years impacted by the change in taxability of the subsidies should be included in calculating the regulatory asset, because CenterPoint's rates assumed, and continue to assume, that the subsidies are not taxable.[252]

CenterPoint also argues that if the Commission intended CenterPoint to establish and compute the subsidy beginning only in 2013, the order's direction that CenterPoint "continue" to monitor and accrue would be nonsensical—there would be no amount or regulatory asset to "continue" to "monitor" or "accrue" before 2013. Also, if Mr. Kollen's interpretation were correct, the order would need to refer to differences in "future" rates resulting from the different tax treatment of the Medicare Part D subsidy.

Mr. Pringle also noted the Docket No. 38339 order states that the Commission has permitted the effects of changes in tax rates or tax laws to be recovered in rates charged to customers. He opined that the Commission allows all periods impacted by a change in tax rates to be recovered or refunded in rates. He cited as an example the recent changes in the federal tax rate from 35% to 21%, with the result that ADFIT included in revenue requirement in periods before the effective date of the federal income tax (FIT) rate change are now being refunded to customers through rates.[253]

Based on the Docket No. 38339 order language, the ALJs find CenterPoint did not meet its burden of proof on this issue and recommend the regulatory asset amount be computed beginning January 1, 2013, when taxability of the Medicare Part D subsidy began. The language authorizing creation of the regulatory asset is the similar language in the order's discussion section and in Finding of Fact No. 159A:

> ***Order pages 9-10***: [T]he Commission authorizes CenterPoint to continue to monitor and accrue the difference between what their rates assume the Medicare Part [D] subsidy tax expense would be and the reality of what CenterPoint is

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[252] CenterPoint Ex. 36 at 7-9.

[253] CenterPoint Ex. 36 at 7.

> required to pay as a regulatory asset to be addressed in CenterPoint's next rate case.[254]
>
> ***Finding of Fact No. 159A.*** It is appropriate for CenterPoint to monitor and accrue the difference between what its rates assume the Medicare Part [D] 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.

The discussion uses the phrase "continue to monitor and accrue" and the finding instead uses the phrase "monitor and accrue." Because both phrases appear in the order, the ALJs conclude the Commission considered them to be consistent with each other. Because the Commission omitted "continue to" from the only finding of fact authorizing creation of the asset, the ALJs conclude the Commission did not consider inclusion of "continue to" to be important. The ALJs find GCCC's interpretation reasonable: the Commission determined it was appropriate for CenterPoint to continue to monitor the difference between what its rates assume the tax expense will be and what CenterPoint is required to pay, because tax laws change, and to accrue that difference as a regulatory asset to be addressed in CenterPoint's next rate case.

In the phrase "difference between [1] what its rates assume the Medicare Part [D] subsidy tax expense will be and [2] what CenterPoint is required to pay," regarding [1], the ALJs find that before and after Docket No. 38339 and currently, CenterPoint's rates assume the Medicare Part D subsidy tax expense is $0. As the order states, the Commission did not include the Medicare Part D subsidy tax expense in cost of service used to set rates in Docket No. 38339 because under the 2010 health care acts, the subsidy would not be taxable until nearly two years later, on January 1, 2013. Regarding [2], "what CenterPoint is required to pay" refers to "the Medicare Part [D] subsidy tax expense" referred to in [1], which CenterPoint was not required to pay until January 1, 2013.

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[254] Docket No. 38339 order at 9-10 (footnote omitted).

ii. Temporary Differences Reflected in Income Tax Expense

Regarding the second CenterPoint computation error alleged by Mr. Kollen, he briefly testified that CenterPoint "failed to offset the temporary difference reflected in the income tax expense allowed in rates in Docket No. 38339 by the changes in the temporary differences from 2013 through 2018."[255]

Mr. Pringle objected that Mr. Kollen's testimony did not provide enough detail to identify which temporary difference he was referencing. Mr. Pringle stated that in any case, CenterPoint made no such error. The required FAS 106 temporary differences were recorded in the first quarter of 2010 and properly reflected in ADFIT in CenterPoint's books and records. Mr. Pringle testified that the FAS 106 temporary differences have no impact on computation of the regulatory asset in subsequent periods, because the subsidies are subject to tax, and the deferred amounts are reflected as required under ASC 740. For the Medicare Part D subsidy balance, a temporary difference was established only for the difference in the accrued permanent benefit as of the first quarter of 2010 and the anticipated cash receipts for 2010, 2011, and 2012, because those receipts would remain nontaxable. After 2012, the temporary difference ceases to exist because the Medicare Part D subsidy becomes taxable.[256]

The ALJs find that Mr. Kollen provided insufficient information to understand his second alleged error and that CenterPoint met its burden of proof regarding it.

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[255] CenterPoint Ex. 36 at 29.

[256] CenterPoint Ex. 36 at 10-11.

iii. Failure to Update Based on Actuarial Reports

The third CenterPoint computation error alleged by Mr. Kollen is that CenterPoint "failed to update the Medicare Part D subsidy based on actuarial reports each of those years [2013 through 2018]."[257]

Mr. Pringle responded that when it calculated the regulatory asset, CenterPoint knew: (1) that any accrued cash received on or after January 1, 2013, has been, and would be, subject to an FIT rate of either 35% or 21% (instead of the 0% reflected in customers' rates); and (2) the amount of subsidy reflected in CenterPoint's rates. He concluded actuarial reports were neither necessary nor required by the Docket No. 38339 order.[258]

The ALJs agree the Docket No. 38339 order does not require actuarial reports in this calculation of the Medicare Part D regulatory asset. Mr. Kollen did not explain why they were necessary. CenterPoint met its burden of proof regarding his third alleged error.

iv. Failure to Offset the Subsidies for 2013 through 2018

The fourth computation error alleged by Mr. Kollen is his brief testimony that CenterPoint "failed to reflect the offset for the actual cash subsidies received from the federal government in each of those years [2013 through 2018] in the same manner that it did in the years 2004 through 2012."[259]

Mr. Pringle responded that cash receipts of the Medicare Part D subsidy starting in 2013 were taxable and thus do not change the computation for the regulatory asset. The regulatory asset represents the recovery of a tax expense that equals the difference between (1) accrued benefits to

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[257] CenterPoint Ex. 36 at 29.

[258] CenterPoint Ex. 36 at 11-12.

[259] GCCC Ex. 1 at 29-30.

ratepayers provided in rates (as a reduction to tax expense) since 2004 and (2) the amount of tax expense benefit actually realized by CenterPoint for the cash received while those amounts were not subject to tax during 2004 through 2012. Mr. Pringle stated that the cash receipts for 2013 through 2018 (when the receipts are taxable) have no impact on the computation of the regulatory asset.[260]

The ALJs find that Mr. Kollen provided insufficient information to understand his fourth alleged error. Mr. Pringle testified that when cash receipts of the Medicare Part D subsidy are taxable, which they were during 2013 through 2018, they have no impact on calculation of the regulatory asset. The ALJs conclude CenterPoint met its burden of proof regarding this issue.

v. Failure to Remove the Portion of the Regulatory Asset Capitalized to CWIP

The fifth error alleged by Mr. Kollen is that CenterPoint "failed to remove the portion [of the Medicare Part D regulatory asset] capitalized to CWIP, an aspect of [CenterPoint's] calculation that would not have been necessary if it had followed the Commission's directive for the calculation of the regulatory asset instead of the same methodology that it sought to use in Docket No. 38339."[261]

Mr. Pringle responded that CenterPoint does not capitalize income tax expense to CWIP. Although pension expense is capitalized to CWIP, the Medicare Part D regulatory asset is related to income tax expense associated with the Medicare Part D subsidy. The income tax expense amount was part of CenterPoint's cost of service and was not capitalized as CWIP, so no reduction should be made.[262]

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[260] CenterPoint Ex. 36 at 12.

[261] GCCC Ex. 1 at 30.

[262] CenterPoint Ex. 36 at 13.

GCCC states that Mr. Pringle's testimony above is suspect. Without citing evidence, GCCC asserts that income tax expense always follows the allocation between expense and CWIP/plant and that a portion of the Medicare Part D subsidy was and continues to be allocated to expense and a portion to CWIP/plant.

Mr. Pringle testified income tax expense was not capitalized as CWIP. GCCC asserts his testimony is suspect but cited no evidence to support that assertion. The ALJs find CenterPoint met its burden of proof regarding Mr. Kollen's fifth alleged error.

vi. ALJs' Recommended Amount for the Regulatory Asset

Mr. Kollen testified he tried to calculate what the Medicare Part D regulatory asset would be after correction of the five errors he alleged, but in discovery CenterPoint did not provide him all components necessary to perform the entire calculation. For example, CenterPoint did not provide the actuarial calculation of the Medicare Part D subsidies or the actual Medicare Part D subsidies received in the years 2013 through 2018. Mr. Kollen testified he was able to calculate a $5.572 million regulatory asset using CenterPoint's data for the years 2013 through 2018 that CenterPoint provided in response to discovery.[263]

CenterPoint has the burden of proof, including regarding the Medicare Part D regulatory asset amount. The ALJs have not identified any amount the evidence specifically shows reflects their acceptance of Mr. Kollen's first alleged error but not his other four alleged errors. Accordingly, the ALJs recommend a Medicare Part D regulatory asset amount of $5.572 million, which Mr. Kollen testified uses CenterPoint's data for the years 2013 through 2018.[264]

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[263] GCCC Ex. 1 at 30, 113-14 (Att. G, CenterPoint response to GCCC RFI 3-12).

[264] If CenterPoint believes a different amount, which is consistent with the ALJs' acceptance of Mr. Kollen's first alleged error but not his other four alleged errors, is in evidence, CenterPoint should identify that amount in its exceptions to the PFD.

d. OPUC's Proposed Amortization Period and Rider MEDD

CenterPoint requests a three-year amortization period for all of its regulatory assets and liabilities, including the Medicare Part D regulatory asset.

Ms. Dively proposed instead removing that asset through the end of the test year from rate base and recovering it over a five-year period through a proposed rider, Rider MEDD. She noted the Docket No. 38339 order did not specify whether the Medicare Part D regulatory asset would be included in rate base and recovered as part of cost of service. She noted some regulatory assets are instead recovered through a rider. She cited a case in which the Commission approved a settlement in which the utility recovered system restoration costs associated with Hurricane Harvey through a rider.[265] Ms. Dively opined it is appropriate to recover regulatory assets through a rider, rather than including them in rate base, when they represent non-recurring costs in a small enough amount to be recovered over five years or less. She stated her approach reflects the general ratemaking principle that base rates are set using a cost of service that is representative of the typical costs a utility incurs each year. Additionally, a rider allows a utility to recover only the amount of the regulatory asset, preventing it from earning a return and recovering amortization expense on a fully amortized regulatory asset once the amortization period has ended. Ms. Dively opined a five-year amortization strikes a balance between achieving intergenerational equity and moderating the impact on current customer rates. She stated that her recommendation would reduce the net impact on customers by $6,530,000, comprising a reduction to the cost of service of $13,171,000 and an increase in charges through Rider MEDD of $6,641,000.[266]

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[265] Docket No. 48401, order, FoF Nos. 62-66. The ALJs agree this case indicates regulatory assets may be recovered through a rider but do not regard the case as precedent supporting such treatment. *See* Docket No. 48401 order, Ordering Paragraph (OP) No. 30: "Entry of this Order does not indicate the Commission's endorsement or approval of any principle or methodology that may underlie the agreement and must not be regarded as precedential as to the appropriateness of any principle or methodology underlying the agreement."

[266] OPUC Ex. 1 at 12, 18-19.

CenterPoint objects that Ms. Dively's proposal to recover regulatory assets over five years while returning regulatory liabilities over three years is inequitable. In its brief, OPUC agreed to five-year amortization of both regulatory assets and liabilities.

Ms. Colvin testified that in Docket No. 38339 the Commission used a three-year period to recover regulatory assets and rate case expenses from prior dockets. She also opined that, compared to a five-year period, a three-year period more closely aligns the return or recovery of costs with the customers that existed at the time the costs were incurred.[267]

Mr. Pringle testified the Commission should allow a return on the Medicare Part D regulatory asset. He noted that with the change in tax law arising from the 2010 health care acts, CenterPoint established a regulatory asset for what its rates historically assumed the tax expense will be ($0) and what CenterPoint is required to pay. He stated that CenterPoint has pre-funded this regulatory asset over multiple years, resulting in a significant amount of funds CenterPoint has yet to recover.[268]

OPUC observes that the length of time the asset has not been recovered in rates is a function of CenterPoint's choice not to file a rate case sooner. OPUC also argues the costs included in the Medicare Part D regulatory asset are expenses, which typically are not eligible to earn a return.[269]

The ALJs recommend a substantially smaller regulatory asset than CenterPoint proposed. Weighing all the Docket No. 38339 order language and the evidence regarding the Medicare Part D regulatory asset, the ALJs find they support including the regulatory asset in rate base and amortizing it over a three-year period, as CenterPoint proposed.

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[267] CenterPoint Ex. 35 at 41-42.

[268] CenterPoint Ex. 36 at 15-16.

[269] *See* 16 TAC § 25.231(c) (allowing a utility a reasonable opportunity to earn a reasonable rate of return on its invested capital).

4. Texas Margin Tax Regulatory Asset

CenterPoint proposes to change its method of accounting for the TMT, and due to a timing difference, requests inclusion in rate base of a one-time TMT regulatory asset. Staff, GCCC, and OPUC oppose such a TMT regulatory asset, arguing the Commission has not authorized it and it would result in double-recovery. For reasons discussed below, the ALJs recommend rejecting CenterPoint's proposed TMT regulatory asset.

In this proceeding, CenterPoint is requesting:

- The actual $20.0 million TMT expense for the 2018 test year (rather than what is paid in the test year); and
- Recovery of the $19.6 million 2017 TMT expense paid in the test year (but not yet recovered) as a regulatory asset to be recovered over three years.[270]

CenterPoint argues that under its proposal, the TMT becomes a current-year expense and the new rate recovery method eliminates the need to record a regulatory asset related to TMT each year, which CenterPoint does currently. CenterPoint contends that if its regulatory asset proposal is denied, it would never recover the $19.6 million of 2017 TMT expense it paid in the test year.

Mr. Pringle testified the Texas franchise tax is now the TMT. The TMT became effective for tax reports due on or after January 1, 2008. He indicated there is a one-year lag between the taxable year and the payment year for the TMT. For example, the TMT that CenterPoint paid in 2018 is based on the 2017 TMT calculation.[271]

Ms. Colvin indicated that with the inception of the TMT, because of the one-year lag, CenterPoint has been deferring the current cost of the TMT each year until it is recovered in rates

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[270] CenterPoint Ex. 12 at 874-75; CenterPoint Ex. 13 at 1025-26.

[271] CenterPoint Ex. 13 at 1023, 1025.

the next year, creating a regulatory asset. According to Ms. Colvin, the Commission approved this accounting practice in Docket No. 29526.[272] Similarly, Mr. Pringle testified the Commission has allowed CenterPoint regulatory recovery for the Texas franchise tax based on the cash payment of taxes during the test period, even though the taxable year is the year before the test period.[273]

Mr. Pringle stated that in CenterPoint's DCRF cases, parties, including Staff, asked CenterPoint to calculate its TMT expense the same way other utilities do. He indicated that in response, CenterPoint now requests to change its method of accounting for the TMT. CenterPoint proposes to transition to include the accrual method required under GAAP in base rates and to recover the balance of the TMT regulatory asset related to the one-year timing difference, amortized over three years. If CenterPoint's proposal is approved, CenterPoint will no longer record a regulatory asset related to the TMT after the asset is extinguished.[274]

Ms. Colvin explained that CenterPoint's TMT expense is based on the accrual amount in the test year reflecting the adjustments necessary to discontinue booking the TMT asset. CenterPoint proposes to transition to including the accrual amounts in base rates, so the tax expense can be charged to the income when it was earned. CenterPoint intends to record TMT as an accrual, rather than as a regulatory asset that consists of actual taxes paid, and proposes to recover the balance as a regulatory asset related to the timing difference.[275]

OPUC witness Dively testified that neither the FERC USOA nor GAAP allows a departure from established accounting principles absent specific authorization from a regulatory agency. She

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[272] CenterPoint Ex. 12 at 875, referencing *Application of CenterPoint Energy Houston Electric, LLC, Reliant Energy Retail Services, LLC, and Texas Genco to Determine Stranded Costs and other True-Up Balances Pursuant to PURA § 39.262*, Docket No. 29256, Order on Rehearing (Dec. 17, 2004) (Docket No. 29256 order).

[273] CenterPoint Ex. 13 at 1025.

[274] CenterPoint Ex. 13 at 989, 1025-26; CenterPoint Ex. 12 at 875.

[275] CenterPoint Ex. 12 at 874-75.

cited 16 TAC § 25.72, which requires adherence to the FERC USOA "at all times, unless provided otherwise by these rules, or specifically permitted by the commission."[276]

Ms. Dively noted CenterPoint has not asserted it has been denied recovery of its TMT expense.[277] GCCC witness Kollen observed that CenterPoint records a liability for TMT payable and an equivalent and offsetting TMT regulatory asset quarterly each year, instead of expensing the liability in the same year the liability is incurred and recorded on its accounting books. CenterPoint expenses the TMT payable and amortizes the TMT regulatory asset in the following year when it pays the TMT. The TMT expense has remained relatively constant at approximately $20 million annually. In Mr. Kollen's view, the regulatory asset is offset or "financed" by the equivalent TMT payable until it is paid in the following year. He testified the regulatory asset has never been financed by an increase in common equity, long-term debt, or short-term debt.[278]

Staff witness Mark Filarowicz stated that in past dockets, Staff has expressed concern about the way CenterPoint determines its TMT and its recording of a regulatory asset. He testified Staff knew of no other utility that records a regulatory asset related to the TMT.[279] Staff argues all utilities pay for TMT the year after it is accrued, but only CenterPoint recorded a TMT regulatory asset on its books. Staff contends CenterPoint should correct its "extraordinary accounting treatment" for TMT without recording a regulatory asset the Commission never authorized.

In contrast, Mr. Kollen opined there is no compelling reason to change the TMT accounting method.[280] OPUC denied any party, including Staff, had asked CenterPoint to change its TMT accounting method in its DCRF cases.

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[276] OPUC Ex. 1 at 23; 16 TAC § 25.72(a). The ALJs note that 16 TAC § 25.72(a) is also authority that the Commission sets rates based on PURA and Commission rules and in doing so is not bound by the accounting rules.

[277] OPUC Ex. 1 at 25.

[278] GCCC Ex. 1 at 31, 33-34.

[279] Staff Ex. 4A at 28-30.

[280] GCCC Ex. 1 at 34.

Ms. Dively regarded CenterPoint's TMT request as impermissible retroactive ratemaking by setting future rates to recoup past losses.[281] CenterPoint responds the TMT regulatory asset is not a loss—the asset was established pursuant to a Commission order and is based on normal ongoing expenses afforded rate recovery in the past.

Ms. Dively, Mr. Kollen, and Mr. Filarowicz disputed CenterPoint's contention that the Commission approved CenterPoint's accounting practice in Docket No. 29256:

- Mr. Filarowicz reasoned that the Commission could not have approved in Docket No. 29256 a regulatory asset for a tax that did not exist at the time of that order. The order was issued on December 17, 2004. The TMT became effective for tax reports on or after January 1, 2008. Prior to that time, entities paid a similar but different tax—the state franchise tax.[282]

- He and Ms. Dively noted Docket No. 29256 was a proceeding to determine the amount of generation stranded costs and true-up balances, related to the transition to competition. Mr. Filarowicz stated that, based on how CenterPoint's predecessor company accounted for the state franchise tax before deregulation, the Commission approved recovery of a generation deferred debit related to state franchise taxes. Ms. Dively explained that under regulation, utilities were required to invest in generation assets that would not hold their value in a competitive market. To address the now uneconomic value of these assets, PURA § 39.362 authorized the recovery of these stranded costs if certain conditions were met. In Docket No. 29256, CenterPoint was allowed to record a regulatory asset to recover deferred debits resulting from the proportionate share of its Texas franchise taxes related to uneconomic generation assets. Ms. Dively opined the Commission was authorizing recovery of stranded costs; the fact they resulted from the Texas franchise tax was not the basis of the decision.[283]

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[281] OPUC Ex. 1 at 26. *See also State v. Pub. Util. Comm'n*, 883 S.W.2d at 199.

[282] Staff Ex. 4A at 29-30.

[283] OPUC Ex. 1 at 23-24; Staff Ex. 4A at 29-30. *See also* Docket No. 29256 order, FoF No. 236 ("Under SFAS No. 71 and GAAP, the joint applicants have no mechanism to recover 2001 deferred debits for state franchise taxes, as the joint applicants did not receive regulated rates in 2002 or subsequent years."), and FoF No. 229 ("Deferred debits related to a utility's discontinuance of the application of SFAS No. 71 for generation-related assets are a component of stranded costs under the definition of 'stranded cost' set forth in PURA § 39.251(7)."). In contrast to the formerly-regulated generation entities after generation in ERCOT was deregulated, CenterPoint will continue operating as a fully-regulated TDU.

- Mr. Kollen testified the order merely allowed CenterPoint to record the offset to the payable as a regulatory asset instead of as a miscellaneous deferred debit. The order did not allow CenterPoint to include the regulatory asset in rate base.[284] Mr. Filarowicz testified the order did not approve any regulatory assets for the regulated T&D operations.[285]

Ms. Dively, Mr. Kollen, and Mr. Filarowicz also noted that in Docket No. 38339, CenterPoint did not request—and its rates did not include—a regulatory asset in rate base related to the TMT.[286] Ms. Colvin responded that was because under the payment method, the regulatory asset CenterPoint recorded each year is recovered in the following year. In contrast, CenterPoint here requests a one-time TMT regulatory asset for an amount CenterPoint has not recovered from ratepayers under the two-year cycle method.[287] Staff argues the Docket No. 38339 order did not authorize CenterPoint to book a regulatory asset for TMT, yet the order did explicitly authorize other regulatory assets. Staff contends CenterPoint cannot reasonably argue it should have been recording a TMT regulatory asset the past 15 years when CenterPoint did not seek or receive authorization for such a regulatory asset in its base rate case a decade ago.

Mr. Kollen and Mr. Filarowicz recommended disallowing from rate base the $19.6 million TMT regulatory asset and disallowing the requested amortization expense of $6.5 million annually.[288] Mr. Kollen stated that if the Commission includes the regulatory asset in rate base, it should subtract the "related liability" (or, the equivalent payable) from rate base to reflect the reality that the payable is the source of the financing, not common equity or debt.[289]

Mr. Kollen objected that amortization of the regulatory asset would result in recovery of two years of TMT expense in the base rate revenue requirement until base rates are again reset. If

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[284] GCCC Ex. 1 at 31.

[285] Staff Ex. 4A at 29-30.

[286] OPUC Ex. 1 at 22; GCCC Ex. 1 at 32, n. 33; Staff Ex. 4A at 30.

[287] CenterPoint Ex. 35 at 27.

