Rec. Number	Recommendation	Priority	Benefits	Level of Effort
	owning and operating the Hunt-Collin facility which are related to the Farmersville Agreement based on the direct labor hours which are incurred to maintain and operate the Farmersville system. (Refers to Finding IV-10)		interests	
IV-7	Allocate IT investment costs related to NewCorp and the Farmersville Agreement. (Refers to Finding IV-11)	B	Protect ratepayer interests	Nominal
V-1	Improve documentation of accounting procedures and the systems of internal controls. (Refers to Finding V-2.)	B	Improved internal control	Moderate
V-2	Develop a long-range financial forecasting process. (Refers to Finding V- 4.)	B	Protect ratepayer interests	Moderate
V-3	Correct the FERC basis accounting for employee uniforms and postage and bill processing costs. (Refers to Finding V-6.)	C	Protect ratepayer interests	Nominal
V-4	Develop reports that will analyze revenue and expenses trends by FERC account. (Refers to Finding V-8.)	C	Protect ratepayer interests	Nominal
V-5	Initiate a comprehensive cash management improvement program. (Refers to Finding V-10.)	B	Protect ratepayer interests	Moderate
VI-1	Update the IT Disaster Recovery Plan to reflect the in-sourcing of IT services, and include IT applications in addition to Oracle Financials and Customer Watch. (Refers to Finding VI-1.)	A	Protect ratepayer interests	Nominal
VI-2	Develop a long-term IT plan that considers known and anticipated changes in technology and changes in both internal and external customer requirements. (Refers to Finding VI-3.)	B	Protect ratepayer interests	Moderate
VI-3	Confirm the economic value of the materials management	C	Protect ratepayer	Nominal

Rec. Number	Recommendation	Priority	Benefits	Level of Effort
	outsourcing arrangement. (Refers to Finding VI-4.)		interests	
VI-4	Formalize training programs and update human resource (HR) policies as recommended in the Hay Study Report. (Refers to Finding VI-7.)	B	Appropriate documentation	Nominal
VI-5	Develop plans to address the aging workforce. (Refers to Finding VI-9.)	B	Protect ratepayer interests	Moderate
VI-6	Improve the methodology for allocating corporate costs to NewCorp, including the adjustment for differences between budget and actual. (Refers to Finding VI-10.)	B	Protect ratepayer interests	Nominal
VII-1	Formalize the existing informal customer service policies and procedures to ensure consistent treatment for all customers regardless of the division or customer service representative. (Refers to Findings VII-2, VII-11, VII-12 and VII-13.)	B	Protect ratepayer interests	Moderate
VII-2	Develop and implement a formalized training program for customer service representatives. (Refers to Finding VII-4.)	B	Protect ratepayer interests	Moderate
VII-3	Implement a formal customer survey process. (Refers to Finding VII-6.)	B	Protect ratepayer interests	Moderate
VII-4	Implement a system that provides automated quality of service results for call handling by the customer service representatives. (Refers to Finding VII-7.)	C	Protect ratepayer interests	Nominal
VII-5	Make appropriate modifications to the customer accounting system. (Refers to Finding VII-10.)	B	Protect ratepayer interests	Moderate
VII-6	Review opportunities to automate the bill collection process.	B	Protect ratepayer	Moderate

Rec. Number	Recommendation	Priority	Benefits	Level of Effort
	(Refers to Finding VII-12.)		interests	
VII-7	Study un-collectibles to determine whether the level should be reduced to be more consistent with CRE's write off experience. (Refers to Finding VII-13.)	B	Protect ratepayer interests	Nominal
VIII-1	Add staff resources to the power procurement function to increase analytical capabilities. (Refers to Finding VIII-4.)	B	Protect ratepayer interests	Nominal
VIII-2	Perform a comprehensive market analysis of the electricity market situation in Texas and the implications it has for the Company. (Refers to Finding VIII-7.)	A	Protect ratepayer interests	Moderate
VIII-3	Develop databases that would allow the Company to analyze and match power supply and retail customer usage characteristics. (Refers to Finding VIII-8.)	B	Protect ratepayer interests	Moderate
IX-1	Formalize and document electric distribution business practices across all divisions. (Refers to Finding IX-10.)	B	Protect ratepayer interests	Moderate

A. BACKGROUND

This chapter discusses our diagnostic review of Cap Rock's executive management and organization area. It covers the structure and function of Cap Rock's senior management and its relations to Cap Rock's Board of Directors. The review explored how effective executives are at identifying opportunities and problems and bringing the appropriate resources to bear on these issues.

Cap Rock Energy (the Company, Cap Rock or CRE) is engaged in the transmission and distribution of electricity in various rural areas in Texas. The Company, headquartered in Midland, Texas, operates a distribution business, and its subsidiary, NewCorp Resources Electric Cooperative, Inc. (NCR) operates a transmission business. The Company served approximately 35,764 active meters in 28 counties in Texas as of June 30, 2007. CRE is a wholly-owned subsidiary of Cap Rock Holding Corporation (Holdings) and has approximately 143 employees. CRE has three executive officers:

- President and Chief Executive Officer (CEO) and Chief Financial Officer (CFO)
- Executive Vice-President and Chief Operating Officer (COO)
- Executive Vice-President and General Counsel.

Holdings was formed in November 2005 by affiliates of Lindsay Goldberg LLC (collectively, Lindsay Goldberg) for the sole purpose of acquiring CRE. Lindsay Goldberg and CRE management (current and retired) own 90 percent of the stock of Holdings. Holdings, in turn, owns 100 percent of the stock of CRE. Lindsay Goldberg is a private-investment firm and the stock of CRE is not publicly traded. The Board of Directors (Board) of CRE consists of three representatives of Lindsay Goldberg and two outside directors. Both outside directors are former senior executives of Texas electric utilities.

In February, 2007, Holdings announced that it was acquiring SEMCO, a large gas distribution company with over 400,000 customers in Michigan and Alaska. This acquisition closed on November 9,, 2007. Since the acquisition was not completed until after our field work, we did not review its effect on CRE operations and finances. However, CRE indicated that it expected minimal effect on its operation due to the different nature and the geographical location of SEMCO's businesses.

B. OBJECTIVE

In this area, we reviewed Cap Rock's executive management and organization. In accord with the RFP, we identified opportunities to improve internal auditing.

C. EVALUATIVE CRITERIA

In conducting our review of executive management and organization, we were guided by the following evaluative criteria:

- Is Cap Rock properly organized to meet the needs of its customers?
- Is Cap Rock's corporate governance structure effective in meeting the needs of its ratepayers?
- Does an appropriate internal control environment exist at Cap Rock?
- Does Cap Rock have effective ethics and conflict of interest policies and enforcement?
- Is the short and long-range goal setting and corporate planning process sufficiently robust and responsive to meet the challenges facing Cap Rock?
- Are Cap Rock's executives compensated fairly in light of their responsibilities and consistent with industry practices?

D. WORK TASKS

During the diagnostic review of Cap Rock's Executive Management and Organization, we examined publicly available information and data request responses provided by Cap Rock. We also conducted interviews with the three top executives of Cap Rock and three of the five members of Cap Rock's Board of Directors, including the two outside directors.

E. FINDINGS AND CONCLUSIONS

1. Cap Rock is properly organized to meet the needs of its customers.
    - The senior management team consists of three individuals who have clearly defined responsibilities – the president and chief executive officer (CEO), the executive vice president and general counsel (general counsel), and the executive vice president and chief operating officer (COO).
    - The CEO, who also serves as the chief financial officer (CFO), has five direct reports including the general counsel, the COO, the controller, the director of information technology and the director of people services.
    - Reporting to the COO are the director of customer services and the systems manager.
    - The director of resource and regulatory administration, who is responsible for negotiating and managing purchased power contracts and marketing, reports to the general counsel.

2. Holdings' Board consists of three representatives from its principal owners and two former senior executives of Texas electric utilities

    - Holdings' Board is comprised of an experienced group of individuals who have the appropriate skills and background to oversee CRE's operations. The Board consists of five members, all of whom are non-management directors.
    - While Holdings' Board does not include any members of CRE's management, it includes three representatives from Lindsay Goldberg, its principal owner. The other two members of the Board are experienced former senior executives of two Texas utilities. This arrangement assures that the entire Board has the input of two knowledgeable people on critical utility operational and financial issues.
    - The composition of the Board is appropriate for a utility owned by a private investment firm.
    - While the Board does not have an Audit Committee, the full Board includes the two outsiders who both have served as chief financial officers of electric utilities.

3. Cap Rock's corporate governance structure is effective in meeting the needs of its ratepayers.

    - The Board has quarterly meetings which are attended by the three members of senior management. Prior to each meeting, board members are provided a detailed and comprehensive package of financial and operating information about Cap Rock.
    - The chairman of the Board is the lead member from Lindsay Goldberg. Due to the size of the Board and Holdings non-public status, it does not have any committees.
    - The Board's principal objectives are to monitor financial results and to ensue that Cap Rock is meeting the needs of its customers and complying with regulatory requirements.

4. Holdings does not have an audit committee on its Board of Directors nor does it have an internal audit department.

    - Cap Rock's current size makes it impractical and non-economic to have either an audit committee on the Board or an internal audit department.
    - Cap Rock's first financial; audit for its new owners was performed by a Big Four public accounting firm. Cap Rock did not receive a management letter from its external auditor for the 2006 fiscal year audit. According to the audit firm's partner-in-charge of the audit, this is a common practice for the firm's non-publicly-owned clients. In a telephone interview with the audit partner,

he indicated that the firm found "no material weaknesses in internal control" at Cap Rock in its audit.

- The recently completed acquisition of SEMCO by Holdings greatly increases the size and capabilities of Holdings. In this respect, the Board of Holdings will increase from five to seven members thereby making the establishment of a separate audit committee feasible. Since SEMCO is large enough to have its own internal audit department, it is reasonable to expect that this internal audit department could serve as Cap Rock's internal auditor.

