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APPLICATION OF AEP TEXAS CENTRAL COMPANY AND CPL RETAIL ENERGY, LP TO DETERMINE TRUE-UP BALANCES PURSUANT TO PURA §39.262 AND PETITION TO DETERMINE AMOUNT OF EXCESS MITIGATION CREDITS TO BE REFUNDED AND RECOVERED	**§**	**PUBLIC UTILITY COMMISSION OF TEXAS**

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I. INTRODUCTION

The common theme throughout Staff's Initial Brief is that the Commission should rely on and affirm its rulings in the previous true-up proceedings and related dockets.[1] The time and effort expended by the Commission and the parties in the previous true-up cases has assured a solid legal and policy-based foundation upon which the Commission should rely in deciding the issues in this final true-up proceeding. There is simply no need to rehash arguments that have been previously vetted. Accordingly, Staff encourages the Commission to adhere to its stranded cost true-up precedent when deciding the issues in this true-up proceeding.

II. STRANDED COST TRUE-UP BALANCE

F. Tax Issues

1. Accumulated Deferred Investment Tax Credit (ADITC) Adjustments

ADITCs are one-time adjustments that offset a company's tax liability.[2] The federal government created ADITCs for the purpose of stimulating economic activity. As the name denotes, investment tax credits are just that—credits against a company's tax bill—that do not have to be paid back to the taxing authority. While a utility receives from the government an immediate credit of the full amount of the ADITC, for regulatory purposes ADITCs are typically amortized into the cost of service over a period of time.

In the UCOS generic issues docket, Docket No. 22344, the Commission said that ADITCs should be reflected in the stranded-cost calculation.[3] The Commission further stated in

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[1] In the CenterPoint true-up Staff recommended, and the Commission agreed, to reduce stranded costs by the *present value* of the excess accumulated deferred income tax ("EADFIT"). Staff now recommends that the Commission reduce TCC's stranded cost balance by the *book value* of EADFIT. This is not actually a change in Staff's recommendation but rather a recognition that because EADFIT has effectively earned a return for ratepayers (i.e., it has been treated as a reduction to rate base), its *present value* is equal to its *book value.*

[2] Staff Exhibit #3, Direct Testimony of Darryl Tietjen at 16.

[3] *Generic Issues Associated with Applications for Approval of Unbundled Cost of Service Rate Pursuant to PURA §39.201 and Public Utility Commission Substantive Rule §25.344,* Docket No. 22344, Order No. 14 (July 18, 2000).

TCC's unbundled cost of service docket, Docket No. 22352,[4] that "It is reasonable to include [AD]ITCs in the stranded-cost calculation." In response to this precedent, Staff recommends that the amount of stranded costs authorized by the Commission reflect a deduction for the present value of the ITCs based on the annual amount that TCC would have included in its traditional revenue requirement. This approach is consistent with traditional regulatory treatment, the orders in the UCOS cases, and the orders in the previous true-up cases.[5]

Using the remaining life of the ADITCs and TCC's pretax weighted-average cost of capital of 11.7951%,[6] the present value, after gross-up of the $102,084,432 ADITC amount included in Schedule IX of TCC's filing is $50,746,718.[7] This amount should be used as a reduction to stranded costs. TCC calculates the same amount in its response to OPC's RFI #2-5.[8]

In the CenterPoint proceeding, Staff recommended using an *after-tax* discount rate—but, only because the ADITC amounts were expressed in *after-tax* dollars.[9] Centerpoint's ADITC amounts had *not* been grossed-up before discounting to present value. It is a fundamental principal of finance that when performing time-value-of-money calculations there should be consistency between the before or after tax character of the discount rate and the before or after tax character of the cash flows to be discounted. Consistent with the Centerpoint true-up case, Staff recommends honoring that principle by applying (in this case) a pretax discount rate to ADITC amounts that have been grossed-up—*i.e.*, ADITC amounts stated on a *pre-tax, revenue-requirements* basis. Moreover, this is effectively the methodology that TCC used in its response to OPC's RFI #2-5, to quantify the present-value amount of the ITCs.[10]

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[4] *Application of Central Power and Light Company for Approval of Unbundled Cost of Service Rate Pursuant to PURA § 39.201 and Public Utility Commission Substantive Rule § 25.344*, Docket No. 22352, Order (October 5, 2001) (FOF #104 at 81).

