over the past 27 years.[140] For the most part, utility companies' dividend, earnings, and book value growth over the 1990 – 2009 time period have been in the 2 percent to 4 percent range. Dr. Szerszen contends that with a larger sample of utility companies, the influence of outliers on the financial statistics used to calculate the DCF growth rate is reduced, and more confidence can be placed in the DCF calculation results.[141] Dr. Szerszen's proxy group includes 31 companies, including CNP, and she criticizes Mr. Hevert for including only 12 companies in his proxy group. CenterPoint argues that the problem with her analysis is that she has sacrificed comparability for size based on her erroneous assumption that a larger proxy group produces more reliable results.[142] Other regulatory commissions have concluded that comparability, not sample size, is the relevant criterion when performing a cost of capital determination.[143]

CenterPoint notes that Dr. Szerszen is the only ROE witness in this case who insists on using a large proxy group. Mr. Hevert and Mr. Gorman both include 12 companies in their proxy groups; Mr. Solomon includes nine companies in his proxy group; and Mr. Cutter includes eight companies in his proxy group. Thus, according to CenterPoint, Dr. Szerszen is the outlier on this issue, and even she does not contend that the larger number of companies in her proxy group makes her result more reliable than the result from Mr. Hevert's proxy group.[144]

Staff witness Cutter used Value Line's online stock-screening capabilities to select a group of companies as much like CenterPoint as possible without excessively restricting their number.[145] Mr. Cutter began with the domestic electric-utility companies and then used five additional screening factors to narrow down his comparable-company proxy group to eight companies, three of which

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[140] OPC Ex. 1 (Szerszen Direct) at 21-22.

[141] *Id.* at 10.

[142] CEHE Ex. 69 (Hevert Rebuttal) at 103.

[143] *Id.* at 104 (*quoting New Hampshire Public Utilities Commission*, Order No. 24,265 (Jan. 16, 2004)); *see also Petal Gas Storage v. Federal Energy Regulatory Comm'n*, 496 F.3d 695, 699 (D.C. Cir. 2007) (concluding that companies in a proxy group must be risk-appropriate in comparison to the subject company).

[144] Tr. at 1549 (Dr. Szerszen agreeing that she "can't say whether somebody's analysis is more reliable or less reliable").

[145] Staff Ex. 1 (Cutter Direct) at 14.

overlap with Mr. Hevert's proxy group.[146] CenterPoint contends that Mr. Cutter's selection of a proxy group is problematic in two respects. First, he does not focus on companies that are primarily regulated electric utilities. Some of the companies in his group derive a substantial portion of their revenue from non-regulated activities.[147] Second, Mr. Cutter errs by relying on the Value Line Financial Strength rating. CenterPoint has no independent Financial Strength rating from Value Line. Although CenterPoint's parent, CNP, does have an independent Financial Strength rating, all of the companies in Mr. Cutter's proxy group have Financial Strength ratings that are higher than CNP's rating of B.[148] Thus, according to CenterPoint, the companies in Mr. Cutter's proxy group are not comparable to CenterPoint, and that causes his DCF result to be unreliable.

2. DCF Analysis

To analyze CenterPoint's cost of equity capital, Mr. Hevert first performed a DCF analysis. The DCF approach is based on the theory that a stock's current price represents the present value of all expected future cash flows.[149] In its most general form, the DCF model is expressed as follows:

$$P_0 = \frac{D_1}{(1+k)} + \frac{D_2}{(1+k)} + \frac{. D_\infty}{(1+k)}$$

Where P_0 represents the current stock price, $D_1 \ldots . D_\infty$ are all expected future dividends, and k is the expected discount rate, or required ROE. That equation can be simplified and rearranged to ascertain the required ROE:

$$k = \frac{D(1+g)}{P_0} + g$$

This is commonly referred to as the "Constant Growth DCF" model in which the first term is the expected dividend yield and the second term is the expected long-term growth rate. The Constant Growth DCF model requires assumptions of: (1) a constant growth rate for earnings and dividends;

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[146] The three overlapping utilities are American Electric Power, Northeast Utilities and Progress Energy.

[147] CEHE Ex. 69 (Hevert Rebuttal) at 10.

[148] *Id.*

[149] CEHE Ex. 35 (Hevert Direct) at 27.

(2) a stable dividend payout ratio; (3) a constant price-to-earnings multiple; and (4) a discount rate greater than the expected growth rate.[150]

To ascertain the dividend yields for companies in his proxy group, Mr. Hevert divided each company's current annualized dividend by the average closing stock prices over the 30, 90, and 180 trading days ended May 28, 2010.[151] He annualized the dividends by applying one-half of the expected growth rate over the next year to the current dividend. That accounts not only for increases in dividends in the first year, but also for the fact that those increases occur at different times in the year. Thus, the annualization helps ensure that the expected dividend yield is representative of the coming 12-month period.[152]

Mr. Hevert next calculated the DCF results for each company in the proxy group by using consensus earnings-per-share growth estimates from three different sources – Zacks, First Call, and Value Line.[153] He calculated a mean high for each company using the average maximum DCF result for the proxy group, and he calculated a mean lower for each company using the minimum growth rate for each company. Finally, he calculated a simple mean, which resulted in values of 11.00 percent, 11.07 percent, and 11.15 percent for the 30, 90, and 180 trading day periods, respectively.[154]

On rebuttal, Mr. Hevert performed a DCF analysis using updated dividend yields and growth rates through September 10, 2010.[155] The more recent data confirms the earlier conclusion that 11.25 percent is a reasonable cost of equity for CenterPoint.[156]

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[150] *Id.* at 27-28.

[151] *Id.* at 28.

[152] *Id.* at 29.

[153] *Id.* at 30.

[154] *Id.* at 30-31.

[155] CEHE Ex. 69 (Hevert Rebuttal) at 2.

[156] *Id.* at 11 ("Based on the updated and revised analysis discussed throughout the balance of my Rebuttal Testimony, I continue to believe that a reasonable range of ROE estimates is from 11.00 percent to 11.50 percent. Within that range, I continue to believe that an ROE of 11.25 percent is reasonable and appropriate.").

TIEC witness Gorman conducted a DCF analysis as well. Rather than rely on the constant growth analysis employed by Mr. Hevert, however, Mr. Gorman also employed that multi-stage growth DCF analysis and the sustainable growth DCF analysis. The multi-stage growth DCF model reflects the possibility of non-constant growth for a company over time. The multi-stage growth DCF model reflects three growth periods: (1) a short-term growth period, which consists of the first five years; (2) a transition period, which consists of the next five years (six through ten); and (3) a long-term growth period, starting in year 11 through perpetuity.[157] The sustainable growth DCF analysis is based on what Mr. Gorman refers to as a "sustainable growth rate," which is based on the percentage of the utility's earnings that is retained and reinvested in utility plant and equipment. These reinvested earnings increase the earnings base (rate base) and will grow earnings when the reinvested earnings investment is put into service, and the Company is allowed to earn its authorized return on the additional rate base investment.[158]

Under Mr. Gorman's constant growth DCF analysis, the average and median constant growth DCF returns for the proxy group were 11.44 percent and 11.07 percent, respectively.[159] Mr. Gorman rejected the results of his constant growth DCF analysis because it is more than twice the current "A" rated utility bond yield of 5.3 percent, and approaching two times the current "Baa" rated utility bond yield of around 6 percent. Hence, according to Mr. Gorman, the constant growth DCF analysis produces an implausible and unrealistically high return estimate.[160]

For his multi-stage growth rate DCF analysis, Mr. Gorman used differing growth rates for each of the periods.[161] For the short-term growth period, he relied on the consensus analysts' growth projections used in his constant growth DCF model. For the transition period, the growth rates were reduced or increased by an equal factor, which reflects the difference between the analysts' growth rates and the Gross Domestic Product (GDP) growth rate. For the long-term growth period, he

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[157] TIEC Ex. 2 (Gorman Direct) at 26

[158] *Id.* at 24.

[159] *Id.* at 21, Ex. MPG-4.

[160] *Id.* at 21.

[161] *Id.* at 26.

assumed each company's growth would converge to the maximum sustainable growth rate for a utility company as proxied by the consensus analysts' projected growth for the U.S. GDP of 4.9 percent.[162] Under Mr. Gorman's multi-stager growth rate DCF analysis, the average and median ROE for the proxy group were 10.47 percent and 10.80 percent, respectively.[163]

Mr. Gorman's sustainable growth DCF analysis assumes that the internal growth methodology is tied to the percentage of earnings retained in the company and not paid out as dividends. The earnings retention ratio is one minus the dividend payout ratio. As the payout ratio declines, the earnings retention ratio increases. An increased earnings retention ratio will fuel stronger growth because the business funds more investments with retained earnings. According to Mr. Gorman, *Value Line* projects the proxy group to have a declining dividend payout ratio over the next three to five years. These dividend payout ratios and earnings retention ratios can then be used to develop a sustainable long-term earnings retention growth rate to help gauge whether analysts' current three-year to five-year growth rate projections can be sustained over an indefinite period of time.[164]

The data used to estimate the long-term sustainable growth rate for Mr. Gorman's analysis is based on the Company's current market to book ratio, and *Value Line's* three-year to five-year projections of earnings, dividends, earned return on book equity, and stock issuances. Using these assumptions, Mr. Gorman's sustainable growth DCF analysis produced group average and median DCF results of 10.35 percent and 9.32 percent, respectively. Mr. Gorman stated that the average result is skewed due to a significant outlier – DPL, Inc., which produces a ROE of 19.17 percent. Excluding DPL, Inc., the proxy group average DCF would be 9.55 percent. Therefore, he concluded that the median result of 9.32 percent better represents the central tendency of his proxy group.[165]

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[162] *Id.*

[163] *Id.* at 27.

[164] *Id.* at 24-25.

[165] *Id.* at 25.

Mr. Gorman concluded that his DCF analyses resulted in a recommended range of 9.3 percent to 10.8 percent for ROE.[166]

COH/HCOC witness Solomon applied the same DCF model formula used by Mr. Hevert to the COH/HCOC nine proxy group companies. However, rather than 30, 90, and 180-day average stock prices, Mr. Solomon used the monthly average high and low prices along with the contemporaneous annualized dividend to calculate low and high average dividend yields for the six months ending August 2010.[167] For expected growth rates, Mr. Solomon used analysts' five-year earnings growth rate estimates and he applied the sustainable growth rate formula, $g = br + sv$, which was the same approach taken by CenterPoint witness Mr. Hevert in CenterPoint's most recent gas rate proceedings before the Railroad Commission of Texas.[168] Based on this analysis, the average ROE result was 10.0 percent, with an average low of 8.4 percent and average high of 11.6 percent.[169] Therefore, Mr. Solomon opines that 9.5 percent to 10.5 percent is a reasonable range and that 10.0 percent should be allowed as CenterPoint's cost of common equity capital.[170] According to Mr. Solomon, this ROE is based on current investor requirements as evidenced in the financial markets and is clearly in line with the 10.15 percent average ROE allowed electric utilities in the most recent quarter by state regulatory commissions and the subsequent decline in market cost of capital.

OPC states that there is minimal disagreement among the Staff and intervenors regarding the dividend yield component of the DCF model. Rather, according to OPC, it is the dividend growth component that the Company and other witnesses disagree about. Dr. Szerszen and Mr. Gorman testify that Mr. Hevert's 6.01 percent earnings growth rate is an unsustainably high growth rate to utilize for a regulated utility.[171] Mr. Solomon, Dr. Szerszen, and Mr. Gorman all consider and use

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166 *Id.* at 28.

167 COH/HCOC Ex. 3 (Solomon Direct) at 32.

168 *Id.* at 32-33.

169 *Id.* at 33.

170 *Id.*

171 TIEC Ex. 2 (Gorman Direct) at 44-45; OPC Ex. 1 (Szerszen Direct) at 10.

the more sustainable BR growth rate in their DCF models.[172] Mr. Hevert, on the other hand, solely relies on investment analyst five-year earnings growth projection in deriving his 6.1 percent DCF growth rate component.

