> method approved under subsection (b)(1)(B) of this section **over the expected useful life of the item or facility.**[380]

By its express terms, the Commission's rule requires the amortization of any depreciation reserve over the expected useful life of the plant assets at issue. This is confirmed by Commission precedent, which has consistently and repeatedly amortized any difference between book and theoretical reserve using straight-line recovery over the remaining useful life of the asset.[381] For example, in Docket No. 35717, the Commission adopted depreciation rates that spread a $274 million deficit between book and theoretical depreciation reserve over the remaining life of the assets.[382] This treatment of the depreciation reserve is the same that CenterPoint used in this case.

Although the intervenors contend that the Commission should reject its past precedent and order the accelerated return of the depreciation reserve to achieve intergenerational equity among customers.[383] As explained above, the remaining life depreciation system that this Commission has relied on for the last 34 years to establish utility depreciation rates ensures that any difference between the actual and theoretical reserve is consistently and ratably amortized over the remaining life of the assets. This means that an equal amount will be returned to all customers benefiting from the use of the assets over the remaining life of the assets. This equal return is fair to all future customers and stands in stark contrast to the intervenors' proposal, which would return the difference more quickly to benefit customers over the next four to eight years, while denying future customers that still use and pay for those assets in later years any equivalent benefit.[384]

The evidence further shows that adoption of the intervenors' accumulated depreciation proposals will have the corresponding effect of increasing the Company's rate base.[385] This, in turn, creates higher revenue requirements and return on investment over the accelerated four and eight

---

380 P.U.C. SUBST. R. 25.231(c)(2)(ii) (*emphasis added*).

381 CEHE Ex. 57 (Watson Rebuttal) at 3.

382 *Id.* at 7.

383 TCUC Ex. 1 (Pous Direct) at 29; TIEC Ex. 1 (Pollock Direct) at 13-14.

384 CEHE Ex. 57 (Watson Rebuttal) at 4.

385 TCUC Ex. 1 (Pous Direct) at 33; CEHE Ex. 57 (Watson Rebuttal) at 5.

year amortization periods recommended by Mr. Pollock and Mr. Pous, respectively. Consequently, current customers will be required to pay a larger "return on investment" than would otherwise be paid if the depreciation reserve were spread over the remaining life of the assets.[386]

In sum, the ALJs recommend that the Commission reject the intervenors' proposed handling of the depreciation reserve and approve the more traditional, remaining life methodology, which uses an inherent self-correcting mechanism to amortize any difference between the book and theoretical reserves over the remaining life of the assets within the function.

2. Service Lives

The determination of service lives applicable to each asset category establishes the period over which the asset's costs are recovered. CenterPoint witness Watson used the simulated plant record (SPR) life analysis for determining the life parameters for the transmission and distribution account categories, using CenterPoint's adjusted annual capital additions, to generate simulated surviving year end balances.[387] The SPR method is used for determining the life parameters for mass property accounts that do not have aged data.[388] In this method of life analysis, the life parameter under consideration is applied to the mass property account's historical additions to calculate the simulated plant balance over a selected period and the result is compared to the actual book balance.[389] The life parameter that most often yields a higher conformance index is considered to better represent the survivor characteristics of the mass property account under study.[390]

Mr. Watson used the proprietary PowerPlant model program to calculate the simulated balance for the various Iowa survivor curve shapes for each account for the period 1975 through 2009 and selected the curve that was the best fit statistically for 10-year, 20-year, and 30-year test

---

386 CEHE Ex. 57 (Watson Rebuttal) at 5.

387 CEHE Ex. 8 (Watson Direct) at 15.

388 Staff Ex. 4 (Srinivasa Direct) at 19.

389 *Id.* at 19-20. The book balance of the account is the actual balance for the vintage entered in CEHE's records. The book balance and simulated balance amounts are shown in Appendix–A of Mr. Srinivasa's testimony.

390 Staff Ex. 4 (Srinivasa Direct) at 20.

bands. Then Mr. Watson, using the indicated life parameter as a starting point, applied his judgment based on his discussions with CenterPoint's operating personnel, to finalize the level of increase or decrease from the current service life in effect. Next, he used the program to calculate the composite remaining life (CRL) of the mass property account for use in calculating the theoretical reserve and the remaining life depreciation rate. Mr. Watson reallocated the booked reserve amount, within a functional plant category, in proportion to the theoretical reserve distribution. The reallocated accumulated depreciation or reserve amount was used in calculating the remaining life straight-line depreciation rate.[391]

No party took issue with Mr. Watson's proposed service lives for T&D Plant Account Nos. 350, 352, 354 through 362, and 365 through 374. Also unchallenged are Mr. Watson's proposed service lives for all General Plant accounts. Therefore, the ALJs recommend that the Commission use these service lives in calculating depreciation rates for the Company's T&D assets.

With respect to the remaining accounts, only Mr. Srinivasa offered alternative life recommendations for certain property accounts. The positions of the parties with respect to the property accounts that remain in dispute are summarized below:

Account Description	CenterPoint	TCUC	Staff
Account 353 – Transmission Station Equipment	46 R1	Agrees w/CenterPoint	47 R1
Account 364 – Distribution Poles and Fixtures	32 R0.5	Agrees w/ CenterPoint	35 R0.5

(a) Account 353

After reviewing Mr. Watson's study for all of the account categories for which Mr. Watson conducted SPR analysis, Mr. Srinivasa was able to independently verify Mr. Watson's calculation of statistical test results.[392] He then requested that CenterPoint run the PowerPlant program using certain Staff-provided life parameters for some accounts. Its model generated the simulated balance

[391] *Id.* at 27.

[392] *Id.*

amounts using the Staff-provided life parameters and CenterPoint's adjusted additions, and balances data.[393] Mr. Srinivasa used the output of the model as provided by CenterPoint to independently calculate the Conformance Index (CI) value and plot the actual and simulated balance amounts for the period 1975 through 2009 for visual examination. As a result of his analysis, Mr. Srinivasa did not agree with Mr. Watson's proposed life parameter and the CRL for one FERC account (Account 353, Station Equipment). His analysis for that account showed a different life parameter as a better fit both statistically and visually.

This result is verified by reviewing the PowerPlant program output for Account 353, as well as Mr. Srinivasa's comparative calculation of the CI values resulting from Mr. Watson's proposed 46 year average service life with Mr. Srinivasa's proposed 47 year average service life, using the Excel program.[394] Mr. Watson's output shows that the best ranking average service life for the R1 curve (which is recommended by both Mr. Srinivasa and Mr. Watson), for each observation band is closer to Staff's proposed service life of 47 years, rather than the 46 year service life proposed by Mr. Watson.[395] The exact CIs for each observation band for the R1 curve are listed below with the difference between the service life and CenterPoint's and Staff's recommendations.[396]

SPR Analysis Provided by CenterPoint for Account No. 353				
Observation Band	**Dispersion Curve**	**Average Service Life (ASL) associated with ranking CI**	**Difference in Proposed ASL for CenterPoint and Staff**	**Closest proposal to ranking CI: Staff or CenterPoint**
2005-2009 5 year band	R1	47.8	Staff: .8 CenterPoint: 1.8	Staff
2000-2009 10 year band	R1	47.8	Staff: .8 CenterPoint: 1.8	Staff
1995-2009 15 year band	R1	48.3	Staff: 1.3 CenterPoint: 2.3	Staff
1990-2009 20 year band	R1	47.8	Staff: .8 CenterPoint: 1.8	Staff

393 *Id. See also* Tr. at 1718.

394 *See* Staff Ex. 16 (CEHE Simulated Plant Record Analysis Account No. 353); Staff Ex. No. 22, Account No. 353.

395 *Id.*

396 *Id.*

SPR Analysis Provided by CenterPoint for Account No. 353				
Observation Band	**Dispersion Curve**	**Average Service Life (ASL) associated with ranking CI**	**Difference in Proposed ASL for CenterPoint and Staff**	**Closest proposal to ranking CI: Staff or CenterPoint**
1985-2009 25 year band	R1	47.3	Staff: .3 CenterPoint: 1.3	Staff
1980-2009 30 year band	R1	46.9	Staff: .1 CenterPoint: .9	Staff
1975-2009 35 year band	R1	46.9	Staff: .1 CenterPoint: .9	Staff
1970-2009 40 year band	R1	46.4	Staff: .6 CenterPoint: .4	CenterPoint
1965-2009 45 year band	R1	46.4	Staff: .6 CenterPoint: .4	CenterPoint
1960-2009 50 year band	R1	46.4	Staff: .6 CenterPoint: .4	CenterPoint

As the above table demonstrates, Staff's proposed ASL is closer to the ASL associated with the ranking CI for seven of the ten observation bands. In the only three observation bands that CenterPoint's proposed ASL is closer to the ASL associated with the ranking CI, the CenterPoint is a mere .2 of a year closer to the ASL. Thus, based on CenterPoint's depreciation model output, Staff's proposed ASL is the higher ranking proposal, as compared to CenterPoint's 46 year ASL and should be used for the life parameter for this account.

Similarly, Staff's proposed ASL outranks CenterPoint's proposal when the CI indices are calculated using the exact whole number (as is proposed by Staff and CenterPoint) as opposed to the numbers produced by CenterPoint's depreciation program, which are provided above. Staff Exhibit No. 22 provides the specific CI values for the listed observation bands based on the simulated balances resulting from Staff's proposed life parameter, which were provided by CenterPoint.[397] These CI values are provided in table format below and show that Staff's proposed ASL results in a higher CI value in each observation band.[398]

---

[397] *Id.*

[398] *Id.*

Conformance Index Values for Account No. 353 Produced by Excel Program Using Exact Proposed Average Service Life of CEHE and Staff			
Life Parameter	CI	Observation Band	Highest Ranking Proposal
46R1 CenterPoint	36.72	35 Years	Staff
47R1 Staff	37.00	35 Years	
46R1 CenterPoint	68.77	25 Years	Staff
47R1 Staff	76.49	25 Years	
46R1 CenterPoint	88.26	20 Years	Staff
47R1 Staff	119.48	20 Years	
46R1 CenterPoint	91.44	15 Years	Staff
47R1 Staff	141.90	15 Years	
46R1 CenterPoint	103.08	10 Years	Staff
47R1 Staff	169.99	10 Years	

As with the output provided by CenterPoint's depreciation program, the outputs from the Excel program show that Staff's proposed ASL of 47 years yields a higher conformance index in the observation bands. The use of the CI is an important tool in depreciation analysis and should be relied upon, especially in instances where the proposed life parameters are extremely close.[399] In this instance the CI values in the record demonstrate the Staff's proposed life parameter of 47R1 is the best fit for Account 353 and, as a consequence, the ALJs recommend that it should be adopted.

(b) Account 364

Account 364 contains poles and towers of various material types, including wood, concrete, and steel.[400] CenterPoint witness Watson recommended a 32 ASL with a R0.5 dispersion curve for a life parameter of 32R0.5.[401] In making this recommendation, Mr. Watson stated that the R0.5 was the top-ranked choice by CI in every observation band examined, and that the Retirement Experience

[399] Staff Ex. 4 (Srinivasa Direct) at 20; *see also* Tr. at 1709.

[400] CEHE Ex. 8 (Watson Direct) Ex. DAW-1 at 34 of 133, bates 1980.

[401] *Id.*

Index (REI) was 100 in all bands.[402] An REI value of over 75 is considered to be excellent, indicating there is ample retirement data and the CI results should be reliable.[403]

While Mr. Srinivasa concurred with the use of the R0.5 dispersion curve, he disagreed with the ASL recommended by Mr. Watson.[404] For account 364, Mr. Srinivasa independently conducted an SPR analysis using the actual booked additions and balances without the adjustments made by CenterPoint to remove retirements associated with hurricane Ike.[405] The resulting analysis showed that a different life parameter with higher ASL was a better fit than the one proposed by Mr. Watson.[406] CenterPoint's adjustments to the actual booked additions, retirements, and balances values yielded a lower ASL as a better fit.[407] As stated above in subsection A of this section, Mr. Watson testified that, theoretically, the removal of the assets *should result in lengthening the ASL* for the assets, while keeping the data in should produce shorter lives.[408] However, Mr. Srinivasa's analysis indicated that the opposite was in fact true for Account 364.[409]

As part of this analysis, Mr. Srinivasa compared the calculated simulated balances to the actual balances to statistically test and select the better fitting life parameter than CenterPoint's proposed life parameter[410] The statistical test consisted of computing the CI value.[411] The life parameter that yielded the higher CI value was selected as a better fit. Mr.Srinivasa tested the CI

---

[402] *Id.*

[403] *Id.* Ex. DAW-1 at 14 of 133, bates 1960.

