



RAILROAD COMMISSION OF TEXAS

OFFICE OF GENERAL COUNSEL

GUD NOS. 10083 and 10093

**STATEMENT OF INTENT OF HUGHES NATURAL GAS, INC. and
PETITION FOR REVIEW FROM ACTION OF THE CITY OF MAGNOLIA
DENYING HUGHES NATURAL GAS INC.'S STATEMENT OF INTENT**

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PROPOSAL FOR DECISION

PROCEDURAL HISTORY:

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STATEMENT OF THE CASE

Hughes Natural Gas, Inc. ("HNG") provides natural gas service to approximately 3,501 customers within the City of Magnolia and environs. HNG filed a *Statement of Intent* to increase rates with the City of Magnolia to increase rates charged customers within the municipal jurisdiction and with the Railroad Commission of Texas to increase rates within the environs. The City of Magnolia denied the proposed increase and HNG appealed the denial. The cases were consolidated and a hearing was held to consider the proposed rate increase. The City of Magnolia, Staff of the Railroad Commission ("Staff"), and seventeen customers intervened.

As initially filed, HNG sought to increase its non-gas cost revenues by approximately \$1,170,332. This represented an increase of 64.01%, excluding gas costs. Staff and the City of Magnolia proposed various adjustments that resulted in a substantial decrease to the company's revenue request. Individually, the proposals of Staff and the City of Magnolia do not result in a decrease to the current revenues of the company. Considering all proposals made by both parties, the Intervenors collectively recommended a revenue decrease, and ultimately a rate reduction. Staff incorporated all of the initially proposed adjustments of the City of Magnolia and prepared a schedule that reflected the combined adjustments. This schedule reflected a revenue *decrease* of \$479,154.

The adjustments recommended by the Examiners are made in three areas of the company's cost of service calculation. In the context of rate base, the Examiners recommend that HNG's proposed treatment of a recent acquisition be denied. HNG recently acquired a distribution system. The purchase price was \$550,000. HNG proposed that instead of \$550,000, the rate base of HNG should increase by \$1,358,645. The Examiners recommend that this proposal be rejected. The Examiners recommend, however, that a plant increase be allowed for the net capital invested. This includes an acquisition adjustment. The company also recently installed automated meter devices and the company requested that the entire expense related to installation be included in rate base despite the fact that the costs of the devices exceed the expected savings. The rate base treatment proposed by the utility allows the utility to recover a return for that investment and diminished the potential savings to customers. The Examiners

recommend that an adjustment be made to remove a component from the cost of service to ensure that customers do not pay more for meter reading than currently charged. Finally, the company failed to meet its burden with regards to certain capitalized costs from its affiliates.

The subject of affiliate expenditures encompassed a large portion of these proceedings. HNG is part of a complex affiliate structure involving six companies. The interrelationship among these companies is informal and business arrangements are often not reduced to writing. For example, the lease agreement among the affiliates has not been reduced to writing. The services provided by employees of HNG to its affiliates are not governed by any formal policies and procedures. Only one employee apparently maintains time records, while none of the other employees track their time. Two individuals serve alternately as President and Vice President among the various companies. The President of HNG provides essential business services to two affiliates. All of these shared assets and all of the services provided by HNG are provided without compensation. The result is that the costs of the utility are overstated and the expenses of charges made by affiliates to HNG are understated. This resulted in several adjustments to the expense of the utility related to salaries, vehicle expenses, and rental expenses. In addition to the expense adjustments the Examiners recommend that the utility be required to undertake a management audit, by an independent auditor, approved by Staff and the City of Magnolia to develop policies and procedures to track services to affiliates and identify expenses that have not been properly allocated.

The company also requested an overall rate of return of 11.80% based, in part, upon a return on equity of 12.40%, and a capital structure that reflected a nearly 90% equity ratio. The Examiners found that HNG failed to establish the reasonableness of a 12.40% return on equity. Furthermore, the Examiners found that HNG was unable to establish that the proposed capital structure was reasonable or that recent cash infusions by the parent corporation were just and reasonable.

Several items not directly related to the proposed rate increase were considered in this case. In the context of affiliates the Examiners recommended that HNG cease advertising on behalf of its utility construction affiliate and that all references in the contracts of that affiliate to

HNG be removed. Staff and the City of Magnolia argued that the pass-through cost of gas was not just and reasonable. This again was related to affiliate issues.

During the test year, HNG acquired its gas supply from an affiliate and transported that supply through another affiliate. The costs are passed through the company's purchased gas adjustment clause. The Examiners found that the fact the gas charges of the affiliate supplier was lower than the gas supplies from competitors to the affiliate was due to the fact that HNG provided all of the essential services to run the company at no cost to the affiliate. While proper allocation addressed this problem, the Examiners found that the purchase gas adjustment clause should include a condition that HNG engage in an independent management audit to identify all shared assets and all services provided by HNG to its affiliates. Furthermore, the costs associated with any unallocated expenses should be reviewed by Staff for consideration for inclusion as a credit in the company's purchase gas adjustment clause. The Examiners do not recommend, however, that a separate gas cost proceeding be established.

In summary, the Examiners recommend that the company's rate base be properly valued, adjustments to the cost of service be made to reflect the use of HNG assets and employees by its affiliates, and that the company engage in an independent management audit to identify all assets of HNG used by its affiliates and all services supplied by HNG to its affiliates. The management audit should develop a policies and procedures manual to properly track expenses among HNG and its affiliates to ensure that the company complies with the FERC USOA.

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1. Procedural History

On June 2, 2011, Hughes Natural Gas, Inc., (“HNG”) filed with the Railroad Commission of Texas (Commission) a *Statement of Intent* to change gas distribution rates in the unincorporated areas of Austin, Colorado, Grimes, Harris, Montgomery and Waller Counties, Texas. The case was docketed as GUD No. 10083. The proposed rates were suspended on June 27, 2011.

Also, on June 2, 2011, HNG filed with the City of Magnolia (“City” or “Magnolia”) a *Statement of Intent* to change gas distribution rates that would implement a system-wide new schedule of rates for natural gas service to all of the customers served by HNG within the City of Magnolia. On June 14, 2011, the City of Magnolia denied HNG’s rate request. An appeal of the City’s action was filed at the Commission on June 20, 2011. The case was docketed as GUD No. 10093. The cases were consolidated on July 1, 2011. Commission Staff intervened in this proceeding on June 9, 2011. The City of Magnolia intervened on July 21, 2011.

Notice of the proposed rate increase was provided on June 7, 2011, by bill insert to all customers inside the City of Magnolia and to all environs customers, in accordance with TEX. UTIL. CODE ANN. § 104.103(b)(2). A Supplemental Notice was mailed to all customers on July 7, 2011.¹

In response, the Commission received over 200 individual letters objecting to the proposed increase, a petition from the Powder Mill Estates Owners Associations signed by 99 residents of that subdivision, 55 protests filed by residents of the High Meadow Ranch Community Association, a petition from the Concord Estates Home Owners Association signed by 16 residents of that subdivision, and several petitions from the Village of New Kentucky POA signed by 107 residents of that community. In all, approximately 470 residents and businesses served by Hughes Natural Gas (“HNG”) have filed letters or signed a petition objecting to the

¹ HNG Ex. 21 pp. 1 -12.

**Throughout the exhibits filed by HNG, there are multiple, different page numbers on many of the documents. This caused confusion during the hearing on the merits. To avoid further issues, the Examiners rely on the top right Bates Stamp numbers on each page.

proposed increase. Based upon the information included in the *Statement of Intent* this represents approximately 13% of HNG's customer base.

The individual letters and petitions span a variety of issues. All, in one form or another, objected to the proposed increase. Some simply protested the proposed increase as excessive. Many letters noted that the proposed increase was inappropriate given current economic conditions. Several complainants noted that the increase, calculated as 33% with gas costs and up to 69% without gas costs, is higher than the increase in the cost of living.

Several letters and petitions addressed specific issues. Some challenged the proposed notice and argued that it was misleading. These individuals suggested that the notice produced a misrepresentation of the actual increase. Several individuals appeared to raise issues related to gradualism and noted that taxing authorities have limits on the size of the increase that may be assessed from one year to the next. Others argued that the cost to provide gas by other utilities was lower than the cost alleged by HNG in this proceeding.

Some objected to the proposed increase and argued that expansion of HNG's system was the principal cause of the requested increase and that expansion should not result in higher rates to all users. Instead, expansion of the system should be offset by an increase in revenues. Also related to the issue of expansion, several customers noted that there was a substantial increase in rates for customers formerly served by Capital Gas Distribution, Inc. ("CapGas"). These customers complained that rates increased after the merger of CapGas and HNG. And the customers also complained that there will now be another increase requested in this proceeding. One letter noted that the rate design of the prior utility should be evaluated and considered in this case. Customers also complained that HNG sought to recover a return on capital that had been initially provided by builders and customers. Several customers raised concerns regarding the affiliate transactions between HNG and its affiliates. Others challenged the proposed rate of return. Some individuals argued that taxes such as *ad valorem* taxes should not be recovered by the utility.

A large number of individuals noted that the proposed increase did not track the changes in the cost of gas. These letters compared the changes in the wellhead cost of gas to the proposed increase in the base rates of HNG. This proceeding was focused on the cost of service and base rates, not on the pass-through cost of gas. Nevertheless, as part of this proceeding, the Commission must evaluate the reasonableness of the company's purchased gas adjustment clause as the company has requested the Commission authorize the continued use of its gas cost recovery clause. Likewise, certain individuals focused on the actual cost of gas included in the purchase gas adjustment clause. These individuals objected to the cost of gas and have requested that the Commission evaluate the cost of gas paid by HNG that is ultimately passed through to customers.

Of the rate payers who filed protest letters, the following individuals also formally intervened as a Protestant in this proceeding: Elizabeth Nixon, Angela Arndt, Sheryl McDonald, Kathleen Garrett, Shannon Hoffart, Ashley Carter, Michael Kelley, Douglas Mendez, Sheila McLendon, Cecilia Whitaker, Robert Whitaker, William Scates, Sherleen Scates, Al Birdwell, Shirley Kerr, Rolf Kerr, and Melissa Rogers.

A prehearing conference was held on July 20, 2011. A technical conference was held on August 2, 2011. Numerous prehearing motions were filed in this case. The motions and rulings are summarized in Appendix A to this proposal for decision. Of note is HNG's Motion to Strike Testimony of Mark Brock. HNG alleged that Staff breached the protective order in this case by including two tables that had been marked Confidential by HNG in Mr. Brock's Prefiled Direct Testimony.² Mr. Brock's testimony also included a copy of the same two pages, however, this version had redacted information. Staff responded that the inclusion of the un-redacted documents was an unintentional oversight. The focus of the motions and responses were related to the manner in which a document marked confidential by a party had been revealed without Staff following the procedures outlined in the Nondisclosure Agreement. Due to the immediate nature of the concern, Staff was directed by Examiners to take actions to ensure all paper originals and copies in RRC public files are placed under seal, that paper originals were accounted for and returned to Staff and that individuals with electronic versions were instructed

² Prefiled Direct Testimony of Mark Brock, August 24, 2011, Schedule MB-2

to delete the electronic copy. During the hearing on the merits, HNG withdrew its objection to strike the entirety of Mr. Brock's testimony and the Examiners granted the company's request to seal two portions of Mr. Brock's testimony related to the affiliate entities.

Two other motions were pending ruling at the conclusion of the hearing on the merits and they are addressed in this proposal for decision. These include *Staff's Motion to Sever Gas Costs* and *HNG's Motion for Expedited Determination Regarding the Adequacy of Notice*. These motions posed policy determinations for the Commission and have been included herein to allow the Commission an opportunity to consider the issues raised in the context of the Final Order to be issued in this case.

The hearing on the merits was held September 26, 27, and 28, 2011. The following individuals testified on behalf of HNG in its direct case: Real Provencher, President of Hughes Natural Gas, Inc.; Charles E. Loy, Principal of GDS Associates, Inc.; Ellen Blumenthal, Principal with GDS Associates, Inc.; Gregory E. Scheig, CPA/ABV/CFF/CFA, Principal with ValueScope, Inc.; and Morey J. Villareal, Principal Consultant of Villareal & Associates.

The City of Magnolia presented the following witness in its direct case: Karl J. Nalepa, President of ReSolved Energy Consulting, LLC.

Staff of the Railroad Commission offered testimony from the following witnesses: Mark Brock, Advising Utility Specialist, Gas Services Division Market Oversight Section – Railroad Commission of Texas; Frank M. Tomicek, Gas Services Division, Market Oversight Section, Utility Specialist – Railroad Commission of Texas; Lynne LeMon, Gas Services Division, Market Oversight Section, Utility Analyst – Railroad Commission of Texas; and David Flores, Deputy Director, Pipeline Safety Division – Railroad Commission of Texas.

Rebuttal testimony was provided for Hughes Natural Gas, Inc. by the following individuals: Real Provencher, Gregory E. Scheig, Ellen Blumenthal, Charles E. Loy, Morey Villareal, and Joe K. Wells, Jr., Professional Engineer with WWD Engineering.

2. Jurisdiction

The Commission has jurisdiction over Hughes Natural Gas, Inc., associated affiliates and over the matters at issue in this proceeding pursuant to Tex. Util. Code Ann. §§ 102.001, 103.003, 103.051, 104.001, 121.051, 121.052, and 121.151 (Vernon 2007 and Supp. 2010). The statutes and rules involved in this proceeding include, but are not limited to Tex. Util. Code Ann. §§ 104.101, 104.102, 104.103, 104.105, 104.106, 104.107, 104.110, 104.301, and 16 Tex. Admin. Code Chapter 7.

3. Books and Records

Commission Rule §7.310 requires that utilities utilize the Federal Energy Regulatory Commission (FERC) Uniform System of Accounts (USOA) for all operating and reporting purposes.³ Aside from assertions made in HNG's Reply Brief, the Examiners are somewhat troubled that they are unable to locate a statement in the record by a company witness specifically asserting that the books and records are kept in accordance with the FERC USOA.⁴

An inference may be drawn from the record that the utility complies with the form of FERC's USOA. Real Provencher, President of HNG testified that HNG's books and records are in accordance with the Commission's rules, without specifying a Commission rule or the FERC USOA.⁵ Charles E. Loy, Principal of GDS Associates, Inc., reviewed HNG's accounting books and records and testified relating to the company's cost of service and revenue. While Mr. Loy refers to the FERC USOA related to an issue of the CapGas acquisition by HNG, Mr. Loy makes no specific mention of how HNG maintains their books and internal records.⁶ A discovery document admitted into the evidentiary record related to an acquisition by the utility states that "Hughes Gas records requirement follows the rules and guidelines required by the Commission. The Commission requires all gas utilities to follow the FERC chart of accounts."⁷

³ TEX. ADMIN. CODE § 7.310 (Tex. R.R. Comm'n, System of Accounts) (Commission Rule 7.310)

⁴ HNG Reply Brief, pp. 1- 3. Mr. Provencher testified that HNG employs a part-time bookkeeper, Barbara Miller, who would have been an appropriate witness to provide such testimony.⁴ However, Ms. Miller did not testify in this case. See, HNG Ex. 6, Rebuttal Testimony of Real Provencher, p. 5, ln. 1-4.

⁵ HNG Ex. 1, Direct Testimony of Real Provencher, p. 7, ln. 15-16

⁶ HNG Ex. 5, Direct Testimony of Charles E. Loy, p. 7, ln. 9 – 11, and Exh. 11, Rebuttal Testimony of Charles E. Loy, p. 13, ln. 8-11, p. 15, ln. 18, and Tr. Vol. 2 p. 132, ln. 9

⁷ HNG Ex. 16, p. 2

Nonetheless, this is an inference that HNG maintains systems of internal controls and its adherence to FERC USOA assuring compliance with Commission Rule §7.310. As stated herein, the Examiners find that HNG is not correctly tracking the costs as required by FERC. Thus, the Company is not entitled to the presumption encapsulated in Commission Rule §7.503. The general definitions and instructions of FERC USOA require that all amounts included in the accounts prescribed for the gas plant and operating expense shall be just and reasonable.⁸ The FERC USOA defines costs to mean:

“[T]he amount of money actually paid for property or services When the consideration given is other than cash in a purchase and sale transaction . . . the value of such consideration shall be determined on a cash basis.”⁹

As to required records, the FERC USOA provides that each entry shall be supported by such detailed information as will permit ready identification, analysis, and verification of all facts relevant thereto. The books and records referred to therein include not only accounting records in a limited technical sense, but all other records, such as minute books, stock books, reports, correspondence, memoranda, etc., which may be useful in developing the history of or facts regarding any transactions.¹⁰ As discussed herein, the management of this utility does not have policies and procedures in place to track the use of assets and employees by affiliates of the applicant. Records, such as leases of rental property, are not recorded or executed to track the history of rental transactions.

It is uncontested that much of the work conducted by the affiliates is done on an informal basis, that no formal structure is used in conducting business among affiliates, and that much of the business among the affiliates is undocumented.¹¹ HNG does not appear to contest this and in its initial brief argued that it was not unusual for a business such as HNG to operate under informal procedures appropriate to its size. Further, HNG contended that there is no provision in law or the Commission’s rules for imposing any requirements for a formal organization level because HNG and HGR cannot reasonably be expected to operate like other large utilities.¹² The

⁸ 18 CFR Part 201, General Instructions, 2. E.

⁹ 18 CFR Part 201, Definitions, 9.

¹⁰ 18 CFR Part 201, General Instructions, 2. A & C.

¹¹ Staff Ex. 7, Direct Testimony of Mark Brock, p. 12, ln. 13 – p. 13, ln. 2.

¹² HNG Initial Brief, pp. 9 – 10.

Examiners find, however, that the FERC USOA impose formal recordkeeping requirements that a utility may not ignore.

Rule 7.310 provides that the amounts shown on the company's books and records as well as summaries and excerpts taken from those records shall be considered *prima facie* evidence of the amount of investment or expense reflected when introduced into evidence, and such amounts are presumed to have been reasonably incurred. The Examiners find that HNG has not established that HNG maintains its books and records in accordance with FERC USOA and therefore the presumption of Rule 7.310 does not apply to this proceeding.

4. Overview of the Company's Rate Request

a. *The Overall Revenue Increase*

As noted above, HNG filed this proceeding on June 2, 2011. As initially proposed the increase requested by HNG would produce an increase to the company's annual revenues of approximately \$1,170,332.¹³ This represents an increase, not including gas costs, of 64.01%.¹⁴ The statement in HNG's Initial Brief that the proposed increase of \$1,170,332 represents an increase of 30.6% is not correct. To arrive at that figure HNG included the company's gas costs. That cost is passed through to the customer.

The inclusion of gas costs in the calculation of the overall increase in this proceeding does not correctly identify the proposed revenue change. The price of the commodity itself is not set by the Commission and, as noted, the gas costs are passed through to the customers. Even including gas costs as purported by HNG in the closing brief, the company has not correctly identified the increase. The company has previously stated that the proposed increase is a 33.01% increase in the company's overall revenues, including gas cost.¹⁵ If gas costs are

¹³ The schedules that reflect this figure were included in the Statement of Intent that was filed on June 2, 2011, and shall be referred to herein as *Original Schedules, June 2, 2011*.

¹⁴ Examiners Ex. 4, Response to Examiners' RFA 1.1.

Please admit or deny the following statement (Statement No. 1)

Statement No. 1. The proposed increase, not including gas costs, will produce an increase to the company's annual revenues, not including gas costs, of approximately 64%.

...
RESPONSE: HNG admits Statement 1.

¹⁵ Examiners' Ex. 4, Response to Examiners' RFI 1.3 The company calculated the increase as a percentage of overall revenues, including gas costs, to be 33.01%.

included 33.01% correctly reflects the percentage increase, not the 30.6% stated in the company's brief. Regardless, the accurate measure of the percentage increase of the non-gas cost portion of the company's rates – the portion at issue in any statement of intent proceeding – is 64.01%.

In the course of this proceeding, HNG reduced its overall revenue increase by \$105,625. This reduction occurred in two stages. On August 19, 2011, HNG filed a revised set of schedules that reduced the overall revenue increase to \$1,104,192.¹⁶ On September 9, 2011, as part of its rebuttal testimony, HNG filed a revised request that reduced the overall revenue increase to \$1,064,707.¹⁷ HNG's current revenue increase, as reflected in the *Second Amended Schedules, September 9, 2011*, is \$1,064,707. This represents an increase of approximately 58% excluding gas costs.

HNG's last rate increase was approved November 6, 2007, in GUD No. 9731, *Statement of Intent Filed by Hughes Natural Gas, Inc. to Change the Rates in the Environs of Wildwood, Pinehurst, and Magnolia* (GUD No. 9731). In that case, HNG indicated that its adjusted test year revenues, for the test year ended December 31, 2006, was \$788,092.¹⁸ The company seeks approval of rates in this proceeding that increase the revenues of the company to \$2,895,676. The difference in revenues over the four year period, from what was identified as the revenues generated during the twelve-month period ended December 31, 2006, to what is requested in this case, is \$2,107,584. This represents an increase of 267% over the non-gas cost revenues booked by the company four years ago.¹⁹

Since the last rate proceeding, HNG's service area has expanded. At the time GUD No. 9731 was issued HNG served approximately 1,862 customers.²⁰ Mr. Provencher testified that HNG now serves 3,501 customers, an increase of approximately 88%. The increase is due

¹⁶ The schedules that reflect this figure were filed under cover of correspondence dated August 19, 2011, and shall be referred to herein as *First Amended Schedules, August 19, 2011*.

¹⁷ These schedules were attached to HNG Ex. 11, Rebuttal Testimony of Charles E. Loy, Exhibit CEL-R1; and, the schedules were also admitted as HNG Ex. 13. These schedules shall be referred to alternatively as either HNG Ex. 11, Rebuttal Testimony of Charles E. Loy, Exhibit CEL-R1; or *Second Amended Schedules, September 9, 2011*.

¹⁸ GUD No. 9731, Final Order, Schedule A-1, ln. 3, col. (d).

¹⁹ The company requested a revenue increase in that case of \$292,571. Instead the Commission approved an increase of \$196,742.

primarily to two components: The acquisition of assets and customers of CapGas resulting in the acquisition of approximately 1,100 customers, and an increase in the customer count of 539 new additional customers.²¹

b. The Change in Base Rates

Turning to the rates proposed in this proceeding, the company seeks to increase the non-gas cost component of the rates charged to residential customers in the environs by 62% and a residential customer within the City of Magnolia would experience a rate increase of approximately 47.20% to the customer's base rates, excluding gas costs rates.²² A commercial customer within the environs would experience an increase of approximately 63.32% to the non-gas cost component of its rates and a commercial customer within the City of Magnolia would experience an increase of approximately 39.72% to the non-gas cost components of its rates.²³ Table 4.1 below sets out the proposed change for the environs residential customers.

Table 4.1²⁴
Average Non-gas Cost Rate Change Proposed for Residential Customers - Environs

	Existing Rates	Proposed Rates	Existing Bills 6 Mcf	Proposed 6 Mcf	Percent Increase
Monthly Cust. Charge	\$15.50	\$24.84	\$15.50	\$24.84	62%
Volumetric Rate	\$5.3650	\$8.7779	\$32.19	\$52.67	

When compared to rates charged just four years ago to customers of HNG, the proposed rate increase in this case is substantial. At the time that GUD No. 9731 was filed, HNG had different rates in the three environs areas served by the company: Pinehurst, Wildwood and Magnolia. If the proposed rates are approved, residential customers in the environs of the City of Magnolia would experience an increase of over 65% from the rates charged November of 2007; residential customers in the Pinehurst area would experience an increase of 65%; and, the change for the Wildwood Residential environs customer is 268%. Table 4.2 below sets out the change that would be experienced by those customers if the proposed rates are approved.

²⁰ GUD No. 9731 FOF 4 & 5.

²¹ HNG Ex. 1, Direct Testimony of Real Provencher, p. 4, ln. 18 – p. 5, ln. 2.

²² These figures are based upon an average consumption of 6 Mcf. The increase will range slightly higher or lower at different consumption levels.

²³ These figures are based upon an average consumption of 30 Mcf. The increase will range slightly higher or lower at different consumption levels.

Table 4.2²⁵

Average Non-Gas Cost Rate Change Proposed for Residential Customers – Environs
November 2007 Rates Compared to Proposed Rates in this Proceeding

	Pre-11/2007 Rates	Proposed Rates in this case	Pre-11/2007 Bills 6 Mcf	Proposed In this Case 6 Mcf	Percent Increase
Pinehurst					
Monthly Cust. Charge	\$12.50	\$24.84	\$12.50	\$24.84	120%
Volumetric Rate	\$3.800	\$8.7779	\$22.80	\$52.67	
			\$35.30	\$77.51	
Wildwood					
Monthly Cust. Charge	\$6.00	\$24.84	\$6.00	\$24.84	268%
Volumetric Rate	\$2.51	\$8.7779	\$32.19	\$52.67	
			\$21.06	\$77.51	
Magnolia Environs					
Monthly Cust. Charge	\$12.50	\$24.84	\$12.50	\$24.84	65%
Volumetric Rate	\$5.75	\$8.7779	\$34.50	\$52.67	
			\$47.00	\$77.51	

A similar analysis for customers within the City of Magnolia establishes that the proposed rates in this proceeding would result in an increase of 65% over the rates charged to those customers at the time of the last rate proceeding, November 2007.

Customers previously served by CapGas will also experience a large increase from rates charged just three years ago. Prior to 2008, CapGas customers paid the same rates as the Wildwood customers in Table 4.2 above. Those rates had been in effect since March 23, 1993, and were approved in GUD Nos. 8310 – 8316, *Statements of Intent filed by Capital Gas Distribution, Inc. to Change Rates in the Unincorporated Areas of Harris, Washington, Montgomery, Waller, Grimes, Colorado, and Austin Counties, Texas* (GUD Nos. 8310 – 9316). After the acquisition those customers experienced a rate increase and paid the rates approved by the Commission in GUD No. 9731. If the proposed rates are approved the CapGas residential customers will experience a 268% increase in rates.²⁶ That change, however, would have occurred in a three-year period instead of the four-year period reflected in Table 4.2 above for those customers. Finally, the Examiners observe that the rate request exceeds the rates charged by utilities in twenty-five Texas cities as reported in the Commission's Six MCF Residential Gas Bill Analysis.²⁷

²⁴ HNG Ex. 13, Schedule F-2

²⁵ HNG Ex. 13, Schedule F-2

²⁶ Examiners' Ex. 6, Response to RFI 3-17

²⁷ Tr. Vol. 1, p. 177, ln. 22 – p. 178, ln. 2

c. The CapGas Merger and Public Interest Evaluation.

As noted, since the last rate proceeding, HNG acquired the assets of CapGas in 2008 and CapGas was merged into HNG. The total consideration paid for the acquisition was \$550,000.²⁸ Section 102.051(a) provides that not later than the 60th day after the date the transaction takes effect, a gas utility shall report to the Commission a merger or consolidation with another gas utility operating in this state. On the filing of a report, the Commission shall investigate the transaction and determine whether the action was consistent with the public interest. In reaching its determination, the Commission shall consider the reasonable value of the property, facility, or securities to be acquired, disposed of, merged or consolidated. If the Commission finds that a transaction is not in the public interest, the Commission shall take the effect of the transaction into consideration in ratemaking proceedings and disallow the effect of the transaction if the transaction has an unreasonable effect on rates or service. HNG requests that the Commission find that the merger with CapGas is consistent with the public interest.

d. The Approval of the Purchased Gas Adjustment Clause

The company also seeks approval of its existing purchase gas adjustment clause ("PGA"). As noted, the cost of gas is not set by the Commission. The cost of gas is passed through and in the case of most utilities the expense is passed through the PGA. Rule 7.5519 sets the standards for approval of a PGA clause. As set out in subsection "a," the Commission may include a PGA clause to provide for the flow-through of part or all of a utility's gas costs. The rule sets out criteria to be used by the Commission in determining whether or not to grant a gas utility a PGA clause:

- The ability of the gas utility to control prices for gas purchased as affected by competition and relative competitive advantage,
- The probability of continued frequent price changes, and
- The availability of alternate gas supply sources.

²⁸ Examiners' Ex. 6, Response to RFI 3-15.

The rule provides that the Commission shall determine in each case the necessary reporting, filing, and other procedures to be followed by a gas utility in implementing a PGA clause. During the test year the total cost of gas passed through to the end use customer, and recovered from the customer, was \$1,721,407.²⁹ The total gas purchases during the test year were \$1,928,971.³⁰ Of the total gas cost expense \$1,000,615 is attributable to Goliad Midstream Energy, LLC (“Goliad” or “GME”) and \$565,049 is attributable to Alamo. Alamo and GME are affiliates of HNG. Thus, 81% of the gas costs that will be passed through the PGA are attributable to affiliates of HNG.

e. Tariff Changes

The company has requested the approval of its proposed tariffs. As noted, HNG seeks approval of continued use of its current PGA. The company also sought the approval of a new *ad valorem* tax recovery surcharge and certain changes to its weather normalization charge.

5. Notice

HNG mailed its customers an initial notice on June 7, 2011, and then sent a supplement notice on July 7, 2011. The supplemental notice was necessitated due to an error in the address referenced for the Railroad Commission of Texas. Two of the protestant’s letters raised issues regarding the adequacy of the notice issued in this case. At a Technical Conference held on August 2, 2011, the Examiners followed up on the question of the adequacy of the notice. On August 10, 2011, the utility filed its *Motion of Hughes Natural Gas, Inc. for an Expedited Determination Regarding the Adequacy of Notice*. The Examiners declined to rule on this motion until a thorough review of the application was completed and here include a recommendation that the notice be found to comply with GURA and Commission Regulations.

In its motion HNG correctly identified the relevant statutory and regulatory provisions regarding notice. The notice requirements for gas utilities proposing to change their rates are set

²⁹ HNG Ex. 13, Schedule F, ln. 9, col. (G).

forth in Title 16 of the Texas Administrative Code, Chapter 7, Subchapter B, Rule § 7.230, and in Sections 104.102 and 104.103 of the Texas Utilities Code. Section 104.102(c) of the Utilities Code and Rule 7.230(a) specifically require disclosure of the following:

1. The proposed revision of rates and schedules;
2. A statement specifying in detail each proposed change/increase;
3. The effect the proposed change is expected to have on the revenues of the company;
4. The classes and number of utility customers affected; and
5. Any other information required by the Commission.

For customers served in environs areas outside of an incorporated city, Rule § 7.230(b) requires, in addition to the information specified in subsection (a), that the notice contain the following information:

1. The date of the filing of the statement of intent;
2. A statement as to whether or not the proposed rates constituted a “major change;”
3. A statement that the proposed change in rates will not become effective until similar changes have become effective within the nearest incorporated city if the rates are sought to be at the same level as the city rates;
4. The location where information concerning the proposed change may be obtained; and
5. A statement that any affected person may file in writing comments or a protest concerning the proposed change in the environs rates with the Commission.

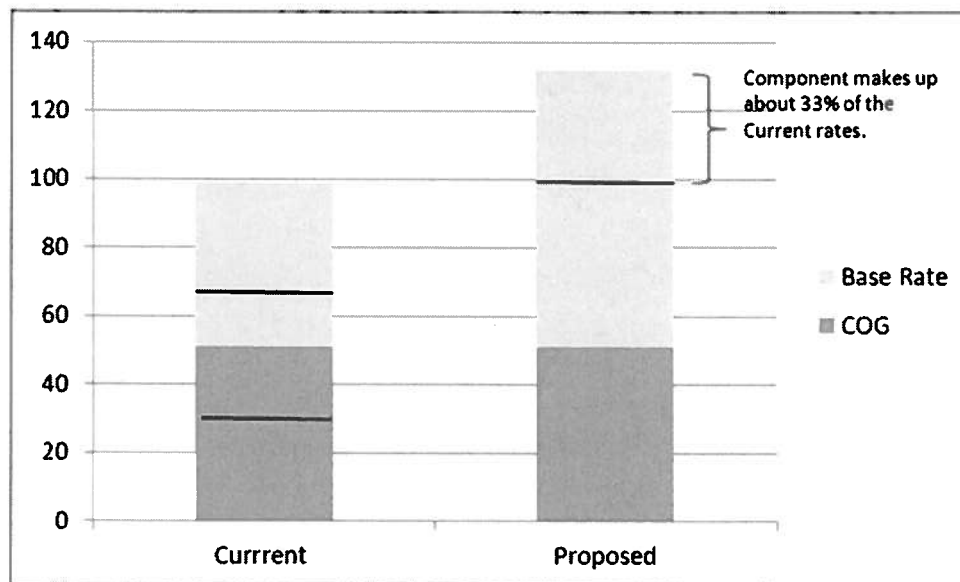
³⁰ HNG Ex. 13, Schedule WP1, Excel Cell Q95. The total amount recovered and the total amount purchased is not equal. This may be due, in part, to the lag in recovery of the expense until the natural gas is consumed by the customer and the customer is billed.

The *Supplemental Notice of Request for Gas Rate Increase* issued indicated that a residential customer receiving a bill for 6 Mcf would experience an increase of 33.1%. The protest letters that were filed implied that the proposed increase was higher than noted in the Notice of Request for Gas Rate Increase. The confusion stemmed from the calculation of the proposed increase.

The typical residential gas bill is made up of two broad components: the amount due as a result of base rates and the amount due for natural gas consumption itself. The second part of the bill is a pass through cost and is not set in the rate proceeding. The company included the pass through cost of gas in the calculation of the percentage increase. A typical customer who consumed 6 Mcf would be charged \$47.69 under current base rates plus a cost of gas of \$51.27. The total rate charged to that customer was \$98.96. Under the proposed rates the same customer would be charged \$80.47 under the proposed base rates plus a cost of gas of \$51.27. The total rate charged to that customer was \$131.74. The percentage change between \$98.96 and \$131.74 is 33.1%. This is the percentage increase including gas costs. This is graphically represented in Table 5.1 below.

