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APPLICATION OF AEP TEXAS CENTRAL COMPANY FOR AUTHORITY TO CHANGE RATES	§ § §	**BEFORE THE PUBLIC UTILITY COMMISSION OF TEXAS**

CITIES' REPLY BRIEF ON REMANDED ISSUES

TO THE HONORABLE COMMISSIONERS:

COMES NOW, the eighty-six cities ("Cities") that have intervened in this case and file this Reply Brief on Remanded Issues. Cities would respectfully show as follows:

I. Merger Costs

Before the Commission allows TCC to add $22.5 million in merger costs to its cost of service, they must be convinced that TCC has demonstrated "that the full level" of merger savings for the applicable year have "been achieved" as required by the Integrated Settlement Agreement ("ISA").[1] Despite repeated opportunities, TCC has failed to make such a demonstration. This is because TCC chose not to track savings. Even if one accepts the flawed evidence presented by Mr. Heyeck, it is only an estimate.

The Company's spin on these shortcomings is that the ISA "rejected tracking of merger savings and does not specify a particular method of demonstrating merger savings."[2] In truth, the ISA is silent with respect to the manner in which TCC must make its demonstration. However, it is clear that TCC must show that it *actually* achieved the promised level of merger savings before it can saddle ratepayers with merger related costs.

The Company's description of the merger savings provision (*i.e.* Section 3(F)(3) of the ISA), overlooks the fundamental purpose of the provision. That is, to act as a disincentive for TCC to file for a rate increase to become effective prior to the end of the six-year period after the effective date of the

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[1] Merger costs are not a cost of service item, an actual test year expense or a recurring expense. Finding that the Company failed to demonstrate that it did not achieve the required amount of merger savings would not result in a disallowance. Instead, theses costs are a proposed adder of $22.5 million to the Company's revenue requirement not typically charged to customers in merger or acquisition cases.

[2] TCC Closing Statement, at 2.

merger. The Company admitted this fact in their rebuttal testimony.[3] This section of the ISA purposefully makes it difficult for TCC to include net merger expenses and costs to achieve in the cost of service.[4]

Recognizing the weakness of its case, the Company tried for the first time at the mini-hearing to shift the focus to witnesses other than Mr. Heyeck. According to the Company, these "merger panelists" are the "first prong" of the merger savings analysis.[5] Significantly, none of these witnesses quantified any merger savings. This was left entirely to Mr. Heyeck.[6] Moreover, the steps to reduce costs discussed by the "panelists" were at the "corporate-wide level" (*i.e.* the AEP service company).[7] Whether there actually are savings at the TCC level is not only unknown, it is unaddressed. Even at the service company level, however, there is doubt about the level of savings given the Company's huge affiliate expense request. In lieu of an actual quantification, the Company simply lists random employment figures they believe support their claims.[8] Finally, the alleged savings are inconsistent with the Company's request in this case to increase rates by $67 million.

The "second form of proof" submitted by TCC is the one it has relied upon throughout this case. This is the reliance upon Mr. Flaherty's 1997 analysis presented by Mr. Heyeck.[9] To begin with, TCC relied upon Mr. Heyeck to *estimate* merger savings. Estimates are not sufficient under the ISA to demonstrate actual merger savings. Even if Mr. Flaherty's work was an appropriate starting point, Mr. Heyeck did not update it appropriately to take into account real world changes such as the move to

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[3] TCC Exh. 66 at 15 ("The ISA included disincentives for both the Company and other parties to initiate a rate case").

[4] *Id.*

[5] TCC Closing Statement, at 2.

[6] Even Mr. Heyeck did not do any analysis of his own and did not know why he came up with his estimate. Remand Tr. 3, at 315.

[7] TCC Closing Statement, at 2.

[8] For example, at page 2 of their closing statement TCC discusses the reduction in employees and attempts to extrapolate a savings amount associated with this reduction. Of course, these reductions are "corporate-wide" and not TCC specific. Even the so called "merger-related staff reduction" of 229 TCC employees is meaningless because TCC has not quantified the amount of savings associated with the reductions, has not shown that the reductions are merger-related and has not demonstrated that employee costs associated with the reductions were not simply shifted to AEPSC to become affiliate expenses.

