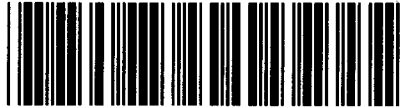




Control Number: 40020



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**SOAH DOCKET NO. 473-12-4133  
PUC DOCKET NO. 40020**

<b>APPLICATION OF LONE STAR</b>	<b>§</b>	<b>BEFORE THE STATE OFFICE</b>
<b>TRANSMISSION, LLC FOR</b>	<b>§</b>	
<b>AUTHORITY TO ESTABLISH</b>	<b>§</b>	<b>OF</b>
<b>INTERIM AND FINAL RATES</b>	<b>§</b>	
<b>AND TARIFFS</b>	<b>§</b>	<b>ADMINISTRATIVE HEARINGS</b>

**REBUTTAL TESTIMONY**

**OF**

**ROBERT N. HUGHES**

**ON BEHALF OF**

**LONE STAR TRANSMISSION, LLC**

12/12/12 PM 3:06  
PUC DOCKET  
40020

**July 12, 2012**

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ROBERT N. HUGHES, WITNESS FOR  
LONE STAR TRANSMISSION, LLC**

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**LIST OF EXHIBITS**

EXHIBIT RNH-R-1	Excerpts of Deposition of Chris Roelse
EXHIBIT RNH-R-2	Excerpts of Deposition of Jeffry Pollock
EXHIBIT RNH-R-3	Excerpts of Deposition of Lane Kollen

**EXECUTIVE SUMMARY OF ROBERT N. HUGHES**

Lone Star Transmission, LLC ("Lone Star" or the "Company") requests approval to create a self-insurance reserve and include accruals in Phase I and Phase II rates to prepare for unanticipated damage to its facilities. My rebuttal testimony responds to arguments from witnesses Jeffry Pollock on behalf of Texas Industrial Energy Consumers ("TIEC"), Lane Kollen on behalf of the Steering Committee of Cities Served by Oncor ("Cities"), and Chris Roelse on behalf of the Staff of the Public Utility Commission of Texas ("Commission"). My rebuttal testimony:

- explains why the Commission should rely on an actuarial study, not an averaging methodology, to determine Lone Star's risk of loss and annual accrual amounts;
- refutes the idea that the Company should establish a threshold under which it will expense certain amounts associated with unexpected property damage;
- demonstrates that the Company's proposal to include losses below deductible amounts in its self-insurance reserve is consistent with Commission precedent;
- addresses the way in which historical loss data from Oncor Electric Delivery Company LLC ("Oncor") was used to accurately determine Lone Star's future risk of loss and necessary annual accruals;
- explains why relying on insurance expenses and self-insurance accruals of other Texas utilities is not relevant for analyzing Lone Star's request; and
- establishes that intervenor and Commission Staff recommendations for a self-insurance accrual of \$0 are neither reasonable nor in the public interest and will fail to allow Lone Star to adequately manage the risk of loss it faces in the future.

The Commission should approve Lone Star's request to establish a self-insurance reserve and include accruals in its rates. Lone Star's self-insurance plan is consistent with Commission precedent and is in the public interest. The plan is also a lower cost alternative to purchasing commercial insurance, and customers will benefit from the savings.

1                   **REBUTTAL TESTIMONY OF ROBERT N. HUGHES**

2           **I. INTRODUCTION AND PURPOSE OF REBUTTAL TESTIMONY**

3   **Q.    PLEASE STATE YOUR NAME AND POSITION.**

4   A.    My name is Robert N. Hughes. I am Chairman and CEO of Robert Hughes  
5       Associates, Inc., a consulting firm founded in 1979.

6

7   **Q.    ARE YOU THE SAME ROBERT HUGHES THAT PREVIOUSLY FILED**  
8       **TESTIMONY IN THIS PROCEEDING?**

9   A.    Yes.

10

11   **Q.    WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY IN THIS**  
12       **PROCEEDING?**

13   A.    The purpose of my rebuttal testimony is to respond to arguments challenging  
14       Lone Star's proposal for a self-insurance reserve and necessary accruals.  
15       Specifically, I respond to arguments from intervenor witnesses Jeffry Pollock on  
16       behalf of TIEC, Lane Kollen on behalf of the Cities, and Chris Roelse on behalf  
17       of Staff.

18

19   **Q.    HAVE YOU PREPARED ANY EXHIBITS IN CONNECTION WITH**  
20       **YOUR REBUTTAL TESTIMONY?**

21   A.    Yes. I have prepared and sponsor the exhibits listed in the table of contents.

1 Q. WERE THESE EXHIBITS PREPARED BY YOU OR UNDER YOUR  
2 DIRECT SUPERVISION?

3 A. Yes.  
4

5 **II. THE COMMISSION SHOULD APPROVE A SELF-INSURANCE**  
6 **RESERVE FOR LONE STAR WITH APPROPRIATE**  
7 **ACCRUAL AMOUNTS**

8 Q. THE INTERVENOR AND STAFF WITNESSES RECOMMEND NO SELF-  
9 INSURANCE ACCRUAL FOR LONE STAR. WOULD IT BE  
10 APPROPRIATE FOR A TEXAS UTILITY TO ESSENTIALLY OPERATE  
11 WITHOUT A SELF-INSURANCE RESERVE?

12 A. No. It would not be prudent for a utility to operate its infrastructure with no  
13 insurance, and in today's insurance market, that requires a self-insurance reserve  
14 with adequate accruals. There are utility assets, such as transmission facilities, for  
15 which commercial insurance is either unavailable or very expensive to the point  
16 of being cost-prohibitive. Lone Star could attempt to purchase first-dollar,  
17 commercial insurance if it was available for all utility assets on reasonable terms  
18 and would include that cost of insurance in operating and maintenance ("O&M")  
19 expense for ratemaking purposes. Other options include operating transmission  
20 facilities with no insurance or relying on self-insurance. Even Staff's witness Mr.  
21 Roelse acknowledged in his deposition that Lone Star is faced with these two  
22 alternatives and noted that operating without insurance "would be very risky."<sup>1</sup>

---

<sup>1</sup> Exhibit RNH-R-1, Deposition of Chris Roelse at 74 (July 5, 2012).

1 Q. TO SUPPORT THEIR CLAIMS THAT AN ACCRUAL OF \$0 IS  
2 APPROPRIATE, INTERVENOR AND STAFF WITNESSES CLAIM  
3 THAT LONE STAR HAS NOT PRESENTED A COST-BENEFIT  
4 ANALYSIS SHOWING THAT SELF-INSURANCE IS A LOWER COST  
5 OPTION THAN COMMERCIAL INSURANCE. DO YOU AGREE?

6 A. No. For reasons I address in this testimony and in my amended direct testimony,  
7 self-insurance represents the most cost-effective and responsible method for Lone  
8 Star to carry insurance protection for all of its assets. Purchasing commercial  
9 insurance at very high rates would create a high insurance premium, the costs of  
10 which Lone Star would have to recover through rates. As part of the high-priced  
11 commercial insurance plan, the insurer also includes overhead, expenses, and a  
12 profit—a practice that Staff witness Mr. Roelse acknowledged in his deposition.<sup>2</sup>  
13 By opting to self-insure assets, Lone Star avoids the cost of a high premium and  
14 instead relies on the cost-effective nature of self-insurance, which benefits  
15 customers.

16  
17 Contrary to Mr. Pollock's allegation that I performed only a one-page cost benefit  
18 analysis, I thoroughly addressed the costs of commercial insurance compared to  
19 the savings the Company and its customers would enjoy under Lone Star's  
20 proposed self-insurance plan. I also noted that any accruals towards a self-  
21 insurance reserve accumulate in the reserve year after year, which puts Lone Star  
22 in the position of building a target reserve for which future accruals could be

---

<sup>2</sup> *Id.* at 83.

reduced or ceased. In contrast, any commercial insurance premiums Lone Star would pay would not accumulate over the years and would instead create profits for only the insurance company. Unlike self-insurance, with commercial insurance, there is not a point at which Lone Star could stop paying annual premiums and still have insurance coverage. Moreover, I followed the same methodology for conducting a cost-benefit analysis for Lone Star as I did for Oncor in Docket No. 35717 in which the Commission determined that Oncor's proposed self-insurance plan was a lower cost alternative to purchasing commercial insurance and provided customers with the benefit of the savings.<sup>3</sup>

**Q. DO YOU AGREE WITH INTERVENOR AND STAFF WITNESSES WHO CONCLUDE THAT LONE STAR'S SELF-INSURANCE PLAN IS NOT IN THE PUBLIC INTEREST AND CONSISTENT WITH PURA AS A WAY TO JUSTIFY AN ACCRUAL OF \$0?**

**A.** No. Section 36.064 of the Public Utility Regulatory Act ("PURA") requires the Commission to approve a self-insurance plan that meets three criteria: (1) coverage is in the public interest; (2) the self-insurance plan is a lower cost alternative to purchasing commercial insurance; and (3) customers will receive the benefits of the savings. Lone Star's proposed self-insurance plan meets the criteria in the statute. Coverage is in the public interest because self-insurance adequately prepares Lone Star for the risk of loss to its transmission assets without forcing the Company to rely on reserve accounting and accrue future

<sup>3</sup> Docket No. 35717, Order on Rehearing at Finding of Fact 98, Conclusion of Law 17 (Nov. 30, 2009).

