IN THE MATTER OF AN APPLICATION FOR A GENERAL CHANGE OR MODIFICATION IN CENTERPOINT ENERGY ARKLA, A DIVISION OF CENTERPOINT ENERGY RESOURCES CORP'S RATES, CHARGES, AND TARIFFS

DOCKET NO. 04-121-U; ORDER NO. 16

Arkansas Public Service Commission

2005 Ark. PUC LEXIS 349; 245 P.U.R.4th 384

September 19, 2005

CORE TERMS: customer, depreciation, allocated, recommended, pipe, recommendation, payroll, storage, pro forma, ratepayer, recommend, rate case, accounting, rider, plant, rate base, billing, transportation, lag, audit, residential, calculation, net salvage, external, pension expense, tariff, customer-related, dividend, shareholder, classified

PANEL: **[*1]** Sandra L. Hochstetter, Chairman; Daryl E. Bassett, Commissioner; Randy Bynum, Commissioner

OPINION: ORDER

On November 24, 2004, CenterPoint Energy Arkla ("Arkla" or the "Company") filed an Application for approval of a general change or modification in its rates and tariffs. n1 Arkla's initial Application reflects that it was seeking a non-gas rate increase of $ 33,996,382 based on an overall non-gas revenue requirement of $ 182,525,265. Order No. 4, entered on December 16, 2004, suspended Arkla's proposed rates, charges, and tariffs pending further investigation by the Commission.

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n1 Arkla filed additional revisions to its Application on December 27, 2004, January 10, 2005, and January 13, 2005.

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

Arkla filed the written testimonies of Jeffrey A. Bish, Charles J. Harder, F. Jay Cummings, **[*2]** Samuel C. Hadaway, Alan D. Henry, Michael TheBerge, Gerald W. Tucker, Steve Malkey, Michael J. Adams, Walter L. Fitzgerald, Michael Hamilton, and John J. Spanos. The Staff filed the written testimonies of Robert Booth, Alice D. Wright, Alisa Williams n2, Don E. Martin, Gail P. Fritchman, Don Malone, L.A. Richmond, Gayle Frier, Johnny Brown, Robert H. Swaim, and Adrienne R.W. Bradley. The AG filed the written testimony of William B. Marcus. AGC filed the written testimonies of Denise E. Baker, and Christopher A. John. CEUG filed the written testimonies of Steven A. Ward, and Timothy P. Staley.

IV. CAPITAL STRUCTURE AND RATE OF RETURN

Four witnesses offered recommendations concerning the appropriate return on common equity for Arkla. Their recommendations are as follows:
Arkla **[*64]** witness Hadaway -- 10.75% (T. 916, 940)

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

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

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

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

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

DCF Analysis

The DCF method calculates the cost of equity as

K[e] = Dividend Yield + Investor-expected growth rate

In Direct Testimony Arkla witness Hadaway recommended an 11% - 11.5% **[*65]** DCF range for the cost of equity (T. 906) This was later updated to a 10.5% - 11% DCF range (T. 916) In both Direct and Surrebuttal Testimony Staff witness Brown recommended a DCF cost of equity range of 9.2% - 10.1% (T. 1861, 1881) Neither CEUG witness Staley nor AG witness Marcus used a DCF Method.

Since there is very little disagreement over the appropriate DCF dividend yield, the sources of disagreement are in the growth rate. Mr. Hadaway used a combination of growth rates from three sources: Zach's 5 year projections; Value Line Earnings Growth Projections from 2001-03 to 2007-09; and annual U.S. Gross Domestic Product Growth. (T. 802, 807, 825) Mr. Brown utilized four different growth rates: (1) Projected Book Value Growth and Retention Growth ("br + vs") ending 2007-09; (2) Value Line average projected growth rates for Earnings per Share ("EPS") and Book Value per Share ("BVPS") for the period 2001-03 to 2007-09; (3) Value Line average projected growth rates for EPS and BVPS for the period 2003 to 2007-09; and (4) Value Line average projected growth rates for EPS and BVPS for the period 2005 to 2007-09. We find that these four growth rates are reasonable estimates of investor-expected **[*66]** growth rates for usage in the DCF formula.

