recover its energy efficiency costs through a cost recovery factor; or (2) in the alternative, to recover the average of its energy efficiency costs for the years 2003 through 2005 ($7,142,792). TCC submits that the PFD disregards the more compelling arguments favoring TCC's proposals.

---

[313] PFD at 88.

[314] PFD at 89.

Because TCC's statutory energy efficiency goals and thus its expenses are both increasing year by year, the PFD will not result in TCC receiving adequate funding. TCC has very limited control and discretion over its DSM costs because PURA § 39.905 mandates that funds be expended to meet the energy efficiency demand reduction goals. TCC's current rates include \$3.7 million, which was the amount necessary to achieve the five percent demand reduction goal for January 1, 2003.[315] For calendar year 2004, TCC's total DSM expenses are \$6.3 million.[316] In 2005, however, these expenses escalate to \$8.8 million, including \$8.6 million to meet the goal. In the next year, TCC's budget to meet its 10% goal is \$11,999,710. One can readily see that TCC's costs in 2004 already exceed the PFD's recommendation by \$250,000, and this shortfall grows dramatically to \$2.7 million next year and to over \$5.6 million the following year.

The PFD first contends that neither of TCC's proposals is supported by the statutory or regulatory framework for DSM cost recovery. The sole basis of this reasoning is the PFD's assertion that no provision in the energy efficiency rule in P.U.C. SUBST. R. 25.181 permits cost recovery on any basis other than what is allowed by the cost of service rules in P.U.C. SUBST. R. 25.231 (that is, historical test year expenses as adjusted for known and measurable changes).[317]

This reasoning cannot be squared with the Commission's energy efficiency rules or precedent. Those rules describe in great detail how a utility must first calculate its annual demand reduction goal and must then provide funds to obtain the energy efficiency savings to meet the goal.[318] P.U.C. SUBST. R. 25.181(i)(7) declares that, "Funds for achieving the energy efficiency goal will be included in each utility's transmission and distribution rates." There is no mention of or limitation to test year amounts. Contrary to what the PFD says, the cost of service rules are not even mentioned in the energy efficiency rules. The PFD thus disregards the relevant and explicit cost recovery language in the energy efficiency rule and wrongly implies

---

315 TCC Exh. 24, Direct Testimony of Billy Berny, at 28, lines 4-6.

316 TCC's budgets to meet its energy efficiency goals through January 1, 2008 and its expenses under pre-existing contracts are contained in Exhibits BGB-4 and 5 of TCC Exh. 24, the direct testimony of Billy Berny. In Exhibit BGB-5, the pre-existing contracts are those under the columns titled "C/I Solicit." and "SPC Prog." The cost information in this paragraph of TCC's exceptions is taken from those Exhibits BGB-4 and 5.

317 PFD at 93.

318 Under PURA § 39.905, each utility must acquire energy efficiency equal to at least 10% of its annual growth in demand by January 1, 2004 and each January 1 thereafter. For January 1, 2003, TCC's goal was 5% of its growth in demand, as specified in P.U.C. SUBST. R. 25.181(f). Thus, during the first half of its test year (June-December 2002), TCC was pursuing the 5% goal. Since then and from now on, the 10% goal applies.

that those rules contain language linking cost recovery to the historical test year cost of service rules.

The PFD also does not note that TCC cannot overrecover its DSM costs (that is, recover more in rates than what it spends). Energy efficiency funds "not spent within a given year shall be considered as a source of funding for the following year,"[319] and "funds approved in the utility's rates for the purpose of the energy efficiency goal under PURA § 39.905 shall be used exclusively to acquire cost-effective energy efficiency savings, even if such savings exceed the utility's energy efficiency goal."[320]

The PFD makes no attempt to validate its reasoning compared to Commission precedent in the UCOS cases of Oncor[321] and Reliant.[322] Its sole comment is that TCC "asserts" that its proposal to recover the average of 2003-2005 costs is supported by these cases, which were decided in 2001 and used projected test years.[323] This point is critical because it shows how the PFD recommends that TCC be subject to stricter cost recovery standards than what the Commission has adopted in other litigated cases.

