

## I. INTRODUCTION

On May 31, 2006, Atmos Energy Corp., Mid-Tex Division, (referred to herein as Atmos Mid-Tex, the Company or Applicant) filed with the Railroad Commission of Texas (Commission) its statement of intent to change rates in the utility's statewide gas utility system pursuant to TEX. UTIL. CODE ANN. (TUC), Title 3, Subtitle A (Gas Utility Regulatory Act, §§101.001, *et seq.*); TEX. UTIL. CODE ANN., Title 3, Subtitle B (Regulation of Transportation and Use, §§121.001, *et seq.*); and, specifically, TEX. UTIL. CODE ANN., Chapter 104, Subchapters A-C, §§104.101-104.111 and 104.301 (Vernon 1998 and Supp. 2006). The Statement of Intent was docketed as GUD No. 9676.

## II. PROCEDURAL HISTORY AND NOTICE

### A. Procedural History

Atmos Mid-Tex filed a petition for review of the action of several municipalities reducing its rates. In each case, the Commission issued an order that found that the duly executed bond was adequate to protect the affected rate payers in each of the municipalities that were the subject of the appeal; that reinstatement of the Company's gas rates that were in effect in the municipalities immediately prior to the effective date of the various ordinances was appropriate under section 121.155 of GURA, and that the reinstated rates should remain in force and effect from the effective dates of the ordinance until the Commission issues a final and appealable order. As part of the order that was issued in GUD No. 9670, the Commission ordered that the cases be consolidated with the Statement of Intent filing. Those filings were styled *Petition for Review of City Rate Reduction and Request for Expedited Approval of Supersedeas Bond and Agreed Reinstatement of Preexisting Rates* and docketed as follows:

GUD No. 9670, *Petition for Review of City Rate Reductions and Request for Expedited Approval of Supersedeas Bond and Agreed Reinstatement of Preexisting Rates* by the Cities of BenBrook, Crandall, et al. This petition appealed the action of the following cities: Benbrook, Brownwood, Burkburnett, Carrollton, Crandall, DeSoto, Kaufman, Keene, Midlothian, Pantego, Richland Hills, Tyler, and Whitesboro. The appeal was filed on May 10, 2006. Final order issued on June 20, 2006.

GUD No. 9672, *Petition for Review of City Rate Reductions and Request for Expedited Approval of Supersedeas Bond and Agreed Reinstatement of Preexisting Rates* by the City of Justin, filed on May 11, 2006. Final Order issued on June 6, 2006.

GUD No. 9674, *Petition for Review of City Rate Reductions and Request for Expedited Approval of Supersedeas Bond and Agreed Reinstatement of Preexisting Rates* by the Cities of Benbrook, Crandall, et al. This petition appealed the action of the following cities: Addison, Burleson, Denison, Harker Heights, Haslet, Honey Grove, Lewisville, Paris, Sherman, The Colony, and University Park. The appeal was filed on May 15, 2006. Final Order issued on June 6, 2006.

GUD No. 9675, Petition for Review of City Rate Reductions and Request for Expedited Approval of Supersedeas Bond and Agreed Reinstatement of Preexisting Rates by the Cities of Blue Ridge, Caddo Mills, et al. This petition appealed the action of the following cities: Blue Ridge, Caddo Mills, Colorado City, Duncanville, Everman, Flower Mound, Gainesville, Grand Prairie, Haltom City, Heath, Highland Park, Keller, Krum, Lake Worth, Lancaster, Little Elm, McKinney, Newark, Prosper, Reno (Parker Co.) Robinson, Rockwall, Rowlett, Saginaw, Snyder, Sweetwater, Vernon, and Woodway. The appeal was filed on May 31, 2006. Final Order issued on June 20, 2006.

GUD No. 9677, Petition for Review of City Rate Reductions and Request for Expedited Approval of Supersedeas Bond and Agreed Reinstatement of Preexisting Rates by the Cities of Bedford and Colleyville. The appeal was filed on June 15, 2006.

GUD No. 9678, Petition for Review of City Rate Reductions and Request for Expedited Approval of Supersedeas Bond and Agreed Reinstatement of Preexisting Rates by the Cities of Fort Worth and Sulphur Springs. The appeal was filed on June 30, 2006.

GUD No. 9699, Petition for Review of City Rate Reductions and Request for Expedited Approval of Supersedeas Bond and Agreed Reinstatement of Preexisting Rates by the City of Dallas. The appeal was filed on October 25, 2006.

After Atmos Mid-Tex filed the Statement of Intent, GUD No. 9676, with the various municipalities, several municipalities denied the requested rate increase. Those municipal decisions were appealed and docketed as follows:

GUD No. 9679, Petition for Review of Atmos Energy Corporation from the Actions of Municipalities Denying a Rate Request. The petition appealed the action of the following municipalities: Abbott, Abilene, Alba, Albany, Alvord, Anna, Anson, Archer City, Argyle, Aurora, Avery, Azle, Baird, Ballinger, Bangs, Bellevue, Benjamin, Blackwell, Blanket, Blossom, Bogata, Bowie, Bridgeport, Bronte, Brownsboro, Bruceville-Eddy, Buckholts, Buffalo, Caldwell, Calvert, Campbell, Carbon, Centerville, Chandler, Chico, Childless, Chillicothe, Cleburne, Clyde, College Station, Comanche, Coolidge, Corral City, Crowley, Dawson, Early, Eastland, Ector, Edgecliff Village, Edorn, Ennis, Euless, Evant, Fairview, Fate, Forest Hill, Forney, Glen Rose, Godley, Gordon, Goree, Gorman, Granger, Gustine, Hamlin, Haskell, Hawley, Highland Village, Holliday, Hubbard, Hutchins, Iowa Park, Iredell, Itasca, Jewett, Joshua, Kennedale, Kerens, Kerrville, Knox City, Kosse, Ladonia, Lakeport, Lawn, Leona, Leondard, Lexington, Lindsay, Little River Academy, Loraine, Lueders, Mabank, Madisonville, Malakoff, Mansfield, Marlin, Maypearl, McGregor, Melissa, Meridian, Merkel, Mesquite, Midway, Miles, Milford, Moody, Moran, Morgan, Muenster, Munday, Murchison, Nocona, Nolanville,

Northlake, Novice, Oak Leaf, Oakwood, O'Brien, Oglesby, Palestine, Paradise, Pecan Hill, Petrolia, Plano, Pleasant Valley, Post Oak Bend, Poynor, Red Oak, Reno (Lamar County), Rhome, Rio Vista, Robert Lee, Roby, Rochester, Rogers, Rosebud, Ross, Rotan, Rowlett, Runaway Bay, Saint Jo, Sansom Park, Savoy, Scurry, Seagoville, Stamford, Stephenville, Strawn, Streetman, Sunnyvale, Sunset, Temple, Terrell, Throckmorton, Tioga, Tom Bean, Trent, Tenton, Trophy Club, Troy, Tuscola, Tye, Valley Mills, Venus, Walnut Springs, Waxahachie, West, Whitehouse, Wilmer, and Windom. The petition was filed on June 30, 2006.

GUD No. 9680, Petition for Review of Atmos Energy Corporation from the Actions of Municipalities Denying a Rate Request. The petition appealed the action of the following municipalities: Allen, Alvarado, Beverly Hills, Boyd, Brazos Bend, Canton, Cedar Hill, Celina, Clarksville, Cockrell Hill, Cooper, Coppel, Corinth, Crawford, Dalworthington Gardens, Decatur, DeLeon, Dodd City, Farmersville, Ferris, Franston, Frisco, Grapevine, Hewitt, Hurst, Killeen, Lavon, Lone Oak, Lott, Murphy, Normangee, North Richland Hills, Pottsboro, Quanah, Quitman, Richardson, Roanoke, Royse City, San Angelo, Seymour, Springtown, Talty, Teague, Waco, Watauga, Westworth Village, Wichita Falls, Winters, Wixon Valley, and Yantis. The petition was filed on July 11, 2006.

GUD No. 9681, Petition for Review of Atmos Energy Corporation from the Actions of Municipalities Denying a Rate Request. The petition appealed the action of the following municipalities: Bartlett, Bedford, Bonham, Bremond, Buffalo Gap, Garland, Glenn Heights, Gunter, Irving, Lakeside, Ovilla, Richland Hills, Rockdale, Santa Anna, Southmayd, Van Alstyne, White Settlement, Whitewright, and Wolfe City. The petition was filed on July 18, 2006.

GUD No. 9682, Petition for Review of Atmos Energy Corporation from the Actions of Municipalities Denying a Rate Request. The petition appealed the action of the following municipalities: Arlington, Bardwell, Sachse, Valley View, and Westlake. The petition was filed on July 25, 2006.

GUD No. 9683, Petition for Review of Atmos Energy Corporation from the Actions of Municipalities Denying a Rate Request. The petition appealed the action of the following municipalities: Alma, Angus, Annona, Athens, Aubrey, Barry, Batonville, Bellmead, Bells, Blooming Groove, Blue Mound, Blum, Burnet, Byers, Cashion Community, Cedar Park, Cleste, Collinsville, Como, Copper Canyon, Covington, Cross Roads, Cumby, Deport, Detroit, Double Oak, Emhouse, Emory, Eustace, Fairfield, Farmers Branch, Franklin, Garrett, Goodlow, Hearne, Hickory Creek, Holland, Howe, Impact, Italy, Josephine, Kemp, Knollwood, Kurten, Lacy Lakeview, Lake Dallas, Lincoln Park, Lipan, Lorena, Malone, Marble Falls, Marshall Creek, Megargel, Mobile City, Nevada, New Chapel Hill, Newcastle, Palmer, Parker, Pecan Gap, Penelope, Pilot Point, Point, Ponder, Powell, Princeton, Putnam, Quinlan, Ravenna, Retreat, Rice, Richland, River Oaks, Roscoe, Roxton, Rule, Sadler,

Sanctuary, Sanger, Shady Shores, South Mountain, Southlake, Sun Valley, Tehuacana, Thrall, Toco, Weinert, Westover Hills, and Wylie. The petition was filed on August 2, 2006.

GUD No. 9684, Petition for Review of Atmos Energy Corporation from the Actions of Municipalities Denying a Rate Request. The petition appealed the action of the following municipalities: Manor and Thornton. The petition was filed on August 9, 2006.

GUD No. 9697,, Petition for Review of Atmos Energy Corporation from the Actions of Municipalities Denying a Rate Request. The petition appealed the action of the following municipalities: Austin, Belton, Cisco, Clifton, Coleman, Copperas Cove, Denton, Dublin, Electra, Fredericksburg, Goldthwaite, Greenville, Groesbeck, Hamilton, Henrietta, Hillsboro, Lampasas, Leander, Llano, Lometa, Longview, Mart, Olney, Ranger, Somerville, Star Harbor, Thorndale, Whitney, and Wortham. The petition was filed on September 27, 2006.

GUD No. 9698, Petition for Review of Atmos Energy Corporation from the Actions of Municipalities Denying a Rate Request. The petition appealed the action of the following municipalities: Balch Springs, Bandera, Bryan, Cameron, Commerce, Corsicana, Gatesville, Georgetown, Granbury, Hico, Hutto, Mexia, Plugerville, Riesel, Round Rock, Taylor, Trinidad. The petition was filed on October 13, 2006.

GUD No. 9700, Petition for Review of Atmos Energy Corporation from the Actions of Municipalities Denying a Rate Request. The petition appealed the action of the following municipalities: Bertham, Frost, Grandview and San Saba. The petition was filed on November 6, 2006.

All of these cases were consolidated into this proceeding.

#### B. Notice

The procedural schedule was established by order of the Commission on July 6, 2006, approving the agreement of the parties. Pursuant to that agreement, the hearing was to commence on October 31, 2006. Publication, however, was not completed until November 3, 2006, after the commencement of the hearing. As noted by the Examiners in Examiners' Letter No. 72, wherein the Examiners noted that the public notice requirements of GURA section 104.103 was predicated upon the assumption that publication would be completed before the proposed effective date. As set out in GURA, the effective date must be no fewer than thirty-five days after the Statement of Intent is filed. TEX. UTIL. CODE ANN. § 104.102(a). If publication is completed before the effective date, an affected person will have a full thirty days notice before many of the statutory deadlines of GURA are initiated and be able to participate fully in the hearing. At the request of the Examiners, the parties filed briefing regarding the problem posed of having the public notice completed after the commencement of the hearing.

On October 18, 2006, the Examiners issued Examiners' Letter No. 81. After reviewing the arguments of the parties, the Examiners determined that the hearing would be conducted in two phases. Phase I was to commence as scheduled. The exact timing of Phase II would be convened in the event that any person requested to participate in the hearing. Thus, the hearing would be reconvened, on all issues, if necessary, if a party made a request to intervene after publication of notice. Several letters protesting the proposed increase were received and reviewed by the Examiners and the parties after the publication of notice was completed. One individual requested to be designated as a Protestant. The record in this proceeding was not closed until February 1, 2007, and no requests for hearing were filed. Accordingly, Phase II was not commenced.

Coserv argued that the bifurcated hearing proceedings established by the Examiners could not satisfy the statutory requirements of GURA. At the outset of the hearing, CoServ urged that the hearing could not properly commence until notice was completed and a reasonable time allowed for interventions as a result of that notice. Coserv argued that the Examiners failed to fully and properly consider the requirements of the Texas Administrative Procedures Act and GURA. Coserv argued that the potential for an additional round of hearings could not cure the fundamental problem, especially given the manifest deterrent to any late interventions by persons who would know that any additional curative hearing would clearly be an afterthought and that they had already been denied the opportunity to be heard at a meaningful time and in a meaningful manner. Accordingly, Coserv argued that the case should be dismissed.<sup>1</sup> ATM outlined the procedural history of notice but did not affirmatively allege that notice was not satisfied. ATM does allege that notice was not published for four consecutive weeks in Mansfield and Hempstead.

In response to ATM's allegation that notice was not completed in Mansfield and Hempstead, Atmos Mid-Tex noted that the Houston Chronicle is a newspaper of general circulation in Waller County, and the Fort Worth Star Telegram is a paper of general circulation in Tarrant County. Atmos published notice of four successive weeks in both the Houston Chronicle and the Fort Worth Star Telegram thereby providing notice according to the provisions of GURA § 104.103(a) in Tarrant County, and Waller County. In response to Coserv's assertion that the case should be dismissed, Atmos Mid-Tex noted that the two-phased structure of the hearing afforded any affected person a full and fair opportunity for a hearing. Further, the Company argued that Coserv does not have standing to assert the argument the due process violation asserted by Coserv denied Coserv due process.<sup>2</sup>

The Examiners find that the notice requirements of GURA were fully complied with and recommend that the request to dismiss this case be denied. Notice was completed prior to the Company's amended effective date of November 3, 2006, as evidenced by the publisher's affidavits included in the record as Atmos Exhibit 76A.

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<sup>1</sup> Coserv Initial Brief, p. 3.

<sup>2</sup> Atmos Reply Brief, pp. 10 - 14.

### III. JURISDICTION

The Commission has jurisdiction over TXU Gas Company and over the matters at issue in this proceeding pursuant to TEX. UTIL. CODE ANN. §§ 102.001, 103.003, 103.051, 104.001, 121.051, 121.052 and 121.151. The Commission is vested with the authority and power to ensure compliance with the obligations of the Gas Utility Regulatory Act and to establish and regulate rates of gas utilities.<sup>3</sup> Gas utilities are affected with a public interest, are monopolies, and are therefore subject to the jurisdiction, control, and regulation of the Commission.<sup>4</sup>

The statutes and rules applicable to this proceeding included but were not limited to all sections of TEX. UTIL. CODE CHAPTERS 101, 102, 103, 104, and 121; and all Commission rules in 16 TEX. ADMIN. CODE, Chapters 1, 7, and 8; and 16 TEX. ADMIN. CODE §3.70 (2003).

#### A. Original

The Commission has exclusive original jurisdiction over the rates and services of a gas utility that distributes natural gas in areas outside a municipality and distributes natural gas in areas inside a municipality that surrenders its jurisdiction to the Commission. The Commission also has exclusive original jurisdiction over the rates and services of a gas utility that transmits, transports, delivers, or sells natural gas to a gas utility that distributes the gas to the public.<sup>5</sup> More specifically, the Commission has exclusive original jurisdiction over the Company's statement of intent filed at the Commission, the schedule of rates and services to be charged to customers that are served by the Applicant, the schedule of rates and services to be charged to all environs customers served by the Applicant, and the schedule of rates and services to be charged to customers located in any municipality located in the distribution system.

#### B. Appellate

The Commission has exclusive appellate jurisdiction to review an order or ordinance of a municipality exercising exclusive original jurisdiction regarding a statement of intent.<sup>6</sup> At the same time Atmos Mid-Tex filed its statement of intent with the Commission on, May 31, 2006, Atmos Mid-Tex also filed with each municipality located in its system a statement of intent to increase rates for all customers. The statements of intent filed with each municipality are the same as that filed at the Commission. As noted above, Atmos Mid-Tex appealed to the Commission the decisions of the governing bodies of the municipalities regarding the Applicant's statement of intent.

### IV. INTERVENING PARTIES AND PROTESTANTS.

The Atmos Cities Steering Committee (ACSC) intervened on behalf of the following

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<sup>3</sup> TUC §101.002 (Vernon 1998 and Supp. 2004).

<sup>4</sup> TUC §101.002 (Vernon 1998 and Supp. 2004); TUC §121.051 (Vernon 1998).

<sup>5</sup> TUC §102.001(a) (Vernon 1998 and Supp. 2004).

<sup>6</sup> TUC §102.001 (Vernon 1998 and Sup. 2004).

municipalities: Abilene, Addison, Allen, Alvarado, Argyle, Arlington, Bedford, Benbrook, Beverly Hills, Blue Ridge, Bowie, Boyd, Bridgeport, Brownwood, Burkburnett, Burleson, Caddo Mills, Carrollton, Cedar Hill, Celeste, Clyde, College Station, Colleyville, Colorado City, Comanche, Coolidge, Coppel, Corinth, Corral City, Crandall, Crowley, Denison, DeSoto, Duncanville, Eastland, Edgecliff Village, Emory, Ennis, Everman, Fairview, Farmers Branch, Farmersville, Fate, Flower Mound, Fort Worth, Frisco, Frost, Gainesville, Garland, Grand Prairie, Grapevine, Haltom City, Harker Heights, Haslet, Heath, Hewitt, Highland Park, Highland Village, Honey Grove, Hurst, Iowa Park, Irving, Justin, Kaufman, Keene, Keller, Kemp, Kennedale, Kerrville, Killeen, Krum, Lake Worth, Lancaster, Lewisville, Little Elm, Mansfield, McKinney, Mesquite, Midlothian, Murphy, Newark, North Richland Hills, Northlake, Palestine, Pantego, Paris, Parker, Plano, Ponder, Prosper, Quitman, Reno (Parker County), Red Oak, Richland Hills, Robinson, Rockwall, Roscoe, Rowlett, Saginaw, San Angelo, Sherman, Snyder, Southlake, Springtown, Stamford, Sulphur Springs, Sweetwater, Terrell, The Colony, Tyler, University Park, Vernon, Waco, Watauga, Waxahachie, Whitesboro, White Settlement, Woodway, and Wylie.

The Atmos Texas Municipality (ATM): Austin, Balch Springs, Bandera, Belton, Bryan, Burnet, Cameron, Cisco, Clifton, Coleman, Copperas Cove, Corsicana, Denton, Dublin, Electra, Fredericksburg, Frost, Gatesville, Georgetown, Goldthwaite, Granbury, Grandview, Greenville, Groesbeck, Hamilton, Henrietta, Hillsboro, Hutto, Lampasas, Leander, Llano, Longview, Lometa, Mexia, Olney, Pflugerville, Ranger, Riesel, Round Rock, San Saba, Somerville, Star Harbor, Thorndale, Trinidad, Whitney, and Wortham

The State of Texas intervened in this case on behalf of State agencies. The state agency account the Atmos service area consist of a wide range of customer types, including a large number of small accounts, such as offices, laboratories, and a small number of large consumption accounts, including universities, hospitals and correctional facilities. Approximately fifty percent of the expenditures by the State agencies were for service in the Commercial class. In addition, State agencies also purchased a significant amount of natural gas transportation service from Atmos during the test-year under tariffs and non-standard contracts. Transportation customers constitute a larger proportions of the State agencies' entire.<sup>7</sup>

The following additional parties intervened: the City of Dallas (Dallas); Industrial Gas Users (IGU); Railroad Commission of Texas (Staff); State of Texas (State); and Coserv Gas, Ltd.

Avner Wolanow-President, Wash-n-Dry Laundries was admitted as a Protestant. Mr. Wolanow expressed concern over the operation of the weather normalization adjustment.

## V. INTERIM ORDERS IN THIS PROCEEDING

On August 15, 2006, the Commission issued an Interim Order (August 15<sup>th</sup> Interim Order) limiting certain issues in this proceeding. First, in its *Statement of Intent*, Atmos Mid-Tex proposed

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<sup>7</sup> State of Texas Exhibit 5, King Direct, p. 5, lns. 1 - 10

the use of the equal life group (ELG) as a method of calculating depreciation expense. The Commission found that the methodology has been previously reviewed and found to be a just and reasonable depreciation methodology for Atmos Mid-Tex by the Commission in the following dockets:

- a. Tex. R.R. Comm'n, *TXU Gas Company Statement of Intent to Change Rates in the Company's Statewide Gas Utility System*, Docket No. 9400 (Gas Utils. Div. May 25, 2004) (final order granting application) ("GUD No. 9400").
- b. Tex. R.R. Comm'n, *Appeal of TXU Gas Distribution From the Action of the City of Dallas, the city of University Park, and the Town of Highland Park, Texas and the Statement of Intent filed by TXU Gas Distribution*, Docket Nos. 9145 - 9148 (Gas Utils. Div. November 20, 2000) (final order granting application) ("GUD No. 9145 - 9148").
- c. Tex. R.R. Comm'n, *Statement of Intent to Change the City-Gate Rate of TXU Lone Star Pipeline, Formerly Known as Lone Star Pipeline Company Established in GUD No. 8664*, Docket Nos. 8976 (Gas Utils. Div. November 20, 2000) (final order granting application) ("GUD No. 8976").
- d. Tex. R.R. Comm'n, *Statement of Intent of Lone Star Gas Company and Lone Star Pipeline Company, Divisions of Enserch Corporation and Ensat Pipeline Company to Increase the Intracompany City Gate Rate*, (Nov. 25, 1997) (Second Order Nunc. Pro Tunc) ("GUD No. 8664").

In each of those cases the Commission concluded that it is reasonable for this utility to have used the ELG depreciation method.

Second, In its *Statement of Intent*, Atmos Mid-Tex has proposed that the accrual of depreciation expense should cease once an account is fully accrued. This methodology for the treatment of fully accrued depreciation accounts has been affirmed as a just and reasonable depreciation methodology for Atmos and its predecessors in interest by the Commission in the following dockets: (1) GUD No. 9400 , (2) GUD Nos. 9145 - 9148, and (3) GUD No. 8976.

Third, In its *Statement of Intent*, Atmos Mid-Tex proposed that sales, transfers of property, outliers, and reimbursed retirements should be excluded from the life and salvage analysis used to calculate depreciation. The Commission determined, that the methodology for the treatment of sales, transfers of property, outliers, and reimbursed retirements in determining the life and salvage analysis used to calculate depreciation has been affirmed as a just and reasonable depreciation methodology for Atmos and its predecessors in interest by the Commission in the following dockets: (1) GUD No. 9400, (2) GUD Nos. 9145 - 9148, (3) GUD No. 8976.

Fourth, in its *Statement of Intent*, Atmos Mid-Tex proposed that a thirteen-month time period be applied for the calculation for materials, supplies, and prepayments for purposes of its test-year



analysis. This methodology was adopted for the Applicant and its predecessors in interest in GUD No. 9400.

Fifth, Atmos Mid-Tex seeks the approval of a Weather Normalization Adjustment (WNA) rider in this proceeding. The parties have entered into an agreement approving an interim WNA rider and reserving certain issues for litigation in this proceeding. In paragraph 3 of the *Agreement to Extend Jurisdictional Deadline & Procedural Schedule* the parties specifically agreed that the final WNA shall be designed as proposed by Atmos Mid-Tex in the written direct testimony of Company witnesses Charles Yarbrough and Michael TheBerge filed in this case, except that the parties reserved the right to litigate in this proceeding the appropriate period of weather data to use in calculating “normal” weather, and any final WNA approved by the Commission shall be modified or adjusted if and as necessary to conform to the findings in a Final Order issued in this case.

Sixth, as reflected in Schedule F- 6, of the *Statement of Intent* filed by Atmos, the Company seeks the approval of an income tax factor of 0.5385 to the dollar return to equity included in the revenue requirements. The Commission determined that the income tax factor is computed based upon the statutory income tax rate of 35 percent. The Commission determined that the proposed income tax rate and factor reflected in Schedule F-6 have been determined by the Commission to be just and reasonable in the following dockets: (1) GUD No. 9400, (2) GUD No. 9145 - 9148, and (3) GUD No. 8976.

Seventh, Atmos Mid-Tex seeks the approval of the use of a minimum distribution system with 2 inch pipe as method for allocation of a portion of the distribution system. The Commission found that the concept of a minimum distribution system with 2 inch pipe as the minimum system has been approved to allocate certain components of rate base in the following docket: GUD No. 9400. As reflected in the *Statement of Intent*, Atmos Mid-Tex proposes that system-wide rate designs be applied in this case.

Eight, a system-wide rate design was proposed for Atmos Mid-Tex in GUD No. 9400 and adopted by order of the Commission on May 25, 2004. As noted in GUD No. 9400, the Company’s intent to set system-wide rates is consistent with 16 TEX. ADMIN. CODE § 7.220 (2005).

Ninth, in the August 15<sup>th</sup> Interim Order the Commission severed the following issues: Rate case expenses for GUD No. 9400 will be considered by the Commission in accordance with TEX. UTIL. CODE ANN. § 103.022 (Vernon 2005), § 104.008 (Vernon 2005), and Tex. Admin. Code § 7.5530, in a separate proceeding. That proceeding has been docketed as GUD No. 9695, *Rate Case Expenses, Severed from Gas Utilities Docket No. 9670*. Additionally, the Commission determined that it was reasonable that issues regarding Atmos’ proposed revision to the gas cost review process be severed and considered in a separate docket. That proceeding has been docketed as GUD No. 9696, *Atmos Energy Corp., Mid-Tex Division Proposed Revisions to the Gas Cost Review Process Severed from Gas Utilities Docket No. 9670*.

On August 22, 2006, the Commission issued its second Interim Order (August 22<sup>nd</sup> Interim Order) wherein the Commission determined that the affiliate standards set out in Tex. Utils. Code

Ann. § 104.055(b) do not apply to intracompany transactions. On the other hand, the Company must establish that those intracompany transactions are just and reasonable. The Commission concluded that the status of a division of Atmos Mid-Tex as an affiliate or intercompany division was a question of fact to be determined at the hearing on the merits.

## VI. HEARING AND WITNESSES

A technical hearing was held on September 19, 2006, to focus on issues related to the mathematical calculations, links, and interconnection in the schedules accompanying the Statement of Intent. The hearing commenced on October 31, 2006, thirty-seven witnesses submitted testimony in thirteen days of hearing. The following eleven witnesses testified on behalf of Atmos Mid-Tex for its direct case: Charles R. Yarbrough II, Vice President, Rates and Regulatory Affairs for the Mid-Tex Division; Bruce H. Fairchild, Financial Concepts and Applications, Inc.; Daniel M. Meziere, Director of Accounting Services for Atmos Energy Corporation; James Cagle, Manager of Rates and Revenue Requirements for Atmos Energy Corporation; Barbara W. Myers, Regulatory Accounting Manager, for the Mid-Tex Division; Laurie M. Sherwood, Vice President of Corporate Development and Treasurer for Atmos Energy Corporation; Donald A. Murry, C.H. Guernsey & Company; Scott Powell, Vice-President of Operations, Mid-Tex Division; Jay Joyce, Alliance Consulting Group; Michael TheBerge, RateMaster Utility Services; Dane A. Watson, Alliance Consulting Group.

The following five witnesses testified on behalf of ACSC: Gerald W. Tucker, R.J. Covington Consulting, LLC; Constance T. Cannady, C2 Consulting Services; Karl J. Nalepa, R.J. Covington Consulting, LLC; Jack Stowe, R.W. Beck, Inc; and, Dr. J. Randall Woolridge, Professor of Finance, Pennsylvania State University.

The following six witnesses testified on behalf of ATM: David C. Parcell, Technical Associates, Inc., Steve Bickerstaff, Michael L. Arndt, public utility rate consultant, Mark Garrett, and Dr. Michael J. Ileo, Technical Associates, Inc., J. Stephen Lord, Technical Associates, Inc.

The following five witnesses provided testimony on behalf of the City of Dallas: Jacob Pous, Diversified Utility Consultants, Michael J. McFadden, McFadden Consulting, Inc., Charles H. Becker, McFadden<sup>8</sup> Consulting Group, Inc.; Basil L. Copeland, Jr. Diversified Utility Consultants, and Sara E. Coleman, Diversified Utility Consultants.

Testimony on behalf of the Industrial Gas Users was filed by Maurice Brubaker, Brubaker & Associates, Inc. Kelso King, Utility Specialist for the Consumer Protection Division filed testimony on behalf of the State of Texas.

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<sup>8</sup> As discussed below, the prefiled testimony of Mr. Becker was not admitted as it was related to the propriety of the minimum distribution system analysis, an issue which was determined by the Commission's August 15<sup>th</sup> Interim Order.

The following fourteen witnesses provided rebuttal testimony on behalf of Atmos Mid-Tex: Mr. Yarbrough, Ms. Sherwood, Christopher Forsythe, Director of Financial Reporting, Atmos Energy Corporation, Pace McDonald, Director of Taxes for Atmos Energy Corporation, Mr. Fairchild, Mr. Joyce, Daryl B. Robertson, partner, Jenkins & Gilchrist, Mr. Watson, Donald S. Roff, Depreciation Specialty Resources, Mr. Powell, Mr. Cagle, Ms. Myers, Mr. Murry, and Mr. TheBerge.

## VII. OVERVIEW OF ATMOS AND MERGER OF TXU AND ATMOS

Atmos Energy, headquartered in Dallas, Texas, is engaged primarily in the regulated natural gas distribution business. Atmos is the country's largest natural-gas-only distributor based on number of customers and is one of the largest intrastate pipeline operators in Texas based on miles of pipe. Atmos distributes natural gas to approximately 3.2 million customers through seven regulated gas utility divisions, which operate in 12 states (Colorado, Kansas, Kentucky, Louisiana, Mississippi, Tennessee, Texas Georgia, Illinois, Iowa, Missouri and Virginia).

Atmos Mid-Tex is an unincorporated division of Atmos Energy Corporation, and one of the seven regulated gas utility divisions. The Company's system consists of numerous distribution networks serving approximately 1.5 million customers in approximately 440 incorporated municipalities, unincorporated communities and their environs in over 100 counties throughout North Central Texas. These systems are comprised of approximately 28,000 miles of pipe and over 14 million service lines, and are primarily used to distribute gas from city gate stations to individual residences or businesses.

The Atmos Mid-Tex operations are divided as follows. The Operations organization performs the operation and maintenance activities of the Company. This group is split geographically into Metro and Non-Metro service areas. The Metro area is responsible for operations in the Dallas-Fort Worth metropolitan area, while the Non-Metro area is responsible for the remainder of the Company's distribution operations. The Technical Services group provides engineering, design, project management, measurement, right-of-way and related services. The remainder of the Atmos Mid-Tex organization includes Finance, Human Resources, Marketing and Rates and Regulatory.

Atmos' other natural gas businesses primarily provide natural gas management and marketing services to municipalities, other local gas distribution companies and industrial customers in 22 states, along with natural gas transportation and storage services to certain of Atmos' utility divisions and third parties.<sup>9</sup>

Effective October 1, 2004, Atmos Energy Corporation, through a series of mergers, acquired

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<sup>9</sup> Atmos Exhibit 19, Yarbrough Direct, p. 8, ln. 10 - p. 9, ln. 29 (Description of Organization and System).

the assets and liabilities of TXU Gas Company (TXU Gas). Atmos Energy formed LSG Acquisition Corporation (LSG) and merged TXU Gas into LSG, both entities surviving. Immediately after the merger, LSG merged with and into Atmos Energy, with Atmos Energy surviving.<sup>10</sup> Atmos Energy referred to the transaction as a "split-up" merger.<sup>11</sup> The assets included all of the natural gas pipeline transmission, distribution and storage assets of TXU Gas, together with all real property, personal property, contract rights, licenses, permits, franchises, computer software and all other property rights and interests.

The assets included approximately 26,400 miles of intrastate distribution pipeline, 6,100 miles of transmission pipeline and five natural gas storage facilities with a working capacity of 38 Bcf. The pipeline and storage facilities held by TXU Gas were then held by Atmos Texas - Pipeline and the distribution assets held by TXU Gas were then held by Atmos Energy - Mid-Tex Division, both unincorporated divisions of Atmos Energy Corporation.<sup>12</sup> The acquisition transaction was Atmos Energy's largest acquisition, which doubled the size of Atmos Energy.<sup>13</sup>

Upon the effective date of the merger, virtually all of the employees of TXU Gas became employees of Atmos Energy and the distribution operations of TXU Gas became known as the Mid-Tex Division of Atmos Energy. Atmos Mid-Tex converted to Atmos Energy's common computer systems such as those used for accounting functions and payroll. Several systems used by field personnel have also been transferred to new programs compatible with Atmos Energy's system standards. In addition, the customer call center function was transferred from the outsourced provider to Atmos Energy's customer support services, which includes call center services, customer billing, and other customer support services. Atmos Energy Corporation has also assumed responsibility for other services that had previously been outsourced, such as information technology, accounting, payroll, and legal. Atmos Mid-Tex moved those operations formerly housed with TXU Electric Delivery operations into other Atmos Mid-Tex facilities and ten new service centers. Finally, the Atmos Mid-Tex divisional and administrative offices moved from downtown Dallas to office space adjacent to Atmos Energy's existing corporate office in North Dallas.<sup>14</sup>

Atmos Energy notified the Railroad Commission of Texas of the transaction on November 22, 2006. The Commission docketed the matter as GUD No. 9555, *Application for Review of the Merger between Atmos Energy Corporation and TXU Gas Company, L.P.* Through a series of questions asked of utilities under Texas Utilities Code § 102.051, Atmos provided information which the Commission retained on file for future consideration in a rate making proceeding.<sup>15</sup>

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<sup>10</sup> Atmos Exhibit 19, CRY-2, November 22, 2004, correspondence notifying the Commission of the acquisition.

<sup>11</sup> Atmos Rebuttal Testimony of Christopher Forsythe, Page 4, Lines 2 - 3 and Rebuttal Testimony of Pace McDonald, Page 4, Line 23.

<sup>12</sup> Atmos Exhibit 19, Exhibit CRY - 2, November 22, 2004, correspondence notifying the Commission of the acquisition.

<sup>13</sup> Atmos Initial Brief, Page 2.

<sup>14</sup> Atmos Exhibit 19, p. 10, ln. 6 - 24.

<sup>15</sup> GUD No. 9555, November 20, 2005, correspondence from the Commission.

## VIII. THE RELIABILITY OF THE BOOKS AND RECORDS.

Atmos Mid - Tex argued that it met the burden of proof through the operation of Rule 7.503 and that compliance with Rule 7.503 establishes a rebuttable presumption that the Company's expenses are reasonable and necessary. Rule 7.503 provides, in relevant part as follows:

(a) In any proceeding before the Commission involving a gas utility that keeps its books and records in accordance with Commission rules, the amounts shown on its books and records as well as summaries and excerpts therefrom shall be considered *prima facie* evidence of the amount of investment or expense reflected when introduced into evidence, and such amounts shall be presumed to have been reasonably and necessarily incurred; provided, however, that if any evidence is introduced that an investment or expense item has been unreasonably incurred, then the presumption as to that specific investment or expense item shall no longer exist and the gas utility shall have the burden of introducing probative evidence that the challenged item has been reasonably and necessarily incurred. The gas utility shall be given a reasonable opportunity to prepare and present such additional evidence relevant to the reasonableness or necessity of any item so challenged. This section shall apply to the books and records of an affiliate of a gas utility engaged in a transaction with the gas utility as described in the Texas Utilities Code, § 102.104.

Atmos Mid-Tex argued that it fully satisfied its initial burden of proof and established that it has complied with the requirements of Rule 7.503. Mr. Meziere testified that Atmos kept its books and records in accordance with the rules of the Commission.<sup>16</sup> Namely, Rule 7.310 requires that each gas utility shall utilize the Federal Energy Regulatory Commission's (FERC) Uniform System of Accounts prescribed for Natural Gas Companies subject to the provisions of the Natural Gas Act for all operating and reporting purposes. The FERC Uniform System of Accounts shall be applicable to all gas utility and gas utility related operations.

As will be discussed herein several issues regarding the reliability of the information contained in the books and records have been challenged by several intervenors. ATM specifically argued in its reply brief that Atmos Mid-Tex violated FERC regulations related to the Uniform System of Accounts and Atmos Mid-Tex has, therefore, forfeited any benefit Rule 7.503 might have conferred.<sup>17</sup>

The issue of the books and records was raised in GUD No. 8664.<sup>18</sup> In that case the allegation was raised that the utility did not keep its books and records in accordance with the Commission's regulations. The Examiners observed that the presumption in the

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<sup>16</sup> Atmos Exhibit 21, Meziere Direct, pp. 4 - 6.

<sup>17</sup> ATM Reply Brief, pp. 52 - 53.

<sup>18</sup> GUD No. 8664, PFD, pp. i-5 - i-6

Commission's regulations were grounded in administrative efficiency. A utility was not required to present original source documents, such as receipts and pay records to support the accuracy of entries in its books if those books are kept in accordance with Commission rules. The procedure avoids the necessity of introducing evidence on uncontroverted issues. Although the utility in GUD No. 8664 did not keep its records completely in accordance the Commission's regulations, the utility in that case established that it was sufficiently close to allow the presumption.<sup>19</sup> Likewise in the case, the Examiners find that the utility has substantially complied with the Commission's book keeping regulations to allow the presumption of Rule 7.503. While, as will be discussed below, the Examiners find that certain FERC rules were violated with regards to certain entries, the Examiners are of the opinion that the evidence is insufficient to show that as a general rule Atmos Mid-Tex does not maintains its books and records in accordance with the FERC Uniform System of Accounts.

## IX. SHARED SERVICES EXPENSES

### A. Overview

Atmos Energy consists of eight unincorporated operating divisions. Seven operating divisions are regulated gas distribution utilities. One is a regulated intrastate natural gas pipeline.<sup>20</sup> Atmos Mid-Tex is a regulated operating division, while Atmos Texas Pipeline is a regulated pipeline.

Shared services are services provided by a common business organization that can be used by more than one entity. Atmos provided these services through its Shared Services Unit (SSU) to its regulated utility divisions as well as to its non-regulated subsidiary companies. These services include accounting, human resources, legal, rates, and risk management. Atmos Mid-Tex claimed that these common costs are allocated to the entities using these services on a fair and consistent basis.<sup>21</sup>

The adjustments related to SSU directly impact expenses associated with operations and maintenance of the Atmos Mid-Tex system. Further, as these expenses are also capitalized they also affect rate base and the provision for depreciation, taxes other than income taxes, and federal income taxes. Shared Services expenses impact several aspects of the cost of service study filed in support of the rate request of Atmos Mid-Tex and the areas affected by Shared Services expenses are highlighted in Table 9.1 below:

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<sup>19</sup> GUD No. 9400, PFD pp. i-7 - i-8. Final Order Finding of Fact No. 10.

<sup>20</sup> Atmos Exhibit 22, Cagle Direct, p. 3, line 11 - p. 4, ln 19.

<sup>21</sup> Atmos Exhibit 22, Cagle, Direct, p. 5, line 22 - 30.

Table 9.1  
Cost of Service Summary—Areas affected by Shared Services  
As filed on May 31, 2006

Description	\$ Amount
<b>Rate Base</b>	<b>\$1,114,225,075</b>
Rate of Return	8.86%
<b>Total Return</b>	<b>\$98,720,342</b>
<b>Operation and Maintenance Expenses</b>	<b>\$160,977,057</b>
<b>Provision for Depreciation</b>	<b>\$85,195,516</b>
Interest on Customer Deposits	\$1,365,082
Interest on Customer Advances	\$13,787
<b>Taxes other than Income Taxes</b>	<b>\$25,337,646</b>
<b>Total Operating Expenses Before Federal Income Taxes</b>	<b>\$371,609,430</b>
<b>Federal Income Taxes</b>	<b>\$35,248,082</b>
<b>Total Cost of Service Request</b>	<b>\$406,857,512</b>

Shared Services expenses also impact the interim rate adjustment request. Due to the multiple impact of this adjustment, several of the shared services issues will be addressed separately in this section. Issues related to shared services depreciation will be addressed in section 13 related to expenses.

At the time the case was filed, Atmos Mid-Tex alleged that shared services operating and maintenance expenses in the amount of \$34,376,687 were just and reasonable.<sup>22</sup> Thus, a full 21% of operations and maintenance expenses of \$160,977,057 is made up of shared services expenses. Atmos Mid-Tex also alleged that \$47,777,031 in net plant assigned from SSU was just and reasonable. Further, \$2,412,520 was assigned to rate base for cash working

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<sup>22</sup> Schedule F-1, ln. 34

capital associated with SSU.<sup>23</sup> Additionally, \$15,783,315 in depreciation/amortization expenses were assigned from SSU.<sup>24</sup> Finally, Atmos maintained that \$1,584,455 in non revenue-related taxes assigned from SSU was just and reasonable.<sup>25</sup> Some of these figures were revised during the hearing as set out in table 9.2 below.

Table 9.2  
Shared Services Adjustments made by Atmos Mid-Tex during the Hearing.

	May 31, 2006 Filing	Adjustments
O&M	\$34,376,687	(\$792,000)
Net Plant	\$47,777,031	- 0 -
Cash Working Capital	\$2,412,520	- 0 -
Depreciation	\$15,783,315	- 0 -
Non Revenue Related Taxes	\$1,584,455	\$65,463

As already noted, the expenses are not only allocated to operations and maintenance accounts, they are also capitalized.<sup>26</sup> Once they are capitalized, those expenses end up in net plant and, if approved, the utility will receive a return on that investment.

#### B. Burden of Proof

Atmos Mid-Tex bears the burden of proof in this proceeding. Three witnesses were presented by Atmos Mid-Tex at the time the Statement of Intent was filed to establish the reasonableness and necessity of the Shared Services Expenditures: Daniel Meziere, Scott Powell, and James Cagle. Each testified that the Company's requested operations and maintenance expenditures are reasonable and necessary.<sup>27</sup> The assertion was based upon the operation of Rule 7.503.

Atmos Mid-Tex argued that it fully satisfied its initial burden of proof and established that it has complied with the requirements of Rule 7.503. Mr. Meziere testified that Atmos kept its books and records in accordance with the rules of the Commission.<sup>28</sup> Mr. Cagle stated that in light of the testimony of Mr. Meziere, Atmos Mid-Tex is entitled to the presumption that the amounts shown on its books and records are presumed to reflect the

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<sup>23</sup> Schedule B

<sup>24</sup> Schedule F - 3.

<sup>25</sup> Schedule F-5, ln 6.

<sup>26</sup> Atmos Exhibit 78, Tr. Vol. 11, pp. 20 - 21, 38 - 39

<sup>27</sup> Atmos Exhibit 26, p. 8, lns. 1 - 5 (Powell), and Atmos Ex. 22, p. 12, ln. 27 - p. 13, ln. 4. (Cagle).

<sup>28</sup> Atmos Exhibit 21, Meziere Direct, pp. 4 - 6.



reasonable and necessary amounts of the Company's investment or expenses.<sup>29</sup> Based upon the Company's alleged compliance with Rule 7.503 and his alleged review of Shared Services costs, Mr. Cagle concluded that the Company's overall level of Shared Services costs was representative of the costs allocable to Atmos Mid-Tex.<sup>30</sup> Thus, Atmos Mid-Tex claims that the burden shifts to the intervening party.

### C. Shared Services Expenses

A considerable portion of the hearing in this case was focused upon several categories of expenses associated with Shared Services and included in the Statement of Intent filing attested to by Mr. Powell, Mr. Cagle, and Mr. Meziere: (1) Travel, (2) Meals & Expenses, (3) Expenses related to Alcohol, (4) Lodging Expenses, and (5) Gifts. ACSC and ATM presented several exhibits and question the reasonableness and necessity of those expenses.<sup>31</sup> The City Intervenors, Coserv, and Staff unanimously challenged many of the alleged expenditures.

After considerable cross-examination regarding those expense items, Atmos Mid-Tex introduced a document which purported to remove several of the objectionable expenses.<sup>32</sup> Atmos Mid-Tex proposed that expenses booked to shared services be adjusted by the removal of \$67,440. Only a portion of that adjustment would have affected the total revenue requirement as those expenses are allocated. The allocation process will be discussed below. As a portion of the expense were capitalized an adjustment to rate base would also have been made. Through that exhibit, Atmos Mid-Tex moved to adjust the filing in this case.<sup>33</sup> At the time that the exhibit was introduced through Mr. Cagle, the principal SSU witness, he indicated that he had not participated in the preparation of the exhibit.<sup>34</sup> Mr. Cagle had not participated in the review of the expense reports, been consulted regarding the specifics of those expenses, or been made aware of the exhibit summarizing the expenses to be removed until after the exhibit had been completed on the evening before it was introduced into the hearing.<sup>35</sup>

After the exhibit was introduced, the Company's witness who directed the preparation of the report was questioned regarding several items that had not been removed from the Company's rate request.<sup>36</sup> As the hearing progressed, several more questions were raised regarding the expenses contained in the expense reports that Atmos Mid-Tex had not

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<sup>29</sup> Atmos Exhibit 40, Cagle Rebuttal, p. 4, lns. 5 - 7.

<sup>30</sup> Atmos Exhibit 40, Cagle Rebuttal, p. 4, lns. 13 - 18.

<sup>31</sup> ACSC Exhibit 13, 25, 98, & 112; ATM Exhibit 24, 25, 26, 27, 30, 31, 32, and 33.

<sup>32</sup> Atmos Exhibit 49, Tr. Vol. 3, p. 146.

<sup>33</sup> Tr. Vol. 3, p. 146, lns. 12 - 16.

<sup>34</sup> Tr. Vol. 3, pp. 156 - 161.

<sup>35</sup> Tr. Vol. 4, p. 181, lns. 3 - 23.

<sup>36</sup> *See generally*, Tr. Vol. 4, pp. 173 - 239.

proposed be adjusted out of the rate request in this proceeding.<sup>37</sup> In addition, testimony in the hearing provided by witnesses for several Intervenors suggested that the proposed adjustments did not capture all of the objectionable expenses.<sup>38</sup> On the eleventh day of the hearing, Atmos Mid-Tex offered an additional exhibit which proposed the removal of several additional amounts related to the category of expenses labeled “meals and entertainment” on the expense reports.<sup>39</sup> The total amount proposed to be removed from the operations and maintenance component of shared services by Atmos Mid-Tex was \$282,480. Atmos Mid-Tex also proposed a capital reduction of \$78,564 to reflect the amount of meals and expenses that had been capitalized.

The City Intervenors argued that the credibility of the sponsoring witnesses was undermined by the fact that the expenses were included in the Statement of Intent that was filed on May 31, 2006. Further, they argued that Atmos Mid-Tex attempted to recover those costs through its practice of including these expenditure as an operations and maintenance expense and capitalizing the expenditure. It is, therefore, evidence of the inadequacy of the procedures of the Company to ensure that only reasonable expenses are expensed and capitalized. Additionally, the City Intervenors maintained that the adjustments offered by Atmos Mid-Tex did not go far enough. ATM argued that the proposed adjustments have not yet been removed and Staff argued that an additional adjustment should be made. Staff agreed that at a minimum the adjustments proposed by the Company should be adopted.<sup>40</sup> ACSC and ATM have specifically argued that no testimony was provided to show the reasonableness and necessity of the costs, and no support was offered for the shared services expenses booked to the individual cost centers, or the amounts allocated.<sup>41</sup> Although every expenditure questioned and examined by those exhibits is not reproduced here, the following sections and tables summarize several of the issues raised by the City Intervenors and Staff.

As an initial matter, the alleged mechanics of the expense reports must be understood. Each expense report, or invoice, is identified with an Electronic Expense Account System number – the IEXP number.<sup>42</sup> The name of the individual who prepared the report appeared at the top of the expense report.<sup>43</sup> The date that the report was prepared is noted at the top of the report and the date that the event or expense occurred is noted in the body of the report.<sup>44</sup> The individual who prepared the report itemized the expenses into one of the following categories:

► Meals & Entertainment

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<sup>37</sup> Tr. Vol. 10, pp. 97 - 103.

<sup>38</sup> Cite to testimony.

<sup>39</sup> Atmos Exhibit 75, Tr. Vol. 11, p. 192.

<sup>40</sup> Staff Initial Brief, p. 5.

<sup>41</sup> ACSC Initial Brief, pp. 74 - 81; ATM Initial Brief, pp. 28 - 33.

<sup>42</sup> Tr. Vol. 4, p. 185, lns. 1 - 22.

<sup>43</sup> Tr. Vol. 11, p. 100, lns. 9 - 14.

<sup>44</sup> Tr. Vol. 11, p. 100, lns. 9 - 14.

- ▶ Transportation
- ▶ Lodging
- ▶ Other<sup>45</sup>

Once the report is completed, it is submitted for approval.<sup>46</sup> At that juncture, the expense is either coded as an expense item, to be expensed as an operations or maintenance expense, or as a capitalized item, to be included in rate base.

### 1. Meals

The City Intervenors and Staff pointed out that the initial filing contained a request for recovery of expenses associated with meals that did not appear to be just and reasonable. Table 9.3 below summarizes some of the meal expenses challenged by the Intervenors in this case.

Table 9.3  
Selected Expenses Related to Meals

Location	Restaurant	Purpose	Number of People	Total Bill	Price per Person
Dallas	III Forks <sup>47</sup>	Retirement	16	\$3,556.72	\$222.29
Dallas	III Forks <sup>48</sup>	Retirement	16	\$3,392.65	\$212.05
Dallas	III Forks <sup>49</sup>	Retirement	20	\$3,342.45	\$167.12
Dallas	III Forks <sup>50</sup>	Sign Unveiling	8	\$3,132.51	\$391.56
Dallas	III Forks <sup>51</sup>	Utility Operations	6	\$654.59	\$109.10
Dallas	III Forks	Utility Operations	20	\$3,163.13	\$158.12
New Orleans	Javier's <sup>52</sup>	AGA	7	\$1,177.85	\$168.26

<sup>45</sup> See e.g., ATM Ex. 25 at 139.

<sup>46</sup> See e.g., ATM Ex. 25 at 139.

<sup>47</sup> ATM Ex. 25 at 140

<sup>48</sup> ATM Ex. 25 at 149

<sup>49</sup> ATM Ex. 25 at 181

<sup>50</sup> ATM Ex. 25 at 193

<sup>51</sup> ATM Ex. 25 at 334

<sup>52</sup> ATM Ex. 25 at 346

New York	Il Tinello <sup>53</sup>	BOD Meeting	17	\$3,519.50	\$207.03
New Orleans	Mike Anderson's Seafood Restaurant <sup>54</sup>	SGA Dinner	31	\$1,656.74	\$53.44
New York	Il Mulino <sup>55</sup>		8	\$1,857.35	\$232.17
Philadelphia	Brasserie Perrier <sup>56</sup>		2	\$373.02	\$186.01
Dallas	III Forks <sup>57</sup>	President's Meeting	8	\$1,707.79	\$213.47
Amarillo	Johnny Carinos <sup>58</sup>		9	\$1,006.42	\$111.82
Dallas	Mi Piaci <sup>59</sup>		6	\$875.80	\$145.96
Irving	Via Real <sup>60</sup>		6	\$806.42	\$134.46
New York	Blue Fin <sup>61</sup>		3	\$448.24	\$149.41
Philadelphia	Park Hyatt <sup>62</sup>	Breakfast	1	\$123.87	\$123.87
Irving	Via Real <sup>63</sup>	Dinner	6	\$806.42	\$134.40
Dallas	Oceanaire <sup>64</sup>	Dinner	3	\$373.95	\$124.65
Philadelphia	Brasserie Perrier <sup>65</sup>	Dinner	3	\$372.02	\$124.01
Dallas	Mercury Grill <sup>66</sup>	Dinner	2	\$215.27	\$107.64

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<sup>53</sup> ATM Ex. 25 at 191

<sup>54</sup> ATM Ex. 25 at 239

<sup>55</sup> ATM Ex. 33 at 130

<sup>56</sup> ATM Ex. 26 at 466

<sup>57</sup> ATM Ex. 25 at 140

<sup>58</sup> ATM Ex. 30 at 376

<sup>59</sup> ATM Ex. 26 at 552

<sup>60</sup> ATM Ex. 26 at 456

<sup>61</sup> ATM Ex. 26 at 513.

<sup>62</sup> ATM Ex. 26 at 449

<sup>63</sup> ATM Ex. 26 at 449

<sup>64</sup> ATM Ex. 26 at 449

<sup>65</sup> ATM Ex. 26 at 463.

<sup>66</sup> ATM Ex. 26 at 463.

Dallas	Aurora <sup>67</sup>	Dinner	3	\$527.85	\$175.95
NYC	Atlantic Grill <sup>68</sup>	Dinner	3	\$435.93	\$145.31
NYC	Blue Fin <sup>69</sup>	Dinner	3	\$448.24	\$149.41
NYC	Lusardi's <sup>70</sup>	Dinner	2	\$309.55	\$154.78
Dallas	Mercury Grill <sup>71</sup>	Dinner	3	\$252.24	\$84.08
Nantucket	21 Federal <sup>72</sup>	Dinner	3	\$397.28	\$132.43
Dallas	Fogo de Chao <sup>73</sup>	Team Dinner	30	\$2,640.43	\$88.01
Amarillo	Johnny Carinos <sup>74</sup>	Not Identified	9	\$1006.42	\$111.82

The City Intervenors and Staff argued that these expenses were not reasonable and necessary and testimony was provided at the hearing challenging those expenses.<sup>75</sup> The challenge to these expenses generally fell into one of several categories. The City Intervenors appeared to challenge the reasonableness of inclusion of some of those expenses in the initial rate filing as simply not reasonably related to the operation of the system. For example, the expense reports revealed that meal expenses for spouses were routinely included, or the expense report indicated a meal expense was incurred for a “former employee” of Atmos Mid-Tex.<sup>76</sup> On one occasion the expense report indicated that the expense was related to an entity other than Atmos Mid-Tex.<sup>77</sup> The City Intervenors argued that it was not reasonable to include, as part of the cost of service, meal expenses for spouses.<sup>78</sup> On quite a few occasions, the expense report indicated that the meal was for the individual preparing the expense report. In other words, there appears to be no business purpose related to the meal expense.<sup>79</sup> The expense was simply made to reimburse the employee for their meal that was not incurred as part of a business meeting or travel. On a couple occasions, the expense report indicated that the meal was with a government official and should have been excluded as a legislative

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<sup>67</sup> ATM Ex. 26 at 496.

<sup>68</sup> ATM Ex. 26 at 496.

<sup>69</sup> ATM Ex. 26 at 496.

<sup>70</sup> ATM Ex. 26 at 496.

<sup>71</sup> ATM Ex. 26 at 517..

<sup>72</sup> ATM Ex. 26 at 552.

<sup>73</sup> ACSC Ex. 13.

<sup>74</sup> ATM Ex. 30 at 376.

<sup>75</sup> ATM Initial Brief, pp. 28 - 33, ACSC Initial Brief, pp. 75 - 77. Tr. Vol. 11, p. 16 - 28

<sup>76</sup> ATM Ex. 25 at 181.

<sup>77</sup> ATM Ex. 26 at 517.

<sup>78</sup> See e.g., ATM Ex. 26 at 463, 496, and 552.

<sup>79</sup> See, e.g., ATM Ex. 30 at 1, 1313.

expense.<sup>80</sup> In addition, the City Intervenor alleged that including meal expenses for a group of individual employees who were not even traveling was not reasonable. Finally, the City Intervenor alleged the reasonableness of the expense on the basis of the cost. Meals that totaled \$1,000 to \$3,000 or over \$350 per person were simply not reasonable.

Atmos Mid-Tex argued that the vast majority of these expenses were legitimate business expenses and that it was reasonable to include them as part of the cost of service in this case.<sup>81</sup> Nevertheless, Atmos Mid-Tex ultimately decided to remove the meals and entertainment expenses incurred by Atmos Mid-Tex and Shared Services personnel. Atmos Mid-Tex initially removed only certain meal expenses.<sup>82</sup> For example, on the third day of the hearing Atmos Mid-Tex proposed the removal of \$3,132.51 for a "Sign Party." On the other hand, a \$3,556.72 expense and a \$3,392.65 for the retirement parties was not removed on that exhibit. On the eleventh day of the hearing, Atmos Mid-Tex filed a document which purported to capture all meal and entertainment expenses.<sup>83</sup>

The Examiners find that evidence was never presented sufficient to support the reasonableness and necessity of these expenses that were initially included in the rate case. No evidence was presented to support the reasonableness of having captive customers pay for meals of spouses or miscellaneous former employees. No evidence was presented that certain expenses in excess of \$350 per person were just and reasonable.

The Examiners find that the inclusion of such exorbitant expenses seriously undermined the credibility of the filing itself and of the witnesses who sponsored the various documents in this case. In addition, the credibility of Mr. Cagle, the sponsoring witness for expenses and accounting, is hampered by the fact that he did not review any of these expense reports prior to the filing of the exhibit that purported to remove these unreasonable expenses. The impact on his credibility on this issue is significant because in response to many of the specific challenges regarding the overhead rate charged to projects, the Company pointed to the policies and procedures in place that would allegedly ensure that costs were just and reasonable. There was no reasonable basis for including expenses for dinners at prices ranging to almost \$400.00 per person. Further, meal expenses related to meetings with government officials appear to be specifically excluded by Rule 7.5414. Accordingly, the Examiners recommend that the adjustment proposed by Atmos Mid-Tex be implemented and those expenses be removed from operations and maintenance expenses. Further, the Examiners recommend that an adjustment to rate base be implemented to remove the capitalized portion of those expenses. Mr. Meziere testified that a portion of the cost, approximately 40%, was capitalized.<sup>84</sup> Therefore, to the extent that an expense item is found to be not just and reasonable, an adjustment must be made to the operations and maintenance expense accounts and a corresponding adjustment must be made to gross plant.

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<sup>80</sup> ATM Ex. 31 at 44 and 197.

<sup>81</sup> Atmos Mid-Tex Initial Brief, p. 69, Tr. Vol. 12 pp. 129 - 130.

<sup>82</sup> Atmos Ex. 49.

<sup>83</sup> Atmos Ex. 75.

<sup>84</sup> Tr. Vol. 3, p. 116, ln. 16 - p. 117, ln. 8.

## 2. Entertainment

The City Intervenors pointed out that the initial filing contained a request for recovery of expenses associated with entertainment that did not appear to be just and reasonable. Table 9.3 below summarizes some of the entertainment expenses challenged by the City Intervenors in this case. These expenses were itemized by employees as either “meals and entertainment” or “other” on expense reports.

Table 9.3  
Selected Expenses Related to Entertainment

Expense	Amount
Reception for Western Kentucky University officials while attending a basketball game in Denton <sup>85</sup>	\$1,357.35
Skybox Service Tip <sup>86</sup>	\$100.00
Guest Remembrance <sup>87</sup>	\$64.00
Membership - Dallas Symphony Orchestra <sup>88</sup>	\$5,000.00
Dallas Symphony Event <sup>89</sup>	\$634.00
Nantucket Whaling Museum <sup>90</sup>	\$30.00
Nantucket Bike Shop <sup>91</sup>	\$42.00
Dallas Symphony Tickets <sup>92</sup>	\$300.00
Dallas Cowboys Tickets <sup>93</sup>	\$201.00
Academy Sports - Footballs for Autographs and Charity Auctions <sup>94</sup>	\$117.53
Texas Stadium - Special Events <sup>95</sup>	\$660.00
Donations to the Dallas Symphony Orchestra. <sup>96</sup>	\$2,750 to \$5,000
Public Affair– Rotary Speaker, Abilene <sup>97</sup>	\$37.89

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<sup>85</sup> ATM Ex. 25 at 322

<sup>86</sup> ATM Ex. 25 at 229.

<sup>87</sup> ATM Ex. 25 at 229.

<sup>88</sup> ATM Ex. 26 at 517.

<sup>89</sup> ATM Ex. 26 at 534.

<sup>90</sup> ATM Ex. 26 at 534.

<sup>91</sup> ATM Ex. 26 at 534.

<sup>92</sup> ATM Ex. 26 at 591.

<sup>93</sup> ATM Ex. 31 at 197.

<sup>94</sup> ATM Ex. 31 at 200.

<sup>95</sup> ATM Ex. 31 at 200.

<sup>96</sup> ATM Ex. 26 at 588, 517, 528, and 605.

<sup>97</sup> ATM Ex. 25 at 229.

The City Intervenors and Staff argued that these expenses were not reasonable and necessary. Testimony was provided at the hearing alleging that those expenses were neither reasonable or necessary.<sup>98</sup> Again, the challenge to these expenses generally fell into one of several categories. The City Intervenors and Staff appeared to challenge the reasonableness of inclusion of some of those expenses in the initial rate filing as simply not reasonably related to the operation of the system. Additionally, they challenged the inclusion of expenses related to spouses at some of these events and the overall cost.<sup>99</sup>

Atmos Mid-Tex argued that the vast majority of these expenses were legitimate business expenses and that it was reasonable to include them as part of the cost of service in this case.<sup>100</sup> Nevertheless, Atmos Mid-Tex ultimately decided to remove several of these expenses.<sup>101</sup> For example, Mr. Yarbrough correctly removed expenses associated with activities related to the Kentucky Board of Regents of one individual. The total expenditures related to one event of \$1,185.74 were identified by Mr. Yarbrough as expenses to be removed from operation and maintenance expenses.<sup>102</sup> Expenses associated with the Dallas Cowboys Skybox were also removed.<sup>103</sup> Certain expenses associated with an event identified as Western Kentucky Sunbelt Tournament appear to have been removed – the presidents brunch and a miscellaneous mileage expense.<sup>104</sup> Whereas a dinner related to that event was not.<sup>105</sup> Admittedly, the bulk of the expenditure was removed. The criteria, and efficacy of the Company's effort to remove these expenses, however, is called into question.

The Examiners find that evidence was never presented sufficient to support the reasonableness and necessity of these expenses that were initially included in the rate case. No evidence was presented to support the reasonableness of having captive customers pay for these entertainment tickets for employees, non-employees, or spouses. Further, the Examiners find that the inclusion of these expenses in the rate request as filed in this case undermined the credibility of the witnesses. Further, expenses such as membership in the Dallas Symphony are explicitly excluded by Rule 7.5414 which provides that no expenditures shall be allowed as a cost of service item for ratemaking purposes for funds expended in support of membership in social, recreational, fraternal or religious clubs or funds expended for contributions and donations to charitable, religious or other nonprofit organization or institutions.<sup>106</sup> The fact that these were initially included taints the efficacy of the procedures Atmos Mid-Tex relied upon to rebut the assertions of the City Intervenors that this category of expenses were unreasonable and the overhead costs attributable thereto were also unreasonable.

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<sup>98</sup> ATM Initial Brief, pp. 28 - 33, ACSC Initial Brief, pp. 75 - 77. Tr. Vol. 11, p. 16 - 28

<sup>99</sup> See e.g., ATM Ex. 26 at 534 & 591.

<sup>100</sup> Atmos Mid-Tex Initial Brief, p. 69, Tr. Vol. 12 pp. 129 - 130.

<sup>101</sup> Atmos Ex. 49.

<sup>102</sup> ATM Ex. 25 at 307 and Atmos Ex. 49.

<sup>103</sup> ATM Ex. 25 at 438 and Atmos Ex. 49.

<sup>104</sup> ATM Ex. 25 at 322.

<sup>105</sup> ATM Ex. 25 at 322.

<sup>106</sup> 16 Tex. Admin. Code § 7.5414(b).



As already noted, Atmos Mid-Tex sought not only to recover these expenses through its cost of service analysis of test year operations and maintenance expenses, Atmos Mid-Tex sought approval to capitalize a portion of those expenses and include the expense as part of rate base and recover a return on that investment. Again, the Examiners find that the credibility of the witnesses testimony is seriously undermined by their assertion that the capitalization of these entertainment expenses was just and reasonable. Accordingly, the Examiners find that the cost of service be adjusted to remove those amounts from the operations and maintenance expenses and rate base.

### 3. Alcohol Expenses

The City Intervenors alleged that the initial filing contained a request for recovery of expenses associated with consumption of alcohol that did not appear to be just and reasonable. Table 9.4 below summarizes some of the alcohol expenses challenged by those Intervenors in this case.

Table 9.4  
Selected Expenses Related to Meals

Expense	Amount
Case of Merlot <sup>107</sup>	\$350.57
Case of Chardonnay <sup>108</sup>	\$467.48
Refreshments <sup>109</sup>	\$81.52
Bar - Four Seasons - NYC <sup>110</sup>	\$56.88
Amarillo Happy Hour <sup>111</sup>	\$43.06
Amarillo Happy Hour <sup>112</sup>	\$141.27
Cricketer's <sup>113</sup>	\$55.35
Amarillo Happy Hour <sup>114</sup>	\$222.10
Amarillo Happy Hour <sup>115</sup>	\$177.40

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<sup>107</sup> ATM Ex. 24 at 3.

<sup>108</sup> ATM Ex. 24 at 3.

<sup>109</sup> ATM Ex. 25 at 155. Although the backup receipt does not confirm this as a liquor expense the price per person, \$13.60, suggests that it might include liquor.

<sup>110</sup> ATM Ex. 27 at 730.

<sup>111</sup> ATM Ex. 30 at 77.

<sup>112</sup> ATM Ex. 30 at 118.

<sup>113</sup> ATM Ex. 30 at 118.

<sup>114</sup> ATM Ex. 30 at 175.

<sup>115</sup> ATM Ex. 30 at 366.

