

ORDINANCE 2004-02

AN ORDINANCE OF THE CITY OF INGLESIDE ON THE BAY, TEXAS FINDING, AFTER REASONABLE NOTICE AND HEARING, THAT AEP TEXAS CENTRAL COMPANY'S ELECTRIC TRANSMISSION AND DISTRIBUTION RATES AND CHARGES WITHIN THE CITY SHOULD BE CHANGED; DETERMINING JUST AND REASONABLE RATES; ADJUSTING STREET LIGHTING CHARGES; ADOPTING RECOMMENDATIONS OF CONSULTANTS; PROVIDING FOR RECOVERY OF RATE CASE EXPENSES; PRESERVING REGULATORY RIGHTS OF THE CITY; PROVIDING FOR REPEAL OF CONFLICTING ORDINANCE

WHEREAS, pursuant to § 33.001 of the Public Utility Regulatory Act, the City of Ingleside on the Bay has exclusive, original jurisdiction over the electric rates, operations, and services provided within city limits;

WHEREAS, on or about November 3, 2003, SEP Texas Central Company ("TCC" or "Company") files with the City of Ingleside on the Bay an application seeking to increase electric transmission and distribution rates by 14.7% on a system-wide basis;

WHEREAS, the Company proposed an effective date of December 8, 2003 that was suspended by resolution to provide time to study the reasonableness of the application;

WHEREAS, on December 19, 2003, TCC extended the effective date by two weeks;

WHEREAS, the City of Ingleside on the Bay, in a reasonably noticed public hearing considered the Company's application and a recommendation from the City's consultants who were retained to evaluate the merits of the Company's application;

WHEREAS, the City has determined that the electric transmission and distribution rates charged by the Company within the City should be reduced pursuant to the recommendations of its consultants;

NOW, THEREFORE, BE IT ORDAINED BY THE CITY COUNCIL OF THE CITY OF INGLESIDE ON THE BAY, TEXAS:

SECTION 1. That the existing rates and charges of SEP Texas Central Company are hereby found, after reasonable notice and hearing, to be unreasonable and shall be changed as hereinafter ordered. The changed rates resulting from this Ordinance are hereby determined to be just and reasonable rates to be observed and in force within the City.

SECTION 2. The Company shall reduce its electric transmission and distribution rates charged to customers located within City limits by 21% on a system-wide basis. The rate decrease shall be allocated to all customer classes uniformly on an equal percentage basis.

SECTION 3. The Company shall lower the facilities charge for both street lighting and non-roadway lighting by 21%.

SECTION 4. The electric rates charged within City limits shall reflect a 9% return on equity and a capital structure comprised of 60% debt and 40% equity in order to reflect the historic low cost of capital and to prevent financial subsidization of TCC's parent company.

SECTION 5. The electric rates charged within City limits shall reflect a total plant depreciation rate of 2.93%, a reduction to the Company's proposed rate of 3.22%.

SECTION 6. TCC has failed to achieve the minimally accepted service reliability standards established by the Public Utility Commission and has failed to properly allocate sufficient resources to

distribution maintenance. TCC shall refund, on a system-wide basis, \$2,754,380 to customers located on feeders failing to meet Commission reliability standards for the years 2001 and 2002.

SECTION 7. TCC has incorrectly interpreted the Integrated Stipulation and Agreement ("ISA") approved by the Public Utility Commission in Docket No. 19265. As a result, the electric rates hereby approved within City limits shall incorporate a \$30 million system-wide reduction to ensure that the provisions of the ISA are implemented.

SECTION 8. TCC's request for authority to defer bad debt expense and include such expense in the next rate case is denied.

SECTION 9. TCC may not charge an account history fee to end-users, REPs, or aggregators. Further, no service fee shall be charged to REPs or aggregators requesting a detailed billing and invoicing analysis.

SECTION 10. Cities' rate case expenses are found to be reasonable and shall be reimbursed by the Company.

SECTION 11. The electric rate reduction herein approved shall be effective for bills rendered on or after approval of this Ordinance. TCC shall file tariffs reflecting the change of rates herein ordered within 10 days of passage of this Ordinance.

SECTION 12. The rates set forth in this Ordinance may be changed and amended by either the City or Company only as provided by law.

