In The
Court of Appeals
Seventh District of Texas at Amarillo

No. 07-17-00146-CV

SOUTHWESTERN PUBLIC SERVICE COMPANY, APPELLANT

V.

PUBLIC UTILITY COMMISSION OF TEXAS, APPELLEE

On Appeal from the 345th District Court
Travis County, Texas[1]
Trial Court No. D-1-GN-16-001675, Honorable Scott H. Jenkins, Presiding

April 26, 2018

MEMORANDUM OPINION

Before QUINN, C.J., and PIRTLE and PARKER, JJ.

Reviewing courts are to defer to statutory interpretations made by the regulatory agency tasked with a statute's enforcement. This is a case in which the Public Utility Commission of Texas altered the proposal for decision entered by the administrative law judges (ALJs) that initially heard the case. Applicable statutes make clear that the

[1] Pursuant to the Texas Supreme Court's docket equalization efforts, this case was transferred to this Court from the Third Court of Appeals. See TEX. GOV'T CODE ANN. § 73.001 (West 2013). As such, we are obligated to apply the precedent of the Third Court of Appeals if there is a conflict between the precedents of that court and this Court. TEX. R. APP. P. 41.3.

Commission is authorized to alter the ALJs' proposal for decision if such alteration is supported by substantial evidence. Appellant, Southwestern Public Service Company (SPS), contends that the Commission's alteration of the ALJs' proposal was in violation of its statutory authority to make such changes. Given the deference afforded the Commission's statutory interpretation, we conclude that the Commission acted appropriately in altering the ALJs' proposal and we affirm the trial court's judgment.

Factual and Procedural Background

SPS is a vertically integrated electric utility that serves retail customers in Texas and New Mexico, and wholesale customers in both states. Because SPS is a government-sanctioned monopoly in its service area, the Commission is tasked with ensuring that its rates are just and reasonable as a substitute for competition.[2]

SPS requested Commission approval to increase the rate it charged in the Texas retail market. Initially, SPS requested an increase of $64.75 million but, subsequently, lowered its request to $42.07 million. After an evidentiary hearing, three ALJs issued a proposal for decision recommending a $14.4 million annual increase in SPS's Texas retail revenue requirement. The Commission modified the ALJs' proposal for decision, including rejecting use of SPS's actual capital structure, denying recovery of expenses related to SPS's annual incentive compensation program, and disallowing a post-test-year adjustment to the test year jurisdictional allocation based on a decrease in sales in SPS's wholesale market.

[2] *See* TEX. UTIL. CODE ANN. §§ 11.002, 36.003(a) (West 2016).

Following the Commission's decision, SPS filed a suit for judicial review. The district court affirmed the Commission's order in all respects. SPS timely appealed. By its appeal, SPS presents three issues. By its first issue, SPS contends that the Commission erred by altering the ALJs' recommendation regarding SPS's capital structure. SPS contends, by its second issue, that the Commission erred in disallowing half of its annual incentive compensation expense based on the program having a financially based "affordability trigger." Finally, SPS contends that the Commission erred by rejecting SPS's proposed "known and measurable" adjustment to its jurisdictional allocation based on a post-test-year decrease in sales in its wholesale market.

Standard of Review

In assessing the scope of an agency's authority, we must give serious consideration to the contemporaneous construction of a statute by the administrative agency charged with its enforcement. *Sergeant Enters., Inc. v. Strayhorn*, 112 S.W.3d 241, 246 (Tex. App.—Austin 2003, no pet.) (citing *Tarrant Appraisal Dist. v. Moore*, 845 S.W.2d 820, 823 (Tex. 1993)). This is so because the legislature intends that an agency created to centralize expertise in a certain regulatory area be given a great degree of discretion in the methods it uses to accomplish its regulatory function. *Id*. "If the agency's interpretation is consistent with the language and the purposes of the statute, the court will accept it, even if other more reasonable interpretations exist." *Anderson-Clayton Bros. Funeral Home, Inc. v. Strayhorn*, 149 S.W.3d 166, 178 (Tex. App.—Austin 2004, pet. denied). However, we do not grant complete discretion to the agency charged with regulating a particular area.