As discussed by Mr. Brown (T. 1871-1872), a major flaw in Mr. Hadaway's analysis is that he failed to use sustainable book value per share growth rates in gauging investor expectations. The underlying long-term and sustainable source of dividend growth rate in the DCF method is growth rate in book value per share. Mr. Brown's analysis appropriately considers that growth rate either explicitly (as in his growth rates 2, 3, and 4) or implicitly as in his "br + vs" growth rate. For that reason, we reject Mr. Hadaway's first two growth rate data sources.

With regard to Mr. Hadaway's use of the Gross Domestic Product (GDP) growth rate, he is correct that investor-expected dividend growth rates overall are likely correlated with GDP growth rate. However, he has failed to demonstrate that industry-specific DCF investor-expected growth rates are also equal to the nominal GDP growth rate. This is a crucial distinction. For example, a mature industry may have a rich dividend yield and a small expected growth rate, while a young industry may, conversely, have a small dividend yield and a large expected growth rate. It would be reasonable to expect the **[*67]** mature industry's expected dividend growth rate to be less than nominal GDP growth, while the young industry's expected growth is greater that GDP growth. Long-term, the three growth rates are not equal. In this case, Mr. Hadaway has failed to show that the nominal GDP growth rate has been, and is expected by investors in LDCs to be, equal to nominal GDP growth.

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

Risk Premium Analysis

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

As noted by both Mr. Hadaway (T. 1862-1863) and Staff witness Brown (T. 1874), risk premiums are not stable, and there is no one risk premium through time. An additional flaw in Mr. Hadaway's analysis is that he has relied upon risk premia studies **[*68]** for the S&P 500. As noted by Brown, utility stocks are perceived to be less risky than the average stock in the S&P 500. (T. 1875) For the above reasons, we conclude that Mr. Hadaway's risk premium method is not a reasonable basis upon which to set Arkla's cost of equity.

Other Cost of Equity Methods

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

Arkansas. Third, this sort of comparison is akin to piecemeal ratemaking **[*69]** and is unacceptable. For example, we do not know the other state commissions' policies regarding rate base, expenses, depreciation, etc. As noted by CEUG witness Staley: "Every natural gas utility has different needs, different risks, different load profiles, and different performance levels. Consequently, every natural gas utility should have a uniquely determined ROE." (T. 1302)

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

Mr. Marcus also performed a Capital Asset Pricing Model (CAPM) analysis in a footnote. (T. 1371) This Commission, to date, has had two problems with CAPM analysis: the lack of stability in estimates of "beta" and the lack of stability in the market **[*70]** premium. Consequently, we can not rely on Mr. Marcus's CAPM analysis.

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

Adjustment to Cost of Equity for Decrease in Risk

Staff (T. 1868-1869), CEUG (T. 1208, 1302), AG (T. 1371), and AGC (T. 1095) argue that, if Arkla proposed riders RSP, LCA, and ICR are approved, Arkla's risk would be reduced, and that a concomitant reduction in Arkla's cost of equity would be warranted. Arkla (T. 41-45) argues that Arkla witness Hadaway's and Staff witness Brown's risk-comparable group includes companies with innovative tariffs and higher customer growth that mitigate their risks. Consequently, proposed Riders RSP, LCA, and ICR do not reduce the business or regulatory risk of Arkla as compared to the risk-comparable sample, and no downward adjustment to the allowed **return on equity** is warranted if these Riders are approved. (T. 41-45, 927-930) Mr. Brown claimed that Arkla has several currently-effective **[*71]** risk-mitigating riders, Purchased Gas Adjustment ('"PGA"), Weather Normalization Adjustment ("WNA"), and Main Replacement Program ("MRP"), which indicate that Arkla is not riskier than the sample. (T. 1892-1894)

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

External Sources of Capital in Capital Structure

Arkla witness Hadaway included three external sources of capital in Arkla's capital structure: long-term debt, preferred equity, and common equity. (T. 8837) Staff witness Brown included five sources of external capital in Arkla's capital structure: long-term debt, short-term debt, preferred equity, common equity, and customer deposits. (T. 1126) The proportions Mr. Brown's first four sources are based upon the risk-comparable sample proportions (T. 1848-1852), as are all three external components for Arkla. The primary differences between Mr. Brown and Mr. Hadaway are: (1) Mr. Hadaway developed the capital proportions using 2003 fiscal year, while Mr. Brown used 2004 fiscal year; **[*72]** (T. 1850) (2) Mr. Brown included short-term debt in the capital structure and Hadaway did not; and (3) Mr. Brown included customer deposits and Mr. Hadaway did not. With the exception of customer deposits, AG witness Marcus has approximately the same external capital structure proportions as does Mr. Brown.