SECTION 13. It is hereby found and determined that said meeting at which this ordinance was passed was open to the public, as required by Texas law, and that advance public notice of the time, place and purpose of said meeting was given.

SECTION 14. This Ordinance shall be served on ^AEP Texas Central Company by U.S. Mail to the Company's authorized representative, Ron Ford, 400 West 15th Street, Suite 610, Austin, Texas 78701.


SECTION 15. Nothing contained in this Ordinance shall be construed now or hereafter in limiting or modifying, in any manner, the right and power of the City under law to regulate the rates and charges of AEP Texas Central Company.


SECTION 16. All ordinances, resolutions or parts thereof, in conflict with this Ordinance are repealed to the extent of such conflict.

PASSED AND APPROVED, this the 16th day of March 2004.

Attest:

Approved:


Diane Hosea
City Secretary


Alfred Robbins
Mayor



City of
Ingleside on the Bay

PO Box 309
Ingleside, TX 78362

(361) 776-5451 Fax (361) 776-5283

Date: March 17, 2004

Company Name: Lloyd, Gosselink, Blevins, Rochelle
Baldwin & Townsend P.C.

To: Darena Golden

Fax#: 512-472-0532

From: Diane Hosea
City Secretary

Number of pages including cover: 3



City of
Ingleside on the Bay

PO Box 309
Ingleside, TX 78362

(361) 776-5451 Fax (361) 776-5283

Date: March 17, 2004

Company Name: CPL

To: Harold Ashley

Fax#: 361-221-0463

From: Diane Hosea
City Secretary

Number of pages including cover: 3



City of Ingleside On The Bay

475 Starlight Drive • Ingleside On The Bay • Texas

P.O. Drawer B • Ingleside • Texas 78362

Bus: 361-776-5451

P.O. Box 309

cityseciob@pelicancoast.net

Fax: 361-776-5283

March 17, 2004

Mr. Ron Ford
AEP Texas Central Company
400 West 15th Street
Suite 610
Austin, TX 78701

Dear Mr. Ford:

Enclosed please find Ingleside on the Bay Ordinance 2004-02, AN ORDINANCE OF THE CITY OF INGLESIDE ON THE BAY, TEXAS FINDING, AFTER REASONABLE NOTICE AND HEARING, THAT AEP TEXAS CENTRAL COMPANY'S ELECTRIC TRANSMISSION AND DISTRIBUTION RATES AND CHARGES WITHIN THE CITY SHOULD BE CHANGED; DETERMINING JUST AND REASONABLE RATES; ADJUSTING STREET LIGHTING CHARGES; ADOPTING RECOMMENDATIONS OF CONSULTANTS; PROVIDING FOR RECOVERY OF RATE CASE EXPENSES; PRESERVING REGULATORY RIGHTS OF THE CITY; PROVIDING FOR REPEAL OF CONFLICTING ORDINANCE Passed and Approved on March 16, 2004.

Sincerely,

Diane Hosea
City Secretary

Enclosure (1)

LLOYD, GOSSELINK, BLEVINS, ROCHELLE,
BALDWIN & TOWNSEND, P.C.
ATTORNEYS AT LAW

111 CONGRESS AVENUE
SUITE 1800
AUSTIN, TEXAS 78701

Mr. Porter's Direct Line: (512) 322-5876
Email: sporter@lglawfirm.com

TELEPHONE (512) 322-5800
TELECOPIER (512) 472-0532
www.lglawfirm.com

MEMORANDUM

TO: Cities Participating In PUC Docket No. 28840¹

FROM: Steven A. Porter and Thomas Brocato

DATE: February 17, 2004

RE: Ordinance Reducing Electric Rates

As we recently informed you,² the testimonies and recommendations of eight expert witnesses were filed on your behalf at the Public Utility Commission of Texas on February 9, 2004. The testimony was filed in response to AEP Texas Central Company's ("TCC") application to increase transmission and distribution electric rates by 14.7%.

Your expert testimony supports a \$97 million electric rate reduction for TCC. Consequently, we recommend that your City adopt rate ordinances reducing TCC's electric transmission and distribution rates by 21% on a system-wide basis. A model ordinance is attached. ***YOUR CITY MUST ENACT A RATE ORDINANCE BY MARCH 19, 2004. FAILURE TO ADOPT A RATE ORDINANCE BY MARCH 19, 2004 MAY ALLOW TCC TO IMPOSE A 14.7% RATE INCREASE IN YOUR CITY.***

In adopting a rate ordinance, a public hearing should be noticed and interested parties allowed to make presentations. You should consult your city attorney to ensure the ordinance complies with the requirements of your City Charter.

