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

CENTERPOINT ENERGY HOUSTON ELECTRIC, LLC'S
INITIAL POST-HEARING BRIEF

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I. Introduction/Summary [Preliminary Order (PO) Issues 1, 2, 3, 4]

For the past 137 years, CenterPoint Energy Houston Electric, LLC ("CEHE" or the "Company") and its predecessors have been serving customers in and around Houston, Texas—one of the most important economic and trade centers in the state and country.[1] Today, CEHE serves approximately 2.5 million metered customers, which is nearly 400,000 customers more than were served by its electric transmission and distribution system at the time of its last base rate case.[2] Over 40,000 of these new customers are non-residential.[3] CEHE has, in accordance with core values that put safety, integrity, and accountability first, invested more than $6 billion since 2010 to respond to customer and load growth.[4] Importantly, this customer and load growth is not geographically concentrated or limited to residential customers. Instead, this customer and load growth has required the deployment of new infrastructure capable of serving increased customer density within the City of Houston, pasture lands housing new suburban developments, and new industrial loads along the Gulf Coast that are subject to flooding and high winds.[5]

CEHE's ability to respond to and serve the needs of its customers is, in large part, due to the sound regulatory policy reflected in the Public Utility Commission of Texas ("Commission") decision in Docket No. 38339.[6] The Commission's decision in that case has allowed CEHE since 2010 to:

- invest over $6 billion in transmission and distribution infrastructure—equivalent to the installation of a new electric system capable of serving a customer base roughly twice the

[1] Rebuttal Testimony of Jeffrey S. Myerson, CEHE Ex. 47 at 22-23 (Exh. R-JSM-1).
[2] Direct Testimony of Kenny M. Mercado, CEHE Ex. 6 at 43, 51 (Bates Pages).
[3] *Id.* at 51.
[4] *Id.* at 39.
[5] Tr. at 146-149 (Mercado Redirect) (Jun. 24, 2019).
[6] *Application of CenterPoint Energy Houston Electric, LLC for Authority to Change Rates*, SOAH Docket No. 473-10-5001; PUC Docket No. 38339 (Jun. 23, 2011).

size of Corpus Christi and its unincorporated areas or, for the past four years, building a distribution line from Austin to Houston and back each year;[7]

- weather the impact of a generational storm event in 2017—Hurricane Harvey;[8]
- install approximately 2.5 million Advanced Metering System ("AMS") meters, improving the intelligence and resiliency of its transmission and distribution system;[9] and
- prudently manage its cash flow so that the Company could take advantage of capital market conditions to lower the Company's overall cost of debt.[10]

Importantly, the factors supporting the Commission's decision in Docket No. 38339, including its approval of a higher capital structure equity ratio and a return on equity ("ROE") capable of attracting investor funding, have not diminished since that case was decided. In fact, those policy decisions have become even more important in light of the intervening pressures and risks that CEHE now faces. As a result, the outcome of this case is vitally important to the Company and the Greater Houston area.

With this in mind, CEHE diligently presented the Commission with a rate filing package ("RFP") that ensured compliance with the form and instructions included in the Commission's RFP.[11] The Company's rate filing includes the direct testimony of 25 witnesses, over seven thousand printed pages of testimony, exhibits, schedules and work papers and over 3.5 gigabytes of electronic supporting material and data. No party challenged the adequacy or completeness of the Company's application, and in Order No. 4, the Administrative Law Judges deemed the Company's application sufficient.[12] In support of its request, CEHE has responded to—with little controversy or disagreement—over 1,400 discovery requests inclusive of subparts. And, CEHE presented the rebuttal testimony, exhibits, schedules and work papers of 18 witnesses to respond thoroughly to every challenge raised by Intervenors and Commission Staff ("Staff").

In its totality, the evidence establishes that CEHE's total revenue requirement based on a test year ended December 31, 2018, as adjusted for known and measurable changes, is

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[7] In a Central Texas context, the magnitude of the Company's investment would equate to an electric system built to serve roughly half the size of the City of Austin or, alternatively, the cities of Round Rock, Pflugerville, Cedar Park and Georgetown, Texas combined.
[8] CEHE Ex. 6 at 46-47, 50 (Mercado Direct); Direct Testimony of Randal M. Pryor, CEHE Ex. 7 at 217-218 (Bates Pages); Direct Testimony of Martin Narendorf, Jr., CEHE Ex. 8 at 353-355 (Bates Pages).
[9] CEHE Ex. 1 at 13 (Application) (Bates Page).
[10] *Id.*
[11] SOAH Order No. 4 at 2 (May 28, 2019); Direct Testimony of Kristie L. Colvin, CEHE Ex. 12 at 840-844 (Bates Pages); Direct Testimony of Mathew A. Troxle, CEHE Ex. 30 at 3016-3017 (Bates Pages).
[12] SOAH Order No. 4 at 2 (May 28, 2019). Similarly, no party disputes that notice was provided as required by the Public Utility Regulatory Act ("PURA") §§ 36.102 and 36.103, as well as 16 Texas Administrative Code ("TAC") § 22.51(a). *See* SOAH Order No. 2 at 2 (May 1, 2019) and Affidavit of Completion of Notice of Alice S. Hart, CEHE Ex. 5.

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approximately $2.3 billion. Approval of the Company's requested revenue requirement will allow it a reasonable opportunity to earn a reasonable return on its invested capital used and useful in providing service to the public in excess of its reasonable and necessary operating expenses and establish a solid foundation that maintains the Company's financial integrity so that it can continue to grow and support the continued population growth and commercial and industrial expansion expected in CEHE's service territory for years to come. It will also position CEHE to continue to run one of the most reliable transmission and distribution utility systems in the state.

While some parties question the overall cost of certain capital projects representing a small fraction of the Company's total capital spend, the necessity of CEHE's capital investment and the prudence of the programs that manage those costs on a day-to-day basis are not reasonably in dispute. Parties have also not challenged the prudence with which CEHE manages operations and maintenance ("O&M") and administrative and general ("A&G") costs or the method CEHE used to allocate costs from CenterPoint Energy Service Company, LLC ("Service Company") to CEHE. These facts, coupled with CEHE's proactive efforts to optimize Company resources and hold down expenses, demonstrate CEHE's unwavering commitment to providing safe and reliable electric service to customers throughout the Greater Houston area at a necessary and reasonable cost.

Unfortunately, the positions of Intervenors and Staff on many issues ignore the need for the Company to build and maintain a system that can be resilient in the face of hurricane risk and the undisputed evidence of the Company's day-to-day diligence in running a reliable and well-maintained transmission and distribution system. They instead take several positions that, if adopted, would threaten the future financial integrity of CEHE. These positions include but are not limited to:

- adjustments to establish an "average" O&M cost for CEHE's distribution and transmission operations (a methodology that conflicts with PURA and 16 TAC § 25.231(b);[13]
- adjustments for alleged post-test year "savings" that ignore unchallenged costs that were incurred to achieve those savings;[14]
- an attempt to re-litigate issues from cases settled years ago despite the clear intent that those issues would never be addressed again;[15] and

[13] Direct Testimony of Scott Norwood, COH/HCC Ex. 1 at 6-13; Public Utility Regulatory Act, Tex. Util. Code Ann. §§ 11.001-66.017 (Supp.) ("PURA").
[14] Direct Testimony of Lane Kollen, GCCC Ex. 1 at 48-49.
[15] *Id.* at 56-61.

- proposals on ROE and capital structure that would give CEHE the lowest rate of return ("ROR") in the State of Texas.[16]

These positions undermine CEHE's financial integrity and jeopardize the Company's ability to maintain, enhance and expand its transmission and distribution system in response to growth that is expected to continue at approximately two percent per year for the next 20 years.[17] Unlike other businesses, CEHE cannot lower its cost of service by reducing its hours of business or by deciding not to respond to service calls over the weekend. CEHE cannot choose to forego necessary capital investment to connect and reliably serve customers and it should not be placed in the position of having to decide whether to eliminate programs that ensure the reliability of service for critical infrastructure, including the Houston Medical Center, which provides patients with life-saving care.[18]

With respect to ROE, capital structure, and ring fencing, the Intervenors and Staff also ask the Commission to ignore not only the scope of its authority in this case, but also the fact that at least one credit rating agency has determined their overall positions to be credit negative and materially different from the positions taken in recent rate cases involving Oncor Electric Delivery Company ("Oncor") and Texas-New Mexico Power Company ("TNMP").[19] Indeed, that credit rating agency appears to be closely watching this case to determine not only whether CEHE's credit is at risk but also whether Texas will remain a constructive regulatory climate for utility investment.[20]

CEHE's role in the Greater Houston economy is unique and essential. Establishing rates that allow CEHE to fully and fairly recover its operating costs and investment, maintain its financial integrity, and provide the Company with the opportunity to earn a reasonable ROR is imperative to the fiscal health of the Company. The evidence shows that this can be achieved, in part, through the adoption of a capital structure composed of 50% equity and 50% long-term debt and a ROE of 10.4%. A fiscally-strong utility is in the interest of all stakeholders and is in the public interest. CEHE's proposed rates achieve this result and the Company requests that these rates be adopted by the Commission.

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[16] Direct Testimony of Anjuli Winker, OPUC Ex. 3; Direct Testimony of J. Randall Woolridge, TCUC Ex. 1; Direct Testimony of Michael P. Gorman, TIEC Ex. 5; Direct Testimony of Jorge Ordonez, Staff Ex. 3A.
[17] Direct Testimony of Dale Bodden CEHE Ex. 9 at 593 (Bates Pages).
[18] *See* COH/HCC Ex. 1 at 16-18 (Norwood Direct) (arguing that the Company's Underground Cable Life Extension Program and Major Underground Rehabilitation programs are imprudent).
[19] Rebuttal Testimony of Ellen Lapson, CEHE Ex. 48 at Exh. R-EL-5 (Bates Pages).
[20] *Id.*

II. Rate Base [PO Issues 4, 5, 10, 11, 12, 13, 15, 16, 17, 18, 19]

A. Transmission and Distribution Capital Investment [PO Issues 4, 5, 10, 11, 12]

Since its last rate case, CEHE has invested over $6 billion in transmission and distribution infrastructure to meet the expectations of its customers, respond to growth, and support economic development within the state of Texas.[21] CEHE is requesting a prudency determination on all capital investments made to its system from January 1, 2010 through December 31, 2018. The costs for transmission capital investments for this time period fall within five broad categories: (1) interconnections; (2) load growth; (3) system improvements; (4) restoration; and, (5) operations support investment.[22] Similarly, distribution capital investments for this same time period fall within the following categories: (1) customer growth, including relocations for public improvements; (2) reliability improvements; (3) service restoration investments; and, (4) operations & support investments associated with the replacement of deteriorated equipment and facilities.[23]

Notably, CEHE's capital investments in customer and load growth comprise approximately 50% of the total distribution and high-voltage transmission plant investment.[24] Capital investment in response to customer and load growth is followed in amount by the Company's reliability and system improvements.[25] Together, customer and load growth, reliability, and system improvements comprise approximately 80% of CEHE's total plant investments.[26]

1. Capital Project Prudence

The Company's RFP reflects net transmission plant investment of $2,758 million and $4,958 million of net distribution plant investment.[27] All parties concede that the Company's capital investment is used and useful in providing service to the public. City of Houston ("COH") witness Scott Norwood and Staff witness Tom Sweatman, however, challenge the reasonableness and necessity of the costs associated with certain capital projects.[28] These parties offer their

[21] CEHE Ex. 6 at 38 (Mercado Direct).
[22] CEHE Ex. 8 at 343 (Narendorf Direct).
[23] CEHE Ex. 7 at 175 (Pryor Direct).
[24] *Id.* at 184 (Figure 3) (Pryor Direct); CEHE Ex. 8 at 343 (Figure 3) (Narendorf Direct).
[25] *Id.*
[26] *Id.*.
[27] Refer to CEHE Ex. 2 at Schedule II-B and III-B of RFP.
[28] COH is represented by Mr. Alton Hall, who also represents the Houston Coalition of Cities ("HCC"). While the COH filed testimony in this proceeding, exhibits admitted into the evidentiary record during the hearing were on behalf of both the COH and HCC. For this reason, CEHE refers to witness testimony on behalf of COH and exhibits as COH/HCC.

arguments despite the clear and uncontroverted evidence that CEHE has effective cost control processes in place and well substantiated documentation showing that these expenditures were prudently incurred.[29] Office of Public Utility Counsel ("OPUC") witness Karl Nalepa and Staff witness Blake Ianni alternatively argue that certain capitalized projects should have been expensed. Once again, the evidence soundly refutes their claims and shows that CEHE has complied with the Federal Energy Regulatory Commission ("FERC") accounting requirements in all respects.

a. Underground Residential Distribution ("URD") Cable Assessment and Life Extension Program ("CLEP Program")

Mr. Norwood also argues that CEHE's $54 million dollar investment in the URD CLEP Program was not reasonable, necessary, and prudently incurred.[30] He renders this opinion on the basis that CEHE's investment in this program has not resulted in a discernible improvement in the Company's System Average Interruption Duration Index ("SAIDI") over the 2010-2018 time period.[31] Mr. Norwood's conclusion is mistaken because it is premised on the incorrect assumption that the program is reactive rather than proactive in nature. While reactive programs are driven by specific cable failures that are singularly addressed, CEHE's CLEP Program is a proactive program that is designed to identify potential failures in aged underground cable and other URD components that do not meet specification before they fail.[32] As explained by CEHE witness Randal Pryor, investment in URD replacement is a necessary cost of providing electric service.[33] By identifying the risk of potential failures, CEHE is able to better serve its customers by preventing future outages and thus maintain system reliability.[34] To achieve this result, the CLEP Program involves a one-time assessment of each of the Company's loops that have cable in excess of 35 years of age.[35] This assessment provides for the rehabilitation of the cable back to original manufacturer specifications, which improves the present condition of the cable and extends the expected life.[36] Stated differently, it preserves CEHE's service reliability, which Mr. Norwood admits is "very good."[37] The evidence further established that:

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29 *Gulf States Utils. Co. v. Pub. Util. Comm'n of Tex.*, 841 S.W.2d 459, 475-76 (Tex. App.—Austin 1992, writ denied).
30 COH/HCC Ex. 1 at 5 (Norwood Direct).
31 *Id.* at 17.
32 CEHE Ex. 7 at 203 (Pryor Direct).
33 *Id.* at 188.
34 *Id.* at 203.
35 *Id.* at 204.
36 *Id.*
37 COH/HCC Ex. 1 at 9 (Norwood Direct).

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- past loop failures have indicated that URD loops over 35 years old have the highest probability of failure within CEHE's distribution system;[38]
- as part of the program activities undertaken, CEHE has been able to assess and extend the life of more than 10 times as many loops as it had been replacing annually, while significantly reducing costs and improving system reliability through innovative and affordable means;[39]
- once spans have been assessed and the appropriate corrective actions have been completed, all spans within the entire loop are guaranteed to perform to the original manufacturer's standards;[40]
- as part of the program, on-site mitigations are performed to eliminate all of the deficiencies identified in the cables in order to bring the entire loop up to the original manufacturer specifications and thereby extend the life of the cable system by curing or replacing cables near or in imminent risk of failure;[41] and
- the Company's contractor, IMCORP, provides a 15-year life extension guarantee for the Company's cable system on all assessed loops.[42]

As a result of the CLEP Program, the Company is systematically reducing the backlog of aging 35-year-old cable and related systems. This is a prudent utility practice and the capital costs associated with these efforts are reasonable and necessary to the provision of utility service.

Finally, the Company has also shown that the CLEP Program is properly capitalized despite Mr. Nalepa's contention to the contrary.[43] The CLEP Program is not a routine maintenance program; it was implemented specifically as part of a one-time major rehabilitation capital project that extends the useful life of the system.[44] In this regard, the CLEP Program meets all FERC criteria for capitalization, as well as the capitalization policy of CEHE's parent company, CenterPoint Energy, Inc. ("CNP").[45]

b. Major Underground Rehabilitation Project

Mr. Norwood challenges the prudence of the Company's Major Underground Rehabilitation Program.[46] Mr. Norwood argues that the $57.5 million dollars that CEHE invested in this capital project should be disallowed because he was unable to "affirmatively determine"

[38] CEHE Ex. 7 at 203 (Pryor Direct).
[39] *Id.* at 204.
[40] *Id.*
[41] *Id.*
[42] *Id.*
[43] Redacted Direct Testimony of Karl Nalepa, OPUC Ex. 5 at 31-32.
[44] Rebuttal Testimony of Kristie L. Colvin, CEHE Ex. 35 at 56-57 (Bates Pages).
[45] *Id.* at 56-57.
[46] COH/HCC Ex. 1 at 15-18 (Norwood Direct).

that the program costs were "reasonable, necessary and cost beneficial" to customers.[47] The evidence proves otherwise. First, the evidence establishes that Mr. Norwood made no effort during the discovery process to obtain information regarding CEHE's Major Underground Rehabilitation Program.[48] The evidence also shows that CEHE's Major Underground Rehabilitation Program has been in place at the Company for over thirty years.[49] This is a proactive program that, consistent with good utility practice, is designed to identify potential failures in aged underground cable and other components before those failures occur.[50] Anytime there is a failure in the operation of underground cable or equipment, the Company tests the remaining cable and equipment in the area and, if testing indicates additional problems or causes additional failures, the cable and equipment are proactively replaced.[51] In terms of customer benefit, the evidence establishes that customers receive enhanced reliability because unscheduled outages due to failures can be avoided and the proactive replacements can often be completed without a customer outage.[52] Additionally, the evidence demonstrates that:

- the proactive inspection and maintenance of the Major Underground facilities is vital to the continuous supply of reliable power to customers served by the Major Underground system;[53]
- the Major Underground system serves the majority of the central business center in downtown Houston, the Texas Medical Center, Bush Intercontinental Airport, and many other areas of critical and highly important businesses and commercial customers who are dependent on a continuous supply of safe and reliable electricity;[54]
- failure in the Major Underground infrastructure requires significant effort and response time to restore and would result in significant environmental, safety, and economic repercussions;[55] and,
- failure in the Major Underground infrastructure would significantly impact hundreds, if not thousands, of individuals living, working or receiving medical treatment.[56]

In sum, the proactive work performed under the Major Underground Rehabilitation Program resolves a problem before the problem occurs. As a result, no lengthy, unscheduled service interruptions occur and customers do not unnecessarily experience outages due to equipment that

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47 *Id.*
48 Rebuttal Testimony of Martin W. Narendorf Jr., CEHE Ex. 32 at 8 (Bates Pages).
49 *Id.* at 9.
50 CEHE Ex. 7 at 203 (Pryor Direct).
51 CEHE Ex. 32 at 9 (Narendorf Rebuttal).
52 *Id.* at 11.
53 *Id.* at 10.
54 *Id.*
55 *Id.* at 10, 12.
56 *Id.* at 12.

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has been allowed to "run to failure."[57] Mr. Norwood's proposed disallowance of these capital costs should be rejected.

c. Capital Project Oversight and Budget Estimation

(1) Foundation Installation – Project HLP/00/0801

Mr. Nalepa seeks to disallow approximately $1.2 million in necessary foundation repair costs, wrongly concluding that the foundation replacements were due to errors in the original installation.[58] The evidence shows that CEHE made no errors, and that the foundation issue was caused by an Alkali-Silica Reaction ("ASR") in the subject foundations. ASR is a condition that occurs in concrete materials unrelated to the method of installation.[59] It is a condition that occurs naturally in all concrete—not just concrete installed by CEHE.[60] ASR is a reaction that occurs between the aggregate in concrete and the cement mix that causes a silica gel to form within the concrete.[61] This silica gel expands and contracts with wetting and drying cycles and causes cracking within the concrete.[62] The evidence further establishes that CEHE acted prudently by taking steps to mitigate the impacts to Company facilities when the cracking issues associated with ASR were first identified.[63] For example, CEHE developed a new concrete specification that included additives to mitigate the risk of an ASR reaction occurring in newly poured concrete.[64] Additionally, CEHE proactively replaced foundations that showed the effects of ASR.[65] Importantly, the risk of ASR cannot be eliminated, it can only be mitigated.[66] Mr. Nalepa offers no evidence that CEHE can avoid the foundation issues created by ASR nor does he challenge the prudence of the corrective actions taken by CEHE to mitigate the impacts of ASR on the Company's facilities. Therefore, these capital costs should be recovered through rates.

(2) The Use of Estimates for Capital Cost Benchmarking

In recommending the disallowance of certain project costs over their budgeted amounts, both Mr. Nalepa and Mr. Sweatman inappropriately rely on initial project estimates as support for their recommended disallowances. Mr. Sweatman further proposes the application of an arbitrary

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[57] *Id.* at 10-12.
[58] OPUC Ex. 5 at 38 (Nalepa Direct).
[59] CEHE Ex. 32 at 15 (Narendorf Rebuttal).
[60] Tr. at 1177 (Narendorf Cross) (Jun. 27, 2019).
[61] *Id.* at 1177-1178.
[62] *Id.*
[63] *Id.* at 1179-1180.
[64] CEHE Ex. 32 at 15-16 (Narendorf Rebuttal).
[65] *Id*; Tr. at 1179-1180 (Narendorf Cross) (Jun. 27, 2019).
[66] Tr. at 1180 (Narendorf Cross) (Jun. 27, 2019).

10% contingency cap on capital cost recovery despite acknowledging that full recovery of capital costs is appropriate if the utility presents well-substantiated justification for the final project costs.[67] During the discovery phase of this proceeding, the Company responded to numerous detailed questions regarding transmission and substation projects. The Company provided project lists, estimated costs, actual costs, and explanations of any variances. This documentation provides ample justification to explain the reasonableness and necessity of any cost overrun of 10% or higher under even Mr. Sweatman's proposed standard.[68] Moreover, the evidence demonstrates that the budget variances identified by Messrs. Nalepa and Sweatman represent approximately 0.12% and 0.68%, respectively, of the approximately $3.0 billion High Voltage Operations capital for which the Company seeks recovery.[69] Further, the Company demonstrated an average cost variance of approximately *negative* 8.5% for all transmission lines reported on its monthly construction progress reports filed between January 1, 2010 and December 31, 2018 that were not paid for by an individual customer.[70] This means that on average the actual cost of the Company's ratepayer funded transmission line projects was *lower* than estimated. These statistics prove that CEHE manages its projects professionally and prudently, and as a result has a very near perfect track record in managing its capital projects.

The evidence further demonstrates why initial estimates should not be used as a basis against which to evaluate final project costs. Initial estimated project costs for both certificate of convenience and necessity ("CCN") and non-CCN projects are developed prior to detailed engineering or construction analysis.[71] Initial estimates are based on very preliminary design without any geotechnical or subsurface engineering data or right of way research and very limited construction input, so they rely heavily on assumptions.[72] Initial estimates are also usually made at least a year and a half in advance of construction and are based on projected costs, rule of thumb guidelines, and a preliminary understanding of actual conditions, including environmental conditions, and project scope, before the work order is prepared.[73] In contrast, after the Company has been able to secure right of way access and conduct soil analysis, detailed engineering is completed and the designs are sent to construction for detailed estimates. Thus, while final

[67] Direct Testimony of Tom Sweatman, Staff Ex. 8 at 6.
[68] CEHE Ex. 32 at Exh. R-MWN-1 (Narendorf Rebuttal).
[69] *Id.* at 28.
[70] *Id.* at 18 & Exh. R-MWN-2.
[71] *Id.* at 19.
[72] *Id.*
[73] *Id.* at 20-21.

estimated project cost is still an estimate, it is created with more detailed information than the initial estimate and provides a more accurate and reasonable basis from which to evaluate actual project costs.[74]

The Alexander Island substation and La Marque substation projects illustrate why Mr. Nalepa's and Mr. Sweatman's use of initial estimates as a basis for their comparisons to final project costs is unreasonable. In particular, the evidence demonstrates that scope changes largely drove the difference in the initial estimate and final project cost of the Alexander Island Substation.[75] Similarly, with regard to the LaMarque substation, the original estimate provided for four structures. Following the engineering phase of the project, seven structures were ultimately required. Thus, Mr. Sweatman's and Mr. Nalepa's conclusion regarding the Alexander Island and La Marque substation costs is mistaken.[76] The evidence further shows that the variance-based disallowances proposed by Mr. Sweatman for the following projects are refuted by well-substantiated and justified explanations.[77]

Capital Projects – Initial Estimates versus Final Costs	Evidence demonstrating prudence of incurred costs
Dow Substation	CEHE has not included costs associated with this project in its rate base.[78] This project was a customer funded project.[79]
W.A. Parish Substation	A comparison of the final actual cost to the final estimate demonstrates that this project actually came in 5.7% under budget.[80]
Jones Creek	Mr. Sweatman acknowledges that the Company responded with a thorough 24-page explanation of cost increases for the Jones Creek Project.[81] As part of this explanation, CEHE demonstrated that the project was reviewed by the Electric Reliability Council of Texas ("ERCOT") Regional Planning Group and was needed to serve a new 721 MW load associated with a proposed natural gas liquefaction and export facility being developed by Freeport LNG in

[74] *Id.* at 19-20.
[75] *Id.* at Exh. R-MWN-1, PUC RFI No. 6-24 & Exh. R-MWN-2.
[76] OPUC Ex. 5 at 39 (Nalepa Direct) (Mr. Nalepa contends that errors in the original construction activities caused project costs to exceed initial budget estimates).
[77] Staff Ex. 8B at 4 (Sweatman Supplemental Direct). Mr. Sweatman withdrew his challenge to the two Sandy Point substation projects, the Flewellen-Fort Bend project, and the Fort Bend-Rosenberg project in his supplement direct testimony.
[78] CEHE Ex. 32 at Exh. R-MWN-1, PUC RFI No. 6-24 (Narendorf Rebuttal).
[79] *Id.*
[80] *Id.* at Exh. R-MWN-2, PUC RFI No. 1-38.
[81] Staff Ex. 8 at 8-9 (Sweatman Direct); *See also* CEHE Ex. 32 at Exh. R-MWN-1, PUC RFI No. 11-2 and Exh. R-MWN-3 (Narendorf Rebuttal).

Capital Projects – Initial Estimates versus Final Costs	**Evidence demonstrating prudence of incurred costs**
	the Freeport area.[82] The magnitude of the project is illustrated in Exhibit R-MWN-3 to Mr. Narendorf's rebuttal testimony and includes a substation capable of withstanding a category 5 hurricane storm surge.
Springwoods	Mr. Sweatman incorrectly states that there was a 15.8% cost overrun for the transmission construction portion of Springwoods substation.[83] The evidence shows that the transmission-only portion of this project had a -10% difference, or a 10% underspend on transmission work.[84] With regard to the substation-only portion of Springwoods, the estimate was $10.6 million, and the actual cost was approximately $11.8 million. Cost variance for the construction of Springwoods substation inside the fence was shown to be primarily driven by increased site improvement costs for vegetation clearing and additional dirt backfill quantities and a wire-wall security fence.[85]
Tanner	Mr. Sweatman is incorrect in stating that the Company indicated a 16.3% cost overrun for the transmission construction portion of Tanner substation.[86] The transmission-only portion of this project was shown to be a -10.5% difference, or a 10.5% *underspend* on transmission work.[87] Further, with respect the substation-only portion of Tanner the evidence demonstrates a 12.6% *underspend*.[88] The estimated costs included site improvements for a transmission laydown yard that was not built on the backside of the site and the removal of the mulch yard which was no longer required because the owner became responsible for this removal (minus $2,600,000). The estimated cost did not include site security ($250,000), additional construction and commissioning resources to meet the schedule ($150,000), and the increased cost for the substation power transformers ($430,000).

This evidence establishes that CEHE has met any perceived burden to substantiate and justify final capital project costs in excess of its final budget estimate.

[82] CEHE Ex. 9 at 606 (Bodden Direct); CEHE Ex. 8 at 415-435, WP-MWN-3 (Narendorf Direct).
[83] Staff Ex. 8 at 9 (Sweatman Direct).
[84] CEHE Ex. 32 at 71-72, Exh. R-MWN-1, PUC RFI No. 6-24 (Narendorf Rebuttal).
[85] *Id.* at Exh. 66-67, R-MWN-1, PUC RFI No. 5-8.
[86] Staff Ex. 8 at 9 (Sweatman Direct).
[87] CEHE Ex. 32 at 71-72, Exh. R-MWN-1, PUC RFI No. 6-24 (Narendorf Rebuttal).
[88] *Id.* at 66-67, Exh. R-MWN-1, PUC RFI No. 5-8.