[404] Staff Ex. 4 (Srinivasa Direct) at 44.

[405] *Id.*

[406] *Id.* at 45.

[407] *Id.*

[408] Tr. at 160-161.

[409] Staff Ex. 4 (Srinivasa Direct) at 45.

[410] *Id.* at 44.

[411] *Id.* at 45, Table 7 (Acct. 364).

values for 10-year, 20-year, 30-Year and the 35-Year (full) bands and determined that his proposed life parameter was a better fit for all test bands.[412]

Under cross-examination, Mr. Watson was questioned regarding the possible reason the ASL for this account was shortened by the adjustments made to account for Hurricanes Ike and Rita.[413] Specifically, whether, in light of the fact that Mr. Watson did not have the actual age of the assets that were destroyed, it was possible that the adjustments made to the data were incorrect, and thus produced the atypical result of shortening the ASL for the account, rather than lengthening the ASL, as he expected.[414] Mr. Watson stated he did not know whether it was the data or analysis, or what was going on with it and that he did not know why the adjustments to the additions and balances would have an effect on it.[415] Mr. Watson conceded that he did not conduct any SPR analysis utilizing the unadjusted data to compare the resulting ASLs for the assets to the results he garnered using the adjusted data.[416]

With regard to this account, the evidence demonstrates that the adjustments made to remove plant destroyed by the hurricanes created the artificial and erroneous result of shortening the expected ASL rather than lengthening it. Mr. Srinivasa's analysis of the unadjusted data clearly showed that his proposed life parameter 35R.05 yields a higher CI value in each band tested than Mr. Watson's proposed 32R0.5. Because the adjustments to the data were made without knowing the actual age of the destroyed assets, it is impossible to know whether they were made correctly. Considering the fact that the adjustments resulted in creating a shorter service life for the assets, as opposed to a longer ASL as they should, it is reasonable to assume there was an error in the adjustments for this account. For this reason, the unadjusted data should be relied on and Mr. Srinivasa's proposed ASL of 35 should be used in the life parameter, as it produces a better CI

412 *Id.*

413 Tr. at 162.

414 *Id.*

415 *Id.* at 162-163.

416 *Id.* at 160.

using the unadjusted data. The ALJs therefore recommend that Mr. Srinivasa's recommendation for a 35R0.5 be adopted for this account.

3. Net Salvage

Net salvage is the gross salvage minus the cost of removing the item. A positive net salvage means a company gets back more money in gross salvage than it costs the company to remove the item. Positive net salvage decreases the depreciation rate. A negative net salvage means a company pays more money to remove the item than it gets back in gross salvage. Negative net salvage increases the depreciation rate. Net salvage value is expressed as a ratio or a percent of the total original plant in calculating the depreciation rate.[417]

For the mass property accounts (Transmission, Distribution, and General Plant), Mr. Watson used the historical salvage data for the period 1974-2009.[418] The use of Company-specific historical data to develop depreciation rates is an industry standard and supported by depreciation treatises.[419] This treatment has been repeatedly approved by the Commission and the Texas courts.[420] After calculating several rolling band averages to study the trend for gross salvage value and cost of removal, Mr. Watson applied his judgment based on future expectations to propose the net salvage value for each FERC account.[421]

With respect to depreciation expense, the calculation of net salvage levels is significant since these values directly affect the Company's calculated depreciation rate. The differing net salvage percentage proposals by account are shown below:

---

417 *Id.* at 162.

418 Staff Ex. 4 (Srinivasa Direct) at 29.

419 The Estimation of Depreciation, W.C. Fitch, F.K. Wolf and B.H. Bissinger, at 63.

420 *See, City of Amarillo vs. Railroad Commission of Texas*, 894 S.W.2d 491, 502 (Tex App. – Austin 1995, writ denied) (stating "...depreciation studies are company and account specific").

421 Staff Ex. 4 (Srinivasa Direct) at 29. *See also* CEHE Ex. 8 (Watson Direct) at 20, Ex. DAW-1.

Account	CenterPoint Proposed	TCUC Proposed	Staff Proposed
354–Transmission Towers and Fixtures	-15	-5	Agrees w/CenterPoint
355–Transmission Poles and Fixtures	-35	-20	Agrees w/CenterPoint
356–Transmission Overhead Conductor	-100	-50	-74
358–Transmission Underground Conduit	-2	Agrees w/ CenterPoint	0
362–Station Equipment	-5	Agrees w/ CenterPoint	0
364–Distribution Poles and Fixtures	-45	-30	Agrees w/CenterPoint
367–Distribution Underground Conductors	-20	-15	-13
368–Line Transformers	-10	Agrees w/ CenterPoint	-2
369–Distribution Services	-50	-35	Agrees w/CenterPoint
390–General Structures and Improvements	0	20	Agrees w/CenterPoint

The positions of the parties on these various proposals are discussed separately below.

(a) Account 354 – Transmission Towers and Fixtures

CenterPoint proposes a negative 15 percent net salvage rate for this account, which it contends reflects the Company's retirement experience, level of expected future net salvage values, future re-conductoring activities, and historic cost of removal.[422] TCUC contends that a negative 5 percent net salvage rate is the more appropriate, based on several problems it perceives in the Company's analysis: CenterPoint ignores economies of scale and relies too heavily on unusual retirement activities to form its opinion on the majority of retirements.[423]

TCUC argues that the Company relied on a long data band to set its net salvage values.[424] CenterPoint counters that its proposed negative 15 percent net salvage rate is supported by the average net salvage experienced in the 1, 2, 7, 8, 9, 10, 11, 12, 13, 14, and 15 year bands.[425] TCUC also argues that 2007 retirements were attributable to re-conductoring activities and thus, evidences future economies of scale.[426] CenterPoint responded that retirements in 2007 were attributable to the Company's asset verification efforts, not re-conductoring projects, and that economies of scale are

[422] CEHE Ex. 8 (Watson Direct) at Ex. DAW-1 at 76-77; CEHE Ex. 57 (Watson Rebuttal) at Rebuttal Ex. DAW-5.

[423] TCUC Ex. 1 (Pous Direct) at 12-14.

[424] *Id.* at 13.

[425] CEHE Ex. 57 (Watson Rebuttal) at 23.

[426] TCUC Ex. 1 (Pous Direct) at 13.

already reflected in the Company's historical net salvage data.[427] TCUC contends that retirement activities related to car strikes should be excluded from the net salvage analysis.[428] CenterPoint responded that car strikes are a force of retirement, are expected to occur in the future, and are necessarily considered in developing a net salvage rate for this account.[429] Finally, TCUC contends that removal costs related to tornado damage should not be considered a recurring year-to-year event and should be reduced when calculating net salvage rates.[430] CenterPoint contends that the evidence establishes that tornadoes and other high wind events are a recurring event throughout CenterPoint's service territory, including as recently as August 23, 2010.[431]

Overall, the ALJs find that CenterPoint's analysis – which is based on a multitude of bands – is more persuasive. Therefore, the ALJs recommend that the Commission adopt a negative 15 percent net salvage rate for Account 354.

(b) Account 355–Transmission Poles and Fixtures

CenterPoint witness Watson proposes a negative 35 percent net salvage rate for this account, which it contends is supported by nearly every year's average net salvage analysis over the last 15 years (including bands of 1, 2, 5, 6, 7, 8, 9, 10, 11, 12, 13, 14, and 15 years).[432] TCUC witness Pous argues in favor of a negative 20 percent net salvage rate, contending that rate "recognizes that the cost of removal can vary year to year depending on the number and size of transmission poles removed" and that economies of scale when more retirements happen in a certain year can cause the historical results to vary significantly.[433]

[427] CEHE Ex. 57 (Watson Rebuttal) at 24.

[428] TCUC Ex. 1 (Pous Direct) at 13.

[429] CEHE Ex. 57 (Watson Rebuttal) at 25-26.

[430] TCUC Ex. 1 (Pous Direct) at 14.

[431] Tr. at 1695-1696; CEHE Ex. 57 (Watson Rebuttal) at 26-27 and Rebuttal Ex. DAW-7.

[432] CEHE Ex. 8 (Watson Direct) at Ex. DAW-1 at 77; CEHE Ex. 57 (Watson Rebuttal) at 28.

[433] TCUC Ex. 1 (Pous Direct) at 15.

TCUC argues that the data 2007 are particularly relevant. In the year of greatest retirement for the account the net salvage was only negative 3 percent, or approximately 19 percent lower than the Company's proposal in this case.[434] In addition to large quantities of assets being retired, a larger percentage of the retirements were associated with taller poles.[435] In other years, a much larger percentage of retirements were associated with shorter poles and underscores that "the Company's simplistic mathematical approach to take the average of the entire database overstates the level of negative net salvage that is reasonable."[436] TCUC argues that its recommendation is "more indicative of the current activity, yet does not place as great a weight on the most current years, especially 2009, a year in which the majority of poles retired on a dollar basis were 65 feet or less."[437]

CenterPoint argues that TCUC's attempt to rely on a 2007 retirement to support its "economies of scale" is misplaced since the retirement was shown to have no direct correlation to the cost of removal for that year. Rather, the 2007 retirement entry relied on by TCUC captures multiple retirements related to the Company's asset verification effort.[438] In other words, according to CenterPoint, $20.4 million of the $20.7 million retirement in 2007 was related to assets retiring over many years, not just 2007. Finally, argues CenterPoint, TCUC's attempt to cast the Company's 2009 retirement experience as an anomaly is misplaced.[439] According to Mr. Watson, the net salvage activity in years 2008 and 2009 reflects expected future net salvage experience and the retirement activities performed in these years are expected to recur in the future.[440]

A negative 35 percent net salvage rate is supported by nearly every year's average net salvage rate analysis over the last 15 years. The ALJs are persuaded that CenterPoint's analysis is the correct

---

434 *Id.* at 15.

435 *Id.* at 16.

436 *Id.*

437 *Id.*

438 CEHE Ex. 57 (Watson Rebuttal) at Rebuttal Ex. DAW-20.

439 TCUC Ex. 1 (Pous Direct) at 16.

440 *See* CEHE Ex. 57 (Watson Rebuttal) at Rebuttal Ex. DAW-8.

one to apply in this case. Therefore, the ALJs recommend that the Commission adopt a negative 35 percent net salvage rate for Account 355.

(c) Account 356–Transmission Overhead Conductor

CenterPoint witness Watson proposed a negative net salvage value of 100 percent for this account. Mr. Srinivasa's analysis of the historical salvage data showed that the overall average and the median of all the historical salvage data recorded by CenterPoint were negative 88 percent and negative 50 percent. The average and the median values of the five-year overlapping bands for the period 1974 – 2009 are negative 57 percent and negative 67 percent, and for ten-year overlapping bands, negative 64 percent and negative 74 percent.[441]

It appears that the gross salvage value recorded during the recent years for aluminum and copper conductors were almost negligible in comparison to the value realized from years 1974 through 2000 (the median gross salvage for those years was 29.8 percent and the highest value was almost at 373 percent in 1983). There is not sufficient evidence to support Mr. Watson's judgment that the gross salvage value will be lower than in the past on a going forward basis.[442] In fact, Mr. Watson agreed that in relation to net salvage, "it's extremely hard to predict whether the market will go up or down and it requires expertise outside of what the depreciation experts may have in this case."[443] Mr. Watson added, "that's why looking at long – at periods of bands makes sense."[444]

Mr. Watson's estimate of 100 percent negative net salvage value for Account 356, Overhead Conductors, was based on his analysis of historical salvage data and his belief that the cost of removal will be labor and equipment cost-intensive in the future. He stated that the activities involved in removing the towers, poles, and conductors are: disconnecting the conductor from the insulator individually on each pole or tower using cranes, placing the conductor on the pulleys,

[441] Staff Ex. 4 (Srinivasa Direct) at 38; *see also* Attachment NSV-4, which shows the comparison of the net salvage ratio averages in comparison to the net salvage ratio medians upon which Mr. Srinivasa relied.

[442] *Id.*

[443] Tr. at 141.

