State Office of Administrative Hearings

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Cathleen Parsley
Chief Administrative Law Judge

December 2, 2010

TO: Stephen Journeay, Director
Commission Advising and Docket Management
William B. Travis State Office Building
1701 N. Congress, 7th Floor
Austin, Texas 78701

<u>Courier Pick-up</u>

RE: SOAH Docket No. 473-10-5001
PUC Docket No. 38339

Application Of Centerpoint Electric Delivery Company, LLC, For Authority To Change Rates

Enclosed is one copy of the Proposal for Decision (PFD) in the above-referenced case. By copy of this letter, the parties to this proceeding are being served with the PFD.

Please place this case on an open meeting agenda for the Commissioners' consideration. The deadline for the Commission to issue its Order is January 1, 2011. It is our understanding that you will be notifying us and the parties of the open meeting date, as well as the deadlines for filing exceptions to the PFD, replies to the exceptions, and requests for oral argument.

Sincerely,

Richard R. Wilfong
Administrative Law Judge

Sincerely,

Steven D. Arnold
Administrative Law Judge

Enclosure

xc: All Parties of Record

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SOAH DOCKET NO. 473-10-5001
PUC DOCKET NO. 38339

APPLICATION OF CENTERPOINT ELECTRIC DELIVERY COMPANY, LLC, FOR AUTHORITY TO CHANGE RATES	§ § § §	**BEFORE THE STATE OFFICE OF ADMINISTRATIVE HEARINGS**

PROPOSAL FOR DECISION

Table of Contents

List of Acronyms and Defined Terms

TERM	DEFINITION
2003 Act	Medicare Prescription Drug, Improvement and Modernization Act of 2003
4CP	Four Coincident Peak
ACC	Alternative Customer Charge
ADFIT	Accumulated Deferred Federal Income Tax
AEP	American Electric Power Company
ALG	Average Life Group
ALJs	Administrative Law Judges
AMS	Advanced Metering System
ARM	Alliance for Retail Markets
ASL	Average Service Life
CAPM	Capital Asset Pricing Model
CEHE	CenterPoint Energy Houston Electric, LLC
CenterPoint	CenterPoint Energy Houston Electric, LLC
CERC	CenterPoint Energy Resource Corp.
CI	Conformance Index
CNP	CenterPoint Energy, Inc.
Code	The Internal Revenue Code of 1986
COH/HCOC	City of Houston
Commission	Public Utility Commission of Texas
Company	CenterPoint Energy Houston Electric, LLC
Comptroller	Comptroller of Public Accounts of the State of Texas
CRL	Composite Remaining Life
C.S.S.B. 1447	Committee Substitute Senate Bill 1447
CTSA	Consolidated Tax Savings Adjustment
CWC	Cash Working Capital
CWIP	Construction Work in Progress
DCF	Discounted Cash Flow
DCRF	Distribution Cost Recovery Factor
Direct Energy	Direct Energy, LP
DOE	United States Department of Energy
DSC	Discretionary Service Charge
DSP	Distribution Service Providers
EE	Energy Efficiency
EECRF	Energy Efficiency Cost Recovery Factor
EIA	Energy Information Administration
EMO	Electric Market Operations
EMR	Earnings Monitoring Report
EPIS	Electric Plant in Service
ERCOT	Electric Reliability Council of Texas

TERM	DEFINITION
FAS 87	FASB Statement No. 87
FAS 106	FASB Statement No. 106
FASB	Financial Accounting Standards Board
FERC	Federal Energy Regulatory Commission
FIN 48	Financial Interpretation Number 48
FIT	Federal Income Tax
Gas Operations	Natural Gas Distribution Operations of CERC
GCCC	Gulf Coast Coalition of Cities
GDP	Gross Domestic Product
GSU	Gulf States Utilities Company
Health Care Legislation	Patient Protection and Affordable Care Act and Health Care and Education Reconciliation Act of 2010
IG	Intelligent Grid
IRS	Internal Revenue Service
kVA	Kilovolt-ampere
kW	Kilowatt
kWh	Kilowatt-hour
LRAM	Lost Revenue Recovery Mechanism
LTI	Long-Term Incentive Compensation Plan
NCP	Non-Coincident Peak
NOC	Network Operating Center
NYPSC	New York Public Service Commission
UCOS	Unbundled Cost of Service
Oncor	Oncor Electric Delivery Company LLC
OPC	Office of Public Utility Counsel
OPEB	Other Post-employment Benefits
PCAOB	Public Company Accounting Oversight Board
PFD	Proposal for Decision
PHFU	Plant Held for Future Use
PUC	Public Utility Commission of Texas
PURA	Public Utility Regulatory Act
Reconciliation Period	January 1, 2009, to March 31, 2010
REI	Retirement Experience Index
REP	Retail Electric Provider
Rider EECRF	Energy Efficiency Cost Recovery Factor Rider
Rider IPC	Rider Insurance Proceeds Credit
Rider SH	System Hardening Rider
ROE	Return on Equity
ROR	Rate of Return
RUWC	Rider UCOS Wholesale Credit
RWIP	Retirement Work in Progress

TERM	DEFINITION
SCUD	State Colleges and Universities Discount
SEC	United States Securities and Exchange Commission
Service Company	CenterPoint Energy Service Company, LLC
SFT	Texas State Franchise Tax
SGIG	Smart Grid Investment Grant
SLA	Service Level Agreements
SOAH	State Office of Administrative Hearings
SOX	Sarbanes-Oxley Act of 2002
SPR	Simulated plant Record
Staff	Staff of the Public Utility Commission of Texas
State Agencies	State of Texas State Agencies
STI	Short-Term Incentive Compensation Plan
Storm Hardening Costs	Future improvements that would include: (1) increased proactive tree trimming; (2) proactive hazard tree removal; (3) increased pole maintenance inspections; (4) increased feeder inspections; and (5) the installation of an intelligent grid adopted by CenterPoint in response to the Commission's adoption of the Storm Hardening Rule
T&D	Transmission and Distribution
TCOS	Transmission Cost of Service
TCUC	Texas Coast Utilities Coalition
TEAM	Texas Energy Association for Marketers
TIEC	Texas Industrial Energy Consumers
TLSC/TxROSE	Texas Legal Services Center/Texas Ratepayers Organization to Save Energy
TNMP	Texas-New Mexico Power Company
TOC	Total Ownership Cost
TSPs	Transmission Service Products
TXU	TXU Energy Retail Company, LLC
USOA	FERC Uniform System of Accounting
UTP	Uncertain Tax Position

SOAH DOCKET NO. 473-10-5001
PUC DOCKET NO. 38339

APPLICATION OF CENTERPOINT ELECTRIC DELIVERY COMPANY, LLC, FOR AUTHORITY TO CHANGE RATES	§ § § §	**BEFORE THE STATE OFFICE OF ADMINISTRATIVE HEARINGS**

PROPOSAL FOR DECISION

I. INTRODUCTION [GERMANE TO PRELIMINARY ORDER ISSUE NO. 1]

CenterPoint Energy Houston Electric, LLC (CenterPoint, CEHE, or Company) is an investor-owned electric utility within the Electric Reliability Council of Texas (ERCOT) system. CenterPoint provides transmission and distribution (T&D) electric services in a roughly 5,000 square-mile territory of the Southeast Coastal region of Texas, including the Houston area. CenterPoint is one of the largest T&D utilities in Texas. It does not sell electricity or purchase electricity for resale, but instead provides transmission service to other electricity distribution companies, cooperatives, and municipalities, and distribution services to retail electric providers (REP). Although CenterPoint does not directly serve residential or industrial customers, the utility delivers electricity to over two million meters in 95 cities in Texas.

Pursuant to the Settlement Agreement reached as part of its 2006 rate case in Docket No. 32093,[1] CenterPoint filed a 2009 Earnings Monitoring Report (EMR) in March 2010 for review by the Public Utility Commission of Texas (Commission or PUC) staff (Staff), the City of Houston, and the Gulf Coast Coalition of Cities (GCCC). The 2009 EMR also showed that CenterPoint earned a weather-adjusted return on equity (ROE) of 9.81 percent. The 2009 EMR showed that CenterPoint earned a non-weather-adjusted ROE of 11.13 percent. On June 30, 2010, CenterPoint filed its Application with the Commission requesting authorization to increase its T&D rates and a reconciliation of costs incurred related to its Advanced Metering System (AMS) deployment. CenterPoint filed this Application at the directive of Staff, the City of Houston, and GCCC, who

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[1] *Petition by Commission Staff for a Review of CenterPoint Energy Houston Electric, LLC Pursuant to PURA § 36.151*, Docket No. 32093, Order (Sept. 5, 2006).

chose to exercise their right under the Order in Docket No. 32093 to require CenterPoint to initiate a general rate case. Under CenterPoint's proposed rates, retail distribution service revenues would increase approximately $92 million, and transmission revenues would increase approximately $18 million. CenterPoint also requests an over-all rate of return (ROR) on investment of 9.0 percent, based on a proposed capital structure having a 50/50 ratio of debt to equity; a 6.74 percent cost of debt; and a ROE of 11.25 percent.

Staff, the Office of Public Utility Counsel (OPC), and intervenors[2] strenuously object to any rate increase, and argue that CenterPoint's rate should decrease. Staff and intervenors point out that CenterPoint only filed this rate case because it was required to do so as part of the settlement reached in Docket No. 32093.

II. JURISDICTION AND NOTICE

The Commission has jurisdiction over CenterPoint and this rate case application pursuant to Public Utility Regulatory Act (PURA) §§ 14.001, 32.001, 33.002 and 35.004. The State Office of Administrative Hearings (SOAH) has jurisdiction over the contested case hearing, including the preparation of the proposal for decision (PFD) pursuant to PURA § 14.053 and TEX. GOV'T CODE ANN. § 2003.049(b). Those municipalities in CenterPoint's service area that have not surrendered jurisdiction to the Commission continue to have exclusive original jurisdiction over CenterPoint's rates, operations, and services, in their respective municipalities pursuant to PURA § 33.001. When CenterPoint filed its application with the Commission, it also filed the application with its original jurisdiction cities. Pursuant to PURA §§ 32.001(b), 33.051, and 33.053, CenterPoint appealed the actions of the original jurisdiction cities to the Commission and had those appeals consolidated with this docket.