Dr. Szerszen testified that projected growth in dividend and earnings do not provide reliable estimates of growth, since year to year changes in earnings and dividends can be unduly influenced by changes in earned returns and/or dividend payout ratios. Investors know that in the long run, growth in book value and retained earnings are the basic source of sustainable earnings growth.[173]

Dr. Szerszen also testified that there are reasons to question whether investors actually use investment analyst earnings growth projections in their investment decisions. Investment analysts often have conflicts of interest when their employers have investment banking relationships with the companies that are reviewed by the investment analysts. It is less likely that the investment analysts will make lower earnings growth projections for these companies when the investment banking firms are dependent on these client revenue streams. Furthermore, as Dr. Szerszen testified, investment analysts must divulge any conflicts of interest when making earnings projections for client companies.[174] Given that Mr. Hevert's "consensus" earnings forecasts do not identify participating analysts,[175] OPC argues that it is likely that investors would view consensus earnings growth estimates with caution.

Dr. Szerszen's final determination of a reasonable sustainable dividend growth rate for her comparable group is 4.25 percent to 5 percent. This range is based on Value Line's projected 2011 BR growth (4.24 percent) and the five-year BR growth (4.69 percent). Dr. Szerszen's 4.25 percent to

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[172] TIEC Ex. 2 (Gorman Direct) at 24, Ex. MPG-18, and Ex. MPG-7; COH/HCOC Ex. 3 (Solomon Direct) at 32 and pages 1 and 4 of Ex. JBS-3; OPC Ex. 1 (Szerszen Direct) at 17-20 and Schedule CAS-6.

[173] OPC Ex. 1 (Szerszen Direct) at 17-19.

[174] *Id.*

[175] Tr. at 1576.

5 percent average growth rate range is consistent with Mr. Solomon's 4.99 percent average[176] and Mr. Gorman's 4.72 percent to 5.25 percent range.[177]

Applying these components to the DCF analysis, Dr. Szerszen testified that her recommended 9.6 percent ROE is the midpoint of her comparable company DCF analysis.[178]

Staff witness Cutter used Value Line's online stock-screening capabilities to select a group of companies as much like CenterPoint as possible without excessively restricting their number. Mr. Cutter began with the domestic electric-utility companies and then used five additional screening factors to narrow down his comparable-company proxy group to eight companies.[179]

Mr. Cutter's single-stage DCF analysis yielded a result of 10.32 percent.[180] The theory underlying this model is that the price of a share is equal to the present value of all future dividends.[181] Mr. Cutter used a single-stage growth model in his analysis because CenterPoint is fully regulated by the Commission and, therefore, growth rates and divided streams to be discounted are expected to be more stable than that of companies competing in an unregulated environment. The use of the single-stage DCF model for this case is appropriate, maintains Mr. Cutter, because it assumes that dividend growth will essentially remain constant over an indefinite period of time.[182]

In order to measure growth expectations, Mr. Cutter's analysis incorporated forward-looking growth rates as reported by *Value Line* and Zacks Investment Services.[183] Mr. Cutter testified that he included *Value Line* because it is the most widely-used, independent investment service in the world,

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176 COH/HCOC Ex. 3 (Solomon Direct) Ex. JBS-3 at 1.

177 TIEC Ex. 2 (Gorman Direct) at 25 and Ex. MPG-7 at 1.

178 OPC Ex. 1 (Szerszen Direct) at 37.

179 Staff Ex. 1 (Cutter Direct) at 14.

180 *Id.* at 11 and 16.

181 *Id.* at 9.

182 *Id.* at 11.

183 *Id.* at 12-13.

while Zacks compiles consensus earnings forecasts from groups of professional security analysts.[184] Mr. Cutter prefers a consensus forecast from professional security analysts over purely historical estimates as a proxy for investor expectations of growth for several reasons. First, to the extent that historical growth rates are relevant to future growth, they are already incorporated into the forecasts. Second, it is not plausible to assume that historic trends will simply be repeated. Third, empirical academic research has consistently shown that consensus forecasts from professional security analysts do a better job of predicting the valuation of common stocks than those mechanically derived from forecasts using historical data.[185] Mr. Cutter's use of the average of earnings growth rates projected by *Value Line* and by Zacks results in the cost of equity falling within the range of 8.55 percent to 11.96 percent and an average estimate of the DCF ROE for the comparable companies of 10.32 percent.[186]

3. CAPM Analysis

The CAPM is a risk premium approach that estimates the ROE for a given security as a function of a risk-free return plus a risk premium to compensate investors for the non-diversifiable, or systematic, risk of that security.[187] The CAPM formula is as follows:

$$K_e = r_f + \beta(r_m - r_f)$$

Where K_e equals the required market ROE; β equals the Beta of an individual security; r_f equals the risk free rate of return; and r_m equals the required return on the market as a whole. In this equation, $(r_m - r_f)$ represents the market risk premium. According to the theory underlying the CAPM, because diversifiable risk can be diversified away, investors should be concerned only with non-diversifiable

[184] *Id.* at 12.

[185] *Id.* at 13-14.

[186] *Id* at 19.

[187] CEHE Ex. 35 (Hevert Direct) at 31.

risk, which is measured by Beta.[188] In effect, Beta represents the risk of the particular security relative to the market as a whole.

In performing his CAPM analysis, Mr. Hevert used the 30-year Treasury bond yield as his estimate of the risk-free rate.[189] To determine the market risk premium, he used two separate methods. In the first method, he subtracted the current 30-year Treasury bond yield from the expected return on the S&P 500 Index, which was calculated using the Constant Growth DCF model for those companies in the S&P 500 Index for which long-term earnings projections were available. Under this method, using a projected 30-year Treasury yield and a current calculated Beta the CPAM yields a result of 12.64 percent, while the result using the current 30-year Treasury bond yield and current calculated Beta was 12.02 percent.[190] Using an average historical Beta results in a CAPM result of 11.14 percent using the projected 30-year Treasury yield, and 10.53 percent using the current Treasury bond yield.[191] CenterPoint contends that these results corroborate the DCF model result.

In the second method, Mr. Hevert used the Sharpe Ratio to calculate the expected market risk premium based on a comparison of historical and expected market volatility.[192] Under that method, the Sharpe Ratio, which is the ratio of the historical market risk premium to the historical market volatility, is multiplied by the expected market volatility to calculate the expected market premium.[193] That method yielded CAPM results of:

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[188] *Id.* at 32.

[189] *Id.*

[190] *Id.* at 37-38. The current 30-year Treasury bond yield was calculated using the historical 30-day average for the period ending May 28, 2010. *Id.*

[191] *Id.* at 38.

[192] *Id.* at 33. The Sharpe Ratio is used by financial professionals to assess how much additional return an investor receives for holding a risky *(i.e.*, volatile) asset than a risk-free (less volatile) asset. *Id.*

[193] *Id.*

- 12.58 percent using the current 30-year Treasury bond and the current calculated Beta;
- 13.20 percent using the projected 30-year Treasury bond yield and the current calculated Beta;
- 10.98 percent using the current 30-year Treasury bond yield and the average historical Beta; and
- 11.59 percent using the projected 30-year Treasury bond yield and the average historical Beta.[194]

Mr. Hevert also used two methods to calculate Beta for the proxy group companies. In his first method, he simply used the average reported Beta from *Value Line*, which calculates Beta over a five-year period, and Bloomberg, which calculates Beta over a two-year period. Those historical averages result in a mean Beta of 0.71.[195]

According to CenterPoint, use of the unadjusted historical Beta is problematic because current market conditions are such that the volatility of the proxy group stock prices has been increasing relative to the broad market.[196] Thus, Betas calculated over a more recent time period provide a more current view of investors' perspectives with respect to systematic risk. Accordingly, Mr. Hevert calculated a mean adjusted Beta of 0.886 for the proxy group over the most recent six-month period, which brings the Beta closer to levels seen before the 2008 financial crisis. As Mr. Hevert noted in his direct testimony, one year before the Lehman Brothers bankruptcy, the average Beta for his proxy group was 0.965.[197] CenterPoint contends that Mr. Hevert's six-month average Beta of 0.886 is, therefore, reasonable, and likely conservative.

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[194] *Id.* at 38.

[195] *Id.* at 34.

[196] *Id.*

[197] *Id.* at 37.

Finally, CenterPoint states that it is important to note that Mr. Hevert did not give any specific weight to the CAPM results.[198] He simply used the CAPM results to corroborate the DCF results discussed earlier. He did, however, update his CAPM results on rebuttal, and the updated results continue to support his initial ROE recommendation of 11.25 percent.[199]

TIEC witness Gorman used *Blue Chip Financial Forecasts*' projected 30-year Treasury bond yield of 4.9 percent for his CAPM analysis and the proxy group average *Value Line* beta estimate of 0.68. He then derived two market risk premium estimates, a forward-looking estimate and one based on a long-term historical average.[200]

The forward-looking estimate was derived by estimating the expected return on the market (as represented by the S&P 500) and subtracting the risk-free rate from this estimate. He estimated the expected return on the S&P 500 by adding an expected inflation rate to the long-term historical arithmetic average real return on the market. The real return on the market represents the achieved return above the rate of inflation.

According to Mr. Gorman, Morningstar's *Stocks, Bonds, Bills and Inflation 2010 Yearbook* publication estimates the historical arithmetic average real market return over the period 1926 to 2009 as 8.6 percent.[201] A current consensus analysts' inflation projection, as measured by the Consumer Price Index, is 2.0 percent.[202] Using these estimates, the expected market return, according to Mr. Gorman, is 10.77 percent. The market premium then is the difference between the 10.77 percent expected market return, and the 4.9 percent risk-free rate estimate, or 5.87 percent.[203]

The historical estimate of the market risk premium was also estimated by Morningstar in *Stocks, Bonds, Bills and Inflation 2010 Yearbook.* Over the period 1926 through 2009,

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198 *Id.* at 38.

199 *See, e.g.*, CEHE Ex. 69 (Hevert Rebuttal) at 13.

200 TIEC Ex. 2 (Gorman Direct) at 34-35.

201 Morningstar, Inc. *Ibbotson SBBI 2010 Classic Yearbook at 82.*

202 *Blue Chip Financial Forecasts*, August 1, 2010 at 2.

203 TIEC Ex. 2 (Gorman Direct) at 35

Morningstar's study estimated that the arithmetic average of the achieved total return on the S&P 500 was 11.80 percent, and the total return on long-term Treasury bonds was 5.8 percent.[204] The indicated equity risk premium is 6.0 percent (11.80 percent - 5.8 percent = 6.00 percent).

Based on a Morningstar low-end market risk premium of 5.2 percent, 6.0 percent, and high-end market risk premium of 6.7 percent, a risk-free rate of 4.9 percent, and a beta of 0.68, Mr. Gorman's CAPM analysis produced a return in the range of 8.45 percent to 9.48 percent, with a midpoint of 8.97 percent, which he rounded to 9.00 percent.[205]

COH/HCOC witness Solomon also conducted a CAPM analysis, although he places little reliance on it. Mr. Solomon found that what he termed the more traditional application of the CAPM approach, which he claims has found acceptance by regulatory commissions that have placed any reliance on the CAPM in the past, results in ROEs in the range of 8.56 percent to 9.02 percent.[206]

OPC witness Szerszen also performed a CAPM analysis. Using what she characterized as a survey of professional forecasters' expected 10-year return on the S&P 500 as her market risk premium, Dr. Szerszen arrived at a CAPM result of 7.0 percent, which is only 26 basis points above CenterPoint's embedded cost of debt.[207] Even Dr. Szerszen agreed that no rational investor would accept an equity return that low.[208]

Dr. Szerszen also performed a CAPM analysis using a 10.0 percent market risk premium derived from Ibbotson's geometric mean return on large company stocks for the 1926-2009 time period.[209] CenterPoint argues that Dr. Szerszen has testified in the past that Ibbotson's historical

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[204] Morningstar, Inc. *Ibbotson SBBI 2010 Classic Yearbook at 82.*

[205] TIEC Ex. 2 (Gorman Direct) at 37.