[444] *Id.* at 142.

removing the insulators, cutting the cable and pulling the cable back on to reel.[445] Mr. Srinivasa countered that he believed that these activities are also required for replacing the existing conductor with new conductor as part of reconductoring activity.[446] Therefore, concluded Mr. Srinivasa, it is likely that CenterPoint decided to allocate a disproportionate portion of reconductoring costs to the cost of removal of the old conductor rather than the original (installation) cost of the new conductor, which skews the historical net salvage values.[447]

Mr. Srinivasa also stated that he found that CenterPoint failed to properly capture or recognize the impact of economies of scale, which results in comparatively less negative net salvage values. CenterPoint's historical data regarding the gross salvage value for retired plant, that contains metals such as copper, aluminum, or steel, appears to be much greater during the earlier vintages than the last four to five years. Mr. Watson's proposal, which is based on the last four or five years of gross salvage, assumed that it will be likely to remain the same in the future. Given the volatility of the gross salvage history, gross salvage may very well go up or down in the future; therefore, according to Mr. Srinivasa, Mr. Watson's proposal cannot be relied on. Instead, a conservative approach of setting the future net salvage value based on the observed medians is preferred.[448]

Mr. Srinivasa also asserted that Mr. Watson failed to properly adjust for the overtime pay incurred due to plant removal activity during emergencies, such as a car hitting a pole or tornado damage, resulting in an overestimate of negative net salvage value compared to what would be expected when the majority of the plant removal activity is planned and may not include overtime pay.[449]

Because of his concerns stated above, Mr. Srinivasa recommended using median values for the three-year, five-year and ten-year overlapping averages for all years, which addresses the

---

445 Staff Ex. 4 (Srinivasa Direct) at 30; *see also* CEHE Ex. 8 (Watson Direct) Ex. DAW-1 page 55.

446 *Id.* at 30, *citing* Watson Work papers, Interview Notes page 2.

447 *Id.*

448 *Id.* at 30-31.

449 *Id.*

concerns of extreme values in the historical data.[450] For example, the salvage history for Account 356 shows an extreme value of negative 1,727 percent for 2006. The median value of the overlapping averages would avoid skewing of the value by the outliers, while an arithmetical average, as Mr. Watson used, would include them.[451]

Principles and Procedures of Statistics, by Steel and Torrie, states that, "Certain types of data show a tendency to have a pronounced tail to the right or the left. Such distributions are said to be skewed, and the arithmetic mean may not be the most informative central value."[452] Where the average of the incomes of a group of individuals is required, and most of those incomes are low, the mean income could be considerably larger than the median.[453] Staff posed the following example, which the ALJs find both informative and persuasive: Suppose a sample of 50 incomes from professional baseball players was taken that happened to include the salary of Albert Puhols or Mark McGuire of the St. Louis Cardinals ball club. As a result, the mean of the salaries would likely be far greater than the median salary, because the use of the median would be skewed by the very high salaries of Puhols and McGuire. The median would likely provide a more accurate measure of the central tendency of the salaries. Such circumstances are found where using the median to find the central tendency prevents outliers in data that "skews" or shows extreme variations rather than showing more symmetrical variations.

With this information, Mr. Srinivasa believed that Mr. Watson's proposed value of negative 100 percent, which is an increase of 94 percent from the currently approved value, is excessive. He therefore recommended using a negative 74 percent for the net salvage value, which is the median of the ten-year overlapping bands for the period 1974-2009. This recommendation removes outliers from the analysis which may skew the results, looks at the entirety of the data provided for net salvage analysis, and utilizes bands, as endorsed by Mr. Watson in his testimony. Mr. Srinivasa's

---

450 The use of overlapping averages addresses the issue of unsynchronized data, which results when plant is retired and removed from service at a certain time, but the cost of removal or the removal of the plant from the rate base is not booked until a later time. *Id.*

451 *Id.*; *see also* CEHE Ex. 8 (Watson Direct) Ex. DAW-1 at 55.

452 Tr. at 1740; *see also* Staff Ex. 20 at 4.

453 *See* Staff Ex. 20 at 4.

recommendation is more conservative than the observed median for the overall, three-year, and five-year overlapping averages and not as excessive as Mr. Watson's estimate. The ALJs, therefore, recommend that the Commission adopt Staff's recommendation for this account.

(d) Account 358–Transmission Underground Conduit

CenterPoint proposed negative 2 percent net salvage value for Account 358. Staff recommended maintaining the current 0 percent net salvage value, contending that the historical salvage data does not show significant activity to change the current net salvage value.[454] CenterPoint claims that there is no dispute that it has experienced removal cost associated with retirements in this account.[455] It also contends that there is no dispute that as part of its retirement activities, the Company incurs costs associated with the removal of terminations from the structure and the removal of cable from the structure to the manhole.[456]

The ALJs are persuaded by CenterPoint's arguments in this instance. Therefore, the ALJs recommend that the Commission adopt a negative 2 percent net salvage value for Account 358.

(e) Account 362–Station Equipment

Mr. Watson proposed a negative net salvage value of negative 5 percent for this account.[457] CenterPoint argues that the net salvage experienced in Account 362 is growing increasingly negative over time.[458] Thus, argues CenterPoint, it is inappropriate to rely on the overall band since it disguises the undisputed change in removal cost experienced by the Company in recent years.

Mr. Srinivasa's analysis of CenterPoint's historical salvage data for the period 1974-2009 shows that 0 percent is the appropriate value.[459] The median values of distribution of the

---

[454] Staff Ex. 4 (Srinivasa Direct) at 40, Attachment NVS-4.

[455] CEHE Ex. 8 (Watson Direct) at Ex. DAW-1; CEHE Ex. 57 (Watson Rebuttal) at Rebuttal Ex. DAW-12.

[456] CEHE Ex. 8 (Watson Direct) at Ex. DAW-1 at 56.

[457] Staff Ex. 4 (Srinivasa Direct) at 43.

[458] CEHE Ex. 57 (Watson Rebuttal) at Rebuttal Ex. DAW-13.

[459] Staff Ex. 4 (Srinivasa Direct) at 43.

overlapping three-year, five-year, and ten-year averages show 0 percent and 1 percent for net salvage value.[460] The overall average is around negative 2 percent.[461] Mr. Srinivasa therefore recommended using 0 percent net salvage value for the station equipment account, because it represents the trend of the median value of overlapping averages.[462] As with Account No. 356, this recommendation prevents outliers from the analysis from skewing the results,[463] looks at the entirety of the data provided for nets salvage analysis, and uses bands, making it a more reasonable and conservative estimate of future net salvage ratios for this account. CenterPoint argues that, whether computed by averages or the median (as Mr. Srinivasa has done) over the last 25 years or less, the historic net salvage experience of the Company clearly establishes that removal cost is in excess of the negative 5 percent the Company is proposing in this case.

The ALJs are persuaded that Mr. Srinivasa's analysis is the more correct of the two presented for consideration. Therefore, the ALJs recommend that the Commission adopt Staff's proposed 0 percent net salvage life for Account 362.

(f) Account 364–Distribution Poles and Fixtures

CenterPoint proposed a net salvage value of negative 45 percent for this account. TCUC proposes a negative 30 percent net salvage value. Although CenterPoint claims that eight of the last ten years have been around negative 46 percent net salvage, TCUC believes this claim fails to recognize that: 2007 contained 58 percent of all retirements during the last five years; 2007 contained 36 percent of retirements for the past ten years; and the year with the most retirements had a negative 11 percent net salvage value. This, according to TCUC, is "a better indication of economies of scale in the future, when larger quantities of retirements will occur in a given year."[464] TCUC contends that this account also suffers from the same issue of allocation between replacement and removal since poles are normally replaced when they are retired and the Company has not provided a valid

---

460 *Id.*

461 *Id.* at 44.

462 *Id.*

463 *See* Staff Ex. 21 at 2 for a graphic representation of outliers for this account.

464 TCUC Ex. 1 (Pous Direct) at 23.

basis for this allocation. And finally, according to TCUC, historical data bands of 4, 5, and 6-years all support a negative 30 percent net salvage.

CenterPoint counters that the evidence established that $21.3 million of the retirements associated with this amount were retired as a result of the Company's asset verification process, and retirements related to the asset verification process have no direct correlation between the actual retirements in a given year and the associated costs of removal. Therefore, according to CenterPoint, any reliance on this retirement to claim future economies of scale is misplaced. Additionally, CenterPoint contends that if the asset verification retirement is removed from the net salvage analysis, the net salvage for 2007 is negative 82 percent, which is clearly higher than the negative 45 percent net salvage rate it has proposed. CenterPoint disputes TCUC's contention that Company personnel arbitrarily allocated costs between retirement of the asset and the construction of the new asset. Rather, CenterPoint presented evidence of uniform, extensive training received by Company personnel responsible for assigning these costs.[465] Finally, CenterPoint argues that TCUC's reliance on bands of 4, 5, and 6 years is skewed by inclusion of the asset verification retirement in 2007.[466] To address the impact of the 2007 retirement, CenterPoint witness Watson stated that he relied on wider bands of seven years and longer, which support the Company proposed negative 45 percent net salvage rate for this account.[467]

The ALJs are persuaded that CenterPoint's analysis is the more correct of the two presented for consideration. Therefore, the ALJs recommend that the Commission adopt CenterPoint's proposed negative 45 percent net salvage life for Account 364.

(g) Account 367–Distribution Underground Conductors

CenterPoint proposed a net salvage value of negative 20 percent for this account. Mr. Srinivasa's analysis of CenterPoint's historical salvage data for the period 1974-2009 showed that the median value of the three-year, five-year, and ten-year overlapping averages is

---

465 CEHE Ex. 57 (Watson Rebuttal) at 38.

466 TCUC Ex. 1 (Pous Direct) at 23.

negative 13 percent.[468] TCUC witness Pous recommends a net salvage value of negative 15 percent, based on the fact that approximately 90 percent of the investment is associated with underground cable and industry practice is to abandon in place direct buried cable when it is retired. According to Mr. Pous, this results in some level of negative net salvage, but it should be less than when cable is physically removed and "the only reason to remove cable in conduit is either because the salvage value is greater than the cost of removal or the conduit provides a less costly alternative for the installation of new replacement cable."[469] In addition, Mr. Pous argues that the Company also fails to take into account economies of scale or the proper blend of investments.

The ALJs are persuaded that Mr. Srinivasa's analysis, which relies on the median value of an appropriate number of years, is the most appropriate for use in this case. Therefore, the ALJs recommend that the Commission adopt negative 13 percent for the net salvage value for this account.

(h) Account 368–Line Transformers

CenterPoint proposed a net salvage value of negative 10 percent for this account. Mr. Srinivasa's analysis of CenterPoint's historical salvage data for the period 1974-2009 showed that the median value of the three-year, five-year, and ten-year overlapping averages is negative 2 percent.[470] CenterPoint criticized Mr. Srinivasa's analysis as inappropriate because it relies on an overall band and the use of a median. CenterPoint states that it has demonstrated that the Company is, over time, experiencing increasingly negative levels whether examining the average or the median.[471]

The ALJs are persuaded that Mr. Srinivasa's analysis, which relies on the median value of an appropriate number of years, is the most appropriate for use in this case. Therefore, the ALJs recommend that the Commission adopt negative 2 percent for the net salvage value for this account.

---

467 CEHE Ex. 8 (Watson Direct) at DAW-1, p. 82.

468 Staff Ex. 4 (Srinivasa Direct) at 48.

469 TCUC Ex. 1 (Pous Direct) at 24-25.

470 Staff Ex. 4 (Srinivasa Direct) at 48-49.

471 CEHE Ex. 57 (Watson Rebuttal) at Rebuttal Ex. DAW-15.

(i) Account 369–Distribution Services

CenterPoint proposed a net salvage value of negative 20 percent for this account. TCUC proposes a net salvage value of negative 35 percent, contending that CenterPoint has significantly understated the level of copper services being retired compared to the level of investment and asserting that CenterPoint provided an arbitrary and unsupported allocation between the cost of removal and the replacement of an investment.[472] CenterPoint responds that TCUC's argument ignores the fact that the impact of historic copper prices on salvage has been captured in the Company's net salvage data and that TCUC's contention ignores the investment mix in this account, which shows that 73 percent of the investment in this account is non-copper material, which will not exhibit the high scrap values for copper.[473]

The ALJs are persuaded that CenterPoint's analysis is the most appropriate for use in this case in that it recognizes the impact of historic copper prices and properly acknowledges the investment mix in the account. Therefore, the ALJs recommend that the Commission adopt negative 20 percent for the net salvage value for this account.