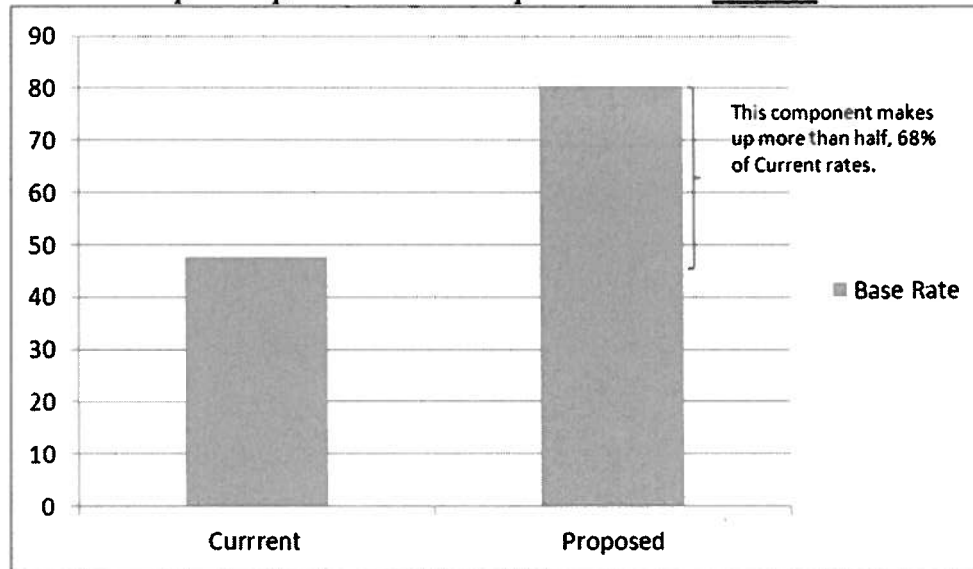
Table 5.1

Graphic Representation of Proposed Increase with Gas Cost



By including the pass through cost of gas in the calculation of the percentage change the notice dampened the effect of the proposed increase on base rates. Removal of the pass through cost of gas reveals the effect of the base rate increase. Namely the change in base rates proposed is approximately a 68.73% increase. Table 5.2 below graphically illustrates this increase without gas costs.

Table 5.2
Graphic Representation of Proposed Increase without Gas Cost



The issue raised by correspondence filed with the Commission, and raised by the Examiners at the Technical Conference, was whether the inclusion of the pass-through-gas-cost component misled or confused customers. The issue is a policy question with regards to notice requirements and was reserved for consideration by the Commission in the *Proposal for Decision*.³¹

The confusion in the notice may have been propounded further by the following sentence:

“A residential customer receiving a bill for 6 Mcf will see a bill of approximately \$131.74 (or \$80.44 excluding gas costs), which would constitute an increase of approximately 33.1% in unincorporated areas”³²

³¹ Additionally, part of the reason for the decision to reserve the question for the *Proposal for Decision* is that at the time a case is filed the utility is the only entity with all facts regarding the proposed increase at its disposal. The true nature of the proposed increase and the adequacy of the notice can be fully evaluated only after a careful review of the filing has been made. Thus, the burden of adequate notice is on the utility.

³² Although the changes are different for the incorporated customers the discussion regarding the notice is equally relevant for both environs and municipal customers.

The company did not clarify that the percentage change included in that sentence was the result of a calculation with gas cost. Although the impact without gas cost is discussed in the parenthetical, the percentage impact is without gas cost. This perhaps leaves the impression that the proposed increase is 33.1% without gas cost.

The City of Magnolia noted the confusion in its *Motion in Support of Staff's Motion to Sever Gas Costs* wherein the City of Magnolia explained that the concern raised by customers is largely due to the fact that the notice sent by the applicant stated that the proposed increase for customers outside the City of Magnolia is 33.12% and for customer located inside the City of Magnolia the increase is 22.77%. The City of Magnolia observed that while the company estimated the percentage increase based on total revenues (for a customer's total bill), the magnitude of the actual increase is not really shown in the company's notice. The City of Magnolia asserted that customers could not see the extent to which base rate charges, which are the only charges proposed to be changed in this proceeding, are proposed to increase.

It has been the practice of other utilities before the Commission in several recent cases to carefully delineate the effect of the proposed increase with and without gas costs. Figure 5.1 below is a copy of the relevant portions of the notice recently issued in GUD No. 10085, *Atmos Energy Corp., West Texas Division Statement of Intent to Change Gas Rates in the Unincorporated Areas of the West Texas Rate Division*. On the other hand, the notice issued by HNG in this proceeding is attached as Appendix B.

Figure 5.1
GUD No. 10085 Notice

As part of its rate filing, Atmos seeks to implement uniform rates for its residential, commercial, industrial, public service authority, and state institution customer classes throughout the unincorporated areas of the West Texas Cities Rate Division and revise its tariffs accordingly. Based on the proposed rate design, the average monthly bill for each customer class in the unincorporated areas of the West Texas Rate Division will increase or decrease by the amount and percentage shown in the table below.

Customer Class	Current Bill*	Proposed Bill*	Difference	Percentage Increase with Gas Cost	Percentage Increase without Gas Cost
Residential	\$49.91	\$53.15	\$3.24	6.50%	16.11%
Commercial	\$213.15	\$220.00	\$6.85	3.21%	11.74%
Industrial	\$2,128.10	\$2,079.50	-\$48.60	-2.28%	-9.18%
Public Authority	\$419.17	\$425.59	\$6.42	1.53%	5.05%
State Institution	\$318.09	\$312.27	-\$5.82	-1.83%	-4.45%

*includes Rider GCA cost of \$0.5214 per Ccf.

The calculation of the bill impacts on the above table assumes approximate monthly consumption of 57 Ccf for residential, 297 Ccf for commercial, 3,066 Ccf for industrial, 560 Ccf for public authority, and 359 for state institution.

The Examiners find that the notice issued by HNG complied with the minimum requirements of the statute and regulations. Further, the notice is consistent with the prior notice submitted in the company's last rate proceeding. The company is correct that there is no requirement in the regulations that the notice carefully distinguish the impact of the proposed increase with or without gas costs. And despite this ambiguity, customers were well aware of the proposed increase as evidenced by the vast number of letters received from HNG's customers. It is also apparent that enough information was included in the notice to provide an opportunity for customers to determine the impact with and without gas costs as was apparently done by a couple of customers filing protests in this case. It is possible, however, that had the notice clearly delineated the base rate increase, without gas costs, that an even higher number of customers would have filed letters in this proceeding.

The Examiners also agree with arguments raised by HNG in this context that regulatory consistency is important. HNG, however, has requested two significant rate increases in the space of five years. In each case, the notice issued did not include the effect on customers of the proposed increase without gas costs. This may operate to confuse consumers and may result in assertions that the public has been misled, as was done in this case. In order to avoid confusion in the future and unnecessary controversy, the Examiners recommend that the Commission direct HNG to precisely describe the proposed rate increase with and without gas costs in all future rate proceedings. This is consistent with Rule 7.230 which provides that the Commission may order the inclusion in the notice of "any other information required by the Commission." This information would be provided in addition to the statutory and regulatory requirements of the GURA.

6. Overview of Affiliate Issues

a. *Statutory and Regulatory Standards*

The issue of the affiliate relationships of HNG encompassed a substantial portion of this proceeding and was a subject of intense debate among the parties. It was also an issue in HNG's

last rate proceeding and the Commission made certain adjustments related to affiliates.³³ Much of Staff's evidentiary testimony focused on this topic and it was a subject that the City of Magnolia identified as one of the key areas of the case.³⁴ It was also the focus of several protest letters filed by customers of the system.³⁵ Three statutory provisions are relevant in this context: (1) Section 104.051 related to the establishment of overall revenues, (2) Section 104.055(b) related to specific findings regarding affiliate expenditures, and (3) Section 104.007 related to discrimination and restriction on competition.

First, Section 104.051 requires that rates be established to permit the utility a reasonable opportunity to earn a reasonable return on the utility's invested capital used and useful in providing service to the public in excess of its reasonable and necessary operating expenses. Thus, in the rate setting context it is necessary to establish the reasonable and necessary operating expenses of the utility.

Proper calculation of costs requires proper calculation of the use of the asset or services of an employee. If an asset or employee of the utility is used by an affiliate the affiliate has contributed to the cost of that asset or impacted the labor expense of the company. In the case of an asset it is clear that the use of that asset by the affiliate contributes to the normal wear and tear of that asset. Failure to assign an expense to the affiliate results in payment of that asset exclusively by the captive customer. In the case of an employee, use of the services of that employee may require the hiring of additional employees to complete the tasks required to operate the utility. Thus, the labor expense is impacted by unrecognized services to affiliates. It is necessary, therefore, to assign the costs of using that asset to the affiliate in order to determine the reasonable and necessary operating expense. The assignment of cost is generally accomplished by either a direct assignment or an allocation.

Second, Section 104.055 provides that in establishing a gas utility's rates, the regulatory authority may not allow a gas utility's payment to an affiliate for the cost of service, property, right or other item or for an interest expense to be included as a capital cost or as expense related to gas utility service except to the extent that the regulatory authority finds the payment is

³³ GUD No. 9731, Finding of Fact No. 32: Hughes did not provide relevant, meaningful, and probative evidence to meet its burden of proof to show that inclusion in cost of service of \$166,920 for theoretical consulting fees from Hughes' affiliate is reasonable and necessary.

³⁴ City of Magnolia Initial Brief, p. 7.

reasonable and necessary for each item or class of items as determined by the regulatory authority. That finding must include a specific finding of the reasonableness and necessity of each item or class of items allowed. Additionally, the regulatory authority must include a finding that the price to the gas utility is not higher than the prices charged by the supplying affiliate to its other affiliates or division or to a nonaffiliated person for the same item or class of items.

Therefore, the price paid by the gas utility to an affiliate must be clearly established. Failure to properly allocate a cost or service provided by a utility to an affiliate results in a subsidy to that affiliate. The subsidy is part of the payment made to the affiliate for the services provided by the affiliate. The failure to account for that subsidy precludes a finding that the price to the gas utility is not higher than the prices charged by the supplying affiliate to its other affiliates or division or to a nonaffiliated person for the same item or class of items. Simply stated, without proper allocation of costs the service provided by the utility to an affiliate is part of the cost of the services that are, in turn, provided by the affiliate to the utility. Failure to quantify the costs and recover those expenses means that Section 104.055(b) cannot be satisfied.

Third, Section 104.007 requires that a gas utility may not engage in a practice that tends to restrict or impair competition against persons who sell or lease equipment or perform services in competition with the gas utility. Several HNG affiliates provide services to HNG and are in competition with other entities that may provide services to HNG. To the extent HNG provides an uncompensated subsidy to an affiliate HNG engages in a practice that restricts or impairs competition. Simply stated, competitors of HNG's affiliates do not enjoy the benefit of the uncompensated subsidy provided by HNG to its affiliates.

In this section, the Examiners provide an overview of the affiliate structure, the Examiners provide a general overview of the arguments raised regarding the affiliate structure, and evaluate whether the affiliates are stand-alone entities. As set forth below, the Examiners find that the utility has not established that the entities are stand-alone entities. The Examiners find that without the use of the assets paid for by HNG and the services of HNG employees the affiliates could not function. In this section, the Examiners also discuss a recommendation regarding a management audit. Namely, that HNG be required to undertake an independent

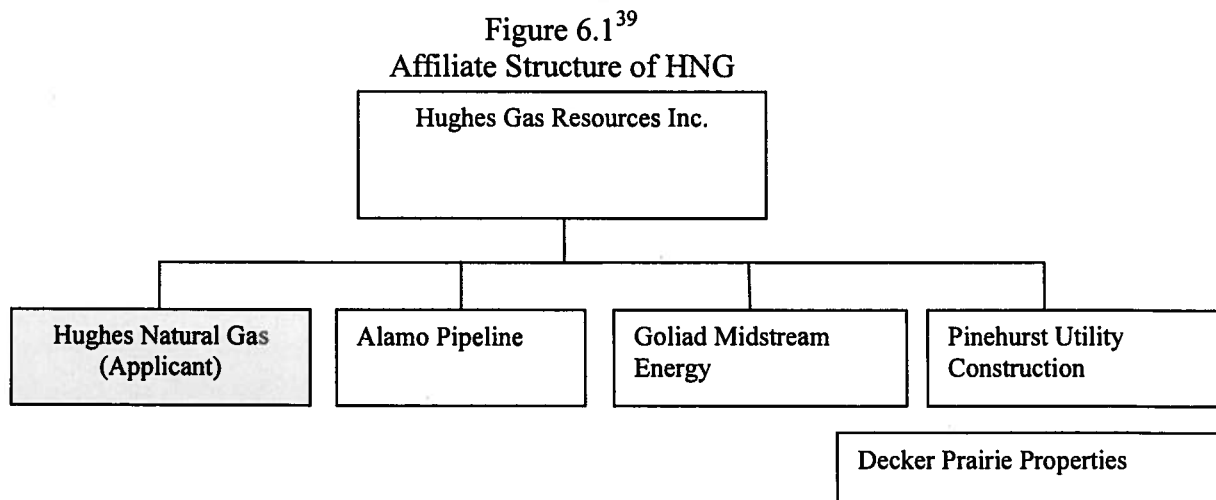
³⁵ See, Examiners' Letter No. 35 citing to letters filed.

management audit of its operations. The cost of the audit shall be borne exclusively by HNG and not passed on to customers of the system.

b. Overview of Hughes Affiliate Structure

HNG is part of an affiliate structure that involves six entities. The parent company Hughes Gas Resources, Inc. (“HGR”) is a holding company organized as a Subchapter S corporation, that owns four subsidiaries: (1) Hughes Natural Gas (“HNG”) (the applicant), (2) Alamo Pipeline LLC, (“Alamo”), (3) Goliad Midstream Energy, LLC. (“Goliad” or “GME”), and (4) Pinehurst Utility Construction, LLC. (“Pinehurst” or “PUC”).³⁶ These companies as a group are related affiliates through their common ownership of the parent company Hughes Gas Resources and are referred to herein as the “Hughes Resources Affiliated Group of Companies.”³⁷

Real Provencher and Frank Hicks are owners of Hughes Gas Resources and officers and directors of the various subsidiaries. The sixth company Decker Prairie Properties, LLC. (“Decker”), is owned exclusively by Frank Hicks and Karen Hicks.³⁸ Decker is an affiliate because of Mr. Hick’s association with Hughes Gas Resources, Inc. and its affiliated group of companies. Figure 6.1 below sets out the affiliate structure:



³⁶ The parties have adopted HNG’s convention to refer to Pinehurst Utility Construction as “PUC.” As the acronym commonly used for the Public Utility Commission is “PUC,” the Examiners have opted to refer to Pinehurst Utility Construction as “Pinehurst” to avoid any confusion. Occasionally where a document is reproduced or quoted the acronym included in the original document has not been changed.

³⁷ HNG Ex. 6, Rebuttal Testimony of Real Provencher, p. 4, Ins. 6 – 12.

³⁸ HNG Ex. 6, Rebuttal Testimony of Real Provencher, p. 6, Ins. 21 – 22.

³⁹ City of Magnolia, Ex. 3 & Staff Ex. 7, Direct Testimony of Mark Brock, p. 9.

Mr. Provencher and Mr. Hicks serve alternately as President and Vice President of the various companies. Hughes Gas Resources has Mr. Hicks as President and Mr. Provencher as Vice President. HNG has Mr. Provencher as President and Mr. Hicks as Vice President. Goliad has Mr. Provencher as President and Mr. Hicks as Vice President. Alamo has Mr. Provencher as President and Mr. Hicks as Vice President. Pinehurst has Mr. Hicks as President and Mr. Provencher as Vice President. Table 6.1 below summarizes the executive roles of Mr. Provencher and Mr. Hicks among the various affiliated entity.

Table 6.1.
Offices held by Real Provencher and Frank Hicks among Affiliates

	Hughes Gas Resources	HNG	Goliad	Alamo	Pinehurst
Mr. Provencher	Vice – President	President	President	President	Vice-President
Mr. Hicks	President	Vice-President	Vice-President	Vice-President	President

All of these affiliates provide services to HNG. Hughes Gas Resources, as the parent company, is a holding company and provides the capital required by the subsidiaries, including HNG. It is owned by Mr. Hicks and Mr. Provencher.⁴⁰ Alamo is a natural gas transmission utility that provides natural gas transportation in Harris and Montgomery County and much of the gas supplied to HNG is transported on Alamo's Pinehurst Pipeline.⁴¹ Alamo delivers gas for Goliad to HNG and XTX Pipeline, LLC.⁴² During the test year HNG paid \$565,049 for transportation services.⁴³ Goliad buys and sells natural gas delivered to local distribution companies in Montgomery and Harris County. All of its sales are delivered on the Pinehurst Pipeline owned by Alamo.⁴⁴ During the test year HNG paid \$1,000,615 to Goliad for natural gas

⁴⁰ HNG Ex. 6, p. 4, ln. 13 – ln. 16.

⁴¹ HNG Ex. 1, Direct Testimony of Real Provencher, p. 7, lns. 15 – 17.

⁴² HNG Ex. 6, Rebuttal Testimony of Real Provencher, p. 5, lns. 24 – 25.

⁴³ HNG Ex. 13, Schedule WP1, Excel Cell: Q72.

⁴⁴ HNG Ex. 1, Direct Testimony of Real Provencher, p. 7, lns. 18 – 20.

purchases.⁴⁵ Together expenses of Alamo and Goliad made up 81% of HNG's total gas costs during the test year in the amount of \$1,928,971.⁴⁶ Pinehurst provides construction services to HNG, to Alamo and to unrelated third parties.⁴⁷ HNG's test-year-operating expenses included \$85,365 for services that were provided by Pinehurst. Additionally, HNG's plant in service includes \$1,306,940 for plant construction services provided by Pinehurst during the test year.⁴⁸ Decker is a property management company and HNG leases office and warehouse space from Decker. The monthly rent is \$3,500.⁴⁹

c. City of Magnolia – Overview of Affiliate Issues Raised

The City of Magnolia maintained that the affiliate structure established by HNG is designed to maximize profits and that the profits are increased by an unnecessary array of affiliates. The structure is not necessary to provide safe and reliable service or just and reasonable rates. The affiliates have not functioned to increase efficiency. Instead, they have functioned to increase profits. The City of Magnolia argued that the services provided by Pinehurst to HNG could be provided by HNG at cost. Instead, HNG has created Pinehurst to allow it to charge a margin for the same services HNG would be able to provide.⁵⁰ Likewise, Goliad was created to recover a profit margin for a service that could be provided by HNG at a cost of service rate.⁵¹ The City of Magnolia also argued Alamo's profits could be avoided if the transportation services were undertaken by HNG directly.⁵² The City of Magnolia requested that all or a portion of the affiliate profit associated with Pinehurst, Goliad, and Alamo be removed from the revenue requirement.

⁴⁵ HNG Ex. 13, Schedule WP1, Excel Cell: Q68.

⁴⁶ HNG Ex. 13, Schedule WP1, Excel Cell: Q95. The 81% figure is calculated as follows:
$$[(\$1,000,615 + \$565,049)/\$1,928,971] * 100 = 81\%$$

⁴⁷ HNG Ex. 1, Direct Testimony of Real Provencher, p. 8, ln. 21 – p. 9, ln. 2.

⁴⁸ HNG Ex. 3, Direct Testimony of Ellen Blumenthal, p. 9, lns. 12 – 14.

⁴⁹ HNG Ex. 3, Direct Testimony of Ellen Blumenthal, p. 13, lns. 8 – 12.

⁵⁰ City of Magnolia Initial Brief, pp. 4 – 12.

⁵¹ City of Magnolia, Ex. 1, Direct Testimony of Karl Nalepa, p. 24 – 28.

⁵² *Id.*

d. Staff – Overview of Affiliate Issues Raised

Mr. Brock testified on behalf of Staff regarding affiliate issues. Staff asserted that there were several considerations which should be made in evaluating affiliate transactions. First, Mr. Brock contended that employees of HNG provide services to the affiliates which are not compensated by the affiliate. Second, Staff argued that the affiliate relationship necessitated an inquiry by the Commission of the charges passed through by Goliad, Alamo, and Pinehurst. Third, Mr. Brock maintained that HNG abused its monopolistic influence on its customers and local competition by setting the standard for construction and repair of customer owned yard lines so high that licensed plumbers, who typically do the work, are not able to compete for the business.⁵³

Generally, Staff argued that various category of expenses should be allocated. For example, Mr. Brock asserted that an allocation of salaries of Mr. Provencher, Mr. Hicks, and Barbara Miller should be made to Hughes Gas Resources because services are provided by those individuals, who are employees of HNG, that are necessary to operate Hughes Gas Resources.⁵⁴ Likewise, Goliad has no employees and the task necessary to support the work necessary to carry on the day to day activities of Goliad are being carried out by employees of HNG. Mr. Brock argued that there should be an allocation of office space, salary expenses, office supply expense, and property insurance expense. Indeed, all of these shared services should be allocated among the different affiliates using the same address as HNG. Staff asserted that Goliad shares office space with HNG.⁵⁵ Staff asserts that Goliad has no capital assets and its activities are supported almost entirely by assets paid for by HNG and employees of HNG.⁵⁶

e. Response of HNG

The company asserted that all affiliates were stand-alone entities. Mr. Provencher explained that the affiliates were created to separate regulated and unregulated business activities, and to facilitate record keeping and accounting, and for liability purposes. Noting the

⁵³ Staff Ex. No. 7, Direct Testimony of Mark Brock, p. 6, lns. 3 – 20.

⁵⁴ Staff Ex. 7, Direct Testimony of Mark Brock, p. 20, ln. 16 – p. 14, ln. 8.

⁵⁵ Staff Ex. 7, Direct Testimony of Mark Brock, p. 16, lns. 9 – 10.

burden imposed by Section 104.055(b) and supporting case law, primarily *Railroad Commission v. Rio Grande Valley Gas Company*, 683 S.W.2d 783 (Tex. App. – Austin 1985, writ denied), Ms. Blumenthal asserted that the utility satisfied its statutory and regulatory burden and that each affiliate pays its own costs.

In the original *Statement of Intent*, except for rent, none of the expenses that appeared in the cost of service calculation for HNG were allocated to any of the affiliates. For example, the test-year salary expense for the Officer Personnel identified as “AP & Human Res.” was booked as \$41,166 and none of that expense was allocated or assigned to any of the other affiliates.

As noted, the only common asset that was recognized in the original *Statement of Intent* was the expense associated with the rent of the office space. That common expense was paid to an affiliate, Decker properties, that managed the property at 31830 State Highway 249, Pinehurst, TX 77362. The rent was allocated among three members of the Hughes Resources Affiliated Group of Companies: HNG, Alamo, and Pinehurst. Ms. Blumenthal explained that HNG leases office and warehouse space from Decker. The monthly rent is \$3,500. Pinehurst, Alamo, and an unaffiliated third party share the same building, warehouse, and parking areas. The rent was based upon the square footage each entity occupies. Hughes Gas Resource and Goliad pay no rent as it was alleged that they occupy no space.⁵⁷

As the case progressed, HNG conceded that one member of the HNG labor force provided services to affiliates, Barbara Miller, the accounts payable and human resources employee. The basis for the allocation was an “estimate of the time spent” by Ms. Miller on services provided to the other affiliates. In the Reply Brief, HNG conceded that the allocation of the vehicle driven by Mr. Hicks, an individual that provided services to all affiliates, was just and reasonable.

Mr. Provencher explained that Goliad is a wholly owned subsidiary of Hughes Gas Resources that sells natural gas to HNG and to an independent third party (XTX Pipeline). Goliad has no paid employees. He asserted that he is responsible for only one task for Goliad: He prepares two invoices each month. He asserted that the executive management function of the company is performed by Mr. Hicks as Vice President. Mr. Hicks devotes an average of 5 to

⁵⁶ Staff Ex. 7, Direct Testimony of Mark Brock, p. 16, Ins. 15 – 17 & p. 17, Ins. 3 – 4.

10 hours a month to the affairs of Hughes Gas Resources and Goliad combined. Mr. Provencher does not receive a salary from Goliad.

f. Examiners' Findings and Recommendations

As noted by HNG, the intent of the parent corporation was to create "stand-alone" entities.⁵⁸ HNG's *Statement of Intent* was premised on the assertion that except for rental expenses shared by HNG, Alamo, and Pinehurst, and the directly assigned salary of Mr. Hicks the affiliates are stand-alone entities. The facts in this case, however, establish that the entities enjoy the use of several physical assets and services provided by HNG personnel for which no costs are assigned to the entity.

The record in this proceeding established that the following entities were able to use the following physical assets without paying for those assets.

- Hughes Gas Resources lists as its principal office and/or the principal place of business: 31830 State Highway 249, Pinehurst Texas 77382.⁵⁹ This address is listed on all business filings with the Secretary of State. Hughes Gas Resources receives mail at that address.⁶⁰ Mr. Provencher and Mr. Hicks perform tasks for all affiliated entities, including Hughes Gas Resources, at that address.⁶¹ Hughes Gas Resources does not pay rent for that property.
- Goliad lists as its principal office and/or the principal place of business: 31830 State Highway 249, Pinehurst Texas 77382.⁶² This address is listed on all business filings with the Secretary of State. Goliad receives mail at that address.⁶³ Mr. Provencher and Mr. Hicks perform tasks for all affiliated entities, including Goliad at that address.⁶⁴ Goliad does not pay rent for that property.

⁵⁷ HNG Ex. 3, Direct Testimony of Ellen Blumenthal, p. 13, LN. 5 – p. 13, ln. 3.

⁵⁸ HNG Reply Brief, p. 11.

⁵⁹ Examiners' Ex. 1 Response to RFI 4-9.

⁶⁰ Examiners' Ex. 1, Response to RFI 4-10 & 4-11.

⁶¹ Examiners' Ex. 1, Response to RFI 4-18

⁶² Examiners' Ex. 1, Response to RFI 4-9.

⁶³ Examiners' Ex. 1, Response to RFI 4-10 & 4-11.

⁶⁴ Examiners' Ex. 1 Response to RFI 4-18

- Mr. Provencher, Mr. Hicks, and Ms. Miller provide services for various members of the Hughes Resources Affiliated Group of Companies. The proposed allocation for rent, however, does not allocate any of the rental expense for the space occupied by those individuals to any of the affiliated members in that group of companies.
- The contract between Goliad, as the seller of natural gas, and HNG, as the buyer of gas provides that notices required by the contract are to be made at the following address, telephone number and facsimile:
 - Physical Address: 31830 State Highway 249, Pinehurst, TX 77362,
 - Telephone: (281)766-1280 (Goliad) and (281) 766-1290 (HNG),
 - Facsimile: (281) 259-7773 (both Goliad and HNG)
 - Attn: Real Provencher (Goliad) and Frank Hicks (HNG)

Figure 6.2 below sets out the notification provision of the Gas Services Agreement.

Figure 6.2.⁶⁵
Notification Provision of Gas Services Agreement B
Between Goliad and HNG

Notice Requirements: All notices are required to be given in writing and shall be deemed received when deposited in the United States mail, postage prepaid and addressed to the address set forth herein for the party being notified or by facsimile transmission, transmission confirmed. Notice of readiness to commence deliveries, suspension or resumption of deliveries, shall be given by certified mail, postage prepaid and addressed to the address set forth herein for the party being notified or by facsimile transmission, transmission confirmed. Either party may change its address for notices by complying with terms of this paragraph. Notices of financial and operating matters shall be addressed as follows:

When to Seller:

Goliad Midstream Energy, LLC
31830 State Highway 249
Pinehurst, TX 77362
Telephone: (281) 766-1280
Facsimile: (281) 259-7773
Attn: Real Provencher

When to Buyer:

Hughes Natural Gas, Inc.
31830 State Highway 249
Pinehurst, TX 77362
Telephone: (281) 766-1290
Facsimile: (281) 259-7773
Attn: Frank M. Hicks

⁶⁵ City of Magnolia Ex. 4, Gas Services Agreement between Goliad and Hughes

Goliad does not pay rent nor does Goliad pay any portion of the telecommunications equipment at that address.

- The contract between Goliad, as the seller of natural gas, and a third party not affiliated with HNG, provides that notices to Goliad are to be made at the following address, telephone number and facsimile:

- Physical Address: 31830 State Highway 249, Pinehurst, TX 77362,
- Telephone: (281)766-1280,
- Facsimile: (281) 259-7773
- Attn: Real Provencher

Figure 6.3 below sets out the notification provision of the Gas Services Agreement.

Figure 6.3.⁶⁶
Notification Provision of Gas Services Agreement B
Between Goliad and XTX Pipeline

Notice Requirements: All notices are required to be given in writing and shall be deemed received when deposited in the United States mail, postage prepaid and addressed to the address set forth herein for the party being notified or by facsimile transmission, transmission confirmed. Notice of readiness to commence deliveries, suspension or resumption of deliveries, shall be given by certified mail, postage prepaid and addressed to the address set forth herein for the party being notified or by facsimile transmission, transmission confirmed. Either party may change its address for notices by complying with terms of this paragraph. Notices of financial and operating matters shall be addressed as follows:

When to Seller:

Goliad Midstream Energy, LLC
31830 State Highway 249
Pinehurst, TX 77362
Telephone: (281) 766-1280
Facsimile: (281) 259-7773
Attn: Real Provencher

When to Buyer:

XTX Pipeline Company, LLC
9750 FM 1488
Magnolia, TX 77354
Telephone: (281) 252-6700
Facsimile: (281) 252-9252
Attn: Robert S. Barnwell III

Goliad does not pay rent nor does Goliad pay any portion of the telecommunications equipment at that address.

⁶⁶ City of Magnolia Ex. 7, Gas Services Agreement between Goliad and XTX Pipeline Company, LLC.

- The President, Frank Hicks, and Vice-President, Real Provencher, of Hughes Gas Resources each drive a vehicle to work and perform tasks on behalf of Hughes Gas Resources, Inc. The parent company, Hughes Gas Resources, Inc., does not pay for the vehicle or the gasoline to operate the vehicle.
- The President, Real Provencher, and Vice-President, Frank Hicks of Alamo each drive a vehicle to work and perform tasks on behalf of Alamo. Alamo does not pay for the vehicle or the gasoline to operate the vehicle.
- The President, Real Provencher, and Vice-President, Frank Hicks, of Goliad each drive a vehicle to work and perform tasks on behalf of Goliad. Goliad does not pay for the vehicle or the gasoline to operate the vehicle.
- Calls received for Goliad at 31830 State Highway 249, Pinehurst Texas 77382 are routed to Mr. Provencher. Goliad does not pay for telephone services at that address.
- Pinehurst advertises on the website operated by HNG.⁶⁷ Pinehurst does not pay for that advertising service.
- Mr. Provencher exchanged several emails with Staff of the Commission at the time the initial rates for Alamo were filed. The email address referenced in some of those documents is as follows: RealP@hughesnaturalgas.com. There was no evidence provided that any allocation has been made of information technology equipment to Alamo.

The record in this proceeding established that the following services were rendered to affiliates at no cost to the affiliate:

- The President, Frank Hicks, and Vice-President, Real Provencher, of Hughes Gas Resources each drive a vehicle to work and perform tasks on behalf of Hughes Gas

⁶⁷ Staff Ex. 7, Direct Testimony of Mark Brock, Exhibit MB – 4.

Resources at the office of HNG. Hughes Gas Resources does not pay for any vehicle insurance.

- The President, Real Provencher, and Vice-President, Frank Hicks, of GME each drive a vehicle to work and perform tasks on behalf of Goliad. Goliad does not contribute to their vehicle insurance.⁶⁸
- The owner of Decker drives a vehicle and performs task on behalf of Decker. Decker does not pay for the vehicle or the gasoline to operate the vehicle. Decker does not contribute to the vehicle insurance.⁶⁹
- Hughes Gas Resources lists as its principal office and/or the principal place of business: 31830 State Highway 249, Pinehurst Texas 77382.⁷⁰ Hughes Gas Resources receives mail at that address.⁷¹ Mr. Provencher and Mr. Hicks perform tasks for all affiliated entities, including Hughes Gas Resources, Inc., at that address.⁷² Hughes Gas Resources does not pay any property insurance.⁷³
- Goliad lists as its principal office and/or the principal place of business: 31830 State Highway 249, Pinehurst Texas 77382.⁷⁴ Goliad receives mail at that address.⁷⁵ Mr. Provencher and Mr. Hicks perform tasks for all affiliated entities, including GME at that address.⁷⁶ Goliad does not pay any property insurance.⁷⁷
- Frank Hicks serves as the President of Hughes Gas Resources. Real Provencher serves as the Vice-President of Hughes Gas Resources. Mr. Hicks and Mr. Provencher also serve as Directors. Mr. Hicks performs administrative, directional, managerial, clerical and

⁶⁸ *Id.*

⁶⁹ *Id.*

⁷⁰ Examiners' Ex. 1, Response to RF1 4-9.

⁷¹ Examiners' Ex. 1, Response to RF1 4-10 & 4-11.

⁷² Examiners' Ex. 1, Response to RF1 4-18

⁷³ HNG Ex. 6, Rebuttal Testimony of Real Provencher, pp. 26 – 27

⁷⁴ Examiners' Ex. 1, Response to RF1 4-9.

⁷⁵ Examiners' Ex. 1, Response to RF1 4-10 & 4-11.