[206] COH/HCOC Ex. 3 (Solomon Direct) at 23-24.

[207] OPC Ex. 1 (Szerszen Direct) at 28.

[208] Tr. at 1560.

[209] OPC Ex. 1 (Szerszen Direct) at 28.

returns are not a valid way to calculate a market risk premium[210] and that, as a consequence, her second CAPM analysis is unreliable as well and should be rejected.

Staff witness Cutter's CAPM analysis yielded a result of 7.73 percent. For the risk-free rate in the CAPM equation, Mr. Cutter used a rate of 3.75, which is the average yield of the 20-year Treasury bond for the 90-day period between June 2, 2010, and August 31, 2010. Mr. Cutter testified that the 20-year maturity of the Treasury bond is appropriate to use for this purpose rather than a shorter-maturity yield, for two reasons. First, a longer investment time horizon is more comparable to the typical investment time frame for equity securities, especially utility stocks. Second, longer-term rates are less volatile and less likely to be influenced by random, short-term phenomena than are short-term rates.[211]

For the beta values, Mr. Cutter used the betas for the comparable group of companies as published by Value Line. The market risk premium was 6.00 percent, which is the arithmetic mean return value between common stocks and long-term government bonds as published in Morningstar's *Stocks, Bonds, Bills, and Inflation, 2010 Yearbook.* Mr. Cutter's CAPM analysis results in a range for the cost of equity of his comparable group of electric utilities ranging from a low estimate of 7.05 percent to a highest estimate of 8.25 percent. The average of all the estimates was 7.73 percent.[212]

4. Risk Premium Analysis

Mr. Hevert also performed a Bond Yield Plus Risk Premium analysis to corroborate the result of the DCF model. That method of determining the cost of equity rests on the principle that equity investors bear the residual risk associated with ownership, and therefore they require a premium over the return that they would have earned as bondholders. A Bond Yield Plus Risk Premium estimates the cost of equity as the sum of the equity risk premium and the yield on a particular class of bonds.

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[210] Tr. at 1562.

[211] Staff Ex. 1 (Cutter Direct) at 17-19.

[212] *Id.* at 17-18.

Because the equity risk premium is not readily observable, it must be estimated using a variety of forward-looking and historical estimates.[213]

From 1992 through May 2010, the average risk premium was approximately 5.42 percent, and the current 30-day Treasury yield is approximately 4.40 percent. After performing a regression analysis to account for the strong negative relationship between risk premia and the 30-year Treasury bond yield, the current risk premium is approximately 6.20 percent, resulting in an estimated ROE of 10.60 percent. Using the near-term projected 30-year Treasury bond yield of 5.02 percent increases that equity risk premium to 10.77 percent, but Mr. Hevert contends that number does not account for any of CenterPoint's specific risk factors or the effect of flotation costs.[214]

Mr. Gorman also conducted a risk premium analysis. His risk premium model is based on two estimates of an equity risk premium. First, he estimated the difference between the required return on utility common equity investments and Treasury bonds. The difference between the required return on common equity and the bond yield is the risk premium. He estimated the risk premium on an annual basis for each year over the period 1986 through June 2010. The common equity required returns were based on regulatory commission-authorized returns for electric utility companies. Authorized returns are typically based on expert witnesses' estimates of the contemporary investor required return.[215]

The second equity risk premium method is based on the difference between regulatory commission-authorized returns on common equity and contemporary "A" rated utility bond yields. This time period was selected because over the period 1986 through June 2010, public utility stocks have consistently traded at a premium to book value. Over the time period since 1986 (when the market to book ratio for the electric utility industry was consistently above 1.0), regulatory authorized returns were sufficient to support market prices that at least exceeded book value. Mr. Gorman contends that this is an indication that regulatory authorized returns on common equity

[213] CEHE Ex. 35 (Hevert Direct) at 38-39.

[214] *Id.* at 40.

[215] TIEC Ex. 2 (Gorman Direct) at 28-29.

supported a utility's ability to issue additional common stock, without diluting existing shares. It further demonstrates, according to Mr. Gorman, that utilities were able to access equity markets without a detrimental impact on current shareholders.[216]

Based on this analysis, the average indicated equity risk premium over U.S. Treasury bond yields has been 5.19 percent. Of the 25 observations, 19 indicated risk premiums fall in the range of 4.40 percent to 6.08 percent. Since the risk premium can vary depending upon market conditions and changing investor risk perceptions, Mr. Gorman stated that he believes using an estimated range of risk premiums provides the best method to measure the current return on common equity using this methodology.[217]

The average indicated equity risk premium over contemporary Moody's utility bond yields was 3.75 percent over the period 1986 through June 2010. The indicated equity risk premium estimates based on this analysis, according to Mr. Gorman, primarily fall in the range of 3.03 percent to 4.59 percent over this time period.[218]

Mr. Gorman states that the equity risk premium should reflect the relative market perception of risk in the utility industry today. Mr. Gorman analyzed the yield spread between utility bonds and Treasury bonds over the last 30 years. The 2008 utility bond yield spreads over Treasury bonds for "A" rated and "Baa" rated utility bonds are 2.25 percent and 2.97 percent, respectively. The utility bond spreads over Treasury bonds for "A" and "Baa" rated utility bonds for 2009 are 1.96 percent and 2.98 percent, respectively. These utility bond yield spreads over Treasury bond yields are, according to Mr. Gorman, much higher than the 30-year average spreads of 1.60 percent and 2.00 percent, respectively.[219]

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[216] *Id.* at 29.

[217] *Id.* at Ex. MPG-11, 29.

[218] *Id.* at Ex. MPG-12, 29-30.

[219] *Id.* at 31.

While the yield spreads for 2008 and 2009 reflect unusually large spreads, Mr. Gorman states that the market has started to improve and these spreads have started to decline. For example, the 13-week average "A" rated utility bond yield has subsided relative to the end of 2008 and 2009, down to around 5.32 percent. This utility bond yield when compared to the current Treasury bond yield of 4.07 percent, according to Mr. Gorman, implies a yield spread of around 1.25 percent, which is lower than the 30-year average spread for "A" utility bonds of 1.60 percent. Mr. Gorman states that the same is true for the "Baa" utility yields and spreads.[220]

Mr. Gorman added a projected long-term Treasury bond yield to his estimated equity risk premium over Treasury yields. The 13-week average 30-year Treasury bond yield, ending August 13, 2010, was 4.07 percent.[221] *Blue Chip Financial Forecasts* projects the 30-year Treasury bond yield to be 4.9 percent, and a 10-year Treasury bond yield to be 4.2 percent.[222] Using the current and projected 30-year bond yield of 4.07 percent and 4.90 percent, respectively, and a Treasury bond risk premium of 4.40 percent to 6.08 percent, as developed above, produces an estimated common equity return in the range of 8.47 percent (4.07 percent + 4.40 percent) to 10.98 percent (4.90 percent + 6.08 percent), with a midpoint of 9.73 percent.

Mr. Gorman next added his equity risk premium over utility bond yields to a current 13-week average yield on "Baa" rated utility bonds for the period ending August 13, 2010, of 5.99 percent. Adding the utility equity risk premium of 3.03 percent to 4.59 percent, as developed above, to a "Baa" rated bond yield of 5.99 percent, produces a cost of equity in the range of 9.02 percent to 10.58 percent, with a midpoint of 9.80 percent.[223]

Although Mr. Gorman states that his risk premium analyses produce a return estimate in the range of 9.73 percent to 9.80 percent, with a midpoint estimate of 9.77 percent, that is an inaccurate portrayal of the true facts. One does not take the midpoints of two ranges – each of which portrays

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[220] *Id.*

[221] *Id.* Ex. MPG-14.

[222] *Blue Chip Financial Forecasts*, August 1, 2010, at 2.

[223] TIEC Ex. 2 (Gorman Direct) Ex. MPG-14, page 1 of 3.

the boundaries one is trying to estimate – and use those midpoints to establish another range. The range of Mr. Gorman's risk premium analysis is either 8.47 percent to 10.98 percent, with a midpoint of 9.73 percent, or 9.02 percent to 10.58 percent, with a midpoint of 9.80 percent.

OPC witness Szerszen also conducted a risk-premium analysis. Dr. Szerszen relied on two different data sets in establishing a risk-premium derived ROE, *i.e.*, the average allowed ROE for electric utilities for the 1992 – 2010 time period, and the Moody's average public utility bond yield for 1992 – 2010.[224]

Dr. Szerszen stated that she had no particular objection to Mr. Hevert's use of Treasury bond yields, rather than utility bond yields, in calculating a risk premium. However, Dr. Szerszen testified that it is much more likely that investors will assess the relative risk of utility common stocks by reviewing the yields on utility company bonds rather than Treasury bonds. Because utility bonds are rated according to credit risk, a historically derived risk premium can be applied to current or projected yields on utility bonds with the same credit rating. This will provide a more valid risk premium derived DCF estimate because it recognizes that equity investments in lower credit rated utility companies will generally require higher returns than equity investments in higher rated utility companies.[225]

Dr. Szerszen derived an average 392 basis point risk premium from the Moody's bond yield and allowed ROE data. Combined with the 5.77 percent current yield for BBB-rated bonds, a 9.69 percent ROE for CenterPoint was found. Unlike Mr. Hevert, Dr. Szerszen did not find it necessary to adjust her risk premium upward for the current low interest rate environment. According to Dr. Szerszen, debt/equity risk premiums have not remained consistent over time, and can exhibit extremely high fluctuations from year to year. Averaging 19 years of risk premiums will

[224] OPC Ex. 1 (Szerszen Direct) at 30-31.

[225] *Id.* at 31.

smooth out year to year variations in risk premiums, and this average will provide a reasonable indication of investor expected risk premiums.[226]

5. ALJs Analysis

Given the detail, time, and effort that went into the various experts' testimony on this issue, one might easily conclude that the development of an estimated cost of equity is a precise science. But, as acknowledged by Mr. Hevert in testimony and by TIEC in brief, estimating the cost of equity is not an exact science but rather a result of informed judgment. Mr. Hevert says, for example, that he applies "my informed judgment" when determining the cost of equity.[227] He further acknowledges that "as a practical matter, however, all of the models available for estimating the cost of equity are subject to *limiting assumptions* or other methodological constraints."[228] He continues, "analysts and academics understand that ROE models are simply tools to be used in the ROE *estimation process* and that strict adherence to any single approach or its results can lead to flawed and uninformed conclusions."[229] Finally, he states that "neither the DCF model nor any other model can be applied without *considerable judgment* in selecting the data and interpreting the results."[230]

At the hearing on the merits, an additional factor was added to the mix. The national average ROE during the first six months of 2010 was 10.41 percent, a fact acknowledged by both TIEC witness Gorman[231] and COH/HCOC witness Solomon.[232] This is a particularly salient fact, especially when compared to the ranges of reasonable ROEs testified to by the experts in this proceeding, as shown in the following table:

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[226] *Id.* at 30 and Schedule CAS-7.

[227] CEHE Ex. 35 (Hevert Direct) at 25 (emphasis added).

[228] *Id.*

[229] *Id.* at 26 (emphasis added).

[230] *Id.* at 27 (emphasis added).

[231] Tr. at 1470.

[232] Tr. at 1420.

Witness/Analysis	Range
Hevert - DCF	11.0 – 11.5
Hevert – CAPM	11.25
Hevert – Risk Premium	10.77
Gorman –DCF	9.3 – 10.8
Gorman – CAPM	8.45 – 9.48
Gorman – Risk Premium	9.02 – 10.58
Solomon – DCF	9.5 – 10.5
Solomon – CAPM	8.56 – 9.02
Szerszen – DCF	9.6
Szerszen – CAPM	9.6
Cutter – DCF	8.5 – 11.96
Cutter – CAPM	7.05 – 8.25

As can be seen, 10.41 percent falls within virtually all of the recommended ranges resulting from the DCF analyses conducted by the intervenors (and is close to the point recommended by OPC). As the DCF analysis is the principal analysis relied on in setting ROE, the ALJs are persuaded that 10.41 percent is the appropriate ROE to recommend for CenterPoint in this proceeding and request the Commission so find.