2. Capital Project Accounting/Capitalization Policy Changes

CEHE does not capitalize O&M costs.[89] There is no dispute that the Company must follow the applicable accounting rules established by generally accepted accounting principles ("GAAP") and the FERC Uniform System of Accounts ("USOA") for public utilities. Under Commission Rule 25.72, the Company is required to keep its books and records in compliance with the FERC USOA. Thus, in accordance with the FERC USOA, a project is either capital or O&M, not both. Mr. Pryor describes in his direct testimony the Company's processes, controls, and training related to work orders to ensure the proper classification of distribution and transmission capital investment.[90] Likewise, as CEHE witness Kristie Colvin explained in her direct testimony and again in her rebuttal testimony, the Company's on-going internal processes and procedures ensure that projects are properly capitalized or expensed according to the Company's capitalization policy, which provides for the cost of the repair and/or replacement to be capitalized only when the project encompasses the repair and/or replacement of the retirement unit in its entirety.[91] In order to ensure compliance, the Company routinely monitors and reviews its accounting policies and practices for compliance with GAAP and FERC standards.[92] Yet, Mr. Nalepa and Mr. Ianni propose disallowances to projects that contain investment that the Company must, under the FERC USOA, record as capital investment. As discussed below, their arguments should be rejected in their entirety.

a. Proactive Routine Capital Replacements to the Overhead Distribution System (AB1Z) and Substation Projects (HLP/00/001 and HLP/00/0012)

Mr. Nalepa seeks to disallow approximately $154.5 million in plant in service on the basis that CEHE capitalized three projects, which he incorrectly considers to be routine or corrective in nature.[93] Mr. Nalepa incorrectly categorizes these three projects as involving activities necessary to maintain a capital asset based solely on the project description. The project description is not, however, used to determine whether a project is treated as capital or O&M.[94] Whether a project is capitalized is driven by the FERC USOA, which the Company is required to follow.[95] Per the

[89] Rebuttal Testimony of Randal M. Pryor, CEHE Ex. 31 at 14 9 (Bates Pages).
[90] CEHE Ex. 7 at 190-193 (Pryor Direct).
[91] CEHE Ex. 12 at 926-930 (Colvin Direct); CEHE Ex. 35 at 51-52 (Colvin Rebuttal).
[92] CEHE Ex. 35 at 59 (Colvin Rebuttal).
[93] OPUC Ex. 5 at 36 (Nalepa Direct).
[94] CEHE Ex. 31 at 13 (Pryor Rebuttal).
[95] *See* 16 TAC § 25.72.

FERC USOA,[96] all property is considered to be either a discrete retirement unit or a minor item of property. Replacements of retirement units are required to be capitalized.[97] Mr. Nalepa does not dispute that the projects at issue are required to be capitalized by the FERC USOA or that these projects involved the replacement of capital equipment or structures on a scheduled or unscheduled basis.[98]

With regard to the projects specifically challenged, the Company demonstrated that there are two AB1Z WBS accounts, Capital AB1Z and O&M AB1Z.[99] As a precaution to ensure that work orders settle to the correct WBS, the system verifies whether capital materials are installed and/or removed.[100] If a capital order is created, but capital items are not used or removed, the system will reject the order and require the costs to be transferred to an expense order.[101] A review of the work orders associated with Capital AB1Z, which Mr. Nalepa challenged, confirms the capital activity. For example, for Project AB1Z, work order 83307305 was shown to capture costs for removing a stepdown bank and converting everything behind it to 35kV and that the poles, wire, and transformers are retirement units that were replaced as part of this work and qualify for capital treatment.[102]

Project HLP/00/0011 was shown to include capital labor and equipment costs incurred while replacing failed equipment on an unscheduled basis.[103] Types of equipment included are breakers, micro-processor relays, power line carrier systems, Supervisory Control and Data Acquisition ("SCADA") sets, disconnect switches, and other essential substation capital equipment that have failed.[104] Therefore, these costs are properly capitalized.

Project HLP/00/0012 involves the scheduled replacement of equipment and structures. Types of equipment replaced and recorded to this project included battery banks, battery chargers, addition or upgrade of carrier systems, varmint control fence installation, relay scheme upgrades, and SCADA replacements.[105] The work included in this project is retirement unit replacement

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[96] CEHE Ex. 35 at 51 & 121-130, Exh. R-KLC-07 (Colvin Rebuttal).
[97] *Id.* at 51.
[98] CEHE Ex. 32 at 15 (Narendorf Rebuttal).
[99] CEHE Ex. 31 at 13 (Pryor Rebuttal).
[100] *Id.*
[101] *Id.*.
[102] *Id.* at 13 & 31-34, Exh. R-RMP-3.
[103] CEHE Ex. 32 at 15-16 (Narendorf Rebuttal).
[104] *Id.*
[105] *Id.*

work, not repair of existing equipment, which is why it is properly capitalized and not expensed as Mr. Nalepa suggests.[106]

In sum, CEHE has demonstrated the replacement activities associated with each of these three projects and that the associated project costs were properly capitalized as required by FERC accounting requirements. Mr. Nalepa's proposed adjustments should be rejected.

b. Capital Projects ENTD086–Corporate Website Redesign and S/101318/CG/Tools

While acknowledging that computers and computer software can be capitalized by a utility, Mr. Nalepa argues that there is no basis for capitalizing Project ENTD086 – Corporate Website Redesign.[107] Mr. Nalepa's position is irreconcilable with GAAP accounting standards. The Company's capitalization of Corporate Website Redesign is appropriately classified as an asset under FASB Accounting Standards Codification ("ASC") 350-50, which provides GAAP standards for the recording of costs for website development.[108] GAAP requires that some of the costs be expensed and others capitalized, dependent upon the stage of the website development project. The Company appropriately capitalized costs that were incurred during the Application Development Stage as outlined in the GAAP standard.[109]

Mr. Nalepa also incorrectly states that tools purchased for substation use are typically expensed under FERC rules, not capitalized.[110] Notably, Mr. Nalepa fails to provide any reference to the FERC rule on which he relies. According to the FERC USOA, the cost of tools and equipment used in construction and/or repair work is eligible for capitalization to FERC Account 3940.[111] CEHE demonstrated that the tools included in this account are not simple hand tools. Each item has a value of more than $500 per tool and is anticipated to provide multiple years of benefit.[112] Consequently, it is appropriate to capitalize the tools and allocate the costs over the period that the tools are expected to provide benefits, which is what the Company has done.[113]

Likewise, the evidence soundly refutes Mr. Norwood's contention that CEHE included indirect corporate costs in its prior Distribution Cost Recovery Factor ("DCRF") filings.[114] First,

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[106] *Id.*
[107] OPUC Ex. 5 at 37 (Nalepa Direct) (Project ENTD086 – Corporate website redesign).
[108] CEHE Ex. 35 at 52 & 131-137, Exhibit R-KLC-08 (Colvin Rebuttal).
[109] *Id.* at 52.
[110] OPUC Ex. 5 at 37-38 (Nalepa Direct).
[111] *See* CEHE Ex. 35 at 121-130, Exh. R-KLC-07 (Colvin Rebuttal).
[112] *Id.* at 52-53.
[113] *See* Direct Testimony of Dane A. Watson, CEHE Ex. 25 at 2455-2456 (Bates Pages).
[114] COH/HCC Ex. 1 at 18-22 (Norwood Direct).

in each of its prior DCRF filings, Docket Nos. 44572, 45747, 47032, and 48226, the Company attested to the fact that indirect corporate costs and capitalized O&M cost were excluded from its DCRF filings as required by 16 TAC § 25.243(b)(3).[115] Second, indirect corporate costs are costs that cannot be directly assigned.[116] For this reason, the Company does not assign indirect corporate costs to capital projects.[117] Third, the Company testified that it only capitalizes corporate costs directly associated with capital projects.[118] The Company established that the work performed by Property Accounting, Accounts Payable and Call Center is all work performed based on capital activity and is not an activity or cost such as corporate aircraft or artwork, which the Commission provided as examples of indirect corporate costs in Project 39465.[119] Because there are no indirect corporate costs assigned to capital projects either in this case or in the Company's prior DCRF filings there is no need to make adjustments to exclude these costs and Mr. Norwood's proposal should be rejected.

3. Land Costs

While CEHE has agreed to remove $8,160 from transmission invested capital associated with GRP 855 Land Rights.[120] Mr. Ianni incorrectly argues that the land costs for the three distribution substation facilities that are not yet energized should also be excluded from rate base.[121] Importantly, Mr. Ianni offers no FERC accounting support for his position. Ms. Colvin, a certified public accountant, testified that if the land were not already included in FERC Account 3600 Land and Land Rights, it would still be classified as Plant Held for Future Use in FERC Account 1050.[122] According to the FERC USOA, FERC Account 1050 shall include the original cost of land and land rights held for future use under a defined plan.[123] A defined plan exists for these assets, as substation projects are currently under construction on the three tracts of land.[124] Thus, under either FERC Account 3600 or FERC Account 1050, the land is appropriately classified as a rate base item functionalized to distribution.

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[115] Rebuttal Testimony of Michelle M. Townsend, CEHE Ex. 37 at 6-7 & n.3 (Bates Pages).
[116] *Id.* at 7.
[117] *Id.*
[118] *Id.*
[119] *Id.* at 5-6.
[120] CEHE Ex. 35 at 54 (Colvin Rebuttal).
[121] Direct Testimony of Blake P. Ianni, Staff Ex. 6 at 7 (Bates Pages).
[122] CEHE Ex. 35 at 54 (Colvin Rebuttal).
[123] *Id.*
[124] *Id*

B. Distribution Line Clearance Project

Contrary to Mr. Ianni's assertion,[125] the Company properly capitalized costs related to Project Number HLP/00/1055. The evidence shows that CEHE performs Lidar surveys on approximately 20% of the transmission system each year to identify and remediate transmission line clearance issues.[126] Once the issues are identified, the resulting capital work charged to Project 1055 was shown to include the replacement of poles, conductors, and other capital assets. These items are classified in the Company's continuing property records as retirement units. Per the FERC USOA,[127] all property is considered to be consisting of retirement units and minor items of property. Replacements of retirement units are required to be capitalized.[128] As stated previously, when a defined retirement unit is added to or retired from electric plant, the cost thereof shall be applied to the appropriate capital account. Thus, while Project 1055 involves work that is required to maintain compliance with National Electrical Safety Code clearance standards, the work is appropriately classified as capital when it involves facility replacement.

C. Prepaid Pension Asset and Accrued Postretirement Cost

1. Prepaid Pension Asset

CEHE's request to include a $176.3 million balance for the prepaid pension asset balance should be approved because CNP, on behalf of CEHE, has made significant payments to the pension plan with funds provided by investors and prior to the recovery from ratepayers through rates.[129] The $176.3 million amount is the 13-month average for the prepaid pension asset, which is the correct amount—rather than the test year-ending amount—because the instructions in the RFP direct utilities to use a 13-month average for prepayments.[130] Contrary to the RFP instructions, Gulf Coast Coalition of Cities ("GCCC") witness Lane Kollen suggests the test year-ending balance for the prepaid pension asset should be used to align with the use of test year pension expense.[131] However, the 13-month average balance should be used to be consistent with the RFP instructions.

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125 Staff Ex. 6 at 12-14 (Ianni Direct).
126 CEHE Ex. 35 at 54 (Colvin Rebuttal); CEHE Ex. 32 at 13-14 & 69-70, Exh. R-MWN-1 at PUC06-22 (Narendorf Rebuttal).
127 *See* CEHE Ex. 35 at 121-130, Exh. R-KLC-07 (Colvin Rebuttal).
128 *Id.* at 51.
129 CEHE Ex. 12 at 903 (Colvin Direct); Rebuttal Testimony of George C. Sanger, CEHE Ex. 46 at 6.
130 CEHE Ex. 12 at 901-902 (Colvin Direct).
131 GCCC Ex. 1 at 19 (Kollen Direct).

The prepaid pension asset exists because cumulative cash contributions to the pension plan have exceeded the cumulative actuarially determined pension expense over the same period.[132] In addition, these contributions are not voluntary—they are federally mandated by the Employee Retirement Income Security Act ("ERISA").[133] The Commission has consistently allowed utilities to include in rate base items for which a utility makes cash contributions on behalf of customers before it recovers the corresponding expenses through rates, including items such as prepayments for materials and supplies.[134] The Commission has also approved the inclusion of a prepaid pension asset in rate base in prior dockets.[135]

Despite prior Commission support and the traditional understanding that investor-supplied balances are properly included in rate base, GCCC challenges the Company's request. Specifically, Mr. Kollen alleges that including the prepaid pension asset in rate base leads to a double-counting of costs because a return on unrecognized losses would be included twice.[136] This erroneous argument is the result of Mr. Kollen unnecessarily complicating issues related to the prepaid pension asset balance. Unrecognized loss is not impacted when CNP, on behalf of CEHE, makes contributions to the pension plan. Unrecognized losses are not immediately reflected in pension expense because they are deferred and amortized into future pension expense over several years.[137] Any unrecognized loss will be the same regardless of the amounts CNP contributes to the pension plan. Thus, the amortization of unrecognized loss in pension expense is not affected by prepayments that are made due to ERISA requirements.[138] For these reasons, there would be no double-counting of the return on a prepaid pension asset included in rate base.

Mr. Kollen also disputes the requested rate base treatment for the prepaid pension asset balance because he claims CNP does not charge the Company a return.[139] This issue, however, is

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[132] CEHE Ex. 12 at 902-903, 965 (Exh. KLC-09) (Colvin Direct). CEHE Ex. 46 at 5-6 (Sanger Rebuttal).
[133] CEHE Ex. 46 at 8 (Sanger Rebuttal).
[134] 16 TAC § 25.231(c)(2)(B)(ii).
[135] *Application of Entergy Texas, Inc. for Authority to Change Rates, Reconcile Fuel Costs, and Obtain Deferred Accounting Treatment,* Docket No. 39896, Order on Rehearing at Finding of Fact 28 (Nov. 2, 2012); *Application of AEP Texas Central Company for Authority to Change Rates,* Docket No. 33309, Order on Rehearing at Finding of Fact 25 (Mar. 4, 2008).
[136] GCCC Ex. 1 at 19 (Kollen Direct). "Unrecognized losses" are losses resulting from plan experience differing from actuarial assumptions as well as assumption changes are not immediately recognized in Pension Expense. Instead, only a portion of accumulated Unrecognized Loss is included in the Pension Expense during the fiscal year based on amortization periods specified by the accounting *standard.* A plan may experience gains as well as losses. If a plan has accumulated more gains than losses, then this component is a reduction to expense. CEHE Ex. 46 at 16-17 (Sanger Rebuttal).
[137] CEHE Ex. 46 at 7-8 (Sanger Rebuttal).
[138] *Id.* at 8.
[139] GCCC Ex. 1 at 17-18 (Kollen Direct).

not relevant to the argument here because federal law obligates CNP to effectively make an interest-free loan to the pension plan due to the fact that contributions to the plan have exceeded the required pension expense. The earnings the plan accumulates help reduce pension expense that would otherwise have to be collected through rates. Without a corresponding ability to include the prepaid pension asset in rate base, the Company (based on its allocated portion of the CNP pension plan) would inequitably be denied a return on cash paid into the pension plan while giving customers the benefit that results from including the prepaid pension asset in rate base.[140]

Finally, the Company agrees with Mr. Kollen that if the Commission approves inclusion of the prepaid pension asset in rate base, the asset should be bifurcated between O&M expense and capital components that Mr. Kollen identifies as construction work in progress ("CWIP").[141] However, if this occurs, the Company must also be permitted to apply and recover an amount for Allowance for Funds Used During Construction ("AFUDC") on the CWIP portion. This is consistent with Commission treatment allowing other utilities to recover a return on capitalized amounts in the prepaid pension asset using the AFUDC rate.[142]

2. Accrued Postretirement Cost

When Postretirement Medical Plan ("PRM") expenses exceed PRM contributions, this amount is called the Accrued Postretirement Cost.[143] Accrued Postretirement Costs should not be used to reduce rate base because that amount consists of items that have not, and will not, be recovered through rates.[144] In addition, rate base should not be reduced by an Accrued Postretirement Cost that has not been recovered through rates and for which no prepayments have been made.[145] Unlike the prepaid pension asset, which is the result of prepayments made by CNP on behalf of the Company, neither the Company nor customers have prepaid amounts for PRM. Instead, the Company recovers PRM expense in rates and directly contributes amounts recovered through rates into the PRM trusts.[146] Mr. Kollen, however, erroneously refers to this amount as a

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140 CEHE Ex. 46 at 9 (Sanger Rebuttal).
141 CEHE Ex. 35 at 50-51 (Colvin Rebuttal); GCCC Ex. 1 at 20-21 (Kollen Direct).
142 CEHE Ex. 35 at 50-51 (Colvin Rebuttal); *See* Docket No. 39896, Order on Rehearing Discussion on Prepaid Pension Asset Balance; *See Application of Southwestern Electric Power Company for Authority to Change Rates and Reconcile Fuel Costs,* Docket No. 40443, Order on Rehearing at Finding of Fact 137 (Oct. 10, 2013).
143 CEHE Ex. 46 at 11 (Sanger Rebuttal).
144 *Id.* at 11-12.
145 *Id.* at 11.
146 *Id.* at 12 (Sanger Rebuttal). There are no federal requirements to pre-fund retiree medical benefits, but it is allowed. The Company established irrevocable external postretirement medical trusts on December 1, 1995 to pre-fund future Company postretirement medical benefits as required by 16 TAC § 25.231(b)(1)(II)(v). *Id*

postretirement benefit regulatory liability or the $146.7 million regulatory liability.[147] As noted previously, however, that amount should not be used to reduce rate base because those amounts are not recovered through rates and there is no prepayment for which to compensate customers.

Rate base should also not be reduced by an amount for the unrecognized gain for the PRM. Mr. Kollen, however, argues there is a $68.5 million Benefit Restoration Plan ("BRP") Pension and Postretirement Regulatory Liability that should be subtracted from rate base. This amount is the result of a negative $69.297 million unrecognized gain associated with the PRM combined with the positive $0.744 million unrecognized loss associated with the Deferred Compensation Plan as of the end of the test year. The BRP is not part of this calculation, and the $0.744 million is not a component of the PRM. Therefore, the only relevant amount is the $69.297 million unrecognized gain for the PRM. This amount, however, is already part of the $146.7 million accrued postretirement cost addressed above, which should not be used to adjust rate base because it is not the result of prepayments made by the Company or customers.[148] The following excerpt from the Postretirement Medical Actuarial Report included in the RFP illustrates the $69.297 million is included in the $146.7 million accrued postretirement cost:

Accounting Requirements—Postretirement Medical and Life Plan

Assets: 12/31/2018

Reconciliation of ASC 715 Funded Status as of December 31, 2018 (000s)

[redacted]

						Unrecognized			
Division		Cost Center	Accumulated Postretirement Benefit Obligation 12/31/2018	Plan Assets	Funded Status	Prior Service Cost	Net Loss (Gain)	Transition Obligation	(Accrued) Prepaid Postretirement Cost
003A	CE Houston Electric	101452	$ (166,645)	$ 89,253	$ (77,392)	$ (52,680)	$ (16,617)	$ 0	$ (146,689)

Sum = $69.297 million

Finally, the Commission should reject Mr. Kollen's one-sided approach of subtracting from rate base unrealized gains in the amount of $69.297 million in the PRM because the Company has not requested to include in rate base the $370.442 million in unrealized losses in the pension plan.[149] Instead, it is reasonable to leave both unrealized gains and unrealized losses out of rate base.[150]

[147] GCCC Ex. 1 at 27 (Kollen Direct).
[148] CEHE Ex. 46 at 14 (Sanger Rebuttal).
[149] GCCC Ex. 1 at Att. F (Kollen Direct); CEHE Ex. 12 at 965 (Exh. KLC-09) (Colvin Direct).
[150] CEHE Ex. 46 at 14-15 (Sanger Rebuttal).

D. Deferred Federal Income Tax [PO Issue 17,[151] 19]

1. Accumulated Deferred Federal Income Tax ("ADFIT")

ADFIT is a net deferred tax liability representing federal income taxes that the Company will have to pay in the future but that are not due yet. ADFIT arises from temporary differences between (1) the tax basis of an asset or liability under the Internal Revenue Code ("IRC") and (2) such asset's or liability's reported amount in the financial statements under GAAP.[152] Because the total amount of income or expense will ultimately be the same under both the IRC and GAAP, these temporary differences will result in taxable income (in the case of a deferred tax liability) or deductions (in the case of a deferred tax asset) upon the reversal of the difference in future periods.[153] CEHE's adjusted test year ADFIT balance was uncontested and has been properly computed as $(969.0) million.[154] Similarly, the undisputed record demonstrates that the Company's ADFIT balance has properly been credited against CEHE's rate base.[155]

2. Excess Deferred Income Taxes ("EDIT")

ADFIT is calculated based on current tax laws and rates.[156] Because Congress enacted the legislation referred to as the Tax Cuts and Jobs Act (the "TCJA") in December 2017, GAAP required CEHE to re-measure ADFIT to reflect the estimated tax owed at the new federal income tax ("FIT") rate under the TCJA (namely, 21% rather than the 35% FIT rate in effect prior to the enactment of the TCJA).[157] EDIT results from a decrease in the applicable tax rate and is the excess of (1) the amount of the ADFIT balance on the day before the date of enactment of the law effecting such decrease over (2) the amount of the ADFIT balance that would have existed on that date if the new rate were in effect for all prior periods.[158] GAAP requires that a regulatory liability

[151] PO 17 includes additional items that are not contested, including CEHE's property insurance reserve, which is shown in CEHE Ex. 2, Schedule II-B-7.
[152] Direct Testimony of Charles W. Pringle, CEHE Ex. 13 at 999–1001 (Bates Pages).
[153] *Id.* at 999–1001.
[154] CEHE Ex. 12 at 898 (Colvin Direct) and CEHE Ex. 2 at 40-41, Schedule II-B-7. While the ADFIT balance is uncontested, Intervenors have proposed adjustments to certain of CEHE's capital investments. Rebuttal Testimony of Charles W. Pringle, CEHE Ex. 36 at 18-19. If any such proposals are accepted by the Commission, there will be an attendant effect on the ADFIT balance. CEHE Ex. 36 at 18-19 (Pringle Rebuttal). CEHE has not quantified any such effect on the ADFIT balance.
[155] CEHE Ex. 12 at 898 (Colvin Direct). *See also* 16 TAC § 25.231(c)(2)(C)(i) (2000) (providing a deduction from rate base of the "accumulated reserve for deferred federal income taxes").
[156] CEHE Ex. 13 at 999-1001 (Pringle Direct).
[157] *Id.*; ASC 740-10-35.
[158] CEHE Ex. 13 at 999-1001 (Pringle Direct).

must be computed and recorded for this EDIT if it is probable that it will be returned to customers through future rates.[159]

The evidence demonstrates that CEHE's EDIT balance has been, and will continue to be, returned to customers.[160] Using the 21% FIT rate enacted by the TCJA, CEHE properly grossed-up the EDIT balance by the income tax effect of the future decrease in revenues to determine the amount of revenue to be returned to (or not collected from) customers so that the correct amount of EDIT is returned.[161] CEHE's total TCJA-related EDIT balance as of December 31, 2018, is \$646.1 million, and the associated regulatory liability as of December 31, 2018 is \$(823.9) million.[162] Of the \$646.1 million, \$562.5 million is "protected EDIT" (relating to "method/life" depreciation differences and described in the direct testimony of CEHE witness Charles W. Pringle)[163] and the remainder is "unprotected EDIT."[164]

The protected EDIT balances here may not be returned more rapidly than under the average rate assumption method ("ARAM") or a normalization violation will occur.[165] Unprotected EDIT refers to all other EDIT balances,[166] and the Company's proposal to return its unprotected EDIT balance pursuant to Rider UEDIT is addressed below in Section IX.A. With the exception of GCCC, as to EDIT relating to Transition Bonds and System Restoration Bonds (addressed below in Section IX.A), no party contests the amount of unprotected EDIT to be returned to customers (though parties may disagree as to the timing of that return).[167] As such, the Commission should find that the Company has correctly calculated both its protected and unprotected EDIT balances.

E. Cash Working Capital ("CWC") [PO Issue 15]

CEHE's requested CWC allowance is addressed in Section XI.B.3 and is uncontested.

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159 *Id.* at 999-1001; ASC 980-740-25.
160 *Id.* at 1002.
161 *Id.*
162 *Id.* at 1006-1007.
163 *Id.* at 1003-1005.
164 *Id.* at 1007.
165 *Id.* at 1003-1005; Pub. L. No. 115-97, Section 13001(d)(1) (2017).
166 CEHE Ex. 13 at 1003-1005 (Pringle Direct).
167 TIEC witness Billie LaConte suggests that the Company's unprotected EDIT balance should be returned over periods shorter than three years. That proposal is also addressed in Section IX.A. below. While the EDIT balance is uncontested, Intervenors have proposed adjustments to certain of CEHE's capital investments. CEHE Ex. 36 at 18-19 (Pringle Rebuttal). If any such proposals are accepted by the Commission, there will be an attendant effect on the EDIT balance. *Id.* CEHE has not quantified any such effect on the EDIT balance.

F. Other Prepayments

Prepayments are expenditures for goods or services paid in advance by the utility in one accounting period to be recovered from ratepayers in a future period. As instructed by the RFP General Instructions, prepayments are included in rate base using a 13-month average balance for the test year ended December 31, 2018.[168] Because the short-term balances in these accounts can vary significantly, a 13-month average is used to provide a more accurate representation of the amount invested throughout the year. As shown on Schedule II-B-10, the total adjusted test year balance for Other Prepayments is $14.1 million, which consists of insurance in the amount of $5.9 million, other taxes in the amount of $5.3 million, and other miscellaneous items in the amount of $2.9 million.[169]

OPUC witness June Dively argues there should be an adjustment to Prepayments for Other Taxes due to her conclusion that the Company made an extra quarterly payment.[170] Yet, franchise taxes are paid monthly, not quarterly.[171] Certain franchise taxes are required to be paid on the 1st of every month. To be timely on franchise tax payments, a prepayment is made only when the 1st of the month occurs on a Saturday, Sunday, or Monday (if it is a holiday). Therefore, the 13-month average is calculated based on the prepayments recorded for those months where the Company had to prepay for an expense that occurs in the following month. The Company does not make quarterly payments, so Ms. Dively's recommended adjustment to prepayments should not be adopted.

G. Regulatory Assets and Liabilities [PO Issues 18, 19, 34, 41, 54, 55, 59]

Consistent with the requirements in the Commission's RFP, CEHE properly included several regulatory assets and regulatory liabilities in its requested rate base.[172] This approach is also consistent with ASC 980, which allows utilities with cost-based rates to defer or capitalize certain costs (or regulatory assets) or obligations (regulatory liabilities) to be applied to future revenues.[173] The following chart identifies each of the regulatory assets or liabilities and the support for the Company's requested treatment:

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[168] CEHE Ex. 12 at 901 (Colvin Direct).

[169] The 13-month average for the prepaid pension asset balance that is included in Prepayments is $176.3 million. *Id.* at 844. The Company's request to include the Prepaid Pension Asset in Rate Base is addressed separately in Section II.C.

[170] Direct Testimony of June Dively, OPUC Ex. 1 at 34.

[171] CEHE Ex. 35 at 49 (Colvin Rebuttal).

[172] Transmission & Distribution (TDU) Investor-Owned Utilities RFP for Cost-Of-Service Determination Instruction for Schedule II-B-12 (Nov. 19, 2015) (TDU RFP).

[173] CEHE Ex. 12 at 868-869 (Colvin Direct).

Item	Asset or Liability	Support
Protected EDIT	Liability	16 TAC § 25.231(c)(2)(C)(i)[174]
Hurricane Harvey	Asset	Docket No. 32093,[175] PURA §§36.402, 36.405
Medicare Part D	Asset	Docket No. 38339[176]
Texas Margin Tax	Asset	Docket Nos. 29526 and 38339[177]
Smart Meter Texas	Asset	Docket No. 47364[178]
REP Bad Debt	Asset	Docket No. 46957,[179] 16 TAC §25.107(f)(3)(B)
PURA Pension and OPEB	Liability	Docket No. 38339,[180] PURA §36.065
Hurricane Ike	Liability	Docket No. 36918[181]
Expedited Switching Costs	Asset	Docket No. 38339,[182] 16 TAC §25.474(o)(2)

The Company is requesting to amortize each of these regulatory assets or regulatory liabilities over a three-year period, which is consistent with treatment approved in Docket No. 38339. In addition, amortizing regulatory assets and liabilities over the same period provides equitable treatment for both customers and the Company.[183] Customers benefit from regulatory liabilities being included in rate base because they reduce costs to be recovered through rates, whereas the Company is able to collect additional amounts through rates for the regulatory assets that are included in rate base. Staff recommends certain regulatory assets and liabilities be amortized over a five-year period.[184] And Ms. Dively recommends a one-sided approach that

[174] 16 TAC § 25.231(c)(2)(C)(i) explains that EDIT, which is a component of ADIT, is a rate base item.
[175] *Petition by Commission Staff for a Review of the Rates of CenterPoint Energy Houston Electric, LLC Pursuant to PURA §36.151*, Docket No. 32093, Final Order at Finding of Fact 78 (Sept. 5, 2006).
[176] Docket No. 38339, Order on Rehearing at Finding of Fact 159A.
[177] *Id.* at Findings of Fact 161-164; *CenterPoint Energy Houston Electric Request for a Docket Number for: Application of CenterPoint Energy Houston Electric for a True-Up Filing*, Docket No. 29526, Final Order at Findings of Fact 227-237 (Dec. 17, 2004).
[178] *Application of CenterPoint Energy Houston Electric, LLC for the Final Reconciliation of Advanced Metering Costs*, Docket No. 47364, Final Order at Finding of Fact 13(e) (Dec. 14, 2017).
[179] *Application of Oncor Electric Delivery Company LLC for Authority to Change Rates*, Docket No. 46957, Final Order at Finding of Fact 53 (Oct. 13, 2017).
[180] Docket No. 38339, Order on Rehearing at Findings of Fact 60 for pension deferral and 66 for expedited switches.
[181] *Application of CenterPoint Energy Houston Electric, LLC for Determination of Hurricane Restoration Costs*, Docket No. 36918, Final Order at Finding of Fact 15 (Aug. 14, 2009).
[182] Docket No. 38339, Order on Rehearing at Findings of Fact 65 and 66.
[183] CEHE Ex. 35 at 42 (Colvin Rebuttal).
[184] Direct Testimony of Mark Filarowicz, Staff Ex. 4A at 31 (Bates Pages).

would move regulatory assets for Hurricanes Ike and Harvey, Medicare Part D and Smart Meter Texas ("SMT") to a rider to be recovered over a five-year period.[185] Notably, Ms. Dively does not make this recommendation for the Company's regulatory liabilities. As a result, Ms. Dively is proposing that ratepayers receive the benefits of the regulatory liabilities remaining in rate base over a three-year period while the Company is penalized by recovering regulatory asset amounts through a rider rather than through rate base. This inequitable, one-sided approach should be rejected. Additionally, the three-year amortization period ensures that the costs to be recovered from or returned to customers are more closely aligned with the customers that existed at the time the costs were incurred—a ratemaking principle that Ms. Dively endorses.[186] The Staff and OPUC recommendations to move regulatory assets and/or regulatory liabilities to a rider should be rejected.