[288] GCCC Ex. 1 at 33, 35; Staff Ex. 4A at 31.

[289] GCCC Ex. 1 at 33-34; Staff Ex. 4A at 31.

CenterPoint's next base rate case occurs in six years, for example, CenterPoint will recover $40 million in excess of its actual TMT expense over that six years plus the return on the regulatory asset at December 31, 2018, even though it will be amortized to zero within the next three years.[290]

Ms. Colvin testified that if CenterPoint's proposal to change its methodology of recording TMT for cost-recovery purposes is not adopted, CenterPoint will continue using its current one-year lag methodology, which results in the 2017 payment being reflected in the cost of service and 2018 expense being recorded as a regulatory asset. She indicated an exhibit to her testimony listed the steps needed to remove the proposed change to the TMT recovery method.[291] CenterPoint clarifies it is willing to accept exclusion of the one-time TMT regulatory asset from rate base only if its related request to change the TMT expense recovery method is not approved. CenterPoint emphasizes that the TMT issue is an all-or-nothing request: either both the TMT expense and regulatory asset recovery are approved, or the regulatory asset is denied and CenterPoint's TMT expense request becomes the $19.6 million.

Finding the OPUC, GCCC, and Staff testimony described above to be compelling, the ALJs:

- Conclude the Commission has not approved CenterPoint's proposed TMT regulatory asset—the issue the Commission addressed in Docket No. 29256 is readily distinguished from the issue here;
- Find the evidence indicates CenterPoint's rates have been sufficient to cover its TMT payments and does not show a change in accounting for TMT expenses would cause CenterPoint to fail to recover a year of TMT expenses unless the one-time TMT regulatory asset is approved; and
- Recommend disallowing CenterPoint's proposed $19.6 million TMT regulatory asset.

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[290] GCCC Ex. 1 at 33-34; Staff Ex. 4A at 31.

[291] CenterPoint Ex. 35 at 33-34, Exh. R-KLC-05.

5. Smart Meter Texas Regulatory Asset

CenterPoint seeks to include in rate base a $6.939 million regulatory asset encompassing the SMT costs incurred since March 2017 through the end of the test year, and to recover that asset over a three-year period.[292] It is undisputed that the Commission approved the establishment of this asset in Docket No. 47364, wherein the Commission found:

> 13.(e) It is reasonable for CenterPoint to establish a regulatory asset in which to record SMT costs incurred after the end of the final reconciliation period and prior to the implementation date of new base rates (the rate implementation date) resulting from its next comprehensive base rate proceeding. CenterPoint will not seek recovery of such costs until such rate proceeding, at which time the reasonableness of the individual SMT costs accumulated in such regulatory asset through the end of the applicable test year (the test year end) will be subject to review. All SMT costs found reasonable will be recovered using an appropriate amortization period to be determined in that proceeding.[293]

OPUC witness Dively challenged CenterPoint's requested treatment for the SMT asset and noted that while the Commission approved the establishment of the asset, the order was silent as to whether it could be included in CenterPoint's rate base and earn a return. In fact, OPUC argues that CenterPoint is prohibited from earning a return on the asset under 16 TAC § 25.231(c).[294] OPUC states that the Docket No. 47364 order describes the costs comprising the asset as one-time expenses that CenterPoint will incur over a finite period. Thus, according to OPUC, the asset is ineligible to earn a return under the above-referenced Commission rule because it consists of O&M expenses, rather than eligible capital assets.

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[292] CenterPoint's contested request for SMT expenses is addressed later in Section IV.

[293] *Application of CenterPoint Energy Houston Electric, LLC for the Final Reconciliation of Advanced Metering Costs,* Docket No. 47364, Order at FoF No. 13(e) (Dec. 14, 2017).

[294] OPUC Initial Brief at 20. OPUC emphasizes that this rule limits approval to earn a rate of return on an electric utility's invested capital.

Additionally, Ms. Dively recommended that a more appropriate treatment for the asset, compared to CenterPoint's proposal, would be to remove it from rate base and recover it through a rider with a five-year amortization period.[295] She emphasized that her recommended approach would prevent CenterPoint's over-recovery on the asset and would balance customer rate impacts with intergenerational equity.[296] OPUC wholly supports Ms. Dively's alternate approach, and asserts that a five-year amortization period for the SMT asset is reasonable. OPUC points to the Commission-approved settlement in Docket No. 48401, which it concedes is not precedential in this case, to show that a five-year amortization period for this type of cost is achievable.[297] OPUC asserts that under CenterPoint's proposed three-year amortization period, CenterPoint is guaranteed at least one year of over-recovery due to the Commission's four-year base rate filing requirement for utilities.[298] OPUC stresses that, under Ms. Dively's alternate recovery approach, that over-recovery can be prevented. According to Ms. Dively, her recommended treatment for the SMT asset would positively impact customers through a net reduction of $1.361 million to CenterPoint's cost of service.[299]

As mentioned previously, Staff recommends the amortization period be extended to five years and does not oppose OPUC's alternative proposal to establish a rider for cost-recovery purposes.[300]

CenterPoint opposes Ms. Dively's recommendation, asserting that her concern regarding over-recovery is overstated and conflicts with her testimony regarding the need to achieve intergenerational equity. Moreover, CenterPoint emphasizes that the Commission approved a

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[295] OPUC Ex. 1 at 29.

[296] OPUC Initial Brief at 17.

[297] Docket No. 48401 order at FoF No. 69.

[298] 16 TAC § 25.247(b)(1). The ALJs note the 48-month period between rate cases is a maximum; the rule does not bar CenterPoint or the Commission from initiating a CenterPoint rate proceeding sooner.

[299] OPUC Ex. 1 at 30.

[300] Staff Ex. 4A at 31-32; Staff Initial Brief at 21.

three-year amortization period to recover regulatory assets in CenterPoint's last base rate case[301] and that OPUC's claim that the SMT asset cannot earn a return lacks merit.

CenterPoint witness Colvin testified that the SMT expenses are recurring expenses and that CenterPoint anticipates deferring the SMT costs it incurs after the end of the test year until the implementation of new rates, as authorized in Docket No. 47364.[302] CenterPoint emphasizes that its proposed three-year amortization period more accurately achieves intergenerational equity in rates compared to Ms. Dively's recommendation because it will more closely align the recovery of the costs with the persons who were customers at the time the costs were incurred. Moreover, CenterPoint argues that the Commission's approval for this regulatory asset in Docket No. 47364 confirms that a regulatory asset may contain expense amounts and may be included in rate base to earn a return. To stress this point, CenterPoint references PURA § 36.065, which explicitly contemplates the creation of a regulatory asset or liability for pension and other postemployment benefit (OPEB) expenses to be included in rate base, and ultimately earn a return.[303] CenterPoint also argues that the Commission's RFP includes the Regulatory Assets schedule within the Rate Base schedules, thereby acknowledging that earning a return on regulatory assets is appropriate.

The ALJs recommend that the Commission approve CenterPoint's request to include the $6.939 million SMT asset in rate base to be recovered over a three-year amortization period. OPUC correctly notes that the Commission did not specifically state that the SMT asset established in Docket No. 47364 should be recovered through rate base; however, the ALJs note that the Commission did not specifically prohibit its inclusion in rate base either. The ALJs find CenterPoint's arguments on this matter compelling and find the evidence supports the conclusion that CenterPoint's request is reasonable and appropriate.

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[301] Docket No. 38339 order at FoF No. 66. *See also* CenterPoint Ex. 35 at 42.

[302] CenterPoint Ex. 12 at 877-78.

[303] PURA § 36.065.

6. REP Bad Debt Regulatory Asset

16 TAC § 25.107(f)(3)(B) provides:

> A TDU shall create a regulatory asset for bad debt expenses, net of collateral posted... and bad debt already included in its rates, resulting from a REP's default on its obligation to pay delivery charges to the TDU. Upon a review of reasonableness and necessity, a reasonable level of amortization of such regulatory asset shall be included as a recoverable cost in the TDU's rates in its next rate case or such other rate recovery proceeding as deemed necessary.

CenterPoint requests inclusion in rate base of a REP bad debt regulatory asset of $1.6 million and an amortization period of three years.[304] OPUC recommends removing the regulatory asset from rate base, reducing its amount by $1,058,255, and recovering the remaining $511,290 as an expense amortized over five years and recorded in FERC Account No. 904, Uncollectible Accounts. TEAM supports OPUC's proposed $1,058,255 disallowance.

For reasons discussed below, the ALJs recommend reducing the balance of CenterPoint's regulatory asset by $1,058,255 to $511,290, including that amount in rate base, and amortizing it over three years.

a. Amount of Regulatory Asset

Ms. Dively testified CenterPoint's requested $1.6 million regulatory asset comprises $511,290 in bad debt from specifically identified REPs plus $1,058,255 that represents a credit reversal of $12,026 per month ($144,308 divided by 12) from the period September 2011 through December 2018. She cited a workpaper from Docket No. 38339 showing net credits of $144,308

[304] CenterPoint Ex. 12 at 847; OPUC Ex. 1 at 31.

for REP bad debt. Ms. Dively recommended reducing the balance of CenterPoint's regulatory asset by $1,058,255 to $511,290.[305]

Citing 16 TAC § 25.107(f)(3)(B), Ms. Dively explained that CenterPoint's current rates do not include bad debt; instead they include the $144,308 credit. She testified such credits typically represent bad debt recoveries, not bad debt expense. Ms. Dively opined that if this credit is a recovery of bad debt, it is a recovery of bad debt incurred outside the 2009 test year used in Docket No. 38339, because CenterPoint had no offsetting bad debt expense during that test year. She complained CenterPoint did not provide a justification for reversing the credit included in rates in Docket No. 38339 to yield an adjustment that increased the amount of its REP bad debt regulatory asset by 200%.[306] An attachment to Ms. Dively's testimony indicates that, in this instance, the $144,308 credit represents a $142,156 write-off from March 2009 and a $2,152 write-off from October 2009 that were not offset by an accrual for REP bad debt booked during the 2009 test year.[307]

OPUC argues CenterPoint seeks to reverse 88 months' worth of the credit included in its current rates and recover it as a regulatory asset. In other words, OPUC contends, CenterPoint is using the Commission rule to make itself whole by reversing a credit, not an expense. Based on Ms. Dively's testimony, OPUC concludes the $1,058,255 is not a "regulatory asset for bad debt expenses" as the rule requires.

Ms. Colvin stated that 16 TAC § 25.107(f)(3)(B) requires that the bad debt expense amount in base rates be included in the regulatory asset calculation. She agreed with Ms. Dively that in this instance, the bad debt expense included in CenterPoint's base rates approved in Docket

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[305] OPUC Ex. 1 at 30-32, Att. JMD-4 (CenterPoint response to COH RFI 3-41), Att. JMD-5 (WP II-D-2.2.1 from Docket No. 38339).

[306] OPUC Ex. 1 at 31-32.

[307] OPUC Ex. 1, Att. JMD-5.

No. 38339 was a credit. Ms. Colvin testified, however, that the rule does not state the amount must be a debit and does not require additional justification as Ms. Dively suggested.[308]

TEAM cites a CenterPoint discovery response stating that CenterPoint "is not currently amortizing or recovering the $1.058M of bad debt in rates."[309] TEAM argues CenterPoint's inclusion of the $1,058,255 in the regulatory asset is an attempt to reverse a credit reflected in base rates in Docket No. 38339. TEAM regards that attempt as retroactive ratemaking and not consistent with Commission rules or sound ratemaking accounting principles.

CenterPoint argues:

> [CenterPoint] is simply following the language in the rule to create a regulatory asset that consists of the bad debt balance in test year *minus* collateral *minus* "bad debt already included in rates." For [CenterPoint], the "bad debt already included in rates" is a negative number because it is a credit. When that negative number is subtracted in the simple formula required by the rule, it becomes a positive number and results in an overall REP Bad Debt regulatory asset balance of $1.569 million. As Ms. Colvin explained, the rule does not state that the "bad debt already included in rates" has to be a debit amount. In short, [CenterPoint] does not have the discretion to ignore the rule requirements; nor can it unilaterally discontinue the credit in its existing rates.[310]

For reasons discussed below, the ALJs conclude CenterPoint did not meet its burden of proof regarding inclusion of $1,058,255 in the regulatory asset. The ALJs thus recommend approving a REP bad debt regulatory asset of $511,290, as calculated by Ms. Dively.

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[308] CenterPoint Ex. 35 at 40, Exh. R-KLC-06 (REP default credits).

[309] TEAM Ex. 1 at 9 (CenterPoint response to TEAM RFI 1-07).

[310] CenterPoint Reply Brief at 53 (emphasis in original), citing 16 TAC § 25.107(f)(3)(B), CenterPoint Ex. 2 at 1334 (WP/II-D-2.2a.1); CenterPoint Ex. 35 at 39-40.

CenterPoint indicated the $1,058,255 was a credit that it is not currently amortizing or recovering in rates. CenterPoint did not controvert Ms. Dively's testimony that:

- Such credits are typically bad debt recoveries, not bad debt expenses;
- Including the $1,058,255 in the regulatory asset represented a reversal of $12,026 per month from September 2011 through December 2018 of a credit used to set CenterPoint's current rates in Docket No. 38339; and
- CenterPoint had no offsetting bad debt expense during the 2009 test year used in Docket No. 38339, so the credit is a recovery of bad debt incurred outside the 2009 test year.

16 TAC § 25.107(f)(3)(B) states: "A TDU shall create a regulatory asset for bad debt expenses, net of collateral posted...and bad debt already included in its rates, resulting from a REP's default on its obligation to pay delivery charges to the TDU." CenterPoint interprets the rule to require creation of "a regulatory asset that consists of the bad debt balance in test year minus collateral minus 'bad debt already included in rates.'" The rule refers to creating a regulatory asset for *bad debt expenses*, net of collateral and bad debt already included in the rates. Given the rule's purpose, the ALJs interpret "bad debt already included in its rates" together with the earlier phrase "bad debt expenses." CenterPoint's current rates do not include bad debt expenses, only the credit. The ALJs also find merit in TEAM's objection that including the $1,058,255 in the regulatory asset to reverse a credit reflected in base rates set in Docket No. 38339 nine years ago is impermissible retroactive ratemaking.[311]

b. Method of Recovery of Regulatory Asset

Ms. Dively recommended removing the REP bad debt regulatory asset from rate base and recovering the correct amount of $511,290 as an expense amortized over five years and recorded in FERC Account No. 904, Uncollectible Accounts. Ms. Dively noted 16 TAC § 25.107(f)(3)(B)

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[311] *See State v. Pub. Util. Comm'n*, 883 S.W.2d at 199.

is silent on whether to allow a utility to earn a return on the REP bad debt regulatory asset. She opined CenterPoint's cost of service should include a reasonable and necessary amount of REP bad debt expense that is representative of what CenterPoint incurs annually.[312]

Ms. Colvin testified that CenterPoint's REP bad debt regulatory asset should be included in rate base earning a return, based on the Commission's order in Docket No. 46957. Citing Finding of Fact No. 48 in that order, she testified the Commission approved the request of Oncor Electric Delivery Company (Oncor) to recover a regulatory asset for bad debt.[313]

The ALJs conclude the Docket No. 46957 order is not precedential for the purpose CenterPoint urges here. Docket No. 46957 was a settled case, in which the Commission's order states: "The entry of this order consistent with the agreement does not indicate the Commission's endorsement of any principle or methodology that may underlie the agreement. Entry of this order shall not be regarded as precedent as to the appropriateness of any principle or methodology underlying the agreement."[314] A REP bad debt regulatory asset was not mentioned in the "black-box" finding of fact Ms. Colvin cites. Finding of Fact No. 48 simply states: "Oncor's total regulatory asset balances...as presented in Oncor's RFP...are approved."

The ALJs nevertheless recommend including their recommended balance for the REP bad debt regulatory asset in rate base and allowing CenterPoint to earn a return on it. The rule does not expressly provide for or prohibit the utility earning a return on this regulatory asset. For reasons discussed previously, and given this regulatory asset is needed pursuant to the regulatory scheme relating to TDUs' duties regarding REPs, the ALJs find it more reasonable to allow CenterPoint to earn a return on it. Consistent with their other recommendations, the ALJs recommend a three-year amortization period for this regulatory asset.

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[312] OPUC Ex. 1 at 31-32.

[313] CenterPoint Ex. 35 at 39, citing *Application of Oncor Electric Delivery Company LLC for Authority to Change Rates*, Docket No. 46957, Order (Oct. 13, 2017) (Docket No. 46957 order), FoF No. 48; Docket No. 46957, RFP Sch. II-B-12.

[314] Docket No. 46957 order at 1, OP No. 18.

7. BRP Pension Liability

The ALJs recommend that the Commission approve CenterPoint's proposed $6.9 million Benefit Restoration Plan (BRP) liability.[315]

GCCC presents a conditional challenge to CenterPoint's requested BRP liability. GCCC argues that if the Commission approves CenterPoint's proposed PPA (discussed above), then $146.689 million[316] must be subtracted from rate base to appropriately take into account CenterPoint's post-retirement regulatory liability, rather than the much lower $6.9 million BRP liability reflected in its RFP.[317] As previously discussed, the ALJs recommend that the Commission reject CenterPoint's proposed PPA in its entirety. As a result, the ALJs do not further address GCCC's conditional challenge. No other parties contested CenterPoint's requested BRP liability.

8. Other Regulatory Assets and Liabilities

Save for Staff's general argument about five-year amortization of regulatory assets, no party challenges CenterPoint's requests regarding the following Other Regulatory Assets and Liabilities: PURA § 36.065 Pension and OPEB Regulatory Liability; Hurricane Ike Regulatory Liability; Expedited Switching Costs Regulatory Asset; and Deferred Accounting Treatment for Interest Rate Hedging. Staff witness Filarowicz briefly testified that, generally, a five-year amortization period for all of CenterPoint's regulatory assets and liabilities is more reasonable because a three-year period, as CenterPoint proposes, makes it more likely that CenterPoint will

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[315] CenterPoint Ex. 1, Exh. WP II-B-11 Adj. 8 at 5752, Exh. CNP Postretirement AV 2018.pdf (confidential); CenterPoint Ex. 46 at 11-15.

[316] GCCC redacted the numerical amount of $146.689 million in its initial and reply briefs, consistent with GCCC witness Kollen's testimony. However, CenterPoint witness Sanger specifically included this numerical amount in his non-confidential testimony and CenterPoint also included the numerical amount in its non-confidential initial and reply briefs. Accordingly, the ALJs do not redact the $146.689 million amount from this PFD.

[317] GCCC Exs. 1 at 25-27, 1A at 26-27.

over-recover the assets.[318] The ALJs conclude that CenterPoint provided sufficient evidence, specific to each of the regulatory assets and liabilities referenced in this subsection, to overcome Staff witness Filarowicz's recommendation for all of CenterPoint's regulatory assets and liabilities. Accordingly, the ALJs recommend approval of CenterPoint's proposals for the Other Regulatory Assets and Liabilities identified above.

F. Capitalized Incentive Compensation

This issue is discussed in greater detail below in Section IV regarding CenterPoint's request to recover financially-based incentive compensation expenses. The arguments presented by Staff, COH, and CenterPoint are substantially the same, as is the ALJs' analysis and recommendation.

1. Staff's and COH's Objections to Capitalized Financially-Based-Incentive Compensation

Staff and COH contest CenterPoint's request for financially-based capitalized incentive compensation. Staff argues that the portion of incentive compensation that CenterPoint has capitalized since the test year of its last base rate case should be treated consistent with Commission precedent regarding recovery of incentive compensation expenses.[319] According to Staff witness Filarowicz, CenterPoint's request for incentive compensation includes affiliate employee STI compensation amounts that were capitalized to invested capital accounts. For this reason, Staff contends that the Commission should disallow all capitalized amounts relating to financially-based incentive compensation and 50% of the capitalized amounts relating to the

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[318] Staff Ex. 4A at 31-32.

[319] Staff Reply Brief at 12. Staff also recommends removing the financially-based incentive compensation costs included within CenterPoint's request to recover expensed amounts of incentive compensation. Staff's arguments for removing financially-based incentive costs are addressed below in Section IV.

remaining (non-financially-based) incentive compensation, for a total $2.365 million reduction in rate base.[320]

Mr. Filarowicz testified that Commission precedent shows that financially-based incentive compensation is unreasonable and unnecessary for a TDU to provide service to the public and therefore should not be included in rates.[321] Based on that precedent, Mr. Filarowicz recommended removing financially-based capitalized incentive costs from rate base so that CenterPoint will not earn a return on the properly disallowed amounts of invested capital. Mr. Filarowicz testified that he applied the same methodology to calculate the financially-based costs that should be removed from CenterPoint's requested capitalized incentive compensation that he applied to the requested incentive compensation expenses (discussed in Section IV below).

COH makes a similar argument, and contends that 83% of CenterPoint's capitalized incentive compensation should be removed from base rates.[322]

2. CenterPoint's Position

CenterPoint disagrees with Staff's and COH's recommended disallowance. CenterPoint argues that Staff's recommended disallowance would, at a minimum, improperly: (1) remove the capitalized portion of incentive compensation pay tied to union employees operating under a collective bargaining agreement, in violation of PURA § 14.006; (2) designate an operationally-based STI compensation goal (*i.e.*, CNP O&M Expenditures) as a financial measure, and thereby remove the capitalized portion of incentive compensation pay tied to that STI goal; and (3) remove

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[320] Staff Ex. 4A, Exh. Att. MF-1 at 42. It is apparent from CenterPoint's arguments in its reply brief (discussed below) that CenterPoint's request included capitalized portions of STI compensation for union and non-union direct employees, in addition to affiliate employees, as Mr. Filarowicz testified. *See* Staff Exs. 4A at 18; 15A (confidential); CenterPoint Reply Brief at 55.

[321] Staff Ex. 4A at 18.

[322] CenterPoint Initial Brief at 23.

50% of the capitalized portion of compensation pay tied to the remaining operationally based STI goals solely because those costs are subject to a financial trigger.[323]

CenterPoint argues that Staff's recommended disallowance is inappropriate for the same reasons it described in Section IV.B.2 below (concerning its requested incentive compensation expenses). Moreover, CenterPoint indicates that Staff under-calculated its recommended disallowance amount. Specifically, CenterPoint asserts:

> *The capitalized incentive compensation amounts tied to Staff's improper designations alone* are: (1) $243,368 tied to capitalized direct union salaries and $461 tied to affiliate union salaries; (2) $1,093,540 tied to direct non-union [CenterPoint] salaries and $211,642 tied to affiliate non-union salaries where Staff has labeled O&M control measures improperly as a financial measure; and (3) $689,538 tied to direct non-union [CenterPoint] salaries and $134,401 tied to affiliate non-union salaries where Staff inappropriately reduces safety and customer service related STI by 50%. The total of this over-reaching is $2,372,950 and would eliminate Staff's proposed adjustment to rate base.[324]

In sum, CenterPoint indicates that the above-referenced $2,372,950 capitalized incentive cost does not reflect its total request for capitalized amounts tied to the incentive compensation cost because it excludes the amounts CenterPoint admits are financially-based.

