CITY OF EL PASO, TEXAS
DEPARTMENT HEAD'S SUMMARY REQUEST FOR COUNCIL ACTION (RCA)

DEPARTMENT: **Financial Services**
AGENDA DATE: **June 6, 2006**
CONTACT PERSON/PHONE: **William F. Studer, Jr./541-4011**
DISTRICT(S) AFFECTED: **All Districts**

SUBJECT:
APPROVE a resolution / ordinance / lease to do what? **OR AUTHORIZE** the City Manager to do what? Be descriptive of what we want Council to approve. Include $ amount if applicable.

Presentation by Navigant Consulting, Inc. ("*Navigant*") regarding the assessment of the El Paso Electric Company's operating expenses pursuant to the Rate Agreement entered into by and between the City of El Paso and the El Paso Electric Company, effective July 1, 2005.

BACKGROUND / DISCUSSION:
Discussion of the what, why, where, when, and how to enable Council to have reasonably complete description of the contemplated action. This should include attachment of bid tabulation, or ordinance or resolution if appropriate. What are the benefits to the City of this action?

The City of El Paso, Texas (the "***City***") entered into a Rate Agreement (the "***Agreement***") with El Paso Electric Company (the "***Company***" or "***EPE***") effective July 1, 2005. The Agreement requires the City to select an outside firm to determine whether the Company's operating expenses are within a reasonable range as compared to the utility industry. If the operating expenses are deemed unreasonable, then the Company and the City will agree upon a remedy, or the Agreement will expire at the end of the twelve –month period. If the operating expenses are deemed to be reasonable, the Agreement shall continue in full force and effect. Navigant was retained by the City to perform the review of the Company's operating expenses.

PRIOR COUNCIL ACTION:
Has the Council previously considered this item or a closely related one? If so, when?
No.

AMOUNT AND SOURCE OF FUNDING:
How will this item be funded? Has the item been budgeted? If so, identify funding source by account numbers and description of account. Does it require a budget transfer?

N/A

BOARD / COMMISSION ACTION:
Enter appropriate comments or N/A

N/A

**********REQUIRED AUTHORIZATION**********

LEGAL: (if required) Jorge Villegas, Asst. City Attorney **FINANCE:** (if required) _____

OTHER: William F. Studer, Deputy City Manager Financial Services _____
(Example: if RCA is initiated by Purchasing, client department should sign also)
Information copy to appropriate Deputy City Manager

APPROVED FOR AGENDA:
CITY MANAGER: _____ **DATE:** _____

Document Name:CITYATTY/1/RCA NAVIGANT PRESENTATION
Document #: 22641
Author_Id: JVIL

El Paso Electric

Scott D. Wilson
Executive Vice President, Chief Financial and Administrative Officer

P.O. Box 982
El Paso, Texas
79960-0982
(915) 543-5711

June 5, 2006

Joyce Wilson
City Manager
City of El Paso
2 Civic Center Plaza
El Paso, Texas 79901

Dear Ms. Wilson:

El Paso Electric Company (EPE) and the City received the Assessment of the El Paso Electric Company's Operating Expenses prepared by Navigant Consulting dated June 2, 2006 (Navigant Report). This report was prepared at the request of the City pursuant to the July 2005 rate agreement between the City and EPE to assess the reasonableness of EPE's operating expenses. The Navigant Report will be presented at the June 6, 2006 City Council Meeting. EPE does not plan on making any comments on the Navigant Report at the City Council Meeting. However, we are providing this letter to inform the City of actions that EPE is already pursuing which address the recommendations in the Navigant Report.

The Report recommends that the City and EPE should identify a set of performance measures that EPE can employ to self-report annual benchmark performance to the City compared to a peer group of companies. EPE will work with the City Staff to establish such a report to be provided to the City.

The Report states that EPE should take action to address its old gas-fired steam generation units including the option of replacing them with new, more efficient units. EPE currently has plans to add new gas-fired generation in 2009, 2010 and 2011. It is not possible to install new generation earlier than 2009 due to the time needed to obtain necessary permits, as well as the time needed to procure the equipment and construct the units. EPE is also working to maintain its older gas-fired generating units in an as efficient manner as possible until they are retired.

EPE is presently pursuing the third recommendation in the Report to develop staffing plans to address its aging workforce. To this end, EPE is developing a Workforce Risk Assessment to evaluate its human resources, technology needs and processes in general to ensure that it has the skill sets, tools, and operational efficiencies necessary to meet future workforce challenges at the lowest reasonable cost. The assessment process will generate plans to

eliminate any such gaps and build the workforce needed for the future. The Workforce Risk Assessment is expected to be concluded in the second half of this year.

The last recommendation was for EPE to continue to seek opportunities to employ new systems and technologies to displace manual processes including a Geographic Information System ("GIS"), Outage Management System and Customer Information System. EPE is actively pursuing increased automation including the systems identified in the recommendations. A GIS is currently being implemented by EPE and is expected to be fully operational in the first quarter of 2007. An Outage Management System (which is an extension of the GIS) has been budgeted and implementation is expected to begin soon. EPE is currently in the early stages of pursuing a new Customer Information System, which we hope to implement by 2009.

These activities discussed above reflect on-going efforts by EPE to actively manage its operating expenses while meeting customer needs. I will be present at the City Council Meeting on June 6, 2006 to address any questions that you may have regarding EPE's activities.

Sincerely,

Scott D. Wilson

cc: Mr. Bill Studer
Mr. Norman Gordon
Mr. Michael Adams

ASSESSMENT OF THE EL PASO ELECTRIC COMPANY'S OPERATING EXPENSES

Prepared for

The City of El Paso, Texas

Prepared by:

Navigant Consulting, Inc.

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June 2, 2006

ASSESSMENT OF THE EL PASO ELECTRIC COMPANY'S OPERATING EXPENSES

This Report summarizes the assessment prepared by Navigant Consulting, Inc. ("Navigant Consulting") of whether the operating expenses of El Paso Electric Company (the "Company" or "EPE") were within a reasonable range as compared to the utility industry. This Report offers a high level summary of Navigant Consulting's assessment process and the resulting findings and recommendations. Attached to this document is a PowerPoint slide presentation offering additional detailed explanation regarding the findings from this assessment.

I. BACKGROUND

The City of El Paso (the "City") entered into a Rate Agreement (the "Rate Agreement") with the Company, effective July 1, 2005. By its terms, the Rate Agreement states it is intended to provide:

- Future rate stability;
- Fair cost-based rates;
- Reduced fuel costs with the sharing of profits from off-system sales;
- Continued improvement in the Company's financial health;
- Expanded participation by the Company in local civic and charitable activities;
- Additional investment by the Company in its delivery systems so that it can maintain a high quality of service;
- Replacement of old local generation with new, more efficient facilities;
- The opportunity to work together for the betterment of the community;
- Recognition of the inevitable interdependence that exists between the economic health of the community and one of its largest companies; and
- Coordination with El Paso Water Utilities to improve water conservation efforts in the City.

The Rate Agreement allowed the City to select a qualified consultant to determine whether the Company's operating expenses are within a reasonable range as compared to the utility industry. The term "operating expenses" for this assessment was assumed to exclude the cost of fuel and purchased power as well as not include taxes, capital expenditures, depreciation, return on investment and profit. If the operating expenses are deemed unreasonable, then the Company and the City will agree upon a remedy, or the Rate Agreement will expire at the end of the twelve-month period. If the operating expenses are deemed to be reasonable, the Agreement shall continue in full force and effect.

Navigant Consulting was retained to prepare the assessment to determine whether the Company's operating expenses are within a reasonable range as compared to the utility industry. The assessment focused on addressing the following questions:

- Are El Paso Electric's costs reasonable given its business structure?
- Are El Paso Electric's operating and maintenance expenses ("O&M") appropriate given its operating environment?
- Are there specific opportunities that emerge from the above analysis that El Paso Electric should pursue?

II. GLOSSARY OF INDUSTRY TERMS

The following is a glossary of electric industry terms used in this Report.

A&G: administrative and general expense; typically including corporate administration (salaries and benefits), accounting, insurance, rents and facility costs for corporate administration

Customer Care: the function of a utility company that supports the direct relationship with customers; typically includes customer call center, sales and marketing, customer accounting and billing, and customer information systems

FERC: The Federal Energy Regulatory Commission has jurisdiction over electric wholesale power and transmission rates and establishes detailed reporting requirements for regulated (investor-owned) utilities.

FERC Form 1: complex annual operational and financial report required to be filed by all regulated electric utilities.

Generation: the production of electric energy by electric generators.

GIS: Geographic Information System; technology equipment and data combined to display actual utility operating conditions to support utility real-time operations and planning.

kWh: kilowatt hour; a unit of energy equal to the consumption of 1,000 watts for the period of an hour.

MWh: megawatt hour; a unit of energy that is equal to 1,000 kWh.

Net Plant in Service: total book value of investment in facilities less accumulated depreciation.

O&M / Operating Expenses: Operations and maintenance expenses as required to operate and maintain a utility; for purposes of this assessment, the cost of fuel and

purchased power have been excluded from operating (O&M) expenses; operating expenses do not include taxes, capital expenditures, depreciation, and return on investment.

SAIDI: an electric utility operations performance measure; SAIDI stands for System Average Interruption Duration Index and presents the average time (in minutes) that customers experience interruptions in the supply of power; for example, the Company's 2005 SAIDI was 31.9 which states that the average length of time for a power interruption in 2005 was 31.9 minutes.

SAIFI: an electric utility operations performance measure; SAIFI stands for System Average Interruption Frequency Index and presents the average number of times all the utility's customers had their power interrupted within a year period.

T&D: Transmission and Distribution

> **Transmission:** the function of transmitting electric power over high voltage lines; typically transmission systems are used to transmit large quantities of power over extended distances from power plants to regional delivery points on a utility's system.
>
> **Distribution:** the function of transmitting electric power over medium voltage lines; typically distribution systems receive power from transmission systems and after reduction in voltage levels through substations, transmit power to the customer.

III. SCOPE OF ASSESSMENT

Navigant Consulting reviewed all operating costs of the Company's regulated utility business. These O&M costs were separated into four main components:

1) Generation
2) Transmission and Distribution ("T&D")
3) Customer Care
4) Corporate/support functions

For the four main components of O& M costs outlined above, Navigant Consulting examined the reasonableness of the Company's:

- Overall O&M expenses
- Capitalization versus expense policies
- Depreciation expenses
- Expenses related to service quality
- Existing workforce
- Projected changes to the workforce
- Routine maintenance programs
- Recent cost-cutting initiatives

In accordance with the recommendation from Navigant Consulting, and acceptance by the City and the Company, Navigant Consulting did not review fuel and purchased power expenses. Fuel and purchased power expenses are formally reviewed in the Company's fuel reconcilliation filings at the Texas Public Utility Commission. In addition, Pensions and Benefits (Account 926); Franchise Requirements (Account 927); and Regulatory Commission Expenses (Account 928) were excluded from the review due to the company-specific uniqueness and high variability of the expenses.

Navigant Consulting relied upon data provided by the Company, publicly available data (primarily FERC Form 1 filings), and its internal databases to assess the reasonableness of the Company's operating costs. Navigant Consulting reviewed the costs in aggregate, by FERC account, as well as on a unitized basis. Examples of unitized costs reviewed were:

- Cost per customer
- Cost per employee
- Cost per line mile
- Cost per meter
- Cost per MWh

A. Peer Group Benchmarking

The overall objective of the review was to determine the reasonableness of the Company's operating expenses as compared to those of similarly situated regulated utilities. It was important to compare the Company with other utilities of similar size and organizational structure to afford a reasonable comparison. The group of comparative companies ("Peer Group") against which the Company's operating expenses were benchmarked was determined after consultation with the City and the Company. The selection of the companies that were included in the Peer Group was based on five selection criteria:

1. *Company Type* - Electric operating utilities required by FERC to file an annual Form 1 (i.e., IOUs)

2. *Company Organization* - Holding companies with many operating utility subsidiaries were generally excluded

3. *Business Composition* - Integrated utilities with both generation and delivery operations

4. *Company Location* - Primarily located in the Midwest or Southwest

5. *Company Size* - Between 100,000 and 1,000,000 customers, annual retail revenues of $200 million -$2 billion, and under $10 billion in net plant

Based on the above selection criteria, the following Peer Group was identified:

» Arizona Public Service Co. (APS)	» Madison Gas & Electric Co. (MGE)
» CLECO (CNL)	» MidAmerican Energy Co. (MA)
» Dayton Power & Light (DPL)	» Northern Indiana PSC (NI)
» Duquesne Light Co. (DQE)	» Oklahoma Gas & Electric Co. (OGE)
» The Empire District Electric Co. (EDE)	» Otter Tail Power Co. (OTTR)
» Indianapolis Power & Light (IPL)	» Public Service Co. of New Mexico (PNM)
» Kansas City Power & Light (KCPL)	» Tampa Electric Co. (TECO)
» Kansas Gas & Electric Co. (KGE)	» Tucson Electric Power Co. (UNS)
» Kentucky Utilities (KU)	» Westar Energy (WR)
» Louisville Gas & Electric (LGE)	» Wisconsin Public Service Corp. (WPS)

B. Benchmarking Metrics

The Peer Group was compared to the Company using the following measures:

- Size indicators
  - Customers
  - Revenues
  - Net plant in service
  - Employees
- Asset metrics
  - Net plant/ MWh
  - Net plant/employee
- Financial metrics
  - Revenues/customer
  - Revenues/employee

C. Assessment Process

The process deployed by Navigant Consulting involved the following key steps:

- Confirm the City's objectives for the O&M cost reasonableness review,
- Meet with City and Company representatives to establish schedule and communication processes to obtain key Company data and discuss findings,
- Prepare requests for financial and performance data from the Company,
- Obtain industry data for utilities in the Peer Group,
- Tabulate Company and Peer Group data and prepare comparisons; for each area, identify the nature of the operating expense, the range of reasonableness based on the Peer Group, and how the Company performed compared to the Peer Group

- Meet with the City and the Company to discuss initial comparisons,
- Obtain supplemental information for the Company and finalize assessment
- Present findings from the assessment to the City and the Company, and
- Finalize Report on O&M cost assessment following receipt of comments from the City and the Company

IV. SUMMARY FINDINGS

Overall, Navigant Consulting found that EPE's O&M costs were reasonable.

- EPE's total O&M costs per customer were slightly lower (i.e., less money is spent per customer) than the Peer Group average.

- EPE's gas and coal steam generation O&M costs per MWh generated were higher (i.e., more money was spent per MWh generated) than the Peer Group average.
  - EPE's steam generation portfolio included a number of old units which require a greater level of maintenance.

- Transmission O&M costs per line mile were lower than average; but not as low as the Peer Group top quartile.

- Distribution O&M per customer were lower than average and within the Peer Group top quartile.
  - Reliability indicators (e.g., SAIFI, SAIDI) were low (i.e., good) compared to the Peer Group.

- Customer Care O&M per customer were lower than average and within the Peer Group top quartile.
  - Customer satisfaction scores were relatively high (i.e., good) along most indicators...although in 2005 they dropped.
  - EPE was in the 2nd quartile (out of about 100 utilities) in customer satisfaction.

- EPE's administrative and general ("A&G") O&M costs were higher than the Peer Group average but this appeared to be attributable to past allocation problems between A&G accounts and distribution and customer care accounts.
  - Too much was allocated to A&G and too little was allocated to customer care and distribution.
  - One of the purposes of the new Oracle accounting system, installed and operating as of mid-2005, was to address this problem.

- EPE's plant was highly depreciated (compared to Peer Group companies) due to the acceleration of the amortization of nuclear production plant and nuclear plant write-offs.

» EPE's capitalization and expense policies (as written) were standard, and no concerns were identified regarding these policies.

» EPE did not have an explicit, targeted cost-cutting program.
  — EPE reported that it had not targeted specific cost cutting initiatives aimed at reducing operating expenses but instead managed and controlled expenses through its budgeting process.
  — In certain key areas (T&D and customer care), EPE's costs were already low, reducing the potential need for any major cost cutting initiatives.

» EPE's employee-to-customer ratio was among the lowest in the Peer Group.
  — Like most utilities, EPE faces an aging workforce…but does not currently have in place explicit succession planning programs to address this issue. The Company reported that it has plans to launch a Workforce Risk Assessment to evaluate these challenges.

» EPE is considering many new systems which have been in place at other utilities for years which could lower costs in the longer term, including:
  — GIS
  — Outage Management System
  — Customer Accounting/Information System
  — Outsourcing of payroll

V. BASIS FOR SUMMARY FINDINGS

Table 1 offers a high level perspective of the Company's O&M cost and proficiency metrics for calendar year 2005.

Table 1

	EPE	Peer Group Average	Peer Group Top Quartile	Gap between EPE and Average (%)*	Gap between EPE and Top Quartile* (%)
O&M/Customer	$512	$526	$451	None	12%
O&M/Employee ($000)	$173	$150	$104	13%	40%
O&M/MWh	$26	$19	$14	26%	47%
Employees/ Thousand Customers	3.0	3.8	2.7	None	9%
O&M/ Utility Revenue	22%	23%	18%	None	19%

» Gaps have been calculated as the percentage of cost reduction needed by EPE to make it to the average or top quartile. Thus, EPE would have to reduce total O&M costs/customer by 12 percent to make it from the current $512 per customer to $451 per customer to be in the top quartile.

» EPE's O&M/MWh average is impacted as a result of EPE having a smaller average level of MWh sales per customer.

Table 2

Key EPE Statistics for 2002-2005

	2002	2003	2004	2005	CAGR*
Retail Revenues ($M)	$580	$576	$617	$710	7%
Retail Customers	313,953	320,180	328,779	337,621	3%
Capital Expenditures ($M)	$71.3	$83.4	$76	$94.2	10%
Operating Expenses**	$208.7	$210.2	$211.1	$219.5	3%
Employees	993	977	990	998	0%
Miles of Transmission Lines	1,984	1,985	1,761	1,738	-4%

» EPE's annual operating expenses increased at about the rate of inflation since 1997, or at about a 3 percent compound annual growth rate ("CAGR").