Amarillo Happy Hour <sup>116</sup>	\$60.77
Amarillo Happy Hour <sup>117</sup>	\$9.20
Amarillo Happy Hour <sup>118</sup>	\$56.81
Amarillo Happy Hour <sup>119</sup>	\$103.54
Amarillo Happy Hour <sup>120</sup>	\$87.60
Amarillo Happy Hour <sup>121</sup>	\$28.40
Waco, Damons <sup>122</sup>	\$289.05
Majestic Liquor <sup>123</sup>	\$105.27

Again, the City Intervenors argued that these expenses are never just and reasonable and should not have been included as part of the rate request.<sup>124</sup> Atmos Mid-Tex argued that the vast majority of these expenses were legitimate business expenses and that it was reasonable to include them as part of the cost of service in this case.<sup>125</sup>

Once again, the Examiners find the credibility of the filing was undermined by the inclusion of these expenses in the Mary 31, 2006, Statement of Intent filing. During the hearing several expense receipts related to alcohol purchases were presented. For example, a receipt for \$350.57 from a Centennial Liquor Store was introduced as an attachment to an expense report. Mr. Meziere, the sponsoring witness, was unable to confirm whether the abbreviation “Chard” for one case and “Mert” for another was an abbreviation for Chardonnay and Merlot. The reluctance to confirm the meaning of those abbreviations affected the credibility of the witness and confirmed that the Company’s witnesses who attested to the expenses related to SSU did not review the particulars that made up the total sum alleged to be just and reasonable.<sup>126</sup>

Mr. Meziere also stated that he was not aware of any company policy with regards to the practice of including in the expense report alcohol purchases.<sup>127</sup> Mr. Yarbrough conceded that it was certainly not appropriate to reimburse an employee for personal liquor purchases.<sup>128</sup> Nevertheless, the record reveals that several expense reports included an expense request for

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<sup>116</sup> ATM Ex. 30 at 376.

<sup>117</sup> ATM Ex. 30 at 376.

<sup>118</sup> ATM Ex. 30 at 394.

<sup>119</sup> ATM Ex. 30 at 394.

<sup>120</sup> ATM Ex. 30 at 394.

<sup>121</sup> ATM Ex. 30 at 394.

<sup>122</sup> ATM Ex. 30 at 913.

<sup>123</sup> ATM Ex. 30 at 1158.

<sup>124</sup> Tr. Vol. 11, p. 40.

<sup>125</sup> Atmos Mid-Tex Initial Brief, p. 69, Tr. Vol. 12 pp. 129 - 130.

<sup>126</sup> Tr. Vol. 2, pp. 180 - 181.

<sup>127</sup> Tr. Vol. 2, p. 181, Ins. 6 - 13 & ATM Ex. 24 at 2 & 3.

<sup>128</sup> Tr. Vol. 4, p. 208, Ins. 17 - 23.

personal liquor consumption.<sup>129</sup>

The Examiners find that evidence was never presented sufficient to support the reasonableness and necessity of these expenses that were initially included in the rate case. No evidence was presented to support the reasonableness of having captive customers pay for these alcohol expenses and there is no basis for the proposition that captive ratepayers should pay expenses associated with the alcohol expenses of the employee or a group of employees attending a happy hour.<sup>130</sup> Further, the Examiners find that the inclusion of these expenses in the rate request as filed in this case undermined the credibility of the witnesses. The fact that these were initially included taints the efficacy of the procedures Atmos Mid-Tex relied upon to rebut the assertions of the City Intervenors that this category of expenses included only reasonable expenditures.

As already noted, Atmos Mid-Tex sought not only to recover these expenses through its cost of service analysis of test year operations and maintenance expenses, Atmos Mid-Tex sought approval to capitalize a portion of those expenses and include the expense as part of rate base and recover a return on that investment. Again, the Examiners find that the credibility of the witnesses testimony is seriously undermined by their assertion that the capitalization of these expenses were just and reasonable. Accordingly, the Examiners find that the cost of service be adjusted to remove those amounts from the operations and maintenance expenses and rate base. Accordingly, the Examiners find that the cost of service be adjusted to remove those amounts from the operations and maintenance expenses and rate base.

#### 4. Lodging

The City Intervenors alleged that the initial filing contained a request for recovery of expenses associated with lodging that did not appear to be just and reasonable. Table 9.5 below summarizes some of the lodging challenged by the Intervenors in this case.

Table 9.5  
Selected Expenses Related to Lodging

Expense	Amount
Hyatt Regency Washington to attend Inauguration <sup>131</sup>	\$1,809.10 (452.58/night)
Four Seasons Hotel <sup>132</sup>	\$961.52 (one evening)
Westin Galleria, Dallas <sup>133</sup>	\$324.54

<sup>129</sup> ATM Ex. 30 at 77

<sup>130</sup> See e.g., ATM Ex. 30 at 118 and 175, happy hour event expensed at \$141.27 and \$222.10, respectively.

<sup>131</sup> ATM Ex. 24, at 2

<sup>132</sup> ATM Ex. 24, at 115 & 132

<sup>133</sup> ATM Ex. 25 at 140

Park Hyatt	\$652.66 (\$326.33/night)
Hyatt Grand Cypress, Orlando <sup>134</sup>	\$255.34
Hyatt Regency Lodging, New Orleans <sup>135</sup>	\$534.45 (178.15/night)
Hyatt Grand Cypress, Orlando <sup>136</sup>	\$265.34
Hyatt Regency, Washington D.C. <sup>137</sup>	\$490.03 (\$245.03/night)
Broadmoor Lodging Colorado Springs <sup>138</sup>	\$293.86
Houstonian	\$193.82
Pierre Four Seasons - NYC - analyst visit <sup>139</sup> - one night	\$372.02
Four Seasons - NYC - 2 nights <sup>140</sup>	\$1480.04 (\$740.02/night)
Westin Westminster - Colorado <sup>141</sup> - one night	\$277.48
Mandarin Oriental Hotel - San Francisco <sup>142</sup> - one night	\$509.32
Ritz Carlton - Marina Del Rey <sup>143</sup> - one night	\$564.37
Four Seasons - NYC <sup>144</sup> - one night	\$456.85
Ritz Carlton - Boston <sup>145</sup> - one night	\$500.76
Grand Hyatt - NYC <sup>146</sup> - one night	\$426.77
Omni Mandalay - Irving <sup>147</sup> - one night	\$357.86
Doubletree - NYC <sup>148</sup> - one night	\$483.71
Four Seasons - NYC <sup>149</sup> - one night	\$777.00
Four Seasons - NYC <sup>150</sup> - 2 nights	\$1,245.52

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<sup>134</sup> ATM Ex. 25 at 216.

<sup>135</sup> ATM Ex. 25 at 239.

<sup>136</sup> ATM Ex. 25 at 216.

<sup>137</sup> ATM Ex. 25 at 299.

<sup>138</sup> ATM Ex. 25 at 363.

<sup>139</sup> ATM Ex. 26 at 463.

<sup>140</sup> ATM Ex. 26 at 517.

<sup>141</sup> ATM Ex. 26 at 517.

<sup>142</sup> ATM Ex. 26 at 517.

<sup>143</sup> ATM Ex. 26 at 517.

<sup>144</sup> ATM Ex. 26 at 534.

<sup>145</sup> ATM Ex. 26 at 534.

<sup>146</sup> ATM Ex. 26 at 534.

<sup>147</sup> ATM Ex. 26 at 564.

<sup>148</sup> ATM Ex. 26 at 564.

<sup>149</sup> ATM Ex. 27 at 606.

<sup>150</sup> ATM Ex. 27 at 730.

Wyndham, New Orleans <sup>151</sup>	\$269.94
Wyndham, New Orleans <sup>152</sup>	\$292.21
Wyndham, Metairie <sup>153</sup>	\$404.53

The City Intervenors argued that these expenses were not reasonable and necessary and testimony was provided at the hearing alleging that those expenses were neither reasonable or necessary.<sup>154</sup> The challenge to these expenses generally fell into one of two categories. On the one hand, these City Intervenors appeared to challenge the reasonableness of inclusion of some of those expenses in the initial rate filing as simply not reasonably related to the operation of the system. For example, hotel expenses related to the inaugural do not appear to be reasonably related to the provision of natural gas service. On the other hand, the City Intervenors allege that the fee itself was exorbitant. Atmos Mid-Tex argued that the vast majority of these expenses were legitimate and has not removed many of these expenses from its rate request.

The Examiners find that Atmos Mid-Tex has not established that these expenses are just and reasonable. Certain lodging expenses simply are not necessary for the provision of natural gas service, such as travel expenses of \$199.20, related to attending a retirement party.<sup>155</sup> An expense Atmos Mid-Tex has not offered to remove. One troubling aspect of these expense reports is the fact that several of the “lodging” expenses include alcohol expenses.<sup>156</sup> For example, the \$404.53 expense for lodging Wyndham, Metairie included \$130 in alcohol related expenses.<sup>157</sup> Likewise the \$292.91 expense for Wyndham, New Orleans included \$84.75 in alcohol related expenses.<sup>158</sup> Only by examining the individual lodging receipt is this fact revealed.

This practice does not appear to be an isolated event. Examiners’ Letter No. 87 was a request for copies of several expense reports selected at random, i.e. not presented by any of the intervenors or previously filed by Atmos Mid-Tex. One expense report, not included in Table 9.6 above, included within the category of “lodging” expenses is either a restaurant or bar expense at an establishment identified as Damons in several expense reports.<sup>159</sup> Apparently, these expenses were approved for reimbursement and no change was made to the expense report. Clearly, these meal and entertainment expenses are not captured by the Company’s offer to remove expenses related to the itemized category of meals and expenses.

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<sup>151</sup> ATM Ex. 30 at 166.

<sup>152</sup> ATM Ex. 30 at 175.

<sup>153</sup> ATM Ex. 30 at 533.

<sup>154</sup> ATM Initial Brief, pp. 28 - 33, ACSC Initial Brief, pp. 75 - 77. Tr. Vol. 11, p. 16 - 28

<sup>155</sup> ATM Ex. 27, p. 632.

<sup>156</sup> ATM Ex. 30 at 166, Included in the lodging total is \$62.48 in imbedded liquor expense, ATM 30 at 175, Included in the lodging total is \$84.75 in imbedded liquor expense, and ATM 30 at 533, Included in the lodging total is \$130.00 in imbedded liquor expense and \$60.31 in meal expense.

<sup>157</sup> ATM Ex. 30 at 533, Tr. Vol. 11, pp. 40 - 41.

<sup>158</sup> ATM Ex. 30 at 175, Tr. Vol. 11, p. 41.

<sup>159</sup> Examiners Exhibit 6, at 2, 5, 16, 18, 20, and 24.

Finally, the Examiners note that one “lodging” expense for \$324.54 at Westin Galleria, Dallas, for an individual whose office location is in Dallas, was itemized by the employee as “other.” Additionally, the Examiners note that several of these expenses appeared related to investor outreach.<sup>160</sup>

The Examiners recommend that any expenses related to these expenditures be disallowed. Clearly not all lodging expenses have been reviewed. The City Intervenors established, however, that the procedures in place to ensure that only just and reasonable expenses are included are not working. Accordingly, the Examiners find that the cost of service be adjusted to remove those amounts from the operations and maintenance expenses and rate base.

## 5. Transportation

The City Intervenors alleged that the initial filing contained a request for recovery of expenses associated with transportation that did not appear to be just and reasonable. Table 9.5 below summarizes some of the transportation expenses challenged by the City Intervenors in this case.

Table 9.5  
Selected Expenses Related to Transportation

Expense	Amount
Airfare to Attend Inauguration <sup>161</sup>	\$1,468.40
Airfare to Attend Inauguration <sup>162</sup>	\$1,722.40
Airfare for spouse to attend Inauguration <sup>163</sup>	\$1,722.40
Airfare for spouse to attend AGA Conf.	\$1,722.20
Airfare for spouse to MEDA meeting. <sup>164</sup>	\$807.40
Travel to attend Funeral <sup>165</sup>	\$273.70
Airfare for spouse <sup>166</sup>	\$847.90
Airfare for spouse <sup>167</sup>	\$528.40

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<sup>160</sup> ATM Ex. 26 at 517, 534, and 564.

<sup>161</sup> ATM Ex. 24, at 2, 11 & 12.

<sup>162</sup> ATM Ex.

<sup>163</sup> ATM Ex. 25 at 176

<sup>164</sup> ATM Ex. 25 at 251.

<sup>165</sup> ATM Ex. 25 at 267. Not removed in Atmos Exhibit 49. The expense report indicates that \$439.86 was expended to attend a funeral. Expenses were identified variously as Meals & Entertainment, Transportation, Lodging, and other.

<sup>166</sup> ATM Ex. 25 at 355.

<sup>167</sup> ATM Ex. 25 at 408.

Airfare for spouse <sup>168</sup>	\$1,348.50
First Class Airfare to visit analysts <sup>169</sup>	\$873.40
Airfare to Chicago - one person <sup>170</sup>	\$1,474.78
Airfare to Nantucket - spouse <sup>171</sup>	\$1,990.90
First Class Airfare to Nantucket <sup>172</sup>	\$1,990.90
Airfare to NYC - spouse <sup>173</sup>	\$1,552.00
Airfare to West Coast <sup>174</sup>	\$2,187.60
Airfare to Nashville <sup>175</sup>	\$572.90
First Class Airfare to Boston <sup>176</sup>	\$2,018.60
First Class Airfare from Boston <sup>177</sup>	\$1,180.29
First Class Airfare to visit analysts <sup>178</sup>	\$873.40
Airfare to Chicago - one person <sup>179</sup>	\$1,474.78
Airfare to Nantucket - spouse <sup>180</sup>	\$1,990.90
First Class Airfare to Nantucket <sup>181</sup>	\$1,990.90
Airfare to NYC - spouse <sup>182</sup>	\$1,552.00
Airfare to West Coast <sup>183</sup>	\$2,187.60
Airfare to Nashville <sup>184</sup>	\$572.90
First Class Airfare to Boston <sup>185</sup>	\$2,018.60
First Class Airfare from Boston <sup>186</sup>	\$1,180.29

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<sup>168</sup> ATM Ex. 25 at 408.

<sup>169</sup> ATM Ex. 26 at 449.

<sup>170</sup> ATM Ex. 26 at 463.

<sup>171</sup> ATM Ex. 26 at 496.

<sup>172</sup> ATM Ex. 26 at 496.

<sup>173</sup> ATM Ex. 26 at 496.

<sup>174</sup> ATM Ex. 26 at 496.

<sup>175</sup> ATM Ex. 26 at 534.

<sup>176</sup> ATM Ex. 26 at 534.

<sup>177</sup> ATM Ex. 26 at 534.

<sup>178</sup> ATM Ex. 26 at 449.

<sup>179</sup> ATM Ex. 26 at 463.

<sup>180</sup> ATM Ex. 26 at 496.

<sup>181</sup> ATM Ex. 26 at 496.

<sup>182</sup> ATM Ex. 26 at 496.

<sup>183</sup> ATM Ex. 26 at 496.

<sup>184</sup> ATM Ex. 26 at 534.

<sup>185</sup> ATM Ex. 26 at 534.

<sup>186</sup> ATM Ex. 26 at 534.

Airfare to Nashville <sup>187</sup>	\$472.90
First Class Airfare to NYC <sup>188</sup>	\$1,416.90
Airfare to Santa Ana <sup>189</sup>	\$491.10
Airfare to Newark <sup>190</sup>	\$1,974.20
Limousine service between airport and hotel <sup>191</sup>	\$311.08
Airfare from Houston to Dallas - spouse <sup>192</sup>	\$199.20
Limousine service between airport and hotel <sup>193</sup>	\$234.65
Limousine service between airport and hotel <sup>194</sup>	\$134.30
Limousine service between airport and hotel <sup>195</sup>	\$134.30
Amarillo to Dallas <sup>196</sup>	\$402.80
Dallas to Amarillo <sup>197</sup>	\$756.28
Waco airfare upgrade <sup>198</sup>	\$100.00
RT - Colorado Legislative Meeting <sup>199</sup>	\$749.85

The City Intervenor argued that these expenses were not reasonable and necessary.<sup>200</sup> The challenge to these expenses generally fell into one of two categories. On the one hand, the City Intervenor appeared to challenge the reasonableness of inclusion of some of those expenses in the initial rate filing as simply not reasonably related to the operation of the system. For example, expenses associated with attending the inauguration do not appear to be related to the provision of safe and adequate natural gas service. Travel to attend an astronaut dedication or legislative meetings would appear to be precluded by Rule 7.5414.<sup>201</sup> In addition, the City Intervenor alleged that all expenses related to travel of the spouse should be removed. The City Intervenor also alleged the reasonableness of the expense on the basis of the cost, several of the expenses associated with airline travel appear to be for first class travel. From the exhibits presented at the hearing, the Examiners have been able to identify

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<sup>187</sup> ATM Ex. 26 at 552.

<sup>188</sup> ATM Ex. 26 at 564.

<sup>189</sup> ATM Ex. 26 at 564.

<sup>190</sup> ATM Ex. 27 at 606.

<sup>191</sup> ATM Ex. 27 at 606.

<sup>192</sup> ATM Ex. 27 at 606.

<sup>193</sup> ATM Ex. 27 at 664.

<sup>194</sup> ATM Ex. 27 at 732.

<sup>195</sup> ATM Ex. 27 at 732.

<sup>196</sup> ATM Ex. 30 at 1158.

<sup>197</sup> ATM Ex. 30 at 1158.

<sup>198</sup> ATM Ex. 30 at 1438.

<sup>199</sup> ATM Ex. 31 at 45.

<sup>200</sup> ATM Initial Brief, pp. 28 - 33, ACSC Initial Brief, pp. 75 - 77. Tr. Vol. 11, p. 16 - 28

<sup>201</sup> ATM Ex. 31 at 84, 91, 95, 118, 151, 198.



a total of \$24,406.80 were related to first class travel.<sup>202</sup> Atmos Mid-Tex argued that the vast majority of these expenses were legitimate and has not removed many of these expenses from its rate request. Atmos Mid-Tex agreed to remove all travel related expenses related to spouses from the expense reports that were presented at the hearing. The total amount of travel expenses related to spouses that Atmos Mid-Tex initially intended be included in the cost of service request based on the documents in evidence was approximately \$11,109.<sup>203</sup> Based on the record before the Examiners it is unclear if all of the expenses related to travel for spouses have been removed.

The Examiners find that Atmos Mid-Tex failed to establish that expenses related to travel were just and reasonable. First, several tickets appear to have been purchased that were first class tickets. Second, travel related to events such as inaugurations or other political events would be precluded by Rule 7.5414(b). Certainly, expenses related to legislative activities in Colorado do not appear to be reasonably related to the provision of natural gas service by Atmos Mid-Tex and also appear to be precluded by Rule 7.541(b). In addition, the Examiners find that other fees related to spouses should also be removed. For example, an AGA Exc. Conf. Registration Fee<sup>204</sup> that included a registration fee amount for a spouse should not have been included.

The Examiners recommend that any expenses related to these expenditures be disallowed. Atmos Mid-Tex has failed to established that the expenditures related to travel are just and reasonable. Again, the Examiners find that the credibility of the witnesses testimony is seriously undermined by their initial assertion that the capitalization of these expenses are just and reasonable. Accordingly, the Examiners find that the cost of service be adjusted to remove those amounts from the operations and maintenance expenses and rate base.

## 6. Employee Welfare

The City Intervenors alleged that the initial filing contained a request for recovery of expenses associated with employee welfare that did not appear to be just and reasonable. Table 7.1 below summarizes some of the transportation expenses challenged by the Intervenors in this case.

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<sup>202</sup> See, Examiners' SSU Exhibit 1

<sup>203</sup> Atmos Ex. 49.

<sup>204</sup> ATM Ex. 25 at 166.

Table 7.1  
Selected Expenses Related to Employee Welfare

Expense	Amount
Retirement Gift from Golfsmith <sup>205</sup>	\$1,407.24
Retirement Gift from Best Buy <sup>206</sup>	\$394.64
Retirement Gift from Wolf Camera <sup>207</sup>	\$514.94
Retirement Gift from Headroom Corp. <sup>208</sup>	\$136.00
Floral Remembrance for family death <sup>209</sup>	\$53.00
American Airlines Admiral Club Renew <sup>210</sup>	\$350.00
Remembrance <sup>211</sup>	\$225.81
National Geographic <sup>212</sup>	\$47.16
National Geographic <sup>213</sup>	\$57.70
Snack <sup>214</sup>	\$242.57
Employee Welfare <sup>215</sup>	\$2,035.50
Miscellaneous <sup>216</sup>	\$60.00
Employee Welfare <sup>217</sup>	\$215.96
Employee Welfare, Gander Mountain <sup>218</sup>	\$300
National Geographic <sup>219</sup>	\$261.54
National Geographic <sup>220</sup>	\$109.80
Internet <sup>221</sup>	\$39.95

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<sup>205</sup> ATM Ex. 25 at 149

<sup>206</sup> ATM Ex. 25 at 181

<sup>207</sup> ATM Ex. 25 at 181

<sup>208</sup> ATM Ex. 25 at 181

<sup>209</sup> ATM Ex. 25 at 275.

<sup>210</sup> ATM Ex. 25 at 275.

<sup>211</sup> ATM Ex. 25 at 307.

<sup>212</sup> ATM Ex. 30, at 77.

<sup>213</sup> ATM Exhibit 30 at 380

<sup>214</sup> ATM Exhibit 30 at 166.

<sup>215</sup> ATM Exhibit 30 at 188.

<sup>216</sup> ATM Exhibit 30 at 188.

<sup>217</sup> ATM Exhibit 30 at 188.

<sup>218</sup> ATM Exhibit 30 at 300.

<sup>219</sup> ATM Exhibit 30 at 265.

<sup>220</sup> ATM Exhibit 30 at 109.

<sup>221</sup> ATM Exhibit 30 at 542.

Employee Welfare, Things Remembered <sup>222</sup>	\$11.26
Employee Welfare, Things Remembered <sup>223</sup>	\$158.34
Supplies, Hobby Lobby <sup>224</sup>	\$48.38
Employee Welfare, Sam Moon <sup>225</sup>	\$153.28
Employee Welfare, Ducks Unlimited for Stamp Collection, Swiss Army Watch, & Luminex DU Taser Night Diver <sup>226</sup>	\$485.95
Employee Welfare <sup>227</sup>	\$25.44
Employee Welfare, Golf Headquarter <sup>228</sup>	\$140.54
Employee Welfare, Outback <sup>229</sup>	\$150.00
Employee Welfare, Newport <sup>230</sup>	\$169.94
Employee Welfare, Membership Fee – American <sup>231</sup>	\$50.00
Employee Welfare, Orvis <sup>232</sup>	\$190.00
Employee Welfare, Back Country, North Face Apex Zip Shirt <sup>233</sup>	\$51.32
Employee Welfare, Orvis, <sup>234</sup>	\$335.95
Employee Welfare, Cattle Call <sup>235</sup>	\$2,300.65
Employee Welfare, PetSmart <sup>236</sup>	\$100.04

The City Intervenors also objected to this category of expenditures. Mr. Pous who testified on behalf of the City of Dallas stated that it is not appropriate to charge gift expenses to residential and commercial customers.<sup>237</sup> Atmos Mid-Tex does not propose to remove the vast majority of expenses related to employee welfare. Atmos Mid-Tex argued that these expenses were just and reasonable and necessary to provide safe and adequate service. These

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<sup>222</sup> ATM Exhibit 30 at 542.

<sup>223</sup> ATM Exhibit 30 at 542.

<sup>224</sup> ATM Exhibit 30 at 991.

<sup>225</sup> ATM Exhibit 30 at 1067.

<sup>226</sup> ATM Exhibit 30 at 1067.

<sup>227</sup> ATM Exhibit 30 at 1313.

<sup>228</sup> ATM Exhibit 30 at 1313.

<sup>229</sup> ATM Exhibit 30 at 1313.

<sup>230</sup> ATM Exhibit 30 at 1313.

<sup>231</sup> ATM Exhibit 30 at 1313.

<sup>232</sup> ATM Exhibit 30 at 1313.

<sup>233</sup> ATM Exhibit 30 at 1313.

<sup>234</sup> ATM Exhibit 30 at 1438.

<sup>235</sup> ATM Exhibit 30 at 1438.

<sup>236</sup> ATM Exhibit 30 at 1438.

<sup>237</sup> Tr. Vol. 11, pp. 23 - 25.

expenses were not removed and Atmos Mid-Tex maintains that these expenses are just and reasonable.

The Examiners find that evidence was not sufficient to support the reasonableness and necessity of these expenses that were included in the rate case. No evidence was presented that a gift of \$300, for example, is a just and reasonable expense for the provision of natural gas service. The Examiners find that the inclusion of such exorbitant expenses seriously undermined the credibility of the filing itself and of the witnesses who sponsored the documents. Further, the Examiners find that the reluctance of Atmos Mid-Tex to remove these expenses undermines the credibility of the witnesses. In addition, once again the misclassification of these expenses undermines the procedures that the Company refers to in responding to challenges regarding the allocation of overhead charges. On several occasions employee welfare expenses which were clearly restaurant and entertainment expenses were classified as “other.”<sup>238</sup>

As already noted, Atmos Mid-Tex sought not only to recover these expenses through its cost of service analysis of test year operations and maintenance expenses, Atmos Mid-Tex sought approval to capitalize a portion of those expenses and include the expense as part of rate base and recover a return on that investment. Thus, for example, Atmos Mid-Tex proposes that the \$300 lodging expense be capitalized. As a result, approximately \$120 of that expense would be capitalized. The Examiners find that capitalizing lodging expenses related to an inaugural attendance is not just and reasonable. Again, the Examiners find that the credibility of the witnesses undermined by their assertion that the capitalization of meals of such exorbitant costs were just and reasonable. Accordingly, the Examiners find that the cost of service be adjusted to remove those amounts from the operations and maintenance expenses and rate base.

## 7. Club Dues

The City Intervenors alleged that the initial filing contained a request for recovery of expenses associated with club dues that did not appear to be just and reasonable.

The City Intervenors objected to the inclusion of any of these expenses in the rate request. Club dues fall squarely within the operation of Rule 7.5414 which clearly and unequivocally provides that funds expended in support of or membership in social, recreational, fraternal or religious clubs or organizations shall not be included.<sup>239</sup> Atmos Mid-Tex claimed they were removed all questionable expenditures by either identifying them individually or removing them.<sup>240</sup> The Examiners find that Atmos Mid-Tex is incorrect. While it is true that some group of expenses were entirely removed others were not. Certain club dues have not been removed and the Examiners recommend that they be removed from the cost of service proposal.<sup>241</sup>

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<sup>238</sup> ATM Ex. 30 at 166 and 188.

<sup>239</sup> 16 Tex. Admin. Code § 7.5414.

<sup>240</sup> Atmos Exhibit 49.

<sup>241</sup> ATM Exhibit 30 at 1 & 77.

8. Process for Capitalizing Expenses

The practice of capitalizing these expenditures poses a problem in the context of the interim rate adjustments and will be discussed in Section X, Interim Rate Adjustment Issues, Subsection I, Establishing that the Interim Rate Adjustment were Just and Reasonable, below. The Examiners note here that to the extent that a portion of these expenses were capitalized, an adjustment to rates collected pursuant to the interim rate adjustments should be made and a portion of these expenses refunded to customers.

9. Various proposed adjustments.

Staff recommended that, at a minimum shared services, operations and maintenance, and rate base reductions proposed by the Company in Atmos Exhibits 49 and 75 be adopted. Specifically, Atmos Exhibit 49 identified \$67,440 of expenditures by top Atmos executives which Staff recommends should be withdrawn. Staff also recommended that the amounts for meals and entertainment identified in Atmos Exhibit 73 should also be withdrawn. Atmos Mid-Tex identified \$282,480 associated with operations and maintenance expenses and \$78,564 associated with rate base. The total disallowance in that context would be \$428,484. The various City Intervenors who have raised these issues have not limited the proposed adjustment to the operations and maintenance expense. Instead, the issues raised form part of the overall challenge to the overhead capital included in the interim rate adjustments and the overhead capital charged by Atmos Mid-Tex. Certainly, the City Intervenors are in agreement that at a minimum the Atmos Mid-Tex proposed adjustment should be adopted and fully implemented. The Examiners agree that at a minimum these adjustments should be made and implemented. The Examiners find, however, that the adjustment proposed by Atmos Mid-Tex is insufficient. The City Intervenors have challenged all four categories of expenses used in the Company's expense reports: Meals, Entertainment, Lodging, and Other. Specific evidence was presented to establish that expenses were included in those categories that were not just and reasonable, and in some cases, plainly not allowed by Commission rule. Accordingly, the Examiners recommend that a larger adjustment be made.

10. Examiners' Recommendation

The Examiners find that the procedures that Atmos Mid-Tex implemented did not reasonably ensure that only just and reasonable expenses were included in the expense reports. In addition to the examples already discussed, expense reports for the Amarillo Cost Center provide an additional example of the infirmity of the procedures in place. First, there appear to be numerous expenses related to "employee" welfare which are not just and reasonable. There can be no argument that these expenses are necessary to provide safe and reliable service to customers. Second, there appears to be no review or analysis of the expense reports themselves. The CSC Director of that office appears to be the individual designated to review the expense report of the employees in that office.<sup>242</sup> On several occasions, however, expense reports that included meals and alcohol expenses as part of the "lodging" expense were not

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<sup>242</sup> Examiners' Exhibit 5 at 1, 15, 19, 34.

corrected.<sup>243</sup> Indeed, the expense reports of the CSC Director also contain the same error.<sup>244</sup> Those expense reports were subsequently reviewed by Senior Vice President's Dallas Office cost center and, again, they do not appear to have been corrected.<sup>245</sup> Thus, the procedures appear to indicate that the expense reports are not properly reviewed. Again, Atmos Mid-Tex relies on the procedures to respond to specific allegations regarding these expense and capitalized costs.

As was set out at the hearing, not all expense reports were reviewed. For example, not all expense reports were reviewed by Atmos Mid-Tex to ensure that travel related to spouses was removed. No effort was made to review shared services expenses that were not the subject of an RFI request.<sup>246</sup> Indeed, even in the documents admitted as evidence expenses related to the travel of spouses remain and not all of those expenses were captured. For example, at least \$115.50 of travel expenses related to spouses remained in the expense reports entered into evidence for Cost Center Dallas 1201. While this is a small amount, it is indicative of the difficulty of removing those expenses after the fact. Indeed, as no special designation is made related to the travel of spouses, the only way to remove them from the cost of service would be to either remove the entirety of the travel expenses or review each and every expense report for the test year, identify expenses related to travel of spouses, and remove those expenses. As the City Intervenors have challenged the entire category of expenses, and Atmos Mid-Tex has failed to respond, the Company has failed to meet its burden of proof with regard to those expenses.

The Examiners find, based upon the evidence discussed above, that the record unequivocally established that Atmos Mid-Tex initially sought to include expenses that were neither just or reasonable as part of its rate request. Evidence in the record also established that despite the Company's willingness to remove some of those expenses, the Company has not offered to remove all of the unreasonable expenses. The Examiners also find that the Company procedures are insufficient to review the reasonableness of expenses included. Furthermore, the Examiners find that even after the removal proposed by Atmos Mid-Tex expenses that are neither just or reasonable would be included in the Company's rate request. Accordingly, the Examiners recommend an adjustment to test-year cost of service that adjusts (1) meals and entertainment, (2) lodging, (3) miscellaneous and other employee expenses, (4) personal vehicle mile expenses, and (5) travel expense. Therefore, the Examiners recommend shared services request be adjusted by \$1,634,549. In addition, the Examiners recommend that an adjustment to rate base be made to adjust the capitalized portion of those expenditures. As will be discussed, in section X below related to interim rate adjustments

The Examiners find that the evidence with regards to the above referenced expenses reveals a breakdown of corporate control and management and a breakdown of the Company's operations and maintenance budgeting and cost control process. The evidence in the record is clear that none of the witnesses who testified reviewed the actual expenditure

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<sup>243</sup> Examiners' Exhibit 5 at 2, 5, 16, 18, 20, 24; ATM Ex. 30 at 166, 173, 175, 180, ,

<sup>244</sup> ATM Exhibit 30 at 533, 536

<sup>245</sup> ATM Exhibit 30 at 119.

<sup>246</sup> Tr. Vol. 4, p. 202, lns. 9 - 25

before the case was filed. The evidence in the record suggests that the expenses are often not reviewed in the Company budgeting and control process. Mr. Cagle testified that “based upon the Company’s compliance with Rule 7.503 and my review of Shared Services costs, I believe the overall level of Shared Services costs is representative of the going forward costs allocable to the Mid-Tex division based on the test year in this case.”<sup>247</sup>

The impact of the Examiners recommendation in this context is to reduce the overall shared services request by \$1,635,409. As these are allocated costs, this does not translate directly into a reduction to the requested rate increase of that amount. Instead, it represents a reduction to operations and maintenance expense for shared services operations and maintenance expense in the amount of \$387,290. The capitalized portion of the adjusted shared services expense is \$164,891. In addition, the Examiners recommend that the adjustment to expenses directly charged to Atmos Mid-Tex should be removed, as offered by the Company. Namely, Atmos Mid-Tex has offered to reduce operations and maintenance for direct meals and entertainment expense of Atmos Mid-Tex by \$215,244. In addition, Atmos Mid-Tex has offered to reduce the capitalized portion of those meals and entertainment expenses in the amount of \$46,416. Thus, the combined reduction to operation and maintenance and capital, as recommended by the Examiners, is \$813,844, instead of the \$428,483 proposed by Atmos Mid-Tex and Staff.

#### D. Cost Allocation of Common Costs and the Composite Allocation Factor

##### 1. Overview

Mr. Cagle described cost allocation as the process of allocating various common costs that are incurred for the benefit of two or more of the Company’s rate divisions and therefore allocable to those rate divisions.<sup>248</sup> The Company proposed to allocate to Atmos Mid-Tex allocations of common costs from Shared Services.<sup>249</sup> The operation and maintenance expenses, depreciation and taxes, other than income taxes, related to Shared Services are allocated on the Company’s ledger utilizing the allocation methodologies described in the Cost Allocation Manual (CAM) and is updated on a periodic basis.<sup>250</sup>

Atmos Mid-Tex used one of three factors to allocate the shared services costs to the various operating units:

- (1) A three-part composite allocation factor that allocates corporate costs to all of the *operating units* of Atmos Energy.
- (2) A three-part composite allocation factor that allocates corporate costs to the *utility divisions* of Atmos Energy, or
- (3) A one-part customer count factor that allocates certain customer support

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<sup>247</sup> Atmos Exhibit 40, Cagle Rebuttal, p. 4, Ins. 13 - 19.

<sup>248</sup> Atmos Exhibit 22, Cagle Direct, p. 4, Ins. 22 - 25.

<sup>249</sup> Atmos Exhibit 22, Cagle Direct, p. 5, Ins. 17 - 30.

<sup>250</sup> Atmos Exhibit 22, Cagle Direct, p. 7, Ins. 15 - 27.

functions to the utility divisions.<sup>251</sup>

The composite allocation factor (CAF) used to allocate corporate costs to operating units and utility divisions proposed by Atmos Mid-Tex is based upon a three factor formula. The first factor is a simple average of the relative percentage of gross plant in service. The second factor is the relative percentage of the average number of customers. The third factor is relative percentages of direct operations and maintenance expense for each of the Company's operating divisions.<sup>252</sup> The customer count factor (CCF) is derived based on the average number of customers of the operating division that receive allocable costs for the services provided.

The City Intervenor all take issue with the CAF as proposed by Atmos Mid-Tex. The fundamental concern of the City Intervenor is that the Company's composite factor allocates a disproportionate share of corporate overhead costs towards the regulated divisions, where recovery is more certain, and away from the unregulated entities where recovery is subject to competitive market forces.<sup>253</sup>

None of the City Intervenor take issue with the inclusion of gross plant in service as a component of the CAF.<sup>254</sup> ATM and the City of Dallas take issue with the inclusion of a factor based upon operations and maintenance expense. ACSC does not propose the removal of the operations and maintenance factor but argues that a factor reflecting operating income should be included. Table 9.7 below summarizes the various positions of the parties regarding the composite factor.

Table 9.7  
Comparison of Composition of the CAF of the Various Parties

<b>Atmos Mid-Tex</b>	<b>ACSC</b>	<b>ATM</b>	<b>City of Dallas</b>
1. Gross plant	1. Gross plant	1. Gross plant	1. Gross plant
2. Average number of customers	2. Average number of customers	2. Net operating income	2. Net operating income
3. O&M	3. O&M	3. Payroll	3. Labor
	4. Operating Income		

<sup>251</sup> Atmos Exhibit 22, Cagle Direct, p. 8, Garrett Direct, p. 58, Cagle Rebuttal p. 5, ln. 27 - p. 6, ln. 10.

<sup>252</sup> Atmos Exhibit 22, Cagle Direct, p. 8, lns. 3 - 11.

<sup>253</sup> ATM Exhibit 1, Garrett Direct, p. 59, lns. 1 - 4.

<sup>254</sup> Atmos Exhibit 40, Atmos Exhibit 40, Cagle Rebuttal, p. 6, lns. 11 - 16, ACSC Exhibit 1, Nalepa Direct, p. 9, lns. 11 - 18, ATM Exhibit 1, Garrett, pp. 58 - 65, City of Dallas Exhibit 2, Pous Direct, pp. 20 - 25.



## 2. The O&M component

Mr. Cagle argued that the relative percentage of operations and maintenance direct expense reflects cost causation attributable to a particular division. Specifically, he maintained that the level of operating and maintenance expense directly attributable to a particular division is one of the principle drivers of the level of services provided by Shared Services.<sup>255</sup> Mr. Cagle argued that utilizing direct operations and maintenance expense is representative of corporate control and management as illustrated by the Company's operations and maintenance budgeting and cost control processes. Therefore, he argued that O&M is a broader and more appropriate measure of activity than any of the alternatives proposed by ATM or the City of Dallas.<sup>256</sup>

## 3. Incorporating Operating Income

As seen in Table 9.7 above, the City Intervenors all agree that some indicia of operating income should be included in the Composite Factor. Mr. Nalepa testified that it makes sense to incorporate some recognition of the sales activities of the non-utility subsidiaries of Atmos to include some recognition of the sales activities of these units.<sup>257</sup> Mr. Pous agreed that revenue is a good indicator of the relationship between divisions.<sup>258</sup> Mr. Garrett also agreed and pointed out that the various management incentive packages are focused almost exclusively on the financial performance of the Company. Thus, inclusion of a revenue factor is essential since so much of the management direction of the company is focused on increasing revenues. He pointed out that none of the factors included in the Composite Factor recognized revenues of the Company. He concluded that when executive incentive compensation payments are based almost exclusively on corporate earnings, the absence of any consideration of earnings or income in the allocation of corporate costs is not credible.<sup>259</sup>

Mr. Cagle argued that the fact that the Company has a profitable non-regulated operation does not mean that additional costs should be allocated to that operation. He argued that the City Intervenors have not provided a correlation between operating income and a division's required level of service.<sup>260</sup> Further, he maintained that the fact that the Company has a profitable non-regulated operation does not indicate that additional costs should be allocated to that portion of the business.<sup>261</sup>

## 4. The Customer Component

Mr. Cagle testified that the need for and level of services provided by the utility is

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<sup>255</sup> Atmos Exhibit 40, Cagle Rebuttal, p. 6, lns. 17 - 28.

<sup>256</sup> Atmos Exhibit 40, Cagle Rebuttal p. 17, lns. 19 - 24.

<sup>257</sup> ACSC Exhibit 1, Nalepa Direct, p. 9, lns. 11 - 18.

<sup>258</sup> City of Dallas Exhibit 2, Pous Direct, p. 23, ln. 22 - p. 24, ln. 31.

<sup>259</sup> ATM Exhibit 1, Garrett Direct, p. 58, ln. 19 - p. 60 ln. 9.

<sup>260</sup> Atmos Exhibit 40, Cagle Rebuttal, p. 10, ln. 18 - p. 11, ln. 12; p. 17, lns. 4 - 8.

<sup>261</sup> Atmos Exhibit 40, Cagle Rebuttal, p. 16, lns. 27 - 30.

principally driven by the number of customers served by a particular operating division. Inclusion of this factor in the composite allocator ensures that common corporate costs are being assigned in reasonable relation to the divisions that generate those costs by providing the necessary functions required to serve customers.<sup>262</sup>

ATM, through the testimony of Mr. Garrett argued that the three-factor formula should not include a factor based on Customer Count, since customer-related costs are allocated separately under a different formula.<sup>263</sup> The City of Dallas argued, through the testimony of Mr. Pous, that the Company's proposal to rely on an average customer approach does not appropriately reflect the cost causation relationship relating to corporate control and management costs. He argued that the customer allocation falsely assumes that all customers have an equal effect on the need for corporate overheads. Mr. Pous also pointed out that the Commission's *Natural Gas Rate Review Handbook* provides examples of factors to be considered in a multi-factor does not include a customer factor.<sup>264</sup>

## 5. Examiners' Recommendation

Mr. Cagle argued that the fact that there is no agreed upon way to allocate common costs among the City Intervenor is indicative of the fact that there is no universally agreed upon way to allocate common costs.<sup>265</sup> The Examiners find that the City Intervenor agree that the cost allocation methodology proposed by Mr. Cagle allocates a disproportionate share of corporate overhead costs towards the regulated divisions. While the City Intervenor may not agree the precise method of remedying the perceived problem there is unanimity among the City Intervenor on that point.

The Examiners find that it is important that the allocation methodology generate cost allocations are just and reasonable. The Examiners find that the proposed cost allocation methodology that ignores operating income and revenues, ignores an important indicator of resource allocation. The proposed Composite Factor of the Company would allocate only 0.03% of costs to Atmos Energy Marketing, a non-regulated operating division of Atmos Energy and is unreasonable in light of the fact that AEM's net operating income was 11.77%.<sup>266</sup> The Examiners conclude that a Composite Factor that excludes any recognition of revenues is unreasonable and recommend that it be rejected.

Further, the Examiners find that the proposed allocator that includes operations and maintenance expenses described above is fundamentally flawed. Mr. Cagle stated that utilizing direct O& M expense is in fact more representative of corporate control and management. In light of the lack of corporate control and management of operations and maintenance expense, the Examiners recommend that the use of a Composite Factor that

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<sup>262</sup> Atmos Exhibit 40, Cagle Rebuttal, p. 7, Ins. 1 - 7.

<sup>263</sup> ATM Exhibit 1 Garrett Direct, p. 60, Ins. 1 - 9.

<sup>264</sup> City of Dallas Exhibit 2, Pous Direct, p. 22, ln. 9 - p. 24, ln. 19.

<sup>265</sup> Atmos Exhibit 40, Cagle Rebuttal, p. 8, ln. 24 - p. 9, ln. 8.

<sup>266</sup> ATM Exhibit 1, Garrett Direct, p. 59, Ins. 13 - 27.

relies on O&M be rejected in this case. The indicator would be directly affected by the inappropriate booking of operation and maintenance expenses.

The Examiners find that the Distrigas Composite Allocation factor, previously considered by this Commission in other cases, and proposed here by ATM, results in a just and reasonable allocation of shared expenses. While the decisions in GUD No. 9465 does not mandate the use of the Distrigas allocator in this case, it does indicate that the Commission has considered that allocator in the past and found it to be just and reasonable. Additionally, while the three factor formula proposed in this case was used and approved in prior cases,<sup>267</sup> the Examiners find that the facts and circumstances of this case indicate that the use of that Composite Factor in this case is not appropriate. Two of those cases were unprotested environs cases.<sup>268</sup> As noted by FERC and echoed by Mr. Cagle, just and reasonable common cost allocation methodology can vary with the cost drivers and varying circumstances of different utilities.<sup>269</sup>

E. Adjustment to Individual Cost Centers

1. Cost Center 1114 — Dallas Vice President and Controller

During the test year this cost center booked \$2,926,662. Of that amount, Atmos Mid-Tex proposed that \$1,136,716 be allocated to Atmos Mid-Tex.<sup>270</sup> Mr. Nalepa, on behalf of ACSC, argued that the cost center should be adjusted because the test year book amount is more than twice the amount in any of the three prior years. As a result, Mr. Nalepa averaged the cost center amounts for 2002 through 2004 to yield \$1,214,072 for the cost center. Mr. Nalepa applied this amount to the cost center as the booked amount. Of that amount, Mr. Nalepa recommended that \$427,535 be allocated to Atmos Mid-Tex.<sup>271</sup> Mr. Cagle testified that the proposed adjustment is inappropriate because the increase noted by Mr. Nalepa was due to an increase in costs related to an outside services expense that was specifically incurred for increased audit fees and he argued that the expense is reoccurring and constitutes a continuing obligation.<sup>272</sup>

The Examiners find that Atmos Mid-Tex failed to establish that the proposed expense booked to this account is just and reasonable. In response to the direct challenge to this expense raised by Mr. Nalepa, no evidence was provided that Mr. Cagle actually examined the individual expense invoices of this cost center or that lead to the increased amount and determined that the amounts were just and reasonable; no evidence was provided to substantiate the amount of the increase; no evidence was provided to substantiate his statement that the expense is reoccurring, or that the expense was reasonably related to the provision of natural gas service. Mr. Cagle testified that he did not have direct oversight over

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<sup>267</sup> GUD 9002-9135, 9563 and 9573.

<sup>268</sup> GUD No. 9563 & 9573.

<sup>269</sup> Atmos Exhibit 40, Cagle Rebuttal, p. 18, Ins. 8 - 10.

<sup>270</sup> Atmos Exhibit 74, Schedule WP\_F-2.2.b

<sup>271</sup> ACSC Exhibit 1, Nalepa Direct, p. 9, Ins. 1 - 10.

<sup>272</sup> Atmos Exhibit 40, Cagle Rebuttal, p. 14, Ins. 23 - 31.

the Company's accounting process and that he relied on the company's processes. Accordingly, the Examiners find that the adjustment proposed by ACSC is reasonable. Atmos Mid-Tex failed to establish that the amounts included in the cost of service schedules for this cost center were just and reasonable. In addition, the Examiners recommend that adjusted amount be adjusted further to remove inappropriate expenses as discussed above. Once those adjustments are made the allocated amounts for this cost center is \$946,610.

## 2. Cost Center 1116 — Taxation

During the test year this cost center booked \$665,996. Of that amount, Atmos Mid-Tex proposed that \$258,673 be allocated to Atmos Mid-Tex.<sup>273</sup> The Company described this cost center as being associated with management of income taxes and property and sales tax department.<sup>274</sup> Mr. Pous, on behalf of the City of Dallas, argued that the Company's management of sales tax is part of its computerized billing system and requires a minimal level of activity to manage. Thus, he assumed that one-half of the activity performed by the Company is associated with the management of federal income taxes. As such, he argued that these are investor related activities rather than customer-related activities.<sup>275</sup>

Mr. Cagle noted that Mr. Pous did not suggest eliminating deferred taxes from the Company's ratebase, which he maintains would be consistent with the proposal of Mr. Pous. He argued that if Mr. Pous is correct, accumulated deferred income taxes (ADIT) benefit only the shareholders and ratepayers, receiving no benefit, should not have ADIT included in the calculation of ratebase. He argued that this logic does not make sense and that the recommendation of the City of Dallas should be rejected. Mr. McDonald provided testimony related to the functions of this section and noted that the sections function included compliance with the Sarbanes Oxley Act of 2002.<sup>276</sup>

The Examiners find that including expenses from this cost center is reasonable. Mr. McDonald, who is the Director of Taxes for Atmos Energy Corporation and is directly involved in the provision of service from this cost center, provided testimony to support the reasonableness of the proposed allocation of \$258,673. As the director of this cost center his testimony related to its expenses are credible. The Examiners recommend that amount be approved as a component of the Company's rate request.

## 3. Cost Center 1129 — Income Tax

During the test year this cost center booked \$554,679. Of that amount, Atmos Mid-Tex proposed that \$215,437 be allocated to Atmos Mid-Tex.<sup>277</sup> The Company stated that this cost center is associated with the processing of the Company's income taxes.<sup>278</sup> Mr. Pous

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<sup>273</sup> Atmos Exhibit 74, Schedule WP\_F-2.2.b

<sup>274</sup> Atmos Exhibit 34, McDonald Rebuttal, p. 20, lns. 6 - 10.

<sup>275</sup> City of Dallas Exhibit 2, Pous Direct, p. 17, lns. 10 - 24.

<sup>276</sup> Atmos Exhibit 34, McDonald Rebuttal, p. 20, ln. 27 - p. 21, ln. 4.

<sup>277</sup> Atmos Exhibit 74, Schedule WP\_F-2.2.b

<sup>278</sup> Atmos Exhibit 34, McDonald Rebuttal, p. 20, lns. 14 - 26.

alleged that similar expenses were removed in GUD No. 9400. He argued that these are investor related activities rather than customer-related activities. Accordingly, he recommended that they be removed from the cost of service request.<sup>279</sup> Mr. Pous argued that the processing of actual income tax is an investor related activity rather than a customer-related activity. He argued that the revenue requirement is based on a hypothetical tax calculation which is relatively easy to perform. He concluded that it was inappropriate to require customers to pay rates based on a hypothetical tax basis that required minimal calculations, yet be burdened with expensive processing associated with actual tax preparation.<sup>280</sup>

Mr. Cagle argued that income taxes are a necessary and normal business expense incurred by every business. The expenses associated with the processing of income taxes should not be disallowed.<sup>281</sup> Pace McDonald, the Director of Taxes for Atmos Energy Corporation, testified that this cost center is dedicated to processing the Company's taxes in compliance with applicable federal statutes and regulations and he described the operations of this section.<sup>282</sup>

Mr. Pous' assertion that these expenses were removed from GUD No. 9400 is incorrect. While the Examiners in that case recommended that they be removed they appear to have been included in the Final Order.<sup>283</sup> The Examiners find that including expenses from this cost center is reasonable. Mr. McDonald, who is the Director of Taxes for Atmos Energy Corporation and is directly involved in the provision of service from this cost center, provided testimony to support the reasonableness of the proposed allocation of \$215,437. Once any adjustment for inappropriate expenses are made, the allocated amounts is \$176,311. The Examiners recommend this amount be approved as a component of the Company's rate request.

#### 4. Cost Center 1132 — Investor Relations

During the test year this cost center booked \$1,460,024. Of that amount, Atmos Mid-Tex proposed that \$587,073 be allocated to Atmos Mid-Tex.<sup>284</sup> Mr. Pous, on behalf of the City of Dallas, pointed out that this cost center tracks expenses associated with the Company's relationship with its shareholders.<sup>285</sup> He pointed out that similar costs were previously denied in GUD No. 9400.<sup>286</sup> He argued that the Company failed to establish that such expenses are just and reasonable. Further, Mr. Pous argued that the expenses are exclusively for the benefit of shareholders and not for the purpose of providing safe and reliable service to customers.<sup>287</sup>

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<sup>279</sup> City of Dallas Exhibit 2, Pous Direct, p. 16, ln. 24 - p. 17, ln. 9

<sup>280</sup> City of Dallas Exhibit 2 Pous Direct, p. 17, ln. 1 - 9.

<sup>281</sup> Atmos Exhibit 40, Cagle Rebuttal p. 26, lns. 1 - 17.

<sup>282</sup> Atmos Exhibit 34, McDonald Rebuttal, p. 20, lns. 13 - 26.

<sup>283</sup> Schedule L-4(d).

<sup>284</sup> Atmos Exhibit 74, Schedule WP\_F-2.2.b

<sup>285</sup> City of Dallas Exhibit 2, Pous Direct, p. 16, lns. 1 - 5.

<sup>286</sup> GUD No. 9400 at page 82.

<sup>287</sup> City of Dallas Exhibit 2, Pous Direct, p. 16, lns. 7 - 8.

Mr. Garrett, on behalf of ATM, agreed that these expenses should be removed because they are investor related costs.<sup>288</sup> Finally, the State of Texas alleged that Atmos Mid-Tex failed to meet its burden of proof.<sup>289</sup>

Mr. Cagle argued that Atmos is a public company and that the Company's operations are funded by both equity and debt. Shareholders provide necessary investment in the Company and the funds from those investments are utilized to provide service to the Company's customers. To arbitrarily exclude costs incurred to maintain the Company's equity funding, which is for the benefit of ratepayers is inconsistent with implementing a just and reasonable cost allocation methodology.<sup>290</sup> One of their main duties is making sure that shareholders have the information that they need, have the dividends paid to them and determining the distribution of shares. The reason none of these expenses are taken below the line is it is work in order to have shareholders.<sup>291</sup>

The Examiners recommend that expenses related to this cost center be removed from the revenue request of the company. Similar costs have previously been denied by the Commission in GUD No. 8664<sup>292</sup> and GUD No. 9400 and the Company has not established that expenses related to this cost center are for the purpose of providing safe and reliable service to customers. In response to the direct challenge to this expense raised by Mr. Garrett and Mr. Pous, no evidence was provided that Mr. Cagle actually examined the individual expense invoices of this cost center or determined if the amount of the allocation was just and reasonable. Mr. Cagle previously testified that he did not have direct oversight over the Company's accounting process and that he relied on the Company's processes.

##### 5. Cost Center 1203 — Amarillo Waco Call Center

During the test year this cost center booked \$12,989,616. Of that amount, Atmos proposed that \$6,289,779 be allocated to Atmos Mid-Tex.<sup>293</sup> Mr. Nalepa, on behalf of ACSC, and Mr. Pous, on behalf of ATM, recommended an adjustment to this cost center. Mr. Nalepa and Mr. Pous testified that the Amarillo Customer Support Center actually serves all of the Atmos Divisions except Atmos Mid-Tex. That is, Atmos Mid-Tex is not served by this call center. Nevertheless, he pointed out that Mr. Cagle, who testified on behalf of Atmos Mid-Tex, sought to allocate over six million dollars in expenses to the customers served by the Atmos Mid-Tex Division. Mr. Pous pointed out that Mr. Cagle admitted that the Amarillo call center only provided overflow call handling for the Atmos Mid-Tex division during peak period. Despite this assertion, however, Mr. Pous pointed out that Mr. Cagle could not identify any values associated with the volume of calls handled.<sup>294</sup> Mr. Nalepa and Mr. Pous noted, however, that the Waco Customer Support Center, Cost Center 1210 is used almost

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<sup>288</sup> ATM Exhibit 1, Garrett Direct, p. 68, Ins. 12 - 18.

<sup>289</sup> State Initial Brief, p. 7.

<sup>290</sup> Atmos Exhibit 40, Cagle Rebuttal, p. 25, Ins. 1 - 10.

<sup>291</sup> Tr. Vol. 4, p. 65, Ins. 1 - 20.

<sup>292</sup> GUD No. 8664, FOF No. 49.

<sup>293</sup> Atmos Exhibit 74, Schedule WP\_F-2.2.b

<sup>294</sup> City of Dallas Exhibit 2, Pous Direct, p. 14, Ins. 19 - 20.

exclusively by Atmos Mid-Tex.<sup>295</sup> Therefore, they recommended that 100% of those costs be allocated to Atmos Mid-Tex.

In response to the issues raised by Mr. Pous and Mr. Nalepa, Mr. Cagle argued that it should not be assumed that the Waco call center functions independently of other corporate service functions.<sup>296</sup> The call centers are designed with capabilities to receive calls from customers in any of the Company's twelve states.<sup>297</sup> He also argued that the Waco call center receives management support and guidance from the customer support management team located in the Amarillo call center.<sup>298</sup> Finally, Mr. Cagle argued that Mr. Pous and Mr. Nalepa failed to take several post-test year changes into account. Specifically, he argued that the Waco call center was only in operation during half of the test-year and shared service expense should be updated to reflect that change and changes to labor.<sup>299</sup>

Except for the generalized statement of Mr. Cagle that the Amarillo Call Center provided guidance, the only evidence in the record that the Amarillo office provided any support to Atmos Mid-Tex is the Company's analysis that out of over three million calls taken in the Amarillo call center during the test year, only 1,112, or approximately .037%, were classified as Atmos Mid-Tex calls.<sup>300</sup> On that basis, Atmos Mid-Tex proposed to allocate \$6,289,779 to Atmos Mid-Tex. The Examiners find that the proposal by Atmos Mid-Tex is not just and reasonable. Mr. Meziere, a witness for Atmos Mid-Tex, conceded that the amount of calls handled by the Amarillo Call Center was negligible. Of course, another option would be to base the allocation of the cost on the number of phone calls from each division.<sup>301</sup> Based on the record, however, this would result in a negligible allocation from the Amarillo call center.

The Examiners recommend that expenses related to this cost center should be removed from the revenue request of the company. Further, the Examiners recommend that the proposed adjustment to the Waco call center that Mr. Cagle proposed in response to the proposal of ACSC and the City of Dallas be rejected. No evidence was provided that Mr. Cagle actually examined the actual expenses of the Waco call center to determine if the amount of the allocation was just and reasonable. Mr. Cagle previously testified that he did not have direct oversight over the Company's accounting process and that he relied on the company's processes. The record reveals that he did not examine individual expenses or invoices.

#### 6. Cost Center 1350 – Dallas Non-Utility Operations

During the test year this cost center booked \$1,025,386. Of that amount Atmos

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<sup>295</sup> City of Dallas Exhibit 2, Pous Direct, p. 14, ln. 10 - p. 15, ln. 10, Nalepa Direct, p. 10, lns. 6 - 18.

<sup>296</sup> Atmos Exhibit 40, Cagle Rebuttal, p. 11, lns. 19 - 20.

<sup>297</sup> Atmos Exhibit 40, Cagle Rebuttal, p. 12, lns. 9 - 12.

<sup>298</sup> Atmos Exhibit 40, Cagle Rebuttal, p. 12, lns. 4 - 14.

<sup>299</sup> Atmos Exhibit 40, Cagle Rebuttal, p. 12, ln. 15 - 27

<sup>300</sup> ATM Exhibit 29.

<sup>301</sup> ATM Exhibit 2, Arndt Direct, p. 64, lns. 16 - 19.

proposed that \$398,260 be allocated to Atmos Mid-Tex.<sup>302</sup> The City of Dallas and ATM argued that expenses associated with Cost Center 1350, Non-Utility Operations, should not be allocated to Atmos Mid - Tex.<sup>303</sup> The cost center accumulates the costs of Mark Johnson, Senior Vice President of Non-Utility operations.<sup>304</sup>

Mr. Pous, on behalf of the City of Dallas, noted the Company's position that this cost center is associated with the Senior Vice President for Non-Utility Operations and that the cost center was used solely for the purpose of capturing costs relating to "Management Committee activities." The primary focus of the Management Committee is to make "organizational decisions."<sup>305</sup> Mr. Pous, recommended excluding the entire amount of the Non-Utility Operations division because that office is not there on behalf of the regulated customers. Mark Johnson is there, by definition, on behalf of non-utility operations.<sup>306</sup> Mr. Garrett, on behalf of ATM, agreed that expenses related to non-utility operations should not be charged to utility operating expense.<sup>307</sup> ATM pointed out that at the hearing, Mr. Cagle indicated that Mr. Johnson's work on the management committee entailed about one conference call a week.<sup>308</sup>

Atmos Mid-Tex argued that the title provided to this cost center is a misnomer that does not indicate the true contribution to the operations of the utility made by Mr. Johnson. Mr. Cagle testified that as a member of the management committee, Mr. Johnson not only represents the Company's non-utility operations, but he is a part of the team that makes decisions for the entire corporation, including the Atmos Mid-Tex Division.<sup>309</sup>

The Examiners find that no evidence was produced to justify the expense that Atmos Mid-Tex seeks to allocate to the residential and commercial customers of Atmos Mid-Tex. The Examiners find that based upon the evidence in the record, Mr. Johnson's attendance at the meetings is not for the benefit of the residential and commercial customer and that it does not contribute to the provision of safe and reliable service. Furthermore, based on the evidence in the record it is not reasonable to allocate \$389,260 to a division for work on a committee that entails on average one conference call a week. Even assuming that Mr. Johnson attended a meeting every week of the test year, Mr. Cagle did not offer any specific statement as to the benefit derived from \$7,000 that each meeting cost rate payers. No evidence was provided that Mr. Cagle actually examined the actual expenses of this cost center to determine if the amount of the allocation was just and reasonable. Mr. Cagle previously testified that he did not have direct oversight over the Company's accounting process and that he relied on the Company's processes. Accordingly, the Examiners recommend that the entire proposed allocation be removed from the revenue request.

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<sup>302</sup> Atmos Exhibit 74, Schedule WP\_F-2.2.b

<sup>303</sup> City of Dallas Initial Brief, pp. 37 - 38, ATM Initial Brief, p. 18.

<sup>304</sup> Atmos Exhibit 40, Cagle Rebuttal, p. 15, Ins. 1 - 15.

<sup>305</sup> City of Dallas Exhibit 2, Pous Direct, p. 17, ln. 25 - p. 18, ln. 5.

<sup>306</sup> City of Dallas Exhibit 2, Pous Direct, p. 18, Ins. 6 - 17.

<sup>307</sup> ATM Exhibit 1, Garrett Direct, p. 68, Ins. 9 - 10.

<sup>308</sup> Tr. Vol. 12, p. 31, Ins. 16 - 22.

<sup>309</sup> Atmos Exhibit 40, Cagle Rebuttal, p. 25, Ins. 11 - 30 & p. 25, Ins. 11 - 30.



7. Cost Center 1904 – Dallas Supplemental Executive Benefit Plan

During the test year this cost center booked \$3,192,964. Of that amount, Atmos Mid-Tex proposed that \$1,269,842 be allocated to Atmos Mid-Tex.<sup>310</sup> Mr. Pous pointed out that this cost center included the cost of the management incentive plan and variable payment plan. Mr. Pous pointed out that the goal, as set out by the plan, was to advance the interest of the shareholders and the Company: Increase total shareholder return, return on assets, and equity, increase profit levels, cash flow and cash flow return on investment, increase economic profit, and earnings per share. The last item included in the plan was to improve measures of customer satisfaction and customer service as surveyed from time.<sup>311</sup> Mr. Pous concluded that as the main focus of the plan is directly related to shareholder benefit captive customers should not bear the costs of that cost center. Mr. Garrett, on behalf of ATM, also pointed out that these amounts should be removed because the stated goals of each of the plans and the measurement criteria are overwhelmingly based on financial performance measures designed to increase earnings.<sup>312</sup>

Mr. Yarbrough argued that there is no division between shareholders and ratepayers and that utility executives are not in a position of favoring one group over another. Shareholder profits are merely a byproduct of providing superior service to ratepayers. Mr. Yarbrough conceded that other utilities treat executive incentive costs as a below-the-line item. On the other hand, Mr. Yarbrough pointed out that Atmos is recovering incentive and executive expenses through rates in Virginia and Colorado. Regardless of the treatment in other jurisdiction, Mr. Yarbrough testified that the Commission should base its decision on the basis of the plans that are before it.<sup>313</sup>

The Examiners find that Atmos Mid-Tex failed to establish that the proposed expense booked to this account is just and reasonable. No evidence was provided that Mr. Cagle actually examined the invoices to determine that the amounts charged to this cost center were just and reasonable even after it was challenged by the City of Dallas. Further, from the evidence in the record it appears that the incentive compensation plans of Atmos Mid-Tex are driven by Company earnings.<sup>314</sup> Accordingly, the Examiners recommend that these expenses be removed from the cost of service request.

8. Cost Center 1905 – Outside Director Retirement Cost

During the test year this cost center booked \$1,282,641. Of that amount, Atmos Mid-Tex proposed that \$498,178 be allocated to Atmos Mid-Tex.<sup>315</sup> Mr. Garrett argued that the additional costs for non-employee members of the board of directors should be borne by the

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<sup>310</sup> Atmos Exhibit 74, Schedule WP\_F-2.2.b

<sup>311</sup> City of Dallas Exhibit 2, Pous Direct, p. 19, lns. 5 -22.

<sup>312</sup> ATM Exhibit 1, p. 24, ln. 24 - p. 30, ln. 11.

<sup>313</sup> Atmos Exhibit 30, Yarbrough Rebuttal, pp. 61 - 63.

<sup>314</sup> ATM Exhibit 42, Tr. Vol. 2, p. 13, ln. 17 - p. 14, ln. 13

<sup>315</sup> Atmos Exhibit 74, Schedule WP\_F-2.2.b

shareholders. They are not necessary costs for the provision of utility service.<sup>316</sup> In its Initial Brief, Atmos argues that outside directors help guide the direction of the entire corporation, including the Mid-Tex Division. Although Atmos Mid-Tex cites to Mr. Cagle, no evidence was presented in the hearing to support this contention.<sup>317</sup>

The Examiners find that no evidence was produced to justify the expense that Atmos Mid-Tex seeks to allocate to the residential and commercial customers of Atmos Mid-Tex.

These expenses are not necessary to the provision of utility service. Accordingly, the Examiners recommend that the entire proposed allocation be removed from the revenue request.

9. Cost Center 1908 – Dallas Supplemental Employee Benefits.

During the test year this cost center booked \$7,870,315. Of that amount, Atmos Mid-Tex proposed that \$3,130,024 be allocated to Atmos Mid-Tex.<sup>318</sup> Cost Center 1908 represents expenses related to the Dallas Supplemental Executive Benefit Plan. Mr. Pous argued that like Cost Center 1904, the main purpose of this expense is to ensure performance for shareholders. Accordingly, Mr. Pous is of the opinion that expenses related to this cost center should not be assigned to captive customers.<sup>319</sup>

Mr. Yarbrough argues that there is no division between shareholders and ratepayers and that utility executives are not in a position of favoring one group over another. Shareholder profits are merely a byproduct of providing superior service to ratepayers. Mr. Yarbrough conceded that other utilities treat executive incentive costs as a below-the-line item. On the other hand, Mr. Yarbrough pointed out that Atmos is recovering incentive and executive expenses through rates in Virginia and Colorado. Regardless of the treatment in other jurisdiction, Mr. Yarbrough testified that the Commission should base its decision on the basis of the plans that are before it.<sup>320</sup>

As with the expenses related to Cost Center 1904, the Examiners find that Atmos Mid-Tex failed to establish that the proposed expense booked to this account is just and reasonable. No evidence was provided that Mr. Cagle actually examined the invoices to determine that the amounts charged to this cost center were just and reasonable even after it was challenged by the City of Dallas. Mr. Cagle previously testified that he did not have direct oversight over the Company's accounting process and that he relied on the company's processes. The record reveals that he did not examine individual expenses or invoices. Further, as noted by Atmos Mid-Tex, the Commission should base its determination based upon the plan before it. From the evidence in the record it appears that the incentive

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<sup>316</sup> ATM Exhibit 1, Garrett Direct, p. 68, Ins. 10 - 11.

<sup>317</sup> Initial Brief of Atmos Mid-Tex, p. 141. Citation to Cagle Rebuttal, Atmos Exh. 40 at 28 Ins. 29 - 31 provides no evidence as to the alleged function provided by this cost center in support of the provision of natural gas service.

<sup>318</sup> Atmos Exhibit 74, Schedule WP\_F-2.2.b

<sup>319</sup> City of Dallas Exhibit 2, Pous Direct, p. 19, ln. 25 - p. 20, ln., 13.

<sup>320</sup> Atmos Exhibit 30, Yarbrough Rebuttal, pp. 61 - 63.

compensation plans of Atmos Mid-Tex are driven by Company earnings.<sup>321</sup> Accordingly, the Examiners recommend that these expenses be removed from the cost of service request.

- F. Adjustment to the allocation factors applied to Cost Center 1109, 1115, 1148, 1151, and 1200.

During cross examination of Mr. Cagle, it became apparent that the allocation factor of certain cost centers changed between the Statement of Intent Filing made on May 31, 2006, and the revised schedules filed on November 13, 2006.<sup>322</sup> While this issue was noted in the briefs a request to change the allocation was specifically not addressed in either the briefs or the testimony. Nevertheless, schedules attached to the particular witnesses for the City Intervenor recommended a change to the allocation factor proposed and the Examiners will address the proposed changes.