3. ALJs' Analysis and Recommendation

The ALJs agree with Staff's recommendation to disallow financially-based capitalized incentive compensation should be disallowed in accordance with the Commission's precedent regarding financially-based incentive compensation expenses. Accordingly, the ALJs recommend that the Commission disallow 92% of CenterPoint's total requested capitalized incentive

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[323] CenterPoint Reply Brief at 55. CenterPoint raises the same arguments in response to Staff's (and other parties') recommendation to exclude financially-based incentive compensation costs from CenterPoint's request to recover expensed amounts of incentive compensation. CenterPoint's counterarguments for the inclusion of financially-based incentive costs are addressed below in Section IV of this PFD.

[324] CenterPoint Reply Brief at 55 (emphasis added); *see* Staff Ex. 15A (confidential).

compensation, as computed using the information CenterPoint provided and admitted into evidence as Staff Exhibit 15A, in order to remove the costs tied to financial metrics, consistent with the ALJs' decision in Section IV below.[325] This recommendation comports with the Commission's policy of removing from rate base compensation payments that primarily benefit a utility's shareholders, rather than its customers.[326]

Neither CenterPoint, Staff, nor COH specified the total amount of capitalized incentive compensation that CenterPoint seeks to include in rate base, nor did they cite where that total amount is identified in CenterPoint's RFP. However, it is apparent that Staff and CenterPoint do not share a common understanding of what expenses are included in this request. Staff witness Filarowicz's testimony and Staff's total recommended disallowance amount indicate that they understood CenterPoint's request to include only capitalized STI compensation for its affiliate employees. In contrast, CenterPoint indicates in its reply brief that its capitalized STI compensation includes costs tied to union and non-union, direct and affiliate employees, and lists specific capitalized amounts tied to those employees. Those specific amounts were derived from a confidential discovery response to Staff RFI 16-01, wherein CenterPoint provided information concerning the estimated amount of STI compensation for affiliate employees and the booked amount of STI compensation for direct employees in 2018.[327] Additionally, CenterPoint implies in its reply brief that Staff under-calculated its total recommended disallowance, as illustrated above.[328]

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[325] *See* Staff Ex. 15A (confidential). As discussed below, the ALJs' recommended disallowance is based on an amount computed from Staff Ex. 15A, which contains a confidential discovery response from CenterPoint. CenterPoint divulged some of the confidential information included within Staff Ex. 15A in its reply brief *(i.e.*, specific amounts of capitalized income for different categories of employees). CenterPoint did not divulge all of the confidential information necessary for the ALJs to compute a total recommended disallowance amount. Rather, CenterPoint, in its Reply Brief, indicated that the divulged amounts made up only a portion of its requested capitalized incentive compensation amounts.

[326] *See* Docket No. 46449 order at FoF No. 133; Docket No. 40443 order at 13, FoF No. 147; Docket No. 39896 order at 5-6, FoF No. 61.

[327] Tr. at 1310-20; *see* Staff Ex. 15A (confidential).

[328] CenterPoint Reply Brief at 55.

In light of the evidence, the ALJs find it appropriate to base their recommended disallowance for financially-based capitalized incentive compensation on the specific amounts CenterPoint acknowledges are included within Staff Ex. 15A. Further, the ALJs find it reasonable to calculate their recommended disallowance using CenterPoint's actual percentage payouts per STI goal for 2018, consistent with the methodology the ALJs used to calculate the disallowance for financially-based incentive compensation expenses in Section IV below.

G. Capitalized Non-Qualified Pension Expense

This issue is discussed in greater detail in Section IV below, concerning CenterPoint's request to recover costs for its BRP. Staff's and CenterPoint's arguments are substantially the same, as is the ALJs' analysis and recommendation.

Staff recommends CenterPoint's request to include $294,923 in capitalized non-qualified pension expense (*i.e.*, CenterPoint's BRP expense) be rejected, consistent with Commission precedent.[329] Staff witness Filarowicz testified that the Commission has previously found that non-qualified retirement benefits are unreasonable and unnecessary to provide utility service to the public and are not in the public interest. Mr. Filarowicz argued that CenterPoint's capitalized non-qualified expense amounts should be removed from rate base so that CenterPoint will not earn a return on the properly disallowed amounts of invested capital.[330]

CenterPoint argues that Staff's recommended disallowance should be rejected for the same reasons set out in Section IV.B.2 below (concerning its BRP expense).

The ALJs recommend that the Commission reject CenterPoint's request to include $294,923 in capitalized non-qualified expenses associated with its BRP in rate base, consistent with their recommendation in Section IV below. The ALJs acknowledge the Commission's

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[329] *See* Docket No. 46449 order at FoF No. 129.

[330] Staff Ex. 4A at 20-21, Exh. MF-12 at 69-70.

precedent to disallow costs related to supplemental executive retirement plans, and conclude that CenterPoint provided insufficient evidence to show that its capitalized non-qualified expenses associated with its BRP costs should be treated differently.

III. RATE OF RETURN [PO Issues 4, 5, 7, 8, 9]

A. Return on Equity [PO Issue 8]

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

> From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having comparable risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.[331]

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

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

CenterPoint, Staff, TIEC, TCUC, and OPUC all presented experts who testified as to the appropriate ROE given the current market conditions and CenterPoint's current financial situation. They all used varying mathematical methodologies to estimate the appropriate ROE for CenterPoint, ranging from the constant growth discounted cash flow (DCF) methodology to the multi-stage DCF methodology to the capital asset pricing model (CAPM) to the comparable earnings model to the risk premium approach. Each of these experts also addressed the recent economic conditions and how they affect the mathematically derived recommendations. WalMart, COH, and GCCC adopted the positions urged by other intervenors and presented no independent evidence or argument. HEB challenged CenterPoint's ROE, basing its positions on what it characterized as CenterPoint's failure to adequately address its service-related complaints.

Application of these varying analytic techniques resulted in equally varying ROE recommendations from the experts, as shown in the table below.

Summary of ROE Recommendations[332]

WITNESS	ROE RANGE		ROE RECOMMENDATION
	LOW	HIGH	
Jorge Ordonez (Staff)	8.34%	9.79%	9.45%
Anjuli Winker (OPUC)	6.76%	9.92%	9.15%
Michael Gorman (TIEC)	9.00%	9.50%	9.25%
J. Randall Woolridge (TCUC)	7.30%	8.65%	9.00%
Robert Hevert (CenterPoint)	10.00%	10.75%	10.40%

[332] CenterPoint Ex. 42 at 8. HEB did not perform any independent analyses of the appropriate ROE for CenterPoint, but based on its experience with service quality issues recommends that the Commission set CenterPoint's ROE at the low end of the range recommended by other intervenors given CenterPoint's failure to reliably serve its customers. HEB contends that an ROE at the low end of the range recommended by other intervenors would best balance ratepayer interests with a reasonable opportunity for CenterPoint to earn a reasonable return in accordance with PURA. HEB Initial Brief at 25.

It is with this backdrop that the ALJs discuss the appropriate ROE for CenterPoint on a going-forward basis, which the ALJs find is 9.45%. Taking into account the three-basis-point reduction for service quality discussed in Section III.A.8 of the PFD results in an ROE recommendation of 9.42%.

1. Proxy Group

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

It is axiomatic that a proxy group should consist of companies with risk profiles comparable to the subject company. The objective in developing the proxy group is to select companies that are highly representative of the risks and prospects faced by the subject company (in this case, CenterPoint), while ensuring a sufficiently large group.[333] CenterPoint witness Hevert began his selection of a proxy group with the universe of companies that Value Line Investment Survey (Value Line) classifies as Electric Utilities, and then applied a number of screening criteria to arrive at his initial 24-member proxy group. Mr. Hevert excluded CNP from the proxy group to avoid what he characterized as "circular logic," and included vertically integrated utilities because there are no "pure play" state-jurisdictional electric TDUs that may be used as a proxy for CenterPoint's Texas electric distribution operations.[334]

TIEC witness Gorman used the same proxy group as Mr. Hevert, with one exception. He removed one of Mr. Hevert's selected companies because less than 20% of its stock is publicly

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[333] CenterPoint Ex. 42 at 27.

[334] CenterPoint Ex. 42 at 27-29.

traded, which means its valuation is not comparable to the other proxy companies.[335] Mr. Hevert did not criticize this adjustment in his rebuttal testimony.[336]

OPUC witness Winker employed a proxy group similar to that used by Mr. Hevert, but with some differences. All of the comparable companies in Ms. Winker's proxy group consistently pay quarterly cash dividends, are reported on by at least two utility industry equity analysts, and have investment grade senior unsecured bond and/or corporate credit ratings from Standard & Poors (S&P).[337] The comparable companies also have regulated electric operating income that is at least 60% of the total regulated operating income.[338] However, Ms. Winker chose "companies whose regulated operating income over the most recently reported fiscal years comprised less than 60.00 percent of the *total income for the company*" rather than "60.00 percent of the *total consolidated enterprise*" because Mr. Hevert's criterion suggests that a company is comparable only if it was formed as the result of the consolidation of multiple companies through a merger or acquisition.[339] She also chose "companies that are currently known to be party to a merger, significant asset sale or acquisition, bankruptcy, or other significant transaction" rather than "companies that are currently known to be a party to transformative transaction" because Mr. Hevert's criterion does not clearly state the types of transactions that are transformative.[340] With these modifications, Ms. Winker's proxy group differs from Mr. Hevert's in that it excludes ALLETE, Inc. (ALLETE); American Electric Power Company, Inc. (AEP); NextEra Energy, Inc. (NextEra), and Southern Company (Southern), all four of which are parties to an ongoing or recently completed significant transaction.[341]

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[335] TIEC Ex. 5 at 39-40.

[336] *See generally* CenterPoint Ex. 42.

[337] OPUC Ex. 3 at 20.

[338] OPUC Ex. 3 at 20.

[339] OPUC Ex. 3 at 21.

[340] OPUC Ex. 3 at 21.

[341] OPUC Ex. 3 at 21.

However, CenterPoint argues that Ms. Winker does not explain what transactions rendered those companies ineligible to be included in her proxy group[342] and contends that Mr. Hevert's rebuttal testimony demonstrates that the recent transactions undergone by Ms. Winker's excluded companies were not significant or transformative to those companies in terms of relative market capitalization.[343] Accordingly, CenterPoint contends these four companies were suitable proxies and should not have been excluded.[344]

TCUC witness Woolridge constructed a proxy group using publicly-held electric utility companies. Dr. Woolridge's "Electric Proxy Group" is composed of 28 companies that Dr. Woolridge found comparable to CenterPoint. Mr. Hevert's Proxy Group is made up of 24 utilities. The financial metrics of the companies in Dr. Woolridge's Electric Proxy Group and those in Mr. Hevert's Proxy Group show the riskiness of the two proxy groups using five different risk measures published by Value Line—Beta, Financial Strength, Safety, Earnings Predictability, and Stock Price Stability—and suggest that the two proxy groups are very similar in risk. TCUC contends that the crucial factor, with regard to either Dr. Woolridge's Electric Proxy Group or Mr. Hevert's Proxy Group, is that the risk associated with investing in CenterPoint is a little lower than the average investment risk of the companies in the proxy groups.[345]

CenterPoint contends that although the proxy group selections performed by Dr. Woolridge and Mr. Hevert have certain criteria in common (for example, both exclude companies that are a party to a significant corporate transaction or that do not consistently pay dividends), Dr. Woolridge's screens do not render a group of companies that is sufficiently comparable to CenterPoint. Mr. Hevert took issue with Dr. Woolridge's use of revenue, rather

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[342] CenterPoint Ex. 42 at 46.

[343] CenterPoint Ex. 42 at 46-47. Mr. Hevert explained that NextEra's purchase of Gulf Power Company and Florida City Gas from Southern represented about 5% of NextEra's and less than 10% of Southern's market capitalization. ALLETE's sale of its U.S. Water Services subsidiary represented about 6% of ALLETE's market value. AEP's acquisition of Sempra Energy Renewables represented about 2% of AEP's market capitalization.

[344] CenterPoint Ex. 42 at 48.

[345] TCUC Ex. 1 at 15-16.

than income, as a screening criterion because measures of income are far more likely to be considered by the financial community in making credit assessments and investment decisions than are measures of revenue. From the perspective of credit markets, measures of financial strength and liquidity are focused on cash from operations, which is directly derivative of earnings, as opposed to revenue.[346]

Staff witness Ordonez developed his proxy group of domestic electric utility companies by starting with all the electric utility companies covered by Value Line's Ratings and Reports. Mr. Ordonez then applied screening criteria and selected the resulting 21 companies that share certain characteristics with CenterPoint without unreasonably restricting their number.[347] Out of the 21 electric utilities selected by Mr. Ordonez as part of his proxy group, 17 were also part of Mr. Hevert's proxy group of 24 electric utilities.[348]

2. DCF Analysis

a. Constant Growth DCF

To analyze CenterPoint's cost of equity capital, Mr. Hevert first performed a DCF analysis. The Constant Growth DCF approach is based on the theory that a stock's current price represents the present value of all expected future cash flows. In its simplest form, the Constant Growth DCF model expresses the cost of equity as the discount rate that sets the current price equal to expected cash flows:

$$P_0 = \frac{D_1}{(1+k)} + \frac{D_2}{(1+k)^2} + \cdots + \frac{D_t}{(1+k)^t}$$

[346] CenterPoint Ex. 42 at 119.

[347] Staff Ex. 3A at 13-14.

[348] Staff Ex. 3A at 15; CenterPoint Ex. 26 at 2690 (Table 3).

where P_0 represents the current stock price, $D_1 \ldots D_t$ represent expected future dividends, and k is the discount rate, or required ROE. This equation is a standard present value calculation that can be simplified and rearranged into the familiar form:

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

This equation often is referred to as the "Constant Growth DCF" model, in which the first term is the expected dividend yield and the second term is the expected long-term growth rate.[349]

Mr. Hevert applied the DCF model to his proxy group using the following inputs for the price and dividend terms: (1) the average daily closing prices for the 30-trading days, 90-trading days, and 180-trading days ended May 17, 2019, for the term P_0; and (2) the annualized dividend per share as of May 17, 2019, for the term D_0. He then calculated the DCF results using the following growth terms: Zacks Investment Research (Zacks) consensus long-term earnings growth estimates; First Call consensus long-term growth estimates; and Value Line earnings growth estimates.[350]

The Constant Growth DCF results from Mr. Hevert's analysis yielded Constant Growth DCF estimates ranging from 7.95% to 9.73%.[351] Mr. Hevert cautioned against using a single analytic model because the cost of equity is not directly observable, it must be estimated based on both quantitative and qualitative information. Although several empirical models have been developed for that purpose, all are subject to limiting assumptions or other constraints. Consequently, many finance texts recommend using multiple approaches to estimate the cost of

[349] CenterPoint Ex. 26 at 2717.

[350] CenterPoint Ex. 26 at 2721-22; CenterPoint Ex. 42 at 6.

[351] CenterPoint Ex. 42, Exh. RBH-1R.

equity.[352] When faced with the task of estimating the cost of equity, analysts and investors are inclined to gather and evaluate as much relevant data as reasonably can be analyzed and, therefore, rely on multiple analytical approaches.

As a practical matter, no individual model is more reliable than all others under all market conditions. Therefore, it is important to use multiple methods to mitigate the effects of assumptions and inputs associated with any single approach. The use of multiple methods, and the consideration given to them, recently was addressed by FERC. In its November 15, 2018 Order Directing Briefs, FERC found that "in light of current investor behavior and capital market conditions, relying on the DCF methodology alone will not produce a just and reasonable ROE".[353]

In its October 16, 2018 Order Directing Briefs, FERC found that although it "previously relied solely on the DCF model to produce the evidentiary zone of reasonableness...", it is "...concerned that relying on that methodology alone will not produce just and reasonable results."[354] As FERC explained, because the cost of equity depends on what the market expects, it is important to understand "how investors analyze and compare their investment opportunities."[355] FERC also explained that, although certain investors may give some weight to the DCF approach, other investors "place greater weight on one or more of the other methods..."[356]

TIEC witness Gorman's constant growth DCF model used the proxy group's 13-week average stock price and most recently reported quarterly dividends, along with a 5.38% growth rate, which was based on a consensus, or mean, of professional securities analysts' growth

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[352] *See, e.g.,* Eugene Brigham & Louis Gapenski, Financial Management: Theory and Practice, 7th ed. at 341, 1994, and Tom Copeland, Tim Koller & Jack Murrin, Valuation: Measuring and Managing the Value of Companies, 3rd ed. at 214, 2000.

[353] Docket Nos. EL14-12-003 and EL15-45-000, Order Directing Briefs at para. 34, 165 FERC ¶ 61,118 (Nov. 15, 2018).

[354] Docket No. EL11-66-001, *et al.*, Order Directing Briefs at 30, 165 FERC ¶ 61,030 (Oct. 16, 2018).

[355] Docket No. EL11-66-001, *et al.*, Order Directing Briefs at 33, 165 FERC ¶ 61,030 (Oct. 16, 2018).

[356] Docket No. EL11-66-001, *et al.*, Order Directing Briefs at 35, 165 FERC ¶ 61,030 (Oct. 16, 2018).

estimates for those companies.[357] The resulting average and median constant growth DCF returns for the proxy group were 9.31% and 9.57%, respectively.[358] Importantly, Mr. Gorman questioned the results of his constant growth DCF model because it is widely accepted that over the long term, utility stocks cannot grow faster than the economy in which they provide goods and services, and consensus economists predict that the United States gross domestic product will grow at approximately 4% per year.[359] In light of this issue, Mr. Gorman considered the results of his constant growth DCF analysis to be a reasonable high-end return estimate.[360]

Mr. Gorman also performed a sustainable growth DCF analysis. This model is based on the principle that a utility's earnings will grow over time as it invests in additional utility plant and equipment, which enables it to earn its authorized return on a larger total rate base. To estimate the sustainable growth in CenterPoint's rate base, Mr. Gorman looked to the proportion of total earnings that his proxy group retained for reinvestment rather than paying out in dividends.[361] He found that, on average, the sustainable growth rate for CenterPoint's proxy group is 4.23%,[362] which is much more in line with the projected gross domestic product (GDP) growth rate of 4.00%. Performing a DCF analysis using this more conservative sustainable growth rate resulted in proxy group average and median ROE requirements of 8.11% and 8.20%, respectively.[363]

OPUC witness Winker used a constant-growth DCF model, which assumes that dividends grow at a constant rate.[364] OPUC's DCF model analysis results in an overall recommended DCF range of 6.76% to 9.92%.[365] Ms. Winker's model incorporates two estimated dividend yields for

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[357] TIEC Ex. 5 at 42-43, Exh. MPG-8.

[358] TIEC Ex. 5 at 43, Exh. MPG-9.

[359] TIEC Ex. 5 at 44.

[360] TIEC Ex. 5 at 44.

[361] TIEC Ex. 5 at 45, Exh. MPG-10.

[362] TIEC Ex. 5 at 45, Exh. MPG-11.

[363] TIEC Ex. 5 at 46.

[364] OPUC Ex. 3 at 24.

[365] OPUC Ex. 3 at 31.

the proxy group. The first estimate of 3.45% used the average high and average low stock prices reported in the issues of Value Line published on March 15, April 26, and May 17, 2019.[366] Ms. Winker's second estimate of 3.33% averaged Value Line's 2019 high and low stock prices with the May 3, 2019, closing stock prices reported by Yahoo Finance.[367] OPUC contends that Ms. Winker's dividend yield calculation is consistent with the industry average yields of 3.4% and 3.3% reported by Value Line on March 15, 2019, and May 17, 2019, respectively.[368]

In addition to estimated dividend yields for the proxy group, the DCF model also requires an estimate of the dividend growth rate expected by investors. The development of the expected dividend growth rate is the most controversial component of the DCF model, and experts can reasonably disagree about the importance of various growth rate measures. OPUC recommends considering the sustainable retained earnings growth rate (*i.e.*, BR growth rate) when estimating a long-term dividend growth rate.[369] Earnings retention rates are the primary source of book value growth, and book value growth, in turn, is the primary source of sustainable dividend growth. This is due to the fact that earnings that are not paid out as dividends are reinvested by the utility.[370] As additional plant is funded by retained earnings, the utility is allowed to earn its authorized rate of return on the additional plant in rate base, which leads to future growth in earnings and dividends.[371] The BR growth rate helps gauge whether investors' current long-term dividend growth rates can be sustained in future periods.[372] In addition to the BR growth rate, Ms. Winker also considered Value Line*'s* historical 5-year and 10-year growth in earnings, dividends and book value for the proxy group as well as Value Line*'s* 5-year projected growth in earnings, dividends and book value.[373]

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[366] OPUC Ex. 3 at 26.

[367] OPUC Ex. 3 at 26.

[368] OPUC Ex. 3B at 17-19.

[369] OPUC Ex. 3 at 27.

[370] OPUC Ex. 3 at 28.

[371] OPUC Ex. 3 at 28.

[372] OPUC Ex. 3 at 28.

[373] OPUC Ex. 3 at 30.

TCUC witness Woolridge relied primarily on his DCF analysis to estimate CenterPoint's cost of equity and employed the "constant-growth" DCF model to estimate CenterPoint's cost of equity.[374] Based on his analysis, Dr. Woolridge calculated the dividend yields for the companies in the proxy group using the current annual dividend and the 30-day, 90-day, and 180-day average stock prices.[375] Using both the means and medians, the dividend yields range from 3.0% to 3.4% for the Dr. Woolridge's proxy group and 3.0% to 3.3% for CenterPoint witness Hevert's proxy group. Given these results Dr. Woolridge used dividend yields of 3.3% and 3.2% for his proxy group and Mr. Hevert's proxy group, respectively to estimate CenterPoint's cost of equity.[376]

Dr. Woolridge next adjusted the dividend yield by one-half of the expected growth to reflect growth over the coming year.[377] For his growth rate, Dr. Woolridge reviewed Value Line's historical and projected growth rate estimates for earnings per share (EPS), dividends per share (DPS), and book value per share (BVPS). He used the average EPS growth rate forecasts of Wall Street analysts as provided by Yahoo, Reuters, and Zacks.

Lastly, Dr. Woolridge assessed prospective growth as measured by prospective earnings retention rates and earned returns on common equity.[378] He testified that in the DCF model, the growth rate is the long-term projected growth rate in EPS, DPS, and BVPS. Therefore, in developing an equity cost rate using the DCF model, the projected long-term growth rate is the projection used in the DCF model.[379] He warned against relying exclusively on EPS forecasts prepared by Wall Street analysts in identifying a DCF growth rate.[380]

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[374] TCUC Ex. 1 at 27; 29-30.

[375] TCUC Ex. 1 at 30; Exh. JRW-7.

[376] TCUC Ex. 1 at 30.

[377] TCUC Ex. 1 at 30-31.

[378] TCUC Ex. 1 at 32.

[379] TCUC Ex. 1 at 35.

[380] TCUC Ex. 1 at 34.

