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245 P.U.R.4th 384

Page 1

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

## H

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.  
Docket No. 04-121-U  
Order No. 16

Arkansas Public Service Commission  
September 19, 2005

ORDER requiring a natural gas local distribution company (LDC) to decrease its rates by \$11.5 million, reflecting an allowed return on equity (ROE) of 9.45% and an overall cost of capital of 5.31%.

The adopted ROE is set below the normally-accepted midpoint of the range found reasonable in consequence of a determination by the commission that the LDC has been deficient in the administration of its tariffs, in its accounting and recordkeeping practices, and in its supporting documentation for rate applications. The commission finds that the evidence, taken as a whole, establishes a pattern of persistent and inadequate customer service and non-compliance with standard accounting practices and commission rules and regulations.

Commission rejects a proposed rate stabilization plan (RSP) that would have provided for annual rate adjustments if earned ROE fell outside of a deadband surrounding allowed ROE. The benefits claimed for the RSP are deemed insufficient to warrant a departure from traditional rate-making policies and procedures. Moreover, the commission finds that the RSP, as proposed, is one-sided in favor of the LDC and its investors.

Commission declines to approve a proposed infrastructure cost recovery (ICR) rider that would have: (1) replaced the existing main replacement program rider as the primary mechanism to fund cast iron and bare steel replacement between rate cases; and (2) allowed between rate case recovery of the costs of (a) street and highway projects of government entities, and (b) legislative and administrative requirements related to public health, safety, and the environment. In rejecting the ICR rider, the commission finds that the LDC has not fully utilized existing means for between rate case recovery of the costs at issue. In addition, it finds that the proposed rider does not meet the criteria traditionally used to evaluate automatic adjustment clauses.

A proposed load change adjustment rider that would adjust rates in response to changes in usage per customer for residential and small commercial sales customers is rejected. The LDC argued that the rider would encourage conservation and efficient use of gas by decoupling revenues from sales. However, the commission

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245 P.U.R.4th 384

Page 2

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

**(Publication page references are not available for this document.)**

finds that the addition of another automatic adjustment clause would diminish the scrutiny associated with general rate cases, as well as the incentive for the LDC to minimize costs. Moreover, it finds that the load change adjustment rider: (1) would inappropriately shift risk from shareholders to ratepayers; (2) would constitute 'piecemeal' ratemaking; (3) would not provide the LDC with sufficient incentive to promote growth in its service territory; and (4) does not meet the criteria traditionally used to evaluate automatic adjustment clauses.

Commission declines to approve a proposed voluntary fixed price option rider for residential and small commercial sales customers. It finds that inasmuch as levelized payment plan options are available there is no reason to add complexity to the gas supply rate process. Concern over the potential for cross subsidization and cost shifting is also cited by the commission as grounds for rejecting the voluntary fixed price option rider.

The LDC is authorized to terminate its rural extension fund due to the lack of a sufficient number of economically feasible projects to which the fund could be applied. The accumulated balance of the fund is to be distributed to ratepayers through a credit to the main replacement rider.

Cash working capital is calculated using a modified balance sheet approach. However, in future proceedings, should a reliable lead lag study be presented, the commission will use a lead lag approach to determine cash working capital.

The pension expense of the LDC is adjusted based on the most recent actuarial report rather than the 2005 budgeted amount. It also reflects a large December 2004 contribution to the pension plan by the corporate parent of the LDC, the effect of which is to reduce the pension expense of the LDC.

Incentive compensation expense is shared on a 50/50 basis between ratepayers and shareholders.

P.U.R. Headnote and Classification

1.

RATES

s120.1

Ar.P.S.C. 2005

[ARK.] Reasonableness -- Test period -- Historical test year -- Adjustment for known and measurable changes -- Natural gas rate proceeding.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

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245 P.U.R.4th 384

Page 3

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

2.

VALUATION

s290

Ar.P.S.C. 2005

[ARK.] Working capital requirement -- Method of calculation -- Modified balance sheet approach -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

3.

VALUATION

s309

Ar.P.S.C. 2005

[ARK.] Cash working capital -- Natural gas local distribution company -- Method of calculation -- Modified balance sheet approach.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

4.

VALUATION

s293

Ar.P.S.C. 2005

[ARK.] Cash working capital -- Method of calculation -- Possible use of lead lag study in future proceedings -- Natural gas LDC.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

5.

VALUATION

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245 P.U.R.4th 384

Page 4

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

s281

Ar.P.S.C. 2005

[ARK.] Natural gas rate base -- Gas in storage -- Inventory balance -- Local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

6.

VALUATION

s192

Ar.P.S.C. 2005

[ARK.] Property excluded from rate base -- Retirement work in progress -- Plant physically removed from service -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

7.

VALUATION

s281

Ar.P.S.C. 2005

[ARK.] Natural gas local distribution company -- Retirement work in progress -- Plant physically removed from service -- Exclusion from rate base.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

8.

EXPENSES

s95

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245 P.U.R.4th 384

Page 5

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

Ar.P.S.C. 2005

[ARK.] Payroll -- Regular salaries and wages -- Competitive pay adjustment --  
Reflection of Pro forma year number of employees -- Rejection of single point  
employee level -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

9.

EXPENSES

s95

Ar.P.S.C. 2005

[ARK.] Payroll -- Overtime -- Actual level -- Rejection of multi-year average --  
Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

10.

EXPENSES

s105

Ar.P.S.C. 2005

[ARK.] Incentive compensation -- Varying payments -- Use of historical average  
-- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

11.

EXPENSES

s105

Ar.P.S.C. 2005

245 P.U.R.4th 384

Page 6

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

[ARK.] Incentive compensation -- 50/50 sharing between ratepayers and shareholders -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

12.

EXPENSES

s19

Ar.P.S.C. 2005

[ARK.] Depreciation -- Development of revised rates -- Cessation of accruals of fully-recovered accounts -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

13.

EXPENSES

s19

Ar.P.S.C. 2005

[ARK.] Depreciation -- Development of revised rates -- Net salvage calculation -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

14.

EXPENSES

s19

Ar.P.S.C. 2005

[ARK.] Depreciation -- Development of revised rates -- Estimate of service lives and salvage percentages -- Average life group procedure -- Natural gas local distribution company.

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245 P.U.R.4th 384

Page 7

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

15.

DEPRECIATION

s31

Ar.P.S.C. 2005

[ARK.] Calculation of annual depreciation -- Life of property and salvage value -- Average life group procedure -- Capping net salvage costs -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

16.

DEPRECIATION

s55

Ar.P.S.C. 2005

[ARK.] Natural gas local distribution company -- Calculation of annual depreciation -- Life of property and salvage value -- Average life group procedure -- Capping net salvage costs.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

17.

DEPRECIATION

s55

Ar.P.S.C. 2005

[ARK.] Natural gas local distribution company -- Data collection and analysis -- Filing requirements.

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245 P.U.R.4th 384

Page 8

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

P.U.R. Headnote and Classification

18.

EXPENSES

s9

Ar.P.S.C. 2005

[ARK.] Ascertainment -- Exclusion of amounts not properly recoverable from ratepayers -- Basis for exclusions -- Results of test year audit sampling -- Description of accounts -- Natural gas rate proceeding.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

19.

EXPENSES

s9

Ar.P.S.C. 2005

[ARK.] Ascertainment -- Exclusion of out-of-period costs -- Natural gas rate proceeding.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

20.

EXPENSES

s46

Ar.P.S.C. 2005

[ARK.] Contributions -- Exclusion from rates -- Natural gas rate proceeding.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

21.

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245 P.U.R.4th 384

Page 9

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

## EXPENSES

s19

Ar.P.S.C. 2005

[ARK.] Entertainment -- Exclusion from rates -- Natural gas rate proceeding.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

22.

## EXPENSES

s49

Ar.P.S.C. 2005

[ARK.] Pension expense -- Method of determination -- Use of most recent  
actuarial report -- Reduction to reflect known and measurable change --  
Contribution to plan by corporate parent -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

23.

## EXPENSES

s83

Ar.P.S.C. 2005

[ARK.] Payments to parent company -- Corporate services -- Shared services -- IT  
services -- Adjustment for known and measurable changes -- Revised allocation  
factors -- Offset for cost savings -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

24.

## EXPENSES

245 P.U.R.4th 384

Page 10

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

s57

Ar.P.S.C. 2005

[ARK.] Interest on customer deposits -- Request for treatment as operating expense -- Grounds for denial -- Inclusion in capital structure -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

25.

EXPENSES

s81

Ar.P.S.C. 2005

[ARK.] Metering -- Contract meter readers -- Actual pro forma year spending -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

26.

EXPENSES

s105

Ar.P.S.C. 2005

[ARK.] Benefits -- Employee savings plan -- Method of calculation -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

27.

EXPENSES

s62

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245 P.U.R.4th 384

Page 11

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

Ar.P.S.C. 2005

[ARK.] Director's and officer's Insurance -- Allocation from corporate parent -- 50/50 sharing between ratepayers and shareholders -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

28.

EXPENSES

s9

Ar.P.S.C. 2005

[ARK.] Ascertainment of revenue requirement -- Allowance for uncollectibles and taxes -- Revenue conversion factor -- Method of calculation -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

29.

EXPENSES

s125

Ar.P.S.C. 2005

[ARK.] Natural gas local distribution company -- Ascertainment of revenue requirement -- Allowance for uncollectibles and taxes -- Revenue conversion factor.

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P.U.R. Headnote and Classification

30.

RETURN

s26.4

Ar.P.S.C. 2005

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245 P.U.R.4th 384

Page 12

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

[ARK.] Reasonableness -- Cost of equity -- Estimation methodology -- Discounted cash flow analysis -- Appropriate growth rate -- Natural gas rate proceeding.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

31.

RETURN

s26.4

Ar.P.S.C. 2005

[ARK.] Reasonableness -- Cost of equity -- Rejected estimation methodology -- Allowed returns in other states -- Expected returns on pension plan investments -- Capital asset pricing model -- Risk premium analysis -- Natural gas rate proceeding.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

32.

RETURN

s26.4

Ar.P.S.C. 2005

[ARK.] Reasonableness -- Cost of equity -- Estimation methodology -- Reliance on discounted cash flow analysis -- Rejection of other methods -- Natural gas rate proceeding.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

33.

RETURN

s26.4

Ar.P.S.C. 2005

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245 P.U.R.4th 384

Page 13

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

[ARK.] Reasonableness -- Cost of equity -- Factors considered -- Business and regulatory risk -- Discussion

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

34.

RETURN

s44

Ar.P.S.C. 2005

[ARK.] Reasonableness -- Factors considered -- Business and regulatory risk -- Discussion

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

35.

RETURN

s26.1

Ar.P.S.C. 2005

[ARK.] Reasonableness -- Capital structure -- Inclusion of short-term debt -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

36.

RETURN

s26.1

Ar.P.S.C. 2005

[ARK.] Reasonableness -- Capital structure -- Inclusion of customer deposits -- Natural gas local distribution company.

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245 P.U.R.4th 384

Page 14

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

37.

RETURN

s26.1

Ar.P.S.C. 2005

[ARK.] Reasonableness -- Capital structure -- Long-term debt -- Preferred stock  
-- Use of current cost rates -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

38.

RETURN

s92

Ar.P.S.C. 2005

[ARK.] Natural gas local distribution company -- Overall cost of capital --  
Reasonableness.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

39.

RETURN

s26.4

Ar.P.S.C. 2005

[ARK.] Reasonableness -- Cost of equity -- Natural gas local distribution  
company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

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245 P.U.R.4th 384

Page 15

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

40.

RETURN

s27

Ar.P.S.C. 2005

[ARK.] Reasonableness -- Interest coverage -- Total debt coverage -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

41.

RETURN

s92

Ar.P.S.C. 2005

[ARK.] Natural gas local distribution company -- Overall cost of capital -- Interest coverage -- Total debt coverage -- Reasonableness.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

42.

RATES

s373

Ar.P.S.C. 2005

[ARK.] Natural gas -- Allocation of costs among customer classes -- Local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

43.

APPORTIONMENT

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245 P.U.R.4th 384

Page 16

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

s47

Ar.P.S.C. 2005

[ARK.] Revenues -- Natural gas -- Administrative fees for transportation supply option -- Allocation based on total gross cost of service -- Local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

44.

APPORTIONMENT

s30

Ar.P.S.C. 2005

[ARK.] Natural gas costs -- Administration of purchases and transportation -- Allocation based on operation and maintenance -- Local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

45.

APPORTIONMENT

s30

Ar.P.S.C. 2005

[ARK.] Natural gas costs -- Allocation of capacity costs -- Demand-based allocations -- Local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

46.

RATES

s373

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245 P.U.R.4th 384

Page 17

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

Ar.P.S.C. 2005

[ARK.] Natural gas -- Allocation of costs among customer classes -- Capacity costs -- Demand-based allocations -- Local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

47.

APPORTIONMENT

s30

Ar.P.S.C. 2005

[ARK.] Natural gas costs -- Cash working capital -- Allocation methodology -- Local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

48.

RATES

s373

Ar.P.S.C. 2005

[ARK.] Natural gas -- Allocation of costs among customer classes -- Cash working capital -- Local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

49.

APPORTIONMENT

s11

Ar.P.S.C. 2005

[ARK.] Distribution costs -- Classification and cost allocation of gas

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245 P.U.R.4th 384

Page 18

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

distribution mains -- Separation of customer-related function from capacity-related function -- Minimum size method -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

50.

APPORTIONMENT

s30

Ar.P.S.C. 2005

[ARK.] Natural gas -- Classification and cost allocation of distribution mains -- Separation of customer-related function from capacity-related function -- Minimum size method -- Local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

51.

APPORTIONMENT

s58

Ar.P.S.C. 2005

[ARK.] Natural gas -- Classification and cost allocation of distribution mains -- Separation of customer-related function from capacity-related function -- Minimum size method -- Local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

52.

RATES

s373

Ar.P.S.C. 2005

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245 P.U.R.4th 384

Page 19

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

[ARK.] Natural gas -- Allocation of costs among customer classes --  
Classification and cost allocation of distribution mains -- Separation of  
customer-related function from capacity-related function -- Minimum size method --  
Local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

53.

APPORTIONMENT

s11

Ar.P.S.C. 2005

[ARK.] Distribution costs -- Classification and cost allocation of gas  
distribution mains -- Zero-intercept method -- Data integrity issues -- Need for  
valid regression method -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

54.

APPORTIONMENT

s30

Ar.P.S.C. 2005

[ARK.] Natural gas -- Classification and cost allocation of distribution mains  
-- Separation of customer-related function from capacity-related function --  
Zero-intercept method -- Data integrity issues -- Need for valid regression method  
-- Local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

55.

APPORTIONMENT

s58

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245 P.U.R.4th 384

Page 20

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

Ar.P.S.C. 2005

[ARK.] Natural gas -- Classification and cost allocation of distribution mains  
-- Separation of customer-related function from capacity-related function --  
Zero-intercept method -- Data integrity issues -- Need for valid regression method  
-- Local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

56.

RATES

s373

Ar.P.S.C. 2005

[ARK.] Natural gas -- Allocation of costs among customer classes -- Customer  
accounting and sales expense -- Local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

57.

APPORTIONMENT

s30

Ar.P.S.C. 2005

[ARK.] Natural gas costs -- Customer accounting and sales expense -- Allocation  
methodology -- Allocation based on unweighted customer counts -- Local  
distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

58.

APPORTIONMENT

s30

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245 P.U.R.4th 384

Page 21

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

Ar.P.S.C. 2005

[ARK.] Natural gas costs -- Customer allocation factors -- Allocation based on normalized customer counts -- Local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

59.

RATES

s373

Ar.P.S.C. 2005

[ARK.] Natural gas -- Allocation of costs among customer classes -- Customer allocation factors -- Allocation based on normalized customer counts -- Local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

60.

APPORTIONMENT

s30

Ar.P.S.C. 2005

[ARK.] Natural gas costs -- Distribution load dispatching -- Classification and allocation as capacity-related -- Local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

61.

APPORTIONMENT

s30

Ar.P.S.C. 2005

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245 P.U.R.4th 384

Page 22

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

[ARK.] Natural gas costs -- Gas storage inventory -- Relative demand allocation  
-- Local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

62.

RATES

s373

Ar.P.S.C. 2005

[ARK.] Natural gas -- Allocation of costs among customer classes -- Gas storage  
inventory -- Relative demand allocation -- Local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

63.

APPORTIONMENT

s30

Ar.P.S.C. 2005

[ARK.] Natural gas costs -- Land occupied by mains and other grid components --  
Classification and allocation based on all facilities on grid -- Local  
distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

64.

APPORTIONMENT

s30

Ar.P.S.C. 2005

[ARK.] Natural gas costs -- Measuring and regulating station equipment --  
Classification as capacity-related -- Allocation based on demand -- Local

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245 P.U.R.4th 384

Page 23

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

65.

APPORTIONMENT

s19

Ar.P.S.C. 2005

[ARK.] Meter installations -- Cost allocation -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

66.

APPORTIONMENT

s47

Ar.P.S.C. 2005

[ARK.] Natural gas -- Other operating revenue -- Allocation based on gross margins -- Local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

67.

APPORTIONMENT

s30

Ar.P.S.C. 2005

[ARK.] Natural gas costs -- Regulatory commission expense -- Classification as revenue-related -- Allocation based on revenues -- Local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

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245 P.U.R.4th 384

Page 24

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

P.U.R. Headnote and Classification

68.

APPORTIONMENT

s30

Ar.P.S.C. 2005

[ARK.] Natural gas costs -- Services -- Metering, measuring, and regulating equipment -- Classification as customer-related -- Allocation based on normalized customer counts -- Local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

69.

APPORTIONMENT

s19

Ar.P.S.C. 2005

[ARK.] Telemetering -- Allocation based on operation and maintenance expense -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

70.

RATES

s373

Ar.P.S.C. 2005

[ARK.] Natural gas rate design -- Allocation of decrease -- Deviation from concept of equal rates of return -- Local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

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245 P.U.R.4th 384

Page 25

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

71.

RATES

s385

Ar.P.S.C. 2005

[ARK.] Natural gas rate design -- Residential class -- Allocation of decrease -- Continuation of current customer charge -- Reduced second block rate -- Local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

72.

EXPENSES

s19

Ar.P.S.C. 2005

[ARK.] Residential customer survey -- Study of customer base -- Authorized expenditure -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

73.

RATES

s384

Ar.P.S.C. 2005

[ARK.] Natural gas rate design -- Small commercial class -- Customer charge -- Volumetric billing for gas supply rate -- Local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

74.

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245 P.U.R.4th 384

Page 26

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

#### RATES

s384

Ar.P.S.C. 2005

[ARK.] Natural gas rate design -- Large commercial class -- Maintenance of current structure -- Local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

75.

#### PUBLIC UTILITIES

s78

Ar.P.S.C. 2005

[ARK.] Alternative regulatory frameworks -- Natural gas rate regulation -- Proposed rate stabilization plan -- Earnings-based rate adjustments -- Grounds for rejection.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

76.

#### REGULATION

Ar.P.S.C. 2005

[ARK.] Natural gas -- Proposed departure from traditional rate regulation -- Rate stabilization plan -- Earnings-based rate adjustments -- Grounds for rejection.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

77.

#### RATES

s380

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245 P.U.R.4th 384

Page 27

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

Ar.P.S.C. 2005

[ARK.] Natural gas -- Proposed departure from traditional policies and procedures -- Rate stabilization plan -- Earnings-based rate adjustments -- Grounds for rejection.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

78.

AUTOMATIC ADJUSTMENT CLAUSES

s47

Ar.P.S.C. 2005

[ARK.] Earnings-based rate adjustments -- Proposed rate stabilization plan -- Natural gas local distribution company -- Grounds for rejection.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

79.

RATES

s235

Ar.P.S.C. 2005

[ARK.] Initiation of changes -- Recovery of costs between rate cases -- Proposed infrastructure cost recovery rider -- Natural gas local distribution company -- Grounds for rejection.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

80.

AUTOMATIC ADJUSTMENT CLAUSES

s36

Ar.P.S.C. 2005

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245 P.U.R.4th 384

Page 28

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

[ARK.] Cost of service -- Recovery of costs between rate cases -- Proposed infrastructure cost recovery rider -- Natural gas local distribution company -- Grounds for rejection.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

81.

EXPENSES

s125

Ar.P.S.C. 2005

[ARK.] Natural gas local distribution company -- Between rate case recovery -- Proposed infrastructure cost recovery rider -- Grounds for rejection.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

82.

RATES

s380

Ar.P.S.C. 2005

[ARK.] Natural gas -- Special factors -- Proposed infrastructure cost recovery rider -- Local distribution company -- Grounds for rejection.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

83.

REVENUES

s5

Ar.P.S.C. 2005

[ARK.] Natural gas -- Decoupling from sales -- Proposed load change adjustment rider -- Local distribution company -- Grounds for rejection.

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245 P.U.R.4th 384

Page 29

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

84.

RATES

s380

Ar.P.S.C. 2005

[ARK.] Natural gas -- Special factors -- Decoupling of revenues from sales -- Proposed load change adjustment rider -- Local distribution company -- Grounds for rejection.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

85.

AUTOMATIC ADJUSTMENT CLAUSES

s45

Ar.P.S.C. 2005

[ARK.] Revenue requirement clauses -- Decoupling of revenues from sales -- Proposed load change adjustment rider -- Local distribution company -- Grounds for rejection.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

86.

SERVICE

s332

Ar.P.S.C. 2005

[ARK.] Natural gas sales service -- Proposed voluntary fixed price option -- Local distribution company -- Grounds for rejection.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

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245 P.U.R.4th 384

Page 30

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

P.U.R. Headnote and Classification

87.

RATES

s384

Ar.P.S.C. 2005

[ARK.] Natural gas sales -- Proposed voluntary fixed price option -- Grounds for rejection -- Potential for cross subsidization and cost shifting -- Existence of levelized payment plan options -- Local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

88.

PAYMENT

s17

Ar.P.S.C. 2005

[ARK.] Billing -- Levelized payment plan options -- No need for fixed price service -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

89.

SERVICE

s199

Ar.P.S.C. 2005

[ARK.] Natural gas extensions -- Rural extension fund -- Termination and refund of remaining monies -- Distribution to ratepayers though credit to main replacement program rider -- Local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

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245 P.U.R.4th 384

Page 31

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

90.

REPARATIONS

s15

Ar.P.S.C. 2005

[ARK.] Grounds for allowing -- Termination of rural extension fund -- Return of balance to ratepayers -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

91.

REPARATIONS

s39

Ar.P.S.C. 2005

[ARK.] Method of payment -- Credit to rate rider -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

92.

REPARATIONS

s39

Ar.P.S.C. 2005

[ARK.] Persons to benefit -- Termination of rural extension fund -- Return of balance to ratepayers -- Credit to rate rider -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

93.

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245 P.U.R.4th 384

Page 32

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

SERVICE

s339.4

Ar.P.S.C. 2005

[ARK.] Natural gas local distribution company -- Capacity release policy -- Upstream contract flexibility -- Proposed modification of policy -- Grounds for denial.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

94.

GAS

s7

Ar.P.S.C. 2005

[ARK.] Local distribution company -- Capacity release policy -- Proposed modification -- Grounds for denial.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

95.

RETURN

s36

Ar.P.S.C. 2005

[ARK.] Reasonableness -- Factors considered -- Efficiency of management and character of service -- Adoption of return below normally-accepted midpoint of range found reasonable -- Grounds -- Deficient tariff administration -- Deficient accounting and recordkeeping -- Deficient rate case filings -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

96.