1. Cost Center 1109 – Dallas Payment Applications.

The Statement of Intent schedules indicated that these would be allocated using a composite allocation factor. The adjusted exhibit indicated that it would be allocated based instead upon a customer factor. The City Intervenor each recommended a composite allocation factor. Atmos Mid-Tex did not indicate the basis for the proposed change or provide testimony in support of the change.<sup>323</sup> He did not explain how the change provided a more accurate allocation of costs. Accordingly, the Examiners recommend that it be allocated as originally filed using the composite allocation factor.

2. Cost Center 1115 – Dallas Billing Services

The Statement of Intent schedules indicated that these would be allocated using a customer factor. The adjusted exhibit indicated that 100% would be allocated to Atmos Mid-Tex. ACSC and ATM recommended the use of a customer factor. On the other hand, the City of Dallas agreed that 100% should be allocated to Atmos Mid-Tex. During cross examination Mr. Cagle explained the error was due to inadvertence. He also provided the rationale for allocating 100% of the expenses to Atmos Mid-Tex. He explained that the duties of the cost center included review of bill exceptions, review of tax rates, review of a PGA rate change, and noted that the cost center serves only Atmos Mid-Tex.<sup>324</sup> The Examiners find that the proposed allocation is just and reasonable based upon the evidence in the record.

3. Cost Center 1148 – Dallas Revenue Support

The Statement of Intent schedules indicated that these costs would be allocated using a composite allocation factor. The adjusted exhibit indicated that it would be allocated based upon a customer factor. ACSC and ATM each agreed that it should be allocated as a

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<sup>321</sup> ATM Exhibit 42, Tr. Vol. 2, p. 13, ln. 17 - p. 14, ln. 13

<sup>322</sup> Tr. Vol. 4, pp. 60 - 86, ATM Exhibit 45.

<sup>323</sup> Tr. Vol. 4, p. 55, ATM Exhibit 45.

<sup>324</sup> Tr. Vol. 4, p. 60, ln. 10 - p. 61, ln. 11.

customer factor. On the other hand, the City of Dallas proposed that it be allocated as a composite allocation factor. Atmos Mid-Tex did not indicate the basis for the proposed change or provide testimony in support of the change.<sup>325</sup> Mr. Cagle did not explain how the change provided a more accurate allocation of costs. Accordingly, the Examiners recommend that it be allocated as originally filed using the composite allocation factor.

4. Cost Center 1151 – Dallas Accounting Director

The Statement of Intent schedules indicated that these costs would be allocated on the basis of a 100% to Atmos Mid-Tex and the Company did not change this in the updated filing. ACSC indicated that it should be allocated through a customer factor. The City of Dallas and ATM agreed that it should be allocated 100% to Atmos Mid-Tex. During the hearing this allocation factor was briefly discussed.<sup>326</sup> As no change was proposed the Examiners find that Atmos Mid-Tex has established that the proposed allocation is just and reasonable.

5. Cost Center 1200 – Customer Revenue Collections

The Statement of Intent schedules indicated that these would be allocated using a composite allocation factor. The adjusted exhibit indicated that it would be allocated based upon a customer factor. The City Intervenors each recommended retention of the composite allocation factor. Atmos Mid-Tex did not indicate the basis for the proposed change or provide testimony in support of the change.<sup>327</sup> Mr. Cagle did not explain how the change provided a more accurate allocation of costs. Accordingly, the Examiners recommend that it be allocated as originally filed using the composite allocation factor.

G. Payroll Adjustment

The Company proposed an adjustment to SSU labor.<sup>328</sup> At the time the Company filed its Statement of Intent on May 31, 2006, the Company estimated that labor should be increased by \$6,076,238 for labor expenses and \$2,043,976 for benefit expenses. On November 13, 2006, those figures were adjusted and reduced to \$5,203,765, for labor, and \$1,765,128, for benefits. ACSC, ATM and the State of Texas object to this adjustment.

The State alleges that Mid-Tex has not met its burden with regards to this adjustment.<sup>329</sup> Mr. Nalepa, on behalf of ACSC argued that the adjustments were not known and measurable and should not be included in rates. He argued that shared services labor should be adjusted to \$2,132,377 and shared services expenses should be reduced to \$783,497.<sup>330</sup>

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<sup>325</sup> Tr. Vol. 4, p. 67, ATM Exhibit 45.

<sup>326</sup> Tr. Vol. 4, pp. 68 - 69

<sup>327</sup> ATM Exhibit 45.

<sup>328</sup> Atmos Exhibit 22, Cagle Direct, p. 11, Ins. 15 - 16, WP 2.2.a

<sup>329</sup> State Initial Brief, p. 6.

<sup>330</sup> ACSC Exhibit 1, Nalepa Direct, p. 11, Ins. 5 - 19.

Mr. Pous, on behalf of the City of Dallas, recommended that the request for an adjustment for unfilled positions be denied. First, he argued the Commission has previously denied a similar request in GUD No. 8033. He argued that the Atmos Mid-Tex has filled only a few of the 118 unfilled positions. Further, he alleged that the Company had failed to comply with the matching principle required for ratemaking purposes. Specifically, the Company seeks to raise the revenue requirement for its expectations up to one year beyond the end of the test year. Finally, Mr. Pous argued that the proposed merit increases should be denied as the same category of expenses have been previously denied by the Commission.<sup>331</sup>

In response to these assertions, Mr. Cagle testified that the merit increases have already happened and it is therefore known and measurable. While the increase percentage presented in the Company's filing package was the budgeted percentage for merit increases for 2006, the actual merit increase for Shared Services was 2.87% of total Shared Services Payroll. Accordingly, Mr. Cagle alleged that this was a known and measurable change. Likewise, the labor adjustment is also known and measurable. He testified that he reviewed the Company's Human Resources department data from May 1, 2006 through September 30, 2006 and noted that 119 positions had been filled. Accordingly, he updated the request to reflect the known and measurable changes.<sup>332</sup>

The Examiners find that Atmos Mid-Tex has established that this is a known and measurable change. Accordingly, the Examiners recommend that the revised adjustment requested by Atmos Mid-Tex be approved.

## X. INTERIM RATE ADJUSTMENT ISSUES

### A. Interim Rate Adjustments: Overview of the Statute and Regulations

In 2003, the Texas Legislature enacted section 104.301 of the Gas Utility Regulatory Act as part of a new Subchapter G to the Texas Utilities Code.<sup>333</sup> Although the statute is commonly referred to as the Gas Reliability Infrastructure Program (GRIP) those terms do not appear in the enabling legislation or statute itself. Nevertheless, the term was used during hearings on the bill that ultimately enacted the statute and reflect an important component of the legislative intent behind the statute. Namely, the statute was enacted to encourage gas utilities to make system improvements.<sup>334</sup> The provisions of this section function in concert with the prior provisions of GURA. The principal procedural mechanism by which utilities may increase rates remains unchanged. Those provisions provide that a gas utility may not

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<sup>331</sup> City of Dallas Exhibit 2, Pous Direct, p. 26, ln. 19 - p. 28, ln. 12.

<sup>332</sup> Atmos Exhibit 22, Cagle Direct, p. 26, ln. 22 - p. 27, ln. 16.

<sup>333</sup> Tex. S.B. No. 1271, 78<sup>th</sup> Leg. R.S. (2005) & Tex. Util. Code Ann. § 104.301 and amended, Tex.H.B. 872, 79<sup>th</sup> Leg. R.S. (2005)..

<sup>334</sup> As set out in the enabling legislation, it was referred to as "an act relating to encourage gas utilities to invest in new infrastructure." See also, Hearing on H.B. 1942, Before the House Committee on Regulated Industries, 78<sup>th</sup> Leg.R.S. (March 25, 2003)

increase its rates unless the utility files a statement of its intent to increase rates with the regulatory authority that has original jurisdiction over those rates.<sup>335</sup> Concurrently, the gas utility must provide public notice of intent to increase rates.<sup>336</sup> The statement of intent filed pursuant to section 104.102, of Subchapter C of Chapter 104 of the Texas Utilities Code initiates the regulatory procedure through which rate increases are implemented. Those cases will be referred to herein as a Subchapter C rate case.

Section 104.301 did not eliminate the statement of intent requirement nor did it remove the procedures of Subchapter C as the central mechanism by which a utility increases its rates. The first sentence of section 104.301, references Subchapter C rate cases. Instead, the statutory provision provided a mechanism through which certain utilities could increase rates between Subchapter C rate cases. As the title of section 104.301 provides, the new provision was intended to provide an *interim* cost recovery and rate adjustment mechanism. Accordingly, certain gas utilities may implement the interim cost recovery and rate adjustment through a tariff, rate schedule, or annual adjustment. After the interim rates have been implemented the gas utility that implemented the interim adjustment must file a Subchapter C rate case before the "fifth anniversary of the date on which the tariff or rate schedule takes effect."<sup>337</sup>

Therefore, section 104.301 created a mechanism through which a utility may begin the recovery of new investment made after a Subchapter C rate case but prior to initiating its next Subchapter C rate case. Pursuant to this statute a gas utility may file a tariff or rate schedule for an adjustment to its rates to recover the cost of new investment made by a utility since the point in time of its last comprehensive rate case. It allows a gas utility to surcharge its customers each year for return on investment, depreciation expense, and associated tax impact related to the annual change in the value of invested capital of the utility. The amounts collected through the surcharge are subject to refund pending review of the investment on which the surcharge is calculated. The review is to be performed in the next rate proceeding after implementation of the interim surcharge. Specifically, any utility that applies for an interim rate adjustment is required to file a Statement of Intent, providing a comprehensive cost of service analysis within five years.<sup>338</sup> On December 24, 2004, the Commission amended 16 TEX. ADMIN. CODE § 7.7115 and adopted new 16 TEX. ADMIN. CODE § 7.101 to implement Texas Utilities Code, § 104.301.

The scope of an interim rate request pursuant to section 104.301 is more limited than the scope of Subchapter C rate case. The interim adjustment allowed by the act is intended to recover only the cost of "changes in the investment in service for gas utility services."<sup>339</sup> As specifically set out in the statute, a gas utility is entitled to adjust the utility's rates upward or downward under the interim tariff or schedule based upon the incremental changes in

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<sup>335</sup> Tex. Util. Code Ann. § 104.102(a).

<sup>336</sup> Tex. Util. Code Ann. § 104.103.

<sup>337</sup> Tex. Util. Code Ann. § 104.301(h).

<sup>338</sup> Tex. Util. Code Ann. § 104.301.

<sup>339</sup> Tex. Util. Code Ann. § 104.301(a)

invested capital from one year to the next.<sup>340</sup> While the parties are at odds as to the meaning of "changes in investment," to be addressed below, all parties appear to agree that section 104.301 does not apply, for example, to changes in operations and maintenance expense accounts. Accordingly, the gas utility may only adjust the rates under the tariff or rates schedule in five areas:

- ▶ Return on Investment
- ▶ Depreciation Expense
- ▶ Ad Valorem Taxes
- ▶ Revenue Related Taxes
- ▶ Incremental Federal Income Taxes

It is in these five areas that the gas utility's cost of providing service will be affected by a change in investment. Thus, for example, during the first interim rate adjustment following the comprehensive rate case, the allowed adjustment is based on the difference between the gas utility's invested capital at the end of the rate case test-year and the invested capital and the end of the calendar-year following the end of the rate case test-year.

The procedural requirements of section 104.301 are not as extensive as the procedural requirements of a Subchapter C rate case. When a utility applies for an interim rate adjustment, it is not required to submit a comprehensive rate package demonstrating the reasonableness of its costs of service. Further, the proceedings pursuant to section 104.301 are not a contested case as that term is defined in the Texas Administrative Procedures Act.<sup>341</sup>

Indeed, the Travis County District Court has recently held that the Texas Legislature did not intend to provide for a substantial review of the interim adjustment in the tariff and rate schedules made by utilities pursuant to section 104.301. The court held further that the review conducted by regulatory authority is a ministerial review of the interim adjustment filings for compliance with the statute.<sup>342</sup> The adjudicative hearing takes place at the time of the Subchapter C rate case filed subsequent to the initial interim rate adjustment request made by the utility.<sup>343</sup>

The statute also requires a gas utility that seeks an interim rate adjustment to file two separate reports. First, the utility must file an annual report.<sup>344</sup> The annual report must include the following items.

- ▶ A description of the investment projects completed and placed in service

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<sup>340</sup> Tex. Util. Code Ann. § 104.103(b).

<sup>341</sup> Tex. Gov't Code Ann. § 2001.003(a). "'Contested case' means a proceeding, including a ratemaking or licensing proceeding, in which the legal rights, duties, or privileges of a party are to be determined by a state agency after an opportunity for adjudicative hearing."

<sup>342</sup> *The Cities of Allen, et al. v. Railroad Commission of Texas, et al.*, No. D-1-GV-05-005221 (53<sup>rd</sup> Dist. Ct., Travis County, Tex. September 21, 2006).

<sup>343</sup> The Examiners are interpreting the statute in a manner consistent with the order issued by the final court. The Examiners' statements are not to be viewed as a change in the Commission's position in the court proceedings. They are, instead, a recognition of the effect of the Court's determination.

<sup>344</sup> Tex. Util. Code Ann. 104.301(e)

- ▶ during the preceding calendar year,
- ▶ Investments retired or abandoned during the preceding calendar year,
- ▶ The cost need and customers benefitted by the change in investment.

Second, the gas utility must file an annual earnings monitoring report.<sup>345</sup> The earnings monitoring report is intended to identify the utility's earnings during the preceding calendar year. If the gas utility is earning a return on invested capital of more than 75 basis points above the return established in the last Subchapter C rate case, the gas utility must file a statement with the earnings monitoring report stating the reasons why the rates are not unreasonable or in violation of law. Prior to the filing of this case, Atmos Mid-Tex made three filings pursuant to section 104.301.

B. Overview of the Interim Rate Adjustment Filings made by Atmos Mid-Tex.

Atmos Mid-Tex filed its interim rate adjustments pursuant to Texas Utilities Code § 104.301 in 2003, 2004, and 2005. Municipalities, of course, have exclusive original jurisdiction over the rates, operations, and services of a gas utility within the municipality.<sup>346</sup> In 2003, 2004, and 2005, Atmos Mid-Tex filed its interim rate adjustment within various municipal jurisdictions. Those filings were denied by the various jurisdiction and Atmos Mid-Tex filed an appeal with the Commission.<sup>347</sup> The Commission approved the interim rate adjustment filings made by Atmos Mid-Tex in those cases and an appeal of the Commission's decision was subsequently filed in the Travis County district court. On September 21, 2006, the District Court held, in part, that a utility does not have the authority to appeal a denial of a filing by a municipality to the Railroad Commission of Texas.

The Court made several findings. First, the Texas legislature did not intend to provide for a substantial review of the interim adjustment in the tariff and rate schedules made by utilities pursuant to Section 104.301. Second, the Legislature's contemplated remedy for a regulatory authority to contest an interim rate adjustment filing is to bring a full rate case based upon the initial filing and/or any annual filings required by the utility. Third, the Court held that the Railroad Commission exceeded its statutory authority by enacting its Rule 7.7101(g)(2)(b) and (g)(2)(c). Accordingly, the Court held that those provisions are void. Fourth, the Court held that municipalities exercising their original jurisdiction do not have authority to deny filings under Section 104.301 of the TUC, but may only conduct a ministerial review of the interim adjustment filings. Fifth, as already noted, a utility does not have the authority to appeal a denial of a filing by a municipality to the Railroad Commission of Texas. Sixth, section 104.301 does not provide municipalities with a full adjudicative hearing at the Commission. The Court did not address the threshold issue raised in this case regarding the applicability of section 104.301.

C. Atmos Mid-Tex's Eligibility to File Interim Rate Adjustments.

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<sup>345</sup> Tex. Util. Code Ann. 104.301(f) & (g).

<sup>346</sup> TUC 103.021

<sup>347</sup> In 2003, those appeals were docketed as follows: GUD Nos. 9598, 9599, 9603, 9606, 9611, 9585, 9588, 9590, 9594, 9596, & 9598. In 2004, those appeals were docketed as follows: GUD Nos. 9623, 9628, 9633. In 2005, the appeal was filed as GUD No. 9671.



ATM and Coserv argue that Atmos does not qualify for interim rate adjustment under 104.301 because Atmos Mid-Tex did not file a rate case within the two years preceding its interim rate adjustment filings.<sup>348</sup> GUD No. 9400, the rate case upon which Atmos Mid-Tex relies, was filed by TXU Gas Company. Additionally, although ACSC has not taken this position in its briefing in this case, ACSC presented testimony articulating the same position regarding the applicability of this statute.<sup>349</sup> Essentially, these intervenors argue that the first sentence in section 104.301 established the threshold applicability of the provisions of section 104.301:

A gas utility that has filed a rate case under Subchapter C within the preceding two years may file with the regulatory authority a tariff or rate schedule that provides for an interim adjustment in the utility's monthly customer charge or initial block rate to recover the cost of changes in the investment in service for gas utility services.<sup>350</sup>

These intervenors argue that a gas utility that does not meet the requirements of this provision may not file for an interim rate adjustment.<sup>351</sup>

Atmos argued that the Commission has already explicitly found that GUD No. 9400 was the Company's most recent rate case and entered a conclusion of law in a prior order approving the interim rate adjustment filings that the two-year requirement of section 104.301(a) had been satisfied.<sup>352</sup> Atmos Mid-Tex also argued that it acquired all of the interests related to the gas utility system operated by TXU Gas and as a result the rights that attached to TXU Gas were acquired by Atmos Mid-Tex and the gas utility that acquired the system stands in the place of TXU Gas with regards to the applicability of this statutory provision.

Coserv, in its Reply Brief argued that the order in GUD No. 9560 is an interim order on all issues and that the order does not constitute collateral estoppel on the issues determined in that case. Coserv also argued that the order issued in GUD No. 9560 was *ex parte* without an opportunity for litigation of the issues. Indeed, the City Intervenors were denied their request to intervene in those dockets. The Commission explained in that order that an evidentiary proceeding was not warranted and deferred "due process protections" until the "next rate case."<sup>353</sup> Thus, the terms of the order deferred adjudication on all issues until the next Subchapter C rate case. Further, the order did not constitute collateral estoppel because a party seeking to assert the bar of collateral estoppel must establish three factors:

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<sup>348</sup> ATM Initial Brief, pp. 65 - 69, Coserv, pp. 4 - 7, Bickerstaff Direct, pp. 1 - 6, and Arndt, pp. 6 -10.

<sup>349</sup> ACSC Exhibit 5, Stowe Direct, Attachment E, (Direct Testimony of Jack Stowe filed in Gas Utilities Docket Nos. 9598, 9599, & 9603, pp. 7 - 10.)

<sup>350</sup> Tex. Util. Code § 104.301.

<sup>351</sup> Atmos Initial Brief, pp. 50 - 55, Robertson Rebuttal, pp. 1 - 9.

<sup>352</sup> Atmos Initial Brief, pp. 51 - 52, Yarbrough Rebuttal p. 23, ln. 22 - p. 24, ln. 4, citing to Application of Atmos Energy Corp., Mid-Tex Division and Atmos Pipeline-Texas for Annual Gas Reliability Infrastructure Program Rate Adjustment for Environs and Pipeline System, GUD No. 9560, Final Order, FOF 20 & 27, and COL 8.

<sup>353</sup> Application of Atmos Energy Corp., Mid-Tex Division and Atmos Pipeline-Texas for Annual Gas Reliability Infrastructure Program Rate Adjustment for the Environs Area and Pipeline System, GUD No. 9560, Final Order March 22, 2005. FOF No. 37 & 38.

- ▶ The facts sought to be litigated in the second action were fully and fairly litigated in the first action
- ▶ Those facts were essential to the judgment in the first action
- ▶ The parties were cast as adversaries in the first action<sup>354</sup>

Coserv maintains that Atmos failed to establish any of those factors.<sup>355</sup>

Mr. Arndt, who testified on behalf of ATM argued that the reason for the statutory structure limiting the applicability to a gas utility that has previously filed a Subchapter C rate case is to protect ratepayers from being forced to pay for piecemeal cost increases when the increases may be offset by savings in other cost areas as a result of the acquisition of the system by the gas utility.<sup>356</sup> Mr. Arndt argued that the company that filed the Subchapter C rate case relied upon, GUD No. 9400, was a distinct corporation from Atmos Mid-Tex. TXU Gas Corporation and Atmos Energy Mid-Tex are, in fact, different utilities with different cost structures.<sup>357</sup> He provided a list of factors which he argued established how the two companies differ:

- ▶ Capitalization levels are different
- ▶ Capital costs are different
- ▶ Significant affiliate transaction from TXU Business Services have been replaced with a significantly different shared services structure.
- ▶ Cash working capital calculation has been revised significantly
- ▶ New officers and directors
- ▶ New service centers
- ▶ New call centers
- ▶ New computer systems and applications
- ▶ New gas supply
- ▶ New Plant

All of these are indices of the distinctive characteristic of the new entity operating the facilities formerly owned and operated by TXU Gas Corporation. Finally, Mr. Arndt pointed out that Atmos Mid-Tex repeatedly explained the changes to the costs of service proposed in this case as being the result of the fact that Atmos Mid-Tex and TXU Gas Corporation are different utilities.<sup>358</sup>

The Examiners find that this issue has been previously considered, and decided, by the Commission. Further, in its briefing, Atmos Mid-Tex noted that the argument that the right to obtain an interim rate adjustment should follow ownership of the asset and that the legislative record contains "nary a hint" that the merger of one utility's system and operation into those of another disqualifies the surviving or acquiring utility from seeking a interim adjustment.<sup>359</sup> This finding is consistent with the proposition argued by the parties, and adopted elsewhere in this

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<sup>354</sup> Coserv Reply Brief, p. 5, *citing* Sysco Food Servs., Inc. V. Trapnell, 890 S.W.2d 796, 801 (Tex. 1994).

<sup>355</sup> Coserv Reply Brief, pp. 3 - 5.

<sup>356</sup> ATM Exhibit 2, Arndt Direct, p. 6, lns. 22 - 32.

<sup>357</sup> ATM Exhibit 2, Arndt, Direct, p. 7, lns. 1 - 23.

<sup>358</sup> Id.

<sup>359</sup> Atmos Mid-Tex Initial Brief, p. 53.

Proposal for Decision, that rates should be consistent from one case to the next for the same utility system. As noted by the State of Texas, the Supreme Court has opined that regulatory agencies should be wary of a utility arbitrarily altering factors considered relevant in justifying rates and that the utility has the burden of proving that the different factors are not only relevant, but the utility must provide supporting evidence that its mathematical formulas or relevant factors were not arbitrarily altered so as to fit its alleged need.<sup>360</sup> As the State of Texas noted, because Atmos Mid-Tex's predecessor, TXU Gas, proposed different factors and formulas than those considered relevant by the Commission for establishing rates for the same system in GUD No. 9400, the Company has the burden of proving that the different factors are reasonable. This will be discussed further in the context of proposed changes to the capitalization policies, depreciation expense, cash working capital, and cost allocation. As the Commission has previously determined that this is the same utility for purposes as the utility in GUD No. 9400, and Atmos Mid-Tex vigorously maintains that, it is in fact the same utility, the issues raised by the court in *Texas Alarm* are relevant to these proceedings.

#### D. Infrastructure or Invested Capital

ACSC and ATM argued that section 104.301 was intended to apply only to the investment in "critical infrastructure" or gas plant infrastructure directly related to safety and reliability.<sup>361</sup> Mr. Bickerstaff pointed out that the title of Senate Bill 1271 indicated that the bill was related to "incentives to encourage gas utilities to invest in new infrastructure."<sup>362</sup> He argued that the terms in the statute itself, "investment in service," "investment" and "invested capital" were not defined and resulted in certain ambiguity regarding the scope of the meaning of those terms. He also argued that in the litigation before the Travis County District Court described above, the Commission took the position that the intent behind section 104.301 was to allow gas utilities to recover a return on certain "new infrastructure investment."<sup>363</sup> Further, Mr. Bickerstaff argued that Atmos Mid-Tex took a similar position in its own briefing before the Travis County District Court. In addition, he argued that the same position was articulated before the hearing on House Bill 1942 before the House Committee on Regulated Industries by Atmos Mid-Tex.<sup>364</sup> Finally, Mr. Bickerstaff argued that the Commission has taken the position that while the utility may request an interim rate adjustment that includes qualifying investment in all plant accounts, the Commission retained the authority to ultimately reject such non-infrastructure costs when submitted for review. Indeed, he argued that the Commission recently rejected an interim rate adjustment request for projects which the Commission concluded were unrelated to gas pipeline infrastructure.<sup>365</sup>

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<sup>360</sup> *Texas Alarm and Signal Ass'n v. Public Utility Comm'n*, 603 S.W.2d 766, 733 ("Texas Alarm").

<sup>361</sup> ACSC Initial Brief, pp. 14 - 15, ACSC Exhibit 1, Nalepa Direct, p. 34, ln. 7 - p. 37, ln. 5.

<sup>362</sup> Tex. S.B. No. 1271, 78<sup>th</sup> Leg. R.S. (2005) & Tex. Util. Code Ann. § 104.301 and amended, Tex.H.B. 872, 79<sup>th</sup> Leg. R.S. (2005).

<sup>363</sup> ATM Exhibit 3, Bickerstaff Direct, citing to *The Cities of Allen, et al. v. Railroad Commission of Texas, et al.*, No. D-1-GV-05-005221 (53<sup>rd</sup> Dist. Ct., Travis County, Tex. June 30, 2006) (Brief of the Railroad Commission of Texas).

<sup>364</sup> ATM Exhibit 3, Bickerstaff Direct, p. 7, lns. 16 - 24.

<sup>365</sup> ATM Exhibit 3, Bickerstaff Direct, p. 7, ln. 25 - p. 8, ln. 19; GUD No. 9658, Application of Atmos Energy Division for Test Year 2005 Annual Interim Rate Adjustment for the Environs Area, Finding of Fact No. 42. "It is reasonable to decrease Atmos' requested interim rate adjustment for Distribution from \$12,132,931 to \$11,890,765 to reflect a \$1,505,542 reduction in net utility investment attributed to expenses for ancillary workplace improvements and

Mr. Nalepa pointed out that in addition to investment that he characterized as potentially legitimate, Atmos Mid-Tex included significant amounts of investment for building improvements, office equipment, computer equipment and administrative adjustments.<sup>366</sup> He argued that these investments were not specifically related to safety and reliability and section 104.301 did not contemplate that a gas utility could seek an interim adjustment for those investments. Similar testimony was submitted by Mr. Stowe on behalf of ACSC that was previously filed in GUD Nos. 9598, 9599, and 9603.<sup>367</sup> ACSC relied primarily on the legislative history. In response, Atmos Mid-Tex argued in briefing that the language is clear and unambiguous and the statute is broad and inclusive.<sup>368</sup> Mr. Yarbrough pointed out that nowhere in the statute does the term "infrastructure" or any similar language appear that implies the limitation advocated by ATM or ACSC.<sup>369</sup>

The Examiners find that there is no limitation in section 104.301 or the regulations of the Commission which limit the recovery to "critical infrastructure" or "safety and reliability." It is reasonable to conclude that the statute allows the replacement of new pipe in the ground and an incremental recovery for costs associated with engineering designs, desks, and supplies necessary to maintain those systems. As noted by the Commission, the statute was designed to provide a gas utility the ability to recover the cost of changes in the utility's invested capital and related expenses and revenue for providing gas utility service.<sup>370</sup> Of course, the investment must be shown to be just and reasonable, and that issue will be addressed below.

E. Whether the Interim Rate Adjustment should be Predicated upon Rate Base.

ACSC, through the testimony of Mr. Nalepa argued that the section 104.301 interim rate increases should be calculated based on the net increase to invested capital, or rate base. He noted that while much of the capital is supplied by investors, a significant amount is provided by customers through deposits, advances, and negative working capital. The "cost - free" sources of capital must be deducted from net plant in service to establish the appropriate value of rate base; otherwise the utility will earn an excessive return. He argued that the language in the statute that states "invested capital is equal to the original cost of the investment at the time the investment was first dedicated to public use minus the accumulated depreciation related to that investment" closely paralleled the same concept in section 104.053. Section 104.053 prescribes that the adjusted value of invested capital shall be computed on the basis of a reasonable balance between original cost less depreciation and current cost less an adjustment for age and condition. He noted that both of the clauses address the depreciable component of invested capital, but do not limit invested capital to one component. He also argued that the Commission's Natural Gas Rate Review HandBook provides that the adjusted value of invested capital is the rate base.<sup>371</sup>

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signage."

<sup>366</sup> ACSC Exhibit 1, Nalepa Direct, p. 35, lns. 1-10 & Bickerstaff Direct, p. 6, ln. 13 - p. 8 ln. 19.

<sup>367</sup> ACSC Exhibit 5, Stowe Direct, Attachment E, *Petition for Review of Municipal Actions Regarding Atmos Energy Corp., Mid-Tex Division's Annual Gas Reliability Infrastructure* Direct Testimony of Jack Stowe, pp. 10 - 14.

<sup>368</sup> Atmos Mid-Tex Initial Brief, pp. 55 - 57.

<sup>369</sup> Atmos Exhibit 19, Yarbrough Direct, p. 16, ln. 7 - 12 & p. 22, lns. 5 -21.

<sup>370</sup> 29 Tex. Reg. 11949.

<sup>371</sup> ACSC Exhibit 1, Nalepa Direct, Attachment C, Corrected Direct Testimony of Karl J. Nalepa, GUD Nos. 9598, 9599, and 9603, *Petition for Review of Municipal Actions Regarding Atmos Energy Corp., Mid-Tex Division's Annual Gas Reliability Infrastructure Program Rate Adjustment*, p. 10, ln. 21, - p. 12, ln. 2.

The Examiners find that the issue is resolved by the language of section 104.301(b). On the one hand, the statute refers to invested capital, as noted by Mr. Nalepa: "The amount the gas utility shall adjust the utility's rates upward or downward under the tariff or rate schedule each calendar year is based upon the value of invested capital for the preceding calendar year." That language would support the reading proposed by Mr. Nalepa. The second sentence of that provision, however, defines how the value of invested capital is to be determined. Namely it is equal to the original cost of the investment at the time the investment was first dedicated to public use minus accumulated depreciation related to that investment. Thus, the statute points to what is referred to in the ratemaking context, gross plant, not total invested capital or rate base. Accordingly, the Examiners find that Atmos Mid-Tex has correctly applied the statute in to changes in gross plant.

F. Earning Monitoring Reports (EMR).

As noted above, a gas utility that has implemented an interim rate adjustment must file an earnings monitoring report. ACSC argued that the EMR filed by Atmos Mid-Tex was inaccurate and that it provided no basis upon which the regulatory authority could determine whether an interim rate adjustment implemented in 2005 will cause Atmos Mid-Tex to over-earn. Mr. Nalepa pointed out that the earnings monitoring reports filed in 2003 and 2004 are the result of rates that pre-date the rates set in GUD 9400, the most recent Subchapter C rate case.<sup>372</sup> This fact was noted by Staff on March 10, 2005.<sup>373</sup> He argued that the EMR made by Atmos Mid-Tex was only meaningful if it was adjusted for the impact of GUD No. 9400 and therefore more adequately represented the earnings of the Company against which the impact of the proposed surcharge can be measured. Additionally, Mr. Nalepa pointed out that none of the projected operations and maintenance savings projected by Atmos Mid-Tex were included in the earnings monitoring report. He argued that if the projected savings had been included in the EMR, Atmos Mid-Tex would have revealed an over-earning.

Other objections to the EMR report made by Mr. Nalepa include a recommendation that the EMR for the 2004 and 2005 interim rate adjustment filings should be adjusted to restore ADFIT and investment tax credits lost when the acquisition of TXU Gas took place.<sup>374</sup> Mr. Nalepa also recommended that the EMR for the 2004 and 2005 interim rate adjustment filings should be adjusted to increase accumulated depreciation by \$88.2 million to recognize the Poly 1 pipe decision in GUD No. 9400.<sup>375</sup> Finally, Mr. Nalepa recommended that the EMR for the 2004 and 2005 interim rate adjustment filings should be adjusted to better represent ongoing operations. He argued that the 2004 interim rate adjustment filing reflected \$310 million in operating expense, while the 2005 filing reflected only \$196 million. The 2004 operating expense should be reduced by \$196 million, and

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<sup>372</sup> ACSC Exhibit 1, Nalepa Direct, Attachment C (Petition for Review of Municipal Actions Regarding Atmos Energy Corp., Mid-Tex Division's Annual Gas Reliability Infrastructure Program Rate Adjustment, GUD Nos. 9598, 9599, 9603, Corrected Direct Testimony of Karl J. Nalepa, p. 15.

<sup>373</sup> Memo from Stephen L. Pitner, Director, Gas Services Division to Railroad Commissioners Carrillo, Williams, and Jones in GUD No. 9560, Application of Atmos Energy Corp., Mid-Tex Division and Atmos Pipeline-Texas for Annual Gas Reliability Infrastructure Program Rate Adjustment for Environs Area and Pipeline System, March 10, 2005, p. 5.

<sup>374</sup> ACSC Exhibit 1, Nalepa Direct, p. 33, Ins. 15 - 16.

<sup>375</sup> ACSC Exhibit 1, Nalepa Direct, p. 33, Ins. 16 - 18.

the 2005 level reduced by \$20 million to capture a portion of the adjustment being proposed in this case.<sup>376</sup>

The Examiners find that the EMR was considered by the legislature as an important component of this statutory provision designed to alert the regulatory authority of potential over earning that would not be just and reasonable. During the hearings on the bill, the EMR was clearly viewed as an important component of the bill and the accuracy of the report was of some concern.<sup>377</sup> The statutory requirements, however, were clear and unambiguous: The EMR was designed to demonstrate "the utility's earnings during the preceding calendar year." The Examiners find that it does not require that the report be adjusted for known and measurable changes.

The Examiners find, based upon the language of the statute and the Commission's rules, that no adjustment is required to the earnings monitoring report based upon the issues raised by ACSC. First, there is no statutory requirement that the EMR reflect projected savings. Second, there is no requirement that the EMR reflect the effect of a Final Order that is entered after the calendar year that is the subject of the utility's interim rate adjustment. Finally, the Examiners note that the underlying purpose of the EMR report is, in part, to assist the regulatory authority in determining whether to initiate a Subchapter C rate case. It does not provide an independent basis for a refund or other adjustment. As a Subchapter C rate case is underway, the Examiners find that there is no purpose in changing the prior EMR reports that have been filed.

G. Does the ruling by the District Court invalidate the interim rate adjustment filings?

ACSC argued that the legal effect of the district court ruling was that all interim approvals made by the Commission are void and should be set aside.<sup>378</sup> That case, *Cities of Allen, et al. v. Railroad Commission of Texas* was a declaratory judgment action filed by several cities seeking to invalidate certain provisions of the interim rate adjustment rules adopted by the Commission. Atmos Mid-Tex argued that the court only stated that the utility cannot appeal an interim rate adjustment denial under the provisions of section 104.301 itself because no mechanism for appeal is explicitly provided in that section. The Company, however, based its appeal upon Section 102.001(b) of GURA, which grants the Commission broad and exclusive appellate jurisdiction over all orders and ordinances adopted by a city in the exercise of the city's exclusive original jurisdiction. The Company argues that ACSC overstates the effect of the court's decision by arguing that the court invalidated the Commissions orders. Finally, Atmos Mid-Tex implies that based on the Commission's orders the act of the municipalities was invalid.<sup>379</sup> The Examiners agree that the court's order does not appear to invalidate the orders of the Commission. Accordingly, those orders are still in effect.

H. Poly I and the Interim Rate Adjustment, and the adjustment to Rate Base.

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<sup>376</sup> ACSC Exhibit 1, Nalepa Direct, p. 33, Ins. 18 - 20, p. 34, Ins. 1 - 2.

<sup>377</sup> Hearings on H.B. 1942 Before the House Committee on Regulated Industries, 78<sup>th</sup> Leg., R.S. (March 25, 2003), p. 35, Ins. 25 - 27, p. 44, Ins. 3 - 13 (Seidlits, for TXU)p. 37, Ins. 5 - 11.

<sup>378</sup> ACSC Initial Brief, pp. 25 - 26.

<sup>379</sup> Atmos Mid-Tex Reply Brief, pp. 57 - 58.

## 1. Introduction

In GUD No. 9400, the Commission reduced rate base (invested capital) for the total investment in Poly 1 replacement pipe:

TXU should not be allowed to include the costs of Poly 1 pipe or the Safety Compliance Program as invested capital or as an expense. It is reasonable for the Commission to disallow, going forward, inclusion of \$42,982,796 as a regulatory asset in invested capital, resulting in a reduction of annual amortization expense of \$3,008,705. *In addition, it is reasonable for the Commission to disallow going forward, inclusion of \$87,837,109 as capitalized gas utility plant in service in invested capital.* These adjustments are included in the attached Schedules H(D), I(D), and I-1(D).<sup>380</sup>

Schedule H(D) set out these, and other adjustments, ordered by the Commission in GUD No. 9400. As can be seen from Schedule H(D), the Commission did not order an offset or adjustment to accumulated depreciation. Thus, the net reduction to rate base/invested capital was \$87,837,109.<sup>381</sup>

The City Intervenors argue that Atmos Mid-Tex made an adjustment to net invested capital in its interim rate adjustment filings and in the cost of service analysis filed in this case that effectively eliminated the Commission's disallowance. The allegations raised by the City Intervenors call into question the interim rate adjustments that were made in 2003, 2004, and 2005. They also call into question the propriety of the rate base proposed as part of the Company's cost of service.<sup>382</sup> All issues related to the proposed Poly 1 adjustment will be addressed here, as the Company made adjustments related to this disallowed asset in its interim rate adjustment filings. Any necessary adjustment to rate base, if any, as a result of any recommendation will be noted here. In order to analyze this issue it is important to first analyze the adjustment that was made in GUD No. 9400 and its legal effect. Once a decision on the legal effect of the prior order is made, the impact on the interim rate adjustment filings and rate base proposed as part of the cost of service study for the Statement of Intent case may be analyzed.

## 2. The Legal Effect of the Final Order issued in GUD No. 9400.

It is not necessary to revisit the entire record in GUD No. 9400, as the language of Finding of Fact No. 78 and accompanying exhibits makes the Commission's adjustment clear. It is sufficient to note in this context the Examiners finding in the Proposal for Decision. Namely, the gas utility in that case failed to meet its burden to prove the reasonableness and prudence of its expenditures relating to the location and replacement of Poly 1 pipe.<sup>383</sup> As explained in Finding of Fact No. 78, the adjustment was to a component of the net investment of the utility system. The Commission

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<sup>380</sup> GUD No. 9400 Final Order FOF 78.

<sup>381</sup> The disallowance reflected on Schedule H(D), page 4 of 4, ln. 1, col. 1 is \$94,830,244 which is made up of \$87,837,109 for Poly 1 Pipe and \$6,993,135 of various other adjustments in Distribution and General Plant.

<sup>382</sup> ACSC Exhibit 1, Nalepa Direct, pp. 43 - 46, ATM Exhibit 2, Arndt Direct, pp. 20 - 23, Initial Brief City of Dallas, pp. 8 - 12.

<sup>383</sup> Proposal for Decision, p. 31.

concluded in that case that it was reasonable to disallow the inclusion of \$87,837,109 as "capitalized gas utility plant in service in *invested capital*."<sup>384</sup>

As is evident from Schedule H(D), and in accordance with section 104.053, the total net plant included as part of rate base was the net valuation after the deduction of the accumulated depreciation. Section 104.053(a) provides that gas utility rates shall be based on the adjusted value of invested capital used and useful to the utility in providing service and that adjusted value shall be computed on the basis of a reasonable balance between original cost less depreciation, on the one hand, and current cost less an adjustment for present age and condition, on the other. The adjustment ordered by the Commission was made to Gross Plant in Schedule H(D). Thus, the Final Order in GUD No. 9400 permitted the Company to earn a return on \$984,355,200 of net plant, which was included in the total *invested capital* of \$769,721,018.<sup>385</sup>

As will be noted later in the context of depreciation *expense*, witnesses for Atmos Mid-Tex define "depreciation" as a system of accounting that distributes the cost of assets, less net salvage (if any), over the estimated useful life of the assets in a systematic and rational manner. Although depreciation is considered an expense or cost, rather than a loss or decrease in value, Atmos Mid-Tex accrues depreciation based on the original cost of all property included in each depreciable plant account. On retirement, the full cost of depreciable property, less the net salvage amount, if any, is charged to the depreciation reserve.<sup>386</sup> As noted by the Examiners in GUD No. 9400, while depreciation records the decline in service capacity of property over an asset's service life, the accumulated depreciation accounts for the cumulative depreciation costs that are recovered through rates.<sup>387</sup> Therefore, accumulated depreciation is based upon the depreciation rates that were set in the prior rate case.<sup>388</sup> Accumulated depreciation functions as a reduction of the investment. The difference between gross plant and accumulated depreciation is the total net plant included in rate base.

Of course, if an adjustment to accumulated depreciation had been ordered in GUD No. 9400 the gross plant would have been increased and the *invested capital* would have also have increased. Thus, for example, if an adjustment of \$10,646,065 had been made to accumulated depreciation total net plant would have been \$995,001,265, and total invested capital would have been increased to \$864,551,262.

Although not ordered by the Commission, Atmos Mid-Tex maintains that the Commission intended to allow it to make two adjustments to accumulated depreciation. First, Atmos Mid-Tex argued that the Commission *intended* to remove an amount of accumulated depreciation reflected in the accumulated depreciation account for Poly 1 pipe and related software at the time of the adjustment in GUD No. 9400. Atmos Mid-Tex alleged that this amount was \$10,646,065. Second, Atmos Mid-Tex alleged that for purposes of tracking the Commission's prior determination, now that the Poly 1 pipe costs have been removed, Atmos Mid-Tex may reinstate the Poly 1 pipe assets

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<sup>384</sup> GUD No. 9400, FOF 78 (emphasis added).

<sup>385</sup> Schedule H(D).

<sup>386</sup> Atmos Exhibit 28, Watson Direct, p. 5, Ins. 10 - 25

<sup>387</sup> GUD No. 9400, Proposal for Decision, p. 122,

<sup>388</sup> See, GUD No. 9145, PFD, p. 55.



in Account 101, as long as a contra entry is made in Account 108. The net effect of the book keeping exercise is zero. Atmos Mid-Tex and Staff maintain that the adjustment is simply a tracking mechanism. The City Intervenors strenuously challenge this assertion and argue that the adjustments are either a modification, or full reversal, of the Commission's action.

Barbara Myers summarized the adjustment Atmos Mid-Tex made to accumulated depreciation from December 31, 2002 through December 31, 2005, which will be analyzed below.<sup>389</sup> Dr. Bruce Fairchild testified on behalf of Atmos Mid-Tex and argued that the Commission intended that the approximately \$88 million of Poly 1 replacement pipe on the gas utility's books at the time of the Commission's order be excluded from rate base and that prospective rates include neither a return on the investment nor a return of investment in Poly 1 replacement pipe.<sup>390</sup> Mr. Yarbrough testified that in his opinion the Company has fully complied with the Commission's order in GUD No. 9400 and that he consulted with Commission staff regarding the proposed adjustments to accumulated depreciation included in the 2003, 2004, and 2005 interim rate adjustment filings.<sup>391</sup>

ACSC argued that the proposed adjustment to accumulated depreciation should be reversed to comply with the Commission's previous Final Order in GUD No. 9400 regarding the disallowances of Poly 1 Pipe investment. ACSC noted in its initial brief, that Atmos Mid-Tex filed an appeal from the Commission's order in GUD No. 9400 that did not complain of the Commission's decision in GUD No. 9400 to not make the adjustment to accumulated depreciation that Atmos Mid-Tex is attempting to interject here. ACSC argued that if the Company disagreed with the Commission's decision to not make the adjustment, the Company should have complained of that decision in its Motion for Rehearing in GUD No. 9400, or in its appeal of that docket to the district court. ACSC noted that the appeal of that order is still pending. If Atmos Mid-Tex were to win, the result would be that Atmos Mid-Tex would have increased rate base, plus increased depreciation expense, increased return, increased federal income taxes, and increased property taxes.<sup>392</sup>

ATM also argued that the adjustments proposed by Atmos Mid-Tex have the effect of reversing the Commission's prior order. ATM argued that if the Commission had disallowed an equal amount of accumulated depreciation, the net impact of the Commission's disallowance would have been zero to the Company's net plant and revenue requirement. ATM argued that is not how the Commission acted. ATM noted that the fact that the Commission only adjusted gross plant and did not adjust accumulated depreciation can be seen by examining GUD Docket No. 9400 Final Order at Schedule H(D). ATM argued that the Company essentially eliminates the Commission's GUD Docket No. 9400 disallowance of Poly 1 Replacement Pipe. ATM makes similar arguments regarding the adjustment of \$10,646,065 to accumulated depreciation that was made in the first interim adjustment filing of 2003, noting that the entry modifies the Final Order.<sup>393</sup>

The City of Dallas alleged that Atmos Mid-Tex did not follow the Commission's order and

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<sup>389</sup> Atmos Exhibit 41, Myers Rebuttal, p. 24, lns. 15 - 21, Exhibit BWM-R-5.

<sup>390</sup> Atmos Exhibit 20, Fairchild Direct, p. 3, lns. 6 - 20.

<sup>391</sup> Atmos Exhibit 30, Yarbrough Rebuttal, p. 26, lns. 14 - 26.

<sup>392</sup> ACSC Initial Brief, pp. 5 - 8, Nalepa Direct, p. 43, ln. 6 - 46, ln. 10.

<sup>393</sup> ATM Initial Brief, pp. 71 - 74, Arndt Direct, p. 20, ln. 2 - p. 23, ln. 18.

that the explanation provided by Atmos Mid-Tex confuse and attempt to obfuscate the fact that the proposed adjustment, in fact, reverses the Commission's order.<sup>394</sup> The City of Dallas also pointed out that Staff, in its Initial Brief, misstated the provisions of the order in GUD No. 9400. Staff argued that the disallowance should be treated as a retirement. In fact, the order does not require that the plant be retired. The order required that the investment be disallowed. The City of Dallas concluded, therefore, that Staff's position was inappropriate.

The Examiners find that part of this issue is disposed of by the plain language of the Final Order issued in GUD No. 9400. As an initial matter, the Examiners note that the Texas Supreme Court has long held a final contested case order has *res judicata* and collateral estoppel effect upon a subsequent contested case proceeding.<sup>395</sup> In that context, the Supreme Court's decision in *Coalition of Cities v. P.U.C.*, is instructive. In that case, the utility sought a rate increase which required the PUC to determine whether \$4.5 billion that it spent for completion of a power plant was a prudently incurred cost. The expense was challenged by intervenors in that administrative proceeding. Because of the lack of sufficient evidence, the PUC excluded from plant in service certain capital costs. The Supreme Court went on to state that the utility "failed to meet its burden of proof on the prudence of the [expense], the PUC effectively disallowed that amount from the rate base."<sup>396</sup> After the order was issued, the utility initiated another case to have the PUC reconsider its prior order. The Supreme Court held, however, that once the order in the initial docket became final, it was not subject to any further review by the agency.<sup>397</sup>

In this case, the language of Finding of Fact No. 78 in GUD No. 9400 was clear and explicit: "[I]t is reasonable for the Commission to disallow, going forward, inclusion of \$87,837,109 as capitalized gas utility plant in service in *invested capital*." Finding of Fact No. 78 dictates precisely how the removal was to be accomplished by reference to Schedule H(D), I(D), and I-1(D). Although witnesses who testified on behalf of the Company have discussed the intent of the Commission, resort to the intent is not warranted where the language is explicit. The argument made by Atmos Mid-Tex is that \$10,646,065 was in accumulation depreciation associated with Poly 1 Pipe at the time the Final Order was issued. But the Commission made no adjustment. Atmos Mid-Tex does not contest that this adjustment was made for an amount that was in accumulated depreciation at that time of the Final Order. In any case, the Commission made no adjustment, the necessity of the adjustment was not brought to the attention of the Commission by Atmos Mid-Tex, and the parties to that proceeding did not raise the issue prior to the issuance of the order or in a motion for rehearing. Finally, the language in the order specifically referred to *invested capital*. In conclusion, if the entry for \$10,646,065 of accumulated depreciation is allowed, that portion of the order is modified.

Once the adjustment for \$10,646,065 is removed, however, there is still the question of the two adjustments that were made to the Company's books. Namely, Ms. Myers claimed that an adjustment was made to reinstate the Poly 1 assets into the books and records under Account 101. That adjustment alone, however, would have the effect of increasing invested capital/rate base

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<sup>394</sup> Initial Brief of the City of Dallas, pp. 8 - 12.

<sup>395</sup> *Coalition of Cities v. P.U.C.*, 798 S.W.2d 590 (Tex. 1990).

<sup>396</sup> Id at 564.

<sup>397</sup> Id at 565.

balances. Accordingly, Mr. Myers claimed that a contra adjustment was made to Accumulated Depreciation, Account 108, so that there was no effect on the invested capital/rate base balances of the Company. The Company claimed that this adjustment was made simply to track the assets. Thus, an adjustment to the books and records must be made at the time of each rate case to remove those assets from both account balances. The Examiners find, that from a technical perspective, these two adjustments together do not modify the Final Order in GUD No. 9400, and no further adjustment is required.

In conclusion, the Examiners find that Finding of Fact No. 78 and the accompanying exhibits made the adjustment clear and principles of *res judicata* prevent an adjustment to accumulated depreciation in the amount of \$10,646,065. Accordingly, the Examiners recommend that an adjustment to the approved interim rate adjustments be made for 2004 and 2005 to account for the \$10,646,065 adjustment to accumulated depreciation. As the adjustment was made after calendar year 2003, the Examiners do not recommend an adjustment to the interim rate adjustment filing made for that year. Further, the Examiners recommend that an adjustment to rate base be made to reverse the effect on rate base of this proposed adjustment.

I. Establishing that the Interim Rate Adjustment were Just and Reasonable.

As noted, Atmos Mid-Tex filed interim rate adjustment requests in 2003, 2004, and 2005. The City Intervenors challenged whether certain expenses included in invested capital were just and reasonable. The burden of proof regarding the expenditures related to interim rate adjustments is on the gas utility that requested the adjustment. As provided in the statute, "until the issuance of a final order or decision by a regulatory authority in a rate case that is filed after the implementation of a tariff or rate schedule under this section, all amounts collected under the tariff or rate schedule before the filing of the rate case are subject to refund."<sup>398</sup>

The Company argued that it has met its burden by maintaining its books and records in accordance with the FERC Uniform System of Accounts ("USOA"), Generally Accepted Accounting Principles ("GAAP"), and the Railroad Commission's gas utility accounting rule, Rule 7.310. Accordingly, the Company qualifies for the presumption of necessity and reasonableness conferred by Rule 7.503.

Three issues were raised by the City Intervenors, Coserv and Staff, related to the burden of proof. First, the City Intervenors and Staff argued that Atmos Mid-Tex failed to provide sufficient evidence to establish that the projects included in the interim rate adjustment filings was sufficient to establish that those projects were just and reasonable. Second, ACSC challenged the prudence of certain particular expenditures. Third, these intervenors alleged that the amounts included in overhead loading, or capitalization, of projects was not just and reasonable.

1. Documentary Support

Pursuant to Texas Utilities Code, section 104.008, in a proceeding involving a proposed rate

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<sup>398</sup> Tex. Util. Code Ann. § 104.301(a) (Vernon Supp. 2006).

change, the gas utility has the burden of proving that the rate change is just and reasonable. As noted by the Commission, in comments to the proposed rules implementing the interim rate adjustment provision, it is always in the economic interest of the utility to maintain accurate and sufficient records of all its accounts, as is already required by Commission rules. If the utility is unable to establish, by a preponderance of the evidence, that its capital investments meet the requirements of section 104.151 and 104.053 of GURA, then the Commission cannot lawfully consider the amount in setting rates. The Commission concluded those comments by noting that the Commission was confident that gas utilities understood their record-keeping obligations under the Texas Utilities Code.<sup>399</sup>

The City Intervenors and Coserv<sup>400</sup> argued that there was insufficient evidence provided upon which the Commission could base its determination that the amounts included in the interim rate adjustment filings are just and reasonable. Mr. Nalepa was critical of the fact that Mr. Scott Powell, the witness designated by Atmos Mid-Tex to support its interim rate adjustment filings was unfamiliar with the specifics of the vast majority of the projects included in those filings.<sup>401</sup> Additionally, in response to numerous discovery questions, Atmos Mid-Tex provided select project files related to the interim rate adjustments. Mr. Nalepa alleged that the files did not provide sufficient support for the reasonableness and necessity of the projects.<sup>402</sup>

As will be discussed shortly, ACSC complained of charges related to chairs, some of which cost approximately \$2,000, artwork, totaling in excess of \$75,000, and other office remodeling projects included in the 2005 rate filing package. In pursuing these categories of expenses for the 2003 and 2004 interim rate adjustments ACSC issued a request for information requesting that the Company identify the amount included in the listed projects for (desks, chairs, tables, and similar items), appliances (televisions, refrigerators, microwave ovens, and similar items) and office improvements (artwork, decorations, and other similar items).<sup>403</sup> The Company indicated that it did not possess the information in either the form or level of detail requested. The Company offered, however, that the amounts would not total a significant amount for those years.<sup>404</sup>

ATM also alleged that the Company failed to provide sufficient documentation related to the projects included in the interim rate adjustment filings in 2003 and 2004.<sup>405</sup> In its Initial Brief, ATM noted that during the hearing the Examiners requested a report from Atmos Mid-Tex providing a summary of expenditures for interim rate adjustment filings in 2003 and 2004. Atmos Mid-Tex was able to provide a report for 2005.<sup>406</sup> On the other hand, the Company indicated that a report for 2003 and 2004 could not be produced.<sup>407</sup> ATM also pointed out that Company witnesses conceded that the record keeping information for 2003 and 2004 did not contain invoice detail.<sup>408</sup> ATM argued that

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<sup>399</sup> 29 *Tex.Reg.* 11961

<sup>400</sup> Coserv Initial Brief, pp. 9 - 10.

<sup>401</sup> ACSC Exhibit 1, Nalepa Direct, p. 38, ln. 1 - p. 39, ln. 7.

<sup>402</sup> ACSC Exhibit 1, Nalepa Direct, p. 39, ln. 1 - p. 41, ln. 6.

<sup>403</sup> ACSC Exhibit 89 & 90.

<sup>404</sup> *Id.*

<sup>405</sup> ATM Initial Brief, pp. 74 - 86, ATM Reply Brief, pp. 50 - 74.

<sup>406</sup> Examiners' Exhibit 6.

<sup>407</sup> Tr. Vol. 12, 232, ln. 15 - 233, ln. 2.

<sup>408</sup> Tr. Vol. 1, p. 92, ln. 14 - p. 92, ln. 7.

meaningful data could not be extracted from the computerized information that Atmos Mid-Tex made available during discovery. Further, ATM argued that the flaws in the record keeping were a violation of the FERC Uniform System of Accounts and Commission Rule 7.310(a). Further, as a result of this violation, the Company could not avail itself of the presumption in Rule 7.503.<sup>409</sup> In this context, ATM pointed out a long list of inappropriate expenses that were ultimately capitalized in the projects and included in the interim adjustment filings. Those items were discussed above in the context of shared services and are briefly summarized below in this section in relation to the evidence of improper accounting practices. ATM concluded that there was no evidence on which to judge the reasonableness of the expenditures associated with the projects included in the three interim adjustment filings.<sup>410</sup> The City of Dallas and Coserv also criticized the Company's record keeping practices.<sup>411</sup>

In response, Atmos Mid-Tex first argued that the interim rate provisions of GURA do not impose a different standard of proof than the standard applicable in Subchapter C rate cases.<sup>412</sup> While Atmos Mid-Tex concedes that due to a dispute with TXU, the Company's electronic books and records no longer contain scanned-in copies of invoices for 2003, 2004, or the first quarter of 2005, the Company argued that the intervenors made little effort to review the records that were available.<sup>413</sup> The Company explained that while certain detailed information was not available, the Company's electronic accounting system contained a wealth of other detailed cost documentation.<sup>414</sup> Further, the Company argued that the position articulated by Staff was more pragmatic than the approach taken by the intervenors in evaluating the question of whether the invoices were required for the Company to meet its burden of proof and argued that, as Staff has noted, there is a significant amount of investment at issue and that it is beyond dispute that the Company's interim rate adjustment investments constitute used and useful plant, and that the Company does have the journal entries described to support its project. Atmos Mid-Tex urged the Commission to adopt the position of Staff in viewing that a total disallowance, as recommend by the intervenors, would be unduly harsh.<sup>415</sup>

The Examiners find that the burden of proof in the context of interim rate adjustment filings made pursuant to section 104.301 is the same as in other Subchapter C rate cases. The Examiners also find, that in the context of the record keeping requirements of the FERC Uniform System of Accounts, Atmos Mid-Tex has failed to maintain appropriate records with regards to the interim rate adjustment of 2003, 2004, and the first quarter of 2005. FERC requires that in connection with the acquisition of gas plant constituting an operating unit or system, the utility shall procure all existing records relating to the property acquired and shall preserve those records in conformity with regulations or practices governing the preservation of records of its own construction.<sup>416</sup> Atmos Mid-Tex failed to maintain its records to allow a review or examination by the regulatory authority and

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<sup>409</sup> ATM Reply Brief, pp. 52 - 61.

<sup>410</sup> Id, at 61 - 74.

<sup>411</sup> City of Dallas, Initial Brief, pp. 1 - 6, Coserv, pp. 9 - 10

<sup>412</sup> Atmos Initial Brief, pp. 60 - 64, Atmos Reply Brief, pp. 59 - 60. See also, Tr. Vol. 1, 22, lns. 3 - 17.

<sup>413</sup> Atmos Initial Brief, pp. 64 - 67, Atmos Reply Breif, pp. 60 - 65.

<sup>414</sup> Atmos Initial Brief, p. 63. See also, Atmos Exhibit 48.

<sup>415</sup> Atmos Reply Brief, p. 64, Staff Initial Brief, pp. 6 - 7.

<sup>416</sup> 18 CFR 201, General Instruction 5, Gas Plant Purchased or Sold, subsection (E).

is in violation of those rules.

The contention that the City Intervenors did not seek to review those records until late in the process is irrelevant to the unequivocal burden placed on the utility by Commission regulations to keep those records. The fact is that the Commission, through a direct request of the Examiners, requested a summary of expenditures for the first and second interim rate adjustment in order to assess the relative amounts attributable to meals and entertainment, travel, lodging and other expenses and the utility was unable to provide that information. In the context of the office remodeling projects discussed above, the Company contended that the amounts would not total to any significant amount and that the totality of the expenditures for that category of items was \$149,000. The Examiners find that the requested information was reasonable and without that information the prudence of the expenditure could not be evaluated.

The Examiners find, however, that evidence was provided of the specific nature of the projects engaged in by the Company in each of the interim rate adjustment filings. The report attached to the direct testimony of Scott Powell provided basic information regarding projects. Thus, the Examiners find that to disallow all expenses associated with those projects would be unreasonable. On the other hand, the City Intervenors have directly challenged the Company's policies with regards to capitalization and overhead costs. The City Intervenors have provided direct evidence that improper expenses are incurred, expensed, and capitalized. Without the underlying documentation, the capitalization and overhead costs cannot be evaluated. The Examiners find that Atmos Mid-Tex failed to establish the reasonableness of the overhead costs and the testimony of Mr. Powell, Cagle, and Meziere combined with the documentary evidence provided was insufficient to prove that any of the overhead costs related to these expenditures were reasonable.

Finally, the Examiners note that the type of information that is lacking is the same type of information that an accounting firm conducting an audit would review. Of course, the accounting audit does not include an assessment of the reasonableness of the expenditure for ratemaking purposes. If that type of information is required for an audit, it is certainly indispensable for ratemaking purposes where the Commission must determine whether the expenses were just and reasonable.<sup>417</sup>

## 2. Specific Projects

ACSC listed several projects that it specifically challenged through the testimony of Mr. Nalepa.<sup>418</sup> ACSC also noted that in the 2005 interim rate adjustment filing the Commission removed \$1,505,542 in chairs, artwork, decorations, carpeting, miscellaneous equipment, televisions and signage.<sup>419</sup> As a result, Atmos Mid-Tex was not able to include an interim surcharge in its rates for those items. ACSC argued that these amounts should now be removed from rate base. An invoice submitted by Atmos Mid-Tex indicated that Atmos Mid-Tex paid \$563,363 for chairs, at an average

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<sup>417</sup> See, ACSC Initial Brief, pp. 13 - 19, ATM Initial Brief, pp. 77 - 86, Tr. Vol. 2, p. 123, lns. 8 - 17, p 136, ln. 18 - p. 138, ln. 18.

<sup>418</sup> ACSC Exhibit 1, Nalepa Direct, p. 36, Table 6.

<sup>419</sup> ACSC Initial Brief, pp. 15 - 17, ACSC Exhibit 1, Nalepa Direct, Att. R (Atmos Response to Staff RFI 1-1, GUD No. 9658).

price of \$442 per chair. ACSC argued that the Company provided no support for the costs and they cannot be presumed reasonable. ACSC recommended either removing the total costs of the chairs or reduce the amount approved to \$277,476 based on an adjustment of the price of each chair to \$221.

In response, Mr. Powell testified that several of these items were necessary for the provision of safe and reliable service. Mr. Powell, however, did not testify regarding the reasonableness of the price paid for these challenged items. As to certain specific items, such as expenses for televisions, Mr. Yarbrough testified that they were necessary for training videos. In addition, Atmos Mid-Tex argued that the operation of Rule 7.503 creates a presumption that the investment or expense is just and reasonable and that specific evidence is necessary to rebut the presumption.

As already noted, the Examiners find that the only limitation on interim rate adjustment filings is that they be reasonable and necessary expenditures. The Examiners find that Atmos Mid-Tex has provided no testimony in support of certain of the challenged items included in 2003 and 2004. Further, Atmos Mid-Tex provided no direct evidence regarding the reasonableness of the prices charged. Atmos Mid-Tex appears to suggest that specific evidence is necessary to challenge the reasonableness of an average price of \$1,283 per chair. Atmos Mid-Tex based this argument on the operation of Rule 7.503. In other words, as Rule 7.503 creates, ACSC had the burden of presenting specific evidence that less expensive chairs were appropriate. The Examiners find ACSC has offered sufficient evidence that the following items were unreasonable as shown in table 10.1 below:

Table 10.1

Wilson Office Interiors		
Cherry Table	\$8,268.15	ACSC 32 at LG_0018937
Laminate Table	\$3,403.78	ACSC 32 at LG_0018937
Laminate Table	\$3,511.18	ACSC 32 at LG_0018938
Average	\$4,008.	
Wilson Office Interiors		
4 chairs	\$8,000.00	ACSC 32 at LG_0018966
6 Chairs	\$5,630.16	ACSC 32 at LG_0018967
3 Chairs	\$3,045.00	ACSC 32 at LG_0018968
Average	\$1,283.	

Accordingly, the Examiners recommend that these amounts be disallowed.

Additionally, the Examiners find that ACSC, through the testimony of Mr. Nalepa has specifically challenged the purchase of \$4,513 in artwork. Atmos Mid-Tex has not provided any evidence that \$4,513 in artwork, included in the 2005 interim rate adjustment is necessary for the provision of natural gas service. In addition, the Examiners recommend that \$75,424.22 in artwork, specifically challenged by the intervenors be disallowed as it is not necessary to provision of natural gas service. Accordingly, the Examiners find that these amounts be disallowed.

In addition, as there is no evidence in the record to support the reasonableness of the purchase of office furniture and equipment that was ultimately capitalized. For example, ACSC, through the testimony of Mr. Nalepa, identified several remodeling projects, the status of the documentary

evidence with regards to these projects was discussed above.

- ▶ Project No. SANAGO2, \$3,402,
- ▶ Project No. KLLNRMDL, \$110,375
- ▶ Project No. 0098001, \$22,163.

As these projects presumably impact overhead capital they will be discussed below. The City Intervenors have specifically challenged the allocation of overhead costs included in the interim rate adjustment filings. Overhead charges from shared services expenses were addressed in Section IX, Shared Services Expenditures, above. Overhead charges included in the interim rate adjustments will be addressed next.

### 3. Overhead Loading Evidence of improper accounting practices

#### (a) Introduction and Position of the Parties.

In the interim rate adjustment filings that were made, several of the City Intervenors attempted to intervene. As already discussed above, the interim rate proceeding is not a contested case proceeding and those motions to intervene were denied. Testimony filed by ACSC in those proceedings was attached to the direct testimony of Mr. Nalepa and Mr. Stowe. An additional item noted, however, related to "overhead loading" applied to the stores warehouse. Mr. Stowe noted that the adjustment does not constitute an increase in any investment expense item but rather is simply a change in allocating overhead costs to inventory.<sup>420</sup> Through Mr. Nalepa's direct testimony, ACSC again challenged the reasonableness of overhead loading and the capitalization of certain projects.<sup>421</sup>

ATM argued that based upon the Company's failure to have records for the 2003 and 2004 interim rate adjustment filings, evidence regarding the Company's expenses, and evidence regarding the capitalization practices of the Company, all projects included in the interim rate adjustment filings should be disallowed.<sup>422</sup> CoServ argued that because Atmos failed to produce records related to the expenditures that underlie the 2003 and 2004 interim rate adjustment filings, all related expenditures should be disallowed.<sup>423</sup> ACSC also agreed that Atmos failed to meet its burden of proof regarding its investments during those years. ACSC recommended that an adjustment be made to rate base to reflect the amount included for meals and expenses and that because Atmos failed to meet its burden of proof, the amounts collected pursuant to those projects should be refunded.<sup>424</sup> The relative position of the parties are set out in Table 10.2 below:

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<sup>420</sup> ACSC Exhibit 5, Stowe Direct, Attachment E, p. 13, Ins. 13 - 17.

<sup>421</sup> ACSC Exhibit 1, Nalepa Direct, p. 35, ln. 1 - p. 41, ln. 6.

<sup>422</sup> ATM Initial Brief, pp. 74 - 86.

<sup>423</sup> Coserv Initial Brief, pp. 9 - 10.

<sup>424</sup> ACSC Initial Brief, pp. 8 - 26.



Table 10.2

Adjustments	ATM, Dallas	CoServ	ACSC	Staff
Rate Base	\$278,864,718 <sup>425</sup>	\$204,898,757 <sup>426</sup>	\$388,380 <sup>427</sup>	\$445,450 <sup>428</sup>
Refund of Rates collected per 104.301	Yes <sup>429</sup>	Yes <sup>430</sup>	Yes <sup>431</sup>	Yes <sup>432</sup>

## (b) Discussion of the Evidence and the Company's Response

Throughout these proceedings the City Intervenors have raised several issues regarding the accounting practices of Atmos Mid-Tex. Many of those issues were discussed in section IX above related to Shared Services. The City Intervenors alleged that these issues affected the cost of service study filed by Atmos Mid-Tex and the interim rate adjustments. These issues may be grouped into four categories:

- ▶ Capitalization of inappropriate expenses,
- ▶ Capitalization of certain short lived items,
- ▶ Changes in capitalization policy that have the effect of increasing the capitalization of projects, and
- ▶ Compliance with FERC USOA.