Dr. Woolridge's analysis reviewed the 5- and 10-year *historical* growth rates of the companies in his Electric Proxy Group and Mr. Hevert's Proxy Group; the *projected* growth rates as shown by Value Line for the two proxy groups; and the proxy-groups' companies as measured by analyst's forecasts of expected 5-year growth in earnings per share.[381] Based on his analysis, Dr. Woolridge concluded that his DCF analysis suggested a cost of equity of 8.50% (based on the growth rates for his proxy group) and 8.65% (based on the growth rates for Mr. Hevert's proxy group).[382]

Staff witness Ordonez employed a single-stage DCF analysis. Mr. Ordonez's DCF model is a long-term, forward-looking model that projects shareholder's cash flows from dividends.[383] The underlying theory of a DCF model is that the price of a share is equal to the present value of all future dividends.[384] Absent the sale of a stock, dividends are the only cash flows received by investors. The purpose of a DCF method is not to measure the rate at which CenterPoint will actually grow (which is primarily a function of regulatory actions, management ability, economic conditions, etc.), but rather the expectations for dividends growth that investors have embodied in the current price of the stock.[385]

Because of the relationship between earnings growth and dividends growth, the growth rate used in Mr. Ordonez's single-stage DCF analysis is the projected earnings growth rates for each of the proxy companies, as forecasted by Value Line and Zacks. Mr. Ordonez relied on Value Line because it is one of the nation's largest, independent investment research services as well as a major money management institution, and he relied on Zacks because it compiles consensus earnings forecasts from groups of professional security analysts.[386] In Mr. Ordonez's single-stage

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[381] TCUC Ex. 1 at 36.

[382] TCUC Ex. 1 at 38.

[383] Staff Ex. 3A at 18, 21.

[384] Staff Ex. 3A at 15-16.

[385] Staff Ex. 3A at 19.

[386] Staff Ex. 3A at 20.

DCF analysis, the stock's dividend growth is based on analysts' estimates of the utility's earnings growth over the next five years.[387]

Each of the intervenor and Staff experts had specific and general critiques of Mr. Hevert's constant growth DCF analysis, and Mr. Hevert likewise had criticisms of their analyses. TIEC contends that Mr. Hevert performed a constant growth DCF analysis that generally supports an ROE of no higher than 9.30%.[388] The mean results of his constant growth DCF model using average projected growth rates for his proxy companies ranged between 9.22% and 9.32%.[389] In his rebuttal testimony, Mr. Hevert revised that "mean" constant growth DCF result downward to a range of 8.71% to 8.9%.[390] But Mr. Gorman explained that these DCF projections likely overstate the required ROE for CenterPoint because they are based on average growth projections for the proxy group that are substantially higher than a reasonable long-term GDP estimate of 4.0%.[391]

Mr. Hevert then performed what he called a "mean high" analysis that used the maximum EPS growth rate estimate for each of his proxy companies.[392] TIEC contends that this approach is not credible because it pushes the expected growth rate even further above the long-term sustainable growth rate.[393] Even with the most inflated possible assumptions, Mr. Hevert's "mean high" constant growth DCF results ranged from 10.09% to 10.20%.[394] Then, in his rebuttal

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[387] Staff Ex. 3A at 18.

[388] TIEC Ex. 5 at 74.

[389] CenterPoint Ex. 26 at 2722.

[390] CenterPoint Ex. 42 at 177.

[391] TIEC Ex. 5 at 44.

[392] CenterPoint Ex. 26 at 2722 ("I calculated the high DCF result by combining the *maximum EPS growth rate estimate* as reported by Value Line, Zacks, and First Call with the subject company's dividend yield.") (emphasis added).

[393] In fact, while Mr. Hevert did not list the average expected growth rate for his "Mean High" analysis, taking the average of the highest number from each row of columns 4, 5, and 6 of Mr. Hevert's Exhibit RBH-1 (the Zacks, First Call, and Value Line growth projections, respectively) results in a "High" average earnings growth rate of 6.65%. This is even more out of line with the long-term sustainable growth rate of 4.0%.

[394] CenterPoint Ex. 26 at 2722.

testimony, he revised that estimate downward to a range of 9.53% to 9.73%,[395] which is still well below his requested ROE of 10.4%. Notably, Mr. Hevert's corresponding "mean low" results are substantially lower, and produced a range of 8.43% to 8.53% in his direct testimony,[396] and 7.95% to 8.14% on rebuttal.[397]

TIEC argues that Mr. Hevert does not acknowledge that the DCF model should represent a high-end estimate of CenterPoint's current market cost of equity.[398] Nor does he balance the results of that constant growth model against other, more conservative DCF models that are based on sustainable growth estimates.[399]

TIEC takes issue with what it characterizes as Mr. Hevert's attempts to discredit the DCF approach.[400] Mr. Hevert claimed that current market conditions reflect a low interest rate environment, which affects security valuation and yields relative to historical levels, and that the market has an expectation of higher interest rates, which will in turn increase the return that investors will demand on their equity investments.[401] However, as Mr. Gorman pointed out, economists have been consistently predicting that interest rates would rise over the last five years, and were even making such predictions at the time of CenterPoint's last rate case.[402] Nevertheless, interest rates have remained stable, and consensus economists have moderated their projections for interest rates over the next five to ten years,[403] which is evidence that the market is embracing the sustainability of low interest rates.[404] TIEC states that despite this shift in economists'

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[395] CenterPoint Ex. 42 at 177.

[396] CenterPoint Ex. 26 at Exh. RBH-1, p. 1-3.

[397] CenterPoint Ex. 42 at 177.

[398] TIEC Ex. 5 at 74.

[399] TIEC Initial Brief at 28.

[400] TIEC Initial Brief at 28.

[401] CenterPoint Ex. 26 at 2666, 2670, 2673, 2722-24.

[402] TIEC Ex. 5 at 76.

[403] TIEC Ex. 5 at 76-77.

[404] TIEC Ex. 5 at 77.

predictions, Mr. Hevert has repeatedly testified in other Texas proceedings that interest rates were about to rise.[405] However, those predictions have been consistently wrong, as interest rates have actually fallen since Mr. Hevert anticipated otherwise in Atmos Energy's, Southwestern Public Service Company's (SPS), and Oncor's recent rate cases.[406] Worse, according to TIEC, Mr. Hevert's prediction of rising interest rates is directly contradicted by statements from the Federal Reserve Board, which has recently revised its interest rate projections significantly downward *twice*,[407] and currently projects that rates will *fall* from their current 2.4% to 2.1% in 2020, and will only rebound to their current levels in 2021.[408] TIEC observes that Mr. Hevert has conceded there is a "zero" chance of the Federal Reserve increasing the federal funds rate before April 2020.[409]

TIEC also contends that Mr. Hevert's use of inflated growth rates (as he did in his DCF analysis) and risk premiums (as he did in his CAPM analysis) is his consistent practice and has been called into question by other regulatory commissions.[410]

OPUC argues that Mr. Hevert relied entirely on analyst estimates of projected earnings growth in developing the dividend growth component of his DCF model.[411] OPUC notes that a recent study by Lacina, Lee, and Xu "has shown that analysts' long-term earnings growth rate forecasts are not more accurate at forecasting future earnings than naive random walk forecasts of

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[405] Tr. at 748-50; TCUC Ex. 92-94.

[406] Tr. at 748-50; TCUC Ex. 92-94.

[407] *See* TIEC Ex. 20 (Mar. 20, 2019 Federal Reserve Board Press Release) (revising December projections downward); TIEC Ex. 21 (June 19, 2019 Federal Reserve Board Press Release) (revising March projections further downward); Tr. at 718-21.

[408] *See* TIEC Ex. 21 (June 19, 2019 Federal Reserve Board Press Release); Tr. at 718-21.

[409] *See* Tr. at 750-53; TCUC Ex. 97.

[410] TIEC Ex. No. 26 (Missouri Public Service Commission Report and Order in Docket No. ER-2014-0370 (Sept. 2, 2015)) at 19-20, FoF No. 33; TIEC Ex. No. 25 (Missouri Public Service Commission Report and Order in Docket No. ER-2014-0258 (Apr. 29, 2015)) at 66, FoF No. 15; TIEC Ex. No. 24 (Maryland Public Service Commission Order in Docket No. 9336 (July 2, 2014)) at 86-87; TIEC Ex. No. 28 (District of Columbia Public Service Commission Opinion and Order in Docket No. FC1137-2017-G-280 (Mar. 3, 2017)) at 27, 65.

[411] CenterPoint Ex. 26 at 2722.

future earnings."[412] OPUC also cites TCUC witness Woolridge's statement that using analyst long-term earnings per share forecasts results in an overstated cost of equity.[413]

TCUC's criticism takes a slightly different approach. CenterPoint contends Mr. Hevert assessed CenterPoint's required ROE based on his DCF analysis, his CAPM review, and his BYPR approach, but TCUC argues that Mr. Hevert ignored all but his CAPM analysis. Mr. Hevert's own DCF analysis showed that CenterPoint's ROE should be in the low-to-mid 9% range.[414] Equally telling that Mr. Hevert's CAPM analysis is at best an outlier, according to TCUC, is that his updated DCF analysis, which he presented in his rebuttal testimony, showed even lower ROEs based on his DCF analysis.[415]

Staff argues that Mr. Hevert's constant growth DCF model is based on a proxy group average growth rate of 5.79%,[416] which in Mr. Hevert's single-stage DCF model is the growth rate that is assumed to infinity, despite being well above economists' consensus projected long-term sustainable growth rate of 4.00%.[417] Like TIEC, Staff contends that Mr. Hevert's analysis is unreliable due to his practice of using inflated growth rates (as Staff contends he did in his DCF analysis) and risk premiums (as Staff contends he did in his CAPM analysis), also noting that his approach has been called into question by other regulatory commissions.[418]

CenterPoint argues that TIEC witness Gorman's DCF analysis relied primarily on the results of his constant growth DCF.[419] This is problematic, CenterPoint contends, because the

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[412] OPUC Initial Brief at 39, citing TCUC Ex. 1 at 58.

[413] OPUC Initial Brief at 39, citing TCUC Ex. 1 at 58.

[414] CenterPoint Ex. 26 at 2668 (Mr. Hevert testifying that his DCF Analysis produced a 30-Day ROE Mean of 9.22%, a 90-Day ROE Mean of 9.24%, and a 180-Day ROE Mean of 9.32%).

[415] CenterPoint Ex. 42 at 177 (Mr. Hevert testifying an updated DCF Analysis of a 30-Day ROE Mean of 8.71%, a 90-Day ROE Mean of 8.79%, and a 180-Day ROE Mean of 8.90%).

[416] CenterPoint Ex. 26 at 2753, Exh. RBH-1.

[417] Staff Reply Brief at 15, citing TIEC Initial Brief at 27-28.

[418] Staff Reply Brief at 16-17.

[419] CenterPoint Initial Brief at 57, *citing* TIEC Ex. 5 at 54.

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.[420] As to OPUC witness Winker's position that sustainable growth rates are more appropriate than earnings growth in the DCF formulation, CenterPoint argues that it is not supported by data from Value Line, a source she relies on in this proceeding.[421] 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.[422] Furthermore, CenterPoint argues, the theoretical basis of Ms. Winker's sustainable retained earnings Growth rate does not apply to her data.[423]

CenterPoint contends that TCUC witness Woolridge, unlike all of the other ROE witnesses in this proceeding, did not base the growth rate in his DCF analysis on the earnings-per-share forecast of analysts for his proxy group.[424] Dr. Woolridge claimed that these analyst forecasts are "overly optimistic" and "upwardly biased;" however, CenterPoint notes, he admitted that none of the studies he cited in support of this premise deals with utilities only.[425] CenterPoint argues that this is problematic, as Dr. Woolridge admitted that the alleged "upward bias" is "much less" for utilities.[426] Additionally, Mr. Hevert testified that analysts are subject to reporting certification requirements, and in his personal experience, their growth projections are not upwardly biased.[427] According to CenterPoint, both Mr. Hevert and Dr. Roger Morin properly rejected Dr. Woolridge's argument, 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.[428] As a

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[420] CenterPoint Ex. 42 at 75.

[421] CenterPoint Ex. 42 at 56.

[422] CenterPoint Ex. 42 at 56.

[423] CenterPoint Ex. 42 at 52, 56.

[424] Tr. at 537-38.

[425] Tr. at 538, 540.

[426] Tr. at 538.

[427] Tr. at 765-66.

[428] Tr. at 541-42. Dr. Morin is the author of the recognized utility finance textbook New Regulatory Finance (Public Utility Reports, Inc. 2006).

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.[429]

Finally, CenterPoint argues that Staff witness Ordonez's DCF analysis also contained several incorrect assumptions, which if remedied, would increase his calculated ROE estimates considerably.[430]

b. Multi-Stage DCF Analysis

TIEC witness Gorman and Staff witness Ordonez also performed a multi-stage DCF analysis. Mr. Gorman's multi-stage growth DCF model reflects what he contended is the reality that while a utility may experience periods of high or low short-term growth, its growth rate will eventually regress toward a long-term sustainable rate.[431] To model this expectation, Mr. Gorman performed a multi-stage growth DCF analysis that starts with the consensus economists' growth rate projections that were used in his constant growth DCF (5.38%), which represent reasonable investor expectations for the next five years.[432] Then, for years six through ten, he adjusted the proxy group's growth rates either upward or downward (as applicable), halfway toward the long-term sustainable growth rate of 4.00%, which mirrors economists' projections for total GDP growth.[433] For years eleven and after, Mr. Gorman projected growth at the long-term sustainable rate of 4.00%.[434] The resulting DCF analysis resulted in average and median DCF ROEs of 8.21% and 8.17%, respectively.[435]

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[429] Tr. at 544.

[430] CenterPoint Ex. 42 at 17-18, 20-21 (applying revised DCF and Risk Premium results produces a weighted average of 9.78%).

[431] TIEC Ex. 5 at 46.

[432] TIEC Ex. 5 at 47.

[433] TIEC Ex. 5 at 47-53, Exh. MPG-13 (demonstrating reasonableness of 4.00% long-term sustainable growth rate estimate).

[434] TIEC Ex. 5 at 48.

[435] TIEC Ex. 5 at 53.

Mr. Ordonez's multi-stage DCF analysis used a two-stage approach. Stage one of his analysis lasts five years and uses the same analysts' estimates that are used in the first DCF analysis. Stage two, which covers years six through 150, is based on a long-run nominal growth rate of 5.14%[436] consisting of (1) the 3.14% per year average real growth rate of GDP for the period 1951 through 2018 as calculated from data reported by the U.S. Bureau of Economic Analysis, and (2) the 2.00% rate of inflation forecast by the Federal Reserve System (FED) in its February 22, 2019, Monetary Policy Report.[437] His multi-stage DCF analysis results in a ROE range of 7.51%-10.22%, with an average of 8.31%.[438]

Mr. Hevert contended that Mr. Gorman's multi-stage DCF model contains several assumptions that produce unreasonably low ROE estimates. In particular, Mr. Gorman's model assumes a perpetual growth rate beginning in the 11th year of his model (that is, beginning in calendar year 2029) based on a GDP growth rate projection that actually ends in 2030.[439] In addition, Mr. Gorman assumed all dividends are received at year-end, rather than over the course of the year.[440]

With respect to Mr. Ordonez's multi-stage DCF analysis, Mr. Hevert stated that he disagreed with Mr. Ordonez's assumptions that quarterly dividends are received at year-end, and that growth will change immediately from Stage 1 to Stage 2 of his analysis.[441] Mr. Hevert opined that simply changing the dividend timing in Mr. Ordonez's analysis to reflect the mid-year convention increases the mean and median results by approximately 13 basis points (from 8.31% to 8.44%, and 8.21% to 8.34% for his average and median results, respectively).[442] As to the

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[436] Staff Ex. 3A at 18.

[437] Staff Ex. 3A at 20-21.

[438] Staff Ex. 3A at 49, Att. JO-9.

[439] TIEC Ex. 5 at 50, 53 and Exh. MPG-14.

[440] CenterPoint Ex. 42 at 76.

[441] CenterPoint Ex. 42 at 19.

[442] CenterPoint Ex. 42 at 20.

second point, Mr. Hevert stated his concern is that the model does not reasonably approximate the transition in growth from the first stage to the terminal stage. Whereas Mr. Ordonez's approach assumes growth will change immediately between years five and six, a more reasoned (and very common) approach is to assume growth will transition from the first to the terminal stage over a certain horizon, Mr. Hevert argued. Morningstar Inc. (Morningstar), for example, described a three-stage approach in which growth moves toward the long-term estimate over a five-year transition stage.[443]

3. CAPM Analysis

Each of the ROE witnesses performed a CAPM analysis to estimate the appropriate ROE for CenterPoint, but OPUC witness Winker and Staff witness Ordonez limited their application of the CAPM analysis to a qualitative check on the results of their other analyses.[444] The CAPM is a risk premium approach that estimates the ROE for a given security as a function of a risk-free return plus a risk premium to compensate investors for the non-diversifiable, or systematic, risk of that security. The CAPM formula is as follows:

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

In the formula, K_e equals the required market ROE; β equals the Beta of an individual security; r_f equals the risk free rate of return; and r_m equals the required return on the market as a whole. In this equation, $(r_m - r_f)$ represents the market risk premium (MRP). According to the theory underlying the CAPM, because diversifiable risk can be diversified away, investors should be concerned only with non-diversifiable risk, which is measured by Beta. In effect, Beta represents the risk of the particular security relative to the market as a whole.[445]

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[443] CenterPoint Ex. 42 at 20, *citing* Morningstar, Inc., 2013 Ibbotson Stocks, Bonds, Bills and Inflation Valuation Yearbook at 50.

[444] OPUC Ex. 3 at 43; Staff Ex. 3A at 25.

[445] CenterPoint Ex. 26 at 2724-26; TIEC Ex. 5 at 61; OPUC Ex. 3 at 37-38; TCUC Ex. 1 at 38-39; Staff Ex. 3a at 25-26.

Mr. Hevert pointed out that it is important to select the term (or maturity) of the risk-free rate that best matches the life of the underlying investment. Electric utilities typically are long-duration investments and, as such, the 30-year Treasury yield is more suitable for the purpose of calculating the cost of equity. As such, he used two different measures of the risk-free rate: (1) the current 30-day average yield on 30-year Treasury bonds (*i.e.*, 3.03%); and (2) the projected 30-year Treasury yield (*i.e.*, 3.33%).[446]

Mr. Hevert testified that he believed each input to the CAPM should be forward-looking. Witnesses in prior rate cases have relied on historical measures of the MRP. While it may be instructive to review historical MRPs to inform the reasonableness of an *ex-ante* estimate, they do not include investors' expectations, and therefore are not appropriate for use in the CAPM. As such, he stated that he believed the *ex-ante* market DCF approach is reasonable.[447] He stated that he relied on the *ex-ante* MRP together with the current and near-term projected 30-year Treasury yields as inputs to the CAPM analyses.[448]

Mr. Hevert also stated that he considered the Beta coefficients reported by two sources: Bloomberg and Value Line. Although both services adjust their calculated (or "raw") Beta coefficients to reflect the tendency of the Beta coefficient to regress to the market mean of 1.00, Value Line calculates the Beta coefficient over a five-year period, while Bloomberg's calculation is based on two years of data.[449] Mr. Hevert's CAPM analyses suggest an ROE range of 8.37% to 11.66%.[450]

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[446] CenterPoint Ex. 26 at 2727.

[447] CenterPoint Ex. 26 at 2728.

[448] CenterPoint Ex. 26 at 2729.

[449] Mr. Hevert noted that Beta coefficients reflect the subject company's relative risk (the standard deviation of its returns relative to the standard deviation of market returns), and the correlation of returns with the overall market. To the extent Federal policies (such as the TCJA and Quantitative Easing) cause utility returns to trade away from the market, the correlation will fall, even if relative risk remains constant, or even increases. Because they are measured over two, rather than five years, Beta coefficients provided by Bloomberg may be more susceptible to those effects. CenterPoint Ex. 26 at 2730, n. 98.

[450] CenterPoint Ex. 26 at 2730.

Mr. Gorman testified that using the CAPM to determine an appropriate ROE for CenterPoint requires an estimate of the market risk-free rate, CenterPoint's Beta, and the MRP.[451] Mr. Gorman used consensus economists' projected 30-year Treasury bond yield of 3.20% as a proxy for the risk-free rate.[452] He considered this a conservative approach in the context of this analysis because Treasury bonds do include some systemic market risks related to unanticipated inflation and interest rates, meaning that using them as a proxy for the risk-free rate has a tendency to *overstate* the CAPM return for companies (like CenterPoint) that have Betas below 1.0, which indicates that they are less risky than the market as a whole.[453]

Mr. Gorman reviewed data from Value Line to determine that the current average Beta for his proxy group is 0.60, compared to the group's historical average Beta of 0.70.[454] For purposes of his CAPM analysis, he applied the higher historical average utility Beta, which, like his risk free rate assumption, has the effect of *increasing* the estimated ROE.[455]

For the next component of the CAPM analysis, Mr. Gorman derived two risk premium estimates. His forward-looking estimate projected the returns of the S&P 500 into the future by adding an expected inflation rate to the long-term arithmetic average real return on the market (as determined by Duff & Phelps), which represents the market's achieved return above inflation.[456] This forward-looking method produced an expected market return of 11.1%.[457] Subtracting the estimated forward-looking risk-free rate of 3.2% results in a forward-looking risk premium of 7.9%. Mr. Gorman also determined a historical estimate of the MRP by reviewing data from Duff & Phelps, which shows that the historical arithmetic average of the achieved total return on

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[451] TIEC Ex. 5 at 62.

[452] TIEC Ex. 5 at 62.

[453] TIEC Ex. 5 at 63.

[454] TIEC Ex. 5 at 63, Exh. MPG-20.

[455] TIEC Ex. 5 at 63.

[456] TIEC Ex. 5 at 63, 64.

[457] TIEC Ex. 5 at 64.

the S&P 500 was 11.9%. By subtracting out the historical total return on long-term Treasury bonds of 5.9%,[458] he determined that the historical MRP was 6.0%.[459] Based on this analysis, Mr. Gorman found that his MRP falls in the range of 6.0% to 7.9%, which is consistent with (and toward the higher end of the range for) forward-looking MRP estimates made by Duff & Phelps, which predicts a MRP in the range of 5.5% to 6.9%.[460]

Combining all of the aspects of Mr. Gorman's CAPM analysis results in an expected ROE of 7.40% to 8.73%. While Mr. Gorman's CAPM range is lower than his DCF analysis, he argued that recent market data support the reasonableness of ROEs in this range.[461] Based on his assessment that the market is currently paying premiums to hold low-risk investments as a hedge against uncertainty, Mr. Gorman determined that investors will require somewhat higher risk premiums relative to risk-free securities to invest in the current market.[462] Accordingly, he recommended the higher end of his CAPM indicated ROE range (8.70%) as his CAPM return.[463]

TCUC witness Woolridge's analysis found the yield on 30-year U.S. Treasury bonds to be in the 2.5% to 4.0% range over the 2013–2019 time period; he also found that the current 30-year Treasury yield is approximately in the middle of this range. Given the recent range of yields, he elected to use the top end of the range as his risk-free interest rate, employing 4.0% as the risk-free rate, or R_f, in his CAPM analysis. His CAPM analysis excludes forecasts of higher interest rates because, in his opinion, forecasts of interest rates have been notoriously wrong for a decade.[464]

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[458] The historical return for Treasury bonds is significantly higher than the projected return because the historical period saw inflation of approximately 3.0%, which Mr. Gorman argued implies that the total real return on long-term government bonds is about 2.9%. TIEC Ex. 5 at 65.

