



Control Number: 49494



Item Number: 515

Addendum StartPage: 0

**PUC DOCKET NO. 49494**  
**SOAH DOCKET NO. 473-19-4421**

**APPLICATION OF AEP TEXAS INC.**  
**FOR AUTHORITY TO CHANGE RATES**

§  
§  
§

**PUBLIC UTILITY COMMISSION**  
**OF TEXAS**

**COMMISSION STAFF'S REPLIES TO EXCEPTIONS**  
**TO THE PROPOSAL FOR DECISION**

Respectfully Submitted,

**PUBLIC UTILITY COMMISSION OF TEXAS**  
**LEGAL DIVISION**

Thomas S. Hunter  
Division Director



Heath D. Armstrong  
State Bar No. 24105048  
Rustin Tawater  
State Bar No. 24110430  
Creighton R. McMurray  
State Bar No. 24109536  
1701 N. Congress Avenue  
P.O. Box 13326  
Austin, Texas 78711-3326  
(512) 936-7255  
(512) 936-7268 (facsimile)  
heath.armstrong@puc.texas.gov

December 20, 2019

## TABLE OF CONTENTS

<b>I.</b>	<b>INTRODUCTION [PO ISSUES 1, 2, 3]</b> .....	<b>3</b>
<b>III.</b>	<b>RATE BASE</b> .....	<b>3</b>
<b>A.</b>	<b>Transmission and Distribution Capital Investment [PO Issues 4, 5, 10, 11, 12]</b> .....	<b>3</b>
<b>B.</b>	<b>Capitalized Vegetation Management</b> .....	<b>5</b>
<b>F.</b>	<b>Capitalized Incentive Compensation</b> .....	<b>7</b>
<b>V.</b>	<b>RATE OF RETURN</b> .....	<b>10</b>
<b>A.</b>	<b>Return on Equity</b> .....	<b>10</b>
<b>E.</b>	<b>Financial Integrity, Including “Ring Fencing”</b> .....	<b>13</b>
<b>VI.</b>	<b>OPERATING AND MAINTENANCE EXPENSES</b> .....	<b>14</b>
<b>B.</b>	<b>Labor Expenses</b> .....	<b>14</b>
<b>1.</b>	<b>Incentive Compensation</b> .....	<b>14</b>
<b>X.</b>	<b>FUNCTIONALIZATION AND COST ALLOCATION</b> .....	<b>16</b>
<b>B.</b>	<b>Class Allocation</b> .....	<b>16</b>
<b>XI.</b>	<b>REVENUE DISTRIBUTION AND RATE DESIGN</b> .....	<b>18</b>
<b>A.</b>	<b>Rate Moderation</b> .....	<b>18</b>
<b>XV.</b>	<b>CONCLUSION</b> .....	<b>21</b>

**PUC DOCKET NO. 49494**  
**SOAH DOCKET NO. 473-19-4421**

<b>APPLICATION OF AEP TEXAS INC.</b>	<b>§</b>	<b>PUBLIC UTILITY COMMISSION</b>
<b>FOR AUTHORITY TO CHANGE RATES</b>	<b>§</b>	
	<b>§</b>	<b>OF TEXAS</b>

**COMMISSION STAFF’S REPLIES TO EXCEPTIONS  
TO THE PROPOSAL FOR DECISION**

**I. INTRODUCTION [PO ISSUES 1, 2, 3]**

Most of the conclusions reached by the Administrative Law Judges (ALJs) in the Proposal for Decision (PFD) are correctly decided and should be maintained over AEP Texas Inc.’s (AEP Texas) objections. Staff remains grateful for the reasoned consideration of the ALJs, and Staff supports their conclusions in the PFD, with the exception of the points previously raised by Staff in its exceptions to the PFD.

In addition, Staff responds to certain exceptions raised by AEP Texas, Texas Industrial Energy Consumers (TIEC), and Cities Served by AEP Texas (Cities). These replies to exceptions will address the following topics: recommended disallowances for certain capital projects, capitalized vegetation management, capitalized incentive compensation, return on equity, ring-fencing, rate moderation, calculation of 4CP allocation, and distribution demand allocation.

**III. RATE BASE**

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

**2. Staff’s Recommended Disallowances Related to 30 Capital Projects**

As noted in Staff’s exceptions, Staff recommends a disallowance of \$14,115,845 in transmission investment-related costs incurred by AEP Texas, as insufficient evidence was provided to determine that those costs were prudently incurred.<sup>1</sup> Under PURA<sup>2</sup> § 36.006, AEP Texas has the burden of proof in this rate case.<sup>3</sup> Therefore, AEP Texas has the burden of proving that any costs associated with capital investments were prudently incurred.

---

<sup>1</sup> Direct Testimony of John Poole, Staff Ex. 6 at 14.

<sup>2</sup> Public Utility Regulatory Act, Tex. Util. Code Ann. §§ 11.001-66.016.

<sup>3</sup> PURA § 36.006.

AEP Texas argues that Staff Witness John Poole and the ALJs in the PFD disregarded its evidence, including high level descriptions, cost drivers, and AEP Texas' internal processes to ensure capital costs are reasonably incurred.<sup>4</sup> However, Mr. Poole reviewed this information and determined that it still did not provide the level of detail necessary for determining the prudence of AEP Texas' decision-making for the 30 projects that were, at minimum, 10% over initial estimates.<sup>5</sup> As the PFD correctly states, AEP Texas bears the burden to prove the costs incurred were reasonably and prudently invested, and enjoys no presumption that the costs reflected in its books were prudently incurred by simply opening its books to inspection.<sup>6</sup> While Staff acknowledges that AEP Texas provided additional information on many of the projects at issue, the information provided was insufficient to justify the cost overruns.

Staff agrees with the PFD's recommendation to adopt Staff's proposed disallowances in five of the 30 projects Staff highlighted because AEP Texas did not justify or adequately explain why the actual cost varied significantly from the estimate.<sup>7</sup> However, Staff's position is that AEP failed to carry its burden with regard to all 30 projects, not just the five highlighted by the PFD. Staff agrees with the PFD that AEP Texas is not required to account for every "bolt, washer, pipe hanger, cable tray, I-beam, or concrete pour",<sup>8</sup> nevertheless, Staff's approach does not require that level of detailed accounting. Rather, Staff's approach simply requires AEP Texas to adequately explain the reason for additional costs incurred and provide sufficient documentation of those costs, which AEP did not do in a manner that was persuasive to Staff.

