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May 28, 2004

Honorable Deborah Taylor Tate
Chairman
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, Tennessee 37243

RE: UNITED CITIES GAS COMPANY, a Division of ATMOS ENERGY CORPORATION, INCENTIVE PLAN ACCOUNT (IPA) AUDIT
Docket No.: 01-00704

Dear Chairman Tate:

Enclosed is an original and thirteen copies of a Reply Opposing Approval Of The Proposed Settlement by the Consumer Advocate and Protection Division of the Office of the Attorney General. Kindly file the attached in this docket. By copy of this letter, we are serving all parties of record. If you have any questions, please feel free to contact me at (615) 741-8700. Thank you.

Sincerely,

Russell T. Perkins
Deputy Attorney General

Enclosures
cc: All Parties of Record

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BEFORE THE TENNESSEE REGULATORY AUTHORITY
AT NASHVILLE, TENNESSEE

IN RE:	)	
	)	
UNITED CITIES GAS COMPANY, a Division of	)	**DOCKET NO.**
AMOS ENERGY CORPORATION,	)	**01-00704**
INCENTIVE PLAN ACCOUNT (IPA) AUDIT	)	

THE CONSUMER ADVOCATE DIVISION'S REPLY OPPOSING APPROVAL OF THE PROPOSED SETTLEMENT

Introduction

In the interest of emphasis, the Consumer Advocate Division ("CAD") will only address certain points here. This Reply, therefore, is not an exhaustive recitation of the CAD's concerns.

The CAD respectfully urges the Hearing Officer to summarily deny the motion of Atmos and the Staff to approve the proposed settlement. Additionally, the CAD suggests that there are sufficient grounds in its Objection to warrant denial of the motion. Similarly, the CAD submits that the body of this Reply sufficiently refutes the material contained in the Response filed by the other parties. As a precautionary measure, however, the CAD is filing herewith and is incorporating by reference in this Reply Addendum "A" and Addendum "B", respectively, which provide more detailed analysis of issues relating to the proposed settlement.

1. The CAD Has Not Joined The Settlement

The settlement package offered by Atmos and the Staff should not be approved because the CAD has not joined the proposed settlement.[1] *See*, Rule 1220-1-3, Rules of Tennessee

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[1]The proponents of the settlement do not counter (and apparently concede) the CAD's contention that the Tennessee Supreme Court case of *Harbour v Brown For Ulrich*, 732 S W 2d

Regulatory Authority Alternatively, the CAD has raised credible objections which under all the circumstances of this case, should be enough to prevent the settlement from being approved. The Hearing Officer, therefore, should summarily deny the pending motion to approve settlement and set a status conference on June 8, 2004, for discussing the further progress of this case.

2. Approving The Settlement Puts The CAD In A Worse Position Than It Was Before It Participated In Good Faith In Mediation

Approving this settlement over the CAD's credible objections puts the CAD in a worse position than it was before it participated in settlement discussions and a mediation which may have also constituted a judicial settlement conference. This is highlighted by Atmos' inappropriate attempt to have its counsel interject incompetent evidence[2] about the settlement discussions. The point is that principles encouraging settlement and mediation militate against the conduct of the Staff and Atmos in trying to settle without the CAD's consent.

3. Atmos' Characterization of Settlement Discussions Should Be Disregarded

In "Response of Atmos Energy Corporation to the Consumer Advocate's Objections to the Motion for Approval of Settlement Agreement" (hereinafter "Atmos's Response"), Atmos asserts that the CAD has waived confidentiality by "revealing the content of the negotiations in previous filings."Atmos Response at 2. *See*, Rule 1220-1-3- 04, Rules of Tennessee Regulatory

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598, 599 (Tenn. 1987), governs this issue. *See* CAD's Objections, page 6.

[2]Atmos' counsel cannot testify through Atmos' response and simultaneously be an advocate of Atmos' position Similarly, the CAD's only context-based reference to settlement in its submissions only pointed out that the proposed settlement is less that what was previously offered. If that was unfair, the Hearing Officer should disregard it or exclude facts along these lines if the CAD ever seeks to introduce them through affidavits filed before the hearing. Also, Atmos does not speak for the CAD, the CAD disagrees with Atmos' characterizations of the settlement discussions.

Authority. As a result of the filing listed, "Consumer Advocate's Motion for Extension of Time to Respond to the Motion to Consolidate and for Approval of Settlement Agreement Filed by Atmos Energy Corporation and the Staff of the Tennessee Regulatory Authority" (hereinafter "Consumer Advocate's Motion"), Atmos asserts that it can reveal the detailed content of the settlement negotiations through "the-good-for-the-goose, good-for-the-gander" rule. See Atmos's Response at 2.

At issue, is language in the Consumer Advocate's Motion which states that the CAD is placed in a worse position as a result of the proposed settlement. Atmos asserts that the language "revealed the content"of the negotiations. The statements in question include:

(1) "It is troublesome that a proposed settlement *providing less to consumers than Atmos offered in mediation* has now been submitted to the Authority for approval without the necessary and proper supporting material" (emphasis added). Consumer Advocate's Motion at 5.

(2) "The net effect of the Consumer Advocate's participation in mediation should not be for the Consumer Advocate to be in a less favorable position than it was before it agreed to pursue mediation . ." *Id.*

(3) " . . . after mediation was unsuccessful, the Staff and Atmos seek to put the Consumer Advocate, *and the consumers it represents*, in a less favorable position by attempting to settle this matter without the Consumer Advocate's approval"(emphasis added). *Id.*

(4) "The parties should be able to return to the position occupied prior to mediation. Otherwise, the Authority's reliance on mediation as a mechanism for resolving matters before it will be compromised." *Id.*

(5) "Prior to the mediation, the Consumer Advocate expected a hearing on the merits after a short time for preparation. Instead, the Staff and Atmos ask the Authority to rule based on unsupported assertions forged in private conferences without the scrutiny of the representative of Tennessee consumers" *Id*

Atmos purports to give a detailed description of the settlement negotiations in "Atmos's Response". It endeavors to describe the settlement negotiations in detail, including:

(1) "The CAD agreed with the terms of the settlement, but would not agree to the effective date of April 1, 2001 for the new TIF tariff." Atmos's Response at 2. Adding, "*At the time of the settlement negotiations* in the summer of 2002, the CAD would however agree to an effective date of April 1, 2002 for the revised transportation calculations." *Id* (emphasis added).