1 losses for which it will have to be made whole by future customers. Self-  
2 insurance is a lower cost alternative to purchasing commercial insurance as  
3 evidenced by the estimated premium of \$6,551,698 calculated on Exhibit RNH-3  
4 compared to the requested Phase II accrual of \$4,338,413. Finally, customers will  
5 receive the benefit of the savings because they are not being asked to pay through  
6 rates for high premium costs that would otherwise be incurred by the Company.  
7

8 **III. CLARIFICATIONS OF INACCURACIES IN CITIES' AND**  
9 **STAFF'S TESTIMONY**

10 **Q. IS MR. POLLOCK CORRECT WHEN HE ASSERTS THAT LONE STAR**  
11 **IS REQUESTING A SINGLE ANNUAL ACCRUAL OF \$4.338 MILLION**  
12 **FOR ALL FACILITIES THAT WOULD TAKE EFFECT BEFORE ALL**  
13 **FACILITIES ARE PLACED INTO SERVICE?**

14 **A.** No. Lone Star is seeking separate and different accrual amounts for each phase.  
15 Lone Star is requesting an accrual of \$1,489,893 through Phase I rates. For Phase  
16 II, Lone Star is requesting an annual accrual of \$4,338,413. As I explained in my  
17 amended direct testimony, the requested Phase I accrual of \$1.489 million would  
18 cease when Lone Star implements Phase II rates, at which time Lone Star would  
19 include the requested \$4.338 million accrual through Phase II rates. Thus, the  
20 requested Phase II accrual would not be recovered through rates until Phase II  
21 assets are placed into service and Phase II rates are implemented. Mr. Pollock  
22 reiterated in his deposition, attached as Exhibit-RNH-R-2, that he thought Lone  
23 Star sought to include an accrual for Phase II facilities before those facilities go

1 into service.<sup>4</sup> This, of course, is wrong. Any suggestion that Lone Star seeks to  
 2 recover an accrual through rates for facilities that would not be in service is  
 3 inaccurate and misstates Lone Star's request.

4  
 5 **Q. HAVE YOU IDENTIFIED ANY INACCURACIES IN STAFF**  
 6 **TESTIMONY THAT NEED TO BE ADDRESSED?**

7 A. Yes. Mr. Roelse on behalf of Staff testifies that the Company is requesting annual  
 8 accruals of \$1,704,480 for Phase I and \$4,521,339 for Phase II. Mr. Roelse also  
 9 claims that the Company is requesting a target reserve of \$7,429,000 and that a  
 10 commercial insurer would charge an annual premium of \$6,827,945 to insure the  
 11 Company's assets. This does not accurately reflect the data included in the errata  
 12 to my amended direct testimony, which the Company filed on June 5, 2012. Lone  
 13 Star's request consists of the following:

Phase I Accrual	\$1,489,893
Phase II Accrual	\$4,338,413
Target Reserve	\$7,076,193

14  
 15 In addition, the estimated annual cost to commercially insure all of the  
 16 Company's assets that will be covered by self-insurance is \$6,551,698. Mr.  
 17 Roelse acknowledges in a footnote on the last page of his testimony that the  
 18 Company filed revised accrual and target reserve amounts, but says he chose not  
 19 to include them in his testimony because the schedules reflect the original

---

<sup>4</sup> Exhibit RNH-R-2, Deposition of Jeffry Pollock at 59 (June 28, 2012).

1 numbers. Nevertheless, I want to be clear about what amounts the Company is  
2 seeking to recover through rates.

3

4 **IV. THE COMPANY'S PROPOSED ACCOUNTING TREATMENT**  
5 **FOR THE SELF-INSURANCE RESERVE IS APPROPRIATE**

6 **Q. MR. KOLLEN ADDRESSES CERTAIN ACCOUNTING ISSUES**  
7 **ASSOCIATED WITH THE SELF-INSURANCE RESERVE. ARE YOU**  
8 **RESPONDING TO HIS TESTIMONY ON THESE ISSUES?**

9 A. I will respond to some of Mr. Kollen's assertions regarding the accounting issues  
10 associated with a self-insurance reserve. Lone Star Witness Richard Cribbs in his  
11 rebuttal testimony will also address Mr. Kollen's testimony on these issues.

12

13 **Q. MR. KOLLEN TAKES ISSUE WITH THE USE OF THE TERM**  
14 **"PROPERTY LOSSES" AS IT RELATES TO THE TYPES OF EXPENSES**  
15 **A UTILITY SHOULD CHARGE TO A SELF-INSURANCE RESERVE.**  
16 **WHAT IS YOUR RESPONSE?**

17 A. Both PURA and the Commission's rule addressing self-insurance state that a  
18 utility may establish a self-insurance reserve for property and liability losses.  
19 Therefore, it is entirely appropriate to use the term "property losses" in the  
20 actuarial and self-insurance analysis because it is consistent with the applicable  
21 statute and rule and makes it clear that the analysis does not include "liability"  
22 losses. For the same reasons, Mr. Kollen's assertion that property losses should  
23 not be a factor in the amount of the self-insurance accrual or reserve is also

1 inaccurate. I also want to make clear that Lone Star is not requesting an accrual  
2 associated with self-insuring any liability losses even though including liability  
3 losses is permitted and has been approved by the Commission for other utilities.  
4

5 **Q. SHOULD A "NAMED" STORM STATUS FOR A STORM BE A**  
6 **PREREQUISITE TO CHARGING THE SELF-INSURANCE RESERVE?**

7 A. No. I disagree with Mr. Kollen's suggestion that "named" storm status should be  
8 a prerequisite to applying losses resulting from a given storm to the self-insurance  
9 reserve. The reason for this is straightforward. Not all storms (*i.e.*, fires, ice, and  
10 tornadoes) are named weather events, and they can still damage the Company's  
11 infrastructure.  
12

13 **Q. MR. KOLLEN ADDRESSES WHAT HE VIEWS AS THE APPROPRIATE**  
14 **ACCOUNTING APPROACH FOR A SELF-INSURANCE RESERVE.**  
15 **HOW DO YOU RESPOND TO MR. KOLLEN'S ASSERTIONS?**

16 A. Mr. Cribbs will respond to the specific accounting issues, but I have some  
17 observations related to the typical operation of a self-insurance reserve. First, the  
18 Company does not materially disagree with Mr. Kollen because the Company  
19 intends to charge to the reserve only costs that it incurs outside of routine  
20 maintenance costs incurred when the Company's self-insured assets are damaged  
21 by an unanticipated incident. By the terms of the statute and rule, a self-insurance  
22 reserve is appropriate only for property losses that could not have been reasonably  
23 anticipated. Therefore, it would be inappropriate for a utility to apply charges for

1 routine maintenance against a self-insurance reserve. Any suggestion that Lone  
2 Star would apply routine maintenance charges against the reserve is inaccurate.

3

4 **Q. DO YOU AGREE WITH MR. KOLLEN THAT NOT HAVING**  
5 **ESTABLISHED ACCOUNTING GUIDELINES SHOULD PRECLUDE**  
6 **LONE STAR FROM ESTABLISHING A SELF-INSURANCE RESERVE**  
7 **AND ASSOCIATED ACCRUAL THROUGH RATES?**

8 A. No. Neither PURA § 36.064 nor P.U.C. Substantive Rule 25.231(b)(1)(G)  
9 require that a utility establish accounting guidelines in order to create a self-  
10 insurance reserve. Nevertheless, Mr. Cribbs identifies in his rebuttal testimony  
11 certain reasonable accounting guidelines that Lone Star will follow regarding the  
12 self-insurance reserve if the Commission deems those guidelines necessary and  
13 appropriate.

**V. THE COMMISSION SHOULD RELY ON AN ACTUARIAL STUDY  
NOT AN AVERAGING APPROACH TO DETERMINE  
THE PROPER ACCRUALS AND TARGET RESERVE**

**Q. STAFF WITNESS MR. ROELSE ASSERTS THAT THE COMMISSION HAS NEVER ADOPTED THE USE OF A SIMULATION MODEL AND HAS HISTORICALLY RELIED ON AVERAGING HISTORICAL INSURANCE LOSSES TO CALCULATE AN ACCRUAL RATHER THAN RELY ON AN ACTUARIAL STUDY. IS THAT YOUR UNDERSTANDING OF COMMISSION POLICY?**

**A.** No. Ms. Camp and I testified for Oncor in Docket Nos. 38929 and 35717. For purposes of those proceedings, Ms. Camp conducted an actuarial analysis that relied on a simulation model, just as she did in this case. Although Mr. Roelse claims that the Commission did not adopt a simulation in model in Docket No. 35717, that is not entirely accurate. In that proceeding, the Proposal for Decision clearly states the following:

The ALJs recommend averaging Oncor's ten-year average with Oncor's proposed accrual at the 50% confidence level, \$44,019,000. In this way, the Commission relies on both the historical averaging methodology and the actuary study in calculating an annual accrual of \$33,284,430.45.<sup>5</sup>

The Commission found that Oncor's self-insurance plan complied with PURA § 36.064 and Commission rules, including a finding that an annual accrual of \$33,284,430.45 was in the public interest.<sup>6</sup> Thus, the Commission did rely on

---

<sup>5</sup> Docket No. 35717, Proposal for Decision at 118 (June 2, 2009).