Mr. Poole also discussed the basis of the standard employed by Staff, which included industry experience within the engineering team, previous cases in which the engineering team has been involved, the contingencies provided by companies, and finally a rule for nuclear decommissioning charges which allows for a 10% cost overrun contingency.<sup>9</sup> While AEP Texas may disagree with the disallowance, Staff provided a reasoned recommendation for a targeted

---

<sup>4</sup> AEP Texas' Exceptions to the Proposal for Decision (AEP Texas' Exceptions) at 7 (Dec. 6, 2019).

<sup>5</sup> Tr. at 283:14-284:5 (Poole Clarifying) (Aug. 20, 2019).

<sup>6</sup> *Entergy Gulf States*, 112 S.W.3d at 214, citing *Public Util. Comm'n v. Houston Lighting & Power Co.*, 778 S.W.2d 195, 198 (Tex. App.—Austin 1989, no writ). See also *Gulf States Utils. Co. v. Pub. Util. Comm'n*, 841 S.W.2d 459, 475 (Tex. App.—Austin 1992, writ denied); PURA §§ 36.051, .057(a); 16 TAC § 25.231(b).

<sup>7</sup> Proposal for Decision (PFD) at 22, 23 (Nov. 12, 2019).

<sup>8</sup> PFD at 18.

<sup>9</sup> Tr. at 282:7-17 (Poole Clarifying) (Aug. 20, 2019).

number of projects with cost overruns of 10% or more beyond a 5% built-in contingency for engineering and material costs and a 15% contingency for construction labor costs.<sup>10</sup>

AEP Texas states in its exceptions that Mr. Poole testified that an individual analysis of the company's transmission and distribution projects would have been preferable to Staff's approach in its disallowance recommendation.<sup>11</sup> This is true, Staff's intent was to evaluate each project individually, and that would have been possible had AEP Texas had provided sufficient evidence. The burden of proving the reasonableness of each investment lies with AEP Texas and focusing on Staff's reasonable review process does not shift that burden away from AEP Texas. As AEP Texas failed to present sufficient information for its transmission and distribution capital investments, it failed to satisfy its burden of proof. Thus, Staff's recommended disallowance of \$14,115,845 relating to costs not prudently incurred is reasonable and should be adopted by the Commission.

## **B. Capitalized Vegetation Management**

Staff supports the PFD's recommendation to apply recent Commission precedent<sup>12</sup> in this case by recommending that no post-initial right-of-way (ROW) clearing costs should be included in rate base.<sup>13</sup> Accordingly, Staff supports the PFD's recommendation to remove the entire \$26 million booked as capital since July 2006 from rate base to comply with the precedent established in Docket No. 46449<sup>14</sup> and to ensure that AEP Texas does not earn a return on this operation and maintenance (O&M) expense amount by including it in rate base.

In its Exceptions to the PFD, AEP Texas alleges that its vegetation management capitalization policy is consistent with the FERC Uniform System of Accounts (FERC USoA).<sup>15</sup> Staff disagrees that AEP Texas' policy is consistent with the FERC USoA. As quoted in the rebuttal testimony of Staff Witness David Bautista, in an audit conducted on American Transmission System Inc in 2013, FERC stated,

---

<sup>10</sup> Staff Ex. 6 at JP-4.

<sup>11</sup> AEP Texas' Exceptions at 4.

<sup>12</sup> See *Application of Southwestern Electric Power Company for Authority to Change Rates*, Docket No. 46449, Order on Rehearing at Findings of Fact Nos. 110-117 (Mar. 19, 2018); see Staff's Initial Brief at 9-15.

<sup>13</sup> PFD at 38.

<sup>14</sup> *Id.*

<sup>15</sup> AEP Texas' Exceptions at 9

The Commission's regulations provide for the capitalization of vegetation management costs incurred for the initial clearing of land during construction. Also, the commission's regulation requires vegetation management costs incurred subsequent to the construction phase of the project to be expensed. Vegetation management for plant in service are costs to trim trees, remove trees, prune, and clear brush specifically to ensure the reliability of the transmission system by preventing vegetation-caused failures. Under the Commission's accounting regulations, costs of this nature are recorded as maintenance expense.<sup>16</sup>

In its Exceptions to the PFD, AEP Texas claims that "trimming trees and clearing brush" are activities "that stand in stark contrast to activities at issue in this case". However, FERC's own instruction states that vegetation management costs to trim trees, remove trees, prune, and clear brush should be expensed. Expansion of ROW subsequent to construction, initial removal of trees that did not occur at the time of project construction, and removal of trees greater than 18 inches in diameter that similarly did not occur at the time of project construction clearly do not qualify as "first clearing and grading of land," despite AEP Texas' claims to the contrary.<sup>17</sup>

AEP Texas has also not illustrated that the activities included in the \$26 million at issue were associated with capital construction projects, which could have had a "first clearing and grading of land" Such capital projects would include construction of new transmission line, or the rebuilding, upgrading, or reconductoring, of existing transmission lines. Projects of this type have been reviewed and addressed separately.

Finally, AEP Texas asserts in its Exceptions that an audit of Ohio Power Company that did not find FERC USoA violations somehow justifies AEP Texas' vegetation management policy in this case, as Ohio Power Company employs the same vegetation management capitalization policy as AEP Texas.<sup>18</sup> This argument is not persuasive. In fact, it is not clear that the aforementioned audit even considered the capitalization of vegetation clearing activities.

Staff's position here, that no post-initial right-of-way (ROW) clearing costs should be included in rate base, aligns with the clear Commission precedent addressing this issue in Docket Nos. 45084<sup>19</sup> and 46449.<sup>20</sup> Consequently, Staff supports the PFD's recommendation to remove

---

<sup>16</sup> Cross-Rebuttal Testimony of David Bautista, Staff. Ex. 5a at 6.