(2) In June 2003, "the only objection the CAD was asserting to the proposed settlement was its position that the April 1, 2001 effective date on the TIF would constitute retroactive rate making." Atmos's Response at 3. Adding, "*at the mediation,* the CAD asserted that since so much time had passed since the last settlement discussions, the CAD's position was now that the effective date of the TIF must be April 1, 2003, not April 1, 2002." *Id.* (emphasis added)

(3) *At settlement discussions,* the "CAD agreed in principal to an effective TIF tariff date of April 1, 2001 (the original date proposed by the Company), provided the

percentage sharings be adjusted downward and that the TIF would be [sic] sunset after 4 years and re-examined at that time." Atmos's Response at 4.

Tennessee's early authority on curative admissibility originally places the state within the jurisdictions which use the doctrine the most expansively. *See Thomas v. State*, 113 S.W. 1041, 1041 (Tenn. 1908). But recent cases before the Tennessee Court of Criminal Appeals have limited curative admissibility to what is needed to remove unfair prejudice. *See e.g , State v. Land*, 34 S.W. 3d 516, 530 (Tenn.Crim App., 2000). Because of the doctrine's strong emphasis on fairness and the acceptance of restrictive curative admissibility in most jurisdictions, it seems that *restrictive* curative admissibility should apply also to civil cases and to this case. The detailed descriptions of settlement negotiations contained in Atmos's Response seem to be outside the scope of a restrictive curative admissibility rule because they appear to be unnecessary to remove the unfair prejudice (if any) that resulted from Consumer Advocate's Motion.

Curative admissibility "allows a party to introduce otherwise inadmissible evidence to remove the prejudice caused by the improper admission of evidence that was offered by the opposing party." Black's Law Dictionary (Bryan A. Garner ed., 8th ed., West 2004). The doctrine of curative admissibility is a product of English common law. Within the United States, the doctrine has been interpreted in three different ways. The first group of states holds that the admission of an inadmissible fact, without an objection, does not justify the other party in rebutting inadmissible facts. 1 Wigmore, Evidence § 15 (Tillers rev. 1983). The second group of states holds that the opponent may "resort to similar inadmissible evidence" regardless of whether he objected. *Id.* The third group, observed in most jurisdictions, holds that the

opponent may reply with similar evidence whenever it is needed to remove an unfair prejudice. *Id* Among these jurisdictions, there is a general requirement that the rebuttal evidence submitted under curative admissibility must relate to the matter submitted by the other party. *Id.*

In the early case on curative admissibility, the Tennessee Supreme Court favorably refers to Wigmore as "embod[ying]" the principle suggested in the *second* group of jurisdictions. *Thomas v State*, 113 S.W. 1041, 1041 (Tenn. 1908) (emphasis added). Under this broad standard, the opponent may "resort to similar inadmissible evidence" regardless of whether the opponent objected. 1 Wigmore, Evidence § 15. This seems to be the standard originally adopted in Tennessee despite the court's ambiguous language in *Thomas*, where it stated "if a party opens the door for the admission of incompetent evidence, he is in no plight to complain that his adversary followed through the door thus opened, and this, although no objection was made in the first instance to the admission of such evidence.[3]" *Thomas v. State*, 113 S.W. 1041, 1041 (Tenn. 1908).

Subsequent Tennessee cases followed *Thomas's* standard in limiting curative admissibility only to what was "related" to the previously admitted evidence. This can be seen in *Thomas* itself, when the court favorably cites *Mobile & B R Co. v Ladd*, which held that "it is never erroneous to receive irrelevant evidence to rebut evidence *of a like kind* offered by the other party." *Thomas v. State*, 113 S.W. 1041, 1041 (Tenn. 1908) (emphasis added)(internal

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[3]This is the exact language cited by *Ray v. Richards,* the case cited as recognizing the "good-for-the-goose, good-for-the-gander" rule in Atmos's Response. Atmos's Response at 2. Because *Ray* quotes *Thomas* which quotes section 15 of Wigmore's Treatise on Evidence entitled "curative admissibility", there does not seem to be an argument that "the-good-for-the-goose, good-for-the-gander" rule and curative admissibility are different rules. In any event, Atmos cannot properly interject this material in the record through the assertions of counsel in a response.

citations omitted). Another case following *Thomas* stated, "the admission of incompetent evidence will justify the admission of *similar* incompetent evidence." *Hood v. Grooms*, 4 Tenn App. 511, 511 (Tenn.App. 1927) *citing Thomas*, 113 S.W. at 1041(emphasis added).

But the Tennessee Court of Criminal Appeals has rejected the broad application of curative admissibility in favor of the more restrictive standard followed by the third, and largest, group of jurisdictions. *See State v Land*, 34 S W. 3d 516, 530 (Tenn.Crim.App. 2000). The court, in explicitly recognizing curative admissibility, referred favorably to another jurisdiction's holding that, "the doctrine's applicability is limited by 'the necessity of removing prejudice in the interest of fairness'." *Land*, 34 S.W. 3d at 530 (citing *Crawford v. United States*, 198 F.2d 976, 979 (D.D.C, 1952)). In addition, the court cited another jurisdiction's holding that curative admissibility "is not an unconstrued remedy permitting introduction of inadmissible evidence merely because the opposing party brought out evidence on the same subject." *Land*, 34 S.W. 3d at 530 (citing *People v. Manning*, 695 N.E. 2d 423, 434 (Ill. 1998)). To further clarify the restrictiveness of curative admissibility, the court states that doctrine "is not to be converted into a doctrine for injecting prejudice." *Land*, 34 S.W. 3d at 531 (citing *Manning*, 695 N.E. 2d at 434).

Other cases have followed *Land* in recognizing that curative admissibility should not be used on evidence that would do more harm than good. (*State v. Taylor*, 2003 WL 402276, * 3 (Tenn.Crim.App. Feb. 14, 2003)) (*State v Cox*, 2000 WL 1562920 (Tenn.Crim.App. Oct. 20, 2000)) (both citing *Land* 34 S.W. 3d at 532 (internal citations omitted)).