In its UCOS case in Docket No. 22350, Oncor was allowed to recover the average of its projected energy efficiency costs to be incurred in the years 2002, 2003 and 2004.[324] The total cost calculation included both the costs to meet its demand reduction goals and the costs of pre-existing contracts. Oncor was allowed to recover $42,663,548, nearly seven times more than what TCC requests under its alternative proposal. Similarly, in its UCOS case in Docket No. 22355, Reliant was allowed to recover the average of its energy efficiency expenditures for the years 2002 and 2003.[325] This included $4.3 million for pre-existing contracts and $12,925,492 for 2002 and 2003 costs to meet its demand reduction goals.

---

[319] P.U.C. SUBST. R. 25.181(i)(7).

[320] P.U.C. SUBST. R. 25.181(i)(8)(A).

[321] *Application of TXU Electric Co. for Approval of Unbundled Cost of Service Rate Pursuant to PURA § 39.201*, Docket No. 22350, Proposal for Decision (Mar. 14, 2001) and Order (Oct. 4, 2001).

[322] *Application of Reliant Energy for Approval of Unbundled Cost of Service Rate Pursuant to PURA § 39.201*, Docket No. 22355, Order (Oct. 4, 2001).

[323] PFD at 93.

[324] Docket No. 22350, Proposal for Decision (Mar. 14, 2001) and Order (Oct. 4, 2001). The Oncor PFD explains how Oncor calculated its costs on page 125, and the Commission approved the proposed rate recovery in FoF 112 and 113 of Subsection III.F.3.m.i-ii, on pages 154-155 of its order.

[325] Docket No. 22355, Order (Oct. 4, 2001). The DSM cost recovery is described in FoF 134 and 135A of Subsection III.D, on pages 134-135 of the Commission's order.

The DSM cost recovery issue was litigated, not settled, in the Oncor and Reliant UCOS cases. In each case, the utility was allowed cost recovery reflecting expenses incurred *after* the 2002 test year. In Oncor's case, the cost recovery formula extended a full *two years* beyond the 2002 test year. Granted that in both cases, a 2002 projected test year was used. However, this fact cannot explain why the Commission allowed cost recovery to reach beyond the test year. In other words, it is not plausible to say that these cases are not relevant to TCC's case here because these cases involved a projected test year and thus the Commission was free to indulge additional projections beyond the test year. Under the PFD's reasoning, Oncor and Reliant should have been allowed to recover only year 2002 costs. The Oncor and Reliant decisions also belie the PFD's assertions that TCC's alternative proposal to use the average of costs in 2003-2005 "would change the manner of measurement of the amount of the allowable costs by substituting estimated amounts for known and measurable amounts. Similarly, this is not permitted in the statutory or regulatory scheme."[326] The PFD's reasoning, not TCC's proposal, is out of step.

The PFD also rejected TCC's primary request for a DSM cost recovery rider.[327] TCC respectfully refers to its own discussion in section VIII.E.1 of these Exceptions for a discussion of that issue.

J. Gain on Sale of the AREP

No exceptions filed.

K. Bad Debt Expense

No exceptions filed.

L. *Ad Valorem* Taxes

No exceptions filed.

M. Consolidated Income Taxes

Exception No. 17

> The PFD erred in recommending that the Commission remand this issue back to SOAH in order to determine the proper amount of a consolidated tax adjustment. (FoF 194-195, and 196; CoL 52 and 53)

---

[326] PFD at 93.

[327] *Id.*

Although the Commission has remanded this issue for further evidence in accordance with the PFD's recommendation, the Company respectfully submits that the evidence introduced at hearing was sufficient to decide the issue without a remand.

The PFD recommends that TCC's rates reflect a consolidated federal income tax adjustment. The ALJs reason that, although the Texas courts have yet to definitively resolve the questions surrounding the issue of consolidated taxes, the Commission has. They observe that the Commission has made some form of consolidated tax adjustment based on the methodology adopted by the Commission in Docket No. 14965 in several subsequent cases, including the unbundling rate cases of TXU and Reliant. The implication that the Commission has resolved the issues surrounding the consolidated federal income tax expense is a curious one given the PFD's discussion on page 102. As even the ALJs noted, the Commission's prior rulings on the issue are inconsistent and lack a reasoned explanation for the various rulings.[328]

The PFD refers to the methodology adopted in Docket No. 14965 as the "interest credit" methodology and explains that the methodology considers the consolidated group's tax savings generated over the past 15 years. After removing all losses that would have been absorbed by the utility's own income during the 15-year period, the remaining tax savings are allocated among the various subsidiaries based on the respective level of income over the period. The utility's share of the savings is then multiplied by its long-term cost of debt to calculate the "benefit" that the Commission claims the utility would have provided its subsidiaries during the 15-year period.