» A&G represents a relatively high proportion of EPE's total O&M costs but when compared against EPE's relatively low distribution and customer care costs they balance out.
- A&G plus Customer Care plus Distribution equals 48 percent of total O&M for EPE and 48 percent of total O&M for the Peer Group average.
- EPE's new Oracle-based accounting system, installed in mid-2005, appears to be allocating costs more appropriately.
- A decline in A&G and increase in customer care and distribution suggest a trend towards more accurate accounting but the accounting system had been installed too recently to make a full assessment.

» EPE's annual capital expenditures have increased substantially since 1997, driven by equipment replacements at Palo Verde and growth of the distribution system to serve new customers.
- EPE's capital expenses have increased at a compound annual rate of about 8 percent since 1997.

» EPE's capital expenditures, as a portion of total expenditures, has generally been lower than the Peer Group average for the years 2002-2005.

A. Generation Metrics

As shown in Table 3, EPE's Generation O&M costs were more expensive per MWh than the Peer Group in 2005.

Table 3

	EPE	Peer Group Average	Peer Group Top Quartile	Gap between EPE and Average (%)	Gap between EPE and Top Quartile (%)
Steam O&M/ Steam MWh	$8.4	$6.4	$4.7	24%	44%
Nuclear O&M/ Nuclear MWh	$11.2	$27	$12.9	None	None
Total O&M/ Total MWh	$10	$7.2	$4.8	28%	52%

- Gas and coal steam generation costs per MWh were higher than average; whereas nuclear generating costs per MWh were lower than average.

- Steam generating O&M costs per MWh increased at about 7 percent compounded annually since 1997.
  - EPE steam generation O&M costs were heavily impacted by maintaining the old Rio Grande and Newman gas-fired units.

- EPE nuclear O&M per MWh increased at a 6 percent compound annual growth rate for the period 1997 to 2005.
  - Despite this level of cost increase, EPE nuclear O&M costs per MWh were lower than the Peer Group average and within the top quartile.

B. Transmission System Metrics

As shown in Table 4, EPE's transmission O&M costs were lower than the Peer Group average for 2005.

Table 4

	EPE	Peer Group Average	Peer Group Top Quartile	Gap between EPE and Average (%)	Gap between EPE and Top Quartile (%)
Trans. Operation Cost/Line Mile	$5,049	$6,893	$3,349	None	34%
Trans. Maintenance Cost/Line Mile	$992	$1,990	$1,069	None	None
Total Trans. O&M Cost/ Line Mile	$6,041	$8,883	$4,418	None	27%

» EPE had a high reliance on its transmission system for the import of power.

» EPE benefits from having more moderate weather conditions than other Peer Group companies (limited ice, limited destructive winds, etc.).

» EPE must maintain many miles of remote transmission lines.

C. Distribution System Metrics

As shown in Table 5, EPE's distribution O&M costs were lower than the Peer Group average and within the top quartile for 2005.

Table 5

	EPE	Peer Group Average	Peer Group Top Quartile	Gap between EPE and Average (%)	Gap between EPE and Top Quartile (%)
Distribution Operation Cost/ Customer	$33.9	$34.8	$28.8	None	15%
Distribution Maintenance Cost/ Customer	$18.8	$40.3	$28.4	None	None
Total Distribution O&M Cost/Customer	$52.7	$75.1	$57.2	None	None

» Since 2002, EPE's distribution O&M costs per customer had risen only at a 2 percent compound average growth rate.

» EPE's distribution reliability statistics reflect system performance well above most of the Peer Group companies.

D. Customer Care Metrics

As shown in Table 6, EPE's Customer Care O&M cost benchmarks were in the top quartile of the Peer Group in 2005.

Table 6

	EPE	Peer Group Average	Peer Group Top Quartile	Gap between EPE and Average (%)	Gap between EPE and Top Quartile (%)
Cust. Account Expenses/ Customer	$32.5	$41.8	$33.7	None	None
Cust. Svc and Info Expenses/ Customer	$1.4	$13.5	$2.1	None	None
Sales Expenses/ Customer	$0.1	$4.0	$0.1	None	None
Total Customer Care Expenses/ Customer	$34.0	$59.3	$35.9	None	None

» Customer Care O&M costs per customer had generally declined over the last 10 years.

» EPE ranked high in most metrics in the annual Market Strategies, Inc. customer satisfaction survey of about 100 utilities annually.

E. Administrative and General Metrics

As shown in Table 7, EPE's A&G O&M cost benchmarks were higher (i.e., worse) than the average of the Peer Group in 2005.

Table 7

	EPE	Peer Group Average	Peer Group Top Quartile	Gap between EPE and Average (%)	Gap between EPE and Top Quartile (%)
A&G Salaries/ Customer (920)	$57.7	$49.0	$28.9	15%	50%
A&G Outside Services/ Customer (923)	$28.9	$19.7	$11.2	32%	61%
Total A&G Expenses/ Customer**	$172.6	$121.6	$85.3	36%	51%

» The high A&G costs were largely balanced out by EPE's low Customer Care and Distribution costs; the new Oracle System is expected to address the allocation of costs by more appropriately tracking the source of each cost item.

» A&G costs had been driven both by increases in consulting and legal fees, as well as by historical accounting practices.

F. Plant in Service

» EPE's plant in service had the highest proportion of depreciated assets in the Peer Group.
- About 60 percent of EPE's total plant was depreciated, higher than all companies in the Peer Group.
- Over the last ten years, EPE accelerated the amortization of nuclear production plant and wrote off nuclear plant costs
- As a result, EPE's nuclear plant was approximately 70 percent depreciated even though it is less than 50 percent through its expected service life
- The last major new non-nuclear generating plant construction was nearly 30 years ago

» EPE's capitalization versus expense policies were standard for the industry.

G. Conclusions

- EPE's O&M costs evaluated in this assessment were "reasonable" given the Company's current structure and operating environment.
  - Steam unit O&M costs were understandably higher because of the age and size of the units.
  - EPE's low T&D O&M costs had not harmed reliability figures.
  - Customer care spending was low, but customer satisfaction numbers (according to the one source EPE uses) were relatively good.
    - Customer expectations are growing…this is an area EPE will likely need to make enhancements to its existing programs to meet expectations.
  - Relatively high A&G expenses appeared to be more a function of accounting practices and accounting systems than actual "unreasonably" high spending.
    - Low distribution and customer care costs "balanced out" high A&G costs.
    - The new Oracle system is expected to address some of these issues.

VI. RECOMMENDATIONS:

- The City and EPE should identify a set of performance measures that EPE can employ to self-report annual benchmark performance to the City to effectively assess EPE's performance compared to an agreed upon Peer Group of companies. This annual activity would facilitate an annual dialogue between the City and EPE to assist the City to:
  - Effectively assess operating cost elements
  - Effectively assess performance and customer satisfaction indices
  - Track EPE performance trends to prepare the City to consider issues to be addressed at the end of the current term of the Rate Agreement

- EPE should take action to address the condition of the old gas-fired steam units being a major cost liability.
  - A logical option to reduce O&M costs is to replace them with new more efficient units (and would also greatly reduce fuel costs).
  - Benchmark generation performance (e.g., forced outage rates; net availability factors) using industry standard practices ("NERC").

- EPE should develop staffing replacement plans, particularly in the generation function, to address potential retirements.

- EPE should continue to seek opportunities to deploy new systems and technologies to displace manual processes and enhance operational proficiency:
  - GIS
  - Outage Management
  - Customer Information System

NAVIGANT CONSULTING

El Paso Electric Benchmarking

June 2, 2006

Information contained in the following Benchmarking Report, originally labeled as "Confidential", has been determined to no longer be "Confidential".

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NAVIGANT CONSULTING

Project Background

- The City of El Paso, Texas (the "City") entered into a Rate Agreement (the "Agreement") with El Paso Electric Company (the "Company" or "EPE") effective July 1, 2005
- The Agreement requires the City to select an outside firm to determine whether the Company's operating expenses are within a reasonable range as compared to the utility industry. If the operating expenses are deemed unreasonable, then the Company and the City will agree upon a remedy, or the Agreement will expire at the end of the twelve-month period. If the operating expenses are deemed to be reasonable, the Agreement shall continue in full force and effect
- Navigant Consulting, Inc. ("NCI") was retained by the City to perform the review of the Company's operating expenses
- Work on the review was initiated in February 2006
- Navigant Consulting worked with City and Company officials to obtain data and review findings

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The City directed NCI to answer the following questions:

- Are EPE's costs reasonable given its business structure?
- Are EPE's operating and maintenance expenses appropriate given its operating environment?
- Are there specific opportunities that emerge from the above analysis that EPE should pursue?

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Scope of Work

- Navigant Consulting reviewed all operating costs of the Company's regulated utility business. The costs were separated into four main components:
  - Generation
  - Transmission and Distribution ("T&D")
  - Customer Care
  - Corporate/support functions ("A&G")

- The Company's fuel and purchased power expenses were excluded from the scope of the review

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Specific issues addressed during the review included:

- Overall operations and maintenance ("O&M") expenses
- Capitalization versus expense policies
- Depreciation expenses
- Expenses related to service quality
- Existing workforce
- Projected changes to the workforce
- Routine maintenance programs
- Recent cost-cutting initiatives

The overall objective of the review was to determine the reasonableness of the Company's operating expenses as compared to those of similarly situated regulated utilities.

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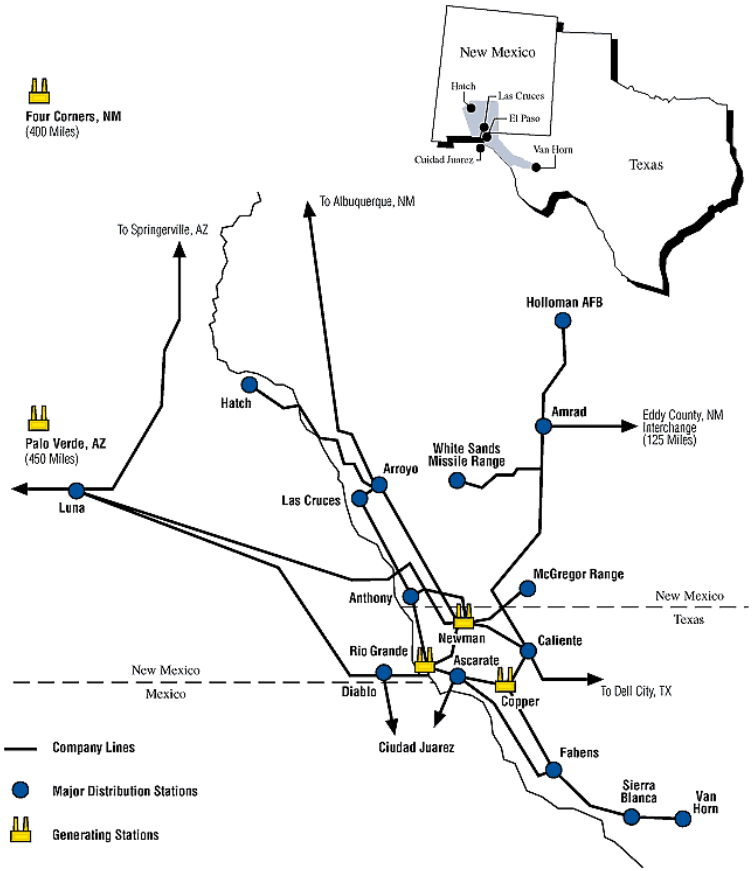
El Paso Electric (EPE) is an integrated investor-owned electric utility with operations in west Texas and southern New Mexico.



- Serves about 338,000 retail electric customers
- Distributes electricity to the cities of El Paso, Texas and Las Cruces, New Mexico, and surrounding areas
  - City of El Paso customers accounted for 60% of EPE's 2005 operating revenues
- ~90% of revenues come from regulated customer base; the rest from "off system" sales
- Owns 1500 MW of installed capacity
- Also purchases power for resale: 15% of 2005 energy sold came from purchased power
- ~1000 employees; 30% union
- Has franchise agreements with the cities of El Paso and Las Cruces

Sources: EPE 10-K, PUC of Texas, NCI analysis

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Key EPE Data For 2002-2005

	2002	2003	2004	2005	CAGR*
Retail Revenues ($M)	$580	$576	$617	$710	**7%**
Retail Customers	313,953	320,180	328,779	337,621	**3%**
Capital Expenditures ($M)	$71.3	$83.4	$76	$94.2	**10%**
Operating Expenses**	$208.7	$210.2	$211.1	$219.5	**3%**
Employees	993	977	990	998	**0%**
Miles of Transmission Lines	1,984	1,985	1,761	1,738	**-4%**

Non-fuel O&M has grown at about a 3% compound annual rate (CAGR) since 2002… approximately the rate of inflation.

*CAGR= compound annual growth rate
Total Non-Fuel and non-Power Purchase O&M. **Includes all A&G operating expenses, (i.e., includes accounts 926, 927, 928).
Source: FERC Form 1, NCI analysis

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NCI's Approach

- NCI relied upon publicly available data, as well as our internal databases, to assess the Company's operating costs. We reviewed the costs in aggregate, by FERC account, as well as on a unitized basis. Examples of unitized costs included:
  - Cost per customer
  - Cost per employee
  - Cost per line mile
  - Cost per meter
  - Cost per MWh

- NCI reviewed the Company's historical costs for the last four (4) years. A multi-year review allowed for the normalizing of expense levels
  - NCI calculates the "compound annual growth rate (CAGR)" for most historical cost categories. (CAGR is the compound annual rate)
- NCI relied upon annual data for the Company and a selected peer group of companies as reported in Form 1 Annual Reports to the Federal Energy Regulatory Commission.

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For comparison purposes, the following FERC Form 1 items were excluded from the benchmarking analysis.

Accounts that the City and EPE originally agreed to exclude:

- Fuel Costs (Account 501)
- Purchased Power Costs (Account 555)
  - System Control and Dispatching (Accounts 556 and 557) are excluded as well, as they are part of the purchased power cost category in FERC Form 1

A&G accounts are unique to each utility and therefore not appropriate for quantitative benchmarking:

- Pensions and Benefits (Account 926)
- Franchise Requirements (Account 927)
- Regulatory Commission Expenses (Account 928)

These costs are excluded from all of the benchmarking analyses unless otherwise noted.

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Peer group selection was based on five factors.

1. **Company Type**: Companies selected are electric operating utilities required by FERC to. file Form 1 (i.e., IOUs)
2. **Company Organization**: Holding companies with many operating utility subsidiaries were generally excluded
3. **Business Composition**: Companies selected are integrated utilities, with both generation and delivery operations
4. **Company Location**: Companies selected are primarily located in the Midwest or Southwest
5. **Company Size**: Companies selected have between 100,000 and 1,000,000 customers, annual retail revenues of $200 million to $2 billion, and under $10 billion in net plant

It is important to compare companies with similar size and organizational structure so as to provide a reasonable comparison.

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Based on these five factors we chose a peer group of 20 operating utilities.

Peer Group Utilities (Ticker or Abbreviation)	
Arizona Public Service Co. (APS)	Madison Gas & Electric Co. (MGE)
CLECO (CNL)	MidAmerican Energy Co. (MA)
Dayton Power & Light (DPL)	Northern Indiana PSC (NI)
Duquesne Light Co. (DQE)	Oklahoma Gas & Electric Co. (OGE)
The Empire District Electric Co. (EDE)	Otter Tail Power Co. (OTTR)
Indianapolis Power & Light (IPL)	Public Service Co. of New Mexico (PNM)
Kansas City Power & Light (KCPL)	Tampa Electric Co. (TECO)
Kansas Gas & Electric Co. (KGE)	Tucson Electric Power Co. (UNS)
Kentucky Utilities (KU)	Westar Energy (WR)
Louisville Gas & Electric (LGE)	Wisconsin Public Service Corp. (WPS)

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Characteristics of the Peer Group Companies

We compared our peer group companies using the following measures:

- Size indicators
  - Customers
  - Revenues
  - Net plant in service
  - Employees
- Asset metrics
  - Net plant/ MWh
  - Net plant/employee
- Financial metrics
  - Revenues/customer
  - Revenues/employee

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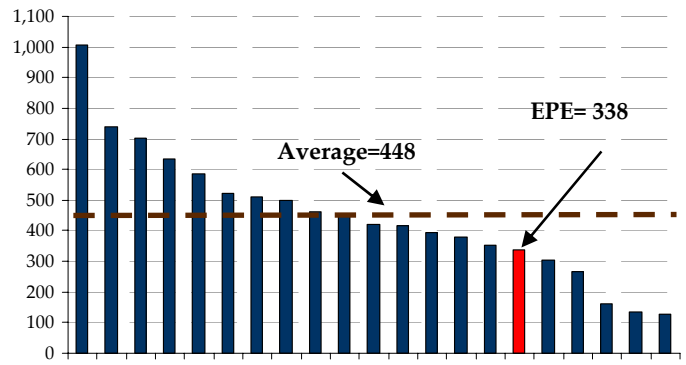
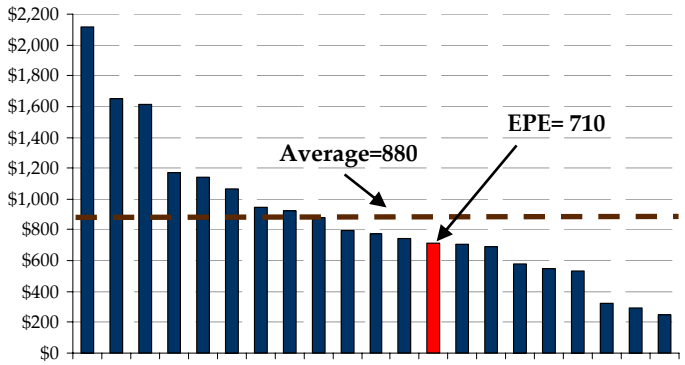
Size Indicators: EPE is slightly smaller than the peer group average.