The Company, no doubt, will appeal your ordinance to the PUC. The hearing will begin in Austin on March 1, 2004 and a Commission decision expected in mid-June. Please let us know if you have any questions.

¹ The list of participating Cities is attached.

² See, memo of February 10, 2004.

ORDINANCE

AN ORDINANCE OF THE CITY OF _____, TEXAS FINDING, AFTER REASONABLE NOTICE AND HEARING, THAT AEP TEXAS CENTRAL COMPANY'S ELECTRIC TRANSMISSION AND DISTRIBUTION RATES AND CHARGES WITHIN THE CITY SHOULD BE CHANGED; DETERMINING JUST AND REASONABLE RATES; ADJUSTING STREET LIGHTING CHARGES; ADOPTING RECOMMENDATIONS OF CONSULTANTS; PROVIDING FOR RECOVERY OF RATE CASE EXPENSES; PRESERVING REGULATORY RIGHTS OF THE CITY; PROVIDING FOR REPEAL OF CONFLICTING ORDINANCE

WHEREAS, pursuant to § 33.001 of the Public Utility Regulatory Act, the City of _____ has exclusive, original jurisdiction over the electric rates, operations, and services provided within city limits;

WHEREAS, on or about November 3, 2003, AEP Texas Central Company ("TCC" or "Company") filed with the City of _____ an application seeking to increase electric transmission and distribution rates by 14.7% on a system-wide basis;

WHEREAS, the Company proposed an effective date of December 8, 2003 that was suspended by resolution to provide time to study the reasonableness of the application;

WHEREAS, on December 19, 2003, TCC extended the effective date by two weeks;

WHEREAS, the City of _____, in a reasonably noticed public hearing considered the Company's application and a recommendation from the City's consultants who were retained to evaluate the merits of the Company's application;

WHEREAS, the City has determined that the electric transmission and distribution rates charged by the Company within the City should be reduced pursuant to the recommendations of its consultants;

NOW, THEREFORE, BE IT ORDAINED BY THE CITY COUNCIL OF THE CITY OF _____, TEXAS:

SECTION 1. That the existing rates and charges of AEP Texas Central Company are hereby found, after reasonable notice and hearing, to be unreasonable and shall be changed as hereinafter ordered. The changed rates resulting from this Ordinance are hereby determined to be just and reasonable rates to be observed and in force within the City.

SECTION 2. The Company shall reduce its electric transmission and distribution rates charged to customers located within City limits by 21% on a system-wide basis. The rate decrease shall be allocated to all customer classes uniformly on an equal percentage basis.

SECTION 3. The Company shall lower the facilities charge for both street lighting and non-roadway lighting by 21%.

SECTION 4. The electric rates charged within City limits shall reflect a 9% return on equity and a capital structure comprised of 60% debt and 40% equity in order to reflect the historic low cost of capital and to prevent financial subsidization of TCC's parent company.

SECTION 5. The electric rates charged within City limits shall reflect a total plant depreciation rate of 2.93%, a reduction to the Company's proposed rate of 3.22%.

SECTION 6. TCC has failed to achieve the minimally accepted service reliability standards established by the Public Utility Commission and has failed to properly allocate sufficient resources to distribution maintenance. TCC shall refund, on a system-wide basis, \$2,754,380 to customers located on feeders failing to meet Commission reliability standards for the years 2001 and 2002.

SECTION 7. TCC has incorrectly interpreted the Integrated Stipulation and Agreement ("ISA") approved by the Public Utility Commission in Docket No. 19265. As a result, the electric rates hereby approved within City limits shall incorporate a \$30 million system-wide reduction to ensure that the provisions of the ISA are implemented.

SECTION 8. TCC's request for authority to defer bad debt expense and include such expense in the next rate case is denied.

SECTION 9. TCC may not charge an account history fee to end-users, REPs, or aggregators. Further, no service fee shall be charged to REPs or aggregators requesting a detailed billing and invoicing analysis.

