



# RAILROAD COMMISSION OF TEXAS

## HEARINGS DIVISION

GUD No. 10170

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**STATEMENT OF INTENT FILED BY ATMOS ENERGY CORPORATION TO INCREASE GAS UTILITY  
RATES WITHIN THE UNINCORPORATED AREAS SERVED BY THE MID-TEX DIVISION**

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**PROCEDURAL HISTORY:**

Docket Established:	May 31, 2012
Final Hearing Date:	
Heard By:	Cecile Hanna, Hearings Examiner Gene Montes, Hearings Examiner Rose Ruiz, Technical Examiner
Record Closed:	November 13, 2012
PFD Circulation:	November 13, 2012

### STATEMENT OF THE CASE

This case is a *Statement of Intent* proceeding related to the Atmos Mid-Tex Division of Atmos Energy Corporation. Atmos filed its rate request with all municipalities served by the Atmos Mid-Tex Division. Atmos also filed a *Statement of Intent* proceeding for all areas served by the Atmos Mid-Tex Division within the original jurisdiction of the Railroad Commission (Commission). All proceedings, the various appeals, and the original proceeding at the Commission were consolidated.

Several parties intervened in these consolidated proceedings. In its initial filing, the company requested a revenue requirement of \$471,882,773, excluding gas costs. ACSC argued that the revenue requirement should be set at \$395,814,962. ATM asserted that the revenue requirement should be set at \$412,293,711. The City of Dallas intervened on the limited issues related to depreciation and did not identify an overall revenue requirement. After considering the evidence presented in the case the Examiners recommend a revenue requirement of \$445,414,170.

Table 1  
Revenue Requirement Requested and Adjusted

	Revenue Requirement	Change from Filing
Atmos (SOI)	\$471,882,773	
Examiners	\$445,426,764	\$26,456,009
ATM	\$412,293,711	\$59,589,062
ACSC	\$395,814,962	\$76,067,811

On a system-wide basis, the company's initial request resulted in an increase in revenues of approximately \$47,709,349. The company updated its filing to address issues raised by the Intervenor, Staff, and the Examiners, which reduced its requested revenue requirement to \$455,661,452. This resulted in a proposed increase of \$31,485,521 on a system-wide basis.

After considering the arguments of the parties and evaluating the evidence presented at the hearing, the Examiners recommend an additional reduction to the revenue request of approximately \$10,234,687. Thus, the Examiners find that a revenue requirement totaling \$445,426,764 is just and reasonable. Based upon the changes that were incorporated into the filing as this case was processed at the Commission, and the additional Examiners' proposed adjustment after considering the arguments of the parties, the Examiners recommend that the increase, on a system-wide basis, be limited to approximately \$21,454,344. This represents a 5.00% increase over current base rates on a system-wide basis.<sup>1</sup>

The parties to this proceeding have presented several individual adjustments that affect all areas of the calculated revenue requirement. The Intervenor alleged that the proposed allocation of corporate services was incorrectly calculated. Additionally, the parties challenged nine areas of the overall calculation of the company's operations and maintenance expense

<sup>1</sup> The calculated revenue changes assume a system-wide calculation of rates. The rates within the City of Dallas are not impacted by this proceeding.

proposing approximately fourteen separate adjustments. In the depreciation expense context the parties have proffered twenty potential adjustments. In the area of rate base the parties have recommended approximate twenty seven separate adjustments in five areas. In the area of rate of return, the Commission must evaluate at least seven distinct proposals to arrive at an overall rate of return.

After reviewing the filing and the arguments of the parties the Examiners find that the company has carefully adhered to Commission precedent. Nevertheless, the Examiners find that the evidence in this case requires adjustments in nine areas:

1. Removal of expense related to insurance for CWIP
2. An average service life adjustment to the depreciation expense for Mid-Tex Account 374.02
3. An average service life adjustment to the depreciation expense for Mid-Tex Account 376.02
4. An average service life adjustment to the depreciation expense for SSU Account 399.08
5. An update to the company's calculation of the Pension and OPEB regulatory asset
6. Removal of ADIT related to uncollectible expenses
7. An overall cost of equity of 10.4%
8. Cost Allocation Adjustment - An adjustment to the minimum system study
9. Rate Design Adjustment - A reduction to the customer charge to reflect the updated changes and Examiner recommended adjustment to the overall revenue requirement: Residential Customer Charge \$17.70 and a Commercial Customer Charge of \$34.72.

With the exception of the Conservation and Energy Efficiency Tariff, and minor adjustment to the Weather Normalization Adjustment, and the service class tariffs to reflect the Examiners above enumerated changes, the Examiners recommend approval of the tariffs as proposed.

The *Proposal for Decision* includes recommendation in areas that do not impact the overall revenue requirement of the company. In two instances, one related to the recovery of an insurance cancellation fee and the other in the context of injuries and damages the Examiners are concerned that there is the potential for over-recovery. The Examiners recommend that a reserve be established in both areas to track any over-recovered amounts. Further, the Examiners recommend that any over-recovered amounts be returned and the rates adjusted in any subsequent proceeding to reflect the recovery of those amounts.

Despite the company's adherence to precedent in the context of incentive compensation plan expenses, the Intervenors have requested an adjustment in this case. The Examiners find that the company has established the reasonableness of the Commission's prior balancing of those expense. The record is clear in this case that the company's incentive compensation plans benefit customers and shareholders alike. The Examiners recommend further, that the company be permitted in future proceedings to propose an alternative balancing of those expenses that provides a fair and transparent distribution of those expenses.

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## PROPOSAL FOR DECISION

### 1. Procedural History

On May 31, 2012, Atmos Energy Corporation (Atmos Energy) filed the *Statement of Intent to Increase Gas Utility Rates in the Unincorporated Areas of Its Mid-Tex Division*. That case was docketed as GUD No. 10170. The proposed rates were suspended on June 26, 2012. Notice of the proposed rate increase was accomplished for unincorporated area residential and commercial customers by bill insert processed beginning on July 20, 2012, and ending on August 20, 2012. Notice to industrial and other non-residential and non-commercial customers was accomplished by mailing the notice to the billing addresses of each directly affected unincorporated customer on July 24, 2012. Furthermore, notice of the proposed increase was published once a week for four or more consecutive weeks, beginning the week of February 6, 2012, and running through the week of March 5, 2012, in newspapers of general circulation in each city affected by the proposed increase.

Atmos Energy Corporation also filed a Statement of Intent proceeding within 441 municipal jurisdictions. The following cities denied the *Statement of Intent* filed by Atmos Energy Corporation, Mid-Tex Division: Abilene, Alba, Albany, Allen, Alvarado, Alvord, Angus, Anna, Anson, Arlington, Aubrey, Avery, Azle, Baird, Bangs, Barry, Bartonville, Bedford, Bellevue, Benbrook, Benjamin, Beverly Hills, Blanket, Blum, Bogata, Bonham, Bowie, Brazos Bend, Bridgeport, Bronte, Brownsboro, Brownwood, Bruceville-Eddy, Buckholts, Buffalo Gap, Burleson, Byers, Caddo Mills, Caldwell, Calvert, Cameron, Campbell, Canton, Cashion Community, Celina, Centerville, Childress, Chillicothe, Cisco, Clarksville, Cleburne, Clifton, Clyde, Coleman, Colleyville, Collinsville, Colorado City, Comanche, Commerce, Coolidge, Cooper, Copper Canyon, Copperas Cove, Corral City, Covington, Crawford, Crowley, Dalworthington Gardens, Decatur, DeLeon, Denison, Desoto, Dodd City, Double Oak, Duncanville, Dublin, Ector, Edgecliff Village, Edom, Emhouse, Emory, Ennis, Euless, Everman, Fairfield, Farmers Branch, Farmersville, Ferris, Forest Hill, Fort Worth, Franklin, Frankston, Frisco, Frost, Gainesville, Glen Rose, Glenn Heights, Godley, Goodlow, Gordon, Goree, Gorman, Grandview, Granger, Gunter, Gustine, Haltom City, Hamilton, Harker Heights, Haskell, Hawley, Henrietta, Hewitt, Hico, Highland Village, Holland, Holliday, Honey Grove, Howe, Hubbard, Hurst, Hutchins, Iowa Park, Iredell, Irving, Italy, Itasca, Jewitt, Josephine, Joshua, Justin, Kaufman, Keene, Kemp, Kennedale, Killeen, Knollwood, Ladonia, Lake Worth, Lakeport, Leona, Leonard, Lewisville, Lindsay, Lipan, Little Elm, Little River Academy, Lometa, Lone Oak, Longview, Lorena, Lott, Mabank, Madisonville, Malakoff, Malone, Mansfield, Marble Falls, Maypearl, McGregor, McKinney, Melissa, Meridian, Merkel, Mesquite, Mexia, Midlothian, Miles, Moran, Morgan, Murchison, Murphy, Newcastle, Nocona, Nolanville, Northlake, Novice, Oak Leaf, Oakwood, O'Brien, Oglesby, Olney, Ovilla, Palestine, Palmer, Paradise, Pecan Gap, Pecan Hill, Penelope, Petrolia, Pilot Point, Pleasant Valley, Ponder, Pottsboro, Poynor, Princeton, Putnam, Quanah, Quitman, Ranger, Ravenna, Red Oak, Reno (Lamar County), Retreat, Richland, Richland Hills, River Oaks, Roanoke, Robert Leek, Rochester, Rockwall, Roscoe, Rosebud, Ross, Rotan, Runaway Bay, Sachse, Saginaw, San Angelo, Sansom Park, Santa Anna, Savoy, Scurry, Seagoville, Sherman, Snyder, Suothmayd,

Stamford, Stephenville, Strawn, Streetman, Sweetwater, Talty, Teague, Tehuacana, Thorndale, Thornton, Throckmorton, Tioga, Tom Bean, Trent, Trinidad, Troy, University Park, Valley View, Van Alstyne, Walnut Springs, Westlake, White Settlement, Whitesboro, Wichita Falls, Woodway, Wortham, Wylie, Venus and Yantis.

The company filed its *Petition for De Novo Review of the Denial of the Statement of Intent* filed by *Atmos Energy Corporation, Mid-Tex Division* by the Cities of Abilene, Alba, Albany, et al. on May 31, 2012. That case was docketed as GUD No. 10171.

The cities of Detroit and Lakeside also denied the requested change and on June 8, 2012, Atmos Energy filed its *Petition for De Novo Review of the Denial of the Statement of Intent* filed by *Atmos Energy Corporation, Mid-Tex Division* by the Cities of Deport, Detroit, and Lakeside and the case was docketed as GUD No. 10176.

Moreover, the following cities subsequently denied the proposed increase: Addison, Alma, Archer City, Argyle, Aurora, Ballinger, Bandera, Bardwell, Bartlett, Bells, Bertram, Blackwell, Blooming Grove, Blossom, Blue Mound, Blue Ridge, Boyd, Bremond, Bryan, Buffalo, Burkburnett, Burnet, Carbon, Carrollton, Cedar Hill, Cedar Park, Chico, College Station, Como, Coppel, Corinth, Corsicana, Crandall, Cross Roads, Dawson, Denton, Early, Eastland, Eustace, Evant, Fairview, Fate, Flower Mound, Forney, Fredericksburg, Garland, Georgetown, Goldthwaite, Granbury, Grand Prairie, Grapevine, Hamlin, Haslet, Hearne, Heath, Hebron, Hickory Creek, Highland Park, Hillsboro, Hutto, Impact, Keller, Kerrville, Knox City, Kosse, Krum, Kurten, Lacy-Lakeview, Lake Dallas, Lampasas, Lancaster, Lavon, Lawn, Leander, Lincoln Park, Llano, Lorain, Lueders, Manor, Mart, McLendon-Chisholm, Megargel, Milford, Midway, Mobile City, Moody, Muenster, Newark, Nevada, New Chapel Hill, Normangee, North Richland Hills, Paris, Parker, Pflugerville, Plano, Powell, Prosper, Quinlan, Rhome, Robinson, Roby, Rogers, Round Rock, Rowlett, Roxton, Royse City, Rule, Sadler, Saint Jo, Sanctuary, Sanger, Seymour, Shady Shores, South Mountain, Southlake, Springtown, Sulphur Springs, Taylor, Temple, Terrell, The Colony, Thrall, Toco, Trenton, Trophy Club, Tye, Tyler, Valley Mills, Vernon, Waco, Watauga, Waxahachie, Weinert, West, Westworth Village, Whitehouse, Whitewright, Whitney, Wilmer, Windom, Winters, and Wolfe City.

The company filed its *Petition for De Novo Review of the Denial of the Statement of Intent* filed by *Atmos Energy Corporation, Mid-Tex Division* by the Cities of Addison, Alma, Archer City, et al. on June 13, 2012, and that case was docketed as GUD No. 10177.

Likewise, the following cities also denied the *Statement of Intent*: Abbott, Annona, Athens, Austin, Balch Springs, Bellmead, Belton, Celeste, Chandler, Cockrell Hill, Coyote Flats, Cumby, Electra Garrett, Gatesville, Greenville, Groesbeck, Kerens, Lexington, Marlin, Millsap, Munday, Pantego, Point, Reno (Parker County), Post Oak Bend, Rice, Richardson, Riesel, Rio Vista, Rockdale, San Saba, Somerville, Star Harbor, Sun Valley, Sunnyvale, Tuscola, Westover Hills, and Wixon Valley.

On July 5, 2011, Atmos Energy filed its *Petition for De Novo Review of the Denial of the Statement of Intent* Filed by *Atmos Energy Corp., Mid-Tex Division* by the Cities of Abbott, Athens, Austin, et al. and the case was docketed as GUD No. 10184.

GUD Nos. 10171, 10176, 10177, and 10184 were subsequently consolidated into GUD No. 10170.

Prior to the filing of this Statement of Intent proceeding, Atmos Energy filed the *Application of Atmos Energy Corporation to Revise Certain Depreciation Rates*, which was docketed as GUD No. 10147. After the filing of this case, Atmos Energy filed a Motion to Consolidate GUD No. 10147 into this proceeding. The Examiners determined that not all portions of GUD No. 10147 were relevant to this proceeding. Accordingly, the Examiners established GUD No. 10179 and severed all depreciation issues related to the Mid-Tex Division into that proceeding, *Atmos Energy Corp.'s Mid-Tex Division's Proposed Depreciation Rates, Severed from GUD No. 10147*. GUD No. 10179 was consolidated into GUD No. 10170 (consolidated).<sup>2</sup>

State Agencies and Institutions of Higher Education (State Agencies) and the Railroad Commission of Texas Staff (Staff) intervened in this docket, GUD No. 10170, on June 14, 2012.

The following entities intervened in this proceeding on June 14, 2012, known as "Atmos Texas Municipalities" (ATM): the Cities of Austin, Balch Springs, Bandera, Barlett, Belton, Blooming Grove, Bryan, Cameron, Cedar Park, Celeste, Clifton, Commerce, Copperas Cove, Corsicana, Denton, Electra, Fredericksburg, Garrett, Gatesville, Georgetown, Goldthwaite, Granbury, Greenville, Groesbeck, Hamilton, Henrietta, Hickory Creek, Hico, Hillsboro, Hutto, Kerens, Lampasas, Leander, Lometa, Longview, Mart, Mexia, Olney, Pantego, Pflugerville, Ranger, Reno (Parker County), Rice, Richardson, Riesel, Round Rock, San Angelo, Sanger, Somerville, Star Harbor, Trinidad, Trophy Club, and Whitney.

Additional cities intervened on June 22, 2012, known as "Atmos Cities Steering Committee" (ACSC) and include the following cities: Abilene, Addison, Allen, Alvarado, Angus, Anna, Argyle, Arlington, Bedford, Bellevue, Benbrook, Beverly Hills, Blossom, Blue Ridge, Bowie, Bridgeport, Brownwood, Burkburnett, Bursleson, Caddo Mills, Carrollton, Cedar Hill, Celina, Cisco, Cleburne, Clyde, College Station, Colleyville, Colorado City, Comanche, Coolidge, Coppel, Corinth, Corral City, Crandall, Crowley, Dalworthington Gardens, Denison, DeSoto, Duncanville, Eastland, Edgecliff Village, Emory, Ennis, Euless, Everman, Fairview, Farmers Branch, Farmersville, Fate, Flower Mound, Forest Hill, Fort Worth, Frisco, Frost, Gainsville, Garland, Grand Prairie, Grapevine, Gunter, Haltom City, Harker Heights, Haskell, Haslett, Hewitt, Highland Park, Highland Village, Honey Grove, Hurst, Iowa Park, Irving, Justin, Kaufman, Keene, Keller, Kemp, Kennedale, Kerrville, Killeen, Krum, Lakeside, Lake Worth, Lancaster, Lewisville, Lincoln Park, Little Elm, Lorena, Madisonville, Malakoff, Mansfield, McKinney, Melissa, Mesquite, Midlothian, Murphy, Newark, Nocona, North Richland Hills, Northlake, Oak Leaf, Ovilla, Palestine, Paris, Parker, Pecan Hill, Plano, Ponder, Pottsboro, Prosper, Quitman, Red Oak, Richland, Richland Hills, River Oaks, Roanoke, Robinson, Rockwall, Roscoe, Rowlett, Royse City, Sachse, Saginaw, Seagoville, Sherman, Snyder, Southlake, Springtown, Stamford, Stephenville, Sulphur Springs, Sweetwater, Temple,

<sup>2</sup> The Examiners also established GUD No. 10180, *Atmos Energy Corp.'s West Texas Division's Proposed Depreciation Rates, Severed from GUD No. 10147*. That docket was consolidated with GUD No. 10174, *Statement of Intent filed by Atmos Energy Corp., to Change Gas Utility Rates within the Unincorporated areas Served by the Atmos Energy Corp., West Texas Division*. GUD No. 10180 was subsequently consolidated into GUD No. 10174, Final Order issued October 2, 2012.

Terrell, The Colony, Trophy Club, Tyler, University Park, Venus, Waco, Watauga, Waxahachie, Westlake, Whitesboro, White Settlement, Wichita Falls, Woodway, and Wylie.

The City of Dallas intervened in the proceeding on July 27, 2012, and CoServ Gas, Ltd., intervened on July 31, 2012.

On June 22, 2012, the Examiners issued, in electronic format, a draft of the Examiners' Schedules that the Examiners intended to use as the case was processed. These integrated schedules were structured upon the schedules provided by the company and provided an overlay that has become familiar in rate proceedings at the Commission. The use of integrated schedules to summarize the recommendations of the Examiners and the final decision of the Commission was first implemented in GUD No. 9902.<sup>3</sup> In GUD No. 10000 a version of the integrated schedules were issued after the case was filed and the parties were directed to specifically identify and describe any adjustment on those schedules (Examiners' Model). The application of these schedules in the Commission's evaluation of the rate proceeding increases the transparency of the process. Once the Commission makes a final determination, the entries in schedules are changed and the revised schedules become the schedules that accompany, and are referenced by, the Final Order.

At the time the Examiners' Model was issued the Examiners made an explicit ruling in this proceeding that parties requesting a change to the proposed rates were directed to specifically identify the worksheet that is to be revised and the specific entry that is to be adjusted:

Parties requesting a change to the proposed rates are directed to specifically identify the worksheet that is to be revised and the specific entry that is to be adjusted. The Examiners request that the printed forms be referenced and that the electronic forms also be referenced. As to the printed forms, the Examiners request that the schedule, line number and column number of each affected entry be identified. The parties are directed to also reference the relevant electronic Excel worksheet and cells. Finally, the Examiners request that any party requesting a change to the proposed rates provide electronic schedules that include the proposed change.<sup>4</sup>

The hearing in this matter commenced on September 12, 2012, and was concluded on September 21, 2012. The following individuals testified on behalf of Atmos Energy Corporation, West Texas Division: David Park, Vice-President of Rates and Regulatory Affairs for the Mid-Tex Division of Atmos Energy Corporation; Thomas H. Petersen, Rates Director for Atmos Energy Corporation; Barbara W. Myers, Regulatory Accounting Manager for Atmos Energy Corporation; Daniel M. Meziere, Vice President and Treasurer, Atmos Energy Corporation; Robert B. Hevert, Managing Partner of Sussex Economic Advisors, LLC Inc., and Executive Advisor to Conentric Energy Advisors, Inc.; Paul H. Raab, an independent economic consultant; Gary L. Smith, Director of Rates and Regulatory Affairs for Atmos Energy

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<sup>3</sup> Tex. R.R. Comm'n, *Statement of Intent of CenterPoint Energy Corp.*, Docket No. 9902 (Gas Utils. Div. Feb. 23, 2010) (Final Order) (GUD No. 9902).

<sup>4</sup> Examiners' Letter No. 10 (Footnotes Omitted).

Corporation; and, Jeffrey S. Knights, Vice President of Operations for the Mid-Tex Division of Atmos Energy Corporation.

The parties refer extensively to prior precedent of Atmos Energy Corp. The Examiners take judicial notice of the following dockets:

*Tex. R.R. Comm'n, Petition for De Novo Review of the Reduction of the Gas Utility Rates of Atmos Energy Corp., Mid-Tex Division, by the Cities of Blue Ridge, Caddo Mills et al; Atmos Energy Corporation Statement of Intent to Change Rates in the Atmos Energy Corp., Mid-Tex Division Gas Utility System; Petition for Review from the Actions of Municipalities Denying Rate Request, Docket No. 9670 (Gas Utils. Div. June 13, 2007) (Final Order) (GUD No. 9670).*

*Tex. R.R. Comm'n, Statement of Intent filed by Atmos Energy Corporation to Increase Utility Rates within the Unincorporated Areas Served by the Atmos Energy Corp., Mid-Tex Division and Petition for De Novo Review of the Denial of the Statement of Intent filed by Atmos in Various Municipalities, Docket No. 9762 (Gas Utils. Div. June 24, 2008) (Final Order) (GUD No. 9762).*

*Tex. R.R. Comm'n, Petition for De Novo Review of the Denial of the Statement of Intent filed by Atmos Energy Corp., Mid-Tex Division by the City of Dallas; Statement of Intent to Increase Gas Utility Rates in the Unincorporated Areas Served by the Mid-Tex Division, Docket No. 9869 (Gas Utils. Div. February 23, 2010) (Final Order Nunc Pro Tunc) (GUD No. 9869).*

*Tex. R.R. Comm'n, Statement of Intent to Change the Rate CGS and Rate PT of Atmos Pipeline – Texas, Docket No. 10000 (Gas Utils. Div. April 18, 2011) (Final Order) (GUD No. 10000).*

*Tex. R.R. Comm'n, Statement of Intent filed Atmos Energy Corporation, West Texas Division to Change Gas Rates in the Unincorporated Areas of the Amarillo Rate Division, Docket No. 10041 (Gas Utils. Div. July 26, 2011) (Final Order) (GUD No. 10041).*

*Tex. R.R. Comm'n, Statement of Intent filed Atmos Energy Corporation, West Texas Division to Change Gas Rates in the Unincorporated Areas of the Lubbock Rate Division, Docket No. 10084 (Gas Utils. Div. November 8, 2011) (Final Order) (GUD No. 10084).*

The parties also refer frequently to the following docket and the Examiners take judicial notice:

*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).*

With issuance of this proposal for decision, the Examiners close the evidentiary record in GUD No. 10170.

## **2. Jurisdiction**

The Commission has jurisdiction over the applicant, associated affiliates 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 (Vernon 2007 and Supp. 2012). The statutes and rules involved in this proceeding include, but are not limited to TEX. UTIL. CODE ANN. §§ 104.101, 104.102, 104.103, 104.105, 104.106, 104.107, 104.110, 104.301, and 16 TEX. ADMIN. CODE Chapter 7.

## **3. Overview of the Company and the Mid-Tex Division**

Atmos Energy is one of the largest natural gas distribution companies in the United States exclusively devoted to the provision of natural gas service. The company delivers natural gas to approximately 3.2 million residential, commercial, industrial, and public authority customers in twelve states. Atmos Energy has six unincorporated gas utility operating divisions. The operating divisions are located in Lubbock, Texas (West Texas Division); Dallas, Texas (Mid-Tex Division); Baton Rouge, Louisiana (Louisiana Division); Jackson, Mississippi (Mississippi Division); Denver, Colorado (Colorado/Kansas Division); and Franklin, Tennessee and Owensboro, Kentucky (Kentucky/Mid-States Division). In addition, Atmos Energy has an operating division, Atmos Pipeline – Texas, which consists of a regulated intrastate pipeline that operates only within Texas. Each of Atmos Energy's utility divisions has its own divisional office that is responsible for the day-to-day operations that are unique to that division.

Several functions that are shared among the divisions are handled by the company's Shared Services Unit (SSU). The company's corporate office is located in Dallas, Texas, and provides services such as accounting, legal, human resources, rates administration, procurement, gas supply, information technology, and customer care. Customer support call centers are located in Amarillo and Waco, Texas. These centralized services, referred to in the Statement of Intent filing and herein as Shared Services, are shared by the company's distribution operating divisions.<sup>5</sup>

The utility operations in the Mid-Tex Division include more than 29,000 miles of mains and greater than 320 miles of transmission pipeline in over 440 cities, towns, and unincorporated areas. The Mid-Tex Division has approximately 350 employees and serves approximately 1.5 million customers in 442 incorporated and unincorporated areas in north and central Texas.<sup>6</sup>

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<sup>5</sup> Atmos Ex. 5, Direct Testimony of David J. Park, p. 11, ln. 1 – p. 12, ln. 2 & Atmos Ex. 12, Direct Testimony of Jeffrey S. Knights, p. 5, lns. 15 – 23.

<sup>6</sup> Atmos Ex. 5, Direct Testimony of David J. Park, p. 12, lns. 4 – 10.

#### 4. Books and Records

Barbara W. Myers, Manager of Rates and Regulatory Affairs for Atmos, testified that Atmos Mid-Tex maintains its books and records in accordance with the Commission's regulations.<sup>7</sup> Namely, Rule 7.310 requires that each gas utility utilize the Federal Energy Regulatory Commission's (FERC) Uniform System of Accounts prescribed for Natural Gas Companies subject to the provision of the Natural Gas Act for all operating and reporting purposes. The FERC Uniform System of Accounts is applicable to all gas utility and gas utility related operations. Ms. Myers asserted that the company maintains its books and records in accordance with Commission Rule 7.310 and the amounts included therein are therefore subject to the presumption that they are reasonable and necessary. Atmos Mid-Tex established that it has fully complied with the requirements of Rule 7.310 and the Examiners find that the amounts noted therein are subject to the presumption encapsulated in Rule 7.503.

As a result, any challenge to the company's requested revenue requirement must be specifically and precisely described. To that end, the Examiners' issued the ruling in Examiners' Letter No. 10, requiring that any proposed change must identify the modification requested by noting the change on the Examiners' Model. Failure to precisely identify the proposed adjustment necessarily implies that the presumption encapsulated in Rule 7.503 has not been rebutted and raises due process considerations.

In *Railroad Commission v. Lone Star Gas Company*, the Austin Court of Appeals considered an appeal of a natural gas ratemaking proceeding.<sup>8</sup> In that case, the Examiners established the rate of return based upon a calculation made by the Examiners. The trial court set aside the order of the Commission and the Court of Appeals affirmed the trial court ruling. The Court of Appeals held that the order of the Commission may not be based upon the application of agency expertise as a substitute for evidence and as a basis for making factual findings as to matters not supported by record evidence.<sup>9</sup> Failure to precisely identify a specific adjustment as directed by the Examiners is indicative of a record that may lack a firm evidentiary foundation.

Finally, aside from the legal issues raised, failure to specifically and precisely describe a proposed adjustment results in added transactional expense incurred by all parties in evaluating proposed changes. Accordingly, the Examiners recommend that the proposed adjustment be rejected.

#### 5. Overview of the Company's Rate Request

The original filing included an overall revenue requirement, excluding gas costs, of \$471,882,773.<sup>10</sup> An errata filing was submitted on July 13, 2012 (July 13<sup>th</sup> Errata).<sup>11</sup> The July 13<sup>th</sup> Errata incorporated several corrections and changes that were identified after the case was filed and during discovery. It included an overall revenue requirement, excluding gas costs, of

<sup>7</sup> Atmos Ex. 7, Direct Testimony of Barbara W. Myers, pp. 9-20.

<sup>8</sup> 611 S.W.2d 908 (Tex. App. – Austin 1981, writ refused n.r.e).

<sup>9</sup> *Id* at 911.

<sup>10</sup> Atmos Ex. 1, Statement of Intent, Cost of Service Schedules, Schedule A, ln. 20, col. (d).

<sup>11</sup> Atmos Ex. 2, Atmos Errata Filing, July 13, 2012.



\$459,168,904.<sup>12</sup> On September 4, 2012, Atmos filed an update, that incorporated several modifications and corrections that were identified during discovery (September 4<sup>th</sup> Update). The overall revenue request, excluding gas costs, included in the September 4<sup>th</sup> Update was \$455,661,452.<sup>13</sup> This filing represented the final request of the company after incorporating several changes and modifications. Those changes were identified during the review of the case after it was filed and resulted in a decrease from the original request of \$16,221,321.

The updates also included a change in the current revenues of the company. On April 10, 2012, Atmos filed an application for an annual interim rate adjustment (IRA) applicable to customers located in the Mid-Tex Environs. On June 26, 2012, in GUD No. 10162, the Commission approved an interim rate adjustment increase in rates charged in the Mid-Tex Environs for the Test Year 2011. Based upon this change, the current revenue projection changed to \$423,967,034.<sup>14</sup> Thus, the company's rate increase request, included in the original filing, would have resulted in an increase of \$47,915,739 in the company's overall revenues. The September 4<sup>th</sup> Update, however, would result in an overall revenue increase of \$31,690,380. This is a reduction of approximately \$16,225,359.<sup>15</sup> This represents a nearly 34% decrease from the overall revenue request increase originally included in the Statement of Intent filing.

The municipal rates and the environs rates for the Atmos Mid-Tex Division are not currently the same. Currently, the municipal rates for residential customers are as follows:

- (a) A customer charge of \$7.50, plus
- (b) A volumetric charge of \$0.25116 per Ccf<sup>16</sup>

Thus, residential rates within the municipalities are governed by the following formula:

$$\text{Formula 5.1} \\ 7.50 + \$0.25116(\text{Volume [Ccf] Consumed}) = \text{Rate}$$

The environs rates for residential customers are as follows:

- (a) A customer charge of \$18.87, plus
- (b) A volumetric charge of \$0.04315 per Ccf<sup>17</sup>

Thus, residential rates within the environs are governed by the following formula:

$$\text{Formula 5.2} \\ 18.87 + \$0.04315(\text{Volume [Ccf] Consumed}) = \text{Rate}$$

<sup>12</sup> Atmos Ex. 2, Atmos Errata Filing, July 13, 2012, Cost of Service Schedules, Schedule A, ln. 20, col(d).

<sup>13</sup> Atmos Ex. 3, Appeal Update Filing Dated September 4, 2012, Schedule A, ln. 20, col(d).

<sup>14</sup> Examiners Schedule, Schedule A(0), ln. 22, col. b "Total."

<sup>15</sup> The difference of \$4,308 is due to rounding in the calculation of proposed revenues.

<sup>16</sup> Atmos Ex. 3, Appeal Update Filing Dated September 4, 2012, Cost of Service Appeal, Schedule J, col(b).

<sup>17</sup> Atmos Ex. 3, Appeal Update Filing Dated September 4, 2012, Cost of Service Unincorporated, Schedule J, col(b).

The proposed rates requested in the September 4<sup>th</sup> Update for all residential customers were, as follows:

- (a) A customer charge of \$18.00, plus
- (b) A volumetric charge of \$0.05738 per Ccf<sup>18</sup>

Thus, the proposed residential rates are governed by the following formula.

$$\text{Formula 5.3} \\ 18.00 + \$0.25116(\text{Volume [Ccf] Consumed}) = \text{Rate}$$

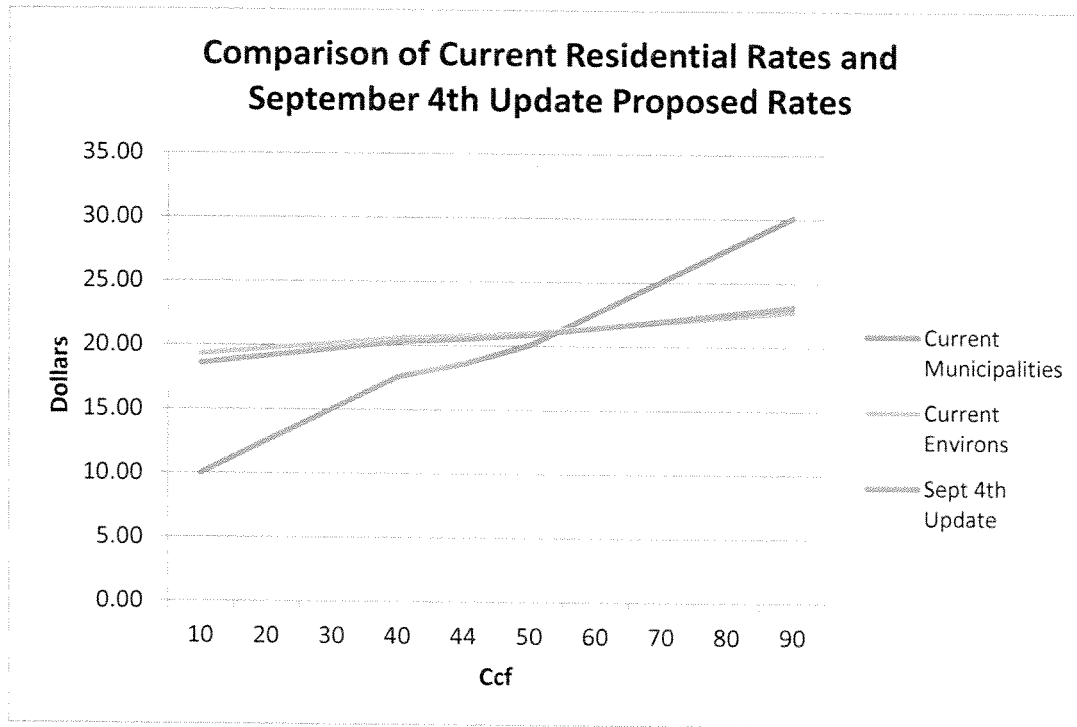
As for these proposed rate changes, the Atmos Mid-Tex Division included a rate comparison in its notice for the average residential customer. That comparison was based upon an average consumption level of 44 Ccf. An average residential customer who consumes 44 Ccf will experience a rate increase of 10.64%, excluding gas costs based upon the proposed rates. Another point of comparison may be gleaned from the underlying assumption of average bill comparison published annually by the Commission entitled, "Six Mcf Residential Gas Analysis." This comparison is based upon the assumption of a consumption level of 60 Ccf. Based upon that consumption level, a residential customer within the municipalities would have experienced a rate decrease of 4.99%. On the other hand, the residential customer in the environs who consumes 60 Ccf would experience a rate decrease of 0.08%. Table 5.1 below provides a summary of the rate impact at various consumption levels and Figure 5.1 provides a linear comparison of three rates.

Table 5.1  
Rate Impact for Residential Customers

	Municipalities	Environs
10	85.52%	-3.77%
20	52.90%	-2.97%
30	31.17%	-2.20%
40	15.67%	-1.46%
50	4.04%	-0.75%
60	-4.99%	-0.08%
70	-12.22%	0.58%
80	-18.13%	1.20%
90	-23.05%	1.80%

<sup>18</sup> Atmos Ex. 3, Appeal Update Filing Dated September 4, 2012, Cost of Service Unincorporated, Schedule J, col(b).

Figure 5.1



On a system-wide basis, the company estimated that the impact of the proposed change in rates on environs customers reduces the revenues generated by those customers by \$326,609. On the other hand, on a system-wide basis, Atmos estimated that the impact of the proposed change in rates would result in an increase in revenues generated by municipal customers in the amount of \$34,966,677.

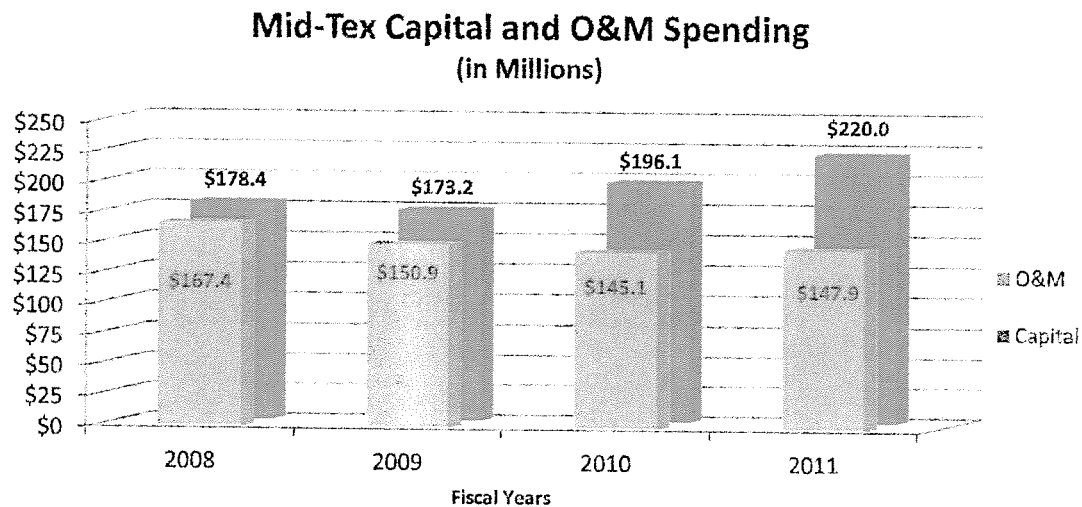
Based on the information provided, the Examiners have attempted to isolate the changes in base rates for the environs and the municipalities on a non-system-wide basis. That analysis is set out in Examiners' Schedule 5. Those schedules compare revenues from environs customers (residential, commercial, and industrial and transportation customers) based upon current rates to revenues from environs customers based upon proposed rates. The analysis confirms that the proposed rates will result in a decrease to the base-rate revenues generated by environs customers. The analysis also confirms that base-rate revenues generated from municipal customers will increase.

David Park, who served as Vice President of Rates and Regulatory Affairs at the time this case was filed, testified that the Atmos Mid-Tex Division has made a concerted effort to keep operation and maintenance expenses down.<sup>19</sup> At the same time, he stated that the company has had to make necessary investments to ensure the safety and reliability of the Atmos Mid-Tex system. He noted that the company has experienced increasing levels of capital investment required to replace aging infrastructure and to respond to the demands placed on the system by

<sup>19</sup> Mr. Park is now the President of the Atmos West Texas Division. Atmos Ex. 8, David J. Park Direct, p. 2, Ins. 1 – 11.

customer growth. Mr. Park provided a figure that contrasted the increasing levels of capital investment with the declining levels of operation and maintenance expense. That figure is reproduced below as Figure 5.2.

Figure 5.2  
O&M Expense and Capital Investment 2008 - 2011<sup>20</sup>



In this filing, the Company is also proposing to replace its existing conservation and energy efficiency tariff with a new Rider CEE. Rider CEE was initially adopted for the Company's use in GUD No. 9762. As originally designed, the conservation program implemented under Rider CEE was a voucher program that provided free energy saving materials and supplies to eligible customers. In GUD No. 9869, Rider CEE was revised to offer a broader spectrum of conservation and energy efficiency programs and services to those customers. Mr. Park testified that unlike the existing tariff, which is limited to low income customers and senior citizens, the proposed Rider CEE will offer assistance to residential and commercial customers to encourage reductions in energy consumption and lower energy utility bills.<sup>21</sup> Cost recovery under the new Rider CEE will occur through the Residential and Commercial customer charge using the cost recovery factor set forth in the proposed Rider CEE. The Company is proposing that ratepayers fully fund the program at \$2,000,000 annually.

Turning to another issue, as originally filed this docket proposed a new Rate Review Mechanism (RRM) that was modeled after the Rider DARR that was adopted by the City of Dallas in June 2011.<sup>22</sup> Mr. Park testified that the on-going capital needs of Atmos' system

<sup>20</sup> Atmos Ex. 8, David J. Park Direct, Exhibit DJP-3.

<sup>21</sup> Atmos Ex. 5, Direct Testimony of David J. Park, pp. 15-17.

<sup>22</sup> The City of Dallas approved new rates under DARR effective June 1, 2012.

require that rates be updated for the company to recover these costs and earn a reasonable return on its investment.<sup>23</sup> While the GRIP statute provides a means to adjust unincorporated areas rates for the company to capture changes in capital investment, the GRIP mechanism is not currently available within the company's incorporated areas. So, Atmos has relied upon the RRM process to adjust rates that were in effect in all municipalities within the Atmos Mid-Tex Division. The proposed RRM was designed to provide for an annual review of the Company's expenses, revenues and rate base investment, and a corresponding adjustment to the Company's rates to reflect annual changes (increases or decreases) in these categories.

Atmos, however, withdrew consideration of the RRM in this docket. Mr. Park testified in rebuttal that for the RRM tariff to work effectively, both the company and the regulator must agree upon a basic construct. The Intervenor proposed several changes to the RRM. Also, Commission Staff proposed recovery limitation revisions that the company opposed. Consequently, Atmos no longer requests approval of the RRM in this case.<sup>24</sup>

## **6. Overview of Rate Base, O&M Expenses, and Depreciation Expenses**

Atmos Energy consists of seven unincorporated operating divisions. Six of the operating divisions are regulated gas distribution utilities. One is a regulated intrastate natural gas pipeline.<sup>25</sup> Atmos Mid-Tex is a regulated gas distribution utility operating division, whereas Atmos Texas Pipeline is a regulated pipeline. The calculation of investment expenses in rate base and operating and maintenance expenses for Atmos Mid-Tex is based upon the level of investments and expenses for the test period in this case. The test period in this case is the twelve months ending September 30, 2011.<sup>26</sup>

Investments in rate base and operating and maintenance expenses necessary for the operation of Atmos Mid-Tex occur at two levels. Atmos Mid-Tex incurs both direct costs and allocated costs related to investment and operating and maintenance expenses required by the company's shared services unit.

The total costs associated with rate base included in the cost of service analysis is \$1,514,381,222.<sup>27</sup> Atmos also included operation and maintenance expenses of \$150,199,427,<sup>28</sup> and depreciation expenses of \$94,252,318.<sup>29</sup> In order to establish the contribution to rate base, operation and maintenance expenses, and depreciation expenses, the Commission must evaluate the allocation methodology of expenses incurred by the company's shared services unit.

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<sup>23</sup> Atmos Ex. 5, Direct Testimony of David J. Park, p. 6, lns. 6-8.

<sup>24</sup> Atmos Ex. 15, Rebuttal Testimony of David J. Park, pp. 7-9.

<sup>25</sup> Atmos Ex. 5, Direct Testimony of David J. Park, Exhibit DJP – 1.

<sup>26</sup> Atmos Ex. 7, Direct Testimony of Barbara W. Myers, p. 3, ln. 28.

<sup>27</sup> Atmos Ex. 3, Appeal Update Filing Dated September 4, 2012, Cost of Service Appeal & Unincorporated Filing, Schedule A, ln. 14, col. (c).

<sup>28</sup> Atmos Ex. 3, Appeal Update Filing Dated September 4, 2012, Cost of Service Appeal & Unincorporated Filing, Schedule A, ln. 6, col. (d).

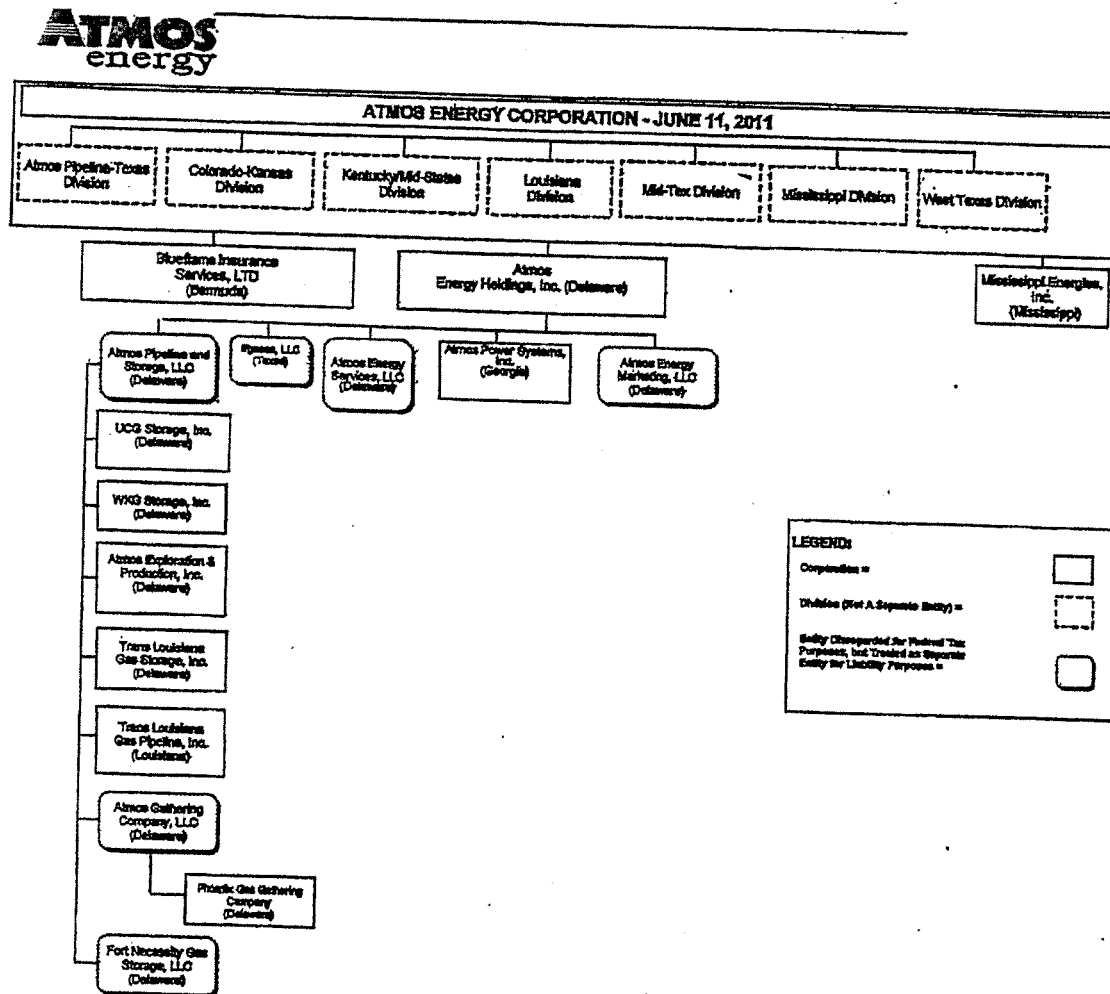
<sup>29</sup> Atmos Ex. 3, Appeal Update Filing Dated September 4, 2012, Cost of Service Appeal & Unincorporated Filing, Schedule A, ln. 10, col. (d).

## 7. Shared Services Unit (SSU) Allocation

### a. Introduction

As noted above, Atmos Energy Corporation consists of seven distribution utilities, a regulated pipeline and various subsidiaries. The company conducts its unregulated operations through its subsidiaries. A chart, showing the corporate structure is reproduced in Figure 7.1 below.<sup>30</sup>

Figure 7.1  
Atmos Corporate Structure



Technical and support services are provided to the operating divisions by centralized shared services departments primarily located at the Atmos headquarters in Dallas. In this proceeding, the collective shared services department are referred to as the "Shared Services Unit" (SSU). The centralized functions provided by the Shared Services Unit include, but are

<sup>30</sup> Atmos Ex. 7, Barbara W. Myers Direct, p.23, Ins. 1-3, Exhibit BWM-2, Appendix A.

not limited to, accounting, gas supply, human resources, information, technology, legal, rates and customer support.<sup>31</sup> The Shared Services Unit is comprised of two divisions:

- Shared Services – Customer Support (sometimes referred to as SSU Customer Support). This division provides functions that include billing, customer call functions and customer support related functions.
- Shared Services – General Office (sometimes referred to as SSU General Office). This division provides functions that include accounting, human resources, legal, rates, risk management and others.

Section 7.5252(b) requires that in any rate proceeding where items of plant, revenues, expenses, taxes, or reserves are shared by or are common to the service area in question and any other service area, those items must be allocated fairly and justly apportioned between the area in question and any other service area of the utility. Costs that are directly attributable and incurred for the sole purpose of operations related to the Atmos Mid-Tex Division are allocated directly to that division.<sup>32</sup> For example, the Shared Services Unit, Dallas Supply Planning (SSU 1831) is allocated entirely to the Atmos Mid-Tex Division. In order to allocate shared costs in compliance with Commission regulations, and the regulations of other jurisdictions where Atmos provided natural gas service, the company has developed a Cost Allocation Manual (CAM).

The CAM allocates two broad categories of costs. First, operation and maintenance expenses, depreciation, and taxes, other than income taxes, related to shared services are allocated on the company's general ledger utilizing the allocation methodologies described in detail in the CAM. Second, shared services that are not allocated on the company's general ledger are allocated based upon a *composite factor* (Composite Factor) or *customer factor* (Customer Factor). Examples of this latter category of cost include plant in service, accumulated deferred income taxes, and other general rate base items.<sup>33</sup>

The Composite Factor was derived based upon a four-factor formula comprised of the simple average of the relative percentage of gross plant in service, the relative percentages of the average number of customers, the relative percentages of direct operating and maintenance expense for each of the company's operating divisions, and operating income. These factors are summarized as follows:

- Gross Direct Property Plant and Equipment
- Number of Customers
- Operating Expenses
- Operating Income

The use of the four-factor formula was first required by the Commission in GUD No. 9670 and its use was affirmed in GUD Nos. 9762, 9869, and 10000.<sup>34</sup>

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<sup>31</sup> Atmos Ex. 7, Barbara W. Myers Direct, Exhibit BWM-2, p.2.

<sup>32</sup> Atmos Ex. 3, Appeal Update Filing Dated September 4, 2012, Schedule WP\_F-2.7, In. 80.

<sup>33</sup> Atmos Ex. 7, Barbara W. Myers Direct, p. 28, Ins. 1 – 20.

<sup>34</sup> Atmos Ex. 7, Barbara W. Myers Direct, p. 29, Ins. 1-20. This is not the method used to allocate costs in the general ledger. ACSC Ex. 3, Constance T. Cannady, p. 7, Ins. 6 – 22 and ATM Ex. 1, Michael L. Brosch, p. 18, Ins. 17 – 24.

The Customer Factor is derived based on the average number of customers in each operating division that receives allocable costs for services provided. The Customer Factor was proposed by the company and subsequently approved by the Commission in GUD Nos. 9670, 9762, and 9869.<sup>35</sup>

The factors used in this case were calculated excluding Illinois, Iowa and Missouri data. Prior to August 1, 2012, the Atmos Energy Kentucky/Mid-States Division was an operating division that operated in more than 420 communities across Georgia, *Illinois*, *Iowa*, Kentucky, *Missouri*, Tennessee and Virginia.<sup>36</sup> On May 12, 2011, Atmos entered into an agreement to sell all of its natural gas distribution assets located in Missouri, Illinois, and Iowa to Liberty Energy (Midstates) Corporation (Liberty Energy), an affiliate of Algonquin Power & Utilities Corp. The transaction closed August 1, 2012.<sup>37</sup>

The company asserted that this was not a change in methodology. Rather, the company considered this adjustment to the calculation of the factors to be an update to the allocation factors to reflect a known and measurable change. ACSC and ATM contended that the adjustment to the allocation factors was not just and reasonable.

b. Intervenor's Position

Constance T. Cannady, testified on behalf of ACSC, and Michael L. Brosch testified on behalf of ATM. The witnesses raised overlapping issues. First, the sale was finalized almost a year after the end of the test year. The timing of the sale precludes incorporation of the change in this filing with a test year ending September 30, 2011.<sup>38</sup> Second, the overall financial impact of the sale was not known and measurable because Atmos failed to account for any expected reductions in common costs. They contended that a downsize in the asset would be accompanied by downsized costs.<sup>39</sup> Third, Atmos will realize a gain on the sale of the assets that are retained for the sole benefit of shareholders.<sup>40</sup> Fourth, the cost of service analysis prepared by the company does not reflect compensation for transaction services to Liberty Energy.<sup>41</sup> Fifth, the position of Atmos is contrary to the position taken in a prior proceeding, GUD No. 9002 – 9135.<sup>42</sup>

ATM and ACSC both proposed that the allocation factors be recalculated based upon factors that are calculated using data from the systems in Illinois, Iowa and Missouri that were sold to Liberty Energy.<sup>43</sup> Although the company did request application of allocation factors using the data from those systems, the company's statement of intent provided supporting documentation showing the application of allocation factors that used that data.<sup>44</sup> The allocation

<sup>35</sup> Atmos Ex. 7, Barbara W. Myers Direct, p. 29, Ins. 10 – 13 & ATM Ex. 1, Michael L. Brosch, p. 18, In. 24 – p. 19, In. 5.

<sup>36</sup> Atmos Ex. 7, Barbara W. Myers Direct, Exhibit BMW -2, p. 5.

<sup>37</sup> Atmos Ex. 7, Barbara W. Myers Direct, p. 29, Ins. 18 – 23.

<sup>38</sup> ATM Ex. 1, Michael L. Brosch, p. 22, Ins. 13 – 22 & ACSC Ex. 3, Constance T. Cannady, p. 8, Ins. 7 – 14.

<sup>39</sup> ATM Ex. 1, Michael L. Brosch, p. 21, Ins. 6 – 17 & ACSC Ex. 3, Constance T. Cannady, p. 8, Ins. 15 – 19.

<sup>40</sup> ATM Ex. 1, Michael L. Brosch, p. 21, In. 18 – p. 22, In. 12.

<sup>41</sup> ATM Ex. 1, Michael L. Brosch, p. 23, Ins. 1 – 17.

<sup>42</sup> ATM Ex. 1, Michael L. Brosch, p. 23, In. 19 – p. 24, In. 12 & ACSC Ex. 3, Constance T. Cannady, p. 8, In. 20 – p. 9, In. 15.

<sup>43</sup> ATM Ex. 1, Michael L. Brosch, p. 24, Ins. 13 – 22 & ACSC Ex. 3, Constance T. Cannady, p. 9, In. 16 – p. 11, In. 3 & Schedule CTC – 3.

<sup>44</sup> Atmos Ex. 1, Statement of Intent Filing, Electronic Data, Allocation Rates FY 12 by Cost Center.



factors applied by ACSC matched the factors in the supporting data provided by Atmos. The allocation factors applied by ATM did not match the factors supporting data provided by Atmos.

c. Company's Response

Barbara Myers, who testified on behalf of Atmos, explained that ATM had incorrectly applied the allocation factors that reflected the data from the systems in Illinois, Iowa and Missouri.<sup>45</sup> First, although the sale occurred nearly a year after the end of the test year, it occurred only four months after the update provided by the company in the Statement of Intent filed in this case. Second, the sale of these facilities is known and measurable but any other change is not known and measurable. Further, there is no reason to believe that the costs of the Shared Services Unit will decrease. Third, ultimately the proceeds of the sale will benefit ratepayers because the funds will be used to fund growth opportunities in the remaining jurisdictions. Fourth, any transitional service agreement billing and reimbursements are temporary in nature and nonrecurring. Fifth, this case is simply not analogous to GUD Nos. 9002-9135. The timing of the sale at issue in that case was different. The purchase of one asset occurred after the hearing in that case and the adjustments in that case were not known and measurable.

d. Examiners' Recommendation

The Examiners find that Atmos has established that the Shared Services Unit allocation factors were correctly calculated. As an initial point, it is correct that ATM has not correctly applied its proposed change. ACSC, on the other hand, correctly applied the proposed change. To the extent the Commission finds that the allocation factors should be recalculated the Examiners recommend that the adjustment proposed by ATM be rejected and instead the adjustment proposed by ACSC be applied. The correctly applied adjustment will reduce the revenue requirement by \$1,417,182. As noted, however, the Examiners find that no adjustment is required.