[9] Instead of conducting his own analysis using actual figures, Mr. Heyeck relied upon the work of Company witness Flaherty. Mr. Flaherty's analysis was done in 1997; 3 years prior to the merger and 4.5 years prior to the test year. Cities Exh. 2, at 14. In his rebuttal testimony, Mr. Heyeck stated that "all assumptions were disclosed and sourced." TCC Exh. 81, at 8. However, this is incorrect. *See,* Tr. 14 at 2988-3000. Mr. Heyeck relied upon Mr. Flaherty's assumptions and these were not included in the record. Tr. 14 at 2982, 2997.

competition which radically altered the Company. Moreover, he failed to apply actual inflation factors. In that regard, the Company has tried to shift the burden of proof to the intervenors by focusing on the appropriateness of relying upon the GNP inflators as a proxy to what Mr. Heyeck used. This is a red herring that distracts from the real issue of whether the Company met its burden of proof under the ISA.[10]

The amount of the revenue requirement credit is not an issue in this remand. The PUC remanded the merger savings issue, not the revenue requirement credit issue. These are two different issues. Moreover, this issue was not included in Order Nos. 23 or 24 which identified the three remanded issues.[11] TCC's response to the orders never suggested the revenue requirement credit issue should be part of the remand. There was also no mention in their January 26 filings identifying witness panels. This was not done until their opening statement at the hearing.

Section 3(F)(3)(b) of the ISA provides that the revenue requirements otherwise determined to be reasonable and necessary in this case will be reduced by the annual amounts included in Attachment E of the ISA. For the test year ended June 30, 2003, Attachment E provides for a revenue requirement credit of $7,495,000. Year 3 of the merger corresponds exactly with the end of test year. Despite this clear language, the Company asks that the Commission ignore the revenue requirement credit amounts on Attachment E for years 3 and 4 and apply the year 5 amount. Of course, the Company's absurd self-serving argument is presented solely because the year 5 credit is lower than year 3. The extent of the self-serving nature of the Company's proposal is revealed by their use of year 3 for calculating merger savings but year 5 for calculating the revenue requirement credit. The Company does this because the merger savings it must demonstrate occurred under Section 3(F)(3) increase over time. Given the clarity of the ISA it is not surprising that the PUC decided this issue without the need for a remand.

II. Affiliate Expenses

TCC declines to "...utilize this closing statement to describe the evidence it has put on regarding affiliate costs."[12] Instead, TCC goes to significant effort to convince the Commission that its burden of

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[10] Attachment A demonstrates that there are no merger savings when actual inflation figures are used rather than Mr. Flaherty's 1997 inflation factor.

[11] Notably, in its February 8 Response to Order Nos. 23 and 24, the Company, in objecting to Cities' attempt to include the distribution A&G expense adjustment in the remand, pointed out that the orders "set out very precisely the issues the commission stated will be examined at the mini-hearing." Because the A&G issue was not identified, TCC claimed Cities request should be rejected.

[12] TCC Closing Statement, at 5.

proof under PURA § 36.058 is no different than the burden of proving up other, non-affiliate costs.[13] Specifically, the Company suggests that it need only "produce evidence" to overcome the presumption that affiliated costs are to be excluded from the utility's cost of service.[14] Producing evidence is not enough, there must also be an analysis of the quality or adequacy of the evidence. The Texas Supreme Court has made clear that generalized conclusory testimony alone does not constitute substantial evidence necessary to support a Commission decision.[15]

TCC asserts that the "standard for recovery" of affiliate costs is the same "reasonableness" test applied to other costs.[16] The Company asks the Commission to interpret § 36.058 so as to reach a "reasonable result."[17] TCC's arguments ignore case law establishing the burden of proof under the affiliate statute and is more wishful thinking than legal analysis.[18] PURA's affiliate standard imposes extraordinary burdens upon the Commission and the utility. PURA § 36.058, of course, requires the Commission to exclude payments to affiliates from rates except under the circumstances set out in the statute.

