SOAH DOCKET NO. 473-07-0833
PUC DOCKET NO. 33309

PUBLIC UTILITY COMMISSION OF TEXAS

APPLICATION OF

AEP TEXAS CENTRAL COMPANY

FOR AUTHORITY TO CHANGE RATES

REBUTTAL TESTIMONY OF

RANDALL W. HAMLETT

FOR

AEP TEXAS CENTRAL COMPANY

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TESTIMONY INDEX

<u>EXHIBITS</u>

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS AND POSITION IN THE COMPANY.

A. My name is Randall W. Hamlett and I am the Director of Regulatory Accounting Services for American Electric Power Service Corporation (AEPSC), a subsidiary of American Electric Power Company, Inc. (AEP). My business address is 212 E. 6th Street, Tulsa, Oklahoma, 74119-1295.

Q. ARE YOU THE SAME RANDALL W. HAMLETT WHO FILED DIRECT TESTIMONY IN THIS CASE?

A. Yes, I am.

II. PURPOSE OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. The purpose of my rebuttal testimony is to address certain positions taken by the witnesses for the Staff and the intervenors on the issues listed in the following table:

Issue	Party	Witness
Schedule B - (Rate Base)		
Reclassification of CWIP	Cities	Lane Kollen
Additional Pension Contributions in Rate Base	Staff	Mary Jacobs
	OPC	David Effron
	Cities	Lane Kollen
Cash Working Capital	Staff	Mary Jacobs
	Cities	Gerald Tucker
Debt Restructuring Costs	Cities	Lane Kollen
Treatment of AROs	Cities	Lane Kollen
Schedule C - (Capitalization and Cost of Capital)		
Debt Restructuring Costs	Cities	Lane Kollen
Amount of Debt in the Capital Structure	Cities	Lane Kollen
Additional Amortization of Unamortized Debt Discount	OPC	Carole Szerszen

Schedule D - (O&M and A&G Expenses)		
Labor Expenses	Staff	Mary Jacobs
	Cities	Constance Cannady
Group life Insurance	Cities	Constance Cannady
Savings Plan	Cities	Constance Cannady
Bad Debt Expense	Staff	Mary Jacobs
	Cities	Lane Kollen
Adjustments to Transmission and Distribution O&M	OPC	David Effron
Treatment of AROs	Cities	Lane Kollen
Schedule E - (Depreciation, Amortization and Taxes)		
Property Taxes	Staff	Mary Jacobs
Treatment of AROs	Cities	Lane Kollen
Gain on the Sale of Office Buildings	Cities	Lane Kollen
TCOS Effect on Distribution O&M Costs	Cities	Lane Kollen
Adjustment to Payroll Taxes	Cities	Constance Cannady
Late Payment Penalty Miscellaneous Revenues	Cities	Gerald Tucker

Q. WHAT ARE YOUR CONCLUSIONS REGARDING THE VARIOUS POSITIONS TAKEN BY STAFF AND INTERVENOR WITNESSES?

A. In the case of property taxes and bad debts, AEP Texas Central Company (TCC or Company) believes that there is merit to the Public Utility Commission of Texas (PUC, PUCT or Commission) Staff and Intervenor positions and has agreed to adjust its requested cost of service as I explain in more detail later in my testimony. As to the other issues listed in the above table, I demonstrate that the witnesses' proposed adjustments should be rejected.

Q. PLEASE PROVIDE A SUMMARY OF THE IMPACT OF THE VARIOUS PARTIES' RECOMMENDATIONS IN THIS PROCEEDING.

A. A summary of the various parties' recommendations is provided as EXHIBIT RWH-1R. This summary starts with the Company's requested base rate increase and details the impact of each of the parties' recommendations as well as the Company rebuttal adjustments and lists the Company rebuttal witness(es) addressing that issue.

The bottom of the exhibit summarizes the recommended base rate change should the adjustments be adopted.

III. REBUTTAL ON SCHEDULE B (RATE BASE)

A. Reclassification of CWIP

Q. PLEASE SUMMARIZE MR. KOLLEN'S RECOMMENDATION AT PAGE 12, LINE 12, THROUGH PAGE 25, LINE 8, OF HIS DIRECT TESTIMONY OPPOSING THE COMPANY'S REQUEST TO RECLASSIFY TO PLANT IN SERVICE CERTAIN PLANT WHICH WAS CLASSIFIED TO CONSTRUCTION WORK IN PROGRESS (CWIP) AS OF JUNE 30, 2006.

A. In its application, the Company included in rate base the investment in certain transmission projects which, as of the end of the test year, had still been classified to CWIP under TCC's accounting system, but which the Company determined, when it prepared its filing, had actually commenced providing service prior to the end of the test year. In making this adjustment, the Company was following its prior practice which had been adopted by the Commission. Mr. Kollen, however, recommends that the investment in these projects should not be permitted to be included in rate base. He bases his recommendation on the grounds that: (1) the Commission ought to be able to rely on the Company's accounting records, (2) certain associated adjustments have not been recognized by the Company, and (3) the cumulative effect of the failure of the accounting records to accurately recognize when a given project is in service are larger than and offset the Company's proposed rate base adjustment.

Q. DO YOU AGREE WITH MR. KOLLEN'S RECOMMENDATION OR THE GROUNDS HE PROVIDES FOR IT?

A. No. Mr. Kollen's recommendation that the Commission reject the Company's reclassification adjustment of $6.9 million from CWIP to plant in service (including attendant impacts) lacks merit and should be rejected. As both I and Mr. Pasternack testified in our direct testimony, the transmission assets reclassified from CWIP to plant in service in fact were providing utility services to customers as of June 30, 2006, and continue to provide utility services to customers. The only distinction between these assets and the Company's remaining assets classified as plant-in-service as of June 30, 2006, is that the final clearance through the property accounting system had not yet been made as of June 30, 2006, to allow the reclassification to be reflected electronically in the accounting system.

Q. ARE THERE VALID REASONS WHY A CONSTRUCTION PROJECT MIGHT NOT YET BE CLASSIFIED AS PLANT IN SERVICE IN THE ACCOUNTING RECORDS DESPITE THE FACT THAT IT IS PROVIDING UTILITY SERVICE TO CUSTOMERS?

A. There are several factors that might account for this. Even though a project may be operating and providing service, a project manager may look at factors other than the "used and useful" aspect of a project to determine whether it is appropriate to close the work order out and declare the project complete. There may be significant costs yet to be charged to the project, anticipated modifications, site clean-up, contract reviews, etc. that are considered before management deems a project complete. This type of situation can delay the accounting clearance that allows the electronic reclassification of CWIP to plant-in-service but they do not at all detract from the fact that they are providing utility service to customers.

Q. HOW MANY CWIP PROJECTS DID TCC RECLASSIFY TO PLANT-IN-SERVICE IN THIS FILING?

A. TCC included eight projects totaling $7.3 million in its filing. This number of projects is small compared to the number of projects completed annually. For example, during the test year, TCC transferred 442 transmission projects totaling $90,636,535 in investment from CWIP to plant in service.

Q. HAS THE COMPANY MADE ADJUSTMENTS TO ACCOUNT FOR THE ATTENDANT IMPACTS OF THE CWIP RECLASSIFICATIONS?

A. Yes, the Company has reduced Allowance for Funds Used During Construction (AFUDC), the carrying cost accrued before plant is placed in service, and increased accumulated depreciation to account for the CWIP reclassification.

Q. WHAT IS THE CURRENT STATUS OF THESE PROJECTS?

A. All of these projects are now classified as plant-in-service in the property accounting system.

Q. IS RECLASSIFICATION OF EXISTING ACCOUNTING BALANCES IN CONNECTION WITH THE RATEMAKING PROCESS UNUSUAL?

A. No. For example, TCC adjusted plant-in-service balances for utility plant the Commission deemed not useful. This $180,000 adjustment to existing plant account balances reduced rate base as ordered in Docket No. 28840. Also, TCC has made additional reclassifications to reduce plant-in-service balances for assets projected to be transferred to the Lower Colorado River Authority that reduces rate base by $629,678. It is not only routine to make such adjustments to accounting balances, it is necessary to do so to properly determine a revenue requirement. Mr. Kollen's argument that the Company's books need correcting is baseless.

Q. DO YOU AGREE WITH MR. KOLLEN'S ASSERTION AT PAGE 13, LINES 7-14, THAT THE RECLASSIFICATION INDICATES A LACK OF ACCURACY IN THE COMPANY'S ACCOUNTING RECORDS?