[459] TIEC Ex. 5 at 65.

[460] TIEC Ex. 5 at 66.

[461] *See* TIEC Ex. 4 at Exh. CSG-3 (Whitepaper: "When 'What Goes Up' Does Not Come Down: Recent Trends in Utility Returns." Griffey, Charles S. (Feb. 15, 2017)).

[462] TIEC Ex. 5 at 67.

[463] TIEC Ex. 5 at 67.

[464] TCUC Ex. 1 at 40.

For the Beta (ß) input, Dr. Woolridge explained that Beta is a measure of the systematic risk of a stock. A stock with below average price movement, such as that of a regulated public utility like CenterPoint, is less risky than the market and has a Beta less than 1.0.[465] Dr. Woolridge concluded that the median Betas for the companies in his proxy group and Mr. Hevert's proxy groups to be the same: a Beta of 0.60.[466]

Dr. Woolridge conducted a detailed analysis of the MRP. In light of his analysis, Dr. Woolridge concluded that the appropriate MRP in the U.S. is in the 4.0% to 6.0% range. Dr. Woolridge used an expected MRP of 5.50%, which is in the upper end of the range, as the MRP. He gave most weight to the MRP estimates of the CFO Survey, Duff & Phelps, the 2019 Dimson, Marsh, Staunton - Credit Suisse Report, the Fernandez survey, and Damodaran.[467]

Based on his CAPM analysis, Dr. Woolridge found CenterPoint's cost of equity to be 7.3% for both his proxy group and for Mr. Hevert's proxy group.[468]

TIEC contends that there are two major issues with Mr. Hevert's CAPM analysis. First, he used extraordinarily high MRPs, which bias his ROE result upward. In his direct testimony, Mr. Hevert based his MRP on assumed market growth of 11.63% to 14.82%,[469] which TIEC argues is two to three times the long-term sustainable growth rate, and far out of line with the actual capital appreciation of the S&P 500 between 1926 and 2018, which is between 5.8% to 7.7%.[470] Further, Mr. Hevert's projection does not take into account the fact that market growth has

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[465] TCUC Ex. 1 at 40.

[466] TCUC Ex. 1 at 44, Exh. JRW-8.

[467] TCUC Ex. 1 at 47.

[468] TCUC Ex. 1 at 48.

[469] TIEC Ex. 5 at 81.

[470] TIEC Ex. 5, citing Duff & Phelps, *2019 SSBI Yearbook* at 6-17.

generally tracked historical U.S. GDP growth, and because GDP growth is currently lower than its historical average, the assumed market growth premium should be as well.[471]

TIEC also contends that Mr. Hevert failed to appropriately set his MRP in relation to the projected risk-free rate.[472] He calculated his MRP by conducting a DCF analysis for the entire market using risk premium estimates from Bloomberg (10.72%) and Value Line (14.10%).[473] Those risk premium estimates used a risk-free rate of 3.03%.[474] Later, however, Mr. Hevert plugged those same risk premium estimates into his CAPM along with a higher risk-free rate of 3.33%.[475] By using MRPs derived using a risk-free rate of 3.03%, but then calculating his CAPM with a risk-free rate of 3.33%, TIEC argues that Mr. Hevert biased his analysis upward.[476]

OPUC argues that Mr. Hevert's CAPM analysis resulted in an ROE range of 8.37% to 11.66%[477] but his CAPM analysis is flawed and should not be given any weight.[478] Mr. Hevert's analysis uses two MRPs that were derived by conducting a DCF analysis for the S&P 500. However, Mr. Hevert's DCF model for the S&P 500 uses sustainable market growth rates that are far too high to be a rational outlook for sustainable long-term market growth, especially when compared to historic returns of the market, OPUC contends. Specifically, Mr. Hevert used sustainable market growth rates of approximately 11.63% and 14.82%. For comparison, Duff & Phelps estimates the actual capital appreciation for the S&P 500 over the period 1926 through 2018 to have been 5.8% to 7.7%. OPUC notes that Mr. Hevert's growth rates are also more than two times the U.S. GDP long-term growth outlook of 4.00%. Current projected U.S. GDP growth

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[471] TIEC Ex. 5 at 81.

[472] TIEC Ex. 5 at 79.

[473] TIEC Ex. 5 at 79-80.

[474] TIEC Ex. 5 at 80.

[475] TIEC Ex. 5 at 81-82; *see also* CenterPoint Ex. 26 at Exh. RBH-4 (*compare* Column 1, which applies different risk-free rates of 3.03% and 3.33% *with* Columns 3 and 4, which apply risk premium estimates derived using only a 3.03% risk-free rate assumption).

[476] TIEC Ex. 5 at 82.

[477] CenterPoint Ex. 26 at 2730.

[478] OPUC Initial Brief at 43-44.

is closer to the 4.0% to 4.5% range.[479] Because Mr. Hevert relied on unreasonably high market growth rates when calculating his estimated market DCF returns for his CAPM analysis, it produces inflated and unreliable results. Therefore, OPUC contends that Mr. Hevert's CAPM results should not be considered by the Commission in establishing CenterPoint Houston's cost of equity.[480]

TCUC argues that Mr. Hevert's CAPM analysis employs an excessively high projected long-term risk-free interest rate. Additionally, TCUC contends that Mr. Hevert's MRPs of 10.72% and 14.10% are exaggerated and do not reflect current market fundamentals.[481]

Further, according to TCUC, Mr. Hevert's EPS growth-rate projections and the resulting expected market returns and MRPs include highly unrealistic assumptions regarding future economic and earnings growth and stock returns. Long-term EPS and economic growth are about one-half of Mr. Hevert's projected EPS growth rates of 11.55% and 15.00%, and have been in the 6% to 7% range.[482] Long-term EPS and GDP growth are directly linked and more recent trends in GDP growth, as well as projections of GDP growth, suggest slower economic and earnings growth in the future.[483] As Dr. Woolridge noted, Mr. Hevert's growth estimates suggest that companies in the U.S. would be expected to increase their growth rate of EPS by 100% in the future, and maintain that growth indefinitely in an economy that is expected to grow at about one-third of his projected growth rates, both unrealistic expectations.[484]

TCUC points out that real GDP growth has gradually declined from the 5.0% to 6.0% range in the 1960s to the 2.0% to 3.0% range during the most recent five-year period. Inflation, the

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[479] OPUC Initial Brief at 43-44, *citing* TIEC Ex. 5 at 80-81.

[480] OPUC Initial Brief at 44.

[481] TCUC Ex. 1 at 60.

[482] TCUC Ex. 1 at 62.

[483] TCUC Ex. 1 at 62-63.

[484] TCUC Ex. 1 at 62.

second component of nominal GDP growth, has declined from above 10% to about 4% in the 1980s, and has been in the 2.0% range or below over the past five years.[485] Moreover, long-term projections of GDP also indicate slower GDP growth in the future in the range of 4.0% to 4.4%. The trends and projections indicating slower GDP growth make Mr. Hevert's MRPs, using analysts' projected EPS growth rates, look even more unrealistic. Mr. Hevert's projected EPS growth rates of 11.55% and 15.00% are almost three times projected GDP growth.[486]

To achieve the ROEs Mr. Hevert recommends, TCUC contends that expected returns would need to be 13.75% (using Bloomberg three- to five-year EPS growth rate estimates) and 17.14% (using Value Line three- to five-year EPS growth rate estimates). TCUC argues that on their face, these results are at best questionable, but more to the point, unrealistic in today's market environment.[487]

Mr. Hevert in his CAPM analysis used the three-to-five- year projected EPS growth rates with Bloomberg and Value Line adjusted Betas, despite the fact that utility Betas do not regress to 1.0 over three-to-five year time periods, thus (in TCUC's view) making it erroneous to use adjusted Betas.[488]

Staff echoes the criticisms leveled at Mr. Hevert's CAPM analysis by the other intervenors. Staff specifically notes that Mr. Hevert based his CAPM analysis on inflated MRPs of 10.72% and 14.10%,[489] which Mr. Hevert derived from assumed market growth of 11.63% to 14.82%. In contrast, the actual capital appreciation of the S&P 500 between 1926 and 2018 was between 5.8%

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[485] TCUC Ex. 1 at 63.

[486] TCUC Ex. 1 at 64-65.

[487] TCUC Ex. 1 at 60.

[488] TCUC Ex. 1 at 54.

[489] Staff Reply Brief at 16, *citing* CenterPoint Ex. 26 at 2771, Exh. RBH-4.

and 7.7%.[490] According to Staff, this practice of using inflated growth rates and risk premiums is consistently used by Mr. Hevert and has been called into question by other commissions.[491]

CenterPoint contends that TIEC witness Gorman's 9.20% expected total market return estimate, which is 268 basis points below the long-term average market return, falls outside the range of average returns during the period 1976-2018 using 50-year annual averages; his higher 11.10% estimate falls in the 14th percentile of the average return over the last fifty years on a rolling average basis and is not reasonable.[492] CenterPoint witness Hevert also critiqued Mr. Gorman's use of historical average MRP because the MRP is inversely related to government bond yields. That is, as interest rates fall, the MRP increases. CenterPoint notes that, in contrast with Mr. Gorman's position, financial researchers have found the MRP to be time-varying, and a function of economic parameters including interest rates.[493]

Mr. Hevert also disagreed with OPUC witness Winker's CAPM analysis even though she stated that she used it only as a qualitative check. Ms. Winker relied on the long-term arithmetic average difference between the returns on common stocks and long-term government bills, as provided in Duff & Phelps' 2018 Valuation Handbook.[494] As Duff & Phelps notes, the long-term return on Large Company Stocks was 12.10%, and the total return on long-term government bills was 3.40%; the approximate difference between the two (8.70%) is the MRP on which Ms. Winker relied. According to Mr. Hevert, there are two problems with that approach. First, Ms. Winker's calculation relied on the return on long-term government bills. Second, her approach does not consider that the MRP changes with the level of interest rates.[495]

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[490] Staff Reply Brief at 16, *citing* TIEC Initial Brief at 30; *see also* TIEC Ex. 5 at 81.

[491] Staff Reply Brief at 16.

[492] CenterPoint Ex. 42 at 81.

[493] CenterPoint Ex. 42 at 82-83.

[494] *See* OPUC Ex. 3 at 39.

[495] CenterPoint Ex. 42 at 63.

According to Mr. Hevert, TCUC witness Woolridge's CAPM analysis produced an estimated cost of equity of 7.30% for both his and Mr. Hevert's proxy groups.[496] Mr. Hevert stated that he strongly disagreed an estimate that low is a reasonable measure of CenterPoint's cost of equity and that Dr. Woolridge's unduly low CAPM estimate principally falls from his estimated MRP.

Dr. Woolridge combined a risk-free rate of 4.00% and an MRP of 5.50% to the average Beta coefficient of his and Mr. Hevert's proxy groups (0.60)[497]. In estimating his MRP, Dr. Woolridge reviewed a series of studies that calculate the MRP using different methodologies; he also considered the results of his "Building Blocks" approach. Based on that review, Dr. Woolridge argued the MRP ranges from 4.00% to 6.00% and, within that range, 5.50% is reasonable.[498]

4. Empirical CAPM Analysis

In response to Dr. Woolridge's comments, Mr. Hevert performed the Empirical form of the CAPM (ECAPM).[499] Mr. Hevert described this as a method that can be applied to address the change in Beta coefficients. The ECAPM adjusts for CAPM's tendency to underestimate returns for companies that (like utilities) have Beta coefficients less than the market mean of 1.00, and over-estimate returns for relatively high-Beta coefficient stocks.[500] Mr. Hevert noted that Fama and French describe the empirical issue addressed by the ECAPM when they state that "[t]he returns on the low beta portfolios are too high, and the returns on the high beta portfolios are too

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[496] TCUC Ex. 1 at 48.

[497] Mr. Hevert noted that Dr. Woolridge's and Mr. Hevert's proxy groups have the same average Beta coefficient value. CenterPoint Ex. 42 at 130.

[498] TCUC Ex. 1 at 47.

[499] CenterPoint Ex. 42 at 6.

[500] Roger A. Morin, New Regulatory Finance (Public Utility Reports, Inc., 2006) at 175-76.

low."[501] Similarly, Dr. Morin observed that "[w]ith few exceptions, the empirical studies agree that ... low-beta securities earn returns somewhat higher than the CAPM would predict, and high-beta securities earn less than predicted."[502] As Dr. Morin also explained, the ECAPM "makes use" of those findings, and estimates the cost of equity.[503]

Mr. Hevert performed an analysis of excess returns produced by the CAPM, by Beta coefficient decile, over the ten years ended 2018. The analysis compared the observed returns of the companies in the S&P 500 Index to expected returns based on the CAPM. Observed returns were calculated as the total return for each company from the first day of a given year to the end of that year. The expected return for each company was calculated using the CAPM as applied to the following annual data: (1) a risk-free rate equal to the average 30-year Treasury yield for that year; (2) an adjusted Beta coefficient as of the beginning of the year using Bloomberg's standard calculation method (two years of weekly return data, using the S&P 500 Index as the comparison benchmark); and (3) a market return equal to the S&P 500 Index total return for that year. The companies were grouped into deciles each year based on their Beta coefficients, and the median excess return (or return deficiency) was calculated for each decile group. Excess returns were calculated as the observed return less the return implied by the CAPM.[504] This analysis shows that the relationship between excess return and Beta coefficient deciles is strong, with deciles explaining approximately 69.00% of the excess return. Using the same data and calculating the excess return by reference to the ECAPM produces the same downward sloping relationship, but not to the same degree.[505]

According to Mr. Hevert, there are two principal observations to be drawn from the data presented his analysis. First, under the ECAPM the slope coefficient falls somewhat (relative to

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[501] Eugene F. Fama & Kenneth R. French, *The Capital Asset Pricing Model: Theory and Evidence*, Journal of Economic Perspectives, Vol. 18, No. 3, Summer 2004, at 33.

[502] Roger A. Morin, New Regulatory Finance (Public Utility Reports, Inc., 2006) at 175.

[503] Roger A. Morin, New Regulatory Finance (Public Utility Reports, Inc., 2006) at 189.

[504] CenterPoint Ex. 42 at 147-48.

[505] CenterPoint Ex. 42 at 148-49.

the CAPM), suggesting a flatter relationship between Beta coefficient deciles and the excess return. The flatter slope moves closer to the point at which the excess return is zero across all deciles. Second, the excess return values are somewhat moderated under the ECAPM; the high excess returns are lower than under the CAPM, and the low excess returns are higher. Again, that finding suggests the ECAPM mitigates, but does not solve, the issue of the CAPM underestimating returns for low-Beta coefficient firms.[506]

Mr. Hevert opined that the CAPM tends to underestimate returns for low-Beta coefficient firms, and the ECAPM moderates that effect to some extent, but it does not appear to eliminate it. Because the ECAPM mitigates the drift in Beta coefficients (which Dr. Woolridge addressed in his discussion of adjusted Beta coefficients), Mr. Hevert believed it is a reasonable method, and had included results based on the ECAPM in his updated analyses.[507]

5. Bond Yield Plus Risk Premium Analysis

The Bond Yield Plus Risk Premium approach is based on the basic financial tenet that equity investors bear the residual risk associated with ownership and therefore require a premium over the return they would have earned as a bondholder. That is, since returns to equity holders are riskier than returns to bondholders, equity investors must be compensated for bearing that additional risk. Risk premium approaches, therefore, estimate the cost of equity as the sum of the equity risk premium and the yield on a particular class of bonds. Since the equity risk premium is not directly observable, it typically is estimated using a variety of approaches, some of which incorporate forward-looking estimates of the cost of equity, and others that consider historical, or ex-post, estimates.[508]

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[506] CenterPoint Ex. 42 at 149.

[507] CenterPoint Ex. 42, at Exh. R-RBH-4.

[508] CenterPoint Ex. 26 at 2731; TIEC Ex. 5 at 54; OPUC Ex. 3 at 33; Staff Ex. 3A at 26.

Mr. Hevert conducted his analysis by first defining the risk premium as the difference between the authorized ROE and the then-prevailing level of long-term (*i.e.*, 30-year) Treasury yield. He then gathered data for 1,580 electric utility rate proceedings between January 1, 1980, and February 15, 2019. In addition to the authorized ROE, he also calculated the average period between the filing of the case and the date of the final order (the "lag period"). To reflect the prevailing level of interest rates during the pendency of the proceedings, he calculated the average 30-year Treasury yield over the average lag period (approximately 200 days).[509]

Because the data cover a number of economic cycles, the analysis also may be used to assess the stability of the equity risk premium. Mr. Hevert contended that prior research, for example, has shown that the equity risk premium is inversely related to the level of interest rates. That analysis is particularly relevant given the relatively low, but increasing, level of current Treasury yields.[510]

Mr. Hevert explained that the basic method used to analyze the relationship between interest rates and the equity risk premium was regression analysis, in which the observed equity risk premium is the dependent variable, and the average 30-year Treasury yield is the independent variable. Relative to the long-term historical average, the analytical period includes interest rates and authorized ROEs that are quite high during one period (*i.e.*, the 1980s) and that are quite low during another (*i.e.*, the post-Lehman bankruptcy period). To account for that variability, he stated that he used the semi-log regression, in which the equity risk premium is expressed as a function of the natural log of the 30-year Treasury yield. Mr. Hevert argued that the semi-log form is useful when measuring an absolute change in the dependent variable (in this case, the risk premium) relative to a proportional change in the independent variable (the 30-year Treasury yield).[511]

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[509] CenterPoint Ex. 26 at 2731-32.

[510] CenterPoint Ex. 26 at 2732.

[511] CenterPoint Ex. 26 at 2732.

According to Mr. Hevert, over time there has been a statistically significant, negative relationship between the 30-year Treasury yield and the equity risk premium. Consequently, simply applying the long-term average equity risk premium of 4.66% would significantly understate the cost of equity and produce results well below any reasonable estimate.[512]

TIEC witness Gorman defined the "Risk Premium" as the difference between average annual authorized equity returns for electric utilities and a measure of long-term interest rates each year from 1986 through 2019.[513] Mr. Gorman's first approach calculates the annual risk premium by reference to the 30-year Treasury yield, and his second approach considers the average A-rated utility bond yield.[514] In each case, Mr. Gorman established his risk premium estimate by reference to five-year and ten-year rolling averages. The lower and upper bounds of Mr. Gorman's risk premium range are defined by the lowest and highest rolling average, respectively, regardless of the year in which those observations occurred.[515]

Mr. Gorman's risk premium analysis separately estimates the additional return that has historically motivated investors to hold utility stock instead of (1) risk-free U.S. Treasury bonds and (2) "A" rated utility bonds.[516] These analyses are based on a comparison of historically awarded utility ROEs to Treasury bond yields and "A" rated utility bond yields, respectively, over the period from 1986 through 2019.[517] This time period was chosen because electric utility stocks consistently traded at a premium to book value over that span, meaning that electric utilities were awarded ROEs that were generally high enough to support market prices in excess of book value and provide utilities with an opportunity to access equity markets.[518] Mr. Gorman calculated

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[512] CenterPoint Ex. 26 at 2733.

[513] TIEC Ex. 5 at 54-55.

[514] TIEC Ex. 5 at 54-55, Exh. MPG-16, Exh. MPG-17.

[515] TIEC Ex. 5 at 55, Exh. MPG-16, Exh. MPG-17.

[516] TIEC Ex. 5 at 54.

[517] TIEC Ex. 5 at 54-55.

[518] TIEC Ex. 5 at 55-56.

average indicated equity risk premiums that utility investments demanded over U.S. Treasury bond yields and "A" rated utility bond yields over the last 33 years.[519] Additionally, to reflect the dynamic nature of utility risk premiums and mitigate the impact of anomalous market conditions, Mr. Gorman also calculated five- and ten-year rolling average risk premiums.[520]

Mr. Gorman analyzed empirical data to determine how the market is currently pricing investment risk.[521] By comparing historical and recent yield spreads for utility bonds and general corporate bonds, Mr. Gorman concluded that today, the market is paying a premium for access to lower-risk utility securities—a premium that is not reflected in higher-risk bond offerings.[522] As a result, Mr. Gorman applied an above-average risk premium by weighting his high-end risk premium estimates (70% weight) significantly higher than the low-end estimates (30% weight).[523] TIEC opined that this had the effect of increasing the ROE recommendation based on Mr. Gorman's risk premium analysis.[524]

Ms. Winker began with the data that Mr. Hevert gathered from SNL Financial to calculate an annual average authorized ROE for regulated electric utility companies.[525] However, instead of using the average 30-year Treasury yields (including a 200-day lag period) and projected near-term and long-term 30-year Treasury yields, Ms. Winker used Moody's Average Public Utility Bond Yields as reported in Mergent Bond Records.[526] Public utility bonds are issued in the industry in which CenterPoint operates; therefore, they provide a more comparable and reasonable

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[519] TIEC Ex. 5 at 55-56, Exh. MPG-16, Exh. MPG-17.

[520] TIEC Ex. 5 at 55-56, Exh. MPG-16, Exh. MPG-17.

[521] TIEC Ex. 5 at 57-58.

[522] TIEC Ex. 5 at 59.

[523] TIEC Ex. 5 at 60.

[524] TIEC Initial Brief at 20.

[525] OPUC Ex. 3 at 34.

[526] OPUC Ex. 3 at 34-35.

estimate of investor risk premium expectations than 30-year historical and projected Treasury yields.[527]

Next, Ms. Winker calculated the difference between the SNL Financial annual average authorized ROEs from January 2000 to December 2018 and Moody's Average Public Utility Bond Yields for the same period.[528] Using this shorter and more current 18-year time period effectively captures the trend in authorized ROEs while remaining long enough to encompass the last two recessions and the last two periods of economic growth.[529] The average risk premium during this 18-year period was 4.64%.[530]

Finally, Ms. Winker added her risk premium of 4.64% to the average 2018 Moody's utility bond yields of 4.34% to reach an ROE of 8.98%.[531] She also added her risk premium to the 4.40% Moody's BBB utility bond yield reported on May 17, 2019 to reach an ROE of 9.04%. Using the resulting ROEs as the upper and lower bounds, Ms. Winker's bond yield plus risk premium model results in a recommended ROE range of 8.98% to 9.04%.[532]

Staff witness Ordonez's "conventional risk premium" methodology estimated the cost of CenterPoint's equity by comparing the costs of equity authorized for electric utilities across the United States to the yields of large-company corporate bonds that are rated Baa by Moody's.[533] This risk premium approach relies on the historical relationship between two indices to forecast a value for one of the indices in a period for which it is unknown by using the known value of the other one during that same period.[534]

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[527] OPUC Ex. 3 at 35.