[5] *Application of Centerpoint Energy Houston Electric, LLC, Reliant Energy Retail Services, LLC, and Texas Genco, LP to Determine Stranded Costs and Other True-Up Balances Pursuant to PURA § 39.262*, Docket No. 29526, Order on Rehearing (December 17, 2004) (see discussion at 85 and FOFs 407-441); see also, *Application of Texas-New Mexico Power Company, First Choice Power, Inc., and Texas Generating Company, L.P. to Finalize Stranded Costs Under PURA § 39.262*, Docket No. 29206, Second Order on Rehearing (July 22, 2005) (FOFs 75-79).

[6] Docket No. 22352, Motion to Request Approval of Stipulation and Agreement (January 19, 2001) (Stipulation and Agreement, Attachment 1, Exhibit A at line 19) (shows after-tax WACC of 9.37% which grosses up to a pre-tax WACC of 11.7951%).

[7] Staff Exhibit #3, Direct Testimony of Darryl Tietjen at 17.

[8] *Id.* at Exh. DT-3.

[9] *Id.* at 18.

[10] *Id.* at 17.

2. Excess Accumulated Deferred Income Tax Adjustments

Excess ADFIT ("EADFIT") is a consequence of the Tax Reform Act of 1986, which reduced the highest corporate tax rate from 46% to 34%.[11] The EADFIT amounts exist to the extent that the balances of the deferred tax amounts existing immediately before the rate reduction exceeded the balance that would have been held in the reserve if the 34% rate had always been in effect. Because companies were paying taxes at a lower rate after the Tax Reform Act, the EADFIT amounts that had already been collected to pay future taxes based upon a higher tax rate would now no longer have to be paid. Like ADITC balances, EADFIT balances do not have to be paid back to the government. Therefore, for regulatory purposes, EADFITs are typically amortized into the cost of service over a period of time, similar to the regulatory treatment of ADITCs.[12]

In CenterPoint's UCOS case, the Commission stated that, "These [excess accumulated deferred income] taxes are similar in nature to [AD]ITCs and should be treated in the same manner."[13] While Staff recommended (and the Commission adopted) a methodology in the Centerpoint true-up case that used a discounted value of EADFIT as an offset to stranded costs, Staff now concludes that the appropriate amount to use as an offset to stranded costs is the book value of EADFIT.[14] This is because the EADFIT balance—*unlike the ADITC balance*—is ordinarily used as a deduction to the amount of return-earning rate base, and such treatment effectively provides a return to ratepayers. TCC confirmed this fact in its response to Alliance for Valley Healthcare RFI #AVHIII-30.[15] Therefore, while the full economic value to ratepayers of *ADITC* is equal to the *present value* of the annual amounts that TCC would have included in its traditional revenue requirement, the full economic value to ratepayers of the *EADFIT* is equal to the *book (non-discounted) balance* of EADFIT.

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[11] *Id.* at 18, FN 11.

[12] *Id.* at 19.

[13] *Application of Reliant Energy for Approval of Unbundled Cost of Service Rate Pursuant to PURA § 39.201 and Public Utility Commission Substantive Rule § 25.344*, Docket No. 22355, Order (October 4, 2001), Section C-9, FOF #36.

[14] Staff Exhibit #3, Direct Testimony of Darryl Tietjen at 19.

[15] *Id.* at Exh. DT-4.