C. Cost of Debt [Germane to Preliminary Order Issue No. 4]

CenterPoint's weighted average cost of debt at the end of the test year was 6.74 percent.[233] No party has taken issue with that cost of debt. Therefore, the ALJs recommend that the Commission enter an order finding that the appropriate cost of debt for CenterPoint is 6.74 percent.

D. Overall Rate of Return [Germane to Preliminary Order Issue No. 4]

The overall rate of return is a product of the capital structure, ROE, and cost of debt. Based on the discussions set forth above, the ALJs recommend that the Commission adopt the following overall rate of return for CenterPoint:

[233] CEHE Ex. 28 Fitzgerald Direct) at 39.

Component	Cost	Weighting	Weighted Cost
Debt	6.74	55%	3.71
Equity	10.41	45%	4.68
Overall			8.39

VII. COST OF SERVICE AND OPERATIONS AND MAINTENANCE [GERMANE TO PRELIMINARY ORDER ISSUE NOS. 2 AND 12]

A. Transmission and Substation Operations

CenterPoint seeks recovery of its test year Transmission O&M expenses in FERC Accounts 560 through 573 in the amount of $182.2 million.[234] CenterPoint's Transmission and Substation Operations Organization plans, engineers, constructs, operates, and maintains the Company's transmission and substation facilities.[235] These functions ensure that CenterPoint can:

- Provide reliable and safe transmission service at a reasonable cost;
- Comply with applicable regulations and laws, including mandatory reliability requirements;
- Ensure non-discriminatory, open access to the transmission grid;
- Maintain a robust transmission and substation system that reliably delivers energy and enables economically efficient energy transfers; and
- Proactively develop and implement flexible plans for systems, organizations, and infrastructure, so as to facilitate the delivery system needs of the electric energy market.[236]

[234] CEHE Ex. 1 at Schedule II-D-1.

[235] CEHE Ex. 10 (Houston Direct) at 8.

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

Four Company departments – Transmission Planning, Transmission Control, Transmission Operations, and Substation Operations – ensure that CenterPoint can achieve all of these objectives at any given moment.[237]

No party asserted that any of the Company's Transmission and Substation operations expenses are unreasonable or unnecessary for the reliable provision of electric service to CenterPoint's customers, and no party contests the Company's Transmission and Substation O&M request. CenterPoint contends that this is a direct result of the fact that CenterPoint has well-established O&M budgeting practices that have been developed over the years to ensure the provision of reliable service at a reasonable cost.[238] CenterPoint explained that proposed O&M expenditures receive a high level of internal scrutiny to ensure that these expenditures are consistent with CenterPoint's policies and good utility practice.[239] Actual O&M expenses are monitored against budgeted amounts on an ongoing basis and variances from budgeted amounts are investigated.[240] These processes, according to CenterPoint, ensure that costs are effectively managed and maintained at reasonable levels through the entire process of business planning, budget plan review, and ongoing budget plan monitoring.

The fact that no party challenged CenterPoint's Transmission and Substation O&M request leads the ALJs to the conclusion that those expenditures are both reasonable and necessary. Therefore, the ALJs recommend that the Commission enter an order finding that CenterPoint's Transmission and Substation expenditures in the amount of $182.2 million are approved.

B. Distribution Operations [Germane to Preliminary Order Issue No. 29]

CenterPoint requests recovery of its test year Distribution O&M expenses in FERC Accounts 580 through 598 in the amount of $190.6 million.[241] According to CenterPoint, its Distribution

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[237] *Id.* at 9.

[238] *Id.* at 29.

[239] *Id.*

[240] *Id.*

[241] CEHE Ex. 1 at Schedule II-D-1.

Operations and Distribution Engineering and Services divisions effectively maintain and operate a distribution system that safely and reliably serves over two million end-use retail electric customers,[242] and the expenses incurred by these two divisions are reasonable and necessary and should be approved. Only COH/HCOC witness Scott Norwood challenged any of CenterPoint's distribution O&M request. Specifically, Mr. Norwood testified that CenterPoint's distribution O&M request should be reduced by $8.4 million to account for: (1) expenses he alleges appear to be associated with CenterPoint's AMS deployment and (2) certain costs he alleges appear to be non-recurring.[243]

CenterPoint argued in response that with respect to the AMS expenses, the evidence clearly demonstrates that these costs were transferred to the AMS surcharge and are not included in the determination of CenterPoint's proposed base rates.[244] With regard to Mr. Norwood's "non-recurring" expense position, CenterPoint argued that crucial to Mr. Norwood's methodology is his comparison of the Company's 2008 distribution O&M costs with 2009 distribution O&M test-year costs. However, CenterPoint pointed out that, as Mr. Finley testified on rebuttal, CenterPoint's 2008 distribution O&M costs fail to present an accurate picture of ongoing expense levels because of the impact of Hurricane Ike during that period.[245] That is, the types of O&M expenses that are experienced in a typical year did not occur in 2008 due to the significant time and costs spent to repair the distribution system after the hurricane.[246] Mr. Finley further testified that a number of costs have increased since 2008, including those associated with revenue protection and evidence collection to curtail theft of electric services. CenterPoint argued that Mr. Finley's explanation is bolstered by the fact that CenterPoint's budget for 2010 distribution O&M expenses is approximately $5 million higher than the test-year amount in this case.

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[242] CEHE Ex. 11 (Finley Direct at 1-2.

[243] COH/HCOC Ex. 5 (Norwood Direct) at 3 and 7.

[244] CEHE Ex. 55 (Finley Rebuttal) at 5 and Rebuttal Ex. TF-1.

[245] *Id.* at 6.

[246] *Id.*

Mr. Finley further testified that CenterPoint carefully plans Distribution O&M activities and related expenses ahead of time, monitors them as the Company goes forward, and controls costs on an ongoing basis.[247]

Based on the preponderance of the evidence, the ALJs find that CenterPoint's test year O&M expense for Distribution Operations and Distribution Engineering Services of $190.6 million is reasonable and necessary and should be recovered without any reduction as proposed by COH/HCOC's witness Mr. Norwood.

C. Labor Expenses

CenterPoint states that CNP constantly studies the employment marketplace in order to maintain the competitiveness of its compensation plans and levels from a "total compensation" perspective.[248] Similarly, according to CenterPoint, CNP attempts to provide a comprehensive set of benefits to meet employees' welfare and financial security needs in an affordable and efficient manner with the overall value targeted at the midpoint of the marketplace.[249]

CenterPoint correctly points out that no party argues that any one of CenterPoint's employees is unnecessary for the provision of safe and reliable service. That, of course, is not the end of the story. A number of parties argue that certain of CenterPoint's labor expenses should be disallowed. Those proposed disallowances are discussed below.

1. Post-Test Year Payroll Adjustment/Competitive Pay Adjustment

The Company seeks to recover a number of post-test year labor expenses stemming from, and including, increases to payroll expense of $4.402 million for distribution and $0.681 million for transmission.[250] As a result, the Company seeks a post-test year increase in pension expense of

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[247] CEHE Ex. 11 (Finley Direct) at 28-41.

[248] CEHE Ex. 23 (Woods Direct) at 15.

[249] *Id.* at 31-32.

[250] CEHE Ex. 28 (Fitzgerald Direct) at 10; GCCC Ex. 1 (Kollen Direct) at 50.

$1.495 million for distribution and $0.232 million for transmission, as well as an increase in FICA tax expense of $0.301 million for distribution and $0.047 million for transmission.[251]

The starting point for CenterPoint's proposed adjustment to payroll expense was base wages as of December 31, 2009. The base wages for employees was then adjusted for an actual competitive pay adjustment in April 2010 for non-union employees and an estimated general wage increase of 3 percent for union employees. This resulted in the adjusted wage expense, which was then compared to the test year. CenterPoint then took the difference to find its adjustment to wage expense.[252]

In his direct testimony, CenterPoint witness Charles D. Woods argued that the post-test year payroll increase was necessary in view of a "compa-ratio"[253] that indicated that the pay of CenterPoint non-union employees in 2010 was 96 percent, suggesting that CenterPoint's non-union employees earned a below-market pay level.[254]

GCCC witness Lane Kollen argued that in making these proposed adjustments, the Company selected increases to the Company's test year cost of service without regard to offsetting post-test year changes that might also have occurred. According to Mr. Kollen, these changes could include increases in revenues, reductions in other expenses, or offsetting reductions in payroll expenses resulting from potential productivity improvements.[255]

Staff witness Mary Jacobs started with CenterPoint's actual payroll for the months of April, May, and June 2010, which totaled $29,913,000.[256] She then annualized this amount, which resulted

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[251] GCCC Ex. 1 (Kollen Direct) at 50.

[252] CEHE Ex. 23 (Woods Direct) at 21.

[253] A compa-ratio is an expression of employee base pay in relation to survey data. The compa-ratio is calculated by dividing the base pay by the survey-derived market reference point expressed as a percentage. The compa-ratio is a management tool that is used in the administration and allocation of pay increase budgets to achieve or maintain CNP's market-based pay philosophy. *Id.* at 20.

[254] *Id.*

[255] GCCC Ex. 1 (Kollen Direct) at 50.

[256] Staff Ex. 8 (Jacobs Direct) at 9.

in an annual payroll expense of $119,652,000, representing a decrease of $3,342,000 to CenterPoint's payroll expense.[257]

CenterPoint also requested an adjustment to benefit costs of $1,727,000 to reflect the post-test year adjustments made to salaries and wages.[258] Because this expense is a function of the amount of the requested increase to salaries and wages, Ms. Jacobs argued that it should be reduced by the same percentage as the reduction to the adjustment to salaries and wages. Ms. Jacobs recommended a decrease of 67.20 percent to CenterPoint's requested increase to payroll expense. Therefore, according to Ms. Jacobs, it is proper to adjust FERC Account 926 by the same 67.20 percent. This results in a decrease of $1,160,544 to CenterPoint's request.[259]

The ALJs are persuaded that Ms. Jacob's analysis is the correct one to apply in this instance. It properly excludes CenterPoint's estimated general wage increase of 3 percent for union employees, which is not a known and measurable adjustment, and accounts for changes in employee departures and additions. Similarly, it makes the appropriate adjustment to benefits, which are a function of the amount of the requested increase to salaries and wages and should, therefore, be reduced by the same percentage as the reduction to the adjustment to salaries and wages.

2. Incentive Compensation

CenterPoint is requesting $5.204 million in total annual long-term incentive (LTI) expense.[260] CenterPoint also is seeking recovery of costs related to its short-term incentive (STI) plan. CenterPoint contends that its STI and LTI plans are reasonable and necessary components of a total compensation package required to recruit, retain, and motivate employees.[261] According to

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[257] *Id.* at 9.

[258] CEHE Ex. 28 (Fitzgerald Direct) at 14.

[259] Staff Ex. 8 (Jacobs Direct) at 9.

[260] *Id.* at 7; GCCC Ex. 1B (Errata to Kollen Direct) at 54.

[261] *Id.* at 22-24, 26-29.

CenterPoint, these forms of compensation are the norm in the utility industry, without which CenterPoint cannot attract and maintain a qualified and skilled workforce.[262]

(a) LTI Expenses

OPC witness June Dively, GCCC witness Lane Kollen, and Staff witness Mary Jacobs all contend that the Company should not be allowed to recovery its LTI expense because of its use of financial measures.[263] According to CenterPoint, however, LTI, along with base pay and STI, helps make up the non-benefits portion of the Company's competitive compensation package that employees may compare to other employers in making employment decisions. CenterPoint stated that LTI ensures that Company employees are focused on the Company's health. Improved performance on corporate measures that increase stock price can lower a company's cost of capital, which, according to CenterPoint, results in lower financing costs for customers.[264]

The core of the intervenors' argument is that CenterPoint's LTI (and, in the case of TIEC, over half of its STI) violates Commission precedent because it is tied to financial measures. The intervenors argue that substantial precedent exists requiring a disallowance of CenterPoint's financial-based incentive compensation. In Docket No. 28840, the Commission adopted the ALJs' findings that the portions of American Electric Power Company's (AEP) incentive compensation program that were tied to operational performance measures are recoverable through rates but that portions tied to financial performance measures are not.[265] The ALJs examined AEP's "CIP" incentive compensation program and determined that 66 percent of the program was tied to financial

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[262] *Id.* at 23 and 28.