<sup>6</sup> Docket No. 35717, Order on Rehearing at Findings of Fact 98-100, Conclusions of Law 17, 18 (Nov. 30, 2009).

1 Ms. Camp's actuarial study in Docket No. 35717 to set the utility's self-insurance  
2 accrual.

3  
4 Similarly, in Docket No. 38929, the Commission approved the use of the accruals  
5 for Oncor's self-insurance reserve at the same levels approved in the Order on  
6 Rehearing in Docket No. 35717.<sup>7</sup> Even though Docket No. 38929 was a settled  
7 proceeding, Staff agreed with the modified stipulation the parties reached, and the  
8 Commission approved the modified stipulation. During his deposition, attached  
9 hereto as Exhibit RNH-R-1, Mr. Roelse admitted that the Commission relied on  
10 simulations, at least in part, in Docket Nos. 35717 and 38929 to approve self-  
11 insurance accruals.<sup>8</sup>

12  
13 Finally, in Docket No. 38339, CenterPoint's self-insurance witness used a Monte  
14 Carlo simulation to calculate the utility's reserve and accrual requirements based  
15 on expected losses.<sup>9</sup> Staff even recommended approval of CenterPoint's  
16 requested annual accrual, which was based on the results of the simulation.<sup>10</sup> In  
17 the Order on Rehearing, the Commission specifically concluded that the Monte  
18 Carlo simulation used to calculate the accrual amount is "a reasonable program  
19 for estimating loss experience over a long period of time" and approved the

---

<sup>7</sup> Docket No. 38929, Modified Stipulation at Paragraph K (July 22, 2011); Final Order at Finding of Fact 42, Conclusion of Law 10 (Aug. 26, 2011).

<sup>8</sup> Exhibit RNH-R-1, Deposition of Chris Roelse at 27, 31 (July 5, 2012).

<sup>9</sup> Docket No. 38339, Direct Testimony of Gregory S. Wilson at 7 (June 30, 2010).

<sup>10</sup> Docket No. 38339, Proposal for Decision at 74 (Dec. 2, 2010); Direct Testimony of Brian T. Almon at 12 (Sept. 17, 2010).

1 utility's requested annual accrual.<sup>11</sup> Mr. Roelse, however, admitted in his  
2 deposition that he did not review any materials from Docket No. 38339 to prepare  
3 his testimony and thus, ignored one of the most recent Commission decisions that  
4 is directly relevant to the recommendations he makes in this case.<sup>12</sup>

5  
6 Commission precedent on self-insurance reserve accruals and the methodologies  
7 used to calculate accruals clearly disproves Mr. Roelse's assertion that the  
8 Commission has not adopted the use of a simulation model for determining  
9 expected losses. Mr. Roelse noted in his deposition that Commission precedent is  
10 the sole basis for his conclusion on this issue.<sup>13</sup> Because Commission precedent  
11 proves his recommendation is wrong, the Commission should reject his  
12 recommendation on this issue.

13  
14 **Q. IS AN ACTUARIAL STUDY A MORE ACCURATE AND REASONABLE**  
15 **WAY TO PREDICT FUTURE LOSSES THAN RELYING ON AN**  
16 **AVERAGE OF HISTORICAL LOSSES OVER SOME PRIOR PERIOD OF**  
17 **TIME?**

18 **A.** Yes. The use of an average is an inaccurate and unreasonable way to predict and  
19 plan for future losses. First, the mean (or average) and the mode (the value that  
20 occurs most often) would have to be the same amount in order for the use of the  
21 average to be appropriate. In other words, an entity would have to suffer exactly

---

<sup>11</sup> Docket No. 38339, Order on Rehearing at Finding of Fact 89, 91 (June 23, 2011).

<sup>12</sup> Exhibit RNH-R-1, Deposition of Chris Roelse at 32-33 (July 5, 2012).

<sup>13</sup> *Id.* at 22.

1 the same amount of loss each year. Such an occurrence is highly improbable if  
2 not impossible. Because actual results are characterized by high points and low  
3 points, an average can only result in an adequate reserve about 50% of the time.  
4 It is, therefore, quite likely that if a utility is forced to rely on an average to  
5 determine future losses and appropriate accruals, the utility will experience  
6 catastrophic losses with no available reserve in one or more years, perhaps even in  
7 sequential years.

8  
9 Oncor is a good example of the fallacy of this methodology. After years of being  
10 forced to reserve on the basis of averages, Oncor found itself with enormous  
11 deficits in its self-insurance reserve of \$146 million in Docket No. 35717 and over  
12 \$250 million in Docket No. 38929.<sup>14</sup> It is striking that the deficit in Oncor's  
13 reserve balance increased dramatically in such a short period of time. In Docket  
14 No. 35717, the Commission granted Oncor approval to include in rates  
15 approximately \$20 million each year for seven years to bring the reserve out of a  
16 deficit position.<sup>15</sup> Oncor was next granted approval in Docket No. 38929 to  
17 include \$31.5 million in rates each year for eight years to make up for the self-  
18 insurance reserve deficit.<sup>16</sup> Similarly, in pending Docket No. 39896, Entergy  
19 Texas, Inc. ("ETP") is requesting accruals necessary to compensate it for a self-  
20 insurance reserve deficit of \$59.8 million.<sup>17</sup> To avoid a similar situation, I have

---

<sup>14</sup> See Docket No. 35717, Proposal for Decision at 104 (June 2, 2009); Docket No. 38929, Order at Finding of Fact 42 (Aug. 26, 2011).

<sup>15</sup> Docket No. 35717, Order on Rehearing at Finding of Fact 101 (Nov. 30, 2009).

<sup>16</sup> Docket No. 38929, Order at Finding of Fact 42 (Aug. 26, 2011).

<sup>17</sup> Docket No. 39896, Direct Testimony of Gregory S. Wilson at 5 (Nov. 28, 2011).

1 recommended that Lone Star include an accrual in rates to reach a target reserve  
2 established at the 75% confidence level. To calculate that level properly, one  
3 must use actuarial techniques rather than averages.

4  
5 Another problem with relying on an average is that it ignores trends and loss  
6 development. Historical loss data for both Oncor and CenterPoint demonstrate  
7 that losses for utilities in Texas have trended sharply upward in both severity and  
8 frequency. In addition, costs have increased exponentially so that the cost to  
9 make repairs for a storm today would be significantly greater than for that same  
10 storm at the time it occurred in the past. Relying on an actuarial study, which  
11 uses sophisticated mathematical techniques to smooth and trend loss data and  
12 relies on thousands of simulations to increase credibility, is far more reliable than  
13 simply adding up a column of observed loss amounts and taking the average.  
14 Using an actuarial study also allows management to more accurately assess future  
15 risk and make informed decisions about how to financially plan for potential  
16 future losses.

**VI. THERE IS NO REQUIREMENT THAT LONE STAR INCLUDE A THRESHOLD IN ITS SELF-INSURANCE PLAN**

**Q. DO YOU AGREE WITH MR. KOLLEN'S AND MR. ROELSE'S SUGGESTIONS THAT LONE STAR SHOULD ESTABLISH A THRESHOLD FOR CHARGES TO ITS SELF-INSURANCE RESERVE?**

**A.** No. Just as PURA and Commission rules do not require established accounting guidelines, there is no requirement that a utility establish a threshold for charges against the reserve. What Messrs. Kollen and Roelse refer to as a "threshold" is known in the risk management and insurance industry as the "attachment point" or the point at which the insurance purchased by the utility begins to pay. That amount is driven by the insurance marketplace for a specific type of asset. Mr. Roelse did not understand the concept, as revealed during his deposition, because he thinks the utility should determine the threshold level over which property losses cannot be reasonably anticipated.<sup>18</sup> When asked during the deposition to describe the kind of criteria he would consider to determine whether a threshold level is appropriate, he stated that he did not "have any particular criteria in mind."<sup>19</sup> When pressed, he noted that determining whether a threshold was appropriate "would all depend on the number of storms and the dollar amount of those storms that [the utility has] experienced."<sup>20</sup>

<sup>18</sup> Exhibit RNH-R-1, Deposition of Chris Roelse at 63 (July 5, 2012).

<sup>19</sup> *Id.* at 64.

<sup>20</sup> *Id.*

1 Unlike a utility with decades of experience operating in Texas, Lone Star is a new  
 2 utility with no current operations. From an insurance standpoint, there is some  
 3 attachment point or threshold at which it becomes efficient to purchase insurance.  
 4 But, for a brand new company such as Lone Star, it is challenging to determine  
 5 that threshold. Mr. Roelse in his deposition seemed to empathize with the  
 6 situation in which Lone Star finds itself, suggesting that relying on another  
 7 utility's historical loss data would "possibly" be sufficient given that Lone Star  
 8 has no assets in service and no historical loss experience.<sup>21</sup> Using a proxy as Ms.  
 9 Camp did, we can establish with reasonable accuracy the level of bulk losses  
 10 Lone Star is likely to experience. But, until the Company has a sufficient number  
 11 of years of experience, even as little as five years experience, it would be difficult  
 12 to determine a dependable threshold level.