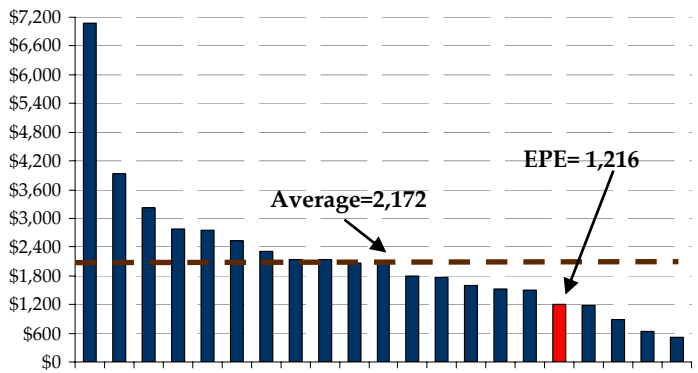
Retail Customers ('000)



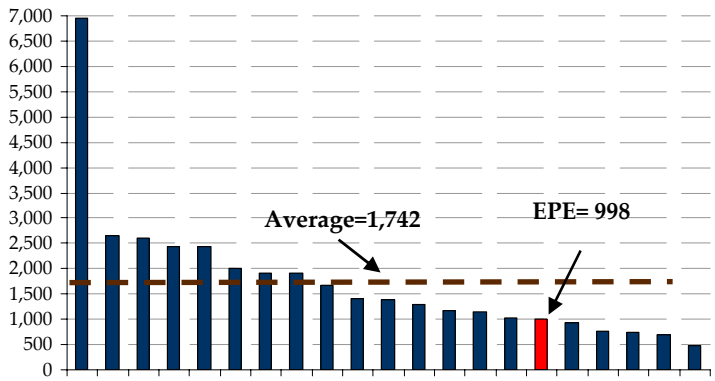
Retail Revenues ($M)



Net Plant in Service ($M)



Number of Utility Employees



Source: FERC Form 1, NCI analysis

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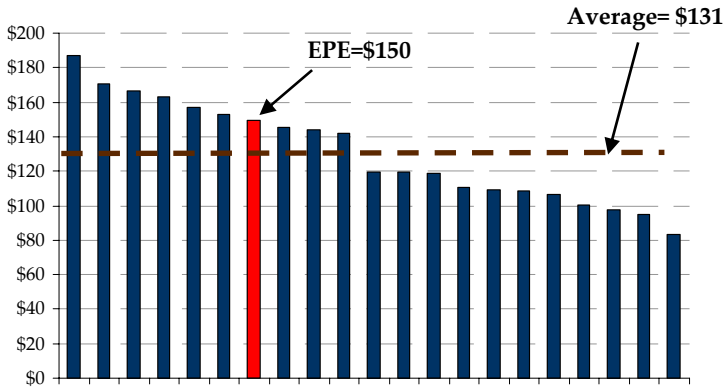
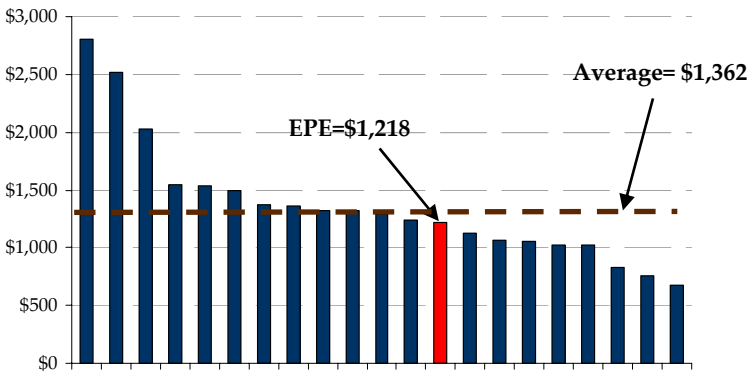
Asset and Financial Metrics: EPE is closer to average across the peer group when measured using key asset and financial metrics.

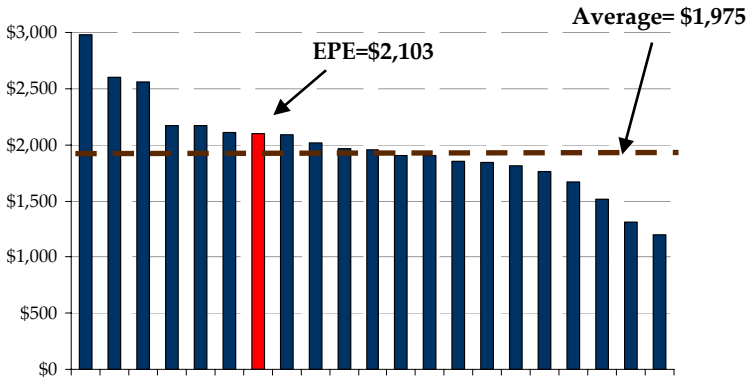
Net Plant/MWh



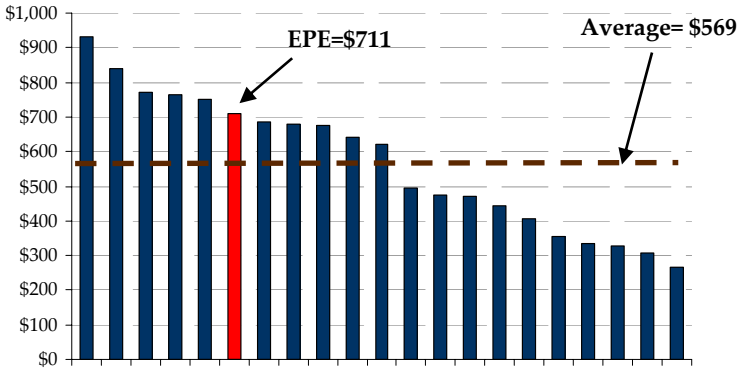
Net Plant/Employee($000)



Retail Revenues/Retail Customer



Retail Revenues/Employee



Source: FERC Form 1, NCI analysis

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Overall, EPE's O&M costs are reasonable.

- EPE's total O&M costs per customer were slightly lower (i.e., less money is spent per customer) than the Peer Group average.
- EPE's gas and coal steam generation O&M costs per MWh generated were higher (i.e., more money was spent per MWh generated) than the Peer Group average.
  - EPE's steam generation portfolio included a number of old units which require a greater level of maintenance.
- Transmission O&M costs per line mile were lower than average; but not as low as the Peer Group top quartile.
- Distribution O&M per customer were lower than average and within the Peer Group top quartile.
  - Reliability indicators (e.g., SAIFI, SAIDI were low (i.e., good) compared to the Peer Group.
- Customer Care O&M per customer were lower than average and within the Peer Group top quartile.
  - Customer satisfaction scores were relatively high (i.e., good) along most indicators...although in 2005 they dropped.
  - EPE was in the 2nd quartile (out of about 100 utilities) in customer satisfaction.
- EPE's administrative and general ("A&G") O&M costs were higher than the Peer Group average but this appeared to be attributable to past allocation problems between A&G accounts and distribution and customer care accounts.
  - Too much was allocated to A&G and too little was allocated to customer care and distribution.
  - One of the purposes of the new Oracle accounting system, installed and operating as of mid-2005, was to address this problem.

Sources: FERC Form 1, EPE 10-K, EPE internal information, NCI analysis

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We made other discoveries when assessing EPE's O&M performance.

- EPE's plant was highly depreciated (compared to Peer Group companies) due to the acceleration of the amortization of nuclear production plant and nuclear plant write-offs.
- EPE's capitalization and expense policies (as written) were standard, and no concerns were identified regarding these policies.
- EPE did not have an explicit, targeted cost-cutting program.
  - EPE reported that it had not targeted specific cost cutting initiatives aimed at reducing operating expenses but instead managed and controlled expenses through its budgeting process.
  - In certain key areas (T&D and customer care), EPE's costs were already low, reducing the potential need for any major cost cutting initiatives.
- EPE's employee-to-customer ratio was among the lowest in the Peer Group.
  - Like most utilities, EPE faces an aging workforce…but does not currently have in place explicit succession planning programs to address this issue. The Company reported that it has plans to launch a Workforce Risk Assessment to evaluate these challenges.
- EPE is considering many new systems which have been in place at other utilities for years which could lower costs in the longer term, including:
  - GIS
  - Outage Management System
  - Customer Accounting/Information System
  - Outsourcing of payroll

*quoted from EPE's written answer to our question regarding cost cutting
Source: FERC, EPE 10-K, EPE internal information, NCI analysis

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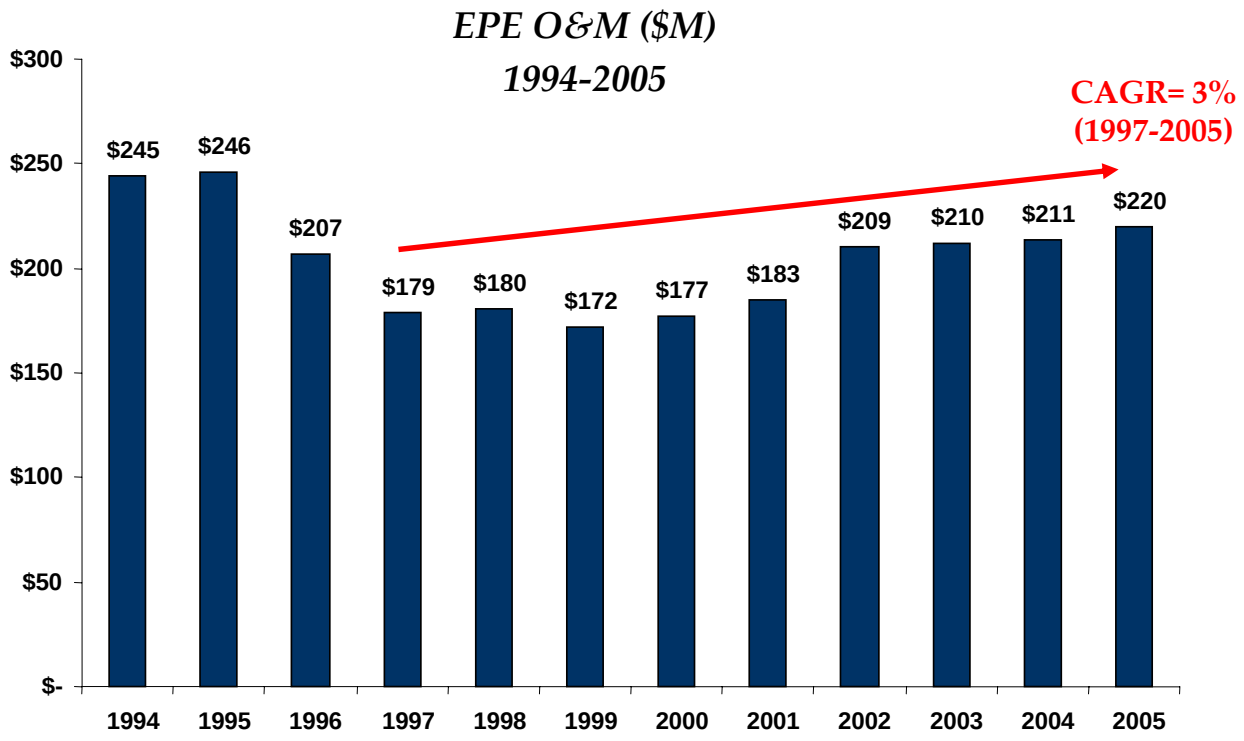
EPE's annual Operating Expenses* have increased at about the rate of inflation since 1997.



EPE's Operating Expenses have increased at a compound annual rate of about 3% since 1997.

*Total Non-Fuel and non-Power Purchase O&M. **Includes all A&G Operating Expenses, i.e., includes accounts 926, 927, 928**
Source: FERC Form 1, NCI analysis

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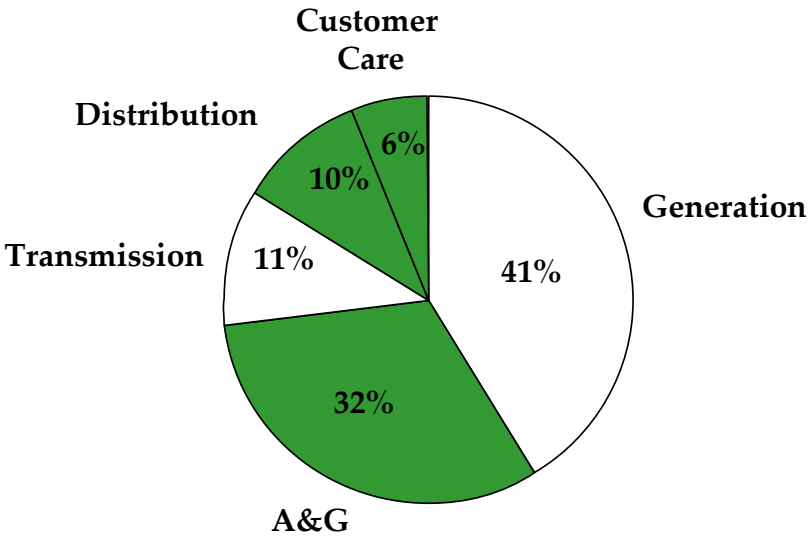
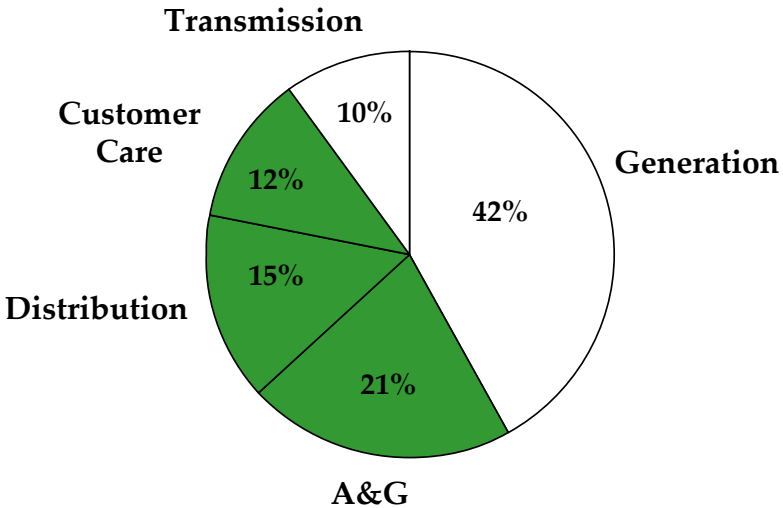
A&G represents a relatively high proportion of EPE's total O&M costs…but when compared against EPE's relatively low distribution and customer care costs…they balance out.

EPE: 2005 Measured O&M Costs
100%= $182 M



Peer Group Average: 2005 Measured O&M Costs
100%= $226 M



A&G plus Customer Care plus Distribution equals 48% of total O&M for EPE and 48% of total O&M for the peer group average.

Source: FERC Form 1, NCI analysis

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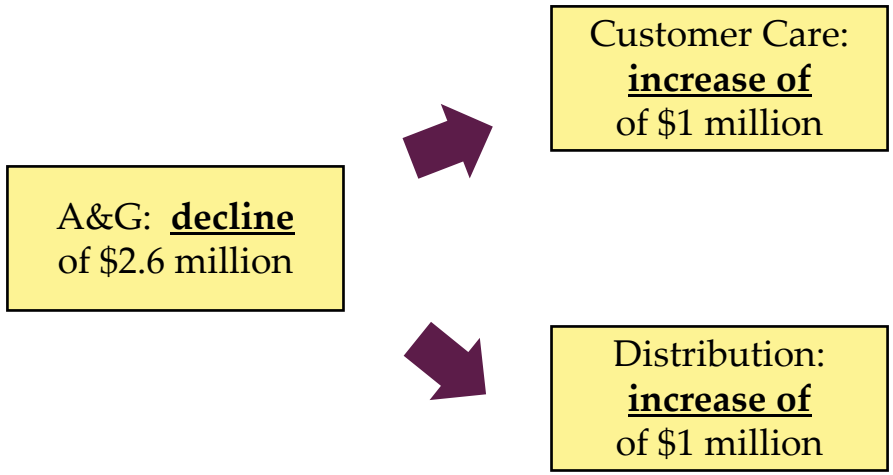
EPE's new Oracle-based accounting system, installed in mid-2005, appears to be allocating costs more appropriately.

***Example** Changes in O&M costs*
Between 2004 and 2005



Decline in A&G and increase in customer care and distribution suggest a trend towards more appropriate accounting…but system installed too recently to make full assessment.

Source: FERC Form 1, NCI analysis

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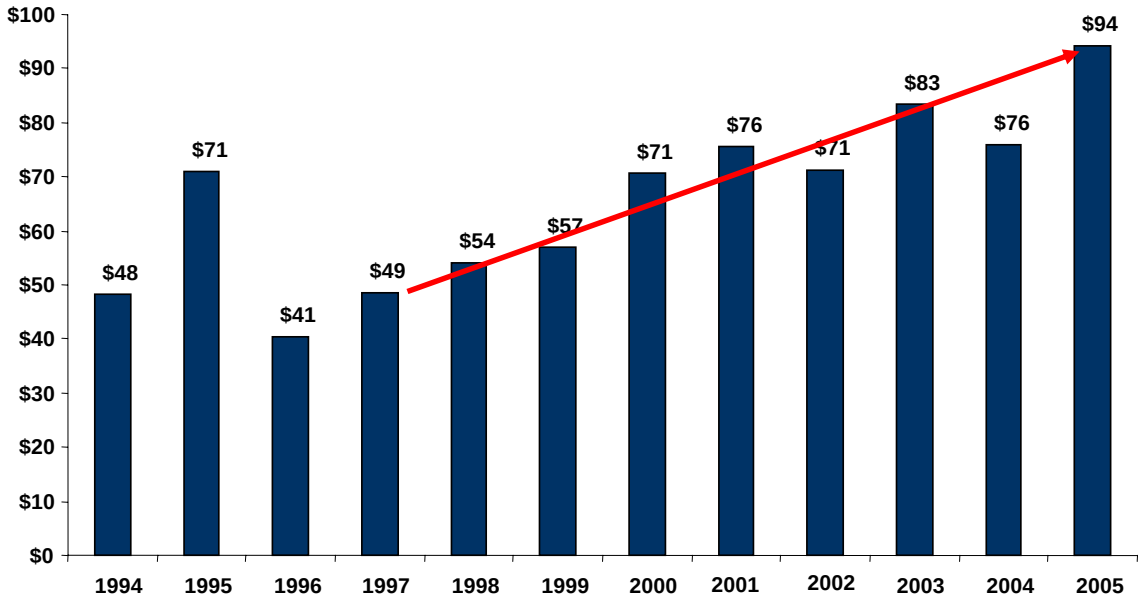
EPE's annual Capital Expenditures* have increased substantially since 1997, driven by equipment replacements at Palo Verde and growth of distribution system.

