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PUC BULLETIN

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ELECTRIC

Docket Nos. 6765 and 6766, Houston Lighting and Power Company.. 123

Editor's Note: The Examiner's Report and final Order in Docket Nos. 6765/6766, Petitions of Houston Lighting & Power for Authority to Change Rates and for Approval of Proposed Interim Accounting Treatment for Limestone Unit I, will be continued in the September, October, November, and December issues of the **PUC Bulletin,** Volume 13, Nos. 1-4.

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PETITION OF HOUSTON LIGHTING AND POWER COMPANY FOR AUTHORITY TO CHANGE RATES § § § DOCKET NOS. 6765 AND 6766

PETITION OF HOUSTON LIGHTING AND POWER COMPANY FOR APPROVAL OF PROPOSED INTERIM ACCOUNTING TREATMENT FOR LIMESTONE UNIT I § § § §

November 14, 1986
On Clarification December 4, 1986
Rehearing Denied December 22, 1986

Houston Lighting and Power Company's application for a general rate increase granted in part and denied in part. $113,024,000 base rate revenue increase granted, as opposed to utility's requested base rate revenue increase of $345,289,000. Reconcilable fuel expense set equal to $1,011,491,278. (Note: there is no Section X in the Examiners' Report, nor Exhibits 2 or 5.)

G. Unrecovered Storm Costs

1. Company's Position

The company has requested that unrecovered storm costs associated with Hurricane Alicia, for which the company did not have sufficient insurance to cover expenditures and for which the shareholders have paid in order to assure HL&P's ratepayers continued service, should now be recovered from the ratepayers. Mr. Brian stated that no return is currently being earned on these funds which were expended for the benefit of HL&P's customers. Mr. Brian therefore concluded that $8,880,000 should be included in the company's rate base.

2. City's Position

City witness Babcock relied on the Commission's decision in Docket No. 5779 where the Commission allowed a seven year amortization period but did not allow the unamortized balance to enjoy rate base treatment. Ms. Babcock agreed with the Commission's analysis that the hurricane is an operating risk to be borne by the ratepayers and shareholders alike. Thus while the amortization is allowed, no rate base treatment should be afforded to the company, so that HL&P's shareholders would share in the cost by paying the associated carrying charges.

3. OPC's Position

OPC witness Paton also recommended disallowance of the unrecovered storm costs relying on the Commission's decision in Docket No. 5779 which results in the company's ratepayers and shareholders sharing in this cost.

4. Staff's Position

Staff witness Keever also recommended disallowance of the rate base treatment for unamortized storm costs relying upon the Commission's decision in Docket No. 5779.

5. Examiners' Discussion and Recommendation

The examiners agree with the city, OPC, and staff that the unamortized storm costs should not receive rate base treatment, in order that the company's ratepayers and shareholders share in this cost. The examiners therefore recommend removal of $8,880,000 from the company's rate base.

H. Deferred Federal Income Tax (DFIT)

1. Company's Position

The company is requesting a deferred FIT amount of $601,625,000. (Schedule B at 2, Rate Filing Package.)

2. City's Position

City witness Jansen increased the DFIT amount by $29,878,000--$1,017,276 for Cedar Bayou/S.R. Bertram repairs, $28,793,802 for Allens Creek and $66,569 for research studies. Mr. Jansen explained that while for tax purposes the company was able to write off these amounts, for book purposes, the company must recover these expenses over several years. Because the booked expenses are used for regulatory purposes, the company, in essence, has realized cost free capital. In order to recognize this cost free capital, in that tax

normalization allows these dollars to be available to HL&P's customers during the life of the asset, Mr. Jansen recommended their removal from the company's rate base. In that regard, Mr. Jansen pointed out that the deferred tax amount includes those associated with STP for which rate base treatment has not been requested.

3. Staff's Position

Staff witness Keever also recommended an increase of $29,878,000 to the company's DFIT because the ratepayers are already providing FIT on a normalized basis in the company's cost of service; this adjustment is necessary to recognize government supplied capital.

4. Examiners' Discussion and Recommendation

HL&P argues in brief that the recommended treatment, while in accordance with the Commission's order in Docket No. 5779, is not in compliance with a recent Court of Appeals decision relating to Docket No. 4540. Public Utility Commission of Texas v. Houston Lighting and Power Company, No. 14,354, slip op. at 11-15 (Tex. App.--Austin, July 2, 1986). The company argues that since the costs are born by the shareholders, the attendant benefit should also flow to the shareholders.

[11] The examiners, however, feel compelled to recommend approval of the city and staff position. First, it is consistent with the Commission's decision in Docket No. 5779. Second, while the Appellate Court in the above decision held that the ratepayers should share in the tax loss of the Allen Creek's write-off only if the associated expenses have been included in the company's cost of service, this decision is not yet final. Moreover, to allow the shareholders to enjoy tax benefits on an asset which the Commission found to be inappropriate provides no incentive for the company to disengage in inefficient management; i.e., should the Commission find that a major plant does not warrant rate base treatment due to the fact it was not used and useful and thus exclude it from rate base, the shareholders would nonetheless receive a tax benefit for the plant which was not found used and useful or proper. Such a situation smacks of illogic. The examiners recommend DFIT in the amount of $631,503,000.

I. Pre-1971 Investment Tax Credits (ITC)

The company's proposal to reduce rate base by $6,302,000 in ITC's went unopposed and the examiners recommend its adoption.

J. Customer Deposits

The company's proposal to reduce rate base by $32,538,000 in customer deposits also went unopposed and the examiners recommend its adoption.

K. Customer Advances for Construction

The company's proposal to reduce rate base by $15,891,000 for customer advances for construction went unopposed and the examiners recommend its adoption.

L. Reserve for Injuries and Damages

The company's proposal to reduce rate base by $5,597,000 for reserve for injuries and damages went unopposed and the examiners recommend approval of its adoption.

M. Property Damage Reserve

The staff recommended inclusion of $1,429,000 for property damage reserve since it represents investor supplied capital on which the shareholders should earn a return. The examiners agree and recommend inclusion of $1,429,000 in the company's rate base.

N. Retirement Plan

1. Executive Incentives

OPC and staff request a reduction to the company's request for executive bonuses. While the general counsel did not quantify this amount, Dr. Szerszen for OPC found that the amount relating to executive incentives is $95,000.

a. Company's Position. The company currently has adopted the Executive Incentive Compensation Plan of Houston Industries Incorporated. Although only executed by HL&P in November 1985, the effective date of the plan is January 1, 1985. (HL&P Exhibit No. 24.) In the company's opinion, the executive incentive amounts are necessary in order to attract and retain qualified persons in the company. As a basis for its program, the company relies upon an April 6, 1982, letter prepared by the consulting firm of Towers, Perrin, Forster and Crosby. In order to compete with the compensation levels of other industries, the firm recommended that HL&P implement an executive incentive compensation program.

Under the January 1, 1985 plan, the Personnel Committee of the Board of Directors (committee) (1) selects the participants in the plan; (2) approves the award levels; and (3) establishes the performance goals for the company and participants. Selected participants are those persons "whose decisions contribute directly to the success of the company." No person has the right to be a participant. The committee establishes annual corporate performance goals. Only when the corporate performance goal is met will an executive incentive award be made. The committee also establishes key performance factors (KPF) for each participant. A certain percentage is assigned to each KPF based upon the degree of influence a participant's decision and actions have on the factor. The sum of the individual KPF percentages total 100 percent. The percentage of award is based upon three levels of achievement: distinguished, excellent and above average. While the actual percentage of the award is dependent on the level attained, achieving any one of the three would provide the participant an opportunity to receive an award. The committee also establishes a long-term performance goal based upon a four-year period beginning when the goal is established. From this long-term goal, the committee determines whether a long-term award is justified.

The funds for the executive incentive award are limited to the lesser of the sum of the maximum annual incentive award opportunities and maximum long-term incentive award opportunities or one percent of HII's net income. (The annual award is a percentage of the employee's annual base salary. No exact figure is provided.) In 1985, the annual awards were allocated in two portions: a 50 percent vested portion to be paid in cash and a 50 percent

contingent portion converted into common stock shares units. These units are based upon the average market price at the end of the plan year. Any dividends regularly paid are credited to a participant's account and converted into additional common shares. In general, the distribution of the shares does not occur until the employee completes four years of continuous employment. As to payment of a long-term award, such is made in cash upon completion of four years of continuous employment and is limited to 5 percent of the employee's average annual base salary over the four years.

The company provided no direct or rebuttal testimony on this issue and, further, did not brief the issue.

b. OPC's Position. Dr. Szerszen had several misgivings of such a plan. HL&P provided no evidence that its executive salaries were not competitive and that as a result incentives are required. Dr. Szerszen further questioned whether it was appropriate to compare the salary levels of regulated and non-regulated companies. Moreover, in Dr. Szerszen's opinion, an incentive program should be designed to encourage efficiencies and savings in the company and not merely to increase a salary level.

Dr. Szerszen explained, as she understood the program, that although a participant's individual KPF may not be reached, such employee would still receive an award if one of two corporate goals were reached, these corporate goals being the attainment of a certain rate of return on capital or of a certain level for budgeted O&M expenses. Aside from the top two or three participants whose total awards are based on the achievement of corporate goals, a participant's award is based upon the achievement of corporate and KPF's.

Dr. Szerszen criticized the company's corporate budgeted O&M goals because she found that HL&P's actual O&M figures have consistently been below the budgeted amounts.

Dr. Szerszen further criticized the individual participant goals because she found them less than challenging, shareholder-oriented, or entirely inappropriate. For example, Dr. Szerszen took exception to HL&P awarding a

participant due to the achievement of a certain rate of return. Dr. Szerszen believed that such award is beneficial to the company's shareholders and not its ratepayers. Another individual objective required a participant to ascertain that the Management Audit conducted by the Commission would provide a fair assessment of HL&P's management. Dr. Szerszen found this objective, and others, to be mere lobbying efforts. Lastly, Dr. Szerszen noted that in 1984, Mr. Horrigan received a "distinguished" award for being 1.1 percent over budget on the Limestone project. Dr. Szerszen further noted that he could have been over 6 percent over budget and still have received an "above average" ranking. Dr. Szerszen did not find such requirement to be either challenging or warranting compensation. Dr. Szerszen therefore recommended exclusion of the total $95,000 relating to these executive incentive awards.

c. Staff's Position. While the staff did not present testimony on this issue, the general counsel did take a position in her participation at the hearing and in her brief. First, the general counsel argues that the attainment of a certain rate of return and desire to hold down O&M expenses are corporate goals which the company should strive for regardless of any incentives. The general counsel pointed out in brief that company witness Brian agreed with this statement. Second, the general counsel argues that the individual goals are often not realistic. In one case, the goal to reduce lost man-hours in one division was not met due to the number of pregnancies in that division. Third, the general counsel noted goals such as contacts with members of the Commission were subject to awards. In essence, the influencing of Commission members was a basis for rewarding a participant. The general counsel recommended that executive bonuses be disallowed from the company's cost of service.

d. Examiners' Discussion and Recommendation. The examiners have found astonishing the company's decision to abstain from developing this issue in its presentation during the hearing and in its brief. The examiners have reviewed HL&P Exhibit No. 24, which reflects the 1985 individual goals of its participants and their attainment and the 1986 individual goals. The examiners would note that a number of individual goals reflected by the company would indeed provide benefits to the ratepayers, such as reduction of fuel oil inventory, improvement in collections, renegotiation of fuel contracts and reduction of expenditures.

However, along with the above laudatory goals, the company has also set goals which have not been shown to be reasonable. The examiners find disturbing those individual objectives referenced by OPC and the general counsel. The examiners wish to bring to the Commission's attention another individual goal which has not been shown to be an appropriate individual goal. The examiners would further note that Mr. Ledbetter, Vice President of Regulatory Relations, and Mr. Steve Schaeffer, Manager, Rate and Research, both had a 1986 individual goal regarding the company's rate case filing. While the targeted date for the rate case filing was March 21, 1986 (HL&P Exhibit No. 24 at 130), the company filed its rate application on March 18, 1986. It would appear that the Commission and the company's shareholders and ratepayers should thank Mr. Ledbetter and Mr. Schaeffer for the timely filing of the instant rate case.

While the examiners find, in general, executive incentive awards are an appropriate compensatory item, the general counsel and OPC raised an issue as to the reasonableness of total inclusion of those amounts. The examiners would note that the company provided no evidence in the record, with or without confidentiality constraints, as to the dollar amounts associated with those specific goals referenced by OPC and the general counsel. The examiners are therefore unable to discern the dollar amounts of the laudatory goals from those that are not challenging or not appropriate. Regretably, owing to the lack of evidence in the record upon which to calculate the amounts of these questionable goals, the examiners must recommend disallowance of the total amount of $95,000.

2. Other Cost Free Capital

City witness Jansen recommended a further reduction of $5,280,000 relating to unclaimed fuel refund checks and unpaid incentive and deferred compensation costs. The company did not state any objections to the city's adjustment. The examiners find the city's adjustment appropriate and recommend its adoption.

3. Summary

With the adjustments, the total recommended reduction from the company's rate base for its retirement plan is $38,937,000.

P. Summary

The examiners recommend adoption of invested capital in the amount of $4,678,518,911 for HL&P, composed of the following elements:

Electric Plant in Service	$5,797,391,000
Less Accumulated Depreciation	(1,201,576)
Net Plant	4,595,815,000
Construction Work in Progress	678,073,000
Electric Plant Held for Future Use	3,095,000
Nuclear Fuel	58,945,500
Working Capital	80,809,411
Deferred Limestone Charges	-0-
Unrecovered Storm Costs	-0-
Deferred Federal Income Taxes	(631,503,000)
Pre-1971 Unamortized Investment Tax Credits	(6,302,000)
Customer Deposits	(32,538,000)
Customer Advances for Construction	(15,891,000)
Reserve for Injuries and Damages	(5,597,000)
Property Damage Reserve	1,429,000
Retirement Plan	(38,937,000)
Total Original Cost Rate Base	$4,687,398,911

The examiners' recommendation is $337,114,089 less than the company's requested invested capital of $5,024,513,000.

VII. Return

A. Return on Equity

Witnesses for the company, the city, OPC and the staff provided recommendations regarding the proper level of return on equity and necessary overall rate of return for the company. To determine the cost of equity, all witnesses performed a Discounted Cash Flow (DCF) analysis on Houston Industries, Inc. (HII), HL&P's parent corporation. HII was chosen because its stock is publicly traded and is most representative of investor perception of HL&P in the market place. A number of other tests were utilized to lend support to the parties' respective DCF analyses. Company witness Bolster conducted a DCF analysis on a sample of companies involved in nuclear construction and of

those not involved in nuclear construction; he also conducted a risk premium analysis. City witness Elliott performed a comparable earnings analysis and a risk premium analysis. OPC witness Szerszen and staff witness Reed conducted an analysis of a comparable group of companies. While Dr. Szerszen and Mr. Reed disallowed any market or flotation adjustment, both Mr. Bolster and Ms. Elliott recommended an adjustment to the company's dividend yield based upon dilutive effects on the company's stock stemming from market and flotation costs.

The following provides the parties' recommendations as reflected in their direct testimonies:

	Dividend Yield	Growth	Market-to-Book Adjustment	Return on Equity	Rate of Return
Company	9.97%	6.0-6.5%	3.0%	16.25%	12.30 %
City	9.31%	4.5-5.5%	5.0%	14.75%	11.45 %
OPC	10.13%	3.9%	-0-	13.80%*	10.957%
Staff	9.36%	4.5-6.0%	-0-	14.44%**	11.37 %***

*based on comparable analysis
**with conservation adjustment
***with adjustment for pollution control bonds the rate of return is 11.26%

1. Company's Position

Mr. Bolster presented testimony to support the company's request for a cost of equity of 16.25 percent. His analysis showed the following:

	Return
DCF for HII	16.22%
7 Nuclear Construction (DCF)	15.73%
6 Non Nuclear Construction (DCF)	14.46%
Risk Premium for HII	15.45%

a. DCF-HII and Comparable Companies. Mr. Bolster utilized the DCF formula to determine the proper return on equity for HII and, in turn, for HL&P. In Mr. Bolster's opinion, the DCF attempts to calculate the present value of the anticipated dividends. Mr. Bolster added that any DCF analysis contains a certain level of judgment in assessing an investor's expectation of an

appropriate dividend yield. However, Mr. Bolster quickly added that it is the growth factor in the formula which generates the most discussion and analysis.

The standard DCF formula is:

$$K = D_1/P_0 + g$$

where
K = required return
D_1 = anticipated dividends
P_0 = current price
g = expected growth

Mr. Bolster testified that the purpose of the dividend yield is to reflect investor's expectations. Mr. Bolster then chose to look at a recent past period, seven months, to determine a proper dividend yield. Mr. Bolster further testified that over the last seven months, HII's dividend yield was 9.54 percent; 8.20 percent for the seven nuclear electric utilities; and 7.54 percent for the six non-nuclear electric utilities.

Mr. Bolster's prospective dividend yield of 9.97 percent was computed by dividing HII's expected dividend which he proposed to be $2.76, by its average market price over the past several months of $27.68. (Mr. Bolster averaged the current annual dividend of $2.64 for one quarter together with the expected annual dividend of $2.80 for three quarters to arrive at his expected annual dividend of $2.76.) Mr. Bolster utilized a similar analysis to arrive at a 8.73 percent expected dividend yield for the seven nuclear electrics and a 7.76 percent expected dividend yield for the six non-nuclear electrics.

As to the proper growth level, Mr. Bolster explained why he did not rely on past growth in earnings, book value or retained earnings. In Mr. Bolster's opinion, such application is only appropriate where (1) the company has always earned its cost of capital; (2) the company has maintained a constant payout ratio; and (3) the company has always had sales at or above book value. Since HL&P has not always experienced all of the above, the result has been a substantially reduced rate of growth in book value and retained earnings, and thus reliance upon HL&P's growth in earnings, book value or retained earnings was not appropriate in his opinion.

Mr. Bolster's analysis consisted of reviewing actual growth rates in dividends over various time periods. These actual figures, in Mr. Bolster's opinion, best reflect the investors' expectations in growth. Although a number of time periods were analyzed, Mr. Bolster primarily relied on those rates for the 1981 through 1985 time frame. In his DCF analysis, Mr. Bolster compared HII's results with that of seven electric companies involved in nuclear construction and six that are not. Prior to reviewing the results for HII and the comparable companies, a summary of the selected electric utilities will be made.

Mr. Bolster selected a group of investment grade electric utilities which were currently involved in nuclear plant construction and/or generation and which reported at least one billion dollars of net utility plant investment at year end 1984. Mr. Bolster then eliminated any companies engaged in non-utility business in order to remove any bias with regard to the non-utility enterprise and to limit the investment purview to all-electric industries. (While Mr. Bolster added that HII is engaged in other businesses, it was Mr. Bolster's opinion that the investor perception is not swayed by HII's other subsidiaries owing to HL&P's significant impact on HII net income vis-á-vis HII's other subsidiaries). To be incuded in the comparable companies, the companies further had to be shown to be investment grade and possess a single A rating by Standard and Poor's and Moody's and B++ rating by Value Line. The <u>beta</u> coefficient, which measures a stock's stability relative to the market, had to be .75 or less. The Value Line Price Stability ranking, which reflects the overall price volatility to the market, had to be .90 or better. Additionally, the utility's earnings had to be stable over the 1972-1981 and 1975-1984 time periods. Thirteen electrics met the above criteria. Seven were currently involved in construction of a major nuclear plant and six were not so engaged. Mr. Bolster determined that HII and the seven nuclear electric utilities shared virtually identical investment indicators. (Company Exhibit No. 1, Exhibit DRB-1 at 1.)

Mr. Bolster found that the annual growth rates for HII reflected a somewhat steady decline to a more levelized growth pattern, especially during the period 1982 to 1985. Mr. Bolster did not perceive the same decline and levelization with the other comparative electric utilities. While Mr. Bolster determined a

growth rate for HII of 5.6 to 7.0 percent, to test the historical growth rate, Mr. Bolster further reviewed the projected growth rates stated by Merrill-Lynch and Value Line which reflected a dividend growth of 5.8 to 6.5 percent for HII, 6.5 to 6.9 percent for the seven nuclear electrics and 6.9 to 7.0 percent for the six non-nuclear electrics. Mr. Bolster concluded from the five year DCF analysis together with the above projected analysis that HII's dividend growth rate would fall between 6.0 to 6.5 percent, that the seven nuclear electrics would have a growth rate of 6.75 to 7.25 percent and that the six non-nuclear electrics would have a growth rate of 6.25 to 6.75 percent. For his cost of equity, Mr. Bolster used the mid points of the above; 6.25, 7.0 and 6.5 percent, respectively.

The expected dividend yield and recommended growth rates of Mr. Bolster provide the following DCF computed cost of equity for HII and the comparable utilities:

Estimated Bare DCF Cost of Equity

	Houston Industries	7 Nuclear Construction Electrics	6 Non-Nuclear Construction Electrics
Expected Dividend Yield	9.97%	8.73%	7.96%
Estimated Dividend Growth	6.25	7.00	6.50
Estimated Bare DCF Cost of Equity	16.22%	15.73%	14.46%

(Company Exhibit No. 1 at 18.) Mr. Bolster then concluded that HL&P's cost of equity falls within the range of 15.73 to 16.22 percent.

b. Equity Risk Premium. Mr. Bolster conducted an equity risk premium analysis to support the company's requested return on equity. Mr. Bolster indicated that the risk premium cost of equity is composed of (1) a risk free

rate of return; (2) an inflation premium; and (3) a risk premium. Mr. Bolster stated that because the government long-term obligation he utilized, U.S. Treasury bonds, includes both the risk free return and inflation factors, his analysis would be focused upon the necessary risk premium, i.e., the additional compensation required to attract investors. Mr. Bolster further stated that a risk premium must reflect compensation to an equity holder for risks which are not attendant to a bondholder. Mr. Bolster explained that while a bondholder's return on investment is fixed by contract, that is not the case with an equity investor.

The first risk premium analysis Mr. Bolster conducted was to review the differential of return on equity (ROE) for electric utilities and for U.S. long-term government bonds. Mr. Bolster developed estimates of the market determined cost of equity on the basis of the DCF method from 1974 to 1985. The growth component of the DCF analysis consisted of the average of five ten year periods for both the nuclear and non-nuclear electrics. Mr. Bolster than compared the DCF determined cost of equity to the yields on long term treasury bonds.

For the seven nuclear electrics, the median equity risk from 1974 to 1985 was 5.1 percent and from 1979 to 1985, in Mr. Bolster's opinion, a period of high interest rates, the median equity risk was 5.6 percent, resulting in a range of 5.1 to 5.6 percent. For the six non-nuclear electrics, the median equity risk from 1974 to 1985 was 3.7 percent, and from 1979 to 1985 and from 1983 to 1985, the median equity risk was 4.0 percent. In Mr. Bolster's opinion, the above demonstrates that the risk associated with utilities involved in nuclear construction is 150 basis points higher than for those utilities not so involved.

Mr. Bolster's second risk premium analysis was based upon the Capital Asset Pricing Model (CAPM) which measures the risk differential, over a relatively long period of time, between realized market return on equity and U.S. Treasury bonds to arrive at an overall market equity risk. The individual utility's market risk is then determined by assessing a beta coefficient to the overall market risk. Based upon Standard and Poor's stock composite index, the average

market risk premium fell between 6.19 and 6.65 percent. Mr. Bolster then determined that the overall market risk premium is the average of the above or 6.4 percent. The current and 1981 beta coefficient for the seven nuclear electrics is .70. Mr. Bolster then indicated that the .70 can be used to estimate this group's risk premium. Applying the 6.4 percent overall market risk and the .70 beta coefficient provides a market risk of 4.5 percent for the nuclear electrics. Mr. Bolster noted that since the six non-nuclear electrics also reflected a beta coefficient of .70, he would give the CAPM results less weight in his recommendations.

Mr. Bolster concluded that the range for the risk premium of HL&P's cost of equity fell between 4.5 and 5.6 percent. Mr. Bolster concluded that the DCF risk premium analysis provides a risk premium for HII of 5.2 percent.

Mr. Bolster stated that the 5.2 percent figure should be added to a riskless investment, such as a long-term U.S. Treasury bond. Mr. Bolster reviewed a then recent seven-month time period wherein the average yield on twenty-year U.S. Treasury bonds was 10.35 percent. In January 1986, this figure fell between 9.4 and 9.9 percent. Mr. Bolster also stated that investment forecasts project that the thirty-year treasury bonds would increase by only 20 basis points, from 9.8 to 10.0 percent by the fourth quarter in 1986. The yield on twenty-year treasury bond future contracts maturing in December 1986 was 11.21 percent while those maturing in September 1987 yielded 11.56 percent. Another forecast upon which Mr. Bolster relied reflected that the expected yield for triple A long-term corporate bonds for the period 1985 to 1990 would be 11.0 percent. Due to what Mr. Bolster characterized as a 25 basis point spread between U.S. Treasury bonds and long-term triple A corporate bonds, Mr. Bolster perceived the yield for twenty-year treasury bonds to be 10.75 percent. Mr. Bolster recommended that the midpoint 10.25 percent, which is within a reasonable range of 9.75 to 10.75 percent, was proper and, coupled with the 5.2 percent risk premium for HII, resulted in a cost of equity of 15.45 percent.

Based upon the cost of equity determined under the DCF and risk premium analyses, Mr. Bolster recommended a range of 15.45 to 16.22 percent for HII's

bare cost of equity. Mr. Bolster stated that the cost of equity should be increased by a market-to-book adjustment.

c. Market-to-Book Adjustment. Mr. Bolster testified that the company's return on equity must be adjusted to reflect the cost of financing or underpricing. The costs of financing are those out-of-pocket expenses incurred in the issuance of stock such as printing, accounting and legal expenses and underwriting and distribution fees. Underpricing would reflect the possible decline in the price of the company's stock due to the additional shares in the market (market pressure) or adverse investor perception of the company or industry (market break).

Mr. Bolster further testified that his company had conducted a study using 1973 to 1984 data which reflected a financing cost for electric utilities of 4.25 percent with a corollary market pressure effect of 1.4 percent, for a total minimum financing and underpricing adjustment of 6.0 percent. While Mr. Bolster indicated that the 6.0 percent may not be applicable to HII owing to its ability to market its stock without significant financing costs in the past, such historical data should not preclude this Commission from granting such an adjustment for a number of reasons. First, no guarantee exists that HII's ability to market its shares with little financing cost would continue in the future. Second, during 1975-1985, HII's unrecovered financing costs of $41 million for the $4.25 billion in proceeds from new issues resulted in a 3.3 percent financing cost.

Mr. Bolster recommended that HII be allowed a 3.0 percent financing cost to its dividend yield, resulting in a range for cost of equity of 15.99 to 16.53 percent. Mr. Bolster selected the midpoint, 16.25 percent, as his recommendation to this Commission for HII's cost of equity. (HL&P Exhibit No. 7 at 34.)

2. City's Position

City witness Elliott testified that it was appropriate to utilize HII in her analysis of the required return on equity for HL&P because HL&P provides

87 percent of revenues and 98 percent of net income to HII. Additionally, as of December 31, 1985, HL&P constituted 94 percent of HII's common equity. Ms. Elliott noted that the financial condition of electric utilities has improved as a whole, owing to the decline in interest and inflation rates and the winding down of construction programs. She noted that such is not the case for HL&P, which still has a large construction program. Ms. Elliott further noted that the electric industry as a whole is facing increased business risks owing to declining electric sales and alternative energy sources such as cogeneration.

Ms. Elliott further stated that the current stock market for electric utilities has improved. In June 1984, the median price earnings ratio, market-to-book ratio and dividend yield were, respectively, 5.9 percent, 87 percent and 11.3 percent. In April 1986, these figures were 9.9 percent, 132 percent and 7.3 percent. With regard to the current debt market for electric utilities, Ms. Elliott stated that the long-term interest rates for single A utilities have declined as much as 500 to 600 basis points. As to HL&P and the current market, Ms. Elliott testified that investors are cognizant of HL&P's involvement in major construction programs such as Limestone 2, STP 1 and 2, and Malakoff. Ms. Elliott found that the significant construction program has led to the company's declining financial indicators, expressed as follows:

	1981	1985
AFUDC as Percent of Net Income to Common	22%	45%
Internal Cash Generation	41%	39%
Cash Flow of Dividends	2.9%	2.1%
Pretax Interest Coverage Excluding AFUDC	3.3%	3.0%

(City Exhibit No. 4 at 6.)

Ms. Elliott also noted that while HL&P's indicators have fallen, HL&P has been able to maintain its single A rating due to its above-average capital structure. Ms. Elliott conducted three reviews to determine an appropriate return on equity for HL&P: a comparative earnings analysis, risk premium analysis, and DCF analysis.

a. Comparable Earnings Analysis. Ms. Elliott reviewed the returns on book equity of companies with risks similar to HII. Two assumptions underlie this analysis--that the companies have earned their cost of equity on net book value, and that risks are similar. To determine this risk, Ms. Elliott reviewed HII's Value Line *beta* coefficient and price stability index. In Ms. Elliott's *beta* coefficient comparison, she computed the realized return on average book equity for a sample of companies listed in the Standard and Poor's 500 Composite Index for 1970-84. HII reflected a *beta* coefficient of .70. Those companies with a *beta* coefficient of .60 to .80 earned, on average, 14.15 percent return on equity for the period 1980 to 1984, 14.40 percent for the period 1975 to 1984, and 13.99 percent for the period 1970 to 1984. Ms. Elliott conducted a similar sampling under the price stability index. Ms. Elliott found that HII's price stability index was 100. Companies with a comparable index to HII demonstrated a return on average book equity of 15.66 percent for the period 1980 to 1984, 15.58 percent for the period 1975 to 1984, and 15.40 percent for the period 1970 to 1984.

Ms. Elliott, however, discounted her comparative earnings analysis for a number of reasons. First, a question exists as to whether the companies are comparable. Second, the assumption that returns were realized is questionable. Third, the lack of consistency as to the bond yields and return on book equity for the period 1970 to 1984 is indicative of an improper analysis. And fourth, the cost of equity is a forward-looking concept, whereas the comparative earnings analysis does not capture the investors' future expectations.

b. Risk Premium Analysis. In Ms. Elliott's risk premium analysis, she attempted to depict that risk associated with the investment in equity, rather than debt. Ms. Elliott indicated that an appropriate risk premium added to a single A bond yield will produce an acceptable cost of equity estimate. As the

basis for her risk premium, Ms. Elliott relied upon a 1985 survey conducted by Paine-Webber which was sent to institutional investors. One of the questions on the survey requested investors to note the required risk premium for a double A long-term bond of 12.50 percent. Approximately 84 of the respondents answered that a 200 to 400 basis point spread for electric utilities not currently involved in nuclear construction would be required. For those utilities involved in nuclear construction, the risk premium was increased to 300 to 600 basis points. Ms. Elliott pointed out that "as with any survey, the results may be affected by the truthfulness of responses, proper interpretation of the questions, sample size and representativeness." (City Exhibit No. 4 at 11.) Nevertheless, adding the 300 to 600 basis points to the average single A bond yield of 9.14 percent provided a cost of equity under this method of 12.14 to 15.14 percent.

c. <u>DCF Analysis</u>. Ms. Elliott, as did all the cost of capital witnesses, conducted a DCF analysis. First, as to the company's expected dividend, Ms. Elliott noted that historically, since 1982, HL&P had increased its quarterly dividend by $.04 in the second quarter. On that basis, Ms. Elliott used the current quarterly dividend of $.70 for the third and fourth quarter of 1986 and first quarter of 1987. She used $.74 for the second quarter of 1987, resulting in an expected dividend of $2.84. Second, as to the stock price, since the cost of equity tends to reflect future investor expectations, Ms. Elliott utilized the average of the then recent weeks' stock price for HII of $30.50. The stock price of $30.50, divided into the expected dividend of $2.84, resulted in a dividend yield of 9.31 percent.

With regard to the expected growth, Ms. Elliott determined that average long-term growth was the appropriate measure. Ms. Elliott reviewed HII's historical earnings per share (eps), dividends per share (dps), and book value per share (bvps) and computed a growth rate over three time periods--five years, ten years, and fifteen years. Ms. Elliott indicated she smoothed out the historical data using a regression analysis. Ms. Elliott also computed HII's sustained <u>br</u> growth rate where <u>b</u> is the expected retention ratio and <u>r</u> is the earned return. Ms. Elliott found that the eps, dps, and bvps have not demonstrated any consistency and ranged from 2.6 to 10.7 percent. While not

consistent, Ms. Elliott nevertheless pointed out that because eps, dps, and bvps had all declined, these phenomena should indicate to investors that they should not expect growth in dividends as has been experienced in the past. As to the sustainable br growth, HII's retention ratio and return on average equity ranged from 36 to 60 percent and 11.0 to 17.0 percent, respectively. The resultant range of growth rates is 4.0 to 12.0 percent.

Based upon the above analysis and relying on judgment, Ms. Elliott found HII's expected growth rate to fall between 4.5 and 5.5 percent.

