DIRECT TESTIMONY OF

H. R. DEAN

for

HOUSTON LIGHTING & POWER COMPANY

July 1981

TESTIMONY OF HOLLIS R. DEAN

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS, AND POSITION WITH HOUSTON LIGHTING & POWER COMPANY.

A. My name is Hollis R. Dean and my address is 611 Walker Avenue, Houston, Texas. I am an Executive Vice President and the chief financial officer of the Company, and have ultimate responsibility for the Accounting, Computer Services, Corporate Development, Internal and Operations Auditing, Rate and Corporate Planning, and Treasury Departments. I am also a director of the Company.

Q. PLEASE BRIEFLY DESCRIBE YOUR EDUCATIONAL BACKGROUND AND BUSINESS EXPERIENCE.

A. I received a Bachelor of Science Degree in Accounting from Bowling Green College of Commerce, Bowling Green, Kentucky, in 1946 and joined the Accounting Department of Houston Lighting & Power Company that same year. I became Comptroller in 1966, Vice President in 1970, Group Vice President in 1973 and Executive Vice President in April, 1981. In April, 1977, I was elected a director of the Company. I am a Certified Public Accountant and a member of the American Institute of Certified Public Accountants, the Texas Society of Certified Public Accountants, the Financial Executives Institute and the Finance Committee of the Edison Electric Institute.

Q. MR. DEAN, PLEASE SUMMARIZE YOUR TESTIMONY IN THIS PROCEEDING.

A. My testimony outlines the need for rate relief at this time to support the financing of HL&P's construction program. I will also discuss the financial aspects of the reassessment of that construction program and the Company's financial objectives.

Q. WHAT IS THE BASIS FOR YOUR EVALUATION OF HL&P's FINANCIAL REQUIREMENTS?

A. I have long been involved in the planning and implementation of HL&P's outside financing, a function that in recent years has been under my control and supervision. Over the years my responsibility for raising funds has led to an understanding of the requirements for financial integrity necessary to raise adequate capital at reasonable cost. Frequent meetings with financial analysts, investment bankers and rating agencies, together with regular review of reports and materials relied on by authorities in the area of corporate financing, enables me to recommend and implement objectives which will contribute to HL&P's financial integrity.

DESCRIPTION OF THE REQUEST

Q. WHY DOES HL&P NEED RATE RELIEF OF $248 MILLION OVER ADJUSTED TEST YEAR REVENUES?

A. This increase is necessary to recover the cost of serving present customers which includes a return on invested capital of 12.32%. The increase will provide HL&P with an opportunity to attain the financial results required to support the construction program necessary to meet the growing demand for electricity.

Q. WHY IS THIS INCREASE NECESSARY AFTER THE RATE INCREASE MADE EFFECTIVE IN OCTOBER, 1980?

A. The rates authorized in Docket 3320 have not and will not enable HL&P to meet the requirements of the financial community. The current construction program will require frequent trips to the capital markets to offer new issues of debt and equity. In order to finance the program, the Company's financial integrity must be improved by increasing interest coverages, the amount of internally generated funds, and the return to the Company's shareholders.

FINANCIAL ENVIRONMENT

Q. MR. DEAN, PLEASE DESCRIBE THE CURRENT FINANCIAL ENVIRONMENT AND ITS EFFECTS ON HL&P.

A. Our nation's high rate of inflation and general economic condition have seriously affected the financial markets. Interest rates are presently at levels that would have seemed impossible just a few years ago. The prime rate, for example, stands as of this writing at 20.0%, which is below the 21.5% reached in December 1980 but is still exceedingly high by historical standards. Interest rates on long-term debt are also high. In February, HL&P for the first time sold first mortgage bonds with a 10-year maturity and raised $125 million at a cost to the Company of over 14%--its most expensive issue to date. This compares to HL&P's embedded cost of debt of 8.71% for 30-year bonds.

High interest rates are indicative of the difficulty in obtaining funds in the current financial environment. The First Mortgage Bonds just described were originally intended to be sold in December 1980 and were to mature in 30 years. Because of the rate differential between 30-year and 10-year bonds in December, the maturity of the issue was shortened to 10 years. The cost of 10-year bonds, however, was still unacceptably high, and the sale was postponed until market conditions improved in February. A proposed new issue of preferred stock that was also to be sold in December was cancelled because there was no market for a split-rated, perpetual preferred stock.

Q. HOW HAS THE MARKET FOR COMMON STOCK BEEN AFFECTED?

A. The prevailing high interest rates have had a depressing effect on the prices of interest-rate sensitive utility common stocks such as those of Houston Industries Incorporated (HII), parent of HL&P, and utility companies in general. With expectations of low dividend growth in utility common stocks, investors are looking primarily at current cash dividend yields, but yields of 11-12% on utility stocks cannot compete with yields of 13-14% that are available on risk-free government securities. Consequently, the cost of common equity, like debt and preferred stock, has risen. In March 1981, Houston Industries sold 3,000,000 shares of common stock for net proceeds of $24.39 per share, which is the lowest price for a Houston Industries common stock sale since February 1976. The market-to-book ratio of the sale was 70%, our lowest ever. This latest issue was the sixth consecutive common stock sale below book value. In addition, the price received at each of these six stock sales has been less than that received at the previous sale.