The Austin Court of Appeals discussed the special burden of proof required in transactions with affiliates as well as the Commission's extraordinary duty in *Railroad Commission of Texas v. Rio Grande Valley Gas Company.*[19] The Court stated:

> In enacting PURA, the Legislature placed a specific duty on the Commission to ***carefully scrutinize all payments*** made by a utility to an affiliate and to disallow ***all*** such payments unless the utility showed that the payments met certain statutory requirements. This skepticism regarding affiliate payments is expressed in 41(c)(1) of PURA...[20]

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[13] *Id.* at 6-11.

[14] *Id.* at 6-8.

[15] *Public Utility Commission of Texas v. Gulf States Utilities*, 809 S.W.2d 201, 211 (reh'g overruled June 19, 1991).

[16] TCC Closing Statement, at 8. This is incorrect. Unlike other cost of service expenses, PURA requires a utility show that the costs incurred by an affiliate are reasonable for each item or class of items and that the service is necessary for the provision of service by the utility. In addition, the utility must prove that the price charged the utility is not higher than that charged to other affiliates or non-affiliated companies.

[17] *Id.* at 9.

[18] The Legislature found that PURA § 39.051 was insufficient for affiliate expenses. As such, it found it necessary to include a separate provision containing a heightened standard exclusively for dealing with the evaluation of affiliate expenses.

[19] *Railroad Commission of Texas v. Rio Grande Valley Gas Company* 683 S.W.2d 783 (Tex. App.-Austin 1984, no writ).

[20] *Id.* at 786 (emphasis added).

The Court rejected the argument repeated by TCC here and said,

> Rio's entire approach has been that the Commission is required to allow the residual affiliate charges unless they are shown to be imprudent, unreasonable, or out of line. ***Although that may be true with respect to arms length*** transactions, it is not that with respect to payments to affiliates about which the ***Legislature has its suspicions and which to any reasonable mind are clearly tainted with the possibility of self-dealing***.[21]

More recently, in *Central Power and Light Company, et al. v. Public Utility Commission of Texas, et al.*, the Austin Court, again, referred to the "high burden of proof" on the utility:[22]

> As noted above, because of the possibility for self-dealing between affiliated companies, PURA regards affiliate transactions with some skepticism and requires the utility to meet a high burden of proof before costs paid to affiliated companies may be allowed as an expense.

TCC's argument in this case that the Commission should reach a "reasonable result" on affiliate costs is the same argument made by the Company in *Central Power and Light Company*. The Court found:

> Finally, CPL claims that even if we accept that there are flaws in the allocation factors used as they are applied to the disputed charges, the Commission's decision to allow ***none*** of the charges is clearly an arbitrary and unreasonable result. Under substantial evidence review, we must reverse the Commission's order if it is "arbitrary or capricious or characterized by abuse of discretion or clearly unwarranted exercise of discretion." TEX. GOV'T CODE ANN. § 2001.174(2)(F). CPL seems to argue that because it showed that it incurred at least ***some*** costs, as evidenced by the work orders it paid to CSWS, allowing it to recover none of those costs is arbitrary and unreasonable. In so arguing, CPL misconstrues its burden in presenting those charges to the Commission. The statutory presumption is that payments made to affiliates are ***not*** allowed. *See* PURA § 36.058(a). Because the Commission found that CPL did not overcome this presumption, CPL was simply not entitled to include those costs in its rate base. In rejecting the allocation factors used by CSW in assessing costs against CPL, the Commission was not required to substitute its own allocation method to enable CPL to satisfy its statutory burden and include some of the costs. We overrule CPL's fifth and final issue.[23]

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[21] *Id.*

[22] *Central Power and Light Company et al. v. Public Utility Commission of Texas, et al.*, 36 S.W.3d 547, 568-69 (Tex. App.-Austin 2001, pet. denied).