[263] OPC Ex. 3 (Dively Direct) at 15; GCCC Ex. 1 (Kollen Direct) at 54; Staff Ex. 8 (Jacobs Direct) at 7-8.

[264] CEHE Ex. 23 (Woods Direct) at 27.

[265] *Application of AEP Texas Central Company for Authority to Change Rates,* Docket No. 28840, Findings of Fact Nos. 164-170, Order at 35 (Aug. 15, 2005).

measures.[266] The Commission agreed with the ALJs that these measures "are of more immediate benefit to shareholders" and are not "necessary and reasonable to provide T&D utility service."[267]

In Docket Nos. 33309 and 35717 the Commission reaffirmed the incentive compensation policy it set out in Docket No. 28840. In Docket No. 33309, the Commission found: "TCC's inclusion of annual and long-term incentive compensation related to financial incentives in cost of service is unreasonable because it is not necessary for the provision of T&D utility services."[268] In Docket No. 35717, the Commission similarly found that "[o]f the amount Oncor requested for incentive compensation, $5,082,326 should be removed because it is related to financial measures that are unreasonable and unnecessary for the provision of T&D utility services."[269]

Although CenterPoint points to a recent Railroad Commission of Texas decision holding the incentive compensation should be recoverable,[270] that decision does not overcome the clear line of Commission precedent. Based on the evidence presented and Commission precedent, the ALJs recommend that the Commission exclude CenterPoint's LTI from recoverable expenses.

(b) STI Expenses

CenterPoint witness Woods states that the corporate and financial goals of STI are directly tied to metrics such as customer service and safety. The financial goals provide economic incentives for employees to conduct their business more effectively, manage expenses, and improve operating income. The Company's operational goals encourage safe and efficient operations, as well as

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[266] *Application of AEP Texas Central Company for Authority to Change Rates,* Docket No. 28840, Proposal for Decision at 78 (July 2, 2004).

[267] *Application of AEP Texas Central Company for Authority to Change Rates,* Docket No. 28840, Findings of Fact Nos. 169-170, Order at 35 (Aug. 15, 2005). The Commission determined that operational measures such as reliability and safety "are of more immediate benefit to ratepayers" and thus qualify as "necessary and reasonable to provide T&D service."

[268] *Application of AEP Texas Central Company for Authority to Change Rates,* Docket No. 33309, Finding of Fact No. 82, Order on Rehearing at 12 (Mar. 14, 2008).

[269] *Application of Oncor Electric Delivery Company, LLC, for Authority to Change Rates,* Docket No. 35717, Finding of Fact No. 93, Order on Rehearing at 22 (Nov. 30, 2009).

[270] CEHE Ex. 65 (Woods Rebuttal) at 12 (citing the Final Order in GUD No. 9902 at Finding of Fact No. 63).

enhanced customer service.[271] In its initial brief, CenterPoint stated that no party disputes the Company's STI costs, but in its initial brief, TIEC contended that although some performance measures in CenterPoint's STI plan are operational, others are financial. Specifically, TIEC pointed to the goals "Core Operating Income" and "Controllable Expenses," which it claimed CenterPoint admitted were financial-based measures.[272] According to TIEC, these financial measures each represent 27 percent (collectively, 54 percent) of the overall goals of CenterPoint's STI.

CenterPoint argues that no witness in this proceeding supports TIEC's new position. According to CenterPoint, the evidence provided by the Company proving that STI is reasonable and necessary is undisputed in the record.[273] TIEC presented no evidence as to the nature of the goals it contended constituted impermissible financial goals. As a consequence, the ALJs find that TIEC's challenge to CenterPoint's inclusion of STI expenses fails and, therefore, recommend that the Commission find that CenterPoint's STI expenses are recoverable.

3. Employee Benefits

CenterPoint witness Woods states that CNP's benefits philosophy is to provide a comprehensive set of benefits to meet its employees' welfare and financial security needs in an affordable and efficient manner with the overall value targeted at the midpoint of the marketplace. According to Mr. Woods, CNP does this through a "one-company" approach with the objective of offering a common set of benefits to all its employees.[274] No party challenges the Company's benefits philosophy or alleges that CenterPoint's benefits package is excessive or unreasonable. Instead, OPC witness Dively recommends disallowances of $1,082,000 in deferred compensation expenses and $1,421,000 in supplemental contract expenses based on the assertion that she cannot identify evidence or testimony on the reasonableness or necessity of these expenses. CenterPoint noted that Ms. Dively does not affirmatively contend that these types of expenses are unreasonable or unnecessary and that, when given the opportunity to conduct discovery on these expenses,

[271] CEHE Ex. 23 (Woods Direct) at 24.

[272] *Id.* at Ex. CDW-5.

[273] CEHE Reply Brief at 32-33.

Ms. Dively chose not to. CenterPoint states that the evidence demonstrates that the amounts Ms. Dively questions are included in FERC account 926 in the grand total as reported and requested on Schedule II-D-2.[275] The ALJs were not persuaded by Ms Dively's testimony and do not recommend her adjustment.

CenterPoint requested an adjustment to benefit costs of $1,727,000 to reflect the adjustments made to salaries and wages.[276] Because this expense is a function of the amount of the requested increase to salaries and wages, Staff argued, and the ALJs agree, it should be reduced by the same percentage as the reduction to the adjustment to salaries and wages. Staff witness Jacobs recommended a decrease of 67.20 percent to CenterPoint's requested increase to payroll expense. Therefore, it is proper to adjust FERC Account 926 by the same 67.20 percent. This results in a decrease of $1,160,544 to CenterPoint's request, which the ALJs recommend that the Commission order.[277]

4. Savings Plan Expense

All CenterPoint employees are eligible for participation in CNP's Savings Plan.[278] CNP's Savings Plan expense is at the median of the market.[279] No party challenges the Company's Savings Plan expense in this proceeding. Accordingly, the ALJs recommend that the Commission find that CenterPoint's Savings Plan expense of $6.763 million is reasonable and should be approved.

D. Pension and OPEB Expense [Issue 13]

Pursuant to PURA § 36.065(a),[280] CenterPoint seeks to include $20.8 million of pension expense to set rates in this proceeding. TIEC and COH/HCOC presented testimony challenging the

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[274] CEHE Ex. 23 (Woods Direct) at 31-32.

[275] CEHE Ex. 65 (Woods Rebuttal) at 17-18.

[276] CEHE Ex. 28 (Fitzgerald Direct) at 14.

[277] Staff Ex. 8 (Jacobs Direct) at 9.

[278] CEHE Ex. 23 (Woods Direct) at 51.

[279] *Id.* at 52-53.

[280] PURA § 36.065(a) provides: "The regulatory authority shall include in the rates of an electric utility expenses for

reasonableness of CenterPoint's requested pension expense. TIEC witness Pollock argued that CenterPoint's test year pension expense is anomalous;[281] while COH/HCOC witness Blumenthal criticized the actuarial assumptions used to calculate the pension expense.[282]

Mr. Pollock claimed that CenterPoint's requested pension expense for 2009 is 1,078 percent greater than its 2008 pension expense, and its projected 2010 pension expense is 107 percent less than its 2009 expense. Thus, he concludes that CenterPoint's test year pension expense is not reflective of its historical or its expected future expenses – it is simply an anomaly. TIEC argued that the test year merely serves as a proxy for the costs a utility is likely to incur in the future. Therefore, the Commission is not bound to set rates according to test year costs, but "may go outside the test year when necessary to achieve just and reasonable rates."[283] TIEC claimed this is proper when information outside the test year provides insight into the cost situation that is expected in the future.[284] According to TIEC, a more complete picture of CenterPoint's pension expense experience is necessary. Comparing the 2009 test year expense to prior and post-test years shows that CenterPoint's 2009 expense was wildly aberrant. Thus, TIEC argued that giving CenterPoint $20.8 million per year for pension expense would likely result in a substantial over-recovery. Accordingly, TIEC recommended that CenterPoint's pension expense should be set at $0.

TIEC further argued in support of its $0 pension expense recommendation by noting that while CenterPoint's historical and post-test year experience alone justifies setting CenterPoint's pension expense at $0, it is especially prudent to do so given that CenterPoint has created a regulatory asset, pursuant to PURA § 36.065(b), to track and recover any net pension expense.[285] According to TIEC, CenterPoint's highly variable year to year pension expenses make recovery through a regulatory asset particularly fitting. In addition, not only will recovery through the PURA

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pension and other postemployment benefits, as determined by actuarial or other similar studies in accordance with generally accepted accounting principles, in an amount the regulatory authority finds reasonable."

[281] TIEC Ex. 1 (Pollock Direct) at 18.

[282] COH/HCOC Ex. 1 (Blumenthal Direct) at 18.

[283] *El Paso v. Pub. Util. Comm'n*, 883 S.W. 2d 179, 188 (Tex. 1994).

[284] *Id.*

[285] TIEC Ex. 21.

§ 36.065 asset make the Company whole, but also the Company earns a guaranteed, regulated return on this asset.[286]

Ms. Blumenthal's testimony disputed the actuarial assumptions used to calculate the FAS 87 estimated pension costs. She asserted that CenterPoint's FAS 87 is not reasonable or necessary based on "turmoil in the worldwide securities markets," and by comparison to FAS 87 pension expense in prior years.[287] For these reasons, she asserted, "it would be reasonable under these circumstances to deny any increase in pension expense over that in current rates. Alternatively, she recommended that the impact of the economic turmoil on [CenterPoint]'s estimated 2010 FAS pension expense should be normalized by averaging the last five years' actuarially estimated FAS 87 pension expense."[288]

CenterPoint witness Fitzgerald responded to the challenges raised by Ms. Blumenthal and Mr. Pollock in his rebuttal testimony. He pointed out that the FAS 87 pension expense requested by CenterPoint is reasonable and necessary, not by comparison to other periods, but because the amount was actuarially determined in accordance with GAAP. In contrast, none of the intervenors, nor Staff, offered a different actuarial computation of the expense, nor any testimony that the amount of the expense is out of line with market compensation rates.

He testified that moreover, the amount of CenterPoint's FAS 87 pension expense is consistent with the requirement of PURA §36.065. He also referred to the testimony of CenterPoint's witness Woods, which supports the reasonableness of the Company's FAS 87 pension expense as it explains in detail the process by which actuarial assumptions are determined and the thorough review process that is undertaken by the CenterPoint and its actuary with regard to pension expense. He stated that pension expenses fluctuate with changes in the securities markets, interest rates and law, among other factors, outside of the Company's control, and for this very reason PURA §36.065, was passed into law to protect the pension and other postemployment benefits of legacy employees of formerly integrated utilities. According to Mr. Fitzgerald, the suggestion by

[286] TIEC Ex. 1 (Pollock Direct) at 18-21.

[287] COH/HCOC Ex. 1 (Blumenthal Direct) at 17-19.

[288] *Id.* at 19.