A. No. The reclassification does not indicate a lack of accuracy in the Company's accounting records. There may be a lag between the reporting of the "in-service" status in the Company's property accounting system and the subsequent transfer from Asset Account 107, CWIP to Asset Account 101, Plant in Service. While this lag is not material for financial reporting purposes (i.e. both accounts 101 and 107 are classified as assets), it is a matter that should be remedied for a cost of service calculation in a rate proceeding, in order to ensure that the rates reflect the appropriate level of costs related to plant that is both used and useful in providing utility services, as mandated by Public Utility Regulatory Act (PURA) § 36.053.

Q. IS MR. KOLLEN CORRECT TO STATE AT PAGE 14, LINE 13, THROUGH PAGE 15, OF HIS DIRECT TESTIMONY THAT THE COMPANY'S PROPOSAL TO RECLASSIFY THESE TRANSMISSION PROJECTS NECESSITATES AN ASSOCIATED ADJUSTMENT TO REDUCE RATE BASE BY CERTAIN CONSTRUCTION ACCOUNTS PAYABLE?

A. No, he is not. Mr. Jay Joyce addresses the inappropriateness of Mr. Kollen's recommendation in his Rebuttal Testimony.

Q. IN DOCKET NO. 28840, DID THE COMMISSION ALLOW RECLASSIFICATION OF CWIP TO PLANT-IN-SERVICE FOR PROJECTS THAT WERE IN SERVICE?

A. Yes, the Commission allowed this reclassification. Finding of Fact No. 37 states, "TCC's proposal to reclassify $24.7 million (distribution) and $18.2 million (transmission) in plant-related investment from construction work in progress to plant in service is uncontested and is reasonable." This Finding of Fact addressed an identical type of adjustment to the one that Mr. Kollen opposes in this case.

<u>B. Additional Pension Contributions in Rate Base</u>

Q. DO ANY WITNESSES FOR OTHER PARTIES ADDRESS THE COMPANY'S INCLUSION IN RATE BASE OF THE ADDITIONAL PENSION CONTRIBUTIONS WHICH GIVE RISE TO AN ASSET RECORDED ON ITS BOOKS AND RECORDS?

A. Yes. Ms. Jacobs, Mr. Effron, and Mr. Kollen all recommend that a portion of the Company's asset (also referred to as the "pension prepayment asset") of $112 million be removed from rate base. The asset is composed of additional pension contributions made by the Company. Ms. Jacobs argues that $62,761,400 of the pension prepayment asset, representing contributions prior to 2004, should be excluded from rate base, because absent authority from the Commission to recognize a deferral asset, it would not be appropriate to recognize an asset on the Company's books. She also claims that most, if not all, of the pre-2004 amount was provided by ratepayers, not shareholders.

Mr. Effron claims that a portion of the pension prepayment asset recorded on the Company's books was not an actual cash outlay of the Company and no funds were required from investors for that portion. Based on this allegation, he recommends that $65,672,000 of the pension prepayment asset, representing both the pre-2004 portion and the additional contribution for 2005, be excluded from rate base.

Mr. Kollen recommends that a portion of the pension prepayment asset equivalent to the amount of pension expense which was recorded to CWIP, or construction activities, in the test year, be excluded from rate base. He also recommends that the portion of the pension prepayment asset that represents amounts that previously were associated with generation operations be excluded from rate base. Based on these claims, he recommends that $17,829,000 of the pension prepayment asset be excluded from rate base

Q. DO YOU AGREE WITH THE RECOMMENDATIONS OF MS. JACOBS, MR. EFFRON, AND MR. KOLLEN WITH RESPECT TO THE PENSION PREPAYMENT ASSET?

A. No. As Mr. Hugh McCoy and I discuss in our rebuttal testimonies, the recommendations of the witnesses for the other parties would deny the Company a return on a portion of its asset that has been dedicated to the rendition of safe and reliable transmission and distribution service to its customers. In summary:

- the entire pension prepayment is used and useful and should earn a return;
- the pension prepayment is properly recorded as an asset utilizing generally accepted accounting principles (GAAP) under Statement of Financial Account Standards (SFAS) No. 87;
- PURA 36.065 requires the use of SFAS No. 87 for determining the amount of pension costs to be included in rates;
- the additional pension contributions included in the pension prepayment have generated tax-free earnings that result in lower pension costs to the benefit of ratepayers;
- it is improper to include the lower pension costs in cost of service and not include the pension prepayment that makes the lower costs possible in rate base; and
- if a portion of the prepaid pension is allocated to CWIP, that portion should earn AFUDC just like CWIP.

I will develop these points in detail in the following discussion.

Q. PLEASE SUMMARIZE MS. JACOBS' RECOMMENDATION REGARDING THE TREATMENT OF THE PENSION PREPAYMENT ASSET.

A. Ms. Jacobs argues that since the pension prepayment asset accrues as a result of past differences between pension funding and pension costs under (SFAS) No. 87, the Company's inclusion of the pension prepayment that accrued prior to 2004 represents an attempt to apply SFAS 87 "retroactively." She also contends that since the Commission previously used the funding method to establish pension expense in setting rates, most if not all of the pension prepayment for the pre-2004 period was provided by ratepayers.

Q. DO YOU AGREE WITH MS. JACOBS?

A. No. Mr. Hugh McCoy will address in his rebuttal testimony the errors in Ms. Jacob's description of the accounting implications of the accrual of the pension prepayment asset prior to 2004.

Q. DO YOU AGREE WITH MS. JACOBS THAT A UTILITY IN TEXAS NEEDS TO OBTAIN A DEFERRAL ORDER FROM THE COMMISSION IN ORDER TO BOOK AN ASSET?

A. No. Capital assets are created and booked under GAAP. This has been true since the inception of regulation in Texas. The only circumstances where a deferral order is necessary is where a utility wants to recover in a future period an item that normally would be expensed currently under GAAP. In that case, the deferral order is necessary to avoid the current expensing of the item and to have the ability instead to book it as an asset. This is not the case with the pension prepayment since SFAS No. 87 mandates the establishment of this asset. The circumstances that could give rise to the need for a deferral order clearly do not apply to the pension prepayment asset. I note further that neither Ms. Jacobs nor any other intervenor witness contends that the pension prepayment is not properly accounted for on the Company's books as an asset.

Q. PLEASE ELABORATE ON YOUR POSITION THAT THE PENSION PREPAYMENT IS PROPERLY RECOGNIZED AS AN ASSET.

A. An asset is created for an item that will have future benefits such as plant in service which provides service for many years. On the other hand, an expense is recognized when it is incurred such as the cost of providing accounting services. The pension prepayment is a balance sheet item, which produces substantial future benefits. As Mr. McCoy indicated in his direct testimony at Exhibit HEM-6, the pension prepayment reduced pension expense in the test year by $11.25 million and will continue to reduce pension expense in the future. This attribute of providing future benefit is precisely the characteristic which causes the pension prepayment asset to have the same characteristics as other assets, such as plant in service, which the Company routinely books as an asset under GAAP without a Commission deferral order.

Q. WHY IS THE STATUS OF THE PENSION PREPAYMENTS AS AN ASSET UNDER GAAP IMPORTANT FROM A RATEMAKING PERSPECTIVE?

A. The pension prepayment asset is indistinguishable from plant in service assets that provide future benefits and are capitalized pursuant to GAAP and included in rate base. The Company does not need a Commission deferral order to book plant in service for future recovery, and the pension prepayment asset is no different. It should be noted that Ms. Jacobs explicitly recognizes in her testimony on page 12 the substantial future benefits that the pension prepayment asset provides in reducing pension expense.

As Mr. McCoy and I discuss at some length in our direct testimony, GAAP as established by SFAS No. 87 mandates the booking of this asset. Thus, the normal accounting for the pension prepayment asset under GAAP requires that it be booked, and the Company has no choice but to book it. Contrary to Ms. Jacob's contention, there is no accounting requirement for this asset that would necessitate a deferral order prior to being able to book it. Such booking is the required outcome of GAAP and reflects the fact, implicit in the GAAP treatment, that the pension prepayment asset is a long-lived asset that produces long-term benefits.