EPE's Capital Expenditures ($M)
1994-2005



CAGR= 8% (1997-2005)

EPE's Capital Expenditures have increased at a compound annual rate of about 8% since 1997.

*Capital expenditures: Investment to replace, expand, or improve utility assets
Source: FERC Form 1, NCI analysis

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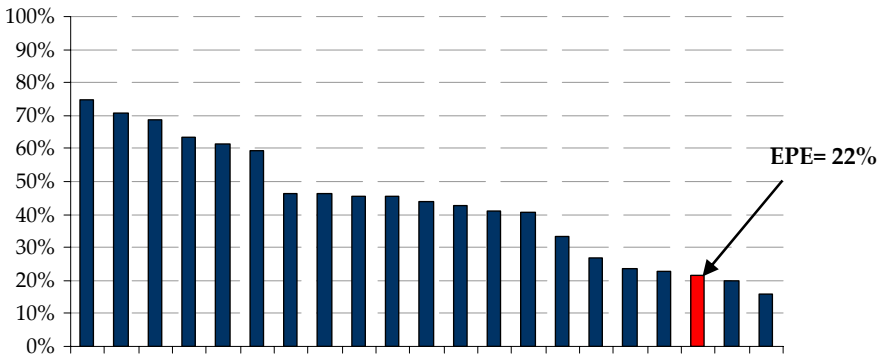
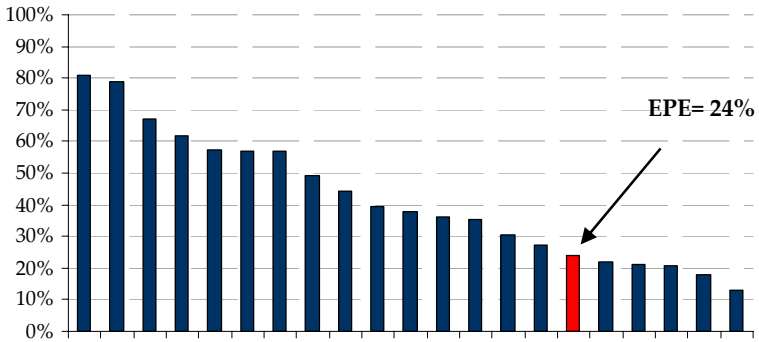
EPE's Capital Expenditures (CAPEX) as a portion of total expenditures has generally been lower than the peer group average for the years 2002-2005.

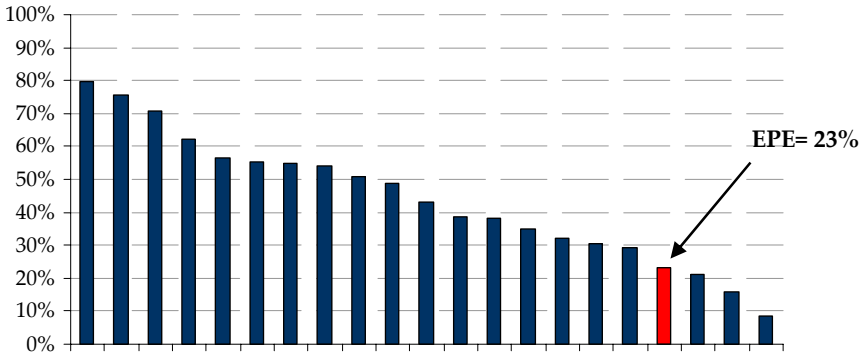
2002 CAPEX as Percent of Total Expenditures



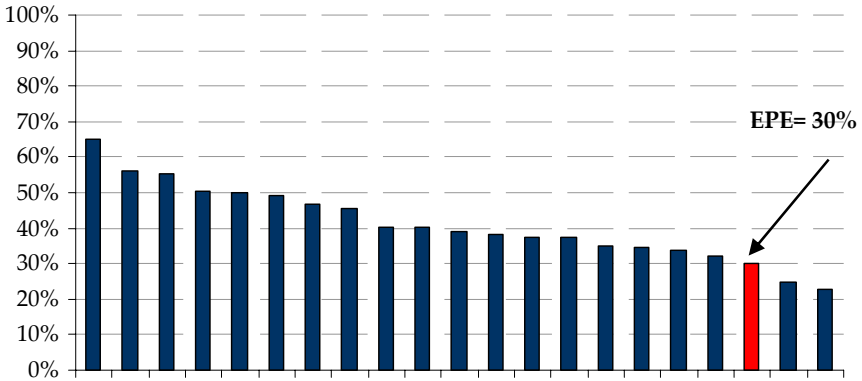
2003 CAPEX as Percent of Total Expenditures



2004 CAPEX as Percent of Total Expenditures



2005 CAPEX as Percent of Total Expenditures



Source: FERC Form 1, NCI analysis

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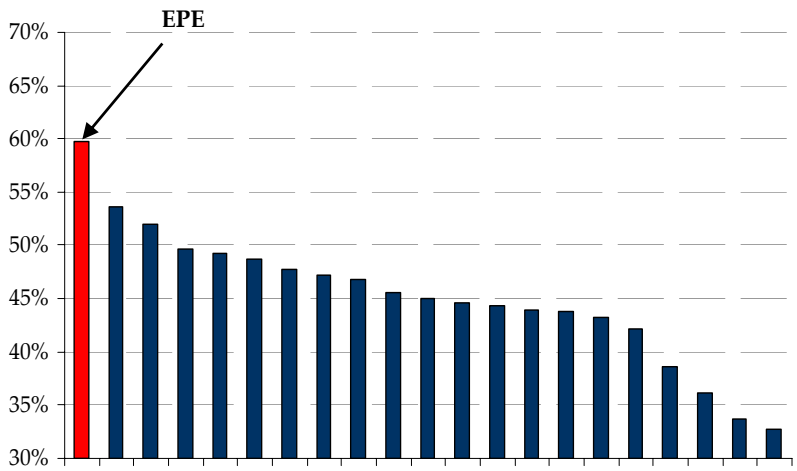
EPE's plant in service consists of highest proportion of depreciated assets in the peer group.

Depreciation as a Proportion of Total Plant in Service– 2005



- About 60 percent of EPE's total plant was depreciated, higher than all companies in the Peer Group.
- Over the last ten years, EPE accelerated the amortization of nuclear production plant and wrote off nuclear plant costs
- As a result, EPE's nuclear plant was approximately 70 percent depreciated even though it is less than 50 percent through its expected service life
- The last major new non-nuclear generating plant construction was nearly 30 years ago

Source: FERC Form 1, NCI analysis

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EPE's capitalization vs expense policies are standard.

- All new construction expenditures and plant additions are capitalized regardless of dollar amount
- Improvement or replacement of generating assets are capitalized if they meet the following criteria:
  - The useful life of the asset is increased
  - The quantity of production from the asset is increased
  - The quality of production is enhanced
- Repairs are capitalized if the life and/or productivity of the asset is increased
- For software, if the cost is below $1000, the purchase is expensed, if above, it is capitalized
- For a typical software project, the preliminary studies involved (e.g., feasibility studies) are expensed, but the rest—design and implementation, is capitalized
- The Company could be more aggressive in capitalizing costs if inclined to do so.

The policies are standard…but we do not have enough information to state whether EPE follows these guidelines in all/most cases.

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EPE has not specifically launched any cost-cutting initiatives.

- EPE manages and controls its expenses through its budgeting process
- EPE divides its expenses into two categories: corporate expenses and departmental expenses
  - Departmental expenses are expenditures directly influenced by decisions and actions of department management
  - Corporate expenses are costs primarily influenced by company-wide decisions and/or external factors (e.g., Palo Verde operations)
- EPE has had significant increases in corporate expenses since 2002 and limited its departmental expenses to counter this trend
  - Palo Verde and Four Corners cost increases are examples of corporate expenses
  - Departmental expenses were reduced by about 3% between 2004 and 2005

EPE's costs are low across most functional categories (except steam generation) so the Company appears to have been effective in managing its operating costs.

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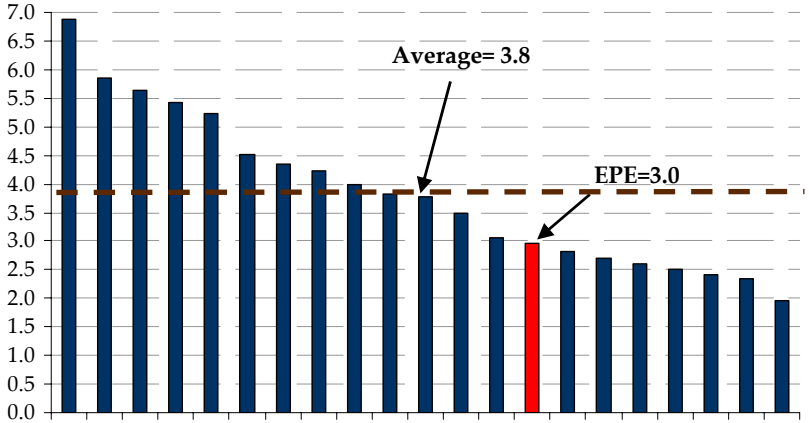
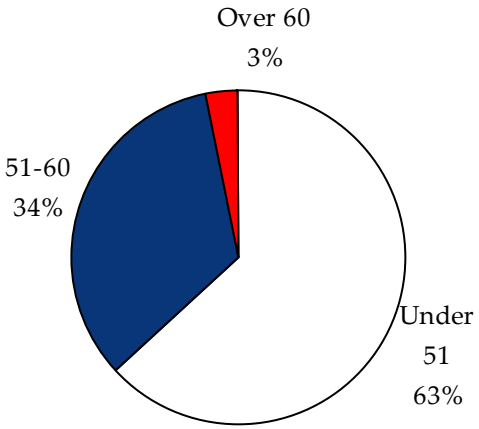
EPE has relatively fewer employees (per customer) than average peer group…and faces the challenges of an aging workforce.

Peer Group: Employees per Thousand Customers



EPE Age of Employees
100%=998



EPE does not currently have a comprehensive plan to address challenges related to its aging workforce.

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Summary Utility Benchmarks

O&M Costs and Efficiency Metrics--2005

	EPE	Peer Group Average	Peer Group Top Quartile	Gap between EPE and Average (%)*	Gap between EPE and Top Quartile* (%)
O&M/Customer	$512	$526	$451	None	12%
O&M/Employee ($000)	$173	$150	$104	13%	40%
O&M/MWh	$26	$19	$14	26%	47%
Employees/ Thousand Customers	3.0	3.8	2.7	None	9%
O&M/ Utility Revenue	22%	23%	18%	None	19%

*** Gaps are calculated as the percentage cost reduction needed by EPE to make it to the average or top quartile. Thus, EPE would have to reduce total O&M costs/customer by 12% to make it from the current $512 per customer to $451 per customer.**

Source: FERC Form 1, NCI analysis

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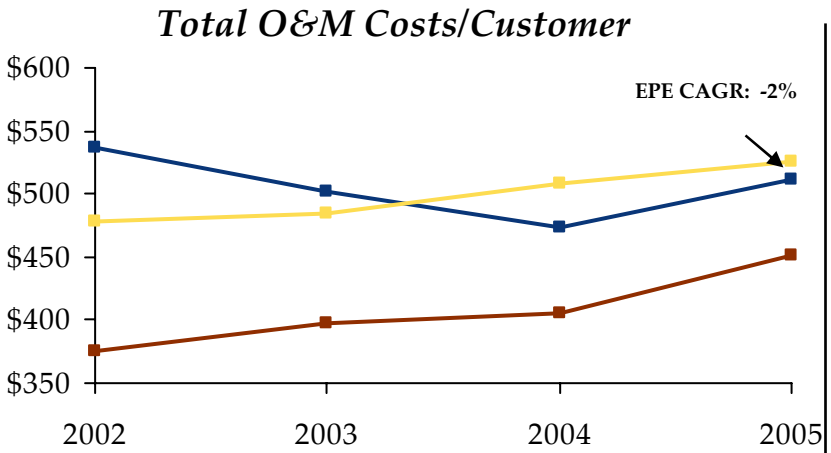
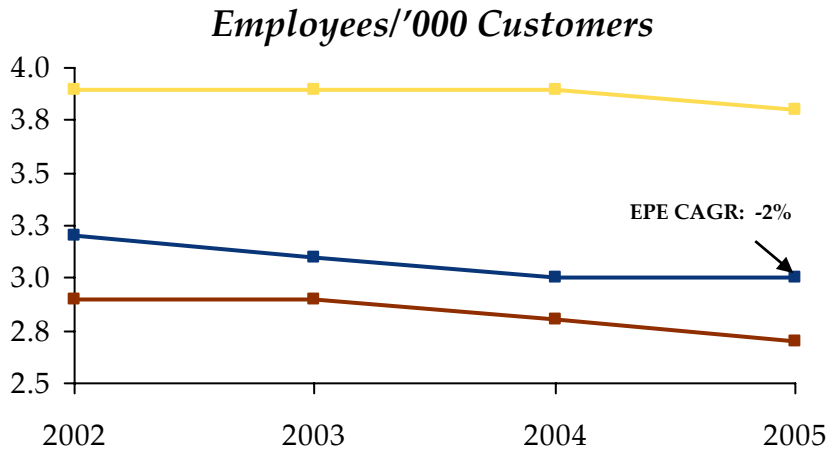
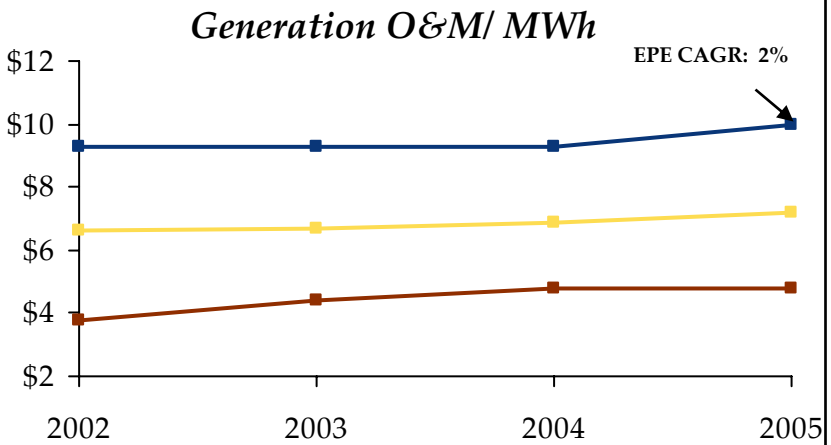
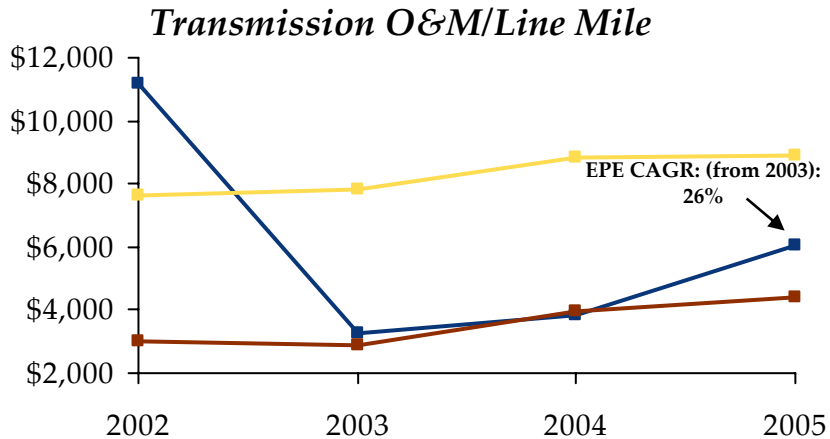
Overall EPE's O&M costs have declined since '02 and are less expensive per customer than the peer group average.