Ms. Blumenthal, who is not an actuary and not qualified to perform an actuarial computation of pension expense, to arbitrarily reduce the actuarially determined amount of FAS 87 pension expense included in rates is not sound and does not meet the requirements of PURA §36.065.[289]

With regard to Mr. Pollock's recommendation that test year pension expense should be $0 because 2009 is an anomaly, and because CenterPoint will be kept whole by the PURA § 36.065(b) regulatory asset, Mr. Fitzgerald rigorously disagreed. He reiterated, as explained above, that pension expenses fluctuate due to various reasons outside of CenterPoint's control, and every year stands to be different, even significantly different, from any other year. The amount of pension expense requested by CenterPoint is actuarially determined in accordance with GAAP as required by PURA §36.065, and is a reasonable and necessary expense. This is the standard set forth under the statute. The actuarial report upon which the requested test-year pension expense is based was received by CenterPoint in December 2009 and it does not show a negative amount for projected 2010 pension expense as Mr. Pollock claimed. Mr. Fitzgerald stated that Mr. Pollock ignores the actuarially determined pension expense for 2010, which is known and measurable, and instead calculates his own 2010 pension expense, but gives no explanation as to why his calculated amount is a better indicator of 2010 pension expense than the amount computed by CenterPoint's actuary.[290]

Mr. Fitzgerald responded to Mr. Pollock's notion that CenterPoint will be kept whole due to the PURA §36.065(b) regulatory asset, claiming it is misleading. He explained that assuming that the Commission adopts Mr. Pollock's suggestion and reduces pension expense included in rates to zero, this will only serve to push the entire actuarially determined amount of pension expense into the reserve. During the next general rate proceeding, the balance of that reserve will be subject to review and approval and included in rates through amortization expense just like the current reserve balance. Including no pension expense in base rates in this case only postpones recovery of known and measurable amounts to future rate periods. He argued that this result is at odds with: (1) the intent of PURA §36.065, which contemplates some base level of expense, and (2) basic ratemaking principles that provide that current customers pay the reasonable costs incurred to provide service.

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[289] CEHE Ex. 66 (Fitzgerald Rebuttal) at 11-12.

[290] *Id.* at 15.

He further argued that Mr. Pollock's approach is contrary to test-period ratemaking rules used by the Commission to set appropriate rates.[291]

The ALJs find the testimony and arguments of CenterPoint most persuasive. More importantly, considering the directives under PURA § 36.065, the ALJs find that the FAS 87 pension expense requested by CenterPoint was actuarially determined in accordance with GAAP in compliance with the requirements of PURA § 36.065(a), and is, therefore, a known and measurable expense that the Commission should find reasonable for inclusion in CenterPoint's rates in accordance with the statute.

E. Self-Insurance Reserve [Germane to Preliminary Order Issues Nos. 16 and 20]

An electric utility is permitted to self-insure all or part of its potential liability or catastrophic property loss, including windstorm, fire, and explosion losses that could not have been reasonably anticipated and included under operating and maintenance expense.[292] Electric utility self-insurance plans are subject to Commission approval.[293] Expenses that are allowed as a cost of service to be accrued in a reserve account for self-insurance are described in P.U.C. SUBST. R. 25.231(b)(1)(G), and expenses that may not be allowed as a cost of service and therefore may not be accrued in a reserve account for self-insurance are described in P.U.C. SUBST. R. 25.231(c)(2)(E). CenterPoint currently accrues $2.4 million to a reserve account annually and has requested recovery of that amount in its cost of service in this docket.[294] In addition to its self-insurance reserve, CenterPoint has property insurance, subject to a deductible, that is available to cover substations.[295]

CenterPoint conducted a cost-benefit analysis of its self-insurance program and claims that its self-insurance program saves the costs of premiums, taxes, commissions, profits, and many of the

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[291] *Id.* at 16.

[292] PURA § 36.064(a).

[293] PURA § 36.064(b).

[294] Staff Ex. 5 (Almon Direct) at 9.

[295] CEHE Ex. 36 (Kilbride Direct) at 53.

general expenses associated with the operation of an insurance company.[296] CenterPoint states that its broker has determined that coverage for losses below $500 million is not available.[297]

CenterPoint has asked to include in its cost of service an annual accrual of $5.28 million for uninsured restoration O&M costs, to be composed of two elements: $4.15 million to provide for average annual expected O&M losses from all storms where the O&M expense is greater than $100,000 and the total storm loss does not exceed $100 million; and $1.13 million accrued annually for ten years to achieve the requested target property insurance reserve of $13.28 million.[298] CenterPoint's $4.15 million request constitutes a 70 percent increase over its current annual accrual amount of $2.4 million.[299]

Staff witness T. Brian Almon recommends approval of CenterPoint's requested annual accrual of $4.15 million.[300] Mr. Almon conducted his own analysis of the data presented by CenterPoint witness Wilson and determined that CenterPoint's requested annual accrual of $4.15 million is within a reasonable range.[301] GCCC witness Lane Kollen, on the other hand, argues against CenterPoint's proposed accrual of $4.15 million for annual expected losses.[302]

In rejecting CenterPoint's proposal, Mr. Kollen removes Hurricane Rita costs of $37.8 million from the calculation of annual expected storm damage expense, arguing that the storm was not a normal occurrence.[303] However, it is precisely for this reason that the Hurricane Rita loss should be included in the calculation, and Mr. Kollen's removal of these costs from the calculation is not reasonable. The timing of such a loss as that incurred by CenterPoint from Hurricane Rita could

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296 CEHE Ex. 29 (Wilson Direct) at 13-15.

297 *Id.* at 14-15.

298 *Id.* at 4-5. The originally amounts ($4.11 million, $1.10 million, and $5.21 million) were corrected by Mr. Wilson due to the discovery of errors during discovery. *Id.*

299 Staff Ex. 5 (Almon Direct) at 13.

300 *Id.* at 12.

301 *Id.*

302 GCCC Ex. 1 (Kollen Direct) at 60-62.

303 *Id.* at 60-61.

not be reasonably anticipated and is therefore a loss appropriately covered by an adequate self-insurance reserve.[304] This conclusion is supported by the Commission's decision in Docket No. 35717, in which the Commission rejected a proposal that Oncor Electric Delivery Company remove large, unusual storms from its data before estimating its needed accrual.[305]

Mr. Kollen also criticizes Mr. Wilson's use of a Monte Carlo simulation in calculating reserve requirements, arguing instead for the use of trended loss data.[306] However, GCCC is incorrect in its assertion regarding Commission precedent.[307] In the *Oncor* case, the Commission gave equal weight to using Monte Carlo simulation and trended loss data.[308] CenterPoint also argues that GCCC failed to show that any difference in the computation would result by using trended loss data instead of a Monte Carlo simulation. CenterPoint states that Mr. Wilson computed an annual expected loss accrual not only using the Monte Carlo simulation, but also using trended loss data over the same time period (1994-2009).[309] The accrual for annual expected losses is $4.15 million,[310] whereas the amount computed using trended loss data is $5.56 million.[311]

GCCC also complains about Mr. Wilson's use of the Handy-Whitman index to adjust historic costs to current levels, contending that the index was not based solely on O&M costs but also included infrastructure costs. Neither Mr. Kollen nor any other party in this proceeding, however, disputes CenterPoint's assertion that the Handy-Whitman index data is a standard type of database used to measure cost changes for utility companies.[312] In fact, Mr. Kollen's own calculations on

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304 CEHE Ex. 58 (Wilson Rebuttal) at 4.

305 *Id.; Application of Oncor Electric Delivery Company, LLC For Authority to Change Rates*, Docket No. 35717, Proposal for Decision at 114 (June 2, 2009). The Commission approved Oncor's self-insurance reserve. *See* Order on Rehearing at Conclusions of Law Nos. 17 and 18 (Nov. 30, 2009).

306 GCCC Initial Brief at 31-32.

307 *Id.*

308 CEHE Ex. 58 (Wilson Rebuttal) at 4. *Application of Oncor Electric Delivery Company, LLC For Authority to Change Rates*, Docket No. 35717, Proposal for Decision at 114 (June 2, 2009). The Commission approved Oncor's self-insurance reserve. *See* Order on Rehearing at Conclusions of Law Nos. 17 and 18 (Nov. 30, 2009).

309 CEHE Ex. 1 (Wilson Workpapers) at Bates 4754-4755.

310 CEHE Ex. 29 (Wilson Direct) at 7.

311 CEHE Ex. 1 (Wilson Workpapers) at Bates 4754-4755.

312 CEHE Ex. 29 (Wilson Direct) at 8.

Schedule 7 to his direct testimony reflect costs adjusted using the Handy-Whitman index rather than another cost escalator.[313]

GCCC relies on the existence of recently adopted securitization legislation and opines that if the criteria to securitize are unmet, the Commission can permit a utility to recover system restoration costs and to recover associated carrying costs, thereby justifying the exclusion of Hurricane Rita costs.[314] However, as CenterPoint points out, the PURA provision on which GCCC relies in discussing unsecuritizable storms clearly states: "This subsection is limited to instances in which an electric utility has incurred system restoration costs of $100 million or more in any calendar year after January 1, 2008."[315] Thus, storms producing losses under $100 million such as Hurricane Rita, which caused roughly $28 million in O&M damage and $38 million in total damage to CenterPoint, would not be large enough to invoke application of the new legislation.[316] As a result, even with the legislation in place, CenterPoint would be forced to seek recovery costs associated with an event of Hurricane Rita's magnitude through other means. Recovery of carrying costs, and therefore full recovery of the costs of such an event, is uncertain at best according to CenterPoint.[317] Therefore, CenterPoint claims that it must have a substantial reserve that it can rely upon to cover costs such as that of Hurricane Rita, and thus inclusion of Hurricane Rita's costs in the computation of the necessary annual reserve accrual is essential.

While agreeing with CenterPoint on the requested $4.15 million annual accrual and the target reserve level of $13.38 million, Staff witness Almon disagreed on the need for an additional annual amount of $1.13 million to build the reserve to the target level.[318] According to Mr. Almon, CenterPoint has been able to accumulate a positive balance of $2.13 million in its reserve account with an annual accrual amount of $2.4 million that began in January 2002, and Mr. Almon

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313 GCCC Ex. 1 (Kollen Direct) Schedule 7.

314 GCCC Initial Brief at 31-32.

315 PURA § 36.403(j).

316 Staff Ex. 5 (Almon Direct) at 12.

317 CEHE Initial Brief at 102.

318 Staff Ex. 5 (Almon Direct) at 12.

recommends approval of an annual accrual amount of $4.15 million in this proceeding.[319] Further, Mr. Almon noted that only in seven out of the last 16 years did CenterPoint's annual trended loss exceed the $4.15 million annual accrual amount.[320] For these reasons, Mr. Almon does not recommend approval of CenterPoint's requested annual accrual amount of $1.13 million.

CenterPoint states that Staff's lack of support for CenterPoint's proposed $1.13 million annual accrual to reach the target reserve is based in part on a comparison of the actual loss amount to the annual accrual amount, and notes that losses exceeded the accrual amount in only seven of 16 years[321] and that observation does not take into account losses of large magnitude which occur infrequently but can still have a major effect on the reserve. CenterPoint's states that Staff's denial of the $1.13 million component of CenterPoint's proposed annual accrual will result in the reserve balance remaining at a target level of zero, something Staff agrees with CenterPoint should be avoided.[322]

The ALJs are persuaded by the arguments advanced by Staff on this issue. As a consequence, the ALJs recommend that the Commission approve an annual accrual of $4.15 million and a target reserve level of $13.28 million, but reject the additional annual accrual of $1.13 million, requested by CenterPoint.

F. Affiliate Expenses [Germane to Preliminary Order Issue No. 17]

CenterPoint seeks to recover $194.7 million for affiliate costs incurred during the test-year. No party offered testimony or a statement of position challenging either the amount of CenterPoint's affiliate costs or the assignment methodologies used by CenterPoint and its affiliates. Accordingly, the ALJs recommend, as further discussed below, that CenterPoint be permitted to recover the full amount of affiliate costs it has requested in this proceeding.

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[319] *Id.* at 13.

[320] *Id.*

[321] *Id*; Staff Initial Brief at 23.

[322] CEHE Initial Brief at 101; Staff Ex. 5 (Almon Direct) at 13; Staff Initial Brief at 23.