(j) Account 390–General Structures and Improvements

CenterPoint proposed a net salvage value of 0 percent for this account.[474] TCUC proposes a net salvage value of positive 20 percent, contending that "well over 40% of the Company's investment in this account represents buildings or structures owned by the Company" and it is "unreasonable and unrealistic to assume that service centers, warehouses, meter labs, and other structures made out of steel-reinforced concrete, many in excess of 50,000 square feet, would be worth zero (0) after the 41-years Company assumed service life for this account."[475] CenterPoint counters that it consistently removed sales of plant from both the historic life and net salvage data. CenterPoint states that authoritative depreciation treatises provide that uniform data should be used

---

472 TCUC Ex. 1 (Pous Direct) at 26-27.

473 CEHE Ex. 57 (Watson Rebuttal) at 43.

474 CEHE Ex. 8 (Watson Direct) at 22.

475 TCUC Ex. 1 (Pous Direct) at 28.

to perform life and net salvage analysis.[476] CenterPoint contends that it used uniform data to perform its life and net salvage analyses and TCUC did not.[477]

The ALJs are persuaded that CenterPoint's analysis is the most appropriate for use in this case in that it uses uniform data to perform the analyses. Therefore, the ALJs recommend that the Commission adopt 0 percent for the net salvage value for this account.

4. Gain on Sale of Land

CenterPoint sold 23 properties since its last litigated rate case and recorded the gain on sale associated with the sales exclusively for the benefit of shareholders. TCUC recommends returning 100 percent of that gain, for all but three properties, to customers.[478]

TCUC contends that in evaluating who is entitled to the gain on this sale, the *Public Utility Comm'n of Texas v. Gulf State Utilities Co.* case is directly on point.[479] In that case the Texas Supreme Court needed to resolve whether the Commission properly allocated the gains from the sale of the plants between Gulf State Utilities' (GSU) ratepayers and its shareholders. The court reversed the Commission because it failed to take into consideration both of the equitable principles commonly used to resolve allocation problem, that the "benefits should follow the burdens" and that "gain should follow risk of loss."[480] As the court went on to state:

> The gain should be allocated to that group (as between shareholders and ratepayers) that has borne the financial burdens (e.g., depreciation, maintenance, taxes) and risks of the asset sold. In addition to these two general equitable factors, courts have also considered numerous other factors, including whether the asset sold had been included in the rate base over the years, whether the asset was depreciable property, nondepreciable property, or a combination of the two types, the impact of the

---

476 *Id.* at 34.

477 CEHE Ex. 57 (Watson Rebuttal) at 44.

478 TCUC Ex. 1 (Pous Direct) at 42.

479 809 S.W.2d 201, 211 (Tex. 1990).

480 *Id.* at 211, *citing Democratic Cent. Comm'n. v. Washington Metro. Transit Comm'n*, 485 F.2d 786 (D.C. Cir. 1973) and *Washington Pub. Interest Org. v. Public Serv. Comm'n*, 393 A.2d 71 (D.C. 1978).

> proposed allocation on the financial strength of the utility, the reason for the asset's appreciation (e.g. inflation, a germinal increase in property value in the area), any advantages enjoyed by the shareholders because of the favored treatment accorded the asset, the dividends paid out to the shareholders over the years, and any extraordinary burdens borne by the ratepayers in connection with that asset.[481]

The court also made it clear that "the proper allocation of such proceeds is a complicated one that cannot be resolved simply by reference to who paid for the property."[482] TCUC stated that a review of the various factors that might impact the allocation of gain between customers and shareholders argues strongly that the gain should be allocated to customers. First, argues TCUC, land is not a depreciable asset and it is presumed it will gain value over time. TCUC contends that its review of the appreciation of the land revealed no special action taken by the Company that created the appreciation of the land. It is likely that system growth and inflation caused the land to gain in value and this is not due to actions taken by shareholders. TCUC further contends that customers had to pay the cost for property taxes, operations and maintenance expense, or any other type of expense would have been borne by customers as a component of the overall revenue requirements for the Company, which contributed to the overall return obtained by the Company and are factors in the timing of rate proceedings. As a consequence, argues TCUC, the customer has always been at risk for the gain or loss associated with the property and shareholders have not shouldered any financial harm associated with the property. TCUC contends that if the ownership of the land were causing any financial hardship, CenterPoint would have initiated a rate case to increase rates and that the record in this case is devoid of any evidence that identifies the prior actions of purchasing land was the reason for a rate filing. In addition, TCUC notes that the Company has continued to pay dividends over this period.[483]

CenterPoint responded to TCUC's arguments by asserting that CenterPoint does not recover depreciation expense on land, and consequently does not recover from ratepayers the money spent to acquire the land. Therefore, the investment in the property is shouldered solely by investors. Further, CenterPoint argued that only two of the land sales that form the basis of TCUC's proposed

---

[481] 809 S.W.2d at 211.

[482] *Id.*

[483] TCUC Ex. 1 (Pous Direct) at 46.

adjustment occurred within the test year, and TCUC has failed to identify any statutory or regulatory authority that allows it to include transactions that occurred outside the test year, and in fact, prior to the Company's last rate case in its proposed adjustment.[484] Finally, CenterPoint contended that the fact that customers may have paid for the cost of property taxes and O&M expense, standing alone, is not sufficient reason to allocate the entire gain on sale of land to customers. These costs support the use of the land for the facilities that provide service; however, they do not maintain or enhance the property for capital appreciation purposes.

The ALJs find that CenterPoint's arguments are the more persuasive of those offered. The fact that CenterPoint did not recover depreciation on the assets that were sold is undisputed. The fact that customers may have borne some level of O&M expenses associated with the properties is, of course, relevant, but nothing indicates that the level borne by customers was significant. Accordingly, the ALJs recommend that the Commission adopt CenterPoint's proposed treatment of the gains from sales of these properties.

L. Federal Income Taxes [Germane to Preliminary Order Issue No. 23]

1. CTSA [Germane to Preliminary Order Issue No. 22]

(a) Applicabilty of PURA § 36.060

PURA § 36.060 provides in relevant part:

> (a) Unless it is shown to the satisfaction of the regulatory authority that it was reasonable to choose not to consolidate returns, an electric utility's income taxes shall be computed as though a consolidated return had been filed and the utility had realized its fair share of the savings resulting from that return, if:
>
> (1) the utility is a member of an affiliated group eligible to file a consolidated income tax return; and
>
> (2) it is advantageous to the utility to do so.

[484] CEHE Ex. 66 (Fitzgerald Rebuttal) at 24-25.

(b) The amount of income tax that a consolidated group of which an electric utility is a member saves, because the consolidated return eliminates the intercompany profit on purchases by the utility from an affiliate, shall be applied to reduce the cost of the property or service purchased from the affiliate.[485]

CenterPoint argued that by referring expressly to utilities that "choose not to consolidate returns" and mandating that taxes be computed "as though a consolidated return had been filed," PURA § 36.060(a) applies only to utilities that were not included in a consolidated tax return but could have been included. CenterPoint further claimed that if Section 36.060(a) is interpreted as being applicable when a utility was included in a consolidated return renders meaningless the phrases "choose not to consolidate returns" and "as though a consolidated return had been filed" which is a result that Texas courts have rejected.[486]

According to CenterPoint the structure of PURA § 36.060 confirms the inapplicability of Subsection (a) to utilities that file as part of a consolidated return. CenterPoint claimed this is so because the treatment of utilities that *were not* included in consolidated tax returns is addressed in Subsection (a) and the treatment of utilities that *were* included in consolidated tax returns is addressed in Subsection (b). Therefore, CenterPoint concluded that the only possible reading of the statute is that Subsection (a) applies only to utilities that could have been included in a consolidated return but were not.

The ALJs find that CenterPoint's interpretation of PURA § 36.060 leads to an illogical result and is unpersuasive. GCCC clearly pointed out, and the ALJs agree, that it is illogical to conclude that the Legislature intended for the Commission to compute the savings that would have resulted if a utility that did not file a consolidated return actually had done so, but require the Commission to ignore the actual savings that resulted from a utility and its affiliates actually filing a consolidated tax return.[487] CenterPoint did not endeavor to justify its interpretation of the statute as being sensible or

---

485 PURA § 36.060(a)-(b) (emphasis added).

486 *See In re Vorwerk*, 6 S.W.3d 781, 784 (Tex. App.—Austin 1999, orig. proceeding) ("An interpretation which ignores a phrase is not favored."); *Carson v. Hudson*, 398 S.W.2d 321, 323 (Tex. Civ. App.—Austin 1966, no writ) (rejecting an interpretation that would render statutory language "a useless appendage").

487 GCCC Reply Brief at 32.

in furtherance of a meritorious policy objective, and the ALJs find that it would not be possible to do so.

(b) Centerpoint's Fair Share of CTSA

It is noteworthy that CenterPoint acknowledged that "despite the seeming inapplicability of PURA § 36.060(a) to CenterPoint, the Commission has applied a CTSA to utilities that file as part of a consolidated return" then assumed that the Commission has the authority to impose a CTSA in this case,[488] and shifted the focus of its arguments contending that CenterPoint's share of the CTSA should be zero because CenterPoint: (1) is ring-fenced, and (2) not needed to produce consolidated tax savings under the "but for" test.[489] CenterPoint further claimed its share of the CTSA should be zero because the principle of "benefits follow burden" requires such.

For more than a decade, the Commission has consistently applied a CTSA to utilities in Texas, including CenterPoint's predecessor Reliant.[490] However, the only instance when the Commission has not applied a CTSA since the seminal Docket. No. 14965 in 1997,[491] was Oncor's recent rate case, Docket No. 35717.[492] In deciding to except Oncor from the application of a CTSA, the Commission's Order on Rehearing relies upon two findings:

---

488 *See* Tr. at 390, 491.

489 CEHE Initial Brief at 138

490 *See, e.g., Application of Central Power and Light Company for Authority to Change Rates*, Docket No. 14965, Order on Rehearing at 7, 45-46 (Findings of Fact Nos. 107-112D), 91-92 (Conclusions of Law Nos. 37-39) (Aug. 27, 1997); *Application of Entergy Gulf States, Inc. for Approval of its Transition to Competition Plan and the Tariffs Implementing the Plan, and for the Authority to Reconcile Fuel Costs, to Set Revised Fuel Factors, and to Recover a Surcharge for Underrecovered Fuel Costs*, Docket No. 16705, Second Order on Rehearing at 93-94 (Findings of Fact Nos. 196, 197), 144-145 (Conclusions of Law Nos. 31, 38), 152-53 (Ordering Paragraph 35) (Oct. 14, 1998); *Application of Reliant Energy for Approval of Unbundled Cost of Service Rate Pursuant to PURA § 39.201 and Public Utility Commission Substantive Rule § 25.344*, Docket No. 22355, Order at 57-58, 123-124 (Findings of Fact Nos. 64, 64A, 64B, 65A, 65B) (Oct. 4, 2001); *Application of AEP Texas Central Company for Authority to Change Rates*, Docket No. 33309, Order on Rehearing at 16 (Findings of Fact Nos. 119-120), 24 (Conclusion of Law Nos. 29) (Mar. 4, 2008).

491 *Application of Central Power and Light Company for Authority to Change Rates,* Docket No. 14965, Second Order on Rehearing (Oct. 16, 1997).

492 *Application of Oncor Electric Delivery Company for Authority to Change Rates,* Docket No. 35717, Order on Rehearing (Nov. 30. 2009).

> 128A. Oncor is not currently a member of an affiliated group eligible to file a consolidated federal income tax return.
>
> 128B. Oncor is a ring-fenced utility that has entered into a tax sharing agreement with EFH and its affiliates that requires Oncor to function as a stand-alone company.[493]

It is apparent to the ALJs that the Oncor case was the impetus for CenterPoint to advance the arguments that it makes in this proceeding. However, as the intervenors argue and the ALJs agree, neither of these two findings apply to CenterPoint. First, CenterPoint ***is*** a member of an affiliated group eligible to file a consolidated federal income tax return.[494] Not only is CenterPoint eligible to do so, it actually does - CenterPoint witness Mr. Reed confirmed that CNP Energy, Inc., files consolidated tax returns for its subsidiaries, including CenterPoint.[495] The result is that, as Mr. Felsenthal testified, CenterPoint paid no tax to the IRS during the test year.[496] This alone is sufficient to render the Commission's decision in the Oncor case inapplicable to CenterPoint. However, upon further analysis the preponderance of the evidence shows and the ALJs find, as discussed below, that CenterPoint fails to satisfy the second criteria relied on by the Commission in the Oncor case, in that CenterPoint is not ring fenced.