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SECTION 11. The electric rate reduction herein approved shall be effective for bills rendered on or after approval of this Ordinance. TCC shall file tariffs reflecting the change of rates herein ordered within 10 days of passage of this Ordinance.

SECTION 12. The rates set forth in this Ordinance may be changed and amended by either the City or Company only as provided by law.

SECTION 13. It is hereby found and determined that said meeting at which this ordinance was passed was open to the public, as required by Texas law, and that advance public notice of the time, place and purpose of said meeting was given.

SECTION 14. This Ordinance shall be served on AEP Texas Central Company by U.S. Mail to the Company's authorized representative, Ron Ford, 400 West 15th Street, Suite 610, Austin, Texas 78701.

SECTION 15. Nothing contained in this Ordinance shall be construed now or hereafter in limiting or modifying, in any manner, the right and power of the City under law to regulate the rates and charges of AEP Texas Central Company.

SECTION 16. All ordinances, resolutions, or parts thereof, in conflict with this Ordinance are repealed to the extent of such conflict.

PASSED AND APPROVED, this the _____ day of _____, 2004.

APPROVED:

ATTEST:

TO: Mayor, City Council

FROM:

DATE:

RE: Staff Report -- Electric Rate Ordinance

Background

During the summer of 2003, the Cities of Corpus Christi, McAllen, Laredo, Harlingen, Victoria, Edna, and Carrizo Springs adopted resolutions requiring AEP Texas Central Company ("TCC" or "Company"), formerly Central Power & Light Company, to provide cost information justifying the electric transmission and distribution rates charged within City limits. The existing rates were established by the Public Utility Commission of Texas in 2001 and are based upon estimated costs. Since that time, the cost of capital has significantly decreased and actual cost information has become available. Investigation of TCC's rates, particularly with regard to unfair street lighting rates, was urged by the member Cities of the South Texas Aggregation Project as well as the CPL Cities Steering Committee. TCC refused to negotiate any change to street light tariffs, leaving the Cities with no choice but to push for a general rate review. Upon passage of local rate review resolutions, TCC requested that the Cities enacting resolutions allow the Company to file a rate filing package containing all cost information with the Public Utility Commission of Texas ("PUC" or "Commission"). The Cities agreed.

On November 3, 2003, TCC filed with the PUC and all Cities in TCC's service territory an application to increase electric transmission and distribution ("T&D") rates by \$66.5 million or 14.7%. The Company seeks to slightly decrease transmission rates by \$2.5 million, but increase distribution rates by \$68.8 million. The Company noticed a December 8, 2003 effective date. The electric T&D rates at issue are charged to the retail electric providers operating in TCC's service territory. Consequently, any rate increase will impact municipal electric accounts served by individual REPs as well as charges from First Choice if the City is a member of the South Texas Aggregation Project. Further, any increase will effect small commercial and residential customers served by a retail electric provider. Residential price to beat customers will not be impacted until price to beat rates expire or customers switch to an alternative provider.

The City, pursuant to § 33.001 of the Public Utility Regulatory Act has exclusive, original jurisdiction over the electric rates charged by TCC. In accordance with that authority the City, on _____, 2003, suspended the effective date for 90 days giving the City time to evaluate the application. Later, TCC amended the effective date by two weeks, extending the City's jurisdiction to March 19, 2004.

Also on _____, 2003, the City authorized joining other Cities to investigate TCC's rates and retained Geoffrey Gay and Steve Porter of the law firm of Lloyd, Gosselink, Blevins, Rochelle, Baldwin & Townsend of Austin, Texas. Lloyd, Gosselink is counsel to STAP and the CPL Cities Steering Committee and Mr. Gay and Mr. Porter have represented CPL Cities on

electric rate matters since the 1980s. Eighty-five Cities have joined together and intervened in the case at the PUC. A list of the intervening Cities is attached. Consultants were hired to review various aspects of TCC's request. All reasonable consulting and legal fees are, by law, reimbursable by TCC.

On February 9, 2004, Cities' representatives filed at the PUC the testimony of eight expert witnesses supporting an electric rate reduction of \$97 million or about 21%. A hearing is scheduled to begin at the PUC on March 1, 2004.

