IN THE TENNESSEE REGULATORY AUTHORITY
NASHVILLE, TENNESSEE

IN RE.	)	
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UNITED CITIES GAS COMPANY, a Division of ATMOS ENERGY CORPORATION INCENTIVE PLAN (IPA) AUDIT	)	Consolidated Docket Nos. 01-00704 and 02-00850
	)	
UNITED CITIES GAS COMPANY, a Division of ATMOS ENERGY CORPORATION, PETITION TO AMEND THE PERFORMANCE BASED RATEMAKING MECHANISM RIDER	)	

DIRECT TESTIMONY OF FRANK H. CREAMER

Q Please state your name, place of employment and title.

A: My name is Frank Creamer. I am a management consultant specializing in business performance, and utility regulatory matters for gas and electric utilities through my own company, Barrington Associates Inc , located at 730 Walnut Road, Barrington, Illinois, 60010. I am Director of the company.

Q: Please describe your educational background.

A I received a Bachelor of Science degree as a Getty Oil Scholar in Petroleum Engineering at the University of Oklahoma in 1973. I also received a Masters of Business Administration with honors specializing in Finance, International Business Economics and Statistics from the University of Chicago in 1989.

Q. Please describe your work experience

A. I have thirty years of energy experience worldwide, with the last thirteen years focused exclusively in the natural gas and electric utility business sectors. I have directed or advised on projects for utilities involving commission-mandated audits, rate design,

affiliated interests reviews, gas supply planning and procurement, privatization preparation, M&A, shared services assessments, and regulatory compliance.

From 1995 to 2002, as an Associate Partner with Accenture in the North America Utility Business Unit, I participated in projects that included business restructuring, energy marketing, gas supply planning, regulatory strategy, rate design, operational improvements, transformation outsourcing and shared services.

From 1994-1995, as a Principle with Computer Science Corp (CSC), I participated in projects that included supply chain reengineering, and T&D reengineering. From 1989-1995, as Principle and head of the Natural Gas Practice for Theodore Barry & Associates (now PA Consulting), I participated in nuclear retrospective prudency audits, cost-of-service audits, general management audits, gas procurement audits, business redesign projects, gas supply designs, and gas marketing development.

From 1981-1989, as Chief Engineer with Craddock Engineering, I was responsible for the engineering design and operations of the exploration and production activities of AGIP's (ENI) oil and gas operations.

From 1978-1981, as Vice President of the Northern Trust Bank, I was responsible for the valuation of the energy-based portfolio of loans

From 1973-1978, as Senior Engineer with Amoco Production and Amoco International Oil Company, I was responsible for certain exploration and production activities in the United States and Middle East.

Q. Have you ever been employed as a consultant by the Tennessee Regulatory Authority ("TRA" or "Authority")?

A Yes. As a consultant to the TRA, I directed the Gas Purchase Prudency Audit for United Cities Gas (UCG), Nashville Gas, and Chattanooga Gas in 1993-1994; prepared an analysis of UCG's 1st year experimental Performance Based Ratemaking ("PBR") program in 1995-1996; prepared an analysis of UCG's 2nd year experimental PBR program in 1996-1997, in 1998, served as the TRA's witness in the remand of UCG's 1996 Phase One proceeding wherein the TRA considered continuing the PBR mechanism; and also in 1998,

served as the TRA's witness for UCG's Phase Two proceeding to determine whether to continue the PBR mechanism beyond its second year on a permanent basis

Q. What is the purpose of your testimony in this matter?

A. I have been retained by United Cities Gas, now known as Atmos Energy Corporation ("Atmos" or "Company"), to provide an opinion as to the following: (1) how the savings Atmos has obtained through negotiated discounts on certain transportation contracts should be treated under the Company's current PBR program; (2) how savings from the Company's NORA contract should be treated under the Company's current PBR program; and (3) how the new tariff proposed in Docket No. 02-00850 will operate.

Q What have you relied upon in reaching your findings?

A: In reaching these findings, I relied on the pleadings in Docket Nos. 01-00704 and 02-00850, the pleadings and testimony in the Phase II proceedings, Atmos annual reports, my report dated February 28, 1997, and notes from my March 13, 2002 meeting with TRA Staff.