5. Lindsay Goldberg's ownership has improved Cap Rock's ability to provide services to its customers.

   - Lindsay Goldberg has significantly improved Cap Rock's capital structure by providing equity to reduce Cap Rock's debt. (See Chapter V – Financial Management.)
   - Lindsay Goldberg has increased capital budgets to enable Cap Rock to make appropriate improvements in its infrastructure. (See Chapter IX – Electric Distribution Operations.)
   - Lindsay Goldberg has authorized Cap Rock's hiring of key management personnel to provide necessary leadership for Cap Rock's operations including a controller and new directors of information technology, human resources and resource planning and regulatory administration.
   - During the 2006 fiscal year, Holdings paid its owners $3.9 million in dividends, an amount in excess of its net income of $2.1 million and its net cash provided by operating activities of $3.6 million.
   - During the period from May 12, 2006 to December 31, 2006 (the post-acquisition period), Holdings recorded $2.7 million in non-cash dividends from Cap Rock. This non-cash dividend was related to the refinancing of Cap Rock's debt with the National Rural Utilities Cooperative Finance Corporation. Cap Rock did not pay any cash dividends to Holdings in 2006.

6. Cap Rock has comprehensive ethics and conflict of interest policies.

   - Cap Rock's Code of Business Conduct and Ethics addresses:
     - Conflicts of interest
     - Conduct involving inter-affiliate matters
     - Confidentiality
     - Protection and use of Company asserts
     - Environmental leadership
     - Accounting practices.

- With respect to compliance with laws, rules and regulations, it includes guidelines with respect to:
    - Antitrust laws
    - Equal employment opportunity
    - Harassment free workplace
    - Threats and violence
    - Drug and alcohol use.
- The policies also promote civic and political participation and participation in charitable activities.

7. Cap Rock's planning processes have effectively identified the challenges facing Cap Rock.
    - Subsequent to the completion of the acquisition of Cap Rock in 2006, the owners' immediate goals for Cap Rock were clearly articulated to management and included:
        - Improving the debt to equity ratio.
        - Improving financial results and recordkeeping.
        - Improving relations with regulators by resolving issues from the last rate case.
        - Resolving outstanding litigation.
        - Improving customer service.
        - Addressing information technology (IT) problems.
        - Strengthening senior management.
        - Addressing employee benefit deficiencies.
    - Management has successfully addressed all of the foregoing goals.
    - Management is currently focused on addressing the following goals:
        - Renegotiating purchase power agreements as appropriate.
        - Improving efforts to service and expand its customer base.
        - Completing implementation of information technology (IT) and accounting system initiatives.
        - Continuing efforts to improve its regulatory compliance and relationships with its regulators.
        - Completing a five-year assessment of its infrastructure needs.

8. Cap Rock's three senior executives are compensated fairly in light of their responsibilities and consistent with industry practices.
   - The base salary for Cap Rock's three senior managers averages $195 thousand. In addition in 2006, they received bonuses of $40,000 for an average compensation of $235,000 each.
   - Prior management's compensation was much greater. In 2005, the three most senior executives' average annual compensation was $350,000 and the new most senior officers' average compensation was $428,000.
   - Since the three senior executives are shareholders of Holdings, they also received dividends proportionate to their ownership.
   - The HayGroup Compensation and Benefits Review issued in October 2006 indicated that the three executives' compensation was either at or below market rates for all three individuals.

9. While CRE's short-term budgeting and planning processes are appropriate, its longer-term planning processes are informal.
   - CRE's short-term strategic planning process incorporates preferred practices for a planning process:
     - It is managed by the President and CEO and directed by the Board.
     - It includes performance goals, and performance is linked to compensation.
     - It reflects the realities of CRE's operating environment.
   - CRE does not have a long-term financial plan (see Chapter V – Financial Management.) or a long-term strategic plan.

F. RECOMMENDATIONS

1. Establish an audit committee on Holdings Board of Directors and have SEMCO's internal audit department serve as Cap Rock's internal auditor. (Refers to Finding III-4.)
2. Prepare a long-term financial and strategic plan. (Refers to Finding III-8.)

A. BACKGROUND

Cap Rock was formed in 1998 as the successor to the Cap Rock Electric Cooperative, Inc. The conversion of the cooperative to Cap Rock was completed in 2002 and its certificate of convenience and necessity (CCN) was approved by the PUCT effective September 1, 2003 at which point it became subject to regulation by the PUCT. CRE is now owned entirely by Cap Rock Holding Corporation (Holdings) which was formed in November 2005 by affiliates of Lindsay Goldberg LLC. (Lindsay Goldberg) for the purpose of acquiring CRE. Holdings is owned by Lindsay Goldberg and current and retired CRE management.

CRE owns one-hundred percent of NewCorp Resources Electric Cooperative, Inc., (NewCorp) which provides electric transmission services for the Stanton and Lone Wolf divisions in West Texas solely for CRE. NewCorp's transmission business is regulated by the Federal Energy Regulatory Commission (FERC) and CRE purchases transmission services from NewCorp at FERC approved tariffs. CRE purchases power directly from Southwestern Public Service (SPS) and then pays NewCorp tariff rates to transmit the purchased power to the Stanton and Lone Wolf division distribution systems. Despite CRE's ownership of NewCorp, in its Affiliate Transaction Report to the PUCT, CRE does not identify NewCorp as an "Affiliate". CRE management follows the PUCT rules which do not include an electric cooperative as an "affiliate" for reporting purposes. While CRE had no other affiliates at the time of our field work, Holdings recently acquired SEMCO Energy, Inc, (SEMCO) which has become an affiliate of CRE.[1]

In addition to "affiliate" relationships, CRE manages the municipal power distribution system in the City of Farmersville, Texas, which is located in Collin County. An Operating and Management Agreement (Farmersville Agreement) between Cap Rock Electric Cooperative, Inc., the predecessor to CRE and the City of Farmersville was effective January 4, 1999. Under the Farmersville Agreement, CRE is responsible for "all aspects of the operation and management of Farmersville's electric system..."[2] For rate-making purposes, the revenues, expenses and investments associated with the Farmersville Agreement are excluded from CRE's financial statements.

In Cap Rock's last rate case, several adjustments or issues related to NewCorp were raised including an asset transfer, non-recurring surcharge amortization elimination and payments by CRE to NewCorp under the FERC approved OATT. None of these issues were controversial.

CRE has the following facilities:

- Corporate office in Midland, Texas – personnel provide services and oversight

[1] Since Holding's acquisition of SEMCO closed subsequent to the completion of our field work, unless otherwise noted in this report, the management audit has not considered the implications of the Cap Rock-SEMCO affiliate relationship.

[2] Response to data request FWL-48.

to all entities and operations.

- Stanton Division office – personnel at the Stanton facility manage CRE's operations in this division and NewCorp operations.
- Hunt-Collin Division office – personnel manage CRE's operations and the Farmersville Agreement.
- McCulloch Division office – employees located at this facility historically managed CRE's operations in this division. As a result of recent organizational changes, the director of customer services for all of CRE will be located at this facility.

CRE does not have any requirements to allocate costs or maintain separate financial records for its operating divisions.

For the year ended December 31, 2006, Cap Rock's sources of revenues were as shown in **Exhibit IV-1**[3]:

Exhibit IV-1
Cap Rock Energy Corporation
Revenues by Line of Business
For the Year Ended December 31, 2006

	Gross Retail Revenues	Power Costs Recovered Through Rates	Base Revenues
Cap Rock Energy	$85,132,568	$51,554,075	$33,578,494
Farmersville	2,946,871	1,889,935	1,056,936
NewCorp	9,000,000		9,000,000
Less Eliminations	(9,000,000)		(9,000,000)
Total	$88,079,440	$53,444,009	$34,635,430

B. OBJECTIVE

The RFP outlined the following as one of the main objectives of the audit:

[3] Response to data request FWL-74.

> "identify, analyze and describe the nature and extent of relationships, transactions, allocations and services between Cap Rock ands its affiliates."

The scope included a review of the following areas related to affiliate relations and transactions:

- Transactions/charges between Cap Rock and its affiliates,
- Management control and overlap, and
- Allocation of common costs.

Management organization and control issues are addressed in Chapter III – Executive Management and Organization of this report. All other aspects of affiliate relations and transactions are addressed in this chapter.

C. EVALUATIVE CRITERIA

In conducting the review in this area, we used the following criteria:

- Are transactions/charges between Cap Rock and its affiliates appropriate and fair?
- Is there appropriate separation between the management and operations of Cap Rock and its affiliates?
- Are common costs allocated between Cap Rock and its affiliates on a fair basis?

D. WORK TASKS

Our assessment was based on a review of Company documentation, interviews with operating personnel and analysis of the existing company methodologies for allocating common (general and administrative) expenses and investments from CRE to NewCorp and the Farmersville Agreement. In conducting this review, we interviewed managers and customer service personnel at each division, observed each division's operations, prepared and submitted data requests, and reviewed and analyzed the Company's responses to interview questions and data requests. We also developed alternatives for common cost allocations. Our focus was on the following:

- Identifying all affiliate relations.
- Understanding and reviewing the Company's policies and methodologies for allocating costs to each affiliate.