Ms. Elliott indicated that a market-to-book adjustment is necessary to offset flotation costs, market swings, and supply pressures which could lead to dilution of stock value. The flotation costs reduce the net proceeds the company receives from the sale of stock, thereby resulting in the dilutive effect. Flotation costs would affect not only the new issuances but also the existing issuances. Market swings occur when a company is obligated to seek external financing even when the market is down, which could also result in dilution. Additionally, supply price pressures, which occur when the supply of stock exceeds the buyers' demand, would also cause dilution. In Ms. Elliott's opinion, any of the above factors would cause the company to sell its stock below book value and thereby result in dilution. Ms. Elliott further believed that the market-to-book adjustment would be appropriate where a utility is engaged in a significant amount of construction.

While not stating specific reasons therefor, Ms. Elliott recommended a market-to-book adjustment for HII. Relying on judgment, Ms. Elliott recommended a market-to-book adjustment of 5.0 percent, resulting in her recommended dividend yield of 9.78 percent.

Using the dividend yield of 9.78 percent, together with a growth rate of 4.5 to 5.5 percent and relying on judgment, provided Ms. Elliott a range for the cost of equity of between 14.25 to 15.25 percent. Ms. Elliott's final recommendation for HII is a return on equity of 14.75 percent.

3. OPC's Position

OPC witness Szerszen conducted an HII-specific DCF analysis and a DCF analysis on comparable companies to determine the appropriate cost of equity for HII. While the other parties utilized an expected dividend yield formula, Dr. Szerszen's approach is based on a current dividend yield. Dr. Szerszen also computed the expected growth in dividends on a sustainable basis. She did not make any market-to-book adjustment.

a. DCF Analysis-HII. Dr. Szerszen, as did the other witnesses, computed a dividend yield based upon HII's indicators. As Dr. Szerszen explained, investors can only invest in HII and not HL&P, and thus HII's expected growth and dividend yield provide the appropriate basis for this analysis. Dr. Szerszen discounted the use of a spot price to calculate the dividend yield since a spot price is merely a snapshot and may not reflect the investor's expectations. Dr. Szerszen calculated an average test year price for HII by averaging the monthly high and low closing prices of HII's stock, which resulted in an average stock price of $26.05. Dr. Szerszen calculated the dividend yield by annualizing the fourth quarter 1985 dividend of $.66 for an annual dividend of $2.64 and a dividend yield of 10.13 percent. As a check on her method, Dr. Szerszen took similar data from the April 1985 to March 1986 time frame; i.e., price of $27.875 and dividend of $2.64 for a dividend yield of 9.47 percent.

Dr. Szerszen stated that her calculation results in a better representation of the company's financial condition since it reflects continuous compounding. In Dr. Szerszen's opinion, efficient management would require the continuous reinvestment of capital until dividends are paid. Thus, under her formula , the company's continuous receipt of revenues is recognized. Under the discrete compound method, essentially proposed in the company's DCF method, the method inherently implies that no revenues are received with which to pay dividends until 12 months have passed. The distinction between continuous and discrete compounding is important, in Dr. Szerszen's opinion, because it is this continuous reinvestment of earnings which allows the utility to pay a larger dividend each year than would exist if no reinvestment occurred.

As to the expected growth, Dr. Szerszen based her recommendations upon a review of HII's growth in bvps and a sustainable growth analysis. Dr. Szerszen indicated she relied upon the company's bvps, rather than the eps and dps, because the latter two are unduly affected by changes in the company's earned returns or dividend payout ratios. In Dr. Szerszen's opinion, the growth in bvps is the basis for earnings growth which, in turn, is the basis for the dividend growth. For the five-year period ending 1985, Dr. Szerszen determined a growth in book value for HII of 1.80 percent, including the Allen's Creek write-off, and 1.74 percent, excluding the Allen's Creek write-off. For the ten-year period ending 1985, the growth in book value was 3.503 percent, including the Allen's Creek write-off, and 3.539 percent, excluding the Allen's Creek write-off. (OPC Exhibit No. 91, Schedule 5.)

With regard to Dr. Szerszen's second method to calculate the expected growth, Dr. Szerszen multiplied the historical expected long-run retention ratio (b) by the expected rate of return (r), which assumes that no new stock was issued or that if issued, it is at book value. In Dr. Szerszen's opinion, a reliance on past indicators is proper because, no doubt, investors will review the company's historical performance. For the five-year period ending 1985, the br produced an internal growth rate of 4.238 percent, including the Allen's Creek write-off, and 6.0152 percent, excluding the write-off. For the ten-year period ending 1985, the br produced an internal growth rate of 5.866 percent, including the write-off, and 6.755 percent, excluding the write-off. Dr. Szerszen noted that the br growth is an upper bound measurement of future growth potential. Due to the fact that HII has not attained this upper bound, Dr. Szerszen opined that it would not be valid to rely solely on the internal growth measurement in determining a growth rate. Therefore, Dr. Szerszen averaged the five-year book value and internal growth rates. While Dr. Szerszen did not believe it appropriate to ignore the Allen's Creek write-off because, in her opinion, investors are aware of this major circumstance, to avoid controversy, Dr. Szerszen excluded the write-off and obtained an average growth rate of 3.9 percent

Combining the dividend yield of 10.13 percent for HII and the 3.9 percent growth rate provides a cost of equity of 14.03 percent. For the updated figures

(April 1985-March 1986), the dividend yield of 9.47 percent, together with a 3.9 percent growth rate, provides a cost of equity of 13.37 percent.

b. DCF-Comparable Companies. As a check on her DCF cost of equity recommendation, Dr. Szerszen performed a comparison of companies comparable in risk to HL&P. The criteria that she utilized were the following: utilities having a single A or triple B rating and that are currently involved in nuclear construction, companies faced with possible disallowance of plant, plant cancellations, excess capacity penalties, and prudence reviews. Using a regression analysis, for the time periods coinciding with those utilized for HII's current and updated DCF analysis, these comparable companies demonstrated a cost of equity which fell between 12.462 and 16.051 percent and 12.03 and 15.014 percent, respectively. The average of these two time periods is 14.401 and 13.819 percent. Dr. Szerszen then averaged the three test year equations to obtain a 13.7 percent DCF rate. Averaging the six updated equations yielded a 13.336 percent DCF rate. Dr. Szerszen recommended that 13.8 percent, which is 10 basis points above the 13.7 percent test year average was a proper cost of equity for HII.

c. Market-to-Book Adjustment. Dr. Szerszen did not adjust HII's dividend yield to reflect market pressure costs. Dr. Szerszen explained that market pressure could not be shown to exist since the company's offerings are only one of many in the marketplace. Additionally, a market pressure study should differentiate the changes in the market in general versus those that are unique to the company. Dr. Szerszen noted that the company's study did not demonstrate that HII was subject to market pressure. In fact, HII's stock outperformed the market in four out of ten issuances.

Dr. Szerszen also recommended that no flotation adjustment be provided to HII. Since 1983, HII has issued new stock under a continuous offering program. Under this program, HII can time its issuances to coincide with favorable market conditions; thus, the company could decide to not offer its stock in times of a depressed market. Dr. Szerszen further noted that HII's underwriting costs have been minimal and have diminished since 1983. She further stated that HII has no plans to issue common stock in 1986 and does not plan to do so until 1987.

Since the underwriting costs were negligible and market pressure had not been demonstrated to have existed, Dr. Szerszen recommended that no market-to-book adjustment be permitted.

4. Staff's Position

Mr. Reed began his analysis by reviewing HL&P's financial indicators and compared them with those of the electric utility industry. In Mr. Reed's opinion, such analysis would more clearly reflect investors' perception of HL&P in the capital market. Mr Reed provided a chart which reflected HL&P's and HII's indicators relative to the industry's:

	12 months Ending				
	Dec.[7] 1985	Dec.[6] 1984	Dec.[6] 1983	Dec.[6] 1982	Dec.[6] 1981
AFUDC AS A PERCENTAGE OF EARNINGS AVAILABLE FOR COMMON DIVIDENDS					
Houston Industries, Inc.	56.0%	38.7%	19.7%	63.5%	29.1%
Houston Lighting & Power	45.0%	37.7%	16.6%	51.6%	26.8%
Industry Average	21.0%	37.6%	40.5%	44.8%	34.2%
PRETAX INTEREST COVERAGE (EXCLUDING AFUDC)					
Houston Industries, Inc.	2.6x	2.77x	3.09x	1.76x	2.78x
Houston Lighting & Power	2.84x	3.04x	3.29x	1.90x	3.28x
Industry Average	3.0x	3.05x	2.86x	2.52x	2.37x
CASH FLOW COVERAGE OF COMMON DIVIDENDS					
Houston Industries, Inc.	2.4x	2.69x	3.22x	1.89x	3.23x
Houston Lighting & Power	2.1x	2.32x	2.85x	1.72x	2.93x
Industry Average	2.6x	2.53x	2.51x	2.39x	2.56x

6. Electric Utility Industry, Dean, Witter, Reynolds, Inc., Summer, 1985.
7. Electric Utility Quality Measurments - Quarterly Review, Salomon Brothers, Inc. April 28, 1986.

(Staff Exhibit No. 9 at 7.)

Mr. Reed noted that the indicators for the industry as a whole have improved due to completion of construction projects. On the other hand, HL&P and HII are still involved in major construction programs which, in his opinion, explains their ratings vis-á-vis those of the electric industry in general. Mr. Reed added that while his analysis attempted to provide the Commission with recommendations based upon investors' perceptions, his judgment is also a factor in his recommendations. Mr. Reed conducted a DCF analysis on HII and on a sample group of comparable companies. He also considered the risk premium analysis as a check on his recommendation.

a. DCF Analysis-HII and Comparable Companies. In determining the proper cost of equity for HL&P, Mr. Reed utilized HII as a proxy. Since HL&P is providing HII with 98.2 percent of HII's net income, Mr. Reed is confident that investors are evaluating HII on the basis of HL&P's performance and operations.

In evaluating the expected growth, Mr. Reed measured HII's historical growth in eps and dps. Mr. Reed did not put much emphasis on the company's historical growth in book value owing to the fact that a utility involved in large construction must, by necessity, issue significant amounts of stock which can dilute the bvps. Mr. Reed explained that a company involved in large construction projects must issue stock when it needs financing, regardless of the market price. Mr. Reed testified that HII was able to sell its stock above book value only once during the period 1977 to 1983. This resulted in a growth in book value of 3.2 percent compared to a growth in eps and dps of 5.3 percent and 9.7 percent, respectively. Mr. Reed calculated compound growth rates for HII's eps, dps and bvps for the periods 1980-1985, 1975-1985, and 1970-1985. Mr. Reed smoothed the above values through a linear regression analysis to account for the sensitivity of the compound growth rates to the beginning and ending values.

Mr. Reed indicated that he could not discern any pattern regarding the historical growth in values, owing to the 1982 Allen's Creek write-off which significantly distorted the 1982 eps and bvps values. Mr. Reed subsequently prepared schedules adding back in the Allen's Creek write-off and restated the

1982 eps and 1982 through 1985 bvps figures. Mr. Reed's revised schedule showed that eps growth has been between 6.0 and 7.0 percent for the three periods, while the dps growth for the 10- and 15-year period was above 10.0 percent and was 7.5 percent for the five-year period. Mr. Reed focused upon the actual growth rate of HII's eps and dps since 1982. Mr. Reed found that the dividend growth during this period demonstrated stability and thus would better reflect the investors' growth expectations. Mr. Reed's analysis illustrated a growth rate in eps of 5.4 percent and a dps growth rate of 6.4 percent. While Mr. Reed believed that sustainable earnings growth determined the future growth in dividends, Mr. Reed believed his analysis was still proper.

Mr. Reed also estimated the appropriate growth level by his review of the rate of earnings retention (b) and expected return (r). His analysis showed that since 1982, the company's retention ratio fluctuated between 42 and 36 percent and the return on equity fluctuated between 16.1 and 14 percent, which resulted in a growth rate of 6.8 to 5.0 percent. Mr. Reed concluded that the br generated growth rates of 5.0 to 6.8 percent which have ocurred since 1982 support his historical analysis.

Mr. Reed conducted a third analysis in determining growth by examining the five-year projected growth estimates for HII of two investment firms--Value Line and Salomon Brothers. Value Line's five-year projection, conducted April 1986, was 6.5 percent and Salomon Brothers' five-year projection, conducted May 2, 1986, was 5.5 percent. In Mr. Reed's opinion, these projections further support his historical analysis. Mr. Reed also noted that the company projected a growth rate of only 4.3 percent, which he believes arises from the company's minimal increase of dividends from $.70 per quarter to an anticipated June 1987 level of $.73 per quarter.

As to Mr. Reed's final recommendation regarding the appropriate growth rate for HII, Mr. Reed found that while HII's current dividend yield is 9.3 percent and its current price to earnings ratio is seven times, the industry average for these two variables is 7.3 percent and 9.9, respectively. In Mr. Reed's opinion, it would not be realistic for investors to anticipate the growth in HII's dividend that had existed in the late 1970s and early 1980s. Mr. Reed

also believed that the company's dividend paymout ratio of 35 to 40 percent is consistent with HL&P's decision to meet 40 percent of its large financing costs internally. Additionally, Mr. Reed anticipated HII's earnings to be flat in 1986, thereby reducing the possibility that such earnings would sustain a high level of dividend growth. Owing to the above, Mr. Reed placed more reliance on his projected analysis. Mr. Reed combined the company's projections and that of Value Line and Salomon Brothers, together with his historical analysis, for a final recommended growth range of between 4.5 and 6.0 percent.

As to Mr. Reed's calculation of a dividend yield, Mr. Reed testified that this figure should reflect the expected or projected dividend. Mr. Reed indicated that the analysis requires a review of the company's historical payment policy to determine when the company generally changes its dividends. Mr. Reed determined that HII has changed its dividend every June quarter since 1983, and anticipates doing the same in June of 1987 to the amount of $.73. Taking three quarters at $.70 and one quarter, the June 1987 quarter, at $.73 resulted in a projected dividend of $2.83. Mr. Reed then determined that in recent weeks the company's stock price has been between $29.25 and $31.38. Mr. Reed chose the approximate midpoint of $30.25 for his calculation of the dividend yield, which he projected to be 9.36 percent.

Mr. Reed's dividend yield of 9.36 percent, coupled with the expected growth rate of 4.5 to 6.0 percent, provided an estimated range for HII's cost of equity of 13.86 percent to 15.36 percent.

Mr. Reed further tested his DCF calculation for HII by performing a DCF analysis on a sample of comparable companies. Mr. Reed found, through his review, that there exists a two-tiered market in the electric utility industry--those involved in nuclear construction, and those not involved in nuclear construction. Mr. Reed chose utilities for his sample from the former group. Mr. Reed used the following criteria:

1. <u>Bond Rating</u> - Electric utilities involved in nuclear construction which have bond ratings of A/A (Standard & Poor's and Moody's, respectively.) (HL&P - A+, A2.)

2. <u>Electric Revenues</u> - Majority of revenues (2/3 or greater) from electric sales.

3. <u>Financial Risk</u> - Electric utilities involved in nuclear construction which have a percentage of long-term debt in their capital structures of between 45 and 55 percent. (HL&P - 47.3 percent.)

4. <u>Asset Exposure</u> - Electric utilities involved in nuclear construction which have a significant (greater than 50 percent) asset exposure.

(Staff Exhibit No. 9 at 20-21.)

Schedule IV of Mr. Reed's testimony reflects the comparable companies' data. Most notably, the average debt percentage was 47.71 percent, with HII's figure at 47.80 percent, and the asset exposure percentage at 124 percent, with HII's at 86.21 percent.

Mr. Reed conducted a similar DCF analysis for each of his comparable companies, which included Carolina Power and Light, Central Hudson, Commonwealth Edison, Illinois Power, Niagara Mohawk and Pacific Gas and Electric. The expected growth rate was measured using historical and projected data. The historical analysis demonstrated a growth rate of 4.0 to 6.0 percent, while the projected analysis revealed a growth rate of 3.0 to 5.0 percent. Mr. Reed determined the price of the expected dividend and projected stock price in the same manner and and for the same time periods as was performed for HII. The dividend yield for the sample comparable companies fell between approximately 8.5 and 10.5 percent, with a range of cost of equity between 13.0 and 15.2 percent and a mean of 14.29 percent. Mr. Reed concluded that his comparable companies support his DCF-specific analysis for HII and recommended that the HII-specific calculation be utilized. Mr. Reed, therefore, recommended the approximate midpoint of his HII-specific DCF range (13.86 to 15.36 percent) for a cost of equity of 14.60 percent.

Mr. Reed testified that a market-to-book adjustment is necessary to prevent dilution in equity values when new shares are issued. Mr. Reed noted two costs which could lead to the dilution--flotation costs and market pressure. Flotation costs are borne by all existing shareholders, so the resulting

dilution effect would be less than if directed only upon the new issuances. Mr. Reed has not perceived any market flotation costs associated with HII stock. Since 1984, HII has issued its stock under Securities and Exchange Commission Rule "415" (Rule 415.) Rule 415 provides that the company, during a two-year period following registration of the issues, can sell its stock on a piecemeal basis. This provides HII with flexibility in the timing of issuances and also results in less issuance costs. Mr. Reed determined that HII's flotation costs were minimal (.3 percent) and thus no adjustment was warranted.

Mr. Reed also explained that market pressure could affect the receipt of net proceeds by the company. Market pressure occurs when the market price of a stock drops when new shares are issued and where the supply exceeds the demand. Market pressure would not only affect new shareholders, but all outstanding shares as well. Mr. Reed found that the company had not adequately demonstrated the existence of market pressure. In particular, Mr. Reed criticized the outdated 1979 market pressure test referenced in Mr. Bolster's testimony.[6] This study was conducted four years prior to the implementation of Rule 415, which HII has used almost exclusively. Additionally, the study is not Houston-specific. Lastly, Mr. Reed finds incredulous the effect of market pressure, since HII, through the continuous offering program under Rule 415, can time its issuances. Mr. Reed, therefore, recommended that no market pressure adjustment be allowed.

b. Risk Premium Analysis. Mr. Reed also conducted a risk premium analysis to estimate HII's cost of equity. Mr. Reed indicated that the basis for a risk premium analysis is that increment needed to encourage investors to invest in equity, rather than debt. Debt, in Mr. Reed's opinion, is generally more risk-free than equity because in case of default, bondholders are paid before equity investors. Mr. Reed added, however, that in today's market, inflation/purchasing power risk and interest risk may affect bonds to a greater extent than equity. With regard to inflation/purchasing power risk,

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[6]Although Mr. Bolster referenced a study from 1973-1984, with regard to market pressure, that data is reflected only through the 1973 to 1979 period.

Mr. Reed explained that because a bond's rate is fixed, if the inflation factor exceeds that amount which the investor anticipated prior to his decision making, the required return may not be fully realized. With regard to interest risk, Mr. Reed found that due to the fluctuating market conditions caused in part by the federal government's decision not to target interest rates during a period of high inflation, the interest on bonds has fluctuated enormously. Due to these circumstances, Mr. Reed believed less reliance can be placed on the historical spread between bonds and stocks to gauge a proper risk premium. Mr. Reed alternatively stated that while a survey of investors could be conducted to ascertain the investors' viewpoint as to a reasonable spread, the last such survey prepared was that conducted by Paine-Webber, performed during March-April 1985. In Mr. Reed's opinion, the survey is now outdated owing to the dramatic change in the capital market; i.e., the falling of interest rates. Because the historical relationship between stocks and bonds is no longer reliable and the Paine-Webber survey is too outdated, Mr. Reed concluded that a valid risk premium analysis could not be performed.

5. Examiners' Discussion and Recommendation

The examiners' recommendations regarding the appropriate rate of return are based upon, in part, the following provision in the PURA and in the Commission's Substantive Rules. Section 39 of PURA states:

> Sec. 39.(a) In fixing the rates of a public utility the regulatory authority shall fix its overall revenues at a level which will permit such utility a reasonable opportunity to earn a reasonable return on its invested capital used and useful in rendering service to the public over and above its reasonable and necessary operating expenses.
>
> (b) In fixing a reasonable return on invested capital, the regulatory authority shall consider, in addition to other applicable factors, efforts to comply with the statewide energy plan, the efforts and achievements of such utility in the conservation of resources, the quality of the utility's services, the efficiency of the utility's operations, and the quality of the utility's management.

P.U.C. SUBST. R. 23.21(c) states, in part:

(c) Return on invested capital. The return on invested capital is the rate of return times invested capital.

(1) Rate of return. The Commission shall allow each utility a reasonable opportunity to earn a reasonable rate of return, which is expressed as a percentage of invested capital, and shall fix the rate of return in accordance with the following principles.

(A) 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. A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market, and business conditions generally.

(C) The Commission may, in addition, consider inflation, deflation, the growth rate of the service area, and the need for the utility to attract new capital. The rate of return must be high enough to attract necessary capital but need not go beyond that. In each case, the Commission shall consider the utility's cost of capital, which is the composite of the cost of the various classes of capital used by the utility.

(i) Debt capital. The cost of debt capital is the actual cost of debt.

(ii) Equity capital. The cost of equity capital shall be based upon a fair return on its value. For companies with ownership expressed in terms of shares of stock, equity capital commonly consists of the following classes of stock . . . .

The examiners would note that while the cost of capital witnesses have proposed varying levels for HII's cost of equity, they are not that far apart in their overall recommendations.

The examiners are not persuaded that the city's comparable earnings analysis is a valid indicator of the proper cost of equity for HL&P, primarily due to the problems cited by Ms. Elliott herself. (Examiners' Report Section VII.2.a.) Additionally, as OPC argued in brief, the witness was not knowledgeable as to the specifics of the study she performed and had not relied upon the study in formulating her recommendation. Since the sponsoring witness

discounted the validity of the study, the examiners would recommend rejection of this method to determine the proper cost of equity for HII.

Ms. Elliott, Mr. Bolster and, to some extent Mr. Reed, all performed a risk premium analysis to develop the cost of equity component. The examiners are not persuaded that Ms. Elliott's is a valid method for several reasons. As pointed out by Mr. Reed in his testimony and OPC in brief, the survey is outdated and would thus not capture the perceptions of the current market. Additionally, as counsel for OPC pointed out in brief, the survey was directed to investment advisors and queried these investors as to questions regarding a double A utility, whereas HL&P is a single A utility. Moreover, Ms. Elliott testified herself that the results of a survey are suspect owing to the degree of truthfulness of responses, interpretation of the questions posed, and the sample size and representativeness. Thus, the examiners would reject Ms. Elliott's risk premium analysis.

The examiners would also recommend rejection of Mr. Bolster's risk premium analysis. Mr. Bolster attempted to quantify the appropriate risk inherent in the purchase of bonds versus the purchase of stock. As Mr. Reed correctly pointed out, Mr. Bolster's analysis failed to consider the non-default risks such as inflation/purchasing power and interest rate risk, which could offset any default risk. It is especially true, as the record reflects and Mr. Bolster admitted, that the rates for long-term treasury bonds have been declining and are now part of the volatile market. Additionally, as the general counsel pointed out in brief, Mr. Bolster stated that investors would only expect to see small increases, if any, in the long-term U.S. Treasury rates. The examiners would further note that because the risk premium approach, as stated by Mr. Reed, is based upon a riskless bond market vis-á-vis the equity market, this volatility in the bond market negates the value of any historic data upon which Mr. Bolster relied. Additionally, the examiners agree with Dr. Szerszen that Mr. Bolster's mismatch of a 59-year period for the CAPM, together with a recent five-year beta coefficient, does not provide a meaningful analysis.

[12] The remaining method to calculate the cost of equity proposed by the witnesses is the DCF analysis. In the examiners' opinion, this analysis would

best reflect investors' expectations and, thus, would best reflect the company's cost of equity. An initial question concerns the purpose of the DCF. In the examiners' opinion, the DCF attempts to capture the expectations of investors. Thus, to some extent, projected data is necessary.

The examiners are not persuaded that the company's proposed dividend, based upon outdated data, is appropriate. As between Mr. Reed and Ms. Elliott's proposed dividends, which are $.01 apart, the examiners find Mr. Reed's more accurate because his $2.83 figure is based upon the company's projected increase in quarterly dividends to $.73, rather than upon an historical estimate of $.74 as relied upon by Ms. Elliott. As to Dr. Szerszen's analysis, she utilized primarily the company's historic dividends in her calculation. Because the examiners are of the opinion that the DCF contemplates a forward-looking dividend, they cannot agree with OPC's use of three quarters of test year dividends. Use of a substantially historically-calculated dividend is inconsistent with the underlying theory of the DCF analysis, which attempts to measure the investors' expectations as to future dividends. The examiners, therefore, recommend adoption of Mr. Reed's expected annual dividend of $2.83.

As to the market price utilized in the dividend yield calculation, again Mr. Bolster's data is outdated and, thus, is not the most current in the record and should be disregarded.

Both Mr. Reed and Ms. Elliott utilized the most recent data available in determining the company's market price. The examiners, once again, find that since Mr. Reed's analysis is based on more recent data than Ms. Elliott's, Mr. Reed's analysis would be more reflective of investors' expectations. With regard to Dr. Szerszen's position, the examiners would note the following. While Dr. Szerszen was consistent in that she utilized the average test year price to determine HII's market price, such method, once again, ignores the fundamental premise of a forward-looking analysis. Additionally, while OPC in brief argues that its method alone is consistent in application, historical dividends and market price versus the other parties' historical market price and expected dividends, the examiners do not find the argument convincing. While the "historical" data referenced by OPC in brief is the then most current and

recent information, Dr. Szerszen's historical data spanned a lengthy period of time; a test year period. The examiners do not find such historical analysis to accurately reflect investors' future expectations. The examiners find Mr. Reed's analysis more reflective of the forward-looking approach contemplated under the DCF formula.

As to the proper growth rate to be reflected in the DCF calculation, the examiners have discounted Mr. Bolster's recommendation. Mr. Bolster relied entirely on historical data for his recommended growth rate of 6.0 to 6.5 percent. Moreover, as the general counsel pointed out in brief, Mr. Bolster admitted that investors cannot reasonably expect the significant growth in dividends that the company experienced in the past to continue. To the examiners, this is especially noteworthy since Mr. Bolster's own study of comparative electric companies exhibited less of a decline in growth than that experienced by HII. The reasonable investor surely cannot expect HII to maintain past growth rates when it is clearly trailing behind the industry. Lastly, the examiners would note that Mr. Bolster relied on studies of Value Line and Merrill-Lynch which were published in 1983 and 1985. Mr. Bolster relied upon less than current data, comparatively, than that which formed the underlying bases of the other parties' recommendations, and thus should be given less weight. While this is not a direct criticism of Mr. Bolster's analysis since he used the then most current data available, for evidentiary purposes the examiners believe that more recent studies are more credible than older ones, given the volatile marketplace. As to the growth rate recommendations of the city and the staff, the examiners would recommend Mr. Reed's over Ms. Elliott's for a number of reasons. First, Mr. Reed conducted a number of analyses to test his projected and historical growth rates. Ms. Elliott only performed two tests, a <u>br</u> and an historical review, and the spread between the two (4.0 to 10.2 and 2.6 to 10.7, respectively) caused Ms. Elliott to rely on judgment for her final recommendation of a 4.5 to 5.5 percent growth rate. As counsel for OPC pointed out in brief, Ms. Elliott did not explain how, based on judgment, she arrived at her recommendation. Second, Mr. Reed, unlike other witnesses, provided explanations as to why his historical analysis was given less weight than the projected data; i.e., that the changes in the market place and HII-specific factors such as level of internal financing and dividend payout

affect the company's growth. This gives the examiners more confidence in Mr. Reed's analysis. Mr. Reed utilized the various growth rates achieved under the various tests to arrive at his "composite" growth range of 4.5 to 6.0 percent. The examiners find such an approach both reasonable and truly reflective of investment scrutiny. It would appear to the examiners that reasonable investors would consider as many factors as would be available in determining investment potential.

With regard to Dr. Szerszen's reliance on the growth in book value as the appropriate measure to determine growth, the examiners disagree in part. While a legitimate factor, the examiners do not believe that the growth in book value can be the only factor in determining the proper growth rate. Although Dr. Szerszen did not rely solely on the average book value, but also reviewed the company's internal growth (br), the examiners believe OPC's analysis still falls short of the complete analysis conducted by Mr. Reed. Additionally, as Mr. Reed in his testimony and the company in its brief pointed out, the book value per share data has been skewed and diluted owing to HL&P's need to obtain external financing for its many construction projects. As Mr. Reed further noted, from 1977 through 1983, HL&P was able to issue stock above book value only once. Since 50 percent of Dr. Szerszen's analysis is based upon this skewed data, the examiners find it less credible than that offered by Mr. Reed. The examiners, therefore, recommend a growth rate of 4.5 to 6.0 percent.

As to the company's proposed market-to-book adjustment, the examiners find that none is warranted. In the examiners' opinion, the company has not demonstrated any significant amount of flotation costs. As Mr. Reed stated, the continuous offering under Rule 415 reduces the company's issuance costs, a fact to which Mr. Bolster admitted on cross-examination. As pointed out by the general counsel, since 1984, the company has issued the majority of its stock under Rule 415. Moreover, Mr. Bolster admitted on cross-examination that he would not anticipate the cessation of this method in the future. (Tr. at 331-332.) Furthermore, the record reflects that the company does not intend to issue stock in 1986, thereby reducing the need for an adjustment for floatation costs.

With regard to the market pressure adjustment, the examiners agree with Mr. Reed's analysis that under a continuous offering, HII has the flexibility to time its issuances to prevent dilution. Moreover, the study upon which Mr. Bolster relied is over seven years old, is not HII-specific, and was conducted prior to the availability of the continuous offering from which the company has issued its stock almost exclusively. While the company did not propose an adjustment resulting from market pressure, it is unclear to the examiners whether Ms. Elliott's market-to-book adjustment is based, in part, on compensation to HII for market pressure. In any case, the examiners find that no market pressure exists. The examiners, therefore, recommend that no market-to-book adjustment be allowed. And while Mr. Reed testified in his discussion of cost of equity that the reason the bvps was not appropriate in determining growth was due to the dilutive effect, the examiners would note that such analysis appears to have been based upon a 1977-1983 time frame, prior to HII's utilization of a the continuous offering. The examiners, therefore, find his statement regarding no dilutive effect on HII's stock arising from market pressure consistent with his testimony on bvps dilution.

OPC raised two additional issues in brief with regard to cost of equity testimony. OPC disagreed with the selection of comparable companies in Mr. Reed's and Mr. Bolster's analyses and further raised what it characterized as the AFUDC issue. While the analysis of comparative companies is helpful, the examiners did not place a great deal of weight on the comparative DCF analysis of any of the parties, other than in the context provided by the parties. For example, Mr. Reed utilized the data from comparable companies in his determination of an appropriate growth rate. He did not, however, substitute the comparable analysis for the HII-specific analysis. In the examiners' opinion, a company-specific DCF analysis is more insightful into the company's projected standing in the marketplace. In that regard, Dr. Szerszen's recommended cost of equity for HII is based upon her analysis of the cost of equity of comparable companies and HII, increased by ten basis points. However, the record does not indicate how and why Dr. Szerszen increased the company's cost of equity by ten basis points.

Second, OPC argued in brief that AFUDC must be removed in order to achieve an accurate picture of the company's financial condition. OPC argued that inclusion of AFUDC increased the level of the company's dividends and earnings. (OPC Brief at 80-82.) OPC, therefore, argued that the analyses which reflect the growth rate in dividends and earnings are faulty and should be rejected. Due to the lack of sufficient data, the examiners choose not to reject the analyses of the other parties. The examiners cannot perceive the extent of such increase as argued by OPC.

6. Summary

The examiners recommend a dividend yield of 9.36 percent, and a growth rate of 5.25 percent, which is the midpoint of Mr. Reed's recommended growth rate of 4.5 to 6.0 percent, for a recommended return on equity of 14.60 percent. The examiners would note that this growth rate falls within the upper range of Mr. Reed's comparable companies. Adjusting the company's return on equity to reflect the conservation adjustment, the examiners would recommend a final return on equity of 14.42 percent. The examiners would note that while this conservation adjustment reflects more than the 16 basis point reduction referenced by the staff, the increase is due to the examiners' change in the company's capital structure. The dollar amount of the adjustment remains unchanged. A complete discussion on this issue can be found under the examiners' recommendation on the company's capital structure. The examiners would further note that the recommended return on equity with the inclusion of the conservation adjustment falls within the range for the cost of equity recommended by Mr. Reed of between 13.86 percent and 15.36 percent.

B. Capital Structure

1. Company's Position

Company witness McClanahan proposed adoption of its test year end capital structure, consisting of 44.09 percent long-term indebtedness, 5.35 percent preferred stock, 42.75 percent common equity, and 7.81 percent unamortized tax credits.

HL&P Test Year Ending December 31, 1985,
Including ITCs

	Percent of Total Capitalization	Cost of Capital Rate	Weighted Cost
Long-Term Debt	44.09%	8.91%	3.93%
Preferred Stock	5.35%	8.61%	0.46%
Common Equity	42.75%	16.25%	6.95%
Unamortized ITC	7.81%	12.30%	0.96%
Total	100.00%		12.30%

(Schedule F, page 2 of 2 of Company Rate Filing Package.)