Mr. Brown noted that short-term debt is used to fund ongoing operations and is a permanent source of capital. (T. 1850) Mr. Marcus also recommended the inclusion of short-term debt in the capital structure. (T. 1360-1361) Mr. Hadaway responded that Mr. Brown should have at least netted out the Construction Work In Progress ("CWIP") financed by short-term debt. (T. 926) Mr. Brown responded to that by noting: (1) the Commission has a long-standing position that CWIP not be included in rate base because it is not used and useful; (2) Arkla's Main Replacement Program, which is temporarily included in CWIP until those assets enter service, is effectively a monthly rate case which allows Arkla to immediately put the majority of plant additions into rates; and (3) the precedent of including short-term debt in the capital structure was specified in Order No. 13 in Arkla Docket No. 93-081-U **[*73]** and was followed by the Company in its two subsequent rate cases, Docket Nos. 94-175-U and 01-243-U.

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

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

Overall Cost of Capital

For all of the above reasons we adopt Staff witness Brown's capital structure, cost of equity range, and other cost rates as shown in Surrebuttal Exhibit JB-14. In conjunction with a 9.45% allowed **return on equity,** discussed later in this order, this results in an overall cost of capital of 5.31%. Further, as demonstrated by Mr. Brown, his overall recommendations result in Funds from Operations interest coverage of at least 5.0, Funds **[*74]** from Operations to Total Debt Coverage of at least 24%, and a total debt ratio of 54%. (T. 1127-1128, 1883) Each of these financial measures meets or exceeds Standard and Poor's benchmarks for an A-rated utility with a business position of 3.

V. COST ALLOCATION

Administrative Fees of the Transportation Supply Option

Arkla witness TheBerge proposed an allocation of these revenues based on Gross Total Cost of Service. CEUG wtiness Ward recommended that these revenues be directly assigned to those classes based on actual contributions. (T. 1154) According contact flexibility to allow reductions in capacity will almost certainly result in increased upstream pipeline capacity costs.

XI. RETURN ON EQUITY ADJUSTMENT

Staff witness Booth recommends that Arkla's **return on equity** be set at the lower end of the range of reasonable equity returns. Various Staff witnesses identified several concerns with Arkla's: (1) filing of its Application; (2) administration of its tariffs; (3) accounting **[*140]** for retirements of plant; (4) costs allocated by its accounting system; and (5) retention of data required for the depreciation study. Staff witness Booth contended that the above concerns cast serious doubt on Arkla's ability to provide adequate service to its customers. Mr. Booth argued that, when a public utility does not provide a satisfactory level of compliance with the Commission's Rules and does not provide a satisfactory level of customer service, it is appropriate to adjust its **return on equity.** (T. 1761-62, 1764)

Staff witness Fritchman testified that Arkla filed three revisions to its deficient original Application filed on November 24, 2004 in an attempt to correct these deficiencies. Ms. Fritchman asserted that as a result, Staff spent considerable time reviewing the original Application and then reviewing and analyzing all the revisions. She claims that Arkla's filing of a deficient Application interrupted and frustrated Staff's review and analysis of Arkla's requested rate relief. (T.1517-1791) Ms. Fritchman further testified that, as a result of a her audit of Arkla's Temporary Low Income Gas Recovery Program ("TLICGRP"), she determined that Arkla was unaware that **[*141]** it had failed to credit $ 2,364,599 back to ratepayers as required by the Commission in Docket No. 01-248-U. Also, Arkla did not have in place a process to properly track collections under the TLICGRP. (T. 1510-1513) Ms. Fritchman found that Arkla did not exercise adequate oversight to ensure compliance with its MRP Rider. As a result, over-collections totaling $ 294,879 occurred because Arkla did not have adequate controls in place to ensure that costs that did not meet the criteria were not included for recovery. (T. 1513-1516) Regarding Arkla's Weather Normalization Adjustment Rider ("WNA"), Fritchman alleged that Arkla, in November 2004, failed to apply the WNA to the bills of its residential and small sales customers. Additionally, Arkla did not compute the sales tax applicable to the WNA charge. (T. 1516-1517) Ms. Fritchman also determined that Arkla had trouble in identifying direct charged and allocated costs in a timely and accurate manner. She identified several instances where costs were improperly charged to Arkla by affiliates and by Arkla Corporate. (T. 1521-1524)

