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

CITIES' SECOND MOTION FOR REHEARING

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March 24, 2008

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CITIES' SECOND MOTION FOR REHEARING

TO THE PUBLIC UTILITY COMMISSION OF TEXAS:

The Steering Committee of Cities served by Texas Central Company ("Cities") move for rehearing of the Order on Rehearing issued March 4, 2008 in Docket No. 33309. Cities request rehearing as follows:

I. INTRODUCTION

On March 4, 2008, the Public Utility Commission ("PUC" or "Commission") issued its Order on Rehearing resolving the issues in this case. The Order on Rehearing confirms that for at least the third consecutive rate case, AEP-Texas Central Company ("TCC" or "Company") has significantly overstated their request. To be clear, however, the overall revenue requirement increase is not the only increase the customers will experience if it is affirmed. In addition to the base rate increase, the elimination last June of the merger savings and rate reduction riders related to the merger of AEP and Central and South West Corporation has already increased TCC's distribution revenues by an additional $19.9 million. The Order on Rehearing also recommends approval of the Company's proposed $3.4 million increase in discretionary service fees. Finally, it is significant to point out that while base rates have remained relatively stable, revenues have not. As noted during the cross examination of Mr. Patton, test year revenues in this proceeding are $28.5 million higher than they were three years earlier in Docket No. 28840.[1]

[1] Tr. at 71 (Apr. 12, 2007). *See also* TIEC Initial Brief at 2 (May 31, 2007).

Accordingly, if the Order on Rehearing is approved, along with the elimination of the merger savings and rate rider reductions, the Company will experience revenues of at least **$60 million** more than the Commission approved two years ago in Docket No. 28840. This is an increase in revenues of over 14 percent within a two year period.

Notwithstanding these facts, Cities request rehearing on several issues that are detailed in this filing. Accordingly, Cities' respectfully request the Commission amend the Order on Rehearing of March 4, 2008, as set out herein.

II. GROUNDS FOR REHEARING

POINT OF ERROR NO. 1

The Order on Rehearing errs in failing to find that rate base should be reduced for the generation-related portion of the pension prepayment asset.[2]

Cities disagree with the Commission's decision to not reduce rate base for the generation-related portion of the pension prepayment asset and urge the Commission to grant rehearing to amend its decision. In its initial filing, the Company included the generation-related portion of the pension prepayment asset in rate base, yet it did not include the negative generation pension ***expense***, *i.e.*, net earnings, to reduce its cost of service. The Company later changed its position with regard to the application of the generation-related earnings to reduce the cost of service,[3] but the Commission has failed to require the Company to remove the generation-related asset ***both*** from rate base and from the revenue requirement.

Ratepayers should not be required to pay a return on the Company's discretionary overfunding of the generation portion of the pension trust fund. The stranded cost true-up proceeding was the appropriate time for the Company to recover this cost. Failing that, the

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[2] Order on Rehearing at 5, FoFs 23-24 and Order on Rehearing at 21-22, CoLs 11-12.

[3] Rebuttal Testimony of Hugh E. McCoy, TCC Ex. 79 at 13.

liability should have been transferred to the purchaser(s) of its generation asset.[4] Having chosen to forego those two opportunities for recovery, the Company has ultimately chosen to burden the ratepayers with these costs. Neither PURA § 36.065, Commission rules, nor general accounting principles mandate that the Commission allow the Company to do so. Although it is true that the generation-related portion of the asset also produces earnings that reduce pension costs (which under PURA § 36.065(a) includes pension costs related to the generation portion of the formerly integrated utility), the better course of action with regard to these generation-related assets is to exclude them from rate base, in addition to the amounts excluded from rate base for the portion attributable to CWIP.[5] The amounts that should be excluded are $15.848 million from distribution rate base and $1.981 million from transmission rate base (net of ADFIT).[6]

POINT OF ERROR NO. 2

The Order on Rehearing errs in failing to reduce Accumulated Deferred Income Taxes ("ADFIT") in rate base to account for accounts with no commensurate rate base amounts.[7]

Cities disagree with the Commission's decision to include ADFIT in the amount of $323.9 million in rate base and urge the Commission to grant rehearing to amend its decision. The Order on Rehearing is based upon the Company's representations (made only in its Reply Brief) that the countervailing rate base reducing effects of each of the items noted by Cities have been appropriately treated in the cash working capital calculation, and are therefore reflected as reductions to rate base. Yet the workpapers cited by the Company and relied upon by the Commission are unclear, at best. The Company's testimony directly addressed only two of the

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4 Direct Testimony of Lane Kollen, Cities Ex. 1 at 34.

5 Cities Brief at 10-11 (May 31, 2007); Direct Testimony of Lane Kollen, Cities Ex. 1 at 21-22.

6 *Id.*

7 Order on Rehearing at 6, FoF 35.

six accounts challenged by Cities; the Company never addressed the other accounts or rebutted Cities' testimony that these accounts did not have a commensurate rate base amount. Therefore, the Company has failed to meet its burden of proof and the ADFIT in rate base should be reduced by an additional $7.895 million.[8]

POINT OF ERROR NO. 3

The Order on Rehearing errs in including in rate base $7.3 million associated with the reclassification of projects from CWIP to plant in service, and in finding this amount to be reasonable.[9]

Cities disagree with the Commission's decision to include in rate base amounts associated with the reclassification of projects from CWIP to plant in service and urge the Commission to grant rehearing to amend its decision. The Commission apparently accepted the rationale in the PFD for the inclusion of the $7.3 million, namely that these projects were providing service and were used and useful to customers as of June 30, 2006. The Order on Rehearing ignores the fact that the transfers from CWIP to plant in service were unreasonably delayed, with unfavorable results to the ratepayers. The cumulative effects of the late transfers that were identified by Cities and that are approved by the Order on Rehearing are: (i) it is appropriate for the Company's rate base to be overstated by projects remaining in CWIP for long periods of time after they have been placed in service, (ii) it is appropriate for the Company's per books balances of accumulated depreciation to be understated because book depreciation is delayed until the projects are transferred, and (iii) it is appropriate for the Company's per books ADIT balances to be understated because tax depreciation is delayed until the projects are transferred from CWIP to Electric Plant in Service ("EPIS").[10]

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[8] Direct Testimony of Lane Kollen, Cities Ex. 1 at 26.

[9] Order on Rehearing at 6, FoF 38.

[10] Direct Testimony of Lane Kollen, Cities Ex. 1 at 13-14.

Transfers from CWIP to EPIS must not necessarily take place on the exact day that the assets are placed in service, but delaying the transfer beyond a reasonable time, and finally making the transfer only because a rate case is imminent, impermissibly results in the cumulative effects outlined above.[11] These impacts are cumulative and will never be reconciled if the utility is allowed to unreasonably delay the transfer of CWIP to EPIS. The Company did not make any adjustments to AFUDC, carrying costs, or depreciation in non-rate case years; therefore, the effects of the delays in non-rate case years have not been adequately addressed.