Mr. McClanahan testified that HL&P's cost of long-term debt decreased from 9.46 percent at the end of test year March 1984 to 8.91 percent for the test year ending December 31, 1985, owing to the issuance of the pollution control bonds and the refinancing of high-coupon debt. Mr. McClanahan testified that the rate on the pollution control bonds ranged from 5.467 percent to 10.625 percent. For the purpose of calculating the interest rates for those bonds, whose rates fluctuate on a quarterly or weekly basis, the company used the test year average. Test year end interest rates were utilized for the company's remaining bonds. As to the company's preferred stock, Mr. McClanahan stated that the company used the annual dividend of each of its nine issues to determine the embedded cost of 5.61 percent. Mr. McClanahan explained that it has adjustable rates for two series of preferred stock. Again, Mr. McClanahan testified that the average dividend rate which occurred during the test year was utilized to determine the cost of the preferred stock. With regard to the investment tax credits, the company used the composite cost of capital. Mr. McClanahan testified that under IRS regulations and prior Commission practice, the ITCs are permitted a rate of return. Mr. McClanahan further testified that based upon Mr. Bolster's recommended return on equity, together with the capital structure proposed by the company, the company's recommended cost of capital is 12.30 percent.

2. City's Position

Ms. Elliott testified that she perceived a number of changes in the company's capital structure since test year end. Ms. Elliott testified that in March 1986, the company's 3-1/4 percent series First Mortgage bonds matured; the company purchased $1,030,000 of First Mortgage bonds at 13-7/8 percent and $738,000 at 15-1/8 percent; and in May 1986, the company retired $117,056,000 of its 12-3/8 percent First Mortgage bonds. Ms. Elliott also noted that the company requisitioned $35,000,000 from the trustee of the pollution control bonds. To reflect these changes, Ms. Elliott utilized the company's March 31, 1986 capital structure:

Component	Percent of Total Capitalization	Cost of Capital Rate	Weighted Cost
Long-Term Debt	46.80%	8.76%	4.10%
Preferred Stock	5.92%	8.49%	0.50%
Common Equity	47.28%	14.75%	6.97%
Total	100.00%		11.58%

(City Exhibit No. 4, Exhibit PE-5.)

As reflected above, Ms. Elliott's overall rate of return based on the above capital structure is 11.58 percent.

3. OPC's Position

Dr. Szerszen testified that to approximate capital costs in the future, it would be better to utilize the most recent data for the variable rates, rather than the company-proposed test year average. This would be especially significant where, as is currently the case, interest rates are declining. Dr. Szerszen, while utilizing the company's December 31, 1985 capital structure, adjusted it by the March 1986 effective dividend and interest rates, and further adjusted it for letter of credit fees on pollution control bonds, where applicable.

OPC, as was discussed earlier in Section VI.B.4., recommended inclusion of the entire $283.88 million of pollution control bonds held in trust in the company's cost of debt. Dr. Szerszen also testified that she did not include ITCs in her calculation of the weighted cost of capital. Dr. Szerszen proposed the following capital structure, which included the adjustments to the variable rates and pollution control bonds.

	Percent of Total Capitalization	Cost of Capital Rate	Weighted Cost
Debt	50.226%	8.748%	4.394%
Preferred	05.539%	8.281%	.4587%
Common	44.234%	13.80%	6.1043%
Total	100.00%		10.957%

(OPC Exhibit No. 91, Schedule 7.)

4. Staff's Position

Mr. Reed utilized the company's March 31, 1986 capital structure, together with several changes thereto. Mr. Reed testified that he utilized the company's most recent schedule for the pollution control bonds which Mr. Reed determined floated annually, monthly, or weekly. Similarly, Mr. Reed utilized the latest cost figures provided by the company for the variable rates for two series of preferred stock. Taking into consideration the above, Mr. Reed proposed the following capital structure, which reflects the conservation adjustment and the aforementioned adjustments in the variable rates:

	Percent of Total Capitalization	Cost of Capital Rate	Weighted Cost
Long-Term Debt	46.80%	8.72%	4.08%
Preferred Stock	5.92%	7.77%	.46%
Common Equity	47.28%	14.44%	6.83%
Total	100.00%		11.37%

(Staff Exhibit No. 9 at 34.)

As reflected above, Mr. Reed's overall recommended rate of return is 11.37 percent.

Lastly, Mr. Reed noted that HL&P currently deposits its pollution control bonds with a trustee who invests these proceeds in treasury securities until such time as HL&P requisitions them. Mr. Reed further noted that HL&P only included those proceeds it actually requisitioned in its capital structure. Based upon staff witness Keever's discussion, Mr. Reed provided an alternate capital structure which included all of the pollution control bond proceeds in the company's capital structure, the variable rates of the pollution control bonds and preferred stock which varied, and the conservation adjustment to the company's cost of equity. This alternate capital structure is as follows:

	Percent of Total Capitalization	Cost of Capital Rate	Weighted Cost
Long-Term Debt	48.99%	8.73%	4.28%
Preferred Stock	5.68%	7.77%	0.44%
Common Equity	45.33%	14.42%	6.54%
Total	100.00%		11.26%

(Staff Exhibit No. 9, Schedule IX at 3.)

Under the above capital structure, which includes the conservation adjustment, the overall rate of return for the company is 11.26 percent

5. Examiners' Discussion and Recommendation

The examiners are convinced that the most current data in the record should be used to determine the company's overall capital structure. This is especially important where the company has issuances of preferred stock and debt in the form of pollution control bonds whose interest rates fluctuate. In that regard, the pollution control bond rates may even fluctuate weekly, thereby necessitating even more the use of the most recent figures available in the record to capture these variations. As is reflected in Mr. Reed's schedules

(Schedule VI, page 2 of 3, Staff Exhibit No. 9.), the adjustable rates are generally consistently lower than the fixed rates-- the low for the adjustable rate of 5.40 percent to a high for the fixed rate of 10.50 percent for the pollution control bonds; with regard to the preferred stock, the lowest dividend per share of $6.35 was for preferred stock with a variable rate compared to the highest dividend per share of $9.52 paid for a fixed rate preferred stock.

The examiners, as previously expressed in Section VI.B.4. of this report, find it appropriate to include all of the proceeds for the pollution control bonds in the company's capital structure, primarily due to the fact that such inclusion would reflect more accurately the company's capital structure and cost of capital. As to OPC's specific request to exclude ITCs, the examiners could not locate where in the testimony of OPC witness Paton this issue was addressed. Nevertheless, the examiners believe that the staff-proposed capital structure is more appropriate than that of OPC because it not only takes into account the changes in variable rates and pollution control bonds, but moreover, uses the most recent capital structure, as of March 31, 1986. (The examiners would note that the staff did not include ITCs in its capital structure.) (Staff Exhibit No. 6 at 11.) Although Ms. Elliott also utilized the company's March 31, 1986 capital structure, Ms. Elliott failed to utilize the most recent data then available regarding the variable rates for the pollution control bonds and preferred stock and merely relied on average test year data. As to the company-proposed capital structure, the examiners have found that such is outdated for the reasons already discussed.

Because the examiners find Mr. Reed's alternate capital structure appropriate because it best represents the changes the company's capital structure has undergone, the conservation adjustment, and the inclusion of the company's pollution control bonds, the examiners recommend adoption of Mr. Reed's alternate capital structure. Utilizing Mr. Reed's alternate capital structure provides an overall rate of return of 11.26 percent.

Should the Commission believe it more appropriate to reduce the return dollars of the company to reflect the conservation adjustment, rather than to adjust the company's cost of equity, the overall rate of return would be

11.34 percent which includes the adjustment for pollution control bonds and preferred stock with variable rates, calculated as follows:

	Percent of Total Capitalization	Cost of Capital Rate	Weighted Cost
Long-Term Debt	48.99%	8.73%	4.28%
Preferred Stock	5.68%	7.77%	0.44%
Common Equity	45.33%	14.60%	6.62%
TOTAL	100.00%		11.34%

(Staff Exhibit No. 9, Schedule IX at 1.)

As to the decrease in the company's return on equity to 14.42 percent under the staff's alternate capital structure, the examiners believe this arises from the inclusion of the proceeds from the pollution control bonds. The examiners believe that Mr. Reed calculated the return on equity of 14.42 percent, found at page 3, Schedule IX, Staff Exhibit No. 9, in the following manner. (It is noted that while Ms. Keever filed supplemental testimony to reflect changes in her testimony, including that of invested capital, Mr. Reed's figures do not reflect the staff's amended invested capital figure.):

Invested Capital	$4,748,523,000.00
(Rate of Return Without Conservation Adjustment in Return on Equity)	11.34
	$ 538,482,502.20
	$ 538,482,502.20
(Conservation Adjustment)	3,986,352.00
	$ 534,496,150.20
	$4,748,523,000.00
(Rate of Return with Conservation Adjustment in Return on Equity)	11.26
	$ 534,683,689.80

$534,683,689.80 / $4,748,523,000.00 = 11.26%

Rate of Return	11.26%
Weighted Cost of Debt	(4.28)%
Weighted Cost of Preferred	(.44)%
Balance as to Return on Equity	6.54%

Weight x Return on Equity = 6.54%
45.33% x Return on Equity = 6.54%
Return on Equity = 14.42%
45.33% x 14.42% = 6.54%

Thus, the return on equity was adjusted to reflect the conservation adjustment. Although reflecting more than a 16 basis point spread, in actuality, the conservation adjustment is accurately captured. Should Ms. Keever's amended invested capital figure be utilized, similar results are obtained:

Invested Capital	$4,752,568,000.00
(Rate of Return Without Conservation Adjustment in Return on Equity)	11.34
	$ 538,941,211.20
	$ 538,941,211.20
(Conservation Adjustment)	3,986,352.00
	$ 534,954,859.20
	$4,752,568,000.00
(Rate of Return with Conservation Adjustment in Return on Equity)	11.26
	$ 535,139,156.80

$535,139,156.80 / $4,752,568,000.00 = 11.26%

Rate of Return	11.26%
Weighted Cost of Debt	(4.28)%
Weighted Cost of Preferred	(.44)%
Balance as to Return on Equity	6.54%

Weight x Return on Equity = 6.54%
45.33% x Return on Equity = 6.54%
Return on Equity = 14.42%
45.33% x 14.42% = 6.54%

VIII. Cost of Service

A. Fuel and Power Related Costs-Nonreconcilable

1. Purchased Power

a. City of Austin and City Public Service Board of San Antonio. HL&P has two firm purchase power contracts, one with the City of Austin (COA), and the other with the City Public Service Board of San Antonio (CPSB.) Both contracts call for a capacity charge and an energy charge (which includes both fuel and operations and maintenance costs). Capacity charges are deemed to be nonreconcilable in nature, and will be considered here. The energy charges will be discussed later in Section VIII.B.2.d, dealing with reconcilable fuel and purchased power costs.

HL&P has requested $17,500,000 for COA capacity costs and $3,600,000 for CPSB capacity costs. Both of these requested amounts are based upon an adjusted test year which corresponds to calendar year 1986. These calculations are based upon a firm commitment of 500 MW of power from COA at a cost of $35 per KW per year and of 200 MW of power from CPSB at a cost of $18 per KW per year.

Staff witness Still made only one adjustment to HL&P's figures, resulting from the staff's use of a rate year from October 1986 through September 1987. Mr. Still increased the amount to be paid to CPSB to $6.3 million because the capacity purchase commitment will increase to 400 MW in 1987. None of the parties has challenged Mr. Still's adjustment in any manner, and the examiners find it to be reasonable. Purchased power capacity costs thus equal $23,800,000.

b. Firm Cogeneration. Currently, HL&P has contracts with four suppliers for provision of firm cogeneration--Applied Energy Services (AES), Diamond Shamrock (Diamond), Dow Chemical (Dow) and Bayou Cogeneration (Bayou). These suppliers will provide a total of 895 MW of firm capacity during the rate year. These four contracts were signed over about a two-year period from early 1983 through early 1985, and each extends through at least 1993. Each of the cogeneration units uses natural gas as the fuel source, with the exception of

the AES project, which uses petroleum coke. The Diamond, Dow, and Bayou contracts each used a committed unit basis (CUB) methodology to calculate the avoided capacity and energy costs, which served as ceiling prices in the negotiations. These three contracts also based the avoided cost estimates upon the proposed Malakoff lignite unit. Each of these four contracts will be touched upon below.

The AES contract is unlike the other three. The contract calls for a capacity payment of $4.95 per KW per month (KW/month), but specifies that the total capacity and energy costs will not exceed 99 percent of HL&P's avoided energy costs. Thus, avoided energy costs are not associated with an avoided generating unit as in the CUB methodology, but instead are based upon the energy not required due to AES's power production. The energy payment under the contract, HL&P's weighted average cost of gas (WACOG), currently exceeds 99 percent of HL&P's avoided energy costs. As a result, HL&P classified all of the payments to be made to AES as reconcilable energy costs rather than nonreconcilable capacity costs, since in essence there are no capacity payments being made. Mr. Still agreed with HL&P's proposal. The examiners concur, and thus all costs associated with the AES contract are treated as reconcilable energy costs.

Diamond Shamrock was the second cogenerator to sign a firm contract with HL&P. In August 1984, Diamond signed a contract to provide 225 MW of gas-fired power to HL&P for ten years beginning January 1984. The base capacity payments of $15.19 per KW/month in 1986 and $16.06 per KW/month in 1987 are adjusted depending upon Diamond's performance during the on-peak periods. (See Staff Exhibit No. 12 at 25 and Schedule MS-15 for details on the capacity payment adjustment methodology.) HL&P has requested that $50,332,959 be recovered through base rates to cover the expected capital charges to be paid to Diamond. Mr. Still adjusted that figure upwards to $50,826,468. His adjustment, caused by use of the October 1986 through September 1987 rate year mentioned earlier, reflects the increased capacity payments due in 1987. None of the parties challenged Mr. Still's adjustment, and the examiners find the $50,826,468 figure to be reasonable.

The contract with Dow was signed on January 24, 1985, and provides 325 MW of firm power through 1994. The base capacity payments in this contract of

$10.97 per KW/month in 1986 and $12.18 per KW/month in 1987 are lower than those in the Diamond contract which was signed about six months earlier. The lower pricing resulted from revised estimates of HL&P's avoided costs and from price competition between cogenerators seeking firm contracts. The Dow contract also contains a capacity payment adjustment mechanism almost identical to that found in the Diamond contract. HL&P has requested $48,732,590 to recover capacity payments to be made to Dow. Once again Mr. Still, utilizing the staff's rate year, increased that figure to account for the increase in capacity payments that will take effect in 1987. And once again, none of the parties has opposed Mr. Still's adjustment. The examiners find Mr. Still's adjusted figure of $54,496,765 to be reasonable.

The firm cogeneration contract with Bayou was signed in early March 1985, about six weeks after the Dow contract was signed. Bayou had been attempting to sign a firm contract with HL&P for over a year. After Bayou discovered that it had lost out to Dow in early January, Bayou reduced its price and came back with a more attractive offer. At $7.99 per KW/month in 1986 and $8.63 per KW/month in 1987, the base capacity rates are more than 25 percent lower than the rates in the Dow contract signed only six weeks earlier. The capacity payment adjustment mechanism is very similar to that found in the Dow contract, but the adjustment applies to only one-half of the 270 MW of capacity involved. HL&P has requested $28,603,088 for capacity payments to Bayou. As with the Diamond and Dow contracts, Mr. Still adjusted that amount upwards, without challenge. The examiners find Mr. Still's adjusted figure of $30,550,291 to be reasonable.

Total payments for firm cogeneration capacity thus equal $135,873,524. This compares to city witness McKinney's slightly higher recommendation of $136,553,000. The examiner cannot explain the difference between the two figures. Ms. McKinney apparently used a rate year very close, if not identical, to that utilized by the staff: in her direct testimony she did not specify what rate year she used; on cross-examination she agreed to a rate year of "sometime in October 1986, through sometime in October 1987." (Tr. at 1871.) To the extent that the rate years were not identical, some difference in cost figures would result. Ms. McKinney also testified as to Dow transferring 25 MW from non-firm to firm capacity. (City Exhibit No. 2 at 10.) Mr. Still testified that HL&P is not currently negotiating for additional firm cogeneration. (Staff

Exhibit 12 at 23.) If Ms. McKinney added 25 MW to the amount of firm cogeneration, that would more than cover the difference in the two figures, and other evidence in the record also indicates that that is not the source of the discrepancy. The examiner will utilize Mr. Still's figure of $135,873,524: Mr. Still's testimony is clearer and more complete, and his figure is also the lower of the two.[7]

[13] Before leaving this area, it should be noted that the base capacity payments to Diamond exceed the base capacity payments of $11.78 per KW/month for 1986 and $12.51 per KW/month for 1987 that were stipulated to in Docket No. 6064, HL&P's standard avoided cost docket. The examiners agree with Mr. Still that such a circumstance does not indicate that the capacity payments are unreasonable. P.U.C. SUBST. R. 23.66(e)(2) states that:

> Rates for purchases of energy and capacity from any qualifying facility shall not exceed avoided cost; however, in the case in which the rates are based upon estimates of avoided costs over the specific term of the contract or other legally enforceable obligation, the rates for such purchases do not violate this subsection if the rates for such purposes differ from avoided costs at the time of delivery.

Thus, the Docket No. 6064 base capacity rates are irrelevant; the question is whether the capacity payments were below HL&P's estimated avoided capacity costs at the time the Diamond contract was signed. Since the capacity costs on a $/KW month basis were more than ten percent less than HL&P's estimated avoided capacity costs at the time the contract was signed, those capacity costs are reasonable under this Commission's substantive rules. HL&P has tried to renegotiate the Diamond contract, but with no success. (Tr. at 1748.) Interestingly, while there are no "economic out" provisions in the Diamond contract, there is a "regulatory out" provision. HL&P witness Brackeen stated that in the event that the price (cost to HL&P) is disallowed by this Commission, then a new price can be set. (Tr. at 1748-49.) However, as detailed above, the capacity costs arising under the Diamond contract are reasonable, even though above the rates set in HL&P's standard avoided cost docket.

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[7] Witnesses would often provide exact figures, then round to the nearest thousand dollars. Some witnesses only provided rounded figures. To be consistent, while exact figures may appear in this Report, in many if not most instances, the final figures have been rounded.

c. Summary. Total nonreconcilable purchased power expenses to be included in base rates equal $159,673,000.

2. Fuel Expenses

a. Coal-Ash Disposal. HL&P requested $1,021,000 for coal combustion residual disposal. Neither staff witness Stan Kaplan nor city witness James Jansen recommended any adjustments, and the examiners find HL&P's request to be reasonable.

b. Coal-UFI Cost of Service. HL&P requested that $62,411,000 in costs relating to coal-fired generation be recovered through base rates. Those costs consist of the coal handling expenses incurred by HL&P's affiliate, Utility Fuels Inc. (UFI), for the coal-burning W. A. Parish units. Both the city and the staff recommended a number of adjustments to that figure.

(1) Operations and maintenance. HL&P calculated O&M by annualizing the December 1985 amount, resulting in a figure of $23,712,000. Mr. Jansen annualized the four-month period December 1985 to March 1986 to obtain a "more representative and ongoing amount." (City Exhibit No. 1 at 16.) Mr. Jansen's recommended O&M expense is $18,156,000, a reduction of $5,556,000.

Staff witness Mark Young recommended a $6,518,000 decrease to HL&P's figure. He objected to annualizing a one-month figure when 12 months of actual operating data exist, testifying that it would be more appropriate to use the test year figure, as adjusted for specific known and measurable changes. Mr. Young then simply utilized the test year amount of $17,194,000 and did not recommend any adjustments to that figure.

The examiners believe that Mr. Young's recommendation is the most reasonable of the three. Twelve months of actual data exist. The test year figure should be utilized, as adjusted for known and measurable changes. No such changes were brought up by any party. The reasonable O&M expense figure is $17,194,000.

(2) Administrative and general. HL&P requested $372,000 in administrative and general expenses. Mr. Jansen did not propose any adjustment to that request. Mr. Young, however, once again objected to use of an annualization of December 1985 data, and instead utilized the test year figure of $310,000. As with O&M expense, the examiners find Mr. Young's adjustment to be reasonable.

(3) Depreciation and amortization. HL&P requested $9,780,000 in depreciation expense. Mr. Jansen's recommended $812,000 decrease to the company's figure reflects the utilization of the depreciation rates recommended by city witness Pous for the assets in service as of December 31, 1985 (where Mr. Pous did not recommend a depreciation rate, Mr. Jansen used the UFI rates).

Mr. Young recommended only one adjustment to HL&P's request. That adjustment, a decrease of $14,000, was made to reflect the fact that one asset will be fully depreciated, and not replaced, by the beginning of the rate year.

Consistent with the examiners' recommendations concerning Mr. Pous' depreciation adjustments (<u>see</u> Section VIII.E.1.e), the examiners will reject the adjustment recommended by Mr. Jansen, and not disturb the depreciation rates put forth by HL&P. With regard to Mr. Young's adjustment, the examiners concur. Depreciation expense equals $9,766,000.

(4) Ad valorem taxes. HL&P requested $2,904,000 in ad valorem taxes. Mr. Young recommended that that amount be reduced by $519,000. Mr. Young objected to HL&P's annualization of the January 1986 ad valorem tax accrual, consistent with his views concerning annualization of only one month of data. Thus, the staff calculated an effective ad valorem tax rate based on 1985 ad valorem taxes assessed on the 1985 physical property subject to tax assessment, and applied that rate to the staff's recommended Parish plant assets and inventories, yielding a proposed expense of $2,385,000. The examiners find the staff methodology to be similar to that used for HL&P's own ad valorem tax expense, and believe it to be reasonable in this instance. Ad valorem taxes equal $2,385,000.

(5) Allocated administrative and general expense. HL&P requested $2,196,000 in allocated administrative and general expense, based upon annualization of December 1985 data. Mr. Jansen, consistent with his O&M adjustment, annualized the costs for the four-month period from December 1985 through March 1986. Mr. Jansen's recommended expense amount is $2,232,000, an increase of $36,000.

Mr. Young's recommendation also mirrors his O&M adjustment. Mr. Young utilized the test year amount of $2,216,000 and made no changes to it, for an increase to HL&P's request of $20,000. For the reasons set out above concerning O&M, the examiners find Mr. Young's adjustment to be the most reasonable. Allocated administrative and general expense equals $2,216,000.

(6) Return on invested capital. HL&P has utilized an approach wherein return (and federal income tax expense) relating to UFI has been separated out and dealt with as a part of nonreconcilable fuel expense. The pertinent portion of the Commission's substantive rules dealing with affiliate return reads as follows:

> (i) The affiliate fuel price shall be "at cost"; no return on equity or equity profit may be included in the affiliate fuel price. The Commission may consider the inclusion of affiliate equity return in rate of return and rate base during the utility's general rate case; however, affiliate equity return or profit shall not be considered part of fuel cost.

(P.U.C. SUBST. R. 23.23(b)(2)(J)(i) (as adopted on an emergency basis February 21, 1986 (10 Tex. Reg. 1033) (henceforth "Emergency Fuel Rule"); currently found at 23.23(b)(2)(H)(iv)(I) (henceforth "Fuel Rule").) Since return will be a nonreconcilable expense, it is not a part of fuel cost insofar as the Emergency Fuel Rule 23.23 envisions "fuel costs" being recovered through a fuel factor. Further, none of the parties has recommended that the return on equity for UFI be any different than for HL&P itself. (The rate of return, however, will vary due to UFI's different capital structure.) Consideration of return and federal income taxes related to UFI separate from HL&P is reasonable and in accord with this Commission's rules.

Turning first to the total invested capital of UFI at the appropriate W. A. Parish units, neither the city nor the staff recommended any adjustment to

HL&P's figure of $160,024,000. It should be noted that no adjustment was made to the accumulated depreciation reserve to recognize one-half of the increase in the amount of depreciation expense included in cost of service. This is consistent with the recommendation of the examiners concerning depreciation for HL&P itself. (*See* Section VI.A.2.c.)

With regard to rate of return, Mr. Jansen made no changes other than to utilize the city's recommended return on equity figure of 14.75 percent. OPC witness Paton also made an adjustment, to reflect OPC's recommended return on equity figure. Mr. Young, however, relied upon a UFI capital structure updated through March 31, 1986, as sponsored by Mr. Reed. That structure, which includes the staff's recommended return on equity of 14.60 percent (excluding the energy efficiency adjustment), is as follows:

Description	Capitalization Amount (000's)	Weight	Component Cost	Weighted Cost
Secured Notes	$ 18,200	4.40%	9.00%	.40%
Capital Leases	34,765	8.40	7.80	.66
Bank Credit	50,000	12.08	8.70	1.05
Commercial Paper	21,600	5.22	8.10	.42
Inter Co. - Long Term	75,000	18.12	9.81	1.78
Inter Co. - Short Term	86,700	20.95	7.90	1.65
Vendors Lien Paper	5,219	1.26	12.00	.15
Total Debt	$291,484	70.43%		6.11%
Common Equity	122,397	29.57	14.60%	4.32
TOTAL	$413,881	100.00%		10.43%

The examiners find the above capital structure, including the return on equity of 14.60 percent (*see* Section VII.A.6), to be reasonable. Applying the 10.43 percent rate of return to the invested capital figure of $160,024,000, produces a figure of $16,691,000, some $1,216,000 less than that requested by the company. (Staff Exhibit No. 7 at Exhibit III.) The examiners find the $16,691,000 amount to be reasonable.

(7) Federal income tax. The company requested $5,540,000 for income tax expense related to UFI. Since the examiners have adopted Mr. Young's recommendation with regard to return, his calculation of federal income taxes will also be accurate. (Staff Exhibit No. 7 at Exhibit 4.) The only issue is

whether or not to accept interest synchronization. The examiners have determined that such a step is proper (see Section VIII.H.5), and thus Mr. Young's recommended federal income tax figure of $4,558,000 is reasonable.

(8) Subtotal. The total UFI coal-related cost of service is $53,120,000, a decrease of $9,291,000 from HL&P's request. However, Mr. Griffey undertook to analyze just rail car maintenance costs, which costs are spread across a number of the categories covered above, to determine if further reductions would be in order. Mr. Griffey concluded that a further decrease was in order, and it is to that recommendation we now turn.

(9) Rail car maintenance costs. HL&P requested $16,500,000 in rail car maintenance costs, reached by annualizing December 1985 data. Mr. Griffey was suspicious of this figure because UFI had begun a rail car preventive maintenance program in January of 1985, which is not scheduled to end until the end of the second quarter of 1987, although it should be noted that rail car maintenance costs did not rise substantially until July of 1985 because the preventive maintenance program did not begin in earnest until that time. Since the staff's rate year is October 1986 through September 1987, the rail car maintenance program will conclude during the middle of the rate year, but UFI's request assumes that the maintenance program will be in effect throughout the rate year. Therefore, Mr. Griffey concluded that under HL&P's proposal, rail car maintenance expense would be higher than that which will likely be incurred, especially in light of the fact that the rail car maintenance expense for December 1985 was the second highest for any month from July 1985 through March 1986.

Mr. Griffey considered utilizing test year data, but rejected such an approach, believing that it would still overestimate rate year rail car maintenance costs. Mr. Griffey based his conclusion on several factors. First, because the rail car maintenance program was in effect throughout the period from which historic information was gathered, utilizing historic data would result in higher expenses than will probably be incurred. Second, since HL&P had more cars in service during 1984 and 1985 than it will have in service in 1986, utilizing historic data would again result in higher expenses than will probably be incurred. Finally, since HL&P's coal consumption is forecast to

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drop in 1987, fewer cars and/or trips will be needed, leading to lower repair and maintenance expenses.

It should be noted that the adjustment already made by Mr. Young constitutes use of historic, test year data. If Mr. Griffey's recommendation is rejected, test year data will be utilized, in essence by default, since no other party made any recommendations specific to the rail car maintenance program. If Mr. Griffey's recommendation is accepted, his reduction in rail car maintenance costs will be offset in part by the reductions already made by Mr. Young. In fact, Mr. Griffey recommends that rail car expense be set at $5,036,064, or $11,463,936 less than HL&P requested. However, the $53,120,000 cost of service figure subtotaled above already includes reductions in rail car maintenance costs of $7,599,000. Thus, should Mr. Griffey's recommendation be accepted, the $53,120,000 amount would be reduced by only $3,865,430, not the full amount of $11,463,936.

Mr. Griffey's method of calculating rail car expense was to determine the most likely rail car maintenance cost without the scheduled maintenance program, and add to this amount the maintenance program costs which have yet to be incurred in order to reach the total rail car maintenance cost for the rate year. In order to calculate rail car maintenance expenses not inflated by the scheduled maintenance program, Mr. Griffey made use of a Monte Carlo simulation. A Monte Carlo simulation is an iterative method used to predict the outcome of some event by using probability distributions to determine the value for some variables. This method is often used when it is impossible to make a point estimate of a variable due to uncertainties in the data or risk factors. The specific application of the Monte Carlo method to the determination of rail car maintenance expense, in a somewhat condensed form, follows.

In the rail car maintenance model, the number of rail cars which need to be maintained or repaired and the cost per repaired car are probabilistically determined. This method is more appropriate than merely using an average, because the standard deviation of the values from the mean is very high. The probability distribution for costs per car was calculated utilizing sample data from September 1983, April 1984, September 1984, and March 1985. All data were expressed in 1985 dollars using DRI's historical GNP deflator. Mr. Griffey

testified that those months were chosen in order to have sample data over as wide a range of time as possible, and that data from other months were also examined and were found to track those months very closely, leading him to conclude that the sample distribution is representative of the period. The distribution for the probable number of cars maintained per month as a percent of the total number of cars in service was also calculated.

The model uses a random number to determine the number of cars which will be maintained in a given month from the known probability distribution for cars repaired per month. For each car to be repaired, a random number is selected which will determine the repair cost per car from that variable's distribution. These costs are then summed to arrive at a total maintenance cost per month for those cars. To this number an amount called "group billable" is added to reach the total maintenance cost per month. This "group billable" represents the costs of brake shoe replacement on rail cars in a given month; since it is fairly small, Mr. Griffey used the average monthly cost, in 1985 dollars, for the 1983 through 1985 time period predict its future value.

The procedure described above was performed for 12 iterations to calculate a cost per year. The simulation was then run for 50 years to determine the most likely yearly cost, and a range for a 99 percent confidence level. The model predicted that one could be 99 percent confident that the most likely value was within $81,843 of $2,702,939. To be conservative, Mr. Griffey chose the upper limit of this range, $2,784,782, as the most likely value. Such is the Monte Carlo simulation presented in this docket.

To determine the remaining costs associated with the scheduled maintenance program, Mr. Griffey calculated an average cost per car through March 1, 1986 of $5,282, and multiplied that figure times the number of cars remaining to be done as of May 1, 1986, arriving at a figure of $3,501,995. However, since the rate year will cover only nine months of the fifteen-month period from May 1, 1986 through June 1987 (when the program will be completed), Mr. Griffey utilized only nine-fifteenths of the $3,501,995 amount, or $2,251,282. That figure, added to the $2,784,782 reached earlier for unscheduled maintenance, produces the figure of $5,036,064 referenced earlier.

HL&P objects to Mr. Griffey's adjustment. With regard to the scheduled maintenance program, HL&P correctly notes that there is no dispute as to the prudence or propriety of the program or its costs. HL&P indicates that use of 1985 test year data, as was done by Mr. Young, picks up about one-half of the annual cost of the program. HL&P objects to Mr. Griffey's use of the $2,251,282 figure, arguing that it is less than 40 percent of the actual test year cost of the program, and only about 20 percent of the total cost of the program.

With regard to unscheduled maintenance, HL&P strongly attacks use of the Monte Carlo simulation. HL&P objects to use of data from outside the test year, particularly insofar as HL&P believes that use of such data will cause a significant underestimation of repair costs. The logic underlying HL&P's argument is well set out in its brief.

> A Monte Carlo simulation is designed to predict future events based on the distribution of events in a prior period (Tr. 3271). In this case Mr. Griffey used a Monte Carlo simulation to predict the frequency of repairs and cost of each repair. For the frequency of repair, he used data from 1983 through 1986. For the cost of repairs, he used data from September, 1983, April, 1984, September, 1984 and March, 1985 (Tr. 3273). Because the frequency distributions used to predict occurrences reflects a weighted average of the four months (Tr. 3286) and March, 1985 was a low month in terms of number of cars repaired, it turns out that 80% of the repairs used in the analysis were from months outside the test period (Tr. 3282). This is significant because the cost of each repair in the earlier periods tended to be lower than those in the test period. For example, the March, 1985 costs averaged $650 per car while the September, 1983 costs averaged $365 per car. Because the model was almost twice as likely to predict that the cost per car would follow the September 1983 pattern than the March 1985 pattern, the result of the Monte Carlo simulation is to underestimate repair costs.

(Brief at 62, footnote 11.) HL&P also notes that Mr. Griffey conceded that the average age of UFI's rail cars has increased each year (Tr. at 3324), and that in general the total maintenance cost per car will increase with the age of the cars. (Tr. at 3269-3270.)