The Company urges the Commission to find that the Company's fair share of the consolidated tax savings is zero. The savings at issue in this case result solely from losses and tax deductions *of other entities*. They represent amounts expended, not by the utility, but by the utility's affiliates. As such, they should not be considered when setting rates for the utility. The Texas Supreme Court has made it clear that a utility's own disallowed expense must not be considered when calculating tax expense.[329] It makes even less sense to consider another entity's disallowed expenses when calculating tax expense included in rates.

---

[328] For example, as noted on page 102 of the PFD, and as pointed out in the Company's initial brief at 102-105, the Commission has, at times, adjusted tax expense for the consolidated tax savings while, at others, it has adjusted rate base. Similarly, in Docket No. 14965, it clearly did not "gross-up" the adjustment, while, at other times, it appeared to.

[329] *Public Utility Commission of Texas v. GET-Southwest, Inc.*, 901 S.W.2d 901 (1995).

Although it found that a consolidated adjustment should be made, the PFD properly rejected Cities' recommended $9,878,000 adjustment (as well as its attempt to improperly "gross-up" this amount to $15,197,000), in part, on the grounds that this amount is not properly "functionalized." In other words, it does not consider only the T&D portion of the tax savings over the 15-year period. However, the PFD also rejects the Company's quantification of the properly functionalized tax savings amount, claiming that the proper methodology would be to deduct the consolidated tax savings amount attributable to the generation function from the Cities' recommended $9,878,000 proposed adjustment. The PFD goes on the recommend that, if the Commission is inclined to make an adjustment, it remand the case to the ALJs in order to determine the proper amount of adjustment.

The Company respectfully suggests that a remand is not necessary for a number of reasons. First, the ALJs are incorrect that the tax savings attributable to the generation function need only be deducted from Cities' recommended disallowance to determine the proper adjustment. First, and most obviously, simply removing amounts attributable to generation would leave amounts attributable to both the T&D *and the retail function for the entire 15-year period.* Any tax savings adjustment should only reflect the T&D function. It should not also include the retail function. The ALJs' proposal would improperly include these amounts.

In addition, the PFD is incorrect when it rules, on pages 101-102, that losses generated by two AEP coal companies after the merger should be considered in the analysis. As explained in Mr. Warren's uncontroverted testimony, these losses would, on a stand-alone basis, have been absorbed by the income previously generated by these same companies. As a result, the losses would not have been offset by utility income and there should be no associated benefit allocated back to the utility in the consolidated income tax calculation.[330] Elsewhere in the PFD, the ALJs acknowledge as much when they observe that, "the losses that would have been offset by the subsidiary's own gains during the fifteen years" should not be considered.[331]

In fact, the Company provided testimony that properly quantified the amount of consolidated tax savings produced by the Docket No. 14965 methodology that is attributable solely to the T&D function. This amount does not reflect any generation or retail savings, and,

[330] TCC Exh. No. 79, Rebuttal Testimony of James Warren at page 24, lines 1-14.

[331] PFD at 101.

as the PFD observes, it corrects minor carryback errors committed by Cities witness Arndt.[332] Company witness Bartsch first determined the ratio of T&D taxable income to total TCC taxable income in 2002. Because unbundling occurred January 1, 2002, this was the only year for which the taxable income was available on a functional basis. This ratio was then applied to the properly calculated tax savings amount to yield a T&D-related tax savings amount of $403,906.[333]

The PFD indicates that the ALJs are not "comfortable" with the Company's calculation. They observe that it was introduced "in rebuttal and with little opportunity to evaluate it."[334] In fact, the calculation was included in rebuttal testimony as a response to the obviously deficient calculation provided by Cities' witness. Further, there was ample opportunity to evaluate the number. Both of the Company's federal income tax witnesses were produced for cross-examination on their direct and rebuttal testimony and, when parties waived cross-examination of the witnesses in both instances, Company counsel repeatedly made it clear that the witness would be available to answer any clarifying question from the ALJs on either their direct or their rebuttal testimony.

There was no need to remand this issue for additional evidence. Although the Company urges the Commission to find that the amount of consolidated tax savings allocable to the Company in this instance is zero, if the Commission is inclined to make an adjustment, the proper amount of the adjustment is $403,906, as indicated in Mr. Bartsch's rebuttal testimony.