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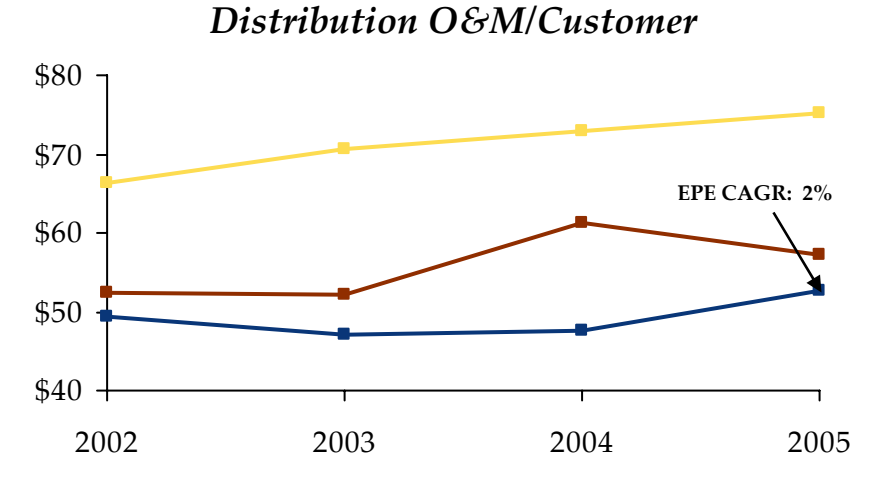
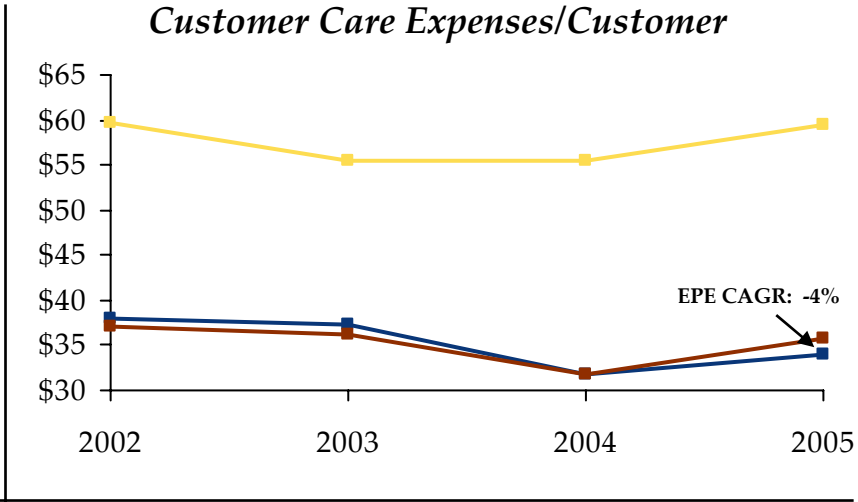
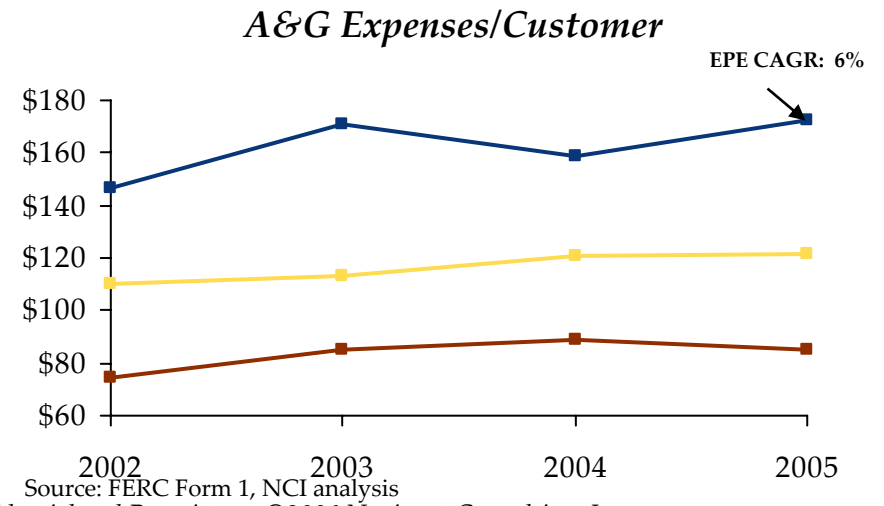
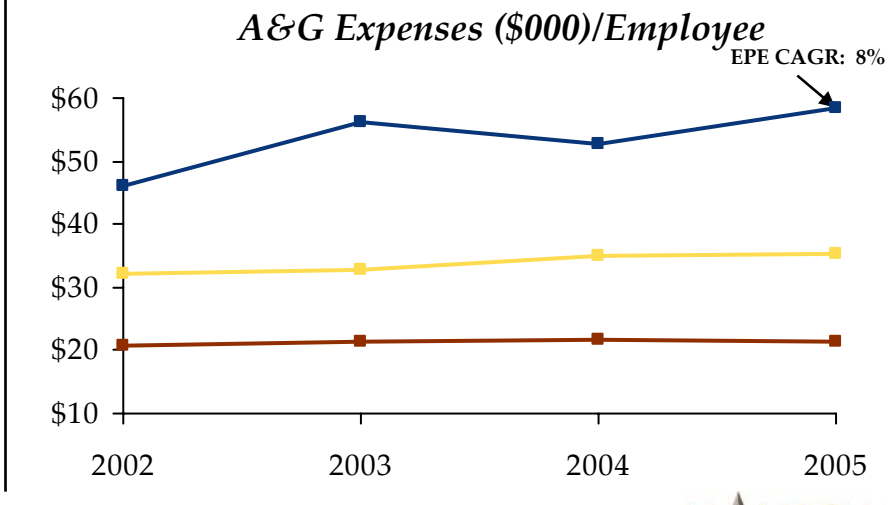
EPE's Distribution and Customer Care O&M costs are less expensive per customer than top quartile.









Source: FERC Form 1, NCI analysis

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EPE's Generation O&M costs were higher per MWh than the peer group average in 2005.

O&M Generation Benchmarks-2005

	EPE	Peer Group Average	Peer Group Top Quartile	Gap between EPE and Average (%)	Gap between EPE and Top Quartile (%)
Steam O&M/ Steam MWh	$8.4	$6.4	$4.7	24%	44%
Nuclear O&M/ Nuclear MWh	$11.2	$27	$12.9	None	None
Total O&M/ Total MWh	$10	$7.2	$4.8	28%	52%

Gas and coal steam generation costs per MWh are higher than average; whereas nuclear generating costs per MWh are lower than average.

Source: FERC Form 1, NCI analysis

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EPE owns 1,500 MW of generating capacity.

	Fuel Type	Nameplate Capacity (MW)
Palo Verde--3 units (owns 15.8%)	Nuclear	600
Newman-- 3 steam units; 1 CCGT (owns 100%)	Gas/Oil	482
Rio Grande– 3 steam units (owns 100%)	Gas/Oil	246
Four Corners—2 steam units (owns 7%)	Coal	104
Copper Power Station—1 CT (owns 100%)	Gas/Oil	68
Hueco Mountain Wind Ranch (owns 100%)	Wind	1

Five out of the six steam units at Rio Grande and Newman are between 40 and 49 years old. Only 69 MW (Copper Power Station and Hueco Wind) are not steam or nuclear.

Source: EPE 10-K

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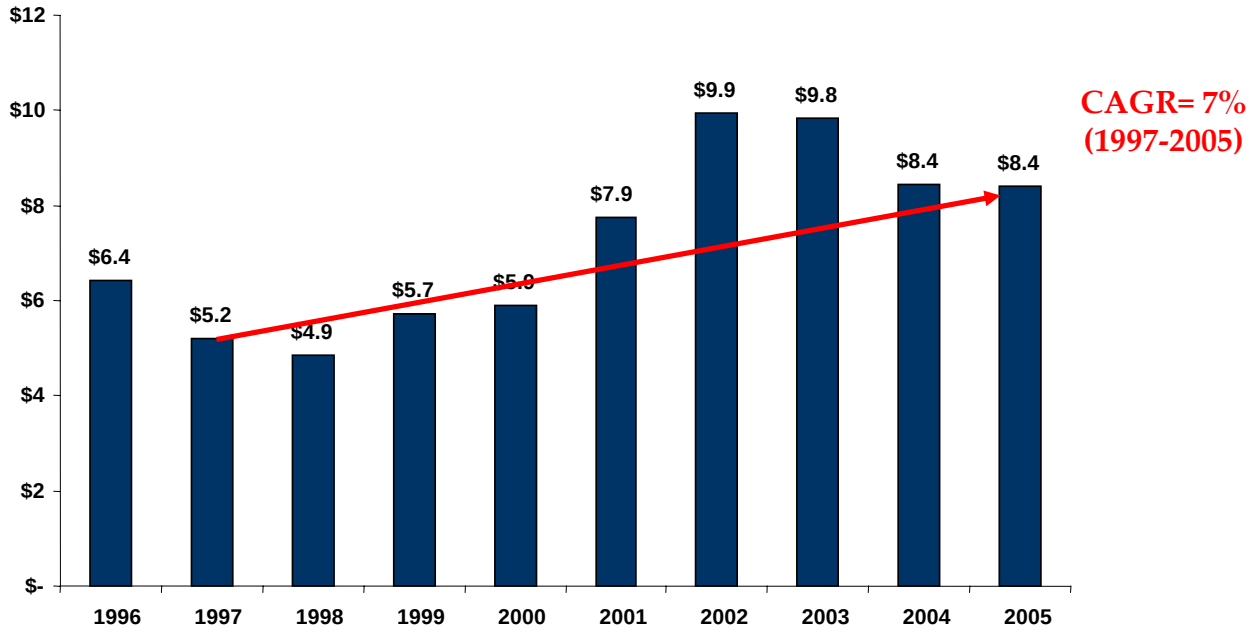
Steam generating O&M costs per MWh have increased at about 7% compounded annually since 1997.

EPE Steam O&M/
Steam Generated MWh



EPE steam generation O&M costs have been heavily impacted by maintaining the old Rio Grande and Newman gas fired units.

Source: FERC Form 1, NCI analysis

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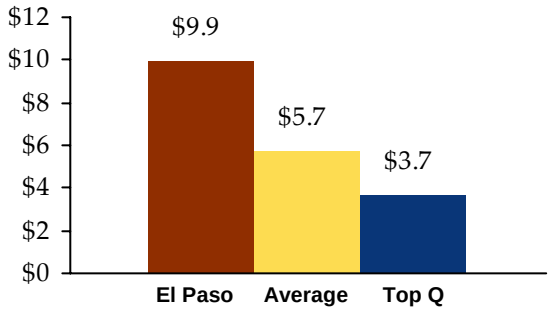
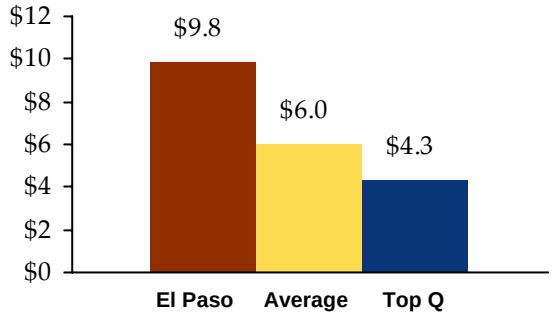
Steam generation O&M costs per MWh were about 40% more expensive than the peer group average in 2002 and 2003.

2002 Steam O&M/ Steam Generated MWh



2003 Steam O&M/ Steam Generated MWh



Key Cost Drivers at EPE

- Scheduled overhaul of Newman Unit 3 (Unit 3 had an EFOR of 12.7%)
- Scheduled overhaul of Four Corners
- Cooling tower and boiler repairs at Rio Grande Unit 8 (Unit 8 had an EFOR of 10.5%)
- Remediation costs accrued at Rio Grande for underground spill and asbestos removal

- Major overhaul and Distributed Control System upgrade at Newman Unit 4
- Boiler repairs at Rio Grande Unit 7 (Unit 7 had an EFOR of 19.2%)
- Generator bearing repairs at Rio Grande Unit 8

Source: FERC Form 1, EPE internal company information, NCI analysis

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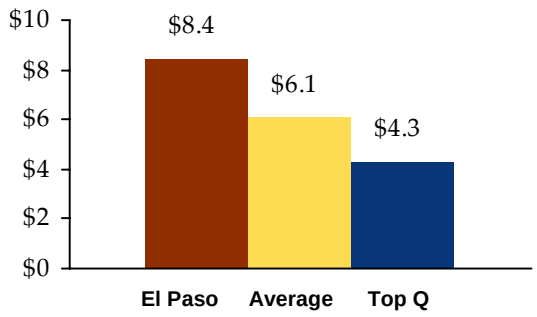
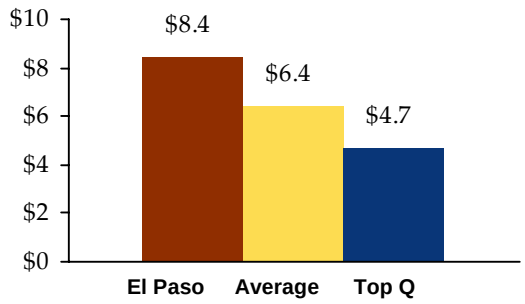
Steam generation O&M costs per MWh were about 25% more expensive than the peer group average in 2004 and 2005.

2004 Steam O&M/ Steam Generated MWh



2005 Steam O&M/ Steam Generated MWh



Key Cost Drivers at EPE

- Boiler repairs on Newman Unit 3
- Boiler repairs on Four Corners
- Newman Unit 2 had major turbine generator overhaul

Source: FERC Form 1, EPE internal company information, NCI analysis

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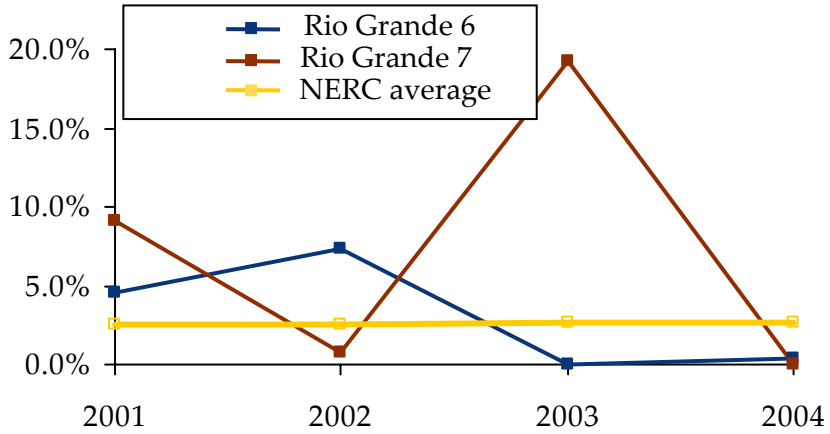
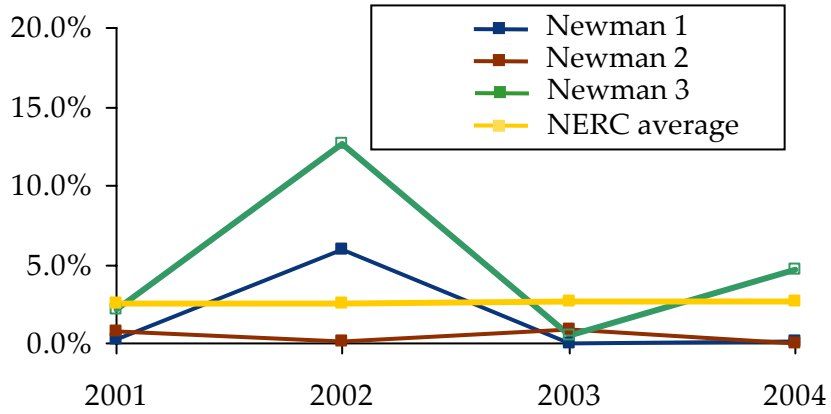
Equivalent Forced Outage Rates (EFOR) have been high since 2001…however, there was improvement in 2004, the last year data was available.

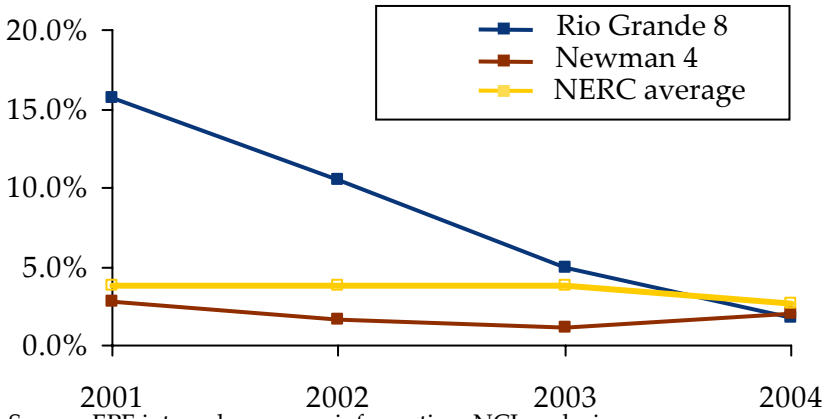
*Rio Grande 6,7 versus NERC Avg. EFOR**



*Newman 1, 2, 3 versus NERC Avg. EFOR**



*Rio Grande 8; Newman 4 versus NERC Avg. EFOR***



Source: EPE internal company information, NCI analysis

* Units are under 100 MW each and compared to NERC average benchmarks for units of 1-99 MW

** Units are above 100 MW each and compared to NERC average benchmarks for units of above 100 MW

Notes: EFOR is calculated as Forced Outage Hours divided by Available Hours. **NCI used data (unadjusted) because this is most comparable to benchmarks.** We did not include Four Corners, because El Paso has little control over this plant's operations.

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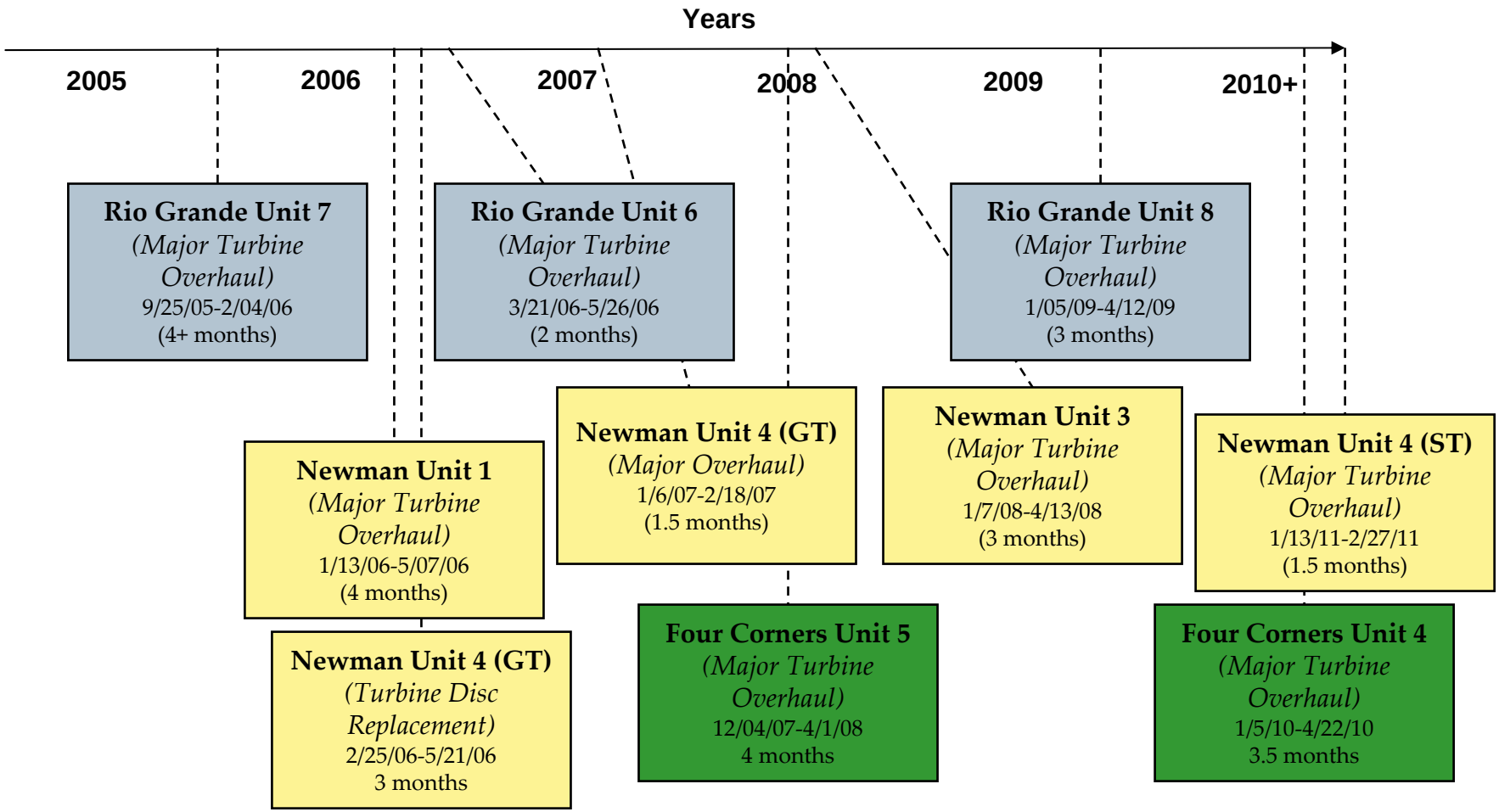
Upcoming major planned outages at steam units may temporarily increase operating and capital costs at those units.