13  
 14 **VII. APPLYING LOSSES BELOW DEDUCTIBLE LEVELS FOR**  
 15 **INSURED ASSETS TO THE SELF-INSURANCE RESERVE**  
 16 **IS CONSISTENT WITH COMMISSION PRECEDENT**

17 **Q. DO YOU AGREE WITH MR. POLLOCK'S AND MR. ROELSE'S**  
 18 **ASSERTIONS THAT INCLUDING PAYMENTS FOR DEDUCTIBLES IN**  
 19 **A SELF-INSURANCE ACCRUAL IS INCONSISTENT WITH PURA AND**  
 20 **P.U.C. SUBSTANTIVE RULE 25.231(b)(1)(G)?**

21 **A. No, I do not. Adopting the recommendations of Mr. Pollock and Mr. Roelse**  
 22 **would also be inconsistent with Commission precedent, as I explain below.**

---

<sup>21</sup> *Id.* at 65.

1    **Q.    WHAT DOES PURA STATE?**

2    A.    PURA § 36.064(a) states that:

3           An electric utility may self-insure all or part of the utility's potential  
4           liability or catastrophic property loss...that could not have been  
5           reasonably anticipated and included in operating and maintenance  
6           expenses.  
7

8    **Q.    WHAT DOES P.U.C. SUBSTANTIVE RULE 25.231(b)(1)(G) STATE?**

9    A.    The rule states, in part, that the reserve accounts of a self-insurance plan:

10                   [A]re to be charged with property and liability losses which occur,  
11                   and which could not have been reasonably anticipated and  
12                   included in operating and maintenance expenses, and are not paid  
13                   or reimbursed by commercial insurance.  
14

15   **Q.    BASED ON YOUR READING OF THE STATUTE AND RULE, WHAT**  
16       **MUST BE UNEXPECTED OR UNANTICIPATED TO QUALIFY FOR**  
17       **TREATMENT AS PART OF A SELF-INSURANCE RESERVE?**

18   A.    As I read the statute and rule, a utility may establish a self-insurance reserve to  
19       account for property losses that could not have been reasonably anticipated and  
20       included in the utility's ongoing level of expense and that are not covered by  
21       commercial insurance. Mr. Pollock's focus on the amount of the deductible being  
22       known and therefore capable of being anticipated completely misses the purpose  
23       of a self-insurance reserve and obtaining insurance coverage, in general. While  
24       the *amount* of the deductible may be known, Lone Star cannot reasonably  
25       anticipate when, with what frequency, and to what extent it will suffer property  
26       losses due to an unexpected event. Mr. Pollock agreed in his deposition that Lone  
27       Star cannot predict when a loss will occur or with what frequency losses will

1 occur.<sup>22</sup> Mr. Roelse holds the same opinion—that a utility cannot predict the  
 2 number of losses or the severity of a loss event.<sup>23</sup> For these reasons, payment of a  
 3 deductible cannot be anticipated with certainty.

4  
 5 Applying deductible payments or losses below deductible levels is also consistent  
 6 with the Commission's rule because losses that qualify for self-insurance  
 7 treatment must not be paid or reimbursed by commercial insurance. By their very  
 8 nature, deductibles are, indeed, "deducted" from commercial insurance payments;  
 9 the insured must sustain or incur a loss equal to the deductible in order for the  
 10 insurer to pay the balance of the loss. Thus, Lone Star has reasonably and  
 11 appropriately proposed to charge deductible payments or losses that fall below the  
 12 deductible levels to its self-insurance reserve. Absent the ability to apply the  
 13 costs below deductible levels resulting from unanticipated loss events to the self-  
 14 insurance reserve, Lone Star would have no mechanism for recovering this  
 15 legitimate cost of providing service.

16  
 17 **Q. DO EITHER MR. POLLOCK OR MR. ROELSE UNDERSTAND THE**  
 18 **PURPOSE OF DEDUCTIBLES OR HOW THEY ARE ESTABLISHED?**

19 **A.** No. Contrary to Mr. Pollock's assertion that deductibles are used by insurers to  
 20 "discourage policyholders from making small claims," deductibles are most often  
 21 dictated by pure cost considerations. As such, the policyholder is seldom able to

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<sup>22</sup> Exhibit RNH-R-2, Deposition of Jeffry Pollock at 55 (June 28, 2012).

<sup>23</sup> Exhibit RNH-R-1, Deposition of Chris Roelse at 18 (July 5, 2012).

1 predict the vagaries of the insurance market and must, therefore, be prepared to  
 2 use a risk management technique other than commercial insurance for risk levels  
 3 below the applicable deductible amount. A carefully constructed self-insurance  
 4 program, such as the one for which Lone Star seeks approval, serves such a  
 5 purpose. Mr. Pollock, who has no expertise with insurance issues, would not be  
 6 aware of these basic insurance principles. Instead, he explained in his deposition  
 7 that his inaccurate assertion about deductibles being a tool to discourage policy  
 8 holders from making small claims is based on his general understanding of  
 9 economics.<sup>24</sup>

10  
 11 **Q. MR. POLLOCK CONCLUDES THAT “INSURANCE DEDUCTIBLES**  
 12 **ARE NOT THE TYPE OF COSTS THAT ARE CONTEMPLATED FOR**  
 13 **SELF-INSURANCE, AND SHOULD INSTEAD BE EXPENSED UPON**  
 14 **OCCURRENCE.” IS HE CORRECT?**

15 **A.** No. Mr. Pollock noted in his deposition that he based this assertion on the  
 16 Commission rule, which he believes states that the self-insurance reserve is for  
 17 properties for which commercial insurance is not available.<sup>25</sup> Mr. Pollock has  
 18 chosen to ignore the portion of P.U.C. Substantive Rule 25.231(b)(1)(G) that  
 19 states that a self-insurance reserve may be charged with property losses that could  
 20 not have been reasonably anticipated and included in O&M expenses, *and are not*  
 21 *paid or reimbursed by commercial insurance.* As I noted previously, deductibles

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<sup>24</sup> Exhibit RNH-R-2, Deposition of Jeffry Pollock at 56 (June 28, 2012).

<sup>25</sup> *Id.*

1 by their very nature are not paid or reimbursed by commercial insurance.  
2 Therefore, Lone Star appropriately intends to apply deductible payments or losses  
3 below the deductible levels to the self-insurance reserve.  
4

5 **Q. HAS THE COMMISSION APPROVED A UTILITY'S PLAN TO**  
6 **INCLUDE DEDUCTIBLE PAYMENTS OR LOSSES BELOW**  
7 **DEDUCTIBLES IN A SELF-INSURANCE RESERVE?**

8 A. Yes, the Commission has approved Oncor's plan to include deductible payments  
9 and losses below the deductible level in its self-insurance reserve. Clearly, Mr.  
10 Pollock and Mr. Roelse are unaware of this precedent (even though Mr. Roelse  
11 relies on it in his testimony) because they each testify that Lone Star's proposal to  
12 include deductible payments or losses below deductible levels should not be  
13 included in a self-insurance plan.  
14

15 **Q. PLEASE DESCRIBE THE COMMISSION PRECEDENT THAT**  
16 **SUPPORTS LONE STAR'S REQUEST TO INCLUDE DEDUCTIBLE**  
17 **PAYMENTS AND LOSSES BELOW DEDUCTIBLE LEVELS IN A SELF-**  
18 **INSURANCE RESERVE.**

19 A. In Docket No. 22350, the Commission approved the self-insurance plan and  
20 associated accruals for Oncor's predecessor company (TXU Electric Company or  
21 "TXU"). TXU's witnesses explained that the self-insured losses for which it  
22 sought recovery through a reserve were losses resulting from occurrences of at

1       least \$500,000 up to the applicable commercial insurance deductibles.<sup>26</sup> The  
2       witness explained that “[t]he purpose of a self-insurance reserve is to provide for  
3       losses in the self-insurance layer (that is, that portion of the loss from an  
4       occurrence that results in a loss of at least \$500,000 and that lies below the  
5       applicable deductible of [commercial insurance]). Each year, an amount of  
6       money would be accrued in the self-insurance reserve to provide for the expected  
7       level” of losses in this layer for each year.<sup>27</sup> Another witness for TXU testified  
8       that the utility’s request to include these losses in the self-insured layer would  
9       continue the self-insurance reserve previously approved by the Commission in  
10      Docket No. 11735.<sup>28</sup> The Commission approved TXU’s self-insurance plan, its  
11      requested accrual, and found that the “self-insurance reserve covers property  
12      losses in excess of \$500,000 but less than large losses against which TXU  
13      purchases commercial insurance.”<sup>29</sup> This precedent was presented to Mr. Roelse  
14      during his deposition during which he admitted that he was not aware of any  
15      Texas utility that charged losses below deductible levels to a self-insurance  
16      reserve.<sup>30</sup> Upon examining the TXU testimony and order, Mr. Roelse agreed that  
17      the Commission approved TXU’s proposal to apply to its self-insurance reserve  
18      losses below a commercial insurance deductible of \$2 million for liability and  
19      property damage.<sup>31</sup>

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<sup>26</sup> Docket No. 22350, Direct Testimony of Charles L. McClenahan at 5 (Mar. 31, 2000).