[23] *Id.*, at 568.

It is clear that the Commission's duty is to "carefully scrutinize ***all*** payments made by a utility to an affiliate" and that TCC's burden is higher than that applied to arm's length transactions. The potential for self-dealing identified by the Legislature is particularly acute in this case as AEP has 200 affiliates. All of these affiliates, under *Rio Grande* must pay their fare share of centralized, allocated costs. TCC's effort to trivialize its burden of proof must be rejected.

The only party to this case exhibiting confusion about the utility's burden of proof on affiliate matters is TCC. The Commission in Docket Nos. 14965 and 16705 gave plenty of guidance on the type of evidence necessary to allow the Commission to make the statutory findings. TCC admits knowledge of such "Guiding Principles"[24] but applied the principles to only a small fraction of the affiliate costs in this case. The conclusory, generalized statement of TCC's witnesses do not rise to the level of substantial evidence according to the Supreme Court.[25] The Supreme Court said it best: "An expert who supplies nothing but a bottom line supplies nothing of value to the judicial process."[26]

III. Distribution O&M Expense Adjustment

Because the requested $1 million for vehicle salvage expense identified by Dr. Patton is a one time non-recurring expense, it should be disallowed. Significantly, the Company chose to not address this issue in their closing statement.

Respectfully submitted,

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[24] TCC Closing Statement, at 5, 11-13.

[25] *Gulf States Utilities,* at 211.

[26] *Merrill Dow Pharmaceuticals, Inc. v. Hauner*, 953 S.W.2d 706, 712 (Tex. 1997).

CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing document was transmitted by email, fax, hand delivery and/or regular, first class mail on this 1st day of April, 2005 to the parties of record.

THOMAS L. BROCATO

MERGER SAVINGS

Company witness Heyeck's merger savings calculation is summarized below. There are no savings when actual inflation is used rather than Mr. Flaherty's 1997 inflation forecast.

	Description (A)	Using Flaherty's Forecasted 3.63% Inflation (B)	Using Actual Inflation (C)
1	1997 O&M expenses	$330,890,318	$330,890,318
2	1998 inflation (3.63% vs. 1.50%)	1.0363	1.0150
3	1998 O&M expenses	$342,901,637	$335,853,673
4	1999 inflation (3.63% vs. 1.77%)	1.0363	1.0177
5	1999 O&M expenses	$355,348,966	$341,798,283
6	2000 inflation (3.63% vs. 2.61%)	1.0363	1.0261
7	2000 O&M expenses	$368,248,133	$350,719,218
8	2001 inflation (3.63% vs. 2.64%)	1.0363	1.0264
9	2001 O&M expenses	$381,615,541	$359,978,205
10	2002 inflation (3.63% vs. 1.75%)	1.0363	1.0175
11	2002 O&M expenses	$395,468,185	$366,277,824
12	One-half 2003 inflation (1.0182% vs. 1.0099)	1.0182	1.0099
13	Forecasted year ended June 30, 2003 operation and maintenance expenses	$402,678,505	$369,903,974
14	Actual test year ended June 30, 2003 operation and maintenance expenses	$373,806,583	$373,806,583
15	Merger savings	$28,871,922	($3,902,609)

Sources:
Column B: Company Exhibits MH-1 and MH-2 corrected per Tr. Vol. 3, at 313
Column C: Cities Exhibit MLA-3
Columns B and C, line 15: Line 13 minus line 14

Assuming it is appropriate to use Mr. Flaherty's outdated forecasted inflation factors, there is still no merger savings when one considers Regulatory Commission Expenses, Account 928, and Customer Assistance Expenses, Account 908. The Company's 1997 regulatory commission expenses were $14.697 million. Using Mr. Heyeck's 3.63% inflation factor,

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escalated regulatory commission expenses for the year ended June 30, 2003 are $17.885 million.[1] Actual test year ended June 30, 2003 regulatory commission expenses were $9,000. This implies a merger savings for regulatory commission expenses of $17.876 million. There is no recurring merger savings related to regulatory commission expenses. The implied savings is simply due to the fact that 1997 regulatory activity was significantly greater that the regulatory activity during the test year ended June 30, 2003.