Atmos has established the following facts. First, while the transaction closed August 1, 2012, it was known on May 12, 2011. Additionally, the close of the transaction occurred within close proximity to the updated data provided by the company in this case. Second, the sale is a known and measurable event that has already occurred. There are no other measurable changes at this time. The company has not eliminated a division – it has only reduced the service area of the affected division, the Kentucky/Mid-States Division. There is insufficient evidence in this case to establish that this change, that does not result in the elimination of a division, will have an impact on the staffing levels of the shared services unit. As of the date of the hearing, Ms. Myers testified that there have been no changes to the Shared Service Unit attributable to the transaction.<sup>46</sup>

Ms. Myers was asked about several cost centers and she was unequivocal in her assertion that she did not foresee any changes in the overall level of Shared Service expenses as a result of the sale of those systems. In particular, Ms. Myers was asked whether expenses related to Cost

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<sup>45</sup> Atmos Ex. 15, p. 12, lns. 6 – 12.

<sup>46</sup> Tr. Vol. 4, p. 98.

Center 1154, Dallas Rates & Regulatory, would be impacted by the sale. Ms. Myers testified as follows:

Certainly doesn't. And I know for a fact that cost center will not, because that happens to be the cost center in which I reside. So we have no planned reductions in our department nor would there be any necessary changes.<sup>47</sup>

As asserted by Atmos, the Examiners were persuaded by evidence that ratepayers will ultimately benefit from the sale of the asset and that any interim transactional agreement between the company and Liberty Energy is temporary. Moreover, the facts of GUD Nos. 9002 – 9135 are not applicable to this case. As conceded by Ms. Cannady, that case was settled after the issuance of a Proposal for Decision and the Commission order did not address the issue.<sup>48</sup> Finally, the timing and circumstances of the transaction issue in that case is distinguishable from the timing and circumstances related to the system sold by Atmos in Missouri, Iowa, and Illinois.

## 8. Operation and Maintenance Expenses

### a. Introduction

The overall operation and maintenance expense requested by Atmos in the *Statement of Intent* filing was \$152,490,153.<sup>49</sup> The July 13<sup>th</sup> Errata included an operation and maintenance expense request of \$152,419,166<sup>50</sup> and the September 4<sup>th</sup> Update included a request for operation and maintenance totaling \$150,199,427.<sup>51</sup> Consequently, Atmos reduced its initial request by \$2,290,726. This reduction was due, in part, to the review and scrutiny of the initial application by the Intervenor and additional analysis by Atmos after the case was filed. Therefore, the reduction is a product of the Railroad Commission proceeding.

The parties have alleged that Atmos has not met its burden of proof in eight areas:

1. Base Payroll
2. Medical and Dental Benefits Expense
3. Pension Expense
4. Incentive Compensation
5. Supplemental Executive Pension and Benefits
6. FAS 106 Expenses
7. Amortized Injuries and Damages, and
8. Affiliate Expenses

The Intervenor asserts that various adjustments should be made to the company's calculation of the cost of service in each of these enumerated categories.

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<sup>47</sup> Tr. Vol. 4, p. 114.

<sup>48</sup> ACSC Ex. 3, Constance T. Cannady, p. 9, Ins. 8 – 10.

<sup>49</sup> Atmos Ex. 1, Statement of Intent, Cost of Service Schedules, Schedule A, p. 2, ln. 6, col(d).

<sup>50</sup> Atmos Ex. 2, Atmos Errata Filing, July 13, 2012, Schedule A, Cost of Service Appeal p. 2, ln. 6, col(d) & Cost of Service Unincorporated, p. 2, ln. 6, col(d).

<sup>51</sup> Atmos Ex. 3, September 4, 2012, Schedule A, Cost of Service Appeal p. 2, ln. 6, col(d) & Cost of Service Unincorporated, p. 2, ln. 6, col(d).

As set out in detail below, the Examiners recommend three adjustments to the operation and maintenance request of the company. First, in the context of injuries and damages, the Intervenor has established the potential for over recovery. The Examiners recommend that a reserve be established to track any over recovery. The amounts recovered in excess of the approved balance be refunded to customer in the next rate proceeding. Second, the Examiners recommend that insurance expenses for construction work in progress (CWIP) be excluded. The effect of this adjustment is to reduce the operation and maintenance expense by \$11,932. Third, in the context of a cancellation fee related to insurance the Examiners again recommend that a reserve be established to track any over recovery. The amounts recovered in excess of the approved balance be refunded to customer in the next rate proceeding.

The Examiners findings regarding the operation and maintenance expenses are due, in large measure, to the company's careful adherence to the Commission's determination in prior proceedings, GUD Nos. 9670, 9762, 9869, and 10000. In each area analyzed in this section the Examiners find that the company has established that its request is just and reasonable and consistent with the precedent enumerated above.

b. Base Payroll

(a) Introduction

The test year in this case is the twelve-month period ending September 30, 2011. The total test-year level of base payroll for SSU was \$60,070,586. A portion of this amount was ultimately allocated to the Atmos Mid-Tex Division. This amount does not include cost centers which do not allocate to the Atmos Mid-Tex Division and employee time charged below the line for rate making purposes. The total test-year level of base labor expense for employees of the Atmos Mid-Tex was \$84,883,392.<sup>52</sup>

Atmos calculated an adjustment to these amounts to annualize employee salaries as of October 2011. The result of the proposed adjustment was an increase to the company's base labor expense included in the cost of service calculation totaling \$2,181,858. Barbara W. Myers explained this adjustment. The base salaries at October 2011, include the effective annual merit increase of 2.95%. The merit increases occurred October 1<sup>st</sup>. The base salaries included in the calculation are for actual Atmos Mid-Tex Division employees and SSU employees at October 31, 2012. The base labor adjustment was calculated by comparing the base labor per book to the annualized Atmos Mid-Tex Division and SSU employee's actual base salary at October 2011.<sup>53</sup> There is no dispute regarding the test year level of base payroll expenses. The dispute focuses upon the post-test-year adjustment. ACSC contended that the post-test-year adjustment was not correctly calculated.

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<sup>52</sup> Atmos Ex. 3, Appeal Update September 4, 2012, Cost of Service Appeal, Schedule WP\_F-2.1, ln. 3 & Cost of Service Unincorporated, Schedule WP\_F-2.1, ln. 3.

<sup>53</sup> Atmos Ex. 7, Barbara W. Myers Direct, p. 33, lns. 5 – 18 & Atmos Ex. 16, p. 27, ln. 12 – 28, ln. 2.

(b) Overview of Issues Raised

Constance T. Cannady, on behalf of ACSC, proposed two adjustments to base labor.<sup>54</sup> First, she proposed that the labor adjustment be based upon the level of labor experienced as of December 31, 2011. Ms. Cannady made this proposal to match the labor expense to the level of plant recommended by Mr. Nalepa. Second, Ms. Cannady recommended an adjustment to the capitalization factor for SSU labor. Atmos proposed a capitalization factor based upon the ratio of capitalized labor to net labor documented by the company during the test year. This calculation was based upon the exclusion of certain capitalized labor accounts and the exclusion of capitalized labor that was transferred to other Atmos entities. Ms. Cannady proposed a calculation of the capitalization ratio based upon an evaluation of the company's payroll tax calculation.

(c) Annualize Labor to December 2011

1. Introduction

As discussed below in Section 9, subsection b, ACSC argued that the company's inclusion of additions to plant in service through March 31, 2012 was unreasonable. ACSC explained that this update was six months after the end of the test year, which was the twelve-month period ended September 31, 2011. ACSC argued that all updates to the plant balances should be limited to December 31, 2011.

2. Intervenor's Position

In order to match this proposed adjustment, Ms. Cannady argued that base labor be updated to December 2011. This was in contrast to the company's proposal to annualize base labor through October 2011. This resulted in a December 2011 annualized employee salary of \$87,124,498 for employees of the Atmos Mid-Tex Division. Ms. Cannady's proposed adjustment resulted in a December 2011 annualized employee salary of \$26,947,276 for SSU – Customer Support, and \$35,259,585 for SSU – General Office Employees.

In order to arrive at these figures, Ms. Cannady first calculated the total labor expense for SSU Customer Support and SSU General Office. Ms. Cannady then removed the SSU labor expense that was not allocable to the Atmos Mid-Tex Division. In briefing, ACSC stated that the removal of expense from base payroll for compensation to employees in SSU cost centers not allocable to Atmos Mid-Tex was a distinct adjustment.<sup>55</sup> The briefing misapprehends the adjustment of its own witness. Ms. Cannady does not propose removal of additional expenses for SSU-employee salaries that are not allocable to the Atmos Mid-Tex Division. This is not a

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<sup>54</sup> Ms. Cannady identified an additional adjustment. She recommended that the allocation factors applied be based upon the allocation factors described in Section 7, above. The proposed adjustment is, in effect, simply a flow through of the adjustment addressed in Section 7, above. Accordingly, it need not be addressed here.

<sup>55</sup> ACSC Initial Brief, p. 23:

The Company is requesting an increase to base payroll. ACSC recommends several adjustments. First, ACSC recommends removal of expense from base payroll for compensation to employees in SSU cost centers not allocable to Mid-Tex (cites omitted).

separate adjustment. Ms. Cannady's schedule, Schedule CTC – 7,<sup>56</sup> clearly states that the appropriate expense level to be included in this calculation for SSU – General Expenses is \$35,658,661. This is the amount included by the company in its September 4<sup>th</sup> Update.

Ms. Cannady's proposed adjustment would have decreased the proposed base labor adjustment by \$25,191. Due to the flow through effect of this adjustment on Medical and Dental Benefits, Pension and Retiree Medical Benefits, and Uncollectible Expense, the overall effect of this adjustment on the operation and maintenance expense calculation is a decrease of \$68,958. Additionally, due to the flow through effect on taxes, the overall impact of this adjustment is to decrease the revenue requirement by \$71,729. Other than matching the labor expenses to ACSC proposed limit on the plant updates, Ms. Cannady offered no other rationale for this adjustment.<sup>57</sup>

### 3. Company's Response

Ms. Myers testified that the calculation of the base payroll adjustment was generally consistent with the calculation approved in GUD No. 9869. Additionally, Ms. Myers noted that the company's update to plant was consistent with the requirements of Examiners' Letter No. 10. In that letter, the Examiners ruled that any updates to the filing be made no later than July 13, 2012. Additionally, Ms. Myers argued that Ms. Cannady's adjustments to match expenses were inconsistent. Ms. Myers asserted that Ms. Cannady did not move all operation and expense categories to match them with ACSC's proposal to limit plant updated to the December 31, 2011 timeframe. She asserted that this selective update was likely due to the fact that other changes would likely result in an increase.<sup>58</sup>

### 4. Examiners' Recommendation

As explained below in Section 9, Subsection b, the Examiners find that the company's proposed update to plant is just and reasonable. Atmos' update to plant was consistent with the Commission's determination in GUD No. 9869. In that case, the utility proposed to updated plant balances through a period that ended nine months after the end of the test year. The Commission disallowed that update. The Commission, however, allowed an update to plant balances through a period that ended six months after the end of the test year.<sup>59</sup>

The company's filing also complied with Examiners' Letter No. 10 wherein the Examiners set a deadline for updates to the company's filing. As explained in that ruling, the Commission has previously determined that late-filed *errata* revisions that incorporate mere updates to the books and records of a utility preclude a practical opportunity to review the proposed increase encompassed by the late-filed documents.<sup>60</sup> As noted by the Examiners in

<sup>56</sup> ACSC Ex. 3, Constance T. Cannady, Schedule CTC – 7 (Second Errata), ln. ("Atmos Oct. 1, 2011 Annualization"), col. ("Net SSU General Office").

<sup>57</sup> ACSC Ex. 3, Constance T. Cannady, p. 31, ln. 14 – p. 32, ln. 3.

<sup>58</sup> Atmos Ex. 16, Barbara W. Myers Rebuttal, p. 29, ln. 6 – p. 30, ln. 9.

<sup>59</sup> GUD No. 9869, Final Order, FOF Nos. 11 & 17 – 19.

<sup>60</sup> Tex. R.R. Comm'n, *Statement of Intent of CenterPoint Energy Resources Corp., D/B/A CenterPoint Energy Entex and CenterPoint Energy Texas Gas to Increase Rates on a Division-Wide Basis in the Houston Division*, Docket No. 9902 (Gas Utils. Div. Feb. 23, 2010) (final order granting application) (GUD No. 9902), Findings of Fact Nos. 21 – 25. ("The parties have not had adequate time in this case to evaluate the updated filing prior to the commencement of the hearing.") & GUD

those proceedings such late-filed updates pose due process considerations and incur additional cost burdens on the proceedings.<sup>61</sup> In an effort to ensure that these proceedings are consistent with recent decisions, avoid additional costs and allow the utility to reasonably update its filing, the Examiners established a deadline consistent with the Commission's prior determination. Atmos' compliance is established by the fact that the update to plant balances was included in the *Statement of Intent* as filed.

Furthermore, the Examiners find that it is unreasonable to update only certain components of the operating and maintenance expenses of the company. Accordingly, the Examiners recommend that the base labor be annualized on the basis of October 2011 salary levels as proposed by Atmos.

Finally, the Examiners find that Atmos has established that expenses for compensation to employees in SSU cost centers that are not allocable to Mid-Tex have already been removed. The schedule in support of this adjustment states that, "SSU amounts exclude cost centers which do not allocate to Mid-Tex and employee time charged below the line for rate making purposes." Additionally, the company noted that this figure was adjusted further to remove salaries below the line.<sup>62</sup> The company noted that the issue was identified in the company's rebuttal review. Accordingly, the Examiners find that ACSC's proposed adjustment is not reasonable.

(d) O& M Expense Factors/Capitalization Factors

1. Introduction

The company calculated an operation and maintenance (O&M) expense factor for SSU labor. The O&M factor was applied to the proposed labor adjustment. The O&M factor applied to SSU Customer Support was 89.60% and the O&M expense factor applied to SSU General Services was 97.72%. The factor was based upon the capitalization ratios experienced by the company during the test year.<sup>63</sup>

2. Intervenor's Position

Ms. Cannady contended that the O&M expense factors were not reasonable and contrasted sharply with the ratios applied in GUD No. 9869. In that case the O&M expense factor for Customer Support was 86.51% and the O&M expense factor for SSU General Office was 76.96%. Ms. Cannady proposed that the ratios be based upon an evaluation of the company's calculation of company's payroll tax calculation. Table 8.1 summarizes the O&M expense factor approved in GUD No. 9869, the O&M expense factor proposed by Atmos in this case, and the O&M expense factor proposed by ACSC.

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No. 9869, Finding of Fact Nos. 18. ("[E]rrata filing is unreasonable because the Commission, Examiners and Intervenor in this proceeding do not have adequate time to review the data.").

<sup>61</sup> See, GUD No. 9902, Proposal for Decision, p. 10, "Such a proposal imposes tremendous costs on an already expensive process and would appear to deprive parties of fundamental due process accorded administrative hearings."

<sup>62</sup> Atmos Ex. 3, September 4<sup>th</sup> Update, Change Listing, ln. 16.

<sup>63</sup> Atmos Ex. 1, Statement of Intent, CD - 1, Mid-Tex Base Labor Adjustments FY11.xlsw, Tabs WP\_F.2.1 & Base Labor Rpt & ACSC Ex. 2, Constance T. Cannady, Attachment 20, Atmos Response to RFI No. 1-23.

Table 8.1  
Comparison of O&M Expense Factors<sup>64</sup>

	SSU Customer Support	SSU General Office
GUD No. 9869	86.51%	76.96%
Atmos Proposed	89.60%	97.72%
ACSC Proposed <sup>65</sup>	86.23%	73.03%

Ms. Cannady's proposed adjustment would decrease the proposed base labor adjustment by \$133,803. Due to the flow through effect of this adjustment on Medical and Dental Benefits, Pension and Retiree Medical Benefits, and Uncollectible Expense, the overall effect of this adjustment on the operation and maintenance expense calculation is a reduction of \$263,692. Additionally, due to the flow through effect on taxes, the overall impact of this adjustment is to reduce the revenue requirement by \$281,090.

### 3. Company's Response

Atmos responded to the proposed adjustment by noting that it applied the same methodology approved in GUD No. 9869.<sup>66</sup> Ms. Myers described one change in the methodology. Instead of making an annualized salary calculation the company used actual salary amounts after the merit increases. In response to discovery, the company explained that the schedule relied upon by Ms. Cannady was not intended to be used for the calculation of payroll adjustments. It is a calculation to derive the Shared Services Unit operation and maintenance expenses based upon the company's four factor allocation formula. The calculated Shared Services Unit labor factor number is only used to calculate the Shared Services Unit payroll taxes.<sup>67</sup>

### 4. Examiners' Recommendation

The Examiners find that Atmos has established that the calculation of the O&M expense factor is just and reasonable. The calculation was based upon the methodology applied in GUD No. 9869. The Intervenor did not object to the change in methodology applied by Ms. Myers. The change only impacted one input in the calculation. In fact, that change would lead to more accurate results. The company proposed an expense of \$35,658,661. The "corrected" amount proposed by Ms. Cannady was \$35,773,928. The objection was that the result in this case produced O&M expense factors that were higher than in prior proceedings. The derivation of the O&M expense factor was consistent with the prior proceeding of this utility. ACSC has not established a sufficient basis for rejection of that methodology. The company has established

<sup>64</sup> In briefing ACSC noted that the O&M Expense factors in GUD No. 9869 were 88.62% for SSU Customer Support and 74.37% for SSU General Office. This is not correct. ACSC's witness correctly stated those factors in her testimony. See, ACSC Ex. 3, Constance T. Cannady, p. 35, lns. 4 – 6 & GUD No. 9869, Final Order, Exhibit B, Schedule WP\_F-2.1, ln. 15.

<sup>65</sup> The methodology adopted by Ms. Cannady is dependent, in part, on the overall allocation of SSU expenses. Applying the methodology proposed by Ms. Cannady using the company's proposed allocation factor results in slightly different O&M factors: 86.44% for SSU Customer Support and 73.48% for SSU General Office. The Examiners have incorporated the ACSC proposed methodology into the Examiners' Schedules.

<sup>66</sup> Atmos Ex. 16, Barbara W. Myers Rebuttal, p. 28, ln. 12 – p. 29, ln. 4.

<sup>67</sup> ACSC Ex. 3, Constance T. Cannady, Attachment 20, Atmos Response to RFI No. 1-23.

that its methodology is logical and that it was correctly applied. Furthermore, Atmos established that it was based upon the capitalization ratio experienced by the company during the test year.

c. Medical and Dental Benefits Expense

(a) Introduction

The company's test-year medical and dental benefit expense was \$10,520,669 for SSU employees and \$16,350,395 for employees of the Atmos Mid-Tex Division.<sup>68</sup> The company provided a post-test-year adjustment to medical and dental benefits expense. The purpose of the adjustment was to calculate the benefits expense at the most current benefit rates available. The adjustment was calculated based on the actual number of employees for the Atmos Mid-Tex Division and SSU at September 30, 2011 multiplied by the fiscal year 2012 projected expense per employee. The per book medical and dental expense amount was compared to the projected amount and the difference was allocated to operation and maintenance expense. The company's proposed adjustment was consistent with the methodology applied in GUD Nos. 9762 and 9869.<sup>69</sup> The proposed adjustment increased the test-year level of medical and dental expense by \$1,170,973.<sup>70</sup>

Atmos initially requested a post-test-year adjustment totaling \$1,336,334.<sup>71</sup> The amount was changed to \$1,170,973 in the September 4<sup>th</sup> Update. Atmos explained that the reduction totaling \$165,361 was due to the removal of medical and dental expenses for excluded cost centers. This correction was identified during the rebuttal review.<sup>72</sup> ACSC proposed three adjustments that are directly related to the calculation of the medical and dental post-test year benefits expense adjustment.<sup>73</sup>

(b) Apply Test-Year Levels of Medical and Dental Expenses

Ms. Cannady, who testified on behalf of ACSC, proposed that the adjustment be established based upon the per employee expense during the test year. The company used the actuarial data prepared by Holmes Murphy to estimate that expense.<sup>74</sup> She asserted that the projected medical expense per employee is not a known and measurable expense. She argued that a review of this expense from 2010 onward established that this expense declined. She proposed that the expense level be set for SSU employees at \$9,906, instead of \$10,985 as proposed by Atmos. Additionally, she testified that the expense level for Atmos Mid-Tex

<sup>68</sup> Atmos Ex. 3, Appeal Updated Filing September 4, 2012, Cost of Service Appeal, Schedule WP\_F-2.2 & Cost of Service Unincorporated WP\_F-2.2.

<sup>69</sup> Atmos Ex. 7, Barbara W. Myers Direct, p. 33, In. 20 – p. 34, In. 8.

<sup>70</sup> Atmos Ex. 3, Atmos Update Filing September 4, 2012, Cost of Service Appeal, Schedule WP\_F2.2 & Cost of Service Unincorporated, Schedule WP\_F 2.2.

<sup>71</sup> Atmos Ex. 1, *Statement of Intent*, Cost of Service Schedule, WP\_F-2.2.

<sup>72</sup> Atmos Ex. 3, Atmos Update Filing September 4, 2012, Change Listing Errata Items, In. 16.

<sup>73</sup> ACSC also proposed that the SSU allocation factors for this expense be adjusted. The proposed adjustment is addressed in Section 7 above and the effect of that adjustment flows through to Schedule WP\_F-2.2. No additional adjustment or decision is required here.

<sup>74</sup> Atmos Ex. 16, Barbara W. Myers Rebuttal, p. 30, Ins. 12 – 22. In briefing ACSC ignores the clarification made in the record of the case. ACSC asserted that the study was prepared by Towers Watson: "The Company has requested projected medical and dental expense based on a study performed by Towers Watson." ACSC Initial Brief, p. 24. The record in this case established that the study was performed by Holmes Murphy.



Division employees should be set at \$9,769 instead of \$10,985 as proposed by Atmos. The effect of this proposal is to reduce the proposed post-test-year adjustment from an increase of \$1,170,973 to a decrease of \$101,000. The overall impact on the revenue requirement is a reduction of \$1,293,428.

In response, Ms. Myers repeated the assertion that the proposed adjustment was computed in a manner consistent with Commission precedent. She argued that the adjustment was necessary in order to ensure that rates capture circumstances when they go into effect. She argued that setting an expense level based upon a comparison of the test-year costs to historical expense levels violates the test-year concept and is inconsistent with Commission precedent. She explained that an outside consultant, Holmes Murphy, prepared the projected level of expense. The consultant incorporated actual employee data from the company that included: Employee demographic data and claim information provided by health care providers. This data combined with the consultant's expertise in this area resulted in the expense levels included in the calculation.

The Examiners find that Atmos has established that the projected expenses for medical and dental benefits used to calculate the post-test-year adjustment is just and reasonable. First, it is consistent with Commission precedent on this issue. Second, evidence in the record established that the company consultant based its calculation on employee data and claim information provided by health care providers. Third, the proposed ACSC adjustment results in a *reduction* to the test-year level of expense. While the company has been able to reign in this expense there is no evidence that the recent historical trend will continue in the future.

(c) Remove Expenses for Certain SSU Employees

Ms. Cannady pointed out that the company should remove the medical and dental benefits expense for SSU employees in cost centers that are not allocable to the Atmos Mid-Tex Division.<sup>75</sup> Atmos concurred. Ms. Myers testified that an adjustment was made to the company's request to reflect this adjustment.<sup>76</sup> This reduced the adjustment from \$1,336,334,<sup>77</sup> as originally requested, to \$1,170,973. This resulted in a reduction of approximately \$165,361 to the company's proposed revenue requirement as reflected in the Sept 4<sup>th</sup> Update. The Examiners find that no further adjustment is required.

(d) Use of Employee Expense Levels as of December 31, 2011

ACSC argued that employee expense levels as of December 31, 2011, should be used to calculate this adjustment.<sup>78</sup> Ms. Cannady offered no explanation for this adjustment. In briefing ACSC asserted that the adjustment was necessary to match its proposal to limit post-test-year adjustments to plant to December 31, 2011.<sup>79</sup> Ms. Myers responded by suggesting that it was

<sup>75</sup> ACSC Ex. 3, Constance T. Cannady, p. 38, ln. 5 – p. 39, ln. 7. See, Atmos Ex. 3, Appeal Update Filing Dated September 4, 2012, Change Listing, Ln. 16.

<sup>76</sup> Atmos Ex. 16, Barbara W. Myers Rebuttal, p. 33, lns. 13 – 17.

<sup>77</sup> Atmos Ex. 2, Atmos Errata Filing, July 13, 2012, Cost of Service Schedules Appeal, Schedule WP\_F-2.2 & Cost of Service Schedules Unincorporated, Schedule WP\_F-2.2.

<sup>78</sup> ACSC Ex. 3, Constance T. Cannady, p. 38, lns. 5 – 17.

<sup>79</sup> ACSC Initial Brief, p. 24.

inconsistent to use the December 31, 2011 level of employees and apply the test year expense levels for the test-year ending September 30, 2011.<sup>80</sup>

The Examiners find that the company's use of the test-year level of employees is just and reasonable. Furthermore, the Examiners find that the proposed adjustment cannot be calculated. Ms. Cannady noted that she incorporated two adjustments into the employee level she employed. Namely, her proposed adjustment to the removal of employees in SSU cost centers not allocable to the Atmos Mid-Tex Division and the December 31, 2011 level of employees. As discussed above in Section 4, without a specific and precise description of the proposed adjustment the evidentiary record is insufficient to allow application of the proposed adjustment.

d. Pension Expense

(a) Introduction

The test-year level for pension expense (Pension Account Plan or PAP) was \$4,370,243 for SSU and \$6,659,714 for the Atmos Mid-Tex Division.<sup>81</sup> The company included an adjustment to the test-year level of pension expense in its revenue requirement calculation. The company's witness testified that the adjustment was intended to calculate benefit expense at the most current benefit rates available.

The adjustment was calculated based upon the fiscal year 2012 Towers Watson (Towers Watson) actuarial data for the Atmos Mid-Tex Division and SSU. Atmos retained Towers Watson to perform an actuarial valuation of the company's Pension Account Plan in order to determine the value of benefit obligations as of October 1, 2011 and the company's pension cost for the fiscal year ending September 20, 2012 in accordance with FASB Accounting Standards.<sup>82</sup> The report concluded that the pension cost increased from fiscal 2011 to fiscal 2012 resulting in a significant deterioration of the funded position.<sup>83</sup>

The company asserted, and the parties do not dispute, that the methodology employed was consistent with the methodology applied in GUD No. 9869 and GUD No. 10000. The per book amounts were compared to the amounts from the Towers Watson report and the difference was allocated to operation and maintenance expense.<sup>84</sup>

Atmos initially requested a post-test-year adjustment for the SSU pension expense of \$734,476.<sup>85</sup> The amount was changed to \$720,927 in the September 4<sup>th</sup> Update.<sup>86</sup> Atmos

<sup>80</sup> ACSC Ex. 16, Barbary W. Myers Rebuttal, p. 31, Ins. 10 – 18.

<sup>81</sup> Atmos Ex. 3, Atmos Update Filing September 4, 2012, Cost of Service Appeal, Schedule WP\_F-2.3 ln. 2, cols (b) & Cost of Service Unincorporated, Schedule WP\_F.2.3, ln. 12, cols (b).

<sup>82</sup> Atmos Ex. 1, Statement of Intent Filing, Disk 1, Actuarial Valuation Report Pension Cost for Fiscal Year Ending September 30, 2012 under GAAP Employer Contributions for Plan Year Beginning January 1, 2011, Disk 1, WP\_F-2.3 2011PAPReport.pdf, p. 1.

<sup>83</sup> *Id.*, p. 10.

<sup>84</sup> Atmos Ex. 7, Barbara W. Myers Direct, p. 34, Ins. 10 – 21.

<sup>85</sup> Atmos Ex. 1, *Statement of Intent*, Cost of Service Schedule, WP\_F-2.3, ln. 12, col(b).

<sup>86</sup> Atmos Ex. 3, Atmos Update Filing September 4, 2012, Cost of Service Appeal, Schedule WP\_F-2.3 ln. 12, cols (b) & (e) & Cost of Service Unincorporated, Schedule WP\_F.2.3, ln. 2, cols (b) & (e).

explained that the reduction totaling \$13,549 was due to the removal of pension expenses for excluded cost centers. This correction was identified during the rebuttal review.<sup>87</sup>

(b) Intervenor's Position

ACSC argued that the proposed adjustment should be limited to the test-year level of the pension expense per employee. ACSC proposed that the adjustment be calculated by establishing the number of employees at the appropriate test-year month to be utilized. ACSC argued that the appropriate month was December 2011. The test-year cost per employee for pension expense would be applied to that figure to update the overall test-year expense.<sup>88</sup> The adjustment should not be based upon the expense projected by the 2012 Towers Watson report. The adjustment would reduce the Pension Expense by \$1,893,908 and result in an overall reduction to the revenue request of \$1,925,852. In this context, Ms. Cannady raised two issues.

First, Ms. Cannady explained that the pension costs may change due to the market-related value of the plan assets. Increases in the market-related value of the pension plan assets decreases the actuarially derived pension costs, and conversely, decreases in the market-related value of the pension plan assets increase the derived pension costs. The market value of the fund increased after the pension costs were calculated by the company's consultants. She based this conclusion, in part, on estimates of the market value of the pension asset as of December 31, 2011, January 31, 2012, and February 29, 2012.<sup>89</sup>

Second, Ms. Cannady asserted that the pension expense may have been less if Atmos had discontinued offering a qualifying pension benefit to new employees before October of 2010. Atmos did not make that decision until October of 2011. She alleged that the timing of the company's change was not consistent with the decision of other large corporations.<sup>90</sup>

(c) Company's Response

Chris Hutzler, who testified on behalf of Atmos, explained that accounting standards required that the pension and OPEB asset value be calculated as of the fiscal year-end. The fiscal year-end for Atmos is September 30<sup>th</sup> of each year. The timing of the calculation is a requirement and not a choice. Furthermore, Mr. Hutzler testified that the timing of financial reporting requirements are not arbitrary. Regardless of changes in the asset value at mid-year, the impacts of those changes are reflected for the valuation at the next fiscal year end.<sup>91</sup>

Mr. Hutzler also described the company's management of the Pension Account Plan since 1999. The company moved to an account-based pension plan in that year and eliminated pension benefit accruals based on final average pay. This change preceded the shift of many comparable companies. In 2010, the company evaluated alternatives to offering the PAP to new

<sup>87</sup> Atmos Ex. 3, Atmos Update Filing September 4, 2012, Change Listing Errata Items, ln. 16.

<sup>88</sup> ACSC Ex. 3, Constance T. Cannady, CTC – 9.

<sup>89</sup> ACSC Ex. 3, Constance T. Cannady, p. 15, ln. 13 – p. 16, ln. 12 & Attachment 6; and p. 41, lns. 1 – 5.

<sup>90</sup> ACSC Ex. 3, Constance T. Cannady, p. 41, lns. 6 – p. 42, ln. 18.

<sup>91</sup> Atmos Ex. 21, Chris Hutzler Rebuttal, p. 4, ln. 4 – p. 6, ln. 18.

employees and effective October 1, 2010, the company closed the plan to new employees. This history is evidence of the company's prudent management of its pension account plans.<sup>92</sup>

He asserted that an earlier change, as advocated by Ms. Cannady, would not have resulted in a lower pension expense in 2012. He testified that the key reasons for the significant increase in the pension expense for FY 2012 was the decrease in the discount rate. As the discount rate decreases, pension expense increases. Thus, the timing of the change was not an important factor in the cost of the pension expense.<sup>93</sup>

(d) Examiners' Recommendation

The Examiners find that Atmos has established that the calculation of the pension expense adjustment was just and reasonable. First, the calculation is consistent with the calculation applied in GUD No. 9869 and GUD No. 10000. A fact not contested by the parties. Second, the timing of the pension expense calculation in the Towers Watson report is governed by the end of the fiscal year. The company did not arbitrarily select the timing of the calculation of the assets. Indeed, recalculating the asset after it was calculated in accordance with accounting standards is arbitrary. Although the fund has experienced a declining balance in each year from 2007 to 2011, to reject a calculation because the pension asset has experienced an increase mid-year is unreasonable. Third, Atmos has established that the timing of its decision to change the plan for new employees in 2010 is not the main factor in the pension expense. The key factor is the discount rate – a market factor outside the control of the company.

The Examiners note that if the Commission determines the test-year figures are the applicable factors to use, the calculation of the Pension and OPEB asset, discussed in Section 9 below must also be altered. The calculation of that asset was based upon the same Towers Watson report and the same issues were raised in the context of that calculation. The cumulative effect of the proposed change is a reduction to the revenue requirement of \$2,256,664.

e. Supplemental Executive Pension and Benefits

(a) Introduction

The test-year levels for Supplemental Executive Benefit Plans (SEBP/SERP) were \$9,134,080 for SSU and \$148,346 for Atmos Mid-Tex Division employees. As a result of prior Commission decisions, none of the SSU expense for SEBP/SERP was allocated to the Atmos Mid-Tex Division. The company calculated an adjustment to the test-year level of expense for SEBP/SERP. These expenses are nonqualified, deferred compensation plans which provide supplemental retirement income, death and disability benefits for certain executive employees of Atmos. There are three separate plans: (1) A Supplemental Executive Benefit Plan for officers, division presidents and certain other employees employed on or before August 12, 1998; (2) A supplemental Executive Retirement Plan for eligible employees who become officers or division presidents after August 12, 1998; and (3) A SERP effective August 4, 2009 for corporate officers, division presidents or other employees selected by the board of directors. These

<sup>92</sup> Atmos Ex. 21, Chris Hutzler Rebuttal, p. 7, ln. 7 – p. 9, ln. 13 & p. 11, ln. 12 – p. 12, ln. 2.

<sup>93</sup> Atmos Ex. 21, Chris Hutzler Rebuttal, p. 10, ln. 11 – p. 11, ln. 16.

programs are restricted to corporate officers, division presidents and other employees selected by the board of directors.<sup>94</sup>

The company's witness testified that the adjustment was intended to calculate benefits expense at the most current benefit rates available. The adjustment was calculated based upon the Towers Watson report previously discussed. As noted, the company removed all expenses related to SSU SEBP/SERP. On the other hand, Atmos included expenses related to those plans for employees of the Atmos Mid-Tex Division. The company asserted, and the parties do not dispute, that this was consistent GUD No. 9869 and GUD No. 10000.<sup>95</sup>

(b) Intervenors' Position

ACSC contended that two adjustments should be made to the company's filings related to SEBP/SERP. The first is to exclude a component of the expense included in the allocation from SSU Cost Center 1402. The second modification is to remove any adjustment related to SERP for Atmos Mid-Tex Direct employees. For the same reasons discussed above, Ms. Cannady argued that the inclusion of that expense is inconsistent with the exclusion of that expense for SSU employees. Accordingly, Ms. Cannady argued that the expense should be excluded.<sup>96</sup> Removal of all proposed SERP expense adjustments for employees of the Atmos Mid-Tex Division results in a decrease to the Pensions and Retirees Expense adjustment of \$47,916 and reduces the overall revenue requirement by \$48,724. Ms. Cannady argued that removal of this expense for Atmos Mid-Tex required an adjustment to the Accumulated Deferred Income Taxes (ADIT) expense.<sup>97</sup>

ATM also recommended the removal of the SERP expenses for Atmos Mid-Tex Direct employees. Mr. Carver, who testified on behalf of ATM repeated many of the same arguments raised by Ms. Cannady. In addition, he observed that while other utilities may offer similar plans, he could not recall any recent proceedings in which the utility either sought to recover or explicitly supported the reasonableness of the cost of such benefit plans.<sup>98</sup>

(c) Company Response

Ms. Myers concurred with Ms. Cannady's first point. She testified that the Commission previously disallowed the SSU SEBP/SERP in GUD No. 9762 and therefore the company set the allocation percentage to zero for this cost center. Ms. Myers explained that during discovery Atmos determined that some expense related to SSU SEBP/SERP was recorded in SSU Cost Center 1402. She agreed that this should be removed and an adjustment was made to remove this amount and is recorded on Schedule WP\_F-2.8.<sup>99</sup>

<sup>94</sup> ATM Ex. 2, Steven C. Carver, p. 60, ln. 1 – p. 65, ln. 15.

<sup>95</sup> Atmos Ex. 7, Barbara W. Myers Direct, p. 34, lns. 10 – 21. Despite its adherence to Commission precedent on this point, it is the company's position that all SEBP/SERP expenses are reasonable and properly includable in the revenue requirement. ATM Ex. 2, Steven C. Carver, p. 64, lns. 24 – 25.

<sup>96</sup> ACSC Ex. 3, Constance T. Cannady, p. 43, ln. 4 – p. 44, ln. 17.

<sup>97</sup> ACSC Ex. 3, Constance T. Cannady, p. 19.

<sup>98</sup> ATM Ex. 2, Steven C. Carver, p. 66, lns. 7 – 12.

<sup>99</sup> Atmos Ex. 16, Barbara W. Myers, p. 37, lns. 1 – 15 & Atmos Ex. 3, Appeal Update Filing Dated September 4, 2012, Appeal Cost of Service, Schedule WP\_F-2.8 & Unincorporated Cost of Service, Schedule WP\_F-2.8.

Mr. Ellerman testified that SERP is a nonqualified supplemental retirement arrangement which provides retirement benefits to key employees and executives that cannot be provided through a tax-qualified retirement plan such as qualified pension plan or qualified 401(k). SERP arrangements address the compensation and benefit limitations embedded in the Internal Revenue Code (IRC). Removal of the SERP plan would disadvantage Atmos executives which, in the long run, would impact the company's recruitment and retention of talented employees.<sup>100</sup> This is a point echoed by Mr. Hutzler, who also testified on behalf of Atmos.<sup>101</sup>

(d) Examiners' Recommendation

The Examiners find that Atmos has removed all SSU SEBP/SERP expenses in its Sept 4<sup>th</sup> Update. With this change, the treatment of SSU SEBP/SERP and SERP for employees of the Atmos Mid-Tex Division is consistent with the prior Commission decisions. This fact is not disputed by the Intervenor and is conceded by ATM.<sup>102</sup> The Examiners find that the company's proposed treatment of SERP is just and reasonable. The Examiners concur that if an adjustment is made to this expense that a corresponding change to the ADIT calculation should be made to reflect the removal of this expense item.

Contrary to the assertion of the Intervenor, the Examiners do not find that the Commission's treatment is inconsistent. On the contrary, the Commission's prior treatment of these expenses strikes a balance for the burden of these expenses. The proposal of the Intervenor would place the entire burden of this expense on the shareholders. The record in this case, however, established that these plans are necessary for the recruitment and retention of qualified employees. On the other hand, the position of the company, that all of these expenses are includable in the cost of service calculation places the entire burden of this expense on ratepayers. The record in this case established that these plans compensate already highly compensated executives.<sup>103</sup>

The company has proposed recovery of this expense in a manner that is consistent with prior precedent. The Examiners note that the company will only recover a fraction of this overall expense. Based upon the record in this case, the total adjusted expenses for SEBP and SERP by the Shared Services Unit was \$7,585,854 and the allocable portion of this expense, based upon a 45.23% composite allocation was \$3,431,082 ( $\$7,585,854 \times 45.23\%$ ). The operation and maintenance expense factor of the Shared Services Unit SEBP and SERP plans is 41.51%. The updated operation and maintenance expense portion for SEBP and SERP for the Shared Services Unit, based upon an operations and maintenance expense factor of 41.51% was \$1,424,242 ( $\$3,431,082 \times 41.51\%$ ). Atmos has not included this amount in the revenue requirement calculation.

The SERP updated expense for the employees of the Atmos Mid-Tex Division is \$143,390. The updated operation and maintenance expense portion for SERP, based upon an

<sup>100</sup> Atmos Ex. 20, John R. Ellerman Rebuttal, p. 18, ln. 20 – p. 21, ln. 17 & p. 26, ln. 8 – p. 27, ln. 11.

<sup>101</sup> Atmos Ex. 21, Chris Hutzler Rebuttal, p. 12, lns. 10 – 19.

<sup>102</sup> ATM Ex. 2, Steven C. Carver, p. 65, ln. 3 – p. 66, ln. 6. Citing to GUD No. 9762 and GUD No. 10000.

<sup>103</sup> It must be emphasized that Atmos has not proposed an allocation of these expenses inconsistent with prior precedent. The company's decision to file this case in conformance with that precedent does not mean that the company concurs with this treatment.

operation and maintenance expense factor of 33.42% was \$47,921 ( $\$143,390 \times 33.42\%$ ). Atmos has included this amount in the revenue requirement calculation. The total updated operation and maintenance expense for SERP/SEBP was \$1,472,163. The company has included only 3.25% of the SERP and SEBP expense, totaling \$47,921, of this expense in the revenue requirement calculation.

Based upon the record in this proceeding, the Examiners recommend that the Commission include a finding in this order that allows the company to explore alternative methods of balancing the burden of recovering this expense. Furthermore, the Examiners recommend that such alternatives be more transparent and discernible. For example, a more balanced approach is a simple percentage allocation of this category of expense.

(e) Concurrent Adjustments to ADIT

As explained above, the Examiners find that Atmos has established that its proposed treatment of SEBP and SERP is just and reasonable and consistent with Commission precedent. ACSC and ATM each argued that if a change is made to the SEBP or SERP level, and incentive compensation levels discussed in Subsection g below, then a corresponding change must be made to the rate base entries for ADIT.<sup>104</sup> As explained by Steven C. Carver, who testified on behalf of ATM, if originating costs that give rise to deferred income tax effects are excluded from (or included in) a utility's revenue requirement, any companion ADIT reserve balance should also be excluded from (or included in) the utility's rate base.<sup>105</sup> Thus, these changes are a theoretical flow through of the determination of the treatment of these expense accounts.

It does not appear that Atmos disputes this treatment. For example, as noted, the expenses for the Shared Services Unit of SEBP have been removed. Atmos has also removed the ADIT entry related to these accounts.<sup>106</sup>

The Examiners find that to the extent that the recommendation of the Examiners on SERP compensation is reversed, it is reasonable to make an adjustment to the ADIT calculation of these accounts.

f. FAS 106 Expense

(a) Introduction

In 1990, the Financial Accounting Standards (FAS) Board published its Statement of Financial Accounting Standards No. 106, related to *Employers' Accounting for Postretirement Benefits Other than Pensions*. The expenses covered in that publication refer to post-employment benefits unrelated to pensions such as, retiree health care, dental care, or life insurance. This category of expenses is sometimes referred to as FAS 106 expenses. The test-year level of these expenses was not challenged by the Intervenor. ACSC challenged the post-test year adjustment to the test-year level. ATM argued that the balance of the account should be

<sup>104</sup> ATM Ex. 2, Steven C. Carver, p. 37, ln. 1 – p. 45, ln. 18 & ACSC Ex. 2, Constance T. Cannady, p. 19, lns. 5 – p. 20, ln. 17.

<sup>105</sup> ATM Ex. 2, Steven C. Carver, p. 38, lns. 10 – 13.

<sup>106</sup> Atmos Ex. 3, Atmos Update Filing September 4, 2011, Cost of Service Appeal, Schedule WP\_B-6, ln. 54 & Cost of Service Unincorporated, Schedule WP\_B-6, ln. 54.

applied as an offset to rate base. ACSC raised a similar argument regarding FAS 106 and rate base. The proposed rate base adjustment will be addressed below, in Section 10, Subsection b. The proposed modification to the company's post-test year adjustment will be addressed here as it is an adjustment to the operation and maintenance expense.

In the context of expenses and ACSC's proposed adjustment, the treatment of the FAS 106 expense and its treatment in GUD No. 10000 must be reviewed. In that case, ATM made two proposals regarding the treatment of FAS 106 expense. One proposal was the same proposal that is discussed in Section 10, Subsection b, below. In GUD No. 10000, the Examiners rejected the proposal. The Examiners recommended approval, however, of ATM's alternative proposal. The Commission ultimately ordered that Atmos Pipeline – Texas establish an external fund for FAS 106 expense. The creation of an external fund was consistent with the treatment of that fund in other jurisdictions where Atmos provided service: Colorado, Iowa, Kansas, Mississippi, Missouri, Tennessee, and Virginia. Further, an external account would limit the use of those funds to the payment of benefits to or on behalf of retirees and the company would not have access to those funds for other purposes.<sup>107</sup> After the Final Order was issued, Atmos established an external fund for the Atmos Pipeline – Texas Division. The first contribution made to the external fund for the Atmos Mid-Tex Division was not until April 6, 2012.<sup>108</sup>

The company's witness testified that the post-test year adjustment was intended to calculate benefits expense at the most current benefit rates available. The adjustment was calculated based upon the fiscal year 2012 Towers Watson actuarial data for Mid-Tex and SSU. Atmos included expenses related to those plans for employees of the Atmos Mid-Tex Division. The company asserted, and the parties do not dispute, that was consistent with GUD No. 9869 and GUD No. 10000.<sup>109</sup>

(b) Intervenor's Position

ACSC contended that this adjustment for FAS 106 should be reduced. The reduction proposed by Ms. Cannady, who testified on behalf of ACSC, would reduce the Pensions and Retiree Medical Benefits Adjustment by \$268,923 and reduce the overall revenue requirement by \$273,459. Ms. Cannady argued that Atmos had not established that its proposed post-test-year adjustment to the FAS 106 expense was reasonable because the company had not taken timely steps to reduce this expense. Specifically, she argued that if Atmos had provided a separate fund for contributions made by ratepayers of the Atmos Mid-Tex Division prior to the 2012 study, the expected return would have been included in the development of the projected FAS 106 expense.<sup>110</sup>

(c) Company's Response

Mr. Petersen argued that Ms. Cannady did not attempt to determine the amount of any contributions by customers available for the external fund. Her proposed adjustment ignores the

<sup>107</sup> GUD No. 10000, Final Order, Findings of Fact Nos. 47 & 48; Proposal for Decision, pp. 31 – 33.

<sup>108</sup> ACSC Ex. 3, Constance T. Cannady, Attachment 31.

<sup>109</sup> Atmos Ex. 7, Barbara W. Myers Direct, p. 34, Ins. 10 – 21. It is the company's position that all SEBP/SERP expenses are reasonable and properly includable in the revenue requirement. ATM Ex. 2, Steven C. Carver, p. 64, Ins. 24 – 25.

<sup>110</sup> ACSC Ex. 3, Constance T. Cannady, p. 44, ln. 18 – p. 46, ln. 4.



level of costs ratepayers have supplied versus the level that shareholders have supplied for FAS 106 expenses. The company's shareholders have had to fund the difference between the FAS 106 expense included in rates and the accrual on the company's books when there has been a shortfall in the amounts collected through rates. Therefore, the amount of any accumulated customer contribution that might be applicable to a fund is not readily known and measurable.

(d) Examiners' Recommendation

Atmos has established that its proposed post-test-year adjustment to FAS 106 expenses is just and reasonable. The Final Order in GUD No. 10000 was issued on June 27, 2011. The company established a separate fund for FAS 106 for the Atmos Mid-Tex Division in April 2012. The \$1,474,249 payment made to that fund related to the fiscal period from January 1, 2012 through March 31, 2012. The Examiners find that the timing of that payment, seven months after the issuance of the Final Order in GUD No. 10000, was not unreasonable. The actuarial study provided by the company established the necessity for the adjustment. The Examiners further find that the record in this case establishes that there is no way to establish that ratepayer-provided funds were available to make an earlier payment into the external fund.

g. Incentive Compensation

(a) Introduction.

The company provides incentive compensation packages to two broad categories of employees: (1) Executive employees and management employees, and (2) all others. Table 8.2 provides a summary of the compensation plan and applicability.

Table 8.2<sup>111</sup>  
Summary of Compensation Plans

Employee Group	Incentive Compensation Plan
Management and Executive	Short-Term: Management Incentive Plan (MIP)  Long-Term: Long-Term Incentive Plan (LTIP)
All other employees	Variable Pay Plans (VPP)

These plans are available to employees in the Shared Services Unit and to direct employees of the Atmos Mid-Tex Division. The MIP and VPP plans provide eligible employees an opportunity to earn a cash-based incentive reward. The LTIP incentive has historically been in two forms: Time-lapse restricted shares and performance-based restricted share units.

<sup>111</sup> Atmos Ex. 20, John R. Ellerman Rebuttal, p. 8, ln. 16 – p. 10, ln. 24 & p.16, ln. 1 – p. 17, ln. 21; ATM Ex. 2, Steven C. Carver, p. 46, ln. 5 – p. 47, ln. 7; and, ACSC Ex. 3, Constance T. Cannady, p. 47, lns. 4 – 7 & p. 54, ln. 22 – p. 58, ln. 16.

In order to conform with Commission precedent, the company has excluded from its cost of service calculation expenses related to the Shared Services Unit VPP and MIP plans that would otherwise have been allocated to the Atmos Mid-Tex Division. On the other hand, Atmos has included the expenses for VPP and MIP plans for employees of the Atmos Mid-Tex Division. The company has also included the LTIP expenses for the Atmos Mid-Tex Division employees, as well as, an allocated portion of the LTIP expenses for employees of the Shared Services Unit. Table 8.3 below summarizes the company's approach in this proceeding:

Table 8.3<sup>112</sup>  
Company Treatment of VPP/MIP/LTIP Expenses in Revenue Requirement Calculation

	VPP	MIP	LTIP
Mid-Tex Direct	Included	Included	Included
SSU Costs Allocated	Excluded	Excluded	Included

The company's filing is consistent with Commission precedent related to Atmos a point the Intervenor do not contest. ATM argued that the issue should be revisited in this proceeding and all incentive compensation expense removed. ACSC also argued for removal of LTIP expenses for employees of the Shared Services Unit and those expenses for the employees of the Atmos Mid-Tex Division. Further, ACSC insisted that Atmos Mid-Tex Division expenses related to VPP and MIP be limited to 2% of an employee's base salary.

(b) Concurrent Adjustments to ADIT

As explained in detail below, the Examiners find that Atmos has established that its proposed treatment of incentive compensation is just and reasonable and consistent with Commission precedent. As noted above in Subsection e(e), ACSC and ATM each argued that if a change is made to the incentive compensation level, a corresponding change must be made to the rate base entries for Accumulated Deferred Income Taxes (ADIT).<sup>113</sup> As explained by Steven C. Carver, who testified on behalf of ATM, if originating costs that give rise to deferred income tax effects are excluded from (or included in) a utility's revenue requirement, any companion ADIT reserve balance should also be excluded from (or included in) the utility's rate base.<sup>114</sup> Thus, these changes are a theoretical flow through of the determination of the treatment of these expense accounts.

It does not appear that Atmos disputes this treatment. For example, as noted, the expenses for the Shared Services Unit of VPP and MIP have been removed. Atmos has also removed the ADIT entry related to these accounts.<sup>115</sup>

The Examiners find that to the extent that the recommendation of the Examiners on incentive compensation is reversed, it is reasonable to make an adjustment to the ADIT calculation of these accounts.

<sup>112</sup> ATM Ex. 2, Steven C. Carver, 47, Ins. 8 – 15.

<sup>113</sup> ATM Ex. 2, Steven C. Carver, p. 37, In. 1 – p. 45, In. 18 & ACSC Ex. 2, Constance T. Cannady, p. 19, Ins. 5 – p. 20, In. 17.

<sup>114</sup> ATM Ex. 2, Steven C. Carver, p. 38, Ins. 10 – 13.

<sup>115</sup> Atmos Ex. 3, Atmos Update Filing September 4, 2011, Cost of Service Appeal, Schedule WP\_B-6, In. 31 & Cost of Service Unincorporated, Schedule WP\_B-6, In. 31.

(c) Concurrent Adjustment to CWC

As with ADIT, ATM contended that if an adjustment is made to remove incentive compensation expenses a concurrent adjustment should be made to cash working capital.<sup>116</sup> Atmos concurred. As explained in detail below, the Examiners do not recommend any adjustment to the company's proposed incentive compensation expense request. To the extent that this recommendation is reversed, however, the Examiners recommend a corresponding change to the cash working capital to reflect the flow through effect of that determination.

(d) Regulatory Background

There are no specific regulatory provisions in either the Gas Utility Regulatory Act or Commission regulations related to expenses for incentive compensation. Thus, the expenses related to incentive compensation are evaluated on a case-by-case basis. In each case the Commission must determine whether the evidence in the record is sufficient to determine that the rates are just and reasonable.

*Precedent Related to Atmos Energy*

In GUD No. 9670 the Commission addressed issues related to SSU Cost Center 1904 and 1908:

Atmos Mid-Tex has not established that the allocation of costs related to Cost Center 1904 Dallas Supplemental Executive Benefit Plan and Cost Center 1908 Dallas Supplemental Employee Benefits, is just and reasonable. The goal, as set out by the benefit plan is to advance the interest of shareholders, and the incentive compensation plans are driven by Company earnings. None of the costs of Cost Center 1904 and Cost Center 1908 should be allocated to Atmos Mid-Tex.<sup>117</sup>

In GUD No. 9762 the Commission addressed issues related to SSU Cost Center 1904. The Commission determined as follows:

Atmos Mid-Tex has not established that the allocation of costs related to Cost Center 1904-Performance Plan is just and reasonable. Evidence was not presented that the costs that are included in this cost center are reasonable and necessary to the provision of natural gas services. It is not appropriate to allocate any of the costs associated with this cost center to Atmos Mid-Tex and an adjustment to the proposed SSU expense and payroll related taxes is necessary to remove all expenses associated with this cost center.<sup>118</sup>

In GUD No. 9869, the Commission addressed issues related to the recovery of incentive compensation programs:

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<sup>116</sup> ATM Ex. 2, Steven C. Carver, p. 72, lns. 3 – 12.

<sup>117</sup> GUD No. 9670, Finding of Fact No. 66.

<sup>118</sup> GUD No. 9762, Finding of Fact No. 76.

Atmos' proposal to include \$5,062,755 in Shared Services Unit incentive compensation in this request, consisting of \$1,989,982 in SSU incentive compensation capitalized and \$3,072,774 of SSU incentive compensation expensed, is unreasonable because the Shared Service Unit incentive compensation is not tied to public safety, and therefore it is more appropriate that shareholders bear incentive compensation expenses as customers do not benefit from Atmos' incentive compensation plan.<sup>119</sup>

In GUD No. 10000 the Commission made the following findings of fact:

Customers and shareholders of Atmos Pipeline – Texas derive a benefit from the incentive compensation programs offered by the company and it is appropriate that the expenses for incentive compensation of direct employees be included in the cost of service calculation as they are just and reasonable expenses.<sup>120</sup>

It is also appropriate that shareholders bear the burden of expenses for incentive compensation programs of the division that provide services to other divisions of Atmos Energy Corporation.<sup>121</sup>

The result of all the prior cases related to Atmos are summarized above in Table 8.3.

#### *Other Utilities*

The Intervenors argue that other determinations by the Commission in this area are relevant. In GUD No. 9791, a case that involved CenterPoint, the Commission made the following finding:

It is reasonable to allow CenterPoint to recover incentive compensation expenses for direct employees of the Texas Coast Division and for Houston Support employees.<sup>122</sup>

In GUD 9988, a case involving TGS, the Commission made the following findings:

TGS' proposed short-term incentive compensation expense is unreasonable because it primarily determines the amount of incentive compensation an employee is able to receive using factors that are not related to safety and uses methods related to financial performance of its parent company, ONEOK, Inc. It is reasonable for TGS to recover 10 percent of its requested short-term incentive

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<sup>119</sup> GUD No. 9868, Finding of Fact No. 34.

<sup>120</sup> GUD No. 10000, Finding of Fact No. 66.

<sup>121</sup> GUD No. 10000, Finding of Fact No. 67.