Accordingly, Staff recommends that the amount of stranded costs authorized by the Commission reflect a deduction for the book value of the EADFIT. As shown on Schedule IX of the filing package, TCC's book balance of EADFIT is $6,278,570, which when grossed up to a revenue requirement basis (using a gross-up factor of [1/(1-.35)], or 1.5385), is $9,659,338.[16]

4. ADFIT Balances and Benefits

Accumulated Deferred Income Tax Liabilities

Staff recommends that if the Commission allows recovery of the full amount of TCC's requested stranded cost amount, TCC's ADFIT balance should not be used as a direct reduction to the amount of stranded cost recovery. However, in the event the Commission disallows some amount of TCC's requested stranded costs, the disallowance must be grossed-up in order to offset the tax benefit that TCC will realize on account of the disallowance.

ADFIT liabilities represent amounts that are payable to the federal government.[17] These amounts arise because of differences in accounting income and taxable income that occur for a variety of reasons. The major element of ADFIT liabilities results from the use of accelerated depreciation of a company's assets for tax purposes—this creates a difference between the taxes reported on the company's books (book depreciation) and the taxes currently payable to the government (tax depreciation). In the early years of an asset's life, tax depreciation is typically higher than book depreciation, resulting in a reduction of current taxes payable and creating a future tax liability payable to the government. In the later years of an asset's life, after the asset is fully depreciated for tax purposes, the book depreciation is higher, causing the tax liability to the government to become due and the accumulated deferred tax amount to reverse.

It is incorrect to say that ADFIT is flowed back to ratepayers as the ADFIT balance decreases because of the reversal of book and tax depreciation.[18] As part of the cost of service, ratepayers typically pay income taxes on a normalized basis. That is, a company's cost of service ordinarily incorporates a constant amount of depreciation each year (*e.g.*, straight-line

[16] *Id.* at 20.
[17] *Id.* at 11.
[18] *Id.* at 12.

depreciation) until the asset is fully depreciated. Thus, while ratepayers pay a relatively constant amount of taxes related to year-to-year differences in depreciation, a portion of this tax liability is not immediately due to the government. Ultimately, however, these amounts *will* be paid—but not back to ratepayers; they will be paid to the government.

If a utility company receives full stranded-cost recovery for its generation assets, it will pay the full amount of the related ADFIT liability to the government.[19] A simple example will demonstrate the point of how a company pays its ADFIT to the government upon receipt of stranded costs. Assume a utility company has a $1000 asset that has been on its books for one year. The company has taken $100 of book depreciation (based on straight-line depreciation over a 10-year life) while taking $200 of tax depreciation. This would mean that the company had $100 less income on its tax books (because tax depreciation exceeds book depreciation) and, assuming a tax rate of 40%, it would therefore have a current tax payable that was $40 lower ($100 less income on the tax books * 40% tax rate) than the book tax expense. This $40, while not payable currently, would be payable in a future period—*i.e.*, the payment of this amount would be deferred.

Now assume that at the beginning of the second year, the company sells the asset for $800, incurring a loss of $100 based on its depreciated book value of $900. The company would claim the $100 as a stranded cost (because the purported market value was less than the book value) and, based upon Commission authorization of stranded-cost recovery from ratepayers of $100, the company would now owe taxes of $40 ($100 of stranded-cost recovery * 40% tax rate). *The company would therefore eliminate the deferred tax liability of $40 created in the first year by paying it to the government.* The company would no longer have any ADFIT related to this asset on its books, and would be made whole with respect to the asset.

Treatment of ADFIT Balances in the Event of Commission Disallowance of Stranded Costs

The discussion above assumes that a company receives full recovery of the claimed amount of stranded costs. If the Commission disallows a portion of the stranded-cost items that gave rise to the ADFIT balances included in Schedule IX of TCC's filing, an additional

[19] *Id.* at 13.

adjustment should be made to reflect the tax effects of the disallowance. That is, in order to achieve a result in which the company bears the full amount of the disallowance, an additional amount of reduction (disallowance) needs to be made to offset the positive tax consequences to TCC of the intended disallowance.