Any party to a proceeding before the Commission is entitled to judicial review under the substantial evidence rule. TEX. UTIL. CODE ANN. § 15.001 (West 2016). In reviewing a case decided under the substantial evidence rule, "a court may not substitute its judgment for the judgment of the state agency on the weight of the evidence on questions committed to agency discretion . . . ." TEX. GOV'T CODE ANN. § 2001.174 (West 2016). Under the substantial evidence standard, the reviewing court must determine whether, after considering the totality of the evidence, reasonable minds could have reached the same conclusion that the agency reached in the disputed action. *Coal. for Long Point Pres. v. Tex. Comm'n on Envtl. Quality*, 106 S.W.3d 363, 366 (Tex. App.—Austin 2003, pet. denied). The reviewing court may not substitute its judgment for that of the agency and must limit its review to the evidence upon which the agency based its decision. *Id*. The reviewing court is not tasked with determining whether the agency made the right decision, but rather whether there is some reasonable basis in the record for the agency's action. *Id*. at 367. We begin with the presumption that the agency's findings, inferences, conclusions, and decisions are supported by substantial evidence, and the burden of proving otherwise is on the contestant. *Id*.

"An agency's decision is arbitrary or results from an abuse of discretion if the agency: (1) failed to consider a factor the legislature directs it to consider; (2) considers an irrelevant factor; or (3) weighs only relevant factors that the legislature directs it to consider but still reaches a completely unreasonable result." *City of El Paso v. Pub. Util. Comm'n of Tex.*, 883 S.W.2d 179, 184 (Tex. 1994). In addition, if the agency fails to follow the clear, unambiguous language of its own regulation, it acts arbitrarily and

capriciously. *Pub. Util. Comm'n of Tex. v. Gulf States Utils. Co.*, 809 S.W.2d 201, 207 (Tex. 1991).

Capital Structure

By its first issue, SPS contends that the Commission erred by adopting a hypothetical capital structure rather than SPS's actual capital structure. According to SPS, the Commission committed legal error by adopting a new policy without following proper procedure, and by failing to comply with the statutory requirements for revising the ALJs' proposal for decision which used SPS's actual capital structure.

In setting rates for a public utility company, the Commission is required to establish the utility's overall revenues at an amount that will permit the utility a reasonable opportunity to earn a reasonable return on the utility's invested capital. TEX. UTIL. CODE ANN. § 36.051 (West 2016). Part of this rate-setting process is determining the appropriate capital structure for the utility. *Pioneer Nat. Res. USA, Inc. v. Pub. Util. Comm'n of Tex.*, 303 S.W.3d 363, 370 (Tex. App.—Austin 2009, no pet.). The percentage of debt and equity capital, or capital structure, is used to determine the appropriate rate of return as well as the revenue requirement to be allocated among the customers. *Id*. at 370-71. Generally, the larger the percentage of equity, the higher the rates charged to customers. *See id*. at 371. In the present case, the ALJs concluded that SPS's actual capital structure of 53.97 percent equity and 46.03 percent long-term debt was reasonable in light of SPS's business and regulatory risks. However, the Commission rejected the ALJs' conclusion and adopted a hypothetical capital structure composed of 51 percent equity and 49 percent debt.

The Texas Government Code provides three grounds upon which the Commission may change ALJ findings or conclusions. *See* TEX. GOV'T CODE ANN. § 2003.049(g) (West 2016). Specifically, the Commission can make such a change if: (1) the ALJ did not properly apply or interpret applicable law, commission rules or policies, or prior administrative decisions; (2) the ALJ's finding of fact is not supported by a preponderance of evidence; or (3) the Commission determines that a commission policy or prior administrative decision upon which the ALJ relied is incorrect or should be changed. *Id*. The Commission's authority to reevaluate the evidence supporting the ALJ's findings of fact has been held to allow the Commission to substitute its judgment for the ALJ's on questions of fact. *Sw. Pub. Serv. Co. v. Pub. Util. Comm'n of Tex.*, 962 S.W.2d 207, 214 (Tex. App.—Austin 1998, pet. denied). However, when the Commission changes the ALJ's findings or conclusions, it must state in writing the specific reasons and legal bases for doing so. TEX. GOV'T CODE ANN. § 2003.049(h); *Sw. Pub. Serv. Co.*, 962 S.W.2d at 214.

