

CENTERPOINT ENERGY INC

Form 10-K

February 28, 2008

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**Form 10-K**

(Mark One)

- ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**For the fiscal year ended December 31, 2007**
- or**
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number 1-31447**

**CenterPoint Energy, Inc.**

*(Exact name of registrant as specified in its charter)*

**Texas**

*(State or other jurisdiction of incorporation or organization)*

**1111 Louisiana**

**Houston, Texas 77002**

*(Address and zip code of principal executive offices)*

**74-0694415**

*(I.R.S. Employer Identification No.)*

**(713) 207-1111**

*(Registrant's telephone number, including area code)*

**Securities registered pursuant to Section 12(b) of the Act:**

**Title of each class**

**Name of each exchange on which registered**

Common Stock, \$0.01 par value and associated rights to purchase preferred stock

New York Stock Exchange  
Chicago Stock Exchange

**Securities registered pursuant to Section 12(g) of the Act:**

**None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

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Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein and will not be contained, to the best of each of the registrants' knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer <input checked="" type="radio"/>	Accelerated filer <input type="radio"/>	Non-accelerated filer <input type="radio"/> (Do not check if a smaller reporting company)	Smaller reporting company <input type="radio"/>
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Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

The aggregate market value of the voting stock held by non-affiliates of CenterPoint Energy, Inc. (Company) was \$5,552,435,108 as of June 30, 2007, using the definition of beneficial ownership contained in Rule 13d-3 promulgated pursuant to the Securities Exchange Act of 1934 and excluding shares held by directors and executive officers. As of February 15, 2008, the Company had 327,346,112 shares of Common Stock outstanding. Excluded from the number of shares of Common Stock outstanding are 166 shares held by the Company as treasury stock.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the definitive proxy statement relating to the 2008 Annual Meeting of Shareholders of the Company, which will be filed with the Securities and Exchange Commission within 120 days of December 31, 2007, are incorporated by reference in Item 10, Item 11, Item 12, Item 13 and Item 14 of Part III of this Form 10-K.

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**CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION**

From time to time we make statements concerning our expectations, beliefs, plans, objectives, goals, strategies, future events or performance and underlying assumptions and other statements that are not historical facts. These statements are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Actual results may differ materially from those expressed or implied by these statements. You can generally identify our forward-looking statements by the words anticipate, believe, continue, could, estimate, expect, forecast, may, objective, plan, potential, predict, projection, should, will, or other similar words.

We have based our forward-looking statements on our management's beliefs and assumptions based on information available to our management at the time the statements are made. We caution you that assumptions, beliefs, expectations, intentions and projections about future events may and often do vary materially from actual results. Therefore, we cannot assure you that actual results will not differ materially from those expressed or implied by our forward-looking statements.

Some of the factors that could cause actual results to differ from those expressed or implied by our forward-looking statements are described under Risk Factors in Item 1A of this report.

You should not place undue reliance on forward-looking statements. Each forward-looking statement speaks only as of the date of the particular statement.

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**PART I**

**Item 1. *Business***

**OUR BUSINESS**

***Overview***

We are a public utility holding company whose indirect wholly owned subsidiaries include:

CenterPoint Energy Houston Electric, LLC (CenterPoint Houston), which engages in the electric transmission and distribution business in a 5,000-square mile area of the Texas Gulf Coast that includes Houston; and

CenterPoint Energy Resources Corp. (CERC Corp., and, together with its subsidiaries, CERC), which owns and operates natural gas distribution systems in six states. Subsidiaries of CERC Corp. own interstate natural gas pipelines and gas gathering systems and provide various ancillary services. A wholly owned subsidiary of CERC Corp. offers variable and fixed-price physical natural gas supplies primarily to commercial and industrial customers and electric and gas utilities.

Our reportable business segments are Electric Transmission & Distribution, Natural Gas Distribution, Competitive Natural Gas Sales and Services, Interstate Pipelines, Field Services and Other Operations. The operations of Texas Genco Holdings, Inc. (Texas Genco), formerly our majority owned electric generating subsidiary, the sale of which was completed in April 2005, are presented as discontinued operations. From time to time, we consider the acquisition or the disposition of assets or businesses.

Our principal executive offices are located at 1111 Louisiana, Houston, Texas 77002 (telephone number: 713-207-1111).

We make available free of charge on our Internet website our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practicable after we electronically file such reports with, or furnish them to, the Securities and Exchange Commission (SEC). Additionally, we make available free of charge on our Internet website:

our Code of Ethics for our Chief Executive Officer and Senior Financial Officers;

our Ethics and Compliance Code;

our Corporate Governance Guidelines; and

the charters of our audit, compensation, finance and governance committees.

Any shareholder who so requests may obtain a printed copy of any of these documents from us. Changes in or waivers of our Code of Ethics for our Chief Executive Officer and Senior Financial Officers and waivers of our Ethics and Compliance Code for directors or executive officers will be posted on our Internet website within five business days of such change or waiver and maintained for at least 12 months or reported on Item 5.05 of Form 8-K. Our website address is [www.centerpointenergy.com](http://www.centerpointenergy.com). Except to the extent explicitly stated herein, documents and information on

our website are not incorporated by reference herein.