CenterPoint's notice of its application and notice of the hearing were not contested and, therefore, do not require further discussion but will be addressed in the proposed findings of fact and conclusions of law.

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[2] A list of the parties whose requests to intervene were granted is included in Section III, *infra*.

III. PROCEDURAL HISTORY

As noted above, CenterPoint filed its application and rate filing package on June 30, 2010. On the same date the Commission referred this proceeding to SOAH. On July 30, 2010, the Commission issued its Preliminary Order setting forth 37 issues to be addressed in this proceeding. The Order also stated that the following issues would not be addressed in this proceeding: whether to permit a lost revenue adjustment through an Energy Efficiency Cost Recovery Factor (EECRF); whether CenterPoint may include money spent pursuant to the settlement in Docket No. 32093 in its calculation of its performance bonus; and whether CenterPoint should be authorized to implement a Distribution Cost Recovery Factor (DCRF) rider.

The following entities were granted intervenor status in this case: The City of Houston and the Houston Coalition of Cities (COH/HCOC); GCCC; Texas Coast Utilities Coalition (TCUC); Texas Industrial Energy Consumers (TIEC); State of Texas State Agencies (State Agencies); OPC; Alliance for Retail Markets (ARM); Reliant Energy Retail Services, LLC; TXU Energy Retail Company, LLC (TXU); Texas Energy Association for Marketers (TEAM); Direct Energy, LP (Direct Energy); Texas Legal Services Center and Texas Ratepayers' Organization to Save Energy (TLSC/TxROSE), and Oncor Electric Delivery Company LLC (Oncor).

The hearing on the merits convened before SOAH ALJs Richard R. Wilfong and Steven D. Arnold on October 11, 2010, and continued through October 15, 2010. The record remained open for the filing of post-hearing briefs. On October 29, 2010, the parties filed their reply briefs and the record closed. Number running began on November 19, 2010, and Staff returned the final numbers to the ALJs on November 23, 2010. The parties requested that the ALJs submit their PFD by December 2, 2010.

Although 14 entities were granted intervenor status, not all of the intervenors participated in the hearing or filed briefs. The following is a list of the parties who participated in the hearing and their counsel:

PARTIES	REPRESENTATIVES
CenterPoint	Jason M. Ryan and Ann Coffin[3]
GCCC	Thomas L. Brocato and Christopher L. Brewster
COH/HCOC	Alton J. Hall, Jr. and Tammy Wavle-Shea
TIEC	Lino Mendiola, Michael Boldt, and Tammy Cooper
Direct Energy, LP	John K. Arnold and James W. Checkley, Jr.
TCUC	Felipe Alonso, III
State of Texas	Susan Kelly
OPC	James Rourke
TLSC/Tx.ROSE	Lanetta Cooper
Staff	Patrick Peters, III, Shelah J. Cisneros, Susan E. Goodson, and Susan Stith

IV. EXECUTIVE SUMMARY [GERMANE TO PRELIMINARY ORDER ISSUE NO. 5]

The ALJs recommend an overall rate decrease for CenterPoint of $84.401 million, as shown on the schedules attached to this PFD. That compares with CenterPoint's proposed overall increase of approximately $110 million. All other parties proposed reductions to the overall revenue requirement ranging from approximately $59 million to $135 million, as well as recommending significant changes to CenterPoint's cost allocation and rate design.

On issues of particular significance, the ALJs' recommendations are set forth below.

A. Rate Base

1. T&D Capital Investment

The ALJs find CenterPoint's transmission and distribution capital investments were used and useful and reasonable and necessary unless otherwise noted.

[3] Several other attorneys appeared on behalf of CEHE. The ALJs listed only the two attorneys who appeared throughout the hearing.

2. Accumulated Deferred Federal Income Taxes (ADFIT)

The ALJs recommend the $164,314,000 removed from the ADFIT because of FIN 48 be reentered into the ADFIT balance and thus reduce CenterPoint's rate base.

3. Cash Working Capital (CWC)

The following changes should be made to CenterPoint's CWC:

a. **Affiliate O&M Expense:** CenterPoint's proposed lead days of 33.70 for expenses to CenterPoint's affiliates, and 33.86 days for expenses charged by CenterPoint to its affiliates should both be changed to 45.21 days. This reduces CenterPoint's proposed distribution revenue requirement by $0.621 million and its proposed transmission revenue requirement by $0.109 million.

b. **Uncollectible Expense:** CenterPoint's calculation of cash working capital should be reduced by $551,000 for bad debt, or uncollectible expense.

4. Plant Held for Future Use (PHFU)

CenterPoint's proposed PHFU level should be increased by $36.74 million for the Rothwood and Meadows substations ($33.3 million) and for transformer improvements ($3.44 million) based on the ALJs'denial of those amounts as post-test year adjustments to rate base.

5. Regulatory Assets

The ALJs propose no change to CenterPoint's requested $58.7 million for pensions and Other Post-employment Benefits (OPEB) and $453,000 for expedited customer switches.

6. Advanced Metering System

The ALJs recommend that the $164,710,917 incurred by CenterPoint over the period January 1, 2009 through March 31, 2010 be approved as reasonable and necessary capital and O&M costs.

B. Rate of Return and Capital Structure

The ALJs recommend a return on equity (ROE) of 10.41 percent; a cost of debt of 6.74 percent; a capital structure comprised of 55 percent debt and 45 percent common equity; and an overall rate of return of 8.3915 percent. The ALJs' recommendation is a downward adjustment to CenterPoint's request for an 11.25 percent ROE; 6.74 percenty cost of debt; and 50/50 capital structure. This compares to Staff's proposed 9.67 percent ROE and 55/45 capital structure; OPC's proposed 9.60 percent ROE; TIEC's proposed 9.75 percent ROE; and GCCC's and COH/HCOC's proposed 10 percent ROE. No party opposed CenterPoint's proposed 6.74 percent cost of debt and all the intervenors proposed a 60/40 capital structure.

C. Cost of Service

1. Pension and OPEB Expenses

No change to CenterPoint's proposal.

2. Self Insurance

The ALJs recommend approval of an annual accrual of $4.15 million and a target reserve level of $13.28 million but recommend denial of the additional $1.13 annual accrual requested by CenterPoint.

3. Energy Efficiency Expenses and Programs

The ALJs recommend no changes.

4. Amortization – Hurricanes Rita and Ike

The ALJs recommend that CenterPoint be allowed to amortize the remaining Hurricane Rita restoration costs over the three remaining years of the seven-year amortization period approved in Docket No. 32093 as requested. However, the ALJs recommend that CenterPoint be required to amortize the Hurricane Ike restoration cost insurance proceeds over a five-year amortization period and thus reduce CenterPoint's distribution revenue requirement by $2.065 million.

5. Depreciation Expense

The ALJs recommend the values proposed by CenterPoint except for the following:

Service Lives:
Account 350-ATOC's 100-year service life.
Account 362-Staff's 50-year service life.
Account 364-ATOC's 41-year service life.

Net Salvage:
Account 352/361-Staff's negative 33 percent.
Account 354-Staff's negative 34 percent
Account 365-ATOC's negative 40 percent.
Account 366-Staff's negative 50 percent.
Account 367-ATOC's and Staff's negative 5 percent.

For Account 370—Distribution Meters, the ALJs recommend Oncor's proposed 11-year depreciation period.

6. Federal Income Tax Expense

The ALJs recommend including $15,076,923 ($9.8 million grossed-up) Consolidated Tax Savings Adjustment (CTSA) in CenterPoint's federal income tax expenses, subject to further adjustments for losses allocated in 2004 and 2005 and the Docket No. 12065 regulatory treatment.

7. Medicare Part D Subsidy

The ALJs recommend including a $9.3 million regulatory asset in CenterPoint's rates and amortizing the amount over three years.

D. Cost Allocation and Rate Design

1. Gradualism

The ALJs recommend that the concept of gradualism not be applied.

2. Transformer Allocation

The ALJs recommend that transformer costs be classified 18 percent energy and 82 percent as demand-related.

3. 4CP Transmission Cost Allocation Factor

For the Transmission Cost Allocation Factor, the four coincident peak (4CP) methodology should be used, but CenterPoint's proposed adjustments for weather, the number of year-end customers, and the use of 15-minute demands rather than hourly demands should be rejected.

4. Uncollectible Expense

The ALJs recommend that CenterPoint be required to track uncollectible expense on a class basis for consideration of revenue versus class allocation in CenterPoint's next rate proceeding.

5. Waiver of Demand Ratchet Provisions

CenterPoint's request for a waiver of demand ratchet provision for loads with maximum annual demand of 20 kilowatt (kW) or less should be approved.

6. Street Lighting

The ALJs agree with CenterPoint's proposal to adopt a 72-hour replacement policy.

7. Rider SH (Storm Hardening)

The ALJs recommend denial of this rider.

8. Rider EECRF (Energy Efficiency Cost Recovery Factor)

The ALJs recommend the Commission approve CenterPoint's rider as modified pursuant to the Commission's Preliminary Order.

9. Rider SCUD—State Colleges and Universities Discount

The ALJs recommend that this discount be eliminated.

10. Deferred Tax Riders

The ALJs recommend denial of these riders consistent with their recommendation to add FIN 48 to ADFIT.

11. Alternative Customer Charge

The ALJs recommend that CenterPoint's proposed alternative customer charge be denied.