⁷⁶ Examiners' Ex. 1, Response to RF1 4-18

⁷⁷ HNG Ex. 6, Rebuttal Testimony of Real Provencher, pp. 26 – 27

secretarial duties on behalf of Hughes Gas Resources.⁷⁸ Mr. Provencher performs monthly accounting duties on behalf of Hughes Gas Resources.⁷⁹ Hughes Gas Resources does not provide a salary to either Mr. Hicks or Mr. Provencher for their services as President and Vice President.⁸⁰

- Mr. Provencher serves as President for Alamo, prepares invoices for Alamo, and submits the transmission annual report to the Commission for Alamo. As President, Mr. Provencher has executed contracts on behalf of Alamo.⁸¹ Mr. Provencher filed the initial rates for Alamo, submitted the study in support of those rates, and discussed those proposed rates with Staff of the Commission in the summer of 2010.⁸² Alamo does not provide a salary for his services.⁸³
- Mr. Provencher serves as President of Goliad. As President, Mr. Provencher has executed contracts on behalf of Goliad. Goliad does not provide a salary for that service.⁸⁴
- Mr. Provencher serves as Vice President of Pinehurst. Pinehurst does not provide a salary for that service.⁸⁵

Based upon this record the Examiners find that the affiliated entities were not “stand-alone” entities as alleged by HNG. As will be explained in each expense category below the Examiners recommend that the costs of assets that are used by affiliates and the expense for labor provided by HNG to the affiliates be assigned.

⁷⁸ Staff Ex. 7, Direct Testimony of Mark Brock, p. 13, lns. 4 – 10.

⁷⁹ *Id.*

⁸⁰ Staff Ex. 7, Direct Testimony of Mark Brock, p. 11, ln. 17 - p. 14, ln. 8

⁸¹ Staff Ex. 7, Direct Testimony of Mark Brock, p. 9, lns. 12 – 14.

⁸² HNG Ex. 6, Rebuttal Testimony of Real Provencher, p. 75.

⁸³ HNG Ex. 6, Rebuttal Testimony of Real Provencher, p. 5, lns. 11 – 19. Examiners’ Ex. 2 2010 Transmission Annual Report and the 2009 Transmission Annual Report. Page 1 of each report includes an affidavit attesting to the following: I declare under penalties prescribed in Texas Utilities Code, Chapter 105, that I am authorized to make this annual report to the Gas Services Division of the Railroad Commission of Texas, that this report was prepared by me or under my supervision, and that the data and facts stated therein are true, correct, and complete to the best of my knowledge

⁸⁴ HNG Ex. 6, Rebuttal Testimony of Real Provencher, p. 5, lns. 11 – 13.

⁸⁵ HNG Ex. 6, Rebuttal Testimony of Real Provencher, p. 6, lns. 17 – 19.

The Examiners find that the approach taken by HNG in filing this proceeding did not produce a just and reasonable calculation of costs for HNG. As shall be seen, the company apparently takes the position that uncompensated services by HNG to its affiliate are reasonable. For example, in response to assertions that Mr. Provencher conducts business activities for Alamo and Goliad, Mr. Provencher provided testimony that all he does is prepare “two invoices a month.”⁸⁶ Despite that assertion, no allocation, assignment or other designation of cost is proffered with regards to Alamo or Goliad for performing this *essential* business function. This problem was endemic to this proceeding and evidences a systemic managerial failure.

The treatment of the account personnel is a further example of the problem. As discussed below, it was not until after this case was filed and after discovery conducted that the company agreed that this individual provided accounting services to several affiliates. This should have been immediately apparent before the case was filed.

It is also fundamentally inconsistent that HNG recognized that Ms. Miller’s accounting and billing services should be allocated but that the same category of service provided by Mr. Provencher is exempt from the same treatment. The record established in this proceeding is that the company takes the position that services may be provided to affiliates at no cost to the affiliate. It is fundamental to ratemaking that the cost of any service provided by HNG to its affiliated must be assigned.

The filing has left the parties and the Examiners to tease out any potential shared service and to develop an alternative rate making methodology. The alternative is at times rejected and at other times embraced by the applicant. It is impossible to identify the myriad of potential shared costs from a filing that is so fundamentally deficient. Accordingly, the Examiners recommend that the company be directed to conduct a management audit of its operations.

The audit is to be conducted by a company approved by the City of Magnolia and Staff of the Railroad Commission. The audit shall include a detailed analysis of the work conducted by employees of HNG and identify any services provided to the Hughes Resources Affiliated Group of Companies by HNG’s employees. The expense of the management audit is to be borne

⁸⁶ HNG Ex. 6, Rebuttal Testimony of Real Provencher, p. 6, ln. 5.

exclusively by HNG and not passed onto customers of the system. The management audit is to be completed within nine months of the date of the Final Order in this proceeding, unless otherwise extended by Staff, but is not to be extended beyond twelve months. Additionally, the management audit shall develop a policies and procedures manual for employees of HNG to track time worked for the various members of the Hughes Resources Affiliated Group of Companies. The management audit shall also develop policies and procedures manual to ensure that all office expenses are properly segregated including, but not limited to, telephone and computer equipment. The results of the management audit are to be filed with Staff within two years of the date of this order, or before the next rate proceeding, and the audit is to be considered at the next rate proceeding.

7. Allocation Methodology and Confidentiality Issues

a. Introduction

As discussed above, the company filed this proceeding on the premise that each of the individual members of the Hughes Resources Affiliated Group of Companies is a stand-alone entity and all expenses are directly assigned to the various affiliates. The Intervenor disagreed that these are stand-alone companies.

As explained below in this proposal for decision, the Intervenor argued that Hughes Resources Affiliated Group of Companies is an interrelated group of companies that cannot function independently. In that context, an issue that had to be addressed was how the costs of services and assets that were not assigned to the individual members of Hughes Resources Affiliated Group of Companies should be allocated. An option was to assert that the company failed to meet its burden of proof as to particular categories of expenses that included expenses for services provided to members of the Hughes Resources Affiliated Group of Companies. Accordingly those categories of expenses should be excluded from the cost of service calculation. Instead, Staff proposed an allocation methodology of certain common expenses. The allocation methodology and the general issues raised by HNG regarding that methodology are addressed here. Additionally, confidentiality issues raised by HNG regarding the underlying data are also addressed in this section.

b. Staff's Proposed Allocation Methodology

The proposed allocation is based upon composite allocation factors derived from the following components for each affiliated group: Percentage of Total Assets/Liabilities, Plant/Investment/Income from Operations, and O&M Expenses. Staff proposed that to the extent a service or facility is shared among only the members of the Hughes Resources Affiliated Group of Companies an allocation should be made among those companies. The four-factor allocation percentage is derived by taking the average of the total assets/liabilities, plant investment, income from operations, and operations and maintenance expense of just those companies to arrive an allocation percentage for HNG to its affiliates.⁸⁷ Figure 7.1 below is taken from a schedule prepared by Staff used to create those allocation factors.

Figure 7.1⁸⁸
Staff Allocations Excluding Decker Properties

Line	Entity	Total Assets/Liabilities (A)	Plant/Investment (B)	Income from Operations (C)	O&M Expenses (D)	Number of Employees					3 Factor (I)	4 Factor (J)
						Indirect (E)	Direct (F)	Indirect % (G)	Direct % (H)	Total (P)		
1	Hughes Gas Resources, Inc.					2.5	0.0	27.78%	0.00%	1	19.25%	14.61%
2												
3												
4	Hughes Natural Gas, Inc.					0.0	9.0	0.00%	48.66%		38.03%	43.10%
5												
6												
7	Alamo Pipeline, LLC					2.5	1.5	27.78%	8.11%	2	17.07%	20.76%
8												
9												
10	Goliad Midstream Energy, LLC					2.0	0.0	22.22%	0.00%	3	4.83%	5.85%
11												
12												
13	Pinehurst Utility Construction, LLC					2.0	0.0	22.22%	43.24%	4	20.83%	15.67%
14												
15	Decker - (Hughes Plus Amerigas)											
16												
17	Total	100.00%	100.00%	100.00%	100.00%	9	19	100.00%	100.00%		100.00%	100.00%
18												
19												

For ease of reference the last two columns of Figure 7.1 are reproduced in Table 7.1 below:

Table 7.1
Hughes Resources Affiliated Group of Companies
3-Factor and 4-Factor Allocations

	3 Factor - Percentage	4 Factor - Percentage
Hughes Gas Resource	19.25	14.61
Hughes Natural Gas	38.03	43.10
Alamo	17.07	20.76
Goliad	4.83	5.85
Pinehurst	20.83	15.67

⁸⁷ Staff Ex. 7, Direct Testimony of Mark Brock p. 49, lns. 8 – 11.

⁸⁸ Staff Ex. 7, Direct Testimony of Mark Brock, RRC Staff Exhibit MB-2.

Staff proposed that the four factor composite allocation percentage be applied to assets and services that are shared by the Hughes Resources Affiliated Group of Companies. This allocation results in a lower adjustment to any disputed expense category than the 3-factor allocation formula.

At times, Staff asserted that services or assets were shared by the sixth affiliate involved in this case, Decker. In that case, Staff argued that a composite allocation factor including the individual components related to Decker should be used allocate costs among all entities that caused the expense. Figure 7.2 below is copy of the composite allocation factor schedule developed by Staff.

Figure 7.2⁸⁹
Staff Allocations Including Decker Properties

Line	Entity	Total Assets/Liabilities (A)	Plant/Investment (B)	Income from Operations (C)	O&M Expenses (D)	Number of Employees					3 Factor (E)	4 Factor (F)
						Indirect (G)	Direct (H)	Indirect % (I)	Direct % (J)	Notes (K)		
1	Hughes Gas Resources, Inc.					2.8	0.0	22.73%	0.00%	1	19.14%	14.53%
2												
3												
4	Hughes Natural Gas, Inc.					0.0	9.0	0.00%	48.66%		37.59%	42.77%
5												
6												
7	Alamo Pipeline, LLC					2.8	1.5	22.73%	8.11%	2	16.89%	20.63%
8												
9												
10	Goliad Midstream Energy, LLC					2.0	0.0	18.18%	0.00%	3	4.58%	5.66%
11												
12	Pinehurst Utility Construction, LLC					2.0	8.0	18.18%	43.24%	4	19.73%	14.85%
13												
14	Decker - (Hughes Plus Amerigas)					2.0	0.0	18.18%	0.00%	5	2.07%	1.55%
15												
16												
17	Total	100.00%	100.00%	100.00%	100.00%	11	19	100.00%	100.00%		100.00%	100.00%
18												

For ease of reference the last two columns of Figure 7.2 are reproduced in Table 7.2 below:

Table 7.2
Hughes Resources Affiliated Group of Companies and Decker Properties
3-Factor and 4-Factor Allocations

	3 Factor - Percentage	4 Factor - Percentage
Hughes Gas Resource	19.14	14.53
Hughes Natural Gas	37.59	42.77
Alamo	16.89	20.63
Goliad	4.58	5.66
Pinehurst	19.73	14.85
Decker	2.07	1.55

⁸⁹ Staff Ex. 7, Direct Testimony of Mark Brock, RRC Staff Ex. MB-2

c. Substantive Issues Raised by HNG Regarding Use of Allocation Factors

Ms. Blumenthal contended that the use of allocation formulas is inappropriate because no member of Hughes Resources Affiliated Group of Companies acts as a service company.⁹⁰ The alternative formulas proposed here, the Distrigas Formula and the Massachusetts Formula, are appropriate to allocate common costs incurred by a service company that provides services to all operating companies in an affiliated group.⁹¹ The formula is used to allocate only those costs that cannot be directly assigned or allocated using a more specific metric.⁹² Ms. Blumenthal opined that when common costs have to be assigned to companies to an affiliated group, the assignment or allocation should be based on sound cost causation bases only after all direct assignments are made. The common costs that cannot be directly assigned should be allocated using a metric or group of metrics that “fit” the cost being allocated. A formulaic approach for assigning costs should only be used when cost causation metrics are not available.⁹³

She alleged that each company pays its own costs and that is a fatal flaw in Mr. Brock’s approach.⁹⁴ Any common costs, such as insurance, are directly assigned. Furthermore, she argued that Mr. Brock failed to recognize the costs already incurred by the affiliate in his allocation of what apparently he considers to be common costs. She argued that by including only HNG expenses, Mr. Brock’s recommendation understates HNG’s actual costs of operations and overstates the costs of operating the other affiliated companies.

Ms. Blumenthal also explained that in her experience, such a formula is used to allocate common costs incurred by a service company that provides services to all operating companies in an affiliated group. The formula is used to allocate only those costs that cannot be directly assigned or allocated using a more specific metric. As an example of a service company, Ms. Blumenthal pointed to Atmos Energy Corporation. Atmos Energy Corporation has a shared services group and its expenses are allocated on the basis of a Cost Allocation Manual. The manual explains that “technical and support services are provided to the operating divisions by

⁹⁰ HNG Ex. 10, Rebuttal Testimony of Ellen Blumenthal, p. 14, ln. 14.

⁹¹ HNG Ex. 10, Rebuttal Testimony of Ellen Blumenthal, p. 14, ln. 20 – p. 15, ln. 1.

⁹² HNG Ex. 10, Rebuttal Testimony of Ellen Blumenthal, p. 16, ln. 1 – 13.

⁹³ HNG Ex. 10, Rebuttal Testimony of Ellen Blumenthal, p. 14, ln. 11 – p. 11, ln. 1.

⁹⁴ HNG Ex. 10, Rebuttal Testimony of Ellen Blumenthal, p. 15, ln. 19 – 20.

centralized shared services departments.” She concluded that when a better metric is not available for allocating shared services costs, Atmos uses a composite factor that is similar to Mr. Brock’s four-part formula.⁹⁵

d. Examiners’ Recommendation On Application of Allocation Formulas

The burden of proof in any ratemaking proceeding is on the applicant. The applicant in this proceeding has not established that each of the entities in the Hughes Resources Affiliated Group of Companies is a stand-alone entity. Furthermore, as discussed below, the Examiners find that employees of HNG provide uncompensated services to members of the Hughes Resources Affiliated Group of Companies. The Examiners concur that, to the extent possible, costs should be directly assigned among affiliates. HNG has asserted for example that the expenses of Mr. Hicks are directly assigned to each affiliate based upon time sheets and the number of hours worked for each entity. HNG, however, has not directly assigned the salaries of other employees who provide services to the affiliates. In that case, disallowance of that employee’s expense would be reasonable because HNG has offered no evidence, such as time-sheets, upon which to base an assignment of costs. An allocation is a reasonable alternative to disallowance.

Furthermore, an allocation methodology must provide reasonable results. Ms. Blumenthal asserted that the allocation of rent, based upon the space occupied by the affiliate at the business address used by all affiliates is reasonable. That allocation methodology results in an allocation of zero costs to two affiliates: HGR and Goliad. Both affiliates, however, use the address for all business related purposes. The Examiners find that it is not credible that HGR and Goliad would have the ability to use any business address for all business purposes, such as filing of documents with the Secretary of State, or referenced in contract documents, for free. Thus, while a direct assignment of costs may appear reasonable for some costs, it may produce unreasonable results that require that the proposed allocation to be reevaluated.

The Examiners find that Staff’s proposed allocation is reasonable and avoids the necessity of disallowing certain categories of expenses because HNG failed to meet its burden of

⁹⁵ HNG Ex. 10, Rebuttal Testimony of Ellen Blumenthal, p. 16, lns. 1 – 13.

proof. The Examiners find further that, in this case, the expenses of the various companies need not be included in Staff's proposed allocation. First, no assertion is made that the affiliates provide uncompensated service to the utility. The compensation paid to the affiliates appears to be made on a regular basis through contracts entered into with each of the affiliates. It is through those contract arrangements that the affiliates recover their direct costs. The issue raised by the Intervenor relates to the uncompensated services provided by HNG to the affiliates. Because HNG has no contract arrangement with them for a vast array of services, the Examiners find that it is necessary to allocate those expenses through either a Distrigas or Massachusetts allocation formula.

e. Confidentiality Issues Raised by HNG Regarding Adjustments and Other Adjustments

HNG has taken the position that the underlying data used to derive the allocation factors is confidential. HNG has removed assertions of confidentiality with the use of the proposed percentage factors identified in the last two columns of Figure 7.1 and 7.2, above. As the company asserted that each affiliate was a stand-alone entity the Examiners did not find it necessary to rule on the question of confidentiality of those figures until the Examiners could evaluate whether the company had met its burden. The Examiners find, however, that the company has failed to establish that the affiliates are stand-alone entities. Thus, it is necessary to address the status of the underlying figures to establish any allocation factor. It is the Examiners recommendation that the Commission rely on these allocation factors to establish any rates and that a finding be made that these figures are not confidential trade secrets.

It has been the well-established practice at the Commission that all figures that make up the allocation of costs included in schedules setting the rates are subject to public disclosure. The underlying premise of that position is that the factors used in setting rates for captive customers should be transparent. Furthermore, the position taken by the company would require that in certain circumstances all discussion regarding a proposed rate adjustment would take place in closed meetings.

In this case, for example, the City of Magnolia proposed an adjustment for expenses related to Pinehurst. The City of Magnolia proposed that the adjustment be based upon the

product of the net income of Pinehurst, a figure considered confidential by the utility, and 80%. Thus, the formula to calculate the proposed adjustment is as follows:

Alleged confidential income figure of affiliate
--

 x 80% = Proposed Adjustment

The utility takes the position that, in this instance, the proposed adjustment could never be revealed publicly. Through simple algebra, revealing that product reveals the alleged confidential number. Thus, any discussion must occur in closed session. The proposed adjustment is to be made directly to the cost service figure calculated. Taken to its logical conclusion the company's position would preclude any public discussion of the impact the proposed adjustment would have on the cost of service. As, once again, a two-step algebraic process would ultimately reveal the alleged confidential income figure of the affiliate. This is a policy question for the Commission. The Examiners do not recommend the adoption of the proposed adjustment in this example and thus have not included the proposed adjustment in the schedules accompanying the *Proposal for Decision*. The Examiners recommend, however, that to the extent the Commission seeks to deliberate on this adjustment that the Commission determine that the information is not subject to confidentiality as a trade secret.

In GUD No. 9670 a dispute arose regarding the confidentiality of formulas contained in schedules filed by the applicant in the case. In a letter ruling, the Examiners set out the issue and the reasons why those figures are subject to disclosure and requested briefing on the issue. The issue was ultimately resolved when the applicant agreed to release the parties from any claims of confidentiality with regards to the schedules and underlying formulas.⁹⁶ In GUD No. 9762, the Examiners schedules, issued with the *Proposal for Decision*, included tables similar to the tables prepared by Staff in this proceeding. Those tables included the same type of information included in Staff's exhibit for the various regulated and unregulated affiliates of the applicant.⁹⁷ The Examiners recommend that the Commission find that the underlying data included in Staff Exhibit MB-2 is not confidential.

⁹⁶ A copy of the letter is attached as Appendix C to this Proposal for Decision.

⁹⁷ A copy of those schedules is attached to this Proposal for Decision as Appendix D. The schedule entitled, "Calculation of SSU Allocation Rate 7" includes specific data regarding what appears to be an unregulated marketing affiliate.

8. Expenses

a. Salaries

(1) Introduction

The company's filing includes a salary request for nine full-time employees and two part-time employees. The total initial salary request of the company was \$511,397.⁹⁸ The company recognized that an adjustment should be made to the salary of the accounts payable and human resources employee, Barbara Miller. This adjustment was necessitated by the company's recognition, after the initial filing was made, that Ms. Miller performed services for various affiliates. Ms. Miller's salary was reduced by \$17,005.⁹⁹ The total salary request to be included in the cost of service is \$494,392.

Part of the company's request was an adjustment to include increases in salaries for all personnel. As a percentage of salary, the increases varied in amounts from 3% to 100%. The company requested a 12% increase to the President's salary and a 100% increase to the salary paid to the Vice President, who was classified as a part time employee.¹⁰⁰ The test-year amount paid to the Vice President was \$24,000. The company included a \$24,000 adjustment into the cost of service calculation to increase that salary to \$48,000. The proposed percentage increases to be included are set out in Table 8.1 below:

Table 8.1
Percentage Increase Proposed to be Included In the Cost of Service

Employee Position	Percentage Increase
Real Provencher, President	12%
Frank Hicks, Vice President	100%
Staff Accountant	8%
Customer Service Representative	4%
Accounts Payable & Human Resources	5%
Tech 1	3%
Tech 2	6%
Tech 3	6%
Tech 4 - New Employee	N/A

⁹⁸ HNG Ex. 5, Direct Testimony of Charles E. Loy, p. 38, Schedule C-2.

⁹⁹ There appears to be a minor inconsistency in the testimony filed by HNG regarding the impact of the salary adjustment. Mr. Loy identified the amount of the reduction as \$17,005. HNG Ex. 11, p. 31. Ms. Blumenthal identified that amount as \$16,500. HNG Ex. 10, Rebuttal Testimony of Barbara Blumenthal, p. 20, Ins. 5 – 11. Based upon the Examiners Schedules attached to this Proposal for Decision it would appear that the change results in a reduction of \$17,005.

¹⁰⁰ See, HNG Ex. 2, Direct Testimony of Morey J. Villareal, Attachment 2, p. 25.

Morey J. Villareal, a specialist in the area of compensation, testified in support of HNG's salary request. He propounded three key conclusions. First, the company's base salary levels are 22.3% below the median salaries paid to the incumbents of comparable jobs in similar organizations in the Houston area. Second, the total cash compensation levels of the company are 28.9% below the median total cash compensation level paid to incumbents of comparable jobs in similar companies in the Houston market. Third, the benefits provided to employees and executives of HNG are not excessive or out of line with competitive market practice.¹⁰¹ Overall, Mr. Villareal asserted that if he were consulting with the company on the management of their compensation program, he would recommend that the company establish higher base salary levels and higher total cash compensation levels. By not paying more competitively, he concluded, the company ran the risk of losing employees to higher-paying competitors in the Houston market place.¹⁰²

(2) Issues Raised by Staff

Staff made two recommendations with regards to salaries. First, Staff recommended that the Commission reject certain salary increases. Second, Staff recommended that certain salaries be allocated among the various affiliates.

Staff recommended that only three adjustments to the test-year level of salaries based upon proposed salary increase be allowed. An adjustment should be allowed to reflect an increase in the number of hours that the part-time Vice President will work on behalf of HNG in the future.¹⁰³ Staff also recommended that an adjustment should be made to allow HNG to hire a fourth field technician.¹⁰⁴ Third, Staff recommended that an increase in salary to the Staff Accountant be permitted. The company proposed an increase of 8% for that position. Staff recommended that the increase be limited to only 3%.¹⁰⁵ All other proposed increases should be rejected.

¹⁰¹ HNG Ex. 2, Direct Testimony of Morey J. Villareal, p. 3, lns. 30 – 41.

¹⁰² HNG Ex. 2, Direct Testimony of Morey J. Villareal, p. 7, lns. 135 – 136.

¹⁰³ Staff Initial Brief, p. 9 & Staff Ex. 7, Direct Testimony of Mark Brock, p. 56, lns. 17 – 22.

¹⁰⁴ Staff Initial Brief, p. 9.

¹⁰⁵ Staff Initial Brief, p. 9 & Staff Ex. 7, Direct Testimony of Mark Brock, p. 56, lns. 1 - 2

Staff reasoned that the increases had not occurred as of the date that Staff's testimony was filed. Staff also objected to the fact that increases were not based on any factors related to customer satisfaction or system safety.¹⁰⁶ Staff asserted that no evidence was submitted affirming that the increases had, in fact, occurred. As to the proposed increase for Mr. Provencher, Staff argued that Mr. Provencher, as a co-owner in HNG, is already "double dipping." Furthermore, as a shareholder of Hughes Gas Resources, Alamo, Goliad, and Pinehurst, he benefits from the combined profits of the affiliated group.¹⁰⁷ Staff did not object to the increase of salary for the Vice President as that increase was based upon an alleged increase in the number of hours to be provided by that employee.¹⁰⁸

Second, Staff initially recommended that the salaries of all employees be allocated using one of the allocation methodologies proposed. At the hearing and in the initial brief Staff amended its recommendation. Staff recommended that the salaries of the following positions be allocated among the various entities:

- President
- Vice President
- Staff Accountant
- Customer Service Rep.
- Accounts Payable and Human Resources
- Digital Mapping (Part-time)
- Meter Painting (Part-time)

Mr. Brock argued that documents provided in discovery indicated that certain affiliates have no employees. Furthermore, Mr. Hicks and Mr. Provencher are co-owners of all affiliated company and that, as co-owners, they should have the salary identified in the cost of service calculation for HNG allocated to the affiliates.¹⁰⁹ Alamo has a part-time Vice President and one senior field employee. Staff argued that HNG does not maintain accurate records or time cards, decisions among the members of the Hughes Resources Affiliated Group of Companies are discussed informally and verbally with no written record. Furthermore, two of the affiliates

¹⁰⁶ Staff Ex. 7, Direct Testimony of Mark Brock, p. 55, lns. 1 – 12.

¹⁰⁷ Staff Ex. 7, Direct Testimony of Mark Brock, p. 56, lns. 6 – 15.

¹⁰⁸ Staff Ex. 7, Direct Testimony of Mark Brock, p. 56, lns. 17 – 22

¹⁰⁹ Staff Ex. 7, Direct Testimony of Mark Brock, p. 57, lns. 11 20.

(Goliad and Hughes Gas Resources) have claimed that they have no employees. Staff contended that it is this loose, informal structure of HNG, the parent and the affiliates that points to the uncertainty of who does what at which affiliate and requires allocation.¹¹⁰

(3) HNG's Response

In the rebuttal schedules filed by Mr. Loy, he indicated the date that several of the salary increases were scheduled to go into effect.¹¹¹ The proposed effective date for the salary increases of the President and Vice President was July 1, 2011; the proposed effective date for the salary increases to the Tech 2 and Tech 3 position were scheduled for September 1, 2011; the proposed effective date for the salary increase for the Tech 1 position was November 1, 2011. Finally, the proposed effective date for the proposed increase for the accounts payable and human resources position and the customer service representative was set at December 1, 2011. In briefing, HNG asserted that the Tech 2 and Tech 3 salary increases have already gone into effect and that the increases for the Tech 1 position, the customer service representative, and the accounts payable/human resources position increase were budgeted and would automatically go into effect November 1, 2011.¹¹²

Mr. Villareal argued that a reduction in the proposed salary levels would place the employees below the market median salary levels. This was particularly true of the adjustments proposed by Staff with regard to the salary of Mr. Provencher. As to the allegations of "double dipping," Mr. Villareal argued that Mr. Brock failed to distinguish between compensation for performing work as an executive and dividends to owners as a return on their investment for the risks taken in making an investment. Mr. Provencher's compensation should not be influenced by his ownership or the dividends he may receive from the company.¹¹³ As to the senior accountant, he argued that the senior accountant is paid 15% below the market in annual base salary. Mr. Villareal contended that Mr. Brock provided no data or analysis on which to base the

¹¹⁰ Staff's Initial Brief, p. 9

¹¹¹ HNG Ex. 11, Rebuttal Testimony of Charles E. Loy, p. 16 (Schedule C-2)

¹¹² HNG Reply Brief, pp. 19 – 20. As to the customer service representative and the accounts payable and human resources position, the Reply Brief contradicts the assertion made in the record that those are scheduled to go into effect on December 1, 2011. See, HNG Ex. 11, Rebuttal Testimony of Charles E. Loy, p. 16 (Schedule C-2).

¹¹³ HNG Ex. 7, Rebuttal Testimony of Morey Villareal, p. 6, Ins. 1 – 18.

3% cap on salary increases to the Senior Accountant. He asserted that capping that increase at 3% limits the salary for this position to the average of projected increase market pay levels in 2011 and keeps the company from moving the salary to a more competitive level in the Houston market.¹¹⁴

As to the issue of allocation of employee expenses, Ms. Blumenthal responded by arguing that the allocation of costs was inappropriate when a company does not act as a service company. She asserted that no company in the Hughes Resources Affiliated Group of Companies acts as a service company. Ms. Blumenthal contended that each of the companies in the affiliated group already pays its own salaries and that Mr. Brock failed to recognize the costs already incurred by the affiliates in his allocation.¹¹⁵ She argued that Staff's proposed allocation transfers nearly 57% of HNG's salary costs to its affiliates and suggested that Mr. Brock should transfer some of the salary costs of the affiliates back to HNG.¹¹⁶

Mr Provencher argued that with the exception of three employees all HNG employees work exclusively for HNG. The three exceptions are Mr. Provencher, Mr. Hicks and Ms. Miller. Ms. Miller performs bookkeeping, accounts payable and human resources duties for Alamo and Pinehurst. Mr. Hicks serves as Vice President of Alamo and President of Pinehurst. He receives a salary from Alamo and Pinehurst. Mr. Provencher serves as President of Goliad and President of Alamo, prepares two invoices a month for them, but receives no salary from them.¹¹⁷ He also serves as Vice President of Pinehurst but receives no salary because he has no day-to-day business responsibilities in the company.¹¹⁸

The company appeared to argue that allocation of salary expenses to entities that do not require a large amount of services is unreasonable. Ms. Blumenthal asserted that Hughes Gas Resources has no employees and stated that Mr. Provencher and Mr. Hicks do not spend any appreciable time on any HGR business. As to Goliad, she asserted that Goliad has no employees because it does not need employees and Mr. Provencher and Mr. Hicks spend a minimal amount

¹¹⁴ HNG Ex. 7, Rebuttal Testimony of Morey Villareal, p. 9, Ins. 1 – 21.

¹¹⁵ HNG Ex. 10, Rebuttal Testimony of Ellen Blumenthal, p. 17, Ins. 5 – 22.

¹¹⁶ HNG Ex. 10, Rebuttal Testimony of Ellen Blumenthal, p. 19, Ins. 7 – 9.

¹¹⁷ HNG Ex. 6, Rebuttal Testimony of Real Provencher, p. 5, Ins. 1 – 13 & p. 5 – 6.

¹¹⁸ HNG Ex. 6, Rebuttal Testimony of Real Provencher, p. 5, Ins. 17 – 19.

of time on Goliad business. Finally, she contended that, except for Ms. Miller, none of the HNG employees conduct business for Alamo and Pinehurst because those entities have their own employees.¹¹⁹

(4) Examiners' Findings and Recommendations

The Examiners find that the applicant has not met its burden with regards to the salary levels included in the cost of service. As an initial point, *any* service provided by an employee of a regulated utility to an affiliate should be compensated by that affiliate. To the extent possible the compensation should be directly assigned. In the event direct assignment is not feasible then a reasonable allocation methodology should be applied to allocate that expense. The proposition, made throughout this proceeding, by the company that minimal services need not be compensated is erroneous.¹²⁰ An un-compensated service is a subsidy. The company's own expert witness explained that it would be unreasonable for services performed by the President of a company to be uncompensated.¹²¹

Any subsidy provided by HNG to an affiliate that, in turn, provides services to HNG is necessarily part of the cost of that service. For example, Alamo provides transportation services to HNG. The transportation rate is \$3.19 per MMBtu. If the President of HNG provides services to Alamo the uncompensated service is part of the company's transportation cost. Unless the costs of uncompensated services are accounted for through a direct assignment or allocation the affiliate standard set out in 104.055(b)(2) cannot be satisfied. Furthermore, the uncompensated service is a restriction on competition. By providing the uncompensated service to Alamo, HNG has engaged in a practice that tends to restrict or impair competition. Third party transporters do not have the benefit of executive services that are paid for by captive customers. The cost of the third party transporter necessarily incorporates the cost of its executive services. An expense that

¹¹⁹ HNG Ex. 10, Rebuttal Testimony of Barbara Miller, p. 21, ln. 11 – p. 22, ln. 7.

¹²⁰ HNG Reply Brief, p. 20. ("Mr. Provencher also explained that he (Provencher) does not track his time because he spends so little time on non-HNG matters.").

¹²¹ Tr. Vol. 1, pp. 145 – 146. Q: Would it be reasonable for this Commission to set the salaries of the officers of Hughes Natural Gas at zero? A: No . . . because they are performing jobs that have worth. *See also*, Tr. Vol. 1, pp. 163 – 164. Mr. Villareal: If, for example, in this case the president were paid zero by HNG . . . Would that be a subsidy . . . Sure, I mean, he's performing a job, the president job for HNG. And that has real value as measured by the market place numbers I reported.

Goliad and Alamo are able to avoid by virtue of the fact that they are members of the Hughes Resources Affiliated Group of Companies.

In this case the record is replete with key services provided by Mr. Provencher, the President of HNG, that have never been compensated by the affiliates. Furthermore, the service provided appears to be more than an occasional document or phone call. The Examiners find that without the services provided by Mr. Provencher, Alamo and Goliad would cease to function. Mr. Provencher serves as President of Alamo and Goliad. Alamo and Goliad do not compensate him for his services. He serves as Vice President of Hughes Gas Resources and Pinehurst. Hughes Gas Resources and Pinehurst do not compensate him for his services. HNG made no effort to recover the costs from its affiliates for the services provided by its President and steadfastly maintains that it is not required to do so.

On behalf of Alamo, the President of HNG, Mr. Provencher, worked with Staff of the Railroad Commission to establish Alamo's initial rates in 2010.¹²² Thus, without the services provided by the President of HNG, Alamo would not have established initial rates. The email exchange regarding the proposed tariff spanned from May of 2010 to November of 2010. Not all emails are summarized here but they include the following dates and times:¹²³

May 21, 2010, Friday, from Mr. Provencher to Teresita Galvan, RRC at 3:26 p.m.
May 24, 2010, Monday, from Mr. Provencher to Teresita Galvan, RRC at 12:25 p.m.
May 27, 2010, Thursday, from Mr. Provencher to Ms. Galvan, RRC at 3:45 p.m.
June 1, 2010, Tuesday, from Mr. Provencher to Ms. Galvan, RRC at 9:37 a.m.
June 18, 2010, Friday, from Mr. Provencher to Ms. Galvan, RRC at 2:01 p.m.
June 22, 2010, Tuesday, from Mr. Provencher to Ms. Galvan, RRC at 10:33 a.m.
July 1, 2010, Thursday, from Mr. Provencher to Ms. Galvan, RRC at 10:43 a.m.
July 27, 2010, Tuesday, from Mr. Provencher to Frank Tomicek, RRC at 4:57 p.m.
August 9, 2010, Monday, from Mr. Provencher to Mr. Tomicek, RRC at 2:16 p.m.
November 10, 2010, Wednesday, from Mr. Provencher to Ms. Galvan, RRC at 4:35 p.m.