(c) Ring Fencing

As CenterPoint's witness Mr. Reed explained, there is no formal definition of "ring fencing," but the Commission introduced the concept of "ring fencing" in its recent order relating to Oncor.[497] Mr. Reed explained that ring fencing essentially means drawing a circle around the utility and keeping its activities separate from the other members of the consolidated group.[498]

---

493 *Id.* at 25

494 GCCC Ex. 1 (Kollen Direct) at 83; Tr. at 426; Tr. at 352.

495 Tr. at 364.

496 *Id.* at 427.

497 CEHE Ex. 68 (Reed Rebuttal) at 10-11.

498 Tr. at 1333-35.

Mr. Reed further explained that there are many factors which demonstrate that CenterPoint is ring-fenced. Among these considerations, CenterPoint:

- maintains separate books and records;
- is a separate registrant with the Securities and Exchange Commission (SEC);
- files quarterly and annual financial statements with the SEC;
- has a separate financing program which includes mortgage bonds issued by it and a revolving credit facility on which it is the sole obligor;
- has debt rated by the three major rating agencies; and
- is restricted by its debt-to-total-capital covenant in its revolving credit facility in paying dividends.[499]

Mr. Reed also claimed that CenterPoint is in full compliance with all Commission rules regarding ring fencing[500] "and for ratemaking purposes is effectively ring-fenced."[501] Mr. Reed concluded that because CenterPoint is a ring-fenced utility bearing no portion of the losses of its affiliates, CenterPoint's fair share of consolidated tax savings should be zero. According to CenterPoint, the Commission's recent Oncor decision embraces this conclusion and demonstrates that the Commission intends to respect ring-fenced utilities for tax purposes. CenterPoint argued that in Docket No. 35717, the Commission found that Oncor "is a ring-fenced utility that has entered into a tax sharing agreement with its affiliates that requires Oncor to function as a stand-alone

[499] CEHE Ex. 68 (Reed Rebuttal) at Rebuttal Ex. JJR-06, CEHE Response to GCCC RFI 01-07.

[500] P.U.C. SUBST. R. 25.272(d)(1) mandates that the utility "shall be a separate, independent entity from any competitive affiliate." As such, the utility cannot, except in narrowly circumscribed cases, share employees, facilities, or other resources with affiliates. The utility must keep separate books of accounts and records, prepare its own financial statements, and carefully track any transactions with its affiliates. It must not allow any affiliate to obtain any credit under an arrangement that would include a specific pledge of any assets included in rate base or any cash reasonably necessary for utility operations. Any transactions with affiliates reflected in rates must be at arm's length. And any shared services must be valued on a fully-allocated cost basis. In all these ways, the Commission has "establish[ed] safeguards to govern the interaction between utilities and their affiliates, both during the transition to and after the introduction of competition, to avoid potential market-power abuses and cross-subsidization between regulated and unregulated activities." P.U.C. SUBST. R. 25.272(a), (d)(1), (d)(2), (d)(6), (d)(7), (e)(1), (e)(2).

[501] CEHE Ex. 25 (Reed Direct) at 36.

company."[502] The Commission then concluded that "[a]s a ring-fenced utility, Oncor's fair share of the tax savings is $0."[503] Therefore, CenterPoint asserted that since CenterPoint is a ring-fenced utility for the reasons discussed above, its fair share of any tax savings is likewise $0.

GCCC distinguishes the Oncor decision by noting that in a proceeding to consider the acquisition of Oncor by Energy Future Holdings, Inc., Oncor agreed to a settlement in which a number of explicit ring-fencing conditions were required of it.[504] GCCC claims in contrast that CenterPoint can point to no such previous Commission decision, and GCCC contended that the record reflects an affiliate structure within which CenterPoint is completely enmeshed with its corporate parent and affiliates. For example GCCC pointed out that: (1) CNP files a consolidated tax return for its affiliates; CenterPoint does not actually file its taxes on a "stand alone" basis;[505] (2) CNP determines the amount of its equity investment in CenterPoint, not CenterPoint - the utility has no say in the matter;[506] (3) CenterPoint has invested $289 million in the CNP money pool that other CNP affiliates may borrow from;[507] and (4) CNP's service affiliate - Service Company – provides a variety of services for CenterPoint, including executive leadership resulting in a leadership team for CenterPoint that is interwoven with other affiliates. According to GCCC, these are not indicators of a utility operated on a "stand alone" basis.

TIEC added that as Mr. Reed testified in the Oncor case, "ring-fenced" means that the company is isolated from the bankruptcy risks of its affiliates.[508] TIEC then pointed out that isolation from affiliate bankruptcy risk is also the way credit rating agencies use the term and Oncor was referred to by numerous credit rating agencies as "ring-fenced." However, in contrast, CenterPoint

---

502 *Application of Oncor Electric Delivery Company LLC for Authority to Change Rates,* Docket No. 35717, Order on Reh'g at 25, Finding of Fact No. 128B (Nov. 30, 2009).

503 *Id.* at 36, Conclusion of Law No. 19B.

504 *Joint Report and Application of Oncor Electric Delivery Company and Texas Energy Future Holdings Limited Partnership Pursuant to PURA § 14.101,* Docket No. 34077, Order on Rehearing (Apr. 24, 2008).

505 GCCC Ex. 1 (Kollen Direct) at 81; Tr. at 352.

506 GCCC Ex. 1 (Kollen Direct) at 81.

507 Tr. at 357– 358.

508 *Id.* at 358-362.

has never been referred to by a credit rating agency as ring-fenced.[509] In fact, no one other than CenterPoint's own expert witness has ever described CenterPoint as ring-fenced.[510]

TIEC further argued that the evidence shows CenterPoint is far from ring-fenced. On the contrary, credit agency reports have consistently given CenterPoint lower credit ratings due to the risks to CenterPoint associated with its affiliates' debt.[511] Similarly, "substantially all" of CenterPoint's assets are secured by debt for which CNP, CenterPoint's corporate parent, is the obligor.[512]

CenterPoint witness Reed also makes the curious claim that CenterPoint is ring-fenced by virtue of its compliance with PURA § 36.058 and P.U.C. SUBST. R. 25.272 regarding payments to affiliates. The position is curious because neither the statute nor the rule addresses ring-fencing. Mr. Reed acknowledged at the hearing that PURA § 36.058 does not address taxes at all. He also conceded that PURA § 36.058 actually addresses only the ratemaking standards that apply to utility requests to recover affiliate costs, and does not address the corporate structure of an affiliate group. He further could not answer whether P.U.C. SUBST. R. 25.272 says anything at all about taxes.[513] Without belaboring the point with further discussion, the ALJs find the record devoid of support for CenterPoint's claim that compliance with PURA § 36.058 and P.U.C. SUBST. R. 25.272 excuses the utility from the application of a CTSA.

Based on the forgoing the ALJs find CenterPoint's assertion that it is ring-fenced in a manner sufficient to exempt it from CTSA is without merit.

---

509 TIEC Ex. 12.

510 *See id.*

511 Tr. 1303-1305.

512 TIEC Ex. 14.

513 Tr. at 375-377

(d) The "But For" Test

CenterPoint further claims that is fair share of CTSA should be zero because its inclusion in the consolidated return was not needed to produce the savings under the "but for" test. CenterPoint bases it argument on the Commission's decision in Docket No. 14965 where it explained:

> The value of the tax shield CPL provides to CSW competitive affiliates is equal to the amount of consolidated tax savings over the last fifteen years that would not have been realized by CSW affiliates as of the test year, *but for* their affiliation with CPL, multiplied by the time value of money.[514]

According to CenterPoint, the Commission held that a CTSA should apply *only* after determining that the regulated utility's income actually monetized tax losses, *i.e.*, a CTSA should be imposed only when the losses would not have been offset by taxable income *but for* the inclusion of the utility in the consolidated group. Stated differently, the utility's fair share of consolidated tax savings can only exceed zero if there is in fact an amount of consolidated tax savings which its income monetized.

Referring to the testimony of Alan Felsenthal, CenterPoint claimed that it did not monetized any of the tax losses within the CenterPoint consolidated group. After analyzing 15 years of consolidated federal income tax returns, Mr. Felsenthal concluded that CenterPoint's affiliates with net taxable income over a 15-year look back period generated sufficient income to use all of the tax losses of CenterPoint's affiliates on both a year-by-year and cumulative basis.[515] Stated differently, there was sufficient taxable income in the CenterPoint consolidated group to offset all of the losses in the CenterPoint consolidated group *regardless of whether CEHE was included in the consolidated group*. Therefore, according to Mr. Felsenthal, CenterPoint simply has not provided any tax shield,

---

[514] *Application of Central Power and Light Company for Authority to Change Rates*, Docket No. 14965, 2nd Order on Reh'g at 46 (Oct. 16, 1997).

[515] CEHE Ex. 67 (Felsenthal Rebuttal) at 10.

monetized any tax losses, or otherwise served any of the purposes animating the imposition of a CTSA. As such, CenterPoint's "fair share" of the consolidated tax savings here is $0.[516]

The intervenors responded that because PURA § 36.060 requires that ratepayers benefit from the lower federal income tax expense incurred by a utility as a result of its membership in a consolidated group, any CTSA method used must implement that goal.[517] They argue that CenterPoint's "but for" test would result in the ratepayers never seeing their tax burdens reduced so long as there are other affiliates with income that can monetize the affiliates' losses. Moreover, in Docket No. 14965, which CenterPoint relies on for its "but for" test, the Commission did not use that test. Rather, it used the "pro rata" that Ms. Blumenthal applied in this case. GCCC points out, and the ALJs agree, that given the statute's purpose to lower the tax burden borne by ratepayers, CenterPoint's "but for" test would frustrate this purpose because it puts ratepayers last in line for any tax expense reduction. Staff further argued that the Commission has consistently imposed an allocation method that attributes the tax benefits produced by the income loss affiliates to all income producing members of the affiliated group on a pro-rata basis, rather than the last in line advocated by CenterPoint in this case.[518] It appears to the ALJs that making the ratepayers last to share any benefits is the inverse of receiving a "fair share" as the statute requires and should, therefore, be rejected.

(e) Benefits Follows Burdens Test

CenterPoint's "benefits follow burdens" test is substantially similar to the "but for" test and is rejected by the ALJs for the same reasons without need for further elaboration.

---

516 This method was adopted by the United States Supreme Court in a similar context. In *Federal Power Commission v. United Gas Pipe Line*, the Supreme Court upheld an adjustment by the Federal Power Commission (FPC) of a utility's cost of service by the computed consolidated tax savings. 386 U.S. 237, 241–43 (1967). The FPC first offset the gains and losses of unregulated group members in the utility's consolidated group. If (and only if) the unregulated group members had a net loss in the aggregate, that net loss was then used to offset the taxable income of regulated group members. This method therefore resulted in a CTSA but did not use unregulated entities' losses to offset regulated utilities' income until after completely offsetting unregulated entities' taxable income.

517 TIEC Initial Brief at 28; GCCC Initial Brief at 44; OPC Initial Brief at 30-31.

518 Staff Reply Brief at 35.

Based on the foregoing, the ALJs conclude that a CTSA should be applied to CenterPoint calculated in accordance with the interest shield method as used by Ms. Blumenthal.

(f) Interest Shield Calculation Adjustments

CenterPoint argued that if the Commission chooses to adopt the interest shield method of computing a CTSA, three adjustments to the calculation need to be made as addressed by Mr. Felsenthal. According to Mr. Felsenthal, after making these adjustments to Ms. Blumenthal's calculation, the revised CTSA adjustment for the years 1994 – 2008 is $9.8 million. Mr. Felsenthal explained that this amount has not been grossed up consistent with his opinion that any gross-up would be inappropriate. This is further discussed below.[519]

Mr. Felsenthal summarized the adjustments that need to be made to Ms. Blumenthal's interest shield calculation as follows:

- the CTSA calculation should recognize that parent company losses have already been allocated to CenterPoint Houston in 2004 and 2005 and that not adjusting those years for this allocation would result in double counting of the same dollars;

- the CTSA imposed in Docket No. 12065 represented the income tax amounts themselves as opposed to the interest shield on the taxes. Accordingly, the CTSA calculation through 2001 needs to consider this different regulatory treatment; and

- the transition bond taxable income and related losses should be treated consistently in the CTSA.[520]

Mr. Felsenthal explained the need to adjust for the allocation of the parent company loss for 2004 and 2005 with reference to his rebuttal Exhibit ADF-9, which shows that in each of those years the parent company loss was allocated to those entities with positive taxable income in accordance

[519] CEHE Ex. 67 (Felsenthal Rebuttal) at 13.