The examiners will reject Mr. Griffey's adjustment, for the reasons that follow. Concerning the scheduled maintenance program, the examiners see no reason to use other than test year data. The program started in January of 1985, but did not begin in earnest until July 1985. To follow Mr. Griffey's

recommendation would result in only around 20 percent of the costs of the entire two and one-half year program being recovered through rates, even though slightly over half of the cost of the program was incurred during the test year. The examiners believe it is appropriate to allow for recovery of the cost of the program utilizing test year data, as Mr. Young has in effect done.

[14] With regard to the Monte Carlo simulation, the examiners believe HL&P's objections are well founded. A Monte Carlo simulation is a useful analytical tool, and the examiners have no difficulty with the use of such a simulation. Where the examiners find fault with Mr. Griffey's Monte Carlo simulation is with the data that was utilized. UFI's rail car maintenance cost has shown an increasingly upward trend. Mr. Griffey's Schedule CG-20 shows that in September 1983, approximately 51 percent of the rail cars were repaired at a cost of $400, but that by March of 1985, that percentage had decreased to 36 percent. Over the same time frame, per car maintenance costs at the $1,200 level went from around 31 percent to 39 percent, and per car maintenance costs of over $4,000 went from 0 percent to around 4 percent. Mr. Griffey checked the overall distribution of costs in his sample with data from six other months in the July 1983 to December 1984 time frame. During those six months, the approximate number of cars repaired for $400 or less was 1.22 times the number of cars with repair costs ranging from $800 to $1,200, which was very close to the 1.25 ratio obtained from the four-month sample actually used by Mr. Griffey in his simulation. But as set out on Mr. Griffey's Schedule CG-21, the trend towards higher per car costs is again clearly visible. In July of 1983, 151 cars were repaired for $400 or less, compared to 75 cars in the $800 to $1,200 range, for a ratio of 2.01. By August of 1984, the ratio had dropped to 1.18, and by December of 1984, it had dropped to 0.876. In other words, by December 1984, more cars were costing $800 to $1,200 to be repaired than were costing $400 or less to be repaired, a far cry from the earlier July 1983 ratio. The significance of this upward trend is not properly reflected in the Monte Carlo simulation due to the frequency distributions used to predict the per car costs to be incurred. The frequency distribution, being a weighted average of the cars repaired in each of the four sample months utilized by Mr. Griffey, was weighted toward the month with the highest number of cars that were repaired. (Tr. at 3286.) As fate would have it, that month was September 1983 (529 cars out of 1419 total), a "low cost" month. Thus the model

was much more likely to predict that the cost per car pattern would follow the September 1983 cost distribution pattern than the March 1985 cost distribution pattern. The model's results are thus inconsistent with the trend toward higher per car costs shown in the underlying data. Since the Monte Carlo simulation will clearly underestimate unscheduled rail car maintenance costs, the examiners believe that it should not be utilized, and instead will rely on test year data as utilized by Mr. Young and already adopted by the examiners above.

(10) Summary. Having rejected Mr. Griffey's additional adjustments, the total UFI coal-related cost of service is $53,120,000.

c. Lignite - Ash Disposal. HL&P's lignite unit is Limestone Unit 1, which only began commercial operation in December of 1985. Because there is relatively little actual operating data for Limestone, it becomes necessary to estimate the costs likely to be incurred, not only for this expense but for other expenses that will be considered in various sections of this report.

HL&P requested $4,296,000 for combustion residual disposal. HL&P does not actually do the disposal, but contracts with Ash Management, Inc. for the service. Both Mr. Jansen and Mr. Kaplan utilized the same basic methodology to calculate this expense, but arrived at different figures. The methodology utilized was to annualize the average monthly variable cost and add in the fixed costs. Mr. Jansen annualized the average monthly variable cost during the December 1985 through March 1986 time frame. Mr. Kaplan did the same, but for only the three months from December 1985 through February/1986. Mr. Jansen's total recommendation was $2,200,000, while Mr. Kaplan's was $2,456,000. The difference between the two, however, cannot be explained away by Mr. Jansen's use of one additional month's worth of data.

Mr. Kaplan testified that beginning in July 1986, the fixed cost would be $175,000 per month, or $2,100,000 a year. Mr. Kaplan then annualized the variable costs of $89,054 incurred, producing a figure of $356,216. Even if no variable costs were incurred in March 1986, the annualized variable cost figure would be $267,162 which when added to the fixed expenses of $2,100,000 equals $2,367,162. This is greater than the figure Mr. Jansen arrived at, and indicates he was using a lower monthly fixed expense amount. Since Mr. Kaplan

has utilized the fixed fee amount that will be in effect during the rate year, at least until Limestone Unit 2 begins commercial operation[8], the examiners will utilize his fixed cost figure of $2,100,000. Since Mr. Jansen did not separate out the fixed and variable components of the expense, the examiners must also utilize Mr. Kaplan's variable expense figure of $356,216, for a total of $2,456,000. The examiners find that amount to be reasonable.

d. Lignite-UFI Cost of Service. As with HL&P's Parish coal plant, UFI is the entity that actually performs the lignite handling chores at Limestone. HL&P has requested $42,349,000 in affiliate lignite handling expenses, and as with the coal handling expenses, numerous adjustments have been recommended.

(1) Operations and maintenance. HL&P once again annualized December 1985 data. Mr. Jansen again annualized data for the four month period from December 1985 through March 1986, reaching a figure of $4,260,000. Mr. Young also utilized an annualized figure, since there is only one month of test year data, but he annualized the costs for the six-month period from October 1985 through March 1986.

HL&P objects to Mr. Young's use of six months of data, arguing that since Limestone only became commercially operable in December 1985, utilizing costs for October and November of 1985 will result in an underestimation of O&M expenses. HL&P also notes that for allocated administrative and general expenses, discussed later, Mr. Young used only four month's worth of data. The examiners agree with HL&P that it is reasonable to base O&M expenses only on costs incurred during months when Limestone was in commercial operation, to prevent any possible underrecovery of costs, and for the sake of consistency. O&M expenses equal $4,260,000, as set forth by Mr. Jansen, or some $1,116,000 less than the company's request.

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[8] At that time, Ash Management, Inc. will charge HL&P actual expenses, plus an index-adjusted cost per ton of residue. Mr. Kaplan testified that without any data for this new pricing mechanism, it would be more reasonable to simply utilize the pricing mechanism currently in effect for the entire rate year.

(2) Depreciation and amortization. HL&P requested $3,144,000 for depreciation and amortization. Mr. Jansen made two adjustments to depreciation. The first was a reclassification of Jewett mining costs to depreciation (HL&P reported $5,064,000 in Jewett mining costs). The second adjustment was a recalculation of depreciation expenses utilizing the depreciation rates used by Mr. Pous. Mr. Jansen's total adjustment was an increase of $3,136,00. Assuming Jewett mining costs were simply reclassified and not adjusted as to their amount (Tr. at 2046-2047), the second component at Mr. Jansen's depreciation adjustment is a decrease to the company's request of $1,928,000.

Mr. Young made one adjustment to depreciation. That adjustment, almost identical to the one made for assets used at Parish, is to decrease depreciation expense to reflect the fact that an asset will be fully depreciated and not replaced. In this case, the asset will be fully depreciated as of the end of October 1986, and thus based on the staff's rate year, Mr. Young allowed one month of depreciation and excluded the remaining eleven months, resulting in a $204,000 decrease to the company's request. Consistent with the examiner's recommendations in Sections VIII.E.I.e and VIII.A.2.b.3, the adjustment based upon Mr. Pous' depreciation rates is rejected, and Mr. Young's adjustment is accepted. As to Mr. Jansen's recommendation to reclassify the Jewett mining costs, Mr. Jansen failed to explain why such a reclassification was either appropriate or necessary. Mr. Young testified that the Jewett mining costs consist of both depreciation and ad valorem expenses (Staff Exhibit No. 7 at 17); thus reclassification of the entire amount would be inappropriate, and Mr. Jansen did not provide a breakdown of the component costs. There should be no financial impact in any event, and thus the examiners will not reclassify the Jewett mining costs. Reasonable depreciation and amortization expenses equal $2,940,000.

(3) Ad valorem taxes. HL&P requested $444,000 in ad valorem tax expense. Mr. Young, utilizing the same approach as was utilized for the Parish cost of service (<u>see</u> Section VIII.A.2.b.4), recommended an increase of $44,000 to the company's request. The examiners once again find the adjustment to be reasonable.

(4) Allocated administrative and general. HL&P requested $1,740,000 in allocated administrative and general expense, an amount reached by annualizing December 1985 data. Mr. Jansen annualized four months of costs (December 1985 through March 1986), and as was noted earlier, so did Mr. Young. While both Mr. Jansen and Mr. Young utilized cost data from the same four months, they did not reach identical figures. Mr. Jansen recommends a $108,000 decrease; Mr. Young a $75,000 decrease. Absent any evidence explaining the discrepancy, the examiners feel compelled to utilize the lower expense figure of $1,632,000 recommended by Mr. Jansen as being the lowest reasonable amount supported by the evidence.

(5) Jewett mining costs. As noted earlier, the mining costs incurred by UFI for the Jewett mine consist of depreciation and ad valorem tax expense. Mr. Young recommended an adjustment to each component. With regard to depreciation expense, Mr. Young agreed with the company's annualization of one month's depreciation accrual, since depreciation is a constant, but found that the accrual amount had been misstated. The corrected amount of depreciation is $4,920,000. As to ad valorem tax expense, Mr. Young recalculated the expense using the same methodology that was applied to the Parish and Limestone facilities, producing a figure of $231,000. The examiners find both adjustments to be reasonable. Jewett mining costs equal $5,151,00, or $87,000 more than the company's request.

(6) Return on invested capital. HL&P has requested $19,351,000 for return on invested capital for UFI. Both Mr. Jansen and Mr. Young made adjustments to that amount to reflect differing recommended rates of return. Neither proposed any adjustment to the invested capital components of the Limestone and Jewett facilities. The examiners have adopted both the UFI capital structure and the rate of return recommended by the staff, and have also agreed that no adjustment to invested capital should be made to reflect increased accumulated depreciation. (<u>See</u> Section VIII.A.2.b.6.) The examiners thus find reasonable the staff return figure of $18,037,000 put forth by Mr. Young, which is a decrease of $1,314,000 to HL&P's request.

(7) Federal income tax. As with income tax expense for Parish, since the examiners have adopted Mr. Young's return recommendation, they must

logically adopt his federal income tax calculation. Federal income taxes equal $6,170,000, or $1,060,000 less than that requested by HL&P.

(8) Summary. The total UFI lignite-related cost of service is $38,678,000, or some $3,671,000 less than that requested by HL&P.

e. Miscellaneous Fuel Oil. HL&P requested that the costs associated with operating its oil pipeline system be treated as nonreconcilable fuel costs. Neither Mr. Still nor city witness Deena McKinney objected to the request, nor did they recommend any adjustments to the test year amount of $2,755,161. The examiners concur with HL&P's request.

f. UFI-Miscellaneous Costs. HL&P requested inclusion in reconcilable fuel costs of $4,479,000 in miscellaneous costs (Rate Filing Package, Schedule A.7-1, p. 1). These miscellaneous costs relate to plant that will be placed in service sometime during 1986, and consist of depreciation and return on those assets. (Rate Filing Package, Schedule A.7-1, p. 1.)

The first issue is whether the costs involved are reconcilable fuel costs or not. They clearly are not. HL&P recovers through base rates the depreciation and return expenses charged by UFI. (See Section VIII.A.2.d.2 and 6.) As to whether the costs are properly included as nonreconcilable costs, Mr. Jansen apparently did not deal with the claimed expense. Neither did Ms. McKinney, Mr. Young, Mr. Griffey or Mr. Kaplan. But it should be noted that they did not include the expense either as nonreconcilable or reconcilable fuel expense. Interestingly, OPC witness Paton did address the issue. Ms. Paton agrees with HL&P that the costs are reconcilable, but because they are estimates, recommends that the costs not be included. Then, when the costs are incurred, they are to be booked as reconcilable fuel expenses, and be taken into account when fuel costs are eventually reconciled. She also notes that HL&P is trying to recover costs associated with plant that was actually CWIP at test year end, and that fact also underlies her recommendation. (OPC Exhibit No. 90 at 17.)

[15] As stated above, the examiners find the costs involved to be nonreconcilable in nature. The Commission's policy is not to allow base rate

recovery of expenses associated with assets that are transferred to plant in service sometime after the test year. This is particularly true when the expenses involved are depreciation and return. The examiners recommend that the UFI miscellaneous expenses be categorized as nonreconcilable in nature, and be disallowed in their entirety.

3. Summary

Total nonreconcilable fuel and purchased power costs to be included in base rates equal $257,703,000, as follows:

Description	Company Request	Examiners' Recommendation
Purchased Power Expense		
City of Austin	$ 17,500,000	$ 17,500,000
City Public Service Board	3,600,000	6,300,000
Firm Cogeneration	127,669,000	135,873,000
Total Purchased Power	$148,769,000	$159,673,000
Fuel Expense		
Coal-Ash Disposal	$ 1,021,000	$ 1,021,000
Coal-UFI Cost of Service	62,411,000	53,120,000
Lignite-Ash Disposal	4,296,000	2,456,000
Lignite-UFI Cost of Service	42,349,000	38,678,000
Fuel Oil-Miscellaneous	2,755,000	2,755,000
Total Fuel Expense	$112,832,000	$ 98,030,000
TOTAL	$261,601,000	$257,703,000

B. Fuel and Power-Related Costs--Reconcilable

Reconcilable fuel and power-related costs consist of the cost of fuel burned by HL&P at its own generation plants, as well as the energy and miscellaneous costs paid to other utilities and cogenerators for purchased power. Purchased power costs will be considered first, but even before that, HL&P's generation mix will be established.

1. Generation Mix

There is no dispute that, at this point in time, natural gas fired generation has become substantially cheaper than western coal fired generation. Lignite, however, is the cheapest fuel source for HL&P by a wide margin. Limestone Unit 2 is forecast to become commercially operable later this year, and should provide nearly 4 million MWH during the rate year, helping to decrease fuel costs. Because lignite is the cheapest fuel source, the lignite units will be base loaded. While gas is cheaper than western coal, sizable amounts of western coal must be burned due to contractual obligations. Likewise in determining generating mix, contractual obligations to cogenerators require purchase of cogenerated power, essentially without regard to cost.

Before any detailed analysis of generation mix can be undertaken, it is necessary to determine the total amount of generation that will be required. The Fuel Rule in effect until February 21, 1986, did not expressly deal with the standard to be utilized in setting the total amount of generation required. The Commission applied the Fuel Rule in such a manner as to allow for the use of test year kWh sales adjusted for known and measurable changes. Those changes would generally take the form of three categories: customer adjustments, weather normalization, and miscellaneous adjustments. In other words, the adjusted test year kWh sales figure utilized in setting base rates would also be utilized as the total net amount of generation necessary (as adjusted for line losses) and in setting the fuel factor.

However, the Emergency Fuel Rule that took effect on February 21, 1986, changed the manner in which the kWh sales figure was to be calculated for use in setting the fuel factor:

> The utility's fixed fuel factor . . . shall be determined by dividing the utility's allowable fuel cost . . . by the corresponding kilowatt-hour sales <u>during the period in which the factor will be in effect</u>. If due to unique circumstances, such a calculation is not appropriate for a particular utility, a different method of calculation may be used. (Emphasis added.)

(P.U.C. SUBST. R. 23.23(b)(2)(B).)[9]

[16] The Emergency Fuel Rule thus requires use of a projected rate year kWh sales figure in calculating the fuel factor and, by logical extension, in determining the amount of generation required (the examiners do not believe it logical to use one kWh figure for determining the amount of generation needed, which figure plays a major role in determining total fuel costs, only to have those fuel costs divided by a different kWh figure when calculating the actual fuel factors to be charged.) Thus, the adjusted test year kWh sales figure used in setting base rates is to be replaced by a forecasted sales figure when calculating fuel costs and setting the fuel factor. Unfortunately in this case, the change in the Fuel Rule apparently escaped the notice of the parties. HL&P, the City of Houston, and the staff all utilized an adjusted test year kWh sales figure.

The initial question is whether the change in the Emergency Fuel Rule, in fact, makes any practical difference. The answer is yes. While weather normalization adjustments and miscellaneous adjustments will likely be made and be identical, under either an adjusted test year standard or a projected standard, the customer adjustment will be different. The policy of the Commission is to base the customer adjustment on test year ending data. (<u>See</u> Section IX.B, below.) The Emergency Fuel Rule, however, will require projections of usage for time periods well into the future; in this case, 21 months after the end of the test year. Obviously, the customer base will change from December 1985 to September 1987, and those changes will be reflected in the amount of kWh sold. Thus, the "customer adjustment" to be used for purposes of nonreconcilable fuel expenses will not be the same as that used for base rate purposes.

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[9] The language in emphasis was carried forward into the current permanent Fuel Rule at subparagraph (b)(2)(C).

In this docket, therefore, we have the scenario where the Emergency Fuel Rule requires one standard, but all of the evidence in the record is based upon another standard. It should be noted that HL&P did present one schedule that includes a projected MWH sales figure. That schedule, Rate Filing Package Schedule A, page 26, contains the calculation of a proposed fuel factor revenue adjustment. The purpose and methodology of that adjustment, as will be discussed in Section VIII.B.7, has escaped the examiners' understanding, despite testimony by Mr. Brian on cross-examination concerning that schedule. (Tr. at 527-531.) While the projected MWH sales figure clearly comes from Docket No. 6678, it is not clear what rate period that figure corresponds to, nor has HL&P actually utilized that figure to calculate its recommended fixed fuel factor. (Compare Schedule A, page 26, lines 10 and 12 with Schedule A-7.1, page 11, line 4.)

The examiners believe that for the purposes of this one docket, it is more reasonable to use a generation requirement based on test year data as adjusted for known and measurable events than to reopen the hearing. The Emergency Fuel Rule itself contains a "unique circumstances" exception, and the examiners will apply it to this case, which is apparently the first major rate case filed under the provisions of the Emergency Fuel Rule. In subsequent cases, allowance of such a dispensation should be viewed with a critical eye. As concerns this docket, adjusted sales at the meter equal 51,671,719 MWH. (See Section IX.) Taking into account average system losses, total net generation will equal 54,165,962 MWH. (Staff Exhibit No 1A.)

Turning now to the question of what fuels, and how much of each, will produce that generation, HL&P states in its brief that:

> The only parties presenting fuel witnesses were HL&P and the PUC Staff. At this stage of the proceeding, there is no dispute about the total expected sales, about the anticipated quantities of each type of fuel or about the average cost of coal and lignite. The only element in dispute is the expected average cost of natural gas.

(HL&P Brief at 55 (footnote omitted).) HL&P has apparently decided not to contest the staff's recommendations, except for natural gas costs. However,

contrary to HL&P's statement, the city did put on an entire fuel case. While HL&P is obviously willing to discount the city's testimony to the point of nonexistence, the examiners do not believe that they can also take that step. While HL&P has acquiesced to the staff's recommendations, the city has not, and thus the examiners will compare the evidence put forth by both the city and the staff.

a. City's Evidence. Ms. McKinney started with a generation requirement of 55,291,000 MWH, or over 1,250,000 MWH more than the examiners have found reasonable. Ms. McKinney than deducted from this amount the MWH to be supplied by firm and non-firm cogeneration (7,466,000 MWH and 7,533,000 MWH, respectively) and other power supply contracts (3 MWH), leaving the amount of power to be generated by HL&P. Ms. McKinney then deducted the amount of generation to be provided by coal and lignite units (19,158,000 MWH), leaving 21,761,000 MWH to be supplied by gas fired units.

Ms. McKinney used HL&P's proposed MMBtu burn levels for coal and lignite, and multiplied those levels by the actual test year coal and lignite heat rates, to arrive at the amount of generation to be supplied by coal and lignite units. Unlike HL&P, Ms. McKinney utilized fuel-specific heat rates, instead of a system-average heat rate.

b. Staff's Evidence. Staff engineer Scott Norwood proceeded in the same general manner. Starting with the total rate year generation requirement, he deducted the MWH to be generated by HL&P's coal and lignite units. Since the staff utilized an October 1986 through September 1987 rate year, Mr. Norwood included in his net lignite generation figure almost 4,000,000 MWH attributable to Limestone Unit 2, which is scheduled to become commercially operable during the rate year. On a combined basis, Mr. Norwood projected that the Limestone units would have a capacity factor of 66.4 percent and a heat rate of 11.1 MMBtu/MWH. Mr. Norwood based these figures upon HL&P's estimated generation and maintenance levels, and a review of the historical performance of Limestone Unit 1 and similar Texas lignite-fired units.

With regard to the Parish coal units, since western coal is more expensive than lignite or gas, Mr. Kaplan provided Mr. Norwood with a floor amount of coal

that should be burned. Mr. Kaplan testified that there was some ambiguity as to exactly how much coal HL&P is required to take. HL&P clearly must take 6,776,000 tons of coal from UFI for Parish Units 5, 6, and 7. UFI, however, is obligated to take approximately 8,300,000 tons of coal annually for Parish Units 5, 6, 7, and 8. Mr. Kaplan testified that it is unclear whether HL&P would be obligated to take the additional 1,524,000 tons of coal associated with Parish Unit 8 from UFI. (Staff Exhibit No. 13 at 27-28; Tr. at 3621-3622.) HL&P itself is anticipating a coal burn of only 7,005,000 tons in 1987, due to coal generation being replaced by cogeneration and because of an extended maintenance shutdown at Unit 6. Thus, Mr. Kaplan informed Mr. Norwood that any coal burn level over 7,005,000 tons would be reasonable. Mr. Norwood ultimately selected a Parish MMBtu burn level of 130,770,000, which equates to 7,528,000 tons of coal, a 21 percent decrease from the test year amount of coal-fired generation.

Mr. Norwood then took the remaining generation requirement amount and subtracted the amount of generation to be supplied by cogeneration, leaving 17,766,408 MWH to be supplied by gas-fired generation. With regard to firm cogeneration, Mr. Norwood testified that Mr. Still had calculated the amount of generation at 7,709,763 MWH. (See Staff Exhibit No. 12 at Schedules MS-15,-17, -18 (revised and in evidence as part of Staff Exhibit No. 12A), and-19.) Concerning non-firm cogeneration, Mr. Norwood utilized a figure of 7,870,000 MWH, which apparently was also supplied by Mr. Still. Mr. Still testified that his projection was based upon the April 17, 1986 Cogeneration Fact Sheet, the 1986 First Quarter Report of HL&P's Cogeneration and Small Power Production Department and the direct testimony and workpapers submitted by Mr. Johnny Blau (HL&P Manager of Projects Division-Cogeneration and Small Power Production Department) in Docket No. 5994, Petition of Inquiry Into the Rates Paid by Houston Lighting and Power Company to Qualifying Facilities for the Purchase of Non-Firm Energy.

c. Examiners' Discussion and Recommendation. Turning first to power supplied by cogeneration, the examiners must first state that there is little in the record that helps establish the superiority of Ms. McKinney's recommendation over that of Mr. Still, or vice versa. As concerns firm cogeneration, the examiners have already adopted the staff's nonreconcilable firm cogeneration capacity payment recommendation, and believe it would be inconsistent not to

also utilize their total MWH cogeneration figure. In any event, the two figures differ by only a little more than 3 percent, which is hardly unusual when dealing with projected figures.

As for non-firm cogeneration purchases, the two recommendations are again relatively close, with a difference of only about four and one-half percent. In this instance, however, the examiners believe that Ms. McKinney's lower, 7,533,000 MWH figure should be utilized. The non-firm cogeneration purchase figure is a projected, rate year figure. While neither Mr. Still nor Ms. McKinney testified as to the total projected amounts of non-firm energy to be supplied by each cogenerator, it would appear that the projections will likely be high. As shown on HL&P Exhibit No. 39, Cogen Lyondell greatly reduced the amount of non-firm energy supplied to HL&P in June 1986 as compared to May 1986. The reduction was from approximately 758 MWH (total on-peak and off-peak) to just below 199 MWH, a decrease of almost 74 percent. There is no evidence as to whether or not Cogen Lyondell will increase its non-firm deliveries to HL&P, and thus an exact impact on rate year MWH figures cannot be calculated. However, in light of that precipitous drop, the examiners believe it reasonable to adopt the lower 7,533,000 MWH figure recommended by Ms. McKinney. It should be mentioned that the examiners have considered use of HL&P's 6,679,305 MWH figure, but because that figure was derived using a rate year of calendar year 1986, they have rejected that possibility due to the difference in rate year periods. Non-firm cogeneration is projected to provide 7,533,000 MWH during the rate year, and total cogeneration should equal 15,242,763 MWH.

As to the 3 MWH attributed to the COA and CPSB by Ms. McKinney, the examiners do not concur. Mr. Still testified that the staff had predicted that no power would be taken due to the relatively high energy costs associated with those contracts. Ms McKinney did not address the issue in her testimony, and the examiners find Mr. Still's testimony to be reasonable.

Turning next to lignite-fueled generation, the examiners believe Mr. Norwood's recommendation is clearly superior for one major reason: he has incorporated into his figure the generation from Limestone Unit 2 projected to be produced during the rate year. Lignite-fueled generation is projected to

provide 8,372,592 MWH during the rate year. At Mr. Norwood's heat rate of 11.10, some 92,898,084 MMBtus of lignite will be required.

The next fuel source to be considered is that of western coal. It is clear that HL&P anticipates burning only 7,005,000 tons of coal in 1987. Yet, if HL&P is in fact obligated to take approximately 8,300,000 tons of coal from UFI annually, HL&P will either be stuck with a very large coal pile, or will have to take some steps to prevent delivery of such coal. If HL&P is not obligated to take more than the 6,776,000 tons of coal for Parish Units 5, 6, and 7, then the problem becomes UFI's. Mr. Kaplan recommended a coal burn of at least 7,005,000 tons, mirroring HL&P's 1987 expectations. Mr. Norwood ultimately recommended a 7,528,000 ton figure. The examiners believe that a figure of 6,776,000 tons is the most reasonable.

It is still not clear that HL&P is obligated to take more than 6,776,000 tons of coal from UFI annually. Since it is possible that that is the case, the examiners believe that that figure should be the minimum amount of coal burned. As to burning more coal than that, the more coal that is burned, the higher the total cost of fuel during the rate year. HL&P itself anticipates almost 1.3 million tons of excess coal in 1987. Quite simply, HL&P will have to do something about that coal. Whatever HL&P does, it can likely take the same action concerning 1.524 million tons of coal as it does concerning 1.3 million tons of coal. At a weighted average Btu content for coal burned at Parish of 17.370 MMBtu per ton, 117,699,120 MMBtus of coal will be burned at Parish. Utilizing Mr. Norwood's heat rate figure of 10.50733, Parish will produce 11,201,620 MWH of energy during the rate year.

With generation levels determined for all units except the gas-fired units, it is possible to back into the amount of gas-fired generation that will be needed: 19,348,987 MWH. In order to determine the MMBtus of gas that will be required to produce that amount of power, a heat rate must be set. Ms. McKinney utilized the test year average heat rate for gas units of 10.273. Mr. Norwood developed capacity factors and heat rates for each of HL&P's plants, with an average heat rate of 10.25 and a range from 9.50 to 11.21. In general, an increase in capacity factor will result in improved heat rates, although if increased use of a unit results in that unit being "cycled" more, the opposite

result may be obtained. The examiners are proposing more MWH of gas-fired generation than that recommended by Mr. Norwood, and thus the heat rate should improve. Not only that, but the additional generation can easily be provided by HL&P's most efficient gas plants, with heat rates at 9.98 and 10.01 levels, using Mr. Norwood's figures, or slightly better (down to 9.87), if test year figures are used. The examiners believe that the amount of generation produced at HL&P's gas units in excess of that recommended by Mr. Norwood can be generated at a heat rate of 10.00. The additional 1,582,579 MWH will thus require 15,825,790 MMBtus of gas. Adding that amount to Mr. Norwood's 182,183,419 MMBtu figure produces a final gas requirement of 198,009,209 MMBtus.

The following chart summarizes the reasonable generation mix for HL&P for the rate year:

Source	MWH	HR*	MMBtu
Firm Cogeneration	7,709,763	--	--
Non-firm Cogeneration	7,533,000	--	--
Lignite	8,372,592	11.09550	92,898,084
Coal	11,201,620	10.50733	117,699,120
Gas	19,348,987	10.23357	198,009,209

*Heat rates may be rounded; MWH and MMBtu figures are precise.

2. Purchased Power Costs

a. Firm Cogeneration - Energy. Ms. McKinney estimated that firm power purchases would cost $27.445 per MWH. She reached this figure by reviewing the specific terms of each of the firm contracts.

Mr. Still estimated that firm power purchases would total $189,252,313, or $24.5471 per MWH (rounded). Mr. Still also reviewed the specifics of each contract, and his calculations were presented on Schedules MS-15, -17, -18 (revised and in evidence as part of Staff Exhibit No. 12A), and -19.

The examiners believe Mr. Still has presented a more complete analysis than has Ms. McKinney, and there is nothing in that analysis that appears to be unreasonable or faulty. Also, Mr. Still's cost figure is lower on a per MWH basis, and in the absence of testimony as to why Mr. Still's lower figure is inaccurate, the examiners feel compelled to utilize the lowest reasonable figure supported by the evidence. Energy payments for firm cogeneration equal $189,252,313.[10]

b. Non-firm Cogeneration - Energy. Ms. McKinney estimated that energy payments for non-firm cogeneration would average $17.211 per MWH. Ms. McKinney reached that figure by utilizing HL&P's weighted average cost of gas (WACOG) as the avoided energy cost. Energy payments were set equal to 99 percent of HL&P's May 1986 WACOG.[11] Ms. McKinney utilized the May 1986 WACOG for HL&P's own gas purchases and in that regard, explained her reasoning as follows: "Since the current gas market has been very unstable and, moreover, since HL&P has instituted the Natural Gas Bidding program, I choose to use the most recent 'known' prices rather than estimated prices which, in my opinion, do not qualify as either 'known' or 'measurable.' (City Exhibit No. 2 at 9-10.) HL&P's May 1986 WACOG on a dollar per MWH basis was $17.385, and 99 percent of that equals $17.211 per MWH.

Mr. Norwood's testimony was that non-firm cogeneration costs would average $19.44 per MWH during the rate year. Mr. Norwood testified that his estimates were based on recent historical costs being paid by HL&P for non-firm purchases, with adjustments made to account for forecasted costs of other energy sources on the HL&P system.

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[10] The examiners will utilize the figure provided by Mr. Still in his revised Schedule MS-14. (See Staff Exhibit No. 12A.) Mr. Norwood's figure of $189,274,682, found in his revised Schedule SN4, was derived by utilizing a rounded cost per MWH figure of $24.55, thus overstating the costs involved. (See Staff Exhibit No. 1A.)

[11] Ms. McKinney's direct testimony was that she utilized a rate year WACOG. (City Exhibit No. 2 at 11.) During clarifying examination, she corrected that testimony and indicated that she had used HL&P's WACOG for May 1986. (Tr. at 1875-1876.)

The examiners do not believe that Ms. McKinney's use of a May 1986 WACOG to determine non-firm cogeneration energy payments is appropriate. Ms. McKinney has apparently utilized a known and measurable standard for gas prices. The standard to be applied in this case is a known and reasonably predictable standard, and that standard has been interpreted as allowing, if not requiring, rate year estimates for reasonably predictable fuel costs, including gas prices and non-firm cogeneration energy prices. The examiners find that Ms. McKinney did not utilized the appropriate standard, and thus they will reject her recommendation.

While Mr. Norwood's testimony on the issue was quite short and lacking in specifics, none of the parties cross-examined him with regard to his $19.44 per MWH recommendation. The examiners will thus accept Mr. Norwood's testimony, and set non-firm cogeneration energy costs equal to $19.43989 per MWH (the examiners will utilize Mr. Norwood's precise figure, rounded to five decimal places). Combined with the examiners' recommended non-firm purchase figure of 7,533,000 MWH, total non-firm cogeneration energy costs will equal $146,440,691.

c. Non-firm Cogeneration - Capacity. HL&P included in its request $33,871,631 for capacity payments to non-firm cogenerators. HL&P is currently paying $3.00 per KW per month to non-firm cogenerators for capacity available on-peak. This issue is complicated by the existence of Docket No. 5994, Petition of Inquiry Into the Rates Paid by Houston Lighting and Power Company to Qualifying Facilities for the Purchase of Non-Firm Energy, in which the question of the continuation of that $3.00 per KW capacity charge is being considered. Luckily, Docket No. 5994 should be decided by the Commission prior to the time that this docket must be decided. The recommendation of the examiners is thus fairly simple: consistency. Whatever decision is reached in Docket No. 5994 should be incorporated into this docket. In order to do so, the Commission should take official notice of the Examiner's Report and the Order entered by the Commission in that docket. Any objection to taking official notice of such documents should be presented in the parties' exceptions to this Report.