Q. How should the savings generated from the discount transportation agreements Atmos has negotiated be treated under the Company's current PBR program?

A: Atmos is entitled to share in those savings under the terms of the current PBR program. As I will demonstrate in more detail below, transportation costs were included within the intent and scope of the original PBR program and to exclude them now would result in a material defect in the PBR plan. As I will explain in more detail below, the savings from Atmos' negotiated transportation discounts were intended to be captured by the transportation cost adjuster for city gate purchases which is contained with the Gas Commodity Cost mechanism of the PBR.

Q: Please describe briefly how the PBR plan originally came into existence.

A. In 1999, after a two-year experimental period and extensive hearings, the TRA approved an amendment to Atmos' tariff implementing a permanent PBR plan The permanent PBR plan is encompassed within the April 1999 Phase Two Order in Docket No.

97-01364, and became effective April 1, 1999.[1] The purpose of the PBR plan is to eliminate the need for the TRA to hire a consultant to conduct a yearly prudency review of Atmos' gas procurement, storage, and capacity activities, and to give the Company an incentive to find and aggressively pursue cost savings on an ongoing basis. Under the PBR plan, Atmos' performance is evaluated on an on-going basis by comparing the Company's performance with pre-defined benchmarks which act as surrogates for the market. The PBR creates an incentive for Atmos to out-perform the market in its acquisition of gas supply and transportation services by allowing Atmos to share in savings obtained, but also requiring Atmos to help absorb excess costs incurred.

The PBR allows Atmos to share in savings obtained and costs incurred through two mechanisms: (1) the Gas Procurement Incentive Mechanism (also referred to as Gas Commodity Cost Mechanism); and (2) the Capacity Management Incentive Mechanism (also referred to as the Capacity Release Sales Mechanism) The issues of the this consolidated docket deal solely with the Gas Commodity Cost Mechanism.

The TRA, in approving the experimental PBR mechanism in 1995, noted that the Authority should begin to look to incentive programs and more streamlined regulation to improve efficiency and hold down costs to consumers [2] Consistent with the TRA objective, the TRA adopted a PBR program that was intended to span the entire spectrum of gas procurement, storage, and capacity activities My testimony during the 1998 proceeding[3] confirms this intent, and notes that these gas cost related activities, which directly impact the ultimate price paid by the consumer, were initially captured through five separate and distinct PBR mechanisms,[4] namely.

a) Gas Procurement

b) Seasonal Pricing Differential

c) Storage Gas Commodity

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1 Phase II Order p 1

2 United Cities Gas Company, Second-Year Review of Experimental Performance-Based Ratemaking Mechanism April 1, 1995 - November 30, 1996, 2/28/97, p. 7

3 Vol 1 p 61, lines 6-9

d) Transportation Capacity Cost; and

e) Storage Capacity Cost.

In making the PBR plan permanent in 1999, the TRA did not revise either the intent or the scope of the plan, but did simplify the PBR mechanism by collapsing the above five mechanisms into two, as follows:[5]

a) Gas Commodity Cost; and

b) Capacity Release Sales.

My testimony as the TRA witness recommended collapsing the five mechanisms into two, and concluded that the sharing formulas would not have to be changed. The intent of the PBR plan was clearly broad enough to account for the entire associated commodity cost of purchasing, delivering, and storing of gas to the end consumer and in doing so, accounted for the:

a) Costs of the commodity portion of gas;

b) Costs of transporting the commodity to Atmos' city gate[6], and

c) Costs of gas storage

Q Please describe how the Gas Commodity Cost mechanism of the PBR plan operates.