[520] *Id.* at 12-13.

with the tax sharing agreement then in effect. Since the tax benefit of those losses was paid to each affiliate with taxable income the CTSA calculation should be adjusted accordingly.

In response, COH/HCOC acknowledges that these consolidated tax savings benefits were paid to CenterPoint but contends, without citing any record evidence or authority, that those benefits have not been flowed down to the ratepayers. Therefore, according to COH/HCOC these amounts should not be removed from the tax shield calculation.

The ALJs find the testimony of Mr. Felsenthal to be persuasive and conclude that Ms. Blumenthal's CTSA calculation should be adjusted accordingly.

Mr. Felsenthal explained the need to adjust for the CTSA imposed in Docket No. 12065 which flowed through tax savings on losses rather than computing an interest shield on the tax savings by quoting the testimony of Staff witness Candice Romines in that docket:

> Q. You stated earlier that your calculation, consistent with the order in Docket No. 16705, disregards the losses for certain affiliates because the savings have been flowed through to ratepayers. Please list those affiliates and explain which losses you disregard.
>
> A. The Docket No. 12065 rates that went into effect on January 1, 1995, are reflective of the Docket No. 12065 Settlement adjustment for consolidated tax savings, a forward-looking cost of service expense adjustment. To account for the flow through associated with the Docket No. 12065 rates, I disregarded losses beginning in 1995 for the affiliates considered in the Settlement adjustment. I disregarded the losses for the following affiliates for years 1995 through 2001: HII, DVI, HID, HIP, HIEI, HIB, and URSI. Additionally, for each year 1997 through 2001, I reduced the REI Unregulated Divisions loss by the amount of the 1997 HII loss. "

Mr. Felsenthal further explained that "[t]he tax on these loss amounts has already been flowed through to ratepayers and accordingly, there can be no tax shield calculation for these amounts. This would be giving a benefit twice, which is why Ms. Romines proposed the adjustment in Docket No. 22355. Ms. Blumenthal should make the same adjustment."[521]

In response, COH/HCOC criticized Mr. Felsenthal for accepting the numbers from Docket No. 12065 without independent verification. They claimed that Ms. Blumenthal did not include these amounts in the interest shield calculation simply because she was unable to verify the numbers and trace them through the CTSA calculation in that old docket.

The ALJs find it reasonable and appropriate for the numbers from Docket No. 12065 to be used and they should be used to adjust Ms. Blumenthal's calculation in this docket to avoid overstating the CTSA as indicated by Mr. Felsenthal.

Mr. Felsenthal explained the need to adjust for consistent treatment of the income and losses of the transition bond company with reference to his rebuttal Exhibit ADF-4 which shows the required adjustment. While the ALJs find the detail of Mr. Felsenthal's explanation somewhat complex, it appears to relate to the need to combine Company taxable losses from 2002 through 2004 with the taxable income of the Transition Bond II division because their activities are one and the same.

In response COH/HCOC claims that on page 2 of rebuttal Exhibit ADF-4, Mr. Felsenthal corrects Ms. Blumenthal's calculation by removing $694.064 million from the TDU's taxable income and adding the same amount to "HL&P Generation, CES and other."[522] They contend that in Ms. Blumenthal's consolidated tax savings tax shield calculation, this amount is already included on the "HL&P Generation, CES, and other" line.[523] Thus, according to COH/HCOC, Mr. Felsenthal's proposed correction is simply wrong and would result in double counting.[524]

---

[521] *Id.* at 15.

[522] CEHE Ex. 67A at 2.

[523] COH/HCOC Ex. 1 (Blumenthal Direct) at Ex. EB-1.

[524] Tr. at 1185-1186.

The ALJ's find that the preponderance of the evidence supports COH/HCOC's position that Mr. Felsenthal's proposed adjustment would result in double-counting and should not be made.

(g) Gross-Up

CenterPoint argued that its fair share of the CTSA calculated under the interest shield method should not be grossed-up. In support of this argument, CenterPoint asserts that under the interest shield method, the portion of a utility's net income that is calculated to have monetized the tax loss of an unregulated affiliate "is treated as a 'loan' from the utility to the consolidated group."[525] Because of this loan treatment, such portion of net income is multiplied by the long-term debt rate of the utility.[526] Thus, according to CenterPoint, the CTSA constitutes interest, measuring the "time value of money benefit to the utility related to the consolidated company's use of tax benefits associated with affiliates generating tax losses earlier than it would have without the utility's taxable income."[527]

CenterPoint concluded that interest cannot be grossed-up and explained that, for purposes of determining a utility's revenue requirement, "after-tax" items (such as return) are grossed-up and "before-tax" items are not.[528] Therefore, according to CenterPoint, any adjustment to the interest

---

[525] CEHE Ex. 26 (Felsenthal Direct) at 29; CEHE Ex. 25 (Reed Direct) at 32 ("The entire rationalization that has been advanced for the CTSA is that the utility is 'loaning' its taxable income to its loss affiliates to accelerate the recovery of tax losses . . . ."); *Central Power & Light Co. v. Pub. Util. Comm'n of Tex.*, 36 S.W.3d 547, 556–57 (Tex. App.—Austin 2000, pet. denied) ("What the Commission apparently concluded is that CPL's fair share of CSW's tax savings—$76 million—is tantamount to free capital provided to CPL over the last fifteen years . . . . Likening the $76 million in savings to loan principal and multiplying that figure by CPL's long-term debt rate, the Commission has essentially determined that CPL would have had to pay $6 million per year to obtain $76 million in capital. Thus, $6 million represents the annual time-value of the $76 million that CPL has been given by virtue of the tax shield its profits provide CSW for the losses of other affiliates . . . . Moreover, the Commission has not attempted to recoup the actual $76 million 'free capital' allocated to CPL in an attempt to recoup past savings. Instead, the Commission multiplied that 'principal' by the long-term debt rate in order to recognize today's value of obtaining that capital.").

[526] COH/HCOC Ex. 1 (Blumenthal Direct) at 33; GCCC Ex. 1 (Kollen Direct) at 83 (adopting Ms. Blumenthal's CTSA revenue requirement); *see also Application of Central Power and Light Company for Authority to Change Rates*, Docket No. 14965, 2nd Order on Reh'g at 46 (Oct. 16, 1997) ("CPL's long-term cost of borrowing, 7.96%, is appropriate to measure the time-value of money for purposes of consolidated tax savings because that percentage reflects the CPL's cost of borrowing.").

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

[528] CEHE Ex. 25 (Reed Direct) at 32.

portion of a utility's return component cannot be grossed-up because interest is deductible when computing federal income taxes.[529]

CenterPoint argued that both Ms. Blumenthal and Mr. Kollen agreed that the CTSA constitutes interest on a loan,[530] but then conveniently ignored this fact when attempting to justify a gross-up of the CTSA. Instead, they propose to treat the CTSA as a reduction to federal income tax expense and then gross-up their adjustments for taxes. According to CenterPoint, this results in Ms.Blumenthal's computed "interest shield" of $15.515 million being unjustifiably increased by an additional 54 percent.[531]

CenterPoint further argued that treating the CTSA as an offset to income taxes, rather than interest from a loan, is "internally inconsistent" and "ha[s] no theoretical or accounting basis."[532] CenterPoint contended that if the rationale for the CTSA is that the utility is loaning its taxable income to its loss affiliates to accelerate the recovery of tax losses, then Ms. Blumenthal and Mr. Kollen cannot simply abandon that rationale when it serves their purposes. As stated by Mr. Felsenthal in his direct testimony, "Just because the interest credit method produces a result that is 'deemed' to be a tax adjustment doesn't make it so."[533] And, as Mr. Reed explained, characterizing the interest shield amount as tax expense simply "mislocate[s]" the CTSA.[534]

---

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

[530] COH/HCOC Ex. 1 (Blumenthal Direct) at 31 ("The consolidated tax savings 'tax shield' adjustment, which the Commission has consistently used since 1996, shares the benefit of consolidated tax savings realized by the consolidated group with the utility's customers in the form of an interest payment that is equal to the utility's share of the consolidated tax savings times its cost of long-term debt."); *id.* at 33 ("This is the loan the utility has made to the consolidated group. The cost of that loan, the tax shield, is equal to this amount multiplied by the utility's cost of long term debt."); GCCC Ex. 1 (Kollen Direct) at 82 ("The income tax rate is applied to the interest on the cumulative amount of loans provided by the Company to its parent and affiliates to quantify the effect on income tax expense."). CEHE Ex. 67 (Felsenthal Rebuttal) at 4-5 (noting (i) that Mr. Kollen, when asked if he agreed that the consolidated tax savings is meant to represent interest on a loan, answered, on page 147, line 2, of his deposition, "Yes, interest on a loan for tax expense" and (ii) that Ms. Blumenthal, when asked if she agreed that the CTSA represents interest on a loan, answered on page 52, lines 2-3, of her deposition, "It's the loan that CenterPoint has made to its affiliates with tax losses, yes").

[531] COH.HCOC Ex. 1 (Blumenthal Direct) at 38–39; GCCC Ex. 1 (Kollen Direct) at 82–83.

[532] CEHE Ex. 25 (Reed Direct) at 32.

[533] CEHE Ex. 26 (Felsenthal Direct) at 30.

[534] Tr. at 1326.

GCCC disagreed with CenterPoint, citing the testimony of Mr. Kollen that the computation of the interest credit results in a reduction to income tax expense. Mr. Kollen explained that CenterPoint's income tax rate must be applied to the interest on the cumulative total of the loans provided by CenterPoint to its parent and affiliates in order to calculate the effect on income tax expense. Mr. Kollen further stated that without a gross-up adjustment, the intended effect of the CTSA is not obtained, because the revenue requirement effect of the adjustment will be diminished. He also noted that the Commission has previously rejected arguments similar to those made by CenterPoint in this case.[535] In this regard, TIEC pointed out that the Commission and the Third Court of Appeals have rejected CenterPoint's arguments and held that because CTSA is an adjustment to prospective tax expense, it is proper to consider prior losses that impact the taxes likely to be incurred in the future.[536] Furthermore, the Commission and the Third Court of Appeals have also concluded that CTSAs may be grossed-up in the manner recommended by Ms. Blumenthal. In fact, according to TIEC, grossing-up is absolutely required given that it is an adjustment to tax expense.[537]

The ALJs find, as argued by GCCC and TIEC, that CenterPoint's arguments supporting its contention that CTSA should not be grossed-up, have previously been rejected by the Commission and the courts, and no change of facts or circumstances has been shown that would warrant a departure from the prior holdings. Applying the gross-up methodology used by Ms. Blumenthal, *i.e.*, the after tax shield adjustment divided by one minus the tax rate, or 65 percent, to the $9.8 million CTSA calculated by Mr. Felsenthal, the revenue requirement amount is $15,076,923, subject to further adjustments for losses allocated in 2004 and 2005, and the Docket No. 12065 regulatory treatment discussed above.

2. Medicare Part D Subsidy

The background of the Medicare prescription drug subsidy issue is succinctly described by CenterPoint witness Felsenthal. This portion of his direct testimony is summarized as follows: The

[535] GCCC Ex. 1 (Kollen Direct) at 82.

[536] *Reliant Energy, Inc.* 153 S.W.3d at 198.

[537] *Id; see also* COH/HCOC Ex. 1 (Blumenthal Direct) at 39.