***Electric Transmission & Distribution***

In 1999, the Texas legislature adopted the Texas Electric Choice Plan (Texas electric restructuring law) that led to the restructuring of integrated electric utilities operating within Texas. Pursuant to that legislation, integrated electric utilities operating within the Electric Reliability Council of Texas, Inc. (ERCOT) were required to separate their integrated operations into separate retail sales, power generation and transmission and distribution companies. The legislation also required that the prices for wholesale generation and retail electric sales be unregulated, but services by companies providing transmission and distribution service, such as CenterPoint Houston, would continue to be regulated by the Public Utility Commission of Texas (Texas Utility Commission). The legislation provided for a transition period to move to the new market structure and provided a true-up mechanism for the

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formerly integrated electric utilities to recover stranded and certain other costs resulting from the transition to competition. Those costs are recoverable after approval by the Texas Utility Commission either through the issuance of securitization bonds or through the implementation of a competition transition charge (CTC) as a rider to the utility's tariff.

CenterPoint Houston is the only business of CenterPoint Energy that continues to engage in electric utility operations. It is a transmission and distribution electric utility that operates wholly within the state of Texas. Neither CenterPoint Houston nor any other subsidiary of CenterPoint Energy makes sales of electric energy at retail or wholesale, or owns or operates any electric generating facilities.

### *Electric Transmission*

On behalf of retail electric providers (REPs), CenterPoint Houston delivers electricity from power plants to substations, from one substation to another and to retail electric customers taking power at or above 69 kilovolts (kV) in locations throughout the control area managed by ERCOT. CenterPoint Houston provides transmission services under tariffs approved by the Texas Utility Commission.

### *Electric Distribution*

In ERCOT, end users purchase their electricity directly from certificated REPs. CenterPoint Houston delivers electricity for REPs in its certificated service area by carrying lower-voltage power from the substation to the retail electric customer. CenterPoint Houston's distribution network receives electricity from the transmission grid through power distribution substations and delivers electricity to end users through distribution feeders. CenterPoint Houston's operations include construction and maintenance of electric transmission and distribution facilities, metering services, outage response services and call center operations. CenterPoint Houston provides distribution services under tariffs approved by the Texas Utility Commission. Texas Utility Commission rules and market protocols govern the commercial operations of distribution companies and other market participants. Rates for these existing services may be reviewed only through rate cases conducted before the Texas Utility Commission.

### *ERCOT Market Framework*

CenterPoint Houston is a member of ERCOT. ERCOT serves as the regional reliability coordinating council for member electric power systems in Texas. ERCOT membership is open to consumer groups, investor and municipally owned electric utilities, rural electric cooperatives, independent generators, power marketers and REPs. The ERCOT market includes most of the State of Texas, other than a portion of the panhandle, a portion of the eastern part of the state bordering Louisiana and the area in and around El Paso. The ERCOT market represents approximately 85% of the demand for power in Texas and is one of the nation's largest power markets. The ERCOT market includes an aggregate net generating capacity of approximately 72,000 megawatts (MW). There are only limited direct current interconnections between the ERCOT market and other power markets in the United States and Mexico.

The ERCOT market operates under the reliability standards set by the North American Electric Reliability Council (NERC) and approved by the Federal Energy Regulatory Commission (FERC). These reliability standards are administered by the Texas Regional Entity, a Division of ERCOT (TRE). The Texas Utility Commission has primary jurisdiction over the ERCOT market to ensure the adequacy and reliability of electricity supply across the state's main interconnected power transmission grid. The ERCOT independent system operator (ERCOT ISO) is responsible for operating the bulk electric power supply system in the ERCOT market. Its responsibilities include ensuring that electricity production and delivery are accurately accounted for among the generation resources and wholesale buyers and sellers. Unlike certain other regional power markets, the ERCOT market is not a centrally dispatched power pool, and the ERCOT ISO does not procure energy on behalf of its members other than to maintain the reliable operations



of the transmission system. Members who sell and purchase power are responsible for contracting sales and purchases of power bilaterally. The ERCOT ISO also serves as agent for procuring ancillary services for those members who elect not to provide their own ancillary services.

CenterPoint Houston's electric transmission business, along with those of other owners of transmission facilities in Texas, supports the operation of the ERCOT ISO. The transmission business has planning, design,

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construction, operation and maintenance responsibility for the portion of the transmission grid and for the load-serving substations it owns, primarily within its certificated area. We participate with the ERCOT ISO and other ERCOT utilities to plan, design, obtain regulatory approval for and construct new transmission lines necessary to increase bulk power transfer capability and to remove existing constraints on the ERCOT transmission grid.

*Recovery of True-Up Balance*

The Texas electric restructuring law substantially amended the regulatory structure governing electric utilities in order to allow retail competition for electric customers beginning in January 2002. The Texas electric restructuring law required the Texas Utility Commission to conduct a true-up proceeding to determine CenterPoint Houston's stranded costs and certain other costs resulting from the transition to a competitive retail electric market and to provide for its recovery of those costs.

In March 2004, CenterPoint Houston filed its true-up application with the Public Utility Commission of Texas (Texas Utility Commission), requesting recovery of \$3.7 billion, excluding interest, as allowed under the Texas Electric Choice Plan (Texas electric restructuring law). In December 2004, the Texas Utility Commission issued its final order (True-Up Order) allowing CenterPoint Houston to recover a true-up balance of approximately \$2.3 billion, which included interest through August 31, 2004, and provided for adjustment of the amount to be recovered to include interest on the balance until recovery, along with the principal portion of additional excess mitigation credits (EMCs) returned to customers after August 31, 2004 and in certain other respects.

CenterPoint Houston and other parties filed appeals of the True-Up Order to a district court in Travis County, Texas. In August 2005, that court issued its judgment on the various appeals. In its judgment, the district court:

reversed the Texas Utility Commission's ruling that had denied recovery of a portion of the capacity auction true-up amounts;

reversed the Texas Utility Commission's ruling that precluded CenterPoint Houston from recovering the interest component of the EMCs paid to REPs; and

affirmed the True-Up Order in all other respects.