A. Atmos' gas purchases are compared to an adjusted simple average of a basket of market indices (Inside FERC, NYMEX, Natural Gas Intelligence, and Gas Daily). The index average is adjusted depending on whether the purchases were long-term contracts and

4 Order of the Tennessee Public Service Commission dated May 12, 1995
5 Final Order Phase II, TRA Docket 97-01464, 8/16/99, p 28
6 "City gate" refers to the pipeline delivery point to Atmos' distribution system

if so, whether delivery of the gas was taken directly at Atmos' city gate or at some point upstream. The two adjustments are

a) Competitive Bid Adjustment for long-term upstream (spot or swing)[7] purchases, using the three-year rolling average of long-term contract premium over spot; and

b) Avoided Cost Adjustment for long-term city-gate (spot or swing) purchases, using the ***appropriate pipeline transportation cost*** (emphasis added).

The table below summarizes the formulas for each of the procurement-related transaction possibilities:

Category	Monthly	Long-term Upstream	Long-term @ City Gate
Spot Gas Purchases	Average of the three market indexes (FERC, NYMEX, NGI)	Average of the three market indexes + Competitive Bid Adjustment	Average of the three market indexes + Competitive Bid Adjustment + Avoided Cost Adjustment
Swing Purchases	Gas Daily Index	Gas Daily Index + Competitive Bid Adjustment	Gas Daily Index + Competitive Bid Adjustment + Avoided Cost Adjustment

Using the above table, each purchasing decision is mapped to the appropriate category in order to determine the relevant index and adjusters. If Atmos' total gas purchases for the month are less than 97.7% of the benchmark, savings are earned and shared equally by the ratepayer and the Company. If Atmos' purchases exceed 102% of the benchmark, penalties

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7 The Spot Market is characterized by short-term contracts for specified volumes of gas. The Spot Price is the current one-time purchase price. A Spot Purchase is a short term sale of gas to an end-user, local distribution company, or pipeline for which the duration varies of a month or more. Swing purchases are also short-term contracts for specified volumes of gas, but for a duration of less than a month.

are calculated and also shared equally between the ratepayer and the Company When Atmos' gas purchases fall between 97.7% and 102% (the deadband), no gains or penalties are calculated.

Q: Are transportation costs included within the scope of the original PBR plan?

A. Yes Otherwise, the plan would contain a material defect.

As noted earlier, the PBR plan confirmed that the PBR was intended to cover all costs of purchasing, delivering, and storing gas to the end consumer, including transportation costs.[8] The Authority's definition of total gas cost in the Phase Two Order specifically recognizes that gas cost includes a transportation cost component. The Authority stated that

> The total cost of the gas includes the commodity cost ***and the transportation cost to move the gas from its source to the city gate.*** In general the closer the gas source is to the city gate, the higher the commodity cost, but, since the distance to be moved is less, the transportation cost is less. In contrast, the farther the gas is from the city gate, the cheaper the commodity cost, but the transportation cost to move it a greater distance is more. It is, therefore, possible that the total of commodity and transportation costs for the higher cost gas could be lower than the ***total costs (commodity plus transportation)*** for the cheaper gas.[9]

As noted in the Phase Two Order, Consumer Advocate and Protection ("CAPD") witness Dan McCormac conceded that Atmos' gas cost consists of both the commodity price of the gas, plus the transportation cost of moving the gas from the pipeline receipt point to the delivery point.[10]

The PBR was designed to create an incentive for Atmos to out-perform the market in its acquisition of gas supplies by allowing Atmos to share in savings obtained and help absorb

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8 Trans of March 26, 1998 Hearing, vol 1 p 61, lines 6-9

9 Phase Two Order p 18 fn 46) (emphasis added).

10 Phase Two Order p 18

excess costs.[11] A fundamental requirement of the PBR is that Atmos is not to be rewarded at the expense of the ratepayer. In order to satisfy the incentive principle behind the PBR, as recognized in the Phase Two Order, the program must be all-inclusive, e.g. it must include all aspects of gas purchasing activities. If transportation costs had been excluded from the PBR program and simply passed on in full to the 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 cost arrangements (which would be passed on to the ratepayer) in order to lower commodity costs. Under this scenario, Atmos could earn benefits at the ratepayers' expense. This is completely inconsistent with the goals of the PBR program, and explains why transportation costs were included in the program from its inception.