<sup>122</sup> Tex. R. R. Comm'n, *Statement of Intent Filed by CenterPoint Energy Entex to Increase the Rates in the Unincorporated Areas of the Texas Coast Division and All Consolidated Dockets*, Docket No. 9791 (Gas Utils. Div. Oct. 20, 2008) (Final Order)(GUD No. 9791) Finding of Fact No. 76.

compensation because 10 percent of the potential award is based on safety metrics.<sup>123</sup>

TGS' proposed long-term incentive compensation expense is unreasonable because it primarily determines the amount of incentive compensation an employee is able to receive using factors that are not related to safety and uses methods related to the financial performance of its parent company, ONEOK, Inc.<sup>124</sup>

Based upon this precedent, ACSC drew the conclusion that the Commission has attempted to exclude incentive costs that are based upon the financial performance of the companies and to exclude any incentives that are awarded to employees other than those directly involved in the system operations.<sup>125</sup>

(e) Intervenor's Position

Mr. Carver, who testified on behalf of ATM proposed that all incentive compensation expenses be removed from the filing. The effect of this proposal is to reduce operation and maintenance expenses by \$2,078,662. The overall effect on the company's revenue requirement, which is higher due to various flow through impacts, totaled approximately \$2,101,791. The arguments raised by Mr. Brosch were as follows.

First, it is inconsistent to remove SSU costs related to VPP and MIP and not remove the SSU expenses related to LTIP. Second, he argued that it was inconsistent to remove SSU costs related to these programs and not remove the Atmos Mid-Tex direct expenses for the same categories.<sup>126</sup> Third, all incentive compensation plans are focused upon earnings per share – a financial based metric that, Mr. Carver alleges exclusively, benefits the shareholder.<sup>127</sup> Removal of these expenses is consistent with Commission precedent. Mr. Carver found it particularly troublesome that the overall rate of return set in this case will help guarantee that the earnings per share goal is achieved.<sup>128</sup> Fourth, the incentive compensation programs are discretionary.<sup>129</sup>

Ms. Cannady, who testified on behalf of ACSC, contended that four adjustments to the company's level of incentive compensation should be made.<sup>130</sup> She correctly noted that adoption of any of her recommendations required a change to the company's rate base to account for the capitalized portion of this expense.<sup>131</sup> First, she testified that LTIP expense for SSU should be removed from the cost of service calculation. This would reduce the operation and maintenance expense included in the cost of service by \$1,275,478, rate base by \$1,120,300 and the overall

<sup>123</sup> Tex. R. R. Comm'n, Petition of the De Novo Review of the Denial of the Statements of Intent Filed by Texas Gas Service Company by the Cities of El Paso, Anthony, Clint, Horizon City, Socorro, and Village of Vinton, Texas, Docket No. 9988 (Gas Utils. Div. Dec. 14, 2010) (Final Order)(GUD No. 9988) Finding of Fact No. 18.

<sup>124</sup> GUD No. 9988, Finding of Fact No. 19.

<sup>125</sup> ACSC Ex. 3, Constance T. Cannady, p. 54, lns. 16 – 18.

<sup>126</sup> ATM Ex. No. 2, Steven C. Carver, p. 47, lns. 14 – 25, p. 56, ln. 8 – p. 60, ln. 18.

<sup>127</sup> ATM Ex. No. 2, Steven C. Carver, p. 49, ln. 1 – p. 51, ln. 10; p. 52, and ln. 1 – p. 54, ln. 11.

<sup>128</sup> ATM Ex. No. 2, Steven C. Carver, p. 55, lns. 6 – 19.

<sup>129</sup> ATM Ex. No. 2, Steven C. Carver, p. 51, lns. 11 – 18 & p. 54, ln. 12 – p. 55, ln. 5.

<sup>130</sup> ACSC Ex. 3, Constance T. Cannady, p. 46, ln. 5 – p. 58, ln. 16.

<sup>131</sup> ACSC Ex. 3, Constance T. Cannady, p. 27, ln. 18 – p. 30, ln. 10.

revenue requirement by approximately \$1,424,021. Second, she contended that the LTIP expenses for Atmos Mid-Tex should be removed from the cost of service calculation. This would reduce the operation and maintenance expense included in the cost of service by \$260,111, base rate by \$523,861 and the overall revenue requirement by approximately \$325,839. Third, Ms. Cannady recommended that the VPP and MIP expenses should be limited to 2% of the base payroll expense. This would reduce the operation and maintenance expense included in the cost of service by \$227,640, rate base by \$619,419 and the overall revenue requirement by approximately \$304,554. Fourth, Ms. Cannady recommended that an adjustment should be made to recognize that certain employees who were the recipient of VPP awards have left the company.<sup>132</sup>

Ms. Cannady relies upon the following for her proposal. First, she recommended removal of all expenses related to LTIP because the plan is focused exclusively on the financial performance of the company.<sup>133</sup> Similarly, she recommended limiting MIP because the vast majority of the underlying metrics of the program are based upon the financial performance of the company.<sup>134</sup> Second, removal of these expenses is consistent with Commission precedent. Ms. Cannady argued, in fact, that prior inclusion in the case of Atmos Energy was an unintended oversight.<sup>135</sup> Third, LTIP awards may not be known and measurable as it is possible that they are ultimately not awarded or subject to clawback provisions.<sup>136</sup> Fourth, the limitation on the VPP and MIP is based, in part, on the fact that VPP has consistently been awarded at a level of 2% of base salary. Accordingly, she reasoned it is reasonable to limit MIP, for executive and management employees to that level.<sup>137</sup> Fifth, she contended that her various recommendations were consistent with Commission precedent.

(f) Company's Response

Barbara W. Myers and John R. Ellerman, a partner of Pay Governance LLC., a management consultant, testified on behalf of Atmos. The company believes that all of its incentive costs should be included in the revenue requirement.<sup>138</sup> Nevertheless, Ms. Myers testified that the company's filing in this case was consistent with GUD Nos. 9762, 9869, and 10000. Therefore, despite the company's overall position regarding these expenses, certain incentive compensation expenses were removed from the revenue requirement calculation. She testified that the company's compensation plans have not changed since GUD No. 10000 nor have the handling of these expense in the filing changed since GUD No. 10000.<sup>139</sup>

Mr. Ellerman reviewed the compensation program of the company and concluded that the company provides a fair and competitive approach to total compensation.<sup>140</sup> He noted Atmos had an incentive compensation program that was compatible with industry standards. The vast majority of investor-owned gas distribution utilities have adopted incentive compensation plans

<sup>132</sup> ACSC Ex. 3, Constance T. Cannady, p. 51, lns. 1 – 5.

<sup>133</sup> ACSC Ex. 3, Constance T. Cannady, p. 54, ln. 22 – p. 56, ln. 16.

<sup>134</sup> ACSC Ex. 3, Constance T. Cannady, p. 51, ln. 8 – p. 54, ln. 7.

<sup>135</sup> ACSC Ex. 3, Constance T. Cannady, p. 56, ln. 17 – p. 57, ln. 14.

<sup>136</sup> ACSC Ex. 3, Constance T. Cannady, p. 57, ln. 15 – p. 58, ln. 17.

<sup>137</sup> ACSC Ex. 3, Constance T. Cannady, p. 48, ln. 6 – p. 50, ln. 11.

<sup>138</sup> ATM Ex. No. 2, Steven C. Carver, p. 56, lns. 1 – 3.

<sup>139</sup> Atmos Ex. 16, Barbara W. Myers Rebuttal, p. 34, lns. 1 – 23.

<sup>140</sup> Atmos Ex. 20, John R. Ellerman, p. 5, lns. 9 – 14.

as an integral element of their compensation programs.<sup>141</sup> He explained that the company targets all elements of direct compensation at the median of the competitive marketplace.<sup>142</sup>

In response to contentions that expenses of incentive compensation plans should be disallowed, Mr. Ellerman made several arguments. Mr. Ellerman asserted that the company's incentive plans benefit all constituents of Atmos: customers, shareholders, and employees. He contended that the plans were directly tied to improvements in performance, productivity, service, expense management, and other performance factors that directly impact earnings per share. He argued that these plans encourage top management to motivate, recognize, and reward employee performance. This he concluded ultimately benefits consumers. He testified that positive financial performance requires the achievement of rate-based revenues while at the same time controlling operating expense levels. Furthermore, positive financial performance requires increased employee productivity, customer retention and satisfaction, adherence to safety and environmental concerns, and control of operations and maintenance expense that minimize operating expense levels to maximize earnings per share.<sup>143</sup>

As to the limitation imposed by Ms. Cannady on VPP and MIP, Mr. Ellerman noted that Ms. Cannady provided no rationale for her reasoning other than to say that any incentive compensation expense greater than 2% should be disallowed.<sup>144</sup> Mr. Ellerman also asserted that Ms. Cannady's arguments regarding the company's recoupment policies should also be rejected. He asserts that Ms. Cannady seeks to punish the company for a policy meant to safeguard disbursement of incentive compensation awards.<sup>145</sup> He also contended that Ms. Cannady's miscellaneous adjustment to incentive compensation because of the departure of employees that were rewarded pursuant to those plans is unwarranted.<sup>146</sup> Finally, Mr. Ellerman disputed that the incentive compensation plans were discretionary. He testified that the plans were formulaic in their application, and the company used mathematical interpolation to calculate the performance results.<sup>147</sup>

(g) Summary of Proposed Adjustment to Incentive Compensation

In summary, the parties proposed four adjustments to the incentive compensation expense request of the company. First, ATM requested that all incentive compensation expenses be removed from the calculation of the revenue requirement. Second, ACSC requested the Shared Services Unit expenses for LTIP be removed. Third, ACSC requested that all of the Atmos Mid-Tex Division expenses for incentive compensation expenses related to LTIP be removed. Fourth, ACSC requested that all expenses of the Atmos Mid-Tex Division related to short term incentive compensation be limited to 2% of the base pay.

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<sup>141</sup> Atmos Ex. 20, John R. Ellerman, p. 12, lns. 11 – p. 15, ln. 15.

<sup>142</sup> Atmos Ex. 20, John R. Ellerman, p. 6, ln. 9 – p. 8, ln. 14.

<sup>143</sup> Atmos Ex. 20, John R. Ellerman, p. 10, lns. 4 – 24; p. 24, lns. 4 – 20 & p. 29, lns. 6 – 19.

<sup>144</sup> Atmos Ex. 20, John R. Ellerman, p. 22, lns. 17 – 20.

<sup>145</sup> Atmos Ex. 20, John R. Ellerman, p. 23, ln. 18 – p. 24, ln. 2.

<sup>146</sup> Atmos Ex. 20, John R. Ellerman, p. 23, lns. 5 – 7.

<sup>147</sup> Atmos Ex. 20, John R. Ellerman, p. 28, ln. 16 – p. 29, ln. 5.

(h) Examiners' Recommendation

The Examiners find that Atmos has established that its treatment of incentive compensation is consistent with Commission precedent applicable to Atmos in general, and the Atmos Mid-Tex Division, in particular. Furthermore, the Examiners find that the treatment of incentive compensation expense is just and reasonable. Finally, the Examiners find that there is no basis to adjust the level of incentive compensation expenses based upon the level of employees as of December 31, 2011. A selective adjustment based upon an arbitrarily selected post-test year month is not reasonable.

The Intervenor do not contest that since the last case, related to Atmos Pipeline Texas, and the prior proceeding, related to the Atmos Mid-Tex Division, there have been no material changes to the incentive plans.<sup>148</sup> In GUD No. 10000, the Examiners found that insufficient evidence was provided to deviate from the Commission's prior determinations on this issue. While the programs may be the same for Shared Services Unit employees and the Shared Service Unit, there was no evidence to show that this is different from the circumstances in the prior proceedings. The distinction provided in prior Commission decisions related to Atmos appeared reasonable.

Those decisions allowed recovery through rates of incentive compensation for employees who are direct employees of the division and required shareholders to bear the burden of incentive compensation for employees that provide services to another division other than the one to which they are directly assigned. Additionally, the recovery of the incentive compensation costs is allowed for employees who interface with customers on behalf of their division and it requires shareholders to shoulder the burden of expenses for incentive compensation for employees who provide services to other divisions. The Examiners, in previous proceedings, concluded that Commission precedent appeared to reasonably balance the burden of these expenses among all who benefit from incentive compensation programs. The proposal of the Intervenor, however, would result in shareholders bearing all expenses related to incentive compensation programs that benefit shareholders and customers. The Examiners find that this proposal is not reasonable in light of the benefit conferred to customers by these programs.

Notwithstanding, the Examiners agree that based upon the evidence presented in this case, it may be reasonable for the Commission to revisit the issue of incentive compensation. The Examiners do not agree, however, that revisiting these issues results in exclusion of expenses. On the contrary, ATM raised arguments which, instead of supporting the proposition that incentive compensation plan expenses should be excluded from the cost of service analysis, support a contrary conclusion. Further, Atmos presented compelling evidence that incentive programs premised upon financial metrics do, in fact, provide a benefit to customers.

Mr. Carver, who testified on behalf of ATM, explained that pursuant to the company's incentive compensation plans, the overall performance of an employee must "meet expectations"

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<sup>148</sup> ATM Ex. No. 2, p. 58, Ins. 22 – 23.



in order to receive an incentive reward.<sup>149</sup> Thus, the evidence in the record suggests that all employees, at all levels of the company, must perform their tasks diligently in order to even be considered for the incentive compensation programs. Therefore, the incentive compensation program provides an incentive to employees to meet the individual performance goals of their assigned task. Additionally, Mr. Carver provided the following explanation related to incentive compensation plans:

Incentive compensation plans are typically designed to attract, retain, and motivate employees, enhance teamwork and encourage high levels of achievement, and are also designed to facilitate the accomplishment of specific corporate, business unit and individual goals. By linking employee compensation to predetermined targets or objectives, individual employees are theoretically incented to perform well by directly influencing their day-to-day actions and activities – because if they do not achieve the established target levels, they will not receive incentive compensation pay.<sup>150</sup>

It must be emphasized that the VPP and MIP include metrics that are, in fact, directly relevant to customer performance. The performance goals common to these two programs are set out below:

- a. Total shareholder return
- b. Return on assets, equity, capital, or investment
- c. Pre-tax or after-tax profit levels, including: earnings per share; earnings before interest and taxes; earnings before interest, taxes, depreciation and amortization; net operating profits after tax, and net income
- d. Cash flow and cash flow return on investment
- e. Economic value added and economic profit
- f. Growth in earnings per share
- g. Levels of operating expense or other expense items as reported on the income statement, including operating and maintenance expense and capital expense.
- h. Measures of customer satisfaction and customer service as surveyed from time to time, including relative improvement therein.<sup>151</sup>

The last metric on the list is directly related to customer service. Beyond that fact, however, the company made a compelling case that even absent that metric, an incentive program based exclusively upon a financial metric provides a benefit to customers.

The record in this case established that financial-based incentives encourage managers and employees to minimize operation and maintenance expenses. There is evidence in the record of this case of active steps that Atmos management has taken to reduce operation and maintenance expense. For example, in an effort to keep medical and dental benefit expenses in check, the company instituted programs to improve the health of employees. Those programs included Atmos Energy's Naturally Slim program and the use of Compass to locate medical

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<sup>149</sup> ATM Ex. 2, Steven C. Carver, p. 49, lns. 16 – 18.

<sup>150</sup> ATM Ex. 2, Steven C. Carver, p. 54, lns. 2 – 9.

<sup>151</sup> ACSC Ex. 2, Constance T. Cannady, Attachment 32, p. LG 005208.

services for employees.<sup>152</sup> ACSC acknowledged the declining level of medical and dental benefits expense.<sup>153</sup>

Another example of increased efficiency is the billing lag. As discussed in Section 10(c) below, related to the calculation of the cash working capital, the company has made significant strides in its billing lag. This is evidenced by the detailed testimony provided by Mr. Petersen regarding the billing lag.<sup>154</sup> It is also evidenced by the change in the billing lag requested in prior cases before the Commission. As detailed in that section, the company's billing lag declined from 4.47 days to 1.74 days. This improvement impacts three areas. First, this places downward pressure on the revenue requirement – a benefit to customers. Second, prompt billing provides timely consumption information to customers – a benefit to customers. Third, efficiencies in billing improve the financial position of the company – a benefit to shareholders.

In the context of depreciation, the facts of this case establish that the actions of company personnel have a direct impact on the service life of the company's assets. These actions benefit shareholders and customers alike. This fact is directly related to safety and contributes to reduced depreciation expense. Two factors that benefit customers. For example, in this proceeding the City of Dallas and Atmos argued that the average service life for mains, Account 376.01, should be extended because of the proactive actions taken by industry and Atmos personnel to extend the useful life of the investment in mains.<sup>155</sup>

The City of Dallas witness cited better installation practices as a reason for supporting an extended service life. The argument was repeated for other accounts: Accounts 376.02 and 380. These improved practices impact the depreciation expense, which in turn benefits customers, safety, which also benefits customers, and the company's overall financial returns. Thus, customers and shareholders benefit from the proactive efforts of the company personnel and incentive compensation expenses applicable to those personnel should be borne by customers and shareholders alike.

The fact that the Atmos Mid-Tex Division reduced its operation and maintenance expense from 2008 through 2011 directly benefits the captive customer. Figure 8.1 below, reproduced from the testimony of David Park, evidences the declining level of operation and maintenance expense. The company's operation and maintenance expense request in this case is \$150,199,427 which is below the 2008 expense level.

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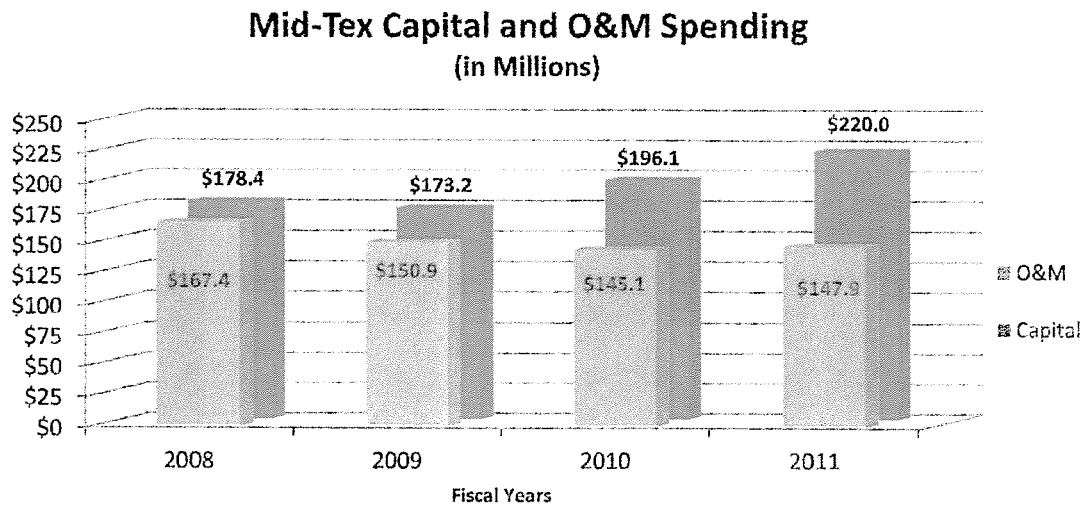
<sup>152</sup> Atmos Ex. 16, Barbara W. Myers Rebuttal, p. 31, ln. 20 – p. 32, ln. 2.

<sup>153</sup> ACSC Ex. 3, Constance T. Cannady, p. 37, ln. 4 – p. 38, ln. 17.

<sup>154</sup> Atmos Ex. 7, Thomas H. Petersen, p. 13, ln. 3 – p. 14, ln. 23.

<sup>155</sup> City of Dallas Ex. 1, Jacob Pous, p. 36, lns. 7 – 8. The dispute centers on the size of the extension: From 60 years to 70 years or 75 years.

Figure 8.1



From a practical perspective, the company's proposed treatment of these expenses does evenly balance the operation and maintenance expense related to these plans. MIP and VPP expenses related to the Shared Services totaled \$5,569,561<sup>156</sup> and 37.60% of those expenses, totaling \$2,094,154 ( $\$5,569,561 \times 37.60\%$ ) would have been allocable to the operation of maintenance expense of the Atmos Mid-Tex Division. Pursuant to Commission precedent, the company excluded those amounts from the revenue requirement of the company. LTIP expenses related to the Shared Services that were allocated to the Atmos Mid-Tex Division as part of the revenue requirement calculation totaled \$1,241,636.<sup>157</sup> MIP, VPP, and LTIP expenses for employees of the Atmos Mid-Tex Division Employees totaled \$825,291.<sup>158</sup> Thus, MIP, VIP, and LTIP operation and maintenance expenses totaled \$4,161,081.<sup>159</sup> Pursuant to precedent, the company has only included \$2,066,927<sup>160</sup> of those expenses in the revenue requirement or 49.67%.<sup>161</sup>

The company's proposed treatment of incentive compensation is consistent with prior precedent that balanced the burden of the recovery of this expense between shareholders and customers by allowing recovery of the Atmos Mid-Tex Division and disallowing recovery of the Shared Services Unit Expense. The Examiners find that consistent treatment provides regulatory certainty and it is reasonable that the expenses be apportioned by applying the methodology approved in prior proceedings. The Examiners are of the opinion, however, that a balanced and more transparent methodology may be appropriate. Thus, continued balancing of this expense in this manner by allowing recovery of the Atmos Mid-Tex Division VPP, MIP, and LTIP

<sup>156</sup> Atmos Ex. 3, Atmos Update Filing September 4, 2012, Cost of Service Appeal, Schedule WP\_F-2.7, ln. 91 & Cost of Service Unincorporated, Schedule WP\_F-2.7, ln. 91.

<sup>157</sup> ATM Ex. 2, Steven C. Carver, SCC Ex. 3, WP\_F-2.12, ln. 35.

<sup>158</sup> ATM Ex. 2, Steven C. Carver, SCC Ex. 3, WP\_F-2.12, ln. 26.

<sup>159</sup>  $\$2,094,154 + \$1,241,636 + \$825,291 = \$4,161,081$ .

<sup>160</sup>  $\$1,241,636 + \$825,291 = \$2,066,927$ .

<sup>161</sup>  $\$2,066,927 / \$4,161,081 = 49.67\%$ .

expenses, Shared Services Unit LTIP expenses and disallowing recovery of Shared Services Unit expense VPP and MIP may not be reasonable in future proceedings. The Examiners recommend that the Commission include a specific finding that the company is not necessarily bound by prior precedent in allocating the burden of MIP, VPP, and LTIP expenses and it is reasonable that the company explore a balanced and transparent apportionment of the burden of this expense.

In conclusion, the company has requested that incentive compensation be established using the methodology established in prior proceedings. The Examiners recommend that the company's proposed treatment be adopted as it is just and reasonable and consistent with Commission precedent. The Examiners recommend, however, that the Commission include findings in this order that allow the company to explore alternative methods of sharing the burden of the expense of incentive compensation programs in subsequent proceedings.

h. Amortized Injuries and Damages

(a) Introduction

Atmos seeks an adjustment to the cost of service in this case in the amount of \$600,000 in amortized costs for injuries and damages in excess of insurance coverage.<sup>162</sup> This issue relates to amortized costs for the amounts not covered by the company's insurance policies for damages, injuries and loss of life associated with the three accidents referred to by the parties as the Wylie, Cleburne and Lutrell incidents.<sup>163</sup>

The first incident occurred in October 2006 in Wylie, Texas where an Atmos pipeline leak led to an explosion and fire resulting in the death of the occupants of a home. (Wylie Incident). The Commission investigated and found that natural gas had leaked from a service line that separated from a compression coupling. There were no alleged violations of the safety regulations and the findings of the investigation did not make a conclusive determination as to how or why the service lines were damaged.<sup>164</sup>

The second incident occurred in May 2007 in Cleburne, Texas (Cleburne Incident). An Atmos pipeline leak led to an explosion and fire that also resulted in the deaths and injury of several individuals. The Commission investigated and found that the probable cause of the incident was natural gas leaks along Atmos' gas main that had migrated natural gas to a residence located in Cleburne. The Commission Pipeline Safety Division issued a notice of violation to Atmos for inadequate analysis of the accident and inadequate training on leak classification.<sup>165</sup>

Then, in May 2009, an Atmos pipeline leak led to an explosion and fire in Irving, Texas (Lutrell incident). The Commission Pipeline Safety Division investigated and issued a notice of

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<sup>162</sup> Atmos Ex. 3, Atmos Update Filing September 4, 2012, Cost of Service Appeal, WP F-2.5 & Cost of Service Unincorporated, WP F-2.5.

<sup>163</sup> ACSC Ex. 1, Karl J. Nalepa, p. 26.

<sup>164</sup> ACSC Ex. 1, Karl J. Nalepa, Attachment 20.

<sup>165</sup> ACSC Ex. 1, Direct Testimony of Karl J. Nalepa, Attachment 20.

violation to Atmos for failure to promptly repair a hazardous leak, and for missing records and inadequate record keeping.<sup>166</sup>

Lawsuits have been filed in all three cases. Atmos is responsible for a \$1 million insurance deductible per incident and the insurance generally covers the settlement and litigation costs of this type of loss.<sup>167</sup> The Cleburne and Wylie incidents were included in the approved level of expense in GUD Nos. 9400, 9762 and 9869.<sup>168</sup> In these prior cases, this adjustment allowed a five-year amortization of \$200,000 per incident per year to recover the \$1 million insurance deductibles.<sup>169</sup>

Ms. Myers testified that the adjustment to injuries and damages was made to adjust the level of expense to a normal level. This adjustment includes amortization of the prior two incidents in the amount of \$200,000 per incident per year and a \$200,000 adjustment for the Lutrell incident, for a total adjustment of \$600,000.<sup>170</sup>

Ms. Myers testified further that the company requests a five (5) year amortization period for the Lutrell incident, which is the same period that was approved for the Cleburne and Wylie incidents. Moreover, the expenses incurred in the test year related to the Lutrell incident have been removed.<sup>171</sup>

(b) Intervenor's Position

ACSC witness, Mr. Nalepa, testified that Atmos has not demonstrated that these costs are reasonable and necessary; therefore, they should not be recovered from customers.<sup>172</sup> ACSC argues that this is the first rate request filing to the Commission since the Luttrell incident and the Commission has not had a chance to previously consider the proposed request. ACSC maintains that the incident is out of the ordinary and not recurring by nature. None of these expenses are associated with providing gas utility service, according to ACSC. Thus, ACSC asserts that these expenses should not be paid by ratepayers.

Consequently, Mr. Nalepa argues that the \$200,000 in amortized costs for injuries and damages in each of the three incidents for a total of \$600,000, be removed from the filing.<sup>173</sup> Mr. Nalepa also testified that the \$800,000, associated with the accumulated provision for injuries and damages related to the Lutrell incident that is included in rate base, should be removed.<sup>174</sup> As explained in more detail below, the Examiners are unable to calculate the overall impact of this adjustment as ACSC has not correctly described the proposed adjustment.

<sup>166</sup> ACSC Ex. 1, Karl J. Nalepa, Attachment 20.

<sup>167</sup> Transcript of Testimony, Vol. IV., Rebuttal Testimony of Barbara W. Myers, p. 95, lns. 5-15.

<sup>168</sup> Atmos Ex. 7, Barbara W. Myers Direct, pp. 35-36; GUD No. 9762, FOF No. 89; GUD No. 9869, the amortization of the Cleburne and Wylie incidents was included in the Final Order approved workpapers.

<sup>169</sup> Atmos Ex. 7, Barbara W. Myers Direct, pp. 35-36 and Workpaper F-2.8 and WP F-2.5.

<sup>170</sup> Atmos Ex. 7, Barbara W. Myers Direct, pp. 35-36 and Workpaper F-2.8 and WP F-2.5.

<sup>171</sup> Atmos Ex. 7, Barbara W. Myers Direct, pp. 35-36 and Workpaper F-2.8 and WP F-2.5 and Atmos Ex. 16, Barbara W. Myers Rebuttal, pp. 41-42.

<sup>172</sup> ACSC Ex. 1, Karl J. Nalepa, p. 27.

<sup>173</sup> ACSC Ex. 1, Karl J. Nalepa, p. 28.

<sup>174</sup> ACSC Ex. 1, Karl J. Nalepa, p. 28.

If the Commission allows the adjustment, ACSC argues that the recovery of these amortized amounts for Wylie and Cleburne will end June 2013. An over-recovery will occur of these amounts if collection continues without a rate case, RRM, or GRIP filing before then.<sup>175</sup> Mr. Nalepa testified that if the rates in this proceeding are effective January 2013, then the expense should only be collected for six months of the new rate period. Mr. Nalepa assumes that a new rate case will be filed in approximately three years (36 months), and the new rates should only reflect 6/36 of the proposed injuries and damages expense. According to Mr. Nalepa, the requested \$400,000 (\$200,000 each for Wylie and Cleburne) should be reduced by \$333,333, leaving the total injuries and damages expense included in rates at \$66,667.<sup>176</sup> The impact of the proposed alternative adjustment is a reduction to the proposed injuries and damages adjustment of \$333,333 and a reduction to the overall revenue requirement of \$338,956.

(c) Company's Response

Ms. Myers responded that the amortization was previously approved by the Commission and is fully known and measurable in the test period and continues a full year well beyond the test year.<sup>177</sup> Furthermore, Atmos argues that requiring the utility alone to bear the financial burden of the incidents ignores that the investigations of the incidents indicate a third party damage or intervening actions of others caused or contributed to the event.<sup>178</sup>

(d) Examiners' Recommendation

As for the Wylie and Cleburne incidents, the Commission has previously determined that recovery of the damages and injuries adjustments in the amount of \$200,000 per incident per year over a five year amortization is reasonable for the Wylie and Cleburne incidents. The Examiners were not persuaded by evidence arguing to the contrary on these prior findings and Final Orders.

The evidence shows, however, that Atmos will have recovered these amounts as of June 2013, for the Wylie and Cleburne incidents.<sup>179</sup> The Examiners concur with ACSC that ratepayers should not pay any over-recovery for these amounts. The Examiners recommend that the company be ordered to establish a reserve account to track any over recovery. ACSC proposed an alternative that would have reduced the amount included in expense by \$333,333. It is not clear how this alternative assures recovery of the requested amount. Rather than adopt this alternative, the Examiners recommend that the company be ordered to reimburse any over-recovery of these amounts during the next IRA, RRM or Statement of Intent proceeding, whichever occurs first.

In regard to the Lutrell incident, the evidence shows that the Lutrell incident resulted in a notice of violation by the Commission's Pipeline Safety Division that a leak was not repaired promptly and Atmos kept insufficient records for inspections.<sup>180</sup> There is also evidence that the

<sup>175</sup> Transcript of Testimony, Vol. IV., Barbara W. Myers Rebuttal, p. 92, Ins. 14-18.

<sup>176</sup> ACSC Ex. 1, Karl J. Nalepa, p. 29 and WP F-2.5, Excel cell E10 and E11.

<sup>177</sup> Atmos Ex. 16, Barbara W. Myers Rebuttal, pp. 42-43.

<sup>178</sup> Atmos Ex. 16, Barbara W. Myers Rebuttal, p. 43.

<sup>179</sup> Transcript of Testimony, Vol. IV., Barbara W. Myers Rebuttal, p. 92, Ins. 14-18; and ACSC Ex. 32.

<sup>180</sup> ACSC Ex. 1, Direct Testimony of Karl J. Nalepa, Attachment 20.

ground was highly saturated with water due to weather conditions and there is controverting evidence as to potential migration of natural gas due to changed soil conditions.<sup>181</sup> Given the correlation between the Cleburne and Lutrell notice of violations and the fact that the Cleburne incident was previously found by the Commission to merit the expense adjustment, the Examiners also recommend that the \$200,000 per incident per year over a five year amortization is reasonable for the Lutrell incident. Therefore, the Examiners recommend that Atmos' proposed adjustment be allowed.

Furthermore, the Examiners find that ACSC's proposed adjustment be rejected as it was not adequately explained. Mr. Nalepa's schedules, Schedule KJN-1 indicated that an adjustment was required to three distinct schedules: Schedule WP\_B-2, WP\_F-2.5, and Schedule WP\_F-2.8. Mr. Nalepa does not explain the adjustments to Schedule WP\_F-2.8.<sup>182</sup> Furthermore, the proposed adjustment results in a rate increase – which is not a reasonable result. As discussed above in Section 4, parties requesting an amendment to the company's proposed revenue requirement must precisely explain and describe the proposed adjustment. Otherwise, there is an insufficient evidentiary record upon which to base an adjustment.

i. Affiliate Expenses: Blueflame Insurance Expense

(a) Introduction

Insurance services required by Atmos Energy are acquired from Blueflame. Blueflame is a wholly owned subsidiary of Atmos Energy that provides insurance for all of the company's divisions. All of the Atmos Mid-Tex Division property, plant, and equipment are covered through property insurance provided by Blueflame. The Gas Utility Regulatory Act provides that the regulatory authority may not allow a gas utility's payment to an affiliate for the cost of a service, property, right, or other item or for an interest expense to be included as capital cost or as expense related to gas utility service except to the extent that the regulatory authority finds the payment is reasonable and necessary for each item or class of items as determined by the regulatory authority.

The statute requires that specific findings be made before rates may be adopted. First, a specific finding of the reasonableness and necessity of each item or class of items allowed must be made. Second 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 non-affiliated person for the same item or class of items must also be made.

Daniel M. Meziere testified that the insurance services provided by Blueflame are at cost and without markup. He explained that Blueflame does not provide services to an entity other than Atmos Energy and its affiliates. The day-to-day management of Blueflame is conducted by Aon Insurance Managers, Ltd., (Aon) a third-party captive manager. Aon provides Atmos Energy with consultation services. The direction and philosophy of Blueflame, however, is determined by Atmos Energy's risk management group. Mr. Meziere asserted that Blueflame

<sup>181</sup> ACSC Ex. 1, Direct Testimony of Karl J. Nalepa, Attachment 20.

<sup>182</sup> ASCSC Ex. 1, Karl J. Nalepa, Schedule KHN-1 (Errata) and compare to ACSC Ex. 1, Karl J. Nalepa, p. 26, ln. 1 – p. 29, ln. 19.

provides cost-effective property insurance coverage for Atmos Energy and its subsidiaries' assets. He contended that Blueflame provides access to the reinsurance market in order to obtain greater and more cost-effective insurance coverage than would otherwise be available to the company. The cost of insurance coverage is allocated among the Atmos Energy divisions and subsidiaries based upon the annual plant balance. For purposes of the test year in this proceeding, the cost of insurance was \$0.085 per \$100 of gross plant.<sup>183</sup>

Mr. Meziere testified that the costs included in the cost of service for property insurance provided by Blueflame to the Atmos Mid-Tex Division are reasonable and necessary. This is because they are less than the costs of premiums that would be paid for traditional commercial property insurance or through a funded reserve. He concluded that the costs are necessary because the company is contractually required to maintain insurance on its property under applicable long-term debt covenants and because it is also a prudent business practice.<sup>184</sup>

The test-year premium amount for the Shared Services Unit was \$302,111 and the test-year premium amount for the Atmos Mid-Tex Division was \$2,143,042. Atmos calculated an adjustment to the insurance expense to reflect the Blueflame premium for the calendar year 2011, which adjusts the insurance costs to the current level of expense. The company also included an adjustment to include the amortization of a Cancellation Fee approved in GUD No. 9762.<sup>185</sup> The Cancellation Fee amortization expires in June 2013.<sup>186</sup>

The Intervenors challenged the property insurance expense and the calculation of the Cancellation Fee Amortization. Four issues were raised in the context of property insurance. First, ACSC contended that the entire Blueflame insurance expense should be removed from the operation and maintenance expense calculation. Second, and in the alternative, ACSC maintained that an adjustment should be made to remove insurance expense for insurance procured to cover construction work in progress. Third, ACSC argued that the cancellation fee, while recoverable, should be amortized over a longer period to avoid over-recovery. Fourth, ATM argued that an adjustment should be made to allow customers to share in the revenues generated by Blueflame.

#### (b) Cancellation of Property Insurance Expense

Karl Nalepa, who presented testimony on behalf of the ACSC, contended that the company failed to meet its burden of proof. Sufficient documentation was not provided to establish that the rate paid by Atmos Energy was less than the costs of premiums that would be paid for traditional commercial property insurance through a funded reserve.<sup>187</sup> Somewhat related, Michael L. Brosch, who presented testimony on behalf of ATM, argued that the property insurance was not actually charged at cost.<sup>188</sup> ATM also argued that the affiliate standard of

<sup>183</sup> Atmos Ex. 8, Daniel Meziere Direct, p. 8, ln. 13 – p. 11, ln. 2.

<sup>184</sup> Atmos Ex. 8, Daniel Meziere Direct, p. 11, ln. 2 – 21.

<sup>185</sup> GUD No. 9762, Finding of Fact No. 87: During the test year Atmos Mid-Tex cancelled an insurance policy in order to procure alternate insurance at a lower rate. Atmos Mid-Tex incurred a cancellation fee which was reasonable as the alternate insurance was at a lower rate.

<sup>186</sup> Atmos Ex. 7, Barbara W. Myers, p. 35, lns. 1 – 13.

<sup>187</sup> ACSC Ex. 1, Karl Nalepa Direct, p. 21, ln. 17 – p. 25, ln. 7.

<sup>188</sup> ATM Ex. 1, Michael L. Brosch, Direct p. 54, ln. 13 – p. 55, ln. 15.



GURA had not been satisfied. The company presented rebuttal testimony through Derek W. Boyd, Director of Risk Management for Atmos Energy and Barbara Myers.<sup>189</sup>

The Examiners find that Atmos has established that the expenses for Blueflame are (1) reasonable and necessary and (2) the price charged to the Atmos Mid-Tex Division is not higher than the prices charged by the supplying affiliate to its other affiliates or division or to a non-affiliated person for the same item or class of items. The company correctly noted that the transaction with Blueflame has been challenged in several prior cases:

- GUD No. 9670, Petition for De Novo Review of the Reduction of the Gas Utility Rates of Atmos Energy Corp., Mid-Tex Division, by the Cities of Blue Ridge, Caddo Mills, et al.;
- GUD No. 9762, Statement of Intent Filed by Atmos Energy Corporation to Increase Utility Rates Within the Unincorporated Areas Served by the Atmos Energy Corp., Mid-Tex Division and Petition of De Novo Review of the Denial of the Statement of Intent Filed by Atmos in Various Municipalities;
- GUD No. 9869, Petition for De Novo Review of the Denial of the Statement of Intent Filed by Atmos Energy Corp., Mid-Tex Division by the City of Dallas; Statement of Intent to Increase Gas Utility Rates in the Unincorporated Areas Served by the Mid-Tex Division;
- GUD No. 10000, Statement of Intent to Change the Rate CGS and Rate PT of Atmos Pipeline - Texas;
- GUD 10041, Statement of Intent Filed by Atmos Energy Corporation, West Texas Division to Change Gas Rates in the Unincorporated Areas of the Amarillo Rate Division;
- GUD No. 10084, Statement of Intent filed Atmos Energy Corporation, West Texas Division to Change Gas Rates in the Unincorporated Areas of the Lubbock Rate Division; and
- GUD No. 10085, Statement of Intent filed by Atmos Energy Corporation, West Texas Division to Change Gas Rates in the Unincorporated Areas of the West Texas Cities Rate Division.

In each case the Commission found that Atmos Energy established that the insurance services provided by Blueflame and the associated expenses were reasonable and necessary. The Commission also found that the price paid for these services was not higher than the price charged by Blueflame to other Atmos Energy affiliates or division or to a non-affiliated person for the same item or class of items. The Examiners note that in each case the fundamental premises of the company's testimony have not been refuted. Namely acquisition of insurance is a necessary expense and the company is unable to obtain insurance at a rate that is lower than the rate included in the cost of service. The record in this case is no different. Accordingly, the Examiners recommend that the Commission include findings in this order that the statutory requirements of Section 104.055(b) have been satisfied.

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<sup>189</sup> Atmos Ex. 22, Rebuttal Testimony of Derek W. Boyd and Atmos Ex. 16, Rebuttal Testimony of Barbara Myers, p. 37, ln. 17 – p. 41, ln. 17.

(c) Insurance and Construction Work in Progress (CWIP)

Ms. Cannady recommended that the December 31, 2011 Blueflame expense be adjusted to exclude the insurance expense on CWIP balance. CWIP was not included in the filing. Therefore, she argued that any outside expenses associated with those balances should also not be included.<sup>190</sup> The proposed adjustment would reduce the property insurance expense request by \$11,865 and the overall revenue requirement by \$12,065.

Ms. Myers, who testified on behalf of Atmos, raised two points. First, she asserted that the proposed adjustment was not included in the model provided by ACSC. Second, she explained that the capitalized portion of insurance expense that was capitalized to CWIP was not included in the filing.<sup>191</sup>

The Examiners find that Atmos Mid-Tex has not established that insurance expenses related to CWIP, that have properly been excluded from rate base, were excluded from the operation and maintenance expense. Based on the record of this case, it is reasonable to exclude expenses related to CWIP that have not been included in the calculation of rate base. ACSC has noted the adjustment in the model.<sup>192</sup> Ms. Myers' testified in rebuttal that no portion of the property insurance adjustment is capitalized. The issue raised by Ms. Cannady, however, is whether the expense portion of the insurance that is used to insure CWIP has been included in rate base. The company has not rebutted the issue. Accordingly, the Examiners find that the company has not met its burden of proof.

(d) Amortization of Cancellation Expense

Mr. Nalepa does not dispute that Atmos is entitled to recovery of the cancellation fee previously approved by the Commission. Mr. Nalepa is concerned that the proposal, as presently structured in the revenue request, may result in an over-recovery. The fee will be completely amortized by June 2013. He estimated that this was only a few months after rates would go into effect. He proposed an alternative which would include a fraction of the expense in the revenue requirement calculation.<sup>193</sup> This would reduce the company's insurance expense request by \$117,681 and the overall revenue requirement by \$119,666.

Ms. Myers noted that Mr. Nalepa's position here was inconsistent with his position on the company's update to plant. The company proposed updating plant through March of 2012, six months after the end of the test year. Whereas Mr. Nalepa was opposed to that adjustment, Mr. Nalepa proposes an adjustment to take into account a change that would occur one year and nine months after the test year. She argued that the Cancellation Fee was previously approved by the Commission and is fully known and measurable for the test period and continues a year well beyond the test year in this case.<sup>194</sup>

<sup>190</sup> ACSC Ex. 3, Constance T. Cannady, p. 58, ln. 17 – p. 59, ln. 15.

<sup>191</sup> Atmos Ex. 16, Barbara W. Myers, p. 40, ln. 1 – p. 41, ln. 17.

<sup>192</sup> ACSC Ex. 2, Karl J. Nalepa, Errata to Schedule KJN-1, Schedule WP\_F-2.4, Cells C10, D10, and E10. The formula in those cells included the alternative adjustments proposed by ACSC.

<sup>193</sup> ACSC Ex. 1, Karl J. Nalepa, p. 25, ln. 8 – p. 26, ln. 4.

<sup>194</sup> Atmos Ex. 1, Barbara W. Myers, p. 38, ln. 7 – p. 39, ln. 11.

The Examiners find that ACSC has established that, under the circumstances of this case, Atmos may over-recover the cancellation fee. None of the parties' dispute, however, that Atmos is entitled to recovery of the expense. Rather than implement an adjustment that may not result in a full recovery, the Examiners recommend that the company be ordered to reimburse any over-recovery of these amounts during the next IRA, RRM or Statement of Intent proceeding, whichever occurs first.

(e) Revenue Sharing

Mr. Brosch noted that the total annual premium calculated in the company's schedules totaling \$2,465,600 was an allocation to jurisdictional operations of the overall premiums to Atmos Energy Corporation. The overall premiums totaled \$6.2 million in the aggregate. Mr. Brosch argued that an adjustment should be made to compensate customers of Blueflame for the excessive level of affiliate profits that are produced by the alleged non-arm's length affiliate business arrangement.<sup>195</sup>

Mr. Brosch argued that, contrary to the assertion of Atmos, Blueflame insurance is not provided at cost. Only the portion of insurance expense related to reinsurance that is purchased from non-affiliated insurance companies is at "cost." He argued that a substantial amount of the affiliate premium that Blueflame charges is for "Property Damage Deductible Reimbursement" coverage and he argued that there is no measurable cost basis for these direct charges. This portion of Blueflame coverage contributes to extremely high earnings for Blueflame, particularly considering that it has never experienced a loss event for the Atmos Mid-Tex Division, the Atmos West Texas Division, or the Shared Services Unit. He contended that these payments, which he calculated to be in excess of four million dollars, become profit for Blueflame.<sup>196</sup>

He maintained that this resulted in a tremendous return for Atmos Energy Corporation, who provided only \$120,000 of initial capital stock into Blueflame. The insurance affiliate has accumulated statutory capital and surplus of more than \$19 million from its accumulated earnings from selling insurance to affiliated entities and has accumulated total assets exceeding \$21 million. As a result, Mr. Brosch proposed an adjustment that would impute a dividend distribution to Blueflame customers equal to 50% of reported test-year Blueflame net income, with allocation to regulated Texas operations.<sup>197</sup>

The adjustment Mr. Brosch proposes is not to operation and maintenance expense.<sup>198</sup> Mr. Brosch proposed that the other revenues be credited with an amount that reflects the proposed revenue sharing. The proposed credit is \$721,855. The effect of the proposal is to deduct this amount from the revenue requirement before rates are set. Thus, the company would recover from rates \$721,855 less than requested.<sup>199</sup>

Mr. Boyd responded to the issues raised by ATM on behalf of Atmos. He asserted that a reserve is created when losses are less than the premium. Blueflame's loss experience in recent

<sup>195</sup> ATM Ex. 1, Michael L. Brosch, p. 53, Ins. 1 – 24.

<sup>196</sup> ATM Ex. 1, Michael L. Brosch, p. 54, In. 22 – p.

<sup>197</sup> ATM Ex. 1, Michael L. Brosch, p. 56, In. 9 – p. 57, In. 7.

<sup>198</sup> It is addressed here, however, in order to have the analysis of Blueflame insurance in one section.

<sup>199</sup> ATM Ex. 2, Steven Carver, Examiners' Model with ATM Proposed Revisions, Schedule WP\_J-2.

years has allowed it to develop a reserve that will allow it to withstand severe losses similar to those associated with Hurricanes Katrina and Rita. He contended that Mr. Brosch's proposal to redistribute that insurance reserve is arbitrary and not supported by any apparent calculation or analysis of actual risk. Mr. Boyd also pointed out that Blueflame's customers enjoy significant benefits. First, he testified that Blueflame offers the lowest available cost for insurance to the Atmos Energy Corporation divisions. Second, he explained that after a significant event such as 9/11 or a devastating hurricane, there is a contraction in property insurance availability. Over time, the contraction typically lessens but will again contract over the next significance property loss event. Blueflame assures that its customers will have the same level of property insurance at consistent premium costs without being subject to insurance cycles.<sup>200</sup>

The Examiners find that the proposed revenue sharing adjustment is not just and reasonable. It is not reasonable that the insurance reserve be returned to the Atmos Energy Corporation affiliates. Rather, Atmos has established that the reserve is necessary to protect the company against unforeseen events. The testimony in the record on this point is clear: The reserves are held inside of Blueflame in order to pay for future claims as well as to maintain continuity of the insurance product at the lowest price possible.<sup>201</sup> In fact, the evidence established that after Hurricanes Katrina and Rita, Blueflame become insolvent because its reinsurers failed and Atmos was required to inject \$1.4 million into Blueflame.<sup>202</sup> It would be unreasonable to remove the reserves from Blueflame and return it to its affiliates. The result of that action would be to leave Blueflame underfunded.

## 9. Depreciation Expense

### a. Introduction

FERC defines Depreciation as the loss in service value not restored by current maintenance, incurred in connection with the consumption or prospective retirement of gas plant in the course of service from causes which are known to be in current operation and against which the utility is not protected by insurance. Among the causes to be given consideration are wear and tear, decay, action of the elements, inadequacy, obsolescence, changes in the art, changes in demand and requirements of public authorities, and, in the case of natural gas companies, the exhaustion of natural resources.<sup>203</sup>

### b. Background

On March 13, 2012, Atmos Energy filed an Application of Atmos Energy Corp., to Revise Certain Depreciation Rates for its Shared Services Unit Assets, as well as, plant assets held by its Mid-Tex Division. Subsequently, on May 31, 2012, Atmos Energy filed the instant *Statement of Intent* for its Mid-Tex Division. On June 6, 2012, the utility filed a *Statement of Intent* for the West Texas Division.<sup>204</sup> During the course of these proceedings, Atmos filed a

<sup>200</sup> Atmos Ex. 22, p. 10, ln. 1 – p. 14, ln. 2.

<sup>201</sup> Tr. Vol. 4, p. 144, lns. 11 – 23.

<sup>202</sup> Tr. Vol. 4, p. 146, lns. 1 – 15.

<sup>203</sup> FERC USOA, Definitions, p. 287.

<sup>204</sup> GUD No. 10174 (consolidated), *Statement of Intent* Filed by Atmos Energy Corp., to Change Gas Utility Rates Within the Unincorporated Areas Served by the Atmos Energy, Corp., West Texas Division, Final Order - October 2, 2012.

Motion to Consolidate proposing to consolidate the depreciation issues related to Atmos Mid-Tex from GUD No. 10147 into the *Statement of Intent* filing for GUD No. 10170. It follows that the Mid-Tex depreciation issues from GUD No. 10147 were severed into a new docket, GUD No. 10179, which was consolidated with GUD No. 10170.<sup>205</sup> Similarly, the Atmos West Texas depreciation issues were severed into a new docket, GUD No. 10180.<sup>206</sup> The Atmos Pipeline-Texas issues remain in GUD No. 10147. Atmos has withdrawn its application with respect to Atmos Pipeline-Texas and GUD No. 10147 is currently pending administrative dismissal.<sup>207</sup>

For consideration in this proceeding are two depreciation studies sponsored by Mr. Dane Watson<sup>208</sup>: 1) Atmos Mid-Tex Division Depreciation Study and, 2) Shared Services Depreciation Study. The total impact of the combined changes in depreciation rates results in a \$12,936,119 reduction in the depreciation expense for Mid-Tex Customers.<sup>209</sup>

The proposed Mid-Tex Division depreciation study analyzes the life and net salvage percentages for Distribution and General Plant Depreciated and General Plant Amortized assets that comprise Atmos Energy's Mid-Tex Division for the period ended September 30, 2011. Atmos Energy's current depreciation rates for its Mid-Tex Division were approved by the Commission in GUD No. 9670, were subsequently reviewed by the Commission in GUD Nos. 9762 and 9869, and are based on a 2004 depreciation study.<sup>210</sup>

The proposed Shared Services study was based on a depreciation study performed as of September 30, 2010. Atmos Energy's current Shared Services depreciation rates have been approved by the Commission for use in Atmos Energy's Mid-Tex (GUD No. 9762) and West Texas Divisions (GUD No. 10041), as well as for Atmos Pipeline – Texas (GUD No. 10000) and are based on a 2006 depreciation study.<sup>211</sup>

c. Atmos Depreciation Study - Methodology

Atmos applied the straight-line method, equal-life group (ELG) procedure, remaining-life technique to comprise the depreciation system employed to calculate the annual accrual for depreciation expense in their study.<sup>212</sup>

In the ELG system, the annual depreciation expense for each group is computed by dividing the original cost of the asset, less allocated depreciation reserve, less estimated net salvage, by its respective equal-life group remaining life. The resulting annual accrual amounts of all depreciable property within an account were accumulated, and the total is divided by the original cost of all account level depreciable property to determine the account-level depreciation rate. The calculated remaining lives and annual depreciation accrual rates are based on attained

<sup>205</sup> GUD No. 10179: Atmos Energy Corp's., Mid-Tex Division's Proposed Depreciation Rates, Severed from GUD No. 10147.

<sup>206</sup> GUD No. 10180: Atmos Energy Corp's., West Texas Division Proposed Depreciation Rates, Severed from GUD No. 10147.

<sup>207</sup> After the issuance of a Final Order in this proceeding the Examiners intend to seek administrative dismissal.

<sup>208</sup> Atmos Ex. 14, Direct Testimony of Dane A. Watson, p. 4, ln. 23.

<sup>209</sup> Atmos Ex. 14, Direct Testimony of Dane A. Watson, p. 8, lns. 4-5.

<sup>210</sup> Atmos Ex. 14, Direct Testimony of Dane A. Watson, p. 6, lns. 5-10.

<sup>211</sup> Atmos Ex. 14, Direct Testimony of Dane A. Watson, p. 6, lns. 9-17.

<sup>212</sup> Atmos Ex. 14, Direct Testimony of Dane A. Watson, p. 11, lns. 2-4.

ages of plant in service and the estimated service life and salvage characteristics of each depreciable group.<sup>213</sup>

An asset's useful life was used to determine the remaining life over which the remaining cost (original cost plus or minus net salvage, minus accumulated depreciation) can be allocated to normalize the asset's cost and spread it ratably over future periods.<sup>214</sup> The establishment of appropriate average service lives for each account within a functional group was determined by applying actuarial analysis methods.<sup>215</sup>

Net Salvage is the difference between the gross salvage (what is received in scrap value for the asset when retired) and the removal cost (cost to remove and dispose of the asset). Salvage and removal cost percentages are calculated by dividing the current cost of salvage or removal by the original installed cost of the asset.<sup>216</sup> The net salvage percentages for each asset group was determined by examination of the experience realized by the company by observing the actual net salvage for various bands (or combinations) of years. Using averages (such as the three-year and five-year bands) allows the smoothing of the timing differences between when retirements, removal cost and salvage are booked. By looking at successive average bands ("rolling bands"), trends in the data are identified to determine net salvage in the account. This examination, in combination with the feedback of company engineers related to any changes in operations or maintenance that would affect the future net salvage of the asset, allowed the selection of the best estimate of future net salvage for each account.<sup>217</sup>

A transition from functionally derived net salvage parameters to individual account net salvage parameters is presented in this study. The company began tracking and recording net salvage at an account level seven years ago and that data is the basis for the net salvage recommendations in the study. This is consistent with the Commission's findings in GUD No. 10000.<sup>218</sup> Atmos claims that the negative net salvage for some of its accounts are related to retirement costs (generally including cutting, capping, and purging of gas for the abandonment of pipe) have increased due to the cost of labor. Performing these activities is more expensive than what has occurred in the past and, it is alleged, more than what has been reflected in the existing depreciation rates.<sup>219</sup>

d. Atmos Depreciation Study Results – Mid-Tex Direct

As shown in the table below, the Mid-Tex depreciation study, proposed by Atmos, results in an annual depreciation expense of approximately \$82.9 million. This represents a decrease to the annual depreciation expense for the Mid-Tex direct assets of approximately \$7.3 million.

<sup>213</sup> Atmos Ex. 14, Direct Testimony of Dane A. Watson, pp. 11-12, Ins. 19-5.

<sup>214</sup> Atmos Ex. 14, Direct Testimony of Dane A. Watson, p. 12, Ins. 9-12.

<sup>215</sup> Atmos Ex. 14, Direct Testimony of Dane A. Watson, p. 12, Ins. 16-17.

<sup>216</sup> Atmos Ex. 14, Direct Testimony of Dane A. Watson, p. 13, Ins. 3-6.

<sup>217</sup> Atmos Ex. 14, Direct Testimony of Dane A. Watson, p. 13, Ins. 8-18.

<sup>218</sup> Atmos Ex. 14, Direct Testimony of Dane A. Watson, p. 19, Ins. 16-21.

Atmos Energy Mid-Tex  
Comparison of Existing vs. Proposed Accrual Rate\*  
At September 30, 2011

Description	Plant Balance	Existing		Proposed		Change in Depreciation Expense
		Annual Accrual Rate	Annual Accrual	Annual Accrual Rate	Annual Accrual	
Total Distribution	\$ 2,507,701,267	3.4800%	\$ 87,268,004	3.1123%	\$ 78,046,333	\$ (9,221,671)
Total General Depreciated	\$ 33,142,322	1.1893%	\$ 394,156	3.5499%	\$ 1,176,517	\$ 782,361
Total General Amortized After Ret	\$ 53,448,563	4.7863%	\$ 2,558,205	6.9749%	\$ 3,727,973	\$ 1,169,767
Total Atmos Mid Tex	\$ 2,594,292,152	3.4776%	\$ 90,220,366	3.1974%	\$ 82,950,823	\$ 7,269,542)

\*Atmos Ex. 14, Direct Testimony of Dane A. Watson, Appendix A, Exhibit 1

e. Atmos Depreciation Study Results – Shared Services

As shown in the table below, the Shared Services depreciation study, proposed by Atmos, results in an annual depreciation expense of approximately \$19.8 million at the corporate level. As compared to rates currently approved by the Commission for this division, this represents a decrease to the annual depreciation expense of approximately \$8.6 million.