The Company's 1997 customer assistance expenses were $15,023,000. Using Mr. Heyeck's 3.63% inflation factor, escalated customer assistance expenses for the year ended June 30, 2003 are $18.280 million.[2] Actual test year ended June 30, 2003 customer assistance expenses were $413,000. This implies a merger savings for customer assistance expenses of $17.867 million. There is no merger savings related to customer assistance expenses. The implied savings is simply due to the fact that in 1997 the Company had 627,940 customers and during the test year ended June 30, 2003 had only 103 customers.

Adjusting Mr. Heyeck's claimed merger savings for regulatory commission expenses and customer assistance expenses changes his claimed $28.872 million merger savings to a **negative** $6.871 million.

	Description (A)	Actual 1997 O&M Expenses (B)	Forecasted Year Ended June 30, 2003 O&M Expenses Using Flaherty's 3.63% Inflation (C)	Actual Test Year Ended June 30, 003 O&M Expenses (D)	Merger Savings (E)
1	O&M expenses	$330,890,318	$402,678,505	$373,806,583	$28,871,922
	Less: Regulatory Commission				
2	expenses	14,697,470	17,884,763	9,047	17,875,716
3	Customer assistance expenses	15,022,566	18,280,360	413,410	17,866,950
4	Net O&M expenses	$301,170,282	$366,513,382	$373,384,126	($6,870,744)

Sources:
Line 1: Company Exhibits MH-1 and MH-2 corrected per Tr. at 313
Lines 2 and 3: Remand Tr. at 71-72
Line 4: Line 1 minus lines 2 and 3
Column C: Column B times five and one-half years of inflation at Flaherty's forecasted 3.63% rate
(i.e., Column B x 1.0363 x 1.0363 x 1.0363 x 1.0363 x 1.0363 x 1.0182 = Column C)

[1] The Company's 1997 regulatory commission expenses of $14,697,470 inflated for five and one-half years using Mr. Heyeck's 3.63% inflation factor (i.e., $14,697,470 x 1.0363 x 1.0363 x 1.0363 x 1.0363 x 1.0363 x 1.0182 = $17,884,763.

[2] The Company's 1997 customer assistance expenses of $15,022,566 inflated for five and one-half years using Mr. Heyeck's 3.63% inflation factor (i.e., $15,022,566 x 1.0363 x 1.0363 x 1.0363 x 1.0363 x 1.0363 x 1.0182 = $18,280,360.

The Company claims that if actual inflation is used, there must be some adjustment for customer growth. This is incorrect for several reasons. First, the Company has performed no studies which show that O&M expenses increase in direct relationship to customer growth. Second, there is no customer growth. The Company's number of customers declined from 627,940 in 1997 to 103 during the test year ended June 30, 2003. The Company has performed no studies to determine the impact on O&M expenses of a reduction in customers from 627,940 to 103. Finally, Mr. Heyeck used Mr. Flaherty's inflation estimates with no adjustment for customer growth or customer reductions. Mr. Heyeck's inflation calculation is shown below. As noted, general inflation accounts for 60.94% of his inflation factor.

	Description	1997 Operation and Maintenance Expenses	Percent of Total	Flaherty's Forecasted Inflation Factors	Weighted Inflation Factors
	(A)	(B)	(C)	(D)	(E)
1	General inflation	$195,602,470	60.94%	3.00%	1.83%
2	Payroll	48,052,661	14.97%	4.00%	0.60%
3	Outside services	77,327,390	24.09%	5.00%	1.20%
4	Total	$320,982,521	100.00%		3.63%

Source: Lines 1-4: Company Exhibit MH-3

The Company's use of Mr. Flaherty's 1997 inflation forecasts is suspect for other reasons. The Company presented no studies showing that payroll and outside services would increase 1.0% and 2.0% greater than general inflation rates.