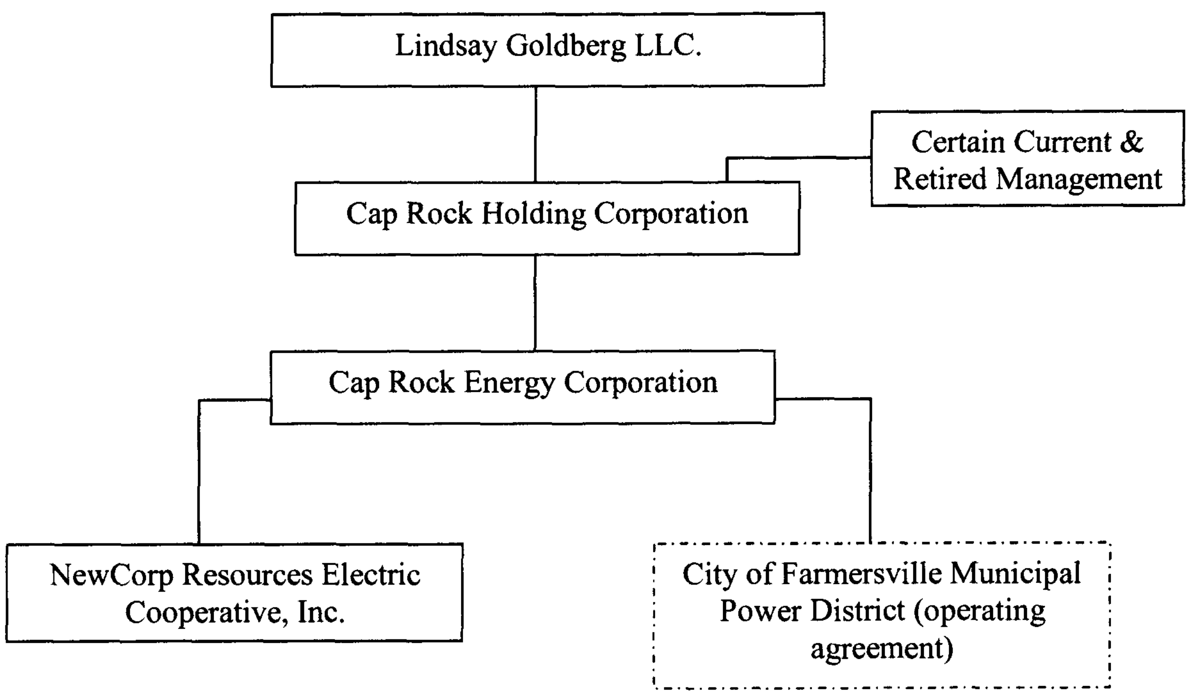
- Determining whether the Company's methodologies eliminated potential cross-subsidies and were supportable from an economic and regulatory standpoint.
- Identifying alternatives which would ensure cost allocations are reasonable and sustainable with limited effort by the Company.

E. FINDINGS AND CONCLUSIONS

1. CRE has very few affiliate relationships and transactions.

- CRE has a parent company (Holdings) which is owned by Lindsay Goldberg and certain current and retired management employees. Holdings owns one-hundred percent of CRE. CRE has two other "affiliate" relationships (NewCorp and the Farmersville Agreement) as indicated in **Exhibit IV-2.**[4]

Exhibit IV-2
Cap Rock Energy Affiliate Structure



- NewCorp has four dedicated employees.[5] All other employees are on the

[4] CRE has no ownership interest in the City of Farmersville municipal power district; CRE only manages and operates the power distribution system. The Company maintains separate accounting records for the Farmersville operation.

[5] If the NewCorp employees perform work for CRE, they can direct charge time and expenses to CRE.

payroll of CRE.

- No employees are assigned directly to the Farmersville Agreement.
- CRE accurately prepares and files the required annual affiliate transactions report with the PUCT.
  - The report does not include CRE's transactions with NewCorp due to NewCorp's status as a cooperative. Texas Administrative Code RULE §11.003 (2) (C) defines a cooperative as follows:

    *"a **corporation** that has at least five percent of its voting securities owned or controlled, directly or indirectly, by a public utility"* (emphasis added)
- The acquisition of SEMCO by Holdings could add complexities to the affiliate transactions. Management expects to utilize limited shared functions for CRE and SEMCO.

2. CRE does not have a cost allocation manual (CAM) or other written cost allocation policies and procedures.
   - CRE has a formal cost allocation model for General and Administrative (G&A) expenses which identifies labor and non-labor G&A expenses for the purpose of developing the annual NewCorp management fee and the expenses associated with the Farmersville Agreement. (See also Findings IV-3 and IV-8.)
   - Both CRE and NewCorp hourly employees follow direct time reporting and can charge time and expenses directly to CRE, NewCorp or the Farmersville Agreement.
   - Management and corporate employees are all CRE employees and their time and expenses are considered G&A expenses. No time or work activity studies are completed by corporate or other management employees.
   - Non-labor expenses can be charged directly to CRE or NewCorp or treated as G&A expenses and allocated to NewCorp through the NewCorp Management Fee or to the Farmersville Agreement.

3. A three-part allocation process is used in the budget process to develop the NewCorp management fee which covers the G&A costs allocated to NewCorp.
   - Part 1 - Accounting salaries and benefits are allocated equally to CRE and NewCorp. (See also Finding IV-4.) Part 2 - Non-Accounting salaries and benefits are allocated to CRE and NewCorp (as well as the Farmersville Agreement) based on the distribution of direct labor charges. Part 3 - Non-labor G&A costs are allocated to CRE and New Corp (as well as to the Farmersville Agreement) based on an equally weighted three-factor general allocator which is composed of the following.

- Plant in service,
- Operating revenues, and
- Direct labor distribution.

- The allocation factors underlying the NewCorp management fee for 2007 are based on November 2006 year to date (YTD) plus December 2005 (i.e., November 2006 twelve months to date (MTD)) financial and operational data as shown in **Exhibit IV-3**.[6]

Exhibit IV-3
Cost Allocation Factor Development for NewCorp Management Fee
(Based on November 2006 12 MTD data)

Description	Amount	Percentage	Weighting	Equal Weighting
Plant in Service:				
CRE	$200,875,244	74.97%		
Farmersville Agreement	$0	0.00%		
NewCorp	$67,070,488	25.03%	33.333%	8.34%
Total	$267,945,732	100%		
Operating Revenues:				
CRE	$31,195,275	76.57%		
Farmersville Agreement	$1,294,185	3.18%		
NewCorp	$8,250,000	20.25%	33.333%	6.75%
Total	$40,739,460	100%		
Direct Labor (capital and expense) Distribution				
CRE	224,942	94.31%		
Farmersville Agreement	3,571	1.50%		
NewCorp	9,988	4.19%	33.333%	1.40%
Total	238,500	100%		
NewCorp Three-Part Weighting				16.49%

[6] Response to data request JFJ-11.

- The wide variation between the direct labor distribution and the other two factors is due to the following:
  - NewCorp has fewer projects, but each project is much larger in size.
  - NewCorp projects tend to be at one location while CRE projects are spread over a wide geographic area. As a result, NewCorp has higher plant investments with much less required direct labor.
  - Since NewCorp's FERC tariff and CRE's PUCT tariff are based on plant in service, a similar relationship of plant in service and operating revenues is found.
- A monthly NewCorp management fee is developed based on 1/12th of the annual G & A costs identified for NewCorp in the budget process.
  - CRE charges the budgeted NewCorp management fee to NewCorp each month.
  - The NewCorp management fee for 2007 is $123,851.66 per month or $1.49 million for the year.
- The NewCorp management fee is not trued up. However, a provision in the NewCorp Master Operation, Maintenance and Administrative Service Agreement allows the following:

  > *"The final Annual Budget as approved by the Parties and the Owner's Lendor shall remain in effect throughout the applicable calendar year, <u>subject to such necessary updating, revisions or amendments as may be proposed by either Party</u> and consented to in writing by the other Party."*[7]

4. The current monthly management fee for NewCorp and the allocation of G&A expenses to the Farmersville Agreement are understated by an annual total of about $14,000.
   - The allocation of G & A expenses to the Farmersville Agreement is understated. The Farmersville (3,571 hours) and NewCorp (9,988 hours) direct labor distribution were double counted as Farmersville/NewCorp hours and CRE hours in the development of the November 2006 twelve MTD direct labor allocation and three-part weighted factor. As a result, CRE G&A costs were overstated.
   - Revising the calculation as shown in **Exhibit IV-4**[8] decreases the CRE percentage of direct labor hours and increases the Farmersville and NewCorp

[7] Response to initial data request 32, Section 6 (c). {Emphasis added.}

[8] Response to data request JFJ-11.

percentage of direct labor hours and the corresponding three-part weighting factors.

Exhibit IV-4

Revised Cost Allocation Factor Development for NewCorp Management Fee (Based on corrected November 2006 Twelve MTD direct labor hours)

Description	Amount	Percentage	Weighting	Equal Weighting
Plant in Service:				
CRE	**$200,875,244**	**74.97%**		
Farmersville Agreement	**$0**	**0.00%**		
NewCorp	**$67,070,488**	**25.03%**	**33.333%**	**8.34%**
Total	**$267,945,732**	**100%**		
Operating Revenues:				
CRE	$31,195,275	76.57%		
Farmersville Agreement	$1,294,185	3.18%		
NewCorp	$8,250,000	20.25%	33.333%	6.75%
Total	$40,739,460	100%		
Direct Labor (capital and expense) Distribution				
CRE	**211,383**	**93.97%**		
Farmersville Agreement	**3,571**	**1.59%**		
NewCorp	**9,988**	**4.44%**	**33.333%**	**1.48%**
Total	**224,942**	**100%**		
NewCorp 3 Part Weighting				16.57%

- NewCorp's and Farmersville's allocated amount of non-accounting salaries and benefits and non-labor G&A costs should be higher.
- As indicated in **Exhibit IV-5**, the revised budgeted monthly management for NewCorp should be $124,808.14 compared to the $123,851.66 currently charged, an increase of approximately $11,500 annually.. Similarly, Farmersville charges were understated by about $2,700 annually.

Exhibit IV-5
Revised 2007 Budgeted NewCorp Management Fee
(Based on corrected November 2006 Twelve MTD direct labor hours)

Description	Total Corporate Expense to be Allocated	Revised Allocation Factor	NewCorp Administrative Fee	Allocation Method
Total G & A Expenses[9]	$5,368,513	16.57%	$889,563	Three Part Weighted
Total Accounting Salaries	$794,426	50.00%	$397,213	Split 50/50 – CRE and NewCorp
Total Accounting Benefits	$171,894	50.00%	$85,947	Split 50/50 – CRE and NewCorp
Total Non-Accounting Salaries	$1,513,070	4.44%	$67,180	Direct Labor Distribution
Total Non-Accounting Benefits	$1,301,684	4.44%	$57,795	Direct Labor Distribution
Total	$9,149,587		$1,497,698	
Monthly Management Fee			$124,808	

5. The Company does not use activity based cost allocations for G&A costs.
   - Based on the November 2006 twelve MTD results, CRE had $9.1 million of corporate G&A expenses to be directly assigned or allocated among CRE, NewCorp and the Farmersville Agreement. $5.4 million of G&A costs are allocated (i.e., not directly assigned).
   - Accounting salaries and benefits are allocated equally to CRE and NewCorp with no allocation to the Farmersville Agreement.
     - Management's logic for the even split is that the accounting department maintains two sets of books which require equal time. This reasoning gives no weight to the number of transactions required for the two entities.