Atmos Energy Corporation  
Shared Services Depreciation Rate Comparison  
At September 30, 2010\*

Description	Plant Balance	Current		Proposed		Increase or (Decrease)
		Annual Accrual		Annual Accrual		
SSU - General Office (Div 002)	\$ 139,841,493	\$ 12,685,438		\$ 9,528,070		\$ (3,157,369)
SSU - Greenville Data Center (Div 002)	\$ 8,664,213	\$ 784,044		\$ 289,839		\$ (494,204)
SSU - Customer Support (Div 012)	\$ 149,776,789	\$ 14,914,616		\$ 9,973,478		\$ (4,941,137)
Total Depreciable Plant	\$ 298,282,496	\$ 28,384,098		\$ 19,791,387		\$ (8,592,711)
Fully Depreciated Accounts (1)	28,003,123					
Total SSU Plant	\$ 326,285,619					

(1) Accounts 399.04, 399.05, 399.09, and 399.24 were fully depreciated at the time the depreciation study was conducted. Therefore, these accounts were not analyzed. \*Atmos Ex. 14, Direct Testimony of Dane A. Watson, Appendix A, Exhibit 3

The City of Dallas is the only intervening party to present testimony challenging Atmos' depreciation study. Dallas witness Jacob Pous testified on the following Mid-Tex depreciation issues: reallocation of book reserve, life, and net salvage. The combined impact of the proposed recommendations related to Mid-Tex results in a \$9.8 million reduction to the annual depreciation expense.<sup>220</sup> Mr. Pous testified on the following Shared Services depreciation issues: reallocation of book reserve, life, and net salvage. The combined impact of the Shared Services issues results in a \$3.4 million reduction to the annual depreciation expense.<sup>221</sup> In total, the City

<sup>219</sup> Atmos Ex. 14, Direct Testimony of Dane A. Watson, p. 20, Ins. 10-14.

<sup>220</sup> City of Dallas Ex. 1, Direct Testimony of Jacob Pous, p. 8, ln. 27.

<sup>221</sup> City of Dallas Ex. 1, Direct Testimony of Jacob Pous, p. 9, ln. 31.

Of Dallas raised twenty distinct issues regarding the depreciation calculations of the company. The total number of potential adjustments is greater because many of the proposed adjustments may be implemented individually or in combination.

After reviewing the arguments of the parties, the Examiners recommend an adjustment to three accounts. All Examiner-recommended adjustments relate to the calculation of the average service life. The impacted accounts are listed below:

*Atmos Mid-Tex Accounts*

- Account 374.02, Land Rights
- Account 376.02, Mains-Plastic

*Atmos Shared Services Accounts*

- Account 399.08, Applications Software

f. Mid-Tex and SSU Depreciation: Reallocation of Book Reserve.

Intervenors' Position:

Mr. Pous contends that Atmos' depreciation study reallocates the company's actual book reserve within each functional group among the various accounts or subaccounts for that function. He states that in doing so, Mr. Watson destroys the actual values recorded by the company for individual accounts and creates an inconsistency between depreciation and the cost allocation portions of the company's filing. Therefore, Mr. Pous recommends the retention and utilization of company actual values rather than hypothetical values created by Mr. Watson as it relates to accounts within a functional depreciation reserve.<sup>222</sup>

Company's Response:

Atmos Energy's depreciation reserve is comprised of retirements, salvage, cost of removal, transfers, adjustments, and depreciation expense accruals. Before Atmos Energy purchased the Mid-Tex assets in 2004, a functional depreciation rate (one rate) was derived for all distribution property. That singular rate was applied to each account within the function to calculate the annual accrual for depreciation expense that was recorded in the depreciation reserve. Because the company believes that there is now sufficient information to analyze assets at an account level and that the resulting depreciation rates will be more representative of the individual accounts and provide accumulated depreciation reserves that better reflect the asset characteristics of each account, the company determined it was appropriate to shift to account-specific rates.<sup>223</sup> Mr. Watson explained that the company effectively had function-level depreciation rates because the net salvage embedded in the depreciation rates were set at a functional level and function-level depreciation rates applied to individual accounts will not generate depreciation reserves that are accurate at an account level. As such, there is no "actual account level depreciation reserve" to destroy. The company is merely trying to bring the depreciation reserves in line with the characteristics of each account through the reallocation

<sup>222</sup> City of Dallas Ex. 1, Direct Testimony of Jacob Pous, p. 13, Ins. 23-30.

<sup>223</sup> Atmos Ex. 25, Rebuttal Testimony of Dane A. Watson, p. 7, Ins. 12-21.



process.<sup>224</sup> The theoretical reserve calculation used for calculating remaining-life depreciation rates is the same as was used for the depreciation reserve allocation and is an accepted practice in Texas and other states.<sup>225</sup>

Examiners' Recommendation:

Theoretical reserve studies can be conducted for the purpose of allocating an existing reserve among operating units or accounts. Such allocation is done when either the reserve has not been accumulated in sufficient detail or cannot be determined from utility records.<sup>226</sup> Atmos purchased the Mid-Tex distribution plant assets from TXU in 2004. Currently, functional level depreciation rates are being used to determine the annual accrual for depreciation expense that was recorded in the depreciation reserve. The Examiners find that Atmos' accounting transition to account-specific accounting will achieve the most accurate depreciation rates. The use of the remaining life depreciation system adds a self-correcting mechanism, which accounts for any differences between theoretical and book depreciation reserve over the remaining life of the group.<sup>227</sup> The proposed methodology for reallocation of book reserves based on the life and net salvage parameters determined in the current depreciation study has been approved in GUDs Nos. 9902, 10000, 10038, and 10041. The Examiners recommend adoption of the reallocation of book reserves as proposed by Atmos.

Additionally, the Examiners have been unable to ascertain, the proposed accrual rates applying the City of Dallas' book reserve recommendation. Unless clarified in the exceptions, the Examiners are concerned that there is an insufficient evidentiary record to support adopting that global adjustment. The attached Examiners' Schedule 7 contains tables summarizing the depreciation recommendations of the City of Dallas, and those tables are identified below:

- COD Mid-Tex Individual Adjustments Using Theoretical Reserve
- COD Mid-Tex Individual Adjustments Using Book Reserve
- COD SSU Individual Adjustments Using Theoretical Reserve
- COD SSU Individual Adjustments Using Book Reserve
- COD Global Adjustment to Mid-Tex Company Book Reserve Only & COD Global Adjustment to SSU Book Reserve Only

The first four tables, are supported by Mr. Pous' testimony and accompanying schedules. The fifth category of tables, however, COD Global was derived. The Examiners are unaware of a document that summarizes the book only request of the City of Dallas. In order to derive that table the Examiners have backed out the adjustments for the twenty accounts identified by Mr. Pous for individual changes to the average service life and net salvage. The remaining accounts were derived by applying the accrual rates for accounts that were not challenged by Mr. Pous and are identified in City of Dallas' Copy of Examiners\_Schedule\_Issued\_July\_18(3).xlsm. That document is in electronic format only and was admitted by the Examiners as part of Examiners Ex. 1. Thus, the Examiners have been required to modify one set of schedules and combine it with another schedule to guess the City of Dallas' book only accrual rates.

<sup>224</sup> Atmos Ex. 25, Rebuttal Testimony of Dane A. Watson, p. 9, Ins. 7-11.

<sup>225</sup> Atmos Ex. 25, Rebuttal Testimony of Dane A. Watson, p. 55, Ins. 15-17.

<sup>226</sup> Public Utility Depreciation Practices, p 188.

<sup>227</sup> Atmos Ex. 14, Direct Testimony of Dane A. Watson, Exhibit Atmos Ex. DAW1 p. 14.

Further compounding the evidentiary infirmity is the fact that the impact of the derived book-only accrual rates do not match the estimated impact of the change cited by Mr. Pous. Mr. Pous stated that the retention and utilization of the actual book reserve by account or subaccount in the calculation of the ultimate depreciation rates results in an approximate \$300,000 reduction to annual depreciation expense on a standalone bases.<sup>228</sup> The result of the Examiners' calculation is a reduction to the annual depreciation rate \$490,317.

As discussed in Section 4, above the Examiners requested that the parties identify the change to the Examiners' Model of all adjustments requested. Accordingly, in addition to the reasons stated above, the Examiners find that the presumption of reasonableness has not been rebutted and that there is insufficient evidence to adopt the Intervenor's proposed adjustment.

g. Mid-Tex Depreciation – Average Service Life (Thirteen Accounts)

Intervenor's Position:

Mr. Pous recommends longer average service lives (ASL) for thirteen (13) distribution function accounts. He recommends longer life expectancy for ten (10) accounts and a shorter life expectancy for three (3) accounts. A comparison to Mr. Watson's proposals is set forth in the table below. The combined impact of these 13 adjustments is a 2.9 million dollar reduction to depreciation expense based on plant as of September 31, 2011.<sup>229</sup>

**Summary of City of Dallas Recommended Mid-Tex Property Life Adjustments**

<u>Item</u>	<u>Account</u>	<u>Atmos Existing</u>	<u>Atmos Proposed</u>	<u>Dallas Proposed</u>	<u>Dallas ASL Adjustments</u>	<u>Annual Impact of Adj.</u>
1	374.02	70R5	80R5	100R4	20	(\$6,000)
2	375	45R1	54R1.5	65R0.5	11	(\$2,000)
3	376	45R1.5	60R3	70R2.5	10	(\$240,000)
4	376.01	60R2.5	70R0.5	75R0.5	5	(\$780,000)
5	376.02	60R2.5	65R2.5	70R2.5	5	(\$1,300,000)
6	378	40R2	57R1	65R1.5	8	(\$135,000)
7	379	45L1.5	57R1	65R1.5	8	(\$10,000)
8	385	NA	57R1	65R1.5	8	(\$6,000)
9	380	35R3	37S0.5	41L1	4	(\$785,000)
10	381	33R1.5	37R1	35R1	-2	\$420,000
11	382	NA	37R1	35R1	-2	Included with item 10
12	383	40R1.5	37R1	35R1	-2	Included with item 10
13	390	40L1.5	45R2.5	55R2.5	10	(\$110,000)

<sup>228</sup> City of Dallas Ex. 1, Jacob Pous, p. 17, Ins. 21 – 29.

<sup>229</sup> City of Dallas Ex. 1, Direct Testimony of Jacob Pous, p. 8, Ins. 1-11.

Mid-Tex ASL Item #1 - Account 374.02 – Land Rights			
Existing: 70R5	Atmos: 80R5	Dallas: 100R4	Examiners' Recommendation: 100R4

Intervenors' Position:

Mr. Pous discusses Mr. Watson's change from the previous 70-year ASL proposed for the investment in this account by 10 years to 80 years with a corresponding R5 Iowa Survivor Curve. He also states that while recognizing the artificially short ASL previously proposed for this account, Mr. Watson now claims reliance on judgment for his recommendation. Other than his judgment, Mr. Watson offers no identifiable basis. Mr. Pous states that Mr. Watson failed to identify, let alone support, any factors that were utilized in his judgmental process and lacks foundation, support, and logic.<sup>230</sup>

Mr. Pous believes the 80 year ASL proposal is still artificially short and inconsistent with the life characteristics of the plant that utilized the land rights. He recommends a further increase to a minimum 100-year ASL with a corresponding R4 Iowa Survivor curve. Mr. Pous states his recommendation of 100R4 life-curve combination is a superior curve fit based on review of the historical transactions for the investment in this account, the type of investment in this account, and the type of investment that utilized the land rights in order to provide service to customers. From an actual historical transaction standpoint, the company reports a limited level of retirements in this account, even though plant additions have been made since the early 1900s. The limited level of retirements associated with over 100 years of plant additions accounted for only approximately \$17,000 in an account that has in excess of \$2.3 million of investment.<sup>231</sup> Therefore, solely from a historical transactional perspective, company specific data demonstrates that the investment in this account can, and is expected to last, for a period well in excess of the 80-year ASL proposed by Mr. Watson.<sup>232</sup>

Company's Response:

Mr. Watson states that the basis for his recommendation for this account was to match the increase in life of the underlying assets (Mains in Account 376.01),<sup>233</sup> which is consistent with the prior study recommendation that was approved by this Commission.<sup>234</sup> Atmos states that the Commission has historically set the life of Land Rights at ten years greater than that of Mains and that tying the life of the land rights to the mains residing on the land rights is both reasonable and appropriate. Finally, Mr. Watson asserts that Mr. Pous' 100-year life recommendation is unprecedented in Texas.<sup>235</sup>

Examiners' Recommendation:

Based on the facts and circumstances of this case, the Examiners recommend adoption of Mr. Pous' recommendation of the 100R4 curve. The 100R4 graph provided in Mr. Pous

<sup>230</sup> City of Dallas Ex. 1, Direct Testimony of Jacob Pous, p. 23, lns. 18-30.

<sup>231</sup> City of Dallas Ex. 1, Direct Testimony of Jacob Pous, p. 24, lns. 13-23.

<sup>232</sup> Mr. Watson's Relied Files, "Atmos Mid Tex Plant Data Set".

<sup>233</sup> Direct Testimony of Dane A. Watson, Exhibit DAW-1, p. 17.

<sup>234</sup> Atmos Ex. 25, Rebuttal Testimony of Dane A. Watson, p. 17, lns. 13-16.

<sup>235</sup> Atmos Initial Brief, Appendix A.

testimony provides a better visual match. More compelling is the fact that in the 100-year history of this account data there have been less than 1%, \$17,000 out of \$23 million dollars that has been retired. Other than matching the land right to the underlying asset associated with the land, Mr. Watson was unable to explain the existing 70R5 or the proposed change.<sup>236</sup> Finally, Mr. Watson approach completely disregarded the actuarial data related to this account. Furthermore, as noted by Mr. Pous the land rights should not retire prior to the mains associated with that land. An adjustment to ASL for this account is necessary to avoid this result.

Mid-Tex ASL Item #2 - Account 375 – Structures			
Existing: 45R1	Atmos: 54R1.5	Dallas: 65R0.5	Examiners' Recommendation: 54R1.5

Intervenors' Position:

Mr. Watson proposes to increase the ASL from 45 years to 54 years, with a corresponding R1.5 Iowa Survivor Curve.<sup>237</sup> Mr. Pous countered that the ASL should be extended further to 65 years. His basis is that in reviewing the historical results of actuarial analyses, it is necessary to take into account the outliers associated with early retirements of underground storage tanks. He claims that there is no data to support early retirement of various structures. Furthermore, he asserts that the retirement activity recorded at an early age is not expected to re-occur. Discounting these outliers would elevate the observed life table associated with the actuarial results and further increase ASL expectations.<sup>238</sup>

Company's Response:

Mr. Watson's study contained 36 different curve fits across various placement and experience bands. Mr. Pous chose to selectively emphasize those curves with a longer life, and wholly ignore the 25 (or 69%) curve fits with life indications that support a shorter service life than his 65-year recommendation.<sup>239</sup> Mr. Watson, in rebuttal, provided an example of a shorter life indication for the 1982-2011 placement and experience band, showing a curve with a good fit, the 50R3, compared to his recommended 54 R1.5 and Mr. Pous' 65 R0.5. Mr. Watson claims the best fit is the 50 R3 which has a shorter life and steeper dispersion pattern than either recommendation.<sup>240</sup> He notes that Mr. Pous argued that the retirement of an underground storage tank had an overly significant impact on the analysis and should be disregarded.<sup>241</sup> Mr. Watson counters that this retirement represented *only 2.5% of the total retirements recorded in the account* and had only modest impacts on the results.<sup>242</sup>

<sup>236</sup> Tr. Vol. 2 at 115-119.

<sup>237</sup> Mid Tex Study at page 18.

<sup>238</sup> City of Dallas Ex. 1, Direct Testimony of Jacob Pous, p. 29, Ins. 4-10.

<sup>239</sup> Rebuttal Testimony of Dane A. Watson, Atmos Ex. 25 at 19.

<sup>240</sup> Atmos Ex. 25, Rebuttal Testimony of Dane A. Watson, p. 20, Ins. 1-7.

<sup>241</sup> Direct Testimony of Jacob Pous, Dallas Ex. 1 at 29.

<sup>242</sup> The 2.5% number is derived from the following calculation: Retirement in 2000 for storage tank (\$66,392)/Total Account Retirements (\$2,683,283) = 2.47%.

Examiners' Recommendation:

The Examiners' find that the retirement of an underground storage tank, representing 2.5% of retirements to date, does not materially affect the results of the study. Atmos' depreciation study considered curves with both shorter and longer service life ranges. In rebuttal Atmos presented a shorter placement band as a justification of the recommendation of the 54R1.5 ASL. The Examiners' agree that the 54R1.5 is a better visual fit for this account and recommend adoption as proposed by Atmos.

Mid-Tex ASL Item #3 - Account 376 – Cathodic Protection Mains			
Existing:45R1.5	Atmos: 60R3	Dallas: 70R.25	Examiners' Recommendation: 60R3

Intervenors' Position:

Mr. Watson proposes to increase the ASL by 15 years from 45 years to 60 years, with a corresponding R3 Iowa Survivor Curve. Mr. Watson increases the ASL because his discussion with Company engineers that valves and couplings in many cases are changed before mains are retired and past conversations with valve manufacturers confirmed that moving parts in valves would cause them to fail faster than mains.<sup>243</sup>

Mr. Pous, on the other hand, argues that the ASL should be extended further to 70 years using a 70R2.5 survivor curve. His recommendation is based on review of the historical data specific to this company. He also asserted that while valves have moving parts and may actually have an overall physical life shorter than mains, there are other retirement forces that may cause valves to last longer than portions of the mains to which they are attached. Mr. Pous also emphasized that from an actuarial standpoint, it must be noted that 70% of the life-curve combinations Mr. Watson presents have ASLs longer than the 60-year ASL he is proposing. Mr. Pous stated that a preponderance of Mr. Watson's workpapers demonstrate that 65, 70, 75, or even an 80-year ASLs are acceptable fits of the historical transactions for this account.<sup>244</sup> He emphasizes that only two out of 35 presentations for life-curve combinations in Mr. Watson's workpapers reflect a value less than the 60 ASL he proposes.<sup>245</sup> Therefore, Mr. Pous concluded that by his actions Mr. Watson admits he has artificially limited the level of increase based on the results of his actuarial analyses.

Company's Response:

Mr. Watson claims Mr. Pous did not consider the existing mix of assets in this account and life expectations for those assets stated in his Depreciation Study Report. Mr. Watson claims 82% of the assets in the account are from the vintage of 1990 or newer.<sup>246</sup> Mr. Watson stated that a portion of the overwhelming majority of the assets in this account have shorter lives than the mains. The company data reveals that 45% of the current investment in the account is in valves. Valves have moving parts and are a shorter-lived asset than mains. In addition to the

<sup>243</sup> City of Dallas Ex. 1, Direct Testimony of Jacob Pous, p. 31, Ins. 1-2.

<sup>244</sup> Mr. Watson's Relied Files, Atmos Mid-Tex Actuarial Analysis, Account 376 Cathodic Protection, Graphs.

<sup>245</sup> *Id.*

<sup>246</sup> Direct Testimony of Dane A. Watson, Exhibit DAW-1, p. 19.

valves, another 39% of the investment is in assets such as anodes (which shrink and disappear over time), leak clamps (which are placed on pipe many years after the pipe is placed in service and retired with the pipe), and ground beds (which also degrade over time), that are also shorter-lived assets. Only 16% of the investment is related to mains. Atmos contends that these facts do not support Mr. Pous' recommendation.

**Examiners' Recommendation:**

Atmos has stated that the mains make up only 16% of this account. The remainder of the account is 45% valves and 39% anodes, leak clamps, and ground beds that are shorter lived assets. Mr. Watson based his recommendation on actuarial analysis and conversations he had with valve manufacturers in 2000. The Examiners find that the issues related to the retirement of valves is already incorporated into the data. After reviewing the evidence provided by Atmos and the City of Dallas it is clear that, on this account, the decision is reduced to one issue: Which proposed curve provides a better match to the actuarial data? While both curves are good visual fits the Examiners recommend using the 60R.3 as recommended by Mr. Watson because 82% of the assets in the account are from the 1990 or newer vintage and Mr. Watson's placement band better reflects the current characteristics of this account.

Mid-Tex ASL Item #4 - Account 376.01 – Mains Steel			
Existing:60R2.5	Atmos: 70R0.5	Dallas: 75R0.5	Examiners' Recommendation: 70R0.5

**Intervenors' Position:**

Mr. Pous contends that while Mr. Watson now attempts to correct his prior artificial short ASL recommendation, he once again limited the level of necessary increase. Mr. Pous recommends a longer service life and he recommends a 75R0.5 life-curve combination.<sup>247</sup> He based his recommendation on review of actuarial results of company-specific data, advancements in technology, and the recognition of more heightened and proactive actions by the industry to maintain and extend the useful life of investment in mains. He notes that even Mr. Watson agrees that a 75R0.5 life-curve combination is a better fit over the existing 60R2.5 based on actuarial analyses.

Mr. Pous argues that what distinguishes Mr. Watson's proposal from his own recommendation is the fact that the current investment reflects a lower level of older investment that Mr. Watson has previously identified as having shorter life expectations due to technology.<sup>248</sup> Mr. Pous believes an even longer ASL is warranted based on company specific data, recognition of a longer ASL as reflected in Mr. Watson's workpapers, a change in the mix in investment to newer mill-wrapped steel, the advancements in manufacturing techniques, and the implementation of proactive inspection and oversight programs. He acknowledges that the

<sup>247</sup> City of Dallas Ex. 1, Direct Testimony of Jacob Pous, p. 33, Ins. 23-25

<sup>248</sup> Atmos Mid Tex 2004 Depreciation Study at page 19, where Mr. Watson stated that older technology corresponding to cast iron and bare steel mains had shorter lives compared to newer technology corresponding to mail wrapped steel.

company has attempted to rectify its prior artificially short ASL for this investment, but argues it still understates the appropriate current level of ASL.<sup>249</sup>

Company's Response:

Mr. Watson recommends a 10-year increase and a 70R0.5 life-curve combination. Mr. Watson claims that he placed more emphasis on recent placement and experience bands due to: (1) the type of material in the account; (2) significantly higher asset levels associated with those time frames; and (3) more homogeneity in the property as reflected in more recent placement bands.<sup>250</sup>

Mr. Watson does not agree with the life-curve proposed by Mr. Pous. He does agree with the assertion that changes in technology and proactive steps to maintain and extend the life of steel main justify a longer service life.<sup>251</sup> Those are the same reasons Mr. Watson provided to support the life increase he recommended. He argues that Mr. Pous simply exaggerates the impact of these changes in his analysis by using Mr. Watson's study and all supporting information, including information about advancements in technology and proactive actions by the company to respond to those advancements, to arrive at a five-year longer service life. In fact, he noted Mr. Pous agreed that his life-curve combination in the 31 different life-curve combinations across multiple placement and experience bands he examined contain life-curve combinations that are both shorter and longer than the approved existing lives in both his recommendation and Mr. Pous' recommendation, depending on the bands. Although Mr. Pous advocates that proper depreciation practices require limiting sudden increases in services lives derived from the actuarial analysis,<sup>252</sup> Mr. Watson argued that Mr. Pous violates that practice in recommending an even longer ASL.

Mr. Watson states that mill-wrapped steel pipe is the dominant type of pipe being installed now, and it does have a longer life expectancy than predecessor steel pipe. He claims he has considered these facts in his study analysis, and his recommendation reflects an increase in the service life for the assets in this account. His proposed extended ASL reflects the larger number of assets in the account that are using more advanced technology. It is inappropriate to set lives as if all assets in the account were of the newer technology.

Mr. Watson claims that Mr. Pous has not given appropriate recognition to other retirement forces that have not and will not change over time. For example, dig-ins, relocations and other forces that are not impacted by the material composition of the pipe will not change simply because the type of material changes. Like the rest of the industry, the company has and will continue to improve its operations and maintenance practices to achieve maximum life expectancy. This has been reflected in the past, current and future expectations discussed and considered in his study. However, there is still some uncertainty as to how advancements will affect the actual service lives of steel pipe. Until the technology is proven to last longer than previous generations, even Mr. Watson's own longer life projection is still somewhat speculative. Consequently, it is unreasonable to adopt the longest possible life expectation for

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<sup>249</sup> City of Dallas Ex. 1, Direct Testimony of Jacob Pous, p. 35, lns. 1-6

<sup>250</sup> Mid Tex Study at page 20.

<sup>251</sup> *Id.* at 34.

<sup>252</sup> Direct Testimony of Jacob Pous at 47.

this account in one study. The more prudent course of action is to implement reasonable projected service life increases as the impacts of technology become more certain. For these reasons, Mr. Pous' recommendations should be rejected.<sup>253</sup>

**Examiners' Recommendation:**

Mr. Watson's analysis considered advancements in technology and also recognized other retirement forces that have not and will not change over time such as dig-ins, relocations and other forces that are not impacted by the material composition of the pipe and will not change because the type of material changes. The Examiners' agree that until the technology is proven to last longer than previous generations, the longer life projection is still somewhat speculative. It is Atmos' policy to conduct a depreciation study every five years or less which will capture advancements in technology as the impacts, if any, are recognized. The Examiners' recommend adoption of the 70R0.5 ASL as proposed by Atmos.

Mid-Tex ASL Item #5 - Account 376.02 - Mains Plastic			
Existing: 60R2.5	Atmos: 65R2.5	Dallas: 70R2.5	Examiners' Recommendation: 70R2.5

Mr. Pous recommends a 70R2.5 life-curve combination based on his review of company specific historical activity, input from company personnel as reported by Mr. Watson, improvements in pipe technology, changes in the investment mix of the account, and better installation practices. Mr. Pous claims that what is significant of the results of Mr. Watson's analysis is that two thirds of his analysis resulted in ASLs greater than 65 years. More than 25% resulted in ASLs of 80 years or longer, yet Mr. Watson limited his increase in ASL to 5 years.<sup>254</sup>

Mr. Pous stated that while Mr. Watson may claim that a trend to a shorter ASL exists as more recent placement bands are relied on, such a claim is inappropriate. His review of the actuarially derived OLTs for the 1962 and 1982 placement bands indicates that reliance on a placement band beginning in 1982 is inappropriate. He highlights that the 1982 placement band only declines very slightly from 100% surviving.<sup>255</sup> Also, Mr. Pous claims the 1982 and 1962 placement band yield very similar results through the overlapping portions. Thus, it is not credible that Mr. Watson could identify a 55-year ASL for a 1982-2011 placement band with a corresponding 2002-2011 experience band when the similarities of the values to the 1962-2011 placement band with a 2002-2011 experience band are realized.<sup>256</sup> Therefore, given that the 1962 and 1982 placement bands provide essentially the results in the overlapping portions of the observed life table, obviously the 1962 placement band provides additional statistical information upon which to estimate the balance of the remaining unidentified life cycle.<sup>257</sup> Mr. Pous included the graph below to illustrate the rationale behind his recommendation:

<sup>253</sup> Atmos Ex. 25, Rebuttal Testimony of Dane A. Watson, p. 28.

<sup>254</sup> City of Dallas Ex. 1, Direct Testimony of Jacob Pous, p. 36, Ins. 7-24.

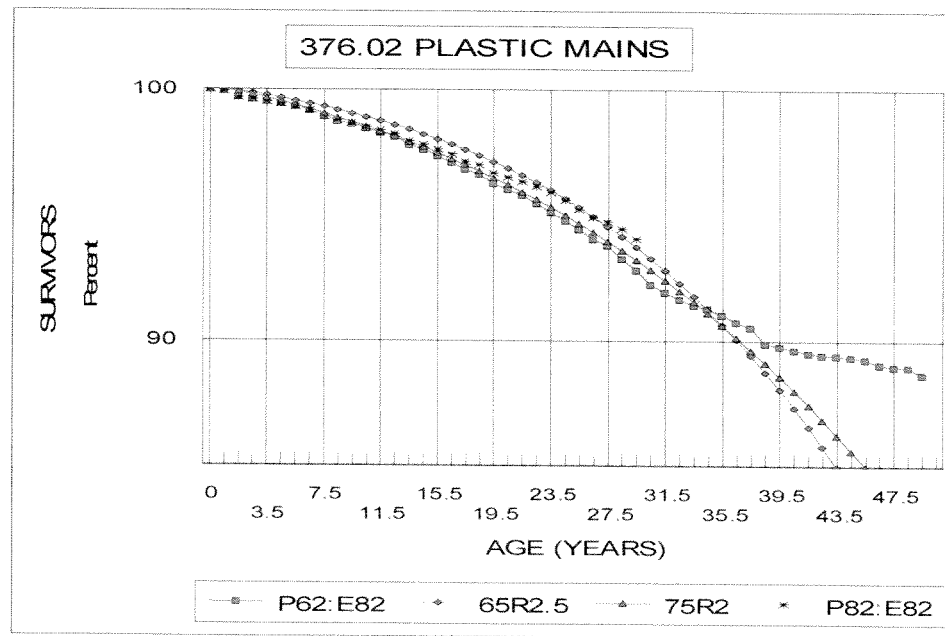
<sup>255</sup> To approximately 94%.

<sup>256</sup> *Id.*

<sup>257</sup> City of Dallas Ex. 1, Direct Testimony of Jacob Pous, p. 37.



Figure 9.1



Mr. Pous also states that from a technological standpoint, a longer ASL than proposed by Mr. Watson is also warranted. First, the historical actuarial results that indicate a 70-year or longer ASL do not adequately reflect the benefits of current technology in the manufacturing and installation of plastic pipe. Early generation plastic pipe did not perform up to expectations and has been retired early. Various poor installation practices in the past also caused early retirements to plastic pipe. In addition, the industry experienced problems in fusion of pipe components which no longer exist. All of these improvements in technology mandate a longer ASL than reflected in the actuarial results.<sup>258</sup>

Mr. Pous discusses life expectancy for plastic pipe, in what Mr. Watson claims are perfect conditions or laboratory conditions, is expected to be very long. He points to several statements made by Mr. Watson: (1) in the prior depreciation study for Atmos he states that the life expectancy in such instances could be longer than 60 years, (2) in this case the same life expectancy is now longer than 65 years and, (3) in a contemporaneous case in Nevada the same life expectancy is 70-plus years.<sup>259</sup> Mr. Pous claims that from these inconsistent statements, Mr. Watson creates an artificially low physical life expectation from which the decline to actual field life expectations is narrowed. In other words, if one realizes that laboratory conditions may yield 100-plus year life expectations, it would require more significant levels of documentation to support an actual field based ASL expectation as low as 60 years due to various non-laboratory retirement forces such as dig-ins and relocations. He states that Mr. Watson's study in this case

<sup>258</sup> City of Dallas Ex. 1, Direct Testimony of Jacob Pous, p. 38, Ins. 9-16.

<sup>259</sup> Mr. Watson's 2004 Depreciation Study for Atmos at page 17 and Mr. Watson's workpapers in Southwest Gas Corporation's 2011 Depreciation Study before the Nevada Public Service Commission in Docket No. 12-04005.

clearly demonstrate the appropriateness of ASLs equal to or in excess of his previously claimed physical or laboratory life expectations.<sup>260</sup>

In an attempt to determine the reasonableness of the reduction in life between laboratory and field settings Mr. Pous inquired regarding specifics as to Mr. Watson's enumerated primary retirement forces. He stated that, neither the company nor Mr. Watson could provide the retirements by year associated with individual claimed retirement forces. However, the Company did inform Mr. Pous that it has continued to place emphasis on proper bedding during construction in order to minimize the impact on life expectation. Mr. Pous claims that action supports a longer ASL. The company also could not explain how different operating pressures would affect the useful life of its current investment, or how changes in street widening policies could materially impact life expectations.<sup>261</sup> Mr. Pous states while Mr. Watson identifies numerous main drivers, neither he nor the company could provide any useful information which would impact whether a 75- or 70-year ASL were appropriate. In no instance he asserts has a 65-year ASL been justified.<sup>262</sup>

Mr. Pous summarizes, whether viewed from company actuarial results relating to company specific data, from a technological improvement standpoint, or from any of the major retirement drivers referenced by Mr. Watson an ASL longer than the 65 years proposed by Mr. Watson is appropriate. Actuarial results easily support a 75-year ASL for the investment in this account. Technological advancements and a change in the mix of investment to more current technology-based pipe also mandate a longer ASL. Finally, from a standpoint of major retirement forces as enumerated by Mr. Watson, there is no reason not to adopt a 70- or even 75-year ASL. He believes his recommended 70R2.5 life-curve combination is a conservative estimate and most likely will need to be increased to 75 years in the next depreciation study.<sup>263</sup>

#### Company's Response:

In rebuttal, Mr. Watson provided an example of a shorter life-curve combination, 55 R3 for the 1982-2011 placement and 2002-2011 experience band and a longer life-curve combination 80 R2 for the 1982-2011 placement and experience band.<sup>264</sup> These were taken from his study workpapers to show the range of curve fits he used to develop his analysis. Mr. Watson stated that even Mr. Pous demonstrates the need to be cautious about relying too dramatically on life expectations of newer technology and that "[e]arly generations of pipe did not live up to expectations and had been retired early."<sup>265</sup> Expectations are simply expectations, until there is experience with a particular technology to validate the expectations. Mr. Watson testifies that some of the forces of retirement were dig-ins, relocations, and replacements due to capacity needs. These forces of retirement are expected to continue. Therefore, while materials and processes have changed other forces triggering retirements continue. For this reason, Mr. Pous' recommendation should be rejected.<sup>266</sup>

<sup>260</sup> City of Dallas Ex. 1, Direct Testimony of Jacob Pous, p. 38, Ins. 18-29, p. 39, Ins 1-3.  
<sup>261</sup> Response to Dallas 1-20.

<sup>262</sup> City of Dallas Ex. 1, Direct Testimony of Jacob Pous, p. 39, Ins. 5-18.

<sup>263</sup> City of Dallas Ex. 1, Direct Testimony of Jacob Pous, p. 39, Ins. 20-29.

<sup>264</sup> Atmos Ex. 25, Rebuttal Testimony of Dane A. Watson, p. 31.

<sup>265</sup> City of Dallas Ex. 1, Direct Testimony of Jacob Pous, p. 38, Ins. 12-13.

<sup>266</sup> Atmos Ex. 25, Rebuttal Testimony of Dane A. Watson, p. 32-33.

Atmos' initial brief claims that Mr. Watson accounted for all of the technological advances, and they were reflected in his workpapers that Mr. Pous reviewed. Mr. Pous' contention that retirement forces affecting the company's assets should be ignored because the company does not quantify the specific cause of each asset retirement should be rejected. The company's practice with treatment of retirement data has not changed since its last rate case. It is not reasonable to require or expect the company to track the specific reason why each asset it owns was retired.

The City of Dallas' reply brief stated that Mr. Watson has not provided evidence to support his claims regarding technology. The City of Dallas believes the question in this account is whether the visual fit, as Mr. Pous testified, from the actuarial standpoint an average service life longer than 70-years is justified. The visual fit of the 75R2 provides a visually superior fit to the recommendation of Mr. Watson as did the majority of his graphs.<sup>267</sup>

Examiners' Recommendation:

Mr. Pous challenges Atmos' recommended ASL based on actuarial results relating to company-specific data, because of technological improvement, a change of mix of investment, and on because of major retirement drivers. Mr. Pous believes an increase in ASL is warranted because of newer pipe technology and improved installation practices are not captured in the history of this account. Mr. Watson stated in his study and in his rebuttal testimony that improved technology had been considered in his analysis. The Examiners agree with Atmos that it is proper to temper future technology expectations.

From an actuarial standpoint Mr. Pous discussed the validity of the 55-year ASL for a 1982-2011 placement (vintages) band and 2002-2011 experience (retirement activity) band as compared to the 70-year ASL 1962-2011 placement and the same experience band. Mr. Pous stated that this 15-year differential when analyzing the same data through comparable portions questions the credibility of the 55-year ASL and he classifies it as an "outlier" because of this. He goes on to say that the 1962 and 1982 placement bands provide essentially the same results in the overlapping portions and that the 1962 placement band should be utilized because it provides additional statistical data. Mr. Watson did not refute this claim specifically. He testified that he provided 61 graphs to illustrate the range of curves used in his analysis.

The Examiners' find that the 1982 placement band declines slightly from 100% surviving and requires Mr. Watson to estimate 94% of the unknown balance of the survivor curve. The 1962 placement band information provides more credible statistical results upon which to draw a conclusion. The Examiners find that Mr. Pous' recommended life-curve is a better visual fit for this account as graphically presented in his direct testimony. The Examiners recommend adoption of Mr. Pous' recommended 70 R2.5 life-curve.

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<sup>267</sup> Dallas Ex. 1, Pous Direct at 36.

Mid-Tex ASL Item #6 - Account 378 – Measuring and Regulating Station Equipment			
Existing:40R2	Atmos: 57R1	Dallas: 65R1.5	Examiner Recommendation: 57R1

Mid-Tex ASL Item #7 - Account 379 – City Gate Equipment			
Existing:45L1.5	Atmos: 57R1	Dallas: 65R1.5	Examiner Recommendation: 57R1

Mid-Tex ASL Item #8 - Account 385 – Industrial Measuring and Regulating Equipment			
Existing: N/A	Atmos: 57R1	Dallas: 65R1.5	Examiner Recommendation: 57R1

The following three accounts serve different purposes, but the assets are similar and perform similar functions and may be evaluated together.

Account 378:

Mr. Pous recommends a 65R1.5 life-curve combination. He claims that Mr. Watson's proposal does not match the actuarial results as reflected in his depreciation study and it understates the ASL expectations reflected in his workpapers. Mr. Pous relied on the same actuarial results as does Mr. Watson. However, Mr. Pous believes the actuarial results for this account predominantly indicate a 70-plus-year ASL for mid-placement band analyses. Mr. Pous states that based on specific company data, a much longer ASL is indicated, however, the statistical data provided can lead to varying results. The analysis that reflects the more statistically stable results, yet does not capture measuring equipment back to the early 1900s, at a minimum reflects a 65-year ASL.<sup>268</sup>

Account 379:

Mr. Pous believes that Mr. Watson's recommendation ignores company-specific data from an actuarial standpoint and relies on generalized statements of company personnel regarding the "expectations" for the type of assets and on his judgment.<sup>269</sup> Mr. Pous disagrees and for consistency with his recommendation for Account 378 recommends a 65R1.5 life-curve combination. He based his recommendation on review of the actuarial analysis, data for Accounts 378 and then 378 and 379 combined and states that a longer ASL of 70-plus years is warranted. However, taking into account concerns raised by company personnel and the minimal ASL required for Account 378, Mr. Pous limited the increase for Account 379 to be consistent with the values recommended for Account 378.

Account 385:

Mr. Pous based his recommendation of a 65 R1.5 life-curve combination on the same approach utilized by Mr. Watson, which is identical to his recommendation for Accounts 378 and 379. Mr. Pous stated that given the lack of historical information but the similarities of the investment with Accounts 378 and 379, it is appropriate to consistently utilize the same life-curve combination for each account.

<sup>268</sup> City of Dallas Ex. 1, Direct Testimony of Jacob Pous, p. 40.

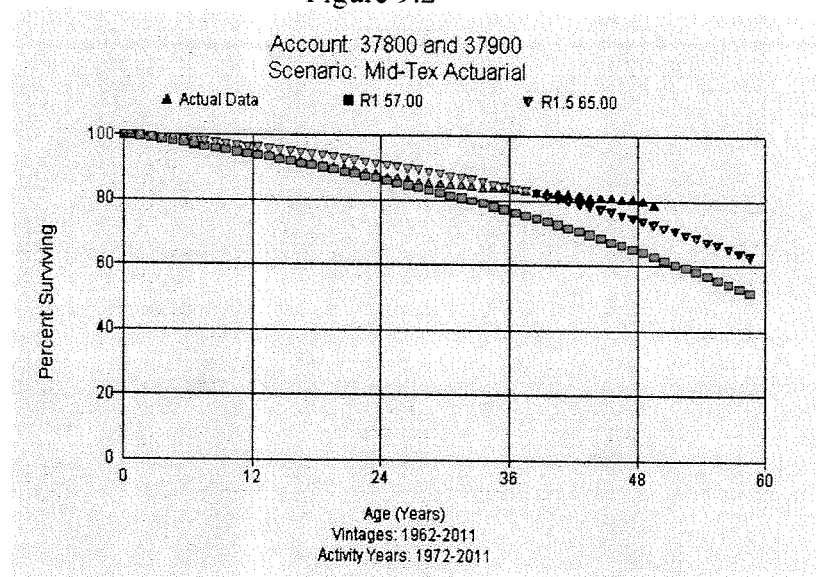
<sup>269</sup> City of Dallas Ex. 1, Direct Testimony of Jacob Pous, p. 41, lns. 22-24.

Company's Response:

Mr. Watson claims that individual account analysis for Accounts 378 and 379 yielded results that are not meaningful. This was due to the low level of retirement transactions in the individual accounts; therefore, a combined analysis was performed. Account 385 did not have an existing approved parameter and had insufficient historical experience. It is the totality of these analyses that were the starting point for his recommendation for all three accounts. The three accounts serve different purposes, but the assets are similar and perform similar functions. He argued that Mr. Pous has relied solely upon the actuarial analysis and not given consideration to the various retirement units and the expected shorter lives of certain assets in these accounts that are technology- and communication-based rather than mechanical. Compared to the existing approved life for Account 378, which is a 40 R2, his analysis recommended extending the life of these assets by 17 years or 43%. Mr. Pous suggests a 25-year, or 63%, increase in life.

Account 379 has an existing approved life of 45 L1.5, so his recommendation was an increase of 12 years, or 27%, while Mr. Pous' recommendation results in an additional 20-year, or 44%, increase in life. In short, Mr. Pous has not given adequate recognition to the changing assets and has increased the life of these assets beyond what can be reasonably expected. The graph below provides a comparison between Mr. Watson's recommendation and that of Mr. Pous. It illustrates that Mr. Pous' life-curve combination is above the actual data, and the company's recommendation nearly from the top of the curve (100% surviving) and remains above it until about 80% surviving. Mr. Pous' recommendation provides a better match at the end of the graph. This match is at the end or tail of the actual data. It is well established that the matching of the curves at the end or tail of the curve should be provided less weight. The graph below illustrates that Mr. Pous' life recommendation is too long.<sup>270</sup>

Figure 9.2



<sup>270</sup> Atmos Ex. 25, Rebuttal Testimony of Dane A. Watson, p. 34-35

Examiners' Recommendation:

The Examiners agree that less significance should be given to the tail end of the curve. The 65 R1 does not match points at the beginning portion of the curve while the 57 R1 matches to about 80% surviving. The Examiners also find that it is prudent to expect shorter lives for accounts that are technology- and communication-based rather than mechanical. The Examiners recommend adopting a 57 R1 life-curve, as proposed by Atmos, for this group of assets.

Mid-Tex ASL Item #9 - Account 380 – Distribution Services			
Existing: 35R3	Atmos: 37S0.5	Dallas: 41L1	Examiners' Recommendation: 37S0.5

Intervenors' Position:

Mr. Pous disagrees with Mr. Watson's proposal claiming it represents one of the shorter ASLs for the industry as well as for what Mr. Watson predominantly recommends elsewhere. He recommends a further increase to a 41L1 life-curve combination. Key factors for his recommendation include visual curve analysis of actuarial results, knowledge of technological improvements, experience and knowledge. He also evaluated the relationship between mains and services. He believes that his recommended 41L1 life-curve combination is a better fit for ages in the early-40-year range and then becomes a poorer fit in the mid-40-year age bracket and discounts the tail end of the curve because the dollar level of exposures at the tail end of the curve (i.e., mid- 40-year age bracket) diminishes to the point where, statistically, it is not stable and should be given limited consideration or ignored. He states that from a technological standpoint, the same advances that have occurred for pipe classified as mains are also applicable to the investment in services. In addition, as previously discussed for mains, better manufactured pipe, along with better installation practices have noticeably extended the expected life of the investment in pipes, whether the pipes are classified as mains or services.<sup>271</sup>

As to the relationship between mains and services, Mr. Pous states that he has reviewed Mr. Watson's testimony in other proceedings and Mr. Watson has recommended the range of ASL differential values identified is between 6 years and 16 years, with an average of 11 years.<sup>272</sup> However, in this case, Mr. Watson proposes a 28- (65-37) to 33- (70-37) year differential between the ASL he proposes for services compared to those for mains.<sup>273</sup>

Company's Response:

Mr. Watson performed 62 individual life-curve combinations over various placement and experience bands and claims where possible, the same bands are fit for all bands for consistency and to provide unbiased curve fits. Mr. Pous did not even attempt to fit any life-curve combination less than 40 years, whereas his analysis evaluated numerous fits both shorter and

<sup>271</sup> City of Dallas Ex. 1, Direct Testimony of Jacob Pous, p. 44, Ins. 1-16.

<sup>272</sup> Atmos Energy Mississippi Division Docket No. 2011-UN-184, Chattanooga Gas Company Docket No. 09-000183, Michigan Gas Utilities Docket No. U-15963, Consumers Energy Docket No. U-16938, Consumers Energy Docket No. U-15629, Atmos Energy Kansas Division Docket No. 12-ATMG-564-RTS, CenterPoint Energy Mississippi Gas Docket No. 09-UN-334, and WE Energies Docket No. 05-DU-101.

<sup>273</sup> City of Dallas Ex. 1, Direct Testimony of Jacob Pous, p. 13, Ins. 23-30.

longer than his recommendations. Atmos claims that since Mr. Pous failed to fit any life-curve combination under 40 years, and this renders his analysis flawed.<sup>274</sup> Atmos argued that industry comparisons can be useful when the company lacks specific historical experience. This is not the case for Mid-Tex because numerous, company-specific factors contribute to the life determinations for Mid-Tex assets and were considered as part of Mr. Watson's analysis.<sup>275</sup>

**Examiners' Recommendation:**

Both witnesses claim that their visual fit is superior in the same graph. Mr. Pous testified that 41L1 is essentially the same as the 35S0.5 through the early part of the process, but that his curve is a better fit in the early 40-year age bracket. As can be seen it is a poorer fit in the mid-40 year, which is a) the tail end, and b) statistically not stable due to the dollar level of exposures at the tail end.<sup>276</sup> Mr. Watson discusses how the recommendations mirror each other until Mr. Pous' life-curve combination falls to the left of his recommendation and even further from the actual data starting at around 90% surviving and age 16. It remains there until it crosses over at age 28 and 65% surviving. As he notes, it is only near the tail of the curve or age 40 to age 44.4, between 40 and 50% surviving, that his curve matches the data better and then only very briefly. Both agree that the tail of the curve is not as important to match as the rest of the curve.

The Examiners find that both curves match well until the beginning of the mid-range, or age 15. Then, the 37S0.5 is a better fit until about age 40. In evaluating these curves, less significance should be given to the tail end of the curve. The Examiners recommend the 37S0.5 ASL as proposed by Atmos.

Regarding Mr. Pous' discussion on the differential between Mr. Watson's recommendation on Mains and Services, the Examiners agree with Mr. Watson that industry comparisons can be useful when the company lacks historical experience. However, company-specific factors were the basis for Mr. Watson's analysis in this docket. It is also worth noting that Mr. Pous' recommendation between mains and services of 70 and 41 years also results in a differential of three times the average in the dockets referenced by Mr. Pous.

Mid-Tex ASL Item #10 - Account 381 – Meters			
Existing: 33R1.5	Atmos: 37R1	Dallas: 35R1	Examiner Recommendation: 37R1

Mid-Tex ASL Item #11 - Account 382 – Meter Installations			
Existing: N/A	Atmos: 37R1	Dallas: 35R1	Examiner Recommendation: 37R1

Mid-Tex Item #12 - Account 383 – House Regulators			
Existing: 40R1.5	Atmos: 37R1	Dallas: 35R1	Examiner Recommendation: 37R1

The three accounts serve different purposes, but the assets are similar and perform similar functions and are evaluated together.

<sup>274</sup> Rebuttal Testimony of Dane A. Watson, Atmos Ex. 25 at 36-37.

<sup>275</sup> *Id.* at 37-38.

<sup>276</sup> City of Dallas Ex. 1, Direct Testimony of Jacob Pous, p. 43.

Intervenors' Position:

Mr. Pous recommends a 35R1 life-curve combination, which is two years shorter than Mr. Watson's proposal and results in an increase to depreciation expense. Mr. Pous based his recommendation on a change throughout the industry in meter technology and the overall life expectancy for meters. Given that the company has already installed 24,000 smart meters and is considering new smart meter technology in the Dallas area, it would be inappropriate to increase the ASL to too great an extent at this time as Mr. Watson proposes. Too great of an increase now may result in a situation of possibly decreasing the ASL in the near-term future as the life associated with the new smart meter installation is recognized. Mr. Pous states that this is an account where there is a clear indication that technology may result in a more efficient operation of the system, but reduce the useful life of the investment necessary to bring about such additional efficiencies. Proper depreciation practices require limiting the level of increase reflected in the actuarial analysis to a greater extent than Mr. Watson has proposed.<sup>277</sup>

Company's Response:

Mr. Watson states that historical data and uncertain future plans do not warrant a lower life recommendation at this time. Also, the company has a policy to conduct a depreciation study every five years or less. He believes it is more reasonable to wait to make any additional life adjustment.<sup>278</sup>

Examiners' Recommendation:

The Examiners recognize that current technology is expected to decrease the life expectancy of this account as Atmos installs new meters. However, Atmos has indicated that it does not have current plans to do so. Atmos has stated that they perform depreciation studies every five years. At this time, it is reasonable to adopt Atmos' recommended life-curve, 37R1, and make the anticipated adjustment when the impact is captured in the next depreciation study.

Item #13 - Account 390 – General Plant Structures and Improvements			
Existing: 40L1.5	Atmos: 45R2.5	Dallas: 55R2.5	Examiner Recommendation: 45R2.5

Intervenor's Position:

Mr. Pous claims that, for unexplained reasons, Mr. Watson analysis appears to include non-recurring events in the life database which caused the visual matching to be difficult and resulted in artificially short life expectations. Mr. Pous' position is that Mr. Watson also fails to explain his judgment process and does not understand the normal life cycle for this property. He recommends a 55R2.5 life-curve combination.

<sup>277</sup> City of Dallas Ex. 1, Direct Testimony of Jacob Pous, p. 47, lns. 19-29.

<sup>278</sup> Atmos Ex. 25, Rebuttal Testimony of Dane A. Watson, p. 39, lns. 19-23, p. 40 lns. 5-13.



Mr. Pous stated that in order to establish a reasonable ASL for this account, it is necessary to know the mix of the investment in the account. Mr. Pous reviewed the actual types of investment in the account and believes a minimum of a 55-year ASL is warranted. Approximately 79% of the investment in the account is associated with building structures, land rights, structures and improvements, and similar long-lived investments.<sup>279</sup> Mr. Pous' recommendation assumes as little as a 65-year life expectancy for buildings, building structures, and similar long-lived assets, and as little as 15 years for short-lived assets such as roofs and air-conditioning systems. He states that for Mr. Watson's proposed ASL to have credibility, one would have to assume as little as a 53-year total life for building and building structures. In reality, the 65-year total life expectancy for building and building structures is too short. In fact, one of the company's major buildings was placed into service in 1960 and the company has no plans to retire such investment.<sup>280</sup>

Company's Response:

Mr. Watson rebuts Mr. Pous' reliance on one single building to attack his recommendation as inconsistent with rulings in prior proceedings where the Commission has required the removal of outliers from both the life and net salvage analysis.<sup>281</sup> Mr. Watson stated that the fact that one building has lived to his recommended average service life is not unexpected. An average service life is exactly that, an average. The expectation is that some assets will live longer, some shorter, but one outlier does not invalidate the entire analysis. Mr. Watson believes Mr. Pous has inappropriately given the long-lived assets (approximately 79% of the assets) a 65-year life a more accurate life estimate for the long-lived assets (buildings) is a 50-year life. Mr. Watson stated that he would also assign the shorter lived assets a 20-year life, not a 15-year life as Mr. Pous suggests.<sup>282</sup> Mr. Watson applied the same percentage allocation that Mr. Pous applied to long lived and short lived assets in this account. Mr. Watson's weighting and lives calculation result in an average service life of approximately 44 years, which is almost exactly what he has proposed.<sup>283</sup>

Examiners' Recommendation:

Commission precedent requires the removal of outliers from the analysis. Mr. Pous' example of an Atmos building still in service since 1960 with no plans to retire does not invalidate study. At its current age the building is near the recommended average life for this account. Mr. Pous does establish the allocation of 79% to the long-lived assets and 21% to the short-lived assets in this account based on his review of this account. However, Mr. Pous does not substantiate his application of 65-year and 15-year, respectively, to arrive at his recommendation of a minimum 55-year ASL. Therefore, the City of Dallas has not established that the company's proposed analysis was unreasonable. The Examiners recommend adoption of the 45R2.5 as proposed by Atmos.

<sup>279</sup> Response to Dallas 1-44 Attachment.

<sup>280</sup> Response to Dallas 1-40 Attachment.

<sup>281</sup> See GUD No. 9145-9148, PFD at 79.

<sup>282</sup> Direct Testimony of Jacob Pous at 50.

<sup>283</sup> Atmos Ex. 25, Rebuttal Testimony of Dane A. Watson, p. 41.

h. Mid-Tex Depreciation – Net Salvage

A negative 40 percent net salvage rate (functional) for Distribution plant was approved in GUD No. 9869 for Distribution assets and is the existing net salvage for all distribution plant accounts. The company now maintains salvage and cost of removal data by account and has been doing so since 2005. Through the 1980s forward, the net salvage percent has been increasingly negative. The small amounts of gross salvage that was received in the past from salvaged pipe and meters have decreased. In the past, some pipe was removed from the ground, but now the company generally abandons pipe in place. Retired meters, another past source of gross salvage, are junked with no scrap value. Increasing costs of removal applied to original cost dollars retired make net salvage even more negative on jobs where pipe is being abandoned in place. For retirement projects, the cost of dispatching a crew, digging a trench, filling the pipe with inert materials if necessary, capping each end, and paving repairs are all part of removal cost. These costs are continuing to increase as labor and material costs escalate. In addition, municipalities are adopting or rigorously enforcing ordinances that significantly increase the cost to retire facilities. One example of an ordinance change is the requirement for compaction of soil under paved surfaces when disturbed. According to company engineers, flowable fill is the most cost effective means of meeting that requirement. Adding in the cost of replacing paving (as well as labor, transportation, etc.) will increase the removal cost even further.<sup>284</sup>

Mr. Pous reviewed the net salvage recommendations for Distribution and General Plant accounts and he believes the company's proposed negative net salvage amounts are overstated and require adjustments. Based on his review and analysis of all mass property accounts, he recommends net salvage adjustments to the following three accounts and reflects a combined depreciation expense impact of \$3.6 million based on plant as of September 31, 2011.<sup>285</sup>

**Summary of Intervenor's Recommended Mass Property Net Salvage Adjustments**

<b><u>Item</u></b>	<b><u>Account</u></b>	<b><u>Atmos Existing</u></b>	<b><u>Atmos Proposed</u></b>	<b><u>Dallas Proposed</u></b>	<b><u>Annual Impact of Proposed Adjustment</u></b>
1	376.01	-40%	-105%	-80%	(\$2,000,000)
2	376.02	-40%	-40%	-30%	(\$1,200,000)
3	390	0%	-5%	15%	(\$90,000)

<sup>284</sup> Atmos Ex. 14, Direct Testimony of Dane A. Watson, DAW-1, p. 46.

<sup>285</sup> City of Dallas Ex. 1, Direct Testimony of Jacob Pous, p. 51, lns. 19-30.

Mid-Tex Net Salvage, Item #1 Account 376.01 – Steel Mains			
Existing: -40%	Atmos: -105%	Dallas: -80%	Examiner Recommendation: -105%

Mid-Tex Net Salvage, Item #2 Account 376.02 – Plastic Mains			
Existing: -40%	Atmos: -40%	Dallas: -30%	Examiner Recommendation: -40%

There are two issues presented in both account 376.01 and 376.02. First, whether it is more appropriate to rely on the four-year rolling average rather than the full seven-year that Mr. Watson analyzed in his study. Second, how to define outliers and whether or not they should be excluded.