SPS contends that the ALJs' finding that SPS's actual capital structure of 46.03 percent debt to 53.97 percent equity was reasonable and consistent with prior Commission decisions. The Commission responds that its imposition of a 49 percent debt to 51 percent equity capital structure is consistent with its prior precedent for vertically integrated utilities. The Commission impliedly found that the ALJs' proposal was not supported by a preponderance of the evidence and its order expressly addressed the substantial evidence upon which it relied in altering the ALJs' recommendation.

SPS contends that it has long been the Commission's policy to accept a vertically integrated utility's actual capital structure. In its brief, SPS follows the history of the

Commission's approach to capital structure for vertically integrated utilities over time. SPS indicates that, in the 1980s and 1990s, the Commission accepted the actual capital structures of vertically integrated utilities. However, SPS fails to identify the actual capital structures of these utilities. In support of its theory, SPS also identifies two recent instances in which the Commission accepted the actual capital structure of vertically integrated utilities. *See* Tex. Pub. Util. Comm'n, *Application of Sw. Elec. Power Co. for Auth. to Change Rates & Reconcile Fuel Costs*, Docket No. 40443, 2013 Tex. PUC LEXIS 98, at *48 (Oct. 10, 2013); Tex. Pub. Util. Comm'n, *Application of Entergy Tex., Inc. for Auth. to Change Rates, Reconcile Fuel Costs, & Obtain Deferred Accounting Treatment*, Docket No. 39896, 2012 Tex. PUC LEXIS 283, at *34 (Nov. 1, 2012). However, the actual capital structure of each of these utilities was approximately 50 percent debt to 50 percent equity. In each of these cases, the Commission found that the utilities' actual capital structures were "reasonable in light of [the] business and regulatory risks" each faced. That the Commission determined that two similarly situated utilities' actual capital structures, which happened to be near 50 percent debt and 50 percent equity, were reasonable does not establish Commission policy that the actual capital structure of a vertically integrated utility is reasonable in all instances. As such, there is recent precedent for the Commission to apply a capital structure to a vertically integrated utility that requires a greater ratio of debt than that applied to SPS.[3] Further, if the Commission were bound to dogmatically accept a utility's actual capital structure in every instance,

[3] SPS contends that the Commission's statement that, "The Commission-adopted capital structure of 49% debt and 51% equity also reflects what would be a more prudent balance sheet of a vertically integrated utility during this period of low-cost debt" reflects a general policy applicable to all vertically integrated utilities. Rather than being a statement of policy, we view this statement as an acknowledgement that in each of the three rate setting cases involving vertically integrated utilities that have gone to final decision during the current period of low-cost debt, a debt to equity ratio approximating 50-50 has represented a "more prudent balance sheet" based on the evidence presented in each case.

there would be no need for the Commission to review any utility's capital structure. If such were the rule, the Commission's obligation to ensure that the rate it sets is just and reasonable would be vitiated. *See* TEX. UTIL. CODE ANN. § 36.003(a).