The district court's decision would have had the effect of restoring approximately \$650 million, plus interest, of the \$1.7 billion the Texas Utility Commission had disallowed from CenterPoint Houston's initial request.

CenterPoint Houston and other parties appealed the district court's judgment to the Texas Third Court of Appeals, which issued its decision in December 2007. In its decision, the court of appeals:

reversed the district court's judgment to the extent it restored the capacity auction true-up amounts;

reversed the district court's judgment to the extent it upheld the Texas Utility Commission's decision to allow CenterPoint Houston to recover EMCs paid to Reliant Energy, Inc. (RRI);

ordered that the tax normalization issue described below be remanded to the Texas Utility Commission; and

affirmed the district court's judgment in all other respects.

CenterPoint Houston and two other parties filed motions for rehearing with the court of appeals. In the event that the motions for rehearing are not resolved in a manner favorable to it, CenterPoint Houston intends to seek further review

by the Texas Supreme Court. Although we and CenterPoint Houston believe that CenterPoint Houston's true-up request is consistent with applicable statutes and regulations and accordingly that it is reasonably possible that it will be successful in its further appeals, we can provide no assurance as to the ultimate rulings by the courts on the issues to be considered in the various appeals or with respect to the ultimate decision by the Texas Utility Commission on the tax normalization issue described below.

To reflect the impact of the True-Up Order, in 2004 and 2005 we recorded a net after-tax extraordinary loss of \$947 million. No amounts related to the district court's judgment or the decision of the court of appeals have been recorded in our consolidated financial statements. However, if the court of appeals decision is not reversed or modified as a result of the pending motions for rehearing or on further review by the Texas Supreme Court, we anticipate that we would be required to record an additional loss to reflect the court of appeals decision. The amount

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of that loss would depend on several factors, including ultimate resolution of the tax normalization issue described below and the calculation of interest on any amounts CenterPoint Houston ultimately is authorized to recover or is required to refund beyond the amounts recorded based on the True-up Order, but could range from \$130 million to \$350 million, plus interest subsequent to December 31, 2007.

In the True-Up Order the Texas Utility Commission reduced CenterPoint Houston's stranded cost recovery by approximately \$146 million, which was included in the extraordinary loss discussed above, for the present value of certain deferred tax benefits associated with its former electric generation assets. We believe that the Texas Utility Commission based its order on proposed regulations issued by the Internal Revenue Service (IRS) in March 2003 which would have allowed utilities owning assets that were deregulated before March 4, 2003 to make a retroactive election to pass the benefits of Accumulated Deferred Investment Tax Credits (ADITC) and Excess Deferred Federal Income Taxes (EDFIT) back to customers. However, in December 2005, the IRS withdrew those proposed normalization regulations and issued new proposed regulations that do not include the provision allowing a retroactive election to pass the tax benefits back to customers. We subsequently requested a Private Letter Ruling (PLR) asking the IRS whether the Texas Utility Commission's order reducing CenterPoint Houston's stranded cost recovery by \$146 million for ADITC and EDFIT would cause normalization violations. In that ruling, which was received in August 2007, the IRS concluded that such reductions would cause normalization violations with respect to the ADITC and EDFIT. As in a similar PLR issued in May 2006 to another Texas utility, the IRS did not reference its proposed regulations.

The district court affirmed the Texas Utility Commission's ruling on the tax normalization issue, but in response to a request from the Texas Utility Commission, the court of appeals ordered that the tax normalization issue be remanded for further consideration. If the Texas Utility Commission's order relating to the ADITC reduction is not reversed or otherwise modified on remand so as to eliminate the normalization violation, the IRS could require us to pay an amount equal to CenterPoint Houston's unamortized ADITC balance as of the date that the normalization violation is deemed to have occurred. In addition, the IRS could deny CenterPoint Houston the ability to elect accelerated tax depreciation benefits beginning in the taxable year that the normalization violation is deemed to have occurred. Such treatment if required by the IRS, could have a material adverse impact on our results of operations, financial condition and cash flows in addition to any potential loss resulting from final resolution of the True-Up Order. However, we and CenterPoint Houston will continue to pursue a favorable resolution of this issue through the appellate or administrative process. Although the Texas Utility Commission has not previously required a company subject to its jurisdiction to take action that would result in a normalization violation, no prediction can be made as to the ultimate action the Texas Utility Commission may take on this issue on remand.

The Texas electric restructuring law allowed the amounts awarded to CenterPoint Houston in the Texas Utility Commission's True-Up Order to be recovered either through the issuance of transition bonds or through implementation of a competition transition charge (CTC) or both. Pursuant to a financing order issued by the Texas Utility Commission in March 2005 and affirmed by a Travis County district court, in December 2005 a subsidiary of CenterPoint Houston issued \$1.85 billion in transition bonds with interest rates ranging from 4.84% to 5.30% and final maturity dates ranging from February 2011 to August 2020. Through issuance of the transition bonds, CenterPoint Houston recovered approximately \$1.7 billion of the true-up balance determined in the True-Up Order plus interest through the date on which the bonds were issued.

In July 2005, CenterPoint Houston received an order from the Texas Utility Commission allowing it to implement a CTC designed to collect the remaining \$596 million from the True-Up Order over 14 years plus interest at an annual rate of 11.075% (CTC Order). The CTC Order authorized CenterPoint Houston to impose a charge on REPs to recover the portion of the true-up balance not recovered through a financing order. The CTC Order also allowed CenterPoint Houston to collect approximately \$24 million of rate case expenses over three years without a return through a separate tariff rider (Rider RCE). CenterPoint Houston implemented the CTC and Rider RCE effective

September 13, 2005 and began recovering approximately \$620 million. Effective September 13, 2005, the return on the CTC portion of the true-up balance is included in CenterPoint Houston's tariff-based revenues.