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245 P.U.R.4th 384

Page 33

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

RETURN

s26.4

Ar.P.S.C. 2005

[ARK.] Reasonableness -- Return on equity -- Adoption of return below normally-accepted midpoint of range found reasonable -- Grounds -- Deficient tariff administration -- Deficient accounting and recordkeeping -- Deficient rate case filings -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

97.

RATES

s640

Ar.P.S.C. 2005

[ARK.] Practice and procedure -- Recordkeeping and reporting requirements -- Commission staff access to external audit workpapers -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

98.

PROCEDURE

s16

Ar.P.S.C. 2005

[ARK.] Production of evidence -- Commission staff access to external audit workpapers -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

99.

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245 P.U.R.4th 384

Page 34

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

#### AUTOMATIC ADJUSTMENT CLAUSES

s54

Ar.P.S.C. 2005

[ARK.] Over- or undercollections -- Interest rate -- Main replacement program rider -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

100.

#### RATES

s640

Ar.P.S.C. 2005

[ARK.] Practice and procedure -- Recordkeeping and reporting -- Costs allocated or direct charged from affiliates -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

101.

#### PROCEDURE

s18

Ar.P.S.C. 2005

[ARK.] Production of evidence -- Matters related to intercorporate relations -- Recordkeeping and reporting -- Costs allocated or direct charged from affiliates -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

102.

#### INTERCORPORATE RELATIONS

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245 P.U.R.4th 384

Page 35

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

s12

Ar.P.S.C. 2005

[ARK.] Jurisdiction and powers -- State commission -- Utility dealings with affiliated interests -- Recordkeeping and reporting procedures -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

103.

APPORTIONMENT

s19

Ar.P.S.C. 2005

[ARK.] Meters, regulators, and domestic meter installations -- Direct assignment going forward -- Allocation of historical balances -- Natural gas local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

P.U.R. Headnote and Classification

104.

APPORTIONMENT

s30

Ar.P.S.C. 2005

[ARK.] Natural gas -- Meters, regulators, and domestic meter installations -- Cost allocation -- Direct assignment going forward -- Allocation of historical balances -- Local distribution company.

Re CenterPoint Energy Arkla, a Division of CenterPoint Energy Resources Corp.

Before Hochstetter, chairman and Bassett and Bynum, commissioners.

BY THE COMMISSION:

ORDER

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245 P.U.R.4th 384

Page 36

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

On November 24, 2004, CenterPoint Energy Arkla ('Arkla' or the 'Company ') filed an Application for approval of a general change or modification in its rates and tariffs. [FN1] Arkla's initial Application reflects that it was seeking a non-gas rate increase of \$33,996,382 based on an overall non-gas revenue requirement of \$182,525,265. Order No. 4, entered on December 16, 2004, suspended Arkla's proposed rates, charges, and tariffs pending further investigation by the Commission.

The parties to this proceeding are Arkla, the General Staff of the Arkansas Public Service Commission ('Staff'), the Attorney General of Arkansas ('AG '), Arkansas Gas Consumers ('AGC'), and the Commercial Energy Users Group ('CEUG').

Arkla filed the written testimonies of Jeffrey A. Bish, Charles J. Harder, F. Jay Cummings, Samuel C. Hadaway, Alan D. Henry, Michael TheBerge, Gerald W. Tucker, Steve Malkey, Michael J. Adams, Walter L. Fitzgerald, Michael Hamilton, and John J. Spanos. The Staff filed the written testimonies of Robert Booth, Alice D. Wright, Alisa Williams, [FN2] Don E. Martin, Gail P. Fritchman, Don Malone, L.A. Richmond, Gayle Frier, Johnny Brown, Robert H. Swaim, and Adrienne R.W. Bradley. The AG filed the written testimony of William B. Marcus. AGC filed the written testimonies of Denise E. Baker, and Chnstopher A. John. CEUG filed the written testimonies of Steven A. Ward, and Timothy P. Staley.

#### PUBLIC HEARINGS

A Public evidentiary hearing was held in Little Rock, Arkansas, on August 9- 12, 2005, for the purpose of receiving public comments, opening statements, and litigating the issues contested by the parties in this proceeding. Additional public comment hearings were conducted at various locations within Arkla's service territory: on August 19, 2005, in Monticello, AR, on August 23, 2005, in Jonesboro, AR, August 25, 2005, in Brinkley, AR, on August 26, 2005, in Texarkana, AR, and on August 30, 2005, in Russellville, AR.

#### TEST YEAR

[1] Arkla's Application in this proceeding is based on a test year ended April 30, 2004 which utilized 12 months of historical data, as adjusted for known and measurable changes for the pro forma year ended April 30, 2005.

#### POSITIONS OF THE PARTIES

Arkla's sur-surrebuttal case, filed on July 22, 2005, revised Arkla's non-gas revenue deficiency to \$27,938,538 [FN3] based on an overall non-gas revenue requirement of \$178,859,792. Also, Arkla proposed: to use a lead lag study ('LLS') rather than the Modified Balance Sheet Approach ('MBSA') to determine the amount of cash working capital to include in rate base; to increase the residential customer charge from \$9.75 to \$17.00; to provide a Voluntary Fixed Price Option ('VFPO') which would allow qualifying customers to fix the cost of their gas supply; and to terminate its Rural Extension Fund ('REF') by contributing those

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245 P.U.R.4th 384

Page 37

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

funds to Arkla's Good Neighbor Fund, and the Arkansas Weatherization Assistance Program. Arkla also proposed various riders, including: (1) a Load Change Adjustment ('LCA'), which would provide margin recovery due to the decline in customers and the decline in average use per customer; (2) an Infrastructure Cost Recovery Rider ('ICR'), which provides for the recovery of the cost of capital related to certain non-revenue producing capital investments in natural gas facilities and certain operating expenses; and (3) if the Commission chooses not to adopt the LCA and/or ICR, a Rate Stabilization Plan which would adjust Arkla's rates or credit customer bills annually to reflect changes in costs and revenues.

In its Surrebuttal case, the Staff determined that Arkla has a revenue excess of \$12,714,105 and a non-gas revenue requirement of \$138,207,149. Major differences between the Arkla and Staff case positions include: plant-in-service, working capital assets; rate of return; depreciation expense; employee wages; salaries and compensation; the cash balance benefit and restoration plan expense; and cost allocation and rate design. The Staff opposes all of Arkla's proposed riders, the VFPO, and the manner in which the termination of the REF is treated.

Neither the AG, AGC, nor CEUG addressed all aspects of Arkla's rate case filing. The AG addressed some rate base and expense issues, rate of return, cost allocation and rate design, and Arkla's rate rider proposals. The AGC made recommendations which concerned cost allocation and rate design, cash working capital, various tariff issues, and Arkla's proposed riders. The CEUG made recommendations to the Commission concerning cost allocation and rate design, rate of return, various tariff issues, billing determinants, master metering combined billing, rate case expense, and Arkla's proposed riders.

#### LITIGATED ISSUES

Below are the Commission's findings on issues litigated by the parties in this proceeding:

#### I. RATE BASE

##### RES-5 Working Capital Assets -- MBSA/Lead Lag Study

[2-4] For approximately the past twenty years, this Commission has used the Modified Balance Sheet Approach ('MBSA'), either in the absence of a lead-lag study ('LLS') or as a check on a LLS filed by a utility (Order No. 7 of Docket No. 84-199-U). This approach has been affirmed on appeal in *General Telephone Co. of the Southwest v. Arkansas Public Service Commission*, 23 Ark. 595, 751 S.W.2d 1 (1988), *General Waterworks of Pine Bluff v. Arkansas Public Service Commission*, 25 Ark. App. 49, 752 S.W. 2nd 52 (1988), and *Associated Natural Gas Company v. Arkansas Public Service Commission*, 25 Ark. App. 115, 752 S.W.2d 766 (1988). The MBSA recognizes three basic facts: (1) a utility has investments in assets other than plant which are necessary to provide utility service, and on which a return should be allowed; (2) a utility has sources of funds, other than equity and long-term debt, which should be included in the capital structure; and (3) all

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245 P.U.R.4th 384

Page 38

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

**(Publication page references are not available for this document.)**

liabilities are fungible sources of funds that are used to fund each and every asset of the utility. A corollary of this third point is that zero-cost liabilities should be placed in the capital structure in calculating the utility's cost of capital.

A LLS attempts to measure the advances and delays involved with expenses and revenues associated with a company's operations on a day-to-day basis. The lags are generally associated with the delay from when customers receive service and when they pay for such service. The leads are associated with the time between when goods and services are rendered to the utility and when the utility pays for the goods and services. A LLS generally will result in a ratio of lead or lag days to the number of days in a year. If the LLS indicates a net lag (positive), such net lag indicates that on average the utility is providing net capital ahead of time to finance customers' normal lag in payment of bills, and this amount should be added to rate base. If there is a net lead, such net lead implies that the utility has a source of zero-cost capital from suppliers of goods and services, which amount should be used to reduce rate base.

A major presentation difference between the MBSA and a LLS in a rate case is that the MBSA has implications for both rate base and the capital structure, while the LLS simply increases or decreases the rate base. Of course, if both are done properly, the revenue requirement results should be approximately equivalent. The MBSA will necessarily result in a greater rate base because the expense lag is not deducted from rate base as is the case with a LLS. Further, the MBSA will necessarily result in a smaller rate of return since the expense lag is comprehended as zero-cost capital. Expenses incurred by the Company give rise to liabilities to be paid by the Company. Further, the lag associated with billing and collecting revenues derived from providing service to ratepayers causes assets, specifically accounts receivable, to be created. (T. 370) The MBSA provides a similar measurement of working capital in that it measures, through thirteen-month averages, leads and lags comparable to leads and lags stated in the Company's LLS. (T. 374 and T. 379)

The rationale for placing all liabilities in the capital structure with the MBSA is that all liabilities are sources of funds used to finance the assets of the Company. No distinction can be made as to which asset a liability is funding because the funds provided by liabilities are fungible. Therefore, to determine the total cost of funds for the Company, the MBSA posits that we cannot ignore current, accrued, and other liabilities. This Commission has consistently acknowledged the concept of fungibility going back at least thirty years. This position has also been accepted by the Arkansas Court of Appeals in *Southwestern Bell Telephone Company v. Arkansas Public Service Commission*, 24 Ark. App. 142, 751 S.W. 2d, 8 (1988).

Arkla implied that the MBSA method is out-of-step with the rest of the country. (T. 747-748, 769) Arkla witness Adams, using Arkla Exhibit MJA-1, testified that 41 of 51 regulatory jurisdictions allow working capital based upon a LLS and five jurisdictions rely upon a balance sheet method. The implication from that exhibit

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245 P.U.R.4th 384

Page 39

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

is that the LLS is preferred across the country. However, it should be noted that Exhibit MJA-1 does not show that jurisdictions that use LLS accept a flawed or incomplete LLS. This Commission is not opposed to the use of a reliable LLS, but the use of a 'sampling' technique, which can produce an unreliable LLS result, is not a sufficient substitute for an MBSA.

Arkla presented an LLS prepared by Arkla witness Tucker in Direct Testimony. In that study, the revenue collection lag was developed using a sample of 4,394 transactions for residential customers and 497 transactions for commercial and industrial customers. The revenue lag was 47.721 days and 43.126 days for residential and commercial/industrial customers, respectively. (T. 1014) Similar analyses were performed for purchased gas, income taxes, payroll, short-term incentive compensation, other operation and maintenance ('O&M ') expenses, taxes other than income, interest on customer advances and deposits, minimum bank balances, and working funds. (T. 1019) As a result of his LLS analysis, Mr. Tucker recommended an addition for cash working capital to Arkla's rate base of \$10,159,575. (T. 1019)

Staff witness Richmond argued that Arkla's LLS did not produce comparable results to those of the MBSA. (T. 1678) According to Mr. Richmond, the MBSA is an all-inclusive method, including all accounts and liabilities, while the LLS is not necessarily all-inclusive. The MBSA should be used to assess the reasonableness of the LLS. In particular, according to Mr. Richmond, (T. 1678-1681), Arkla's LLS as submitted in this case:

- (1) failed to consider accrued interest payable on debt;
- (2) failed to consider time-lags associated with amounts that are capitalized;
- (3) incorrectly calculated the revenue lag-residential;
- (4) incorrectly calculated the purchased gas cost-lag; and
- (5) potentially had sampling errors as a general problem with the LLS. (T. 1678-1681)

Further, Arkla's application of the LLS instead of an MBSA, using its own Filing Schedules (B-4, B-5, D-5, and D-6), results in an overstatement of revenue requirement of approximately \$11.5 million. (T. 444 and 1085-1086) Because of this readily discernible overstatement and the readily identifiable deficiencies in Arkla's LLS, Mr. Richmond concluded that there was a problem with Arkla's LLS, and that the MBSA better reflects the cash working capital requirements of Arkla. (T. 444-445)

Another, more general, problem with Arkla's LLS identified by Mr. Richmond is that it relies upon samples, which may not encompass all of the days in the test year. In sharp contrast, the MBSA is all inclusive. (T. 451 and T. 455) It considers all liabilities and assets and all days of the test year, since each

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245 P.U.R.4th 384

Page 40

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

end-of-month balance includes the effects of all of the days in the month.

For Staff's MBSA, Staff witness Richmond calculated Working Capital Assets ('WCA') as an addition to rate base, and included current, accrued, and other liabilities ('CAOL') at their appropriate costs. Mr. Richmond calculated \$121,536,104 for WCA based on a 13-month average of asset accounts for the 13 months ended April 30, 2004, as adjusted. (T. 1669) In calculating WCA, Mr. Richmond made adjustments to the Company's calculations in order to derive more representative balances for: (1) storage gas inventory; (2) bank account and cash amounts; (3) Accounts Receivable Contra account and Note Receivable-Associated Company account related to factoring; (4) Accumulated Provision for Uncollectible Accounts Receivable for bad debt reserve; (5) Unbilled Customer Accounts Receivable; (6) Deferred Arkansas Rate Case Expense; and (7) Miscellaneous other adjustments. (T. 1670-1673) The net effect of Mr. Richmond's adjustments is an increase in WCA of \$65,786,281, resulting in a balance of \$121,536,104. (T. 1673)

For the CAOL component of his MBSA, Mr. Richmond calculated the average CAOL on a total company basis for the test year, using 13 month averages ending April 30, 2004, for all liabilities. (T. 1706) In particular, Mr. Richmond included dividends payable and interest payable. (T. 1675-1677) (T. 1454) Mr. Richmond calculated CAOL of \$155,923,798. (T. 1677) AG witness Marcus agreed with the inclusion of interest payable as a zero-cost component of CAOL.

Arkla disagreed with all of Staff witness Richmond's adjustments with the exception of his adjustment for purchased gas lead (T. 1021-1031). Arkla witness Tucker disagreed with the inclusion of accrued interest and dividends payable in CAOL at zero-cost because those amounts belong entirely to the providers of capital and the rates of return that lenders and stockholders demand reflect these discrete payment conventions. (T. 757-758, 924, 1026)

In Rebuttal Testimony, Arkla witness Harder proposed adjustments to Staff's WCA in the amount of \$18,764,863 for gas in storage inventory and unbilled revenues. (T. 131-133) Staff witness Richmond agreed with those adjustments to gas storage inventory and unbilled revenues which resulted in an adjustment of \$84,551,144 and a revised balance of \$140,300,967. (T. 1703-1706) However, Mr. Richmond did not agree with Mr. Harder's proposed increase in cash and cash equivalents in WCA by \$5,427,354 and deferred rate case expense in WCA. (T. 1704-1706)

Arkla witness Adams alleged in Rebuttal Testimony that over one-half of the CAOL included by Staff in the capital structure either does not represent a source of funds or is not a zero cost source of funds: (1) \$5.6 million in Accumulated Provisions for Injuries and Damages; (2) Pension Liability; (3) Other Post-Employment Benefits; and (4) Notes Payable-Associated Companies. (T. 758-762)

Staff witness Richmond disagreed with those claims, with the exception of the removal of the 13-month balance of \$21,386,116 in the Post-Retirement-FAS 106 liability account from CAOL (T. 1710-1714). AG witness Marcus also argued for inclusion of the reserve for Injuries and Damages in CAOL. (T. 135) Staff

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245 P.U.R.4th 384

Page 41

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

witnesses Richmond and Brown also disagreed with Arkla's claims that accrued interest payable and dividends payable should not be included in CAOL. (T. 1715-1716, 1886-1887)

Additionally Mr. Richmond made adjustments to include \$12,094,413 in Accounts Payable-Gas to recognize liability for additional firm storage capacity, \$921,953 for an update of gas storage inventory amounts, and increases for accrued dividends payable. (T. 1717)

As a result of these revisions, Staff's revised CAOL is \$147,652,949, which is a decrease of \$8,270,849 from CAOL in Staff's Prepared Testimony. (T. 1717)

Mr. Richmond also modified Accumulated Deferred Income Taxes ('ADIT') as of April 30, 2005, from the Company-proposed \$33,076,031 to \$37,046,891. This difference is related to the depreciation portion of ADIT, and is based on Staff's updated depreciation expense for the pro forma year. (T. 1717-1718) Mr. Richmond also proposed that, if Arkla's proposed new depreciation rates are accepted, any changes in timing differences between book and tax depreciation be appropriately reflected in ADIT.

The Staff has met the threshold issue of identifying a sufficient number of flaws in the Company's lead-lag study, therefore, it is appropriate to utilize Staff's MBSA in this particular case. We comment on several of the contested issues.

First, we note that the Company fails to understand the Staff's rationale for inclusion of accrued interest and dividends payable as zero-cost sources of capital. Because investors in Company debt instruments and in common stock do not immediately receive returns on their investments, but receive the required returns with a lag, those same investors require correspondingly higher returns than if cash flows were received daily or weekly. Further, those higher costs of debt and equity are reflected in market-based methods for determining those costs. This Commission properly reflects those market-based costs in rate determinations. Until dividends and interest are paid, the Company has the use of that money. Without appropriate adjustments for accrued interest and dividends payable, the Company's ratepayers would be paying twice for that lag in payments to debt-holders and stockholders. (T.1887-1888) In particular, the Commission's preferred method for calculating the cost of equity, the Discounted Cash Flow ('DCF') Method, explicitly includes as a component of the DCF calculation the dividend yield, (Dividend/Market Price). Because of the lag in receipt of dividends, reflected in dividends payable, the market price is correspondingly smaller, and the dividend yield is greater. This makes the DCF estimated cost of equity larger. Consequently, shareholders are already allowed a higher return for the lag in dividend payments. We agree with Staff that accrued interest and dividends payable, as calculated by Staff, should be included at zero-cost in CAOL.

Although the Company purportedly attempted to include accrued interest, it did so using a lag of only 32.958 days, based on the timing of Arkla's payment of interest to the parent company. (T. 1626-1627) This is significantly shorter than

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245 P.U.R.4th 384

Page 42

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

**(Publication page references are not available for this document.)**

Staff witness Richmond's accrued interest lag of 91.25 days, based upon the fact that interest is paid at six month intervals. (T. 1676) We agree with Staff's approach, as ratepayers should not be penalized because Arkla turns the money over to its parent more often than necessary.

With regard to Account 228.2 Injuries and Damages-General Liability, Injuries and Damages-Workers Comp, Staff has included these expenses in revenue requirements, so that ratepayers are paying those expenses on a daily basis. This is shown in the Surrebuttal Testimony of Staff witness Richmond, pp. 28-9 and the Surrebuttal Testimony of Staff witness Malone, p. 13. We agree with Staff that Account 228.2, as adjusted by Staff, should be included at zero-cost in CAOL.

With regard to Account No. 228.3, Pension Liability, excluding Other Post-Employment Benefits ('OPEB'), Staff has already included these expenses in the revenue requirement, so that ratepayers are already paying those expenses on a daily basis. This is shown in the Surrebuttal Testimony of Staff witness Malone, pp. 8-11. We agree with Staff that Account 228.3, as adjusted by Staff, should be included at zero-cost in CAOL.

With regard to Account No. 233, ST Notes and LT Payable to Associated Companies, the Staff eliminated the interest-bearing portion of the account from Current, Accrued, and Other Liabilities. This is addressed in the Surrebuttal Testimony of Staff witness Richmond, pp. 19-20. In Sur-Surrebuttal Testimony, Arkla witness Adams agreed that Staff correctly removed the interest bearing portion of this account. We agree with Staff that Account 233, as adjusted by Staff, should be included at zero-cost in CAOL.

Arkla witness Adams argued that the low overall rate of return recommended by Staff is attributable to the application of the MBSA. (T. 773) As we discussed earlier, the application of the MBSA will necessarily result in a smaller rate of return but a greater rate base. Consequently, there is nothing inherently punitive about the MBSA. Further, as we discuss later, Staff witness Brown has shown that Staff's overall recommendations, including return on equity, result in Funds from Operations Interest Coverage of at least 5.0, Funds from Operations to Total Debt Coverage of at least 24%, and a total debt ratio of 54%. (T. 773, 1127-1128) Each of these financial measures meet or exceed Standard and Poor's benchmarks for an A-rated utility with a business position of 3. [FN4]

One other issue related to cash working capital needs to be addressed. Staff witness Brown argued that the application of the MBSA in this case produces reasonable results, and, in particular that the MBSA method increases Arkla's revenue requirement by \$3.5 million. (T. 1884-1885) The Company attempted to disprove that allegation on cross-examination of Mr. Brown at hearing.

As discussed in that cross-examination colloquy, the \$3.5 million increase was determined by taking Staff's rate base of \$469 million, found in Surrebuttal Exhibit GPF-2, page 1 of 1 (T. 1058, line 13; T. 499-500), multiplied by a pre-tax cost of capital of 7.19 percent to get a result of \$33,710,198. (T. 500) Compare

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245 P.U.R.4th 384

Page 43

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

this to the result without the MBSA method: multiply Staff's net utility plant in service of \$328 million, [FN5] found in Surrebuttal Exhibit GPF-2, page 1 of 1 (T. 1058, T. 500) times the pretax cost of capital of 9.2 %, without CAOL and zero cost in that calculation, to obtain \$30,226,361. The difference between these two calculations is \$33,710,198-\$30,226,361, or approximately \$3.5 million.

On cross-examination, Arkla's counsel attempted to disprove this result. Counsel posited that in his MBSA revenue requirement calculation, Staff witness Brown should have included \$67 million for gas in storage, \$2.7 million for materials and supplies, and prepayments of \$435,000 to obtain a rate base figure without MBSA of approximately \$399 million. (T. 505-506) Accordingly, if we multiply .092 times \$399 million, we obtain \$36,713,000. Arkla's counsel then asked Mr. Brown if, in fact, the MBSA revenue requirement is less than the lead lag revenue requirement (T. 507). Mr. Brown did not agree with those calculations. (T. 507) He did not agree that the \$36.7 million figure was calculated correctly. Mr. Brown noted that the latter calculation posited by Arkla's counsel is making an apples-to-oranges comparison. (T.516)

While there was much wrangling back and forth between Mr. Brown and Arkla's counsel (T. 507-519), the ultimate source of the disagreement is the determination of the proper 'starting point' in the calculation. Mr. Brown claims that the proper starting point is a net utility plant rate base of \$328 million, while the Company believes that the proper starting point should include, in addition to net utility plant, gas in storage, materials and supplies, and prepayments, for a total amount of \$399 million. We agree with Staff on this point. Staff's MBSA is all-inclusive; it is improper to use as a starting point only a portion of the working capital assets, gas in storage, materials and supplies, and prepayments, which are part and parcel of the overall MBSA approach. For example, if we are to include these additional assets as a starting point, then perhaps additional zero-cost liabilities, such as Accounts Payable-Gas (T. 1717 and T. 510), should be included at the starting point, as well. The correct starting point is the one used by Mr. Brown. Consequently, Mr. Brown is correct that the MBSA increases revenue requirement by approximately \$3.5 million relative to the MBSA not being used.