Since the Examiner's Report in Docket No. 5994 recommends that the capacity payments cease upon the Commission's entry of an Order in that docket, the examiners will not include any dollar amount in reconcilable fuel costs

associated with capacity payments for non-firm cogeneration. Should the Commission ultimately continue the capacity payments at their current level, the examiners would recommend that $32,706,600 be included in reconcilable fuel costs. That amount is the figure recommended by Mr. Still, as opposed to HL&P's $33,872,00. Mr. Still's figure is reasonable and is the lowest amount supported by the evidence and should be utilized.

Finally, in the event that any amount is allowed to be included in fuel costs, all parties agree, as do the examiners, that due to the uncertainty surrounding this expense, it should be treated as a reconcilable fuel cost.

d. <u>City of Austin and City Public Service Board of San Antonio - Energy</u>. Ms. McKinney recommended two adjustment to HL&P's requested expense associated with power purchases from the COA and CPSB. The first was to recalculate the fuel expenses associated with the power purchased. HL&P arranges for gas to be delivered to the COA and CPSB, and Ms. McKinney used the $1.60 per MMBtu that HL&P had been able to arrange in May of 1986. This reduced fuel costs from $87,900 to $49,000. Ms. McKinney's second adjustment was to categorize $6,034,000 of O&M payments as nonreconcilable, and have those costs recovered through base rates.

Mr. Still, consistent with the staff's view that no power will be taken from either the COA or CPSB because HL&P can generate the power cheaper on its own gas-fired system (purchases from COA or CPSB would replace gas-fired generation), recommended that fuel costs be set at $0. As to O&M payments, Mr. Still testified that CPSB does not require any O&M payments if no power is purchased, and thus O&M for CPSB should also be set at $0. The COA has a minimum O&M take or pay obligation equal to 12 percent of the available energy, and Mr. Still thus set the O&M expense for the COA at $3,563,568.

In setting the generation mix, the examiners have accepted the staff's view that no power will be purchased from the COA or CPSB. Fuel costs thus equal zero. The examiners find unrebutted Mr. Still's testimony as to CPSB O&M costs, and will also set those equal to zero. Also unrebutted is Mr. Still's testimony as to the amount of O&M due the COA (Ms. McKinney utilized HL&P's figures for both the COA and CPSB.) The only question is whether to classify that expense as reconcilable or nonreconcilable.

[17] Ms. McKinney felt that the O&M expenses, because they are required regardless of whether any power is taken, were in reality capacity charges and properly recoverable through base rates. Mr. Still, on Schedule MS-11, classified the O&M costs as semi-variable, but reconcilable.[12] The examiners agree with Mr. Still. While there is a "take or pay" O&M obligation to the COA, O&M costs can vary depending upon the amount of power taken. It is true that the examiners propose that no power be taken from the COA during the rate year, but that could change in future years. Rather than have the O&M costs change from reconcilable to nonreconcilable and back, depending upon the circumstances, the examiners believe it is easier to simply continue categorizing the O&M costs as reconcilable, in recognition of the fact that the O&M costs are semi-variable in nature. Reconcilable energy costs for firm purchased power thus equal $3,563,568, consisting solely of the O&M expenses associated with the COA contract.

3. Wheeling Expense

Ms. McKinney decreased HL&P's wheeling expenses by $196,700, down to $1,626,000. This decrease consisted of two components. The first, an increase of $61,300, was made to reflect updated information concerning transactions with the COA and Texas Utilities Electric Company. The second, a decrease of $258,000, was made to reflect the termination of test year contracts with the Lower Colorado River Authority for the transmission of power from the COA and CPSB.

Mr. Still recommended that no wheeling costs be allowed, because no power purchases have been predicted from the COA and CPSB. Mr. Still also recommended that should any wheeling costs be incurred, they be treated as reconcilable, because wheeling costs will vary depending upon the quantity of power purchased.

[12] While Mr. Still classified the O&M expenses as reconcilable, for some reason they do not appear on Mr. Norwood's Revised Schedule SN4 (Staff Exhibit No. 1A), which summarizes the staff's recommendations as to reconcilable fuel costs.

The examiners will set wheeling costs equal to zero. Mr. Brian testified that the costs that HL&P had requested were associated with wheeling power from the COA and CPSB. (HL&P Exhibit No. 11 at 19.) Since the examiners have concluded that HL&P will take no power from the COA or CPSB during the rate year, no wheeling costs will be incurred. However, should wheeling costs be incurred, they should be accounted for as reconcilable fuel costs, for the reasons advanced by Mr. Still.

4. Coal Costs

Ms. McKinney set coal costs equal to $22.075 per MWH, or $2.110 per MMBtu. How Ms. Mckinney arrived at that cost figure is not apparent from her testimony: she clearly used May 1986 cost data for gas prices; whether she also did so for coal prices is not clear.

Mr. Kaplan estimated that coal prices would be $2.05 per MMBtu for the first quarter of the rate year, and would increase a penny per MMBtu each subsequent quarter. The rate year average cost, as found in Staff Exhibit No. 1A, is $2.07 per MMBtu, or $21.71 per MWH (both figures rounded). Mr. Kaplan arrived at these figures by examining the specific provisions of UFI's coal contracts with the Kerr-McGee Coal Company and Spring Creek Coal Company, and creating a computer model to simulate the pricing provisions of those contracts (and the applicable rail rates). Where the price components were tied to changes in various indices, Mr. Kaplan utilized forecasts provided by Data Resources, Inc. (DRI).

As will be discussed further in Section VIII.C.1.a, Mr. Kaplan had serious doubts as to the prudence of the two coal contracts, and recommended that the issue be dealt with in greater detail in a new docket. In the meantime, Mr. Kaplan recommended that HL&P be allowed to recover the coal costs which he estimated would be incurred, but that HL&P "be directed to put into a deferred account the portion of the coal costs which would be at risk in a prudence determination." (Staff Exhibit No. 13 at 18.) It should be made clear that the staff does not intend for the actual recovery of the coal costs "at risk" to be deferred: the costs will be included in the calculation of the fuel factor. Rather, HL&P will be required to "track," or account for, all coal costs

incurred (Mr. Kaplan's preliminary estimate as to the magnitude of the possible imprudence is that it encompasses all costs in excess of $1.51 per MMBtu).

The examiners recommend that Mr. Kaplan's recommended coal cost figure of $2.07 per MMBtu be utilized. Ms. McKinney's testimony on this issue is rather sparse, while Mr. Kaplan has conducted a detailed, in-depth review of the coal contracts, and prepared a computer model to simulate the pricing mechanisms. Mr. Kaplan's recommendation is also slightly lower than Ms. McKinney's. The examiners thus find coal costs to equal $2.06630 per MMBtu (rounded). Taking that figure times the MMBtu figure recommended earlier (117,699,120) equals $243,201,692, and that is the coal cost figure that should be utilized in setting HL&P's fuel factor. How to deal with the issue of the prudence of the coal contracts will be considered in greater detail later.

5. Lignite Costs

As with coal costs, Ms. McKinney's testimony on lignite costs was fairly abbreviated and less than crystal clear. Ms. McKinney recommended that lignite costs be set at $1.119 per MMBtu, or $12.487 per MWH.

Mr. Kaplan reviewed the contracts concerning Jewett mining costs between HL&P and UFI, and Northwest Resources (NWR) (which operates the mine and has control over some of the lignite leases). Mr. Kaplan reviewed NWR's five year lagged budget, and found it to be detailed and reasonable. Mr. Kaplan utilized NWR's lagged budget, as adjusted by a UFI model which accounts for inventory activity, in calculating lignite costs. The UFI model provided a monthly price estimate for October through December 1986, and an annual estimate for calendar year 1987. (<u>See</u> Staff Exhibit No. 13 at Schedule SK-A-2.) The average lignite cost for the rate year recommended by Mr. Kaplan is $1.08776 per MMBtu, or $12.07 per MWH (both figures rounded).

As with coal costs, the examiners find Mr. Kaplan's testimony to be the most detailed and comprehensive, and once again his recommended unit cost figure is the lowest supported by the evidence in the record. Since the examiners have previously adopted the staff's recommendations concerning Limestone's heat rate and rate year generation level, the staff's lignite cost figure of $101,050,560

(*see* Staff Exhibit No. 1A) represents the appropriate lignite expense figure, and the examiners hereby adopt it.

6. Gas Costs

As was noted earlier, HL&P has not agreed to the staff's recommendation concerning gas costs. The city also put on evidence concerning gas costs, so there is a full blown three-way dispute as to gas costs. However, rather than set out the evidence and rebuttal evidence of the parties, and then make a decision thereon, the examiners will approach this area using a different tack. First, they will show why Ms. McKinney's testimony should not be utilized. Then, they will cover each of the five general areas of disagreement between the company and the staff. Before turning to the issues at hand, however, the examiners would like to set out three broad concepts or factors which they believe underlie this entire area.

First, the final recommendations of the three parties are fairly close (HL&P's most recent estimate of the average cost of gas for the rate year is approximately $1.74 per MMBtu, while the city has utilized a $1.692 per MMBtu figure, and the staff a figure of $1.65640 per MMBtu). Taking into account the volume of gas to be burned, an 8.54 cent differential spread over 198,009,209 MMBtu's equals not quite $17,000,000. Yet that figure is almost inconsequential when compared to HL&P's total annual reconcilable fuel and purchased power cost of over $1 billion. The parties, in particular HL&P, spent a fair amount of hearing time dealing with gas costs, although the $17,000,000 difference between the high figure and the low figure equals less than 2 percent of the fuel revenues to be recovered via the fuel factor (utilizing the staff's recommended figure). Thus, unlike some cases, while the difference in the recommendations of the parties is sizable, it is certainly not enormous. Indeed, under the current Fuel Rule, which will be applicable to the fuel costs and fuel factor revenues set in this docket, the $17,000,000 figure is not even half of the amount of the cumulative over or underrecovery level that is deemed "material":

> "Materially" or "material" as used in this paragraph shall mean that the cumulative amount of over- or under-recovery, including interest, is the lesser of $40 million or 4% of the annual known or reasonably predictable fuel cost figure most recently adopted by the commission, as shown by the utility's fuel filings with the commission.

(P.U.C. SUBST. R. 23.23(b)(2)(D)(iii).) While this Commission should strive for accuracy, all of the parties' recommendations fall within the range of reasonableness.

The second factor which the examiners wish to stress is their desire to utilize the lowest reasonable recommendation supported by the evidence. In the recent past, this Commission has consistently set HL&P's fuel factor too high, shouldering the ratepayers with short-term overpayments and the company with the need to make refunds. During the period from August 1984 through January 1986, HL&P overrecovered its fuel costs 15 of those 18 months. The total overrecovery was over $300 million. (Schedule G-3 at 1, Rate Filing Package.) Refunds were ordered in Docket Nos. 5779, 6279, and 6678, but the net overrecovery balance was never extinguished, and in July 1986 an additional interim refund of over $37 million was ordered in this docket. In light of these facts, the predisposition of the Commission should be to adopt fuel cost figures in the lower end of the range of reasonableness.

The final factor the examiners find important is a recent change in the Fuel Rule. The Fuel Rule has, in its various incarnations since September 1983, always placed a heavy burden on a utility requesting reconciliation for fuel underrecoveries:

> Under-recovery reconciliation shall be granted only for that portion of fuel costs increased by conditions or events beyond the control of the utility, <u>and upon demonstration of proof by the utility that such conditions or events could not have been reasonably foreseen at the time the rates were established</u>. (Emphasis added.)

(Emergency Fuel Rule 23.23(b)(2)(F)(ii).) The Fuel Rule currently in effect has deleted the portion of clause (ii) emphasized above. (*See* Rule 23.23(b)(2)(H).) HL&P no longer has to prove that the conditions or events giving rise to the increase in fuel prices could not have been foreseen. This is an important change, because it removes any possibility of a Catch-22 situation. That situation would arise where the utility argued in a fuel case that, for instance, gas prices had hit bottom and would be increasing, but the Commission decided otherwise. If the cost of fuel then rose for the very reason foreseen by the utility, in order to recoup its underrecovery the utility would

have to prove that the very situation it foresaw in fact had not been reasonably foreseeable. Such a burden would be difficult to meet at best. Under the current Fuel Rule, however, all that the utility will have to prove is that its own actions did not cause the increase in fuel costs (in addition to meeting various reasonableness tests). In essence, underrecovery reconciliation is now on a par with overrecovery reconciliation, and HL&P has much less to fear in the event it underrecovers its fuel costs. This again leads the examiners to the belief that the Commission should set fuel costs at a level somewhere in the lower end of the range of reasonableness.

The above three factors lead the examiners to the view that Mr. Griffey's recommendation should be utilized unless it is found to be seriously lacking in some manner. For as HL&P's own witness conceded, Mr. Griffey's recommendation is within the range of reasonableness:

> Q. And I believe you also made a statement that, in other words, where it would be foolish to defend the precise forecast that you have presented?
>
> A. To defend the precision of the forecast.
>
> Q. All right. Would you agree that there is sort of a range of reasonableness in a forecast?
>
> A. I guess, yes.
>
> Q. And certainly 5 percent difference between forecasts is really a small amount, is it not?
>
> A. Yes.
>
> Q. Would you agree that there is only about 5 percent difference in the forecast that you have mentioned yesterday and today as well, $1.74, and that presented by Mr. Griffey of $1.65?
>
> A. Yes.

(Tr. at 1709-1710.) Indeed, Mr. Brackeen admitted that HL&P's $1.74 price could be off by as much as 30 percent:

> Q. So since Docket 6279 and Docket 6678 and the prefiled package in this docket and your response to the RFI by PUC marked as OPC Exhibit 82, you have been off in your price forecast as much as 30 percent. Is that correct?

A. True.

During that period, we've cut our gas price in half, too.

Q. And if you'll recall our discussion yesterday of the way in which you arrived at a price forecast, can you tell me if you changed your method of forecasting prices, your method of arriving at a price forecast, since Docket 6279?

A. Not significantly.

Q. Is it possible currently that your current price forecast could be off that much?

A. It certainly is, and it may be off in either direction that much.

Q. Okay.

A. It would be foolish to extrapolate the price continuing down at 30 percent a year because it's going to hit bottom and rebound, and I'm not sure when that is going to happen.

(Tr. at 1695-1696.) Mr. Brackeen's testimony should not be misconstrued as indicating that HL&P's projections are not credible, but simply as reflective of the inherent uncertainties involved in trying to forecast prices for a 15-month period during an unstable market. In fact, Mr. Brackeen's testimony serves to highlight the factor mentioned earlier, that the differences in the parties' price projections are basically insignificant. In sum, unless HL&P can prove that a serious deficiency exists in Mr. Griffey's analysis, his recommendation will be adopted.

Turning first, however, as to why Ms. McKinney's recommendation should not be used, the issue was already broached earlier, when considering non-firm cogeneration energy costs. As set out above, Ms. McKinney utilized as her rate year average cost of gas the WACOG for HL&P during May of 1986. The examiners simply do not believe that the WACOG for one month can properly be used as a surrogate for the average cost of gas during the rate year. Ms. McKinney has utilized a known and measurable standard, which is not the standard the Commission has chosen to apply to reconcilable fuel costs. Ms. McKinney's recommended price is certainly within the range of reasonableness, and may prove to be the most accurate of the three. But the examiners cannot countenance the manner in which Ms. McKinney reached that price, and thus they will not adopt her recommendation.

The examiners will now consider the major issues on which the staff and the company disagree.

a. Cost of Delivery. In his rebuttal testimony, Mr. Brackeen testified that Mr. Griffey's analysis was flawed because it failed to take into account the cost of transporting the gas to HL&P's generating units. (HL&P Exhibit No. 47 at 2.) On clarifying examination, however, Mr. Griffey testified that the price projections contained on his Schedule CG-1 were delivered prices (Tr. at 3328.) The examiners believe that Mr. Griffey would be the most knowledgeable person as to what costs are included in his price projections, and thus they accept his testimony as accurate.

b. Effects of FERC Order 436. Federal Energy Regulatory Commission (FERC) Order 436 requires interstate pipelines that request a certificate under that Order to transport gas on a first-come first-serve basis to end users (open access). Interstate gas pipelines need not become Order 436 carriers. However, due to other actions by FERC, and the effects of Order 436, it has become somewhat more difficult for producers to sell directly to end-users, in other states, although there are still means of doing so. By utilizing an Order 436 carrier, in some cases it is easier to sell directly to end-users, and also in some cases it will be possible for producers to sell to end-users that they could not sell to but for an Order 436 pipeline. (Tr. at 3320-3323.) On an historical note, FERC Order 436 was first proposed late in 1984, was adopted in October 1985, and Order Nos. 436A and 436B were entered in December 1985 and February 1986, respectively. (Tr. at 3325.) Transportation programs to end-users under Order 234B, which was eliminated by Order 436, were in some instances granted 120 day extensions, so the full impact of Order 436 was not felt until sometime during January 1986. (Tr. at 3326.)

HL&P witness John A. Brickhill testified that as more interstate pipeline companies accept FERC Order 436 and become open access transporters, the demand for direct purchase gas will increase, thus causing an increase in Texas intrastate gas prices. (HL&P Exhibit No. 46 at 4.) The price increase will result because, in Mr. Brickhill's view, there has been a backing up of gas supply in the HL&P area because none of the interstate pipelines in HL&P's gas supply area have been transporting gas on a nondiscriminatory basis pursuant to Order No. 436. (Tr. at 3326 and 3540-3541.)

In response, Mr. Griffey testified that as to a glut of gas in Texas, there was no significant drop in spot prices in Texas from November 1985 through January 1986. The large price decreases did not occur until March. (Tr. at 3326, 3331; See Staff Exhibit No. 11 at Schedule G-3.) Mr. Griffey went on to testify that while early reports concerning the effects of Order 436 indicated prices would increase, more recent market studies have indicated that open access will lead to a reduction in prices. (Tr. at 3331-3333.)

In rebuttal, Mr. Brickhill stated that the more recent studies indicating a decrease in prices were entirely consistent with his views, in that none of the articles quoted by Mr. Griffey said Texas intrastate prices would fall, but rather were referencing the interstate market and spot gas prices. (Tr. at 3540.)

The examiners cannot agree with Mr. Brickhill's conclusions as to the effects of FERC Order 436. First, with regard to the recent market studies, the portions of the studies in evidence do not indicate whether they are referencing solely the interstate market, solely the Texas intrastate market, or both. (Tr. at 3332-3333.) Thus it is impossible to say that either Mr. Griffey or Mr. Brickhill have based their opinions in part on articles that do not support those opinions.

As to the back-up of gas in Texas caused by Order 436, there is no evidence from the Texas spot market prices that Order 436 increased the supply of gas in Texas. As Mr. Griffey testified, the major decreases in spot prices did not occur until March, April and May of 1986, well after the entry of Order 436, and also after the 120 day extensions noted earlier. In fact, spot prices were decreasing prior to November 1985, and tended to stabilize during the November 1985 through January 1986 time period. Thus, while the examiners do not doubt that there currently exists a gas deliverability surplus, or gas bubble, in Texas, they do not believe the evidence shows that Order 436 either caused that surplus, or exacerbated it. Also, the examiners disagree with Mr. Brickhill that the gas bubble in general will disappear over the next 18 months. Mr. Brickhill testified that he expected demand to outstrip incremental supply, as the number of buyers increases while the number of sellers remains stable. (HL&P Exhibit No. 46 at 7.) Yet the examiners do not

believe that the evidence in the record shows that the number of buyers will increase, both for the reason to be discussed in the next paragraph, and in light of the recent declines in the price of residual fuel oil.

The examiners cannot agree with Mr. Brickhill's contention that an increase in the number of open access carriers, causing an increase in interstate sales and a decrease in interstate prices, will necessarily cause an increase in Texas spot prices. First, as discussed later, there is substantial oil vs. gas competition, due to the decreasing price of residual fuel oil. However, Mr. Brickhill indicated that only 20 percent of the interstate market has the ability to burn residual fuel oil. The remaining 80 percent of the market must, and has been, purchasing gas via the interstate market. Thus, if there currently is a glut in the Texas spot market, open access will not reduce that glut. The volume of gas being burned will not increase, because at least 80 percent of the market, and most likely more, has been burning gas anyway. What will increase is competition, bringing prices down. But as long as demand does not exceed supply, there is no reason why the Texas intrastate market price will rise. Equilibrium should be reached at the Texas intrastate market price. (*See* Tr. at 3566-3570.)

It should also be noted that even if Mr. Brickhill is correct conceptually in that increasing interstate sales will increase Texas spot market prices, he did not provide any data as to the amount of gas that will be transported under the open access provisions, nor did he attempt to quantify what the equilibrium price would be. He simply stated that it would be above the Texas intrastate spot market price and below the current interstate market price of $2.25 per MMBtu. While Mr. Brickhill may be correct in that "Anybody who can call it better than that is going to be so wealthy from playing the futures market that they won't proffer advice" (Tr. at 3570), in order to set rates, some quantification is necessary. Without quantification of the anticipated effects of increasing levels of open access transportation, there is no data to show that the effects will be of a magnitude to make Mr. Griffey's estimates inaccurate.

Also with regard to this issue, the examiners find there to be a lack of convincing evidence that pipelines will in fact participate in open access

transportation. Of the five major interstate pipelines that would be transporting gas out of Texas under open access, three have only just recently applied to FERC to become Order 436 carriers (Tr. at 3577), although the FERC's notice of proposed rulemaking that led to Order 436 was published at least by November of 1984. And of those three, one has potential take-or-pay liabilities of hundreds of millions of dollars that would be incurred if it becomes an open access carrier. The same is true for one of the two pipeline companies that has not yet applied to FERC. Mr. Brickhill also thought that another of the three companies that have filed might have a "large exposure." (Tr. at 3573-3575.) Mr. Brickhill agreed that those potential take-or-pay liabilities have been one of the reasons the pipelines had not applied for open access sooner. (Tr. at 3573.) Thus at this time there is a reasonable doubt that any major interstate pipeline will begin transporting gas from HL&P's supply area into the interstate market under open access provisions any time in the near future. Mr. Brickhill's reluctance to quantify the amount of such gas to be transported may be caused in great part by the possibility that there may not be any gas that will be transported during the rate year. The uncertainties involved are such that even if Mr. Brickhill had quantified the effect, it is questionable whether that quantification would fall within the known and reasonably predictable standard that applies to fuel expenses.

In sum, the examiners do not find that the evidence shows that FERC Order 436 has had an appreciable effect on either the supply of gas in Texas or on Texas spot market prices. They likewise find that is no evidence to show that, even if more carriers comply with that Order and become open access carriers, the Texas intrastate spot gas market will be appreciably affected as to either supply or price. The examiners conclude that Mr. Griffey's analysis is not flawed by a failure to take into account FERC Order 436.

c. Locking Up Long-Term Supplies. As proof that spot market prices will begin to rise substantially during the rate year and that Mr. Griffey's forecast of stable prices during the rate year is inaccurate, Mr. Brickhill testified that:

> Many distributors and large industrial users served through interstate pipelines are considering locking up suppliers, but are unable or unwilling to do so until their pipelines become open access transporters. In other words, buyers need to know what the terms and conditions of transportation will be.
>
> Some distributors and large industrial users are in active negotiations for long-term contracts at the present time, and some of my clients have recently consummated such contracts.

(HL&P Exhibit No. 46 at 4.) However, other than the above testimony, there is no evidence on this issue. Mr. Brickhill did not indicate how many companies have actually entered into contracts or are in active negotiation. Nor were the terms of the contracts actually entered into, especially the provisions as to length, volume and price, made known.

The examiners find that the fact that some distributors and large industrial customers have entered into long-term contracts does not prove or necessarily imply that the spot market has bottomed out, nor that a substantial price increase during the rate year will occur. The evidence in the record is that spot market prices are nearing their trough. Mr. Griffey concurs with this view. (Staff Exhibit No. 11 at 9.) The examiners believe that as any market in a decline begins to reach its low point, certain buyers will begin to lock up long-term suppliers, or, as with the stock of a publicly traded company, purchase the stock of that company. Other buyers, however, will wait, in the hopes that the price will decline even further. Still other buyers may hedge their bets, buying stock or entering into long-term contracts now, but not to the fullest extent possible, in the event that prices continue to decline. Whether a buyer is willing to sign a long-term contract, and if so in what quantities, depends upon that buyer's perception of what the market will do in the future. Since buyers will hold a variety of views, it is to be expected that some will enter into contracts sooner than others. But the fact that those buyers do so does not necessarily indicate that the market has either bottomed out or that it is going to bottom out. Quite simply, those buyers could be wrong in their views as to what the future will hold. Likewise, those buyers could be right. The market may have bottomed out and an increase in prices could be imminent. But the fact that buyers enter into long-term contracts does not provide proof one way or the other.

In conclusion, Mr. Brickhill's testimony that some distributors and large industrial users have entered into long-term contracts does not prove that the market either has already hit bottom, and it certainly does not prove a substantial price increase is imminent. Particularly so in light of Mr. Brickhill's failure to quantify the terms of the contracts that have been entered into.

d. Residual Oil Prices. Mr. Brickhill prefiled his direct testimony on June 30, 1986. That testimony, which was not modified and was admitted in evidence on July 25, 1986, included the following statement:

> It is and has been my view for a number of months that spot gas prices, particularly South Texas prices, would reach bottom this summer absent a substantial further decline in the price of residual fuel oil.

(HL&P Exhibit No. 46 at 2.) From June 30th to July 25th, the price of residual fuel oil fell from roughly $12 per barrel to $8.50 per barrel. (Tr. at 3551.) That is a decline of nearly 30 percent (Mr. Brickhill's 20 to 25 percent figure--Tr. at 3552--is inaccurate). Mr. Brickhill testified on cross-examination that the decline actually helps support his ultimate conclusion that gas prices would rise, because gas prices had actually increased slightly during the time period fuel oil prices were substantially declining. Thus Mr. Brickhill concluded that the relationship between residual oil prices and gas prices, of which he had been unsure of in late June, had by late July been shown to be not that strong, particularly over shorter periods of time. (Tr. at 3552-3553.)

There are two countervailing points to Mr. Brickhill's views. First, Mr. Brickhill agreed that the entire impact of the decline in residual fuel oil prices may not have yet been fully felt in the spot market gas price. (Tr. at 3562-3563.) Second, Mr. Brickhill agreed that short-term occurrences such as the decline in residual fuel oil prices are not reliable indicators of what the future market will be. (Tr. at 3553.)

All of the witnesses agreed that the price of oil influences gas prices. The extent of that influence no doubt varies depending upon the time period over

which the two are compared, and the price differential between the two. The examiners agree with Mr. Brickhill that the short-term relationship is not very strong. In light of the volatility in the oil markets, it is not reasonable to think that gas producers will allow themselves to be greatly affected by daily and weekly swings in the residual fuel oil market. However, over the long term, gas prices are affected by oil prices. Residual fuel oil is a substitute for gas, and it is unlikely that gas prices will be greater than residual oil prices except for short periods of times. In other words, oil prices serve as a cap for gas prices, as Mr. Brackeen testified. (Tr. at 1639-1640.)

As regards the case at hand, the examiners believe that there is nothing to indicate that gas prices will rise due to events in the residual fuel oil market. Residual fuel oil prices are not increasing, nor is the price differential between oil and gas expanding. Neither do the examiners believe that the short-term decline in residual fuel oil prices, although substantial, will cause gas prices to decline. As concerns the recent refusal of gas producers to cut prices to compete with fuel oil prices (Tr. at 3629 and 3645), the examiners believe that that is entirely consistent with their analysis. Gas prices are not going to decline in response to short-term declines in fuel oil prices. Instead, gas producers will allow oil to replace gas on occasion, rather than lower their prices. If oil prices remain low over a period of time, gas producers will then either have to decrease their prices or allow fuel oil to take over a substantial share of the market. In this regard, it should be noted that HL&P does have several gas units capable of burning fuel oil on a continuous basis, and that the units that are able to do so--at least one of the Cedar Bayou units, two of the Robinson units, and one or more of the Parish units (Tr. at 3662)--are HL&P's newer units, and are units at plants that provide the bulk of HL&P's gas generation. (See Schedule A-7.1., Rate Filing Package.) Thus even if gas does not decline in order to match oil prices, HL&P can avail itself of declining oil prices, although it is limited in the amount of oil it can utilize, due to contractual obligations and unit capabilities. (Tr. at 3642-3643.) In fact, HL&P is already burning oil on a test basis to determine the relative inefficiencies of burning oil compared to burning gas.(Id.). Yet even if some gas producers would rather shut in than reduce prices, other producers may be willing to reduce prices, as gas demand slackens due to increased oil consumption, plus HL&P will also be able to take advantage of the declining oil market.

In sum, based upon the evidence in the record, the examiners find the residual fuel oil issues to be of no determinable consequence in setting HL&P's gas prices for the rate year.

e. Producer Resistance and Price Increases. HL&P's witnesses also testified that HL&P's suppliers had been unable to obtain, or unwilling to sell, supplies to meet HL&P's peak demand at prices of $1.60 per MMBtu or less. (Tr. at 1639 and 1719-1720.) HL&P also notes that all of the witnesses agreed that some of the producers had already shut-in some wells rather than sell at current prices. Mr. Griffey indicated the total amount of production that had been shut-in at 600 mcf per day, or about one-half of one percent of U.S. production. (Staff Exhibit No. 11 at 8.) Finally, HL&P testified that one of its suppliers, Exxon, had increased prices for both July and August. The prices went from $1.45 in June to $1.50 in July to $1.60 in August for first tier gas, and from $1.50 in June to $1.60 in July to $1.70 in August for second tier gas. (Tr. at 1637, 3634 and 3652.)

Mr. Griffey testified as to producer shut-ins. He stated that many more firms would probably have to shut-in before prices stabilize. (Staff Exhibit No. 11 at 8.) He also constructed a model to try to determine the current price at which a producer would shut-in. Based upon the results of that model, Mr. Griffey testified that wellhead prices in the $1.20 per mcf range will be near the bottom of the market. (Id.)

In brief, HL&P argues that Mr. Griffey's shut-in model shows that producers who shut-in at current prices of $1.50 per mcf are expecting prices to rise to $1.66 to $1.88 per mcf in one year.

As concerns shut-ins, the examiners would note that Mr. Griffey's analysis was the only one presented. While HL&P has correctly concluded that those producers who shut-in at $1.50 per mcf are expecting prices in the $1.66 to $1.88 per mcf range in one year, only one-half of one percent of total U.S. production is currently shut-in. Producers with lower costs or who are less able to withstand the financial impacts of shutting-in will continue to produce until the price drops further. As Mr. Griffey testified, producers have "selectively" shut in wells. Once again, while the existence of some shut-in

wells indicates that the market is approaching bottom, the quantity of gas shut-in is insufficient to show that the market has in fact reached bottom, or that a substantial rate year increase in prices will occur.

The examiners find the same conclusion to be true of HL&P's inability to obtain gas for peak demand from its suppliers at prices below $1.60 per MMBtu, and of the recent price increases in spot gas. While Mr. Brickhill agreed with the concept that, in a declining market, sellers might announce they will not sell below a certain price in the hope of exercising whatever market power they possess to try to prevent a further decline in prices. Mr. Brickhill did not think such a scenario could be involved in these circumstances, in light of the number of major buyers and sellers that see the current situation as the bottom. However, Mr. Brickhill agreed that for some period of time there has been a perception among some people that the market is at bottom, but he dismissed those earlier perceptions because the buyers who held them were not willing "to put their money where their mouths were in the past." (Tr. at 3562.) The examiners do not think that such previous, and inaccurate, predictions can be so easily dismissed. Further, Mr. Brickhill testified that only "some" distributors and large industrial users are actively negotiating for long-term contacts, and only "some of his clients" have consummated such contracts. (HL&P Exhibit No. 46 at 4.) As noted earlier, Mr. Brickhill did not quantify how many "some" are. Also, the fact that "some" persons have entered into long-term contracts does not mean that the bottom of the market is here, as was discussed above. The examiners simply do not find the existence of some long-term contracts sufficient to dismiss the possibility that major producers are simply trying to exert market pressure to stop further declines--which attempts may or may not be successful.

Concerning the recent price increases, Mr. Brickhill indicated that short-term trends are not reliable predictors of the future. Mr. Brackeen agreed that during the general decline in gas prices that has taken place since the summer of 1985, there have been some months when, in general, spot prices either remained constant or actually rose. (Tr. at 3662.) As the examiners have discounted the one-month decline in residual fuel oil prices, so they will discount the recent increases in gas prices. Fuel markets are simply too volatile to base projections for a twelve-month period ending September 30, 1987 on one- or two-month fluctuations occurring in July and August of 1986.

f. Summary. The examiners find HL&P's evidence shows only that the gas market is about to bottom out, not that it has already done so, and certainly not that gas prices will rise substantially during the rate year. HL&P has failed to show that Mr. Griffey's analysis is seriously flawed or fatally incomplete. In light of the fact that Mr. Griffey's recommendation is clearly within the range of reasonableness, and taking into account the broad factors discussed earlier, the examiners find the staff's composite rate year gas price of $1.65640 per MMBtu to be the most reasonable in the record. Multiplying that price times the examiners' recommended MMBtu figure of 198,009,209 produces a total reconcilable gas cost of $327,982,454.