Certain parties appealed the CTC Order to a district court in Travis County. In May 2006, the district court issued a judgment reversing the CTC Order in three respects. First, the court ruled that the Texas Utility

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Commission had improperly relied on provisions of its rule dealing with the interest rate applicable to CTC amounts. The district court reached that conclusion based on its belief that the Texas Supreme Court had previously invalidated that entire section of the rule. The 11.075% interest rate in question was applicable from the implementation of the CTC Order on September 13, 2005 until August 1, 2006, the effective date of the implementation of a new CTC in compliance with the new rule discussed below. Second, the district court reversed the Texas Utility Commission's ruling that allows CenterPoint Houston to recover through the Rider RCE the costs (approximately \$5 million) for a panel appointed by the Texas Utility Commission in connection with the valuation of electric generation assets. Finally, the district court accepted the contention of one party that the CTC should not be allocated to retail customers that have switched to new on-site generation. The Texas Utility Commission and CenterPoint Houston disagree with the district court's conclusions and, in May 2006, appealed the judgment to the Texas Third Court of Appeals, and if required, CenterPoint Houston plans to seek further review from the Texas Supreme Court. All briefs in the appeal have been filed, and oral arguments were held in December 2006. The ultimate outcome of this matter cannot be predicted at this time. However, we do not expect the disposition of this matter to have a material adverse effect on our or CenterPoint Houston's financial condition, results of operations or cash flows.

In June 2006, the Texas Utility Commission adopted the revised rule governing the carrying charges on unrecovered CTC balances as recommended by its staff (Staff). The rule, which applies to CenterPoint Houston, reduced the allowed interest rate on the unrecovered CTC balance prospectively from 11.075% to a weighted average cost of capital of 8.06%. The annualized impact on operating income is a reduction of approximately \$18 million per year for the first year with lesser impacts in subsequent years. In July 2006, CenterPoint Houston made a compliance filing necessary to implement the rule changes effective August 1, 2006.

During the years ended December 31, 2005, 2006 and 2007, CenterPoint Houston recognized approximately \$19 million, \$55 million and \$42 million, respectively, in operating income from the CTC. Additionally, during the years ended December 31, 2005, 2006 and 2007, CenterPoint Houston recognized approximately \$1 million, \$13 million and \$14 million, respectively, of the allowed equity return not previously recorded. As of December 31, 2007, we have not recorded an allowed equity return of \$220 million on CenterPoint Houston's true-up balance because such return will be recognized as it is recovered in rates.

During the 2007 legislative session, the Texas legislature amended statutes prescribing the types of true-up balances that can be securitized by utilities and authorized the issuance of transition bonds to recover the balance of the CTC. In June 2007, CenterPoint Houston filed a request with the Texas Utility Commission for a financing order that would allow the securitization of the remaining balance of the CTC, after taking into account the environmental refund and the fuel reconciliation settlement amounts discussed below. CenterPoint Houston reached substantial agreement with other parties to this proceeding, and a financing order was approved by the Texas Utility Commission in September 2007. In February 2008, a new special purpose subsidiary of CenterPoint Houston issued approximately \$488 million of transition bonds pursuant to the financing order in two tranches with interest rates of 4.192% and 5.234% and final maturity dates of February 2020 and February 2023, respectively. Contemporaneously with the issuance of those bonds, the CTC was terminated and a transition charge was implemented.

### *Refund of Environmental Retrofit Costs*

The True-Up Order allowed recovery of approximately \$699 million of environmental retrofit costs related to CenterPoint Houston's generation assets. The True-Up Order required CenterPoint Houston to provide evidence by January 31, 2007 that the entire \$699 million was actually spent by December 31, 2006 on environmental programs and provided for the Texas Utility Commission to determine the appropriate manner to return to customers any unused portion of these funds, including interest on the funds and on stranded costs attributable to the environmental costs portion of the stranded costs recovery. In January 2007, the successor in interest to CenterPoint Houston's generation assets advised that, as of December 31, 2006, it had spent only approximately \$664 million. On January 31, 2007,

CenterPoint Houston made the required filing with the Texas Utility Commission, identifying approximately \$35 million in unspent funds to be refunded to customers along with approximately \$7 million of interest and requesting permission to refund these amounts through a reduction of the CTC. Such amounts were recorded as regulatory liabilities as of December 31, 2006. In July 2007, CenterPoint Houston, the Staff and the

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other parties filed a settlement agreement in which it was agreed that the total amount of the refund, including all principal and interest, was \$45 million as of May 31, 2007, that interest would continue to accrue after May 31, 2007 on any unrefunded balance at a rate of 5.4519% per year and that the refund should be used to offset the principal amount proposed in CenterPoint Houston's application to securitize the CTC and other amounts. The offset occurred in connection with the approximately \$488 million of transition bonds issued in February 2008. In August 2007, the Texas Utility Commission issued a final order consistent with the terms of that settlement agreement. As of December 31, 2007, CenterPoint Houston had recorded a regulatory liability of \$46 million related to this matter.

### *Final Fuel Reconciliation*

The results of the Texas Utility Commission's final decision related to CenterPoint Houston's final fuel reconciliation were a component of the True-Up Order. CenterPoint Houston appealed certain portions of the True-Up Order involving a disallowance of approximately \$67 million relating to the final fuel reconciliation in 2003 plus interest of \$10 million. That decision was upheld by a Travis County district court and affirmed by the Texas Third Court of Appeals. Although it filed an appeal with the Texas Supreme Court, in February 2007 CenterPoint Houston asked the Texas Supreme Court to hold that appeal in abeyance pending consideration by the Texas Utility Commission of a tentative settlement reached by the parties. In October 2007, the Texas Utility Commission issued a final order consistent with the settlement, and the Texas Supreme Court ultimately vacated the lower court decisions. The settlement allows CenterPoint Houston recovery of \$12.5 million plus interest from January 2002. As a result of the settlement, CenterPoint Houston recorded a regulatory asset of \$17 million in 2007.