Additionally, the record reflects substantial evidence that supports the Commission's change of the ALJs' proposed capital structure. As previously addressed, the Commission maintains an original fact-finding role in reviewing an ALJ's findings of fact. *Sw. Pub. Serv. Co.*, 962 S.W.2d at 213. One expert witness, Michael Gorman, testified that, due to the current marginal cost of debt, a utility's equity capital is roughly three times more expensive to ratepayers than debt capital. Gorman further testified that use of SPS's actual capital structure was not reasonable, particularly given current low interest rates. According to his analysis, from 2009 through 2014, the average ratio of equity in utility capital structure ranged from 48.3 percent to 50.7 percent. For the foregoing reasons, Gorman recommended that SPS's capital structure be set at 50 percent debt and 50 percent equity. While the Commission did not adopt Gorman's suggestion, it did adopt a capital structure within the range presented by expert witnesses in the case. *See City of El Paso*, 883 S.W.2d at 186 (substantial evidence exists when the Commission selects an outcome within the range of evidence provided by expert testimony); *State v. Pub. Util. Comm'n of Tex.*, 246 S.W.3d 324, 337 (Tex. App.—Austin 2008, pet. denied) (same). As such, we conclude that the Commission's determination of the appropriate capital structure for SPS was supported by substantial evidence.

SPS further contends that the Commission failed to specifically identify the reasons or legal bases for changing the ALJs' proposal of using SPS's actual capital structure. *See* TEX. GOV'T CODE ANN. § 2003.049(h); *Sw. Pub. Serv. Co.*, 962 S.W.2d at 214. The

Commission's order generally stated that its capital structure was "based on the totality of the record." However, it went on to state that the 49 percent debt to 51 percent equity capital structure falls within the range supported by record evidence[4] and is based on SPS's test-year capital structure,[5] recent Commission decisions in which the Commission set capital structures of approximately 50 percent debt and 50 percent equity,[6] and the current period of low-cost debt.[7] The Commission then entered explicit findings of fact consistent with the above. Based on the above, we conclude that the Commission identified the facts supporting its finding regarding its alteration of the ALJs' proposed capital structure. *See Oncor Elec. Delivery Co. v. Pub. Util. Comm'n of Tex.*, 406 S.W.3d 253, 268 (Tex. App.—Austin 2013, no pet.) (concluding that the Commission's written explanation must identify the substantial evidence upon which it is based).

Finally, SPS contends that the Commission deviated from precedent by not adjusting the applicable return on equity when it altered SPS's capital structure. We note that the return on equity that was proposed by the ALJs was adopted by the Commission. The ALJs reached their proposed return on equity after discussing SPS's risk, market conditions, and interest rates. The Commission agreed with the ALJs' analysis. The low-

[4] SPS proposed a capital structure of 53.97 percent equity and 46.03 percent debt. Gorman testified that SPS's capital structure should consist of 50 percent equity and 50 percent debt. Thus, the Commission's capital structure of 51 percent equity and 49 percent debt falls within the range supported by record evidence.

[5] SPS's actual test-year capital structure included 52.44 percent equity, rather than the actual capital structure SPS proposed, which included several post-test-year adjustments.

[6] Evidence established that these recent cases involved vertically integrated utilities and were decided under similar market conditions, including during the current period of low-interest debt.

[7] Evidence was presented that established that debt is especially less expensive than equity under current market conditions and, thus, it is unreasonable for a utility to have a higher ratio of equity without proof that a higher ratio of debt would be unreasonably risky. SPS did not prove that it is in an unreasonably risky position.

cost debt environment that led to the Commission's 49 percent debt and 51 percent equity capital structure had already been accounted for by the ALJs in determining their proposed return on equity, so it appears that the Commission simply did not believe that the return on equity needed to be adjusted when the capital structure was altered. It is within the Commission's discretion to adopt the ALJs' proposal.

Consequently, we conclude that there was substantial evidence that justified the Commission's decision to alter the ALJs' proposal and to set SPS's capital structure to 51 percent equity and 49 percent debt. We also conclude that the Commission properly stated in writing its specific reasons and legal bases for doing so. As such, we deny SPS's first issue and affirm the trial court's judgment regarding SPS's capital structure.

Annual Incentive Compensation Program

By its second issue, SPS contends that the Commission acted arbitrarily and capriciously when it disallowed half of SPS's Annual Incentive Compensation Program. Specifically, SPS contends that the Commission's conclusion that the program's "affordability trigger" constituted a financially based condition precedent conflicts with prior decisions of the Commission.