Staff witness Williams testified that Arkla still had assets on its books that were no longer used and useful, **[*142]** assets that Arkla no longer owned, accounts in which the Company failed to book retirements, and assets that were fully amortized. (T. 1928-1932) Staff witness Freier discovered that Arkla had not been using the correct depreciation rates that were approved in Docket No. 01-243-U. Ms. Freier concluded that Arkla needs considerable improvement in its data retention and record keeping processes. (T. 2016-2022)

Various Arkla witnesses responded to the Staff's concerns with Arkla's tariff administration, application, and accounting. Arkla witness Harder, in citing a Continental Telephone Company of Arkansas case, acknowledges that there is precedent for reducing a Company's ROE for failure to provide adequate customer service. (T. 175) However, Mr. Harder argued that case concerned the actual quality of the utility service provided to customers, not the type of concerns identified by

Staff in this case. He asserted that the Staff's concerns in this docket have no direct bearing on customer service. (T. 175-177) Mr. Harder responded to Staff's concerns that Arkla failed to properly administer its TLICGRP by stating that: (1) this was a one-time program that did not conform with any existing **[*143]** accounting or billing mechanism; (2) when Arkla became aware of problems; it developed corrective measures; and (3) the amount of the over-billing errors represented only a small portion of the total amount billed. (T. 179-180)

Regarding Staff's concerns about the MRP Rider, Mr. Harder observed that with any program of this magnitude, mistakes will occur. He also noted that the MRP under billing error represents only a small portion of the total billings during that time period and thus should not warrant a reduction in the Company's ROE. (T. 180-181) Concerning Arkla's WNA, Mr. Harder stated that the Company remedied this error in accordance with Commission Rules. Mr. Harder insisted that the failure to bill sales tax on the WNA was not an error, but rather a conscious decision to forego the collection of sales tax from its customers. (T. 181-183) With regard to deficiencies in the Company's Application, Mr. Harder stated that the alleged deficiencies did not materially affect the amount sought by the Company or Staff's audit. Mr. Harder testified that Arkla subsequently reduced its requested rate relief as a result of a filing deficiency. Mr. Harder also asserted that Arkla has **[*144]** not experienced problems with the filing requirements in other jurisdictions. (T. 174-186)

Arkla witness Hamilton contended that the Staff should modify its auditing procedures to obtain the information that it needs by examining the accounting records that are maintained by the Arkla corporate offices and developing an audit program tailored to the specific requirements of each of the larger companies it audits. With regard to the Staff's recommendation that it have access to external auditor working papers, Mr. Hamiliton does not believe that future external auditor engagement letters should provide the Staff with full access to all working papers created by the Company's external auditor. He contended that audit working papers are not designed in a manner that would or should permit third parties to use the information found in those audit working papers for other purposes. (T. 1038-1047)

Arkla witness Fitzgerald's testimony addressed certain of the allegations made by the Staff concerning various deficiencies in the Company's accounting system and practices. Mr. Fitzgerald argued that, even if each of the accounting allegations were true, the Staff has not presented any evidence **[*145]** that the deficiencies have negatively affected the quality of service provided by the Company. Mr. Fitzgerald further testified that the Staff has not cited any specific rules that Arkla violated in reaching its conclusion that Arkla's accounting and system and reporting processes are out of compliance with Commission Rules or are not suitable for regulatory purposes. (T. 1951-1953)