### *Customers*

CenterPoint Houston serves nearly all of the Houston/Galveston metropolitan area. CenterPoint Houston's customers consist of 74 REPs, which sell electricity to approximately 2 million metered customers in CenterPoint Houston's certificated service area, and municipalities, electric cooperatives and other distribution companies located outside CenterPoint Houston's certificated service area. Each REP is licensed by, and must meet minimal creditworthiness criteria established by the Texas Utility Commission. Two of the REPs in CenterPoint Houston's service area are subsidiaries of RRI. Sales to subsidiaries of RRI represented approximately 62%, 56% and 51% of CenterPoint Houston's transmission and distribution revenues in 2005, 2006 and 2007, respectively. CenterPoint Houston's billed receivables balance from REPs as of December 31, 2007 was \$141 million. Approximately 48% of this amount was owed by subsidiaries of RRI. CenterPoint Houston does not have long-term contracts with any of its customers. It operates on a continuous billing cycle, with meter readings being conducted and invoices being distributed to REPs each business day.

### *Advanced Metering System and Distribution Automation (Intelligent Grid)*

CenterPoint Houston is pursuing development and possible deployment of an advanced metering system (AMS) and electric distribution grid automation strategy that involves the implementation of an Intelligent Grid which would make use of CenterPoint Houston's lines and other facilities to provide on-demand data and information about electricity usage and the status of facilities on our system. Although this technology is still in the developmental stage, CenterPoint Houston believes it has the potential to enable customers of the REPs to better monitor and control their usage of electricity as well as offer a significant improvement in metering, grid planning, operations and maintenance of the CenterPoint Houston distribution system. These improvements would be expected to contribute to fewer and shorter outages, better customer service, improved operations costs, improved security and more effective use of our workforce. In May 2007, the Texas Utility Commission issued rules establishing minimum functionality requirements for an AMS and a surcharge mechanism to enable timely recovery of the costs of implementation. To date, CenterPoint Houston has deployed approximately 10,000 advanced meters and utilized broadband over power line technology as part of a limited deployment to help in proving the technology and in validating its potential benefits



prior to a full-scale implementation. CenterPoint Houston would be required to file its deployment plan for approval by the Texas Utility Commission prior to full scale implementation of this technology.

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### *Competition*

There are no other electric transmission and distribution utilities in CenterPoint Houston's service area. In order for another provider of transmission and distribution services to provide such services in CenterPoint Houston's territory, it would be required to obtain a certificate of convenience and necessity from the Texas Utility Commission and, depending on the location of the facilities, may also be required to obtain franchises from one or more municipalities. We know of no other party intending to enter this business in CenterPoint Houston's service area at this time.

### *Seasonality*

A significant portion of CenterPoint Houston's revenues is derived from rates that it collects from each REP based on the amount of electricity it distributes on behalf of such REP. Thus, CenterPoint Houston's revenues and results of operations are subject to seasonality, weather conditions and other changes in electricity usage, with revenues being higher during the warmer months.

### *Properties*

All of CenterPoint Houston's properties are located in Texas. Its properties consist primarily of high voltage electric transmission lines and poles, distribution lines, substations, service wires and meters. Most of CenterPoint Houston's transmission and distribution lines have been constructed over lands of others pursuant to easements or along public highways and streets as permitted by law.

All real and tangible properties of CenterPoint Houston, subject to certain exclusions, are currently subject to:

the lien of a Mortgage and Deed of Trust (the Mortgage) dated November 1, 1944, as supplemented; and

the lien of a General Mortgage (the General Mortgage) dated October 10, 2002, as supplemented, which is junior to the lien of the Mortgage.

As of December 31, 2007, CenterPoint Houston had outstanding \$2.0 billion aggregate principal amount of general mortgage bonds under the General Mortgage, including approximately \$527 million held in trust to secure pollution control bonds for which CenterPoint Energy is obligated and approximately \$229 million held in trust to secure pollution control bonds for which CenterPoint Houston is obligated. Additionally, CenterPoint Houston had outstanding approximately \$253 million aggregate principal amount of first mortgage bonds under the Mortgage, including approximately \$151 million held in trust to secure certain pollution control bonds for which CenterPoint Energy is obligated. CenterPoint Houston may issue additional general mortgage bonds on the basis of retired bonds, 70% of property additions or cash deposited with the trustee. Approximately \$2.3 billion of additional first mortgage bonds and general mortgage bonds in the aggregate could be issued on the basis of retired bonds and 70% of property additions as of December 31, 2007. However, CenterPoint Houston has contractually agreed that it will not issue additional first mortgage bonds, subject to certain exceptions.

*Electric Lines - Overhead.* As of December 31, 2007, CenterPoint Houston owned 27,421 pole miles of overhead distribution lines and 3,738 circuit miles of overhead transmission lines, including 424 circuit miles operated at 69,000 volts, 2,098 circuit miles operated at 138,000 volts and 1,216 circuit miles operated at 345,000 volts.

*Electric Lines - Underground.* As of December 31, 2007, CenterPoint Houston owned 18,955 circuit miles of underground distribution lines and 28.4 circuit miles of underground transmission lines, including 4.5 circuit miles operated at 69,000 volts and 23.9 circuit miles operated at 138,000 volts.