It is clear that the financial integrity of the Company has not been maintained as evidenced by the continued sale of substantial amounts of common stock below book value. This alarming trend must be reversed if we are to be successful in raising the capital required to support the required large construction program.

Q. WHAT ARE THE IMPLICATIONS OF SELLING HOUSTON INDUSTRIES' COMMON STOCK BELOW BOOK VALUE?

A. The sale of common stock below book value dilutes the ownership interests of existing shareholders. To illustrate, the March sale of 3,000,000 common shares at a price to the public of $25.25 per share occurred at a time when the book value per share was $34.97. Immediately following the sale, though, book value per share dropped $0.70 to $34.27, simply because the new investors paid less than book value for their shares.

Continued dilution has caused many institutional investors to avoid purchases of newly-issued HII common stock. In the March sale, an estimated 30% of the shares offered were bought by institutions. This compares with 70% institutional purchases in one of our last sales above book value in February 1973. The loss of the institutional market has required HII to place greater emphasis on retail customers for purchases of its stock, which has led to the addition of a third manager to the distribution group. One drawback of the retail market is that flotation costs are higher. An even greater concern is that if individual investors begin to avoid purchases of new stock issues like the more sophisticated institutional investors, the amount of common equity financing and ultimately all financing could be severely limited.

Q. WHAT IS THE EFFECT OF THE MOODY'S DOWNGRADING ON HL&P?

A. Effective November 21, 1980, Moody's Investors Service lowered the rating on HL&P's first mortgage bonds from "Aa" to "A" and on HL&P's preferred stock from "aa" to "a". The rating report, which appears in Schedule H-9, says "these actions reflect the increased vulnerability of Houston Lighting & Power Company in recognition of their large continuous construction program and the financing pressure placed on the company by that program."

Even though Standard & Poor's, Duff and Phelps, and Fitch Investors Service maintained their "AA" or equivalent ratings on HL&P's first mortgage bonds and preferred stock, the Moody's downgrading signaled the increased risk of owning HL&P securities. The downgrading also contributed to our difficulty in raising funds in late 1980 and early 1981, and will continue to do so until Moody's "Aa" rating is restored.

A higher cost of funds is inevitable with a Moody's "A" rating. The demand for funds is more intense since more electric utilities have "A" - rated securities than "AA", while the supply of funds is diminished since some institutional investors are limited to purchases of high-grade bonds ("AAA" and "AA") while many are limited to at least upper medium grade obligations ("A"). Every downgrading thus eliminates a portion of the market for our securities.

Any further deterioration in HL&P's credit standing would jeopardize the Company's ability to finance its construction program. There are, of course, no assurances that the Moody's "Aa" rating can be restored, but adequate rate relief and the reassessment of HL&P's construction program are major steps in that effort.

REASSESSMENT OF CONSTRUCTION PROGRAM

Q. WHY HAS HL&P REASSESSED ITS CONSTRUCTION PROGRAM?

A. The reassessment was largely a financial decision that complements HL&P's purchased power and load management programs, and was prompted by the inability to obtain the massive amount of external funds that the prior program required. This inability was based on a judgment by the Company, with input from its investment bankers, as to the maximum amount of new equity financing -- initially $200 million of common stock and $100 million of preferred stock--that can reasonably be obtained in a single year. The revised program recognizes these limits.

The financing plan will nevertheless entail considerable difficulty. These limits exceed (by $27 million in the case of common equity and $50 million in the case of preferred stock) the largest amounts ever raised in a single year by HL&P. Thus, the continued support of individual investors and the return of institutional investors are important for the success of the financing plan.

Without a foreseeable improvement in the market-to-book value ratio of our common stock, investors may refuse to purchase future stock issues. If this occurs, the $200 million of common stock per year would not be achievable, thereby eliminating the one source of funds which is the catalyst to raising alternate types of external funds (preferred stock and debt).

Despite the Company's efforts to make financing its construction program attainable, major uncertainties still exist. For example, the dollar limits mentioned above could easily change with financial market conditions. Also, the total effects from the Moody's downgrading are unknown. These and other uncertainties make adequate and timely rate relief all the more important if we are to continue to serve the customer in a reliable manner.

FINANCIAL OBJECTIVES

Q. WHAT ARE HL&P's FINANCIAL OBJECTIVES?

A. My evaluation of the financial objectives necessary for satisfactory financial performance, based on in-depth discussions with the financial community, are as follows:

1) Generate at least 40% of construction requirements from internal sources.
2) Sell common stock at or above book value.
3) Achieve a pre-tax interest coverage excluding AFUDC of not less than 3.5 times.
4) Attain a targeted capital structure of 45% common equity, debt less than 50% with preferred stock making up the difference.
5) Limit the percentage of AFUDC to income available to common to a level consistent with achieving the objectives listed above.