<sup>17</sup> AEP Texas' Exceptions at 7

<sup>18</sup> *Id.* at 9.

<sup>19</sup> *Application of Entergy Texas, Inc. for Approval of a Transmission Cost Recovery Factor*, Docket No. 45084 (Jul. 20, 2016).

the \$26 million booked as capital since July 2006 from rate base to comply with the Commission precedent and to ensure that AEP Texas is not allowed to earn a return on what is clearly an operation and maintenance (O&M) expense per Commission precedent and the FERC USoA.

#### **F. Capitalized Incentive Compensation**

The PFD correctly recommended removal of \$92,357,577 in capitalized financially based incentive compensation (FBIC) from rate base. The PFD's recommendation to remove this amount relies on longstanding Commission precedent that FBIC is not recoverable from customers.<sup>21</sup> Additionally, Staff based its disallowance on FBIC amounts provided by AEP Texas. In its exceptions to the PFD, AEP Texas argues that this recommendation marks a significant departure from Commission precedent and arbitrarily applies policies to AEP Texas that the Commission has not applied to other Texas utilities.<sup>22</sup> Staff disagrees.

As the PFD correctly states, the Commission's policy that FBIC is not recoverable from customers has held consistent over the past 14 years.<sup>23</sup> Rather than being an "evolving" policy as AEP Texas claims, the history of this issue suggests that whenever the Commission determines that some form of FBIC is being recovered from customers through either O&M expense or rate base, recovery of that amount is disallowed in every instance.<sup>24</sup> AEP Texas was notified in two of its own proceedings that FBIC was not reasonable and necessary for the provision of electric utility service.<sup>25</sup> Despite this, AEP Texas chose to continue to include FBIC in its expenses as well as in its invested capital. AEP Texas has not cited to a Commission decision that expressly allowed some form of FBIC recovery. Further, the precedent applicable to capitalized FBIC is to remove the item from rate base as of the first day after the utility's last test year, rather than only going forward from the date new rates are set.<sup>26</sup>

---

<sup>20</sup> Docket No. 46449, Order on Rehearing, Findings of Fact Nos. 110-117 (Mar. 19, 2018).

<sup>21</sup> *Application of AEP Texas Central Company for Authority to Change Rates* Application of AEP Texas Central Company for Authority to Change Rates Docket No. 28840, Order at FoF Nos. 164-70 (Aug. 15, 2005).

<sup>22</sup> AEP Texas' Exceptions at 11.

<sup>23</sup> PFD at 63.

<sup>24</sup> *Id.*

<sup>25</sup> *Application of AEP Texas Central Company for Authority to Change Rates*, Docket No. 33309, Order on Rehearing at Finding of Fact No. 82 (Mar. 4, 2008) and *Application of AEP Texas Central Company for Authority to Change Rates*, Docket No. 28840, Order on Rehearing at Findings of Fact No. 169, 170 (Aug. 15, 2005).

<sup>26</sup> *Application of Entergy Texas, Inc. For Authority to Change Rates and Reconcile Fuel Costs*, Docket No. 39896 Order on Rehearing at 5-6 (Nov. 2, 2012).



AEP Texas claims that the recommended disallowance is “breathtaking.” In fact, the amount of capitalized FBIC is the product of AEP Texas’ own presentation of its rate filing package and subsequent responses to discovery. The disallowance recommended by Staff and adopted by the ALJs was based on AEP Texas’ own calculation of FBIC as provided to Staff under oath through the course of the discovery phase in this proceeding. Staff, in as simple and explicit terms as possible, requested AEP Texas to, “please provide the amount of FBIC included in the Company’s requested rate base since the end of its Docket Nos. 33309 and 33310 June 30, 2006 test year, by FERC account.”<sup>27</sup> AEP Texas responded to Staff request for information (RFI) No. 2-49 with attachments that provided Staff with the amount of capitalized FBIC that Staff ultimately included as its recommended disallowance.<sup>28</sup> Staff’s RFI was clear and AEP Texas, in preparing its response, chose the dollar amount to disclose as representing its FBIC included in plant in service FERC accounts since the end of its previous test year. Staff’s approach was direct: eliminate all of the FBIC from rates in accordance with Commission precedent as ordered in Docket No. 43695 and Docket No. 46449.<sup>29</sup>

AEP Texas argues that Staff “arbitrarily applies policies to AEP Texas that the Commission has not applied to other Texas utilities.”<sup>30</sup> AEP Texas also asserts that the Commission must allow one-half of capitalized FBIC in its rate base. However, AEP Texas’ assertion is in and of itself arbitrary and a departure from Commission-authorized cost recovery. Commission precedent provides that:

It is well-established that a utility may not include in its rates the costs of incentives that are tied to financial-performance measures. The Commission agrees with the SOAH ALJs’ characterization of the annual incentive plan as “complicated” and notes that when a utility elects to adopt a compensation plan that involves both financially-based and performance-based metrics, the utility still must show it has removed all aspects of the financially-based goals from its requested expense. Based on the testimony of the experts offered by AXM and OPUC, the Commission is not convinced SPS’s adjustment fully captured the financial aspects of the annual incentive plan.<sup>31</sup>

---

<sup>27</sup> Staff Ex. 4A at Attachment AG-31.

<sup>28</sup> *Id.*

<sup>29</sup> Staff Ex. 4A at 14 (citing Docket No. 43695, Order on Rehearing at 5 (Feb. 23, 2016); Docket No. 46449, Order on Rehearing, Findings of Fact Nos. 194-199 (Mar. 19, 2018)).

<sup>30</sup> AEP Texas Exceptions at 11.