The allegation is that these practices directly impact the calculation of the net increase to plant that are the subject of the interim adjustment filings.<sup>433</sup>

First, with regards to the capitalization of alleged inappropriate expenses, the City Intervenors

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<sup>425</sup> Total incremental increase to gross plant of the three interim rate adjustment filings. *See* Schedule A, ln. 1, col. (g) attached to each interim rate adjustment filing.

<sup>426</sup> Total incremental increase to gross plant in 2003 and 2005 interim rate adjustment filing. *See*, Schedule A, ln. 1 col. (g).

<sup>427</sup> ACSC Initial Brief, p. 19.

<sup>428</sup> Staff Initial Brief, p. 7. It is not clear from the Initial Brief if Staff proposed to adjust rate base by the entire \$445,450 or only \$13,450. Staff divided its calculation between an operation and maintenance adjustment and a rate base adjustment. As interim rate adjustment filings are related only to rate base, the proposed operations and maintenance component may not apply.

<sup>429</sup> Although it is not clear that ATM and Dallas recommend that the amounts collected should be refunded to customers, it is the logical implication if the increase upon which those rates were based are disallowed. ATM argued that a full refund is required for other reasons.

<sup>430</sup> As with ATM and Dallas above, Coserv has not explicitly stated that those amounts should be refunded. A refund of the rates collected, however, is the logical conclusion if Atmos Mid-Tex has not established that those investments were just and reasonable.

<sup>431</sup> ACSC recommend a full refund to the customer.

<sup>432</sup> Although it is not clear that Staff recommended that the amounts collected should be refunded to customers, it is the logical implication if the increase upon which those rates were based should be refunded if Atmos Mid-Tex has not established that those investments were just and reasonable.

<sup>433</sup> Staff Initial Brief Sec. IV.

and Staff are critical of the Company's practices with regards to the capitalization of inappropriate expense items. Several of these issues have already been addressed. Throughout the hearing the City Intervenors presented evidence that related to expense reports and invoices which they alleged revealed the capitalization of inappropriate expenses claimed related to travel related to employees and spouses, inappropriate expenses for incidentals being capitalized, and specifically exempt expenses associated with legislative entertainment.<sup>434</sup> The expense reports entered into evidence by City Intervenors were those of executives and shared services employees.<sup>435</sup> As already noted the City Intervenors argued that meals, entertainment, lodging, travel and liquor of executives and employees should not be capitalized through and in projects. The City Intervenors argued that any expenses related to liquor should not be borne by the rate payer as a capitalized asset.<sup>436</sup> Atmos provided a written reimbursement of business expense policy upon the request of the Examiners.<sup>437</sup> The following table, Table 10.3, provides an example of the types of expenses included in this case Atmos that would have been capitalized had the Company not offered to remove them from rate base.

Table 10.3

Purpose	Amount	Exhibit
Airfare Inauguration	\$1,468	ATM 24 at 2
Airfare Inauguration	\$1,722	ATM 25 at 176
Airfare Inauguration Spouse	\$1,722	ATM 25 at 176
Celebration - Fogo de Chao	\$2,640	ACSC 13
Airfare - Nantucket - Spouse	\$1,991	ATM 26 at 496
Colorado Legislative Meeting	\$750	ATM 31 at 45
Employee Welfare	\$300	ATM 30 at 300
Employee Welfare	\$2,036	ATM 30 at 188
National Geographic	\$47	ATM 30 at 77
National Geographic	\$58	ATM 30 at 380
Snack	\$243	ATM 30 at 166
Employee Welfare, Orvis,	\$336	ATM 30 at 1438
Employee Welfare, Cattle Call - meal	\$2,301	ATM 30 at 1438
Club Dues	\$216	ATM 30 at 1
III Forks - Retirement	\$3,557	ATM 25 at 140
III Forks - Retirement	\$3,393	ATM 25 at 149
III Forks - Retirement	\$3,342	ATM 25 at 181
III Forks - Sign Unveiling	\$3,133	ATM 25 at 193
III Forks - Utility operations	\$3,163	ATM 25
Javier's - AGA	\$1,178	ATM 25 at 346

Aside from the inappropriate capitalization of meals, lodging, liquor and travel for spouses, the City Intervenors allege that Atmos Mid-Tex capitalized expenditures for such disposable and short lived items as Kleenex, trash can liners, staples, and other similar items that should be recorded as an

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<sup>434</sup> Portions of Day 2, 3, 4, 5, 6, 10, 11, 12.

<sup>435</sup> ACSC Exhibit No's. 12, 13, 98, 99; ATM Exhibit No's. 21, 22, 24, 25, 26, 30, 31, 33.

<sup>436</sup> Transcript Vol. 10, Page 144.

<sup>437</sup> Examiners' Exhibit No. 4.

expense in operation and maintenance accounts.<sup>438</sup>

Second, as to the issue of capitalization of certain short lived items, Mr. Pous, who testified on behalf of the City of Dallas, stated that in his experience companies do not capitalize something with a life of less than one year as a standard policy.<sup>439</sup> In fact, the FERC USOA states under Gas Plant Instructions that "The cost of individual items of equipment of small value (for example, \$500 or less) or of short life, including small portable tools and implements, shall not be charged to utility plant accounts unless the correctness of the accounting therefor is verified by current inventories. The cost shall be charged to the appropriate operating expense or clearing accounts, according to the use of such items, or, if such items are consumed directly in construction work, the cost shall be included as part of the cost of the construction."<sup>440</sup> Mr. Cagle, who testified on behalf of Atmos Mid-Tex and is a registered CPA, supported that statement by stating he could not think of a reason personally or professionally that it would be appropriate to capitalize a box of Kleenex to a project.<sup>441</sup> The following table, Table 10.4, provides select examples of the types of expenses included in this case by Atmos Mid-Tex, a portion of which would be capitalized and included in rate base:

Table 10.4

Project No.	Retail Store	Description	Amount	Exhibit
080-19292	Walmart	Ziploc Cont.	\$1.98	ACSC 10 at LG_0016806
		Foil Wrap	\$3.11	ACSC 10 at LG_0016806
		Alum Foil	\$4.97	ACSC 10 at LG_0016806
		Total Receipt	\$376.07	
080-19292	IJS-EJS Industrial Janitorial	Tissue - Bath	\$50.49	ACSC 10 at LG_0016807
		Total Receipt	\$251.10	
080-19292	Office Depot	Kleenex	\$16.04	ACSC 10 at LG_0016812
		Tape, Scotch	\$14.38	ACSC 10 at LG_0016812
		Spoon, jr, med wt, plst	\$2.94	ACSC 10 at LG_0016812
		Fork, jr, plst, med wt	\$2.94	ACSC 10 at LG_0016812
		Knife, plastic, medium	\$2.94	ACSC 10 at LG_0016812
		Plate, flat, hefty, 150	\$4.94	ACSC 10 at LG_0016812
		Towel, roll, perf, 2ply	\$20.17	ACSC 10 at LG_0016812
		Pad, note, highland, 3"X3"	\$9.60	ACSC 10 at LG_0016813
		Cleaner, bathroom, comet	\$24.44	ACSC 10 at LG_0016813
		Total Receipt	\$585.83	
Unknown	Wilson Office Interiors	Cherry Table	\$8,268.15	ACSC 32 at LG_0018937
		Laminate Table	\$3,403.78	ACSC 32 at LG_0018937
		Laminate Table	\$3,511.18	ACSC 32 at LG_0018938
		Total Receipt	\$103,753.21	

<sup>438</sup> ATM Initial Brief Sec. IV., ACSC Initial Brief Sec. IV (B), and City of Dallas Initial Brief Sec. V.

<sup>439</sup> City of Dallas Exhibit 2, Witness Pous, Volume 11, Page 20 Lines 7 - 14.

<sup>440</sup> FERC USOA, Gas Plant Instructions, 3. Components of Construction Cost, Note.

<sup>441</sup> Transcript Volume 4, Pages 162 - 165.

Unknown Wilson Office Interiors

4 chairs	\$8,000.00	ACSC 32 at LG_0018966
6 Chairs	\$5,630.16	ACSC 32 at LG_0018967
3 Chairs	\$3,045.00	ACSC 32 at LG_0018968
Total Receipt	\$96,378.15	

Third, with regards to the capitalization policy, the City Interveners also argued that the revised policy of capitalizing replacement of pipe that was only one foot in length was improper. The Federal Energy Regulatory Commission's Uniform System of Accounts (FERC USOA) has specific instructions related to materials to be recorded as expenses in the operation and maintenance accounts as incidentals and replacement of pipe as maintenance, as opposed to a capitalized asset. The FERC USOA speaks in terms of minor units being replaced to be recorded in operation and maintenance expense accounts.<sup>442</sup>

Fourth, with regards to compliance to the FERC USOA, the City Interveners alleged that it does not appear that the Company complied with the FERC USOA requirements regarding capitalization of overhead costs:

All overhead construction costs, such as engineering, supervision, general office salaries and expenses, construction engineering and supervision by others than the accounting utility, law expenses, insurance, injuries and damages, relief and pensions taxes and interest, shall be charged to particular jobs or units on the basis of the amount of such overheads reasonably applicable thereto, to the end that each job or unit shall bear its equitable proportion of such costs, and that the entire cost of the unit, both direct and overhead, shall be deducted from the plant accounts at the time the property is retired.

As far as practicable, the determination of payroll charges includable in construction overheads shall be based on time card distributions thereof. Where this procedure is impractical, *special studies shall be made* periodically of the time of supervisory employees devoted to construction activities to the end that only such overhead costs as have a definite relation to construction shall be capitalized. The addition to direct construction costs of arbitrary percentages or amounts to cover assumed overhead costs is not permitted.<sup>443</sup>

The Examiners find that Atmos Mid-Tex has not established that capitalizing the replacement of one foot is reasonable. Further, the Examiners find that this deviation from FERC USOA instructions has a significant impact on rates, especially in light of the interim rate adjustment filings.

Atmos Mid-Tex pointed out that some of invoices and receipts relied on by the City Interveners for the allegation of improper capitalization were costs incurred in establishing four new facilities and are included in the record of some of the exhibits.<sup>444</sup> Atmos argued that without

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<sup>442</sup> FERC USOA Gas Plant Instructions 10. *Additions and retirements of gas plant* (c)(1) & (3).

<sup>443</sup> 18 CFR Part 201, Gas Plant Instruction No. 4 A & B. (emphasis added).

<sup>444</sup> Atmos Reply Brief, pp. 65 - 74.

checking the invoices and receipts from the project files against the Company's general ledger and other electronic books and records, one cannot simply assume that all of the items referenced by the City Intervenors were in fact capitalized rather than expensed. Atmos also argued that it is clear from certain notations and from the dates on each invoice and receipt that almost all of these items were purchased during a relatively short stretch of time in the fall of 2005 in anticipation of or connection with the opening of these three new centers. Thus, to the extent that consumable office, kitchen, and restroom supplies were purchased, they were purchased to provide an initial supply that would enable the facility to open. The Company argued further that it was never established that the consumable items were actually capitalized. One cannot tell from the documentation in the exhibits whether or not all of the items on the various invoices were actually capitalized. The Company argues that it has met its burden by maintaining its books and record in accordance with the FERC Uniform System of Accounts ("USOA"), Generally Accepted Accounting Principles ("GAAP"), and the Railroad Commission's gas utility accounting rule (§ 7.310). Accordingly, the Company qualifies for the presumption of necessity and reasonableness conferred by Rule 7.503.

In addition, Atmos Mid-Tex maintains that most of the items shown can reasonably be expected to have a useful life of more than 12 months, and many of several years: mailboxes, kitchen cookware, service ware, and utensil; mop buckets; wastebaskets; tools and tool cabinets; outdoor benches; portable blowers; compressors; welders; serving carts; refrigerators and microwaves; fans; television and DVD/VCRs (for breakrooms and instructional videos); a flag; prints or decorative items; plumbing tools; workbenches and floormats; warehouse trash bins; and so on. Atmos Mid-Tex argued that these are not frivolous purchases, but rather items one would expect to see in a commercial operation of this sort. Finally, Atmos Mid-Tex notes that the consumable items noted represent a small percentage of the overall costs at issue. The Company concludes, that ACSC and ATM, therefore, have overblown the effect of these items.

(c) Examiners' Recommendation

The Examiners find that the City Intervenors and Staff have directly challenged the reasonableness of the overhead factor alleged by Atmos Mid-Tex. Atmos has been unable to establish that the capitalized overhead loading is reasonable. Evidence was presented at the hearing that the procedures in place repeatedly permitted the inclusion of inappropriate overhead expenses. Consequently, Examiners find that Atmos Mid-Tex has failed to establish the reasonableness of the overhead included in the interim rate adjustment filings. The Examiners find that it was not reasonable that the rate payer should provide Atmos a rate of return on the unreasonable expenses included in the meals and entertainment, lodging and other expenses and that it is unreasonable that these expenses should earn a rate of return for the life of an asset, which could turn out to be 10, 20, 30 or 40 years of return. The Examiners find that Atmos Mid-Tex conducted no study to confirm that only such overhead costs that have a definite relation to construction shall be capitalized. The addition to direct construction costs of arbitrary percentages or amounts to cover assumed overhead costs is not permitted.<sup>445</sup> Capitalization percentages of overhead costs varied on a monthly basis from 23% to 60% between October 2004 and September 2005.<sup>446</sup>

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<sup>445</sup> Tr. Vol. 4, pp. 48 - 49.

<sup>446</sup> ACSC Ex. 78.

Further, the Examiners' find that disposable items such as Kleenex, trash can liners, staples, and other similar items should not be capitalized. The Examiners find that the evidence established that these expenses were capitalized. Certainly, the capitalization of these items was raised by the City Intervenor and Atmos Mid-Tex did not establish that they were not capitalized. The Examiners find that the overhead costs applied to various projects has a significant impact on the rate base. In the context of the interim adjustment statute, that impact is immediately reflected in the annual interim rate adjustment filings of the utility. The Examiners find that based upon the forgoing evidence Atmos has not established that the overhead associated with projects in 2003 and 2004 interim rate adjustment filings is reasonable. The Examiners find that the FERC USOA provides specific instructions regarding overhead costs and their calculation.<sup>447</sup> The process the Company used to determine overhead costs attributed to each project did not follow FERC's instructions.<sup>448</sup>

The lack of documentation makes the calculation of any adjustment for inappropriate expenditures and inappropriate capitalization, short of a complete disallowance, difficult. Atmos Mid-Tex failed to maintain adequate underlying records regarding its expenditures. On the other hand, Atmos testified that it used a 33% construction overhead factor for their two-inch pipe calculations, to be discussed below in section XV. This was challenged by ACSC as unsubstantiated, in part based upon information provided by Mr. Meziere, Director of Accounting Services for Atmos Mid-Tex. He provided information that construction overhead costs to total investments by year for the 2003, 2004, and 2005 investment included in the interim rate adjustment filing was 24.1%, 11.83%, and 14.3%, respectively for Atmos Mid-Tex. These percentages do not include the amount of overhead contributed by Shared Services. Shared Services overhead did not become a factor until 2005, at the time of the third interim rate adjustment filing. Mr. TheBerge alleged that Atmos Mid-Tex contributed, on average, 9% to the overhead costs of pipe replacement projects. This means the last factor in Mr. Meziere's exhibit must be increased by 9% to 23%. The *RS Means Cost Guide for Heavy Construction* provides a sampling of the range of overhead construction costs experienced by various industries in the range of 11% to 16%.<sup>449</sup> In two of the three years in which Atmos Mid-Tex made an interim rate adjustment filing, the overhead factor exceeded that range by over 7%.

Table 10.5

Year	Percentage of overhead costs to total investments	RS Means Cost Guide Range of 11% - 16%
2003	24.1%	Outside the range
2004	11.83%	Within the range
2005	23.3%	Outside the range

The Examiners find that the mid-point of those two numbers range shown in the RS Means

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<sup>447</sup> FERC USOA Gas Plant Instructions 4. *Overhead construction costs* (A) (B)(C).

<sup>448</sup> Transcript Volume 4, Pages 48 - 49.

<sup>449</sup> ACSC Exhibit 5, Direct Testimony of Jack Stowe, Page 51, Lines 3 - 5.

Cost Guide of 13.5% represents a reasonable proxy for should have been charged to projects from Atmos Mid-Tex. The reasonableness of the 13.5% is confirmed by the fact that in 2004, Atmos Mid-Tex shows that overhead capital was actually less and if the 9% shared services overhead is not added to the overhead capital included in 2005, the overhead capital was just above the mid-point at 14.3%. No additional adjustment is required in 2005 as the adjustments made in Section X address the excess overhead charged to projects in the last year. The overhead included in the second year is within the range predicted by *RS Means Cost Guide for Heavy Construction*. On the other hand, the Examiners recommend an adjustment to the overhead charged in 2003 as it exceeded the range predicted by that publication. Accordingly, the Examiners recommend that all amounts in excess of 10.6% be removed from rate base for projects completed in 2003.

The adjustment to gross plant in the 2003 interim rate adjustment filing is \$74,686,890. Based on the information provided by Mr. Meziere, 24.1% is the percentage of overhead costs included in that figure, or \$17,784,826. Based on the application of 13.5% derived from the *RS Means Cost Guide for Heavy Construction*, the Examiners find that \$9,962,454 of the overhead capitalized costs is reasonable. Accordingly, the Examiners find that Atmos Mid-Tex has not established that \$7,822,372 of the capitalized costs for that year is reasonable. Accordingly, the Examiners recommend that this amount be disallowed.

As noted above, Atmos Mid-Tex filed interim rate adjustment requests in 2003, 2004, and 2005. The Intervenor challenged whether certain expenses included in the invested capital were just and reasonable. The burden of proof regarding the expenditures related to interim rate adjustments is on the gas utility that requested the adjustment. As provided in the statute, "until the issuance of a final order or decision by a regulatory authority in rate case that is filed after the implementation of a tariff or rate schedule under this section, all amounts collected under the tariff or rate schedule before the filing of the rate case are subject to refund."<sup>450</sup> Additionally, as Atmos Mid-Tex has failed to establish that \$7,822,372 included in the 2003 interim rate adjustment the Examiners recommend that a portion of those rates be refunded to customers. The amounts to be refunded will be discussed below after all issues related to the interim rate adjustments have been addressed.

The Examiners find that the proposed adjustment is conservative for several reasons. First, although the Examiners adjustment is based upon the alleged overhead loading factors identified by Mr. Meziere of 24.1%, 11.83%, and 14.3%, the Examiners note that Atmos Mid-Tex insists that the appropriate factor is 33% to account for the overhead costs associated with shared services. Mr. Stowe, who testified for ACSC, in the context of cost allocation issues observed that this would result in a rather large percentage of overhead costs associated with projects undertaken pursuant to construction contracts. He noted that because the outside construction contractor would bear the cost of F.I.C.A, employee benefits, insurance requirements, etc., it would follow that the outside construction contractors overhead incorporated in the construction contract would approach 33%. Applying a 33% construction overhead loading plus the overhead loading already embedded in the contracting price he estimated that 76.89% in construction overhead loading would be included for each and every project.<sup>451</sup> The recommended adjustment is substantially less than if it would have

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<sup>450</sup> Tex. Util. Code Ann. § 104.301(a) (Vernon Supp. 2006).

<sup>451</sup> ACSC Exhibit 5, Stowe Direct, p. 51, ln. 18 - p. 52, ln. 5.

been based upon the 76.89% overhead calculated by Mr. Stowe.

The Operation and Maintenance budget of Atmos Mid-Tex for fiscal year 2006 included approximately \$4,589,745 for the following categories of expenses: Miscellaneous employee welfare, Meals & Entertainment, Spouse, and Dependent Travel, Transportation, Lodging, Miscellaneous Employee Expenses, Travel, and Club Dues and Entertainment expense.<sup>452</sup> In the fiscal year Capital Plan, Atmos Mid-Tex indicated that it estimated that it would spend \$95,301,635 in direct costs related to capital expenditures. The plan included 24% overhead rate to be applied to capital projects for a total of \$24,264,965 in overhead costs.<sup>453</sup>

Finally, the Examiners recommend that all interim rate adjustment reports filed with the Company's next Subchapter C rate case include, but not be limited to, the following information: (1) Project Number (2) Cost, (3) Capitalized Portion of the Cost, (4) generalized description of the sources of those costs, (5) Description of Completed Projects Placed in Service or Retired, (6) Customers Benefitted, (7) Location, and (8) Purpose of Project. In short, the report should include information similar to the information provided as part of Atmos Exhibit 26 and include the capitalized portion of each cost. Additionally, the Company should include a description of how overhead costs are tracked and accounted.

#### J. Affiliate Transactions: TXU Australia

One issue related to an alleged affiliate transaction was raised by ACSC regarding the first interim rate adjustment of 2003. The transaction that is the subject of ACSC's objection took place prior to the merger of TXU Gas and Atmos Energy Corporation. TXU Australia provided services related to an interim rate adjustment project identified as GRIP 009890950.<sup>454</sup> That project was related to the costs of converting paper maps to a digital format. Once the maps were digitized they could be uploaded into the FRAMME graphical mapping module of the Distribution Information System (DIS).<sup>455</sup> Atmos Mid-Tex noted that the DIS project was completed in-house by TXU employees and through the assistance of various affiliates. The project spanned several years and in 2004, \$11,638,858 in costs were booked to that project. Of that amount, \$849,869.64, was paid to TXU Australia. The Company also explained that the conversion from paper to an electronic format allowed the loading of the distribution gas facilities into a Geographical Information System and enhanced the overall management of the system including design, construction, operations and maintenance functions so that gas service can be provided in a safe and reliable manner.<sup>456</sup> TXU Australia was an affiliate of TXU Gas at the time of the transaction.<sup>457</sup> The Company witnesses explained that it turned to TXU Australia because it had superior knowledge and experience with DIS.<sup>458</sup>

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<sup>452</sup> ACSC Exhibit 76.

<sup>453</sup> ATM Initial Brief, p. 86, ACSC Exhibit 76.

<sup>454</sup> ACSC Exhibit No. 113.

<sup>455</sup> Other aspects of the DIS system are addressed in section XX, below.

<sup>456</sup> ACSC Exhibit No. 37.

<sup>457</sup> Tr. Vol. 6, p. 218, ln. 8 - p. 221, ln. 5.

<sup>458</sup> Tr. Vol. 6, p. 220, lns. 2 - 25.



Section 104.055(b) precludes the Commission from allowing a gas utility's payment to an affiliate for the cost of a service to be included as capital cost to the unless the Commission finds the payment to be reasonable and necessary. In the context of affiliate transactions, GURA requires that two specific findings be made. First, the Commission must find that the service was reasonable and necessary. Second, a finding must be made that the price the utility paid for the service is not higher than the prices charged by the supplying affiliates to its other affiliates or division or to a nonaffiliated person for the same item or class of items.<sup>459</sup> ACSC contended that Atmos Mid-Tex made no attempt to meet the affiliate transaction standard for these costs.

Atmos Mid-Tex does not dispute that section 104.055(b) places a higher evidentiary burden on the utility regarding affiliate expenses. In response to the arguments made by ACSC, Atmos Mid-Tex argued that ACSC made the argument based upon the incorrect assumption that TXU Australia Service should be construed as an affiliate of Atmos Energy Corporation. The Company argued that ACSC has not shown – because it cannot – that TXU Australia Services is an affiliate of Atmos Energy Corporation and concluded that the Company, therefore, does not carry the higher burden of proof with respect to services provided by TXU Australia Services.<sup>460</sup>

The Examiners find that the issue is not whether TXU Australia is an affiliate of Atmos, the issue is that TXU Australia was an affiliate of TXU Gas at the time of the transaction. As TXU Australia was an affiliate of the operators of this utility system at the time of the transaction, the Examiners find that the provisions of 104.055(b) apply. The Examiners find that Atmos Mid-Tex established the necessity of the project. The Examiners find, however, that the record is devoid of any evidence upon which a finding may be made regarding the second requirement of section 104.055(b): "The finding must include . . . a finding that the price to the gas utility is not higher than the prices charged by the supplying affiliate to its other affiliates or division or to a nonaffiliated person for the same item or class of items." Accordingly, the Examiners recommend that an adjustment to the 2003 interim rate adjustment be made in the amount of \$849,869.64. Further, the Examiners recommend that an adjustment to ratebase be made to remove this expenditure from rate base.

#### K. System Classification and Reclassification

Coserv argued in its initial brief that the manner in which Atmos Energy Corporation assigns – and reassigns assets between the two division, pipeline and distribution, without review and approval from any regulatory body undermines the integrity of rates that are established as if the divisions were truly separate. Coserv argued that the Company has an ability to increase revenues through its reassignment, or reclassification, of assets and effectively increase rates charged without any material change in service. Coserve argued that by reclassifying assets from pipeline to distribution Atmos is able to increase revenues through several mechanisms. One is through the interim rate adjustments and the other is by adding an additional distribution charge to industrial, commercial, and transportation customers in instances where neither the service nor th cost of service has materially changed. Coserv argued that the functionalization criteria through which

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<sup>459</sup> Section 104.055(b).

<sup>460</sup> Atmos Reply Brief, pp. 151 - 152.

Atmos reclassifies pipeline from a pipeline function to a distribution function is subjective and arbitrary and that Atmos has a clear incentive to reclassify plant to distribution to increase revenues. Coserv argued that Atmos has reclassified plant as new plant for purposes of the interim rate adjustment provisions, even though this is not new plant. Coserv maintained that transfers through reclassification are not eligible for purposes of interim rate adjustments.<sup>461</sup>

In response Atmos Mid-Tex argued that there is no language in the interim rate adjustment statute that conditions the investment for inclusion in interim rate adjustment filings beyond being used and useful for gas service. The Company pointed out, as noted above, that the statute only speaks of the change in invested capital from one calendar year to the next calendar year in defining the amount of investment to be included in the interim rate adjustments. Atmos Mid-Tex also argued that Coserv was unable establish that the transfer of assets is accomplished for the purpose of increasing revenues.

The Examiners find that the record in this case does not establish that the reclassification of assets is made for the sole purpose of increasing revenues. Further, the Examiners find that there is no limitation in the interim rate adjustment statute that would preclude the inclusion of reclassified assets in an interim rate adjustment filing.

L. Refund Calculation for Amounts Collected Pursuant to the Company's Interim Rate Adjustments.

Based upon the above findings and recommendations the Examiners find that certain amounts collected pursuant to the interim rate adjustments should be refunded. Those amounts are set out in Schedule IRA 1 (IRA 2003 A) - Schedule IRA 12 (IRA 2005 WorkPapers/Schedule A), attached to this proposal for decision. First an adjustment must be made to the 2003 interim rate adjustment filing to remove expenses related to TXU Australia. Second, an adjustment must be made to the 2003 interim rate adjustment filing to remove expenses related to overhead costs that Atmos Mid-Tex has not established are just and reasonable. Third, adjustment must be made to the 2004 and 2005 interim rate adjustment filing to reverse the adjustment to accumulated depreciation in the amount of \$10,646,065. Fifth, an adjustment must be made to the 2005 interim rate adjustment filing to remove expenses related to Shared Service Capitalization Expenses and Mid-Tex Capitalization expenses. Based on evidence provided by the Company, Atmos Mid-Tex collected \$16,634,370 in revenues based upon its interim rate adjustments. Of that amount the Examiners recommend that \$2,568,955 be refunded. This is predicated upon a base refund amount of \$2,459,955 with 4.91% interest.

XI. RATE BASE

A. Adjustments to accumulated depreciation due to Poly 1.

As discussed in Section X, Interim Rate Adjustment Issues, above, an adjustment to accumulated depreciation must be reversed in the amount of \$10,646,065. This adjustment is

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<sup>461</sup> Coserv Initial Brief, pp. 11 - 16.

necessary to eliminate the modification of the Final Order issued in GUD No. 9400.

B. Cash Working Capital.

1. Introduction

Cash working capital represents an amount of cash that a utility must have available to meet current obligations as they arise, due to the time lag between payment of expenses and collection of revenues.<sup>462</sup> The need for working cash has long been recognized by regulatory bodies and the courts.<sup>463</sup> An allowance of cash working capital, however, is not guaranteed as a matter of course and the utility carries the burden of establishing the need for cash working capital.<sup>464</sup> In order to determine the cash working capital needs of the Atmos Mid-Tex system Atmos prepared a lead-lag study.<sup>465</sup> A lead-lag study empirically identifies the difference in timing between outward cash flow for labor, materials and supplies, inventory, and other expenses, and inward cash flow of revenue from payments to customers.<sup>466</sup>

Cash working capital requirements may be positive or negative. Positive working capital is investor-supplied. In contrast, negative working capital reduces the need for investor-supplied capital and arises when the utility receives customer payments before service is rendered, or when it receives funds before it must satisfy a corresponding liability. To illustrate the concept of cash working capital, if one assumed that the utility paid for natural gas before it supplied the natural gas to the consumer, then the utility would be using positive cash working capital, i.e., money from its investors, to pay for natural gas until the consumer paid the utility. In that case, the investors have an expectation of receiving a reasonable return on its investment. If, however, the consumer paid the utility in advance for use of the product, the company has negative cash working capital and the investor would have no expectation of return because the investor's capital was not being used.<sup>467</sup>

The CWC component feeds in directly to the calculation of rate base. In the Statement of Intent that was filed on May 31, 2006, and subsequently revised, Atmos Mid-Tex proposed a rate base requirement of \$1,111,791,170. Atmos Mid-Tex seeks a rate of return of 8.86%. Consequently, the return associated with rate base in its initial filing was \$98,449,108. As proposed by the company, the \$1,111,791,170 rate base component was comprised of a positive \$188,700 in cash working capital. In other words, Atmos Mid-Tex alleged that investors supplied \$188,700 in CWC. This is contrary to GUD No. 9400 where the CWC component approved by the Commission

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<sup>462</sup> Alabama-Tennessee Natural Gas Co. v. Federal Power Commission, 203 F.2d 494, 498 (3<sup>rd</sup> Cir. 1953); People's Counsel v. Public Service Commission, 399 A.2d 43, 46 (D.C. Cir. 1979).

<sup>463</sup> Smyth v. Ames, 169 U.S. 466 - 418 (1898).

<sup>464</sup> Southern Union Gas Co. v. Railroad Commission of Texas, 701 S.W.2d 277 (Tex. App. — Austin 1986 (Gas utility failed in its burden of proof regarding its working capital needs); Peoples Counsel v. Public Serv. Comm'n, 399 A.2d 43, 45.

<sup>465</sup> Atmos Exhibit 27, Joyce Direct, p. 4, lns. 16 - 31.

<sup>466</sup> Colorado Municipal league v. Public Util. Comm'n, 687 PR 2d, 416, 420; Cent. La. Elec. Co. Inc. v. La. Publ. Serv. Comm'n, 373 So.2d 123, 130 (La. 1979).

<sup>467</sup> Zia Natural gas Company v. New Mexico Public Utility Commission, et al., 2000 WL 358390 (March 1, 2000).

was a negative \$61,241,394.<sup>468</sup> There, the Commission found that residential and commercial customers supplied \$61,241,394 in CWC. If the CWC component of rate base had not changed, the rate base in this case would be reduced by \$61,441,019. The return associated with that amount of rate base would be \$93,061,991, assuming a rate of return of 8.86%. Thus, the CWC study presented accounts for \$5,442,706 of the proposed rate increase.

In support of the proposed cash working capital allowance, Jay Joyce presented the results of his cash working capital study and the relevant findings are reproduced at Table 11.1 below.

Table 11.1

	Adjusted Amount	Avg. Daily Expense	Revenue Lag Days	Expense Lead Days	Net Lag/Lead	Working Capital Req.
Operation & Maintenance						
Rider GCR Part A	\$1,155,349,775	3,165,342	43.590	(41.897)	1.693	\$ 5,358,924
Rider GCR Part B	\$ 74,642,335	204,500	43.590	(18.889)	24.701	\$ 5,501,343
Other O & M	\$ 159,896,630	438,073	43.590	(25.794)	17.796	\$ 7,795,946
Taxes Other than Income	\$ 108,677,952	297,748	43.590	(96.646)	(53.056)	\$(15,797,308)
Interest on Customer Advances and Deposits	\$ 1,378,869	3,778	43.590	(631.300)	(587.710)	\$( 2,220,206)
Total CWC Allowance						\$ 188,700

The City Intervenors have challenged the components of the cash working capital analysis presented by Atmos. First, the City Intervenors challenged the calculation of revenue lag days. Second, the City Intervenors have raised several issues related to the calculation of expense lead days.

Jay Joyce, of Alliance Consulting Group, and Laurie Sherwood, Treasurer of Atmos Energy Corp., testified on behalf of Atmos Mid-Tex in support of its proposed cash working capital requirement. Each of the issues raised by the City Intervenors, and the Company's position, will be addressed below. As a general matter, Mr. Joyce argued that the City Intervenors ignored the purpose of calculating the cash working capital requirements of a specific company. Further, he argued that the City Intervenors' criticism overlapped in certain places and sometimes produced conflicting results.<sup>469</sup> In response, the City Intervenors argued that the Company has created inefficient practices that degraded its cash working capital position.

## 2. Revenue Lag Days

<sup>468</sup> GUD No. 9400 Final Order, Schedule J(D).

<sup>469</sup> Atmos Exhibit 36, Joyce Rebuttal, p. 3, ln. 4 - p. 7, ln. 23.

Atmos proposed a revenue lag day of 43.59 days.<sup>470</sup> Revenue lag days are made up of four components: (1) Average service period, (2) Billing Lag, (3) Collection Lag, and (4) Receipt of Funds Lag. The lag days for each component were calculated as part of the lead/lag analysis. In GUD No. 9400, the revenue lag days used to determine the cash working capital requirement for the utility operating this distribution system, TXU Gas - Distribution, was 23.830.<sup>471</sup>

Two components of the revenue lag day calculation were challenged by ACSC, ATM and the City of Dallas. They argued that the total number of revenue lag days should be reduced. The City of Dallas maintained that the revenue lag days should be 23.320. The overall impact on CWC is to reduce the CWC to a negative \$83,109,647 and reduce the revenue request by \$7,380,234. On the other hand, ATM argued that the appropriate revenue lag days is 39.120. This would reduce the CWC to a negative \$18,180,497 and reduce the revenue request by \$1,627,511.

a. Billing Lag

The billing lag represents the period of time between when a meter is read and a bill is issued.<sup>472</sup> Atmos has calculated a billing lag of 4.47 days. The billing lag in GUD No. 9400 and approved by the Commission, was zero. Thus, customers were billed on the same day that meters were read.<sup>473</sup> A zero billing lag would result in a cash working capital of a negative \$18,139,402 and would reduce rates by approximately \$2,180,077. Mr. Joyce, who testified on behalf of Atmos Mid-Tex, indicated that the increase in billing lag was the result of differences in the billing practices between Atmos Mid-Tex and TXU Gas. ACSC, ATM, and The City of Dallas directly challenged this assertion.

Mr. Tucker, on behalf of ACSC, and Mr. Pous, who testified on behalf of the City of Dallas, argued that the facts did not support the claim made by Mr. Joyce. First, the TXU Gas billing systems were used for at least a portion of the test year. Logically, Mr. Pous concluded that there should be no change in the amount of time necessary to process bills. Second, Atmos Mid-Tex employed the same or similar technology used by TXU Gas. That technology enabled the utility to automatically upload meter readings directly into the Company's billing system promptly after a meter was read. Mr. Tucker indicated that Scott Powell, Vice-President of Operations in the Mid-Tex Division of Atmos Energy Corporation, confirmed this fact.<sup>474</sup> Consequently, Mr. Tucker concluded that the billing lag days should be zero and consistent with the level approved in GUD No. 9400. Furthermore, even if the *alleged* business practice was to hold bills for an average of 4.47 days, the City Intervenor witnesses argued that setting the billing lag days at an amount greater than zero resulted in a penalty to customers because of an *alleged* inefficient practice by Atmos Mid-Tex

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<sup>470</sup> Atmos Exhibit 17, Cost of Service, Schedule E.

<sup>471</sup> GUD No. 9400, Schedule J(D), col. (e).

<sup>472</sup> Atmos Exhibit 27, Joyce Direct, p. 9, Ins. 7 - 10, Pous Direct, p. 67, Ins. 18 - 19, & Tucker Direct, p. 6, Ins. 6 - 10.

<sup>473</sup> ACSC Exhibit 2, Tucker Direct, p. 6, Ins. 11 - 15.

<sup>474</sup> ACSC Exhibit 2, Tucker Direct, p. 7, Ins. 9 - 20, Tucker Attachment H (Atmos Response to Dallas RFI 4-41.

compared to those of TXU Gas.<sup>475</sup> As noted by Mr. Garrett, the utilization of sound cash management techniques will, in most situations, produce a negative cash working capital requirement.<sup>476</sup>

Mr. Joyce argued that witnesses for ACSC, ATM, and the City of Dallas suggest that the Commission completely ignore the actual customer billing practices of Atmos Mid-Tex. He argued that instead of relying on actual practice, Mr. Pous and Mr. Tucker suggested that the Commission impose the zero day billing lag calculation that was developed in GUD No. 9400 based on 2002 test year information for TXU Gas. He argued that the billing lag reflected in Atmos Mid-Tex's cash working capital analysis reflected Atmos Mid-Tex's actual billing practices. Mr. Joyce emphasized that the Commission approved a method for calculating billing lag days in GUD No. 9400 that resulted in zero days for TXU Gas – it did not necessarily approve the number of days. He contended that he simply applied the approved methodology in this case and arrived at 4.47 day billing lag. He also pointed out that Mr. Tucker has testified in cases where he recommended billing lags of 4.5 days, and 4.807 days, and even 5.8 days. Therefore a billing lag of 4.47 days is not unreasonable.<sup>477</sup>

The Examiners find that Atmos Mid-Tex has failed to establish that a billing lag of 4.47 is just and reasonable. The Examiners find that the Company's claim that it averages more than four days to process a bill after the meter is read is not supported by the evidence in the record. First, the evidence presented at the hearing reveals that the meter reading process is the same as it has been for several years and enables the utility to promptly upload information. A fact confirmed by witnesses for Atmos Mid-Tex. Second, the Commission examined the same procedures used by TXU Gas Distribution and concluded that a billing lag of zero was just and reasonable. Third, evidence presented at the hearing revealed the actual billing lag experienced in processing several bills. Six sample bills were produced at the hearing.<sup>478</sup> Of those one was sent on the same day the meter was read; four were issued one day after the meters was read, and one was issued two days after the meter was read.<sup>479</sup>

In response to the contentions raised regarding the billing lag Atmos Mid-Tex did not produce one example of a bill that was issued four days after the meter was read. In fact, no evidence was provided to support the 4.47 billing lag days other than the unsupported assertion of Mr. Joyce. During the hearing he testified that an employee from Atmos Mid-Tex informed him the billing lag was 4.47 days. Mr. Joyce could not describe the billing process that resulted in a 4.47 billing lag. The rebuttal testimony was limited to the assertion that the company that was the subject of the proceeding in GUD No. 9400 is different than the company that is the subject of this proceeding. The Examiners find that the testimony was not relevant to the assertion made by these City Intervenors.

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<sup>475</sup> ACSC Exhibit 2, Tucker Direct, p. 7, Ins. 3 - 25 & p. 8, Ins. 1 - 10, City of Dallas Exhibit 2, Pous Direct, p. 68, ln. 17 - 19, and ATM Exhibit 1, Garrett Direct, p. 14, Ins. 10 - 18.

<sup>476</sup> ATM Exhibit 1, Garrett Direct, p. 4, Ins. 15 - 17.

<sup>477</sup> Atmos Exhibit 36, Joyce Rebuttal, p. 14, ln. 1 - p. 16, ln. 21.

<sup>478</sup> Dallas Exhibit 17 & Tr. Vol. 8, pp. 126 - 129.

<sup>479</sup> Further, several Protestants who filed a protest in response to the notice provided by Atmos included copies of Atmos bills. Not one bill supported Atmos' contention that the billing lag was 4.47 days.

Even assuming, for the purposes of this discussion, that these are two different companies, an assertion that is inconsistent with other positions taken by Atmos Mid-Tex in this case, Mr. Joyce did not address the basic contention of the City Intervenors: Atmos Mid-Tex processes bills in less than 4.47 days. Mr. Joyce produced no evidence that the billing lag was, in fact, 4.47 days other than to assert that he was provided that calculation by an Atmos Mid-Tex employee. Indeed, Mr. Joyce unequivocally stated that he conducted no investigation to determine the veracity of that claim.<sup>480</sup> Furthermore, Mr. Joyce candidly admitted his lack of familiarity regarding the actual billing process of Atmos Mid-Tex and stated that he did not “know enough of the details to” explain the billing process.<sup>481</sup> Beyond that, Mr. Joyce merely asserted that a billing lag of 4.47 is within a range experienced by other utilities. The experience of other utilities, however, is not a substitute for evidence to prove the actual billing lag of this utility.

In addition, the Examiners note that Mr. Joyce’s reluctance to examine this claim made by Atmos Mid-Tex affects the credibility of the witness and the lead/lag study. Mr. Joyce participated in the lead/lag study that was prepared in GUD No. 9400. Mr. Joyce was aware of the impact of a 4.47 billing lag on the Company’s revenue request. Indeed, the overall increase in revenue lag days from 23.830 in GUD No. 9400 to 43.590, a 19.76 day increase, would prompt a reasonable and prudent person to examine the assertions of Atmos Mid-Tex. As already noted, the revenue impact of a 4.47 day billing lag as opposed to a zero day billing lag is over two million dollars. Finally, while it is true that the lead/lag study should be based on the facts of the utility, reasonable billing practices should be established to minimize the CWC requirements. In this context, Atmos Mid-Tex did not present evidence to rebut the assertions of the City Intervenors, to establish that its management techniques were reasonable, nor to rebut the assertion that the billing practices were manipulated to increase the overall revenue lag days. The Examiners recommend a zero day billing lag.

b. Collection Lag

Collection lag measures the period of time between the mailing of the customer’s bill until the company receives payment.<sup>482</sup> Collection lag is impacted by the speed with which customers remit payment.<sup>483</sup> Two aspects of the Company’s calculation of collection lag were challenged in this case. First, the City Intervenors challenge the methodology selected to calculate collection lag. Second, the City Intervenors take issue with the decision of Atmos Mid-Tex to discontinue the practice of factoring or securitizing accounts receivable. In GUD No. 9400, TXU Gas Distribution, calculated a collection lag of 22.59 days. The collection lag was positively impacted by the process of securitizing accounts receivable. As noted by the Examiners in GUD No. 9400, the receivables securitization program was a method by which a company sells its accounts receivable to a third party for cash, thereby accelerating the receipt of cash collected.<sup>484</sup> The decision of Atmos Mid-Tex to discontinue the securitization program is challenged by ACSC and the City of Dallas.

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<sup>480</sup> Tr. Vol. 8, pp. 104 - 107

<sup>481</sup> Tr. Vol. 8, pp. 124 - 125.

<sup>482</sup> Atmos Exhibit 27, Joyce Direct, p. 9, Ins. 11 - 13, ACSC Exhibit 2, Tucker Direct, p. 8, Ins. 12 - 13.

<sup>483</sup> ACSC Exhibit 2, Tucker Direct, p. 8, Ins. 12 - 15.

<sup>484</sup> GUD No. 9400, PFD, p. 156.

## (1) Method of calculation

In GUD No. 9400 TXU Gas calculated the component of revenue lag using samples of one hundred customer transactions for both residential and commercial revenues and a sample of fifty transactions for each of the other customer classes. In this proceeding, on the contrary, Atmos Mid-Tex has elected to calculate the collection lag based on an analysis of the month-end accounts receivable balances.<sup>485</sup> ACSC and the City of Dallas argued that the changed methodology was erroneous and that the best method is to use the method applied in GUD No. 9400. Mr. Tucker, on behalf of ACSC, argued that the correct measure of collection lag results in a 16.65 day collection lag. On the other hand, Mr. Pous, on behalf of the City of Dallas, argued that a correctly calculated collection lag is approximately 15.63 days. They both argued that they employed the methodology used to determine the collection lag in GUD No. 9400.

Mr. Tucker and Mr. Pous argued that the methodology applied in this case differed significantly from the methodology used in GUD No. 9400. The approach relied on in that case was based on an examination of actual bills and payments of customers.<sup>486</sup> Mr. Tucker noted that the most accurate method to calculate collection lag would be to examine the actual payment patterns of all customers. That method, however, would be time consuming and expensive. Thus, in GUD No. 9400 the utility chose to examine a sample of customers in each class.<sup>487</sup> Mr. Tucker argued that Atmos Mid-Tex initially claimed that a sampling of customers was not available. He pointed out, however, that the utility, in response to a discovery request, indicated that the computerized accounting system would be made available so that the consultants working for the Intervenor could perform their own random sampling.<sup>488</sup> Thus, Mr. Tucker did not find credible the initial assertion of Atmos Mid-Tex, that a sampling was not available credible.

ACSC and the City of Dallas also argued that the alternative methodology elected by Atmos resulted in a significantly higher collection lag than approved in GUD No. 9400.<sup>489</sup> Mr. Tucker argued that *monthly* account receivable balances provide a snapshot of outstanding balances that may distort the collection lag realized by the Company.<sup>490</sup> Further, *monthly* account receivable balances lead to a less accurate calculation of the collection lag experienced by the utility.<sup>491</sup> Mr. Pous explained that he examined the size of the bills that occurred late in the billing cycle and found that these bills were larger and would impact an analysis based upon *monthly* account receivable balances. While he recommended retention of the prior collection lag which he estimated to be 15.59, Mr. Tucker argued that the average daily accounts receivable balances should be the data relied upon instead of average month-end values.<sup>492</sup> Mr. Tucker noted that in other jurisdictions

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<sup>485</sup> Atmos Exhibit 27, Joyce Direct, p. 9, lns. 13 - 15.

<sup>486</sup> ACSC Exhibit 2, Tucker Direct, p. 9, lns. 3 - 13, Pous Direct, p. 65, lns. 12 - 24.

<sup>487</sup> Dallas Exhibit 2, Pous Direct, p. 9, lns. 14 - 21 & p. 10, lns. 1 - 4.

<sup>488</sup> ACSC Exhibit 2, Tucker Direct, p. 10, lns. 5 - 16 &

<sup>489</sup> ACSC Exhibit 2, Tucker Direct, p. 9, lns. 3 - 13.

<sup>490</sup> ACSC Exhibit 2, Tucker Direct, p. 11, lns. 18 - 23 & p. 12, lns.

<sup>491</sup> Dallas Exhibit 2, Pous Direct, p. 66, lns 1 - 15, and Tucker Direct, p. 12, lns. 11 - 13.

<sup>492</sup> ACSC Exhibit 2, Tucker Direct, p. 11, lns. 12 - 14.



Atmos Energy Corporation has used *daily* accounts receivable balances.<sup>493</sup> Although Atmos Mid-Tex claims that daily balances are not available, Mr. Tucker pointed out that Atmos Mid-Tex used average daily accounts receivable balances in two prior cases.

In response Mr. Joyce argued that average *monthly* account receivable balances were not substantially different from average *daily* accounts receivable balances and endeavored to establish that fact by analyzing data attached to the testimony of Mr. Tucker. He argued that an analysis of the data available to Mr. Tucker would reveal that fact. Further, he argued that the insignificance of the difference between the calculations of collection lag days using daily accounts receivables versus month-end accounts receivable balances is not surprising because Atmos Mid-Tex utilized cycle billing and the number of invoices sent to customers is relatively constant throughout the month and year. In addition, he maintained that Mr. Tucker is mistaken in his assertion that daily account receivable balances are available. He argued that the information was never available to Atmos Mid-Tex nor was the information available when this system was operated by TXU Gas. As to the use of a billing sample, Mr. Joyce argued that it was no more accurate than the use of *monthly* account receivable balances both are acceptable methods of determining collection lag. Finally, he took issue with Mr. Tucker's contention that there was regulatory precedent for the adoption of a collection lag adopted in a prior proceeding.<sup>494</sup>

The Examiners agree that the most accurate method of calculating the collection lag would be to examine each customer bill and calculate the collection lag associated with each bill. Such a process, however, would be time consuming and expensive. In the alternative the Examiners find that the most accurate method is the method adopted by TXU Gas Distribution, in GUD No. 9400 – the use of a customer sample. In fact, Mr. Joyce conceded during cross-examination that he first inquired as to the availability of customer sample in order to duplicate the method used in GUD No. 9400.<sup>495</sup> The Examiners find that the data Atmos Mid-Tex proposed adopted a methodology that differed from the methodology used in other cases involving other divisions of Atmos Corporation – where average daily accounts receivable data was used. Furthermore, the Examiners find from the record in this case that a sample could have been derived.<sup>496</sup> Nevertheless, Atmos Mid-Tex declined to duplicate the methodology used in GUD No. 9400. The Company did not establish that the change in collection lag was not due to a change in the methodology used to calculate the collection lag.

Mr. Joyce maintains that the methodology adopted, the use of month-end of accounts produced the same result. Nevertheless, the fact remains that collection lag for the same category of customers differed substantially from GUD No. 9400. This difference is not explained by Atmos Mid-Tex and no evidence was produced to explain the change. In fact, the Examiners find that there

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<sup>493</sup> ACSC Exhibit 2, Tucker Direct, p. 12, lns. 14 - 22 & p. 13, lns. 1 - 9. The case before the Commission was GUD No. 9091, *Petition of Energas Company for Review of the Rate Action of the City of Lamesa, Texas, et al.* The case before the Missouri Public Service Commission was Case No. GR - 2006 - 0387, *In the Matter of Atmos Energy Corporation's Tariff Revision Designed to Consolidate Rates and Implement a General Rate Increase for Natural Gas Service in the Missouri Service Area of the Company.*

<sup>494</sup> Atmos Exhibit 36, Joyce Rebuttal, p. 16, ln. 22 - p. 20, ln. 19.

<sup>495</sup> Tr. Vol. 8, p 109, lns. 5 - 11.

<sup>496</sup> ACSC Exhibit 2, Tucker Direct, p. 10, lns. 5 - 16.

is evidence to suggest that the collection lag should have declined because of the alleged aggressive collection efforts employed since Atmos Mid-Tex acquired the TXU Gas Distribution system.<sup>497</sup>

Mr. Joyce has correctly noted that this Commission has previously considered the use of a cash working capital component developed in a different case. In GUD No. 9145 - 9148, the Commission found that the “adoption of an expense lead day calculation developed in another case is not reasonable.”<sup>498</sup> That finding was predicated, in part, on the request of the intervenors in that case to use an expense lead in a pipeline distribution case involving different assets from those operated by a local distribution company.<sup>499</sup> As noted by the Examiners in that case, the Intervenor in that case was not aware whether TXU LSP and TXU Gas Distribution had equivalent tax payments. Further, as noted by the Examiners in that case, the Intervenor had not demonstrated that the expense lead calculation of the Applicant was unreasonable.<sup>500</sup> In this case, Atmos Mid-Tex has not established that the proposed calculation was just and reasonable. The Examiners find that there is precedent to support the use of a collection lag adopted in a prior rate case as cited by the City of Dallas in its Initial Brief.<sup>501</sup>

(2) Securitization or factoring of accounts receivable.

As noted above, in GUD No. 9400 TXU Gas Company, the predecessor in interest of Atmos Mid-Tex calculated an average collection lag of 7.23 days.<sup>502</sup> The City Intervenor objected to the decision by Atmos Mid-Tex to discontinue the program of securitizing, or factoring, accounts receivable. They noted that this program had a beneficial impact on the calculation of the collection lag in GUD No. 9400. They both argue that Atmos Mid-Tex has not adequately explained its decision to discontinue this practice.<sup>503</sup> While the City of Dallas argues that the effects of failing to continue this practice should be limited by adopting the collection lag in GUD No. 9400, Mr. Tucker argued that the Commission should further investigate the decision of Atmos Mid-Tex to terminate the program upon acquisition of TXU Gas Distribution. Mr. Pous argued that if no other aspect of the collection lag had been changed, i.e., the methodological issues raised in section XX above, then the collection lag would have been reduced to 9.8808 days.<sup>504</sup>

Laurie M. Sherwood testified on behalf of the Company regarding the issue of securitizing or factoring accounts receivable. A business typically chooses to finance its receivables in order to stabilize cash flow, and it is a method of enhancing cash working capital when other forms of credit are not readily available. She explained that TXU Corp. financed receivables by establishing a securitization program. Under the program, TXU Corp. subsidiaries, including electric and gas companies, pooled their receivables and sold them to TXU Receivables Company, a subsidiary of

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<sup>497</sup> ACSC Exhibit 2, Tucker Direct, p. 11, Ins. 5 - 8.

<sup>498</sup> Finding of Fact No. 70.

<sup>499</sup> See, Finding of Fact No. 69.

<sup>500</sup> PFD pp. 32 - 33.

<sup>501</sup> City of Dallas Initial Brief, pp. 19 - 20, citing to PUC Docekt No. 22350.

<sup>502</sup> ACSC Exhibit 2, Tucker Direct, p. 8, In. 18 (citing to response to Request for Information No. 5 - 9 provided by Atmos).

<sup>503</sup> City of Dallas Exhibit 2, Pous Direct, p. 62, Ins. 23 - 29, ACSC Exhibit 2, Tucker Direct, p. 14, Ins. 16 - 23 through p. 15, Ins. 1 - 6.

<sup>504</sup> City of Dallas Exhibit 2, Pous Direct, p. 65, fn. 159.

TXU Corp. TXU Receivables Company sold interests in these purchased accounts to funding entities established by financial institutions. She explained that an alternative to securitizing the receivables is the practice of selling receivables to willing buyers at a discounted rate, a method referred to as factoring. While factoring and securitizing are not the same, they are both methods of financing receivables. She argued that the Atmos Mid-Tex division is not capable of securitizing receivables because the Company does not have the same complement of receivables available to finance that was available to TXU Corp. Further, the creation of a similar subsidiary essential to such a securitization program would subject Atmos Mid-Tex to burdensome affiliate scrutiny in a number of the jurisdictions in which it operates.<sup>505</sup>

In response to the allegation that Atmos Mid-Tex failed to adequately examine this option, Ms. Sherwood argued that based upon the experience of the Company it was not necessary to spend dollars to re-visit the issues of receivables financing. She also noted that the testimony of TXU Gas established several reasons why Atmos Mid-Tex could not continue the program of securitization. In that case, Mr. Casey testified that, of the total pool of receivables actually sold, TXU Gas contributed a mere 6% while TXU Energy, an unregulated electric affiliate accounted for 88%. She concluded that by pooling receivables, a practice not available to Atmos Mid-Tex, TXU Gas was able to achieve securitization. Finally, she noted that the Atmos West Texas Division receivables are treated in the same manner as the Atmos Mid-Tex Division Receivable. She concluded that in her opinion, the gas utility does not create enough receivables on a consistent, year-round basis to justify factoring, as it is an expense form of financing that would not significantly enhance the Company's cash flow.<sup>506</sup>

The Examiners find that Atmos Mid-Tex failed to establish that the failure to continue a securitization or factoring program was just and reasonable. At the time of the acquisition, Atmos Mid-Tex was aware of this practice of TXU Gas. A practice that was directly beneficial to the residential and commercial customers.<sup>507</sup> The significant benefit accorded to customer by this practice required a more significant analysis than the record reveals. Accordingly, the Examiners recommend that the impact of the factoring of accounts receivable be imputed and that 7.23 collection lag days be applied in the present case. At the next rate case the Commission may determine, based on that study the reasonableness of the Company's decision. The Examiners do not recommend, however, that Atmos Mid-Tex be ordered to factor accounts receivables. The Examiners are only recommending that in the future the Company must establish the prudence of its decision, which it has not done in this case. Should the Examiners' recommended 7.23 collection lag days not be approved, the Examiners recommend that collection lag days be set at a 15.54, the results of the sample study performed in GUD No. 9400.

### 3. Expense Lead Days

#### a. Pipeline Expense Lead Days

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<sup>505</sup> Atmos Exhibit 31, Sherwood Rebuttal, p. 26, ln. 17 - p. 29, ln. 8.

<sup>506</sup> Atmos Exhibit 31, Sherwood Rebuttal, p. 29, ln 8 - 31, ln. 20.

<sup>507</sup> Atmos Exhibit 31, Sherwood Rebuttal, p. 26, ln. 18 - 31.

Atmos Mid-Tex incurs upstream transportation costs for services provided by Atmos Pipeline-Texas, an unincorporated division of Atmos Corporation. Atmos Mid-Tex makes a journal entry on the third workday of each month to reflect the payment of upstream transportation costs for the preceding month. The expense lead days for the service were calculated by adding the service days and payment days.<sup>508</sup> The City Intervenors do not challenge the calculation of service days of 15.21 days. On the other hand, the City Intervenors challenge the calculation of payment days. The payment days were calculated at a little over three days. In GUD No. 9400 TXU Gas Distribution calculated that it made payment a little over 23 days after the service period. Atmos Mid-Tex, has moved up the payment date by about 20 days. This practice increases the cash working capital requirement of Atmos Mid-Tex by approximately \$4,071,177.

Mr. Pous, on behalf of the City of Dallas, argued that the impact on customers associated with the sale of the system must be addressed in this case and that customers should not be penalized if the new owner of the system operates the system in a less efficient manner.<sup>509</sup> Mr. Pous also pointed out that the Company's expense lead days for its other expenditures that include the vast majority of non-affiliated charges are much longer. In that context, Atmos Mid-Tex makes a payment between the 21<sup>st</sup> and 24<sup>th</sup> of the month after service was rendered to the Company. As a result, in that context the expense lag would be 39.5 days. Thus, it appears that the Company takes much longer to pay non-affiliated companies than it does to pay an affiliate, or unincorporated division. As a result, Mr. Pous argued that the business process established by Atmos Mid-Tex amounted to self-dealing and preferential treatment that should be denied.<sup>510</sup> Consequently Mr. Pous recommended that the Commission retain the Expense lead day determined in GUD No. 9400 of 38.797 days.

Mr. Garrett, who testified on behalf of ATM, testified that the problem with the Company's analysis is the incorrect assumption that cash changes hands when a journal entry is made. He argued that the effect of the transaction are reflected in the receivables and payables balances of the company when the books are closed at the end of the month. Thus, Mr. Garrett concluded that the service days should be 30.42 payment days resulting in an expense lead of 45.63 days for pipeline transactions. Furthermore, Mr. Garrett argued that if the Company actually effected a transfer of funds on the third day after the conclusion of the service period, the Company has provided preferential treatment to its sister company. He noted that the standard invoicing and payment terms in the market for similar services is much longer. Mr. Garrett investigated standard contract services to third parties by Atmos Pipeline-Texas and concluded that those contracts provided a total of 35 payment days, when invoicing days are included in the payment date. The result was an expense lead of 40.21 days.<sup>511</sup> ACSC agreed with many of the same points made by ATM. Mr. Tucker pointed out that there are no contractual requirements that compel an early payment to Atmos Mid-Tex. He also reviewed third party contracted and concluded that those involved 24 payment days. The result of his analysis was a total of 39.22 lead days.<sup>512</sup>

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<sup>508</sup> Atmos Exhibit 27, Joyce Direct, p. 10, Ins. 6 - 13, Tucker Direct, Attachment H, RFI Response to Dallas RFI Set No. 4, Question No. 4 - 46, ATM Exhibit 1, Garret Direct, p. 6, Ins. 19 - 25 & p. 7, Ins. 1 - 3..

<sup>509</sup> City of Dallas Exhibit 2, Pous Direct, p. 70, Ins. 1 - 8.

<sup>510</sup> City of Dallas Exhibit 2, Pous Direct, p. 70, Ins. 8 - 21,

<sup>511</sup> ATM Exhibit 1, Garrett Direct, p. 7, Ins. 14 - 27 & p. 8, Ins. 1 - 18.

<sup>512</sup> ACSC Exhibit 2, Tucker Direct, p. 16 - 17, Ins. 1 - 7.

Mr. Joyce responded that the actual practice of Atmos Mid-Tex was to make the journal entry on the third day. Mr. Joyce argued that Atmos Mid-Tex has established a pattern of recurring accounting payment entries and that all of the transactions among all of Atmos Energy Corporation's various divisions are non-cash accounting transactions. He also argued that all of the transactions between Atmos Texas Pipeline and Atmos Mid-Tex are intra-company transactions and contended that the end of the month should not be used to measure the effects of the transaction between Atmos Mid-Tex and Atmos Texas Pipeline. Finally, he argued that the expense lead days of this intra-company transaction are consistent with the expense lead days experienced by other utilities for intra-company transactions.<sup>513</sup>

The Examiners find the evidence in the record is insufficient to support the reasonableness of the claimed practice. Atmos Mid-Tex did not produce any evidence that imposed on Atmos Mid-Tex the obligation to make an early payment to the unincorporated division of Atmos Energy Corporation that supplied the pipeline services. The decision of the Company imposes an expense on the residential and commercial customers. As requested that expense is \$5,051,343 in cash working capital requirement for pipeline services. GURA requires that each rate a gas utility makes is just and reasonable.<sup>514</sup> Atmos Mid-Tex has not established that the expense is just and reasonable. This increase in expense is due, in large measure, to the arbitrary reduction in expense lead days for services offered by Atmos Pipeline and provides Atmos Pipeline the advantage of receiving funds twenty days earlier. It is also worth noting that Atmos Pipeline's rates were based, in part, on a cash working capital that used the collection lag that matched the payment lead set in that case for TXU Gas Distribution. If the payment days were changed substantially in this case from those set in GUD No. 9400, Atmos would receive a windfall. Mr. Tucker and Mr. Garrett provided evidence to establish the reasonableness of either 24 payment days or 35 payment days. On the other hand, Atmos Mid-Tex provided no evidence in support of the reasonableness of its three payment days, other than a reference to the practice of other utilities regarding certain intra-company transactions. Accordingly, the Examiners recommend that expense lead days for pipeline expenses be set at 39.22 days. This is a result of a service period lag of 15.206 days and a 24 day payment lag consistent with GUD No. 9400.<sup>515</sup>

b. Other O&M: Labor expenses

The lead days for expenses related to other operations and maintenance expenses were classified into two groups: labor costs and non-labor costs. Mr. Joyce calculated the lead days for each group independently, and the results were combined to produce weighted lead days for all O&M expenses.<sup>516</sup> The City of Dallas argued that Atmos Mid-Tex incorrectly calculated the payroll expense lead. Mr. Joyce calculated a payroll expense lead of 30.85.<sup>517</sup> Mr. Joyce noted that the vacation policy of Atmos Mid-Tex is different from the vacation policy of TXU Gas Distribution. Vacation and sick leave time have been eliminated and replaced by Paid Time Off (PTO). The PTO liability is accrued on the balance sheet and that is different from the policy at TXU. Mr. Joyce

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<sup>513</sup> Atmos Exhibit 36, Joyce Rebuttal, p.8, ln 23 - p 13, ln. 25.

<sup>514</sup> Tex. Util. Code Ann. § 104.003(a).

<sup>515</sup> ACSC Exhibit 2, Tucker Direct, p. 16, ln. 13.

<sup>516</sup> Atmos Exhibit 27, Joyce Direct, p. 10, lns. 15 - 21.

<sup>517</sup> Atmos Mid-Tex Workpaper WP-JJJ-D.

pointed out that, consistent with the previous rate case, the accrued PTO payable balance at the end of the test year is used to calculate an adjustment to payroll lead days for “vacation” days.<sup>518</sup>

Mr. Pous argued that Company incorrectly calculated the level of paid time off (PTO) taken by employees of Atmos Mid-Tex.<sup>519</sup> Mr. Joyce responded that Atmos Mid-Tex used the actual PTO expenditure during the test year and derived that amount from the test year payroll.<sup>520</sup> The Examiners find that Atmos Mid-Tex has been consistent with prior rate cases and has correctly calculated the payroll expense lead based on actual data, and the City Intervenors have not raised sufficient evidence to challenge the veracity of the underlying data. Further, the Examiners are not aware of any challenge to the reasonableness of the Company’s vacation policy.

c. Other O&M: Non-Labor

(1) Categorizations.

As noted above, the lead days for expenses related to other operations and maintenance expenses were classified into two groups: labor costs and non-labor costs. Mr. Joyce calculated the lead days for each group independently, and the results were combined to produce weighted lead days for all O&M expenses. The measure of lead days for the expenses in the non-labor group of other operating and maintenance expenses was calculated using a random sampling of those expenses recorded during the test year period. The average lead was dollar weighted and calculated from the invoice date to the later of the invoice due date or payment clear date. The invoice date was used as the starting period because many of the invoices did not have an easily identifiable service period.

Mr. Garrett argued that the groupings in this category should be divided. Mr. Garrett divided the Non-Labor category into six separate categories: (1) Mid-Tex Contract Labor Expense, (2) Outside Services Expense, (3) Injuries and Damages, (4) Uncollectible Accounts Expense, (5) Pension Expense, and (6) Other O&M for which the service period could not be recalculated.<sup>521</sup>

Mr. Joyce pointed out, however, that the method proposed in this case was consistent with the prior rate cases. He pointed out that the Other O&M groupings were reduced from five to two. The regular pay categories and the bonus pay categories have been combined into one labor category and the groupings for affiliate expenses and employee benefits have been eliminated because of changes. The affiliate expenses were removed because inclusion of the affiliate payment as a separate category would have a negligible effect on the CWC requirement. The segregation of employee benefits was eliminated because the costs were included in the population of non-labor O&M invoices used for the random sample selection.<sup>522</sup> The Examiners find that the proposed grouping is reasonable and consistent with prior rate cases, and no adjustment is necessary in this case.

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<sup>518</sup> Atmos Exhibit 27, Joyce Direct, p. 11, 8 - 19.

<sup>519</sup> City of Dallas Exhibit 2, Pous Direct, p. 71, lns. 15 - 23 & p. 72, lns. 1 - 10.

<sup>520</sup> Atmos Exhibit 36, Joyce, Rebuttal, p. 34, lns. 1 - 3.

<sup>521</sup> Atmos Exhibit 27, Joyce Direct, p. 10.

<sup>522</sup> Atmos Exhibit 27, Joyce Direct, p. 12, lns. 24 - 31 through p. 13, lns. 1 - 14.