N. Distribution O&M Expense Adjustments

Exception No. 18

> The ALJs erred in reducing TCC's cost of service by $1 million in distribution operation and maintenance (O&M) expense adjustments. (FoF 199, 200, 201; CoL 55)

As discussed by the ALJs, Cities witness Dr. Alton Patton, an engineer and not an accountant, proposed certain accounting adjustments to TCC's O&M expense, alleging they were one-time, non-recurring expenses and should not be included in revenue requirements.

[332] PFD at 101.

[333] TCC Ex. No. 78, Rebuttal Testimony of Jeffrey Bartsch at 6, lines 4-17 and Exh. JJB-1R (Errata Mar. 1, 2004).

[334] PFD at 103-104.

TCC presented the rebuttal testimony of Mr. Randall Hamlett, an accountant, who demonstrated that Dr. Patton's adjustment, with the exception of $1 million, had no basis.

The ALJs agreed with Mr. Hamlett, with the exception of an additional $1 million related to vehicle expense for TCC's transmission and distribution system. As discussed by the ALJs, the vehicle expense issue concerned $3.4 million, of which TCC agreed $1 million should be removed from cost of service. The ALJs recommended that of the remaining $2.4 million, $1.0 million be eliminated because TCC's explanation for this expense is "so vague as to be unconvincing."[335] The ALJs stated they were "uncomfortable with this lack of specificity."[336]

The ALJs are simply wrong when they contend that TCC was not specific regarding this issue. Mr. Hamlett testified very explicitly concerning the entire $2.4 million.[337] The $1 million expense which troubled the ALJs represents an increase in vehicle expense charged to Account 588 during the test year. Vehicle expense charged to other distribution O&M accounts decreased by a similar amount when compared to 2001 actual expenses.[338] As Mr. Hamlett testified, this occurred because during the test year, the Company charged its vehicle expense to different distribution FERC accounts for the time prior to the test year.[339] He further stated that this $1 million in vehicle expense which was charged to Account 588 during the test year is an appropriate cost of TCC because it will continue to incur vehicle expenses to maintain its distribution system as it did during the test year.[340] To remove this $1 million simply reduces TCC's vehicle expenses by that amount for no reason.

It is inconceivable how the ALJs could contend that the explanation of that $1 million by Mr. Hamlett was "so vague as to be unconvincing." While the subject is a bit complicated, it was explained precisely and carefully. There is no basis for this adjustment to be made, and this finding of the ALJs should be reversed.

---

[335] PFD at 107-108.

[336] *Id.* at 108.

[337] TCC Exh. 67, Rebuttal Testimony of Randall Hamlett, at 51, lines 9-17.

[338] *Id.* at lines 12-17.

[339] *Id.*

[340] *Id.*

O. Distribution A&G Expense Adjustments

Exception No. 19

> The ALJs erroneously concluded that TCC's A&G costs were unreasonably high compared to other T&D utilities and should be reduced.

The ALJs make the surprising and unsupported conclusion that TCC's total administrative and general (A&G) costs for distribution service are "unreasonably high when compared to similar T&D utilities and should be reduced."[341] Although the ALJs did not recommend a specific dollar disallowance they seemed to indicate this adjustment might be appropriate if the Commission does not accept the ALJs' recommendations regarding merger savings and catastrophe reserve. Therefore, TCC excepts to the ALJs' finding on this issue. The ALJs' conclusion is surprising because the lion's share of the ALJs' discussion of this issue centers on the flaws in the testimony of Dr. A.D. Patton, the Cities' witness who recommended a $13,857,271 reduction in TCC's A&G expenses. While the ALJs recommended no disallowance, TCC excepts to their conclusion that TCC's A&G costs "are unreasonably high."

After briefly describing Dr. Patton's methodology of comparing certain TCC A&G cost ratios with what Dr. Patton alleged to be comparable A&G cost ratios from two other utilities, the ALJs summarized for two more pages TCC's evidence of the many serious flaws in Dr. Patton's analysis.[342] The ALJ's also described the rebuttal testimony of Randall W. Hamlett who testified that any A&G cost comparison to other utilities, even if done correctly, should not be used as a basis to disallow costs.[343] Mr. Hamlett further demonstrated that even if an A&G cost comparison had some value and if the many flaws in Dr. Patton's methodology were corrected, TCC's A&G cost ratio was in line with and trending better than the ratios of the two peer utilities used by Dr. Patton.[344] Regarding Mr. Hamlett's testimony, the ALJ's observed that "the Intervenors did not maintain any serious challenge to these data or assertions" on cross-examination.[345]

---

[341] PFD at 111.