Source: EPE internal company information, NCI analysis

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EPE's steam generating units are old and expensive to operate.

- Staffing levels may be high at several of the gas powered steam units, but benchmarking staffing is not possible using public data
- EPE has recently (within the last year) hired a new VP of Fossil Generation who has goals/expectations to review staffing and operational performance at the plants within the next five years
- Recent trends show improvement…but more data points (i.e., years) are needed before any conclusions can be drawn
- Several major planned outages at EPE's steam plants will likely lead to higher EFORs in the years directly following (this is a common trend at most utilities)
- The Four Corners Units have performed poorly (with EFORs of 11.5% and 6.7% in 2004) but EPE has very limited control over these performance levels

Source: EPE internal company information, NCI analysis

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EPE compares its generating performance metrics (e.g., EFOR) using different assumptions than those used by NERC.

- EPE benchmarks their own steam units against unit data provided by the North American Reliability Council (NERC)
- However, EPE adjusts its own data "by omitting events that are considered atypical and thus, not expected to repeat in the future"
  - A meeting is held with each plant's manager to determine what events should be considered non-routine or unanticipated for their particular plant
  - Thus, EPE excludes such events as boiler repairs, condenser tube leak repairs, etc.
  - NERC data includes such events, however
- In this analysis, we have therefore used EPE's unadjusted data, which offers a closer comparison to the benchmarks used by NERC (and what is generally accepted in the industry

Source: EPE internal company information, NCI analysis

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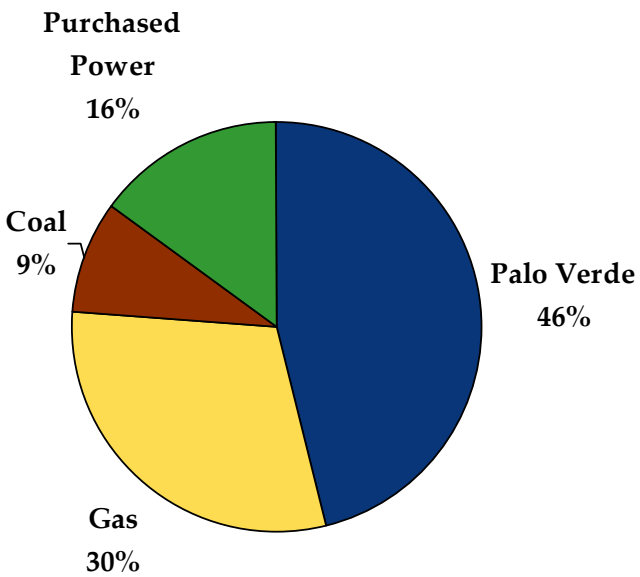
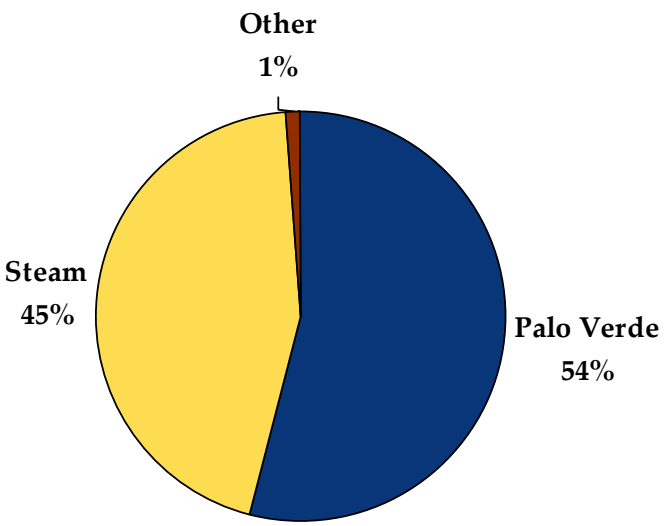
EPE's 15.8 percent ownership in Palo Verde represents about 46% of EPE's available resources and 54% of energy generated in 2005.

2005 Supply by Source (MW)
100%- 1500 MW



2005 Production by Source (GWh)
100%- 7.5 GWh



Note: excludes energy purchased

Source: EPE 2005 10-K, NCI analysis

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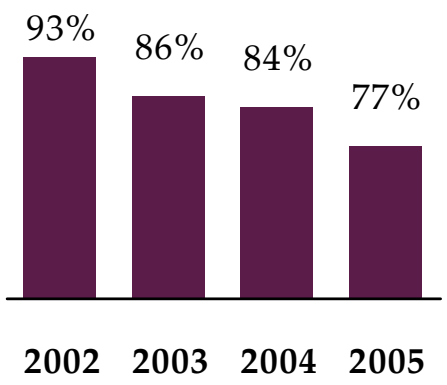
Palo Verde's capacity factor has declined since 2002.

- Palo Verde's output was 40% less in 2005 than in 2004 due to equipment problems
- Palo Verde experienced 78 more unplanned outage days in 2005 than it did in 2004 and had 11 more planned outage days.
- Continued problems at Palo Verde—currently experiencing "harmonic vibration" in one of the piping systems
- Estimated $2 million- $3 million per month (over first Q 06) reduction of off-system sales due to reduced operating capacity
  - Results in a comparable increase in necessary power purchases

Palo Verde Capacity Factor



Source: EPE 2005 10-K; EPE internal company information, NCI analysis

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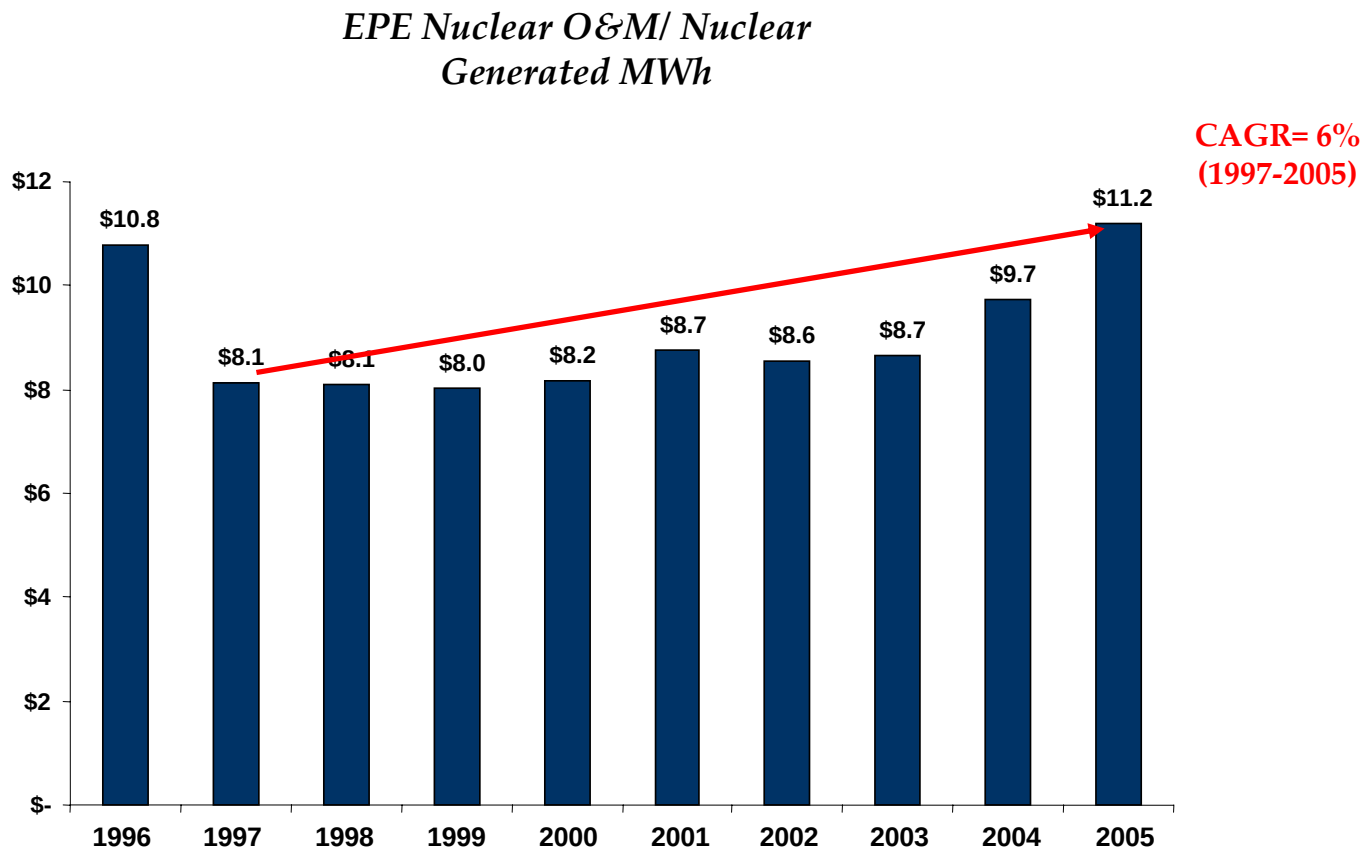
O&M costs per MWh have increased from 1997



Source: FERC Form 1, NCI analysis

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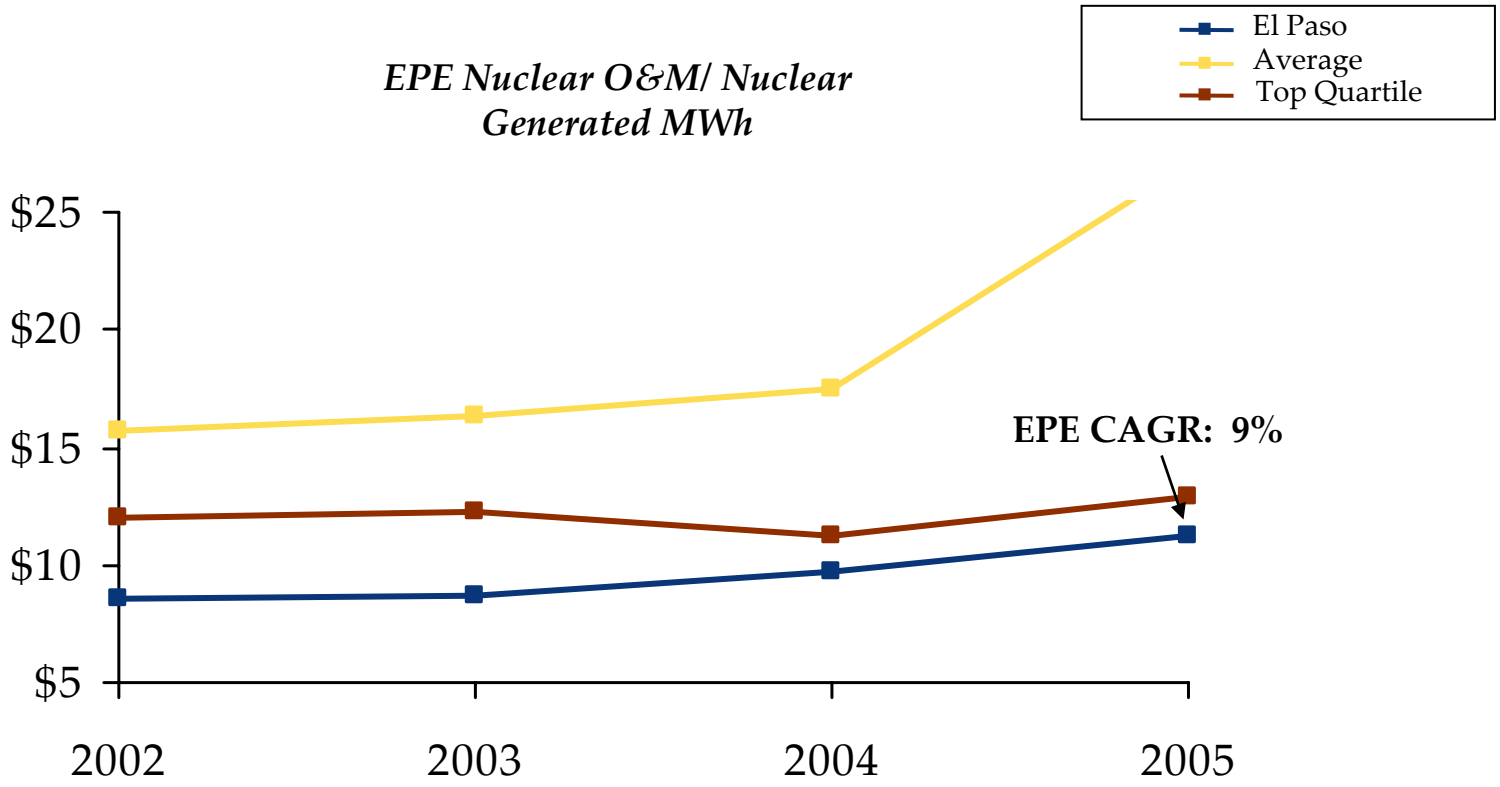
Despite this cost increase, EPE's nuclear O&M costs per MWh are lower than the peer group average and within the top quartile.



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Palo Verde's O&M costs have a significant impact on EPE's overall O&M costs.

- EPE has experienced increasing costs from the nuclear units since 1997
- The reduced nuclear unit availability has resulted in reduced revenues (i.e., from off-system sales)
- There is limited opportunity for EPE to influence this trend, as it is a cost-taker vis-à-vis Palo Verde
- Even though EPE's nuclear costs are increasing, Palo Verde is still a relatively low cost nuclear plant

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EPE's Transmission O&M cost benchmarks were lower (less expensive) than the peer group average in 2005.

Transmission O&M Benchmarks-2005

	EPE	Peer Group Average	Peer Group Top Quartile	Gap between EPE and Average (%)	Gap between EPE and Top Quartile (%)
Trans. Operation Cost/Line Mile	$5,049	$6,893	$3,349	None	34%
Trans. Maintenance Cost/Line Mile	$992	$1,990	$1,069	None	None
Total Trans. O&M Cost/ Line Mile	$6,041	$8,883	$4,418	None	27%

EPE benefits from having more moderate weather conditions than other peer group companies (limited ice, limited high winds, etc., but must maintain many miles of remote line

Source: FERC Form 1, NCI analysis

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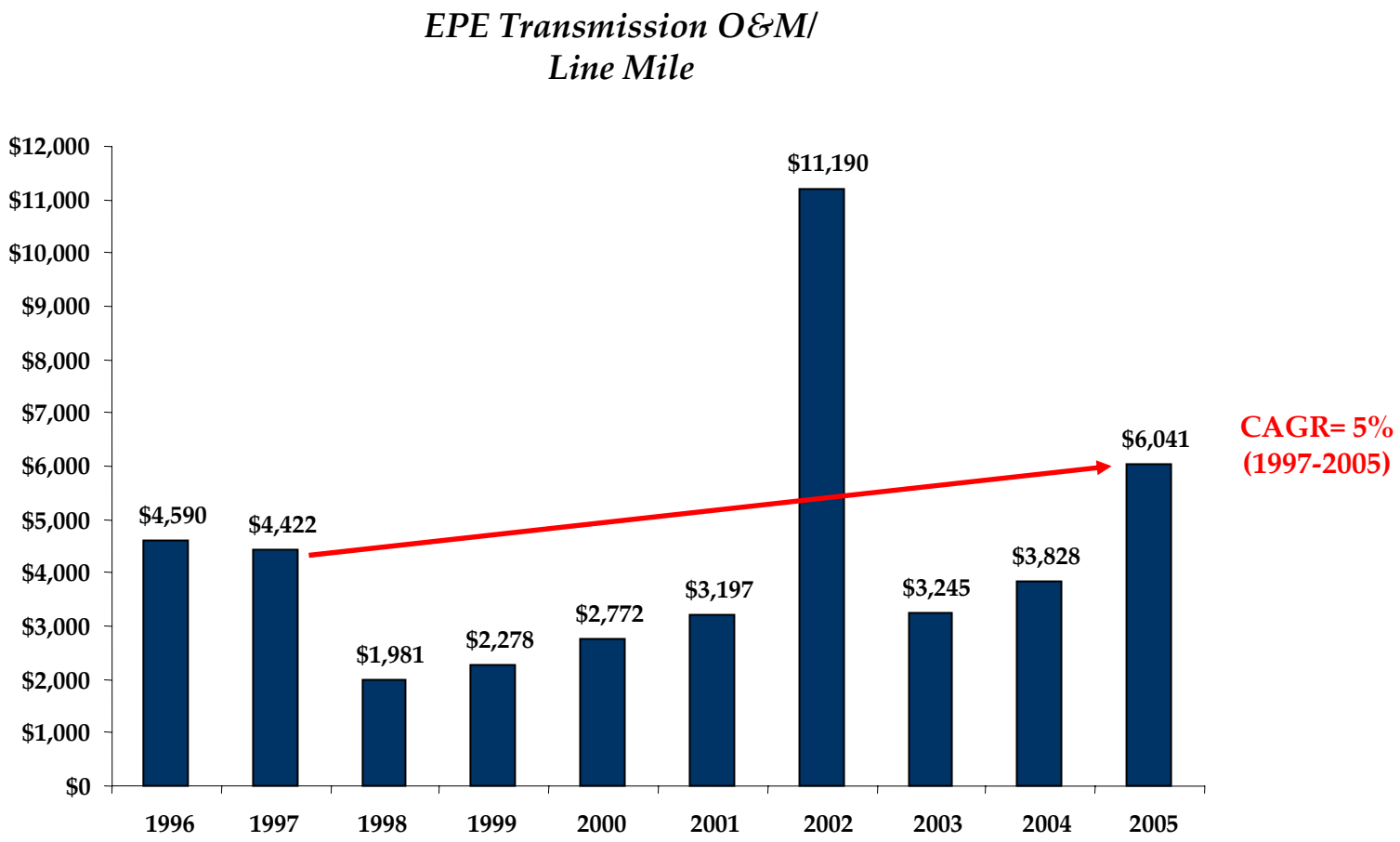
Transmission O&M costs have been "up and down" since 1997.



