

**GUD Docket No. 9530**

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**ATMOS ENERGY CORPORATION TRANSMISSION GAS COST REVIEW**

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**PROPOSAL FOR DECISION**

**PROCEDURAL HISTORY**

**COMPLIANCE FILING:  
HEARING DATES:**

September 24, 2004  
June 15 - 20, 2005

**HEARD BY:**

Gene Montes, Hearings Examiner  
Rose Ruiz, Technical Examiner

**RECORD CLOSED:**

May 12, 2006

**PFD CIRCULATION DATE:**

May 17, 2006

**STATEMENT OF THE CASE**

This case is a triennial review of the gas costs of Atmos Mid - Tex that was filed pursuant to the requirements of Tex. R.R. Comm'n, *Statement of Intent of Lone Star Gas Company and Lone Star Pipeline Company, Divisions of Enserch Corporation, and Ensat Pipeline Company to Increase the Intracompany City Gate Rate*, (Nov. 25, 1997) (Second Order Nunc. Pro Tunc) ("GUD No. 8664"). The Final Order in GUD No. 8664 ordered that this utility file "with this Commission every thirty-six months beginning from the date this Order is signed for an application for a reconciliation proceeding to demonstrate that its gas costs are reasonable and necessary."

Atmos Mid - Tex made its filing on September 4, 2004, for the period from November 1, 2000, through October 31, 2003 ("Review Period"). The filing summarized over 200 contracts that were used to procure gas during the review period and provided monthly summaries, nearly 3000 entries, to detail how those contracts were executed. Total purchases during the review period were \$2,233,362,412. Those purchases were made pursuant to baseload, peaking, swing and spot contracts as follows:

**Summary of Gas Purchases During the Review Period**  
(November 1, 2000 - October 31, 2003)

Type of Contract	Volume (MMBtu)	Overall Cost
Baseload	176,132,401	\$742,561,648
Peaking	40,826,316	\$242,704,201
Swing	11,568,404	\$77,659,241
Spot	249,800,716	\$1,170,437,322
Total	478,327,837	\$2,233,362,412

### SUMMARY OF MAJOR ISSUES

As an initial matter, it is clear from this case that Atmos Mid - Tex has complied with the seven specific restrictions set forth in GUD No. 8664. The focus of the Intervenor's case has been the prudence of the utility's gas procurement practices and the costs associated with the Company's gas procurement decisions. The Intervenor's have challenged several of the gas procurement management practices of Atmos Mid - Tex. Two principle areas of the Company's gas procurement decisions dominated this case: Issues related to hedging of gas costs and issues related to storage. In the area of hedging, the utility argues that hedging is a price volatility tool and is not a price reduction tool. The Intervenor's agree that a principle goal of hedging is volatility management. The Intervenor's argue, however, that cost minimization may also be accomplished through a prudently managed hedging program. On the other hand, there is no guarantee that a prudently managed hedging program will reduce costs. The Examiners find, based on the evidence in this record, that a prudently managed hedging program will likely result in gains and losses that, over time, will roughly even out when consistently applied.

In addition, the Intervenor's maintain that the company imprudently limited its hedging program to 35 to 40 percent of anticipated demand. The Examiners find that, to the extent that Atmos Mid - Tex limited its hedging to baseload and storage requirements, the utility prudently set its hedging program to 35 to 40 percent of anticipated winter demand. Winter requirement baseload purchases that were not hedged should have been prudently made at market prices. The Examiners find that Atmos Mid - Tex entered into certain baseload contracts above the spot price that the utility was paying and recommend a disallowance in the amount of \$374,704.94. The Examiners also find that Atmos managed its swing and peaking contracts prudently and prudently limited its hedging program to 35 to 40 percent of its anticipated winter natural gas requirements.

In the area of hedging, the Intervenor's argue that the Company failed to attain its own hedging goals, and recommend a disallowance from \$35.2 million to \$54.8 million. Although the utility appears to have achieved its hedging goal through a consistent and prudent hedging policy in the first two winters, Atmos Mid - Tex changed its policy in the third winter. Because the utility failed to consistently implement its hedging program, and failed to provide any explanation for the changed policy, the Examiners recommend a disallowance of \$15,436,099.

The Atmos Cities Steering Committee (ACSC), argue that Atmos Mid - Tex should have used financial hedging instruments to effectively place a price cap on gas costs. ACSC argues that a price cap could have reduced costs by \$144 million. The Alliance of Texas Municipalities argues that Atmos Mid - Tex could have used financial hedges to eliminate swing and peaking contracts to save \$26,746,259 to \$42,580,510. The City of Dallas argues that financial hedges could have been implemented to eliminate peaking contracts at a savings of \$73,026,255. The Examiners find, that it prudently managed its peaking and swing contracts.

In the area of storage management, several issues were raised by the Intervenor. As an initial matter, the parties disagree on the overall goals of storage. The utility takes the position that cost is never a consideration with regard to storage management. Instead, storage decisions are governed exclusively by operational and reliability considerations. The Intervenor disagrees and maintains that cost considerations must be a part of a prudent manager's analysis. The Examiners find, that while operational considerations are the most important component of storage, a prudent manager would not, as a general rule, exclude cost considerations from storage management decisions.

Several specific storage issues were raised. The City of Dallas argues that Atmos Mid - Tex did not prudently manage the replenishment of storage. The City of Dallas maintains that Atmos Mid - Tex began its storage replenishment shortly after the winter season when gas prices were higher. Further, a disproportionate amount of the overall replenishment volumes were purchased when gas prices were still high. By more evenly spacing out the storage replenishment Atmos Mid - Tex could have saved \$15,835,077. The Examiners conclude that Atmos Mid - Tex prudently managed its storage replenishment. Both operational and cost considerations support the decisions made by the utility.

The State of Texas and ACSC argue that the sale of one of the company's storage facilities, the Hill Lake storage facility, was not prudently made because the facility could have provided an important vehicle for cost minimization. The utility argues that the reasonableness of the sale of this facility was supported by operational considerations and precluded by a prior decision regarding the rates of Atmos Mid - Tex. The State of Texas recommended a disallowance for the imprudent sale ranging from \$12,905,960 to \$16,651,712. The Examiners are of the opinion that cost considerations were not taken into account at the time of the sale and consideration of the sale, for gas cost management purposes, was not precluded by the prior rate case. The Examiners find that the State of Texas overstated the operational capacity of the facility, and recommend that the disallowance for the imprudent sale be limited to \$10,161,220.

Additional storage management issues include an allegation that the cost of gas in storage was not properly accounted for in the sale. The State of Texas recommended a disallowance of \$2,493,386. The Examiners find, that the cost of gas in storage was properly handled. ACSC argues that storage quantities should have been dispatched in an effort to minimize costs. Similarly, the State of Texas argues that storage should have been managed differently in the second winter of the Review Period to minimize costs. The State recommends a disallowance of \$40 million and ACSC recommends a disallowance of \$26,977,877. The Examiners find, that the recommendations of ACSC and the State of Texas ignore the operational requirements of the utility. While the Examiners agree that cost should be a consideration in all storage decisions, the Examiners are not of the opinion that operational considerations should be ignored.

Several other issues were raised. ACSC argued that specific spot purchases should be disallowed. The Examiners find that the challenged spot purchases were at market prices. The Examiners do not recommend approval of the proposed disallowance of \$3,974,358. ACSC argued that specific swing purchases made pursuant to Contract No. 6690 should be disallowed. Atmos Mid - Tex established that those purchases, totaling \$5,570,301, were prudent. The State of Texas alleges that Atmos Mid - Tex violated the terms of the final order issued in GUD No. 9233 and the \$18,822,061 should be disallowed. The Examiners did not find that Atmos Mid - Tex violated the terms of that order. In addition to the issues raised with specific proposed disallowances the Intervenors raised several allegations regarding the general sufficiency of the filing and the utility's gas procurement policies. Finally, the utility was unable to explain a discrepancy in billing of \$3,008.48. The utility did not concede that it was not appropriately paid to the supplier. Nevertheless, the utility was unable to establish that the amount was just and reasonable. Accordingly, the Examiners recommend that it be disallowed.

In summary, Atmos Mid - Tex spent \$2,233,362,411.91 to acquire natural gas to serve its customers during the Review Period. Atmos Mid - Tex was unable to establish that \$26,374,010.42 of its natural gas acquisition expenditures was prudent. Accordingly, the Examiners recommend that the above amount, which represents 1.18 percent of its overall natural gas procurement expenditures, be disallowed. The Examiners total recommended disallowance is as follows:

Failure to prudently manage its hedging program	\$15,835,077.00
	<u>\$ 374,704.94</u>
Subtotal:	\$16,209,781.94
Failure to prudently manage storage:	\$10,161,220.00
Failure to establish necessity of payment to supplier:	\$ 3,008.48

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**I. Parties to the Proceeding***a. The Applicant.*

The predecessor in interest to Atmos Energy Corporation, TXU Gas Distribution - Transmission, filed this case pursuant to the requirements of Tex. R.R. Comm'n, *Statement of Intent of Lone Star Gas Company and Lone Star Pipeline Company, Divisions of Enserch Corporation, and Ensar Pipeline Company to Increase the Intracompany City Gate Rate*, (Nov. 25, 1997) (Second Order Nunc. Pro Tunc) ("GUD No. 8664"). As indicated by the style of that case, GUD No. 8664 applied to, among other entities to Enserch Corporation and Lone Star Pipeline Company. Through a series of mergers, the operations of those entities have ultimately become part of the operations of Atmos Energy Corporation.

Enserch merged with TXU Corporation in 1997, and became TXU Gas Company. TXU Gas Distribution was an unincorporated division of TXU Gas Company, and TXU Gas Distribution - Transmission, the entity that filed this case, was an operating unit of TXU Gas Distribution. By an Agreement of Merger, effective on October 1, 2004, Atmos Energy Corporation acquired the operations of TXU Gas Company. After the merger, the name of TXU Gas Distribution was changed to Atmos Energy Corp., Mid-Tex Division (referred to herein variously as "Atmos," "Atmos Mid - Tex," "the Company," "the utility" or "the Applicant"). References to Atmos Mid - Tex, the Company, or the Applicant include any, and all of the relevant predecessors in interest.

*b. The Intervenors*

Several entities filed motions to intervene, which the Examiners granted. The Office of the Attorney General filed an intervention on behalf of Texas state agencies, including colleges and universities as customers of the Company. The respective State agencies paid Atmos Mid - Tex a total of \$16,800,000 for natural gas during the Review Period. By intervening in this case the State sought to ensure that the gas costs passed through to State agencies were reasonable and necessary.<sup>1</sup>

Additionally, several municipalities intervened in these proceedings. The following municipalities intervened as the Atmos Cities Steering Committee (ACSC): Abilene, Addison, Alvarado, Angus, Arlington, Argyle, Austin, Bedford, Bellmead, Benbrook, Blue Ridge, Bowie, Bridgeport, Brownwood, Bryan, Burkburnett, Burleson, Caddo Mills, Carrollton, Cedar Hill, Cleburne, Clyde, College Station, Colleyville, Colorado City, Comanche, Coppell, Corinth, Corral City, Crandall, Dalworthington Gardens, Denison, Desoto, Duncanville, Edgecliff Village, Ennis, Everman, Farmers Branch, Farmersville, Flower Mound, Fort Worth, Frisco, Gainesville, Garland, Grand Prairie, Grapevine, Haltom City, Harker Heights, Haskell, Haslet, Heath, Highland Park, Highland Village, Honey Grove, Hurst, Irving, Justin, Keene, Keller, Kennedale, Kaufman, Kerrville, Killeen, Krum, Lake Worth, Lamesa, Lancaster, Lewisville, Little Elm, McKinney,

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<sup>1</sup> State Exhibit 1, Higgins Direct, p. 2, Ins. 9 - 20.

Mallakoff, Mansfield, Mesquite, Midlothian, Murphy, Northlake, North Richland Hills, Ovilla, Palestine, Pantego, Paris, Parker, Pecan Hill, Plano, Ponder, Prosper, Putnam, Red Oak, Richardson, Richland Hills, Roanoke, Robinson, Rockwall, Rowlett, Sachse, Saginaw, San Angelo, Seagoville, Sherman, Snyder, Southlake, Springtown, Stamford, Stephenville, Sulphur Springs, Sweetwater, The Colony, Town of Fairview, Trophy Club, University Park, Vernon, Waco, Watauga, Waxahachie, Westworth Village, Whitesboro, Woodway, and Wylie.

The following municipalities intervened as the Alliance of Texas Municipalities (ATM): Balch Springs, Bandera, Belton, Burnet, Caldwell, Cedar Park, Celina, Clifton, Coleman, Copperas Cove, Corsicana, Crowley, Denton, Dublin, Electra, Frost, Gatesville, Goldthwaite, Granbury, Greenville, Groesbeck, Hamilton, Hickory Creek, Hillsboro, Lampasas, Lexington, Llano, Lometa, Longview, Mart, McGregor, Mexia, Pflugerville, Ranger, Round Rock, Seymour, Somerville, Thorndale, West, and Whitney.

In addition to the State of Texas, ACSC, and ATM, the City of Dallas and Staff of the Railroad Commission (“Staff”) filed motions to intervene. The motions of the City of Dallas and Staff were granted. The City of Dallas was not aligned with either ACSC or ATM. The State of Texas, ACSC, ATM, the City of Dallas, and Staff will be collectively referred to as the Intervenors.

## **II. Jurisdiction and Notice of Compliance Filing.**

The Commission has jurisdiction over Atmos Mid - Tex, 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 2004). 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 Chapters 1 and 7. The Notice of Hearing was issued on June 3, 2005, and satisfied the requirements of 16 TEX. ADMIN. CODE § 1.45 and of TEX. GOV’T CODE ANN, CHAPTER 2001, and TEX. GOV’T CODE ANN. § 2001.052 (Vernon 2004).

Atmos provided notice of this Compliance Filing as required by Commission Rule 7.235. Atmos Mid - Tex mailed notice to each incorporated municipality in which the Company provides gas service and the Company also published notice in newspapers of general circulation in each county.<sup>2</sup>

## **III. Overview of Utility Operations and the Purchase Gas Adjustment Clause.**

Atmos Mid - Tex is a natural gas local distribution company (“LDC”) serving approximately 1.4 million residential, commercial, and industrial customers in parts of north, central, east and west Texas. Like many utilities, Atmos purchases natural gas to supply its customers, and recovers the

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<sup>2</sup> Atmos Ex. 7, Affidavit of Notice.

actual cost of those purchases from its customers through its gas cost adjustment tariff.<sup>3</sup>

It is well settled that regulatory authorities in Texas do not have the jurisdiction to set the well-head cost of gas. The Commission has found that the cost of gas, however, is the most significant expense for a gas utility, typically responsible for 70 percent or more of the customer's bill.<sup>4</sup> Gas costs may be recovered through an escalator clause, commonly referred to as a purchased gas adjustment clause — the PGA. A purchased gas adjustment clause is a portion of a gas utility's tariff, approved by the appropriate regulatory authority, that allows proper gas costs, or changes in gas costs, to be passed on to the customer without the necessity of filing a full utility rate case. The actual gas expenses flow through to the consumer's bill as gas costs change.<sup>5</sup> The Austin Court of Appeals has explained that a PGA is an automatic escalator mechanism devised by utility regulators to deal with rapid fluctuations in the cost of natural gas and it operates to increase or decrease the revenue of a gas company by the amount of the increased, or decreased, costs of gas charged the gas company by its suppliers.<sup>6</sup> In November of 1997, the Commission established a procedure to review the prudence of the gas cost purchases that are ultimately passed through the PGA by Atmos Mid - Tex.

#### IV. History of the Gas Cost Review Procedure.

The operation of a purchase gas adjustment clause is always potentially subject to an adjustment and potential refund in a subsequent proceeding. The procedures for the review of the operation of the purchase gas adjustment clause operated by Atmos are set out in several different orders of the Commission. Essentially, Atmos Mid - Tex is subject to two types of automatic administrative proceedings: a prudence review and a reconciliation proceeding. Prior to 1997, Atmos had not been the subject of either type of administrative procedure.

The Company's predecessors in interest previously applied a monthly gas cost adjustment clause from at least March 12, 1980, when the final order in GUD No. 2087 was entered, until the issuance of the final order in GUD No. 8664.<sup>7</sup> In GUD No. 8664, the Commission ordered Atmos

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<sup>3</sup> Atmos Ex. 11, Wollitz Rebuttal, Exhibit CMW-R-2.

<sup>4</sup> Tex. R.R. Comm'n, *Joint Petition of CenterPoint Energy Entex and the City of Tyler for Review of Charges for Gas Sales*, Docket No. 9364 (Gas Utils. Div. May 24, 2005) (final order).

<sup>5</sup> G. William Fowler, *Purchased Gas Adjustment Clauses: An Adjuster's Viewpoint*, 6 St. Mary's Law Journal 567, 568 (1974).

<sup>6</sup> *Southern Union Gas Company v. Railroad Commission of Texas*, 692 S.W.2d 137, 193 (Tex. App. — Austin 1985). Cited by witnesses for the City of Tyler and Entex: Tyler Exhibit No. 1, Direct Testimony of G. William Fowler, p. 5, Ins. 5 - 15; Entex Exhibit 3, Direct Testimony of Joe N. McClendon, p. 6, Ins. 10 - 16.

<sup>7</sup> Tex. R.R. Comm'n, *Statement of Intent Filed By Lone Star Gas Company, A Division of Enserch Corporation, and Lone Star Gas Company of Texas, Inc. to Change the Intracompany City Gate Charge*, Docket No.

Mid - Tex to file a reconciliation application every 36 months to allow evaluation of its gas purchases.<sup>8</sup> In that case, after nearly seventeen years of using the monthly gas cost adjustment methodology approved in GUD No. 2087, Atmos Mid - Tex, WTU, and the Aligned Cities, proposed, and the Commission apparently rejected, a change to the monthly gas cost adjustment. Rather than establish a new gas cost adjustment methodology, the Commission, based in part on an alternative proposal made by Aligned Cities and WTU, modified the existing gas cost adjustment clause to add a periodic reconciliation procedure to be conducted at 36-month intervals.<sup>9</sup> Specifically, the utility was ordered to file “with the Commission every thirty-six months beginning from the date this Order is signed for an application for a reconciliation proceeding to demonstrate that its gas costs are reasonable and necessary.”

Ultimately, the operation of the Company’s gas cost adjustment mechanism was divided into two parts. On February 25, 1999, Atmos Mid - Tex filed an application to add a correcting mechanism to its tariff.<sup>10</sup> A cycle billing adjustment was added to the monthly gas cost adjustment. The adjustment was temporary and the Company was required to file an application to revise its tariff on January 14, 2000.<sup>11</sup> The order revising the cycle billing adjustment, the final order in GUD No. 8996, established a procedure which permits Atmos Mid - Tex to recover its gas costs through a gas cost correction factor calculated on a 12-month basis and applied over a nine-month period. Thus, there are two types of cases, or filings, in which the operation of the gas cost adjustment mechanism is reviewed: (1) A review to demonstrate that the gas costs are reasonable and necessary, i.e., prudent, and (2) a reconciliation proceeding to ensure that Atmos Mid - Tex has accurately recovered its gas costs. The filing made by Atmos Mid - Tex in this case was designed to establish that the gas purchases made during the review period were prudent.

As already noted, GUD No. 8664 established a prudence proceeding every thirty-six months to demonstrate that its gas costs were reasonable and necessary. As part of that review GUD No. 8664 also required that Atmos establish that the Company has complied with the following limitations regarding its gas purchase practices:

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2087 (Gas Utils. Div. March 12, 1980) (Final Order).

<sup>8</sup> GUD No. 8664, Final Order, FOF No. 128, 139, 190 and Ordering paragraph No. 14 on page 25.

<sup>9</sup> GUD No. 8664, Final Order, FOF No. 128. As discussed in the PFD several alternatives were proposed in that case. The Examiners argued that the “most reasonable alternative is the one proposed by WTU and, in part Aligned Cities’ second alternative; retain the rate design and gas cost recovery mechanism established in GUD No. 3543 and add a reconciliation procedure.” Revised Proposal for Decision, p. V-81.

<sup>10</sup> Tex. R.R. Comm’n, *Application of Lone Star Gas Company-Transmission (LSG-T) to Add Additional Correcting Mechanism to LSG-T Rate Schedule No. 56*, Docket No. 8935 (Gas Utils. Div. August 24, 1999) (Application filed on Feb 25, 1999).

<sup>11</sup> Tex. R.R. Comm’n, *Application of TXU Gas Distribution-Transmission to Adopt a Revised Rate Schedule No. 56*, Docket No. 8996 (Gas Utils. Div. December 20, 2000) (Final Order).

1. Affiliate purchases may be included at the lowest price charged by the affiliated supplier to other divisions, affiliates, or third parties for the same class of purchased gas.
2. Spot purchases made to cover imbalances to transportation customers may not be included.
3. The duplicative approximately \$0.58 per Mcf NGPA §311 transport fee component for LSGCOT/ONEOK purchases may not be included.
4. Any other similar double charges for transportation due to an NGPA §311 rate charged for service that is implicitly contained in the city gate rate, or any other cause, may not be included.
5. Charges under the LSGCOT/ONEOK contract may be included at LSGCOT's actual cost.
6. Charges by affiliates of any margin above the affiliate's cost of gas may not be included.
7. Take-or-pay payments to affiliated companies may not be included, unless the Company obtains approval of the Director of the Gas Services Section in writing prior to inclusion, i.e., Contract No. 3708, Enserch Exploration, Inc.

This is the second prudence review proceeding filed by Atmos Mid - Tex. On July 16, 2001, the Company, filed its first reconciliation proceeding. That case was docketed as GUD No. 9233, *TXU Gas Distribution-Transmission Gas Cost Review Compliance Filing with GUD No. 8664* after Atmos filed its first Compliance Filing and Motion for Final Order. Many of the parties in this docket were involved in that case. Staff and the State of Texas intervened in that case. Several of the same cities intervened and were aligned as either the Steering Committee of Cities Served by TXU Gas Distribution - Transmission or the Alliance of Texas Municipalities. In GUD 9233, The City of Dallas was part of the Steering Committee of Cities Served by TXU Gas Distribution - Transmission. That case was resolved through a settlement agreement adopted through a final order of the Commission entered on April 23, 2004.<sup>12</sup>

The Settlement Agreement resolved all prudence issues regarding the utility's natural gas purchases during the period between November 1, 1997, and October 31, 2000. The parties in that case agreed that all of the natural gas purchases during the relevant review period were reasonable and necessary and that Atmos had complied with all of the conditions in GUD No. 8664. According

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<sup>12</sup> Tex. R.R. Comm'n, *TXU Gas Distribution - Transmission Gas Cost Review*, (April 23, 2004) (Final Order).



to the provisions contained in the settlement agreement, the parties entered the agreement to avoid the cost of prolonged litigation and to bar further litigation of issues from past periods. The parties specifically agreed that in approving, accepting, and agreeing to the provisions therein, the parties did not approve, accept, agree to, or consent to any theory or principle of ratemaking. The parties also agreed to rate case expenses for that case in the amount of \$2,155,508.83.

After the order GUD No. 9233 was issued, the Commission issued its order in Tex. R.R. Comm'n, *Statement of Intent filed by TXU Gas Company to Change Rates in the Company's Statewide Gas Utility System*, Docket No. 9400 (Gas Utils. Div. May 25, 2004) (final order) ("GUD No. 9400"). Schedule R, made part of the Company's Tariff in GUD No. 9400, modified the procedures of the prudence review applicable to Atmos Mid - Tex and modified GUD No. 8664. That schedule provided that the Company's gas cost review filings should include a Gas Purchase Report. The Gas Purchase Report was to include the following items:

1. Gas Contract Index, which includes the contract number, effective date, type of contract, Mcf purchased, MMBtu purchased, purchase amount, and \$/MMBtu.
2. Contract Summary, which should include a contract number, date, type of purchases (i.e., baseload, swing, peaking, etc.), terms, cancellation date, penalty provisions, pricing, minimum and maximum daily quantities, and seasonal minimum and maximums, if any.
3. Monthly Gas Purchase Schedules, which should include schedules of gas purchases by month, by contract, purchase price, average Btu content per month, Mcf purchased, and MMBtu purchased each month.
4. Statement of Gas Hedging Procedures, which should include a written statement of hedging policies and procedures.

The next triennial review will cover the period from November 1, 2003, through October 31, 2006. Table 1 summarizes the triennial review periods.

**Table 1**  
**Triennial Review Periods**

1 <sup>st</sup> Triennial Review (GUD No. 9233):	November 1, 1997, through October 31, 2000
2 <sup>nd</sup> Triennial Review (GUD No. 9530):	November 1, 2000, through October 31, 2003
3 <sup>rd</sup> Triennial Review (to be filed)	November 1, 2003, through October 31, 2006

Unlike the first triennial review, the parties have not been able to settle this case.

## **V. Hearing**

The hearing in this case commenced on June 15, 2005, and continued to June 20, 2005. At the conclusion of the hearing the parties requested that the post-hearing schedule be extended to allow time for the parties to negotiate a settlement. No settlement was achieved and the parties filed Initial Briefs on September 23, 2005, and Reply Briefs on October 21, 2005. A post-hearing conference was convened on November 14, 2005, to consider evidentiary issues related to rate case expenses and an evidentiary issue raised in the Reply Brief filed by Atmos Mid - Tex.

As explained more fully below, in section VIIIa, the Examiners issued three sets of requests for information on December 29, 2005, January 13, 2006, and February 3, 2006. On May 11, 2006, the Examiners, after considering the objections of the parties, admitted the following documents into the record of this case: Examiners' Exhibit No. 4, Examiners' Exhibit No. 5, and Examiners' Exhibit No. 6. ACSC made a motion to reopen the hearing, which was denied. The rationale for the Examiners' decision will be discussed in section VIIIa below. On that date, the Company's motion to strike certain portions of the Initial Brief and Reply Brief was denied.

This docket was initiated by the filing made by Atmos Mid - Tex on September 4, 2004. That filing included a report by C. Michael Wollitz and Alan D. Anderson, PhD. Mr. Wollitz was the gas supply manager for the Company during the Review Period. Dr. Anderson is an energy consulting expert who was retained to evaluate both the decision process related to gas purchases and the results that were achieved by the utility. At the commencement of the hearing of this case Mr. Wollitz and Dr. Anderson presented their report as the initial testimony of Atmos Mid - Tex in this proceeding.

Larry A. Marshall, a natural gas price analyst and consultant testified on behalf of ATM. Jacob Pous, a professional engineer, testified on behalf of the City of Dallas. Hugh K. Higgins, a utility specialist within the Public Agency Representation Section of the Consumer Protection Division at the Office of the Attorney General testified on behalf of the State of Texas. Karl Nalepa, a management consultant of RJ Covington Consulting, an independent utility consulting company, testified on behalf of ACSC. Donald W. Niemiec, an energy consultant and president of WR Energy, LLC, also testified on behalf of ACSC.

Atmos Mid - Tex presented five rebuttal witness. Richard A. Erskine, President of Atmos Pipeline - Texas testified regarding issues related to storage usage and storage management. Mr. Wollitz and Dr. Anderson also presented rebuttal testimony. Barbara W. Myers, the Regulatory Accounting Manager of Atmos Mid - Tex testified on behalf of the utility. Finally, Kenneth L. Beckman, an energy consultant with International Gas Consulting, Inc., and a gas storage expert, testified on behalf of the utility.

## VI. Prudence Standard

The Intervenors have raised several questions regarding the gas acquisition practices of Atmos Mid - Tex. All parties agree that the standard that should be applied here is the standard applied by the Public Utility Commission of Texas, upheld by Texas appellate courts, and subsequently adopted by this Commission in GUD No. 9364.<sup>13</sup> Namely, prudence should be defined as follows:

The exercise of that judgment and the choosing of one of that select range of options which a reasonable utility manager would exercise or choose in the same or similar circumstances given the information or alternatives available at the point in time such judgment is exercised or option is chosen.<sup>14</sup>

The parties agree on this standard and the Examiners agree that this is the appropriate standard to apply. The Examiners further agree that prudence cannot be based on hindsight, that is, by using information that was not available to the utility at the time. Finally, the Examiners note that the prudence standard does not require perfection and, as noted by Atmos Mid - Tex, more than one prudent option may be available within a range of options.<sup>15</sup>

In any prudence review case two methods of proof are available: (1) Contemporaneous documentation; and (2) after-the-fact analysis. Efforts to demonstrate prudent decision-making by retrospective analysis has been considered by the courts as defensive and inherently suspect.<sup>16</sup> The

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<sup>13</sup> City of Dallas Exhibit 1, Pous Direct p. 3 - 4; ACSC Exhibit 1, Nalepa Direct, pp. 5 - 6; *Initial Brief of The Atmos Texas Municipalities*, p. 6; and, *Initial Post-Hearing Brief of Atmos Energy Corp., Mid - Tex Division*, pp. 13 - 14.

<sup>14</sup> *Inquiry of the Public Utility Commission of Texas into the Prudence and Efficiency of the Planning and Management of the Construction of the South Texas Nuclear Project*, Docket No. 6668, see also 16 P.U.C. Bull. 183, 483 (June 20, 1990); *Application of Gulf States Utilities Company to Reconcile its Fuel Costs, for Permission to Delay Requesting a Surcharge, or in the Alternative, for a Surcharge to Recover Under-Recovered Fuel Expense*, Docket No. 15102, Order on Rehearing at 2 (June 24, 1997); *Gulf States Utilities v. Public Utility Comm'n of Texas*, 841 S.W.2d 459, 475 (Tex. App. — Austin 1992, writ denied).

<sup>15</sup> *Initial Post-Hearing Brief of Atmos Energy Corp., Mid-Tex Division*, p. 14.

<sup>16</sup> *Gulf States*, at 476 (Tex. App. — Austin 1992, writ denied).

Intervenors argue that there is little or no contemporaneous evidence and a heavier burden should apply in this case. Atmos counters that ample contemporaneous evidence and after-the-fact evidence exists and both burdens have been met. In each instance in which a claim is made that the utility failed to act prudently, the nature of the evidence must be evaluated.

ACSC has raised an issue regarding the general application of this standard to the operation of the purchase gas adjustment clause. In several of its gas supply plans, the utility indicated that the goal was to structure a gas supply portfolio that allows the distribution Company to reliably meet “a wide range of peak and minimum day gas requirements while satisfying the total gas requirements of our customers during the heating season at a *reasonable cost*.”<sup>17</sup> ACSC argued that a standard based on the reasonable cost of gas falls short of the statutory standard of reasonable and necessary. The Examiners agree and recommend that the standard recently adopted in *Tex. R.R. Comm’n, Joint Petition of CenterPoint Energy Entex and the City of Tyler for Review of Charges for Gas Sales*, Docket No. 9233 (Gas Utils. Div. May 24, 2005) (final order) (“GUD No. 9364”) be applied in this case: A utility should seek the lowest cost of gas with the highest reliability for its customers.<sup>18</sup>

## VII. Burden of Proof and the effect of 16 Tex. Admin. Code § 7.503.

Atmos acknowledged that it bears the burden of proof in this proceeding, and argues that the Compliance Filing established that it met the initial burden of proof.<sup>19</sup> Specifically, Atmos argues that it has met the burden of proof by complying with the filing requirements of GUD No. 8664, the requirements of Schedule R of GUD No. 9400, and Commission Rule 7.503. The issues raised by Atmos Mid - Tex regarding its compliance with the filing requirements of GUD No. 8664 and GUD No. 9400 will be addressed in section VIII below. In this section the Examiners address the requirements of Rule 7.503 and the issues raised by Atmos Mid - Tex regarding the application of that rule.

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

- (a) In any proceeding before the Commission involving a gas utility that keeps its books and records in accordance with Commission rules, the amounts shown on its books and records as well as summaries and excerpts therefrom shall be considered *prima facie* evidence of the amount of investment or expense reflected when

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<sup>17</sup> Atmos Exhibit 14, Gas Supply Plans, Winter Gas Supply Plan of 2000/2001.

<sup>18</sup> GUD No. 9233, Finding of Fact No. 64.

<sup>19</sup> *Initial Post - Hearing Brief of Atmos Energy Corp., Mid - Tex Division*, p. 6. (Emphasis added).

introduced into evidence, and such amounts shall be presumed to have been reasonably and necessarily incurred; provided, however, that if any evidence is introduced that an investment or expense item has been unreasonably incurred, then the presumption as to that specific investment or expense item shall no longer exist and the gas utility shall have the burden of introducing probative evidence that the challenged item has been reasonably and necessarily incurred. The gas utility shall be given a reasonable opportunity to prepare and present such additional evidence relevant to the reasonableness or necessity of any item so challenged. This section shall apply to the books and records of an affiliate of a gas utility engaged in a transaction with the gas utility as described in the Texas Utilities Code, § 102.104.