[9] Expenses, salaries and benefits based on CRE model; data is twelve MTD November 2006.

  - Accounting personnel are assigned to specific functions including reporting and budgeting, general ledger, inter-company billing, payroll, accounts payable, property (fixed assets), capital project control, cash reconciliation and oversight. Many of these functions involve specific measurable activities which will vary for CRE, NewCorp and the Farmersville Agreement.

- The direct labor charges used to allocate non-accounting corporate salaries and benefits do not reflect the activities underlying these corporate G&A costs.
- An equally-weighted three-factor general allocator is used to allocate all non-labor G&A costs to CRE, New Corp and the Farmersville Agreement based on plant in service, operating revenue and direct labor distribution without an examination of the activities underlying the specific G&A expenses.
- Costs associated with the CRE corporate or common capital investments used for NewCorp or Farmersville operations are not allocated to NewCorp or the Farmersville agreement.

6. CRE maintains effective control over its affiliate transactions and cost allocation practices.

   - Affiliate transactions and cost allocation policies are reviewed and approved by the Controller and CEO/CFO.
   - The company files timely affiliate transactions reports with the PUCT as required by state rules.
   - CRE has documented the NewCorp management fee in accordance with FERC requirements.

7. CRE's compensation from the current Farmersville Agreement is set by contract, but can be changed if base revenues from customers or CRE's costs associated with servicing the agreement change significantly.

   - CRE bills and collects all revenue from Farmersville customers.
   - The baseline annual customer revenue is set at $1.8 million exclusive of the fuel surcharge (PCRF).
     - If revenues exceed the baseline by five percent or more, 30 percent of the excess is paid to Farmersville.
     - If revenues fall short of the baseline by five percent or more, CRE's annual payment to Farmersville is reduced by 30 percent of the difference below the five percent.
   - CRE currently pays the City of Farmersville a base annual payment of $530,000.

- CRE is responsible for all labor and overhead, and Farmersville is responsible for materials used for maintenance and facility upgrades.
- The contract does not permit baseline price adjustments by CRE for changes in the cost of service.

8. The profitability of the Farmersville Agreement is unclear.
   - CRE maintains separate accounting records to track the direct and allocated costs associated with the Farmersville Agreement.
   - The allocation factors for G&A costs are developed as part of the budget process in the same manner as the NewCorp allocations and management fee.
   - Correcting the double count of direct labor hours would slightly increase the allocation of labor and non-labor G&A expenses to Farmersville in the same manner as the impact on the NewCorp management fee (refer to Finding IV-4).
   - CRE has presented the City of Farmersville with recommendations for capital and operating projects to improve the quality of the distribution system and control future maintenance expenses.
   - Cap Rock does not routinely prepare financial statements that reflect actual costs incurred to service the Farmersville operations.

9. The Stanton division office services both the Stanton/Lone Wolf divisions of CRE and NewCorp, but no investment or operating expenses for the facility are allocated to NewCorp.
   - Some employees at this facility provide service to both CRE and NewCorp – approximately 14 of the 84 employees at the facility provide service at least part-time to NewCorp.
     - Four employees are directly assigned to NewCorp and eleven other employees provide some level of support for NewCorp.
     - The power systems group/function is responsible for NewCorp. operations.
     - The dispatch and engineering functions are shared between CRE and NewCorp.
   - Common costs for the Stanton facility through August 2007 include the following:[10]

Assets	$1,383,261
Less accumulated depreciation	(847,413)
Net Plant	$ 535,848

[10] Response to data request FWL-52.

Monthly depreciation expense	$ 4,590
Property taxes	$ 2,423[11]
Repairs and maintenance	$ 81,469
Other common costs	$ 17,381

No utilities expenses were provided for the Stanton facility.

- The configuration of the building and location of NewCorp employees in the building would make a floor space study difficult.

10. The Hunt-Collin division office services the division's retail operation and the Farmersville Agreement, but no investment or operating expenses for the facility are allocated to the Farmersville Agreement.

    - The Farmersville profitability analysis (refer to Finding IV-8) does not consider any costs associated with the Hunt-Collin division office.
    - All employees are on the CRE payroll and no employees are dedicated to the Farmersville Agreement.
    - Approximately 20 to 25 percent of the division's service order activity and sales is related to the Farmersville Agreement as shown in **Exhibit IV-6**.

Exhibit IV-6
Hunt-Collin Division Activity and Sales[12]

Activity	Farmersville	Hunt-Collin Retail
Orders (2007 YTD):		
Connect	33.7%	66.3%
Disconnect	30.9%	69.1%
Trouble Reports	22.2%	77.8%
Total	25.9%	74.1%
Orders (2003-2007 YTD):		
Connect	40.2%	59.8%
Disconnect	38.4%	61.6%
Trouble Reports	20.0%	80.0%

[11] The property tax amount is for 2006.

[12] Response to data requests FWL-28, JFJ-8 and JFJ-11.

Activity	Farmersville	Hunt-Collin Retail
Total	26.5%	73.5%
MWH Sales:		
2006	29.2%	70.8%
2003-2006	29.7%	70.3%
Direct Labor Hours (11/06 12 MTD)	13.4%	86.6%

11. Most of the Company's information technology systems are used to support both CRE and NewCorp, but all of the investment costs are charged to CRE.[13]
    - CRE uses some of the systems to provide services under the Farmersville Agreement.
    - No investment expenses are allocated to NewCorp or the Farmersville Agreement.
    - The NewCorp operations receive significant benefit and could not function as efficiently without the shared system arrangement.

F. RECOMMENDATIONS

1. Prepare a cost allocation manual (CAM) to document affiliate transactions and cost allocation mechanisms. (Refers to Finding IV-1.)
    - The CAM should include the following:
        - Identification of all affiliate type transactions.
        - Processes and procedures for directly charging expenses where possible.
        - An activity-based or other cost-causative mechanism for each type of expense which cannot be direct assigned.
        - Direct charges and allocations to CRE, NewCorp and the Farmersville Agreement.
        - Required approvals for affiliate transactions and cost allocations.

[13] Response to data request FWL-51.

  - A true-up mechanism for the NewCorp management fee.

- The CAM should reflect new affiliate relationships and any new sharing of services among entities resulting from the acquisition of SEMCO by Holdings.

2. Adjust the current monthly management fee for NewCorp and the allocation of G & A expenses to the Farmersville Agreement. Modify the NewCorp Master Operation, Maintenance and Administrative Service Agreement to allow the NewCorp management fee to be trued-up annually on a going-forward basis. In lieu of a true-up in 2007, include the necessary adjustments in the 2008 fee. (Refers to Finding IV-4.)

3. Implement the use of activity-based costing to allocate G & A expenses. (Refers to Finding IV-5)

   - Management time and salaries including accounting should be directly charged to CRE, NewCorp or the Farmersville Agreement where appropriate with only the residual time allocated.[14]

   - An activity based factor such as the number of accounts payable vouchers, payroll checks or journal entries could be used for accounting personnel involved in these types of functions in lieu of a time study or to support a time study.

   - Benefits and other employee expenses which are not direct charged should be allocated to CRE, NewCorp or the Farmersville Agreement in the same proportion as time/salaries.

   - Time surveys can be completed more frequently if job requirements change to provide a more accurate assessment of the entities benefiting from the labor and non-labor costs.

4. Prepare monthly financial statements for the Farmersville contract to provide management improved visibility over the profitability of this operation. (Refers to Finding IV-8.)

5. Allocate a portion of the capital and operating expenses for owning and operating the Stanton facility to NewCorp based on the direct labor hours which are charged to NewCorp. In lieu of allocating any capital or assets, the capital expenses for NewCorp can be determined based on a capital carrying charge which includes the rate of return, depreciation, maintenance and property taxes associated with the building. (Refers to Finding IV- 9)

6. Allocate the portion of the capital and operating expenses for owning and operating the Hunt-Collin facility which are related to the Farmersville

[14] Expenses associated with the Farmersville Agreement could remain on the books of CRE, but would be separately identified for profitability analysis and rate-making purposes.

Agreement based on the direct labor hours which are incurred to maintain and operate the Farmersville system. In lieu of allocating any capital or assets, the capital expenses can be determined based on a capital carrying charge which includes the rate of return, depreciation, maintenance and property taxes associated with the building. (Refers to Finding IV-10)

7. Allocate IT investment costs related to NewCorp and the Farmersville Agreement. System usage measures could be used to allocate some or all of the systems' expenses. In lieu of allocating any capital costs or assets, the capital expenses associated with the common systems can be determined based on a capital carrying charge which includes the rate of return, depreciation and property taxes. (Refers to Finding IV-11)

A. BACKGROUND

Cap Rock's financial management processes are directed by the Controller and include financial reporting, regulatory reporting, general ledger, payroll, accounts payable, property accounting, project accounting, budgeting and management reporting, and cash management. The Controller, hired by Cap Rock in December 2006, reports directly to the President and CEO, who is also the Company's chief financial officer (CFO). Cap Rock uses Oracle Financials for its accounting system and OutlookSoft for its budgeting and management reporting system.

B. OBJECTIVE

In this task area, we performed a diagnostic review of Cap Rock's financial management activities.

C. EVALUATIVE CRITERIA

To assess Cap Rock's financial management efforts, we used the following evaluative criteria:

- Are Cap Rock's financial accounting and planning activities performed appropriately and in accordance with generally accepted accounting practices?
- Are Cap Rock's financial planning processes adequate to provide Cap Rock management the information it needs in a timely and accurate manner?
- Are Cap Rock's plans for its capital structure practical, attainable and in the best interests of its ratepayers?
- Do Cap Rock and its affiliates maintain their accounting records and prepare their reports in accordance with PUCT and FERC guidelines and regulations?
- Are Cap Rock's classification of revenues, expenses and costs consistent with the FERC Uniform System of Accounts (USOA), other applicable FERC policies and requirements, and industry practices?
- Does Cap Rock's capital and operating budget processes provide managers with the information necessary to control spending and allocate resources wisely?
- Does Cap Rock have an effective cash management program?