[342] *See* PFD at 108-111.

[343] TCC Exh. 67, Rebuttal Testimony of Randall Hamlett, at 43, line 7 through 44, line 2.

[344] *Id.* at 45, line 8 through 46, line 21; *id.* at Exh. RWH-4R.

[345] PFD at 111.

Nevertheless, without providing any explanation as to why TCC's criticisms of Dr. Patton's testimony should be ignored or how his testimony could be reconciled with the unchallenged opposing testimony of Mr. Hamlett, the ALJs stated that "both Dr. Patton's and Mr. Hamlett's analyses are useful."[346] The ALJs then elected to only make use of Dr. Patton's testimony and concluded, "the A&G [cost recovery] that TCC seeks is out of proportion to similar T&D utilities, which suggests that it is unreasonably high, as Dr. Patton concluded."[347] The ALJs' conclusion, like that of Dr. Patton upon which it relies, is seriously flawed and should be rejected by the Commission.

It is significant to note at the outset that Dr. Patton is an electrical engineer and has no professional training or practical experience as a utility accountant.[348] Perhaps due to his lack of professional accounting training, Dr. Patton attempted to use apples to oranges cost comparisons to demonstrate that TCC's A&G expenses were excessive in comparison to TXU and Reliant Energy. Incredibly, Dr. Patton attempted this comparison despite the fact that, by his own admission, he had no knowledge or understanding of the accounting practices at either TXU or Reliant Energy.[349]

The very fact that Dr. Patton attempted to compare TCC's A&G cost ratios with those of other utilities to disallow specific TCC costs is contrary to longstanding practice for determining the reasonableness of utility rates. As Mr. Hamlett testified, each disallowance must identifiable and concrete and must be supported by valid conclusions about why the activities associated with the cost are not reasonable or necessary.[350] Costs should not be disallowed by simply calculating the amount of reduction in A&G costs necessary to move a particular ratio to a desired level.

Moreover, the ratio on which Dr. Patton based his comparative analysis was the ratio of administrative and general costs to operations and maintenance (O&M) costs. This ratio itself is a poor comparison because A&G expenditures may or may not be directly related to the operations and maintenance of a company's facilities. Mr. Hamlett testified that O&M costs are direct charges to operate a company's distribution activities and are specifically assigned to the

---

[346] *Id.*

[347] *Id.*

[348] Tr. 8 at 1580-1582; TCC Initial Brief at 108.

[349] Tr. 8 at 1585.

[350] TCC Exh. 67, Rebuttal Testimony of Randall Hamlett, at 43, line 7 through 44, line 2.

FERC distribution related account.[351] A&G costs are more general and may not relate to distribution activities. For example, certain consulting fees, legal bills and employee benefits are considered A&G expenses but are typically more influenced by external forces including market changes, lawsuits, or stock market fluctuation than variables affecting O&M costs, including employee counts. These external forces may be different for each utility. Legal fees and medical premiums may be dramatically different for two equally efficient companies. Thus, as Mr. Hamlett explained, even if all other variables were kept the same, comparing one company's ratio of A&G costs to O&M costs to that of another company does not provide a meaningful measure of efficiencies.

This comparison is further weakened by the fact that different utilities may use different criteria to categorize expenses as A&G versus O&M costs. Costs recorded as A&G expenses in one company may be recorded in on O&M account at another company. Mr. Hamlett testified that without complete knowledge and evaluation of both companies' accounting policies, this analysis is incomplete and meaningless.[352] Dr. Patton was asked specifically on cross-examination whether he made an inquiry into the accounting practices of TXU and Reliant with respect to what expenses those utility companies included in their A&G accounts rather than in O&M accounts and he admitted he had not.[353] Relevant portions of Dr. Patton's testimony are attached hereto as Appendix H. Because Dr. Patton made no effort to determine the extent of the differences among the three utility companies' cost accounting practices, his conclusion that TCC's A&G costs are excessive is uninformed and unsupported.

Even if Dr. Patton's method of comparing A&G cost ratios yielded any credible information, which Mr. Hamlett's testimony refutes, that information would be discredited in this case because Dr. Patton used only a single data point of information for each utility from which to compare costs. Mr. Hamlett pointed out that even in the extremely unlikely event that all three companies had exactly the same accounting policies, a proper analysis would consider multiple data points to determine whether there are irregular trends or unusual events that could

[351] *Id.* at 41, line 12 through 42, line 11.