Atmos argues that pursuant to this rule, once a gas utility demonstrates to the Commission that it has kept its books and records in accordance with Commission rules, the amounts shown on those books and records, and any summaries and excerpts derived therefrom, are (1) *prima facie* evidence of the amount of expense reflected when introduced into evidence and (2) presumed to be reasonably and necessarily incurred.<sup>20</sup> Atmos argues that it has fully satisfied its initial burden of proof and established that it has complied with the requirements of Rule 7.503. Ms. Myers testified that Atmos kept its books and records in accordance with the rules of the Commission.<sup>21</sup> Further, the Company's schedules filed in this proceeding are summaries of its contemporaneous books and records related to gas costs during the Review Period. Thus, Atmos Mid - Tex claims that the burden shifts to the intervening party.

Atmos Mid - Tex argues that any party challenging the level of expense must introduce evidence that a specific expense item has been unreasonably incurred. Once that party has introduced specific evidence, the burden shifts back to the utility. It is the Company's position, that except in a few cases, specific items have not been challenged by the Intervenor. If, and only if, a party introduces such countering evidence regarding a specific expense item, the presumption as to that specific expense item is eliminated and the burden of proof shifts back to the gas utility to introduce probative evidence that the challenged expense has been reasonably and necessarily incurred.<sup>22</sup> Atmos notes that either the Examiners or the Commission can require the gas utility to submit additional information in support of specific expense items at any time, even after a contested case hearing.<sup>23</sup>

In this case, the Company argues that there are only a few instances where any Intervenor

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<sup>20</sup> *City of Amarillo v. Railroad Commission*, 894 S.W.2d 491, 498 (Tex. App. — Austin, 1995, writ denied).

<sup>21</sup> Atmos Exhibit No. 3, Affidavit of Barbara Myers.

<sup>22</sup> *Initial Post-Hearing Brief of Atmos Energy Corp., Mid - Tex Division*, p. 9 - 10.

<sup>23</sup> *Initial Post-Hearing Brief of Atmos Energy Corp., Mid - Tex Division*, p. 10, fn 8, citing 16 Tex. Admin. Code § 7.503(b) (2005).

witness has questioned a specific item of expense in the Company's case. The Company argues that the Intervenor has instead elected to attack the gas purchase process, not the actual purchases. While the Intervenor seeks large disallowances, Atmos maintains that they offer little evidence that any specific purchases were not prudent when made.

ACSC argues that Atmos misunderstands the applicability of Rule 7.503 and maintains that the rule was designed to avoid the unnecessary burden of presenting detailed proof of the reasonableness and necessity of every individual expense encompassed by a rate filing where there are no challenges to the utility's filing, or to certain components of that filing. ACSC explained that in contested cost-of-service rate cases, some categories of expenses are routinely challenged by Intervenor and other categories are never mentioned. The Rule 7.503 presumption will apply to avoid unnecessary evidentiary proceedings as to unchallenged expenses, but it does not relieve the utility of the burden of proof as to the challenged categories.<sup>24</sup> The City of Dallas appears to agree with ACSC's interpretation of the rule and adds that, in this case, the presumption applies to that portion of gas costs that were not attacked by any party in this case.<sup>25</sup>

The State of Texas takes the position that the rule merely provides an accounting presumption that the utility's entries are accurate.<sup>26</sup> ATM appears to agree with the State of Texas as to the applicability of the rule: ATM argues that the Company recorded all alleged excess gas costs in its books and records, and that schedules filed in this proceeding are summaries of the Company's contemporaneous books and records for the Review Period which, according to ATM, reflected the excess gas costs resulting from imprudent gas planning.<sup>27</sup> It appears that it is their position that the presumption cannot operate to establish that the decision to undertake an expense that was not prudent was reasonable and necessary.

The Examiners find that the Texas Utilities Code requires that only reasonable and necessary expenses may be recovered through a gas utility's rates, and that the utility has the burden of proving that its charges are just and reasonable.<sup>28</sup> The burden of proof, therefore, is placed upon Atmos Mid - Tex. The Examiners find that by making the Compliance Filing, satisfying the filing requirements of GUD No. 8664, as originally issued and later modified through Schedule R in GUD No. 9400, and establishing that the filing is based upon the books and records of the Company, kept in accordance with the Commission rules, Atmos Mid - Tex is able to meet its initial burden of proof. The Examiners find that the rule was designed to avoid the unnecessary burden of presenting

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<sup>24</sup> *Reply Brief of Atmos Cities Steering Committee*, p. 7.

<sup>25</sup> *Reply Brief of the City of Dallas*, p. 2.

<sup>26</sup> *State of Texas' Reply Brief*, p. 2.

<sup>27</sup> *Reply Brief of Atmos Texas Municipalities*, p. 6.

<sup>28</sup> Tex. Util. Code Ann. § 104.008 & 104.051 (Vernon 1998).

detailed proof of the reasonableness and necessity of every individual expense encompassed by a rate filing where there are no challenges to the utility's filing, or to certain components of that filing. In this case, the presumption will remain unaffected for that portion of the gas costs which were not attacked by any party in this case.

The Examiners find that the Intervenor's challenges do, in fact, rebut the presumption as to specific contracts. Even assuming that Atmos Mid - Tex is correct and only a generalized criticism of a certain category of contracts was made, that would be sufficient to call into question the specific contracts within that category. Accordingly, the burden of proof has shifted. The evidence required to meet that burden, and overcome the shifted burden of proof, depends upon the specificity of the criticism or attack. As will be seen in each case below, the Intervenor's have questioned the prudence of nearly every contract entered into by the utility. The level of specificity of each attack varies. Thus, it is the opinion of the Examiners that the response required to rebut the attack necessarily varies.

### **VIII. The Compliance Filing**

As noted in section VII above, Atmos Mid - Tex argues that by making the Compliance Filing that satisfied the requirement stated in the final order of GUD No. 8664, and subsequently modified in GUD No. 9400, and by complying with the requirements of Commission Rule 7.503, Atmos Mid - Tex has met its initial burden of proof.

As noted in section IV above, the Final Order in Gas Utilities Docket No. 8664 required Atmos Mid - Tex to demonstrate that its gas costs are reasonable and necessary.<sup>29</sup> Furthermore, as already noted, GUD 9400 provided additional guidance regarding the contents of the triennial reconciliation<sup>30</sup>:

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<sup>29</sup> GUD No. 8664: "IT IS FURTHER ORDERED that Lone Star shall file with the Commission every thirty - six months beginning from the date this Order is signed for an application for a reconciliation proceeding to demonstrate that its gas costs are reasonable and necessary. The Commission may order surcharge or refund, as appropriate."

<sup>30</sup> Described in greater detail on page 6 above.

1. Gas Contract Index.
2. Contract Summary.
3. Monthly Gas Purchase Schedules.
4. Statement of Gas Hedging Procedures.

The State of Texas has raised several issues that challenge the adequacy of the Compliance filing. In addition, ACSC argues that the compliance filing was insufficient and, at least with regard to what Atmos Mid - Tex identified as the deal capture system, the Company's filing was insufficient to satisfy Rule 7.503 discussed above.

*a. Adequacy of the Compliance Filing, Errors, and Omissions.*

The State of Texas alleges that the Compliance Filing itself is entirely inadequate to satisfy the burden of proof in this case. Specifically, the State points out that the Company's entire filing in this proceeding consists of two reports and three schedules. Mr. Higgins alleged that the reports fall short of the reliability and authenticity associated with sworn testimony and the Schedules reflect inconsistent and unproven content.<sup>31</sup> Mr. Higgins argues that GUD No. 8664 places an affirmative duty on the utility to **demonstrate** the reasonableness of its gas costs. The reports, he argues, are inadequate. Mr. Nalepa, testifying on behalf of ACSC, noted that Atmos Mid - Tex provided some alleged facts in this case — sales contract, storage injections and withdrawals — which were used in evaluating its gas costs, but that it failed to provide proof that the gas costs were reasonable and necessary. Mr. Nalepa argues that Dr. Anderson's report, attached to the compliance filing, provided an after-the-fact review of gas costs that were suspect because of his close relationship with the gas acquisition process since the beginning of its implementation.<sup>32</sup>

Ms. Myers testified on behalf of the Company and noted that the filing package in this docket contains: (i) a gas contract index that includes the contract number, effective date, type of contract, MMBtu purchased, purchased amount, and \$/MMBtu; (ii) a contract summary that includes the contract number, date, type of purchase (i.e. baseload, swing, peaking, etc.), term, cancellation date, penalty provision, pricing, minimum and maximum daily quantities, and seasonal minimum and maximum quantities; (iii) monthly gas purchase schedules that include gas purchases by month, by contract, purchase price, average Btu content per month, and MMBtu purchased each month; and (iv) reports that evaluate the Company's gas purchases during the Review Period, detail the

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<sup>31</sup> State of Texas Exhibit 1, Higgins Direct, p. 4, Ins. 2 - 6.

<sup>32</sup> ACSC Exhibit 1, Nalepa Direct, p. 7, Ins. 11 - 19.



Company's gas supply planning process, and identify the Company's gas hedging procedures.<sup>33</sup>

The Examiners find that the filing package included many of the items enumerated by Ms. Myers. The Examiners are not of the opinion that the reports fall short of reliability and authenticity, as those reports were attested to at the hearing. The Examiners further find, however, that the Compliance Filing does not, by itself, demonstrate that the gas costs were reasonable and necessary. Contrary to the assertion of the Company in its Initial Brief, answers to some of the essential questions regarding the Company's hedging program were lacking.

The Compliance Filing failed to provide sufficient information to evaluate the prudence of the Company's gas purchases. Schedule R required that the company provide a "statement of gas hedging procedures, and, if applicable, a schedule of hedging activities."<sup>34</sup> Mr. Wollitz included fewer than thirteen sentences to describe the Company's gas hedging activities.<sup>35</sup> Dr. Anderson's report included a mere four sentences to describe the hedging procedures.<sup>36</sup> No schedules were provided that directly addressed the Company's hedging process, and the reasonableness of the Company's hedging program could not be assessed from the initial Compliance Filing.

It appears that the witnesses for Atmos Mid - Tex understood the necessity of the information that was lacking in the Compliance Filing. As set out by Dr. Anderson himself, a witness for Atmos Mid - Tex, in order to determine if a transaction is a proper hedge to a future purchase requirement, the purchase being hedged must be specifically identified in terms of volume and timing.<sup>37</sup> Those two components were lacking from the Compliance Filing. It is also apparent that the Intervenors had the opportunity to obtain this information through discovery. In retrospect, although not enough information was available in the Compliance Filing to fully evaluate the hedging program, enough information was available to alert the Intervenors of the general nature of the Company's hedging program.

On the other hand, considerable confusion was generated during the hearing because it appeared to be generally assumed by the Intervenors that the required information was provided as part of the Compliance Filing. For example, Atmos Mid - Tex provided a contract summary for the contract identified as Contract No. 7099. That contract was identified by Atmos Mid - Tex as a fixed-priced contract. The contract summary indicated, under the column identified "\$/MMBtu," that the price in March of 2003 was \$8.64. During the hearing, counsel for ATM attempted to have

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<sup>33</sup> Atmos Exhibit 10, Myers Rebuttal, p. 4 ln 14 - p. 5 ln. 12.

<sup>34</sup> GUD No. 9400.

<sup>35</sup> Atmos Exhibit 1, Wollitz Report, pp. 5 - 13 & 10 - 11.

<sup>36</sup> Atmos Exhibit 2, Anderson Report, p. 4.

<sup>37</sup> Atmos Exhibit 12, Anderson Rebuttal, p. 7, lns. 5 - 9.

Mr. Wollitz compare and contrast that price to the spot market price identified in Contract No. 7101 of \$7.00 for the same month. Intervenor counsel queried Mr. Wollitz, asking him how the fixed price contract protected consumers from the daily spot market if the price under that contract was \$1.64/MMBtu more than the fixed price contract. Mr. Wollitz' response was that the March price indicated in the contract summary for Contract No. 7099 may, or may not, include a fixed price.<sup>38</sup>

The essential components of a hedging program, timing and volume, were not provided at the hearing. Counsel for the City of Dallas asked Mr. Wollitz if he could identify from the information provided in the Compliance Filing, or even in the information in the rebuttal testimony, exactly which months' gas supply was fixed pursuant to Contract No. 7099, and at what price. Mr. Wollitz stated that he could not. Further, Mr. Wollitz agreed that the information was nowhere to be found in the record.<sup>39</sup> Looking only at the Compliance Filing, Mr. Wollitz was unable to say how much of the contract was fixed, the price at which it was fixed, and when the price was fixed.<sup>40</sup> Generally, the witness for Atmos Mid - Tex conceded that it was not possible to derive this information from the documents provided in the record for several of the contracts claimed to be fixed price.<sup>41</sup>

In fact, the contract summaries provided by Atmos could mislead the regulatory authority regarding the hedging practices of the utility. For example, the contract summary for the contract identified as Contract No. 7042 indicated that in each of the months of the second winter, November through March, the price per MMBtu was \$3.97. The following winter the price appeared to vary as follows:

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<sup>38</sup> Tr. Vol. IV, pp. 109 - 112.

<sup>39</sup> Tr. Vol. IV, p. 130, lns. 24 - 25 & p. 131, lns. 1 - 24.

<sup>40</sup> Tr. Vol. IV, p. 131, lns. 8 - 13.

<sup>41</sup> See, Tr. Vol. IV, p. 143, lns. 11 - 21 & p. 151.

**Table 2**  
Contract No. 7042 Second Winter Period Summary

Month (2001 - 2002)	\$/MMBtu
November	\$3.97
December	\$3.76
January	\$3.69
February	\$5.46
March	\$8.95

It would appear from the contract summary that none of the gas was fixed during the second winter period. In fact, that was not the case. Mr. Wollitz testified that the rates reflected in the contract summary were a blended rate — a combination of fixed prices, fixed on a seasonal basis and three days prior to the month of delivery, and first of the month prices.<sup>42</sup> Mr. Wollitz testified that the only way to determine which amounts were fixed, and when they were fixed, was to query an accounting software system referred to as “the deal capture system.”<sup>43</sup>

The Examiners found that without this information it was not possible to determine the reasonableness and necessity of the Company’s gas purchases. Consequently, the Examiners issued three requests for information to obtain the information that was lacking.<sup>44</sup> With the additional information, the Examiners find that the Compliance Filing is sufficient to evaluate the Company’s hedging program, and in conjunction with Commission Rule 7.503 the initial burden of proof can be met. Finally, the Examiners are of the opinion that detailed information regarding the timing, volume, and price of the hedging program should be included as part of the Company’s future filings.

ACSC argued that the additional information could not be admitted into the record without reopening the hearing. Further, ACSC pointed out that derivation of the fixed price established in certain contracts, identified as float-to-fix contracts, was not noted in the contract summary provided as part of the Compliance Summary and was provided in the information provided in response to

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<sup>42</sup> Tr. Vol. IV, p. 143 - 144.

<sup>43</sup> Tr. Vol. IV, p. 144, lns. 2 - 5, p. 147, lns. 2 - 22, and p. 151, lns. 2 - 17.

<sup>44</sup> Examiners’ Exhibits 4, 5, & 6.

the request for information. The Examiners denied ACSC's motion to reopen the hearing. As already noted, sufficient information was provided to apprise the Intervenors of the general nature of the Company's hedging program. Further, the additional information sought falls squarely within the ambit of Commission Rule 7.503(b) which provides that nothing in Rule 7.503 "shall prevent the examiner or any commissioner from requiring the gas utility to provide additional information to support any specific record, fact, or argument at any time, whether or not such was put in issue at the hearing."

Furthermore, reopening the hearing to allow further cross-examination would be redundant. The issue was the timing, volume, and price of alleged fixed prices and the impact of the Company's timing on the price of gas. The Intervenors argue that Atmos Mid - Tex did not fix the price of sufficient quantities of gas early enough in the Winter Season to protect residential and commercial customers. The supplemental information provided by the Applicant identified the quantity of fixed-priced gas and the date that the price was fixed. It was established through abundant testimony by the Intervenors, and cross-examination of the Company's witnesses, that the Intervenors did not believe that the decision of Atmos Mid - Tex regarding timing and volume of fixed-priced contracts were prudent.

Part of the Examiners' requests for information included questions regarding apparent inconsistencies within the Compliance filing. Atmos Mid - Tex has corrected the errors identified by the Examiners. For example, the contract identified as Contract No. 6614 indicated that the price per MMBtu in June was \$4.68. The Company confirmed that the amount was incorrect and indicated that an overpayment was made that month. Other similar inconsistencies, that were due to an under payment to a supplier, were noted in Contract Nos. 3250 - 00, 3775 - 00, 3775 - 07, 3821 - 00, 3821 - 04, 3824 - 00, and 6481 - 00. Other inconsistencies identified by the Examiners were due to prior period adjustments and data entry errors and do not affect the evaluation of the Company's prudence with regard to its gas management practices.

Another apparent inconsistency was noted by the Examiners regarding Contract Nos. 5164 - 00 and 5165 - 00. Atmos Mid - Tex explained that the inconsistency noted was caused by periodic payment of tax reimbursement. The contract summary provided as part of the Compliance Filing did not indicate that tax reimbursements were a part of the terms of that contract. The Examiners are of the opinion that the information should be included as part of the contract summary.

Finally, Atmos Mid - Tex was unable to explain and clarify one inconsistency. The Company noted that Contract 6481 - 00, for the total dollar amount provided in the Compliance Filing, includes an amount of \$3,008.48 that it is unable to explain. Because Atmos Mid - Tex has not shown that amount to be just and reasonable and concedes that the amount is unexplained, the Examiners recommend that it be disallowed.

*b. Use of Inconsistent Terms in the Compliance Filing.*

Mr. Higgins points out that the term “reconciliation proceeding,” implies a comparison to actual accounting records.<sup>45</sup> Mr. Higgins argues that the data provided by the Company, in the initial filing and in responses to various requests for information, preclude a reconciliation of comparable accounts because of the inconsistent use of terms. Mr. Higgins alleged that Atmos Mid - Tex did not use consistent accounting methodology for tracking amounts in storage; sometimes, the Company used records that were kept on a “nominated” basis, at other times the records were on a “production month basis,” and at times it was not apparent what accounting method was used.<sup>46</sup> Other terms which Mr. Higgins alleges were treated with persistent ambiguity are “mitigate” or “mitigation.” He points out that at certain times Mr. Wollitz uses the term to describe the use of storage. On the other hand, the Company stated emphatically that storage is not used to “mitigate” gas cost, but rather to provide firm delivery of gas in peak demand situations.<sup>47</sup>

Ms. Myers testified that the storage schedule provided as part of the compliance filing, GCR - 2, was intended to provide an understanding of the storage and injection withdrawal practices of the Company. Accordingly, it was appropriate for the Company to use *nominations* in preparing that schedule because the storage service provided to the Company is based upon nominations, not physical injections and withdrawals.<sup>48</sup> Actual gas expenses were included in the Compliance Filing as part of Schedules GCR - 1 and GCR - 3.

Ms. Myers acknowledged that information can be generated on an *accounting month basis* and on a *production month basis*. She explained that an *accounting month basis* means that the applicable data reflect the transactions that are recorded in the books and records of the Company during the relevant month, as the information becomes available. Accounting adjustments are recorded in an accounting month when newer information indicates that the accounting data for a prior period requires a change.<sup>49</sup> The reconciliation filings are accompanied by accounting month data. The data generated for this case are on a production month basis because this methodology reflects the Company’s gas purchase costs during the months the costs were actually incurred.<sup>50</sup> A *production month basis* means that all applicable data reflect the metered or allocated deliveries during the calendar month in which the gas flows. She noted that if subsequent to the applicable

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<sup>45</sup> State of Texas Exhibit 1, Higgins Direct, p. 4, Ins. 8 - 9. As noted above, GUD No. 8664, which required the filing of this prudence review, provided that the utility “shall file with the Commission every thirty-six months beginning from the date this Order is signed for an application for a reconciliation proceeding to demonstrate that its gas costs are reasonable and necessary.” Emphasis added.

<sup>46</sup> State of Texas Exhibit 1, Higgins Direct, p. 7, Ins. 7 - 22.

<sup>47</sup> State of Texas Exhibit 1, Higgins Direct, p. 6, Ins. 3 - 23.

<sup>48</sup> Atmos Exhibit 10, Myers Rebuttal, pp. 6, Ins. 27 - 31 & p. 7, Ins. 1 - 4.

<sup>49</sup> Atmos Exhibit 10, Myers Rebuttal, p. 7, fn. 2.

<sup>50</sup> Atmos Exhibit 10, Myers Rebuttal, p. 8, Ins. 12 - 16.

production month it is determined that accounting data is incorrect for that month, an adjustment is made to adjust the values for the production month.

The Examiners find that using production month data enables the Commission and Intervenors to accurately match quantities and prices under the Company's gas purchase contracts because that methodology reflects the Company's gas purchase costs during the months the costs were actually incurred. The Examiners do not find any inconsistency in the data that were produced by the utility, or how that information was maintained for purposes of the gas storage activities. *Accounting month data* appear to be appropriate for purposes of the reconciliation proceedings and *production month data* appear to be appropriate for a prudence proceeding.

Finally, the Examiners do not find that the terms "mitigate" or "mitigation" were treated with persistent ambiguity in the context of gas storage. The use of those terms were clear from the context of Mr. Wollitz' statements. Atmos Mid - Tex maintained throughout the hearing that a by-product of storage was that the gas in storage had a known price prior to the winter season.<sup>51</sup> Accordingly, storage provided two functions: (1) to provide firm delivery of gas in peak demand situations, and (2) to mitigate the effect of price volatility.<sup>52</sup> Mr. Wollitz, and all of the Company's witnesses, consistently maintained that storage was not considered as a tool that could ensure that customers paid the lowest price for gas. As discussed below, while the Examiners find that, as a general proposition with regard to storage, the Company's position is not prudent, the Company's rhetoric in this regard was not internally inconsistent.

*c. Control of Gas Storage Accounting Reflected in the Compliance Filing*

Mr. Higgins alleged that Atmos Mid - Tex had little or no accounting control over gas in storage. He argued that the data provided regarding gas storage do not mathematically agree. He pointed out that any review of gas costs must have a distinct starting point. He alleged that the Company provided four different amounts when it identified the cost of gas in storage on the first day of the Review Period — two of which, he noted, differed by more than forty-one million dollars.<sup>53</sup>

Ms. Myers testified that Atmos Mid - Tex keeps its books and records in accordance with the Commission's rules. All storage data are subject to internal accounting controls and are audited periodically by an outside accounting firm. Furthermore, the Company's Annual Report, filed with the Commission, is subject to audit by the Commission.<sup>54</sup> As to the apparent inconsistent values for

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<sup>51</sup> Atmos Exhibit 12, Anderson Rebuttal, p. 14, Ins. 30 - 31 & p. 15, Ins. 1 - 2.

<sup>52</sup> *Initial Post-Hearing Brief of Atmos Energy Corp., Mid - Tex Division*, p. 45.

<sup>53</sup> State of Texas Exhibit 1, Higgins Direct, p. 7, Ins. 3 - 6.

<sup>54</sup> Atmos Exhibit 10, Myers Direct, p. 9, Ins. 6 - 16.

the cost of gas in storage, Ms. Myers maintains that Mr. Higgins was simply mistaken. The Company's responses to the different requests for information from the State were different because the Company was asked different questions. In one case the company was asked the ending balance as of October 31, 2003 and, in the other, the Company was asked to provide the ending balance as of October 31, 2000.

The Examiners find that the Company had adequate accounting controls over its storage gas costs. The Examiners find that Atmos Mid - Tex did not provide conflicting information regarding the cost of gas in storage. Other differences noted by the State were due to differences in the purposes of the reports provided. Certain reports required accounting month data and others required production month data. Finally, the Examiners find that Ms. Myers established that the data provided regarding gas storage were mathematically consistent.

#### **IX. Natural Gas Acquisition: Summary of the Gas Purchases and the Gas Plan.**

During the Review Period, Atmos spent \$2,233,362,411.91 to acquire its natural gas supply. The total volume of gas purchased was 478,327,837 MMBtu. Gas was purchased pursuant to baseload, peaking, swing, and spot contracts. Table 3 summarizes those purchases:

**Table 3  
Summary of Gas Purchases During the Review Period**

Type of Contract	Volume (MMBtu)	Overall Cost	Per MMBtu Cost
Baseload <sup>55</sup>	176,132,401	\$742,561,648	\$4.22
Peaking <sup>56</sup>	40,826,316	\$242,704,201	\$5.94
Swing <sup>57</sup>	11,568,404	\$77,659,241	\$6.71
Spot <sup>58</sup>	249,800,716	\$1,170,437,322	\$4.69

According to Mr. Wollitz, the natural gas requirements for each winter were estimated as part of what Atmos referred to as the "Gas Supply Plan."<sup>59</sup> The Gas Supply Plan generally described the Company's overall goals in acquiring the natural gas supply requirements for a

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<sup>55</sup> See, Examiners Schedule 1, Tab 1.

<sup>56</sup> See, Examiners Schedule 2, Tab 2.

<sup>57</sup> See, Examiners Schedule 3, Tab 3.

<sup>58</sup> See, Examiners Schedule 4, Tab 4.

<sup>59</sup> Atmos Exhibit 1, Wollitz Report, p. 2.

particular winter.<sup>60</sup>

The gas supply plan is completed a number of months before the winter season.<sup>61</sup> Atmos prepared a Gas Supply Plan for each of the three winters encompassed in this compliance filing: Winter of 2000/2001, dated August 2000; Winter of 2001/2002, dated June 2001; and Winter of 2002/2003, which is not dated.<sup>62</sup>

The Company's general goal was set out in the Winter 2000/2001 Gas Supply Plan as follows:

Structure a gas supply portfolio that allows [the utility] to reliably meet a wide range of peak and minimum day gas requirements while satisfying the total gas requirements of our customers during the heating season at a reasonable cost.<sup>63</sup>

This overall goal was reflected in the general winter gas supply planning document filed at the time of the first triennial review.<sup>64</sup> Although not specifically included in later Gas Supply Plans, Mr. Wollitz testified that Atmos actively administered its Gas Supply Plan to ensure the "reasonableness" of its gas costs.<sup>65</sup>

The various types of contracts contained in the Company's gas contract portfolio are as follows: Baseload, Peaking, Swing, and Spot. Under its baseload contract Atmos undertakes level commitments for the planning periods.<sup>66</sup> Baseload contracts are those that obligate the seller under the contract to sell, and Atmos Mid - Tex to purchase, a predetermined quantity of gas during each day of the contract term.<sup>67</sup> A subset of baseload contracts are production contracts. These contracts are also referred to as wellhead contracts, in which a gas producer will typically dedicate a certain percentage of the production from its wells to Atmos Mid - Tex.<sup>68</sup> Baseload contracts are

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<sup>60</sup> Atmos Exhibit 14, Gas Supply Plans.

<sup>61</sup> Tr. Vol. IV, Ins. 1 - 10.

<sup>62</sup> Atmos Exhibit 14, Gas Supply Plans.

<sup>63</sup> Atmos Exhibit 14, Gas Supply Plans.

<sup>64</sup> GUD No. 9233, Testimony of C.M. Wollitz, Exhibit CMW -1.

<sup>65</sup> Atmos Exhibit 1, Wollitz Report, p. 5.

<sup>66</sup> Atmos Exhibit 9, Beckman Rebuttal, p. 5, Ins. 5 - 8

<sup>67</sup> Atmos Exhibit 1, Wollitz Report, p. 4.

<sup>68</sup> Id.



usually in place for a single heating season. In some cases, however, they run for a year or more.<sup>69</sup> “Peaking” and “swing” contracts allow Atmos to vary the daily volume purchased within certain limits. Under those contracts, Atmos may have no obligation to purchase any quantity of gas on a particular day, but there is generally a minimum seasonal purchase obligation. These contracts assist in meeting peak day requirements. Swing contracts have higher minimum take requirements than peaking contracts, and thus have somewhat less flexibility in daily dispatching. A peaking contract allows the buyer to despatch gas as needed up to the contract maximum quantity.<sup>70</sup> Swing contracts, on the other hand, provide some variation in purchases but not as much variation as peaking contracts.<sup>71</sup> Peaking and swing contracts may be used as a surrogate for storage.<sup>72</sup> “Spot” contracts allow the parties to purchase and sell gas during a particular day, or number of days, in which the buyer and seller agree to a price, volume and delivery point, typically on the day before the delivery of the natural gas.<sup>73</sup> Spot contracts also help manage the day-to-day and intra-day changes in the gas requirements.<sup>74</sup> The daily spot purchase decision process begins at 6:00 a.m. with the preparations of a daily gas supply plan. An estimate of the gas available under baseload, peaking, and swing contracts is made. The remaining gas requirements must be met through Spot purchases and storage.<sup>75</sup>

Mr. Wollitz summarized the portfolio mix of baseload, peaking, swing and spot as set out in Table 4.

**Table 4**  
**The Company’s Gas Supply Mix**

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<sup>69</sup> Atmos Exhibit 2, Anderson Report, p. 3.

<sup>70</sup> Atmos Exhibit 2, Anderson Report, p. 3.

<sup>71</sup> *Id.*

<sup>72</sup> Tr. Vol. 3, p. 39, lns. 15 - 25, and p. 40, lns. 1 - 16.

<sup>73</sup> Atmos Exhibit 1, Wollitz Report, p. 5, Tr. Vol. 2, p. 203, lns. 5 - 17.

<sup>74</sup> Atmos Exhibit 1, Wollitz Report, p. 5.

<sup>75</sup> Atmos Exhibit 2, Anderson Report, p. 7.

Supply Type	11/2000 - 10/2001	11/2001 - 10/2002	11/2002 - 10/2003
Baseload	28.0%	40.6%	42.6%
Peaking	7.0%	9.4%	9.4%
Swing	6.1%	0.9%	0
Spot	59.0%	49.1%	48.0%

Mr. Wollitz explained that Atmos Mid - Tex engaged in an active price volatility mitigation effort to help limit the impact of spikes in the price of natural gas on the cost to customers. An important component of price volatility mitigation is accomplished by fixing the price of a portion of the Company's gas supplies. Mr. Wollitz alleged that baseload supply contracts have provided the avenue by which Atmos fixed the price of gas delivered to it during the winter season. Further, while having sufficient quantities of natural gas in storage is essential for purposes of reliability, the practice of purchasing natural gas in non-winter months and having it injected into storage also provides price certainty related to any gas withdrawn from storage. Thus, Atmos Mid - Tex claims to actively mitigate the impact of price volatility to customers by establishing a known price for approximately 35 percent to 40 percent of total expected winter season supplies.<sup>76</sup>

## **X. Failure to Engage in Prudent Management Practices**

### *a. Introduction*

Two areas dominated the issues raised in this case: hedging and storage. The Intervenors raised several hedging issues. First, the Intervenors allege that limiting a hedging program to physical hedging of baseload contracts was not prudent. Second, the Intervenors argue that Atmos Mid - Tex did not prudently manage its physical hedging program of baseload contracts. Third, the Intervenors maintain that Atmos Mid - Tex should have engaged in financial hedging to hedge beyond baseload and storage requirements. As to storage, the Intervenors allege that Atmos Mid - Tex did not prudently manage storage as a tool to minimize gas costs and that the Company did not consider the impact on prices of the sale of the Hill Lake storage facility.

The beginning of the Review Period coincided with marked changes in the natural gas market. Those changes heightened interest in identifying mechanisms to minimize the impact of changes in the natural gas market. Testimony presented by all parties at the hearing revealed that continued volatility in market prices increased the importance of price stability for gas utilities.<sup>77</sup> Mr. Marshall testified that during the decade of the 1990s, the natural gas market was characterized by relatively stable gas prices. As stated by Mr. Marshall, and echoed by others to varying degrees, in the late spring of 2000, prior to the first winter under review in this case, the natural gas market

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<sup>76</sup> Atmos Ex. 1, Wollitz Report, p. 6.

<sup>77</sup> Atmos Ex. 12, Exhibit ADA - R- 1, GAO Report, p. 7

changed dramatically.<sup>78</sup> As pointed out in a General Accounting Office (GAO) report presented at the hearing, a result of this market change is that gas utility companies have increased their use of hedging:

For example, 20 percent of the large and 32 percent of the small gas utilities responding to our survey reported that before the price spike of 2000 - 2001 they had not planned to hedge any of their gas supply. Consequently, their customers had to pay the prevailing market prices. In contrast, 90 percent of all the utilities companies responding to our survey reported they had decided to hedge some portion of their gas supply before the next winter (2001 - 2002).<sup>79</sup>

The winter season cited Winter 2001 - 2002, is the second winter period of the review period.