Moreover, there do not appear to be any compelling reasons to limit the application of the restrictive curative admissibility rule to criminal cases. While curative admissibility is most

often used in criminal cases, its use is not restricted to them. *See State v Cox*, 2000 WL 1562920, *17 (Tenn.Crim.App. Oct. 20, 2000). Curative admissibility, which is used both in civil and criminal cases, "is derived from the fundamental guarantee of fairness." *State v Land*, 34 S W.3d 516, 531 (Tenn.Crim.App., 2000). Additionally, *Ray v. Richards*, the case cited by Atmos for curative admissibility, contains no explicit endorsement of either the broad or restrictive standard. *See Ray*, 2001 WL 799756 at *4-5 (Tenn.Ct.App. July 17, 2001). Because there was no explicit endorsement of the standard in *Ray* or other civil cases, the restrictive standard for curative admissibility described in *Land* should control, assuming that there are no compelling reasons to confine the restrictive doctrine to criminal cases.

One might argue that the unique constitutional implications of admitting incompetent evidence in criminal cases justifies the application of the restrictive curative admissibility rule. While this seems well founded, it does not follow that the restrictive doctrine should not apply to civil cases. This seems to be particularly valid given the doctrine's fundamental emphasis on fairness (*State v Land*, 34 S.W. 3d 516, 531 (Tenn.Crim.App. 2000)(citations omitted)), a quality which is needed in both civil and criminal cases. The Tennessee Court of Criminal Appeals cites another jurisdiction which addresses the constitutional problem through a heightened test "requiring a clear showing of prejudice before the open the [sic] door of rebuttal may be involved." *State v Land*, 34 S.W.3d 516, 531 (Tenn.Crim.App., 2000) (citing *Lampkins v. United States*, 515 A.2d 428, 431 (D.C., 1986)). In other words, where constitutional issues are most frequently implicated (e g. criminal cases), the court has indicated that a "super-restrictive" standard might be used. It is unclear why such a "super-restrictive" standard in criminal cases for curative admissibility would prevent the application of a "restrictive"standard

in civil cases. After all, there is still the concern for fairness in civil trials, even if one of the party's liberty is not in jeopardy. This logic seems to be why most jurisdictions apply curative admissibility restrictively, including civil cases. *See 1Wigmore, Evidence § 15* (Tillers rev. 1983).

Atmos's description of the settlement negotiations contained in Atmos's Response goes much further in describing the substance of settlement negotiations then CAD's brief statement in Consumer Advocate's Motion.[4] The Consumer Advocate's Motion seems to describe chiefly whether the settlement terms are appropriate. Assuming that a restrictive application of curative admissibility is used, it appears that Atmos's descriptions on settlement negotiations should be excluded because they are not needed to remove any perceived unfair prejudice from the Consumer Advocate's motion.

The Consumer Advocate's Motion's description of negotiations is chiefly limited to whether the settlement is appropriate. An example is found in the statement, "the net effect of the Consumer Advocate's participation in mediation should not be for the Consumer Advocate to be in a less favorable position than it was before it agreed to pursue mediation . . ." Consumer Advocate's Motion at 5. The other statements (except for the statement mentioned in the next paragraph) echo the fact that CAD is now in a worse position as a result of the settlement. A good way of gauging the level of prejudice that Atmos suffered as a result of the Consumer Advocate's Motion, is to compare the position that Atmos is in as a result of the words used in

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[4]As forestated, because the CAD's statement that the proposed settlement is less favorable than prior offers has not been offered in evidence through affidavits, the Hearing Officer can simply disregard it if it is deemed unfair. On the other hand, the CAD's statement that it was entitled to a hearing before agreeing to mediation does not trigger this rule and presents no possibility of prejudice to the proponents of the settlement.

the Consumer Advocate's Motion with the position that Atmos would be in without the words. It is difficult to find a difference in the two positions. If the words, which describe only the appropriateness of the settlement, were excluded from the Consumer Advocate's Motion, the TRA would still know that the settlement was not acceptable to CAD.

The only conceivably prejudicial statement to Atmos appears to be: "It is troublesome that a proposed settlement *providing less to consumers than Atmos offered in mediation* has now been submitted to the Authority for approval without the necessary and proper supporting material"(emphasis added). Consumer Advocate's Motion at 5 Here, the TRA now knows that the CAD is asserting that Atmos is offering less to consumers in the proposed settlement then it did during mediation. But this seems to be only a more forceful way of saying that the settlement is not appropriate for consumers, which the CAD represents. Moreover, the Consumer Advocate does not explicitly list what Atmos offered during mediation. In any event, both proposals were unacceptable to the CAD.

But even if we assume that Atmos did suffer some remote prejudice as a result of the Consumer Advocate's Motion and that the Consumer Advocate's Motion did reveal the content of the settlement negotiations through the preceding statement, Atmos's Response, which describes the CAD's offers during negotiations in detail, seems much more prejudicial and not needed to remove any unfair prejudice, particularly since the statement is in a brief and has not been allowed into evidence. As stated in *Land*, curative admissibility should not be used on evidence that would do more harm than good. (*State v Land*, 34 S.W. 3d 516, 532 (Tenn.Crim.App. 2000)(internal citations omitted). Atmos's Response describes at least four of the positions taken by CAD at different stages of negotiation and mediation Atmos states that

CAD "agreed with the terms of the settlement, but would not agree to the effective date of April 1, 2001 for the new TIF tariff." Atmos's Response at 2. Atmos also asserts that "*at the mediation,* CAD asserted that since so much time had passed since the last settlement discussions, the CAD's position was now that the effective date of the TIF must be April 1, 2003, not April 1, 2002 " Atmos's Response at 3. Additionally, it asserts that "[at settlement discussions] CAD agreed in principal to an effective TIF tariff date of April 1, 2001 (the original date proposed by the Company), provided the percentage sharings be adjusted downward and that the TIF would be [sic] sunset after 4 years and re-examined at that time." Atmos's Response at 4.

Atmos's Response lists some major concessions which the CAD allegedly accepted tentatively during negotiations. The concessions, if admitted and published, potentially could be prejudicial. The prejudice to the CAD is much greater than to Atmos because the statement in the Consumer Advocate's Motion did not explicitly describe what Atmos's position was during mediation. Because of this disparity in prejudice and the likelihood of a restrictive application of curative admissibility in civil cases (discussed above), the description of settlement negotiations in Atmos's Response should not be admitted. Additionally, because these assertions were not submitted in an affidavit on or before May 21, 2004, they should be disregarded.