<sup>31</sup> Docket No. 43695, Order on Rehearing at 5 (Feb. 23, 2016)

AEP Texas, without dispute, adopted a compensation plan that involves both financially based and performance-based metrics.<sup>32</sup> AEP Texas did not show that it removed **all** aspects of the financially-based goals from its request. Staff afforded AEP Texas the opportunity to present the information that represents requested dollars associated with **all** aspects of the financially-based goals.<sup>33</sup> AEP Texas responded with exactly the information requested by Staff and Staff adjusted the rate base and revenue requirement accordingly.<sup>34</sup> AEP Texas did not update its discovery response and it did not respond to Staff's request in testimony urging AEP Texas that if its RFI responses double count the FBIC it should provide complete, explanatory information in its rebuttal testimony.<sup>35</sup> The rebuttal testimony presents a worksheet of calculations that appear to remove the arbitrary one-half of some portions of the incentive compensation requested, but did not detail how that calculation captures the 70% financial funding mechanism.<sup>36</sup> Complete explanatory information with regard to AEP Texas' flow-through of the effects of the funding mechanism and its interpretation of what it believes to be a 50% sharing among shareholders and ratepayers is at best lacking in this proceeding. AEP Texas cites to Docket No. 43695 in its Exceptions to support its position that only 50% of FBIC should be removed.<sup>37</sup> However, to be clear, the goal stated by the Commission in that proceeding was the same as the goal in this proceeding – to remove all FBIC from rate base.<sup>38</sup> AEP Texas argues further that Staff's recommendation conflicts with what Staff recommended and supported in the PFD in the pending CenterPoint rate case Docket No. 49421. CenterPoint's FBIC capitalization policy is not an issue in this proceeding, and therefore, to compare the magnitude of the CenterPoint adjustment to the magnitude of the AEP Texas adjustment requires the reader to assume that both companies employ identical capitalization policies with regard to FBIC, that both companies calculate FBIC using identical measures, and that countless other accounting policies are identical. This is unlikely to be the case. As stated in the direct testimony of Staff's accounting witness in the CenterPoint rate case, "Consistent with the Commission's recent precedent in Docket Nos. 43695 and 46449, I recommend removing all of CenterPoint's

---

<sup>32</sup> AEP Texas' Exceptions at 10

<sup>33</sup> Staff Ex. 4A at Attachment AG-31

<sup>34</sup> *Id.*

<sup>35</sup> Staff Ex. 4A at 20.

<sup>36</sup> Rebuttal Testimony of Randall W. Hamlett Rebuttal at Exhibit RWH-4R

<sup>37</sup> AEP Texas' Exceptions at 12

<sup>38</sup> Staff Ex. 4A at 14 (citing Docket No. 43695, Order on Rehearing at 5 (Feb. 23, 2016)).

financially based incentive compensation.”<sup>39</sup> In both dockets, Staff’s recommendation is to remove all of the financially-based incentive compensation from the companies’ requests.

AEP Texas includes in its Exceptions the claim that it requested recovery of incentive compensation without disallowance because, at the time AEP Texas filed its case, there was legislation pending at the Texas Legislature that would have allowed for such recovery by electric utilities.<sup>40</sup> However, AEP Texas filed its 45-day update on June 17, 2019, well after the close of the 2019 Legislative Session in which the aforementioned legislation did not pass and failed to adjust its request to remove FBIC. AEP Texas’ own witness at the hearing on the merits confirmed that once the bill was referred to committee it failed to move any further in the legislative process.<sup>41</sup>

AEP Texas argues that the application of the Commission’s policy to deny recovery of capitalized FBIC is improper and violates due process. However, AEP Texas knew, or at least should have known, since the conclusion of the rate cases in Docket Nos. 33309 and 33310 that future recovery of its FBIC was at risk when the Commission clearly and explicitly stated, “TCC’s [now AEP Texas] inclusion of annual and long-term incentive compensation related to financial incentives in cost of service is unreasonable because it is not necessary for the provision of T&D [transmission and distribution] utility services.”<sup>42</sup>

Therefore, Staff supports the PFD’s recommended removal of the entire \$92,357,577 in capitalized FBIC from rate base. These adjustments are recommended because it is well-established Commission precedent that FBIC should be excluded from rates charged to customers because financial measures are of more immediate benefit to shareholders and are not measures that are necessary and reasonable to provide T&D utility services.<sup>43</sup>

## **V. RATE OF RETURN**

### **A. Return on Equity**

Staff respectfully excepts to the ALJs’ Return on Equity (ROE) recommendation of 9.4%. Staff recommends a 9.35% ROE.

---

<sup>39</sup> Filarowicz Direct at 13, Docket No. 49421

<sup>40</sup> AEP Texas’ Exceptions at 14

<sup>41</sup> Tr. at 74:18 to 74:23 (Talavera Redirect) (Aug. 21, 2019).

<sup>42</sup> Docket No. 33309, Order on Rehearing, Finding of Fact No. 82 (Mar. 4, 2008).

<sup>43</sup> *Application of AEP Texas Central Company for Authority to Change Rates*, Docket No. 28840, Order, Findings of Fact Nos. 169-170 (Aug. 15, 2005).

***Staff's Recommended ROE of 9.35% is based on sound and reasoned analysis***

Staff's ROE recommendation of 9.35% is based on discounted cash flow (DCF) and risk-premium methodologies that are well-established at the Commission,<sup>44</sup> in line with the trend in ROEs awarded by the Commission since 2014, and consistent with the 9.38% average authorized ROE for delivery-only electric utilities since 2018. The results of these methodologies are shown in the chart below:<sup>45</sup>

<b><u>Methodology</u></b>	<b><u>Point Estimate</u></b>	<b><u>Range</u></b>
Single Stage DCF Analysis	8.61%	5.94% – 11.57%
Multistage DCF Analysis	8.31%	7.36% – 10.1%
Conventional Risk-Premium	9.66%	N/A
CAPM Analysis	6.20%	N/A
<b>Return on Equity (ROE)</b>	<b>9.35% (excluding CAPM)</b>	<b>8.46% – 9.66%</b>

Staff's ROE recommendation of 9.35% lies in stark contrast to AEP Texas' ROE recommendation of 10.5%, which is based on unreliable and unrealistic assumptions and far exceeds recent ROEs approved by the Commission or the average authorized ROEs for delivery-only electric utilities since 2018.