D. WORK TASKS

To complete the review, we performed the following tasks:

- Reviewed Cap Rock's two most recent annual financial statements provided to its owners.
    - Identified any unusual trends that may suggest inconsistent accounting for transactions between periods.
    - Obtained explanations for unusual trends noted.
- Interviewed the E&Y audit partner regarding management letters.
- Reviewed the chart of accounts used by Cap Rock for consistency with FERC accounting requirements.
- Tested specific transactions occurring during August 2007 for the appropriateness of the accounting for those transactions based on the nature of the charge and supporting documentation.
    - Tested a representative sample of transactions from each feeder system (e.g., accounts payable, stores/materials management, and payroll).
    - Reviewed all December 2006 journal entries.
- Reviewed accounting adjustments proposed by Cap Rock's external auditors in connection with its audit of the Fiscal 2006 financial statements and reports regarding accounting control issues (including internal audit reports).
- Reviewed the general accounting applications and evaluated the system, use of automation, and functionality.
- Assessed Cap Rock's financial modeling capabilities.
- Assessed Cap Rock's capital structure and compared it to other investor-owned electric utilities.
- Reviewed Cap Rock's 2006 annual report filed with the PUCT.
    - Identified any unusual trends that may suggest inconsistent accounting for transactions among periods.
    - Obtained explanations for unusual trends noted.
    - Reviewed the chart of accounts used by Cap Rock for consistency with the USOA and other FERC accounting requirements.
- Assessed the adequacy of processes used for establishing, monitoring and revising capital and operating budgets and forecasts.
- Reviewed the system of internal controls in place to ensure that transactions are reported consistent with the USOA.
- Reviewed procedures for receiving cash, and evaluated whether Cap Rock is maximizing cash turnover and minimizing the need for short-term debt.
- Evaluated the use of available, or idle, cash.

- Reviewed the cash forecasting process, assumptions, timeliness and historical accuracy.

E. FINDINGS AND CONCLUSIONS

1. Cap Rock's financial accounting activities are performed appropriately and in accordance with generally accepted accounting practices.

   - The Reports of Independent Auditors issued by Ernst & Young (E&Y) on March 29, 2007 for Holdings and Cap Rock present unqualified opinions on their financial statements for the year ended December 31, 2006.
   - Based on a discussion with the E&Y audit partner, E&Y detected no material weaknesses in CRE's system of internal controls in connection with its 2006 financial statement audit.
   - Oracle Financials, used by Cap Rock and NewCorp for accounting purposes, meets the needs for financial reporting, regulatory reporting, and internal management reporting. The account flexfield, which consists of the following fields, provides for the coding of transactions to comply with GAAP and FERC requirements, while also meeting internal management reporting needs.
     - Company Name (first two digits)
     - Line of Business (next three digits)
     - Department (next four digits)
     - Division (next nine digits)
     - Natural General Ledger Account (next four digits)
     - FERC Account (next six digits)
     - Reserved for Future Use (last three digits)

2. Documentation of accounting procedures and systems of internal controls could be improved.

   - Cap Rock has an accounting procedures manual that is reasonably complete and current although many of the procedures are re-prints of emails. The accounting procedures are not numbered, approval of the procedures is not clearly indicated, and there is no table of contents to allow the user to quickly find specific procedures.
   - The cash remittance process is not fully documented.
   - As a non-public company, Cap Rock is not required to comply with the requirements of the Sarbanes-Oxley Act and has not completed a SOX Section 404 review of internal controls.
   - In April 2007, the Company kicked off the project of establishing continuing

property records for substations and transmission facilities owned by NewCorp. After this project is completed, the Company will perform a depreciation study of the substation and transmission system. These projects should be completed in 2007.

3. The Company did not record all of the proposed E&Y adjusting entries for 2006.

- The Company recorded a number of adjusting entries proposed by E&Y in connection with its fiscal 2006 financial audit. Due to the mid-year purchase of Cap Rock by Holdings, the 2006 financials statements presented results through May 11, 2006 and through December 31, 2006.
- The entries that were not made were as follows:
  - Adjust purchased power expense for 2006 to properly reflect amounts incurred in 2006 ($293,564).
  - Adjust the year-end amount to not double-book the expense for the property tax adjustment made at May 11, 2006 ($87,929).
  - Record the estimated misstatement of materials and supplies (M&S) inventory extrapolated from testing sample for differences in price testing and from sample counts ($44,000).
  - To record a legal accrual at May 11, 2006 in the Lee Atkins claim ($275,000).
  - To decrease the property tax accrual at May 11, 2006 to be aligned with the actual expense for the year ($87,929).
- We agree with management that the effects of any unrecorded audit differences are immaterial, both individually and in the aggregate, to the consolidated financial statements taken as a whole. The principal reason that Cap Rock did not make these adjustments was their immateriality.

4. While Cap Rock's financial planning processes provide management with the information it needs in a timely and accurate manner for ongoing operations, long-term financial plans are not prepared.

- The Company develops an annual Business Effectiveness and Improvement Plan which for Fiscal 2007 includes the following financial performance-related goals:[15]
  - Monitor "earnings before interest, taxes, depreciation and amortization" (EBITDA) against forecast as a basis for preemptive intervention in case of shifts or trends. Stretch goal – Actual year-end earnings exceed year-end forecast by ten percent or more. Through June 30, 2007, actual earnings exceeded 110 percent of budget.

[15] Response to IDR No. 6.

- Monitor forecasted capital spending against actual capital spending as a basis for preemptive intervention in case of shifts or trends. Stretch goal – actual year-end spending varies by less than seven percent over forecast. Through June 30, 2007, actual capital spending is approximately 102 percent of budget.

- Each month, the accounting department prepares a comprehensive internal financial reporting package which is provided to the Board of directors.[16] The following information is included:
  - Summary of Financial Data, actual compared to prior year
  - Summary of Financial Data, actual compared to budget
  - MWh sales and Revenue Report
  - Billed Sales
  - Cash Flow Statement – Indirect Method
  - Direct Cash Flow Statement
  - MTD & YTD Comparative Income Statement CRC
  - MTD & YTD Comparative Income Statement vs. Budget CHC
  - Capital Budget Variance MTD
  - Capital Budget Variance YTD
  - Balance Sheet by Company CHC
  - MTD Income Statement by Company CHC
  - MTD Income Statement Variance Summary CHC
  - YTD Income Statement by Company CHC
  - YTD Income Statement Variance Summary CHC
  - Payroll Variance Report (Budget vs. Actual)
  - Overtime Payroll Hours By Organization
  - Staffing Report
  - Outside Services Summary.
- Cap Rock does not prepare a long-term financial plan.

5. Cap Rock's capital structure is reasonable and consistent with other investor-owned utilities.

- Cap Rock has significantly improved its capital structure since its 2003 rate case as shown in **Exhibit V-1**.

[16] Response to JFJ-15

Exhibit V-1
Change in Capital Structure – Cap Rock Energy
2003 to 2006

	2003 Test Year (percent)	**Requested by Cap Rock (percent)**	**Approved in Rate Case (percent)**	**2006 (\$million)**
Long-term Debt				\$90,450
Percent LTD	83%	60%	75%	**52.6%**
Shareholders' Equity				\$81,507
Percent Shareholders' Equity	17%	40%	25%	**47.4%**

- Based on our review of electric utility industry data from the SNL utility industry database, Cap Rock's capital structure of approximately 53 percent debt and 47 percent equity is consistent with the industry.
- As required by Ordering paragraph 4 of the Order on Rehearing, the Company submitted its "....filing detailing the company's progress in moving to a more balanced capital structure." This filing, which was made on January 29, 2007, was required to be made within 30 days of its fiscal year end.[17]

6. While revenues and labor charges of Cap Rock Energy and NewCorp are classified in accordance with the FERC Uniform System of Accounts, the accounting for non-labor charges could be improved.

- The current e-Time Task List, which represents tasks used for time reporting, and the project expenditure list, is comprehensive and includes account codes for information for all feeder systems. The Company has mapped labor tasks to the appropriate FERC account for regulatory reporting.
- For non-labor charges, Huron tested transactions from the August 2007 trial balance. The supporting documents confirmed the amounts charged. In several instances, however, the correct FERC account was not charged. For example:
  - The cost of uniforms is charged to 588, Miscellaneous Distribution Expense. This cost should be assigned to the primary accounts charged by the employee on whose behalf the uniform was rented.

[17] Response to FWL-21.

- Postage and bill processing costs are charged to 902, Meter Reading, rather than 903, Customer Records and Collections Expense.

- Beginning in 2004, purchased power costs were accounted for on the books of Cap Rock, not on NewCorp. Only transmission services are now purchased (under tariff) by Cap Rock from NewCorp.
- Administrative and general (A&G) expenses allocated from Cap Rock are charged to Office Supplies and Expenses (921). This account includes charges for A&G expenses that aren't specifically included in the FERC Uniform System of Accounts descriptions for other A&G accounts. This is the case for allocated A&G expenses, although FERC now has additional reporting requirements (Form No. 60) for shared services companies providing services to regulated utility affiliates.

7. NewCorp's FERC Form 1 Reports as originally prepared for the years 2002-2004 required correction.

- The original FERC Form 1 Report for 2002 included distribution operations, distribution maintenance, customer accounts, customer service and informational, and sales expenses. The 2003 FERC Form 1 Report reflected corrected 2002 amounts by eliminating charges reported to these FERC accounts.
- The 2004 FERC Form 1 Report reflected an adjustment in the prior year column (2003) to combine A&G Salaries (920) with Office Supplies and Expenses (923).
- The 2005 FERC Form 1 Report reflected an adjustment to the prior year column (2004) for the elimination of the pass through of $3,441,294 for credits NCR received from the power supplier for interruptible rates in 2004.
- **Exhibit V-2** presents O&M expenses by FERC account for NewCorp for the years 2002 through 2006, as corrected.