If, however, the Commission supports the use of a rider to collect costs for regulatory assets and regulatory liabilities, the Company requests that all of the regulatory assets and liabilities other than (a) the TMT regulatory asset, if the Company's request to change the rate recovery method is not approved, and (b) amounts in Rider UEDIT be included in a single rider to be amortized over a three-year period.[187] If such a rider is created, the Company's authorized ROR should be applied across all of the items included in the rider.[188] Based on the date when new rates will be effective following this case and the length of the amortization period for regulatory assets and liabilities, including a return is appropriate for the Company to be made whole for the significant amount of funds the Company has not yet recovered.[189] This is consistent with the proposed Rider UEDIT, which is a regulatory liability and includes a return.

1. Protected Excess Deferred Income Tax[190]

As discussed above, CEHE's entire TCJA-related protected EDIT balance of $562.5 million must be returned to customers under ARAM.[191] This amount will be reflected in rate base through ADFIT as the balance is returned to customers. The protected EDIT regulatory liability from Schedule II-B-11 carries forward into rate base on Schedule II-B. Neither Staff nor

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[185] OPUC Ex. 1 at 14-15 (Dively Direct).
[186] *Id* at 12.
[187] CEHE Ex. 35 at 43 (Colvin Rebuttal).
[188] *Id.*
[189] *Id.* at 44.
[190] CEHE believes the parties' agreed briefing outline designated this section as "Unprotected Excess Deferred Income Tax" in error and is addressing Protected Excess Deferred Income Tax here, as a result. CEHE addresses Unprotected Excess Deferred Income Tax in Section IX.A.
[191] CEHE Ex. 13 at 1020 (Pringle Direct).

Intervenors challenge such return or the Company's rate base treatment of EDIT, and it should be approved. Similarly, no party disputes that the Company's protected EDIT balance should be adjusted when calculating ADFIT in future DCRF filings.[192] This treatment recognizes the benefit customers receive from the return of protected EDIT as the return of that liability occurs over time, and the Company requests that the Commission issue a finding to that effect, so as to provide clarity regarding the treatment of EDIT in future DCRF cases.[193]

2. Hurricane Harvey Regulatory Asset

a. O&M Costs included in Hurricane Harvey Regulatory Asset

The Company's request to recover storm restoration O&M costs and related carrying charges related to Hurricane Harvey is consistent with the PURA, Commission decisions in prior cases and the Company's past practice. The Company seeks to recover all of its Hurricane Harvey O&M restoration costs, offset by insurance proceeds, by including in rate base a regulatory asset to be amortized over three years.[194] The Company received $23.6 million, consisting of $12.3 million for capital and $11.3 million for O&M, in insurance proceeds, which have been recorded to the applicable regulatory asset and capital assets.[195] The Company has settled all electric restoration insurance claims related to Hurricane Harvey and does not expect to receive additional insurance settlements.[196] After applying insurance proceeds to the Hurricane Harvey regulatory asset and making minor adjustments for items identified by Mr. Nalepa, the regulatory asset balance related to Hurricane Harvey restoration costs as of December 31, 2018 was $64.3 million.[197] Additionally, the Company is requesting carrying costs of $8.7 million through December 2018 and expects to continue to accrue carrying costs until the system restoration costs are included in base rates.[198] Staff supports the Company's requested recovery, with Staff witness Jorge Ordonez noting that, "it is important to assure utilities that the Commission will allow them to recover prudently incurred costs, including carrying costs, associated with hurricane restoration."[199] Other parties, however, dispute CEHE's proposal.

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[192] CEHE Ex. 12 at 937 (Colvin Direct).
[193] *Id.*
[194] *Id.* at 870-871.
[195] *Id.* at 870.
[196] *Id.*
[197] *Id.*; CEHE Ex. 35 at 35 (Colvin Rebuttal); CEHE Ex. 2 at 59-60, Schedule II-B-12.
[198] CEHE Ex. 12 at 870 (Colvin Direct); CEHE Errata 1 filing.
[199] Staff Ex. 3A at 39 (Ordonez Direct).

Of the $9.5 million Mr. Nalepa suggests should be removed from the Hurricane Harvey regulatory asset based on the results of the Hurricane Harvey Emergency Operation Plan ("EOP") Expense Validation Review (the "Audit"),[200] only $96,696, and any associated carrying costs, should be excluded. This amount is related to $77,983 for hotel invoices with unresolved discrepancies, hotel occupancy taxes, and catering expenses with inconsistent contract rate documentation[201] and $18,713 related to employee awards and gifts and expensed capital costs.[202] The remaining costs Mr. Nalepa identifies for a disallowance are based on a misrepresentation of the results of the Audit. The overall conclusion of the Audit was that the EOP expense validation effort provided reasonable justification for Hurricane Harvey-related expenses.[203]

As with most audits, the Audit identified some opportunities for improvement in documentation and the control process. Such a determination is not the rate-making standard by which expenses should be included or removed from the Hurricane Harvey regulatory asset. As detailed below, the Company appropriately responded to a crisis and sufficiently documented its expenses for the purpose of including those expenses in the Hurricane Harvey regulatory asset. Contrary to Mr. Nalepa's assertions, the vast majority of the expenses he identified were documented sufficiently to conclude that the expenses were incurred in support of Hurricane Harvey storm restoration efforts and were valid and appropriate.[204]

- Hotel expenses were supported by hotel folios that allowed Audit services to match up the dates of stay during the Hurricane Harvey EOP response effort against invoices, and the Company's use of reserved room blocks allowed Audit Services to confirm that hotel expenses were (i) related to those blocks, (ii) incurred during the response period, and (iii) charged at agreed-upon room rates.[205]
- For catering and logistics, expenses were also documented. Contrary to Mr. Nalepa's statement that $2 million in services were procured and paid for by the same manager, only the $50,000 initial payment on the $2 million was paid for by the EOP Staging site manager, which was necessary for the center to start providing meals to crews supporting the restoration efforts.[206] And the $50,000 payment was supported with a Company credit card receipt and was approved within the OnePay system by the manager's direct supervisor.[207] The remaining $1.95 million was validated and approved by other members of management and was largely supported by

[200] Confidential Pages to the Direct Testimony of Karl Nalepa, OPUC Ex. 5A at 15-18.
[201] Rebuttal Testimony of Kelly C. Gauger, CEHE Ex. 38 at 9-10.
[202] CEHE Ex. 35 at 35 (Colvin Rebuttal).
[203] CEHE Ex. 38 at 5 (Gauger Rebuttal).
[204] *Id.*
[205] *Id.* at 6.
[206] *Id.* at 6-7.
[207] *Id.* at 7.

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documentation confirming the number of meals and services requested.[208] In addition, the $3.4 million catering expense was supported by an original proposal with itemized descriptions of the meals and related services to be provided and there were email communications from CNP management requesting that the caterer provide items identified in the original proposal.[209]

- Mr. Nalepa also incorrectly states that a third invoice of $957,344 had "inconsistently applied contract rates and lacked documentation on a portion of the expenses," which vastly overstates the findings of the Audit. Of the $957,344, only $68,550 did not have adequate supporting documentation.[210]
- Finally, Mr. Nalepa also relies on the Audit to conclude that $1.52 million worth of invoices were not signed when services were rendered by the vendor.[211] Vendor agreements were signed, however. Although daily vendor delivery confirmation forms, which merely acknowledge receipt of catered meals were not signed on the same day that services were rendered, they were signed by individuals with knowledge of the services rendered while the restoration efforts were still ongoing.[212]
- For $373,833 related to EOP OnePay expenses, Audit Services was able to validate the expenses based on (i) reviewing credit card receipts documented in the OnePay system, (ii) confirming that the services provided by these vendors were relevant to the Hurricane Harvey storm restoration efforts and (iii) confirming that the services provided were approved by each individual's manager. This documentation is sufficient to support the conclusion that the expenses were valid and appropriate.[213]

Finally, Mr. Nalepa arrives at the dollar amounts discussed above by grossing up the Audit findings, which relied on judgmental sampling, to the entire population of certain cost categories.[214] A gross-up might be appropriate when statistical sampling is used—typically in populations with voluminous transactions sharing *uniform* attributes—but that is not the case here.[215] As described in detail in CEHE witness Kelly Gauger's rebuttal testimony, such a gross-up is not appropriate when judgmental sampling is used, as was necessary in the Audit due to the limited number of transactions in certain of the cost categories as well as the *non-uniform* nature of the expenses—i.e., hotels, catering, etc.[216] Thus, even if the issues identified in the Audit supported a disallowance, Mr. Nalepa's flawed gross-up calculations produce erroneously inflated final dollar amounts.

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[208] *Id.*
[209] *Id.*
[210] *Id.*
[211] OPUC Ex. 5A at 17 (Nalepa Direct-Confidential).
[212] CEHE Ex. 38 at 8 (Gauger Rebuttal).
[213] *Id.*
[214] OPUC Ex. 5A at 17 nn.37, 39 & 42 (Nalepa Direct-Confidential).
[215] CEHE Ex. 38 at 10 (Gauger Rebuttal).
[216] *Id.*

b. Including Carrying Charges in the Hurricane Harvey Regulatory Asset is Appropriate

PURA, prior Commission decisions and the Company's own prior practice support the inclusion of $8.7 million in carrying costs in the Hurricane Harvey Regulatory Asset. Yet, Mr. Nalepa and Mr. Kollen oppose the Company's request to recover Hurricane Harvey carrying charges.[217] Both witnesses argue that PURA does not provide guidance for whether a utility is allowed to recover carrying charges related to system restoration costs, and they assert that Sections 36.401 to 36.403 of PURA apply only to securitization proceedings for storm restoration costs.[218] Their positions seem based on the fact that the relevant subsection of PURA is called "Securitization for Recovery of System Restoration Costs," but the statutory language in that subchapter is not limited to securitization proceedings. To the contrary, PURA §36.405(a) plainly states that system restoration costs can be recovered in a base rate proceeding such as this case:

> An electric utility is entitled to recover system restoration costs consistent with the provisions of this subchapter and *is entitled to seek recovery of amounts not recovered under this subchapter*, including system restoration costs not yet incurred at the time an application is filed under Subsection (b), *in its next base rate proceeding or through any other proceeding authorized by Subchapter C or D* (emphasis added).

In addition, PURA § 36.402(b) includes carrying costs in the definition of "system restoration costs" as follows:

> *System restoration costs shall include carrying costs* at the electric utility's weighted average cost of capital as last approved by the commission in a general rate proceeding from the date on which the system restoration costs were incurred until the date that transition bonds are issued or *until system restoration costs are otherwise recovered pursuant to the provisions of this subchapter* (emphasis added).

In addition, the fact that PURA § 36.402(b) refers to transition bonds, which are issued following a securitization proceeding, or "until system restoration costs are otherwise recovered" shows that it is appropriate for the Company to request recovery of carrying charges for storm restoration cost under $100 million in this rate case. The plain language of these provisions fully support the Company's recovery of system restoration costs and the corresponding carrying costs through the time new base rates are implemented. And, as noted previously, Staff agrees with the Company's calculation and methodology, including reliance on PURA § 36.402, which Mr. Ordonez agrees provides for recovery of carrying charges.[219]

[217] OPUC Ex. 5 at 22 (Nalepa Direct); GCCC Ex. 1 at 37 n.41 (Kollen Direct).
[218] OPUC Ex. 5 at 22 (Nalepa Direct); GCCC Ex. 1 at 11 (Kollen Direct).
[219] Staff Ex. 3A at 39 (Ordonez Direct).

The Company's request is also consistent with its recovery of carrying costs associated with Hurricane Ike system restoration costs as approved by the Commission.[220] And the Company's request is consistent with (even though not required by) the Commission-approved settlement agreement in Docket No. 48401 that allowed TNMP to recover carrying charges related to Hurricane Harvey.[221] In light of the plain language of PURA § 36.402 and prior treatment of this issue by the Commission, the Company's request to seek carrying costs associated with its system restoration costs caused by Hurricane Harvey should be approved. Carrying costs will continue to be recorded until new base rates are implemented.[222] Likewise, the monthly compounding method used by the Company reflects the Company's actual carrying costs,[223] is supported by Staff,[224] and is consistent with Commission practice.[225] The Company's request to amortize the Hurricane Harvey regulatory asset, including carrying costs, over three years should be approved.

3. Medicare Part D Regulatory Asset

The Medicare Part D Regulatory Asset issue boils down to resolving a timing difference and properly implementing the Commission's express order in Docket No. 38339. CEHE's proposal does so and should be adopted in full. Mr. Kollen's proposals do not and should be rejected.

CEHE provides retiree prescription drug coverage. Under the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the "2003 Medicare Legislation"), CEHE began receiving a subsidy from the federal government equal to 28% of the cost of providing such coverage ("Medicare Part D Subsidy").[226] The 2003 Medicare Legislation also made the Medicare Part D Subsidy effectively exempt from tax.[227]

In 2010, Congress passed the Patient Protection and Affordable Care Act ("PPACA") and the Health Care and Education Reconciliation Act of 2010 (collectively with the PPACA, the

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[220] Docket No. 36918, Final Order at Finding of Fact 24.
[221] *Application of Texas-New Mexico Power Company to Change Rates*, Docket No. 48401, Final Order at Finding of Fact 62 (Dec. 20, 2018).
[222] CEHE Ex. 35 at 38 (Colvin Rebuttal).
[223] *Id.*
[224] Staff Ex. 3A at 39 (Ordonez Direct).
[225] Docket No. 48401, Testimony is Support of Stipulation at Exhibit SRW-S-2, page 2 of 12 (Nov. 12, 2018).
[226] CEHE Ex. 13 at 1027 (Pringle Direct).
[227] The 2003 Medicare Legislation permitted CEHE to deduct for FIT purposes the full cost of providing such coverage and did not require CEHE to reduce its deduction for the Medicare Part D Subsidy. CEHE Ex. 13 at 1027 (Pringle Direct).

"2010 Health Care Legislation").[228] The 2010 Health Care Legislation made the Medicare Part D Subsidy effectively taxable to CEHE beginning January 1, 2013.[229]

In Docket No. 38339 (which had a 2009 test year), CEHE proposed the recovery of a regulatory asset to reflect the 2010 Health Care Legislation (as further detailed below), and the Commission acknowledged that the Medicare Part D Subsidy would have future impacts on the Company's tax expense. However, at that time, the Commission concluded that the change in taxability of the Medicare Part D Subsidy was too far into the future for the Company to recover that regulatory asset in rates resulting from that case.[230]

Accordingly, in Docket No. 38339, the Commission approved a Medicare Part D Subsidy permanent adjustment of $6.5 million, which reduced CEHE's taxable income in the income tax expense calculation *even though* that permanent difference became a temporary difference (due to the 2010 Health Care Legislation) and related mainly to amounts of Medicare Part D Subsidy that were anticipated to be received *after* 2012 and so would be fully taxable to CEHE.[231]

Thus, customers have benefited and continue to benefit from a $6.5 million reduction in taxable income in the income tax expense calculation as a result of the Commission's approach in Docket No. 38339.[232]

Nevertheless, the Commission in Docket No. 38339 fully recognized that not taking the 2010 Health Care Legislation into account in Docket No. 38339 would create a timing issue for CEHE with respect to the Medicare Part D Subsidy. The Commission thus permitted CEHE to *continue* to monitor and accrue the difference—between what its rates had assumed the Medicare Part D Subsidy expense would be and what CEHE was required to pay—as a regulatory asset to be addressed in its next rate case.[233] The Commission expressly provided:

> The health care legislation underlying CenterPoint's proposal to amortize this regulatory asset will not be effective until January 1, 2013, a change too far into the future to be included in the rates set in this proceeding. However, the Commission *authorizes* CenterPoint *to continue to monitor and accrue* the difference between what their rates assume the Medicare Part B [sic] subsidy tax expense would be and

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[228] CEHE Ex. 13 at 1027-1028 (Pringle Direct); Pub. L. No. 111-148 (2010); Pub. L. No. 111-152 (2010).

[229] Under the 2010 Health Care Legislation, beginning January 1, 2013, CEHE's deduction for providing prescription drug coverage was reduced by the amount of the Medicare Part D Subsidy. CEHE Ex. 13 at 1027-1028 (Pringle Direct); Pub. L. No. 111-148, Section 9012(b) (2010); Pub. L. No. 111-152, Section 1407 (2010).

[230] CEHE Ex. 13 at 1030 (Pringle Direct); Docket No. 38339, Order on Rehearing at Finding of Fact 159A.

[231] CEHE Ex. 13 at 1030-1031 (Pringle Direct).

[232] Using the 35% tax rate in effect in 2010 and the associated tax gross-up factor of 1.53845 (computed as 1/(1-35%)), the annual revenue requirement reduction due to this item is $3.5 million (computed as $6.5 million x 35% x the gross up of 1.53845). *Id.* at 1030.

[233] *Id.* at 1031.

the reality of what CenterPoint is required to pay as a regulatory asset to be addressed in CenterPoint's next rate case.[234]

The Commission thus clearly and specifically (1) acknowledged that CEHE had been required to compute and establish a Medicare Part D Subsidy regulatory asset, (2) recognized that the asset would continue to increase over time, (3) authorized CEHE to continue to monitor and accrue that regulatory asset, and (4) recognized that CEHE may seek recovery of that asset in its next rate case, which is this proceeding.

Nevertheless, Mr. Kollen asks the Commission to ignore the facts that led to its prior order, seeks to eliminate the regulatory asset ordered by the Commission in Docket 38339, and makes numerous other erroneous assertions in criticizing CEHE's computation of the asset.[235] These proposals should be rejected. To understand the errors in Mr. Kollen's proposals, it is necessary to understand the GAAP treatment of the 2003 Medicare Legislation and the 2010 Health Care Legislation.

a. The Medicare Part D Subsidy under the 2003 Medicare Legislation Originally Created a Favorable Permanent Difference and Decreased Tax Expense

The 2003 Medicare Legislation originally created a customer-favorable permanent difference because the Medicare Part D Subsidy was tax free thereunder. This difference was required to assume future accruals of the Medicare Part D Subsidy—including accruals well into this century.

CEHE uses the accrual method under GAAP for accounting purposes.[236] As required under FASB Statement No. 106 (SFAS 106), the amount of the anticipated Medicare Part D Subsidy that CEHE accrued and recorded for accounting purposes to reflect the 2003 Medicare Legislation included *both* estimated receipts for benefits owed to current retirees *and* benefits promised to current employees when they retire, an accrual that considered anticipated payments extending well into this century.[237] And, because the Medicare Part D Subsidy was nontaxable

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[234] Docket No. 38339, Order on Rehearing at Part II.F (emphasis added). *See also* Docket No. 38339, Order on Rehearing at Finding of Fact 159A ("It is appropriate for CenterPoint to monitor and accrue the difference between what its rates assume the Medicare Part B [sic] subsidy tax expense will be and what CenterPoint is required to pay as a regulatory asset to be addressed in CenterPoint's next rate case.").

[235] GCCC Ex. 1 at 28-31 (Kollen Direct). While Ms. Dively appears to agree with CEHE's computation of the Medicare Part D Subsidiary regulatory asset and to appreciate the Commission's order in Docket No. 38339 with respect to this issue, she proposes to move CEHE's recovery of the asset to a separate rider and recover it without a return over a longer amortization period than CEHE proposes. Ms. Dively's proposals are in error for the reasons discussed in Parts II.G and II.G.3.e of this Initial Brief.

[236] CEHE Ex. 13 at 1028 (Pringle Direct).

[237] *Id.*

under the 2003 Medicare Legislation and did not reduce the full deductibility of drug benefits paid, CEHE's accrual created a customer-favorable permanent book/tax difference (*i.e.*, a reduction in income tax expense) equal to the full amount of *all* of its anticipated Medicare Part D Subsidies—not just the anticipated Medicare Part D Subsidies received, or to be received, prior to 2013.[238] Thus, prior to the enactment of the 2010 Health Care Legislation, CEHE's financial books assumed that the Medicare Part D Subsidy was, and always would be, non-taxable.

Specifically, the Medicare Part D Subsidy originally resulted in an income tax permanent difference of $28.6 million from 2004 through 2009, as calculated pursuant to FASB Statement No. 109.[239] But only $5.4 million of the Medicare Part D Subsidy was actually received during that time. An estimated $6.0 million of the permanent difference related to amounts that were anticipated to be received from 2010 to 2012, and the remaining $17.2 million of the permanent difference related to amounts that were anticipated to be received on and after January 1, 2013.[240]

b. The 2010 Health Care Legislation and GAAP Required CEHE to Immediately Account for the Unique Income Tax Treatment of the Medicare Part D Subsidy

Because the 2010 Health Care Legislation made the Medicare Part D Subsidy taxable, CEHE was required in 2010 to immediately create a regulatory asset. It is this asset that the Commission in Docket No. 38339 expressly authorized CEHE to continue to monitor and accrue and address in CEHE's next rate case.

The evidence demonstrates that the 2010 Health Care Legislation caused the Medicare Part D Subsidy to be taxable for amounts received in tax years beginning January 1, 2013.[241] So while the Medicare Part D Subsidy amounts received prior to January 1, 2013, remained nontaxable, there was no longer a permanent item to consider in the income tax calculation for the Medicare Part D Subsidies received beginning in 2013.[242] Rather, the $17.2 million described earlier that had been a permanent difference immediately became a temporary difference *in 2010* when the 2010 Health Care Legislation was enacted.

This occurred because GAAP requires that deferred income tax liabilities or assets must be measured "using the enacted tax rate(s) expected to apply to taxable income in the periods in which

[238] *Id.*
[239] *Id.*
[240] CEHE Ex. 13 at 1029 (Pringle Direct).
[241] *Id.*; Pub. L. No. 111-148, Section 9012(b) (2010); Pub. L. No. 111-152, Section 1407 (2010).
[242] CEHE Ex. 13 at 1029 (Pringle Direct).

the deferred income tax liability or asset is expected to be settled or realized," and they are to be "adjusted for the effect of a change in tax laws or rates."[243] Thus, when the 2010 Health Care Legislation passed *in 2010*, CEHE properly recorded *in 2010* a reduction to the ADFIT asset because Medicare Part D Subsidy receipts expected to be received on and after January 1, 2013, would be taxable.[244]

Additionally, because CEHE believed that the financial impacts from this change in tax law would be recoverable in future rates, a regulatory asset was established.[245] The regulatory asset was calculated in 2010 by taking the following steps:

- first, multiplying the $17.2 million temporary difference by the 35% federal tax rate in effect in 2010 to arrive at an ADFIT balance of $6.0 million;[246] and
- second, establishing the proper regulatory asset balance by grossing up the $6.0 million balance (that is, multiplying the $6.0 million by 1/(1-35%).[247]

After the gross-up, the resulting regulatory asset balance was approximately $9.3 million.[248] This regulatory asset was the regulatory asset that the Commission in Docket No. 38339 authorized CEHE to *continue* to *monitor* and *accrue*.[249]

c. CEHE's Request in this Proceeding Properly Complies with and Implements the Commission's Order in Docket No. 38339

As discussed in detail below, CEHE properly continued to monitor, accrue, and compute such regulatory asset. CEHE's request in this proceeding thus fully and correctly addresses the timing issue that the Commission in Docket No. 38339 recognized would be resolved in this rate case.

Mr. Kollen seeks to deny any recovery of the regulatory asset that the Commission authorized in Docket No. 38339 and, in the alternative, argues that CEHE is entitled to recover a regulatory asset as computed only beginning in 2013 because that is when the Medicare Part D Subsidy became taxable.[250] However, that position is not consistent with the Commission's order

[243] ASC 740-10-30-8 & ASC 740-10-35-4.
[244] CEHE Ex. 13 at 1029 (Pringle Direct).
[245] *Id.* at 1030; ASC 740-10-35-4.
[246] CEHE Ex. 13 at 1030 (Pringle Direct).
[247] *Id.* The gross-up calculates the pre-tax balance of the regulatory asset by multiplying the $6.0 million by 1/(1-35%)) and uses 35% because that was the federal tax rate then in effect.
[248] *Id.* at 1030.
[249] Docket No. 38339, Order on Rehearing at Part II.F. *See also* Docket No. 38339, Order on Rehearing at Finding of Fact 159A.
[250] GCCC Ex. 1 at 28 (Kollen Direct).

in Docket No. 38339 and appears to be a result of Mr. Kollen's misunderstanding of GAAP's accounting treatment of the Medicare Part D Subsidy.

As an initial matter, there is no reference anywhere in the Commission's Docket No. 38339 Order on Rehearing indicating that it applied only to temporary differences beginning in 2013. And there is no reference to adopting a "with and without" calculation of the effect of the Medicare Part D Subsidy on rates that are to be established in a *future* proceeding.

The Commission's order instead speaks expressly to CEHE "continu[ing]" to "monitor" and "accrue" the regulatory asset and to "its rates"—clearly referencing CEHE's then-existing Medicare Part D Subsidy regulatory asset and then existing rates.[251] If the Commission intended CEHE to establish and compute the Medicare Part D Subsidy beginning only in 2013, the Commission's direction to CEHE to "continue" to monitor and accrue would be nonsensical. There would be no amount or regulatory asset to "continue" to "monitor" or "accrue" before 2013, and there would need to be some reference in the order to the differences in "future" rates resulting from the different tax treatment of the Medicare Part D Subsidy. Mr. Kollen is thus fundamentally mistaken.

Instead, following the Commission's Order in Docket No. 38339, CEHE properly undertook the following steps in its proposal in this proceeding. First, CEHE determined the reduction in income tax expense by computing the difference between (1) what its rates since 2004 have been and (2) what its rates would have been had they reflected the taxability of the Medicare Part D Subsidy beginning in 2013.[252] This "with and without" computation is exactly what the Commission anticipated in its order in Docket No. 38339.

Second, in addition to the amounts that reduced income tax expense, CEHE necessarily took into account the need to recover the $6.5 million permanent adjustment included in rates for the period from 2011 through 2018 and described earlier. This permanent tax benefit was included in rates in Docket No. 38339, is still in effect today, and is expected to be in effect through 2019.[253]

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[251] Docket No. 38339, Order on Rehearing at Part II.F. *See also* Docket No. 38339, Order on Rehearing at Finding of Fact 159A.

[252] More precisely, CEHE calculated the difference between (1) the actual permanent differences that were claimed on CEHE's tax returns from 2004 through 2010 and (2) the actual non-taxable Medicare Part D Subsidy receipts that were received by CEHE for that same period. CEHE Ex. 13 at 1031-1033 (Pringle Direct). The permanent differences claimed on the tax returns were actuarially determined estimated receipts that were treated as adjustments to income tax expense based on the assumption that they would *never* be taxable when collected in future periods. *Id.* In both CEHE's 2006 and 2009 rate cases, tax expense was reduced reflecting this treatment. *Id.*

[253] CEHE Ex. 13 at 1031-1033 (Pringle Direct).