[528] OPUC Ex. 3 at 35 and Att. AW-3.

[529] OPUC Ex. 3 at 34.

[530] OPUC Ex. 3 at 35.

[531] OPUC Ex. 3 at 35.

[532] OPUC Ex. 3 at 35.

[533] Staff Ex. 3A at 24.

[534] Staff Ex. 3A at 12-13.

To account for the relationship between the authorized costs of equity and the bond yields required to quantify CenterPoint's cost of equity, Mr. Ordonez subtracted the bond yields from the historical authorized costs of equity to determine a risk premium for the riskier equity. The data were tested by performing a regression analysis, which showed with high confidence that there is a trend in the relationship between risk premiums and bond yields. It is an inverse trend, in which the risk premiums increase as bond yields decrease. On average, during the 1980 to 2018 time period, risk premiums increased 0.4392% for every 1.00% that bond yields decreased.[535] The results of this risk premium analysis indicate a cost of equity of 9.79%.[536]

TIEC contends that because of errors in his analysis, Mr. Hevert's recommendation significantly overstates CenterPoint's market cost of equity and results in an excessive, unjustified ROE recommendation. With respect to risk premium, TIEC argues that Mr. Hevert's bond yield plus risk premium studies are based on inflated utility equity risk premiums, which translate into inflated ROE recommendations.[537]

OPUC argues that Mr. Hevert's analysis has several conceptual problems that result in an inflated risk premium.[538] Mr. Hevert based his analysis on electric utility rate proceedings conducted between January 1, 1980, and February 15, 2019, which had an average risk premium of 4.66%.[539] This amount is comparable to the risk premium of 4.64% calculated by Ms. Winker. However, because Mr. Hevert believed that his calculated risk premium would understate the cost of equity, he made an upward adjustment of 1.46% to 2.24%, which he stated accounts for the inverse relationship between interest rates and risk premiums.[540] The adjustment results in Mr. Hevert's recommended ROE range moving upward from an unadjusted 7.69% - 8.71% to

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[535] Staff Ex. 3A at 24-25.

[536] Staff Ex. 3A at 2, 47, Att. JO-7.

[537] TIEC Ex. 5 at 71.

[538] OPUC Ex. 3 at 36-37.

[539] CenterPoint Ex. 26 at 2731, 2733.

[540] OPUC Ex. 3 at 36; CenterPoint Ex. 26 at 2733.

9.93% - 10.17%.[541] However, Mr. Hevert's adjustment to account for the inverse relationship between interest rates and risk premiums was redundant and inflates his results. The 39 years of historical data that Mr. Hevert used to calculate his risk premium reaches back to 1980 and incorporates various periods of very high, medium, and very low interest rates, according to OPUC. Mr. Hevert's 39-year time period makes it unnecessary to upwardly adjust his risk premium because it already incorporates the tendency of an inverse relationship between interest rates and risk premiums.[542]

Further, TIEC contends, Mr. Hevert's upward adjustment to his 4.66% basic risk premium also does not recognize that investor-expected risk premiums do not remain constant over time. As noted by TIEC witness Gorman, academic studies have shown that the relationship between interest rates and risk premiums is influenced by changes in *perception of the risk* of bond investments relative to equity investments, and not simply by changes in interest rates.[543]

TCUC witness Woolridge contended that the base yield in Mr. Hevert's risk premium analyses is the prospective yield on long-term, Treasury bonds. This includes a long-term projected rate of 4.05%. Investors would not be buying Treasury bonds at their current yield of about 2.75% if they expected interest rates to go up to 4.05% in the future. This would, in Dr. Woolridge's opinion, result in a significant negative return due to the inverse relationship between interest rates and bond prices.[544]

According to Dr. Woolridge, there are several problems with Mr. Hevert's approach to the risk premium analysis. First, his risk premium methodology produces an inflated measure of the risk premium because the approach uses historic authorized ROEs and Treasury yields, and the resulting risk premium is applied to projected Treasury yields. Since Treasury yields are always

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[541] OPUC Ex. 3 at 35; CenterPoint Ex. 26 at Exh. RBH-5.

[542] OPUC Ex. 3 at 36.

[543] TIEC Ex. 5 at 83-84.

[544] TCUC Ex. 1 at 74.

forecasted to increase, the resulting risk premium would be smaller if done correctly, which would be to use projected Treasury yields in the analysis rather than historic Treasury yields.[545]

In addition, Mr. Hevert's risk premium approach is a gauge of commission behavior and not investor behavior, TCUC argues. Capital costs are determined in the market place through the financial decisions of investors and are reflected in such fundamental factors as dividend yields, expected growth rates, interest rates, and investors' assessment of the risk and expected return of different investments. Regulatory commissions evaluate capital market data in setting authorized ROEs, but also take into account other utility- and rate case-specific information in setting ROEs.[546]

Finally, Dr. Woolridge contended that Mr. Hevert's methodology produces an inflated required rate of return since utilities have been selling at market-to-book ratios well in excess of 1.0 for many years. This indicates that the authorized and earned rates of ROE have been greater than the return that investors require.[547]

Mr. Hevert expressed general concerns about TIEC witness Gorman's risk premium analyses in addition to several specific concerns. In assessing his DCF analyses, Mr. Gorman relied on his highest results, effectively discarding several other results ranging from 8.11% to 8.21%.[548] In a similar fashion, Mr. Gorman relied on his high-end CAPM result, discarding an 7.40% estimate.[549] In his risk premium analysis, however, Mr. Gorman retained risk premiums that produced ROE estimates below the DCF and CAPM estimates he discarded. Despite their low levels, Mr. Gorman gave those risk premium estimates (producing ROE results of 7.45% and

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[545] TCUC Ex. 1 at 74-75.

[546] TCUC Ex. 1 at 75.

[547] TCUC Ex. 1 at 75.

[548] CenterPoint Ex. 42 at 54.

[549] CenterPoint Ex. 42 at 66.

7.50%) weights of 30% in aggregate. Mr. Gorman did not explain why he would exclude DCF results of 8.21% and lower, but include risk premium results of 7.45% and 7.50%.[550]

Turning to his specific concerns, Mr. Hevert testified that he had three concerns with his analysis: (1) Mr. Gorman's method understates the required risk premium in the current market because it fails to reasonably reflect an important relationship confirmed by his own data, *i.e.,* that the risk premium is inversely related to the level of interest rates (whether measured by Treasury or utility bond yields); (2) the low end of Mr. Gorman's risk premium results is far lower than any ROE authorized since at least 1986 and, as such, is disconnected to CenterPoint's current cost of equity; and (3) Mr. Gorman suggested a market/book ratio of 1.00 is a relevant benchmark for assessing authorized ROEs.[551]

With respect to OPUC witness Winker's risk premium analysis, Ms. Winker's bond yield plus risk premium analysis uses a shorter data set (18 years) than Mr. Hevert's analysis does. Ms. Winker argued her shorter period better reflects current investor expectations and market conditions,[552] 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.[553] According to CenterPoint, 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.[554]

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[550] CenterPoint Ex. 42 at 85.

[551] CenterPoint Ex. 42 at 55.

[552] OPUC Ex. 3 at 34.

[553] CenterPoint Ex. 42 at 58.

[554] CenterPoint Ex. 42 at 59.

6. Expected Earnings Analysis

Mr. Hevert also performed an expected earnings analysis, which is based on the principle of opportunity costs. Because investors may invest in, and earn returns on alternative investments of similar risk, those rates of return can provide a useful benchmark in determining the appropriate rate of return for a firm.[555]

The expected earnings analysis typically takes the actual earnings on book value of investment for each of the members of the proxy group and compares those values to the rate of return in question. Although the traditional approach uses data based on historical accounting records, it is common to use forecasted data in conducting the analysis. Projected returns on book investment are provided by various industry publications (*e.g.,* Value Line), which Mr. Hevert used in his analysis.[556]

Mr. Hevert stated that he relied on Value Line's projected return on common equity for the period 2021-2023, and adjusted those projected returns to account for the fact that they reflect common shares outstanding at the end of the period, rather than the average shares outstanding over the course of the year.[557] The expected earnings analysis results in an average value of 10.27% and a median value of 10.26%.[558]

Mr. Hevert applied an expected earnings analysis in an attempt to bolster the outputs of his other models. That analysis used Value Line's projected returns on "book equity" to show that analysts expect the proxy group to actually earn returns in excess of 10%.[559] However, the

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[555] CenterPoint Ex. 26 at 73.

[556] CenterPoint Ex. 26 at 73.

[557] Mr. Hevert explained that the rationale for that adjustment is straightforward: Earnings are achieved over the course of a year, and should be related to the equity that was, on average, in place during that year. *See* Leopold A. Bernstein, Financial Statement Analysis: Theory, Application, and Interpretation at 630, Irwin, 4th ed., 1988.

[558] CenterPoint Ex. 26 at 2734.

[559] CenterPoint Ex. 26 at 2733.

expected earnings analysis only says what a proxy group of utilities' earnings (likely) will be, and that information is not helpful in utility ratemaking, which attempts to determine a fair market ROE rather than just awarding returns based on other utilities' expected performance.[560]

As Mr. Gorman explained, projected book accounting return is useful only in determining whether utilities' rate revenues are generally too high or too low to achieve a valid market ROE.[561] In other words, the expected earnings analysis will show whether the proxy group utilities are generally projected to over- or under-earn. However, it could just be the case that analysts' projected earnings for the proxy group are high because, on average, their rates are simply set too high and/or they are expected to earn in excess of a fair market return. In fact, TIEC notes that Mr. Hevert's result is easily explained by Charles Griffey's analysis that regulators have been slow to decrease utility ROEs to market levels in response to changing market conditions.[562] Just because the proxy group is projected to earn a high actual return does not mean that regulated rates should be set at that level. It could simply mean that in general, the proxy group utilities are projected to earn more than is fair to ratepayers.[563]

Further, using expected earnings to set utility rates simply perpetuates those projections: if a proxy group of similar utilities is generally expected to over-earn, then the expected earnings analysis would suggest that their rates should be increased, and if rates are increased in response to that analysis then the group's expected earnings would increase even further. And vice versa in the event they were expected to under-earn. As such, TIEC argues that the expected earnings analysis is meaningless in the context of a proceeding that is designed to develop a fair market return, and the Commission should disregard the results of that analysis.[564]

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[560] TIEC Initial Brief at 32.

[561] TIEC Ex. 5 at 88.

[562] TIEC Ex. 4 at 26-27.

[563] TIEC Initial Brief at 32-33.

[564] TIEC Initial Brief at 33.

TCUC likewise responded negatively to Mr. Hevert's expected earnings analysis, arguing that this approach does not measure the market cost of equity capital because there is no way to assess whether the earnings are greater than or less than the earnings investors require, and therefore this approach does not measure the market cost of equity capital.[565]

According to TCUC, Mr. Hevert's expected earnings approach is independent of most cost of capital indicators. The ROE ratios are an accounting measure that does not measure investor return requirements. Investors had no opportunity to invest in the proxy companies at the accounting book value of equity. That is, the equity's book value to investors is tied to market prices, which means that investors' required return on market-priced equity aligns with expected return on book equity only when the equity's market price and book value are aligned. Therefore, a market-based evaluation of the cost of equity to investors in the proxies requires an associated analysis of the proxies' market-to-book ratios.[566]

7. Economic and Market Considerations

Mr. Hevert considered the particular operational and financial risk factors that CenterPoint faces, including its elevated capital expenditure programs relative to peer utilities, its geographic and weather-related risks, its regulatory framework, and its customer concentration.[567] 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 CenterPoint's ROE should fall within the range of results.[568]

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[565] TCUC Ex. 1 at 76.

[566] TCUC Ex.1 at 76-77.

[567] CenterPoint Ex. 26 at 2703-13.

[568] CenterPoint Ex. 26 at 2703. Although he indicated that he used flotation costs as a consideration in determining the appropriate ROE, Mr. Hevert did not propose a specific adjustment for flotation costs. CenterPoint Ex. 26 at 2699-2703. As a consequence, although CenterPoint, TIEC, and TCUC include arguments regarding flotation costs in their testimony and briefs, this PFD will not address it further.

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.[569] Moreover, investors are projecting that interest rates will keep rising throughout the remainder of 2019 and 2020.[570] Because equity investors demand a premium over the cost of debt, the rising debt costs lead investors to require higher equity returns.[571]

Mr. Hevert also expressed concern about the impacts of the recently enacted TCJA. He noted that the major rating agencies have observed that a reduction in utilities' revenue associated with lower income taxes and the potential return of, and the loss of bonus depreciation also may reduce utilities' cash flow, putting downward pressure on key credit metrics. Because rating agencies have assessed the consequences of the TCJA to utilities' cash flow and credit statistics, he argued that it is reasonable to assume equity investors also recognize those concerns.[572]

With respect to the business risks that CenterPoint faces, Mr. Hevert observed that although the Commission recently updated its credit requirements for REPs with below-investment-grade credit ratings, including stand-by letters of credit,[573] there remains a high degree of customer concentration in CenterPoint's case and, consequently, a relatively high risk of suffering an adverse financial effect following an event of default by one or more of these customers.[574] According to Mr. Hevert, if just one of CenterPoint's larger customers were to declare bankruptcy, or were to delay or default on its obligations, CenterPoint's financial profile may be adversely

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[569] CenterPoint Ex. 26 at 2671-83; *see* Tr. at 531.

[570] *See* CenterPoint Ex. 26 at 2673.

[571] CenterPoint Initial Brief at 56.

[572] CenterPoint Ex. 26 at 2677-80.

[573] *Rulemaking to Amend Chapter 23 Substantive Rules Relating to the Elimination of the System Benefit Fund*, Project No. 47343 Order at 172-173, Adopting Amendments to §§ 25.5, 25.41, 25.43, 25.107, 25.181, 25.344, 25.431, 25.475, 25.478, 25.479, 25.480, 25.491, 25.497, 25.498, Repeal of §§ 25.451, 25.453, 25.454, 25.455, and 25.457, and New § 25.45 as approved at the April 12, 2018 Open Meeting (Apr. 13, 2018).

[574] CenterPoint Ex. 26 at 2704.

affected, which is a potentially adverse effect on cash flow and is a significant source of risk for CenterPoint's equity investors.[575]

CenterPoint also faces the risk of sudden, unexpected damage from severe storms according to Mr. Hevert. The incidence of hurricanes, such as Ike in 2008 and Harvey in 2017, indicate that CenterPoint's operating area has a high risk of incurring weather-related infrastructure repair costs and service disruptions; CenterPoint incurred over $600 million in storm recovery in connection with Hurricane Ike, and approximately $117 million due to Hurricane Harvey.[576] In addition to the need to fund repair costs, severe weather causes CenterPoint to incur unplanned expenses and results in lower sales due to damage of T&D infrastructure. Together, these effects can reduce CenterPoint's revenue, put strain on its operating cash flow, and highlight the need for financial liquidity and flexibility.[577]

Finally, Mr. Hevert noted that CenterPoint's capital expenditure plan is significantly larger than its internally generated cash, likely placing downward pressure on its free cash flow and credit profile. CenterPoint's capital recovery mechanisms are important to continue to provide retained earnings as a funding source for it to avoid equity capital market risk. Although CenterPoint's recovery mechanisms may be credit supportive, in Mr. Hevert's opinion they are not necessarily credit enhancing. Consequently, Mr. Hevert argued that the Commission's decision in this proceeding will directly affect CenterPoint's ability to fund capital investments with operating cash flows, and the financial community's view of its financial profile.[578]

TIEC witness Michael Gorman argued that in the current market environment, utilities have maintained or improved their credit quality, access to capital, and stock valuations at much

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[575] CenterPoint Ex. 26 at 2705, citing CNP SEC Form 10-K at 25 for the fiscal year end December 31, 2018.

[576] CenterPoint Ex. 26 at 2706, citing CenterPoint, SEC Form 10-K at 6 for fiscal year end December 31, 2009; *see* CenterPoint Ex. 27.

[577] CenterPoint Ex. 26 at 2706-07.

[578] CenterPoint Ex. 26 at 2709-13.

lower authorized ROEs on average.[579] TIEC notes that Mr. Hevert admitted that since February 2018, no electric utility in the country has been awarded an ROE of greater than 10.0%.[580] Additionally, TIEC argues that the record shows that awarded ROEs have fallen even more for low-risk utilities like CenterPoint.[581] The average awarded ROE for wires-only utilities was 9.18% in the first half of 2018—122 basis points below CenterPoint's request—which was down from an average of 9.43% across all of 2017.[582] This downward trend in utility ROEs has not impaired the credit quality of utilities, or their ability to access capital, according to TIEC. To the contrary, as shown in an *RRA Financial Focus*, utilities have continued to access significant amounts of capital to support construction programs over the past decade.[583]

Even compared to historically high risk premiums for regulated utilities, TIEC contends that CenterPoint's rate request is disproportionately high. Since 1980, utility ROEs have been above 30-year Treasury yields by an average of 467 basis points.[584] CenterPoint's requested ROE of 10.4% would be 730 basis points above long-term Treasury yields, which TIEC states is well above the all-time high for utility risk premiums.[585] According to TIEC witness Mr. Griffey, these risk premiums are "allowing equity investor returns equivalent or superior than what is available in the markets generally, but for *a lower level of risk*. This runs completely counter to reasonable economics or market theory. As one observer colorfully put it, '...if you want actionable [investment] intelligence up front, here it is: invest in regulated utilities.'"[586]

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[579] TIEC Ex. 5 at 8.

[580] CenterPoint Ex. 42 at 73; Tr. at 741.

[581] TIEC Initial Brief at 11.

[582] TIEC Ex. 19 (S&P Article: "Average U.S. Electric, Gas ROE Authorizations in H1'18 Down from 2017") at 2; Tr. at 714-15.

[583] TIEC Ex. 5 at 11, citing S&P Global Market Intelligence, RRA Financial Focus: "Utility Capital Expenditures Update," (Oct. 30, 2018).

[584] TIEC Ex. 4 at 26-27.

[585] TIEC Ex. 4 at 27.

[586] TIEC Ex. 4 at Exh. CSG-3, p. 8 (quoting Huntoon, S., "Nice Work If You Can Get It," Public Utilities Fortnightly (Aug. 2016)).

OPUC argues that it appears that interest rates will continue to remain at low levels for the foreseeable future, and CenterPoint's authorized cost of equity should reflect this market expectation.[587] OPUC also takes issue with the contention that investors currently see the utility sector as relatively risky. OPUC witness Winker testified, "[m]ost electric utility stocks have performed well in 2019."[588] The U.S. financial market viewed the TCJA as an overall near-term negative but a longer-term positive for regulated utilities, and has continued to view the assets of regulated utilities as critical infrastructure assets that are generally less risky than other types of corporate assets.[589] According to OPUC, the utility sector has exhibited robust utility stock valuations over the last several years, which is a strong indicator that utilities have access to capital under reasonable terms and conditions, and at relatively low costs.[590]

TCUC argues that the trend in authorized ROEs that regulatory agencies have been approving is downward.[591] It contends that the uncontroverted evidence established that from 2000 to 2018, authorized ROEs for electric utilities have declined from an average of 10.01% in 2012, to 9.8% in 2013, 9.76% in 2014, 9.58% in 2015, 9.60% in 2016, 9.68% in 2017, 9.56% in 2018, and 9.57% in the first quarter of 2019.[592] Moreover, authorized ROEs for companies like CenterPoint, a "wires-only" company, have consistently been 30 to 50 basis points below those of vertically integrated utilities because of the lesser risk "wires-only" companies face.[593] In 2018, the average authorized ROE for electric delivery companies was 9.38%.[594]

TCUC contends that despite the Federal Reserve's moves to increase the federal funds rate, interest rates and capital costs have remained at historically low levels and are likely to remain low

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[587] OPUC Initial Brief at 35-36.

[588] OPUC Ex. 3 at 5.

[589] OPUC Ex. 3 at 17.

[590] OPUC Ex. 3 at 17.

[591] TCUC Ex. 1 at 12-13.

[592] TCUC Ex. 1 at 13.

[593] TCUC Ex. 1 at 13-14.

[594] TCUC Ex. 1 at 14.

for some time.[595] TCUC argues that even considering this fact, Mr. Hevert's analyses and ROE results and recommendations continue to reflect the assumption of higher interest rates and capital costs, a prediction he has made in this proceeding and at least three recent proceedings before Texas regulatory agencies, predictions that have not been borne out.[596]

Staff argues that in the last five rate cases for investor-owned electric utility companies, the Commission has authorized an ROE between 9.50% and 9.65%.[597] Staff contends that CenterPoint agrees with this, because in its initial brief CenterPoint notes, "[t]he evidence in this proceeding establishes that the average authorized ROE for electric utilities since 2014 is 9.68%, and the Commission's most recently authorized ROE is 9.65%."[598]

Furthermore, Staff opines that its ROE recommendation is consistent with the national average authorized ROE of 9.42% for delivery-only electric utilities in other jurisdictions as published on the S&P Global Market Intelligence RRA Regulatory Focus report for the first quarter of 2019 (1Q-2019 S&P Global Market Intelligence RRA Report).[599] This is notable, according to Staff, considering that the "delivery-only" electric utilities included in the S&P Global Market Intelligence RRA Regulatory Focus reports purchase and sell electricity and therefore have greater risk than CenterPoint, a wires-only utility that is not affected by the

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[595] TCUC Ex. 1 at 5. *See also* TCUC Ex. 96 (showing U.S. Treasury yields from Jan. 1, 2019, to Jun. 24, 2019, declining); and TCUC Ex. 97 (showing the probability that the Federal Reserve would increase interest rates at its upcoming meetings through May 29, 2020, at zero).

[596] TCUC Ex. 92 (Hevert Direct Testimony in Gas Utility Docket 10779, Atmos Energy, Inc.'s 2018 Rate Case before the Railroad Commission of Texas); TCUC Ex. 93 (Hevert Direct Testimony in Docket No. 47527 SPS's 2017 Rate Case); and TCUC Ex. 94 (Hevert Direct Testimony in Docket No. 46957 (Oncor's 2017 Rate Case)).

[597] *Application of El Paso Electric Company to Change Rates*, Docket No. 46831, Order, FoF No. 30 (Dec. 18, 2017); Docket No. 46449 order, FoF Nos. 158-160; *Entergy Texas, Inc.'s Statement of Intent and Application for Authority to Change Rates*, Docket No. 48371, Order, FoF Nos. 47-51 (Dec. 20, 2018); *Application of Southwestern Public Service Company for Authority to Change Rates*, Docket No. 47527, Order, FoF No. 58 (Dec. 10, 2018); Docket No. 48401 order, FoF No. 48.

[598] CenterPoint Initial Brief at 54.