However, even if a ruling body were to reject a restrictive application of curative admissibility for civil cases, it appears that the judge's discretion is still limited by the requirement that the evidence admitted must relate to the originally admitted evidence. *See Hood v. Grooms*, 4 Tenn.App. 511, 511 (Tenn.App. 1927). Here, there is no previously submitted evidence and the statements contained in Atmos's Response about the settlement negotiations

and positions taken by CAD has to be related to the (brief) description of the settlement in the Consumer's Advocate's Motion. If "related" where to encompass the validity of CAD's "suit", the "related" limitation would be so broad as to be no limitation at all. If the "related" limitation was that expansive, any piece of evidence no matter how tangentially related to the incompetent evidence could be admitted. "Related" under a broad curative admissibility standard seems to include, at most, the settlement negotiations and mediation since both subject matters were mentioned in the Consumer Advocate's Motion. But, as mentioned above, this broad standard should not apply.

Because of the impropriety of Atmos's listing of specific offers during negotiation, curative admissibility's foundation in fairness, and the likelihood of a restrictive curative admissibility (admitting only the incompetent evidence needed to remove the unfair harm) extending to civil cases, the description of settlement negotiations in Atmos's Response should be stricken or simply disregarded.

4. The CAD Should Not Have Been Required To Disprove The Proponents' Claims.

The CAD has been prejudiced by being required to file its objections before the proponents filed a memorandum in support of their motion to approve the settlement, or otherwise stated detailed grounds in support of the relief they were seeking. *See*, Rules 1220-1-1-.08 and 1220-1-2-.16, Rules of Tennessee Regulatory Authority. It required the CAD to attempt to disprove assertions that the proponents of the settlement had not yet made.

5. There Is Retroactive Ratemaking And Alternatively An Attempt To Reward Atmos For Past Conduct — Contrary To The Notion Of Incentive-Based Ratemaking.

This Tribunal should not reward Atmos' conduct in brazenly attempting to assert that negotiated transportation contracts were included in the PBR when they clearly were not and then in attempting to retroactively apply this "incentive". The net effect of this retroactive application is to reward this kind of chameleon-like posturing The whole purpose of the PBR, according to Atmos' predecessor, was to allow "upfront regulatory oversight"[5] — not amendments through hindsight and pressure on the TRA staff.

6 The Settlement Itself Is Problematic.

The settlement proposal is flawed in the following respects:

A. The proposed settlement which allows "savings" for negotiated transportation contracts may be inconsistent with national policy as articulated by the Federal Energy Regulatory Commission ("FERC");

B. Atmos has admitted in its discovery responses that the proposed inclusion of Transportation Index Factors is not based on any market benchmark or industry standard but rather the maximum FERC rate[6];

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[5]*See* January 20, 1995, Application for performance-based ratemaking.

[6]Neither the TRA or its predecessor, the Public Service Commission, has ever approved an incentive plan's use of the maximum FERC rate as the standard for measuring a company's performance. This unprecedented proposal, therefore, should not be adopted in the context of a settlement approved by only two of the three parties before the TRA. Additionally, assertions by Atmos' predecessor in its January 20, 1995, Application for performance based ratemaking supports the CAD's position:

> In addition to lower regulatory costs, this proposal is designed to promote these other regulatory objectives: To send clear signals to United Cities by establishing benchmark standards. To achieve

C. Because of the lack of a reliable market index, "real" savings cannot be accurately measured;

D. The proposed calculation of "savings," even if there were an appropriate benchmark, are flawed because they do not take into account relevant factors;

E. Because the "standard" proposed is the same as the "maximum," there is no risk[7] for Atmos, only rewards at the expense of ratepayers;

F. The proposed incentive is unearned and only serves to increase costs to consumers;

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improvement in performance measurement by using external criteria, *i.e* , cost of service. To implement market-based benchmarks from actual uses therefore ensuring prudency.

January 20, 1995, Application for performance based ratemaking, page 4.

[7]

Question: Please define the term "performance-based ratemaking" for this proceeding.
Answer: Performance-based or incentive ratemaking is a regulatory scheme that indexes a utility's profits to how effectively it performs against predetermined, extenal benchmark. A properly designed program will encourage effective risk-taking by the utility in response to a more competitive environment. The incentive rate program for United Cities is a company-wide program independent of individual rate schedules and is presented as an integrated package.

January 20, 1995, Application for performance based ratemaking, prefiled testimoney of Mr Harrington at page 4, beginning at line 1.

Without proper incentives, it would not be prudent for United Cities to engage in certain transactions due to their attended risk.

January 20, 1995, Application for performance based ratemaking, prefiled testimony of Mr. Harrington at page 10, line 14.

G. Even if the "savings" were real as measured by an appropriate benchmark and factoring in all relevant factors, moving these "savings" from the ratepayers to the company contradicts a recent change in ratemaking policy; and

H. A detailed audit and review of current facts should precede any additional rate increases charged to consumers. *See* Affidavits of Stephen N. Brown and Daniel W. McCormac.

Put simply, Atmos is improperly attempting to charge consumers with extra-tariff "savings" which, as of today's date, are not authorized under its Performance Based Ratemaking tariff.

7. Atmos' Attempt To Have A Hearing On The Merits On June 8 Is Unfair.

Discovery has proceeded in two rounds to this point. The first round was related to summary judgment in the audit case (01-00704) and the second round was limited to questions of the appropriateness of the proposed settlement package in this consolidated docket. There has not been any round of discovery devoted to the merits of the "TIF" docket. Atmos' conduct in insisting on limited discovery and a limited hearing at the outset and now attempting to have an evidentiary hearing on the merits of the "TIF" docket, therefore, is simply inappropriate.

On page 21 of the Order on Motions For Summary Judgment, the Hearing Officer set a status conference "to establish a procedural schedule for this matter." After several months of settlement discussions in lieu of a procedural order, the Hearing Officer should reject the proposed settlement and take steps to establish a procedural schedule to address the merits.