Consultant Recommendations

As noted above, the rate decrease is supported by the recommendation of Cities' consultants. Cities have assembled a team of experts with vast regulatory experience. Each is highly qualified to evaluate the assigned issues. All of Cities' witnesses understand that this is an important case in determining whether electric competition will thrive and provide benefits to consumers. The following is a list of Cities' witnesses with a brief summary of the testimony each witness is presenting to the PUC:

Stephen G. Hill

Mr. Hill presents Cities' recommended return on equity, capital structure and overall cost of capital. Having participated in the generic ROE phase of TCC's last case, Mr. Hill is familiar with the risks facing T&D utilities. His 9% return on equity incorporates an adjustment to account for the poor quality of TCC's service and is based upon the well-accepted discounted cash flow method. The capital structure recommended by Cities' (60% debt - 40% equity) witness helps prevent financial subsidization and is the same adopted by the Commission in TCC's last case. Mr. Hill has concluded that the overall rate of return will allow TCC to maintain its bond rating and financial integrity.

Mick Arndt

Mr. Arndt, a CPA, has been involved in utility regulation for 30 years and has testified in Texas numerous times. He presents Cities' recommended system-wide rate reduction of \$97.715 million. As the regulatory accountant on this case, Mr. Arndt applies well-established ratemaking principals including historical test-year ratemaking. Mr. Arndt adjusts TCC's cost of service to comply with the Agreement approved by the Commission in Docket No. 19265. TCC's faulty interpretation of the Agreement has unnecessarily increased cost of service by about \$30 million. He presents a consolidated tax savings adjustment of \$9.8 million based on the method adopted by the PUC in Docket No. 14965 and approved by the courts. His recommendation concerning the gain on the sale of AEP's affiliated REP provides the fair sharing necessary to ensure customers benefit from the good-will and brand name recognition built by ratepayers over several decades.

Gerald Tucker

A former CPL Controller, Gerald Tucker is uniquely qualified to review and evaluate the affiliated service company's charges to TCC. Mr. Tucker found that the problems existing in Docket No. 14965, which led to a large disallowance by the Commission, remain today. Direct assignment of costs has decreased in violation of Commission policy, while allocated charges

have increased. The complexity of the affiliate charge system makes it difficult, if not impossible, to review the charges and apply the standard required by law. Applying the standards set out in PURA, case law and Commission precedent, witness Tucker concludes that while TCC has not met its burden of proof, it would be reasonable to hold affiliate charges to that level allowed in CPL's last proceeding. He recommends a \$16.5 million adjustment to TCC's request.

Nancy Hughes

Ms. Hughes has performed depreciation studies for utilities and customers. Based on industry-accepted methods, she adjusts TCC's recommended service lives and net salvage values for several accounts, and recommends a reduction of depreciation expense of \$8 million. She has also reviewed TCC's calculation of decommissioning costs and recommends that the Company's calculation include only the 10% contingency allowed by PUC rules.

Bill Starnes

Mr. Starnes is a consultant to two of the largest municipal aggregators in Texas, including STAP, and is intimately familiar with the problems experienced in the transition to competition. Mr. Starnes has evaluated TCC's street and non-roadway lighting rates and services. His investigation reveals that TCC has over-estimated the billing determinants necessary to calculate lighting rates and that the facilities charge is too high in two respects. Adoption of Mr. Starnes' testimony will ensure reasonable rates for a service with significant health and safety implications.

Dr. A. D. Patton

Dr. Patton may be the premier electric system reliability expert in Texas. Dr. Patton concludes that TCC has not achieved the level of service contemplated by the Commission's reliability rules. In fact, Dr. Patton concludes that TCC's service reliability is declining. The cause, according to Cities' witness, is TCC's misallocation of resources. While charging TCC substantial amounts of administrative and general costs ("A&G") incurred in Columbus, Ohio, corporate headquarters has reduced TCC's maintenance budget as well as the work force necessary to maintain the system. Dr. Patton calculates a \$2.7 million service penalty owed customers pursuant to the Agreement adopted by the PUC in a prior docket; recommends that \$1.5 million be reallocated to actual maintenance of the system; finds that \$13.8 million in unnecessary affiliate A&G costs be disallowed; and recommends that one-time, non-recurring costs of \$6 million allocated to distribution O&M be removed from cost of service.