<sup>27</sup> *Id.*

<sup>28</sup> Docket No. 22350, Amended Direct Testimony of T.M. Williams at 8 (Aug. 28, 2000).

<sup>29</sup> Docket No. 22350, Order at Finding of Fact 33 (Oct. 4, 2001).

<sup>30</sup> Exhibit RNH-R-1, Deposition of Chris Roelse at 42 (July 5, 2012).

<sup>31</sup> *Id.* at 44, 46, 48-56.

1 In Oncor's next rate case, Docket No. 35717, it sought to continue the same self-  
 2 insurance treatment for losses below deductible levels. I testified that Oncor's  
 3 property and liability insurance coverage included using "an internal, self-  
 4 insurance reserve to cover insurable property loss occurrences of \$500,000 to  
 5 \$2,000,000 and liability loss occurrences of \$500,000 to \$3,000,000" where  
 6 commercial insurance would apply for insurance property losses over \$2 million  
 7 and liability losses over \$3 million.<sup>32</sup> As it did in Docket No. 22350, the  
 8 Commission approved Oncor's requested self-insurance plan.<sup>33</sup> In his deposition,  
 9 Mr. Roelse agreed that the Commission approved Oncor's plan.<sup>34</sup>

10  
 11 Lone Star's proposal is no different than the one the Commission approved for  
 12 Oncor. Lone Star requests an accrual amount sufficient to account for unexpected  
 13 property losses up to the applicable deductible levels for its insured assets.

14  
 15 **Q. WHY SHOULD THE COMPANY BE PERMITTED TO APPLY**  
 16 **DEDUCTIBLE PAYMENTS TO THE SELF-INSURANCE RESERVE?**

17 **A.** The Company should be permitted to charge deductible payments and losses  
 18 below deductible levels to the reserve because doing so is consistent with  
 19 Commission precedent and the payment of deductibles results from unexpected  
 20 property loss events. While a deductible represents a "known" amount an insured

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<sup>32</sup> Docket No. 35717, Direct Testimony of Robert N. Hughes at 5 (June 27, 2008).

<sup>33</sup> Docket No. 35717, Order on Rehearing at Finding Fact 98, Conclusion of Law 18 (Nov. 30, 2009).

<sup>34</sup> Exhibit RNH-R-1, Deposition of Chris Roelse at 61 (July 5, 2012).

1       entity must pay, *whether* the insured will ever have to pay a deductible is not  
2       known.

3

4                   **VIII. THE ACTUARIAL ANALYSIS APPROPRIATELY**  
5                   **ADDRESSED THE SIZE OF ONCOR VERSUS**  
6                   **THE SIZE OF LONE STAR**

7    **Q.     BASED ON MR. ROELSE'S COMPARISON OF THE SIZE OF ONCOR'S**  
8           **AND LONE STAR'S TRANSMISSION SYSTEMS, HE CLAIMS THAT**  
9           **LONE STAR'S SYSTEM "IS AT MUCH LESS RISK FOR**  
10          **CATASTROPHIC TRANSMISSION PROPERTY LOSSES" THAN**  
11          **ONCOR'S SYSTEM. IS HE CORRECT?**

12   **A.**    No. In fact, the opposite is the case. The proper calculation of a reserve for  
13           losses of any kind does not bear a direct correlation to total amounts at risk. For  
14           instance, a company owning one \$1 million building would be prudent to reserve  
15           for the loss of that building, *i.e.*, \$1 million. On the other hand, a company  
16           owning fifty \$1 million buildings might find that, due to dispersion and other  
17           factors, its risk of property damage or loss is also only \$1 million. That does not  
18           mean, however, that the smaller company should and could only reserve for 1/50<sup>th</sup>  
19           of \$1 million when compared to the company owning 50 buildings. The proper  
20           result would be that both companies maintain a reserve of \$1 million due to the  
21           unique circumstances of each company. The same logic is true for Lone Star as

1 compared to Oncor. These principles prove that Mr. Roelse's assertion, which he  
2 says is based on "common sense," is not accurate.<sup>35</sup>

3

4 **Q. SO, DO YOU AGREE WITH MR. POLLOCK THAT ONCOR IS NOT A**  
5 **REASONABLE PROXY BECAUSE IT HAS MORE INVESTMENT AT**  
6 **RISK THAN LONE STAR?**

7 A. No. When attempting to establish a credible self-insurance reserve, data is  
8 paramount. One of the principal elements of the calculations is the "law of large  
9 numbers," meaning that the larger the number of observations, the more credible  
10 the result will be.<sup>36</sup> Having a proxy the size of Oncor for insurance purposes is, in  
11 fact, a great advantage to smaller, start-up utilities such as Lone Star. Because  
12 Oncor's historical transmission loss experience is based on a large exposure base,  
13 the data is more credible than relying on a smaller entity's operating history as a  
14 proxy for Lone Star. Just as the observation of state-wide exposures and losses  
15 for automobiles produces credible rates and premiums for the individual, the same  
16 holds true for the situation Lone Star faces. The large data base available through  
17 Oncor's experience provides an appropriate source of information for analyzing  
18 Lone Star's risk of loss. Moreover, the actuarial analysis Ms. Camp conducted  
19 accounts for the difference in size between Lone Star's investment and Oncor's  
20 investment through the reduced expected number of claims for Lone Star.

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<sup>35</sup> Exhibit RNH-R-1, Deposition of Chris Roelse at 61 (July 5, 2012).

<sup>36</sup> See Principles of Insurance, Mehr and Cammack, Richard D. Irwin, Inc., 1972, pg. 33, "The greater the number of exposures, the more nearly will the actual results obtained approach the probably result expected with an infinite number of exposures."

1 I would also like to point out that Mr. Pollock offers Exhibit JP-5 as a comparison  
2 between Lone Star's and Oncor's transmission facilities in an effort to support his  
3 argument that the size of each utility's operations is not comparable. His exhibit  
4 does not compare like data, however. The 15,341 miles of transmission lines he  
5 shows for Oncor are circuit miles of line.<sup>37</sup> The 320 miles of transmission lines  
6 on JP-5 for Lone Star are not circuit miles. Lone Star will own 640 circuit miles  
7 of transmission lines.

8  
9 **Q. MESSRS. POLLOCK AND ROELSE ASSERT THAT THE RESULTS OF**  
10 **THE ACTUARIAL ANALYSIS FOR LONE STAR'S TRANSMISSION**  
11 **LINE ARE OVERSTATED BASED ON THE USE OF ONCOR**  
12 **HISTORICAL LOSS DATA. IS THIS ACCURATE?**

13 **A.** No. First, as I just discussed, the use of a data pool the size of Oncor's lends  
14 credibility and accuracy to the actuarial analysis for Lone Star. Second, as Ms.  
15 Camp explains in her rebuttal testimony, she included an additional \$500,000 in  
16 each of Oncor's reported transmission losses to determine Lone Star's annual  
17 mean losses and associated accrual amounts. This approach is reasonable because  
18 it allows Lone Star to request accruals necessary to establish a reserve at the 75%  
19 confidence level to prepare for future losses. As I noted previously, utilities that  
20 have not accrued sufficient amounts towards self-insurance reserves have faced  
21 significant deficits in their reserve accounts, which must be paid for later. If this

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<sup>37</sup> Docket No. 38929, Direct Testimony of Wesley Speed at 7 (Jan. 7, 2011).

occurs, future Lone Star customers would have to pay accruals through rates that should be the responsibility of today's customers. Avoiding a deficit balance in its self-insurance reserve should be a priority for a new utility such as Lone Star.

**IX. COMPARING LONE STAR'S REQUESTED ACCRUALS TO  
THE ACCRUALS OF OTHER UTILITIES IS NOT  
RELEVANT TO DETERMINING THE REASONABLENESS  
OF LONE STAR'S REQUEST**

**Q. MR. POLLOCK CONCLUDES THAT LONE STAR'S PROPOSED SELF-INSURANCE ACCRUALS ARE SUBSTANTIALLY HIGHER THAN OTHER TEXAS UTILITIES. HAVE YOU IDENTIFIED ANY FLAWS IN MR. POLLOCK'S ANALYSIS?**

**A.** Yes. Mr. Pollock bases his assertion on the ratio of a utility's property insurance expense compared to its ending plant balance as shown in Exhibit JP-6. The first problem with Mr. Pollock's analysis is the total plant balances include Transmission, Distribution, and General Plant. Lone Star has no distribution facilities whereas the other utilities Mr. Pollock identifies, AEP TNC, Oncor, and TNMP, do operate both distribution and transmission facilities. In fact, the work papers Mr. Pollock provided with Exhibit JP-6 show that the comparison utilities' plant assets consist of the following amounts of plant by type:

Utility	% Transmission	% Distribution	% General Plant
AEP TNC	40%	53%	7%
Oncor	31%	67%	3%
TNMP	18%	78%	4%

1 Distribution assets make up the majority of each of the comparison utilities' plant  
2 balances. Because Lone Star has only transmission facilities and no distribution  
3 facilities, the denominator in Mr. Pollock's calculations is unfairly skewed against  
4 Lone Star. Certainly, each of the three comparison utilities incurs some type of  
5 insurance expense for its distribution and general plant assets. Yet, Mr. Pollock  
6 pretends that the components of the utilities' plant investment are irrelevant for  
7 purposes of his analysis when that is simply not true.