¹²² HNG Ex. 6, Rebuttal Testimony of Real Provencher, pp. 73 – 119.

¹²³ This list only includes the date of emails sent by Mr. Provencher. The date and times of emails sent to Mr. Provencher from the Commission have not been included in this list but the emails are in evidence.

These emails were sent during the test year and evidence a substantial involvement by the President of HNG in the day-to-day business activities of Alamo. They all appear to occur during normal business hours. The email address for some of these emails trace back to the email account of HNG: realp@hughesnaturalgas.com. Additionally, Mr. Provencher indicated that three conference calls took place on September 2nd (Thursday), 14th (Tuesday), and the 29th (Wednesday) of 2010.¹²⁴ The conference calls were with personnel of the Market Oversight Section and all occurred during normal business hours.

The President of HNG, Mr. Provencher, submitted the initial study, prepared by GDS Associates, in support of that tariff. He indicated in an email exchange that he was “willing to meet with you and others to answer any question you may have after going through this material.”¹²⁵ This evidences his familiarity with that document and that Mr. Provencher spent substantial time reviewing the document. That study was prepared February 2010 and updated on April 15, 2010, within the test-year period of this case. Furthermore, he indicated that finalizing the tariff was necessary so that Alamo “can timely file our annual report for 2010.”¹²⁶ The Distribution Annual Report on file at the Commission is signed by Mr. Provencher accompanied with the declaration that it “was prepared by me or under my supervision, and that the data and facts stated therein are true, correct, and complete to the best of my knowledge.”

Furthermore, Mr. Provencher is a signatory on the Gas Services Agreement entered into between HNG and Goliad and XTX Pipeline and Goliad. In each of those contracts, Alamo participated for the purpose of indicating its agreement with the terms of the contract. Mr. Provencher also conceded that he is responsible for preparation of monthly invoices for Alamo.¹²⁷ Preparation of invoices is an essential function of the operation of Alamo. The President of HNG participated in those negotiations not only on behalf of Alamo, but also on behalf of Goliad.

¹²⁴ HNG Ex. 6, Rebuttal Testimony of Real Provencher, p. 31.

¹²⁵ Id, p. 75.

¹²⁶ HNG Ex. 6, Rebuttal Testimony of Real Provencher, p. 54.

¹²⁷ HNG Ex. 6, Rebuttal Testimony of Real Provencher, p. 6, Ins. 12 – 13.

Mr. Provencher signed on behalf of Goliad as the supplier to Goliad's contract with XTX Pipeline and HNG. As President of Goliad, Mr. Provencher is the designated individual to be notified of "readiness to commence deliveries or suspension or resumption of deliveries." As signatory he presumably participated in the negotiations of those contracts. Mr. Provencher concedes that he is responsible for producing two Goliad invoices each month.¹²⁸ Preparation of invoices is an essential function of the operation of Goliad.

The Examiners find that having failed to allocate any of Mr. Provencher's expenses to the affiliates the company has failed to meet the burden of proof with regards to salary calculation included for Mr. Provencher in the cost of service calculation. It would be reasonable on that basis alone to exclude the entire \$120,000 salary request for Mr. Provencher. Furthermore, because of the company's refusal to recognize the necessity of recovering from its affiliates compensation for the services provided by its President, the Examiners find that the company has failed to meet its burden with regards to all salary expenses. In short, HNG's failure to recognize the necessity of allocating the expenses of the President of HNG who conducts substantial business activities for members of the Hughes Resources Affiliated Group of Companies, suggests that the entire salary request is unreliable. Staff, however, has offered an alternative that would allow the inclusion of a certain level of salary expense for Mr. Provencher, and for all employees.

In briefing, the company asserted that allocation of salary expenses would result in compensation levels far below industry averages. This misstates the effect of the allocation. Allocation of salaries, either directly or indirectly, is recognition that the *total* salary should be compensated by contributions of the various affiliates that receive the services provided by the employee. The company's own treatment of the salary calculation of Frank Hicks and Barbara Miller are examples of this point.

The company included in the cost of service a salary expense level of \$48,000 for Mr. Hicks, the Vice President of HNG.¹²⁹ The test-year salary was \$24,000 and the company

¹²⁸ HNG Ex. 6, Rebuttal Testimony of Real Provencher, p. 6, lns 4 – 6.

¹²⁹ HNG Ex. 13, Schedule C-3.

proposed to increase this amount to \$48,000.¹³⁰ This request was based, in part, on the fact that Mr. Hicks worked only part-time. Mr. Hicks also received a salary from his work with various affiliates.¹³¹ It was not suggested that the total compensation of Mr. Hicks for work performed to all affiliates is limited to the amount included in the cost of service calculation for HNG.

Likewise, the company proposed a similar adjustment to Ms. Miller's salary. The original *Statement of Intent* included a salary request for Ms. Miller in the amount of \$41,166. The company recognized, after the case was filed, that Ms. Miller performed tasks for the other affiliates and has allocated \$14,408 in salary expenses to the other affiliates.¹³² It is presumed that Ms. Miller's compensation, as proposed by the company, would not change. Ms. Miller would still receive \$41,166.

In short, the suggestion made by the company that allocation of salaries would result in reduced compensation for employees is not credible. Further, it is contradicted by the company's own treatment of the salaries provided to Mr. Hicks and Ms. Miller. The allocation simply reflects the fact that the HNG employees provide services to affiliates and that those affiliates should pay for those services. Of course, the affiliate may decline to pay for those services. In that event, however, HNG should not be allowed to recover the expenses from captive customers.

The Examiners do not recommend that an adjustment be made to all salaries. The company established that Mr. Hicks tracks his time and his salary compensation is based on that level of service. The cost of service study reflects this fact and no further adjustment should be made. It is also reasonable to assume that except for Alamo none of the other members of the Hughes Resources Affiliated Group of Companies has meters that require painting. Alamo only has three meters and the company presented testimony that these meters are not painted by HNG personnel. Likewise, evidence was presented that except for Alamo none of the other affiliates

¹³⁰ HNG Ex. 2, Direct Testimony of Morey J. Villareal, Attachment 2, p. 25

¹³¹ As presented by HNG the record on the salary received from the other affiliates is contradictory. At times the company states that certain affiliates have no employees yet it is asserted that Mr. Hicks receives a salary from all entities.

¹³² The total allocation is in the amount of \$17,005. This figure reflects the effect on payroll fees, benefits, and medical expenses of allocating a \$14,408 to the other affiliates.

require digital mapping. Further, testimony was offered that HNG never provided digital mapping or meter painting services to Alamo.

The Examiners recommend, however, that the following salaries be allocated: President, Staff Accountant, Customer Service Representative, and Accounts Payable and Human Resources. The evidence in the record established that the President of HNG provided extensive services to its affiliates. Additionally, HNG provides extensive information to the customer regarding Pinehurst. As discussed below, the HNG website provides detailed information related to the services provided by Pinehurst to customers of HNG. It is simply not credible that the customer service representative of HNG does not provide information related to Pinehurst services. Further, the company has no system in place for tracking time spent by employees working on behalf of its affiliates. In fact, as evidenced by the position asserted in this proceeding, the company policy is that a certain level of service can be provided to those affiliates without compensation to HNG. Thus, the Intervenors have established that an adjustment is necessary.

The Examiners recommend that the allocation of Ms. Miller be based upon the allocation percentage developed by Staff and not a haphazard estimate made during discovery. The allocation described for Ms. Miller is not based upon any recordkeeping regarding her time. The description of Ms. Miller's allocation follows:

An adjustment to payroll expense was made when the Rate Study was updated and the schedules reissued. The adjustment is made to reflect the time an employee, Barabara Miller, spent on payroll and bookkeeping tasks associated with PUC, Alamo, GME [Goliad], and HGR [Hughes Gas Resources]. Ms. Miller's compensation was reduced by 35% to properly reflect her actual allocation of time. Ms. Miller indicates she spends 25% of her time dealing with HNG customer calls and 40% of her time handling payroll and bookkeeping tasks for HNG. Of the remaining 35%, Ms. Miller believes she spends 25% on payroll and bookkeeping tasks for PUC, 5% on payroll and bookkeeping tasks for Alamo and 5% of her time on miscellaneous bookkeeping tasks for HGR and GME.¹³³

¹³³ HNG Ex. 10, Rebuttal Testimony of Ellen Blumenthal, p. 44.

The Examiners find that this description is based upon an estimate made by the employee not on any actual timekeeping records. The allocation proposed by Staff is based upon an objective verifiable standard and should be applied in the case of Ms. Miller.

As to salary increases, except in the case of the Vice President, the Examiners find that the company has established that the proposed salary increases are reasonable. Staff concurred that a salary increase was appropriate for the HNG's Staff Accountant but did not explain why the increase should be capped at 3%. Based on the evidence in the record provided by Mr. Villareal, the company's requested salary increase adjustment is just and reasonable. Except for the allocations related to the Vice President, allocations of salary should be made based upon the adjusted salary.

As to the Vice President, HNG asserts that the salary increase is due to the increased number of hours Mr. Hicks must work on behalf of HNG. Mr. Loy testified that at the beginning of the test year, this individual averaged thirty-five hours per month. At the end of the test year, this employee's average hours increased to more than seventy hours per month. The increase shown reflects the increased working hours. No explanation is provided regarding what has necessitated the doubling of Mr. Hicks time billed to HNG. HNG has not established that the increased labor requirement is not due to the fact that Mr. Provencher, Ms. Miller and other employees of the company, are providing additional services to the growing number of affiliates in the Hughes Resources Affiliated Group of Companies. Accordingly, the Examiners recommend that this proposed increase be disallowed.

b. Vehicles

(1) Introduction

Vehicles are part of the total compensation package provided to the President and the Vice President of HNG.¹³⁴ As set out in the testimony of Mr. Villareal, in addition to the salary provided to the President and Vice President, each individual is provided a 2008 Ford Explorer.

¹³⁴ HNG Ex. 2, Direct Testimony of Morey J. Villareal, Attachment 5, p. 34

This testimony is not exactly consistent with the testimony of Mr. Provencher or responses to Requests for Information. Mr. Provencher testified that the vehicle provided to the President is an Explorer and the vehicle provided to the Vice President is an Expedition.¹³⁵ This is consistent with the information provided in discovery.¹³⁶

Mr. Provencher also testified as to the expenses associated with those vehicles. He asserted that the total cost of the vehicles for the President is \$10,000 and the total cost for the Vice President is \$11,000. Documents provided in response to a request for information indicated that the test year expense for the vehicle provided to the President was \$11,872 and the expense for the vehicle provided to the Vice President was \$14,476.¹³⁷ These figures apparently include expenses for fuel, maintenance, and lease.¹³⁸ Mr. Provencher also testified that the expenses for those vehicles were booked to operations and maintenance expense in a subaccount on vehicles and included in the operations and maintenance expense request in this proceeding.¹³⁹

(2) Issues Raised by Staff

Mr. Brock argued that an adjustment should be made to allocate the expenses of the vehicles among the various members of the Hughes Resources Affiliated Group of Companies. Staff opined that Mr. Provencher and Mr. Hicks use those vehicles in the performance of their duties for all members of the affiliated group.¹⁴⁰ In the case of Mr. Hicks this would include Decker. Mr. Brock's adjustment, however, was limited to an allocation of the fuel expenses.

Based upon data provided by the company, Mr. Brock reasoned that the gasoline expense for each vehicle was 2,898 gallons. As Mr. Provencher was an officer of all members of the Hughes Resources Affiliated Group of Companies, he argued that the 2,898 gallons should be allocated among all members of the affiliated group of companies. Thus, the cost of service

¹³⁵ Tr. Vol. 2, p. 94, ln. 23 – p. 95, ln. 3 & City of Magnolia Ex. 24.

¹³⁶ Examiners' Ex. 1, Response to Request for Information No. 4-32.

¹³⁷ *Id.*

¹³⁸ Tr. Vol. 2, p. 94, ln. 21 – p. 12.

¹³⁹ Tr. Vol. 2, p. 94, lns. 1 – 14.

¹⁴⁰ Staff Ex. 7, Direct Testimony of Mark Brock, p. 48, ln. 18 – p. 49, ln. 4.

calculation for HNG should only include the expense associated with 1,249 gallons of total fuel consumption for his vehicle. As Mr. Hicks worked for all members of Hughes Resources Affiliated Group of Companies and Decker, the allocation formula should reflect the composite factors of Decker. Accordingly, only the expense of 1,239 gallons in fuel should be included in the cost of service calculation.¹⁴¹

(3) HNG's Response

In briefing, after the hearing, HNG conceded that the expenses related to Mr. Hick's vehicle should be allocated: "HNG will also accept Staff's proposed allocation of 43.10% of the cost of Mr. Hick's vehicle to HNG, since Mr. Hicks does work for (and is paid a separate salary by) other affiliates."¹⁴² Based upon the adjustment proposed by Staff, the adjustment would only address the fuel expense component of Mr. Hicks vehicle. HNG does not agree that the allocation of Mr. Provencher's vehicle expense because, as alleged by HNG, he does no work for other affiliates that requires a vehicle.¹⁴³

(4) Examiners' Findings and Recommendations

The Examiners find that the allocation of the vehicle expense for the Vice President, Mr. Hicks, is just and reasonable. The Examiners find troubling that while HNG found it necessary to require detailed time-keeping by the Vice President of HNG, it did not impose a similar requirement for tracking expenses of the Vice President's vehicle. Indeed, it did not concede the need to allocate the expense until after the hearing on the merits. The Examiners note that the company found Staff's proposed application of an allocation formula a reasonable proxy to direct expense allocation in this instance.

HNG's tardy concession is evidence of HNG's apparent lack of understanding of the necessity to properly allocate expenses among the Hughes Resources Affiliated Group of Companies. The company did not previously concede the necessity of allocating the vehicle

¹⁴¹ Staff Ex. 7, Direct Testimony of Mark Brock, RRC Staff MB Exhibit CEL-1, Schedule C-1 Staff, p. 15 of 47.

¹⁴² HNG Reply Brief, p. 16.

¹⁴³ *Id.*

expense until the President of HNG admitted at hearing that the Vice President of HNG is in the field either for Pinehurst or Alamo and there is a definite possibility the he is driving “his vehicle to get there.”¹⁴⁴ The statement made at the hearing is also an example of HNG’s fundamental misunderstanding of utility assets. The vehicles, which are part of the total compensation package offered to the executives of HNG, are a utility asset that are paid for by the captive customers of the system through the rates charged to those customers.

In the case of a shared asset such as a vehicle, an allocation formula similar to the Distrigas formula or the Massachusetts formula is just and reasonable. The vehicle is used by the officers to drive to and from the office building at 31830 State Highway, 249, Pinehurst, TX 77362 – 3804. Work is conducted by the President of HNG and the Vice President of HNG for all members of the Hughes Resources Affiliated Group of Companies at that address. A point conceded by Mr. Provencher.¹⁴⁵ Thus, it is reasonable not only to allocate the vehicle expense of Mr. Hicks but the Examiners find that allocation of the vehicle expense associated with Mr. Provencher is also necessary.

The Examiners find that the adjustment proposed by Staff, however, does not capture all expenses associated with the vehicles. The adjustment only captures the fuel expense. In the case of the vehicle operated by the President, the evidence in the record is that \$11,872 is included in the cost of service. That amount includes fuel, maintenance and lease expenses. It is reasonable to include only \$5,116.83 in the cost of service calculation for HNG. Similarly, the expenses of the vehicle operated by the Vice President are \$14,476. The Vice President provides services to Hughes Resources Affiliated Group of Companies and Decker. Accordingly, based upon the allocation factor for fuel expense of 42.77% developed by Staff that HNG conceded is reasonable, the Examiners recommend that only \$6,191.38 be included in the cost of service calculation for HNG. Thus, the total vehicle expense that should be included in the cost of service calculation is \$11,308.21. The evidence in the record is that the vehicle expense included in the cost of service calculation is \$26,348. Accordingly, the Examiners recommend that \$15,039.79 be removed from the cost of service calculation.

¹⁴⁴ Tr. Vol. II, p. 60, Ins. 18 – 23 (Emphasis added).

¹⁴⁵ Examiners Ex. 1, Response to RFI 4-16 & 4-18.

c. Rent, Telephones, and other Utilities Included in Rent

(1) Introduction

Decker collects rent for the property located at 31830 State Highway 249, Pinehurst, TX 77362. The rental expense is calculated is based on the square footage of four entities that occupy the physical space: HNG, Pinehurst, Alamo and a third party. The total annual rental expense collected from those members of the Hughes Resources Affiliated Group of Companies is \$62,688. The rental expense collected from HNG is \$42,072 and that amount has been included in the cost of service calculation. The space occupied by Mr. Provencher, Mr. Hicks, and Ms. Miller are allocated only to HNG. Thus, Pinehurst and Alamo are not assigned any expenses for the offices occupied by Mr. Provencher, Mr. Hicks, and Ms. Miller. Goliad and Hughes Gas Resources are assigned no expenses.

The phone system installed in the office is shared among Hughes Resources Affiliated Group of Companies. It was purchased in mid-2007 at a total cost of \$13,891 of which Hughes Propane, a former affiliate of HNG, paid \$7,796 and HNG paid \$6,095. The allocation was based on the number of handsets assigned to each company. There are 16 handsets in the office of which nine were originally assigned to Hughes Propane and seven assigned to HNG. Hughes Propane donated its ownership in the phone system to Decker when Hughes Propane was sold to Amerigas.¹⁴⁶ The nine handsets donated to Decker are available for general use at no cost to the members of Hughes Resources Affiliated Group of Companies.

Computer equipment was originally purchased by Hughes Propane. HNG purchased its first server to supplement the Hughes Propane server in mid-2007 to run its billing software. All of the affiliates have utilized and continue to use the original server owned by Hughes Propane for file storage and data retrieval. Hughes Propane donated that server to Decker Prairie Properties when it was sold to Amerigas Propane. In 2007, Hughes Propane donated an old computer to Pinehurst that was being replaced.

¹⁴⁶ HGN Ex. 6, Rebuttal Testimony of Real Provencher, p. 24.

(2) Staff's Position

In prefiled testimony, Mr. Brock recommended that the \$42,000 lease payment be allocated among the affiliates. He contended that this was fair because all of the affiliates list the address of 31830 SH 249 in Pinehurst, Texas as their address. At the hearing and in briefing it appears that Staff has abandoned its requested adjustment.

(3) HNG's Response

Ms. Blumenthal asserted that even though there is no written lease agreement between Decker and each of the affiliated tenants at 31830 SH 246, the amount paid by each affiliate has been provided. She indicated that all entities at that address pay the same rate per square foot for the office space, storage facilities, parking, and warehouse space. She argued that allocation of a portion of HNG's rent to each affiliate will result in HNG and its affiliates violating the requirements of Section 104.055(b) because HNG would pay less per square foot for its office space than each of the other affiliates.¹⁴⁷

(4) Examiners' Findings and Recommendations

The Examiners find that HNG has failed to meet its burden regarding the allocation of rental expenses. As noted above, the total amount in rental expenses paid by Hughes Resources Affiliated Group of Companies is \$62,688. HNG's share is based on the physical space occupied at that address. No allocation is made for the space occupied by Mr. Provencher or Mr. Hicks despite the fact that they conduct activities for all affiliates at that address. Furthermore, HNG alleges that no cost should be allocated to HGR and Goliad despite the fact that business is conducted on behalf of those entities at that address. Furthermore, all official business correspondence related to those entities is to be submitted at that address. For example, the Gas Supply Agreement of April 29, 2010 listed that address for Goliad for all official notices and correspondence. The franchise agreement on file with the Texas Secretary of State for HGR

¹⁴⁷ HNG Ex. 10, Rebuttal Testimony of Ellen Blumenthal, p. 13, ln. 13 – p. 14, ln. 10.

identified 31830 State Highway 249, Pinehurst, Texas, as the business address for HGR. No costs, however, are allocated to those affiliates.

The unreasonableness of the proposed allocation methodology is compounded by the fact that all entities are provided access to the telephone system at that address. Thus, Hughes Gas Resources and Goliad, who pay no rent, are also provided telephone services at no charge. Similarly, certain computer equipment is made available to all entities by virtue of the access to the same property address. Again, Hughes Gas Resources and Goliad, who pay no rent, have access to computer equipment. HNG asserts that these added functions are provided free of charge to all affiliates. The fact established in this record is that HNG does not dispute that all official business documentation filed with the Secretary of State for Hughes Gas Resources and Goliad reference the building address that is the office of HNG. Despite that fact, HNG asserts that this essential asset for any business – a business address – should remain uncompensated.

A more reasonable allocation is achieved by applying the allocation factors developed by Staff to the entire rental expense of the Hughes Resources Affiliated Group of Companies. The entire rental expense is \$62,688. Application of the four-factor allocation formula developed for the Hughes Resources Affiliated Group of Companies results in an allocation of \$27,018.53 in rental expense to HNG instead of \$42,072. Thus, the Examiners recommend that the rental expense included in the cost of service analysis be reduced by \$15,053.47. Finally, the Examiners recommend the Commission order that a lease agreement between each member of the Hughes Resources Affiliated Group of Companies be executed in writing.

d. Office Supply Expense

(1) Introduction

The company included \$57,890 in office supply expense. Staff proposed that this expense be allocated based upon a four factor percentage of 43.19%.

(2) Issues Raised by Staff

Staff argued that HNG should be allocated only \$24,951 of the office supply expenses. Mr. Brock argued that the allocation was appropriate because all of the affiliates share the same office space and the company has not established that the office supply is segregated.¹⁴⁸ In briefing, Staff explained its concern further. Namely, the informal organization of the Hughes Resources Affiliated Group of Companies raises a concern that costs are properly traced to the entity that generated the expense.¹⁴⁹

(3) HNG's Response

As to office supply expenses, Ms. Blumenthal testified that each of the affiliated companies in fact pay for their own office supplies. She provided an office supply expense accounting for HNG, Alamo, Pinehurst and Goliad.¹⁵⁰ She argued that an allocation of expenses of HNG's offices expenses as set out in the cost of service calculation was inappropriate where there was evidence in the record that each entity paid for its own office supplies.¹⁵¹

(4) Examiners' Findings and Recommendations

The Examiners find that HNG established that each affiliate in the Hughes Resources Affiliated Group of Companies pays an amount for office supply expense. It is not clear, however, from the record in this case that the affiliates of HNG do not make use of the office supplies purchased by HNG. As noted, the utility's insistence that services may be offered to affiliates by HNG employees establishes evidence of a systemic failure regarding the assignment of costs. As previously noted, the Examiners recommend that HNG be required to undertake a management audit. The expense of the management audit is to be borne exclusively by HNG and not passed onto customers of the system. The Examiners recommend that the management audit specifically examine the use of office supplies and determine whether management systems

¹⁴⁸ Staff Ex. 7, Direct Testimony of Mark Brock, p. 52, lns 7 – 17.

¹⁴⁹ Staff Initial Brief, p. 6.

¹⁵⁰ HNG Ex. 10, Rebuttal Testimony of Ellen Blumenthal, p. 10, ln. 11.

¹⁵¹ HNG Ex. 10, Rebuttal Testimony of Ellen Blumenthal, p. 22, lns. 1 – 6.

are in place to track their usage by all members of the Hughes Resources Affiliated Group of Companies. The company should be directed to establish policies to ensure that none of the other members of the Hughes Resources Affiliated Group of Companies make use of office supplies purchased by HNG.

e. Pinehurst

(1) Introduction

Pinehurst provides construction services to HNG, to Alamo, and to unrelated third parties.¹⁵² The total workforce associated with Pinehurst is not clear in this record. It is a wholly owned subsidiary of HGR. The record has established that Mr. Hicks, the Vice President of HNG, serves as the President of Pinehurst and Mr. Provencher, the President of HNG, serve as a Vice President of Pinehurst. Mr. Provencher asserted that Mr. Hicks is responsible for the day-to-day executive management of the company and is paid a salary by Pinehurst. Rodney Leblanc serves as Vice President and is responsible for the day-to-day operations of the company. Mr. Leblanc is paid a salary by Pinehurst. The parties raised issues regarding services provided directly to HNG and services provided by Pinehurst to customers of HNG.

(A) Pinehurst Services to HNG

As noted, Pinehurst provides utility construction services to HNG. Since 2006, HNG replaced 1,765 feet of mains associated with highway expansion and added 112,339 feet of mains. The utility also replaced pipe associated with the CapGas system and installed automated meter reading devices.¹⁵³ Pinehurst conducted much of that work. HNG's operating expense included \$85,365 for services provided by Pinehurst and the applicant's plant in service included \$1,306,940 for plant construction services provided by Pinehurst during the test year.

(B) Pinehurst Services to Customers of HNG

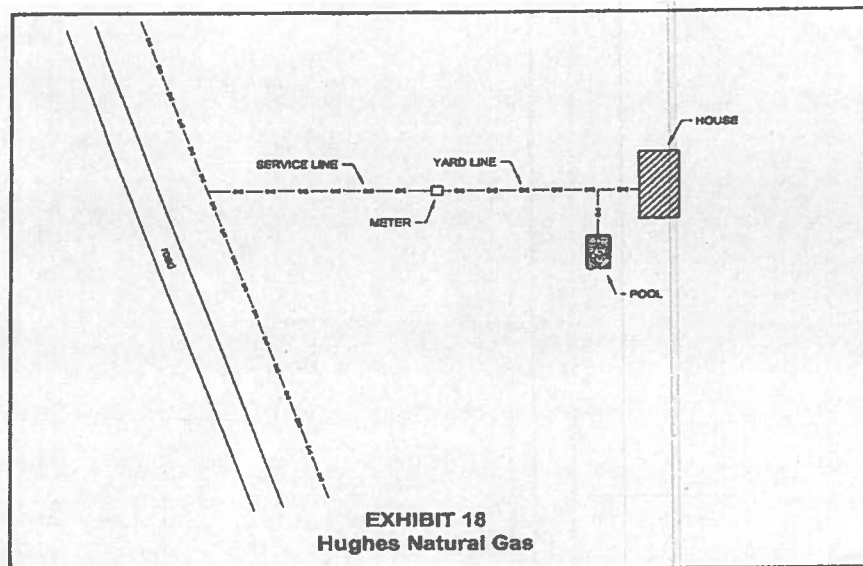
One of the services provided by Pinehurst to customers of HNG is the installation of service lines and yard lines. The term "yard lines," generally includes the natural gas lines

¹⁵² HNG Ex. 1, Direct Testimony of Real Provencher, p. 8, ln. 21 – p. 9, ln. 2.

¹⁵³ HNG Ex. 1, Direct Testimony of Real Provencher, p. 13, lns. 1 – 9.

downstream of the meter that ultimately lead to the customer's home and related buildings. It is to be distinguished from service lines that lead from the utility to the meter. Figure 8.1 below is a reproduction of an exhibit that schematically sets out service lines and yard lines.

Figure 8.1
HNG Ex. 16, Schematic Describing Service Lines and Yard Lines



HNG allows customers to construct service lines as well as yard lines.¹⁵⁴ A yard line construction project may generally be divided into five tasks:

1. Trenching
2. Laying the pipe and locator wire
3. Welding connections
4. Pressure testing the pipe and connections,
5. Purging, tying in the yard line into the meter set, and testing final connections at system pressure for leaks.¹⁵⁵

¹⁵⁴ HNG Ex. 9, Rebuttal Testimony of Joe K. Wells, p. 8, Ins. 16 – 19.

¹⁵⁵ HNG Ex. 9, Rebuttal Testimony of Joe K. Wells, p. 8, Ins. 7 – 15.

Pressure testing the pipe and connections and purging, tying in the yard line to the meter set, and testing final connections at system pressure for leaks is completed by HNG at no out-of-pocket cost to the customer.¹⁵⁶

The customer owns the lines downstream of the meter.¹⁵⁷ It is not disputed that the utility has the responsibility to ensure that the line is safe before introducing gas into the line that are owned and maintained by the customer.¹⁵⁸ It is also not disputed that if a utility is aware of a leak downstream of the meter or if a dangerous condition exists with the proper use of gas, then the utility must turn off the gas until the customer repairs the leak, removes or corrects the dangerous condition.¹⁵⁹

The HNG website contains information regarding service line construction standards, repairs, gas yard line additions, and yard line construction standards. The HNG website specifically references Pinehurst as an entity that installs yard lines. The website provides a link to the Pinehurst "Construction Application," and the Pinehurst "Liability Forms."¹⁶⁰ The contract form includes certain billing information relevant to Pinehurst and HNG. Figure 8.2 below sets out the relevant section of the contract.

Figure 8.2
Portion of Pinehurst Construction Application on HNG Website

Information for New Construction:

Base Charges Billed By PUC:

Mobilization Fee:	<u>\$500.00</u>
Tap Fee:	<u>\$285.00</u>
Service Line Fees (Labor Only):	<u>\$5.00/ft</u>
Plus: Parts & Materials	<u>TBD</u>

Base Charges Billed By HNG When Gas Service Is Connected:

Institution of Service:	<u>\$45.00</u>
Deposit:	<u>Varies; Waived w/ Letter of Credit from Current Natural Gas Provider</u>

¹⁵⁶ HNG Ex. 9, Rebuttal Testimony of Joe K. Wells, p. 9, Ins. 2 – 4.

¹⁵⁷ Staff Ex. 4, Direct Testimony of David Flores, p. 3, Ins. 13 – 14.

¹⁵⁸ Staff Ex. 4, Direct Testimony of David Flores, p. 4, Ins. 6 – 10.

¹⁵⁹ Staff Ex. 4, Direct Testimony of David Flores, RRC Staff Ex. MB-4, Ins. 11 – 17.

¹⁶⁰ Staff Ex. 7, Direct Testimony of Mark Brock, RRC Staff Ex. MB-4. All documents referenced herein related to the HNG website are documents included in Staff Ex. 7, Direct Testimony of Mark Brock, RRC Staff Ex. MB – 4.

The website specifically requests that the customer call HNG if a customer is considering installation by someone other than Pinehurst:

If you are planning on having a contractor, other than our affiliate, Pinehurst Utility Construction, LLC., complete your installation; please contact us prior to beginning.¹⁶¹

The website also provides a link to a document entitled “Construction Options New Natural Gas Service.” This document explains to customers of HNG that to receive natural gas service the customer must construct the service line in full compliance with HNG’s most recent Service/Yard Line specifications. HNG notes therein that all natural gas service line installations must be constructed and paid for by the homeowner. To complete the installation the homeowner must employ a “qualified contractor or builder.” The system design must be reviewed and approved by HNG prior to the commencement of construction. The document notes, in bold, as follows:

HNG has an affiliate that is fully qualified in all respects to construct natural gas pipelines and install service/yard lines as well as install meters, regulators and complete main line taps.

The first page of the document concludes by referencing Pinehurst contact information. No information regarding other potential contractors is included.

The Construction Options New Natural Gas Service documents provides several options for customers of HNG. The first option is construction by a contractor chosen by the homeowner. HNG explains that upon completion of construction HNG, at no cost to the customer will engage Pinehurst to inspect and test the system prior to initiating service. The other various options provided involve Pinehurst providing various degrees of service in order to complete the installation. For example, Pinehurst will install the meter, regulator and main line tap, while another contractor completes the installation of the service line. In the alternative, the

¹⁶¹ Id. (Emphasis in the original).

customer may have Pinehurst install the meter, regulator and main line tap and complete the installation of the service line.

The HNG website also includes a document entitled Requirements for Construction of Service/Yard Lines. This is a document apparently referenced in the Construction Options New Natural Gas Service previously discussed. It appears to set the standards that HNG imposes upon contractors who install yard lines. The document provides that all “[b]id packages, job books and job records are subject to audit periodically by HNG personnel to ensure all personnel are qualified to perform their tasks.”

The website also provides information regarding gas line additions through a document entitled, “Information Regarding Gas Line Additions.” HNG explains that all connections must be installed by a contractor that holds current Railroad Commission of Texas qualifications and has an active drug and alcohol testing program. The document notes as follows:

Our affiliate, Pinehurst Utility Construction is fully qualified and can perform these connections.

The document provides contact information for Pinehurst. No information regarding other potential contractors is included.

Finally, the documentation provided by HNG includes a document entitled, “Information Regarding Repairs to Outside Gas Lines.” The document provides information in the event a customer has been turned off due to a leak between the meter and the gas stub-out at the customer’s residence. It also provides information if service has been turned off to a customer’s pool heater, generator or other outdoor appliance due to a leak. HNG explains that all connections must be installed by a contractor that holds current Railroad Commission of Texas qualifications and has an active drug and alcohol testing program. The document notes as follows:

Our affiliate, Pinehurst Utility Construction is fully qualified and can perform these connections.

The document provides contact information for Pinehurst. No information regarding other potential contractors is included.