For account 376.01 the seven-year average of data yields -80%, Mr. Watson bases his recommendation on the intermediate four-year rolling averages which results in a -105%. For account 376.02 the seven-year historical average is a -32%, Mr. Watson again relies on a four-year average for his recommendation which results in a -41% net salvage.

**Intervenors' Position:**

Mr. Pous argues the company's approach yields an excessively negative result. It is not based on an appropriate review of historical data. He bases his analysis on the full seven-years of data and recommends a -80% net salvage for account 376.01 and a -30% net salvage for account 376.02. He states that while even more data would be desirable, the company could only provide data from 2005-2011.<sup>286</sup>

Mr. Pous challenges Mr. Watson's claim that the particular information relied upon is that a four-year average of activity is a better indication of future expectations because it corresponds with the conversion to Atmos' accounting system. He bases his challenge on the fact that the company's accounting system was fully implemented in 2005. Therefore, reliance on at least the 2006-2011 period better corresponds with Atmos' accounting system than does reliance on only a four-year average.

Mr. Pous also takes issue with Mr. Watson's claim that the historical data is not synchronized. What this means is that cost of removal and gross salvage associated with a retirement may not be recorded in the same year as the retirement is recorded. Mr. Watson claimed that reported gross salvage values are recorded as much as five to six years after the retirement event.<sup>287</sup> Therefore, an arbitrary decision by Mr. Watson, which coincidentally captures basically the most negative net salvage value in the historical database, violates his concept of ensuring that non-synchronized data is corrected.<sup>288</sup>

**Company's Response:**

For account 376.01, Mr. Watson testified he consistently used the more recent history unless the facts or data suggested moderation of the results of the shorter bands. For consistency

<sup>286</sup> Mid-Tex Study, Appendix D.

<sup>287</sup> Response to Dallas 2-18 and 2-20.

<sup>288</sup> City of Dallas Ex. 1, Direct Testimony of Jacob Pous, p. 56, Ins. 22-27.

and comparability, he also performed a functional analysis to confirm individual account indications.<sup>289</sup> He refers to the data presented in Appendix D of Atmos' Depreciation Study report,<sup>290</sup> there were no retirements, gross salvage or removal costs recorded for this account in 2005 after the company's purchase of the Mid-Tex system from TXU and while the company was transitioning the assets to a new fixed asset accounting system. In 2006, although the retirements in that year reflected two years of retirements (for 2005 and 2006), the company only recorded \$0.9 million in removal cost, which was as little as *half* of the removal costs recorded by the company in *any* subsequent year (\$1.7 million in 2008 being the next highest) and as little as *one quarter* of the removal costs recorded in 2010 (\$3.5 million). Clearly, the system implementation and transition of ownership created anomalies in the data for 2005 and 2006 making them outliers compared to more recent data. He also compares his recommendation to the fact that years 2007 to 2011 experienced a negative 107%, negative 103%, negative 105% and negative 102% net salvage, respectively. He claims his treatment of these outliers is consistent with recognized depreciation texts<sup>291</sup> and Commission precedent.<sup>292</sup> Mr. Pous inappropriately includes both years 2005 and 2006 in his analysis, he argued, and distorts the results.<sup>293</sup>

For account 376.02, Mr. Watson reiterates that the years 2005 and 2006 were anomalous because of Atmos Energy's acquisition of Mid-Tex assets and the transition of those assets to a new accounting system. As in account 376.01 described above, the first year of net salvage information (2006) is dramatically different than all other years. 2006 experienced \$84 thousand in removal cost, including the catch-up for 2005 retirements, as compared to between \$300 thousand and over \$1 million in removal cost in all subsequent years. Therefore, it is inappropriate and unreasonable to include 2006 as representative of ongoing activity because it will distort the results.<sup>294</sup>

Mr. Watson claims the issue of time synchronized data is not new and should be viewed as a non-issue when rolling averages are calculated and evaluated such as those contained in his net salvage analysis provided in Exhibit DAW-1 of his Direct Testimony. By viewing the results of the rolling and shrinking bands, generally the analyst is able to see the matching of the salvage, removal cost and retirements in the same analysis. However, because of the anomalies in 2005 and 2006 data, he discounted those years in some instances because they were not representative of ongoing activity. Mr. Pous' suggestion that the company use rolling bands that include anomalous data is inappropriate.<sup>295</sup>

#### Examiners' Recommendation:

Atmos' depreciation study contains seven years of account-specific historical experience which Mr. Watson relied on to make his recommendations for account 376.01 and 376.02. Mr. Watson's identification and treatment of the 2005 and 2006 outliers is consistent Commission

<sup>289</sup> Atmos Ex. 25, Rebuttal Testimony of Dane A. Watson, p. 44, Ins. 8-14.

<sup>290</sup> Direct Testimony of Dane A. Watson, Exhibit DAW-1, Appendix D.

<sup>291</sup> Frank K. Wolf and W.C. Fitch, *Depreciation Systems* at 17-18 (1994).

<sup>292</sup> GUD No. 9145-9148, PFD at 79.

<sup>293</sup> Atmos Ex. 25, Rebuttal Testimony of Dane A. Watson, p. 46, Ins. 2-18.

<sup>294</sup> Atmos Ex. 25, Rebuttal Testimony of Dane A. Watson, p. 49, Ins. 14-22.

<sup>295</sup> Atmos Ex. 25, Rebuttal Testimony of Dane A. Watson, p. 48, Ins. 11-21.

precedent. The Examiners recommend adoption of net salvage values as proposed by Atmos, -105% for 376.01 and -40% for 376.02.

Mid-Tex Net Salvage, Item #3 Account 390 – Structures and Improvements			
Existing: 0	Atmos: -5%	Dallas: +15%	Examiner Recommendation: -5%

Intervenors' Position:

Mr. Watson, after removing sales of office buildings, relied on a two-year average, which produced a less negative value and also relied on future expectations and judgment.<sup>296</sup> Mr. Pous recommends a positive 15% as an initial step towards the recognition of significant positive salvage normally associated with the retirement of buildings.

Mr. Pous notes that Mr. Watson admits that he removed sales from the salvage portion of his analysis but for life purposes he states that in the early 1990s the company closed many local distribution offices which resulted in nonrecurring events when those offices were sold. However, in Mr. Watson's life analysis he continued by stating that those retirements associated with sales make visual matching difficult. Mr. Pous believes Mr. Watson was incorrect when he removed all aspects of prior sale of offices. Mr. Watson's reliance on selective quotes from publications is misleading. For example, the publication Depreciation Systems specifically states that activity that "results from unusual occurrences" is considered an outlier.<sup>297</sup> Mr. Pous noted that the authors of that publication have also published other depreciation-related texts in which they state an outlier reflects a highly improbable occurrence. These occurrences should be classified as outliers, "if during the process of data assembly, the situation under which the retirement occurs can be documented as being exceptionally unusual." (Emphasis added).<sup>298</sup> The sale of office buildings cannot be considered exceptionally unusual or highly improbable.<sup>298</sup>

Company's Response:

Mr. Watson stated that he did removed office building sales from both the life analysis and the net salvage analysis using the same method approved by this Commission in previous dockets. In GUD No. 9145-9148, this Commission determined that outliers (sales) should be removed from the data for this account for both life and net salvage.<sup>299</sup> Once sales are removed, there is little if any salvage, which is more than offset by the cost of retiring the assets. Mr. Pous does not even evaluate the costs of removal but merely concludes that there must be some salvage value in the construction materials used to build these buildings structures. Mr. Watson asserts that his negative 5% net salvage value recommendation is reasonable, especially given the fact that the net salvage result for the seven-year band that Mr. Pous has been suggesting for the other accounts is a *negative 12%*. Mr. Watson's states that his recommendation in this account is also consistent with his recommendations in other accounts where he has relied on more recent activity than the full seven years of data.

<sup>296</sup> City of Dallas Ex. 1, Direct Testimony of Jacob Pous, p. 59, Ins. 8-10.

<sup>297</sup> City of Dallas Ex. 1, Direct Testimony of Jacob Pous, p. 60, Ins. 1-9 (citing to Depreciation Systems at page 17).

<sup>298</sup> City of Dallas Ex. 1, Direct Testimony of Jacob Pous, p. 60, Ins. 9-15 (citing to The Estimation of Depreciation at page 77).

<sup>299</sup> GUD Nos. 9145-9148, PFD at 79.

Exclusion of sales and outliers was approved by this Commission in GUD Nos. 9670, 9400, 9145-9148, 8976 and 9762.<sup>300</sup> No portion of Dallas' briefing explains why this approved methodology should be rejected. Further, Dallas does not dispute that in GUD No. 9145, the Commissioners agreed with the removal of certain outlier sales and adopted the company's proposed net salvage rates based on the removal of those buildings.<sup>301</sup>

**Examiners' Recommendation:**

The issue in this account is the inclusion or non-inclusion of sales of building in the analysis. The crux of the issue is whether sales of buildings is defined by any precedent as outliers. In GUD No. 9145-9148, this Commission determined that outliers (sales) should be removed from the data for this account for both life and net salvage.<sup>302</sup> Mr. Pous does not evaluate the cost of removal to substantiate his recommendation of 15% net salvage recommendation. Therefore, the City of Dallas has not established that the company's proposed analysis was unreasonable. The Examiners recommend adoption of -5% as proposed by Atmos.

i. SSU Depreciation – Average Service Life (Two Accounts)

Mr. Pous recommends adjustments to two SSU accounts with a corresponding impact of an approximate \$1.8 million reduction prior to allocation to any of Atmos' divisions based on plant as of September 30, 2010.<sup>303</sup>

**Summary of Dallas' Recommended Mass Property Life Adjustments**

<u>Item</u>	<u>Account</u>	<u>Atmos Existing</u>	<u>Atmos Proposed</u>	<u>Dallas Proposed</u>	<u>Dallas ASL Adjustments</u>	<u>Annual Adj. Amount</u>
1	390	N/A	40R2	55R2.5	15	(\$90,000)
2	399.08	10	12R5	15R5	3	(\$1,600,000)

**SSU ASL, Item #1 - Account 390 Structures and Improvements**

<b>Existing: N/A</b>	<b>Atmos: 40R2</b>	<b>Dallas: 55R2.5</b>	<b>Examiner Recommendation: 40R2</b>
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**Intervenors' Position:**

Mr. Pous recommends the same 55R2.5 life-curve combination for these general plant structures and improvements as he did for the Mid-Tex equivalent account. His recommendation is based on his claim that new buildings, whether used for training centers or operation centers, do not realistically exhibit life characteristics associated with a 40-year ASL. Office buildings and operational centers can normally be expected to easily exceed 50-, 60-, or even 70-year useful lives.

<sup>300</sup> GUD No. 9762, Final Order at FOF 21 (Jun. 25, 2008) ("It is reasonable to remove sales, transfers of property, outliers, and reimbursed retirements in the calculation of life and salvage analysis for this utility.").

<sup>301</sup> Atmos Reply Brief, p. 33.

<sup>302</sup> GUD No. 9145-9148, PFD at 79.

<sup>303</sup> All SSU values are stated at the total Atmos level prior to allocation to any division.

Company's Response:

Mr. Watson asserts that Mr. Pous' recommendation does not consider the use of the assets and that buildings, regardless of their purpose, will exhibit a longer life than what he has recommended. The average age of the surviving assets at the time of the study was less than two years old. Considering the mix of assets in the account—many of which, such as roofing, HVAC, etc. will be replaced prior to the end of the life of the building—the 40-year life assigned to the account is the most appropriate life recommendation at this time.

Examiners' Recommendation:

The average age of assets in this account is 1.5 years. This account contains items other than longer-lived buildings such as roofing, HVAC, etc. that will be replaced prior to the end of the life of the building.<sup>304</sup> The 40-year life Mr. Watson recommends is a reasonable estimate at this time. Also, given that Mid-Tex performs depreciation studies every three to five years required adjustments may be implemented in future studies. The Examiners recommend adoption of 40R2 as proposed by Atmos.

SSU ASL, Item #2 - Account 399.08 – Application Software			
Existing:10	Atmos: 12R5	Dallas: 15R5	Examiner Recommendation: 15R5

Intervenors' Position:

Mr. Pous recommended a 15-year ASL based on the following:

1. The previous legacy systems that were accounted for as application software for many utilities lasted 25 to 30 years or longer.
2. Over \$65 million of Atmos' investment in this account has already exceeded the existing approved 10-year ASL.
3. In addition, in a current Florida Power & Light case before the Florida Public Utilities Commission, that utility is increasing the life expectancy for SAP investment from 5 years to 20 years.<sup>305</sup>
4. The reason for longer life expectancy is due in part to the architecture, modularization and scalability associated with such type of software. In other words, the core portion of the software application system can be retained and expanded as necessary without retiring the software system itself.
5. For his actuarial interpretation presented at page 27 of the SSU Study, Mr. Watson relied on a 1985-2010 placement band. This long of a placement band is inappropriate for current software applications. In fact, 100% of his

<sup>304</sup> Rebuttal Testimony of Dane A. Watson, Atmos Ex. 25 at 52.

<sup>305</sup> Florida Public Service Commission Docket No. 12-04005.

actuarial interpretations for placement bands beginning in 1996 were 20 years.<sup>306</sup>

Company's Response:

Mr. Watson recommended increasing the life from the existing ten years to twelve years. While some of the assets have aged beyond the existing ten-year life, this account uses an average life because the company expects some assets to live longer than the twelve years and some to retire earlier than twelve years. He claims that this is evidenced by his interview notes of discussions with company personnel who stated that they will be retiring and replacing a significant amount of software in the next two years. In addition, the GAAP guidance for software (AICPA SOP 98-1 – Accounting for the Cost of Software Developed or Obtained for Internal Use) requires the assignment of lives based on the specific expectations for the assets.<sup>307</sup>

Examiners' Recommendation:

As discussed above, Mr. Pous' direct testimony contained several reasons why the recommended service life for this account is understated. On rebuttal, Mr. Watson's two main points failed to address Mr. Pous' issues. Mr. Watson stated that while some of the assets have aged beyond the existing ten-year life, this account uses an average life because the company expects some assets to live longer than the twelve years and some to retire earlier than twelve years. He also referenced his interview notes dated April 2011. The entire content of his interview notes is as follows: "CIS/Billing System changing to SAP Platform and expected in 18-24 months. BMax needed for SAP application for easier replication."<sup>308</sup> Also, he claims that the AICPA guidance provides – the input of company personnel who are involved in retiring and replacing software guide the service life assessment. His interview notes do not discuss the expected replacement period and the AICPA reference says nothing about the proper average service life in years, it discusses the proper amortization method.<sup>309</sup>

As filed, the company satisfied its initial burden of proof regarding its analysis of this account as Mr. Watson's report provides the rationale of extending the average service life from ten to twelve years. Ultimately the fact is that the City of Dallas raised several specific challenges to the depreciation analysis provided by Atmos. This challenge shifted the burden of proof but there was no rebuttal to the several facts raised by the City of Dallas. The weight of the substantial evidence in this case is insufficient to support the company's proposed ASL. Therefore, the Examiners recommend adoption of the 15-year ASL as proposed by the City of Dallas.

<sup>306</sup> Mr. Watson's Relied Files, Shared Services Alliance Workpaper Final, PP Data Set, Vintage Plant & Transaction History, Account 39908 balances.

<sup>307</sup> AICPA SOP 98-1 – "The capitalized costs of computer software developed or obtained for internal use should be amortized on a straight-line basis unless another systematic and rational basis is more representative of the software's use."

<sup>308</sup> Atmos Ex. 14, Watson Direct, Relied Files\Shared Services Alliance Workpapers Final\Interview Notes\Atmos Shared Services Interview 4-27-2011.doc (page 2).

<sup>309</sup> Tr. Vol. 2 at 107 lns. 18-108, ln. 14.



j. SSU Depreciation – Net Salvage

Account 390.00 – Structure and Improvements			
Existing:N/A	Atmos: 0%	Dallas: +15%	Examiner Recommendation: 0%

Intervenors' Position:

The City of Dallas addresses the proposed zero net salvage amount the company seeks for SSU plant. Mr. Pous testifies that zero understates the net salvage for account 390.00 Structures and Improvements and recommends a positive 15% net salvage which reflects a depreciation expense impact of \$45,000 based on plant as of September 30, 2010. Mr. Pous describes his recommendation as an initial step towards the recognition of significant positive salvage normally associated with the retirement of buildings. His basis is the same as for his recommendation of this account in the Mid-Tex study. Mr. Pous believes it is unreasonable to assume or expect that buildings will be demolished rather than sold after 40 or 50 years of use as Atmos has sold other buildings rather than demolished them.<sup>310</sup> Mr. Pous disagrees with Mr. Watson claim that Commission precedent requires that sales be removed from both life and net salvage analysis. The City of Dallas contended that Mr. Watson's reliance on precedent is misplaced. The City of Dallas does not believe it is reasonable to use -5% negative salvage for Mid-Tex and 0% for SSU.<sup>311</sup>

Company's Response:

Mr. Watson responded that Mr. Pous based his proposal for this account on the future expectation that buildings will be sold and ignores valid Commission precedent that requires that sales should be removed from both life and net salvage analysis.<sup>312</sup> Mr. Watson based his recommendation on Commission precedent and additional analysis of this SSU account. As in Mid-Tex he believes any salvage received would be offset by any costs incurred to retire and/or remove the assets. While Mid-Tex is experiencing a negative net salvage for this account, the Shared Services Unit does not yet have the historical experience to set a negative net salvage. Until specific company experience is obtained for the assets in this account (as seen for the same account in Mid-Tex where a negative 5% net salvage is recommended), he recommends a 0% net salvage factor.<sup>313</sup>

Examiners' Recommendation:

In GUD Nos. 9145-9148, this Commission determined that outliers (sales) should be removed from the data for this account for both life and net salvage.<sup>314</sup> Also, Mr. Pous does not evaluate the cost of removal to substantiate his recommendation of 15% net salvage recommendation. Therefore, the City of Dallas has not established that the company's proposed analysis was unreasonable. The Examiners recommend adoption of 0% net salvage as proposed by Atmos.

<sup>310</sup> City of Dallas Ex. 1, Direct Testimony of Jacob Pous, p. 64-65.

<sup>311</sup> City of Dallas Reply Brief, p. 13.

<sup>312</sup> GUD No. 9145-9148, PFD at 79.

<sup>313</sup> Atmos Ex. 25, Rebuttal Testimony of Dane A. Watson, p. 6, Ins. 5-8.

<sup>314</sup> GUD No. 9145-9148, PFD at 79.

## 10. Rate Base

### a. Introduction

The company's requested rate base totals \$1,514,381,221, based upon a test year ended September 30, 2011, updated for known changes and conditions that are measurable with reasonable accuracy, including capital investments through March 31, 2012.<sup>315</sup> Table 10.1 below summarizes the rate base request of the company.

Table 10.1  
Rate Base Request

Description		Total Requested
Net Plant	Gross Plant	\$2,862,971,783
	Accumulated Depreciation	1,069,874,434
	Total Net Plant	\$1,793,097,349
Additions	Materials & Supplies	850,505
	Prepayments	10,692,714
	Pension and Other Postemployment Benefits Regulatory Asset	1,973,612
	Total Additions	\$13,516,832
Deductions	Customer Deposits	\$21,808,614
	Injuries and Damages Reserve	1,925,776
	Accumulated Deferred Income Taxes	239,932,144
	Rate Base Adjustments	9,249,927
	Total Deductions	\$272,916,461
	Cash Working Capital	(19,316,498)
Total Rate Base: <u>Total Net Plant</u> plus <u>Total Additions</u> minus <u>Total Deductions</u> plus <u>Cash Working Capital</u>		\$1,514,381,222

The initial filing included a rate-base request of \$1,524,446,270.<sup>316</sup> Thus, Atmos reduced its initial rate base request by \$10,065,048. The Intervenor proposed several adjustments to the company's rate base request in the following areas:

1. Post-Test-Year Adjustments
2. Pension/OBEB Regulatory Asset
3. Accumulated Deferred Income Taxes (ADIT)
4. Cash Working Capital
5. FAS 106 Balance Reduction to Rate Base

The Examiners recommend one adjustment to the ADIT calculation. This adjustment reduces the overall rate base request by approximately \$1,409,030. The overall revenue requirement impact of this adjustment is a reduction in the amount of \$172,624. The Examiners' recommendation is the result, in large measure, to the company's careful adherence to

<sup>315</sup> Atmos Ex. 1, *Statement of Intent*, p. 1.

<sup>316</sup> Atmos Ex. 1, *Statement of Intent*, Schedule B, ln. 21, col. (e).

Commission precedent. Issues related to Pension/OPEB Regulatory Asset is an issue of first impression raised by the recent enactment of Section 104.059. The Examiners find that the company has complied with the statutory requirement of that section. Further, as noted above in Section 8, the pension and OPEB expense level was calculated by Towers Watson. That calculation was based upon the requirements of U.S. GAAP, the Pension Protection Act and limitations imposed by the Internal Revenue Code. Accordingly, the Examiners recommend the adoption of a total rate base of \$1,512,972,192.

b. Post-Test-Year Adjustments

(a) Introduction

The company's test year in this proceeding is the twelve-month period ending September 31, 2011, as adjusted for known and measurable changes through March 31, 2012. The fact that the test-year figures were adjusted through March 31, 2012 was stated in the *Statement of Intent* filing that was made on May 31, 2012. The company's rate-base calculation included gross plant in the amount of \$2,862,971,783. ACSC contended that the company's update through March 31, 2012 was not reasonable.

The focus of ACSC's adjustment is to remove approximately \$39,196,474 from gross plant. Thus, the gross plant included in the cost of service study is reduced from \$2,862,971,783 to \$2,823,755,309. The impact on the company's calculated rate base is to reduce the proposed rate base by approximately \$39,186,122.<sup>317</sup> The proposed adjustment would reduce the cost of service request of the company by approximately \$5,995,719.

(b) Intervenor's Position

Mr. Nalepa contended that all post-test year adjustments must satisfy several criteria. First, post-test year adjustments must be based upon amounts that are known and measurable. He did not claim, however, that the adjustments were not known and measurable. Second, he testified that matching costs and revenues is a fundamental regulatory concept. He asserted, therefore, that updates to rate base must recognize offsets, such as higher revenues due to customer growth. Mr. Nalepa pointed out that Atmos has not attempted to match post-test year plant with associated revenues and that no other component to the filing was recognized beyond the test year. Mr. Nalepa proposed that post-test year adjustments be recognized only through December 31, 2011 and that certain adjustments be made in an effort to match changes in revenue calculations.<sup>318</sup> ACSC has contended that if plant in service is updated through December 31, 2011, as requested a corresponding change is required to the calculation for Accumulated Deferred Income Taxes (ADIT) and accumulated depreciation.<sup>319</sup>

(c) Company's Response

Mr. Peterson responded by asserting that all updated information was based upon known and measurable changes. He also contended that the updated information was made available to

<sup>317</sup> A flow-through effect on the cash working capital calculation reduces the effect of the adjustment by approximately \$10,212.

<sup>318</sup> ACSC Ex. 1, Karl J. Nalepa, p. 12, ln. 1 – p. 14, ln. 17.

<sup>319</sup> ACSC Ex. 1, Karl J. Nalepa, p. 14, Footnote 11 & ACSC Ex. 3, Constance T. Cannady, p. 18, ln. 9 – p. 18, ln. 17.

all parties at the time the *Statement of Intent* was filed. Final data on the March 31, 2012 amounts was provided to the parties on May 31, 2012. Further, he stated that the company included all changes to net plant – including changes to accumulated deferred income taxes.<sup>320</sup>

(d) Examiners' Recommendation

The Examiners find that the company has established that a rate-base calculation founded upon a test year ending September 31, 2011, as adjusted for known and measurable changes through March 31, 2012, is just and reasonable. First, no contention has been made that the proposed adjustments are not known and measurable. Second, Atmos' update to plant was consistent with the Commission's determination in GUD No. 9869. In that case, the utility proposed to update plant balances through a period that ended nine months after the end of the test year. The Commission disallowed that update. The Commission, however, *allowed* an update to plant balances through a period that ended six months after the end of the test year.<sup>321</sup>

Third, the company's filing also complied with Examiners' Letter No. 10 wherein the Examiners set a deadline for updates to the company's filing. As explained in that ruling, the Commission has previously determined that late-filed *errata* revisions that incorporate mere updates to the books and records of a utility preclude a practical opportunity to review the proposed increase encompassed by the late-filed documents.<sup>322</sup> As noted by the Examiners in those proceedings such late-filed updates pose due process considerations and incur additional cost burdens on the proceedings.<sup>323</sup> In an effort to ensure that these proceedings are consistent with recent decisions, avoid additional costs and allow the utility to reasonably update its filing, the Examiners established a deadline consistent with the Commission's prior determination. Atmos' compliance is established by the fact that the update to plant balances was included in the *Statement of Intent* as filed.

In short, in prior proceedings, the Commission has determined that late-filed *errata* revisions that incorporate mere updates to the books and records of a utility preclude a practical opportunity to review the proposed increase encompassed by the late-filed documents.<sup>324</sup> That was not a factor in this case. The parties were aware of the update as of the date the case was filed. Accordingly, the Examiners recommend that the proposal of ACSC be rejected. The

<sup>320</sup> Atmos Ex. 17, Thomas H. Petersen Rebuttal, p. 31, ln. 16 – p. 34, ln. 5.

<sup>321</sup> GUD No. 9869, Final Order, FOF Nos. 11 & 17 – 19.

<sup>322</sup> GUD No. 9902, Findings of Fact Nos. 21 – 25. ("The parties have not had adequate time in this case to evaluate the updated filing prior to the commencement of the hearing.") & GUD No. 9869, Finding of Fact Nos. 18. ("[E]rrata filing is unreasonable because the Commission, Examiners and Intervenors in this proceeding do not have adequate time to review the data.").

<sup>323</sup> See, GUD No. 9902, Proposal for Decision, p. 10, "Such a proposal imposes tremendous costs on an already expensive process and would appear to deprive parties of fundamental due process accorded administrative hearings."

<sup>324</sup> Tex. R.R. Comm'n, *Statement of Intent of CenterPoint Energy Resources Corp., D/B/A CenterPoint Energy Entex and CenterPoint Energy Texas Gas to Increase Rates on a Division-Wide Basis in the Houston Division*, Docket No. 9902 (Gas Utils. Div. Feb. 23, 2010) (final order granting application) (GUD No. 9902), Findings of Fact Nos. 21 – 25. ("The parties have not had adequate time in this case to evaluate the updated filing prior to the commencement of the hearing."). Tex. R.R. Comm'n, *Petition for De Novo Review of the Denial of the Statement of Intent filed by Atmos Energy Corp., Mid-Tex Division by the City of Dallas; Statement of Intent to Increase Gas Utility Rates in the Unincorporated Areas Served by the Mid-Tex Division*, (Gas Utils. Div. Feb. 23, 2010) (final order *nunc pro tunc* granting application) (GUD No. 9869), Finding of Fact Nos. 18. ("[E]rrata filing is unreasonable because the Commission, Examiners and Intervenors in this proceeding do not have adequate time to review the data.").

Examiners concur that if the adjustment to plant is made a corresponding adjustment to accumulated depreciation and ADIT must also be made.

c. Pension and OPEB Regulatory Asset

(a) Introduction

Pensions are, of course, amounts paid to retirees. Other post-employment benefits (OPEB) may include retiree health care, dental care, and other post-employment health benefits. The legislature adopted Section 104.059 of the Texas Utilities Code during the 2011 Legislative Session. The Committee Report summarized the purpose of the bill as follows:

The cost of providing pensions and other postemployment benefits can significantly increase from year to year. Such increases in pension and retiree health care expenses can force gas utilities to file more frequent rate cases, at a cost to the ratepayer. S.B. 403 seeks to help gas utilities to better manage the challenges of volatile and escalating pension and retiree health care expenses by allowing a gas utility to establish one or more reserve accounts for expenses related to pension and other postemployment benefits and by requiring a utility that establishes one or more reserves to record and review any difference between the annual amount of pension and other postemployment benefits approved and included in utility's then current rates.<sup>325</sup>

Specifically, the statute directed that the regulatory authority set rates for a utility to allow recovery of the gas utility's costs of pensions and other postemployment benefits, as determined by actuarial or other similar studies in accordance with generally accepted accounting principles, in amounts that the regulatory authority finds reasonable and necessary.<sup>326</sup>

The statutory mechanism provided to accomplish that goal was a comparison of recovered expenses through rates to the estimated expense on an annual basis. The statute provides that a gas utility may establish one or more reserve accounts in order to track changes in the costs of pensions and other OPEB. If so, the gas utility shall periodically record in a reserve account any difference between the annual amount of pension and other OPEB included in the gas utility's current rates and the annual amount of costs of pensions and OPEB as determined by actuarial or other similar studies that would otherwise be recorded by the gas utility. The comparison may be simplified and stated as an inequality:

Formula 10.1

*Pension & OPEB previously approved < or > Pension & OPEB determined by actuarial analysis*

The annual amount of pension and other OPEB expense must have been approved in the company's "last general rate proceeding."<sup>327</sup>

<sup>325</sup> S.B. 403, Bill Analysis State Affairs Committee Report.

<sup>326</sup> Tex. Util. Code Ann. § 104.059(a).

<sup>327</sup> Tex. Util. Code Ann. § 104.059(b).

In subsequent cases, the regulatory authority must determine whether a surplus reserve exists. A shortage results if the amounts previously approved and included in rates were less than the amounts determined by actuarial analysis. This is the situation expressed in Formula 10.2.

Formula 10.2

*Pension & OPEB previously approved < Pension & OPEB determined by actuarial analysis*

A surplus results if the amounts previously approved and included in rates are greater than the amounts determined by actuarial analysis. This is the situation expressed in Formula 10-3.

Formula 10.3

*Pension & OPEB previously approved > Pension & OPEB determined by actuarial analysis*

Any surplus must be subtracted from the gas utility's rate base. On the other hand, a shortage must be added to the utility's rate base and amortized over a reasonable time.<sup>328</sup>

The company has determined that a shortage exists and included that amount, \$1,973,612, in rate base. A corresponding amortized amount, totaling \$197,361 has been added as an expense to the company's operating and maintenance expense.<sup>329</sup> As an initial matter, Atmos updated the calculation and determined that the amount of the asset was slightly lower, \$1,954,911.<sup>330</sup> The corresponding amortization expense was \$195,491. The update was not included in the September 4<sup>th</sup> Update. If the proposed adjustments of the Intervenor's are rejected, the Commission must determine whether the company's schedules included in the September 4<sup>th</sup> Update should be modified to reflect the company's final update.

The schedules that reflect the initial calculation have been attached to the Examiners' Schedules.<sup>331</sup> ACSC, ATM, and Staff contend that the pension and OPEB regulatory asset, and corresponding amortized expense amount, have been incorrectly calculated.

(b) Disallow the Pension and OPEB Asset

The primary request of the Intervenor's is to disallow any adjustment to rate base, or any corresponding amortized amount. The proposed disallowance would reduce rate base by approximately \$1,973,205<sup>332</sup> and it would reduce operation and maintenance expenses by \$199,817. The overall impact on the revenue requirement is a reduction of \$439,771.

<sup>328</sup> Tex. Util. Code Ann. § 104.059(e)(3). Testimony regarding the statute was provided by Atmos, Staff, and ATM: Atmos Ex. 7, Barbara W. Myers Direct, p. 19, ln. 8 – p. 20, ln. 23; Staff Ex. 2, Lynne LeMon, p. 24, ln. 2 – p. 26, ln. 13, ATM Ex. 2, Steven C. Carver, p. 11, ln. 15 – p. 12, ln. 4 & Atmos Ex. 16, Barbara W. Myers Rebuttal, p. 14, lns. 5 – 20.

<sup>329</sup> Atmos Ex. 3, Appeal Update Filing Dated September 4, 2012, Schedule B-7. In an updated filing, Atmos determined that the actual amount of the shortage was \$1,954,911.

<sup>330</sup> Atmos Ex. 7, Barbara W. Myers Direct, Exhibit BMW – 1.

<sup>331</sup> Examiners' Schedules, Pension Asset 1, Pension Asset 2, and Pension Asset 3. These schedules were taken from Atmos Ex. 1, Statement of Intent, Electronic Schedules Exhibit BMW – 1 – Pension and Other Postemployment Benefits Calculation.

<sup>332</sup> The impact on rate base is offset slightly by a flow through effect to the calculation of the cash working capital.

The principle driver of the Intervenor's position is the fact that Atmos used the pension amounts reviewed and approved in GUD No. 9869 as the baseline. In the context of the formula at Formula 9.1, GUD No. 9869 was the source data for calculating "Pension & OPEB previously approved." The Intervenor argued that GUD No. 9869 was inappropriate for the following reasons.

First, the rates set in GUD No. 9869 applied only to the City of Dallas and its environs. It did not establish rates for the entire area served by the Atmos Mid-Tex Division. Second, and somewhat related to the first issue, rates for the majority of the municipalities served by the Atmos Mid-Tex Division have been established through the RRM process. The most recent RRM proceeding occurred in 2011. Failure to acknowledge the RRM proceedings ignored the fact that the amounts included in the expenses for Pension and OPEB included in those rates may have been greater than the expenses for Pension and OPEB included in rates approved in GUD No. 9869. Third, the Final Order in GUD No. 9869 was issued on January 26, 2010. The engrossed version of S.B. No. 403, that enacted Section 104.059, included the following provision:

SECTION 2. Subsection (b) through (e), Section 104.059, Utilities Code, as added by this Act, apply in relation to a reserve account established by a gas utility on or after January 1, 2012.

Ms. Myers, who testified on behalf of Atmos, argued that the Commission's order in GUD No. 9869 is the only order the company can rely upon to determine the amount of pension and OPEBs approved and included in current rates. The statute refers to the "last general rate proceeding."<sup>333</sup> Further, the RRM rates implemented for the past three years in the ATM and ACSC municipalities was not a "general rate proceeding." The RRM mechanism was formulaic in nature and included caps for increases in operations and maintenance expenses and capital investments.<sup>334</sup> In response to the third issue raised by Staff, Ms. Myers noted that the statute contains no effective date with regard to establishing the tracking mechanism to create the asset.<sup>335</sup>

The Examiners find that the use of GUD No. 9869 in order to establish a baseline is just and reasonable. As to the statutory arguments, the language in Section 2 of the enrolled bill does not preclude application of a baseline that predates January 1, 2012. The provision explicitly states that the statute applies to reserve accounts established by a gas utility on or after January 1, 2012. Adopting the interpretation proposed by Staff would result in a situation where the statute would have no effect until after a company established a baseline in a general rate proceeding initiated after January 1, 2012. In other words, the proposed interpretation would delay the ability of a utility to address the issues identified by the legislature when it enacted Section 104.059. Instead, the statute explicitly grants utilities the ability to implement the statute after January 1, 2012 by implementing the reserve account.

<sup>333</sup> Atmos Ex. 16, Barbara W. Myers Rebuttal, p. 16, lns. 1 – 20.

<sup>334</sup> Atmos Ex. 16, Barbara W. Myers Rebuttal, p. 19, lns. 4 – 17.

<sup>335</sup> Atmos Ex. 16, Barbara W. Myers Rebuttal, p. 24, ln. 1 – p. 25, ln. 15.

Atmos established the account after January 1, 2012. In order to establish the account, Atmos must determine an appropriate baseline. That baseline is determined by reference to the last general rate proceeding. While GUD No. 9869 may have set rates for only the City of Dallas and its environs, the rates were established applying a system-wide methodology. Finally, the Examiners find that the RRM process cannot be characterized as a general rate proceeding. The RRM process includes agreed upon parameters that limit the rates that may be approved that are not present in a *Statement of Intent* proceeding. RRM rates may not form the foundation of the baseline required by §104.059.

(c) Recalculate the Baseline Benefit Costs

In the alternative, ACSC and ATM contended that the baseline should be recalculated by examining the pension and OPEB expenses submitted by Atmos in the RRM proceedings. This proposal would reduce rate base by approximately \$927,554 and it would reduce operation and maintenance expenses by \$93,909. The overall impact on the revenue requirement is a reduction of \$206,683.

The argument is found not on the legal infirmity raised in the previous section, but upon the assertion that the use of the GUD No. 9869 levels of pension and OPEB expense provided an artificially low baseline.<sup>336</sup> Ms. Cannady suggested that it may be reasonable to assume that the actuarial values filed by Atmos in the 2011 RRM proceeding identify the value accepted in the most recent general rate case. The company continued to change rates annually with the RRM and should not now use GUD No. 9869 as the baseline for its calculation. Mr. Carver concurred and he asserted that the fact that those rates were set through a black-box settlement does not preclude a determination of the pension and OPEB amounts. He argued that 104.059 does not preclude use of the amounts in the RRM filings. Those rates, he asserted, may be derived from the company's proposed calculation set forth in the various RRM filings with the cities.<sup>337</sup>

The company responded by raising the same issues discussed in the previous section: RRM-established rates are statutorily precluded. Further, because of parameters of the RRM process the pension expense included in the RRM rates may not be discerned. As discussed in the previous section, the Examiners find that the use of the RRM-established rates, in order to establish a baseline, is not just and reasonable.

(d) Application of Allocation Factors and ATM Calculation of the Asset

In addition to updating the baseline calculation by using the RRM generated data instead of the data embodied in GUD No. 9869, ATM altered several additional aspects of calculation. Those additional changes are summarized in Table 10.2 below:

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<sup>336</sup> ACSC Ex. 3, Constance T. Cannady, p. 14, Ins. 15 – 18.

<sup>337</sup> ATM Ex. 2, Steven C. Carver, p. 16, ln. 3 – p. 19, ln. 14.



Table 10.2<sup>338</sup>

Baseline Calculation	Actuarial Analysis
(1) Test-year amounts	(4) Test-year amounts
(2) SSU Allocation to Mid-Tex	(5) SSU Allocation to Mid-Tex
(3) Mid-Tex Direct Allocation	(6) Mid-Tex Direct Allocation

This proposal would reduce rate base by approximately \$695,845 and it would reduce operation and maintenance expenses by \$70,401. The overall impact on the revenue requirement is a reduction of \$154,944.

Each of the entries altered, summarized in Table 10.2 above, is distinct. For example, the SSU Allocation to Mid-Tex in the baseline calculation, item (2), is not the same as the SSU Allocation to Mid-Tex in the Actuarial Analysis. ATM explained its proposed change to the allocation factors. ATM also generally described that certain changes should be made to account for Shared Services Supplemental Executive Benefit (SEBP/SERP). The other changes are not addressed in the testimony offered by ATM and the Examiners find that there is no evidence to support those changes in the alternative recommendation.

As to the allocation factors, Mr. Carver argued that the allocation factors developed in GUD No. 9869 should not be applied in the calculation of both sides of inequality comparison mandated by Section 104.059. Mr. Carver asserted that the allocation factors have changed since GUD No. 9869. He asserted that the allocation factors that should be applied are the factors developed in this case. ATM proposed application of the allocation factors developed by Mr. Brosch discussed in Section 7, above.<sup>339</sup>

Ms. Myers testified that the company's use of the GUD NO. 9869 factors to calculate the baseline was reasonable because those were the factors approved in that case and allowed a consistent comparison. She contended that to use different factors to calculate the baseline and the new amount is inconsistent, illogical, and results in a mismatch.<sup>340</sup>

The Examiners' find that the company's approach to calculate both sides of the comparison mandated by Section 104.059 is logical and consistent. There are several problems with the proposed alternative that preclude its application in this case. Except for the use of the RRM factors to calculate the baseline and the SSU allocation factors applicable to the calculation of the 2012 amounts, ATM has failed to offer any evidence in support of the myriad of other changes included in its recommendation. Accordingly, the Examiners find that there is no evidence in the record to support its adoption.

<sup>338</sup> Compare ATM Ex. No. 2, Steven C. Carver SCC – Exhibit 4 to Examiners Schedules Pension Asset 1, Pension Asset 2, and Pension Asset 3. These schedules were taken from Atmos Ex. 1, Statement of Intent, Electronic Schedules Exhibit BWM – 1 – Pension and Other Postemployment Benefits Calculation and Atmos Ex. 7, Barbara W. Myers, Exhibit BWM – 1 (Errata).

<sup>339</sup> ATM Ex. No. 2, p. 21, ln. 4 – p. 23, ln. 10.

<sup>340</sup> Atmos Ex. 16, p. 21, ln. 20 – p. 22, ln. 11.

(e) Calculated Pension and OPEB Overinflated

ACSC argued that the calculated pension and OPEB fund was overinflated. In this context, ACSC raised the same issues that were raised in the context of the Pension Account Plan discussed in Section 8(d) above. For the reasons stated above, the Examiners find that Atmos has established that the value of the pension plan assets used to determine the pension and OPEB asset to rate base and accompanying amortization amount to operating and maintenance expense was reasonable.

(f) Notice of Creation of a Reserve Fund

ACSC argued that the company was obligated to notify the municipalities of its intent to establish a reserve fund. Once again, ACSC proffered this point as a basis for rejecting the calculated pension and OPEB asset to rate base and accompanying amortization expense.<sup>341</sup> Ms. Myers noted that there is no requirement that imposes an affirmative duty on a utility to notify the regulatory authority of its intent to establish a reserve fund.<sup>342</sup> The Examiners find that Section 104.059 does not impose a requirement that a utility notify the regulatory authority of its intent to establish a reserve fund. This is not a basis upon which to reject the proposed pension and OPEB asset and accompanying amortization expense.

(g) Update to Company's Calculation

At the time filed its June 13<sup>th</sup> Errata, Atmos made a correction to its pension and retiree medical benefits adjustment. This reduced the pension expense adjustment by \$18,701. At that time, the calculation for the reserve adjustment was not updated.<sup>343</sup> At the hearing, Ms. Myers corrected the calculation of the pension and OPEB regulatory asset. The net effect of the adjustment is a reduction to the revenue requirement of \$4,167. The Examiners find that the adjustment is just and reasonable and recommend it be adopted.

(h) Section 104.059 Benchmark.

The company has requested that the base year level of pension expense and OPEB be established in this proceeding.<sup>344</sup> For the reasons discussed above in this section and Section 8, Subsection d, e, and f, the Examiners find that the base year level of pension expense requested is just and reasonable. The Examiners find that the expense level requested was calculated pursuant to GAAP and applicable statutes. Accordingly, the Examiners recommend that the following pension expense, as reflected on the attached Examiners' Schedule 5, be adopted:

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<sup>341</sup> ACSC Ex. 3, Constance T. Cannady, p. 17, Ins. 7 – 15.

<sup>342</sup> Atmos Ex. 16, p. 17, ln. 23 – p. 18, ln. 2.

<sup>343</sup> Tr. Vol. 3, p. 45 – 46.

<sup>344</sup> Atmos Ex. 6, Barbara W. Myers, p. 20.

Table 10.4  
Section 104.059 Benchmarks

	PAP (FAS 87)	Post-Retirement Medical Plans (FAS 106)	SERP
SSU Allocated to Mid-Tex	\$2,756,682	\$1,971,341	
Mid-Tex Direct	\$8,087,526	\$7,092,975	\$143,390
Total	\$10,844,208	\$9,064,316	\$143,390

d. Accumulated Deferred Federal Income Taxes (ADIT)

(a) Introduction

Deferred taxes arise because of timing differences between recognition of certain items for book purposes versus tax purposes.<sup>345</sup> Deferred taxes represent the difference between what is included as income taxes in the ratemaking context and what is actually paid in federal income taxes. Accumulated Deferred Federal Income Taxes or (ADIT) is the amount of the difference that has accumulated over time. The ADIT balances are either an asset or liability that represent the cumulative amounts of additional income taxes that are estimated to become receivable or payable in future periods.<sup>346</sup>

As presented by Atmos, an ADIT liability is an ADIT balance that results in a decrease to rate base. Generally, it represents an amount of revenues collected for income taxes that are not yet due. In essence, ratepayers have contributed these amounts. Thus, an ADIT liability is a credit for ratemaking purposes and the effect of the credit is to reduce the cost of providing service to ratepayers by an amount equal to the deferred income taxes multiplied by the overall rate of return. In the context of ratemaking, a typical example of an ADIT credit is usually related to depreciation expense. ADIT associated with depreciation expense results because of differences due to the amount of depreciation expenses recovered versus the amount of depreciation expenses that may be claimed for tax purposes.

An ADIT balance, however, will not always result in a credit for ratemaking purposes. Contributions in aid of construction (CIAC), for example, may have an impact on the company's tax liability. That tax liability, however, was not a part of the previously approved rates and, in essence, the shareholder was required to provide the funds to pay the taxes. As presented by Atmos, this is an example of an ADIT asset and results in an increase to rate base. Thus, an ADIT asset is a debit for ratemaking purposes and the effect of the debit is to increase the cost of providing service to ratepayers by an amount equal to the deferred income taxes multiplied by the overall rate of return.

<sup>345</sup> *Natural Gas Rate Review Handbook*, pp. 19 – 20.

<sup>346</sup> ATM Ex. 1, Michael L. Brosch Direct, p. 25, Ins. 5 – 7.

(b) ADIT Balance Related to Income Tax Net Operating Loss Carryforward

1. Introduction

Depending on the income and deductions reported by Atmos on its tax returns, either a positive or negative taxable income is reported on the tax return. A positive taxable income will result in the imposition of tax at the applicable tax rate. A negative taxable income creates an income tax net operating loss (NOL). Under provisions of the Internal Revenue Code, a tax NOL may first be carried back to offset taxable income. Any loss remaining after the carryback is available to carry forward for up to twenty years to reduce taxable income in a future period.

The company reports its taxable income on a consolidated basis and files a consolidated tax return. The filing includes both the regulated and non-regulated legal entities of the company. On a consolidated basis the NOL ADIT asset balance totaled approximately \$49,081,456. The company, however, did not apply the allocated portion of this asset to the ADIT calculation for the Atmos Mid-Tex Division.

Although Atmos files a consolidated return, the company calculates the taxable income of the regulated operations separately from the non-regulated operations. Instead of applying the consolidated ADIT calculation for NOL carryforwards, Atmos calculated an ADIT asset for its regulated entities in the amount of \$242,675,429. A portion of this amount was allocated to the Atmos Mid-Tex Division and based upon the company's proposed allocation the ADIT asset attributable to NOL that was assigned to Mid-Tex was \$91,245,961. This ADIT asset was added to rate base.

2. Intervenor's Position

ATM and ACSC objected to the approach proposed by the company. Mr. Brosch, who testified on behalf of ATM, and Ms. Cannady, who testified on behalf of ACSC asserted that this ADIT asset was incorrectly calculated.<sup>347</sup> Both witnesses argued that the NOL ADIT balance should be based upon the consolidated taxes of the company. They asserted that the company's proposed treatment was based upon a hypothetical exercise based upon an assumed separate tax filing. Mr. Brosch argued further that the calculation of a negative NOL tax credit carryforward assumed in the exercise was nonsensical. Any negative tax NOL would represent taxable income.<sup>348</sup>

Mr. Brosch argued that the exercise was flawed for additional reasons. The calculation of the utility NOL included tax losses in the "utility" category of NOL carryforwards that were caused by more than \$228 million of tax deductions taken on prior tax returns to amortize the goodwill that was recorded in connection with its acquisition of property from TXU. He argued that this was improper because recovery of goodwill amortization is not allowed in determining utility rates. Accordingly, it should not be allowed to increase the NOL carryforward tax assets being included in rate base.<sup>349</sup>

<sup>347</sup> ATM Ex. 1, Michael L. Brosch Direct, p. 43, ln. 21 – p. 46, ln. 20 & ACSC Ex. 3, p. 21, ln. 3 – p. 22, ln. 17.

<sup>348</sup> ATM Ex. 1, Michael L. Brosch Direct, p. 45, ln. 20 – p. 46, ln. 3.

<sup>349</sup> ATM Ex. 1, Michael L. Brosch Direct, p. 47, ln. 9 – p. 48, ln. 7.

The result of the approach proposed by ATM and ACSC is that the allocable NOL ADIT asset should total approximately \$49,081,455 based upon the consolidated taxes of Atmos. Therefore, based upon the company's proposed allocation, the total allocated ADIT asset to be included in the cost of service calculation should not exceed \$19,133,610. The overall effect of this adjustment to the company's ADIT calculation was to increase the proposed ADIT balance from \$239,932,144 to \$312,723,478. The net effect on rate base was a reduction of approximately \$72,776,316, which would result in a rate base of \$1,441,604,906. The overall impact on the company's cost of service was a reduction of \$8,817,854.

### 3. Company's Response

Mr. McDonald described the process by which the company calculated the tax liability of the regulated and unregulated entities that make up the affiliated group of companies within the corporation.<sup>350</sup> Mr. McDonald argued that to include the consolidated ADIT asset for tax NOLs would result in the inclusion of non-regulated tax matters in rates.<sup>351</sup> He contended that in order to ensure that rates reflect only the NOL attributable to the company's regulated utility operations, the effect of the non-regulated ADIT asset for income tax NOLs must be excluded.<sup>352</sup> He also contended that this was reasonable because the regulated utility operations are the primary driver in creating tax losses.<sup>353</sup> Furthermore, a separation of ADIT asset between utility and non-regulated operations is also appropriate to properly match the ADIT asset from the tax NOL with the AIT liability that gave rise to the NOLs.<sup>354</sup>

As to the issue of goodwill deductions that were included in the calculation of the ADIT NOL asset, Mr. McDonald argued that there are many factors that contribute to the generation or utilization of the federal NOL carryforward. He testified that it would be difficult to isolate items that contributed to the NOL carryforward in the proforma tax returns selectively. Further, he contended that it is important to recognize that the deduction of the goodwill for tax purposes has benefitted customers because the tax deduction has reduced the tax liability of the company.

### 4. Examiners' Recommendation

The Examiners find that the company has established that its calculation of the ADIT asset related to NOLs was just and reasonable. The issue of whether the NOL ADIT balance should be calculated based upon the consolidated returns of the company or the calculation of the stand-alone taxes of the regulated entities is a question of first impression. Atmos has established that the regulated operations generated substantial ADIT liabilities which gave rise to the NOLs in the first place.<sup>355</sup> The company's approach matches the ADIT liabilities to the ADIT NOL asset created by those deductions.

<sup>350</sup> Atmos Ex. 18, Pace McDonald Rebuttal, p. 5, ln. 5 – p. 10, ln. 2.

<sup>351</sup> Atmos Ex. 18, Pace McDonald Rebuttal, p. 15, lns. 1 – 5.

<sup>352</sup> Atmos Ex. 18, Pace McDonald Rebuttal, p. 12, lns. 8 – 12.

<sup>353</sup> Atmos Ex. 18, Pace McDonald Rebuttal, p. 10, lns. 4 – 17.

<sup>354</sup> Atmos Ex. 18, Pace McDonald Rebuttal, p. 13, lns. 13 – 21.

<sup>355</sup> See, ACSC Ex. 3, Constance Cannady Redacted Direct, Attachment 8, Schedule Showing NOL Position for Utility, Unregulated, and Consolidated Operations.

The Examiners recognize that the proposed calculation includes the impact of goodwill on the calculation of the NOL ADIT balance. Under the circumstances of this case, however, the company's proposal is reasonable. As Mr. Brosch noted, Atmos has included tax losses in the utility category of NOL carryforwards that were caused by more than \$228 million of tax deductions, taken on prior tax returns to amortize the goodwill that was recorded in connection with its acquisition of property from TXU. The tax losses reported by the company in recent years, from 2008 to 2011 in the amount of \$774,107,432 eclipse any loss that may be attributable to the amortized goodwill. Furthermore, it is not clear from the record in this case, that the alternative proposed by the Intervenor would avoid a calculated NOL ADIT balance that excluded the effects of previously amortized goodwill.

(c) ADIT Balance Related to Treasury Lock

An issue was raised by ATM during this proceeding regarding the treatment of the ADIT balance related to Treasury Locks. As originally filed, the company included an ADIT asset related to Treasury Locks that would have resulted in a \$4,382,823 increase to rate base.<sup>356</sup> In its Sept 4<sup>th</sup> Update, the company revised its request. The company included an ADIT liability in the amount of (\$5,296,340).<sup>357</sup> This adjustment resulted in a decrease to rate base and a decrease to the overall revenue requirement. Subsequent to that change, ATM agreed that the revised position was acceptable and eliminated the disputed issue.<sup>358</sup>

(d) ADIT Balance Related to AMT Minimum Tax Credits

Atmos is required to pay an Alternative Minimum Tax (AMT) amount if the company's regular tax is less than the calculated AMT. Anytime the company is required to pay an AMT, a credit is created. The AMT credit may be carried forward indefinitely to future periods. An ADIT asset is realized at the time the AMT credit is created. In a future year, when the credit is realized the inverse occurs.<sup>359</sup> Atmos included an ADIT asset related to the AMT tax credit in the amount of \$10,099,286. The ADIT asset is booked within SSU general office. The portion of that ADIT asset allocated to the Atmos Mid-Tex Division totaled \$3,797,332.<sup>360</sup> The allocated ADIT asset balance is added to rate base.<sup>361</sup>

Mr. Brosch, who testified on behalf of ATM argued that the AMT ADIT asset balance should be removed from rate base absent a recalculation of the company's taxes that recognizes AMT. He contended that Atmos completely ignored AMT tax credits when the income tax expense portion of the revenue requirement is determined. Thus, ratepayers never receive a credit to the income tax expense. Furthermore, he argued that the Mid-Tex assets of TXU were not acquired by Atmos until October of 2004. Consequently, most of the company's asserted

<sup>356</sup> The ADIT Asset totaled \$11,656,443. Atmos Ex. 2, Errata Filing July 13, 2012, Cost of Service Appeal, Schedule WP\_B-6, ln. 81 & Cost of Service Unincorporated, Schedule WP\_B-6, ln. 81.

<sup>357</sup> Atmos Ex. 3, Atmos Update Filing September 4, 2012, Cost of Service Appeal, Schedule WP\_B-6, ln. 81 & Cost of Service Unincorporated, Schedule WP\_B-6, ln. 81.

<sup>358</sup> Tr. Vol. V, p. 47 & ATM Initial Brief, p. 5.

<sup>359</sup> Atmos Ex. 18, Pace McDonald Rebuttal, p. 18, ln. 9 – p. 21, ln. 4.

<sup>360</sup> Atmos Ex. 3, Appeal Update Filing Dated September 4, 2012, Schedule B-6, ln. 83. The amount booked to SSU General was \$10,099,286. Atmos proposed to allocate 37.60% of that amount, totaling \$3,797,332, to the Atmos Mid-Tex Division.

<sup>361</sup> The total increase to rate base is slightly less than \$3,797,332 because the increase is offset slightly by the impact to the cash working capital calculation.

AMT credit was incurred prior to October 2004 and should not be considered in setting Mid-Tex rates.<sup>362</sup>

In response, Mr. McDonald explained that a deferred tax asset for the AMT credit reflects the fact that cash has been paid to the government that will be realized in the future when the company reduces regular tax. Thus, it is cash that the company has on deposit with the government that it is unable to use. Mr. McDonald also explained re-computation of the tax, to give effect to the AMT tax credit, would produce no net effect:

Over the long term, a corporate taxpayer will pay tax at the regular corporate tax rate. The imposition of an AMT in one year is later offset with the realization of the AMT credit in a future year.<sup>363</sup>

Finally, Mr. McDonald does not dispute that the AMT tax credits were created prior to the acquisition of the Mid-Tex system by Atmos. Mr. McDonald pointed out, however, that Atmos has been unable to apply the credit because of the tax effects of the operations of the system by the company.<sup>364</sup>

The Examiners find that the company has established that the AMT ADIT asset is just and reasonable. Atmos was required to pay these taxes and they have not previously been reflected in the revenue requirement. Thus, the AMT ADIT asset represents funds that the company is unable to use. Finally, the Examiners find that under the facts of this case, the exact timing of the creation of the AMT ADIT asset is irrelevant. The AMT ADIT asset was on the books at the time the system was acquired and due to the operations of the system since the acquisition by Atmos, Atmos has been unable to utilize the credit.