In the event that the Commission disallows some amount of the requested stranded costs, such disallowance is a loss for the company, and this loss will generate a tax benefit.[20] This tax benefit has the effect of mitigating the disallowance imposed by the Commission. Therefore, if the full pecuniary impact of the Commission's disallowance is to be realized, the amount of the disallowance must be increased to offset the effects of the tax benefit.[21]

To achieve the intended financial impact of a stranded cost disallowance the amount of the intended disallowance is multiplied by the gross-up tax rate factor.[22] The product of this multiplication is the adjusted amount of the disallowance that should be assessed against the stranded cost balance by the Commission.

For example, using the figures from the previous example in which a company had a depreciated book value of $900, an ADFIT liability of $40, and a $100 loss on the sale of the asset, assume that after requesting stranded costs of $100, the company was authorized by the Commission to recover stranded costs of only $90—*i.e.*, the Commission imposed a $10 disallowance. After receiving the $90 of stranded-cost recovery, the company would pay $36 of taxes ($90 * 40% tax rate). The company, however, had an existing ADFIT balance of $40, and hence the remaining $4, which it would now not have to pay, would represent the government's subsidization of the company's stranded cost disallowance loss. In other words, even though the Commission assessed a disallowance of $10, the after-tax cost of that disallowance was only $6. Staff's recommendation, therefore, is to adjust the disallowance to achieve a result in which the company, after taxes, bears the full $10 impact.

The adjustment to the disallowance is made by multiplying the amount of the intended disallowance by the gross-up tax rate factor. In the example from the previous question, this is accomplished by multiplying the $10 disallowance by the grossed-up tax rate factor, which, in

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[20] *Id.* at 14.

[21] This approach was adopted by the Commission in Docket No. 29526, CenterPoint's true-up (see FOF 436), and Docket No. 29206, TNMP's true-up (see FOFs 74-74A).

[22] *Id.* at 15.

the case of a 40% tax rate, is 1.667 (calculated as 1/[1-.4]). The result of multiplying $10 by 1.667 provides for a final disallowance amount of $16.67. The grossed-up disallowance of $16.67 results in an after-tax disallowance of $10. With a grossed-up disallowance of $16.67, the company receives stranded-cost recovery of $83.33 ($100 requested stranded costs less the $16.67 disallowance). The company then pays taxes of $33.33 ($83.33 * 40% tax rate) on the stranded-cost recovery, and is left with $6.67 from the existing ADFIT liability of $40. The company retains this $6.67, and when this amount is considered along with the $83.33 of stranded costs, the company ends up with $90 of stranded-cost recovery, which fully reflects the intended disallowance amount of $10.

Recommendation on ADFIT Benefits

As described above, ADFIT *balances* consist of the funds reflected on a company's books that are payable to the government for tax liabilities. Until these liabilities are paid, however, the company has the use of these funds. Essentially, ADFIT *benefits* refer to the value that can be created by putting the ADFIT *balances* to use. For example, if a company has $100 in a deferred income tax account, but because of tax laws the company is not obligated to make the payment until one year from now, the company can invest that $100 balance for one year in a savings account and earn, say, 8% on the $100, or $8. In this situation, the deferred tax-liability (ADFIT) *balance* is $100, while the related (ADFIT) *benefit* from being able to use the funds is $8.

ADFIT balances provide benefits to a regulated company because these amounts are considered to be *cost-free* capital to the company.[23] As with any form of capital, the ADFIT can be employed to fund the company's operations; thus, the use of the ADFIT provides economic value. But, because the ADFIT amount has been "contributed" to the company by the government, the company did not have to promise the government any return on those funds in order to receive them. Therefore, a value or benefit is created as a result of the company being able to use the cost-free ADFIT as a *substitute* for other capital which can only be acquired by the company by promising investors a return, on average, at the company's weighted average cost of capital ("WACC").

[23] *Id.* at 21.

In a traditional cost-of-service rate proceeding, the benefits of cost-free ADFIT are realized by subtracting the ADFIT balance from the company's return-earning rate base.[24] Ratepayers thereby receive the benefit of the cost-free capital by paying a reduced amount of return dollars in rates, with the reduction being equivalent to the company's rate of return—*i.e.*, its WACC—multiplied by its ADFIT balance.[25] In addition, because ratepayers pay a lesser amount of return dollars, they also pay a lesser amount of taxes; thus, the overall cost of service (revenue requirement) is reduced by the *combined* effect of lower return dollars *and* lower taxes. A utility company, however, still receives its regulated rate of return when the benefits of cost-free capital are flowed through to ratepayers.

