

NO. 08-0421

STATE OF TEXAS, *ET AL.*,
Petitioners,

v.

PUBLIC UTILITY COMMISSION OF TEXAS, *ET AL.*,
Respondents.

RESPONSE TO PETITIONS FOR REVIEW

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Issues Presented

Issue 1: Should this Court overturn the court of appeals' decision that "[g]iven the explicit reference to the 15% requirement found in both the administrative code and the utilities code, . . . the Commission's construction of the capacity-auction-true-up provisions as requiring compliance with the 15% requirement for proper utilization of the true-up formula accurately reflects the legislature's intent"? (Responds to CenterPoint Issue 2) *Discussed at pages 77-96 of the Slip Opinion*¹

Issue 2: Should this Court overturn the court of appeals' decision that given that "none of the other listed methods [to determine market value] could have been employed because their requirements were not satisfied" and given the "overwhelming statutory mandate that utilities be allowed to recover their stranded costs," the Commission did not exceed its authority "when it developed an alternative valuation method"? (Responds to Joint Petitioners Issue 1 and State Issue 1) *Discussed at pages 33-47 of the Slip Opinion*²

¹ *CenterPoint Energy Houston Elec., LLC v. Pub. Util. Comm'n*, 252 S.W.3d 1 (Tex. App.—Austin Apr. 17, 2008, pet. filed). Citations in this response are to the opinion in slip and cited "Slip op." The quotation is from page 85 of the slip opinion.

² Slip op. at 39.

Issue 3: Should this Court overturn the court of appeals' determination that the customers received the process they were due since "the Customers and Utility Counsel argued [to the Commission] that the requirements of the partial-stock valuation method might not have been satisfied and were allowed to present evidence regarding other market valuations that might be employed"? (Responds to State Issue 2) *Discussed at pages 43-48 of the Slip Opinion*³

Issue 4: Should this Court overturn the court of appeals' determination that the Commission's refusal to adjust stranded costs for commercially unreasonable conduct was reasonable because the market value used to determine stranded costs was unaffected by the commercially unreasonable conduct? (Responds to Joint Petitioners Issue 2) *Discussed at pages 49-53 of the Slip Opinion*⁴

³ Slip op. at 46.

⁴ Slip op. at 52.

Issue 5: Should this Court overturn the court of appeals’ decision that “given that the true-up proceeding was designed to be a one-time event in which utilities are allowed to recover their stranded costs,” excluding investments from stranded costs based on the timing requirements for ratemaking in section 36.054 “would forever deny the utilities the right to recover these otherwise recoverable expenses” and “violate the utilities code’s mandate that utilities are allowed to recover ‘all’ of their stranded costs”? (Responds to Joint Petitioners Issue 3) *Discussed at pages 72-77 of the Slip Opinion*⁵

Issue 6: Should this Court overturn the court of appeals’ decision that “the overall legislative mandate that utilities recover the expenses that they incur as a result of the transition to a competitive market would seem to require the Commission to award utilities the time value associated with the delay in recovering the capacity-auction award”? (Responds to Joint Petitioner Issue 4) *Discussed at pages 96-102 of the Slip Opinion*⁶

⁵ Slip op. at 75.

⁶ Slip op. at 98-99.

Statement of Facts

Both the utility⁷ and ratepayers⁸ challenge the order⁹ of the Public Utility Commission (“PUC”) that trued up stranded costs and the capacity auction for the former incumbent electric utility in the Houston area. The utility claims it recovered too little, and the ratepayers claim the utility recovered too much.

Stranded costs are “generally speaking . . . the extent to which the book value of generation-related assets and purchased power contracts exceeds their market value.”

CenterPoint Energy, Inc. v. Pub. Util. Comm’n, 143 S.W.3d 81, 82-83 (Tex. 2004)

(“*CenterPoint*”). The statute allows the utility to chose among several methods for determining market value, and this utility chose the partial-stock-valuation method.

(Order at 14.) It requires the utility to spin off and sell at least 19 percent but less than 51 percent of its stock. Tex. Util. Code § 39.262(h)(3). But the PUC found that the utility failed to comply—less than 19 percent of the stock was sold. (Order at 18.)