V. RATE BASE [GERMANE TO PRELIMINARY ORDER ISSUE NOS. 7 AND 9]

A. Capital Investment

1. Transmission

CenterPoint included in rate base approximately $651.6 million for transmission and substation investment that it incurred between January 1, 2003, and December 31, 2009.[4] The evidence established that CenterPoint's transmission capital investment is used and useful in providing service to the public. According to CenterPoint witness John C. Houston these capital expenditures were reasonable and necessary to: (1) provide transmission system interconnections; (2) make necessary transmission system upgrades; (3) construct transmission facilities associated with distribution substations; (4) replace and modify transmission facilities; (5) support the operation of the transmission and substation organization; and (6) restore the transmission system after Hurricane Ike in accordance with the Commission's final order in Docket No. 36918.[5] CenterPoint's request to recover $651.6 million of capital investment in transmission was not challenged by any party and should be approved.

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[4] CEHE Ex 10 (Houston Direct) at 29-30. CenterPoint seeks recovery of transmission investment made since 2003 because the net plant balances in its last rate case (Docket No. 32093) were established as of January 1, 2003.

2. Distribution

CenterPoint invested $802.5 million in distribution plant additions between January 1, 2006, and December 31, 2009. CenterPoint witness Terry Finley testified that these capital investments were reasonable and necessary to: (1) satisfy service area growth needs; (2) improve system reliability; (3) make required service restorations; and (4) support other distribution activities.[6] CenterPoint's request to recover $802.5 million of distribution capital investment was not challenged by any party and should be approved.

B. Adjustments [Germane to Preliminary Order Issue No. 6]

1. Post-Test Year Adjustments

CenterPoint sought to recover, in addition to the transmission and distribution capital investments discussed above, $33.3 million for two substations (Rothwood and Meadows) not placed in service until 2010, and $3.44 million in post-test year distribution transformer improvements.[7] Staff and GCCC objected on the grounds that: (1) the request did not meet the 10 percent of requested rate base threshold established by P.U.C. SUBST. R. 25.231(c)(2)(F)(II), and (2) CenterPoint had not made a timely request for a good cause waiver of this requirement. At the beginning of the hearing, on October 11, 2010, the ALJ's denied CenterPoint's late filed request for a good cause waiver because the request was untimely, and amounted to little more than a challenge to the Commission's rule. Thus, CenterPoint's request to include this $36.74 million as post-test year adjustments should be denied. However, the ALJ's agree with CenterPoint that if these post-test year adjustments to rate base are disallowed, a corresponding adjustment must be made to the balance of Plant Held for Future Use (PHFU).[8]

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5 *Application of CenterPoint Houston Electric, LLC for Determination of Hurricane Restoration Costs,* Docket No. 36918, Order (Aug. 14, 2009); CEHE Ex 10 (Houston Direct) at 33-48.

6 CEHE Ex. 11 (Finley Direct) at 19-28.

7 CEHE Ex. 10 (Houston Direct) at 30; CEHE Ex. 28 (Fitzgerald Direct) at Exhibit WLF-8a; GCCC Ex. 1 (Kollen Direct) at 35.

8 This is further addressed in Section III.G. below.

2. AMS

CenterPoint made an adjustment to include its $52.6 million investment in AMS capital costs incurred from January 1, 2010, through March 31, 2010. CenterPoint correctly points out that this is not, however, a post-test year adjustment. Rather, this investment was incurred consistent with the Commission's order in Docket No. 35639.[9] No party challenged CenterPoint's request to include the investment of $52.6 million in AMS capital costs. The ALJ's find that CenterPoint's request is reasonable and should be allowed.

C. ADFIT

1. FIN 48 Liabilities [Germane to Preliminary Order Issue No. 24]

Under Financial Accounting Standards Board (FASB) Interpretation No. 48 (FIN 48), CenterPoint and its independent auditors are required to evaluate each of its uncertain tax positions (UTP) to determine, under the most objective, reasonable standards, which portion of each position will ultimately be paid to taxing authorities. FIN 48 requires that this portion—the FIN 48 liability—related to temporary or timing differences be excluded from ADFIT for financial reporting purposes and accrue interest and penalties.

Tax law is complex. The Internal Revenue Code of 1986 (Code), Treasury regulations, Internal Revenue Service (IRS) pronouncements, and court decisions form a web of authority that frequently does not yield clear answers. In fact, in many instances, no authority addresses the proper tax treatment of a particular transaction.[10] In filing annual tax returns, companies must therefore

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[9] CEHE Ex. 28 (Fitzgerald Direct) at 29, Ex. WLF-8a, and Ex. WLF-8b; CEHE Ex. 1 at Schedule II-B; Docket No. 35639 was the *Application of CenterPoint Energy Houston Electric, LLC for Approval of Deployment Plan and Request for Surcharge for an Advanced Metering System*.

[10] *See* CEHE Ex. 26 (Felsenthal Direct) at Ex. ADF-1, ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES, Interpretation No. 48 at Summary (Fin. Accounting Standards Bd. 2006), *available at* ACCOUNTING STANDARDS CODIFICATION 740-10 (hereinafter cited as FIN 48).

often choose among competing tax reporting positions when there is no certain answer under the tax law.[11]

Before the adoption of FIN 48, companies lacked specific guidance about how to treat these uncertain tax liabilities for financial reporting purposes. FIN 48 was promulgated to provide that guidance and eliminate the "diverse accounting practices [that had] developed resulting in inconsistency in the criteria used to recognize, derecognize, and measure benefits related to income taxes, [which in turn] resulted in noncomparability in reporting income tax assets and liabilities."[12] FIN 48 was issued in June 2006 and adopted by CenterPoint in 2007.[13]

Generally speaking, under FIN 48, companies may record the benefits from tax filing positions on their financial statements only if those positions meet the specific standards discussed below.[14] Amounts relating to temporary differences that are attributable to tax positions not meeting the FIN 48 standards (*i.e.*, FIN 48 liabilities) are excluded from deferred tax liabilities (or assets) and stated separately on a company's financial statements.[15] Thus, for financial reporting purposes, FIN 48 liabilities are expressly excluded from ADFIT, a fact the Commission has previously expressly recognized.[16]

FIN 48 sets forth a rigorous two-step test that requires a company to make an objective, pragmatic analysis of each tax position claimed on its tax return in order to determine the largest amount of tax benefit that it ultimately expects to realize, based on the facts, the state of the tax law, and the IRS's administrative practice.[17] In the first step, the company must determine, based on the

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[11] *See id.*

[12] *Id.* at 55–56.

[13] *Id.* at 55.

[14] *Id.* at 56.

[15] FIN 48 ¶ 17; CEHE Ex. 26 (Felsenthal Direct) at 60.

[16] *See Application of Oncor Electric Delivery Company LLC for Authority to Change Rates,* Docket No. 35717, Order on Reh'g at 18, FOF 55 (Nov. 30, 2009) ("FIN 48 . . . requires companies with uncertain tax positions to remove the amount from the ADFIT and record it as a potential liability with interest to better reflect the company's financial condition.").

[17] CEHE Ex. 26 (Felsenthal Direct) at 56.

technical merits of each tax position, whether it is at least more likely than not (*i.e.*, there is more than a 50 percent chance) that the company's tax position would be sustained upon the resolution of any examination, related appeals, or litigation.[18] If a tax position has a 50 percent or less of chance of being sustained, the company cannot book the benefits of such position for financial reporting purposes.[19] In making this determination, a company is to assume review by the IRS (and all other relevant taxing authorities) with full knowledge and consideration of all relevant facts and law.[20] This assumption "is not an 'overly conservative' assumption" but is instead a "realistic assumption for large entities such as CenterPoint Energy, which is subject to continuous IRS audits performed by qualified IRS personnel,"[21] and mirrors reality given the new IRS Schedule UTP on which taxpayers like CenterPoint Energy, Inc. (CNP) will be required to describe, list, and rank each tax position for which a FIN 48 liability exists.

For tax positions that relate only to a question of timing (*i.e.*, "when" the deduction will be permitted, not "if"), the first step of the FIN 48 inquiry is deemed satisfied.[22] For a tax position that passes the first step (*i.e.*, is at least more likely than not to be sustained), the company must then measure the probable tax benefit that it will recognize for the tax position.[23] Under this second step of the FIN 48 test, a company records the largest amount of tax benefit that is more likely than not to be realized upon settlement with the taxing authority, again assuming the authority's full knowledge of all relevant facts and law.[24] The portion of the UTP not meeting this threshold is recorded as a FIN 48 liability and excluded from ADFIT for financial reporting purposes.[25]

A company must accrue interest and penalties payable to the IRS on its FIN 48 liabilities. In this manner, the FIN 48 liabilities are similar to a loan from the Treasury, however, unlike ADFIT,

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[18] FIN 48 ¶ 6; CEHE Ex. 26 (Felsenthal Direct) at 56.

[19] FIN 48 ¶ 6.

[20] *Id.* at ¶ 7(a).

[21] CEHE Ex. 26 (Felsenthal Direct) at 61.

[22] *Id.* at 56.

[23] FIN 48 ¶ 8.

[24] *Id.*; CEHE Ex. 26 (Felsenthal Direct) at 56–57.

[25] FIN 48 ¶ 17.

which is commonly referred to as an "interest-free" loan or "cost-free capital," FIN 48 liabilities have an associated cost. The amount of interest expense to be recognized on a company's books is computed by applying the applicable statutory rate of interest to the FIN 48 liability amount.[26] Likewise, if a FIN 48 liability does not meet the minimum threshold to avoid the payment of penalties, the company must recognize an expense for the amount of the statutory penalty in the period in which the company claims or expects to claim the position in its tax return.[27] Such interest and penalties continue to accrue until the tax position is finally settled or resolved.[28] In this way, FIN 48 liabilities capture the entire amount that the company expects it will, more likely than not, ultimately pay the taxing authorities as a result of various taxing authorities' adjustments to its filed income tax returns.[29]

A company's independent external auditors apply detailed auditing procedures to a company's FIN 48 liabilities as part of its annual audit before certifying its financial statement.[30] Further, FIN 48 liabilities are subject to the Sarbanes-Oxley Act of 2002 (SOX), which prohibits an officer or director of an audited company, or any person acting under the company's direction, from "fraudulently influenc[ing], coerc[ing], manipulat[ing] or mislead[ing]" any independent auditor of that company with the purpose of rendering the financial statements prepared by that auditor "materially misleading."[31]

Independent auditors themselves have strong incentives to accurately review a company's FIN 48 positions, ensuring that amounts set forth therein are neither "over" nor "under" reported. SOX established the Public Company Accounting Oversight Board (PCAOB), a nonprofit entity

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[26] *Id. at* ¶ 15.