[352] *Id.* at 42, line 12 through 43, line 6.

[353] Tr. at 1585.

have affected one company's A&G costs but not the other companies'.[354] Dr. Patton's "snap-shot" analysis does not account for these potential anomalies.

Finally, the information in the single data point compared by Dr. Patton was obtained from two different test periods and two different filings. Dr. Patton did not even bother to look at the final orders in the TXU and Reliant UCOS cases or any actual A&G expenses incurred by TXU or Reliant. Instead, he compared the forecasted 2002 data from the PFD with TCC's actual costs from its June 2003 rate filing.[355] Dr. Patton had no reasonable explanation for why he chose to use data from the PFD or why he elected to compare the forecasted UCOS amounts rather than actual cost data which was more recent.[356] To the extent that the UCOS forecasts in the PFD were changed by the Commission or market conditions changed between TXU's and Reliant's 2000 UCOS filings and June 2003, the comparison to TCC's actual costs is flawed. Compounding this fact, Mr. Hamlett pointed out that the actual costs set out in TCC's rate filing include multiple categories of costs that were excluded from the forecasted UCOS filings of the other utilities.[357]

Because there are so many problems and inaccuracies with Dr. Patton's analysis, the ALJs were wrong to even consider it "useful" much less rely on it to conclude that TCC A&G costs were unreasonably high. Although, the ALJs ultimately concluded that other reductions in TCC's A&G costs associated with the merger revenue requirement credit and pension expense increase would make any further reduction in TCC's A&G costs unnecessary,[358] the Commission should not adopt the ALJs' conclusion that TCC's A&G costs are unreasonable.

P. Depreciation Expense

1. Average Service Lives

Exception No. 20

The ALJs erred in rejecting TCC's proposed average service lives for four distribution and four transmission accounts, and instead adopting dramatically longer average service lives. (CoL 56)

---

[354] TCC Exh. 67, Rebuttal Testimony of Randall Hamlett, at 44, line 5-9.

[355] Tr. at 1583-1584.

[356] *Id.*

[357] TCC Exh. 67, Rebuttal Testimony of Randall Hamlett, at 44, line 16-21.

[358] *See* PFD at 111.

The PFD gives conflicting signals about what it intends for TCC's depreciation expense. On one hand, the text of the PFD suggests that the ALJs adopt TCC's revised proposal (the one reflecting TCC's agreement with some of Cities' recommendations), except that the ALJs disagree with TCC and adopt Cities' proposed adjustment to extend the average service lives of eight accounts. Hence, the ALJs say the depreciation expense should be no more than TCC's revised proposal of $71,814,601.[359] The PFD's summary of issues says that TCC's request should be reduced to $63,596,403.[360] On the other hand, Conclusion of Law 56 states that "TCC's amended proposed depreciation expense of $71,814,601 should be adopted." TCC assumes that the PFD probably intended that TCC's proposed depreciation expense of $71.8 million be reduced to account for the ALJs' recommendation concerning average service lives, and TCC's exceptions reflect that assumption. By TCC's calculation, the effect of this adjustment to the average service lives is an $8.8 million reduction to TCC's request.

The PFD accurately describes what is at stake in the average service life issue. The longer the average service life of an asset, the more years there are in which to depreciate the asset and thus the lower the depreciation rate and expense. Cities' witness, Ms. Nancy Heller Hughes, recommended average service lives for eight accounts that are longer than those proposed by TCC's witness, Mr. James Henderson.[361] Therefore, the effect of Cities' average service life adjustment is to lower TCC's depreciation expense.

Calculating the average service life of assets involves extrapolating the projected life of assets by establishing a good "fit" with the closest Iowa survivor curve. But there is a larger perspective than this arcane technique which the PFD does not acknowledge—compared to the status quo, Ms. Hughes' recommendation for these eight accounts results in dramatically longer and thus unreasonable average service lives. Mr. Henderson's recommended average service lives took account of the fact that the lives of TCC's plant have been increasing since the last depreciation study. For the eight accounts in issue, he proposed an average increase of 6.4 years

[359] PFD at 112.

[360] PFD at 8, item 16.