Also, an important feature of the PBR program in addition to the incentive component was the elimination of the need for the TRA to hire a consultant each year to review Atmos' gas costs for the past year to determine if they were prudent.[12] If transportation costs are now excluded from the PBR, as recommended by the CAPD, Atmos would have no incentive to beat the market, and there would be no process in place for the TRA to verify market transportation costs, short of ordering a prudency audit – the very type of regulatory activity the PBR was designed to avoid.

For these reasons, transportation costs were included within the scope of the current PBR plan, and were captured through the transportation cost adjuster within the Gas Commodity Cost mechanism.

Q: How were Atmos' transportation costs determined when the PBR plan was originally implemented?

A: During the experimental PBR timeframe, Atmos' actual transportation costs for moving the gas from the pipeline receipt point to Atmos' city gate were at the applicable undiscounted, published FERC tariffed rate. Each pipeline seeks and receives an approved FERC rate, the maximum the pipeline transportation provider is allowed to charge. These

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11 Phase Two Order p. 2
12 Phase Two Order p 1

maximum-approved rates are for firm, long-term transportation arrangements, not for short-term, interruptible service. Subsequent to the experimental PBR timeframe, Atmos began extensive negotiations with pipeline companies seeking to obtain discounted transportation contracts for moving gas from the respective pipeline receipt points to Atmos' city gate. The prospects of sharing the realized transportation savings with the consumer through the PBR plan were clearly a positive incentive for Atmos to actively and aggressively pursue these opportunities

Q: How has Atmos taken advantage of the cost saving opportunities with regard to transportation costs?

A: As noted earlier, when the PBR plan was originally implemented, all transportation rates were at the undiscounted published FERC tariffed rate. Transportation discounts first became available in the marketplace during the fall of 1999. Atmos, based on the incentives of the PBR plan, aggressively pursued those discounts. Those discounts were not available merely for the asking, but had to be actively pursued. Transportation discounts are the exception, not the rule. For example, Atmos as a whole holds transportation contracts with 28 interstate pipelines, but has only two pipelines which offer discounts on all of their contracts. Ten of the pipelines have agreed to discounts on some, but not all of the contracts. Therefore, Atmos has, in fact, been unsuccessful in obtaining discounts from the majority of the available pipelines. Similarly, Atmos' Tennessee service territory is served by six pipelines, none of which have discounts on ***all*** of Atmos' contracts. Only three pipelines serving Atmos' Tennessee territory have some contracts that are discounted. Therefore, half of the pipelines serving Atmos' Tennessee territory have no discounted contracts.[13] Additionally, Atmos held a total of 16 contracts on the six pipelines servicing its Tennessee territory, of which 11 contracts were undiscounted and priced at the maximum FERC rate.[14] This magnitude of undiscounted contracts demonstrates that discounts were

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13 East Tennessee, Columbia Gulf, and Tennessee Gas have some discounted contracts, Texas Gas, Southern Natural, and Texas Eastern have no discounted contracts

14 Atmos held two contracts on Tennessee Gas One of these contracts was a partially discounted contract This partially discounted contract provided a transportation rate that moves the commodity from Zone 0-1 at the maximum FERC rate, whereas the transportation rate that then moves the gas through Zone 1-1 to Atmos' city gate is at a discount off maximum FERC rate The other Tennessee Gas contract is priced at the maximum FERC rate Atmos also holds three contracts

not routinely and easily granted, and required Atmos to actively seek and negotiate discounts.

Q: How are transportation cost savings calculated under the current PBR plan?

A: The PBR plan provides for consideration of transportation cost savings through the transportation cost adjuster in the Gas Cost Commodity mechanism. As noted earlier, the Gas Cost Commodity mechanism measures Atmos' performance against a benchmark that consists of three published market indexes ***and transportation cost adjuster.*** Specifically, the PBR plan provides that "[f]or city gate purchases, these indexes will be adjusted for the avoided transportation costs that would have been paid if the upstream capacity were purchased versus the demand charges actually paid to the supplier."[15] The benchmark average index for long-term city gate purchases should be adjusted by adding the appropriate avoided pipeline transportation cost to the average index price of gas.