Third, to fully and properly implement the Commission's order in Docket No. 38339, CEHE reduced the permanent adjustment from 2011 through 2018 for actual Medicare Part D Subsidy cash receipts received prior to 2013 (because those amounts remained tax exempt).[254]

Fourth, the Medicare Part D Subsidy permanent item for each year from 2004 through 2018 was then tax effected at the applicable FIT rate. For 2004 through 2017, that rate was 35%; for 2018, the rate was 21%.[255] The resulting calculation is a regulatory asset before gross-up of $26.2 million through 2018.[256]

Fifth, the regulatory asset must be grossed-up using the current 21% FIT rate (calculated as 1/(1- 21%)).[257] After gross-up, the regulatory asset to be recovered from customers is $33.2 million.[258]

Finally, because CEHE is authorized to continue to monitor and accrue the Medicare Part D Subsidy regulatory asset prior to the implementation of new base rates for recovery in a future base rate proceeding, the Medicare Part D Subsidy regulatory asset accrued from the end of the test year to the implementation date of new rates will be deferred for a future base rate recovery.[259]

In sum, CEHE's calculation properly complies with the Commission's order in Docket No. 38339 and makes CEHE whole through the end of the test year in this proceeding for tax benefits previously passed through to customers that were not realized and will never be realized. Indeed, Ms. Dively raises no objection to this computation.[260] She also recognizes what Mr. Kollen does not: that the Commission allowed CEHE to "continue" to accrue the Medicare Part D Subsidy regulatory asset at issue in Docket No. 38339.[261]

d. Mr. Kollen Fails to Understand the Medicare Part D Subsidy Calculation

In addition to ignoring or misunderstanding the Commission's order regarding the Medicare Part D Subsidy in Docket No. 38339, Mr. Kollen asserts that CEHE made five errors with respect to its Medicare Part D Subsidy calculation.[262] Mr. Kollen gives no detailed

[254] *Id.*
[255] *Id.*
[256] *Id.*
[257] *Id.*
[258] *Id.*
[259] *Id.* at 1033.
[260] OPUC Ex. 1 at 18 (Dively Direct).
[261] *Id.*; CEHE Ex. 36 at 6-8 (Pringle Rebuttal).
[262] CEHE Ex. 36 at 6 (Pringle Rebuttal).

explanations of, and provides no support for, his assertions with respect to CEHE's calculations.[263] However, each is specifically refuted in the rebuttal testimony of Mr. Pringle.[264]

e. The Medicare Part D Subsidy Should Be Recovered Over a Three-Year Amortization Period

CEHE is requesting a consistent three-year amortization period for all of its regulatory assets and liabilities in this proceeding, including the Medicare Part D Subsidy regulatory asset.[265] Ms. Dively proposes that the Medicare Part D Subsidy regulatory asset through the end of the test year be removed from rate base for recovery—without any return—through a proposed Rider MEDD over a five-year period.[266] The Company addresses Ms. Dively's proposed amortization period above. However, Ms. Dively's proposal that the Medicare Part D Subsidy regulatory asset be included in Rider MEDD contains two additional errors. First, Ms. Dively removes the return component associated with the Medicare Part D Subsidy regulatory asset.[267] Yet, as discussed above, CEHE's rates since 2004 have included an assumption that Medicare Part D Subsidy receipts will be forever nontaxable.[268] With the change in tax law arising from the 2010 Health Care Legislation, CEHE established a regulatory asset for what its rates have historically assumed the tax expense will be (that is, $0) and what CEHE is required to pay.[269] This regulatory asset has been pre-funded by CEHE over multiple years, resulting in a significant amount of funds CEHE has yet to recover.[270] CEHE's proposal to include a ROR on this regulatory asset is appropriate and reasonable and should be allowed by the Commission. Second, when Ms. Dively removed the Medicare Part D Subsidy regulatory asset from base rates, she made an adjustment to remove the Texas margin tax ("TMT") from the base rate revenue requirement associated with lost revenue.[271] However, Ms. Dively included no offsetting increase with respect to the TMT on the revenue she includes in her proposed Rider MEDD.[272] If Rider MEDD were adopted, the evidence demonstrates that an increase for the TMT should be included in the rider to make CEHE whole.[273]

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263 *Id.*
264 *Id.* at 5-16.
265 CEHE Ex. 35 at 41-43 (Colvin Rebuttal).
266 OPUC Ex. 1 at 18 (Dively Direct); CEHE Ex. 35 at 41-43 (Colvin Rebuttal).
267 CEHE Ex. 36 at 15 (Pringle Rebuttal).
268 *Id.* at 15-16.
269 *Id.*
270 CEHE Ex. 36 at 16 (Pringle Rebuttal).
271 *Id.*
272 *Id.*
273 *Id.*

4. Texas Margin Tax Regulatory Asset

a. Change from Booking a TMT Regulatory Asset to An Accrual Reflected in Rate Base

CEHE's TMT Regulatory Asset request is quite simple. CEHE is seeking to change the way it recovers TMT expense through rates in response to feedback from parties in prior CEHE proceedings. To be kept whole for the transition from the current TMT recovery method to the requested method, CEHE is seeking approval to also recover the one-time regulatory asset that results. Under the current method, no party disputes that a one-year lag exists between the taxable year for the TMT and the year it is paid by the Company.[274] Put differently, the TMT paid in 2018 is based on the 2017 TMT calculation while the TMT calculation for 2018 is not paid until 2019.[275] The TMT paid in the test year is thus effectively not a test year expense but is instead an expense of the year ***before*** the test year. Without a change in this method, CEHE's TMT is always a year behind. In past proceedings, the Commission has allowed CEHE rate recovery for the TMT based on the cash payment of taxes during the test year even though the taxable year is the year prior to the test year.[276] CEHE has been deferring the current cost each year until it is recovered in rates the next year, which results in a regulatory asset to reflect the one-year lag between the taxable year and the payment year.[277]

To address comments made by parties in the Company's prior DCRF proceedings, CEHE requested a change in accounting for its TMT expense to turn it into a current expense and extinguish the existing, annual regulatory asset.[278] Specifically, CEHE requested:

- recovery of its TMT expense for the tax year ($20,027,248, as described below) so as to recover its current TMT expense on a GAAP accrual method; and
- recovery over three years of its prior-year TMT regulatory asset (namely, $19.6 million total, an amount which neither Intervenors nor Staff dispute) that exists due to the one-year lag described above, which asset would otherwise *never be recovered* if it were denied.[279]

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[274] CEHE Ex. 13 at 1024-1025 (Pringle Direct).
[275] *Id.*
[276] *Id*; CEHE Ex. 12 at 874 (Colvin Direct).
[277] CEHE Ex. 12 at 874-875 (Colvin Direct).
[278] CEHE Ex. 13 at 1024-1025 (Pringle Direct); CEHE Ex. 12 at 874 (Colvin Direct) (citing *Application of CenterPoint Energy Houston Electric, LLC for Approval of a Distribution Cost Recovery Factor Pursuant to P.U.C. Substantive Rule 25.243*, Docket No. 44572, Rebuttal Testimony of Mary A. Kirk for CEHE and Direct Testimony of Glenda Spence (Staff)).
[279] CEHE Ex. 13 at 1026 (Pringle Direct); CEHE Ex. 12 at 875 (Colvin Direct); WP/II-E-4.1 Adj 4 for the Texas Margin Tax Amortization adjustment.

The Company's proposal ensures that the TMT expense requested in this proceeding becomes a *test year* expense, protects customers from paying any duplicative TMT, eliminates the need to record TMT as a regulatory asset in the future, and stretches out the recovery of the regulatory asset over three years (consistent with other regulatory assets and liabilities).[280] The total amount of the adjustment for the change from a regulatory asset to accrual basis is $6.5 million, as shown in the TMT Amortization adjustment, which has been functionalized by total revenue requirement.[281]

b. Intervenors and Staff Misunderstand CEHE's TMT Regulatory Asset Request

While Intervenors and Staff do not challenge the Company's computation of its TMT, they do challenge the Company's proposed change in accounting for the TMT.[282] Further, Mr. Kollen, mistakenly argues that CEHE gave no reason for the change in accounting for the TMT.[283] As discussed above, the evidence demonstrates that CEHE simply proposed the change in response to parties' comments in its DCRF proceedings and to reduce a point of confusion in the future.[284] The change also eliminates the need to create any additional TMT regulatory assets.

Mr. Kollen incorrectly concludes that customers will be harmed if CEHE is allowed to recover the TMT regulatory asset.[285] This is not the case. The evidence demonstrates that there is no possible duplicative recovery in CEHE's proposal. CEHE has been deferring the current cost each year until it is recovered in rates the next year, creating a regulatory asset to reflect the one-year lag between the taxable year and the payment year.[286] Thus, CEHE would be harmed if the Commission were to disallow recovery of the regulatory asset because it would forever be denied recovery of these expenses.[287]

Ms. Dively also argues, in error, that CEHE should be afforded recovery only for the difference between the cumulative historical accrual-based amounts and the historical amounts

280 CEHE Ex. 13 at 1026 (Pringle Direct).
281 CEHE Ex. 12 at 882 (Colvin Direct).
282 OPUC Ex. 1 at 20 (Dively Direct); GCCC Ex. 1 at 35 (Kollen Direct); Staff Ex. 4A at 28 (Filarowicz Direct).
283 GCCC Ex. 1 at 35 (Kollen Direct).
284 CEHE Ex. 35 at 24 (Colvin Rebuttal); Staff Ex. 4A at 28 (Filarowicz Direct).
285 GCCC Ex. 1 at 32-33 (Kollen Direct). Mr. Kollen also erroneously compares the 1992 change in accounting method for unbilled revenue to the proposed change in TMT treatment. GCCC Ex. 1 at 36 (Kollen Direct). Mr. Kollen neglects to consider the fact that unbilled revenue is a non-cash accrual item that will reverse and never be collected from customers. In contrast, TMT is a cash item that must be collected and submitted to taxing authorities. CEHE Ex. 35 at 29 (Colvin Rebuttal).
286 CEHE Ex. 12 at 874-875 (Colvin Direct).
287 CEHE Ex. 35 at 29 (Colvin Rebuttal).

recovered in rates.[288] However, Ms. Dively identifies the wrong adjustment to test year TMT expense.[289] As described above, under CEHE's current method, there is a one-year lag between the accrual year and the payment year for TMT, which results in CEHE recording a regulatory asset each year.[290] The regulatory asset is thus the entire amount of the TMT for the year preceding the test year. The regulatory asset is ***not*** any sort of "true up" between the accrued amount and the actual amount paid, as Ms. Dively appears to believe. Ms. Dively also alleges that CEHE's TMT request amounts to retroactive ratemaking to recoup losses.[291] This is not the case. The TMT regulatory asset is not a loss—the asset was established pursuant to an order issued by the Commission and the asset amount is based on normal on-going expenses that have been afforded rate recovery in the past.[292]

Staff witness Mark Filarowicz's disagreements with CEHE's proposal are likewise without merit. For instance, Mr. Filarowicz claims that TMT treatment first became an issue only in 2008 because the TMT began in 2008.[293] However, the evidence demonstrates that TMT has evolved over the years and its predecessor—the state franchise tax—was in existence prior to 2008.[294] CEHE recorded the state franchise tax regulatory asset several years prior to 2008 as shown on CEHE's 2003 FERC Form 1.[295] In addition, in the Order on Rehearing in Docket No. 29526, the Commission recognized a deferred debit for state franchise tax.[296] While this reference is to the generation portion of the state franchise tax, CEHE recorded a similar regulatory asset for its transmission and distribution related state margin tax obligation.[297]

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[288] *Id.* at 30; OPUC Ex. 1 at 26 (Dively Direct).
[289] CEHE Ex. 35 at 30 (Colvin Rebuttal).
[290] *Id.*
[291] OPUC Ex. 1 at 26 (Dively Direct); CEHE Ex. 35 at 30 (Colvin Rebuttal). Ms. Dively also argues that CEHE is not following the FERC USOA by using general ledger account 179060. OPUC Ex. 1 at 26 (Dively Direct). Ms. Dively is misinterpreting a reference to general ledger account 179060 that was included in a discovery response on this subject. CEHE Ex. 35 at 29-30 (Colvin Rebuttal). In fact, CEHE uses separate general ledger accounts to track the individual regulatory assets in FERC Account 1823, which includes TMT. CEHE Ex. 35 at 29-30 (Colvin Rebuttal). According to FERC USOA requirements, Account 1823 is to include amounts for items "in the current period under the general requirements of the Uniform System of Accounts but for it being probable that such items will be included in a different period(s)." CEHE Ex. 35 at 29-30 (Colvin Rebuttal). Following the FERC USOA, CEHE records its TMT in FERC Account 1823 as shown on CEHE Ex. 2 at 59-60, Schedule II-B-12. CEHE Ex. 35 at 29-30 (Colvin Rebuttal).
[292] CEHE Ex. 35 at 30 (Colvin Rebuttal).
[293] Staff Ex. 4A at 29 (Filarowicz Direct); CEHE Ex. 35 at 31 (Colvin Rebuttal).
[294] CEHE Ex. 35 at 31 (Colvin Rebuttal).
[295] *Id.* at 31 & 118, Exh. R-KLC-04.
[296] Docket No. 29526, Order on Rehearing at 46.
[297] CEHE Ex. 35 at 32 (Colvin Rebuttal).

Mr. Filarowicz also claims the absence of the TMT regulatory asset in rate base in Docket No. 38339 is a reason for its exclusion in this proceeding.[298] This again reflects a misunderstanding of the issue. The TMT regulatory asset in this case is ***not*** the same as the TMT regulatory asset in prior dockets (including Docket No. 38339).[299] The TMT regulatory asset in prior dockets was not requested for rate base treatment because under the payment method the regulatory asset each year would be recovered in the following year.[300] As discussed above, under the proposed accrual method here, the TMT regulatory asset would be equal to a one-time TMT amount that must be recovered (over three years) to fully transition to the new method requested by CEHE in this proceeding.[301]

In sum, CEHE's TMT regulatory asset proposal is reasonable, avoids duplicative recovery, ensures recovery of all reasonable and necessary TMT amounts, and should be approved. However, if CEHE's proposal is not approved, CEHE will revert to its former methodology—resulting in the 2017 payment being reflected in the cost of service and 2018 expense being recorded as a regulatory asset, including the specific steps contained in Exhibit R-KLC-05 to Ms. Colvin's Rebuttal Testimony.

5. Smart Meter Texas Regulatory Asset

CEHE has been recovering its SMT costs as a part of its AMS deployment costs since Project No. 34610 through its AMS surcharge. The Company concluded its AMS deployment and filed its final reconciliation of AMS cost recovery through February 2017 in Docket No. 47364.[302] In Docket No. 47364, the Commission found that it was appropriate for CEHE to defer its reasonable and necessary O&M costs associated with SMT after February 2017 until the costs could be recovered in the Company's next base rate proceeding.[303] The Company incurred SMT related O&M expenses as a result of complying with 16 TAC § 25.130(d), (g) and (j), which has created a $6.9 million regulatory asset balance for total SMT costs incurred through the end of the test year. The reasonableness of CEHE's SMT expenses is addressed in Section IV.I. Recovering

298 Staff Ex. 4A at 30 (Filarowicz Direct).
299 CEHE Ex. 35 at 32 (Colvin Rebuttal).
300 *Id.*
301 Further, Mr. Filarowicz's implication that CenterPoint should not have recorded the TMT regulatory asset because Staff is not aware of other utilities that record a TMT regulatory asset is without merit. Staff Ex. 4A at 30 (Filarowicz Direct). CEHE relied on FERC and GAAP requirements and prior CenterPoint dockets to record its TMT regulatory asset. CEHE Ex. 35 at 32 (Colvin Rebuttal). What other utilities choose to do with their TMT expenses is irrelevant. CEHE Ex. 35 at 32 (Colvin Rebuttal).
302 CEHE Ex. 12 at 877 (Colvin Direct); Docket No. 47364, Final Order at Finding of Fact 13(b).
303 CEHE Ex. 12 at 877 (Colvin Direct); Docket No. 47364, Final Order at Finding of Fact 13(e).

the SMT Regulatory Asset over the requested three-year period results in an increase of $2.3 million per year.[304] In addition, as approved in Docket No. 47364, CEHE is authorized to defer any SMT costs incurred prior to the implementation of new base rates for recovery in a future base rate proceeding.[305] SMT costs incurred from the end of the test year to the implementation date of new rates will be deferred for future base rate recovery.

6. Retail Electric Provider ("REP") Bad Debt Regulatory Asset

REPs collect the Company's receivables from the distribution of electricity to their own customers. There are instances, however, when REPs default on payments to the Company.[306] Commission Rule 25.107(f)(3)(B) authorizes the Company to establish a regulatory asset for bad debt expenses resulting from a REP's default on its obligation to pay delivery charges to the Company net of collateral and bad debt currently included in rates and to request recovery of those costs through rates.[307] Even though OPUC agrees the Company is following the Commission rule, Ms. Dively challenges the Company's recovery of the bad debt regulatory asset, arguing that it improperly includes a credit for REP bad debt that was approved in the Company's last rate case and the asset should be removed from rate base.[308] The fact that the bad debt expense currently being recovered through rates is a credit does not prohibit recovery of the regulatory asset—Rule 25.107(f)(3)(B) simply refers to the bad debt currently included in rates, which happens in this instance to be a credit for CEHE. In addition, the Company's request to include a REP Bad Debt asset in rate base is consistent with the Commission's support of a similar request made by Oncor in Docket No. 46957, which was resolved through a settlement agreement.[309] For these reasons, the Company's REP Bad Debt regulatory asset should be included in rate base.

7. BRP Pension and Postretirement Issues

This issue is addressed in Section II.C (Rate Base—Prepaid Pension Asset/Accrued Postretirement Cost—Postretirement Cost). The amounts addressed under Postretirement Cost, including discussion of Postretirement Medical costs are neither assets nor liabilities that should be included in rate base for the reasons addressed in Section II.C.2.

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304 CEHE Ex. 12 at 875 (Colvin Direct); *See* CEHE Ex. 2 at 1634, WP/II-E-4.1 Adj 8 for Smart Meter Texas Amortization adjustment.
305 CEHE Ex. 12 at 875 (Colvin Direct); Docket No. 47364, Final Order at Finding of Fact 13(e).
306 Direct Testimony of John R. Hudson, CEHE Ex. 11 at 780 (Bates Pages).
307 *See* CEHE Ex. 2 at 1243-1248, WP/II-D-1 Adj 3 for the Bad Debt adjustment.
308 OPUC Ex. 1 at 31-32 (Dively Direct).
309 CEHE Ex. 35 at 39 (Colvin Rebuttal); Docket No. 46957, Final Order at Finding of Fact 48, RFP Schedule II-B-12; Stipulation at Section H.1 (Aug. 2, 2017).

8. Other Regulatory Assets and Liabilities

a. PURA §36.065 Pension and OPEB Regulatory Liability

No party challenged the Company's compliance with PURA § 36.065 related to (1) the pension and other postemployment benefits ("OPEB") reserve account the Company established after it was authorized to do so in Docket No. 38339; (2) the $60.6 million liability that reflects the surplus that was properly recorded in the reserve account; and (3) the reasonableness of the expenses in the reserve account, which are based on amounts reflected in actuarial reports since rates were approved in Docket No. 38339.[310] The Company's proposal to amortize the regulatory liability over three years is reasonable and results in an adjustment to decrease amortization expense by $20.2 million per year as part of the overall rate base calculation.[311] While no party challenges the reasonableness of the amount in the reserve account or the requested three-year amortization period, Ms. Dively argues most of the Company's regulatory assets should be moved out of rate base and recovered through a rider.[312] If regulatory assets are moved to a rider, it is necessary to also move regulatory liabilities into a rider as well, including the $60.6 million pension and OPEB liability. Staff acknowledges the need for this treatment.[313] Moving both regulatory assets and regulatory liabilities produces an equitable outcome by treating those amounts the same way rather than leaving only regulatory liabilities, such as the pension and OPEB liability, in base rates. If the pension and OPEB liability is moved to a rider, the amounts reflected must also include return due to the statutory support for recovery of the amount as part of rate base.

Going forward, the baseline expense levels that should be used for tracking annual costs are $25,629,455 for pension and $2,671,274 for OPEB expense.[314]

b. Hurricane Ike Regulatory Liability

No party challenges the Company's request to return amounts to customers in the form of a regulatory liability for Hurricane Ike costs. In Docket No. 36918, the Commission authorized the Company to recover reasonable and necessary Hurricane Ike restoration costs incurred through February 28, 2009 plus carrying costs.[315] In the final order, the Commission ordered the Company

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[310] CEHE Ex. 12 at 872-873 (Colvin Direct).
[311] *See* CEHE Ex. 2 at 1634, WP/II-E-4.1 Adj 3 for the Pension PURA Amortization adjustment.
[312] OPUC Ex. 1 at 12 (Dively Direct).
[313] CEHE Ex. 4A at 31-32, Att. MF-6 (Filarowicz Direct).
[314] CEHE Ex. 2 at 1294, WP/II-D-2 Adj 6.1.
[315] Docket No. 36918, Final Order at Finding of Fact 15.

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to defer other sources of funding that compensate the Company for Hurricane Ike costs received after issuance of the financing order.[316] In addition, CEHE will continue to record carrying costs until new base rates are implemented.[317] The regulatory liability balance of $4.0 million is the sales tax refund net of the additional costs incurred related to Hurricane Ike restoration plus carrying charges.[318] The Company's proposal to amortize this amount over a three-year period should be approved.

c. Expedited Switching Costs Regulatory Asset

No party challenges the Company's request to include a regulatory asset in rate base and earn a related return for expedited switching costs that result from end-use customers switching REPs, which is consistent with the treatment the Commission approved for these costs in Docket No. 38339.[319] To encourage a faster response time from REPs, the Commission required utilities to reduce the time for processing customer-requested switches from 45 days to 7 business days or less.[320] Consistent with the requirements in 16 TAC § 25.474(o), transmission and distribution utilities ("TDUs") can recover the increased costs resulting from the shorter switching timelines through a regulatory asset. For these reasons, the Company has created a regulatory asset to defer and track the costs associated with performing meter reads for purposes of switching a customer's REP.[321] This regulatory asset results in an adjustment of $0.4 million to test year costs to recover the regulatory asset over a three-year period consistent with other regulatory assets and liabilities.[322] The Expedited Switches Amortization adjustment has been functionalized by Metering.[323] In addition, CEHE will continue to record expedited switching costs to a regulatory asset for recovery in a future rate proceeding.[324] For these reasons, including that no party challenged the inclusion of this regulatory asset in rate base, the Company's request should be approved.

d. Deferred Accounting Treatment for Interest Rate Hedging

No party challenged CEHE's request to defer the ineffective component of interest rate hedging that may occur in the future. CEHE's accounting treatment under GAAP and the FERC

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[316] *Id.* at Finding of Fact 22.
[317] *See id.* at Finding of Fact 24.
[318] CEHE Ex. 12 at 871-872 (Colvin Direct).*See* WP/II-E-4 for Adj 1 Hurricane Ike Adjustment.
[319] CEHE Ex. 12 at 876 (Colvin Direct).
[320] *Id.*; 16 TAC §§ 25.214 and 25.474, Project No. 36536, *Rulemaking to Expedite Customer Switch Timelines* at 16.
[321] CEHE Ex. 12 at 876 (Colvin Direct).
[322] *See* CEHE Ex. 2 at 1634, WP/II-E-4.1 Adj 5 for the Expedited Switches Amortization Adjustment.
[323] CEHE Ex. 12 at 876-877 (Colvin Direct).
[324] *Id.* at 877.

USOA for an effective interest rate hedge is to defer the gains/losses and amortize the gains/losses through interest expense over the life of the corresponding debt.[325] CEHE is requesting to include the interest rate hedge in the weighted cost of capital. To do this, CEHE is first requesting to move the effective component of the interest rate hedge from accumulated other comprehensive income to a regulatory liability as shown on Schedule II-B-11. Second, CEHE will include the amortization of the regulatory liability over the life of the debt in the cost of debt.[326] CEHE's accounting treatment under GAAP for ineffective interest is to expense the entire amount when incurred. The ineffective component of interest hedging should be deferred and amortized over the life of the associated debt and therefore, included in the cost of debt calculation. Even though CEHE did not incur an ineffective component of interest rate hedging during the test year, it is requesting the authority to defer such items in the future, if and when they are incurred with amortization similar to the effective component.[327]

H. Capitalized Incentive Compensation [PO Issue 13]

Mr. Filarowicz challenges the capitalized portions of incentive compensation by essentially offering a flow-through argument: if certain incentive compensation expenses are disallowed in this case, so too should the capitalized portions of those costs be removed from rates.[328] Mr. Filarowicz's position should be rejected based on the evidence detailed in Section IV.B.1 of CEHE's Initial Brief and a flow-through adjustment to remove the capitalized portions of reasonable and necessary incentive compensation costs should not be made.

III. Rate of Return [PO Issues 4, 5, 7, 8, 9]

Well-established precedent requires that a utility be allowed a reasonable opportunity to earn a reasonable ROR on invested capital.[329] A utility must have a reasonable opportunity to earn a return that is: (1) commensurate with returns on equity investments in enterprises having comparable risks; (2) sufficient to ensure the financial soundness of the utility's operations; and (3) adequate to attract capital at reasonable rates, thereby enabling it to provide safe, reliable service.[330] The ability to attract capital on reasonable terms is critically important to CEHE, which

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[325] *Id* at 908.
[326] *Id.*
[327] *Id.*
[328] Staff Ex. 4A at 18 (Filarowicz Direct).
[329] *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944); *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n of W. Va.*, 262 U.S. 679, 692-93 (1923).
[330] *See Bluefield*, 262 U.S. at 692-93; Direct Testimony of Robert B. Hevert, CEHE Ex. 26 at 2684 (Bates Pages).

will expend approximately $5.14 billion for capital investments in the next five years.[331] The TCJA will reduce CEHE's cash flow on a going-forward basis, which will place significant downward pressure on its credit metrics if the Commission does not approve constructive measures to mitigate the effects of the reduced cash flow. Moreover, Moody's Investors Service ("Moody's) has viewed Staff and Intervenor's ROE and capital structure recommendations in this case, and has expressly stated that the adoption of an equity ratio below 40% or an ROE materially below 10% would be considered credit-negative.[332] Therefore, it is necessary for the Commission to provide CEHE an opportunity to attract capital on reasonable terms so that CEHE can continue to provide safe, reliable, electric utility service while maintaining its financial integrity and credit ratings.

A. Return on Equity [PO Issue 8]

As previously explained, the Commission-approved return to the equity owner should be reasonably sufficient to assure confidence in the financial soundness of the utility, to maintain and support the utility's credit, and to attract the capital necessary for the proper discharge of the utility's public duties.[333] As further explained below, CEHE witness Robert B. Hevert's analyses establish that the appropriate return on common equity for CEHE is 10.4%.[334] Staff and Intervenors' ROE recommendations should be rejected, as they are far removed from recently authorized returns and fail to adequately reflect evolving capital market conditions. Moreover, their recommendations are materially lower than 10%, and, if adopted, would negatively impact CEHE's credit metrics.[335]

1. Mr. Hevert's ROE analysis is based on well-established methodologies and produces a reasonable result.

Mr. Hevert estimated CEHE's cost of equity by applying several widely accepted approaches: (1) the Constant Growth Discounted Cash Flow ("DCF") model; (2) the Capital Asset Pricing Model ("CAPM"); and (3) the Bond Yield Plus Risk Premium approach.[336] In addition to those quantitative analyses, Mr. Hevert considered the particular operational and financial risk factors that CEHE faces, including its elevated capital expenditure programs relative to peer utilities, its geographic and weather-related risks, its regulatory framework, and its customer

[331] Direct Testimony of Robert B. McRae, CEHE Ex. 27 at 2832 (Bates Pages).
[332] Rebuttal Testimony of Robert B. McRae, CEHE Ex. 43, Confidential Exh. R-RBM-3 at 1 (Bates Pages).
[333] *Bluefield*, 262 U.S. at 692-93.
[334] CEHE Ex. 26 at 2664 (Hevert Direct).
[335] *See* CEHE Ex. 43, Exh. R-RBM-3 at 1 (McRae Rebuttal).
[336] CEHE Ex. 26 at 2665 (Hevert Direct).

concentration.[337] Mr. Hevert did not make any specific adjustments to his ROE estimates for the identified business and financial risk factors, but he considered them in the aggregate when determining where CEHE's ROE should fall within the range of results.[338]

Mr. Hevert further explained that interest rates have been rising since 2016 and are expected to continue to rise during the period that the rates in this case will be in effect. The Federal Reserve raised the Federal Funds target rate eight times between December 2016 and 2018, and short-term and long-term interest rates have also increased.[339] Moreover, investors are projecting that interest rates will keep rising throughout the remainder of 2019 and 2020.[340] Because equity investors demand a premium over the cost of debt, the rising debt costs lead investors to require higher equity returns.

The Intervenor witnesses take issue with several aspects of Mr. Hevert's ROE analyses, but their criticisms are misplaced. For example, some of the Intervenor witnesses challenge Mr. Hevert's CAPM analysis on the ground that he established his market risk premium by conducting a DCF analysis of all of the companies in the Standard & Poor's ("S&P") 500 Index.[341] Texas Coast Utilities Coalition ("TCUC") witness J. Randall Woolridge argues that the resulting DCF value is overstated and too high to be sustainable.[342] However, CEHE established on cross that FERC has approved the use of a DCF study of the S&P 500 companies to establish the market risk premium for the CAPM analysis, and FERC has expressly rejected the argument that the DCF results of the S&P 500 are too high to be sustainable.[343]

The Intervenor witnesses also dispute Mr. Hevert's application of the Bond Yield Plus Risk Premium model because Mr. Hevert performed a regression analysis to quantify the negative correlation between equity risk premiums and interest rates.[344] Texas Industrial Energy Consumers ("TIEC") witness Michael P. Gorman, for example, asserts that although such a correlation may have existed in the 1980s, it is insignificant now.[345] On rebuttal, however, Mr.

[337] *Id.* at 2703-2713.
[338] *Id.* at 2703. Mr. Hevert also did not make a specific adjustment for flotation costs.
[339] *Id.* at 2671-2683 (Hevert Direct); *see* Tr. at 531 (Woolridge Cross) (Jun. 26, 2019).
[340] *See* CEHE Ex. 26 at 2673 (Hevert Direct).
[341] TCUC Ex. 1 at 60 (Woolridge Direct).
[342] Tr. at 545-546 (Woolridge Cross) (Jun. 26, 2019).
[343] *Id.* at 547-549; CEHE Ex. 69, Tab 11 at 60-62.
[344] Tr. at 652 (Winker Cross) (Jun. 26, 2019).
[345] TIEC Ex. 5 at 84 (Gorman Direct).