Payroll costs are usually included among a utility's reasonable and necessary expenses. *Entergy Tex., Inc. v. Pub. Util. Comm'n of Tex.*, No. 03-14-00706-CV, 2016 Tex. App. LEXIS 2983, at *2-3 (Tex. App.—Austin Mar. 24, 2016, no pet.) (mem. op.). Incentive compensation programs are a form of payroll cost, so they are eligible for recovery if they are proven to be reasonable and necessary. *See generally* TEX. UTIL. CODE ANN. § 36.051. In 2003, the Commission established a policy of disallowing

payments made under incentive programs if the payments are made based on the achievement of financial-based goals rather than operational-based goals because such financially triggered payments are not reasonable and necessary to provide utility services. *Entergy Tex., Inc.*, 2016 Tex. App. LEXIS 2983, at *3 (citing Tex. Pub. Util. Comm'n, *Application of AEP Tex. Cent. Co. for Auth. to Change Rates*, Docket No. 28840, 2005 Tex. PUC LEXIS 32, at *62-63 (Aug. 15, 2005) (order)). The reason for this distinction is that operational-based incentives provide an immediate benefit to ratepayers, while financial-based incentives primarily benefit shareholders. *Id*. While there is often a fact question about whether an incentive compensation program is financially or operationally based, the Commission's policy that incentive programs tied to financial goals are not recoverable has remained constant. *Id*. at *4; *State of Tex. Agencies & Insts. of Higher Learning v. Pub. Util. Comm'n of Tex.*, 450 S.W.3d 615, 660 n.34 (Tex. App.—Austin 2014), *aff'd in part, rev'd on other grounds, Oncor Elec. Delivery Co. v. Pub. Util. Comm'n of Tex.*, 507 S.W.3d 706 (Tex. 2017). Because the question of whether incentive compensation payments are financially or operationally based is one of fact, we must uphold the Commission's decision if it is reasonable in light of the record and supported by substantial evidence. *State of Tex. Agencies & Insts. of Higher Learning*, 450 S.W.3d at 660.

SPS contends that its annual incentive compensation program is based on operational goals but has an "affordability trigger" that is tied to SPS's earnings per share. Because payments made under the program are premised on operational goals, SPS contends that the Commission should have determined that such payments were reasonable and necessary payroll expenses. However, evidence established that the

incentive program's "affordability trigger" would fund the incentive plan only when a benchmark earnings per share is met. As such, all payments under SPS's annual incentive compensation program are dependent on the achievement of financial-based goals, which runs afoul of the Commission's policy of disallowing incentive compensation program expenses that are based on the achievement of financial-based goals. *See Entergy Tex., Inc.*, 2016 Tex. App. LEXIS 2983, at *3. Nonetheless, the Commission acknowledged that a portion of the plan was tied to operational-based objectives and allowed half of what SPS had requested. We conclude that there was substantial evidence to support the Commission's determination that SPS's annual incentive program included significant financial-based goals that justified the exclusion of half of SPS's request. *See State of Tex. Agencies & Insts. of Higher Learning*, 450 S.W.3d at 660.

We overrule SPS's second issue and affirm the trial court's judgment regarding the disallowance of half of SPS's annual incentive program.

Known and Measurable Change

By its third issue, SPS contends that the Commission acted arbitrarily and capriciously by denying SPS's proposal for a post-test-year jurisdictional adjustment to account for its known and measurable loss to its wholesale load.

The Commission has authority to allow adjustments to a utility's cost of service during a historical test year for changes that are known and measurable. 16 TEX. ADMIN. CODE § 25.231 (Pub. Util. Comm'n, Cost of Service). The Commission may, in its discretion, go outside the test year when necessary to achieve just and reasonable rates that will more accurately reflect the cost of service that is apt to apply to the utility in the

future. *City of El Paso*, 883 S.W.2d at 188. We will not substitute our judgment for that of the Commission on the weight to be given the evidence on questions committed to the Commission's discretion. *City of Corpus Christi v. Pub. Util. Comm'n of Tex.*, No. 03-06-00585-CV, 2008 Tex. App. LEXIS 1706, at *20-21 (Tex. App.—Austin Mar. 5, 2008, no pet.) (mem. op.) (citing *Office of Pub. Util. Counsel v. Pub. Util. Comm'n of Tex.*, 185 S.W.3d 555, 566 n.14, 567 (Tex. App.—Austin 2006, pet. denied)).