Therefore, the appropriate rate of interest for calculating the benefits of cost-free ADFIT is the company's *pretax* WACC.[26] This rate represents a company's composite opportunity cost that can be avoided as a result of using the ADFIT as a substitute for traditional forms of capital. Accordingly, Staff recommends that the Commission use TCC's pretax UCOS WACC of 11.7951% to calculate ADFIT benefits.

In the CenterPoint true-up case, the Commission found that an ADFIT benefit accrued for the period from January 2004 to the estimated time of securitized bond issuance (retrospective benefit) and a benefit that would accrue for the period during the expected amortization of the securitized bonds (prospective benefit).[27] In its calculation of the total ADFIT benefits, the Commission used CenterPoint's pretax WACC authorized in the company's UCOS proceeding. The Commission used a starting date of January 2004 because, theoretically, the benefits of ADFIT for 2002 and 2003 were taken into account by the Commission's decisions regarding the capacity auction true-up balance and the impact thereon of the results of the UCOS ECOM model.[28]

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[24] *Id.*

[25] This point is directly comparable to the earlier discussion concerning how a company would be able to enjoy a benefit of $8 on a $100 deferred tax balance.

[26] Staff Exhibit #3, Direct Testimony of Darryl Tietjen at 22.

[27] *Id.* at 23.

Staff's Recommendation for TCC's *Retrospective* ADFIT benefit

Using the same methodology the Commission adopted in the CenterPoint true-up case, TCC has quantified the retrospective ADFIT benefit in its response to Cities' RFI #35-2.[29] The amount shown in the RFI response is $99,499,662. Accordingly, Staff recommends that $99,499,662 be reflected as a reduction to TCC's recoverable true-up balances.[30]

Staff's Recommendation for TCC's *Prospective* ADFIT benefit

Based on work papers supplied by TCC witness David Carpenter (Ron Ford), TCC estimates its prospective ADFIT benefit to be $488,219,896.[31] This estimate is based on TCC's unadjusted, requested amount of stranded costs and incorporates the general methodology that the Commission used in the CenterPoint true-up case.

Staff estimates the amount of prospective ADFIT benefits at $459,639,759.[32] This estimate is also based on the same assumptions used by TCC concerning the transition bond repayment schedule. However, Staff's estimate reflects its proposed adjustments to TCC's stranded cost balance.

Staff recommends that after reflecting the effects of any Commission adjustments to TCC's stranded cost request, the Commission should apply the same general methodology described in Exhibit DT-6 of the direct testimony of Staff witness Darryl Tietjen, as a reduction to the recoverable true-up balances. Staff further recommends that the Commission revisit this issue in TCC's post true-up proceeding and update the calculations for the total ADFIT benefits with more current data.

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[28] Id. at 24 (In the ECOM model, ADFIT balances were accounted for as an offset to the return-earning balance of rate base, which affected the calculated margins, and ultimately, the capacity auction true-up amount.)

[29] Staff Exhibit #3, Direct Testimony of Darryl Tietjen, Exh. DT-5.

[30] *Id.* at 24; see also, 6 Tr. 1301-1306 (Note that during cross-examination, Mr. Tietjen agreed that this number should be revised to reflect certain adjustments contained in Exhibit RWH-14R from TCC witness Hamlett's rebuttal testimony).

[31] Staff Exhibit #3, Direct Testimony of Darryl Tietjen, Exh. DT-6.

[32] *Id.* at 25; See also, 6 Tr. 1306-1309 (Note that during cross-examination, Mr. Tietjen agreed that this number should be revised to reflect a corrected balance of stranded costs).