8  
9 Mr. Pollock failed to provide a similar break out by property type for the utilities'  
10 insurance expense. In his deposition, Mr. Pollock explained that he did not know  
11 what portion of the other utilities' insurance expense was associated with a  
12 specific type of asset.<sup>38</sup> It is essential to have a breakout of insurance expense by  
13 the type of asset to fully analyze Mr. Pollock's comparison of Lone Star to  
14 utilities that operate transmission and distribution facilities. Even without that  
15 crucial data, I know that a utility incurs insurance expense in direct proportion to  
16 the value of the assets the utility seeks to insure. Given that a majority of the  
17 value of the comparison utilities' facilities are associated with distribution plant, it  
18 is reasonable to conclude that the majority of insurance expense for the other  
19 utilities is associated with a type of asset that Lone Star will not operate. For  
20 these reasons, Exhibit JP-6 should be rejected because the data is neither  
21 transparent, reasonable, nor comparable to Lone Star's transmission-only  
22 operations.

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<sup>38</sup> Exhibit RNH-R-2, Deposition of Jeffrey Pollock at 53 (June 28, 2012).

1    **Q.    ARE THERE OTHER ASPECTS OF MR. POLLOCK'S EXHIBIT JP-6**  
2           **THAT RENDER IT INADEQUATE FOR PURPOSES OF ANALYZING**  
3           **LONE STAR'S REQUESTED INSURANCE ACCRUAL?**

4    **A.    Yes. Another major problem is that the exhibit presents a five-year average of**  
5           **property insurance expense and ending plant balances for AEP TNC, Oncor, and**  
6           **TNMP. Yet, for Lone Star, Mr. Pollock relies on one or two years of data—Test**  
7           **Year data and Phase I and Phase II. Thus, this comparison between the average**  
8           **expenses of the other utilities and the property insurance expense of Lone Star**  
9           **does not compare like data sets. Again, Mr. Pollock's approach inaccurately**  
10          **skews the data against Lone Star.**

11

12          The other problem with Exhibit JP-6 is that the use of only five years of data  
13          ignores the valid and traditional technique used by some experts of reserving for a  
14          25-year or 50-year loss, which means preparing for the type of unexpected  
15          damage that occurs once every 25 or 50 years. This technique was used by  
16          Gregory Wilson in his development of the target reserve for CenterPoint in  
17          Docket No. 38339, which the Commission approved.<sup>39</sup>

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<sup>39</sup> Docket No. 38339, Direct Testimony of Gregory S. Wilson at 10 (June 30, 2010).

1    **Q.    ARE THERE OTHER REASONS WHY MR. POLLOCK'S COMPARISON**  
2           **OF LONE STAR'S PROPERTY INSURANCE EXPENSE TO THAT OF**  
3           **OTHER UTILITIES IS UNCONVINCING?**

4    A.    Yes, it is inappropriate to compare the early accrual elements of a start-up or new  
5           utility such as Lone Star with the annual risk and insurance costs for a utility with  
6           long-standing operations such as AEP TNC, Oncor, or TNMP. On the one hand,  
7           the more mature operation could already have fully accrued its target reserve, in  
8           which case the costs would appear to be much lower. At the opposite end of the  
9           scale, the more mature company could have millions of dollars of under-accrued  
10          costs that are being amortized (as in the case of Oncor), which creates an unfair  
11          comparison between the purpose for the accruals.

12

13   **Q.    MR. POLLOCK ASSERTS THAT LONE STAR'S SELF-INSURANCE**  
14           **PLAN SHOULD EITHER BE REJECTED ENTIRELY OR, IF**  
15           **APPROVED, THE ACCRUAL SHOULD BE NO HIGHER THAN THE**  
16           **AVERAGE RATIO OF CERTAIN OTHER TEXAS UTILITIES,**  
17           **RESULTING IN AN ESTIMATED ACCRUAL OF \$722,000. IS A \$722,000**  
18           **ACCRUAL APPROPRIATE FOR LONE STAR?**

19   A.    No. As previously explained, the recommended accrual for which Lone Star  
20           seeks approval is an annual amount that will be collected through either Phase I or  
21           Phase II rates with the aim of accumulating a target reserve in the amount of  
22           \$7,076,193. The requested target reserve amount is set at the 75% confidence  
23           level. Based on the recommended target reserve amount, an accrual of \$722,000

would be appropriate only if Lone Star could guarantee that it would suffer no unexpected losses for 10 years, thus accumulating a reserve of \$7,220,000, which is comparable to my recommendation in this case.

Mr. Pollock's approach would be entirely contrary to the purpose of the self-insurance reserve, which should be sufficient to prepare Lone Star for losses that could occur in any given year. Based on Ms. Camp's actuarial analysis, an accrual of \$722,000 would be sufficient to cover losses only:

- 33% of the time for Phase I; and
- 14% of the time for Phase II.

Mr. Pollock admitted in his deposition that he had performed no analysis of what the correct confidence level should be for Lone Star's accruals.<sup>40</sup> That idea that Lone Star would accrue only \$722,000 annually for a self-insurance reserve illustrates his inexperience with assessing an appropriate accrual amount.

**Q. MR. KOLLEN ALSO COMPARES LONE STAR'S REQUEST TO OTHER UTILITIES. HOW DO YOU RESPOND TO MR. KOLLEN'S ANALYSIS OF LONE STAR'S REQUEST TO THE COMMISSION'S RECENT DECISION FOR ONCOR IN DOCKET NO. 38929?**

**A.** There are several issues with Mr. Kollen's analysis that deem it fundamentally flawed for purposes of analyzing Lone Star's plan. First, Mr. Kollen misstates or misunderstands the basis for Lone Star's request in this case. Oncor's accrual and

<sup>40</sup> Exhibit RNH-R-2, Deposition of Jeffrey Pollock at 47 (June 28, 2012).

1 self-insurance request in Docket No. 38929 relate in no way to Lone Star's  
2 requested accruals in this case. Instead, Ms. Camp relied on Oncor's loss history  
3 to predict Lone Star's risk of loss. Second, unlike Oncor, Lone Star, is  
4 requesting accruals to reach a target reserve set at the 75% confidence level.  
5 Lone Star's requested accruals are appropriate for a new utility with no existing  
6 reserve that needs to avoid a deficit in its self-insurance reserve. Therefore, Mr.  
7 Kollen's comparison to the Commission's decision for Oncor is irrelevant for  
8 assessing the reasonableness of Lone Star's requested accruals.

9  
10 **Q. MR. KOLLEN ASSERTS THAT, BASED ON ONCOR'S ACCRUAL**  
11 **LEVELS APPROVED IN DOCKET NO. 38929 COMPARED TO ITS**  
12 **TOTAL TRANSMISSION PLANT, LONE STAR'S PHASE I ACCRUAL**  
13 **SHOULD BE \$16,000 AND PHASE II ACCRUAL SHOULD BE \$234,000.**  
14 **ARE THESE APPROPRIATE ACCRUAL AMOUNTS FOR LONE STAR?**

15 **A.** No. Mr. Kollen's comparison of using a percentage of gross plant is  
16 inappropriate and attempts to substitute subjective probability (assumptions based  
17 upon a person's beliefs and/or prejudices) for sound actuarial and risk  
18 management science. The proper calculation of a reserve for losses of any kind  
19 does not bear a direct correlation to total amounts of investment at risk.  
20 Moreover, as I noted in response to Mr. Pollock's suggestion that a \$722,000  
21 accrual might be appropriate, the \$16,000 and \$234,000 amounts Mr. Kollen  
22 identifies are wholly inadequate to prepare the Company for the risks of loss it  
23 faces as calculated by Ms. Camp's actuarial analysis.

1 Q. AS HE DID WITH ONCOR, MR. KOLLEN ALSO COMPARES LONE  
2 STAR'S PROPOSED SELF-INSURANCE REQUEST TO THAT OF  
3 CENTERPOINT. IS THE COMPARISON TO CENTERPOINT  
4 APPROPRIATE?

5 A. No. The CenterPoint comparison is flawed for the same reasons the Oncor  
6 comparison fails. Mr. Kollen's comparison of using a percentage of gross plant,  
7 again, is inappropriate and attempts to substitute subjective probability for sound  
8 actuarial and risk management science  
9

10 Q. MR. KOLLEN ASSERTS THAT BASED ON CENTERPOINT'S  
11 ACCRUAL LEVELS, LONE STAR'S PHASE I ACCRUAL SHOULD BE  
12 \$11,000 AND ITS PHASE II ACCRUAL SHOULD BE \$156,000. ARE  
13 THESE APPROPRIATE ACCRUAL AMOUNTS FOR LONE STAR?