(e) ADIT Balance Related to CWIP

In calculating rate base, Atmos has not included a component for construction work in progress (CWIP). This is consistent with 16 *Tex. Admin. Code* § 7.5212, which provides that CWIP may be included in rate base only when the utility is able to establish that it is necessary to the financial integrity of the utility. The estimated cost of funds used to finance construction of major CWIP projects is an Allowance for Funds Used During Construction (AFUDC). AFUDC is a component of construction costs representing net cost of borrowed funds and a reasonable rate on other funds used during the period of construction. Commission regulations also limit the recovery of AFUDC. Section 7.5213 provides that a utility may be permitted to include AFUDC related to a project in its rate base in rate proceedings after completion of the project.<sup>365</sup>

Mr. Brosch, who testified on behalf of ATM argued that CWIP-related ADIT amounts should be included in rate base. Mr. Brosch conceded, however, that this treatment is inconsistent.<sup>366</sup> The Examiners find the Atmos' proposed treatment is just and reasonable and results in a consistent treatment of CWIP and the associated ADIT balance.

<sup>362</sup> ATM Ex. 1, Michael L. Brosch, p. 38, ln. 1 – p. 40, ln. 10.

<sup>363</sup> Atmos Ex. 18, Pace McDonald Rebuttal, p. 20, lns. 1 – 5. See also, p. 23, ln. 14 – p. 24, ln. 2.

<sup>364</sup> Atmos Ex. 18, Pace McDonald Rebuttal, p. 22, ln. 4 – p. 24, ln. 20.

<sup>365</sup> 16 *Tex. Admin. Code Ann.* §§ 7.5212 & 7.5213.

<sup>366</sup> ATM Ex. 1, Michael L. Brosch, p. 41 – 42.

(f) ADIT Balance Related to Allowance for Doubtful Accounts

Atmos has included an ADIT asset, totaling \$1,390,603, associated with uncollectible accounts. The ADIT asset operates as an increase to rate base. ADIT balances associated with allowance for doubtful accounts relate to bad debt accruals that are recorded on the company's books based upon estimates of future write-offs. ATM maintained that the ADIT asset should be removed.<sup>367</sup> The impact of that recommendation is a reduction to rate base totaling \$1,390,315 and an overall revenue reduction totaling \$168,456.

Mr. Brosch explained that the related tax deduction on Atmos' tax returns associated with uncollectible is allowed only when the uncollectible account is actually written off. For ratemaking purposes, uncollectible expenses are determined by reference to an experience rate calculated using the three-year average of actual net charge-offs. Mr. Carver noted that Atmos has not included the balance in the reserve for uncollectible accounts in rate base and he concedes that it is properly excluded. Given the write-off approach to uncollectible expense quantification, as well as, no recognition of the accrued reserve for uncollectible accounts in rate base, the ADIT associated with this reserve should not be included in rate base.<sup>368</sup>

Mr. Petersen responded that Mr. Brosch conceded that the allowance for doubtful accounts was properly written off. He asserted that the ADIT related to this account occurs independent of rate treatment. The required financial treatment and the required tax treatment of uncollectible expense creates an ADIT item separately from any rate treatment. He argued that the ADIT item occurs as part of operating the utility business under existing accounting and tax rules, which creates the financing requirement. He concluded that the item and its financing is a necessary part of providing utility service.<sup>369</sup>

The Examiners find that Atmos has not established that inclusion of this account is just and reasonable. First, the inclusion of an ADIT balance is inconsistent with the exclusion of the item for ratemaking purposes. The inconsistent treatment is not addressed by Atmos. Second, uncollectible expenses are included in the company's expenses for purposes of calculating the revenue requirement and it was included in the cash working capital analysis for purposes of calculating the cash working capital requirement of the company. Thus, ratepayers provided funds are available to address any tax liability incurred from uncollectibles. The Examiners recognize that this recommendation is inconsistent with the treatment of ADIT related to uncollectible accounts in GUD No. 9869. The Examiners note, however, that the ADIT balance has been previously excluded in other cases involving other utilities.<sup>370</sup> Under the facts of this case, however, the company has not established that inclusion of the ADIT asset is just and reasonable.

<sup>367</sup> ATM Ex. 1, Michael L. Brosch, p. 31, lns. 10 – 31.

<sup>368</sup> ATM Ex. 1, Michael L. Brosch, p. 31 ln. 10 – p. 32, ln. 6.

<sup>369</sup> ATM Ex. 17, Thomas H. Petersen, p. 18, lns. 4 – 16.

<sup>370</sup> GUD No. 9902, Finding of Fact No. 53.



(g) ADIT Balance Related to State Net Operating Loss (Mid-Tex Only)

Atmos included ADIT amounts associated with a State Net Operating Loss (NOL) tax asset and related Federal Tax on the State NOL. The net effect of these ADIT balances was an ADIT asset of \$678,983. The company added this amount to rate base. The overall impact on the company's revenue requirement calculation is to increase the revenue requirement by approximately \$82,251.

ATM contended that the State NOL ADIT asset balance was inappropriate unless the company adjusted the State tax calculation to reflect the credit taken each year by Atmos.<sup>371</sup> The company conceded that an adjustment was required. Accordingly, the company has included an adjustment to the State Franchise Tax calculation that reflects a reduction of \$52,627.<sup>372</sup> The overall effect of this adjustment is to decrease the revenue requirement by approximately \$53,446. As the company has incorporated this adjustment into its revenue requirement calculation, the Examiners find that no further adjustment is required.

(h) ADIT Balance Related to Intra-Period Tax Allocations

The company calculates an annual effective tax rate for income tax expenses. The projected expense rarely matches the actual expense. In order to properly record income tax expenses, an ADIT entry is made to record the difference between actual expense and projected expense.<sup>373</sup> In its initial filing, the company included an ADIT asset balance in the amount of \$2,099,308 for intra period tax allocations.<sup>374</sup> This amount was added to the calculation of the company's rate base and the overall effect on the revenue requirement was to add approximately \$254,308 to the company's revenue requirement. ATM requested removal of this entry from the company's overall ADIT calculation because the company had not provided a substantive explanation or justification for this amount.<sup>375</sup>

Atmos noted it reversed the ADIT entry entirely in the final month of the fiscal year, September. Therefore, it was reasonable to remove this entry, as it is a known and measurable change.<sup>376</sup> The company incorporated this change into its revised schedules filed July 13, 2012 and it is included in the final schedules filed on September 4, 2012. Accordingly, the Examiners find that no further adjustment is required at this time.<sup>377</sup>

(i) ADIT Adjustments that Flow From Other Expense Adjustments

The Intervenors have proposed adjustments to expense items that, if adopted, would impact the ADIT calculation. The impact on the ADIT calculation is a flow through effect of the final determination related to the proposed expense adjustment. Rather than treat the impact on

<sup>371</sup> ATM Ex. 1, Michael L. Brosch, p. 42, ln. 8 – p. 43, ln. 20.

<sup>372</sup> Atmos Ex. 18, Pace McDonald Rebuttal, p. 29, ln. 9 – p. 30, ln. 20 & Atmos Ex. No. 3, Schedule F-6.

<sup>373</sup> Atmos Ex. 18, Pace McDonald Rebuttal, p. 30, ln. 21 – p. 31, ln. 20.

<sup>374</sup> Atmos Ex. 1, Statement of Intent filed May 31, 2012, Exhibit D, Schedule WP\_B-6, ln. 25.

<sup>375</sup> ATM Ex. 1, Michael L. Brosch, p. 33, lns. 2 – 9.

<sup>376</sup> Atmos Ex. 18, Pace McDonald Rebuttal, p. 31, ln. 22 – p. 32, ln. 11.

<sup>377</sup> Atmos Ex. 2, Errata Filing Dated July 13, 2012, Schedule B-6, ln. 25 & Atmos Ex. 3, Appeal Update Filing Dated September 4, 2012, Schedule B-6, ln. 25.

the ADIT calculation as a separate adjustment in this section, the issue is addressed when the related expense item is considered.

e. FAS 106 Liability

(a) Introduction

Atmos has included an ADIT balance for FAS 106 Liability. The total ADIT asset associated with the various FAS 106 accounts in the Shared Services Unit and the Atmos Mid-Tex Division totaled \$25,195,904 which operates to increase rate base. ATM and ACSC argued that in order to provide consistent treatment the FAS 106 Liability should be deducted from rate base. The effect of this proposal is to reduce rate base by \$66,239,245 which would reduce the overall revenue requirement by \$8,025,798. In the alternative, the Intervenor argued that the ADIT balance associated with the FAS 106 Liability should be deducted from rate base. The effect of this proposal is to reduce rate base by \$25,190,706 which would reduce the overall revenue requirement by \$3,052,202.

(b) Intervenor's Position

ATM and ASCS asserted that the treatment of the FAS 106 reserve and the treatment of the FAS 106 ADIT balance is inconsistent. Mr. Brosch argued that if the company had acted to recognize the FAS106 liability balance as an offset to rate base then it would have been reasonable to include the ADIT balance related to FAS 106. He explained that he raised the same issue in GUD No. 10000. In that case, the Commission rejected his primary recommendation, which he re-urges here. Instead, the Commission adopted his alternative recommendation set forth below:

47. Atmos Pipeline – Texas did not establish that the funds collected for FAS 106 are restricted or dedicated to FAS 106 and it is reasonable that an external fund be established as has been the case for the other states where Atmos Energy Corporation conducts business.<sup>378</sup>

Subject to the creation of an external fund, the Commission determined that it was reasonable to include the ADIT balance for FAS 106 and allow the exclusion of the FAS 106 liability from the calculation of rate base. Thus, the FAS 106 liability was not deducted from rate base in that case.

Mr. Brosch noted that although the Atmos Mid-Tex Division was not subject to that order, an external fund was also established for the Atmos Mid-Tex Division. The problem, he argued, was that the external fund was established upon a prospective basis. As a result he concluded that the company's treatment addressed only a small portion of the FAS106 fund. Mr. Brosch contended that in GUD NO. 9869 and GUD No. 10000, the Commission did not address the alleged issue that FAS106 liability represents a source of zero-cost capital. Accordingly, in recognition of this assertion, the Commission should require either (1) a deduction to rate base to

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<sup>378</sup> GUD No. 10000, Finding of Fact No. 10000.

recognize the FAS 106 liability as a source of zero-cost capital and a corresponding FAS 106 ADIT entry; or, (2) the removal from the effect of FAS 106 from both.<sup>379</sup>

(c) Company's Response

Mr. Petersen responded by explaining that the company has followed the treatment order in GUD No. 10000. He noted that Mr. Carver made the same arguments in GUD No. 10000. The Commission made the determination reflected in Finding of Fact No. 47, quoted above, and the facts have not changed since that case. He testified that the company's treatment of the FAS 106 fund has been consistent for several years. He argued that the contention that the FAS 106 fund is a source a cost free capital is inaccurate. Finally, in response to arguments raised by ACSC he maintained that shareholders have, in fact, been required to provide funds to FAS 106.<sup>380</sup>

(d) Examiners' Recommendation

The Examiners find that the company's proposed treatment of the FAS 106 liability and the treatment of the FAS 106 ADIT liability is just and reasonable. First, Atmos has explained that an external fund was created that limits accessibility to those funds. Second, Section 104.059 effectively requires recognition of FAS 106 in rate base in the future. The company has included a calculation of the pension and OPEB reserve as contemplated by the statute. That statute raises the question of whether an external fund is necessary. No party has suggested that the ruling of the Commission in GUD No. 10000 be revisited at this juncture. Nevertheless, the Examiners recommend that the Commission include a specific finding in this proceeding that allows Atmos to explore the necessity of an external fund in a future proceeding.

Third, contrary to Mr. Brosch's suggestion, the Commission has effectively considered the issue of whether the fund represents a source of zero-cost capital by rejecting the proposed adjustment in GUD No. 10000. In light of the strict accounting principles and laws governing those funds, described by Mr. Hutzler and the Towers Watson report, an external fund may further formalize the protected status of those funds. The fact remains, however, that those funds are subject to strict accounting standards intended to protect those funds. As Mr. Hutzler noted, companies must disclose their plan-funded status at fiscal year-end and then measure their pension cost of the following fiscal year. This is required by U.S. generally accepted accounting principles and the financial reporting rules under Accounting Standards Codification (ASC) 960.<sup>381</sup> Thus, the availability of those funds as a source of zero-cost capital has simply not been established.

Fourth, the record in this case is not clear that customers solely fund the account. On the contrary, company shareholders have had to fund the difference between the FAS 106 expense

<sup>379</sup> ACSC Ex. 1, Constance T. Cannady, p. 22, ln. 17 – p. 26, ln. 8 & ATM Ex. 2, p. 26, ln. 19 – p. 37, ln. 19.  
<sup>380</sup> Atmos Ex. 17, Thomas H. Petersen, p. 4, ln. 1 – p. 10, ln. 12.

<sup>381</sup> Atmos Ex. 21, Chris Hutzler, p. 4, ln. 13 – p. 6, ln. 18. *See also*, Actuarial Valuation Report Pension Cost for Fiscal Year Ending September 30, 2012 under U.S. GAAP Employer Contributions for Plan Year Beginning January 1, 2011 Atmos Ex. 1, Statement of Intent, Disk 1, WP\_F-2.3 2011 PAPReport.pdf.

included in rates and the accrual on the company's books when there has been a shortfall. Mr. Petersen's assertion is supported by the fact that accounting standards require an annual evaluation of the status of the fund. For all these reasons the Examiners recommend that the proposed adjustment of the Intervenor be rejected.

f. Cash Working Capital

(a) 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. The need for working cash has long been recognized by regulatory bodies and the courts. 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. The Atmos Mid-Tex Division prepared a lead-lag study to determine the cash working capital needs of the division. A lead-lag study empirically identifies the difference in timing between outward cash flow for labor, materials and supplies, inventory, other expenses, and inward cash flow of revenue from payments to customers.

The cash working capital analysis measures payment and collection time lags to determine the amount of cash working capital used to provide utility service. This analysis compares two different lags. The lag between the provision of service to customers and the collection of cash from customers is determined. This gap is compared to the lag between the recording of expenses and the payment of cash by the company for those expenses.<sup>382</sup>

Cash working capital requirements may be positive or negative. Positive working capital is investor-supplied. In contrast, negative working capital is funded by the ratepayer and 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.

In this proceeding, the overall cash working capital study submitted as part of the *Statement of Intent* indicated that the company has a negative cash working capital. Thus, the company determined that the overall cash working capital was ratepayer funded and should be deducted from rate base. In its *Statement of Intent* filing, the company estimated that the amount of ratepayer funded cash working capital was \$18,186,913.<sup>383</sup> In the September 4<sup>th</sup> Update, the company revised its cash working capital calculation and determined that the amount of

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<sup>382</sup> Atmos Ex. 6, Thomas H. Peterson, p. 10, Ins. 9 – 20.

<sup>383</sup> Atmos Ex. 1, *Statement of Intent*, Cost of Service Schedules, Schedule E, ln. 28.

ratepayer funded cash working capital was \$19,316,498.<sup>384</sup> Referring to Table 10.1, this amount is deducted from rate base. Thus, the amount deducted from rate base increased by \$1,129,585. ATM and ACSC contested the results of the company's cash working capital study. ATM contended that the cash working capital of the company was a negative \$20,150,097. ACSC contended that the cash working capital of the company should be a negative \$27,890,011.<sup>385</sup> As explained in detail below, the Examiners find that Atmos has established that its proposed cash working capital is just and reasonable.

Mr. Petersen testified that he conducted the cash working capital study for the test year ending September 30, 2011. While he did not necessarily agree with all methodologies applied in the study, the study reflected the determination made by the Commission in GUD Nos. 9869 and 10000.<sup>386</sup> The company, however, deviated from Commission precedent in one respect: The use of a billing lag of 1.74 days in order to calculate the overall revenue lag, which in this study was 36.17 days.

(b) Billing Lag Adjustment

1. Introduction

The calculations in the cash working capital depend in part on the calculated revenue lag. In general, the revenue lag is a measure of the period of time between when service is provided by the company and payment is received. The revenue lag is made up of four components: (1) billing lag,<sup>387</sup> (2) service lag,<sup>388</sup> (3) collection lag,<sup>389</sup> and (4) bank lag.<sup>390</sup> The only component of the revenue lag challenged by the Intervenors was the billing lag.

In GUD No. 9762, the Commission ordered the use of a one-day billing lag. In this study, Mr. Petersen applied a billing lag of 1.74 days in order to calculate the overall revenue lag.<sup>391</sup> The actual billing lag of mass billed customers during the test year was 1.28 calendar days. Mr. Petersen testified that with a five day week, an average billing lag of one business day produces a 1.4 calendar day lag. He explained that incorporating the billing lag on complex bills for transportation and large industrial customers produces an overall billing lag of 1.74 days.

He also detailed the billing process. Customers are assigned to meter routes, and meter routes are assigned to one of 20 billing cycles. Meter route information is generated three business days before bills from the route are printed. Local offices have three days from the time meter route information is available for loading to the handheld devices used for meter reading until the information is required for bill preparation. In that timeframe, the company employees read the meters, identify problems, and resolve bill exceptions that would prevent the billing

<sup>384</sup> Atmos Ex. 3, Atmos Update Filing, September 4, 2012, Cost of Service Appeal Schedule E, ln. 28, & Cost of Service Unincorporated, Schedule E, ln. 28.

<sup>385</sup> This figure reflects the impact of flowthrough effects that are not addressed here. Those issues were addressed in Section 8 above.

<sup>386</sup> Atmos Ex. 7, Thomas H. Petersen, p. 9, ln. 11 – p. 11, ln. 6.

<sup>387</sup> The billing lag is the time lag from meter reading to bill issuance.

<sup>388</sup> Service lag is the average number of days from the time service is provided until the meter is read.

<sup>389</sup> Collection lag is the average number of days between issuing a bill and receiving payment.

<sup>390</sup> Bank lag is the lag between receiving payment and having funds available to draw at the bank.

<sup>391</sup> Atmos Ex. 3, Atmos Update Filing, September 4, 2012, Cash Working Capital Study, Schedule THP-CWC2, ln. 6.

system from preparing the bills. Bills printed at the end of the third day are in the mail at the beginning of the fourth day. Complex bills may require more time.<sup>392</sup>

## 2. Intervenor's Position

Mr. Nalepa contended that in this context the company ignored the precedent of the Commission. In a prior proceeding, the Commission established a one-day billing lag and the relevant findings of fact in GUD No. 9762 are set forth below:

49. The billing lag is the period of time between when a meter is read and a bill is issued.
50. Evidence presented at the hearing indicated that a meter route is generated four days before bills are due and meters must be read within that period of time.
51. Evidence in the record indicated that the utility is able to bill a customer on the same day that the meter is read and the utility did not establish that a billing lag of 2.72 days is reasonable. A billing lag of one day is reasonable.
52. The average billing lag was established by analyzing the billing lag for January and June of the test year.
53. Evidence presented at the hearing established that the meter reading process and resulting billing lag for the Company averaged 2.72 days.<sup>393</sup>

Mr. Nalepa raised several complaints regarding the billing lag process. First, Mr. Nalepa argued that the study included bills that were issued more than two years after the meter read date and that these outliers skewed the analysis. Second, Mr. Nalepa faulted the company's analysis for applying only two months of data to conduct its billing lag study. Third, in reliance of Finding of Fact No. 51, which reflected a finding that the company was able to bill a customer on the same day that a meter is read, he appeared to conclude that the company is able to read meters and bill customers within one day. Fourth, he asserted that the company gave no consideration to its ongoing investment in automated meter reading. He noted that during calendar year 2011 alone, the company invested over \$700,000 in automatic meter reading facilities. He concluded that the significant ongoing investment in these facilities should result in more bill processing efficiency.<sup>394</sup>

Mr. Nalepa's proposal to increase the billing lag, results in a negative cash working capital totaling \$21,252,498. The impact on the revenue requirement is an overall reduction of \$234,561.

## 3. Company's Response

In response to the first issue raised by Mr. Nalepa, Mr. Petersen testified that he removed the alleged outliers and modified the billing lag request from 1.82, initially requested, to 1.74.

<sup>392</sup> Atmos Ex. 6, p. 12, ln. 18 – p. 14, ln. 23.

<sup>393</sup> GUD No. 9762 Final Order and Order Nunc Pro Tunc (correcting Finding of Fact No. 53).

<sup>394</sup> ACSC Ex. 1, Karl Nalepa, p. 18, ln. 3 – p. 20, ln. 18.

As to the size of the billing sample, Mr. Petersen explained that the billing sample included one-sixth of the test-year's bills. Half of the bills are from a month in the heating season and half are from a month outside of the heating season. Thus, he concluded this provided a significant sample set. As to the issues raised regarding the findings in GUD No. 9762 and the billing lag efficiencies, Mr. Petersen explained that the company made significant strides to improve the billing process since GUD No. 9762. Those improvements are encompassed in the billing process described above. Finally, as to the investment in improved automated meter reading, Mr. Petersen explained that those changes impacted a small percentage of the customers served. In any case, he asserted that the effect of that change was captured in the cash working capital study.<sup>395</sup>

#### 4. Examiners' Recommendation

The Examiners find that the proposed billing lag of 1.74 days is just and reasonable. The Examiners recognize that this is inconsistent with Commission precedent. In GUD No. 9670, the Commission established a billing lag of zero days based upon the evidence presented in that case.<sup>396</sup> Several of the findings refer to the specific facts of that case. Finding of Fact No. 124 states that the witnesses for the Atmos Mid-Tex Division could not provide evidence to explain what would account for the requested billing lag of 4.47 days. Additionally, the Commission found that the cash working capital witness was unfamiliar with the company's actual billing practice and could not explain those practices.<sup>397</sup> It appears that the Commission simply set the billing lag to zero because it was the billing lag used by the operator of the system in GUD No. 9400.<sup>398</sup> These evidentiary infirmities are not present here.

In this case, the company has established that its proposal is just and reasonable by detailing its billing process. No Intervenor argued that the process itself was flawed or that the conduct of the cash working capital study was flawed. The only issue presented was that the proposed billing lag was inconsistent with GUD No. 9762. The company has improved its billing process and reduced the billing lag from 4.47 requested in GUD No. 9670 and 2.72 days requested in GUD No. 9762 to 1.74 days requested in this case. As the measure of time, this represents a 61% improvement in the billing process. Finally, no party presented evidence in this case to support the fact that bills were processed within one day. In any case, even if such evidence were produced, that fact would have been captured in the study. Based upon the substantial weight of the evidence in this case a billing lag of 1.74 days is reasonable.

#### (c) O&M – Non labor expense lag adjustment – Selected Categories

##### 1. Introduction

Consistent with Commission precedent, Mr. Petersen calculated an overall O&M Non-Labor cash working capital requirement. Mr. Petersen explained that he applied the same methodology approved in GUD No. 10000. He testified that the calculation was based on an analysis of payments for the Atmos Mid-Tex Division during the test year ended September 30,

<sup>395</sup> Atmos Ex. 17, Thomas H. Petersen Rebuttal, p. 27, ln. 1 – p. 29, ln. 10.

<sup>396</sup> GUD No. 9670, Findings of Fact No. 118 – 129.

<sup>397</sup> GUD No. 9670, Findings of Fact No. 127.

<sup>398</sup> At that time the system was operated by TXU Gas Company.

2011. He demonstrated in his testimony and supporting workpapers that he analyzed a random sample of 400 invoices of the 29,538 total O&M invoices paid during the test year to determine the lag between the date services were provided to the company and the date the company paid the bill for those services.<sup>399</sup>

## 2. Intervenor's Position

ATM recommended that certain items included in the overall O&M cash working capital requirement be calculated separately. Those items include Pension Contributions, OPEB/FAS 106 Contributions, and SSU LTIP Costs. The impact on the cash working capital analysis and the overall revenue requirement is set out below in Table 10.1

Table 10.2  
O&M Non-Labor Items Selected for Individual Analysis by ATM

	Change	Overall CWC	Overall Revenue Requirement Impact
Pension Contribution	(\$1,424,021)	(\$20,740,520)	Reduce by: \$172,540
OPEB/FAS 106 Contributions	(\$406,673)	(\$19,721,171)	Increase by: \$49,032
SSU LTIP	(\$15,267,264)	(\$16,069,487)	Reduce by: \$1,947,040
Cumulative Impact	(\$17,898,181)	(\$37,214,679)	Reduce by: \$2,071,411
CWC Requested		(\$19,316,498)	

## 3. Company's Response

In response Mr. Petersen explained that the approach he applied was consistent with the methodology employed in GUD Nos. 9670, 9762, 9869, and 10000. In those cases, the Commission approved the method applied in this case of using the direct pay invoices for all Non-Labor O&M. This method, he maintained, avoided the need to conduct an unnecessary and time-consuming analysis of several categories of O&M expense. He countered that the approach applied by Mr. Carver was to selectively pull out particular components of the Non-Labor O&M Expense.<sup>400</sup>

## 4. Examiners' Recommendation

The Examiners find that the company's calculation of O&M Expense labor is just and reasonable. The company's methodology is consistent with the methodology employed in GUD Nos. 9670, 9762, 9869, and 10000. Further, Mr. Carver has not explained why these categories of expenses should be singled out for separate treatment.

Additionally, the Examiners note that ATM failed to provide sufficient evidence regarding the proposed adjustment to SSU LTIP. Although an adjustment is incorporated into the Examiners' Schedules, the Examiners note that several components of that adjustment were extrapolated and are not in evidence. Mr. Carver spoke generally about the calculation of the

<sup>399</sup> Atmos Ex. 6, Thomas H. Petersen Direct, p. 18, ln. 13 – p. 19, ln. 6; Atmos Ex. 3, Atmos Update Filing September 4, 2012, Cash Working Capital Study & Schedule THP CWC5 & WP 5-1, Mid-Tex SOI – Cash Working Capital Study Sept4 (Disk to Exhibit 3: Document Filed Electronically).

<sup>400</sup> Atmos Ex. 17, Thomas H. Petersen Rebuttal, p. 23, lns. 7 – 16 and p. 24, lns. 6 – 14.



expense lag, and discussed a range for that category of expense. Mr. Carver did not, however, specifically articulate or describe the proposed adjustment. As discussed above in Section 4, the Examiners find that the presumption of reasonableness has not been rebutted and that there is insufficient evidence to adopt the Intervenor's proposed adjustment.

(d) O&M – Non labor expense lag adjustment – Sample Modification

1. Introduction

Atmos determined an expense lag for Other O&M – Non Labor of 28.73 days. The expense lag is the time period between when a good or service is provided to the date the company pays for the good or service. As noted above, in order to calculate the O&M non-labor expense lag, the company examined a random sample of 400 invoices from a population of 29,538 related invoices paid during the test year. One of the 400 invoices was a payment to GE Capital Fleet Services. ATM contended that an adjustment should be made to the calculation to account for the impact of this single unit in the sample.

2. Intervenor's Position

This payment represented 66.2% of the total sample dollars and 0.25% of the total sample count. ATM argued that an adjustment should be made to dampen the effect of this single unit in the sample. Mr. Carver proposed that the weight in the sample attributable to this unit be limited to 17.3%, instead of the 66.2% weight assigned by the company's analysis.

Mr. Carver explained the basis for the 17.3% weight, as follows. The company stated that the twelve monthly invoices from this vendor total \$16,578,417 of direct charges to the Atmos Mid-Tex Division operation and maintenance expense which represented 17.3% of the adjusted non-labor operation and maintenance expense in the company's filing. Mr. Carver proposed an expense lag of 32.67 days.<sup>401</sup> This would result in a negative cash working capital requirement of \$19,426,921 and an overall reduction to the revenue requirement of \$13,379.

3. Company's Response

In response, Mr. Petersen agreed that an adjustment should be made to dampen the impact of this unit in the sample. He proposed an alternative adjustment to the proposal of Mr. Carver. Mr. Petersen proposed that the average lag to incorporate the average of all twelve bills from this vendor in the test year be applied. This would not limit the adjustment to a single unit that fell into the random sample. He argued that his proposed adjustment would accurately represent the payments made to that particular vendor during the test year. His adjustment resulted in an expense lag of 32.24 days which he incorporated into the cash working capital calculation.

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<sup>401</sup> ATM Ex. 2, Steven C. Carver, p. 74, ln. 6 – p. 77, ln. 15.

4. Examiners' Recommendation

The Examiners find that the company's correction is just and reasonable. The proposed adjustment accurately reflects the company's payment experience with this vendor. Thus, the company's proposed adjustment is consistent with the focus of the cash working capital study. On the other hand, ATM's proposed adjustment is not based on the pattern of payment with the vendor. Instead, it is based upon the proportional impact of all payments to the vendor relative to the overall operation and maintenance expense.

(e) Uncollectibles

ATM argued that non-cash items should be excluded from the cash working capital study. ATM contended that by definition the cash working capital is "the amount of cash needed by a utility to pay its day-to-day expenses incurred in providing service in relation to the timing of the collection of revenues for those services."<sup>402</sup> ATM contended that the uncollectibles expenses should be removed from the calculation of cash working capital because, in Mr. Carver's view, it is a non-cash transaction.<sup>403</sup> The impact of the uncollectibles expense adjustment proposed by Mr. Carver is to reduce the cash working capital expense by \$39,130 to a negative \$19,355,628. The overall result is an increase in the revenue requirement of \$4,741.

In response, Mr. Petersen contended that Mr. Carver's definition of cash working capital is too narrow. Mr. Petersen argued that working capital is the amount of investor funding necessary to provide service in addition to plant investments. Thus, cash working capital is the required working capital investment after considering the other working capital items. He explained that Mr. Carver's narrow definition resulted in the exclusion of the uncollectibles expense from the cash working capital analysis. In Mr. Petersen's view, the uncollectibles expense does impose a financial requirement on the utility and is therefore, properly included in the calculation.<sup>404</sup>

The Examiners find that Atmos has established that the treatment of the uncollectibles expense in the cash working capital study is just and reasonable. As explained by Mr. Petersen, the uncollectibles expense relates to amounts not received from billings, which are eventually charged off. The company does not receive that amount at the time service is provided and there is a collection lag in revenues.<sup>405</sup> Accordingly, it is reasonable to include this expense in the calculation of cash working capital.

g. Steel Service Line Replacement Program

ACSC originally raised an issue regarding steel service line replacements arguing that an adjustment was required to the company's contributions in aid of construction. In its Initial Brief, ACSC withdrew this requested adjustment.

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<sup>402</sup> ATM Ex. 2, Steven C. Carver, p. 69, Ins. 8 – 12.

<sup>403</sup> ATM Ex. 2, Steven C. Carver, p. 71, ln. 7 – p. 72, ln. 2.

<sup>404</sup> Atmos Ex. 17, Thomas H. Petersen Rebuttal, p. 21, ln. 12 – p. 22, ln. 4 & p. 23, ln. 18 – p. 24, ln. 4.

<sup>405</sup> *Id.*

h. Summary of Rate Base Recommendation

In conclusion, the Examiners recommend two adjustments to rate base. First, the Examiners recommend that the ADIT entry related to doubtful accounts be removed. Second, the Examiners recommend that the calculation of the Pension and OPEB regulatory asset be updated to reflect the update to the pension costs. The result of these adjustments is a reduction to rate base in the amount of \$1,392,020. These adjustments reduce the overall revenue requirement by approximately \$172,623. Thus, the Examiners find that a rate base totaling \$1,512,989,202 is just and reasonable.

**11. Rate of Return**

a. Introduction

The Commission must establish the rate of return for Atmos to earn on the utility's rate base. In setting a gas utility's rates, the regulatory authority shall establish the utility's overall revenues at an amount that will permit the utility an 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.<sup>406</sup>

These regulatory principles were established in the U.S. Supreme Court cases, *Bluefield Gasworks* and *Hope Natural Gas*:

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; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures.<sup>407</sup>

Similarly, 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>408</sup>

The overall rate of return is based on a calculation of the weighted average cost of capital (WACC), which weights the company's cost of debt and equity financing by the relative percentage of debt and equity in the company's capital structure to arrive at an overall cost of

<sup>406</sup> TEX. UTIL. CODE ANN. § 104.052 (Vernon 2007 and Supp. 2011).

<sup>407</sup> *Bluefield Gasworks & Improvement Company v. Public Service Commission of West Virginia*, 262 U.S. 679, 692-693 (1923); *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

<sup>408</sup> *Railroad Commission of Texas v. Lone Star Gas Company*, 599 S.W.2d 659 (Tex. App. – Austin 1980).

capital, or rate of return for the company.<sup>409</sup> Frank M. Tomicek, Utility Specialist, Market Oversight Section of the Gas Services Division of the Railroad Commission of Texas, testified that this is a standard financial calculation that provides the basis for the calculation for rate of return as applied to rate base used in rate cases.<sup>410</sup>

To determine the cost of capital, it is necessary to identify a capital structure, a cost of debt, and a cost of equity. The capital structure and cost of debt can typically be derived from the actual reported financial measures for a company. The cost of equity, however, is not readily observable and must be estimated.<sup>411</sup>

The parties to this proceeding propose the following overall rates of return: Atmos – 8.85%; Railroad Commission of Texas Staff – 8.36%; Atmos Cities Steering Committee – 7.54%; and Atmos Texas Municipalities – 7.63%. The State Agencies of Texas challenge aspects of the rate of return methodologies used in this case. The State Agencies did not tender a witness in support of its position. Also, the State Agencies declined to state its position in briefing on an overall rate of return for the company. Neither the City of Dallas, nor Co-Serv Gas, Ltd. filed positions on the company's proposed rate of return.

Table 11.1  
Proposed Overall Rates of Return

Atmos	RRC Staff	ACSC	ATM
8.85%	8.36%	7.54%	7.63%

b. Capital Structure

(a) Introduction

Capital structure is an important aspect in a rate case because it influences the overall cost of capital through the proportions of equity and debt capital. A utility's capital structure is comprised of the ratios of the utility's various sources of capital to total permanent capital.<sup>412</sup> 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. The issue of whether short term debt should be included as a component for a calculation of the combined return presents itself in this case.

<sup>409</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, p. 3, lns. 11-17.

<sup>410</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, p. 3, lns. 14-16.

<sup>411</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, p. 3, lns. 16-19.

<sup>412</sup> Gas Services Division, Natural Gas Rate Review Handbook, Railroad Commission of Texas, May 2010, p. 23.

The parties to this proceeding propose the following capital structures for Atmos Mid-Tex:

Table 11.2  
Proposed Capital Structure

	Atmos	RRC Staff	ACSC <sup>413</sup>	ATM
Long-term Debt	48.31%	48.31%	52.81%	46.54%
Short-term Debt	0%	0%	0%	3.67%
Common Equity	51.69%	51.69%	47.19%	49.79%

Atmos Mid-Tex is an operating division of the parent company, Atmos Energy Corporation. Therefore, Atmos Mid-Tex does not issue its own capital to investors. Rather, all capital issuances are done at the parent company level. In this case, both Atmos and Staff are proposing an actual, consolidated capital structure composed of 48.31% long-term debt and 51.69% common equity.<sup>414</sup> On the other hand, the Atmos Cities Steering Committee believes appropriate capital structure for the utility is 58.21% long term debt and 41.79% common equity. Whereas, Atmos Texas Municipalities argues for a capital structure of 46.54% long-term debt, 3.67% short-term debt, and 49.79% common equity.

(b) Atmos' Position

Daniel M. Meziere, Vice President and Treasurer for Atmos Energy Corporation testified on behalf of Atmos. It is the utility's position that the company's consolidated actual capital structure is appropriate for use in this case to calculate the overall rate of return. Atmos conducts regulated operations in 12 states through unincorporated divisions. These divisions are not separate legal entities. Thus, the debt or equity funding for division operations are performed by Atmos Energy as a whole, on a consolidated basis.<sup>415</sup> Atmos also points out that a consolidated capital structure is consistent with the Commission's decisions.<sup>416</sup>

Mr. Meziere testified that the company's actual reported consolidated capital structure for Atmos comes from the company's quarterly Form 10-Q filed with the Securities and Exchange Commission.<sup>417</sup> To give effect to known and measureable events, Mr. Meziere updated the capital structure for the company from the end of the test period, September 30, 2011, to the capital structure at the end of the most recently reported quarter for the 10-Q filing as of March

<sup>413</sup> Initially, ACSC proposed a capital structure of 58.21% long-term debt and 41.79% common equity, which was amended with the filing of Initial Briefs to 52.81% long-term debt and 47.19% common equity.

<sup>414</sup> Atmos Ex. 8, Direct Testimony of Daniel M. Meziere, p. 6 and Ex. DMM-R-2 and Staff Ex. 1, Direct Testimony of Frank M. Tomicek, pp. 4 -5.

<sup>415</sup> Atmos Ex. 8, Direct Testimony of Daniel M. Meziere, pp. 4-5.

<sup>416</sup> Atmos Ex. 8, Direct Testimony of Daniel M. Meziere, p. 5. and GUD Nos. 9670, 9762, 9869, 10000, 10041, and 10084.

<sup>417</sup> Atmos Ex. 8, Direct Testimony of Daniel M. Meziere, p. 6 and Ex. DMM-R-2.

31, 2012.<sup>418</sup> The capital structure is comprised of long-term debt in the amount of \$2,206,344,<sup>419</sup> or 48.31% and common equity of \$2,360,712, or 51.69% for a total capital of \$4,567,056.<sup>420</sup> This capital structure does not include short-term debt. Thus, Atmos proposes the following actual, consolidated capital structure for the company:<sup>421</sup>

Table 11.3  
Atmos Proposed Capital Structure

Debt	Shareholder Equity	Total
2,206,344	2,360,712	4,567,056
48.31%	51.69%	100.0%

*Amounts shown are in 000s*

Mr. Meziere testified that Atmos does not include short-term debt in the capital structure for the testing period because the company does not historically rely upon short-term debt as a permanent form of capital. Instead, Atmos uses short-term debt to finance purchased gas costs to meet its needs for the heating season. According to Mr. Meziere, the company's short term balance falls to zero often and stays there during much of the spring and summer.<sup>422</sup> Moreover, Mr. Meziere testified that in prior rate cases for the Mid-Tex Division,<sup>423</sup> the Commission considered this issue and concluded that the company's capital structure should not include a short-term debt component.<sup>424</sup>

(c) Staff's Position

Mr. Tomicek testified that when a utility's actual capital structure is consistent with those of publicly-traded gas distribution utilities within the segment of the industry, then use of the company's actual capital structure is appropriate. As part of the process of making a cost of equity determination in this docket, Staff employed a grouping of comparable natural gas distribution utilities with a calculated average capital structure for the grouping of 46.29% long-term debt and 53.71% common equity as reported in the most recent form 10-K annual filings for the companies.<sup>425</sup>

The form 10-K data used to calculate Staff's average proxy company capital structure is shown below:<sup>426</sup>

<sup>418</sup> Atmos Ex. 8, Direct Testimony of Daniel M. Meziere, p. 6 and Ex. DMM-R-2.

<sup>419</sup> Balance Sheet and Form 10-Q data is reflected in thousands.

<sup>420</sup> Atmos Ex. 8, Direct Testimony of Daniel M. Meziere, p. 6 and Ex. DMM-R-2.

<sup>421</sup> Atmos Ex. 8, Direct Testimony of Daniel M. Meziere, p. 6, Ins. 11-14 and DMM-R-2.

<sup>422</sup> Atmos Ex. 8, Direct Testimony of Daniel M. Meziere, p. 7, Ins. 1-10.

<sup>423</sup> GUD No. 9670, 9762, 9869, 10000, 10041, and 10084.

<sup>424</sup> Atmos Ex. 8, Direct Testimony of Daniel M. Meziere, p. 7, Ins. 12-22.

<sup>425</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, p. 4, Ins. 7-13.

<sup>426</sup> Ex. FMT-1.

Table 11.4  
Average Capital Structure for Comparable Utility Company Grouping

<u>Company</u>	<u>Ticker</u>	<u>Debt</u>	<u>Equity</u>
AGL Resources	AGL	51.77%	48.23%
NiSource	NI	55.64%	44.36%
Laclede Gas	LG	38.86%	61.14%
Northwest Nat. Gas	NWN	64.81%	35.19%
Piedmont Natural Gas	PNY	39.32%	60.68%
South Jersey Industries	SJI	40.47%	59.53%
Southwest Gas	SWX	47.83%	52.17%
WGL Holdings Inc.	WGL	31.61%	68.39%
Company Grouping Mean		46.29%	53.71%

Mr. Tomicek testified further that Atmos' proposed capital structure of 48.31% long-term debt and 51.69% common equity is within the range of the average calculated from Staff's selected proxy companies for this case. Moreover, the capital structure reported on the company's SEC Form 10-Q is the capital structure available to investors and reflected in investment service reports. This is the capital structure used by investors to evaluate the financial position of the company. As a result, Staff agrees with Atmos that the company's actual, consolidated capital structure is appropriate for this proceeding.<sup>427</sup>

In considering a capital structure, Mr. Tomicek notes that natural gas distribution utilities may typically employ some component of short-term debt, which is often used toward procurement of gas supplies during peak load periods, and Atmos follows this practice. However, short-term debt is not a permanent element of the Company's capital structure, and a capital structure based on actual long-term debt and common equity has been adopted by the Commission in Atmos' recent rate decisions.<sup>428</sup>

(d) Issues Raised by the Atmos Cities Steering Committee

Stephen G. Hill, Principal of Hill Associates, testified on behalf of ACSC related to return on equity and the overall cost of capital in this proceeding. As to Atmos' capital structure, Mr. Hill's main issue of contention is that the goodwill, or acquisition premium, shown on Atmos' balance sheet should be eliminated from Atmos' ratemaking capital structure.<sup>429</sup> Mr. Hill defines goodwill as the difference between the amount paid for acquired assets and their underlying book value, which is an acquisition premium.<sup>430</sup> The goodwill on Atmos' March 31, 2012 balance sheet was \$740 million.<sup>431</sup>

<sup>427</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, pp. 4, Ins. 14-17.

<sup>428</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, pp. 4, Ins. 17-22; GUD Nos. 10000, 9869, 9762, 9670 (based on actual capital structure for Atmos comprised of a combination of long-term debt and common equity, which was similarly applied in GUD Nos. 10041, 10084 and 10085).

<sup>429</sup> ACSC Ex. 7, Direct Testimony of Stephen G. Hill, pp. 24-25.

<sup>430</sup> ACSC Ex. 7, Direct Testimony of Stephen G. Hill, p. 25, Ins. 4-5.

<sup>431</sup> Ex. DDM-R-2.

Mr. Hill testified further that because utility rates are set and equity returns are allowed on original cost book value (not on market value, acquisition value or replacement cost), the difference between the acquisition's market value and its book value (goodwill/acquisition premium) must be removed from the total equity balances of the parent's capital structure in order to determine a book value based capital structure for ratemaking purposes. Mr. Hill believes that to do otherwise would result in "deal-based ratemaking." According to Mr. Hill rates for utility assets would be whatever market price was paid for those assets, not on their book value, and the company would receive a return on assets including the acquisition premium.<sup>432</sup>

As for the issue of short-term debt, Mr. Hill testified that short-term debt may be a permanent part of utility capital structures appropriately considered for ratemaking purposes, however, in this case, he does not recommend the use of an average level of short-term debt for rate making.<sup>433</sup> Mr. Hill bases this decision on the fact that the short-term debt balance of the parent company was zero in the end of the first and second quarters of 2011. In his opinion, the issue of short-term debt is secondary to the removal of goodwill assets in the company's capital structure.<sup>434</sup>

Consequently, Mr. Hill recommends a capital structure consisting of 41.79% common equity and 58.21% long-term debt, based on the recent average parent company capital structure, which is based on the book value of the parent's underlying assets, excluding short-term debt and any goodwill or acquisition premiums in the capital structure.<sup>435</sup>

Yet, in closing briefing, ASCS recommends an alternative capital structure to Mr. Hill's recommendation. ACSC recommends the proposed capital structure be adjusted to remove the portion of equity associated with goodwill on the company's balance sheet, which Mr. Meziere calculated in rebuttal testimony as \$205.7 million.<sup>436</sup> Mr. Meziere, however, argues that goodwill should come from both debt and equity. Applying this results in a capital structure of 43.69% debt and 56.31% equity.<sup>437</sup> Whereas, Mr. Hill's analysis removes goodwill only from the company's common equity to revise the recommendation in closing briefs to a capital structure of 47.19% equity and 52.81% debt.<sup>438</sup> ACSC concludes by maintaining that any capital structure where equity exceeds 50% is unreasonable.

(e) Atmos Texas Municipalities' Position

ATM argues that Atmos should base its capital structure with 46.54% long-term debt, 3.67% short-term debt and 49.79% equity, as of the March 31, 2012 consolidated capital structure. The primary distinction between ATM's position and that of Atmos, relates to the treatment of short-term debt. According to ATM, Atmos consistently used short-term debt to finance a portion of its rate base during the test year, which ATM argues is contrary to Atmos'

<sup>432</sup> ACSC Ex. 7, Direct Testimony of Stephen G. Hill, p. 25, Ins. 8-17.

<sup>433</sup> ACSC Ex. 7, Direct Testimony of Stephen G. Hill, p. 26, Ins. 4-5 and p. 27, Ins. 9-11.

<sup>434</sup> ACSC Ex. 7, Direct Testimony of Stephen G. Hill, p. 25, ln. 23 through p. 26, ln. 6.

<sup>435</sup> ACSC Ex. 7, Direct Testimony of Stephen G. Hill, p. 27, Ins. 15-19 and SGH Schedule 1

<sup>436</sup> Atmos Ex. 26, Rebuttal Testimony of Daniel M. Meziere, p. 13, ln. 18.

<sup>437</sup> Atmos Ex. 26, Rebuttal Testimony of Daniel M. Meziere, p. 13, Ins. 14-20.

<sup>438</sup> Atmos Ex. 26, Rebuttal Testimony of Daniel M. Meziere, p. 5, Ins. 9-18, p. 10, Ins. 15-18 and DMM-R-2; and ACSC Ex. 7, Direct Testimony of Stephen G. Hill, pp. 25-27 and SGH Schedule 1.



position that it primarily uses short-term debt to finance its gas costs during the heating season.<sup>439</sup> Specifically, ATM points to the May 2010 through September 2011 period where Atmos shows a short-term debt balance ranging from \$12,870,967 to \$140,000,000 during these months outside of the heating season.<sup>440</sup>

(f) Position of State Agencies of Texas

The State Agencies maintain that the company should make adjustments for goodwill and short-term debt in proposing its capital structure for rate-making purposes. Moreover, they assert that Mr. Meziere fails to support his position about excluding goodwill from capital structure. The State Agencies also agree with ATM that short-term debt should be included in the capital structure debt calculation because the company had balances of short-term debt in the amounts of \$255 and \$140 million in May and June of 2011, respectively, compared to no short-term debt in May and June of 2010.<sup>441</sup> The State Agencies, however, did not specifically state the percentages of capital structure recommended as a result of their position to include short-term debt and eliminate goodwill in the calculations for capital structure.

(g) Atmos' Response

In response to the arguments regarding goodwill and acquisition adjustments, Mr. Meziere testified on rebuttal that Atmos has already removed goodwill from its rate base in accordance with the principle that utility rates be set based on original cost. Atmos maintains that ACSC's attempt to make a second adjustment to eliminate goodwill from shareholder equity ignores the structure of the financing for the related acquisitions and assumes that all goodwill is financed with equity.<sup>442</sup> Mr. Meziere believes that excluding goodwill from capital structure for ratemaking purposes is inconsistent with the way in which the markets understand the company's capital structure and is therefore, not reasonable. According to Mr. Meziere, if an adjustment were made to account for goodwill, the component financed through debt and equity would actually result in a capital structure of 43.69% debt and 56.31% equity, not the 58.21% debt and 41.79% equity as calculated by Mr. Hill.<sup>443</sup> Finally, Atmos asserts that its proposed capital structure of 48.31% long-term debt and 51.69% common equity is, comparable to the average capital structure of utilities included in both Atmos' and Staff's proxy groups.

(h) Examiners' Findings and Recommendations

After careful consideration of the evidence and arguments of the parties, the Examiners recommend that the actual, consolidated capital structure of 48.31% long-term debt and 51.69% common equity be used for purposes of setting rates for the Mid-Tex Division in this proceeding, as proposed by Staff and Atmos.<sup>444</sup> The Examiners concur that using the actual capital structure contained in the company's most recent reported form 10-Q is consistent with precedent in GUD Nos. 9762, 9869, 10000, 10041, 10084, and 10085. The Examiners were persuaded by Staff

<sup>439</sup> ATM Ex. 3, Direct Testimony of David C. Parcell, Bates 15, Ins. 13-19, Schedule 5 at Bates 49, and Attachment 2.

<sup>440</sup> ATM Ex. 3, Direct Testimony of David C. Parcell, Attachment 2 at Bates 82.

<sup>441</sup> ATM Ex. 3, Direct Testimony of David C. Parcell, Attachment 2 at Bates 77-82.

<sup>442</sup> Atmos Ex. 26, Rebuttal Testimony of Daniel M. Meziere, p. 4.

<sup>443</sup> *Id.* p. 13.

<sup>444</sup> Atmos Ex. 8, Direct Testimony of Daniel M. Meziere, p. 6 and Staff Ex. 1, Direct Testimony of Frank M. Tomicek, pp. 3-5.

witness, Mr. Tomicek, that the Commission has a history of accepting the actual capital structures of a utility when the actual capital structure is in line with those of publicly-traded gas distribution utilities within this segment of the industry.<sup>445</sup> After reviewing the capital structures of Mr. Tomicek's and Mr. Meziere's proxy groups, the Examiners conclude that the company's requested capital structure is within the range of these companies included in the Intervenor and Staff proxy groups and prior Commission dockets.<sup>446</sup>

ATM and ACSC, on the other hand, seek a capital structure using methodologies less common. Specifically, ATM witness Mr. Parcell claims that the Company's capital structure should include 49.79% common equity, 46.54% long-term debt, and 3.67% short-term debt.<sup>447</sup> The Examiners recommend that short-term debt be excluded from the company's capital structure because the evidence demonstrates that Atmos' short-term debt is used primarily as a means to finance seasonal gas costs and short-term debt is not a permanent element of the Company's capital structure.<sup>448</sup> Furthermore, a capital structure based on actual long-term debt and common equity is consistent with Commission decisions in Atmos' recent rate decisions.<sup>449</sup>

Mr. Hill recommends in direct testimony an adjustment for the amount of goodwill on Atmos Energy's balance sheet deriving a capital structure of 58.21% debt and 41.79% common equity, which was further adjusted after the close of the hearing in Initial Briefs to 47.19% equity and 52.81% debt.<sup>450</sup> With regard to a goodwill adjustment, the Examiners were again persuaded by Mr. Petersen's testimony that Mid-Tex has already removed goodwill from its rate base in accordance with the principle that utility rates be set based on original cost.<sup>451</sup> Moreover, Mr. Meziere showed that the exclusion of goodwill from capital structure as proposed by Mr. Hill is inconsistent with the structure of the financing for the related acquisitions and assumes that all goodwill is financed with equity.<sup>452</sup> Furthermore, Mr. Meziere demonstrated that, if an adjustment were to be made to account for goodwill, the component financed through debt and equity would actually result in a capital structure of 43.69% debt and 56.31% equity.<sup>453</sup> The evidence also demonstrates that the company's treatment of goodwill is consistent with FERC precedent.<sup>454</sup>

Given that Atmos has removed goodwill from rate base, the Examiners conclude that requiring the company to also exclude goodwill from capital structure for ratemaking purposes is inconsistent with the way in which the markets operate related to the company's capital structure and is therefore, not reasonable.<sup>455</sup> The Examiners recommend a capital structure of 48.31% long-term debt and 51.69% common equity as it is comparable to the average capital structure of utilities included in both Atmos and Staff's proxy groups and is also consistent with Commission precedent.

<sup>445</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, p. 4.

<sup>446</sup> Atmos Ex. 8, Direct Testimony of Daniel M. Meziere, pp. 11-12 and Staff Ex. 1, Direct Testimony of Frank M. Tomicek, pp. 4, Ins. 7-13 and FMT-1.

<sup>447</sup> ATM Ex. 3, Direct Testimony of David C. Parcell, Bates 14, Ins. 8-10.

<sup>448</sup> Atmos Ex. 27, Rebuttal Testimony of Robert B. Hevert, pp. 11-12.

<sup>449</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, pp. 4-5.

<sup>450</sup> ACSC Ex. 7, Direct Testimony of Stephen G. Hill, p. 24, Ins. 18-24 and p. 27, Ins. 15-19.

<sup>451</sup> Atmos Ex. 6, Direct Testimony of Thomas H. Petersen, pp. 6-7.

<sup>452</sup> Atmos Ex. 26, Rebuttal Testimony of Daniel M. Meziere, p. 4.

<sup>453</sup> *Id.* at 13.

<sup>454</sup> *SFPP, L.P.*, Opinion No. 511, 134 FERC ¶61,121 at P169, 179 (2011).

<sup>455</sup> Atmos Ex. 27, Rebuttal Testimony of Robert B. Hevert, pp. 13-15.

c. Cost of Debt

(a) Introduction

The cost of debt is generally not the subject of much debate because it is based upon known, measurable factors such as the cost of borrowing instruments that are easily identifiable. The company's books should clearly display the cost of debt. The proper cost of debt is the embedded cost of debt with adjustments made for current maturities.<sup>456</sup>

(b) Position of the Parties

Mr. Meziere testified on behalf of Atmos that a 6.50% weighted average cost of debt is appropriate in order for Atmos to raise the debt capital required to support its operations for the Mid-Tex customers. Mr. Meziere added that to determine the appropriate embedded cost of debt, he used the amount reported to the SEC on the most recent Form 10-Q as of March 31, 2012.<sup>457</sup>

No Intervenor contests the company's actual cost of debt. Staff proposes the same 6.5% cost of debt based on the company's actual incurred debt financing. Mr. Tomicek testified that it is Staff's preference to use actual financial performance results when available, accurate and reasonable, which Mr. Tomicek accepts in this proceeding.<sup>458</sup> ACSC witness Mr. Hill recommends 6.5% long-term cost of debt but suggests that the company should recalculate embedded cost of debt if it issues additional debt prior to the close of the record.<sup>459</sup> ATM witness, Mr. Parcell recommends a mix of the company's actual 6.5% long-term debt, as well as, a 2.02% short-term cost of debt for the company's cost of debt.<sup>460</sup>

(c) Treasury Lock Issue

(1) Overview

A treasury lock is a hedging tool used to manage interest rate risk by locking interest rates to federal government securities. The goal is to lock the interest rate associated with future borrowings.<sup>461</sup> It is not disputed that the company regularly and routinely engages in treasury lock agreements to manage interest rate risks associated with its debt financings.<sup>462</sup>

During the test year, Atmos unwound treasury lock agreements that it had entered into in anticipation of new debt financing that it ultimately did not require.<sup>463</sup> The company initially anticipated a November 2011 debt issuance. By March 2011, as a result of tax law changes, the need to issue debt in November 2011 was eliminated, and the related treasury lock agreement was settled at a gain of approximately \$27.8 million. The impact of the unwinding transaction

<sup>456</sup> Gas Services Division, Natural Gas Rate Review Handbook, Railroad Commission of Texas, May 2010, p. 24

<sup>457</sup> Atmos Ex. 8, Direct Testimony of Daniel M. Meziere, p. 8 and Ex. DMM-R-2.

<sup>458</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, p. 5, Ins. 7-10.

<sup>459</sup> ACSC Ex. 7, Direct Testimony of Stephen G. Hill, p. 27, Ins. 22-24 through p. 28, Ins. 1-6.

<sup>460</sup> ATM Ex. 3, Direct Testimony of David C. Parcell, Bates 15, Ins. 17-19, Schedule 1 at Bates 45.

<sup>461</sup> Atmos Ex. 18, Pace McDonald Rebuttal, p. 25, Ins. 3 – 5.

<sup>462</sup> ATM Ex. 1, Michael L. Brosch, p. 52, Ins. 3 – 4.