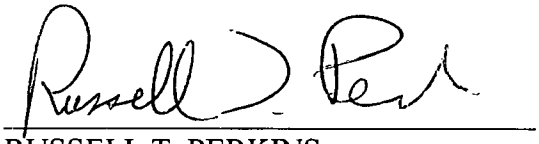
Denying the settlement, accordingly, will put parties back on track. This is particularly true if Atmos is finally willing to stipulate that the "TIF" was not included in the Phase II order. The parties, therefore, will not be litigating about who said what at meetings several years ago

but will be addressing whether the "TIF" should be allowed and, if allowed after a hearing on the merits, should the "TIF" have any effect during the period before it was allowed. These narrow questions can be quickly prepared for a hearing on the merits.

Conclusion

For these reasons and for the reasons previously stated by the CAD, the proponents' motion to approve the proposed settlement package should be denied.

Respectfully submitted,



RUSSELL T. PERKINS
B.P.R. No. 10282
Deputy Attorney General
Office of the Attorney General
Consumer Advocate and Protection Division
(615) 741-1376

CERTIFICATE OF SERVICE

I hereby certify that on May 28, 2004, a true and exact copy of the foregoing document has been mailed, first class U.S. postage prepaid, and faxed to the following:

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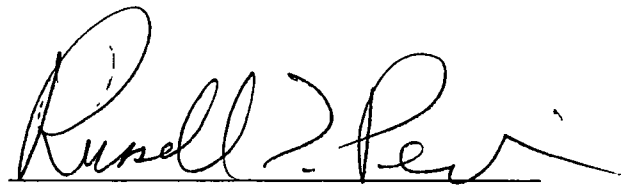

Russell T. Perkins

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ADDENDUM A:
PROVIDING MORE DETAILED REASONS FOR THE TRA TO NOT APPROVE THE PROPOSED SETTLEMENT

In further reply to the Staff of the Energy and Water Division of the Tennessee Regulatory Authority ("Staff") response to the Consumer Advocate's opposition to the proposed settlement, and in further reply to the response of Atmos Energy Corporation ("Atmos") to the Consumer Advocate's opposition to the proposed settlement, the Consumer Advocate replies in detail:

I. Staff's Response Confirms That the Proposed Settlement Is Contrary to the Intent of the Tennessee Regulatory Authority ("Authority").

Staff's response affirms that its proposed settlement allows Atmos to achieve gains without Atmos being at risk for losses: "Risk does not play a part of this negotiation and is irrelevant to the decision at hand" [Staff's response, page 15, last line].

Staff's position on risk-taking by Atmos conflicts with the Authority's orders in Docket 97-01364: "The gains and losses under the plan should be calculated on a monthly basis rather than on a transaction basis" [Phase One Order, page 29] and "...the gains and losses to be derived from the mechanism are to be accounted for..." [Phase Two Order, page 28] Nothing in the Authority's orders supports Staff's opinion that risk "is irrelevant" to an incentive program or that the incentive program should be risk-free to Atmos. Thus, the proposed settlement cannot be in the public interest.

Extensive testimony by Mr. Frank Creamer, a witness for Atmos, in Docket 97-01364 confirms that risk-taking and potential loss are central to the incentive plan. In cross-examination by the Consumer Advocate Mr. Creamer testified:

> "The intent of the incentive program is to provide rewards to encourage the company to take greater risk in purchasing gas leading to benefits" [Transcript, Thursday, March 26, 1998 Volume I, page 76, lines 3-6].

And

> "So what I observed in interviewing United Cities Gas is, tell me what you're doing differently in terms of behaviors, not process, but in terms of behaviors in how you're looking at buying gas. Are you taking more risk? Are you looking to, in one case, incur a higher-than-index price for gas in order to earn a benefit in a lower-than-index purchase of gas a week later or two weeks later? That's what we're trying to get at in terms of an incentive program....
>
> Q. And so, you say they're taking more risks?
>
> A Yes."

[Transcript, Thursday, March 26, 1998 Volume I, page 77, lines 16-25 and page 78, lines 8-9].

In redirect examination by Atmos Mr. Creamer was asked and testified:

"Q. Mr. Williams also asked you some questions about basis points and rate of return on equity and what the staff recommended in that case. You understand that the way this plan works is if United Cities does not do a very good job of purchasing gas that it can incur a penalty and the result of that penalty would essence be a lowering of their authorized rate of return?

A. The penalty would be a lowering of their rate of return?

Q. Yes. Based upon the answer that you gave to Mr. Williams about the fact that if they were awarded, that, in essence, would increase their rate of return?

A. Would increase their overall return -- or decrease their overall return, what you said. But there would be no Commission action that would penalize them. The plan itself would take care of that.

Q. It's an automatic penalty?

A. Yes." [Transcript, Thursday, March 26, 1998 Volume I, page 285, lines 6-25 and page 286, line 1].

The Authority's clear policy is that the incentive program be conditioned by the company's gains and losses, rather than being conditioned solely by the company's gains as Staff asserts.

II. The Authority's Public Policy Is Consistent with the Federal Energy Regulatory Authority's ("FERC") Policy Towards Negotiated Transportation Rates.

The Authority's public policy is consistent with the Federal Energy Regulatory Authority's ("FERC") policy towards negotiated transportation rates. In FERC Order 637, "Regulation of Short-Term Natural Gas Transportation Services, Docket RM98-10-000, and Regulation of Interstate Natural Gas Transportation Services, Docket RM98-12-000," the federal agency declared:

"The Commission is clarifying the operation of its policies regarding negotiated rates and negotiated terms and conditions of service in light of its decision in this rule not to adopt regulations providing pre-approval for pipelines to negotiate terms and conditions of service."[FERC Order 637, page 38]

And

> "Customers opting for negotiated service should be subject to the risk of that choice and not be able to choose to negotiate only when it benefits them. [FERC Order 637, page 44]

III. FERC's Policy Invalidates Staff's Assertion That the Maximum FERC Rate Is a Meaningful Benchmark.

Staff asserts that ".. the TRA would look to published FERC transportation rates...as a measure of prudence"[Staff's response, page 15], and that "the current PBR...provides the Company with a perverse incentive to purchase gas in an uneconomical manner...[;] to eliminate this perverse incentive the Proposed settlement includes both the Company's transportation costs as well as their commodity costs." [Staff's response, page 15]. These opinions intertwine to support Staff's opinion that the FERC maximum rate is a meaningful benchmark, but they do not withstand scrutiny.