Dr. Sarah Goodfriend

Dr. Sarah Goodfriend, former Texas Commissioner, was asked by Cities to review TCC's interaction with REPs, proposed service fees, TCC's tariff, and compliance with quality of service standards. Cities are concerned about the potential for cross-subsidies and incentive for anti-competitive behavior inherent in the competitive market scheme implemented in Texas. Dr. Goodfriend addresses TCC's poor quality of service which is having adverse cost effects on the market as well as making it more difficult for REPs to compete.

Dr. Goodfriend finds that TCC's service to the REPs does not compare favorably to the quality of service provided by TXU and Reliant. She makes several recommendations designed to curb cross-subsidies and improve service. Among those are to deny TCC's request to share in the profit of non-regulated construction projects and to place a moratorium on TCC's efforts to provide unregulated services. TCC, according to Dr. Goodfriend, should improve services provided to its customers prior to expending resources in providing services to others.

A summary of the consultants' findings are as follows:

- On a system-wide basis, Cities propose a \$97.715 million reduction to existing rates. This compares to the Company's request to increase system-wide rates by \$66.476 million. Cities urge the Commission to decrease transmission rates by \$35.586 million and to decrease distribution rates by \$62.135 million.
- TCC's rate of return is overstated. Cities recommend a return on equity of 9%. As explained by Cities' witness Hill, this is in line with the historic low cost of capital and investors expectations. Cities' ROE recommendation reflects consideration of TCC's failure to provide reliable, quality electric service.
- A capital structure of 60% debt and 40% equity is reasonable. It is the same capital structure adopted by the Commission in CPL's UCOS case and ensures against financial cross-subsidization of the parent company as described by Mr. Hill.
- Adoption of TCC's request would require captive ratepayers to subsidize AEP's unregulated businesses in several respects. As noted above, Cities' financial witness found that adoption of TCC's proposed capital structure would require ratepayers to financially subsidize TCC's parent company. TCC's charges from the affiliated service company result in subsidization and should be reduced by \$16.5 million. The Company's affiliate expense request gives rise to the same concerns as presented in Docket No. 14965 where the Commission disallowed a substantial portion of CPL's affiliate transactions. Finally, TCC's venture into the provision of non-regulated services results in a subsidy by ratepayers and poor customer and distribution service for ratepayers.
- TCC's requested cost of service is inflated because the Company misapplied the provisions of the Agreement approved by the Commission in Docket No. 19265. TCC has inappropriately inflated the cost of service by \$22.5 million as it failed to demonstrate that the rate increase request filed by TCC was not associated with the merger of CSW and AEP. In addition, TCC ignored the Agreement's requirement that TCC's revenue requirement be reduced by \$7.5 million.
- TCC failed to calculate Federal Income Tax expense as though it filed a consolidated tax return. A consolidated income tax savings adjustment of \$9.8 million needs to be made in accordance with state law and well-established PUC precedent.
- Over the years, CPL built up its brand name and good will, fairness requires that TCC customers share in the gain attributed to the sale of AEP's affiliated REPs.

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- TCC's depreciation expense is excessive by \$8 million.
 - The Company has unreasonably increased cost of service by going well outside the test-year to recognize particular expenses and failing to account for increased revenues. Specifically, TCC has abandoned historical test-year ratemaking by projecting DSM, pension and salary expenses.
 - TCC's desire for a 429% increase in the catastrophic insurance reserve should be rejected.
 - TCC has reduced expenditures associated with the maintenance of the distribution system. Consequently, the Company has not achieved the reliability standards set out in the PUC's rules. In fact, reliability of TCC's service has declined. The Company owes customers \$2.7 million in service penalties.
 - At the same time that TCC's service reliability and maintenance expenditures are declining, TCC's request includes a substantial amount of affiliated administrative and general expenses. Excessive, as compared to other T&D companies, and unnecessary, affiliated A&G costs of \$13.8 million should be disallowed.
 - Not only is the reliability of TCC's service declining, but TCC has failed to achieve other quality of service standards.
 - TCC's request for a good cause exception to the PUC's rules to allow for a sharing of non-regulated service revenues should be denied in order to help prevent greater cross-subsidy. TCC has not provided reliable, quality service to its captive customers and surely should not be allowed to engage in unregulated businesses.

Recommendation

The electric rate ordinance included in your package adopts your consultants' recommendations and lowers electric T&D rates by \$97 million or 21%. Similar rate ordinances are being considered and adopted by the other participating Cities.