⁷ CenterPoint Energy Houston Electric, LLC and Texas Genco, LP, are two of the three companies created out of what was formerly Houston Lighting and Power Company. Those two companies, together with the third company, Reliant Energy Retail Services were the “joint applicants” who filed to true up stranded costs. In the court of appeals’ opinion, the utility is called the “Joint Applicants.” The PUC will call them the “utility” in this response to avoid confusion with the “Joint Petitioners” that are ratepayers.

⁸ The ratepayer groups include Texas Industrial Energy Consumers, Houston Council for Health and Education, City of Houston and Coalition of Cities, and Gulf Coast Coalition of Cities, who filed as the “Joint Petitioners” and the State of Texas (as a consumer).

⁹ Tex. Pub. Util. Comm’n, *Application of CenterPoint Energy Houston Electric, LLC, Reliant Energy Retail Services, LLC, and Texas Genco, LP to Determine Stranded Costs and Other True-Up Balances Pursuant to PURA § 39.262*, No. 29526 (Order on Rehearing) (Dec. 17, 2004) (the “Order”). The Order is Item 842 in the Administrative Record, which was admitted into evidence at the district court. RR Vol. 2 at 6.

That presented the PUC with a dilemma: the public policy announced in the statute was that utilities should recover stranded costs, but the utility failed to comply with the statutory method to determine market value—one half of the formula for stranded costs. Some ratepayers argued that, having failed to prove market value, the utility should recover zero stranded costs. (*See* Order at 18); slip op. at 33. Various ratepayer groups also relied on the record to argue for different amounts of market value. (Order at 20); *see* slip op. at 46.

The PUC found that denying stranded-cost recovery would be contrary to statutory intent. (Order at 18.) So, the PUC used the statutory definition of “market value” and relied upon information in the record to determine market value. (Order at 18.) The PUC’s market-value determination was within the range of those proposed by the utility and the ratepayer groups. (Order at 20); slip op. at 42. It was closest to the market value a panel of experts had found as part of determining whether the utility’s market value should be adjusted for a control premium.

Ratepayer groups complain that the PUC should also have made other stranded-cost adjustments. The statute directs the PUC to adjust stranded costs if the utility fails to “pursue commercially reasonable means” to mitigate stranded costs, including “the exercise of normal business practices to protect the value of its assets.” Tex. Util. Code § 39.252(d). The PUC found that an option that the utility gave to a related company fell short of that commercial-reasonableness requirement. (Order at 64.). But the PUC made no adjustment. The data the PUC relied on to determine market value in light of the

utility's failure to comply with the statutory method was unaffected by the option. (Order at 51.)

Ratepayer groups also complained that the PUC allowed the utility to recover stranded costs for some recent investments. Under traditional ratemaking, Utilities Code Section 36.054 required a special showing for a utility to earn a return on investments that had not yet been approved as invested capital in a rate case. The PUC decided that those ratemaking requirements had no application to this stranded-cost proceeding. (Order at 35.)

In addition to stranded costs, the PUC had to reconcile the market price of power, determined by the capacity auction, with the price of power estimated in the ECOM model. Tex. Util. Code § 39.262(d)(2). Although the statute required the utility to sell 15 percent of its generation capacity in the capacity auctions, the PUC found that the utility failed both to sell 15 percent and to comply with provisions in the PUC's rule that would have allowed the utility to be deemed to have sold 15 percent. (Order at 104-05.) The PUC held that the sale prices of the utility's inadequate capacity auction would not reflect the market price for sales of power during the first two years of competition. (Order at 107.) Meanwhile, the utility sold the rest of its generation capacity at private auctions. (*See* Order at 107-08.) To meet the legislative intent of the capacity-auction true up—ensuring that the utility recovers no more and no less for sales of power during the first two years of competition than the margin predicted by the ECOM model—the PUC used an average price from all of the utility's sales—private and statutorily required

capacity auctions. (Order at 107-108.) The PUC also determined that the utility was entitled to interest as compensation for the time value of its money until the capacity-auction reconciliation amounts were paid. (Order at 98-99.)

Ten sets of parties filed suits challenged the PUC's Order. (CR 50.) Their briefs raised at least fifty-five distinct issues in district court. After briefing and a hearing, the district court affirmed the PUC's Order against all but two complaints: 1) the adjustment the PUC made for the utility's failure to comply with the capacity auction and 2) interest on mitigation credits that the utility held for two years. (CR 51.)