That the TRA would look to the FERC maximum rates as a measure of prudence is an unsupported opinion of Staff. Furthermore, Staff's opinion about the "perverse" incentive is not informed by FERC's policy on negotiated transportation rates.

FERC's policy is that any shipper employing a negotiated rate always has the discretion to pay the maximum rate at any time for the pipeline's service. In FERC Docket PL02-6-001 "Natural Gas Pipeline Negotiated Rate Policies and Practices," the Interstate Natural Gas Association of America ("INGAA") petitioned FERC for a reconsideration of an earlier FERC order.

INGAA, one of whose members is AGL Resources, said in its petition:

> "As the record shows, '[n]egotiated rate deals based upon price differentials are really no different than fixed price negotiated rate deals since in either circumstance the shipper can always revert to a recourse rate.'"[FERC Docket PL02-6-001 "Request for Rehearing of Interstate Natural Gas Association of America" Filed August 25, 2003, page 9].

The recourse rate is another term which pipelines and FERC use to describe the maximum FERC rate.

Staff does not explain the meaning of "prudence" and "uneconomical" in a federal regulatory framework where Atmos has the discretion to pay the negotiated price, the FERC maximum price, or any price in-between for the pipeline's service. Staff's opinion carries with it the assumption that if Atmos is paying the FERC maximum price, then Atmos is making an

"uneconomical"and "imprudent" transportation purchase, even though such a purchase is perfectly consistent with FERC's policy.

Atmos acknowledges that it has the discretion to pay the FERC maximum rate and that the maximum rate will be utilized if necessary to maximize the company's savings:

> "If transportation costs are excluded from the PBR program and simply passed on in full to consumers, the PBR plan would have a material defect. Atmos could increase its savings on the commodity portion, which it would share in, by entering into relatively high transportation costs arrangements...in order to lower commodity costs."[Atmos response, page 15]

Thus, it appears that Atmos is declaring that "consumer savings" are incidental to Atmos, *i e*, that it is willing to act to increase its profits by increasing consumers' cost unless explicitly enjoined from doing so.

The current unwillingness of Atmos to minimize consumer cost is a marked contrast to its testimony in TRA Docket 97-01364. Under cross-examination by Chairman Greer, Mr. Ron McDowell agreed that the company had motivation to purchase the "cheapest gas possible."

> "Q. And what motivation would you have to purchase the cheapest gas possible if 100 percent of the cost of gas is passed through to the ratepayers via the PGA?
>
> A. To be truthful, it's ego, you know, that I do a good job, that I'm measured on that job. Part of the incentive that I have at the company -- gas supply itself was rated. And part of my incentive was tied to that." [Transcript, Tuesday, March 31, 1998 Volume III, page 666, lines 12-20]

The difference between Atmos's policy positions in 1998 and 2004 suggests that the PBR itself has caused Atmos to dismiss cost-minimization as a method of serving consumers. This is another "perverse incentive" of the current PBR.

Furthermore, Atmos' opinion of the PBR's incentives differs greatly from Staff's opinion. Atmos says, "One reason Atmos invested so much time and effort into negotiating the discounted transportation rates was because of the incentives provided under the Company's PBR tariff." [Atmos response, page 16]. In contrast, Staff says "the current PBR provides Atmos a perverse incentive to purchase gas in an uneconomical manner." Thus, Staff acknowledges that the current PBR does not have the incentives which Atmos claims are in the current PBR.

That the two parties to the proposed settlement cannot agree on the PBR's meaning for transportation cost is a sure sign that the proposed settlement is not founded on the evidence presented in the exhaustive hearings of Docket 97-01364.

Despite Staff's acknowledgment that there is a "current PBR" as of May 24, 2004 and that the current PBR does not include the transportation incentives claimed by Atmos, Staff's opinion is that "an incentive plan (including most of the components of the PBR) is, by design, retroactive in operation."[Staff's response, page 9, last line]. Atmos shares the opinion: "The new tariff will begin effective April 1, 2001."[Atmos response, page 10]. The joint opinion of Staff and Atmos is totally contradicted by the testimony of Mr. Creamer in Docket 97-01364:

> "But that's the point of the PBR. It's to establish a target against which the company will be judged next year, the year after, and the year after that. So it makes it clear for everybody to understand and see how rewards are being earned, how penalties are being absorbed, and the standards against which gas purchase prudencies will be measured against." [Transcript, Friday, March 27, 1998 Volume II, page 477, lines 7-15].

Mr. Creamer speaks to "next year, the year after and the year after that... so it makes it clear to everybody" while Staff and Atmos speak to last year, 2003, the year before that, 2002, and the year before that, 2001 because "the PBR is by design retroactive..."

Staff also asserts that "the prohibition against retroactive ratemaking applies only [to]... a base rate... [it]does not apply to surcharge proceedings ...we are not 'making rates.'" [Staff's response, page 9]. Staff's opinion is contradicted by the caption of the Docket 97-01364, "Application of United Cities Gas to Establish an Experimental Performance-based Ratemaking Mechanism." Staff's opinion suggests there is no need for the "just and reasonable" standard to be applied to an incentive program, but the Authority approved the current PBR by determining it met the standard. Chairman Greer cross-examined Atmos witness James Harrington:

> "Q. If this plan is denied, how would you suggest that the TRA determine the company's purchasing gas at just and reasonable rates?
>
> A. Let me just make sure I understand the hypothetical. You're saying there's no incentive plan?
>
> Q. Yeah.
>
> A. But the Woodward contract exists or doesn't exist?
>
> Q. Well, if United Cities' plan is denied, how would the TRA determine if the company is purchasing gas at just and reasonable rates?
>
> A. If you don't employ an incentive program, the other existing mechanism is through a prudence review process." [Transcript, Friday, March 27, 1998 Volume II, page 517, lines 10-25]

Thus, the Authority's Phase Two Order waived prudence reviews of Atmos:

> "For each plan year in which this Performance-Based Ratemaking Mechanism is in effect, the requirements of Section 1220-4-7.05 of the Purchased Gas Adjustment Rules of the...Authority entitled 'Audit of Prudence of Gas Purchases are hereby waived.'" [Phase Two Order, page 27]