<sup>463</sup> ATM Ex. 1, Michael L. Brosch, p. 50, Ins. 10 – 11.

was not included in the revenue requirement calculation of Atmos.<sup>464</sup> Thus, shareholders retained all of the financial gain from this transaction.<sup>465</sup>

(2) Position of Parties

ATM argued that it was inappropriate to exclude the impact of the unwinding transaction on the revenue requirement. Mr. Brosch, on behalf of ATM, contended that Atmos normally charged the cost of realized gains or losses on treasury lock transactions to ratepayers, when the gains or losses relate to the completed debt financings that are included in the company's capital structure. As a result, he considered it unreasonable that shareholders of the company should retain all of the financial gain realized from this transaction.<sup>466</sup>

ATM proposed that a portion of the \$27.8 million gain be recognized as other revenues. In essence, Mr. Brosch proposed a three-year amortization of the allocated Atmos Mid-Tex share of the \$27.8 million pre-tax gain realized by Atmos. Specifically, he proposed that the revenues to be generated by the rates set in this case be reduced by \$2,919,565.<sup>467</sup>

(3) Atmos' Response

Mr. Peterson, who testified on behalf of Atmos, responded to the allegations raised by ATM. He countered that the gain was not included in the revenue requirement calculation because it was not directly related to investment or expense incurred in providing service in the areas served by the Atmos Mid-Tex Division. He argued that the Intervenor's position was inconsistent with the company's methodology to take into account for ratemaking purposes only activities related to the regulated utility business. He argued this approach was consistent with Commission precedent. In the alternative, Mr. Peterson opined that if the effect of this transaction is to be reflected in the revenue requirement calculation of the company, the effect of the transaction should be reflected in the cost of debt.<sup>468</sup>

(4) Examiners' Recommendation

The Examiners find that the company has established that the treasury lock transaction is just and reasonable. The company updated its filing to differentiate between realized and unrealized treasury instruments in its ADIT calculation.<sup>469</sup> Additionally, the gain from the treasury lock transaction is not related to the operations of the Atmos Mid-Tex Division and it would be inappropriate to include the effect of the transaction in the revenue requirement. The Examiners find, however, that if an adjustment is to be made, the appropriate adjustment is the alternative proposed by Mr. Petersen. The transaction is directly related to management of the company's debt levels. Accordingly, to the extent a determination is made that an adjustment must be made, it would be reasonable to reduce the cost of debt to 6.46%. Notwithstanding, the Examiners recommend that no adjustment be made.

<sup>464</sup> Atmos Ex. 17, Thomas H. Petersen Rebuttal, p. 30, Ins. 4 – 13.

<sup>465</sup> ATM Ex. 1, Michael L. Brosch, p. 51, ln. 21.

<sup>466</sup> ATM Ex. 1, Michael L. Brosch, p. 51, Ins. 1 – p. 52, ln. 17.

<sup>467</sup> ATM Ex. 1, Michael L. Brosch, p. 52, Ins. 21 – 23; ATM Ex. 2, Steven C. Carver, Schedule WP\_J-2.

<sup>468</sup> Atmos Ex. 17, Thomas H. Petersen Rebuttal, p. 29, ln. 20 – p. 31, ln. 14.

<sup>469</sup> ACSC Ex. 3, Constance T. Cannady, p. 26, Ins. 19 – 22.

Table 11.5

Party	Impact on Revenues Recovered	Location of Adjustment	Change in Rates		
			Residential	Commercial	Industrial & Transportation
ATM	(\$2,919,565)	Recognized as other revenues	.0031	.0010	.0030 .0022 .0005
Atmos Alternative	(\$309,331)	Adjustment to cost of debt	.0003	.0001	.0003 .0002 .0001

(d) Examiners' Findings and Recommendation

The Examiners find that the company's actual cost of debt of 6.5% is just and reasonable because Atmos has established that 6.5% is the company's actual long-term cost of debt and it is within the range of cost of debt in prior Commission dockets.<sup>470</sup> The Examiners do not believe that short-term debt should also be included as recommended by ATM. Atmos has established that short-term debt is not a part of the company's permanent capital structure. Accordingly, it is just and reasonable for the company to use a 6.5% cost of long-term debt in the company's capital structure.

d. Return on Equity

(a) Introduction

Equity investors expect a return on their capital commensurate with the risks they take and consistent with returns that might be available from other similar investments. Unlike returns from debt and preferred stocks, the equity return is not directly observable in advance and therefore, it must be estimated or inferred from capital market data and trading activity. Since the cost of equity is based upon the interpretation of financial and market data, it is subjective by nature. As a result, the cost of equity component of a utility's weighted average cost of capital is usually the most contested aspect of setting an appropriate rate of return. Investors and analysts tend to use multiple approaches in developing their estimate of return requirements, with each methodology requiring certain judgment with respect to the reasonableness of assumptions and the validity of proxies in its application.<sup>471</sup>

<sup>470</sup> Staff Ex. 4.

<sup>471</sup> Atmos Ex. 9, Direct Testimony of Robert B. Hevert, p. 15, lns. 15-18.

(b) Overview of Cost of Equity Proposals

In this docket, Atmos' expert witness, Robert B. Hevert, utilized three methods to estimate the company's cost of equity: (1) the Discounted Cash Flow method (DCF); (2) the Bond Yield Plus Risk Premium Method (RP); and (3) the Capital Asset Pricing Model method (CAPM).<sup>472</sup>

Table No. 11.6 below summarizes the relative positions of the parties related to the return on equity (ROE) in this proceeding:

Table 11.6  
ROE Proposals by Atmos and Intervenors

Atmos	RRC Staff	ACSC	ATM	State Agencies
11.05%	10.10%	9.0%	9.1% - 9.75%	< or = 10.00%

As can be seen from the table above, the parties controvert each other's return on equity recommendations. Mr. Tomicek limited his analysis to the DCF and CAPM methods.<sup>473</sup> Mr. Tomicek testified that in the past, the Commission has accepted primarily the DCF and CAPM methodologies to support the cost of equity.<sup>474</sup> ACSC's witness, Mr. Hill utilized the DCF, CAPM, Modified Earnings-Price Ratio Analysis and Market-to-book Ratio Analysis. Mr. Parcell, ATM's witness, used the DCF, CAPM and Comparable Earnings Analysis in his cost of equity analysis.

(c) Proxy Companies

The parties used a group of comparable, proxy companies similarly situated to perform their analysis. Atmos' primary service areas are located in Colorado, Kansas, Kentucky, Louisiana, Mississippi, Tennessee and Texas. Within Texas, Atmos has two natural gas distribution divisions—Mid-Tex and West Texas.<sup>475</sup> Mid-Tex serves approximately 550 incorporated and unincorporated communities in the north-central, eastern and western parts of Texas, including the Dallas/Fort Worth Metroplex, which in total represents approximately 1,573,802 customers.<sup>476</sup> Net income from gas distribution operations accounted for 78.38% of Atmos' total net income in 2011.<sup>477</sup>

Atmos currently has an unsecured long-term debt ratings of A- from Fitch Ratings, BBB+ from Standard & Poor's, and Baal from Moody's Investors Service.<sup>478</sup> In developing

<sup>472</sup> Atmos Exs. 9 and 27, Direct and Rebuttal Testimony of Robert B. Hevert.

<sup>473</sup> Railroad Commission Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 6, Ins. 1-11.

<sup>474</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, p. 6, Ins. 6-11.

<sup>475</sup> Atmos Ex. 9, Direct Testimony of Robert B. Hevert, p. 11, Ins. 16-18.

<sup>476</sup> Atmos Ex. 9, Direct Testimony of Robert B. Hevert, p. 11, Ins. 18-21.

<sup>477</sup> *Id.* at 11-12.

<sup>478</sup> *Id.* at 11-12.

Mid-Tex's proxy group, Mr. Hevert reviewed the financial and operational characteristics of businesses with characteristics fundamentally comparable to Mid-Tex.<sup>479</sup> Mr. Hevert selected the following eight companies for his proxy grouping:

Table 11.7  
Atmos Proxy ROE Group

Company	Ticker
AGL Resources	GAS
Laclede Group	LG
New Jersey Resources	NJR
Northwest Natural Gas	NWN
Piedmont Natural Gas	PNY
South Jersey Industries	SJI
Southwest Gas	SWX
Washington Gas Light	WGL

Staff witness, Mr. Tomicek, testified that he selected a grouping of proxy companies comprised of natural gas utility companies that are primarily engaged in gas distribution operations, receive investment analyst coverage, and exhibit stable investment grade credit ratings.<sup>480</sup> This is the same grouping of natural gas distribution companies as previously referenced in Staff's position related to capital structure. Seven of the eight companies in the proxy group companies utilized by Atmos and Staff are the same with the exception of one company. Mr. Tomicek includes NiSource, Inc. in Staff's proxy grouping of comparable companies.<sup>481</sup> Whereas, Atmos does not have NiSource in its group and instead replaces NiSource with New Jersey Resources.<sup>482</sup>

As for ACSC, Mr. Hill relied upon the gas utility companies that Atmos and Staff relied upon with the addition of UGI Corp. for his proxy group.<sup>483</sup> Finally, ATM witness, Mr. Parcell, selected seven companies for his proxy group that include: AGL, Atmos, Laclede Group, Northwest Natural Gas, Piedmont Natural Gas, South Jersey Industries, and Southwest Gas.<sup>484</sup>

(d) DCF Analysis

1. Introduction

The Discounted Cash Flow or DCF is a widely used method to analyze the cost of common equity. The DCF model is based on the "dividend discount model" of financial theory,

<sup>479</sup> *Id.* at 12.

<sup>480</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, p. 7, Ins. 7-11.

<sup>481</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, p. 7, Ins. 15-16.

<sup>482</sup> Atmos Ex. 9, Direct Testimony of Robert B. Hevert, p. 13.

<sup>483</sup> ACSC Ex. 7, Direct Testimony of Stephen G. Hill, p. 33, Ins. 1-5.

<sup>484</sup> ATM Ex. 3, Direct Testimony of David C. Parcell, Bates p. 12, Ins. 12-13 and p. 48 (Schedule 4).

which maintains that the value (price) of any security or commodity is the discounted present value of all future cash flows.<sup>485</sup> Therefore, this model attempts to quantify a market-based value of common equity based on the present value of a stream of returns. This is because the DCF model assumes that an investor values an asset on the basis of the future cash flows he expects to receive from owning the asset, and that due to the time value of money current dollars are more valuable than future dollars.

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.

This formula essentially recognizes that the return expected or required by investors is comprised of two factors: the dividend yield (current income) and expected growth in dividends (future income).<sup>486</sup> While the formula may appear to be relatively straightforward, the variables are, of course, subject to interpretation and the subject of debate.<sup>487</sup>

## 2. DCF Evaluation

Mr. Hevert developed his proposed ROE using the Quarterly Growth, Constant Growth, and Multi-Stage forms of the DCF model, as discussed below. Mr. Hevert believes that Atmos' recommended ROE of 11.05% is reasonable based on the analysis and that the company's current cost of equity ranges from 10.4% to 11.25%.

On the other hand, Mr. Tomicek applied the DCF method using an annualized dividend constant growth approach based on earnings growth rates for its proxy grouping of distribution utility companies.<sup>488</sup> Mr. Tomicek testified that for the eight proxy companies, he developed a comparative DCF analysis using the average of a range of 30-day, 90-day, and 180-day share prices for a trading day period ending on July 2, 2012. According to Mr. Tomicek, this is consistent with Mr. Hevert's approach, though Staff used a more recent range of stock prices. Mr. Tomicek testified further that he took the results for the average values of share prices for the three observed periods and divided them into the current annualized dividends for the proxy companies to calculate a range of dividend yields which comprise the first part of the DCF calculation. The mean projected long-term growth in earnings per share (EPS) analyst consensus estimates as reported by Zacks, First Call, Thomson Reuters, and Morningstar Inc., were then added to the dividend yields to derive the range of equity cost estimates for the proxy companies. Mr. Tomicek believes that a constant growth methodology using consensus earnings estimates

<sup>485</sup> ATM Ex. 3, Direct Testimony of David C. Parcell, Bates 26.

<sup>486</sup> ATM Ex. 3, Direct Testimony of David C. Parcell, Bates 26.

<sup>487</sup> Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 9, Ins. 1-13.

<sup>488</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, p. 9 Ins. 16-22.



considers a range of analysts' opinions, and is a standard application of the DCF approach.<sup>489</sup> Staff's DCF approach resulted in a mean of 10.19% for the constant growth DCF model.<sup>490</sup>

ACSC witness, Mr. Hill, concludes that a pure distribution utility like Mid-Tex is less risky than the proxy groups used by the parties, which have significant revenues from unregulated businesses.<sup>491</sup> Also, Mr. Hill points out that the return that Atmos expects on its own investments is similar to and below the 9.0% that Mr. Hill proposes.<sup>492</sup> With the annual rate review mechanism, Mr. Hill believes that it "effectively guarantees" that the allowed return will actually be earned.<sup>493</sup> According to Mr. Hill, the following other factors contribute to his ROE recommendation: the pace of the economic recovery is moderate, core inflation is low, capital costs are low and expected to remain so until at least 2015 with low interest rates.<sup>494</sup> Mr. Hill asserts that a ROE of 9.0% would allow investors a 475 basis points greater return than the company's current marginal cost of debt.<sup>495</sup>

ATM witness, Mr. Parcell, relied upon the constant growth DCF model and combined the current dividend yield for the groups of proxy company stocks. Mr. Parcell concluded ROE results from 8.9% to 9.2% from his proxy grouping.<sup>496</sup>

### 3. Quarterly Growth DCF Method

Atmos' Quarterly Growth DCF Model resulted in ROE results of 11.48% to 11.65%.<sup>497</sup> This approach is based on the theory that a stock's current price represents the present value of all expected future cash flows, but unlike in the constant growth DCF analysis, the dividend yield is calculated such that it incorporates the time value of money associated with quarterly compounding.<sup>498</sup> Thus, the distinction with the Quarterly DCF Model relates to the timing of the cash flows.<sup>499</sup>

In his analysis, Mr. Hevert used an average of recent trading days (*i.e.*, the 30-, 90-, and 180-day averaging periods) in an effort to ensure that the calculated ROE is not impacted by anomalous events that may affect stock prices on any given trading day.<sup>500</sup> Mr. Hevert testified that for the purposes of the Quarterly Growth DCF model, growth in EPS represents the appropriate measure of long-term growth.<sup>501</sup> Mr. Hevert, however, utilized a retention growth estimate methodology to his Quarterly Growth DCF Model to estimate long-term growth as an alternative approach to the use of analysts' earnings growth estimates.<sup>502</sup>

<sup>489</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, p. 10, Ins. 6-20.

<sup>490</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, p. 11.

<sup>491</sup> ACSC Ex. 7, Direct Testimony of Stephen G. Hill, pp. 7-8.

<sup>492</sup> ACSC Ex. 7, Direct Testimony of Stephen G. Hill, p. 10, Ins. 9-16.

<sup>493</sup> ACSC Ex. 7, Direct Testimony of Stephen G. Hill, p. 7.

<sup>494</sup> ACSC Ex. 7, Direct Testimony of Stephen G. Hill, pp. 22-23.

<sup>495</sup> ACSC Ex. 7, Direct Testimony of Stephen G. Hill, p. 28.

<sup>496</sup> ATM Ex. 3, Direct Testimony of David C. Parcell, Bates p. 29.

<sup>497</sup> Atmos Ex. 9, Direct Testimony of Robert B. Hevert, p. 32.

<sup>498</sup> Atmos Ex. 9, Direct Testimony of Robert B. Hevert, pp. 16 – 18.

<sup>499</sup> Atmos Ex. 27, Rebuttal Testimony of Robert B. Hevert, p. 28.

<sup>500</sup> Atmos Ex. 9, Direct Testimony of Robert B. Hevert, p. 19.

<sup>501</sup> Atmos Ex. 9, Direct Testimony of Robert B. Hevert, p. 20, Ins. 3-18.

<sup>502</sup> Atmos Ex. 9, Direct Testimony of Robert B. Hevert, p. 22.

Nevertheless, Staff and ACSC contend that the Quarterly DCF Model is not appropriate for use in setting the cost of service because investors' returns on reinvested dividends exceed their annual opportunity cost of capital.<sup>503</sup> Mr. Hill testified that the "compounding treatment, if taken literally, would have investors expecting and regulators awarding, higher and higher rates of return to account for larger and larger dividends. The logic is circular, would lead to over-earning and is without merit."<sup>504</sup> Mr. Hevert responds that the Quarterly DCF model is a refinement of the Constant Growth Model and the results of the Quarterly DCF Model and the Constant Growth DCF Model generally overlap each other.<sup>505</sup>

Atmos points out that in GUD Nos. 9869 and 10000, the Commission expressed support for the use of the Quarterly DCF Model.<sup>506</sup> Mr. Tomicek responds that the actual rate of return adopted by the Commission in GUD No. 9869 was based upon Staff's recommended return on equity, which was derived from an annual constant growth DCF method, the same that Staff presents in the instant case.<sup>507</sup>

#### 4. Constant Growth DCF Method

The proposed growth rate in both Staff's and Atmos' DCF model is an area of dispute. Mr. Hevert maintains that analysts' forecasts of projections of future earnings growth are the best estimate of investors' expectations of future long-term growth not dividend growth.<sup>508</sup> Mr. Hevert testified that there has been significant research on the importance of analysts' growth estimates in determining the cost of equity.<sup>509</sup> For the Constant Growth DCF Model, Mr. Hevert utilized the projected EPS growth rates and the retention growth estimate as applied in his Quarterly Growth DCF model analysis.<sup>510</sup> He concluded ROE ranges from 11.26% to 11.42%.<sup>511</sup>

As for Staff's results, Mr. Tomicek's Constant Growth DCF Model indicated ROEs from 10.17% to 10.21%.<sup>512</sup> Mr. Tomicek agrees with Mr. Hevert related to the use of growth EPS as a common application for the growth term in the DCF.<sup>513</sup> Mr. Tomicek testified that other metrics for growth may also be appropriate for estimating growth in a DCF Model and these include sustainable growth, growth in book value per share and growth in dividends.<sup>514</sup> He testified further that in most DCF applications for ratemaking purposes, EPS growth is used as the constant-growth parameter because growth in EPS drives growth in dividends.<sup>515</sup>

Likewise, according to Mr. Tomicek, using an annualized dividend as a growth rate in the DCF is also appropriate for ratemaking purposes and is consistent with Commission

<sup>503</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, p. 20.

<sup>504</sup> ACSC Ex. 7, Direct Testimony of Stephen G. Hill, pp. 67-68.

<sup>505</sup> Atmos Ex. 27, Rebuttal Testimony of Robert B. Hevert, p. 29.

<sup>506</sup> GUD No. 10000, Final Order at FOF 88 (Apr. 19, 2011); GUD No. 9869, Final Order at FOF 46 (Jan. 27, 2010).

<sup>507</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, pp. 19-20.

<sup>508</sup> Atmos Ex. 9, Direct Testimony of Robert B. Hevert, p. 22, Ins. 1-14.

<sup>509</sup> Atmos Ex. 9, Direct Testimony of Robert B. Hevert, p. 21.

<sup>510</sup> Atmos Ex. 9, Direct Testimony of Robert B. Hevert, p. 26, Ins. 7-8.

<sup>511</sup> Atmos Ex. 9, Direct Testimony of Robert B. Hevert, p. 32.

<sup>512</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, p. 11.

<sup>513</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, p. 9, Ins. 20-22.

<sup>514</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, p. 9.

<sup>515</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, p. 9.

precedent.<sup>516</sup> Mr. Tomicek testified that the dividend growth rate of the proxy companies is lower than the EPS growth rate, and consequently using dividend growth rates would generate a series of results with lower cost of equity values for the proxy group. Mr. Tomicek stated that Staff's intention was to define a high end of the return on equity range.<sup>517</sup>

When Atmos' witness, Mr. Hevert, calculated the expected dividend yield, he applied one-half of the long-term growth rate to the current dividend yield.<sup>518</sup> Mr. Hevert testified that he calculated the dividend yield based on the proxy companies' current annualized dividend average closing stock prices over 30, 90, and 180 days as of May 18, 2012.<sup>519</sup> According to Mr. Hevert, that adjustment ensures that the expected dividend yield is, on average, representative of the coming twelve-month period, and does not overstate the dividends to be paid during that time.<sup>520</sup> Staff adopted a similar methodology, using the earnings growth projections as the appropriate measure of long-term growth, calculating the dividend yield component of the model over 30-, 90-, and 180-day periods, and calculating the expected dividend yield for proxy companies based on one-half of the expected growth rate.<sup>521</sup>

ACSC witness Mr. Hill and ATM witness Mr. Parcell argue that different DCF growth rates such as dividend and book value should also be considered.<sup>522</sup> Yet, Mr. Hevert disagrees and notes in his rebuttal testimony that investors tend to value common equity on the basis of P/E ratios. From that conclusion he testified that the expected ROE is a function of the long-term growth in earnings, not dividends or book value.<sup>523</sup>

Mr. Hill recommends a DCF growth rate estimate of 5.07% and he believes that analysts' earnings forecasts were too overly optimistic to rely on for estimating growth rates.<sup>524</sup> In rebuttal, Atmos questions Mr. Hill's assertions that he did not rely on analysts' earnings projections in support of his position that the sources of growth rates used in the Company's or Staff's DCF analyses are subject to a systemic and pervasive bias. In contrast, Mr. Hevert testified that actual earnings for the proxy group were 2.02% higher than projected earnings establishing the opposite of Mr. Hill's conclusions.<sup>525</sup>

The State Agencies oppose the use of forecasted EPS growth rates for the members of Staff's proxy groups in its three DCF model results. State Agencies argue that the use of EPS is inconsistent with GUD No. 9869, which included six members of the proxy grouping recommended by Staff in the instant docket. The State Agencies also object to Staff's methodology using all three DCF results (30-day, 90-day, and 180-day) with the CAPM results to obtain a ROE average. The State Agencies believe that this results in an unequal weighting between the two models allowing the DCF results three times more weight. According to the State Agencies, by averaging Staff's CAPM result of 9.84% with Staff's DCF (180-day) result of

<sup>516</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, pp. 9-10.

<sup>517</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, p. 12.

<sup>518</sup> Atmos Ex. 9, Direct Testimony of Robert B. Hevert, p. 25.

<sup>519</sup> Atmos Ex. 9, Direct Testimony of Robert B. Hevert, p. 25, Ins. 12-14.

<sup>520</sup> *Id.* at 25-26.

<sup>521</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, pp. 9-10.

<sup>522</sup> ACSC Ex. 7, Direct Testimony of Stephen G. Hill, pp. 29-42.

<sup>523</sup> Atmos Ex. 27, Rebuttal Testimony of Robert B. Hevert, pp. 47-48.

<sup>524</sup> ACSC Ex. 7, Direct Testimony of Stephen G. Hill, pp. 37, 39-40.

<sup>525</sup> Atmos Ex. 27, Rebuttal Testimony of Robert B. Hevert, p. 73.

10.17% to produce a recommended upper limit of 10.00% is more consistent with the methodology used by Staff in GUD No. 9869 and produces the same ROE adopted by the Commission for Mid-Tex in GUD Nos. 9670 and 9762.

#### 5. Multi-Stage DCF Method

Atmos further employed the Multi-Stage Model in its DCF analysis. Mr. Hevert testified that the Multi-Stage Model enables the analyst to specify growth rates over three distinct stages.<sup>526</sup> As with the Constant Growth form of the DCF model, the Multi-Stage form defines the Cost of Equity as the discount rate that sets the current price equal to the discounted value of future cash flows.<sup>527</sup> Unlike the Constant Growth form, however, the Multi-Stage model must be solved in an iterative fashion.<sup>528</sup>

Mr. Tomicek testified that the Multi-Stage DCF is inappropriate in this case because it imposes subjective assumptions of the time periods and additional growth rates to be used in applying the model, creating a less reliable result.<sup>529</sup> He added that it is "most suited to an unregulated company in a younger industry segment."<sup>530</sup> Mr. Hevert testified in rebuttal, however, that it is undisputed that analysts tend to focus on the next three to five years of performance so he believes that the Multi-Stage DCF method offers a reasonable alternative that allows for short-term variation in growth rates and earnings payout ratios, while reflecting a constant growth rate and payout ratio over the long-term.<sup>531</sup>

#### 6. Examiners' Findings and Recommendations

The DCF model essentially calculates a present value of the cash flows an investor may receive from owning a particular equity. An area of contention concerning Atmos' return on equity is the use of the Quarterly Dividend DCF model. Intervenors oppose its use in the model and recommend using an annual approach. Both Mr. Tomicek and Mr. Hill argue that to use the quarterly dividend approach overstates the cost of equity. The Examiners concur and were not persuaded that the Quarterly Dividend DCF model is a reliable method to calculate the cost of equity in this docket.

Another area of disagreement in this case is the proposed growth rate to the DCF model. After careful consideration of the evidence in the record, the Examiners are persuaded that the analysts' forecasts for EPS growth are a reliable indicator of investors' expectations of future long-term growth. The evidence in the record shows that using growth rates, as proposed by Mr. Tomicek, based on growth in earnings per share, or EPS, is a common practice in applying the DCF in utility rate proceedings and is appropriate to assess investor expectations. This methodology does not, however, apply the retention growth estimate that Mr. Hevert used and with that exception, the record in this case establishes that analyst estimates of EPS growth for

<sup>526</sup> Atmos Ex. 9, Direct Testimony of Robert B. Hevert, p. 27.

<sup>527</sup> *Id.*

<sup>528</sup> *Id.*

<sup>529</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, p. 21.

<sup>530</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, pp. 20-21.

<sup>531</sup> Atmos Ex. 27, Rebuttal Testimony of Robert B. Hevert, pp. 29-30.

the proxy groupings are reliable, accurate, and capable of forecasting the future EPS growth of these specific companies.

(e) CAPM

1. Introduction

The Capital Asset Pricing Model (CAPM) is also a method for measuring the cost of equity. The concept behind the CAPM is that investors need to be compensated in two ways: time value of money and risk. Thus, it is a risk premium methodology that conceptually represents the relationship between the risk of an asset in a portfolio of securities and its expected return.<sup>532</sup> As with the DCF Model, the CAPM requires selection of several variables. The CAPM is expressed in a formula as:

$$K = R_f + R_p$$

Where: K = the estimated rate of return of the stock  
R<sub>f</sub> = risk free rate of interest  
R<sub>p</sub> = risk premium (subject to additional equation).

The CAPM methodology addresses equity valuation from the standpoint of investors that hold equities in a reasonably well-diversified portfolio as the sum of a risk free return plus a risk premium to compensate investors for systemic risks associated with that security.<sup>533</sup> In CAPM applications, the risk-free rate is generally recognized by use of U.S. Treasury securities. Beta is a measure of the relative volatility, and thus the risk, of a particular stock in relation to the overall market. Betas of less than one are considered less risky than the market, whereas betas greater than one are more risky.<sup>534</sup>

Table 11.8  
CAPM ROE Mean Results by Atmos and Intervenors

Atmos	RRC Staff	ACSC	ATM
8.56% to 12.11%	7.87%%	7.78%	6.10%

2. CAPM Analysis

The results of the CAPM analysis of company witness, Mr. Hevert, demonstrate rates of equity ranging from 8.56% to 12.11%.<sup>535</sup> Atmos' CAPM model used two different specifications of the risk-free rate as the estimate of the risk-free rate: (1) the current 30-day

<sup>532</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, pp. 12-13.

<sup>533</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, pp. 13-14.

<sup>534</sup> ATM Ex. 3, Direct Testimony of David C. Parcell, Bates p. 31.

<sup>535</sup> Atmos Ex. 9, Direct Testimony of Robert B. Hevert, p. 40, Ins. 17-18.

average yield on 30-year Treasury bonds (*i.e.*, 3.08 percent), and (2) the projected 30-year Treasury yield (*i.e.*, 3.58 percent).<sup>536</sup> For the risk premium, Mr. Hevert did not use a historical average but instead used two forward-looking (*ex-ante*) estimates of the market risk premium.

The first estimate of the *ex-ante* is an approach based on the market capitalization weighted average ROE of all companies for which data is available, based on the Constant Growth DCF model using Bloomberg and Capital IQ derived dividend yields and consensus growth rates.<sup>537</sup> The second *ex-ante* approach is a product of the Sharpe Ratio and expected market volatility using the thirty-day average of the CBOE's three-month volatility index (*i.e.*, the VXV) and the average of settlement prices over the same thirty-day period of futures on the Chicago Board Options Exchange, CBOE's, one-month volatility index (*i.e.*, the VIX) for September through November, 2012.<sup>538</sup>

For the Beta coefficient, Mr. Hevert used a twelve-month average of the proxy group mean adjusted Beta, which reflects the current relationship between the proxy group companies and the S&P 500.<sup>539</sup> Mr. Hevert's CAPM analysis, based on a Beta of 0.814, produces a range of 8.56% to 12.11%, which Atmos argues is consistent with his DCF analysis.<sup>540</sup>

Staff witness, Mr. Tomicek, derived a range of values from 5.97% to 9.84%, with a mean Beta value cost of equity estimate of 7.87% for his CAPM.<sup>541</sup> Staff used a six-month average of the 10-year Treasury bond yield as its risk-free rate for the period of January through June of 2012 resulting in a risk-free rate of 1.93%.<sup>542</sup> In calculating the market risk premium, Staff used the average of Mr. Hevert's two DCF derived total required returns on the S&P 500, arriving at an *ex-ante*, or forward-looking risk premium of 11.41%.<sup>543</sup> For the Beta term, Staff applied a range of reported Beta values from Value Line, Zacks, and Yahoo Finance in the CAPM equation.<sup>544</sup> Mr. Tomicek concluded that the high CAPM result of 9.84% is based on the Value Line Betas that incorporate adjusted five-year historic data and fall between Staff's respective DCF average mean and mean high values of 9.23% to 10.19%, which Mr. Tomicek states is a credible estimate.<sup>545</sup>

Although they use different measures of the Beta coefficient and the risk-free rate terms, both Mr. Hevert and Mr. Tomicek agree that it is appropriate to use *ex-ante* measures of the market risk premium. Mr. Tomicek agrees with the use of a forward-looking market risk premium, but he disagrees with the use of forward-looking risk-free rates, and the use of adjusted Beta coefficients. Mr. Tomicek asserts that Mr. Hevert's inputs are inflated to drive results. He also believes that the use of a forecast 30-year Treasury bond yield is unreliable, as well as, the use of beta values calculated from a single year of market data.

<sup>536</sup> Atmos Ex. 9, Direct Testimony of Robert B. Hevert, p. 35; Blue Chip Financial Forecast, Vol. 31, No. 5 at 2 (May 1, 2012).

<sup>537</sup> Atmos Ex. 9, Direct Testimony of Robert B. Hevert, pp. 35-36.

<sup>538</sup> *Id.* at 36-37.

<sup>539</sup> *Id.* at 38-39.

<sup>540</sup> Atmos Ex. 9, Direct Testimony of Robert B. Hevert, p. 40.

<sup>541</sup> Direct Testimony of Frank M. Tomicek, Staff Ex. 1 at 15.

<sup>542</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, p. 14.

<sup>543</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, p. 14.

<sup>544</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, p. 15.

<sup>545</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, p. 16.

ACSC's witness, Mr. Hill, testified that the risk-free rate is the rate of return investors can realize with certainty. Mr. Hill used a forward-looking CAPM analysis of 3.75% yield as the long-term risk-free rate of long-term Treasury bond yields.<sup>546</sup> Mr. Hill testified, with that measure of the risk-free rate, he used the corresponding measure of the market risk premium, (i.e., that based on the long-term historical return difference between common stocks and long-term Treasury bonds).<sup>547</sup> He relied upon the upper end of the historical risk premium of 6.0% published by Ibbotson in his analysis. Furthermore, Mr. Hill utilized a Beta coefficient of 0.67 derived from Value Line reports Beta coefficients, which is derived from a regression analysis between weekly percentage changes in the market price of a stock and weekly percentage changes in the New York Stock Exchange Composite Index over a five-year period. This analysis results in a cost of equity of 7.78%.<sup>548</sup>

ATM's witness, Mr. Parcell, for the risk free rate used a three-month average yield of 2.35% for 20-year Treasury bonds.<sup>549</sup> Mr. Parcell calculated a market risk premium of 5.42% and used the most recent Betas from Value Line between 0.55 and 0.75.<sup>550</sup> These figures produced a cost of equity range of 5.9% to 6.1%.<sup>551</sup>

The State Agencies assert that the risk premium of 11.51% used by Staff in this case is out of line with that of the other ROE witnesses, as well as, the one used by Staff in GUD No. 9869. Furthermore, the State Agencies claim that Staff ignores the lower and mean values from their CAPM results when Staff takes the position that it is doubtful that investors would consider an equity return within 100 basis points of the company's cost of debt to be adequate compensation for their level of risk. The State Agencies disagree and believe that the company's cost of debt does not accurately represent the yield currently demanded by debt investors.

### 3. Examiners' Findings and Recommendations

The CAPM model is based on the premise that investors demand a return on equity that is greater than a risk free return and which is sufficient to account for the inherent risk involved with an equity investment. The validity of the model results may be questioned by the choice of Beta and market risk premium factors. The Examiners believe that Mr. Hevert's use of a forecast 30-year Treasury bond yield is subject to uncertainty and unreliable. Also, Mr. Hevert's use of the adjusted Beta coefficient values used in Mr. Hevert's CAPM analysis is uncertain because there is little basis for the premise that investors will limit their perceptions to using equity returns derived from a beta grouping solely focused on the upper range of values. Mr. Hevert's highest CAPM results come from using the Beta values calculated from a single year of market data, whereas most Betas encompass an observation period of five years.

The Examiners recommend that Staff's CAPM analysis is reasonable and reliable. Staff's results are based on a 10-year Treasury bond average yield for the six-month period added to the product of the mean Beta value and calculated *ex-ante* risk premium. The

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<sup>546</sup> ACSC Ex. 7, Direct Testimony of Stephen G. Hill, pp. 45-46.

<sup>547</sup> ACSC Ex. 7, Direct Testimony of Stephen G. Hill, p. 46.

<sup>548</sup> ACSC Ex. 7, Direct Testimony of Stephen G. Hill, p. 47.

<sup>549</sup> ATM Ex. 3, Direct Testimony of David C. Parcell, Bates p. 31.

<sup>550</sup> ATM Ex. 3, Direct Testimony of David C. Parcell, Bates p. 31 and Schedule 10.

<sup>551</sup> ATM Ex. 3, Direct Testimony of David C. Parcell, Bates p. 33.

Examiners find that Staff's CAPM derived range of values from 5.97% to 9.84%, with a mean Beta value cost of equity estimate of 7.87% is reasonable.

(f) Risk Premium Analysis

The company witness, Mr. Hevert also developed a cost of equity estimate based on a Bond Yield Plus Risk Premium Approach. This analysis is based on the fundamental principle that equity investors bear the residual risk associated with ownership. Therefore, they require a premium over the return they would have earned as a bondholder.<sup>552</sup> According to Mr. Hevert, returns to equity holders are more risky than returns to bondholders. Consequently, equity investors must be compensated for bearing that risk.<sup>553</sup>

Mr. Hevert defined the risk premium as the difference between the authorized ROE and the then-prevailing level of long-term (*i.e.*, 30-year) Treasury yield, using data from over 900 natural gas rate proceedings between January 1980 and May 2012.<sup>554</sup> He also calculated the average period between the filing of the case and the date of the final order, known as the lag period, and in order to reflect the prevailing level of interest rates during the pendency of the proceedings, he calculated the average 30-year Treasury yield over the average lag period (approximately 188 days).<sup>555</sup> Because the analytical period includes interest rates and authorized ROEs that during one period (*i.e.*, the 1980's) are quite high and another (the post-Lehman bankruptcy period) that are quite low relative to the long-term historical average, Mr. Hevert used the semi-log regression, in which the Equity Risk Premium is expressed as a function of the natural log of the 30-year Treasury yield.<sup>556</sup> Mr. Hevert concluded that this analysis results in a reasonable estimate for the cost of equity ranging from 10.12% to 10.73%.<sup>557</sup>

On the other hand, Mr. Tomicek argues that the bond yield plus risk premium approach overstates the required ROE because it incorporates a period when authorized returns were higher skewing the results upward.<sup>558</sup> Furthermore, Mr. Tomicek testifies that the actual recent authorized equity rates of return are not supportive of Mr. Hevert's ROE recommendation from the risk premium approach.<sup>559</sup> Mr. Tomicek testifies further that isolating a recent range of the approved equity returns for the period from 2009 through 2012 are more reflective of current conditions, which show an average ROE of 10.07%.<sup>560</sup>

Similarly, Mr. Hill argues that Mr. Hevert's analysis does not capture the potential lag that may exist between the data incorporated into authorized equity returns by regulatory bodies and market conditions at the time rates are authorized.<sup>561</sup> Mr. Hill also points out that Mr. Hevert's analysis produces overstated returns given that the market price of gas utilities over the

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<sup>552</sup> Atmos Ex. 9, Direct Testimony of Robert B. Hevert, p. 42.

<sup>553</sup> Atmos Ex. 9, Direct Testimony of Robert B. Hevert, p. 42.

<sup>554</sup> *Id.*

<sup>555</sup> *Id.* at 43.

<sup>556</sup> *Id.*

<sup>557</sup> Atmos Ex. 9, Direct Testimony of Robert B. Hevert, p.44 and Ex. RBH-8.

<sup>558</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, p. 30.

<sup>559</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, p. 30.

<sup>560</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, p. 30.

<sup>561</sup> ACSC Ex. 7, Direct Testimony of Stephen G. Hill, p. 86.



time period studied by Mr. Hevert has been substantially above book value.<sup>562</sup> Finally, Mr. Hill challenges Mr. Hevert's conclusion that there is an inverse relationship between bond yields and the Market Risk Premium.<sup>563</sup>

The Examiners conclude that a Bond Yield Plus Risk Premium analysis is a useful gauge as a secondary estimate to gauge the viability of the primary ROE estimation techniques. The Examiners concur with Staff that using a more recent range of the approved equity returns for the period from 2009 through 2012 are more reflective of current conditions rather than the over 30 year period utilized by Atmos. The Examiners were persuaded by Mr. Tomicek's testimony that if the recent range of approved equity returns are isolated from the period of 2009 through 2012, the average authorized ROE of 10.07% is consistent with Staff's recommended 10.10% recommended ROE.

(g) Current Market Conditions

The cost of equity models are influenced by current and expected capital market conditions.<sup>564</sup> Mr. Hevert considered several measures of capital market risk, including: (1) incremental credit spreads on investment grade utility debt; (2) the relationship between natural gas utility dividend yields and long-term Treasury yields; and (3) equity market volatility and correlations.<sup>565</sup> In assessing the company's cost of equity, the implication of these factors show that the recent decline in long-term Treasury yields has been accompanied by an increase in the premium required by investors to accept incremental levels of credit risk, according to Mr. Hevert.<sup>566</sup>

Mr. Hevert determined further that current levels of instability and risk aversion are in fact higher than the levels observed prior to the recent recession, and are generally higher than levels experienced during the 2002-2003 capital market contraction.<sup>567</sup> Mr. Hevert points out that the increases in both absolute and relative credit spreads of utility bonds indicates that simply observing that absolute bond yields have fallen does not give a complete assessment of capital market conditions and the degree of investor risk aversion.<sup>568</sup>

ACSC witness Mr. Hill and ATM witness Mr. Parcell argue that current market conditions require a reduction to the ROE. Mr. Parcell describes widening credit spreads, declining equity valuations, and elevated volatility, which he suggests represent a negative perception of the recent market distress, and which have resulted in the reduced valuation of retirement accounts, investment portfolios, and other assets.<sup>569</sup> Mr. Hill looks at current bond yields and claims that the broad economic environment currently is more benign than it was prior to the financial crisis and that capital costs are lower, thus, more favorable for capital intensive industries like utilities.<sup>570</sup> On the other hand, Atmos argues that neither Mr. Hill, nor Mr. Parcell

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<sup>562</sup> *Id.*

<sup>563</sup> ACSC Ex. 7, Direct Testimony of Stephen G. Hill, pp. 86-88.

<sup>564</sup> Atmos Ex. 9, Direct Testimony of Robert B. Hevert, p. 49.

<sup>565</sup> *Id.*

<sup>566</sup> *Id.* p. 51.

<sup>567</sup> Atmos Ex. 27, Rebuttal Testimony of Robert B. Hevert, p. 41.

<sup>568</sup> *Id.* p. 43.

<sup>569</sup> ATM Ex. 3, Direct Testimony of David C. Parcell, p. 22.

<sup>570</sup> ACSC Ex. 7, Direct Testimony of Stephen G. Hill, p. 19.

address the analytical issue of whether current capital market conditions support the lower ROEs they recommend or why the company's 10.40% ROE, approved in 2010, should be reduced by 130-140 basis points.<sup>571</sup>

Mr. Tomicek testified that the role of current economic conditions necessarily influences cost of equity. He notes that with the recent and severe recession in the U.S. coupled with slow economic growth, less-risky debt issues are more attractive to investors over stocks. This results in bond prices being driven up while subsequently depressing bond yields keep downward pressure on interest rates.<sup>572</sup> Mr. Tomicek believes that utility stocks as a group are differentiated from unregulated capital market sectors. This is due to that they pay stable dividends and typically exhibit consistent, if not spectacular growth with relative low risk levels as evidenced by their beta values during volatile periods.<sup>573</sup> While gas distribution utilities operate in market environments with both business and regulatory risk, recent trends have led to greater stabilization of distribution utility company revenues, having the net effect of decreasing business risk and securing stable utility credit ratings.<sup>574</sup>

The Examiners agree that regulated utilities generally benefit from concerned investors in search of safe havens. The Examiners conclude that since utility stocks are a regulated sector that pay stable dividends and have consistent growth, they are generally lower risk during volatile periods. Likewise, Atmos' business risk is mitigated to some degree by revenue stabilization measures in place like the purchased gas adjustments (PGA) and the weather normalization adjustment (WNA). The proposal for a rate structure allowing greater recovery of revenues through an increase in the fixed residential customer charge is also a measure to further de-couple revenues from consumption usage levels. Such measures serve to mitigate a portion of the company's business risk and provide stable returns to Atmos. It is reasonable to consider these factors in determining a return on equity.

#### (h) Conclusions on Cost of Equity

A return on equity determination is a process of estimation using analytical techniques that attempt to quantify an equity return based on subjective choices for assumptions and available data. Given this wide range of opinions on methodology among analysts and academicians in applying the cost of equity valuation techniques, and the resulting rate of return on equity in utility rate cases, it becomes a contentious issue.<sup>575</sup>

In summary, to calculate the cost of equity, Atmos employed (1) three forms of the Discounted Cash Flow Model (DCF) (Quarterly Growth, Constant Growth and Multi-Stage), (2) a Capital Asset Pricing Model (CAPM), and (3) a Bond Yield Plus risk Premium Analysis. The final range for the cost of equity after considering these analyses by Atmos result in a cost of

<sup>571</sup> GUD No. 9869, *Petition for De Novo Review of the Statement of Intent Filed by Atmos Energy Corp., Mid-Tex Division by the City of Dallas, Statement of Intent to Increase Gas utility Rates in the Unincorporated Areas Served by the Mid-Tex Division*, Final order Nunc Pro Tunc.

<sup>572</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, p. 31-32.

<sup>573</sup> Staff Ex. 1, Direct Testimony of Frank Tomicek, p. 32.

<sup>574</sup> Staff Ex. 1, Direct Testimony of Frank Tomicek, pp. 32-33.

<sup>575</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, p.31.

equity ranging from 10.40% to 11.25%.<sup>576</sup> Atmos concludes that a cost of equity of 11.05% is reasonable.

Staff's approach was to derive results from a standard application of the DCF and CAPM methods based on previous rate cases to recommend a return on equity that considers the upper-end results of the DCF and CAPM methods.<sup>577</sup> Based on Staff's proxy grouping of utilities with comparable risks and revenue stabilization measures, a point estimate based on a mean of the upper values is appropriate, according to Staff, to capture market uncertainty and provide a fair and reasonable estimated cost of equity.<sup>578</sup> Staff's analyses result in a mean high value average of 10.10% for the cost of equity, as follows:

Table 11.9  
Average of Mean High Values for Staff's DCF & CAPM Analyses

DCF (30-Day)	10.18%
DCF (90-Day)	10.21%
DCF (180-Day)	10.17%
CAPM	9.84%
Average	10.10%

ACSC witness, Mr. Hill, utilized the DCF, CAPM, Modified Earnings-Price Ratio, and Market-to-Book Ratio analyses for his cost of equity recommendation. Mr. Hill's analyses results in a current cost of equity for his sample group of gas companies ranging from 8.50% to 9.25%. Mr. Hill concludes that a cost of equity of 9.0% is reasonable.<sup>579</sup>

ATM witness, Mr. Parcell, prepared his cost of equity recommendation using DCF, CAPM and Comparable Earnings analyses. These methods produced a broad range of 6.10% to 10.0%. Mr. Parcell concludes that a cost of equity of 9.1% to 9.75% is appropriate.<sup>580</sup>

After careful consideration of the substantial evidence presented on this issue, the Examiners' find Atmos has not established that its proposed return on equity of 11.05% is just and reasonable. The Examiners were persuaded that some of the methodologies employed by Atmos tended to skew the results upward. On the other hand, the preponderance of the credible evidence supports Staff's proposed cost of equity of 10.10%. Staff's proposals are derived from DCF and CAPM methodologies that have been demonstrated in this case to be reasonable and within the range of prior Commission precedent. Yet, the Examiners also believe that prior Commission precedent is an important aspect in determining a return on equity. The evidence in the record shows that 10.915% is the average return on equity awarded by the Commission since GUD No. 9721.<sup>581</sup> Moreover, the Commission approved a 10.40% return on equity for Atmos Mid-Tex in the last rate case proceeding in 2010. A 10.40% return on equity range is also consistent with Mr. Hevert's DCF range of 10.40% to 11.25% and CAPM range of 8.56% to

<sup>576</sup> Tr. Vol. 1, pp. 38 - 40 and Atmos Ex. 3 p. 30 and Schedule A-3.

<sup>577</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, p. 17.

<sup>578</sup> Staff Ex. 1, Direct Testimony of Frank M. Tomicek, pp. 17-18.

<sup>579</sup> ACSC Ex. 7, Direct Testimony of Stephen G. Hill, p. 64 and Schedule 11.

<sup>580</sup> ATM Ex. 3, Direct Testimony of David C. Parcell, Bates pp. 35-36 and Schedule 1.

<sup>581</sup> Staff Ex. 4

12.11%. After evaluating the credible evidence with existing Commission precedent, the Examiners, recommend that a return on equity of 10.40% is just and reasonable in this docket.

e. Overall Weighted Average Cost of Capital

After carefully considering the facts presented and the arguments of the parties in this case, the Examiners find that Atmos did not meet its burden of proof to establish its proposed overall rate of return of 8.85%. In short, the preponderance of the credible evidence demonstrates that Staff's methodologies combined with consideration of Commission precedent results in an overall rate of return that also in line with past Commission decisions.

The Examiners recommend based on the preponderance of the credible evidence, the following: (1) Capital Structure as proposed by Atmos and Staff of 48.31% Long-term debt and 51.69% Common equity; (2) Actual Cost of long-term debt of 6.50%; and (3) Cost of equity of 10.40%. Thus, the proposed weighted cost of capital of 8.52%.

Since Atmos has utilized a consolidated capital structure, the percentages are derived, as follows:

Table 11.10  
Atmos Energy Corp. - Consolidated  
Capital Structure and Proforma Cost of Capital as of March 31, 2012<sup>582</sup>

Long Term Debt Capital	\$2,206,343,717	48.31%
Equity Capital	<u>\$2,360,711,148</u>	51.69%
Total Capital	<u>\$4,567,054,865</u>	

Accordingly, the Examiners Recommended Overall Rate of Return is shown below in Table 11.11:

Table 11.11  
Examiners' Recommended Overall Rate of Return

Capital Component	% of Total Capitalization	Cost	Weighted Average Cost
Long Term Debt	48.31%	6.50%	3.14%
Common Equity	51.69%	10.40%	5.38%
Total			8.52%

The overall impact on the company's revenue requirement request is \$7,949,733.

<sup>582</sup> Atmos Ex. 1, Statement of Intent Filing, Relied Upon File: Capital Structure 03-31-12 , Consolidated Capital Structure (Disk 1: Excel Document Filed Electronically).

## 12. Taxes

No independent issues have been raised regarding the calculation of taxes. The only changes related to taxes result from the flow-through of the proposed recommendations. Based upon the adjustments recommended above, the Examiners find that the reflected on the attached schedules, Schedule A(0) and Schedule F-6, totaling \$51,043,275 are just and reasonable.

## 13. Summary of Overall Recommended Revenue Requirement

As noted above, and as reflected in the September 4<sup>th</sup> Update, the company's calculated revenue requirement was \$455,661,452.<sup>583</sup> The Examiners find that Atmos Mid-Tex has not established that the proposed revenue requirement is just and reasonable. Based upon the adjustments noted above, the Examiners find that Atmos Mid-Tex has not established that the proposed cost of service is just and reasonable. The Examiners find that a total base revenue requirement of \$447,699,125 is just and reasonable.

## 14. Interim Rate Adjustment Review

### a. Interim Rate Adjustment Review

Pursuant to GURA §104.301 and TEX. ADMIN. CODE ("Rule"), §7.7101 a gas utility may file an interim rate adjustment (IRA) request. That provision provides utilities a mechanism to adjust rates annually with an interim adjustment for capital investment. Prior to this statute, a utility's rate could be increased only through a full *Statement of Intent* proceeding. Once a utility files its first IRA filing, it is required to make an IRA filing annually. The amounts are subject to review for prudence in a subsequent proceeding and any amounts collected through the adjusted rates are subject to refund until the subsequent *Statement of Intent* proceeding. After the fifth anniversary of the first IRA filing the utility must undertake a *Statement of Intent* proceeding.

Atmos has applied for three IRAs since its last full rate case:

Tex. R.R. Comm'n, Application of Atmos Energy Corp., Mid-Tex Division for the Test Year 2009 Annual Interim Rate Adjustment Program for the Environs Areas, Docket No. 9961, (Gas Utils. Div. August 24, 2010).

Tex. R.R. Comm'n, Application of Atmos Energy Corp., Mid-Tex Division for the Test Year 2010 Annual Interim Rate Adjustment Program for the Environs Areas, Docket No. 10059, (Gas Utils. Div. June 27, 2011).

Tex. R.R. Comm'n, Application of Atmos Energy Corp., Mid-Tex Division for the Test Year 2011 Annual Interim Rate Adjustment Program for the Environs Areas, Docket No. 10162, (Gas Utils. Div. June 18, 2012).

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<sup>583</sup> Atmos Ex. I, Cost of Service Schedules, Schedule A, p. 2, ln. col. (d).

The company seeks a prudence finding regarding the capital expenditures related to these interim rate adjustment filings, and all actual capital investment booked to plant during the period from January 1, 2012 through March 31, 2012.

Once the utility files a rate case subsequent to its initial IRA filing and the issuance of a final order or decision by a regulatory authority is made, all amounts collected are no longer subject to refund.<sup>584</sup> In other words, once the Commission issues a final order in this docket, the revenues that Atmos received from the interim rate adjustments from capital investment will no longer be subject to refund.

In support of its investment, the company provided a summary of all capital projects undertaken during that period. Jeffrey S. Knights provided testimony in support of all capital expenditure undertaken in support of the IRA filings.<sup>585</sup> Mr. Knights also provided a detail list of every capital project undertaken from 2009 through March 31, 2012.

Staff undertook a review of these investments. Gary M. Torrent described the review undertaken. First, Mr. Torrent observed that the number of individual projects is daunting. For example, the documentation in support of investments made in support of its 2010 IRA filing include approximately 2,060 individual projects that could be evaluated for reasonableness and prudence. Second, Mr. Torrent explained that for each IRA filing and associated schedule he selected, at random, two projects to analyze. Thus, Mr. Torrent selected eight projects to analyze. Of the eight, one was voluntarily removed from the filing. The company explained that the removal of the project included no net change because the total included in the account for this project over the years was \$0.<sup>586</sup>

It should be noted that ACSC, who initial indicated that an adjustment should be made to remove the amounts related to this investment has withdrawn its objection.<sup>587</sup> Mr. Torrent undertook an evaluation of the remaining investment selected for review. Based on his evaluation of those projects and a review of the processes in place Mr. Torrent concluded that the company's investments are reasonable and prudent.<sup>588</sup>

The Examiners find that, based upon the evidence in this case, the company has established that its investments pursuant to the interim rate adjustment filings outlined above are just and reasonable. Accordingly, no refund of any of those investments is required.

Staff, however, raised two additional points. First, Mr. Torrent contended that a capital project that was not included in a prior IRA, but is included in this proceeding, should be removed from rate base. Second, Mr. Torrent recommended that the project review process be supplemented by an additional audit requirement.

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<sup>584</sup> TEX. UTIL. CODE §104.301(a).

<sup>585</sup> Atmos Ex. 12, Jeffrey S. Knights Direct.

<sup>586</sup> Atmos Ex. 16, Barbara W. Myers, Direct, p. 26, lns. 1 – p. 27, ln. 10.

<sup>587</sup> ACSC Initial Brief, p. 7, "ASCS accepts the Company's representation in its rebuttal testimony that not rebuttal is necessary.

<sup>588</sup> Staff Ex. 2, Gary M. Torrent, p. 12.

b. Capital Project – Segways

In the course of one of the IRA proceedings, Atmos indicated that it had included the cost of Segways as part in its calculation of the requested adjustment. Staff objected and, in order to avoid controversy, the company voluntarily removed that adjustment. The company has now included the expenditure in its rate-base request. Mr. Torrent contended that the costs related to the purchase of Segway vehicles be removed. The total costs related to this investment was \$72,759.

Mr. Knights explained that the Segway vehicles were procured for use in the Mid-Tex Meter Reading organization in an effort to gain efficiencies and reduce route time. He testified that meter reading routes that took over eleven hours to read could be read in six hours. He also explained that the vehicles increased public safety by reducing automobile usage on the streets and alley and improved overall safety for meter readers. He asserted that the vehicles resulted in reduced fuel costs. Finally, he noted that since the purchase of the vehicles the company has explored other applications. Mr. Knights supported his assertions with a time study.<sup>589</sup> He explained that a Segway vehicle is currently being piloted for central business district leak survey activity.<sup>590</sup>

The Examiners find that the substantial weight of the evidence in this case supports the inclusion of those costs. Atmos has established that the expenditure related to Segways is just and reasonable. Accordingly, the Examiners recommend that no adjustment be made.

c. Interim Rate Audit

Mr. Torrent recommended that in light of the large number of projects, the Commission should consider establishing requirements in this proceeding to lay the foundation for the evidentiary record in Atmos' next *Statement of Intent* rate case. In particular, before Atmos files its next Statement of Intent proceeding, it should be required to engage a third party auditor to conduct a prudence review of its IRA capital investment projects, to have the third party audit completed before its next Statement of Intent application is filed, and to include the third party's report, and all supporting data, with its Statement of Intent proceeding application. He also suggested that to make such a requirement uniformly applicable to all gas utilities, the Commission might consider initiating a rulemaking.

This recommendation was raised by Staff in GUD No. 10000. In that proceeding the Commission rejected the proposal and no facts have changed to suggest that the issue be revisited here. In that proceeding, the Examiners explained that the statute and Commission rules require the review of IRA filings be conducted in a general rate case. While the utility has the burden to prove all investment are just, reasonable and necessary, Staff's recommendation shifts the burden for review from regulatory authorities to the utility. Thus, the review would be conducted by the utility that implemented the IRA proceeding. It also imposes an additional cost for this audit that must ultimately be borne by the utility and the ratepayer.<sup>591</sup>

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<sup>589</sup> Atmos Ex. 19, Jeffrey S. Knights, Segway Route Time Stamp Report, (Electronic Document).

<sup>590</sup> Atmos Ex. 19, Jeffrey S. Knights.

<sup>591</sup> GUD No. 10000, Proposal for Decision, p. 22.