Exhibit V-2
NewCorp
O&M Trend Analysis by FERC Account
2002 - 2006

	2002 (Rev)	2003 (Rev)	2004 (Rev)	2005	2006
555 - Purchased Power	$21,200,730	$23,113,903	$6,755,616	$77	$0
560-567 – Transmission Operations Supervision and Engineering	333,619	83,207	64,784	106,983	237,065
568-573 – Transmission	1,053,623	743,468	383,469	523,258	766,010

	2002 (Rev)	2003 (Rev)	2004 (Rev)	2005	2006
Maintenance of Overhead Lines					
582 – Distribution Station	0	0	0	3,453	3,603
920 – A&G Salaries	0	0	0	0	0
921 – Office Supplies and Expenses	1,026,925	1,787,800	1,997,745	1,525,708	1,952,967
923 – Outside Services Employed	569,606	125,608	170,043	313,303	51,416
924 – Property Insurance	0	0	0	57,405	78,603
925 – Injuries and Damages	0	0	90	0	0
930.1 – General Advertising	0	0	0	24	0
930.2 – Miscellaneous General	0	0	0	4,631	2,078
Total	$24,184,502	$25,853,986	$9,371,748	$2,534,842	$3,091,742

8. While Cap Rock's PUCT annual report for 2006 meets the Commission's requirements, Cap Rock does not have the capability to perform revenue and expenses trend analyses by FERC account.

- 2006 was the first year that Cap Rock Energy was required to complete the PUCT annual report. This report does not present information by FERC account but requires the summary information be based on the FERC Uniform System of Accounts.
- The PUCT report does not present comparative data for the current and prior years by FERC account as does the FERC Form 1 reports for NewCorp. As a result, there is no readily available means to compare trends in expenses by FERC account (or even at the FERC cost category) level. CRE should develop reports that will allow it to complete a trend analysis of revenue and expenses by FERC account prior to filing the annual PUCT report.
- **Exhibit V-3** presents O&M expenses by FERC account for Cap Rock Energy for the years 2005 and 2006. Information systems were not in place to provide comparable information for 2004.

Exhibit V-3
Expenses by FERC Account – Cap Rock Energy
2005 – 2006

FERC ACCOUNT		Amount		
Number	**Description**	**2005**	**2006**	**Percent Change**
555	Purchased Power	48,290,591.06	46,441,294.44	-3.8%
Total Power Supply Expenses		**48,290,591.06**	**46,441,294.44**	-3.8%
565	Transmisison of Electricity by Others	9,189,517.84	9,362,780.27	1.9%
566	Miscellaneous Transmission Expense	49,547.13	22,318.64	-55.0%
567	Rents	15,874.50	24,105.92	51.9%
Total Transmission Expenses		**9,254,939.47**	**9,409,204.83**	1.7%
580	Operation Supervision and Engineering	290,195.33	282,159.93	-2.8%
581	Load Dispatching	2,896.49	49,477.53	1608.2%
582	Station Expense	102,335.99	14,162.18	-86.2%
583	Overhead Line Expense	1,768,927.42	945,419.66	-46.6%
584		(857.09)		-100.0%
586	Meter Expense	242,929.53	206,426.22	-15.0%
588	Miscellaneous Expenses	1,434,502.34	1,062,237.13	-26.0%
589	Rents	406,173.35	513,323.38	26.4%
590	Maintenance Supervision and Engineering	-	7,696.60	#DIV/0!
592	Maintenance of Station Expense	30,223.70	29,695.01	-1.7%
593	Maintenance of Overhead Lines	1,503,511.52	2,025,859.55	34.7%
594	Maintenance of Underground Lines	900,689.27	1,144,581.97	27.1%
595	Maintenance of Line Transformers	514,645.57	464,133.21	-9.8%
596	Maintenance of Street Lighting and Signal Systems	76,400.87	111,506.28	45.9%
597	Maintenance of Meters	155,877.96	310,286.86	99.1%
598	Maintenance of Miscellaneous Distribution Plant	234,109.99	330,307.04	41.1%
Total Distribution Expenses		**7,662,562.24**	**7,497,272.55**	-2.2%
901	Supervision - Customer Accounts	182,378.79	135,112.94	-25.9%
902	Meter Reading Expenses	1,227,036.71	1,514,998.09	23.5%
903	Customer Records and Collections Expenses	1,034,718.22	973,634.63	-5.9%
904	Uncollectible Accounts	104,807.72	60,753.63	-42.0%
905	Miscellaneous Customer Accounts Expenses	365,438.99	337,962.98	-7.5%
907	Supervision - Customer Service & Informational Exp.	-	1,500.00	#DIV/0!
912	Demonstrating and Selling Expenses	(1,466.04)	(1,098.97)	-25.0%
913	Advertising Expenses	62,004.52	37,147.43	-40.1%
916	Miscellaneous Sales Expenses	15,845.19	2,267.05	-85.7%
Total Customer Accounts, Customer Service and Informational, and Sales Expenses		**2,990,764.10**	**3,062,277.78**	2.4%
920	A&G Salaries	5,419,264.94	3,065,566.95	-43.4%
921	Office Supplies and Expenses	153,338.93	250,298.88	63.2%
922	Administrative Expenses Transferred (Credit)	(3,995,868.47)	(5,483,984.13)	37.2%
923	Outside Services Employed	6,170,448.29	5,298,447.09	-14.1%
924	Property Insurance	254,633.76	134,127.08	-47.3%
925	Injuries and Damages	586,714.45	495,431.38	-15.6%
926	Employee Pensions and Benefits	1,996,574.15	1,725,485.14	-13.6%
930.1	General Advertising Expenses	1,267.08	15,254.20	1103.9%
930.2	Miscellaneous General Expenses	1,983,995.29	1,131,159.93	-43.0%
933	Transportation	103,028.47	(270,271.51)	-362.3%
935	Maintenance of General Plant	71,799.40	67,619.02	-5.8%
Total A&G Expenses		**12,745,196.29**	**6,429,134.03**	-49.6%
Total O&M Expenses		**$ 80,944,053.16**	**$ 72,839,183.63**	-10.0%

- The Company provided reasonable explanations for significant variances noted above. These explanations include (a) the payment of bonuses in 2005 and not in 2006, (b) increased funding for preventative maintenance in 2006, (c) reduced claims settlements, (d) lower premiums, and (e) a change in the calculation of overhead accruals.[18]

9. Cap Rock's capital and operating budget processes provide managers with the information necessary to control spending and allocate resources appropriately.

- The Company uses OutlookSoft for budgeting, forecasting and variance reporting. This software has the functionality to meet management reporting requirements. The budgeting process is managed by the Controller. Separate individuals in the accounting organization have Company-wide responsibility for managing the development of the expense and capital budgets.
- Budgeting processes, which are documented, updated annually, and properly communicated to employees, are driven from the bottom-up, giving cost center managers buy-in to the numbers they are managing to. This ensures that costs can be managed, and cost center managers are accountable for their budgets.
- The Company has corporate cost centers for accounting, corporate administration, information technology, legal, and payroll benefits (in addition to a "default" cost center managed by the Controller for non-controllable items). Each of the three operating divisions has cost centers for customer service and operations; in addition, the Stanton Division has cost centers for billing, distribution design, mapping/GIS/GPS, meter reading, dispatching, power systems, SCADA and system engineering.
- Expense budgets are developed by month and instructions are given that the monthly budgets not simply represent 1/12th of the annual budget unless that is representative of how costs are actually incurred. This process ensures that variance analysis is an important management tool.
- The capital budget process is appropriate:
  - For the Fiscal 2008 Budget, the Company had managers propose a bottoms-up, detailed capital budget by project. This initial exercise resulted in a list of potential capital projects totaling $19 million. The final capital budget is expected to be approximately $10 million.
  - In a one-day work session facilitated by accounting department personnel, the managers developed a prioritized list of capital projects based on the following criteria: (1) projects that are essential or necessary (e.g., to meet regulatory, environmental, or governmental

[18] Response to FWL-69.

requirements; new services; correct service that is expected to fall below recognized standards in the budget year); (2) projects that are recommended (e.g., correct service that is expected to fall below recognized standards one year beyond the budget year; achieve identified cost reductions); and (3) projects that offer opportunities (e.g., correct service that is expected to fall below recognized standards two or more years beyond the budget year; provide for future growth; achieve possible cost reductions).

10. Cap Rock's cash management has a number of deficiencies.

- Cash management is the primary responsibility of the Controller, with day to day activities performed by an accountant reporting to the Controller.
- Cap Rock is not able to forecast it receipts and disbursements accurately and therefore is unable to use excess cash effectively.
- Cap Rock does not issue its customer bills in a timely fashion thereby reducing its cash flow. Standard practice in the utility industry is to issue bills within one day of reading a customer's meter. Currently, Cap Rock has different billing procedures for its various offices.
- Cap Rock maintains 25 separate banks accounts are used for each affiliate (i.e., cash is not commingled), including both general and money market accounts. In addition, CRE maintains accounts in local banks in each operating division for the deposit of funds received locally, and separate accounts are maintained for restricted use funds.
- The Company is moving most of its bank accounts to Wells Fargo. Once the accounts with Wells Fargo are established, the Company intends to eliminate accounts with Midland banks resulting in a reduction in the number of its bank accounts.
- A Wells Fargo overnight sweep account will allow excess cash to be invested on a timely basis. Other benefits include:
    - Additional disbursement-related controls. With "positive pay," Wells Fargo will only process payments after being pre-notified by the Company.
    - An ability to offer on-line banking to Cap Rock customers.

11. In December, 2006, the Company appropriately refinanced its long-term debt previously held by the National Rural Utilities Cooperative Finance Corporation (CFC) with new debt issued by the Royal Bank of Canada and Union Bank of California.

- At December 15, 2006, $104 million in CFC debt remained outstanding under 42 tranches, with maturities ranging from 2007 to 2035.

- Of the $104 million, approximately $67 million was due to be refinanced in 2007 at CFC's current rates and the remaining $37 million was fixed at a rate of 6.5 percent through 2011.
- The refinancing was completed for the following reasons[19]:
  - The rates offered by CFC are less favorable than what was available in the debt markets at the time. Long-term rates and spreads to treasuries were at historically low levels.
  - The Company gained access to capital markets and other sources of financing. Because the Company was no longer a Cooperative, CFC would not provide additional financing, while at the same time the existing CFC debt held a lien on all the Company's assets precluding it from raising financing from outside parties.
  - The existing CFC debt was less flexible than debt that could be raised in the capital markets.
  - The Company is no longer a cooperative.