Further, as I indicated in my direct testimony at page 29, Commission Substantive Rule (P.U.C. SUBST. R. 25.231(c)(2)(B)(ii)) provides for the inclusion of prepayments in rate base as part of the cash working capital calculation. Thus, the Commission's rules recognize that prepayments in general provide future benefit and qualify for inclusion in rate base. There are absolutely no grounds that Ms. Jacobs has offered to support the conclusion that a special deferral order from the Commission is needed to book the particular asset comprising the pension prepayment asset. Although Ms. Jacobs' claim that TCC needed a deferral order to book the asset is clearly erroneous, her position in this case nevertheless recognizes that the pension prepayment has the attributes of an asset because it provides future benefits.

Q. DO YOU AGREE WITH MS. JACOBS' STATEMENT AT PAGE 11, LINES 8-10, OF HER DIRECT TESTIMONY THAT ABSENT A DEFERRAL ORDER IT WOULD BE UNREASONABLE TO INCLUDE THESE PRE-2004 "COSTS" IN RATES?

A. No. The pension prepayment asset is not a "cost." It is an asset that provides substantial future benefits to customers, a fact that Ms. Jacobs herself explicitly recognizes. Because the customers receive benefits from the pre-2004 portion of the pension prepayment asset, there is nothing unreasonable about including it in rate base, just as pre-2004 plant in service is included in rate base even though the rate case to include it might not take place until 2006. It would be unreasonable to exclude the pre-2004 portion of the pension prepayment asset from rate base, as Ms. Jacobs proposes, while at the same time providing the customers the benefits of the lower pension costs resulting from the earnings generated from that portion of the pension prepayment asset. Since the customers benefit, it is entirely reasonable for the Company to seek and receive a return on this asset.

Q. DO YOU AGREE WITH MS. JACOBS THAT THE COMPANY'S REQUEST TO INCLUDE THE PENSION PREPAYMENT ASSET IN RATE BASE IS AN ATTEMPT TO APPLY SFAS NO. 87 "RETROACTIVELY"?

A. No. Since 1987, the Company has been subject to SFAS No. 87 and has been required to maintain its financial accounting and reporting in compliance with SFAS No. 87. While the Commission for ratemaking purposes may have chosen to establish the level of pension expense upon which rates are based using the funding level and not use the SFAS No. 87 level of expense, that choice has had absolutely no bearing on whether the Company was required to adhere to SFAS No. 87 for its books and records. Nor do the Commission's decisions for ratemaking purposes have any bearing on the actual funding made by the Company. Accordingly, there is no retroactivity involved in the application to the Company of SFAS No. 87.

What has happened is that by passing Senate Bill (SB) 1447 in 2005 (codified as PURA §36.065), the Legislature mandated that pension expense for ratemaking purposes must be determined in accordance with GAAP accounting under SFAS No. 87. The consequence of SB 1447's mandate is that pension expense included in rates must be established in accordance with SFAS No. 87. That expense and, therefore, customers' rates, are lower due to the reductions to *current* pension expense attributable to the earnings produced by the pension prepayment asset. In other words, the pension prepayment asset is now directly relevant to Texas ratemaking as a result of this legislative mandate. Thus, the appropriate treatment of the entirety of the pension prepayment asset, consisting of both the pre-2004 and the 2004 and 2005 portions, is a *current* issue for ratemaking, relating to *current and future* benefits to customers. This is exactly the same as including in rate base the current level of plant in service which represents prior investment in plant.

Under SFAS No. 87, the customers receive the benefits of the pension prepayment irrespective of whether or not that pension prepayment asset arose in 2004, or 2005, or 2006, or in prior periods. All of the Company's pension funds generate tax-free earnings from the totality of the pension fund assets, and the earnings are not distinguished between those tax-free earnings that are derived from pre-2004 funds or post-2004 funds.

Q. DO YOU AGREE WITH MS. JACOBS' AND MR. EFFRON'S POSITION THAT TO THE EXTENT THE COMMISSION PREVIOUSLY SET PENSION EXPENSE BASED ON FUNDING, THE PREPAYMENT WAS PROVIDED BY RATEPAYERS AND NOT INVESTORS?

A. No. I disagree because the fundamental underlying premise of ratemaking is that customers pay for *service* and not for the discrete components making up the costs of the utility. The only exception is where the Commission sets up a special mechanism for the treatment of a specific item and requires a true-up or reconciliation of the utility's revenues collected for the item with the costs actually incurred—examples of such special mechanisms include the traditional treatment of fuel for an integrated utility or a rider such as the House Bill 11 tax rider, both of which are periodically trued-up.

While the Commission in a rate case may base a utility's rates on a specific analysis of the utility's underlying costs, the objective of the exercise is to arrive at a just and reasonable rate for *service*. This does not create a vested interest for the ratepayers in the actual outcome of the utility's incurrence of individual expense items. For example, if the Commission includes $10 million of labor expense in a utility's rates and the utility only incurs $9 million, no one would argue that the ratepayers are entitled to the $1 million difference. Similarly if the utility invests the after-tax earnings derived from that $1 million in new plant, no one would argue that the investment represents ratepayer-supplied funding, as opposed to investor-supplied funding.

Yet this is precisely what Ms. Jacobs and Mr. Effron are arguing with respect to the pre-2004 portion of the pension prepayment asset. Their position is that because the Commission in the past set pension expense in developing the Company's rates at the funding level, any difference between that pension funding level and the amount of annual pension expense recorded under SFAS No. 87 was supplied by the ratepayers. As, I have explained, their position is contrary to the underlying premise of rate setting.

It is true the Commission may have included in cost of service a component for pension expense based on funding, but the objective of that exercise was not to make the ratepayers guarantors of pension funding. The Commission's objective was simply to arrive at just and reasonable rates for service. And once the customers paid the rates for service rendered, the Commission did not intend the customers to have any rights or obligations with respect to the outcome of the pension funding/expense equation, just as it did not as to any other base rate item, such as labor expense.

The situation prevailing in the mid-to-late 1990's, as Mr. Effron points out at page 6 of his testimony, was that pension funding exceeded pension expense principally as a result of fund earnings exceeding expectations, which resulted in negative expense and the build-up of the pension prepayment asset. He then concludes that the Company did not withdraw cash from its pension funds in association with the negative pension expense. The importance of this fact is that because the Company did not, and could not, withdraw cash from the pension fund, the funds, related to the negative pension expense, continue to earn tax-free earnings that reduce future pension cost. As with Ms. Jacobs, Mr. Effron wants the benefits of the lower current pension cost, that resulted because the cash was not withdrawn, but does not want to pay the cost related to that benefit. If the pre-2004 pension prepayment is removed from rate base, then the pension expense benefit related to the fact that the cash was not withdrawn from the trust must be removed from cost of service.

In sum, once the customers pay for service under conventional ratemaking principles, their rights and obligations end as to the individual components of the Company's costs. Either good fund performance or direct cash contributions in excess of pension expense produces the pension prepayment asset. In either case, the resulting asset does not represent customer-supplied funds, and the related assets, which are investor-supplied, generate earnings that reduce current and future pension costs.

Q. DO YOU AGREE WITH MS. JACOBS' STATEMENT AT PAGE 11, LINES 21-25 THAT PURA § 36.065 DOES NOT ADDRESS "THE TREATMENT OF THE DIFFERENCE BETWEEN THE AMOUNT INCLUDED IN RATES AND THE ADDITIONAL AMOUNT PAID BY THE COMPANY TO FUND THE PENSION PLAN"?

A. No. I agree with Ms. Jacobs that, as I discussed at page 33 of my Direct Testimony, that the deferral mechanism described in PURA § 36.065(b)-(d) does not apply to the differential between pension expense and pension funding that has resulted in the pension prepayment asset. However, I disagree with any implication that this means that PURA § 36.065 does not address the treatment of the pension prepayment asset. PURA § 36.065(a), as I discuss in my direct testimony, mandates the use of GAAP pursuant to SFAS No. 87 to develop pension expense for ratemaking purposes. The pension prepayment asset and the reduction in pension costs resulting from the tax-free earnings from the pension prepayment asset are integral aspects of the calculation of pension expense pursuant to SFAS No. 87. Thus, the pension prepayment is integral to application of the mandate of PURA § 36.065(a) that GAAP accounting under SFAS No. 87 must be used to establish pension expense in this case.

Q DOES MR. EFFRON'S RECOMMENDED ADJUSTMENT DIFFER FROM MS. JACOBS' ADJUSTMENT?