Medicare Prescription Drug, Improvement and Modernization Act of 2003 (2003 Act) expanded Medicare to include prescription drugs, and provided a subsidy to companies such as CenterPoint that provide prescription drug benefits to retirees that are actuarially equivalent to Medicare Part D. The 2003 Act provided a 28 percent subsidy for the employer's cost relating to providing prescription drugs to its retirees. Under the 2003 Act, this subsidy was not taxable for income tax purposes and the receipt of the subsidy did not diminish the tax deductibility of the subsidized prescription drug benefits paid by CenterPoint. Thus the Medicare Part D subsidy was effectively exempt from tax.[538]

In 2010, Congress passed comprehensive health care legislation—the Patient Protection and Affordable Care Act and Health Care and Education Reconciliation Act of 2010 (collectively the Health Care Legislation). Under the Health Care Legislation, beginning January 1, 2013, CenterPoint's tax deduction for providing prescription drug coverage must be reduced by the amount of the Medicare Part D subsidy. Thus, the Medicare Part D subsidy was rendered effectively taxable.[539]

All parties agree with the summary of the 2003 and 2010 laws set forth above, and further agree that:

- CenterPoint is allowed to include the accrued cost of providing retiree drug coverage as part of its OPEB expense;
- Prior to the Health Care Legislation, the tax expense associated with providing retiree drug coverage assumed the non-taxability of the Medicare Part D Subsidy; and
- Upon enactment of the Health Care Legislation, employers who provided retiree prescription drug coverage were required to make two accruals under GAAP: (1) to record ADFIT for the portion of previously recognized OPEB expense relating to the provision of prescription drug benefits after 2012 that had been treated as a permanent difference in OPEB calculations since 2003 due to the effective non-taxability of the Medicare Part D subsidy for tax purposes, and (2) to adjust income tax expense going forward to eliminate the permanent

538 CEHE Ex. 26 (Felsenthal Direct) at 45.

539 *Id.* at 47.

difference for the Medicare Part D subsidy that has been rendered effectively taxable. Both impacts were recorded in CenterPoint's 2010 financial statements.

Although the parties agree as summarized above, the parties do not agree that these two accruals should be recognized for ratemaking purposes in this proceeding.

CenterPoint argued that existing rates are based on certain assumptions about accrued expenses. The Health Care Legislation makes those assumptions inaccurate, and the amounts accrued must be adjusted as described above. CenterPoint asserted that the Health Care Legislation essentially effects a change in income tax rates (*i.e.*, the Medicare Part D subsidy was previously subject to a tax rate of 0 percent, but due to the Health Care Legislation it is effectively subject to a 35 percent tax rate), which the Commission has consistently allowed to be considered in revenue requirements when the tax rate change is enacted.

(a) The Medicare Part D Subsidy Originally Created a Favorable Permanent Difference and Decreased Tax Expense

The 2003 Act granted the Medicare Part D subsidy to companies providing certain prescription drug benefits to retirees. The subsidy equaled 28 percent of a company's costs relating to providing drug benefits; it was neither taxable nor did it reduce the deductibility of the drug benefits paid by the company.[540]

As required under FAS 106, the amount of the anticipated Medicare Part D subsidy a company accrues and records for accounting purposes includes both estimated receipts for benefits owed to current retirees and benefits promised to current employees when they retire. Thus it is an accrual that considers anticipated payments extending well into the future. Mr. Felsenthal stated that because the Medicare Part D subsidy was nontaxable and did not reduce the full deductibility of drug benefits paid, a customer-favorable permanent book/tax difference was created equal to the full amount of all of the anticipated Medicare Part D subsidies.[541]

---

[540] CEHE Ex. 26 (Felsenthal Direct) at 45.

[541] *Id.* at 45-46.

According to CenterPoint, the Medicare Part D subsidy created an income tax permanent difference (*i.e.*, a reduction in income tax expense) of $28.6 million from 2004 through 2009, as calculated pursuant to FASB Statement No. 109. But only $5.4 million of the Medicare Part D subsidy was actually received during that time; the other $23.2 million of the permanent difference related to amounts that were anticipated to be received in 2010 and afterwards, but that were required to be accrued under FAS 106.[542]

(b) The Health Care Legislation Created a Change in Taxability That Results in a Known and Measurable Change to CenterPoint's Test Year

The Health Care Legislation caused the Medicare Part D subsidy to be taxable for tax years beginning after December 31, 2012. The actual amounts of the Medicare Part D subsidy received prior to January 1, 2013, will continue to be nontaxable while amounts received in 2013 and beyond will no longer be nontaxable.[543] In other words, according to Mr. Felsenthal, the Health Care Legislation increased the accrued cost of retiree drug coverage by effectively increasing the income tax rate applicable to such coverage.

Mr. Felsenthal stated that the effects of the Health Care Legislation have already been reflected in CenterPoint's financial statements for the first three months ended March 31, 2010, because GAAP requires that deferred income tax liabilities or assets are to be measured "using the enacted tax rate(s) expected to apply to taxable income in the periods in which the deferred income tax liability or asset is expected to be settled or realized" and are to be "adjusted for the effect of a change in tax laws or rates."[544] Thus, Mr. Felsenthal concluded that the Health Care Legislation results in a fixed, known, and measurable change to the test year.[545] CenterPoint argued that under these circumstances the Commission's rules provide that "rates are to be based on an electric utility's cost of rendering service to the public during a historical test year, adjusted for known and

542 *Id.* at 46.

543 *Id.* at 47.

544 CEHE Ex. 67 (Felsenthal Rebuttal) at 37 (quoting ASC 740-10-30-8 and ASC 740-10-35-4).

545 CEHE Ex. 26 (Felsenthal Direct) at 48.

measurable changes."[546] This is for the simple reason that rates must, as closely as possible, account for known, future costs.[547] Mr. Felsenthal contended that to properly account for the Health Care Legislation, (1) there must be an elimination of the permanent difference related to the Medicare Part D subsidy and (2) tax expense must be increased to recover from customers the anticipated benefit of the Medicare Part D subsidy that was used to reduce income tax expense that will never be realized.[548]

(c) The Medicare Part D subsidy's favorable permanent difference must be eliminated.

Mr. Felsenthal testified that if the favorable permanent difference created by the Medicare Part D subsidy remains unchanged, CenterPoint's customers would receive the benefit of a nontaxable Medicare Part D subsidy (which benefit is entirely based on an accrual that assumes the future non-taxability of the Medicare Part D subsidy) when there is in fact no such nontaxable subsidy. The actual amount of Medicare Part D subsidy receipts that CenterPoint will receive in 2010, 2011, and 2012, which will continue to be non-taxable under the Health Care Legislation, have already been fully reflected in the income tax calculations CenterPoint has accrued in years before 2010.[549] Mr. Felsenthal concluded that there can be no doubt that CenterPoint's income tax expense in 2010 and beyond will no longer contain a permanent difference for the Medicare Part D subsidy.

Because rates are intended "to match the environment under which the Company will operate when new rates are in effect," Mr. Felsenthal contended that the permanent item for the Medicare Part D subsidy must be eliminated or else revenue requirements will be understated.[550]

---

546 16 TEX. ADMIN. CODE § 25.231(a) (2010).

547 *See City of El Paso v. Pub. Util. Comm'n of Tex.*, 883 S.W.2d 179, 188 (Tex. 1994) ("Changes occurring after the test period, if known, may be taken into consideration by the regulatory agency . . . in order to make the test year data as representative as possible of the cost situation that is apt to prevail in the future.") (quoting *Suburban Util. Corp. v. Pub. Util. Comm'n of Tex.*, 652 S.W.2d 358, 366 (Tex. 1983)).

548 CEHE Ex. 26 (Felsenthal Direct) at 48-49.

549 *Id.*

550 *Id.* at 48.

(d) Income Tax Expense Must be Increased to Recapture Tax Benefits Previously Passed Through to Customers That Will Never Be Realized

Mr. Felsenthal testified that since a permanent difference was created with respect to Medicare Part D subsidies actually received and expected to be received well into the future, some portion of the Medicare Part D subsidy permanent difference relates to (i) amounts received or accrued for periods prior to January 1, 2013 and (ii) amounts accrued for periods after January 1, 2013.[551] Because Medicare Part D subsidies are nontaxable until January 1, 2013, the permanent difference relating to amounts received or accrued for periods prior to January 1, 2013 is appropriate, and CenterPoint's customers "should have (and did) receive this benefit."[552] But because the amounts expected to be received after 2013 are now taxable as a result of the Health Care Legislation, the permanent difference relating to those amounts is no longer appropriate.[553] Thus, Mr. Felsenthal opined that the effects of these anticipated amounts previously accrued for and reflected in customer rates will never be received tax free and must be reversed.[554]

Mr. Felsenthal explained that to do so, CenterPoint's actuaries performed the following analysis. First, they quantified the portion of the Medicare Part D subsidy receivable as of December 31, 2009, that had previously been accrued for and treated as a permanent difference for the 2004-2009 period, *i.e.*, the amount of the Medicare Part D subsidy required to be included in the permanent difference calculation but that had not actually been received in the 2004-2009 period. Second, they reduced the receivable by the estimated Medicare Part D subsidy amounts that will be received in 2010, 2011, and 2012 because such amounts will still be received tax free under the Health Care Legislation.[555]

---

[551] *Id.* at 48-49.

[552] *Id.* at 49.

[553] *See id.* at 46.

[554] *Id.* at 49.

[555] *Id.* at 46-51.

The remaining amount—\$17.2 million—"represents the expected subsidy receipts for 2013 and beyond, which, after the change in tax law, are effectively no longer nontaxable."[556] The \$17.2 million was multiplied by the federal tax rate of 35 percent to arrive at an ADFIT asset of approximately \$6 million. That \$6 million was then grossed-up because this is an income tax amount. After gross-up, the resulting ADFIT and the income-tax-related regulatory asset is \$9.3 million.[557]

(e) The Resulting Regulatory Asset Proposed by CenterPoint Should Be Amortized Over Three Years

Mr. Felsenthal explained that the resulting regulatory asset should be amortized over a three-year period for two reasons. First, this is the same amortization period for the pension regulatory asset in this proceeding. Second, a three-year recovery period "will more closely charge the same generation of customers who previously received the benefit" than a longer amortization period.[558]

GCCC, OPC, and Staff strongly oppose CenterPoint's proposed regulatory asset to account for the effects of the Health Care Legislation on the Medicare Part D subsidy.

OPC summarized that CenterPoint proposes two adjustments to its federal income tax expense calculation associated with the future taxability of subsidies received for prescriptions drug payments to its employees. The first is the elimination of the favorable permanent difference related to the Medicare Part D subsidy in the amount of \$6,520,000. The second is to increase the test year income tax provision to recover from customers the amount of \$5,747,000 related to the three-year amortization of the anticipated benefit of the Medicare Part D subsidy that was used to reduce income tax expense in previous years and that, as a result of the Health Care Legislation, will not be realized.

---

[556] *Id.*

[557] *Id.*

[558] *Id.* at 52.

OPC's witness Ms. Dively recommended reducing CenterPoint's federal income tax expense by $6,605,000 for the federal income tax impact of CenterPoint's proposed adjustments to its income tax calculation because the adjustments are too far removed into the future to be appropriate for establishing rates as of the test year end in this case. She testified that because CenterPoint's proposed adjustments are based upon events that will not take place until 2013, CenterPoint was compelled to use an estimate of the subsidies it will receive in 2010, 2011 and 2012 to calculate the amount it proposes to recover from ratepayers for reductions in income tax expense in previous years.[559] However, Ms. Dively contended that CenterPoint has failed to acknowledge there will be no actual federal income tax expense paid by CenterPoint until 2013 and later years, thereby overstating the cost of service for the three years 2010, 2011, and 2012 because CenterPoint will continue to take the deduction related to subsidies during those years.

Additionally, Ms. Dively testified that by proposing a three-year amortization of the permanent difference, CenterPoint will have recovered the entire amount of the anticipated tax benefit of the Medicare Part D subsidy that will not be realized as a result of the Health Care Legislation, before experiencing any tax effect from the legislation related to its 2013 federal income tax return that will be filed in 2014, or any extension thereof. Ms. Dively concluded that CenterPoint's federal income tax expense should be reduced by $6,605,000 because its proposed adjustments are too far reaching into the future to be appropriate for establishing rates as of the end of the test year in this case, and will result in CenterPoint's over-recovery of its tax expense. Staff agrees with Ms. Dively.

CenterPoint responded that on the contrary, (i) the amount of the Medicare Part D subsidy receipts that CenterPoint will receive in 2010, 2011, and 2012 are already reflected in the income tax calculations CenterPoint was required to accrue under GAAP in years prior to 2010; and (ii) to maintain the "phantom" permanent difference would result in customers continuing to erroneously receive the benefit of a nontaxable Medicare Part D subsidy that is no longer nontaxable.[560]

---

[559] OPC Ex.3 (Dively Direct) at 19-20.