If the Commission allows the Company's proposed adjustments to EPIS, accumulated depreciation, ADIT, and depreciation expenses, then the Company's rate base should also be reduced by the amount of construction accounts payable. The Commission's determination to not reduce rate base results in the Company retaining the entirety of the benefit of the zero-cost financing provided by its vendors in the amount of $12.561 million.[12]

The rationale in the PFD was that the Commission's rules require the construction accounts payable be included in cash working capital calculations. Cities' recommendation did not address cash working capital calculations; rather, Cities recommended that the construction accounts payable be considered a source of ***working capital*** that includes accounts such as prepayments (including the prepaid pension asset), materials, and supplies.[13] Under the Commission's Substantive Rules, cash working capital is only one of several components of working capital. There is no prohibition in the Commission's rules against including construction accounts payable as a ***working capital*** line item. Similarly, there is no revenue lag involved because this is not a cash working capital "expense" any more than pension

[11] *Id.*

[12] *Id.* at 14-15. The Company pays in arrears after receiving the vendor's goods or services.

[13] P.U.C. SUBST. R. 25.231(c)(2)(B).

prepayments are a cash working capital "expense." Therefore, in order not to allow the Company to retain the entirety of the benefit provided by vendors, its rate base should be reduced by the amount of that zero-cost financing, as proposed by Cities.

POINT OF ERROR NO. 4

The Order on Rehearing errs in including $10.2 million in debt restructuring costs related to business separation in rate base and including in cost of service an annual amortization expense of $914,892 for amortization of these debt restructuring costs over a 15-year period.[14]

Cities disagree with the Commission's decision to include these debt restructuring costs in rate base and urge the Commission to grant rehearing to amend its decision. The Order on Rehearing is based on conclusions that the Commission is foreclosed by prior dockets from reviewing the reasonableness of the method of recovery of the Company's debt restructuring costs. However, these conclusions erroneously ignore the fact that these regulatory assets should be treated consistently with the Commission's historical treatment of such assets. Clearly, these restructuring costs are costs of debt and should earn a debt-only rate of return, not the grossed-up return on rate base (which includes an equity return as well as income taxes on the equity return).[15]

The Order on Rehearing makes no findings of the reasonableness or necessity of these costs, but merely refers to the Commission's determinations in Docket Nos. 22352 and 28840 and concludes that the Company's treatment "conforms" to such determinations. The Order on Rehearing fails to recognize, however, that the issue was not contested in Docket No. 28840, and therefore, the issue was not directly addressed in that docket. Additionally, the issue of whether the debt restructuring costs should be included in the average interest rate used as the cost of debt

[14] Order on Rehearing at 7, FoF 41 and Order on Rehearing at 21-22, CoLs 10 and 17.

[15] Direct Testimony of Lane Kollen, Cities Ex. 1 at 23-24.

or in rate base and operating expenses was not addressed in Docket No. 28840. In these prior dockets, the Commission merely accepted the Company's quantification of the issue and did not make ***any findings*** as to the correct manner in which the costs should be quantified: "The order in Docket No. 22352 did not state that TCC may recover a total amount of debt restructuring charges that must be further allocated between T&D and generation; rather, the debt-restructuring cost discussed in the order reflects an amount *already* allocated to transmission and distribution."[16]

Thus, the propriety of the amount to be included in rate base was properly before the Commission in this docket. In order to be at least partially consistent with the Commission's historic treatment of such costs, the Company reflected all other debt refinancing costs, along with the issuance, discount and premium amounts, in the computation of the average debt interest rate.[17] To be ***completely*** consistent with precedent, since the debt-only rate of return was identifiable, it should be applied to these restructuring costs, which are clearly costs of debt.

POINT OF ERROR NO. 5

The Order on Rehearing departs significantly from Commission precedent and errs in finding that the Company's use of SFAS 143 accounting for ratemaking purposes "aligns the regulatory treatment with Generally Accepted Accounting Principles."[18]

Cities disagree with the Commission's decision that the use of SFAS 143 is mandated for asset retirement obligations and urge the Commission to grant rehearing to amend its decision. The Commission's decision with regard to the use of SFAS 143 for ratemaking purposes is clearly a departure from current Commission practice. As stated in the PFD, this is a new issue

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16 *Application of AEP Texas Central Company for Authority to Change Rates*, Docket No. 28840, Final Order at 13-14 (Aug. 15, 2005).

17 Direct Testimony of Lane Kollen, Cities Ex. 1 at 23; TCC Ex. 2 at Schedules II-C-2.4 and II-C-2.4a.

18 Order on Rehearing at 8 and 15, FoFs 49, 50, 51, 113 and 114.

for the Commission.[19] However, rather than requiring the party suggesting a departure from Commission practice to shoulder the burden of justifying the need for such departure, the PFD and the Order on Rehearing erroneously placed the burden on Cities, the party ***supporting*** the current practice, to justify the continued use of the current practice. The PFD actually faulted the Cities for "offer[ing] no substantive reason for why GAAP, as reflected in SFAS 143, should not be used to account for AROs for ratemaking purposes."[20]

It is correct that, ***for financial reporting purposes only***, TCC was required to account for the legal retirement of asbestos-containing buildings in accordance with SFAS 143.[21] However, there is no requirement, either in GAAP or in PURA, that SFAS 143 be used for ***ratemaking purposes***. In fact, this is a ***significant departure*** from Commission precedent, with no meaningful support given for making such a departure.

The effects of the Order on Rehearing are significant and should not be lightly dismissed. This Commission has historically determined the net salvage rate that will be included in the depreciation rate for ratemaking purposes. The Commission has ***not*** allowed accounting requirements, be they related to SFAS 143 or otherwise, to dictate any component of depreciation expense.[22] The Commission has not blindly adhered to financial reporting requirements when setting rates; rather, it has appropriately recognized that financial reporting and ratemaking have different goals. Ratemaking has never been in lock-step with SFAS standards; there are more instances in which ratemaking does ***not*** follow SFAS accounting standards than there are instances in which it does. The Company's claim of "potential

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[19] PFD at 34.

[20] *Id.* at 37.

[21] Order on Rehearing at 8, FoF 49.

[22] Direct Testimony of Lane Kollen, Cities Ex. 1 at 16.

complexity and confusion over time" is a red herring.[23] The Company itself has taken advantage of ratemaking procedures that depart from SFAS standards on numerous occasions (witness its use of regulatory assets), and has never before been heard to complain that it was too complex or confusing to do so. In fact, there is no testimony supporting any requirement that SFAS 143 be used for ratemaking purposes. If the Commission is searching for the simplest, least complicated way to address asset retirement obligations, it should continue with its precedent and include the net salvage in the depreciation rate for Account 390, rather than having a separate SFAS 143 liability, amortization expense, related ADFIT, and so on. It is far simpler, and far more consistent with ratemaking practices and Commission precedent for all accounts, ***not*** to carve out Account 390 for special complicated rate base and expense treatment.

GAAP standards are not more "important" or more "correct" than ratemaking standards. Each has its appropriate uses. The Company has not carried the burden of proving that accounting standards must dictate the ratemaking treatment of these retirement obligations. Rather, it has merely shown that SFAS 143 is required for its financial reporting responsibilities. The Commission should not abdicate its responsibility for determining the net salvage component of the depreciation expense for distribution buildings by blindly following GAAP standards that are not required for ratemaking purposes.