A. Yes, Mr. Effron also excludes the 2005 additional contribution made by the Company.

Q. DOES MR. EFFRON EXPLAIN THE RATIONALE BEHIND HIS EXCLUSION FROM RATE BASE OF THE COMPANY'S 2005 ADDITIONAL CONTRIBUTION?

A. Aside from a mere assertion that the Company has not established that any portion of the pension prepayment asset other than the 2004 amount represents investor-supplied funds, Mr. Effron provides no rationale for his exclusion of the 2005 portion. However, as Mr. McCoy described in his direct testimony, the 2005 contribution was an additional contribution made for similar reasons to the 2004 additional contribution which Mr. Effron does not oppose. Accordingly, I am at a complete loss to understand why Mr. Effron chooses to distinguish the 2005 contribution from the 2004 one. It should be noted that, despite sharing Mr. Effron's objection to the pre-2004 portion of the pension prepayment asset, Ms. Jacobs recognized the 2004 and 2005 contributions to share similar characteristics, which led her to include both in rate base.

Q. DOES ANY OTHER WITNESS ADDRESS THE PENSION PREPAYMENT?

A. Yes, Mr. Kollen also addresses the pension prepayment and has two recommendations. Mr. Kollen recommends that a portion of the pension prepayment asset be assigned to CWIP and that this portion be removed from rate base. Mr. Kollen also recommends that a portion formerly assigned to TCC's generation operations be removed from rate base. I will address Mr. Kollen's CWIP position along with Mr. McCoy. Mr. McCoy will address Mr. Kollen's recommendation regarding the generation component.

Q. PLEASE SUMMARIZE MR. KOLLEN'S RECOMMENDATION THAT THE AMOUNT OF THE PENSION PREPAYMENT IN RATE BASE SHOULD BE REDUCED BY AN AMOUNT ATTRIBUTABLE TO THE PENSION EXPENSE WHICH WAS RECORDED TO CAPITAL IN THE TEST YEAR.

A. A portion of pension expense in the test year is apportioned to the labor costs devoted to capital projects, or CWIP, and a portion is apportioned to labor costs included in operating and maintenance (O&M) and administrative and general (A&G) accounts. Based on this treatment of the test year pension expense, Mr. Kollen recommends that the amount of the pension prepayment asset included in rate base should be reduced by an amount equivalent to the proportion of pension expense in the test year allocated to CWIP.

Q. WHAT EXPLANATION DOES MR. KOLLEN PROVIDE FOR THIS RECOMMENDATION?

A Mr. Kollen states that under the Company's proposed treatment of this portion of the pension prepayment asset, the customers will pay a current return on the portion of the pension prepayment asset that represents CWIP, or construction work in progress. He argues that the Company's treatment in effect is an indirect method of including CWIP in rate base and obtaining a current return on CWIP costs.

Q. IS MR. KOLLEN CORRECT?

A. No. In general terms, the argument for excluding CWIP from rate base is that the projects are not yet used and useful in providing utility service because they are under construction and they are not currently providing service to customers. Regarding the pension prepayment, there is no debate that the assets are included in the pension fund and those assets are generating tax-free earnings that reduce pension costs. Thus, these assets are used and useful because they are currently reducing pension costs. Because the status of this asset is fundamentally different than the status of CWIP, it is appropriate to include the entire pension prepayment in rate base. In addition, I am not aware of any provisions in PURA or the P.U.C. Substantive Rules that would require or even hint that a prepayment should be split between capital and O&M, and the capital portion be denied a return. Mr. Kollen's recommendation should be rejected.

Q. DO YOU HAVE ANY OTHER CONCERNS REGARDING MR. KOLLEN'S RECOMMENDATION?

A. Yes, I do. Mr. Kollen's position and arguments fail to address the fact that, under ratemaking principles as implemented by both the Federal Energy Regulatory

Commission (FERC) and this Commission, the Company's investors are entitled to a return on CWIP. Normally CWIP earns a return through a mechanism known as AFUDC, which I mentioned in Section III.A. above. AFUDC recognizes the return on funds devoted to construction by accruing a return component on those funds until a given asset is completed and placed in service. At that point, customers pay a cash return on the plant in service. The important thing is that at all times, the investment or asset earns a return, which is contrary to Mr. Kollen's recommendation regarding the portion of the pension prepayment asset he would attribute to construction. Under Mr. Kollen's recommendation, that portion of the pension prepayment asset will not earn a return at all during the construction period.

Q IF THE COMMISSION WERE TO CONSIDER ADOPTING MR. KOLLEN'S RECOMMENDATION, WOULD IT NEED TO BE MODIFIED?

A. Yes. While I strongly oppose adoption of Mr. Kollen's recommendation, if the Commission were inclined to consider it, the Commission should modify it by authorizing the Company to accrue a return equivalent to an AFUDC return on the portion of the pension prepayment asset allocated to CWIP. This will allow the Company to earn a return on the portion of its pension prepayment asset allocated to CWIP in a manner similar to the AFUDC return it earns on its CWIP balance. This return equivalent to AFUDC on the portion of the pension prepayment asset would be capitalized to CWIP just as AFUDC is capitalized to CWIP.

C. Cash Working Capital

Q. HAS ANY WITNESS MADE AN ADJUSTMENT TO THE LEAD/LAG STUDY REGARDING THE PAYMENTS OF THE AEPSC BILL?

A. Yes, Ms. Mary Jacobs and Mr. Gerald Tucker made adjustments. Ms. Jacobs and Mr. Tucker increased the lead days from the actual number of lead days experienced during the test year to the number of lead days that would exist under the assumption that the company paid for the services provided by AEPSC on the 30th day after receipt of the bill. The effect of this adjustment is to reduce the company's cash working capital request. Mr. Tucker also makes an adjustment related to the lead period associated with payments to third parties. In his rebuttal testimony, Mr. Jay Joyce addresses Ms. Jacobs' and Mr. Tucker's calculations and agrees with their recommendation that the 30th day after receipt of the bill be used. However, Mr. Joyce notes that both witnesses failed to take into account the additional costs TCC will be billed by AEPSC if it pays later. I will address that issue.

Q. MR. TUCKER CLAIMS THAT THERE WOULD BE NO HIGHER COSTS TO THE COMPANY IF PAYMENT WERE MADE TO AEPSC 30 DAYS AFTER RECEIPT OF THE BILL, RATHER THAN THE EARLIER ACTUAL PAYMENT DATE. IS THIS CORRECT?

A. No, it is not. AEPSC incurs financing costs over the period it must await payment of its bill. These financing costs are included in the amount AEPSC bills the company. As noted by Mr. Tucker in his testimony, the Company explained that the payment of funds to AEPSC reduces the costs of financing for AEPSC. Thus, if there is a delay in AEPSC's receipt of payment for its services, it will incur additional financing costs. For example, AEPSC incurs payroll expense for which it pays its employee salaries every two weeks. AEPSC will continue to pay its employees every two weeks and if, as recommended by Mr. Tucker, it receives payment for its services from TCC later, it will be required to borrow the money for a longer time period, thus incurring additional financing costs. These additional financing costs will be billed to TCC. Mr. Tucker and Ms. Jacobs did not include these additional finance charges in their recommendations.

Q. HOW MUCH ADDITIONAL FINANCING COSTS WOULD TCC HAVE BEEN REQUIRED TO PAY, IF IT PAID FOR THE AEPSC SERVICES ON THE 3OTH DAY AFTER RECEIPT OF THE AEPSC BILL?

A. TCC would have been required to pay additional financing costs to AEPSC of $110,000 related to transmission and $251,000 related to distribution as detailed on EXHIBIT RWH-2R.

Q. DID MS. JACOBS OR MR. TUCKER INCLUDE IN THEIR ADJUSTMENTS ANY ADDITIONAL FINANCING COSTS THAT TCC WOULD BE REQUIRED TO PAY AEPSC, IF IT PAID THE AEPSC SERVICE COMPANY BILL ON THE 30TH DAY INSTEAD OF EARLIER AS IT DID IN THE TEST YEAR?

A. As stated earlier, they did not. If the Commission adopts Ms. Jacobs' or Mr. Tucker's recommendation regarding the lead/lag study as it relates to the AEPSC bill, then the $361,000 of additional financing costs that result from paying the AEPSC bill later must be included in the Company's cost of service.