## (2) Invoice #139. The prepayment

As noted above, the measure of lead days for the expenses in the non-labor group of other operating and maintenance expenses was calculated using a random sampling of those expenses recorded during the test period. ATM and the City of Dallas objected to one of the items in the random sample. Mr. Tucker and Mr. Pous argued that Invoice #139 should be removed from the random sampling for several reasons.<sup>523</sup> First, Mr. Tucker argued that the invoice contains funds that are reflected in prepayments that are included in rate base.<sup>524</sup> Second, Mr. Pous argued that Atmos Mid-Tex capitalized a portion of the invoice. Third, he argued the invoice was a statistical outlier because of its size and the lead days associated with it. The amount associated with Invoice #139 was 174,108 and the total sample was \$530,841.<sup>525</sup> Thus, Mr. Pous argued that Invoice #139 represented 33% of the total sample. He argued that if this one invoice is removed, the dollar size of the various invoices in the sample is more evenly dispersed. Furthermore, he noted that this invoice is the only invoice in the entire sample that experienced a zero level of lead days.<sup>526</sup> Fourth, Mr. Tucker argued that use of the invoice date of the mid-point of the service period is inherently unreliable because it requires the utility to recognize the invoice in order to be included in the payment lead calculation.<sup>527</sup>

Mr. Joyce testified that the City Intervenors offered no evidence to support for their argument that the invoice was a statistical outlier. Mr. Joyce also argued that outliers have been included in the operations and maintenance invoice sample in prior cases. Furthermore, Mr. Joyce argued that the lead days assigned to this invoice were based upon the underlying fact that the invoice was paid electronically on the date of the invoice. In addition, the fact that part of the invoice was capitalized does not have any effect on the validity of the random sample and he contended that the dollars in this invoice do not represent a prepayment.<sup>528</sup>

The Examiners find that the use of the invoice date instead of midpoint of the service period as the beginning point for the calculation of payment lead days is consistent with GUD No. 9400. The Examiners find, based upon the testimony of Mr. Tucker that the Company has agreed to remove Invoice No. 132, that the invoice should be removed from the cash working capital analysis. As to Item No. 139, the Examiners find that this item impacted the sampling to such an extent to call into question the reasonableness of the result. This figure represents a disproportionate share of the entire sample and is larger, by a significant magnitude, than any other figure. Further, the fact that this item may be accounted for elsewhere makes the use of it in the context of cash working capital inappropriate. The purpose of the cash working capital study is to identify funds that are not adequately identified elsewhere in the cost of service study. Based on the removal of Invoice #132, and Invoice #139, the Examiners recommend expense lead days for operations and maintenance – of 33.48.

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<sup>523</sup> City of Dallas Exhibit 2, Pous Direct, p. 75, lns. 1 - 29.

<sup>524</sup> ACSC Exhibit 2, Tucker Direct, p. 18, ln. 1 - p. 19, ln. 2.

<sup>525</sup> Atmos Exhibit 17, WP-JJ-D-2, p. 6, ln. 139 & p. 7, ln. 177.

<sup>526</sup> City of Dallas Exhibit 2, Pous Direct, p. 76, lns. 1 - 11.

<sup>527</sup> ACSC Exhibit 2, Tucker Direct, p. 20, ln. 19 - p. 21, ln. 20.

<sup>528</sup> Atmos Exhibit 36, Joyce Rebuttal, p. 21, ln. 11 - p. 24, ln. 22.

d. Taxes other than income taxes.

ACSC, through the testimony of Mr. Tucker, challenged the expense lead days for taxes other than income taxes. First, Mr. Tucker noted that the Company include State Gross Receipt's taxes in its calculation of lead days for Taxes Other than Income Taxes even though those taxes are prepaid and have been reflected in the proposed prepayment amounts to be included in rate base. Mr. Tucker pointed out that in GUD No. 9400 the Company included a reduction in weighted dollar amounts to represent the amount of prepayments associated with State Gross Receipt Taxes. Mr. Joyce responded that while Mr. Tucker alleged that the Company's methodology was inconsistent with GUD No. 9400, he contended that Mr. Tucker offered no explanation as to how his method of using zero days was consistent with the methodology of that case. Further, he argued that Mr. Tucker ignored the fact that payments were made in January, March, July, and September of the test year for GUD No. 9400, which is different from the payment dates of January, May, August, and October for Atmos Mid-Tex.<sup>529</sup>

The Examiners find that Atmos Mid-Tex failed to establish that the proposed expense lead days for state gross receipts was reasonable. The Company did not present evidence regarding the fundamental contention that no adjustment was made to account for the prepaid amounts. This adjustment was made in GUD No. 9400. Accordingly, the Examiners recommend that the expense lead be set at zero days for State Gross Receipt's tax. This results in an overall expense lead for taxes other than income taxes of 100.201.

C. Review Pursuant to Section 102.051 and ADFIT and ITC.

1. Overview

Accumulated Deferred Federal Income Taxes (ADFIT) and Deferred Investment Tax Credits (ITC) represent the sum of the differences between the income tax expenses recorded on a firm's financial books versus its actual income tax liabilities. ADFIT arises from difference in how items are treated for financial reporting purposes versus income tax purposes and, in most instances, are the result of timing differences that net out over time. For utilities, ADFIT are usually primarily attributable to the use of straight-line methods to calculate book (and ratemaking) depreciation expense versus accelerated depreciation methods for tax purposes. The resulting ADFIT liability is regarded as a source of non-investor supplied capital for ratemaking purposes and deducted from rate base as zero-cost capital.<sup>530</sup>

As described by Dr. Fairchild, ADFIT was authorized by the U.S. Congress to encourage investment and stimulate the economy. Passing the immediate benefits of accelerated depreciation to a utility's customers through lower rates would negate the incentive to invest. Therefore, Congress required that income taxes be "normalized" so that revenue requirements reflect the statutory tax liability. In order to provide customers a benefit from accelerated depreciation,

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<sup>529</sup> Atmos Exhibit 36, Joyce Rebuttal, p. 32, ln. 27 - p. 33, ln. 22.

<sup>530</sup> Atmos Exhibit 35, Fairchild Rebuttal, p. 8, lns. 14 - 24, ACSC Exhibit 2, ACSC Exhibit 2, Tucker Direct, p. 26, ln. 7 - p. 27, ln. 17, ATM Exhibit 2, Arndt, p. 12, ln. 14 - p. 13, ln. 5,



Congress allowed ADFIT to be used as a rate base deduction. Thus, the utility receives, in essence, an interest-free loan from the government because income taxes are deferred. As a consequence funds for investment become available, and customers benefit because they do not have to pay capital carrying costs on the assets financed with ADFIT.<sup>531</sup>

ADFIT balances are deducted from the net plant balances in the calculation of rate base.<sup>532</sup> The City Intervenors pointed out that prior to the purchase of TXU Gas by Atmos Mid-Tex, substantial ADFIT balances were lost. Customers of TXU Gas paid taxes for many years, a portion of which was deferred by the utility and accumulated in the ADFIT account to be used to reduce rate base. The City Intervenors argued that Atmos now asks the Commission to require those same customers to pay higher rates resulting from the loss of the rate base reduction to ADFIT. The City Intervenors argued that the merger resulted in a similar impact to ratepayers as a result of Accumulated Deferred Income Tax Credits (ADITC).

The ADITC tax benefit relates to prior investment tax credits which were available to corporations as an incentive to invest in capital. For federal income tax purposes, the utilities deducted the investment tax credits immediately, resulting in an immediate reduction in federal income taxes. For ratemaking purposes, however, ratepayers have only been provided the benefits of investment tax credits over the life of the plant and were charged for income taxes in excess of the actual federal income taxes paid. The investment tax credit timing difference between income tax and ratemaking produced the ADITC balance.<sup>533</sup> As noted by Dr. Fairchild, and the witnesses for the City Intervenors, ADITC often functioned as a deduction from rate base. The City Intervenors argued that the Commission must take the impact of the loss of ADITC into account in this case.

Atmos Mid-Tex argued that before any adjustment to the ADFIT balances are made, the Commission must make a determination pursuant to GURA § 102.051(a)(1). Section 102.051 provides that a gas utility shall report an acquisition of utility plant as an operating unit or system for total consideration of more than \$1 million. In GUD No. 9555, Atmos reported to the Commission its acquisition, and the Commission explicitly deferred its statutory consideration of the acquisition under section 102.051 until this rate proceeding.<sup>534</sup> Specifically, the Commission must investigate whether the reported acquisition was consistent with the public interest. If the Commission determines that the transaction was not consistent with the public interest, then it must take the effect of the transaction into consideration in this ratemaking proceeding and disallow the effect of the transaction.

The Examiners find that the statute requires a consideration of whether the transaction was consistent with the public interest.

## 2. The public interest determination

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<sup>531</sup> Atmos Exhibit 35, Fairchild Rebuttal, p. 15, lns. 15 - 28.

<sup>532</sup> Schedule B.

<sup>533</sup> ATM Exhibit 2, Arndt, p. 12, ln. 23 - p. 13, ln. 5, Fairchild, p. 20, ln. 18 - p. 21, ln. 17.

<sup>534</sup> GUD No. 9555, *Application for Review of Merger Between Atmos Energy Corporation and TXU Gas Company, LP*.

The statute provides that in order to make the public interest determination the Commission must consider the reasonable value of the property, facilities, or securities to be acquired, disposed of, merged, or consolidated. Atmos Mid-Tex argued that outside of its plain meaning, there is little guidance in Texas law about the public interest standard in GURA. The Company argued that FERC utilizes a similar transaction approval standard in Section 203(a) of the Federal Power Act.<sup>535</sup> That standard has been interpreted to mean that the utility need not demonstrate that the transaction “positively benefits the public interest, but rather that it is ‘consistent with the public interest,’ i.e., that the transaction does not harm the public interest.”<sup>536</sup> Witnesses for Atmos Mid-Tex testified that the public interest as it relates to a gas utility acquisition encompasses both direct and indirect ratepayer benefits, benefits to the utility system, and benefits to the general public.<sup>537</sup>

While reference to Section 203(a) may provide some insightful analysis, the Examiners find that complete reliance on that provision ignores an important component of GURA section 102.051, which provides as follows:

On filing of a report with the railroad commission, the railroad commission shall investigate the transaction . . . and determine whether the action is consistent with the public interest. *In reaching its determination, the railroad commission shall consider the reasonable value of property, facilities, or securities to be acquired, disposed of, merged, or consolidated.*<sup>538</sup>

The Texas provision focuses the public interest inquiry on the reasonable value of property, facilities, or securities to be acquired, disposed of, merged, or consolidated. It is arguable, in fact, that none of the other public interest issues raised by Atmos Mid-Tex are relevant to the inquiry mandated by Section 102.051. Nevertheless, the Examiners find that even in light of the issues raised by Atmos Mid-Tex the circumstances of the merger were not consistent with the public interest for the following reasons:

1. The loss of ADFIT and ADITC recorded in the records of TXU Gas had an adverse impact on rates paid by the current customers of Atmos Mid-Tex, by increasing the rate base,
2. Atmos Mid-Tex did not acquire all of the records necessary to maintain compliance with the requirements of the USOA and allow an investigation of the projects that were the subject of the 2003 and 2004 interim rate adjustments,
3. In the context of calculating the cash working capital, customers of the utility system lost the benefit of the use of accounts receivable to minimize the collection lag,

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<sup>535</sup> 16 U.S.C. § 824b(a).

<sup>536</sup> Texas-New Mexico Power Co., 105 FERC 61,028 at p. 23 n. 14 (2003).

<sup>537</sup> Atmos Exhibit 30, Yarbrough Rebuttal, p. 45, Ins. 18 - 20; Atmos Exhibit 35, Fairchild Rebuttal, p. 10, Ins.

<sup>538</sup> Tex. Util. Code Ann. § 102.051(b). Emphasis added.

4. Capitalization of general expenses previously provided by TXU Business Services resulted in unreasonable increases to ratebase, and
3. The addition of depreciation expenses from Shared Services, to be addressed below in Section XII, Expenses, subsection B.

All parties agree that the loss of ADFIT and ITC previously recorded on TXU Gas' books had an adverse rate impact.<sup>539</sup> As noted in Table 11.2 below, the parties calculate the impact of the loss of ADFIT and ITC as ranging between \$137,304,761 and \$149,555,153. ACSC based its calculation on the amounts recorded in the SEC report 10-Q of TXU Gas for quarter ended March 31, 2004. ATM based its calculation on the interim rate adjustment filing made in 2003.<sup>540</sup> The City of Dallas based its calculation on the amounts included in the Final Order issued in GUD No. 9400.<sup>541</sup>

Table 11.2  
Comparisons of ADFIT and ITC Analysis of City Intervenor

	ACSC	ATM	City of Dallas
ADFIT	\$133,948,985	\$139,917,347	
ITC	\$9,462,148	\$9,637,806	
Total Adjustment	\$143,411,133	\$149,555,153	\$137,304,761

The City Intervenor argued that the merger could have been structured in such a way to guarantee that the benefits of ADFIT and ITC would have been preserved. For example, Mr. Arndt testified that Atmos Energy has acquired utilities in several other states and structured the acquisition in a manner that would allow the retention of the tax benefits for ratepayers.<sup>542</sup> In a merger consummated in the State of Tennessee, the Tennessee Regulatory Authority noted that the form of the merger was a tax-free exchange of stock and the accumulated deferred income taxes were not liquidated.<sup>543</sup> Similar arrangements were made to complete mergers in Virginia and Iowa.<sup>544</sup> Thus,

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<sup>539</sup> Atmos Exhibit 35, Fairchild Rebuttal, p. 10, Ins. 4 - 6, ACSC Exhibit 2, Tucker Direct, p. 27, Ins. 13 - 17, ATM Exhibit 2, Arndt Direct, p. 11, Ins 12 - 15, Dallas Exhibit 3, Coleman Direct, p. 7, Ins. 23 - 30.

<sup>540</sup> ATM Exhibit 2, Arndt Direct, p. 19, Ins. 13 - 22.

<sup>541</sup> Dallas Exhibit 3, Coleman Direct, p. 9, Ins. 14 - 20.

<sup>542</sup> ATM Exhibit 2, Arndt Direct, p. 13, ln. 17 - p. 14, ln. 25.

<sup>543</sup> *Joint Application of Atmos Energy Corporation and United Cities Gas Company for an Order authorizing (1) the acquisition and merger of United Cities Gas Company into Atmos Energy Corporation; (2) the issuance of up to 18,000,000 shares of common stock by Atmos Energy Corporation in order to effect said merger, and for other corporate purposes; (3) transfer of authority to provide utility service from United Cities Gas Company to Atmos Energy Corporation, for related authority, and for other further, general relief*, Docket No. 96-01299, before the Tennessee Regulatory Authority, the Tennessee Commission's Order, January 24, 1997.

<sup>544</sup> *Applications fo United Cities Gas Company and Atmos Energy Corporation for Authority and Approval under Chapters 3, 5, and 10 of Title 56 of the Code of Virginia*, Case No. PUE960232, February 20, 1997 (Virginia State Corporation Commission) and *Atmos Energy Corporation and United Cities Gas Company*, Docket No. SPU-96-25, December 19, 1996 (Iowa Utilities Board).

Atmos Energy Corporation made arrangements in three other jurisdiction that preserved this important benefit for ratepayers, but Atmos Energy Corporation refrained from entering into a similar arrangement when it made the decision to acquire TXU Gas Distribution.

The focus of the public interest analysis proposed by Atmos Mid-Tex is safety and reliability, service quality, and a commitment to customers and the community.<sup>545</sup> Atmos Mid-Tex argued that the acquisition was consistent with the public interest, despite the impact of the loss of the benefit of ADFIT and ITC for several reasons. First, the Company argued that customers benefit because natural gas service is now provided by a corporation that is singularly focused on the gas utility business. In contrast, TXU Corporation was focused on several different aspects of the energy market.<sup>546</sup> Second, Atmos Mid-Tex has committed to invest in significant capital improvements to enhance safety and reliability.<sup>547</sup> Third, Atmos Mid-Tex has reversed the decision of TXU Gas to out source certain customer service functions.<sup>548</sup> Fourth, Atmos Mid-Tex pointed to various potential cost savings.<sup>549</sup>

The City Intervenors argued that the interests of present and future customers have not been balanced with those of past customers.<sup>550</sup> The City Intervenors also complained that Atmos Mid-Tex made representations in GUD No. 9555 that the acquisition would not have any impact on the rates or services of the former customers of TXU Gas.<sup>551</sup> Further, the City of Dallas argued that the claimed benefits cannot be quantified.<sup>552</sup>

The Examiners find that the safety, reliability, and quality of the natural gas service has not been affected by the merger and in that regard the merger was consistent with the public interest. The Examiners find, however, that the cost savings are speculative and difficult to quantify. Further, the speculative calculations regarding the alleged savings are belied by the fact that, absent the adjustment recommended in this Proposal for Decision, Atmos Mid-Tex is seeking a rate increase of \$59,519,424, not a rate decrease.

The Examiners find that the loss of ADFIT and ITC resulted in a merger that is not consistent with the public interest. In addition, as already noted above, the merger resulted in a lack of documentation necessary to review the rates that Atmos Mid-Tex implemented in its 2003 and 2004 interim rate adjustments. The failure to ensure that the information necessary to review those files was not transferred to Atmos Mid-Tex is not consistent with the public interest. That information is certainly property that section 102.051 mandates be considered in the context of determining whether the merger was consistent with the public interest and it is property that should have been acquired by Atmos Mid-Tex in the transaction. Further, as already noted, customers of the utility system lost the benefit of the use of accounts receivable to minimize the collection lag. The accounts

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<sup>545</sup> Atmos Exhibit 35, Fairchild Rebuttal, p. 10, ln. 7.

<sup>546</sup> Atmos Exhibit 30, Yarbrough Rebuttal, p. 45, lns. 20 - 24.

<sup>547</sup> Atmos Exhibit 30, Yarbrough Rebuttal, p. 45, lns. 26 - 28, Powell Rebuttal, p. 3, ln. 1 - p. 6, ln. 14.

<sup>548</sup> Atmos Exhibit 30, Yarbrough Rebuttal, p. 45, ln. 29 - p. 46, ln. 2.

<sup>549</sup> Atmos Exhibit 31, Sherwood Rebuttal, p. 10, ln.4 - p. 18, ln 24.

<sup>550</sup> ACSC Initial Brief, pp. 42 - 44

<sup>551</sup> Dallas Exhibit 3, Coleman Direct, p. 6, lns. 12 - 29.

<sup>552</sup> City of Dallas Reply Brief, pp. 6 - 10.

receivables were certainly property or security that section 102.051 mandates be considered in the context of determining whether the merger was consistent with the public interest. Finally, as already noted the merger resulted in increased depreciation expense and shared services expenses.

For the forgoing reasons the Examiners recommend that the Commission find that the merger was not consistent with the public interest. Once it is determine that the merger was not consistent with the public interest, the Commission must consider the nature of the adjustment necessary to disallow the effect of the transaction, if the transaction will unreasonably affect rates or service.

3. Adjustment to disallow the effect of the transaction.

The City Intervenor argued that Section 104.056 regulates the treatment of certain income taxes. Specifically, the provision provides that in determining the allocation of tax savings derived from liberalized depreciation and amortization and investment tax credits a regulatory authority must balance equitably the interests of present and future customers and apportion the benefits between consumers accordingly.<sup>553</sup> The City Intervenor argued that the interest of present and future customers have not been balanced with those of past customers. Customers of TXU Gas paid taxes for many years, a portion of which was deferred by the utility and accumulated in ADFIT and ADITC accounts to be used to reduce rate base. If the rates proposed by Atmos Mid-Tex are approved, those same customers would pay higher rates because of the merger of TXU Gas into Atmos.

Atmos Mid-Tex argued that there is FERC precedent to suggest that because the ADFIT and ADITC were paid to the federal government as a result of the transfer, the credit to rate base was effectively extinguished and no adjustment is necessary.<sup>554</sup> Company witnesses argued that the acquisition of the TXU Gas operations was treated for tax purposes as an asset sale and purchase and the sales price of the assets exceeded their book value, the ADFIT previously recorded on TXU Gas' books became due at the time of the sale.<sup>555</sup> Further, in GUD No. 9456 which involved a Texas Gas Service rate case, no ADFIT issues were raised. ADFIT was lost as a result of the purchase of SUG assets by TGS.<sup>556</sup> In addition, other regulatory commissions that have been faced with a similar proposals have declined to make a similar adjustment.<sup>557</sup> Atmos Mid-Tex also argued that an adjustment in this case would result in Atmos Mid-Tex forever losing the ability to use the adjustment in the future. After the merger, ADFIT balances will be accumulated by Atmos Mid-Tex. In future rate cases, that accumulated balance would be used as an offset to net plant and reduce the rate base. Company witnesses argued that the federal government would view the adjustment as a violation of "normalization" rules and would prohibit Atmos Mid-Tex from making the adjustment of ADFIT in the future.<sup>558</sup> Finally, Dr. Fairchild argued that no adjustment is required because it is likely that the ADFIT on the assets Atmos Mid-Tex purchased from TXU Gas have turned around

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<sup>553</sup> Tex. Util. Code § 104.056.

<sup>554</sup> Koch Gateway Pipeline Company, 74 FERC 61,088 and 75 FERC 61,132, and Enbridge Pipeline Pipelines, 100 FERC 61,290 and 102 FERC 61,310).

<sup>555</sup> Atmos Exhibit 35, Fairchild Rebuttal, p. 8, ln. 28 - p. 9, ln. 7.

<sup>556</sup> GUD 9465.

<sup>557</sup> Atmos Exhibit 35, Fairchild Rebuttal, p. 14, lns. 5 - 20.

<sup>558</sup> Atmos Exhibit 34, Pace Rebuttal, p. 6, ln. 20 - p. 19, ln. 27.

and are declining toward zero.<sup>559</sup> Company witnesses argued that the option to include the balances was not included because the merger was presented as a take it or leave it deal.<sup>560</sup> The Company also argued that certain options that could have preserved the ADFIT and ADITC balances were no longer available.<sup>561</sup>

The Examiners find that the arguments regarding the FERC precedent are not persuasive, arguments related to the “take it or leave it” nature of the proposed merger, and arguments related to the limitations on how the deal could have been structured to preserve the ADFIT and ADITC balances are equally unpersuasive. The arguments of the City Intervenors suggested that from the perspective of the rate payer, who was not represented in the negotiations, under those conditions the Company should not have engaged in the merger. GUD No. 9465 was an appeal and no party ever raised the issue of the lost balances related to ADFIT and ADITC. Finally, although the Company raised the argument that the proposed adjustment will result in a loss of the ability to use the ADFIT and ADITC balances in the future, the Company has not pointed to one case where that has actually happened. The Examiners find that the former customers of TXU Gas will be harmed absent an adjustment. The Examiners therefore recommend that an adjustment as proposed by the City of Dallas in the amount of \$137,304,761 be made to disallow the effect on rates. The Examiners agree that this asset purchase adjustment should be amortized over 30.85 years, the remaining life of the plant.<sup>562</sup>

#### D. Computer Software Included in Rate Base.

In the Statement of Intent filed on May 31, 2006, Atmos Mid-Tex included a \$23,111,240 in rate base related to computer software.<sup>563</sup> ACSC proposed an adjustment to this amount based upon the argument that much of the computer software expense was not just and reasonable because the function of several of the software applications overlapped and Atmos admitted that it did not use one of the software applications. Specifically, Ms. Cannady argued that the Distribution Information System (DIS) and the Customer Information System (CIS) should be removed from rate base. ACSC noted that after conducting a review of the Company’s filing, Ms. Cannady discovered that Atmos Mid-Tex had not removed the old computer system from rate base even though new systems are now in use. Atmos Mid-Tex admitted that the CIS system was replaced by the Banner/Advantage system during the test year and agreed to remove it from ratebase.<sup>564</sup>

ACSC argued that all expenses related to the DIS system should also be removed from rate base. Ms. Cannady noted that a part of the DIS system was no longer used and useful, a fact not disputed by Atmos Mid-Tex. On the other hand, one component of the DIS system, referred to as DIS (FRAMME) was utilized for part of the test-year. Ms. Cannady complained that the net amount included in rate base of \$3,240,668 was comprised of the remaining book value of the old DIS component that was no longer used and useful (Geographical Mapping) and DIS (FRAMME).

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<sup>559</sup> Atmos Exhibit 35, Fairchild Rebuttal, p. 19, Ins. 10 - 18.

<sup>560</sup> Atmos Exhibit 31, Sherwood Rebuttal, pp. 2 - 10

<sup>561</sup> Atmos Exhibit 33, Forsythe Rebuttal, pp. 3 - 4.

<sup>562</sup> Dallas Exhibit 3A, Coleman Supplemental Direct, p. 2, Ins. 6-8.

<sup>563</sup> Schedule C, ln. 15, col (f).

<sup>564</sup> Atmos Mid-Tex Initial Brief, p. 119, Atmos Exhibit 19, Yarbrough Direct, p. 69, Ins. 4 - 7.

Because Atmos has clearly stated that DIS is no longer used, Ms. Cannady argued that the entire net amount should be excluded as no longer being used and useful in providing service to the customers. Finally, Ms. Cannady argued that expenses related to GE Small World, which replaced the DIS (FRAMME) would result in a double booking if the other expenses related to DIS were not removed.<sup>565</sup> Although, as will be noted below Mr. Yarbrough testified that expenses related to GE Small World were not booked to plant during the test year, ACSC argued that evidence in the record reveals that the expense was booked to net plant.<sup>566</sup>

In response Atmos Mid-Tex pointed out that the DIS system that was no longer used and useful was, in fact, used for part of the test-year. It was replaced, in part, by the Enterprise Asset Management System (EAM) and the Asset Capture & Estimation (ACE) module.<sup>567</sup> The DIS (FRAMME) was used for several months after the use of the other components of the DIS system were abandoned.<sup>568</sup> Atmos Mid-Tex argued that Ms. Cannady was confused by the incorrect assumption that the DIS (FRAMME) system was also retired when the other components of the DIS System were abandoned.<sup>569</sup> Ultimately, however, Atmos Mid-Tex noted that the DIS (FRAMME) system was abandoned in favor of the GE Smallworld system.<sup>570</sup> Finally, Atmos Mid-Tex responded to the allegation that the GE Smallworld system might result in a double booking by alleging that the GE Smallworld system was not booked during the test-year.

The Examiners find that rate base should only include those amounts which are used and useful. There is no dispute that the CIS system is no longer used and useful, Atmos Mid-Tex has agreed to remove those amounts from its books, and the adjustments made in the Company's revised schedule reflecting that adjustment should be adopted.<sup>571</sup> The Examiners do not recommend any further adjustment.

## XII. Expenses

### A. Introduction

Atmos Mid-Tex proposed several changes to test-year expenses. Those changes will be addressed in sections XII. B. 1 through XII. B. 10, below. ACSC's proposal to adjust rates based upon alleged merger savings will be addressed in section XII. B. 12. An additional adjustment related to Ad Valorem Tax Expense will be discussed in XII.B. 12, below. Other Expense issues considered that are not post-test year adjustments are issues related to computer software amortization, affiliate expenditures and depreciation expense issues will be addressed here.

As a general matter, with regards to post-test year known and measurable changes, the Examiners note that the Texas Supreme Court has recognized that, because future rates are set on

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<sup>565</sup> ACSC Exhibit 3, Cannady Direct, p. 25, lns. 1 - 9.

<sup>566</sup> ACSC Initial Brief, ACSC Ex. 29.

<sup>567</sup> Atmos Exhibit 39, Powell Rebuttal, p. 19, lns. 13 - 18.

<sup>568</sup> Atmos Exhibit 39, Powell Rebuttal, p. 19, lns. 19 - 24.

<sup>569</sup> Atmos Exhibit 19, Yarbrough Direct, p. 68, lns. 11 - 12.

<sup>570</sup> Atmos Exhibit 39, Powell Rebuttal, p. 19, lns. 24 - 25.

<sup>571</sup> Atmos Ex. 68 & 74.

the basis of past costs, it is necessary to account for changes occurring after the test-year period “to make the test-year data as representative as possible of the cost situation that is apt to prevail in the future.”<sup>572</sup> Regulatory commissions often permit such adjustments only when those changes are known and measurable. For example, the Public Utility Commission regulations provide that post test-year adjustments are permitted where “the attendant impacts on all aspects of a utility’s operations (including but not limited to, revenue, expenses and invested capital) can with reasonable certainty be identified, quantified and matched.”<sup>573</sup> The standard that proposed post-test year adjustments be known and measurable is the standard set out in GURA for an appeal under section 103.055, and is the standard that should be applied here.<sup>574</sup>

## B. Expenses

### 1. Labor – Merit Increases

Atmos Mid-Tex included an adjustment to labor expense to reflect \$1,219,282 in merit increases to be awarded in October of 2006.<sup>575</sup> Barbara Myers testified that two increases were awarded to Atmos Mid-Tex employees during calendar year 2005. The first increase was a transition increase in the amount of 3.5% awarded to certain employees in March. TXU Gas employees typically received a merit increase in March of each year. Whereas, Atmos Mid-Tex employees received a merit increase in October of each year. Rather than delay the merit increase of former TXU Gas employees, Atmos Mid-Tex awarded those employees a merit increase in March. In October 2005, the former TXU Gas employees were placed in the Atmos Mid-Tex cycle of salary increases, and those employees received a partial merit increase. Therefore, Ms. Myers concluded that the unadjusted per books labor expense in January and February was understated by both the transition and merit increases.

ATM, the City of Dallas, and the State of Texas objected to the proposed adjustment. ATM and the City of Dallas agree that the adjustment proposed by Atmos Mid-Tex should be removed. Mr. Pous argued that the merit increase is an expenditure that Atmos Mid-Tex may, or may not award. Thus, the recommended adjustment is speculative as managers may decide not to issue the award, or only issue a partial amount. Further, merit increases are already included because 2005 merit increases formed a component of the labor expense during the test year.<sup>576</sup> Finally, he noted that in GUD No. 8664, the Commission allowed merit increases that were awarded during the test year but denied any post test year adjustments.<sup>577</sup> Mr. Garrett argued that the proposed merit increase adjustment was an adjustment made outside of the test-year that was not known and measurable. He argued that post-test year adjustments to labor should be rejected as they are speculative and could be affected by workforce reductions, other more subtle changes to the workforce composition,

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<sup>572</sup> *Suburban Util. Corp. v. Public Util. Comm’n*, 652 S.W.2d 358, 366 (Tex. 1983).

<sup>573</sup> P.U.C. Subst. R. 25.231(c)(2)(F).

<sup>574</sup> Tex. Util. Code Ann. § 103.055(a).

<sup>575</sup> Atmos Exhibit 23, Myers Direct, p. 5, Ins. 8 - 12, Schedule WP\_F-2.11, ln. 24, col. (e).

<sup>576</sup> City of Dallas Exhibit 2, Pous Direct, p. 32, ln. 4 - 21.

<sup>577</sup> City of Dallas Exhibit 2, Pous Direct, p. 32, ln. 22 - p. 33, ln. 3. FOF 87. A generally-stated increase to labor expenses, without evidence indicating which employees’ salaries will be increased by what amounts, is not a reasonable adjustment to labor expenses.



or even changes to the Company's capitalization policy as it relates to labor.<sup>578</sup> Ms. Cannady, who testified on behalf of ACSC, did not reject the proposed adjustment. Instead, she argued that the adjustment should be reduced because Ms. Myers' estimate was inflated due to the early merit increase that former TXU Gas employees received in March.<sup>579</sup> Finally, the State of Texas argued that Atmos Mid-Tex failed to meet its burden with regard to this adjustment.<sup>580</sup>

The Examiners find that Atmos Mid-Tex failed to establish that the proposed adjustment for post-test year merit increases is just and reasonable. Although Atmos Mid-Tex argued that the adjustment was based on a known and measurable change, it is evident from the method that Ms. Myers adopted that the increase is estimated upon salaries for the test year ending in December of 2005. Thus, it is an estimated adjustment. This is contrary to the evidence presented by Atmos Mid-Tex regarding proposed post-test year adjustment to shared services payroll. Specific evidence regarding the post test year expenses was presented.<sup>581</sup> Atmos Mid-Tex could have provided evidence regarding known and measurable changes as the rebuttal testimony was not filed until October of 2006 and the hearing on the merits did not commence until November of 2006, after the Atmos Mid-Tex merit increases had taken effect. Accordingly, the Examiners recommend that the proposed adjustment of \$1,219,928 be disallowed.

## 2. Labor – Benefits

Atmos Mid-Tex proposed an adjustment to post test year data for employee benefits.<sup>582</sup> Ms. Myers adjusted the test year benefit expense upward by \$5,928,155, to reflect annualized costs incurred in fiscal year 2006. To make this adjustment the Company applied a benefits ratio of 32.96%, which was used using per book labor and per book benefit expense for the first quarter of Fiscal Year 2006.<sup>583</sup> The City Intervenors objected to the proposed adjustment. Mr. Pous, who testified on behalf of the City of Dallas and Mr. Garrett each suggested that this adjustment be rejected as being outside of the test year.<sup>584</sup> Ms. Cannady, on behalf of ACSC, argued that the adjustment should be based upon post-test year known and measurable changes and adjusted to separate the adjustment from various benefit programs of the Company.<sup>585</sup>

The Examiners find that the Company's argument that the adjustment was based on data from fiscal year 2006 misleading. Atmos Mid-Tex defines the fiscal year of 2006 as the period from October of 2005 through September of 2006. Thus, the first three months of the 2006 Atmos Mid-Tex fiscal year are, in fact, the last three months of the test year. Therefore, to base any adjustment on the first three months of the fiscal year 2006 is, in fact, an estimated adjustment based on data developed during the test year. It is not based upon post test year data. Accordingly, the Examiners

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<sup>578</sup> ATM Exhibit 1, Garrett Direct, p. 16, ln.

<sup>579</sup> ACSC Exhibit 3, Cannady Direct, p. 17, ln. 1 - p. 18, ln. 5.

<sup>580</sup> State Initial Brief, p. 6.

<sup>581</sup> Atmos Exhibit 74, Schedule F\_2.2.a

<sup>582</sup> Atmos Exhibit 23, Myers Direct, p. 5, lns. 8 - 12.

<sup>583</sup> Atmos Exhibit 41, Myers Rebuttal, p. 17, ln. 21 - 26

<sup>584</sup> City of Dallas Exhibit 2, Pous Direct, p. 9, ln. 29 - p. 10, ln. 2; ATM Exhibit 1, ATM Exhibit 1, Garrett Direct, p. 16, ln. 1 - p. 18, ln. 7.

<sup>585</sup> ACSC Exhibit 3, Cannady, p. 17, ln. 1 - p. 20, ln. 5.

find that the adjustment be based upon the latest post test year known and measurable figures. The parties provided the relevant data for October 2005 through May 2006. Using that data, the Examiners have calculated benefits expense ratio is 32% based upon known and measurable changes.

### 3. Labor – Marketing Expense

Atmos Mid-Tex seeks to recover from ratepayers expenses related to marketing. The actual expense related to marketing expenditures during the test year was approximately \$316,003. Atmos Mid-Tex seeks to adjust the test year amounts by projected expenditures of \$1,194,518.<sup>586</sup> The City of Dallas argued that the expense should be disallowed because Atmos Mid-Tex has not established that the expanded marketing department will provide any service that is useful to customers and a similar request was rejected by the Commission in GUD No. 8664.<sup>587</sup> The City of Dallas and ATM argued that residential and commercial customers do not benefit from promotional marketing programs.<sup>588</sup> In addition to this Commission's previous determination in GUD No. 8664 pointed out by Mr. Pous, Mr. Garrett pointed out that the Oklahoma Commission excluded similar charges.<sup>589</sup> The Oklahoma Commission rejected the recovery of these expenses because they were associated with promotional marketing campaigns that encouraged greater consumption of gas and promoted the use of one fuel over another.<sup>590</sup>

In addition, all of the City Intervenors argued that the adjustment is speculative and not known and measurable. Ms. Cannady argued that the Company's adjustment was premised on the addition of eight account manager positions and five marketing development specialist positions that were not filled at the end of the test year. She noted that only six of the thirteen had been filed by June 19, 2006. She also objected to the fact that the amount included was based on the mid-range salary for these positions rather than actual expense. Finally, she objected that no effort was made to quantify the increased income that these positions would generate and provide a corresponding adjustment.<sup>591</sup> Mr. Garrett had many similar objections to those raised by Ms. Cannady. An additional objection raised by Mr. Garrett, however, was that many of the positions were filled by internal transfers and as a result it is likely that Atmos Mid-Tex overstated the proposed increase. He pointed out that of the thirteen positions that were filed as of September 22, 2006, eleven were filled internally. The result is that there was no change to net labor expenses as of September 22, 2006.<sup>592</sup> Further, Mr. Garrett agreed with Ms. Cannady that Atmos Mid-Tex had failed to quantify the revenues generated. The problem he observed was not just a failure to use an estimate to offset expenses, but that the revenues generated by a successful marketing program should equal or exceed

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<sup>586</sup> Atmos Exhibit 23, Myers Direct, p. 4, lns. 8 - 14, Schedule WP\_F2.11

<sup>587</sup> GUD No. 8664, FOF No. 120: It is necessary to make [an] adjustment before allocation to the city gate . . . to remove costs of the Company's Marketing Group, which works exclusively with the Company's distribution system industrial customers, from the expenses to be recovered from the city gate residential and commercial customers. The Marketing Group does not provide services useful to the city gate, and therefore its exclusion from the cost of service on with return is permitted is reasonable.

<sup>588</sup> ATM Exhibit 1, Garrett Direct, p. 37, ln. ln. 7 - p. 38, ln. 14.

<sup>589</sup> Order No. 388124 in Cause No. PUD 910001190.

<sup>590</sup> Cause No. PUD 200500151.

<sup>591</sup> ACSC Exhibit 3, Cannady Direct, p. 7, ln. 12 - p. 8, ln. 9.

<sup>592</sup> ATM Exhibit 1, Garrett Direct, p. 33, ln. 1 - p. 34, ln. 32.

the program costs. He noted that since the Company will retain all of the additional revenues generated by the new marketing program, during the period prospective rates are in effect, the Company should also bear the additional costs incurred to generate these revenues.<sup>593</sup>

Mr. Yarbrough argued that Mr. Garrett mischaracterized the nature of the activities being performed by the marketing group. The focus of this group was on the builder developer market, not increased consumption by individual customers. The efforts of the new marketing group will result in new customers being added to the system so that fixed costs of the system will be spread over a larger customer base. All Atmos Mid-Tex customers would benefit from any increased or retained gas sales by spreading the investment and cost of operating and maintaining the system over a greater number of customers.<sup>594</sup> In response to Mr. Pous' argument regarding the Final Order in GUD No. 8664, Mr. Yarbrough argued that the finding of fact cited in GUD No. 8664 involved the pipeline company not the local distribution company. Further, he argued that the request of Atmos Mid-Tex in this case was within the limits of Commission Rule 7.5414 which explicitly allows the inclusion of advertising expenses in a rate request. As for the arguments of the City Intevernors that there was no net change to labor because the marketing positions were filled by internal highers positions, Mr. Yarbrough argued that those positions would eventually be filled. Finally, he argued that no offsetting revenues should be considered as they are entirely speculative and may not be realized for several years. Ms. Myers responded to allegations that the change in marketing labor expenses was not known and measurable by providing a comparison of the Marketing Department salaries as compared to the proposed adjustment based upon costs as of October 24, 2006, to establish that the proposed adjustment mirrored the actual costs. The actual costs of that date was \$1,444,448 compared to the projected costs of \$1,510,521.<sup>595</sup>

The Examiners recommend that the entire amount requested for marketing expenses be disallowed. Although Rule 7.5414 contemplates the inclusion of advertising expenses, the City of Dallas correctly pointed out that the Commission has acted in the past to disallow similar expenses. Further, ATM correctly noted that the revenues generated from a successful marketing program should eventually cover the costs of such a program. To guarantee recovery of the costs in the approved rates would remove any incentive to evaluate the effectiveness of the Company's marketing program. The Company would continue to have a marketing program regardless of the success of the program because the revenue to run the program would be included in rates. Thus, there is no risk to the Company. Finally, the Examiners agree that the adjustment is speculative. While Ms. Myers calculated the post test year expense that is currently in the marketing program her analysis does not address the question of whether the net revenue costs have been altered. Further, it reveals that the known expenses associated with the program itself is \$1,444,448 not \$1,510,521. Even if the Commission were to approve the inclusion expenses associated with the marketing program in the proposed rates, the Commission should at a maximum approve \$1,444,448 and not \$1,510,521, as the former is based upon known and measurable changes. Nevertheless, the Examiners recommend that all expenses associated with this program be removed from the proposed rates.

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<sup>593</sup> ATM Exhibit 1, Garrett Direct, p. 37, Ins. 1 - 6.

<sup>594</sup> Atmos Exhibit 30, Yarbrough Rebuttal, p. 21, Ins. 2 - 11

<sup>595</sup> Atmos Exhibit 41, Myers Rebuttal, p. 21, Ins. 1 - 19, Exhibit BWM-R-4.

#### 4. Labor – Contract Labor Expense

Atmos Mid-Tex indicated that the test year level of spending for contractor costs related to five categories of expenses was \$12,964,358. Atmos Mid-Tex proposed that test year levels of contract spending be adjusted for post test year projected expenditures by \$3,527,356.<sup>596</sup> Mr. Powell testified that while the Company operated in a safe and reliable manner during the test year it delayed or modified tasks or functions due to lower revenues associated with warmer than normal weather. As a result, Mr. Powell argued that lower annual expenses were experienced during the test year and the expenses must be adjusted to reflect expected expense levels.<sup>597</sup> The City Intervenors argued that the proposed adjustment should be rejected. ACSC argued that the proposed adjustment should be rejected in favor of an adjustment based on actual contract labor expense for the period from July 2005, through June, 2006. ATM argued that the contract labor expense should be adjusted and reduced to reflect lower contract labor costs in all areas of contract labor not just the five areas isolated by the Company's proposed adjustment. The City of Dallas argued that the proposed adjustment should be rejected because Atmos Mid-Tex did not meet its burden of proof.

As noted, ACSC argued that the proposed adjustment should be rejected in favor of an adjustment based on actual contract labor expense. Ms. Cannady noted that Atmos Mid-Tex has provided nothing more than estimates of activities and unsubstantiated estimated costs associated with these five activities. Instead, if an adjustment is to be made, Ms. Cannady recommended that actual annual expenses from July of 2005 through June of 2006 be applied. This adjustment would increase the test year expense for these five categories by \$1,940,023 over the test year amounts.

ATM argued that the contract labor expense should be reduced to reflect lower contract labor costs in all areas of contract labor. Mr. Garrett pointed out that the post test-year adjustment only adjusted for contract labor accounts that show increases in the post test year period. Several other accounts revealed that in 2006 there was a substantial decrease in over-all contract labor accounts.<sup>598</sup> Mr. Garrett proposed that total contractor costs for all contract labor, not just the five categories of expenses isolated by Atmos Mid-Tex, be adjusted by annualizing expenses for the period from January to June of 2006.

The City of Dallas argued that the proposed adjustment should be rejected because Atmos Mid-Tex did not meet its burden of proof. Mr. Pous pointed out that in response to the Company's allegation that expenses during the test year were lower than normal, the City of Dallas made a request for information seeking historical data related to expense level when "normal" whether occurred. Mr. Pous noted that no response was provided. The Company was also requested to provide a list of all the deferred projects and the Company did not produce a list.<sup>599</sup> The City of Dallas noted that when the issue was posed to Mr. Powell at the hearing, Mr. Powell, the Vice-President of Operations, was unable to identify any projects.<sup>600</sup> Mr. Pous recommended that the entire proposed adjustment be rejected.

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<sup>596</sup> Schedule WP\_F-2.9

<sup>597</sup> Atmos Exhibit 26, Powell Direct, p. 7, lns. ?? - ??

<sup>598</sup> ATM Exhibit 1, Garrett Direct, p. 22, lns. 1 - 28.

<sup>599</sup> City of Dallas Exhibit 2, Pous Direct, p. 33, ln. 16 - p. 34, ln. 8.

<sup>600</sup> Dallas Initial Brief, p. 54, citing to the deposition of Scott Powell, p. 113 - 114.

Ms. Myers noted that Mr. Garrett recognized that expense for these five categories of contract labor increased after the test year.<sup>601</sup> She argued that Mr. Garrett failed to consider the Company's contractor expenses included in other adjustments. As a result, Ms. Myers alleged that Mr. Garrett would have realized that, in fact, the Company understated its requested expense.<sup>602</sup> Ms. Myers argued that Ms. Cannady made several errors in her analysis that significantly reduced her proposed adjustment.<sup>603</sup> As to the allegations raised by Mr. Pous, Ms. Myers alleged that Mr. Pous attempted to alter the Company's standard of proof by asserting that contemporaneous documentation is necessary to support each number and every calculation. In response to the lack of information alleged by Mr. Pous, Ms. Myers offered a description of her consultation with the Company's Management Support Group that reviewed the underlying data records. That data was made available to the City Intervenors.<sup>604</sup>

The Examiners find that Atmos Mid-Tex has met its burden of proof with regards to the proposed adjustment. Although the proposed adjustment was based on estimates, the post test year data contained in the information provided by ACSC supported the request. Per book expenditures, during the first six months of 2006 were uniformly higher than the test year expenditures. The Examiners find that figures provided by ACSC, and the testimony of Mr. Garrett justify a higher level than established in the unadjusted test year books of the Company.

#### 5. Labor – Meter Reading Expense

At issue is the means of calculation of the expense associated with meter reading. Atmos has proposed the use of its budgeted expense to calculate the expense. Atmos Mid-Tex argued this is the most appropriate method of calculation because the Company was in a transition of moving the expense in-house during the last quarter of 2005, the test year.<sup>605</sup> Prior to October 2005, the meter reading function was conducted by TXU. Atmos asserted that they were understaffed in October 2005 when TXU ceased providing the service for Atmos Mid-Tex.<sup>606</sup> As a result of being understaffed, the utility asserts the budgeted expense is the most appropriate means with which to calculate the projected expense. Atmos counters ACSC's use of the unusually low October through December period with an annualized calculation of expenses from January 2006 through June 2006. Atmos now contends this calculation closely supports the initial calculation.

ACSC argued that use of budgeted amounts as not known and measurable<sup>607</sup> and the State of Texas concurred that Atmos Mid-Tex failed to meet its burden of proof.<sup>608</sup> As a result, of the Company's use of the budgeted information, ACSC recommended an adjustment of \$942,525 to Atmos' proposed amount for a total meter reading expense of \$8,029,672.<sup>609</sup> ACSC made this calculation by annualizing actual amounts expended from October 2005 through June 2006. Atmos

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<sup>601</sup> Atmos Exhibit 41, Myers Rebuttal, p. 7, ln. 20 - 28

<sup>602</sup> Atmos Exhibit 41, Myers Rebuttal, p. 7, ln. 1 - 18.

<sup>603</sup> Atmos Exhibit 41, Myers Rebuttal, p. 9, ln. 13 - p. 10, ln. 23.

<sup>604</sup> Atmos Exhibit 41, Myers Rebuttal, p. 8, ln. 19 - p. 9, ln. 12.

<sup>605</sup> Atmos Exhibit 23, Myers Direct, p11, lns. 30-31.

<sup>606</sup> Atmos Reply Brief, Page 106

<sup>607</sup> ACSC Reply Brief, Page 47

<sup>608</sup> State Initial Brief, p. 7.

<sup>609</sup> ACSC Exhibit 3, Cannady Direct, p.16, lns. 16-18.

Mid-Tex claimed that the approach taken by the Company was conservative.<sup>610</sup> The Company claimed the budget information is the best measure because of the transition.<sup>611</sup> Atmos Mid-Tex argued that the last quarter of 2005 is not representative of ongoing expense levels because it was understaffed during the transition period.<sup>612</sup>

The Examiners find that the proposed adjustment is not known and measurable. The Examiner's calculated an annualized amount based upon Atmos Rebuttal Exhibit BWM-R-1 (Dallas RFI 1-34) of direct expenses for January 2006 through June 2006 of FERC Account No. 904, Meter Reading Expense. While that annualized amount suggests a \$8,476,244 annualized expense, it included two months with significantly higher costs than the cost incurred in other months. Consequently a nine-month annualized calculation seems to be more representative than ACSC's calculation. Moreover, the Examiners find that the average (\$599,714) of the months in dispute (October through December 2005) does not appear to be significantly out of alignment with the average (\$617,143) of the 2006 months, after removing the two usually high months.

In conclusion, based upon the evidence presented, the Examiners find that the proposal of the Company is not reasonable. While the evidence in the record suggests a higher adjustment, the Examiners find that the proposal of ACSC's position that a reduction of \$942,525 is reasonable. That provides an adjusted amount of \$7,887,147 for meter reading expense.<sup>613</sup>

## 6. Uncollectible Expense

The City Intervenors have raised two issues related to uncollectible expense. First is the issue of how much to include in the revenue requirements for FERC Account No. 904 - Uncollectible Expense. Atmos has proposed an adjusted amount equal to \$12,167,775 for FERC Account No. 904. Atmos calculated the amount by using the 2005 experience rate of 0.708% on the proposed revenue requirement of \$1,718,015,739. The second issue the proposed recovery of uncollected gas cost through the gas cost recovery mechanism. The rate design issues will be addressed in section XV, related to rate design.

ACSC recommended an adjustment to the Company's originally requested amount of \$12,456,182 by using an average of three-years of actual uncollectible expense yielding a percentage of 0.62%.<sup>614</sup> This lower percentage results in a recommended uncollectible expense amount equal to \$10,904,170, or \$10,817,322 if calculated using ACSC's recommended revenue requirement which included several other adjustments. In its reply brief, ACSC stated that FERC Account No. 904 - Uncollectible Expense "shall be charged with amounts sufficient to provide for losses from uncollectible utility revenues."<sup>615</sup> ACSC contended that Atmos Mid-Tex has consistently accrued more than the actual expense over the past three years.<sup>616</sup> As a result, ACSC recommended using

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<sup>610</sup> Atmos Exhibit 39, Powell Rebuttal, p.14

<sup>611</sup> Atmos Exhibit 41, Myers Rebuttal, p.11.

<sup>612</sup> Atmos Exhibit 41, Myers Rebuttal, page 11.

<sup>613</sup> Atmos Schedule F-2.1, Col. f minus \$942,525.

<sup>614</sup> ACSC Exhibit 1, Nalepa Direct, p. 23, Lns. 11-12.

<sup>615</sup> ACSC Reply Brief, Page 52.

<sup>616</sup> ACSC Reply Brief, Page 52

the three-year average as a percentage of 0.62% to more accurately represent the Company's actual experience rate.

ATM recommended a write-off percentage of 0.482% based upon actual write-off level established in ATM RFI 2-15.<sup>617</sup> ATM also recommended using current revenues from Atmos' Schedule A to apply the 0.482%, as opposed to the revenue requirement used by Atmos Mid-Tex, to calculate bad debt expense, and argued that this is more accurate.<sup>618</sup> ATM's calculation resulted in a recommended reduction of \$4,266,836.<sup>619</sup> ATM pointed out that the same Company witness in this docket, Ms. Barbara Myers, testified in a prior docket, GUD No. 9145, that net write-offs, not accruals, should be used to calculate uncollectible expense.<sup>620</sup> A position opposite of that this same witness is testifying to as appropriate is this case.

The City of Dallas proposed an uncollectible rate of 0.6076% using a three-year average of actual write-offs as a basis of calculation as opposed to accruals.<sup>621</sup> The City of Dallas, based its calculation, in part, on the Company's response to ATM RFI 2-15. The City of Dallas recommended a reduction to the uncollectible expense of \$2,358,330 or a total uncollectible expense of \$10,097,852.<sup>622</sup>

Atmos Mid-Tex argued that the proposed method is consistent with the methodology between TXU Electric and TXU Gas Distribution.<sup>623</sup> Atmos Mid-Tex believes that the use of FERC Account No. 904 as Atmos has calculated results in matching revenues with expenses which is contrary to the use of ATM's proposed method of actual net-write offs because it includes prior periods that could be years old. Atmos also argues that the use of historical data is improper because it includes a different ownership and does not predict ongoing expenses.<sup>624</sup> Atmos contended using data from prior periods distorts the results.<sup>625</sup>

The Examiners' find that Atmos Mid-Tex has not established that its proposed methodology is just and reasonable. The Examiners find that the use of historical experience is reasonable as the historical data should not be affected as a result of the merger as the utility system and the customers served by that system are the same. Further, Atmos Mid-Tex has relied on historical data in the context of Bill Print Expense, to be addressed below.

The Examiners find the methodology in the calculation of these two expenses should not change just because ownership changes and find Atmos' argument inconsistent in this instance that the use of historical data by Atmos was appropriate for Bill Print Expense and not for Uncollectible Expense. As a result, the Examiners' do not find Atmos has presented a reasonable argument to use

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<sup>617</sup> ATM Exhibit 1, testimony of Mark Garrett, Page 40, Lines 8-9. ATM RFI 2-15.

<sup>618</sup> ATM Exhibit 1, Direct Testimony of Mark Garrett, Page 41, Lines 2 - 4.

<sup>619</sup> Exhibit MG-2, Page 19 of 26, Schedule F-8.

<sup>620</sup> ATM Reply Brief, Page 22.

<sup>621</sup> City of Dallas Exhibit 3, testimony of Sara E. Coleman, Page 11, Line 17.

<sup>622</sup> City of Dallas Exhibit 3, testimony of Sara E. Coleman, Page 12, Lines 12-14.

<sup>623</sup> Atmos Reply Brief, Page 123.

<sup>624</sup> Atmos Reply Brief, Page 123.

<sup>625</sup> Atmos Reply Brief, Page 124.

the proposed rate of 0.708%. The Examiners' recommend three-year average of 0.62% using historical data on revenue requirement, as proposed by ACSC as a reasonable method of calculation.

#### 7. Gas Technology Institute Expense

Atmos Mid-Tex proposed a post year adjustment of \$750,000 for Gas Technology Institute (GTI) expense. GTI provides research and development activities beneficial to the gas industry. The amount was determined by observing the level of expenditures of similarly sized utilities.<sup>626</sup> Additionally, the Company argued that the \$750,000 is comparable to the \$650,000 spent by the other Atmos divisions.<sup>627</sup> Atmos disputed the allegations that approximately \$2 million of the GTI funding comes from industry and \$7-10 million comes from state and federal sources.<sup>628</sup> Atmos believes the contributions made by the entire gas industry to GTI for research and development benefits the rate payers. In summary, Atmos argued that the natural gas industry and rate payers have a responsibility to assure that adequate funding is made for research and development for technology improvements.<sup>629</sup>

ACSC recommended a total disallowance of the requested amount of \$750,000. ACSC listed several reasons to deny Atmos' request.<sup>630</sup> First, Atmos is listed as a sustaining member at the GTI website for which membership fees are \$15,000-\$100,000 per annum, not the level Atmos is requesting. ACSC also contended that all of the company's divisions benefit from GTI technologies, not just the Mid-Tex division. Finally, the proposed amount by Atmos is an estimate based upon the Company's estimated anticipated contribution and, therefore, is not a known and measurable expense according to the intervenor.

ATM argued that Atmos' actual GTI expenditure for the past four-years is \$75,000 for 2003, \$80,693 for 2004, \$5,000 for 2005 and \$151,000 for 2006.<sup>631</sup> ATM argued that these costs are not necessary in providing natural gas service to the customer.<sup>632</sup> As a result, ATM recommended denying the requested amount by Atmos. In the intervenor's Reply Brief, ATM noted that Atmos provided no evidence that it has requested recovery of these fees in the West Texas Division, Atmos Energy Corporation's other Texas division.<sup>633</sup> ATM also noted that the Georgia Public Service Commission recently rejected the Company's request to include GTI fees in its cost of service for the Company's Georgia customers.<sup>634</sup>

Upon review of the positions expressed by the parties on the broad issue of the appropriate level of contributions, GTI's benefits to the industry and to the customer, and whose responsibility it is to fund technology improvements, the Examiners' find Atmos Mid-Tex has not established that its request is just and reasonable. The Examiners' find that it is not reasonable for the Company's

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<sup>626</sup> Atmos Exhibit 30, Rebuttal - Yarbrough II, Page 32, Lines 24 - 28.

<sup>627</sup> Atmos Reply Brief, Page 118.

<sup>628</sup> Atmos Exhibit 30, Rebuttal - Yarbrough II, Page 33, Lines 16 - 25.

<sup>629</sup> Atmos Reply Brief, Page 119.

<sup>630</sup> ACSC Exhibit 3, testimony of Constance T. Cannady, Page 21, Lines 1-19

<sup>631</sup> ATM Exhibit 1, testimony of Mark Garrett, Page 32, Table at Line 19.

<sup>632</sup> ATM Exhibit 1, testimony of Mark Garrett, Page 32, Line 21. ACSC RFI 1-24.

<sup>633</sup> ATM Reply Brief, Page 26.

<sup>634</sup> ATM Reply Brief, Pages 26-27.



customers to bear the requested GTI expense for the following reasons. First, evidence was not provided that contributions are uniformly made by all of the Atmos divisions, or that it is consistently requested to be included in rates. Atmos did not establish that the level of the requested expense is known and measurable. The level of the requested contribution (\$750,000) is a significant increase (nearly 5 times) over actual expenditures in the past and the proposed request is a significant percentage of GTI's total funding.

#### 8. Odorant Expense

Atmos is proposing a change to the collection of odorant expense in the amount of \$458,289. Presently, Atmos records odorant expense in FERC Account No. 871 - Distribution Load Dispatching. Atmos seeks to record odorant expense in FERC Account No. 813 - Other Gas Expense and recover the expense in Rider GCR. According to Atmos, the Gas Services Division, Gas Utility Audit Section instructed Atmos to *record odorant expense in any other account other than FERC Account No. 813* during an audit. Atmos has suggested a change in traditional rate making procedure for this expense claiming the expense fluctuates with volumes sold. In other words, as the utility has to purchase more volume, the more odorant it needs to purchase. Therefore, Atmos believes it is appropriate to include the expense in an account which is included in gas cost and recovered from the customer through the Rider GCR. Atmos has calculated \$458,289 as the expense for the test year.<sup>635</sup> Atmos contended that Commission rule 7.5519(c) supports its position: "[T]he items of expense that fluctuate with [gas cost] may be recovered."

The City of Dallas recommended denying the utility's requested change. The City of Dallas contended the utility recovers the expense in the currently approved pipeline rates.<sup>636</sup> The City of Dallas argued that the expense is directly associated with the purchase of gas and should remain as a component of gas cost (pipeline's) and not be included as a base rate revenue requirement<sup>637</sup>.

ACSC recommended that the cost of odorant continue to be recovered through the distribution base rates as previously directed by Audit Staff, rather than through the GCR Rider<sup>638</sup>. ACSC asserted that the GCR Rider should include only reasonably incurred purchase of natural gas.<sup>639</sup> ACSC suggested that these costs should be included in the pipeline rates. ACSC recommended Operations and Maintenance be reduced by the cost of odorant, \$458,289, to accomplish this recommendation.<sup>640</sup>

Staff knows of no other large Local Distribution Utility (LDC) that recovers odorant expense through the GCR, citing all other LDC's book odorant to operations and maintenance expenses.<sup>641</sup> Staff provided evidence in the form of a letter from the Utility Audit Section of the Commission urging the utility to book odorant to O & M expense.<sup>642</sup> Staff recommended that the Company's

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<sup>635</sup> Atmos WP-F-2.7

<sup>636</sup> City of Dallas Exhibit 2, testimony of Jacob Pous, page 38, Line 9-10.

<sup>637</sup> City of Dallas Exhibit 2, testimony of Jacob Pous, page 38, Line 12-13.

<sup>638</sup> ACSC Exhibit 1, testimony of Karl J. Nalepa, Page 4, lines 11-13.

<sup>639</sup> ACSC Exhibit 1, testimony of Karl J. Nalepa, Page 28 Lines 19-21.

<sup>640</sup> ACSC Exhibit 3, testimony of Constance T. Cannady, Page 8, Lines 8-10.

<sup>641</sup> Railroad Commission Staff Initial Brief, Page 1.

<sup>642</sup> Railroad Commission Staff Exhibit 2.

request be denied.

Atmos pointed to the phrase "the items of expense that fluctuate with gas cost may be recovered" as partial support for its request to include the cost of odorant in the GCR Rider. Section (c) of 16 T.A.C. 7.5519 states in full:

"The Commission shall determine in each case the necessary reporting, filing, and other procedures to be followed by a gas utility in implementing a purchased gas adjustment clause, if any, as well as other items of expense that fluctuate with gas costs which may be included in such a clause."

The rule taken as a whole, however, the Examiners find that the Company's proposed interpretation is not reasonable:

(a) Each gas utility subject to the original jurisdiction or which becomes subject to the appellate jurisdiction of the Commission may include a purchased gas adjustment clause in its rates to provide for the flow-through of part or all of its gas costs above or below the cost of gas contained in its rates, subject to proof, by a preponderance of the evidence, of certain criteria. Criteria to be used by the Commission in determining whether or not to grant a gas utility a purchased gas adjustment clause as well as the percentage thereof shall include but not be limited to:

- (1) the ability of the gas utility to control prices for gas purchased as affected by competition and relative competitive advantage;
- (2) the probability of continued frequent price changes; and
- (3) the availability of alternate gas supply sources.

(b) This section shall be applied prospectively only to rate cases filed and only after notice and hearing pursuant to the Texas Utilities Code, Title 3. The gas utility shall have the burden of proof regarding the necessity, if any, of a purchased gas adjustment clause and any amount of adjustment. This section shall not impair the rights of existing contract gas customers in any manner except as otherwise provided by law.<sup>643</sup>

The Examiners find that the rule contemplates that a purchased gas adjustment clause should include only items directly associated with the cost of gas, as opposed to other materials that fluctuate with the volume purchased. From a traditional standpoint, this would include the price, or cost, per unit of measure (Mcf, MMBtu, Decatherm) of the natural gas purchased and other items directly

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<sup>643</sup> 16 T.A.C. Section 7.5519

associated with obtaining the natural gas supply such as compression, various taxes associated with gas revenue, capacity or reservation fees, storage fees (injection and withdrawal costs). Since the rule has been written and implemented by various utilities, the Commission has allowed the inclusion of a calculation for lost and unaccounted for gas loss (LUG). The inclusion of LUG is only intended to assure the utility recovery of all of its gas cost. More recently, the Commission has allowed inclusion of hedging costs directly associated with financial hedging instruments directly related to gas cost.<sup>644</sup>

Based upon the testimony provided by all parties, it is clear that odorant costs do fluctuate with the volume purchased. Atmos has not shown that odorant costs are directly associated with the cost of gas itself. While the Examiners agree that additional odorant is necessary when additional gas supply is purchased or that odorant is necessary for safe service, the odorant itself is not a component of the cost of gas. The Examiners' find that the expense of odorant is an operation and maintenance expense. This finding is consistent with the treatment previously afforded odorant expense by the Railroad Commission.

The Examiners' find that Atmos has not shown that it is reasonable to include the odorant expense in Rider GCR. The Examiners' recommend that the Company record the expense of odorant as an operation and maintenance expense to be recorded in FERC Account No. 871, Distribution Load Dispatching. As a result, the proposed expense of odorant, \$458,289, should be recovered as an operation and maintenance expense.

## 9. Facilities Expense

There are several facilities at issue with Facilities Expense. The issues center around several adjustments in several accounts Atmos has made to reflect a full year of operations. Because of the acquisition of the distribution assets by Atmos, the gas distribution side of TXU ceased sharing facility space with the electric side of TXU. As a result, Atmos developed ten new service centers which the utility didn't place into service until sometime after January 1, 2005. Atmos made an adjustment to reflect the anticipated cost of a full year of operations. Atmos also made an adjustment to reflect the discontinuance of their old downtown building, the Harwood building. The final adjustment was made to reflect costs of the new Lincoln Center headquarters. While the total of these adjustments was \$307,563,<sup>645</sup> a relatively small amount compared to the totality of the rate case, the interveners take issue with the reasons for the adjustments, the level of adjustments, and whether or not the adjustments adequately represent the purpose of the adjustment itself. The adjustment is reflective to the anticipated cost of operations, not to the assets (utility plant) itself. The following Table 12.1 provides a summary of the net adjustments shown in WP\_F-2.8:

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<sup>644</sup> GUD Nos. 9345, 9469, 9533, 9534.

<sup>645</sup> Atmos Exhibit 23, Direct Testimony of Barbara W. Myers, Page 4, Lines 24 - 30, Schedule F-2, and WP\_F-2.8.

Table 12.1  
Net Adjustments Related to Facilities Cost

Facilities Cost Adjustment				
	FERC Acct. No.	2005	Adjustment	Net Adjusted Cost
Lincoln Center II	931	\$ 257,932	\$ 371,492	\$ 629,424
Service Centers	881		\$ 583,667	\$ 494,604
	931	\$ 89,063	\$ (89,063)	
Harwood Complex	870	\$139,317	\$ (139,317)	\$ 0
	880	\$ 57,099	\$ (57,099)	\$ 0
	921	\$ 205,411	\$ (205,411)	\$ 0
	931	\$ 558,533	\$ (558,533)	\$ 0
Totals			\$ 307,563	

ACSC has provided testimony on several issues regarding Facilities Expenses. In addition, the State of Texas alleged that Atmos Mid-Tex failed to meet its burden of proof on this issue.<sup>646</sup> Witness Cannady recommended a reduction of \$228,068 to the utilities proposed increase of \$583,667 for the 10 new service centers in FERC Account No. 881. This adjustment is the combined result of using actual lease agreement information, the removal of lease expense for the McKinney location and an adjustment for cost savings lost to the customer from Atmos' discontinuance of the use of TXU service centers.<sup>647</sup> ACSC recommended using actual lease data for all service centers.<sup>648</sup> Use of the actual lease information accounts for \$47,508 of the recommended \$228,068 adjustment. ACSC has justified the adjustment to the service centers reasoning Atmos continued to use the TXU service centers for "free" until the new service centers were used and useful which Atmos did not account for the savings in their adjustments. ACSC amortized the cost savings over a five-year period. This adjustment represents \$66,634. The adjustment to the McKinney Service Center of \$113,925, to FERC Account No. 881, was based upon the fact that lease agreement applicable to the McKinney Service center wasn't effective until October 2006, the beginning of Atmos 2007 Fiscal year. ACSC acknowledged that it is a known and

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<sup>646</sup> State Initial Brief, p. 7.

<sup>647</sup> ACSC Exhibit 3, Testimony of Constance T. Cannady, Page 10, Lines 8-16.

<sup>648</sup> ACSC Reply Brief Page 49.

measurable adjustment, but contended the center wasn't used and useful during the test year.<sup>649</sup> ACSC recommended an upward adjustment, or increase, of \$15,188 to the expense for the Lincoln Center, using the same reasoning and methodology used to calculate the adjustment for the 10 service centers, including the McKinney Service Center. ACSC notes that Atmos agreed with ACSC's adjustment treatment of the Lincoln Center II lease in their Initial Brief.<sup>650</sup> The three recommended adjustments combined equal \$228,068.

The Harwood complex presents a dimension to the facilities expense that ACSC claimed Atmos has not fully recognized the expense. Atmos donated the Harwood complex to the City of Dallas and has adjusted the expense account by a reduction of \$558,533. ACSC claimed donating the Harwood Complex had an expected tax benefit to Atmos of \$2,300,000. ACSC has calculated the alleged tax benefit by assuming cash value of \$6,000,000, a single bid when Atmos decided to put the complex up for sale.<sup>651</sup> ACSC contended customers have been providing Atmos and other utilities that operated this system a return on this asset for years. As such, it is reasonable that the customers benefit from the donation. Rather than recognize a one time adjustment to the federal income tax computation, ACSC recommends taking the \$6,000,000 be used to reduce rent payments related to the Lincoln Center over the next 5-years. This reduction of \$1,200,000 is applied to FERC account 931.