12. Cash disbursements are properly managed and controlled.[20]
    - Checks are written one time per week. The Controller approves all invoices scheduled for payment as listed on the Preliminary Payment Register.
    - Checks under $500 are signed using the COO's signature stamp. Checks over $500 must be manually signed by the COO, and checks over $5,000 required two signatures. The second signature is accomplished by using the CEO's signature stamp, not a manual signature. A log is maintained of when the CEO's signature stamp is used.
    - Blank checks and signature stamps are kept in a locked file cabinet.
    - The Company also disburses funds through wire transfers and ACH direct deposits. All wire transfers must be approved by the CEO. ACH direct deposit is only used for the remittance of sales tax to the State Comptroller's Office, payroll and related taxes to ADP, 401(k) contributions to Principle, and flex and medical plan payments to Benefit Planners.
13. Cap Rock reconciles its bank accounts on a timely basis.
    - Bank accounts are reconciled monthly, although not all reconciling items are cleared on a timely basis.
    - Bank reconciliations are prepared by the Cash Management Accountant who

[19] Response to JFJ-31

[20] Response to FWL-08.

has no cash receipt or disbursement responsibilities.

- Bank reconciliations are approved by the Controller, although this approval is not documented on the bank reconciliations.
- Service charges and fees paid are minimal except for fees paid related to customer payments by credit card. Customers paying by credit card are charged the tariff rate for this service of $2.00 per transaction.

F. RECOMMENDATIONS

1. Improve documentation of accounting procedures and the systems of internal controls. (Refers to Finding V-2.)
2. Develop a long-range financial forecasting process. (Refers to Finding V- 4.)
3. Correct the FERC basis accounting for employee uniforms and postage and bill processing costs. (Refers to Finding V-6.)
4. Develop reports that will analyze revenue and expenses trends by FERC account. (Refers to Finding V-8.)
5. Initiate a comprehensive cash management improvement program.
   - Revise customer billing to issue statements within one day of reading the meter.
   - Consolidate bank accounts and establish a sweep account to better manage excess cash.
   - Develop and implement an effective cash forecasting process. (Refers to Finding V-10.)

A. BACKGROUND

Cap Rock has centralized departments which provide information technology (IT), accounting and finance, and human resources (HR) services. The Company is currently in the process of bringing certain IT functions back in-house. The IT outsourcing agreement with Delinea (since acquired by One Neck) expires at the end of 2007. The contract with Delinea/One Neck will not be renewed. In addition, the Company utilizes an independent third party, HD Supply, a subsidiary of Home Depot, for its material warehousing function in most locations.

Cap Rock uses the following information systems. All systems are used company-wide and are not dependent on physical location.

Information System	Description
Oracle Financials/Oracle E-Business Suite	General ledger, accounts payable, miscellaneous. accounts receivable, inventory, and fixed assets
OutlookSoft	Financial reporting, budgeting and variance reporting
Customer Watch	Customer information / billing system
People-Trak	Employee record keeping
StakeOut	Construction cost estimates and mapping
Share Point	Corporate intranet, used for document sharing and IT Service Request Tracking
Exchange	Email
eTime, PCPW (ADP)	Time reporting and payroll processing
Dispatch/Windmill (Milsoft)	Engineering and outage management (interfaces with Customer Watch)
Crystal Reports	General purpose reporting tool for Oracle, Customer Watch and StakeOut; standard reports accessed through Share Point
Itron – MVRS	Meter reading
Porsche	IVR used during major outages

The current IT Director was hired in April 2006 to manage the IT outsourcing contract with One Neck. This contract requires the payment of $155,000 per month plus expenses to the One Neck. Since the outsourcing firm was unable to meet deadlines and unable to deliver desired results, the Company began to explore options including finding a new service provider, bringing the function in-house, or a combination of the two. The Company is moving to a model which is a combination of both in-sourcing and outsourcing. In this connection, the Company has expanded its in-house capabilities. In addition to the IT Director, there are three IT professionals on staff and one open position. All department employees have significant IT experience.

Cap Rock has approximately 15 salaried employees and 125 hourly employees. A significant portion of this workforce is, or will soon be, retirement-eligible. The HR department is responsible for performance management, recruiting and hiring, compensation, benefits, and safety. The department also has responsibility for quality improvement. None of the Company's employees are represented by a union. The HR Director started with the Company in September, 2006. The HR Director is supported by a coordinator (hired in August 2007) and an executive administrative assistant (one-half time equivalent).

The Company offers the following benefit plans to its employees:

- Executive Deferred Compensation Plans: This plan, which was approved by the Board or Directors in November 2002, offers management, members of the Board and certain highly compensated employees the option to defer a portion of their compensation pursuant to the terms of the plan. The Company may also make contributions to the plan on behalf of the individuals participating in the plan.
- Defined Contribution Plan: The Company has a 401(k) plan for employees who meet certain eligibility requirements. The plan permits a specified percentage of an employee's salary to be voluntarily contributed on a pre-tax basis, with a Company matching feature. The plan provides for various levels of Company matching contributions depending upon the level of employee contributions.
- Postretirement Benefits: The Company provides continued major medical coverage to retired employees and their dependents.

Under the Integrated Supply Agreement[21] between HD Supply and Cap Rock, HD Supply is responsible for procuring all utility and other related products, monitoring and maintaining inventories of such products at levels which it determines are appropriate and consistent with industry standards, and employing and stationing personnel at the Stanton facility.

B. OBJECTIVE

In this task area, we performed a diagnostic review of Cap Rock's corporate

[21] Response to JFJ-18.

support services activities.

C. EVALUATIVE CRITERIA

To assess Cap Rock's corporate support services efforts, we used the following evaluative criteria:

- Does Cap Rock manage its computer systems in a cost effective manner?
- Has Cap Rock successfully implemented new computer systems?
- Does Cap Rock manage its materials and supplies inventory in a cost effective manner?
- Does Cap rock manage its HR function effectively?
- Are corporate support services costs allocated in a fair and appropriate manner?

D. WORK TASKS

To complete the review, we performed the following tasks:

- Determined the current status of the Oracle System implementation. Determined if Cap Rock continues to use the Daffron and Cameo systems.
- Evaluated the decision to in-source services previously provided by Delinea/One Neck.
- Determined the quality and suitability of current computer systems.
- Assessed Cap Rock's long-term computer systems plan.
- Reviewed the adequacy of training and technical support provided to users of corporate computer systems.
- Reviewed the adequacy of internal controls over computer systems.
- Identified corporate support costs for Cap Rock and its affiliates for the three years ended December 31, 2006.
- Interviewed individuals responsible for preparing, processing, approving and monitoring cost allocations to confirm that practices are consistent with policies and procedures and that the system of internal controls is operating effectively.
- Assessed the methods for direct charging versus allocating the costs for each cost element and compared them to applicable industry standards and practices.

E. FINDINGS AND CONCLUSIONS

1. While Cap Rock manages it computer systems in a cost-effective manner, it needs to update its disaster recovery plan and explore additional opportunities for efficiency gains.

   - The decision to not renew the One Neck contract is sound and should result in noticeable cost savings and performance improvements if the transition plan is effectively implemented. The Company is currently on schedule for its transition to in-sourcing the services previously provided by One Neck. After the in-sourcing is complete, Cap Rock will still use vendors and vendor-certified suppliers for certain system maintenance and enhancement activities.
   - Several corporate users of IT services indicate that service levels have remained the same or have improved for those services already brought in house from One Neck. The Company has a service tracking system in place that effectively monitors and reports IT service requests. This system was not available prior to bringing the help desk function in house in April 2007.
   - The 2007 IT budget reflects savings in excess of $750,000 resulting from the in-sourcing of IT management services.
   - The Company has a disaster recovery plan for Oracle Financials and Customer Watch, its two major information systems. The plan does not reflect the recent in-sourcing of IT services and other IT applications.
   - Access to Company information systems is controlled by IT personnel. IT hardware (e.g. servers) is maintained in locked facilities that have appropriate environmental controls.
   - Limited opportunities for efficiency gains may exist through the implementation of new technologies. For example, the Company has not yet implemented mapping software which it has purchased.

2. Cap Rock's information systems have appropriate functionality and support the Company's business needs.

   - As indicated in Chapter VII – Customer Service, the Customer Watch system meets Cap Rock's customer service needs.
   - Oracle financials effectively supports the needs of external reporting (GAAP basis financials) and regulatory reporting (FERC basis financials). CRE has fully implemented Oracle Financials and no longer uses the Daffron and Cameo systems.
   - OutlookSoft is an effective tool for budgeting and management reporting. OutlookSoft has a later release than the version used by Cap Rock, and the current version is still fully supported by the vendor. Given the absence of both long-range financial forecasts and long-term IT plans, the cost and timing

of the upgrade could not be determined.

- Exchange and Share Point facilitate ready communications and information sharing.

3. The Company does not have a long-term information technology plan in place.

   - The Company does not have a long-range financial forecast which is typically one of the drivers of a long-term information technology plan.
   - The decision to in-source IT management services and the resulting formation of an internal IT staff, including an IT Director, should facilitate the development of a long-term IT plan.
   - The current primary focus of the IT Director is managing the transition to an in-sourced IT function.
   - While the lack of a long-term plan does not appear to have resulted in inadequate IT hardware and software resources at this time, the development of a long-term plan would better assure that IT resources are available when needed, including, for example, the upgrade to the latest version of OutlookSoft.

4. While Cap Rock manages its materials and supplies (M&S) inventory in a cost-effective manner, it has not competitively bid its distribution M&S outsourcing contract in recent years.

   - HD Supply, a national distributor of electric utility industry materials and supplies, provides distribution materials to the Company on a cost-plus basis. The contract with HD Supply allows a small utility such as Cap Rock to take advantage of the purchasing power of a significantly larger organization.
   - The mark-up provided to HD Supply covers the cost of storeroom personnel, purchasing personnel, inventory carrying costs, inventory shrinkage, and personal property taxes on the inventory.
   - While the Company believes it realizes significant benefits from its contract with HD Supply, Cap Rock has not recently compared the amounts paid to HD Supply in mark-ups to its avoided costs. In addition, the Company has not competitively bid the contract with HD Supply when the contract has come up for renewal.
   - To ensure the availability of materials when needed, HD Supply is required to maintain appropriate inventory levels. Cap Rock accomplishes this by meeting with HD Supply after the budget is approved to discuss the timing and scope of projects requiring materials and supplies.
   - Material standards are developed and maintained by the Company.