The Commission agrees with Staff witness Richmond's calculations of the MBSA for purposes of calculating cash working capital in this case. In the future, however, should Arkla or any other utility prepare and present a reliable LLS, thereby producing a more comparable and accurate result for cash working capital as does the MBSA, the Commission will consider utilizing that approach.

#### RB-5A Gas in Storage Inventory

[5] The Company claims that the appropriate gas in storage ('GIs') inventory balance to be included in rate base is \$67,286,309. (T. 173) This figure reflects actual month end balances for the period May 31, 2004 through April 30, 2005, plus an adjustment to reflect the annualized effect of the additional firm storage capacity which the Company acquired from Centerpoint Energy Gas Transmission

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245 P.U.R.4th 384

Page 44

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

('CEGT') on April 1, 2005. The Commission approved the Company's purchase of this additional firm storage capacity in Commission Docket No. 04-029-U, Order No. 8. (T. 129-130)

Staff initially contested Arkla's claim. However, in his Surrebuttal testimony, Staff witness Richmond accepted the Company's GIS inventory balance but noted that the Company had failed to appropriately recognize the payable associated with this balance.

AG witness Marcus proposed to reduce Arkla's GIS inventory by \$1,146,597 to reflect the elimination of an excess average balance caused by purchasing more gas early in the injection cycle. (T. 1476-1478) He also reduced the GIS balance by \$12,095,413 to eliminate the additional costs associated with new capacity because the gas will not be purchased and stored until after the end of the pro forma year. (T. 1478-1479)

Arkla disputed both of Mr. Marcus' proposed adjustments. Arkla witness TheBerge argued that Mr. Marcus had not shown that his 'theoretical' storage cycle was more realistic than the actual storage cycle or that injections in excess of equal daily injections were excess. While the goal may be to inject on an equal daily basis, that goal is rarely, if ever, achieved for a variety of reasons. (T. 722) As acknowledged by Mr. Marcus on cross-examination, actual injections should take into consideration projections of price and must also recognize the physical constraints on injections that exist in the later months of the injection period. (T. 332-333)

With regard to the additional storage contract with CEGT, Arkla witness Harder noted that Arkla had a firm entitlement to the additional storage which has now been approved by FERC and will be available this winter. Because Arkla contracted for this capacity during the pro forma period, the additional allowance qualifies for recognition. (T. 216-218)

We will accept the GIS balance agreed to by Staff and Arkla. We agree that the additional inventory associated with the additional firm storage capacity is properly recognized in this proceeding. We also accept the GIS balance for existing storage based on the actual balances during the period May 31, 2004 through April 30, 2005.

RB-3 Accumulated Depreciation -- Retirement Work In Progress ('RWIP')

[6, 7] Staff witness Williams testified that any RWIP balances related to projects not completed by the end of the pro forma year should be eliminated. Staff Adjustment RB-3 eliminated the RWIP balance at test year end amounting to \$5,712,053. (T. 1935) Arkla witness Harder testified that the pending decrease in the reserve for accumulated depreciation for RWIP at the end of the pro forma period should be accounted for as a reduction to accumulated depreciation, otherwise plant-in-service will be understated. Mr. Harder argued that RWIP represents gas plant that has been physically removed from service and Gross Plant

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245 P.U.R.4th 384

Page 45

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

**(Publication page references are not available for this document.)**

In Service ('GPIS'). He further contended that, under the FERC Uniform System of Accounts ('USOA'), Arkla is allowed to include RWIP in a separate subaccount. According to Mr. Harder, this treatment of RWIP, as a reduction to the accumulated reserve for depreciation is both appropriate and necessary. (T. 118-119)

In surrebuttal testimony, Staff witness Williams disagreed with Arkla witness Harder that RWIP should be included in accumulated depreciation. Ms. Williams stated that, contrary to Mr. Harder's rebuttal testimony, the Company stated in response to Staff Interrogatory No. AUD-401 that, although assets have been physically removed from service, they have not been removed from GPIS. Ms. Williams asserts that these amounts are not reflective of the final accounting of costs and benefits related to retirements that are in progress, are still currently included in GPIS, and therefore, should not be included in Plant In Service (PIS). (T. 1952) In sur-surrebuttal testimony, Mr. Harder continued to argue that RWIP should be included in rate base. He contended that RWIP represents additional investment by the Company that should be included in plant. Mr. Harder further asserted that if the asset is not removed from service, then RWIP represents additional costs associated with the asset. If the asset has been removed, then RWIP should be netted against accumulated depreciation. (T. 214-215)

The Commission finds that the Staff's treatment of this issue represents a more reasonable resolution than the Company's proposal. Arkla is essentially requesting that it should be allowed to include in rate base and earn a return on \$5,084,504 of RWIP. The Staff recommends that Arkla's proposal be denied. Arkla states that under the FERC USOA, Arkla is allowed to include RWIP in a separate subaccount under accumulated depreciation. This would suggest to the Commission that the RWIP subaccount is an account where, as Staff witness Williams testified, costs are being accumulated on retirement work orders that have not been completed. As Ms. Williams further testified, the 'amounts are not reflective of the final accounting of costs related to the retirements that are in progress. ...' (T. 1952) In other words, it is only after the final costs of the amounts contained in the subaccount are known and finalized that the accumulated reserve for depreciation is charged or reduced. Arkla has simply not sustained its burden of proof with regard to the proper accounting treatment of RWIP nor has it adequately shown why RWIP should be included in rate base. Therefore, the Commission finds that the Company's proposed treatment of RWIP is not acceptable, and its request to include RWIP in rate base is denied.

## II. OPERATING EXPENSES

### IS-20 Payroll

[8-11] The Company's initial filing included a pro forma adjustment to annualize payroll expense. This adjustment was based upon the annualization of payroll based on the level of employees at September 2004, which resulted in an annualized payroll of \$33,611,947. In its rebuttal filing, the Company updated its payroll adjustment to reflect the actual payroll for the twelve months ending April 30, 2005, adjusted to reflect the competitive pay adjustment ('CPA') of 3 percent that

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245 P.U.R.4th 384

Page 46

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

was granted on April 1, 2005. According to Arkla witness Harder, the revised payroll adjustment would recognize a number of factors that affect the payroll, such as employee turnover, promotions, etc. (T. 141) Mr. Harder also explained that this method of annualizing payroll expense avoids any distortion of the annual payroll expense that may result from the April 1, 2004, corporate reorganization, since employee levels remained relatively stable during the 12 months ending April 30, 2005. The updated payroll adjustment resulted in an annualized payroll of \$33,764,815 or \$152,868 higher than the Company's initial payroll claim.

In Staff witness Malone's direct testimony, he recommended an adjustment to payroll to reflect two changes. The first change was to reflect the most recent number of employees available at the time it filed testimony, which was the number of employees at February 28, 2005. Mr. Malone explained that the Company had used a 'per person' basis to calculate payroll, and by using the most recent known level of employees, its adjustment resulted in the exclusion of 44 positions that were vacant on that date. In Mr. Malone's surrebuttal testimony, he pointed out that the Company's rebuttal payroll calculation moves away from the 'per person' calculation. According to Mr. Malone, the Company's rebuttal payroll calculation is affected by the corporate reorganization since the workforce continued to decline through December 2004. (T. 1980) Mr. Malone also updated his adjustment by annualizing payroll based upon the number of employees at the end of the pro forma year. Mr. Malone calculated his revised payroll based on the number of employees on March 31, 2005, adjusted to reflect vacancies and the CPA as of April 2005. The payroll was also adjusted for normal overtime and Short-Term Incentive Pay.

The second change reflected by Mr. Malone related to the Short-Term Incentive Plan ('STIP') and the Long-Term Incentive Plan ('LTIP'). Essentially, Mr. Malone proposed a 50/50 sharing of the incentive pay that was related to achieving financial goals. However, Mr. Malone revised his STIP adjustment in his surrebuttal. Mr. Malone indicated that, based upon his review of those costs for the pro forma year and the preceding three years, a three-year average of the STIP should be used to determine the STIP amount included in rates. (T. 1983)

In his surrebuttal testimony, Mr. Malone also modified his calculation of the level of overtime to be included in the cost of service in this proceeding. Similar to its surrebuttal recommendation for the STIP, Mr. Malone recommended that the overtime level be based on the average amount for the three preceding years.

The AG limited its payroll adjustments to the incentive pay components of payroll. With respect to the STIP, AG witness Marcus proposes an adjustment that is similar to Staff's in that the AG proposes a 50/50 sharing of the incentive pay related to financial goals, and that the amount be based on the three-year average. With respect to the LTIP, Mr. Marcus proposed to remove 50 percent of the Company's CEO bonus and 100 percent of the restricted stock compensation to the top four corporate officers.

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245 P.U.R.4th 384

Page 47

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

In his Sur-Surrebuttal testimony, Arkla witness Harder addressed several of the payroll issues raised by Staff and the AG. He criticized the revised payroll adjustment recommended by Staff witness Malone in his Surrebuttal filing as being based upon a 'snap shot' or only one point in time. However, with regard to salary and wages, Mr. Harder indicated that of the \$734,704 difference between the Staff and the Company, \$536,255 is the result of differences between the two parties in the capitalization rate. According to Mr. Harder, Mr. Malone used the budgeted capitalization rate from the original filing, while he used the actual capitalization rate for the pro forma period. (T. 223) Mr. Harder identified the remaining difference of \$198,449 as related to the difference in the level of employees due to turnover. (T. 224) With respect to Staff witness Malone's use of the three-year average overtime pay, Mr. Harder suggested that the increased overtime is a direct result of the corporate reorganization and argued that Mr. Malone failed to take that into consideration. Finally, in his Sur-Surrebuttal testimony, Mr. Harder accepted Staff's and the AG's recommendation to use a three-year average for the STIP, but rejected the 50/50 sharing of those costs.

The Company's payroll claim can be broken down into three components -- regular salaries and wages, overtime payroll, and incentive compensation. The parties disagree on how these three components should be determined. With regard to regular salaries and wages, the Company's rebuttal approach considers the CPA-adjusted actual payroll (and the actual pro forma year number of employees) to be representative of the ongoing level of payroll. Arkla witness Harder indicated that the restructuring in April 2004 resulted in a reduction of the workforce that is properly reflected in the pro forma year employee and wage levels that reflect employee levels after the corporate reorganization. In his rebuttal testimony, Mr. Harder stated that he revised his payroll adjustment to the pro forma period because the workforce was relatively stable and was not tainted by workforce reductions.

Staff witness Malone proposed to determine annualized regular salaries and wages by first calculating the most recent level of salaries and wages per employee, including the April 1, 2005, CPA adjustment. This cost per employee was then multiplied by the end of pro forma year employee level to derive the Staff's recommended allowance for salaries and wages.

Based on our review, we are satisfied that Arkla's pro forma year wages, adjusted for the April 1, 2005, CPA increase, reflect the impacts of the restructuring which occurred prior to the pro forma year. Based on the information before us in this proceeding, we are not convinced that the Staff's proposal to use employee levels as of a single point in time is representative of Arkla's normal ongoing employee levels upon which forward-looking rates are to be based. Accordingly, we reject Staff's adjustment to regular salaries and wages.

With regard to overtime, Arkla witness Harder again proposed to utilize the actual level of overtime during the pro forma period. Staff witness Malone proposed to base overtime on the average level during the three preceding years. Mr. Harder argued that Mr. Malone's use of a three year average fails to recognize

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245 P.U.R.4th 384

Page 48

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

that the employee reductions resulting from the April 2004 restructuring will affect the level of overtime required prospectively. In his Sur-Surrebutta testimony, Mr. Harder noted that Arkla's use of the pro forma period level of overtime reflects the impact of the reorganization.

We agree that reductions in the number of employees may increase the need for overtime for remaining employees. Accordingly, we conclude that use of a multi-year average for overtime is not appropriate in this case because it includes periods prior to the recent restructuring. Therefore, we reject Staff's adjustment to overtime.

Regarding the incentive compensation portion of the payroll, it should be recognized that incentive pay can be considered 'at risk'. As such, there is no guarantee that incentive payments will be made in any given year. As pointed out by Staff witness Malone and AG witness Marcus, financial and customer service goals are established and have to be achieved in order for payments to be made under the plan. (T. 1963, 1372) In fact, Mr. Marcus points out that in 2001, one of the corporate affiliates from whom the Company receives charges did not make incentive payments to its employees. (T. 1374) The other aspect of incentive payments is that the amount paid can be affected based upon whether the goals were simply achieved or were exceeded. In other words, if the results of operations exceed the goals by certain benchmarks, the incentive payments are higher than they would have been if the goals were achieved at the minimum level. This means that even if incentives were paid every year, the level of incentives paid may fluctuate from year to year. Therefore, the incentive payments made in any single year cannot be considered the normal level. Accordingly, the Staff and AG's recommendation that the average incentive pay be used in determining the allowable incentive pay is adopted.

Both Staff witness Malone and AG witness Marcus recommend that the Company be allowed to recover only 50 percent of the incentive pay related to financial goals. This sharing of the financial goals has merit because both shareholders and ratepayers stand to benefit from the Company's achieving these goals. Shareholders benefit because, when the goals are achieved or exceeded, additional income is earned which translates into increased shareholder value. Ratepayers benefit because, when the Company is able to achieve additional income, it is able to pass the additional income on to its customers by keeping rates down or filing less frequent rate cases. Although the Company rejects the 50/50 sharing by stating that the STIP is performance-related, it has not denied nor presented any contrary evidence that financial goals govern the payment of the STIP.

With regard to the LTIP, AG witness Marcus recommends that 50 percent of Arkla's share of the incentive bonuses paid to Centerpoint's CEO be disallowed to reflect benefits to both ratepayers and shareholders. (T. 1374) In support of the position, Mr. Marcus noted, in his Surrebuttal Testimony at page 18, that the compensation of Centerpoint's CEO has increased by 93 percent from 2001-2004. In his Sur-Surrebuttal testimony, Arkla witness Harder argued that incentive bonuses are based on individual performance and are an appropriate part of overall

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245 P.U.R.4th 384

Page 49

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

compensation. AG witness Marcus also recommended that all of the Restricted Stock bonuses paid to certain corporate executives be removed from the cost of service. (T. 1375-1376) He argued that costs should be borne by shareholders since they are given to only a few highly paid individuals.

In his Sur-Surrebuttal testimony at pages 24-25, Arkla witness Harder rejected the 50/50 sharing of the STIP, but accepted the 50/50 sharing of the LTP costs. Hence, only the STIP sharing is currently being contested by the Company. As we explained above, there are benefits to both ratepayers and shareholders when the Company achieves the financial goals that trigger the payment of incentive compensation. Therefore, we accept the recommendation that there be a 50/50 sharing of the STIP. With regard to AG witness Marcus' recommendation to disallow 100 percent of the restricted stock payment to certain corporate officers, we find that Mr. Marcus has not provided sufficient reasons to treat these employees differently. As a result, we decline to accept his recommendation. We also note that by the parties' agreement on the 50/50 sharing of the LTIP and our acceptance of the 50/50 sharing of the STIP, the CEO bonus is effectively being shared on a 50/50 basis between ratepayers and shareholders. (TR 89-90.) As a result, AG witness Marcus' recommendation regarding the CEO bonus is resolved, and a separate adjustment is not needed. In summary, an adjustment to payroll expense of \$530,874 is found appropriate in this proceeding. This reflects Staff's adjustment to disallow 50 percent of STIP expense.

#### Depreciation -- Rates (IS-48 Depreciation Expense)

[12-17] In its Application, Arkla proposed to continue to utilize the depreciation rates approved in Arkla's prior rate case and elected not to present a new depreciation study in this proceeding. (T. 85) Because of concerns which were raised in that rate case (Docket No. 01-243-U) with regard to net negative salvage, Staff witness Freier prepared a depreciation study and has proposed new depreciation rates. Based on the findings of her study, Ms. Freier recommended that the Company's proposal to adopt the currently authorized depreciation rates be rejected. Adoption of Staff witness Freier's recommended depreciation rates will result in a composite depreciation rate of approximately 3.80 percent compared to the current composite rate of approximately 5.42 percent. (T. 2007-2009)

According to Ms. Freier, the primary factor causing the difference between her proposed depreciation rates and the current rates relates to net negative salvage for the mains and services accounts. The current depreciation rates for mains and services are based on negative net salvage factors of -115 percent and -275 percent, respectively. (T. 2012-2013) Based on her analysis, Ms. Freier proposed negative net salvage allowances of -70 percent for Mains and -115 percent for services. (T. 2032)

The salvage ratios underlying Arkla's current depreciation rate are based on the ratio of the cost of removal net of any gross salvage realized compared to the original cost of the assets retired and removed from service. Staff witness Freier

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245 P.U.R.4th 384

Page 50

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

**(Publication page references are not available for this document.)**

notes that this has the effect of not stating retirement amounts and the negative net salvage amounts in comparable dollars because of the historical inflation which has taken place from installation to removal. According to Ms. Freier, the failure to restate historical original costs on the same basis as retirements 'interjects considerable historical inflation differences into the calculation and significantly overstates the appropriate net salvage [and] the depreciation rates ... .' (T. 2013) Accordingly, Ms. Freier developed her negative net salvage ratios and, in turn, her depreciation rates by restating retirements, gross salvage and cost of removal on a constant price level. (Id., p. 10.)

In addition to developing revised depreciation rates, Staff witness Freier also made several other recommendations with regard to depreciation expense. These recommendations deal with various data retention and record keeping issues as set forth on pages 16-18 of her Prepared Testimony. Ms. Freier also identified six accounts that are fully recovered or overrecovered including: Other Structures-Distribution; Cast Iron Mains; Other Structures-Levy PH (call center); Structures & Improvements-Services; Data Processing Equipment-Misc.; and Other Equipment-Communications Equipment-Mtr. She recommended that depreciation accruals cease on these and any other accounts where the reserve ratio equals 100 percent plus or minus any applicable net salvage. (T. 2032)

In his rebuttal testimony, Arkla witness Harder argued that Ms. Freier's proposed depreciation rates significantly understate the appropriate allowance for depreciation expense. Mr. Harder indicated that Arkla did not propose to adjust its current depreciation rates in order to narrow the issues in the instant proceeding. However, in response to Ms. Freier's proposals, Arkla submitted its own new depreciation study, sponsored by Mr. John Spanos. [FN6] (T. 170)

In his study, Mr. Spanos took exception to Ms. Freier's net salvage calculations. He argued that the Commission should follow the traditional method of calculating net salvage, as it has in the past. He noted that the traditional approach (comparing net salvage to original cost of the retired plant) collects net salvage ratably over the life of the plant, from the customers served by that plant. Mr. Spanos claimed this approach is both equitable and consistent with sound ratemaking principles. In contrast, he contended Staff witness Freier's approach fails to recover the total loss in-service value (depreciation plus net salvage) over the life of the asset. Mr. Spanos testified that by excluding inflation, Ms. Freier's proposal will delay recovery of full service value and create intergenerational inequities. (T. 370-371, 383-384)

In addition to responding to Staff witness Freier with regard to net salvage, Arkla witness Spanos also presented a new depreciation study to demonstrate that Ms. Freier's proposed depreciation rates were too low. As part of this study, Mr. Spanos developed new estimates of service lives and salvage percentages. In addition, the depreciation rates which he developed were based on converting from average life group ('ALG') to equal life group ('ELG ') procedure.

In her Surrebuttal Testimony, Ms. Freier argued that Mr. Spanos' proposal should

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245 P.U.R.4th 384

Page 51

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

**(Publication page references are not available for this document.)**

be rejected. She noted that the composite depreciation rate proposal by Mr. Spanos would be 7.42 percent compared to the composite of 5.42 percent based on Arkla's current depreciation rates and her proposed composite of 3.80 percent. She compared this composite with the composite rates for other LDCs regulated by this Commission and concluded that the new depreciation rates proposed by Arkla are excessive. (T. 2045-2047)

In response to Mr. Spanos' criticisms of her proposal to restate the salvage allowance on a constant dollar basis, Ms. Freier noted that her treatment is fundamentally consistent with the treatment of negative salvage used in Entergy Arkansas, Inc.'s [FN7] nuclear decommissioning calculations. Those calculations provide for the recovery of decommissioning costs over the life of the plant in levelized, not constant, dollars. (T. 2057)

Ms. Freier also responded to Mr. Spanos' proposal to utilize the ELG procedure for calculating depreciation rates by noting that this procedure was inconsistent with Commission practice. Ms. Freier explained that both ALG and ELG are systematic and rational frameworks for calculating depreciation accruals over the life of the asset. However, ELG would cause depreciation rates to be higher in the early years of an asset's life. Moreover, because of the increasing cost of plant over time, she argued that depreciation expense will always be higher under ELG than under ALG. (T. 2047-2050) This is particularly important for a utility such as Arkla that is adding new plant as a result of its main replacement program (TR 273.)

In his Sur-Surrebuttal testimony, Mr. Spanos argued that comparisons of composite depreciation rates are not meaningful without more specific information. (T. 394) He also claimed that the higher depreciation accruals under ELG compared to ALG are offset by future return on rate base savings. (T. 395-397) In addition, Mr. Spanos noted that Staff witness Freier's adjustment to levelize salvage cost recovery will result in the underrecovery of future net salvage costs. He further argued that, because the accruals for the recovery of original cost are not stated in levelized dollars, Ms. Freier's procedure to restate salvage costs creates an inconsistency between the recovery of the original cost of the plant and salvage costs. Finally, Mr. Spanos noted that ratepayers receive a rate base deduction for the amounts they provide for the recovery of future net salvage because those amounts are included in the balance of accumulated depreciation until the net negative salvage costs are incurred. (T. 397-399)

With regard to the proposal to adopt ELG depreciation, we agree with the criticisms raised by Ms. Freier. As we have noted in the past, ELG will continue to result in higher depreciation rates and expense as long as a utility's plant continues to grow. The higher accruals in the early years of an asset's life exacerbate the problem that capital costs are already front end loaded because of the higher return on investment in the early years of that asset's life. Both ALG and ELG provide for full recovery of the investment in an asset over its life when coupled with remaining life depreciation. We conclude that ALG better balances the interests of shareholders and ratepayers and reject Arkla's argument that the ELG

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245 P.U.R.4th 384

Page 52

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

procedure is appropriate to establish depreciation rates.

We are also very concerned about the high level of negative net salvage associated with Arkla's mains and services. This issue arose previously in Arkla Docket No. 01-243-U in which Arkla was directed to perform a removal cost study. However, according to Staff witness Freier, that study did not explain why Arkla's net salvage values are so far out of the norm. As a result, Ms. Freier proposed an inflation adjustment as a means of addressing this issue. (T. 271) Ms. Freier's methodology for calculating net salvage on a constant dollar basis represents a departure from the historical procedure we have followed to set Arkla's depreciation rates. However, we note that the net salvage allowances recommended by Ms. Freier of -70 percent for Mains and -115 percent for Services are still significant and are in line with experience elsewhere as cited by Mr. Spanos. (T. 218-220) Moreover, the use of remaining life depreciation will ensure that Arkla will fully recover its original investment and the actual amount it incurs for negative net salvage. Accordingly, we adopt Staff's proposed net salvage values and, in turn, Staff's depreciation rates as a means of capping net salvage cost.