ACSC asserted that if the Commission rejects ACSC's other recommendations regarding the facilities expense, for consistency reasons, the Commission should also reject the adjustment for the Lincoln Center II.<sup>652</sup>

In response, Atmos explained that the Harwood complex was not owned by Atmos Mid-Tex. Atmos contended that not only was the Harwood complex not included in rate base in GUD No. 9400, it was owned by PDH I Holdings, Inc.<sup>653</sup> Atmos further argued that ACSC has no support for its contention that the donation would have resulted in a tax benefit to Atmos Mid-Tex.<sup>654</sup> Atmos stated the Harwood complex (consisting of the North, West, South and Park Street buildings) was transferred to Enserch eight years ago.<sup>655</sup> Atmos further stated that only the North building had been on the books of the distribution company and it was transferred eight years ago. The purchase price paid for TXU was allocated to three businesses: (1) the natural gas distribution operations of TXU,; (2) the intrastate transmission pipeline operations of TXU Gas; and, ( 3) a subsidiary of TXU Gas.<sup>656</sup>

ACSC reaffirms in their Reply Brief that the adjustment they recommend regarding the Harwood complex is that the customer should reap some benefit from the donation of the Harwood complex because it had been used to provide service to ratepayers and had been included in the cost

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<sup>649</sup> ACSC Exhibit 3, Testimony of Constance T. Cannady, Page 11, Lines 8 - 11.

<sup>650</sup> Atmos Initial Brief, Page 113.

<sup>651</sup> ACSC Exhibit 3, Testimony of Constance T. Cannady, Page 14, Lines 1 - 4.

<sup>652</sup> ACSC Reply Brief, Page 49.

<sup>653</sup> Atmos Exhibit 30, Charles R. Yarbrough II Rebuttal, Page 54, lines 16 - 23.

<sup>654</sup> Atmos Exhibit 34, Pace McDonald Rebuttal, Page 27, Lines 12 - 17.

<sup>655</sup> Atmos Reply Brief, Page 112.

<sup>656</sup> Atmos Reply Brief, Page 113.

of service.<sup>657</sup>

The Examiners' find that Atmos Mid-Tex has not established that its request to include its full adjustment of \$494,604 for the 10 new service centers is reasonable. ACSC's contention of a cost savings of "free" use to justify its adjustment was not found to be reasonable. However, the Examiners' agree with ACSC that even though the McKinney Service Center is going to be used and useful at some point into the future, the lease wasn't effective until October 2006 and was not used and useful during the test year or even throughout the discovery period. ACSC also calculated a \$47,508 adjustment using actual lease agreement information. As a result, the Examiners' recommended a reduction to FERC Account No. 881 in the amount of \$113,925 attributed to the McKinney Service Center and a \$47,508 adjustment for the use of actual data for lease expense calculation. The Examiners' total recommended adjustment to Atmos' FERC Account No. 881 is a reduction of \$161,433.

Finally, the Examiners' find that ACSC has established that there should be an additional adjustment for the Harwood complex. Any cost savings attributed to the Harwood building should have been addressed eight years ago when it was transferred to Enserch. As a result, the Examiners' find Atmos' adjustment to be reasonable and do not recommend any further adjustment.

#### 10. Bill Print Expense

ACSC objected to the Company's use of budgeted amounts for Bill Print Expense stating that proposed budgets are not known and measurable.<sup>658</sup> In addition, the State of Texas alleged that Atmos Mid-Tex failed to meet its burden of proof on this issue.<sup>659</sup> After adjustments for labor expenses, ACSC recommends a reduction of \$2,625,294 to Bill Print Expense using actual expense over a nine-month period and annualizing the expense.<sup>660</sup> ACSC argued that this adjustment fairly represents the expected savings Atmos claimed when Atmos stopped using TXU CapGemini for collection, billing, and other services.<sup>661</sup> ACSC's calculation is based on actual expenses to perform the function.

The City of Dallas also argued that Atmos is claiming an excessive amount for Bill Print Expense. Sara E. Coleman recommended a reduction of \$1,513,533 contending that the utility has over estimated the additional pieces of paper sent to the customer allegedly sent in separate mailings.<sup>662</sup> The City of Dallas argued that these additional pieces of paper can be combined with monthly billings. The City of Dallas maintained that a reasonable estimate of billings is 17.9 million.<sup>663</sup>

Atmos responded by asserting the interveners did not allow for the additional 20% of separate

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<sup>657</sup> ACSC Reply Brief, page 49.

<sup>658</sup> ACSC Exhibit 3, Direct Testimony of Constance T. Cannady, Page 5, lines 5 - 8.

<sup>659</sup> State Initial Brief, p. 6 - 7.

<sup>660</sup> ACSC Exhibit 3, Direct Testimony of Constance T. Cannady, Page 6, lines 11 - 15, Schedule CTC - 10.

<sup>661</sup> ACSC Exhibit 3, Direct Testimony of Constance T. Cannady, Page 6, lines 20 - 22, Page 7, Line 1.

<sup>662</sup> The City of Dallas Exhibit 3, Direct Testimony of Sara E. Coleman, Pages 13 - 14.

<sup>663</sup> The City of Dallas Exhibit 3, Direct Testimony of Sara E. Coleman, Pages 13, Lines 12 - 13.

mailings that must be done annually for "Welcome Letters" to new customer, late payment notices, final bills, budget billing enrollment forms, copies of billing histories, notices of insufficient funds, termination notices and other informational mailings.<sup>664</sup> Atmos calculates 21.6 million pieces of mail is reasonable (1.5 million customers times 12 months = 18 Million bills; 18 million bills times 20% = 3.6 Million additional pieces of mail). Atmos further justified its \$0.411 rate stating that it is made up of a blended postage rate of \$0.30, plus \$0.041 for paper costs and \$0.07 for printing and processing.<sup>665</sup> Atmos holds that while the Collection and Bill Print calculation is based on the budget, the utility has historical data with which to draw from for these calculations.

The interveners did not contest the rate of \$0.411 per piece of mail as being unreasonable. The argument of the interveners is the alleged cost savings claimed by Atmos of not continuing to use TXU CapGemini to do billing and collection and the number of pieces of mailings made annually. The Examiners' believe Atmos has provided sufficient evidence to support the utility's request and recommend approval of Atmos' requested amount for Bill Print and Collection.

11. Cost Savings from CapGemini savings and savings identified by Sungard Support

ACSC argued, through the testimony of Mr. Nalepa, that Atmos Mid-Tex failed to adequately reflect cost reductions associated with the transfer of services formerly provided by CapGemini. ACSC recommended that the Company's rates reflect the allocated amount of these savings associated with bringing the CapGemini activities in-house. Mr. Nalepa calculated that this resulted in a reduction of \$3,649,077 to Shared Services Expenses. In addition, ACSC argued that Sungard Enform Consulting prepared a call center and billing evaluation study for Atmos to determine the cost benefit of converting from CapGemini to an in-house program. Mr. Nalepa argued that the annualized saving over the five year projection allocated to Atmos Mid-Tex totaled \$7,536,301. ACSC argued that these savings are not reflected in the Company's filing, but they should be acknowledged in order to offset the cost increases reflected in the filing. The decision to bring these services in-house was based on the net benefit of these savings over the increased costs to provide the services.

In response to the issues regarding Sungard, Mr. Yarbrough argued that the proposed revenue requirement incorporates the costs actually incurred and any savings achieved have already been reflected. In addition, he argued that it is good public policy to allow utilities to have the freedom to explore the best and most efficient means of providing quality service to customers. Basing an adjustment on what basically amounts to cost savings research effectively punishes Atmos for doing its homework.<sup>666</sup> The Examiners find that the revenue requirement established in this case should capture both the savings and expenses of the merger. Accordingly, the Examiners recommend that no adjustment be done at this time.

12. Ad Valorem Tax Expense

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<sup>664</sup> Atmos Exhibit 41, Myers Rebuttal, Page 4, Lines 8 - 24.

<sup>665</sup> Atmos Exhibit 41, Myers Rebuttal, Page 5, Lines 6 -10..

<sup>666</sup> Atmos Exhibit 30, Yarbrough Rebuttal, p. 67, lns. 8 - 26.

Atmos Mid-Tex included the Ad Valorem Tax paid during the test year in the amount of \$16,940,955.<sup>667</sup> The City Intervenors argued that Atmos Mid-Tex will benefit from significant reductions to its property tax liability as a result of the school finance reform bill that was signed into law on May 18, 2006. Mr. Garrett, who testified on behalf of ATM, noted that the legislation was expected to provide the largest property reduction in the state's history. He argued that the bill would result in significant reductions to the Company's property tax liability, and those reductions will take effect before the new rates are implemented. He argued that this was a known and measurable change. Using data from the Company's own analysis, Mr. Garret noted that the amount Atmos Mid-Tex expected to pay in 2006 would be \$16,221,260, a reduction of \$719,735.<sup>668</sup> Mr. Pous, on behalf of the City of Dallas, argued that the reduction should be \$1,919,979.<sup>669</sup>

Atmos Mid-Tex argued that the potential changes in tax liability should not be included for two primary reasons. First, the changes do not meet the standard of being known and measurable. Mr. McDonald argued that the final amount of the reduced property tax liability would not be known until January of 2007 when all local property tax bills have been paid. The change in tax liability is not easily measured at the time his testimony was filed. He argued that witnesses proposing this adjustment failed to make any inquiry regarding the assumptions underlying the lower tax estimate. He also noted that the property tax reduction, if any, would likely be offset by increases in appraisal values and margin tax liabilities. Finally, he alleged that Mr. Pous, who testified on behalf of the City of Dallas, had incorrectly calculated the tax liability.<sup>670</sup>

The Examiners find that the Company has established that this is not a known and measurable change. Accordingly, the Examiners do not recommend that an adjustment be made.

### 13. Affiliate Expense: Blueflame

Atmos Mid-Tex seeks the recovery of \$904,432 paid to the Company's sole affiliate, Blueflame Insurance Services. Blueflame is a wholly-owned incorporated subsidiary of Atmos Energy and provides service exclusively to the division of Atmos Energy Corporation.<sup>671</sup> There is no dispute that Blueflame is an affiliate of Atmos pursuant to the terms of section 101.001 of the Texas Utilities Code. Atmos asserted that Blueflame provides comprehensive property insurance to all divisions of Atmos Energy.<sup>672</sup> Blueflame provides insurance for property losses, including losses from earthquakes, floods, and acts of terrorism, up to \$255,000,000.<sup>673</sup> Blueflame is operated by Ray Hoover, Director of Risk Management for Atmos.<sup>674</sup> ACSC argued that Atmos Mid-Tex failed to meet its burden that the expenses related to this affiliate are just and reasonable.<sup>675</sup>

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<sup>667</sup> Atmos Exhibit 68, Schedule F-5, ln. 1, col. (d).

<sup>668</sup> ATM Exhibit 1, Garret Direct, p. 43, lns. 25 - 26.

<sup>669</sup> City of Dallas Exhibit 2 Pous Direct, p. 56, lns. 17 - 23.

<sup>670</sup> Atmos Exhibit 34, McDonald Rebuttal, p. 22, ln. 7 - p. 25, ln. 30.

<sup>671</sup> Atmos Exhibit 24, Sherwood Direct, p. 3, ln. 31 - p. 4, ln. 3.

<sup>672</sup> Atmos Exhibit 31, Sherwood Rebuttal, p. 22, lns. 17 - 20.

<sup>673</sup> Atmos Exhibit 24, Sherwood Direct, p. 5, lns. 9 - 19, Sherwood Rebuttal, p. 24, lns. 21 - 27.

<sup>674</sup> Atmos Exhibit 31, Sherwood Rebuttal, p. 23, lns. 27 - 30, ACSC Exhibit 1, Nalepa Direct, p. 16, lns. 7 -

<sup>675</sup> ACSC Initial Brief, pp. 92 - 96, ACSC Exhibit 1, Nalepa Direct, p. 14, ln. 8 - p. 20, ln. 3.



Section 104.055(b) governs the standard applicable to transactions involving the affiliate of a utility. In this context, section 104.055(b) requires that the Commission must make a specific find that the payment for insurance is reasonable and necessary. The Commission's determination must include a finding that the insurance was reasonable and necessary and that the price paid by the Atmos Mid-Tex is not higher than the price charged by Blueflame to other affiliates or divisions, or to a third party.<sup>676</sup>

Mr. Nalepa does not contest that the insurance is necessary and recognized that some level of property insurance is necessary in order for the ongoing operations of the Company to provide reliable service to ratepayers.<sup>677</sup> Additionally, Mr. Nalepa does not appear to contest the overall coverage selected by Atmos Mid-Tex. Mr. Nalepa contested the reasonableness of the amount paid. The challenge, however, is not based upon evidence that other insurance was available through a less expensive mechanism. Rather the challenge was focused on the relationship between Mr. Hoover, who acted as the Director of Risk Management for Atmos and directed the operations of Blueflame. Indeed, Blueflame itself has no employees, Mr. Hoover provides all functions related to its operations. Mr. Nalepa testified that the conception, operation, and management of Blueflame lie in the hands of Mr. Hoover.<sup>678</sup> These facts are not contested by Atmos Mid-Tex.<sup>679</sup> In addition to the foregoing facts, ACSC points to the following facts revealed in the record of this case to support its contention that the relationship between Atmos and Blueflame is not an arms length relationship:

- Mr. Hoover negotiates on behalf of Atmos and Blueflame with reinsurers who provided reinsurance to Blueflame.<sup>680</sup>
- Mr. Hoover has final authority to conclude negotiation and agree to terms.<sup>681</sup>
- Mr. Hoover makes the decisions on assigning risk factors that determine the cost of insurance coverage provided by Blueflame without reinsurance.<sup>682</sup>
- Mr. Hoover executed the Insurance Service Agreement between Atmos and Blueflame on behalf of Blueflame while at the same time advising Atmos on insurance issues.<sup>683</sup>

ACSC argued that Mr. Hoover found himself negotiating with himself on behalf of Blueflame and Atmos Energy Corporation and that those negotiations are necessarily suspect.

In response Atmos Mid-Tex pointed out that it turned to the concept proposed by Mr. Hoover because third party insurance necessary to cover the magnitude of property and operations of Atmos Mid-Tex was either very expensive or nonexistent.<sup>684</sup> In addition, Ms. Sherwood testified that the composite property insurance rate was about \$0.10 per \$100 of insurable value.<sup>685</sup> In response to

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<sup>676</sup> Tex. Util. Code Ann. 104.055(b) (Vernon 1998).

<sup>677</sup> ACSC Exhibit 1, Nalepa Direct, p. 19, lns. 20 - 21.

<sup>678</sup> ACSC Exhibit 1, Nalepa Direct, p. 16, lns. 3 - 10.

<sup>679</sup> Atmos Exhibit 31, Sherwood Rebuttal, p. 23, ln. 30 - 31.

<sup>680</sup> Tr. Vol. 5, p. 18, ln. 7 - 17..

<sup>681</sup> Tr. Vol 5, p. 18, lns. 18 - 22.

<sup>682</sup> Tr. Vol. 5, p. 19, ln. 18 - ln. 23.

<sup>683</sup> ACSC Exhibit 1, Nalepa Direct, Attachment Z, ACSC Ex. 101, Tr. Vol. 5, p. 15, ln. 4 - ln. 6.

<sup>684</sup> Atmos Exhibit 24, Sherwood Direct, p. 4, ln. 28 - p. 8, ln. 4.

<sup>685</sup> Atmos Exhibit 31, Sherwood Rebuttal, p. 25, ln. 3 - ln. 5.

the concerns regarding the relationship between Blueflame and Mr. Hoover, Ms. Sherwood testified that the concerns are misplaced because Mr. Hoover's compensation is in no way related or linked to Blueflame's performance or the premiums charged by Blueflame to Atmos or its various divisions and subsidiaries. In addition, Blueflame provides certain levels of insurance through third-party reinsurers and the premium for those levels of coverage are, in fact, arms-length transactions with third parties.<sup>686</sup>

The Examiners find the staffing relationship between Blueflame and Atmos Energy Corporation troubling. Further, as noted by witnesses in this case, there are several management programs that provide managers incentive to increase profits and, as stated by Ms. Sherwood, any profits from Blueflame go directly to Atmos.<sup>687</sup> Nevertheless, Atmos Mid-Tex has met its burden that the amount requested is just and reasonable. First, ACSC and Atmos agree that the acquisition of insurance is necessary. Second, Blueflame provides service exclusively to Atmos Energy Corporation. Therefore, Atmos Mid-Tex was able to satisfy the second prong of section 104.055(b) and established that the cost of insurance charged by Blueflame to Atmos Energy Corporation was no higher than the cost of insurance provided to other divisions or a third party. Further, Atmos Mid-Tex established that acquisition of insurance from a third party was either non-existent or more expensive than \$0.10 per \$100 of insurable property. ACSC did not challenge this cost as being unreasonable. On the other hand, the Examiners find that the relationship between Blueflame and Atmos Energy Corporation merit careful scrutiny in each case before the Commission and facts regarding the pricing may change, or be presented in future cases, that will call into question the reasonableness of these costs.

#### 14. Computer Software Amortization

Atmos Mid-Tex seeks \$1.7 million of annual amortization expenses for computer software.<sup>688</sup> The request is based on the remaining amortization periods that range from approximately one to two years beyond when rates in this case go into effect. The City of Dallas argued that the Company has underestimated the useful life of software systems and that the Company relied on useful service life periods that are too short. Mr. Pous noted that the Company has already fully amortized five of the eight software systems as of the end of the test year, and has already amortized 7.5% of the total costs. Mr. Pous recommended that the useful service lives of the software systems be extended. The result is that the amortization expense would be reduced by \$1,259,210.<sup>689</sup>

Mr. Yarbrough responded that the amortization periods used by Atmos for the software acquired through the TXU Gas acquisition are the same amortization periods approved by the Commission for that software in GUD No. 9400. Further, Mr. Yarbrough argued that while some of the software discussed in the testimony presented by the City of Dallas was fully amortized before the end of its useful life other software did not become fully amortized until after the end of its useful life.<sup>690</sup> Finally, Atmos Mid-Tex maintained that issues regarding the useful life used to establish

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<sup>686</sup> Atmos Exhibit 31 Sherwood Rebuttal, p. 25, ln. 1 - p. 26, ln. 15.

<sup>687</sup> Atmos Exhibit 31, Sherwood Rebuttal, p. 26, ln. 10.

<sup>688</sup> Schedule F-3, ln. 5

<sup>689</sup> City of Dallas Exhibit 2, Pous p. 35, lns. 3 - 23.

<sup>690</sup> Atmos Exhibit 19, Yarbrough Direct, p. 69, lns. 13 - 25.

amortization periods were precluded by the Commission's August 15<sup>th</sup> Interim Order in this case and the Commission has already decided this issue.<sup>691</sup>

The Examiners find that this issue was not precluded by the Commission's August 15<sup>th</sup> Interim Order. The Examiners find, however, that Atmos Mid-Tex has established that the estimated useful life for these assets used and approved in GUD No. 9400 are just and reasonable.

15. Depreciation Expense

a. Shared Services

Atmos Mid-Tex is proposing a depreciation expense for assets within Shared Services of \$15,783,315.<sup>692</sup> Of the total depreciation expense proposed, for Mid-Tex and Shared Services combined the depreciation expense from Shared Services accounts for nineteen percent.

ATM and the City of Dallas alleged that Atmos failed to satisfy the burden of proof in this case because Atmos Mid-Tex did not provide the depreciation study in support of the depreciation rates it sought to approve as part of the materials included with the Statement of Intent filing. The only support for the proposed shared services depreciation amounts allocated to shared services was included in Schedule F-3, WP F-3.a, and WP F-3.6. The study in support of the proposed rates was not provided in any of the documentation included in the Statement of Intent that was filed on May 31, 2006.

ATM and the City of Dallas pointed out that in the State of Georgia a similar circumstance occurred. The Georgia Public Service Commission decided that Atmos did not meet its burden of proof when it failed to include the depreciation study as part of its periled testimony.<sup>693</sup> The Georgia Public Service Commission made the following finding:

The Commission agrees that the Company failed to support its proposed doubling of depreciation expense for shared services plant. No witness mentioned or sponsored these increases, and the basic underlying theme was revealed only in the discovery phase of the case.

ATM and the City of Dallas recommend that, as in Georgia, the Commission should reject the proposed depreciation rates because Atmos Mid-Tex failed to provide the underlying study as part of its Statement of Intent. Atmos Mid-Tex responded by arguing that the Railroad Commission rules do not require that all documentation supportive of the rate request be filed with the Statement of Intent.

ATM and the City of Dallas also question the credibility of the rebuttal witness who

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<sup>691</sup> Atmos Initial Brief, p. 118, Atmos Exhibit 19, Yarbrough Direct, p. 69/

<sup>692</sup> Atmos Ex. 68, Schedule F-3, ln. 18.

<sup>693</sup> Docket No. 20298-U, In Re: Atmos Energy Corporation's 2005 Rate Case,

ultimately sponsored the underlying depreciation study. First, these Intervenor challenge the credibility of Mr. Roff because Mr. Roff represented to the Commission in his Exhibit DSR-1 that he is a registered Professional Engineer in Pennsylvania when, in fact, his license had expired nine years ago. Second, Mr. Roff represented that the depreciation rates resulting from the 2002 Study had been approved in Louisiana, Texas and Virginia. He specifically noted in his testimony that for other jurisdictions, "Atmos has not requested a change in depreciation rates, including SSU." A statement which they argue is incorrect. As already noted, Georgia had rejected the proposed rates. Further, they noted that the proposed depreciation rates were requested and rejected by the Tennessee Regulatory Authority. Indeed, they contend even the alleged approval referenced by Mr. Roff in Virginia was misleading as the order of the Commission there included a specific stipulation that the settlement was not to be regarded as a precedent with respect to any ratemaking issue in any future case. ATM also questioned the credibility of Mr. Cagle who also sponsored the underlying depreciation study during redirect at the hearing because he could not speak to the specifics of the study nor was he aware of the administrative history regarding the approval of shared services rates.

Mr. Pous alleged that the depreciation study relied upon is dated and is not supportive of the depreciation rates of assets currently held by Atmos Mid-Tex. Mr. Pous noted that the remaining life for the entire investment at issue was only 5.5 years. Thus, more than 82% of the remaining life of the investment investigated by the Company as of September 2002 will have expired by the time the rates go into effect.<sup>694</sup> Atmos Mid-Tex argued in response that this is contrary to the position Mr. Pous has taken in regards to depreciation analysis of Atmos Mid-Tex plant. There Mr. Pous argued that the results of the more recent study should be rejected in favor of the 2002 study that supported the depreciation rates in GUD No. 9400.<sup>695</sup> Mr. Roff also argued in response to some of the issues raised that new assets have been added to the accounts. Thus, the Company is not acquiring depreciation for fully depreciated accounts.

Mr. Nalepa noted that the Company's shared services depreciation rates as reflected in its filing do not correspond to the depreciation rates requested in its updated depreciation study in this docket sponsored by Mr. Watson. He compared the depreciation rates that Mr. Watson calculated for similar assets to the depreciation rates that Mr. Roff developed for the same category of assets in the Shared Services accounts. He found a wide disparity in the proposed depreciation rates. Mr. Nalepa argued that it was reasonable to revise the shared services depreciation rate for consistency with the rates proposed for direct plant. He pointed out that the Company agreed that Shared Services expends capital for similar items that operating divisions do, such as office equipment, computers, software, and other comparable items.<sup>696</sup>

The Examiners find that the Company satisfied the filing requirements by specifically noting in Schedule F-3, and Work Paper 1.1.c. the proposed Shared Services depreciation amount. The Examiners agree that it is unfortunate that the underlying study in support of those depreciation calculations was not initially included. Nevertheless, the fact remains that the Company placed all parties on notice of the request and the total amount requested. Further, there is no evidence in the

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<sup>694</sup> City of Dallas Exhibit 2, Pous Direct, p. 51, lns. 16 - 26.

<sup>695</sup> Atmos Mid-Tex, Initial Brief pp. 165 - 166, Roff, p. 5, lns. 18 - 28.

<sup>696</sup> ACSC Exhibit 1, Nalepa Direct, Attachments to the Direct Testimony of Karl J. Nalepa, Tab AA, Atmos Response to ACSC RFI-4.

record that once the parties requested the underlying study, it was not made available.

As to the credibility of Mr. Roff, the Examiners find that the only significant aspect to these proceedings that affected Mr. Roff's credibility is the candor with which he described the decisions in other jurisdictions. Clearly, the decision before the Tennessee Valley Authority and the limitation in Virginia impact the persuasive effect of his statement that the proposed Shared Service depreciation rates were approved in certain jurisdictions. The Company understood this fact, otherwise it would not have taken the trouble to discuss those jurisdictions approving the Shared Service depreciation rates in the first place. As to the alleged lack of credibility of Mr. Cagle regarding depreciation issues, the Examiners find that it is not surprising that his knowledge on depreciation issues was superficial given his lack of qualifications as a depreciation expert.

The Company has placed considerable weight on the fact that the proposed rates were approved by the Railroad Commission in GUD No. 9563. Conversely, the Company does not deny the fact that different depreciation rates for shared services assets were approved in GUD No. 9573. A fact that the City Intervenors argue should be persuasive here. The persuasive effect of those two cases is tempered by the fact that they were environ cases where the Company sought approval of settled rates for the environs. In GUD No. 9563, the rates that Atmos Energy Corporation sought to approve were settled rates with the City of Lubbock and in GUD No. 9573, the rates that the Atmos Energy Corporation sought to approve were settled rates with the West Texas Cities. No one protested those proposed rates and no one sought to intervene in those cases. No objection was raised regarding the proposed depreciation rates. The Commission's rules specifically provide that environs rates may be the same rates as those in effect in the nearest incorporated area in Texas served by the same utility where gas is obtained from at least one common pipeline supplier or transmission system.<sup>697</sup> In the end, the Examiners find that the administrative history in other dockets of the shared services rates does not resolve the issue of the reasonableness of those rates in the context of Atmos Mid-Tex in this case. What is determinative is the reliability of the results of the 2002 Study.

The Examiners find that the study relied upon by the Company is dated and no longer reflects the appropriate depreciation rates for the assets in those accounts. The assets in this account have an average life of only 5.5 years, whereas the assets in the accounts at issue regarding Atmos Mid-Tex plant discussed in the context of negative net salvage have an average service life of several decades.<sup>698</sup> That study also contained a depreciation analysis of assets comparable to assets at issue in the study prepared by Mr. Roff. The Examiners find that the most troubling aspect of the Company's proposed depreciation rates for shared services is the disparity between the rates for the same category of assets in Atmos Mid-Tex. For example, Atmos proposed a depreciation rate for account 391, Office Furniture & Equipment for Shared Services of 3.29%.<sup>699</sup> The same account for Atmos Mid-Tex had a depreciation rate of 0.98%. Likewise the depreciation rate for various computer equipment in the Shared Services accounts ranged from 6.21% to 29.95%. On the other

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<sup>697</sup> Rule 7.220.

<sup>698</sup> As noted by Mr. Watson in the context of Atmos Mid-Tex plant: "The average age of retirements during 2002 - 2004 is 19.64 years. Although this is shorter than the average life of the assets, it cannot be characterized as 'very early or very late stages of retirement activity. Atmos Exhibit 37, Watson Rebuttal, p. 9, Ins. 1 - 4.

<sup>699</sup> Atmos Exhibit 38, Roff, Rebuttal Exhibit DSR-3 of Don Roff, Schedule 1.

hand, the depreciation rate for Atmos Mid-Tex computer equipment was 11.79%. The Examiners find that such wide disparities fatally undermine the credibility of the 2002 Study prepared by Mr. Roff. The large disparity between the two studies undermines the reliability of the 2002 Study prepared by Mr. Roff and in light of the disparity between the 2002 Study and the prior depreciation study for the same assets the Examiners find that Atmos has failed to meet its burden of proof. The Examiners find that it is reasonable to have consistent depreciation rates for the same category of assets across General Plant SSU and General Plant Atmos Mid-Tex as proposed by ACSC. As the rates proposed by Mr. Roff have not been proven to be just and reasonable, the Examiners recommend that the rates developed in Mr. Watson's Depreciation Study be applied.

b. Mid-Tex

(1.) Introduction

Atmos Mid-Tex included a request for \$85,195,517 in depreciation expenses in the Statement of Intent filed on May 31, 2006, and as subsequently revised now seeks \$84,449,984.<sup>700</sup> The only proposed salvage level that has been challenged in this case involves the Mid-Tex Distribution Plant accounts. The current net salvage level for these assets is a negative 40% and it was established in GUD No. 9400. In that case, the Commission approved \$55,042,990 depreciation expense for the utility operating this system.<sup>701</sup>

As noted by Dane Watson, who testified on behalf of Atmos Mid-Tex on issues regarding depreciation rates for Atmos Mid-Tex, there are two general classes, or functional groups, of depreciable property: (1) the Distribution Plant property; and (2) General Plant property. General Plant is the overall distribution of gas to the customers of Atmos Mid-Tex.<sup>702</sup> One factor that accounts for the increase in depreciation expense is related to the negative net salvage. The change in net salvage alone impacts the proposed increase by six million dollars, a fact not disputed by the Company.<sup>703</sup>

Salvage value is the amount recovered for retired property. Net salvage is the difference between the gross salvage and the removal cost. In cases where the salvage value of property will be greater than the cost to remove property, net salvage is positive and is a decrease in the amount of plant to be depreciated over the life of the plant. On the other hand, in those cases where the cost to remove plant will be greater than the value of the plant removed, net salvage is negative and is an increase to the plant balance to be depreciated.<sup>704</sup>

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<sup>700</sup> Schedule A, Atmos Exhibit 68, Schedule A

<sup>701</sup> GUD No. 9400, Schedule B(D), ln. 34, col. (f).

<sup>702</sup> Atmos Exhibit 28, Watson Direct, p. 5, lns. 3 - 9.

<sup>703</sup> Tr. Vol. 9, p. 230, lns. 15 - 18.

<sup>704</sup> Atmos Exhibit 28, Watson Direct, Depreciation Rate Study, p. 27; ATM Exhibit 1, Garrett Direct, p. 45, ln. 11 - 19.

Atmos Proposed	GUD No.9400	ATM & City of Dallas
-50%	-40%	Recommend a less negative net salvage: – City of Dallas argued insufficient evidence provided for a change, and evidence supports - 30%. – ATM recommended that a normalized level of net salvage value based on the past five years be adopted and that it be set at a -5.78%.

The City of Dallas and ATM offered several criticisms to the proposed increase. Each issue raised and the Company's response, will be discussed below. First, the City of Dallas and ATM argued that the proximity with the most recent case does not merit an increase in the negative net salvage value. Second, these Intervenor also argued that the practice of abandoning the facilities in place was not considered in the depreciation study. Third, the City of Dallas alleged that the underlying data was manipulated. Fourth, the City of Dallas argued that only a small percentage of plant was retired and that could skew the results of the updated depreciation study. Fifth, the City of Dallas argued that the use of a functional basis for net salvage analysis distorts the results. Sixth, the net salvage values have resulted in significant over accruals. Seventh, the City of Dallas pointed out that the net salvage recommendation is inconsistent with the recommendations of other Atmos Energy Corporation entities. Eighth, ATM raised several issues regarding the treatment of removal costs.

Additionally, the State of Texas agreed that Atmos Mid-Tex failed to meet its burden of proof on this issue.<sup>705</sup> Specifically, the *State of Texas argued that the Texas Alarm and Signal Assen v. Public Utility Comm'n*, 603 S.W.2d 766, 733 (Tex. 1980) requires the utility to be consistent with the factors it chooses to meet its statutory burden in justifying its rates. The State argued that in *Texas Alarm*, the Supreme Court cautioned state regulatory agencies to not "allow a utility to arbitrarily alter factors considered relevant in justifying rates. The State argued that because the Company has proposed a change to depreciation rates, Atmos Mid-Tex carries the burden of proving that the different factors are not only relevant, but also Atmos Mid-Tex has the added burden of "providing supporting evidence [that its] mathematical formulas or relevant factors" were not arbitrarily altered "so as to fit [its] alleged need."<sup>706</sup> The State alleged that Atmos Mid-Tex failed to meet its burden, especially in light of the fact that Atmos Energy Corporation has requested different net salvage depreciation rates in other jurisdictions.

## (2.) Specific Objections to Calculation of Net Salvage.

The intervenors argue that the current depreciation net salvage rate is based upon a case which became effective in calendar year 2004. The movement from a negative 40% to a negative

<sup>705</sup> State Initial Brief, p. 6 & pp. 7 - 8.

<sup>706</sup> State Initial Brief, p. 2 & 7, citing to *Texas Alarm* at 733.

50% net salvage over such a short period of time is unreasonable, and would yield an additional \$171 million of depreciation recovery over the remaining life of the investment. Mr. Pous pointed out that this results in an additional \$6 million of annual revenue requirements.<sup>707</sup>

ATM and the City of Dallas maintained that the removal cost used to develop the proposed negative 50% net salvage rate for the distribution function does not reflect the Company's policy of abandoning facilities in place.<sup>708</sup> Mr. Watson responded that the Commission considered this same argument in GUD No. 9400 and rejected it. Further, even though the facility is not removed, that action is not without its costs — a fact conceded by Mr. Garrett.<sup>709</sup>

The Intervenors argue that the data used by the Company has been modified and manipulated in a manner that was not made known or identified and is inconsistent from year to year. In this context, the City of Dallas is critical of the fact that outliers have been removed.<sup>710</sup> Further, Mr. Pous argued that the Company does not know the underlying causes of retirements and the Company did not confirm whether the simple moving averages are indicative of future trends. He argued that several factors might have influenced the removal costs underlying the data relied on by Atmos Mid-Tex:

- Excess levels of contractor expenses
- Inappropriate allocations of costs where replacement is part of the retirement
- Non-representative levels of abandonments
- Manipulations of historical data

In short, Mr. Pous argued that the odd results of the allegedly simplified analysis have not been examined to determine the underlying causes of the allegedly distorted net salvage results.<sup>711</sup> In response to these allegations, Mr. Watson argued that of the nearly 19,000 retirement or removal projects from 2000 through 2004 every project was examined and a list of all adjustments were included in the depreciation study WorkPapers. In addition, Mr. Watson conducted interviews with Company personnel and samples of the interview notes were attached to his rebuttal testimony.<sup>712</sup>

Mr. Pous pointed out that only a small percentage of the existing plant balance has been retired – less than 2/10th of 1%. He postulated that these retirements are most likely not representative of the retirements of the vast majority of these assets and are early retirements or replacement of plant and equipment. The only way to identify the nature of these retirements at this early stage is through a specific cause of retirement study or other analysis to determine the specific type and mix of historic retirement. In response, Mr. Watson noted that the average age of retirements during 2002-2004 is 19.64 years. Although he conceded that this is shorter than the average life of the assets, he argued that it cannot be characterized as very early states of retirement activity.

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<sup>707</sup> City of Dallas Exhibit 2, Pous Direct, p. 39, ln. 1 - 18.

<sup>708</sup> City of Dallas Exhibit 2, Pous p. 47, lns. 12 - 15, ATM Exhibit 1, Garrett p. 48, ln. 16 - p. 49, ln. 28.

<sup>709</sup> Atmos Exhibit 37, Watson Rebuttal, p. 5, lns. 19 - 24 & p. 14, ln. 8 - p. 19, ln. 2.

<sup>710</sup> City of Dallas Initial Brief, pp. 42 - 43.

<sup>711</sup> City of Dallas Exhibit 2, Pous, p. 41, lns. 9 - p. 44, ln. 10.

<sup>712</sup> Atmos Exhibit 37, Watson Rebuttal, p. 7, ln. 6 - p. 8, ln. 25, Rebuttal Exhibit DAW-R-2.



Mr. Pous also argued that the use of a function level net salvage analysis distorted the results and the fact that in the most recent years only a small percentage of the Distribution Mains account was retired would skew the entire analysis. The cost of removal reported for Account 376 Mains during the last several years of the Company's analysis represents approximately only 4% of the total cost of removal for the distribution function. In years where the mains account accounted for a higher percentage of retirements, the net salvage percentage ranged from a negative 34% to a negative 22%. This is significant because Account 376 Mains is approximately 60% of the surviving investment used in Mr. Watson's depreciation study. Thus, the results for this one account, that by itself represents the majority of the distribution plant, is significantly under represented in the recent grouped salvage data. In response to the allegation that the function level net salvage analysis may distort the overall results of the negative net salvage analysis, Mr. Watson argued that this methodology was adopted in GUD No. 8976, 9145, and 9400.<sup>713</sup>

The City of Dallas and ATM argue that the Company's pattern of collection has resulted in an over-accrual and will continue to over accrue significantly during the next several years.<sup>714</sup> Mr. Garrett argued that the data he examined revealed that the estimated removal costs requested by Atmos Mid-Tex in this proceeding are more than ten times higher than the level of costs the Company actually incurs to remove assets.<sup>715</sup> Mr. Pous pointed out that the Company has averaged only \$1.1 million of annual cost of removal during the entire 43-year database it reviewed yet the Company is projecting that it will expend \$30 million on an annual basis based upon the approved rates. In contrast, Mr. Pous noted that the Company's highest annual level of cost of removal was \$3.4 million. Mr. Pous concluded that the Company has been significantly over-recovering the cost of removal in comparison to actual annual costs of removal incurred. In response, Mr. Watson essentially argues that the Commission has adopted a policy of accruing on an annual basis a portion of the removal cost of an asset. Thus, a comparison of the accrual of the depreciation expense portion attributable to net salvage with the annual cost of removal in any given year is misleading.<sup>716</sup>

The salvage recommendation is inconsistent with the experience in at least two other jurisdictions and Mr. Pous suggested that these net salvage recommendations were more realistic.<sup>717</sup> Atmos' Georgia operating division proposed a negative 22% net salvage for its Distribution Plant.<sup>718</sup> Atmos' Missouri division, currently before the Missouri public service Commission, is recommending an approximately 22% negative net salvage.<sup>719</sup> In response to this argument, Mr. Watson noted the assets owned and operated by the various divisions may not be comparable.<sup>720</sup>

Mr. Garrett made several objections to the Company's treatment of removal costs. Mr. Garrett argued that a mismatch occurs when the original asset cost, not adjusted for inflation, is

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<sup>713</sup> Atmos Exhibit 37, Watson Rebuttal, p. 9, lns. 1 - 9 & p. 9, ln. 27 - p. 10, ln. 10.

<sup>714</sup> ATM Initial Brief, pp. 50 - 52, City of Dallas Initial Brief, pp. 44 - 47.

<sup>715</sup> ATM Exhibit 1, Garrett Direct, p. 53, lns. 5 - 8.

<sup>716</sup> Atmos Exhibit 37, Watson Rebuttal, p. 11, ln. 26 - p. 13, ln. 5.

<sup>717</sup> City of Dallas Exhibit 2, Pous, p. 40, lns. 8 - 15.

<sup>718</sup> City of Dallas Exhibit 2, Pous, p. 40. lns. 4 - 5, citing Georgia Public Service Commission Docket No. 20298 - U.

<sup>719</sup> City of Dallas Exhibit 2, Pous, p. 40, ln. 5 - 7, citing Missouri Public Service Commission Case No. GR-2006-0387

<sup>720</sup> Atmos Exhibit 37, Watson Rebuttal, p. 13, ln. 6 - p. 14, ln. 7.

compared with the removal cost, which presumably occurs years later and is impacted by inflation. He argued that two problems are raised by this fact. Namely, that there is an inherent assumption that inflation levels will be sustained in the future and current ratepayers will be forced to pay now for inflation that has not yet occurred. He argued that removal costs, if included in rates at all, should be included at current values and not at inflated future values.<sup>721</sup> Mr. Garrett also argued most of the historical cost data of removal costs indicated that the cost to remove utility plant assets that are being replaced should be charged to new plant. The cost to replace existing plant, including the cost to remove the retired plant, is all part of the cost to construct and install new plant, and should not be included in the salvage calculation. In addition, Mr. Garrett alleged that the Company now charges most replacement costs to the new project and approximately 96.20% of the assets that are retired are being replaced with new assets.<sup>722</sup>

The City of Dallas recommended that the net salvage remain unchanged or be changed to a negative 30% whereas ATM argued that the normalized level of net salvage based on the past five years of actual activity be included as an annual expense.<sup>723</sup> Mr. Watson argued that the proposal of the City of Dallas is not based on actual data but is based merely on the perceived over recovery of depreciation expense and that the Commission considered this proposal in GUD No. 9400 and rejected it. Mr. Watson argued that the evidence presented in that case supported a negative net salvage value well above negative 40%.<sup>724</sup> Furthermore, while it is generally accepted practice that a utility may rely on a depreciation study that is three to five years old to establish depreciation rates, it is reasonable to update that study to identify the scope of observed trends.<sup>725</sup> Furthermore, Mr. Watson argued that updated data supports an upward adjustment of net salvage rate for the distribution function, not a decrease.<sup>726</sup>

### (3.) Examiners' Recommendation

The Examiners find that Atmos Mid-Tex has failed to establish that the movement from a negative 40% to a negative 50% net salvage in such a short period of time is reasonable. Mr. Watson concedes that it is generally accepted practice that a utility may rely on a depreciation study that is three to five years old to establish depreciation rates.<sup>727</sup> Further, as noted at the hearing, the negative net salvage was one of the few material changes that occurred between the study used in GUD No. 9400 and the updated study used in this case.<sup>728</sup> The Examiners find that this isolated change merits a longer time period to establish whether the alleged trend is permanent. In addition, the Examiners find that based on the evidence in the record, the average age of the retirements is considerably shorter than the average life of the assets, a fact conceded by Mr. Watson, and a fact that calls into question the reliability of the net salvage analysis of the updated study. The Examiners also find that

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<sup>721</sup> ATM Exhibit 1, Garrett Direct, p. 50, ln. 1 - 51, ln. 13.

<sup>722</sup> ATM Exhibit 1, Garrett, p. 46, ln. 12 - p. 48, ln. 3.

<sup>723</sup> City of Dallas Exhibit 2, Pous Direct, p. 48, lns. 3 - 8, ATM Exhibit 1, Garrett Direct, p. 55, ln. 14 - p. 56, ln. 17

<sup>724</sup> Atmos Exhibit 37, Watson Rebuttal, p. 4, ln. 14 - 30 & p. 5, lns. 15 - 23.

<sup>725</sup> Atmos Exhibit 37, Watson Rebuttal, p. 6, lns. 10 - 11.

<sup>726</sup> Atmos Exhibit 37 Watson Rebuttal, p. 5, lns. 1 - p. 6, ln. 5.

<sup>727</sup> Atmos Exhibit 37, Watson Rebuttal, p. 6, lns. 10 - 12.

<sup>728</sup> Tr. Vol. 9, p. 229, ln. 19 - p. 230, ln. 15.

the negative net salvage proposed in Georgia and Missouri of negative 22% are significantly different from the proposed negative 50%, and although they are different utility systems in different jurisdictions the negative net salvage calculation is concerned with the similar asset groups. The Company's other depreciation expert, Donald S. Roff conceded that net salvage calculations may sometimes be compared from one location to another and one state to another.<sup>729</sup> Finally, the Examiners find that on an annual basis Atmos Mid-Tex accrues depreciation expense from ratepayers in excess of the actual depreciation expense incurred.

With regards to the removal of sales, transfers of property, outliers, and reimbursed retirements from the life and salvage analysis used to calculate depreciation noted in the Initial Brief of the City of Dallas, the Commission affirmed in its August 15<sup>th</sup> Interim Order that this treatment was a just and reasonable depreciation methodology. This issue was examined in GUD No. 8664, and revisited in GUD No. 8976, and 9145. In each case, the Commission determined that it was a just and reasonable depreciation methodology for the utility system now operated by Atmos Mid-Tex. Further, it appears from the record in this case that Atmos Mid-Tex examined the underlying reasons for many of the retirements and that information related to the retirements was provided to the Intervenor.

Atmos Mid-Tex pointed to several practices that have previously been approved in the depreciation analysis performed by the Company, such as the inclusion of removal costs and the functionalized aspect of the study. In light of the Interim Rate Adjustment provisions recently approved by the Texas Legislature, these methodologies may no longer be appropriate. While the use of the function level net salvage analysis has been approved in the past, the Examiners agree that it may distort the results of the salvage analysis. Further, while the Commission has allowed the inclusion of removal costs, even though they may be recovered elsewhere, the apparent over accrual and the fact that 96.20% of retired assets are being replaced with new assets -- and those costs may be recovered through future interim rate adjustment filings -- suggests that the policy should perhaps be revisited. In that context, the Examiners find that the cost of abandoning a facility in place should be considered in the depreciation analysis.

The Examiners do not recommend a change in the methodology as proposed by ATM at this time. Nevertheless, in light of interim rate adjustment provisions of section 104.301, the Examiners are of the opinion that the proposal by ATM is reasonable and should be considered in future rate cases involving this utility in connection with interim rate adjustment projects. Indeed, it may not be necessary for the company to accumulate removal costs. Nevertheless, the Examiners recommend that the method not be changed in this docket, but that the determination be reserved for the next Subchapter C case. In the interim, the Examiners find that the utility has not met its burden of proof to support a more negative net salvage rate than was approved in GUD No. 9400 and recommend that the negative net salvage rate of negative 40% established in GUD No. 9400 be maintained for distribution plant accounts. Finally, the Examiners note that the Company's proposed change results in an increase to the Depreciation Plant composite depreciation rate of 3.83%. The rate order in GUD 9400 was 3.49%. The result of the Examiners recommendation is a composite rate of 3.48%.

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<sup>729</sup> Tr. Vol. 11, p. 172, lns. 12 - 18.

### XIII CAPITAL STRUCTURE AND RATE OF RETURN

#### A. Introduction

As part of this proceeding, the Commission must establish a reasonable rate of return for Atmos Mid-Tex. In establishing a gas utility's rates, the regulatory authority shall establish the utility's overall revenues at an amount that will permit the utility a reasonable opportunity to earn a reasonable return on the utility's invested capital used and useful in providing service to the public in excess of its reasonable and necessary operating expenses. The regulatory authority may not establish a rate that yields more than a fair return on the adjusted value of the invested capital used and useful in providing service to the public.

As noted by the Austin Court of Appeals in *Railroad Commission of Texas v. Lone Star Gas Company*, to achieve the rate of return that a utility should be allowed to earn, the regulatory agency should consider the cost to the utility of its capital expressed as follows: (1) interest on long-term debt; (2) dividends on preferred stock; and (3) earnings on common stock.<sup>730</sup> As stated by the United States Supreme Court, the annual rate that will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment:

A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties . . . . The return should be reasonably sufficient to assure confidence in the financial soundness of the utility, and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time, and become too high or too low by changes affecting opportunities for investment, the money market, and business conditions generally.<sup>731</sup>

The overall rate of return is a simple mathematical calculation. It is simply the sum of the percent return on cost of debt and cost of equity. The overall rate of return represents a weighted cost of debt and return for equity. Regulated utilities have several sources of capital with which to finance their utility assets: issuance of common stock and preferred stock, long-term debt, and common equity. Sometimes preferred stock and short term debt is included as a component for a calculation of the combined return. In this case, Atmos has proposed two components: Cost of Debt and Cost of Common Equity.

Breaking the components down is also a simple task. Cost of debt is typically not debated because it is based upon known facts. That is, cost of debt is the utility's actual cost of long-term

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<sup>730</sup> *Railroad Commission of Texas v. Lone Star Gas Company*, 599 S.W.2d 659 (Tex. App. — Austin 1980).

<sup>731</sup> *Bluefield Water Works and Improvements Co. v. Public Serv. Comm'n of West Virginia*, 262 U.S. 679 (1923), see also, *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1942).

debt, taken from financial instruments, already executed to finance its capital expenditures and operations. The cost of debt, because it is based on known, measurable factors such as the cost of borrowing instruments is easily identified and not the subject debate in this case. Conversely, the cost of common equity is nearly always the subject of debate because it is subjective in nature. Thus, two issues dominate the debate in this case regarding the return: Capital structure and the cost of equity.

## B. Capital Structure

Dr. Murry, who testified on behalf of Atmos Mid-Tex, suggested that the Company's common equity ratio be set at 50%. Dr. Murry does not dispute that the current capital cost structure is not 50% debt and 50% common equity. Instead, Dr. Murry argued that the current capital cost structure is affected by the recent merger of Atmos with TXU Gas. He argued that prior to the merger the capital structure was, in fact, closer to 50% common equity and 50% long-term debt. He also noted that the common equity ratio of comparable utilities was around 53.6%. Finally, he argued that Atmos Mid-Tex has manifested an intent to achieve a ratio of 50% equity and 50% long-term debt.<sup>732</sup>

ACSC and the City of Dallas argued that the current ratio should be the basis of setting rates in this case. Whether the Company intends to achieve a split of 50% common equity and 50% long-term debt is a matter of conjecture. Dr. Woolridge noted that the average common equity ratio over the past two years for Atmos Energy has been 40.71%. He analyzed a proxy group of gas distribution companies including Atmos Energy and found that the average common equity ratio over the past two years for this group is 43.04%. Mr. Parcell noted that Atmos has had a common equity ratio as high as 50% in only one year during the past ten years.<sup>733</sup> Dr. Woolridge examined the actual capitalization ratio for Atmos Energy and found that it was made up of 56.45% long-term debt and 43.55% common equity.<sup>734</sup> He argued that it is the Company's actual capital structure that forms the basis upon which Atmos Energy attracts capital.<sup>735</sup> Finally, Mr. Parcell noted that, based upon the Value Line report on Atmos dated June 11, 2006, the projected common equity ratio for the Company is 45%.

Only ATM recommended a capital rate structure that included short-term debt. Thus, ATM proposed that the following capital structure be applied in setting rates: long-term debt, 53.36%, short-term debt, 5.97%, and common equity 40.67%. Mr. Parcell argued that Atmos Mid-Tex has consistently had short-term debt outstanding during part of every year since at least 2000, and argued that it should be included in the Company's ratemaking capital structure. Additionally, he noted that in Georgia and Virginia, the state regulatory Commissions recognized the inclusion of short-term debt as part of the Company's capital structure.<sup>736</sup>

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<sup>732</sup> Atmos Exhibit 25, Murry Direct, p. 17, ln. 1 - p. 18, ln. 31 & p. 22, ln. 1 - 27.

<sup>733</sup> ATM Exhibit 4, Parcell Direct, p. 14, ln. 9 - p. 16, ln. 5.

<sup>734</sup> ACSC Exhibit 4, Woolridge Direct, p. 12, ln. 1 - 20.

<sup>735</sup> ACSC Exhibit 4, Woolridge Direct, p. 57, lns. 16 - 22.

<sup>736</sup> ATM Exhibit 4, Parcell, p. 16, lns. 6 - 21.

In response to the proposals of ACSC, ATM, and the City of Dallas, Dr. Murry argued that Dr. Woolridge has in the past argued that the past capital structure of the corporation is not as important as the expected future capital structure of the corporation and expected market yield levels of its debt and equity.<sup>737</sup> He reiterated the Company's intention to achieve a 50% ratio for debt and equity.<sup>738</sup> Responding to ATM's proposed capital structure Dr. Murry noted that the short-term debt balance of Atmos falls to zero and stays there for several consecutive months.

The Examiners find that the Company has not met its burden of proof to establish that the ratio of common debt and equity should be set at 50% each. The Examiners find that the history of the Company establishes that it was not recently 50% debt and 50% equity. The experience of other comparable natural gas utilities suggests that those ratios are not typically at parity. The Examiners find that the actual ratio of the Company is 56.45% debt and 43.55% equity. The Examiners do not find that the information cited in *Streetsmart Guide to Valuing a Stock*, coauthored by Mr. Woolridge, is relevant to this issue in the rate setting context. To set the ratio at the intended ratio of the corporation is not consistent with precedent for this utility and other rate setting principles. First, it is not consistent with the methodology used in GUD No. 9400. Second, it would deviate from the well settled rule that rates should be set on historic test-year data and that changes to test-year data should be based upon known and measurable changes. The intent of Atmos Mid-Tex with regard to its capitalization, while it may be sincere, is speculative and not a sufficient basis upon which to set the rates in this case. On the other hand, Atmos Mid-Tex has met its burden with regard to the issue of whether short-term debt should be part of the Company's capital structure. Accordingly, the Examiners do not recommend that the capital structure include a short-term debt component.

The Examiners note that if the capital structure is changed to reflect the current alleged ratio of 56.45% long-term debt and 43.55% common equity, the impact of that change, without making any other adjustment to the cost of service study filed by the Company, is to reduce the overall requested return by \$4,152,040, as reflected in Table 13.1.

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<sup>737</sup> Atmos Exhibit 25, Murry Direct, p. 6, Ins. 12 to p. 7, ln. 25, citing to Gary, Patrick J. Cusatis, and J. Randall Woolridge, Chapter 6: Estimating the Cost of Capital, *Streetsmart Guide to Valuing a Stock* (2004: McGraw-Hill, New York), p. 159.

<sup>738</sup> Atmos Exhibit 42, Murry Rebuttal, p. 8, Ins. 1 - 9.

Table 13.1  
Comparison of Proposed 50% Ratio to Actual Capital Structure

	Capital Structure			Cost	Return
Total Rate Base			\$1,111,791,170		
Atmos Proposed	Debt	50.00%	\$555,895,585	5.96%	\$33,131,377
	Equity	50.00%	\$555,895,585	11.75%	\$65,317,731
Total Return on Invested Capital					\$98,449,108
ACSC & Dallas – Actual	Debt	56.45%	\$627,606,115	5.96%	\$37,405,324
	Equity	43.55%	\$484,185,055	11.75%	\$56,891,744
Total Return on Invested Capital					\$94,297,068
Net reduction					\$4,152,040

### C. Cost of Equity

#### 1. Introduction

All parties agree that the cost of debt is directly measured and agree that a 5.96% cost of debt for Atmos Mid-Tex is reasonable.<sup>739</sup> The analysis of most of the parties regarding the cost of equity centered on two separate studies to determine the cost of equity: (1) the discounted cash flow (DCF)<sup>740</sup>, and (2) Capital Asset Pricing Model (CAPM).<sup>741</sup> One component of this analysis was to develop a group of comparable companies. In general, the parties also explored general market and economic conditions as a backdrop to place the analysis in context and support their conclusions.

#### 2. Comparable firms.

In order to perform the DCF and CAPM analysis, each party selected a list of allegedly comparable companies. Dr. Murry and Mr. Copeland used a list that was comprised of seven companies; Dr. Woolridge developed a list of twelve companies, Mr. Parcell developed a proxy of fifteen companies and included Atmos. Dr. Murry further modified the results of his analysis by

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<sup>739</sup> Atmos Exhibit 25, Murry Direct, p. 19, Ins. 1 - 26, ACSC Exhibit 4, Woolridge p. 11, ln. 14 - p. 13, ln. 3, ATM Exhibit 4, Parcell, p. 17, Ins. 1 - 8, City of Dallas Exhibit 1, Copeland Direct, p.5, ln. 1, and p. 6, Ins. 4 - 10,

<sup>740</sup> Atmos Exhibit 25, Murry Direct, p. 23, ln. 1 - p. 29, ln. 29.

<sup>741</sup> Atmos Exhibit 25, Murry Direct, p. 30, ln. 1 - p. 33, ln. 1.

excluding two firms from his list.<sup>742</sup> Dr. Woolridge argued that New Jersey resources should be excluded from any comparable list because it receives only 35% of revenues from regulated gas operations. Thus, its risk and return profile is not likely to reflect that of a regulated gas company.<sup>743</sup> Mr. Parcell, and Mr. Copeland included New Jersey Resources in their lists.

The Examiners find that Atmos Mid-Tex failed to establish that the use of such a restrictive list is just and reasonable. The Examiners note that the list of proxy companies used in prior cases was larger, and included the use of New Jersey Resources.<sup>744</sup> The use of a different proxy appears to be a change in methodology that was not explained. In any case, while the use in GUD No. 9400 of New Jersey Resources may be reasonable, the Company failed to establish that its use here did not unreasonable affect the results of its analysis. The Examiners find that its impact may be greater in some contexts where Dr. Murry decided to exclude the results of two comparable utilities from its list.<sup>745</sup> On the other hand, the Examiners find that the list of comparable utilities proposed by ATM is reasonable and reflects the contributions of estimates regarding Atmos Energy because it is included in the analysis.

### 3. DCF Analysis, CAPM Analysis, and other Economic Factors

The Discounted Cash Flow or DCF is a widely used method to analyze the cost of common equity. The DCF is expressed in a formula as:

$$K = D/P + g$$

Where: K = cost of common equity  
D = dividend per share  
P = price per share  
G = rate of growth of dividends, or, common stock earnings.

While the formula may appear to be relatively straightforward, the variables are, of course, subject to interpretation which was the subject of vigorous debate.

The parties agree that the Discounted Cash Flow (DCF) methodology is a reasonable method for measuring the cost of equity.<sup>746</sup> Dr. Murry argued that a DCF analysis should be based upon forecasts instead of historical growth rates.<sup>747</sup> He prepared a DCF analysis of Atmos and also prepared an analysis of what he alleged was a comparable group. Based upon his analysis, Dr. Murry identified several DCF ranges for cost of equity and he determined that a range of cost of equity

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<sup>742</sup> Tr. Vol. VI, p. 29, ln. 18 - p. 34, ln. 12.

<sup>743</sup> ACSC Exhibit 4, Woolridge Direct, p. 58, lns. 6 - 12.

<sup>744</sup> GUD No. 9145, Proposal for Decision, p. 39, and GUD No. 9400, Fairchild Rebuttal, Exhibit BHF-4.

<sup>745</sup> Tr. Vol. VI, p. 29, ln. 18 - p. 34, ln. 12.

<sup>746</sup> Atmos Exhibit 25, Murry Direct, p. 23, ln. 28 - p. 24, ln. 2; ACSC Exhibit 4, Woolridge, Direct, p. 23, lns. 17 - 19; ATM Exhibit 4, Parcell Direct, p. 18, lns. 20 - 21, City of Dallas Exhibit 1, Copeland Direct, p. 20, lns. 1 - 23.

<sup>747</sup> Atmos Exhibit 25, Murry Direct, p. 25, ln. 1 - p. 29, ln. 29.



between 11.74% and 12.04% for Atmos was reasonable.<sup>748</sup> A summary of his findings is provided in Table 13.2 below. In selecting a final DCF range, Dr. Murry appears to have applied his analysis of other economic factors and concluded that the relevant DCF range for Atmos Energy were the estimates of 11.74% percent and 12.04% for the forecasted earning per share growth rate.<sup>749</sup>

Table 13.2

	Atmos Energy Corp.		Comparable Co. Avg.	
	Range		Range	
	Low	High	Low	High
52-Week Projected Growth Rates <sup>750</sup>	9.20%	<b>12.04%</b>	6.47%	9.82%
52-Week Earnings Growth Rates <sup>751</sup>	11.59%	12.42%	9.89%	10.62%
Current Projected Growth Rates <sup>752</sup>	9.69%	<b>11.74%</b>	6.91%	9.48%
Current Earnings Growth Rates <sup>753</sup>	12.07%	12.13%	10.21%	10.27%

Suggested Rate Range	11.59%	12.04%
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Requested Rate	11.75%
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Dr. Woolridge also applied a DCF analysis.<sup>754</sup> He explained that estimates of expected growth are difficult to make.<sup>755</sup> In preparing his DCF analysis, Dr. Woolridge examined historical and projected growth rate estimates for earnings per share, dividends per share, and book value per share.<sup>756</sup> Applying a mix of historical and projected growth rate indicators Dr. Woolridge developed

<sup>748</sup> Atmos Exhibit 25, Murry Direct, Exhibit DAM - 19.

<sup>749</sup> Atmos Exhibit 25, Murry Direct, p. 38, lns. 27 - 29.

<sup>750</sup> Atmos DAM-19.

<sup>751</sup> Atmos DAM-18.

<sup>752</sup> Atmos DAM-22.

<sup>753</sup> Atmos DAM-20.

<sup>754</sup> ACSC Exhibit 4, Woolridge Direct, p. 22, ln. 16 -

<sup>755</sup> ACSC Exhibit 4, Woolridge Direct, p. 28, lns. 5 - 21.

<sup>756</sup> ACSC Exhibit 4, Woolridge Direct, p. 29, lns. 12 - 22.

a DCF-derived equity cost rate for Atmos of 9.7%.<sup>757</sup> He argued that Dr. Murry ignored the results of a DCF analysis based upon dividends per share, which are relatively low at this time.<sup>758</sup> Further, Dr. Woolridge argued that Dr. Murry excluded from his own analysis two entities that have low DCF results. Including these results into the mix Dr. Murry used changes the Company's proposed DCF ranges to 7.25% to 9.25%.<sup>759</sup>

Mr. Parcell also applied a DCF analysis. He was critical of Dr. Murry's exclusive reliance on analysts' forecasts in developing his DCF analysis.<sup>760</sup> Furthermore, he argued that it is nearly universal for cost of capital witnesses to use the results of comparable or proxy companies to estimate the cost of common equity and that he has rarely, if ever, encountered a witness who only used one company to estimate the cost of equity.<sup>761</sup>

In response to Dr. Woolridge's analysis, Dr. Murry was critical of the fact that his group of comparable companies included companies that were involved in mergers and this fact would impact the analysis.<sup>762</sup> He also alleged that the proxy group selected by Dr. Woolridge was less risky.<sup>763</sup> In response to Mr. Parcell's DCF analysis, Dr. Murry argued that increasing the dividend for ½ year of growth only approximated the average dividend that will be paid in the following year. Mr. Parcell's DCF method did not account for the quarterly payment of dividends. He argued that using the Earnings Retention Method, a methodology also applied by Dr. Woolridge, for determining expected dividends produced low biased results. Finally, he argued that Dr. Parcell's reliance on historical growth estimates was mistaken because analyst's forecast are superior to historical growth as predictors of future performance.

The parties also agreed that the CAPM is a reasonable method for measuring the cost of equity. The CAPM is expressed in a formula as:

$$K = R_f + RP$$

Where:      K = the estimated rate of return of the stock  
               R<sub>f</sub> = risk free rate of interest  
               RP = risk premium (subject to additional equation).

While the DCF method is a market-based measure of the cost of capital, the CAPM method is a risk premium measure that measures the cost of capital based on an investor's ability to diversify by combining various securities into an investment portfolio.<sup>764</sup> Dr. Murry argued that the CAPM

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<sup>757</sup> ACSC Exhibit 4, Woolridge Direct, p. 33, lns. 1 - 4.

<sup>758</sup> ACSC Exhibit 4, Woolridge Direct, p. 61, lns. 10 - 14.

<sup>759</sup> ACSC Exhibit 4, Woolridge Direct, p. 61, ln. 15 - p. 62, ln. 12

<sup>760</sup> ATM Exhibit 4, Parcell Direct, p. 31, ln. 26 - 28.

<sup>761</sup> ATM Exhibit 4, Parcell Direct, p. 31, ln. 21 - 25.

<sup>762</sup> Atmos Exhibit 42, Murry Rebuttal, p. 8, ln. 17 - p. 9, ln. 16.

<sup>763</sup> ACSC Exhibit 4, Woolridge Direct, p. 9, ln. 22 - p.

<sup>764</sup> Atmos Exhibit 25, Murry Direct, p. 24, lns. 2 - 13, and p. 30, lns. 1 - 24.

analysis provided a longer-term perspective than the more volatile DCF analysis.<sup>765</sup> Dr. Murry argued that the CAPM analysis served as a benchmark for the DCF analysis. For Atmos Energy, Dr. Murry concluded that the estimated costs of common stock are 11.21%, for a size adjusted CAPM, and 11.90%, for a historical asset pricing model. For the comparable companies used by Dr. Murry the results are 12.83% and 13.32%.<sup>766</sup> The DCF analysis and CAPM analysis led Dr. Murry to conclude that the high range produced by the DCF analysis of 11.74% to 12.42% was reasonable. Accordingly, Dr. Murry determined that a cost of equity of 11.75% was reasonable.

Dr. Woolridge determined that the CAPM analysis produced a cost of equity for his comparable group of 8.1%, and a cost of equity for Atmos of 8.6%. Comparing the results of his DCF analysis and the CAPM, Dr. Woolridge determined that a cost of equity of 9.0% is reasonable. Mr. Parcell concluded that his CAPM analysis produced a cost of equity range of 10.1% to 10.5%. Combining that result with the results of a DCF analysis and a comparable earnings analysis he concluded that a cost of equity of 9.7 % was reasonable. Mr. Copeland determined that a cost of equity of 7.4% was reasonable based upon his CAPM analysis. The DCF and CAPM analysis combined resulted in a recommended cost of equity of 9.0% .

Mr. Parcell and Mr. Copeland noted that the WNA proposed in this case had the effect of reducing the Company's overall risk. In response, Dr. Murry argued that the WNA does not transfer risk. The WNA is a mechanism that reduces the variability of the revenue stream but not a Company's risk. In fact, it helps the company achieve the cost recovery determined by the Commission to be appropriate in any period, but it is otherwise revenue neutral with respect to base revenues. Further, he argued that many gas companies nationwide have decided to forego the implementation of a WNA because it removed the opportunity to accrue economic profits during periods of colder than normal weather.<sup>767</sup>

In order to consider the results of his DCF and CAPM analysis in perspective, Dr. Murry evaluated economic conditions and concluded that the economy is in a period of relatively healthy growth, subject to inflationary pressure, with rising interest rates.<sup>768</sup> Dr. Murry argued that natural gas utilities are subject to a greater degree of risk when natural gas prices are high, as they have been in recent years.<sup>769</sup> Dr. Woolridge noted, on the other hand, that economic indicators suggest that capital costs have decreased and changes in federal tax regulation have generally tended to reduce capital costs.<sup>770</sup> Dr. Woolridge argued that the overall investment risk of public utilities is below other industries because the level of business risk is low due to the essential nature of their service. This outweighs the higher financial risk they incur due to high borrowing rates in the financial markets compared to other industries.<sup>771</sup>

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<sup>765</sup> Atmos Exhibit 25, Murry Direct, p. 30, Ins. 25 - 27.

<sup>766</sup> Atmos Exhibit 25, Murry Direct, p. 32, ln. 25 - p. 33, ln. 4.

<sup>767</sup> Atmos Exhibit 42, Murry Rebuttal, p. 19, ln. 1 - p. 20, ln. 24.

<sup>768</sup> Atmos Exhibit 25, Murry Direct, p. 32, Ins. 13 - 30, and p. 34, ln. 1 - p. 35, ln. 3.

<sup>769</sup> Atmos Exhibit 25, Murry Direct, p. 36, ln. 1 - 14.

<sup>770</sup> ACSC Exhibit 4, Woolridge Direct, p. 2, ln. 14 - p. 3, ln. 4, and p. 19, Ins. 1 - 21.