All parties appealed. The court of appeals reversed parts of the district court judgment that had reversed the PUC's order. Most notably, the appellate court affirmed the PUC's capacity-auction determination. Slip. op. at 118. But the court of appeals found an error the district court had not found concerning excess mitigation credits and that certain tax issues needed to be remanded to the PUC. Slip op. at 117.

Summary of the Argument

The PUC urges the Court not to grant petitions in this case. It, like two other cases before this Court,¹⁰ challenges a PUC true-up decision concerning the transition to competitive retail electric rates, and raises issues that are unlikely to arise in any subsequent cases. Although the case addresses a new, complicated statutory scheme and involves large sums, the court of appeals thoroughly considered it. That court extended

¹⁰ The other challenged true-up proceedings are before this Court in *AEP Texas Central Co. v. Pub. Util. Comm'n*, No. 08-0634 and *Texas New-Mexico Power Co. v. Pub. Util. Comm'n*, No. 08-0187.

the page limits for briefing, granted two hours for oral argument in this case and, after hearing oral argument on all three cases, issued its 118-page opinion in this, the largest true-up case. Although the court of appeals remanded two issues to the PUC, the agency chose not to appeal, and it asks this Court not to grant the petitions for review, but to leave the court of appeals decision standing.

Argument

This case concerns the last major step in the transition from regulated to competitive electric rates—the true-up proceeding. The PUC reconciled both stranded costs and the price of power sold at wholesale for 2002 and 2003.

Standard of Review

Several suits for judicial review under the Administrative Procedure Act (“APA”) were consolidated. Because the challenged PUC decision was made in a contested case, the substantial-evidence scope of review applies. PURA § 15.001; Tex. Gov’t Code § 2001.174; *Tex. Health Facilities Comm’n v. Charter Medical-Dallas, Inc.*, 665 S.W.2d 446, 450 (Tex. 1984). Because each reason the APA lists for reversal presents the district court with a question of law, an appellate court reviews the district court’s decisions *de novo*. See *In re Humphreys*, 880 S.W.2d 402, 404 (Tex. 1994). That raises the further question of the standard of review that the district court should have used. “[A] standard of review is more than just words; rather, it embodies principles regarding the amount of deference a reviewing tribunal accords the original tribunal’s decision.” *Quick v. City of Austin*, 7 S.W.3d 109, 116 (Tex. 1998). In administrative appeals, the

deference owed the agency varies depending on the type of error alleged. Complaints in the petitions before the Court invoke the abuse-of-discretion standard, the substantial-evidence standard, and statutory construction.

Abuse of discretion occurs when the agency acts in an arbitrary or unreasonable manner without reference to any guiding rules or principles. *See Downer v. Aquamarine Operators, Inc.*, 701 S.W.2d 238, 241-42 (Tex. 1985) (describing abuse of discretion by a court). This Court has also recognized the narrowness of the arbitrary-and-capricious standard of review when applied to agency decisions: “[W]e do not think that the legislature intended it to be interpreted as a broad, all-encompassing standard for reviewing the rationale of agency actions.” *Charter Medical*, 665 S.W.2d at 454.

The substantial-evidence standard prohibits courts from substituting their judgment for the agency’s as to the weight of evidence on questions committed to agency discretion. *Pub. Util. Comm’n v. Gulf States Utils. Co.*, 809 S.W.2d 201, 211 (Tex. 1991). The true test is not whether the agency reached the correct conclusion, but whether some reasonable basis exists in the record for the agency’s action. *Charter Medical*, 665 S.W.2d at 452.

For questions of statutory construction, the cardinal rule is to give effect to the intent of the legislature. *Cities of Austin v. Southwestern Bell Tel. Co.*, 92 S.W.3d 434, 442 (Tex. 2002). “To determine legislative intent, courts may consider the language of the statute, the legislative history, the nature and object to be obtained, and the consequences that would follow from alternate constructions.” *In re Bay Area Citizens*

Against Lawsuit Abuse, 982 S.W.2d 371, 380 (Tex. 1998.) This Court grants deference to an agency construing its statutory authority. “In ascertaining the scope of an agency’s authority, we give great weight to the agency’s own construction of a statute.” *Tex. Mun. Power Agency v. Pub. Util. Comm’n*, 253 S.W.3d 184, 192 (Tex. 2007).