7. Fuel Factor Revenue Adjustment

HL&P has proposed a $1,193,000 fuel factor revenue adjustment. (Rate Filing Package, Schedule A, p. 26.) Apparently the only witness to address the adjustment was Ms. Paton. She recommended that the adjustment be disallowed:

> Apparently, the Company does not believe that this fuel and purchased power cost of $1,265,810,000 is a reasonable estimate of its anticipated fuel costs. If this is the case, the Company could have proposed the same fuel costs and fuel factor in this proceeding that it proposed in Docket No. 6678.

(OPC Exhibit No. 90 at 19.) On cross-examination, Mr. Brian clarified the adjustment as follows:

> Q. Page 26 of Schedule A is entitled, "Fuel Factor Revenue Adjustment," and it is a 15-line calculation. The Office of Public Utility Counsel asked the question in OPC RFI 532 for you to,
>
> "Please explain the Fuel Factor Revenue Adjustment on Schedule A, Page 26 of 26."
>
> And I would like for you to read your six-line response, if you don't mind, please, sir.
>
> A. Answer to OPC 7-532:
>
> "The Company believes the MMBtu's and KWH sales used in Docket No. 6678 to be the best estimate of fuel expense, but we

are unable to calculate a fuel factor using test year adjusted sales as required by the Commission rules. The purpose of this adjustment is to adjust fuel expense to equal the amount produced by the fuel factor calculated on MMBtu's and KWH sales from Docket No. 6678."

Q. All right, sir. I take it that you are unable to update information beyond the information relied upon in Docket No. 6678. Is that how I should interpret the response?

A. No, sir.

Q. All right, sir. Maybe you can explain it to me once again.

A. Okay. The Commission's rules require test year adjusted sales to be used in all these calculations.

However, we felt that the projected megawatt-hour sales which were used in Docket 6678 -- and I believe is required for fuel factors to use prospective costs and sales -- was different.

So therefore, this adjustment, which amounts to a little over a million dollars, was necessary to reconcile the fact that for one purpose we had to use test year adjusted sales to compute revenues and on the other side we had used projected sales and costs to determine the fuel factor. And when you apply that fuel factor you get a different revenue number. And the million dollars is the difference.

(Tr. at 528-531.) The examiners must confess that they remain unenlightened as to the purpose of the adjustment, and thus quite simply are unable to say it is reasonable and should be approved. The adjustment apparently involves using the projected MMBtu and MWH figures from Docket No. 6678, and the unit fuel prices and other costs as testified to in this docket. The resultant fuel factor at \$0.024534 represents a fuel factor based on projected prices and sales (for calendar year 1986). But why that factor is then multiplied by adjusted test year sales and the result compared to rate year fuel costs remains unclear. The examiners must therefore recommend that the adjustment be disallowed.

8. Summary

Total reconcilable fuel costs equal \$1,011,491,278 comprised of the following components:

Description	Company Request	Examiners' Recommendation
Purchased Power Costs		
Firm Cogeneration - Energy	$ 204,887,000	$ 189,252,313
Non-firm Cogeneration - Energy	145,807,000	146,440,691
Non-firm Cogeneration - Capacity	33,872,000	-0-
COA/CPSB - Energy	6,122,000	3,563,568
Total Purchased Power	$ 390,488,000	$ 339,256,572
Fuel Expense		
Coal Costs	$ 326,476,000	$ 243,201,692
Lignite Costs	65,333,000	101,050,560
Gas Costs	483,513,000	327,982,454
Total Fuel Expense	$ 875,322,000	$ 672,234,706
Wheeling Expense*	1,822,000	-0-
TOTAL*	$1,265,810,000	$1,011,491,278

*HL&P did not include wheeling expense as a reconcilable fuel cost.

C. Fuel Reconciliation and Miscellaneous Fuel Matters

1. Miscellaneous Fuel Matters

a. Coal Contract Prudence Review. On June 26, 1986, the general counsel filed a motion to sever all issues concerning the reasonableness of coal costs under the Spring Creek and Kerr-McGee coal contracts. On June 30, 1986, the general counsel amended her motion to deal with several issues concerning such a severance that were not addressed in the original motion. HL&P did not oppose the motion. The amended motion was orally granted on July 7, 1986, and was reduced to writing in Examiners' Order No. 32. That Order created Docket No. 6963, In Re the Reasonableness of the Spring Creek and Kerr-McGee Coal Contract Costs. As noted earlier, with regard to coal costs, all coal costs incurred by HL&P will be recovered through the fuel factor, but all coal costs associated with those contracts will be "earmarked" for possible refunds should,

upon the conclusion of Docket No. 6963, any imprudence be found. As concerns CWIP related to Parish baghouses, as also dealt with earlier, it will be included in rate base, although it too will be "tracked" and subject to refund.

b. United Texas Transmission Contract. Mr. Griffey considered the possibility that HL&P should try to relieve itself from its United Texas Transmission (UTT) obligations. While the UTT contract does contain a "market out" provision if UTT's WACOG exceeds a given benchmark price, UTT has kept its WACOG below that benchmark price. The examiners agree with Mr. Brackeen that there is no reason to believe HL&P will have the opportunity to "market-out" of any of the gas to be taken from UTT. (HL&P Exhibit No. 47 at 3.) Mr. Griffey, however, focused his analysis not on the market-out provisions, but on the possibility of HL&P's either "buying out" the contract, or simply not taking the amounts of gas it is required to take and allowing the liquidated damages clause to go into effect. With regard to the latter, Mr. Griffey concluded that if HL&P cannot "market-out" from taking all of the UTT gas, it should make use of the liquidated damages option. Based upon his liquidated damages clause option analysis, Mr. Griffey concluded that HL&P would likely save between $4,900,000 and $10,800,000 if it refused to take 25 percent of its annual requirement. It should be noted, however, that under one of his scenarios, a loss of $4,400,000 is possible. (Staff Exhibit No. 11 at 28-30.)

As to buying out the UTT contract, Mr. Griffey concluded that while HL&P could likely save $5,000,000 to $50,000,000 if it did so, considerable risk is involved in a buyout, including regulatory and legal risk. Mr. Griffey testified that a more detailed examination of that option would be required in order to determine its feasibility, and that HL&P should explore the market-out and liquidated damages options first. (Id. at 25-28.)

Mr. Brackeen testified during rebuttal that HL&P could not utilize the liquidated damages option in 1986 because HL&P had recently agreed to take specified volumes in 1986 in return for a $0.10 per MMBtu reduction in UTT's service charge. Mr. Brackeen also noted UTT's large swing capability (from 40 percent to 225 percent of the average daily volume for the year), and its pipeline connections to all of HL&P's gas plants, indicating that such flexibility was necessary for HL&P to operate on an efficient low cost basis.

(HL&P Exhibit No. 47 at 4.) Mr. Brackeen also testified that while disagreeing with Mr. Griffey's buyout analysis, he agreed with its final conclusion.

Mr. Griffey's ultimate recommendation was that:

> HL&P should aggressively seek to have UTT lower its price closer to market levels and to limit their takes from UTT to a level which still guarantees security of supply. These goals could be achieved through renegotiations, market-outs, payment of liquidated damages, or a buyout. HL&P should be creative in its renegotiations with suppliers, and they should not be constrained to only using alternatives that are explicitly in the contract.

(Staff Exhibit No. 11 at 30.) The examiners agree. However, HL&P apparently will not be able to exercise the market-out provision anytime soon, if at all. HL&P has also effectively prevented any use of the liquidated damages clause provision until 1987. But the rate year extends through the fall of 1987, and in any event, reconciliation must always be done after the fact. HL&P thus stands forewarned that in future fuel cases it may be required to show why it did not exercise the liquidated damages clause of its contract, and possibly have reduced its gas costs.

c. Utility Rail Car Maintenance Budgets. Mr. Griffey recommended that UFI investigate using Monte Carlo simulations to see if they would be useful in controlling rail car maintenance expense. Mr. Griffey in any event would like to see the accumulation of data needed for Monte Carlo simulations, to be utilized by the staff in its analyses of utilities' rail car maintenance procedures.

While the examiners did not adopt Mr. Griffey's rail car maintenance recommendations, it was not because of any conceptual difficulty with utilizing a Monte Carlo simulation. Since UFI is relatively new to rail car ownership, it should be willing to consider any analytical tool which could help keep expenses as low as possible. Further, since the staff has requested that HL&P maintain data in the form needed to perform Monte Carlo simulations, to be used in staff analyses in the future, the examiners believe it reasonable to require HL&P to do so.

d. <u>Excess Coal Deliveries</u>. As touched upon above in Section VIII.B.1.c, UFI is contractually obligated to take much more coal than HL&P plans to burn. Under the examiners' recommended generation mix, that excess grows from around 1,300,000 tons of coal to over 1,500,000 tons of coal. Obviously, UFI and HL&P need to have a plan for dealing with this excess coal. Mr. Kaplan testified that HL&P had basically four options, none of them promising: 1) Get stuck with a very large coal pile, which could take years to eliminate, during which the coal slowly deteriorates and carrying charges accumulate; 2) Resell the coal, which would be difficult because spot coal prices are currently about half what HL&P pays for its coal; 3) Exercise the force majeure clauses in its coal contracts, which could lead to legal disputes; and 4) Refuse the coal and accept the take-or-pay penalties. Further, depending upon the option chosen, UFI could encounter problems with minimum volume requirements in its rail contract. The examiners would add that a fifth option for HL&P and UFI is to negotiate for some type of release from its contractual obligations.

Surprisingly, HL&P's reply to the question of how it was going to deal with the situation was that is was "beginning initial evaluations" addressing the potential excess of coal deliveries. (Staff Exhibit No. 13 at 28.) As Mr. Kaplan notes, 1987 is not that far away. Since all of the options available appear to increase coal costs beyond what they would otherwise be, HL&P once again stands forewarned that when reconciliation of fuel costs eventually takes place concerning the time periods that will be involved, it may bear a heavy burden to show the reasonableness of its coal costs.

e. <u>Rail Rate Index Adjustment</u>. Mr. Kaplan testified that he thought that an error had been made by Burlington Northern in recalculating one of the price indices that is adjusted periodically, and upon which the rail rate is calculated. (<u>Id</u>. at 34-37.) Mr. Baalman had testified on clarifying examination that the current index was correct. (Tr. at 439-441.) During cross-examination, Mr. Kaplan indicated that he still thought the index had not been correctly calculated. (Tr. at 3611.)

All that Mr. Kaplan had requested was that UFI and HL&P check to see if an error had been made, and report back to the Commission on its findings. The examiners believe that that is a reasonable request, in light of the continuing

disagreement on the issue. The examiners recommend that HL&P be ordered to discover if an error has been made in the calculation of the rail index, and report back to the Commission on its findings by no later than December 1, 1986. Such report should be detailed and contain all documentation necessary to support its findings.

f. Renegotiation of the Kerr-McGee Materials and Supplies Escalator. Mr. Kaplan testified that the 1980 Kerr-McGee contract sets out what is called the E4 escalator, by which the materials and supplies component of the contract is escalated. The E4 escalator can be renegotiated, and in fact could have been modified as early as January 1985. Mr. Kaplan testified that while HL&P itself believes the current component indices of the E4 escalator are of questionable appropriateness, UFI is still studying the issue. Mr. Kaplan recommends that HL&P and UFI aggressively pursue the opportunity to reduce the escalation rates in the Kerr-McGee contract, and also confirm that there are no other potential cost-saving opportunities which they have failed to aggressively pursue.

The examiners believe that the recommendation is appropriate. HL&P should be ordered to report to the Commission by December 31, 1986, on all cost-saving opportunities available to HL&P and UFI under the terms of the Kerr-McGee contract, and what actions have been taken with regard to those opportunities. The examiners anticipate that this issue will be revisited in Docket No. 6963, where the prudence of all coal costs incurred under the Kerr-McGee contract will be considered.

g. Backup to Rate Filing Package. Mr. Kaplan testified that while HL&P and UFI were cooperative in trying to met his information requests, they had considerable difficulty in providing complete backup materials for their coal and lignite forecasts. (Staff Exhibit No. 13 at 32-34.) He recommended that HL&P and UFI implement whatever procedures are needed in order to ensure that all of their final fuel forecasts, not just those used for rate cases, are fully documented. The examiners find the request reasonable, and recommend that HL&P be ordered to comply.

2. Fuel Reconciliation

[18] HL&P's last reconciliation was in Docket No. 5779, and covered the period from September 1983 through July 31, 1984. Thus, the reconciliation in this docket should cover from August 1, 1984 through April 30, 1986, the most recent month for which data was available. (Staff Exhibit No. 1 at 4.) With the exceptions to be discussed below, all of the testimony in the record was that HL&P had met the requirements of the Emergency Fuel Rule concerning efficient generation, maintenance of effective cost controls, and procuring fuel at the lowest reasonable cost possible. The examiners find that the evidence is convincing, and thus, with the following exceptions, find that HL&P has met the burden of proof imposed on it by the Emergency Fuel Rule as to fuel expenses incurred from August 1, 1984 through April 30, 1986.

a. Coal Costs. As discussed earlier, the question of the prudence of coal costs incurred under the Spring Creek and Kerr-McGee coal contracts has not been resolved in this docket. Final reconciliation of those costs will be made in Docket No. 6963.

b. Lignite Costs. Ms. McKinney testified that when Limestone Unit 1 began burning lignite in October of 1985, HL&P initially included as reconcilable fuel expenses only "pure" lignite costs. In November, HL&P changed the expenses considered as reconcilable fuel costs and began including O&M handling costs, depreciation and taxes charged by UFI, and a substantial percentage of return on UFI's investment. Ms. McKinney recommends that HL&P be ordered to exclude all such costs in its over/underrecovery calculations, and that those expenses and the interest thereon be included at the time of the next fuel refund. As of March 31, 1986, the amount to be refunded, not including interest, equaled $12,950,281.

The basis for Ms. McKinney's recommendation is the Emergency Fuel Rule, in particular Section 23.23(b)(2)(J)(i) which states that:

> The affiliate fuel price shall be "at cost"; no return on equity or equity profit may be included in the affiliate fuel price. The commission may consider the inclusion of affiliate equity return in rate of return and rate base during the utility's general rate case;

however, affiliate equity return or profit shall not be considered part of fuel cost.

[19] While Ms. McKinney was cross-examined concerning her recommendation (Tr. at 1843-1849), such cross-examination did nothing more than deal with hypothetical, non-affiliated fuel suppliers, and in no way negated or damaged Ms. McKinney's recommendation. The examiners believe Ms. McKinney's interpretation of the Emergency Fuel Rule is correct. They would also note that her recommendation is consistent with the separation of lignite-related costs into either base rate or reconcilable costs recommended in this Report. The examiners do feel compelled to make it clear that the adjustment being made will result in a total non-recovery of the dollars at issue in this adjustment. (Tr. at 1847.) However, as Ms. McKinney explained, non-recovery of those expenses is the result of regulatory lag. (Id.) Shareholders are recompensed for such risks through return on equity. Finally, the examiners would note that this adjustment is consistent with their rejection of deferred accounting for Limestone, which likewise will result in the total non-recovery of certain expenses due to regulatory lag. HL&P should be ordered to adjust its under/overrecovery calculations to exclude from reconcilable fuel expense all lignite-related costs except for "pure" lignite costs.

c. Refunds. On July 25, 1986, the Commission entered an order requiring HL&P to make refunds in the total amount of $37,214,087. Those refunds were based upon the most recent data in evidence in this docket. No further refunds need to be made at this time. However, in light of the examiners' recommendation in the previous paragraph, HL&P will have overrecovered nearly $28,000,000 in fuel expenses by the time the rates set herein go into effect; (average monthly overrecovery of $2,150,000 multiplied by the thirteen months from October 1, 1985 through October 31, 1986.) That figure does not include interest. In light of that fact, the Commission may wish to order HL&P to refund its cumulative overrecovery balance as of October 31, 1986, although the examiners do not recommend that action because under the Commission's current Fuel Rule, HL&P will not have "materially" overrecovered its fuel expenses until such time as its net cumulative overrecovery equals $40,000,000. (Since HL&P's fuel expense is over $1 billion, $40,000,000 will be less than four percent of HL&P's reconcilable fuel expense.) In any event, HL&P itself can at any time request approval to refund fuel cost overrecoveries.

D. Operations and Maintenance

1. Salaries and Wages

a. Company's Position. HL&P requested a total salaries and wage expense of $241,024,000 which reflects an increase of $14,104,000 from its test year booked expense. (Schedule A at 3, Company Rate Filing Package.) The components of this adjustment are:

Annualization of Wages as of 12-31-85	$ 7,258,000
Wage Increase for Non-Union Personnel	$ 6,846,000
	$14,104,000

The annualization of wages calculates total wages which would have been paid during the test year if the December 1985 employee and salary levels had been in effect for the entire year. The wage increase reflects an approximate 5.5 percent increase in wages for non-union personnel. In that regard, Mr. Brian testified that the 5.5 percent reflects that increase anticipated to be provided to employees at the time of their performance reviews which coincide with their anniversary dates. At the time the company filed its testimony, the bargaining unit's agreement, which was to expire in May 1985, was still in force. Thus, Mr. Brian testified that the company had not proposed an adjustment to increase the salary levels of its union employees because negotiations were not yet finalized.

b. City's Position. Mr. Jansen recommended several adjustments to the company's proposed salary and wage level. First, Mr. Jansen found the December 1985 level of employees excessive due to a decline in the number of employees as reflected in his employee count for the December 1985 to April 1986 time period and further due to the company's hiring freeze. Mr. Jansen recalculated the company's salary and wage expense by annualizing the April 1986

level of employees. Mr. Jansen stated that the city's calculation would include those salary increases provided employees through April 1986. Second, Mr. Jansen determined that a union agreement signed in May 1986 reflected a 3.5 percent increase in union salaries. Mr. Jansen included this increase in his calculation of April 1986 union employee salary levels. Third, Mr. Jansen reduced the total salaries, union and non-union, to account for what he perceived to be a 2 percent hiring freeze--a 2 percent reduction in the company's authorized employee level. The total net effect of Mr. Jansen's recommended adjustments is a decrease of $4,618,000 to the company's salaries and wage expense.

c. Staff's Position. The staff also made several adjustments to the company's salary and wage expense. Mr. Young also found the December 1985 pay period to be inappropriate because this period reflected the third highest level of employees on the company's payroll during the test year. Mr. Young further noted that the number of HL&P employees had been declining during the first quarter of 1986. Mr. Young utilized the April 1986 payroll period for both inside (non-union) and outside (union) employees to calculate an average annual salary, which he multiplied by the average total test year employee figure. Mr. Young noted that the use of his average test year employee figure coincides with the company's April 13 and April 15, 1986 pay period employee levels. Mr. Young then added supplementary payroll for the period January through March 1986. To arrive at a total payroll expense, Mr. Young subsequently multiplied the total annual base and supplementary payroll by the test year overtime factor. Applying the test year percentage charged to expense to the company's total payroll expense provided a salary and wage expense of $237,096,000. Mr. Young noted that this figure resulted in a $3,928,000 decrease to the company's request. Mr. Young further noted that his calculation would reflect those salary increases for all non-union employees through the April 1986 pay period.

d. Examiners' Discussion and Recommendation. The examiners find the staff calculated decrease of $3,928,000 is reasonable and supported by the evidence in the record. The examiners agree with the staff and the city that the use of the December 1985 payroll level is inappropriate because this figure

is usually high. Moreover, the examiners agree that the average test year employee level best reflects the company's employee level, especially in light of the 2 percent reduction in the company's authorized number of employees. As to the staff's and city's calculations, which capture only three and one-half months of the 5.5 percent increase for non-union employees, the examiners find that this amount is the only amount supported in the record. As pointed out by the general counsel in brief, the salary increase to employees is a discretionary decision of the employees' supervisor. The inclusion of the total adjustment of 5.5 percent would require speculation on the part of the examiners that all employees would receive a salary increase. As to the 3.5 percent increase for non-union employees, for which the company had not initially requested recovery, the examiners find this amount also to be speculative. While Mr. Jansen did recommend inclusion of this amount in his recommended salary and wage expense, Mr. Jansen did not provide any reason for his decision. The evidence in the record does not indicate that the 3.5 percent increase was granted at one time. The company, upon cross-examination, provided Mr. Young a hypothetical that assumed the raises for non-union employees were provided all at once. (Tr. at 2860.) However, a hypothetical is not evidence. It would have been a very simple task for the company to get such information into the record, either through cross-examination of Mr. Jansen, a witness who had recommended inclusion of this increase, or through its rebuttal testimony. The company chose to do neither. The examiners are not inclined to speculate as to whether this increase was known and measurable, especially in light of the fact that the company could have easily met its burden on this issue when raised by the staff. The examiners find the company failed to meet its burden and therefore the adjustment must fail. For the reasons discussed above, the examiners recommend reduction to the company's requested salary and wage expense in the amount of $3,928,000, for a total salary and wage expense of $237,096,000.

2. Employee Benefits

a. <u>Company's Position</u>. The company made adjustments to its life insurance and long-term disability insurance, medical and dental insurance, retirement plan costs, workman's compensation insurance and savings plans cost

for a total net reduction of $488,000 resulting in a total request for employee benefits expense of $29,023,000. (Schedule A at 4 and 5, Company Rate Filing Package.)

b. City's Position. The city reduced the company's employee benefit expense by $816,000. The city computed the annual long-term disability and annual life insurance together with an interest credit on the deposits held with Great Southern Life. This figure multiplied by the city's expense factor of 63.49 percent resulted in a decrease of $816,000 to the company's annual long-term disability and life insurance expense.

c. Examiners' Discussion and Recommendation. In its brief, the company stated that it did not object to the city's adjustment. The examiners find the city's adjustment reasonable and thus recommend a reduction in the company's employee benefits expense in the amount of $816,000 for a total expense level of $28,207,000.

3. Limestone Operating Expense

a. Company's Position. The company requested $12,482,000 for operating expenses for Limestone 1. The company's request is based upon budgeted amounts for calendar year 1986. (Schedule A at 10, Company Rate Filing Package.)

b. City's Position. City witness Babcock made a number of adjustments to the company's request. Ms. Babcock determined that the company's budgeted figure included operating expenses for Limestone 2, which is not yet in service. Ms. Babcock annualized the actual Limestone operating expenses to calculate the operating costs.

In Ms. Babcock's opinion, adjustments to the company's actual operating costs prior to annualizing of the expense level were necessary for several reasons. First, Ms. Babcock recalculated the company's moving expense for March 31, 1986 because the expense was abnormally high and thus not representative. Second, Ms. Babcock included an additional amount for property insurance in order to reflect a full year's insurance premium. Third,

Ms. Babcock removed vacation and holiday expense since this amount was already included in the company's salary and wage level expense. Including the above adjustments and the annualization of operating expense, Ms. Babcock reduced the company's request by $1,889,000 for a total expense of $10,593,000.

c. OPC's and Staff's Positions. OPC witness Paton and staff witness Young both proposed an annualization of Limestone 1 operating expense based upon the actual expenses incurred for the January through March 1986 time frame. Ms. Paton and Mr. Young reduced the Limestone operating expense by $2,013,000 for a total expense of $10,317,000.

d. Examiners' Discussion and Recommendation. The examiners agree with an annualization of actual expense. As both Ms. Babcock and Mr. Young noted, the actual expenses have been considerably lower than the budgeted expenses. While not objecting to such analysis, the company in brief urged the adoption of the city's calculation because it is more thorough than that offered by OPC and the staff. The examiners agree. Therefore, the examiners recommend a reduction for the Limestone operating expense of $1,889,000 for a total expense level of $10,593,000.

4. Storm Costs Since Docket No. 5779

a. Company's Position. The company has incurred additional non-Alicia storm expense since Docket No. 5779. The self-insurance accrual of $433,000 was netted against the additional non-Alicia storm costs of $1,667,000 for an expense of $1,234,000. The company proposed recovery of this amount in a one-year period. (Schedule A at 12, Company Rate Filing Package.)

b. OPC's Position. Ms. Paton recommended that additional storm damage of $1,234,000 be amortized with the remaining unamortized balance of excess storm costs approved in Docket No. 5779 to be amortized over the same time period as the company's excess storm costs discussed in Section VIII.D.5. of this report. Ms. Paton relied upon the Commission's language in that case which indicated that any extraordinary or excessive storm damage should be amortized rather than expensed during one year. The effect of Ms. Paton's adjustment is to reduce the

company's cost of service by $997,000. In brief, OPC argued that the Commission's intent with regard to recovery of extraordinary storm losses to be recovered over more than a one-year period should also be adopted in this case absent any compelling reason to the contrary.

c. Examiners' Discussion and Recommendation. The examiners have reviewed the Commission's decision in Docket No. 5779 and are not convinced that either the company or OPC are entirely correct in their respective positions. OPC contended that the amortization period utilized for Hurricane Alicia is appropriate. The company argued no amortization is proper and that the amount should be expensed. The examiners would note that the company in its last rate case proposed a three-year amortization period owing to the infrequent occurrence of a disaster the size of Hurricane Alicia. In the instant case, there is no discussion of the type of repair required and thus it is unclear from the record whether such repairs are of a routine or infrequent nature. Because the company failed to prove that the items are of the type properly expensed in one year, such period will not be recommended. Moreover, the examiners are not convinced that the $1,234,000 should be treated as a major expenditure of the proportion of that caused by Hurricane Alicia. For that reason, the examiners would recommend a two year amortization with the unamortized balance receiving no rate base treatment. This sharing of the risk would be consistent with the Commission's decision in Docket No. 5779. The examiners therefore recommend an expense of $617,000.

5. Storm Damage in Excess of Insurance

The company reduced its requested level of storm damage in excess of insurance from $2,076,000 to $1,374,000. (Schedule A at 11, Company Rate Filing Package.) This figure represents an adjustment to the amortization of the storm costs relating to Hurricane Alicia to reflect additional costs incurred subsequent to March 1984 and proceeds received from insurance claims.

The examiners have previously discussed OPC's treatment of this adjustment in their discussion of storm costs since Docket No. 5779. Due to the fact that the examiners have chosen not to adopt OPC's position, the examiner's recommend adoption of the company proposed expense of $1,374,000.

6. Franchise Requirement

a. Company's Position. The company requested inclusion of $78,744,000 in its cost of service for its franchise requirement. (Schedule A at 13, Company Rate Filing Package.)

b. City's Position. City witness Babcock adjusted the company's request to reflect a deduction for a non-recurring surcharge of $464,805 which arose out of a settlement of a city lawsuit. Ms. Babcock multiplied the resultant 2.301 percent factor times the city recommended revenue requirement of $3,087,697,000 to obtain the city recommended franchise requirement of $71,048,000.

c. Staff's Position. Staff witness Young recommended a franchise factor of .023142 based upon the test year local gross receipts taxes paid divided by the test year operating revenues for a reduction of $9,644,000 to the company's request or a total franchise requirement of $69,100,000. Mr. Young also testified that because the franchise requirement is a revenue related tax, the staff reclassified the franchise requirement from operations and maintenance to a revenue related tax so that the changes in the revenue requirement will be appropriately reflected in the company's franchise requirement.

d. Examiners' Discussion and Recommendation. The examiners find that a franchise factor of .023142 percent should be applied to the examiners' recommended revenue requirement because it reflects more closely the actual payments of the company. Consistent with the Commission's treatment of this expense as a revenue related tax, the examiners recommend adoption of the staff proposal.

7. Rate Case Expense

a. Company's Position. The company requested rate case expenses in the amount of $1,255,000. (Schedule A at 14, Company Rate Filing Package.) This amount includes the following:

Estimate Expenses for Instant Rate Case	$ 442,000
Additional Expense for Docket No. 5779	$1,212,000
Additional Expense for Docket No. 4540	$ 7,000

The company is requesting a one year amortization of costs relating to the instant application because the company expects to file a rate case next year.

b. City's Position. City witness McKinney reduced the company's requested rate case expense by $1,059,000. Ms. McKinney included only actual expenses for HL&P through March 18, 1986, of $175,000, and the city's expenses of $118,000, because in Ms. McKinney's opinion, these are the only known and measurable amounts. Additionally, Ms. McKinney determined that $841,000 of expenses relating to Docket No. 5779 expenses were related to STP. Ms. McKinney further found that $100,000 of the company's other O&M expense was also STP related; consequently, Ms. McKinney reclassified this amount to STP related rate case expenses. Ms. McKinney reduced the company's total rate case expense by 50 percent in order to effect a sharing of expenses. In Ms. McKinney's opinion, shareholders should bear equally in these expenses for a number of reasons. First, shareholders receive benefits from a rate case decision because the decision will ensure that the company's rates will accurately recover its costs and provide a return on equity. Second, the timing of requested rate relief is a management decision; thus it is appropriate that shareholders who theoretically control management decisions should bear a portion of these non-recurring costs. As to a proper amortization period, Mr. McKinney recommended a one-year period for the general rate case expenses and a two years for the STP related expense. The total recommended amount of rate case expenses is $196,000.

c. OPC's Position. OPC witness Paton determined that the company did not deduct the amount amortized during the test year to determine the level of unrecovered rate case expense. Ms. Paton determined that the unrecovered balance, with the above adjustment, reduces the company's request by $877,000.

Ms. Paton recommended a total unrecovered rate case amount of $756,000.[13] Ms. Paton recommended a 50/50 sharing of these costs between ratepayers and shareholders providing inclusion of $378,000 for rate case expenses in the company's cost of service.

In brief, OPC urged one additional adjustment to the company's requested rate case expense. OPC argued that $312,000 of those expenses relating to Docket No. 5779 were the result of the company's "failed" effort to prove that STP was prudently and efficiently managed. Thus, OPC recommended exclusion of $312,000 from Ms. Paton's recommended $756,000 figure, to provide a total of $224,000 in rate case expense, which includes the 50 percent sharing in costs.

d. Staff's Position. Staff witness Young recommended exclusion of $150,000 of "other" expenses related to the company's estimate for current rate case expense. Mr. Young testified that the company's estimate of "other" expenses was computed as a percentage of the "other" expenses incurred in Docket No. 5779. However, the company failed to provide information as to the exact percentage utilized and the actual components of the "other" expense. The staff proposed that the recommended rate case expense of $1,105,000 be amortized over a one-year period as requested by the company.

e. Examiners' Discussion and Recommendation. The examiners find that two adjustments to the company's request are appropriate. First, the examiners find that the staff's recommended adjustment is reasonable and should be adopted; the company did not adequately document the reasonableness of the $150,000 expense. Second, the examiners agree that the $100,000 of other O&M associated with STP should be reclassified as STP related rate case expenses.

The examiners do not agree with Ms. Paton's adjustment regarding the test year amortization adjustment. Schedule A at 14 of the company's rate filing

[13] While OPC argued in brief that the reduction is $880,000 to the company's request, as reflected in OPC Exhibit 90A, Schedule 4-1 at 1, this figure is in actuality $877,000.

package reflects that the company already considered such amortization expense. What the schedule reflects in the examiners' opinion is that the current amount of rate case expenses at test year end, as estimated by the company was $1,255,000. The company appropriately excluded its test year amortization expense from this figure. Additionally, the examiners would note that while the city did not introduce evidence as to the reasonableness of its request for rate case expenses of $118,000, the examiners find this amount reasonable owing to the fact that this figure reflects a March 18, 1986 amount. The examiners are certain that the city expended funds for its participation at the hearing on the merits in these dockets. As to OPC's position in brief, the examiners cannot agree to penalize HL&P by excluding rate case litigation costs related to STP. HL&P, under the Act, has a right to prosecute its case. A mere denial of the requested relief does not warrant exclusion of those litigation costs as argued by OPC.

[20] The examiners further agree that the above amount should be shared equally between the ratepayers and shareholders. The rate case expense for the instant proceeding is an estimate. To encourage proper estimates, a sharing of these costs is necessary. Moreover, rate case expenses are a non-recurring cost determined by the management alone. In that regard, the company's shareholders should share in the management's decision. The examiners further agree that a one-year amortization period is appropriate given the potential timing of the company's next rate request, which it projects to be in 1987. Thus, the examiners recommend exclusion one-half of the total allowed rate case expense of $1,205,000 for a total recommended amount of $602,500 to be included in the company's cost of service.

8. Edison Electric Institute Dues

a. <u>Company's Position</u>. HL&P requested inclusion of $331,000 relating to Edison Electric Institute (EEI) dues. Although HL&P paid approximately $414,000 in dues, HL&P excluded $83,000 as expenses relating to EEI Legislative activities. EEI is a national trade association which makes available information and research to investor-owned utilities. (Schedule A at 15, Company Rate Filing Package.) Company witness Brian testified that such

assistance not only results in economical efficiency but further provides increased benefits because EEI can perform functions that individual companies could not conduct with their own individual resources.

b. City's and OPC's Positions. City witness McKinney and OPC witness Paton both recommended total exclusion of HL&P's request. Ms. Paton testified that HL&P did not prove that the legislative advocacy portion of EEI's efforts was limited to only 20 percent of HL&P's dues. Ms. McKinney cited the Commission's action in excluding the recovery of such costs in several other rate cases as another basis for her recommendation: Docket Nos. 5560 (Gulf States Utilities Company), 5568 (Texas-New Mexico Power Company), and 5779 (HL&P).

c. Examiners' Discussion and Recommendation. The examiners are persuaded that HL&P has not proven that legislative advocacy is only limited to 20 percent of its dues.