Hevert pointed to academic research by Dr. Roger Morin and others showing that the inverse relationship continues to exist.[346]

On rebuttal, Mr. Hevert updated his DCF, CAPM, Bond Yield Risk Premium, and Expected Earnings analysis based on data through May 17, 2019.[347] The more recent data confirms Mr. Hevert's earlier conclusion that 10.4% is a reasonable cost of equity for CEHE, and it should be adopted by the Commission.

2. Staff and Intervenors' ROE recommendations are not in line with other authorized returns, and are not reasonable.

As explained earlier, one of the key principles of utility regulation is that the return to the equity owner should be commensurate with returns on investment in other enterprises having comparable risks.[348] The evidence in this proceeding establishes that the average authorized ROE for electric utilities since 2014 is 9.68%,[349] and the Commission's most recently authorized ROE is 9.65%.[350] In contrast, Dr. Woolridge's primary ROE recommendation is 9.0%,[351] OPUC witness Anjuli Winker recommends a 9.15% ROE,[352] Mr. Gorman recommends a 9.25% ROE,[353] and Mr. Ordonez recommends a 9.45% ROE.[354] Even the highest of their recommendations, 9.45%, is 23 basis points below the average return for electric utilities since 2014.[355] None of the Intervenor and Staff witnesses explains why CEHE is so much less risky than other utilities that it would be able to attract capital with an authorized ROE so far below other authorized ROEs.[356]

Because Staff and Intervenor witnesses have given considerable weight to their DCF-based results, it is not surprising that their recommendations fall well below currently authorized returns.[357] Their common dependence on the DCF method also explains why their recommendations generally fall within a narrow range.[358] As Mr. Hevert's testimony explains,

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[346] Rebuttal Testimony of Robert B. Hevert, CEHE Ex. 42 at 88, 104.
[347] *Id.* at 6.
[348] *Hope Natural Gas Co.*, 320 U.S. at 603.
[349] CEHE Ex. 42 at 16 (Hevert Rebuttal).
[350] Docket No. 48401, Final Order at Finding of Fact No. 47.
[351] TCUC Ex. 1 at 4 (Woolridge Direct). Dr. Woolridge also offers an alternative recommendation of 8.65%.
[352] OPUC Ex. 3 at 4 (Winker Direct).
[353] TIEC Ex. 5 at 5 (Gorman Direct).
[354] Staff Ex. 3A at 7 (Ordonez Direct).
[355] CEHE Ex. 42 at 9 (Hevert Rebuttal).
[356] *E g*, CEHE Ex. 42 at 116-117 (Hevert Rebuttal).
[357] *Id.* at 8.
[358] *Id.* at 9.

since 2014 the Constant Growth DCF model has produced ROE estimates notably below the returns then authorized by regulatory commissions.[359]

The Intervenor and Staff witnesses focus on the mechanisms of their analytical models and insist that the results of their analyses must be reasonable because the models and the inputs to the models are reasonable.[360] But that argument is exactly backwards. *Hope Natural Gas* teaches that it is the result reached, not the method employed, that is evaluated for reasonableness.[361] No one financial model is more reliable than another at all times and under all market conditions.[362] As Mr. Hevert explains, there are times when certain models' assumptions become incompatible with market conditions, and their results do not make practical sense.[363] Consequently, model results cannot always be assumed to constitute a reasonable cost of equity. Rather, it is necessary to apply reasoned judgment in vetting model assumptions and assessing the reasonableness of their results.[364]

a. Staff witness Mr. Ordonez

Mr. Ordonez determined his recommended ROE using a Constant Growth and Multi-Stage DCF analysis and a Risk Premium analysis.[365] In effect, his recommendation gives approximately 77% weight to his Risk Premium results (9.79%) and approximately 23% weight to the approximate average of his two DCF results (8.34%).[366] This is concerning, as a considerable portion of Mr. Ordonez's recommended ROE is based on an estimate of 8.34%, which is 134 basis points below the average authorized return for electric utilities since 2014.[367] Mr. Ordonez's DCF and Risk Premium analyses also contain several incorrect assumptions, which if remedied, would increase his calculated ROE estimates considerably.[368]

However, most troubling is Mr. Ordonez's failure to consider the impacts of the TCJA in any meaningful way in determining his ROE recommendation. Mr. Ordonez asserts that because

[359] CEHE Ex. 26 at 2667, Chart 1 (Hevert Direct); CEHE Ex. 42 at 9, Figure 2 (Hevert Rebuttal).
[360] *E.g.* Tr. at 545 (Woolridge Cross) (Jun. 26, 2019) (Dr. Woolridge testifies that his CAPM results support his lower numbers, while admitting he has never seen an authorized ROE that low).
[361] *Hope Natural Gas Co.*, 320 U.S. at 603.
[362] CEHE Ex. 42 at 6 (Hevert Rebuttal).
[363] *Id.*
[364] *Id.*
[365] Staff Ex. 3A at 28 (Ordonez Direct). Mr. Ordonez also conducted a CAPM analysis, but did not give any weight to that result.
[366] CEHE Ex. 42 at 17 (Hevert Rebuttal).
[367] *Id* at 16.
[368] *Id.* at 17-18, 20-21 (applying revised DCF and Risk Premium results produces a weighted average of 9.78%).

the TCJA affects all utilities, its effect is reflected in his proxy group.[369] However, Mr. Ordonez admitted on cross that his proxy group selection would not have been any different if the TCJA had not been enacted,[370] thereby demonstrating that his analysis reflected no actual consideration of the effect of the TCJA on CEHE's required ROE. Mr. Ordonez offered nothing but his unsupported opinion that no further consideration was needed to account for the risks of the TCJA. In contrast, Mr. Hevert presented an analysis of stock prices in his rebuttal testimony which shows that the TCJA has meaningfully – and negatively – affected utility stock valuations, and therefore should be reflected in CEHE's ROE.[371]

b. OPUC witness Ms. Winker

Ms. Winker conducted a Constant Growth DCF analysis and a Bond Yield Plus Risk Premium analysis to determine her recommended ROE and conducted a CAPM analysis as a quantitative check on her other results.[372] However, her analyses suffer from several errors.

Ms. Winker does not accurately consider the current capital market conditions and their effect on the cost of equity. For example, she incorrectly assumes that capital costs will remain at historically low levels "due to the [Federal Open Market Committee's ("FOMC")] plan to put a hold on interest rate increases over the next few years," and cites this as support for the reasonableness of her ROE recommendation.[373] As Mr. Hevert testified in his rebuttal, there is no indication that the FOMC—the monetary policymaking body of the Federal Reserve System—has any such plan.[374]

Ms. Winker's position that Sustainable Growth rates are more appropriate than earnings growth in the DCF formulation is not supported by data from Value Line, a source she relies on in this proceeding.[375] Because projected earnings per share growth is the only variable that has any explanatory value, projected earnings growth should be the only variable used in the DCF analysis.[376] Furthermore, the theoretical basis of Ms. Winker's Sustainable Retained Earnings Growth rate does not apply to her data.[377]

[369] Staff Ex. 3A at 31 (Ordonez Direct); Tr. at 703 (Ordonez Cross) (Jun. 26, 2019).
[370] Tr. at 702-703 (Ordonez Cross) (Jun. 26, 2019).
[371] CEHE Ex. 42 at 23-26 (Hevert Rebuttal).
[372] OPUC Ex. 3 at 23 (Winker Direct).
[373] *Id.* at 40.
[374] CEHE Ex. 42 at 40 (Hevert Rebuttal).
[375] *Id.* at 56.
[376] *Id.*
[377] *Id.* at 52, 56.

Ms. Winker's Bond Yield Plus Risk Premium analysis uses a shorter data set (18 years) than Mr. Hevert's analysis does. Ms. Winker argues her shorter period better reflects current investor expectations and market conditions,[378] but by ignoring the several capital market and macroeconomic cycles covered in Mr. Hevert's 39-year data set, Ms. Winker's analysis unnecessarily makes the model less robust.[379] Ms. Winker has also underestimated the cost of equity by applying an historical average Equity Risk Premium calculated over a period during which interest rates were higher than their current levels.[380]

Finally, Ms. Winker's CAPM results are too low to be a reasonable estimate of CEHE's cost of equity, as a result of her unduly low market risk premium and her risk-free estimate.[381] Ms. Winker's market risk premium relies on the return on long-term Government bills, rather than the 30-year Treasury which better matches the life of the investment, and her analysis fails to consider that the market risk premium changes with the level of interest rates.[382]

c. TIEC witness Mr. Gorman

Mr. Gorman recommends that the Commission approve a ROE of 9.25% based on the results of his DCF, CAPM, and Bond Yield Plus Risk Premium analyses.[383] As discussed above, Mr. Gorman's ROE is lower than other authorized ROEs and fails to meet the minimum standard for an authorized utility return. Moreover, his analyses contain multiple flaws and should be disregarded.

First, Mr. Gorman's DCF analysis relies primarily on the results of his Constant Growth DCF.[384] This is problematic because the Constant Growth DCF model is based on several underlying assumptions, including the constancy of dividend yields and price/earnings ratios, that do not hold under current market conditions.[385]

Second, Mr. Gorman's 9.20% expected total market return estimate used in his CAPM analysis is 268 basis points below the long-term average market return and falls outside the range of average returns during the period 1976-2018 using 50-year annual averages.[386] Comparing the 9.20% to the rolling 50-year average annual market return of 11.90% makes it clear that

[378] OPUC Ex. 3 at 34 (Winker Direct).
[379] CEHE Ex. 42 at 58 (Hevert Rebuttal).
[380] *Id.* at 59.
[381] *Id.* at 62.
[382] *Id.* at 63, 64.
[383] TIEC Ex. 5 at 5, 39 (Gorman Direct).
[384] *Id.* at 54.
[385] CEHE Ex. 42 at 75 (Hevert Rebuttal).
[386] *Id* at 81.

Mr. Gorman's expected market return is well below the long-term market experience and is therefore not reasonable.[387] Additionally, Mr. Gorman's use of historical average market risk premiums is not likely to mirror changes in investment return requirement, as the market risk premium is meant to be a forward-looking parameter.[388]

Third, Mr. Gorman's Risk Premium analysis failed to account for the inverse relationship between interest rates and equity risks, which significantly understates CEHE's required ROE.[389] Mr. Hevert presented evidence demonstrating that equity premiums rise as interest rates fall,[390] but rather than account for that, Mr. Gorman applied a long-term average risk premium.[391] Mr. Gorman's assertion that this inverse relationship is outdated[392] is demonstrably wrong, as Dr. Morin recounts much more recent studies showing that the inverse relationship continues to exist.[393]

d. TCUC witness Dr. Woolridge

Dr. Woolridge recommends an ROE of 9.0%, based on his DCF and CAPM analyses.[394] Dr. Woolridge's recommended ROE is the lowest of any witness, and would reduce CEHE's currently authorized ROE by 100 basis points if adopted.[395] The Commission's most recently authorized return is 65 basis points above Dr. Woolridge's recommendation, and 235 basis points above the low end of his range.[396] Dr. Woolridge has provided no evidence to support his conclusion that CEHE is so much less risky that investors would require a return 65 to 235 basis points below those authorized for other electric utilities in Texas.[397]

Dr. Woolridge argues that his recommendation is consistent with a downward trend in ROEs. However, there is no downward trend.[398]

Unlike all of the other ROE witnesses in this proceeding, Dr. Woolridge does not base the growth rate in his DCF analysis on the earnings-per-share forecast of analysts for his proxy

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[387] *Id.*
[388] *Id.* at 82-83.
[389] *Id.* at 86.
[390] *Id.* at 87.
[391] TIEC Ex. 5 at 54-56 (Gorman Direct).
[392] *Id.* at 84.
[393] CEHE Ex. 42 at 88 n.183 (Hevert Rebuttal).
[394] TCUC Ex. 1 at 3 (Woolridge Direct).
[395] *See* Tr. at 523-524 (Woolridge Cross) (Jun. 26, 2019).
[396] CEHE Ex. 42 at 116 (Hevert Rebuttal).
[397] *Id.* at 116-117.
[398] *See* Tr. at 525 (Woolridge Cross) (Jun. 26, 2019).

group.[399] Dr. Woolridge claims that these analyst forecasts are "overly optimistic" and "upwardly biased;" however he admits that none of the studies he cites in support of this premise deal with utilities only.[400] This is problematic, as Dr. Woolridge admits that the alleged "upward bias" is "much less" for utilities.[401] Additionally, Mr. Hevert testified that analysts are subject to reporting certification requirements, and in his personal experience, their growth projections are not upwardly biased.[402] Mr. Hevert's opinion is consistent with Dr. Morin's conclusion that the argument made by Dr. Woolridge should be rejected, as the magnitude of the optimism bias for large rate-regulated companies in stable segments of the industry is likely to be very small if it exists at all.[403] As a result of his use of Value Line projected growth rates, Dr. Woolridge's growth rates used in his DCF analysis are higher than the earnings-per-share growth rates.[404]

Dr. Woolridge's CAPM analysis produces an estimated cost of equity of 7.30% for both his proxy group and Mr. Hevert's.[405] This estimate is far too low to be a reasonable measure of CEHE's cost of equity—Dr. Woolridge himself admits that he is not aware of a ROE in any jurisdiction that is as low as 7.30%.[406]

e. Walmart witness Mr. Chriss and HEB witness Mr. Presses

Neither Walmart witness Steve Chriss nor HEB witness George Presses performed any quantitative analyses or offer a specific ROE recommendation in this case. While Mr. Chriss expresses "concern" about CEHE's proposed ROE based on his review of authorized ROEs since 2016,[407] his review of nationwide ROEs fails to consider the extent to which the authorizing jurisdictions are viewed by credit rating agencies as having constructive regulatory environments.[408] Considering only the ROEs authorized in more constructive jurisdictions demonstrates that Mr. Hevert's recommended range is consistent with those returns.[409]

Mr. Presses expresses the view that the Company's ROE should be reduced or, at a minimum, limited due to a failure to reliably serve customers (although the only evidence he offers

[399] *Id.* at 537-538.
[400] *Id.* at 538, 540.
[401] *Id.* at 538.
[402] Tr. at 765-766 (Hevert Redirect) (Jun. 26, 2019).
[403] Tr. at 541-542 (Woolridge Cross) (Jun. 26, 2019).
[404] *Id.* at 544.
[405] TCUC Ex. 1 at 48 (Woolridge Direct).
[406] Tr. at 545 (Woolridge Cross) (Jun. 26, 2019).
[407] *See* Direct Testimony of Steve W. Chriss, Walmart Ex. WMT-1 at 8, 9.
[408] CEHE Ex. 42 at 171 (Hevert Rebuttal).
[409] *Id.* at 173.

relates solely to HEB and not to any of CEHE's more than 2.5 million other customers).[410] Section 36.052 of PURA speaks to the factors the Commission shall consider in setting the authorized return. As CEHE witnesses Dale Bodden and Julienne Sugarek explain, the quality of CEHE's services (considering *all* customers, not just one) is very high.[411] COH agrees.[412] Based on a plain reading of PURA Section 36.052, the Commission should, if anything, increase the Company's authorized ROE in recognition of that service quality.

B. Cost of Debt [PO Issue 8]

CEHE's current embedded cost of long-term debt is 4.38%.[413] No party has taken issue with that cost of debt, which reflects the impact of pre-issuance hedging.[414]

C. Capital Structure [PO Issue 7]

A capital structure composed of 50% debt and 50% equity will support a single-A credit rating, which helps ensure that CEHE will be able to access capital in nearly all economic climates; it is consistent with the level of equity recently established for comparable utilities in other jurisdictions; and it reasonably reflects the business and regulatory risks that CEHE faces.[415] Mr. Gorman, Dr. Woolridge, and Mr. Ordonez argue that the Commission should adopt a capital structure consisting of 60% debt and 40% equity,[416] whereas Ms. Winker argues for the adoption of a capital structure consisting of 54.5% debt and 45.5% equity.[417] As explained below, the Intervenor and Staff witnesses:

- misapply the Commission's rulings in prior cases;
- fail to recognize the detrimental effects that the TCJA has had on utilities' cash flows and will have going forward;
- rely on erroneous premises about the nature and extent of CEHE's business and regulatory risks; and
- largely fail to account for how their recommendations would affect CEHE's credit metrics.

Accordingly, the Commission should reject their capital structure recommendations.

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[410] Direct Testimony of George Presses, HEB Ex. 1 at 22.
[411] CEHE Ex. 9 at 609-611 (Bodden Direct); Rebuttal Testimony of Julienne P. Sugarek, CEHE Ex. 33 at 4-5 (Bates Pages).
[412] COH/HCC Ex. 1 at 9 (Norwood Direct).
[413] CEHE Ex. 43 at 4 (McRae Rebuttal).
[414] *Id.* at 4, 40.
[415] CEHE Ex. 27 at 2834 (McRae Direct).
[416] TIEC Ex. 5 at 37, Table 7 (Gorman Direct); TCUC Ex. 1 at 20 (Woolridge Direct) (Dr. Woolridge also presents an alternative capital structure composed of 55.48% long-term debt, 0.90% short-term debt, and 43.62% common equity); Staff Ex. 3A at 37 (Ordonez Direct).
[417] OPUC Ex 3 at 43 (Winker Direct).

1. The evidence establishes that CEHE needs a 50/50 capital structure to maintain its current credit ratings.

CEHE has established that its currently approved equity ratio of 45% will not produce financial metrics that are sufficient to maintain its current credit ratings.[418] Unlike most of the Staff and Intervenor witnesses, CEHE witnesses Robert B. McRae and Ellen Lapson, who was a Managing Director at Fitch Ratings ("Fitch") for more than a decade,[419] each performed a quantitative analysis showing how an equity ratio of 45% would affect CEHE's credit ratings in light of TCJA impacts. Both Mr. McRae and Ms. Lapson concluded that without an increase in equity ratio, CEHE would be subject to a downgrade of one notch in its credit ratings from at least Moody's and Fitch.[420] Using the "predominant rating" approach to reconcile split ratings, the impact for investors would be that CEHE's unsecured issuer credit rating could no longer be grouped in the A category and would be categorized in the BBB rating category.[421]

Mr. McRae's analysis further shows that in order to maintain sufficient cushion against a downgrade, CEHE needs not only a 50% equity ratio, but also the 10.4% ROE supported by Mr. Hevert.[422] The combination of 50% equity ratio and a 10.4% ROE would increase CEHE's ratio of Cash from Operations to Debt ("CFO/Debt") ratio by roughly 200 basis points, which may help maintain its current credit ratings and offset the cash flow impact of the TCJA.[423]

Regulatory commissions in several other jurisdictions have agreed that it is important to provide constructive relief to preserve cash flows in the wake of the TCJA. For example, the Alabama Public Service Commission,[424] Georgia Public Service Commission,[425] and Florida Public Service Commission[426] have all approved requests by utilities to increase their equity ratios to mitigate the effects of the TCJA.

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418 CEHE Ex. 27 at 2843 (McRae Direct); CEHE Ex. 48 at 42 (Lapson Rebuttal).
419 CEHE Ex. 48, Exh. R-EL-1 at 1 (Lapson Rebuttal).
420 *Id.* at 43-44; *see* CEHE Ex. 27 at 2843 (McRae Direct).
421 CEHE Ex. 48 at 44 (Lapson Rebuttal).
422 CEHE Ex. 27 at 2844 (McRae Direct).
423 *Id.* at 2845.
424 Alabama Pub. Serv. Comm'n, *Petition for Revision to Rate RSE,* Docket Nos. 18117 and 18416, Order at 7 (May 7, 2018).
425 Georgia Pub. Serv. Comm'n, *In re Georgia Power Company's 2013 Rate Case*, Docket No. 36989, Order on the Tax Cuts and Jobs Act at 1 and Exhibit 1 (Mar. 6, 2018); Georgia Public Service Comm'n, *In re Atlanta Gas Light Company Georgia Rate Adjustment Mechanism: Application for Approval of an Alternative Form of Regulation,* Docket No. 40824, Stipulation and Joint Motion for Approval of Staff and Atlanta Gas Light Company at 3 (May 9, 2018).
426 Florida Pub. Serv. Comm'n, *In re: Petition for Rate Increase by Florida City Gas,* Docket No. 20170179-GU, Order No. PSC-2018-0190-FOF-GU (Apr. 20, 2018).

2. Staff and Intervenor witnesses' capital structure recommendations would threaten CEHE's financial integrity and would drive up the cost of capital, to the detriment of CEHE's customers.

All of the Staff and Intervenor cost-of-capital witnesses opposed a capital structure with 50% equity, but none of them has put forth credible evidence demonstrating that an equity ratio lower than 50% would allow CEHE to maintain its current credit ratings. Aside from Mr. Gorman, whose flawed analysis should be disregarded,[427] none of the witnesses even performed a quantitative analysis to determine the effect of their recommendations on CEHE's credit metrics.[428] Furthermore, they tout CEHE's past ability to maintain its credit metrics under its existing 55% debt/45% equity capital structure as support for their recommendations.[429] CEHE's current capital structure, however, does not account for the reduced cash flow attributable to the TCJA or CEHE's impending capital expenditures.[430] Moreover, their arguments are disingenuous because, with the exception of Ms. Winker, they all propose an equity ratio 500 basis points below CEHE's existing capital structure—the same equity ratio that put CEHE's credit metrics at risk prior to the decision in Docket No. 38339.[431]

Finally, the evidence in the record establishes that Moody's has reviewed the Staff and Intervenor recommendations in this proceeding, and it considers a rate case outcome for CEHE that included an equity ratio lower than 45% to be credit-negative.[432] The Staff and Intervenor witnesses acknowledge that their capital structure and ROE recommendations would be considered to be credit-negative for CEHE,[433] but they all choose to bury their heads in the sand with respect to the implications of their recommendations.

CEHE will address each witness's other arguments in turn.

a. TCUC witness Dr. Woolridge

Dr. Woolridge asserts that CEHE is proposing a higher equity ratio than it and CNP have maintained in the past, based on the average ratios shown in his Exhibit JRW-3.[434] However, Exhibit JRW-3 shows the most recent equity ratios for CEHE and CNP are higher than those

[427] CEHE Ex. 43 at 10, 20-23 (McRae Rebuttal).
[428] Tr. at 516-518 (Woolridge Cross) (Jun. 26, 2019); Tr. at 654-655 (Winker Cross) (Jun. 26, 2019); Tr. at 693 (Ordonez Cross) (Jun. 26, 2019); *see also* CEHE Ex. 43 at 10 (McRae Rebuttal).
[429] *See* TCUC Ex. 1 at 21 (Woolridge Direct); OPUC Ex. 3 at 42 (Winker Direct); TIEC Ex. 5 at 29 (Gorman Direct).
[430] *See* CEHE Ex. 43 at 17, 31 (McRae Rebuttal).
[431] CEHE Ex. 48 at 45-46 (Lapson Rebuttal); *see* CEHE Ex. 43 at 26 (McRae Rebuttal).
[432] CEHE Ex. 43, Confidential Exh. R-RBM-3 at 1 (McRae Rebuttal).
[433] Tr. at 519-520 (Woolridge Cross) (Jun. 26, 2019); Tr. at 559 (Gorman Cross) (Jun. 26, 2019); *see* Tr. at 671 (Ordonez Cross) (Jun. 26, 2019).
[434] TCUC Ex. 1 at 17 (Woolridge Direct).

reported by Dr. Woolridge,[435] thereby discrediting his argument. Moreover, Dr. Woolridge is including short-term debt in his calculation, which is inappropriate because CEHE finances its rate base investment with long-term debt and common equity, not short-term debt, and the inclusion of short-term debt contradicts long-standing Commission precedent.[436] Dr. Woolridge was unaware that the Commission had rejected the inclusion of short-term debt in a utility's authorized capital structure.[437] Dr. Woolridge's alternative capital structure should likewise be rejected, due to its inclusion of short-term debt.[438]

b. TIEC witness Mr. Gorman

Mr. Gorman's recommendation is based on his argument that CEHE would have a higher credit rating if it were severed from its parent through financial ring-fencing measures.[439] Mr. Gorman mistakenly asserts that S&P currently measures CEHE under the "medial volatility" table and he argues that if considered on its own, CEHE would be measured under the "low-volatility" table, which would allow it to maintain its current credit rating with his proposed 40% equity ratio and 9.25% ROE.[440] In fact, S&P has expressly stated that it evaluates CEHE under the low-volatility table. Thus, TIEC's proposed ring-fencing would make no difference to S&P's rating.[441] The actual reason S&P rates CEHE lower than the other two agencies is that S&P currently uses a "group rating" methodology.[442] However, S&P has indicated that this methodology will be revised in mid-July 2019, and as a result, CEHE may realize a higher rating from S&P provided that increased financial risk from the TCJA is mitigated.[443] Consequently, TIEC's proposed ring-fencing would not have any appreciable effect on either the S&P rating or the ratings assigned by Moody's and Fitch, which view operating company subsidiaries such as CEHE on a more standalone basis.[444] In fact, Mr. Gorman admits that according to the Moody's and Fitch metrics, under his recommended ROE and capital structure, CEHE's credit metrics would be weak and could potentially result in a downgrade.[445]

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435 CEHE Ex. 43 at 14-15 (McRae Rebuttal).
436 *Id.* at 14.
437 Tr. at 522-523 (Woolridge Cross) (Jun. 26, 2019).
438 CEHE Ex. 43 at 16 (McRae Rebuttal).
439 TIEC Ex. 5 at 27, 32-33 (Gorman Direct).
440 *Id.* at 36-37.
441 CEHE Ex. 43 at 19 (McRae Rebuttal) (*citing* Exh. R-RBM-4 at 4).
442 *Id.*
443 *Id.* at 19-20 (McRae Rebuttal).
444 *Id.* at 20.
445 Tr. at 581 (Gorman Cross) (Jun. 26, 2019).

As discussed previously, Mr. Gorman attempted to support his assertion that CEHE could maintain its current credit metrics under his recommendation.[446] However, his analysis originally contains several major computational errors which inflate his credit metrics, thereby rendering them unreliable.[447] When Mr. Gorman corrected those errors, it became clear that the metrics resulting from his recommendations would map to a "Baa" rating under the Moody's methodology, and a "BBB" rating under the Fitch methodology, representing a downgrade from CEHE's current A- rating.[448] On cross, Mr. Gorman acknowledged that his ROE recommendation, in conjunction with his proposed capital structure, will diminish CEHE's credit metrics, but argues that CEHE will still be able to maintain an "investment credit bond rating."[449] However, that is an unusually low hurdle because, as Mr. Gorman admitted, in 2016-2018, there were no other utilities below investment grade.[450] Accordingly, Mr. Gorman's recommendation would not ensure CEHE's financial integrity, but would merely keep CEHE's credit metrics from falling below every other utility.

c. OPUC witness Ms. Winker

Ms. Winker's conclusory statement that CEHE will continue to be able to attract financial capital on reasonable terms using her recommended capital structure, presumably based on the fact that CEHE has been able to attract capital on reasonable terms since the enactment of the TCJA,[451] should be rejected. In addition, Ms. Winker admitted that she had not done any quantitative analysis to determine how her recommended capital structure would impact CEHE's credit metrics used by the various credit rating agencies.[452] As Mr. McRae testified, credit rating agencies are awaiting the outcomes of individual regulatory proceedings to determine how to rate utilities on a going-forward basis; therefore, the mere fact that CEHE has not yet been downgraded is no indication that it will not be in the future.[453]

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[446] *See* TIEC Ex. 5 at 36-37 & Exh. MPG-5 (Gorman Direct).
[447] CEHE Ex. 43 at 21-23 (McRae Rebuttal); CEHE Ex. 48 at 54 (Lapson Rebuttal) (stating that the largest impact on the credit ratios results from Mr. Gorman's reversal of the signs of income tax adjustments, which overstated his forecasts of net income and EBITDA and had the result of forecasting the equivalent of a 10% ROE) *see also* Errata to the Direct Testimony of Michael P. Gorman, TIEC Ex. 5D.
[448] TIEC Ex. 5D (Gorman Errata); CEHE Ex. 43 at 24-25 (McRae Rebuttal); *see* CEHE Ex. 48 at 54 (Lapson Rebuttal).
[449] Tr. at 605-607 (Gorman Cross) (Jun. 26, 2019).
[450] *Id.* at 605-606.
[451] OPUC Ex. 3 at 43 (Winker Direct).
[452] Tr. at 654-655 (Winker Cross) (Jun. 26, 2019).
[453] CEHE Ex. 43 at 31-32 (McRae Rebuttal).

d. Staff witness Mr. Ordonez

Mr. Ordonez's primary rationale for his capital structure recommendation is the Commission's order in Docket No. 22344,[454] a case addressing generic issues relating to the early days of TDUs in Texas.[455] Mr. Ordonez's reliance on this order is misplaced for numerous reasons: (1) the generic capital structure established was based on conjecture about the then-nonexistent retail market in ERCOT and not any TDU's individual circumstances;[456] (2) Mr. Ordonez selectively relies only on the portion of the order establishing capital structure, and does not make a corresponding upward adjustment to his recommended ROE to account for the higher financial risk associated with greater leverage, as the Commission did in Docket No. 22344;[457] and (3) his recommendation completely ignores the Commission's more recent precedent in Docket No. 38339.[458]

Mr. Ordonez asserts that Docket No. 22344 is still relevant because TDUs in ERCOT operate in a "low risk environment," in part because credit rating agencies characterize the Texas regulatory framework as constructive and credit-positive.[459] However, as Mr. McRae and Ms. Lapson testified, rating agencies would undoubtedly view it as non-constructive and credit-negative if the Commission were to lower CEHE's authorized equity ratio by 500 basis points based on the rationale that the Commission established a generic debt ratio of 60% in a proceeding that occurred almost 20 years ago.[460] As Mr. Ordonez acknowledges, CEHE is not "recently unbundled" but is an established utility, the transition period is over, and nothing in the order in Docket No. 22344 indicated that it was intended to continue in effect in perpetuity.[461] The Commission should reject Mr. Ordonez's recommendation as directly contrary to Commission practice and precedent of reviewing the individual facts and circumstances of each case in establishing a utility's capital structure.[462]

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[454] Staff Ex. 3A at 36 (Ordonez Direct) (citing to *Generic Issues Associated with Application for Approval of Unbundled Cost of Service Rate Pursuant to PURA § 39.201 and Public Utility Commission Substantive Rule § 25.344*, Docket No. 22344, Order No. 42, Interim Order Establishing Return on Equity and Capital Structure (Dec. 22, 2000)).
[455] CEHE Ex. 48 at 50 (Lapson Rebuttal).
[456] CEHE Ex. 43 at 33-34 (McRae Rebuttal); CEHE Ex. 48 at 50-51 (Lapson Rebuttal).
[457] CEHE Ex. 43 at 34-35 (McRae Rebuttal); *see* Tr. at 687-688 (Ordonez Cross) (Jun. 26, 2019).
[458] CEHE Ex. 43 at 35 (McRae Rebuttal) (In Docket No. 38339, the Commission evaluated CEHE specifically and found that its business and regulatory risk justified a capital structure of 55% debt and 45% equity); *see* Tr. at 686 (Ordonez Cross) (Jun. 26, 2019).
[459] Staff Ex. 3A at 37 (Ordonez Direct).
[460] CEHE Ex. 43 at 36 (McRae Rebuttal); *see* CEHE Ex. 48 at 51-52 (Lapson Rebuttal).
[461] Tr. at 685-686 (Ordonez Cross) (Jun. 26, 2019).
[462] CEHE Ex. 43 at 36 (McRae Rebuttal).