We agree with Ms. Freier's recommendation that depreciation should cease on all plant accounts where depreciation accruals are at or above 100 percent adjusted for net salvage. Arkla has accepted the Ms. Freier's recommendation that Arkla be required to apply the depreciation rates approved by this Commission to each of its accounts whether is direct-assigned allocated, general or shared, with the condition that it be allowed to use fixed life depreciation for certain general plant assets. (T. 978-979) Given the low dollar value of these assets, this is reasonable and is accepted. Finally, we hereby require Arkla to implement the new reporting requirements proposed by Ms. Freier. We are concerned about the issues that have arisen with regard to plant accounting under Arkla's new SAP accounting system ('SAP') and will take this opportunity to ensure that they are corrected. Accordingly, Arkla is directed to:

. Retain both electronically and in hard-copy format, the data that was ultimately provided in the responses to Staff data requests AUD-057 and AUD-058, to be used in future depreciation studies, as well as to keep the same level of data going forward.

. Perform an analysis and produce a report that 1) identifies each and every missing retirement for all accounts other than mains and services since SAP was implemented; 2) describes the processes followed in identifying and reporting the missing data; and 3) provides any source documents that were relied upon. This report should be filed with the Commission by March 31, 2006.

. File data annually that would support a depreciation study, including by activity year, plant additions by vintage, retirements by vintage, salvage and cost of removal by individual plant account, for the preceding calendar year. The first submission should be filed by March 31, 2006, and include the two years of data for 2004 and 2005, and thereafter include one year of data.

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245 P.U.R.4th 384

Page 53

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

#### IS-65 Test Year Audit Sampling

[18-21] For purposes of this proceeding, Staff and Arkla agreed to utilize sampling to evaluate the amount of costs included in Arkla's test year that are not properly recovered from ratepayers. At pages 22 through 25 of her Prepared Testimony, Staff witness Fritchman described the problems that Staff encountered in obtaining the necessary sampling and conducting its audit in a timely manner. Because of these difficulties, Staff was unable to complete its review prior to its direct testimony. Accordingly, Ms. Fritchman proposed to eliminate \$1,580,576 from test year expenses for amounts not necessary to provide utility service (Adjustment IS-65). This adjustment was based on the percent of disallowed operating expenses in Docket No. 01-243-U applied to the sample populations in this docket.

In response, Arkla presented the Rebuttal Testimony of Mr. Michael Hamilton and Mr. Walter Fitzgerald to explain why it believed Staff encountered problems and to explain the efforts Arkla had undertaken to satisfy the Staff's requirements. It was the Company's position that it had at that time provided Staff with the requested information necessary to complete its analysis and to substantiate its operating expenses. (T. 965-968)

In surrebuttal, Ms. Fritchman provided updated recommendations based on the Staff's completed test year audit. Ms. Fritchman testified that, while Staff was unable to conduct the sampling effort to the extent it desired, it was able to develop a recommendation based on limited review of source documentation. Ms. Fritchman's revised recommendation was to reduce test year costs by \$682,767 to exclude amounts not properly recovered from ratepayers. This amount included: \$599,101 based on sampling results; \$80,889 based on the description of natural accounts allocated to Arkla by Centerpoint Energy Service Company, Entex and Arkla Corporate; and \$2,778 of purchases on a company provided credit card (P-card) at Centerpoint Energy Service Company. (T. 1584-1590)

In Sur-Surrebuttal, Mr. Fitzgerald argued that the portion of Ms. Fritchman's adjustment related to out of period items is improper because there are expenses in any 12-month period that lag into the next 12 months. (T. 1580) However, as noted during Ms. Fritchman's cross-examination, the Company selected the test year and then had the opportunity to make any necessary adjustments for such costs and did not do so. (T. 174) It also had the opportunity to provide information regarding such costs to the Staff but did not do so. (TR 183)

Accordingly, we adopt the Staff's audit adjustment to exclude \$682,767 from test year. These costs include out-of-period expenses, contributions, entertainment and other costs. expenses routinely disallowed by this Commission as not properly recovered from ratepayers.

#### IS-22 Retirement Plan and Benefit (Pension Expense)

[22] Staff witness Malone testified that pension expense was adjusted based on

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245 P.U.R.4th 384

Page 54

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

the most recent actuarial report rather than the 2005 budgeted amount proposed by Arkla. Mr. Malone stated that the difference between the Arkla and the Staff pension expense adjustment is a large December 2004 contribution by Centerpoint Energy to its pension plan which greatly reduced pro forma year pension expense. (T. 1965-1966) Arkla witness Harder testified that Arkla's pension expense is susceptible to annual fluctuations caused by the actuary's estimate of Arkla's pension contribution, sudden changes in the market value of plan assets, and the amount contributed by the Company to the plan. Arkla contends that the large December 2004 contribution to the plan will have a short-term impact on Arkla's pension expense and the actuary's estimate does not fairly represent an on-going level of pension expense for ratemaking purposes. Mr. Harder used a three-year average of pension expense for calendar years 2002- 2004. Mr. Harder argued that a three-year average to normalize pension expenses mitigates the short-term impact of recent events. (T. 146-147)

The Staff testified that Arkla has not provided any evidence to show that the pension expense determined from the 2005 actuary report does not represent an ongoing level of pension expense. Mr. Malone argued that Arkla's pension expense is declining and a three-year average based on 2002-2004 pension expenses is not appropriate or representative of the ongoing pension expense level. (T. 1985-1986) In sur-surrebuttal testimony, Mr. Harder argued that Staff's approach should be rejected because (1) actuarial reports are less reliable than actual expenses, (2) the 2005 Actuarial Report forecasts includes 8 months of data that is beyond the end of the pro forma period, and (3) as of June 30, 2005, the pension plan assets have underperformed the return expected in the 2005 Actuarial Report. (T. 229-230)

The Commission adopts Staff's method for determining Arkla's pension expense adjustment. The Company's most recent actuarial report represents independent and reliable evidence for Arkla's pro forma level pension expense. The Commission also concurs with Staff's reduction of the Company's pension expense resulting from the large December 2004 contribution by CenterPoint Energy. The contribution represents a known and measurable change which should be considered in determining Arkla's pro forma level pension expense. The Commission agrees with the Staff's contention that the 2005 actuary report provides a better representation of ongoing pension expense than Arkla's method, which is based on an average pension expense for calendar years 2002 through 2004. Arkla's average pension expense for 2002-2004 shows that Arkla's pension expense is declining, and therefore a three-year average is not appropriate or representative of the Company's ongoing level of expense. Mr. Malone testified at the hearing that his pension expense adjustment included all known and measurable changes occurring through the end of the pro forma year. He further testified that Arkla's adjustment, which used the three previous years' average, would not have taken into account several changes including a half-billion dollar contribution to plant assets, the change in the work force level, the number of participants in the plan due to the sale of Texas GENCO, and the reorganization which reduced the work force levels. (T. 147)

IS-34 Corporate, Shared Services, and IT Expense

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245 P.U.R.4th 384

Page 55

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

[23] Staff Witness Fritchman testified that Arkla's test year expenses were increased to recognize the increase in costs from CenterPoint Energy Service Company ('CNP Service Co.') for corporate, shared services, and IT services performed on behalf of Arkla. These services include corporate planning, legal, human resources, security, maintenance, payroll, and computer support. (T. 1532-1533) Arkla Witness Harder argued that Staff's pro forma expense should be adjusted to reflect (1) the annualization of corporate allocation factors that became effective in 2005, (2) Centerpoint Energy's sale on April 13, 2005, of its interests in Texas Genco Holdings, Inc, and (3) the fact that Staff already included, in another Staff adjustment, Staff's removal of certain corporate allocated legal expenses and payroll costs. (T. 155-157) Staff testified that Arkla's projected allocation factors for April 2005 through December 2005, revised to reflect the Texas Genco sale, failed to recognize the projected savings that the Company anticipates. Regarding Arkla's contention that Staff's adjustment has already been reduced for corporate legal costs, Ms. Fritchman stated that: (1) it is inappropriate for Arkla to reduce this adjustment for the corporate legal costs disallowed in another adjustment; and (2) Arkla is attempting to recover the corporate legal cost disallowance which Arkla agreed was appropriate. (T. 1590-1592) In sur-surrebuttal testimony, Mr. Harder stated that the remaining issue between Arkla and Staff relates to the annualization of corporate allocation factors that became effective in 2005. Mr. Harder asserted that the change in allocation factors represents a reasonably known and measurable change which occurred in the pro forma period. He contended that Staff's reliance on cost savings expected to occur in the future does not meet this standard. Mr. Harder asserted that Staff has not: (1) attempted to reasonably measure the expected savings; (2) produced any evidence to support its inference that savings will offset the impact of the change in allocation factors; or (3) reconciled its position on this adjustment with its position on the cathodic protection expense adjustment, in which Staff indicated that costs outside the pro forma year should not be accepted. (T. 230-232)

The Commission finds that the Staff's calculation of this adjustment is appropriate. Any utility management decision to centralize its utility service obligations into a 'shared services' contract should inherently be designed to improve service delivery and save ratepayers money, and not the reverse. Regarding the issue of Arkla's revised allocation factors from the sale of Texas Genco, Arkla in its response to Staff Interrogatory No. AUD-309 affirms that cost savings from the sale are expected to offset the change in the allocation factors. Arkla's response to Staff's Interrogatory No. AUD-309 provides concrete evidence that refutes the testimony presented by the Company. According to Ms. Fritchman's testimony (T. 1591), the Company's response to Staff Interrogatory AUD-309 states that:

'...there are programs in place to improve the controllable expenditures in the Corporate Areas by \$30M over a 3-year period (2004-2006) which will offset any impact the sale of Texas Genco might have on CNP (Centerpoint Energy) affiliates due to the change of allocation factors ...'

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245 P.U.R.4th 384

Page 56

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

Arkla's response to the interrogatory establishes that: (1) there are measurable expected savings to offset the impact of the change in allocation factors; and (2) a portion of the cost savings will be realized within a period which encompasses the test year and pro forma year. The Commission finds that the change in allocation factors and the cost savings are reasonably known and measurable changes which should both be recognized in order to produce a symmetrical result. The Company would have the Commission recognize the additional expense caused by the change in allocation factors but ignore the Company's own statement that cost savings are expected to offset the change in the allocation factors. Furthermore, the Company should take note that any decisions it makes in another jurisdiction, whether for political, legislative or economic reasons, such as its sale of Texas Genco (T. 69, 86, 157, 1591) as a quid pro quo for other concessions it received in the Texas legislative process to implement 'electric retail choice,' will not be allowed to have adverse cost implications on this jurisdiction's retail ratepayers. Arkansas ratepayers should be, and shall be, held harmless from decisions made by a utility in another jurisdiction that are adverse to the interests of Arkansas ratepayers.

#### IS-38 Interest on Customer Deposits

[24] Because Arkla did not include customer deposits in its capital structure, the Company requests that the interest on customer deposits treated as an operating expense. The amount of operating expense that the Company recommends reflects the amount of interest payable on a 13-month average of customer deposits at the 1.8% interest rate set by Order No. 3 in APSC Docket No. 04-135-U. (T. 160-161) The Staff and the AG included customer deposits in their capital structures, using the MBSA Approach. (T. 1687, 1362)

The Commission adopts the position of the Staff and AG on this issue consistent with the Commission's decision adopting the MBSA.

#### IS-37 Contract Meter Reading Expense

[25] Arkla and the Staff are in agreement on the adjustment of this expense. (T. 1724) Arkla witness Harder stated that, as the Company loses meter readers, it evaluates the feasibility of replacing those positions with contract meter readers. (T. 84) Mr. Harder further stated that the number of Company meter readers has been reduced in the pro forma period and replaced with contract meter readers. As a result, Arkla contends that its contract metering expense should be increased. (T. 158) The AG believes that recorded costs in this Account 902 for the pro forma year should be used in its entirety. The AG recommends that actual pro forma year spending be used for this account in order to capture everything that is occurring, rather than selectively updating pieces of it. (T. 1468-1469)

The Commission accepts Arkla's and Staff's position on this adjustment. Staff indicates that Arkla has now provided: (1) the actual amounts of contract meter reading expense for the months of March and April 2005; and (2) the corrected amounts for July through December 2004. (T. 1724) The Commission finds that this

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245 P.U.R.4th 384

Page 57

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

updated information provides sufficient evidence to satisfy the AG's concern that actual pro forma year spending be used for this adjustment.

#### IS-25 Employee Saving Plan Expense

[26] Arkla and the Staff agree on the employee savings plan contribution rate. However, Arkla and Staff disagree on the proper level of pro forma payroll expense to which the contribution rate would be applied. (T. 1988) Arkla's and the Staff's saving plan expense adjustments were calculated by applying the contribution rate to each party's respective payroll adjustments.

The Commission finds that the employee savings plan contribution rate should be applied to the amount determined for regular salaries and wages, overtime, and incentive pay consistent with the Commission's decision on these issues. The Commission accepted Arkla's position on regular salaries and wages, and overtime, and the Staff's position on incentive pay. (Adjustment No. IS-20).

#### Director's and Officer's Insurance ('D&O')

[27] The purpose of D&O insurance is to protect officers and directors of a corporation from liability in the event of a claim or lawsuit against them asserting wrongdoing in connection with the Company's business. AG witness Marcus has two concerns with Arkla's treatment of this expense: (1) Arkla's revised allocation methodology from an asset-based to an O&M-based allocation has doubled Arkla's costs; and (2) the costs should be split on a 50-50 basis to recognize that shareholders are the major beneficiaries of policy payouts when something goes wrong. (T. 1376-1377) Arkla Witness Harder testified that the use of an O&M allocation factor is appropriate for an expense that bears no relation to the level of plant. He contended that this is a necessary business expense which enables the Company to attract and retain qualified management. (T. 152-153) Mr. Marcus disagreed, stating that the expense is not related to O&M expense either, the allocation shifts the cost to Arkla away from Arkla's electric affiliate, and utility profits are asset-based. Also, since shareholders receive the benefit of insurance payouts, they should bear a portion of the cost of buying the insurance. (T. 1465-1466) Mr. Harder responded, contending that: (1) the AG cites no evidence to show shareholders are the primary beneficiaries of these insurance proceeds; (2) litigation often involves past stockholders, in which instance they are no different than other individuals filing tort claims; and (3) when current shareholders are involved, payments are made to the corporation in which case customers are the ultimate beneficiaries. (T. 1227-1229)

The Commission finds that Arkla has not justified its change in allocation factors nor has it justified why this expense should not be split equally between stockholders and ratepayers. Arkla did not adequately explain why, at this time, it changed from a asset-based to an O&M expense-based allocation factor. Arkla's explanation that it is an expense to attract qualified management does not establish a justifiable relationship between the cost and the cost expense allocation factor the Company used. Mr. Marcus testified that D&O insurance costs

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245 P.U.R.4th 384

Page 58

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

are part of general corporate overhead to protect Company profits which are largely asset-based for a utility. (T. 167-169) Mr. Marcus' testimony that this insurance protects corporate profits also lends support for sharing the insurance costs between shareholders and ratepayers. The news (T. 1040) is replete with stories about companies experiencing lawsuits by shareholders. The Commission agrees with the AG that more often than not it is the current shareholders who sue management and who receive a large portion of the proceeds from the D&O insurance payouts. Accordingly, the Commission finds that Arkla's existing asset-based allocation for D&O insurance should be maintained and that the expense for D&O insurance should be shared on a 50-50 basis between shareholders and ratepayers.

### III. REVENUE CONVERSION FACTOR

[28, 29] Traditionally, the revenue conversion factor is used to determine the revenues a utility needs to collect to allow for state and federal taxes and uncollectibles. The parties, including the AG, do not dispute the level or amounts of Arkla's revenues (IS-17) or the uncollectible accounts experience ratio determined in conjunction with Arkla's Bad Debt Expense (IS-41). The only remaining issue is whether or not late payment revenues should be included as part of the revenue conversion factor.

AG witness Marcus argued that lower uncollectible accounts expenses and the inclusion of late payment revenues reduces the level of the revenue conversion factor. Mr. Marcus contended that, if Arkla's rates are increased, its late payment revenue should also be increased and included in the revenue conversion factor. (T. 1390-1391, 1474) Arkla witness Henry asserted that, even if Arkla's rate increase is granted, no additional late charge revenue will be generated and such revenues should not be projected as a percentage of revenues and included in the revenue conversion factor. (T. 301-305) Arkla witness Harder testified that it is appropriate to follow past practices and include the uncollectible percentage in the calculation of the revenue conversion factor. (T. 166, 236-237)

AG witness Marcus acknowledged that the uncollectible percentage has traditionally been included in the revenue conversion factor. (T. 1474) Mr. Marcus has not shown that late charge payment revenues should also be included in the revenue conversion factor. This Commission historically has not included late payment revenues in the calculation of the revenue conversion factor. The AG has not demonstrated that the Commission should depart from its historical practice.

### IV. CAPITAL STRUCTURE AND RATE OF RETURN

[30-31] Four witnesses offered recommendations concerning the appropriate return on common equity for Arkla. Their recommendations are as follows:

Arkla witness Hadaway -- 10.75% (T. 916, 940)

Staff witness Brown -- 9.2% (T. 1896)

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245 P.U.R.4th 384

Page 59

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

CEUG witness Staley -- Maximum of 9.9% (T. 1208)

AG witness Marcus -- 9.6% (T. 1371, 1459)

The required return on equity is a cost just as any other explicit expense incurred by the utility in its operation. The allowed return on equity affords the utility the opportunity, not a guarantee, to earn that return and attract capital. Additionally, the cost of equity represents a return commensurate with the returns on investments of similar risk.

In cases such as this, there are usually expert witness disagreements concerning: (1) methodology (Discounted Cash Flow ('DCF'), Risk Premium, etc.); (2) risk-comparable sample; (3) DCF growth rate; and (4) adjustments within the recommended cost of equity range. However, in this case, the three primary differences are in the DCF growth rate, the adjustment in the event Arkla-proposed Riders RSP, LCA, and/or ICR are approved, and the adjustment for Arkla's performance.

#### DCF Analysis

The DCF method calculates the cost of equity as

$$K_e = \text{Dividend Yield} + \text{Investor-expected growth rate}$$

In Direct Testimony Arkla witness Hadaway recommended an 11%-11.5% DCF range for the cost of equity (T. 906) This was later updated to a 10.5%-11% DCF range (T. 916) In both Direct and Surrebuttal Testimony Staff witness Brown recommended a DCF cost of equity range of 9.2%-10.1% (T. 1861, 1881) Neither CEUG witness Staley nor AG witness Marcus used a DCF Method.

Since there is very little disagreement over the appropriate DCF dividend yield, the sources of disagreement are in the growth rate. Mr. Hadaway used a combination of growth rates from three sources: Zach's 5 year projections; Value Line Earnings Growth Projections from 2001-03 to 2007-09; and annual U.S. Gross Domestic Product Growth. (T. 802, 807, 825) Mr. Brown utilized four different growth rates: (1) Projected Book Value Growth and Retention Growth ('br + vs') ending 2007-09; (2) Value Line average projected growth rates for Earnings per Share ('EPS') and Book Value per Share ('BVPS') for the period 2001-03 to 2007-09; (3) Value Line average projected growth rates for EPS and BVPS for the period 2003 to 2007-09; and (4) Value Line average projected growth rates for EPS and BVPS for the period 2005 to 2007-09. We find that these four growth rates are reasonable estimates of investor-expected growth rates for usage in the DCF formula.

As discussed by Mr. Brown (T. 1871-1872), a major flaw in Mr. Hadaway's analysis is that he failed to use sustainable book value per share growth rates in gauging investor expectations. The underlying long-term and sustainable source of dividend growth rate in the DCF method is growth rate in book value per share. Mr. Brown's analysis appropriately considers that growth rate either explicitly (as in his

245 P.U.R.4th 384

Page 60

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

growth rates 2, 3, and 4) or implicitly as in his 'br + vs' growth rate. For that reason, we reject Mr. Hadaway's first two growth rate data sources.

With regard to Mr. Hadaway's use of the Gross Domestic Product (GDP) growth rate, he is correct that investor-expected dividend growth rates overall are likely correlated with GDP growth rate. However, he has failed to demonstrate that industry-specific DCF investor-expected growth rates are also equal to the nominal GDP growth rate. This is a crucial distinction. For example, a mature industry may have a rich dividend yield and a small expected growth rate, while a young industry may, conversely, have a small dividend yield and a large expected growth rate. It would be reasonable to expect the mature industry's expected dividend growth rate to be less than nominal GDP growth, while the young industry's expected growth is greater than GDP growth. Long-term, the three growth rates are not equal. In this case, Mr. Hadaway has failed to show that the nominal GDP growth rate has been, and is expected by investors in LDCs to be, equal to nominal GDP growth.

In both his Direct Testimony and Surrebuttal Testimony, Mr. Brown developed a cost of equity range of 9.2%-10.1%. This is shown in his Exhibit JB-9. His four different growth rates resulted in four sample cost of equity estimates of 9.3%, 9.2%, 10.1%, and 10.0%, which results in his range of 9.2%-10.1%. We find that Mr. Brown's DCF range of 9.2%-10.1% is appropriate in this case.

#### Risk Premium Analysis

[32] Arkla witness Hadaway was the only witness to perform a risk premium analysis. (T. 911-913, 940-942) Mr. Hadaway estimated a risk premium-based cost of equity of 10.8%.

As noted by both Mr. Hadaway (T. 1862-1863) and Staff witness Brown (T. 1874), risk premiums are not stable, and there is no one risk premium through time. An additional flaw in Mr. Hadaway's analysis is that he has relied upon risk premium studies for the S&P 500. As noted by Brown, utility stocks are perceived to be less risky than the average stock in the S&P 500. (T. 1875) For the above reasons, we conclude that Mr. Hadaway's risk premium method is not a reasonable basis upon which to set Arkla's cost of equity.

#### Other Cost of Equity Methods

Several parties present as evidence information on recent allowed returns for LDCs in other states (T. 837-841, 911-913, 940-942), (Hadaway Exhibits SCH-11 and SCH-12), (T. 135, 209, 234, 1888) This Commission gives no weight to such data for three reasons. First, there is an element of circularity involved if this Commission, as well as other state Commissions, rely upon rate of return determinations in other states for determining the appropriate allowed return for utilities in their states. Second, neither this Commission nor the parties have had an opportunity to probe the factors that made up the allowed return determinations in the other states. This Commission must make determinations based

245 P.U.R.4th 384

Page 61

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

**(Publication page references are not available for this document.)**

upon the evidence presented in testimony and hearings before this Commission, pursuant to the laws of the State of Arkansas. Third, this sort of comparison is akin to piecemeal ratemaking and is unacceptable. For example, we do not know the other state commissions' policies regarding rate base, expenses, depreciation, etc. As noted by CEUG witness Staley: '[E]very natural gas utility has different needs, different risks, different load profiles, and different performance levels. Consequently, every natural gas utility should have a uniquely determined ROE.' (T. 1302)

AG witness Marcus considered expected returns on equity investments in pension plans by utilities as determined from utility annual reports. (T. 1366, 1456-1458) There are two major problems with this sort of analysis: (1) it is unclear how long the time horizon is; and (2) these returns are expected, not required. It is well-established that expected returns may be less than, equal to, or greater than required returns. For that reason, expected returns cannot be used directly as a proxy for required returns, which is the information sought in a general rate case.

Mr. Marcus also performed a Capital Asset Pricing Model (CAPM) analysis in a footnote. (T. 1371) This Commission, to date, has had two problems with CAPM analysis: the lack of stability in estimates of 'beta' and the lack of stability in the market premium. Consequently, we can not rely on Mr. Marcus's CAPM analysis.

Because of the flaws identified in the risk premium and other analyses, the only reliable measure of required return on equity in the record is the DCF calculation discussed above. We will therefore utilize a DCF cost of equity range of 9.2% -- 10.1% as the allowed return on equity range in this case.