As basis for its 20 percent exclusion, HL&P referenced a letter from EEI in Volume XI of its rate filing packing. Neither the letter nor Volume XI were introduced into evidence. Additionally, as was clear during the cross-examination on this issue, NARUC was to have prepared a study regarding this issue. Although the company supplemented its RFI response to parties by providing them a copy of such report, it was not submitted in the record. The record reflects that the NARUC study was issued on May 30, 1986 and HL&P received the study on June 17, 1986. (Tr. at 667-668.) HL&P, thus, had an opportunity to introduce such evidence, if it so chose, in its rebuttal testimony. The record does not reflect the overall recommendations of NARUC. In the examiners' opinion, the company has not sufficiently met the objection of the parties and therefore the examiners recommend exclusion of $331,000 relating to EEI dues.

9. Research and Development

a. Company's Position. The company requested $12,779,000 for research funds provided to the Electric Power Research Institute (EPRI) for 1986. (Schedule A at 16, Company Rate Filing Package.) Mr. Brian testified that the company's participation together with the participation of other utilities provides EPRI the ability to spread research and development dollars farther. Such participation also eliminates duplication in efforts. Mr. Brian indicated that the company has access to information from a number of projects including solar and wind power research, equipment utilization testing and environmental studies.

b. OPC's Position. In brief, OPC argued that it does not seek to disallow $12,722,995 from Account 930.2, which reflects the company's test year expense for research and development. (OPC Brief at 96.) OPC does object to the company requested increase of $1,058,000. OPC argues that the company has not demonstrated a need to increase this expense. Furthermore, the company has not demonstrated what percentage of EPRI services it actually uses. OPC noted further that 20 percent of the EPRI payments made in 1985 could be utilized for in-house research. The company has only spent approximately one-half of this allotted expense.

c. Examiners' Discussion and Recommendation. The examiners agree with OPC that the additional increase has not been shown to be warranted. Due to the fact that OPC does not object to $12,722,995, the examiners recommend disallowance of $56,005 for a total research and development expense of $12,722,995.

10. Advertising, Contributions and Donations

a. Company's Position. HL&P requested inclusion of expenses relating to advertising, contributions and donations of $3,587,000. The company's request represents an increase of $784,000 over its test year expense. Mr. Brian testified that the requested amount falls within the limitation set forth in P.U.C. SUBST. R. 23.21(b)(1)(E). Mr. Brian testified that the intent of the

company's advertising program is to educate customers in electric safety, and advise them of conservation efforts and available services.

b. City's Position. City witness McKinney identified a number of charitable contributions which she determined constituted legislative advocacy activities. These contributions were to the following organizations: "The Close-up Foundation," "Citizens Against Government Takeover," "The 41st Annual Convention and Seminar of the Justices of the Peace and Constables Association of Texas," and "The Greater Houston Community Foundation." The total recommended amount to be excluded is $13,000 for a total recommended expense of $3,574,000.

c. OPC's Position. Ms. Paton recommended disallowance of $95,000 of contributions recorded in Account 930.2 as well as $20,000 in business gifts and $45,000 in organizational dues from Account 930. In brief, OPC argued that the primary expenditures on the business gifts were tickets to the Houston Oilers, Houston Rockets and Houston Sports Association. Ms. Paton further recommended exclusion of all contributions recorded in Account 426 in the amount of $784,000. Ms. Paton stated that while P.U.C. SUBST. R. 23.21 permits the inclusion of advertising, contributions and donations, it does not require such inclusion. Moreover, Ms. Paton could not agree with "forcing" ratepayers to pay for contributions and donations they may not wish to make and from which they do not receive associated tax benefits. OPC further argued in brief that developing HL&P's status as a corporate good citizen provides benefits to the company's shareholders, not its ratepayers.

OPC witness Paton further recommended exclusion of payments the company made in association with EEI--EEI's Media Communications Fund, Utility Air Regulatory Group and the Utility Solid Waste Activities Group. Ms. Paton's recommended disallowance for these expenses totaled $201,000.[14]

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[14] This amount also includes the excluded amount of EEI dues. The total amount to be excluded for industries dues, aside from EEI, is $269,165.

In brief, OPC recommended additional exclusion of the company's industry dues. OPC argued that almost all of those industries reflected in OPC Exhibit No. 41 are involved in lobbying activities or efforts which have little benefit to ratepayers. OPC cited as examples, the American Nuclear Energy Council, and expenditures to advance utility views on the Clean Air Act, Clean Water Act, Toxic Substances Control Act and World Energy Conference. (OPC Brief at 94.) OPC recommended exclusion of $600,165 relating to industry dues.

Additionally, OPC in brief recommended exclusion of $165,118 relating to payments to the Texas Atomic Energy Research Foundation. While both the company and OPC agree that expenditures in advertising assist in developing the corporate goodwill image of the company, OPC could not find that such corporate image building inures to the benefit of the ratepayer. Therefore, OPC recommended exclusion of $728,869 relating to advertising from Account 930.1. The examiners' calculations show that OPC is recommending a total exclusion for advertising, contributions and donations of $2,314,152.

d. Staff's Position. The staff recommended exclusion of $6,000 of HL&P's contribution of $11,500 to the American Nuclear Energy Council (Council) owing to their legislative advocacy nature and the lack of recognizable benefit flowing to the company's ratepayers. Mr. Young further stated that the basis for his disallowance rests upon a letter from the Council which sets forth the percentage of the Council's activities associated with legislative advocacy. Additionally, Mr. Young excluded $4,000 of expenses relating to the "Citizens Against Government Takeover" and the "Lunar Rendezvous Committee." The total staff recommended reduction to contributions expense is $10,000.

e. Examiners' Discussion and Recommendations. The company in its brief did not object to the proposed adjustments of the city and staff. The company, however, did object to OPC's recommended adjustments. The examiners would initially note that the company's increase in expenditures for this cost of service expense item results in approximately a 36 percent increase over such expenditures requested in Docket No. 5779. However, the examiners would further note that owing to the analysis conducted by the city, OPC and the staff, the examiners believe it can be reasonably presumed that such increase is not in and

of itself demonstrative of an unreasonable level of expense since no party raised this percentage increase as an issue. The parties did, however, raise specific disallowances to the requested amount.

The examiners cannot agree with OPC that all contributions must be excluded from the company's cost of service. Contributions are, in the examiners' opinion, a necessary and almost expected function of any major corporation. Moreover, the Commission's Substantive Rules permit inclusion of a certain level of expense. Had this Commission determined that such expense, while laudable, should not be subject to cost of service treatment, the Commission could very well have so stated in its rules. The examiners do agree, however, with the city and staff that certain expenditures are inappropriate because they are related to lobbying efforts or are strictly utility oriented. The examiners therefore recommend the disallowance of $23,000 in the company's contributions as recommended by Ms. McKinney and Mr. Young. As to industry dues in general, the examiners further believe that such expenditures are a necessary expense of a company such as HL&P. As to those expenses relating to EEI in the amount of $201,000, the examiners find that the company has not shown the reasonableness of these EEI-related payments. With regard to advertising expense, HL&P has two accounts--one account for general informational and instructional advertising, and another account for its corporate image building. The examiners do not find that advertising related to the company's corporate image building is an unreasonable expenditure by the company. The examiners do recommend adoption of a number of adjustments proposed by OPC--$20,000 relating to business gifts and $165,118 relating to the Texas Atomic Energy Research Foundation. The company failed to demonstrate the reasonableness of such payments.

Including the above adjustments which total $409,118, the examiners recommend a total amount of $3,177,882 to be included in the company's cost of service for advertising, contributions and donations.

11. Public Affairs, District Operations, and External Strategy Development

a. <u>OPC's Position</u>. In its brief, OPC recommended exclusion of a portion of the company's expenses relating to the Public Affairs Office, District Operations and External Strategy Development computed as follows:

	O&M Expense	Deduction	Total
Public Affairs	$ 4,673,000	$386,032	$ 4,286,968
District Operations	$15,506,000	$ 8,600	$15,491,400
External Strategy Development	$ 461,785	$ 2,467	$ 459,318
			$20,237,686[15]

In its brief, OPC cited the following as justification for the exclusion:

1. Duplication in the functions and expenses of those three areas of HL&P operations;

2. The $20,237,686 includes indirect if not direct lobbying and legislative activity;

3. Considerable effort of the above operations focuses upon STP, improvement of the company's image regarding STP, and control over the opposition to STP;

4. Considerable effort of the above operations focuses upon influencing the media to favorably reflect public opinion of HL&P's management and corporate objectives;

5. Certain labor expenses are expended to encourage economic development and to participate in local business, civic and professional organizations;

6. The overriding function and responsibility of all three operations is the improvement of HL&P's corporate image.

(OPC Brief at 99.) First, OPC excluded those amounts related to legislative advocacy or social dues which appear as deductions above. Second, OPC argued it is willing to assume that $728,869 associated with general advertising arises from the Public Affairs budget and therefore the amount to be subject to the OPC's adjustment would be $19,508,817. Third, OPC recommended that because the major costs of these three operations are directed toward corporate rather than

[15] Although OPC argued in brief that this figure was $20,240,153, it appears to be an error in not excluding the $2,467 adjustment to the External Strategy Department ($4,286,968 + $15,491,400 + $461,785 = $20,240,153).

ratepayer goals, the ratepayers and shareholders should share equally in the cost thereby resulting in the inclusion of only $9,754,408.50 in the company's cost of service.[16]

OPC further recommended in brief that HL&P should be ordered to conduct more in-depth reporting of employee time and the appropriate assignment of costs. OPC pointed out that Mr. Brian, who sponsored HL&P's legislative advocacy policy appeared unclear regarding the company's guidelines as to legislative advocacy. But what is clear is Mr. Brian's definition of legislative advocacy. Mr. Brian testified that he construed legislative advocacy to exist only when contacts are made regarding pending legislation. (Tr. at 1039-1040.) Mr. Brian further testified that contacts made with quasi-legislative bodies such as this Commission would not be viewed as legislative advocacy. (Tr. at 1025.)

b. Company's Position. The company argued in its reply brief that legislative activity and image building of the three operations constitute only a small portion of the operations efforts. In its reply brief, the company argued that OPC's proposed exclusion of almost $7,750,000 in the district operations is inappropriate. The district managers who engage in any legislative advocacy do so only approximately 5 percent of their time and usually after working hours. (Tr. at 9469.)

c. Examiners' Discussion and Recommendation. The examiners are not convinced that the three operations perform identical functions or that they engage extensively in lobbying efforts. The examiners have reviewed OPC Exhibit Nos. 44-49 and while some duplication exists, such duplication is not so significant as to find that the three divisions are identical. Additionally, while OPC proposed that legislative advocacy is a function of these three operations, the examiners once again cannot find that such activity

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[16] The examiners would note that these figures reflect the inclusion of the corrected figure of $20,237,686 as calculated by the examiners.

predominates the operations. Moreover, the company has excluded portions of those expenses relating to legislative advocacy.

In that regard, the examiners find that the company has provided a working definition of legislative advocacy. In Docket No. 5779, the Commission ordered HL&P to maintain records as to indirect utility business i.e., that activity conducted by employees for religious, political or other non-utility related activities. The company developed a form and required its employees to record time spent on indirect utility business. (HL&P Exhibit No. 22.) The examiners would note that although the memorandum regarding this form was dated August 29, 1985, the employees were to have completed the form as if available for use as of February 1, 1985. While such after the fact recordkeeping can be viewed as less than adequate, the examiners were not pointed to evidence in the record which would cast doubt on the employees' ability to recall and report such activities. Due to apparent confusion as to what was to be recorded, the company provided a memorandum which contained certain definitions, one of which was legislative advocacy. The company defined legislative advocacy in its August 29 memo as follows:

> Account 426400 Legislative Advocacy - Indicate the time spent in writing or speaking directly to members of legislative bodies for the purpose of influencing legislative action. This would include discussions with individual elected officials, as well as appearances before legislative bodies (including city councils). You should also include time spent preparing materials for such appearances. Do not include the time you spend at receptions or social functions merely because legislators are present unless you spend a significant portion of your time discussing pending or proposed legislation. You should also include time spent in connection with any political campaigns including referenda or bond issues or in connection with the activities of HIPAC. Legislative advocacy does not include responding to requests for information or other routine inquiries, but you should not spend Company time to assist any candidate for local, state or national office in his or her election campaign or any political party.

(*Id.*) No party provided the examiners any alternative criteria to be utilized other than the attack regarding the company's failure to include Commission contacts as legislative activities. If the company's form has any shortcomings, it may be in part its definition of what circumstances or communications would

constitute legislative advocacy. The examiners cannot find, however, that the company's definition of legislative advocacy has been shown to be totally in error. The examiners themselves are uncertain as to what activities this Commission would construe as constituting legislative advocacy. The examiners do agree with OPC, however, that contacts with quasi-legislative agencies, such as this Commission, should be construed as legislative advocacy. The examiners are certain the parties will provide the Commission additional situations or circumstances which can be characterized as legislative advocacy other than those listed by the company in its memorandum to be included in the future reporting of indirect utility business. The examiners would recommend that the company be required to list contacts with this Commission or any administrative agency for the purpose of influencing the agency's decisions as legislative activities on its indirect utility records.

In this case, however, the examiners recommend that no adjustment be made to the company's expenses for these three operational divisions.

12. Legislative Advocacy and Social Dues

The company excluded $9,000 relating to legislative advocacy expense and $25,000 relating to social dues from its cost of service. No party objected to such adjustments. The examiners find them reasonable and recommend their adoption.

13. Amortization of Deferred Charges

The company requested an amortization expense of $204,000 to reflect the amount granted by the Commission regarding the extraordinary maintenance on the Sam Bertron and Cedar Bayou Power Plants. (Schedule A at 16, Company Rate Filing Package.) No party objected to the request. The examiners find this amount reasonable and recommend its adoption.

14. Management Audit

a. Company's Position. In 1984, the Commission commissioned a management audit of HL&P conducted by Arthur Young and Company. Mr. Brian testified that the company has paid the firm the total amount of the audit expense of $978,000. (Schedule A at 17, Company Rate Filing Package.) The company requested recovery of this expense within one year.

b. City's and Staff's Positions. Both city witness Babcock and staff witness Young recommended inclusion of the total amount but with a three-year amortization for a total recommended expense of $326,000 or an exclusion of $652,000. Both Ms. Babcock and Mr. Young relied on the Commission's adoption of a three-year amortization period for El Paso Electric Company's audit expense in Docket No. 6350.

c. OPC's Position. OPC witness Paton, relying upon Section 16(h) of the Act and the fact that management audits are generally planned to occur every ten years recommended a ten-year amortization period--inclusion of $98,000 or exclusion of $880,000.

d. Examiners' Discussion and Recommendation. The examiners find that the recommendations of a management audit have far reaching consequences and thus a one-year recovery period is entirely inappropriate. The examiners find reasonable the three-year amortization period recommended by the city and staff. The examiners also rely on the Commission's decision in Docket No. 6350 to deny the adoption of the OPC-recommended period of ten years. Moreover, while a management audit may not occur no less often than every ten years, the Act does not prohibit audits more frequently than every ten years. The examiners therefore recommend an audit expense of $326,000.

15. Lease and Rental Charges

a. Company's Position. The company proposed a lease and rental expense of $5,686,000. (Schedule A at 19, Company Rate Filing Package.) Mr. Brian testified that the company has found leasing additional space to be preferable

to obtaining space through additional construction. Mr. Brian noted two advantages of leasing space over construction. First, due to the present depressed state of the local economy, the price per square foot of leased property has dropped significantly. Second, leasing offers the company flexibility in that it can terminate the lease when the need for the additional space no longer exists.

b. City's Position. City witness Babcock made several adjustments to the company's request. First, Ms. Babcock deducted $224,670 from the increase proposed by the company for the Greenway Plaza and Southpoint II leases. In Ms. Babcock's opinion, these increases would occur only if the operating costs increased. Because HL&P did not provide such documentation, Ms. Babcock believed the increase was not substantiated. Second, Ms. Babcock reversed the "rounding" of the Greenway Plaza lease expense proposed by HL&P from $276,694 to $280,000, thereby reducing the company's request by $39,672. Third, Ms. Babcock removed the costs for two suites of offices the company maintains in Austin in the amount of $42,700. Fourth, Ms. Babcock removed $11,560 for costs the company incurred in connection with housing documents relating to the Brown and Root lawsuit. The total recommended exclusion of $318,000 provides a recommended rental and lease expense of $5,368,000.

c. Staff's Position. Staff witness Young reduced the company's lease and rental expense by $283,000. Mr. Young annualized the actual booked lease and rental expense for the first quarter of 1986. The company had utilized projected annual lease and rental costs. Mr. Young found the company's projected amount considerably higher than the actual annualized amount. Mr. Young did exclude, prior to his annualization, costs related to leased space for "Austin--State Relations" and "Washington D.C." office. Mr. Young perceived the leasing of these offices as related to the company's legislative advocacy efforts. The total staff recommend lease and rental expense is $5,403,000.

d. Examiners' Discussion and Recommendation. The examiners recommend adoption of the staff's lease and rental expense. The examiners find the staff's method appropriate because it not only presents a more accurate level of expenses but further reflects inclusion of two of the city's adjustments.

Because Mr. Young used actual data, Mr. Young's calculation should reflect the proposed decrease in the Greenway and Plaza Point leases which were based on anticipated costs and the rounding error of the company. The examiners therefore recommend exclusion of $283,000 from the company's request for a total lease and rental expense of $5,403,000.

16. Uncollectible Expense

a. Company's Position. The company requested inclusion of $15,321,000 for its uncollectible expense. (Schedule A at 20, Company Rate Filing Package.) Mr. Brian testified that the company has changed its customer deposit policy which has led to reduced levels of uncollectibles. Additionally, the company has tightened its credit and extension policies and is monitoring more closely its industrial and commercial customers who are late in paying. Mr. Brian added that the company has treated the uncollectible expense as a revenue-related item which will change according to the revenues received.

b. City's Position. City witness McKinney recalculated the company's uncollectible expense in two ways. First, Ms. McKinney utilized the city's recommended revenue requirement. Second, Ms. McKinney determined that the lag between revenue collection and bad debt write-offs was 140 days and not 120 days as computed by the company. Ms. McKinney recomputed the write-off factor and determined that based upon a 140 day lag, the factor was 0.46554 percent and not .466821 percent as proposed by the company. (Schedule A at 20, Company Rate Filing Package.) Ms. McKinney therefore reduced the company's request by $947,000 for a total uncollectible expense of $14,374,000.

c. Staff's Position. Staff witness Young, based upon the revenue requirement of the staff, recommended an uncollectible expense of $13,944,000. Mr. Young made no adjustment to the company's write-off factor.

d. Examiners' Discussion and Recommendation. The examiners would note that the company did not object to the city's adjusted factor. The examiners therefore recommend the use of city's adjusted write-off factor. The examiners recommend the application of the city's uncollectible factor of 0.46554 percent

to the examiners' recommended revenue requirement to obtain the company's uncollectible expense.

17. Amortization of Deferred Limestone Charges

The examiners have recommended that the company's requested deferral treatment of Limestone charges be denied. Accordingly, there is no necessity to include an amortization expense. If the Commission chooses to include the requested deferral treatment, the examiners, as referenced in Section VI.C. of this report, recommend adoption of the staff's amount of $4,152,000.

18. Other Maintenance Expense

a. Company's Position. The company proposed other maintenance expense of $88,661,000. (Schedule A at 1, Company Rate Filing Package.)

b. City's Position. City witness McKinney recommended a reduction of $9,464,000 to reflect the decreased O&M expense associated with decreased gas generation. Ms. McKinney compared the MWH output for gas units, actual and adjusted, and calculated a 38 percent reduction in gas-fired MWH generation. For each plant, Ms. McKinney determined the reduced output. Ms. McKinney then reduced each plant's total O&M by excluding its respective fuel expense and payroll expense (excluding overhead and any non-recurring expenses) to arrive at a net test year O&M expense per plant. Ms. McKinney, after comparing the 1985 and 1986 maintenance schedule, chose to adjust only those plants which either had less maintenance scheduled in 1986 than actually performed 1985, or those units which were retired in December 1985. Three plants met Ms. McKinney's first criteria: Deepwater, Green Bayou and S. R. Bertron.

Ms. McKinney determined the percentage MWH reduction of the recommended versus test year MWH generation for these three plants. Applying this percentage to each of the plants' net O&M expense provided the following recommended exclusions:

Deepwater	$1,425,742
Greens Bayou	$3,108,166
S. R. Bertron	4,661,588

Two power plants had certain units which were retired--H. O. Clarke and Webster. Ms. McKinney recommended reductions in O&M expense for those units which had been retired: H. O. Clarke - $40,528, Webster - $227,830.

Ms. McKinney further recommended several adjustments to the company's non-recurring production expenses. Ms. McKinney recommended that a stator replacement to P. H. Robinson Unit 4 in the amount of $3,582,000, stator replacement for W. A. Parish Unit 5 in the amount of $466,000, and rotor replacement to Greens Bayou in the amount of $2,585,000 all be reclassified as CWIP. Ms. McKinney also recommended a three year versus one year amortization of the HELP blade installations at P. H. Robinson and Cedar Bayou because such expenditures are non-recurring in nature. Thus, Ms. McKinney reduced the company's proposed expense of $2,876,000 for the HELP blade installation by $1,918,000 to reflect a total amount to be included for this item of $958,000.

c. OPC's Position. OPC witness Paton removed the associated O&M expense in the amount of $1,835,000 of eight retired gas units: Webster 1 and 2, Greens Bayou 3 and 4, and H. O. Clarke Units 1, 2, 3 and 4. In brief, OPC argued that its figure is based on actual allocated costs, rather than the kWh basis which is reflected in the staff's recommendation.

d. Staff's Position. Staff witness Young, relying upon the company's response to a data request which provided estimated O&M costs associated with retired gas units, recommended excluding $1,139,000 from the company's other O&M expense.

e. Examiners' Discussion and Recommendation. The examiners would note that while the parties discuss certain exclusion of items under the company's other O&M expense, the company has provided three O&M accounts: maintenance, customer expenses and other O&M. The examiners have attempted to address the adjustments under the appropriate account.

The examiners agree with the OPC-recommended adjustment to retired O&M gas-fired plants in the amount of $1,835,000 because it best reflects those expenses associated with these retired plants. The examiners further find appropriate the city's proposed reclassification of production expenditures as CWIP. As to the amortization of the HELP blade installation, the examiners would note that the company has not objected to such treatment. The examiners find it reasonable and therefore recommend exclusion of $1,918,000 relating to the HELP blade installation. With the recommended adjustments, the company's total other maintenance expense is $78,275,000.

19. Other Customer Expense

The company requested $31,298,000 for expenses relating to its other customer expense. City witness McKinney adjusted such request by $255,000 owing to the expected savings arising from the company's redesigned customer bills. The company did not object to the adjustment. The examiners recommend adoption of Ms. McKinney's adjustment for a recommended total other customer expense of $31,043,000.

20. Other O&M Expense

a. Company's Position. The company requested other O&M expense in the amount of $72,831,000. (Schedule A at 2, Company Rate Filing Package.)

b. City's Position. City witness McKinney made several adjustments to the company's other O&M expense. First, Ms. McKinney determined that certain activities such as funds expended for the presidential ball and dues to the American Nuclear Energy Council were legislative activities. Therefore, Ms. McKinney recommended exclusion of $17,000. Second, Ms. McKinney excluded $85,000 relating to unsupported or excessive officer reimbursement for hotel and meal allowances. Additionally, Ms. McKinney found that HL&P's executives were reimbursed for expenses at an EEI spring conference, legislators' weekends and other related legislative functions which she also excluded. Ms. McKinney further noted that she was unable to review such reimbursable expenditures for all of the company's employees because the information was not readily

accessible. Ms. McKinney therefore recommended that HL&P be ordered to charge all employee reimbursed expenses to a specified, discrete FERC subaccount which can be readily reviewed from HL&P's general ledger. Third, Ms. McKinney adjusted the company's request for administrative costs in the amount of $495,533 relating to the fuel refund ordered in May 1985. Because the amount is non-recurring, Ms. McKinney recommended a two-year amortization which results in inclusion of $248,000. Fourth, Ms. McKinney recommended that $16,000 associated with legal costs relating to the inquiry into decertificating Malakoff be capitalized and transferred to CWIP.

City witness Babcock, who testified as to the company's lease and rental expense found that the company double counted its lease and rental expense for the Greenspoint Employment Office. While Ms. Babcock permitted such expenditures as a reasonable lease and rental expense, to avoid a double counting, she removed such expense from the company's other O&M expense. Ms. Babcock recommended exclusion of $51,000 from the company's request.

City witness Jansen recommended two adjustments to the city's request. First, Mr. Jansen recommended a decrease of $538,000 relating to HII's management fee. Mr. Jansen testified that HL&P is charged 90 percent of HII's expenses, while UFI and PFI are each charged 5 percent. Because HII has formed three new subsidiaries, which should also be allocated a portion of HII's expense, Mr. Jansen recommended that HL&P be responsible for only 75 percent of HII's total expense of $3,587,012, for a total affiliate expense of $2,690,259 which is a reduction of $538,052 to the company's request of $3,228,311. (The company had requested inclusion of 90 percent of HII's total affiliate cost in the amount of $3,228,311.) Second, consistent with the Commission's decision in Docket No. 5779, Mr. Jansen recommended exclusion of $181,000 (rounded) relating to the employee appliance store and service center.

The total amount of the city's recommend O&M adjustment is a decrease of $1,136,000.

c. <u>OPC's Position</u>. OPC witness Paton recommended three adjustments to the company's other O&M expense. First, Ms. Paton recommended that HL&P's

management fee expense should be 60 percent, resulting in a decrease of $1,076,000. Ms. Paton reasoned that because HII's new subsidiaries would require more management from HII than PFI or UFI, she allocated 10 percent to each of the new subsidiaries. Second, Ms. Paton recommended exclusion of the test year expense of $180,659 relating to the employee appliance store. Third, Ms. Paton recommended that the company's cost of service be reduced by $933,748, owing to the personal use of company automobiles. Ms. Paton's total recommended reduction is $2,190,407.

d. Examiners' Discussion and Recommendation. The examiners find reasonable the city's proposed adjustments of $17,000 relating to disallowance of legislative activities; $85,000 relating to officer reimbursements; $248,000 relating to the fuel refund amortization; $16,000 relating to CWIP reclassification of litigation fees for Malakoff; and $51,000 relating to the Greenspoint Employment Office for the reasons set forth by the city's witnesses. The examiners would note that the company did not object to the proposed adjustments. The examiners also find appropriate the exclusion of $181,000 for the appliance store expense. As to the HII management fee, the examiners find reasonable Mr. Jansen's allocation of an additional 5 percent to the newly created subsidiaries. Therefore, the examiners recommend a further reduction of $538,000 (rounded). Additionally, the examiners find reasonable the exclusion of costs relating to the personal use of automobiles in the amount of $933,748. Lastly, the examiners would note that Ms. McKinney had reclassified certain rate case expenses from other O&M to STP rate case expenses. (City Exhibit 2 at 19.) Since the examiners have accepted such reclassification, an appropriate exclusion of the $100,000 in other O&M expense is necessary. The examiners therefore recommend a total reduction in other O&M of $2,169,748 for a total other O&M expense of $70,661,252. The examiners would further recommend that the company be ordered to charge all reimbursed employee expenses to a specified discrete FERC subaccount which can be readily reviewed from the company's general ledger in order that such expense can be reviewed in the company's subsequent proceedings before this Commission.

21. Energy Efficiency Adjustment

[21] Staff witness Biedrzycki determined that the company had reduced its conservation and load management expenditures. Ms. Biedrzycki determined that the decrease in expenses is related to HL&P's decreased program activity. Ms. Biedrzycki determined the average cost per customer multiplied by the number of expected participants in 1986. From this calculation, Ms. Biedrzycki recommended a downward adjustment of $6,581,658 to the company's request of $10,100,871, or inclusion of only $3,519,213 in the company's cost of service.

There was no serious dispute with regard to the staff's calculation. The examiners find it reasonable and therefore recommend a reduction of $6,581,658 to the company's cost of service.

COMMISSION EXHIBIT NO. 11

PUBLIC UTILITY COMMISSION OF TEXAS
EL PASO ELECTRIC COMPANY
DOCKET NO. 6350
JURISDICTIONAL COST OF SERVICE STUDY
SUMMARY OF REVENUE REQUIREMENT ALLOCATION
CWIP CASE

Description	Total System	Texas Retail	Other Jurisdictions
	($)	($)	($)
Fuel	66,142,165	44,710,253	21,431,912
Purchased Power	67,930,008	45,913,521	22,016,487
Operation & Maintenance	44,839,575	33,071,001	11,768,574
Depreciation & Amortization	15,895,831	10,965,862	4,929,969
Decommissioning Cost	0	0	0
Other Taxes	18,406,667	15,640,748	2,765,919
Interest on Customer Deposit	199,360	157,739	41,621
State Income Taxes	349,944	157,696	192,248
Federal Income Taxes	32,065,062	20,429,643	11,635,418
Return on Rate Base	91,687,049	61,310,557	30,376,493
Revenue Requirement	337,515,661	232,357,020	105,158,641
Miscellaneous Revenue	(2,141,641)	(1,551,875)	(589,766)
Fuel Revenue	(126,030,973)	(85,193,409)	(40,837,564)
Base Rate Revenue	209,343,047	145,611,736	63,731,311
Percent (%)	100.0000	69.5565	30.4435

PUBLIC UTILITY COMMISSION OF TEXAS
EL PASO ELECTRIC COMPANY
DOCKET NO. 6350
JURISDICTIONAL COST OF SERVICE STUDY
RATE BASE ALLOCATION
CWIP CASE

Description	Total System ($)	Texas Retail ($)	Other Jurisdictions ($)
Plant In Service	458,113,725	318,487,418	139,626,307
Accumulated Depreciation	(128,906,480)	(89,895,277)	(39,011,203)
Accumulated Decommissioning	0	0	0
Net Plant	329,207,245	228,592,141	100,615,104
CWIP-Net	548,388,190	350,642,896	197,745,294
Working Capital Allowance	7,268,170	5,559,167	1,709,003
Accum. Deferred Income taxes	(110,982,319)	(67,424,128)	(43,558,191)
Injury & Damage Reserves	(100,000)	(74,002)	(25,998)
Customer Advance for Constr.	(992,941)	(144,782)	(848,159)
Customer Deposits	(2,966,146)	(2,346,901)	(619,245)
Unamortized Pre 1971 ITC	(757,940)	(527,626)	(230,314)
Unamort.gain on turbine sale	(1,808,615)	(1,217,714)	(590,901)
Total Rate Base	767,255,644	513,059,051	254,196,593
Percent (%)	100.0000	66.8694	33.1306

PUBLIC UTILITY COMMISSION OF TEXAS

COMMISSION EXHIBIT NO. 13

PUCT COST OF SERVICE STUDY
EL PASO ELECTRIC COMPANY
DOCKET NO.6350
RECOMMENDED BASE RATE REVENUE REQUIREMENT
CWIP CASE

Class		(1) Examiner Adj.Current Base Rate Revenue	(2) Recommended Increase (Decrease)	(3) Revenue Increase (Decrease)	(4) Recommended Base Rate Revenue
		($)	%	($)	(%)
01	Residential	55,593,326	(8.95)	(4,976,840)	50,616,486
08	E.P.St.Light & Sig	1,677,982	(8.95)	(150,217)	1,527,765
11	E.P.Mun.Pumping	4,948,568	(8.95)	(443,007)	4,505,561
15	Electrolyte Refin.	3,586,285	(8.95)	(321,052)	3,265,233
21	Off-Peak W.H.	1,627,623	(8.95)	(145,708)	1,481,915
22	Irrigation	63,771	(8.95)	(5,709)	58,062
24	General Service	49,112,891	(8.95)	(4,396,697)	44,716,194
25	Large Power	22,723,246	(8.95)	(2,034,236)	20,689,010
28	Area Lighting	755,118	(8.95)	(67,600)	687,518
29	Transm. Voltage	4,149,997	(8.95)	(371,517)	3,778,480
30	Electric Furnace	3,159,211	(8.95)	(282,820)	2,876,391
31	Military Service	5,392,789	(8.95)	(482,775)	4,910,014
34	Cotton Gin	126,481	(8.95)	(11,323)	115,158
41	City & County	6,858,443	(8.95)	(613,983)	6,244,460
54	Mun.Pumping	153,203	(8.95)	(13,715)	139,488
	Total	159,928,934	(8.95)	(14,317,198)	145,611,736

COMPLAINT OF ROSE MONROE AGAINST §
HOUSTON LIGHTING AND POWER FOR § DOCKET NO. 6138
DISCONNECTION OF SERVICE §

August 26, 1986

Appeal of Rose Monroe from ordinance of City Council of the City of Houston regarding her complaint against Houston Lighting and Power for disconnection of service. Commission discussed the burden of proof in complaint cases.