AEP Texas argues that the ROE recommended in the PFD is inappropriate because it is lower than that of some of its peers. It suggests that the average ROEs among companies included in witness' respective proxy groups equal 9.68%, which is clearly higher than that recommended in the PFD. However, this is not a valid comparison, as proxy group ROEs are not metrics utilized in any of Staff's ROE analyses. The only proxy company information considered in Staff's single and multi-stage DCF and risk premium methodologies was individual proxy company stock prices, dividends, and earnings growth rates. Further, as Staff's ROE estimation methodologies have been relied upon to estimate Staff's ROE recommendations for several decades, it stands to reason that any recent Commission precedent to support the use of proxy company ROEs for this purpose is entirely lacking, and AEP Texas' comparison is not a valid one

---

<sup>44</sup> Docket No. 46449, Order on Rehearing at Finding of Fact No. 159 (Mar. 19, 2018) ("The results of the discounted-cash-flow model and risk-premium approach support an ROE of 9.60%"); Docket No. 40413, Order on Rehearing at Finding of Fact No. 151 (Mar. 6, 2014).

<sup>45</sup> Direct Testimony of Nancy Palma, Staff Ex. 3 at 28 and Attachment NP-9.

AEP Texas also points to authorized ROEs in 173 state regulated utility cases from February 2014 through May 2019 in which only 32 involved an authorized ROE below 9.5.<sup>46</sup> However, most of these cases did not involve Texas utilities or companies sharing comparable risk profiles. In their most recent credit rating reports for AEP Texas, Moody's and Standard and Poors (S&P) recognized "supportive" and "constructive" nature of the regulatory environment in Texas (particularly for transmission and distribution utilities),<sup>47</sup> and AEP Texas' excellent business risk profile, both of which merit a lower ROE for AEP Texas in this context.<sup>48</sup> AEP Texas next presents a chart of eight Texas utilities that have higher authorized ROEs than AEP Texas. However, seven of the eight cases it cited were settled and are therefore not precedential.<sup>49</sup>

AEP Texas also rejects the argument advanced by Staff and Intervenors that authorized ROEs for wires-only utilities are on the decline. However, as TIEC witness Michael Gorman notes, ROEs have been trending downward over the last several years.<sup>50</sup> For the 2018 to 2019 time frame, ROEs for distribution-only utilities have averaged 9.38%.<sup>51</sup> Staff's recommended ROE of 9.35% is consistent with the downward trend in authorized ROEs over the last five years and entirely consistent with the recent average authorized ROEs of 9.38% for distribution-only utilities.

In its Exceptions, AEP Texas also argues that the recommended ROE could negatively affect its ability to attract investors as compared to its peers when considering the 5.8 billion dollars it intends to spend over the next several years.<sup>52</sup> However, all investments will be made in regulated operations, the costs for which may be recovered in a timely manner via several cost recovery mechanisms available to AEP Texas.<sup>53</sup> These mechanisms therefore reduce AEP Texas's risk when compared to peers for which these are not available.

---

<sup>46</sup> AEP Texas' Exceptions at 26.

<sup>47</sup> Moody's Investors Service, *AEP Texas, Inc.: Update to Credit Analysis* at 1 (Sept. 20, 2018).

<sup>48</sup> Staff Ex. 3 (Palma Dir.) at 37, 39.

<sup>49</sup> *Application of Texas-New Mexico Power Company for Authority to Change Rates*, Docket No. 48401, Order, Conclusion of Law No. 30 (Dec. 20, 2018); *Application of Oncor Electric Delivery Company LLC for Authority to Change Rates*, Docket No. 46957, Order, Conclusion of Law No. 18 (Oct. 13, 2017).

<sup>50</sup> Direct Testimony of Michael Gorman, TIEC Ex. 3 at 6:21-23.

<sup>51</sup> Tr. at 552:24 to 553:4 (Palma Redirect) (Aug. 22, 2019).

<sup>52</sup> AEP Texas' Exceptions at 27.

<sup>53</sup> Staff Ex. 3 (Palma Dir.) at 39.

AEP Texas also argues that its credit rating could be negatively affected if the recommended ROE is adopted. It is true that the Moody's report issued on Nov 26, 2019 indicates a downgrade in outlook from "Stable" to "Negative" given the PFD's recommendation. However, a "negative" outlook does not mean AEP Texas will be downgraded. Further, even if a downgrade did occur, AEP Texas would still maintain an investment grade credit rating as its current S&P and Moody's ratings are four notches and three notches above the highest non-investment-grade rating, respectively.<sup>54</sup> Consequently, even in the unlikely event that AEP Texas did experience a downgrade in its credit rating, its credit would still be considered "investment grade" and maintain its access to affordable financing.

Staff utilized well-established methodologies that are consistent with Commission precedent to determine its 9.35% ROE recommendation. In contrast, AEP Texas relied on inappropriate comparisons and exaggerated fears concerning its credit rating to support its 10.5% ROE recommendation, which far exceeds the Commission-approved ROEs for vertically-integrated utilities that bear significantly more risk than a TDU. For these reasons, Staff recommends that the Commission authorize a 9.35% ROE for AEP Texas as it appropriately reflects its risk profile and properly balances the needs of AEP Texas's stakeholders and its rate payers.

#### **E. Financial Integrity, Including "Ring Fencing"**

The PFD correctly concludes that PURA grants the Commission authority to order the ring-fencing provisions in the context of a rate case.<sup>55</sup> In its Exceptions, AEP Texas rehashes its argument from briefing that the Commission lacks the authority in the context of a rate proceeding to impose ring-fencing protections, and that the relevant statutes do not explicitly mention ring-fencing.<sup>56</sup> Staff respectfully disagrees.

PURA provides a broad grant of authority in the context of rate proceedings, if the determinations made by the Commission involves the implementation of ring-fencing mechanisms that serve to maintain a utility's financial stability and the ability to provide reliable

---

<sup>54</sup> AEP Texas Inc., S&P Global Ratings (March 26, 2019), AEP Texas Inc., Moody's Investors Service (September 20, 2018).

<sup>55</sup> PFD at 154.