G. Interest on Stranded Costs

1. Unrefunded Excess Earnings

In Docket No. 22352, the Commission estimated that the book value of TCC's generation assets would exceed their market value by $615 million.[33] Because TCC had already been mitigating its estimated stranded costs by applying its excess earnings to decrease its book value, the Commission required TCC to implement an excess mitigation credit to undo the effects of TCC's excess-earnings mitigation.[34] Accordingly, TCC was ordered in Docket No. 22352 to credit to ratepayers its excess-earnings mitigation amounts over a five-year time period with a 7.5% interest rate applied to the unrefunded balance.[35] The total excess mitigation credit was initially based on an estimated excess earnings amount of $54,788,702, but this figure was subsequently revised to $42,209,382 pursuant to the stipulation in Docket No. 29938.[36] The interest calculated on this amount at the midpoint of each year (1999, 2000, and 2001) for which the excess earnings were calculated, plus the interest paid through July 2005 is projected to be $14,092,574.[37]

While TCC is not making a specific request for the $14,092,574 of interest related to the EMC payments, TCC also includes in its filing a request to not take into account the effects of the EMCs in the calculation of interest on stranded costs. This request has the effect of increasing the amount of stranded-cost interest beyond that which TCC is entitled to recover.[38] Thus, while TCC is not making a direct request for the interest it paid as part of the EMCs, it is making an indirect request for these amounts. Specifically, TCC's proposal for the calculation of interest on stranded costs includes no adjustment to reflect the outstanding EMC balance as a reduction to the stranded-cost amount on which interest is calculated. This proposal ignores the

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[33] *Application of Central Power and Light Company for Approval of Unbundled Cost of Service Rate Pursuant to PURA § 39.201 and Public Utility Commission Substantive Rule § 25.344*, Docket No. 22352, Order (October 5, 2001).

[34] Staff Exhibit #3, Direct Testimony of Darryl Tietjen at 8.

[35] *Id.* at 7.

[36] *Id.* at 8.

[37] *Id.*

[38] *Id.* at 9.

approach adopted by the Commission in Centerpoint's true-up case.[39] TCC proposes to omit entirely the impact of the EMCs from the determination of interest on stranded costs—that is, TCC does not reduce the interest-earning stranded-cost balance by the beginning EMC balance and does not reflect the subsequent monthly payments of the credits. The result of TCC's treatment is that the total amount of stranded-cost interest as calculated on Exhibit RWH-7 of TCC's filing is approximately $12.6 million higher than it would be if TCC had used the same method adopted by the Commission in the CenterPoint true-up case.[40]

Staff witness Darryl Tietjen recommends that the Commission adopt for TCC the same methodology for determining stranded-cost interest that was used in the CenterPoint true-up case. In the CenterPoint case the Commission used the total amount of excess earnings mitigation as a reduction to the beginning (December 31, 2001) stranded-cost balance on which interest was calculated and then gradually decreased this reduction by adding the amount of EMCs paid every month.[41] Thus, while the stranded-cost amount on which interest was computed was initially reduced by the entire EMC balance, the amount was gradually increased to reflect the growing accumulation of paid EMCs. This resulted in a correspondingly higher amount of stranded-cost interest in successive months.[42] The effect of applying this same methodology to TCC's recoverable interest on stranded costs is a reduction of $12,550,013 to its request.

On September 23, 2005, while this true-up proceeding was pending, the Third Court of Appeals ruled on the Commission's authority to order the payment of EMCs.[43] The Court agreed with TCC that the Commission did not have the authority to "order refunds of 'over-mitigated' stranded costs determined before the 2004 true-ups."[44] The Third Court reversed the district court's judgment compelling such refunds and remanded to the Commission for further proceedings.[45]

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[39] *Id.*; *see also, Application of Centerpoint Energy Houston Electric, LLC, Reliant Energy Retail Services, LLC, and Texas Genco, LP to Determine Stranded Costs and Other True-Up Balances Pursuant to PURA § 39.262*, Docket No. 29526, Order on Rehearing (December 17, 2004).

[40] Staff Exhibit #3, Direct Testimony of Darryl Tietjen at 10.