3. A 50/50 capital structure is consistent with the equity levels recently established for comparable utilities in other jurisdictions.

For the last eight calendar quarters, the average equity ratio was 53.28% for the holding companies in Mr. Hevert's proxy group, and 53.13% for the utility operating companies encompassed within those holding companies.[463] The average equity ratio of electric delivery-only utilities for calendar year 2018 was 49.91%.[464] Accordingly, CEHE's proposed 50% equity ratio is consistent with the level of equity authorized for comparable utilities in other jurisdictions.[465]

Dr. Woolridge argues that CEHE's proposed capital structure contains more equity than his proxy group and Mr. Hevert's proxy group.[466] However, as illustrated by Mr. McRae's testimony, the Value Line data upon which Dr. Woolridge claims to base his Exhibit JRW-2 cannot be reconciled with the equity ratios listed for those utilities in the most recent versions of the Value Line reports.[467] Even assuming the equity ratios listed in Dr. Woolridge's exhibit are accurate, they indicate a 47.2% average, which is closer to CEHE's proposed equity ratio (50%) than to Dr. Woolridge's (40%).[468] Moreover, Dr. Woolridge's erroneous inclusion of short-term debt in the capital structures skews his comparison in a way that makes it misleading.[469]

Both Mr. Gorman and Mr. Ordonez argue that CEHE's existing capital structure is consistent with other TDUs operating in ERCOT.[470] However, three of Mr. Ordonez's five listed examples are transmission-only utilities[471] which have lower risk than TDUs, and the other two represent a double-counting of AEP Texas, which is requesting a higher equity ratio in its currently pending rate case.[472] Also, a number of the equity ratios for TDUs in ERCOT were established before the enactment of the TCJA, and neither Mr. Gorman nor Mr. Ordonez has established that these utilities are forecasting the same high levels of capital expenditures as CEHE.[473] Finally, a more appropriate comparison necessarily extends beyond TDUs in ERCOT, because CEHE

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463 *Id.* at 34.
464 *Id.*
465 *Id.* at 14.
466 *See* TCUC Ex. 1 at 17 (Woolridge Direct).
467 CEHE Ex. 43 at 12-13 (McRae Rebuttal).
468 *Id.* at 14.
469 *Id.*; CEHE Ex. 48 at 56 (Lapson Rebuttal).
470 TIEC Ex. 5 at 29 (Gorman Direct); Staff Ex. 3A at 37 (Ordonez Direct).
471 Tr. at 691-692 (Ordonez Cross) (Jun. 26, 2019).
472 CEHE Ex. 43 at 37 (McRae Rebuttal).
473 *Id.* at 28.

competes for capital with utilities across the country.[474] Mr. Ordonez's own testimony acknowledges that the 2018 national average authorized equity ratio for delivery-only utilities such as CEHE was 49.91% and has been trending upward in recent years,[475] which highlights that Intervenors' recommended 40% equity ratio is a stark departure from the capital structure determinations for comparable utilities[476] and should be rejected.

4. A 50/50 capital structure properly accounts for CEHE's business and regulatory risks.

CEHE's requested 50/50 capital structure is appropriate for the business and regulatory risks it faces.[477] First, no party took issue with CEHE's forecast of approximately $5.14 billion in capital expenditures from 2019-2023 to construct facilities to serve its rapidly expanding service area.[478] CEHE's revenue from operations will not be sufficient to fund all of that investment, so it will be necessary for CEHE to finance a portion of the costs with debt issuances, retained earnings, and equity infusions from CNP.[479] Mr. Ordonez attempts to dismiss this risk as the "nature of the utility" industry,[480] but not all utilities face equally high capital expenditures,[481] and Mr. Ordonez admits that he conducted no specific comparison of CEHE's capital expenditures to those of his proxy group companies.[482]

Second, CEHE will experience significant declines in cash flows and credit quality because of the effects of the TCJA. The weakening of credit quality occurs primarily because of the combination of lower tax rates and the elimination of bonus depreciation.[483] On a going-forward basis, CEHE will be collecting lower amounts of tax expense because of the reduced tax rates, but at the same time it will be paying the Internal Revenue Service more of the tax expense it collects because bonus depreciation is not available to shield net income from taxes.[484] Moreover, CEHE will be refunding EDIT that it previously collected under the prior 35% tax rate as discussed in Section II.D.2. The combination of those factors reduces CEHE's CFO, Funds From Operations

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[474] *Id.* at 38.
[475] Staff Ex. 3A at 36 (Ordonez Direct); CEHE Ex. 43 at 38 (McRae Rebuttal); CEHE Ex. 48 at 50 (Lapson Rebuttal).
[476] *See* CEHE Ex. 48 at 50 (Lapson Rebuttal).
[477] CEHE Ex. 27 at 2835 (McRae Direct).
[478] *Id.* at 2832 (*citing* CenterPoint Energy, Inc. Form 10-K at 68 (Feb. 28, 2019)).
[479] *Id.* at 2836.
[480] Staff Ex. 3A at 31 (Ordonez Direct).
[481] CEHE Ex. 48 at 49 (Lapson Rebuttal).
[482] Tr. at 668 (Ordonez Cross) (Jun. 26, 2019).
[483] CEHE Ex. 27 at 2837 (McRae Direct).
[484] *Id.* at 2838.

and Earnings Before Interest, Taxes, Depreciation and Amortization, three of the key cash flow metrics used by the rating agencies to assign credit ratings.[485]

In fact, in January 2018, Moody's placed 24 utilities on negative outlook because of the effects of the TCJA,[486] and the other two major rating agencies—S&P and Fitch—indicated that they would be watching the responses by regulatory commissions to determine whether rating actions were warranted.[487] In June 2018, Moody's placed the entire regulated utility industry on a negative outlook, indicating that the rating agency foresees more downgrades than upgrades over the intermediate term for that industry.[488] The rating agencies have also downgraded certain utilities' credit ratings because the regulatory response to the TCJA was inadequate to protect the utilities' credit metrics.[489]

The rating agencies have identified particular measures that regulators could take to mitigate the effect that the TCJA will have on cash flow, the most prominent of which are: (1) an increase in the authorized equity ratio; (2) an increase in the authorized ROE; and (3) an increase in depreciation expense.[490] CEHE proposes the first mitigation option—an increase in the authorized equity ratio to 50%, which mitigates the effects on cash flow at the lowest cost to customers.[491]

Ms. Winker and Dr. Woolridge downplay this risk by asserting that the effects of the TCJA are "temporary."[492] However, as Mr. McRae explained, the TCJA will continue to erode key ratios used by the rating agencies over the next several years.[493] In its June 2018 report, Moody's noted that the ratio of CFO to debt is projected to continue declining through at least 2022, and perhaps longer.[494] Mr. Ordonez similarly attempts to discount the risk attributable to the TCJA by arguing

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485 *Id.*; *see* Tr. at 516 (Woolridge Cross) (Jun. 26, 2019).
486 CEHE Ex. 27 at 2839 (McRae Direct).
487 *Id.*
488 *Id.*; *see* Tr. at 592 (Gorman Cross) (Jun. 26, 2019).
489 *See* CEHE Ex. 27 at 2839 (McRae Direct) (referring to Moody's October 2018 rating action changing Xcel Energy Inc.'s outlook to negative and downgrading Southwestern Public Service Company); CEHE Ex. 43 at 7, Confidential Exh. R-RBM-2 at 9-10 (McRae Rebuttal) (S&P presentation showing that the number of utilities on positive outlook has fallen by 80% since 2014, and in 2019 alone, S&P downgraded 18 utilities while upgrading only 9.).
490 CEHE Ex. 27 at 2841 (McRae Direct).
491 *Id.*; CEHE Ex. 43 at 7 (McRae Rebuttal).
492 OPUC Ex. 3 at 43 (Winker Direct); TCUC Ex. 1 at 43 (Woolridge Direct).
493 CEHE Ex. 43 at 8 (McRae Rebuttal); *see* CEHE Ex. 48 at 47-48 (Lapson Rebuttal).
494 CEHE Ex. 43 at 8 (McRae Rebuttal) (*citing* Moody's Investors Service, *Regulated Utilities – US: 2019 Outlook Shifts to Negative Due to Weaker Cash Flows, Continued High Leverage* at 2 (Jun. 18, 2018); *see* CEHE Ex. 48 at 48 (Lapson Rebuttal).

that it affects all utilities,[495] but on cross-examination he acknowledged that it does not affect all utilities in the same way.[496]

Third, CEHE is exposed to high risk of hurricane damage because all of its service territory is within 100 miles of the Gulf Coast.[497] Severe weather causes CEHE to incur unplanned expenditures and results in lower sales due to damage to its infrastructure, which collectively can reduce CEHE's revenue and strain its operating cash flow, highlighting the need for financial liquidity and flexibility.[498] Mr. Ordonez argues that hurricane risk does not justify a higher level of equity because Texas law allows utilities to securitize system restoration costs after a natural disaster.[499] Although helpful, the securitization statute obviously provides funding only after the fact, it is not available for losses below $100 million and it may take up to 12 months to obtain the capital from the proceeds of the securitization bonds.[500] In the interim, the utility must have the financial strength to attract the capital needed to restore its transmission and distribution system.

Finally, as Mr. McRae testified, unfavorable policies and outcomes in regulatory and legislative decisions are among the largest risks for most regulated utilities, and investors will continue to focus on CEHE's regulatory risk, especially in light of the TCJA's impact on debt and cash flow.[501] Intervenor and Staff witnesses gave great weight to the existence of various cost-recovery mechanisms available to utilities in Texas as mitigating CEHE's regulatory risk and supporting their recommended 40% equity ratios;[502] however, these mechanisms were also available in 2011 when the Commission determined that CEHE's risks merited a 45% equity ratio.[503] Moreover, these mechanisms are acknowledged by Moody's in its June 17, 2019 issuer comment, but Moody's nevertheless foresees that CEHE's credit metrics will weaken in light of the TCJA and CEHE's capital expenditure forecast:

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495 Staff Ex. 3A at 31 (Ordonez Direct).
496 Tr. at 668-669, 703 (Ordonez Cross) (Jun. 26, 2019); *see also* CEHE Ex. 48 at 49 (Lapson Rebuttal).
497 CEHE Ex. 26 at 2706 (Hevert Direct); CEHE Ex. 27 at 2846 (McRae Direct). For example, CEHE incurred over $600 million in storm recovery in connection with Hurricane Ike in 2008, and approximately $117 million due to Hurricane Harvey in 2017.
498 CEHE Ex. 26 at 2706 (Hevert Direct); *see also* CEHE Ex. 27 at 2846 (McRae Direct).
499 *See* Staff Ex. 3A at 32 (Ordonez Direct).
500 CEHE Ex. 27 at 2847-2848 (McRae Direct); CEHE Ex. 43 at 39 (McRae Rebuttal); *see* CEHE Ex. 26 at 2709 (Hevert Direct); *see also* Tr. at 670 (Ordonez Cross) (Jun. 26, 2019).
501 CEHE Ex. 27 at 2849 (McRae Direct).
502 Tr. at 696-696 (Ordonez Cross) (Jun. 26, 2019); Tr. at 615-616 (Gorman Cross) (Jun. 26, 2019).
503 Tr. at 663-665 (Ordonez Cross) (Jun. 26, 2019); Tr. at 625-627 (Gorman Cross) (Jun. 26, 2019).

> Although [CEHE] benefits from transmission and distribution cost riders that reduce regulatory lag, absent a credit positive [general rate case outcome], we see [CEHE's] credit metrics weakening owing to the company's robust capital plan and the negative implications from the 2017 U.S. federal tax reform.[504]

For all of these reasons, CEHE needs a capital structure composed of 50% equity and 50% long-term debt.

D. Overall Rate of Return [PO Issue 8]

Based on the 50/50 capital structure supported by Mr. McRae and Ms. Lapson, the 10.4% ROE supported by Mr. Hevert, and the 4.38% cost of debt supported by Mr. McRae, CEHE's overall ROR is 7.39%.[505] For the reasons discussed in this brief, CEHE asks the Commission to approve the 7.39% overall ROR.

E. Financial Integrity [PO Issue 9]

As the evidence in this case has established, rating agencies are looking to the results of this proceeding to determine CEHE's future credit ratings in light of the effects of the TCJA. Moody's has viewed Staff and Intervenor's ROE and capital structure recommendations, and has expressly stated that the Commission's adoption of an equity ratio below 45% or an ROE materially below 10% would be considered credit-negative.[506] If the financial results established in this case are not sufficient to mitigate the effects of the TCJA on CEHE's cash flow, as well as account for its other specific business and regulatory risks, CEHE will face a potential credit downgrade. Because CEHE is entering an intensive capital spending cycle to build the infrastructure needed to serve its growing customer-base, it is critically important for CEHE and its customers that CEHE's financial integrity be preserved so that it can access capital at reasonable rates.[507] For the reasons set forth above in Sections III.A and C, an increased equity ratio of 50% and an ROE of 10.4% are necessary to protect CEHE's financial integrity and its ability to provide reliable service at just and reasonable rates.

With regard to financial protections or "ring-fencing" measures, the Commission lacks the authority to impose such conditions in this proceeding. The Commission "has only the powers that the Legislature confers upon it" and "any implied powers that are necessary to carry out the

[504] CEHE Ex. 43, Confidential Exh. R-RBM-3 at 1 (McRae Rebuttal); *see* Tr. at 662 (Ordonez Cross) (Jun. 26, 2019).
[505] CEHE Ex. 43 at 4 (McRae Rebuttal).
[506] *Id.*; Confidential Exh. R-RBM-3 at 1.
[507] *See* Tr. at 604 (Gorman Cross) (Jun. 26, 2019) ("To maintain financial integrity can be expanded to suggest that it has to be able to attract capital to make necessary infrastructure investments, yes.").

express responsibilities given to it by the Legislature."[508] The statutory bases for the Commission's authority to consider and approve the rates of an electric utility are found in Chapter 36 of PURA, which provides the Commission with the authority to "establish and regulate the rates of an electric utility."[509] There are no provisions within Chapter 36 that give the Commission the power to establish financial protections or "ring-fencing" provisions.[510] The Commission has previously set rates without imposing ring-fencing protections, and therefore such a power is not necessary to carry out its express rate-setting responsibilities.[511]

Texas courts have already determined there is not a general implied power to enforce ring-fencing provisions. In *Nucor Steel-Texas v. Public Utility Comm'n of Texas*, the court held that "[p]rior to the enactment of [PURA] subsection 39.262(o), the Commission had no express authority to enforce stipulations filed as part of a notification of a proposed transaction under section 14.101."[512] However, "section 39.262(o) granted the additional authority to enforce stipulations made as part of a filing under section 14.101."[513] The enactment of PURA §§ 39.262(o) and 39.915 created the authority to enforce ring-fencing protections for a specific purpose: the review and approval of certain utility sales, acquisitions, or mergers. If the Commission had a general implied power to enforce ring-fencing, that specific grant of statutory authority given to the Commission would be redundant and without a purpose, which is in conflict with the requirements of statutory construction. Further, PURA §§ 39.262(o) and 39.915 are not relevant or applicable in this proceeding given there is not a transaction under review.

Even if the Commission has the authority to consider and impose ring-fencing measures within the context of a rate case, which it does not, the Commission's imposition of such measures is not appropriate based on the facts of this case. CEHE currently has adequate financial insulation in place that secure its financial integrity and its ability to provide reliable service at just and reasonable rates. CEHE currently has ring-fencing protections in place that are similar to most other U.S. rate-regulated electric and gas utilities.[514] CEHE's current ring-fencing practices are "robust" and provide an adequate degree of separation from CNP and CEHE's affiliates, which

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508 *Public Util. Comm'n v. City Pub. Serv. Bd.*, 53 S.W.3d 310, 316 (Tex. 2001).
509 PURA § 36.001.
510 *See* PURA Chapter 36.
511 Mr. Griffey testified that he is unaware of any instance in which the Commission has imposed ring-fencing conditions in a rate proceeding, and that he had not previously proposed ring-fencing conditions as an expert witness in a rate proceeding. Tr. at 634-635 (Griffey Cross) (Jun. 26, 2019).
512 363 S.W.3d 871 (Tex. App.—Austin 2012, no pet.).
513 *Nucor*, 363 S.W.3d at 883.
514 CEHE Ex. 48 at 21-22 (Lapson Rebuttal).

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will protect CEHE from being subject to an involuntary bankruptcy and allow CEHE to maintain access to funding and liquidity in the event of financial distress of CNP or any of CEHE's affiliates.[515] In addition, CEHE and CNP deal with each other in a prudent manner, observing all necessary legal formalities to maintain separation.[516] The adequate level of separateness, and therefore the financial integrity of CEHE, is supported by the fact that both Moody's and Fitch award CEHE a separate credit rating from that of its parent.[517] Both Moody's and Fitch currently have CEHE rated at two notches above that of CNP.[518] This indicates that Moody's and Fitch have a substantial level of confidence in CEHE's viability on its own and its insulation from CNP and CEHE's affiliates.[519]

Only two parties presented any testimony in favor of formalized financial or ring-fencing protections, TIEC and Staff, and neither party provided evidence showing that additional financial protections beyond those already in place at CEHE are needed to protect CEHE's financial integrity and ability to provide reliable services at just and reasonable rates. Staff witness Darryl Tietjen contends that additional ring-fencing measures are needed to protect from the *possibility* that the activities of CNP could lead to higher costs of capital, and the *possibility* that CEHE would request to cover those higher costs from ratepayers in a later rate case.[520] No party submitted evidence in this case establishing that the activities of CNP are resulting in higher costs of capital now for which CEHE is seeking recovery. Mr. Tietjen did not present any legitimate justification for imposing financial protections for what CEHE could possibly do in the future, particularly when the Commission would have full authority in a future rate case to review CEHE's claims and reject the recovery of any costs it finds unreasonable.[521]

Mr. Tietjen and TIEC witness Charles S. Griffey also point to the bankruptcy of Energy Future Holdings Corp., the former parent of Oncor as a justification for financial protections.[522] But neither Mr. Tietjen nor Mr. Griffey present any evidence to support a claim that CNP is currently at any risk of bankruptcy or that there is any concern for the financial health of CNP. This is in contrast to the issues present during the acquisition of TXU Energy in 2007 where the

[515] *Id.* at 25-26.
[516] *Id.* at 26.
[517] *Id.*
[518] *Id.*
[519] *Id.*
[520] Direct Testimony of Darryl Tietjen, Staff Ex. 1A at 9-10 (Bates Pages).
[521] CEHE Ex. 48 at 27 (Lapson Rebuttal).
[522] Direct Testimony of Charles S. Griffey, TIEC Ex. 4 at 15-16; Staff Ex. 1A at 17 (Tietjen Direct).

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private equity purchasers only funded 9% of a $45 billion transaction, the parent had a deeply speculative credit rating, and the debt issued by the holding company had a deeply speculative rating indicating a high likelihood of default.[523] Mr. Tietjen acknowledges that transaction was the largest leveraged buyout in history.[524] On the other hand, CNP currently has investment grade credit ratings from all of the ratings agencies, and CNP used approximately 53% equity in its recent purchase of Vectren, which is not even considered a leveraged transaction.[525]

Mr. Tietjen and Mr. Griffey testify that CEHE's credit rating is hurt by its association with CNP, particularly in light of the recent Vectren acquisition.[526] Mr. Griffey contends that the ring-fencing protections he proposes would provide additional insulation and improve CEHE's credit profile.[527] However, Mr. Griffey and Mr. Tietjen's analysis relies entirely on S&P's credit rating analysis of CEHE, which uses the Consolidated Rating Methodology to evaluate the credit profiles of utilities.[528] The two other ratings agencies, Fitch and Moody's, both employ an individual analysis, and they currently have CEHE rated at two notches above CNP.[529] When a company has a "split rating" among the ratings agencies, as CEHE currently does, investors typically use a method to reconcile the differences.[530] They can consider the preponderance of two out of three ratings or the middle of three ratings.[531] Using either method would result in an A- rating for CEHE.[532] Importantly, after Staff and TIEC filed testimony in this proceeding proposing the ring-fencing measures, Moody's issued a credit outlook on June 17, 2019, stating that the proposed ring-fencing measures proposed by the parties were "credit neutral,"[533] not credit positive as claimed by Mr. Griffey.[534]

Mr. Griffey also claims that because the current CEHE financial protections are voluntary and "could change in the future" the Commission should formalize the protections through an order in this proceeding.[535] Mr. Griffey however, provides no evidence to support the claim that

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[523] CEHE Ex. 48 at 29 (Lapson Rebuttal).
[524] Staff Ex. 1A at 17 (Tietjen Direct).
[525] CEHE Ex. 48 at 12-13 (Lapson Rebuttal).
[526] TIEC Ex. 4 at 10-11 (Griffey Direct); Staff Ex. 1A at 11-13 (Tietjen Direct).
[527] TIEC Ex. 4 at 7 (Griffey Direct).
[528] CEHE Ex. 48 at 10-11 (Lapson Rebuttal).
[529] *Id.* at 16.
[530] *Id.* at 17-18.
[531] *Id.* at 18.
[532] *Id.*
[533] *Id.* at Confidential Exh. R-EL-5 (Lapson Rebuttal).
[534] TIEC Ex. 4 at 24 (Griffey Direct).
[535] *Id.* at 23.

CEHE would change any of its current protections. To the contrary, during the serious capital market disruption following September 2008 and 2009, CNP and CEHE continued to follow prudent practices despite the period of financial market distress.[536] Further, there are strong incentives for CNP to retain equity at CEHE equal to its authorized regulatory capital structure on the assumption that the Commission will provide a just and reasonable return on invested capital.[537] Because neither TIEC nor Staff have provided any material evidence to support the need for ring-fencing for CEHE, the Commission should reject the proposals and find that the financial protections currently in place are adequate.

IV. Operating and Maintenance Expenses [PO Issues 4, 5, 21, 22, 25, 26, 28, 29, 33, 35, 38, 39, 54, 55]

A. Transmission and Distribution O&M Expenses [PO Issue 21]

CEHE seeks recovery of its test year High Voltage Operations O&M expenses in FERC Accounts 560 through 573 in the amount of $58.7 million.[538] CEHE's High Voltage Operations plans, engineers, constructs, operates, and maintains the Company's transmission, substation and major underground facilities. CEHE also requests recovery of its test year Distribution Operations Division ("Distribution") O&M expenses in FERC Accounts 580 through 598 in the amount of $206.7 million.[539] The Company's Distribution Operations Division makes it possible for the Company to maintain and operate a distribution system that safely and reliably serves over 2.5 million end-use retail electric customers across an approximately 5,000 square mile service territory.[540]

Importantly, no party asserts that any of the Company's High Voltage Operations or Distribution O&M activities are unreasonable or unnecessary for the reliable provision of electric service to CEHE's customers. Rather, Intervenors and Staff have proposed several simplistic, overarching disallowances to CEHE's requested test year O&M expense based solely on their unsubstantiated opinion that these costs are too high. For example, Mr. Norwood rejects the use of a historic test year and instead proposes to use 2017 expenses escalated by 2.6% which excludes the test year in its entirety, to establish CEHE's test year transmission and distribution O&M expense.[541] Similarly, Mr. Nalepa and Mr. Ianni reject the use of test year expense levels to

[536] CEHE Ex. 48 at 31 (Lapson Rebuttal).
[537] *Id.* at 35-36.
[538] CEHE Ex. 8 at 339 (Narendorf Direct).
[539] CEHE Ex. 7 at 171 (Pryor Direct).
[540] *Id.* at 170.
[541] COH/HCC Ex. 1 at 13 (Norwood Direct).

establish CEHE's vegetation management in favor of a multi-year average.[542] As explained below, each of the intervenor and staff proposals should be rejected because they do not represent the level of O&M expense required to operate and maintain the Company's transmission and distribution system.

As a threshold matter, CEHE has shown that it has well-established O&M budgeting practices in place that have been developed over the years to ensure the provision of reliable service at a reasonable cost.[543] CEHE has also proven that proposed O&M expenditures receive a high level of internal scrutiny to ensure that these expenditures are consistent with CEHE's policies and good utility practice.[544] Actual O&M expenses are monitored against budgeted amounts on an ongoing basis and variances from budgeted amounts are investigated.[545] These processes ensure that costs are effectively managed and maintained at reasonable levels through the entire process of business planning, budget plan review, and ongoing budget plan monitoring.[546] Importantly, the evidence also establishes that the Company's annual O&M expense has been increasing due to customer growth, increased circuit miles (both overhead and underground circuits), increased number of transformers, and increasing labor costs. While COH seeks to dismiss the significance of customer and sales growth as a justification for test year expense levels,[547] the actual effect these drivers have and will continue to have on CEHE's ongoing expenses cannot be ignored.

In terms of customer growth, the population in and around Houston grew from approximately 5.9 million in 2010 to nearly 6.9 million in 2017, an increase of more than 16 percent.[548] In response, the Company began serving an additional 359,525 new residential customers and 41,991 new commercial customers from January 1, 2010 through December 31, 2018.[549] Customer growth has occurred not only in areas with existing infrastructure, but also in undeveloped locations, which require the deployment of all new infrastructure.[550] This has resulted in system growth, which includes more distribution lines and more transformers. From

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542 OPUC Ex. 5 at 11 (Nalepa Direct) (Mr. Nalepa ignores the test year in its entirety and proposes the use of a 2015-2017 average for vegetation management expense); Staff Ex. 6 at 8-11 (Ianni Direct) (Mr. Ianni proposed to utilize a three-year average (2016-2018) to set vegetation management expense).
543 CEHE Ex. 7 at 193-199 (Pryor Direct); CEHE Ex. 8 at 357-359 (Narendorf Direct); CEHE Ex. 9 at 589-607 (Bodden Direct).
544 *Id.*
545 *Id.*
546 *Id.*
547 COH/HCC Ex. 1 at 7-8 (Norwood Direct).
548 CEHE Ex. 7 at 175 (Pryor Direct).
549 CEHE Ex. 9 at 593 (Bodden Direct); CEHE Ex. 7 at 175 (Pryor Direct).
550 Tr. at 147-149 (Mercado Redirect) (Jun. 24, 2019).

an infrastructure perspective, over the past four years, overhead distribution pole miles (feeder-main and laterals) have increased an average of 171 miles per year, while URD circuit miles have increased an average of 257 miles per year.[551] Ms. Bodden testified that necessary infrastructure to support economic growth within the City of Houston and surrounding areas has resulted in the need to build or install approximately 221 new substation feeder positions to accommodate new distribution feeders, 55 new substation transformers, size upgrades for 12 substation transformers, and 6 new distribution substations.[552] Naturally, this growth has required the Company to spend more on a day-to-day basis in certain O&M expense categories, particularly labor.