POINT OF ERROR NO. 6

The Order on Rehearing errs in adopting the Company's survivor curve and depreciation rate for Account 364.[24]

Cities disagree with the Commission's decision to adopt the Company's survivor curve and depreciation rate for Account 364 and urge the Commission to grant rehearing to amend its

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23 Rebuttal Testimony of Randall W. Hamlett, TCC Ex. 78 at 32; *see also* PFD at 36.

24 Order on Rehearing at 13-14, FoFs 98 and 104.

decision. The Order on Rehearing inappropriately rejects Cities' recommended average service life and survivor curve for Account 364, Poles, Towers, and Fixtures. The goodness of fit information provided for this account by Cities, through the sum of squared deviations for the S-.5 survivor curve, clearly shows that the Cities' average service life of 41 years is a much better statistical fit for this account, 0.0644 compared to 0.1157 for the Company's average service life of 39 years.[25]

The Company could not rebut Cities' testimony, other than to make general, unfocused objections to placing too much emphasis on the end of the curve. As Cities testified, the ***entire curve*** must be examined, and the curve with the best goodness of fit statistic must be chosen. There is no basis in the record for disregarding the goodness of fit statistics for Account 364, therefore the Order on Rehearing is erroneous.

POINT OF ERROR NO. 7

The Order on Rehearing errs in adopting the Staff's survivor curve for Account 368.[26]

Cities disagree with the Commission's decision to adopt the survivor curve for Account 368 that was recommended by the Staff and urge the Commission to grant rehearing to amend its decision. Cities' recommended average service life and survivor curve for Account 368, Line Transformers, was adopted by the Company in its rebuttal testimony,[27] and there is no reasoned justification in the record for adopting the Staff's survivor curve instead of that proposed by Cities and Company. The goodness of fit information provided for this account by Cities, through the sum of squared deviations for the 40 S-.5 survivor curve, clearly shows that this

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[25] Direct Testimony of Nancy H. Hughes, Cities Ex. 4 at 17.

[26] Order on Rehearing at 13, FoF 99.

[27] Rebuttal Testimony of James E. Henderson, TCC Ex. 91 at 6.

survivor curve is a much better statistical fit for this account (0.0291 compared to 0.0558 for the Staff's proposed curve of 40 S0).[28] The Order on Rehearing has no support in the record, therefore it is in error.

POINT OF ERROR NO. 8

The Order on Rehearing errs in adopting the Staff's survivor curve for Account 371.[29]

Cities disagree with the Commission's decision to adopt the Staff's survivor curve for Account 371 and urge the Commission to grant rehearing to amend its decision. There is no reasoned basis in the record for rejection of Cities' recommended average service life and survivor curve for Account 371, Installations on Customer Premises. The Staff's proposed 35 L0 survivor curve does not match ***any*** of the actuarial data for this Account until year 40, whereas the Cities' 25 - R0.5 curve moderates the over- and under-statements of both the Staff's and the Company's curves, and is the closest to the actual data for years 17 through 30.[30] There is no evidence in the record explaining why the Staff's curve, which does not match any data for 40 years, is better than the Cities' curve, which has a deviation of only 0.8234. Therefore, the Order on Rehearing is in error.

POINT OF ERROR NO. 9

The Order on Rehearing errs in its treatment of Account 390.[31]

Cities disagree with the Commission's decision adopting the Company's proposed net salvage rate for this account, approving the change in accounting for asset retirement obligations in Account 390, finding that the Company's treatment of sales of buildings in Account 390 is

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28 Direct Testimony of Nancy H. Hughes, Cities Ex. 4 at 19 (Errata).

29 Order on Rehearing at 13-14, FoFs 99, 101, 104 and 105.

30 Direct Testimony of Nancy H. Hughes, Cities Ex. 4 at 20, Figure 6.

31 Order on Rehearing at 13-15, FoFs 95, 101, 103, 104, 106, 107, 108, 109, 110, 111, 112, 113 and 114.

reasonable and appropriate, and finding that such sales are not likely to recur on a regular basis. Cities urge the Commission to grant rehearing to amend its decision.

The Order on Rehearing erroneously determines that the Company's net salvage rates for 1999 and 2005 were skewed by the sales of buildings, and that such sales are not likely to recur regularly. On that basis, the Order on Rehearing essentially ignores what the PFD termed outlier activities. However, the evidence clearly shows that the Company received net salvage ***above 50%*** in all of the following years: 1984 (87%), 1987 (74%), 1993 (52%), 1994 (68%), 1999 (57%), and 2005 (73%).[32] Clearly, some activities are taking place that regularly result in high net salvage rates in this account. Rather than ignoring this experience, the Commission should come to terms with the fact that the Company is experiencing high net gains from the sales of utility property. The way to come to terms with this fact is to fairly and adequately share the benefit of these gains with the ratepayers by returning the value of the gains through the establishment of a regulatory liability that is amortized over a three year period. If this is done, then a 17% net salvage rate should be used to calculate the depreciation rate of the remaining assets in Account 390.[33] Otherwise, the net salvage value of 53% is the appropriate value.[34]

POINT OF ERROR NO. 10

The Order on Rehearing errs in overstating TCC's capital costs that results in an unreasonably high 7.50% rate of return.[35]

The 7.50% rate of return recommended by the Order on Rehearing overstates the rate necessary to reward shareholders and unreasonably burdens TCC ratepayers. Cities except to the Order on Rehearing's Finding of Fact 52-55, 63 and Conclusion of Law 18 and recommends that

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32 Direct Testimony of Nancy H. Hughes, Cities Ex. 4 at 52.

33 *Id.* at 25.

34 *Id.* at 25.

35 PFD at 37-59; Order on Rehearing, FoFs 52-55, 63; CoL 18.

the Commission grant rehearing and set a rate of return for TCC operations of 7.14%, including a return on equity (ROE) of 9.00%. Cities respectfully urge the Commission to grant rehearing and establish an overall rate of return of 7.14%. A rate of return of 7.14%, as reflected in the table below, suitably spans the twin dictates of the statute: it is sufficient to attract investors and capital while not awarding TCC shareholders more than a fair return on the adjusted value of the invested capital.[36]

Cities' Recommended Overall Cost of Capital[37]

Source of Capital	Capitalization Ratio	Cost Rate	Weighted Cost Rate
Long-Term Debt	60%	5.898%	3.539%
Common Equity	40%	9.000%	3.600%
Cost of Capital			7.139%

The Return on Equity Overstates TCC's Capital Costs

The Order on Rehearing recommends a ROE of 9.96% based upon an amalgamation of three different analyses from three different witnesses.[38] The effort to reach consensus among the different experts results in a ROE that exaggerates the perceived risk of TCC. The record evidence demonstrates that TCC does not require an inflated ROE to maintain financial integrity and attract investment capital. This evidence includes objective benchmarks, relied upon by Standard & Poor's, an unbiased, widely used bond rating service used by financial analysts, that:

- S&P's current bond rating for TCC is BBB. A 60% debt ratio falls squarely within S&P's requirements for a BBB-rated utility with a business risk ranking of 3.[39] According to S&P, a company like TCC, with a relatively low business risk rank of 3, can achieve a triple-B bond rating (TCC's current rating) with a debt ratio ranging from 55% to 65% of total capital. Cities' recommended (and AEP requested) 60% debt ratio, falls in the middle of that range.

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[36] PURA § 36.051.