The second winter season experienced low demand for natural gas. Due to low demand, the price of gas during the winter season was less than the price of gas during the spring. The Winter of 2001 - 2002 was typified by unseasonably warm temperature, weak demand resulting from the slowing of the U.S. economy following the September 11, 2001, terrorist attack, and a general decline in petroleum prices.<sup>80</sup> In fact, actual natural gas acquisition by Atmos Mid - Tex during that winter was less than projected requirements.<sup>81</sup> Although consumption patterns were higher during the third winter season than during the second, and appear to have been normal, price fluctuations during that period did not return to the pattern experienced prior to the winter of 2000 - 2001.<sup>82</sup> As an initial matter, the Examiners find that a manager's decisions regarding hedging were, to some extent, dependent upon the market conditions just described for this particular Review Period. Accordingly, the conclusions made herein are, in part, limited to the experiences of this Review Period.

*b. Hedging Issues.*

The intervening parties argue that a central issue of this case involves the hedging of the Company's gas costs. The Intervenors argue that Atmos did not sufficiently hedge its natural gas costs. Mr. Wollitz acknowledged in his report accompanying the Compliance Filing that hedging is an important component of what he referred to as the Company's cost volatility mitigation plan.

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<sup>78</sup> ATM Exhibit 14, Marshall, Direct, pp. 17 - 18, Tr. Vol. 2, pp. 28 29 & Tr. Vol. 2, pp. 99 - 100 (Cross examination of Mr. Pous).

<sup>79</sup> Atmos Exhibit 12, Exhibit ADA - R - 1, GAO Report, p. 7.

<sup>80</sup> State of Texas Exhibit 1, Higgins Direct, p. 22, Ins. 1 - 6; Tr. Vol. 2, p. 149.

<sup>81</sup> See, ACSC Exhibit 1, Nalepa Direct, Exhibit KJN - 4.

<sup>82</sup> Tr. Vol. 2, p. 76.

The Examiners agree that a central issue in this case is the amount of hedging engaged in by the utility. Before addressing the specific disallowance proposed by the Intervenors as a result of the Company's hedging policies, several general propositions regarding hedging must be addressed. First, hedging must be defined generally and several of its characteristics explored. The parties do not appear to dispute the general definition of hedging. Second, the two basic types of hedging, financial and physical, must be described generally. Again, the parties do not appear to dispute the general characteristics of these two types of hedging. Third, the goals of hedging must be determined. On this point, the parties have a fundamental disagreement. Atmos Mid - Tex maintains that hedging is limited to dampening the volatility of spikes, both highs and lows, of natural gas prices. While the Intervenors agree that this is a primary goal, the Intervenors maintain that a properly managed hedging program should result in lower costs and substantial overall savings to consumers.

After the general propositions have been addressed the exact nature of the Company's hedging program must be described. As already noted, Atmos Mid - Tex alleged that it hedged 35 to 40 percent of its estimated winter supply requirements. The Intervenors argue that Atmos Mid - Tex did not establish that it met the hedging goals established by the Company. In other words, Atmos Mid - Tex failed to establish in this proceeding that 35 to 40 percent of its winter supply requirements were, in fact, hedged. Once the program is described, the Commission is able to evaluate whether the Company prudently set its hedging goal at 35 to 40 percent, whether the Company achieved that goal, and whether the Company prudently implemented its hedging program.

In addition to the allegations regarding the implementation of the Company's own hedging program, the Intervenors maintain that a prudent manager should employ financial hedging instruments. The Intervenors allege that Atmos Mid - Tex failed to establish that the Company's decision to purchase 55 to 60 percent of its gas requirements without engaging in either a financial or a physical hedge was not prudent. The Intervenors argue that financial hedging instruments could be used to eliminate swing and peaking contracts or to effectuate a price cap on gas costs. Therefore, the Intervenors argue, the incremental costs of gas incurred in excess of the cost of gas, had those purchases been adequately hedged, were not reasonable and necessary.

(A) *Hedging Defined.*

The characteristics of a hedge are straightforward. ATM noted in its Initial Brief that at the simplest level, hedging is merely locking-in a price. Dr. Anderson, testifying on behalf of the Company, indicated that a reasonable hedge to a future purchase contains three elements:

- The purchase being hedged must be specifically identified in terms of volume and timing.
- The purchase being hedged must be identified with enough specificity so that when the purchase is made it will be identifiable.

- The price in the transaction used as the hedging instrument must be highly correlated to the price in the hedged purchase.<sup>83</sup>

The Examiners find that a hedge, whether financial or physical, is a method of locking-in a price and quantity prior to delivery of the product, in this case, natural gas. The Examiners find that a reasonable hedge to a future purchase should be identified in terms of volume and timing; the purchase being hedged should be identified with specificity; and, in the case of a financial hedge, the price in the transaction used as the hedging instrument must be correlated to the price in the hedged purchase.

(B) *Financial Hedging and Physical Hedging*

All witnesses acknowledge that there are two principle types of hedging, financial and physical. Financial hedging is the purchase or sale of either a regulated futures contract on an exchange, a derivative, or the purchase of a specialized instrument in the over-the-counter market.<sup>84</sup> Physical hedging fixes prices and volumes in advance of the winter heating season through the use of contracts and storage. The Examiners find that there are two basic types of hedging, physical and financial.

(C) *Goals of Financial and Physical Hedging.*

There is a fundamental deference between Atmos Mid - Tex and the Intervenors related to the goals of hedging. All parties acknowledge that one goal of financial and physical hedging is to ensure stable prices and ensure that future purchases will not be subject to variability of the market place. As described by Mr. Wollitz in his report, the Company engaged in an active “price volatility mitigation effort” with the goal of avoiding the impact of spikes on the price of natural gas.<sup>85</sup>

Throughout this hearing Atmos Mid - Tex argued that because it is a *volatility mitigation tool*, hedging, whether physical or financial, is not a *cost minimization tool*. Atmos Mid - Tex relied, in part, on a study prepared by the Government Accounting Office that concluded that over several years a financial hedging program will not necessarily result in lower costs.<sup>86</sup> The goal of hedging, as articulated by the Company was *price stability*. Mr. Wollitz points to the GAO Report to support his proposition that minimizing price volatility through hedging and minimizing gas costs are two

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<sup>83</sup> Atmos Exhibit 12, Anderson Rebuttal, p. 7, lns. 8 - 13.

<sup>84</sup> ATM Exhibit 14, Marshall Direct, Tr. Vol. 2, p. 71, lns. 7 - 16 & Tr. Vol. 2, p. 71, 121

<sup>85</sup> Atmos, Ex. 1, Wollitz Report, p. 5.

<sup>86</sup> Atmos Exhibit 12, Anderson Rebuttal, Exhibit ADA - R - 1, United States General Accounting Office, Natural Gas: Analysis of Changes in Market Price, pp. 38 - 39.

entirely different objectives.<sup>87</sup>

The Intervenors agree that volatility mitigation is an important goal of a company's hedging program. Mr. Pous, testifying on behalf of the City of Dallas, and Mr. Nalepa, testifying on behalf of ACSC, noted that financial hedging protects against volatility.<sup>88</sup> The Intervenors also agree with the Company that hedging doesn't *guarantee* a lower price. Hedging, whether physical or financial, is intended to reduce the exposure to price risk. That does not necessarily ensure that prices are the lowest possible prices; stable prices locked in for the future may be lower or higher than future market prices.<sup>89</sup>

Although, the Intervenors do not dispute that hedging is primarily a volatility mitigation tool, it is clear that the Intervenors maintain that a properly managed hedging portfolio can result in substantial savings. As described below, Mr. Marshall, testifying on behalf of ATM, maintains that a properly managed hedging program could have eliminated peaking and swing gas purchases, resulting in a potential savings during the review period of \$26,746,259 to \$42,580,510.<sup>90</sup> Mr. Pous acknowledged during the hearing that financial hedging could result in a savings to customers and estimated that a properly managed hedging program could have resulted in a savings of \$73,026,254.<sup>91</sup> Mr. Nalepa and Mr. Niemiec concluded that a properly managed hedging program could have reduced gas costs by \$144.4 million during the review period. Conversely, an improperly managed program will result in substantial costs to customers.

The Intervenors pointed out that other division of Atmos Energy Corporation acknowledge the savings that may be garnered from a properly managed hedging program. During cross examination, Mr. Wollitz acknowledged that other unregulated divisions of Atmos Energy Corporation have engaged in hedging programs and have declared that the hedging programs have saved its customers substantial costs.<sup>92</sup> Atmos Energy described the secondary effect of hedging as follows: "Although financial hedging is mainly to minimize price spikes, it also saved Atmos Energy Customers more than \$26 million last year."<sup>93</sup> In addition, witnesses for the Intervenors

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<sup>87</sup> Atmos Exhibit 11, Wollitz Rebuttal, p. 27, lns. 36 - 37 & p. 28, lns. 1 - 9, citing GAO Report, p. 37.

<sup>88</sup> Tr. Vol. II, p. 113 (Pous) and Tr. Vol. 3, p. 69 (Nalepa).

<sup>89</sup> Atmos Exhibit 12, Anderson Rebuttal, Exhibit ADA - R - 1 United States General Accounting Office, Natural Gas: Analysis of Changes in Market Price, p. 6, cited in Wollitz Rebuttal, p. 26, lns. 32 - 33 & 27, lns. 1 - 2.

<sup>90</sup> ATM Exhibit 14, Marshall Direct, pp. 19 - 21, & p. 23, lns. 25 - 30.

<sup>91</sup> Tr. Vol. II, p. 113 & Pous Direct, p. 29, lns. 24 - 29.

<sup>92</sup> Tr. Vol. IV, p. 118, lns. 1 - 16; ATM Ex. 10 (Quoting President and CEO of Atmos Energy Corp in a 2004 Atmos News Release)

<sup>93</sup> Tr. Vol. 4 pp. 119 - 120; ATM Ex. 10 (Atmos Energy publication entitled, Perspective.)

pointed out that Atmos Energy Corporation also employed financial hedging in its operations.<sup>94</sup>

Other utilities acknowledged the cost saving potential of a properly managed hedging program. The City of Dallas introduced into evidence a document authored by representatives of Reliant Arkla, addressed to Commissioner Michael L. Williams, in which that utility stated that, “. . . we anticipate this program will save our residential customers in Texas about \$1 million during the upcoming heating season (November - March) when compared with the overall cost of gas prices entirely at first of the month indexes.”<sup>95</sup> Reliant Entex echoed this statement as follows:

Using the natural gas futures prices (forward curve) as of Thursday October 5, we anticipate this program will save our residential and commercial customers in Texas about \$16 million during the upcoming heating season (November - March) and an additional \$15 million next summer (April - October) when compared with the overall cost of gas prices entirely at first month of indexes.

To put this in basic terms for our customers, the impact on the cost of gas component of an average residential winter bill will be a saving of about \$9.00 or 6.5% as compared with pure index pricing.<sup>96</sup>

The Examiners conclude that the primary goal of hedging, whether physical or financial, is minimizing the effects of volatile natural gas prices. Obviously, a prudent gas manager enters into a hedge to protect against the risk of increases in the cost of gas. Furthermore a prudent manager who engages in either physical or financial hedging would engage in a market analysis in the hopes of purchasing, or locking in a price, when prices are low. Consequently, the Examiners conclude that a secondary goal of hedging is to accomplish cost minimization. It is clear that other divisions of Atmos Energy Corporation recognize this potential. A prudent manager knowing that prices are high, would not hedge simply for the purpose of protecting a company from fluctuations in the market. Thus, there may be valid reasons to avoid hedging when the market is at a particular level that would make the prudent manager reluctant to enter into a hedge, whether physical or financial. Any decision to enter into a hedge would be made by a prudent manager using well reasoned gas cost procurement analysis. The Examiners find, however, that even after the application of sound gas cost procurement analysis, a hedge, even if prudently acquired by a gas manager, may not necessarily result in the lowest possible cost.

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<sup>94</sup> Dallas Exhibit 1, Pous Direct, p. 22 - 23, citing to Atmos Energy Corporation SEC Form 10 - Q for quarter ended 3/31/01, pages 12 and 13.

<sup>95</sup> Dallas, Exhibit 2 (Letter to Chairman Michael L. Williams from Daen Liellie, President of Reliant Energy, dated October 13, 2000).

<sup>96</sup> Dallas, Exhibit 3 (Letter to Chairman Michael L. Williams from Dean Liellie, President of Reliant Energy, dated October 13, 2000).

*(D) The Company's Hedging Program*

As noted in section VIIIa above, Atmos was required to include, as part of the Compliance Filing, a statement of gas hedging procedures. Mr. Wollitz, through the report filed with the Compliance Filing, stated that Atmos Mid - Tex evaluated each year the need for, the amount of, and the timing of any price volatility mitigation efforts. He stated that the Company has chosen to mitigate its price exposure to the daily or spot market by: (i) entering into fixed-price baseload contracts with suppliers and (ii) the injection of gas into storage, which is typically purchased, and the prices established, prior to the winter heating season. Mr. Wollitz noted that Atmos Mid - Tex did not use the financial markets during the Review Period and therefore, there are no financial instruments related to hedging losses or gains applied to sales customers via the gas cost adjustment clause and/or any other credit/surcharge mechanism. He noted that the Company attempted to actively mitigate the impact of price volatility to customers by establishing a known price for approximately 35 to 40 percent of expected winter season suppliers, assuming a normal winter heating season.<sup>97</sup> Dr. Anderson also testified that the Company sought to hedge its purchases against the possibility of rapid price increases during the heating season through the use of storage, and also through the purchase of gas under baseload contracts where the price and quantity was fixed for the season or determined at the beginning of the month.<sup>98</sup>

Atmos Mid - Tex indicated that the Winter 2000 - 2001 plan projected that the Company would require 105.5 Bcf of natural gas.<sup>99</sup> Mr. Wollitz explained that 35 to 40 percent of the projected requirement corresponded to 36.9 Bcf (35% of 105.5) to 42.4 Bcf (40% of 105.5). In that winter, Atmos Mid - Tex projected estimated storage withdrawals in the amount of 18.8 Bcf.<sup>100</sup> In order to meet the projected 35 to 40 percent hedging requirement, Atmos Mid - Tex indicated that an additional 18.1 Bcf (36.9 Bcf minus 18.8 Bcf) to 23.6 Bcf (42.4 Bcf minus 18.8 Bcf) would be hedged through contracts. Atmos Mid - Tex decided that it would hedge baseload contracts to achieve its goal and examined two categories of baseload contracts: existing contracts (Existing Contracts) and new contracts (New Contracts). Atmos Mid - Tex estimated that it could hedge 5.5 Bcf of Existing Contracts. In that winter, Atmos Mid - Tex hedged 18.12 Bcf of its New Contracts. The hedging activities of the first winter, Winter 2000 - 2001, as attested to by Mr. Wollitz, are summarized in Table 5.

**Table 5**  
**Amounts Alleged to be Hedged by Atmos Mid - Tex**

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<sup>97</sup> Atmos Exhibit 1, Wollitz Report, pp. 10 - 11.

<sup>98</sup> Atmos Exhibit 2, Anderson Report, p. 4

<sup>99</sup> Atmos Ex. 14, Gas Supply Plans, Winter Gas Supply Plan 2000/2001, p. 26.

<sup>100</sup> Atmos Ex. 14, Gas Supply Plans, Winter Gas Supply Plan 2001/2002, p. 7 & Atmos Exhibit 11, Wollitz Rebuttal, Exhibit CMW - R - 1.



**Winter 2000 - 2001**

Winter	Projected Demand	Existing Contracts	New Contracts	Storage	Total Hedged	Percentage Hedged
2000 - 2001	105.5	5.5	18.12	18.8	42.42	40.21%

Atmos Mid - Tex indicated that the Winter 2001 - 2002 plan projected that the Company would require 109.1 Bcf of natural gas.<sup>101</sup> Mr. Wollitz explained that 35 to 40 percent of the projected requirements corresponded to 38.2 Bcf (35% of 109.1) to 43.6 Bcf (40% of 109.1). In that winter, Atmos Mid - Tex projected estimated storage withdrawals in the amount of 15.4 Bcf.<sup>102</sup> In order to meet the projected 35 to 40 percent hedging requirement, Atmos Mid - Tex indicated that an additional 22.8 Bcf (38.2 Bcf minus 15.4 Bcf) to 28.2 Bcf (43.6 Bcf minus 15.4 Bcf) would be hedged through contracts. Atmos Mid - Tex decided that it would hedge baseload contracts to achieve its goal and examined two categories of baseload contracts: Existing Contracts and New Contracts. Atmos Mid - Tex estimated that it could hedge 5.7 Bcf of Existing Contracts. In that winter, Atmos Mid - Tex hedged 22.84 Bcf of its New Contracts. The hedging activities of the first winter, Winter 2000 - 2001, and second winter, Winter 2001 - 2002, as attested to by Mr. Wollitz, are summarized in Table 6.

**Table 6**  
**Amounts Alleged to be Hedged by Atmos Mid - Tex**  
**Winter 2000 - 2001, Winter 2001 - 2002**

Winter	Projected Demand	Existing Contracts	New Contracts	Storage	Total Hedged	Percentage Hedged
2000 - 2001	105.5	5.5	18.12	18.8	42.42	40.21%
2001 - 2002	109.1	5.7	22.84	15.4	43.94	40.27%

Atmos Mid - Tex indicated that the Winter 2002 - 2003 plan project that the Company would require 111.8 Bcf of natural gas.<sup>103</sup> Mr. Wollitz explained that 35 to 40 percent of the projected requirements corresponded to 39.1 Bcf (35% of 111.8) to 44.7 (40% of 111.8). In that winter,

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<sup>101</sup> Atmos Ex. 14, Gas Supply Plans, Winter Gas Supply Plan 2001/2002, p. 12.

<sup>102</sup> Atmos Ex. 14, Gas Supply Plans, Winter Gas Supply Plan 2001/2002, p. 7 & Atmos Exhibit 11, Wollitz Rebuttal, Exhibit CMW - R - 1.

<sup>103</sup> Atmos Ex. 14, Gas Supply Plans, Winter Gas Supply Plan 2001/2002, p. 12.

Atmos Mid - Tex projected estimated storage withdrawals in the amount of 15.7 Bcf.<sup>104</sup> In order to meet the projected 35 to 40 percent hedging requirement, Atmos Mid - Tex indicated that an additional 23.4 Bcf (39.1 Bcf minus 15.7 Bcf) to 29 Bcf (44.7 Bcf minus 15.7 Bcf) would be hedged through contracts. Atmos Mid - Tex decided that it would hedge baseload contracts to achieve its goal and examined two categories of baseload contracts: Existing Contracts and New Contracts. Atmos Mid - Tex estimated that it could hedge 1.9 Bcf of Existing Contracts. In that winter, Atmos Mid - Tex hedged 21.76 Bcf of its New Contracts. The hedging activities of the first winter, Winter 2000 - 2001, and second winter, Winter 2001 - 2002, and third winter, Winter 2002 - 2003, as attested to by Mr. Wollitz, are summarized in Table 7.

**Table 7**  
**Amounts Alleged to be Hedged by Atmos Mid - Tex**  
**Winter 2000 - 2001, Winter 2001 - 2002, and Winter 2002 - 2003**

Winter	Projected Demand	Existing Contracts	New Contracts	Storage	Total Hedged	Percentage Hedged
2000 - 2001	105.5	5.5	18.12	18.8	42.42	40.21%
2001 - 2002	109.1	5.7	22.84	15.4	43.94	40.27%
2002 - 2003	111.8	1.9	21.76	15.7	39.36	35.20%

*(E) The Company's Overall Hedging Goals of 35 - 40 Percent.*

The Intervenor's argue that the level of hedging, 35 to 40 percent of predicted winter gas requirements, was insufficient. As an initial matter, and with regard to issues discussed in section VII above regarding the application of Rule 7.503, this allegation calls into question every contract and all volumes purchased during each of the winter seasons that were not alleged to be hedged. Thus, Atmos Mid - Tex has the burden of establishing that a prudent manager would not have hedged those volumes. As will be seen, in the context of the Company's hedging program, the Intervenor's allegation regarding the overall goal of 35 to 40 percent hedging calls into question the Company's decision not to hedge certain baseload contracts which will be addressed here. The Intervenor's allegation regarding the overall goal also calls into question the Company's decision not to hedge over 60 to 65 percent of its planned requirements, which will be addressed in sections X(b)(G) - X(b)(J) below.

ACSC, ATM, the City of Dallas, and the State of Texas all take issue with the alleged level of hedging. First, the Intervenor's argue that there was no rationale basis for settling upon 35 to 40 percent of predicted natural gas requirements. The Intervenor's argue that the decision was arbitrary

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<sup>104</sup> Atmos Ex. 14, Gas Supply Plans, Winter Gas Supply Plan 2002/2003, p. 9 & Wollitz Rebuttal, Exhibit CMW - R - 1.

and no contemporaneous evidence is provided to support the decision to hedge at that level. Second, the Intervenor argue that a more aggressive level of hedging should have been adopted.

Dr. Anderson, testifying on behalf of Atmos, argues that the level of hedging is a matter of preference not a matter of prudence. This proposition stems primarily from his conclusion that hedging does not lower prices; instead, it reduces price volatility. In addition, Dr. Anderson points out that there is a cost associated with reducing the risk of price volatility. Risk reduction is accomplished at a price and must be balanced against the value of the increased price certainty gained through hedging. Dr. Anderson concludes that risk aversion is a matter of preference and the level of hedging is a matter of preference and policy.<sup>105</sup> It is not, Dr. Anderson asserted, a matter of prudence. During cross examination Dr. Anderson testified that fixing the price for one percent going into the winter would be sufficient. Conversely, fixing the price for 50% would be fine as the level of hedging is a matter of preference, not prudence.<sup>106</sup>

As already noted, the Intervenor take issue with the fundamental premise of Dr. Anderson's analysis that hedging is merely a price volatility tool. As will be discussed in greater detail below, the Intervenor argue that a more aggressive level of hedging could have accomplished substantial savings to customers. The Examiners find that there appears to be no contemporaneous documentation to support the level of hedging selected by this utility. Mr. Wollitz offered an after-the-fact analysis of the process. First, the Company examined the contracts that were in place, intended to meet baseload requirements, and considered new contracts to be acquired to meet baseload requirements. Second, the Company made a determination that some of those contracts could be fixed. Mr. Wollitz did not offer the criteria, if any, used to determine what contract could be fixed and what contracts could not be fixed. Natural gas was acquired pursuant to the following baseload contracts that all parties agree were not fixed: 7006 - 00, 7019 - 00, 7027 - 00, 7030 - 00, 7034 - 00, 7035 - 00, 7038 - 00, 7041 - 00, 7043 - 00, 7052 - 00, 7055 - 00, 7056 - 00, 7057 - 00, 7068 - 00, 7079 - 00, 7083 - 00, 7085 - 00, 7086 - 00, 7132 - 00, 7133 - 00, 7134 - 00, 7135 - 00, 7136 - 00, 7137 - 00, 7138 - 00, and 7139 - 00. In addition, data provided by the Company indicates that additional quantities were purchased under certain other baseload contracts that were not fixed.<sup>107</sup>

On the other hand, it appears that Atmos - Mid Tex limited its hedging program to estimated baseload and storage requirements. The Examiners find that limiting a hedging program to estimated baseload and storage requirements is reasonable and consistent with industry practice. The GAO report, for example, employed a hypothetical to describe a financial hedging program

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<sup>105</sup> Atmos Exhibit 12, Anderson Rebuttal, p. 15, Ins. 22 - 28 & p. 16, Ins. 1 - 2.

<sup>106</sup> Tr. Vol. IV 214, Ins. 9 - 24.

<sup>107</sup> Examiners' Exhibits 4 & 5, Examiners Schedules 6 - A & B, Tab 6, and Examiners Schedules 7 - A & B, Tab 7.

wherein the hypothetical utility hedged all baseload quantities.<sup>108</sup> Dr. Anderson stated that if a utility hedges beyond the baseload requirements, that utility would be speculating on the markets and weather.<sup>109</sup> As already noted above, however, a considerable volume of baseload contracts that were not hedged were entered into during the Review Period. The total volume purchased under those contracts was 19,423,894 MMBtu at a total price of approximately \$89,850,830.<sup>110</sup>

As the baseload requirements were estimated, it appears that those estimated requirements changed as temperature projections and demand changed throughout the winter. Accordingly, Atmos Mid - Tex adjusted its purchases under those contracts, or entered into new baseload contracts, which were presumably the least expensive source of supply. To the extent that these baseload contracts were at or below the prevailing spot market price at the time they were entered into, the Examiners find that they were prudent. The Examiners have compared the price paid pursuant to these contracts to the average spot price paid by Atmos Mid - Tex in the first month of delivery and the average spot price in the month prior to the first month of delivery.<sup>111</sup> In five cases, the baseload contract price was over 10 percent above the average monthly spot price paid by Atmos Mid - Tex: Contract No. 7038 - 00, 7052 - 00, 7055 - 00, 7057 - 00, and 7068 - 00. Table 8, summarizes these baseload contract purchases compared to the average spot prices:

**Table 8**  
**Baseload Contract Purchases at prices that were greater  
than or equal to 10 percent above known spot prices.**

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<sup>108</sup> Atmos Exhibit 12, Anderson Rebuttal, Exhibit ADA - R - 1, p. 38.

<sup>109</sup> State of Texas Exhibit 1, Higgins Direct, Tab 15, Deposition of Dr. Anderson, 46.

<sup>110</sup> Atmos Exhibit 6, GCR 3

<sup>111</sup> See, Examiners Schedule 4, Tab 4, the monthly average spot price paid by Atmos Mid - Tex, and Examiners' Schedule 5, Tab 5, comparison of the monthly average spot price to initial price negotiated in non-hedged baseload contracts.

Contract No.	Paid Per MMBtu	Average Monthly Spot Price Month of Purchase	Average Monthly Spot Price Month Prior of Purchase	Difference between Spot Price in Month of Purchase	Difference with Spot Price in Month Prior to Purchase	Percentage increase over spot price in Month Prior to Purchase
7038 - 00	\$10.59	\$8.12	\$9.01	\$2.47	\$1.58	14.92%
7052 - 00	\$2.88	\$2.18	\$2.24	0.70	0.64	22.08%
7055 - 00	\$2.81	\$2.18	\$2.24	0.63	0.57	20.14%
7057 - 00	\$2.86	\$2.18	\$2.24	0.68	0.62	21.54%
7068 - 00	\$3.00	\$2.18	\$2.24	0.82	0.76	25.20%

These baseload contracts were placed at issue by virtue of the Intervenor's allegations that Atmos Mid - Tex did not prudently set its hedging goals. The baseload contracts were entered into at prices that exceed the spot market price paid by Atmos Mid - Tex at the time the contract was initiated by at least 10 percent, in most cases they were over 20 percent above the average spot market price paid by the Company. Furthermore, Contract No. 7038 was above the prevailing spot market price. Atmos Mid - Tex provided information related to the prevailing market price in December of 2000, and January of 2001.<sup>112</sup> The per MMBtu price for gas delivered pursuant to Contract No. 7038 was above nearly all of the prevailing market data provided by Atmos Mid - Tex. On two occasions in December 2000, the price rises above \$10.59 per MMBtu; on others it is as low as \$9.21 per MMBtu. Furthermore, it was above the Houston Ship Channel Price and the Waha index prices for both December and January.<sup>113</sup> If Atmos Mid - Tex had paid the spot market price it paid pursuant to its spot contracts, Atmos Mid - Tex could have saved its customers \$374,704.94. With the spot market exhibiting the prices lower than these baseload contracts it was not prudent of Atmos Mid - Tex to enter into these higher-priced contracts. Accordingly, the Examiners recommend that \$374,704.94 be disallowed.

*(F) Did the Company Prudently Implement its Hedging Program.*

The Intervenor's allege that Atmos Mid - Tex failed to achieve its hedging goals as described in Table 7. In order to ascertain whether the Company achieved its hedging goal the implementation of its hedging program must be sufficiently described. The Intervenor argue that the Company did not provide sufficient information to evaluate whether its own hedging goals were achieved.

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<sup>112</sup> Atmos Exhibit Wollitz Rebuttal, CMW - R- 4.

<sup>113</sup> ACSC Exhibit 1, Nalepa Direct, Appendix E, p. 18.

## i. The Company's Description of its Hedging Program.

The Intervenors argue that the Company did not establish that it met its own hedging program. ATM maintains that Atmos Mid - Tex provided no evidence to show when the prices under any of the contracts it characterizes as fixed-priced contracts were locked.<sup>114</sup> As already noted, during the hearing, counsel for the City of Dallas asked Mr. Wollitz if he could identify from the information provided in the Compliance Filing, or even in the information in the rebuttal testimony, exactly which month's gas supply was fixed pursuant to Contract No. 7099, and at what price. Mr. Wollitz stated that he could not. Further, Mr. Wollitz agreed that the information was nowhere to be found in the record.<sup>115</sup> Looking only at the Compliance Filing, Mr. Wollitz was unable to say how much of the contract was fixed, the price at which it was fixed, and when the price was fixed.<sup>116</sup>

Generally, the witness for Atmos Mid - Tex conceded that it was not possible to derive this information from the documents provided in the record for several of the alleged fixed-priced contracts.<sup>117</sup>

The Company argues that no Intervenor made a specific inquiry regarding the timing of the alleged hedges. The Examiners find otherwise. The Intervenors specifically addressed this issue in the direct testimony. Mr. Nalepa testified that most of the Company's baseload contracts executed for Winter 2002 - 2003 included the option to fix the price on a portion of supply, "but the Company provided no documentation showing that those options were ever exercised."<sup>118</sup> Mr. Pous observed that many of the fix-priced contracts that are part of the Company's physical hedging process do not set the price but rather set the pricing mechanism.<sup>119</sup> The Examiners note that as to the issue regarding the application of Commission Rule 7.503, the allegations raised by Mr. Nalepa and Mr. Pous — that the price fixing option of certain contracts was never exercised — challenged the adequacy of all baseload requirements contracts alleged to have been hedged.<sup>120</sup>

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<sup>114</sup> Initial Brief of the Atmos Texas Municipalities, p. 17.

<sup>115</sup> Tr. Vol. IV, p. 130, lns. 24 - 25 & p. 131, lns. 1 - 24.

<sup>116</sup> Tr. Vol. IV, p. 131, lns. 8 - 13.

<sup>117</sup> See, Tr. Vol. IV, p. 143, lns. 11 - 21 & p. 151.

<sup>118</sup> ACSC Exhibit 1, Nalepa Direct, p. 19, lns. 11 - 15.

<sup>119</sup> City of Dallas Exhibit 1, Pous, Direct, p. 22, lns. 1 - 4.

<sup>120</sup> Those contracts are identified as follows: Existing contracts, generally described in Exhibit CMW - R - 1, and specifically identified in response to Examiners Letter No 22, Examiners' Exhibit No. 4: 2298 - 00, 2298 - 01, 3250 - 01, 3775 - 00, 3775 - 03, 3775 - 04, 3775 - 05, 3775 - 06, 3775 - 07, 3821 - 00, 3821 - 01, 3821 - 04, 3821 - 05, 3824 - 00, 3824 - 01, 4132 - 01, 4132 - 39, 4132 - 41, 4201 - 00, 4304 - 00, 4646 - 00, 4751 - 00, 4794 - 00, 4862 - 00, 4926 - 00, 5122 - 00, 5138 - 00, 5164 - 00, 5165 - 00, 5171 - 00, 5185 - 00, 5192 - 01, 5462 - 00, 5469 - 00, 5508 - 00, 5469 - 00, 5508 - 00, 5812 - 00, 5817 - 00, 6043 - 00, 6072 - 00, 6177 - 00, 6311 - 00, 6440 - 00, 6461 - 00, 6479 - 00, 6479 - 22, 6480 - 00, 6481 - 00, 6481 - 05, 6482 - 00, 6487 - 00, 6488 - 00, 6614 - 00, 6617 - 00, 6717 - 00, 6717 - 01,

In response, Mr. Wollitz testified regarding the overall volumes alleged to have been hedged, but not the specific dates the prices were fixed nor the overall volumes that were fixed.<sup>121</sup> It was through Exhibit CMW - R - 1, referenced above and attached to his rebuttal testimony, that Mr. Wollitz testified that Atmos Mid - Tex accomplished its hedging goals through three principal vehicles: Certain Existing Contracts that were hedged, certain New Contracts that were hedged, and storage. He testified that during the Winter 2000 - 2001, Atmos Mid - Tex hedged, on a seasonal and monthly basis, 42.43 Bcf. That was 40 percent of projected demand. Mr. Wollitz testified that during the Winter 2001 - 2002, Atmos Mid - Tex hedged, on a seasonal and monthly basis, 43.94 Bcf. That was 40 percent of projected demand. Mr. Wollitz testified that during the Winter 2002 - 2003, Atmos Mid - Tex hedged, on a seasonal and monthly basis, 39.36 Bcf. That was 35 percent of projected demand.<sup>122</sup> Table 9 summarizes the components of the Company's gas costs procurement plan that were alleged to be hedged.