[41] Docket No. 29526, Schedule II, Interest on Stranded Cost.

[42] Staff Exhibit #3, Direct Testimony of Darryl Tietjen at 10.

[43] *City of Corpus Christi v. Public Utility Commission of Texas*, No. 03-03-00428-CV, 2005 WL 2313113 (Tex. App.—Austin September 23, 2005, no pet. h.).

[44] *City of Corpus Christi*, No. 03-03-00428-CV, slip op. at 2.

[45] *Id.*

With respect to the impact of EMCs on the recovery of *stranded costs*, this ruling has no effect because to the extent that TCC has paid EMCs, such payments are reflected in TCC's recoverable book value of generation assets, and TCC will thus be made whole for these amounts.

However, the Third Court's ruling does impact the calculation of *interest* on stranded costs. If the EMCs should never have been paid in the first place, the paid amounts should not be used as a reduction to the stranded cost balance on which interest is earned. Moreover, just as the EMCs should not have been paid, likewise the interest amounts associated with the EMCs should not have been paid. Consequently, because the amounts of EMC interest that were paid must now be recovered, these amounts must be added to the total balance to be recovered by TCC.

Accordingly, Staff would suggest that the Commission has two possible courses of action with respect to its treatment of the EMCs and the associated effect on stranded-cost interest. First, if the Commission chooses to appeal the Third Court's decision, Staff recommends that the Commission adopt Mr. Tietjen's adjustments to the calculation of TCC's interest on stranded costs as set forth in his testimony.[46] This approach would reduce TCC's interest on stranded costs by approximately $12.5 million and would be consistent with the Commission's treatment of this issue in the CenterPoint case.

In the alternative, if the Commission does not appeal the Third Court's ruling, Staff recommends that the Commission reverse the effects of the EMC payments and the associated interest payments. To achieve this result, two adjustments would need to be made to the interest-calculation methodology that the Commission adopted in the CenterPoint case: 1) the un-refunded EMC balance would not be used as a reduction to the stranded-cost balance on which interest is calculated, and 2) the amount of EMC interest that was paid by TCC would be added back to the interest-earning stranded-cost balance in a manner reflecting the same timing as the initial payment of the interest. Following these two steps would reverse the effects on stranded costs of the EMC payments and associated interest.

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[46] Staff Exhibit #3, Direct Testimony of Darryl Tietjen at 7.

III. NON-STRANDED COST TRUE-UP

C. Relation of Capacity Auction True-up to Stranded Cost

Staff did not consider the question of whether TCC complied with the capacity auction true-up formula as contained in PUC Substantive Rule §25.263(i). Rather, Staff considered only whether the capacity auction true-up provides for a return *of* a company's investment in generation assets through recovery of depreciation amounts for 2002 and 2003.[47] In the CenterPoint true-up, the Commission determined that, because the capacity auction true-up for 2002 and 2003 provided for a return *of* depreciation—and, hence, a return of some stranded costs for those years,[48] it was appropriate to reduce the amount of recoverable stranded costs by the total amount of depreciation for 2002 and 2003. Staff recommends that the Commission make a similar adjustment in this case.[49]

TCC claims that because of specific differences in the results of Centerpoint's and TCC's UCOS ECOM model estimates, TCC's capacity auction true-up determination should be calculated differently than CenterPoint's capacity auction true-up.[50] Specifically, Mr. Hamlett makes the point that for 2002 and 2003—the two years covered by the capacity auction true-up—the ECOM model estimate in TCC's UCOS case indicated that in a deregulated environment TCC would not fully receive its regulated cost of service and therefore not fully recover its depreciation for those two years. In contrast, the ECOM model estimate in CenterPoint's UCOS case indicated that for 2002 and 2003, CenterPoint would receive *more* revenues in a deregulated environment than in a regulated environment (i.e., CenterPoint would recover at least its depreciation for those two years). This difference means that the application in this docket of the Commission's 2002-2003 depreciation disallowance used in the CenterPoint case will result in

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[47] *CenterPoint Energy, Inc. v. Public Utility Com'n of Texas*, 143 S.W.3d 81, 98 (Tex. 2004) ("However, that determination does not foreclose the commission from taking into account any ***return of*** or on stranded costs that the margin from the capacity auction true-up contains in determining the appropriate carrying costs on stranded costs.") (emphasis added).