[27] *Id.* at ¶ 16.

[28] *Id.*

[29] CEHE Ex. 26 (Felsenthal Direct) at 59.

[30] *Id.*; *see also* 17 C.F.R. § 210.2-02(b), (c) (2009) (requiring accountants to verify that they audited the registered entity and produce its financial statements under GAAP); FIN 48 ¶ 6 (permitting entities to recognize in their financial statements only those tax positions that are more likely than not to be sustained upon examination).

[31] 15 U.S.C. § 7242(a) (2006); 17 C.F.R. § 240.13b2-2(b)(1) (2009).

which oversees independent auditors of public companies.[32] The PCAOB investigates the practices of independent auditors at least every three years, and at least annually for independent auditors that audit more than 100 public companies each year.[33] The PCAOB can impose sanctions on independent auditors that knowingly or recklessly contribute to a company's violation of professional accounting standards.[34] Potential sanctions include substantial fines and suspension from auditing public companies.[35]

On a quarterly basis, a company must review and adjust, as appropriate, its FIN 48 liabilities, taking into account changes in law and the effect of those changes on the company's prospects of prevailing before the applicable taxing authority. This quarterly review must also account for any settlements with taxing authorities that may impact FIN 48 liability amounts.[36]

OPC witness June Dively, COH/HCOC witness Ellen Blumenthal, and GCCC witness Lane Kollen each assert that deductions of $164,314,000 – representing CenterPoint's FIN 48 liabilities – should be added to CenterPoint's ADFIT and thus be used to reduce CenterPoint's rate base. CenterPoint acknowledges the principle basis for this position – the Commission first considered this issue in the recent Oncor docket.[37] In that docket, the Commission decided to include FIN 48 liabilities in ADFIT because of the low likelihood that the IRS would actually audit and review the issue.[38] If nothing else had changed, there would be no controversy here; CenterPoint would surely lose. However, there has been a new development that CenterPoint claims changes the entire landscape of the argument. That change is the release by the IRS of a new Schedule UTP on which taxpayers like CenterPoint are required to describe, list, and rank each tax position for which a

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32 *Id.* at § 7211(a) (2006).

33 *Id.* at § 7214(b) (2006).

34 *Id.* at § 7215(c)(4) (2006); PCAOB Rule 3502: Responsibility Not to Knowingly or Recklessly Contribute to Violations, 71 Fed. Reg. 12,721 (Mar. 13, 2006) (adopted April 25, 2006); Tr. at 4967 (Oct. 12, 2010).

35 15 U.S.C. 7215(c)(4) (2006).

36 CEHE Ex. 26 (Felsenthal Direct) at 60.

37 *See Application of Oncor Electric Delivery Company LLC for Authority to Change Rates,* Docket No. 35717, Order on Reh'g (Nov. 30, 2009).

38 *Id.* at 18 FOF 59 ("The IRS may not audit or reverse Oncor's position as to the tax deductions identified as FIN 48 deductions and moved into the FIN 48 reserve.").

FIN 48 liability exists. Given this new schedule, CenterPoint argues, there is virtual certainty the IRS will audit the UTPs.[39] Thus, according to CenterPoint, the key premise underlying the Oncor decision is no longer present, and it seems clear that in light of this development the Commission should conclude that FIN 48 liabilities are not reasonably included in ADFIT.

Unfortunately for CenterPoint, however, the introduction of Schedule UTP into the argument really changes very little. Even before the creation of the Schedule UTP disclosure, a company is to assume review by the IRS (and all other relevant taxing authorities) *with full knowledge and consideration of all relevant facts and law.*[40] Therefore, as a practical matter, the addition of Schedule UTP adds little to the landscape of the argument. While the addition of Schedule UTP increases the odds of an audit, in the minds of the ALJs it is only a small increase in the odds when compared to the prospects of audit where the IRS has full knowledge of the facts and applicable law. Therefore, the ALJs recommend that the Commission find that deductions of $164,314,000 – representing CenterPoint's FIN 48 liabilities – should be added to CenterPoint's ADFIT and thus be used to reduce CenterPoint's rate base.

2. Intervenors' Proposed Rate Base Items

As the ALJs have recommended rejection of the intervenors' proposed rate base adjustments, no further adjustments are necessary, and the ALJs recommend that the Commission so find.

D. Cash Working Capital

1. State Franchise Tax

CenterPoint witness Joyce claims that in computing cash working capital, the service period regarding the Texas State Franchise Tax (SFT) is the year in which the expense is paid. Using this

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[39] CEHE Ex. 26 (Felsenthal Direct) at 63 ("This schedule will arm the IRS auditors with sufficient information to quickly determine which UTPs are of a magnitude worth investigating.").

[40] FIN 48 at ¶ 7(a).

approach, CenterPoint proposes 48.5 negative lead days,[41] meaning that the tax is paid 48.5 days before the midpoint of the year in which it is paid.[42]

GCCC argues that the Commission has addressed the service period for the SFT before. In Oncor's most recent rate case, Docket No. 35717, the issue of what is the correct service period for this tax was fully litigated and decided by the Commission. In the Oncor case, the Commission determined that the service period for the SFT was the year that the liability for the tax was incurred, not the year in which the tax was paid.[43]

GCCC further argues that CenterPoint accrues the liability for the Texas margin tax each quarter during the year prior to the year in which the tax is paid so that the liability is fully accrued at the end of the prior year.[44] For 2008, the Company deferred the quarterly amounts as a regulatory asset and then expensed the total amount for the year in 2009 once it paid the tax.

Mr. Kollen testified that the SFT paid in the test year was accrued as a liability throughout the prior year, an accounting treatment which signifies that the expense was actually incurred in the prior year and that the service period was the prior year, not the test year.[45] Given this accounting treatment by the Company, argues GCCC, there is simply no plausible argument that the service period for this expense was 2009. If the expense was incurred in 2009, according to GCCC, it would not have recorded it simultaneously as a liability in 2008.

GCCC also argues that CenterPoint witness Alan Felsenthal contradicts the testimony of Mr. Joyce on this point and agrees with Mr. Kollen that the expense actually is incurred in the prior year. Mr. Felsenthal testifies that: "[t]here is a one year lag between the taxable year and the payment year for the Texas margin tax (*e.g.*, 2008 Texas margin tax is paid in 2009, 2009 Texas

[41] CEHE Ex. 24 (Joyce Direct) at JJJ-3 and JJJ-4

[42] GCCC Ex. 1 (Kollen Direct) at 44

[43] *Id.* at 47

[44] *Id.* at 45 and Attachments G and H.

[45] *Id.* at 46

margin tax is paid in 2010.)"[46] According to GCCC, Mr. Felsenthal's description of this tax is correct, and accords with how CenterPoint actually accounts for it – during the taxable year, CenterPoint records a liability for the expense and then defers the expense as a regulatory asset until the following year when the tax is paid and the regulatory asset is amortized to expense.

CenterPoint counters that subsequent to the Commission's decision in Docket No. 35717, the Comptroller of Public Accounts of the State of Texas (Comptroller) issued an opinion that makes clear that the SFT payment is made during, and not after, the current annual privilege period (*i.e.*, service period).[47] CenterPoint claims that it is undisputed that the Company's calculation of the SFT is consistent with the Comptroller's opinion.

The privilege period is the equivalent of the service period – it is the period that covers the timeframe that electric service is provided to the customers.[48] In this case, the evidence establishes that the SFT is paid for the privilege period of the calendar year in which the payment is made and the report is due, regardless of when the accounting accrual for the cost occurs. The Comptroller's opinion confirms Mr. Joyce's testimony on this issue:

> The privilege period covered by the first annual report will be from the date the entity became subject to the franchise tax through 12/31 of the following calendar year. *For example, an entity becoming subject on 11/15/2009 will file a 2010 annual report due 05/17/2010 for the privilege period 11/15/2009 through 12/31/2010.*[49]

The actual SFT return filed for CenterPoint also clearly demonstrates that the payment is made during the annual privilege period (*i.e.*, service period).[50] The SFT payment is made on May 15 of any given year and relates to the service provided during the calendar year. For example, CenterPoint's May 15, 2009, payment relates to 2009 service, but is based on the tax base from

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46 CEHE Ex. 26 (Felsenthal Direct) at 20.

47 CEHE Ex. 24 (Joyce Direct) at 21.

48 *Id.* at 20.

49 *See* CEHE Ex. 24 (Joyce Direct) at 21, *citing* Comptroller's Frequently Asked Questions relating to the SFT, http://www.window.state.tx.us/taxinfo/franchise/faq_rpt_pay.html (emphasis added).

50 CEHE Ex. 1 at Schedule II-B-9 workpapers.

2008.[51] The evidence further demonstrates that it is not unusual for a franchise to have a period for the tax base that is different than the service period, as is the case with the SFT.[52] This is evidenced by the Commission's approval of the advanced payment of Local Franchise Taxes in Docket No. 35717.[53] Finally, the evidence establishes that other regulatory commissions have, since the issuance of the Comptroller's guidance, treated the SFT payment as being paid during the annual service period.[54]

The ALJs are persuaded by CenterPoint's arguments and authorities. Therefore, the ALJs recommend that the Commission approve CenterPoint's use of 48.5 negative lead days for SFT.