<sup>56</sup> PFD at 153-54; AEP Texas Inc.'s Exceptions to the Proposal for Decision at 29.

service at reasonable rates.<sup>57</sup> The authority arises regardless of whether the proceeding is a rate-related docket or a sale, transfer, merger docket.<sup>58</sup> In the PFD, the ALJs properly recognize this authority in observing that ring-fencing powers are not limited to matters filed in connection with PURA §§ 14.101, 39.262, or 39.915 transactions.<sup>59</sup> Instead, PURA grants the Commission broad authority to enact measures to ensure the financial integrity of electric utility, including ring-fencing measures, especially in the context of reducing risk to Texas ratepayers.

Staff recommends that the Commission utilize this authority to adopt Staff's proposed ring-fencing measures.

## **VI. OPERATING AND MAINTENANCE EXPENSES**

### **B. Labor Expenses**

#### **1. Incentive Compensation**

Staff recommends a decrease of \$8,372,002 to AEP Texas' request for annual incentive compensation<sup>60</sup> and a decrease of \$2,250,463 to its requested long-term incentive compensation.<sup>61</sup> Well-established Commission precedent provides that FBIC should be excluded from rates charged to customers because financial measures are of more immediate benefit to shareholders and are not measures that are necessary and reasonable to provide transmission and distribution utility services.<sup>62</sup>

In its Exceptions, AEP Texas argues that Staff's approach in this docket is inconsistent with its approach in CenterPoint's pending rate case, Docket No. 49421. This is simply incorrect. As was discussed above, Staff's ultimate goal is to remove all of the FBIC and to include the compensation that is based upon operational measures. That goal is consistent throughout both this proceeding and the CenterPoint proceeding. Staff's testimony in Docket No. 49421 states

---

<sup>57</sup> Direct Testimony of Darryl Tietjen at 10.

<sup>58</sup> *Id.*

<sup>59</sup> PFD at 155.

<sup>60</sup> Direct Testimony of Anna Givens, Staff Ex. 2 at 19.

<sup>61</sup> Staff Ex. 2 at 21.

<sup>62</sup> *Application of AEP Texas Central Company for Authority to Change Rates*, Docket No. 28840, Order, Findings of Fact Nos. 169-170 (Aug. 15, 2005).

that it recommends removing all of the FBIC from rates and the recommendation in Docket No. 49494 is consistent with that testimony.<sup>63</sup>

AEP Texas' requested recovery includes incentive compensation based on plans that consist of operational and financial goals, as well as plan funding based on operational and financial measures. In preparing its rate filing package, AEP Texas made no attempt to remove any of the FBIC expense from its request. Even when the 2019 Legislative Session ended, and with it the Company's stated "primary reason" for including FBIC,<sup>64</sup> and AEP Texas was required to file its 45-day update to the rate filing package, it continued to request 100% of its FBIC expense.<sup>65</sup>

As addressed more thoroughly in the section addressing capitalized FBIC, Section III.F, Staff maintains that the clear direction from Commission precedent that covers 20 years of electric rate setting requires removal of *all* of the financially-based incentive compensation from rates. Staff's approach was direct: eliminate all of the financially-based incentive compensation from rates just as the Commission ordered in Docket No. 43695 and Docket No. 46449.<sup>66</sup> Staff explicitly asked AEP Texas to provide all amounts of FBIC.<sup>67</sup> AEP Texas answered Staff's RFI and provided all of the FBIC that was included in its request.<sup>68</sup> Because AEP Texas made no attempt to remove any of the FBIC from its request, the adjustment is a clean 100% disallowance of the amounts submitted by AEP Texas in discovery.

For those reasons, Staff's recommendation for a decrease of \$8,372,002 to AEP Texas' request for annual incentive compensation and a decrease of \$2,250,463 to its requested long-term incentive compensation should be adopted.

---

<sup>63</sup> Staff Ex. 4A at 14 (citing Docket No. 43695, Order on Rehearing at 5 (Feb. 23, 2016); Docket No. 46449, Order on Rehearing, Findings of Fact Nos. 194-199 (Mar. 19, 2018)).

<sup>64</sup> Tr. at 430:13-21, (Carlin Cross) (Aug. 21, 2019).

<sup>65</sup> The session ended on May 27, 2019 and the 45-day update was filed on June 17, 2019.

<sup>66</sup> Staff Ex. 4A at 14 (citing Docket No. 43695, Order on Rehearing at 5 (Feb. 23, 2016); Docket No. 46449, Order on Rehearing, Findings of Fact Nos. 194-199 (Mar. 19, 2018)).

<sup>67</sup> *Id.* at Attachment AG-16.

<sup>68</sup> *Id.*



## **X. FUNCTIONALIZATION AND COST ALLOCATION**

### **B. Class Allocation**

#### **2. Distribution Demand Class Allocation**

Staff disagrees with the PFD's recommendation to use the Residential class' summer peak instead of its non-coincident peak (1 NCP) for the reason outlined in Staff's Exceptions to the PFD. Instead, Staff supports the ALJs' recommendation that distribution demand costs should be allocated to the classes based on 1 NCP demand instead of the average of each month's non-coincident peak (12 NCP) demand. As stated in the PFD, 1 NCP is a more reasonable means of allocating distribution demand costs among the classes because it "more accurately reflects cost causation and is consistent with Commission precedent."<sup>69</sup> The PFD further states:

A 1 NCP allocation is appropriate for demand-related distribution costs because most elements of the distribution system must be sized to handle localized loads that may peak at times other than the system peak. Distribution systems must be capable of meeting each class' maximum demand, irrespective of class load at the time of the system peak. For this reason, the 1 NCP allocator is a more appropriate method of allocating distribution plant costs.<sup>70</sup>

The PFD's decision to recommend using the 1 NCP method for demand-related distribution costs as recommended by Staff, TIEC, and Federal Executive Agencies (FEA), and accepted by AEP Texas, is consistent with Commission precedent.<sup>71</sup> Distribution systems must be sized to serve the localized peak demand regardless of when that localized peak demand occurs compared to the overall system peak.<sup>72</sup>

Despite this accurate recommendation, Cities excepts to the use of 1 NCP demand to allocate distribution demand costs among the classes and continues to argue that a 12 NCP

---

<sup>69</sup> PFD at 270 (Nov 12, 2019).