I. Capacity-auction True Up

The court of appeals affirmed the PUC’s capacity-auction true up; that decision should be affirmed.

A. The utility did not meet its statutory duty to sell capacity.

The utility misreads the statute, arguing that the law only required the utility to *offer* capacity for sale. Instead, the statute states that the utility “shall *sell* at auction . . . entitlements to at least 15 percent of the electric utility’s . . . generation capacity.” Tex. Util. Code § 39.153(a) (emphasis added).

The PUC’s rules do not exempt the utility from its requirement to sell capacity. As required by the statute, the PUC adopted rules about the capacity auction. Slip op. at 77; Tex. Util. Code § 39.153(e-f) (requiring the PUC to adopt rules); 16 Tex. Admin. Code § 25.381 (the rules). Those rules described the four products that the utility had to sell. Slip op. at 78;¹¹ 16 Tex. Admin. Code § 25.381(c)(5), (f), (g) (describing the products). The court of appeals recognized that the rule required the utility to *sell* capacity: “Under

¹¹ “During the auctions, the utilities were obligated to sell entitlements to four types of capacity products: baseload, gas-intermediate, gas cyclic, and gas-peaking products. *Id.* The amount of each type of entitlement that a utility was required to sell varied depending on the company’s generation assets, but the total amount of the entitlements sold had to amount to at least 15% of the utility’s total generation capacity. *Id.* § 25.381(e)(1).” Slip op. at 78 (citations omitted).

the [rule], to be deemed compliant a utility had to ‘offer[] products in a product category (for example, gas-intermediate) *and successfully* [sell], at least, all of the entitlements offered in one particular month, in that category.’ Slip op. at 78 (emphasis added).

The court of appeals recognized that the utility failed to meet the statutory requirement: “During the auctions in 2002 and 2003, the [utility] only auctioned off 10% of [its] capacity, much less than the 15% required by statute.” Slip op. at 88-89. For 2003, the PUC’s rule included a safe harbor. “[I]n recognition of the possibility that full compliance may not always be possible, the [PUC] promulgated the safe-harbor provision, allowing a utility to be deemed compliant with the capacity-auction requirements even though the utility sold less than 15% of its capacity products.” Slip op. at 89. The court of appeals recognized that “in 2002 and 2003, the [utility] failed to sell the required amount of entitlements for any of their products, meaning that less than the statutorily required 15% was sold.” Slip op. at 94.

B. Because the utility failed to sell capacity as required by statute, the PUC had to look elsewhere for the market price of power needed for the capacity-auction true up. (Responds to Joint Petitioners’ Issue 1 & State’s Issues 1 & 2)

CenterPoint’s attempt to divorce its duty to sell 15 percent of its capacity at statutory auctions from the capacity-auction price—the price used to reconcile the market margins with ECOM margins—fails. The court of appeals correctly understood the connection: relying on “the explicit reference to the 15% requirement found in both the administrative code and the utilities code” the court of appeals was “persuaded that the Commission’s construction of the capacity-auction-true-up provisions as requiring

compliance with the 15% requirement for proper utilization of the true-up formula accurately reflects the legislature’s intent.” Slip op. at 85.

Thus, the PUC had to decide how to proceed without a statutory capacity-auction price. “The relevant rule and statutory provision assume that the utility will comply with the 15% requirement or with the safe-harbor provision, and neither one addresses the situation of noncompliance.” Slip op. at 93; *see* Tex. Util. Code § 39.153 & 39.262(d); 16 Tex. Admin. Code § 25.381. “[T]he [PUC] was caught between a statutory mandate requiring that utilities recover for their capacity-auction costs and the [utility’s] noncompliance with the requirements necessary for determining an accurate award.” Slip op. at 93.