(2) Issues Raised by the City of Magnolia – Pinehurst Services to HNG

The focus of the issues raised by the City of Magnolia related to the construction work done by Pinehurst directly for HNG. The City of Magnolia contended that Pinehurst is an example of HNG using an affiliate to capture additional profits from HNG customers. The City of Magnolia maintained that the level of profits captured by HNG from customers through its affiliates is enormous. Of the revenues generated by Pinehurst during the test year, the City of Magnolia asserted that at least 80% of those were derived from work done by Pinehurst on behalf of HNG and/or Alamo. The City of Magnolia argued, however, that Mr. Provencher could not identify any work that was done for Alamo. Thus, most of those revenues were derived from work done for HNG. The City of Magnolia requested that all or some of the portion of affiliate profit associated with Pinehurst be removed from the revenue requirement in this proceeding.¹⁶²

(3) Issues Raised by Staff – Pinehurst Services to Customers of HNG

Staff generally objected to the close relationship between HNG and Pinehurst. The focus of Staff's objection related to the work done by Pinehurst on behalf of customers for yard-line installation and HNG's yard-line standards. Testimony regarding the construction standards imposed by HNG on its customers, and the link between HNG and Pinehurst was provided by Mark Brock and David Flores, Deputy Director of the Pipeline Safety Division at the

¹⁶² As noted above, HNG asserts that the precise calculation of the City of Magnolia Pinehurst Profit Adjustment is a trade secret subject to confidentiality and may not be disclosed. Accordingly, the value is not disclosed in the *Proposal for Decision*. As the Examiners are not recommending approval of this particular adjustment the calculation shall be provided to the Offices of the Railroad Commission under seal, if requested. As noted above, the Examiners recommend that the Commission determine this information is not subject to trade secret protection in the event the Commission determines that the adjustment should be deliberated further. Otherwise all deliberations must be conducted in closed session.

Commission. Mr. Flores compared the standards imposed by HNG to the standards imposed by other utilities on lines owned and maintained by the customer. Mr. Flores explained that the pressure test requirements for the lines owned and maintained by the customer exceed the typical testing pressure of those lines.¹⁶³ He also stated that he was not aware of any other gas distribution that requires the utility's approval of the design and materials used prior to installation.¹⁶⁴ Mr. Flores was not aware of any other utility that required documentation of an approved drug/alcohol testing program of a third-party contractor.¹⁶⁵

Mr. Flores noted that typically yard lines must meet the minimum standard set under a recognized building or gas code. Those publications include the International Building Code and the Southern Building Code. Mr. Flores specifically asserted that he could not attest to what the cost would be to the customer using HNG's specification. In his opinion, however, there was an added cost to meet the specifications of HNG as compared to the cost to meet the minimum standards accepted by other utilities.

Mr. Brock took umbrage to the yard-line requirements and to the standards set by HNG.¹⁶⁶ Central to his objection is the close relationship between HNG and Pinehurst and his contention that HNG has set yard-line installation standards so high that it has affected the competition of licensed plumbers in the HNG service area. He contended that references on the HNG website recommending Pinehurst for repairs, installation, or addition of customer owned and maintained lines was a conflict of interest. He objected to the fact that HNG provided contact information for Pinehurst and that the applicant went so far as to provide Pinehurst's Application for Natural Gas Installation and Liability Release on the HNG website. This was evidence of what Mr. Brock perceived as all affiliates running together.¹⁶⁷

¹⁶³ Staff Ex. 4, Direct Testimony of David Flores, p. 6, ln. 14 – p. 7, ln. 6.

¹⁶⁴ Staff Ex. 4, Direct Testimony of David Flores, p. 6, lns. 7 – 12.

¹⁶⁵ Staff Ex. 4, Direct Testimony of David Flores, p. 6, lns. 14 – 18.

¹⁶⁶ Staff Ex. 7, Direct Testimony of Mark Brock, p. 28, ln. 16 – p. 40, ln. 14.

¹⁶⁷ He also objected to the fact that Mr. Provencher, Mr. Hicks, and Ms. Miller provide services for Pinehurst and, as the case was filed, none of the salaries were allocated. An issue addressed in section "XX" above.

Mr. Brock explained that he was not aware of any other utility that installed yard lines.¹⁶⁸ He contended that most utilities refer the customer to a licensed contractor/plumber to install those lines.¹⁶⁹ He asserted that other utilities have adopted standards for yard lines by the International Building Code, International Residential Code, International Plumbing Code, and the Southwest Plumbing Code. Licensed plumbers are able to perform the work under these standards. He maintained that since HNG has imposed standards for yard lines that are designed for service lines, licensed plumbers are not qualified or certified to perform those installations.¹⁷⁰

Mr. Brock had a litany of recommendations regarding Pinehurst:¹⁷¹

- HNG should adopt the minimum standard set by each municipality and county or, in the alternative if neither have a specific code, the minimum standard of the International Building Code, International Residential Code, International Plumbing Code, and the Southwest Plumbing Code. The installation and repair standard for yard lines should be the same standard adopted by all other gas distribution utilities operating in Texas. Furthermore, the only requirement to connect a customer's yard lines to HNG's facilities is that the customers provide a pressure test from a qualified licensed plumber.
- HNG and Pinehurst should be barred from restricting trade on any new installation or repair on the customer's yard lines.
- HNG should remove any reference to Pinehurst from its website.
- HNG should obtain at least three bids from qualified contractors for new installation or repair work on HNG's assets or any affiliate of HNG's assets in addition to any bid from Pinehurst or a company owned or controlled by Mr. Provencher or Mr. Hicks. The bids should be identical to all third-party contractors and suppliers for materials in addition to any bid from Pinehurst.
- HNG should make efforts to solicit the bids from local contractors. HNG should accept the lowest bids.

¹⁶⁸ Staff Ex. 7, Direct Testimony of Mark Brock, p. 33, lns. 1 – 6. He specifically referenced CenterPoint Energy Entex, Atmos Energy Corp, Mid-Tex Division, and Texas Gas Service Company.

¹⁶⁹ Staff Ex. 7, Direct Testimony of Mark Brock, p. 33, ln. 8 – p. 34, ln. 8.

¹⁷⁰ Staff Ex. 7, Direct Testimony of Mark Brock, p. 34, lns. 1 – 8.

¹⁷¹ Staff Ex. 7, Direct Testimony of Mark Brock, p. 39, ln. 1 – p. 40, ln. 13.

- HNG should obtain at least three bids from its suppliers and materials in addition to Pinehurst or a company owned or controlled by Mr. Provencher or Mr. Hicks. The bids should be identical to all third-party contractors and suppliers for materials in addition to any bid from Pinehurst. HNG should make efforts to solicit the bids from local contractors. HNG should accept the lowest bids.
- HNG should file an annual report showing each new installation project and each repair project. The report shall show the reason for the project, the date the project was initiated and completed, whether request for bids solicited, the bids the vendors provided, the vendor the project or material request was awarded, a list of materials used in the new installation or repair and the vendor performing the work or material supplied.
- Projects should be booked as instructed by the FERC USOA at original cost with no adjustment of its value.
- Materials and supplies held in inventory and then used in projects or expensed should be accounted for according to FERC USOA.

(4) HNG's Response

(A) Pinehurst Services to HNG

Ms. Blumenthal provided an analysis of charges made by Pinehurst to HNG in her direct testimony. She explained that Pinehurst charged the same price to each of its affiliates and that the affiliate has a two tiered rate structure. The first tier is the rate charged to non-affiliated customers. The second tier applies to members of the Hughes Resources Affiliated Group of Companies. The first tier unit prices are higher than the prices charged to affiliates.

She also compared the rates charged to Pinehurst to the rates charged by other companies that provide the same services in the same geographical area and concluded that Pinehurst's rates are competitive. She stated that approximately 14% of the Pinehurst's sales were generated from sales to the general public and concluded that the charges of Pinehurst are competitive. She also compared the rates charged by Pinehurst to the rates charged by third-party vendors and

concluded that those rates are higher than the rates charged by Pinehurst. She also stated that Pinehurst does not charge HNG a mobilization fee, taping fee, pressure testing fee, or fusion weld fee. Finally, Pinehurst maintains an “On-Call” crew around the clock seven days a week to respond to HNG emergencies but that Pinehurst only charges HNG for actual calls.¹⁷²

(B) Pinehurst Services to Customers of HNG

Joe K. Wells, Jr. testified on behalf of the utility in this proceeding and responded to the testimony of Mr. Brock and Mr. Flores. He characterized Mr. Flores’ testimony as simply acknowledging that HNG’s construction standards for yard lines are different from those of most gas utilities in Texas and that they exceed minimum code requirements.¹⁷³ Mr. Wells did not dispute that unlike many gas utilities in Texas HNG has established standards for the construction of yard lines that must be met by the customer in order to receive natural gas service. He contended that these standards address an element of gas distribution that is unregulated by federal, state, and local authorities.¹⁷⁴ He argued HNG has determined that the best way to comply with safety requirements where regulatory authorities have not prescribed the method of compliance is by establishing reasonable standards for the construction of customer-constructed yard lines.¹⁷⁵

Mr. Wells noted that most of the work involved to install a yard line could be completed without using the services of a licensed contractor or licensed plumbers. The work necessary to complete a yard-line installation includes the following steps: trenching, laying pipe, installing the locator wires, and pressure testing. Pursuant to HNG’s standards only welding connections require a welding certification and participation in a Department of Transportation compliant drug and alcohol testing program.¹⁷⁶ He contended that HNG’s construction standard do not impose a barrier for either journeyman or master plumbers and that third-party contractors may achieve the required certifications at a modest cost.

¹⁷² HNG Ex. 4, Direct Testimony of Ellen Blumenthal, p. 9, ln. 9 - p. 13, ln. 4.

¹⁷³ HNG Ex. 9, Rebuttal Testimony of Joe K. Wells, p. 5, lns. 15 – 18.

¹⁷⁴ HNG Ex. 9, Rebuttal Testimony of Joe K. Wells, p. 6, lns. 1 – 4.

¹⁷⁵ HNG Ex. 9, Rebuttal Testimony of Joe K. Wells, p. 7, lns. 18 – 19.

¹⁷⁶ HNG Ex. 9, Rebuttal Testimony of Joe K. Wells, p. 8, ln. 25 – p. 9, ln. 4.

He explained that the total investment required of an individual, plumber or contractor who decides to be in the business of completing all of the tasks associated with constructing yard lines, using standards required by HNG, is approximately \$1,500 to start, plus an annual \$300 fee beginning in the second year. The expenses are for certification and participation in a Department of Transportation compliant drug and alcohol testing program; demonstrated ability to join polyethylene pipe evidenced by a training session; welding certification; and, digital recording pressure gauge or analog chart recorder.¹⁷⁷

He also alleged that the majority of new yard lines constructed during the test year were constructed in whole, or in part, by contractors, plumbers or individuals unrelated to HNG or Pinehurst. A point echoed by Mr. Provencher.¹⁷⁸ Mr. Wells provided the underlying analysis for this conclusion as follows:

“Of the 52 yard lines constructed during the test year:

9 were trenched by the customer or a party other than PUC;

14 were trenched and pipe and locator wire was installed by the customer or a party other than PUC

11 were trenched, pipe and locator wire was installed, and all welds were performed by the customer or a party other than PUC.

A total of 34 of the 52 yard lines had the bulk of construction work completed by parties other than PUC.”¹⁷⁹

Mr. Wells’ principle objection to Mr. Flores’ testimony was his contention that Mr. Flores failed to address the safety benefits of HNG’s construction standards and he objected to Mr. Flores’ statements regarding requirements of pressure testing pipe. Finally, Mr. Wells

¹⁷⁷ HNG Ex. 9, Rebuttal Testimony of Joe K. Wells, p. 8, ln. 27 – p. 10, ln. 29.

¹⁷⁸ HNG Ex. 6, p. 12, lns. 11 – 26.

¹⁷⁹ HNG Ex. 9, Rebuttal Testimony of Joe K. Wells, p. 11, lns. 1 – 12.

argued the HNG's practice created more efficient operations through pricing transparency and standardized methods and materials.¹⁸⁰

Mr. Provencher testified that he has had discussions with local personnel from the Pipeline Safety Division and that he has never been informed that the HNG yard-line standards are unreasonable. In fact, he explained that Commission personnel have been supportive of those standards.¹⁸¹ He also noted that the issue of yard-line construction standards has previously been addressed to Mark Evarts, Director of the Market Oversight section. Two customers have previously complained to the Commission regarding the yard-line construction standards. Mr. Evarts stated in an email as follows:

“ . . . [T]he utility may require reasonable standards to ensure safety on the customer's side of the meter. Welded on risers are considered reasonable since they are safer than compression joints, and they are required by the Railroad Commission on the utility's side of the meters. I would advise you to comply with the specifications required by the utility.”¹⁸²

(5) Examiners' Findings and Recommendations

(A) Introduction

As an initial point, it is disconcerting that the total workforce associated with Pinehurst is not clear in the record. This basic fact should have been unequivocally established by HNG. This is especially true in light of the fact that the single asset originally proposed to be allocated by HNG, rent, was allocated based upon space occupied by various affiliates. Certainly an accurate employee count is relevant to that allocation process.

¹⁸⁰ HNG Ex. 9, Rebuttal Testimony of Joe K. Wells, Jr., p. 5, lns 7 – 8.

¹⁸¹ HNG Ex. 6, Rebuttal Testimony of Real Provencher, p. 20, ln. 17 – p. 21, ln. 7.

¹⁸² HNG Ex. 6, Rebuttal Testimony of Real Provencher, p. 12, lns. 18 – 26.

Mr. Brock stated that information Pinehurst provided to Staff indicated Pinehurst had eight employees.¹⁸³ On the other hand, he noted that in response to a request for information provided to Staff HNG identified ten employees: a part-time President, a Vice President, three crew chiefs, and five service individuals.¹⁸⁴ In response to a request for information sent by the Examiners HNG identified 11 employees: President, two Vice Presidents, three crew chiefs, and five service personnel.¹⁸⁵ None of these calculations included the part-time work of Ms. Miller. On rebuttal, Mr. Provencher stated that Pinehurst has a total of nine full-time employees and one part-time employee. It is not clear if this calculation includes the three executive officers and Ms. Miller, in which case the total count would be 12.5.¹⁸⁶ As suggested above, this disparity in the employee count undermines the credibility of the rental allocation methodology proposed by the utility.

(B) Pinehurst Services to HNG

The Examiners find that the company has not included all costs of receiving service from Pinehurst for construction projects undertaken for HNG. HNG focused on the dollars charged by Pinehurst to HNG for construction services. HNG, however, provides a host of uncompensated services to Pinehurst. In the market-place these services have a value and their expense should have been included in the calculation of the costs of receiving service from Pinehurst. Certainly, no third-party vender would have provided these services for free.¹⁸⁷

These services included the following. First, Real Provencher, the President of HNG, serves as Vice President of Pinehurst. Despite Mr. Provencher's assertion that he does nothing in his capacity as Vice President of Pinehurst, he indicated at the hearing that he participates in

¹⁸³ Staff Ex. 7, Direct Testimony of Mark Brock, p. 29, ln. 5.

¹⁸⁴ Staff Ex. 7, Direct Testimony of Mark Brock, p. 29, lns. 4 – 7 & HNG Ex. 10, Rebuttal Ex. Of Ellen Blumenthal, Rebuttal Exhibit EB-2, p. 7 of 13.

¹⁸⁵ Examiners' Ex. 1, Response to Request for Information No. 4-8.

¹⁸⁶ HNG Ex. 6, Rebuttal Testimony of Real Provencher, p. 6, lns. 10 – 20.

¹⁸⁷ As noted above, the FERC USOA defines "cost" as follow: Cost means the amount of money actually paid for property or services. When the consideration given is other than cash in a purchase and sale transaction . . . the value of such consideration shall be determined on a cash basis. Part 201, Definitions, 9.

accounting processes for Pinehurst.¹⁸⁸ While Mr. Hicks keeps timesheets, Mr. Provencher does not because the “amount of time that [he] spend[s] on non-HNG activities is very, very limited.”¹⁸⁹ In light of his involvement with Alamo’s day-to-day activities, discussed above, without a formalized system to track time the assertion is not credible. Furthermore, the fundamental assumption that a limited service level may be provided by employees of HNG to affiliates free of charge is not correct. It is not just and reasonable for ratepayers to bear that expense, it is not consistent with the requirements of the FERC USOA, and it is unfair to competitors of the affiliate.

Second, HNG conceded that Ms. Miller provided uncompensated services to HNG during the test year. Third, during the test year, two of the officers and Ms. Miller occupied space at 31830 State Highway 249, Pinehurst, Texas. The expenses associated with the space occupied by those officers were not charged to Pinehurst. Fourth, two of the officers were provided vehicles to travel to and from the office where they performed work for Pinehurst. Fifth, HNG provided uncompensated advertising on its website on behalf of Pinehurst.

None of these services were factored into the calculation of the costs of construction services provided to Pinehurst. Thus, there is no way to assess whether the rate charged by Pinehurst is competitive and therefore includable as a just and reasonable expense. This evidentiary infirmity is fatal to all rate base items traced back to Pinehurst. Accordingly, the plant in service contributed by Pinehurst to HNG is properly removable from rate base.

The applicant asserted that the amount of plant in service contributed by Pinehurst to the cost of service is \$1,306,940.¹⁹⁰ This amount necessarily includes the materials installed. Except for the installation of the AMR devices, the company has not included the amounts associated with the materials. The total cost of those devices was \$202,520.75.¹⁹¹ That amount may be included in rate-base. The Commission may remove the remaining amount traced back

¹⁸⁸ Tr. Vol. 2, p. 97, lns. 16 – 19: Occasionally I am involved in some account stuff that occurs on a monthly basis. Most of the account for PUC is done by the accounting firm and so my focus is on HNG.

¹⁸⁹ Tr. Vol. 2, p. 97, ln. 23 – p. 98, ln. 1.

¹⁹⁰ This includes the work done by Pinehurst to install the AMR devices. If this recommendation is adopted by the Commission, no further adjustment to the AMR expense is required.

¹⁹¹ Pinehurst charged \$102,240 to install those devices

to Pinehurst, \$1,104,420, as a result of the applicant's failure to meet its burden. As an alternative, the Commission may employ the labor to capital ratio in the context of the AMRs. The total capitalized cost of the AMR was \$304,760.75. The Pinehurst labor component of that amount was \$102,240, or 33.55%. The Examiners recommend that only that portion of the \$1,104,420 expense be removed from rate base or \$370,532.91. The Examiners reiterate, that from an evidentiary standpoint, HNG has failed to meet its burden on the entire amount traced back to Pinehurst, \$1,104,420.

The proposed adjustment of the City of Magnolia attempts to recognizes inappropriate profits that accrue to the parent company and, in turn, to Mr. Provencher and Mr. Hicks. As noted above the City of Magnolia recommended that an adjustment be made by multiplying 80% to the profits earned by Pinehurst. The rational for the adjustment is that all profits related to Pinehurst are the result of transactions with HNG. This adjustment is not required, however, if the costs that were passed through from Pinehurst to the utility are excluded. Furthermore, the Examiners find that the problem with Pinehurst is not the fact that Pinehurst earns a profit. The problem is that HNG provides tremendous support to Pinehurst. The value of that support is neither tracked nor compensated.

HNG included \$85,365 in operating expenses for services provided by Pinehurst to HNG. The Examiners find that if the allocations of costs are made to account for the services provided by HNG to Pinehurst an additional adjustment to the operating expense calculation for services provided by Pinehurst is not required.

As noted above, the Examiners recommend further that HNG be directed to engage an independent management company, approved by Staff, to undertake an audit of the operations of the Hughes Resources Affiliated Group of Companies and identify all assets used by the member companies. The audit shall include a detailed analysis of the work conducted by employees of HNG and identify any services provided by those employees to the Hughes Resources Affiliated Group of Companies. The expense of the management audit is to be borne exclusively by HNG and not passed onto customers of the system. The management audit is to be completed within nine months of the date of the Final Order in this proceeding, unless otherwise extended by Staff,

but is not to be extended beyond twelve months. Additionally, the management audit shall develop a policies and procedures manual for employees of HNG to track time worked for the various members of the Hughes Resources Affiliated Group of Companies.

The Examiners recommend that HNG obtain at least three bids from its suppliers and materials in addition to Pinehurst or a company owned or controlled by Mr. Provencher or Mr. Hicks. The bids should be identical to all third-party contractors and suppliers for materials in addition to any bid from Pinehurst. HNG should make efforts to solicit the bids from local contractors. HNG should file an annual report showing each new installation project and each repair project. The report shall show the reason for the project, the date the project was initiated and completed, the request for bids solicited, the bids the vendors provided, the vendor the project or material request was awarded, a list of materials used in the new installation or repair and the vendor performing the work or material supplied. Projects should be booked as instructed by the FERC USOA at original cost with no adjustment of its value. Materials and supplies held in inventory and then used in projects or expensed should be accounted for according to FERC USOA.

(C) Pinehurst Services to Customers of HNG

The Intervenors have not established that the standards for yard-line installation are unreasonable. Those standards are clearly above the industry average but the Intervenors have not pointed to any statute, rule or regulation that precludes their adoption. Staff argued that the high standards impair competition. Section 104.007 requires that a gas utility may not engage in a practice that tends to restrict or impair competition against persons who sell or lease equipment or perform services in competition with the gas utility. The impairment of competition, however, is not the standard itself. If HNG imposed the standard but was not involved, either directly or through an affiliate with yard-line construction, there could be no argument that the standard impaired competition.

Rather it is the unsubsidized support that the affiliate receives from the utility that impairs competition. The utility sets the standard. The utility advertises on behalf of its affiliate. No

other contractor enjoys the benefit of the reference and any advertising undertaken by a competitor must be paid by that competitor. Pinehurst does not pay for the advertising on HNG's website. Instead, the captive customers pay for that advertisement. The utility facilitates approval by the utility of work conducted by the affiliate.

HNG's argument that the practice of HNG creates pricing transparency is incorrect. HNG provides information regarding pricing of one potential contractor for the installation of yard lines and repairs – Pinehurst. No information is provided regarding alternate contractors. This advertising service provided by HNG is unique to Pinehurst and the burden of providing this advertisement is paid for entirely by the captive customers of HNG.

HNG has taken the position that it may provide uncompensated advertising, uncompensated services through Mr. Provencher, and uncompensated office expense for its executives, uncompensated referrals through HNG's customer service relationship, to an affiliate. The only allocated expenses included in the original filing are the direct expenses of Mr. Hicks and the rental expense for certain office and parking spaces occupied by non-executive employees. All paid through the rates provided by customers of HNG. Only after discovery did the utility concede that Ms. Miller provided certain services to Pinehurst and only after the hearing on the merits did the utility concede that certain vehicle expenses of Mr. Hicks should be allocated to Pinehurst.

Furthermore, HNG provides the singular requirement on competitors of Pinehurst that customers who chose to employ a competitor must submit the construction plans for prior approval to HNG. The fact that contractors must provide construction plans for prior approval is not by itself an impediment to competition. The fact that only competitors to Pinehurst are subject to that requirement *is* a hindrance to competition. HNG has not explained why Pinehurst is excused from this requirement. But it suggests a close relationship between HNG and Pinehurst that has not been developed with other contractors.

The Examiners find that the evidence in this case established that Pinehurst had been employed, in one capacity or another, in the construction of the vast majority of yard lines. The

contention that the majority of yard-line construction projects is undertaken by a third party is misleading. Mr. Wells pointed out that the installation of yard lines involves several steps and the customer may employ various entities to complete various components. Based upon the data provided by Mr. Wells only 11 of the 52 yard lines constructed during the test year were completed *entirely* by a third party contractor. Thus, in 78% of the yard line constructions undertaken during the test year, Pinehurst was engaged to complete some aspect of that project.¹⁹²

The Examiners find that HNG should be required to remove all references to Pinehurst in materials provided through its website or other documentation with customers of HNG. HNG may impose a requirement of prior approval but that requirement must be uniformly applied to all customers of HNG regardless of the entity that conducted the installation. Further, the contract provisions of Pinehurst should not include any reference to HNG as that may be misleading. Figure 8.2. above included a section of the Pinehurst Construction Application. It included a reference to base charges billed by HNG. Those charges are set by the Commission.

On the other, the charges related to Pinehurst are not set by the Commission. To avoid the appearance that the charges of Pinehurst are set by the Commission, the Examiners recommend that all charges referenced on Pinehurst documents should include only Pinehurst charges. Furthermore, the contract documents should state that none of the charges made by Pinehurst are set by the Commission or any other state agency. Additionally, documents provided to customers of HNG by HNG, or any of its affiliates, should not include the acronym "PUC" as this may mislead the public into believing that those rates are set by a state agency. Thus, for example the statement that reads "Base Charges Billed by PUC" should state "Base Charges Billed by Pinehurst Utility Construction."

The Examiners make one final observation and recommendation regarding the practices of the Hughes Resources Affiliated Group of Companies. Through its affiliate HNG is able to

¹⁹² Mr. Wells states that 9 were trenched by the customer or a party other than Pinehurst. It is assumed that the remainder of the project was completed by Pinehurst. Likewise he states that 14 were trenched and pipe and locator wire was installed by the customer or a party other than Pinehurst. Again, it is assumed that the remainder of the project was completed by Pinehurst. In only 11 cases where the yard lines (1) trenched, (2) pipe and locator wire installed, and (3) welds completed by the customer or third party other than Pinehurst.

accomplish a pricing scheme that it could not accomplish directly. As noted in Figure 8.2, above, the customer of HNG, who employs Pinehurst for yard-line installation or service line installation must pay the Third Party contract rate charged by Pinehurst to entities who are not members Hughes Resources Affiliated Group of Companies. For example, Pinehurst charges a \$500 mobilization fee to customers of HNG. None of the member companies pay that fee.¹⁹³ Customers of HNG, however, are imposed that fee if they request any installation service from Pinehurst.¹⁹⁴ If on the other hand, HNG were to employ Pinehurst to complete the service line installation or the yard line installation, the mobilization fee would not be charged. Although the Intervenors have pointed to no statute that would prohibit this practice, it appears fundamentally unfair.

The tariffs set out the standards and charges that HNG may charge for service lines. As stated in the record, HNG is unique because other entities do not allow customers to install service lines.¹⁹⁵ The installation of a service line is governed by the utility's line extension policy as set out in the company's tariff. HNG should be directed to provide installation of all service lines that are to be owned and controlled by the utility under the terms of its tariff. In this case, installation and extension of new mains under normal conditions, no larger than two inches and diameter and not more than 100 feet in length at no cost and at cost after the first 100 feet.

f. Bad Debt and Informational Advertising

Two issues were raised by Staff that appear to have been resolved in the rebuttal filing of the utility. Staff raised an issue regarding the calculation of bad debt expense. Mr. Brock asserted that the proposed adjustment to bad debt was incorrectly calculated.¹⁹⁶ It appears from the schedules filed in rebuttal that the correction has been made.¹⁹⁷ Staff concurred that the correction had properly been made.¹⁹⁸ Staff also raised an issue regarding informational

¹⁹³ HNG Ex. 4, Direct Testimony of Ellen Blumenthal, p. 16.

¹⁹⁴ As noted, above Pinehurst was involved in 41 yard line construction projects. From the contract materials provided at the hearing there is no arrangement that can be made when Pinehurst is involved in the construction project to avoid that fee. Thus, customers were charged \$20,500 in mobilization fees during the test year. A fee that is not assessed to any other affiliate entity.

¹⁹⁵ HNG – 9, Rebuttal Testimony of Joe K. Wells, p. 8, lns. 16 – 18.

¹⁹⁶ Staff Ex. 7, Direct Testimony of Mark Brock, p. 40, ln. 16 – p. 42, ln. 8.

¹⁹⁷ HNG Ex. 13, Reconciliation

¹⁹⁸ Staff Initial Brief, p. CITE.

advertising expense. Namely, Staff complained about the inclusion of an out of period advertising invoice that was included in the cost of services calculation. HNG has removed that expense from its cost of service calculation.¹⁹⁹ Staff concurred that the expense was removed from the request.²⁰⁰ The Examiners find that no additional adjustment is required.

9. Rate Base

a. *CapGas Acquisition*

(1) Public Interest Determination

Section 102.051 requires a gas utility that merges or consolidates with another gas utility to file a report of the transaction within 60 days of the effected date. On the filing of a report with the Commission, the Commission shall investigate the transaction with or without a public hearing, to determine whether the action is consistent with the public interest. The statute provides that in reaching its determination, the Commission shall consider the reasonable value of the property, facilities, or securities to be acquired, disposed of, merged or consolidated.

Staff contended that neither HNG nor CapGas filed a report with the Commission within 60 days of the merger. Staff argued that the merger was not in the public interest, in part, because on the date of the acquisition HNG began charging former customers of CapGas the rates approved in GUD No. 9731, HNG's previous rate proceeding. Thus, as outlined in Section 4b above, those customers experienced a rate increase at the time of the acquisition.

In response to Staff's assertions, HNG argued that CapGas was a failing distribution system, both from a financial standpoint, and in terms of the physical condition of the deteriorating pipeline facilities. HNG has invested substantial capital to replace mains and services lines to bring the facilities into compliance with the Commission's integrity management and safety standards. Additionally, HNG argues that case law²⁰¹ is well settled that HNG was entitled to raise the rates previously charged CapGas customers to HNG's Commission-approved tariff rate.

¹⁹⁹ HNG Ex. 13, Reconciliation.

²⁰⁰ Staff Initial Brief, p. CIT

The Examiners find that HNG has correctly characterized the status of the law with regards to the rates that an acquiring utility may charge to customers of the former utility. The cited case stands for the proposition as stated by HNG that the utility was entitled to raise the rates previously charged CapGas customers to HNG's Commission-approved tariff rate. The Commission has previously considered the public interest issue posed by Section 102.051. In GUD No. 9670 the Commission evaluated the question by considering the following factors:²⁰²

- (1) The reasonable value of property, facilities, or securities;
- (2) investments made to enhance or improve reliability;
- (3) actions implemented to enhance or improve safety;
- (4) efforts to enhance or improve customer service quality;
- (5) measures accomplished for improvements to operations, management, and administrative process;
- (6) community benefits resulting from the acquisition;
- (7) impacts on bond ratings and investment community's view of the acquisition;
- (8) efficiencies and economies of scope and scale resulting from the acquisition;
- (9) liability avoidance or mitigation as a result of the acquisition; and,
- (10) effect on customer rates.

The company established that CapGas was in a precarious financial position and that the customers of that system avoided the consequences of having a utility close its doors. The record in this proceeding established that HNG made investments to enhance and improve the reliability and safety of the system. Mr. Provencher testimony regarding the condition of CapGas is not contradicted. CapGas had at least 20% of its mains that were beyond their useful life with unacceptable integrity issues. The mains were PVC lines that should have been replaced many years prior to the acquisition and long sections of CapGas' steel mains lacked cathodic protection.²⁰³ In summary, the Examiners recommend that the Commission find that the acquisition of CapGas by HNG was in the public interest.

²⁰¹ *Entex v. Railroad Commission of Texas*, 18 S.W. 3d 858 (Tex. App. – Austin 2000, writ denied)

²⁰² GUD No. 9670, Petition for de novo Review of the Reduction of the Gas Utility Rates of Atmos Energy Corp., Mid-Tex Division, by the Cities of Addison, Bedford, Benbrook, et al. & Statement of Intent filed by Atmos Energy Corp., Mid-Tex Division, Finding of Fact No. 167.

²⁰³ HNG Ex. 6, Rebuttal Testimony of Real Provencher, p. 13, ln. 21 – p. 16, ln. 12.

(2) Valuation of the CapGas System

As noted above, on January 4, 2008, HNG completed a major acquisition by acquiring the assets of CapGas, a local natural gas distribution company with approximately 1,100 customers and 177,652 feet of mains in Harris, Waller, Grimes, Austin and Colorado counties. The CapGas distribution system was located just south of HNG's existing distribution system. HNG claims the acquisition was accounted for utilizing FERC accounting procedures with Original Cost of Distribution Plant totaling \$2,908,441 and Accumulated Depreciation totaling \$1,250,971 as of the acquisition date.²⁰⁴ These values were determined as the result of a trending analysis performed by GDS which was signed on June 3, 2008.²⁰⁵

As part of the due diligence effort for the acquisition, HNG had the assets catalogued and digitally mapped, and a pipeline integrity risk assessment was conducted by GDS Associates, Inc. ("GDS"). GDS recommended that fourteen sections of the distribution system be considered for replacement. They consisted of PVC and Steel mains and services originally installed between 1961 and 1975. The Steel mains had not been cathodictly protected. Over the 2008 through 2011 period, HNG completed twelve construction projects to replace mains and services in accordance with GDS recommendations. A total of 43,660 feet of new mains have been installed as replacements for PVC and Steel mains in what was formally the CapGas service areas. The original cost of the main replacements, including new service lines, was \$933,694.²⁰⁶

(A) Introduction: HNG's valuation of the CapGas system:

HNG claims the trending study was necessary due to the absence of detailed plant records and accounting information when the company was acquired.²⁰⁷ An original cost trending study is a computational methodology used to develop a reliable value of utility plant for different times. If the value of an item is known at any point in time, trending indices can be used to estimate its value at any other point in time. A trending study is normally initiated with a

²⁰⁴ HNG Ex. 1, p 12, lns 5-10

²⁰⁵ City of Magnolia Ex. 19

²⁰⁶ HNG Ex. 1, p 12, lns 14-22

²⁰⁷ HNG Ex. 5, p 6, lns 21-22, p 7 lns 1-2

replacement cost of an item for a point in time and, with trending indices from that point in time and from the time the item was installed, a value is computed at the time of installation, a substitute for the original cost of the item.²⁰⁸ HNG witness Mr. Loy provided the CapGas trended original cost study. The results were updated through the end of the test year are presented at Table 9.1.²⁰⁹

Table 9.1
HNG Trended Original Cost Study

Description (A)	Trended Original Cost Value (B)	Plant Retired (C)	Depr Exp 1/2008 thru 3/2011 (D)	Trended Plant In Rate Base (E)	Trended Plant Depr Expense (F)
(376) Mains Accum. Depr.	\$ 1,335,649 (381,862)	\$ (96,550) 87,916	(100,677)	\$ 1,239,098 (394,623)	\$30,977
(378) Meas & Reg Station Accum. Depr.	298,109 (131,461)	(60,447) 57,140	(23,406)	237,662 (97,727)	7,202
(380) Services Accum. Depr.	1,275,413 (737,958)	(19,870) 19,870	(163,221)	1,255,543 (881,308)	50,222
Total Net Plant	<u>\$ 1,657,890</u>	<u>\$ (11,941)</u>	<u>\$ (287,303)</u>	<u>\$ 1,358,645</u>	<u>\$88,401</u>
Test Year CapGas Net Acquisition Adjustment				<u>\$ (1,133,381)</u>	<u>\$(31,190)</u>
Total Gross Plant	2,909,171			2,732,303	88,401
Total Accumulated Depreciation	<u>(1,251,281)</u>			<u>(1,373,658)</u>	
Total Net Plant	<u>\$ 1,657,890</u>			<u>\$ 1,358,645</u>	<u>\$88,401</u>

(B) Staff's Proposed Valuation of the CapGas System:

Staff, in its closing brief, states that HNG paid \$550.00 for the assets of CapGas and the net cost, after cash and liabilities are accounted for, was \$421,158. The amount on the books of CapGas at the end of 2007 was \$321,596. Staff recommends that the Commission sets rates on invested capital and that the amount of invested capital by HNG for the CapGas purchase is \$550,000, not the amount HNG represents in the trended original cost study. Staff relies on the Tex. Util. Code Section 104.053 definition of invested capital as original cost as actual money cost or the actual money value of consideration paid other than money.²¹⁰

²⁰⁸ HNG Ex. 5, p 8, lns 8-13

²⁰⁹ HNG Ex. 11

²¹⁰ Staff's Initial brief, p 15

(C) City of Magnolia Multiple Proposals for Valuation of CapGas:

The City of Magnolia argues that the plant value of \$1,637,889, (\$1,358,645 updated to end of test year for retirements and depreciation) established by the trending analysis proposed by HNG is unreasonable and not in the public interest. They caution the Commission against allowing a methodology that has never been proposed before the Commission and inflates the assets of CapGas to nearly six times its book value.