*Substations.* As of December 31, 2007, CenterPoint Houston owned 229 major substation sites having total installed rated transformer capacity of 50,586 megavolt amperes.

*Service Centers.* CenterPoint Houston operates 14 regional service centers located on a total of 291 acres of land. These service centers consist of office buildings, warehouses and repair facilities that are used in the business of transmitting and distributing electricity.

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### *Franchises*

CenterPoint Houston holds non-exclusive franchises from the incorporated municipalities in its service territory. In exchange for the payment of fees, these franchises give CenterPoint Houston the right to use the streets and public rights-of way of these municipalities to construct, operate and maintain its transmission and distribution system and to use that system to conduct its electric delivery business and for other purposes that the franchises permit. The terms of the franchises, with various expiration dates, typically range from 30 to 50 years.

### *Natural Gas Distribution*

CERC Corp.'s natural gas distribution business (Gas Operations) engages in regulated intrastate natural gas sales to, and natural gas transportation for, approximately 3.2 million residential, commercial and industrial customers in Arkansas, Louisiana, Minnesota, Mississippi, Oklahoma and Texas. The largest metropolitan areas served in each state by Gas Operations are Houston, Texas; Minneapolis, Minnesota; Little Rock, Arkansas; Shreveport, Louisiana; Biloxi, Mississippi; and Lawton, Oklahoma. In 2007, approximately 43% of Gas Operations' total throughput was attributable to residential customers and approximately 57% was attributable to commercial and industrial customers.

Gas Operations also provides unregulated services consisting of heating, ventilating and air conditioning (HVAC) equipment and appliance repair, and sales of HVAC, hearth and water heating equipment in Minnesota.

The demand for intrastate natural gas sales to, and natural gas transportation for, residential, commercial and industrial customers is seasonal. In 2007, approximately 71% of the total throughput of Gas Operations' business occurred in the first and fourth quarters. These patterns reflect the higher demand for natural gas for heating purposes during those periods.

*Supply and Transportation.* In 2007, Gas Operations purchased virtually all of its natural gas supply pursuant to contracts with remaining terms varying from a few months to four years. Major suppliers in 2007 included BP Canada Energy Marketing Corp. (21.0% of supply volumes), Oneok Energy Marketing (14.7%), Energy Transfer (10.3%), Coral Energy Resources (9.8%) and Tenaska Marketing Ventures (7.8%). Numerous other suppliers provided the remaining 36.4% of Gas Operations' natural gas supply requirements. Gas Operations transports its natural gas supplies through various intrastate and interstate pipelines, including those owned by our other subsidiaries, under contracts with remaining terms, including extensions, varying from one to fifteen years. Gas Operations anticipates that these gas supply and transportation contracts will be renewed or replaced prior to their expiration.

We actively engage in commodity price stabilization pursuant to annual gas supply plans presented to and/or filed with each of our state regulatory authorities. These price stabilization activities include use of storage gas, contractually establishing fixed prices with our physical gas suppliers and utilizing financial derivative instruments to achieve a variety of pricing structures (e.g., fixed price, costless collars, and caps). Our gas supply plans generally call for 25-50% of winter supplies to be hedged in some fashion.

Generally, the regulations of the states in which Gas Operations operates allow it to pass through changes in the cost of natural gas, including gains and losses on financial derivatives associated with the index-priced physical supply, to its customers under purchased gas adjustment provisions in its tariffs. Depending upon the jurisdiction, the purchased gas adjustment factors are updated periodically, ranging from monthly to semi-annually, using estimated gas costs. The changes in the cost of gas billed to customers are subject to review by the applicable regulatory bodies.

Gas Operations uses various third-party storage services or owned natural gas storage facilities to meet peak-day requirements and to manage the daily changes in demand due to changes in weather and may also supplement contracted supplies and storage from time to time with stored liquefied natural gas and propane-air plant production.

Gas Operations owns and operates an underground natural gas storage facility with a capacity of 7.0 billion cubic feet (Bcf). It has a working capacity of 2.0 Bcf available for use during a normal heating season and a maximum daily withdrawal rate of 50 million cubic feet (MMcf). It also owns nine propane-air plants with a total

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production rate of 200 MMcf per day and on-site storage facilities for 12 million gallons of propane (1.0 Bcf natural gas equivalent). It owns liquefied natural gas plant facilities with a 12 million-gallon liquefied natural gas storage tank (1.0 Bcf natural gas equivalent) and a production rate of 72 MMcf per day.

On an ongoing basis, Gas Operations enters into contracts to provide sufficient supplies and pipeline capacity to meet its customer requirements. However, it is possible for limited service disruptions to occur from time to time due to weather conditions, transportation constraints and other events. As a result of these factors, supplies of natural gas may become unavailable from time to time, or prices may increase rapidly in response to temporary supply constraints or other factors.

### *Assets*

As of December 31, 2007, Gas Operations owned approximately 69,000 linear miles of natural gas distribution mains, varying in size from one-half inch to 24 inches in diameter. Generally, in each of the cities, towns and rural areas served by Gas Operations, it owns the underground gas mains and service lines, metering and regulating equipment located on customers' premises and the district regulating equipment necessary for pressure maintenance. With a few exceptions, the measuring stations at which Gas Operations receives gas are owned, operated and maintained by others, and its distribution facilities begin at the outlet of the measuring equipment. These facilities, including odorizing equipment, are usually located on the land owned by suppliers.

### *Competition*

Gas Operations competes primarily with alternate energy sources such as electricity and other fuel sources. In some areas, intrastate pipelines, other gas distributors and marketers also compete directly for gas sales to end-users. In addition, as a result of federal regulations affecting interstate pipelines, natural gas marketers operating on these pipelines may be able to bypass Gas Operations' facilities and market and sell and/or transport natural gas directly to commercial and industrial customers.