Any standard of prudence is embodied with a means of distinguishing better from worse and gains from losses. That ability to distinguish was the basis of the waiver. The Authority's waiver was reached after lengthy testimony and depositions in TRA Docket 97-01364 where a "benchmark" was shown to incorporate gains and losses, just as the Authority's orders do. On March 23, 1998 the Consumer advocate took the deposition of the Authority's staff:

> "Q. Question No. 2, the part of it that states that are they really meaningful, and that indicates the so-called "market benchmarks." What do you mean by that?
>
> A. How are the benchmarks calculated. At that time, I didn't know what went into a benchmark. The company had proposed three different benchmarks for gas, and I needed to evaluate how those were determined and did it produce a meaningful result; did that benchmark mean anything.
>
> Q. And that's because you can have indexes, I guess, that can be allegedly relevant or material but, actually, when you apply them in the real world, they're not necessarily meaningful and do not necessarily describe anything?
>
> A. Well, that could be the case, yes". [Deposition of William H. Novak, Monday, March 23, 1998, page 122 line 22 to page 123 line 3]

And

> "A. I see your question. United Cities, prior to the adoption of the incentive plan, was actually able to, quote, beat the market, unquote. For every winner in the market there must be a loser. That's the whole idea of the market index, that it comes back to an average price that everyone is paying." [Deposition of William H. Novak, Monday, March 23, 1998, page 91 lines 12-13]

In 1998 Staff acknowledged that an average price was the benchmark that separated winners and losers. In 2004 Staff's opinion is that FERC's maximum price is a meaningful benchmark, that risk is irrelevant to the incentive program, that the maximum rate would be the Authority's basis for judging the prudence of Atmos's transportation purchases, and that Atmos' transportation purchases at the FERC maximum rate are uneconomical and imprudent even though such purchases are perfectly consistent with FERC policy.

Staff's opinion in 2004 has no foundation in the Authority's Phase One and Phase Two Orders and no foundation in FERC's regulatory regime.

IV. FERC's July 25, 2003 Order, "Modification of Negotiated Rates Policy...." Is Relevant.

Staff dismisses the FERC order as irrelevant:

> "the order... focuses on ... basis differential pricing ... None of the contracts... in this docket utilize basis differential pricing ... [which] results from the practice of comparing the difference in the cost of gas at various points along a pipeline ... the FERC order is irrelevant "[Staff's response, page 12].

Atmos also dismisses the FERC order:

> "Basis differential pricing is the practice of pricing transportation services on the difference between the commodity gas price at two different points...None of Atmos'... contracts employ [such pricing].. The manipulation risk the FERC was concerned about and discussed in Dr. Brown's affidavit simply does not exist for Atmos..."[Atmos response, page 13].
>
> "All of these contracts...are priced as fixed rates."[Atmos response, Affidavit of Ron McDowell, page 1].

Staff and Atmos ignore the fact that Woodward's control of the commodity price and Atmos's subsequent control of the commodity price give Atmos an incentive to pursue negotiated rates despite FERC's finding that the risks of the pipeline's abuse in the commodity markets are shifted to the market as a whole. Staff and Atmos share the opinion that Atmos does not engage in the practice of comparing commodity prices at various points on a pipeline and acting accordingly. In Docket 97-01364 Atmos testified:

> "And when I get to the same point, if it's in Morristown, Tennessee, or Johnson City, and it's in your house, how I got it there -- you know, I'm going to compare prices to get it to that point. And that's the whole -- conceptually, that's what we're talking about here is physically getting the gas from different points. And there's premiums paid in different areas, and depends on pipeline constraints."[Transcript, Tuesday, March 31, 1998 Volume III, page 665, line 21 to page 666, line 4].

In addition, basis differential rates and fixed rates are the same thing according to the INGAA, whose statement has already been presented. Fixed rates do not necessarily prevent market manipulation and do not necessarily serve the public interest:

"Pipelines should be prohibited from charging a transportation rate based on commodity sales prices, whether in a negotiated fixed rate or in a negotiated rate formula A pipeline that captures part of the commodity gas price is essentially partnering in a merchant transaction." [FERC Docket PL02-6-000, "Inquiry Concerning Natural Gas Pipeline Negotiated Rate Policies and Practices" California Public Utilities Commission, filed September 25, 2002, page 4]

A fixed rate also suggests that other users of the pipeline are subsidizing the shipper who negotiated the fixed rate, or that a pipeline is selling its services at less than cost:

"For example, a pipeline and a shipper may agree to a long-term fixed negotiated rate, which is initially lower than the pipeline's current recourse rate but over the life of the contract as the recourse rate declines, the negotiated rate is expected to compensate the pipeline for providing service If a price cap is imposed, then any opportunity for the pipeline to recoup it under collections through the revenues generated in the future is lost. Under this example, not only would the pipeline have to accept a loss in revenue, but would also have to assume certain regulatory risks that, if the negotiated rate results in a discount, the associated volumes may not be included as part of a discount adjustment in a future rate case." [FERC Docket PL02-6-000 "Inquiry Concerning Natural Gas Pipeline Negotiated Rate Policies and Practices" Gulf South Pipeline Company, LP , Filed September 25, 2002, page 14].

ADDENDUM B:
RETROACTIVE RATEMAKING

In further reply to the Staff and Atmos, the CAD offers this Addendum:

Atmos cites several cases to support its assertion that approval of the settlement agreement will not result in retroactive ratemaking. Upon further review, these cases, which reject retroactive ratemaking arguments, are distinguishable based on the fact that they are more materially prospective.

I. *Consumer Advocate Division v. Tennessee Regulatory Authority*, 2000 WL 13794 (Tenn. Ct. App. Jan. 10, 2000).

The facts of *Consumer Advocate Division v Tennessee Regulatory Authority* are complex. The case arose after the Tennessee Court of Appeals remanded a prior appeal stating that the TRA's predecessor should have approved the telephone company's price regulation plan based on its rates as of June 6, 1995. *Consumer Advocate Division*, 2000 WL 13794, *1. As a result of the instruction on remand, the TRA entered an order approving a price regulation plan effective as of October 1, 1995 *Id.* In the order, the Commission decided that the indexing for annual adjustments was to be calculated from December 1, 1998. *Id.*

Consumer Advocate Division is distinguishable from Atmos's settlement agreement because the TRA is not under the instruction of a high court to approve a regulation plan based on rates existing at a particular time. Although the court did assert that the rate changes in the Authority's order were prospective, the chief reason for the rejection of the retroactive ratemaking argument seems to be a desire to place the telephone company "as nearly as possible in the position they would have been in except for the Commission's error," which it states "was the goal of the Authority on remand " *Consumer Advocate Division v Tennessee Regulatory Authority*, 2000 WL 13794, *3 (Tenn. Ct. App. Jan. 10, 2000). The case appears distinguishable

partly because of the unique procedural setting in which the Authority had to follow the court's instruction on remand.