5. NewCorp purchases its own materials and supplies.

- Transmission and substation materials are owned by NewCorp. and are acquired through competitive bidding processes separate from the HD Supply contract.
- Inventories owned and on hand are primarily transmission parts and materials which are not normally stocked by a warehousing company like HD Supply. Supplies and materials are maintained on service trucks, and materials at various remote field locations.

6. Cap Rock manages its human resources function effectively.
   - The Company's HR department is comprised of 2.5 full-time equivalents (FTEs) a reasonable number for a company the size of Cap Rock.
   - The Company's performance management program is well conceived and typical in the industry.
   - The Company is in the process of establishing an incentive compensation program for employees. This program will not put a portion of base pay at risk. The Company believes its base pay is market competitive but not its total compensation program.

7. Cap Rock has made good progress in implementing the recommendations made by the Hay Group in its October 2006 Compensation and Benefits Review report.
   - **Exhibit VI-1** presents the study recommendations and the Company's actions taken to implement those recommendations.[22]

Exhibit VI-1
Implementation Status of Hay Study Recommendations

Recommendation	Implementation Status
Develop an employee handbook.	An employee handbook is currently being prepared and will be distributed to all employees during the first quarter of 2008.
Create an effective recruiting function, improve the interviewing process, and develop a new hire orientation program.	HR will begin using an online recruiting and retention tool (iApplicants) in November 2007 to enhance recruiting efforts and standardize interviewing practices. The newly hired HR Coordinator for safety and performance will facilitate the development of a new hire orientation program to be implemented during the first quarter of 2008.

[22] Responses to IDR No. 17 and JFJ-1.

Recommendation	Implementation Status
Create a formalized training program.	HR will undertake a formal assessment of the Company's training needs during the first quarter of 2008.
Document current HR administrative practices and streamline HR administration.	The Company purchased and implemented an HRIS (PeopleTrak) during the first quarter of 2007.
Develop open door and progressive discipline policies.	HR has established and implemented a Complaint Resolution process that employees are to use in resolving problems related to their employment. The process was introduced to employees during the second quarter of 2007. The new employee handbook includes Open Door and progressive discipline policies.
Establish termination procedures including exit interviews.	HR has established a termination checklist.
Compensation and Communication review. (The Hay Group Report contained a number of specific recommendations related to salary and benefit and communications issues.)	HR is reviewing and revising the recommended Salary Administration Policy and Guidelines (including salary grade structure). The policy will be implemented during the first half of 2008 following revision and approval. CRE has implemented the following benefits changes in response to the review: • The 401(k) matching plan is now offered to all employees. • A paid time-off (PTO) policy that is the same for all employees became effective October 1, 2007. • Company-paid life insurance is now provided to all employees at four times base salary. • Company-paid long-term disability insurance is now provided to all employees. • Optional, employee-paid life insurance (including spouse and dependent coverage) is now available to all employees. • Optional, employee paid short-term disability insurance is now available to all employees.

- As indicated in the above table, Cap Rock does not have formal training programs and its HR policies are not current.

8. The Company's current initiative to achieve parity in the benefit plans offered to employees by January 1, 2008 is appropriate.

- On May 1, 2002, the Company's benefit plans were changed so that employees hired after May 1, 2002 would receive significantly reduced benefits.
- The Company plans to offer the same levels of benefits to all employees beginning January 1, 2008. Effective October 1, 2007, the Company established a consistent paid-time-off policy.
- The Company expects to achieve parity in its benefit plans while staying within its established benefit plan budget. This will be accomplished by price shopping for providers of these services.
- Benefit plans should provide a competitive level of benefits once parity is achieved. Vision care will be offered to employees beginning January 1, 2008.
- The healthcare plan, typically a high-cost benefit, is appropriately funded. The Company self-funds up to $75,000 per incident, with employees paying 20 percent of the costs.

9. Typical of the utility industry, the Company has an aging workforce issue to address.

- A significant portion of the Company's workforce is, or will soon become, retirement eligible.
- There are no plans currently in place to address this issue.

10. The process for allocating corporate support services costs does not effectively use either the direct charging of costs or the allocation of costs based on cost causative factors.

- Corporate support costs are allocated using a general and administrative (G&A) cost allocation process. Administrative costs are allocated using high level allocation factors. Typically, cost allocation policies specify that costs be direct charged if possible; next, that costs be allocated based on cost causative factors (such as activity volumes); and finally, that residual costs are allocated using a general allocation These cost allocation policies and procedures are commonly documented in a Cost Allocation Manual (CAM). Cap Rock does not have a CAM.
- **Exhibit VI-2** shows allocations to NewCorp as a percent of total G&A costs. G&A costs in total dropped significantly from 2005 to 2006 as a result of (a) the payment of bonuses in 2005 and not in 2006, (b) reduced claims

settlements, (c) lower insurance premiums, and (d) a change in the calculation of capitalized G&A expenses.

Exhibit VI-2
Allocation of G&A Costs to NewCorp
($ millions)

Company	2005		2006	
	A&G Costs	Percent of Total	A&G Costs	Percent of Total
NewCorp	$1.9	23.2 %	$2.1	40.5 %
Cap Rock Energy	12.7	76.8	6.4	59.5
Totals	$14.6		$8.5	

- The Master Operation, Maintenance and Administrative Services Agreement between Cap Rock Energy Corporation and NewCorp Resources Electric Cooperative, Inc., calls for the payment by NewCorp to Cap Rock (Service Provider) of the following amounts (section 5(a)(i), (ii) and (iii)):[23]
  - All verifiable direct and indirect reasonable costs of personnel of the Service Provider (including, but not limited to costs of labor, benefits, materials, storage and transportation plus a verifiable allocation of overhead costs calculated under the same methodology as is employed by the Services Provider from time in connection with the provision of services for affiliated entities and business units) in connection with the performance of the Variable Services;
  - Reimbursement for all Variable Services performed by subcontractors based on the reasonable costs invoiced by invoiced by such subcontractors (without any mark-up or adder) other than subcontracts in which the Owner elects to pay directly (collectively, the amounts in clause (i) and (ii) are referred to as the Reimbursable Costs); and
  - An administration fee equal to the amount agreed to in the Annual Budget for payment of all Administrative Services (the Administrative Fee).
- As of January 1, 2007, the four employees who run the daily operations for NewCorp became NewCorp employees and their salaries and benefits are paid by and charged to NewCorp. All materials, vehicles and other items used by NewCorp are charged directly to and paid by NewCorp. To the extent that any Cap Rock non-corporate employees spend time working for NewCorp,

[23] Response to IDR No. 32.

their time is directly charged to NewCorp.[24]

- The Company's current corporate support services cost allocation process (used to identify and allocate the Administrative Fee) is based on the following:
  - Accounting salaries and benefits are allocated equally between Cap Rock Energy and NewCorp under the assumption that the time required to maintain two separate sets of books and processes are equal. While this assumption may be reasonable for general ledger and financial reporting personnel, the costs of employees in transaction processing positions (e.g., payroll, accounts payable) are more appropriately allocated based on numbers of transactions. Accounting department costs other than salaries and benefits are allocated using the three part weighted allocation factor used for other non-labor/benefits expenses.
  - Non-labor related G&A expenses are allocated using a three-part factor. This factor is based on the equal weighting of electric plant-in-service, operating revenues, and direct labor distribution. Non-operating expenses associated with G&A assets (e.g., depreciation, property taxes) are not allocated.
  - G&A labor and benefits (excluding accounting) are based on the direct labor distribution.
  - The Administrative Fee is not trued-up for differences between actual and budget.

F. RECOMMENDATIONS

1. Update the IT Disaster Recovery Plan to reflect the in-sourcing of IT services, and include IT applications in addition to Oracle Financials and Customer Watch. (Refers to Finding VI-1.)
2. Develop a long-term IT plan that considers known and anticipated changes in technology and changes in both internal and external customer requirements. (Refers to Finding VI-3.)
3. Confirm the economic value of the materials management outsourcing arrangement. The Company should compare the amounts paid to HD Supply in mark-ups to its avoided costs and then competitively bid the contract with HD Supply when the contract comes up for renewal. (Refers to Finding VI-4.)

[24] Response to IDR No. 1. Improving the system for allocating charges to NewCorp was a corporate goal and objective for CRE since its purchase by Lindsay Goldberg on May 11, 2006.

4. Formalize training programs and update HR policies as recommended in the Hay Study Report. (Refers to Finding VI-7.)
5. Develop plans to address the aging workforce. (Refers to Finding VI-9.)
6. Improve the methodology for allocating corporate costs to NewCorp, including the adjustment for differences between budget and actual. (Refers to Finding VI-10.)

A. BACKGROUND

The customer service task area covered the following functions:

- Customer relations,
- Customer accounting,
- Billing and collections, and
- Service quality.

CRE has three operating divisions which are each responsible for a specific portion of the Company's service territory as described below:

- Stanton/Lone Wolf divisions cover rural Midland customers and portions of the oil-rich Permian Basin.
- Hunt-Collin division is a northeast suburb of Dallas and includes the management of the Farmersville municipal system.
- McCulloch division in central Texas is a semi-rural area that includes residential and some commercial customers in the Hill Country region of the state.

Each division has customer service personnel responsible for the following work areas:

- Customer accounts (connect orders, disconnect orders, name change orders, service outage reports, billing and collection).
- Meter reading.
- Maintenance and repair.

The customer service functions and personnel are mainly decentralized with each division responsible for customers located in its geographic territory. Work practices are similar in each customer service division office. The Stanton division office provides after hours support for all the divisions and some oversight for billing as well as general policies. In October 2007, CRE reorganized its customer service operations, and assigned overall responsibility for all customer service operations to the Division Manager for the McCulloch Division. Two manager level personnel were reassigned to the resource management and administrative area to provide more focus on account management and regulatory for all of CRE at a corporate level. However, daily customer service continues to be mainly decentralized.

As shown in **Exhibit VII-1**, CRE's residential rates compare favorably to its closest competitor (TXU Energy).