The avoided pipeline transportation costs should be calculated by comparing Atmos' actual transportation costs for each purchase to the maximum approved FERC rate for firm, long-term transportation contracts published for each particular pipeline.[16]

The transportation cost adjuster is necessary because the basket of market indices represents only the transportation costs to get the gas from the well head to the pipeline receipt point (upstream transportation) and not the Company's costs of transporting the gas from the receipt point to the city gate (downstream transportation) Because Atmos' total cost of gas is a bundled price which includes both commodity and downstream transportation costs, in order to have an apples to apples comparison, the benchmark used to measure the Company's performance with regard to that total cost must also include components for both commodity and downstream transportation. The market indices are commodity based only and do not contain a component for downstream transportation costs without application of the transportation cost adjuster.

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on Columbia Gulf, only one of which is discounted Atmos also holds four contracts on East Tennessee, three of which are partially or fully discounted

15 UCG Tariff Sheet 45 2

16 As discussed in more detail below, this is how transportation savings from the Company's NORA contract were calculated during the PBR experimental period

Hence, the indices do indeed serve as a proxy for the market place, but only with regard to commodity purchases at pipeline receipt points. For example, Inside FERC tracts first-of-the-month bidweek price reports for monthly spot gas delivered to 46 locations on 25 pipelines. Reported for each pipeline receipt point is a price range and an index price. The index price is an assessment of the price at which the majority of dealmaking occurred for the pipeline ***delivery location***.[17]

As noted above, these price indices, in themselves, are commodity only based indices, and do not contain downstream transportation costs, i.e the transportation cost from the pipeline receipt point to the Company's city gate, without the appropriate transportation cost adjusters.

Q: Why should avoided transportation costs be calculated by comparing actual costs to the maximum approved FERC rate?

A: Because at present, the maximum FERC rate is the market indicator for transportation costs. A published index for transportation costs does not currently exist Although FERC, in 1996, required pipelines to file Discount Transportation Reports, which provided particular information regarding discounted rates, either firm or interruptible, the reports are not a reliable source of information regarding firm transportation arrangements. My review of the reports indicated that certain transportation transactions that were reported were actually found to be capacity release, even though a pipeline was not required to file this information if the discount was related to the release of capacity. Furthermore, the reported discounted transportation arrangements were not differentiated between firm, forward haul, backhaul, interruptible and/or winter only service. Consequently, prices would have been found to vary widely when making an apples-to-oranges comparison between firm, interruptible, and capacity release arrangements.

The maximum FERC rate is the market indicator for transportation costs. The best measure of Atmos' success in seeking lower cost, firm transportation arrangements that would impact the ultimate total cost of gas to the ratepayer would be its ability in:

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17 McGraw-Hill's U S Natural Gas Methodology

a) Obtaining discounts off of FERC maximum approved price;

b) Sustaining these discounts upon renewal or renegotiation; and

c) Maximizing the discount off the approved price that Atmos receives from its pipeline transportation provider for the specific and unique pipeline transportation paths, e.g. receipt point to city gate

As noted above, following the experimental PBR plan period, discounted firm transportation contracts began to be a feature of the marketplace and accordingly, have been aggressively pursued by Atmos. As noted above, Atmos currently holds ***some*** discounted firm transportation contracts on one-half of its pipelines serving the Tennessee territory, which are a result of successfully negotiating discounts off the maximum approved FERC rates. The remaining one-half of Atmos' pipelines provide no discounted firm transportation contracts and are priced at the maximum FERC approved transportation rate. Therefore, the benchmark is indeed the maximum FERC approved transportation rates, which is the market-clearing price for the majority of the firm transportation contracts and the basis for the negotiations for any discounts.

The approved FERC rate is unique to a pipeline, and to a pipeline's receipt point and delivery point. These prices do not in fact vary widely, but instead are specific to the contract type (e g. delivery/receipt points, volumes, seasonality, and duration). Therefore, the maximum approved FERC transportation rates serve as the most objective benchmark for the transportation component of total gas costs.