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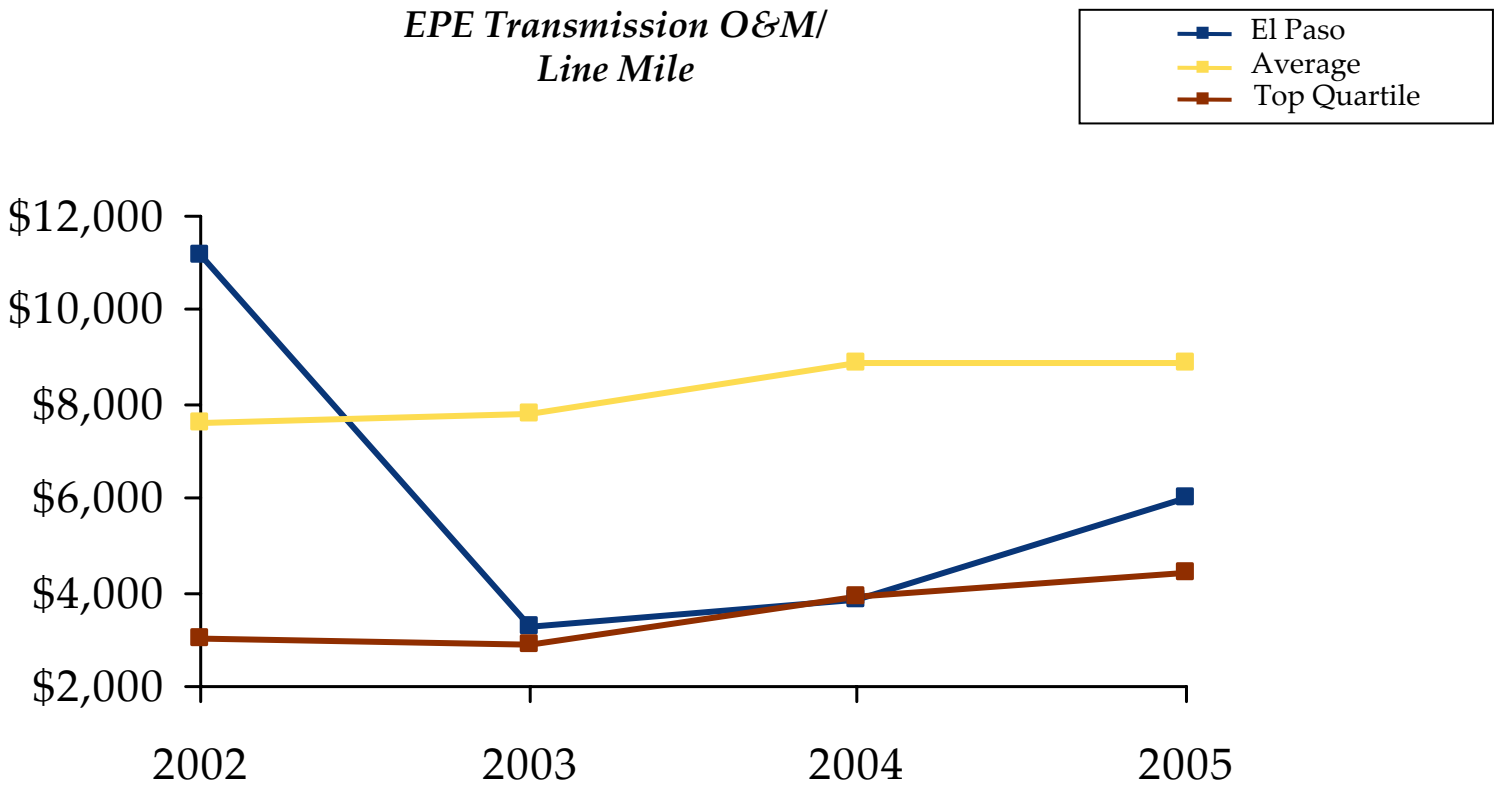
EPE's Transmission O&M costs per line mile—excluding the extraordinary costs in 2002– have been below (less expensive) than the peer group average.



Source: FERC Form 1, NCI analysis

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Key Transmission Findings

- Transmission O&M costs are "reasonable"
- EPE enjoys a good operating environment impacting both cost and performance of transmission
- Unlike other business functions, the transmission staff is made up of mainly young people
  - 65% of employees are 50 or younger, versus 56% of employees in generation

Source: El Paso internal materials, NCI analysis

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EPE's Distribution O&M cost benchmarks were below (less expensive) than the peer group average in 2005.

Distribution O&M Benchmarks-2005

	EPE	Peer Group Average	Peer Group Top Quartile	Gap between EPE and Average (%)	Gap between EPE and Top Quartile (%)
Distribution Operation Cost/ Customer	$33.9	$34.8	$28.8	None	15%
Distribution Maintenance Cost/ Customer	$18.8	$40.3	$28.4	None	None
Total Distribution O&M Cost/Customer	$52.7	$75.1	$57.2	None	None

EPE benefits from having more moderate weather conditions than other peer group companies (limited ice, limited high winds, etc.)

Source: FERC Form 1, NCI analysis

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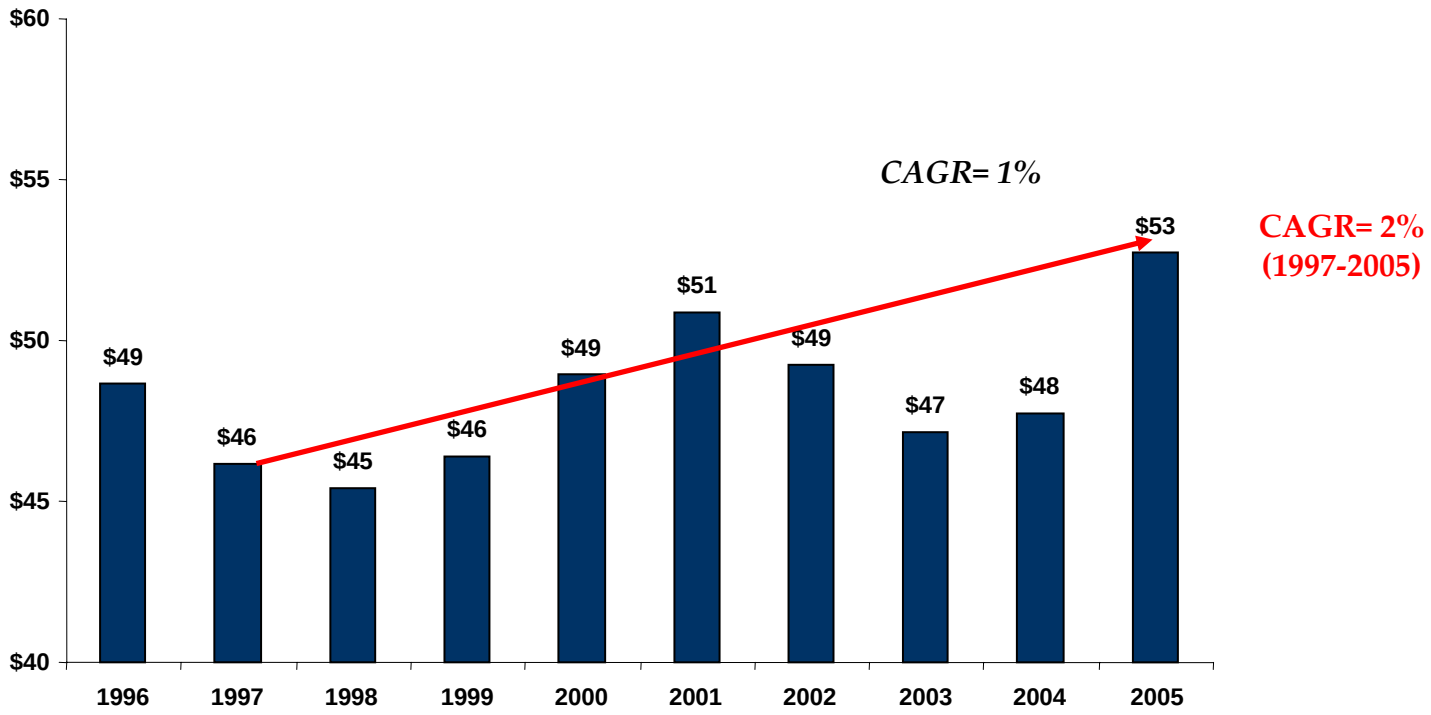
Distribution O&M costs per customer have remained relatively flat.

EPE Distribution O&M/ Customer



Source: FERC Form 1, NCI analysis

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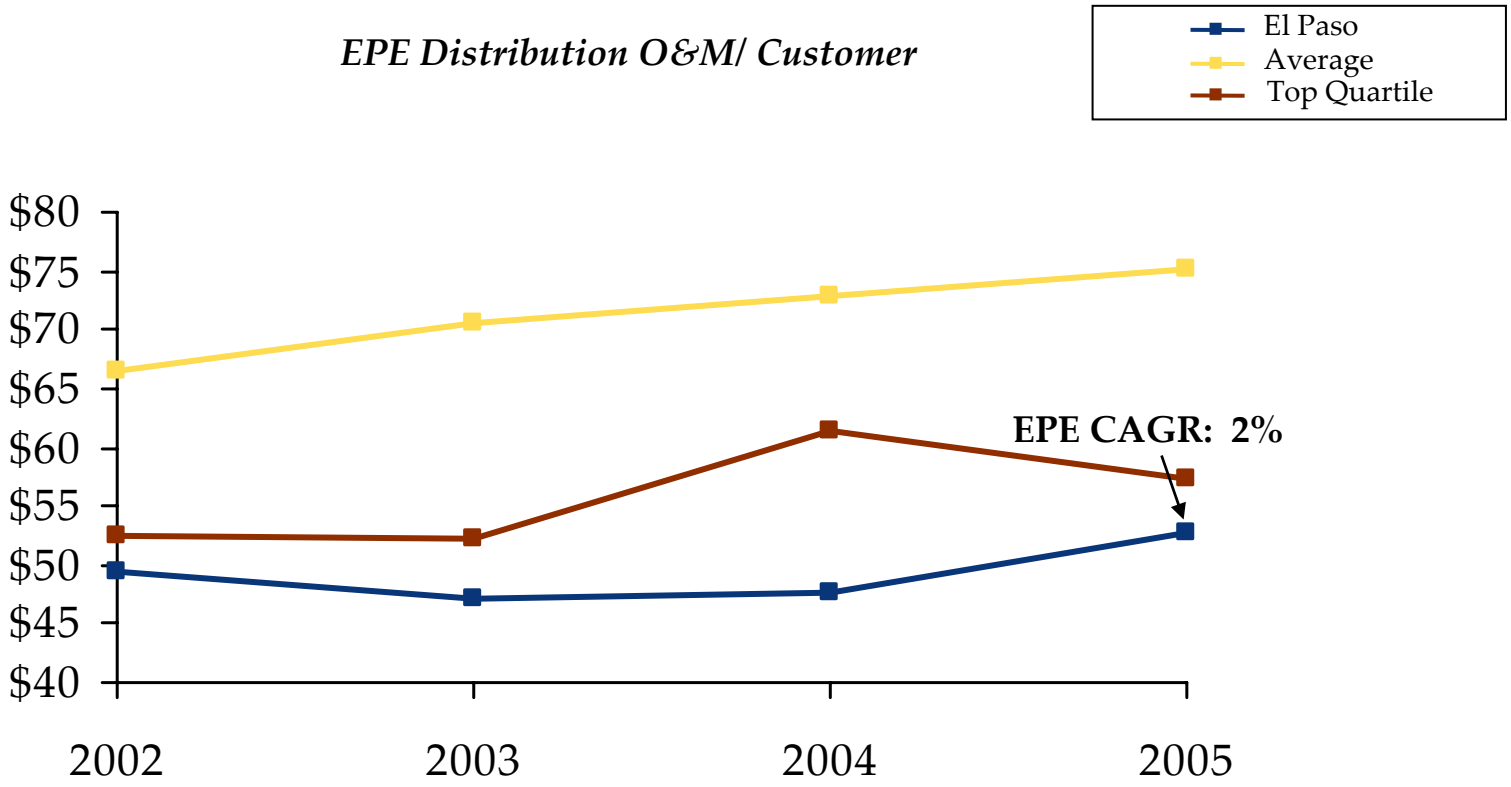
Since 2002, EPE's Distribution O&M costs per customer have risen only 2% and remain less expensive than the peer group average and top quartile.



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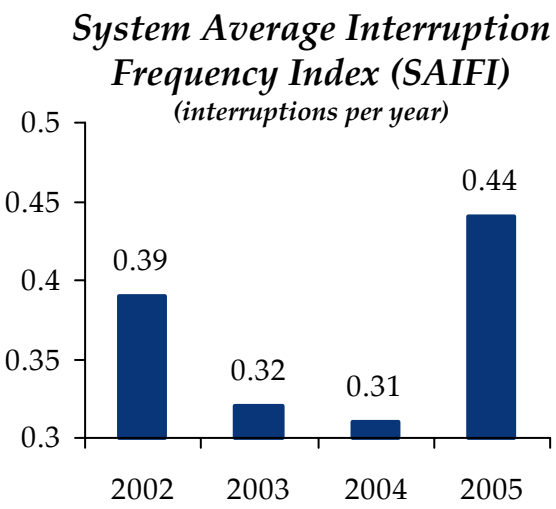
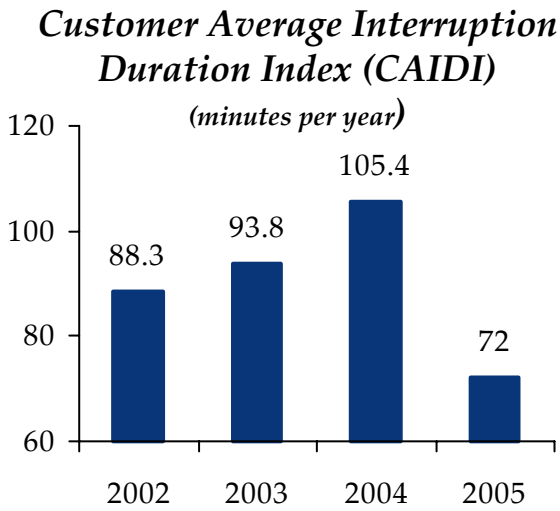
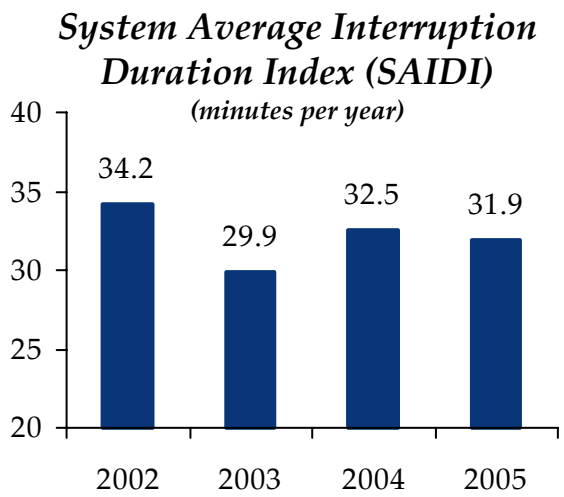
EPE's Texas System Reliability Indices (Forced Outage Data)*







- Outage frequency increased in 2005, but duration has generally declined
- Reduction in operating expenditures does not seem to have negatively impacted reliability

*Annual data
Source: El Paso, NCI analysis

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In general, EPE has superior SAIDI and SAIFI metrics.

- EPE provided four differing SAIDI, SAIFI, CAIDI "categories." The "Forced Outage" data is the best one to use to compare performance with other companies.
- While most of the peer group companies have a SAIFI of around 1.0, EPE has a SAIFI of between 0.3 and 0.5.
- While most of the peer group companies have a SAIDI of around 50-60, EPE has a SAIDI of between 30-35.

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EPE's Customer Care O&M cost benchmarks in the top quartile of the peer group in 2005.