Failure to take action on TCC's application by March 19, 2004 would allow TCC, under the Public Utility Regulatory Act, to implement the Company's proposed rates. It is recommended that the proposed rate Ordinance reducing electric rates by 21% be adopted.

TO: Mayor, City Council

FROM:

DATE:

RE: Staff Report -- Electric Rate Ordinance

Background

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Mick Arndt

Mr. Arndt, a CPA, has been involved in utility regulation for 30 years and has testified in Texas numerous times. He presents Cities' recommended system-wide rate reduction of \$97.715 million. As the regulatory accountant on this case, Mr. Arndt applies well-established ratemaking principals including historical test-year ratemaking. Mr. Arndt adjusts TCC's cost of service to comply with the Agreement approved by the Commission in Docket No. 19265. TCC's faulty interpretation of the Agreement has unnecessarily increased cost of service by about \$30 million. He presents a consolidated tax savings adjustment of \$9.8 million based on the method adopted by the PUC in Docket No. 14965 and approved by the courts. His recommendation concerning the gain on the sale of AEP's affiliated REP provides the fair sharing necessary to ensure customers benefit from the good-will and brand name recognition built by ratepayers over several decades.

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Mr. Starnes is a consultant to two of the largest municipal aggregators in Texas, including STAP, and is intimately familiar with the problems experienced in the transition to competition. Mr. Starnes has evaluated TCC's street and non-roadway lighting rates and services. His investigation reveals that TCC has over-estimated the billing determinants necessary to calculate lighting rates and that the facilities charge is too high in two respects. Adoption of Mr. Starnes' testimony will ensure reasonable rates for a service with significant health and safety implications.

Dr. A. D. Patton

Dr. Patton may be the premier electric system reliability expert in Texas. Dr. Patton concludes that TCC has not achieved the level of service contemplated by the Commission's reliability rules. In fact, Dr. Patton concludes that TCC's service reliability is declining. The cause, according to Cities' witness, is TCC's misallocation of resources. While charging TCC substantial amounts of administrative and general costs ("A&G") incurred in Columbus, Ohio, corporate headquarters has reduced TCC's maintenance budget as well as the work force necessary to maintain the system. Dr. Patton calculates a \$2.7 million service penalty owed customers pursuant to the Agreement adopted by the PUC in a prior docket; recommends that \$1.5 million be reallocated to actual maintenance of the system; finds that \$13.8 million in unnecessary affiliate A&G costs be disallowed; and recommends that one-time, non-recurring costs of \$6 million allocated to distribution O&M be removed from cost of service.

Dr. Sarah Goodfriend

Dr. Sarah Goodfriend, former Texas Commissioner, was asked by Cities to review TCC's interaction with REPs, proposed service fees, TCC's tariff, and compliance with quality of service standards. Cities are concerned about the potential for cross-subsidies and incentive for anti-competitive behavior inherent in the competitive market scheme implemented in Texas. Dr. Goodfriend addresses TCC's poor quality of service which is having adverse cost effects on the market as well as making it more difficult for REPs to compete.

Dr. Goodfriend finds that TCC's service to the REPs does not compare favorably to the quality of service provided by TXU and Reliant. She makes several recommendations designed to curb cross-subsidies and improve service. Among those are to deny TCC's request to share in the profit of non-regulated construction projects and to place a moratorium on TCC's efforts to provide unregulated services. TCC, according to Dr. Goodfriend, should improve services provided to its customers prior to expending resources in providing services to others.

A summary of the consultants' findings are as follows:

- On a system-wide basis, Cities propose a \$97.715 million reduction to existing rates. This compares to the Company's request to increase system-wide rates by \$66.476 million. Cities urge the Commission to decrease transmission rates by \$35.586 million and to decrease distribution rates by \$62.135 million.
- TCC's rate of return is overstated. Cities recommend a return on equity of 9%. As explained by Cities' witness Hill, this is in line with the historic low cost of capital and investors expectations. Cities' ROE recommendation reflects consideration of TCC's failure to provide reliable, quality electric service.
- A capital structure of 60% debt and 40% equity is reasonable. It is the same capital structure adopted by the Commission in CPL's UCOS case and ensures against financial cross-subsidization of the parent company as described by Mr. Hill.
- Adoption of TCC's request would require captive ratepayers to subsidize AEP's unregulated businesses in several respects. As noted above, Cities' financial witness found that adoption of TCC's proposed capital structure would require ratepayers to financially subsidize TCC's parent company. TCC's charges from the affiliated service company result in subsidization and should be reduced by \$16.5 million. The Company's affiliate expense request gives rise to the same concerns as presented in Docket No. 14965 where the Commission disallowed a substantial portion of CPL's affiliate transactions. Finally, TCC's venture into the provision of non-regulated services results in a subsidy by ratepayers and poor customer and distribution service for ratepayers.
- TCC's requested cost of service is inflated because the Company misapplied the provisions of the Agreement approved by the Commission in Docket No. 19265. TCC has inappropriately inflated the cost of service by \$22.5 million as it failed to demonstrate that the rate increase request filed by TCC was not associated with the merger of CSW and AEP. In addition, TCC ignored the Agreement's requirement that TCC's revenue requirement be reduced by \$7.5 million.
- TCC failed to calculate Federal Income Tax expense as though it filed a consolidated tax return. A consolidated income tax savings adjustment of \$9.8 million needs to be made in accordance with state law and well-established PUC precedent.
- Over the years, CPL built up its brand name and good will, fairness requires that TCC customers share in the gain attributed to the sale of AEP's affiliated REPs.

- TCC's depreciation expense is excessive by \$8 million.
- The Company has unreasonably increased cost of service by going well outside the test-year to recognize particular expenses and failing to account for increased revenues. Specifically, TCC has abandoned historical test-year ratemaking by projecting DSM, pension and salary expenses.
- TCC's desire for a 429% increase in the catastrophic insurance reserve should be rejected.
- TCC has reduced expenditures associated with the maintenance of the distribution system. Consequently, the Company has not achieved the reliability standards set out in the PUC's rules. In fact, reliability of TCC's service has declined. The Company owes customers \$2.7 million in service penalties.
- At the same time that TCC's service reliability and maintenance expenditures are declining, TCC's request includes a substantial amount of affiliated administrative and general expenses. Excessive, as compared to other T&D companies, and unnecessary, affiliated A&G costs of \$13.8 million should be disallowed.
- Not only is the reliability of TCC's service declining, but TCC has failed to achieve other quality of service standards.
- TCC's request for a good cause exception to the PUC's rules to allow for a sharing of non-regulated service revenues should be denied in order to help prevent greater cross-subsidy. TCC has not provided reliable, quality service to its captive customers and surely should not be allowed to engage in unregulated businesses.

Recommendation

The electric rate ordinance included in your package adopts your consultants' recommendations and lowers electric T&D rates by \$97 million or 21%. Similar rate ordinances are being considered and adopted by the other participating Cities.

Failure to take action on TCC's application by March 19, 2004 would allow TCC, under the Public Utility Regulatory Act, to implement the Company's proposed rates. It is recommended that the proposed rate Ordinance reducing electric rates by 21% be adopted.

CITIES INTERVENING IN PUC DOCKET NO. 28840

Agua Dulce	Luling
Alamo	Lyford
Alice	Lytle
Alton	Mathis
Aransas Pass	McAllen
Asherton	Mercedes
Bay City	Mission
Bayside	Nordheim
Bayview	Odem
Beeville	Orange Grove
Bishop	Palacios
Carrizo Springs	Palm Valley
Charlotte	Pearsall
Columbus	Peñitas
Corpus Christi	Pharr
Cotulla	Pleasanton
Crystal City	Port Aransas
Del Rio	Port Isabel
Dilley	Portland
Donna	Port Lavaca
Eagle Lake	Poteet
Edinburg	Primera
Edna	Progreso
El Campo	Rancho Viejo
Elsa	Raymondville
Freer	Refugio
Ganado	Rio Hondo
George West	Rio Gande City
Goliad	Rockport
Gregory	Roma
Harlingen	Runge
Ingleside	San Benito
Ingleside on the Bay	San Juan
Jourdanton	Santa Rosa
Karnes City	Sinton
Kingsville	Smiley
La Feria	South Padre Island
Laguna Vista	Taft
La Joya	Three Rivers
Laredo	Uvalde
La Villa	Victoria
Leakey	Weslaco
Los Fresnos	Woodsboro