<sup>70</sup> *Id.*

<sup>71</sup> *Application of Southwestern Public Service Company for Authority to Change Rates*, Docket No. 43695, Order on Rehearing at Findings of Fact Nos. 278-279, 281-282, and 359, (Feb 23, 2016).

<sup>72</sup> *Id.*

demand should be adopted. Although Cities acknowledged that the distribution system is built to meet the maximum demands for local areas of the system,<sup>73</sup> the 12 NCP allocator proposed by Cities is not an accurate measure of each classes' maximum load. The 12 NCP allocator is calculated based on each classes' average monthly peak demands in the test year, giving equal weight to the monthly peak demands in all 12 test year months. Although Cities states that the classes' maximum demand is included in the 12 NCP calculation,<sup>74</sup> this is ill-advised because averaging each classes' average monthly peak demands in the test year dilutes the class actual maximum load by including load values from months where the class monthly peak load is lower.<sup>75</sup>

In addition, Cities makes the argument that class 1 NCP allocation is a proxy or representation of the distribution planning process and is intended to represent the diversity in time periods of maximum demand among customer classes.<sup>76</sup> They conclude that the distribution system would be oversized if it was designed to meet maximum demands for all the customer classes.<sup>77</sup> As an initial point, this argument provides no support for the 12 NCP approach as being more reasonable or more consistent with cost causation than the standard 1 NCP allocation. Furthermore, the use of the 1 NCP method does not imply that distribution systems are sized to meet the maximum demands for all the customer classes at every location. As stated above, distribution systems must be sized to handle localized loads that may peak at times other than the system peak, and localized areas on the distribution system tend to be dominated by one particular class. For example, a distribution substation serving a residential neighborhood is unlikely to also be serving industrial or large commercial load. The 1 NCP method reflects the fact that the distribution system must be built to meet the maximum demand in residential areas, even if the residential class is winter-peaking, and commercial areas, even if the Secondary < 10 kW and Secondary > 10 kW classes are summer peaking. For these reasons, as well as the reasons discussed in Staff's Exceptions to the PFD, Cities' recommendation to use the 12 NCP approach or to adopt the PFD's recommendation to use the summer peak for the Residential

---

<sup>73</sup> Cities' Exceptions to the PFD (Cities' Exceptions) at 20 (Dec 6, 2019).

<sup>74</sup> *Id.*

<sup>75</sup> Direct Testimony of Adrian Narvaez at 27 (Aug 1, 2019).

<sup>76</sup> Cities' Exceptions at 20 (Dec 6, 2019).

<sup>77</sup> *Id.*

class instead of the class NCP should be rejected as inconsistent with cost causation and commission precedent.

## **XI. REVENUE DISTRIBUTION AND RATE DESIGN**

### **A. Rate Moderation**

Staff supports the ALJs' decision to reject any rate moderation measures in this proceeding and disagrees with TIEC's exception to setting cost-based rates in this proceeding. TIEC's recommendation to moderate the update to the 4CP class allocation factors as well as distribution delivery rates fails to comply with the language of the rule and Commission precedent. Establishing rates at cost is required under 16 TAC § 25.234, and Commission precedent. Under 16 TAC § 25.234:

Rates shall not be unreasonably preferential, prejudicial, or discriminatory, but shall be sufficient, equitable, and consistent in application to each class of customers, and shall be based on cost.

Additionally, compared to ratemaking in areas not subject to competition, setting rates at cost is more important for TDUs serving customers in the competitive ERCOT market, and has been an important component of Commission policy since the inception of the competitive market.<sup>78</sup> However, the Commission has found that gradualism was appropriate for certain vertically integrated utilities not operating within the competitive ERCOT market where movement to cost would result in an increase that is "out of proportion or harsh to a particular class," or where an increase is "harsh to particular classes and promote[s] rate shock."<sup>79</sup>

While TIEC incorrectly claims that AEP Texas' filed case would abruptly increase the North division Transmission class' rates by 140.1%, the actual increase under AEP Texas' filed case was 117.5%.<sup>80</sup> TIEC later acknowledges that the actual increase for North division retail Transmission customers would only be 82.1% under the PFD.<sup>81</sup> However, this analysis focuses solely on the increase in delivery rates, not total bill impacts. While TIEC focuses only on delivery rates, the Commission has previously stated that "any gradualism methodology should

---

<sup>78</sup> Cross-Rebuttal Testimony of Adrian Narvaez at 10 (Aug 13, 2019).

<sup>79</sup> *Application of Southwestern Electric Power Company for Authority to Change Rates and Reconcile Fuel Costs*, Docket No. 40443, Redacted Proposal for Decision at 269 (May 20, 2013).

<sup>80</sup> Direct Testimony of Jennifer Jackson, AEP Texas at 34.

<sup>81</sup> TIEC's Exceptions to the PFD (TIEC's Exceptions) at 39 (Dec 6, 2019).

evaluate the differences in rates that customers pay.”<sup>82</sup> This point was emphasized by AEP witness Jennifer Jackson in her direct testimony when she stated:

In reviewing these numbers, it is important to keep three things in mind:

(1) the proposed rates are Transmission and Distribution rates only and comprise only a portion of an non-industrial end use customer's bills; (approximately 50% of a residential customer's bill); therefore the overall bill impact on non-industrial end-use customers will be less than the impact shown above; (2) the REP's bill the end-use customers and set the total overall rate for the end-use customers. Therefore, individual rate impacts could vary significantly based on the pricing arrangement between the REP and end-use customer.<sup>83</sup>

TIEC's suggestion to focus solely on increases in delivery rates not only ignores the Commission's explicit requirement to evaluate the differences in rates that customers actually pay, it also violates Commission precedent because it fails to demonstrate that such an increase in delivery rates constitutes rate shock. Recent rate moderation proposals adopted by the Commission relate to vertically-integrated utilities whose rates encompass generation, retail, and transmission and distribution delivery costs.<sup>84</sup> However, base rate case proceedings for regulated ERCOT transmission and distribution utilities establish transmission and distribution delivery rates exclusively.<sup>85</sup> Consequently, transmission and distribution utilities' rates typically comprise a smaller portion of an end use customer's bills, as opposed to vertically-integrated utility's rates. It would be misleading to argue that a steep increase in transmission and distribution delivery rates constitutes rate shock when this increase only represents a fraction of the total bill that customers are responsible for paying, and it is therefore unknown what the total bill impact will be.