SPS operates in three ratemaking jurisdictions: Texas retail, New Mexico retail, and wholesale. Part of ratemaking is allocating the costs of service amongst the three jurisdictions. When one of SPS's wholesale customers, Golden Spread Electric Cooperative, Inc., notified SPS that it intended to reduce the amount of energy it would purchase in the coming year, SPS contends that this "known and measurable change" necessarily influenced the jurisdictional allocation amongst the three ratemaking jurisdictions. As such, SPS proposed that the Commission consider this ramp down to be a known and measurable change and to adjust the test-year jurisdictional allocation to spread the effect of this decrease in sales to the other two jurisdictions. While the ALJs agreed with SPS that the Golden Spread decrease was a known and measurable change, the Commission disagreed and disallowed any change to the test-year jurisdictional allocation.

The Commission determined that SPS did not prove that its proposed change qualifies as a known and measurable change to test-year data. *See Sw. Pub. Serv. Co.*, 962 S.W.2d at 213 (authorizing the Commission to assume an original fact-finding role when reviewing ALJ proposal). The Commission explained that SPS's proposal to increase the Texas revenue requirement by $11.1 million "cherry picks one change in the

utility's wholesale sales . . . and fails to show [how] this single change, in the absence of a broader analysis, will better represent the utility's jurisdictional costs and revenues that are apt to prevail in the future." The Commission determined that the reduction in SPS's wholesale market, based on the decrease of a single customer's demands occurring eleven months after the end of the test year, was not sufficient to show a known and measurable change to SPS's jurisdictional allocation, which had been determined based on the data derived during the historical test year. SPS's proposal identifies a known and measurable change in SPS's sales and revenue rather than identifying a known and measurable change in the jurisdictional allocation derived from the test-year data. As such, SPS failed to meet its burden of proof. *See Coal. for Long Point Pres.*, 106 S.W.3d at 367.

SPS identifies other proposed known and measurable changes that were approved by the Commission as evidence that the Commission acted arbitrarily and capriciously in denying SPS's proposed adjustment to the jurisdictional allocation. However, a review of each of these other changes reveals that the effects of these changes on the Texas jurisdiction were known and measurable. Further, none of these proposed changes sought to change the jurisdictional allocation. Consequently, we view these other changes as distinguishable from SPS's proposed change to the jurisdictional allocation.

Further, the Commission's rejection of SPS's proposed change to the test-year jurisdictional allocation is supported by substantial evidence. One expert witness, Jeffry Pollock, testified that it would be inappropriate to recognize a post-test-year decrease in sales to one customer as affecting the entire test-year jurisdictional allocation because

customer demands always change after the test year. Another expert, Clarence Johnson, testified that it is inappropriate to simply reallocate a decrease in revenue from one jurisdiction to others without also accounting for resultant changes to costs and revenues caused by the decrease. In addition, SPS has not cited this Court to any prior Commission decision in which a post-test-year adjustment to a utility's jurisdictional allocation has been approved. The Commission has discretion whether to incorporate known and measurable changes to test-year data, and we will not substitute our judgment for that of the Commission on the weight to be given the evidence on questions committed to the Commission's discretion. *City of Corpus Christi*, 2008 Tex. App. LEXIS 1706, at *20-21.

Because we conclude that there was substantial evidence to support the Commission's disallowance of SPS's proposed known and measurable change based on the Golden Spread ramp down, we overrule SPS's third issue.

Conclusion

Having found substantial evidence to support the Commission's alterations to the ALJs' proposed decision in this case and overruling each of SPS's issues, we affirm the trial court's judgment.

Judy C. Parker
Justice