PURA § 36.058 allows a utility to recover expenses paid by a utility to an affiliate entity if it demonstrates that its payments are "reasonable and necessary for each item or class of items as determined by the commission."[323] To recover these expenses, the utility must demonstrate two things: (1) the reasonableness and necessity of each item or class of items allowed; and (2) that the price to the electric utility is not higher than the prices charged by the supplying affiliate to its other affiliates or divisions or to a nonaffiliated person within the same market area or having the same market conditions.[324]

The ALJs find that CenterPoint has met its burden under PURA § 36.058 and the affiliate expense standards in *Railroad Commission of Texas v. Rio Grande Valley Gas Company* to present evidence on the reasonableness and necessity of its affiliate costs, which totaled $194.7 million for the test year.[325] CenterPoint's affiliated entities, specifically Service Company, and the natural gas distribution operations (Gas Operations) of CenterPoint Energy Resource Corp. (CERC), provided services to CenterPoint during the test year.[326] Service Company and CERC are subsidiaries of CNP.[327] Service Company provides corporate services to CenterPoint including (i) executive management, (ii) regulated operations management, (iii) human resources, (iv) procurement, information technology, (v) regulatory services, (vi) administrative services, (vii) real estate services, (viii) legal services, (ix) accounting, (x) environmental services, (xi) internal audit, (xii) community relations, (xiii) corporate communications, (xiv) financial services, (xv) financial planning and management support, (xvi) corporate services, (xvii) corporate secretary, (xviii) corporate planning,

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[323] *See* PURA § 36.058(a)(1)-(2) (Vernon 2007); *see also* P.U.C. SUBST. R. 25.231(b)(1)(A) (referring to PURA § 36.058 for cost of service standards for affiliate expenses); *Cities of Corpus Christi v. Pub. Util. Comm'n of Texas*, No. 03-06-00585-CV, 2008 WL 615417, at *10 (Tex. App. - Austin 2008, no pet. h) (noting that under PURA § 36.058 "the Commission may not include affiliate costs in a utility's rates unless the Commission makes a specific finding of reasonableness and necessity for each item or class of items, and also finds that the price charged by the affiliate to the utility is no higher than the price charged by the affiliate to other purchasers"); *Railroad Comm'n of Texas v. Rio Grande Valley Gas Co.*, 683 S.W.2d 783 (Tex. App. - Austin 1984, no writ).

[324] *See* PURA § 36.058(c).

[325] CEHE Ex. 14 (Dominguez Direct) at 1-38; CEHE Ex. 19 (Campbell Direct)at 1-26; CEHE Ex. 17 (Graham Direct adopted by Pratt)at 1-17; CEHE Ex. 16 (Kneipp Direct)at 1-17; CEHE Ex. 18 LeBlanc Direct)at 1-13; CEHE Ex. 15 (Liu Direct)at 1-16; CEHE Ex. 20 (Owens Direct) at 1-19; CEHE Ex. 21 (Paulsen Direct) at 1-15; CEHE Ex. 23 (Woods Direct) at 1-15; CEHE Ex. 12 (Hagen Direct) at 1-32; CEHE Ex. 11 (Finley Direct) at 28-41; CEHE Ex. 36 (Kilbride Direct) at 43-52; CEHE Ex. 28 (Fitzgerald Direct) at 40-51.

[326] CEHE Ex. 12 (Hagen Direct) at 24.

and (xix) research and development unrelated to marketing activity and/or business development for the competitive affiliate regarding its services and products.[328] Gas Operations provides underground line locating services to CenterPoint.[329]

The preponderance of the evidence shows that: (1) each of these classes of services is prudent, necessary, and reasonable; (2) not duplicative of services otherwise provided by CenterPoint;[330] (3) CenterPoint would have to incur similar types of costs if it were not affiliated with CNP; and (4) the cost of those services would be equal to or greater than those charged by the affiliates.[331]

The evidence further demonstrates that CenterPoint and its affiliates follow a number of processes to ensure that its affiliate charges are reasonable and necessary and that CenterPoint and its affiliates are charged the same rate for similar services. These processes include: (i) the use of Service Level Agreements (SLA) to define the level of service required and the cost of those services; (ii) direct billing of affiliate costs where possible; (iii) reasonable allocation methodologies for costs that cannot be directly billed; (iv) budgeting processes and controls to ensure budgeted costs are reasonable and necessary to ensure appropriate levels of service to its customers; (v) financial system controls to ensure that billings are accurate and timely; (vi) accounting controls; (vii) oversight controls such as the Commitment Review Team, the Risk Oversight Committee, and the Executive Committee that provide control over business unit and Service Company expenditures and activities; and (viii) labor cost controls that evaluate and price each job.[332]

The evidence establishes that CenterPoint's four main categories of allocation factors used by Service Company – Composite Ratio, Assets, Operating Expense, and Headcount – are

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[327] CEHE Ex. 14 (Dominguez Direct) at ES-1; CEHE Ex. 1 at Schedule V-K-3.

[328] CEHE Ex. 1 at Schedule V-K-7.

[329] *Id.* at line 10.

[330] CEHE Ex. 12 (Hagen Direct) at 22, 31; CEHE Ex. 14 (Dominguez Direct) at 36.

[331] CEHE Ex. 12 (Hagen Direct) at 31.

[332] CEHE Ex. 14 (Dominguez Direct) at 9-19, 28; CEHE Ex. 12 (Hagen Direct) at 28.

reasonable.[333] CenterPoint's assignment methodologies are appropriate to further ensure that its affiliate charges are reasonable and necessary. These assignment methodologies are described in the CenterPoint Corporate Cost Center Assignment Manual (2009), the Information Technology Cost Center Assignment Manual (2009), the Business Support Services Cost Center Assignment Manual (2009), and the Regulated Operations Cost Center Assignment Manual (2009). These Manuals provide appropriate and reasonable methodologies for assigning affiliate costs, including the Composite Ratio that considers assets, gross margin, and head count in the allocation of those costs.[334]

Total net Service Company and other affiliate billings to CenterPoint, as adjusted, are $194.7 million.[335] The preponderance of the evidence shows that these affiliate-related costs were not higher than charges to a third party or other affiliate for the same class of items,[336] and there is no preferential treatment among, or cross subsidization of, affiliates, by Service Company.[337]

The ALJ's further find that the Service Company has complied with Commission rules requiring that affiliate costs be fully allocated. These costs are fully assigned, and otherwise comport with the applicable requirements of P.U.C. SUBST. R. 25.272 and PURA § 36.058.[338]

CenterPoint also provides affiliate services to Service Company, Properties, and Gas Operations.[339] CenterPoint services to its affiliates include meter reading, fleet services, shop services, geographic information services, surveying and right-of-way, underground line locating, radio communications, data circuit management, field operations, community relations, and other incidental and/or intermittent services.[340] The evidence established that services provided: (i) by

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[333] CEHE Ex. 14 (Dominguez Direct) at 27-32.

[334] *Id.* at 29-32, Ex. KCD-2, KCD-3, KCD-4, and KCD -5.

[335] CEHE Ex. 1 at Schedule V-K-2.

[336] CEHE Ex. 12 (Hagen Direct) at 31; CEHE Ex. 14 (Dominguez Direct) at ES-1, 19, 37.

[337] *Id.* at 37.

[338] *Id.* at 36-37.

[339] CEHE Ex. 12 (Hagen Direct) at 24.

[340] *Id.* at 25-27.

CenterPoint to its affiliates and (ii) by Service Company and other affiliates to CenterPoint, are billed at cost.[341] CenterPoint billed its affiliates $33.7 million for the test year and such costs are reasonable.[342]

G. Customer Service

As part of its cost of service request, CenterPoint is seeking $7.9 million for its Customer Services organization.[343] These costs were not challenged by any party. As established by the preponderance of the evidence, Customer Services is responsible for providing necessary Call Center services that act as the front-line of communication between CenterPoint and Competitive Retailers and end-use retail electric customers to whom the Company delivers electricity.[344] To ensure positive customer experience and operational efficiency, the Customer Services organization complements its Call Center responsibilities with training, performance management, customer account support, quality assurance, and vendor management activities.[345] By aggregating these activities within Customer Services,[346] the Company is able to provide a comprehensive set of skills and resources capable of meeting the needs of customers in an affordable and efficient manner. Based on the forgoing, the ALJs recommend that $7.9 million for customer service costs should be included in CenterPoint's recoverable cost of service.

H. Electric Market Operations

CenterPoint seeks to recover test year expenses for Electric Marketing Operations (EMO) in the amount of $7.1 million.[347] As explained by CenterPoint, EMO is responsible for Competitive

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[341] *Id.* at 27; CEHE Ex. 14 (Dominguez Direct) at 18.

[342] CEHE Ex. 1 at Schedule V-K-8.

[343] CEHE Ex. 22 (Knight Direct) at 22.

[344] *Id.* at 5-6.

[345] *See id.* at 24.

[346] The Customer Services organization includes four areas, which provide necessary support to the electric utility service offered by CEHE: (1) Call Center, (2) Customer Account Support, (3) Customer Care (Quality Assurance, Training and Vendor Management), and (4) Performance Management and Strategy. CEHE Ex. 22 (Knight Direct) at 3-4.

[347] CEHE Ex. 13 (Neel Direct) at 3.

Retailer and ERCOT relations, credit and risk management, and resolution of retail market and internal system issues to facilitate the timely processing, execution, and delivery of retail market electronic transactions. CenterPoint witness Susan J. Neel testified that crucial to CenterPoint's operations, EMO manages average daily receivables of approximately $5.1 million and works to mitigate the possible effects of Competitive Retailer defaults and bankruptcies by monitoring daily invoice payments to resolve disputes and collect outstanding invoices.[348]

Ms. Neel further testified that EMO's test year expenses are reasonable because they adhere to CenterPoint's overall budgeting process and EMO seeks to reduce costs when possible. She stated that the implementation of automated processes and system enhancements have allowed EMO to avoid cost increases by reducing the manual processing and intervention previously required to resolve transactional processing issues.[349] CenterPoint argued that the test year costs are necessary because the services EMO provides are critical to ensure that CenterPoint successfully manages retail market electronic transactions for the mutual benefit of Competitive Retailers and CenterPoint.

The evidence presented by CenterPoint in support of its request to recover test-year EMO expenses of $7.1 million was uncontroverted. Considering the persuasive evidence presented by CenterPoint and the absence of any challenge to the requested recovery, the ALJs recommend that CenterPoint be allowed to recover its test-year EMO expenses of $7.1 million.

I. Energy Efficiency Expenses and Programs [Germane to Preliminary Order Issue No. 31]

No party disputes the reasonableness and necessity of CenterPoint's proposed 2011 energy efficiency program expenditures. Similarly, no party alleges the Company's current and past energy efficiency programs are imprudent or improperly managed. According to CenterPoint, the energy efficiency programs at issue in this proceeding, including those initially implemented under the settlement agreement in Docket No. 32093, are being implemented in conformance with P.U.C. SUBST. R. 25.181 and are reasonable and eligible programs subject to the reconciliation of costs as

[348] *Id.* at 26-28.

[349] *Id.* at 7-8.

stated in the Rule.[350] CenterPoint witness Alan C. Ahrens testified that in accordance with PURA § 39.905 and P.U.C. SUBST. R. 25.181, CenterPoint implements a highly successful set of energy efficiency programs that offer forward-thinking, innovative and cost-effective approaches to meeting the state's aggressive energy efficiency goals.[351] Mr. Ahrens further testified that CenterPoint's requests to recover through its proposed Energy Efficiency Cost Recovery Factor Rider (Rider EECRF): (1) $30,784,000 to fund its 2011 state-mandated energy efficiency programs and (2) $3,007,344 in performance bonus related to the Company's 2009 energy efficiency program accomplishments are reasonable and should be approved. [352] No party disputed the reasonableness and necessity of CenterPoint's proposed 2011 energy efficiency expenditures, nor did any party contend that CenterPoint's energy efficiency programs are imprudent or improperly managed. Accordingly, the ALJs recommend that CenterPoint's requested recovery be allowed.

J. Amortization Expense [Germane to Preliminary Order Issue No. 19]

Part of CenterPoint's cost of service in this proceeding relates to the amortization periods for hurricane-related costs. CenterPoint's proposed amortization periods were challenged by GCCC witness Lane Kollen.