Maintenance of the quality of the Company's fixed income securities and improvement of common stock performance are contingent upon the actual realization of these parameters. The proposed level of revenues, which includes a 17% return on common equity with 7 % CWIP and NFIP in rate base, should afford HL&P the opportunity to satisfy the requirements of investors and maintain financial integrity.

Q. HOW DID YOU DETERMINE THE OBJECTIVE FOR INTERNAL FUNDS GENERATION?

A. HL&P's financial objective of at least 40% internally generated funds reflects a realistic appraisal of the constraints to external financing. As the high level of construction expenditures places pressure on the Company's cash position, investors recognize that additional external financing is necessary. Based on the size of our current construction program and the amount of external financing that we can reasonably expect to accomplish during a year, a minimum of 40% internally generated funds is required if we are to successfully complete our financing program.

Q. WHY IS A PRE-TAX INTEREST COVERAGE OF NOT LESS THAN 3.5 TIMES REQUIRED?

A. The financial risk associated with a company's debt securities is whether earnings are sufficient for timely payment of interest.

In order to quantify this risk, bond rating agencies utilize coverage ratios in assigning credit ratings. If a "AA" rating is to be maintained, an electric utility should consistently achieve interest coverages in the 3.5x to 4.0x range.

HL&P's rate application will provide earnings which will result in coverage ratios within this range and allow for financing flexibility by keeping pro forma coverages from dropping below acceptable levels when new bonds are sold.

Q. HOW DID YOU DETERMINE HL&P's TARGETED CAPITAL STRUCTURE?

A. The capital structure should change over time to reflect changing conditions, such as the costs and risks associated with various sources of capital. Required return on equity, interest coverages, and embedded and current costs of debt all influence the development of an appropriate capital structure. HL&P's current capital structure objective represents an increase in the equity portion of permanent capital. This is in response to the increased risk associated with electric utility operating environments in general, high interest rates, volatile financial markets, economic uncertainty, and HL&P's construction requirements.

Q. PLEASE SUMMARIZE HL&P'S CAPITAL STRUCTURE AT THE END OF THE TEST YEAR.

A. As shown in Schedule H, HL&P's capitalization at March 31, 1981 consisted of:

	Amount (000 Omitted)	Percent
Long Term Debt	$1,704,142	49.05%
Preferred Stock	243,518	7.01
Common Equity	1,526,588	43.94

This capital structure reflects a movement toward the ranges established in our statement of financial objectives and in prior rate cases before this

Commission. It is therefore an appropriate basis for the determination of HL&P's overall cost of capital.

Q. MR. DEAN, HOW DOES THE "QUALITY OF EARNINGS" RELATE TO THE CONSTRUCTION BUDGET AND THE LEVEL OF AFUDC?

A. Construction expenditures can only be met with cash. Thus, earnings that result from AFUDC, which is simply a non-cash book entry, are not available to finance HL&P's construction program since no internal cash is generated. Earnings, which include AFUDC, must be at a level sufficient to meet investor requirements. However, the AFUDC component must be limited to a level which will still allow the Company to generate at least 40% of its capital requirements internally. This can be accomplished by allowing sufficient construction work in progress in rate base.

Q. WHAT CAN HAPPEN IF INVESTORS PERCEIVE THAT HL&P MAY NOT MEET SOME OR ALL OF THE FINANCIAL OBJECTIVES YOU HAVE DISCUSSED?

A. Expectations of inadequate cash generation, increased external financing, and prospective limits to dividend growth may preclude sales of common stock at or above book value and adversely affect the risk posture of the Company's debt securities. It is investor expectations that will ultimately determine the Company's actual cost of capital and market accessibility.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

THE STATE OF TEXAS §

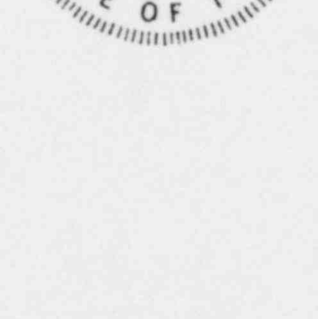
COUNTY OF HARRIS §

Before me, the undersigned authority, on this day personally appeared Hollis R. Dean, having been duly sworn, upon oath says:

"My name is Hollis R. Dean, I am of legal age and a resident of the State of Texas. The foregoing testimony, and exhibits, offered by me on behalf of Houston Lighting & Power Company, are true and correct, and the opinions stated therein are, in my judgment and based upon my professional experience, true and correct."

Hollis R. Dean

Subscribed and sworn to before me by the said Hollis R. Dean this **15TH** day of **JUNE**, 1981.



John P. Sterner

Notary Public in and for

Harris County, Texas

JOHN P. STERNER
Notary Public, State of Texas
My Commission Expires MAR 31 1985