[1] PROCEDURE - JURISDICTION - APPEALS FROM MUNICIPALITIES - PETITION AND FILING REQUIREMENTS

COMPLAINTS AND DISPUTES - MISCELLANEOUS

Since complaint of HL&P customer is not a rate proceeding in which the utility's cost of service and rate design are at issue, this matter falls under the Commission's general appellate jurisdiction as reserved under Section 17(d), and the customer's appeal from the municipal ordinance passed and adopted by the City Council of the City of Houston is properly before the Commission.

[2] COMPLAINTS AND DISPUTES - MISCELLANEOUS

Because complainant was neither a customer nor an applicant for service, a utility representative's statement that service could not be restored to complainant's residence, regardless of who occupied the residence, until the delinquent bill was paid did not violate P.U.C. SUBST. R. 23.42(c)(1).

[3] COMPLAINTS AND DISPUTES - TERMINATION OF SERVICE

Facts demonstrate utility's technical failure to comply with P.U.C. SUBST. R. 052.02.04.044(c) [now 23.46] regarding form, content, and timing of notice of service termination.

[4] PROCEDURE - EVIDENCE - BURDEN OF PROOF
COMPLAINTS AND DISPUTES - MISCELLANEOUS

Although a complainant has the burden of presenting a prima facie case with respect to a utility's noncompliance with its tariffs or the Commission's rules, when the prima facie case has been made, the utility has the burden of going forward with the evidence showing compliance with its tariff or the Commission's rules.

DOCKET NO. 6138

COMPLAINT OF ROSE MONROE AGAINST HOUSTON LIGHTING AND POWER FOR DISCONNECTION OF SERVICE	I I I	PUBLIC UTILITY COMMISSION OF TEXAS

EXAMINER'S REPORT

I. Procedural History

On May 28, 1984, the City of Houston found the complaint of Rose Monroe to be without merit pursuant to its regulatory powers set forth in the Public Utility Regulatory Act (hereinafter the Act), Tex. Rev. Civ. Stat. Ann. art. 1446c (Vernon's Supp. 1986). Thereafter information regarding the City's action was forwarded to the Commission's general counsel. By memo dated January 16, 1985, a staff attorney for the Commission recommended that Rose Monroe's appeal be docketed pursuant to Section 17(d) of the Act. Several attachments accompanied the memo delineating the City of Houston's actions. This matter was docketed on January 16, 1985.

There was no document from Rose Monroe which could be considered an appeal attached to the memo. However, on February 20, 1985, Rose Monroe filed a letter with the Commission requesting review of the City of Houston's actions in regard to her complaint. On April 2, 1985, HL&P was ordered to file an answer to Rose Monroe's complaint and a hearing was set to occur on May 16, 1985. HL&P filed its answer on April 30, 1985.

On May 3, 1985, the Office of Public Counsel (OPC) entered this matter on the complainant's behalf pursuant to Section 15(f)(7) of the Act. On that same day, HL&P filed a Motion for a Continuance of the Hearing. The motion stated HL&P and OPC both desired a continuance to allow for settlement discussions. The motion was granted on May 6, 1985, and the hearing was reset for June 6, 1985. On May 30, 1985, general counsel requested a continuance of the hearing; General counsel's request was unopposed and therefore the hearing was rescheduled to occur on June 20, 1985.

The hearing was convened on June 20, 1985. The following entered appearances at the hearing: Walter Washington from OPC on behalf of the complainant; Glen Adams also on behalf of complainant; Harris S. Leven and Lynn Hokanson on behalf of HL&P; and Bret Slocum from the general counsel's office.

Prior to proceeding with the complainant's direct case at the June 20, 1985, hearing, the parties were allowed to orally argue HL&P's motion to dismiss filed on June 17, 1985. The motion was denied after argument was taken and the hearing on the merits commenced. The hearing lasted two days. The complainant presented herself and three exhibits in support of her direct case. HL&P presented 13 witnesses and twenty-four exhibits. Staff presented

one witness. The hearing was adjourned on June 21, 1985 and a briefing schedule was set. By agreement the parties modified the briefing schedule from time to time. Briefs were filed by OPC, HL&P and general counsel. Rely briefs were filed by OPC and HL&P. The briefing schedule was completed on October 15, 1985.

Jurisdiction was not pled or addressed by the parties in regard to this matter and is addressed in Section II below.

II. Opinion

A. Jurisdiction of the Commission

This matter involves the appeal of a municipal ordinance passed and adopted by the City Council of the City of Houston. The Commission's jurisdiction over municipal orders or ordinances is established by Section 17(d) of the Act. Section 17(d) of the Act provides that "(t)he Commission shall have exclusive appellate jurisdiction to review orders or ordinances of such municipalities as provided in this Act." Section 26 of the Act provides for Commission review of rate proceedings held before the governing bodies of municipalities. There is no other section of the Act which provides for the review of municipal orders or ordinances.

[1] However, the Commission's appellate jurisdiction is not limited by the phrase "as provided in this Act" at the end of PURA Section 17(d). In Appeal of the City of Floresville, Docket No. 5524, 10 P.U.C. BULL. 1285, 1287 (April 6, 1984), the Commission concluded that that phrase modifies the verb "review" so as to require the Commission, when it has appellate jurisdiction, to conduct its review in a manner consistent with the provisions of the PURA. This interpretation was reaffirmed by the Commission in the consolidated Docket Nos. 6117, 6170, 6171 and 6172, (final order issued February 6, 1986). Consequently, since this matter is not a rate proceeding in which the utility's cost of service and rate design are at issue, this matter falls under the Commission's general appellate jurisdiction as reserved under Section 17(d). Therefore the instant appeal is properly before this Commission.

On June 20, 1985, HL&P filed a Motion to Dismiss this matter. The motion cited that the complainant had filed suit at District Court in Fort Bend County seeking damages for alleged wrongful termination. HL&P argued that the merits of this docket would again have to be litigated at District Court and therefore this matter should not proceed. That motion was denied.

B. Burden of Proof

OPC began its analysis of who carries the burden of proof in a complaint proceeding by noting that neither the Act nor the Commission's rules address the burden of proof in a proceeding such as this. Section 40 of the Act which

allocates the burden of proof to utilities in rate proceedings is applicable only in instances where the reasonableness of a utility's proposed or current rates are at issue. Given the above, OPC made the following analysis in its initial brief at page 6:

> The requirement of Sec. 40 that in rate proceedings in which an existing utility rate is challenged (presumably under Sec. 42 of the PURA) the burden to prove the reasonableness of the rate remains on the utility suggests that in cases where a complainant challenges a utility's compliance with a Commission Rule, the burden to provide compliance should also remain on the utility.
>
> OPC recognizes that in a complaint proceeding such as this, the Complainant must set out a prima facie case that the utility failed to comply with the Commission's Rules, otherwise there would be no basis for a proceeding. However, once the complainant has made a factual presentation establishing a prima facie case of noncompliance, the burden must shift to the utility to prove compliance.

HL&P responded to the above by stating that it is a "well settled principle that the burden of persuasion in an administrative proceeding rests upon the claimant or initiator of the proceeding." HL&P initial brief page 3. OPC's retort is that there is an equally well settled exception to the above principle, to wit: A party has the burden of proving facts peculiarly within his own knowledge and which are not known by the opposing party. OPC reply brief at page 2.

The ALJ agrees with all of the above set out arguments made by OPC and HL&P and does not find any significant difference between their positions, except for OPC's claim that the burden of proof regarding compliance with a rule rests on the utility. As concerns that difference, the ALJ concurs entirely with OPC's analysis of the allocation of the burden of proof in this matter in regard to factual disputes.

In those instances where the utility's actions pursuant to a Commission rule require an interpretation of a rule, that is whether the utility's actions are a reasonable application of the rule, the burden of persuasion must be placed on the utility in the same manner a utility must defend its actions in applying one of its own tariffs.

Consequently, in a complaint proceeding, the complainant must establish a prima facie case that the utility has failed to comply with its tariffs or the Commission's rules. The utility must then provide evidence of compliance. In those instances involving factual disputes, such as kwh usage or the correctness of a bill where the utility possesses superior knowledge of facts, the utility must carry the burden of proof.

C. Issues Presented for Resolution by the Parties and Background History

1. Issues

The issues presented for resolution herein are as follows:

Did HL&P violate P.U.C. SUBST. R. 23.47(d) regarding meter tests?
Did HL&P violate P.U.C. SUBST. R. 23.42 regarding refusal to serve?
Did HL&P violate Rule 052.02.04.044(c), which was in effect at the time of termination, when it terminated service to Rose Monroe?
Was Rose Monroe's meter accurate?
Is Rose Monroe's current indebtedness to HL&P $1,826.81?

2. Historical Background

Rose Monroe's complaint stems from HL&P's termination of service on January 26, 1984, to her home at 6827 Indian Falls, Missouri City, Texas 77489, (this address will be referred to as Rose Monroe's home even though she no longer resided there at the time of the hearing). HL&P terminated service for Rose Monroe's failure to pay a delinquent account. It is not disputed that Rose Monroe was delinquent on her account for her December bill (service rendered to December 15, 1983 in the amount of $163.08). It is also not disputed that Gulf Coast Community Services pledged to pay $400 on Rose Monroe's account on the day service was disconnected at Rose Monroe's home, January 26, 1984. Payment of that pledge was not received by HL&P until February 1, 1984.

Andy and Rose Monroe moved into the house at 6827 Indian Falls in July of 1979 and became HL&P customers that month. The house is a four bedroom structure with approximately 2,000 square feet of space. The house is surrounded by a fence with a gate. The gate was locked on occasion. The electric meter is located in the Monroe's back yard. The Monroe's also kept a dog in the back yard. The dog was a doberman pinscher.

Andy Monroe moved out of the house in 1983 and the Monroe's have since divorced. Electric service to the house remains in Mr. Monroe's name. The record reflects that prior to Andy Monroe's leaving in 1983, he experienced periods of unemployment due to layoffs. After Mr. Monroe left, Rose Monroe proceeded to raise her two children (ages 17 and 9 at the time of the hearing) on her own, working sporadically as a substitute teacher.

The Monroe billing history is an exercise of confusion. The Monroe's billing history shows a continual pattern of delinquent payments and requested extensions. The billing history also shows a continual pattern of a lack of actual meter readings. This lack of meter readings resulted in two major

billing adjustments; one in 1980 and a second in 1982. In both instances, the complainant entered into payment agreements with HL&P to avoid termination of service.

The billing adjustments were both underbillings, that is, the complainant was sent a bill to recover payment for usage which had not been previously billed. Both underbillings were near $1,000 in amount. These underbillings and the payment agreements necessary to maintain service exacerbated the Monroe's problems in paying their electric bills.

The Company's business records reflect that HL&P personnel experienced difficulty in securing regular meter readings because the meter was inaccessible due to the Monroe's dog or the gate being locked. The Company attempted to use customer prepared dial cards for monthly billing, but abandoned such due to inaccurate recordings by the complainant.

The complainant maintained that the meter was accessible. However, the complainant did admit the gate was occasionally locked. The status of the dog's personality is the subject of conflicting evidence. These conflicts are not germane to the issues herein. The point which should be kept in mind is that while Rose Monroe struggled to pay her bills while experiencing income interruptions, the Company's actions show equal resolve to help Rose Monroe maintain service.

The billing records show that Rose Monroe was allowed to enter into a payment plan which required her to pay her current bill plus $50 each month after the July 1982 underbilling. It was that payment plan Rose Monroe failed to maintain in January of 1984 that led to a termination of service. Between July of 1982 and January of 1984 there were continual extensions of time (approximately 14) for Rose Monroe on monthly bills. There were additional billing problems experienced, none of which rose to the level of the 1980 and 1982 underbillings. Finally, in January of 1984, with an outstanding balance of $1,618.19, HL&P refused to provide any further extension of the complainant's December 15, 1983 bill and discontinued service. Pursuant to the payment plan, the complainant owed a current bill of $163.08 and plus $50 for a total $213.08 which was due on January 12, 1986.

D. Discussion of the Issues

1. Did HL&P violate P.U.C. SUBST. R. 23.47(d) regarding meter tests?

Complainant's brief alleges that the complainant requested a meter test after receiving her second underbilling in July of 1982. The brief then claims that HL&P violated Rule 23.47(d) by not informing complainant that she could be present during such a requested test and by failing to inform complainant the results of that requested test. HL&P maintains that no meter test request was made by Rose Monroe during the time she was a customer of the Company.

Rose Monroe testified that she requested a new meter from HL&P several times. When questioned on direct examination whether she requested a meter test in 1980 after she received her first large underbilling, she testified that she could not remember (TR 31). Her answer to a question on direct examination about whether she requested a meter test after her second underbilling in July of 1982 has become the subject of debate between OPC and HL&P. Rose Monroe's answer clearly indicates she requested a meter test. However, it is not clear when that request was made. The question and answer at page 35 of the transcript are as follows:

> Q. Did you ever request during this time, in 1982, that it be tested?
>
> A. I requested that it be tested after--I wrote the Public Utility Commission. I began to call the Public Utility Commission. A substantial (sic) rule book was sent to me by State Representative Craig Washington. And I began to read it; then I asked for a testing.

OPC maintains that the answer to the above question is an affirmative response to the question asked. However, the answer in relation to other events testified about leads one to the conclusion that Rose Monroe requested a meter test after her service was terminated. The answer indicates that the meter test request was made after Rose Monroe contacted the Commission and after the receipt of a copy of the Commission's substantive rules. The record reflects that Rose Monroe's contact with this Commission occurred after termination. The record also reflects that Rose Monroe's contact with Representative Craig Washington occurred after termination of her service. There is no evidence that Rose Monroe contacted the Commission or Representative Washington prior to January 26, 1984. Consequently, the answer in the context of requesting a meter test after contacting the Commission and Representative Washington leads to the conclusion that the request for a meter test was made after service to Rose Monroe was terminated.

Rule 23.47(d) allows a customer of a utility to request a meter test free of charge. The rule is silent regarding customers whose service has been terminated. HL&P's position was that Rose Monroe did not request a meter test until after service was terminated and that after termination she was no longer a customer of the utility. Therefore, HL&P found Rule 23.47(d) inapplicable to any meter test request made after January 26, 1984. OPC in its reply brief did not contest HL&P's argument that Rose Monroe is no longer a customer of the utility. The ALJ concurs with HL&P's position that Rule 23.47(d) is applicable only to customers of the utility, i.e., those receiving service from the utility.

The ALJ is of the opinion that the evidence of record supports a finding that Rose Monroe did not request a meter test while she was a customer of HL&P. Regardless of that finding, Rose Monroe's answer set out above, made in response to a question from her own attorney, is not an affirmative response to the question asked. On the basis of that question and answer only, one cannot

establish whether Rose Monroe requested a meter test before or after her service was terminated. Consequently, the complainant has failed to present a prima facie case in regard to a violation of Rule 23.47(d). The ultimate conclusion here is that no violation of Rule 23.47(d) has occurred.

HL&P's records indicate that three tests of the meter located at the complainant's home were made on the following dates: July 11, 1980, June 7, 1982; and March 14, 1984. Had OPC established that a test request was made after July of 1982, and before January 26, 1984, then the evidence is clear that no test was conducted and HL&P would have been in violation of Rule 23.47(d).

2. Did HL&P violate P.U.C. SUBST. R. 23.42 regarding refusal to serve?

Sometime between January of 1984 and February of 1985, Rose Monroe contacted HL&P about changing the account name of her residence at 6827 Indian Falls. Apparently, the complainant was considering moving in order to rent her home. Rose Monroe stated that she began her discussion with an HL&P credit advisor by suggesting the account for her home be changed from her husband's name to her name in order to have service restored. Upon being informed that change would not relieve her of the responsibility for the outstanding bill and therefore service would not be restored, Rose Monroe claims she questioned the credit advisor about what would happen if she leased her home. Rose Monroe stated that the credit advisor informed her that service would not be restored to her home until the outstanding bill was paid. On the basis of that conversation, Rose Monroe claims she believed she could not rent her house and turned away prospective tenants.

OPC maintains that the above exchange as described by Rose Monroe violates Rule 23.42(c)(1). Rule 23.42(c)(1) provides as follows:

> Insufficient grounds for refusal to serve. The following shall not constitute sufficient cause for refusal of service to a present customer or applicant:
>
> (1) delinquency in payment for service by a previous occupant of the premises to be served;

The problem with OPC's position is that Rose Monroe was not a present customer or applicant when she discussed restoring service to her home. Consequently, no violation of Rule 23.42(c) has occurred.

Rule 23.42(c) cannot be stretched to include advice provided to people who are neither customers nor applicants for service. The ALJ is troubled by the lack of a statute or rule which would address such a situation. The obvious response which should have been given Rose Monroe, assuming her account of the conversation was accurate, was that her tenants could receive service from HL&P at 6827 Indian Falls upon showing a valid lease to HL&P and meeting any other requirements set out by the Commission's rules.

There is nothing to cover misrepresentations of the Commission's rules or a utility's tariff by a utility to someone who is not a customer or an applicant for service. However, if there was a rule specifically prohibiting misrepresentation by a utility to persons which were not customers or applicants for service, the only remedy available would be a penalty action brought on behalf of the Commission by the Attorney General. Consequently, the ALJ is not convinced that such occurrences necessarily would be best handled by a rule.

[2] HL&P did not rebut Rose Monroe's account of her conversation with HL&P. Rose Monroe's account was likewise not impeached on cross-examination. HL&P primarily argued that under the facts as presented by the complainant, Rule 23.42(c)(1) cannot be interpreted to find a violation has occurred. The conclusion to be entered here is that Rule 23.42(c) applies only to present customers or applicants for service.

3. Did HL&P violate Commission Rule 052.02.04.044(c), which was in effect at the time termination occurred, when HL&P terminated service to Rose Monroe?

The complainant has alleged that HL&P failed to comply with the Commission's rule on service termination cited above. As was discussed in Section II.A. of this report, the utility carries the burden of proof in showing compliance with Commission rules. The complainant's allegation that the rule was not complied with constitutes a prima facie case as to this issue.

Rule 052.02.04.044(c), which set forth the Commission's requirements for discontinuance of service, is the forerunner of the Commission's current discontinuance of service rule. (Rule 23.46.) The only substantive differences between the Commission's present rule and the rule in effect on January 26, 1984, are the time limits set by the rule. Pursuant to Rule 052.02.04.044, a utility may terminate service to a customer:

> A. If the customer's bill has not been paid or a deferred payment agreement entered into within twenty-two (22) days (pursuant to Rule 23.46, it is now 26 days) from the date of issuance and if proper notice is given;
>
> B. proper notice shall consist of a separate mailing or hand delivery;
>
> 1. at least seven (7) days (pursuant to Rule 23.46 it is now 10 days) prior to a stated date of disconnection;
>
> 2. with the words "termination notice" or similar language prominently displayed on the notice.
>
> C. Service may also be terminated for a failure to comply with the terms of a deferred payment agreement after proper notice as set forth above.

The record demonstrates that the complainant received her bill for service rendered to December 15, 1983, and a notice of termination. The record further demonstrates that the complainant understood that failure to pay her then

current bill of $163.08 plus $50.00 would result in a termination of service. As a practical matter, the purpose behind the Commission's discontinuance of service rule was accomplished, i.e., the customer was fully aware of her circumstances should she fail to pay her bill. However, the Company failed to show that it fully complied with the Commission's then-in-effect rule and therefore, as a technical matter, a violation of that rule has occurred.

HL&P failed to show that the bill for service to December 15, 1983, was issued 22 days prior to disconnection. There is no testimony from the complainant as to when she received her bill for service rendered to December 15, 1983. The in-effect rule and present Rule 23.45 define the date of issuance as the postmark on the bill or the date of issuance on the bill. Neither party introduced Rose Monroe's bill for service rendered to December 15, 1983. Consequently, the Company has failed to establish that the bill in question was issued 22 days prior to disconnection. However, were it not for HL&P's billing documentation showing that the complainant was two months behind in her payment agreement (specifically, $50.00 payments were missed in May and September of 1983, see HL&P Exhibit No. 23) the Company's failure to show a date of issuance would have resulted in a violation of the rule in question. Since service may be terminated for a failure to maintain a deferred payment agreement it was unnecessary for HL&P to show that the complainant's December 1983 bill was issued 22 days prior to disconnection.

The issue then, turns on whether proper notice was provided. Once again, the Company failed to establish when the notice (OPC Exhibit No. 2, attached to this report as Appendix A) was mailed. HL&P witness Curbow was asked when she prepared the termination notice. It was not established when she mailed it. One could assume that the notice was mailed on the day it was prepared. However, it is the Company's burden to prove compliance and it has failed to show that the notice was mailed or hand delivered seven days prior to disconnection.

OPC also placed in question the form of the notice sent to the complainant. OPC argues that the notice lacks a "stated date of disconnection" and that similar language to the term "termination notice" cannot be found "prominently displayed" on the notice. The notice sent to Rose Monroe by HL&P is attached hereto as Appendix A. Nowhere are there words prominently displayed which indicate that the notice relates to termination of service. The first impression given by the notice are the words "PAST DUE NOTICE" set in 9 point type. The only language which informs the reader that service will be discontinued is found in the smallest type on the notice (8 point). That language states that "service is subject to suspension without further notice." Furthermore, the notice states service will be suspended if payment is not received by the "Final Payment Date."

[3] The rule requires a stated date of disconnection and the language "termination notice," or other similar language, to be prominently displayed. "Past Due Notice" is not other similar language, nor is "your service is subject to suspension." The notice should contain language indicating termination or disconnection of service in at least 18 or 30 point type (which is the type size the Company used for its name which is set out twice) and provide a date on which service will be subject to termination. The notice should clearly indicate that it is the notice by which the Company may thereafter terminate service and not that termination may occur without further notice. The notice of termination sent by HL&P for the customer's failure to maintain a payment agreement and current bill does not comply with the Commission's then-in-effect rule or the Commission's present rule. HL&P in choosing not to use the language specifically approved by the rule has violated the rule by using language which fails to be "similar language."

OPC also argued that the pledge by Gulf Coast Community Services should be treated as a payment received. Assuming that the pledge from Gulf Coast was made prior to disconnection, the rule states that disconnection may occur if a bill has not been paid or there has been a failure to comply with a payment agreement. The operative word here is paid. A pledge is not payment and therefore HL&P did not violate the discontinuance of service rule on that point. The payment made by Gulf Coast was not received until after disconnection.

4. Was Rose Monroe's meter accurate and is Rose Monroe's current indebtedness to HL&P $1,826.81?

At the beginning of the hearing, OPC was required to make an opening statement to set forth the matters in issue between the complainant and HL&P since there was no formal pleading filed by the complainant setting forth her position. After questioning from the bench, OPC stated it did not believe HL&P could prove the accuracy of its meter and therefore, Rose Monroe was not indebted to HL&P in the amount of $1,826.81. These two points were not argued at brief by OPC and relief in the form of a bill adjustment was not requested by OPC. HL&P by its brief specifically requested that findings be made on the accuracy of the meter and the amount of the bill outstanding. OPC's reply brief also did not address these issues or rebut HL&P's claims.

The uncontroverted and unimpeached evidence of record is that HL&P performed three tests of the meter located at Rose Monroe's home and found the meter to be within the accepted limits of accuracy each time. HL&P also provided the complainant's entire billing history record. The accuracy of those records was not challenged. Given the unrefuted accuracy of the meter and HL&P's business records, the only finding possible herein is that Rose Monroe owes HL&P $1,826.81.

E. Final Remarks

This report would be incomplete if some additional background history were not noted. In Section II.B. the relationship between HL&P as the utility and Rose Monroe as the customer was set forth as the utility and customer working together in an attempt to maintain that relationship. That rapport lasted four years despite continued problems on both parties' behalf in issuing bills and getting them paid. The record also reflects an ongoing misunderstanding by the complainant about HL&P's billing process. Additionally, it should be noted that the rapport between utility and customer completely deteriorated on the day of termination with conflicting allegations of who pushed whom. These matters were not presented as issues of fact or law to the Commission, but were elicited on the record nonetheless.

Given the nature of the rule violations found herein, the ALJ does not recommend that the Commission seek penalties through the Attorney General's office. However, it is recommended that HL&P be required to file a report setting forth the changes it will make to its termination notice to comply with P.U.C. SUBST. R. 23.46 as interpreted herein.

III. Findings of Fact and Conclusions of Law

A. Findings of Fact

1. Rose Monroe's appeal from the City of Houston's Order entered on May 28, 1984, was docketed at the Commission on January 16, 1985.

2. A hearing in this matter was held on June 20, 1985.

3. No party contested Rose Monroe's perfection of her appeal.

4. While Rose Monroe did request HL&P to test her meter, it cannot be established from the record whether that request was made before or after Rose Monroe ceased to be a customer of HL&P.

5. Rose Monroe received a bill for service rendered to December 15, 1983, in the amount of $163.08.

6. Rose Monroe received a past due notice in the amount of $213.08 which she understood to be a notice of termination.

7. The issue date of Rose Monroe's utility bill for service rendered to December 15, 1983, by HL&P was not established.

8. The delivery date or date of mailing of HL&P's past due notice was not established.

9. Rose Monroe's current bill and payment agreement was not paid as of the time service was disconnected to her home on January 26, 1984.

10. The meter at Rose Monroe's home was accurate during the time Rose Monroe was an HL&P customer.

11. Rose Monroe entered into a deferred payment plan which required her to pay $50.00 a month in addition to her current monthly bill.

12. Rose Monroe owes HL&P $1,826.81 for service rendered.

B. Conclusions of Law

1. HL&P is a public utility as defined by Section 3 of the Public Utility Regulatory Act (hereinafter the Act), Tex. Rev. Civ. Stat. Ann. art. 1446c (Vernon Supp. 1986).

2. The Commission has jurisdiction over the matters herein pursuant to Section 17(d) of the Act.

3. The Commission's jurisdiction pursuant to Section 26 appeals is limited to rate proceedings.

4. The burden of proof regarding a utility's compliance with its tariff or the Commission's rules is upon the utility in complaint proceedings as discussed in Section II.B. of the Examiner's Report.

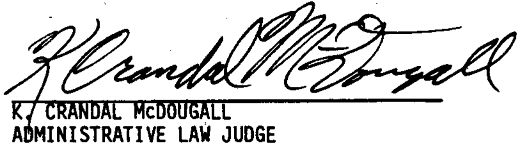
5. P.U.C. SUBST. R. 23.42(c)(1) applies only to present customers or applicants for services of a public utility.

6. HL&P failed to establish that notice of termination was provided seven days prior to termination of service to Rose Monroe and therefore failed to establish compliance with the Commission Rule 052.02.04.044 in effect on the date of termination. Consequently, HL&P violated that rule.

7. HL&P's past due notice sent to Rose Monroe attached hereto as Appendix A violates Commission Rule 052.02.04.044 (in effect at the time service was terminated to Rose Monroe) and P.U.C. SUBST. R. 23.46 since the notice failed to prominently display similar language to "termination notice" and failed to state a date of disconnection as discussed in Section II.D.3. of the Examiner's Report.

8. A payment pledge from a community service organization is not payment within the meaning of Commission Rule 052.02.04.044 or P.U.C. SUBST. R. 23.46.

Respectfully submitted,



K. CRANDAL McDOUGALL
ADMINISTRATIVE LAW JUDGE

APPROVED on this the 27th day of June 1986.

RHONDA COLBERT RYAN
DIRECTOR OF HEARINGS

nsh

1308

Houston Lighting & Power Company

This bill is now past due. Unless full payment is received in our Business Office by the Final Payment Date shown below, your electric service is subject to suspension without further notice.

Receipt of a new monthly bill does not extend this Final Payment Date.

ACCOUNT NUMBER	SERVICE ADDRESS	SERVICE TO
16 1 9127 80059 3	6827 INDIAN FALLS	12 15 83

AMOUNT PAST DUE	213	08

FINAL PAYMENT DATE 1-20-84

AMOUNT PAST DUE 213 08

THIS PART OF BILL FOR YOUR RECORDS

The Light company
Houston Lighting & Power

PAST DUE NOTICE

MONROE, ANDY JR.
6827 INDIAN FALLS
MISSOURI CITY TEX 77489

AMOUNT PAST DUE 213 08

FINAL PAYMENT DATE 1-20-84

16 19127 80059 3 5 300 2130 800 213080 4

Please enclose this part of bill if you pay by mail

APPENDIX A

DOCKET NO. 6138

RECEIVED
1986 AUG 26 PM 4:32
PUBLIC UTILITY COMMISSION
FILING CLERK

COMPLAINT OF ROSE MONROE AGAINST HOUSTON LIGHTING AND POWER FOR DISCONNECTION OF SERVICE	§	PUBLIC UTILITY COMMISSION OF TEXAS

ORDER GRANTING MOTIONS FOR REHEARING

On August 26, 1986, the Commission considered motions for rehearing filed by the Office of Public Utility Counsel and Houston Lighting and Power Company. The motions were partially GRANTED and therefore the Examiner's Report is amended as follows:

1. Conclusion of Law No. 4 is amended to read as follows:

[4] 4. Although a complainant has the burden of presenting a prima facie case with respect to a utility's noncompliance with its tariffs or the Commission's rules, when the prima facie case has been made, the utility has the burden of going forward with the evidence showing compliance with its tariff or the Commission's rules.

2. Conclusion of Law No. 6 is hereby deleted.

3. Conclusion of Law No. 8 is amended to read as follows:

8. A payment pledge from a community service organization is not payment within the meaning of Commission Rule 052.02.04.044 which was in effect at the time of disconnection; however, Rule 23.46 currently regards pledges from community service organizations as payment for utility bills.

SIGNED AT AUSTIN, TEXAS on this the 26th day of August 1986.

PUBLIC UTILITY COMMISSION OF TEXAS

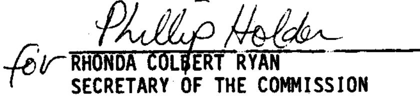
SIGNED: Dennis L. Thomas
DENNIS L. THOMAS

SIGNED: Jo Campbell
JO CAMPBELL

I respectfully dissent to the order adopted above with respect to the amendment to Conclusion of Law No. 4 and the deletion of Conclusion of Law No. 6. The Examiner's Report should remain as originally adopted on July 23, 1986 in regard to the burden of proof in complaint proceedings.

SIGNED:
PEGGY ROSSON

ATTEST:


for RHONDA COLBERT RYAN
SECRETARY OF THE COMMISSION

nsh

DOCKET NO. 6138

1986 JUL 23 PM 4:42

COMPLAINT OF ROSE MONROE AGAINST HOUSTON LIGHTING AND POWER FOR DISCONNECTION OF SERVICE | PUBLIC UTILITY COMMISSION OF TEXAS

ORDER

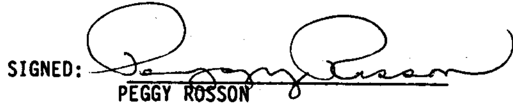
In public meeting at its offices in Austin, Texas, the Public Utility Commission of Texas finds that the above styled application was processed in accordance with applicable statutes by an administrative law judge who prepared and filed a report containing Findings of Fact and Conclusions of Law, which Examiner's Report is ADOPTED and made a part hereof. The Commission further issues the following Order:

1. HL&P is ORDERED to file a report with the Commission's staff within 30 days after the signing of this Order showing the changes HL&P proposes to make to its termination notice consistent with the Examiner's Report.

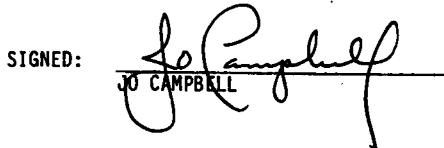
2. All motions and requests for entry of specific findings of fact and conclusions of law, and any other requests for relief, general or specific, if not expressly granted herein are DENIED for want of merit.

SIGNED AT AUSTIN, TEXAS on this the 23rd day of July 1986.

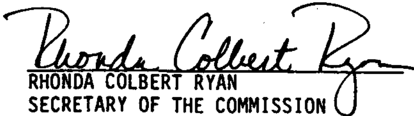
PUBLIC UTILITY COMMISSION OF TEXAS

SIGNED: 
PEGGY ROSSON

SIGNED:
DENNIS L. THOMAS

SIGNED: 
JO CAMPBELL

ATTEST:


RHONDA COLBERT RYAN
SECRETARY OF THE COMMISSION

nsh

MEMORANDUM DECISIONS

TELEPHONE

Elcotel LD*OS, Docket No. 8080. Dismissed April 27, 1988. Application for CCN withdrawn and dismissed.

ELECTRIC

San Marcos Electric Utility, Docket 7851. Examiner's Report adopted March 16, 1988. SMEU's CCN No. 30184 and Pedernales Electric Cooperative's CCN No. 30128 amended to revise the service area boundaries in Hays County.

Houston Lighting and Power Company, Docket 7618. Examiner's Report adopted March 16, 1988. Transmission line and associated substation in Fort Bend and Harris Counties approved.

Texas Utilities Electric Company, Docket 7638. Examiner's Report adopted March 16, 1988. Transmission line in Fannin and Grayson Counties approved.

Texas Utilities Electric Company, Docket 7707. Examiner's Report adopted March 16, 1988. Transmission line and associated substation in Grayson County approved.