**Table 9**  
**Amounts Alleged to be Hedged by Atmos Mid - Tex**  
**Winter 2000 - 2001, Winter 2001 - 2002, and Winter 2002 - 2003**

Winter	Projected Demand	Existing Contracts	New Contracts	Storage	Total Hedged	Percentage Hedged
2000 - 2001	105.5	5.5	18.12	18.8	42.42	40.21%
2001 - 2002	109.1	5.7	22.84	15.4	43.94	40.27%
2002 - 2003	111.8	1.9	21.76	15.7	39.36	35.20%

While the New Contracts were specifically listed, the Existing Contracts were not identified in that rebuttal testimony. The date that the prices and volumes were fixed was not identified for all Existing and New Contracts in the rebuttal testimony. Further, the volumes fixed, the prices and the date that the volumes were fixed, for either category of contracts, could not be ascertained from the Compliance Filing.

The Examiners find that the Company initially failed to establish in this proceeding the date that the prices and volumes were fixed. After carefully reviewing the record as presented in the initial Compliance Filing, the rebuttal testimony, and the record of the hearing, the Examiners were

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6723 - 00, 6750 - 00, 6815 - 00, 6968 - 00, 6971 - 00, and 7085 - 00; New contracts specifically identified in Exhibit CMW - R - 1: 7007 - 00, 7008 - 00, 7009 - 00, 7010 - 00, 7011 - 00, 7017 - 00, 7023 - 00, 7032 - 00, 7040 - 00, 7042 - 00, 7046 - 00, 7047 - 00, 7048 - 00, 7049 - 00, 7050 - 00, 7051 - 00, 7053 - 00, 7066 - 00, 7073 - 00, 7078 - 00, 7082 - 00, 7042 - 00, 7047 - 00, 7091 - 00, 7092 - 00, 7093 - 00, 7094 - 00, 7095 - 00, 7096 - 00, 7097 - 00, 7098 - 00, 7099 - 00, 7105 - 00, 7114 - 00, and 7122 - 00.

<sup>121</sup> Atmos Exhibit 11, Wollitz Rebuttal, CMW - R - 1.

<sup>122</sup> *Id.*

unable to identify all the contracts that were fixed, as to price and volume, on a daily, monthly, or seasonal basis. Through several requests for information issued after the hearing, the Examiners were able to ascertain the exact nature of the Company's hedging program. Those facts, the volumes fixed, the prices, and the date that the volumes were fixed, could not be ascertained until the Examiners' requests for information were issued after the hearing.

ii. Hedged Natural Gas Acquired through Baseload Contracts.

The timing of the particular hedge is crucial in order to describe completely the Company's hedging program. Atmos Mid - Tex engaged in three types of hedging: seasonal hedges, self-executing multi-month hedges, and monthly hedges. A seasonal hedge is a hedge that is established prior to the winter season. The Company's winter season begins in November and ends in March. The Company's self-executing multi-month hedges sometimes were fixed prior to the winter season and sometimes were fixed after the winter season commenced. Atmos Mid - Tex incorporated a monthly hedge, which fixed the price, and volume, in the month prior to the delivery month (Prompt Month Settlement Contracts).

The nature of the Company's hedging program could be adequately evaluated after the Company responded to the Examiners' request for information. With that information the price that was fixed, the volumes that were fixed, and the date on which those components were established could be ascertained. In order to ascertain the nature of the Company's hedging program, the volumes that were hedged on a seasonal basis and the volumes that were hedged after the winter season commenced need to be identified. That evidence was not in the Compliance Filing and was not available at the conclusion of the hearing.

Based on the information in the record, ACSC, in its Initial Brief, presented an analysis of the baseload contracts contained in GCR-3. ACSC identified baseload contracts that it determined provided known prices prior to the winter season for each winter. ACSC compared the average price, per MMBtu, to the average price of gas acquired pursuant to baseload contracts where the price was not determined on a seasonal basis.<sup>123</sup> ACSC calculated that if Atmos Mid - Tex had fixed the price of volumes acquired through baseload requirements contracts to achieve its goal of hedging 35 percent of its volumes on a seasonal basis, Atmos Mid - Tex could have saved its customers \$38,370,572 throughout the Review Period. If Atmos Mid - Tex had achieved 40 percent of its hedging goals, by incorporating seasonally fixed baseload contracts, the Company could have achieved a savings of \$54,800,285.<sup>124</sup> The analysis was based upon total volumes, and not limited to planned hedged volumes. In addition, it was based upon a hindsight analysis of actual monthly withdrawals, not estimated monthly withdrawals. Finally, the analysis required ACSC to guess the total fixed volumes based on the incomplete data available at the conclusion of the hearing.

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<sup>123</sup> Initial Brief of Atmos Cities Steering Committee, Tab 3.

<sup>124</sup> Reply Brief of Atmos Cities Steering Committee, Tab 1.



The Examiners evaluated the evidence provided by Atmos Mid - Tex and determined that the price of certain volumes was fixed on a seasonal basis and the price of other volumes was fixed on a monthly basis. The Examiners also found that certain contracts contained self-executing provisions which recalculated the price paid at certain intervals. If the recalculation occurred in advance of the winter season, then the price was considered fixed on a seasonal basis by the Examiners. Sometimes, however, the price was recalculated in the middle of the winter season. As that price was not determined until after the beginning of the winter season, that price was not fixed on a seasonal basis. Thus, for example, if the price was recalculated in January, as in the case of Contract No. 6479 - 22, the price in November, and December, was considered fixed on a seasonal basis. The price in January, February, and March, however, was not considered fixed on a seasonal basis, as that price was not known prior to the winter season.

The Examiners included in this analysis all volumes purchased pursuant to the Existing Contracts. During the hearing Mr. Wollitz testified that Atmos Mid - Tex sought to hedge certain volumes pursuant to certain Existing Contracts during each winter. The Examiners determined, through an examination of the data provided in Compliance Filing, that total volumes purchased pursuant to those Existing Contracts exceeded the projected amounts identified in CMW - R - 1 by Mr. Wollitz. All volumes delivered pursuant to those contracts were considered by the Examiners.

The results of the Examiners' analysis are presented in Examiners' Schedule 6, at Tab 6 and in Examiners' Schedule 7, at Tab 7. Those schedules will be discussed further below. At this juncture, however, the Examiners note that Schedule 6 identified the volumes that were hedged prior to October of each winter season and the volumes that were hedged after October of each winter season. Schedule 7 identified the volumes that were hedged prior to November of each winter season and the volumes that were hedged after November, of each winter season. These schedules were developed in part based upon the information provided in the initial Compliance Filing and in responses to the Examiners' request for information admitted as Examiners' Exhibits 4, 5, and 6.

Mr. Wollitz testified that during the Winter 2000 - 2001, Atmos Mid - Tex sought to hedge at least 18.1 Bcf through fixed baseload contracts. The evidence reveals that during that winter Atmos Mid - Tex fixed the price of 1.4 Bcf prior to October.<sup>125</sup> Mr. Wollitz testified that during the Winter of 2001 - 2002, Atmos Mid - Tex sought to hedge at least 22.8 Bcf. The evidence in the record reveals that during that winter Atmos Mid - Tex fixed the price of 17.9 Bcf prior to October.<sup>126</sup> Mr. Wollitz testified that during the Winter of 2002 - 2003, Atmos Mid - Tex sought to hedge at least 23.4 Bcf. The evidence in the record reveals that during that winter Atmos Mid -

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<sup>125</sup> Wollitz Rebuttal, Exhibit CMW - R - 1, Examiners' Exhibit No. 22 & 23. *See*, Examiners Schedule 1 attached at Tab 2.

<sup>126</sup> Atmos Exhibit 11, Wollitz Rebuttal, Exhibit CMW - R - 1, Examiners' Exhibit No. 22 & 23. *See*, Examiners Schedule 1 attached at Tab 2..

Tex fixed the price of 1 Bcf prior to October.<sup>127</sup> Table 10 summarizes the Examiners' findings.

**Table 10**  
**Amounts of alleged baseload contracts for which**  
**price was fixed prior to the Winter Season**  
**(Amounts in Bcf)**

Winter	Hedged Goal is 35% of Total Projected Requirements: Total Fixed Baseload	Price fixed prior to October	Price fixed prior to November
2000 - 2001	18.1 Bcf of 105.5 projected req.	1.4	19.9
2001 - 2002	22.8 Bcf of 109.1 projected req.	17.9	22.0
2002 - 2003	23.4 Bcf of 111.8 projected req.	1	6.4

Included in Table 10 above is an analysis of the quantities for which the price was fixed prior to November. As shown, in Winter 2000 - 2001 that amount was 19.9 Bcf, in Winter 2001 - 2002, that amount was 22.0 Bcf, and in Winter 2002 - 2003, that amount was 6.4 Bcf.<sup>128</sup>

In Winter 2000 - 2001, while certain prices were established prior to October, all volumes to be purchased do not appear to have been specified prior to that date. The pre-October, fixed-priced volumes identified by the Examiners were acquired pursuant to 34 baseload contracts.<sup>129</sup> Thirty-one of those contracts were identified in the Compliance Filing as lease dedication contracts. Contract 4926-00 identified the volume as "seller's pipeline output;" Contract 6614-00 identified the quantity as a full requirements contract for the cities of Lipan and Black Ranch; and, quantities under Contract 6723 - 00 also varied from month to month. In other words, the quantity to be delivered pursuant to those contracts was not known. Thus, the amounts expected to be delivered pursuant to those contracts was necessarily an estimate. As noted above, the Company's own witness indicated that in order to determine whether a transaction is a proper hedge, both the timing of the hedge and the quantity to be hedged must be specifically identified. Thus, the Examiners find that the quantities acquired through these baseload contracts cannot be classified as a hedge.

A similar circumstance occurs during the Winter 2002 - 2003. While the specific prices

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<sup>127</sup> Atmos Exhibit 11, Wollitz Rebuttal, Exhibit CMW - R - 1, Examiners' Exhibit No. 22 & 23. See, Examiners Schedule 1 attached at Tab 2..

<sup>128</sup> See, Examiners Schedule, 2 attached at Tab 3.

<sup>129</sup> 02298-00, 02298-01, 03250-01, 04201-00, 04304-00, 04646-00, 04751-00, 04794-00, 04862-00, 04926-00, 05138-00, 05164-00, 05165-00, 05171-00, 05185-00, 05192-01, 05469-00, 05812-00, 05817-00, 06043-00, 06072-00, 06177-00, 06311-00, 06461-00, 06479-00, 06479-22, 06480-00, 06481-00, 06481-05, 06482-00, 06487-00, 06488-00, 06614-00, and 06723-00.

were established prior to October, all volumes to be purchased do not appear to have been specified prior to that date. The pre-October, fixed-priced volumes identified by the Examiners were acquired pursuant to 15 baseload contracts.<sup>130</sup> Thirteen of those contracts were identified in the Compliance Filing as lease dedication contracts. In other words, the quantity to be delivered pursuant to those contracts was not known. As already noted, the volumes purchased pursuant to Contracts 6614 - 00 and 6723 - 00 also varied from month to month. Thus, the amounts expected to be delivered pursuant to those contracts was necessarily an estimate. Again, as noted above, the Company's own witness indicated that in order to determine whether a transaction is a proper hedge, both the timing of the hedge and the quantity to be hedged must be specifically identified. Thus, the Examiners find that those quantities cannot be classified as a hedge.

The middle winter, the Winter 2001 - 2002, presents a somewhat different circumstance. Again, while the specific prices were established prior to October 1, all volumes to be purchased do not appear to have been specified prior to that date. The pre-October 1, fixed-priced volumes identified by the Examiners were acquired pursuant to 20 contracts identified as Existing Contracts and 10 contracts identified as New Contracts.<sup>131</sup> Again, all of the Existing Contracts were identified in the Compliance Filing as lease dedication contracts. In other words, the quantity to be delivered pursuant to those contracts was not known. Thus, the amounts expected to be delivered pursuant to those contracts were necessarily an estimate. As noted above, the Company's own witness indicated that in order to determine whether a transaction is a proper hedge, both the timing of the hedge and the quantity to be hedged must be specifically identified. Thus, the Examiners find that those quantities cannot be classified as a hedge.

Table 11 revises the data found in Table 9 above to reflect the actual natural gas acquisitions that were known in both quantity and price — fully hedged — it is apparent that no gas acquisitions were actually hedged prior to October, in either the first winter, Winter 2000 - 2001, or the third winter, Winter 2002 - 2003. Only in the second winter, Winter 2001 - 2002, were any quantities of natural gas, acquired pursuant to baseload contracts, hedged prior to October. Prior to November, the Company fully hedged 18.1 Bcf in the first winter, 20.2 Bcf in the second winter, and 4.9 Bcf in the third winter. Thus, Table 11 summarizes the quantities of baseload contracts fully hedged.

**Table 11**  
**Amounts of alleged baseload contracts fully hedged prior to the Winter Seasons**  
**(Amounts in Bcf)**

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<sup>130</sup> 02298-00, 02298-01, 04304-00, 05812-00, 05817-00, 06461-00, 06479-00, 06480-00, 06481-00, 06481-05, 06482-00, 06487-00, 06488-00, 06614-00, and 06723-00.

<sup>131</sup> 02298-00, 02298-01, 03250-01, 04304-00, 04794-00, 05462-00, 05812-00, 05817-00, 06043-00, 06461-00, 06479-00, 06479-22, 06480-00, 06481-00, 06481-05, 06482-00, 06487-00, 06488-00, 06614-00, 06723-00, 07040-00, 07042-00, 07046-00, 07047-00, 07049-00, 07051-00, 07053-00, 07066-00, 07078-00, and 07082-00.

Winter	Hedged Goal is 35% of Total Projected Requirements: Total Fixed Baseload	Amount hedged prior to October	Amount hedged prior to November
2000 - 2001	18.1 Bcf of 105.5 projected req.	0	18.1
2001 - 2002	22.8 Bcf of 109.1 projected req.	16.6	20.2
2002 - 2003	23.4 Bcf of 111.8 projected req.	0	4.9

The Examiners find that the quantities of gas fully hedged (as to price and quantity), through baseload contracts and storage, prior to the winter season, assuming an October, cutoff, is 18.8 Bcf for Winter 2000 - 2001, 32 Bcf for Winter 2001 - 2002, and 15.7 Bcf for Winter 2002 - 2003. On the other hand, assuming a November cutoff, the amounts fully hedged (as to price and quantity), through baseload contracts and storage, prior to the winter season are 36.9 Bcf for Winter 2000 - 2001, 35.6 Bcf for Winter 2001 - 2002, and 20.6 Bcf for Winter 2002 - 2003. As a percentage of predicted demand, the amounts actually fully hedged, including storage, are described below in Table 12.

**Table 12**  
**Percentage of Projected Demand Fully Hedged as to**  
**Time and Volume prior to the Winter Seasons**

Winter	Projected Demand	Percentage fully hedged (Time and Volume) Prior to 10/01	Percentage fully hedged (Time and Volume) Prior to 11/01
2000 - 2001	105.5 Bcf	17.8%	35%
2001 - 2002	109.1 Bcf	33.3%	36%
2002 - 2003	111.8 Bcf	14.0%	18%

In conclusion, Atmos achieved its hedging goal in the first and second winter by hedging approximately 35 percent of its projected demand prior to the winter season, the period from November through March. In the final winter, Atmos did not achieve its hedging goals through seasonal hedges. Instead, Atmos Mid - Tex relied on post-November fixed-priced baseload requirements contracts and that decision will be analyzed below.

By arguing that Atmos Mid - Tex should have hedged volumes on a seasonal basis, the Intervenor allege that the Company has not established that it prudently implemented its hedging goals. As seen in Table 12 above, the Company achieved its goal through the use of seasonal hedges in the first and second winter. The only issue remaining is whether it was prudent to hedge prior to November, as appears to have been accomplished, or whether the Company should have hedged prior to October. Because Atmos relied on pre-November fixed-priced baseload requirements

contracts to achieve its hedging goals the prudence of the decision to hedge prior to November, and not October, must be evaluated for the first and second winter season.

iii. The Company's Decision to Enter into pre-November Hedges.

The Intervenors do not directly address, in the context of fixed baseload requirements contracts, exactly how early, prior to the winter season, a prudent manager should fix baseload requirements. In the context of financial hedges, Mr. Marshall testified that generally, the first and third quarters of the year experience the lowest prices.<sup>132</sup> Indeed, prices of natural gas in October are among the highest all year and prices generally peak on or before the first week of November.<sup>133</sup> He noted that there is a high probability for a very significant high during the fourth quarter.<sup>134</sup> In a newsletter issued by Mr. Marshall in July of 2000, and provided by Atmos Mid - Tex during the hearing, he noted that the period at the beginning of the third quarter had been, in two of the last three years, the period that "immediately preceded the traditional 3<sup>rd</sup> quarter low."<sup>135</sup> He also explained to his customers that the most consistent of seasonal tendencies since gas began trading at the NYMEX has been for gas prices to make a first quarter low, a second quarter high, a third quarter low, and a fourth quarter high.<sup>136</sup> Mr. Marshall testified at the hearing that since 1994, a significant price low has occurred in the middle of the summer to late summer.<sup>137</sup>

Mr. Pous made a similar observation, again in the context of financial hedges, noting that gas prices reach a low in the third quarter.<sup>138</sup> Mr. Pous stated that natural gas prices tend to follow cycles. Pricing lows can be observed during the third quarter or summer period of operations. Thus, if the Company were inclined to hedge its gas supplies, it could have been expected to establish the hedge sometime during the third quarter of the year prior to the upcoming winter heating season.<sup>139</sup> Thus, the Intervenor testimony suggests that a prudent manager would have hedged seasonal volumes prior to October.

Dr. Anderson does not agree that the natural gas market follows a cyclical pattern. He argues

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<sup>132</sup> ATM Exhibit 14, Marshall, Direct, p. 9, lns. 2 - 8.

<sup>133</sup> ATM Exhibit 14, Marshall, Direct, pp. 12, lns. 28 - 31, and p. 13, lns. 16 - 18.

<sup>134</sup> ATM Exhibit 14, Marshall, Direct, p. 19, lns. 29 - 31.

<sup>135</sup> Atmos Exhibit 19, p. 9 (July 2, 2000, Newsletter issued by Larry Marshall, p. 1).

<sup>136</sup> *Id.*

<sup>137</sup> ATM Exhibit 14 Marshall, Direct, p. 13, lns. 11 - 18.

<sup>138</sup> City of Dallas Exhibit 1, Pous Direct, p. 24, lns. 17 - 18.

<sup>139</sup> City of Dallas Exhibit 1, Pous Direct, p. 23, lns. 1 - 12.

that if such cycles existed, the rest of the industry would have noticed and arbitragers would have moved to eliminate any advantage that the cyclic patterns might provide. He argues that one might be able to select the absolute high in each quarter and the patterns observed by Mr. Marshall would be reversed.<sup>140</sup> In addition, through a lengthy and detailed cross-examination of Mr. Marshall, Atmos Mid - Tex established that even though cycles may exist, the precise high and low is difficult if not impossible to predict.<sup>141</sup> Nevertheless, the evidence provided by Atmos Mid - Tex on the cyclic nature of the natural gas market is contradictory.

Dr. Anderson provided data for NYMEX prompt month settlement prices from 1995 - 1999.<sup>142</sup> That schedule illustrates that in each of the five years surveyed, the lowest prompt month settlement occurred prior to the beginning of the winter season. In addition, the NYMEX Natural Gas Forward Curves provided by Dr. Anderson for March 2000, 2001, and 2002, clearly indicate that in March of each of those years the market expected a jump in prices before, or slightly before, the fourth quarter of each year.<sup>143</sup> Indeed, in the context of issues related to storage, discussed below, the Company acknowledges that historic trends suggest that on average April, at the beginning of the second quarter, had the lowest average price of any month during the season from April through October.<sup>144</sup> In addition, Mr. Beckman, who testified primarily on storage issues on behalf of the Company, acknowledged the cyclic nature of the natural gas market. He noted that traditionally, LDCs were buying gas at summer prices with the result that the LDC would enjoy a price advantage.<sup>145</sup> Thus, implicit in the Company's testimony is the recognition of the cyclic nature of gas prices.

It is also clear that if all volumes sought to have been hedged by the Company had been fixed at the average pre-October prices that Atmos Mid - Tex paid, the Company could have saved substantial amounts using an October cutoff and a November cutoff. This is established through an examination of the pricing patterns experienced by Atmos Mid - Tex during the Review Period. As can be seen from Examiners Schedule 6, attached at Tab 6, if Atmos Mid - Tex had paid the average pre-October fixed price, Atmos Mid - Tex could have saved \$59,324,592 in the first winter season, and \$28,433,245 in the third winter season. On the other hand, Atmos Mid - Tex would have paid an additional \$7,565,704 in the Second Winter season. In other words, prices that were fixed prior to the winter season were higher during that season than prices that were not fixed.

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<sup>140</sup> Atmos Exhibit 12, Anderson Rebuttal, p. 10, lns. 14 - 31.

<sup>141</sup> Tr. Vol. I, p. 170 - Tr. Vol. II, p. 82.

<sup>142</sup> Atmos Exhibit 12, Anderson Rebuttal, Exhibit ADA - R - 7.

<sup>143</sup> Atmos Exhibit 12, Anderson Rebuttal, Exhibit ADA - R - 8.

<sup>144</sup> *Initial Post-Hearing Brief of Atmos Energy Corp., Mid-Tex Division*, p. 54 - 55, Atmos Exhibit . 12 Anderson Rebuttal, p. 19.

<sup>145</sup> Tr. Vol, 4, p. 83, lns. 12 - 19.

Overall savings in that scenario during the Review Period would have been \$80,192,132.

The Examiners also found that substantial savings could have been achieved as well if Atmos Mid - Tex had fixed all volumes at pre-November 1, fixed prices. That analysis is found in Examiners' Schedule 7, at Tab 7. In that case, Atmos Mid - Tex would have saved customers \$12,671,691 in the first winter and \$39,289,690 in the third winter. The loss in the second winter would have been reduced to \$3,643,842. Again, prices that were fixed prior to the winter season were higher during that season than prices that were not fixed. By waiting until just prior to November, instead of October, Atmos Mid - Tex acquired better fixed prices than by fixing the price in October. Overall savings during the Review Period in that scenario would have been \$48,317,538. Table 13 summarizes the Examiners' findings:

**Table 13**  
**Potential Savings if all natural gas purchases had been made by**  
**Atmos Mid - Tex prior to the Winter Season**

	Potential Savings/Loss all prices fixed prior to October	Potential Savings/Loss all prices fixed prior to November
Winter 2000 - 2001	\$59,324,592	\$12,671,691
Winter 2001 - 2002	(\$7,565,704)	(\$3,643,842)
Winter 2002 - 2003	\$28,433,245	\$39,289,690
Total	\$80,192,132	\$48,317,538

The Examiners conclude from these data that one reasonable option for a prudent manager is to fix the price of natural gas prior to October. On the other hand, the data suggest that a reasonable option, based upon the data provided by Atmos Mid - Tex, would be for a prudent manager to fix the price of natural gas prior to November. The data for the second winter suggest that a prudent manager might opt to wait and fix prices prior to November, instead of October. In both scenarios it would have cost customers an additional amount in that middle winter to fix all gas costs prior to the winter season. In the November scenario, those costs were reduced. In addition, it was clearly established at the hearing that Atmos Mid - Tex uses a November through March winter season. Thus, a pre-November seasonal fix makes operational sense. Further, the GAO report defined the winter heating season as November 1 - April 1. Thus, it appears that the scenarios examined by the GAO assumed a November cutoff for seasonal hedges.<sup>146</sup> In addition, Mr. Pous, testifying on behalf of the City of Dallas, acknowledged that the winter season in Texas would

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<sup>146</sup> Atmos Exhibit 12, Exhibit ADA-R-1, GAO Report, pp. 38 & 56

normally be the December through March time frame.<sup>147</sup>

Once it is determined that pre-November seasonal hedges are prudent, it is clear that Atmos Mid - Tex achieved its own hedging goals, on a seasonal basis in the Winter Season 2000 - 2001 and Winter Season 2001 - 2002. As can be seen in Table 12 above, Atmos Mid - Tex did not achieve its hedging goals on a seasonal basis during the Winter Season 2002 - 2003. Atmos Mid - Tex necessarily achieved its hedging goal by fixing the price of gas to be delivered after November 1<sup>st</sup>, and by entering into monthly hedges. Accordingly, the prudence of monthly hedges and the decision to fix prices after the commencement of the winter season must be examined.

iv. The Company's Decision to Enter into post-November Fixed-Priced Contracts and Monthly Hedges.

As noted, Atmos Mid - Tex engaged in a practice of monthly hedges which Mr. Wollitz alleges protected customers from the monthly spot market prices. The Company also used several contracts containing self-executing provisions which were recalculated after the commencement of the winter season. Atmos Mid - Tex used a combination of these contracts in all three winters. It is only in the third winter, Winter 2002 - 2003, that it appears that Atmos Mid - Tex relied on monthly hedges and post-November fixed-priced contracts to achieve a substantial portion of its hedging goal.

The Company witnesses alleged that baseload contracts that were fixed on a monthly basis after the commencement of the winter seasons provided protection from the spot market and provided flexibility that would allow the Company to take advantage of buying opportunities.<sup>148</sup> The Intervenors alleged through cross-examination at the hearing and in briefing after the hearing that the practice of using post-November fixed-priced contracts and monthly hedges was not prudent.<sup>149</sup>

Documents provided by Atmos Mid - Tex prepared by the American Gas Association and the Government Accounting Office discuss long-term fixed-priced contracts and hedges. Those documents suggest that a prudent manager would engage in long-term fixed-priced contracts to avoid monthly changes in the natural gas market. A document prepared by the American Gas Association (AGA), and proffered by Atmos Mid -Tex at the hearing noted that long-term fixed-priced contracts can protect natural gas customers from volatility. The report described that LDCs often use multi-month gas supply contracts. Most of those contracts, however, were adjusted monthly and they move with the market. In contrast, fixed price contracts are stable, and that

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<sup>147</sup> City of Dallas Exhibit 1, p. 9, lns. 1 - 3.

<sup>148</sup> Atmos Exhibit 2, p. 8.

<sup>149</sup> See, *Initial Brief of the City of Dallas*, pp. 18 - 27, *Initial Brief of Atmos Cities Steering Committee*, pp. 2 - 9, and *Initial Brief of the Atmos Texas Municipalities*, pp. 22 - 25.



stability protects natural gas customers.<sup>150</sup>

An examination of the pricing data provided by the Company in its Compliance Filing indicates that, as a general matter, in two of the three years, the average November and pre-November prices were lower than post-November prices. First, data are in the record showing the price the Company paid for natural gas requirements through baseload contracts. The average price of gas paid by Atmos Mid - Tex in November of 2000 was \$4.47; in November of 2001, the average price of all baseload gas acquired by the Company was \$3.11; and in November of 2002, the average price of all baseload gas acquired by the Company was \$3.87.<sup>151</sup> In the first and third winters, these prices were lower than the price paid for gas acquired pursuant to contracts where the price was fixed after the winter season commenced. The second winter, the one with the lowest demand, is an exception. The average price that November was \$3.11, a price that is higher than the price paid for natural gas acquired through baseload contracts that were fixed on a monthly basis.

**Table 14**  
**Average Cost of Base Load Gas Acquired in November Compared to**  
**Average Cost of Gas Acquired throughout the Winter Season**

	2000 - 2001	2001 - 2002	2002 - 2003
Average Price paid by Atmos Mid - Tex for all baseload in November of each winter.	\$4.47	\$3.11	\$3.18
December	6.47	2.32	4.27
January	8.86	2.65	4.37
February	5.90	2.67	5.31
March	5.02	2.89	6.91

As can be observed from the above Table 13, the second winter, Winter 2001 - 2002, deviates from the pattern in the other winters. As seen in Examiners Schedule 7, attached at Tab 7 to this Proposal for Decision, in the second winter, the post-November fixed-price contracts were uniformly lower than prices for contracts that were fixed on a seasonal basis.

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<sup>150</sup> Atmos 66, *Avoiding the Wild Ride: Ways to Tame Natural Gas Price Volatility*, p. 1.

<sup>151</sup> See, Examiners Schedule 1, Tab 1.

Second, an examination of the individual contract summaries reveals that in several cases during the third winter, Winter 2002 - 2003, the price of gas in November, and prior to November was lower than the price of natural gas during the winter season. As an example, the contract summaries for the contracts identified as 7042 and 7091 provide the information contained in Table 15.

**Table 15**  
**Summaries of Contract 7042 and 7091**

	Contract No. 7042 (Price/MMBtu)	Contract No. 7091 (Price/MMBtu)
October, 2002	\$3.50	\$3.50
November, 2002	\$3.97	\$3.94
December, 2002	\$3.76	\$3.64
January, 2003	\$3.69	\$4.62
February, 2003	\$5.46	\$5.30
March, 2003	\$8.95	\$8.65

These contracts indicated that Atmos Mid - Tex had the right to convert to a fixed price for all or any portion of the gas. Atmos Mid - Tex decided not to fix all of the volumes purchased under these contracts. In November, it appears that the volumes could have been fixed around \$3.94 per MMBtu, pursuant to Contract No. 7091, and \$3.97 per MMBtu pursuant to Contract No. 7042. Thus, purchases in February and March would have been substantially lower. On the other hand, the purchases in December and January would have been lower than the November price.

The Examiners acknowledge that long-term hedges have the potential to minimize gas costs. The Examiners recognize, however, that long-term hedges provide no guarantee that gas costs will be minimized. It is true that the analysis provided by ACSC in its Initial Brief reveals that savings could have been garnered by fixing the cost of gas in the first and third winter. ACSC's analysis reveals, however, that fixed prices would have resulted in higher costs during the second winter: \$3,845,467 to \$7,280,926. Even the analysis provided by Mr. Pous, in the context of financial hedges, which will be addressed below, establishes a potential loss in the second winter if the Company had hedged its peaking gas requirements as suggested by the City of Dallas.<sup>152</sup>

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<sup>152</sup> City of Dallas Exhibit 1, Pous Direct, Schedule JP - 5, evidencing a potential loss of \$16,071,743 during the second winter, Winter 2001 - 2003, if the recommendation of the City of Dallas regarding financial hedging had been adopted.

While the analysis in Table 13, at page 44 above, suggests that the Company could have saved a substantial amount in this Review Period by fixing all of its gas costs at the prices it was able to acquire prior to the winter season, it is equally clear, as evidenced by the second winter, that fixing the price, while having the potential to lead to lower gas costs, does not guarantee lower costs. If Atmos Mid - Tex had fixed the price of all the gas it acquired at its pre-November fixed-priced contract prices, it would have resulted in higher costs during the second winter. As noted above, a hedging program does not guarantee a lower price — a fact conceded by Mr. Pous.<sup>153</sup> The GAO has noted as follows:

Hedging does not, however, ensure that a utility company will pay the lowest possible price for future natural gas purchases: It simply provides stable gas prices and protection against price spikes such as the one that occurred in 2000 - 2001. Hedging may result in the utility company paying natural gas prices that are higher or lower than the prevailing market price.<sup>154</sup>

A consistent application, over time, will likely result in an overall evening out of losses and gains as discussed in the GAO report.

The GAO report, relied upon by the Company for the proposition that hedging does not guarantee lower prices, prepared a study that compared the results of a utility that hedged all of its baseload and a utility that did not hedge any of its baseload. The result was that the utility with a hedging strategy would have had net savings over the spot market price in gas purchase costs for some winter seasons and losses for others. In fact, the overall average price paid for gas under the two scenarios was virtually the same.<sup>155</sup>

The Examiners find that a mix of long-term hedges and short-term hedges is reasonable. While a program that relies entirely on hedges entered into prior to October or November, may also be reasonable, the Company's experience in the second winter reveals that there are prudent reasons to maintain a mix of long-term hedges and short-term hedges. While Examiners' Schedules 6 and 7 suggest that a potential savings could have been achieved had the Company engaged solely in long-term fixed-priced contracts during the Review Period, they also reveal that in the second winter, long-term fixed-priced contracts would have resulted in added costs.

The overall savings or costs during the Review Period, however, may be misleading. In relative terms, the Review Period comprises a small sampling to evaluate the hedging program on a long-term basis. The GAO report evaluated a hypothetical over a substantial period of time — ten years. The data presented in this Review Period is over a significantly shorter period of time —

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<sup>153</sup> Tr. Vol. 2, p. 113, lns. 11- 22.

<sup>154</sup> Atmos Exhibit 12, Exhibit ADA-R-1, GAO Report, p. 35.