14 A. No. For the same reasons an accrual of \$722,000 as suggested by Mr. Pollock  
15 would not be appropriate, accruals even less than that amount are wholly  
16 insufficient to adequately prepare Lone Star to plan for the risk of unexpected  
17 property damage to its assets. An accrual of either \$11,000 or \$156,000 would be  
18 adequate less than 10% of the time for Phase I or Phase II as illustrated by Ms.  
19 Camp's actuarial analysis. Moreover, as I explained above with regard to the  
20 comparisons to Oncor, this calculation based upon the ratio of property losses to  
21 total transmission asset base as it relates to CenterPoint is also inappropriate.

**X. AN ACCRUAL FOR PHASE II SHOULD BE APPROVED**  
**IN THIS CASE**

**Q. HOW DO YOU RESPOND TO MR. POLLOCK'S ALLEGATION THAT LONE STAR'S PROPOSED RESERVE FOR PHASE II FACILITIES IS NOT A KNOWN AND MEASURABLE CHANGE?**

**A.** I think Mr. Pollock is referring to the fact that, traditionally, the Commission sets rates for a utility based on the costs the utility incurs during a historical test year. As I understand it, those costs can be adjusted for "known and measurable changes" as necessary to reflect the operating conditions the utility expects will be in place at the time new rates are implemented. He seems to take issue with the fact that Lone Star has no operating history and no actual losses and then concludes that the annual Phase II accrual is not known.

Lone Star, as a new entrant to the Texas market, is not yet operating facilities and is following the parties' settlement processing agreement for purposes of presenting its case. This means that Lone Star's test year does not include operation of all of its facilities, and Lone Star has no actual loss history for its Phase I and Phase II assets. Nevertheless, based on Ms. Camp's actuarial analysis, the amount of the annual accrual is known and measurable for purposes of including an accrual in Lone Star's Phase II rates. Relying on data from a proxy utility, adjusted to account for certain Lone Star-specific variables, Ms. Camp has calculated an accrual for Phase II. In addition, no witness in this case has offered a comparable actuarial analysis or similar simulation that can

1 accurately predict Lone Star's risk of loss the way Ms. Camp has calculated Lone  
2 Star's risk of loss.

3  
4 Even in a rate case for a utility with long-standing operations in Texas, a self-  
5 insurance accrual is never an amount based solely on historical, incurred costs of  
6 the utility. Instead, in a case involving a utility with existing operations, Ms.  
7 Camp would analyze the actual loss history of the utility itself to determine  
8 expected future property losses or damage, and I would recommend an accrual  
9 adequate to allow the utility to create a reserve sufficient to cover expected losses.  
10 The recommended accrual, therefore, is always an estimate of some sort. As Ms.  
11 Camp and I explain, the most accurate and sound way to measure that future  
12 accrual is through an actuarial analysis. The amount of Lone Star's annual  
13 accrual is known based on Ms. Camp's actuarial analysis, which takes into  
14 account the amount of assets Lone Star will be operating and expected property  
15 losses to those assets. Therefore, Mr. Pollock's criticism is unfounded.

1    **Q.   MR. POLLOCK ALSO CLAIMS THAT IT IS PREMATURE AND**  
2       **INCONSISTENT WITH THE COMMISSION'S RULES TO ALLOW ANY**  
3       **SELF-INSURANCE   ACCRUAL   BECAUSE   THE   TEST   YEAR**  
4       **FACILITIES ARE INSURED AND THE PHASE II FACILITIES ARE**  
5       **NOT INCLUDED IN RATE BASE IN THIS CASE.  HOW DO YOU**  
6       **RESPOND TO MR. POLLOCK'S ASSERTION?**

7    A.   First, any focus on "Test Year facilities" is improper and reveals Mr. Pollock's  
8       lack of understanding regarding when the Company intends to place its facilities  
9       in service.  The Company's facilities were not in service during the test year.  
10      Phase I assets will be in service beginning in October 2012.  Lone Star's Phase I  
11      facilities are commercially insured, and Phase II facilities, which include all of the  
12      Company's assets, would be insured through a combination of commercial and  
13      self-insurance.  Second, Lone Star's request for an accrual for the Phase I  
14      facilities is consistent with Commission precedent, as I have discussed, and  
15      should be approved.

16  
17      Finally, for the Phase II assets, it is my understanding that, even though the  
18      Company has agreed not to seek recovery of capital costs incurred after March 31,  
19      2012, in this case, which is addressed by Company witnesses Michael G. Grable  
20      and David K. Turner in their amended direct testimonies, Lone Star is requesting  
21      that the Commission establish the level of O&M expense that will ultimately be  
22      included in Phase II rates.  Thus, the Company is requesting approval of its Phase  
23      II accrual for the self-insurance reserve so that amount can be included in the

1 level of expense to be recovered as part of its Phase II rates. In fact, as I have  
2 addressed throughout this testimony, it would be unreasonable for Lone Star to  
3 commence operation of its Phase II facilities *without* a self-insurance reserve.  
4 Therefore, it is entirely appropriate and prudent for the Company to request a self-  
5 insurance accrual as part of its Phase II rates.

6  
7 **XI. INTERVENOR AND STAFF RECOMMENDATIONS**  
8 **FOR AN ACCRUAL OF \$0 ARE UNREASONABLE**

9 **Q. MESSRS. KOLLEN, POLLOCK, AND ROELSE RECOMMEND AN**  
10 **ACCRUAL OF \$0 FOR LONE STAR. IS THAT AN APPROPRIATE**  
11 **ACCRUAL AMOUNT?**

12 No. As I have noted throughout this testimony, an annual accrual of \$0 is not  
13 appropriate because:

14 (1) Lone Star is unable to commercially insure all of its assets and must  
15 therefore rely on self-insurance.

16  
17 (2) The self-insurance reserve and associated accruals Lone Star is  
18 requesting are consistent with PURA § 36.064 and P.U.C. Rule  
19 25.231(b)(1)(G).

20  
21 (3) Commission precedent supports Lone Star's requested reserve and  
22 accruals.

23  
24 (4) An accrual of \$0 is not supported by any analysis and is inconsistent  
25 with the actuarial analysis performed for Lone Star.

1 Q. IF THE COMMISSION APPROVED AN ACCRUAL OF \$0 AS  
2 ADVOCATED BY THE INTERVENORS AND STAFF, WOULD LONE  
3 STAR BE AN OUTLIER AMONG TRANSMISSION SERVICE  
4 PROVIDERS ("TSPs")?

5 A. Yes. Mr. Roelse addresses this issue in his testimony and notes that certain  
6 regulated TSPs that operate self-insurance reserves also operate distribution  
7 facilities. In his deposition, Mr. Roelse admitted that each of the TSPs he  
8 identifies has been granted approval by the Commission to self-insure its  
9 transmission assets—which is the same treatment Lone Star requests in this  
10 case.<sup>41</sup> In fact, if the Commission adopted Mr. Roelse's position that Lone Star  
11 should not establish a reserve or do so with an accrual of \$0, Lone Star would be  
12 an outlier compared to other utilities that operate transmission assets. There is no  
13 reason to treat Lone Star differently than any other TSP.

14  
15 Q. IF THE COMMISSION ADOPTS THE INTERVENOR AND STAFF  
16 RECOMMENDATIONS FOR AN ACCRUAL OF \$0 AND LONE STAR  
17 EXPERIENCES UNANTICIPATED LOSSES, WHAT WILL HAPPEN TO  
18 THE RESERVE BALANCE?

19 A. If Lone Star has no amounts accrued in a reserve account, the self-insurance  
20 reserve will fall into a deficit position because there will be a shortage of accruals  
21 to the reserve as Lone Star experiences unanticipated property losses in the future.

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<sup>41</sup> See Exhibit RNH-R-1, Deposition of Chris Roelse at 71 (July 5, 2012).

1 If that occurs, PURA § 36.064(d) and (e) require that any shortage in a self-  
2 insurance reserve account be added to the utility's rate base in a future case.

3  
4 The Intervenor and Staff are offering a short-sighted approach that would require  
5 future Lone Star customers to pay accruals through rates necessary to compensate  
6 the Company for unexpected loss events that should be the responsibility of  
7 today's customers. This situation would also force Lone Star—like Oncor and  
8 ETI—to request accruals in a subsequent case sufficient to pull the reserve out of  
9 a deficit position and to prepare for future losses. Again, that approach will cost  
10 customers more than adopting the recommendations I am making in this case.

11  
12 **Q. DO THE INTERVENOR AND STAFF WITNESSES ACKNOWLEDGE**  
13 **THAT AN ACCRUAL OF \$0 COULD PUSH LONE STAR'S RESERVE**  
14 **INTO A DEFICIT?**

15 **A.** Yes, but they do not seem to appreciate all the implications of that issue. In his  
16 deposition, Mr. Roelse agreed that if Lone Star includes no self-insurance accrual  
17 in its rates, Lone Star would end up with a shortage in its reserve.<sup>42</sup> Mr. Roelse  
18 also explained while being deposed that his goal is to consider the public interest  
19 when making recommendations on behalf of the Commission, and he understands  
20 that to mean making sure the self-insurance reserve is appropriate.<sup>43</sup> Yet, Mr.  
21 Roelse's recommendation would leave Lone Star unprepared financially for

---

<sup>42</sup> *Id.* at 97.