Customer Care O&M Benchmarks—2005

	EPE	Peer Group Average	Peer Group Top Quartile	Gap between EPE and Average (%)	Gap between EPE and Top Quartile (%)
Cust. Account Expenses/ Customer	$32.5	$41.8	$33.7	None	None
Cust. Svc and Info Expenses/ Customer	$1.4	$13.5	$2.1	None	None
Sales Expenses/ Customer	$0.1	$4.0	$0.1	None	None
Total Customer Care Expenses/ Customer	$34.0	$59.3	$35.9	None	None

Source: FERC Form 1, NCI analysis

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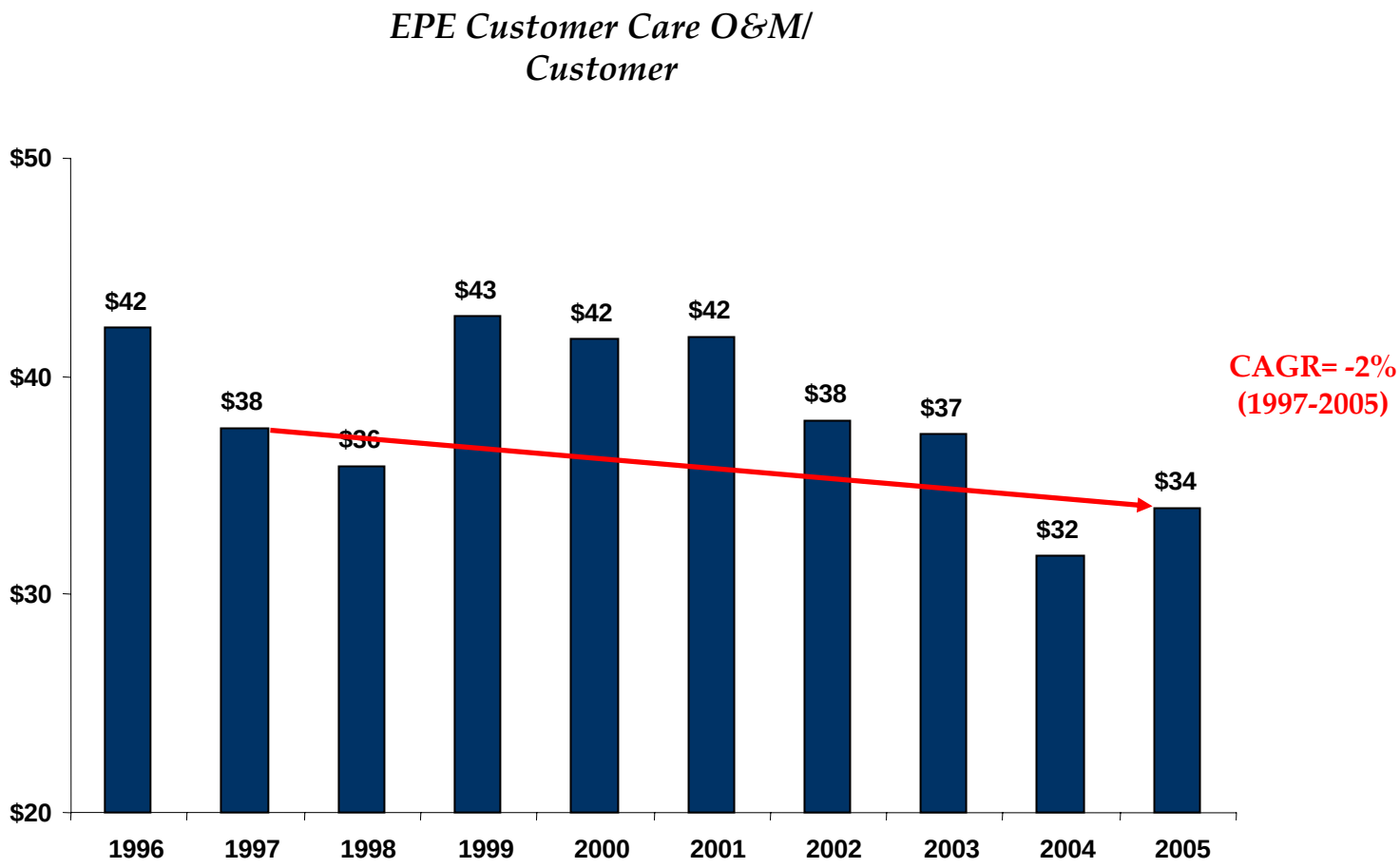
Customer Care O&M costs per customer have generally declined since 1997.



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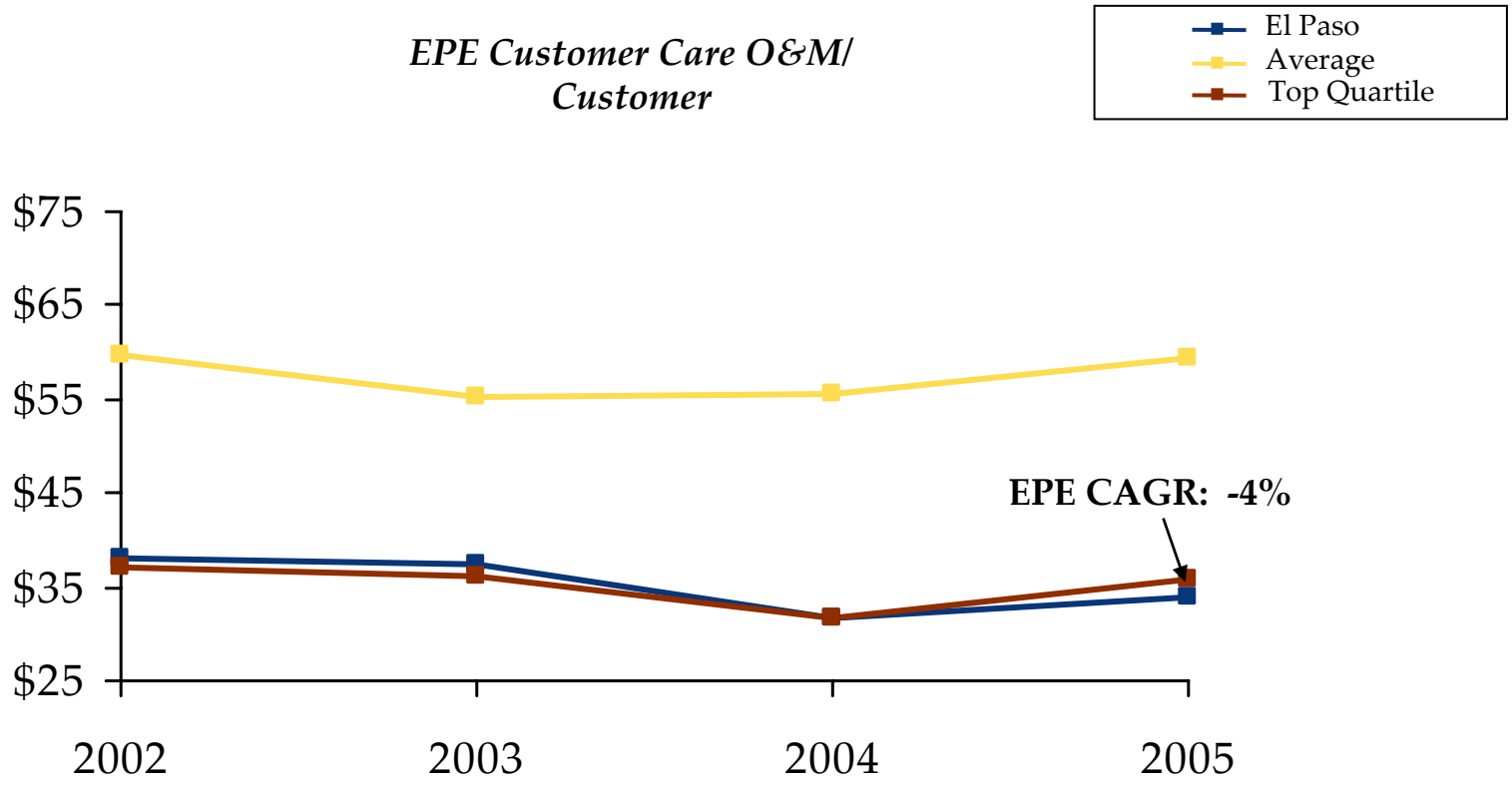
EPE's Customer Care O&M costs per customer since 2002 have been declining and are currently within top-quartile of the peer group.



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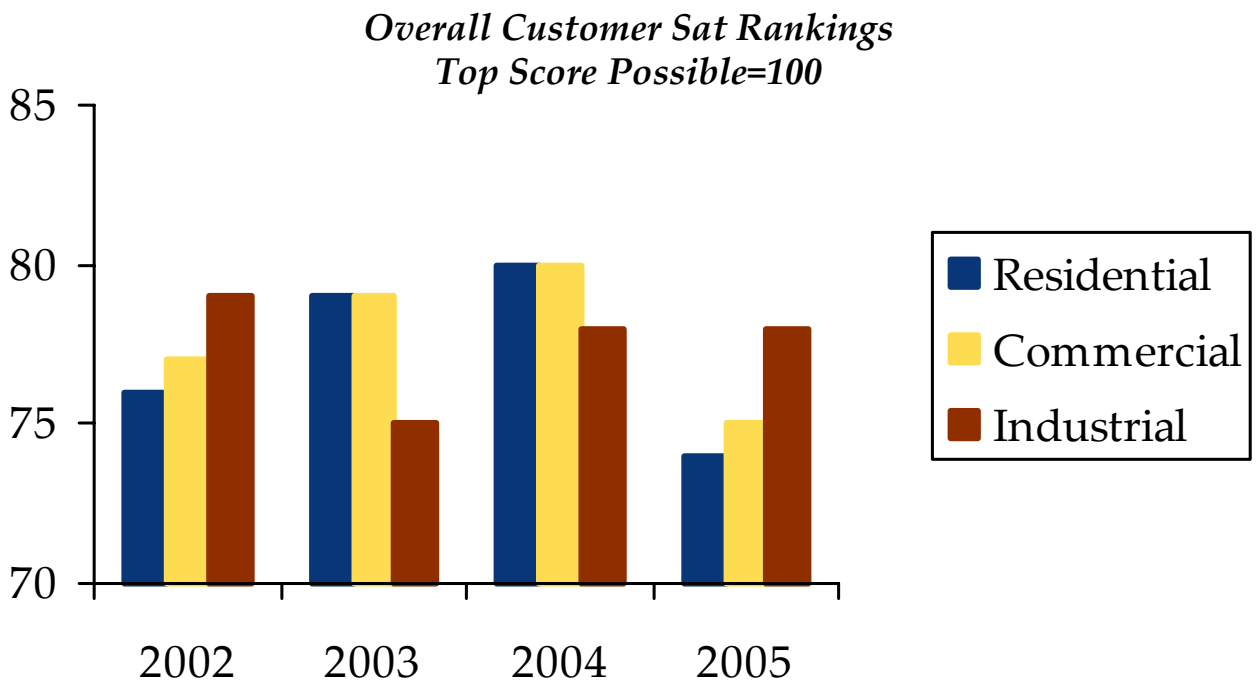
Market Strategies Inc. (MSI) conducts EPE's customer satisfaction survey. The results of their survey are below.



MSI measures customer satisfaction for about 100 utilities. In 2005, EPE's residential customer satisfaction scores were ranked in the second quartile of this group.

Source: El Paso, NCI analysis

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Key Customer Care and Customer Satisfaction Findings

- MSI provides an in-depth survey of customer opinions.
- In general, EPE rates highly on most metrics, and in fact is above average on every metric except for one.
- EPE ranks highest on such metrics as service quality, environmental protection, and being a good corporate citizen.
- The only metric upon which EPE rates below the MSI database average is "reasonableness of electric rates."
  - Only 16% of EPE's surveyed customers give the company a "very positive" rating to this question.
- Residential customer satisfaction declined significantly in 2005…according to the company-- due to the timing of the survey, which was conducted immediately after a rate increase.

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EPE's A&G O&M cost benchmarks were higher than the average of the peer group in 2005.

Example A&G O&M Metrics- 2005*

	EPE	Peer Group Average	Peer Group Top Quartile	Gap between EPE and Average (%)	Gap between EPE and Top Quartile (%)
A&G Salaries/ Customer (920)	$57.7	$49.0	$28.9	15%	50%
A&G Outside Services/ Customer (923)	$28.9	$19.7	$11.2	32%	61%
Total A&G Expenses/ Customer**	$172.6	$121.6	$85.3	36%	51%

The high A&G costs are largely balanced out by EPE's low Customer Care and Distribution costs.

*Not all A&G accounts are listed here…the third row (Total A&G costs) is therefore not the sum of the first two rows

**Total A&G excludes accounts 926 (Pensions and Benefits); 927 (Franchise Requirements); 928 (Regulatory Commission Expenses)

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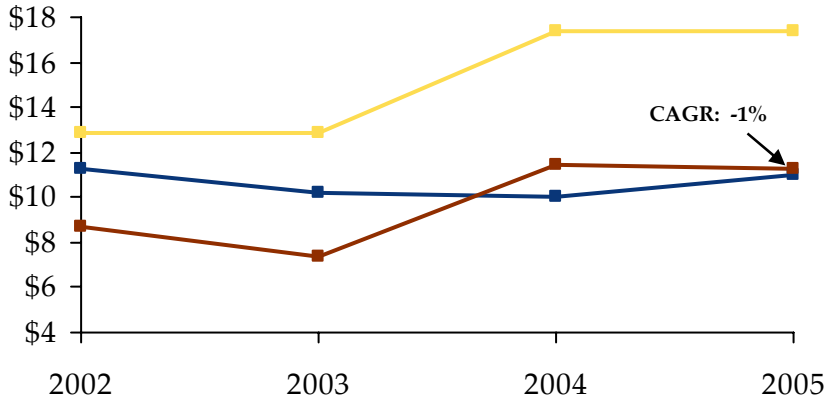
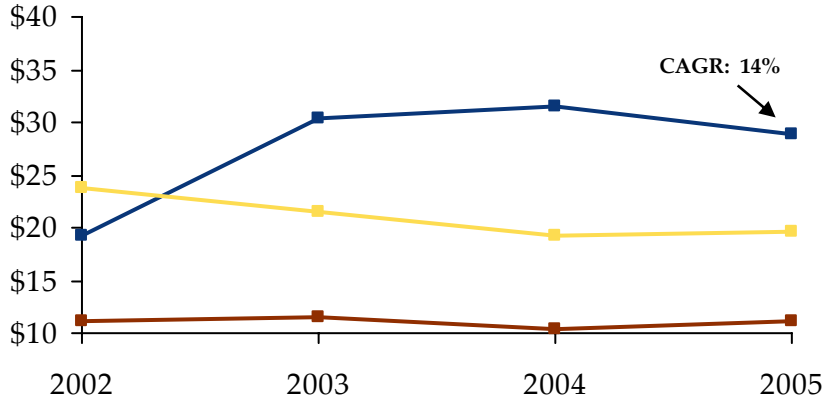
EPE's A&G O&M costs/ per customer for most accounts in most cases are higher than the peer group average.

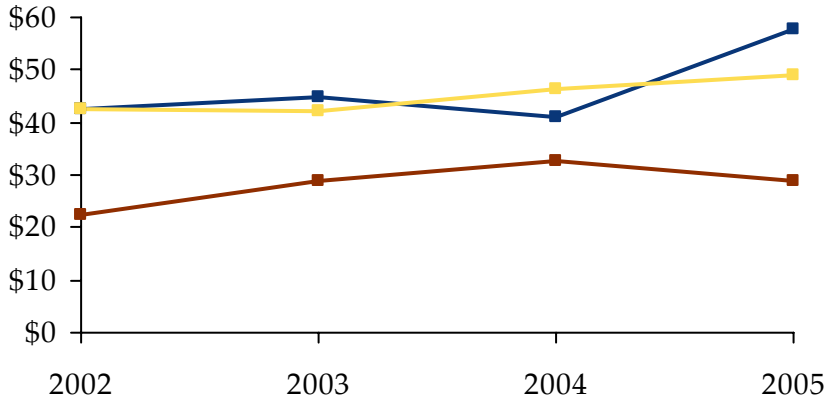
Office Supplies and Expense/ Customer



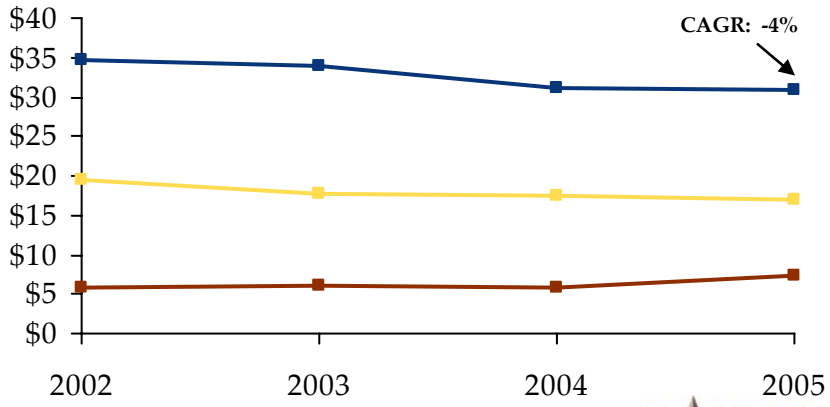
Outside Services/ Customer



A&G Salaries/ Customer



Misc. General Expense/ Customer



Source: FERC Form 1, NCI analysis

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A&G costs have been driven both by increases in consulting and legal fees, as well as by historical accounting practices.

Some examples:

- Outside Services Employed (Account 923) has been driven by:
  - Legal fees, e.g., in 2003, EPE booked nearly $2 million due to class action lawsuits
  - Consultant fees, e.g., $1.4 million in 2003 for an analysis of options for constructing new generating plants in its service territory
  - Sarbannes-Oxley related fees
- Administrative and General Salaries and Miscellaneous General Expenses (Accounts 920 and 930.2) have been driven by:
  - Non-productive time allocated to this account rather than functional accounts (e.g., T&D)
  - Paid Time Off for functional employees (charged in A&G versus to the appropriate function)

The new Oracle System will be addressing the allocation of costs by more appropriately tracking the source of each cost item.

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EPE's measured* O&M costs are "reasonable" given the company's current structure and operating environment.

- Overall, EPE's costs are reasonable given the company's current business structure and operating environment
- Steam unit O&M costs is understandably high because of the age and size most of the units
- EPE's low T&D O&M costs have not harmed reliability figures
- Customer care spending is low, but customer satisfaction numbers (according to the one source EPE uses) are relatively good.
  - Customer expectations are growing…this is an area EPE will likely need to make enhancements to its existing programs to meet expectations
- Relatively high A&G expenses appear to be more of a function of accounting practices and tools than actual "unreasonably" high spending
  - Low distribution and customer care costs "balance out" high A&G costs
  - The new Oracle system should address some of these issues

*all costs on this page are the "measured" costs, which exclude the six FERC account items noted on page 10
Sources: FERC Form 1, EPE 10-K, EPE internal information, NCI analysis

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Recommendations

- The City and EPE should identify a set of performance measures that EPE can employ to self-report annual benchmark performance to the City to effectively assess EPE's performance compared to an agreed upon Peer Group of companies. This annual activity would facilitate an annual dialogue between the City and EPE to assist the City to:
  - Effectively assess operating cost elements
  - Effectively assess performance and customer satisfaction indices
  - Track EPE performance trends to prepare the City to consider issues to be addressed at the end of the current term of the Rate Agreement
- EPE should take action to address the condition of the old gas-fired steam units being a major cost liability.
  - A logical option to reduce O&M costs is to replace them with new more efficient units (and would also greatly reduce fuel costs).
  - Benchmark generation performance (e.g., forced outage rates; net availability factors) using industry standard practices ("NERC").
- EPE should develop staffing replacement plans, particularly in the generation function, to address potential retirements.
- EPE should continue to seek opportunities to deploy new systems and technologies to displace manual processes and enhance operational proficiency:
  - GIS
  - Outage Management
  - Customer Information System

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