[37] Direct Testimony of Stephen G. Hill, Cities Ex. 3 at 119.

[38] PFD at 53.

[39] Direct Testimony of Stephen G. Hill, Cities Ex. 3 at 119-20.

- Using Cities' recommended 9.00% return on equity, an overall return of 7.14% and Cities' rate base and depreciation recommendations, the Funds From Operations ("FFO") to interest ratio (FFO/interest) is 3.4x. For a utility with a business ranking of 3 like TCC, S&P's benchmarks indicate that an FFO/interest coverage ranging from 2.5x to 3.5x could attain an "A" bond rating. Given that the Company's current bond rating is "BBB," by this measure, a 9.0% ROE provides an opportunity for the Company to *improve* its financial position.[40]

- Another S&P benchmark is debt-to-capital. The debt-to-total capital ratio for TCC is 60%.[41] S&P indicates that for an "A" rating, a company with a business position of "3" should have a total debt to capital ratio ranging from 50% to 55%; and for a "BBB" bond rating that ratio can range from 55% to 65%. With this metric, TCC's 60% debt-to-capital ratio is appropriate for its current bond rating.

- S&P also indicates that, for a utility with a business risk profile of 3, a FFO/total debt ratio of 15% to 25% is the benchmark for an "A" rating. Cities' ROE recommendation affords the Company an opportunity to achieve an FFO/total debt ratio of 15%, which is the bottom of the "A" range, and at the top of the "BBB" range.[42]

The Order on Rehearing relies upon TCC's argument that its 60/40 debt-to-equity ratio presents greater financial risk than do debt-to-equity ratios nearer to 50/50 in order to justify approval of an inflated ROE. The Company's claim is premised on a TCC-created comparison of purported average equity ratios for the experts' comparable groups. However, because short-term debt levels have been excluded from the Company's common equity ratios, these "averages" provide an incomplete and inaccurate picture that does not support TCC's position or the Order on Rehearing's determination that 9.96% is a reasonable return on equity.[43] Developing an overall rate of return recommendation requires modeling the financial

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40 *Id.* To calculate the FFO for TCC, Mr. Hill multiplied Cities' recommended weighted equity return (3.600%) by Cities' recommended rate base for the Company's utility operations. Added to that are Cities' ratemaking estimates for the Company's depreciation and amortization, and deferred tax expenses. Interest expense is calculated by multiplying the weighted debt cost of the Company's long-term debt by Cities' recommended rate base. Adding that amount to FFO and dividing the total by the interest expense provides the FFO/interest coverage benchmark of 3.4x for TCC.

41 *Id.*

42 *Id.* at 45.

43 *Id.* at 40-41.

community's willingness to invest in a company.[44] Investors consider *all* forms of the Company's debt when evaluating a company's capital structure. Excluding short term debt from the common equity ratios of comparable companies precludes an honest assessment of the analysts' expectations.

Short-term debt is a significant portion of the capital structure for some of the comparable groups included in the record evidence. When short term debt is included in the analysis, the average common equity ratio for the electric industry is 44%.[45] In fact, it is likely that the 44% common equity ratio for the group is even *lower* because Cities' electric industry capital structure averages do not account for purchased power debt equivalents.[46] Purchased power obligations are relevant to the consideration of equity ratios since the contracts are viewed by the bond rating agencies to be off-balance sheet, debt-like commitments. This means that more debt is effectively added to the capital structure for integrated electric companies because of their purchase power obligations. TCC, as a pure TDU, is unencumbered by purchased power debt equivalents.

It is important that although TCC's financial risk is not appreciably different, the business risk of TCC's T&D operations is substantially lower than that of either the electric or gas industries and the sample groups used by experts in this case to estimate the cost of equity. Unlike the comparable electric companies considered in this case, TCC is not burdened by generation, purchased power, and provider of last resort ("POLR") risk. Similarly, because of energy trading businesses and POLR requirements, the comparable gas utilities studied in this

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44 Although Cities did not make a recommendation in this case to include short term debt in TCC's capital structure, it does not follow that excluding reported short term debt from the common equity ratios is appropriate for purposes of TCC's purported comparison.

45 Direct Testimony of Stephen G. Hill, Cities Ex. 3 at 101.

46 *Id.* at 40; Tr. at 1496, 1500 (Apr. 30, 2007).

case operate with substantial risks that do not affect or impair TCC. Standard & Poor's provides an objective measure of TCC's business risk relative to the business risk of the comparable electric companies in this case. The average S&P business risk ranking of the electric companies in Mr. Hill's comparable group is 5.6, while the S&P business risk ranking for TCC is 3.[47]

The experiences of TCC's parent company, AEP provide further evidence that TCC can maintain its financial integrity and attract investors with a 60/40 debt to equity ratio. For the past five quarters, AEP has maintained an average capital structure of 42.71% common equity, 0.28% preferred stock, and 57.01% total debt (long-term and short-term).[48] Like the other electric utilities in Mr. Hill's comparable group, AEP's consolidated operations include generation and other unregulated businesses in addition to its transmission and distribution functions. As a result, AEP is considered by financial analysts to be more operationally risky than TCC.[49] The fact that AEP, with greater business risk than TCC, maintains an investment grade bond rating with a 43% common equity ratio, supports the reasonableness of setting rates for the lower-risk TCC with a common equity ratio lower than 43%.

The ROE set by the Order on Rehearing is also flawed because it relies upon TCC's risk premium result.[50] A major problem with any risk premium analysis, which was underscored during the live testimony of Cities' witness Hill, is the extreme volatility of the data.[51] Reliance on Dr. Hadaway's risk premium analyses to justify an inflated ROE is not credible because it

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[47] Direct Testimony of Stephen G. Hill, Cities Ex. 3 at 40.

[48] *Id.* at 100 shows the capital structure of the consolidated operations of TCC's parent company, American Electric Power Company, over the past five quarters.

[49] *Id.* at 25-26. AEP has a current S&P Business Position rank of 5 (1=lowest risk; 10=highest risk), while TCC has an S&P Business Position rank of 3. TCC has lower business or operational risk.

[50] PFD at 55. Risk premium analyses are generally based on historical differences between equity returns and debt returns. Those average historical return differences, once calculated, are then added to current bond yields to produce an estimate of the current cost of equity.

[51] Tr. at 1513-15 (Apr. 30, 2007) (emphasis added).

requires the rather heroic assumption that investors currently expect the risk premium in the future to be *exactly* equal to that which has happened in the past. In fact, as Mr. Hill explained during the hearing, investors expect risk premiums (and, as a result, equity return requirements) to be **substantially lower** than historical averages indicate.[52] Recent economic research in the field of market risk premiums underscore the conclusion that investors do not expect the future to be exactly like the past.[53] This is substantiated by the unrebutted evidence that demonstrates historical utility earnings, dividend and book value growth rates are lower than GDP growth.[54] Finally, the Company presented no evidence to rebut the conclusion of the studies included in Mr. Hill's testimony -- that market risk premiums (the return investors require above Treasury Bonds) are currently about 4%-5%, not the 6.5%-7% evidenced in the historical data.