<sup>155</sup> Atmos Exhibit 12, Exhibit ADA-R-1, GAO, pp. 37 - 39.

three years. The GAO report suggests that if the Company's procurement plan is evaluated over a longer period of time, the result would be neutral. As suggested by the GAO report, consistent application of a buying methodology should result in no overall long term gain or loss.

Thus, the Examiners conclude that a consistent prudent approach is required in order to achieve the results observed in the GAO study. Absent a change in market conditions or some other factor that would impact the decision of a prudent manager, a prudent manager should apply a consistent hedging strategy that utilizes sound gas procurement strategies. In this case, Atmos Mid - Tex engaged in a major shift during the third winter, Winter 2002 - 2003, that resulted in a greater reliance on short-term post-November fixed-priced contracts to achieve its hedging goals.

v. The Company's Change in Methodology in the Second Winter.

Atmos Mid - Tex appears to have changed its methodology in the third winter, Winter 2002 - 2003. Atmos Mid - Tex fixed approximately 71 percent of its hedged baseload requirements prior to November 1<sup>st</sup> of the first and second winters. In the third winter, however, Atmos Mid - Tex only fixed 21 percent prior to the winter season. A summary of the change is provided in Table 16 below.

**Table 16**  
**Percentage of Volume Fixed Prior to Winter Season**

	Percentage Fixed Prior to Nov. 1	Percentage Fixed After Nov. 1
Winter 2000 - 2001	71%	29%
Winter 2001 - 2002	72%	28%
Winter 2002 - 2003	21%	79%

The change in methodology is evident from Mr. Wollitz' rebuttal testimony in which he revealed that the Company attempted to meet its hedging goals through Existing Contracts and New Contracts. In the first and second winters the Company planned to rely on 5.5 Bcf and 5.7 Bcf of Existing Contracts to achieve that goal. In the final winter, however, Atmos Mid - Tex appeared to rely on only 1.9 Bcf of Existing Contracts. In addition, while the monthly fixed-priced contracts (Prompt Month Settlement Contracts) did not play a role in the first winter, almost all of the New Contracts are Prompt Month Settlement contracts in the third winter. Atmos Mid - Tex gave no explanation for that change.

The shift is evident from an examination of the individual contracts. Contract 7042, for example, is puzzling because the summary provided by Atmos Mid - Tex appears to show the shift in the decision making of the Company at the individual contract level. In the prior winter, Winter 2001 - 2002, Atmos fixed the price in November at \$3.97 per MMBtu from November through March. Yet in the following winter, Winter 2002 - 2003, Atmos chose to fix only a portion of all

of the volumes purchased pursuant to that contract.

Total gas costs during the third year pursuant to contracts alleged to be hedged by Atmos Mid - Tex were \$142,579,208. If the Company had applied the same ratio of pre-November fixed-priced contracts to post-November fixed-priced contracts in the last winter season, the total costs would have been \$127,143,109. In other words, Atmos Mid - Tex incurred an additional \$15,436,099 by changing its methodology in that third year.<sup>156</sup> The GAO's finding that hedging will result in neither an overall gain nor loss, is premised on the proposition that the hypothetical utility engages in a *consistent* hedging policy. Of course, there may be prudent reasons to deviate from the hedging policy, but none has been provided in this case. The Examiners find that this sudden change in methodology was imprudent and recommend that the excess costs incurred by that change be disallowed.

(G) *Use of Financial Hedging Instruments.*

As already noted, several Intervenors maintain that a prudent manager would have engaged in financial hedging. At a minimum, they claim a prudent manager would have considered the impact that financial hedging could have on both price volatility mitigation and overall cost mitigation for purchases of natural gas. Atmos Mid - Tex maintains that hedging goals may be accomplished through physical hedging as well as financial hedging. Thus, the Company had no need to enter into a financial hedge. Furthermore, the current tariff did not allow for the recovery of costs related to financial hedging. Costs associated with using financial hedging instruments include premiums to be paid in certain instances and potential losses. The pass through of those costs would not be permitted by the purchase gas adjustment clause.<sup>157</sup>

The Intervenors first point out that Atmos Mid - Tex could not assess whether or not a financial hedging program could benefit the Company's customers since no one on the Atmos staff of the Company was familiar with financial hedging. Mr. Marshall testified that while some hedging may be accomplished through physical hedging, the Company should have engaged in a more aggressive system of hedging and engaged in financial hedges as well. Mr. Marshall maintains that the Company could have engaged in a hedging strategy, using both physical and financial mechanisms, to achieve substantial savings to his customers. Mr. Marshall argued that Atmos Mid - Tex should be required to conduct a study of the use of financial hedging techniques and acquire an expertise in implementing appropriate financial hedges with the objective of reducing their weighted average cost of gas and price volatility.

Furthermore, Mr. Pous argued that affiliates of the Company actively engaged in financial

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<sup>156</sup> See, Examiners Schedule 8 attached at Tab 8.

<sup>157</sup> Tr. Vol. 2, pp. 119 - 120.

hedging. TXU Electric and TXU Energy employed financial hedging.<sup>158</sup> In addition, prior to purchasing TXU Gas Corporation, Atmos Energy Corporation employed financial hedging.<sup>159</sup> Mr. Pous points out that the GAO report found that forty-two of the state utility regulatory agencies allowed the use of financial futures as a cost stabilization tool.<sup>160</sup> In addition, evidence in the record was presented to suggest that some analysts believe that purchasing options is the best way for gas utility companies to hedge against possible price increases, because the utility holding an option is protected against possible increases in the price of gas, but at the same time has the ability to participate in any downward changes in price.<sup>161</sup>

The Intervenors also argue that the tariff provisions allow the recovery of costs associated with the use of financial hedging instruments. Furthermore, the interpretation of the tariff provisions should not limit a company's consideration of prudent alternatives. Mr. Marshall testified that the Company failed to employ financial hedging techniques because company officials were more concerned with shareholder cost recovery than price mitigation.<sup>162</sup> Further, the Intervenors argue that it is incumbent on the utility to prudently explore management options despite the applicable tariff. If a prudent manager determines that a tariff provision should be changed in order to engage in a prudent management practice, the Company should seek that change. Mr. Pous testified that the Company's concern regarding the tariff provisions in no way diminished the Company's responsibility for retaining reasonably priced gas on behalf of customers, nor does it change the fact that the Company failed to prudently follow practices employed by other utilities. If the Company was of the opinion that it could not recover the costs associated with financial hedging the Company should have approached the regulatory authorities to clarify or change the tariff.<sup>163</sup>

Finally, Staff of the Railroad Commission recommend that all forms of non-speculative hedging be authorized in the future. Staff recommends that the Company's gas cost recovery mechanism contain specific language allowing all forms of hedging, both physical and financial, "with specific guidelines, warnings and limitations."<sup>164</sup> As already noted, it is the Staff's position that physical hedging is one of the portfolio choices available to a utility. It is a more certain, more reliable, less risky fuel supply portfolio choice when compared to financial hedges. Staff recommends, nevertheless, that the Company's purchase gas adjustment clause be clarified to allow

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<sup>158</sup> City of Dallas Exhibit 1, Pous Direct, p. 19, Ins. 11 - 18.

<sup>159</sup> City of Dallas Exhibit 1, Pous, Direct, p. 19, Ins. 20 - 24.

<sup>160</sup> City of Dallas Exhibit 1, Pous Direct, p. 20, Ins. 4 - 9.

<sup>161</sup> Atmos Exhibit 12, Anderson Rebuttal, Exhibit ADA - R - 1, GAO Report, p. 37.

<sup>162</sup> ATM Exhibit 14, Marshal, Direct, p. 15 - 16

<sup>163</sup> City of Dallas Exhibit 1, Pous Direct, p. 28, Ins. 1 - 19.

<sup>164</sup> *Staff's Initial Brief*, p. 4.

it to use all types of hedging in future years, including financial hedging instruments, with the understanding that the reasonableness and prudence of the Company's hedging practices be subject to review and potential refund in subsequent proceedings.<sup>165</sup> Although not specifically stated by Staff, Staff's recommendation implies that it agrees that the current purchase gas adjustment clause found in the tariffs filed pursuant to GUD No. 9400, and the prior purchase gas adjustment clause did not allow for the recovery of costs associated with the purchase gas adjustment clause.<sup>166</sup>

Mr. Wollitz testified that it was his opinion that the gas cost recovery mechanism did not allow for the recovery of costs association with financial hedging.<sup>167</sup> Mr. Wollitz also testified that while the Company does not trade financial futures, the process the Company uses to fix the price of a significant portion of its physical supplies does make use of the futures market. Most of the baseload supply on which the Company has fixed the price is bought on a futures-based price. For example, the Company may choose to fix the price under a baseload contract on 10,000 MMBtu per day for the months of December, January, and February. Under a baseload contract in which the Company has the right to establish a fixed price, the Company may select the futures price for December through February, less the basis differential between Henry Hub and the Houston Ship Channel ("the Henry Hub/HSC Basis Differential"), and less the applicable discount per MMBtu negotiated in the contract.<sup>168</sup>

At the time the Company elects to lock in a price, it will gather market price information, for example, the current futures prices for December, January, and February at Henry Hub, and then Henry Hub/HSC Basis Differential for the relevant time period. The Company and supplier would then attempt to agree on a final fixed price. For example, Mr. Wollitz described the process as follows: If the December through February futures average were \$5.50/MMBtu, the Henry Hub/HSC Basis Differential for the same time period were (\$0.25)/Mmbtu and the negotiated discount in the contract were (\$0.15)/MMBtu, then a final price may be calculated as follows:

- \$5.50 NYMEX Average December - February Price
- (\$0.25) Henry Hub/HSC Basis Differential
- (\$0.15) Discount per MMBtu in the applicable contract
- \$5.10 Final Fixed Price

In short, while Atmos Mid - Tex does not trade financial instruments, Mr. Wollitz maintains that the

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<sup>165</sup> *Id.*

<sup>166</sup> Tr. Vol. IV pp. 236 - 237.

<sup>167</sup> Atmos Exhibit 11, Wollitz Rebuttal, p. 23, Ins. 1 - 15 & p. 26 Ins. 10 - 13.

<sup>168</sup> Atmos Exhibit 11, Wollitz Rebuttal, p. 23, Ins. 16 - 27.

Company relies on the futures markets for price discovery and in determining the price of the fixed price contract.<sup>169</sup>

Mr. Wollitz asserted, in response to Mr. Marshall's allegation that the Company was more interested in shareholder cost recovery than price mitigation, that financial hedging was only one way, but not the only way, to establish a fixed and known price for natural gas purchases. Atmos chose to fix a portion of its natural gas requirements through the price of its baseload supplies through contacts and using storage withdrawals.

Mr. Wollitz testified that the reason Atmos did not engage in financial hedging is because Atmos already had a robust physical hedging program. Physical hedging is one mechanism by which a utility may protect itself from increases in future prices. As the name implies it is one of the avenues by which the price of a resource may be hedged. Further, the GAO Report identified it as one method of achieving a utility's hedging goals. Hence there was no need to engage in financial hedging.<sup>170</sup> Mr. Wollitz also points out that a hedging strategy does not guarantee a lower price.<sup>171</sup>

The Examiners find that both physical and financial hedging may be utilized to achieve a company's hedging goals. The Examiners also find that a prudent manager cannot assess the potential value of financial hedging without training, knowledge, and experience. Atmos Mid - Tex has admitted that its employees are not trained in financial hedging techniques. The Examiners acknowledge that most regulatory agencies that allowed or encouraged the use of hedging favored the use of physical hedging tools over financial tools.<sup>172</sup> Nevertheless, a prudent manager would base their decision upon an informed analysis of the potential harms and benefits of a certain course of action. Accordingly, the Examiners recommend that Atmos Mid - Tex engage in a study of the use of financial hedging techniques and acquire in-house expertise or engage a consultant to advise on, implementing appropriate financial hedges. As noted above, however, the Examiners find that Atmos Mid - Tex made no formal evaluation of the use of financial hedging. Thus, the utility has not established that financial instruments could not be used to dampen the effect of price fluctuations. The Examiners find, however, that the tariff does not allow the recovery of expenses associated with financial hedging instruments. If, after acquiring the necessary expertise to fully evaluate financial hedging techniques, Atmos Mid - Tex concludes that financial hedging may provide further price stability and potential cost savings to customers, the Examiners recommend that the Company be directed to file a Statement of Intent indicating the potential change to its tariff. The Examiners recommend that Staff be directed to intervene in such a proceeding in order to

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<sup>169</sup> Atmos Exhibit 11, Wollitz Rebuttal, p. 23, Ins. 28 - 30 & p. 24, Ins. 1 - 13.

<sup>170</sup> Atmos Exhibit 11, Wollitz Rebuttal, p. 27, Ins. 4 - 29.

<sup>171</sup> Atmos Exhibit 11, Wollitz Rebuttal, p. 27, Ins. 33 - 34.

<sup>172</sup> Atmos Exhibit 12, Anderson Rebuttal, Exhibit ADA-R-1, GAO Report, p. 44



recommend specific guidelines, warnings, and limitations.

*(H) Financial Hedging Alternatives to Swing and Peaking Contracts*

As discussed in section IX above, swing and peaking contracts were part of the Company's winter gas acquisition plan. The City of Dallas and ATM question the Company's policy with regard to these contracts. During the first winter, Atmos planned to meet the natural gas requirements of its customers by acquiring 13.1 percent of the gas supply needs through swing and peaking contracts; during the second and third winter periods, Atmos planned to acquire 9.4 percent of its gas supply requirements through those contracts. ATM argues that Atmos' swing purchases and peaking purchases were not prudent and should be disallowed.<sup>173</sup> As a result of the Company's gas purchasing practices, ATM alleges that customers paid unreasonably higher gas costs than necessary.

During the Review Period, Atmos purchased 11,568,404 MMBtu pursuant to its various peaking contracts at a cost of \$77,659,201. Atmos also purchased 40,826,316 MMBtu of gas pursuant to its swing contracts at a cost of \$242,704,201. ATM argues that the total amount for swing and peaking purchases, \$320,363,442 was in excess of what a prudent manager should have spent. ATM argues that a prudent manager's gas purchases during the Review Period should have been within the range of \$277,782,935 to \$293,617,186. Thus, ATM alleged that the imprudent purchases resulted in excess gas costs during the Review Period that ranged between \$26,746,259 to \$42,580,510.

Mr. Marshall argues that relying on swing and peaking contracts and restricting hedging activity to 35 - 40 percent of anticipated winter season demand instead of, for example, to the level of least historical demand is speculation.<sup>174</sup> Mr. Marshall recommends, therefore, that 100 percent of anticipated demand, whether baseload, peaking, or swing, be locked in. His impression of the gas supply plan is that it is deemed preferable to rely on purchase mechanisms with variable takes than to commit to too much gas. His recommendation, however, would be the opposite. The demand base would be better served by committing to an excess of gas. In order to accomplish this, Mr. Marshall recommends that base load should be increased. Importantly, he notes that this assures that base load purchases would be made consistent with the demonstrated seasonal price lows. The increased base load should be complemented with financial hedges to smooth out the impact of the

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<sup>173</sup> ATM's allegation call into question the prudence of the following swing contracts: 06680-00, 07029-00, 07067-00. The prudence of the following peaking contracts were challenged by ATM: 07014-00, 07015-00, 07016-00, 07018-00, 07020-00, 07022-00, 07024-00, 07025-00, 07026-00, 07028-00, 07031-00, 07033-00, 07036-00, 07059-00, 07060-00, 07061-00, 07062-00, 07063-00, 07064-00, 07065-00, 07069-00, 07071-00, 07072-00, 07074-00, 07075-00, 07076-00, 07077-00, 07081-00, 07103-00, 07106-00, 07107-00, 07108-00, 07109-00, 07110-00, 07111-00, 07112-00, 07113-00, 07116-00, 07117-00, 07118-00, 07119-00, 07120-00, and 07123-00.

<sup>174</sup> ATM Exhibit 1, Marshall Direct, p. 19, Ins. 11 - 16.

likelihood of increased spot purchases and more efficient use of storage withdrawals.<sup>175</sup>

Dr. Anderson testified that Mr. Marshall did not explain how the Company would have the ability to purchase the additional supplies at the price proposed by Mr. Marshall. In addition, he notes that Mr. Marshall readily admits that his proposed recommendation would require the Company to buy gas in quantities that greatly exceeded the baseload needs of its customers. The utility would be required to sell the excess gas that Mr. Marshall proposes should be locked in. Mr. Marshall does not make any allowance for the loss, if the Company is required to sell the gas at a lower cost. And Mr. Marshall does not account for the cost associated with trading the amounts of natural gas proposed by Mr. Marshall. Finally, Dr. Anderson testified that the types of contracts that Mr. Marshall declares imprudent were reviewed in the previous prudence review and were found to be prudent. Dr. Anderson concludes that the peaking and swing contracts represent a prudent way to deal with peak demand for human needs customers.<sup>176</sup> Further, Dr. Anderson maintains that if a utility hedges beyond its base-load requirement, it is speculating.<sup>177</sup>

Mr. Beckman also testified in an effort to establish that Mr. Marshall's proposal is not consistent with industry practice because it would not be cost-effective. He cites the example of a Midwestern utility and points out that a utility in that circumstance would not obtain a baseload contract at an amount equal to the amount required for peak day usage, what he refers to as maximum sendout. Instead, that utility would distribute its contracts, selecting from different types of services, including baseload, seasonal, swing, peaking, and storage.<sup>178</sup>

The Examiners find that the peaking and swing contracts engaged in by Atmos Mid - Tex represent one prudent method to deal with peak demand. Further, as noted by Dr. Anderson, these types of contracts were reviewed by the Intervening parties in the prior prudence review. The Examiners find that the Company established that its practice, with regard to peaking and swing contracts, is consistent with the practice of other market participants. It was not established that other LDCs engaged in recommendations that paralleled Mr. Marshall's recommendation with regards to swing and peaking contracts. While the use of financial instruments to mitigate price volatility, or to attempt to reduce gas costs for these categories of contracts, may be prudent, the Company has met its burden that its practice was also prudent. As noted above, the prudence standard does not require perfection.

In addition, the Examiners note that Mr. Marshall's recommendation may lead to the acquisition of natural gas that is not required in the winter season. Regardless of whether the tariff

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<sup>175</sup> ATM Exhibit 1, Marshall Direct, p. 23, Ins. 1 - 13.

<sup>176</sup> Atmos Exhibit 12, Anderson Rebuttal, p. 25.

<sup>177</sup> State of Texas Exhibit 1, Higgins Direct, Tab 15 (Deposition of Alan D. Anderson, p. 46, Ins. 9 - 16).

<sup>178</sup> Atmos Exhibit 9, Beckman Rebuttal, p. 5, Ins. 25 - 31 & p. 6, Ins. 1 - 5.

allowed the recovery of costs associated with financial hedging instruments, the Examiners point out that *Gulf States Utilities v. PUC of Texas*, 841 S.W.2d 459 (Tex. App. — Austin, 1992) (Gulf States), suggests that resultant costs from the acquisition of excess capacity would be found to be imprudent. In that case, the dispute arose because Gulf States, an electric utility, sought to recover its capacity costs. The Public Utility Commission disallowed those expenses because it found that Gulf States knew or should have known that it did not need the capacity in order to meet its future requirements.<sup>179</sup> The Public Utility Commission's decision was ultimately upheld by the Austin Court of Appeals.

(I) *Financial Hedging Alternative to Peaking contracts*

The City of Dallas argues that Atmos Mid - Tex could have substantially reduced the costs associated with peaking gas supplies through the use of futures or options contracts. Futures are contracts that are traded on the NYMEX. Futures represent a financial transaction at a set price between a party willing to pay a set price for gas and another party willing to guarantee that price at a stated point in the future. Thus, as described by Mr. Pous, a company could purchase futures contracts on the NYMEX guaranteeing a price of \$4.00 per MMBtu for gas delivered during the months of December through March of the upcoming winter period.<sup>180</sup>

Mr. Pous points out that the buyers of futures do not normally take delivery of gas but use such financial instruments to set a specific price for gas in the market corresponding to the time frame of the futures contract. In the example above, if the Company were to have entered into a futures contract for \$4.00 per MMBtu for delivery in December, and the price of gas had actually reached \$5.00 per MMBtu in December, Atmos Mid - Tex would, in effect, obtain \$1.00 per MMBtu for its futures. In order to obtain delivery of gas, the Company would have to actually go into the market place and pay \$5.00 per MMBtu for the gas it needed. Even though the Company was required to pay \$5.00 per MMBtu for gas, since it acquired \$1.00 per MMBtu on the futures contracts held by the Company, gas would have been acquired for a net amount of \$4.00 per MMBtu.<sup>181</sup> Conversely, if the price of gas dropped to \$3.00 per MMBtu, Atmos Mid - Tex would have had to pay \$1.00 per MMBtu on the gas futures contracts held. The result, is that Atmos Mid - Tex would have had to pay \$4.00 per MMBtu to acquire its natural gas supplies at a time when the price for the supply was \$3.00 per MMBtu.<sup>182</sup>

Mr. Pous explained that options represent a financial instrument bought for a premium in a financial market that give the utility the right but not the obligation to purchase gas at a certain price

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<sup>179</sup> *Gulf States*, 841 S.W.2d 459, 461.

<sup>180</sup> City of Dallas Exhibit 1, Pous Direct, p. 17, lns. 25 - 31.

<sup>181</sup> City of Dallas Exhibit 1, Pous Direct, p. 18, lns. 1 - 9.

<sup>182</sup> City of Dallas Exhibit 1, Pous Direct, p. 18, lns. 1 - 12.

during some future period. Whether the Company exercises its options, it would still have to pay the premium demanded by the financial market for the option at a given price for a particular future period.<sup>183</sup>

Mr. Pous explained further that pursuant to its peaking contracts, the Company purchased anywhere from 11.8 million MMBtu to 15 million MMBtu during each of the three winter heating seasons of the Review Period. The total for the three winter heating seasons was 40.8 million MMBtu at a cost of \$242.7 million, or \$5.94 per MMBtu.<sup>184</sup> Mr. Pous testified that the Company could have garnered substantial savings had Atmos Mid - Tex employed the purchase of either futures or options. As already noted, the Intervenors observed that historical price patterns and cycles reveal that typically natural gas prices reach a low in the third quarter after establishing a higher price during the second quarter of each year.<sup>185</sup> Using this information, Mr. Pous argued that the Company should have had a methodology in place to determine a buying opportunity in that quarter. Mr. Pous suggested that the Company examine third quarter prices for a noticeable increase. He suggested that an increase of five percent would be a reasonable indicator that prices have reached a low and are beginning to increase. He pointed out that there is no certainty prices will not decline further, however, a substantial jump in prices suggests prices have reached, and passed, the lowest point.<sup>186</sup> Mr. Pous argued that if this methodology had been applied throughout all three winter periods, Atmos Mid - Tex could have saved \$73,026,255. During the first winter, Winter 2000 - 2001, Atmos Mid - Tex would have saved \$35,618,719. During the second winter, Winter 2001 - 2002, Atmos Mid - Tex would have actually spent more for gas — an additional \$16,071,744. In the third winter, Atmos Mid - Tex would have saved \$73,026,255.<sup>187</sup> Finally, Mr. Pous made an adjustment to reflect interest on the amounts that were alleged to have been spent in excess of what was reasonable and necessary.<sup>188</sup>

Dr. Anderson argued that the recommendations by Mr. Pous are speculative. He argued that while peaking purchases are known fairly well over the course of a season, they are not known from day to day or even month to month. He pointed out that gas futures contract are based on monthly purchases, not on daily purchases. Since peaking purchases are daily purchases, the volumes being hedged do not correspond to the volumes specified in the hedging instruments. Mr. Pous divided peaking purchases equally across each day of the winter season, contrary to the normal pattern of peaking purchases. Dr. Anderson argued further that the prices contained in peaking contracts do

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<sup>183</sup> City of Dallas Exhibit 1, Pous Direct, p. 18, Ins. 14 - 20.

<sup>184</sup> City of Dallas Exhibit 1, Pous Direct, p. 23, Ins. 19 - 25.

<sup>185</sup> City of Dallas Exhibit 1, Pous Direct, p. 24, Ins. 12 - 25.

<sup>186</sup> City of Dallas Exhibit 1, Pous Direct, p. 25, Ins. 6 - 18.

<sup>187</sup> City of Dallas Exhibit 1, Pous Direct, p. 25, Ins. 27 - 31 & p. 26, Ins. 1 - 9, Schedule JP - 1.

<sup>188</sup> City of Dallas Exhibit 1, Pous, Direct, p. 30, Ins. 19 - 23.

not correlate with the monthly prices contained in the futures contracts. As a result Dr. Anderson concluded that the recommendation of Mr. Pous is speculative and fails to qualify as a hedge.<sup>189</sup> Dr. Anderson argued that the recommendation proposed by the City of Dallas would increase the risk to the Company and Ratepayers. The risk involved has two aspects. First, the price may decline and be lower than the amount of the futures contract. Second, depending on the weather, the utility may not be required to purchase any peaking gas.<sup>190</sup>

Dr. Anderson also argued that Mr. Pous misstates the practices of regulated utilities with respect to futures trading. He acknowledged that a report prepared by the GAO indicated that there appears to be an increasing acceptance to the idea of using financial instruments as hedging tools. Nevertheless, the GAO noted that the regulatory agencies favored the use of physical hedging tools over financial tools. Thus, Dr. Anderson concluded that it could hardly be considered imprudent of the Company to favor physical hedges and storage when those appear to be the preferred methods of hedging for the industry.<sup>191</sup> Dr. Anderson repeated his criticism noted above that hedging, whether financial or physical, is not intended to reduce costs. Instead, hedging is a tool for reducing price volatility. While buying futures contracts pays off in some years, it does not in others. The overall result is only known in retrospect.<sup>192</sup> Finally, Dr. Anderson argued that it is impossible to time the market.<sup>193</sup>

The Examiners find that the peaking contracts engaged in by Atmos Mid - Tex represent one prudent method to deal with peak demand. Further, as noted by Dr. Anderson, these types of contracts were reviewed by the Intervening parties in the prior prudence review. The Examiners conclude that the Company established that its practice with regard to peaking and swing contracts is consistent with the practice of other market participants. It was not established that other LDCs engaged in recommendations that paralleled Mr. Pous's recommendation with regard to swing and peaking contracts.<sup>194</sup> While the use of financial instruments to mitigate price volatility or to attempt to reduce gas costs for this category of contracts may be prudent, the Company has met its burden of showing that its practice was also prudent. As noted above, the prudence standard does not require perfection.

(J) *Financial Hedging to Provide a Cap on all Gas Costs.*

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<sup>189</sup> Atmos Exhibit 12, Anderson Rebuttal, p. 7, Ins. 14 - 31.

<sup>190</sup> Atmos Exhibit 12, Anderson Rebuttal, p. 8, Ins. 1 - 15.

<sup>191</sup> Atmos Exhibit 12, Anderson Rebuttal, p. 20, Ins. 17 - 31 & p. 21, Ins. 1 - 8.

<sup>192</sup> Atmos Exhibit 12, Anderson Rebuttal, p. 21, Ins. 9 - 15.

<sup>193</sup> Atmos Exhibit 12, Anderson Rebuttal, p. 21, Ins. 16 - 23.

<sup>194</sup> Tr. Vol. 2, p. 108 - 109.

Mr. Niemiec, testifying on behalf of ACSC, argued that Atmos Mid - Tex did not have a robust supply plan that had as its paramount goal the securing of reliable gas supplies at the lowest reasonable costs.<sup>195</sup> Mr. Niemiec argued that the gas supply portfolio should be divided into two broad goals. On the one hand, a combination of gas supply sources should be protected from high prices through fixed prices and price caps. On the other hand, certain gas supply sources should be structured to allow the utility to benefit from lower prices if the market is weak. He proposed a gas supply portfolio, for the Company's entire gas supply requirement, that was divided as follows:

- 1/3 at a fixed price
- 1/3 with price caps
- 1/3 left floating

The fixed price sources would be protected from high prices. The floating contracts that were floating would benefit from lower prices if the market is weak. Gas supply sources with price caps would serve a dual purpose. Those sources would be protected from high prices, presumably prices that were above the cap. At the same time, because those supply sources were capped, the Company would be in a position to take advantage of prices that were below the cap.<sup>196</sup> Mr. Niemiec and Mr. Nalepa alleged that Atmos could have saved \$144 million if such a plan had been adopted during the review period.<sup>197</sup>

Mr. Wollitz argued that the \$6.50 per MMBtu price cap is arbitrary and no support is provided to indicate why that supposed cap is logical.<sup>198</sup> He also noted that Mr. Niemiec did not mention the cost that the Company would necessarily incur to establish the supposed price caps.<sup>199</sup> Dr. Anderson argued that Mr. Niemiec provided no basis for his recommendation and did not suggest how it would be implemented. As he has already noted, hedging is a matter of preference and not an issue related to prudence.

The Examiners find that the peaking and swing contracts engaged in by Atmos Mid - Tex represent one prudent method to deal with peak demand. Further, as noted by Dr. Anderson, these types of contracts were reviewed by the Intervening parties in the prior prudence review. The Examiners find that the Company established that their practice with regard to peaking and swing contracts is consistent with the practice of other market participants. It was not established that other LDCs engaged in recommendations that paralleled Mr. Niemiec's recommendation with

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<sup>195</sup> ACSC Exhibit 2, Niemiec Direct, p. 5, Ins. 16 - 22 & p. 8, Ins. 1 - 4.

<sup>196</sup> ACSC Exhibit 2, Niemiec Direct, p. 8, Ins. 10 - 24.

<sup>197</sup> ACSC Exhibit 2, Niemiec Direct, p. 10, Ins. 5 - 9.

<sup>198</sup> Atmos Exhibit 11, Wollitz Rebuttal, p. 24, Ins. 15 - 30 & p. 25, Ins. 1 - 3

<sup>199</sup> Atmos Exhibit 11, Wollitz Rebuttal, p. 24, Ins. 27 - 29.

regards to swing and peaking contracts.<sup>200</sup> During the hearing Mr. Niemiec testified that he was not aware of any LDC that has adopted this approach.<sup>201</sup> While the use financial instruments to mitigate price volatility, or to attempt to reduce gas costs for all categories of contracts may be prudent, the Company has met its burden of proving that its practice was also prudent. As noted above, the prudence standard does not require perfection.

*c. Storage*

Atmos Pipeline - Texas (formerly TXU Lone Star Pipeline) operated eight natural gas storage facilities in Texas during the Review Period: Bethel, LaPan, Lake Dallas, Hill Lake, New York City, Tri-Cities (Bacon), Tri-Cities (Rodessa), and Pecan Station. The Bethel facility is a salt dome storage facility; the other storage facilities are depleted oil and gas reservoirs.<sup>202</sup> Atmos Pipeline - Texas previously took the Pecan Station facility out of service, and that decision is not at issue in this case.

The storage facilities are located near the market areas and were developed to be used primarily as pressure and supply support, in the form of deliverability, necessary to maintain service during higher demand periods.<sup>203</sup> Mr. Wollitz testified that storage was used for three primary purposes. First, storage withdrawals occur to meet unexpected demand.<sup>204</sup> Second, Atmos Mid - Tex turns to storage to meet demand in the event of a temperature forecasting error.<sup>205</sup> Third, storage withdrawals are used to meet demand over weekend or holiday periods.<sup>206</sup> The use of the storage facilities between Atmos Pipeline - Texas and Atmos Mid - Tex is governed by a Transportation and Storage Service Agreement, dated October 28, 1999, to provide certain firm transportation and storage capacity, and injection and withdrawal rights.

*(A) Storage and Cost Minimization.*

A fundamental difference exists between the Intervenors and the Company on the issue of storage and cost minimization. The Company unequivocally states that costs will never be a factor in the use of storage:

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<sup>200</sup> Tr. Vol. 2, p. 108 - 109.

<sup>201</sup> Tr. Vol. 3, p. 268, Ins. 13 - 17.

<sup>202</sup> Atmos Exhibit 8, Erskine Rebuttal, p. 4, Ins. 20 - 25.

<sup>203</sup> Atmos Exhibit 8, Erskine Rebuttal, p. 3, Ins. 26 - 30 & p. 5, Ins. 1 - 2.

<sup>204</sup> Atmos Exhibit 11, Wollitz Rebuttal, p. 32, Ins. 3 - 5.

<sup>205</sup> Atmos Exhibit 11, Wollitz Rebuttal, p. 32, Ins. 16 - 17.

<sup>206</sup> Atmos Exhibit 11, Wollitz Rebuttal, p. 32, Ins. 30 - 31.

Storage is, for the Company, first foremost and always, an operational and reliability tool. **The Company does not and will not dispatch from storage to arbitrage prices, as the intervenors have suggested.**<sup>207</sup>

The Intervenors disagree with this approach. First, the Intervenors argued that cost must be a factor when storage is replenished. Second, the Intervenors argued that the impact on the cost of gas must be a consideration whenever a management decision is made with regard to the sale of an asset, such as the Hill Lake storage facility. Third, the Intervenors maintain that the cost of gas should be a consideration whenever the decision is made to dispatch storage.