The City of Magnolia claims the trending analysis is flawed because it is based on estimates. GDS had very little information on CapGas system replacements, additions, and retirements. In the hearing Mr. Loy agreed there were no formal records.²¹¹ Mr. Loy further agreed there was no systematic inventory.²¹² Mr. Loy acknowledged that the CapGas general manager, Ms. Smith provided her “recollections” regarding the CapGas distribution system inventory.²¹³ The report was based on estimated quantities, labor costs, material costs, and installation dates and applied a 10% contingency estimate to the estimated cost. At the hearing an error was also acknowledged by Mr. Loy in the per unit charge for 1” diameter gas line which was used to calculate replacement costs for that class of items.²¹⁴

The City of Magnolia contends that without detailed knowledge of when facilities were installed the trending analysis ratios are applied to some undocumented time in the past. Applying the ratios to estimates that cannot be supported renders the results unreliable and has the potential of overstating original cost values. The City of Magnolia also claims that HNG has not established that the regional cost data utilized in the trending analysis accurately represent the costs incurred by CapGas. The City of Magnolia believes that the trended analysis is only an estimate of the CapGas purchase and they have raised doubts about the study methodology and results.

²¹¹ Tr., Vol. 2 at 127:2-4.

²¹² Tr., Vol. 2 at 127:21-22.

²¹³ Tr., Vol. 2 at 128:16.

²¹⁴ Tr., Vol. 2 p. 136, lns. 6 – 8.

The City of Magnolia states that, “in this case, HNG acquired CapGas distribution assets of \$296,904²¹⁵ for a net purchase price of \$421,158²¹⁶ and wants to include this transaction in rate base at an amount of \$1,358,645. This proposal causes rate payers to pay \$188,990 more, in profits and associated taxes alone, to Messrs. Hicks and Provencher.²¹⁷ The HNG owners should not be allowed to earn profits on investment that was never made – that would be unjust and unreasonable.”²¹⁸

As their principle alternative, the City of Magnolia proposes that a more reasonable valuation of the assets acquired from CapGas is the actual net book value of the distribution plant assets, or \$296,904 at December 31, 2007 as filed in the CapGas Annual Report. In addition to the proposed book value methodology the City of Magnolia proposes two additional options for assigning a value to the CapGas system purchase price of \$421,158 with an acquisition adjustment; or, contract purchase price of \$550,000. Thus, the City of Magnolia has presented three alternatives which shall be discussed in detail.

a. Valuation Based Upon 2007 Railroad Commission Annual Report

HNG relied on the 1992 Commission order in GUD Nos. 8310-8316 which identified deficiencies in CapGas’s plant accounting to establish the need for a trended original cost study. The City claims that those issues were resolved with the Commission because of the subsequent acceptance of CapGas’ 1993-2007 Gas Services Division Annual Reports.

This recommendation is to value the CapGas assets using the book value of plant as filed in the CapGas 2007 Railroad Commission’s Annual Report because subsequent to the purchase of CapGas, Real Provencher filed the 2007 Annual Report for CapGas attesting that “the facts stated therein are true, correct, and complete to the best of his knowledge.”²¹⁹ The Annual Report was signed/dated May 28, 2008.

²¹⁵ City of Magnolia Ex. 1, at 27:21

²¹⁶ City of Magnolia Ex. 20

²¹⁷ City of Magnolia Initial Brief, p. 5, footnote 8

²¹⁸ City of Magnolia Initial Brief, p. 20

²¹⁹ City of Magnolia Initial Brief, p. 26

The City of Magnolia states as follows: The Commission must be able to rely on the CapGas books and records vouched for by Mr. Provencher if it so chooses in this proceeding. If the Commission cannot rely on the books and records vouched for by Mr. Provencher then the whole cost of service would be unreliable as the cost of service witness, Mr. Loy, did not vouch for any of the costs in the case. Mr. Loy testified that he relied on Mr. Provencher.²²⁰

This adjustment takes the trended plant balances of accounts 376-Mains, 378-Meas & Reg, and 380-Services as filed in HNG Exhibit CEL-1 and then reduced by the difference between the trended balances and the 2007 annual report balances. The result is a decrease on Schedule B-1 of (\$2,050,018) to distribution plant accounts a \$(66,326) decrease to depreciation expense and a decrease on Schedule B-2 of \$(909,462) for the associated accumulated depreciation. This is a net adjustment to rate base of (\$1,140,556) and a \$(269,895) decrease to the requested revenue requirement.

b. Valuation Based Upon CapGas Net Purchased Price Paid

The Net purchase price paid for the CapGas system is \$421,158. Adopting this adjustment is using the upper amount recommended by the City of Magnolia. The City of Magnolia believes that any amount allowed over the net purchase price would cause shareholders to be earning profits on an investment that was never made.

Table 9.2 - CapGas Acquisition²²¹

1. Stock Purchase plus liabilities	\$550,000:	\$150,000 cash, \$400,000 note
2. Customer Deposits	25,464	
3. Accounts Payable	82,428	
4. Sales Tax Payable		
Less assets	1,473	
5. CapGas checking	45,779	
6. Prepaid Assets	1,400	
7. Accounts Receivable	154,553	
8. <u>Due from Pinehurst</u>	<u>36,475</u>	
Net Amount Paid	\$421,158	

²²⁰ City of Magnolia Initial Brief, p. 26

²²¹ City of Magnolia Initial Brief, p. 27

This adjustment takes the trended plant balances of accounts 376-Mains, 378-Meas & Reg, and 380-Services as filed in HNG Exhibit CEL-R1 and then reduced by the difference between the trended balances and the net purchase price of \$421,158. The result is a decrease on Schedule B-1 of (\$2,038,209) to distribution plant accounts a \$(65,944) decrease to depreciation expense and a decrease on Schedule B-2 of \$(1,020,544) for the associated accumulated depreciation. This is a net adjustment to rate base of (\$1,017,665) and a \$(247,591) decrease to the requested revenue requirement.

c. Valuation Based Upon Gross Contract Price

This adjustment bases the CapGas value on the gross contract price of \$550,000. This method, as illustrated in Table 9.2 does not include adjustments for assets and liabilities assumed in the purchase.

This recommendation takes the trended plant balances of accounts 376-Mains, 378-Meas & Reg, and 380-Services as filed in HNG Exhibit CEL-R1 and then reduced by the difference between the trended balances and the contract price of \$550,000. The result is a decrease on Schedule B-1 of (\$1,825,869) to distribution plant accounts a \$(59,074) decrease to depreciation expense and a decrease on Schedule B-2 of \$(912,518) for the associated accumulated depreciation. This is a net adjustment to rate base of (\$913,351) and a \$(222,102) decrease to the requested revenue requirement.

(D) HNG's Rebuttal

HNG argues that the City's assertion that the study relies on estimated installation dates that cannot be supported is incorrect. The City was provided a copy of the study's work papers which included a detailed list of line lengths of the pipe and the dates they were installed. Also the work papers included notes that were taken during discussions with the former General Manager of CapGas. These discussions provided more information regarding installation dates, lengths, locations, composition, materials, etc. Also, the information provided to the City indicated that the installation dates were verified by reviewing subdivision plat maps, which are

a very reliable source. These maps were made available to the City to review in HNG's offices, but the City did not avail itself the opportunity.²²²

Furthermore, HNG maintains that the City erroneously claims that the study did not establish that the regional cost data indices used would accurately reflect the original costs incurred by CapGas because a key component of an original cost study is to determine installation and construction replacement costs in the specific area in which the subject utility is located. It incorporates all the specific construction constraints identified in the utility's service area, such as whether the ground is hard, soft or rocky, whether road bores were needed, etc. and other physical characteristics that would impact the cost of construction. HNG asserted that GDS conducted just this type of detailed analysis and provided the work papers that included detailed cost information as well as summaries of the cost data used to compute the replacement costs.²²³

Furthermore, HNG asserted that Final Order in GUD 8310-8316 expressly states that the original cost values of CapGas were not known and that CapGas was not following correct accounting procedures and the City still believes that CapGas plant values were correct when it was purchased by HNG.

The statement by the City that the study results are unreasonable because they produce a value that is 5.6 times greater than the Annual Report value is also incorrect because the study is using straight-line depreciation and the Annual report is using accelerated depreciation. This, HNG argues is an apples to oranges comparison. HNG claims that taking the gross plant value from the 2006 CapGas Annual Report divided by feet of mains demonstrates that the annual report values were significantly understated because it is impossible to install mains for 1.21 per foot.²²⁴

The real issue is how this Commission should value the CapGas utility plant when it is known that the costs reflected on its books and records do not reflect "original cost of the

²²² HNG Ex. 11, p 11, lns 1-8

²²³ HNG Ex. 11, p 11, lns 12-22

property when first dedicated to public service,” as required by statute. The Commission acknowledged plant values were not maintained under FERC standards but for federal income tax purposes. HNG acknowledged that the plant original cost values were not supportable and determined that estimates were necessary based on the Commission mandated use of FERC’s USOA.²²⁵

HNG maintains that the correct valuation of the CapGas system is that produced by the GDS study. However, they also present an alternative computation of CapGas plant using fair value mix of 60% original cost to 40% replacement cost adjusted for age and condition and that this method also adjusts the 2007 annual report depreciation to a level more representative of straight-line depreciation.

This adjustment takes the trended plant balances of accounts 376-Mains, 378-Meas & Reg, and 380-Services as filed in HNG Exhibit CEL-R4 and then reduced by the difference between the trended balances and the 60/40% weighted plant values. The result is a decrease on Schedule B-1 of (\$607,421) to distribution plant accounts a \$(20,742) decrease to depreciation expense and a decrease on Schedule B-2 of \$(112,612) for the associated accumulated depreciation. This is a net adjustment to rate base of (\$494,809) and a \$(149,215) decrease to the requested revenue requirement.

(E) Examiners’ Findings and Recommendations

In the previous CapGas docket, GUD 8310-8316, signed March 29, 1993, CapGas was ordered by the Commission to book plant according to NARUC. Mr. Provencher signed the 2007 Annual Report on May 28, 2008. He filed that report and attested to the veracity of the figures included therein:

“I declare under penalties prescribed in the Texas Utilities Code, Chapter 105, that I am authorized to make this annual report to the Gas Services Division of the Railroad Commission of Texas, that this report was prepared by me or under my

²²⁴ The Examiners note that this calculation is incorrect. The calculation used accumulated depreciation divided by feet of pipe and should have used plant in service balance for account 376 which results in \$2.35 per foot.

²²⁵ HNG 11, p 15, lns 11-18

supervision, and that data and facts stated therein are true, correct, and complete to the best of my knowledge.”

HNG has not established that his attestation was false or incorrect and that the figures in the 2007 Annual Report are not correct. In fact, by then the Trending Report, prepared by GDS, was well underway. That report is dated June 3, 2008.²²⁶

The Examiner’s agree with the City of Magnolia and Staff and recommend utilizing CapGas book values as the amount in plant for setting rates in this docket and that allowing an amount over the net purchase price would cause shareholders to be earning profits on investment that was never made.

For ease of reference the Examiners summarize the various proposals made by the parties in Table 9.3, below.

Table 9.3

Summary of Impacts of Various Proposals for Valuation of the CapGas System

Methodology	CapGas Plant in Rate Base (Original Cost)	Reduction to Requested Rate Base	Reduction to Revenue Requirement
Trending Study	1,358,645	0	0
Book Value	218,089	(1,140,556)	(269,895)
Net Purchase Price(\$421,158)	340,980	(1,017,666)	(247,591)
Gross Purchase Price (\$550,000)	445,293	(913,352)	(222,102)
*Fair Value Mix 60% Original Cost /40% Replacement Cost	863,836	(494,809)	(109,041)
*Fair Value Mix 70% Original Cost / 30% Replacement Cost	731,672	(626,974)	(144,043)

*Based on CapGas trending study results

²²⁶ City of Magnolia Ex. 19.

The Examiner's recommendation is to utilize the CapGas 2007 Annual Report book value as the CapGas plant in service value. The Commission has the discretion to allow an acquisition adjustment. The Examiners recommend allowing an acquisition adjustment in the amount of \$203,069 which is the difference between the net purchase price of \$421,158 and book value of \$218,089. As discussed above, the company established that CapGas was in a precarious financial position and has established that HNG made investments to enhance and improve the reliability and safety of the system. Mr. Provencher testimony regarding the condition of CapGas is not contradicted. CapGas had at least 20% of its mains that were beyond their useful life with unacceptable integrity issues. The mains were PVC lines that should have been replaced many years prior to the acquisition and long sections of CapGas' steel mains lacked cathodic protection.²²⁷ Allowing this acquisition adjustment would allow the utility the opportunity to earn a reasonable return on its investment without allowing shareholders to earn profits on investment that was never made.

b. AMRs

(1) Introduction

The company included in rate base a calculation of \$269,189 for the test year ending March 31, 2011, for an investment of Automatic Meter Reading (AMR) devices.²²⁸ Mr. Provencher testified that the AMR device is one-way communication with associated hardware and software that is attached to the customer's existing meter. Every 13 seconds, the AMR transmits a microdata burst that can be read remotely by a portable radio unit allowing a company technician to capture readings by simply driving by the meter.²²⁹ After collecting the information, the readings are uploaded into a computer at the company's offices and a software program then converts the data stream into text form that is uploaded into the company's billing system.²³⁰ To clarify, the AMR is not a "Smart Meter" with two-way communication but is a data repeater attached to existing meters.²³¹

²²⁷ HNG Ex. 6, Rebuttal Testimony of Real Provencher, p. 13, ln. 21 – p. 16, ln. 12

²²⁸ The \$304,761 capitalized amount is booked to FERC account #380 (Services) and accumulated depreciation of \$30,475 booked to FERC account #8380, in HNG Ex. 11, Schedule B-1, Line 5, Column B and Schedule B-2, Line 5, Column B, respectively and Examiners' Ex. No. 7, Response to Examiners' RFI 6.2

²²⁹ Tr. Vol. 3, p. 125, ln. 7-17

²³⁰ Examiners' Ex. No. 5, Response to Examiners' RFI 2.1 2.5

²³¹ Tr. Vol. 2, p. 191, ln. 17 - 21

The photographs in Figure 9.1 demonstrate the meter, the AMR device, and then the meter with the AMR device installed.

FIGURE 9.1

RESPONSE:

Meter:



AMR:



Meter with AMR:



It is the company's position that the acquisition and installation of the AMR devices is used and useful in providing natural gas services to HNG's customers and therefore should be allowable in rate base. Specifically, the company purchased 4,409 AMRs from Neptune at an average cost of \$53.39 per device including sales tax and shipping for a total cost of \$239,353.75. In 2009, HNG received a reimbursement of \$36,833 for the return of 866 unused devices. The company engaged affiliate, Pinehurst, to install the AMRs at a cost of \$30 per unit totaling an expense of an additional \$102,240. As a result, HNG's purchased, installed and capitalized cost is \$304,761. After depreciation, HNG maintains the company is due a rate base amount of \$269,189 for the AMR investment.²³²

With the AMRs, the company takes approximately two days to read customer's meters. Prior to 2008, manual meter reading took approximately three weeks to complete.²³³ According to HNG, continuing to manually read meters would have resulted in expenses of more than \$40,000 per year. In calendar year 2010, the meter reading expenses with the AMRs were \$392.²³⁴ As for using the affiliate, Pinehurst, to install the AMR devices, it is HNG's position that the utility could not have installed the AMRs in 2008 with only two full-time and one part-time field technician, given their other daily responsibilities.²³⁵

HNG argues that the company should not be required to quantify or provide a detailed cost/benefit analysis to rate payers regarding AMRs because the company asserts that the proper test for determining whether costs should be included in rate base is whether the investment is used and useful and prudently incurred. Still, Mr. Loy performed an analysis comparing the cost of the AMR investment (expenses for meter reading, associated depreciation, and tax adjustments) to the expenses that HNG would incur for manual meter reading.²³⁶ The analysis shows costs to rate payers in the first year and at the conclusion of the remaining 25 years of the life of the assets, the analysis shows a total savings of \$1.48 million.²³⁷

Mr. Provencher testified further that HNG's customers are receiving the following benefits from the use of the AMRs: (1) reduced need for meter readers, (2) improved meter reading accuracy, (3) improved employee safety, (4) reduction in meter reading cycle time, (5) more timely and accurate billing, (6) reduced working capital requirements for the company, (7) more accurate weather normalization adjustments, (8) more reliable data for mass system balances, (9) early identification of system leaks and meter failures, and (10) additional customer privacy.²³⁸

²³² HNG Ex. 11, Rebuttal Testimony of Charles E. Loy, Schedule CEL-R3 and Examiners' Ex. No. 5, Response to Examiners' RFI 2.5

²³³ Examiners' Ex. No. 5, Response to Examiners' RFI 2.6

²³⁴ Examiners' Ex. No. 5 Response to Examiners' RFI 2.6

²³⁵ HNG Ex. No. 10, Rebuttal Exhibit of Ellen Blumenthal No. EB-2, pp. 5 - 6

²³⁶ Tr., Vol. 3, p. 149, ln. 14 through p. 150, ln. 7

²³⁷ HNG Ex. No. 11, Rebuttal Testimony of Charles E. Loy, p. 8, ln. 4-6, p. 24 and Schedule CEL R-3

²³⁸ HNG Ex. No. 6, Rebuttal Testimony of Real Provencher, p. 15, ln. 15

(2) Issues Raised by the City of Magnolia

The City points out that the company's \$304,761 expenditure has an annual cost to ratepayers in excess of the meter reading expenses that the devices were intended to replace. Consequently, the City argues that the Commission should disallow the excess costs as not reasonable or necessary.²³⁹ Mr. Nalepa testified on behalf of the City and presented an analysis of the company's cost of service for the AMRs. He concluded that meter reading with the AMRs results in approximately an additional \$24,633 annually to rate payers than the \$40,000 manual meter reading costs.²⁴⁰

The City also finds it improper that HNG used affiliate, Pinehurst to install the AMRs at a cost of \$102,240 and then HNG capitalized the installation cost of the meter.²⁴¹ The City believes HNG's actions were improper to use the affiliate to install the devices with shareholders taking a profit on the installation and then turning around and including the identical profit in utility rate base for a return to the same individual shareholders. So, in addition to charging customers a profit on the installation, HNG proposes to earn its own profit based upon the increased cost of installation.

In consequence, Mr. Nalepa proposes that the additional annual amount of \$24,633 be reduced from rate base because the company has failed to show that this investment has a cost benefit to ratepayers.²⁴² In other words, Mr. Nalepa asserts that the total costs of the AMR devices was unreasonable as the costs of purchasing, installing, and operating these devices outweighed the cost that HNG had previously incurred for meter reading.²⁴³ The City argues that a reasonable approach is to include in rate base an amount for the AMR meters that flow through to customers such that the revenue requirement for the investment, return, taxes, and operation

²³⁹ City of Magnolia Ex. 1, Direct Testimony of Karl J. Nalepa, p. 16, ln. 5 - 9

²⁴⁰ City of Magnolia Ex. 1, Direct Testimony of Karl J. Nalepa, pp. 17 - 18; This calculation is derived with a starting point of a capitalized investment of \$304,761, less annual depreciation reserve of \$27,428, equals net plant in service of \$277,334. That amount is then multiplied by a requested rate of return (calculated from HNG's Scheduled A-1 and E, the requested after tax weighted equity return of 11.15% after grossed up for income taxes at 35%) to a rate of return and tax component of \$49,404. Then annual depreciation in the amount of \$12,190 and annual operating costs of \$3039 is added for a total cost of service of \$64,633; and Tr. Vol. 2, pp. 155-156

²⁴¹ City of Magnolia Ex. 41

²⁴² City of Magnolia Ex. 1, Direct Testimony of Karl J. Nalepa, p. 18, ln. 10 - 14 and p. 19, ln. 1 - 2

²⁴³ City of Magnolia Ex. 1, Direct Testimony of Karl J. Nalepa, pp. 17 - 18

and maintenance would be no higher than the costs customers would have incurred prior to the installation of the meters.

In response to Mr. Loy's analysis, Mr. Nalepa utilized Mr. Loy's figures and adjusted inflation from 3.5% to 1.6% and the net present value of the investment back to the time it was placed in service, and concluded an overall increase in costs to customers of \$38,171 over the approximate 25 year life of the AMRs.²⁴⁴ Furthermore, Mr. Nalepa testified that every year the company is incurring the depreciation and return expense and every year the company is also avoiding the previously paid \$40,000 for manual meter reading. Under Mr. Nalepa's analysis, there is never a payout for the company.²⁴⁵ The City maintains that determining the net present value of an investment at the time it was placed in service is the test to determine the prudence of an investment.²⁴⁶ The City criticizes Mr. Loy's analysis because it lacks a discounted cash flow analysis. If making the investment did not yield a positive net present value at the time of the investment, then the investment is not economical, according to the City.²⁴⁷

(3) HNG's Response

HNG criticizes Mr. Nalepa's analysis for recommending that the first year's loss be removed entirely from the utility's revenue requirements. HNG maintains that the year 2008 has passed and those losses are "water under the bridge."²⁴⁸ According to HNG's analysis, the customers will receive a positive cash benefit from the AMRs over their useful life.²⁴⁹

(4) Cash Working Capital (CWC) Issue

Cash working capital represents an amount of cash that a utility must have available to meet current obligations as they arise due to the time lag between payment of expenses and

²⁴⁴ City of Magnolia Ex. 33, Tr. Vol. 2, p. 198, ln. 16 – 25 and p. 204, ln. 15 - 22

²⁴⁵ Tr. Vol. 2, p. 181 and Tr. Vol. 3 p. 155, ln. 8 - 11

²⁴⁶ AEP v. PUC, 286 S.W.3d 450, 482 (Tex. App.—Corpus Christi 2008, pet. den'd) (defining "prudence" as the "exercise of that judgment and the choosing of one of that select range of options which a reasonable utility manager would exercise or choose in the same or similar circumstances given the information or alternatives available at the point in time such judgment is exercised or option is chosen.")

²⁴⁷ Tr. Vol. 2, p. 198, ln. 16 through p. 199, ln. 7

²⁴⁸ HNG Ex. No. 11, Rebuttal Testimony of Charles E. Loy, p. 7, ln. 16 through p. 8, ln. 6

collection of revenues. The need for working cash has long been recognized by regulatory bodies and the courts. An allowance of cash working capital, however, is not guaranteed as a matter of course and the utility carries the burden of establishing the need for cash working capital. HNG did not perform a lead-lag study, which is necessary to determine a reasonable basis for the cash working capital needs of the utility's system.²⁵⁰ A lead-lag study would identify the difference in timing between outward cash flow for labor, materials and supplies, inventory, other expenses, and inward cash flow of revenue from payments to customers.

Cash working capital requirements may be positive or negative. Positive working capital is investor-supplied. In contrast, negative working capital reduces the need for investor-supplied capital and arises when the utility receives customer payments before service is rendered, or when it receives funds before it must satisfy a corresponding liability. To illustrate the concept of cash working capital, if one assumed that the utility paid for natural gas before it supplied the natural gas to the consumer, then the utility would be using positive cash working capital, i.e., money from its investors, to pay for natural gas until the consumer paid the utility. In that case, the investors have an expectation of receiving a reasonable return on its investment. If, however, the consumer paid the utility in advance for use of the product, the company has negative cash working capital and the investor would have no expectation of return because the investor's capital was not being used.

The company did not perform a cash working capital benefit analysis for the meter reading devices.²⁵¹ Instead, HNG has added approximately \$23,000 for cash working capital to rate base utilizing the one-eighth rule that the Commission has previously employed in the absence of a lead-lag study.²⁵² The company argues that since the Commission granted HNG a cash working capital allowance using the one-eighth rule in their last rate case, GUD No. 9731, then it is also reasonable to allow HNG the same for its cash working capital requirements in this docket.²⁵³

²⁴⁹ HNG. Ex. No. 11, Schedule CEL-R3 and Tr. Vol. 2, p. 203-205 and City of Magnolia Ex. No. 33

²⁵⁰ HNG Ex. 5, Direct Testimony of Charles E. Loy, p. 5 and Schedule B and Tr., Vol. 3 p. 150, ln. 15-16

²⁵¹ Tr., Vol. 3 p. 150, ln. 17 – 20

²⁵² Tr., Vol. 3, p. 150 and p. 153, ln. 5 – 10 and HNG Ex. 11, Rebuttal Testimony of Charles E. Loy, p. 6, ln. 18-21

²⁵³ Tr., Vol. 3 p. 150, ln. 18 through p. 151, ln. 1 – 13

Conversely, company witness, Mr. Loy, also testified that by shortening HNG's billing cycle approximately 22 days, the AMRs have reduced the company's cash working capital allowance and also improves the company's chances of actually realizing a zero cash working capital.²⁵⁴ Thus, it may be appropriate to remove the approximate \$23,000 in cash working capital and reduce the corresponding revenue requirement.²⁵⁵ HNG argues, however, that if the cash working capital allowance is eliminated in this docket, then it is reasonable to include the entirety of the purchase and installation costs of the AMR devices in rate base.²⁵⁶

On the other hand, Mr. Nalepa testified that the company's cash working capital allowance should be completely eliminated because HNG failed to do a lead-lag study.²⁵⁷ Mr. Nalepa testified further that the one-eighth rule often used by the Commission in the absence of a lead lag study is not reasonable in this case because the company used affiliates to provide the majority of the utility's gas supply, gas transportation, and construction services. According to Mr. Nalepa, unlike companies without affiliates, HNG's use of affiliates to provide most services keeps HNG in control of the company's cash working capital. Moreover, Mr. Nalepa testified that the utility's \$23,000 cash working capital figure is simply a derived number without a basis. He stated that this figure is not necessarily a right or a wrong number; Thus, he believes it is not appropriate for use in the company's schedules and should be disallowed.²⁵⁸

(5) Examiners' Findings and Recommendations

The Examiners' find that HNG has not met its burden of proof on the issues of including the entirety of the AMR costs in rate base, or allowing the approximately \$23,000 in rate base for cash working capital. While HNG did demonstrate that the devices are used and useful, the utility failed to show that the entirety of the AMR investment is just and reasonable or prudent.

The Examiners were persuaded by the City's evidence particularly Mr. Nalepa's economic analysis, which included the net present value of the AMR investment back to the time

²⁵⁴ HNG Ex. 11, Rebuttal Testimony of Charles E. Loy, p. 7, ln. 9-13

²⁵⁵ Vol. 3 p. 152, ln. 16 – 21

²⁵⁶ HNG Ex. 11, Rebuttal Testimony of Charles E. Loy, pp. 6 – 7, ln. 12-13

²⁵⁷ City of Magnolia Ex. 1, Direct Testimony of Karl J. Nalepa, pp. 5 and 23

²⁵⁸ Tr., Vol. 2, p. 198, ln. 10 - 15

it was placed in service, showing excess costs to utility customers for existing meter reading by installing the AMRs.²⁵⁹ What is more, the concept of affiliate Pinehurst earning a profit on the installation and then HNG turning around and obtaining a return on the same profit by including the total amount in rate base is symptomatic of the inherent issues surrounding the utility's affiliates. The Examiners also recommend a finding that the utility's costs associated with this investment are not consistent a prudent utility investor.

Furthermore, the Examiners recommend disallowing the approximately \$23,000 for the cash working capital amount from the one-eighth rule because of the absence of a lead-lag study. The utility failed to meet its burden of proof to demonstrate that all of the rate base calculations were credible, thus it is improper to calculate a one-eighth rule from them.

The Examiners recommend adopting the City's position on these issues by calculating a rate base amount for the AMR devices such that the revenue requirement for the investment, return, taxes, and operation and maintenance would be no higher than the costs customers would have incurred prior to the installation of the meters. This adjustment is dependent, in part, upon the rate of return to be earned on the investment made. Based on the company's proposed return the adjustment would be \$24,633. Given the recommended return, addressed below in Section 10, the adjustment would be \$7,863.

c. Rate Base Adjustments Related to Affiliate Transactions

One adjustment is recommended to rate base as a result of affiliate transaction issues related to Pinehurst. That issue is addressed in Section 8E, above.

10. Rate of Return

a. Introduction

As part of this proceeding, the Commission must determine a reasonable rate of return for HNG. In establishing a gas utility's rates, the regulatory authority shall set the utility's overall revenues at an amount that will permit the utility an opportunity to earn a reasonable return on

²⁵⁹ City of Magnolia Ex. No. 33

the utility's invested capital used and useful in providing service to the public in excess of its reasonable and necessary operating expenses. The regulatory authority may not establish a rate that yields more than a fair return on the adjusted value of the invested capital used and useful in providing service to the public.

As noted by the Austin Court of Appeals in *Railroad Commission of Texas v. Lone Star Gas Company*, to achieve the rate of return that a utility should be allowed to earn, the regulatory agency should consider the cost to the utility of its capital expressed as follows: (1) interest on long-term debt; (2) dividends on preferred stock; and (3) earnings on common stock.²⁶⁰ As stated by the United States Supreme Court, the annual rate that will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment:

A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties The return should be reasonably sufficient to assure confidence in the financial soundness of the utility, and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time, and become too high or too low by changes affecting opportunities for investment, the money market, and business conditions generally.²⁶¹

The overall rate of return is the sum of a weighted cost of debt and return for equity. Regulated utilities have several sources of capital with which to finance their utility assets: issuance of common stock and preferred stock, long-term debt, and common equity. Sometimes preferred stock and short term debt is included as a component for a calculation of the combined return. In this case, three components are at issue: Capital Structure, Cost of Debt, and Cost of Common Equity.

²⁶⁰ *Railroad Commission of Texas v. Lone Star Gas Company*, 599 S.W.2d 659 (Tex. App. – Austin 1980).

HNG and Staff of the Railroad Commission both presented witnesses on issues related to the appropriate rate of return. The parties to this proceeding propose the following overall rates of return: HNG Direct Case – 11.8%; HNG Rebuttal Case – 11.4%; Railroad Commission of Texas Staff – 8.66%; The City of Magnolia concurs with Staff.

b. Capital Structure

(1) Introduction

Capital structure is an important aspect in a rate case because it influences the overall cost of capital through the proportions of equity and debt capital. A utility's capital structure is comprised of the ratios of the utility's various sources of capital to total permanent capital.²⁶² HNG proposes a capital structure composed of 10.1% long-term debt and 89.9% common equity.²⁶³ In its rebuttal case, the company proposes an alternative capital structure based on a group of proxy companies of 40% long-term debt and 60% common equity.²⁶⁴ Conversely, Staff advocates for a hypothetical capital structure based on a group of different proxy companies averaging 44.5% long-term debt and 55.5% common equity.²⁶⁵ Similarly, the City of Magnolia argues that Staff's capital structure should be adopted by the Commission.

(2) HNG's Position

Gregory E. Scheig, CPA/ABV/CFF/CFA, testified on behalf of HNG. It is the utility's position that the company's actual capital structure is appropriate for use in this case to calculate the overall rate of return. The capital structure is reported on HNG's balance sheet with the test year ending March 31, 2011. The capital structure is comprised of long-term debt in the amount of \$897,262, or 10.1% and common equity of \$7,968,940, or 89.9% for a total capital of \$8,866,203.²⁶⁶ This capital structure does not include short-term debt.

²⁶¹ *Bluefield Water Works and Improvements Co. v. Public Serv. Comm'n of West Virginia*, 262 U.S. 679 (1923), see also, *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1942).