Cities urge the Commission to grant rehearing to approve Cities' ROE recommendation of 9.00% and an overall rate of return of 7.14% to appropriately reflect the moderate expectations for investor returns on utility stocks and the economic factors influencing investors' expectations. The record evidence supports Cities' recommended cost of capital as consistent with current economic conditions and adequate to support and improve the Company's financial position. It affords the Company an opportunity to achieve a pre-tax interest coverage level of 2.70 times ("x").[55] That level of pre-tax coverage exceeds the three-year average interest

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[52] Tr. at 1512-13 (Apr. 30, 2007).

[53] Workpapers of Stephen G. Hill, Cities Ex. 3A at 77-97. Fama, E., French, K., "The Equity Premium," *The Journal of Finance*, Vol. LVII, No. 2, April 2003, at 637-659; Ibbotson, R, Chen, P., "Long-Run Stock Returns: Participating in the Real Economy," *Financial Analysts Journal*, January/February 2003, at 98-99; Dimson, March, Staunton, "Risk and Return in the 20th and 21st Centuries," *Business Strategy Review*, 2000, Volume 11, Issue 2, at 43-60; Seigel, J., *Stocks for the Long Run, A Guide to Selecting Markets for Long-term Growth* (Irwin Professional Publishing, Chicago, IL, 1994, at 11-15; Graham, Harvey, "The Equity Risk Premium in January 2007: Evidence From the Global CFO Outlook Survey," Duke University, 2007).

[54] Direct Testimony of Stephen G. Hill, Cities Ex. 3 at 121.

[55] *Id.* at 7.

coverage (2.36x) achieved by TCC's parent, AEP, even though AEP has a higher risk profile than TCC.[56]

POINT OF ERROR NO. 11

The Order on Rehearing errs in failing to find that cost of service for labor expenses should be reduced by $1,140,606 for the AEPSC charges allocated to TCC for distribution.[57]

Cities disagree with the Commission's decision to not reduce the Company's cost of service by $1,140,606 representing a modification of the amount AEPSC charges to TCC for distribution related costs and urge the Commission to grant rehearing to amend its decision. The issue is one of the Company failing to meet its burden of proof. While no one disputes that in an organization as large as AEPSC, there is constant change, however, that fact alone is insufficient under PURA to meet the Company's burden of proof that the charges under scrutiny are just and reasonable. The evidence is clear that the burden has not been met regarding these costs.

The Company's rationale for transferring the 160 AEPSC employees to TCC in its direct case was that most of their time was devoted to TCC matters. Cities' adjustment of removing one-half of the costs associated with these employees was based on the timing of the transfer (December 2005, one half of the test year). Cities accepted the Company's rationale that the transfer made sense because these employees were spending most of their time on TCC matters. Cities' assumption that the employees were spending most of their time on TCC matters was based on TCC's evidence and it was the Company's rationale for transferring them. Instead of following this logic, the Order on Rehearing, adopting the PFD, uses it to deny Cities' adjustment.

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[56] *Id.* Because AEP owns generation operations, independent power production and coal transportation operations, it has a higher risk profile than TCC, a pure transmission and distribution ("T&D") company. With an average pre-tax interest coverage level of 2.36x, AEP has maintained a "BBB" investment-grade bond rating.

[57] Order on Rehearing at 11, FoF 72; Order on Rehearing at 23, CoL 23.

Another error is the acceptance of Company witness Hamlett's upward adjustment for additional AEPSC employees of $177,000. This adjustment was made by the Company's rebuttal case and should not be allowed. It was known when the case was filed in the fall of 2006 and should have been part of that filing. The parties opposing the Company were denied the opportunity to have adequate discovery on this change made at such a late date. For instance, there is no evidence as to what portion of these additional AEPSC employees' time was devoted to TCC. The Company has the burden of proof and should not be allowed to profit from this type of adjustment that was known prior to the filing of the case.

POINT OF ERROR NO. 12

The Order on Rehearing errs in failing to find that cost of service for group insurance expense should be reduced by $366,979 for distribution and $78,879 for transmission.[58]

Cities disagree with the Commission's decision to not reduce the Company's cost of service by $366,979 for distribution and $78,879 for transmission to comply with P.U.C. Subst. R. 25.231(b) and urge the Commission to grant rehearing to amend its decision. Under the rule, P.U.C. SUBST R. 25.231(b), group insurance expense must be based on the historical test year, as adjusted for known and measurable changes. The Order on Rehearing, following the PFD, accepts the Company's annualization of a single month, June 2006, rather than using the test year as required by the Commission's rules. The PFD, relied on and adopted by the Order on Rehearing, concluded that this breach of the Commission's mandatory rules is justified because the difference is only $236,000 from the test year.[59] The magnitude of the difference cannot override the rule.

[58] Order on Rehearing at 12, FoF 83; Order on Rehearing at 21, CoL 9.

[59] PFD at 104-106.

There was a finding that the Cities' adjustment was not properly calculated.[60] This conclusion is categorically in error. Cities' calculations began with the expense amounts and the actual capital/expense ratios for the months June 2006 through November 2006. (September was eliminated as being unrepresentative.) The results were then annualized using this five month period. On the other hand, the Company took expenses from a single month, June 2006, and annualized that amount, then used the test year ratios to arrive at their number. Cities' believe that the Company's approach overstated the amount and is not representative of the future. The Company's capital/O&M ratios change over time. The most recent six months will be more representative of the future than the ratios from 2005 and the first half of 2006 used by the Company. The Cities' calculations are not "wrong" as the Company alleges. In fact they are mathematically accurate, and more representative of future costs as they used five times as many months for calculating the expense amount as well as the actual ratios from a more recent period. By using known and measurable changes (actual months beyond the test year) Cities' methodology is consistent with the rules. Cities are recommending that group insurance expense be reduced by $366,979 for distribution and by $78,879 for transmission. Cities recommend that in this case the level of group insurance costs be based on actual costs incurred for the period June 2006 through November 2006.

The Company is requesting group insurance and savings plan costs[61] based on the single month of June 2006 annualized and expensed at the average expense ratio developed for the test year. Due to the fluctuations in monthly expense, as well as the fluctuations in the fringe benefits loading factors, using the single month of June 2006 is inappropriate and

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[60] *Id.* at 106.

[61] Cities argument on Savings Plan Expense follows in the next Point of Error.

unrepresentative of costs going forward. Additionally, test year actual expenses are not necessarily representative as the number of eligible employees has changed significantly during the test year. The use of the most recent information subsequent to the test year is most representative of costs going forward.

Based on the Company's response to Cities RFI 18-17, Cities annualized the group insurance costs and the savings plan costs for the period June 2006 through November 2006. These costs better reflect the costs going forward for employees as of the end of the test year.

In addition, using the same period to annualize the amount of group insurance that is noted as capitalized, rather than using the average capitalization ratio for the test year is appropriate. The actual fringe benefits loading by month is more accurate than the average computed from the test year.

Finally, with respect to the savings plan, Cities' witness Cannady eliminated the data from the month of September 2006 in her computations. This was done because the data for September 2006 appeared to be unrepresentative of any month under review. Her annualization of savings plan expense is based on an actual five months of data rather than the six months of data used for the group insurance cost analysis.

It is also in error for the Order on Rehearing to accept the PFD's finding that the amount is de minimus.[62] The Company annualized the June 2006 amount per books.[63] The Company took this approach, not because it was representative, but rather because it resulted in the largest adjustment based on other periods.[64]

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[62] PFD at 106.