2. Lead Days on Affiliate O&M Expense

CenterPoint proposes lead days of 33.70 for expenses to CenterPoint's affiliates, and 33.86 days for expenses charged by CenterPoint to its affiliates.[55] The lead days for CenterPoint's expenses charged by its affiliates assumes that CenterPoint pays CenterPoint Energy Service Company, LLC (Service Company) within 2-3 weeks after the end of the month in which it receives the services.[56] CenterPoint derived this payment timeline based on its actual payment history.[57]

CenterPoint's contends that its affiliate charges are settled in the month following the month in which charges were incurred[58] and that CenterPoint's affiliate contracts do not specify a contractual payment due date.[59] In addition, the Master Agreement specifically states that, "This agreement, together with its exhibits, constitutes the entire understanding and agreement of the

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[51] CEHE Ex. 24 (Joyce Direct) at 20.

[52] *Id.* at 22.

[53] *Id.* (referencing the Commission's decision in *Application of Oncor Electric Delivery Company LLC for Authority to Change Rates*, Docket No. 35717 (Nov. 30, 2009)).

[54] *Id.* at 23.

[55] *Id.* at Ex. JJJ-4, Schedule 2-3

[56] GCCC Ex. 1 (Kollen Direct) at 48

[57] *Id.*

[58] CEHE Ex. 24 (Joyce Direct) at 14.

[59] CEHE Ex. 56 (Joyce Rebuttal) at 13.

parties with respect to the subject matter...."[60] According to CenterPoint, this means that there are no other applicable payment provisions other than those in the affiliate agreement. Thus, CenterPoint argues, pursuant to the requirements of P.U.C. SUBST. R. 25.231(c)(2)(B)(iii)(IV)(c), it properly calculated the period as the number of days from the mid-month to the actual payment clear date or settlement date in the following month. Finally, CenterPoint notes that affiliate invoices often contain the phrase "DUE UPON RECEIPT," and since the Commission's rules require lead-lag days to be calculated using the later of the due date or the check clear date, CenterPoint is required to use the check clear date.[61]

GCCC concedes that CenterPoint is correct that P.U.C. SUBST. R. 25.231(c)(2)(B)(iii)(IV)(c) requires the use of the later of the check clear date or the invoice due date in computing lead-lag days. But, according to GCCC, CenterPoint's own rate filing package states that affiliate expenses are due 30 days from the date of receipt of the charges. GCCC argues that because CenterPoint does not acknowledge this fact, it draws the wrong conclusion from the rule; indeed, the rule requires the calculation of affiliate expense lead days using a 30-day payment period, as GCCC witness Kollen did. The ALJs are persuaded that the fact that CenterPoint's affiliates might put "DUE UPON RECEIPT" as part of their invoice boilerplate is determinative of nothing; in its rate filing package, CenterPoint itself has stated that affiliate invoices are due within 30 days. Similarly, the ALJs find that the fact that the relevant affiliate agreements state no due date for payments under the agreement does not illuminate this issue. The evidence clearly indicates that a 30-day deadline for payment is established by CenterPoint's affiliate expense policy.

Use of this full 30-day payment period increases the affiliate expense lead days to 45.21, as testified to by GCCC witness Lane Kollen.[62] Mr. Kollen computed this figure by adding the 15.21 expense lead days from the midpoint of the service period in the preceding month and the 30 expense lead days for the payment period after the end of the preceding month.[63] For consistency,

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[60] CEHE Ex. 14 (Dominguez Direct) at Ex. KCD-7, p. 9.

[61] CEHE Ex. 56 (Joyce Rebuttal) at 14.

[62] GCCC Ex. 1 (Kollen Direct) at 49.

[63] *Id.*

Mr. Kollen applied the same lead days for both charges to CenterPoint by its affiliates and charges to its affiliates by CenterPoint,[64] which the ALJs find reasonable. Applying the correct lead days to these charges reduces the Company's proposed distribution revenue requirement by $0.621 million and its proposed transmission revenue requirement by $0.109 million[65] and the ALJs recommend that the Commission adopt Mr. Kollen's lead days and resulting impacts on revenue requirement.

3. Remaining CWC Issues

OPC witness June Dively offered three suggestions relating to CWC. The first suggestion involved a change in the calculation of the lead days on employee bonuses. As pointed out by the Company as part of discovery in this case and noted by Mr. Joyce in his rebuttal testimony, the Company adjusted the lead days on employee bonus expense to 254.30 days. Ms. Dively agrees with Mr. Joyce's 254.30 lead days.[66] Therefore, this component of the working capital calculation is no longer in dispute.

Second, Ms. Dively argued that several additional expense items (pension, FASB Statement No. 106 (FAS 106), bad debts, and depreciation expense on transportation equipment that is recorded in O&M accounts) should be removed from O&M expenses for purposes of calculating cash working capital.[67] Ms. Dively later withdrew her position on this issue as it relates to pension and FAS 106 expense, and the Company updated its cash working capital calculation to remove depreciation expense on transportation equipment from the cash working capital calculation.[68] Thus, the only issue that remains in dispute is the inclusion of bad debt expense in the cash working capital calculation. CenterPoint's witness Joyce asserts that he is not aware of any rationale for excluding uncollectible expense from the operations and maintenance expenses used in the calculation of CenterPoint cash working capital requirement.[69] However, the Commission's substantive rules

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64 *Id.*

65 *Id.*

66 OPC Ex. 11 (Second Errata to Dively Direct) at 8.

67 OPC Ex. 3 (Dively Direct) at 9-10.

68 OPC Ex. 11 (Second Errata to Dively Direct) at 9; CEHE Ex. 56 (Joyce Rebuttal) at 7 and Rebuttal Ex. JJJ-2.

69 CEHE Ex. 56 (Joyce Rebuttal) at 7.

clearly require the use of the cash method and all non-cash items should not be considered.[70] Uncollectible expense represents amounts that were billed but never received through a cash transaction. Therefore, the ALJs recommend that the Commission reduce the amount of O&M expense used in the calculation of cash working capital by $551,000 for bad debt, or uncollectibles, expense.

Finally, Ms. Dively proposes a different approach to calculating the O&M portion of the cash working capital calculation. CenterPoint contends that the evidence establishes that the method employed by Mr. Joyce is consistent with the method approved by the Commission in Docket Nos. 33309 and 33310.[71] CenterPoint further argues that Ms. Dively's proposal is methodologically flawed in that she selectively picked certain O&M expense line items, while excluding others, in order to manufacture a lower cash working capital requirement.[72] When Ms. Dively's method is corrected to properly include all components of O&M, according to CenterPoint, her result was shown to be approximately equal to the Company's calculation based on applying the lead/lag days to total O&M.[73]

OPC contends that a review of the orders in both Docket Nos. 33309 and 33310 shows no conclusion that the actual methodology employed by Mr. Joyce was reasonable and that, regardless, the present case is a different docket presenting different circumstances. As to CenterPoint's arguments that OPC selectively chose her components, OPC responds that the components used by Ms. Dively in the O&M section of her proposed working capital calculation[74] agree with the components used by Mr. Joyce in his blended calculation of the O&M Lead/Lag Days shown on page 5 of Exhibit JJJ-4.[75] Mr. Joyce uses the following components: payroll, annual bonus, employee benefits, and other O&M. Ms. Dively uses payroll (regular and overtime payroll, severance and other

[70] P.U.C. SUBST. R. § 25.231(c)(2)(B)(iii)(IV)(a).

[71] CEHE Ex. 56 (Joyce Rebuttal) at 10.

[72] *Id.* at 8.

[73] *Id.* at 8, 12.

[74] OPC Ex. 3 (Dively Direct) at 31.

[75] CEHE Ex. 24 (Joyce Direct) at Ex. JJJ-4, page 5 of 23.

compensation), annual bonus (short-term incentive), employee benefits, and other O&M. The only differences are related to the insignificant components of payroll for severance and other compensation to which Ms. Dively applied the same lag days as for the regular and overtime payroll, and by doing so resulted in no difference than if the items are added together on a single line. According to OPC, if Ms. Dively selectively "picked certain O&M expense line items, while excluding others," she clearly chose those used by Mr. Joyce in his own calculation of the O&M Lead/Lag Days.

The ALJs are persuaded by CenterPoint's arguments with respect to this issue and, as a consequence, recommend that the Commission reject OPC's proposed adjustment.

E. Materials and Supplies

CenterPoint calculated its 13-month average balance of Materials and Supplies by function. CenterPoint's Materials and Supplies 13-month average balance is $68.4 million for the adjusted test year.[76] These costs have been functionalized using warehouse and part numbers that specifically identify the function based on the inventory.[77] Staff witness Mary Jacobs recommends using the most current 13-month period available, instead of the test-year 13-month average balance.[78] This time frame is from June 2009 through June 2010, whereas CenterPoint's request is based on the period beginning December 2008 and ending in December 2009. The average of the amounts recorded in FERC accounts 154 and 163 during the applicable June 2009 through June 2010 is $64,367,000, which is $3,989,000 less than CenterPoint's request.[79]

CenterPoint responded that it has calculated its Materials and Supplies balance based on a test-year 13-month average balance as required by the Commission's own rate filing package

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[76] CEHE Ex. 28 (Fitzgerald Direct) at 36; CEHE Ex. 1 at Schedule II-B-8.

[77] CEHE Ex. 28 (Fitzgerald Direct) at 37; CEHE Ex. 1 at Schedule II-B-8.

[78] Staff Ex. 8 (Jacobs Direct) at 13.

[79] *Id.*

instructions.[80] Further, CenterPoint contends that Staff's argument for a post-test year reduction to the balance of Materials and Supplies should be denied because:

- *Staff's position is inconsistent with its position in the Oncor rate case in Docket No. 35717.* In that case, Oncor calculated Materials and Supplies using the ending balance for the historical test year, even though using a more current, 13-month, non-historical test year balance (such as proposed by Staff in this case) would have increased its rate base.[81] Staff did not contest this method of calculation, and specifically did not advocate for use of a current 13-month average, as it does in this case.[82] Thus, CenterPoint contends, its position is not only consistent with Commission rules, but is also consistent with position taken by Staff in Docket No. 35717.