<u>D. Debt Restructuring Costs</u>

Q. PLEASE SUMMARIZE MR. KOLLEN'S RECOMMENDATION THAT THE DEBT RESTRUCTURING COSTS INCURRED IN CONNECTION WITH UNBUNDLING SHOULD BE INCLUDED IN THE COST OF DEBT INSTEAD OF FOLLOWING THE METHODOLOGY PRESCRIBED BY THE COMMISSION'S FINAL ORDER IN DOCKET NO. 22352 AND DOCKET NO. 28840?

A. Based on the Commission's decisions in Docket Nos. 22352 and 28840, the Company includes in rate base, as a regulatory asset in FERC Account 182.3, certain costs incurred in restructuring its debt to permit it to unbundle in accordance with the Texas electric utility restructuring act, known as Senate Bill 7. Mr. Kollen recommends that the $10.2 million regulatory asset that the Company included in rate base in accordance with the prior Commission decisions be removed from rate base and that the amortization expense of $915,000 included in cost of service for amortization of this asset be removed. In lieu of this treatment, Mr. Kollen proposes that these costs be handled in the cost of debt calculation.

Q. DO YOU AGREE WITH MR. KOLLEN'S RECOMMENDATION?

A. No. There is simply no justification to deviate from what the Commission has previously decided. The treatment of these costs should continue to utilize the methodology ordered in Docket No. 22352 and in Docket No. 28840. Finding of Fact No. 98 in Docket No. 22352 states,

> It is reasonable that the debt refinancing costs incurred to restructure CPL should be deferred and amortized over a 15-year period beginning January 1, 2002, with the unamortized balance included in rate base.

Finding of Fact No. 162 in Docket No. 28840 states,

> The debt reacquisition costs should be included in rate base and amortized over fifteen years, as required by Docket No. 22352, CPL's UCOS case.

Obviously, precedent exists regarding how these debt reacquisition costs are to be recovered, and Mr. Kollen's recommendation is inconsistent with the methodology twice ordered by the Commission.

Q. WHAT ARE MR. KOLLEN'S CONTENTIONS REGARDING THE ORDERS IN DOCKET NO. 22352 AND DOCKET NO. 28840?

A. Mr. Kollen claims that the Commission's order in Docket No. 22352 did not address the issue of whether the unamortized balance should be included in rate base in all future ratemaking proceedings. With respect to the Docket No. 28840 order, he claims the Commission did not affirmatively address the issue of whether the unamortized balance should be included in rate base or in the cost of debt because the issue was not contested by any party.

Q. DO YOU AGREE WITH THESE CONTENTIONS?

A. No. The Commission in Docket No. 28840, (TCC's last rate case), included the debt reacquisition costs in rate base, just as it did in Docket No. 22352. There is nothing in the order in Docket No. 22352 to suggest that the finding of fact on rate base treatment is applicable only for that proceeding and is not applicable to future proceedings, as Mr. Kollen concludes. As a matter of fact, the Docket No. 22352 order provides for the amortization of the costs over 15 years, which indicates that this accounting treatment should be utilized for future proceedings. As noted earlier, in Docket No. 28840, the Commission continued to follow the accounting and cost recovery mechanism it ordered in Docket No. 22352. Mr. Kollen has offered no reason why the Commission should reverse itself now.

While Mr. Kollen may be correct that the inclusion of the unamortized balance in the cost of debt versus rate base was not a contested issue in Docket No. 28840, the recovery of these costs were litigated in that case and the opportunity existed in that case for the parties opposed to it to litigate it there. In sum, the Commission's practice in two proceedings has been to include the unamortized balance in rate base, and such practice should be continued until the unamortized balance is zero.

Q. IS THERE AN ADDITIONAL FLAW IN MR. KOLLEN'S PROPOSED REVISED TREATMENT OF THE DEBT RESTRUCTURING COSTS?

A. Yes, although the Commission need not reach this issue so long as it continues to follow the methodology ordered in previous cases. In attempting to implement his recommendation, Mr. Kollen failed to follow through the complete proper course of the accounting, in particular when he removed the debt reacquisition costs from cost of debt, but left the capital structure at 60% debt and 40% equity.

When determining the outstanding debt balance, the unamortized reacquisition costs are subtracted from the outstanding debt balance to determine the amount of debt in the capital structure as detailed in the rate filing package attachment included as EXHIBIT RWH-3R. For example, assume a company has $60 of outstanding debt and $40 of outstanding equity, which equates to a capital structure of 60% debt and

40% equity. Now assume that one wants to adjust this capital structure for $5 of unamortized reacquisition costs. Thus, the debt component becomes $55 ($60 - $5) while equity remains at $40. Under this scenario, which is what Mr. Kollen proposes, debt represents 57.9% ($55 / $95) of the capital structure, while equity represents 42.1% ($40 / $95). This effectively increases the Company's weighted average cost of capital because equity earns a higher return than debt and it now represents a larger portion of the capital structure (42.1% versus 40%). Accordingly, if the Commission were to consider adopting Mr. Kollen's recommendation, it should follow the accounting through to its proper conclusion and increase the equity percentage of the capital structure.

E. Treatment of AROs

Q. PLEASE SUMMARIZE MR. KOLLEN'S POSITION REGARDING THE ADOPTION OF THE ACCOUNTING REQUIREMENTS OF SFAS NO. 143-ACCOUNTING FOR ASSET RETIREMENT OBLIGATIONS (AROs) AND INCORPORATING THEM IN THE RATE-MAKING PROCESS.

A. Mr. Kollen contends that for ratemaking purposes, SFAS No. 143 is not required. He claims there is no compelling reason and no requirement for the Commission to change past practices. Mr. Kollen asserts that by accepting SFAS No. 143 accounting in ratemaking, the Commission may establish a precedent that effectively relinquishes its right to determine the appropriate net salvage depreciation rate, independent of SFAS No. 143 accounting requirements.

Q. DO YOU AGREE WITH MR. KOLLEN?

A. No. There are definite advantages for ratemaking to follow the SFAS No. 143 accounting, as the Company recommends. On the other hand, Mr. Kollen has not provided any specific or tangible reason why ratemaking should not follow the SFAS No. 143 accounting. Following GAAP provides uniformity in accounting for all entities that come before the Commission. Section 25.72(a) of the Commission's Substantive Rules states,

> Each electric utility and electric cooperative shall keep uniform accounts, in accordance with this section, of all business transacted. The classification of electric utilities and electric cooperatives, index of accounts, definitions and general instructions pertaining to each uniform system of accounts as amended from time to time shall be adhered to at all times, unless provided otherwise by these rules, or specifically by the commission.

While Mr. Kollen claims that there is no compelling reason to follow GAAP (through the use of SFAS 143) in ratemaking process, I believe the burden should be on the person who advocates deviating from GAAP requirements to provide a compelling reason or reasons for why a deviation is justified. No such reason has been provided by Mr. Kollen in the case of AROs for the removal of asbestos from buildings. While accounting rules do not invariably control ratemaking, GAAP should be applied in ratemaking to the extent possible.

Q. WOULD FOLLOWING SFAS NO. 143 IN THE MANNER RECOMMENDED BY THE COMPANY WITH RESPECT TO ASBESTOS REMOVAL IN BUILDINGS CAUSE THE COMMISSION TO RELINQUISH ITS RIGHT TO DETERMINE THE APPROPRIATE NET SALVAGE INDEPENDENT OF SFAS NO. 143?

A. No. While adoption of the Company's recommendation in this case will set a precedent for the accounting treatment of the costs of removal of asbestos from buildings in subsequent rate cases, it will not adversely affect the Commission's ability in subsequent rate cases to appropriately review the reasonableness of the asbestos removal costs in buildings employed by the Company. Nor would it adversely affect the ability of the Commission in future cases to appropriately oversee and review other costs of removal and salvage. Mr. Kollen's objection in this respect is a "red herring" and completely without sound basis.

Q. DOES MR. KOLLEN ADDRESS THE COMPLEXITY OF ADJUSTING NON-GAAP CONFORMING ACCOUNTING RECORDS TO USE IN RATEMAKING?

A. No, Mr. Kollen does not address this complexity. Nor does he address the potential for confusion and misapprehension of the financial and accounting results that might occur over an extended period of time where a disjuncture between the GAAP and ratemaking exists.

IV. REBUTTAL ON SCHEDULE C - (CAPITALIZATION AND COST OF CAPITAL)

A. Debt Restructuring Costs

Q. HAVE YOU PREVIOUSLY DISCUSSED MR. KOLLEN'S RECOMMENDATIONS REGARDING THE TREATMENT OF DEBT

RESTRUCTURING COSTS ASSOCIATED WITH UNBUNDLING IN CALCULATING THE COST OF DEBT?