#### Adjustment to Cost of Equity for Decrease in Risk

[33, 34] Staff (T. 1868-1869), CEUG (T. 1208, 1302), AG (T. 1371), and AGC (T. 1095) argue that, if Arkla proposed riders RSP, LCA, and ICR are approved, Arkla's risk would be reduced, and that a concomitant reduction in Arkla's cost of equity would be warranted. Arkla (T. 41-45) argues that Arkla witness Hadaway's and Staff witness Brown's risk-comparable group includes companies with innovative tariffs and higher customer growth that mitigate their risks. Consequently, proposed Riders RSP, LCA, and ICR do not reduce the business or regulatory risk of Arkla as compared to the risk-comparable sample, and no downward adjustment to the allowed return on equity is warranted if these Riders are approved. (T. 41-45, 927-930) Mr. Brown claimed that Arkla has several currently-effective risk-mitigating riders, Purchased Gas Adjustment ('PGA'), Weather Normalization Adjustment ('WNA'), and Main Replacement Program ('MRP'), which indicate that Arkla is not riskier than the sample. (T. 1892-1894)

As discussed elsewhere in this Order, we are not approving Proposed Riders RSP, LCA, and ICR, so that the issue of a downward adjustment in Arkla's allowed return on equity associated with approval of these Riders, need not be decided here.

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

#### External Sources of Capital in Capital Structure

[35-37] Arkla witness Hadaway included three external sources of capital structure: long-term debt, preferred equity, and common equity. (T. 8837) Staff witness Brown included five sources of external capital in Arkla's capital structure: long-term debt, short-term debt, preferred equity, common equity, and customer deposits. (T. 1126) The proportions Mr. Brown's first four sources are based upon the risk-comparable sample proportions (T. 1848-1852), as are all three external components for Arkla. The primary differences between Mr. Brown and Mr. Hadaway are: (1) Mr. Hadaway developed the capital proportions using 2003 fiscal year, while Mr. Brown used 2004 fiscal year; (T. 1850) (2) Mr. Brown included short-term debt in the capital structure and Hadaway did not; and (3) Mr. Brown included customer deposits and Mr. Hadaway did not. With the exception of customer deposits, AG witness Marcus has approximately the same external capital structure proportions as does Mr. Brown.

Mr. Brown noted that short-term debt is used to fund ongoing operations and is a permanent source of capital. (T. 1850) Mr. Marcus also recommended the inclusion of short-term debt in the capital structure. (T. 1360-1361) Mr. Hadaway responded that Mr. Brown should have at least netted out the Construction Work In Progress ('CWIP') financed by short-term debt. (T. 926) Mr. Brown responded to that by noting: (1) the Commission has a long-standing position that CWIP not be included in rate base because it is not used and useful; (2) Arkla's Main Replacement Program, which is temporarily included in CWIP until those assets enter service, is effectively a monthly rate case which allows Arkla to immediately put the majority of plant additions into rates; and (3) the precedent of including short-term debt in the capital structure was specified in Order No. 13 in Arkla Docket No. 93-081-U and was followed by the Company in its two subsequent rate cases, Docket Nos. 94-175-U and 01-243-U.

This Commission is not persuaded to change its policy on the inclusion of short-term debt in the capital structure. Consequently, we will include it as recommended by Mr. Brown and Mr. Marcus.

With regard to cost rates, Mr. Brown's cost rates for long-term debt and preferred stock are more current than Mr. Hadaway's and we will adopt those. (T. 1855) Further, Mr. Brown used a current short-term debt cost rate, which we will adopt. (T. 1855-1856) Finally, no party contested either Staff's inclusion of customer deposits in the capital structure or its cost rate. Consistent with our precedent we will include those as well.

#### Overall Cost of Capital

[38-41] For all of the above reasons we adopt Staff witness Brown's capital structure, cost of equity range, and other cost rates as shown in Surrebuttal Exhibit JB-14. In conjunction with a 9.45% allowed return on equity, discussed later in this order, this results in an overall cost of capital of 5.31%. Further, as demonstrated by Mr. Brown, his overall recommendations result in Funds

245 P.U.R.4th 384

Page 63

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

from Operations interest coverage of at least 5.0, Funds from Operations to Total Debt Coverage of at least 24%, and a total debt ratio of 54%. (T. 1127-1128, 1883) Each of these financial measures meets or exceeds Standard and Poor's benchmarks for an A-rated utility with a business position of 3.

#### V. COST ALLOCATION

##### Administrative Fees of the Transportation Supply Option

[42-44] Arkla witness TheBerge proposed an allocation of these revenues based on Gross Total Cost of Service. CEUG witness Ward recommended that these revenues be directly assigned to those classes based on actual contributions. (T. 1154) According to Mr. Ward, by reallocating operating revenues in a manner that differs from the expense allocation, an interclass subsidy is introduced. (T. 1153) However, Mr. TheBerge notes that both fees and expenses are consistently allocated across classes. (T. 639, 709) Staff, AGC, and the AG had no comments on this issue. We agree with the Company because its allocation of revenues is consistent with the allocation of related expenses.

##### Administration of Gas Purchases and Transportation

Arkla and CEUG recommend that these costs be allocated based on O&M. (T. 1291) The AG argues that 50% should be assigned to transportation administration, with the remainder spread by throughput to sales customers. (T. 1420-1422) CEUG witness Staley argued that it is inappropriate to charge transportation customers without crediting separate revenues to the transportation customers. (T. 1291) Staff took no position on this issue. Arkla witness TheBerge responds that it is not necessarily true that large customers require greater administration costs. In fact small customers, who tend to have low load factors, require swing contracts with special provisions. In contrast, large customers, who tend to have high load factors, have a lower need for swing or special contracts. Finally, the cost of administering gas purchases does not vary with throughput, and is not indicative of the relative cost incurred on behalf of the class (T. 622-624). We agree with Arkla and CEUG because their allocation better reflects cost causation.

##### Capacity-Based or Demand-Based Allocations

[45, 46] Arkla witness TheBerge developed a 'relative demand allocation' for purposes of allocating capacity costs among customer classes. For loads that are primarily weather-sensitive, the 'design-day' demand level is used. That design day is based on 59 HDD. For those loads that are not weather-sensitive, the Company used calculated winter demands. According to Mr. TheBerge, this approach captures the off-peak utilization that should bear some capacity costs. The overall relative demand level for any customer class is the sum of the two demand indicators. Finally, an adjustment was made to these two demand levels to account for overlap between minimum system analysis and cost in excess of the minimum system. (T. 494)

245 P.U.R.4th 384

Page 64

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

CEUG witness Staley disagreed with this approach for several reasons. First, off-peak consumption volumes should not be considered in any allocation of capacity costs. Second, the Company's approach does not sufficiently encourage off-peak natural gas consumption. (T. 1199) Third, a 59 HDD design day will result in demand exceeding the capacity of the Company's system. Consequently, the capacity-related costs should be based upon the curtailed coincident peak day demand. (T. 1198-1202)

Arkla. witness Henry posited that the Arkla system is designed to serve a 'design day' with 59 HDD and that no empirical data is provided to support CEUG's proposal. (T. 299)

Staff witness Bradley agreed with the Company's demand allocation methodology (T. 1654), while AG witness Marcus and AGC witnesses did not comment on it.

We agree with the Company and Staff since their allocation methodology better reflects cost causation. Demand-related costs are not solely incurred to meet the peak. A good portion of capacity-related costs is incurred to meet baseload and off-peak usage. For example, it could be argued that a smaller size of pipe is needed to meet that load. That is the rationale for the offpeak component in Mr. TheBerge's demand allocator. Additionally, there is an incremental component of capital associated with the peak day. That peak requires the Company to incrementally size the pipe to a greater size, above that needed for baseload or off-peak. That component is captured in Mr. TheBerge's first component. This is analogous to the Average and Peak Method often used to allocate production plant in electric utility rate cases, and has been previously recommended by Staff in those electric utility cases. Finally, service curtailment is a non-event for purposes of cost causation and cost allocation since curtailment is an unplanned event.

#### Cash Working Capital

[47, 48] Arkla witness TheBerge proposed that cash working capital be allocated based on O&M costs. Staff witness Bradley recommended that Accounts Receivable (Account No. 142) and the Accumulated Provision for Uncollectible Amounts be allocated based on total revenues. (T. 1623, 1648-1 649) AG witness Marcus recommended that all working capital except accounts receivable, accrued revenues, and the accumulated provision for uncollectibles be allocated based on distribution property, that accounts receivable and accrued revenues be allocated based on revenues; and that the accumulated provision for uncollectibles be based on actual uncollectibles. (T. 1416-1417) AGC witness John argued that the purchased gas component of cash working, capital costs should not be allocated to the LCS-1 transportation class since cash working capital costs are allegedly attributable to Gas Storage costs, and he argued that Gas Storage Costs should not be allocated to transportation customers since imbalance penalties fairly apportion gas storage costs. (T. 1075)

In Surrebuttal Testimony, Staff witness Bradley agreed with Mr. John, although

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245 P.U.R.4th 384

Page 65

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

she noted that he made no attempt to specifically identify the purchased gas costs allocated to the LCS-1 transportation class. (T. 1649) Mr. TheBerge agreed with Mr. John with regard to uncollected gas costs, but thought that it would be immaterial. (T. 620) CEUG made no comment on this issue.

Based on principles of cost causation, we agree with the Company that cash working capital should be allocated based on O&M, with the exceptions that accounts receivable and the accumulated provision for uncollectibles be allocated based on total revenues. However, LCS-1 transportation customers should be allocated gas storage, any purchased gas costs included in Staff's MBSA should be allocated to the LCS-1 transportation customers consistent with our decision that LCS-1 transportation customers should be allocated gas storage.

#### Cost Classification and Cost Allocation of Distribution Mains

[49-55] The largest single investment in the Company's distribution system is its distribution mains. This Commission historically has considered distribution mains as having a customer-related portion and a capacity-related portion. This assumes that there is a zero-or minimum size necessary to connect the customer to the distribution system. Considering the magnitude of the distribution mains account, the classification and allocation of distribution mains has a significant impact on the cost of service. The heart of the issue is separating the customer-related function from the capacity-related function.

To gain some perspective on the importance of this issue we refer to Arkla Exhibit MT-60. As shown there, the net distribution main plant is approximately \$165 million, according to Arkla's Sur-Surrebuttal case. As shown in Table 4 of Staff witness Bradley's Prepared Testimony, she recommends that 62.30% of the distribution main costs be classified and allocated to the Residential Class, with 37.70% classified and allocated to the Small and Large Commercial Classes. In contrast, Arkla proposes that 78.62% of the distribution main costs be classified and allocated to the Residential Class with 21.38% classified and allocated to the Small and Large Commercial Classes. The amount of rate base in play is then  $(78.62\% - 62.30\%) \times \$165 \text{ million} = \$27 \text{ million}$ . This does not include other cost categories that may be affected by this classification.

There are two generally-recognized methods for determining the customer-related portion of distribution mains: the zero-intercept method and the minimum size method (T. 1616-1617) and Gas Distribution Rate Design Manual, National Association of Regulatory Utility Commissioners, (Washington, D.C., January, 1989), p.22.) The zero-intercept method involves performing a statistical ordinary least squares regression of main cost (as the dependent variable) on main size (as the independent variable). The resulting positive-valued Y-intercept represents the cost of a main with a size of zero. This cost amount is then considered the 'customer cost', with the remaining portion representing capacity costs.

The minimum-size method involves the determination of the 'minimum size' main on the system and pricing out the entire length of system distribution mains at the

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245 P.U.R.4th 384

Page 66

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

historical cost of this minimum size main. This is considered customer-related, with the remaining portion of distribution main costs considered capacity-related. While the zero-intercept method, with reliable data, estimates the customer costs associated with a zero-size pipe, the minimum-size method may include some capacity costs since any minimum size pipe considered will be strictly greater than zero. (T. 666, 1617)

Arkla witness TheBerge uses a minimum size method with 2' pipes. He considered two constraints in determining this size. The first constraint is that the minimum pipe size should reflect the least amount of theoretical capacity. The second constraint on the pipe-size selection is presence within the Mains account at a representative level; that is, the pipe size should have a sufficient footprint within the Mains account to reflect original installation costs under a variety of physical conditions and economic circumstances throughout Arkla's 65-year time period. He concluded that a 2' pipe best meets these criteria. This resulted in a 70.54% classification to customer-related and a 29.46% classification to capacity-related.

Relying on engineering studies, Mr. TheBerge determined that the 2' pipe on Arkla's system did contain some level of capacity, approximately 2.5 cubic feet per hour. For adjustment purposes he used 5 CFH, and used this to adjust the design day levels of demand for each customer class.

Staff witness Bradley testified that the Staff prefers the zero-intercept method because, even with the smallest size pipe on the system, customer-related costs are overstated since some material costs are included. (T. 1617) However, because of issues of data integrity associated with the Company-supplied data necessary for the zero-intercept method, she opted to use the minimum size method. (T. 1618) Ms. Bradley argued for three criteria for determination of the 'minimum size': (1) the appropriate pipe size for the minimum size study is in fact the minimum size; (2) the minimum size pipe should be present in a variety of locations throughout the distribution system; (3) the minimum size should have been installed throughout the service territory. (T. 1620) In particular, she noted Tables 4 and 5 in her Surrebuttal Testimony, p. 13, which show the dispersion, through time and across Arkansas counties, of 1' Mains.

Based on these criteria Ms. Bradley concluded that the 1' pipe meets the criteria and used that size in her minimum size study. That resulted in her classification of approximately 24.3% of the Company's investment in distribution mains as customer-related, with the remaining portion, 75.7% classified as capacity-related. (T. 1646) Arkla witness TheBerge argued that the 1' pipe did not meet her criteria (2) and (3). (T. 665-669)

AG witness Marcus used three approaches for classifying and allocating distribution mains: (1) the peak and average method; (2) the zero-intercept method; and (3) the minimum connection method. The peak and average method assigns no distribution main costs as customer-related, but instead assigns them to commodity (throughput) related and capacity (demand) related. The amount assigned

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245 P.U.R.4th 384

Page 67

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

to commodity is equal to the load factor [(volume /8760 hrs. [FN8] )/coincident peak], which in this case was calculated by Mr. Marcus at 22.48%. The remainder, 77.24% was assigned to capacity. (T. 1407) Mr. Marcus then allocated the commodity component to classes based on a volumetric allocation factor, and the capacity component was allocated based on peak demand allocation factors. Arkla witness TheBerge argued that if the peak and average method is used here, it should be distance-weighted. (T. 576-577)

Mr. Marcus used Company-provided data (Response to AUD-061) for the zero-intercept method and determined that 24.08% of distribution main costs are customer-related with the remainder classified as capacity, or demand, related.

Under Mr. Marcus' minimum connection method, he assigned 56 feet of two inch main per customer as a customer cost. He believes that that is the minimum amount of main required to connect a medium-sized customer to the system. With that method, he determined that 24.2% of distribution main costs are customer-related. (T. 1407-1413) Arkla witness TheBerge disagreed with the 56 feet method used by Mr. Marcus, and argued that a reasonable minimum connection should classify no less than 108 feet as customer-related. (T. 583-587)

CEUG witness Staley endorsed the Company's 2' minimum-size method with one modification: off-peak customers should be excluded from calculation of the 'design day' demand day. (T. 1279)

AGC witness John recommended that an average of the costs of 2' and 4' mains be used to determine customer-related costs. He asserted that large customers are not typically served by 2' mains and that 4' mains are used to serve some residential customers. This approach results in customer-related costs of 85.19% and capacity-related costs of 14.81%. (T. 1081-1083)

In support of his analysis Mr. John provided his Gas Main Study. (T. 912, 927, 1112-1116) In essence, this study attempts to ascertain the embedded cost of a stand-alone mains system for the LGS-1 class. That study allegedly demonstrates that a physical analysis of the pipes in the ground serving the LCS-1 class is comparable in costs to the classification and allocation method used by AGC.

Staff witness Bradley responded to this analysis by arguing that (1) some customers receive gas from more than one point of receipt, depending upon operating conditions; (2) some customers are located on a part of the distribution system where the gas travels more than one path and route; (3) all Arkla customers in the state are served by all gas mains; and (4) because the mains are common facilities, there is no way to determine if one particular gas main is dedicated to one particular customer. (T. 646-648)

In consideration of all of the testimony, exhibits, and studies presented to us by all of the parties, we adopt the Staff allocation since it better reflects cost causation.

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245 P.U.R.4th 384

Page 68

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

During cross-examination, CEUG's counsel made much of the prevalence of the 2' main size on the system, relative to the 1' main size. (T. 651-652) But that argument misses the point. The minimum size method seeks the smallest size main given the constraint that the main size is a representative price proxy. While the 2' main would provide a representative proxy, it would abysmally fail the 'minimum-size' test. Entirely too much of the cost of a 2' pipe is associated with providing capacity.

As shown in Staff witness Bradley's Table 4, the 1' main has been used over the 1939-2004 time period. Because of that wide dispersion in installation dates, the use of a 1' main is fairly representative of the embedded customer costs, without upward bias due to a preponderance of later installations, or downward bias because of a preponderance of earlier installations. This bias can occur for two reasons: (1) later installations cost more because of inflation; and (2) later installations are not as depreciated as earlier installations. A good example of that potential bias was provided in a discussion with the Commission on the merits of using the absolute smallest pipe size (0.5' in.). That size has only been installed since 1999, and would not be representative of the system across time and location. (T. 671- 673)

Additionally, the 1' pipe has been installed in 93% of Arkansas counties in Arkla's service territory, as shown in Ms. Bradley's Surrebuttal Table 5, and in 15,000 records in the Arkla database provided in Response to Staff data request AUD 061. (T. 656) Geographical dispersion is important in the evaluation of representation since Arkansas has a wide variety of geographical landscapes, which will have an influence on the costs of any given pipe size. (T. 657) The 1' pipe was installed in a variety of these landscapes. (T. 657)

Consequently, the 1' pipe does a reasonable job of meeting the minimum-size criterion while also being a representative price proxy (representative across time and geographical landscape), while the 2' and 4' pipe sizes do not meet the minimum-size criterion.

Although the Company attempted to remove any related capacity costs in the 2' main cost, the basis for that adjustment is not useful for this case. First, the engineering study upon which the adjustment was based was developed for another case. Second, the study does not represent the Arkla service territory. (T. 659) As noted by Ms. Bradley, it is more efficient to go directly to a representative size pipe, 1', rather than to follow the circuitous route of using an above-minimum size pipe, 2' and then attempting to adjust capacity costs out of it. (T. 659)

We also note that AG witness Marcus performed a zero-intercept regression analysis that was supportive of Ms. Bradley's classification of 24.3% of distribution main costs as customer related. Mr. Marcus' regression results indicate a customer-related classification for distribution mains of 24.08%. (T. 141)

245 P.U.R.4th 384

Page 69

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

With regard to AGC's Gas Main study, we agree with Staff witness Bradley's assessment of the difficulty of accurately ascertaining the stand-alone costs of serving a particular customer class on a network system with common costs. Further, the Commission notes several analytical errors in the AGC study. Primary inputs to that study are the estimates of unit cost per foot of main across the Arkla system, shown in Arkla Rebuttal Exhibit MT-43. Those unit costs per foot are used by AGC to estimate individual customer main costs in Protected Exhibit AGC-10. There are two problems with the application of this data to the AGC Gas Mains Study. First, the unit costs for many of the main sizes are anomalous. One would expect that as the size of the pipe increases, the unit cost per foot would increase. That is simply not the case: (1) 1.5' pipe has smaller unit cost per foot than does 1' pipe; (2) 2.5' pipe has smaller unit cost per foot than do 1.25' pipe and 2' pipe; (3) 3.5' pipe has smaller unit cost per foot than do 2' pipe and 3' pipe; (4) 4.5' pipe has smaller unit cost per foot than do 3' pipe and 4' pipe; (5) 7' pipe has smaller unit cost per foot than do 2' and 6' pipe; (6) 8' pipe has smaller unit cost per foot than do 6' and 7' pipe; (7) 16' pipe has smaller unit cost per foot than does 12' pipe; and (8) 20' pipe has smaller unit cost per foot than do 6', 10', 12', 16', and 18' pipe. We are not saying that the actual calculations of the unit costs per foot are in error. It is just that the data is not useful for purposes of the AGC Cost Study. It is likely that the reason this occurs is because many of these unit costs per foot are not representative across time and geographical location.

A second problem with the AGC Gas Mains Study is that the analysis does not focus on the costs at a particular LGS-1 customer location. These unit cost estimates are based on the average across the Arkla system.

Finally, the AGC Gas Mains Study uses an average 41% Accumulated Depreciation factor to adjust gross plant to net distribution mains plant. Again, this factor is Arkla system distribution wide and is not specific to the accumulated depreciation at a particular LGS-1 customer's location.

Given these three analytical flaws in the AGS Gas Mains Study and the common plant point raised by Ms. Bradley (T. 646-648) we give very little weight to the AGC Gas Mains Study.

Ms. Bradley also recommended that Arkla be required to accumulate and maintain the data necessary to properly perform the zero-intercept method. She stated that both linear and non-linear regression analyses can be run, that both Arkansas Western Gas and Arkansas Oklahoma Gas currently accumulate and maintain data for the zero-intercept method, and that it is unlikely that the additional data accumulation would be at great cost. Further, she recommended that the Company be required to accumulate and maintain the following data necessary to perform a zero-intercept study in the future: (1) authorization for expenditure or job number; (2) code identifying the type of material, e.g. plastic, steel, cast iron, and a number identifying the size of the pipe in inches; (3) number of units, e.g. footage for pipe, count for fittings and valves; (4) cost of materials; (5) cost of labor; and (6) cost of overhead. (T. 1618, 1646-1648)

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245 P.U.R.4th 384

Page 70

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

**(Publication page references are not available for this document.)**

The Commission agrees with Staff witness Bradley's recommendation, and hereby directs Arkla to begin accumulating the necessary data for performing a valid zero-intercept regression method. We do not agree with the Company that having non-linear data will automatically invalidate the zero-intercept method; the appropriate solution is to perform a nonlinear regression. At this time we are not prejudging whether such analysis should be linear or non-linear, but note that there are numerous statistical packages that can do either.

#### Customer Accounting and Sales Expenses (Account 916)

[56, 57] The Company and CEUG recommend that Customer Accounting be allocated based on unweighted customer counts. (T. 1289-1290) The AG recommends that weighted customer information be used because it is more complex to read meters and provide service to large customers. (T. 1418) CEUG witness Staley testified that there is no evidence to support that claim and that, based on his experience, it is less complex and less costly to read the meters of larger customers. The Company and CEUG recommend that Account 916 be classified and allocated based on the number of customers. The AG recommends that 90% of the costs in Account 916 be directly assigned to transportation customers and 10% assigned to the LCS class. (T. 1419) Staff and AGC did not comment.

We agree with Arkla and CEUG because their allocation better reflects cost causation.

#### Customer Allocation Factors

[58, 59] Arkla witness TheBerge proposes a customer allocation factor based on the number of current fixed installations for each customer class. (T. 494, 691-692) Staff witness Bradley recommends that those allocations be based on normalized customer counts. (T. 1623) Neither the AG, AGC nor CEUG made comments. We agree with the Staff since its allocation more reasonably reflects ongoing conditions.

#### Distribution Load Dispatching

[60] The Company and CEUG propose that Distribution Load Dispatching be classified as both customer- and capacity-related, and allocated accordingly. (T. 519, 1288) Staff witness Bradley proposes that this account be classified solely as capacity-related and allocated accordingly. (T. 1648) AG witness Marcus proposes that this Account 871 be classified as 9% directly to transportation administration, and 45.5% be classified and allocated to capacity and throughput each. (T. 1417-1418). We agree with Staff witness Bradley since these facilities are used in dispatching gas and thus do not have a customer-specific component, and are entirely capacity-related.