<sup>771</sup> ACSC Exhibit 4, Woolridge Direct, p. 20, Ins. 13 - 20.

D. Examiners' Recommendation on Cost of Equity and Overall Return.

The Examiners find that it was unreasonable for Dr. Murry to rely exclusively on a DCF analysis of Atmos Energy Corporation in arriving at a DCF range to use in this case. The use of a proxy was the methodology previously applied for this utility in a long series of cases before this Commission.<sup>772</sup> Indeed, in those cases the cost of equity proposed by the utility was either within, or close to, the applicable DCF range recommended by the applicant.<sup>773</sup> In each case the cost of equity approved was within the applicable DCF range. Further, the Examiners find additionally, that a DCF analysis that relies exclusively on analyst's forecasts is unreasonable.

The ultimate range determined by Dr. Murry for the DCF analysis was 11.74% - 12.04%. The Examiners find that the DCF range proposed by several of the witnesses of the City Intervenors coincided with the findings of Dr. Murry in his comparable group. Dr. Woolridge proposed a DCF cost of equity rate for Atmos Energy of 9.7% and for the comparable group of 9.7%, Mr. Parcell proposed a cost of equity range of 8.5% to 9.5%, and Mr. Copeland proposed a cost of equity 8.28%. The Examiners find that the DCF calculation of each City Intervenor is well within the range predicted by Dr. Murry's analysis for the comparable group. Accordingly, the Examiners find that Atmos Mid-Tex has failed to establish that a DCF cost of equity range of 11.74% to 12.04% based on an Atmos Energy Corporation DCF analysis is just and reasonable.

The Examiners find that Atmos Mid-Tex did not establish that a cost of equity of 11.75% is reasonable. As already noted, the Examiners find that Dr. Murry did not use the results of the comparable group in any way to inform his analysis of the applicable DCF range to be applied in this case. The overall range for that group varied from 6.47% to 10.62%.<sup>774</sup> Each of the cost of equity recommendations made by the various City Intervenors fall within that range. The DCF range may be narrowed to the highs identified by Mr. Murry of the 52-week DCF analysis and the high of the current discounted cash flow analysis. That range is 9.48% to 9.82%. The cost of equity recommendation of ATM is within that range. Whereas the cost of equity recommendation of the City of Dallas and ACSC is below that range by approximately fifty basis points. On the other hand, the cost of equity recommendation of Dr. Murry is over a 190 basis points above that range. In light of the DCF analysis of comparable companies presented by the Company and the City Intervenors, a cost of equity so far above that range is not credible.

Furthermore, the Examiners find that the return on equity recently determined for nine separate distribution utilities were all substantially less than the return on equity requested by Atmos Mid-Tex.

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<sup>772</sup> GUD Nos. 8976, 9145, and 9400.

<sup>773</sup> GUD No. 9145, PFD, pp. 40 - 41, FOF No. 82 - 90, and GUD No. 9400, PFD, pp. 174, referencing TXU Exhibit 62 (Testimony of Dr. Bruce Fairchild, p. 7 - 6).

<sup>774</sup> Tr. Vol. 6, p. 39, Ins. 4 - 21.

Table 13.3

Company	State	Date	Return on Equity
Northern States Power	WI	1/5/2006	11.00%
Wisconsin Electric Power	WI	1/25/2006	11.20%
Wisconsin Gas	WI	1/25/2006	11.20%
Public Service of Colorado	CO	2/3/2006	10.50%
Southwest Gas	AZ	2/23/2006	9.50%
Aquila Networks	IA	3/1/2006	10.40%
Sierra Pacific Power	NV	4/26/2006	10.60%
Louisiana Gas Service/TransLA Gas	LA	5/25/2006	10.40%
Average			10.60%

The average of 10.60%<sup>775</sup> is far below Dr. Murry's recommended 11.75% requested.

Additionally, ATM pointed to comments and decisions made by the Georgia Public Service Commission as a result of Atmos Energy's 2005 rate case before that regulatory Commission.<sup>776</sup> In that proceeding, Atmos proposed a cost of common equity of 12%. The Georgia Commission noted that although Atmos Energy was the largest gas distributor in the U.S., the company is deemed to be a "small" company (with respect to size in Georgia), which required a "size premium" to account for increased risk. The Georgia Commission further noted that smaller companies are considered more risky investments than larger companies. The Georgia Commission ultimately determined that an equity return rate of 10.125% was reasonable and would provide the company an opportunity under efficient management to maintain its financial position and attract the capital necessary to meet its public service obligations.<sup>777</sup>

Again, in light of the fact that the proposed cost of equity is so far above the DCF analysis for

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<sup>775</sup> Atmos Rebuttal Schedule DAM-R-1.

<sup>776</sup> ATM Exhibit No. 129, Order on Reconsideration and Final Order, Docket No. 20298-U.

<sup>777</sup> ATM Exhibit No. 129, Docket No. 20298-U, page 27 of 29.

comparable companies performed by Atmos Mid-Tex and in light of the recent decisions noted by Atmos Mid-Tex, reproduced in Table 13.3, above, and the recent decision of the Georgia Public Service Commission, the Examiners find that the Company has failed to establish that its requested cost of equity is just and reasonable.

Additionally, the Examiners find that the operation of the proposed weather normalization adjustment and the interim rate adjustment provision operate to reduce the risk for Atmos Mid-Tex. In GUD No. 9400, the Examiners recommended an adjustment to the proposed cost of equity to reflect the reduced risk provided by the interim rate adjustment provisions of GURA. Specifically, the Examiners noted that the ability to recover streams of revenue from investment under section 104.301 would tend to lower the risk premium demanded by a hypothetical investor in the utility's securities. Accordingly, in that case, the Examiners recommended that the Commission approve a cost of equity of 10%.<sup>778</sup> The Examiners recommend that a similar adjustment be made in this case. Further, the Examiners find that the WNA requested and already approved reduces the risk factors attributable to this distribution system. The Examiners recommend that the cost of equity be set at 9.70% as proposed by ATM. While the Examiners would recommend an additional reduction, the Examiners note that the rate proposed by ATM is lower than the upper DCF range of the comparables analyzed by the Company. It is certainly within the DCF range of the comparable companies analyzed by Dr. Murry and approximates the level achieved by comparing the average approved in several utility cases cited by Dr. Murry, adjusted for the reduced risk afforded by the interim rate adjustment provisions and the WNA.

The Examiners find that both the WNA and the interim rate adjustment provisions significantly reduce the risks associated with Atmos Mid-Tex. Accordingly, consistent with GUD No. 9400, the Examiners recommend consideration of these factors, or an adjustment to reflect this reduced risk in determining the cost of equity. Finally, the Examiners find that the economic conditions discussed by Dr. Murry are offset by other changes to the economy including changes in federal tax laws that were enacted after GUD No. 9400. Accordingly, those factors should be considered in setting the return on equity.

Table 13.4 summarizes the Examiners' recommendation of capital structure cost of debt and cost of common equity:

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<sup>778</sup> GUD No. 9400, PFD, pp. 175 - 176.

Table 13.4

Source of Capital	Cost (a)	Weighting (b)	Weighted Cost (a * b)
Long-Term Debt	5.96 %	56.45 %	3.36 %
Common Equity	9.70 %	43.55 %	4.22 %
Overall			7.59 %

## XIV BILLING DETERMINANTS

Atmos Mid-Tex explained that the billing determinants are composed of two factors: (1) the number of monthly customer bills rendered during the course of the year; and (2) the volumes of natural gas consumed over the same annual period. Mr. TheBerge testified that the level of annual consumption for the Residential and Commercial classes used as billing determinants consists of the actual amounts of the test year ending with December 2005, adjusted to reflect: (1) changes in the base load in the Residential Class; (2) growth in the number of customers in the Residential class; (3) declines in the number of customers in the Residential class; and (4) normal weather conditions in both the Residential and Commercial classes. The Company proposed to calculate normal weather conditions based on the average weather conditions that have occurred over the most recent ten years. The level of annual consumption used as billing determinants for the Industrial customer class consists of the actual amounts for the test year ending with December 2005 adjusted to reflect changes in the load requirements of these customers based on individualized review.<sup>779</sup>

## A. Total Annual Consumption – Base load Adjustment

Mr. TheBerge explained that the Residential and Commercial billing determinant levels are the product of the *adjusted number of customers* multiplied by the *adjusted use per customer*. The *adjusted use per customers* is calculated as the sum of the two elements identified in Table 13.1 below.

Table 14.1

	Adjusted use per customer for Residential and Commercial Customers	
Residential	Adjusted base load per customer	+ Adjusted weather sensitive load per customer
Commercial	Unadjusted test-year base load	+ Adjusted weather sensitive load per customer

Mr. TheBerge explained that the purpose of the *base load adjustment* is to calculate and apply

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<sup>779</sup> Atmos Exhibit 29, TheBerge Direct, p. 17, ln. 10 - p. 18, ln.7.

the current degree of change, upward or downward, in base load. Mr. TheBerge concluded that a *base load adjustment* for residential customers of 1.36 Mcf per month was appropriate and postulated several reasons for the decline. He did not adjust base load for the commercial class.<sup>780</sup> He adjusted the *weather sensitive load* per Residential customer based upon his conclusion that a normal year was comprised of 2,192 heating degree days as opposed to the 1,936 heating degree days that actually occurred during the test year. In order to arrive at the number of heating degree days Mr. TheBerge applied a weather sensitivity factor based upon historical heating degree days measured at the Dallas Fort Worth International airport for the 36-month period ending with June of 2005. For the residential customers, Mr. TheBerge calculated a 5 Mcf annual change in the use per customer. For the commercial class, Mr. TheBerge calculated a weather sensitivity adjustment to the test year use per customer of about 21.5 Mcf per year.<sup>781</sup>

Mr. Stowe argued that he is not aware that such an adjustment has ever been requested. Furthermore, he noted that the trend noted by Mr. TheBerge may not be a permanent decline and he argued that the trend in base load is not known and measurable. He noted that the Commission has never adopted such an adjustment and that Mr. TheBerge conceded that Atmos Mid-Tex is the first natural gas distribution system for which he has been retained to testify on the subject of residential base loads. Mr. Stowe argued that this proposed adjustment should be rejected because it is not known and measurable.

Dr. Ileo agreed with the Company's initial proposal to include an adjustment to recognize changes in the base load or non-weather sensitive usage characteristics for the Company. In the initial proposal, Atmos Mid-Tex included the adjustment only for the residential and commercial customer classes. Dr. Ileo included a base load adjustment calculation for the residential, commercial, and industrial class.<sup>782</sup>

Mr. TheBerge, in his rebuttal, alleged that the base load adjustment was removed because the base loads that the adjustment sought to approximate have now been incorporated through the adoption of actual loads experienced subsequent to the rate filing. As for Dr. Ileo's proposed base load adjustment to industrial customers, Mr. TheBerge argued that it was not appropriate for this class of customers that are affected primarily by business cycles.<sup>783</sup>

The Examiners find that the base load adjustment was, in fact, removed in the rebuttal that updated the Company's proposed rates.<sup>784</sup> The Examiners find the removal appropriate as the proposed adjustment was not a known and measurable change.

#### B. Total Number of Bills – Customer Growth Adjustment

ACSC and ATM challenge the estimate of total number of customers developed by Atmos Mid-Tex. Table 13.2 below compares the relative positions of the Company, ACSC and ATM

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<sup>780</sup> Atmos Exhibit 29, TheBerge Direct, p. 18, ln. 21 - p. 21, ln. 6.

<sup>781</sup> Atmos Exhibit 29, TheBerge Direct, p. 21, ln. 7 - p. 23, ln. 11.

<sup>782</sup> ATM Exhibit 6, Ileo Direct, p. 45, lns. 15 - 23, and p. 46, ln. 16 - p. 48, ln. 24.

<sup>783</sup> Atmos Exhibit 29, TheBerge Rebuttal, p. 60, lns. 26 - 30, p. 63, lns. 3 - 11, and p. 68, ln. 11 - p. 69, ln. 7.

<sup>784</sup> Atmos Exhibit 29, TheBerge Rebuttal, p. 60, lns. 26 - 30.



regarding the calculation of the number of customers on the system.

Table 14.2

	Residential	Commercial	Industrial
Atmos Mid-Tex	1,399,924	122,496	868
ACSC	1,395,527	121,944	964
ATM	1,371,625	121,643	893

Mr. TheBerge explained that the number of bills rendered during the year reflects the number of customers subscribing to natural gas delivery service. He noted that the number of residential and commercial subscribers is largely a function of the population level within the service territory and the degree of market penetration enjoyed by natural gas. He explained that he estimated the number of customers for each class based on the nature of the class. As for the number of industrial customers, he estimated that class based on a review of individual customers. In the case of the Residential customer class, the calculation he made produced an increase in the annual average number of customers of just over 6,700. In the case of commercial customers, he estimated a decline in the average number of customers of approximately 700. Finally, he noted that the Commission has approved this kind of customer growth adjustment in the past.<sup>785</sup>

Mr. Stowe argued that the methodology employed by Mr. TheBerge did not adequately recognize the actual level of customer growth experienced by Atmos Mid-Tex. He noted that from January 2004 through December 2004, the level of residential customer growth on the Atmos Mid-Tex system was approximately 0.58%, and between January 2005 through December of 2005, the Company experienced a 1.41% increase in residential customers. Mr. Stowe noted that the number of residential customers for December of 2004 noted by Mr. TheBerge was 1,369,223. Mr. TheBerge has estimated, however, that the number of customers in January 2006 at 1,378,924 – a decline of 10,813. Mr. Stowe noted that there is no explanation provided for the decline. Mr. Stowe recommended that the change in number of residential customers be based upon the percentage of residential customers in each month in calendar year 2005 over the residential customer level for December 2005. Utilizing this method, he calculated an average of 1,395,527 residential customers for the projected twelve months of 2006. As for commercial customers, Mr. Stowe also measured a decline.

Mr. Stowe also argued that the Company had incorrectly calculated the number of industrial and transportation customers. He noted that a workpaper provided by the Company reflected a downward adjustment to the test year of 63 customers to account for customers lost due to plant closings as well as customers that have been moved to the commercial or pipeline customer classes. By applying the test year adjustment to that level of customers Mr. Stowe concluded that the total number of industrial customers should be set at 964. This number includes both the standard and

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<sup>785</sup> Atmos Exhibit 29, TheBerge Direct, p. 23, ln. 12 - p. 25, ln. 29.

non-standard contract industrial / transport customers. Mr. Stowe adjusted the number of total industrial customers, 1,027, to reflect the 63 customers lost to plant closings and customer transfers to pipeline and the commercial class as shown on Company Workpaper J-1.6.<sup>786 787</sup>

Dr. Ileo's recommendation for the Residential and Commercial classes is based on the Company's estimates included in the original filing.<sup>788</sup> Dr. Ileo noted that Mr. TheBerge did not apply the methodology used to calculate the total number residential and commercial customers to his calculation of industrial customers. Dr. Ileo argued that the same methodology should have been employed and noted that application of that methodology to the calculation of Industrial customers results in a customer count for that class of 893.<sup>789</sup>

In response to Mr. Stowe's testimony regarding the number of industrial customers, the Company argued that Mr. Stowe's number of standard and non-standard contract industrial customers does not reflect the Company's most recent adjustments made on rebuttal.<sup>790</sup> The Examiners find that Mr. Stowe's proposed number of 964 standard and non-standard contract industrial customers is reasonable in that it reflects the best information available to participants in the rate case regarding the number of standard and non-standard contract industrial customers. The Company did not meet its burden of proof regarding the total number of standard and non-standard contract industrial / transportation customers.

The Company also disagreed with Mr. Stowe's inclusion of the non-standard customers in the cost allocation process in lieu of a revenue credit. The Company argued that the contributions made by the non-standard contract industrial customers, which were credited to the cost of service, benefit other customers. Further, differentiating these customers recognizes that they have other service options and can only be retained through reduced rate levels.<sup>791</sup> ACSC responds that without including the non-standard contract customers' demand, the cost allocation process will be skewed, which could result in the under-recovered costs being allocated to the residential, commercial, and standard industrial customers.<sup>792</sup> The Examiners find that it is appropriate to include the non-standard contract customers in the cost allocation and rate design process as this is necessary to ensure that any under-recovery of the cost of service attributable to these non-standard contract customers does not fall to the residential, commercial, and standard contract industrial / transport customers.

The Company provided updated schedules, which calculated customer growth adjustments to the residential and commercial classes of customers.<sup>793</sup> The Examiners find that these schedules illustrate reasonable calculations of the appropriate number of residential and commercial customers to use in this case: 1,399,924 residential customers; 122,496 commercial customers.

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<sup>786</sup> ACSC Exhibit 5, Stowe, p. 41, ln. 14 - p. 42, ln. 3.

<sup>787</sup> Atmos Mid-Tex Ex. 74, Excel file version.

<sup>788</sup> ATM Exhibit 6, Ileo Direct, p. 43, lns. 23 - 25 & p. 45, lns. 18 - 21.

<sup>789</sup> ATM Exhibit 6, Ileo Direct, p. 45, ln. 15 - p. 46, ln. 15.

<sup>790</sup> Atmos Mid-Tex Initial Brief, p. 199.

<sup>791</sup> Atmos Exhibit 29, TheBerge Direct, p. 70, lns. 16 - 25.

<sup>792</sup> ACSC Reply Brief, p. 75.

<sup>793</sup> Atmos Mid-Tex Ex. 68.

## C. Weather Adjustment

Mr. TheBerge testified that the purpose of adjusting the test-year volumetric billing determinants is to establish a level of volumetric billing determinants that reflect normal weather. The adjusted volumetric billing determinants are then used to set rates. Mr. TheBerge used the average of the heating degree days reported by the Dallas Fort Worth International airport for the ten calendar years ending with 2005. He argued that this was consistent with prior decisions of the Commission.<sup>794</sup> He argued that the ten-year weather normal has been more representative of ongoing weather experience than the average for the 30-year time period used in GUD No. 9400.

He based his conclusion on an analysis of the heating degree days reported for the Dallas Fort Worth International airport from 1951 through 2005. Mr. TheBerge reached his conclusion by comparing moving averages of the weather data and by performing a linear regression analysis of that data. First, by comparing the moving averages he concluded that the long-term averages (30-year and 25-year) differ significantly from any *recent* measure of cold weather. Second, he also compared the 30-year average and the 10-year average with the long term weather trend during the last 15 years and concluded that the moving 10-year average currently provides a better correlation with, and a better approximation of, the weather trend than does the 30-year moving average.<sup>795</sup>

Mr. Stowe, who testified on behalf of ACSC, was critical of the fact that Mr. TheBerge did not perform additional statistical analysis to verify his result. Mr. Stowe argued that while the analysis contained in Mr. TheBerge's testimony tends to show a warming of the local climate, Mr. TheBerge has not presented evidence that permanent climate change has taken place within the North Texas region. He noted that NOAA still used 30-year averages in its definition of normal weather. He also noted that Atmos Mid-Tex used 30-year normal weather in its budgeting processes.<sup>796</sup> Mr. Stowe recommended the use of 30 years of dates as of 2005.<sup>797</sup> ACSC also argued that the use of 30-year normal weather is consistent with past Commission decisions regarding this distribution system. Mr. Copeland, who testified on behalf of the City of Dallas, agreed with ACSC and argued that 10 years is too short a time frame to quantify "normal" weather. Based on a statistical analysis of weather data that spanned fifty-five years, he concluded that there was no reason to depart from the standard climatological normal of using 30 years to define normal weather.<sup>798</sup> In contrast to the ACSC and the City of Dallas, Dr. Ileo, who testified on behalf of ATM, agreed with Atmos Mid-Tex that the use of 10-year weather data was appropriate.<sup>799</sup>

The Examiners recommend that the Company's proposed use of 10-year weather data to determine the volumetric billing determinants be adopted. Although the use of 30-year data was approved in GUD No. 9400, the Company has established that the use of 10-year data is just and reasonable. This recommendation yields the following annual usage volumes to be employed in the cost allocation and rate design phases of the case: 1)79,918,668 Mcf for the residential customer

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<sup>794</sup> GUD Nos. 9533, 9534, and 9465.

<sup>795</sup> Atmos Exhibit 29, TheBerge Direct, p. 26, ln. 1 - p. 28, ln. 18.

<sup>796</sup> ACSC Exhibit 5, Stowe Direct, p. 33, ln. 9 - p. 37, ln. 10.

<sup>797</sup> ACSC Exhibit 5, Stowe Direct, p. 40, lns. 17 - 23.

<sup>798</sup> Copeland Direct, p. 35, ln. 18 - p. 37, ln. 8.

<sup>799</sup> ATM Exhibit 6, Ileo Direct, p. 43, lns. 14 - 22.

class; 51,064,050 Mcf for the commercial class; and 40,808,292 MMBtu for standard contract industrial / transportation customers and 12,731,255 MMBtu for non-standard customers.<sup>800</sup>

## XV. FUNCTIONALIZATION, CLASSIFICATION, and ALLOCATION

### A. Introduction

The initial step in setting the rates to be charged by a regulated utility is the determination of the cost of service, that is the total revenues required to cover the utility's cost of operation, including a fair rate of return on its investment. Utilities serve several classes of customers. Accordingly, the cost of the system must be allocated among the various customers. In this case, Atmos Mid-Tex has classified the customers served by the utility system into three broad groups: Residential, Commercial, and Industrial & Transportation. As set out by the utility, the revenue requirement to be allocated and recovered through rates was \$404,611,426. Based upon the above recommendations and adjustments the total revenue requirement to be allocated and recovered through rates is \$324,948,322<sup>801</sup>. The attached CARD (cost allocation and rate design) schedules detail the recommended methodology for cost functionalization, classification, and allocation in this case.<sup>802</sup>

Mr. TheBerge prepared the cost classification, functionalization, and allocation study that ultimately allocated the costs on behalf of the Company.<sup>803</sup> As an overview to his proposal in this case, he testified that cost causation was the controlling element of the cost classification, cost allocation and rate design process. Once the cost of service is established translating the cost of service into rates involved three steps: (1) cost classification, (2) cost allocation, and (3) rate design.<sup>804</sup> Mr. TheBerge classified costs as one or more of the following: (1) *customer costs*, (2) *capacity costs*, (3) *commodity costs*, and (4) *revenue costs*. Capacity costs and customer costs are fixed costs, whereas commodity costs are variable, and revenue costs can be either.<sup>805</sup>

Mr. TheBerge explained further that *customer costs* are related to the number of customers on the system and that these costs include investments and expenses incurred to build, operate, and maintain commonly shared distribution plant and delivery facilities that are related to the location of and number of customers served.<sup>806</sup> *Capacity costs*, as defined by Mr. TheBerge, are costs related to the distribution systems' maximum rate-of-flow capability or requirement. He defined *commodity costs* as costs that are related to, and vary with, the actual volumetric throughput on the distribution system without regard to either the maximum peak period demand placed on the system or the number of customers on the system. Finally, *revenue costs* are related to the level of revenues

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<sup>800</sup> Atmos Ex. 68.

<sup>801</sup> These amounts exclude gas cost, upstream pipeline cost, and revenue related taxes, amounts collected separately through Rider GCR, Rider FF, and Rider Tax.

<sup>802</sup> The CARD schedules were provided by Atmos Mid-Tex witness, Mr. TheBerge. These original schedules have been significantly modified for the purposes of the Examiners' recommendations and the Final Order.

<sup>803</sup> Atmos Exhibit 29, TheBerge Direct, p. 31, lns. 17 - 18. Mr. TheBerge defined variable costs to mean those costs that vary materially with the actual level of consumption of gas. On the other hand, "fixed costs" are those that do not vary with the consumption of gas. *Id* at lns. 3 - 21 & p. 58, ln. 1 - p. 60, ln 23.

<sup>804</sup> Atmos Exhibit 29, TheBerge Direct, p. 33, lns. 1 - 10.

<sup>805</sup> Atmos Exhibit 29, TheBerge Direct, p. 33, ln. 27 - p. 34, ln. 2.

<sup>806</sup> Atmos Exhibit 29, TheBerge, Direct, p. 34, ln. 22 - p. 35, ln. 9.

collected by the Company and can include such costs as revenue-related taxes.<sup>807</sup>

Applying those general concepts to this case, Mr. Theberge classified the various gas plant accounts based upon the function served by the facilities. He referred to this process as plant functionalization. The purpose of functionalization, as described by Mr. Theberge was to group assets into categories that reflect a commonality of use. He determined that there were three functional categories: (1) Central Distribution Plant function, (2) Downstream Distribution Plant function, and (3) Auxiliary Plant function.<sup>808</sup> Once the functions were identified, Mr. TheBerge proceeded to classify the costs.

Mr. TheBerge testified that Auxiliary Plant and Downstream Distribution Plant were classified in the same manner that was done in GUD No. 9400.<sup>809</sup> Central Distribution Plant is the operating plant that receives natural gas at the city gate and town border stations and moves the gas to the downstream customer lateral facilities and includes the measurement, regulation, and odorization of the natural gas. He noted that the central distribution plant function has at its core the Distribution Mains account recorded in FERC Account No. 376. The investment in this functional category is caused by the requirement to (a) install facilities that connect all customers to the distribution network and (b) install facilities with sufficient capacity to meet the demands of all customers. Mr. TheBerge subdivided Central Distribution Plant into two subdivisions: (1) the portion of total costs incurred to connect the central distribution network to the individual downstream customer laterals, and (2) the portion of total costs incurred to achieve the collective capacity requirements of the central distribution network.

He separated the two types of costs within the mains account using a form of the minimum system analysis to isolate *customer costs*. The use of the minimum system is a hypothetical exercise to identify the cost of connecting customers to the system that cannot be explained by capacity requirements. The costs in excess of the minimum system costs were defined by Mr. TheBerge as *capacity costs*.<sup>810</sup> Mr. TheBerge argued that he has updated and applied the form of the minimum system analysis approved by the Commission in GUD No. 9400.<sup>811</sup> Mr. TheBerge argued that there were some flaws with the minimum system analysis adopted in GUD No. 9400 that should be corrected in this case.<sup>812</sup> The various classifications of gas plant are ultimately allocated to the various customer classes on the basis of either number of customer locations, design day study, directly, or a composite factor.

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<sup>807</sup> Atmos Exhibit 29, TheBerge, Direct, p.36, lns. 1 - 4.

<sup>808</sup> Atmos Exhibit 29, TheBerge Direct, p. 36, lns. 6 - 17.

<sup>809</sup> Atmos Exhibit 29, TheBerge, p. 44, ln. 26 - p. 45, ln. 17.

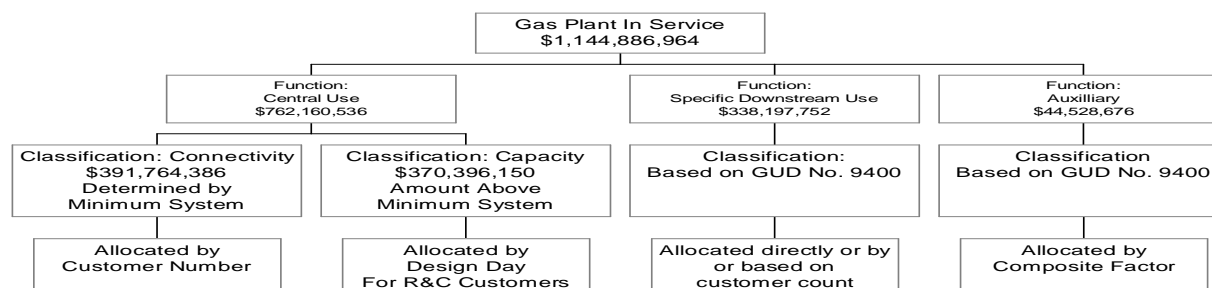
<sup>810</sup> Atmos Exhibit 29, TheBerge, p. 37, ln. 3 - p. 38, ln. 11 - 29.

<sup>811</sup> Atmos Exhibit 29, TheBerge, p. 40, lns. 5 - 16.

<sup>812</sup> Atmos Exhibit 29, TheBerge, p. 40, ln. 21 - p. 42, ln. 7, Stowe Direct, Attachment P, Response to ACSC RFI 2 - 21.

Table 15.1

Gas Plant Account  
Functionalization, Classification, and Allocation of Proposed by Atmos Mid-Tex



B. Minimum System Analysis.

1. Minimum System Analysis – Introduction

As noted above, the costs associated with the function that Mr. TheBerge identified as Central Use Distribution are classified into two classes he termed connectivity and capacity. In order to divide that cost into the two classes, Mr. TheBerge applied the ratio derived from the minimum system analysis which is the current cost of two-inch minimum system, \$1,315,166,056 divided by the total cost of construction mains in service in 2005 dollars, \$2,558,598,234. To arrive at the current cost of two-inch minimum system Mr. TheBerge multiplied the current cost of two-inch mains per foot which he estimated as \$9.05 per foot, by the total linear feet of Mains in service.<sup>813</sup>

The use of a minimum system analysis was initially proposed by TXU Gas, and adopted by the Commission, in GUD No. 9145. In that case, TXU Gas used a zero - intercept methodology. As noted by witnesses in that case, the zero intercept method is a conservative method that establishes the cost of a theoretical main that has zero capacity. The result in that case was to classify 16.55% of the mains as customer related costs. For the zero intercept method applied in that case the cost per linear foot was \$3.16.<sup>814</sup> The zero-intercept method has been proposed by Atmos Energy Corporation in other jurisdictions. For example, the zero intercept method was the system proposed by Atmos Energy Corporation before the Georgia Service Commission, which ultimately rejected the proposed methodology.<sup>815</sup> In GUD No. 9400, TXU Gas proposed, and the Commission adopted, a revision to the minimum system analysis. Namely, TXU Gas proposed that the minimum system analysis be conducted using two-inch pipe. The result was that TXU Gas proposed allocating approximately 43% of expense related Distribution Mains as customer related. For its analysis in that case, TXU proposed that the linear per foot cost of two-inch pipe be set at \$5.57.<sup>816</sup> In its August 15<sup>th</sup>

<sup>813</sup> Exhibit MT-R-26.

<sup>814</sup> GUD 9145, PFD, p. 99.

<sup>815</sup> Order on Reconsideration and Final Order

<sup>816</sup> GUD No. 9400, PFD, pp. 241.

Interim Order, the Commission affirmed that the concept of a minimum distribution system with a 2-inch pipe is a just and reasonable method of allocating certain costs for this utility system.<sup>817</sup>

In this case, Atmos Mid-Tex proposed the adoption of a \$9.05 cost per linear foot of two inch pipe and a change in the analysis by which capacity costs are allocated. The result of the minimum system analysis in this case is that approximately 51% of costs associated with mains are classified as *customer costs*. All parties agree that the change proposed by Atmos Mid-Tex in this case increases the costs that will be allocated to captive residential and commercial customers. From November 20, 2000, the date the Final Order was issued in GUD No. 9145, through May 25, 2004, the date the Final Order was issued in GUD No. 9400, through May 31, 2005, the date the Statement of Intent was filed in this case the classification of Distribution Mains customer costs has increased from a little over 16% to approximately 51%.

The Examiners note that despite the fact that the minimum system methodology was approved in GUD No. 9145, and modified in GUD No. 9400, and found to be just and reasonable in the Commission's August 15<sup>th</sup> Interim Order, the City Intervenors objected to its use here. Mr. Stowe testified that the amount of two-inch pipe in the utility system represented a small percentage of the overall pipe in the Atmos Mid-Tex system.<sup>818</sup> Atmos Mid-Tex filed a motion to strike the testimony of certain portions of the testimony of Micheal J. McFadden and Charles H. Becker on the basis that it was testimony elicited to discredit this methodology. The Examiners granted that motion to strike. Atmos Mid-Tex also filed a motion to strike certain portions of testimony of Micheal J. Ileo, which was also granted.<sup>819</sup> The State of Texas noted that the minimum distribution system was an issue of considerable debate in GUD No. 9400 and the Commission's August 15<sup>th</sup> Interim Order should resolve a large measure of the debate over some of these issues.<sup>820</sup> The Examiners continue to recommend adoption of the two-inch minimum system as approved in GUD No. 9400. That case was decided May 25, 2004, barely two years to the date before this case was filed. The Examiners recommend that a methodology so recently adopted for this utility system be continued at this time. Mr. Ileo urged the Commission to reconsider the position expressed in the August 16, 2006 Interim Order, at least in anticipation of Atmos Mid-Tex's next general rate case.<sup>821</sup> The Examiners note that the Commission may certainly reconsider this policy question regarding the allocation of costs for this utility system at any time.

Issues regarding the overall use of a theoretical minimum system aside, there are several issues that the parties raised with regards to the functionalization, classification, and allocation of assets that the Company identified as being Central Distribution Plant function. The portion of Table 15.1 that relates to this functional category is reproduced at Table 15.2.

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<sup>817</sup> FOF Nos. 20 - 23.

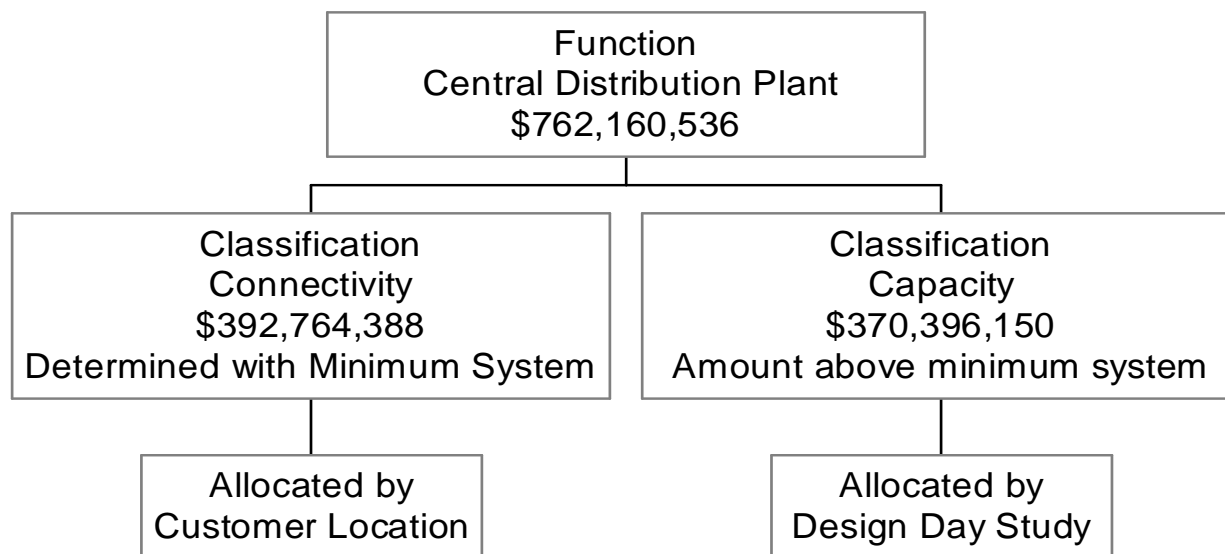
<sup>818</sup> ACSC Exhibit 5, Stowe Direct, p. 46, ln. 7 - 20.

<sup>819</sup> Tr. Vol. Pp. 6 - 24.

<sup>820</sup> State Exhibit 1, King Direct, p. 10, lns. 7 - 21.

<sup>821</sup> ATM Exhibit 6, Ileo Direct, p. 78, ln. 10 - 13.

Table 15.2  
Functionalization, Classification, Allocation of Central Distribution Plant



The City Intervenor challenged several issues regarding the components used to calculate the minimum system. In addition, they challenged specific aspects of the design day study. As can be observed from Table 15.2, issues regarding the components of the minimum system will be addressed first, and then issues regarding the allocation of the costs classified as capacity costs will be addressed. The State of Texas argued that the minimum system method used to determine the State's share of expenses be applied in the same manner and to the same components for which this method was approved in GUD 9400.<sup>822</sup>

## 2. Minimum System Analysis – Cost of Pipe (\$9.05/linear ft.)

The minimum system analysis applied in GUD No. 9400 incorporated a cost of two-inch pipe of \$5.57.<sup>823</sup> ACSC and ATM proposed that the calculated per linear foot cost of two-inch pipe proposed by Atmos Mid-Tex be rejected. They argued that the Company has not met its burden of proof with regard to the \$9.05 per linear foot price. ACSC argued, through the testimony of Mr. Stowe, that the appropriate cost of one foot of two-inch pipe was \$7.62 per linear foot. On the other hand, ATM maintained, through the testimony of Dr. Ileo and Mr. Lord, that the appropriate cost was \$2.81 per foot. The relative positions of the parties regarding the cost of two-inch pipe are set out in Table 15.3 below.

<sup>822</sup> State of Texas Exhibit 5, King Direct, p. 4, lns. 4 - 7.

<sup>823</sup> ACSC Exhibit 5, Stowe Direct, Schedule JES - 8.



Table 15.3

Cost of one foot of two-inch pipe proposed by parties compared to cost used in GUD No. 9400

ATM	GUD No. 9400	ACSC	Atmos Mid-Tex
\$2.81/ft	\$5.57/ft	\$7.62/ft	\$9.04/ft

Mr. Stowe argued that Mr. TheBerge developed the cost of two inch pipe based upon a 300 foot installation, yet he provided no evidence as to why 300 feet is the appropriate length to be used in the calculation. He argued that the use of the 300 foot length was arbitrary and would drive up the per foot cost estimate.<sup>824</sup> Mr. Stowe was also critical of the fact that Mr. TheBerge employed a 33% construction overhead factor and alleged that this factor was based on the unsupported allegation that 33% reflects the current capitalization rate of Atmos Mid-Tex. As noted above, however, Mr. Stowe argued that industry documents and the Company's own documentation support a lower overhead factor. Mr. Meziere stated that the construction overhead costs to total investment additions by year 2003, 2004, and 2005 categories of interim rate adjustment projects was 24.1%, 11.83% and 14.3% respectively. Mr. Stowe also argued that replacement cost should have been used on both sides of the minimum system ratio. Finally, in arriving at his proposed cost of \$7.62, Mr. Stowe attempted to update the figure in GUD No. 9400.

Mr. Ileo was also critical of the cost per linear foot calculated by Mr. TheBerge. He argued that data presented by Mr. TheBerge in support of that cost estimate did not support his claim. The projects cited by Mr. TheBerge were of a complex nature consisting of replacements, relocations, removal, and abandonments that were well-beyond the sole purpose of installing new two inch pipe. He concluded that those pipe installations cannot be used to support the reasonableness of a current cost estimate at \$9.05 per foot to install new two inch Distribution Mains.<sup>825</sup> Mr. Ileo and Mr. Lord presented an analysis of projects solely involving the installation of new distribution mains and concluded that the average cost experience of the Company with the installation of two inch pipe was \$2.81 per foot in 2005.<sup>826</sup> He presented several different analyses to support the validity of his calculation.<sup>827</sup>

In response to the issues raised by ATM, Mr. TheBerge responded that Mr. Ileo misunderstood the purpose of the data provided. He intended to emphasize the mismatch implicit in the numerator and denominator of the allocative function.<sup>828</sup> Mr. TheBerge is critical of the underlying data used by Mr. Ileo to arrive at his estimated cost of one foot of two-inch pipe and alleged that the data understated costs, overstated the linear footage of each project, and included unit prices that were meaningless. He argued that all of Mr. Ileo's conclusions that were based on this data were, as a result, invalid.<sup>829</sup> Mr. TheBerge was also critical of other aspects of Mr. Ileo's analysis. For example, he argued that analysis conducted by Mr. Ileo to confirm the validity of his estimate was invalid as

<sup>824</sup> ACSC Exhibit 5, Stowe Direct, p. 49, ln. 10 - p. 50, ln. 13.

<sup>825</sup> ATM Exhibit 6, Ileo Direct, p. 64, ln. 10 - p. 66, ln. 6.

<sup>826</sup> ATM Exhibit 6, Ileo Direct, p. 66, ln. 7 - p. 69, ln. 24 & p. 71, ln. 1 - 14; Lord, p. 7, ln. 1 - p. 8, ln. 8.

<sup>827</sup> ATM Exhibit 6, Ileo Direct, p. 69, lns. 4 - 11 & p. 72, ln. 1 - p. 77, ln. 4.

<sup>828</sup> Atmos Exhibit 43, TheBerge Rebuttal, p. 21, ln. 24 - p. 23, ln. 6.

<sup>829</sup> Atmos Exhibit 43, TheBerge Rebuttal, p. 23, ln. 7 - p. 24, ln. 7.

it was not a customer ratio.<sup>830</sup> He argued that analysis by Mr. Ileo that relied on the experience of an actual subdivision served by Mid-Tex was incorrectly analyzed by Mr. Ileo.<sup>831</sup>

In response to the issues raised by ACSC regarding the use of the 300 linear foot installation project, Mr. TheBerge responded that this was the methodology used in GUD No. 9400. Further, Mr. TheBerge argued that he had tried to limit the update of the methodology to errors he identified. In other words, the use of 300 linear feet was not necessarily erroneous. If that one parameter were to be adjusted, however, other parameters should be examined as well. For example, the study in GUD No. 9400 assumed ideal soil conditions. If the 300 linear foot parameter was abandoned, the actual soil conditions encountered should be incorporated as well.<sup>832</sup> The principal driver to the increase to \$9.05 per linear foot was an error Mr. TheBerge alleges to have found in the cost calculation used in GUD No. 9400. As to the allegations regarding the overhead factor, Mr. TheBerge simply noted that “the 33% overhead rate is still valid and is currently used by Mid-Tex in the capitalization of gas mains installations.”<sup>833</sup> He was critical of Mr. Stowe’s analysis arguing that the overhead rates discussed by Mr. Stowe are corporate overhead rates and do not reflect the divisional overheads included in the 33% figure. Finally, Mr. TheBerge attacked the ultimate recommendation of ACSC arguing that Mr. Stowe arrived at that figure using a circular calculation that perpetuates a result that is known to be incorrect.<sup>834</sup>

The Examiners find that GUD No. 9400 used 300 feet in the calculation of the per foot cost of two-inch pipe. While a longer length of project may be reasonable, Atmos Mid-Tex has established that for purposes of this proceeding, it is reasonable to adhere to the same parameter used in GUD No. 9400. The Examiners find that GUD No. 9400 used ideal soil conditions as a parameter in the calculation of the per foot cost of two-inch pipe. While other soil conditions may be reasonable, Atmos Mid-Tex has established that for purposes of this proceeding, it is reasonable to adhere to the same parameter used in GUD No. 9400. The Examiners find that ATM has not established that a cost of two-inch pipe of \$2.81 per foot is reasonable. Further, the Examiners agree that the use of a calculation that contains a known error is not reasonable. Accordingly, the ATM proposed cost of \$7.62 per foot and the Atmos Mid-Tex proposed cost of \$9.05 per foot should be rejected. Atmos Mid-Tex pointed out that the price in GUD No. 9400 did not reflect the reality of the final cost – although, the Examiners note this was the figure proposed by the utility in that case. On the other hand, based on the discussion in section IX related to shared services and section X related to capitalization policies, Atmos Mid-Tex has failed to establish the reasonableness of a 33% capitalization factor in the calculation of the per unit cost of pipe. Incorporating the figure into this calculation would incorporate a known error.

One option would be to maintain all of the allocation factors and percentages developed in GUD No. 9400. The Examiners find, however, that there is evidence in the record to make

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<sup>830</sup> Atmos Exhibit 43, TheBerge, Rebuttal, p. 25, lns. 4 - 23. Mr. TheBerge argued that corrected data supported a cost of two-inch mains of \$9.63.

<sup>831</sup> Atmos Exhibit 43, TheBerge Rebuttal, p. 25, ln. 24 - p. 27, ln. 24. Analysis regarding Stonebridge Piping solutions.

<sup>832</sup> Atmos Exhibit 43, The Berge Rebuttal, p. 29, ln. 11 - p. 31, ln. 13.

<sup>833</sup> Atmos Exhibit 43, TheBerge Rebuttal, p. 31, ln. 16 - 18.

<sup>834</sup> Atmos Exhibit 43, TheBerge Rebuttal, p. 32, ln. 23 - p. 33, ln. 6.

adjustments to the alleged overhead factors proposed by Atmos Mid-Tex. The Company indicated that the 33% overhead loading factor is made up of 24% from Atmos Mid-Tex and 9% of SSU. Using the data found in *RS Means Cost Guide for Heavy Construction*, the Examiners find that the typical overhead factors range from 11% to 16%. The Examiners find that the mid-point of those two numbers, 13.5% represents a reasonable proxy for overhead associated with Atmos Mid-Tex. The Examiners find that the alleged SSU overhead factor of 9% should be adjusted to reflect the adjustments made in this case. The Examiners recommended above that SSU capitalized expenses be reduced by 36%. A 36% adjustment to alleged SSU overhead of 9% would reduce it to 5.76%. Accordingly, the overhead loading factor is reduced to 19.26%. The impact on the proposed cost of one foot of two-inch pipe is to reduce the price from \$9.05 to \$8.11. This adjustment addresses the concern raised by Mr. TheBerge regarding the error included in the \$5.57 per foot figure and removes the impact of any inappropriate expenditures and capitalization practices inherent in the 33% overhead loading factor.

The Examiners note that the excerpt from the *RS Means Cost Guide for Heavy Construction* reveals that the total unit cost for the installation of two inch diameter pipe is \$4.64, which includes overhead and profit, but does not include excavation or backfill. The record indicates that Mr. TheBerge utilized \$2.70 for trenching at 12" wide and 37" deep. Thus, the unit cost is \$7.34, which is \$0.77 below the recommended unit cost were the Company able to efficiently perform this work internally. Thus, it would appear that \$8.11 per linear foot recommendation captures a just and reasonable amount of overhead.

### 3. Minimum System Analysis – Construction Cost of the Total System

Mr. Stowe argued that the total cost in the system calculated by Mr. Watson did not contain a full 33% construction overhead factor. Whereas, the estimated cost of a system comprised of two inch pipe did contain the inflated 33% overhead factor. Accordingly, Mr. Stowe argued that the percentage is skewed because the numerator is inflated by a factor that is not included in the denominator, resulting in a higher percentage of costs that are classified as connectivity. As summarized by Mr. Stowe, by increasing this percentage, Mr. TheBerge is allocating more of the costs associated with distribution plant to “customer related” as opposed to “capacity related.”<sup>835</sup> Additionally, Mr. Stowe is critical of the fact that the total cost of construction mains in service at 2005 dollars was developed by Mr. Watson, not Mr. TheBerge, the individual who developed the per foot current cost of two-inch (\$9.05). The concern was that since this was an effort to develop a ratio, the development of the two figures by different individuals could not ensure that the same factors were included in the development of the two figures used in the minimum system ratio. Additionally, Mr. Stowe complained that Mr. Watson inappropriately applied the Handy-Whitman Index to arrive at the total cost of construction mains in service at 2005 dollars.<sup>836</sup>

Mr. Ileo argued that Mr. TheBerge incorrectly calculated the total cost of the system. He noted that the estimated cost, based on approximately \$16 per foot, stemmed from the application of Handy-Whitman Indices to vintages at embedded costs of Atmos Mid-Tex’s total Distribution Mains

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<sup>835</sup> ACSC Exhibit 5, Stowe Direct, p. 52, ln. 9 - 53, ln 10.

<sup>836</sup> ACSC Exhibit 5, Stowe Direct, p. 53, ln.

investment. A consistent application of the minimum system approach required that the same current cost standard be utilized. Mr. Ileo suggested that the figure be calculated using the average current cost per foot experienced by the Company for all sizes of new Distribution Mains installed during 2005.<sup>837</sup>

Mr. TheBerge argued that the analysis of the overhead issues noted by Mr. Stowe with regard to the total system costs was incorrect. From his perspective, the index used already included an overhead rate.<sup>838</sup> As to the argument that the replacement cost for two-inch pipe should have been in the numerator and denominator, Mr. TheBerge alleged that the results of that analysis would be an even higher unit cost of \$9.63 per linear foot.<sup>839</sup>

The Examiners find that the proposed methodology to calculate the total cost of construction mains in service at 2005 dollars and updated by the Company on rebuttal is reasonable and do not recommend an adjustment.

#### 4. Allocation of Capacity Costs – Design Day and Annual Throughput

In order to allocate the costs that were classified as capacity costs, the Company first had to determine the relative demands on the system of the various classes of customers. Mr. TheBerge used two different methodologies for determining the relative demands. Mr. TheBerge testified that the relative demands for residential and commercial customers were based on “design-day” demand levels. A design day is defined as a 24-hour period of demand which is used as a basis for planning gas capacity requirements. The design day used by the Company for the distribution system was based on a mean temperature of 15 degrees Fahrenheit which translates into fifty heating degree days. Thus, the distribution system of gas mains, regulators and other equipment is designed from the city gate to the point of lowest pressure on the system to meet firm residential and commercial demands on the system under those weather conditions. On the other hand, the relative demands for industrial sales and transportation customer classes were established based upon the actual average annual daily deliveries.<sup>840</sup> In order for the design day to be a reasonable measure of capacity, Mr. TheBerge must make an adjustment to account for the capacity that is embedded in the two-inch minimum system.<sup>841</sup>

Dr. Ileo recommended that capacity-related costs be allocated through a percent weighting of Design Day Demands and Annual Volumes. This was the methodology approved in GUD No. 9400 and Dr. Ileo argued that it represents an appropriate balance among the supply-side and demand-side goals of sound regulatory practice.<sup>842</sup> Dr. Ileo noted that the Commission in GUD No. 9400 adopted the findings of the Hearings Examiners that the demand-related costs of TXU Gas be assigned to customer classes on the basis of an equal weighting of annual volumes or consumption and maximum daily usage during the four winter months of December through March (4MDU).<sup>843</sup> Dr. Ileo noted,

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<sup>837</sup> ATM Exhibit 6, Ileo Direct, p. 67, ln. 27 - p. 69, ln. 24.

<sup>838</sup> Atmos Exhibit 43, TheBerge Rebuttal, p. 31, ln. 21 - p. 32, ln. 2.

<sup>839</sup> Atmos Exhibit 43, TheBerge Rebuttal, p. 32, lns. 3 - 12.

<sup>840</sup> Atmos Exhibit 29, TheBerge Direct, p. 49, ln. - p. 54, ln. 3.

<sup>841</sup> Atmos Exhibit 29, TheBerge Direct, p. 62, ln. 1 - p. 65, ln 6.

<sup>842</sup> ATM Exhibit 6, Ileo, p. 80, lns. 1 - 21.

<sup>843</sup> ATM Exhibit 6, Ileo, p. 81, lns. 4 - 15, citing to Final Order (pp. 15 - 16) and PFD p. 244 - 248

however, that available data in this case does not permit the use of a 4MDU. The 4MDU would likely result in a more favorable allocation for the residential and commercial customer than the proposed design day capacity allocation methodology. As the data for 4MDU is not available, the design day study would most closely approximate the 50 percent capacity factor adopted by the Commission in GUD No. 9400. Thus, Dr. Ileo recommended that a 50/50 allocation be adopted using a combination of annual throughput and adjusted design day data.<sup>844</sup>

Mr. McFadden argued that local distribution companies typically design, construct, and operate their distribution facilities to meet the maximum requirements of all of their customers regardless of whether or not they are served under an interruptible tariff.<sup>845</sup> Mr. McFadden argued that the Company's use of a design day demand allocator to allocate the costs of residential and commercial customers is faulty, discriminatory, and results in unjust and unreasonable rates for residential and commercial customers and preferential rates for industrial sales and transportation customers. He contended that Mr. TheBerge is allocating costs to residential customers based on the possibility that those customers may use the system. Furthermore, Mr. McFadden points out the fact that the design day capacity rarely occurs, in fact the most recent occurrence was in December of 1989 and he concluded that a day with 50 heating degree days as used by Atmos for design day purposes occurs once in twenty-five years. Mr. McFadden noted that the corollary to infrequently experiencing the design day is that the capacity in the system is available to serve interruptible customers. In short, interruptible customers are not, in fact, interrupted.<sup>846</sup> He argued that a method such as the Seaboard method, used in part in GUD No. 9400 be taken into account in allocating costs in order to relate the assignment of costs to classes based upon usage and to minimize interclass subsidies.

Maurice Brubaker, who testified on behalf of Industrial Gas Users, argued that a design day approach, like the one used by Mr. TheBerge is a reasonable representation of the demands of residential and commercial customers classes during a day when the temperature is equal to the temperature which is used to size the system. He argued that the design day demand is a form of temperature normalized demand requirement for residential and commercial customers. As Atmos Mid-Tex designs its system based on expected demands under these conditions, it is appropriate to utilize these demands for purposes of allocating the investment that results from designing to these conditions. He argued further that there should be no volumetric considerations blended into the demand or capacity component of cost allocation as it would dilute cost responsibility for the recovery of the fixed investment. Distribution systems, he argued, are designed to meet the peak demand, and not some diluted or average demand.<sup>847</sup>

Mr. Brubaker noted that for industrial and transportation customers, Mr. TheBerge has used actual average throughput for purposes of allocating distribution main costs. Thus, the Company study assumes that, even during adverse times, the industrial and transportation customers continue to take their average usage when capacity may be unavailable or firm load threatened. Specifically, the industrial and transportation customers do not have any contractual entitlement to utilize the distribution system if capacity is unavailable or firm loads are threatened. Atmos Mid-Tex, however,

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<sup>844</sup> ATM Exhibit 6, Ileo, p. 79, ln. 22 - p. 84, ln. 3.

<sup>845</sup> City of Dallas Exhibit 5, McFadden Direct, p. 20, lns. 15 - 17.

<sup>846</sup> City of Dallas 5, McFadden Direct, p. 15, ln. 13 - p. 21, ln. 16.

<sup>847</sup> IGU Exhibit 1, Brubaker Direct, p. 9, ln. 19 - p. 10, ln. 22.

assigns a value based on average usage of the system. Mr. Brubaker argued that this results in a highly favorable result for residential and commercial customers. Although he did not recommend that no costs be assigned to the industrial and transportation classes, he noted that a pure cost of service based allocation would assign zero demands to these customers since they have zero entitlement to capacity. Mr. Brubaker concluded that under the rates proposed by Atmos Mid-Tex industrial and transportation customers would contribute approximately \$5.5 million per year over and above their actual cost of service.<sup>848</sup>

In response to the various allocation formulas proposed by Dr. Ileo, Mr. TheBerge argued that the proposed ratios are all presumably offered to allow the result-fixed cost-allocation practitioner to select methods and are not based on merit. Allocation of costs should adhere as closely as possible to costs incurred.<sup>849</sup> In response to Mr. McFadden's allegation that local distribution companies design systems to meet the requirements of all customers, Mr. TheBerge stated that he has not encountered any gas distribution companies that included the maximum requirement of customers served solely under an interruptible tariff in the design, and construction of distribution facilities.<sup>850</sup> As to the discriminatory nature of the capacity analysis, Mr. TheBerge argued that the issue is whether it is unduly discriminatory. After all, utilities provide service under different rate tariffs to different categories of customers. The proposed distinction underlying his methodology is no different than the distinction used by this Commission and other jurisdictions, including FERC.<sup>851</sup>

The Examiners find that it is unreasonable to assign capacity costs for residential and commercial customers exclusively on the design day model proposed by Atmos Mid-Tex. A parallel argument was made in GUD No. 9400 and rejected. Such an allocation scheme represents a significant departure from prior Commission policy for this system, and through its use the relative costs associated with average throughput and the role of off-peak customers in cost causation are minimized. The Examiners recommend that accounts allocated by Atmos Mid-Tex using the design day allocator be allocated as 50% Capacity and 50% Commodity. That is, the Examiners recommend the allocator be equally weighted as 50% adjusted design day and 50% volume. The Examiners' recommendation is consistent with the recommendation in GUD No. 9400.

Table 15.4

Pipeline Capacity Allocation	Residential	Commercial	Industria/Transportation
Atmos Mid-Tex Proposed	63.97%	30.29%	5.73%
GUD No. 9400	49.97%	27.98%	22.04%
Examiners' Recommendation	53.07%	28.89%	18.04%

### C. General objections to the functionalization, classification and allocation

<sup>848</sup> IGU Exhibit 1, Brubaker Direct, p. 11, Ins. 1 - 18.

<sup>849</sup> Atmos Exhibit 43, TheBerge Rebuttal, p. 44, ln. 7 - p. 47, ln. 4.

<sup>850</sup> Atmos Exhibit 43, TheBerge Rebuttal, p. 43, ln. 8 - 21.

<sup>851</sup> Atmos Exhibit 43, TheBerge Rebuttal, p. 43, ln. 22 - p. 44, ln. 6.

The City Intervenors raised several general objections to the functionalization, classification, and allocation proposed by Atmos Mid-Tex. ACSC noted that there were several errors in Mr. TheBerge's supporting work papers that call into question the validity of the study offered by Mr. TheBerge and his conclusions.<sup>852</sup> Mr. Stowe also argued that Mr. TheBerge erred in using the replacement cost analysis to determine the level of booked cost to be assigned instead of using per book amounts.<sup>853</sup> The City of Dallas recommended that the proposed cost of service and rate design be rejected. Mr. McFadden argued that the proposals regarding functionalization, classification and allocation are so flawed that any changes in revenue requirements resulting from this case should be recovered from customers on a percentage rider basis. He argued that this could be accomplished by increasing the non-gas cost portion of each component of the Company's rates, i.e., the Customer Charge, initial block charge, and subsequent block charges by a uniform percentage amount.<sup>854</sup>

Mr. McFadden raised several general issues. First, he questioned why the Company grouped industrial sales and industrial transportation customers together.<sup>855</sup> Second, Mr. McFadden is critical of the Company's decision to not consider groupings based on geographic locations.<sup>856</sup> Third, he argued that Mr. TheBerge's general assumptions regarding cost causation were unreasonable.<sup>857</sup>

He recommended that the Commission split the current proceeding into two phases. Phase I would apply to determining the Company's revenue requirements with the statutory time lines. In Phase 2, the parties would fully explore the cost allocation and rate design issues he raised in his testimony. In the alternative, he recommended that the Commission require the Company to begin a collaborative process to consider issues raised in his testimony before the next filing. He recommended that the Commission require that the collaborative process be completed within one year from the approval of the revenue requirements in this case and that the Commission require quarterly written reports on the status of the collaborative.<sup>858</sup>

Mr. TheBerge argued that with regards to the errors noted by Mr. Stowe, they are typographical and do not invalidate the conclusions of his study.<sup>859</sup> As to the use of replacement cost instead of per book amounts, Mr. TheBerge noted that in this context he applied the methodology approved in GUD No. 9400. Further, the use of per book amounts would result in a higher amount being classified as capacity related costs.<sup>860</sup>

As to the general errors noted in Mr. TheBerge's analysis, the Examiners find that they do not invalidate the underlying analysis. The Examiners find that while it may be reasonable to treat industrial sales and industrial transport customers together, it is not unreasonable to treat them as a group as has been done in the past. As to the issue of grouping or segregating geographic locations,

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<sup>852</sup> ACSC Exhibit 5, Stowe Direct, p. 45, ln. 1 - p. 46, ln. 6.

<sup>853</sup> ACSC Exhibit 5, Stowe Direct, p. 47, ln. 17 - p. 48, ln. 16.

<sup>854</sup> City of Dallas Exhibit 5, McFadden, Direct, p. 2, lns. 9 - 19.

<sup>855</sup> City of Dallas Exhibit 5, McFadden Direct, p. 7, ln. 10 - 8.

<sup>856</sup> Id.

<sup>857</sup> City of Dallas Exhibit 5, McFadden Direct, p. 21, ln. 17 - p. 27, ln. 14.

<sup>858</sup> City of Dallas Exhibit 5, McFadden Direct, p. 3, lns. 1 - 12.

<sup>859</sup> Atmos Exhibit 43 TheBerge Rebuttal, p. 27, ln. 25 - p. 28, ln. 2.

<sup>860</sup> Atmos Exhibit 43, TheBerge Rebuttal, p. 28, ln. 3 - p. 29, ln. 1.

it would appear that this is a suggestion that rates not be established on a systemwide basis and that issue was settled in GUD No. 9400 and by the August 15<sup>th</sup> Interim Rate Order. The Examiners find that Mr. TheBerge's underlying assumptions regarding cost causation are reasonable. The Examiners are aware that there are certainly other reasonable academic assumptions that may be applied in the context of functionalization, classification, and allocation. Nevertheless, the basic underlying assumptions of the Company and its witness are reasonable.

D. The use of the number of customer locations in the cost allocation rate design

Mr. Stowe argued that Mr. TheBerge failed to realize that the cost associated with simply having a customer service location is minimal, and should be captured in FERC Account No. 879. The remaining accounts to which he has applied this factor, with the exception of FERC Account No. 904, represents costs incurred for serving customers. Customer service expenses are not incurred for an installation that is not being used to serve a customer.<sup>861</sup>

Mr. McFadden argued that Mr. TheBerge erred in using the number of customer locations in designing his cost allocation model, instead of using number of customer bills. He argued that Mr. TheBerge did not provide any support for the method of calculating customer locations and Mr. McFadden pointed to discrepancies within the documents produced by Atmos Mid-Tex regarding that calculation. Further, Mr. McFadden raises questions regarding how the number of customer locations was calculated and the method of determining that an unoccupied location is even habitable.<sup>862</sup>

Mr. TheBerge explained his reasoning for selecting customer service locations as follows. The cost of having a customer service location is the same whether the location is occupied and flowing gas to an active customer, or unoccupied and not flowing gas at all. The service location requires that the meter be read monthly; is subject to the same record keeping requirements; and remains subject to the same maintenance schedule and requirements whether occupied or unoccupied.<sup>863</sup> Finally, he argued that Mr. McFadden has confused cost allocation with rate design. Revenue stability is largely unaffected by cost allocation.<sup>864</sup> The Examiners find that the use of customer locations, while a departure from the methodology applied in GUD No. 9400, is reasonable. Further, Examiners find that from a statistical perspective the method of calculating the number of customer locations is reasonable.

E. Distribution Plant – Should minimum system analysis be applied to FERC Account Nos. 374, 375, 378 & 379.

Mr. TheBerge used the minimum system method to classify the following FERC accounts into Customer Related and Capacity Related Components:

► FERC Account No. 374 – Land & Land Rights

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<sup>861</sup> ACSC Exhibit 5, Stowe Direct, p. 71, ln. 8 - 23.

<sup>862</sup> City of Dallas Exhibit 5, McFadden Direct, p. 7, ln. 13 - p. 11, ln. 16.

<sup>863</sup> Atmos Exhibit 43, TheBerge Rebuttal, p. 54, ln. 1 - 15.

<sup>864</sup> Atmos Exhibit 43, TheBerge Rebuttal, p. 37, ln. 14 - 18.



- ▶ FERC Account No. 375 – Structures & Improvements
- ▶ FERC Account No. 376 – Mains
- ▶ FERC Account No. 378 – Measuring and regulating equipment – General
- ▶ FERC Account No. 379 – Measuring and regulating equipment – City Gate Check Station

Mr. Stowe testified that it was not appropriate to classify these accounts using the minimum system. Mr. Stowe argued that the dollars contained in FERC Account Nos. 374, 375, 378, and 379 are not incurred based upon replacement cost. As an example, he noted that FERC Account No. 374 – Land and Land Rights and FERC Account No. 375 – Structures and Improvements are not influenced by the replacement cost of pipe. He recommended that FERC Account No. 374 and FERC Account No. 375 be classified as customer related. For FERC Account No. 378 and FERC Account No. 379, he proposed that costs be classified as customer related and capacity related based upon inch feet.<sup>865</sup> Mr. TheBerge raised several arguments in response. First, he argued that it is an attempt to isolate capacity-related and customer-related components within assets where no such distinction exists. Second, the stated reason provided by Mr. Stowe for departing from the classifications he had made was that the minimum-system made use of replacement costs that are not applicable to these accounts. Third, the process proposed by Mr. Stowe is redundant and inconsistent.<sup>866</sup>

The Examiners find Mr. TheBerge's proposed methodology closely parallels the methodology approved in GUD No. 9145 and GUD No. 9400 for these accounts and is reasonable in this case. It is true that in GUD No. 9400 the only account subject to the minimum system methodology was FERC Account No. 376 mains. Nevertheless, once the mains account was allocated, FERC Account Nos. 374, 375, 378, & 379, were allocated based upon the ratios developed for net plant.<sup>867</sup> Thus, the result is similar, and the costs follow these assets.

F. FERC Account No. 385 – Allocation of Costs directly to industrial customers.

Mr. Stowe argued that this account should be allocated directly to industrial and transportation customers. According to the FERC Uniform System of Accounts, FERC Account No. 385 “shall include the cost of special and expensive installations of measuring and regulating station equipment, located on the distribution system, serving large industrial customers.” He argued that based upon the description of this account by FERC, the costs in this account should be directly assigned to the industrial/transportation customers.<sup>868</sup> Mr. TheBerge noted that this account contained a negative balance, which he used to offset FERC Account 383 – House Regulators.<sup>869</sup> The Examiners find that the proposed treatment of this account was reasonable.

G. FERC Account Nos. 870, 880, 881, 885, and 894

Mr. TheBerge used a composite allocation factor for several operation and maintenance

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<sup>865</sup> ACSC Exhibit 5, Stowe Direct, p. 57, ln. 10 - p. 59, ln. 21.

<sup>866</sup> Atmos Exhibit 43, TheBerge Rebuttal, p. 48, ln. 4 - p. 51, ln. 14.

<sup>867</sup> See, GUD No. 9400, Schedule E(D) p. 1, lns. 1 - 10, & Schedule F(D), p. 2, ln 1.

<sup>868</sup> ACSC Exhibit 5, Stowe Direct, p. 63, lns. 7 - 18.

<sup>869</sup> Atmos Exhibit 43, TheBerge Rebuttal, p. 51, ln. 15 - 26.

accounts. This composite resulted in an allocation of 79.63%, 18.03%, and 2.34% to the residential, commercial, and industrial/transportation customer classes, respectively. The allocation of these accounts differed from the allocation applied in GUD No. 9400 and resulted in a lower share of the costs being allocated to the industrial and transportation customers. Mr. Stowe argued that these accounts should be allocated either based upon a composite of total distribution operations expense (FERC Account Nos. 870, 880, and 881) or a composite of maintenance expenses (FERC Account Nos. 885 and 894).<sup>870</sup>

Mr. TheBerge indicated that he did not disagree with Mr. Stowe's reasoning regarding FERC Account Nos. 870, 880, 881, and 885. Nevertheless, he explained that the amounts in FERC Account Nos. 870, 880, 881, and 885 actually encompass the supervision, other expenses, and rents incurred in both the operations and maintenance. Mr. TheBerge notes that the facts in the case justify the allocation methodology he proposed.<sup>871</sup> The examiners agree that the Company's accounting practice with respect to these accounts justifies the proposed allocation methodology and recommend that the Company's proposed allocation methodology for these accounts be adopted.