The Examiners find that reliability is a central factor of the prudence standard. Nevertheless, the Examiners also find that the prudence standard requires cost consideration in all management decisions of the Company, including gas storage. As noted above, this Commission has found that utilities should seek the lowest cost of gas with the highest reliability for its customers.<sup>208</sup> The Examiners find that the practice of excluding price considerations, as a general rule, from any storage decision is, by definition, not prudent.

*(B) Failure to Properly Manage Storage Replenishment.*

Typically, at the end of winter season (November through March) storage volumes are low and must be replenished. Storage replenishment is typically accomplished throughout the storage replenishment season (April through October).<sup>209</sup> The City of Dallas argues that Atmos imprudently injected large quantities of gas into storage early in the storage replenishment season when prices for natural gas were still high. Mr. Pous, testifying on behalf of the City of Dallas, concluded that the Company's act of replenishing gas in large quantities during April and May of each year was imprudent.<sup>210</sup> In this proceeding Mr. Pous recommends that the quantity of gas that the Company purchased for replenishment of natural gas storage facilities be spread out in the same manner as the industry replenished storage gas nationwide.<sup>211</sup> His analysis is based upon statistics provided by the Energy Information Agency for use of natural gas storage by LDCs.<sup>212</sup>

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<sup>207</sup> *Initial Post - Hearing Brief of Atmos Energy Corp., Mid - Tex Division*, p. 45. (Emphasis in the original, cites omitted).

<sup>208</sup> GUD No. 9233, Finding of Fact No. 64.

<sup>209</sup> *See*, Atmos Exhibit 12, Anderson Rebuttal, p. 19, Ins. 21 - 26 & GAO Report, p. 20 which identify the storage injection seasons as the period from April through October.

<sup>210</sup> City of Dallas Exhibit 1, Pous Direct, p. 7, Ins. 24 - 27.

<sup>211</sup> Tr. Vol. 2, pp. 93 - 94.

<sup>212</sup> Tr. Vol. 2, p. 104.



The 2000 - 2001 winter season, the first winter season during the Review Period, produced a combination of cold weather and exceptionally high gas prices. The Company's WACOG for that winter period approached \$8.00 per MMBtu. The Company withdrew over 22 million MMBtu of gas from storage during that winter. In April 2001, immediately after the winter heating season, the Company began to replenish its storage facilities by injecting approximately 14 million MMBtu of gas over a 7-month period ending in October 2001. Mr. Pous alleges that a problem arises because the Company purchased 8.8 million MMBtu in April and May 2001, the first two months after the end of the winter heating season. He alleges that this front-end loaded gas into storage during the Replenishment Period prior to the next winter heating season and he considers that to be imprudent.<sup>213</sup>

During the first two months subsequent to the 2000 - 2001 heating season, when gas prices still remained at historically high levels compared to prior years, the Company purchased and injected over 63 percent of the replacement storage volume purchased for the upcoming winter season. Mr. Pous argues that during the April through October replenishment period, the owners of underground gas storage facilities nation wide replenished only 30 percent of their total gas purchased in April and May 2001 compared to the Company's 63 percent level during these two months. Indeed, even though other entities may have faced circumstances that required them to begin replenishing gas immediately after the winter heating season, the overall practice of the industry was not to front-end load replenishment in April and May. Moreover, Mr. Pous argues that because the winter heating season in Texas starts later than in other parts of the country Atmos had even less reason to front-end load replenishment gas purchases. Mr. Pous alleges that a review of the Company's storage agreement with Atmos Pipeline - Texas did not identify any critical reasons for the front-end loading of gas replenishment.<sup>214</sup>

Additionally, Mr. Pous argues that there is no contemporaneous documentation to support the Company's storage practices. While the Company has an overall Winter Gas Supply plan, he argues that it does not address the specific pattern and quantity of gas to be purchased after the winter heating season. In fact, the supply plan developed for the winter heating season identified April 27, 2000, as the date to compile gas storage plans of Winter 2000 - 2001. The corresponding date for the Winter 2001 - 2002 plan was April 2, 2001. Given that heating season supply plans were still a work in progress after the initial target dates for compilation of the gas storage plan, it would have been impossible for that plan to rely on April spot gas to replenish gas storage facilities. April 2001 is the month with the greatest purchase of replenishment gas by the Company. Moreover, when requested to provide all studies relating to the storage injection decisions that addressed the basis for the timing and the quantity of purchases, the Company provided only very limited data that demonstrated the range between front-end and back-end loading.<sup>215</sup>

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<sup>213</sup> City of Dallas Exhibit 1, Pous Direct, p. 8, Ins. 1 - 12 & p. 9, Ins. 10 - 21.

<sup>214</sup> City of Dallas Exhibit 1, Pous Direct, p. 10, Ins. 9 - 14.

<sup>215</sup> City of Dallas Exhibit 1, Pous Direct, p. 10, Ins 16 - 29 & 11, Ins. 1 - 6.

Mr. Pous also noted that the Company in prior periods normally purchased the majority of replenishment gas for its storage facilities during the months of April and May. The only exception observed by Mr. Pous occurred during 2000, prior to the Review Period. In that year, the Company experienced its lowest level of gas withdrawals during a winter heating season, and, in fact, purchased the largest quantity of replacement gas during March 2000. March is normally considered part of the winter heating load except for 2000, when conditions warranted very little gas withdrawal during March and almost 4 Bcf of gas injections. In fact, for the period 1997 through the present, the winter of 2000 ranked as the warmest.<sup>216</sup>

Although prices drop after the winter heating season, the drop is not immediate. In fact, Mr. Pous notes that from an historical perspective, the industry generally experienced price increases in April.<sup>217</sup> Mr. Pous goes on to argue that the period after April and before the end of October are lower cost gas purchasing periods.<sup>218</sup> Thus, from a historical perspective, Mr. Pous concludes that the Company's gas storage activities were imprudent.<sup>219</sup>

Atmos Mid - Tex presented evidence that confirmed that the industry practice is to purchase and inject into storage gas during the seven-month period from April through October.<sup>220</sup> Mr. Wollitz argues that Mr. Pous fails to take into account the Company's ultimate obligation to provide reliable gas services to its customers. As such, the Company is unwilling to take the risk of waiting until the last possible moment to begin filling its storage facilities. From an operational and a financial perspective, it was prudent of the Company to inject gas into its storage facilities during the months of April and May of each year during the Review Period.<sup>221</sup> Maintenance activities, storage inventory verification testing, and the potential of *force majeure* events all require that the Company begin refilling storage in April and May to be certain that the storage facilities will be full at the beginning of the winter heating season.

Further, using after-the-fact data, Dr. Anderson testified that Mr. Pous's analysis regarding price conditions is incorrect. First, Dr. Anderson testified that April is a relatively low priced month, while June and July are higher priced months. He provided an analysis of NYMEX prompt month settlement prices for the five-year period from 1991 - 1995, and noted that on average, April had the

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<sup>216</sup> City of Dallas Exhibit 1, Pous Direct, p. 11, Ins. 7 - 18.

<sup>217</sup> City of Dallas Exhibit 1, Pous Direct, p. 11, Ins. 25 - 26.

<sup>218</sup> City of Dallas Exhibit 1, Pous Direct, p. 12, Ins. 7 - 10.

<sup>219</sup> City of Dallas, Exhibit 1, Pous Direct, p. 12, Ins. 10 - 11.

<sup>220</sup> Atmos Exhibit 12, Anderson Rebuttal, Exhibit ADA - R - 1, GAO Report, p. 20.

<sup>221</sup> Atmos Exhibit 11, Wollitz Rebuttal, p. 35, Ins 18 - 25.

lowest average price of any month during the storage injection season.<sup>222</sup> In addition, Dr. Anderson noted that the futures curves at the end of March in each of the years under consideration here indicated that the market expected prices to increase over the coming months in each of the refill seasons. It is only after the fact that it becomes evident that prices moved downward during the summer of 2001.<sup>223</sup> Finally, Dr. Anderson notes that the industry was engaging in record injections into storage during April and May of 2001 in large measure because the previous winter had been cold and the expectations were for further price increases.<sup>224</sup>

Mr. Beckman testified that Atmos Mid-Tex made use of contractual storage rights in a manner consistent with typical LDC storage use.<sup>225</sup> LDCs use storage as part of their natural gas supply portfolio, primarily to assure supply security and operational integrity.<sup>226</sup> Storage provides the ability to deliver natural gas of a secure quantity for a specific period of time. The natural gas is stored in depleted reservoirs or salt caverns, as in the case for Atmos Pipeline, and then delivered when needed to supply demand or operation requirements.<sup>227</sup> Mr. Pous used data from the EIA for the entire country. Instead Mr. Beckman used the EIA's Producing Region data revealing storage withdrawal and injection activity for the region which includes Alabama, Arkansas, Kansas, Louisiana, Mississippi, New Mexico, Oklahoma, and Texas. Mr. Beckman concluded that Atmos' behavior is not significantly different from the industry in this region.<sup>228</sup>

Atmos pointed out that the ATM's witness, Mr. Marshall, confirmed that prices in April 2001 would have been projected to be cyclic lows. Mr. Marshall wrote on April 22, 2001, to his clients, anticipating a rally that would "push gas prices to a high most likely in June prior to a decline to a tradable low in the third quarter."<sup>229</sup> Atmos points out that a week later, Mr. Marshall predicted that prices would be higher three to five weeks into the future.<sup>230</sup> On May 13, 2001, Mr. Marshall repeated that predication.<sup>231</sup> Atmos argues that it was only with the benefit of hindsight

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<sup>222</sup> Atmos Exhibit 12, Anderson Rebuttal, p. 19, Ins. 21 - 26.

<sup>223</sup> Atmos Exhibit 12, Anderson Rebuttal, p. 19, Ins. 27 - 30, 20, Ins. 1 - 5

<sup>224</sup> Atmos Exhibit 12, Anderson Rebuttal, p. 20, Ins. 6 - 10.

<sup>225</sup> Atmos Exhibit 9, Beckman Rebuttal, p. 4, Ins. 27 - 28.

<sup>226</sup> Atmos Exhibit 9, Beckman Rebuttal, p. 4, Ins. 30 - 31.

<sup>227</sup> Atmos Exhibit 9, Beckman Rebuttal, p. 6, Ins. 29 - 31 & p. 7, Ins. 1 - 2

<sup>228</sup> Atmos Exhibit 9, Beckman Rebuttal, p. 10, Ins. 8 - 26.

<sup>229</sup> Atmos Exhibit 27, p. 2.

<sup>230</sup> Atmos Exhibit 28, p. 7.

<sup>231</sup> Atmos Exhibit 29, p. 8.

that Mr. Marshall could observe that gas prices experienced no significant rally during late May or June.<sup>232</sup> Further, Atmos criticizes Mr. Pous's use of storage statistics that includes many northern states that cannot be filled in April and May because there is still heating load in those parts of the country and that he did not have storage replenishment statistics specifically for LDCs.<sup>233</sup>

The Examiners find that the actions of Atmos Mid - Tex were prudent. The Company's practice was consistent with industry practice as established by Mr. Beckman. The Company established, through after-the-fact evidence, that market conditions did not warrant deviating from the Company's replenishment practice. In fact, evidence was presented in the record to establish that based on information available to a prudent manager, a prudent manager would have expected prices in April to be reasonable.

*(C) Sale of the Hill Lake Storage Facility*

The Hill Lake storage facility, located in the western part of Texas, is a depleted oil and gas reservoir. It has been in operation since the early 1960s and was relied upon to support operations in the Abilene area. It was not directly connected to the Dallas/Fort Worth Metroplex, where a majority of the customers of Atmos Mid - Tex are located.<sup>234</sup> The Hill Lake Storage Facility was sold to Falcon Gas Storage in March of 2001. Atmos Mid - Tex received \$7,500,000 for the Hill Lake Storage Facility.<sup>235</sup>

The sale of the Hill Lake storage facility was reported to the Commission pursuant to the requirements of Texas Utilities Code, § 102.051. That section provides that a gas utility must report a transaction to sale of plant and equipment in excess of one million dollars. Once the report is filed, the statute requires that the Commission investigate the transaction to determine whether the action is consistent with the public interest. In reaching the determination, the Commission shall consider the reasonable value of the property and facility. If the Commission finds that the transaction is not in the public interest, the Commission shall "take the effect of the transaction into consideration in ratemaking proceedings and disallow the effect of the transaction if the transaction will unreasonably affect rates or service."

After the sale, Atmos Pipeline - Texas and Atmos Energy Mid - Tex executed an amendment to the existing Transportation and Storage Service Agreement, effective April 1, 2001. The amendment reduced the storage capacity and injection and withdrawal rights for Atmos Energy Mid - Tex by removing the Hill Lake facility. The State of Texas, through its witness, Mr. Higgins, and

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<sup>232</sup> Atmos Exhibit 30, p. 1.

<sup>233</sup> Tr. Vol. 2 at 104.

<sup>234</sup> Atmos Exhibit 8, Erskine Rebuttal, p. 4 Ins. 28 - 29 & p. 5, Ins. 3 - 7.

<sup>235</sup> Examiners' Exhibit 2, Response to RRC Staff RFI Set No. 1, Question No. 1 - 03.

ACSC, through its witness Mr. Nalepa argue that the sale of the Hill Lake storage facility was not prudent.

Mr. Nalepa and Mr. Higgins agreed that the sale of the Hill Lake storage facility was not supported by adequate analysis and argue that the one contemporaneous document that exists is insufficient to establish that the sale was prudent.<sup>236</sup> Both witnesses point out that the only document that provides any sort of analysis regarding the sale was completed one day prior to the date the sale was executed.<sup>237</sup> The implication is that a document prepared so close to the sale of the facility would be of little value to a prudent manager attempting to evaluate the consequences of that sale. In addition, Mr. Nalepa argues that any analysis should consider the impact of the sale of the Hill Lake facility on the cost of gas. He adds that, even though a presale study was done, that study was completed one day prior to the sale and he noted that the amendment reduced the available storage capacity.<sup>238</sup>

Storage provides a cost mitigation function. The impact of the sale on the ability of Atmos Mid - Tex to mitigate costs was not considered.<sup>239</sup> Further, these witnesses argue that the study itself contained contradictory conclusions regarding the effect of the sale on the Company's ability to provide service.<sup>240</sup> Finally, Mr. Higgins argues that Dr. Anderson's after-the-fact analysis is contradictory, and appears to acknowledge that the sale restricted the Company's ability to mitigate costs, and that Dr. Anderson fails to understand the impact of the sale of the Hill Lake storage facility.<sup>241</sup> Mr. Nalepa points out that Dr. Anderson was unable to establish the prudence of the sale and was only able to generally state that the facility had become "less useful."<sup>242</sup>

Mr. Higgins explores two separate scenarios to argue that if the Company had not sold the facility, Atmos Mid - Tex could have saved its customers between \$12,905,960<sup>243</sup> and

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<sup>236</sup> ACSC Exhibit 1, Nalepa Direct, p. 28, lns. 14 - 16 & State of Texas Exhibit 1, Higgins Direct, p. 16, lns. 18 - 23.

<sup>237</sup> ACSC Exhibit 1, Nalepa Direct, p. 29, lns. 13 - 14 & State of Texas Exhibit 1, Higgins Direct, p. 15, lns. 16 - 17 & fn. 55.

<sup>238</sup> ACSC Exhibit 1, Nalepa Direct, p. 27, lns. 5 - 16.

<sup>239</sup> ACSC Exhibit 1, Nalepa Direct, p. 30, ln. 6 - p. 31, ln. 3.

<sup>240</sup> ACSC Exhibit 1, Nalepa Direct, p. 29, lns. 9 - 13 & Higgins Direct, pp. 15 - 16.

<sup>241</sup> State of Texas Exhibit 1, Higgins Direct, p. 15, lns. 2 - 13

<sup>242</sup> State of Texas Exhibit 1, Higgins Direct, p. 29, lns. 15 - 16.

<sup>243</sup> State of Texas Exhibit 1, Higgins Direct, p. 19, ln. 8 - p. 20, ln. 2, Scenario B.

\$16,651,712.<sup>244</sup> In each case, Mr. Higgins argues, the Hill Lake storage facility was an asset that could have been used to hedge gas costs. The two scenarios are the result of different timing and use of the stored gas. Mr. Nalepa considers the effect of the sale of the Hill Lake storage facility when he testified about storage redispatch issues discussed below.

Mr. Erskine argues that the sale of the Hill Lake storage facility was reasonable and prudent in light of changed operating conditions on the pipeline system.<sup>245</sup> Mr. Erskine explained that, for operational reasons, the Hill Lake storage facility was originally used to ensure supply to the Abilene system.<sup>246</sup> In the mid-1990s, the Company installed a compression station that allowed delivery of natural gas into the Abilene area from a different portion of the pipeline system. In addition, beginning in 2000, rapidly increasing production from the Barnett Shale Field was available to provide natural gas to the northwest of the Metroplex. As a result, more natural gas supplies were available to be used in the western portion of the pipeline system. The combination of those two factors substantially reduced the need for the Hill Lake storage facility.<sup>247</sup> Mr. Erskine also notes that an analysis was performed to consider the impact that the sale of the Hill Lake storage facility had on winter deliveries to customers. This analysis concluded that the Hill Lake storage facility was not required to supply residential and commercial customers in the Abilene area.<sup>248</sup> Finally, Mr. Erskine notes that even though the Hill Lake storage facility had a capacity of over 8 Bcf, due to geologic considerations of the reservoir, it only had a useable capacity of 6.1 Bcf.<sup>249</sup> Based upon these factors, the Company decided to sell the Hill Lake storage facility. No consideration was given before the sale of the Hill Lake storage facility as to whether the sale of the facility would affect the cost of gas to end-use customers. The basis for the decision was whether the facility was needed to serve customers operationally and hydraulically.<sup>250</sup>

Atmos Mid - Tex also argues that the key issue with regard to the sale of the facility was not the overall capacity. Instead, Atmos Mid - Tex argues, the key issue was deliverability. Mr. Beckman argues that while total storage capacity was reduced, the key contractual element, deliverability remained at 1,000 MMcf/D.<sup>251</sup> Mr. Beckman also pointed out that the Hill Lake

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<sup>244</sup> State of Texas Exhibit 1, Higgins Direct, p. 17, ln. 15 - p. 19, ln. 7, Scenario A.

<sup>245</sup> Atmos Exhibit 8, Erskine Rebuttal, p. 4, lns. 3 - 4.

<sup>246</sup> Atmos Exhibit 8, Erskine Rebuttal, p. 4, lns. 10 - 17.

<sup>247</sup> Atmos Exhibit 8, Erskine Rebuttal, p. 4, lns. 18 - 27.

<sup>248</sup> Atmos Exhibit 8, Erskine Rebuttal, p. 6, lns. 5 - 15.

<sup>249</sup> Atmos Exhibit 8, Erskine Rebuttal, p. 8, lns. 27 - 29.

<sup>250</sup> Tr. Vol. 4, pp. 52 - 53.

<sup>251</sup> Atmos Exhibit 8, Beckman Rebuttal, p. 11, lns. 19 - 23, & lns. 30 - 31.

facility was at a location that limited its use; it is at some distance from the Dallas/Ft. Worth Metroplex area and the facility provided service to the Abilene district. Further, he repeats the operational considerations already noted by Mr. Erskine that limits the usable capacity.<sup>252</sup>

Mr. Erskine states that at the time of the §102.051 report, the Commission did not find that the sale was imprudent. At the time of the review, the Commission staff assigned to review the filing noted in a letter to Atmos Pipeline that staff had no further inquiries. Staff concluded that the consequences of the transaction for future rate hearings did not need to be decided at that time. Instead, Staff concluded that when one of the affected parties comes before the Commission in a rate proceeding, then in accordance with Texas Utilities Code, § 102.051, the Commission would take the effect of the transaction into consideration.<sup>253</sup> Mr. Erskine notes that no party raised an issue regarding the sale of the Hill Lake storage facility in GUD No. 9400 and, therefore, the issue has already been litigated.<sup>254</sup>

The Examiners find that the sale of the Hill Lake storage facility was not prudent. Even assuming, for the sake of argument, that the Company's assertions that storage management decisions are governed exclusively by reliability issues, the Company's decision was not prudent. Once the Company determined that operational reliability did not require the use of the Hill Lake storage facility, a prudent manager would naturally inquire as to the cost minimizing value of this asset. Through the approved rates, the Company has earned a return for this asset over nearly three decades. In fact, after the sale of the asset the Company continued to earn a return on the asset through the conclusion of the subsequent rate case. The Examiners conclude that no prudent manager would have excluded any consideration of the cost minimization potential that this asset represented.

The impact of that decision extends beyond the date of the sale in March of 2001. Nevertheless, after GUD No. 9400, rates approved for Atmos Mid - Tex no longer included depreciation on the facility and the Company no longer earned a return for this facility. The Company argues that concepts of *res judicata* and *collateral estoppel* preclude consideration of the effects of the sale of the Hill Lake storage facility in this case. The Examiners find that issues regarding the gain on sale could have been raised in GUD No. 9400 and do not appear to have been raised in that case. The prudence of that transaction for purposes of gas cost management, however, was not an issue in that case or in the filing made pursuant to Texas Utilities Code § 102.051. The prudence of the gas cost management decisions and their impact on gas costs were reserved in GUD No. 8664 for this proceeding. The Examiners find that during this review period that decision had an impact on the cost of gas.

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<sup>252</sup> Atmos Exhibit 8, Beckman Rebuttal, p. 12, Ins. 7 - 8.

<sup>253</sup> Examiners' Ex. 2, p. 2 (Copies of Documents in Tex. R.R. Comm'n, § 102.051 Sale of Hill Lake Sand Gas Storage Facility to Falcon Gas Storage, Docket No. 9214)

<sup>254</sup> Atmos Exhibit 9, Erskine Rebuttal, p. 4, Ins. 1 - 17.

The Company decided to decrease total storage capacity even though the overall estimated projected demand increased every year during the review period. This is illustrated in Examiners Schedule 9 attached at Tab 9 to this Proposal for Decision. As can be seen, projected demand increased from 105.5 Bcf in the first winter to 109.1BCF in the second winter, to 111.8 Bcf in the third winter. Meanwhile, storage capacity was reduced from 36 Bcf to 31 Bcf. This parallels the decrease in gas the Company projected it would take from storage in each of the winter periods. The Examiners find that a prudent manager would not have divested itself of storage capacity under these circumstances.

Further, the evidence in the record does not establish that deliverability remained unchanged. Mr. Beckman acknowledged that, as inventory declines, the maximum amount that the Company can nominate also declines.<sup>255</sup> While the maximum deliverability remains unchanged when the storage facilities are full, the deliverability changes as soon as the volumes begin to be depleted. The contract provides that maximum deliverability of 1,000 Mmcf per day is available only when the maximum capacity is achieved. In the original agreement the maximum capacity was 36.8 Bcf.<sup>256</sup> The maximum capacity under the revised agreement after the sale of the Hill Lake storage facility was 31.6 Bcf.<sup>257</sup> The maximum deliverability changes as soon as the reservoirs begin to be depleted. That is seen in Exhibit D of the original agreement and the revised Exhibit D that was part of the First Amendment to the Agreement. The change is graphically illustrated in Examiners Schedule 10, attached at Tab 10. Thus, the examiners conclude that deliverability was adversely affected. An examination of the monthly ending balances quickly reveals that the maximum deliverability was only available twice in the thirty month period after the sale of the Hill Lake storage facility.<sup>258</sup>

As explained by Mr. Higgins and Mr. Nalepa, the Company could have used storage to minimize gas costs and avoid certain purchases. The Company complains that Mr. Higgins and Mr. Nalepa overstated the capacity of this facility and the Examiners agree. As pointed out by Mr. Beckman, a facility's total capacity has two components: base gas, which is the amount of natural gas needed to assure the operational performance of the facility, and working gas, which is the amount that can actually be withdrawn and delivered to gas markets.<sup>259</sup> Testimony in the case

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<sup>255</sup> Tr. Vol. 4, p. 78, Ins. 12 - 15. (Beckman)

<sup>256</sup> ACSC Exhibit 1, Nalepa Direct, Appendix E, p. 76 (Transportation and Storage Agreement between TXU Lone Star Pipeline (Atmos Pipeline) and Texas Lone Star Gas (Atmos Mid - Tex).

<sup>257</sup> *Id.*, at 83 (First Amendment to Transportation and Storage Service Agreement).

<sup>258</sup> Atmos Exhibit 10, Myers Rebuttal, Exhibit BWM - R - 1.

<sup>259</sup> Atmos Exhibit 8, Beckman Rebuttal, p. 7, Ins. 5 - 9.



estimated the working capacity at the Hill Lake Storage Facility 5.2 Bcf<sup>260</sup> and 6.1 Bcf.<sup>261</sup> Accordingly, the Examiners have prepared Examiners Schedule 11, attached at Tab 11, which assumes that the maximum usable capacity in the facility was 6.1 MMBtu, as attested by Mr. Erskine.<sup>262</sup> As can be seen in that schedule, the Hill Storage facility had the ability to provide \$10,161,330 in gas costs savings to the residential and commercial customers.

*(D) Accounting of Gas in Storage at Time of the Sale of Hill Lake*

Mr. Higgins pointed out that at the time of the sale of the Hill Lake Storage, the reservoir contained a total of 3,041,715 MMBtu of working gas inventory that was owned by Atmos Mid - Tex, at an average cost of \$3.65/MMBtu, for a total cost to the Company of \$121,098,608. He alleges that Atmos Mid - Tex was not correctly reimbursed for that gas. Mr. Higgins alleged that Atmos Mid - Tex lost the 3,040,715 MMBtu of Hill Lake gas at a cost of \$3.65 per MMBtu, and then replaced that Hill Lake gas by other purchases and injections that cost it an average price of \$4.47 per MMBtu. Mr. Higgins concludes that this raised the weighted average cost of gas in storage by \$.82 per MMBtu.<sup>263</sup>

Mr. Erskine, testifying on behalf of Atmos Mid - Tex, simply pointed out that the overall balance in all of the storage facilities available to Atmos Mid - Tex, did not change as a result of the sales transaction. Thus, the Company's working gas inventory was not reduced as a result of the sale of the Hill Lake storage facility.<sup>264</sup>

The Examiners find no evidence in the record to suggest that the overall balance available to Atmos Mid - Tex declined as a result of the sale of the Hill Lake storage facility. While the gas in the Hill Lake storage facility was no longer available, as long as the overall balance at the time of the sale and the weighted average cost of gas did not change as a result of the sale, Atmos Mid - Tex was unaffected. While there is evidence in the record that establishes that the overall capacity was and the maximum deliverability was reduced, as related to volume in the storage facilities, there is no evidence in this record that the existing volume available to Atmos Mid - Tex was altered as of the date of the sale.

*(E) Redispatch of Storage and Winter 2001 - 2002 Storage Management.*

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<sup>260</sup> Tr. Vol. 3, p. 215, Ins. 18 - 21.

<sup>261</sup> Atmos Exhibit 9, Erskine Rebuttal, p. 8, Ins. 27 - 29

<sup>262</sup> *Id.*

<sup>263</sup> State of Texas Exhibit 1, Higgins Direct, pp. 28 - 29.

<sup>264</sup> Atmos Exhibit 9, Erskine Rebuttal, p. 9, Ins. 8 - 12.

Mr. Nalepa concluded that Atmos Mid - Tex did not maximize the value of its natural gas storage agreement. Specifically, Mr. Nalepa argued that Atmos did not effectively dispatch storage relative to other market supply options to minimize cost. As a result, the cost to ratepayers was higher than necessary.<sup>265</sup> In addition, as noted above, Mr. Nalepa agreed that the sale of the Hill Lake Storage facility was not prudent. Accordingly, he recalculated the dispatch of storage gas on the assumption that the storage capacity available at the Hill Lake storage facility was available throughout the entire Review Period. Mr. Nalepa alleged that by dispatching storage by comparing the cost of gas in storage with other market supplies and selecting lower cost options, Atmos Mid - Tex could have saved a considerable amount in gas acquisition costs. He argued that during the winter of 2001 - 2002 Atmos Mid - Tex should have withdrawn less gas from storage and relied more on spot gas purchases because, at that time, spot gas was less expensive than storage gas.<sup>266</sup> Mr. Nalepa testified that none of the additional withdrawals or injections he suggested exceeded what Atmos Mid - Tex reported as nominated withdrawals or injections. He recognized the uncertainty of matching supply to demand by drawing down storage just enough during the 2001 - 2002 winter to allow some injection during the rest of 2002.

In a similar vein, the State of Texas argued that the utility mismanaged its storage gas during the second winter, Winter 2001 - 2002. Mr. Higgins noted that the Winter of 2001 - 2002 was unusual in that instead of gas prices rising during the cold weather, gas prices actually held level or declined. He noted that the winter was typified by unseasonably warm temperatures, weak demand resulting from the slowing of the economy, and a general decline in petroleum product prices.<sup>267</sup> Mr. Higgins alleged that this resulted in lower prices on the spot market. He calculated that the over-all average price of purchased gas during the period from November 1, 2001, through April 30, 2002, was \$2.67 per MMBtu. On the other hand, spot gas was being purchased by Atmos Mid - Tex at an average price of only \$2.38 per MMBtu.<sup>268</sup> Instead of purchasing gas on the spot market, Atmos Mid - Tex opted to use the more expensive gas in storage. Mr. Higgins estimated that costs to customers could have been reduced by nearly \$40 million dollars.<sup>269</sup>

The Company argued that Mr. Nalepa ignored that the Company uses storage primarily for operational reasons, that is, to support pressures on the system. Atmos Mid - Tex argued that it must withdraw certain amounts from storage simply to support system pressures and operational integrity.<sup>270</sup> Mr. Wollitz criticized the analysis provided by Mr. Nalepa because he used monthly

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<sup>265</sup> ACSC Exhibit 1, Nalepa Direct, p. 28, lns. 13 - 18.

<sup>266</sup> ACSC Exhibit 1, Nalepa Direct, p. 31, lns. 12 - 20.

<sup>267</sup> State of Texas Exhibit 1, Higgins Direct, p. 22, lns. 2 - 6.

<sup>268</sup> State of Texas Exhibit 1, Higgins Direct, p. 22, lns. 15 - 18.

<sup>269</sup> State of Texas Exhibit 1, Higgins Direct, p. 23, lns. 6 - 7.

<sup>270</sup> Atmos Exhibit 11, Wollitz Rebuttal, pp. 31 - 35; Atmos Mid - Tex Initial Brief, p. 57.

storage dispatch and not daily dispatch.<sup>271</sup> He also noted that Mr. Nalepa's efforts to replace storage gas with peaking gas was not prudent. Specifically, on the occasions when Mr. Nalepa suggested that storage gas be used instead of peaking gas, Mr. Wollitz explained that peaking contracts require that the Company manage those contracts to the minimum level. Thus, using more storage would have required using peaking supply later in the winter to fulfill the minimum take under those contracts.<sup>272</sup>

The Company also argued that from an operational perspective a certain amount of natural gas must remain in storage to meet increases in demand due to weather forecast errors and weekend and holiday demand. Regarding the second winter, Winter 2001 - 2002, Mr. Wollitz testified that the Company was required to withdraw a minimum amount of gas to meet requirements during weekend and holiday periods and to meet requirements due to short term forecast errors.<sup>273</sup> Furthermore, during cross-examination of Mr. Higgins, the Company pointed out that Mr. Higgins did not take into account minimum storage withdrawals.<sup>274</sup> As for suggested withdrawals in the third winter, Winter 2002 - 2003, Mr. Wollitz explained that the Company sought to maintain a certain level of gas in storage to meet late winter demands. A withdrawal early in the winter would have resulted in curtailment to interruptible customers or refilling storage in the winter to maintain the desired level.<sup>275</sup>

The Examiners find that Atmos Mid - Tex has established that it acted prudently during the Review Period and that no recalculation based on "redispatch" of storage should be made. The Company's desire to maintain a certain level of storage throughout the winter season is reasonable and Mr. Wollitz established that refilling storage during the winter season to achieve those levels would not result in lower expenses. The Examiners find that the redispatch of storage on a monthly basis is unreasonable and note that the analysis of Mr. Nalepa and Mr. Higgins is insufficient to call into question the daily storage dispatch decisions of the Company. The Company, primarily through the testimony of Mr. Wollitz, has met its burden and established that its daily storage dispatch decisions were reasonable.

*d. Specific Spot Purchases*

Atmos relies on the daily spot gas market to meet the differences between anticipated customer demand and gas supplied under its other contracted supplies. Atmos executes Master

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<sup>271</sup> Atmos Exhibit 11, Wollitz Rebuttal, p. 33, Ins. 28 - 29.