[63] TCC Initial Brief at 84 (May 31, 2007).

[64] TCC Response to Cities RFI 18-19, Cities Ex. 9.

Although the Company accuses Cities of going outside the test year because that would reduce the costs included in the cost of service,[65] the opposite is true. For transmission, Cities' recommendation of $502,485 is actually a 9% increase to the test year amount. This compares to the Company's request for a 26% increase. For distribution costs, the Cities' proposal results in a 29% increase (primarily due to increased employees) compared to the Company's request for a 40% increase. The Cities' position was, and is, that the most recent data results in this cost item with the most representative figures going forward. It is, in fact, the Company who wants to use the data resulting in the highest adjustment, regardless of whether it is the most representative.

POINT OF ERROR NO. 13

The Order on Rehearing errs in failing to find that cost of service for savings plan expense should be reduced by $190,754 for distribution and $17,903 for transmission.[66]

Cities disagree with the Commission's decision to not reduce the Company's cost of service by $190,754 for distribution and $17,903 for transmission to comply with P.U.C. SUBST. R. 25.231(b) and urge the Commission to grant rehearing to amend its decision. This issue is related to the previous argument. The Order on Rehearing adopts the PFD that incorrectly accepted the Company's annualization of a single month, June 2006, rather than using the test year with known and measurable changes.

The Cities' evidence recommended a decrease of $190,754 for distribution and $17,903 for transmission. The PFD erred in accepting the Company's argument that the Cities' calculation was incorrect. Even accepting the Company's argument that September 2006 had three pay periods and excluding it skews the result, the Cities' result is still more close in time to

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[65] Rebuttal Testimony of Randall W. Hamlett, TCC Ex. 78 at 47.

[66] Order on Rehearing at 12, FoF 84; Order on Rehearing at 21, CoL 9.

the future and contains more months for determining the average than using just one month, June 2006, as the Company did.

The Company's argument that the Cities' adjustment would result in a number greater than the Company's request is in error. There is no record evidence to support the use of a single month as being more representative than the Cities' use of the June-November, 2006 period.

POINT OF ERROR NO. 14

The Order on Rehearing errs in failing to find that cost of service for postretirement benefits (OPEB) expense should be reduced by $866,264.[67]

POINT OF ERROR NO. 14A

The Order on Rehearing errs in failing to find that cost of service for postretirement benefits (OPEB) expense should be reduced by $564,736 related to former generation company employees.[68]

POINT OF ERROR NO. 14B

The Order on Rehearing errs in failing to find that cost of service for total postretirement benefits (OPEB) expense should include $5,632,673 as just and reasonable.[69]

Cities disagree with the Commission's decision in the aforementioned three (3) Points of Error to not reduce total OPEB to $5,632,673 in the Company's cost of service based upon the fact that in order to recover costs those expenditures must be reasonable and necessary to the provision of utility service and that the Order on Rehearing incorrectly accepts the Company's position that the terms "post retirement" and "post employment" are synonymous and interchangeable. Such a finding violates both GAAP and the Financial and Accounting

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[67] Order on Rehearing at 12, FoF 86; Order on Rehearing at 22, CoL 12; Order on Rehearing at 23, CoL 25.

[68] Order on Rehearing at 12, FoF 87; Order on Rehearing at 22, CoL 13.

[69] Order on Rehearing at 12, FoF 88; Order on Rehearing at 22, CoL 12; Order on Rehearing at 23, CoL 25.

Standards Board (FASB) rules. Cities request that the Commission grant rehearing to amend its decision.

Substantive Rule 25.231(b)(1)(H), defining OPEB as postretirement benefits other than pensions, does not allow cost recovery to the extent that those costs are not found to be reasonable and necessary to the provision of utility services. Benefits to TCC's former generation employees cannot be recovered from current TCC ratepayers under this section except to the extent allowed by law. The law allows collection of former generation employees post employment costs, including pensions, under PURA § 36.065(a). This statute requires these costs to be included in the utility's cost of service under GAAP. It does not allow recovery of postretirement costs.

The terms "post employment" and "post retirement" have different meanings under GAAP and the FASB. They are not interchangeable. The "Author's/Sponsor's Statement of Intent," relied upon by the PFD, and accepted by the Order on Rehearing, cannot change GAAP. The author's intention filed with this piece of legislation cannot change GAAP, but must operate in conformity with GAAP. What the Order on Rehearing does is have Substantive Rule 25.231(b)(1)(H) change GAAP and PURA § 36.065. That it cannot do.

The definition of post employment benefits according to SFAS 112 is "benefits provided by an employer to former or inactive employees after employment but before retirement (referred to in this Statement as *postemployment benefits).*"[70] By contrast, post retirement benefits are addressed by, defined by, and determined in accordance with SFAS 106, and include those benefits provided by an employer to former employees after retirement. The terms "post employment" and "post retirement" are not interchangeable in GAAP and there is no overlap

[70] Direct Testimony of Lane Kollen, Cities Ex. 1 at 35; *see* Cities Ex. 22.

between the post employment benefits computed pursuant to SFAS 112 and the post retirement benefits computed pursuant to SFAS 106.[71]

It is especially inappropriate to grant TCC this recovery when the Company had two perfectly legitimate alternatives in which to recover these costs, and disregarded both alternatives. Neither would have compromised GAAP or the law as the PFD attempts to do. The Company could have sought recovery of this cost in the stranded cost true-up proceeding or transferred the liability to the purchaser(s) of its generation assets. It did neither. Instead, the Company continues to use this tortured and convoluted reasoning to include these costs in distribution and transmission rates, in express contradiction to GAAP and the Commission's rules requiring adherence to GAAP.

POINT OF ERROR NO. 15

The Order on Rehearing errs in failing to reduce Company cost of service for energy efficiency programs to $5,556,847.[72]

Cities disagree with the Commission's decision to not reduce the Company's cost of service for energy efficiency programs to $5,556,847 because the Company's costs violate P.U.C. SUBST. R. 25.181(i)(7) and urge the Commission to grant rehearing to amend its decision. In pertinent part, P.U.C. SUBST. R. 25.181(i)(7) states: "[f]unds for achieving the energy efficiency goal will be included in each utility's transmission and distribution rates."

The Cities' position is that the rule means what it says, that is, a utility can recover the costs it spent for that part of the energy efficiency goal it actually achieved. Conversely, it cannot recover funds it spent for programs that provide no results. In contrast, under the Order on Rehearing's acceptance of the PFD on this issue, a company could spend millions of dollars,

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71 *Id.* at 35.

72 Order on Rehearing at 13, FoF 94; Order on Rehearing at 24, CoL 32.

meet none of its goals, and still the Commission is required to let it recover all of those costs. Ratepayers should not be forced to pay for programs that do not achieve energy savings. Cities' interpretation is correct, sends the appropriate price signal to the Company, and insures that frivolous or nonproductive projects are not undertaken.

Nor is the "reason" the goals were not met sufficient to impose collection of the costs on the ratepayers, as the PFD states.[73] Regardless of the reasons the goals were not met, the costs should not be recovered unless there is a corresponding benefit received by the ratepayers. The law does not allow cost recovery based upon "good intentions," but rather imposes a requirement that the cost be necessary in providing electric service to the customers. Again, allowing recovery of costs for nonproductive programs hurts ratepayers, while tying recovery of the costs to results properly incentivizes the Company to fund those programs that actually work.