1. Hurricane Rita

CenterPoint has proposed to amortize the deferred cost of restoration efforts after Hurricane Rita over the three years remaining of the seven-year amortization period established in Docket No. 32093, CenterPoint's prior general rate proceeding.[353] GCCC witness Kollen recommends that this three-year period be extended to five years. He argued that a proper amortization period for this deferred expense should closely match the expected interval between this rate case and CenterPoint's next rate case. He claimed that choosing an amortization period that is too short poses a risk to

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[350] CEHE Ex. 64 (Ahrens Rebuttal) at 5.

[351] CEHE Ex. 32 (Ahrens Direct) at 7.

[352] *Id.* at Ex. AA-1; CEHE Ex. 64 (Ahrens Rebuttal) at 4-5; CEHE Ex. 61 (Troxle Rebuttal) at Rebuttal Ex. MAT-6.

[353] *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).

ratepayers, while choosing a longer one poses no similar risk to CenterPoint. According to Mr. Kollen, if the Commission sets the amortization period at three years, and CenterPoint does not have a base rate case for five years, CenterPoint will continue to collect its yearly amortization amount for two years during which CenterPoint will over-recover its deferred costs by $8.2 million, consisting of the $4.1 million annual figure produced by a three-year amortization period times two years.[354] Conversely, however, if the utility were to file a rate case in year three of a five-year amortization period, it could still continue to collect the remaining annual amortization amount for the deferred expense.[355] GCCC asserts that CenterPoint has not addressed the risk of over-recovery as identified by Mr. Kollen.[356] According to GCCC, correction of the amortization period as Mr. Kollen recommends reduces CenterPoint's proposed distribution revenue requirement by $1.64 million.[357] Mr. Kollen calculated this reduction by dividing the remaining $12.3 million in remaining distribution costs by five years and the subtracting the Company's proposed annual amortization expense for this item.[358]

In response, CenterPoint's witness Mr. Fitzgerald emphasized that the Commission previously determined in Docket No. 32093 that a seven-year amortization period for these expenses was appropriate. He further testified that to arbitrarily extend the amortization period for these expenses in this proceeding is not appropriate and should be rejected. He claimed it would not be appropriate because, among other reasons, CenterPoint is not earning a return on the unamortized balance of Hurricane Rita costs. Therefore, an extension of the amortization period would only add to the unrecoverable carrying costs that shareholders have already had to absorb. He added that if the Commission decides to extend the amortization period, it should allow CenterPoint to recognize carrying costs on the unamortized balance. In summary, CenterPoint argued:

- Three years remain on the seven-year amortization period set in Docket No. 32093, and the Commission should not revisit that decision.

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354 GCCC Ex. 1 (Kollen Direct) at 65.

355 *Id.* at 65-66.

356 CEHE Ex. 66 (Fitzgerald Rebuttal) at 27.

357 GCCC Ex. 1 (Kollen Direct) at 66.

358 *Id.*

- CenterPoint does not earn carrying costs on the balance of this amount, so further extending the period unfairly penalizes CenterPoint.

- There is no evidence to support GCCC's speculation that CenterPoint may not come in for another rate case in five years, and the risk of regulatory lag is a concern that one could raise about every item in this rate case.

Accordingly, CenterPoint argued, and the ALJs agree, that the Commission should not revisit the amortization period in Docket No. 32093, and CenterPoint should amortize its remaining Hurricane Rita expenses over the remaining three years of the seven year amortization period approved in Docket No. 32093.

2. Hurricane Ike

CenterPoint proposes to amortize the $22.625 million in insurance proceeds related to Hurricane Ike over the life of the system restoration bonds that the Company was authorized to issue in Docket No. 36918.[359] Specifically, CenterPoint requests a *negative* amortization expense of $1.475 million to amortize the $17.7 million in distribution insurance proceeds. For the proceeds related to transmission, CenterPoint proposes to first net the $5.5 million in proceeds against the related regulatory asset and then amortize the remaining amount via a credit rider in its transmission cost of service (TCOS) tariff over three years.[360]

GCCC witness Kollen recommended that the distribution portion of the proceeds be amortized over five years, rather than over the life of the storm restoration bonds. However, he recommends a three-year amortization period if the Commission adopts a three-year period for the Hurricane Rita deferred cost amortization discussed above. He contended this should be done because regulatory assets and liabilities should use the same amortization period absent a compelling rationale to do otherwise.[361] Mr. Kollen testified that any notion of fairness or equity in returning

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[359] *Application of CenterPoint Energy Houston Electric, LLC for Determination of Hurricane Restoration Costs,* Docket No. 36918 (Aug 14, 2009).

[360] GCCC Ex. 1 (Kollen Direct) at 66; *citing* CEHE's Rate Filing Package, CEHE Ex. 1 at Schedule II-E-1.

[361] GCCC Ex. 1 (Kollen Direct) at 67.

those proceeds to ratepayers (as proposed by CenterPoint[362]) is undercut by the fact that CenterPoint proposes to collect the remaining Hurricane Rita expenses over three years, but wants to pass the Hurricane Ike insurance proceeds to ratepayers over more than a decade. According to GCCC, Mr. Kollen's recommendation that both items be amortized over the same period, either three or five years, is inherently more fair.

Mr. Kollen testified that using of a five-year amortization period for the Hurricane Ike insurance proceeds results in a reduction to CenterPoint's requested distribution revenue requirement of $2.065 million, or $4.425 million if a three-year period is used.[363] Mr. Kollen computed these amounts by dividing the $17.7 million in distribution insurance proceeds by five years and then three years, and then subtracting the resulting figure from CenterPoint's requested amortization of the Hurricane Ike proceeds.[364]

Additionally, Mr. Kollen noted that CenterPoint had not included the Hurricane Ike proceeds as a reduction to rate base. Therefore, he recommends that CenterPoint be directed to reduce rate base by the amount of the regulatory liability for the proceeds *if* the Company is permitted to amortize those proceeds over the life of the restoration bonds.[365]

In rebuttal, CenterPoint witness Fitzgerald testified that the Commission should reject Mr. Kollen's recommendation because CenterPoint's proposed amortization period is consistent with the time frame over which customers will be paying non-bypassable charges, including interest (which benefits customers), to cover the cost of the system restoration bonds.[366] He contended that customers have not yet paid for the system restoration bonds approved in the Hurricane Ike proceeding. Therefore, it would be premature to refund the insurance proceeds at a faster pace than the payment of the charges themselves. Mr. Fitzgerald also took issue with Mr. Kollen's assertion

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362 CEHE Ex. 66 (Fitzgerald Rebuttal) at 28.

363 GCCC Ex. 1 (Kollen Direct) at 67.

364 *Id.* at 67-68.

365 *Id.* at 67.

366 CEHE Ex. 66 (Fitzgerald Rebuttal) at 28.

that CenterPoint's rate base should be reduced by the amount of the regulatory liability associated with the insurance proceeds if the Commission approves the Company's proposal to refund the proceeds over the life of the system restoration bonds. According to Mr. Fitzgerald, Mr. Kollen's recommendation would result in a double counting of the carrying cost component.[367]

The ALJs find that Mr. Kollen's recommendations are reasonable. The ALJs agree that because CenterPoint has received the restoration bond proceeds, it is most appropriate for CenterPoint to use a five-year amortization period for the Hurricane Ike restoration cost insurance proceeds and CenterPoint's requested distribution revenue requirement should correspondingly be reduced by $2.065 million

K. Depreciation [Preliminary Order Issue No. 11]

CenterPoint seeks Commission approval to adopt the depreciation rates contained in the depreciation study performed by its depreciation expert, Mr. Dane Watson. These rates are set forth in the depreciation study prepared by Mr. Watson. The effect of applying the recommended depreciation rates to the December 31, 2009, depreciable plant balances is an annualized depreciation expense of approximately $206.9 million dollars. This represents a decrease in total Company annual depreciation expense of approximately $38 million, compared with the level of annual depreciation expense developed by application of the currently authorized depreciation rates to the same plant balances.

1. Accumulated Depreciation Reserve

As part of the depreciation analysis, it is necessary to analyze the depreciation reserve, which represents the amounts customers have contributed to the return of the investment.[368] The depreciation reserve is determined by comparing the book depreciation reserve to the theoretical depreciation reserve. A theoretical depreciation reserve measures the depreciation reserve as if

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[367] *Id.* at 28-29.

[368] CEHE Ex. 8 (Watson Direct) at 10.

certain life and net salvage parameters had been used throughout the life of the property.[369] Book depreciation reserves represent the actual amount of accumulated depreciation that has been booked to the reserve account for a category of plant and reflect the reality of numerous proceedings in which depreciation parameters were determined.[370] When new depreciation rates are established, it is common to realign the depreciation reserve with the life characteristics of the transmission, distribution, and general plants functions reflected in the new depreciation rates.[371] In recognition of this practice, CenterPoint reallocated the depreciation reserve for all accounts within each function over the remaining average life of the plant in the particular function to ensure that the relative reserve positions of each account mirrored the life characteristics of the underlying assets.[372] As a consequence, the calculated theoretical reserve is approximately $443,546,615.32 lower than the actual or booked reserve amount of $1,946,954,120.[373]

With respect to the treatment of the depreciation reserve, the central issue focuses on the time period over which the reallocation of the reserve should occur. CenterPoint contends that its methodology of reallocating the reserve over the remaining average life of the plant is consistent with the Commission's rules, the vast majority of regulatory precedent at both this Commission and throughout the country, and is supported by Staff witness Nara Srinivasa.[374] Moreover, contends CenterPoint, its methodology is consistent with the Average Life Group (ALG) remaining life depreciation system. CenterPoint witness Dane Watson testified that the remaining life depreciation system has a self-correcting mechanism where any differences between book and theoretical reserves determined at the time of each depreciation study are amortized over the remaining life of the assets in each group.[375] No party disputes this fact.

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369 CEHE Ex. 57 (Watson Rebuttal) at 6.

370 *Id.*

371 CEHE Ex. 8 (Watson Direct) at 10.

372 *Id.* at 10-11.

373 Staff Ex. 4 (Srinivasa Direct) at 7-8.

374 *Id.* at 8.

375 CEHE Ex. 57 (Watson Rebuttal) at 2.

In contrast, TCUC witness Jacob Pous, GCCC witness Lane Kollen, and TIEC witness Jeffry Pollock all offer various proposals to accelerate the amortization of CenterPoint's accumulated depreciation reserve over a time period that is significantly shorter than the average remaining life of the assets within the function.[376]

Messrs. Pous and Pollock believe it is more equitable to amortize a portion of the imbalance over four or eight years, as the ratepayers in the past have paid a higher proportion of the depreciation expense for the distribution plant than they would have if the proposed life and salvage parameters had been in effect.[377] Mr. Pollock recommends that CenterPoint be required to implement a four-year amortization of the surplus, which would result in crediting back depreciation expense to the depreciation reserve in the amount of $108.3 million dollars per year.[378] Similarly, Mr. Pous recommends that one-half of the surplus reserve for the distribution plant be amortized over a period of eight years. This results in a recommended reduction of $18,350,817 in depreciation expense based on plant as of December 31, 2009. Mr. Pous asserts that his recommendation will provide a substantial cushion to eliminate any possibility that the excess reserve could be extinguished during the next four to eight years. Mr. Pous further believes, based on the recommendation of COH/HCOC rate of return witness Mr. Solomon, that his recommendation recognizes that CenterPoint is capable of withstanding a change of approximately $18 million in its cash flow associated with this issue without affecting its credit rating.[379]

P.U.C. SUBST. R. 25.231(c)(2)(ii) provides:

> Reserve for depreciation is the accumulation of recognized allocations of original cost, representing recovery of initial investment, over the estimated useful life of the asset. Depreciation shall be computed on a **straight-line basis** or by such other

[376] TCUC Ex. 1 (Pous Direct) at 7; TIEC Ex. 1 (Pollock Direct) at 7. GCCC Ex. 1 (Kollen Direct) at 64 (Mr. Kollen merely adopts Mr. Pous' proposal regarding the treatment of the accumulated depreciation reserve absent any substantive discussion).

[377] Staff Ex. 4 (Srinivasa Direct) at 8.

[378] TIEC Ex. 1 (Pollock Direct) at 15.

[379] TCUC Ex. 1 (Pous Direct) at 40-41.