#### Gas Storage Inventory

[61, 62] Arkla and Staff propose that gas storage inventory be allocated based on

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245 P.U.R.4th 384

Page 71

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

**(Publication page references are not available for this document.)**

demand. (T. 608, 1653) AG witness Marcus recommends that the allocations be based on 45.6% by sales to sales customers and 55.6% by peak demand to all customers. (T. 1490) Further, Mr. Marcus recommended a 35-65 commodity/demand split. (T. 1490) AGC witness John recommended that no gas storage inventory costs be allocated to the LCS-1 transportation class. (T. 1074-1075, 1120) Mr. John also notes that Section 3.21.1 of the LCS-1 Rate Schedule provides that Transportation Supply Option ('TSO') transactions are not allocated any storage costs. (T. 1119) CEUG witness Ward proposes that no gas storage inventory be allocated to TSO since the Company's balancing provisions for TSO customers protect those supply-related assets by imposing significant penalties for excessive imbalances. (T. 1154-1156) Consequently, according to AGC and CEUG, those imbalance penalties already fairly apportion gas storage costs to transportation customers.

We agree with the Company and Staff since their proposed allocation better reflect cost causation. Gas storage brings significant operational benefits to the on-system operation of the distribution grid. Arkla's allocation of gas storage inventory is designed to recognize the continuous minute-to-minute pressure balancing required for both sales and transportation customers. (r. 568-569, 594) Storage service is a prerequisite for load-following service, which benefits sales and transportation customers. Additionally, the imbalance fee recovered from transportation customers is significantly less than the cost of the imbalance fees that would be associated with load-following services provided to stand-alone transportation customers. (T. 576, 703) A relative demand allocation best meets the cost causation principles for gas storage as noted in the Rebuttal Testimony of Arkla witness TheBerge: (1) storage is used to meet peak-day demand; (2) storage is able to meet downstream load-following service based on load following receipts upstream; (3) storage is used to meet periodic imbalances; and (4) storage is used to capture and transfer methane prices between seasons. This last function is properly reflected in the GSR mechanism in the form of methane costs that are allocated based on sales volumes. (T. 709)

#### Land and Land Rights and Structures and Improvements

[63] Arkla witness TheBerge argues that Land and Land Rights and Structures and Improvements, Accounts 374 and 375, should be allocated based on the classification and allocation of distribution mains. Staff witness Bradley recommends that they be classified and allocated based on all facilities on the grid, Accounts 376, 378, and 389. (T. 1623) AG, AGC, and CEUG did not comment on this issue.

We agree with the Staff since its allocation better reflects cost causation. As noted by Mr. TheBerge, items recorded in Account 374 are the cost of owning, leasing, or accessing the land occupied by the distribution mains and other components of the grid. (T. 510) Also, items recorded on Account 375 represent investment primarily required for the support of the Company's distribution system networks. (T. 510) Since those accounts support the distribution grid, generally, Staff's allocation is more reasonable.

245 P.U.R.4th 384

Page 72

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

#### Measuring and Regulating Station Equipment

[64] Arkla witness TheBerge recommended that Accounts 378 and 379, Measuring and Regulating Equipment, be allocated based on the allocation of Distribution Mains, Account 379. (T. 595-598, 686-691) Staff witness Bradley argued that those amounts should be classified as capacity-related and allocated based on demand (T. 1623), while AG witness Marcus recommended that they be classified as capacity-related and allocated based on a peak and average method or some form of a minimum system analysis that excludes the customer portion. (T. 1413-1414, 1484-1485) Neither AGC nor CEUG commented on this issue.

We agree with the Staff since these facilities are used in measuring and regulating gas and therefore do not have a customer-specific component and are entirely capacity-related. As noted by Ms. Bradley: 'Measuring and regulating equipment would not exist if gas were not being delivered. Again, customer-related costs pertain to having access to the distribution system, not the delivery of gas.' (T. 567)

#### Meter Installations

[65] Arkla allocated Meter Installations, Account No. 382, based on the cost of meter installations used to serve each customer class. AG witness Marcus argued that the Company incorrectly applied sales tax and purchasing and warehousing overheads. (T. 1414-1415) Arkla witness TheBerge agreed but noted that Mr. Marcus then introduced a new error in removing the excess from the replacement-cost-new level exclusively for the residential class instead of all of the classes. (T. 598-599) Correcting for that results in the Company-revised allocations shown on p. 51 of Mr. TheBerge's Rebuttal Testimony. Mr. Marcus agreed with those corrections. (1483) We agree with those revised allocations.

#### Other Operating Revenue

[66] The Company and CEUG propose that tariffed charges such as late payments, returned checks, service establishment, collection, reconnection, etc., be allocated based on gross margins. In particular, CEUG witness Staley notes that the allocations of revenues and expenses should be applied consistently. (T. 1223) AG witness Marcus proposes to assign these based on the classes who pay the charges. (T. 1423) Staff and AGC did not comment on this issue.

We agree with the Company and CEUG since their allocation better reflects cost causation. Many of these charges are simply penalties which are designed to discourage specific behavior and, consequently, have no class-specific entitlement. (T. 629) With regard to the other charges, since they are not being redesigned in this proceeding we do not know their specific cost components. Further, many of the charges are the product of earlier proceedings including settlements. (T. 629-630)

#### Regulatory Commission Expense

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245 P.U.R.4th 384

Page 73

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

[67] Arkla and CEUG propose that Account 928, Regulatory Commission Expense, be classified as customer-related and allocated based on customer counts. (T. 1289-1290) Staff and the AG argue that it should be classified as revenue-related and allocated based upon revenues. (T. 1419-1420, 1629-1637) AG witness Marcus also specifies that 75% of these costs be allocated by gross margins and 25% allocated by gas sales revenues. CEUG witness Staley responds by saying that many of the contentious issues in this rate case have significant effects upon all of the rate classes, not just the large customers. (T. 1289-1290) CEUG argues that the AG's position should be rejected. AGC did not comment on this issue.

We agree with the Staff and the AG that revenue allocations better reflect cost causation in this case. As discussed by Arkla witness TheBerge in cross-examination, he has used a revenue allocator for this cost item in other cases. (T. 595-596) However, he is concerned about the potential circularity involved in allocating this item based on revenue, or cost of service. We do not see such circularity. A straightforward way of accomplishing this allocation is to allocate Regulatory Commission Expense based on the final cost of service, excluding Regulatory Commission Expense. It is a simple matter of arithmetic to show that after that allocation, and inclusion in the cost of service, the equivalent allocation results are produced. Given the relatively small size of this expense in the revenue requirement, class revenues are a good proxy for class cost of service.

Services, Meters, Meter and Regulator Installation, House Regulators, Individual Measuring and Regulating Equipment

[68] Arkla witness TheBerge recommends that Accounts 380-3 85 be classified as customer and capacity-related and allocated based on point-in-time customer locations. Staff witness Bradley recommends that these be classified as entirely customer-related and allocated based on normalized customer counts. (T. 1623) The AG, AGC, and CEUG had no comments on this issue. We agree with Ms. Bradley since its allocation better reflects cost causation. These items are strictly customer-related and have very little, if any, demand, or capacity-related, component.

Telemetry Costs (A&G Accounts 920 and 921)

[69] Arkla and CEUG propose that telemetry costs be allocated based on O&M expenses. (T. 1290-1291) AG witness Marcus argues that all of telemetry costs be directly assigned to LCS-1 customers, with an adjustment to rate base for Account 902 to prevent overlap. (T. 1420) CEUG witness Staley argues that it is inequitable to charge LCS-1 customers without crediting them with separate revenues. (T. 1290-1291) Staff and AGC did not comment on this issue. We agree with Arkla and CEUG since their allocation better reflects cost causation.

## VI. RATE DESIGN

### Class Rates of Return

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245 P.U.R.4th 384

Page 74

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

[70] Arkla and Staff recommend that all classes pay equivalent rates of return. This is consistent with the principle that each class should pay its Cost of Service. (T. 649-650, 1614, 1655) Arkla's Cost of Service Study indicates an approximate 10% increase for the Residential Class, a 2% increase for the SGS Class, and a 0.13% increase for the LGS Class.

Using Staff's Cost of Service study, the net result would be approximately a 4% decrease for the Residential Class, a very slight 0.3% increase for the SCS Class, and a 7% increase for the LGS Class. In designing rates once the revenue requirement is decided upon, Staff witness Bradley emphasized the principles of gradualism and stability; rate design should minimize adverse impacts while providing the Company with a reasonable opportunity to recover its approved revenue requirement. (T. 1625, 1657).

AG witness Marcus asserted that cost studies should be treated as guidelines, that differentials in class rates of return may be justified by risk, and that a cost study's results must be balanced with other ratemaking and public policy goals of the Commission. Examples of the latter are avoidance of rate instability and giving customers control over their bills. (T. 1396-1399, 1425) In Supplemental Surrebuttal Testimony, Mr. Marcus proposed assigning all of the decrease in rates to the Residential Class, and freezing the Commercial Classes at current rate levels. (T. 1448) This would have the effect of the Residential Class having a greater rate of return than the Commercial Class, based on the AG's Cost of Service Study.

AGC witness John argues that AGC customers should be appropriately assigned their costs in rate design. (T. 1083) CEUG took no position on the issue.

Generally speaking the Commission agrees with the concept of equal rates of return as recommended by Staff. Adopting equal rates of return in rate increase cases has been the norm for the Commission for a number of years. However, given that the net result of this order is a substantial rate decrease, and given that Staff's rate design proposal would mean a slight increase for the small commercial class and a significant rate increase for the large commercial class while decreasing rates only for the residential class, the Commission finds that it is more appropriate to deviate somewhat from Staff's rate design proposal. For purposes of this rate case the Commission finds that the rates for the small commercial class and the large industrial class should be held constant and the rates for the residential class should be decreased accordingly. [FN9]

#### Residential Class Rate Design

[71] Arkla proposes that the customer charge for the RS-1 class increase from \$9.75 to \$17.00. The Company proposes to decrease the amount of usage applicable to the first block from 50 CCF to 15 CCF, increase that block's charge from \$0.2630 to \$0.8267, and decrease the second block from \$0.1847 to \$0.0572

245 P.U.R.4th 384

Page 75

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

Staff witness Bradley opposed those changes because they will, taken together, significantly increase the minimum charge to many residential customers. (T. 1625-1627) As shown in Table 7, p. 19, of her Prepared Testimony, that increase may be as high as 114.7%. Given the principle of rate stability, she believes that a rate increase of this magnitude would have a significantly adverse impact. (T. 1626) Ms. Bradley recommended that the Residential Class pay its cost of service, that the RS-1 customer charge rate remain at the current level, and that the residential rate decrease, based on Staff's cost of service (T. 1634), be accomplished by reducing the rates applicable to the second block. (T. 1627, 1658)

AG witness Marcus claimed that under virtually any method for classifying distribution main costs, with the exception of Arkla witness TheBerge's, the RS-1 class is paying above the system average. (T. 1426) Further, Mr. Marcus does not believe that complete equalization of rates of return is required. (T. 1427)

Mr. Marcus recommended that the current rate structure be maintained for all rate classes, including RS-1. Further, he proposed that the RS-1 customer charge remain the same, and that any rate increases for the residential class occur in both volumetric blocks. In support of this, he noted that the customer impacts of Arkla's proposal may be extreme. (T. 1429-1434) He asserted that this major increase in the customer charge reduces shareholder risk dramatically. (T. 1428)

Mr. Marcus claimed that the increase in the customer charge would have disproportionate impacts on lower-income people since the proposal would primarily impact low usage customer, and lower income people use less gas than higher income people. (T. 1430-1431) He cited five studies to support this hypothesis. First, he performed a regression analysis using Arkansas zip codes, which showed that people in upper-income areas use more gas than the average customer. (T. 1431) Second, he ran another regression on Arkansas counties, which showed that in 2003 usage per customer was 472 CCF plus 11 CCF per \$1,000 of income. (T. 1431) Third, he presented data from the Bureau of Labor Statistics that show a positive correlation between income level and natural gas usage in the southern region of the U.S. (T. 1431) Fourth, he relied upon data from the Energy Information Administration, which indicates that a family over the \$50,000 income level uses 36% more natural gas than the average family under the poverty line. (T. 1432-1433) Fifth, he conducted a study using survey data from Pacific Gas & Electric that shows that lower income customers use considerably less gas than higher income customers. (T. 1433)

Arkla witness TheBerge claims that its proposed residential rate design will result in smaller bills for many underprivileged customers, particularly in east Arkansas. This is because many of those customers have poorly insulated homes. (T. 679-680) Mr. TheBerge also noted that all of the studies that he has seen indicate that there is not much difference in usage between lower-income and upper-income customers. (T. 687) In response to a question from the Commission. Mr. TheBerge stated that the average residential customer uses 54 CCF per month and would see a \$3.20 per bill increase under the Company's proposal. (T.723) He also stated that 4 counties in east Arkansas with below average incomes have above average

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245 P.U.R.4th 384

Page 76

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

**(Publication page references are not available for this document.)**

consumption of natural gas. (T. 724)

CEUG did not directly address RS-1 rate design. AGC witness John indirectly addressed RS-1 rate design in that he has concerns that the LCS-1 class is subsidizing the other classes. (T. 1084-1086)

We agree with both Staff and the AG that Arkla's proposed rate design for the RS-1 class would have severe rate shock impacts on many residential customers, especially lower income customers. We agree that the Residential Class should pay its cost of service, that the RS-1 customer charge rate should remain at the current level, and that the residential rate decrease from Staff's cost of service should be accomplished by reducing the rates applicable to the second block.

#### Residential Customer Survey

[72] AG witness Marcus proposed that Arkla conduct a study of its customer base, in particular with regard to gas usage, economic factors, and demographic factors. He claimed that there is a paucity of data regarding the impacts of various rate designs. He recommended that this Commission authorize \$150,000, amortized over three years, in this rate case to be spent by Arkla on such a study. (T. 1435-1436)

We agree with his proposal and authorize an additional \$50,000 in expenses for this project. The study should be comprehensive and include factors such as those listed in Mr. Marcus Direct Testimony, p. 91.

#### Small Commercial Class Rate Design

[73] Arkla witness TheBerge proposes that the customer charge for the SCS-1 class increase from \$13.00 to \$18.00. In addition, Mr. TheBerge proposes an increase in the SCS-2 (Off-peak) first 1500 CCF block rate from \$.1817 to \$.2060. Mr. TheBerge proposes that the Gas Supply Rate ('GSR') charges for the SCS rate class be set on a volumetric basis, instead of the current demand based billing. (T. 276) Arkla witness Henry proposes this change because of the significant increase in customer complaints after the initiation of the new SCS rates in September, 2002. (T. 276) As noted by Mr. The Berge, the volumetric rate design works well for the majority of the SCS Class because the the customers in this class are predominantly low-load factor customers. (T. 839) Mr. Henry also proposes the elimination of the SCS-2 true-up mechanism. Instead, over- and under-recoveries would be recovered from all SCS customers.

Staff witness Booth agreed with the change to volumetric billing for the GSR rate in the SCS class for the same reason as the Company. (T. 863-864, 1751) However, Mr. Booth opposed the elimination of the true-up mechanism for the SCS-2 class because it is appropriate for the SCS-2 customers to pay the costs of providing service to them and it is inappropriate for those costs to be spread to other SCS customers. (T. 1753) Staff witness Bradley opposed the increase in the SCS customer charge because it will significantly increase the minimum charge to many SCS customers. (T. 1625-1627) She recommended that the SCS class pay its cost of

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245 P.U.R.4th 384

Page 77

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

**(Publication page references are not available for this document.)**

service, and that, because of the minimal change in the SCS class cost of service, this class increase occur entirely in the customer charge. (T. 1634, 1658)

CEUG witness Staley recommends that the Company-proposed increase in SCS-1 fixed costs be reduced. (T. 1209) Further, Mr. Staley opposed the recovery of GSR charges on a volumetric basis and recommended continuation of the current demand based billing. (T. 1211-1212) Mr. Staley noted that a change from demand-based to volumetric billing in the GSR rate would be confusing and would restore a subsidy among sales customers. (T. 1222) Additionally, Mr. Staley pointed out that many customers now have equipment that can accurately measure demand. (T. 1306) Even if the GSR rate is not maintained as a demand-based billing component, a volumetric GSR rate should be of the declining block type. (T. 1222)

AGC witness John indirectly addressed SCS rate design in that he has concerns that the LCS-1 class is subsidizing the other classes. (T. 1084-1086) The AG did not comment on the SCS class rate design.

We agree with Staff that the only change in the SCS class should be a slight increase in the customer charge and that the SCS class should pay its cost of service. Further, the change to volumetric billing for the GSR rate is appropriate because of the prior customer confusion. We also agree with Staff that the true-up mechanism should stay solely within the SCS-2 subclass. Large Commercial Class Rate Design

[74] Arkla witness TheBerge proposes a decrease in the LCS-1 customer charge from \$290 to \$26. Further, he proposes a flat demand charge of \$3.3S/MMBtu for all MMBtus (one-step) rather than \$5.5790/MMBtu for the first 400 MMBtu and \$.400 for all MMBtu over 400 (two-step). The LCS-1 rate changes are proposed to be delayed until November 1, 2006.

Staff witness Bradley recommended that the current structure be maintained by increasing each current charge equally. (T. 1627) Ms. Bradley expressed concerns that Arkla's LCS-1 rate design proposals may cause some customers to experience increases of more than 70%. (T. 1657)

AG witness Marcus recommended that no change to the LCS transportation administration fee be made. (T. 1495)

CEUG witness Staley recommended that the LCS-1 class retain its declining block rate and that any proposed increase or decrease in this class be accomplished by increasing or decreasing each tier demand charge equally. (T. 1211, 1312)

AGC witness John agrees with Staff witness TheBerge's proposed one-step rate design, but noted that since that rate design, if approved, would reduce Arkla's business risk, the Commission should reduce Arkla's allowed return on equity. (T. 933, 1083-1084, 1129-1130) He disagreed with a two-step declining block demand charge because it will result in intra-class subsidies.

245 P.U.R.4th 384

Page 78

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

**(Publication page references are not available for this document.)**

CEUG witness Ward and AGC witness John also proposed that the LGS class be divided into a transportation class and a sales class because the underlying characteristics of sale customers and transportation customers are different. In particular, sales customers receive a 'bundled service', and transportation customers are governed by the balancing provisions of the LCS-1 tariff. Additionally, separating sales and transportation customers would help ensure that purchased gas and administrative costs are more easily tracked and allocated. (T. 1087-1088, 1130)

Arkla witness TheBerge claimed that the nature of distribution service provided to sales This is evidenced by the customers and transportation customers is essentially the same historical conversions back and forth between the two. He also noted that separate schedules will not facilitate revenue or expense tracking because the Company is not constructed, organized, managed, or operated based on rate schedules. Additionally, cost allocation models will be no less complex. (T. 710-713) No other party addressed that issue.

We agree with Staff witness Bradley's proposal that the current LGS-1 rate structure be maintained by increasing each current charge equally and that the LGS class pay its cost of service. Further, we agree with the Company that there should be no split between transportation customers and sales customers. In the past few years, Arkla's rate Schedules have been simplified. complexity. We do not intend to reverse that course and go down the path of increasing

## VII. RATE RIDERS

### Rate Stabilization Plan

[75-78] In its filing, Arkla proposed a new Rate Stabilization Plan ('RSP '). This RSP would provide for the review and, if necessary, adjustment of rates on an annual basis. Under the Company's proposal, earnings would be evaluated annually based on a test year ending April 30 with rate changes to take effect on October 1. For purposes of determining earnings, net income would be based on actual results adjusted for: weather normalization; gas cost normalization; wage, salary and benefit increases effective at the end of the test period ending April 30; tax rate and assessments and other items of expense at the end of the test period or which are established by contract or government action for the 12 months beginning May 1; and interest synchronization. (Application Vol. 11, Schedule J, p. 7.)

To determine whether a rate adjustment is necessary, Arkla has proposed that a 100 basis point deadband around the allowed return on equity ('ROE') be established. To the extent that its earned ROE is more than 50 basis points below the allowed ROE, rates would be increased by the amount necessary to generate the revenues necessary to increase the earned ROE to the allowed ROE. If the earned ROE exceeded the allowed ROE by more than 50 basis points but not more than 150 basis points, Arkla would refund 50 percent of the excess earnings in excess of the 50 basis point deadband. To the extent the earned ROE exceeded the allowed ROE by more than 150 basis points but not more than 250 basis points, an additional 75

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245 P.U.R.4th 384

Page 79

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

percent of the earnings in the excess of 150 basis points would be refunded. Finally, if the earned ROE exceeded the allowed ROE by more than 250 basis points, Arkla would refund 100 percent of the earnings above the 250 basis point threshold. (Application Vol. 11, Schedule J, pp. 2-3.)

Both the Staff and the AG urge that the RSP be rejected. Staff witness Booth noted that the Commission has historically elected to approve riders such as the RSP only where doing so resulted in an equitable balance of the interest of the Company and its customers. Mr. Booth argued that the claimed benefits of the RSP, avoidance of regulatory lag and reduced rate case expense, do not warrant a departure from traditional ratemaking practices. He also testified that the RSP does not satisfy the criteria applicable to the evaluation of automatic adjustment clauses. Those criteria are: (1) the RSP does not apply to a cost element that represents a significant portion of the utility's total operation costs; (2) the costs do not exhibit extreme volatility and unpredictability; and (3) the cost item is not outside the control of the utility's management. (T. 1740-1744)

AG witness Marcus argued that the RSP is one-sided in that it protects the Company from all risk on the downside, but only results in a small sharing of the upside risk. He further pointed out that the RSP is one-sided in that it provides permanent rate increases when earnings shortfalls occur. However, when earnings surpluses arise, one time bill credits or refunds are given for a portion of the excess. He noted that while performance based regulation mechanisms have been given greater consideration in recent years, Arkla's proposed RSP does not qualify as performance based regulation. (T. 1354-1358)

In his Rebuttal Testimony at page 88, Arkla witness Harder argued that the Commission has the discretion to depart from traditional ratemaking policies and procedures to approve a rider such as the RSP. He argued that there are additional benefits that the Staff ignored, including more closely aligning rates with costs and capping the Company's ROE at 1.25 percent above the Commission approved ROE. (T. 94) Mr. Harder argued that those benefits, in combination with reductions in rate case expense and regulatory lag, warrant departing from traditional ratemaking.

As noted by Staff witness Booth in his Prepared Testimony, (T. 1743) the Commission addressed a similar proposal (called the Rate Evaluation Plan or REP) by Arkla in Docket No. 93-081-U. In Order No. 13 in that docket, the Commission found that the REP did not meet the criteria historically used in evaluating automatic adjustment clauses and it rejected that proposed rider. In this case, the RSP is rejected for the same reasons. Those are: (1) the RSP does not apply to a cost element that represents a significant portion of the utility's total operation costs; (2) the costs do not exhibit extreme volatility and unpredictability; and (3) the costs addressed by the RSP are not outside the control of the utility's management. We do not agree that the benefits identified by Arkla satisfy the criteria that would warrant a departure from traditional ratemaking policies and procedures and justify the implementation of the RSP.