While TIEC claims that delivery rates have become a larger percentage of the total bill over the past ten years, they do not provide any tangible evidence to support this claim.<sup>86</sup> In fact, TIEC admitted that they did not attempt any assessment of the need for rate moderation from the

---

<sup>82</sup> *Application of Southwestern Electric Power Company for Authority to Change Rates*, Docket No. 46449, Final Order at Finding of Fact No. 314A (Mar. 19, 2018).

<sup>83</sup> Direct Testimony of Jennifer L. Jackson at 35-36.

<sup>84</sup> Cross-Rebuttal Testimony of Adrian Narvaez at 11 (Aug 13, 2019).

<sup>85</sup> *Id.*

<sup>86</sup> TIEC's Exceptions at 39-40 (Dec 6, 2019).

perspective of total bill impacts.<sup>87</sup> No party has demonstrated that any customer class would experience rate shock, as defined under Commission precedent. Therefore, as was aptly pointed out by the ALJs in the PFD, a gradualism adjustment is not necessary in this case. On the other hand, Staff estimated that when evaluated on a total-bill basis, as required under Commission precedent, the bill impacts for the North division's retail Transmission class might only represent a 25% overall bill increase, or lower.<sup>88</sup> Considering that the Commission has approved rate increases of up to 42.6% in base rate cases relating to vertically-integrated utilities, it is not reasonable to argue that a 25% total bill increase constitutes rate shock.<sup>89</sup> TIEC has not provided evidence sufficient to show good cause for deviating from cost-based rates in this proceeding.

While Staff continues to support cost-based rates, Staff agrees with the PFD's recommendation to adopt Staff's alternative rate moderation proposal in the unlikely event that the Commission decides that a gradualism adjustment is necessary in this case. TIEC states that Staff's alternative rate moderation proposal is inequitable because other than taking service at the same voltage, Texas Central division retail Transmission customers have no relationship with the Texas North division retail Transmission customers.<sup>90</sup> This assertion ignores the fact that the only relationship that other North division retail classes have with North division retail Transmission customers is that the other North division retail classes have been subsidizing the North division retail Transmission customers for the past decade. The level of increases facing the North division retail Transmission class results directly from increases in billing determinants for this class without a corresponding update to the class allocation factors due to a flaw in the ERCOT transmission cost recovery factor.<sup>91</sup> This has resulted in the Primary and Transmission Service customer classes being subsidized by the other classes for 12 to 13 years. TIEC's rate moderation proposal would continue the interclass subsidization for the North division for another four years and would result in higher rates for classes that should actually receive a rate reduction. This scenario is inappropriate given the requirements of 16 TAC § 25.234 and commission precedent when rate shock is not a concern in this case. The answer to the

---

<sup>87</sup> Tr. at 194:21-195:11 (Pollock Cross) (Aug. 20, 2019).

<sup>88</sup> Cross-Rebuttal Testimony of Adrian Narvaez at 12 (Aug 13, 2019).

<sup>89</sup> *Application of Southwestern Electric Power Company for Authority to Change Rates*, Docket No. 46449, Commission Number Run (Revenue Distribution Schedule) (Dec. 20, 2017).

<sup>90</sup> TIEC's Exceptions at 42 (Dec 6, 2019).

<sup>91</sup> Tr. at 319:2-6 (Williams Clarifying) (Aug. 20, 2019).

subsidization of the North Transmission class should not be the continued subsidization of that class when rate shock is not a concern under Commission precedent.

TIEC asserts that Central division retail Transmission customers are facing steep increases, and therefore, Staff's alternative rate moderation proposal would be discriminatory and unreasonable.<sup>92</sup> This, however, is misleading as TIEC refers to a steep increase in TCRF allocation factors not a steep increase in the actual electric bills these customers must pay.<sup>93</sup> Although Staff's alternative rate moderation proposal would result in a small surcharge on Central Division retail transmission customers in order to fund the approximately \$397,014 credit to the North Division retail transmission class, this surcharge would have a negligible impact on Central Division retail transmission customers.<sup>94</sup> Staff's alternative rate moderation proposal would result in an approximately 8.2% increase in delivery rates for the Central division retail Transmission class, compared to an approximately 7.38% increase in delivery rates with cost-based rates.<sup>95</sup> This represents an even smaller increase in the total bill these customers will face.

Additionally, Staff's alternative proposal would allow for consolidated cost-based rates within one or two years, compared to TIEC's proposal which would maintain separate divisional rates until AEP Texas' next rate case.<sup>96</sup> Maintaining separate divisional rates in this proceeding would not be justified considering that rate consolidation is not a factor in the increases in delivery rates for the North division retail Transmission class.<sup>97</sup>

## **XV. CONCLUSION**

As stated in its Exceptions and in this pleading, Staff supports most of the PFD's recommendations. Staff respectfully requests the adoption of Staff's positions in the foregoing discussion.

---

<sup>92</sup> TIEC's Exceptions at 42 (Dec 6, 2019).

<sup>93</sup> *Id.*

<sup>94</sup> Cross-Rebuttal Testimony of Adrian Narvaez at 17 (Aug 13, 2019).

<sup>95</sup> *Id.* at 19.

<sup>96</sup> *Id.* and PFD at 305 (Nov 12, 2019).

<sup>97</sup> Cross-Rebuttal Testimony of Adrian Narvaez at 6 (Aug 13, 2019).

**PUC DOCKET NO. 49494**  
**SOAH DOCKET NO. 473-19-4421**

**CERTIFICATE OF SERVICE**

I certify that a copy of this document will be served on all parties of record on December 20, 2019 in accordance with 16 TAC § 22.74.

A handwritten signature in black ink, appearing to read 'H. Armstrong', written over a horizontal line.

Heath D. Armstrong