POINT OF ERROR NO. 16

The Order on Rehearing errs in failing to find that the Company's adjustment for creation of ETT is not reasonable.[74]

POINT OF ERROR NO. 16A

The Order on Rehearing errs in finding that the Company is exiting the third party construction business and therefore its miscellaneous revenues should be reduced to $789,714.[75]

POINT OF ERROR NO. 16B

The Order on Rehearing errs in finding that the Company's adjustment to miscellaneous revenues to account for the decrease in third-party revenues is reasonable, known, and measurable.[76]

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73 PFD at 127.

74 Order on Rehearing at 11, FoF 80; Order on Rehearing at 24, CoL 31.

75 Order on Rehearing at 15, FoF 117; Order on Rehearing at 24, CoLs 31 and 33.

76 Order on Rehearing at 15, FoF 118; Order on Rehearing at 24, CoLs 31 and 33.

Cities disagree with the Order on Rehearing finding that TCC's adjustment for the creation of a new affiliate, ETT, was reasonable; and that TCC's reduction in its miscellaneous revenues from $3.3 million to $789,714 was reasonable and known and measurable, and urge the Commission to grant rehearing to amend its decision. A review of the evidence demonstrates that the Cities recommendation to input revenues is not speculative and is supported both by the Commission's rules and the prior orders of the Commission.

Under the Commission's rules, the $3.3 million in margins earned by TCC in the test year are required to be booked as an offset against TCC's revenue requirement. Because TCC will be providing the same services it currently provides to LCRA, the $3.3 million earned by TCC in the test year for third party construction services is properly included as a credit against the rate base under P.U.C. SUBST. R. 25.342(f)(1)(D).

A further review of the facts supports the Cities' recommendation. TCC performed construction services for third parties during the test year, earning margins totaling $3.3 million. The amount is properly included as a credit against the rate base in this docket because TCC will continue to provide construction services for a third party, its affiliate ETT.[77]

TCC asserts that there is no connection between ETT and the LCRA JDA.[78] The connection between the two, however, is striking and undeniable. ETT proposes to perform the same services that TCC currently performs for LCRA.[79] The only difference stated by the Company is that by performing the services for an affiliate, ETT, it can redirect all profits gained from the services from TCC to the affiliate, ETT.

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[77] Tr. at 1756 (May 1, 2007).

[78] TCC Initial Brief at 121 (May 31, 2007).

[79] Tr. at 1756 (May 1, 2007).

Regardless of whether a connection exists, the rule does not contemplate TCC choosing which services constitute "other services" and which do not. In the docket referenced by TCC, Docket No. 28840, TCC urged that construction services for third parties be considered "other services," while Cities opposed such classification. Nevertheless, the Commission found that construction services performed for third parties, as well as operation and maintenance activities for third parties, were "other services" under P.U.C. SUBST. R. 25.342(f)(1)(D) and included the net revenues received from such services as a credit against the revenue requirement.[80] TCC now seeks to reclaim the card it already played. On the contrary, the same treatment should be afforded to TCC's third party services to ETT, as was afforded, at TCC's request, in Docket No. 28840.

The PUC rule is concerned with maximizing value.[81] Switching from currently providing services for a profit to providing them at cost fails to maximize the value of ratepayers' assets. In fact, it is TCC's attempt to use assets, both equipment and personnel, it did not pay for to earn a profit for its affiliate instead of a profit for its ratepayers. This result is unjust and against the spirit of the Commission's rule. Ratepayers deserve to earn margins when the assets they paid for are used for a purpose other than to support TCC. Not only do customers deserve such treatment, it is the treatment provided for in the Commission's rule.

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80 PUC Docket No. 28840, Final Order at 42, FoF 207.

81 P.U.C. SUBST. R. 25.342(f)(1)(D)(1).

POINT OF ERROR NO. 17

The Order on Rehearing errs in failing to increase the CTSA allocated to TCC by $766,000.[82]

Cities disagree with the Order on Rehearing's determination that the Consolidated Tax Savings Allocation ("CTSA") methodology of the Company is the correct one to use, and with the determination of the amount produced by that methodology, and urge the Commission to grant rehearing to amend its decision to increase CTSA by $766,000.

The ALJs' expressed concern that use of the TCC methodology produces very low allocation factors for the years 2002-2005.[83] This is more than a valid concern, it is part of the reason TCC's methodology should be rejected in this case. The Company's computation of transmission and distribution taxable income is fundamentally flawed and therefore unreliable.[84] Clearly, the Commission cannot, and should not, rely on the Company's computation. Cities recommend that the Commission use either the method proposed by the Cities or by OPC. A review of the facts will illustrate this point.

First, the evidence shows that the 2002-2005 allocation factors were 4.43% in 2002, 0% in 2003, 0.48% in 2004, and 3.06% in 2005. These annual allocations of the CTSA to distribution and transmission for the years 2002-2005 compare to the 24.30% allocations to those functions prior to 2002. Consequently, the ALJs' expressed concerns about the Company's methodology are well grounded.

Although the Company's computation (accepted by the ALJ) generally is consistent with the methodology used by the Commission in Docket No. 28840, there exists a continuing

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82 Order on Rehearing at 16, FoF 120; Order on Rehearing at 21, CoL 9.

83 PFD at 159.

84 Direct Testimony of Lane Kollen, Cities Ex. 1 at 52-53.

problem involving the allocation of the Company's CTSA to the transmission and distribution functions for the years subsequent to 2001. The Company failed to fix the 2002 percentage allocation to transmission and distribution for the years 2003 through 2005 in the same manner that it fixed the percentage allocations to transmission and distribution between rate cases for the years prior to 2002.

The Cities' calculation methodology was erroneously rejected by the ALJs, citing Company testimony that the income differences reported between the Company tax return and its FERC Form 1 were explainable. Cities do not dispute that some differences can exist. But a look at the facts shows such huge differences that that methodology should not be used for allocation purposes. For the years 2002-2005, the Company's methodology resulted in phenomenally high generation taxable income and phenomenally low transmission and distribution taxable income for those four years as reflected on Bartsch Exhibit JBB-2.[85] A review of the results demonstrates that they are not reasonable and cannot be relied on to determine the portion of the total Company CTSA that should be allocated to distribution and transmission. For example, in 2005, the Company's methodology resulted in generation taxable income of $260.279 million, which greatly and inexplicably exceeded the total generation revenues that year reported in the Company's FERC Form 1 filing of $177.572 million. In addition, the total Company revenues the Company used to compute generation taxable income (total Company taxable income less the proforma transmission and distribution taxable income) are far greater than the total revenues reported in the FERC Form 1 filings for each of the years 2002-2005.[86] The following table illustrates these differences.

[85] Direct Testimony of Jeffrey B. Bartsch, TCC Ex. 41.

[86] *See* Direct Testimony of Lane Kollen, Cities Ex. 1 at 45-56.