### *Competitive Natural Gas Sales and Services*

CERC offers variable and fixed-priced physical natural gas supplies primarily to commercial and industrial customers and electric and gas utilities through CenterPoint Energy Services, Inc. (CES) and its subsidiary, CenterPoint Energy Intrastate Pipeline LLC (CEIP).

In 2007, CES marketed approximately 522 Bcf of natural gas, transportation and related energy services to approximately 7,000 customers (including approximately 9 Bcf to affiliates). CES customers vary in size from small commercial customers to large utility companies in the central and eastern regions of the United States, and are served from offices located in Illinois, Indiana, Louisiana, Minnesota, Missouri, Pennsylvania, Texas and Wisconsin. The business has three operational functions: wholesale, retail and intrastate pipelines, which are further described below.

*Wholesale Operations.* CES offers a portfolio of physical delivery services and financial products designed to meet wholesale customers' supply and price risk management needs. These customers are served directly through interconnects with various inter- and intra-state pipeline companies, and include gas utilities, large industrial customers and electric generation customers.

*Retail Operations.* CES offers a variety of natural gas management services to smaller commercial and industrial customers, municipalities, educational institutions and hospitals, whose facilities are located downstream of natural gas distribution utility city gate stations. These services include load forecasting, supply acquisition, daily swing volume management, invoice consolidation, storage asset management, firm and interruptible transportation

administration and forward price management. CES manages transportation contracts and energy supply for retail customers in sixteen states.

*Intrastate Pipeline Operations.* CEIP primarily provides transportation services to shippers and end-users and contracts out approximately 2 Bcf of storage at its Pierce Junction facility in Texas.

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CES currently transports natural gas on over 34 interstate and intrastate pipelines within states located throughout the central and eastern United States. CES maintains a portfolio of natural gas supply contracts and firm transportation and storage agreements to meet the natural gas requirements of its customers. CES aggregates supply from various producing regions and offers contracts to buy natural gas with terms ranging from one month to over five years. In addition, CES actively participates in the spot natural gas markets in an effort to balance daily and monthly purchases and sales obligations. Natural gas supply and transportation capabilities are leveraged through contracts for ancillary services including physical storage and other balancing arrangements.

As described above, CES offers its customers a variety of load following services. In providing these services, CES uses its customers' purchase commitments to forecast and arrange its own supply purchases, storage and transportation services to serve customers' natural gas requirements. As a result of the variance between this forecast activity and the actual monthly activity, CES will either have too much supply or too little supply relative to its customers' purchase commitments. These supply imbalances arise each month as customers' natural gas requirements are scheduled and corresponding natural gas supplies are nominated by CES for delivery to those customers. CES' processes and risk control environment are designed to measure and value imbalances on a real-time basis to ensure that CES' exposure to commodity price risk is kept to a minimum. The value assigned to these imbalances is calculated daily and is known as the aggregate Value at Risk (VaR). In 2007, CES' VaR averaged \$1.2 million with a high of \$2.6 million.

The CenterPoint Energy risk control policy, governed by our Risk Oversight Committee, defines authorized and prohibited trading instruments and trading limits. CES is a physical marketer of natural gas and uses a variety of tools, including pipeline and storage capacity, financial instruments and physical commodity purchase contracts to support its sales. The CES business optimizes its use of these various tools to minimize its supply costs and does not engage in proprietary or speculative commodity trading. The VaR limits within which CES operates are consistent with its operational objective of matching its aggregate sales obligations (including the swing associated with load following services) with its supply portfolio in a manner that minimizes its total cost of supply.

### *Assets*

CEIP owns and operates approximately 217 miles of intrastate pipeline in Louisiana and Texas and holds storage facilities of approximately 2 Bcf in Texas under long-term leases. In addition, CES leases transportation capacity of approximately 725 MMcf per day on various inter- and intrastate pipelines and approximately 8.5 Bcf of storage to service its customer base.

### *Competition*

CES competes with regional and national wholesale and retail gas marketers including the marketing divisions of natural gas producers and utilities. In addition, CES competes with intrastate pipelines for customers and services in its market areas.

### *Interstate Pipelines*

CERC's pipeline business operates interstate natural gas pipelines with gas transmission lines primarily located in Arkansas, Illinois, Louisiana, Missouri, Oklahoma and Texas. CERC's interstate pipeline operations are primarily conducted by two wholly owned subsidiaries that provide gas transportation and storage services primarily to industrial customers and local distribution companies:

CenterPoint Energy Gas Transmission Company (CEGT) is an interstate pipeline that provides natural gas transportation, natural gas storage and pipeline services to customers principally in Arkansas, Louisiana, Oklahoma and Texas; and



CenterPoint Energy-Mississippi River Transmission Corporation (MRT) is an interstate pipeline that provides natural gas transportation, natural gas storage and pipeline services to customers principally in Arkansas and Missouri.

The rates charged by CEGT and MRT for interstate transportation and storage services are regulated by the FERC. Our interstate pipelines business operations may be affected by changes in the demand for natural gas, the

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available supply and relative price of natural gas in the Mid-continent and Gulf Coast natural gas supply regions and general economic conditions.

In 2007, approximately 20% of CEGT and MRT's total operating revenue was attributable to services provided to Gas Operations and approximately 10% was attributable to services provided to Laclede Gas Company (Laclede), an unaffiliated distribution company that provides natural gas utility service to the greater St. Louis metropolitan area in Illinois and Missouri. Services to Gas Operations and Laclede are provided under several long-term firm storage and transportation agreements. Since October 31, 2006, MRT's contract with Laclede has been terminable upon one year's prior notice. MRT has not received a termination notice and is currently negotiating a long-term contract with Laclede. Agreements for firm transportation, no notice transportation service and storage service in certain of Gas Operations' service areas (Arkansas, Louisiana and Oklahoma) expire in 2012.