245 P.U.R.4th 384

Page 80

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

We also agree with the concerns raised by AG witness Marcus that the RSC is one-sided in favor of the Company and investors. When earnings are below the proposed deadband, or more than 50 percent basis points below the allowed ROE midpoint, revenues would be increased by an amount necessary to bring the earned ROE back to the midpoint or allowed ROE. [FN10] In contrast, when rates are above the upper end of the deadband, or more than 50 basis points above the allowed ROE, the Company would refund only a portion of the excess over the upper end of the deadband. Moreover, because rates themselves are not changed, Arkla would be left with the potential to over-earn again the following year. Accordingly, we reject the RSP.

#### Infrastructure Cost Recovery (ICR) Rider

[79-82] Arkla witness Harder states that the purpose of the ICR Rider is to replace the existing Main Replacement Program ('MRP') Rider as the primary mechanism to fund the cost of the cast iron and bare steel replacement program between general rate cases. Mr. Harder contends that the ICR Rider, when used with the LCA Rider, would mitigate Arkla's need to file rate cases and it would provide the means to improve and maintain a safe, adequate, and reliable distribution system. The ICR Rider would expand the scope of the MRP Rider to include (1) street and highway projects of government entities, and (2) legislative and administrative requirements relating to public health, safety, and environment. Mr. Harder asserts that the scope of the MRP Rider should be expanded to include street and highway improvements because a sizeable portion of what Arkla expends is not reimbursed. Also, the ICR Rider would avoid the need for the Company to file under Ark. Code Ann. 23-4-501 (Act 310) for the recovery of qualifying costs. (T. 32-36)

Staff Witness Booth testified that Arkla has not justified the need for the ICR Rider. Mr. Booth stated that Arkla is requesting that the Commission approve an open ended rider that goes far beyond the current MRP Rider in the types of costs that could be recovered. Mr. Booth argues that eligible facility relocation and city public work project costs could be recovered using an Act 310 or general rate case filing. (T. 1744-1746)

The AG, and AGC also oppose the Company's proposed ICR Rider. AG witness Marcus characterizes the ICR Rider as an open-ended program that should be summarily rejected. (T. 1353) AGC witness John contends that the ICR Rider will: (1) ensure that Arkla is made whole for certain expenses without providing any identifiable benefits to customers, and (2) insulate Arkla from the risk of doing business and ignore the fact that a company's business risk is factored into the determination of its return allowance. (T. 1091-1092)

Arkla Witness Harder asserted that the Commission should exercise its discretion to approve both Riders ICR and LCA. He contends that the ICR Rider provides a cost-effective alternative to the current MRP Rider by including other costs incurred as a result of government action. Mr. Harder argues that the ICR Rider reduces the cost of regulation by avoiding costs associated with Act 310 filings

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245 P.U.R.4th 384

Page 81

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

and the disputes that can occur under Act 310 filings. Mr. Harder believes that Ark. Code Ann. 23-4-108 does not specify the criteria to be followed nor does it limit the Commission's evaluation to Staff's automatic adjustment criteria. (T. 195-197)

In surrebuttal testimony, Staff Witness Booth testified that the Staff does not agree that the proposed ICR Rider is a cost-effective alternative to filing rate cases because: (1) the rider will generate additional revenue for Arkla with little regulatory oversight; and (2) it is unlikely the rider will result in lower bills or provide benefits to ratepayers. Mr. Booth further testified that, if the rider is approved, ratepayers can expect that, in contrast to the MRP Rider: (1) the ICR Rider will not limit the types of cost that it can recover; and (2) Arkla will recover a much larger annual revenue requirement under the proposed ICR Rider. (1778-1779) AG witness Marcus continues to recommend rejection of Arkla's proposed ICR Rider. Mr. Marcus contended that Arkla would have no incentive to be cost-conscious if recovery of costs were automatic, with a blank check and no regulatory review. With regard to highway relocations, the AG states that these costs have been ongoing for decades and are not new unusual requirements meriting a new policy. (T. 1451-1452) In sur-surrebuttal testimony, Arkla Witness Harder proposed modifications to the MRP Rider that would make it the vehicle for recovering cathodic protection expenses and costs that have been pre-approved for recovery. Mr. Harder, therefore, proposed that its MRP Rider should be designated as the ICR Rider because it will ultimately recover infrastructure costs beyond the scope of the bare steel and cast iron replacement program. (T. 244-245)

The Staff, AG, and AGC all recommend that the Commission reject Arkla's proposed ICR Rider. The Commission agrees with these parties' recommendation. Arkla already has in place the MRP Rider for the purpose of addressing safety concerns related to the replacement of bare steel and cast iron mains and services. The testimony of Staff witness Booth establishes that other regulatory mechanisms exist for Arkla to recover the eligible costs associated with relocating facilities for state, county, and city public works projects. Act 310 provides a means for Arkla to recover some of the costs that would be included in the ICR Rider. While Arkla could use the Act 310 filing procedure, Booth's testimony has shown that Arkla has not chosen, in approximately 14 years, to use an Act 310 filing to recover the cost of relocating pipeline facilities. Arkla could also use a general rate case filing to pursue the recovery of these costs. The Commission also finds that the proposed ICR Rider, as analyzed by Staff, does not meet the criteria applicable to the evaluation of other automatic adjustment clauses. Unlike, for example, the single expense for the purchase of natural gas, the ICR Rider would bundle together various types of capital costs and other expenses as a group. Also, unlike purchased gas costs, ICR-type costs could not typically be considered as volatile. Moreover, Arkla has not shown that ICR-type costs that would be included for recovery are beyond Arkla's control as are natural gas costs.

In summary, Arkla has not fully utilized the regulatory options available to the Company. The proposed rider fails to meet the criteria traditionally used to evaluate automatic adjustment clauses. Arkla's proposed ICR Rider fails to balance

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245 P.U.R.4th 384

Page 82

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

**(Publication page references are not available for this document.)**

both Company and ratepayer interests. While the proposed rider would keep Arkla whole and insulated from certain business risks, it would not provide the same level of benefits for ratepayers. For the reasons enumerated above, Arkla's late request to have the MRP Rider designated as the ICR Rider in recognition of its expanded scope for infrastructure costs is also denied.

#### Load Change Adjustment Rider

[83-85] Arkla witness Cummings proposed a Load Change Adjustment Rider designed to reflect changes in two factors: (1) Number of customers; and (2) Usage per customer for Residential and Small Commercial Sales customers. (T. 822-836) In Rebuttal Testimony, Arkla witness Cummings dropped the component of the LCA that addressed changes in the number of customers. (T. 841-842)

According to Arkla witness Cummings, the Company has experienced a long-term declining trend in usage per customer in the Residential and Small Commercial Classes. (T. 828-832, 780-781) Also, according to Arkla witness Henry, Arkla's billing determinants have fallen from 31.5 BCF to 24.0 BCF since 1993. (T. 251-252) While other natural gas utilities have faced declines in usage per customer, they continue to experience growth in number of customers. (T. 243, 253) In contrast, Arkansas electric utilities have seen growth in electric residential customers and usage per customer. (T. 244, 253)

The proposed LCA Rider would adjust the bills of Residential and SCS customers for changes in non-gas revenue resulting from the changes in usage per customer levels used to set volumetric rates and the weather adjusted actual usage per customer levels experienced in the months following the implementation of those rates. According to Arkla witness Harder, two factors have affected the Company's ability to recover its cost of service: revenue-related risk and regulatory lag. (T. 30-31) Arkla witness Cummings alleged that the LCA rider: (1) should enable the Company to file rate cases less frequently, thus saving rate case expense, and (2) will more closely align the Company and customer interests of conserving and efficiently using gas ('decoupling'). (T. 33-35)

Staff witness Wright noted several problems with the LCA Rider. First, it would shift risk from Arkla's stockholders to Arkla's customers (T. 1901) This does not provide an equitable balance between the interests of the Company and its customers. (T. 1908) Second, the LCA Rider, if approved, would represent a significant departure from the traditional and fundamental ratemaking policies and procedures of this Commission. (T. 1905) Third, there is no guarantee that Arkla will file rate cases less frequently and that the associated savings, if any, will be passed on to customers. (T. 1906) Fourth, the LCA Rider is a type of 'piecemeal' ratemaking where the level of the rate change would be based solely on the change in usage per customer without any review or determination of other factors such as rate base, expenses, or capital costs.

In response to the Company's concerns about 'regulatory lag', Staff witness Booth claimed that Arkla has not fully availed itself of the provisions of Ark. Code

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245 P.U.R.4th 384

Page 83

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

Ann. §23-4-406 with regard to test-year and forward-looking cost data. (T. 1739-1740) Booth also noted that the LCA Rider fails the three criteria applicable for evaluation of an automatic adjustment clause: (1) the cost is a significant portion of a utility's operating costs; (2) the cost item exhibits extreme volatility and unpredictability, with that volatility defined as upward or downward-trending; and (3) the cost item is outside the control of the utility's management. (T. 1740-1742, 1772)

CEUG witness Ward opposed the LCA Rider because it: (1) provides the Company a mechanism to adjust rates without representation of intervening parties; (2) does not provide the Company incentive to promote growth in its service territory; and (3) guarantees a rate of return independent of performance. (T. 1158-1159)

AG witness Marcus would consider a tradeoff that accepts the Company's revised LCA Rider in exchange for no increases to customer charges and a reduction in the return on common equity that is commensurate with the risk reduction. (T. 1351) Further, if the proposed LCA Rider is approved, Mr. Marcus recommends that it should be combined with the existing Weather Normalization Adjustment clause into one adjustment clause to avoid unnecessary complexity. (T. 1352) Arkla rejects Mr. Marcus' recommendation that customer charges remain at their current levels and that the allowed return on equity be reduced if the LCA Rider is approved. (T. 41-45, 331, 856-857, 927-933) Arkla witness Cummings opposes the merging of the LCA and the WNA because customers would lose the immediate bill adjustments of the WNA if it were eliminated and incorporated into the LCA. (T. 835-836, 324)

AGC witness Johns opposed the LCA Rider because it would shift risk to customers and would lessen Arkla's incentive to maintain service levels used to set rates. (T. 1094) Additionally, Mr. John noted that the LCA rider is 'piecemeal ratemaking' and that all inter class subsidies should be eliminated before adopting proposals which would extend the time between rate cases. (T. 1095-1096)

In Rebuttal Testimony, Mr. Cummings proposed the addition of Company funding of conservation and energy efficiency programs of 10% of LCA collections, up to \$100,000 per year. These programs would include energy efficiency premises audits, educational programs, and load research programs. (T. 842) Also in Rebuttal Testimony, Arkla witness Henry alleged that the Company has incurred a \$4.9 million marginal revenue erosion since its last rate case. (T. 328)

In Surrebuttal Testimony, Staff witness Wright noted that the 10% or \$100,000 provision alone will be unlikely to produce significant benefits for customers (T. 1916). Further, Ms. Wright claimed that Arkla's expenses, as reported in its Annual Report to the Commission, have declined by approximately \$8.2 million from 2002 to 2004, and that Staff's case here shows a revenue excess of \$12.7 million. This indicates to Ms. Wright that Arkla's cost of service has declined by a greater amount than the estimated revenue loss from a decline in billing determinants. (T. 1918-1919, 1057) Arkla witness Henry responds that the \$8.2 million corresponds to a change in capitalization policy in FERC Accounts 887 and 892, and that further declines were unlikely. (T. 351-352) CEUG witness Staley

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245 P.U.R.4th 384

Page 84

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

noted that the Company has increased its non-gas revenue requirement by 21% to 33% in a three to four year period, which is sufficient evidence to show that the Company has not attempted to aggressively control costs. (T. 1297-1298)

This Commission rejects the LCA Rider for the following reasons. First and foremost, the Company already has a number of automatic adjustment clauses, namely a GSR, WNA, and an MRP. The addition of another automatic adjustment clause would diminish the ability for enhanced scrutiny associated with traditional rate cases and also diminish the incentives for the Company to minimize costs. Second, the LCA Rider would inappropriately shift risk from Arkla's stockholders to Arkla's customers and, thus, would not provide an equitable balance between the interests of the Company and its customers. Third, the LCA Rider would be a type of 'piecemeal' ratemaking where the level of the rate change would be based solely on the change in usage per customer without any review or determination of other potential offsetting factors such as rate base, expenses, or capital costs. Fourth, it would not provide the Company sufficient incentive to promote growth in its service territory. Fifth, the LCA Rider does not meet each of the three automatic adjustment clause criteria, outlined in the Prepared Testimony of Staff witness Booth.

#### VIII. VOLUNTARY FIXED PRICE OPTION

[86-88] Arkla is requesting Commission approval of a Voluntary Fixed Price Option ('VFPO') Rider for residential and smaller SCS customers. The VFPO Rider provides these customers the option to have the GSR component of their utility bill fixed for a one-year period. (T. 271-272) Under Arkla's current GSR Rider, the Company is required to make two scheduled GSR filings annually: (1) a Scheduled Winter Season GSR filing effective for the billing months of November through March; and (2) a Scheduled Summer Season GSR filing effective for the billing months of April through October. Each filing is based on projected purchased gas costs and sales volumes, and includes a 'true-up' of projected and actual gas costs incurred during the prior season. (T. 1748-1749) Under the VFPO, there would be no subsequent true-up of projected and actual costs. (T. 310)

In his prepared testimony, Staff witness Robert Booth recommended that the Commission reject the VFPO. Mr. Booth claimed there is no evidence that ratepayers will materially benefit under the VFPO. Mr. Booth claimed that the seasonal GSR rate filings have resulted in a stabilized GSR rate and, therefore, the VFPO Rider is not necessary to achieve the goal of a 'fixed' GSR rate. (T. 1749) Mr. Booth also raised concerns with respect to the Company's ability to administer the VFPO, given the Company's prior purchased gas cost accounting errors. (T. 1750) In his surrebuttal testimony, Mr. Booth raised an additional concern that the VFPO will add complexity to the GSR process. (T. 1782)

CEUG witness Staley recommended that the VFPO be provided only to residential customers and requested it be denied for SCS customers. He recommended that all SCS customers be provided the opportunity to transport gas to attain the benefits of a fixed price. (T. 1215)

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245 P.U.R.4th 384

Page 85

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

In his rebuttal testimony and again in his Sur-Surrebuttal testimony, Arkla witness Henry claimed the VFPO boils down to a policy issue that can only be answered by the Commission. Mr. Henry encouraged the Commission to approve the VFPO. (T. 3132, 346) With respect to CEUG witness Staley's recommendation, Mr. Henry claimed that transportation service is simply not economic for many SCS customers and, therefore, they should not be denied the VFPO option. (T. 312)

The Commission finds merit in the concerns expressed by Staff. In the Commission's Natural Gas Procurement Plan Rules, Section 6, Customer Education, it states that 'each gas utility shall engage in appropriate customer education efforts concerning the availability and benefits of levelized billing or average payment plans' ('Plans'). Generally, these Plans allow customers to even out their monthly bills by paying more for their bill in the summer and less than the full amount in the winter. Such Plans can help minimize and stabilize customer bills during the winter heating season. Under Arkla's tariffs, customers may avail themselves of these Plans. These Plans, in addition to the seasonal GSR, also produce virtually the same 'fixed price' result with less cost, complexity, or potential for cross-subsidies.

Since the seasonal GSR rate filings have resulted in a stabilized GSR rate, and the combination of the new GSR system with levelized payment plan options produces an essentially 'fixed bill,' there is no reason to approve a VFPO that adds complexity to the GSR process and can cause more billing accounting problems. The Commission is also concerned with the potential for cross-subsidization and cost shifting to customers who do not elect the VFPO. Cost shifting could occur if the actual gas costs of VFPO customers exceed gas cost recoveries. Therefore, we reject the VFPO Rider.

#### IX. RURAL EXTENSION FUND ('FUND')

[89-92] According to testimony in this proceeding, the Fund was approved in Docket No. 85-043-U for the purpose of using post-1970 investment tax credits to fund the extension of gas mains into areas where such service would otherwise not have been practical. Interest on the funds was set in Docket No. 93-081-U at the Commission approved customer deposit rate. Arkla has proposed to terminate the fund because the Company has not had a sufficient number of economically feasible, rural extension projects to which the Fund could be applied. Arkla proposes that the Fund be terminated and distributed in equal shares to the Good Neighbor Fund ('GNF') and the Weatherization Assistance Program ('WAP'). The GNF is designed to help Arkla customers who have trouble paying their gas bill during the winter heating season, and who need financial assistance to maintain their gas service. The WAP installs energy conservation materials and appliances in homes of low-income families annually to lower their utility bills. (T. 25, 29, 197, 1754)

Staff Witness Booth testified that the approximate balance of the Fund is \$1,300,408 as of April 30, 2005. Mr. Booth agrees with the Company that the Fund should be terminated. However, Mr. Booth does not agree with Arkla's proposal to distribute the Fund in equal shares to the GNF and the WAP. Mr. Booth recommends

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245 P.U.R.4th 384

Page 86

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

**(Publication page references are not available for this document.)**

that: (1) the Fund monies be returned to all customers; (2;) Arkla credit the accumulated balance of the fund to Arkla's MRP Rider; and (3) Arkla clearly document the crediting of the Fund amount in the MRP filings, in accordance with Section 2.3.4 of Staff's proposed MRP Rider. (T. 1755-1756, 1786-1787)

Both Arkla and the Staff agree that the fund should be terminated and that the monies remaining in the fund distributed to other various recipients. We agree. The only remaining issue is who should receive the balance of the monies in the Fund. Arkla's proposal to distribute the funds to the GNF and the WAP, while laudable, would target fewer customers than Staff's recommendation. Staff's proposal is adopted since it will ensure that all customers will receive some benefit from the balance of the fund.

#### X. OTHER TARIFF ISSUES

##### GSR -- Language

The Company has proposed that the following tariff language be added to the text of the GSR Rider:

'The Company shall recover all of its gas costs from its customers under this rider and the Voluntary Fixed Price Option ('VFPO'), Rider Schedule No. 6' (Schedule I, page 132).

Staff witness Booth disagreed with the proposed language, claiming that the text appears to be inserting a requirement that Arkla be guaranteed recovery of its gas costs. Mr. Booth further claimed that the Company has not supported the proposed language. (T. 1754) Arkla witness Henry claimed that the proposed tariff language was simply intended to recognize that some of the Company's gas costs would now be recovered through the proposed VFPO. Previously, all gas costs were recovered through the GSR. (T. 320)

In his surrebuttal testimony, Staff witness Booth continued to recommend that the proposed language be rejected. The basis of his recommendation was that he continued to recommend that the VFPO Rider be rejected. (T. 1785)

As discussed above, the Commission has rejected the proposed VFPO Rider. Therefore the proposed GSR language is also rejected.

##### Master Metering/Combined Billing

CEUG witness Staley testified that the Stipulation and Settlement Agreement in Arkla's last rate case in Docket No. 01-243-U directed the parties to negotiate in good faith to develop master metering/combined billing ('MMCB ') guidelines for Arkla. While the parties to Arkla's previous rate case met to develop the guidelines, they were unable to reach agreement on a set of guidelines. [n this proceeding, CEUG witness Staley recommended approval of the MMCP guidelines attached to his direct testimony. (T. 1196) Arkla witness Bish testified that this

245 P.U.R.4th 384

Page 87

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

rate proceeding is not the appropriate proceeding to adopt MNCB guidelines. Mr. Bish contended that the APSC General Service Rule 5.20 ('Rule') does not permit combined billing in the manner advocated by CEUG. He recommended that a separate proceeding involving all of the other gas utilities as parties would be a more appropriate forum to address this issue. (T. 449) In surrebuttal testimony, CEUG witness Staley argued that Mr. Bish did not raise any specific objections to CEUG's guidelines. Mr. Staley asserted that Mr. Bish's general concerns are without merit. (T. 1263-1267) Staff witness Booth agreed with Arkla that a rate case docket is not the appropriate proceeding to consider this issue because MNCB is governed by the Commission's Rule. Mr. Booth recommended that any changes to the Rule should be adopted by the Commission in a generic proceeding or a rule-making docket to ensure that all interested/affected parties can participate. (T. 1788) In sur-surrebuttal testimony, Arkla witness Bish continued to recommend that the Commission not adopt MNCB guidelines in this proceeding. He contended that addressing the issue for each utility in separate rate cases in a piecemeal fashion is not conducive to either participation by all affected parties or a consistent result. (Bish SS2-5)

For the reasons advanced by Arkla and the Staff, the Commission finds that any changes to the MNCB Rule should be addressed in a generic rule-making proceeding and not in this docket. The Commission also notes that the guidelines stemming from Docket No. 01-243-U, were developed by the parties between that docket and this proceeding. Therefore, we do not find CEUG's contention that the guidelines must be developed within the confines of a rate case to be persuasive. Therefore, the Commission finds that any interested party (or parties) may petition the Commission to open such a proceeding to address issues related to MNCB. In the alternative, the parties (and any other interested parties) may continue to work on their own to finalize the proposed guidelines contemplated in Docket No. 01-243-U.

#### Upstream Contract Flexibility

[93, 94] CEUG witness Ward recommended a modification of the Company's capacity release policy to provide greater flexibility for Transportation Service Option ('TSO') customers. Arkla's current policy is to specify the amount of pipeline capacity to be released to the TSO customer. If the TSO customer does not accept the capacity release, Arkla assesses the customer with the fixed charges associated with any resulting excess capacity. Mr. Ward noted that this policy was implemented because of Arkla's belief that TSO customers were burdening the remaining Supply Service Option ('SSO') customers with excess capacity due to differences between the capacity releases elected by TSO customers and their allocated contract capacity. While agreeing that SSO customers should be kept economically whole and not burdened with excess capacity, Mr. Ward proposes that Arkla should put in place contractual mechanisms with its upstream pipeline that provide TSO customers with the level of choice intended for those customers. (T. 1162-1164)

In Rebuttal Testimony, Arkla witness TheBerge agreed that Mr. Ward accurately

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245 P.U.R.4th 384

Page 88

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

characterized the problem. However, he contended that the solution proposed by Mr. Ward to balance the interests of TSO and SSO customers cannot be implemented without additional costs. That is, increasing the flexibility of the contract with Arkla's upstream supplier to accommodate adjustments for TSO customers would increase the costs of that upstream contract, making it more expensive for all customers. (T. 639) In his Surrebuttal Testimony, Mr. Ward argued that Mr. TheBerge provided no support for his claim that upstream contract flexibility would result in higher costs. He stated that: 'In a truly competitive environment, ths additional flexibility may result in no additional cost to the Company's customers.' (T. 1185) Mr. TheBerge responded that this conclusion is totally at odds with Arkla's experience that additional flexibility translates into higher costs. (T. 723)

We decline to order the Company to modify its capacity release policy as proposed by Mr. Ward. We agree that experience has shown that increasing the level of contact flexibility to allow reductions in capacity will almost certainly result in increased upstream pipeline capacity costs.