- *Staff's position is inconsistent with its reliance on P.U.C. SUBST. R. 25.231(c)(2)(F) in this case.* Staff relies on this rule to assert that CenterPoint's claim for otherwise known and measurable post-test year increases to rate base of $36.735 million should be disallowed because the rule requires such additions to rate base "to be at least $368 million to meet the rule's 10% threshold requirement."[83] CenterPoint contends that the argument that the Commission's rule prevents recognition of the post-test year additions applies with equal force here to Staff's argument for a post-test year rate base decrease to Materials and Supplies, because criteria in the same rule for a proposed post-test year decrease to rate base are not met. Two of the requirements of this rule are not met: (1) as the decrease is not the type of asset subject to such an adjustment (such as plant or construction work in progress [CWIP]), and (2) it does not represent plant that has been removed from service, mothballed, or sold during the year.[84] Thus, according to CenterPoint, under the same rule cited by Staff, its proposed post-test year reduction of Materials and Supplies should be denied.

The ALJs are persuaded by CenterPoint's arguments that the 13-month average balance for Materials and Supplies should be calculated using its methodology, which comports with the Commission's rate filing package instructions. Accordingly, the ALJs recommend that the Commission approve a balance of $68.4 million for the adjusted test year.

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[80] CEHE Initial Brief at 36.

[81] Oncor Initial Brief, Docket No. 35717 at 47.

[82] Staff Initial Brief, Docket No. 35717 at 49.

[83] *See* Staff Initial Brief at 10-11, citing P.U.C. SUBST. R. 25.231(c)(2)(F)(iii).

[84] *Id.*, citing P.U.C. SUBST. R. 25.231 at (iii)(I) and (II).

F. Electric Plant in Service (EPIS) [Germane to Preliminary Order Issue No. 18]

CenterPoint's EPIS includes expenditures for assets that are used and useful for the transmission and distribution of electricity. CenterPoint's total EPIS for the test year was \$7.231 billion, less accumulated depreciation of \$2.987 billion, for a net EPIS of \$4.244 billion.[85] CenterPoint included storm restoration costs for Hurricane Ike in EPIS, for the wholesale transmission portion of EPIS, based on the findings in Docket No. 36918. CenterPoint's request that \$20 million for recovery of Hurricane Ike costs is consistent with the Commission's Final Order in Docket No. 36918 and was not opposed. Moreover, CenterPoint's request for total EPIS of \$4.244 billion was not contested by any party. Therefore, in view of the absence of any challenge, the ALJs recommend that CenterPoint's request for \$4.244 billion of EPIS in rate base be approved without further discussion.

G. Electric Plant Held for Future Use (PHFU)

Commission precedent authorizes inclusion of PHFU in rate base when the utility has a definitive plan to put the property into service within the next ten years.[86] The Company's total electric PHFU as of the test year was \$14.2 million. Of this amount, \$4.6 million is eligible for recovery since it relates to property the Company expects to be used and useful in the next ten years.[87] To capture this amount, the Company requested a PHFU balance of \$217,000 in recognition of the \$4.3 million post-test year adjustment it made to reflect the cost of the land associated with the new Rothwood and Meadow substations.[88] Because the ALJs are recommending rejection of the post-test year adjustment to rate base, the \$4.3 million cost of the land, as well as the \$36.74 million for the substations themselves, must be added back into rate base as part of the PHFU

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[85] CEHE Ex. 28 (Fitzgerald Direct) at 28; CEHE Ex. 1 at Schedule II-B-1.

[86] Rate Filing Package at § II-B-6; *See also Application of Oncor Electric Delivery Company, LLC for Authority to Change Rates*, Docket No. 35717, Order on Reh'g at FoF 73A (Nov. 30, 2009); *Docket* No. 11735, 20 P.U.C. BULL. 1029, Final Order (Jan. 28, 1994), Final Order on Rehearing (Apr. 20, 1994), and Second Order on Rehearing (May 27, 1994).

[87] CEHE Ex. 28 (Fitzgerald Direct) at 34; CEHE Ex. 1 at Schedule II-B-6.

[88] *Id.* at 34.

balances.[89] The amount of this adjustment is an increase in the PHFU balance of $41.04 million, or a total PHFU balance of $44.04 million.

GCCC opposed CenterPoint's request to add the disallowed post-test year adjustment amounts relating to the Rothwood and Meadow substations to the PHFU, contending that the parties had no opportunity to evaluate and test the Company's claim that those amounts qualify as PHFU.[90] The ALJs note, however, that Staff stated in its Initial Brief that it did not oppose CenterPoint's request for PHFU[91] and did not object to the concept of adding the Rothwood and NMeadow substations to PHFU in its Reply Brief.[92] As a consequence, the ALJs recommend that the Rothwood and Meadow amounts disallowed as post-test year adjustments be added to PHFU and that the Commission approve a total PHFU balance of $44.04 million.

H. Injuries and Damages Reserve

This issue is uncontested. The total Injuries and Damages Reserve for the test year is $10.1 million and has been functionalized using plant and PAYXAG functionalization factors.[93] The ALJs recommend that the Commission approve the $10.1 million balance.

I. Prepayments

The Company requests recovery of $4.4 million for prepayments during the test year.[94] Prepayments have been functionalized using the net plant functionalization factor.[95] This issue is uncontested. The ALJs recommend that the Commission approve the $4.4 million balance.

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89 *Id.* and WLF-8a.

90 GCCC Reply Brief at 15.

91 Staff Initial Brief at 12.

92 Staff Reply Brief at 10.

93 CEHE Ex. 28 (Fitzgerald Direct) at 35; CEHE Ex. 1 at Schedule II-B-7.

94 CEHE Ex. 28 (Fitzgerald Direct) at 38; CEHE Ex. 1 at Schedule II-B-10.

95 *Id.*

J. Regulatory Assets [Preliminary Order Issue No. 10]

1. Pension Assets

PURA §36.065 addresses pension and other post-employment benefits. It was added to PURA in 2005. It states in relevant part as follows:

> (b) An electric utility shall periodically record in the reserve account any difference between:
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> (1) the annual amount of pension and other postemployment benefits approved as an operating expense in the electric utility's last general rate proceeding or, if that amount cannot be determined from the regulatory authority's order, the amount recorded for pension and other postemployment benefits under generally accepted accounting principles during the first year that rates from the electric utility's last general rate proceeding are in effect; and
>
> (2) the annual amount of pension and other postemployment benefits as determined by actuarial or other similar studies that are chargeable to the electric utility's operating expense.

CenterPoint's last general rate proceeding was Docket No. 32093, which was a settled docket that did not specify the costs of pension and OPEB. The Commission approved the settlement at the August 23, 2006, Open Meeting, and the approved settled rates went into effect on October 10, 2006.

CenterPoint used 2007 as the base year (the first year new rates were in effect) and compared the amount of the base 2007 pension and OPEB expense to the actuarially-determined amounts for 2008, 2009, and 2010, the comparison years. The amount of pension and OPEB expense for these years was determined to be 65 percent of the total actuarially-determined amounts based on CenterPoint's experience over time and its actual experience during the test year.[96] CenterPoint also adjusted its pension and OPEB expense to reflect known and measurable changes. Specifically, CenterPoint made an adjustment of an additional $26.9 million to reflect the amount of the actuarially-determined 2010 pension and OPEB expense as of December 31, 2009.[97] As a result,

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

[97] *Id.* at 15.

CenterPoint has requested a PURA § 36.065(b) regulatory asset in the total amount of $58.7 million.[98] CenterPoint proposes that its PURA § 36.065(b) regulatory asset be included in rate base and amortized over three years because the balance of the regulatory asset has three years of deferred pension and OPEB.[99]

Intervenor witnesses Ms. Blumenthal and Mr. Kollen rigorously disputed various aspects of CenterPoint's calculation of its PURA § 36.065 regulatory asset. They both contended that CenterPoint should have used 2006 rather than 2007 as the base year.[100] Ms. Blumenthal additionally disputed the: (1) 65 percent expense rate that CenterPoint used to determine the deferral rate; (2) inclusion of long-term disability expenses in the deferred calculation; and (3) inclusion of affiliate pension and OPEB costs for the Service Company.

Ms. Blumenthal recomputed the deferral using 2006 as the base year and her corrections of the disputed components of the calculation listed above (and discussed in more detail below), and arrived at her recommendation that CenterPoint's PURA § 36.065(b) Pension and OPEB Regulatory Asset balance for inclusion in rate base should be $12,786,092 rather than CenterPoint's proposed $57,887,000.[101] She further calculated the annual amortization based on her recommended seven year amortization (rather than CenterPoint's proposed three year amortization) and arrived at $1,826,585 rather than CenterPoint's proposed $19,295,667.[102]

(a) Base Year: 2006 v. 2007

Ms. Blumenthal and Mr. Kollen testified that use of 2007 as the base period is inconsistent with the clear language of the statute. They claimed the "first year that rates from the electric utility's

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98 *Id.*

99 *Id.* at 11.

100 COH/HCOC Ex. 1 (Blumenthal Direct) at 8; GCCC Ex. 1 (Kollen Direct) at 36-40.

101 CEHE's testimony and briefs consistently refer to $58.7 million as the amount of the PURA § 36.065(b) Pension and OPEB Regulatory Asset. The record is less clear as to the basis for Ms. Blumenthal's $57,826,000. Therefore, unless corrected through number running or exceptions to the PFD, the ALJs adopt CEHE's $58.7 million as the correct amount.