The PUC needed to accomplish the legislative intent for the capacity-auction true up, which this Court described in 2004: “The Legislature . . . designed the capacity auction true-up proceeding because of the likelihood that no stable market would exist until up to two years after the first day of deregulation.” *CenterPoint*, 143 S.W.3d at 96. One reason for the capacity-auction true up “is that a generation company is limited to a set margin that it will receive for sales of power” *Id.* The capacity-auction true up “essentially guarantees consumers and power companies that the power company will receive no more and no less than a margin predetermined by the Commission in 2001 when the ECOM model was run” *Id.* “Because the utilities code mandates that the utilities auction off a significant portion of their capacity assets, it also provides the

utilities with a method for recovering partial losses in the event that the sale price at the auction is less than [under regulated rates]” Slip op. at 79.

The court of appeals held that, in order to accomplish the statutory intent of ensuring that the utility recovered exactly the margin predicted for sales of generation capacity during the first two years of competition, “the [PUC] had the implied power to develop an alternative means for estimating the ‘capacity-auction price’ to be used in the true-up calculation” Slip op. at 93.

Not only does the plain language of the statute show a link between a utility meeting its duty to sell 15 percent of its capacity at the statutory auctions and the capacity-auction true up, but without that link, the legislative intent of the true up would not be accomplished. Prices the utility obtained through its inadequate capacity auction failed to reflect the market price of power during the first two years of competition. The utility not only sold less capacity than required; it also failed to sell the more expensive capacity. The utility sold the rest of its capacity outside the capacity auctions. And “[the utility] sold entitlements to [its] products in private auctions for prices that were higher than the sale price in the capacity auctions.” Slip op. at 82.

The PUC reasonably used those sales together with the capacity-auction sales to determine the market price of power for the capacity-auction true up. The court of appeals stated: “[T]he [PUC] logically looked to the private auctions to help estimate the value of the entitlements in a public auction. This decision seems particularly appropriate

given the relative success that the [utility] had in auctioning off the entitlements in the private auctions.” Slip op. at. 94.

Those private auctions also refute the utility’s claim that there was no market for the type of products it failed to sell in the capacity auctions. The court of appeals stated: “It is apparent from the fact that the [utility was] able to sell the gas-intermediate product in private auctions that the market value of this product was not zero.” Slip op. at 92.

“For all these reasons, we conclude that the failure to comply with the 15% requirement or the safe-harbor provisions is relevant to the true-up calculation as well as the need to foster competition.” Slip op. at 86

C. The PUC has statutory authority to award interest on the capacity-auction award. (Responds to Joint Petitioners’ Issue 4)

The court of appeals disagreed with ratepayer groups’ challenge to giving the utility interest on the capacity-auction true up. “[T]he overall legislative mandate that utilities recover the expenses that they incur as a result of the transition to a competitive market would seem to require the [PUC] to award utilities the time value associated with the delay in recovering the capacity-auction award.” Slip op. at 98-99. Based on this Court’s recognition in *CenterPoint* that utilities are entitled to the time value of stranded costs from the time they arise, the court of appeals stated: “We see no discernable difference between recovery for capacity-auction costs and stranded-cost recovery that would warrant a decision completely at odds with prior precedent.” Slip op. at 99.

II. Stranded-cost True up

A. **The utility failed to comply with statutory requirements for the method it chose to determine market value, which is half of the stranded-cost formula. But, because the legislature intended that the utility recover stranded costs, the PUC properly relied on other information in the record to determine market value. (Responds to Joint Petitioners' Issue 1 and State's Issues 1 & 2)**

The PUC found that the partial-stock-valuation method that the utility chose to determine the market value required that at least 19 percent of the stock be sold. The utility spun off slightly more than 19 percent of its stock, but less than 19 percent was sold. The court of appeals agreed that "sold" did not equate to "offered." "When the word 'sold' is read in the context of the remainder of the sentence, it becomes clear that 'sold,' as used in [39.262(h)(3)], does not mean to offer for sale." Slip op. at 28-29.

The failure of the utility to comply with the statutory partial-stock-valuation method to determine market value left the PUC with a problem. "Under [some ratepayers'] interpretation, if a utility is ultimately unable to fulfill the requirements of a valuation method and there is no time to fulfill the requirements of another method, the utility would not be entitled to recover for stranded costs." Slip op. at 38-39. As the court of appeals recognized, "given the tremendous legislative emphasis placed on the need for stranded-cost recovery," the ratepayers' argument was contrary to legislative intent. Slip op. at 39.