²⁶² Gas Services Division, Natural Gas Rate Review Handbook, Railroad Commission of Texas, May 2010, p. 23

²⁶³ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, Schedules A.1 and I.2

²⁶⁴ HNG Ex. 8, Rebuttal Testimony of Gregory E. Scheig, pp. 4 and 20 and Schedule A.1

²⁶⁵ Staff Ex. 1, Direct Testimony of Frank M. Tomicek, p. 8, ln. 7-8

²⁶⁶ HNG Ex. 3, Schedule I.2

Mr. Scheig testified total assets on the balance sheet show \$9,389,616, total liabilities of \$1,420,676, and total shareholders' equity of \$7,968,940.²⁶⁷

During this timeframe, HNG's current assets are reported as \$624,746, or 6.7% of total assets. The company's net fixed assets totaled \$8,764,869, or 93.3% of total assets.²⁶⁸ Whereas, current liabilities consisted of \$523,414 in accounts payable, accrued expenses and other current liabilities, or 5.6% total assets.²⁶⁹

(3) Issues Raised by Staff

Staff's witness, Frank M. Tomicek, Utility Specialist, Market Oversight Section of the Gas Services Division of the Railroad Commission of Texas, testified that the HNG distribution company servicing approximately 3,500 customers does not have publicly traded stock.²⁷⁰ HNG is a wholly-owned subsidiary of Hughes Gas Resources, Inc., (HGR), which is also privately owned and the holder of HNG's debt. Mr. Tomicek testified that this type of parent and subsidiary relationship is not comparable to the gas distribution utility segment that is publicly traded and results in an unnatural capital structure that is contrary to the ratemaking principles of applying market-based financial parameters in determining a utility's rate of return.²⁷¹

One of Staff's concerns is that HNG's proposed 90% equity ratio is abnormally high and inconsistent with recent contested rate cases. Staff notes that the capital structure proposed by HNG would give undue weight to the return on equity component in the weighted average cost of capital (WACC), resulting in an inflated rate of return in comparison to other LDCs, which is contrary to ratemaking principles that require rates to be fair and sufficient to ensure safe and reliable service and avoid ratepayers paying unnecessarily high rates.²⁷²

²⁶⁷ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 18, ln. 16 - 17 and Schedule I.2, ln. 20

²⁶⁸ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 19, ln. 1 - 2 and Schedule I.2

²⁶⁹ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 19, ln. 3 - 6 and Schedule I.2

²⁷⁰ Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 5, ln. 8 - 10

²⁷¹ Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 9, ln. 1 - 6 and Tr. Vol. 1, p. 95, ln. 11 - 12

²⁷² Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 8, ln. 10 - 22

Given that the capital structure that HNG proposes is significantly outside of the industry range, Staff argues that the use of a grouping of comparable, or proxy, companies, is appropriate. Typically in ratemaking when market data for a specific company is unknown, cannot be estimated with accuracy, or in contravention with equity valuation methods, proxy companies are a useful methodology for determining baseline estimates of financial performance for utility sector companies.²⁷³ Moreover, it is Staff's position that the Commission's Gas Utility Section's Rate Review Handbook provides for the use of a proxy group average capital structure be implemented in these circumstances to determine a reasonable rate of return.²⁷⁴

Mr. Tomicek testified that consistent with the principle in rate making that a utility should be allowed the opportunity to earn a rate of return commensurate with other businesses of comparable risk, Staff has employed a grouping of proxy companies for its recommendation related to rate of return. The proxy group is comprised of natural gas utility companies that are primarily engaged in gas distribution operations, receive investment analyst coverage, and exhibit stable investment grade credit ratings.²⁷⁵

Staff's proxy companies are listed in the table below:

TABLE NO. 10.1
Composition of Staff Proxy Group²⁷⁶

<u>Company</u>	<u>Ticker Symbol</u>
AGL Resources	AGL
Atmos Energy Inc.	ATO
Laclede natural Gas	LG
Northwest Natural Gas	NWN
Piedmont natural Gas	PNY
South Jersey Industries	SJI
Southwest Gas	SWX
WGL Holdings Inc.	WGL

²⁷³ Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 6, ln. 8 – 17

²⁷⁴ Gas Services Division, Natural Gas Rate Review Handbook, Railroad Commission of Texas, May 2010, pp. 22-23, 24 & 29

²⁷⁵ Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 6, ln. 11 – 17 and Schedule FMT - 1

²⁷⁶ Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 7 and Schedule FMT - 1

Staff bases its recommended capital structure on the average of actual capital structures reported by the grouping of proxy utility companies and reported in their form 10-K filings for the most recent year period of 2010.²⁷⁷ Among these gas distribution utility companies, the average industry capital structure is 44.49% long-term debt and 55.51% common equity, with the highest equity ratio being 62.66% among these companies.²⁷⁸ Thus, Staff has rounded this average and proposes a capital structure of 44.5% long-term debt and 55.5% common equity be adopted for HNG. This recommended capital structure reflects the trend toward stronger equity ratios among LDCs in recent years and is consistent with a range of capital structures approved by the Commission in recent rate cases.²⁷⁹

(4) Issues Raised by the City of Magnolia

It is the City's position that the only credible evidence presented in this case is from Staff and thus, Staff's proposed 55.5% equity ratio and 44.5% debt ratio should be adopted. The City maintains that HNG's proposed "actual" capital structure is not supported by the evidence and that the company has a much lower equity ratio. The City points out that equity growth comes from either equity infusions of cash or assets, or the company's retained earnings.²⁸⁰ Since HNG is a wholly-owned subsidiary of HGR, which is also privately owned by Mr. Provencher and Mr. Hicks, then HGR provides all of the cash equity infusions into HNG.

First, the City believes that Mr. Scheig's testimony related to the company's capital structure is unreliable because he used only the numbers given to him by HNG's officers as the basis of his work. Mr. Scheig never performed an audit or complete analysis of the company's books and records.²⁸¹ As an example, Mr. Scheig was unable to answer questions related to the company's equity growth from \$3,010,863 in the last rate case in December 2006 to \$7,968,940 in the test year ending in March 2011.²⁸² Additionally, Mr. Scheig was unaware of the source of

²⁷⁷ Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 9, ln. 10 – 12 and FMT-1

²⁷⁸ Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 7, ln. 1 – 5

²⁷⁹ Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 9, ln. 13 – 18 and FMT-7

²⁸⁰ Tr. Vol. 1, p. 32, ln. 8 - 16

²⁸¹ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 28, ln. 5 - 10 and p. 34, ln. 5 - 15

²⁸² HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 30, ln. 12 - 13

an increase in capital structure in the amount of \$1,352,289 in the last three months of the test year.²⁸³

More specifically related to the issue surrounding the company's growth in capital structure of \$3,010,863 in 2006 to \$7,968,940 in March 2011, the City maintains that conflicting evidence presented to support the annual common stock changes discredits the company's value of equity. The incompatible evidence referenced by the City includes two documents that demonstrate different capital additions of equity of HNG for the same time periods, as follows:²⁸⁴

TABLE 10.2

	City <u>Exhibit 15</u>	City <u>Exhibit 12</u>
2007	\$1,412,853	\$ 708,069
2008	\$1,335,120	\$1,335,120
2009	\$ 170,000	\$ 0
2010	\$ 0	\$ 0
2011 YTD	\$ 0	\$1,352,289

It is the City's position that these exhibits show that HNG's books and records are not accurate and yet their cost of capital expert relied upon these numbers.²⁸⁵ Since Mr. Scheig testified that he did not perform an independent investigation as to their accuracy, the City argues that the only credible evidence in the record comes from Staff. Moreover, Mr. Scheig was unable to provide clarity as to these discrepancies.²⁸⁶

The City also questioned, Mr. Provencher in regard to the company's stated equity infusions. In regard to the 2007 amounts, Mr. Provencher testified that parent company, HGR, provided a cash infusion of \$708,000 and the remainder of the \$1,412,000 was an infusion of an

²⁸³ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 33, ln. 6 - 7 and p. 57, ln. 2 - 15

²⁸⁴ City Ex. No. 12 (HNG Year-end equity amounts for Annual Reports and HNG Ex. 3, Direct Testimony of Gregory E. Scheig Schedule I.2) and City Ex. No. 15 (Response of HNG to Magnolia's 3rd RFI, dated 07/25/11, response date 08/04/11)

²⁸⁵ Tr. Vol. 1, p. 26, ln. 6 - 13 and pp. 27 - 28

²⁸⁶ Tr. Vol. 1, pp. 30 - 36

affiliate facility. But, Mr. Provencher doesn't recall what affiliate or facility.²⁸⁷ The City maintains that in 2007 HNG only had two affiliates, Pinehurst and Decker, and thus this response by the President of the company lacks credibility. Furthermore, the City asserts that neither of the two different equity infusion values presented by HNG, \$1,412,853 from the RFI or \$708,069 from the Annual Reports, are supported by the evidence.

Next, in 2008, there is no discrepancy in the amount of equity infusion. Mr. Provencher testified that the \$1,335,120 was an equity infusion from parent company, HGR.²⁸⁸ The City points out that there is no explanation as to why such an equity infusion was necessary in 2008 given that the retained earnings of the company at that time were \$781,668.²⁸⁹ Likewise, the City does not challenge the retained earnings amounts of \$1,842,623 at test year end of March 31, 2011, which the City believes demonstrates healthy annual earnings of profits under the existing rates.²⁹⁰

Mr. Provencher testified that there was no change in common stock equity value during 2009 to 2010.²⁹¹ On the other hand, in the three months between January 2011 and March 31, 2011, the common stock equity growth of owner's equity increased by \$1,352,289.²⁹²

Mr. Provencher testified that this amount reflects the Cap-Gas acquisition from 2008 that has been added to the Annual Report in 2011.²⁹³ The City is concerned with the company's position on this issue because the amount of \$1,352,289 is inconsistent with any number calculated by Mr. Loy as the Cap-Gas acquisition.²⁹⁴ Also, Mr. Provencher testified that the acquisition was made for \$550,000, with a \$150,000 cash payment from HGR and a \$400,000 loan debt payment.²⁹⁵ The City argues that Mr. Provencher disregards the fact that the acquisition was made with only \$150,000 equity and instead includes the entire alleged acquisition value as equity.

²⁸⁷ Tr. Vol. 2, p. 30, ln. 15 - 25 and p. 31, ln. 1 - 17

²⁸⁸ Tr. Vol. 2, p. 31, ln. 20 through p. 32, ln. 13

²⁸⁹ City Ex. No. 12

²⁹⁰ City Ex. No. 12

²⁹¹ Tr. Vol. 2 p. 32, ln. 14-18

²⁹² City Ex. No. 15

²⁹³ Tr. Vol. 2, p. 33, ln. 6 - 12

²⁹⁴ HNG Exs. 11 (Loy Rebuttal at Schedule CEL-R-4) and 13 (Schedule B-3, GDS Trending Analysis at 12 of 42)

According to the City's assertions, the claimed equity infusion of \$1,352,289 included in the last three months of the test year is based on a trending estimate, not the actual value, and is approximately two and one half times larger than the \$550,000 acquisition price. It is the City's position that the trending estimate is not common stock equity and the company should not be allowed to include this in the calculations for rate of return.

Finally, the City argues that at best HNG's proposed equity ratio is hypothetical and at worst it is pure guess. The City asserts that the only capital structure supported by evidence is the 44.5% debt and 55.5% equity capital structure proposed by Mr. Tomicek, which is supported by industry averages.²⁹⁶

(5) HNG's Response

HNG argues that Staff's proposed capital structure suffers from infirmities especially that Mr. Tomicek's analysis fails to account for HNG's small size. In other words, HNG has a problem with the lack of adjustment given for the size of companies within the proxy group. The company argues that its actual capital structure should be utilized in this case. Alternatively, if the Commission decides that a hypothetical capital structure is appropriate in this docket, then HNG proposes a 60% equity and 40% debt structure. Mr. Scheig testified that the 60/40 structure is in the range to Mr. Tomicek's proposal but is closer to HNG's actual capital structure.²⁹⁷

(6) Examiners' Findings and Recommendations

The Examiners' find that the company has not met its burden of proof to establish the ratio of common debt and equity should be set at 90% equity and 10% debt. The Examiners were persuaded by Staff's arguments that the parent/subsidiary relationship between HNG and HGR, with the parent holding the subsidiary's debt, results in the utility's capital structure being atypical and unrepresentative of typical gas LDCs. This conclusion is so especially, in light of

²⁹⁵ City Ex. No. 18 and Tr. Vol. 2, p. 37, ln. 1 - 14

²⁹⁶ Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 9, ln. 8 - 18

²⁹⁷ HNG Ex. 8, Rebuttal Testimony of Gregory E. Scheig, p. 4

the fact that neither the company's debt nor equity is publicly traded. Furthermore, the capital structure proposed by HNG deviates significantly from the capital structure of its affiliate: 40% debt and 60% equity.²⁹⁸

Moreover, the Examiners find that HNG failed to meet its burden of proof to demonstrate an alleged equity infusion of \$1,352,289 between January 2011 and March 2011 was just and reasonable. Mr. Scheig was unable to explain the source of such equity infusion. Mr. Provencher's explanation that the source was the CapGas acquisition approximately three years earlier was contrary to other testimony regarding the alleged purchase price of this acquisition.

In accordance with ratemaking principles that apply market-based financial parameters and proxy company comparisons to avoid a utility's atypical capital structure from allowing undue weight to the return on equity component in the weighted average cost of capital, the Examiners find that the evidence supports Staff's analysis and recommendation, and the City's position, for a capital structure of 44.5% long-term debt and 55.5% common equity and that this capital structure is just and reasonable. This conclusion is consistent with a Commission decision²⁹⁹ adopting a comparable capital structure of 51.9% debt and 48.1% equity because the company's capital structure was not accurate or reasonable.

The Examiners note that in HNG's last rate case, GUD No. 9731, the capital structure was 100% common equity and 0% debt. No parties intervened in GUD No. 9731 and the proposal for decision does not reference any rate payer protests. On the other hand, the instant docket has drawn voluminous protest letters by rate payers and multiple intervenors. Furthermore, factual distinctions have arisen since the company's last rate. When the last docket concluded in late 2007, HNG serviced approximately 43 commercial and 140 residential customers in the City of Magnolia and 18 commercial and 1,661 residential environs. Even though the utility started operations in approximately 1996, employees were not hired until January 2007, the year of the rate case, with one full-time and one part time employee.

²⁹⁸ HNG Ex. 6, Direct Testimony of Real Provencher, p. 85

²⁹⁹ Docket No. 9670 (and consolidated cases) *Petition for De Novo Review of the Reduction of the Gas Utility Rates of Atmos Energy Corp., Mid-Tex Division, by the Cities of Blue Ridge, Caddo Mills, et al.; Atmos Energy Corporation Statement of Intent to Change Rates in the Atmos Energy Corp., Mid-Tex Division Gas Utility System; and Petition for Review from the Actions of Municipalities Denying Rate Request*

In the last rate case, a substantial part of the case was allocating expenses from Hughes Propane to HNG, which was an affiliate providing services to HNG. The reason that capital structure was approved cannot be gleaned from the record in that case. At the time of the last rate proceeding, however, HNG began its conversation from an entity almost entirely supported by the affiliate, to a semi-independent functioning utility which may have required the larger equity infusion reflected by the approved capital structure.

Now, not only the company's size but structure is significantly different. HNG has hired and trained employees to complete tasks formerly performed by Hughes Propane. The utility now serves approximately 3,309 environs customers and approximately 193 customers in the City of Magnolia. HNG is requesting an annual rate increase of \$1,064,707 while serving approximately 3,502 customers representing an average of \$304 per year for each customer and an approximately 58% increase above current base rate revenues of \$1,830,969. These changes have produced further scrutiny of the company's proposals.

c. Cost of Debt

(1) Introduction

Contrary to most cases, the cost of debt is at issue in this proceeding. Generally, the cost of debt is not the subject of much debate because it is based upon known, measurable factors such as the cost of borrowing instruments that are easily identifiable. The company's books should clearly display the cost of debt. The proper cost of debt is the embedded cost of debt with adjustments made for current maturities.³⁰⁰

(2) HNG's Position

In Mr. Scheig's direct testimony he states that HNG's actual cost of debt at 6.5% should be utilized in arriving at the company's cost of debt. Mr. Scheig testified that HNG's debt on the

³⁰⁰ Gas Services Division, Natural Gas Rate Review Handbook, Railroad Commission of Texas, May 2010, p. 24

balance sheet is from a loan by their parent corporation at a weighted average rate of 6.5% and is an affiliate transaction.³⁰¹ The loan is also in the form of a five-year interest only loan with a balloon payment due at the end. Mr. Scheig maintains that the loan may need to be refinanced before the company's next rate proceeding. Because the loan is from an affiliate and not a market based interest rate, he has estimated a market-based interest rate for the debt to test the reasonableness of using the company's actual cost of debt.³⁰²

Mr. Scheig based his analysis on a review of market debt costs and interest rate spreads between different observable market indices as of April 11, 2011. At that time, Long-Term Treasuries yielded 4.45%, Moody's Aaa Corporate Bonds yielded 5.16% and Baa Corporate bonds yielded 5.98%. According to Mr. Scheig, these yields result in a spread between Aaa and Baa corporate debt of 0.82%, which shows the yield difference between the highest and lowest investment-grade bonds.³⁰³

In addition, Mr. Scheig asserts that he examined the yield and spread data from the *Wall Street Journal's Market Data* as of April 26, 2011, which showed a spread between Aa and Baa debt of 0.75%. He testified that he also observed that the Merrill Lynch Index High Yield 100 Index had a spread above Baa corporate debt rates of 2.58%.³⁰⁴

From this data, Mr. Scheig estimated the cost of debt for HNG by applying a premium of 1.29% for the small size of HNG. He testified that the utility's size makes it difficult to attract debt capital.³⁰⁵ Thus, the 1.29% premium is added to the Moody's Baa utility bond yield of 5.97%, which results in a cost of debt for the company of 7.25%.³⁰⁶ Mr. Scheig concludes that the proper cost of debt in this proceeding is HNG's actual cost of debt to its parent company's at a rate of 6.5%.³⁰⁷

³⁰¹ HNG Ex. 3, Schedule G.2

³⁰² HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 31, ln. 6 - 11

³⁰³ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 31, ln. 13 - 18

³⁰⁴ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 32, ln. 1 - 4

³⁰⁵ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 32, ln. 7 - 15

³⁰⁶ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 32, ln. 14 - 16

³⁰⁷ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 32, ln. 17 - 18

(3) Staff's Position

According to Mr. Tomicek, the 6.5% cost of debt proposed by HNG is the company's actual incurred debt financing from parent company Hughes Gas Resources. Mr. Tomicek testified that the actual cost of debt is used whenever it is reasonable to do so. He added that an unreasonable cost of debt would be where the methodology was bringing in a result too high or too low within the range of capital structures. According to Mr. Tomicek, the actual cost of debt for HNG is within the range of other recent prior rate cases before the Commission. The following table, Table 10.3, demonstrates Commission approved cost of debt in dockets since 2007:

Table 10.3
Approved Actual Costs of Debt in
Commission Dockets Since 2007³⁰⁸

Docket	Actual Approved Cost of Debt
9670	5.96%
9713	7.23%
9762	6.10%
9791	7.24%
9810	7.65%
9837	7.50%
9839	6.22%
9869	6.88%
9902	6.33%
9951	8.50%
9988	6.21%
10038	7.13%
10041	6.87%
Average	6.91%
Cost of Debt	

Mr. Tomicek testified that since the company's actual cost of debt figures are available, accurate, and reasonable, and then they should be relied upon.³⁰⁹

³⁰⁸ Railroad Commission Staff Ex. 1, from Schedule FMT-7

The City of Magnolia also agrees with Staff on this issue that the utility's cost of debt of 6.5% is proper in this docket.

(4) HNG's Response

The controversy over an alternate cost of debt is limited to application of the issue of the company's proposed alternative capital structure of 60% common equity and 40% debt. In his rebuttal case, Mr. Scheig testified that if you depart from the company's actual capital structure to a more leveraged hypothetical capital structure, then it is appropriate to use a higher cost of debt. He explains that more highly leveraged companies have a higher percentage chance of default and thus, financial markets assign a higher cost of debt.³¹⁰ Mr. Scheig believes that 8.55% is the correct cost of debt using his alternative hypothetical capital structure of 60% equity and 40% debt.³¹¹

(5) Examiners' Findings and Recommendation

The Examiners find that the evidence supports that HNG's actual cost of debt of 6.5% is just and reasonable and recommend that it be approved.

While it may be typical in financial theory that increased levels of debt financing result in higher costs of debt, the context of this case is distinct from the general market place as a regulated utility ratemaking process. The company has not met its burden of proof in this case to demonstrate that Mr. Scheig's recalculated cost of debt estimate of 8.55% is within the actual LDCs industry average debt costs or the company's own actual debt cost. On the other hand, the company's actual cost of debt is above the mean of the Moody's utility bond yields for the recent five-year period referenced by Mr. Scheig and is consistent with the range observed in Mr. Tomicek's testimony. Therefore, the Examiners find that the evidence supports that HNG's actual cost of debt of 6.5% is just and reasonable and recommend that it be approved.

³⁰⁹ Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 10, lns. 1 – 5

³¹⁰ HNG Ex. 8, Rebuttal Testimony of Gregory E. Scheig, p. 5 and Schedule A.5

³¹¹ HNG Ex. 8, Rebuttal Testimony of Gregory E. Scheig, p. 5 and Schedule A.5

Furthermore, the Commission lacks the authority to approve the inflated alternative cost of debt proposed by Mr. Scheig. As conceded by Mr. Scheig, the loan is from an affiliate. Section 104.055 provides that in establishing a gas utility's payment to an affiliate for an interest expense a specific finding must be included that the price to the gas utility is not higher than the prices charged by the supplying affiliate to its other affiliates. The interest rate charged by Hughes Gas Resources to HNG's affiliate, Alamo is 7.00%.³¹² The proposed alternative rate is 8.55%. Therefore, the Commission is without statutory authority to approve that rate.

d. *Return on Equity*

(1) Introduction

Equity investors expect a return on their capital commensurate with the risks they take and consistent with returns that might be available from other similar investments. These regulatory principles were established in the U.S. Supreme Court cases, *Bluefield Gasworks* and *Hope Natural Gas*:

A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures.³¹³

In a Texas Supreme Court case, it was decided that "the rate of return must be high enough to attract ample capital but need not be beyond that [amount]."³¹⁴

³¹² HNG Ex. 6, Rebuttal Testimony of Real Provencher, p. 85

³¹³ *Bluefield Gasworks & Improvement Company v. Public Service Commission of West Virginia*, 262 U.S. 679, 692-693 (1923)

³¹⁴ *Railroad Commission v. Houston Natural Gas Corporation*, 289 S.W.2d 559 (Tex. 1956), *Southwestern Bell Telephone Company v. Public Utility Commission*, 571 S.W.2d 203 (Tex. 1978)

(2) Overview of Cost of Equity Proposals

Unlike returns from debt and preferred stocks, the equity return is not directly observable in advance and therefore, it must be estimated or inferred from capital market data and trading activity. Estimating the cost of equity is fundamentally a matter of informed judgment.³¹⁵ Each witness proposed a different cost of equity estimate even though the base equity return calculated by the two witnesses is fairly close. Mr. Scheig calculated a base equity return range of 9.52% - 10.56%.³¹⁶ Mr. Tomicek calculated a base return on equity estimate of 9.6%³¹⁷ Next, both witnesses made upward adjustments to their respective equity return base estimates to calculate their final cost of equity recommendation.

Table No. 10.3 below summarizes the relative positions of the parties, after adjustments, related to return on equity in this proceeding:

Table 10.3
ROE Proposals by HNG and Intervenors

City of Magnolia	RRC Staff	HNG Rebuttal Case	HNG Direct Case
10.05%	10.4%	13.3%	12.4%

The parties controvert each other's methodologies for their respective return on equity recommendations. Mr. Scheig utilized the following four pricing models to determine his proposed return on equity: Capital Asset Pricing Model (CAPM), Constant Growth and Non-Constant Growth Discounted Cash Flow (DCF) Models, Risk Premium Analysis, and Comparable Earnings Model.³¹⁸ Whereas, Mr. Tomicek limited his analysis to the DCF and CAPM methods.³¹⁹ Mr. Tomicek testified that in the past, the Commission has accepted primarily the DCF and CAPM methodologies to support the cost of equity and the other

³¹⁵ Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 24, ln. 10 – 15

³¹⁶ HNG Ex. 3, Schedule A.3. ln. 21

³¹⁷ Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 18, ln. 8 – 9

³¹⁸ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 3, ln. 7 - 9

³¹⁹ Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 26, ln. 7- 9

methodologies have been only secondary mechanisms.³²⁰ Moreover, Mr. Tomicek points out that the DCF takes precedence as a method with the FERC.³²¹

(3) Proxy Companies

Both HNG and Staff used a group of comparable, proxy, companies to perform their DCF and CAPM analysis. Staff utilized the same grouping of natural gas distribution companies as previously noted in Table 10.1. Company witness, Mr. Scheig, testified that since there was no market data available for HNG, then he also utilized a group of proxy companies to analyze HNG. HNG's 12 proxy companies were the same companies used by Staff with the addition of the following four companies: Nicor Inc., NiSource, Inc., New Jersey Resources, and UGI Corporation.³²²

(4) DCF Analysis

(A) Introduction

The Discounted Cash Flow or DCF is a widely used method to analyze the cost of common equity. The DCF attempts to quantify a market-based value of common equity based on the present value of a stream of returns. The DCF is expressed in a formula as:

$$K = D/P + g$$

Where: K = cost of common equity

D = dividend per share

P = price per share

G = rate of growth of dividends, or, common stock earnings.

³²⁰ Tr. Vol. 1, p. 100, ln. 12 - 24

³²¹ Tr. Vol. 1, p. 100, ln. 21 - 24 ³²¹ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 3, ln. 7 - 9

³²¹ Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 26, ln. 7- 9

³²¹ Tr. Vol. 1, p. 100, ln. 12 - 24

³²¹ Tr. Vol. 1, p. 100, ln. 21 - 24

³²² Tr. Vol. 1, p. 37, ln. 1 - 18 and HNG Ex. 3 Schedule B-1

While the formula may appear to be relatively straightforward, the variables are, of course, subject to interpretation and the subject of debate.³²³

(B) DCF Evaluation

In his direct testimony, Mr. Scheig applied the DCF models to a group of guideline gas companies covered by Value Line. He presented both constant and non-constant growth forms of the DCF model.³²⁴ In the constant growth analysis, Mr. Scheig identified a range for the cost of equity from 8.94% to 9.15%. The non-constant growth models indicate a range of 9.35% to 11.23%.³²⁵

Throughout Mr. Scheig's DCF analysis, he used average stock prices for the month ending March 31, 2011 for each proxy company.³²⁶ The dividend yield for Mr. Scheig's DCF model was based upon the expected upcoming 12 month dividend calculated as the remaining estimate of three quarters of 2011 dividends plus the dividends to be received in the first quarter of 2012 as estimated by Value Line.³²⁷

As for growth rates considered in the DCF analysis, Mr. Scheig testified that he relied upon a combination of growth rates to estimate investors' expectations.³²⁸ For the constant growth models, he considered three groups of analysts' growth rates from (1) Zack's earning growth estimates as of March 31, 2011, (2) Thomsons' Earnings estimates as of March 31, 2011, and (3) Value Line earning growth rates as of January 21, 2011.³²⁹ Mr. Scheig also factored in the expected growth in the Gross Domestic Product (GDP) and the sustainable growth rate (SGR) for each company.³³⁰

³²³ Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 11, ln. 3 – 14

³²⁴ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 14, ln. 10 and Schedules E and F

³²⁵ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 23, ln. 10 - 14 and Schedules E and F

³²⁶ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 22 and Schedules E and F

³²⁷ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 22 and Schedules E and F

³²⁸ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 12, ln. 10 and Schedules E and F

³²⁹ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 23, ln. 10 - 14 and Schedules E and F

³³⁰ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 22 and Schedules E and F

In developing his conclusion, Mr. Scheig excluded rates of return in the schedules that were not within a reasonable range. He defined a reasonable range to be greater than Moody's Baa Utility Bond Index plus 1%, and less than Moody's Baa Utility Bond Index plus 10%.³³¹

On the other hand, Mr. Tomicek utilized an annualized dividend constant growth version of the DCF formula based on earnings growth rates for Staff's proxy companies.³³² Mr. Tomicek testified that for the eight proxy companies, he developed a comparative DCF analysis using the average of a range of 30-day and 90-day share prices for a trading day period ending on July 1, 2011. The results for the average values of share prices for the two observed periods were then divided into the current annualized dividends for the proxy companies to calculate a range of dividend yields which comprise the first part of the DCF calculation.³³³

Mr. Tomicek then added to the dividend yields the mean projected long-term growth in earnings per share as reported by Zack's, Morningstar Inc. and Thompson Reuters to derive the range of cost of equity estimates for the proxy companies.³³⁴ For the 30-day share price data, Staff defined a cost of equity range of 7.46% to 9.65% with a mean value of 8.52% for the proxy distribution companies. In the case of the 90-day share price data, the results showed a cost of equity range of 7.61% to 9.61% with a mean value of 8.57% for the company grouping.³³⁵

Mr. Tomicek takes issue with Mr. Scheig's non-standard growth DCF analysis. Mr. Tomicek asserts that this three, four, and five-year multi-stage DCF model fails to provide detail of "non-standard" growth. The multi-stage DCF model imposes assumptions that are subjective choices and adds greater levels of complexity that require careful consideration. Mr. Tomicek testified that in Mr. Scheig's model, he fails to detail what he has used as his initial, intermediate, and terminal stage growth estimates. Mr. Tomicek believes that a multi-stage model would generate results greatly different from that of a single-stage under market assumptions for a mature and price-regulated gas utility industry.³³⁶

³³¹ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, pp. 22-23 and Schedules E and F

³³² Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 11, ln. 17 – 23

³³³ Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 12, ln. 5 – 10

³³⁴ Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 12, ln. 10 – 19 and Schedules FMT-2 and FMT - 3

³³⁵ Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 14, ln. 15 – 19 and Schedules FMT-2 and FMT - 3

³³⁶ Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 22, ln. 1 – 22

(C) Examiners' Findings and Recommendations

The Examiners find that the DCF ranges identified by Mr. Tomicek in both the 30 day constant growth and 90 day constant growth from 7.65% to 9.35% and 7.56% to 9.29%, respectively are reasonable. Furthermore, the DCF model employed by Mr. Tomicek is consistent with the Gas Utilities Rate Review Handbook and prior Commission decisions. On the contrary, HNG's three, four, and five-year multi-stage DCF model fails to provide detail of "non-standard" growth. The utility's multi-stage DCF model imposes assumptions that are subjective choices and adds greater levels of complexity.

(5) CAPM

(A) Introduction

The parties agree that the Capital Asset Pricing Model (CAPM) is also a reasonable method for measuring the cost of equity. As with the DCF Model the CAPM requires selection of several variables. The CAPM is expressed in a formula as:

$$K = R_f + R_p$$

Where: K = the estimated rate of return of the stock
 R_f = risk free rate of interest
 R_p = risk premium (subject to additional equation).

The CAPM methodology addresses equity valuation from the standpoint of investors that hold equities in a reasonably well-diversified portfolio as the sum of a risk free return plus a risk premium to compensate investors for systemic risks associated with that security. The yields on Treasury bonds are commonly accepted measures of the risk-free asset in the CAPM method.³³⁷

³³⁷ Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 15, ln. 6 – 22

(B) CAPM Analysis

The results of Mr. Scheig's CAPM analysis demonstrate rates of return from 9.09% to 10.27%, prior to the inclusion of a small stock and company specific risk premium.³³⁸ Mr. Scheig's analysis uses the same group of proxy gas utility companies covered by Value Line, considering different sources for beta and market risk premia.³³⁹ Mr. Scheig testified that he used two market risk premia in his calculations. The first is a 6.7% historical market risk premium from Ibbotson Associates SBBI, which reflects large company stock total returns minus long-term government bond income returns for the period 1926 through 2009.³⁴⁰ Secondly, he considered a forward-looking market risk premium that he developed designed to estimate the market's expected rate of return on an equity investment.

This process analyzes the companies in the S&P 500 index that currently pay dividends. Then, a constant growth DCF model for the group is employed, combining these companies' dividend yield and growth rates as forecasted by *Zach's*. The market cap-weighted expected return for the market under this method was 12.62%. From this rate of return, Mr. Scheig subtracted the current 30-year Treasury bond yield to conclude a forward-looking equity risk premium of 8.1%.³⁴¹

According to Mr. Scheig, spreads between classes of debt and equities expand and contract over time requiring a forward risk premium as another method to determine the market risk premium input in the CAPM methodology.³⁴² Mr. Scheig testified that he also uses S&P 500 companies like Microsoft and Ambercrombie and Fitch because they indicate a comparison to the return on long-term treasury stocks to determine the market risk premium input for the CAPM.³⁴³

³³⁸ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 20, ln. 13 - 15 and Schedule B.1 - C.2

³³⁹ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 20, ln. 6 - 8 and Schedule B.1 - C.2

³⁴⁰ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 20, ln. 17 - 19 and Schedule B.1 - C.2

³⁴¹ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 20, ln. 6 - 8 and Schedule B.1 - C.2

³⁴² HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 21, ln. 15 - 20 and Schedule B.1 - C.2

³⁴³ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 21, ln. 11 - 13 and Schedule B.1 - C.2

Alternatively, Staff witness, Mr. Tomicek, takes issue with Mr. Scheig's use of companies in his analysis that are industrials and unregulated companies. Mr. Tomicek argues that these companies do not serve as a similar basis for comparison for a regulated natural gas utility.³⁴⁴ Instead, Mr. Tomicek in his CAPM methodology used a 10-year Treasury bond yield average for a six month period for the months January through June of 2011 and came up with a risk-free rate of 3.33%. In calculating the market risk premium, Staff used the DCF-derived total required return on the S&P 500 of 12.62% that Mr. Scheig has employed and then subtracts the risk free rate of 3.33% to arrive at a forward-looking risk premium of 9.29%.³⁴⁵

Mr. Tomicek testified that his application of the CAPM terms resulted in a cost of equity estimate of 7.72%. When he applied these CAPM terms based on a 10-year Treasury bond average yield for the six-month period added to the product of the mean beta and calculated ex-ante risk premium generates high and low results based on differences in the reported beta values used. Mr. Tomicek testified that the CAPM derived range of values was from 6.77% to 9.55%, with a mean beta value cost of equity estimate of 7.72%.³⁴⁶

(C) Examiners' Findings and Recommendations

The Examiners find that a CAPM methodology premised upon a 10-year Treasury Bond is just and reasonable. The use of analyses including industrials and unregulated companies by HNG is not reasonable and is not consistent with Commission precedent. Accordingly, the Examiners find that a CAPM result of 7.72% is reasonable.