102 COH/HCOC Ex. 1 (Blumenthal Direct) at 11-13.

last general rate proceeding are in effect" was 2006. Ms. Blumenthal testified that the amount of pension expense and OPEB expense recorded as an operating expense during 2006 was approximately $16.016 million, or 69.48 percent of the total estimated FASB Statement No. 87 (FAS 87) pension and FAS 106 OPEB costs of $23.05 million. She therefore concluded that this is the amount of pension expense that should be deemed to be in current rates pursuant to PURA § 36.065(b)(1) and should serve as the starting point for the deferral calculation.[103]

CenterPoint's witness Mr. Fitzgerald argued in rebuttal that PURA § 36.065(b)(1) provides that, in CenterPoint's case, the base year is "the first year that rates from the electric utility's last general rate proceeding are in effect." The first year, as opposed to the first month or three months, that rates from CenterPoint's last general rate proceeding were in effect was 2007, not 2006. The year 2006 was the year *of*, not the year *following*, the rate order and was the *last* year that the old rates were in effect, not the first year of new rates, the opposite of what PURA § 36.065(b) and the legislative history provide. Moreover, Mr. Fitzgerald testified that the legislative history of Committee Substitute Senate Bill 1447 (C.S.S.B 1447), which was passed into law as PURA § 36.065(b), confirms that the base year is intended to be the year following the rate order:

> C.S.S.B. 1447 adds a provision to reflect that if the pension and other post employment benefits expense cannot be determined from the last rate order, then, as an alternative, it is permissible to compare the pension and other post employment expenses recorded on the company's books *for the year following the rate order* with the current year's pension and other post employment benefits. (*emphasis added*)[104]

Mr. Fitzgerald noted that both of the intervenor's witnesses testified on deposition that they were not aware of the legislative history when they filed their testimony, and when asked, admitted that the year following the Company's last rate order is 2007.[105]

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[103] *Id.* at 8-9.

[104] CEHE Ex. 66 (Fitzgerald Rebuttal) at 3-4 (quoting the analysis produced by the legislative committee hearing the bill comparing the original proposed language in Senate Bill 1447 to what was adopted in C.S.S.B. 1447).

[105] *Id.* Both GCCC witness Mr. Lane Kollen and COH/HCOC witness Ms. Ellen Blumenthal admitted in their depositions that they had not examined or analyzed the legislative history of PURA § 36.065 when considering whether the meaning of the statute is consistent with this interpretation.

The ALJs find Mr. Fitzgerald's argument to be compelling. Moreover, the legislative history removes any doubt that CenterPoint's use of 2007 as the base year was correct.

(b) 65 Percent Expense Rate for Deferral Calculation

Ms. Blumenthal testified that "[t]he Company's deferral calculation simply assumes, without any support, that 65 percent of the FAS 87 pension costs and FAS 106 OPEB costs were charged to expense in 2007, 2008, 2009, and 2010." She claimed this value is inconsistent with the actual data for all the years. In her revised calculation of the expense portion of the Hewitt actuarially determined pension and OPEB costs for these years she used wage and salary data taken from Schedule II-D-3.4, which indicated that 69.48 percent of total payroll was charged to expense in 2006, 67.92 percent in 2007, 48.24 percent in 2008, and 59.2 percent in 2009.[106]

However, Mr. Fitzgerald explained in his rebuttal testimony the folly of using the payroll data reported on Schedule II-D-3.4. According to the instructions in the rate filing package Schedule II-D3.4, as well as Schedule II-D-3.2 report regular and overtime pay. However, that information does not include all components of payroll, including non-standard pay such as incentive compensation. Thus, Mr. Fitzgerald concluded, and the ALJs agree, that the amounts on Schedule II-D-3.4 do not accurately reflect actual expensed and capitalized payroll, and it follows that the expense rates Ms. Blumenthal calculated are less accurate than CenterPoint's historical experience with the percent of payroll.

(c) Inclusion of Long Term Disability in Deferral Calculation

Ms, Blumenthal disagreed with CenterPoint's inclusion of long term disability expense in the deferral calculation. She testified that while long term disability may be provided to retirees, Hewitt does not address this cost in its annual actuarially determined costs for pension and OPEB. She claimed that because PURA § 36,065 makes clear that the deferral is only to include "pension and other postemployment benefits as determined by actuarial or other similar studies that are chargeable

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[106] COH/HCOC Ex. 1 (Blumenthal Direct) at 10-11.

to the utility's operating expense."[107] Therefore, she removed the long term disability expense from her revised calculation.

Mr. Fitzgerald responded that Ms. Blumenthal has mistakenly concluded that these expenses are provided to retirees, and that Hewitt has not addressed these expenses in its annual actuarial studies. He claimed this is not the case. First, these expenses are for health and welfare benefits provided to former or inactive employees after employment but *before* retirement. Secondly, in response to RFI COH 21-11 (Rebuttal Exhibit WLF-3), CenterPoint provided the actuarial report prepared by Hewitt related to FAS 112 postemployment benefits, which is an actuarial study prepared in accordance with GAAP with respect to these benefits. Thus, these costs meet the definition of PURA § 36.065 as *"pension and other postemployment benefits as determined by actuarial or other similar studies that are chargeable to the utility's operating expense" (emphasis added)* and are properly included in the calculation of the PURA § 36.065 deferral."[108] It appears to the ALJs that Ms. Blumenthal's assumptions were incorrect and her removal of these costs was inappropriate.

(d) Inclusion of Service Company Pension and OPEB Costs

Ms. Blumenthal testified that she excluded pension and OPEB expenses allocated to CenterPoint from the Service Company because "there is no provision in PURA § 36.065 for including allocated costs in the deferral."[109]

In his rebuttal testimony Mr. Fitzgerald strongly disagreed with Ms. Blumenthal on this point. He testified that "PURA§ 36.065(a) specifies that the costs to be included in calculating the deferral amount are 'the annual amount of pension and other postemployment benefits as determined by actuarial or other similar studies that are chargeable to the electric utility's operating expense.' This

107 *Id.*

108 CEHE Ex. 66 (Fitzgerald Rebuttal) at 8.

109 COH/HCOC Ex. 1 (Blumenthal Direct) at 12.

would include both direct and allocated pension and other postemployment expenses that are charged to CenterPoint Houston and recorded on the Company's books and records."[110]

Mr. Fitzgerald testified, and the ALJs agree, that the assignment of pension and other postemployment expenses to CenterPoint from the Service Company is no different than any other operating expenses that have been assigned to CenterPoint in the test year and are included in the Company's revenue requirement. In her deposition, Ms. Blumenthal took the position that if an employee who provides services to the Company is employed by the Company, then the expense is included, but if that same employee, providing the exact same services, is employed by the Service Company, then the expense is excluded for purposes of the deferral. Clearly, this is a distinction based on form over substance. Mr. Fitzgerald further testified that Ms. Blumenthal cited no authority for this position.

Additionally, Mr. Fitzgerald pointed out that a significant number of Service Company employees were legacy employees of the integrated utility prior to deregulation. These are the very employees whose benefits PURA § 36.065 seeks to protect as stated in PURA § 36.065(a) as follows:

> "Expenses for pension and other postemployment benefits include, in an amount found reasonable by the regulatory authority, the benefits attributable to the service of employees who were employed by the predecessor integrated electric utility of an electric utility before the utility's unbundling under Chapter 39 ***irrespective of the business activity performed by the employee or the affiliate to which the employee was transferred*** on or after the unbundling." (*emphasis added.*)

The ALJs find that Ms. Blumenthal's approach is one-sided and should be rejected by the Commission.

(e) ALJs Analysis

Based on the forgoing discussion of the evidence and arguments of the parties, the ALJs find that CenterPoint has effectively rebutted all of the challenges raised by the intervenors and proved by

[110] CEHE Ex. 66 (Fitzgerald Rebuttal) at 9.

the preponderance of the evidence that its PURA § 36.065(b) Pension and OPEB Expense Regulatory Asset in the amount of $58.7 million has been properly calculated and recorded, and should be included in base rates ansd amortized over three years.

2. Other Regulatory Assets

The Company proposes to amortize a regulatory asset of $453,000 for expenses associated with the cost of performing expedited switches (pursuant to Project No. 36536, Rulemaking to Expedite Customer Switch Timelines), for a three-year period at an annual expense of $151,000.[111] This expense has been directly assigned, consistent with the FERC account designation. This issue is uncontested. The ALJs recommend that the Commission approve this regulatory asset and the treatment proposed by CenterPoint.

K. Retirement Work in Progress

OPC argues for removal of $1.978 million related to Retirement Work in Progress (RWIP), with an offsetting adjustment to deferred federal income taxes of $692,300. The basis for OPC's proposed adjustment is that just as it is appropriate to exclude from rate base CWIP that has not been placed in service, it is also appropriate to exclude RWIP related to incomplete retirement activities.[112] CenterPoint responded that OPC's proposal should be rejected for three reasons:

- The basis of OPC's argument is that CWIP is not included in rate base so RWIP should not be included in rate base. This rationale is erroneous because RWIP and CWIP are not comparable.[113] CWIP is not included in rate base but the utility is compensated for carrying costs during construction through the Allowance for Funds Used During Construction. This is not true of RWIP.[114]

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[111] CEHE Ex. 28 (Fitzgerald Direct) at 23; CEHE Ex. 1 at Schedule II-B-12.

[112] OPC Ex. 3 (Dively Direct) at 8.

[113] CEHE Ex. 66 (Fitzgerald Rebuttal) at 25.

[114] *Id.*

- The retirement activity related to the RWIP amounts has been completed, and the costs have been incurred by the Company. The RWIP account is merely a clearing account for net salvage related to retirements.[115]

- The Company followed the same method in this case for including RWIP as it did in Docket No. 32093.[116]

The ALJs are persuaded by CenterPoint's arguments and, therefore, recommend that the Commission reject OPC's proposed adjustments.