B. Labor Expenses

Growth in the Houston-area economy and competition in the local job market has undisputedly increased the Company's labor costs, including base pay and incentive compensation. Given the strong economy, maintaining the competitiveness of compensation is particularly crucial for CNP and CEHE at this time. For executive, managerial and professional positions, CNP competes on a national scale, whereas for most hourly or non-exempt positions, the relevant market is regional.[553] In the period from 2013 through 2018, the national unemployment rate declined from 8% to 3.9%.[554] Similarly, the unemployment rate in Texas also declined during this period from 6.5% to 3.7%.[555] According to the Texas Workforce Commission, this 3.7% jobless rate is the lowest since 1976 when officials started collecting statewide unemployment data.[556] Competition in the Houston area is even more acute. According to the United States Bureau of Labor Statistics ("BLS"), Houston ranked first in both the number of jobs added in the twelve-month period ending October 2018, which coincides with most of the test year period, and the annual rate of job growth.[557] Specifically in the trade, transportation, and utilities sector, which encompasses Houston's largest employers, local employment increased by 2.6%, which is more than double the 1.1% nationwide increase.[558] BLS data confirms the year-over-year percent change in total non-farm employment in Houston remains more competitive than in the United States as a whole.[559]

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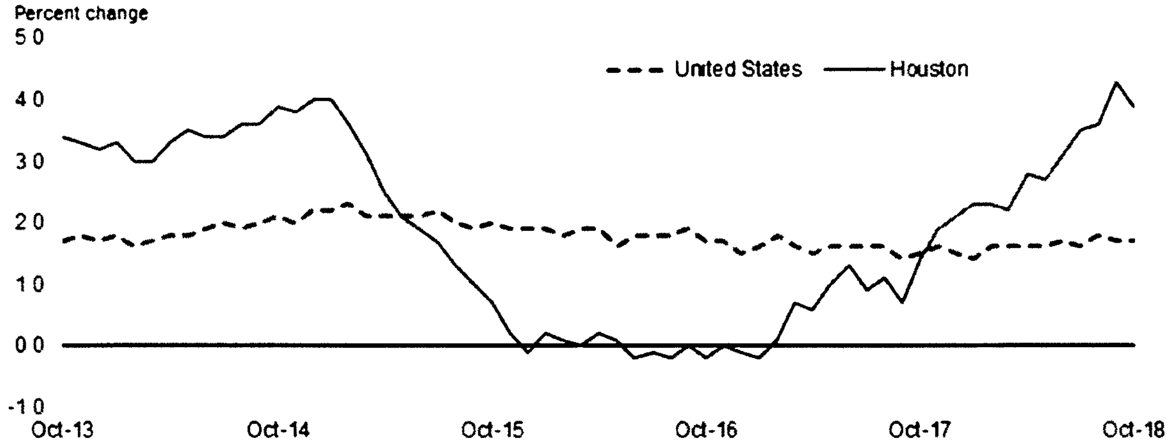
[551] CEHE Ex. 7 at 210-211 (Pryor Direct).
[552] CEHE Ex. 9 at 596 (Bodden Direct).
[553] Direct Testimony of Lynne Harkel-Rumford, CEHE Ex. 22 at 1842-1843, Exh. LHR-3 (Bates Pages).
[554] *Id.* at 1841.
[555] *Id.* & 1876-1879 Exh. LHR-1.
[556] Direct Testimony of John J. Reed, CEHE Ex. 23 at 1906 (Bates Pages).
[557] *Id.* at 1903.
[558] *Id.* at 1905.
[559] *Id.* at 1904.

Chart 1. Total nonfarm employment, over-the-year percent change in the United States and the Houston metropolitan area, October 2013–October 2018



Source U S Bureau of Labor Statistics

Thus, the pool of potential qualified candidates is smaller than in other regions of the country. Robust job growth nationally and locally also coincides with a wave of retirement-eligible employees. Approximately 28% of CNP employees were eligible to retire in 2018, and 38% will be eligible to retire by 2022.[560] Given this reality, CNP must be proactive in retaining current employees with specialized knowledge and experience that is not easily developed or replaced.

More specifically, there is a growing industry shortage of electric utility line skills due to the aging work force and increased electric utility work in Texas and across the United States, as well as increasingly aggressive recruitment of skilled labor from California utilities.[561] Mr. Pryor testified that California utilities are offering compensation packages above the local and national market.[562] This has resulted in the Company experiencing the loss of approximately 100 line skills from its internal and contractor resources during the first half of 2019.[563] The Company has seen an increase in labor costs for both internal labor and external contractors. In fact, the evidence shows that an average increase in compensation paid to the transportation and utilities trade of 2.6% per year between 2010 and 2018.[564] This represents a total increase of 4.7% (2.1% customer count and 2.6% labor costs), which aligns with the 4.6% increase in O&M per year for CEHE.[565]

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[560] CEHE Ex. 22 at 1840 (Harkel-Rumford Direct).
[561] CEHE Ex. 31 at 16 (Pryor Rebuttal).
[562] *Id.* at 16-17.
[563] *Id.* at 17.
[564] *Id.* at 18-19.
[565] This survey is available at https://www.bls.gov/web/eci/echistrynaics.pdf.

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To attract and retain employees, CNP targets the median or 50th percentile of the market when determining the value of compensation offered to all employees, and it does so based on data contained in market compensation studies.[566] No party disputes that these market studies provide an objective and thorough source of information that allows CNP to assess the competitiveness of the compensation it offers to CEHE, CenterPoint Energy Resources Corp. ("CERC") and Service Company employees. CNP measures the competitiveness of its compensation plans and levels from a "total compensation" perspective—meaning the *combination* of base pay, short-term incentive compensation ("STI") and long-term incentive compensation ("LTI") is targeted to be at the median of the market. If any one of those pay components is eliminated or reduced, CNP would not be able to offer a level of compensation that would allow it to compete for the experienced and skilled personnel it must attract in order to provide safe and reliable electric service. The reality of the current employment market plus the large number of retirement-eligible employees means that CNP's philosophy of targeting the median to design competitive compensation options is more important than ever. No party in this case offered any evidence to the contrary.

CNP's use of market studies to determine pay base, incentive opportunities and benefits is also supported by a newly enacted law, HB 1767, which the Governor signed in June 2019 that creates a presumption of reasonableness and necessity for base salaries, wages, incentive compensation and benefits for gas utilities as long as those costs are consistent with recently issued market compensation studies.[567] The new legislation is a "triggering event" that gives the Commission an opportunity to evaluate and potentially reconsider the way it has viewed total compensation, including incentive pay, in a rate proceeding.[568] Specifically, the Governor signed this bill last month—after Commission decisions for other utilities such as Southwestern Electric Power Company ("SWEPCO") and Southwestern Public Service Company ("SPS"), which the Intervenors and Staff point to for support for their positions to disallow financially-based incentive compensation.

During the hearing on the merits, TIEC and COH challenged whether HB 1767 provided support for the Company's request to recover labor costs including base pay and incentive

[566] CEHE Ex. 22 at 1840 (Harkel-Rumford Direct).
[567] Rebuttal Testimony of Lynne Harkel-Rumford, CEHE Ex. 39 at 8 9 (Bates Pages); Rebuttal Testimony of John J. Reed, CEHE Ex. 40 at 24. Financially-based incentive pay for certain executive officers is excluded from that presumption. CEHE Ex. 40 at 29-31, Exh. R-JJR-1 (Reed Rebuttal).
[568] CEHE Ex. 40 at 26 (Reed Rebuttal).

compensation. The Company is not arguing that the law, which is codified in the Gas Utility Regulatory Act, applies to CEHE as an electric utility. However, the law *does* reflect a new policy pronouncement from the Legislature and Governor, which confirms it is reasonable for a utility to rely on recent market compensation studies to determine base salaries, wages, incentive compensation and benefits.[569] CEHE witness John Reed observed that it would be good regulatory policy to treat gas and electric utilities similarly when establishing rates to avoid providing an undue advantage or benefit to one utility over another.[570] This is particularly true for CNP, which operates both gas and electric divisions in the state of Texas. CEHE witness Lynne Harkel-Rumford explained that Human Resources administers compensation and benefits for all employees across CNP.[571] In fact, Ms. Harkel-Rumford provided a list of over 1,500 non-union CNP positions for employees who provide services to both CEHE and CNP's gas divisions.[572] Examples include customer service representatives, operations supervisors, land and field services employees (Geographic Information Systems ("GIS"), Right of Way, Surveying) and regulatory personnel.[573] These employees perform their job duties while being compensated by a consistent "total compensation" approach administered by Human Resources. As Mr. Reed noted during the hearing when referring to HB 1767, "the conclusion I drew from that was, in this case, this relates to costs incurred under the same programs, for the same company and in some cases, even the same employees as at issue in this docket for CenterPoint Houston."[574] Therefore, "a different standard should not apply as a matter of regulatory policy" regarding the recovery of compensation and benefits costs for the gas utility and the electric utility when both rely on market studies to determine compensation for employees and those employees are offering the same services to both types of utilities.[575]

In short, the facts and evidence in this case show that CNP and CEHE must be proactive in attracting and retaining employees in an environment where employment rates are high, there is significant competition for utility employees, and many employees are at or nearing retirement age. The record evidence, which is addressed in detail below, supports the Company's request to recover its requested incentive compensation, payroll and benefits costs for direct Company

[569] Tex. Util. Code § 104.060; CEHE Ex. 40 at 29-31, Exh. R-JJR-1 (Reed Rebuttal).
[570] CEHE Ex. 40 at 24-25 (Reed Rebuttal).
[571] CEHE Ex. 39 at 8 (Harkel-Rumford Rebuttal).
[572] *Id.* at 9 & 32-45, Exh R-LHR-1.
[573] *Id.*
[574] Tr. at 1354 (Reed Cross) (Jun. 28, 2019).
[575] *Id.* at 1354, 1356.

employees and the CERC and Service Company employees who also provide necessary services to the Company.

1. Incentive Compensation

As mentioned above, recently enacted law, HB 1767, offers new clarity regarding the standard to be used to evaluate the reasonableness and necessity for base salaries, wages, and incentive compensation.[576] It also reflects an acknowledgement that customers and shareholders alike benefit by encouraging high performance through a balanced mix of incentives, including safety, operational, and customer satisfaction goals. Importantly, the new statute provides the Commission with an opportunity to evaluate and potentially reconsider the way it has viewed total compensation, including incentive pay, and the recoverability of those costs.[577] Not surprisingly, Intervenors and Staff continue to pit the interests of customers and shareholders against one another to support their positions that shareholders, not customers, should bear incentive costs tied to financial measures. The Company, however, takes a different view—when employee, customer and shareholder interests are aligned, the Company is successful. And, when the Company is successful, customers receive safe and reliable service, investors continue to provide necessary capital that allows the Company to continue to invest in its electric system, and employees remain with the Company and work hard every day. For example, Ms. Harkel-Rumford explained during the hearing that investment from shareholders gives the Company the opportunity to install infrastructure, make capital expenditures, and allows the Company to manage rates charged to customers by lowering borrowing costs.[578]

Contrary to the positions advanced by TIEC, Staff, OPUC and COH, incentive pay and the goals upon which it is based are not an "either/or" issue for customers and shareholders. As Mr. Reed explained, everything the Company does impacts customers and shareholders and employees know this.[579] For example, if the Company hires additional linemen to focus on system reliability, that will lead to higher operating expenses and should also improve reliability, but will also reduce the amount of net income available for distribution to shareholders until new rates are approved that reflect the additional costs for the new personnel.[580] Nevertheless, the Company's

[576] CEHE Ex. 39 at 8 (Harkel-Rumford Rebuttal); CEHE Ex. 40 at 24 (Reed Rebuttal). Financially based incentive pay for certain executive officers is excluded from that presumption. CEHE Ex. 40 at 29-31, Exh. R-JJR-1 (Reed Rebuttal).
[577] CEHE Ex. 40 at 26 (Reed Rebuttal).
[578] Tr. at 1344 (Harkel-Rumford Cross) (Jun. 28, 2019).
[579] CEHE Ex. 40 at 14 (Reed Rebuttal).
[580] *Id.*

primary focus is appropriately on its customers. If the Company does not provide safe, reliable service at a reasonable cost, neither its customers nor shareholders will be satisfied. This highlights precisely why, as Ms. Harkel-Rumford explained, a properly designed incentive compensation plan must include a mixture of goals that lead to success for all interested stakeholders.[581] Therefore, Intervenor and Staff arguments that either customers or shareholders benefit over the other is seriously flawed and misguided. At the end of the day, if the Company provides safe, reliable service at a reasonable cost, which depends upon productive employee behavior, all parties benefit from the Company's actions.

CNP relies on market studies to determine STI opportunities and on a peer group analysis performed by a consultant, Meridian Compensation Partners, LLC ("Meridian"), to determine LTI opportunities. COH witness Mark Garrett, however, suggests that incentive compensation does not need to be offered because most electric cooperatives and municipally and federally owned utilities do not offer incentive pay.[582] The flaw in that position, however, is that those entities are not peers of CNP or the Company based on the number of customers and employees or the size of CNP.[583] In addition, those types of electric providers do not provide service in the greater Houston area, which is a highly competitive environment with low unemployment rates. Moreover, entities such as electric cooperatives and municipally and federally owned utilities make up for the lack of one compensation component in other components or forms of compensation and benefits.[584] Mr. Garrett does not dispute that CEHE operates in a very competitive environment against other publicly-traded companies from various industries, including the energy industry. For example, CNP is in direct competition with other Houston-based companies that offer a higher level of compensation and benefits, including upstream and midstream energy companies who also need engineers, financial analysts, accountants, and skills that are necessary for CNP to operate safely and reliably.[585]

Although Mr. Garrett identifies reasons for his belief that costs for financially-based incentive compensation should not be recovered through rates,[586] his positions are generic and not tied to CEHE's circumstances. For example, the evidence shows:

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[581] CEHE Ex. 39 at 7-8, 15, 20 (Harkel-Rumford Rebuttal).
[582] Direct Testimony of Mark Garrett, COH/HCC Ex. 2 at 28, 40.
[583] CEHE Ex. 39 at 10 (Harkel-Rumford Rebuttal).
[584] *Id.*
[585] *Id.*
[586] COH/HCC Ex. 2 at 20-24 (Garrett Direct).

- Contrary to Mr. Garrett's assertions that payment is uncertain, CNP has consistently paid incentive compensation over the last ten years.[587]
- Contrary to Mr. Garrett's assumption that most incentive plan measures are outside the control of employees, CEHE employees are aware of the need to control expenses and the fact that customers benefit when that occurs. Every avoided accident and every satisfied customer lead to more cost-effective operations. Employees also manage vendors who provide services to CNP to not only ensure employees and customers are served effectively but also help control costs by negotiating pricing and using their services efficiently.[588]
- Contrary to Mr. Garrett's assertion that certain factors beyond the Company's control might lead to increased revenues and therefore promote the achievement of financial goals, he fails to acknowledge the ways in which those same issues can lead to the need for additional Company resources and related expense.[589]
- Contrary to Mr. Garrett's position that stockholders assume no risk for incentive payments, the evidence shows they absorb the same risk with incentive payments as they do with any other element in the revenue requirement. Shareholders absorb the risk that allowed rates will be inadequate to earn the return authorized by the Commission.[590]

Most importantly, the incentive compensation element of the Company's cost of providing service is not unique or in any way different from office supplies, information technology costs or base compensation.[591] It is a valid cost that should be included in base rates.

a. Short-Term Incentive Compensation

The Company is requesting recovery of STI for direct and Service Company employees using the four-year average achievement level (i.e., 122%) applied to the total labor costs, including the wage adjustment, rather than the test year level of costs that was incurred at the 131% achievement level.[592] Unlike Intervenor witnesses who ignore test year numbers in favor of multi-year averages only when it benefits their position (Norwood, Nalepa, and Ianni, e.g.), CEHE's use here of a multi-year average instead of the actual test year number *lowers* its requested revenue requirement, and the four-year average for STI is used to adjust actual test year costs. The STI request includes union and non-union amounts for direct and affiliate employees. The requested STI costs are:

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587 CEHE Ex. 39 at 12 & 46, Exh. R-LHR-2 (Harkel-Rumford Rebuttal).
588 *Id.* at 12; CEHE Ex. 40 at 10-11 (Reed Rebuttal).
589 CEHE Ex. 39 at 13 (Harkel-Rumford Rebuttal).
590 CEHE Ex. 40 at 11-12 (Reed Rebuttal).
591 *Id.* at 14.
592 CEHE Ex. 35 at 17 (Colvin Rebuttal); Direct Testimony of Michelle M. Townsend, CEHE Ex. 15 at 1111-1113 (Bates Pages). The Company is requesting recovery of $4,641 for CERC STI, which amount was not adjusted. *See* Staff Ex. 15A at Att. 2, STI tab (page 2 of 2), cell H73.

Figure 1. Requested STI Expense Amounts (in Thousands)[593]

	Union	Non-Union	Total[594]
Direct	$1,374	$5,933	$7,307
Affiliate	117	9,461	9,578
	$1,491	$15,394	$16,885

Despite this evidence, Mr. Filarowicz, Ms. Dively, and TIEC witness Billie LaConte incorrectly base their direct STI disallowances on the Company's test year amounts[595] rather than the four-year average STI achievement level.[596] For this reason, the amounts they identify in their testimonies do not reflect the Company's requested STI amounts. Their proposed disallowances also include STI costs for union employees, which are presumed reasonable under PURA § 14.006, and which none of these witnesses identify or acknowledge. In fact, during the hearing, Ms. LaConte admitted she had not reviewed PURA § 14.006.[597] After the presumption of reasonableness for union costs that are the product of a collective bargaining agreement was brought to her attention, Ms. LaConte confirmed her recommendation to disallow union STI costs was contrary to Texas law.[598] As Ms. LaConte acknowledged, Intervenor and Staff recommendations to disallow union STI costs should not be adopted.

In addition, Mr. Filarowicz, Ms. LaConte, Ms. Dively and Mr. Garrett recommend disallowances for all financially-based STI. Mr. Filarowicz and Ms. Dively treat the STI goal for CNP O&M Expenditures as a financial goal and Mr. Garrett notes it could be treated as a financial goal.[599] The Company disagrees. Mr. Filarowicz and Mr. Garrett also recommend a disallowance of half of the STI costs related to safety, operational or customer satisfaction goals due to a "financial trigger" in the STI plan.[600] In making these arguments, all four witnesses refer to Commission decisions for other utilities or decisions made by commissions in other states without

[593] CEHE Ex. 35 at 17 (Colvin Rebuttal); These amounts exclude FICA and Savings Match.
[594] *Id.* and WP R-KLC-02 Requested STI Expense Calculation contain Direct and Service Company amounts of $7,306,583 and $9,573,305, respectively. For the CERC amount of $4,641 included in the Affiliate totals, refer to Staff Ex. 15A at Att. 2, STI tab (page 2 of 2), cell H73. Taken together, the Affiliate amount for Service Company of $9,573,305 plus the $4,641 for CERC equals $9,578,000 rounded to the nearest thousand.
[595] Staff Ex. 4A at 15 (Filarowicz Direct); Direct Testimony of Billie S. LaConte, TIEC Ex. 3 at 17-18 (Bates Pages); OPUC Ex. 1 at 45 (Dively Direct); COH/HCC Ex. 2 at 30 (Garrett Direct).
[596] CEHE Ex. 12 at 849 (Colvin Direct).
[597] Tr. at 437-438 (LaConte Cross) (Jun. 25, 2019).
[598] *Id.* at 438, 446.
[599] COH/HCC Ex. 2 at 25 (Garrett Direct).
[600] Staff Ex. 4A at 13-14 (Filarowicz Direct); COH/HCC Ex. 2 at 30-31 (Garrett Direct).

adequately considering or discussing whether those decisions reflect sound policy given the facts of *this* case.[601]

In the Company's last rate case in Docket No. 38339, the Commission approved recovery of all STI costs and found that STI was a reasonable and necessary component of a total compensation package required to recruit, retain, and motivate employees.[602] The Commission also found that the corporate and financial goals of STI are directly tied to metrics such as customer service and safety.[603] And, since Docket No. 38339, the overall STI plan purpose has remained the same and continues to rely on a plan concept that aligns customer, shareholder and employee interests.[604] Notably, Ms. LaConte for TIEC did not review this prior Company decision.[605] Other parties side-step this reality in favor of relying on Commission decisions related to other utilities in which costs tied to financially-based STI goals were disallowed because—unlike either Docket No. 38339 or this docket—there was no testimony presented that those STI goals benefited customers. Mr. Garrett also tries to undermine these findings by arguing that the Company prevailed only due to an evidentiary issue.[606] The Commission's findings, however, affirmatively support recovery of all STI costs, including those based on the achievement of financial goals. Thus, the Company's request in this case to recover STI, which includes a reduction to test year amounts to reflect a 122% achievement level (rather than the actual 131% achievement for the test year), is consistent with Commission precedent for CEHE.

Short-term incentive compensation is offered by the vast majority of companies in the market. Eighty-five percent of approximately 1,900 U.S. survey respondents, including 96 utilities, use short-term incentive pay according to a 2018-2019 WorldatWork survey.[607] In addition, since Docket No. 38339, the overall STI plan purpose has remained the same. Although some of the specific plan goals have changed, the design of the STI plan continues to align customer, employee and shareholder interests. The 2018 STI Plan goals are as follows and are consistent with goals used by most of CNP's peer utilities:[608]

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[601] Staff Ex. 4A at 12-14 (Filarowicz Direct); TIEC Ex. 3 at 14-16 (LaConte Direct); OPUC Ex. 1 at 41-42 (Dively Direct); COH/HCC Ex. 2 at 10-20 (Garrett Direct).
[602] Docket No. 38339, Order on Rehearing at Finding of Fact 81.
[603] *Id.* at Finding of Fact 83.
[604] CEHE Ex. 22 at 1853 (Harkel-Rumford Direct).
[605] Tr. at 427 (LaConte Cross) (Jun. 26, 2019).
[606] COH/HCC Ex. 2 at 15 (Garrett Direct).
[607] CEHE Ex. 22 at 1851 (Harkel-Rumford Direct).
[608] CEHE Ex. 22 at 1853-1854 & Confidential Exhs. LHR-5 and LHR-6 (Harkel-Rumford Direct).

GOAL	WEIGHTING
CNP Core Operating Income	35%
CNP Consolidated Diluted Earnings Per Share	20%
CNP O&M Expenditures	25%
Customer Satisfaction Composite	10%
CNP Safety Composite	10%

The combination of financial, safety, operational, and customer satisfaction goals works to motivate employee behavior in a way that benefits customers and shareholders. The STI goals encourage expense management and operational efficiencies that benefit customers through reasonable rates, safe and reliable operations and enhanced customer service.[609] Not only are the requested STI costs reasonable because they are the result of an STI Plan that is comparable to those in the market and necessary because the costs are part of an overall compensation package that must be competitive, the STI Plan also includes goals that lead to customer and shareholder benefits. In this way, STI is no different than the Company's ongoing capital investment in new infrastructure, which also benefits customers and shareholders.

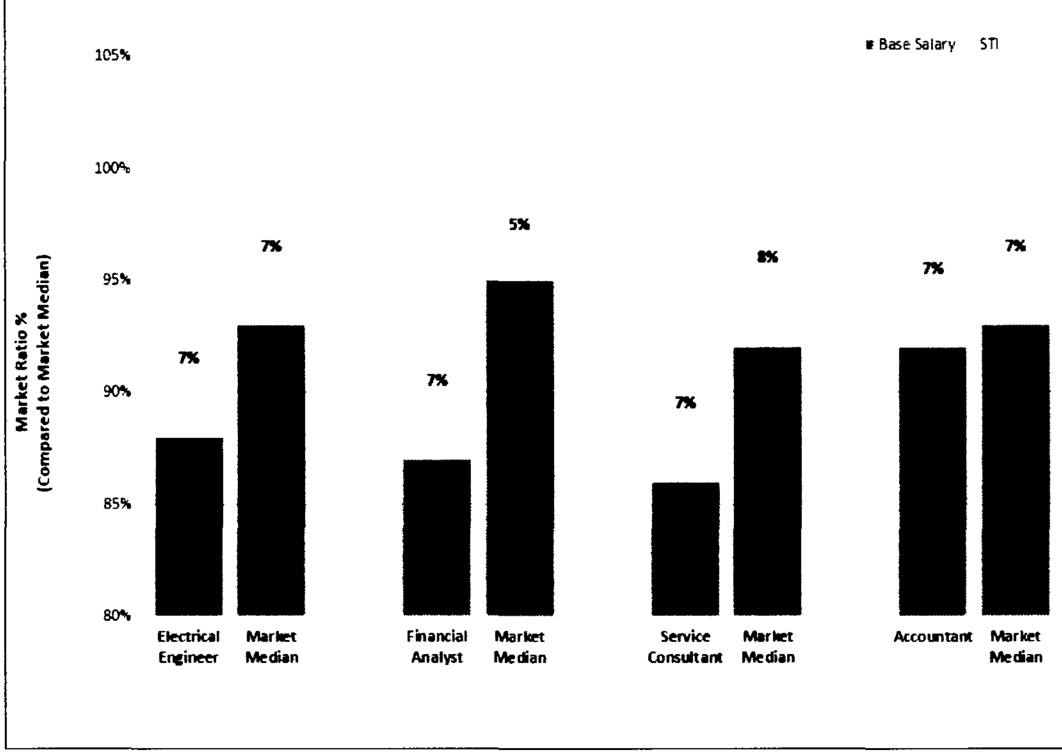
Staff and COH allege the CNP O&M Expenditures goal should be considered financial and not operational.[610] However, simply because a goal is measured in dollars does not make it a financial goal. O&M expense is an operational metric because it is critical for CNP to operate efficiently, effectively and safely to meet the expectations for the O&M goal. The calculation of this metric starts with total O&M that is then adjusted to remove items that have revenue offsets or are outside of employees' control.[611] This approach aligns employees' day-to-day actions with the impact to the Company's operating expense and its ability to provide service at a reasonable cost. The O&M goal motivates employees to find operational efficiencies that benefit customers through reasonable rates, safe and reliable operations and enhanced customer service.[612] In fact, in communications with employees, CNP explains this is an operational goal.[613] To the extent the employee efforts help the Company successfully manage O&M expenses, those efforts help limit

[609] CEHE Ex. 22 at 1854 (Harkel-Rumford Direct).
[610] COH/HCC Ex. 2 at 25 (Garrett Direct); Staff Ex. 4A at 16-17 (Filarowicz Direct).
[611] CEHE Ex. 39 at 15 (Harkel-Rumford Rebuttal).
[612] *Id.*
[613] Tr. at 307 (Harkel-Rumford Cross) (Jun. 25, 2019).

the growth in the overall revenue requirement and therefore reduce customer rates. For this reason, the O&M expenditures goal in the STI Plan promotes long-term benefits for customers.

Critically, even with STI, the combination of CNP's total cash compensation, which is base pay and STI, is below the market median. The chart below illustrates that the base salary and STI levels are below the market median elements for several positions.[614]

Figure 1 - Total Cash Compensation Market Comparison



*Data showcases approximately the median of the experienced level of the families listed above.

Neither the Intervenors nor Staff addressed this data in their testimony. Instead, they rely on a default assumption that is it unreasonable for a utility to either offer or recover STI costs that are based on achieving financial goals.

Even though the evidence supports the reasonableness of the STI costs the Company seeks to recover, Intervenors and Staff recommend disallowances that would force the Company into a position of not recovering costs it must pay to remain competitive. Specifically, the Company's request to recover STI at the 122% threshold level is reasonable when considered against the

[614] The Electrical Engineer and Service Consultant examples are Company positions. The Financial Analyst and Accountant examples are Service Company positions.

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market median. For the test year, base pay plus STI costs at the requested 122% achievement level results in total cash compensation costs that are at the market median—recovering STI at the 122% achievement level does not increase the Company's overall cash compensation request above the market median. This is illustrated in Exhibit R-LHR-3 to Ms. Harkel-Rumford's rebuttal testimony. Using the positions in Figure 1 above, that exhibit shows the actual average total cash compensation, including STI at the 122% level is as follows:

- Electrical Engineer position is at 96% of the market median, which is 4% below median;
- Financial Analyst position is at 97% of the market median, which is 3% below median;
- Service Consultant position is at 95% of the market median, which is 5% below median; and
- Accountant position is at 100%, which does not exceed the market median.[615]

Thus, the actual base pay plus STI costs the Company seeks to recover—even at the 122% STI level—do not exceed the median of the market and should be recovered through rates.

Mr. Garrett also recommends the Company's STI request be reduced to the 100% target level rather than the 122% level CEHE is requesting.[616] Rate recovery at that level, however, is not consistent with recent achievement levels that have consistently been above the target level:

	Actual STI Achievement Level
2015	113%
2016	112%
2017	133%
2018	131%

Using the four-year average of 122% to reduce actual STI test year costs is also consistent with the actual achievement levels for the past 10 years, which are shown in Exhibit R-LHR-2. These historical STI achievement levels show that recovering only the target level of expense does not reflect the actual test year STI expenses nor those that CEHE believes are likely to occur when new rates are implemented.[617] For these reasons, Mr. Garrett's position should not be adopted.

The STI plan is also subject to a funding trigger. For STI payments to be made, CNP must achieve a threshold level of core operating income, which helps ensure that CNP is financially healthy and able to support all of its operations, in addition to awarding incentive pay.[618] Based on this "trigger," Mr. Garrett and Mr. Filarowicz recommend that half of the STI tied to operational

[615] CEHE Ex. 39 at 17-18 & 47-48, Exh. R-LHR-3 (Harkel-Rumford Rebuttal).
[616] COH/HCC Ex. 2 at 32-33 (Garrett Direct).
[617] CEHE Ex. 35 at 15-16 (Colvin Rebuttal).
[618] Tr. at 313, 315-316 (Harkel-Rumford Cross) (Jun. 25, 2019).