[361] There are four distribution and four transmission accounts in question. The transmission accounts are: 355-Station Equipment; 354-Towers & Fixtures; 355-Poles & Fixtures; and 356-Overhead Conductor. The distribution accounts are 362-Station Equipment; 364-Poles & Fixtures; 365-Overhead Conductor; and 357-Underground Conductor. Cities Exh.5, Direct Testimony of Nancy Heller Hughes, at 13, Table 2, the column "Average Service Life."

(or 15.3%). In contrast, Ms. Hughes' average increase is 16.1 years (or 38.4%) or well over twice the increase TCC had proposed.[362]

A review of the four accounts with the largest differences, taken from page 9 of Mr. Henderson's rebuttal testimony, drives home this point:

Account	**Current years**	**TCC Proposed years (% increase over current)**	**Cities Proposed years (% increase over current)**
354 Towers & Fixtures	50 years	60 (20%)	71 (42%)
355 Poles & Fixtures	46 years	50 (9%)	65 (41%)
356 Overhead Conductor	42 years	50 (19%)	65 (55%)
362 Station Equipment	38 years	47 (24%)	60 (58%)

Ms. Hughes proposes dramatic life extension by any measure. Yet mortality characteristics for mass plant accounts usually do not change dramatically. The changes that do occur can cause the lives of property to both increase and decrease.[363] For this reason alone, Ms. Hughes' recommendations are excessive and her recommended quantum leap in the proposed average service lives should be rejected.

As a reminder, TCC notes that, once the decisions are made on the depreciation issues, the final numbers must be run using the correct plant balances as adopted by the Commission. Mr. Henderson, TCC's depreciation witness, utilized December 31, 2002 depreciable plant balances.[364] TCC witness Mr. Hamlett, however, sponsored TCC's requested depreciation expense by applying Mr. Henderson's proposed depreciation rates to the plant in service at the end of the test year.[365] TCC's proposed depreciation expense is $73,931,184, the amount sponsored by Mr. Hamlett.[366] The recommendations of Ms. Hughes with which Mr. Henderson agreed in his rebuttal testimony as well as the ultimate decisions made by the Commission will need to be reflected in the final calculation that is based upon the test year end balances.

[362] TCC Exh. 85, Rebuttal Testimony of James Henderson, at 9.

[363] *Id.* at 9.

[364] TCC Exh. 17, Direct Testimony of James Henderson, at 6, lines 5-6, 15-20.

[365] *Id.* at 6, lines 15-20; TCC Exh. 5, Direct Testimony of Randall Hamlett, at 51, lines 2-7.

[366] TCC Exh. 2.1, at I-A-1.

2. Net Salvage

No exceptions filed.

Q. Decommissioning Expense

Exception No. 21

> The ALJs erred by limiting decommissioning costs for the South Texas Project to $7.58 million. (FoF 206; CoL 57)

The current annual decommissioning expense allowed for the South Texas Project, which is collected by TCC, is $8.16 million. While TCC witness Mr. Steven Kiser's analysis yielded an estimated annual contribution of $7.58 million, he recommended that TCC's current annual authorized level of funding be maintained. He pointed out in his direct testimony that the forecasts necessary for projected decommissioning cost recovery are very sensitive to slight changes in assumptions.[367] This is particularly true with respect to actual rates of return achieved by trust fund investments, rates of increase in waste burial costs, and inflation rates for labor and energy.[368] Because of the sensitivity of these factors, TCC proposed that there be no change in the decommissioning fund expense.

Only one party, Cities, proposed an adjustment. Cities witness Ms. Hughes objected to continuing to fund decommissioning expense at the current level. She recommended that only $7.58 million in decommissioning expense be included in the cost of service, claiming that TCC's request to continue the $8.16 million in decommissioning funding amounts to adding to the 10 percent contingency amount allowed by P.U.C. SUBST. R. 25.231(b)(1)(F)(i) and is thus not allowed by the rules. The ALJs agreed.

Ms. Hughes' and the ALJs' interpretation of the rule is incorrect. The rule clearly provides that the 10 percent contingency applies to the actual decommissioning cost study. It does not apply to the financial and economic forecasts that must be considered in determining how to collect the actual decommissioning costs. It is correct that TCC has a 10 percent contingency in the decommissioning cost study in this case, which was sponsored by TCC witness Thomas LaGuardia. That does not mean, however, that the Commission cannot take into

---

[367] TCC Exh. 18, Direct Testimony of J. Steven Kiser, at 30 , lines 7-8.

[368] *Id.* at lines 14-16.