A. Yes, in Section III.D above I discuss his recommendations in this respect.

B. Amount of Debt in the Capital Structure

Q. PLEASE SUMMARIZE MR. KOLLEN'S RECOMMENDATION AT PAGE 29, LINE 1, THROUGH PAGE 31, LINE 5, OF HIS DIRECT TESTIMONY TO MODIFY THE LEVEL OF THE DEBT BALANCE USED TO CALCULATE THE COMPANY'S COST OF DEBT.

A. Mr. Kollen claims that there is a disconnect between what he characterizes as the amount of debt supporting the rate base and the actual book amount of debt which the company used to calculate the average cost of debt. He recommends that the average cost of debt calculation should use the amount of debt supporting the rate base.

Q. DO YOU AGREE WITH MR. KOLLEN'S RECOMMENDATION?

A. No. Mr. Kollen's recommendation is in direct conflict with the Commission's Substantive Rules and the rate filing package schedules. P.U.C. SUBST. R. 25.231(c)(1)(C)(i) states:

> Debt Capital. The cost of debt capital is the actual cost of debt at the time of issuance, plus adjustments for premiums, discounts, and refunding and issuance costs.

The Company's calculation follows the rule, while Mr. Kollen admits that his cost of debt calculation is based on a debt balance that is $319 million greater than the actual per book amount. Thus, it cannot reflect the "actual cost of debt at the time of issuance." In addition, the PUCT-approved rate filing package contains detailed instructions and schedules for calculating the cost of debt, which are attached as EXHIBIT RWH-3R. As with P.U.C. SUBST. R. 25.231(c)(1)(C)(i), the rate filing package is very specific about how the cost of debt is to be determined, stating,

> Please provide the weighted average cost of long-term debt capital based on the following data for each class and services of long-term debt outstanding according to the balance sheet as of the end of the monitoring period.

Attached to the rate filing package is a form that details the inputs needed to calculate the weighted average cost of long-term debt. The inputs require the use of actual balances and there is no input for Mr. Kollen's $319 million adjustment, since it does not represent an actual balance. It is obvious that the Commission requires the cost of long-term debt to be based on actual long-term debt.

Q. DO YOU AGREE WITH MR. KOLLEN THAT THERE IS AN INTERNAL INCONSISTENCY IN THE COMPANY'S FILING?

A. Not at all. While Mr. Kollen notes that there is a disconnect between the per book amount of debt and the amount of debt supporting rate base, this is nothing new, nor is this type of disjuncture uncommon in electric utility rate making. The majority of the difference for TCC is the result of the Accumulated Deferred Federal Income Taxes (ADFIT) on the Company's books related to TCC's securitized stranded costs. The benefit related to this ADFIT was quantified in TCC's securitization proceeding, Docket No. 32745, and the benefit quantified is being refunded to TCC's customers through the separate Competition Transition Charge, ordered in Docket No. 32758 consistent with PURA §39.201(l). Any so called internal inconsistency in the Company's filing has already been addressed by the Commission and the benefit generated from that difference is being refunded to customers. The ADFIT benefit was quantified utilizing TCC's Unbundled Cost of Service (UCOS) weighted cost of capital, which included the cost of long-term debt. Consequently, it is inappropriate in this proceeding to reduce the cost of debt based on the alleged "inconsistency" arising from the prior Commission decisions, which would effectively double count a portion of ADFIT benefit.

C. Amortization of Unamortized Losses and Gains on Reacquired Debt

Q. PLEASE SUMMARIZE DR. SZERSZEN'S TESTIMONY REGARDING THE $1,716,074 INCREASE IN THE COMPANY'S BALANCE OF UNAMORTIZED LOSSES AND GAINS ON REACQUIRED DEBT IN THE PROFORMA COST OF DEBT CALCULATION.

A. Dr. Szerszen claims that the $1,716,074 increase between the test-year-end balance of unamortized losses and gains on reacquired debt and the pro-forma balance is not explained and is not reasonable. She claims that the securitization transaction could not have resulted in an increase of that magnitude in that item.

Q. DO YOU AGREE WITH DR. SZERSZEN?

A. No, I do not. By focusing on the change in the entry entitled "Unamortized Loss on Reacquired Debt" in WP II-C-2.1.1 and by not considering the offsetting changes to unamortized debt issuance costs and unamortized bond insurance premiums associated with the debt restructuring in connection with the securitization, Dr. Szerzsen reaches an erroneous conclusion. In her rebuttal testimony, Ms. Pamela Sutton-Hall also rebuts Dr. Szerszen on this issue.

EXHIBIT RWH-4R is a copy of the first page of Exhibit PSH-4R to Ms. Sutton-Hall's rebuttal testimony. EXHIBIT RWH-4R is a schedule showing and reconciling the various changes that occurred to retire debt and to fix the interest rates on the Matagorda County Navigation District (Matagorda) Pollution Control Revenue Bonds (PCRBs) Series 2005A and B on the balances of: (1) unamortized debt issuance costs in FERC Account 181; (2) unamortized debt discount in FERC Account 226; and (3) unamortized debt losses and gains in FERC Account 189. All of these changes resulted from debt refinancing associated with securitization.

Q. PLEASE CONTINUE BY EXPLAINING THE CHANGES REFLECTED IN EXHIBIT RWH-4R.

A. There are several changes. First, as a consequence of fixing the interest rates on the Matagorda PCRBs Series 2005A and B, the Company was required by the FERC System of Accounts to reclassify pre-existing debt issuance costs associated with these bonds from unamortized debt discount and issuance costs in Account 181 to unamortized loss on reacquired debt in Account 189. Thus, as shown on EXHIBIT RWH-4R, the pro-forma adjustments included in WP II-C-2.1.1 included an increase to unamortized losses and gains on reacquired debt in Account 189 and corresponding decrease to unamortized debt discount and issuance costs in Account 181. Thus, while it appeared to Dr. Szerszen that there was an explained $1.7 million increase in unamortized loss on reacquired debt, her conclusion failed to account for the fact that there was a corresponding reduction to unamortized debt issuance costs

Q. PLEASE ADDRESS WHY ADDITIONAL ADJUSTMENTS IN THE TREATMENT OF UNAMORTIZED BOND PREMIUMS RELATED TO THE MATAGORDA PCRBS SERIES 2005A AND B WERE INVOLVED.

A The entry for "Unamortized Loss on Reacquired Debt" on both Schedule II-C-2.4 and WP II-C-2.1.1 in the rate filing package includes two items: (1) the unamortized balance of losses and gains on reacquired debt included in Account 189 and (2) unamortized bond insurance premiums which are included in Account 181. In the initial pro-forma calculation in WP II-C-2.1.1, the Company reclassified the unamortized bond premiums for the Matagorda PCRBs Series 2005A and B from FERC Account 181 to FERC Account 189, because it was anticipated that the unamortized bond premium outstanding on September 30, 2006 would no longer be effective and new insurance would have to be purchased. The Company also included a new full year's premium for the replacement insurance as well, because as Ms. Sutton-Hall explains in her rebuttal testimony, the Matagorda PCRBs Series 2005A and B were being converted into fixed rate bonds and the obligation to provide bond insurance on the converted bonds would be a continuing obligation.

However, when the interest rates on the Matagorda PCRBs Series 2005A and B were fixed, as Ms. Sutton-Hall explains, the Company was able to confirm that the existing bond insurance would continue to be effective and that a new policy did not need to be purchased with the incurrence of a full year's premiums. Consequently, further adjustments were required to the pro-forma calculation of the cost of debt to properly reflect the actual effect of the fixing of the interest rates for the Matagorda PCRBs Series 2005A and B on the level of bond insurance premiums to come up with the correct calculation of the cost of debt.

Q. PLEASE ADDRESS DR. SZERSZEN'S RECOMMENDATION AT PAGE 28, LINES 9-17, THAT THE COMPANY'S COST OF DEBT SHOULD BE ADJUSTED TO REFLECT AN ADDITIONAL YEAR'S AMORTIZATION OF UNAMORTIZED LOSSES AND GAINS ON REACQUIRED DEBT TO REFLECT THE COST OF DEBT ON A "GO FORWARD" BASIS?