(6) Risk Premium Analysis

The company witness, Mr. Scheig also developed a cost of equity estimate based on a risk premium approach. Risk premium methods rely upon the assumption that equity securities are riskier than debt and therefore, that equity investors require a higher rate of return. Mr. Scheig testified that his analysis compares average returns on equity allowed each year for gas

³⁴⁴ Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, pp. 88 and 110, ln. 1 – 20

³⁴⁵ Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 16, ln. 2 – 13

³⁴⁶ Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 16, ln. 15 – 23 and Schedules FMT-4

utilities by the various state regulatory commissions to long-term utility debt costs.³⁴⁷ Mr. Scheig takes the differences between average authorized returns on equity and debt costs to measure each year's equity risk premium. He built in a nine-month regulatory lag and considered the period ranging from 1990 through 2010. Mr. Scheig testified that he performed a regression analysis of the allowed rates of return on the utility industry interest rates of debt from Moody's Average Utility Bond Index. Then, he applied the regression results to the current cost of Moody's Baa-rated utility debt cost of 5.97% and the company's 6.5% cost of debt. Mr. Scheig concluded with a cost of equity range of 10.22% to 10.52%. He believes this shows that an equity risk premium of 4.02% to 4.25% is appropriate.³⁴⁸

Staff witness, Mr. Tomicek did not utilize a risk premium analysis on utility debt costs because he does not believe that the parameters of this case require it.³⁴⁹ Furthermore, Mr. Tomicek testified that Mr. Scheig's method is of limited value because the results are suspect due to the inability to ascertain the facts and methodology that were used in the underlying cases of these allowed returns. The data also includes equity returns reached through settlement agreements.³⁵⁰

(7) Comparable Earnings Analysis

HNG's witness also used a comparable earnings model to come up with a cost of equity recommendation. This method looks at forecast returns on book equity across similar companies as forecast by Value Line. By taking the forecast earnings per share (EPS) and dividing by the expected book value per share (BVPS), an estimate of the expected return on equity may be derived.³⁵¹ The comparable group of companies had an equity ratio of 57% on book value for the time period of May 2011.³⁵² Mr. Scheig testified that the company's equity ratio is approximately 90% and a firm with higher equity has lower costs of equity. Therefore, he selected the lower point of his range at 9.52% for the cost of equity.³⁵³

³⁴⁷ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 23, ln. 16 -20 and Schedule G.1

³⁴⁸ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 24, ln. 1 - 12 and Schedule G.1

³⁴⁹ Tr. Vol. 1, p. 103, ln. 16 - 24

³⁵⁰ Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, pp. 23 - 24

³⁵¹ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 15, ln. 2 - 4 and Schedule H

³⁵² Tr. Vol. 1, pp. 38 - 41 and HNG Ex. 3 Schedule H

³⁵³ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 26, ln. 1 - 7 and Schedule H

(8) Small Stock Risk Premium Adjustment

Mr. Scheig testified that smaller company stocks have higher risk and expected returns in the market requiring an adjustment to the cost of equity.³⁵⁴ According to Mr. Scheig, each firm's size is estimated by dividing the universe of securities listed, using NYSE/AMEX/NASDAQ from 1926 to present, into portfolios based on their market capitalization and measuring the premium required beyond the risk-free rate and the security's risk factor, Beta. Mr. Scheig's conclusion is that the required small size stock premium increases inversely to firm size and is in addition to the required systematic market risk reflected in the CAPM.³⁵⁵

Analyzing his results, Mr. Scheig concludes that HNG would be eligible for a small stock risk premium of 6.28% to 12.06%. Mr. Scheig, however, applied a lower indicated range from the Low-Cap and Micro-Cap groups of 1.85% to 3.99%.³⁵⁶

Staff's witness, Mr. Tomicek disagrees with the 288 basis points of small stock risk premium applied by Mr. Scheig.³⁵⁷ Mr. Tomicek maintains that this level of adjustment is not warranted and serves to inflate the company's requested rate of return. HNG does not obtain financing through publicly traded stock in capital markets and no common stock for HNG actually exists. Mr. Tomicek believes that since there are no public investors in HNG, then there is no basis to apply a small stock premium. Rather than apply a large adjustment for stock that doesn't exist, Mr. Tomicek testified that Staff has recognized an adjustment for a final return on equity recommendation that is consistent with the capital structure based on companies of commensurate risk to provide a fair and reasonable return on equity consistent with recent Commission decisions.³⁵⁸ Mr. Tomicek testified further that his upward adjustment of 80 basis points is attributable to 35 points for the utility's size and the remaining amount is for the recent conditions of market uncertainty.³⁵⁹

³⁵⁴ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 26, ln. 10 -14 and Schedule G.1

³⁵⁵ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 27, ln. 7 -12 and p. 28

³⁵⁶ HNG Ex. 3, Direct Testimony of Gregory E. Scheig, p. 28 – 29

³⁵⁷ Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 19 and Tr. Vol. 1, p. 109 and HNG Ex. 3 at Schedule A-2

³⁵⁸ Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 21, ln. 3 – 15

³⁵⁹ Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, pp. 68, ln. 10 – 11 and pp. 108 - 109

The City of Magnolia points out that HNG's small size risk premium results in an increase of 2.9% for total cost of equity for HNG, which equates to an approximate additional \$300,000 to HNG customers. The City argues that the evidence presented fails to support the inclusion such premium.³⁶⁰

(9) Economic Conditions

Mr. Tomicek testified that the role of current economic conditions necessarily influences cost of equity. He notes that the U.S. is in a severe recession and the capital market conditions have been abnormally volatile.³⁶¹ Mr. Tomicek believes that utility stocks as a group pay stable dividends and typically exhibit consistent, if not spectacular growth with relative low risk levels as evidenced by their beta values, compared to the aggregate capital market.³⁶² Even so, Mr. Tomicek argues that an upward adjustment of 80 basis points is appropriate due to the market uncertainty that we have seen in recent conditions and the utility's size.³⁶³

The Examiners agree that regulated utilities generally benefit from concerned investors in search of safe havens. The Examiners conclude, however, that substantial evidence was presented that indicated that the current economic environment has adversely affected the utility industry. Thus, it is reasonable to recognize that fact as the Commission determines the appropriate rate of return.

(10) Conclusions on Cost of Equity

In summary, to calculate the cost of equity, HNG employed a Capital Asset Pricing Model (CAPM), two forms of Discounted Cash Flow Model (DCF) – a constant growth DCF and a non-constant growth DCF, a Risk Premium Analysis and a Comparable Earnings Analysis.

³⁶⁰ Tr. Vol. 1, p. 44, ln. 7 - 22 and HNG Ex. 3 Schedule A - 2

³⁶¹ Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 24, ln. 16 - 18

³⁶² Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 25, ln. 3 - 5

³⁶³ Tr. Vol. 1, pp. 108 - 109

The analyses for all of these data ended in March 2011.³⁶⁴ The final range for cost of equity after considering these analysis results in a base cost of equity of 9.52% to 10.56%.³⁶⁵ However, HNG then adds a small stock (small company size) risk premium of approximately 2.9% to arrive at a proposed cost of equity for the company of 12.4%.³⁶⁶ In its rebuttal case, the company proposes a cost of equity of 13.3%.

Staff recommended a return on equity that considers the upper-end results of the DCF and CAPM methods, which result in an overall mean value of 9.6%.³⁶⁷ Next, Mr. Tomicek adds an upwards adjustment of 80 basis points for market uncertainty and utility small size to arrive at a final cost of equity recommendation of 10.4%.³⁶⁸ The City of Magnolia concurs with Staff's position, except that the City argues that the small size adjustment of 35 basis points should be eliminated setting the cost of equity at 10.05%.

The Examiners' find HNG has not established that its proposed return on equity of 12.4% or 13.3% is just and reasonable. Further, the requested cost of equity deviates significantly from the 10.25% return on equity currently earned by Alamo.³⁶⁹ On the other hand, the preponderance of the credible evidence supports Staff's proposed cost of equity of 10.4% as just and reasonable. Staff's proposals are derived from DCF and CAPM methodologies that have been demonstrated in this case to be reasonable and within the range of prior Commission precedent.

e. Overall Weighted Average Cost of Capital

After carefully considering the facts presented and the arguments of the parties in this case, the Examiners find that HNG did not meet its burden of proof to establish its proposed overall rate of return of 11.8% in its direct case or 11.4% in the rebuttal case.

In short, the preponderance of the credible evidence demonstrates that Staff's position merits adopting with one exception. Staff's proposal uses methodologies consistent with

³⁶⁴ Tr. Vol. 1, p. 38 and HNG Ex. 3 Schedule A-3

³⁶⁵ Tr. Vol. 1, pp. 38 - 40 and HNG Ex. 3 p. 30 and Schedule A-3

³⁶⁶ Tr. Vol. 1, pp. 43 - 44 and HNG Ex. 3 Schedule A-2

³⁶⁷ Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 17, ln. 6 - 15

³⁶⁸ Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 18, ln. 8 - 10 and Schedule FMT-6, and Tr. Vol. 1, p. 109

Commission precedent and results in an overall rate of return also in line with past Commission decisions. The Examiners find that the upward adjustment by Staff of 80 basis points is appropriate due to current economic conditions and the size of the utility.

The Examiners, however, were persuaded by the City's arguments that the company failed to demonstrate credible evidence supporting the alleged cash infusion in January 2011 through March 2011, of \$1,352,289. The Examiners recommend that this amount be reduced in the common equity amount. So, the company's proposed \$7,968,940 is reduced to \$6,616,651. The Examiners recommend using the company's actual cost of debt, Staff's proposed capital structure and return on equity for a weighted cost of capital of 8.66%, calculated as follows:

Table 10.4
Examiners Recommended Rate of Return

Capital Component	Amount	% of Total Capitalization	Cost	Weighted Average Cost
Common Equity	\$6,616,651	55.50%	10.4%	5.77%
Long Term Debt	\$ 897,262	44.50%	6.5%	2.89%
Total	\$7,513,913			8.66%

11. **Should an Inquiry into Gas Costs Be Initiated?**

a. *Procedural Background to the Issue of a Gas Cost Inquiry*

On August 5, 2011, Staff filed a *Motion to Sever Gas Cost*. A reply was filed on August 15, 2011, HNG and the City of Magnolia, Inc. filed its *Motion in Support of Staff's Motion to Sever Gas Costs Issues*. Staff filed a *Response to Hughes' Opposition to Staff's Motion to Sever* on August 22, 2011. The Examiners took the motion under advisement for a recommendation on the issue of a severance of gas cost issue and a prudence review for the proposal for decision and final order. The Examiners found that the issue of a severance of gas cost issues and a prudence review should be reserved to the hearing on the merits and the final order.

³⁶⁹ HNG Ex. 6, Rebuttal Testimony of Real Provencher, p. 85

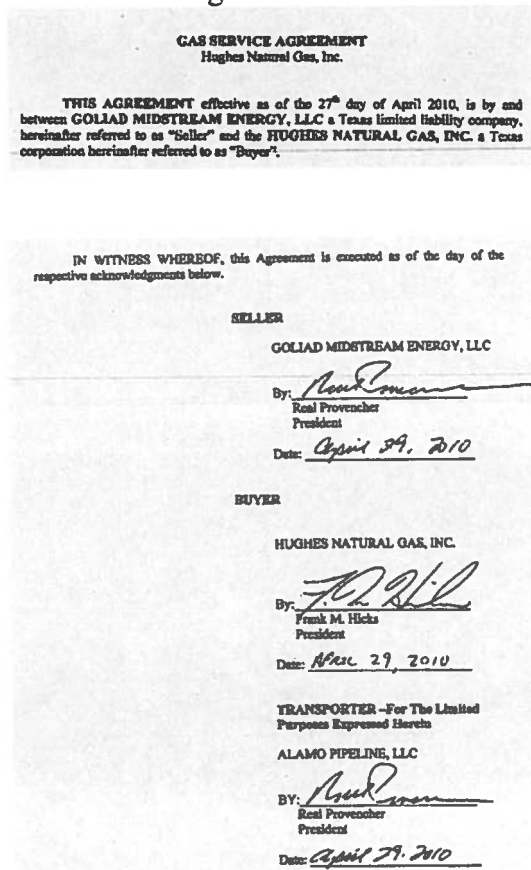
The applicant's filing included an average cost of gas during the test year of \$8.55 per Mcf. The cost of gas is comprised of two components: (1) the cost of gas to be paid to Goliad Midstream Services, Inc. ("Goliad") and (2) the transportation charge of Alamo Pipeline LLC ("Alamo") charged by Alamo to Goliad. The overall cost of gas is an issue that was raised by several customers of HNG who wrote in opposition of the proposed rate increase. Staff and the City of Magnolia appear to contend that the components of this pass through should be considered in a separate proceeding.

The Examiners' decision on taking the motion under advisement was based on four principle rationales. First, the proposed scope of the severed proceeding was not immediately apparent from the filing of the parties. The City of Magnolia appeared to suggest that the scope of the severed proceeding should include a prudence review of the company's past gas costs. The Staff's motion, on the other hand, appeared to contemplate a proceeding limited to the setting of a prospective rate and it did not appear that Staff was requesting that a prudence review be established. Second, HNG contended that the transportation rate of Alamo was set by the Commission and this contention may be relevant to the issue of the scope of the severed proceeding – if such a proceeding is established. Third, the severance of gas costs and the determination that a prudence review should be established is a policy issue that should be addressed by the Railroad Commission in this proceeding as a component of the Final Order. Fourth, severance might have operated to cloud the issue of affiliate expenses as the argument might have been made that certain evidentiary matters should have been evaluated in the severed case. Thus, the ruling was based in part on an effort to avoid further confusion and and conserve judicial resources, the Examiners

b. Factual Background of the Gas Cost Issues

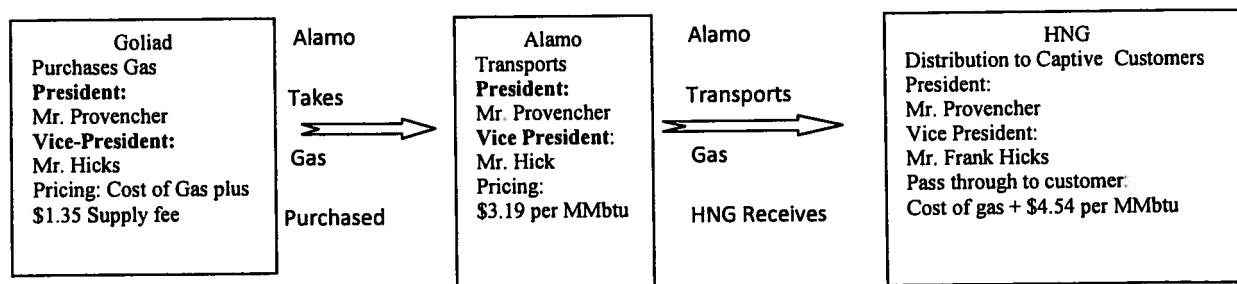
The April 27, 2010, Gas Services Agreement is between Goliad, as Seller, and HNG, as Buyer. As of the date of the hearing, that agreement was still in effect. Alamo, as transporter, executed the contract for the purposes of agreeing to the terms and conditions including the obligation to deliver a firm supply of gas. Figure 11.1 below sets out certain portions of the agreement and the signature page.

Figure 11.1³⁷⁰



The pricing mechanism among the affiliates is set out in the contract. The price per MMBtu based on the "Daily MidPoint" as reported in the "Daily Price Survey of Plats' Gas Daily. Additionally, HNG is required to pay a "Supply Fee" of \$1.35 per MMBtu.³⁷¹ This fee is paid to Goliad. Pursuant to the contract, HNG must also pay the transportation fee of \$3.19 per MMBtu to Alamo.³⁷² Schematically, the pricing and services are summarized below in Figure 11.2

Figure 11.2



³⁷⁰ City of Magnolia Ex. 4, April 27, 2010, Gas Services Agreement between Goliad and Hughes.

³⁷¹ Id.

³⁷² Id.

The gas cost purchases may be broken down further. Presumably, Goliad purchases natural gas from a non-affiliated supplier. The first pricing term is intended to recover that amount. During the test year this appears to have made up \$761,488 of the total gas cost payments made by HNG. This represents approximately 39% of the company's total test year natural gas costs. The contract permits Goliad to add a "Supply Fee." During the test year the supply fee was \$239,127. This is about 12% of HNG's gas cost payments made during the test year. Finally, HNG paid Alamo for natural gas transportation. This amount represents approximately 31% of gas costs payments made during the test year. The result is that approximately 43% of the natural gas cost payments made during the test year went directly to Goliad and Alamo. Table 11.1 below summarizes the percentage attributable paid by HNG to its affiliates broken down by the cost components of the April 27, 2010, Gas Services Agreement.

Table 11.1

		Supply Fee	Percentage of Test-Year Gas Cost
Goliad Cost of Gas Purchased		\$761,488	39%
Goliad Supply Fee		\$239,127	12%
Alamo Transportation		\$565,049	31%

c. Issues Raised by Staff

As to Goliad, Mr. Brock argued that the April 27, 2010, Gas Services Agreement is not an arms-length transaction and is a manifestation of self-dealing by Mr. Provencher and Mr. Hicks.³⁷³ Staff asserted that Goliad has no operating expenses. Neither Mr. Provencher nor Mr. Hicks receive a salary from Goliad and Goliad appears to have no capital assets. Mr. Brock contended that the charge from Goliad to HNG is not just and reasonable. He argued that HNG could purchase gas directly and avoid the added expenses generated by Goliad in the gas supply chain. After all, he argued that either, or both, Mr. Provencher and Mr. Hicks negotiated on

³⁷³ Staff Ex. 7, Direct Testimony of Mark Brock, p. 15, lns. 3 – 16.

behalf of Goliad to acquire a gas supply. They did this as representatives of Goliad. They could just as easily perform the same function as representatives of HNG. That would reduce the overall gas cost. Mr. Brock maintained that any amount added by Goliad above the cost of gas is simply a markup that is not grounded in any cost. He concluded that this required an inquiry into the gas costs. Pending an inquiry, Mr. Brock recommended that the Commission issue an order requiring that HNG cease passing through the markup.

As to Alamo, Mr. Brock referred to the same April 27, 2010 contract and asserted that the agreement is not an arms-length agreement and can be construed as self-dealing. He noted that HNG takes the position that because Alamo charged a rate that is on file with the Commission, that rate is by definition just and reasonable. Mr. Brock disagreed. He contended that because Alamo is controlled by Mr. Provencher and Mr. Hicks, shares offices and other physical assets with HNG the transportation rate is not, by definition, just and reasonable simply because it is on file with the Commission.³⁷⁴ Similar to the arguments raised in the context of Goliad, Mr. Brock argued that all of the functions undertaken by Alamo could be handled by HNG at a lower cost to HNG. The Pinehurst Pipeline system could be operated by HNG. Because all of Alamo's activities are related to providing service to HNG, there is no real difference between Alamo and HNG.

Mr. Brock concluded that a separate inquiry should be initiated to investigate the gas cost charged by Goliad and Alamo to HNG. Pending a conclusion, Staff recommended that the Commission issue an order to preclude the pass through of any gas costs to the customers.

d. Issues Raised by the City of Magnolia

Mr. Nalepa argued that a gas utility may include a purchased gas adjustment clause in its rates to provide for the flow-through of part or all of its gas costs above or below the cost of gas contained in its base rates. He maintained that the Commission has consistently interpreted this to mean that the purchased gas adjustment clause may only include the cost of gas without

³⁷⁴ Staff Ex. 7, Direct Testimony of Mark Brock, p. 19, lns. 1 – 16.

markup by the utility. He maintained that HNG was using the affiliate to do what HNG could not do directly: Mark up the price of gas. He also argued that this expense must pass the affiliate standard test of GURA 104.055(b). He was struck by the lack of arm's length-transactions in the contracts between Goliad, Alamo, and HNG. Those contracts were executed by Frank Hicks and Real Provencher who are partners in HNG, Goliad, and Alamo. Consequently, the protections offered by a competitive arm's-length transaction do not exist.³⁷⁵

Mr. Nalepa had two alternative recommendations. First, that the cost of gas from the affiliate supplier Goliad and the affiliate transporter Alamo be reduced prospectively to reflect only the cost of gas without mark-up or profits. For Goliad, the price of gas should be index plus transportation, without the \$1.35 per MMBtu mark-up. For Alamo, the transportation rate should be \$3.19 per MMBtu less \$1.96 per MMBtu grossed-up return, or \$1.23 per MMBtu. He argued that this amount represented the transportation component of the delivered cost of gas from Goliad.³⁷⁶ Mr. Nalepa's second alternative recommendation is that the proposed revenue requirement be reduced by \$586,304. This represented the test year profit calculation for Goliad and Alamo. The only profit that should be authorized is the approved rate of return applied to the approved rate base.³⁷⁷

e. HNG's Response

As noted above, Mr. Provencher asserted that the affiliates were created to separate regulated and unregulated business activities. If the unregulated services were offered through a regulated utility, it would be difficult to break-out the unregulated profits that do not accrue to the customers of the utility that cannot be credited against the cost of service.

³⁷⁵ City of Magnolia Ex. 1, p. 25, ln. 5 – p. 27, ln. 5.

³⁷⁶ City of Magnolia Ex. 1, p. 27, lns. 7 – 16.

³⁷⁷ City of Magnolia Ex. 1, p. 27, ln. 18 – p. 28, ln. 2.

(1) Alamo

HNG asserted that Alamo complied with the requirements of Rule 7.315 and that the tariff filed pursuant to that rule is the legal rate to be charged by Alamo: \$3.19. Pursuant to 7.315(e), the Commission's Gas Services Division reviews the tariff rate filed by the utility and either accepts or rejects it. Section 7.315(e) provides that in circumstances where the utility has filed a rate "which on its face is not just and reasonable," the Gas Services Division can request a full review of the rate by the Commission under GURA. HNG asserted that after a thorough rate review by the Gas Services Division, Alamo's proposed rate was accepted by the Commission, making it the lawful rate, and the only rates, Alamo may charge pursuant to Section 104.005 of GURA.³⁷⁸

(2) Goliad

HNG conceded that Goliad purchases gas from Kinder Morgan Pipeline for a price of Houston Ship Channel Index plus 15 cents per MMBtu for resale to HNG at Index plus \$1.35 per MMBtu, a markup of \$1.20 per MMBtu.³⁷⁹ HNG asserted that at Index plus \$1.35 per MMBtu, these supplies are the lowest cost gas that HNG has been able to purchase to serve its customers.³⁸⁰ Except for Goliad, all of HNG's suppliers are unaffiliated companies, and their gas cost is more than Index plus \$1.35 per MMBtu. Eagle Rock sells gas to HNG on an interruptible basis for \$1.50 per MMBtu over Index and has offered to sell gas to HNG on a firm basis for \$1.70 per MMBtu over Index (Summer) and \$1.90 per MMBtu over Index (Winter). Thus, all of the prices charged by, and currently being paid to, the non-affiliated suppliers are higher than the rate charged by Goliad.

As to the proposed refund of the mark-up proposed by Staff or the deduction to rates proposed by the City of Magnolia, Ms. Blumenthal contended that the implicit assumption is that HNG would have been able to buy gas from Goliad or some non-affiliated marketer at the index price without any premium whatsoever. She pointed out that no support is offered for this proposition. Additionally, she argued that HNG has satisfied the affiliate transaction standard imposed by Section 104.055(b) with regards to the rates charged by Goliad to HNG.

³⁷⁸ HNG Initial Brief, pp. 13 – 14.

³⁷⁹ Tr. Vol. 1, p. 219 & Tr. Vol. 2, pp. 11 – 12 (Real Provencher).

f. Examiners' Findings and Recommendations

(1) Alamo

The Examiners find that the tariffed rate for Alamo is the appropriate rate to be charged by Alamo. The Commission may initiate an inquiry at any time to analyze those rates and may decide to do so based upon the facts in this case. Although a rate proceeding was not initiated at the time the initial rates were filed, the record in this case established that Alamo filed those rates, the Gas Services Division reviewed those rates, and the Gas Services Division did not initiate an inquiry.

The Examiners find, however, that Alamo receives an array of services from HNG that are not compensated. The President of HNG, Mr. Provencher, serves as the President of Alamo. He is not compensated for that service. He provides an array of essential services for the company including preparation and filing proposed initial tariffs; discussions with the Commission Staff regarding the initial rates; review of the rate study filed on behalf of Alamo, preparation of the Distribution Annual report with the Commission; and, participation in contract negotiations on behalf of Alamo in contracts involving Goliad, HNG, and XTX Pipeline; and preparation of billing invoices.

As discussed above, a portion of the overall rental expense paid by the Hughes Resources Affiliated Group of Companies is paid by Alamo. The affiliated group pays a total of \$5,224 in monthly rental expense for the space occupied at 31830 State Highway 259, Pinehurst, Texas, or \$62,688 on an annual basis. Alamo pays a total of \$252 per month, or approximately 5% of the total rental expense for the affiliated companies, for the rental space. It was asserted that the allocation was based upon area occupied by Alamo. None of the space occupied by Mr. Provencher, Mr. Hicks, or Ms. Miller is allocated to Alamo. In addition to these individuals, Alamo employs one Senior Field Service Technician.

To address these issues the Examiners recommend that the allocations discussed in Section 8, above be adopted. Additionally, the Examiners recommend that HNG be directed to

³⁸⁰ Tr. Vol. 2, p. 66 (Real Provencher).

conduct a management audit. The audit is to be conducted by a company approved by the City of Magnolia and Staff of the Railroad Commission. The audit shall include a detailed analysis of the work conducted by employees of HNG and identify any services provided to the Hughes Resources Affiliated Group of Companies by HNG's employees. The expense of the management audit is to be borne exclusively by HNG and not passed onto customers of the system. The management audit is to be completed within nine months of the date of the Final Order in this proceeding, unless otherwise extended by Staff, but is not to be extended beyond twelve months. Additionally, the management audit shall develop a policies and procedures manual for employees of HNG to track time worked for the various members of the Hughes Resources Affiliated Group of Companies. The management audit shall also develop policies and procedures manual to ensure that all office expenses are properly segregated including telephone and computer equipment. The results of the management audit are to be filed with Staff and the audit be considered at the next rate proceeding.

The management audit is to identify any services provided by HNG to Alamo and any shared assets used by Alamo whose costs have not previously been assigned to Alamo. The management audit should be directed to produce an estimate of the value of those services and assets. Staff shall review the audit to determine whether any additional amounts identified should be credited to the customer through the operation of the purchase gas adjustment clause.

(2) Goliad

As an initial point, the Examiners again find disturbing the discrepancy regarding the number of employees associated with Goliad. In response to an Examiners' Request for Information, the company asserted that Goliad had a President, Real Provencher, Vice President, Frank Hicks, and a Senior Field Technician.³⁸¹ Mr. Provencher identified the President and Vice President but stated that Goliad has no paid employees. By the time the rebuttal testimony was filed, the company had already represented to Staff, in response to a Request for Information, that Ms. Miller provided payroll and bookkeeping tasks associated with Goliad.³⁸² Ms. Miller does not appear to have been included in Mr. Provencher's tally.

³⁸¹ Examiners' Ex. 1, Response to RFI No. 4-8.

³⁸² HNG Ex. 10, Rebuttal Testimony of Ellen Blumenthal, p. 44.

As in the case of all the affiliates previously discussed, the actual expense of service from Goliad includes a host of uncompensated services. Mr. Provencher serves as President of this company. He has indicated that he prepared invoices for Goliad. This is an essential business service. The April 27, 2010 gas services agreement between Goliad and HNG has the same contact address and facsimile number for Goliad and HNG. Goliad neither pays rent nor telephone expenses at that address. The company incurs no vehicle expense. Instead the vehicle expense for the President and Vice President of Goliad is paid for by HNG. Until the rebuttal filing was made, none of the expenses associated with the accountant, Ms. Miller, had previously been allocated to Goliad. The company incurs no rental expense because the rent of its office address is paid for by HNG. The company has no insurance expenditure.³⁸³ Given the fact that all of these essential business expenses are provided free of charge to HNG the Examiners are not surprised that the price charged for natural gas by Goliad to HNG is lower than the prices charged by competitors to Goliad.

To address these issues the Examiners recommend that the allocations discussed in Section 8, above be adopted. Additionally, the Examiners recommend that HNG be directed to conduct a management audit. The audit is to be conducted by a company approved by the City of Magnolia and Staff of the Railroad Commission. The audit shall include a detailed analysis of the work conducted by employees of HNG and identify any services provided to the Hughes Resources Affiliated Group of Companies by HNG's employees. The expense of the management audit is to be borne exclusively by HNG and not passed onto customers of the system. The management audit is to be completed within nine months of the date of the Final Order in this proceeding, unless otherwise extended by Staff, but is not to be extended beyond twelve months. Additionally, the management audit shall develop a policies and procedures manual for employees of HNG to track time worked for the various members of the Hughes Resources Affiliated Group of Companies. The management audit shall also develop policies and procedures manual to ensure that all office expenses are properly segregated including telephone and computer equipment. The results of the management audit are to be filed with Staff and the audit is to be considered at the next rate proceeding.

³⁸³ Examiners' Ex. 1, Response to RFI No. 4-29.

The management audit is to identify any services provided by HNG to Goliad and any shared assets used by Goliad whose costs have not previously been assigned to Goliad. Staff shall review the audit to determine whether any additional amounts should be credited through the operation of the purchase gas adjustment clause.

Additionally, HNG shall make a request for proposal for gas supply to HNG. On a quarterly basis, HNG shall file with the Commission proof of the proposal for bids. Copies of all bids submitted shall be maintained at the HNG offices and available for inspection by Commission Staff or the City of Magnolia.

12. Tariffs

HNG and Staff filed proposed agreed tariffs to reflect the adoption of uniform rates and to reflect certain changes to the Weather Normalization charges, a tax adjustment clause, and the addition of an *ad valorem* tax adjustment. The Examiners recommend that the proposed tariffs be approved. The Examiners recommend that HNG be directed to work directly with Staff and the Tariff Analysis Section of the Gas Services Division to ensure that tariffs are properly filed at the conclusion of this case.

As noted in Section 11, the Examiners recommend that certain changes be made to the purchase gas adjustment tariff. Specifically, the Examiners recommend that HNG be directed to conduct a management audit to identify all assets and employees shared by the affiliates of HNG, including, Alamo, Goliad and HNG. The Examiners recommend that the provision requiring the audit be added to the purchase gas adjustment tariff as a condition pursuant to Rule 7.5519.

The audit shall include a detailed analysis of the work conducted by employees of HNG and identify any services provided to Goliad and Alamo by HNG's employees. The expense of the management audit is to be borne exclusively by HNG and not passed onto customers of the system. The management audit is to be completed within nine months of the date of the Final Order in this proceeding, unless otherwise extended by Staff, but is not to be extended beyond twelve months. Additionally, the management audit shall develop a policies and procedures manual for employees of HNG to track time worked for the various members of the Hughes

Resources Affiliated Group of Companies, including Goliad and Alamo. The management audit shall also develop policies and procedures manual to ensure that all office expenses are properly segregated including telephone and computer equipment. The results of the management audit are to be filed with Staff and the audit is to be considered at the next rate proceeding. The audit is to be conducted by a company approved by the City of Magnolia and Staff of the Railroad Commission.

The management audit is to identify any services provided by HNG to Goliad and Alamo and any shared assets used by Goliad and Alamo whose costs have not previously been assigned to Goliad and Alamo. Staff shall review the audit to determine whether any additional amounts should be credited through the operation of the purchase gas adjustment clause.

HNG shall make a request for proposal for gas supply to HNG. On a quarterly basis, HNG shall file with the Commission proof of the proposal for bids. Copies of all bids submitted shall be maintained at the HNG offices and available for inspection by Commission Staff or the City of Magnolia.

13. Conclusion

As initially filed, HNG sought to increase its non-gas cost revenues by approximately \$1,170,332. This represented an increase of 64.01%, excluding gas costs. Staff and the City of Magnolia proposed various adjustments that resulted in a substantial decrease to the company's revenue request. Individually, the proposals of Staff and the City of Magnolia do not result in a decrease to the current revenues of the company. Considering all proposals made by both parties, the Intervenor collectively recommended a revenue decrease, and ultimately a rate reduction. Staff incorporated all of the initially proposed adjustments of the City of Magnolia and prepared a schedule that reflected the combined adjustments. This schedule reflected a revenue *decrease* of \$479,154.

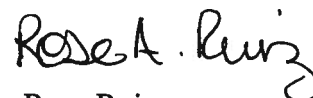
After considering the evidence in the record, the Examiners recommend an increase of \$163,258. This represents a revenue increase of approximately 9%, excluding gas costs. The Examiners recommend that the company's rate base be properly valued, adjustments to the cost of service be made to reflect the use of HNG assets and employees by its affiliates, and that the company engage in an independent management audit to identify all assets of HNG used by its affiliates and all services supplied by HNG to its affiliates. The management audit should develop a policies and procedures manual to properly track expenses among HNG and its affiliates to ensure that the company complies with the FERC USOA.

Respectfully submitted,

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