[48] Docket No. 29526, Order on Rehearing (December 17, 2004) (FOFs 192-198; see also page 112: "Stranded-costs recovery is simply a method to recover the book value of generation assets that would have been recovered through depreciation and amortization ordinarily over the life of the asset under traditional rate regulation. In this sense, stranded-cost recovery is a substitute for depreciation.")

[49] Staff Exhibit #3, Direct Testimony of Darryl Tietjen at 26.

an adjustment to TCC's stranded-cost recovery that is less than the full amount of depreciation for 2002 and 2003.

The rationale underlying the CenterPoint methodology was that the margins recovered by CenterPoint through its capacity auction true-up provided for the complete return on and of stranded costs for 2002 and 2003, and such recovery was duplicative of the recovery of 2002-2003 depreciation embedded in the 12/31/01 book value. To avoid this double recovery, the Commission reduced CenterPoint's stranded-cost recovery by the depreciation amounts for 2002 and 2003.

Following this same approach for TCC yields a reduction that is less than the full amount of depreciation, because the margins received by TCC in its requested capacity auction true-up would not provide for full return of and on stranded costs for 2002 and 2003. The shortfall, as calculated on Mr. Hamlett's Exhibit RWH-10, is $206,362,682.[51] When this figure is compared to TCC's total 2002 and 2003 depreciation amount of $238,122,688, the difference is $31,760,006.[52] Therefore, reducing TCC's stranded costs by this $31,760,006 difference achieves the same effect as if TCC had received margins sufficient to provide for full return of and on stranded costs (as did CenterPoint), but then had the recoverable stranded-cost amount reduced by the full amount of 2002-2003 depreciation.

Accordingly, Staff recommends that TCC's stranded cost balance be reduced by $31,760,006. Reducing TCC's request by this amount is consistent with the approach used by the Commission in the CenterPoint true-up case.

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[50] TCC Exh #8, Direct Testimony of Randall W. Hamlett at 36-37.

[51] Id. at Exh. RWH-10.

[52] Staff Exhibit #3, Direct Testimony of Darryl Tietjen at 29.

D. Time Value of Capacity Auction Award

The methodology[53] used by TCC witness, Randall W. Hamlett for calculating the time value of money on the capacity auction true-up amount is consistent with Staff's recommended methodology[54] in the CenterPoint true-up case and the methodology in the Commission's final order in that case. Accordingly, Staff recommends that the Commission adopt the methodology proposed by Staff and TCC for calculating the time value of money on the capacity auction true-up amount.

E Retail Clawback

Staff has determined that the PTB true-up amount is $61,384,500.[55] The same amount was proposed by CPL Retail Energy LP, in its filing.[56] All parties waived cross-examination of the only two witnesses that addressed this issue, and the Commission did not ask any clarifying questions. Accordingly, Staff requests that the Commission adopt the retail clawback recommendation made by Staff and CPL Retail Energy LP.

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[53] TCC Exh #8, Direct Testimony of Randall W. Hamlett, Exh. RWH-8.

[54] While the Commission's order in the CenterPoint case incorporated the conceptual methodology recommended by Staff for determining the time value of money on the capacity auction true-up amount, it did not incorporate Staff's recommended interest rate. Additionally, while Staff recommended a starting date of 1/1/02 for the calculation of the time value of money on the capacity auction, Staff recommended a starting date of 1/1/04 for the calculation of interest on stranded costs. The Commission did not accept the latter recommendation, opting to use 1/1/02 as the starting date for both calculations.

[55] Staff Exh. #1, Direct Testimony of S. Balakrishnan at2.

[56] CPL Retail Energy, LP Exh. #1, Direct Testimony of J. Patrick Keene at 12.