AEP Texas Central Company
Comparison of Total Company Revenue
($ Millions)[87]

	Tax Returns	Form 1	Difference	% Difference
2002	1,893	1,600	293	18.3%
2003	2,132	1,655	477	28.8%
2004	1,649	1,090	558	51.2%
2005	894	677	217	32.0%

While there can be some differences between per books revenues and taxable revenues, these differences as shown above are of unusually great magnitude and the differences are allocated in their entirety under the Company's methodology to the generation function. Thus, the allocation of taxable income and the CTSA to the generation function is inordinately high and the allocations to the transmission and distribution functions are almost eliminated.[88]

The Cities urge that when the differences are as great as those in this case, TCC's methodology should not be used as the basis for an allocation between generation and T&D functions. This is especially true when, as in this case, there is no evidence explaining what those differences are, and why those differences are so far out of the previous years' experiences.

Cities witness Kollen recommended an alternative allocation methodology that avoids the demonstrated problems in the Company's allocation methodology for the years 2002-2005. Cities recommend that the Commission use net plant to allocate the total Company CTSA to the distribution and transmission functions instead of the Company's methodology for the years 2002-2005. Net plant is a reasonable proxy for the Commission's rate base functional allocation methodology used for the years prior to 2002 and, while not perfect, the net plant allocation factor does not suffer from the problems evident in the Company's methodology for these years. Using a net plant allocation factor based on the 2002 FERC Form 1 functional plant accounts

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87 *Id.* at 54.

88 *Id.* at 53-54.

results in an allocation of 46.60% to the transmission and distribution functions. This net plant allocation factor compares more closely and more reasonably to the net rate base functionalization of 38.16% based on the Company's filing in the Docket No. 22352 UCOS proceeding that unbundled its rates. In addition, this allocation is more realistic given that the Company is no longer in the generation business except for its remaining interest in the Oklaunion plant.[89]

The Cities recommendation would result in an increase in the Company's quantification of the CTSA of $10.979 million (combined distribution and transmission) using the net plant allocation factor for the years 2002-2005.[90]

The Company's recomputation of the allocation to transmission and distribution every year for the years 2002-2005 is internally inconsistent with the use of the same functional allocation factor for multiple years in the years prior to 2002. In other words, once the functional allocation was computed in a rate case, then it remained unchanged until it was recomputed in a subsequent rate case. As a matter of consistency, the Company should have used the 2002 functional allocator computed in Docket No. 28840 for all years after 2002 through 2005. The functional allocation should be a non-issue after 2005 because the Commission should direct that a 100% transmission and distribution functional allocation factor be used thereafter.[91]

When this problem is corrected, it will increase the CTSA by $0.766 million over the Company's quantification. It should be noted, however, that this correction is unnecessary if the Commission adopts Mr. Kollen's recommendation to use the net plant allocation factor for the years 2002-2005.

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[89] *Id.* at 54-55.

[90] *Id.* at 55 and at Schedule 4; *see* Tables 1 and 2 at 7 and 8.

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

POINT OF ERROR NO. 18

TCC's proposed municipal franchise fee rider (Rider MFFA-C) should have been approved.

The Order on Rehearing denies TCC's requested Rider MFFA-C on the basis that implementation of Rider MFFA-C would lead to complex, non-uniform rates throughout the TCC footprint and would result in confusion.[92]

However, the Order on Rehearing fails to recognize that Rider MFFA-C simply embodies the existing statutory authority of municipalities and utilities to negotiate a new franchise fee and the ability of cities to direct that it be collected from ratepayers within their jurisdiction -- that is, within the municipal boundary. Rejecting the rider based on the supposed complexity that would result, overlooks this statutory scheme.

As Cities described in their initial post-hearing brief and exceptions to the PFD, the ability of municipalities and utilities to set and recover municipal franchise fees is clearly set forth in PURA. Cities have the statutory authority to impose a franchise fee on an electric utility that provides distribution service in the city in exchange for the city allowing the utility to use municipal streets, alleys, or other public ways in providing that service.[93] PURA also gives cities the authority to negotiate an increased franchise fee with the relevant utility.[94] In turn, the franchise fee established by a city is to be considered a reasonable and necessary operating expense of each electric utility, and thus may be recovered in the utility's rates.[95] Finally, PURA

[92] Order on Rehearing at 18, FoFs 149 and 150.

[93] PURA § 33.008(a).

[94] PURA § 33.008(f).

[95] PURA § 33.008(c).

establishes that the governing body of a municipality has exclusive original jurisdiction over the rates of an electric utility that are charged within the municipal boundary.[96]

As Cities have noted in their Initial Brief and Exceptions,[97] the end result produced by Rider MFFA-C and the statutory regime just described is identical: cities may negotiate franchise fee arrangements with utilities, and utilities may then charge a rate to recover a city-specific franchise fee from ratepayers within that city. TCC's proposed Rider MFFA-C would do nothing to change the abilities of municipalities and TCC to address franchise fee issues.

Contrary to the Order on Rehearing's conclusion, a rejection of Rider MFFA-C holds the potential to inject *greater* confusion and complexity into the market. The rider would have specified exactly how charges under the rider are calculated, and for what city. This information would have appeared in the company's tariff manual. For these reasons, the transparency and simplicity of T&D charges are best served by approving Rider MFFA-C.

III. CORRECTIONS

Order on Rehearing makes no findings regarding outage repair deadline – municipal street lighting and non-roadway lighting.

Cities request that the Order on Rehearing be corrected to reflect TCC's commitment to repairing street and other lighting within three days, a commitment which the Order on Rehearing fails to memorialize.

In its direct case, TCC proposed to modify its tariff manual to permit it two more days to repair street and other lighting under its Municipal Street Lighting and Non-Roadway Lighting

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96 PURA § 33.001(a).

97 Cities' Initial Brief at 110-112 (May 31, 2007); Cities' Exceptions at 44-45 (Sept. 20, 2007).

Service tariff schedules.[98] This amendment would have extended the deadline by which the Company must repair lighting outages from three to five days.[99]

Cities' witness Scott Norwood testified that this modification was not warranted and raised significant public safety issues for municipalities.[100] Mr. Norwood also noted that, in recent years, the Company had successfully met the three-day repair deadline stated in its current tariffs.[101] In rebuttal testimony, TCC witness Jennifer Jackson agreed to maintain the current three-day repair deadline for both lighting schedules, and suggested that the Company's proposed tariff schedules be changed accordingly.[102]

However, the Order on Rehearing does not include any findings regarding this issue. Cities therefore request that the Order on Rehearing be corrected to adopt TCC's commitment to a three-day outage repair deadline for service under the Municipal Street Lighting and Non-Roadway Lighting Schedules.

IV. CONCLUSION

Cities respectfully request that the Commission grant rehearing and amend the Order on Rehearing as described in this pleading. Further, Cities' request any further relief to which they are entitled.

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98 Direct Testimony of Jennifer L. Jackson, TCC Ex. 45 at 44.

99 *Id.*

100 Direct Testimony of Scott Norwood, Cities Ex. 2 at 12-13.

101 *Id.* at 12.

102 Rebuttal Testimony of Jennifer L. Jackson, TCC Ex. 94 at 14; Rebuttal Testimony of Charles R. Patton, TCC Ex. 77 at 16-17.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing document was transmitted by e-mail, fax, hand-delivery and/or regular, first class mail on this 24th day of March 2008 to the parties of record.

Thomas L. Brocato