<sup>272</sup> Atmos Exhibit 11, Wollitz Rebuttal, p. 34, Ins. 1 - 4 & Ins. 26 - 32.

<sup>273</sup> Atmos Exhibit 11, Wollitz Rebuttal, p. 32, Ins. 14 - 25.

<sup>274</sup> Tr. Vol. 2, pp. 170 -174 & p. 192, Ins. 1 - 18.

<sup>275</sup> Atmos Exhibit 11, Wollitz Rebuttal, p. 34, Ins. 14 - 25 & 33 - 42, & p. 35 Ins. 1 - 11.

contacts with potential spot suppliers and negotiates supply and price as needed under these agreements.<sup>276</sup> Atmos does not rely on a bidding process to purchase any of its spot gas; instead, Atmos relies on its gas buyers to negotiate daily purchases aided by real time market and price information. Mr. Nalepa argues that no documentation was provided to establish that the spot gas that was purchased was purchased at the lowest reasonable cost. Mr. Nalepa reviewed the range of spot gas purchases for each month of the Review Period, and identified purchases that appeared to be above a reasonable range of prices. He was able to identify purchases during the period that fell well outside the range of other purchases. These occurred in December 2000, January 2001, January 2002, and February 2003. Except for February, the contracts under which purchases occurred are identified in the table below.

**Table 17**  
**Alleged Outlier Spot Purchases**

	December 2000	January 2001	January 2002	February 2003
Contract/Price	6767 - \$10.37 6782 - \$10.25 6858 - \$ 9.90 6839 - \$10.00 6970 - \$10.19	6720 - \$ 9.51 6721 - \$ 9.05 6774 - \$ 9.78	6754 - \$2.71	Various

In each case, he compared the purchases to other spot purchases during the month and revised the prices for the outlier purchase to the average of the other spot purchases during the month. The adjusted price for December 2000 was \$8.99, January 2001, was \$8.09, and for January 2002, was \$2.21. From February 21<sup>st</sup> through the 28<sup>th</sup> the Company experienced higher demand due to colder than expected weather during this period, and market prices soared in response to the higher demand. These revisions resulted in a reduction to spot gas costs of \$3,974,358. The adjustment for February 2003 made up \$2.9 million of the total amount.

Mr. Wollitz argues that Mr. Nalepa's analysis is arbitrary and without basis.<sup>277</sup> Mr. Wollitz presented evidence to show that the prices for the contracts identified in the table, and for the various February prices, were all at published and widely-accepted, industry index prices.<sup>278</sup> The Examiners find that the spot purchases were prudent and that the prices were all at published and widely-accepted, industry index prices. Accordingly, Atmos Mid - Tex established that these spot purchases were reasonable.

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<sup>276</sup> ACSC Exhibit 1, Nalepa Direct, p. 34, Ins. 1 - 6;

<sup>277</sup> Atmos Exhibit 11, Wollitz Rebuttal, p. 28, Ins. 30 - 31.

<sup>278</sup> Atmos Exhibit 11, Wollitz Rebuttal, p. 29, Ins. 1 - 15, Exhibit CMW - R - 4 & Higgens Direct, Attachment 14, pp. 161 - 163.

*d. Specific Swing Gas Supply Contract — Contract 6680*

The Company's swing supply contracts are similar to its peaking supply contracts, but generally have less flexibility than its peaking contracts. During the Review Period Atmos purchased gas under three swing agreements: Contracts, 6680, 7029, and 7067. Contract 6680 is a legacy contract with an effective date of December 1993, while the other two contracts have effective dates of December 2000 and December 2001, respectively.<sup>279</sup>

Mr. Nalepa argues that, because the swing contracts provide less flexible service than other peaking supply, the cost of gas under these contracts should be no more than that under other peaking agreements. He concludes that contract 7029 and 7067 are priced competitively with other peaking contracts. Contract 6680, however, is priced much higher than other contracts during the review period.<sup>280</sup>

Contract 6680 was reviewed in GUD No. 8647, but administration of the contract is ongoing. If the Company can avoid or minimize takes under a more expensive supply agreement, it is responsible for doing so. The Atmos contract summary for Contract 6680 states that there is a price adjustment if purchases average less than a certain amount per month, but at the same time, the summary states that there is no minimum take obligation for the period November 2000 through March 2001. For the period January 2001 through March 2001, Atmos purchased 3.6 million MMBtu under this contract, at an average price of \$7.38 per MMBtu. This is \$1.56 per MMBtu more than the average of other peaking contracts during the same period.<sup>281</sup>

Mr. Nalepa argues that according to its take obligations, Atmos could have taken peaking gas under other existing agreements and minimized purchases under Contract 6680 for January through March 2001. He adjusted the price under this contract to equal the average price of all other peaking contracts and recommended a reduction in purchased gas costs of \$5,570,301.<sup>282</sup>

Mr. Wollitz maintains that Mr. Nalepa's analysis is flawed due to a flawed understanding of the contract. In addition to a variable commodity charge for gas actually received under the contract, the Company is required to pay a demand charge.<sup>283</sup> The demand charge was viewed by the Company as a "sunk" cost; Atmos Mid - Tex was required to pay that cost regardless of

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<sup>279</sup> ACSC Exhibit 1, Nalepa Direct, p. 37, lns. 1 - 9.

<sup>280</sup> ACSC Exhibit 1, Nalepa Direct, p. 37, lns. 16 - 20 & p. 38, lns. 1 - 2.

<sup>281</sup> ACSC Exhibit 1, Nalepa Direct, p. 38, lns. 4 - 15.

<sup>282</sup> ACSC Exhibit 1, Nalepa Direct, p. 38, lns. 17 - 21 & p. 39, lns. 1 - 2.

<sup>283</sup> Atmos Exhibit 11, Wollitz Rebuttal, p. 29, lns. 25 - 27.

whether it took any gas.<sup>284</sup> Thus, Atmos Mid - Tex based its decision to purchase under that contract based upon the variable commodity costs.<sup>285</sup>

The Examiners find that Atmos Mid - Tex prudently managed its gas costs under that contract. While the contract itself may or may not be prudent, that is not at issue in this case. As pointed out by Mr. Wollitz all of the provisions of Contract No. 6680, including the demand charge component, were reviewed in two previous Commission cases, GUD No. 8647 and GUD No. 9233. Mr. Nalepa does not appear to dispute this issue.<sup>286</sup> Furthermore, the contract has expired and will no longer be used to acquire gas supplies.<sup>287</sup> The Examiners find that the Company's decision to view the demand charge as a sunk cost is reasonable. When the variable cost is compared to the other peaking contracts, the price paid under Contract 6680 does not appear to be unreasonable.

*f. Preapproval Issues*

The Company points out that on an annual basis during the Review Period, the Company advised Commission representatives about its gas purchase process and plans for the upcoming winter.<sup>288</sup> Atmos Mid - Tex points that this was done in direct response to initiatives of the Commission and requests of the Commissioners themselves. The Company acknowledged that it neither sought, nor did the Commission provide formal approval. Nevertheless, it is the Company's position that it received only positive feedback on its plans and that no one at the Commission objected to the plans. In conclusion, Atmos Mid -Tex argues that its plans should not be second-guessed.

More specifically, during the hearing Mr. Wollitz attacked the credibility of Mr. Nalepa by arguing that Mr. Nalepa, as an Assistant Director of the Gas Services Division of the Commission, never criticized the Company's gas supply plan. Each year during the Review Period, Atmos presented its gas supply plans to the Staff of the Railroad Commission. Mr. Nalepa was present during several of those presentation. Mr. Nalepa never indicated that there was any problem with the planning process.<sup>289</sup>

As already noted, the actual plan that was implemented could not be accurately ascertained from the Compliance Filing, or from the data provided as part of the rebuttal testimony and at the

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<sup>284</sup> Atmos Exhibit 11, Wollitz Rebuttal, p. 30, lns. 7 - 10.

<sup>285</sup> Atmos Exhibit 11, Wollitz Rebuttal, p. 30, lns. 12 - 15.

<sup>286</sup> ACSC Exhibit 1, Nalepa Direct, p. 38, lns. 6 - 7.

<sup>287</sup> Atmos Exhibit 3, GCR, S - 54 & A - 54.

<sup>288</sup> *Initial Post-Hearing Brief of Atmos Energy Corp., Mid - Tex Division*, p. 16.

<sup>289</sup> Atmos Exhibit 11, Wollitz Rebuttal, p. 6, lns. 18 - 28.

hearing. The Gas Supply Plans presented to the Commission were fewer than thirty power point slides for each year, and an aggregate total of 81 pages.<sup>290</sup> The pages provided a general description of overall goals. The intent was to generally describe a program that would encompass a total of 219 individual contracts and nearly 3,000 entries to summarize a myriad of transactions that occurred during the Review Period. Furthermore, nowhere in those documents does the utility indicate when it intended to implement its hedges, nor does it describe the change in the hedging program that it undertook in the third year. Those plans cannot preclude an examination of the 219 contracts that were used to procure gas, the nearly 3,000 monthly summaries indicating how those contracts were executed, and examining the \$2.2 billion in gas cost expenses that customers have paid.

*g. General Gas Acquisition Issues Alleged to Impact Gas Costs*

*(A) Introduction*

ACSC and the State of Texas raised several general issues which are not specifically linked to a proposed disallowance. Mr. Nalepa estimated that the issues to be discussed below in sections Xf(B) to Xf(E), the issues related to financial hedging and establishing a price cap, discussed in section Xb(J), above and issues related to the implementation of the Company's hedging program, discussed in Xb(F) above, could have resulted in customers paying \$180 million in excess gas costs.<sup>291</sup> Since Mr. Nalepa attributed \$144 million and \$35 million dollars to the financial hedging issues and the implementation of the Company's financial hedging program his direct testimony, the remaining issues discussed in this section account for about one million dollars of Mr. Nalepa's proposed disallowance.

Mr. Nalepa calculated that disallowance based upon a comparison of the average cost of gas paid by four major utilities operating in the State of Texas: Atmos West Texas, CenterPoint Entex, Texas Gas Service, and West Texas Gas. He maintained that the price for natural gas paid by Atmos Mid - Tex was higher, on average, than the price paid by the other utilities during the Review Period.<sup>292</sup>

Mr. Wollitz argued that Mr. Nalepa's analysis is incorrect because he failed to take into account the weighted average cost of gas. Mr. Nalepa compared simple averages and Mr. Wollitz argued that simple averages give too much weight to the purchase of smaller gas utilities and too little weight to the gas utility that purchased the large volumes purchased by Atmos Mid - Tex

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<sup>290</sup> Atmos Exhibit 14.

<sup>291</sup> ACSC Exhibit 1, Nalepa Direct, p. 23, lns. 12 - 17.

<sup>292</sup> ACSC Exhibit 1, Nalepa Direct, p. 23, lns. 1 - 12.

during the applicable time periods.<sup>293</sup> Further, the analysis provided by Mr. Nalepa did not take into account the vast service area of Atmos Mid - Tex, requiring gas acquisition in areas that could prove more expensive than the acquisition costs of the other utilities.<sup>294</sup>

The Examiners find the Mr. Nalepa correctly performed a comparison of costs using simple averages. Nevertheless, the analysis, while providing a useful starting point, is nothing more than a starting point. There is no evidence in the record regarding the gas acquisition practices of the other utilities. They may all engage in the same practice and have acquired gas at a lower costs. The key question is whether the utility acquired a reliable gas supply at the lowest possible price. The utility with the lowest overall gas costs may have been able to acquire gas at a lower price. Simply put, a disallowance based solely upon an average cost comparison is not reasonable.

(B) *Gas Supply Purchaser Participation in Demand Forecasts Development.*

Atmos Mid - Tex has two primary groups involved in the development of the winter demand forecast and the gas supply acquisition plan. The Corporate Forecasting Group was part of TXU Business Services and it develops the winter demand forecast. The Gas Supply Group is within Atmos Mid - Tex and it develops the gas supply acquisition plan. Mr. Nalepa criticizes the Company's planning process because the gas supply personnel do not participate in the development of the forecasts of winter supplies. The gas supply personnel develop a gas supply plan, but they do not participate in the development of the forecasted requirements and alternative demand scenarios.<sup>295</sup>

Mr. Wollitz explained that the Corporate Forecasting Group developed the customer demand forecast. The customer demand forecasts are a mathematical calculation of expected customer demand based on a number of factors, including, for example, trends in historical usage and expected customer growth. It is not required for the gas buyers themselves to be involved in what, in Mr. Wollitz's view, is a mathematical calculation.<sup>296</sup> Nevertheless, Mr. Wollitz explained that a member of the buyers group did, in fact, interact with the Corporate Forecasting Group.

The Examiners find that the process outlined by Mr. Wollitz is reasonable. While it is true that members of the buyers group did not participate in the development of the forecast, that the forecast is primarily a mathematical calculation. Furthermore, as Mr. Wollitz pointed out, Mr. Nalepa appears to be in error regarding the interaction between the buying group and the Corporate Forecasting Group.

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<sup>293</sup> Atmos Exhibit 11, Wollitz Rebuttal, p. 37, lns. 6 - 10.

<sup>294</sup> Atmos Exhibit 11, Wollitz Rebuttal, p. 36, lns. 22 - 30.

<sup>295</sup> ACSC Exhibit 1, Nalepa Direct, p. 14, lns 6 - 15 & p. 15, lns. 1 - 9

<sup>296</sup> Atmos Exhibit 11, Wollitz Rebuttal, p. 5, lns. 6 - 15.



(C) *The RFP Process*

Mr. Nalepa raised three particular issues with the request for proposal (RFP) process. First, he argued that there was a lack of diligence in obtaining a broad range of viable proposals. Second, Mr. Nalepa maintained that it was difficult to evaluate whether any substantive analysis of the proposals received was ever performed. Third, he maintained that the documentation provided by the Company to support the process was incomplete. Furthermore, Atmos Mid - Tex did not maintain either organized or comprehensive documentation as to how the Company proceeds from an RFP to a contract.<sup>297</sup>

Mr. Wollitz argues that an offer/response rate of slightly less than 20 percent of RFPs sent out does not by any means suggest that the process is not efficient or diligent. He argued that the Company was trying to contact as many suppliers as possible to identify competitively priced supplies of natural gas. Mr. Wollitz testified that Atmos sent out hundreds of RFPs to potential gas suppliers each year to large and small independent producers, large and small marketing companies, major producers, gatherers, and other market participants. He testified that an emphasis was placed on the number of companies and individuals to be contacted. Atmos Mid - Tex sought to increase the RFP list each year to cover the widest possible array of suppliers. Indeed, he argues that if the Company were concerned that someone was going to criticize it for its response rate, it could limit its distribution to only those companies that have contracted with the Company in the past and, of course, the response rate would increase. The focus of the Company has been to announce its RFPs to as many suppliers as possible, in order to examine all of the opportunities to supply gas to Atmos.<sup>298</sup>

Mr. Wollitz testified that the Company provided ample information regarding the RFP process and the individual proposals. The Company provided a complete mailing list, sample letters of the RFP notice, documentation of the RFP notice on the web page of the Company, and copies of written responses received. The contracts that resulted from this process were made available and summaries of these contracts were provided as part of the Company's filing as Schedule GCR-3.<sup>299</sup>

Mr. Wollitz testified that certain suppliers would not, as a matter of company policy, respond in writing to the Company's RFP. Atmos contacted these suppliers directly. As a result of these efforts, Atmos was able to enter into several contracts in addition to those that were executed as a result of the written proposals received during the RFP process. Each contract had a price that was substantially similar to the other contracts entered into through the RFP process.<sup>300</sup>

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<sup>297</sup> ACSC Exhibit 1, Nalepa Direct, p. 15, lns. 11 - 20, & p. 16, lns. 1 - 8.

<sup>298</sup> Atmos Exhibit 11, Wollitz Rebuttal, p. 7, lns. 14 - 24 & lns. 27 - 29.

<sup>299</sup> Atmos Exhibit 11, Wollitz Rebuttal, p. 8, lns. 21 - 29.

<sup>300</sup> Atmos Exhibit 11, Wollitz Rebuttal, p. 9, lns. 11 - 31.

In short, Mr. Wollitz argued that these contracts were the result of the Company's efforts to expand the RFP process.<sup>301</sup>

Finally, in response to a contention that almost every proposal in response to the RFP resulted in contracts and that it was therefore difficult to evaluate whether any substantive analysis was preformed, Mr. Wollitz stated that the Company received 296 proposals in response to RFPs during the Review Period. Less than one-third of those proposals resulted in contracts. The ratio of Peaking and Swing contracts executed compared to the number of RFP responses for Peaking and Swing supply was higher because (1) fewer gas suppliers can provide this type of highly variable service, and (2) the Company has a substantial need for this type of supply alternative.

The Examiners find that Atmos Mid - Tex has established that its RFP process was reasonable and prudent. The Company's response rate was reasonable, it provided sufficient information, and it provided a reasonable explanation for the lack of documentation in certain circumstances.

(D) *Code of Conduct Issues*

Mr. Nalepa argues that the request for proposal process is tarnished by the relationship between certain suppliers and the gas purchasers at Atmos Mid - Tex. He points out that Mr. Wollitz conceded that buyers will occasionally accept meals and entertainment from gas suppliers; the buyers will attend sporting events, such as Dallas Cowboy games, as guests of gas suppliers; the suppliers have attended meetings held in other states; and some suppliers have paid for ski trips to Colorado.<sup>302</sup> Mr. Nalepa argues that customers should not be burdened with the expense associated with those perks.<sup>303</sup>

The Staff of the Railroad Commission also objected to the practice of Atmos Mid - Tex. In its Initial Brief, Staff noted that the Company's practice was in violation of its own corporate code of conduct rule.<sup>304</sup> The Staff pointed out that there appears to be no requirement to report benefits.<sup>305</sup> Staff argued that the activities of the utility's employees regarding gifts should have been reported. Failure to report those activities could result in higher prices paid by the company and passed through to the ratepayers.

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<sup>301</sup> Atmos Exhibit 11, Wollitz Rebuttal, p. 10, lns. 1 - 8 & pp. 11 - 12

<sup>302</sup> ACSC Exhibit 1, Nalepa Direct, p. 16, lns. 10 - 20.

<sup>303</sup> ACSC Exhibit 1, Nalepa Direct, p. 17, lns. 1 - 7.

<sup>304</sup> *Staff's Initial Brief*, p. 2.

<sup>305</sup> *Staff's Initial Brief*, p. 1, citing Wollitz Deposition at p. 63, ln 20 - 64, ln. 3, attached as Appendix C to Nalepa Direct.).

Mr. Wollitz argues that Mr. Nalepa has provided no factual support for this allegation. In fact, he notes that during his deposition, Mr. Nalepa admitted that there was no evidence that the Company's gas purchases were influenced by social activities. The attendance of the Company's gas buyers at lunches or occasional sporting events was important to maintaining an open and good relationship with the natural gas suppliers. Such relationships may be helpful in acquiring natural gas supplies during peak demand periods. Further, Mr. Wollitz testified that he was not aware of anyone in the industry who did not participate in these events. Finally, he notes that such social gatherings provide an opportunity for Atmos to develop a better understanding of the suppliers' business and marketing plans, the quantities of natural gas they may have, and general market trends.<sup>306</sup>

The Examiners find that the internal code of conduct of Atmos Mid - Tex appears to have been violated to the extent that gifts were not reported. On the other hand, the Examiners do not recommend disallowing the costs for activities described by the Intervenors. Mr. Wollitz correctly pointed out that attending meetings, and even sporting events, was important to maintaining an open and good relationship with natural gas suppliers. The Examiners recommend that Atmos Mid - Tex make efforts to comply with the Company's code of conduct.

(E) *Cross Subsidization*

Mr. Nalepa expressed a concern about the relationship between TXU Electric and TXU Gas during the review period. TXU Electric bought natural gas to generate electricity for sale in the competitive electric marketplace. He maintained that to the extent that gas is bought at the same time for both entities, the temptation and opportunity for captive gas customers to subsidize gas costs for competitive electric generation existed. In 1999 and 2000, Mr. Wollitz was the Gas Supply Manager for both TXU Electric and TXU Gas Distribution. Mr. Nalepa maintained that having the two gas acquisition groups in such proximity and under the same manager inevitably lead to subsidization of training and information by TXU Gas of TXU Electric.<sup>307</sup>

Mr. Wollitz was responsible for supervising the gas buyers of TXU Gas Company and TXU Electric Company during only the first two months of the Review Period, i.e., November and December 2000. These were the only two months during the Review Period that there was a common supervisor of both sets of gas buyers. At no time during these two months were there purchases for TXU Electric Company for "competitive electric generation," as alleged by Mr. Nalepa. Rather, these two months were before the restructure of electric regulation which did not occur until January 1, 2002. In short, there was no possibility for any kind of subsidy from one class of gas customers to another class of electric generation customers, because both purchases for TXU Electric Company and TXU Gas Company were regulated activities. Thus, neither utility could

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<sup>306</sup> Atmos Exhibit 11, Wollitz Rebuttal, p. 13, lns. 10 - 25 & fn 1.

<sup>307</sup> ACSC Exhibit 1, Nalepa Direct, p. 17, lns. 9 - 22 & p. 18.

recover any more than its actual cost of purchasing natural gas.

Mr. Niemiec testified that there should have been separation between the gas and the electric purchasing functions. Mr. Wollitz argued that it was important to understand that the gas acquisition activities of the Company and TXU Electric have always been separate. There have been no joint purchases for both companies. There have been separate books, records, and accounting systems. The customer bases are different and, as such, there was no effort to combine the gas acquisition activities of the Company and TXU Electric. Mr. Niemiec seemed to be unaware that there has always been complete separation of the gas acquisition activities between the regulated purchases on behalf of the Company, and the unregulated purchases on behalf of the unregulated marketing subsidiaries of TXU Corp. The unregulated marketing subsidiaries of TXU Corp. were in a separate building, several blocks away, and were completely isolated and segregated from the regulated gas acquisition activities of the Company during each and every month of the Review Period.<sup>308</sup>

Mr. Higgins also complained about the alleged combination of the gas purchase activities of Atmos Pipeline - Texas and the Distribution Division. Mr. Wollitz argue that Mr. Higgins is confused on this issue. Mr. Higgins' testimony makes reference to the Pipeline division and the Distribution division of Atmos being "active in the business of purchasing natural gas form Texas Sellers, co-terminously." This, Mr. Wollitz argued, is incorrect. Atmos Pipeline - Texas, the Pipeline Division, was at no time during the Review Period active in purchasing natural gas. The Examiners find that there is no evidence in the record that establishes that TXU Gas operations subsidized the operations of TXU Electric.

*h. Alleged Violations of GUD No. 9233.*

Mr. Higgins argues that Atmos Mid - Tex ignored the settlement of GUD No. 9233. Mr. Higgins apparently argues that an adjustment made in a prior reconciliation proceeding, a \$16,794,249 adjustment, made for unrecovered amounts during the period from July 2000 through October 2000 was incorrect. The adjustment was recovered during this review period.<sup>309</sup> Once interest is added to the amount, Mr. Higgins maintains, customers are due a refund of \$18,822,061.<sup>310</sup>

Ms. Myers argues that Mr. Higgins appears to confuse this proceeding, a prudence review

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<sup>308</sup> Atmos Exhibit 11, Wollitz Rebuttal, p. 14, lns. 26 - 31 & p. 15, lns. 1 - 15.

<sup>309</sup> Higgins Direct, p. 24, lns. 14 - 22.

<sup>310</sup> State of Texas Exhibit 1, Higgins Direct, p. 25, lns. 3 - 5.

of gas costs, with the Company's various reconciliation filings. She maintains that at issue in this docket is whether the gas costs of Atmos - Mid Tex were prudent, not whether the Company recovered those costs from its customers. In GUD No. 9246, the Commission entered a Consent Order memorializing the settlement of the parties regarding the reconciliation of gas costs for the period from July 2000 through October 2000. That order specifically authorized Atmos Mid - Tex to recover certain unrecovered amounts totaling approximately 18 million dollars. Ms. Myers points out that Mr. Higgins is arguing that the Commission should ignore that order and disallow the recovery of the agreed amount.

The Examiners find that the proposed disallowance appears to be in violation of the agreement of the parties, and subsequent order issued by the Commission, in GUD No. 9246. Mr. Higgins' complaint involves two cases that evaluated two different aspects of the Company's gas costs:

- GUD No. 9233 — Prudence Proceeding. Order entered on April 24, **2004**.
- GUD No. 9246 — Reconciliation Proceeding. Order entered on August 6, **2002**.

The reconciliation proceeding was resolved prior to the prudence proceeding. In the reconciliation proceeding, involving the same counsel for the State of Texas that is involved in this case, the parties agreed that Atmos Mid - Tex was allowed to recover over \$18 million in unrecovered gas costs. The prudence proceeding was resolved two years later and settled all prudence issues raised in that case. Atmos Mid - Tex merely charged customers the amounts they were authorized to charge, as stated in the order of the Commission approving and adopting agreement of the parties, including the State of Texas, in the reconciliation proceeding. The settlement in the subsequent prudence proceeding did not appear to alter the prior agreement of the parties.

*i. Synchronized Filings*

The State of Texas, through the testimony of Mr. Higgins argues that the deadline for several filings of Atmos Mid - Tex should be synchronized. Atmos Mid - Tex files a reconciliation proceeding every year, an annual report every year, and a gas cost prudence review every three years. The annual report covers a twelve month period ending December 31<sup>st</sup>, of each year. The reconciliation covers a twelve month period ending June 30<sup>th</sup>, of each year. And the Annual reconciliation covers a 36 month period ending October 31<sup>st</sup>. Mr. Higgins proposes that Atmos Mid - Tex file all reports on December 31<sup>st</sup>.<sup>311</sup>

Ms. Myers testified that the current filing dates should not be revised. The current filing

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<sup>311</sup> State of Texas Exhibit 1, Higgins Direct, p. 26, lns. 21 - 24 & 27, lns. 1 - 14.

dates were established by prior Commission order, are synchronized with the terms of the Company's approved tariffs and the Commission's rule regarding lost and unaccounted for gas.<sup>312</sup> The Examiners agree with Atmos Mid - Tex and do not recommend that the filing dates be changed.

#### IX. Rate Case Expenses

The parties seek actual rate case expenses in the amount of \$1,783,322.00. Atmos filed testimony and documentation to support its request of \$1,152,996.70 in actual rate case expenses.<sup>313</sup> The City of Dallas filed documentation in support of its request for \$133,513.07 in actual rate case expenses.<sup>314</sup> ACSC filed documentation in support of its request of \$320,099.55 in actual rate case expenses.<sup>315</sup> ATM filed testimony and documentation in support of its request for \$176,712.62 in actual rate case expenses.<sup>316</sup> In addition to actual rate case expenses, the parties request approval of an amount for expenses estimated to complete these proceedings here and on appeal. Total expenses, including estimated amounts and actual expenses, are \$2,155,508.83. Total projected costs for Atmos are \$75,000.00, ATM are \$95,700.00, ACSC are \$115,000, and the City of Dallas are \$86,486.93.

Generally, in ratemaking proceedings involving municipalities, the municipality and the utility may recover rate case expenses. The recovery of rate case expenses is premised on two provisions of the Texas Utilities Code. Section 103, addresses municipal rate case expenses.

#### Sec. 103.022. RATE ASSISTANCE AND COST REIMBURSEMENT.

(a) The governing body of a municipality participating in or conducting a ratemaking proceeding may engage rate consultants, accountants, auditors, attorneys, and engineers to:

(1) conduct investigations, present evidence, and advise and represent the governing body; and

(2) assist the governing body with litigation or a gas utility ratemaking proceeding before a regulatory authority or court.

(b) The gas utility in the ratemaking proceeding shall reimburse the governing body of the municipality for the reasonable cost of the services of a person engaged under Subsection (a) to the extent the applicable regulatory authority

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<sup>312</sup> Atmos Exhibit 10, Myers Rebuttal, p. 12, lns. 1 - 11.

<sup>313</sup> Atmos Exhibits 67 & 68.

<sup>314</sup> City of Dallas Exhibit 8, 9, 10, & 11.

<sup>315</sup> ACSC Exhibit 13, & 14.

<sup>316</sup> ATM Exhibit 15

determines reasonable.<sup>317</sup>

The utility is generally, entitled to recover rate case expenses pursuant to section 104.051:

Sec. 104.051. ESTABLISHING OVERALL REVENUES. In establishing a gas utility's rates, the regulatory authority shall establish the utility's overall revenues at an amount that will permit the utility a reasonable opportunity to earn a reasonable return on the utility's invested capital used and useful in providing service to the public in excess of its reasonable and necessary operating expenses.<sup>318</sup>

In determining the recovery of rate case expenses, section 7.5530 of the Commission's rules also controls:

- (a) In any rate proceeding, any utility and/or municipality claiming reimbursement for its rate case expenses pursuant to Texas Utilities Code, § 103.022(b), shall have the burden to prove the reasonableness of such rate case expenses by a preponderance of the evidence. Each gas utility and/or municipality shall detail and itemize all rate case expenses and allocation and shall provide evidence showing the reasonableness of the cost of all professional services, including but not limited to:
  - (1) the amount of work done;
  - (2) the time and labor required to accomplish the work;
  - (3) the nature, extent, and difficulty of the work done;
  - (4) the originality of the work;
  - (5) the charges by others for work of the same or similar nature; and
  - (6) any other factors taken into account in setting the amount of the compensation.
  
- (b) In determining the reasonableness of the rate case expenses, the Commission shall consider all relevant factors including but not limited to those set out previously, and shall also consider whether the request for a rate change was warranted, whether there was duplication of services or testimony, whether the work was relevant and reasonably necessary to the proceeding, and whether the complexity and expense of the work was commensurate with both the complexity of the issues in the proceeding and the amount of the increase sought as well as the amount of any increase granted.

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<sup>317</sup> Tex. Util. Code Ann. § 103.022.

<sup>318</sup> Tex. Util. Code Ann. § 104.051.

The Examiners find that extensive work was conducted in this case, and that to a large degree this was a case of first impression. The issues presented were complex and difficult. At issue in this case was an enormous number of transactions totaling \$2,233,362,412 over a three year period. The Examiners find that the Intervening parties assiduously avoided duplication of services or testimony and all work performed was relevant and necessary to the proceeding. In addition, the total actual rate case expenses requested were less than the rate case expenses approved in GUD No. 9233. In that case the parties ultimately reached a settlement and no hearing was held. The parties requested recovery of \$2,155,508.83 in actual rate case expenses. In the event that the Commission approves the recovery of rate case expenses the Examiners do not recommend that any amount be approved for anticipated expenses to complete the proceeding. Accordingly, the Examiners would recommend that the parties file a separate docket after the conclusion of all future proceedings related to this case, if they intend to recover those expenses from ratepayers. Nevertheless, the recovery of rate case expenses may be precluded by a recent decision issued by the Third Court of Appeals.

While the Examiners are of the opinion that the amounts requested for actual rate case expenses are reasonable, the recent opinion in *CenterPoint Energy Entex v. Railroad Commission*, \_\_\_ S.W.3d \_\_\_ (Tex. App. — Austin, 2006), raises the issue of whether rate case expenses are recoverable in this case. That case involved the prudence review conducted in Tex. R.R. Comm'n, *Joint Petition of CenterPoint Energy Entex and the City of Tyler for Review of Charges for Gas Sales* (May 24, 2005) (“GUD No. 9364”). Entex filed an appeal in that case seeking a declaration that a retroactive prudence review of gas purchases was not a “ratemaking proceeding” in which the municipality could recover rate case expenses. The Court of Appeals concluded that it was not a rate making proceeding:

We have already concluded that the issue presented here is one concerning alleged misapplication of Entex’s approved rates, not the setting of Entex’s rates. The City is not seeking to adjust the formula contained in the PGA clause or to change Entex’s approved rate. As a result, these proceedings are not “ratemaking proceedings,” and the City is not entitled to reimbursement for its costs for its participation in the review.

The Examiners in GUD No. 9364 made a distinction between the prudence review being conducted and the prudence review in GUD No. 9233, and by extension the present pending case.<sup>319</sup> Specifically, the prudence review conducted in this case and GUD No. 9233 was ordered by the Commission in GUD No. 8664 and emanated from a ratemaking proceeding. The procedural posture of GUD No. 9364, however, was not the same. While the Examiners continue to believe that the two cases present distinct procedural circumstances, the Examiners do not believe that the decision of the Court of Appeals depends upon that distinction. The Court of Appeals decision is based on the nature of the decision being made by the Commission. Accordingly, the Examiners

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<sup>319</sup> Attached at Tab 13, is a copy of Examiners’ Letter No. 16 issued in GUD No. 9364.



find that the decision by the Third Court of Appeals suggests that rate case expenses requested should be denied.