A. Without providing any detailed discussion of her reason for so doing, Dr. Szerszen reduces the unamortized balance of unamortized losses and gains on reacquired debt to reflect a year's amortization from July 1, 2006, through June 30, 2007.

Q. DO YOU AGREE WITH DR. SZERSZEN'S RECOMMENDATION TO INCLUDE AN ADDITIONAL YEAR'S AMORTIZATION TO THAT BALANCE?

A. No. Dr. Szerszen's recommendation violates the test year concept and should be rejected. The Company's rate base is based on balances at June 30, 2006, as are its unamortized losses and gains on reacquired debt. Dr. Szerszen is recommending that the unamortized losses and gains on reacquired debt be based on a June 30, 2007 amount, while leaving rate base at the June 30, 2006 level. This creates a mismatch (June 30 2006 rate base and June 30, 2007 unamortized losses and gains on reacquired debt) that is inappropriate and should be rejected. If such an adjustment were to be allowed, then the Commission should adopt a forward looking test year with all components adjusted to June 30, 2007 levels.

V. REBUTTAL ON SCHEDULE D- (O&M AND A&G EXPENSE AND TAXES)

A. Labor Expenses

Q. DO ANY WITNESSES ADDRESS THE AMOUNT OF LABOR EXPENSE INCLUDED IN TCC'S REQUESTED COST OF SERVICE?

A. Yes, Cities witness Constance T. Cannady made various recommendations regarding the amount of labor expense included in TCC's requested cost of service. Ms. Cannady reduced TCC's direct regular labor expense, TCC's direct overtime payroll expense, TCC's direct incentive costs and the AEPSC regular labor costs and incentive costs billed to TCC. In addition, in their testimonies, Staff witness Ms. Mary Jacobs makes recommendations regarding overtime payroll and incentive compensation, while Staff witness Candice Romines and Office of Public Utility Counsel (OPC) witness Mr. David Effron make recommendations regarding incentive compensation.

Q. PLEASE EXPLAIN MS. CANNADY'S DIRECT REGULAR LABOR EXPENSE ADJUSTMENT.

A. Ms. Cannady recommends that the TCC's annualized level of payroll be adjusted by \$36,761 (transmission) and \$183,570 (distribution) to reflect an average test year increase more in line with the level of salary increases that she claims have been reported as reasonable by TCC. Ms. Cannady removed the actual test year increases of 4.04% and 4.42% and replaced them with an overall average increase of 3.5%, which she states is more reasonable.

Q. DO YOU AGREE WITH MS. CANNADY'S ADJUSTMENT?

A. No, I do not. As explained by Mr. David Jolley in his rebuttal testimony, the 3.5% Ms. Cannady utilized is based on the Company's targeted merit salary increase. This 3.5% merit increase is the target which employees receive if their job performance is satisfactory and they continue to hold their current position. In addition to the standard merit increase, employees may receive promotions or step progressions. Step progressions are generally utilized for hour/craft employees and salary increases are controlled by time for a particular position. Thus, when one analyzes a set group of employees that received salary increases in a given 12 month time period, it should be no surprise that the actual salary increases in total will exceed the merit salary increase percentage, which incorporates only a subset of the total drivers of salary increases. That is exactly what TCC's data shows.

Q. WHAT IS THE EFFECT OF MS. CANNADY'S RECOMMENDATION?

A. The effect of Ms. Cannady's recommendation is to eliminate all promotions and step progression raises given to various Company employees during the test year. Ms. Cannady has not addressed why she believes that promotions and step progression wage and salary increases are not appropriate.

Q. DO YOU BELIEVE IT IS APPROPRIATE TO OFFER EMPLOYEES THE OPPORTUNITY FOR PROMOTIONS AND STEP PROGRESSION WAGE INCREASES?

A. Yes, I do. It seems inconceivable to not provide opportunities for advancement for employees. Both promotions and step progression wage increases provide an incentive to employees. It is my understanding that promotions and step progression wage increases are standard business practice. If promotions and step progression wage increases were eliminated, one would have to wonder how that would impact the ability of the company to attract and maintain a qualified workforce. This issue is addressed in more detail in Mr. Jolley's rebuttal testimony.

Q. WHAT ARE MS. JACOB'S AND MS. CANNADY'S RECOMMENDATIONS REGARDING TCC'S OVERTIME PAYROLL EXPENSE?

A. Ms. Jacobs recommends that the overtime expense should be based on the 12 month period ending November 2006 instead of the test year, which reduces the company's cost of service by $1,575,945. Ms. Cannady recommends that the Company's test year level of overtime be reduced to reflect a 12 month average amount based on annual data from June 2003 through June 2006 and annualized July through November 2006 overtime amounts. This adjustment alone reduces the Company's request by $1.059 million for distribution and $184,000 for transmission.

Q. IS MS. JACOB'S ADJUSTMENT APPROPRIATE?

A. No, it is not. I will discuss errors in Ms. Jacobs' calculation that would significantly reduce her recommendation while, in their rebuttal testimonies, Mr. Harry R. Gordon and Mr. Bernard M. Pasternack discuss that the test year level of overtime is reasonable and ongoing. Ms. Jacobs incorrectly claims that her overtime payroll O&M recommendation is based on the 12 months ended November 2006. The actual overtime charged to O&M for the 12 months ended November 2006 is $4,639,829. What Ms. Jacobs did was take the actual total overtime for the year ending November

2006 and then multiplied that amount by a payroll O&M ratio based on the year ending June 2006. This created a mismatch that overstated her recommended overtime adjustment. With a proper matching of the O&M rates for the twelve months ending November 2006, Ms. Jacob's recommended overtime adjustment would decrease to $778,058 as detailed on EXHIBIT RWH-5R. As noted earlier, Mr. Pasternack and Mr. Gordon discuss that any adjustment to overtime is not appropriate because the test year amount of overtime is reasonable and ongoing.

Q. IS MS. CANNADY'S ADJUSTMENT APPROPRIATE?

No, it is not. As noted earlier, Mr. Pasternack and Mr. Gordon support the level of overtime incurred in the test year as being reasonable and ongoing. In addition, Ms. Cannady's calculation contains the same basic flaw as that of Ms. Jacobs. Ms. Cannady's calculation was based on the total amount of overtime for the particular time periods she looked at and not the actual amount of overtime charged to O&M during that time period.

Q. HAVE YOU PREPARED AN EXHIBIT THAT PROPERLY UTILIZES ACTUAL O&M OVERTIME?

A. Yes, I have. EXHIBIT RWH-6R is based on the actual overtime O&M for the given time periods reviewed by Ms. Cannady with this correction. When properly done, the distribution calculation now yields a $293,000 figure while the transmission calculation yields a $133,000 figure. As with Ms. Jacobs' adjustment, it is the Company's position that the test year amount of O&M overtime is reasonable and ongoing and that no adjustment is warranted and Ms. Jacobs' and Ms. Cannady's recommendations regarding the Company's overtime O&M expense should be rejected.

Q. WILL YOU BE ADDRESSING RECOMMENDATIONS REGARDING INCENTIVE COMPENSATION?

A. No, I will not. Company witness Mr. David Jolley will address incentive compensation.

Q. DID ANY WITNESS MAKE AN ADJUSTMENT TO THE ANNUALIZED AEPSC BASE PAYROLL PROPOSED BY TCC?

A. Yes, Ms. Cannady proposes to reduce the annualized AEPSC base payroll included in the TCC's filing by $1.1 million. Ms. Cannady believes that TCC's methodology for annualizing base payroll did not fully capture the fact that 160 employees transferred from AEPSC to TCC at the end of December 2005.

Q. DO YOU AGREE WITH MS. CANNADY'S CONTENTION?

A. No, I do not. TCC's methodology for annualizing base payroll properly accounted for TCC and AEPSC employees because TCC performed two separate calculations for annualizing base payroll, one for TCC employees and one for AEPSC employees. The first calculation utilized the actual base payroll salaries of TCC's employees on TCC's payroll at June 30, 2006. The second calculation utilized the actual base salaries of AEPSC employees on AEPSC's payroll at June 30, 2006. These AEPSC annualized base salaries were allocated to TCC based on the actual amount of base payroll billed to TCC during the last six months of the test year. The Company utilized the last six months of the test year because this time period was after various employees had been transferred from AEPSC to operating company payrolls. By specifically utilizing the time period after the employees had transferred to the operating company payrolls, a proper level of AEPSC base payroll is included in the Company's filing. In addition, employees are only on one payroll (i.e. they are either on TCC's payroll or AEPSC's payroll, not both). This provides assurance that there has not been any double counting of employees and that the Company's annualized base payroll results in a proper amount of base payroll to be used in the development of wires rates.