[599] Staff Initial Brief at 28; Staff Ex. 3A at 29.

commodity risk associated with the purchase and sale of electricity.[600] In fact, the average awarded ROE for wires-only utilities was 9.18% in the first half of 2018.[601]

Staff contends that recent regulatory action belies the validity of Mr. Hevert's analysis. Other regulatory bodies have seriously questioned Mr. Hevert's consistent practice of using inflated growth rates and risk premiums. Furthermore, Staff argues that Mr. Hevert has recommended an ROE lower than 10.0% in only three out of 143 cases over the last five years, and during that time period, his recommended ROE was never adopted by a regulator.[602]

8. HEB Service Quality Issue

HEB recommends a reduction in CenterPoint's ROE because of CenterPoint's poor service quality,[603] based on PURA § 36.052, which requires that a utility's rate of return be calculated based in part on "the quality of the utility's services."[604]

HEB experienced frequent outages at its facilities located within CenterPoint's service area.[605] HEB's facilities with on-site generation experienced 521 outages from January 2017 through May 2019 for a total duration of approximately 20,000 minutes, which is just over 333 hours or 13.88 days.[606] These outages ranged from brief interruptions lasting less than one minute to longstanding outages lasting more than 17 hours.[607] Outages of less than one minute may cause HEB's equipment to malfunction.[608] HEB had reliability issues with CenterPoint

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[600] Staff Initial Brief at 28; Staff Ex. 3A at 29.

[601] TIEC Initial Brief at 11.

[602] Staff Reply Brief at 17, *citing* TIEC Initial Brief at 24.

[603] *See* HEB Initial Brief at 24-26.

[604] PURA § 36.052(2).

[605] HEB Ex. 1 at 16-18.

[606] HEB Ex. 1 at 11.

[607] HEB Ex. 1 at 9.

[608] HEB Ex. 1 at 16-17.

during the grand opening of a new store that forced HEB to shed load to avoid shutting down the store entirely during the grand opening.[609]

The value of the loss of electricity to HEB is four-fold: (1) the value of lost load to HEB is the loss of the product in the "cold chain," which is a large portion of HEB's inventory for a store or a manufacturing facility; (2) the cost of removing the product; (3) the harm from being unavailable to its customers during the outage; and (4) the cost to replace the product.[610]

Over the last three years, there were 45 separate instances where HEB experienced a longer outage in a single day than the outage duration experienced by an average CenterPoint customer for an entire year. These outages occurred at both older, existing facilities and newly developed facilities.[611]

After CenterPoint failed to address the reliability issues, HEB made the business decision that it was more cost-efficient for HEB to install on-site generation at its facilities than to continue to accrue the costs incurred due to CenterPoint's frequent power outages.[612] HEB's installation of on-site generation was so successful at resolving the issues caused by CenterPoint's frequent outages that HEB decided to expand the installation of on-site generation to additional stores to protect them from CenterPoint outages.[613]

CenterPoint argues that its SAIDI levels indicate that an "average customer" experienced less than two hours of outage minutes during the entire year.[614] In all but two years between 2008

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[609] HEB Ex. 1 at 12.

[610] HEB Ex. 1 at 8.

[611] HEB Ex. 1 at 17.

[612] HEB Ex. 1 at 13.

[613] HEB Ex. 1 at 13-14.

[614] CenterPoint Ex. 9 at 609.

and today, CenterPoint's SAIDI has been better than the Commission standard.[615] Among ERCOT investor-owned utilities, CenterPoint is consistently the least penalized utility for violations of the Commission's SAIDI standard.[616] Indeed, COH notes the "high level of customer satisfaction with CenterPoint's service reliability."[617] This is true despite the fact that CenterPoint is located in a climate that produces above average rainfall, routine thunderstorm and lightning activity, and annual exposure to tropical depressions, storms, and hurricanes.[618]

CenterPoint presents several additional responses to HEB's allegations:

- CenterPoint contends that HEB's allegations are limited to the experience of only a single customer and are based on unreliable data and incomplete analysis.

- CenterPoint serves over 2.5 million customers.[619] It is inappropriate to draw conclusions about CenterPoint's reliability based on a single customer, even one that takes service at 166 locations (0.00000664% of CenterPoint's total).

- The data presented by HEB are not reliable. CenterPoint witness Sugarek provided a variety of statistics related specifically to HEB's facilities that show good reliability and facts very different from those alleged by HEB witness George W. Presses.[620] Mr. Presses acknowledged that HEB has outage records for some, but not all of its facilities.[621] HEB's only outage records are for its facilities that have on-site generation installed.[622] In contrast, Ms. Sugarek presented comprehensive data for all of HEB's locations.[623]

- Mr. Presses's analysis is incomplete, because it does not account for problems caused by HEB's own equipment. Mr. Presses testified on redirect that none of the outages described in his testimony were the result of problems with HEB's

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[615] CenterPoint Ex. 9 at 609-11; CenterPoint Ex. 33 at 4-5.

[616] CenterPoint Ex. 33 at 5.

[617] COH/HCC Ex. 1 at 9.

[618] CenterPoint Ex. 33 at 6.

[619] Tr. at 1252.

[620] CenterPoint Ex. 33 at 8.

[621] HEB Ex. 1 at 10.

[622] HEB Ex. 1 at 11.

[623] CenterPoint Ex. 33 at 7.

equipment and that they were all the result of CenterPoint outages,[624] but admitted on examination that certain outages did result from matters on HEB's side of the meter rather than on CenterPoint's side of the meter.[625] CenterPoint contends that these instances undermine Mr. Presses's assurances that all of the outages he described are the fault of CenterPoint, not HEB's own equipment.

In response to CenterPoint's arguments that HEB's position is based on unreliable data, HEB notes that HEB, not CenterPoint, is in the best position to identify when an HEB location is experiencing a power outage. HEB's customers and partners experience these outages in real time and report the outages. Additionally, HEB contends that its data are reliable and are metered to the exact second. Mr. Presses testified that HEB's outages are captured by HEB, with each decrease in voltage from CenterPoint being recorded by HEB's meters at the HEB locations with on-site generation.[626]

HEB argues that, even relying on CenterPoint's data, CenterPoint is responsible for 8,345 total outage minutes, which is 139 hours or 5.8 days, in 2018 at HEB locations.[627] CenterPoint admits that its own data show that many HEB locations have experienced outages for at least two hours or more for 48 days out of the year for 2018 alone.[628]

HEB contends that, contrary to CenterPoint's claims, HEB has outage data for its locations without on-site generation. HEB's outage data for these locations are not as detailed or as granular as HEB's data for locations with on-site generation. Although HEB does not maintain as granular a data set for these locations, CenterPoint admitted that outages at these facilities have occurred, and continue to occur frequently. Such outages, even slight interruptions, at these stores without on-site generation cause damage to HEB's equipment. HEB has maintained throughout this proceeding that HEB locations with and without on-site generation experience frequent, sustained,

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[624] Tr. at 413-14 (Declassified).

[625] Tr. at 407-09, 413-14.

[626] Tr. at 417.

[627] CenterPoint Ex. 33 at 12.

[628] Tr. at 1218-19.

and continuing outages. HEB points out that Ms. Sugarek admitted on cross-examination that these outages have continued since Mr. Presses approached CenterPoint about these issues in 2015,[629] with CenterPoint not having addressed or resolved these problems.[630]

Furthermore, HEB argues that because Highly Sensitive Exhibit GWP-1 only contains data for HEB locations with on-site generation, the number of outages described by HEB is extremely conservative compared with the number of outages HEB actually experienced due to CenterPoint's poor service quality. These outages do not include the many, sustained, and frequent outages at HEB locations in CenterPoint's territory that do not have on-site generation. These problems continue at all locations, and at the HEB locations without on-site generation, the economic harm to HEB is substantial.[631]

With respect to CenterPoint's arguments based on its SAIDI and System Average Interruption Frequency Index (SAIFI) statistics, HEB's testimony regarding its experience illustrates that customer experiences are not accurately captured or accounted for in aggregate measurements like SAIDI and SAIFI. HEB disagrees with CenterPoint's assertion that these are the sole metrics to be used when considering whether CenterPoint is providing reliable and adequate service to its customers. The frequency and duration of outages that HEB has experienced are not reflected in the data provided in CenterPoint's application or in the data described in the direct testimony of COH witness Norwood.[632]

Had HEB filed a complaint for the conservative number of outages identified in Highly Sensitive Exhibit GWP-1, CenterPoint would have had 521 complaints from HEB alone. That number would have been multiplied for each of the customers complaining to CenterPoint that did

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[629] Tr. at 1191.

[630] HEB Ex. 1 at 9, 14-15.

[631] HEB Ex. 1 at 8, 25.

[632] HEB Reply Brief at 15.

not file Commission complaints but for whom complaint correspondence was provided.[633] If HEB had received complaint correspondence associated with the other 2,499,955 CenterPoint customers, those numbers would be exponentially higher.

Records of customer communications with CenterPoint reveal that other CenterPoint customers have experienced similar reliability problems and a lack of responsiveness from CenterPoint in effectively addressing such issues.[634] The emails contained in HEB Ex. 31 (excerpts of which are shown in HEB's reply brief[635]) show that, like HEB, other customers have had frequent outages that cause financial harm to their business operations; other customers have had to rely on back-up generation when CenterPoint failed to provide reliable service; and other customers have experienced frustration with the lack of responsiveness from CenterPoint in addressing service quality problems.

HEB responds to CenterPoint's claims that "H-E-B's own on-site generation equipment is likely the root cause of a material portion of H-E-B's outages"[636] and that HEB's on-site generation "has caused the fuses of several transformers serving H-E-B locations to melt, resulting in outages"[637] by noting the following:

- HEB began installing on-site generation facilities within CenterPoint's service area in 2016 and CenterPoint has never informed HEB that these facilities cause any outages.[638]

- HEB's issues with outages in CenterPoint's service territory began in 2015, well before HEB's decision to install any on-site generation at its facilities.[639] CenterPoint's lack of attention to the issues raised by HEB and CenterPoint's failure to address HEB's problems led HEB to make the capital-intensive decision

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[633] Tr. at 1199-1200.

[634] HEB Ex. 31 (CenterPoint Response to HEB RFI 1-032U).

[635] HEB Reply Brief at 17-20.

[636] CenterPoint Initial Brief at 147.

[637] CenterPoint Initial Brief at 148.

[638] Tr. at 1216.

[639] HEB Ex. 1 at 12 ("H-E-B first raised these issues with CenterPoint in 2015 and requested a meeting to discuss the problems that H-E-B was encountering and options for resolving the reliability issues.").

to begin installing on-site generation at its locations.[640] According to HEB, CenterPoint's statements belie the fact that there are multiple, sustained, repeated outages at locations that do not have on-site generation.

- HEB contends that it does not experience service quality, reliability issues, voltage fluctuations, or power outages when its on-site generators are running[641] and that CenterPoint acknowledged as much when it admitted that HEB's on-site generators for HEB's stores in CenterPoint's service territory have insulated HEB from the effects of CenterPoint's continuing outages.[642] CenterPoint further admits that it is aware that there are several HEB locations in CenterPoint's service territory and within the service territories of other utilities without on-site generation that suffer routine outages.[643]

- Regarding CenterPoint's claims that HEB's outages are a result of HEB's on-site generation causing transformer fuses to melt, CenterPoint acknowledged that HEB has on-site generation at locations within the service territories of other utilities in ERCOT and operates them without issues related to melted fuses.[644] Furthermore, CenterPoint never communicated to HEB or HEB's on-site generation developer its concerns regarding melted fuses.[645] CenterPoint witness Sugarek admitted that CenterPoint does not even know what types of fuses are installed at each HEB facility.[646] Ms. Sugarek also admitted on re-cross that CenterPoint is not sure that melted fuses are the cause of HEB's outages from CenterPoint.[647]

- CenterPoint admitted that a fuse can fail under a number of conditions, including "through an insurgence of voltage,"[648] most commonly caused by lightning strikes.[649] HEB notes that CenterPoint admits that it operates in a climate that produces "routine thunderstorm and lightning activity[,]...[and] storms."[650] Thus, CenterPoint's fuses, to the extent any were damaged, were likely damaged as a

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[640] HEB Ex. 1 at 24 ("H-E-B would not have pursued on-site generation if not for the consistent, frequent outages that continued to occur at H-E-B's facilities within CenterPoint's service territory.").

[641] HEB Ex. 1 at 15.

[642] Tr. at 1194.

[643] Tr. at 1217, 1221.

[644] Tr. at 1220-21.

[645] Tr. at 1220.

[646] Tr. at 1255.

[647] Tr. at 1262-63.

[648] Tr. at 1260.

[649] Tr. at 1260.

[650] CenterPoint Initial Brief at 146.

result of lightning within CenterPoint's service territory—not because of HEB's on-site generation facilities.

The ALJs find CenterPoint's unwillingness to accept even a modicum of responsibility for the reliability issues faced by HEB disturbing. CenterPoint is the entity that the Commission charges with providing safe, adequate, and reliable electric service to its customers.[651] CenterPoint is the entity that approved each on-site generation facility that HEB has installed within the CenterPoint service area. Instead of taking responsibility for the recurring outages and fixing the problem, CenterPoint's response has been to attempt to shift its burden to HEB. CenterPoint's lack of an "unwavering commitment" to its customers is best demonstrated by the fact that it has encouraged the Commission to disregard HEB's complaints altogether because HEB is only 0.0000064% of CenterPoint's total customers and is apparently therefore too insignificant to be of concern to CenterPoint.

CenterPoint's repeated and sustained distribution outages continue to result in substantial losses to perishable product in HEB's core business.[652] Although CenterPoint's SAIDI and SAIFI statistics show that it provides reliable service in general, HEB presented evidence demonstrating that not all customers who experience service problems file complaints that would be captured by SAIDI and SAIFI statistics or reports. HEB's evidence also demonstrates that CenterPoint failed to provide reliable service to HEB and was insufficiently responsive to its complaints, a failure that may have extended to many more customers. This creates a situation in which a reduction in ROE is permitted under PURA § 36.052, which requires that a utility's rate of return be calculated based in part on the quality of the utility's service.[653]

In calculating the amount of the penalty, the ALJs find that it must not be exorbitant, but it must be sufficiently large to focus the attention of the utility on the problem and force it to institute actions to cure the problem in the future. The ALJs find that a three-basis-point reduction in the

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[651] *See* PURA § 38.001(a).

[652] HEB Ex. 1 at 15.

[653] PURA § 36.052(2).

ROE found above will accomplish these goals and recommend that the Commission adopt that reduction.

9. ALJs' Analysis and Recommendation

As discussed at the outset of this section, the experts presenting testimony on the appropriate ROE to assign to CenterPoint employed both mathematical analyses and empirical data. The results of these analyses and examinations were predictably grouped: Staff and the intervenors at one end and CenterPoint at the opposite end. Surprisingly, there were no real outliers within any one grouping. Staff's and the intervenors' analyses resulted in a relatively tight grouping in the range of 9.0% to 9.45%. When taking into consideration the ranges that resulted in those final analyses, the picture becomes a little clearer, with the reasonable lower end reaching the mid-8% range at the low point and the high-9% range at the high point. Taking all of the analyses into consideration, a reasonable range would be from 9.2% on the low end to 10.0% on the high end.

The economic metrics raised by the parties are not singularly aligned. Some of the metrics argue in favor of a lower ROE, while others argue for a higher ROE. It appears to the ALJs that there is no clearly dispositive factor on the subjective side of the analysis, but to the extent there is a bias it lies towards lowering the ROE rather than setting it higher.

The mathematical analyses demonstrate that the reasonable range for CenterPoint's ROE is between 9.0% and 10.0%. A mid-point of this range would result in an ROE of 9.5% for CenterPoint. Inasmuch as Staff recommended a 9.45% ROE, and the economic, subjective factors indicate a slight reduction in ROE from the midpoint, the ALJs find that the ROE recommended by Staff is the appropriate ROE for CenterPoint. That would indicate a recommended ROE of 9.45% before taking into account the ROE reduction associated with the HEB service quality issues. With that reduction of three basis points, the ALJs recommend the Commission adopt an ROE for CenterPoint of 9.42%.

B. Cost of Debt [PO Issue 8]

CenterPoint's current embedded cost of long-term debt is 4.38%. No party has taken issue with that cost of long-term debt, which reflects the impact of pre-issuance hedging.[654] There is, however, one challenge to CenterPoint's overall cost of debt. TCUC argues, as an alternative if its primary long-term debt and equity-based capital structure is not adopted, that short-term debt be included in CenterPoint's capital structure, and that the cost of short-term debt to be used in calculating CenterPoint's overall rate of return is 2.27%.[655] The ALJs find that, for the reasons discussed below, it is not appropriate to include short-term debt in the rate of return calculation and, therefore, recommend that TCUC's alternative recommendation be rejected. The ALJs recommend adoption of CenterPoint's actual cost of long-term debt (reflecting the impact of pre-issuance hedging) of 4.38%.

TCUC's contention rests principally on the grounds that CenterPoint employs short-term debt to finance its operations,[656] including financing of its capital expenditures.[657] As recently as March 28, 2019, CenterPoint employed $590 million in short-term borrowings from the money pool in which CNP subsidiaries participate for short-term borrowings.[658] Dr. Woolridge's analysis established that CenterPoint's use of short-term financing requirements and debt varies by the day, and it had short-term debt outstanding for 225 of the 365 days in 2018. Dr. Woolridge calculated

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[654] CenterPoint Ex. 43 at 4, 40. CenterPoint's accounting treatment under GAAP and FERC 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. CenterPoint Ex. 12 at 907-09; CenterPoint Ex. 27 at 2859-60. No party challenged the inclusion of the interest rate hedge issuance cost in the cost of debt calculation.

[655] TCUC Initial Brief at 30.

[656] TCUC Ex. 21 (response to TCUC RFI 3-10(p)) at 5.

[657] TCUC Ex. 14 (response to TCUC RFI 1-27) (showing use of short-term debt by calendar quarter); TCUC Ex. 18 (response to TCUC RFI 3-07) (establishing that borrowings from the "money pool" are short-term debt borrowings); TCUC Ex. 19 (response to TCUC RFI 3-08) (establishing that commercial paper is short-term debt); TCUC Ex. 20 (response to TCUC RFI 3-09) (establishing that use of revolving credit facilities are short-term debt); TCUC Ex. 21 (response to TCUC RFI 3-10) (establishing that short-term debt is used not only for general corporate purposes but also for capital expenditures).

[658] *See* TCUC Ex. 18 (response to TCUC RFI 3-07) (borrowings from the money pool are short-term debt); and TCUC Ex. 23 (response to TCUC RFI 3-14) (CenterPoint borrowed $590 million from the money pool on Mar. 28, 2019).

CenterPoint's average daily balance of short-term-debt to be $52.1 million in 2018.[659] Additionally, TCUC cites to the fact that when it reports its finances to the investment community, CenterPoint makes clear that it is reporting the entirety of its debt and is not limiting its financial reporting only to long-term debt.[660]

CenterPoint responds by noting that Dr. Woolridge's inclusion of short-term debt in CenterPoint's capital structure is inappropriate because CenterPoint 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.[661] Dr. Woolridge was unaware that the Commission had rejected the inclusion of short-term debt in a utility's authorized capital structure.[662]

CenterPoint notes that it initially funds its capital investments with a combination of internally-generated funds, short-term debt, long-term debt, and common equity investments from CNP.[663] But the short-term debt initially used to fund operations and capital investments is converted to long-term debt, similar to when a utility asset is removed from CWIP and placed in service. Thus, according to CenterPoint, its long-term investments that are placed in service are financed with long-term debt and equity.[664] Because CenterPoint earns a return on the investment only after it has been placed in service, only the long-term debt used to finance that investment should be included in the capital structure.[665]

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[659] TCUC Ex. 1 at 17, 20.

[660] *See,* TCUC Ex. 27 (CNP Dec. 31, 2018 Form 10-K); TCUC Ex. 31 (CNP Dec. 31, 2017 Form 10-K); TCUC Ex. 35 (CNP Dec. 31, 2016 Form 10-K); TCUC Ex. 39 (CNP Dec. 31, 2015 Form 10-K; TCUC Ex. 43 (CNP Dec. 31, 2014 Form-K).

[661] CenterPoint Ex. 43 at 14.

[662] Tr. at 522-23.

[663] *See* CenterPoint Ex. 27 at 2836; CenterPoint Ex. 43 at 16; TCUC Initial Brief at 33.

[664] CenterPoint Ex. 43 at 14, 16.

[665] TCUC also argues that the credit-rating agencies include the entirety of CenterPoint's debt obligations in their ratings. TCUC Initial Brief at 33. However, CenterPoint responds that while rating agencies consider all forms of debt obligations, not all of the expenditures financed with those various forms of debt are included in rate base or considered in ratemaking.

Although TCUC correctly argues that the Commission is not bound by its past decisions on this issue,[666] CenterPoint contends that TCUC has presented no compelling reasons for the Commission to depart from its 2016 holding in Docket No. 43695 that "it is unreasonable and inconsistent with Commission precedent" to include short-term debt in a utility's capital structure.[667] In fact, the arguments that TCUC presents here are largely the same arguments raised by the U.S. Department of Energy in Docket No. 43695, which were expressly rejected by the ALJs[668] and subsequently the Commission.[669]

The ALJs are persuaded by CenterPoint's arguments on the question of whether short-term debt cost should be included. As CenterPoint states, although the initial acquisition of assets may be funded through short-term debt, that debt is refinanced with long-term debt or equity when the asset is removed from CWIP. More importantly, although not binding, Commission precedent and long-standing practice has been to exclude the cost of short-term debt from the rate of return calculation and capital structure. TCUC has presented no evidence supporting a change in that long-standing practice. Accordingly, the ALJs recommend that TCUC's proposal to include the cost of short-term debt in CenterPoint's rate of return and capital structure be rejected and that CenterPoint's uncontested long-term debt cost of 4.38% be used to calculate CenterPoint's rate of return.

C. Capital Structure [PO Issue 7]

CenterPoint's current capital structure is 55% debt and 45% equity.[670] In this proceeding, CenterPoint requests a capital structure composed of 50% debt and 50% equity, which CenterPoint contends will support a single-A credit rating, help ensure that CenterPoint will be able to access

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[666] TCUC Initial Brief at 37-38.

[667] CenterPoint Ex. 69 at Tab 6.

[668] *See Application of Southwestern Public Service Co. for Authority to Change Rates*, Docket No. 43695, PFD at 78-81 (Oct. 12, 2015) (Docket No. 43695 PFD).

[669] CenterPoint Ex. 69 at Tab 6.

[670] Docket No. 38339 order at 21, FoF No. 68.

capital in nearly all economic climates be consistent with the level of equity recently established for comparable utilities in other jurisdictions and reasonably reflect the business and regulatory risks that CenterPoint faces.[671] TIEC, TCUC, HEB, and Staff argue that the Commission should adopt a capital structure consisting of 60% debt and 40% equity,[672] and OPUC argues for the adoption of a capital structure consisting of 54.5% debt and 45.5% equity.[673] For the reasons discussed below, the ALJs recommend the Commission adopt a capital structure of 55% long-term debt and 45% common equity.