#### H. FERC Account Nos. 875, 877, 886, 887 and 889

These accounts were allocated in GUD No. 9400 based upon FERC Account No. 376 – Mains.<sup>872</sup> He recommended that the allocation of FERC Account Nos. 875, 877, and 886 should be based upon each account's corresponding customer class plant allocation. For FERC Account No. 875 this would be FERC Account No. 378 – Measuring and Regulating Equipment (General), for FERC Account No. 877, this would be FERC Account No. 379 – Measuring and Regulating Equipment (City Gate), and for FERC Account No. 886, this would be FERC Account No. 375 – Structures and Improvements. He argued that FERC Account No. 887 should be allocated based on plant. Mr. Stowe argued that this account should be allocated as it was allocated in GUD No. 9400, based upon the allocation of plant FERC Account No. 376 – Mains. He argued that FERC Account No. 889 should be allocated on the basis of the allocation of FERC Account No. 378.<sup>873</sup> Dr. Ileo noted that FERC Account No. 875 is an account that is designated to industrial customers and should be not be allocated as proposed by Mr. TheBerge.<sup>874</sup>

Mr. TheBerge noted that he and Mr. Stowe agreed that the allocation of these expenses should applied to the gas assets being operated and maintained. He noted, however, that they differed on the underlying allocation of the assets. He explained that he allocated these expenses as a package based on the group of underlying assets, which he treated as a single package because they collectively had a single function.<sup>875</sup> In response to Mr. Ileo's contention that FERC Account No. 875 is designated as an industrial account, Mr. TheBerge noted that it does not have an "industrial" designation.<sup>876</sup>

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<sup>870</sup> ACSC Exhibit 5, Stowe Direct, p. 64, ln. 1 - p. 68, ln. 16.

<sup>871</sup> Atmos Exhibit 29, TheBerge Direct, p. 51, ln. 27 - p. 52, ln. 13.

<sup>872</sup> GUD No. 9400, Schedule E(D)

<sup>873</sup> ACSC Exhibit 5, Stowe Direct, p. 68, ln. 17 - 71, ln. 6.

<sup>874</sup> ATM Exhibit 6, Ileo Direct, p. 85, lns. 11 - 20.

<sup>875</sup> Atmos Exhibit 43 TheBerge Rebuttal, p. 53, ln. 3 - 19.

<sup>876</sup> Atmos Exhibit 43, TheBerge Rebuttal, p. 52, ln. 20 - 22.

The Examiners find that methodology proposed by the Atmos Mid-Tex, which appears to allocate costs as they were allocated in GUD No. 9400, based upon plant is reasonable.

I. FERC Account Nos. 876 and 890

FERC Account No. 876 does not appear to have been allocated in GUD No. 9400. On the other hand, FERC Account No. 890 was allocated in that case on the basis of the plant account. In this case, Mr. Stowe recommended that these accounts be directly assigned to industrial and transportation customers as they are directly related to providing service to those customers.<sup>877</sup> Mr. Ileo is critical of the fact that the allocation of FERC Account No. 890 is not transparent. On the one hand, the model presented by Mr. TheBerge indicates that it is allocated based upon a composite described as “central, pressurized, measured, regulated flow dispatched system.”<sup>878</sup> On the other hand, the schedules reveal that the account is allocated based upon the central distribution plant.<sup>879</sup> In response, Mr. TheBerge noted that the Company does not intentionally record amounts to FERC Account No. 876 or FERC Account No. 890. He also noted that FERC Account No. 876 does not carry the term “industrial” in the FERC Uniform System of Accounts.<sup>880</sup>

The Examiners find that it is reasonable to assign the costs of these accounts directly to the industrial and transportation customers. Mr. TheBerge appeared conceded that FERC Account No. 890 is, in fact, designated an industrial account. While Atmos Mid-Tex may not intentionally record amounts in FERC Account No. 876, the fact is that an amount, albeit a small amount, was recorded into that account. The Examiners note that FERC Account No. 876 does not appear in the allocation tables attached to the Final Order in GUD No. 9400. The account is designated by Atmos Mid-Tex as an industrial account. Accordingly, the evidence in the record supports allocating this account directly to the industrial and transportation customers. The Examiners find that there exists an ambiguity between the stated allocated composite factor and the allocation factor ultimately used. The Examiners’ recommendation is based upon the allocation factor actually applied by Atmos Mid-Tex.

J. FERC Account No. 904 – Uncollectible Expenses

The Company has proposed an allocation methodology that departs from the methodology approved in GUD No. 9400. Mr. Stowe argued that an alternative methodology should be used to allocate this account that incorporates a measure of the revenues generated from each class of customer. The relative percentages are summarized in Table 15.5 below:

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<sup>877</sup> ACSC Exhibit 5, Stowe Direct, p. 68, ln. 18 - p. 69, ln. 7.

<sup>878</sup> Exhibit MT - R - 1, p. 1, ln. 18. *See*, Ileo Direct, p. 85, ln. 21 - p. 86, ln. 3.

<sup>879</sup> Exhibit MT - R - 14, p. 1, ln. 11. *See*, Ileo Direct, p. 85, ln. 21 - p. 86, ln. 3.

<sup>880</sup> Atmos Exhibit 29, TheBerge Direct, p. 52, ln. 14 - p. 53, ln. 2.

Table 15.5

	Residential	Commercial	Industrial
GUD No. 9400	81.26%	14.80%	3.93%
GUD No. 9670	91.77%	8.14%	8.97%
ACSC	63.53%	29.47%	22.42%

Mr. Stowe argued that this account is not a reflection of simply having a customer location, which is the basis of the Company's proposed allocation, rather it is a reflection of the revenues generated by each customer class, which consists of the cost of gas purchased.<sup>881</sup> Mr. Ileo argued that this account could be easily assigned to the individual customer classes that generated the costs.<sup>882</sup> In response, Mr. TheBerge argued that the recommendation results in an allocation of a substantial portion of the account to the industrial customers that do not contribute to the problem, and is premised on gas costs which make his method incompatible with the proposed collection of the gas portion the uncollectible accounts thought the GCR.<sup>883</sup>

The Examiners find that the Company has not met its burden of proof to justify such a significant departure from the allocation methodology and factors applied in GUD 9400. The Examiners find that allocating uncollectible expenses, Account, 904, according to customer locations as proposed by Atmos Mid-Tex is not reasonable. The Examiners recommend that the allocation factors used in GUD 9400 for FERC Account No. 904 be applied in this case.

#### K. FERC Account Nos. 903 and 922

Dr. Ileo complained that the allocation of FERC Account No. 903 and FERC Account No. 922 was not adequately explained as the allocation factor "Investment - Weighted Number of Customers" was not explained.<sup>884</sup> FERC Account No. 903 was allocated in GUD No. 9400 on the basis of the number of customer locations.<sup>885</sup> Mr. Stowe argued that these accounts should be allocated based upon the number of customers weighted by net plant.<sup>886</sup> Mr. TheBerge responded that, while these accounts are often allocated based on number of customers, such an allocation would have resulted in a higher allocation to residential and commercial customers than the allocation factor he applied. Mr. TheBerge also noted that the Company's proposed allocation factor reflects the fact that commercial and industrial accounts can require higher levels of these services commensurate with the higher level of investment required to serve these locations.<sup>887</sup> The Examiners find that

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<sup>881</sup> ACSC Exhibit 5, Stowe Direct, p. 71, ln. 7 - p. 72, ln. 8.

<sup>882</sup> ATM Exhibit 6, Ileo Direct, p. 89, lns. 7 - 9.

<sup>883</sup> Atmos Exhibit 29, TheBerge, p. 54, lns. 16 - 23.

<sup>884</sup> ATM Exhibit 6, Ileo Direct, p. 86, lns. 4 - 11.

<sup>885</sup> GUD No. 9400, Schedule E(D), p. 6, ln. 903. Account No. 922 does not appear on the allocations schedules of GUD No. 9400.

<sup>886</sup> ACSC Exhibit 5, Stowe Direct, p. 72, lns. 10 - 21.

<sup>887</sup> Atmos Exhibit 43, TheBerge Rebuttal, p. 55, lns. 15 - 26.

allocating these accounts on the basis of investment weighted customer locations as determined in the cost allocation and rate design schedules is reasonable.

Table 15.6

	Residential	Commercial	Industrial
GUD No. 9400 – Customer Meter	90.95%	8.95%	0.087%
Customer Meter Locations	91.77%	8.14%	0.089%
Allocation factor proposed for FERC Account Nos. 903 & 922	79.81%	17.99%	2.19%

L. FERC Account No. 380 – Services

FERC Account No. 380 includes the cost of installed service pipes and accessories leading to customer premises. Completed services begin with connection to a distribution system main and extend to the inlet side of a customer's meter installation, while stub services extend only to the customer's property line or curb stop. Mr. TheBerge argued that this investment is caused by the requirement to connect individual customers to the common distribution system networks and he allocated the account balance based upon the number of locations used to serve each customer class.<sup>888</sup> Account No. 380 was allocated based upon customer meter locations in GUD No. 9400. Table 15.7 below compares the allocation percentage in that docket with the allocation percentages proposed by Mr. TheBerge.

Table 15.7

	Residential	Commercial	Industrial
GUD No. 9400 – Customer Meter	90.95%	8.95%	0.087%
Atmos Proposed – Customer Meter Locations	91.77%	8.14%	0.089%

Dr. Ileo argued that the procedure proposed by Mr. TheBerge would have been reasonable if he had demonstrated its credibility, such as through statistical regression analysis or through a showing that Atmos Mid-Tex installs the same sized service pipe irrespective of customer type. Mr. Ileo also notes that the bias is further underscored by the fact that he has never encountered a gas distribution utility comparable to Atmos Mid-Tex that installs the same sized service pipe for all customers. Mr. Ileo analyzed several project engaged in during 2005 and determined that it included pipe sizes of varying sizes that suggested that the majority of the costs were not due to residential customers. Accordingly, the proposed allocation factors were not appropriate.<sup>889</sup>

<sup>888</sup> Atmos Exhibit 29, TheBerge Direct, p. 66, ln. 27 - p. 67, ln. 7.

<sup>889</sup> ATM Exhibit 6, Ileo Direct, p. 86, ln. 19 - p. 88, ln. 16; Lord Direct, p. 7, ln. 1 - p. 8, ln. 10, Exhibit MJL -

In response, Mr. TheBerge noted that many of the services installed by Atmos Mid-Tex are under blanket projects for service lines and not all project descriptions in the report that involve services will contain the term “service” or the size of such services. In addition, he noted that the relative cost of service lines is more dependent on the length of service than on the diameter of pipe because of the relative costs of pipe versions labor-intensive trenches. In general, the residential customers have longer service lines than commercial and industrial customers. Larger diameter service lines are not used exclusively by non-residential customers, because some of the residential customers require the larger diameter service lines due to distance or non-standard equipment. Finally, Mr. TheBerge noted that his recommendation paralleled the recommendation in GUD No. 9400.

The Examiners find that the proposed allocation for service lines is reasonable. As noted above, the allocation methodology results in a similar allocation to the allocation determined for this utility system in GUD No. 9400. Accordingly, the Examiners recommend that the proposed allocation be adopted.

M. FERC Account Nos. 901, 902, and 905 through 916.

These accounts refer generally to amounts categorized as Customer Account Expenses, Customer Service and Informational Expenses, and Administrative and General Expenses. Mr. Ileo argued that a blanket account allocator for these accounts is inappropriate because it presumes that the work efforts and attendant costs are the same irrespective of the customer type. Mr. TheBerge assumes that Atmos Mid-Tex spends the same amount per customer on advertising, sales, record keeping, and related functions regardless of customer consumption. Mr. Ileo recommended that costs should be allocated to customer classes based on the average of contributions to total base rate revenues and total customers. This two-factor technique gives equal weight to two service parameters most likely to be primarily responsible for the incidence of costs.<sup>890</sup>

Mr. TheBerge objected to Mr. Ileo’s two-factor technique as being inherently circular. One of the factors is the relative contribution to total base rate revenue, which is based on existing rates that are in turn based on cost allocation decisions in the prior cases. This circular allocation would serve to perpetuate whatever cost allocation decisions were made in the prior case without regard to the facts that gave rise to those cost allocation decisions and without regard to current facts and circumstances.

Except for FERC Account No. 901, all of these accounts that were considered in GUD No. 9400 were allocated based upon customer meters. Account 901 was allocated based upon a labor allocation factor. In that case, FERC Account No. 901 contained a negative balance. In the current case before the Commission, this account contained approximately \$372 and the Company proposed to allocate that amount on the basis of number of customer locations. The Company indicated that this account contained the cost of labor and expenses incurred in the general direction and supervision of customer accounting and collecting activities.<sup>891</sup> The Examiners find that in this case allocation

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<sup>890</sup> ATM Exhibit 6, Ileo Direct, p. 88, ln. 17 - p. 89, ln. 22.

<sup>891</sup> Atmos Exhibit 29, TheBerge Direct, p. 76, ln. 19 - ln. 29.

of FERC Account Nos. 901, 902, and 905 through 916 on the basis of customer locations within each class is reasonable.

N. Administrative and General Expenses (FERC Account Nos. 920 - 932)

Mr. Stowe argued that FERC Account No. 924 should be allocated based upon net plant, not total distribution plant as was done in GUD No. 9400. Mr. Stowe argued that the allocation factor applied to FERC Account Nos. 920, 921, 922 (General), 923, 926, 930.2, 931, and 932 should not incorporate FERC Account No. 904 -- Uncollectible Accounts. He testified that uncollectible accounts provide for the losses from uncollectible revenues, which does not reflect a provision of service to customers. He recommended that the allocation factor be adjusted accordingly.<sup>892</sup>

Mr. Stowe also argued that the allocation factor applied to FERC Account No. 925 was inappropriate. FERC Account No. 925 includes the cost of insurance or reserve accruals to protect the utility against injuries and damages claims of employees or others, similar losses not covered by others, and expenses incurred in settlement of injuries and damages claims. Thus, the account encompasses the costs of any claims made against the utility or accruals to cover such claims. He argued that these costs are incurred by the utility as a whole and not unique to gas system operation and maintenance. As the costs in this account are part of the general cost to serve customers, he recommended that the account be allocated based upon the gross cost of service.<sup>893</sup>

Dr. Ileo concurred with Mr. TheBerge's allocation of FERC Account No. 925. On the other hand, Dr. Ileo argued that the allocation factors applied to some of the accounts in this group were particularly egregious. He argued that the allocations in this account should be made on the basis of a three factor method giving equal weighting to the number of customers, base rate revenues and distribution plant in service.<sup>894</sup>

With regards to FERC Account No. 924 and the issues raised by Mr. Stowe, Mr. TheBerge argued that he allocated the account as Mr. Stowe described.<sup>895</sup> As for the issues related to FERC Account No. 925, Mr. TheBerge argued that injuries and damages are more related to people, processes, and activities as opposed to objects. He contended that the allocation he proposed, based on the subtotal of operations and maintenance, customer accounting and marketing, reflected that relationship. The use of the total cost of service as recommended by Mr. Stowe, on the other hand, reflected costs of property that are not the source of injury and damages claims.<sup>896</sup>

Mr. TheBerge disagreed with the proposal suggested by Dr. Ileo. He noted that Mr. Ileo's method included current customers and the current plant as did the proposal made by Atmos Mid-Tex. He argued, however, that the allocation proposed by the company reflected a weighting of customers and plant based on the weighting of administrative and general expense over the underlying mix of customer-related (office) expenses and plant-related (field) expenses based on their relative

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<sup>892</sup> ACSC Exhibit 5, Stowe Direct, p. 73, ln. 16 - p. 75, ln. 12.

<sup>893</sup> ACSC Exhibit 5, Stowe Direct, p. 75, ln. 13 - p. 76, ln. 10

<sup>894</sup> ATM Exhibit 6, Ileo Direct, p. 88, ln. 17 - 90, ln. 13.

<sup>895</sup> Atmos Exhibit 29, TheBerge, p. 58, ln. 27 - ln. 32.

<sup>896</sup> Atmos Exhibit 29, TheBerge, p. 59, lns. 1 - 9.

proportions. Mr. TheBerge argued that such weighting was consistent with the oversight and overhead nature of the expenses in question because those expenses are incurred overseeing people and processes. Finally, he criticized Mr. Ileo's proposed allocation factor because it includes a circular factor which is the relative contribution to total base rate revenue, which is based on existing rates that are in turn based on cost allocation decisions of prior cases.<sup>897</sup>

The Examiners find that the allocation proposed by Mr. TheBerge and Mr. Stowe are the same for FERC Account No. 924. Most of the other accounts in this group of accounts were allocated in GUD No. 9400 on the basis of a labor allocation factor and Table 15.8 below compares that factor to the factor proposed by Mr. TheBerge.

Table 15.8

	Residential	Commercial	Industrial
GUD No. 9400 – Labor	77.77%	17.91%	4.3%
Atmos Proposed – Customer Meter Locations	82.53%	15.69%	1.77%

The Examiners find that Atmos Mid-Tex has failed to establish that the proposed change is just and reasonable. Further, the Examiners conclude that the inclusion of FERC Account No. 904 – Uncollectible Expense as a component of the allocation factor used to allocate these expenses is not reasonable as uncollectible accounts provide for the losses from uncollectible revenues, which does not reflect a provision of service to customers. The Examiners find that expenses related to injuries and damages should be allocated as proposed by the Company once the allocation factor is adjusted by the removal of FERC Account No. 904 — Uncollectible Expenses.

#### O. Allocation of Customer Deposits

Mr. Stowe of ACSC argued that customer deposits should be allocated based upon number of customers.<sup>898</sup> Mr. TheBerge, in the initial filing, allocated customer deposits based on net plant. On rebuttal, Mr. TheBerge responded to Mr. Stowe's comments by allocating customer deposits based on the ratio by customer class of actual deposits on the general ledger.<sup>899</sup> The Examiners recommend that customer deposits be allocated as Mr. TheBerge proposes in his rebuttal testimony and schedule. This method is consistent with the allocation of customer deposits in GUD No. 9400.<sup>900</sup>

#### P. Allocation of Injuries and Damages Reserve

Mr. Stowe argues that injuries and damages reserve should be allocated based on the gross cost of service, as the costs in this account are part of the general cost to serve a customer.<sup>901</sup> Mr.

<sup>897</sup> Atmos Exhibit 29, TheBerge, p. 58, Ins. 8 - 26.

<sup>898</sup> ACSC Exhibit 5, Stowe Direct, p.76, Ins. 13 - 22.

<sup>899</sup> Atmos Exhibit 43, TheBerge Rebuttal, p. 59, Ins. 10 - 15.

<sup>900</sup> GUD No. 9400, Schedule E(D), p. 4, ln. 17.

<sup>901</sup> ACSC Exhibit 5, Stowe Direct, p. 77, Ins. 3 - 7.



TheBerge responds that his allocation of this account based on the allocation of total O & M expenses better reflects his belief that injuries and damages reserve is more related to people, processes, and activities as opposed to objects, which would be included in the overall cost of service.<sup>902</sup> The Examiners agree with Mr. TheBerge that the most reasonable allocation of injuries and damages reserve should reflect the allocation of overall O & M expenses.

**Q. Allocation of Rate Base Deductions for Shared Services**

Mr. Stowe argues that Rate Base Deductions for Shared Services should be allocated based on total O & M Expenses.<sup>903</sup> On rebuttal, Mr. TheBerge agrees and changes the Company's rebuttal schedules to reflect the change.

**R. Upstream Pipeline Costs**

Upstream Pipeline costs are currently recovered through the operation of the Company's Rider GCR-gas cost recovery mechanism. The gas cost recovery rider, for the purposes of the recovery of pipeline system costs, is applicable to residential, commercial, and industrial/transportation customers under various tariffs. Under the terms of the gas recovery rider, the allocation of pipeline costs among the classes of customers is based on a set of fixed percentages established in GUD No. 9400. The allocations factors are 49.9742%, 27.9835%, and 22.0423% for residential, commercial, and industrial/transport customers, respectively. These allocation factors were the capacity/demand allocation factors established in GUD No. 9400. Atmos Mid-Tex proposed that the allocation methodology be revised in this case.

The Company proposed that the fixed allocation factor be abandoned and replaced with a two part billing mechanism. The first component is a revised fixed allocation factor based upon the updated distribution class demand data applied to the monthly fixed pipeline costs. The proposed revised fixed and overall allocation factors are set out in Table 15.9 below.

Table 15.9

Allocation of Pipeline Costs				
	Residential	Commercial	Industrial	Total
GUD No. 9400	49.9742%	27.9835%	22.0423%	100%
Proposed (fixed)	65.3437%	27.7650%	6.8913%	100%
Proposed (overall) <sup>904</sup>	53.4018%	27.9010%	18.6972%	100%
Recommended (fixed)	62.7262%	29.7022%	7.5717%	100%

<sup>902</sup> Atmos Exhibit 43, TheBerge Rebuttal, p. 59, Ins. 1 - 9.

<sup>903</sup> ACSC Exhibit 5, Stowe Direct, p. 77, Ins. 8 - 13.

<sup>904</sup> Overall allocation of upstream transportation costs will vary from month to month due to changes in the allocation factor resulting from relative monthly usage volumes between customer classes.

The second component is a monthly commodity based pipeline costs billed based upon monthly coincident customer class throughput. The allocation ratios that result from this monthly allocation will vary from month to month.<sup>905</sup>

Mr. TheBerge argued that the revision was reasonable for two reasons. First, the relative cost facts should be updated to reflect more recent capacity costs to be determined in this case. Second, the continued allocation of all costs based on fixed percentages is inappropriate because it creates a disconnect between downstream cost causation and the upstream incurrence of these costs. He maintained that the 100% fixed allocation can result in the recovery of these costs from the wrong customer classes. He also argued that the proposed cost allocation structure has been the standard approach for many years by FERC on interstate pipelines for the downstream recovery of costs.

Maurice Brubaker, who testified on behalf of the Industrial Gas Users, argued that there are two fundamental problems with the current methodology of allocating pipeline costs. First, although the charges from the pipeline under the current tariff consist of both demand charges and commodity charges, the fixed percentages blur the distinction between the two and treat all charges the same. The second problem is that the fixed percentages were amounts established in the last rate case and do not reflect what actually occurs on the system. He argued that increases and decreases in the overall level of consumption as a result of any factor, including weather, cause the amount of both demand and commodity charges to vary and be different from the amounts reflected in the last rate case. Mr. Brubaker argued that the Company's proposal recognized the distinction between the capacity charges and the commodity charges and allocates them separately to residential, commercial, and industrial and transportation customers. Thus, he concluded that each class would receive its appropriate share of costs based upon the demand allocation factor established in this case. He noted that it is not an ideal solution, but it represents an improvement over the current methodology.<sup>906</sup>

The City Intervenors object to the proposed modification for several reasons. ACSC argued that the Company had taken a contradictory position in the context of costs related to Atmos Pipeline compared to the costs of Atmos Mid-Tex. Atmos Mid-Tex costs were viewed by Mr. TheBerge as being almost all fixed. On the other hand, the costs of Atmos Pipeline were so vastly variable that an allocation that changed monthly was required to avoid the alleged inequality that may result from a fixed allocation rate schedule. Furthermore, Mr. Stowe noted that the allocation factors sought to be altered by Atmos Mid-Tex were set in GUD 9400 and were predicated on an evidentiary hearing where both the distribution and the pipeline operations were examined. This filing only addresses the distribution side of the operations of Atmos Mid-Tex. He argued that the Commission cannot confirm or challenge the 71.33% allocation of pipeline operations to the city gate established by the Final Order in GUD No. 9400. He concluded that in as much as the record for these proceedings is void of any specific information/evidence to pipeline operations, the request of the Company should be denied.<sup>907</sup>

ATM also argued that Atmos Mid-Tex failed to meet its burden of proof. First, Dr. Ileo

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<sup>905</sup> TheBerge Direct, p. 29, ln. 1 - p. 31, ln. 9; Atmos Mid-Tex, Initial Brief, pp. 192 - 194.

<sup>906</sup> IGU Exhibit 1, Brubaker Direct, p. 13, ln. 3 - p. 15, ln. 9.

<sup>907</sup> Stowe Direct, p. 19, ln. 8 - p. 20, p. 23.

identified several errors in the brief testimony and supporting documentation provided by Atmos Mid-Tex.<sup>908</sup> Dr. Ileo objected to the notion that only design demands should be considered in the allocation of attributed fixed costs. While Dr. Ileo agreed that fixed and commodity costs may be appropriately allocated using a different set of factors, he agreed that it was a departure from the current authorized method and he disagreed with the notion that the variable costs should be subject to automatic adjustment.<sup>909</sup>

The Examiners find that the allocation of upstream Pipeline costs to the Distribution system was set in GUD No. 9400 based upon the capacity allocators for the distribution system as examined in GUD 9400 and were specific to that case. Accordingly, the Examiners are of the opinion that the rates should be revised in this case, as the capacity allocation has changed. The Examiners recommend that the allocation of pipeline costs be allocated as follows: 1) The fixed Pipeline charges to distribution shall be allocated according to the capacity allocation factor approved in this case and utilized in Schedule CARD 25, page 1 of 1, line 25. This fixed cost allocation factor shall not be modified until the next rate case unless by order of the Commission. 2) The Pipeline commodity charges to distribution shall be allocated according to the relative deliveries between customer classes and should be adjusted from month to month as proposed by the Company. 3) The applicable Gas Utility Tax should be allocated as proposed by the Company between distribution customer classes according to the composite fixed/commodity allocation factor.

#### S. Overall Cost of Service Allocation

The results of the overall cost of service functionalization, classification and allocation are set out below.

Table 15.10  
Overall Cost of Service Allocation

	Residential	Commercial	Ind. / Transport
Proposed by Atmos	81.70%	16.37%	1.94%
GUD 9400	77.90%	17.02%	5.08%
Recommended by Examiners	76.58%	17.10%	6.32%

The Company proposed to recover the allocated cost of service equitably among customer classes. It is the Company's contention that rates should be designed to allow the recovery from each customer class of its specific, allocated cost of service.<sup>910</sup> Mr. Kelso of the State of Texas supports

<sup>908</sup> Ileo Direct, p. 22, ln. 20 - p. 24, ln. 15

<sup>909</sup> Ileo Direct, p. 25, lns. 17 - 29

<sup>910</sup> Atmos Ex. 68, Ex. MT-R-1, Ex. MT-R-2, Ex. MT-R-3

this methodology, which results in a relative rate of return of 1.0 for each customer class.<sup>911</sup> Given an equitable overall cost of service allocation, the Examiners support the equitable method of recovery of these costs that provides for a relative rate of return of 1.0 for each customer class.

## XVI. RATE DESIGN

### A. Rate Design

Mr. TheBerge testified that the objectives of the Company in designing the proposed rates to protect customers from potential over collections and provide Atmos Mid-Tex with a fair and reasonable opportunity to earn its authorized return and expenses. He argued that the Company's proposed rate structure also reflects the need to coordinate the rate design with the weather normalization adjustment proposed in the Company's filing. Atmos Mid-Tex proposed for the residential and commercial customers a rate design comprised of a customer charge and a two part, declining block. While similar to the declining block structure currently in effect, the Company's proposed rate structure includes a significant increase in the customer charges and a large and sharply declining initial block relative to the final block.<sup>912</sup>

The Company proposed an increase to the customer charge of the Industrial and Transportation customers, and a decrease in the block rates. The proposed block rate structure of the industrial and transportation customers was modified from four blocks to three. The changes for each of the customer classes is set out below in Table 15.1, 15.2, and 15.3 for residential, commercial, and industrial/transportation customers respectively.

Table 15.1

Residential Rate			
Charge	Current <sup>913</sup>	Proposed <sup>914</sup>	Percentage Change
Customer Charge	10.10	13.50	33.66%
0 MCF to 1.5 MCF	Single Block	\$3.014 per Mcf	143.26%
1.5 MCF to 3.0 MCF	\$1.2390 per Mcf	\$0.414 per Mcf	(66.59%)
All Additional MCF	\$0.9890 per Mcf	\$0.414 per Mcf	(58.14%)

<sup>911</sup> State of Texas Ex. 1, p.25, lns. 3-15.

<sup>912</sup> Atmos Exhibit 29, TheBerge Direct, p. 12, lns. 17 - 27.

<sup>913</sup> Current Rates obtained from Atmos' Tariffs on file with Commission, plus Interim Rate Adjustments approved in GUD 9560, 9615 and 9658.

<sup>914</sup> Proposed rates obtained from Atmos Exhibit No. 68, Sch. J.

Table 15.2

Commercial Rate			
Charge	Current <sup>2</sup>	Proposed <sup>3</sup>	Percentage Change
Customer Charge	\$18.81	\$30.00	59.49%
0 MCF to 20 MCF	Single Block	\$0.996 per Mcf	26.17%
Next 10 MCF	\$0.7894 per Mcf	\$0.196 per Mcf	(75.17%)
Next 320 Mcf	\$0.5394 per Mcf	\$0.196 per Mcf	(63.66%)
All additional Mcf	\$0.2894 per Mcf	\$0.196 per Mcf	(32.27%)

Table 15.3

Industrial (Rate I) and Transportation Rate (Rate T)			
Charge	Current <sup>2</sup>	Proposed <sup>3</sup>	Percentage Change
Customer Charge	\$316.01	\$430.00	36.07%
0 - 1,500 MMBTU	\$0.4882 per MMBtu	\$0.1400 per MMBtu	(71.32%)
Next 3,500 MMBTU	\$0.3382 per MMBtu	\$0.1016 per MMBtu	(69.96%)
Next 45,000 MMBTU	\$0.1882 per MMBtu	Single Block \$0.0216 per MMBtu	(88.52%)
All additional MMBTU	\$0.0382 per MMBtu		(43.46%)

### 1. Customer Charge

Atmos Mid-Tex proposed increasing the residential monthly customer charge from its current approved rate of \$10.10 to \$13.50. The purpose of increasing the customer charge component of the rate structure is to reduce the emphasis of the usage components. In support of this change, Mr. TheBerge argued that the Company incurred a \$19.35 per residential customer, per month of cost to provide service. He concluded, therefore, that the proposed customer charge recovers only 70% of the Company's fixed-costs of rendering service to residential customer class. He argued that this

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charge reflects the inclusion of the accumulated interim adjustment approved under the interim rate adjustment provisions of GURA. Specifically, under current rates approved in the 2005 interim rate adjustment tariff, the customer charge is \$10.10. He noted that the Commission recently approved a \$13.00 per month customer charge in GUD No. 9534.<sup>4</sup>

The Company also proposed increasing the customer charge for the commercial customer class from \$18.81 to \$30.00. In the context of commercial customers, he argued that the Company incurred \$42.78 per customer per month cost to provide commercial service. As in the context of the proposed residential customer charge, the proposed customer charge for commercial customers also included the accumulated interim adjustment approved under the interim rate adjustment provisions of GURA. Specifically, under current rates approved in the 2005 interim rate adjustment tariff, the current customer charge is \$17.43.<sup>5</sup> For the industrial customers Atmos Mid-Tex proposed relabeling its current monthly Meter Charge for Industrial customers to a “Customer Charge.”

As evidenced in Table 15.3, above, the customer charge would increase from \$316.01 to \$430.00. Based on his analysis, the Company incurs a \$612.03 per customer, per month cost to provide industrial service. The proposed customer charge therefore, recovers only 70% of the Company’s fixed-costs of rendering service to its industrial customers class.<sup>6</sup>

## 2. Changes to the block rate structure

As noted above, the Atmos Mid-Tex proposed to change its initial block rate structure for residential and commercial customers. As for the residential class, the Company proposed a change in the revenues collected through the initial block rate from \$1.2390 per Mcf to \$3.014 per Mcf for residential customers. The Company’s proposal included a reduction to the usage level covered by the initial residential block rate from the current 3 Mcf to 1.5 Mcf. Mr. TheBerge argued that the purpose of this change was to define the first block based on the actual level of average residential base load which is approximately 1.5 Mcf per month. He maintained that the base load is evidenced by the average base load experienced during the test year of 1.42 Mcf per customer for the three months of July, August, and September. A similar change was proposed for commercial customers. The Company proposed to reduce the usage level covered by the initial commercial rate block from the current 30 Mcf to 20 Mcf. Again, Mr. TheBerge argued that the purpose of this change was to define the first block based on the actual level of average commercial base load of approximately 20 Mcf per month. He argued that the base load is evidenced by the average experienced during the test year of 18.8 Mcf per customer for the three months of July, August, and September.<sup>7</sup> Mr. TheBerge noted that the Company proposed to reduce the number of rate blocks within the industrial rate schedule from four rate blocks to three.<sup>8</sup>

Mr. TheBerge testified that the residential second rate block will apply to gas used by an individual customer above 1.5 Mcf and the second rate block for commercial customers will apply

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<sup>4</sup> Atmos Exhibit 29, TheBerge Direct, p. 13, lns. 8 - 30.

<sup>5</sup> Atmos Exhibit 29, TheBerge Direct, p. 14, lns. 1 - 14.

<sup>6</sup> Atmos Exhibit 29, TheBerge Direct, p. 16, lns. 2 - 15.

<sup>7</sup> Atmos Exhibit 29, TheBerge Direct, p. 14, ln. 16 - p. 15, ln. 4.

<sup>8</sup> Atmos Exhibit 29, TheBerge Direct, p. 16, ln. 16 - p. 17, ln. 3.

to gas used by an individual customer above 20 Mcf in any given month. He argued that these revised second blocks will exclude all of the consumption that is related to base load and will, thereby, serve to isolate that portion of the total load that largely varies with the weather conditions that increase space and water heating consumption. He argued that, as a result, the revised residential and commercial block rate structures will more readily accommodate the weather normalization adjustment proposed in the Company's filing.<sup>9</sup>

## II Position of the Parties

The City Intervenors and the State raised several objections to the proposed rate structure. First, they argued that the proposed rate structure resulted in a substantial increase for amounts that customers pay through the customer charge and the initial block rate. In this context, they argued that the proposed structure deviated from GUD No. 9400, and that the Company failed to provide evidence that the existing structure was deficient in recovering approved rates. Second, they argued that the proposed rate structure was a declining rate structure that does not promote conservation. Third, they argued that it resulted in interclass subsidies. The position of the parties will be discussed in more detail below.

### a. Change from GUD No. 9400 resulting in sharp increases for some customers

ACSC noted that the proposed change in rate design is a marked change from the rate design approved in GUD No. 9400 and that the current rate design has been in place for approximately ten years. Mr. Stowe noted that based upon this length of service, it can be assumed that the current ratepayers are familiar with and understand its structure.<sup>10</sup> He also argued that the Company has not provided evidence sufficient to establish that the existing structure has been detrimental to its collection of revenues. As noted in Tables 15.1 and 15.2, the proposed rate structure results in an increase of the customer charge and initial block rates. Those tables incorporate the interim rate adjustments. Mr. Stowe made a similar comparison but removed the 2005 interim rate adjustment from his analysis. Naturally, this results in a greater increase in the initial block.<sup>11</sup>

The City of Dallas, through the testimony of Mr. McFadden, argued that the sharp increase in the customer charge is significant in light of the interim rate adjustments. In other words, the decision on customer charges and rate design will be even more significant as Atmos Mid-Tex adds infrastructure and further increases customer charges in the interim rate adjustment filings.<sup>12</sup>

The State also argued that the proposed changes are excessive and will result in very large increases in bills for certain customers. Mr. King argued that customers that consume a relatively small amount of gas would experience a significant negative impact. Mr. King argued that the Company has not pointed to any substantial change in cost underlying the proposed revision to the rate structure. As for the change to the customer charge, Mr. King noted that the Natural Rate Review

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<sup>9</sup> Atmos Exhibit 29, TheBerge Direct, p. 15, ln 5 - p. 16, ln. 1.

<sup>10</sup> ACSC Exhibit 5, Stowe Direct, p. 82, lns. 12 - 22.

<sup>11</sup> ACSC Exhibit 5, Stowe Direct, p. 77, ln. 20 - p. 80, ln. 4.

<sup>12</sup> City of Dallas Exhibit 5, McFadden Direct, p. 45, lns. 13 - 18.

Handbook provides that the customer charge “...may or may not reflect the entire fixed cost of providing service. It has been argued that a customer charge of a magnitude necessary to recover all of the fixed costs in providing service to the customer would be so large as to be unacceptable to most customers.”<sup>13</sup> Furthermore, Mr. King noted that the increase in customer charge was an issue in GUD No. 9400. In that case, this utility requested an increase up to 71% in the residential customer charge, and an increase in the commercial customer charge up to 66%. The Examiners found in that case that it was unreasonable to increase the customer charges by the amounts proposed by the utility and instead recommended smaller increases. Mr. King noted that the Final Order in GUD No. 9400 approved the residential and commercial customer charges that were recommended by the Examiners.

ATM argues that the record evidence does not support the declining block rates proposed by the Company. ATM argues that the most appropriate rate structure for residential and commercial customer classes in this case is a customer charge with a single usage block, or flat block. ATM contends that a flat usage block promotes the goals of rate design: stability; simplicity; fairness; and discouragement of wasteful consumption.<sup>14</sup>

b. Intraclass subsidization

Mr. Stowe also argued that the proposed rate design results in intraclass subsidization. He explained that intraclass subsidization occurs when the population within a defined customer class does not possess sufficient homogenous characteristics, and thus there is a significant disparity in the demands, and the costs required, to serve individual customers. He noted that while some level of intraclass rate subsidization, and thus discrimination, is unavoidable, any rate design which encourages intraclass discrimination should be flatly rejected.<sup>15</sup> The City of Dallas, through the testimony of Mr. McFadden, also alleged a potential intraclass discrimination problem.<sup>16</sup>

Mr. King, on behalf of the State, argued that the combined impact of the Company’s proposal will have a dramatic impact on the bills of low consumption customers. Mr. King explained that the Public Notice provided by Atmos Mid-Tex indicated the proposed increase on “typical” customers. The analysis of the increase provided by Atmos Mid-Tex was that the typical residential customer would experience a rate increase of 5.36%, the typical commercial customer would experience a rate increase of 5.56%, and the typical industrial customer would experience an increase of .21%. Mr. King argued that what the notice fails to reveal is the impact on low consumption customers who are not “typical.” He also noted that the Company has failed to conduct a study that would analyze the impact on customers other than its “typical” or “average” customer. Mr. King maintained that without a study measuring the impact on range of customers within the residential customer a determination cannot be made that the proposed rate design is just and reasonable. He argued that customer impacts are critical to evaluating rate design changes.

Mr. King prepared an analysis of the impacts of the proposed rate design on Commercial Customers. He noted that the largest impact is on low consumption customers. For example, a

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<sup>13</sup> State of Texas Exhibit 5, King Direct, p. 34, lns. 2 - 19.

<sup>14</sup> ATM Reply Brief at pp. 137 - 140.

<sup>15</sup> ACSC Exhibit 5, Stowe Direct, p. 80, ln. 14 - p. 82, ln. 11.

<sup>16</sup> City of Dallas Exhibit 5, McFadden Direct, p. 54, lns. 18 - 21.



customer with zero consumption would have their bill increase by almost 50%. The largest dollar impact would be experienced by customers with consumption of approximately 20 Mcf who would experience an increase of over \$20 per month or \$240 per year. He argued that a similar pattern is experienced by customers in the industrial class as customers with the lowest usage would experience the largest increases. He argued that the declining rate structure proposed by the Company would affect a large number of commercial customers.<sup>17</sup>

In response, Mr. TheBerge argued that significant intraclass subsidies result whenever a significant portion of the customers within a rate class do not exhibit the same characteristics in terms of revenue responsibility versus cost responsibility as the average member of the same rate class. He maintained that because of the relative simplicity of cost characteristics, designing rates that will translate customer behavior into revenue responsibility commensurate with the underlying cost of providing service is not a complex procedure. On the other hand, he argued that designing rates to account for differing usage within a class would be a complex endeavor with varying results.<sup>18</sup>

#### c. Conservation

ACSC, ATM and the State argue that the declining block rate structure proposed by the Company discourages conservation.<sup>19</sup> ACSC argued that for that reason, declining block rates are generally in disfavor.<sup>20</sup> The State pointed out that the Natural Gas Rate Review handbook also notes that declining block rates discourage conservation.<sup>21</sup>

In response to arguments about conservation, Mr. TheBerge argued that the issue was one of degree as opposed to direction. Specifically, he argued that the reality is that because the cost of gas is such a large component of the natural gas bill, no particular rate design for natural gas distribution service will significantly influence individual customer decisions related to consumption. The cost of natural gas, which represents from 60% to 70% of natural gas bills, will continue to be collected based on levels of consumption. That fact, is the proper price signaling mechanism to encourage consumption.<sup>22</sup> Finally, he argued that commodity driven rates artificially shift costs to high volume customers.<sup>23</sup>

#### 4. Examiners' Recommendation

The Examiners find that Atmos Mid-Tex has failed to establish that the proposed rate structure is reasonable. The proposed rate design significantly increases costs to low volume users in the residential and commercial classes. While a declining block rate will not always lead to intraclass subsidies, the proposed change from the first block to the second block is so severe that the threat of discriminatory intraclass subsidies has been established. Atmos Mid-Tex has not established that the

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<sup>17</sup> State of Texas Exhibit 5, King Direct, p. 26, ln. 1 - p. 36, ln. 7.

<sup>18</sup> State of Texas Exhibit 43, TheBerge Rebuttal, p. 70, ln. 27 - p. 74, ln. 2.

<sup>19</sup> ACSC Exhibit 5, Stowe Direct, p. 81, lns. 14 - 15, Ileo Direct, p. 5, ln. 10 - 11.

<sup>20</sup> ACSC Initial Brief, p. 142.

<sup>21</sup> State of Texas Exhibit 5, King Direct, p. 33, ln. 11 - p. 34, ln. 2.

<sup>22</sup> State of Texas Exhibit 43, TheBerge Rebuttal, p. 74, lns. 14 - 31.

<sup>23</sup> State of Texas Exhibit 43, TheBerge Rebuttal, p. 75, ln. 1 - p. 76, ln. 12.

increased intraclass pressures created by the proposed rate design are reasonable. Further, the Examiners find that the proposed rate design discourages conservation. The price signals for commodity cost of gas and the distribution system cost of providing natural gas should be synchronized. The Examiners find that a single block rate design for residential and commercial customers is reasonable. On the other hand, the Examiners find that the proposed declining block rate for the industrial/transportation customer as proposed by Atmos Mid-Tex is reasonable. The amount of decline from the first block to the second is not a large change from GUD No. 9400. Further, the high volume industrial/transportation customer will be able to take advantage of the declining block.

The price signal between the commodity cost of gas and the distribution cost of providing natural gas signal should be synchronized. The Examiners find that a single block rate design for residential and commercial customers is reasonable. On the other hand, the Examiners find that the proposed declining block rate for the industrial/transportation customer as proposed by Atmos Mid-Tex is reasonable. The amount of decline from the first block to the second is not a large change from GUD No. 9400. Further, the high volume industrial/transportation customer will be able to take advantage of the declining block.

The Examiners' recommended rate design and rates are included in the following Table 15.4, 15.5, and 15.6.

Table 15.4

Residential Rate - Rate R			
Charge	Current <sup>24</sup>	Proposed <sup>25</sup>	Recommended
Customer Charge	\$10.10	\$13.50	\$10.10
0 MCF to 1.5 MCF	Single Block	\$3.014 per Mcf	\$0.8267 per Mcf All Usage
1.5 MCF to 3.0 MCF	\$1.2390 per Mcf	\$0.414 per Mcf	
All Additional MCF	\$0.9890 per Mcf	\$0.414 per Mcf	

Table 15.5

Commercial Rate - Rate C
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<sup>24</sup> Current Rates obtained from Atmos' Tariffs on file with Commission, plus Interim Rate Adjustments approved in GUD 9560, 9615 and 9658.

<sup>25</sup> Proposed rates obtained from Atmos Exhibit No. 68, Sch. J.

Charge	Current	Proposed	Recommended
Customer Charge	\$18.81	\$30.00	\$18.81
0 MCF to 20 MCF	Single Block	\$0.996 per Mcf	\$0.4858 per Mcf  All Usage
Next 10 MCF	\$0.7894 per Mcf	\$0.196 per Mcf	
Next 320 Mcf	\$0.5394 per Mcf	\$0.196 per Mcf	
All additional Mcf	\$0.2894 per Mcf	\$0.196 per Mcf	

Table 15.6

Industrial (Rate I) and Transportation Rate (Rate T)			
Charge	Current	Proposed	Recommended
Customer Charge	\$316.01	\$430.00	\$316.01
0 - 1,500 MMBTU	\$0.4882 per MMBtu	\$0.1400 per MMBtu	\$0.3601 per MMBtu
Next 3,500 MMBTU	\$0.3382 per MMBtu	\$0.1016 per MMBtu	\$0.3217 per MMBtu
Next 45,000 MMBTU	\$0.1882 per MMBtu	Single Block \$0.0216 per MMBtu	
All additional MMBTU	\$0.0382 per MMBtu		\$0.2417 per MMBtu

## B. Revenue Stabilization Adjustment

Atmos has proposed a Revenue Stabilization Adjustment (RSA) clause as a new tariff item to adjust for any over or under recovery of the authorized revenue requirement from each class of customer.<sup>2</sup> Atmos proposed the adjustment be calculated for two bi-annual periods, a winter period (November through March) and a summer period (April through October).<sup>3</sup> Similar to the Rider GCR, an annual true-up for over and under recoveries would be made to assure proper recovery. Atmos contends this is necessary to provide a reasonable opportunity to earn its authorized return.<sup>4</sup> The utility contends that a fixed cost rate design combined with fluctuating volumes necessitates a need for the RSA. The RSA will allow the utility to adjust its approved rates to compensate for the decline in customer count they are experiencing and the decline in base load in the residential area. Since 1989, Atmos alleges a decline in average residential base load from 2.172 Mcf per month to 1.395 Mcf per month.<sup>5</sup> The RSA will impose a surcharge or a credit to each customer's bill based on the difference between actual base revenues and the test year base revenues established in the latest rate

<sup>2</sup> Atmos Direct Testimony of Charles R. Yarbrough II, Page 18, Lines 9 - 12.

<sup>3</sup> Atmos Direct Testimony of Charles R. Yarbrough II, Page 18, Lines 12 - 15.

<sup>4</sup> Atmos Direct Testimony of Charles R. Yarbrough II, Page 18, Lines 23 - 24.

<sup>5</sup> Atmos Direct Testimony of Charles R. Yarbrough II, Page 19, Lines 21-24.

proceeding, including an adjustment for customer growth and GRIP<sup>6</sup>. Customer growth will be accounted for based on total bills rendered for each customer class during the adjustment period as compared to the same period in the test year. The test year base rate revenue will then be adjusted based on the test year average use per customer<sup>7</sup>. The utility proposes an annual report within 60 days of the end of the winter recovery period for the two prior adjustment periods<sup>8</sup>.

ACSC identified the adjustment is applicable to base revenues of rate revenues associated with 0 - 1.5 Mcf per customer usage for Residential and 0 - 20 Mcf per customer usage for Commercial<sup>9</sup>. ACSC contends that the approval of an RSA will eliminate virtually all business risk to the shareholders associated with variables in sales or throughput and shift it to the ratepayers<sup>10</sup>. ACSC further asserts that the utility's intention of the RSA is to increase its revenues<sup>11</sup>. Additionally, ACSC states that the RSA is at odds with the fundamental notions of ratemaking that require the utility to bear such risk and in return compensates it by allowing it a reasonable opportunity to earn a return on its invested capital<sup>12</sup>. The approval of a WNA and/or RSA would materially diminish risk to investors and should be accompanied by a downward adjustment in the cost of equity<sup>13</sup>. ACSC suggests a reduction to cost of equity of 50 basis points is reasonable, should an RSA be approved<sup>14</sup>.

The City of Dallas also recommends rejection of the RSA<sup>15</sup>. The City of Dallas furthers states that the RSA is an attrition adjustment, that all discussions relate to declining usage. The nature of the adjustment is such that even with additional customers and increased overall usage, the clause will operate to increase rates<sup>16</sup>. Additionally, the City of Dallas argues that according to the utility, base load usage (the key factor in the RSA) will never go up, which will in turn increase rates<sup>17</sup>. Finally, the clause has no identification of the factors and how they will be calculated<sup>18</sup>.

ATM does not believe there is a basis to justify the approval of the proposed RSA. ATM states that average consumption has steadily declined since 1989, using Atmos Exhibit 19, Exhibit CRY-3, as its basis of determination<sup>19</sup>. ATM also contends the RSA is a violation of the matching principle because only revenues are considered in the formula, not expenses as well. ATM further states the RSA is piecemeal rate making, citing comments to that effect in a decision by the Arkansas Commission in 2005 regarding a Load Change Adjustment Rider proposed by CenterPoint Energy Arkla<sup>20</sup>. ATM notes that only the Texas legislature can provide for piecemeal legislation and has

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<sup>6</sup> TheBerge Dircet Testimonay, Page 11, Lines 2 - 6.

<sup>7</sup> TheBerge Direct Testimony, Page 11, Lines 30 - 31 & Page 12, Lines 1 - 3.

<sup>8</sup> TheBerge Direct Testimony, Page 12, Lines 11 - 14.

<sup>9</sup> ACSC Reply Brief, Page 83.

<sup>10</sup> ACSC Reply Brief, Page 83.

<sup>11</sup> ACSC Reply Brief, Page 84.

<sup>12</sup> ACSC Reply Brief, page 84.

<sup>13</sup> ACSC Reply Brief, page 84.

<sup>14</sup> ACSC Reply Brief, page 84.

<sup>15</sup> City of Dallas Reply Brief, Page 41.

<sup>16</sup> City of Dallas Reply Brief, Page 42.

<sup>17</sup> City of Dallas Reply Brief, page 42.

<sup>18</sup> City of Dallas Reply Brief, page 42.

<sup>19</sup> ATM Reply Brief, Page 141.

<sup>20</sup> ATM Reply Brief, Page 142.

provided the utilities piecemeal legislation in the form of GURA § 104.112, Surcharge to Recover Relocation Costs in 1999 and in 2003 GURA § 104.301, Interim Adjustment for Changes in Investment.<sup>21</sup> ATM suggests the Commission should not support this piecemeal legislation proposed by Atmos.

Railroad Commission of Texas Staff recommends denying Atmos' proposed RSA. Staff does not believe the proposed RSA provides sufficient detail to evaluate and approve the mechanism.<sup>22</sup> Staff asserts Atmos has adequately mitigated its revenue volatility through GRIP and Weather Normalization.<sup>23</sup> Staff qualifies approval of an RSA mechanism only if the utility has available a Demand Side Management Program (DSM) to encourage energy conservation. Staff suggests a DSM that would generate \$3 million annually, \$1.5 million from ratepayers and \$1.5 Million in matching funds from the company.<sup>24</sup> The purpose of the program would be to promote the conservation of energy through energy audits sponsored by the utility, to include rebates on high-efficient appliances, furnaces, water heaters, etc.<sup>25</sup> While it is not possible at present to calculate the surcharge because a rate design has not yet been determined, Staff estimates it would be approximately 0.66 percent.<sup>26</sup> Staff suggests the utility track the seasonal impacts on revenue as if the RSA had been approved. This will help the Commission determine the integrity of such a mechanism.<sup>27</sup>

Atmos argued that the RSA is not an automatic adjustment to rates because it does not change the rates, that the RSA and WNA is revenue neutral. Atmos claimed it compares actual revenue recovery to approved revenue recovery for two periods during the year. Atmos disagreed with the allegation that approval will remove incentives on cost effectiveness. Atmos also states that its website already offers customers an opportunity to conduct their own energy audit on their home, where they can evaluate their energy bills, and can obtain information on ways to conserve energy.<sup>28</sup> Atmos offers that if the Commission wishes to condition approval of the RSA on conservation programs for customers, Atmos is willing to consider such programs provided there is adequate cost recovery to Atmos for the programs.<sup>29</sup> However, Atmos believes Staff's recommendation for its DSM costs to much and is not proportional to the purpose and value of the programs.<sup>30</sup> Atmos suggests a maximum initial funding be set at \$3 million for any program and that it be funded equally by shareholders and rate payers. Additionally, if the Commission were to favor such a program, Atmos recommends that a pre-authorized RSA be delayed for 6-months to one year after the final order to allow time for the program to become established and fully operational. After the end of the six-month to one year period, the RSA would be implemented.<sup>31</sup>

The RSA is a new concept for the Commission to evaluate. This is uncharted territory for this

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<sup>21</sup> ATM Reply Brief, Page 143.

<sup>22</sup> Railroad Commission Staff Initial Brief, Page 2.

<sup>23</sup> Railroad Commission Staff Initial Brief, Page 2.

<sup>24</sup> Railroad Commission Staff's Reply Brief, Page 1.

<sup>25</sup> Railroad Commission Staff Initial Brief, Page 3.

<sup>26</sup> Railroad Commission Staff's Reply Brief, Page 1.

<sup>27</sup> Railroad Commission Staff Initial Brief, Page 3.

<sup>28</sup> Yarbrough Rebuttal Testimony, Page 52, Lines 4 - 7.

<sup>29</sup> Yarbrough Rebuttal Testimony, Page 52, Lines 7 - 10.

<sup>30</sup> Atmos Reply Brief, Page 228.

<sup>31</sup> Atmos Reply Brief, Page 228.

Commission, not unlike the implementation of the GRIP legislation. There is evidence nationwide that there is a need for a more forward-looking approach to rate-making given more energy efficient appliances, general decline in base load, and the need to reduce rate case expenses. Nonetheless, the Examiners' do not believe Atmos has adequately supported the reasonableness of its proposed RSA; nor has the Company adequately demonstrated the feasibility of the RSA over time and with actual experience on its system; nor has the Company demonstrated a strong commitment to demand side management, an complementary effort to an RSA type mechanism.

### C. Weather Normalization Adjustment (WNA)

Atmos proposed a WNA for approval in this Statement of Intent. In an effort to minimize Rate Case Expenses passed on to the rate payer, the Commission issued an interim order, dated August 15, 2006, in which the Commission found, among other areas of agreement, that the proposed WNA was just and reasonable, except for issues reserved for litigation in this proceeding by agreement of the parties.<sup>32</sup> Pursuant to paragraph 3 of the *Agreement to Extend Jurisdictional Deadline & Procedural Schedule*, the parties specifically agreed that the final WNA shall be designed as proposed by Atmos Mid-Tex in the written testimony of Atmos' witness Charles Yarbrough and Michael TheBerge filed in the case, except for the parties reserved right to litigate the appropriate period of weather data to use in calculating "normal" weather, and any final WNA approved by the Commission shall be modified if and as necessary to conform to the findings in a final order issued in this case, i.e., rate design.<sup>33</sup>

Atmos proposed to use a 10-year period for use in calculating "normal" weather. As originally proposed, Atmos would calculate an adjustment for each billing cycle during the months of November through May.<sup>34</sup> Atmos proposed the adjustment for each billing cycle would be based on the difference between the 10-year average Heating Degree Day (HDD) for that cycle and the actual HDDs experienced in that cycle.<sup>35</sup> Atmos stated the proposed WNA addressed a significant contributor to volume variations that impact the Company's earnings.<sup>36</sup>

At issue is the whether or not 10-year weather data is a better option than 30-year weather data. Atmos contended that 10-year data better reflects the actual weather warming trend over the last 10-years. The 30-year weather data does not necessarily represent the gradual warming trend as well as the 10-year data, according to Atmos.<sup>37</sup>

ACSC recommended the use of 30-year weather for calculations of "normal" weather. ACSC argues that The Railroad Commission Natural Gas Review Handbook adopted the National Oceanic

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<sup>32</sup> Conclusion of Law No. 7, Interim Order GUD No. 9670, dated August 15, 2006.

<sup>33</sup> FOF No. 14, Interim Order GUD No. 9670, dated August 15, 2006.

<sup>34</sup> Atmos Direct Testimony of Charles R. Yarbrough II, Page 17, Lines 9 - 11. Originally, the WNA included the month of October.

<sup>35</sup> Atmos Direct Testimony of Charles R. Yarbrough II, Page 17, Lines 13 - 16.

<sup>36</sup> Atmos Direct Testimony of Charles R. Yarbrough II, Page 19, Lines 1 - 4.

<sup>37</sup> Atmos Direct Testimony of Charles R. Yarbrough II, Page 21, Lines 10-19.

and Atmosphere Administration (NOAA) definition of 'normal weather' to be 30-years.<sup>38</sup> ACSC also noted that the use of 30-year weather was used in GUD No. 9400.

ATM recommended the adoption of Atmos' proposed WNA use of 10-year data.<sup>39</sup> However, ATM suggests a modification to the formula which, ATM represents, would make for a more simpler formula that the customer would understand. ATM also recommended a mandatory 3-year full rate review of the WNA and other important rate making matters.<sup>40</sup> ATM's formula change allegedly eliminates the heat sensitive factor and the non-weather sensitive load, because they were set at 1.00 and 0.00, respectively.<sup>41</sup> ATM also suggests a rate design change which will be discussed in another section of the PFD.

The City of Dallas noted problems and issues in the application of the WNA as evident from the statements in customer complaints following its implementation after the Interim Order.<sup>42</sup> The City of Dallas advocated the use of 30-year weather data and argues that Atmos has not proved that 10-year data is preferable over 30-year data.<sup>43</sup>

Staff asserted that no WNA should be approved without first requiring Atmos to determine the basic load for each customer.<sup>44</sup> Staff further recommended a 10-year WNA and eliminating the months of October and May from the any approved WNA.<sup>45</sup>

Atmos argued that the only issue left open to litigation is the use of 10-year or 30-year weather data.<sup>46</sup> Atmos argued that all parties agreed to the WNA in the form presented by Atmos. Staff's assertion that no WNA should be approved without first requiring the company to determine the basic load for each customer is contrary to Staff's agreement already approved by the Commission.<sup>47</sup> Atmos stated it does not have the capability of customer specific base-load calculations as Staff recommends. However, they are willing to develop such capability and implement it when developed. Atmos also contended that a review of the WNA and possible changes to the WNA can be made through the tariff filing process.<sup>48</sup>

Atmos added that the only difference between ATM's recommended formula change and Atmos' proposed formula is ATM divided the difference between actual and normal HDDs by normal HDDs instead of actual HDDs. Atmos contended the ATM formula change increases the rate paid by the customer.<sup>49</sup>

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<sup>38</sup> ACSC Reply Brief, Page 81.

<sup>39</sup> ATM Michael J. Ileo, Phd, Page 14, lines 18-22.

<sup>40</sup> ATM Direct Testimony of Michael J. Ileo, Phd., Page 15, Lines 9 - 17.

<sup>41</sup> ATM Direct Testimony of Michael J. Ileo, Phd., Page 19, Lines 3 -8.

<sup>42</sup> City of Dallas Reply Brief, Page 41.

<sup>43</sup> City of Dallas Reply Brief, page 41.

<sup>44</sup> Staff Initial Brief, Page 4.

<sup>45</sup> Staff Initial Brief, Page 4.

<sup>46</sup> Atmos Reply Brief, page 223.

<sup>47</sup> Interim Order, GUD No. 9670, dated August 15, 2006.

<sup>48</sup> Atmos Rebuttal of Charles R. Yarbrough II, Page 53, lines 24 - 30.

<sup>49</sup> Atmos TheBerge Direct Testimony, Page 12, lines 5 - 18.

After the WNA was implemented, October 1, 2006, the Commission received numerous letters from customers complaining about the WNA and the amounts being charged under the WNA. The amounts did appear to be excessive and were a subject of discussion during the hearing phase of this case. Atmos explained that the formula is being calculated correctly and applied to rates approved in GUD No. 9400. Staff witness Mr. Steve Pitner confirmed that the WNA was being calculated and applied correctly.<sup>50</sup>

While the interveners provided arguments for the use of 30-year weather data for the determination of "normal" weather, the Examiners' find it is reasonable to use 10-year weather data in the proposed WNA calculation. The Examiners' further find that although modifications and qualifications for approval were made by several interveners, the only issues subject to litigation were the use of 10-year vs. 30-year weather data and the ultimate design dependent on rate design, pursuant to the settlement agreement signed by the parties. The Examiners recommend approval of the WNA as proposed by the Company, subject to review by and discussions with Staff regarding the need for modification of the WNA mechanism to render the adjustment compatible with the rate design ultimately approved in this rate case.

#### D. Uncollectibles

Atmos has proposed the collection of uncollectible gas cost in the Rider GCR. Atmos cites the Commission Rule 16 T.A.C. § 7.551 (a) as basis for inclusion because Atmos contends the rule contemplates the ability of a gas utility to recover its gas cost.<sup>51</sup> Atmos supports the conclusion by referencing the PFD in GUD No. 9539, wherein the Examiner concludes that "[t]o the extent that a utility can identify unrecovered gas costs, then the utility should be able to recover those costs through an adjustment to the formula [of the PGA]."<sup>52</sup> The proposal would calculate an adjustment for uncollectible gas cost comparable to that approved in GUD No. 9539.

While intervenor ACSC has made an adjustment to the uncollectible experience rate to better reflect the expected level of ongoing uncollectible expense for the first issue, ACSC is recommending the Commission deny the utility's request to include uncollectible amounts in the GCR Rider. ACSC made four points of disagreement to Atmos' proposal to include the uncollectible gas cost in the GCR Rider.<sup>53</sup> First, the proposal eliminates an incentive to minimize uncollectible expenses. Second, the proposal may lead to double recovery. Third, ACSC contends that collection of uncollectible expense is a billing issue, not a gas cost issue. Fourth, ACSC contends Atmos has failed to provide documentation that this is a problem or that the proposal will solve a problem. ACSC urges the Commission to include safeguards to minimize the impact on the ratepayers if the Commission were to approve Atmos' request by: a) placing an upper limit on the amount included in the GCR Rider, b) flow subsequent payments collected through the Rider GCR, c) providing reports similar to those required in GUD No. 9539, d) explicitly requiring the amounts to be on an interim basis pending a subsequent reconciliation of gas costs.<sup>54</sup>

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<sup>50</sup> Volume 10, November 13, 2006 Transcript, Page 226 and 227.

<sup>51</sup> Atmos Direct Testimony of Charles R. Yarbrough, Page 22, Lines 11 - 13.

<sup>52</sup> Atmos Direct Testimony of Charles R. Yarbrough, Page 22, Lines 13 - 20.

<sup>53</sup> ACSC testimony of Karl J. Nalepa, Page 24, Lines 12-19.

<sup>54</sup> ACSC testimony of Karl J. Nalepa Page 4, Lines 3-8 and Page 28, Lines 7-14.



ATM also recommends denying the utilities request to include uncollectible gas cost in Rider GCR. ATM sites rejection of Oklahoma Natural Gas Co.'s (a division of ONEOK) proposal similar to that of Atmos' by the Oklahoma Corporation Commission.<sup>55</sup> ATM provides that if the Commission were to agree to allow Atmos recovery of uncollectible gas cost, it should be capped at 0.482% of actual gas sales<sup>56</sup>. ATM further points out that the Commission's decision in GUD No. 9539, which the utility points to as evidence of Commission precedent, was an adoption of a settlement between the parties<sup>57</sup>, i.e., Atmos Energy Corporation, West Texas Division and the City of Amarillo. Finally, ATM believes approval will reduce the utilities incentive to pursue late payment accounts.<sup>58</sup> ATM's Reply Brief notes that the Commission also held that the decision to include bad debt expense in the GCR is discretionary in GUD No. 9539.<sup>59</sup> And as such, the request should be denied in this case. ATM further notes that a bad debt component in the GCR was not approved in the Lubbock Environs case, GUD No. 9563, or in the West Texas Environs case, GUD No. 9573, the other Atmos Energy Texas Division.<sup>60</sup> In addition, ATM points to the Third Court of Appeals ruling that fuel reconciliation proceedings are not "rate making proceedings" and concludes that as a result of this ruling rate case expenses will not be reimbursed for future fuel reconciliations. ATM noted that two of the three Commission Commissioner's have expressed concerns over continuing a triennial review. As a result of a discontinuance, there will be no municipal participation with no rate case expense reimbursement and it is likely that a fuel reconciliation proceeding will not be done in the future. For these reasons, ATM believes it is inappropriate to add the bad debt component to the GCR.<sup>61</sup> ATM asserts that the ruling in GUD No. 9400 to reduce the requested uncollectible gas cost is an example of a good reason to not allow the request. Denying the request provides the Commission and other parties and opportunity to review uncollectible expense and evaluate whether the utility is managing late payment accounts.<sup>62</sup>

In Atmos' rebuttal testimony, Atmos disagrees with the interveners contention that they (the interveners) lose the ability to review gas cost, holding that gas cost is reviewed in every full blown rate case. Atmos also points out that the shift to shareholders is untrue because the utility is entitled to recover all of its costs whether it is through the Rider GCR or through the rates as Uncollectible Expense.<sup>63</sup> Atmos also asserts that they are very aggressive in pursuing uncollectible bills and the proposed change will not change this policy.<sup>64</sup> Finally, the claim that this is a billing issue and not a gas cost issue was disputed by submitting that gas cost on a utility bill does not change from gas cost to a billing issue solely because it a delinquent account.

Although the Examiners' find it is reasonable to include uncollectible gas cost in the Rider GCR, the Examiners recommend rejection of this request because the West Texas Division did not file the report required by GUD No. 9573 until required to do so by the Gas Services Division, Audit

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<sup>55</sup> ATM testimony of Mark Garrett, Page 42, lines 11-14. Oklahoma Corporation Commission Cause No. PUD 2004-00610.

<sup>56</sup> ATM testimony of Mark Garrett, Page 42, Lines 25-26

<sup>57</sup> ATM testimony of Michael L. Arndt, Page 25, Lines 22-25.

<sup>58</sup> ATM testimony of Michael L. Arndt, Page 28, Lines 10-12.

<sup>59</sup> ATM Reply Brief, Page 145.

<sup>60</sup> ATM Reply Brief, Page 145.

<sup>61</sup> ATM Reply Brief, Page 146.

<sup>62</sup> ATM testimony of Michael L. Arndt, Page 24, Lines 13-24.

<sup>63</sup> Atmos Rebuttal of Charles R. Yarbrough II, Page 37, Lines 11 - 31.

<sup>64</sup> Atmos Rebuttal of Charles R. Yarbrough II, Page 41, Lines 7 - 14.

Section. As noted that approval was predicated upon the timely filing of the reports. While the proposed mechanism may be approved in the future based upon the experience in the West Texas Division, the Examiners recommend that it be rejected at this time. If the Commissioner determines that it is reasonable, the Examiners' find it is reasonable to cap uncollectible expense at the recommended rate of 0.62%, or the uncollectible expense rate determined by the Commission in its final order. Additionally, the Examiners' recommend the utility include a credit for subsequent payments of uncollectibles collected to be flowed through the Rider GCR. For Commission consistency in its approval, recovery should be in a manner similar, if not the same, as that of its sister division, Atmos Energy Corporation, West Texas Division. It is reasonable to require a report to the Commission on a quarterly basis similar to that filed by its sister division, Atmos Energy Corporation, West Texas Division, or at a frequency equal to the filing requirements of the Rider GCR.

## **XVII. CONCLUSION**

Atmos Mid-Tex requested a total base revenue requirement of \$404,611,426, which would result in an increase of \$56,859,139 from its calculation of current base revenue. For the reasons discussed in the preceding sections of this Proposal for Decision, the Examiners recommend that the Commission approve a total base revenue requirement of \$324,948,322, a decrease of \$22,803,964 from current base revenue.

Respectfully submitted,

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Office of General Counsel

Mark Evarts  
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