Q. MS. CANNADY CLAIMS (PAGE 16) THAT THE REDUCTION PROPOSED BY THE COMPANY RELATED TO THE AEPSC PAYROLL ANNUALIZATION IS NOT SUFFICIENT TO ACCOUNT FOR THE TRANSFER OF EMPLOYEES FROM AEPSC TO TCC DISTRIBUTION OPERATIONS. IS THIS CORRECT?

A. No, it is not. As explained earlier, TCC's annualization utilized the employees on the AEPSC payroll as of June 30, 2006. The employee transfer occurred at the end of December 2005. Therefore, the Company's annualization fully accounted for the employee transfer because those employees were no longer on AEPSC's payroll.

Q. ARE THERE ANY ADDITIONAL FLAWS REGARDING MS. CANNADY'S ANALYSIS AS IT RELATES TO HER RECOMMENDATION REGARDING AEPSC PAYROLL?

A. Yes, there are additional flaws. Ms. Cannady states that because of the timing of the transfer, the decrease of the test year allocation from AEPSC to TCC should be one-half of these employees' salaries (pages 16 – 17). This is incorrect because it is based on a false assumption that each of the AEPSC employees that transferred to TCC charged 100% of their time to TCC. In reality, many of these AEPSC employees charged a portion of their time to operating companies other than TCC, most notably TNC. For example, dispatching employees dispatch both the TCC and TNC systems. These dispatching employees were some of the employees who transferred from AEPSC to TCC. During the last six months of 2005, the employees that were subsequently transferred to TCC charged $796,000 to operating companies other than TCC. Had Ms. Cannady considered the fact that these employees charged time to companies other than TCC, it would have decreased her $1.140 million disallowance by 70% to $344,000. See EXHIBIT RWH-7R.

Q. IS THERE ANYTHING ELSE MS. CANNADY FAILED TO CONSIDER WHEN SHE MADE HER AEPSC PAYROLL RECOMMENDATION?

A. Yes, there is. Ms. Cannady failed to recognize that AEPSC is a dynamic organization where the make-up is always changing. She erroneously and simplistically assumed that only one thing changed during the test year, namely that 160 employees transferred from AEPSC to TCC at the end of December 2005. Remember that the Company's proposal was to annualize employees on the AEPSC payroll at June 30, 2006, which would effectively pick up any additional changes that occurred during the first six months of 2006, such as AEPSC adding employees during the first six months of 2006. AEPSC added 284 employees during that time period as detailed in the response to Cities 43rd Request for Information, Question No. CC 43-1. The annualized payroll for those additional employees who performed customer operations for TCC distribution is $177,000 as detailed on EXHIBIT RWH-8R. In addition, some AEPSC employee received raises during the first six months of 2006. When one considers these additional changes, they easily explain the remaining increase in the AEPSC payroll annualization adjustment, which is less than 1% of the total test year payroll ($167,000 / $19,759,000).

B. Group Insurance

Q. PLEASE DESCRIBE THE GROUP INSURANCE ADJUSTMENT PROPOSED BY CITIES WITNESS MS. CANNADY.

A. Ms. Cannady proposes that the level of group insurance costs be based on annualizing actual costs incurred for the period June 2006 through November 2006 as opposed to the costs in the Company's filing, which are based on an annualized June 2006 amount. The impact of her approach is a $366,979 (distribution) and $78,879 (transmission) reduction to the Company's proposed level of group insurance.

Q. WHAT SUPPORT DOES MS. CANNADY PROVIDE TO SUPPORT THE USE OF THE PERIOD JUNE 2006 THROUGH NOVEMBER 2006?

A. On page 21 of her testimony, Ms. Cannady states the fluctuations in monthly expense and fringe benefit loading factors cause the use of the month of June to annualize costs to be inappropriate and unrepresentative of costs going forward. She also adds that test year expenses are not necessarily representative since the number of employees has changed significantly during the test year. She adds, "in my opinion, the use of the most recent information subsequent to the test year is most representative of costs going forward."

Q. DOES MS. CANNADY'S PROPOSED PERIOD FOR DETERMINING GROUP INSURANCE COSTS HAVE MERIT?

A. No, Ms. Cannady is reaching outside the test year in an attempt to find combinations of monthly amounts to reduce the amount of group insurance expense included in cost of service.

Q. PLEASE EXPLAIN HOW MS. CANNADY DETERMINED THE RECOMMENDED GROUP INSURANCE EXPENSE AS SHOWN ON SCHEDULE 17 OF HER TESTIMONY.

A. Ms. Cannady determined the total group insurance costs (amounts expensed and capitalized) by using the June 2006 through November 2006 costs of $504,300, which equates to an annualized $1,008,600 for transmission. For distribution she utilized the June 2006 through November 2006 costs of $4,195,042, which equates to an annualized amount of $8,390,084. Ms. Cannady used the fringe loading amounts, which include all amounts charged to non-O&M accounts including the stores (materials & supplies) and transportation clearing accounts for the twelve month period December 2005 through November 2006, to derive a capitalization ratio of 46.45%. This ratio determined the amount she says should be capitalized, which she subtracted from the total costs to derive the group insurance expense amount.

Q. WHAT ARE THE PROBLEMS WITH MS. CANNADY'S CALCULATION?

A. Ms. Cannady's use of the fringe benefit loading ratio does not properly reflect the true capital / O&M ratio. Under Ms. Cannady's methodology, all of the costs related to transportation and all stores clearing (materials and supplies) are effectively capitalized, which is incorrect, because a large portion of these costs are O&M. An additional analysis must be performed to determine how much of the transportation and stores clearing went to O&M expense. My EXHIBIT RWH-9R, which is based on test year data, shows the outcome on the level of group insurance if Ms. Cannady's methodology were used properly. This exhibit illustrates how the fringe benefit loading amounts are further adjusted to determine the portion of stores and transportation clearing ultimately charged to O&M. Based on this analysis, $657,704 or 8.1% of group insurance that were charged to stores or transportation balance sheet accounts were ultimately cleared to O&M expense. Properly applying Ms. Cannady's methodology would indicate that the Company's amount included in its request should be increased, not decreased as Ms. Cannady's erroneous calculation shows.

Q. WHAT O&M RATIO DID TCC ACTUALLY USE IN DETERMINING VARIOUS PRO FORMA ADJUSTMENTS IN THIS FILING, INCLUDING GROUP INSURANCE?

A. TCC has used the test year ending June 2006 payroll expense ratio for the pension, Other Post Employment Benefits, SFAS 112, and group insurance adjustments in this filing as well as previous filings with the PUCT. This calculation is provided in WP II-D-1-1.

Q. WHAT IS YOUR RECOMMENDATION WITH REGARDS TO MS. CANNADY'S PROPOSED GROUP INSURANCE ADJUSTMENT?

A. The Commission should not accept her proposed use of the annualization of group insurance costs for the period June 2006 through November 2006, which falls outside the test year. The Commission should not accept her flawed attempt at deriving the costs related to this period nor should the Commission accept the use the capital/expense ratio used by Ms. Cannady due to the significant error it contains. I recommend the Commission accept the group insurance costs included in TCC's filing. My EXHIBIT RWH-10R compares TCC's proposed pro forma test year group insurance costs with Ms. Cannady's proposed test year June 2006 through November 2006, using an appropriate O&M expense ratio derived from the test year 2006 Payroll Expense Ratio. My EXHIBIT RWH-10R shows TCC group insurance expense to be $581,364 and $4,859,967 for transmission and distribution respectively. This exhibit shows that the annualization of the period June 2006 through November 2006 results in insurance expense of $583,616 and $4,937,145 for transmission and distribution respectively. A correct annualization of the post test year period group insurance expense suggested by Ms. Cannady actually results in a larger group insurance expense than that included in TCC's filing, with the results being very similar.

C. Savings Plan

Q. DOES MS. CANNADY'S PROPOSED SAVINGS PLAN ADJUSTMENT FOLLOW THE SAME METHODOLOGY AS HER PROPOSED ADJUSTMENT TO GROUP INSURANCE EXPENSE?

A. Her savings plan adjustment is similar to her group insurance expense adjustment, but she has selectively modified it to obtain a lower adjustment amount.