[560] Tr. at 916.

GCCC's witness Mr. Kollen testified, in agreement with Ms. Dively, that CenterPoint's income tax expense has not increased as a result of the Health Care Legislation, and will not until 2013. He further testified that this issue has in actuality not created any expense at all – the accounting for the regulatory asset and ADFIT that CenterPoint describes occurred only on its balance sheet, not its income statement. He explained that there was simply no increase in income tax expense – the regulatory asset offsets the recognition of ADFIT.[561]

Mr. Kollen further testified that both the ADFIT and the regulatory asset that CenterPoint has recorded for the Medicare Part D subsidy will reverse in future years. Therefore, he agrued that permitting CenterPoint to amortize these amounts into rates now will unavoidably result in an over-recovery. He urged that after 2013 CenterPoint should simply seek to include its increased income tax expense in its cost of service.[562]

Mr. Kollen also testified that CenterPoint's claim that ratepayers "benefited from an anticipated tax treatment that did not occur" as rationale for recording and amortizing its proposed regulatory asset is unsupported by the statute and the settlement in Docket No. 32093, CenterPoint's last rate case. The settlement was a "black box" that defined only a total revenue requirement, therefore, there is no basis for CenterPoint to claim that ratepayers have received a benefit. He further contended that even assuming ratepayers did benefit, any attempt at recouping that benefit would amount to retroactive ratemaking that is prohibited by PURA § 36.111(b). The prohibition of retroactive ratemaking "prohibits a public utility commission from setting future rates to allow a utility to recoup past losses or to refund to consumers excess utility profits,"[563] and GCCC argued that CenterPoint's proposal would do just that, and for that reason should be denied.

CenterPoint responded that increasing income tax expense as proposed does not result in "improper retroactive ratemaking," as Mr. Kollen alleges.[564] It asserts that the change in the taxation

---

561 GCCC Ex. 1 (Kollen Direct) at 85.

562 *Id.*

563 *State v. Public Utility Commission of Texas*, 883 S.W.2d 190, 199 (Tex. 1994).

564 GCCC Ex. 1 (Kollen Direct) at 86.

of the Medicare Part D subsidy is no different than a change in the tax rate, which impacts accumulated deferred income taxes.[565] CenterPoint claimed that the Commission regularly permits the recovery of tax rate change effects.[566] Moreover, CenterPoint asserted that Mr. Kollen acknowledged in his deposition that regulatory commissions generally take future tax rate changes into account when setting rates.[567]

Mr. Kollen further testified that in addition to the deferred accounting issue discussed above, CenterPoint also proposes to increase its income tax expense by eliminating the Medicare Part D subsidies in the test year.[568] He claimed that despite the fact that the subsidies will not become taxable until 2013, CenterPoint proposes to reflect that change now as a "known change."[569] The proposed adjustment totals $6.520 million, which once functionalized using a payroll allocator equates to a $5.525 million deduction to distribution taxable income and a $0.995 million deduction to transmission taxable income. On a revenue requirement basis, Mr. Kollen calculated that these changes mean a $2.975 million increase to the Company's distribution revenue requirement and a $0.536 million transmission revenue requirement.[570]

CenterPoint responded that Mr. Kollen erred in functionalizing the test year deduction of $6.520 million thereby improperly over-estimating the revenue requirement effect of CenterPoint's proposal. Mr. Kollen criticized CenterPoint for failing to functionalize the deduction to distribution and transmission using a payroll allocator claiming that doing so eliminates $5.525 million as a deduction to distribution taxable income, which in turn has a $2.975 million revenue requirement

---

565 CEHE Ex. 26 (Felsenthal Direct) at 43-44.

566 *Id. See also Williams v. Houston Lighting and Power Company*, Docket No. 12065, Order at Finding of Fact 43 (Aug. 30, 1995) (addressing the issue of unprotected deferred taxes when the highest marginal federal income tax rate increased from 34 percent to 35 percent and concluding that "[r]estoration of the deficiency in unprotected deferred taxes of $9,909,946 as of January 1, 1995 will occur over ten years"); *Application of Houston Lighting and Power Company*, Docket No. 8425, Order at Finding of Fact 245 (June 20, 1990) (addressing unprotected deferred taxes when the federal income tax rate decreased in 1986 and 1987 and concluding that "[t]he evidence supports a three year amortization period for unprotected excess deferred income taxes").

567 CEHE Ex. 67 (Felsenthal Rebuttal) at 44 (citing Mr. Kollen's deposition at 62-63).

568 GCCC Ex. 1 (Kollen Direct) at 86, *citing* CEHE Ex. 26 (Felsenthal Direct) at 48.

569 GCCC Ex. 1 (Kollen Direct) at 87.

570 *Id.*

effect.[571] However, according to CenterPoint Mr. Kollen used an erroneous payroll allocator which, if corrected, results in only a $4.382 million allocation to distribution and a lower revenue requirement effect.[572]

Mr. Kollen also testified that CenterPoint's proposal fails to qualify as a "known" change that should be built into CenterPoint's rates. He stated that with rates in this case likely going into effect in early 2011, CenterPoint would be over-recovering for this item for nearly two years prior to 2013, when the subsidy becomes taxable. GCCC reiterated that CenterPoint remains able to seek recovery of test year amounts of income tax incurred at that time. Thus, GCCC concluded that recovery of that expense two years ahead of time is unreasonable and unnecessary, and should be rejected.[573]

The ALJs find the evidence and arguments on both sides of this issue to be persuasive, but they conclude that CenterPoint's proposal to account for this known change in tax treatment in 2013, in current rates is preferable in that it more closely matches the recovery of the increased tax expense with the ratepayers who received the benefit of the nontaxable Medicare Part D subsidy in prior years. Thus, the principle of intergenerational equity favors amortization of the regulatory asset over three years as CenterPoint proposes, and the ALJs so recommend.

M. Taxes Other than Income Taxes [Germane to Preliminary Order Issue No. 23]

1. Ad Valorem (Property) Taxes

CenterPoint's property tax obligations in the test year totaled approximately $68.45 million.[574] Like most Texas property owners, CenterPoint must pay property taxes each year to various taxing units.[575] Service Company's Property Tax Department aggressively and proactively

---

571 *Id.*

572 CEHE Ex. 67 (Felsenthal Rebuttal) at 45.

573 GCCC Initial Brief at 49.

574 CEHE Ex. 27 (Ramsey Direct) at 9.

575 TEX. TAX CODE § 11.01 (Vernon 2005).

negotiates with appraisal districts to secure appropriate values for CenterPoint's property.[576] These efforts ensure that CenterPoint and its customers pay no more property tax than reasonable and necessary.[577] As neither the intervenors nor Staff challenged the proposed ad valorem tax expenses, the ALJs recommend that the Commission approve those expenses.

2. Texas Gross Margin Tax

CenterPoint computed its Texas franchise tax on a stand-alone basis using its own financial information and applying what it contends is the only method available under state law to compute such taxes.[578] The result is a state franchise tax amount of $16.338 million.

GCCC (but not Staff or any other intervenor) proposes that CenterPoint change the method its combined group uses (and which CenterPoint is statutorily and administratively required to use) and instead take 70 percent of revenue as margin.[579] Texas law does not, however, allow CenterPoint to choose another method.[580]

For all tax reports due on or after January 1, 2008, Texas imposes a 1 percent franchise tax on the taxable margin of each taxable entity.[581] It is undisputed that Texas requires affiliated entities in a unitary business to file a combined franchise tax return.[582] It is also undisputed that all entities in the combined group must use the same method to calculate their margin: the method used by the consolidated group is in fact "binding" on all the members of the group.[583] Finally, there is no dispute that CenterPoint is part of a combined group for purposes of calculating and reporting the

---

576 CEHE Ex. 27 (Ramsey Direct) at 2-3, 9.

577 *Id.* at 2–3.

578 CEHE Ex. 26 (Felsenthal Direct) at 18-20.

579 GCCC Ex. 1 (Kollen Direct) at 69.

580 CEHE Ex. 26 (Felsenthal Direct) at 19; TEX. TAX CODE § 171.1014(d) (Vernon 2005).

581 TEX. TAX CODE §§ 171.001(a), .002(a) (Vernon 2005).

582 *Id.*; TEX. TAX CODE § 171.1014(a) (Vernon 2005).

583 CEHE Ex. 26 (Felsenthal Direct) at 19; TEX. TAX CODE § 171.1014(d) (Vernon 2005); TEX. ADMIN. CODE § 3.590(e)(1)(B) ("Any elections required by the combined group are binding on all members of the group.").

franchise tax.[584] This group calculates its margin by subtracting cost of goods sold from revenue, which produces the lowest margin for the combined group, and each group member computes the amount it pays to CNP based on this method.[585] Using this required method, CenterPoint's franchise tax for the test year is approximately $16,338,000, and the ALJs recommend that the Commission so find.[586]

3. Payroll Taxes

The Company made an adjustment of $348,000 to increase Federal Insurance Contributions Act taxes (commonly known and Medicare and Social Security taxes), which is the related impact of the proposed wage adjustment.[587] An adjustment of $111,000 was also made to reflect an increase in state unemployment taxes, which is related to the increase in the Texas state unemployment tax rate from 0.56 percent in 2009 to 1.26 percent in 2010.[588] The details of these adjustments are provided in the workpaper to Schedule II-E-2. No party contests these adjustments. Accordingly, they are reasonable and necessary, and the ALJs recommend that the Commission approve these adjustments.

N. Municipal Franchise Fees [Preliminary Order Issue No. 21]

Franchise fees are fees paid by utilities such as CenterPoint to cities for the right to install electric facilities within municipal right-of-ways. As the cost of maintaining right-of-ways have increased, these payments are of significant importance to cities. Staff witness Jacobs recommends a reduction of $24.1 million to CenterPoint's franchise fee request of $138.6 million. Ms. Jacobs claims that the $24.1 million in municipal franchise fees expense does not meet the P.U.C. SUBST. R. 25.231(b) requirement that expenses be reasonable and necessary to provide service to the public. The sole basis for her position is her contention that the amount requested does not meet the

---

584 CEHE Ex. 26 (Felsenthal Direct) at 18-19.

585 *Id.* at 18-20.

586 CEHE Ex. 1 at Schedule II-E-2. This amount was computed on a stand-alone basis by reference to the items of income and expense reflected in CEHE's financial statements. *See* CEHE Ex. 67 (Felsenthal Rebuttal) at 34.

587 CEHE Ex. 23 (Woods Direct) at 30.

588 *Id.*

requirements of TAX CODE § 182.025 or PURA § 33.008(b).[589] CenterPoint, COH/HCOC, and GCCC contend that Ms. Jacob's recommendation is based upon an incorrect and incomplete interpretation of PURA.

While Ms. Jacobs has accurately referenced PURA § 33.008(b), which establishes the amount of the franchise fee that can be collected after the rate freeze period, she ignored subsection (f) of the same section of PURA, which states:

> Notwithstanding any other provision of this section, on the expiration of a franchise agreement existing on September 1, 1999, an electric utility, transmission and distribution utility, municipally owned utility, or electric cooperative and a municipality may mutually agree to a different level of compensation or to a different method for determining the amount the municipality may charge for the use of a municipal street, alley, or public way in connection with the delivery of electricity at retail within the municipality.

Under this provision, utilities and cities can agree to a different level of compensation. Additionally, because subsection (f) is part of PURA § 33.008, subsection (c) makes the agreed to amounts recoverable in rates. Specifically, subsection § 33.008(c) states:

> The municipal franchise charges authorized by this section shall be considered a reasonable and necessary operating expense of each electric utility, transmission and distribution utility, municipally owned utility, or electric cooperative that is subject to a charge under this section.

CenterPoint, COH/HCOC, and GCCC contend that contrary to the Staff's position, if the franchise fees are lawful, they are recoverable. Subsection (c) states that the franchise fees authorized by "this section" shall be considered a reasonable and necessary operating expense. Subsection (c) does not reference any specific *sub*sections within "this section." Logically, subsection (c) would apply to all subsections, including both subsections (b) and (f). If the charges are authorized by "this section," then regardless of the subsection, the amounts are recoverable because they are considered a "reasonable and necessary operating expense."

---

[589] Staff Ex. 8 (Jacobs Direct) at 14-16.