In surrebuttal testimony, Staff witness Fritchman continued to assert that the Company failed to properly administer and monitor the operation of the TLICGRP and MRP Riders. Ms. Fritchman contended that Arkla's lack of administrative oversight of these riders raises the concern that similar problems, if not addressed, could occur with the operation of other tariffs. (T. 1567) She stated that the magnitude of the errors in administering the TLICGRP and MRP Rider cannot be dismissed as being immaterial. (T. 1567-1570) The Staff continues to assert that the problems with Arkla's Application impeded its review and audit. (T. 1572-1573) Regarding access to external auditor work papers, Ms. Fritchman pointed out that Staff routinely reviews the external auditor work papers for the companies it audits to determine **[*146]** if there are any issues that should be further investigated. (T. 1574-1575) Staff witness Booth testified that Arkla continues to fail in its obligation as a regulated public utility. Mr. Booth asserted that, while the facts in this case differ from the Continental case, the Continental case recognized that the cost of equity can be adjusted when supported by certain facts. He argued that, if a utility fails to follow any standard, regulation, or practice set by the Commission, the utility has failed to meet its obligations as a regulated public utility and has thus negatively affected its customers. (T. 1789-1791)

In sur-surrebuttal testimony, Arkla witness Harder testified that the Staff has not shown that its downward ROE adjustment is permitted under Arkansas law, does not violate Arkla's right to due process, and is proportionate to the alleged harm to ratepayers. (T. 237) Regarding the administration of its tariffs, Mr. Harder stated that Arkla takes billing problems seriously and that it seeks to promptly correct such problems and take corrective action to prevent their recurrence. Mr. Harder argued that Staff's audit was not impaired despite the problems the Staff experienced **[*147]** with Arkla's Application. According to Harder, this was evidenced by the fact that the Staff was able to comply with all of the established procedural dates in this proceeding.

Arkla witness Hamilton continued to assert that gaining access to the external audit working papers provides little, if any, additional rate case audit support and that if access is granted, the cost of the audit will increase. (T. 1051-1052) Arkla witness Fitzgerald testified that except for certain MFRs, the Staff did not cite one Commission rule that Arkla violated. Mr. Fitzgerald contended that there were only three accounting-related errors cited by Staff, which represents only a small portion of an enormous number of accounting entries made daily by the Company. He contended that Arkla acted properly and reasonably by correcting each of the accounting errors, and Arkla agreed to institute various new processes to help minimize their chances of recurring in the future. (T. 985-987) Mr. Fitzgerald further testified that, without a showing of persistently inadequate customer service, the Commission has no history of punishing a utility through its rate of return and has held that a punitive ROE is contrary **[*148]** to accepted legal standards for reasonable returns. (T. 987)

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

Testimony has been presented by Staff witnesses which identified numerous instances in which Arkla's billing of customers, accounting practices, and rate case filings were deficient. While Arkla asserts that the alleged deficiencies had no bearing on the quality of service provided to its customers, quality of service has as **[*149]** much to do with utilizing proper inventory and accounting practices as it does pipe replacement and quality field service. Arkla, as a public utility, is required and obligated to maintain proper accounting and financial records in compliance with uniform accounting practices, and to file Applications for rate changes in compliance with the Commission's Minimum Filing Requirements ("MFRs"). In return for compliance with these accounting requirements, among others, utilities are allowed to recover their reasonable and prudently-incurred expenses, earn a fair and reasonable return on capital investments, and enjoy a monopoly service territory. A public utility's accounting systems form the basis for establishing appropriate rates for its customers. For ratemaking purposes, it is the regulatory commission which has the responsibility and authority for exercising control of the rates, charges and services provided by the utility company. The Commission notes that Arkla did not substantively deny the allegations made by Staff regarding the administration of its TLICGRP, MRP Rider, or WNA, or that there were various deficiencies with its Application filing package. Arkla simply provided **[*150]** various explanations such as: (1) the overbilling errors were small in comparison with the total amount billed; (2) humans do make mistakes; (3) the billing errors were corrected; and (4) the Application deficiencies did not materially affect the amount of revenue sought by the Company or impair Staff's investigation.

The Commission cannot ignore what appears to be a pattern of deficiencies as to Arkla's recordkeeping, accounting systems, customer billings, and rate case filings. Staff witness Booth testified that Arkla's rate Applications in its last four rate cases were also cited for numerous MFR deficiencies. These deficiencies occurred even after Arkla was given waivers of certain MFRs in those cases. While it appears that Arkla did address some of the Staff's accounting concerns identified in Arkla's last rate case (Docket No. 01-243-U), the reoccurrence of related and numerous problems in this docket and in recent Staff tariff audits leads the Commission to believe that the Company has not yet undertaken the serious corrective actions it must take in order to establish a prudent and credible basis for its accounting and billing systems -- all of which are fundamental to the **[*151]** determination of reasonable rates. Accordingly, an ROE below the mid-point of the range that reflects poor performance in this area will hopefully serve as an appropriate inducement to incent corrective action by Arkla that will produce more confidence and integrity in future inventory numbers, cost accounting, customer billing, rate case applications, and compliance with the Commission's MFRs.