1. CenterPoint's Evidence and Arguments

CenterPoint argues that its currently approved equity ratio of 45% will not produce financial metrics that are sufficient to maintain its current credit ratings.[674] CenterPoint witnesses Robert B. McRae and Ellen Lapson, who was a Managing Director at Fitch Ratings (Fitch) for more than a decade,[675] each performed a quantitative analysis showing how an equity ratio of 45% would affect CenterPoint's credit ratings in light of TCJA impacts. Both Mr. McRae and Ms. Lapson concluded that without an increase in equity ratio, CenterPoint would be subject to a downgrade of one notch in its credit ratings from at least Moody's Investor Service (Moody's) and Fitch.[676] Using the "predominant rating" approach to reconcile split ratings, the impact for investors would be that CenterPoint's unsecured issuer credit rating could no longer be grouped in the A category and would be categorized in the BBB rating category.[677]

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[671] CenterPoint Ex. 27 at 2834.

[672] TIEC Ex. 5 at 37, Table 7; TCUC Ex. 1 at 20 (Dr. Woolridge also presented an alternative capital structure composed of 55.48% long-term debt, 0.90% short-term debt, and 43.62% common equity); HEB Initial Brief at 27-28; Staff Ex. 3A at 37.

[673] OPUC Ex 3 at 43.

[674] CenterPoint Ex. 27 at 2843; CenterPoint Ex. 48 at 42.

[675] CenterPoint Ex. 48, Exh. R-EL-1 at 1.

[676] CenterPoint Ex. 48 at 43-44; *see* CenterPoint Ex. 27 at 2843.

[677] CenterPoint Ex. 48 at 44.

According to CenterPoint, 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,[678] Georgia Public Service Commission,[679] and Florida Public Service Commission[680] have all approved requests by utilities to increase their equity ratios to mitigate the effects of the TCJA.

In CenterPoint's view, a 50% equity and 50% debt capital structure is consistent with equity levels established by regulatory commissions in other jurisdictions. For the last eight calendar quarters, the average equity ratio was 53.28% for the holding companies in CenterPoint witness Hevert's proxy group, and 53.13% for the utility operating companies encompassed within those holding companies. The average equity ratio of electric delivery-only utilities for calendar year 2018 was 49.91%.[681] Accordingly, CenterPoint's proposed 50% equity ratio is consistent with the level of equity authorized for comparable utilities in other jurisdictions.[682]

CenterPoint contends that its requested 50/50 capital structure is appropriate for the business and regulatory risks it faces.[683] First, no party took issue with CenterPoint's forecast of approximately $5.14 billion in capital expenditures from 2019-2023 to construct facilities to serve its rapidly expanding service area.[684] CenterPoint claims that its revenue from operations will not

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[678] Alabama Pub. Serv. Comm'n, *Petition for Revision to Rate RSE*, Docket Nos. 18117 and 18416, Order at 7 (May 7, 2018).

[679] 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 Ex. 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).

[680] 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).

[681] CenterPoint Ex. 43 at 34.

[682] CenterPoint Ex. 43 at 14.

[683] CenterPoint Ex. 27 at 2835.

[684] CenterPoint Ex. 27 at 2832, *citing* CenterPoint Energy, Inc. Form 10-K at 68 (Feb. 28, 2019).

be sufficient to fund all of that investment, so it will be necessary for CenterPoint to finance a portion of the costs with debt issuances, retained earnings, and equity infusions from CNP.[685]

Second, CenterPoint argues that it 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.[686] In January 2018, Moody's placed 24 utilities on negative outlook because of the effects of the TCJA, 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.[687] CenterPoint argues that 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.[688] CenterPoint 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.[689]

Third, CenterPoint contends that it is exposed to high risk of hurricane damage because all of its service territory is within 100 miles of the Gulf Coast. Severe weather causes CenterPoint to incur unplanned expenditures and results in lower sales due to damage to its infrastructure, which collectively can reduce CenterPoint's revenue and strain its operating cash flow, highlighting the need for financial liquidity and flexibility.[690]

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[685] CenterPoint Ex. 27 at 2836.

[686] CenterPoint Ex. 27 at 2837-38; Tr. at 516.

[687] CenterPoint Ex. 27 at 2839.

[688] CenterPoint Ex. 27 at 2841.

[689] CenterPoint Ex. 27 at 2841; CenterPoint Ex. 43 at 7.

[690] CenterPoint Ex. 26 at 2706; *see also* CenterPoint Ex. 27 at 2846.

Finally, in CenterPoint's view, 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 CenterPoint's regulatory risk, especially in light of the TCJA's impact on debt and cash flow.[691] Although many cost-recovery mechanisms are available to utilities in Texas as mitigating CenterPoint's regulatory risk, these mechanisms were also available in 2011 when the Commission determined that CenterPoint's risks merited a 45% equity ratio.[692] Moreover, these mechanisms are acknowledged by Moody's in its June 17, 2019 issuer comment, but Moody's nevertheless foresees that CenterPoint's credit metrics will weaken in light of the TCJA and CenterPoint's capital expenditure forecast.[693]

As to TIEC's arguments regarding CenterPoint's requested capital structure, CenterPoint contends that while the impacts of the TCJA do benefit CenterPoint's customers by reducing CenterPoint's revenue requirement, it is also true that they weaken CenterPoint's credit quality in the absence of any mitigation measures.[694]

With respect to TIEC's argument that CenterPoint has admitted that TIEC's proposed ROE and capital structure would allow CenterPoint to continue to enjoy "investment grade credit ratings" and thus has confirmed that TIEC's recommendations would allow CenterPoint to maintain its financial integrity,[695] CenterPoint contends that TIEC is conflating two different things—"investment grade" credit ratings do not equate to financial integrity.[696] Further, CenterPoint contends that TIEC is also incorrect that its recommendations would result in a "one-notch upgrade" for CenterPoint under S&P's ratings.[697] CenterPoint's standalone S&P rating

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[691] CenterPoint Ex. 27 at 2849.

[692] Tr. at 625-27, 663-65.

[693] CenterPoint Ex. 43, Confidential Exh. R-RBM-3 at 1; *see* Tr. at 662.

[694] CenterPoint Ex. 27 at 2837.

[695] TIEC Initial Brief at 50.

[696] CenterPoint Initial Brief at 64.

[697] TIEC Initial Brief at 48.

is a+, and TIEC's recommendations would represent a two-notch downgrade for CenterPoint to a-.[698] TIEC's evaluation of CenterPoint's credit metrics is based entirely on S&P's rating system, and TIEC's witness did no analysis with respect to Moody's or Fitch.[699] CenterPoint contends that its metrics would experience a downgrade under both Moody's and Fitch's criteria if TIEC's recommendation was adopted.[700]

Responding to OPUC's evidence and arguments, CenterPoint states that OPUC witness Winker admitted that she had not done any quantitative analysis to determine how her recommended capital structure would impact CenterPoint's credit metrics used by the various credit rating agencies.[701] 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 CenterPoint has not yet been downgraded is no indication that it will not be in the future.[702]

As to HEB's arguments, CenterPoint responds by stating that it is not attempting to stray from some established standard in this case; rather, it is seeking Commission review of its current individual circumstances and risk, which exceed the risks presented in the last case that merited a 45% equity ratio, due to the enactment of the TCJA.[703]

CenterPoint notes that its requested equity ratio will help CenterPoint maintain,[704] not increase (as urged by HEB), its current credit rating in light of the impacts of the TCJA. HEB states that CenterPoint's ratepayers "should not bear the burden" of CenterPoint's February 2019 downgrade.[705] HEB recommends a capital structure that has been expressly identified by Moody's

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[698] CenterPoint Ex. 43 at 23.

[699] Tr. at 580, 608-10.

[700] CenterPoint Ex. 43 at 24-25; Tr. at 581.

[701] Tr. at 654-55.

[702] CenterPoint Ex. 43 at 31-32.

[703] CenterPoint Reply Brief at 76.

[704] CenterPoint Ex. 27 at 2834.

[705] HEB Initial Brief at 27.

as "credit-negative" and that will likely subject CenterPoint to further downgrades in the future. HEB asserts that CenterPoint has not demonstrated that a change in its credit rating would improve service to, or benefit, customers.[706] In fact, CenterPoint argues that it has established that a downgrade in its credit metrics, which it would be subject to under HEB's recommended capital structure, would be detrimental to CenterPoint's customers.[707]

CenterPoint contends that Staff argues that CenterPoint's risk associated with timely recovery of transmission and capital expenditures is mitigated by the existence of the Interim Transmission Cost of Service (TCOS) mechanism and the DCRF mechanism.[708] These mechanisms were available at the time that the Commission issued its decision in Docket No. 38339, and accordingly would have been considered by the Commission in setting an equity ratio of higher than 40% for CenterPoint.[709] CenterPoint argues that Staff attempts to discount this fact with an argument that "it was not apparent at the time how well these mechanisms would be utilized," but that nine years later it has been established that these mechanisms "work well."[710] In essence, Staff appears to be stating that because CenterPoint has effectively used these regulatory cost-recovery mechanisms, this is a result that the Commission can consider in reducing CenterPoint's equity ratio to a level below the one established in Docket No. 38339. According to CenterPoint, this argument seems to speculate that the Commission did not account for the future effectiveness of these cost-recovery mechanisms in setting CenterPoint's equity ratio, which CenterPoint contends is too tenuous a premise to be given any weight. As an initial matter it disregards that the Commission approved a 45% equity ratio for Texas New-Mexico Power (TNMP) with full knowledge of how both DCRF and TCOS were working.[711] Moreover, Staff's argument willfully ignores that the credit rating agencies are fully aware of the availability and

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[706] HEB Initial Brief at 28.

[707] CenterPoint Ex. 43 at 40-41.

[708] Staff Initial Brief at 30.

[709] Tr. at 625-27, 663-65.

[710] Staff Initial Brief at 30.

[711] Docket No. 48401, Order at FoF No. 48 (Dec. 20, 2018).

utilization of these regulatory cost-recovery mechanisms by utilities over the past nine years, and Moody's has still stated that, absent a credit positive rate case outcome (*i.e.*, an equity ratio of at least 45%), CenterPoint's credit metrics will weaken.[712]

Staff acknowledges that an increase in ROE or authorized depreciation rates are tools to mitigate the effects of the TCJA, but CenterPoint emphasizes that rating agencies have identified a third option: an increase in the authorized equity ratio.[713] Staff appears to assert that—because it has recommended relief through its two acknowledged mitigation options by supporting CenterPoint's proposed depreciation rates, as well as allegedly accounting for the effects of the TCJA through Staff witness Ordonez's proxy group—an increase in CenterPoint's authorized equity ratio is unnecessary.[714] This argument, according to CenterPoint, is flawed and should be disregarded. First, CenterPoint has not proposed increased depreciation rates as a mitigation measure in this case. CenterPoint chose to propose an increase in its authorized equity ratio in order to mitigate the TCJA's effects on cash flow at the lowest cost to customers.[715] Thus, Staff's support of CenterPoint's proposed depreciation rates does nothing to mitigate the impact of the TCJA. Second, Staff witness Ordonez admitted that the TCJA had no effect on his selection of proxy group companies.[716]

2. TIEC's Evidence and Arguments

TIEC recommends that the Commission set CenterPoint's ratemaking capital structure at 60% debt, 40% equity.[717] That capital structure is consistent with the prevailing capital structure

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[712] CenterPoint Ex. 43, Confidential Exh. R-RBM-3 at 1.

[713] Staff Initial Brief at 30.

[714] *See* Staff Initial Brief at 30-31.

[715] CenterPoint Ex. 27 at 2841; CenterPoint Ex. 43 at 7.

[716] CenterPoint Initial Brief at 55-56.

[717] TIEC Ex. 5 at 37.

of many ERCOT TDUs,[718] reflects the Commission Staff's "benchmark" for ERCOT TDUs,[719] and will be sufficient, in TIEC's view, to allow CenterPoint to attract capital at reasonable rates.

TIEC witness Gorman's recommendation was based on his argument that CenterPoint would have a higher credit rating if it were severed from its parent through financial ring-fencing measures.[720] Mr. Gorman asserted that S&P currently measures CenterPoint under the "medial volatility" table and argued that, if considered on its own, CenterPoint 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.[721]

With respect to CenterPoint's requested 50% debt/50% equity capital structure, TIEC argues that the requested capital structure would do nothing but benefit the shareholders of CenterPoint's parent, CNP, at ratepayers' expense. To illustrate this point, based on its own stand-alone metrics, CenterPoint would be rated a+ by S&P but for its affiliation with its parent, which drags its rating down to BBB+.[722] CenterPoint's credit rating is being determined by the riskier business activities of its parent, according to TIEC. As such, increasing the equity component of CenterPoint's rates does nothing except provide additional revenues for its parent (so that it can continue to engage in other business activities) and provides no benefit to CenterPoint or its customers.[723]

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[718] Staff Ex. 39 at 37, n. 41 ("The following TDUs are operating in Texas with authorized capital structures comprising 60% long-term debt and 40% equity: Cross Texas Transmission, LLC (Docket No. 43950), Electric Transmission Texas, LLC (Docket No. 33734), AEP Texas Central Company (Docket No. 33309), AEP Texas North Company (Docket No. 33310), Wind Energy Transmission Texas, LLC (Docket No. 44746).").

[719] TIEC Ex. 14 (Project 46910 Memo) at 3.

[720] TIEC Ex. 5 at 27, 32-33.

[721] TIEC Ex. 5 at 36-37.

[722] TIEC Ex. 5 at 24-25.

[723] *See* TIEC Ex. 4 at 12 ("Even if a utility would have a higher credit rating on a stand-alone basis, it may be notched downward if its parent has a lower credit rating and is depending on dividends from the utility. In such cases, a utility's ratepayers are paying for the equivalent of a higher rated entity, but higher financial and/or business risk at the parent prevents ratepayers from getting the full benefit of what they are paying for in rates (*e.g.*, increased equity that should give rise to lower debt costs).").

As to the four reasons proffered by CenterPoint as justification for the increase in the equity portion of its capital structure, TIEC contends that CenterPoint has not shown that it faces business risks that will require it to maintain a higher equity percentage.

CenterPoint's growth and capital expenditures are in line with its historical experience. Although CenterPoint witness McRae stated that in recent years, CenterPoint's load growth has averaged 2% per year and is expected to continue on that trajectory for several more,[724] TIEC argues that significant load growth is nothing new for CenterPoint. The Commission has previously recognized that CenterPoint's industrial and residential load has been growing rapidly for many years.[725] In its Q1 2019 Earnings Call with investors, CenterPoint's parent stated that CenterPoint has experienced consistent customer growth over the last 30 years.[726] Further, consistent growth represents an opportunity for CenterPoint, rather than a risk.[727] In that same investor presentation, CNP emphasized its prospects for additional growth and capital investment (in particular, the Bailey to Jones Creek transmission line), and even listed "Customer Growth" as a positive driver for 2019.[728]

Additionally, while TIEC acknowledges that CenterPoint's capital investment has grown over time, TIEC also notes that CenterPoint earns a return on all of that investment, which increases revenues.[729] This growth in rate base has allowed CenterPoint to support additional (and growing) investment without the need for additional equity in its capital structure. Further,

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[724] CenterPoint Ex. 27 at 2835.

[725] Tr. at 51-52; *Application of Cross Texas Transmission, LLC to Amend a Certificate of Convenience and Necessity for the Limestone to Gibbons Creek 345-KV Transmission Line in Brazos, Freestone, Grimes, Leon, Limestone, Madison, and Robertson Counties*, Docket No. 44649, Order at 16-17, FoF Nos. 137, 139 (Jan. 13, 2016).

[726] Tr. at 87–88; TIEC Ex. 13 (1st Quarter 2019 Earnings Transcript on May 9, 2019) at 6.

[727] *See* TIEC Ex. 4 at 24-25 ("Given current prevailing utility returns on equity, including those awarded in Texas, capital expenditures are more of a business opportunity than a business risk.... If additional capital expenditures were a burden and not an opportunity, management would be seeking to *limit* capital expenditures, not grow them.").

[728] Tr. at 84; TIEC Ex. 12 (1st Quarter 2019 Earnings Presentation on May 9, 2019) at 5.

[729] Tr. at 62; TIEC Ex. 8 (Investor & Analyst Day Presentation in Jun. 2014) at 2.

CenterPoint's ratio of capital expenditures to net electric plant in service has been nearly flat since its last rate case.[730]

TIEC also disputes CenterPoint's claims regarding the impact of the TCJA. In its first quarter earnings call with investors, CNP listed "Reduced Income Tax Expense" as a positive driver for 2019.[731] CenterPoint witness Mercado also testified that growth in rate base increases earnings.[732] Since bonus depreciation increases ADFIT, which is an offset to rate base, decreasing ADFIT will actually increase rate base, which increases earnings.[733] This additional return mutes the impacts of the TCJA, according to TIEC.

Contrary to its claims, TIEC asserts that CenterPoint is facing no new natural disaster risk that would justify increasing the amount of equity in its capital structure. CenterPoint has always faced risks from hurricanes and serious storms, and TIEC claims that CenterPoint witness Mercado admitted as much.[734] Additionally, CenterPoint has shown that it is able to successfully prepare for and deal with large storm events when they do occur, and as CenterPoint acknowledges, the risk of storm events is largely mitigated by CenterPoint's ability to securitize storm restoration costs.[735] According to TIEC, the risk of future storms does not justify increasing the proportion of equity in CenterPoint's capital structure.

TIEC contends that CenterPoint's arguments regarding the regulatory risks it faces are baseless. As CenterPoint itself admits, and the credit rating agencies recognize, CenterPoint is an extremely low-risk "wires-only" utility, meaning that unlike most utilities, it is not exposed to the environmental and financing risks associated with constructing generation projects, or the

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[730] Tr. at 100-02, 104, 106; CenterPoint Ex 6 at WP KMM-10 (09 to 18 10K CenterPoint CapEx); TIEC Ex. 16 (Docket No. 38339 order at 19, FoF No. 54); TIEC Ex. 17 (Sch. II-B).

[731] Tr. at 84; TIEC Ex. 12 (1st Quarter 2019 Earnings Presentation on May 9, 2019) at 5.

[732] Tr. at 62; *see also* TIEC Ex. 4 at 24-25.

[733] Tr. at 786-87; *see also* TIEC Ex. 4 at Exh. CSG-3, p. 7.

[734] Tr. at 151.

[735] TIEC Ex. 4 at 28; CenterPoint Ex. 27 at 27-28.

commodity risks associated with procuring fuel.[736] Further, CenterPoint enjoys prompt and nearly dollar-for-dollar capital recovery through various rate riders, such as the TCRF and DCRF, which are available to ERCOT utilities.[737]

3. OPUC's Evidence and Arguments

OPUC recommends a capital structure of 54.5% debt and 45.5% equity.[738] This capital structure differs only slightly from CenterPoint's current capital structure, which was approved by the Commission in Docket No. 38339, and reflects the current book values found in CenterPoint's RFP.[739] CenterPoint's current capital structure has supported the issuance of long-term debt totaling approximately $2.4 billion since 2012.[740] Even after the TCJA took effect, OPUC argues that CenterPoint was able to issue $400 million in long-term debt at a 3.95% interest rate.[741] Therefore, a 54.5%-45.5% capital structure will allow CenterPoint to continue to attract capital without unnecessarily inflating its rates.

4. TCUC's Evidence and Arguments

TCUC recommends adoption of a capital structure of 60% long-term debt and 40% equity and alternatively recommends a capital structure that includes short-term debt, resulting a capital structure of 0.90% short-term debt, 55.48% long-term debt, and 43.62% equity.[742]

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[736] *See* TIEC Ex. 5 at 26.

[737] TIEC Ex. 4 at 27.

[738] OPUC Ex. 3 at 43.

[739] OPUC Ex. 3 at 43.

[740] OPUC Ex. 3 at 42.

[741] OPUC Ex. 3 at 43-44.

[742] TCUC Ex. 1 at 4-5.

TCUC argues that CenterPoint's common equity ratio has been in the 38% to 45% range over the three-year time period from January 1, 2016 through December 31, 2018.[743] Moreover, with this capitalization CenterPoint not only has been able to raise capital but has maintained its credit ratings.[744]

5. HEB's Evidence and Arguments

HEB's position is that CenterPoint seeks Commission approval of a capital structure of 50% debt and 50% equity, a significant deviation from its current 55% debt to 45% equity capital structure approved by the Commission in Docket No. 38339,[745] CenterPoint's last base-rate case, which was itself higher than the Commission's standard of 60% debit to 40% equity. HEB also argues that CenterPoint is requesting a higher amount of equity in its capital structure based on part on its "hope to return to, and maintain, a higher credit rating than its current credit rating" given its February 2019 downgrade. Finally, HEB states that CenterPoint's current credit rating is sufficient, and CenterPoint is currently able to raise capital under its existing capital structure.[746]

HEB notes that CenterPoint argues its requested capital structure of 50% debt and 50% equity will finance more of its capital investment with equity and improve metrics and benefit customers.[747] HEB disagrees, stating that the Commission should reject CenterPoint's proposal because CenterPoint has not demonstrated an increase in CenterPoint's credit rating is warranted, CenterPoint has little business and regulatory risk, and its proposal will result in increased costs to

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[743] TCUC Ex. 1 at Exh. JRW-3 at 2 (*see* table related to CenterPoint Energy Houston Electric, LLC at row for "Member's Equity").

[744] TCUC Ex. 1 at 21.

[745] Docket No. 38339 order at 21, FoF No. 67.

[746] HEB Initial Brief at 27-28.

[747] CenterPoint Ex. 27 at 2836.

ratepayers without a corresponding benefit or increase in the reliability of service provided by CenterPoint.[748]

HEB contends that CenterPoint's ratepayers should not bear the burden of CenterPoint's credit downgrade. CenterPoint is requesting a higher amount of equity in its capital structure (and a higher ROE) based in part on CenterPoint's hope to return to, and maintain, a higher credit rating than its current credit rating.[749] CenterPoint's credit rating was recently downgraded in February 2019 because of "the risks associated" with CenterPoint's parent company, including its parent's acquisition of Vectren, not because of the risks associated with CenterPoint, as CenterPoint claims.[750] In fact, CenterPoint's credit rating downgrade "had nothing to do with ...[CenterPoint]."[751]

Further, HEB argues that because an increase in CenterPoint's credit rating due to a change in capital structure will not affect its ability to provide reliable service, the Commission should not permit CenterPoint to use its customers to achieve a higher credit rating when the reasons for its credit rating are unrelated to CenterPoint's business. CenterPoint has not demonstrated that a change in its credit rating would improve service to, or benefit, customers.[752]

HEB further contends that CenterPoint has "extraordinarily low business risk."[753] As a regulated TDU, CenterPoint faces less risk than that faced by vertically integrated utilities that

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[748] HEB Initial Brief at 27.

[749] CenterPoint Ex. 27 at 2834.

[750] TCUC Ex. 1 at 16, n. 11, 21.

[751] TCUC Ex. 1 at 21.

[752] HEB Initial Brief at 28.

[753] Tr. at 565.