Another point of distinction lies in the court's finding that since the order was prospective, the "Authority avoided the charge that future ratepayers would 'pay for past use,' which is the essence of retroactive ratemaking." *Consumer Advocate Division v. Tennessee Regulatory Authority*, 2000 WL 13794, *3 (Tenn. Ct. App Jan. 10, 2000) (internal citations omitted). There seems to be no such assurance in Atmos's settlement agreement because the agreement makes adjustments to future rates based upon the savings or losses that TRA staff and Atmos agree upon 3 years before approval by the TRA. *Atmos's Response at 9.* With the "pay for past use" lodestar of retroactive ratemaking in mind, making adjustments to future rates does not in itself prevent the rates from being retroactive.

II. *American Ass'n of Retired Persons v. Tenn. Pub. Svc. Comm'n*, 896 S.W.2d 127 (Tenn. Ct. App. 1994).

In *AARP v. Tennessee Public Service Commission*, the organization unsuccessfully argued that a provision within a regulatory reform rule that allowed the phone company to share in earnings in excess of a certain range constituted retroactive ratemaking. 896 S W.2d 127, 134 (Tenn. Ct. App 1994). The court rejected the argument because the sharing of earnings at a certain range, which was based on a forecasted range of rates of return locked-in a year before implementation, was deemed to be prospective. Id.

The settlement agreement in this case is not based on a forecasted range that was locked-in a year in advance of implementation. Far from being locked-in in advance of implementation, the agreements on savings are calculated reaching back a period of three years. *Atmos's*

Response at 9. Still, Atmos asserts that these ad-hoc agreements on transportation cost savings after the filing of its annual report for past years "is precisely the arrangement that was held valid in *AARP*"(*Atmos's Response at 10),* despite the fact that in *AARP* the forecasted range of rates of return were "locked-in" a year before implementation. *American Ass'n of Retired Persons v Tenn Pub Svc. Comm'n*, 896 S.W 2d 127, 134 (Tenn. Ct. App. 1994). Therefore, one arrives at the primary concern. It is clear that the rates, for which the Staff and Atmos choose to make adjustments now, were not set by approval of the TRA before implementation.

III. *Consumer Advocate Division v. Tennessee Regulatory Authority*, 1998 WL 684536 (Tenn. Ct. App. July 1, 1998).

In *Consumer Advocate Division v Tennessee Regulatory Authority*, the TRA held a hearing on a rate increase on December 17, 1996 and issued an oral ruling approving the rate increase. 1998 WL 684536 at *1 (Tenn. Ct. App July 1, 1998). It did not complete a written order of its ruling until after the new rates had gone into effect. Id The court ultimately rejected the Consumer Advocate's objection that because the written order was issued after the rates went into effect, it was retroactive. *Id.* at *3. Apart from the procedural fault and an argument questioning the utility company's authority to implement this rate, the ratemaking is essentially prospective. The "retroactiveness" in the Atmos settlement agreement is much more material. The agreement between Atmos and Staff reaches back in time beyond any colorable claim of approval.[1]

In describing *Consumer Advocate Division v Tennessee Regulatory Authority* (1998) to support its contention that the settlement agreement does not result in retroactive ratemaking,

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[1] The agreement actually requires rates to be set retroactive to April 1, 2001, a period in excess of 3 years.

Atmos takes some liberties with the text that do not seem to be justified. Atmos asserts that "the court summarily rejected CAD's argument, noting that the *retroactive* argument "exalts form over substance." Atmos's Response at 11 (emphasis added). Within the "retroactive ratemaking" subsection of the case, the Consumer Advocate Division essentially argued two separate points. *See Consumer Advocate Division v. Tennessee Regulatory Authority*, 1998 WL 684536, *3 (Tenn. Ct. App. July 1, 1998). The first, the retroactive argument, was that the written order was signed by the TRA after the rates had already gone into effect. *Id* at *3. The second argument put forth by the Consumer Advocate was that the six month period required for the utility company to implement increased rates during a TRA investigation had not passed because the utility company had to file a new petition after the Public Service Commission changed its name to the Tennessee Regulatory Authority. *Id* at *3. Atmos' argument, and not the CAD's retroactive argument, however, "exalts form over substance." *Id.* at *3.

IV. *Consumer Advocate Division v. Bissell*, 1996 WL 482970 (Tenn. Ct. App. Aug., 28, 1996).

In *Consumer Advocate Division v. Bissell*, the court rejected the Consumer Advocate's contention that the TRA's order, which required the utility company to pass a refund to consumers that was created when a rate increase was invalidated by the Federal Regulatory Commission, was retroactive ratemaking . 1996 WL 482970 at *3 (Tenn. Ct. App. Aug. 28, 1996). While the court ultimately rejected the retroactive ratemaking argument, it stated "the only offending part of the tariff is the refund provision," which "otherwise operates prospectively " Id Despite acknowledging that the refund was "offending", the court reasoned that the refund was the third step in a larger proceeding where the two prior steps were governed by federal law. Id.

The court also suggested that if the Consumer Advocate were correct that the refund constituted retroactive ratemaking, the logical conclusion would be that the telephone company would get to keep the refund it received from its supplier. *Consumer Advocate Division v Bissell*, 1996 WL 482970 at *3 (Tenn. Ct. App. Aug. 28, 1996). But previously, the same court added that consumers had some avenues of recourse. "If a company should be allowed to retain its 'windfall profits' because of invalidity of a commission order it would face the possibility of a class action by its patrons for unjust enrichment, or it would be confronted with its retention of excess profit in the consideration of future rate increases." *South Central Bell v Tenn Pub Svc Comm'n*, 675 S.W. 2d 718, 720-721 (Tenn. Ct. App., 1984).

The cases cited by Atmos are distinguishable from Atmos's present settlement agreement because the cases cited are more materially prospective and do not make future ratepayers "pay for past use".