To comply with legislative intent that utilities recover stranded costs, "the Commission relied extensively on information already in the record." Slip op. at 39. Contrary to allegations by the ratepayers, the PUC looked at the entire record to find the

market value. “[S]everal parties presented alternative valuations calculated by using methods not considered by the valuation panel. These estimates provided a range of values that were above and below the amount ultimately chosen by the Commission.”

Slip op. at 42 n.23.

The court of appeals’ opinion also explains why the PUC did not apply the sale-of-assets method to a pending sale of generation assets to determine market value. Citing Utilities Code Section 39.262(h)(1), the opinion states that the “sale-of-assets method requires that the generation assets be ‘sold’ prior to the stranded-cost reconciliation.” Slip op. at 36. The court held that the PUC’s decision “that the word ‘sold,’ . . . necessarily limits consideration of a sale for market-valuation purposes to sales occurring before the true-up reconciliation” accurately reflects the legislature’s intent. Slip op. at 36-37. Moreover, “the [utility] did not select another market-valuation method, and the Commission properly concluded that none of the other listed methods could have been employed because their requirements were not satisfied.” Slip op. at 39.

Finally, due process did not require the PUC to inform parties which evidence and argument it would find most persuasive before the parties presented evidence and argument. How to determine market value in light of the utility’s failure to comply with the statutory requirements was an issue before the PUC. As the court of appeals noted, ratepayers themselves “argued that the requirements of the partial-stock valuation method might not have been satisfied and were allowed to present evidence regarding other market valuations that might be employed.” Slip op. at 46.

B. The PUC reasonably did not adjust stranded costs for commercially unreasonable actions when those actions did not affect stranded costs as determined by the PUC. (Responds to Joint Petitioners' Issue 2)

Section 39.252(d) requires the utility to mitigate stranded costs by acting in a commercially reasonable manner. The PUC agreed with ratepayers that an option granted to the utility's affiliated company was commercially unreasonable, but the PUC did not therefore adjust stranded costs. "After concluding that the various market valuations that it relied on [to determine market value] were unaffected by the option, the Commission determined that . . . no adjustment for commercially unreasonable behavior needed to be made." Slip op. at 52. Because the option did not affect market value, it did not affect stranded costs.

C. The PUC properly decided that a statute about the time to include an investment in traditional rates, had no application to stranded costs. (Responds to Joint Petitioners' Issue 3)

The court of appeals also realized traditional ratemaking restrictions on the time to include an investment in rate base did not apply to stranded costs. Under regulated rates, an investment had to already be used and useful for providing service before the utility could earn a return on the investment. *See Cities for Fair Util. Rates v. Pub. Util. Comm'n*, 924 S.W.2d 933, 935 (Tex. 1996). Nonetheless, for massive investments, the lag time between making the investment and receiving a return on the investment sometimes threatened the utility's financial integrity. *Id.* at 936. In those cases, Section 36.054 allowed a utility to include "construction work in progress" in rates. In this case, ratepayers argued that Section 36.054 requirements applied to investments the utility

made after its last regular rate case in the stranded-cost true up. The PUC disagreed. The court of appeals agreed with the PUC's order. "[G]iven that the true-up proceeding was designed to be a one-time event in which utilities are allowed to recover their stranded costs, construing the relevant provisions in the manner suggested would forever deny the utilities the right to recover these otherwise recoverable expenses." Slip op. at 75.

Moreover, "[s]uch a construction would . . . violate the utilities code's mandate that utilities are allowed to recover 'all' of their stranded costs." Slip op. at 75.

III. Issues Not Argued

Because CenterPoint did not brief its Issues Three and Four, the PUC has not addressed them in this response. The court of appeals addressed CenterPoint Issue Three at pages 102 through 117 of the Slip Opinion and CenterPoint Issue Four (which the utility argues in one of its respondent's briefs before this Court) at pages 21 through 33.

The PUC was aligned with CenterPoint on its Issue One in the courts below, but chose not to appeal any issue in this case.

Prayer

The Public Utility Commission asks this Court to deny the petitions for review. The Commission prays for such other relief as it may show itself entitled.


Respectfully submitted,

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Certificate of Service

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