VI. RATE OF RETURN

A. Capital Structure [Germane to Preliminary Order Issue No. 3]

CenterPoint argues that a capital structure composed of 50 percent debt and 50 percent equity reasonably reflects the business and regulatory risks that CenterPoint faces and will help CenterPoint attain a solid single-A credit rating on its general mortgage bonds, which should facilitate CenterPoint's access to capital in nearly all market conditions.[117] A 50/50 capital structure, according to CenterPoint, is also consistent with the level of equity authorized for comparable utilities in other jurisdictions.[118]

TIEC witness Michael Gorman, COH/HCOC witness J. Bertram Solomon, and OPC witness Carol Szerszen argue that the Commission should adopt a capital structure consisting of 60 percent debt and 40 percent equity[119] The principle bases of their position is that CenterPoint, as a TDU, enjoys a significantly lower risk profile that do vertically integrated utilities and that this is exactly the scenario envisioned by the Commission when, in the Unbundled Cost of Service (UCOS) cases,

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115 *Id.*

116 *Id.* at 26.

117 CEHE Ex. 36 (Kilbride Direct) at 15-16.

118 *Id.* at 39.

119 TIEC Ex. 2 (Gorman Direct) at 15; COH/HCOC Ex. 3 (Solomon Direct) at 4; OPC Ex. 1 (Szerszen Direct) at 38.

the Commission established an immutable "regulatory principle" that Texas TDUs should have a capital structure with 40 percent equity.[120]

Staff witness Slade Cutter supports the Company's proposal to move away from a 60/40 capital structure. Mr. Cutter recommends that the Commission adopt a capital structure consisting of 55 percent debt and 45 percent equity.[121]

The Commission adopted and applied the hypothetical capital structure to newly unbundled TDUs beginning in 2001.[122] During that timeframe, the historically integrated electric utilities operating in Texas were required by Senate Bill 7 to unbundle their generation, transmission, and distribution functions to allow customers the opportunity to choose their electric supplier. As stand-alone companies, TDUs were transitioning into a new operating environment with no operating track records. Because the Commission determined the new business setting was less risky, it required more debt in the capital structures of the companies than the 50-50 capital structure requested by most utilities.[123] The Commission stated that the hypothetical capital structure was established for newly unbundled TDUs during the transition period.[124]

Although the Commission ordered the hypothetical 60 percent debt and 40 percent equity capital structure at the time of unbundling of transmission and distribution operations from integrated utilities in ERCOT, Mr. Cutter testified that it was not the Commission's intent to permanently restrict TDUs to a 60 percent debt and 40 percent equity capital structure.[125] CenterPoint's proposed 50-50 capital structure request is a departure from Commission precedent

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120 TIEC Ex. 2 (Gorman Direct) at 14.

121 Staff Ex. 1 (Cutter Direct) at 22.

122 *Generic Issues Associated with Applications for Approval of Unbundled Cost of Service Rate Pursuant to PURA § 39.201 and Public Utility Commission Substantive Rule § 25.344*, Docket No. 22344, Order No. 42 at 11 (Dec. 18, 2000).

123 *Id.* at 2 and 9.

124 *Id.* at 8-9.

125 Tr. at 1602-1603.

regarding capital structure for utilities in Texas; however, until this rate case no TDU had requested a capital structure other than 60 percent debt to 40 percent equity in a base rate case.

Mr. Cutter recommended a 45 percent common equity and 55 percent long-term debt capital structure for CenterPoint,[126] which is nearly identical to CenterPoint's *actual* capital structure of 45.2 percent equity and 54.8 percent of long-term debt.[127]

In screening for companies comparable with CenterPoint in his cost-of-equity analysis, Mr. Cutter testified that the companies chosen for his proxy group had capital structures comprised of between 51.4 percent and 57.5 percent of long-term debt, with an average of 54.3 percent.[128] Further, Mr. Cutter testified that rating agencies generally endorse a debt level of 55 percent for utilities with CenterPoint's credit rating, which is in the middle of the BBB/Baa range.[129]

Both CenterPoint and the various intervenors advanced strong arguments in favor of their diverse positions on the issue of the appropriate capital structure. That is not surprising, because – depending on the outcome of the issue – it will mean significant dollars for their various constituents. In the end, the ALJs are persuaded by the arguments advanced by the only party that has "no dog in this fight" – Staff witness Cutter. His analysis demonstrates that for utilities such as CenterPoint, a debt level of 55 percent is endorsed by credit rating agencies. He deflected the arguments of the intervenors that the Commission's decision in Docket No. 22344 was binding precedent with an historical perspective that showed the Commission's true intent at the time, which was to establish a capital structure during the transition to competition and then, as time passed and the competitive markets matured, to re-evaluate the matter. Mr. Cutter has performed that re-evaluation and succinctly provided the appropriate capital structure for CenterPoint – 55 percent debt and 45 percent common equity – which has the added advantage of mirroring CenterPoint's

126 Staff Ex. 1 (Cutter Direct) at 6.

127 CEHE Ex. 36 (Kilbride Direct) at 5.

128 Staff Ex. 1 (Cutter Direct) at 22.

129 *Id* at 22.

actual capital structure. The ALJs recommend that the Commission enter an order approving a 55 percent long-term debt and 45 percent common equity capital structure for CenterPoint.

B. Return on Equity [Germane to Preliminary Order Issue No. 4]

The United States Supreme Court has set forth a minimum constitutional standard governing equity returns for utility investors:

> From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having comparable risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.[130]

Thus, a utility must have a reasonable opportunity to earn a return that is: (1) commensurate with returns on equity investments in enterprises having comparable risks; (2) sufficient to ensure the financial soundness of the utility's operations; and (3) adequate to attract capital at reasonable rates, thereby enabling it to provide safe, reliable service.[131] The allowed ROE should enable the utility to finance capital expenditures at reasonable rates and to maintain its financial flexibility during the period in which the rates are expected to remain in effect.[132]

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[130] *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603, 64 S. Ct. 281, 288 (1944); *see also Bluefield Waterworks & Improvement Co. v. Public Serv. Comm'n of W. Va.*, 262 U.S. 679, 692-93, 43 S. Ct. 675, 679 (1923) ("A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.").

[131] CEHE Ex. 35 (Hevert Direct) at 6-7.

[132] *Id.* at 7.

1. Proxy Group

Because CenterPoint is not a publicly traded company, it is necessary to establish a group of companies that are publicly traded and that are comparable to CenterPoint in certain fundamental business and financial respects to serve as its "proxy" in the ROE estimation process. Both financial theory and legal precedent support the use of comparable companies within a proxy group to determine a utility's ROE,[133] and all of the ROE witnesses in this case have relied on proxy groups to estimate a required ROE for CenterPoint.

There is, of course, disagreement among the various experts regarding the composition of the proxy group. In selecting the companies for his proxy group, Mr. Hevert applied five screening criteria:

- He excluded companies that do not pay cash dividends because those companies cannot be analyzed using the discounted cash-flow (DCF) model.
- He selected companies that have senior unsecured bond and/or corporate ratings of BBB- to AAA (S&P or Moody's equivalent);
- He excluded companies whose average regulated revenue and net income for the years 2007, 2008 and 2008 comprised less than 60 percent of the consolidated total;
- He excluded companies whose average regulated electric revenues and operating income over 2007, 2008 and 2009 represented less than 90 percent of total regulated revenue and operating income; and
- He eliminated any companies that are currently known to be a party to a merger or other transformative transaction.[134]

The application of those screening criteria left Mr. Hevert with 15 utilities in his proxy group.[135] He then excluded three of those companies because they had experienced events during the relevant time

[133] *Petal Gas Storage v. Federal Energy Regulatory Comm'n*, 496 F.3d 695, 699 (D.C. Cir. 2007).

[134] CEHE Ex. 35 (Hevert Direct) at 20.

[135] *Id.* at 22.

period that rendered them unsuitable to be considered as proxy companies.[136] That left a total of 12 comparable companies in Mr. Hevert's final proxy group. Notably, Mr. Gorman accepted Mr. Hevert's proxy group without change.[137]

In his analysis, COH/HCOC witness Solomon narrowed Mr. Hevert's proxy group by eliminating three companies whose S&P or Moody's corporate or senior unsecured ratings were more than one notch away from that of CenterPoint. COH/HCOC contended that Mr. Hevert's inclusion of companies with any investment grade rating is simply too broad to provide a truly risk-comparable group. CenterPoint's S&P corporate credit rating is BBB, and its Moody's issuer rating is now Baa2 after its August 3, 2010, upgrade. Thus, Mr. Solomon's criterion would eliminate any company whose S&P rating is not BBB-, BBB, or BBB+ or whose Moody's rating is not Baa3, Baa2, or Baa1. Applying this more stringent ratings criterion caused the elimination of DPL, Inc., and FPL Group, Inc., which had A- ratings from S&P, as well as Southern Company due to its S&P rating of A.[138]

The comparable company selection criteria used by OPC witness Szerszen were far less restrictive than Mr. Hevert's. The comparable utilities were required to have A or BBB bond ratings (similar to CenterPoint), have at least 70 percent of their operating revenues from domestic utility operations, to be currently paying dividends, and to have no current merger activities. Dr. Szerszen's utility selection criterion has been utilized in numerous past utility rate cases[139] and, according to Dr. Szerszen, the use of a larger comparable company sample avoids the bias problem inherent in small samples. Dr. Szerszen stated that it is highly unlikely that any utility company can sustain a 7.5 percent to 11.5 percent yearly earnings growth rate over the long term. Dr. Szerszen testified that she is not aware of any regulated utility that has achieved such consistently high earnings growth

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[136] *Id.* at 22-23. As noted in Mr. Hevert's testimony, ITC Holdings Corp. was excluded because it is a transmission-only business and therefore is not comparable to CEHE; Great Plains Energy, Inc. was excluded because it implemented a 50% dividend cut in 2008, which renders its dividend yield unreliable for purposes of a DCF analysis; and Edison International was excluded because it experienced significant unrelated operating losses in 2009 as a result of a tax settlement. *Id.*

[137] TIEC Ex. 2 (Gorman Direct) at 17.

[138] COH/HCOC Ex. 3 (Solomon Direct) at 32.

[139] TR at 1571 (Oct. 15, 2010).