#### XI. RETURN ON EQUITY ADJUSTMENT

[95, 96] Staff witness Booth recommends that Arkla's return on equity be set at the lower end of the range of reasonable equity returns. Various Staff witnesses identified several concerns with Arkla's: (1) filing of its Application; (2) administration of its tariffs; (3) accounting for retirements of plant; (4) costs allocated by its accounting system; and (5) retention of data required for the depreciation study. Staff witness Booth contended that the above concerns cast serious doubt on Arkla's ability to provide adequate service to its customers. Mr. Booth argued that, when a public utility does not provide a satisfactory level of compliance with the Commission's Rules and does not provide a satisfactory level of customer service, it is appropriate to adjust its return on equity. (T. 1761-62, 1764)

Staff witness Fritchman testified that Arkla filed three revisions to its deficient original Application filed on November 24, 2004 in an attempt to correct these deficiencies. Ms. Fritchman asserted that as a result, Staff spent considerable time reviewing the original Application and then reviewing and analyzing all the revisions. She claims that Arkla's filing of a deficient Application interrupted and frustrated Staff's review and analysis of Arkla's requested rate relief. (T. 1517-1791) Ms. Fritchman further testified that, as a result of a her audit of Arkla's Temporary Low Income Gas Recovery Program ('TLICGRP'), she determined that Arkla was unaware that it had failed to credit \$2,364,599 back to ratepayers as required by the Commission in Docket No. 01-248-U. Also, Arkla did not have in place a process to properly track collections under the TLICGRP. (T. 1510-1513) Ms. Fritchman found that Arkla did not exercise adequate oversight to ensure compliance with its MRP Rider. As a result, overcollections totaling \$294,879 occurred because Arkla did not have adequate controls in place to ensure that costs that did not meet the criteria were not included for recovery. (T. 1513-1516) Regarding Arkla's Weather

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245 P.U.R.4th 384

Page 89

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

**(Publication page references are not available for this document.)**

Normalization Adjustment Rider ('WNA'), Fritchman alleged that Arkla, in November 2004, failed to apply the WNA to the bills of its residential and small sales customers. Additionally, Arkla did not compute the sales tax applicable to the WNA charge. (T. 1516-1517) Ms. Fritchman also determined that Arkla had trouble in identifying direct charged and allocated costs in a timely and accurate manner. She identified several instances where costs were improperly charged to Arkla by affiliates and by Arkla Corporate. (T. 1521- 1524)

Staff witness Williams testified that Arkla still had assets on its books that were no longer used and useful, assets that Arkla no longer owned, accounts in which the Company failed to book retirements, and assets that were fully amortized. (T. 1928-1932) Staff witness Freier discovered that Arkla had not been using the correct depreciation rates that were approved in Docket No. 01-243-U. Ms. Freier concluded that Arkla needs considerable improvement in its data retention and record keeping processes. (T. 2016-2022)

Various Arkla witnesses responded to the Staff's concerns with Arkla's tariff administration, application, and accounting. Arkla witness Harder, in citing a Continental Telephone Company of Arkansas case, acknowledges that there is precedent for reducing a Company's ROE for failure to provide adequate customer service. (T. 175) However, Mr. Harder argued that case concerned the actual quality of the utility service provided to customers, not the type of concerns identified by Staff in this case. He asserted that the Staff's concerns in this docket have no direct bearing on customer service. (T. 175-177) Mr. Harder responded to Staff's concerns that Arkla failed to properly administer its TLICGRP by stating that: (1) this was a one-time program that did not conform with any existing accounting or billing mechanism; (2) when Arkla became aware of problems; it developed corrective measures; and (3) the amount of the over-billing errors represented only a small portion of the total amount billed. (T. 179-180)

Regarding Staff's concerns about the MRP Rider, Mr. Harder observed that with any program of this magnitude, mistakes will occur. He also noted that the MRP under billing error represents only a small portion of the total billings during that time period and thus should not warrant a reduction in the Company's ROE. (T. 180-181) Concerning Arkla's WNA, Mr. Harder stated that the Company remedied this error in accordance with Commission Rules. Mr. Harder insisted that the failure to bill sales tax on the WNA was not an error, but rather a conscious decision to forego the collection of sales tax from its customers. (T. 181-183) With regard to deficiencies in the Company's Application, Mr. Harder stated that the alleged deficiencies did not materially affect the amount sought by the Company or Staff's audit. Mr. Harder testified that Arkla subsequently reduced its requested rate relief as a result of a filing deficiency. Mr. Harder also asserted that Arkla has not experienced problems with the filing requirements in other jurisdictions. (T. 174-186)

Arkla witness Hamilton contended that the Staff should modify its auditing procedures to obtain the information that it needs by examining the accounting records that are maintained by the Arkla corporate offices and developing an audit

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245 P.U.R.4th 384

Page 90

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

program tailored to the specific requirements of each of the larger companies it audits. With regard to the Staff's recommendation that it have access to external auditor working papers, Mr. Hamilton does not believe that future external auditor engagement letters should provide the Staff with full access to all working papers created by the Company's external auditor. He contended that audit working papers are not designed in a manner that would or should permit third parties to use the information found in those audit working papers for other purposes. (T. 1038-1047)

Arkla witness Fitzgerald's testimony addressed certain of the allegations made by the Staff concerning various deficiencies in the Company's accounting system and practices. Mr. Fitzgerald argued that, even if each of the accounting allegations were true, the Staff has not presented any evidence that the deficiencies have negatively affected the quality of service provided by the Company. Mr. Fitzgerald further testified that the Staff has not cited any specific rules that Arkla violated in reaching its conclusion that Arkla's accounting and system and reporting processes are out of compliance with Commission Rules or are not suitable for regulatory purposes. (T. 1951-1953)

In surrebuttal testimony, Staff witness Fritchman continued to assert that the Company failed to properly administer and monitor the operation of the TLICGRP and MRP Riders. Ms. Fritchman contended that Arkla's lack of administrative oversight of these riders raises the concern that similar problems, if not addressed, could occur with the operation of other tariffs. (T. 1567) She stated that the magnitude of the errors in administering the TLICGRP and MRP Rider cannot be dismissed as being immaterial. (T. 1567-1570) The Staff continues to assert that the problems with Arkla's Application impeded its review and audit. (T. 1572-1573) Regarding access to external auditor work papers, Ms. Fritchman pointed out that Staff routinely reviews the external auditor work papers for the companies it audits to determine if there are any issues that should be further investigated. (T. 1574-1575) Staff witness Booth testified that Arkla continues to fail in its obligation as a regulated public utility. Mr. Booth asserted that, while the facts in this case differ from the Continental case, the Continental case recognized that the cost of equity can be adjusted when supported by certain facts. He argued that, if a utility fails to follow any standard, regulation, or practice set by the Commission, the utility has failed to meet its obligations as a regulated public utility and has thus negatively affected its customers. (T. 1789-1791)

In sur-surrebuttal testimony, Arkla witness Harder testified that the Staff has not shown that its downward ROE adjustment is permitted under Arkansas law, does not violate Arkla's right to due process, and is proportionate to the alleged harm to ratepayers. (T. 237) Regarding the administration of its tariffs, Mr. Harder stated that Arkla takes billing problems seriously and that it seeks to promptly correct such problems and take corrective action to prevent their recurrence. Mr. Harder argued that Staff's audit was not impaired despite the problems the Staff experienced with Arkla's Application. According to Harder, this was evidenced by the fact that the Staff was able to comply with all of the established procedural dates in this proceeding.

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245 P.U.R.4th 384

Page 91

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

Arkla witness Hamilton continued to assert that gaining access to the external audit working papers provides little, if any, additional rate case audit support and that if access is granted, the cost of the audit will increase. (T. 1051-1052) Arkla witness Fitzgerald testified that except for certain MFRs, the Staff did not cite one Commission rule that Arkla violated. Mr. Fitzgerald contended that there were only three accounting-related errors cited by Staff, which represents only a small portion of an enormous number of accounting entries made daily by the Company. He contended that Arkla acted properly and reasonably by correcting each of the accounting errors, and Arkla agreed to institute various new processes to help minimize their chances of recurring in the future. (T. 985-987) Mr. Fitzgerald further testified that, without a showing of persistently inadequate customer service, the Commission has no history of punishing a utility through its rate of return and has held that a punitive ROE is contrary to accepted legal standards for reasonable returns. (T. 987)

The primary issue here is whether or not Arkla's administration of its tariffs, its accounting and recordkeeping practices, and its supporting documentation for rate applications have been deficient to the extent that it would warrant the selection of an ROE at some point below the middle of Staff's recommended range of reasonableness. At the hearing, Staff witness Booth testified that 'any point within the range of reasonable returns is a reasonable return, and there does not need to be even a reason for the Commission to choose any point within that range since any point is a reasonable range.' (T. 955, 965-966) The Commission finds that the balance of Staff's and Arkla's testimony on this issue reflects the need to adopt an ROE between Staff's recommendation and the normally-accepted ROE midpoint.

Testimony has been presented by Staff witnesses which identified numerous instances in which Arkla's billing of customers, accounting practices, and rate case filings were deficient. While Arkla asserts that the alleged deficiencies had no bearing on the quality of service provided to its customers, quality of service has as much to do with utilizing proper inventory and accounting practices as it does pipe replacement and quality field service. Arkla, as a public utility, is required and obligated to maintain proper accounting and financial records in compliance with uniform accounting practices, and to file Applications for rate changes in compliance with the Commission's Minimum Filing Requirements ('MFRs'). In return for compliance with these accounting requirements, among others, utilities are allowed to recover their reasonable and prudently-incurred expenses, earn a fair and reasonable return on capital investments, and enjoy a monopoly service territory. A public utility's accounting systems form the basis for establishing appropriate rates for its customers. For ratemaking purposes, it is the regulatory commission which has the responsibility and authority for exercising control of the rates, charges and services provided by the utility company. The Commission notes that Arkla did not substantively deny the allegations made by Staff regarding the administration of its TLICGRP, MRP Rider, or WNA, or that there were various deficiencies with its Application filing package. Arkla simply provided various explanations such as: (1) the overbilling errors were small in comparison with the total amount billed; (2) humans do make

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245 P.U.R.4th 384

Page 92

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

mistakes; (3) the billing errors were corrected; and (4) the Application deficiencies did not materially affect the amount of revenue sought by the Company or impair Staff's investigation.

The Commission cannot ignore what appears to be a pattern of deficiencies as to Arkla's recordkeeping, accounting systems, customer billings, and rate case filings. Staff witness Booth testified that Arkla's rate Applications in its last four rate cases were also cited for numerous MFR deficiencies. These deficiencies occurred even after Arkla was given waivers of certain MFRs in those cases. While it appears that Arkla did address some of the Staff's accounting concerns identified in Arkla's last rate case (Docket No. 01-243-U), the reoccurrence of related and numerous problems in this docket and in recent Staff tariff audits leads the Commission to believe that the Company has not yet undertaken the serious corrective actions it must take in order to establish a prudent and credible basis for its accounting and billing systems ---all of which are fundamental to the determination of reasonable rates. Accordingly, an ROE below the mid-point of the range that reflects poor performance in this area will hopefully serve as an appropriate inducement to incent corrective action by Arkla that will produce more confidence and integrity in future inventory numbers, cost accounting, customer billing, rate case applications, and compliance with the Commission's MFRs.

In describing the difference between the Continental Telephone Case and this proceeding, the Company argued that: (1) in this proceeding, there is no evidence that the quality of service was inadequate; (2) the evidence in this case does not show a pattern of non-compliance; and (3) absent a showing of poor customer service, the Commission has no history of punishing a utility through its rate of return. (T. 1566) The Commission does not agree with Arkla's reasoning. Arkla's service to its customers is provided via its rate schedules, riders, and tariffs. If the quality of customer service is inadequate in the administration of these tariffs, riders, and rate schedules, or the accounting and inventory practices that underline those rate schedules, the Commission may apply the 'Continental case standard.' The record in this proceeding provides substantial evidence to support a finding that the quality of service provided by Arkla by its administration of several Arkla riders was inadequate. Through its audits, the Staff found that ratepayers were overcharged by approximately \$2,659,478 for the service that Arkla provided through its TLICGRP and MRP Riders. (T. 1566-1567) Also, the Staff found that Arkla misapplied the terms of its WNA Rider to bills of its residential and small commercial customers in November 2001. (T. 1566-1567)

The record also shows a pattern of non-compliance with Commission rules and regulations. As previously mentioned, uncontroverted testimony was presented that Arkla's Applications in its most recent Arkansas rate cases in Docket Nos. 01-243-U, 94-175-U, 93-081-U, and 92-032-U were cited for numerous MFR deficiencies even after being granted waivers of certain MFRs. Furthermore, the deficiencies occurred again in the current Application. (T. 1792) The record also shows that: (1) Arkla's accounting system failed to properly account for retirements of plant no longer serving customers, and failed to readily identify

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245 P.U.R.4th 384

Page 93

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

the amounts and types of cost being allocated to it; and (2) Arkla failed to retain data required for depreciation studies and record keeping processes. (T. 1790) When taken as a whole, this evidence establishes a pattern of persistent and inadequate customer service and non-compliance with standard accounting practices and Commission rules and regulations. The fact that the Commission may not have a consistent history of reducing a rate of return allowance for service quality and rule violation issues only indicates that the magnitude of such patterns of conduct as reflected in this case have not often occurred in this state.

The Commission, however, is encouraged by the testimony of Arkla Vice President and Controller, Walter L. Fitzgerald. Mr. Fitzgerald testified that the Company has made improvements in various accounting and computing systems. Some of the improvements the Company identified included: (1) a process called 'record and report' which tracks transactions through the accounting process; (2) a computer system which tracks various processes, and (3) since the last rate case, a 'special projects ledger. [FN11] (T. 886-887) Mr. Fitzgerald was confident that the problems that Staff has identified in the past, and in this proceeding, have been addressed and that the Company will continue to maintain these 'state of the art' type systems. (T. 886-888) Given these improvements cited by Arkla and its commitment that the problems have been and will continue to be addressed, the Commission will modify Staff's recommendation that Arkla's ROE be set at the lower end of Staff's range of reasonableness and set Arkla's ROE in this proceeding at 9.45%, which is approximately half-way between Staff's recommendation and the mid-point of the range of reasonableness.

The Commission, directs its General Staff, to closely monitor Arkla's progress in correcting the various cited deficiencies. If progress is not being made as promised by Arkla, the Commission will take appropriate steps to ensure that deficiencies are corrected in a timely manner. Prior to its next rate case, Arkla must bring its books and records into full compliance with standard accounting practices and with the Commission's MFRs.

#### XII. STAFF RECORDKEEPING AND REPORTING RECOMMENDATIONS

Staff witness Booth identified seven Staff recordkeeping and reporting recommendations that Arkla either partially accepted or completely rejected. [FN12] Mr. Booth argued that Arkla should be required to comply with the recommendations that the Company did not fully accept and those that Arkla rejected outright. (T. 1779-1780, 1798-1804) The Staff recommendations relate to the following issues: (1) external audit work papers, (2) retirement inventory, (3) annual depreciation study data, (4) pre-tax rate for MRP over-collections, (5) allocation of affiliate charges, (6) allocation of meters, regulator, etc., and (7) APSC-approved depreciation rates.

##### Access to External Audit Workpapers

[97, 98] In her direct testimony, Staff witness Fritchman discussed the difficulties in gaining access to the workpapers prepared by CenterPoint's

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245 P.U.R.4th 384

Page 94

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

**(Publication page references are not available for this document.)**

external auditor due to confidentiality issues. Accordingly, she recommended that the Commission require that all future engagement letters between CenterPoint Energy and its external auditor expressly require that full access to all workpapers created by the external auditor be provided to the Staff of the APSC. (T. 1521)

In response, Arkla presented the Rebuttal testimony of Mr. Fitzgerald and Mr. Hamilton. Mr. Fitzgerald explained that the difficulties were not caused by the Company and that it does not have control over the workpapers prepared by its external auditor (currently Deloitte and Touche, LLP). He also noted that the issues with Deloitte & Touche had been resolved. (T. 958-959) Mr. Hamilton testified that the workpapers of the outside auditor were not prepared for the purpose of the ratemaking process and should not be relied upon for that purpose. He also testified that Ms. Fritchman's recommendation would increase the costs of the audit to the Company while providing little meaningful information to the Staff. (T. 1044-1045) In response to Arkla's rebuttal, Ms. Fritchman continued to recommend that access to the external auditor's workpapers be required as a provision in all future engagement letters with external auditors. However, she modified her recommendation to make it clear that the external audit will not be conducted for the purposes of a third party and that the audit will not replace or supplant the procedures or inquiries that should be undertaken by the regulator for its purposes. Ms. Fritchman expressed the view that this should avoid the additional costs noted by Mr. Hamilton. (T. 1577-1578) In Sur-Surrebuttal, Mr. Fitzgerald noted that the Company will attempt to negotiate such terms with its external auditor. However, the Company has no ability to dictate the terms of an engagement letter with external independent auditors. In

We recognize that Arkla does not have the ability to dictate the terms of an engagement letter with outside independent auditors. Accordingly, we will not order the Company to include a provision in all future engagement letters which requires the external audit workpapers to be provided to the Staff. We do, however, direct the Company to make it clear to its external auditors that its workpapers are to be made available for review under the terms of an appropriate confidentiality agreement.

#### Pre-Tax Rate on MRP Rider Over-collections

[99] Staff witness Fritchman testified that the MRP Rider recovers on an interim basis between rate cases Arkla's cost of replacing bare steel and cast iron mains along with associated services. Ms. Fritchman further testified that as a result of her audit of the MRP Rider she discovered an Arkla over-collection of \$294,879 which included interest computed pursuant to Rule 5.19 of the Commission's General Service Rules. In light of Arkla's over-recovery, Ms. Fritchman recommended that the interest rate applicable to any over-collections be set at the pretax rate of return determined in this proceeding. (T. 1513-1515) Arkla witness Harder argued that the Staff's recommendation is 'one-sided' and is unwarranted and excessive. (T. 181) Staff witness Booth disagreed, stating that, since under the MRP Rider Arkla recovers the pre-tax return on qualifying investments, it is reasonable to

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245 P.U.R.4th 384

Page 95

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

**(Publication page references are not available for this document.)**

use that rate of return to compensate ratepayers for any over-collections. (T. 1780-1781) Mr. Harder proposed that the use of the pretax rate of return for over-collections under the MRP Rider should be removed, or alternatively, the pre-tax return should apply to both over-collections and under-collections. (T. 239-244)

The Commission rejects Staff's recommendation to use the pre-tax rate of return for MRP Rider over-collections. Interest on MRP billing corrections, i.e., over or under-collections will be assessed pursuant to Rule 5.19 of the Commission's General Service Rules.

#### Allocation of Affiliate Charges

100-102] Staff identified several problems with obtaining accurate information on costs that were allocated and direct charged to Arkla from its affiliates. Affiliate costs allocated to Arkla lose their identity because thousands of transactions are aggregated at the end of the month prior to being allocated. (T. 1521-1522) This significantly increases the difficulty of tracing costs on Arkla's books back to source documents. Staff has not experienced problems of this magnitude with other multi-jurisdictional utilities that the Commission regulates. (T. 1795)

Two examples of these problems are charitable contributions costs (T. 1521, 1523) and Minnegasco costs. (T. 1521-1522) Other examples of costs improperly allocated to Arkansas that came out during the hearing are: (1) Texas lieutenant governor reception; (2) TicketMaster tickets; (3) Electric Power conference; and (4) Indiana University Varsity Shop. (T. 877-881) The Company failed to eliminate some charitable contribution costs from its revenue requirement as required by the MFR. Absent the intervention of Staff witness Fritchman, these costs would have been inappropriately recovered from Arkansas ratepayers. (T. 1582)

Staff recommends that the Commission require Arkla to develop a procedure whereby costs that are allocated or direct charged from affiliates can be specifically identified by Arkla so that the information will be provided in a clear, accurate, and timely manner for regulatory purposes. This procedure should be filed with the Commission by January 3, 2006. (T. 1524)

The Company dismissed these alleged difficulties as being insignificant, or caused by human error on the part of the Company, or data input error on the part of the Company, or the manner in which Staff conducted its audit. Nevertheless, the Company has indicated that it will file its procedure that identifies direct versus allocated costs with the Commission by January 3, 2006.

We hereby direct Arkla to file the procedure recommended by Staff with the Commission by January 3, 2006. Prior to the filing Arkla will consult with Staff, and other interested intervenors, regarding the details of such a procedure.

#### Allocation of Meters, Regulators, and Domestic Meter Installations

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245 P.U.R.4th 384

Page 96

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

103, 104] Staff recommends that the Company be required to directly assign the costs of domestic meters, domestic regulators, and domestic meter installations for use in the Arkansas jurisdiction to Arkansas. The Company proposed that going forward such direct assignments be made, but that the historical balance of these assets be allocated on the basis of customer count. Staff would like to see the results of that historical allocation before it can be assessed.

We agree with this approach and hereby direct Arkla to file with the Commission by January 3, 2006 all workpapers associated with the historical allocations, and a specific procedure for direct assignment going forward. Prior to the filing Arkla will consult with Staff, and other interested intervenors, regarding the details of such a procedure.

THEREFORE, the Cornmission orders as follows:

1. That the rates and tariffs proposed in this proceeding by Arkla are hereby disapproved.

2. Arkla is ordered to file new rates and tariffs designed in conformity with this order. [FN13]

3. Upon and review and approval by subsequent order, the new rates and tariffs shall become effective for meters read on or after September 25, 2005.

This 19th day of September, 2005.

#### FOOTNOTES

FN1 Arkla filed additional revisions to its Application on December 27, 2004, January 10, 2005, and January 13, 2005.

FN2 On August 3, 2005, the Staff filed Notice that Jeff Hilton, Manager of Staff's Audit Section, was adopting the prefiled testimony of Staff witness Alisa Williams.

FN3 On August 4, 2005, the Commission issued Order No. 14 denying Arkla's proposal to amend its rate increase Application for new depreciation rates and expense by approximately \$13 million. At the public hearing, Arkla stated that it was now requesting a rate increase of \$14.6 million. (T. 9)

FN4 Standard and Poor's rates companies on a Business Position Scale of 1 to 10 with 1 being the most safe and 10 being the least safe. A Business Position of 3 is above average. All of the sample utility companies used by Staff are rated as a 3 on the Business Position scale.

FN5 The primary difference between Staff's rate base of \$469 million and Staff's net utility plant in service of \$328 million is \$140 million in working capital assets.

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245 P.U.R.4th 384

Page 97

245 P.U.R.4th 384, 2005 WL 3354346 (Ala.P.S.C.)

(Publication page references are not available for this document.)

FN6 In our Order No. 14 in this docket dated August 4, 2005, we ruled that this study was proper rebuttal, but could not be used to amend the Company's application to seek a higher depreciation allowance.

FN7 Entergy Arkansas, Inc. is a retail public electric distribution utility regulated by this Commission.

FN8 8,760 hours represents the number of hours in a year.

FN9 The application of equal rates of return would mean that the residential class would receive a rate decrease of approximately 4.04%. Taking into consideration the Commission's findings on rate design, the residential class will receive a rate decrease of approximately 3.54%.

FN10 It is noted that this provides the incentive to increase expenses if earnings would otherwise be below the allowed ROE, but not more than 50 basis points below, in order to ensure a rate increase back to the allowed ROE.

FN11 The Commission notes that Staff witnesses Fritchman and Booth indicated that, while Arkla has made changes to its accounting systems since Arkla's last rate case, some of the same problems from the last rate cases were identified in this proceeding. With regard to Arkla's Application deficiencies, the Staff indicated it would not know whether those type problems have been resolved until Arkla files its next rate Application. (T. 894, 923, 961-63)

FN12 The Commission's finding on Recommendations Nos. 2,3, and 7 have been incorporated into the order's section on depreciation rates/expense.

FN13 Arkla's rates, will be reduced by approximately \$1 1.5 million.

#### EDITOR'S APPENDIX

#### PUR Citations in Text

ARK.] Re Arkansas Louisiana Gas Co., a Division of Arkla, Inc., 150 PUR4th 333, Docket No. 93-081-U, Order No. 13, Feb. 9, 1994.

ARK.] Re Arkansas Power & Light Co., 66 PUR4th 167, Docket No. 84-199-U, Order No. 7, Apr. 3, 1983.

ARK.Ct.App.] General Waterworks Co. of Pine Bluff v. Arkansas Pub. Service Commission, 25 Ark.App. 49, 95 PUR4th 528, 752 S.W.2d 52 (1988).

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