<sup>43</sup> *Id.* at 15-16.

1 future losses and would push costs that today's customers should incur onto future  
2 generations of Lone Star's customers. This concept of generational inequities  
3 among customers is not something Mr. Roelse understood as stated in his  
4 deposition.<sup>44</sup> Creating such inequities is not consistent with the public interest.

5  
6 Mr. Pollock also acknowledged in his deposition that if Lone Star's reserve  
7 balance is \$0 and it experiences unexpected losses, the subsequent reserve deficit  
8 can be added to Lone Star's rate base in a future case.<sup>45</sup> If this occurs, the deficit  
9 would be included in rate base and the utility would earn a return on it.

10  
11 The Intervenor and Staff witnesses seem to blindly accept these consequences—  
12 financial and otherwise—for Lone Star without appreciating their negative  
13 implications. This approach is more expensive than adopting the  
14 recommendations I offer in this case. An accrual of \$0 would unnecessarily  
15 increase the utility's rate base in a future case when that scenario could be  
16 avoided with sufficient accruals approved in this docket.

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<sup>44</sup> *Id.* at 19.

<sup>45</sup> Exhibit RNH-R-2, Deposition of Jeffry Pollock at 57 (June 28, 2012).

**XII. RELYING ON RESERVE ACCOUNTING RATHER  
THAN A SELF-INSURANCE RESERVE IS NOT CONSISTENT  
WITH COMMISSION POLICY OR PRECEDENT**

**Q. MR. KOLLEN RECOMMENDS THAT THE COMMISSION COULD  
AUTHORIZE LONE STAR TO RELY ON RESERVE ACCOUNTING IN  
THE EVENT OF A STORM. HOW DO YOU RESPOND TO THIS  
PROPOSAL?**

**A.** Mr. Kollen's proposal to rely on reserve accounting and preserve as a regulatory asset any costs that would have been charged to a self-insurance reserve is unreasonable and inconsistent with the Commission's established policy of creating a self-insurance reserve as a tool for planning for and accounting for unanticipated losses to utility assets. Requiring Lone Star to operate its assets without a self-insurance accrual would be inconsistent with the operations of other Texas utilities, which have Commission-approved self-insurance reserves and accruals.

In his deposition, Mr. Kollen attempted to explain the basis for his reserve accounting approach. Mr. Kollen noted that, if the Commission approves the creation of a self-insurance reserve with an accrual of \$0, any unexpected property losses would go into the reserve rather than be expensed, and the Commission could provide recovery of the necessary costs in a subsequent case.<sup>46</sup>

Mr. Kollen asserted that his approach is consistent with what the Commission

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<sup>46</sup> Exhibit RNH-R-3, Deposition of Lane Kollen at 60 (June 27, 2012).

1 does for other utilities such as Oncor and CenterPoint.<sup>47</sup> This is not accurate.  
 2 Both Oncor and CenterPoint, as evidenced by the Commission's orders in Docket  
 3 Nos. 35717 and 38929 for Oncor and Docket No. 38339 for CenterPoint, have  
 4 authorized self-insurance accruals that will accumulate in a reserve account.  
 5 Having an established reserve with a specific accrual collected through rates is  
 6 fundamentally different than reserve accounting, which would force Lone Star to  
 7 make no accrual for self-insurance and seek an order from the Commission every  
 8 time it wanted to include the costs of unexpected property damage in rates.

9  
 10 **Q. ARE THERE ANY OTHER DRAWBACKS TO MR. KOLLEN'S**  
 11 **RESERVE ACCOUNTING RECOMMENDATION?**

12 **A.** Yes. Mr. Kollen's recommendation to forego a self-insurance reserve would  
 13 result in rate instability. If Lone Star had to request and obtain an accounting  
 14 order from the Commission each time it experienced an unexpected loss to its  
 15 property, its rates would fluctuate every time the accounting order and request to  
 16 recover costs was approved. Rather than create such an inconsistent and unstable  
 17 rate situation, the Commission should approve Lone Star's request to establish a  
 18 self-insurance reserve with a consistent accrual amount to allow for rate stability  
 19 for Lone Star's customers.

20  
 21 The use of a self-insurance reserve as contemplated in PURA also provides  
 22 historical balance and rate equity with respect to current and future customers.

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<sup>47</sup> *Id.* at 60-63.

1 Relying on reserve accounting places the burden of uninsured losses upon future  
2 customers who may be paying during years when there are fewer (or no) losses,  
3 whereas the use of a self-insurance reserve spreads the effect of catastrophic  
4 losses over the relevant time period. This produces a more equitable result for  
5 customers.

6

7 **Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?**

8 **A.** Yes, it does.

STATE OF FLORIDA

§  
§  
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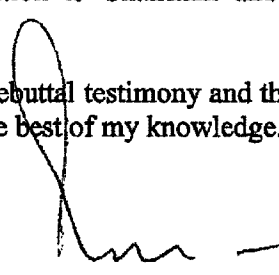
COUNTY OF PALM BEACH

**AFFIDAVIT OF ROBERT N. HUGHES**

BEFORE ME, the undersigned authority, on this day personally appeared Robert N. Hughes, who, having been placed under oath by me, did depose as follows:

1. "My name is Robert N. Hughes. I am of sound mind and capable of making this affidavit. The facts stated herein are true and correct based upon my personal knowledge. My current position is Chairman and CEO of Robert Hughes Associates, Inc.
2. I have prepared the foregoing rebuttal testimony and the attached exhibits offered by me are true and correct to the best of my knowledge."

Further affiant sayeth not.

  
\_\_\_\_\_  
Robert N. Hughes

SUBSCRIBED AND SWORN TO BEFORE ME by the said Robert N. Hughes this  
11<sup>th</sup> day of July 2012.

  
\_\_\_\_\_  
Notary Public, State of Florida



1 SOAH DOCKET NO. 473-12-4133

2 PUC DOCKET NO. 40020

3  
4 APPLICATION OF LONE STAR ) STATE OFFICE OF  
5 TRANSMISSION, LLC FOR )  
6 AUTHORITY TO ESTABLISH )  
7 INTERIM AND FINAL RATES )  
8 AND TARIFFS ) ADMINISTRATIVE HEARINGS  
9  
10

11 ORAL DEPOSITION

12 CHRIS ROELSE

13 Thursday, July 5, 2012  
14

15 ORAL DEPOSITION OF CHRIS ROELSE, produced as a  
16 witness at the instance of Lone Star Transmission, LLC,  
17 and duly sworn, was taken in the above-styled and  
18 numbered cause on Thursday, July 5, 2012, from  
19 10:06 a.m. to 12:15 p.m., before Lou Ray, Certified  
20 Shorthand Reporter in and for the State of Texas,  
21 reported by computerized stenotype machine at the  
22 offices of Parsley, Coffin, Renner, LLP, 98 San Jacinto,  
23 Suite 1450, Austin, Texas 78701, pursuant to the Texas  
24 Rules of Civil Procedure.  
25

1 Q Did you work with any insurance issues at  
2 Applied Materials?

3 A No, ma'am.

4 Q Okay. And what about Accretech USA? Did  
5 you -- were you responsible for any insurance issues  
6 there?

7 A No, ma'am.

8 Q Okay. Do you have any training or expertise  
9 with insurance issues?

10 A No, just what I've gained at the Commission.

11 Q Okay. Are you a qualified independent  
12 insurance consultant?

13 A No, ma'am.

14 Q No. Are you an actuary?

15 A No, ma'am.

16 Q Okay. Do you have any experience with  
17 actuarial science?

18 A No.

19 Q And in this case, who is your client?

20 A I work for the Commission -- Public Utility  
21 Commission.

22 Q And when you're testifying or advocating on  
23 behalf of the Commission, what sort of -- what sort of  
24 goals are you trying to achieve for your client?

25 A I'm just trying to make sure that I consider

1 the public interest --

2 Q Okay.

3 A -- in my decisions.

4 Q Okay. And what does "the public interest" mean  
5 to you?

6 A Well, in this particular case, it's making sure  
7 that the self-insurance is the appropriate -- is  
8 appropriate.

9 Q Okay. Just making sure self-insurance is  
10 appropriate?

11 A Right.

12 Q Appropriate for --

13 A For the --

14 Q -- who?

15 A Well, it's in the public interest for the  
16 utility to have a self-insurance reserve.

17 Q And I just want to move into some general  
18 questions related to the insurance topics in your  
19 testimony, and then we'll get into some more specifics.  
20 But, Mr. Roelse, what do you think the purpose of a  
21 self-insurance reserve is?

22 A It's to cover catastrophic property losses or  
23 liability losses. It's to cover that risk that exists.

24 Q The risk of what?

25 A Of a catastrophic property loss.