On the other hand, the full effect of that decision on this case is not clear. The procedural posture of that case is such that the parties may request rehearing and ultimately appeal the decision to the Supreme Court. Furthermore, the parties have not had an opportunity to brief the opinion of the Court and the applicability of that decision to these proceedings. Accordingly, the Examiners recommend that all issues related to rate case expenses be severed to a separate docket. Additionally, the Examiners recommend that briefing on the issues in the severed docket should not commence until after a final and non-appealable decision is rendered in *CenterPoint Energy Entex v. Railroad Commission*, \_\_\_ S.W.3d \_\_\_ (Tex. App. — Austin, 2006).

**XII. Conclusion**

In conclusion, Atmos Mid - Tex spent \$2,233,362,411.91 to acquire natural gas to serve its customers during the Review Period. Atmos Mid - Tex was unable to establish that \$26,374,010.42 of its natural gas acquisition expenditures was prudent. Accordingly, the Examiners recommend that the above amount, which represents 1.18 percent of its overall natural gas procurement expenditures, be disallowed. The Examiners total recommended disallowance is as follows:

Failure to prudently manage its hedging program	\$15,835,077.00
	<u>\$ 374,704.94</u>
Subtotal:	\$16,209,781.94
Failure to prudently manage storage:	\$10,161,220.00
Failure to establish necessity of payment to supplier:	\$ 3,008.48

Respectfully submitted,

Gene Montes  
Hearings Examiner  
Office of General Counsel

Rose Ruiz  
Technical Examiner  
Gas Services Division

Baseload Purchases  
 Monthly Averages  
 November 2000 - October 2003

Year	Month	MMBTU	Amount \$	Average \$/MMBTU
2000	11	2,852,944.00	12,751,683.04	\$4.47
2000	12	8,888,102.00	46,366,667.28	\$5.22
2001	1	8,995,279.00	57,151,542.22	\$6.35
2001	2	8,023,402.00	42,481,096.96	\$5.29
2001	3	2,897,605.00	14,261,904.89	\$4.92
2001	4	1,507,342.00	7,500,279.17	\$4.98
2001	5	2,371,993.00	11,113,281.58	\$4.69
2001	6	2,396,495.00	9,297,822.21	\$3.88
2001	7	2,310,994.00	8,356,839.26	\$3.62
2001	8	2,361,075.00	8,527,124.65	\$3.61
2001	9	2,232,985.00	6,554,463.04	\$2.94
2001	10	2,371,610.00	6,358,276.58	\$2.68
2001	11	6,235,545.00	19,403,393.04	\$3.11
2001	12	8,567,823.00	25,176,875.34	\$2.94
2002	1	10,090,622.00	28,929,710.59	\$2.87
2002	2	8,909,352.00	23,795,839.00	\$2.67
2002	3	5,901,997.00	15,790,826.64	\$2.68
2002	4	2,206,599.00	7,452,795.45	\$3.38
2002	5	2,289,095.00	7,515,273.61	\$3.28
2002	6	3,285,332.00	10,632,907.76	\$3.24
2002	7	3,371,502.00	10,587,805.03	\$3.14
2002	8	3,234,112.00	9,357,229.25	\$2.89
2002	9	3,315,840.00	10,529,344.91	\$3.18
2002	10	3,411,025.00	11,903,426.07	\$3.49
2002	11	6,237,609.00	24,129,917.15	\$3.87
2002	12	9,533,530.00	35,485,233.45	\$3.72
2003	1	10,837,281.00	48,152,753.14	\$4.44
2003	2	9,651,234.00	50,643,647.73	\$5.25
2003	3	6,602,969.00	53,987,259.25	\$8.18
2003	4	2,929,930.00	13,395,753.48	\$4.57
2003	5	3,661,770.00	17,171,020.84	\$4.69
2003	6	3,578,303.00	19,751,925.59	\$5.52
2003	7	3,668,009.00	18,573,543.24	\$5.06
2003	8	3,664,613.00	16,209,263.01	\$4.42
2003	9	3,536,465.00	16,205,780.07	\$4.58
2003	10	4,202,018.00	17,059,143.84	\$4.06
TOTAL		176,132,401.00	742,561,648.36	

Peaking Purchases  
Monthly Averages  
Nov. 2000 - Oct 2003

Year	Month	MMBTU	Amount \$	\$/MMBTU
2000	12	5,013,679.00	45,816,593.06	\$9.14
2001	1	3,600,000.00	33,055,732.64	\$9.18
2001	2	780,061.00	4,297,051.97	\$5.51
2001	3	2,372,685.00	12,222,477.52	\$5.15
2001	12	1,182,147.00	3,153,551.46	\$2.67
2002	1	3,390,501.00	7,993,667.07	\$2.36
2002	2	3,634,849.00	8,605,063.62	\$2.37
2002	3	5,845,697.00	17,227,211.57	\$2.95
2002	12	3,117,230.00	14,270,560.52	\$4.58
2003	1	5,819,296.00	31,916,083.69	\$5.48
2003	2	5,540,171.00	59,241,231.60	\$10.69
2003	3	530,000.00	4,904,976.70	\$9.25
Total		40,826,316.00	242,704,201.42	

Swing Purchases  
Monthly Averages  
Nov. 2000 - Oct 2003

Year	Month	MMBTU	Amount \$	\$/MMBTU
2000	11	1,539,068.00	8,594,155.72	\$5.58
2000	12	4,120,145.00	33,113,582.22	\$8.04
2001	1	680,351.00	7,907,538.59	\$11.62
2001	2	1,638,216.00	11,388,425.42	\$6.95
2001	3	2,240,624.00	13,118,263.56	\$5.85
2001	12	360,000.00	948,075.00	\$2.63
2002	1	300,000.00	737,700.00	\$2.46
2002	2	315,000.00	750,600.00	\$2.38
2002	3	375,000.00	1,100,900.00	\$2.94
Total		11,568,404.00	77,659,240.51	

Spot Purchase  
Monthly Averages  
November 2000 - October 2003

Year	Month	MMBTU	Amount \$	Average \$/MMBtu
2000	11	17,692,174.00	100,107,076.10	\$5.66
2000	12	12,106,007.00	109,072,157.26	\$9.01
2001	1	17,525,187.00	142,377,043.20	\$8.12
2001	2	8,163,072.00	47,037,766.71	\$5.76
2001	3	8,286,216.00	43,079,052.38	\$5.20
2001	4	10,875,573.00	55,517,352.03	\$5.10
2001	5	6,660,699.00	27,603,177.33	\$4.14
2001	6	2,900,724.00	10,325,918.91	\$3.56
2001	7	3,392,224.00	10,246,394.58	\$3.02
2001	8	2,334,241.00	6,709,789.26	\$2.87
2001	9	3,608,450.00	7,111,069.80	\$1.97
2001	10	6,096,956.00	13,682,054.30	\$2.24
2001	11	6,177,631.00	13,494,790.68	\$2.18
2001	12	9,717,389.00	23,038,284.64	\$2.37
2002	1	8,130,019.00	18,085,565.67	\$2.22
2002	2	9,091,972.00	19,749,830.25	\$2.17
2002	3	7,861,377.00	23,163,143.56	\$2.95
2002	4	7,983,094.00	25,609,939.67	\$3.21
2002	5	5,956,112.00	18,360,908.51	\$3.08
2002	6	4,298,788.00	12,570,425.54	\$2.92
2002	7	2,195,739.00	6,206,586.67	\$2.83
2002	8	3,106,611.00	8,934,901.62	\$2.88
2002	9	2,924,544.00	9,497,276.49	\$3.25
2002	10	6,030,784.00	23,397,006.59	\$3.88
2002	11	13,070,908.00	51,059,476.94	\$3.91
2002	12	12,528,741.00	54,693,333.22	\$4.37
2003	1	8,793,173.00	44,233,802.14	\$5.03
2003	2	7,343,710.00	55,126,114.55	\$7.51
2003	3	5,702,416.00	46,029,218.33	\$8.07
2003	4	8,664,186.00	42,442,721.49	\$4.90
2003	5	5,660,000.00	31,147,716.38	\$5.50
2003	6	3,755,374.00	20,328,103.50	\$5.41
2003	7	1,568,524.00	7,595,127.76	\$4.84
2003	8	2,814,062.00	13,678,548.56	\$4.86
2003	9	3,187,084.00	13,564,241.01	\$4.26
2003	10	3,596,955.00	15,561,405.99	\$4.33
TOTAL		249,800,716.00	1,170,437,321.62	

Baseload Contracts Entered Into Above Spot Prices

Contract	Initial Purchase		MMBTU	Amt Paid	Average Monthly		Average Monthly		Diff	Diff	% Change	% Change	% Change	% Change	Amount of	Amount of
	Month	Year			Paid Per	Spot Price	Spot Price	Mo of Purchase								
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)	(k)	(l)	(m)	(n)	(o)	(p)	
									f-g	f-h	i/f	j/f	k>10%	l>10%	(i*d)	(j*d)
1	07006-00	12	2000	155,000	919,925.00	\$5.94	\$9.01	\$5.66	-3.07	0.28	-51.68%	4.74%	No	No		
2	07019-00	11	2000	81,574	418,409.37	\$5.13	\$5.66	n/a	-0.53	n/a	-10.30%	n/a	No	n/a		
3	07027-00	12	2000	217,000	1,287,895.00	\$5.94	\$9.01	\$5.66	-3.07	0.28	-51.68%	4.74%	No	No		
4	07030-00	12	2000	620,000	3,679,700.00	\$5.94	\$9.01	\$5.66	-3.07	0.28	-51.68%	4.74%	No	No		
5	07034-00	12	2000	2,940	17,346.00	\$5.90	\$9.01	\$5.66	-3.11	0.24	-52.71%	4.10%	No	No		
6	07035-00	12	2000	52,035	321,316.13	\$6.18	\$9.01	\$5.66	-2.83	0.52	-45.79%	8.44%	No	No		
7	07038-00	1	2001	88,896	941,719.78	\$10.59	\$8.12	\$9.01	2.47	1.58	23.32%	14.92%	Yes	Yes	\$219,573.12	\$140,477.46
8	07041-00	5	2001	66,433	320,207.06	\$4.82	\$4.14	\$5.10	0.68	-0.28	14.02%	-5.91%	Yes	No		
9	07043-00	5	2001	155,000	748,650.00	\$4.83	\$4.14	\$5.10	0.69	-0.27	14.20%	-5.69%	Yes	No		
10	07052-00	11	2001	150,000	431,250.00	\$2.88	\$2.18	\$2.24	0.70	0.64	24.15%	22.08%	Yes	Yes	\$104,330.93	\$95,388.07
11	07055-00	11	2001	81,751	229,311.56	\$2.81	\$2.18	\$2.24	0.63	0.57	22.26%	20.14%	Yes	Yes	\$51,138.48	\$46,264.56
12	07056-00	9	2001	5,139	11,511.36	\$2.24	\$1.97	\$2.87	0.27	-0.63	12.02%	-28.33%	Yes	No		
13	07057-00	11	2001	137,435	393,407.69	\$2.86	\$2.18	\$2.24	0.68	0.62	23.62%	21.54%	Yes	Yes	\$92,842.78	\$84,649.03
14	07068-00	11	2001	10,485	31,402.58	\$3.00	\$2.18	\$2.24	0.82	0.76	27.18%	25.20%	Yes	Yes	\$8,550.93	\$7,925.83
15	07079-00	12	2001	155,000	347,587.50	\$2.24	\$2.37	\$2.18	-0.13	0.06	-5.84%	2.48%	No	No		
16	07083-00	12	2001	155,000	369,675.00	\$2.38	\$2.37	\$2.18	0.01	0.20	0.39%	8.22%	No	No		
17	07085-00	1	2002	358	767.16	\$2.14	\$2.22	\$2.37	-0.08	-0.23	-3.95%	-10.79%	No	No		
18	07086-00	2	2002	1,778	2,844.80	\$1.60	\$2.17	\$2.22	-0.57	-0.62	-35.76%	-39.03%	No	No		
19	07132-00	6	2003	300,000	1,666,500.00	\$5.56	\$5.41	\$5.50	0.15	0.06	2.64%	1.02%	No	No		
20	07133-00	4	2003	150,000	708,000.00	\$4.72	\$4.90	\$8.07	-0.18	-3.35	-3.78%	-71.01%	No	No		
21	07134-00	5	2003	558,000	2,577,960.00	\$4.62	\$5.50	\$4.90	-0.88	-0.28	-19.12%	-6.03%	No	No		
22	07135-00	5	2003	795	3,173.64	\$3.99	\$5.50	\$4.90	-1.51	-0.91	-37.92%	-22.77%	No	No		
23	07136-00	5	2003	62,662	298,897.74	\$4.77	\$5.50	\$4.90	-0.73	-0.13	-15.37%	-2.70%	No	No		
24	07137-00	4	2003	450,000	1,993,500.00	\$4.43	\$4.90	\$8.07	-0.47	-3.64	-10.58%	-82.21%	No	No		
25	07138-00	6	2003	1,200,000	6,768,000.00	\$5.64	\$5.41	\$5.50	0.23	0.14	4.02%	2.43%	No	No		
26	07139-00	6	2003	40,736	222,418.56	\$5.46	\$5.41	\$5.50	0.05	-0.04	0.86%	-0.79%	No	No		
													TOTAL	\$476,436.24	\$374,704.94	

Comparison of Gas Cost  
Fixed Prior to October 1  
Compared to Gas Cost Fixed During the Winter Season

Month	Winter Baseload Fixed Prior to October 1			Winter Baseload Fixed After October 1			(g) Total Mmbtu  (col a + col d)	(h) Total Dollars Paid  (col b + col e)	(i) Cost if all Vols Fixed  ((col a + col d) * c)	(j) Difference  (h-i)
	(a) Mmbtu	(b) Dollar Amount	(c) Price per Mmbtu	(d) Mmbtu	(e) Dollar Amount	(f) Price per Mmbtu				
Nov-00	521,721	\$1,662,344.11	\$3.19	2,249,649	\$10,670,704.56	\$4.74	2,771,370	\$12,333,048.67	\$8,830,333.83	\$3,502,714.84
Dec-00	537,151	\$1,693,668.80	\$3.15	7,118,288	\$37,273,447.16	\$5.24	7,655,439	\$38,967,115.96	\$24,138,050.91	\$14,829,065.05
Jan-01	262,230	\$942,601.72	\$3.59	7,548,668	\$44,557,070.07	\$5.90	7,810,898	\$45,499,671.79	\$28,076,749.00	\$17,422,922.79
Feb-01	49,190	\$133,322.71	\$2.71	6,909,806	\$35,731,275.08	\$5.17	6,958,996	\$35,864,597.79	\$18,861,398.77	\$17,003,199.02
Mar-01	53,068	\$137,936.89	\$2.60	2,790,184	\$13,819,070.62	\$4.95	2,843,252	\$13,957,007.51	\$7,390,316.92	\$6,566,690.59
	1,423,360	\$4,569,874.23		26,616,595			28,039,955	\$146,621,441.72	\$87,296,849.43	\$59,324,592.29
Nov-01	2,376,638	\$8,409,441.38	\$3.54	2,024,221	\$5,485,710.88	\$2.71	4,400,859	\$13,895,152.26	\$15,571,898.53	(\$1,676,746.27)
Dec-01	5,448,097	\$17,727,468.71	\$3.25	2,268,353	\$5,498,666.42	\$2.42	7,716,450	\$23,226,135.13	\$25,108,423.35	(\$1,882,288.22)
Jan-02	4,488,478	\$14,298,032.57	\$3.19	4,144,855	\$10,893,598.48	\$2.63	8,633,333	\$25,191,631.05	\$27,501,455.15	(\$2,309,824.10)
Feb-02	3,918,348	\$12,079,624.49	\$3.08	2,971,570	\$7,830,773.02	\$2.64	6,889,918	\$19,910,397.51	\$21,240,487.63	(\$1,330,090.12)
Mar-02	1,666,685	\$5,232,968.18	\$3.14	1,431,854	\$4,128,902.53	\$2.88	3,098,539	\$9,361,870.71	\$9,728,626.58	(\$366,755.87)
	17,898,246			12,840,853			30,739,099	\$91,585,186.66	\$99,150,891.24	(\$7,565,704.58)
Nov-02	402,041	1,484,576.12	\$3.69	5,379,792	\$20,851,543.07	\$3.88	5,781,833	\$22,336,119.19	\$21,349,989.68	\$986,129.51
Dec-02	434,806	1,567,752.74	\$3.61	9,092,856	\$33,894,997.43	\$3.73	9,527,662	\$35,462,750.17	\$34,353,293.67	\$1,109,456.50
Jan-03	166,082	822,238.04	\$4.95	7,009,731	\$30,404,157.92	\$4.34	7,175,813	\$31,226,395.96	\$35,525,983.65	(\$4,299,587.69)
Feb-03	11,723	32,520.62	\$2.77	4,963,435	\$26,098,512.75	\$5.26	4,975,158	\$26,131,033.37	\$13,801,520.32	\$12,329,513.05
Mar-03	4,584	11,390.89	\$2.48	3,402,150	\$26,761,816.63	\$7.87	3,406,734	\$26,773,207.52	\$8,465,473.88	\$18,307,733.64
	1,019,236			29,847,964			30,867,200	\$141,929,506.20	\$113,496,261.20	\$28,433,245.00
<b>Total</b>	20,340,842			69,305,412			89,646,254	\$380,136,134.58	\$299,944,001.87	\$80,192,132.71



Comparison of Gas Cost  
Fixed Prior to November 1  
Compared to Gas Cost Fixed During the Winter Season

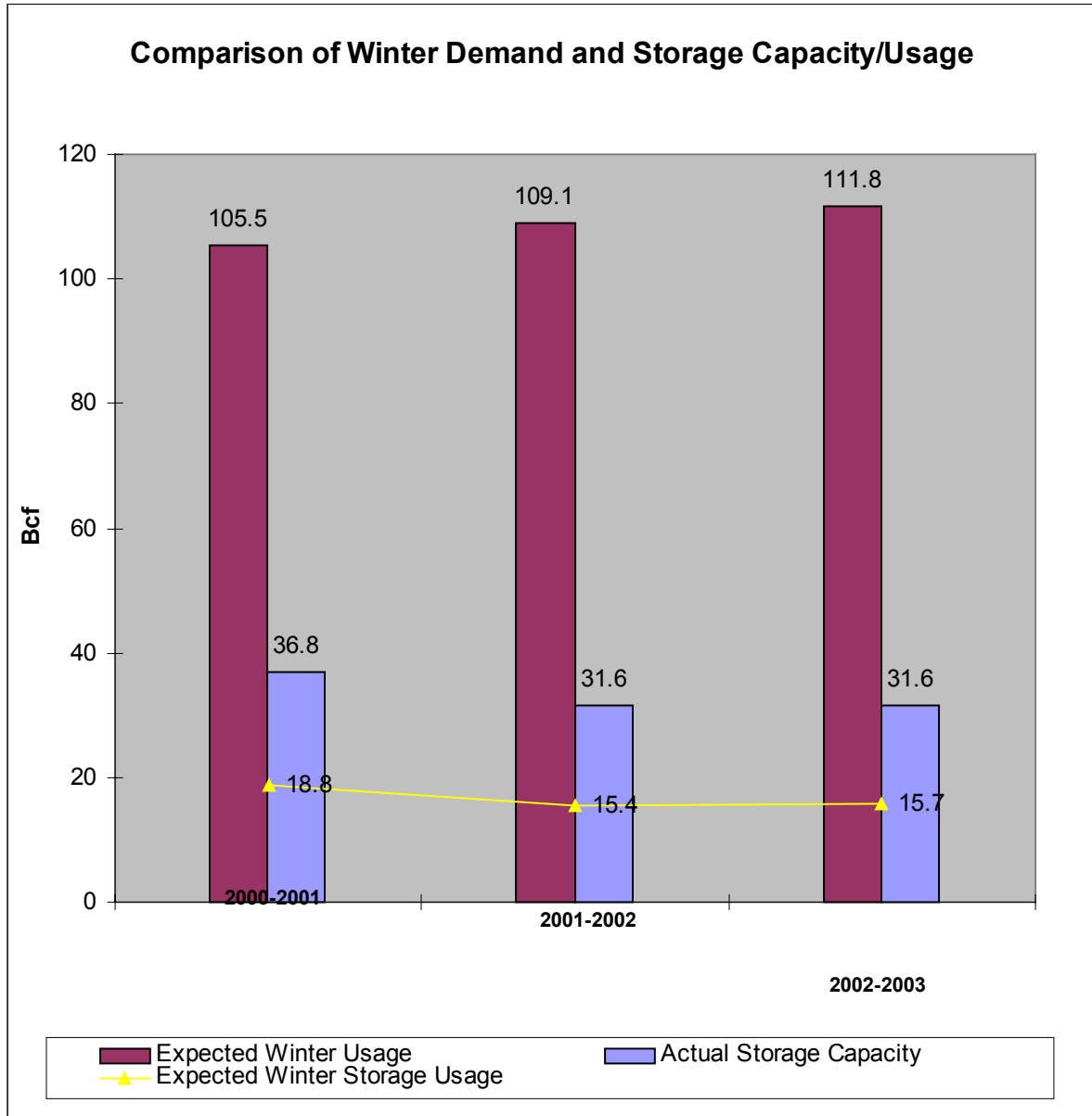
Month	Winter Baseload Fixed Prior to November 1			Winter Baseload Fixed After November 1			(g) Total Mmbtu  (col a + col d)	(h) Total Dollars Paid  (col b + col e)	(i) Cost if all Vols Fixed  ((col a + col d) * c)	(j) Difference  (h-i)
	(a) Mmbtu	(b) Dollar Amount	(c) Price per Mmbtu	(d) Mmbtu	(e) Dollar Amount	(f) Price per Mmbtu				
Nov-00	1,505,714.00	\$6,415,370.68	\$4.26	1,265,656.00	\$5,917,677.99	\$4.68	2,771,370	\$12,333,048.67	\$11,807,930.22	\$525,118.45
Dec-00	6,230,476.00	\$29,743,952.26	\$4.77	1,424,963.00	\$9,224,713.70	\$6.47	7,655,439	\$38,968,665.96	\$36,546,647.82	\$2,422,018.14
Jan-01	5,945,381.00	\$28,965,591.47	\$4.87	1,865,517.00	\$16,535,630.32	\$8.86	7,810,898	\$45,501,221.79	\$38,054,294.67	\$7,446,927.12
Feb-01	5,201,097.00	\$25,493,742.96	\$4.90	1,757,899.00	\$10,372,254.83	\$5.90	6,958,996	\$35,865,997.79	\$34,110,276.21	\$1,755,721.58
Mar-01	1,067,105.00	\$5,042,347.38	\$4.73	1,776,147.00	\$8,914,660.13	\$5.02	2,843,252	\$13,957,007.51	\$13,435,101.77	\$521,905.74
	19,949,773	\$95,661,004.75		8,090,182	\$50,964,936.97		28,039,955	\$146,625,941.72	\$133,954,250.69	\$12,671,691.03
Nov-01	3,385,019.00	\$10,991,101.33	\$3.25	1,015,840.00	\$2,903,113.43	\$2.86	4,400,859	\$13,894,214.76	\$14,289,517.20	(\$395,302.44)
Dec-01	6,458,041.00	\$20,278,872.66	\$3.14	1,258,409.00	\$2,920,107.24	\$2.32	7,716,450	\$23,198,979.90	\$24,230,398.50	(\$1,031,418.60)
Jan-02	5,537,415.00	\$16,978,169.71	\$3.07	3,095,918.00	\$8,206,137.65	\$2.65	8,633,333	\$25,184,307.36	\$26,470,508.86	(\$1,286,201.50)
Feb-02	4,863,667.00	\$14,462,186.84	\$2.97	2,026,251.00	\$5,409,808.97	\$2.67	6,889,918	\$19,871,995.81	\$20,487,274.61	(\$615,278.80)
Mar-02	1,768,657.00	\$5,523,405.13	\$3.12	1,329,882.00	\$3,837,496.83	\$2.89	3,098,539	\$9,360,901.96	\$9,676,543.39	(\$315,641.43)
	22,012,799			8,726,300			30,739,099	\$91,510,399.79	\$95,154,242.56	(\$3,643,842.77)
Nov-02	4,480,584.00	\$17,905,455.18	\$4.00	1,301,249.00	\$5,078,589.01	\$3.90	5,781,833	\$22,984,044.19	\$23,105,548.66	(\$121,504.47)
Dec-02	1,482,161.00	\$5,305,653.92	\$3.58	8,045,501.00	\$30,160,196.25	\$3.75	9,527,662	\$35,465,850.17	\$34,105,928.60	\$1,359,921.57
Jan-03	270,541.00	\$1,045,311.10	\$3.86	6,905,272.00	\$30,178,372.36	\$4.37	7,175,813	\$31,223,683.46	\$27,725,767.93	\$3,497,915.53
Feb-03	98,908.00	\$219,127.02	\$2.22	4,876,250.00	\$25,910,506.35	\$5.31	4,975,158	\$26,129,633.37	\$11,022,278.75	\$15,107,354.62

Comparison of Gas Cost  
Fixed Prior to November 1  
Compared to Gas Cost Fixed During the Winter Season

Mar-03	103,690.00	\$223,101.40	\$2.15	3,303,044.00	\$26,552,896.12	\$8.04	3,406,734	\$26,775,997.52	\$7,329,994.45	\$19,446,003.07
	6,435,884			24,431,316			30,867,200	\$142,579,208.70	\$103,289,518.39	\$39,289,690.31
<b>Total</b>	48,398,456			41,247,798			89,646,254	\$380,715,550.21	\$332,398,011.64	\$48,317,538.58

November Analysis  
 Winter 2002-2003  
 Normalized Volumes

Month	Winter Baseload Fixed Prior to November 1			Winter Baseload Fixed After November 1			(g) Total Mmbtu  (col a + col d)	(h) Total Dollars Paid  (col b + col e)	(i) Cost if all Vols Fixed  (col a + col d) * c	(j) Difference  (h-i)		
	(a) Mmbtu	(b) Dollar Amount	(c) Price per Mmbtu	(d) Mmbtu	(e) Dollar Amount	(f) Price per Mmbtu						
Nov-02	4,480,584.00	\$17,905,455.18	\$4.00	1,301,249.00	\$5,078,589.01	\$3.90	5,781,833	\$22,984,044.19	\$23,105,548.66	(\$121,504.47)		
Dec-02	1,482,161.00	\$5,305,653.92	\$3.58	8,045,501.00	\$30,160,196.25	\$3.75	9,527,662	\$35,465,850.17	\$34,105,928.60	\$1,359,921.57		
Jan-03	270,541.00	\$1,045,311.10	\$3.86	6,905,272.00	\$30,178,372.36	\$4.37	7,175,813	\$31,223,683.46	\$27,725,767.93	\$3,497,915.53		
Feb-03	98,908.00	\$219,127.02	\$2.22	4,876,250.00	\$25,910,506.35	\$5.31	4,975,158	\$26,129,633.37	\$11,022,278.75	\$15,107,354.62		
Mar-03	103,690.00	\$223,101.40	\$2.15	3,303,044.00	\$26,552,896.12	\$8.04	3,406,734	\$26,775,997.52	\$7,329,994.45	\$19,446,003.07		
Volumes as a % of Total Vols	6,435,884	24,698,648.62	\$3.84	24,431,316	117,880,560.08	\$4.82	30,867,200	\$142,579,208.70	\$103,289,518.39	\$39,289,690.31		
	20.85%			79.15%								
Month	(a) Mmbtu	(b) Dollar Amount	(c) Price per Mmbtu	(d) Mmbtu	(e) Dollar Amount	(f) Price per Mmbtu	(g) Total Mmbtu  (col a + col d)	(h) Total Dollars Paid  (col b + col e)	(i) Cost if all Vols Fixed  (col a + col d) * c	(j) Difference  (h-i)		
Normalized Volumes	71.50%	22,070,048.00	84,697,045.59	\$3.84	28.50%	8,797,152.00	42,446,064.10	4.824978	30,867,200	\$142,579,208.70	\$127,143,109.69	\$15,436,099.01



**Storage Injection Season Prior to Second Winter**

	Actual Storage Activity Injections (1)		Assumed Activity Injections (3)	Company Actual Gas Costs \$/Mmbtu (2)		Cost of Gas Injected into Storage (3)
	(1)	(2)	(3)	(4)		(5)
Apr-01	4,674,000	0.336827917	2,054,650	\$ 5.09	\$	10,458,170
May-01	4,089,000	0.294670379	1,797,489	\$ 4.29	\$	7,711,229
Jun-01	868,300	0.062573316	381,697	\$ 3.70	\$	1,412,280
Jul-01	1,233,000	0.088855118	542,016	\$ 3.26	\$	1,766,973
Aug-01	225,000	0.016214438	98,908	\$ 3.25	\$	321,451
Sep-01	1,141,000	0.082225215	501,574	\$ 2.34	\$	1,173,683
Oct-01	1,646,222	0.118633617	723,665	\$ 2.37	\$	1,715,086
	13,876,522	1	6,100,000 (4)		\$	24,558,872
Total Cost of gas injected into Hill Lake prior to second winter						\$ 24,558,872

**Second Winter Season**

	Actual Storage Activity Withdrawals (1)		Assumed Activity Withdrawals (3)	Company Actual Gas Costs \$/Mmbtu (2)		Cost of Gas Withdrawn In Leu of Purchases (3)
	(1)	(2)	(3)	(4)		(5)
Nov-01	1,162,000	0.085181873	519,609	\$ 2.65	\$	1,376,965
Dec-01	2,492,000	0.182679197	1,114,343	\$ 2.64	\$	2,941,866
Jan-01	3,463,000	0.253859575	1,548,543	\$ 2.54	\$	3,933,300
Feb-02	2,570,900	0.188463061	1,149,625	\$ 2.41	\$	2,770,595
Mar-01	3,953,500	0.289816295	1,767,879	\$ 2.87	\$	5,073,814
	13,641,400	1	6,100,000 (4)		\$	16,096,540
Cost of 6,100,000 MMBtu of gas						\$ 16,096,540

**Storage Injection Season Prior to Third Winter**

	Actual Storage Activity Injections (1)		Assumed Activity Injections (3)	Company Actual Gas Costs \$/Mmbtu (2)		Cost of Gas Injected into Storage (3)
	(1)	(2)	(3)	(4)		(5)
Apr-02	1,505,900	0.143492707	875,306	\$ 3.24	\$	2,835,990
May-02	2,710,000	0.258227795	1,575,190	\$ 3.14	\$	4,946,095
Jun-02	3,192,700	0.304222834	1,855,759	\$ 3.06	\$	5,678,623
Jul-02	761,000	0.072513414	442,332	\$ 3.02	\$	1,335,842
Aug-02	685,000	0.065271601	398,157	\$ 2.88	\$	1,146,691
Sep-02	552,000	0.052598429	320,850	\$ 3.21	\$	1,029,930
Oct-02	1,088,010	0.103673219	632,407	\$ 3.74	\$	2,365,201
	10,494,610	1	6,100,000 (4)		\$	19,338,373
Total Cost of gas injected into Hill Lake prior to third winter						\$ 19,338,373

**Third Winter Season**

	Actual Storage Activity Withdrawals (1)		Assumed Activity Withdrawals (3)	Company Actual Gas Costs \$/Mmbtu (2)		Cost of Gas Withdrawn In Leu of Purchases (3)
	(1)	(2)	(3)	(4)		(5)
Nov-02	190,000	0.011280316	68,810	\$ 3.89	\$	267,671
Dec-02	1,890,000	0.112209458	684,478	\$ 4.15	\$	2,840,582
Jan-03	6,127,000	0.363760501	2,218,939	\$ 4.88	\$	10,828,423
Feb-03	4,965,500	0.294802149	1,798,293	\$ 7.32	\$	13,163,506
Mar-03	3,671,000	0.217947576	1,329,480	\$ 8.17	\$	10,861,853
	16,843,500	1	6,100,000 (4)		\$	37,962,035
Cost of 3,000,000 MMBtu of gas						\$ 37,962,035

Winter 2	\$ 16,096,540	What Atmos Mid - Tex paid for 6.1 Bcf non stored gas
	\$ 24,558,872	Cost of 6.1 Bcf of stored gas
	\$ (8,462,332)	Savings or (loss) for use of stored gas
Winter 3	\$ 37,962,035	What Atmos Mid - Tex paid for 6.1 Bcf non stored gas
	\$ 19,338,373	Cost of 6.1 Bcf of stored gas
	\$ 18,623,662	Savings or (loss) for use of stored gas
Overall	\$ 10,161,330	Overall savings/loss

Notes	(1)	See HKH - II - B Col D
	(2)	See HKH - II - B Col C
	(3)	Col. 4 x Col. 5
	(4)	Mr. Erskine Rebuttal, p 8, ln 28

# Hill Lake Storage Facility Nomination Balances