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and customer satisfaction goals be disallowed.[619] This position should be rejected because, as both COH and Staff acknowledge, customers are the direct beneficiaries of operational, safety, and customer satisfaction metrics.[620] Thus, there should be no disallowance for STI tied to operational or safety measures, particularly when that type of employee behavior drives cost-effective and safe operations.[621] In addition, because the overall STI costs are reasonable and necessary and fall at or below median levels, and because customers benefit from the use of financial goals, the Commission should reject any disallowance related to the operational, safety and customer satisfaction goals. Requested STI amounts for the goals the Company properly considers to be operational, safety, and customer satisfaction are as follows:[622]

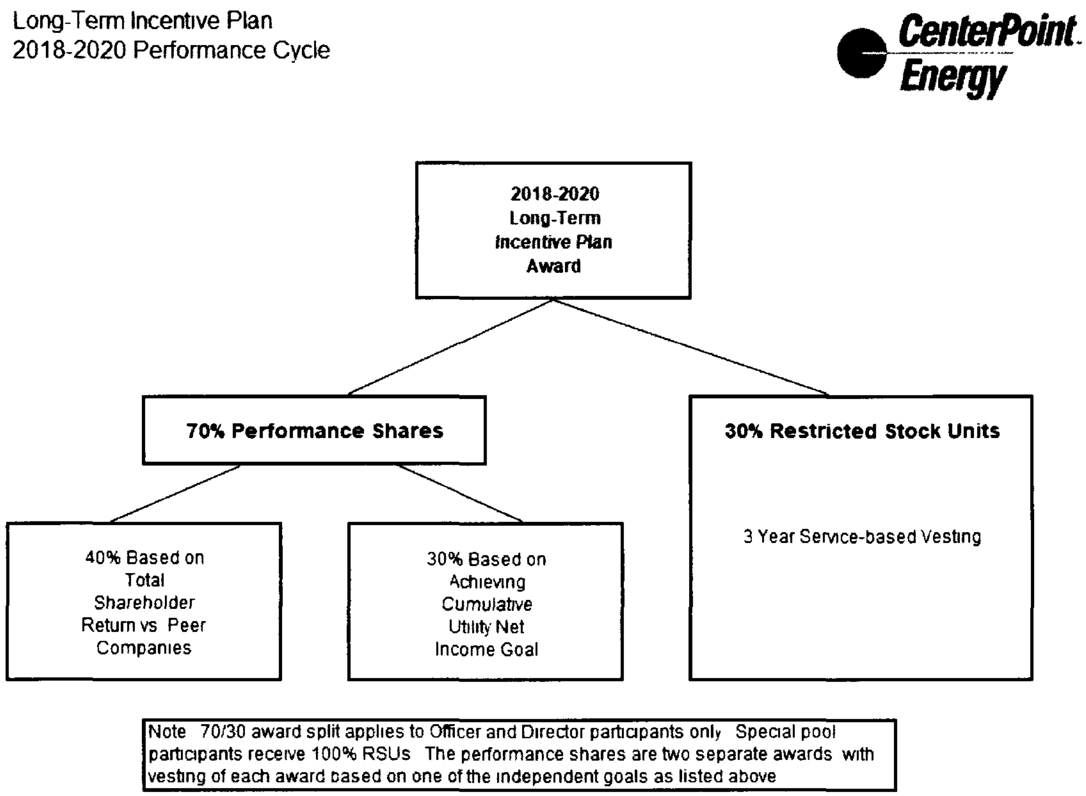
	Overall O&M Expenditures	Customer Satisfaction	Overall Safety Performance	**Totals by Employee Type**
Direct - Union	$302,210	$127,615	$118,360	**$548,185**
Direct - Non-Union	$1,305,149	$551,130	$511,158	**$2,367,437**
Affiliate - Union	$15,969	$8,276	$12,006	**$36,251**
Affiliate - Non-Union	$1,296,209	$671,758	$974,522	**$2,942,489**
Totals by Goal	**$2,919,537**	**$1,358,779**	**$1,616,046**	

b. Long-Term Incentive Compensation

As they did with STI, Intervenor and Staff witnesses take the position that LTI costs, which they assume are all based on the achievement of financial goals, should not be recovered through rates.[623] There are, however, two forms of LTI offered to eligible employees: performance shares are based on achievement of financial goals whereas restricted stock units ("RSUs") are not tied

[619] COH/HCC Ex. 2 at 31 (Garrett Direct); Staff Ex. 4A at 13 (Filarowicz Direct).
[620] CEHE Ex. 39 at 19 (Harkel-Rumford Rebuttal).
[621] *Id.*
[622] CEHE Ex. 35 at WP R-KLC-02 (Colvin Rebuttal) for Direct and Service Company amounts. For CERC STI amounts, refer to Staff Ex. 15A at Att. 2, STI tab (page 2 of 2), cell H73. The Affiliate amounts by goal were calculated using the Percent of Overall Funding by Goal shown on Staff Ex. 15A at Att. 1 (page 3 of 3) multiplied by the total Affiliate amounts for Service Company and CERC. The Percent of Overall Funding by Goal was 13.7% for Overall O&M Expenditures, 7.1% for Customer Satisfaction, and 10.3% for Overall Safety Performance. The total Affiliate-Union amount for Service Company is $116,563 as shown on WP R-KLC-02. The total Affiliate-Non-Union amount for Service Company is $9,456,742 and for CERC is $4,641.
[623] Staff Ex. 4A at 13 (Filarowicz Direct); OPUC Ex. 1 at 43 (Dively Direct); COH/HCC Ex. 2 at 31 (Garrett Direct); TIEC Ex. 3 at 14 (LaConte Direct).

to any financial goals.[624] The RSUs, which make up 30% of the LTI award for officers and directors for 2018-2020, are time-based. In addition, 100% of the LTI award for employees below the director level is time-based. An LTI-eligible employee must remain with CNP during that three-year period to be eligible to receive RSUs, which highlights the retentive nature of these grants.[625] This is illustrated in Ms. Harkel-Rumford's direct testimony.



The Company's requested LTI expenses related to RSUs are $3.8 million and have no correlation to the achievement of financial goals.[626] Nevertheless, Mr. Filarowicz for Staff, Ms. Dively for OPUC, Mr. Garrett for COH and Ms. LaConte for TIEC recommend the Commission disallow these time-based LTI costs. Mr. Garrett also argues the RSUs should be considered a financial measure because the award is tied to the value of CNP stock. That position misses the point—the activity that drives achievement of the LTI goal for RSUs is purely time-based and is geared towards retaining eligible employees.[627] The fact that the award for this time-based

[624] CEHE Ex. 22 at 1858-1859, Confidential Exh. LHR-8 (Harkel-Rumford Direct), CEHE Ex. 39 at 23 (Harkel-Rumford Rebuttal).
[625] CEHE Ex. 39 at 23 (Harkel-Rumford Rebuttal).
[626] CEHE Ex. 35 at 18 (Colvin Rebuttal).
[627] CEHE Ex. 39 at 25 (Harkel-Rumford Rebuttal).

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accomplishment is in the form of stock does not make RSUs a financially-based component of LTI.[628] In addition, the Commission has previously approved recovery of costs for RSUs that are part of an LTI plan and are not financially-based.[629] Therefore, even if the Commission were to adopt the Intervenor and Staff recommendations to disallow LTI costs based on financial goals, it would not be appropriate to disallow costs related to the restricted stock awards.

More broadly, Intervenor and Staff witnesses reiterate their positions that customers do not benefit in any way from achievement of financial goals that are part of the awarding of performance shares in the LTI plan. A specific purpose of the LTI plan is to focus employee attention toward ensuring sustained improvements in performance over longer periods of time.[630] The goals associated with performance-based LTI motivate participating employees to effectively manage operations because achievement of financial goals enables CNP and CEHE to adequately maintain its assets and provide safe and reliable electric service to customers with a focus on controlling costs.[631] This attracts new investors and allows for greater access to capital at better rates. Healthy cash flow enables CEHE to proactively maintain and repair electric delivery infrastructure and provide enhanced customer service. And, as Ms. Harkel-Rumford noted during the hearing, CNP views "customers and the shareholders as being aligned in many aspects, because, again, if the financial health of the Company is good, that is good for the customers . . . ."[632] Customers necessarily benefit from CNP and CEHE recruiting and retaining key employees who are motivated to make positive strategic decisions that will benefit the Company and its customers over the long run.[633] In addition, no party disputes the strong job growth and economic data that illustrates the competitiveness of the local Houston economy, as well as significant growth in the state and national economies.[634]

Just as the Company relies on market studies to determine base pay and STI opportunities, CNP also relies on external data related to LTI opportunities. Specifically, the market requires that a significant portion of the total compensation for senior executives and management is at-risk pay.[635] This "pay for performance" philosophy is consistent with the market and requires that

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[628] *Id.*
[629] CEHE Ex. 40 at 8 (Reed Rebuttal), citing to *Application of Southwestern Electric Power Company for Authority to Change Rates,* Docket No. 46449, Order, Finding of Fact 199 at 35 (Jan. 11, 2018).
[630] CEHE Ex. 39 at 20 (Harkel-Rumford Rebuttal).
[631] *Id.* at 21.
[632] Tr. at 1345 (Harkel-Rumford Cross) (Jun. 28, 2019).
[633] CEHE Ex. 39 at 21 (Harkel-Rumford Rebuttal).
[634] CEHE Ex. 40 at 22 (Reed Rebuttal).
[635] CEHE Ex. 39 at 22 (Harkel-Rumford Rebuttal).

senior executives and management meet established goals related to customer and shareholder expectations. In addition, the boards of directors for publicly-traded companies continue to receive significant pressure on executive compensation from various groups, including those representing the interest of shareholders to ensure that compensation is reasonable, comparable with peer companies and tied to company performance.[636] The CNP board reviews executive compensation to ensure it is not excessive or inconsistent with what is being offered in the market. This is precisely why the board's Compensation Committee hires an independent compensation consultant, Meridian, to advise the committee on current practices and how to best position CNP to compete for executive talent that is necessary to oversee, manage, and provide utility operations.[637]

In short, the Intervenor and Staff arguments in opposition to the Company's request to recover LTI costs default to inaccurate notions that only shareholders benefit from LTI plan goals. And, they urge these positions without considering economic conditions, the need to retain existing employees and the recent enactment of legislation that supports recovery of incentive compensation costs for nearly all employees of a gas utility that are based on market studies. Because the need for attracting and retaining employees at the operating level, as well as at executive levels, is increasingly important, the Commission's decision regarding recovery of LTI costs should not rest simply on whether financial goals are the basis for awarding LTI payments. Instead, there is a serious need for qualified employees who maintain levels of system reliability, who are responsive to customers' needs, and who can prudently manage the needed enhancement of the grid to meet customer demand. For these reasons, the evidence supports the Company's request to recover $7.5 million in LTI costs associated with performance shares, which are awarded based on the achievement of financial goals.[638]

2. Executive Employee Related Expenses

Challenged issues related to payroll and benefits expenses for executives are addressed in Sections IV.B.1 (Incentive Compensation), IV.B.3 (Payroll Adjustments), and IV.B.5 (Other Benefits).

[636] *Id.*
[637] *Id.*
[638] COH/HCC Ex. 2 at Exh MG-24 (LTI Total of $11.3 million minus $3.8 million for RSUs).

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3. Payroll Adjustments

Just as CNP relies on market studies to determine incentive pay opportunities, it also relies on market studies to determine median base pay. In 2018, the overall average CNP non-union base salaries were below the market median base salaries of the companies included in the surveys by approximately 2 percent.[639] In addition to this data, the 2018 test year level of salaries and wages is not representative of labor costs that are expected to occur at the time new rates become effective because competitive pay adjustments ("CPA") are made in March each year.[640] The Company made the following adjustments to test year direct labor expense: (1) annualized calendar year-end salaries; (2) included a 3% increase for the CPAs that were effective in March or April 2019 for non-union employees and a CPA for union employees; (3) adjusted for direct STI using the adjusted salary (base, CPA and union step increases) multiplied by the STI percentage per position, which was then multiplied by the average achievement of 122% for the last four years; (4) further adjusted the union STI percentage based on the three-year average goal achievement level. The total salary adjustment and STI was then used to calculate the adjustment for the applicable savings match and employment taxes for the Company. Test year O&M salary, CPA, and incentive compensation were then adjusted to effective levels for 2019.

Payroll adjustments for direct and affiliate employees include amounts for union employees. The Company's requested adjustments for direct and affiliate union employees should be approved based upon the unrebuttable presumption in PURA § 14.006, which states:

> The commission *may not* interfere with employee wages and benefits, working conditions, or other terms or conditions of employment that are the product of a collective bargaining agreement recognized under federal law. An employee wage rate or benefit that is the product of the collective bargaining is presumed to be reasonable (emphasis added).

The table below shows the Wage Adjustments (excluding STI) for Direct and Affiliate union and non-union employees, by category. The details of the wage adjustment are shown in multiple work papers the Company provided with its RFP.[641]

[639] CEHE Ex. 22 at 1845 (Harkel-Rumford Direct).
[640] CEHE Ex. 12 at 848 (Colvin Direct).
[641] CEHE Ex. 2 at 1411-1413, WP/II-D-3 Adj 2, 1285, WP/II-D-2 Adj 4 for the Affiliate Wages adjustment & 1285, WP/II-D-2 Adj 5 for the Direct Wages adjustment.

Wage Adjustment (In Thousands, excluding STI)

		Non-Union	Union	Total
Direct	Salary Adjustment[642]	$ 437	$ 2,126	$ 2,563
Direct	CPA Adjustment[643]	1,200	1,971	3,171
	Total Direct	1,637	4,097	5,734
Affiliate	Salary Adjustment	$ 1,705	447	2,152
Affiliate	CPA Adjustment	1,361	52	1,414
	Total Affiliate[644]	3,066	499	3,565
	Total Wage Adjustment	**$ 4,703**	**$ 4,596**	**$ 9,299**
Direct	FICA Tax[645]	22	(14)	8
Direct	Savings[646]	(15)	169	154
	Grand Total	**$ 4,710**	**$ 4,751**	**$ 9,461**

a. Annualizing December 2018 Salaries is Reasonable

The Company's adjustment to annualize December 2018 payroll is reasonable because the average of 2,808 CEHE direct employees throughout the test year is nearly identical to the number of direct employees for December 2018, which was 2,796.[647] The Company made a corresponding adjustment to annualize December 2018 affiliate payroll.[648] Mr. Garrett challenges the Company's annualization of salaries, arguing that the wage adjustment does not reflect retirements, workforce reorganization or productivity gains.[649] The Company's approach, however, is a reasonable way to adjust test year wages based on known and measurable adjustments for the number of employees and salary amounts as of the last month of the test year, whereas the issues Mr. Garrett identifies are not known and measurable.[650] Mr. Garrett's position also improperly excludes necessary wage adjustments that are contained in the union contracts. Because that is contrary to PURA § 14.006, his position for affiliate employees should also be rejected.

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642 CEHE Ex. 2 at RFP Workpapers WP II-D-3 Adj 2 (Ref cells 03767-Q3767).
643 *Id.* at RFP Workpapers WP II-D-3 Adj 2 (Ref cells R3767-U3767; Y3767-AA3767).
644 *Id.* at RFP Workpapers WP II-D-1 Adj 4 (Ref cells X212-Z216).
645 *Id.* at RFP Workpapers WP II-D-3 Adj 2 (Ref cells 03786-Q3786).
646 *Id* at RFP Workpapers WP II-D-3 Adj 2 (Ref cells 03778-Q3778).
647 CEHE Ex. 35 at 11-12 (Colvin Rebuttal); CEHE Ex. 2 at 270, Schedule II-D-3.5.
648 CEHE Ex. 15 at 1111 (Townsend Direct).
649 COH/HCC Ex. 2 at 49 (Garrett Direct).
650 CEHE Ex. 35 at 12 (Colvin Rebuttal).

b. The 3% CPA for CEHE, CERC and Service Company Labor is reasonable.

To meet market conditions, CNP salaries, union and nonunion, are adjusted on an annual basis. Following the test year, CNP salaries increased by an estimated 3.0% for all business units, including Service Company and CEHE. An average 3% increase was effective on April 1, 2019, for non-union employees.[651] The annual 3% increase for non-union employees is based on market compensation studies because CNP relies on market data to ensure it is remaining competitive with the market to retain employees.[652]

For union employees such as linemen, electricians, meter installers and meter testers, a 3% increase in wages was effective on May 26, 2018 as required by the collective bargaining agreement between the Company and the International Brotherhood of Electrical Workers ("IBEW") Local 66.[653] CEHE is also proposing an increase to union wages for the step movement within the Apprentice Training Program as described in the IBEW Local 66 union contract.[654] A 3% increase in wages was also effective for affiliate union employees on June 1, 2018 for the Office & Professional Employees International Union Local No. 12 AFL CIO ("Metro") and on April 1, 2018 for the Office & Professional Employees International Union Local No. 12 AFL-CIO representing Mankato ("Mankato").[655] Employees represented by Metro include positions such as customer information phone representatives and other office clerical workers. Employees represented by Mankato include positions such as customer information phone representatives, lead customer information phone representatives, Customer Billing representatives, and lead Customer Billing representatives.[656] The IBEW Local 66, Metro and Mankato union contracts require a 3% increase in wages in 2019.[657]

Distributing CPA to employees was shown to help CNP stay competitive with the industry while retaining talented and experienced staff. As shown on Schedule V-K-2, and detailed on Schedule V-K-6 Adjustments to test year Expenses, the adjustments proposed to the 2018 test year

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[651] CEHE Ex. 22 at 1845 (Harkel-Rumford Direct).
[652] *Id.* at 1846.
[653] *Id.* at 1845.
[654] CEHE Ex. 12 at 549 (Colvin Direct). Please refer to CEHE Ex. 22 for the workpapers filed with Ms. Harkel-Rumford's direct testimony, which include copies of the union contracts.
[655] CEHE Ex. 22 at 1846 (Harkel-Rumford Direct).
[656] *Id.*
[657] *Id.* at 1845-1846.

Service Company billings to CEHE is a 3% Competitive Pay Adjustment which has a $4.4 million impact on total Service Company billings to CEHE.

Only COH challenged the Company's CPA adjustment, yet Mr. Garrett seems to misunderstand how it was applied. He seems to confuse the CPA amount that is already included in the test year with the need to adjust wages for the CPA that occurred in April or May 2019 for union and non-union employees.[658] For union employees, the Company is contractually obligated to increase wages every year.[659] In addition, for non-union employees, the 3% CPA is made, in part, because it is consistent with pay increases offered in the market.[660] The Company's reliance on market studies for the annual CPA is reasonable, maintains the Company's competitiveness and the related adjustment should be approved. It is also a known and measurable change and is consistent with the Commission's order in SWEPCO's most recent rate case in Docket No. 46449.[661]

c. Adjustments for Payroll Taxes

The Company's adjustments to payroll require a related adjustment to payroll taxes, which must reflect the expected 2019 salary levels and limits on taxable income for individual base wages. The payroll tax adjustment is shown on WP II-D-3 Adj 2, which was provided with the Company's RFP. Due to his proposed change to the Company's Direct CPA adjustment, Mr. Garrett also calculated a change to payroll taxes. His proposed tax adjustment is overstated, however, because he fails to consider the applicable limits on taxable income. Similarly, Mr. Filarowicz identifies a reduction to the Company's requested payroll tax amount due to the flow-through effects of his position on incentive compensation and a reduction in headcount for 32 CEHE employees.[662] Because those Staff positions should not be adopted, the related payroll expense adjustment should also be rejected. The Company's properly calculated payroll tax adjustment should be adopted.

d. An Adjustment for Changes to CEHE Headcount is not Reasonable

As noted above, the Company used the number of active employees as of the end of the test year to calculate wage amounts included in the cost of service. Nevertheless, Staff

[658] CEHE Ex. 35 at 11 (Colvin Rebuttal).
[659] *Id.*
[660] CEHE Ex. 22 at 1846-1847 (Harkel-Rumford Direct).
[661] Docket No. 46449, Order at Findings of Fact 191-193.
[662] Staff Ex. 4A at 25-26 (Filarowicz Direct).

recommends an adjustment to remove $1.65 million in base pay related to 32 CEHE employees who were severed following CNP's acquisition of Vectren.[663] This adjustment related to Vectren issues should not be made because other Vectren-related changes in the Company's cost of service after the end of the test year have not been used to adjust test year costs. For example, the 32 CEHE employees Staff identifies received severance payments totaling $3.6 million upon their separation.[664] Providing severance to employees whose jobs were affected through no fault of their own is fair and reasonable and consistent with market practices.[665] Severance is also a recurring expense, and no party challenged the recovery of the severance costs that were incurred during the test year.[666] If the Commission approves a decrease for the $1.65 million in base pay, related to the severed CEHE employees, it would be reasonable and appropriate to also include the increase of $3.6 million for the associated severance costs to reflect the costs the Company incurred to achieve the reduction in base pay amounts. This would result in a net increase of $1.95 million to the Company's cost of service.

e. Executive Base Pay is consistent with the median of the market.

CNP's base salaries for senior executives are based on peer group analysis performed by Meridian to provide independent advice on executive compensation matters to the Compensation Committee of the CNP board of directors.[667] The 2018 comparison group included 19 publicly-traded companies comparable in size to CNP in terms of annual revenues and the value of ongoing operations.[668] It is widely accepted that using market studies and targeting the 50th percentile of the market to set compensation levels is reasonable.

Despite the widely-accepted use of market compensation studies, Mr. Garrett claims salaries in excess of $1 million are not necessary for the provision of utility service.[669] For support, he alleges the TCJA made salaries in excess of $1 million non-deductible.[670] As a threshold matter, the TCJA did not change deductibility rules for base salaries, and the $1 million cap on executive salaries for tax deductibility purposes is unrelated to defining what is reasonable and necessary compensation for executives.[671] In addition, the reasons the IRC imposes limits or rules for tax

[663] Staff. Ex. 4A at 25-26 (Filarowicz Direct).
[664] CEHE Ex. 35 at 19-20 (Colvin Rebuttal).
[665] CEHE Ex. 39 at 29 (Harkel-Rumford Rebuttal).
[666] *Id*; CEHE Ex. 35 at 19-20 (Colvin Rebuttal).
[667] CEHE Ex. 22 at 1844 (Harkel-Rumford Direct).
[668] *Id.* at 1845.
[669] COH/HCC Ex. 2 at 46 (Garrett Direct).
[670] *Id.*
[671] CEHE Ex. 39 at 28 (Harkel-Rumford Rebuttal).

purposes has nothing to do with setting competitive levels of reasonable and necessary compensation.[672] Mr. Garrett's challenge of executive salaries is also inconsistent with the Legislature's and Governor's support expressed in HB 1767 for all base salary amounts that are consistent with market compensation studies for gas utilities. For these reasons, the Company's request to recover its portion of the base pay amounts for the one employee whose pay exceeds $1 million is reasonable and should be approved.

Finally, the amount of salary in excess of $1 million that Mr. Garrett identifies is not accurate. As shown in the CNP Proxy Statement, only one executive has a base salary over $1 million, and CEHE receives an allocated 54.20% share of that cost, which is less than the $1 million threshold amount that Mr. Garrett proposes.[673] Even if Mr. Garrett's position was adopted, the only amount that should be adjusted is the incremental amount for the single employee whose base pay is over $1 million. That incremental amount is $245,000. If this amount is assigned using CEHE's 54.20% allocation, the adjustment totals $132,786, not $1.143 million as Mr. Garrett proposes.[674]

4. Pension and Other Postemployment Benefits Expense

No party challenged the Company's reliance on the 2019 actuarial studies to determine its requested pension and OPEB expense.[675] These studies were provided as attachments to Schedules II-D-3.8.1 and II-D-3.9.1. The Company also agrees with Mr. Kollen that capital charges that were inadvertently included in the allocation of Service Company's portion of pension and OPEB expense to CEHE should be excluded.[676] The Company revised this amount in its Errata 1 filing. As corrected, this benefits adjustment results in a decrease of $9.0 million in pension and OPEB expense for the test year and has been functionalized to payroll.[677]

5. Other Benefits

Ms. Harkel-Rumford explained the benefits CNP offers employees of all business units, including CEHE, Service Company and CERC. Specifically, employee benefit expenses include the cost for the retirement plan (or pension), post-retirement and post-employment benefits, employee health and welfare plan, savings plan and other benefit program costs recorded to FERC

[672] *Id.*
[673] CEHE Ex. 37 at 19 (Townsend Rebuttal).
[674] *Id.*
[675] CEHE Ex. 35 at 23 (Colvin Rebuttal).
[676] CEHE Ex. 37 at 12 (Townsend Rebuttal).
[677] *See* CEHE Ex. 2 at 1290-1293, WP/II-D-2 Adj 6 for the benefits adjustment.

Account 9260.[678] These expenses are shown on Schedule II-D-2. In addition to the pension and OPEB adjustment noted above, the Company also included an adjustment to benefit expense of $0.2 million resulting from adjustments to salaries, wages and STI.[679] The vast majority of the Company's requested benefits costs are unchallenged.

The only disputed benefits costs are BRP costs, which are related to a non-qualified plan for the retirement (or pension) plan for certain employees whose retirement benefits under the traditional plan have been negatively impacted by reaching certain limits contained in the IRC.[680] The BRP effectively restores, to some extent, benefits that would have otherwise been available under the traditional qualified plan but were lost due to the IRC income limits. For this reason, the BRP is generally classified as a "restoration plan." It is not a traditional supplemental executive retirement plan (or SERP) that provides benefits over and above those available to other employees.[681] CNP must offer this benefit to eligible employees as part of their total compensation package in order to retain those employees and provide a compensation level that is commensurate with their level of responsibility.[682]

Despite the reasonableness of offering the BRP to certain high-level employees and without analyzing the facts and evidence in this case, Mr. Filarowicz relies on a Commission decision for another utility and Mr. Garrett alleges several reasons why the Company's requested BRP costs should be disallowed.[683] In taking this position, Staff and COH rely largely on similar arguments they used to challenge the recovery of incentive compensation tied to financial goals, again relying on the erroneous positions that customers do not benefit from the achievement of financial goals and that the focus of executive-level employees is not aligned with customer interests. Contrary to that position, the actions of CNP officers and executives demonstrate a balanced approach to customers and shareholders.[684] Intervenor and Staff positions that shareholders should bear the BRP costs whereas customers would bear the costs for regular pension expense, conflicts with the overall standard that reasonable and necessary costs must be recoverable through rates.[685]

[678] CEHE Ex. 35 at 22 (Colvin Rebuttal).
[679] *See* CEHE Ex. 2 at 1411-1413, WP/II-D-3 Adj 2.
[680] CEHE Ex. 39 at 25 (Harkel-Rumford Rebuttal).
[681] *Id.*
[682] *Id.*
[683] Staff. Ex. 4A at 19-20 (Filarowicz Direct), COH/HCC Ex. 2 at 42-45 (Garrett Direct).
[684] CEHE Ex. 39 at 26-27 (Harkel-Rumford Rebuttal).
[685] *Id.* at 26 (Harkel-Rumford Rebuttal).

Mr. Garrett also claims that providing this benefit is "discretionary," so shareholders should bear the burden of these costs.[686] Yet, CNP offers this benefit as part of its total compensation package, which is structured consistent with the compensation plans offered by its peers with whom the Company competes for management talent. If CNP did not offer a BRP, it would have to find another way to compensate employees whose retirement benefit is subject to certain limitations under the IRC. Mr. Garrett dismisses that aspect of CNP's approach to compensation. From CNP's perspective, however, the provision of a competitive compensation and benefits package is not discretionary—it is critical to CNP's ability to attract and retain the management personnel who are necessary to operate the utility and provide strategic and management guidance.[687]

C. Depreciation and Amortization Expense [PO Issue 25]

The Company calculated its reasonable and necessary depreciation expense based on a new depreciation study using depreciable plant in service as of December 31, 2017 and intangible plant in service as of December 31, 2018. The results of the depreciation study support an annualized depreciation and amortization expense for CEHE of approximately $378 million, which represents an overall increase of approximately $2.5 million compared to the Company's annualized depreciation and amortization expense at prior depreciation rates.[688] Detailed information regarding the service life and net salvage characteristics that support the new depreciation and amortization rates can be found in Exhibit DAW-1 to the direct testimony of CEHE witness Dane A. Watson. Notably, Staff witness Reginald Tuvilla reviewed Mr. Watson's study and, after conducting his own simulated plant record ("SPR") and actuarial analysis, recommended *no changes* to Mr. Watson's service lives, net salvage rates, or resulting depreciation rates.[689]

In fact, no party contests the Company's proposed net salvage rates. Only TCUC challenged Mr. Watson's service lives, and only for nine accounts. A summary of TCUC witness David Garrett's and the Company's proposed service lives follows:

[686] COH/HCC Ex. 2 at 43 (Garrett Direct).
[687] CEHE Ex. 39 at 27 (Harkel-Rumford Rebuttal).
[688] CEHE Ex. 2 at 313-316, Schedule II-E-1 & 1478-1479, WP/II-E-1 Adj 1 & 1480, WP/II-E-1 Adj 1a.
[689] Direct Testimony of Reginald Tuvilla, Staff Ex. 9 at 6.