*Carthage to Perryville.* In April 2007, CEGT, a wholly owned subsidiary of CERC Corp., completed phase one construction of a 172-mile, 42-inch diameter pipeline and related compression facilities for the transportation of gas from Carthage, Texas to CEGT's Perryville hub in northeast Louisiana. On May 1, 2007, CEGT began service under its firm transportation agreements with shippers of approximately 960 MMcf per day. CEGT's second phase of the project, which involved adding compression that increased the total capacity of the pipeline to approximately 1.25 Bcf per day, was placed into service in August 2007. CEGT has signed firm contracts for the full capacity of phases one and two.

In May 2007, CEGT received FERC approval for the third phase of the project to expand capacity of the pipeline to 1.5 Bcf per day by adding additional compression and operating at higher pressures, and in July 2007, CEGT received approval from the Pipeline and Hazardous Materials Administration (PHMSA) to increase the maximum allowable operating pressure. The PHMSA's approval contained certain conditions and requirements, which CEGT expects to satisfy in the first quarter of 2008. CEGT has executed contracts for approximately 150 MMcf per day of the 250 MMcf per day phase three expansion. The third phase is projected to be in-service in the second quarter of 2008.

In September 2007, CEGT initiated an investigation into allegations received from two former employees of the manufacturer of pipe installed in CEGT's Carthage to Perryville pipeline segment. That pipeline segment was placed in commercial service in May 2007 after satisfactory completion of hydrostatic testing designed to ensure that the pipe and its welds would be structurally sound when placed in service and operated at design pressure. According to the complainants, records relating to radiographic inspections of certain welds made at the fabrication facility had been altered resulting in the possibility that pipe with alleged substandard welds had been installed in the pipeline. In conducting its investigation, among other things, CEGT and its counsel interviewed the complainants and other individuals, including CEGT and contractor personnel, and reviewed documentation related to the manufacture and construction of the pipeline, including radiographic records related to the allegedly deficient welds. CEGT kept appropriate governmental officials informed throughout its investigation and consulted appropriate technical consultants and pre-existing regulatory guidance. CEGT excavated and inspected certain welds at the request of the PHMSA, and in each case, CEGT found those welds to be structurally sound. Although its investigation has not been formally concluded, CEGT has worked closely with the appropriate regulatory authorities to determine and take all necessary actions. To date, CEGT has found no reason to modify the operation of its Carthage to Perryville line or take other significant action, and no such action has been directed or requested by any governmental authority. Absent new evidence, CEGT believes that no significant action by CEGT will be necessary and that the Carthage to Perryville line can be operated at expected operating pressures without threat to the public health or safety and does not plan to take any significant additional action.

*Southeast Supply Header.* In June 2006, CenterPoint Energy Southeast Pipelines Holding, L.L.C., a wholly owned subsidiary of CERC Corp., and a subsidiary of Spectra Energy Corp. (Spectra) formed a joint venture (Southeast Supply Header or SESH) to construct, own and operate a 270-mile pipeline with a capacity of approximately 1 Bcf

per day that will extend from CEGT's Perryville hub in northeast Louisiana to an interconnection in southern Alabama with Gulfstream Natural Gas System, which is 50% owned by an affiliate of Spectra. We account for our 50% interest in SESH as an equity investment. In 2006, SESH signed agreements with shippers for firm transportation services, which subscribed capacity of 945 MMcf per day. Additionally, SESH and Southern Natural Gas (SNG) have executed a definitive agreement that provides for SNG to jointly own the first 115 miles of

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the pipeline. Under the agreement, SNG will own an undivided interest in the portion of the pipeline from Perryville, Louisiana to an interconnect with SNG in Mississippi. The pipe diameter was increased from 36 inches to 42 inches, thereby increasing the initial capacity of 1 Bcf per day by 140 MMcf per day to accommodate SNG. SESH will own assets providing approximately 1 Bcf per day of capacity as initially planned and will maintain economic expansion opportunities in the future. SNG will own assets providing 140 MMcf per day of capacity, and the agreement provides for a future compression expansion that will increase the jointly owned capacity up to 500 MMcf per day, subject to FERC approval.

An application to construct, own and operate the pipeline was filed with the FERC in December 2006. In September 2007, the FERC issued the certificate authorizing the construction of the pipeline. This FERC approval does not include the expansion capacity that would take SNG to 500 MMcf per day. SESH began construction in November 2007. SESH expects to complete construction of the pipeline as approved by the FERC in the second half of 2008. SESH's net costs after SNG's contribution are estimated to have increased to approximately \$1 billion.

*Assets*

Our interstate pipelines business currently owns and operates approximately 8,100 miles of natural gas transmission lines primarily located in Arkansas, Illinois, Louisiana, Missouri, Oklahoma and Texas. It also owns and operates six natural gas storage fields with a combined daily deliverability of approximately 1.2 Bcf per day and a combined working gas capacity of approximately 59.0 Bcf. It also owns a 10% interest in the Bistineau storage facility located in Bienville Parish, Louisiana, with the remaining interest owned and operated by Gulf South Pipeline Company, LP. This facility has a total working gas capacity of 85.7 Bcf and approximately 1.1 Bcf per day of deliverability. Storage capacity in the Bistineau facility is 8 Bcf of working gas with 100 MMcf per day of deliverability. Most storage operations are in north Louisiana and Oklahoma.