The Examiners find further, that a proposal such as this should not be imposed on a case-by-case basis. The result of imposing this requirement here is that Atmos would be the only utility in the state subject to the proposed process. Accordingly, the Examiners recommend that Staff's proposed audit requirement be rejected.

## **15. Classification of Costs and Allocation Among Customer Classes.**

### **a. Introduction**

The initial step in setting the rates to be charged by a regulated utility is the determination of the cost of service. In this case, the utility proposed a cost of service, excluding gas costs, in the amount of \$458,572,407. As discussed above, the Examiners find that Atmos Energy Corp., Mid-Tex has established that a cost of service of \$447,521,834 is just and reasonable. Utilities have several classes of customers. As a result once the revenue requirement is determined, the cost of the system must be allocated among the various customers.

Atmos proposed allocating the overall cost of service to three classes of customers: (1) residential, (2) commercial, and (3) industrial and transportation. The September 4<sup>th</sup> Update results in the following allocation of overall proposed costs: Residential customer generate 80% of the overall cost of service, commercial customers generate 17% of the overall cost of service and industrial and transportation customers generate 2% of the overall cost of service.<sup>592</sup>

The allocation of the cost of service among the various customer classes is accomplished through a class cost of service study. The applicant in this case retained Paul H. Raab to conduct the class cost of service study presented in this case. Mr. Raab is an independent economic consultant. As he explained, a class cost of service analysis is the process by which the costs that a utility incurs to serve particular classes of customers are linked to the classes of customers that caused those costs to be incurred. To the extent that an expense may be directly assigned to a class, it is assigned to that customer class. Account 385, Industrial Measuring and Regulating Equipment Station is an example of such an account. The entire amount associated with this account is directly assigned to the Industrial and Transportation Class.<sup>593</sup> The process is complicated, however, by the fact that many of the costs incurred to provide different types of service are "joint" costs and many are "common" costs. Assigning those costs to different classes is not necessarily based upon a theoretically precise method.<sup>594</sup>

Mr. Raab proposed the allocation of costs to the different customer classes in three steps: (1) functionalization, (2) classification, and (3) allocation. *Functionalization* is the process whereby the capital and operating costs incurred by the utility to provide service are categorized by function. The typical functions of a natural gas utility are transmission, distribution, customer service and facilities, and administrative and general. The functionalization process in this study

<sup>592</sup> Atmos Ex. 3, Atmos Update Filing September 4, 2012, Class Cost of Service, RevReq-CCS1 and Unincorporated Class Cost of Service, RevReq-CCS1. (Residential % = \$366,326,513/\$455,661,452; Commercial % = \$79,328,018/\$455,661,452; and, I&T% = \$10,006,921/\$455,661,452.

<sup>593</sup> Atmos Ex. 3, Atmos Update Filing September 4, 2012, , Class Cost of Service Study Schedule 2, In. 19, col. k.

<sup>594</sup> Atmos Ex. 10, Paul H. Raab Direct, p. 5, Ins. 10 - p. 6, In. 20.



was facilitated by the fact that Atmos Energy follows the FERC Uniform System of Accounts. This system of accounts records costs by the function for which they were incurred.<sup>595</sup>

The *classification* process recognizes that the utility's costs are incurred for a number of purposes. They may be incurred to meet the customers' peak demand and are often referred to as "demand-related costs" or "demand cost." The costs may be incurred to provide energy, in which case they are referred to as "commodity-related costs" or "commodity cost." Odorant is an example of a commodity cost. Another example, are "customer related costs" or "customer costs." These costs are incurred because there are customers on the system. Metering expense is an example of a customer cost.<sup>596</sup>

*Allocation* is the process by which the functionalized and classified costs are assigned to specific customer classes. Mr. Raab assumed that the load characteristics of the customers within each of the major customers classes are relatively homogenous with respect to their usage characteristics. Thus, costs are allocated to these customer classes based upon these characteristics. Demand costs are allocated on the basis of demands imposed on the system during the design day. Commodity costs are allocated on the basis of system throughput and customer costs are allocated to the different customer classes on the basis of the number of customers.<sup>597</sup>

The only area of dispute in the class cost of service study relates to one component of the classification of costs. Atmos classified the feet of main as either customer-related or capacity-related based upon a minimum system study. ACSC challenged one component of that calculation – the overall feet of main. The impact of ACSC proposed adjustment is to alter the overall allocation of the company's costs.

In order to isolate the impact of the proposed adjustment it is assumed that the company's overall revenue requirement is adopted totaling \$455,661,452. Residential customers generate 78% of the overall cost of service, commercial customers generate 19% of the overall cost of service and industrial and transportation customers generate 3% of the overall cost of service. Table X.1 provides a comparison of the proposed allocation and the adjusted allocation – assuming a revenue requirement of \$455,661,452.

Table X.1  
Comparison of Proposed and ACSC Adjusted Allocation

	Residential	Commercial	I&T
Proposed	80.39%	17.41%	2.20%
ACSC Adjusted	77.92%	19.43%	2.65%

<sup>595</sup> Atmos Ex. 10, Paul H. Raab, p. 7, ln. 1 – p. 8, ln. 2.

<sup>596</sup> Atmos Ex. 10, Direct Testimony of Paul H. Raab, p. 8, lns. 4 – 13.

<sup>597</sup> Atmos Ex. 10, Direct Testimony of Paul H. Raab, p. 9, ln. 20 – p. 10, ln. 3.

b. Minimum System

(a) Introduction

A minimum system is defined as a “skeleton” system adequate to supply a usable gas pressure to customers.<sup>598</sup> Under this methodology, all distribution mains are priced out at the historic cost of the smallest main installed on the system, and those costs are assigned to a customer cost component. The remaining book cost of the distribution mains is assigned to the capacity component.<sup>599</sup> Atmos witness, Mr. Raab, testified that the theoretical rationale for this approach is that there is a minimum investment in mains that is required to serve a customer that is not influenced by the amount of natural gas that the customer uses, whether throughout the year or on the design day. However, as customers place demands on the system, incremental investments are needed to meet those demands. These incremental investments are considered to be demand related.<sup>600</sup> In prior decisions, the Commission has previously found that the minimum size main is considered to be the 2-inch main.<sup>601</sup>

Mr. Raab testified that the company’s minimum distribution study evaluates 228,021,565 feet of main in service in Mid-Tex’s service territory.<sup>602</sup> He also testified that the average cost per foot of the 2 inch main is approximately \$5.70 per foot. This figure was then multiplied by the total feet of mains to determine a total investment in the minimum size main of \$1,200,193,019. Mr. Raab testified further that the total investment in mains is \$2,838,530,956. According to Mr. Raab, the portion that is customer related is  $\$1,300,193,019 / \$2,838,530,956$ , or 45.81%. The portion that is demand related is  $(\$2,838,530,956 - \$1,300,193,019) / \$2,838,530,956 = (\$1,538,337,937 / \$2,838,530,956)$ , or 54.19%.<sup>603</sup>

(b) Intervenor’s Position

ACSC argues that the company has overstated the miles of distribution mains in its analysis, and therefore has exaggerated the customer cost component in its minimum system study. This is because for the first time, Atmos proposes not to use the number of feet of main in its system to determine its minimum system, but instead proposes the use of a unit of measurement taken from its accounting books called retirement units.<sup>604</sup>

In support of its position, ACSC points to the fact that Atmos filed with the U.S. Department of Transportation (“DOT”) records that Atmos had 153,690,240 feet of mains in the system, yet Atmos used a number of 228,021,565 feet of mains in its Class Cost of Service Study.<sup>605</sup> ACSC maintains that it is impossible to reconcile these numbers that produced a

<sup>598</sup> ACSC Ex. 1, Direct Testimony of Karl J. Nalepa, p. 36, Ins. 7-10

<sup>599</sup> ACSC Ex. 1, Direct Testimony of Karl J. Nalepa, p. 36

<sup>600</sup> Atmos Ex. 10, Direct Testimony of Paul H. Raab, p. 14, Ins. 13-19

<sup>601</sup> Atmos Ex. 10, Direct Testimony of Paul H. Raab, pp. 14-15; GUD Nos. 9400, 9670, and 9869.

<sup>602</sup> Atmos Ex. 10, Direct Testimony of Paul H. Raab, p. 14, ln. 22 through p. 15, ln.3

<sup>603</sup> Atmos Ex. 10, Direct Testimony of Paul H. Raab, pp. 14-15 and Atmos Ex. 1, *Statement of Intent*, Cost of Service Schedules, Class Cost of Service Study – 3.

<sup>604</sup> ACSC Ex. 38 (Atmos Response to ACSC RFI 29-17); and Transcript of Testimony of Thomas H. Petersen, Vol. V., p. 109, ln. 8 through p. 110, ln. 4

<sup>605</sup> *Statement of Intent*, Cost of Service Schedules, Class Cost of Service Study – 3 and ACSC Ex. 1, Direct Testimony of Karl J. Nalepa, pp. 36-37

customer cost allocation of 45.81% instead of an allocation of 30.87%, if the lower, DOT reported number is used.<sup>606</sup> According to ACSC, this is a radical change to how the company has previously conducted its minimum system analysis.

ACSC takes issue with Mr. Raab's testimony that the study "evaluates 228,021,565 feet of main in service in Mid-Tex's service territory."<sup>607</sup> It is ACSC's position that the company's study did not evaluate the number of feet of main in service. Had it done so, it would have evaluated 153,690,240 feet of main in service, the actual number of feet of main reported by Atmos to the DOT for calendar year 2011.<sup>608</sup> ACSC contends that the use of DOT reported numbers are consistent with Atmos' practice in the three prior dockets and that according to discovery responses from Atmos, the last three Mid-Tex minimum system studies reflect 147,761,265 feet of main, in GUD Nos. 9400, 9670 and 9869.<sup>609</sup> ACSC recognizes that the DOT numbers reported by Atmos in the years since GUD No. 9869 (with a test year ending June 30, 2008) show growth in the system. ACSC argues that by using a new accounting unit as the measurement, instead of feet of main in service, the company has grown its system by over 67%.

Atmos provided the following comparison in an effort to "reduc[e] the quantity units proportionately across all sizes of mains":

<b>DOT Annual Report as of December 31, 2010:</b>	<b>Proportioned Retirement Units:</b>
Steel: 63,650,400 feet of mains	Steel: 34,826,853
Plastic: 84,833,760 feet of mains	Plastic: 118,165,963
Cast Iron: 4,509,120 feet of mains	Cast Iron: 4

ACSC contends that these comparisons show that these two data sets are different and change the calculation of a minimum system study fundamentally.<sup>610</sup> Intervenor, ACSC, argues that the switch serves to substantially increase the percentage of costs allocated to customer costs, and does not otherwise advance the cause of determining what is actually in the system and what is actually used to provide service to Atmos' customers. ACSC believes that Atmos' use of retirement units as the unit of measurement is basically an attempt to classify even more costs as customer-related, in a continuing trend of placing on residential customers the costs of Atmos' entire system. ACSC argues that the unit of measurement for minimum systems should be feet of main, as in all of Atmos' prior dockets. As a result, ACSC requests an adjustment to use feet of mains in place of retirement units as a measurement of minimum system, so that the customer-related allocation is reduced to 30.87%.<sup>611</sup>

Finally, ACSC is opposed to the use of a 2-inch pipe to establish the minimum system. This is because ACSC believes that it has progressively worked to the disadvantage of Atmos' customers, as it has resulted in a significantly greater percentage of Atmos' system being classified as customer-related costs. In GUD No. 9400, the Commission approved a change

<sup>606</sup> ACSC Ex. 1, Direct Testimony of Karl J. Nalepa, p. 38, lines 2-4.

<sup>607</sup> Atmos Ex. 10, Direct Testimony of Paul H. Raab, pp. 14-15

<sup>608</sup> ACSC Ex. 54 (Atmos Response to ACSC RFI 32-01), bates page LG 030209.

<sup>609</sup> ACSC Ex. 41 (Atmos Response to ACSC RFI 29-20), referencing GUD Nos. 9400, 9670, and 9869.

<sup>610</sup> Transcript of Testimony of Thomas H. Petersen, Vol. V., p. 111, Ins. 7-14

<sup>611</sup> ACSC Ex. 1, Direct Testimony of Karl J. Nalepa, p. 38

from a zero-intercept methodology (which classified 16.55% of the mains as customer-related), to a 2-inch minimum system (which classified approximately 43% of the mains as customer-related).<sup>612</sup> In GUD No. 9670, Atmos again proposed the use of a 2-inch pipe minimum system, which resulted in an allocation of 51% of mains as customer-related costs.<sup>613</sup>

(c) Company's Response

It is Atmos Energy's position that the company's minimum system study accurately determines the portion of costs that are customer-related to determine the minimum investment in mains that is required to serve a customer that is not influenced by the amount of natural gas that the customer uses.<sup>614</sup> Mr. Petersen testified that the only connection in the company's accounting system that connects plant amounts with cost is retirement units, whereas the feet of main quantified in the DOT reports are not tied to investment costs.<sup>615</sup> This case is the first time the company has conducted a minimum system study since Atmos Energy acquired the Mid-Tex assets from TXU.<sup>616</sup> Prior to this case, in Docket Nos. 9400, 9670 and 9869, the Company relied on a minimum system study that was used and developed prior to Atmos Energy's acquisition of the Mid-Tex assets, and that study relied on feet of mains as the unit of measurement.<sup>617</sup>

The basis for the change from using feet on mains to retirement units is because the company's current plant and accounting system ties plant and costs through retirement units, which according to Atmos is the only information available to the Company to conduct the minimum system study.<sup>618</sup> Mr. Petersen testified that the quantity data in the study of 228,021,565 retirement units is larger than the 153,690,240 feet of mains reported to the DOT, but this does not affect the results of Atmos Energy's study because, as long as the relative quantities of 2-inch mains to larger mains used in the study represent the actual relative proportion of 2-inch mains to larger mains, the study results are not affected.<sup>619</sup> Furthermore, in support of the new methodology, Mr. Petersen compared the results of the company's study in this case, which resulted in allocations of 45.81% as customer-related and 54.19% as capacity-related, with the results of the study used in GUD Nos. 9400, 9670, and 9869, which showed allocations of 45.84% as customer-related and 54.16% as capacity-related.<sup>620</sup> Atmos maintains that analysis confirms that the company's plant system quantities and allocations are proportionally accurate with prior minimum system studies.

(d) Examiners' Recommendation

The Examiners continue to recommend adoption of the 2 inch minimum system as previously found just and reasonable by the Commission in GUD Nos. 9400, 9670 and 9869.

<sup>612</sup> See, GUD No. 9670, PFD, pp. 150-151.

<sup>613</sup> *Id.*

<sup>614</sup> Atmos Ex. 10, Direct Testimony of Paul H. Raab, p. 14; Atmos Ex. 17, Rebuttal Testimony of Thomas H. Petersen, pp. 34-35.

<sup>615</sup> Transcript of Testimony of Thomas H. Petersen, Vol. V., p. 108, lns. 13-19 and pp. 138-39

<sup>616</sup> *Id.* at 109.

<sup>617</sup> *Id.* at 108.

<sup>618</sup> *Id.* at 109.

<sup>619</sup> Atmos Ex. 17, Rebuttal Testimony of Thomas H. Petersen, pp. 34-35; and Transcript of Testimony of Thomas H. Petersen, Vol. V., p. 108

<sup>620</sup> Atmos Ex. 17, Rebuttal Testimony of Thomas H. Petersen, p. 35

The parties do not contest the proposed \$5.70 per foot cost for 2 inch main. The contested issue relates to whether the proper unit of measurement for minimum systems should be feet of main, as in the prior Atmos dockets, or the newly proposed measure of retirement units. The Examiners note that Atmos' own witness, Mr. Raab was apparently confused by this issue and he testified that the company was using the number of feet of main in service when it provided the number to Mr. Raab for inclusion in his cost of service study.<sup>621</sup>

The Examiners concur with ACSC that the company has not met its burden of proof on this issue to establish that it is just and reasonable to use an allocation based upon a minimum system study utilizing retirement units instead of feet of mains. The most reliable evidence of the quantity of 2 inch main is the U.S. DOT records that Atmos had 153,690,240 feet of mains in the system for calendar year 2011.

The Examiners were not persuaded by the company's argument that the retirement units methodology is reliable because it results in a 45.81% customer-related figure, and the study using feet of mains in GUD Nos. 9400, 9670, and 9869, resulted in a 45.84% customer-related figure because this is not reflective of the customer related costs at issue in the instant proceeding.

Therefore, the Examiners recommend the adjustment as proposed by ACSC to use feet of mains in place of retirement units as a measurement of minimum system, so that the customer-related allocation is reduced to 30.87%.

## 16. Rate Design

### a. Introduction

Once the revenue requirement is determined the regulatory authority must establish rates that will ultimately recover that revenue requirement. Among the necessary components of the rate design are the billing determinants and the components of the rate design. *Billing determinants* are units of service to which the company's distribution rates are applied. In order to determine these components, the company prepared a detailed billing determinants study.<sup>622</sup> The Intervenor challenged one aspect of the calculation of billing determinants – the total volumes per class. Atmos has proposed a *rate design* that includes a customer charge and a volumetric charge. The customer charge is applied to the total number of bills and the volumetric charge is applied to the total volumes per class. The Intervenor challenged one aspect of the rate design for residential and commercial customers – the customer charge.

### b. Billing Determinants - Volumes

#### (a) Introduction

The billing determinants will impact three aspects of the cost of service analysis. First, the calculation of current revenues is based upon the current rate applied to the estimated billing determinants. Thus, changes to the billing determinants will impact the calculation of current

<sup>621</sup> Transcript of Testimony, Vol. III, p. 73, ln. 12 through p. 74, ln. 20

<sup>622</sup> Atmos Ex. 11, Gary L. Smith Direct, p. 7, ln. 19 – p. 14, ln. 2.

revenues. Second, billing determinants will also impact the revenue requirement due to the flow through effect of the change on certain components of the cost of service study. Third, it will impact the volumetric charge on the calculated rates. The two billing determinants that must be established in this case are (1) the total number of bills, and (2) the total volumes per class.

(b) Intervenor's Position

Mr. Nalepa pointed out that the company did not update its billing determinants to match the company's proposed update to gross plant that included additions through March 31, 2012. The company's billing determinants are weather and customer growth adjusted through the end of September 30, 2011 test year. Mr. Nalepa claimed that he requested updating billing determinants but that the company declined to provide that information because it would have required preparation of a separate study. Mr. Nalepa undertook an update of the billing determinants through December 2011. This would have matched his recommendation regarding post-test-year adjustments to plant discussed in Section 9, subsection b, above. He concluded that updated billing determinates would have resulted in an increase to residential volumes in the amount of 11,682,530 Ccf and an increase to commercial customers of 7,616,949 Ccf. The impact on the revenue requirement is due to the flow-through effects on the calculation of the cash working capital, uncollectible expense, and taxes. The net result is a reduction to the revenue requirement of approximately \$13,321. The volumetric charge to the residential customer is reduced by \$0.0009 per Ccf and the volumetric charge to the commercial customer is reduced by \$0.0007 per Ccf.<sup>623</sup>

(c) Company's Response

Mr. Smith testified on behalf of Atmos. As to Mr. Nalepa's argument that billing determinants must match update to plant, Mr. Smith points to arguments made by Atmos that the plant update is consistent with Commission precedent and does not require that the billing determinants analysis coincide precisely with updates to the company's accounts. In any case, he notes that the billing determinant study did, in fact, incorporate future changes in billing units beyond September 30, 2011.

He also argued that Mr. Nalepa's analysis fails to correctly normalize raw weather data. The result, he concluded, is an overstatement of Mr. Nalepa's billing determinants analysis. In this context, he noted that the period ending September 2011 enjoyed near normal weather. On the other hand, the twelve months ending December 2011 experienced significantly cooler than normal weather. Thus, the matching concerns raised by Mr. Nalepa were, in fact, addressed.<sup>624</sup>

(d) Examiners' Recommendation

The Examiners find that Atmos has established that the proposed billing determinants are just and reasonable. Atmos established that the test-year data was adjusted for future growth. This fact was detailed in direct testimony:

In GUD Nos. 9762 and 9869, the Commission approved the Company's use of a single-year growth rate based on an analysis of the monthly one-year growth rate

<sup>623</sup> ACSC Ex. 1, Karl J. Nalepa, p. 8, ln. 12 – p. 11, ln. 8

<sup>624</sup> Atmos Ex. 24, Gary L. Smith Direct, p.3, ln 4 – p. 7, ln. 10.

for each month. This same methodology was used to compute the growth projection for Rate R and Rate C services in this case.<sup>625</sup>

Thus, the billing determinants study is consistent with Commission precedent and includes a post-test-year adjustment. Additionally, the proposed adjustment has not been weather normalized to account for uncharacteristically cold weather in December 2011.

c. Rate Design

(a) Introduction

Atmos asserted that the primary goal of designing rates in this case was to balance the fixed and variable elements in the distribution rates to reflect the underlying cost characteristics of the service and establish rates for each class that recover the appropriate contribution to the company's overall requirement. The fixed and variable elements were established by Paul H. Raab who prepared the class cost of service study.<sup>626</sup> That study and supporting documentation was filed with the *Statement of Intent*. Based upon that study, Mr. Raab determined that fixed costs for the residential class are \$21 per month. The fixed cost for commercial customers was \$53.41 per month and the fixed cost for the industrial and transportation customers was \$907.93 per month.<sup>627</sup> Atmos did not propose raising the customer charge to the level identified by Mr. Raab necessary to recover the fixed cost component. Instead, Atmos proposed a customer charge of \$18.00 per month for residential customers, a customer charge of \$35.00 per month for commercial customers, and a customer charge of \$600 per month for industrial and transportation customers.

Table 16.1 below compares the proposed customer charges to the customer charge in effect in the municipalities and in effect in the environs. Table 16.1 includes the customer charge in effect at the time the case was initially filed and the customer charge that was adopted in GUD No. 10162. GUD No. 10162 was an interim adjustment proceeding that was concluded after this case was filed. The post-GUD No. 10162 customer charge is also set forth in Table 16.1 below. The Intervenors challenged the change in the customer charge.

Table 16.1  
Comparison of Customer Charges  
Environs, Municipal and Atmos Proposed

Customer Class	Environs Customer Charge		Municipal Customer Charge	Atmos Proposed
	Proposed Customer Charge Before GUD No. 10162 but after Statement of Intent	Customer Charge After GUD No. 10162		
Residential	\$17.70	\$18.87	\$7.50	\$18.00
Commercial	\$34.72	\$38.04	\$16.75	\$35.00
Industrial	\$626.00	\$678.33	\$450.00	\$600.00

<sup>625</sup> Atmos Ex. 11, Gary L. Smith Direct, p. 11, Ins. 18 – 22.

<sup>626</sup> Atmos Ex. 10, Paul H. Raab Direct & (Cite to CCCS)

<sup>627</sup> Atmos Ex. 10, Paul H. Raab Direct, p. 25.

The difference in the customer charge between the incorporated areas and the unincorporated areas is due, in part, to the differing rate mechanism that apply in each area. The unincorporated areas are impacted primarily by interim rate adjustment filings similar to the proceeding in GUD No. 10162. On the other hand, the majority of the municipalities had an RRM mechanism that allowed for a review proceeding based, in part, on a negotiated rate between the utility and the municipalities.

(b) Intervenor's Position

The Intervenor raised the following issues. First, the change in the customer charge is disproportionate to the increase in base rates. Mr. Nalepa pointed out that Atmos seeks an 11.34% increase in residential base rates whereas the change in the customer charge is an increase of over 140% over the current customer charge.<sup>628</sup> Second, the Intervenor argued that the increase to the customer charge proposed by Atmos would disproportionately impact low use customers.<sup>629</sup> Third, increases in the customer charge reduce the commodity charge and thereby stifle the conservation efforts of consumers.<sup>630</sup> Fourth, despite general agreement that cost-based rates are one goal in setting rates, the regulatory authority may limit immediate movement to cost-based rates by applying principles of gradualism to mitigate rate shock.<sup>631</sup> Fifth, the proposed customer charge increases the overall revenues derived from fixed charges.<sup>632</sup> Sixth, the proposed customer charge shifts costs from higher-use customers to lower-use customers.<sup>633</sup> Seventh, the company's proposal is not consistent with pricing outcomes commonly observed in competitive markets. Eighth, other regulatory agencies have rejected similar efforts to recover all fixed costs in the customer charge.<sup>634</sup>

Ninth, the Intervenor alleged that the company's proposed customer charge is significantly higher than the customer charge approved by this Commission in several recent cases. Table 16.2 is a table that summarizes the various customer charges applicable to recent rate proceedings. This table was provided by Mr. Lain on behalf of ATM. The Examiners have added the customer charge applicable in the recently settled proceeding in GUD No. 10174.

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<sup>628</sup> ACSC Ex. 1, Karl J. Nalepa, p. 40, Ins. 1 – 13.

<sup>629</sup> ACSC Ex. 1, Karl J. Nalepa, p. 40, Ins. 10 – 11.

<sup>630</sup> ACSC Ex. 1, Karl J. Nalepa, p. 40, Ins. 11 – 12; ATM Ex. 5, Richard Lain, p. 10, ln. 16 – p. 11, ln. 2 & p. 16, ln. 21.

<sup>631</sup> ATM Ex. 5, Richard Lain, p. 5, Ins. 5 – 9.

<sup>632</sup> ATM Ex. 5, Richard Lain, p. 8, ln. 16 – p. 10, ln. 15.

<sup>633</sup> ATM Ex. 5, Richard Lain, p. 11, ln. 4 – p. 15, ln. 2

<sup>634</sup> ATM Ex. 5, Richard Lain, p. 18, ln. 2 – p. 20, ln. 15.



Table 16.2<sup>635</sup>  
Customer Charges in Recent Proceedings

Company Name	Approved Residential Customer Charge
Bluebonnet Natural Gas, LLC	\$15.00
CenterPoint Energy Texas	\$13.95
CenterPoint Houston	\$13.54
CoServ Gas	\$7.00
GreenLight Gas	\$9.00
Hughes Natural Gas, Inc.	\$15.50
LDC, LLC	\$15.00
NatGas, Inc.	\$5.00
Onalaska Water & Gas Supply	\$10.00
Plains Gas Farmers Co-op	\$10.00
Si Energy, L.P.	\$15.00
T&L Gas Co.	\$16.00
Texas Gas Service	\$11.38
Universal Natural Gas, Inc.	\$12.00
Atmos West Texas Division	\$13.50

ACSC proposed a residential customer charge of \$9.00 per month and a commercial customer charge of \$20.00 per month.<sup>636</sup> ACSC did not propose a modification to the industrial and transportation customer charge. ATM proposed a residential customer charge of \$7.50 per month a commercial customer charge of \$16.75 and an industrial and transportation customer charge of \$450.00 per month.

(c) Company's Response

Mr. Smith began by noting that no party argued that the company's calculation or methodology for determining its fixed costs was flawed. He reiterated the point that Atmos seeks to better balance the fixed and variable elements in the distribution rates. The variable portion of fixed rates is only \$0.002 per Ccf. The company's proposed \$18.00 customer charge for residential rates and \$35.00 for commercial rates is below what was justified by the class cost of service analysis. Mr. Smith contended that the parties have previously raised the same arguments and that they were rejected in the past.

Counter to the conservation arguments raised by the Intervenors, Mr. Smith argued that the commodity costs provide a strong price signal to customers that encourage conservation. Mr. Smith also pointed to the trend among regulators in the country to move towards decoupled rates and he argued that the Intervenor's position runs counter to this trend. In support of that contention, he cited to the following NARUC resolution that stated, in relevant part, as follows:

<sup>635</sup> ATM Ex. 5, Richard Lain, Table 6, p. 10.

<sup>636</sup> ACSC Ex. 1, Karl J. Nalepa, p. 39, Ins. 16 – 18.

WHEREAS, the Natural Resources Defense Council (NRDC), the American Gas Association (AGA) and the American Council for an Energy Efficient Economy (ACEEE) have urged public utility commissions to align the interests of consumers, utility shareholders, and society as a whole by encouraging conservation. Among the mechanisms supported by these groups is the use of automatic rate true-ups to ensure that a utility's opportunity to recover authorized fixed costs is not held hostage to fluctuations in retail gas sales.

Mr. Smith asserted that the Commission's concurrence with the principles embodied in this resolution is manifested by its decision in GUD Nos. 9762, 9869, and 10000. This precedent is distinct from the precedent of other regulatory bodies that cited by the Intervenor – City of Austin and the PUC. And he suggested that the precedent at the PUC, in particular, may be impacted by the specific regulatory structure of the electric related to unbundled rates.

(d) Examiners' Recommendation

The Examiners find that Atmos has not established that the proposed customer charge for residential and commercial customers is just and reasonable. The Examiners find, however, that the principles articulated by Atmos are just and reasonable and consistent with Commission precedent. The Examiners recommend an adjustment to the customer charge for both the residential and customer charge to \$17.70 for residential customers and \$34.72 for commercial customers that are consistent with the company's proposed customer charge and reflects the updates to the filing and the Examiners' overall recommendation in this proceeding.

The study relied upon by Atmos established that the fixed costs for the residential class was \$21 per month and the fixed cost for commercial customers was \$53.41 per month. Atmos did not dispute that the result of the study should be tempered. On cross-examination Mr. Smith acknowledged that the reduction was due, in part, with a desire to moderate the impact. Mr. Smith also explained that it was within the range that was approved for the unincorporated areas.<sup>637</sup>

The customer charged calculation was not revised after the filing of the July 13<sup>th</sup> Errata or the September 14<sup>th</sup> Update. Those two filings resulted in a decrease to the original request of approximately \$16,221,321. Yet no corresponding adjustment was made to the proposed customer charge. In light of those reductions, and the reductions to the cost of service recommended herein, the Examiners find that it would be reasonable to reduce the customer charge for residential and commercial customers to the customer charge in effect for environs customers at the time the *Statement of Intent* was filed on May 31, 2012: \$17.70 customer charge for residential customers and a \$34.72 customer charge for commercial customers. An adjustment to the customer charge is also merited in light of the recommended change to the minimum system study outlined in Section 15, above. This recommended adjustment is made to reflect the reduction in the proposed increase reflected in the company's updated filing and in this *Proposal for Decision*.

The reduction is not recommended on the basis of the various arguments raised by the Intervenor who advocated a dramatic reduction to the company's proposed customer charge and rate design. The recommendation is also consistent with the approach taken by Atmos to

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<sup>637</sup> Tr. Vol. 5, pp. 175 – 177.

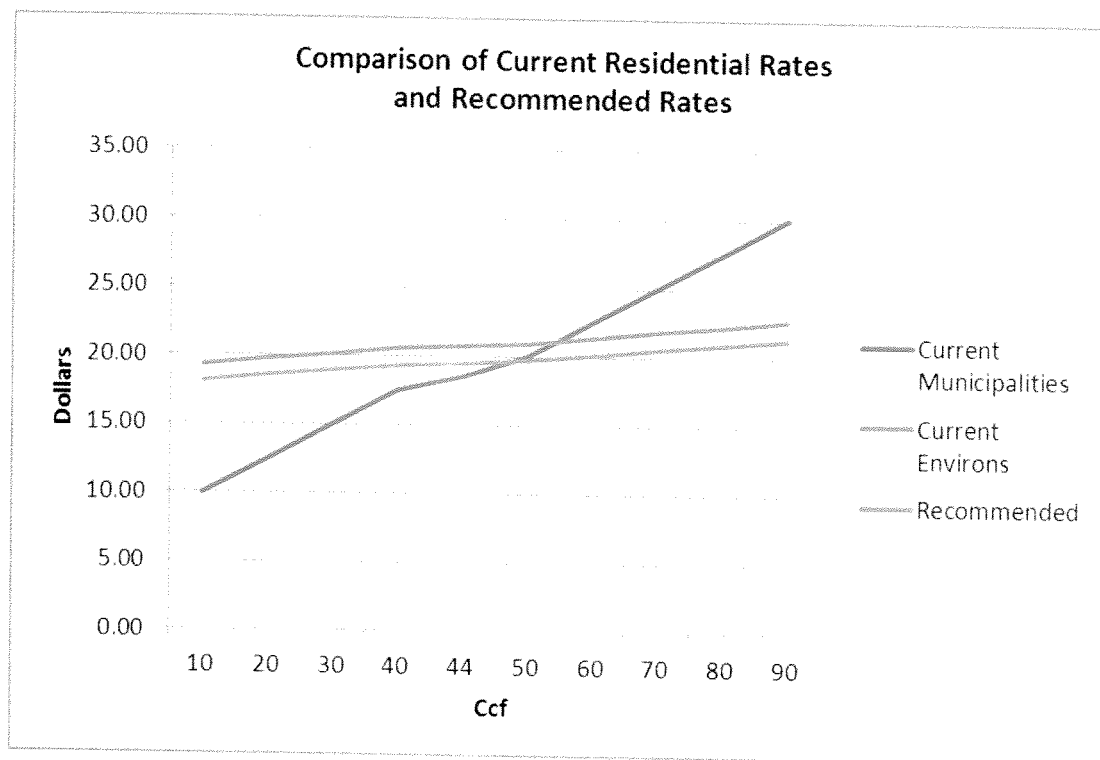
determine an appropriate customer charge in this proceeding. Namely, it is keyed to the customer charges in effect for environs customers. The Examiners recommend that if this adjustment is rejected, the Commission adopt the company's proposed customer charge.

The vast majority of the Intervenor's arguments have been previously considered and rejected by the Commission. The arguments related to the impact on conservation were not persuasive. The arguments raised by the parties tended to ignore or dismiss the fact that these rates are only one component of the customers' bill. The second major component relates to natural gas consumption. This fact, combined with the fact that there is still a price sensitive component to the base rate, ensures that consumers will perceive and enjoy the benefit to conservation. The Intervenor provided no economic expert or study to rebut the assumption that consumers will react rationally to this pricing input.

The company has established that the company's proposed customer charge is consistent with Commission precedent and consistent with a national trend towards decoupled rates. The proposed rate design will ensure that the company's fixed costs are not held hostage to fluctuations to the retail gas sales. This may, in the long run, reduce the necessity for frequent rate proceedings and their attendant costs.

Other regulatory bodies recognized that the company's proposed rate design is consistent with conservation. Atmos correctly observed that in recent proceedings the Commission has tended towards adoption of a rate design that sends accurate and transparent price signals. The rate design proposed by the Intervenor, and in effect in the municipalities sends a contrary signal and lacks transparency. Figure 16.1 below compares the existing environs rates, the existing municipal rates, and the recommended rates.

Figure 16.1



As is evident from this graph, the existing environs rates and the recommended rates closely approximate the actual fixed costs alleged by Atmos. Customer bills based upon that rate structure have a clearer understanding of actual costs than customers who are subject to the rates in effect for the municipalities. For customers subject to that rate design, only customers who are within a tight area around the average consumption level receive a bill that reflects the actual cost of providing service.

Given the rate design imposed at the municipal level *any* rate design change will have a larger impact on customers whose consumption patterns are in the extreme of the consumption range – either very low consumers of natural gas or very high consumers of natural gas. The company's proposed rate design, however, will impose a moderate change, or even a decrease for some consumers who fall within the average of the consumption pattern. Finally, the arguments raised by the Intervenors regarding an alleged cross subsidy implicit in the company's proposed rate design are unpersuasive. In fact, the opposite appears to be the case. The rate design in effect in the municipalities and proposed by the Intervenors suggests that average-use customers subsidize low-use customers. The Examiners recommend that the proposed rate design of the company be adopted subject to an adjustment to reflect the changes to the revenue requirement made by the company and any adjustments made by the Commission.

In the event that the Commission determines that a downward adjustment to the customer charge should be applied, the Examiners recommend adoption of the company's calculation of the customer costs in the allocation study. ACSC presented an exhibit that shows the fixed costs calculated by Mr. Raab and the customer costs. As noted above, the fixed costs were \$21 for residential customers and \$53.41 for commercial customers. The study's customer costs calculations were \$16.08 for residential customers and \$22.95 for commercial customers.<sup>638</sup>

## 17. Tariffs

### a. Conservation and Energy Efficiency (Rider CEE)

Rider CEE was initially adopted for the Company's use in GUD No. 9762. As first designed, the conservation program implemented under Rider CEE was a voucher program that provided free energy saving materials and supplies to eligible customers. In GUD No. 9869, Rider CEE was revised to offer a broader spectrum of conservation and energy efficiency programs and services to those customers. In this filing, the Company is proposing to replace its existing conservation and energy efficiency tariff with a new Rider CEE. Unlike the existing tariff, which is limited to low income customers and senior citizens, the proposed Rider CEE will offer assistance to residential and commercial customers to encourage reductions in energy consumption and lower energy utility bills. Cost recovery under the new Rider CEE will occur through the Residential and Commercial customer charge using the cost recovery factor set forth in the proposed Rider CEE.

The Company intends to retain its low income weatherization program and at the same time adopt additional programs designed to encourage customer participation and educate

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<sup>638</sup> ACSC Ex. 13

customers regarding the efficient use of energy. For example, the Company proposes to implement a number of rebate programs under the new Rider CEE that will be made available to customers, including:

- ENERGY STAR® Gas Forced Air Furnace
- ENERGY STAR® High Efficiency Gas Storage Water Heater
- ENERGY STAR® Tankless Gas Water Heater
- Efficient Gas Clothes Dryers
- Efficient Commercial Kitchen Equipment

The Company is proposing that ratepayers fully fund the program at \$2,000,000 annually.

Annual funding for the program is currently provided by both Mid-Tex and ratepayers (\$1 million by Mid-Tex, \$1 million by ratepayers). The Company is requesting that ratepayers assume full funding responsibilities for the CEE program. Atmos argues that this is appropriate given the maturity of the program and that ratepayers receive all of the benefits resulting from the program. Full ratepayer funding is also consistent with the manner in which energy conservation programs are implemented in the Company's other jurisdictions and for electric utilities in Texas.<sup>639</sup>

Intervenors' Position:

ACSC witness Mr. Nalepa claims the proposed new CEE program introduces a number of threshold issues to the Commission that would better be considered in a separate proceeding focused on energy efficiency only. He states the proposed program is at its core a rebate program that relies on a multitude of energy efficiency industry measures to determine the impact of the programs, which have not been fully evaluated by the Commission.

Mr. Nalepa discusses the four cost-benefit measures that Atmos used to test each program: 1) Total Resource Cost Test, 2) Program Administrator Cost Test, 3) Rate Impact Measure Test, and 4) Participant Cost Test.<sup>640</sup> He states that each of these four tests measure different categories of benefits and costs associated with a particular program and claims that not all of the programs pass the cost-benefit test. According to Mr. Nalepa, the entire residential program fails the cost-benefit test, as well as, the water heater programs. He also claims that not all programs are designed to conserve consumption as the company's gas dryer program is a fuel switching program intended to persuade customers to switch from electric to gas clothes dryers. This will increase, not decrease, the use of natural gas.<sup>641</sup> Mr. Nalepa recommends the Company's new CEE program be rejected at this time because not all of the proposed rebate programs are cost effective nor do all the programs reduce natural gas consumption; the programs have not been shown to be reasonable.

Mr. Nalepa is also troubled by the company's proposed CEE recovery mechanism. He claims Rider CEE would result in an adder to its residential and commercial customer charges,

<sup>639</sup> Atmos Ex. 5, David Park Direct, pp. 15-17.

<sup>640</sup> See Attachment 23 (Response to ACSC RFI 20-1).

<sup>641</sup> See Attachment 22 (Response to ACSC RFI 16-1, Attachment 1).

<sup>642</sup>which is an automatic cost recovery mechanism. As designed there is no opportunity for review and evaluation of the costs. Rider CEE is also based on recovery of “expected” costs plus a reconciliation of prior year costs.<sup>643</sup> Since the calculation of the adder includes “expected” costs (*i.e.*, cost not currently identified), Mr. Nalepa believes it is not a known and measurable adjustment. He acknowledges the company has proposed to file an Annual Report with the Commission that will identify the program offerings and costs and provide calculation of the adder. The company has indicated that it will work with cities on program selection and reporting.<sup>644</sup> There is no provision in the Rider CEE for formal review of the costs. For example, how will the Commission determine if a particular program is cost effective, or if the customer educational materials are effective, or if the program administration costs are reasonable.<sup>645</sup>

Commission Staff witness, Ms. LeMon, summarized the three primary changes to the revised CEE tariff, as follows:

- to make Mid-Tex’s CEE offerings available to all residential and commercial customers, rather than the narrowly-focused CEE offerings, which are currently available only to eligible low-income customers and customers who have reached age 65;
- to fully fund the company’s \$2 million CEE program through a CEE Cost Recovery Component applied to residential and commercial customer bills, rather than funding its program 50/50 from shareholders and customers; and
- to introduce a balance adjustment factor into the CEE Cost Recovery Component formula, so that the company doesn’t continue to carry millions of dollars of unexpended CEE funds on its books.

Ms. LeMon supports the company’s proposal and believes energy efficiency and the conservation of energy can lead to significant public benefits, most notably reductions in the United States’ dependency on foreign energy sources. Another significant public benefit of conservation and energy efficiency is the avoidance of certain costs, that is, avoidance of the necessity to fund and construct *as much* oil and gas and electric infrastructure as would be necessary without conservation and energy efficiency. Ms. LeMon maintains that these are substantial, long-term, public benefits that accrue to utility customers, employees, and shareholders. In addition, customers who take advantage of individual CEE programs may realize short-term monetary benefits, such as a one-time rebate on an appliance or, possibly, reductions in monthly energy bills. Customers who do not take advantage of CEE programs, nevertheless, may realize a small bill increase through the application of the CEE Cost Recovery Component. In her opinion, Mid-Tex’s relatively modest level of funding for CEE programs combined with significant, long-term public benefits, justify application of the CEE Cost Recovery Component to all residential and commercial customers. Ms. LeMon believes the “Balance Adjustment” provision in the proposed tariff is a positive step toward reconciling annual CEE over-collections as reported to the Commission:

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<sup>642</sup> Atmos Rider CEE – Conservation and Energy Efficiency.

<sup>643</sup> *Id.*

<sup>644</sup> See Attachment 25 (Response to ACSC RFI 21-1).

<sup>645</sup> ACSC Karl Nalepa Direct, p30 ln 11 – p 34, ln 7

- January 29, 2010, \$1.4 million
- January 31, 2011, \$2.7 million
- January 31, 2012, \$2.1 million

Ms. LeMon recommends that the tariff formula be modified to include such funds as grants, tax credits, contributions, or other government funding as an offset to CEE costs. Also, the CEE Cost Recovery Component is applied per bill, but the tariff does not appear to provide the complete formula for how the CEE Cost Recovery Component is calculated. She recommends a modification to Section II of the tariff to include number of bills as the denominator.

Her final recommendation is that the following statement be omitted from the tariff: "The CEE will be collected from each customer class eligible to participate in the applicable CEE program." Ms. LeMon argues that the meaning of this statement is not clear because no eligibility requirements are identified in the tariff. The statement implies that, rather than having a single CEE Cost Recovery Component applicable to all residential and commercial customers that Mid-Tex intends to engage in a complex allocation of costs between customer classes for the \$2 million CEE program. This level of complexity is neither necessary nor desirable and could result in similarly-situated customers having different CEE charges. This approach could also make the CEE program unnecessarily challenging to audit. It is preferable that a single CEE Cost Recovery Component be applied uniformly to residential and commercial customers, as proposed in the modified formula. She also discusses that a 10% cap of up to \$200,000 per year to administer up to \$2 million of CEE programs is reasonable and should be considered for inclusion in the CEE tariff, with the addition of: "Administrative costs shall not exceed 10% of total program costs."

ATM witness Mr. Fratto reached the following conclusions:<sup>646</sup>

1. Three of six programs are not anticipated to be cost effective according to the Total Resource Cost (TRC) ratio metric.
2. Atmos did not provide the overall TRC ratio for the portfolio.
3. Use of the TRC test as the basis for determining program cost-effectiveness.
4. Atmos should be required to demonstrate that the proposed portfolio of programs is cost-effective using the TRC test.
5. The portfolio funded by the CEE Rider should only include individual programs that pass the TRC test with the exception of the Low Income Weatherization Program.
6. For non-cost-effective programs, the amount of cost recovery should be reduced until the TRC ratio of the individual programs is greater than or equal to 1.
7. Atmos should modify non cost-effective programs to make them cost-effective, and if the programs cannot be made cost-effective, terminate them.
8. Atmos should be required to provide a source for the deemed savings values it proposes to use.
9. Atmos should provide an explanation regarding the utility of an expanded level of verification to ensure precise and accurate savings estimates.

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<sup>646</sup> ATM Exhibit 4, Robert L. Fratto Direct, pp 13-15

Company's Response:

As to the argument that this should be evaluated in a separate proceeding, the company responded by noting that the Commission has approved the existing Rider CEE as part of a comprehensive rate proceeding. Atmos witness, Mr. Brooks, responded that the TRC test is not the only cost-effectiveness test to be applied. Additional tests are the program administrator cost tests (PACT) and the rate impact measure (RIM). Mr. Brooks points out that Atmos Energy's CEE portfolio programs are cost-effective, even though a few of the specific programs are not.<sup>647</sup> The National Action Plan for Energy Efficiency ("NAPEE") Guide to Cost Effectiveness points out that the Company's cost-effectiveness tests can be at the measure, program, or portfolio level, and that the portfolio level approach allows the greatest flexibility. The NAPEE also allows non-cost-effective programs to be included so long as their shortfall is more than compensated for by the balance of cost-effective programs in the aggregate.<sup>648</sup>

Mr. Fratto's recommendations are inconsistent with the NAPEE Guide, which encourages utilities to use a variety of cost-effectiveness tests providing administrative flexibility.<sup>649</sup> Further, Mr. Fratto used the same cost-effectiveness calculator as Atmos and the company's results show that the program passes the TRC test for cost-effectiveness.<sup>650</sup> Mr. Fratto also ignores the fact that Atmos Energy uses the deemed savings values approved by the Arkansas Public Service Commission, which are applicable to the Texas counties served by the Mid-Tex division.<sup>651</sup>

Staff witness, Ms. LeMon, argued that the CEE rider also be modified to net out any tax credits, contributions or other government funding that Atmos Energy received during the program year. She also recommended a cap on administrative costs of 10%. Atmos claims both of those suggestions are unnecessary. As discussed by Mr. Brooks, he is unaware of any reliable source of funds but believes that any such funds would supplement Atmos Energy's spending rather than supplant it.<sup>652</sup> Finally, Atmos Energy's witnesses testified that a 10% administrative cap would be unnecessarily restrictive. Atmos Energy budgeted a 15% administrative cost in the implementation phase of the program, and Mr. Brooks noted that electric utilities may recover up to 15% of their administrative costs and an additional 10% of costs for research and development.<sup>653</sup>

Examiners' Recommendation:

The Examiners recommend rejection of the 10% administrative cap limit as proposed by Commission Staff. Examiner's recommend adoption of a 15% administrative cap limit to equal

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<sup>647</sup> Atmos Exhibit 23, William L. Brooks Rebuttal, p 5, lns. 6-13

<sup>648</sup> *Id.* at 6-9.

<sup>649</sup> *Id.* at 7-8.

<sup>650</sup> *Id.* at 10-11.

<sup>651</sup> *Id.* at 12-13.

<sup>652</sup> *Id.* at 15.

<sup>653</sup> *Id.* 15-16.



administrative costs as budgeted by Atmos. The following language has been added to CRC of the proposed tariff "Administrative costs shall not exceed 15% of total program costs."

The Commission has approved the CEE for Mid-Tex in two comprehensive rate proceedings, GUD Nos. 9762 and 9869. The Examiners recommend maintaining the currently approved funding structure, which is shared by ratepayers and shareholders. Conservation benefits shareholders and customers alike. Customers benefit by reduced bills, whereas, the shareholders benefit by an increase in customer base due to switching from electric to gas appliances. The Examiners also recommend collection of the ratepayer contributed funds through a separate CEE rider. As a surcharge, this separate mechanism is transparent. The surcharge also allows the Commission to modify as necessary without requiring a full Statement of Intent filing.

The Examiners recommend adoption of the reporting language Section V, as proposed by Atmos, with the addition of the following underlined portion:

*The Company will file an annual report with the Director of the Gas Services Division of the Railroad Commission on or before March 1 of each calendar year. The annual report shall also be made available on the Company's website. The annual report will identify the portfolio of program offerings the Company will provide during the twelve-month period commencing July 1 of each year. This annual filing shall include detailed calculations of the CRC and the Balancing Adjustments, as well as data on the total cost of the CEE Program in total and by each individual rebate program. Detailed tracking and reporting of program administration costs is also required.*

b. Weather Normalization Adjustment Tariff

Staff Witness, Lynne LeMon, addresses the proposed WNA tariff. She recommends changes to the section titled *Provision for Adjustment*. She contends that the tariff omits several important items that should be included to enable residential and commercial customers to determine the applicability of the WNA factor to the Commodity Charge. As proposed by Mid-Tex, the WNA tariff does not state:

- that the WNA factor is applied to the company's Commodity Charge,
- that the purpose of the WNA is to adjust for abnormal weather variations,
- that the company uses a 10-year average of heating degree days, or
- that WNA factors might change, if a rate review mechanism (RRM) is in effect.

Ms. LeMon also states that the Gas Services Division has a long-standing preference for applying weather normalization factors to a standard winter season which includes November, December, January, February, and March. She recommends that the Examiners endorse and the Commission adopt these five months as the standard winter season for application of the Mid-Tex weather normalization factors, rather than the November through April period proposed by Atmos' Mid-Tex Division or the October through May period proposed by Atmos' West Texas

Division. Ms. LeMon also recommends a change to the definition of the term Ccf as 100,000 British thermal units (BTUs), to one hundred cubic feet since residential customers and commercial customers are billed in cubic feet, rather than British thermal units.

Atmos proposed deletion of the monthly reporting requirement. Ms. LeMon is concerned that if deleted from the tariff, no report will be regularly available to monitor or reconcile Mid-Tex's WNAs. She believes the reporting process should be routine and transparent, given the significant impact on customer's bills. Moreover, the Commission routinely requires gas utilities to provide reports describing how the WNA is calculated. She recommends the current WNA reporting requirement be modified as follows: first, reduce the frequency from monthly to once annually, avoid filing in multiple jurisdictions by requiring Mid-Tex to post its report on its website. This allows the Commission's Staff and employees of any incorporated municipality and any Mid-Tex customer to have access to the information and would be able to perform their own calculations to verify that the WNA factor is calculated and applied to bills in the manner approved by the Commission. She recommends that Atmos be required to maintain up to five years of these reports on its website beginning with the 2013 report.

Company's Response:

Atmos Energy has agreed to revise its WNA Rider to reflect certain language changes proposed by Staff witness Ms. LeMon.<sup>654</sup> However, Atmos Energy continues to disagree with Ms. LeMon's proposal to eliminate from the winter season the month of April as the purpose of the WNA tariff is to control the impact of abnormal weather.<sup>655</sup> Accordingly, the WNA tariff needs to include months in which the utility typically experiences heating degree days ("HDDs"),<sup>656</sup> and the Mid-Tex division always experiences HDDs in the month of April.<sup>657</sup> The Commission has approved this same winter season repeatedly for Atmos Energy, and Ms. LeMon does not provide any compelling reason to depart from this prior precedent.

Examiners' Recommendation:

The Examiners do not agree with Staff's recommendation to remove the month of April as a WNA month. This has been established as a winter season month for Atmos Mid-Tex and there is no compelling reason to modify.

The Examiners recommend adopting the clarifications to the Provision for Adjustment Section as proposed by Staff. Additionally, the Examiners recommend the addition of the following reporting language as proposed by Staff, with the modifications shown below.

Weather Normalization Adjustment (WNA) Report:

On or before June 1 of each year, the company posts on its website at (ENTER WEBSITE LINK), in PDF format, a *Weather Normalization Adjustment (WNA) Report* to show how the company calculated its WNA factors during the preceding winter season. ~~The company maintains on its website up to five years~~

<sup>654</sup> Atmos Letter to Examiners (Sept. 21, 2012).

<sup>655</sup> Rebuttal Testimony of Gary L. Smith, Atmos Ex. 24 at 21.

<sup>656</sup> *Id.* at 23.

<sup>657</sup> *Id.*

~~of the most recent WNA Reports so that any interested person may review the manner in which the WNA factor was calculated.~~ Additionally, on or before June 1 of each year, the company files one hard copy and an Excel version of the *WNA Report* with the Railroad Commission of Texas' Gas Services Division, addressed to the Director of that Division.

~~The annual WNA Report includes approximately 750 lines of spreadsheet data. The WNA Report shows how each WNA factor was calculated for each of the five (5) WNA months and for each of the five (5) NOAA weather stations in the Mid-Tex Division during each of approximately thirty (30) bill cycles. The WNA months for a winter season include November, December, January, February, and March.~~

c. Miscellaneous Charges Rider

Staff witness, Ms. LeMon proposes modifications to address Staff's concerns with the proposed Miscellaneous Charges Rider. She states that the Commission's service quality rule, Rule 7.45, prohibits a utility from charging for a meter test under two circumstances. First, there is no charge for a meter test if the meter has not been tested in four years. Second, whether or not there has been a meter test previously, there is no charge for a meter test when the meter is found to be more than nominally defective, per 16 TAC §7.45(7)(B)(iv)(II). The Mid-Tex Miscellaneous Charges tariff has the first exception, but not the second. She recommends the second exception pertaining to meters that are more than nominally defective be added to the tariff.

Ms. Lemon also addresses the field read of a meter, the Commission's Rule 7.45 has the same two exceptions as for a meter test. The tariff currently does not mention these two exceptions for the field read of a meter. She recommends Mid-Tex's tariff be modified to include these two exceptions, to better align the tariff with the Commission's rule.

Her final recommendation addresses service outage or system disruption during and after a natural disaster or similar emergency. She testifies that it is customary for gas utilities to not charge service restoration fees, disconnection fees, and other such fees and recommends Mid-Tex include in its Miscellaneous Service tariff a statement identifying those charges that do not apply following a system disruption due to a natural disaster or area emergency. Such a statement reduces much confusion following a system disruption.

Company's Response:

Atmos believes that Staff's recommendation is unnecessary because the Company must follow Rule 7.45 regardless of the language in the tariff.<sup>658</sup> However, as a compromise, the Company proposed that the tariff include the following sentence: "The service charges on this

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<sup>658</sup> *Id.* at 25.

tariff will be applied in accordance with Atmos Energy's Quality of Service rules and Commission rule 7.45."

Atmos disagrees with Ms. LeMon's recommendation to include additional language indicating Mid-Tex will not charge for restoration or disconnection fees after a natural disaster as Staff identifies no rule or law that would require this language, which does not currently exist on the Company's tariffs.

Examiners' Recommendation:

The Examiners recommend adoption of the modified proposed Miscellaneous Service tariff as agreed between Atmos and Staff. The Examiners also agree that the additional language, as propose by Ms. Lemon, that Atmos will not charge service restoration fees, disconnection fees, and other such fees following a system disruption due to a natural disaster or area emergency is not required by Rule and is unnecessary.

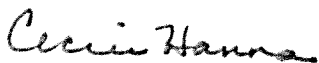
d. Tariffs Conclusions

The Examiners find that the attached tariffs are just and reasonable and recommend their adoption.

**18. Conclusion**

Atmos initially requested a revenue requirement totaling \$471,882,773. On a system-wide basis, this resulted in an increase in revenues of approximately \$47,709,349. The company updated its filing to address issues raised by the Intervenors, Staff, and the Examiners, which reduced its requested revenue requirement to \$455,661,452. This resulted in a proposed increase of approximately \$31,485,521. After considering the arguments of the parties and evaluating the evidence presented at the hearing, the Examiners recommend an additional reduction to the revenue request of approximately \$10,234,687. Thus, the Examiners find that a revenue requirement totaling \$445,426,764 is just and reasonable. Based upon the changes that were incorporated into the filing as this case was processed at the Commission, and the additional Examiners' proposed adjustment after considering the arguments of the parties, the Examiners recommend that the increase, on a system-wide basis, be limited to approximately \$21,460,423. This represents a 5.00% increase over current base rates.

Respectfully submitted,



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