In describing the difference between the Continental Telephone Case and this proceeding, the Company argued that: (1) in this proceeding, there is no evidence that the quality of service was inadequate; (2) the evidence in this case does not show a pattern of non-compliance; and (3) absent a showing of poor customer service, the Commission has no history of punishing a utility through its rate of return. (T. 1566) The Commission does not agree with Arkla's reasoning. Arkla's service to its customers is provided via its rate schedules, riders, and tariffs. If the quality of customer service is inadequate in the administration of these tariffs, riders, and rate schedules, or the accounting and inventory practices that underline those rate schedules, the Commission may apply the "Continental case **[*152]** standard." The record in this proceeding provides substantial evidence to support a finding that the quality of service provided by Arkla by its administration of several Arkla riders was inadequate. Through its audits, the Staff found that ratepayers were overcharged by approximately $ 2,659,478 for the service that Arkla provided through its TLICGRP and MRP Riders. (T. 1566-1567) Also, the Staff found that Arkla misapplied the terms of its WNA Rider to bills of its residential and small commercial customers in November 2001. (T. 1566-1567)

The record also shows a pattern of non-compliance with Commission rules and regulations. As previously mentioned, uncontroverted testimony was presented that Arkla's Applications in its most recent Arkansas rate cases in Docket Nos. 01-243-U, 94-175-U, 93-081-U, and 92-032-U were cited for numerous MFR deficiencies even after being granted waivers of certain MFRs. Furthermore, the deficiencies occurred again in the current Application. (T. 1792) The record also shows that: (1) Arkla's accounting system failed to properly account for retirements of plant no longer serving customers, and failed to readily identify the amounts and types of cost being **[*153]** *allocated to it; and* (2) *Arkla failed to retain data required for* depreciation studies and record keeping processes. (T. 1790) When taken as a whole, this evidence establishes a pattern of persistent and inadequate customer service and non-compliance with standard accounting practices and Commission rules and regulations. The fact that the Commission may not have a consistent history of reducing a rate of return allowance for service quality and rule violation issues only indicates that the magnitude of such patterns of conduct as reflected in this case have not often occurred in this state.

The Commission, however, is encouraged by the testimony of Arkla Vice President and Controller, Walter L. Fitzgerald. Mr. Fitzgerald testified that the Company has made improvements in various accounting and computing systems. Some of the improvements the Company identified included: (1) a process called "record and report" which tracks transactions through the accounting process; (2) a computer *system which tracks various processes, and* (3) *since the last rate case, a* "special projects ledger. n12 (T. 886-887) Mr. Fitzgerald was confident that the problems that Staff has identified in the past, **[*154]** and in this proceeding, have been addressed and that the Company will continue to maintain these "state of the art" type systems. (T. 886-888) Given these improvements cited by Arkla and its commitment that the problems have been and will continue to be addressed, the Commission will modify Staff's recommendation that Arkla's ROE be set at the lower end of Staff's range of reasonableness and set Arkla's ROE in this proceeding at 9.45%, which is approximately half-way between Staff's recommendation and the mid-point of the range of reasonableness.

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n12 The Commission notes that Staff witnesses Fritchman and Booth indicated that, while Arkla has made changes to its accounting systems since Arkla's last rate case, some of the same problems from the last rate cases were identified in this proceeding. With regard to Arkla's Application deficiencies, the Staff indicated it would not know whether those type problems have been resolved until Arkla files its next rate Application. (T. 894, 923, 961-63)

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The Commission, directs **[*155]** its General Staff, to closely monitor Arkla's progress in correcting the various cited deficiencies. If progress is not being made as promised by Arkla, the Commission will take appropriate steps to ensure that deficiencies are corrected in a timely manner. Prior to its next rate case, Arkla must bring its books and records into full compliance with standard accounting practices and with the Commission's MFRs.

XII. STAFF RECORDKEEPING AND REPORTING RECOMMENDATIONS