A review of several additional factors also supports the view that the maximum FERC rates do serve as the indicator of prices achieved in the market. For instance:

a) Atmos negotiates discounts off of FERC approved rates, not off commodity-based indices;

b) The maximum FERC rate has been accepted by other state public utility commissions as the true market indicator of long-term, firm transportation costs;[18]

[18] PBR plans for LG&E, and Western Kentucky Gas

c) The maximum FERC rate would serve as the benchmark for any PGA audit or prudence review of Atmos' purchases. If, for example, the downstream, firm transportation costs were excluded from the PBR, the TRA would be required to establish the basis for comparing actual firm transportation costs to a standard of prudence, e.g approved, maximum FERC rates;

d) A review of all of the transportation contracts negotiated by Atmos reveals that the majority of contracts are priced at the maximum approved FERC rate; and

e) The approved NORA arrangement, per the existing PBR plan, relied on the maximum FERC rate in calculating the transportation cost adjuster to the commodity market indexes.

Q. Could you provide an example of how transportation costs savings should be calculated for a particular month under the current PBR plan?

A. Yes. The calculation would rely on determining the specific transportation costs, both discounted and undiscounted, for a unique delivery path and in some instances, multiple delivery paths for a particular commodity. A FERC published rate for each delivery path would be determined and then applied as the transportation component in the bundled market index. However, rather than track both discounted and undiscounted transportation costs associated with each gas commodity purchase and map these purchases to a unique, and sometimes multiple delivery paths, a simpler reporting and tracking format is recommended, as follows.

a) Calculate the total actual monthly transportation cost paid by Atmos under each of its discounted and undiscounted transporting pipeline contracts for the state of Tennessee;[19]

b) Allocate the total actual monthly transportation costs to each of Atmos' supplier commodity purchases in order to calculate a total bundled price

for that purchased commodity. The resulting total price for that commodity purchase would then reflect both commodity and transportation costs;[20]

c) Determine the transportation cost adjuster utilizing the FERC approved maximum transportation rates, both fixed and variable.[21] As in NORA, add this transportation cost adjuster to the commodity index so as to determine a bundled market index, that includes both commodity and transportation components, against which performance would be determined;

d) Calculate the average of the three commodity only indexes, in the same manner used for all commodity purchases as laid out in the PBR plan;

e) Add the transportation cost adjuster calculated in step c) above to the commodity only index from step d) above in order to determine the bundled index, as in NORA. This market index serves as the standard of performance against which Atmos' commodity purchases, and the transportation costs of delivering that commodity to Atmos' city gate would be compared; and

f) Compare actual bundled costs (both commodity and transportation) against the adjusted market index to determine gains/losses. Apply the

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19 Sum the actual invoiced transportation costs, both fixed and variable, for each of Atmos' transporting pipeline contracts associated with delivery of the commodity from the pipeline receipt point to Atmos' delivery point(s) in the state of Tennessee

20 Divide Atmos' total transportation costs for the state of Tennessee by the total commodity supplier purchases for the month in order to determine a transportation cost per MMBTU allocation factor Each of the supplier's commodity purchases would be multiplied by the transportation allocation factor to determine the actual transportation cost allocated to that specific supplier's commodity purchase and therefore, reflect the allocated transportation cost to move the commodity from the pipeline receipt point to Atmos' city gate.

21 As in NORA, for each transporting pipeline contract, use the maximum FERC rate to determine the benchmark cost for the transportation component of the market index Undiscounted contracts would, of course, have the same actual transportation costs as the benchmark for that contract. The discounted contracts would show some amount of avoided transportation costs As in NORA, these benchmark transportation costs, based off of maximum FERC rates, include both the pipeline demand and volumetric costs and would be based on the FERC Tariffed Transportation Demand Rate, Tariffed Transportation Commodity Rate and Surcharges and Direct Bills

deadband to determine the amount of gains /losses that would be shared between the ratepayer and Atmos under the 50/50 sharing formula.

The following table illustrates the above methodology for a single month and for a single supplier commodity purchase contract:

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Category	Cost ($)	Volumes (MMBTU)	Index ($/MMBTU)	Cost ($/MMBTU)	Gains/losses ($/MMBTU)
Supplier Invoice Contract Price (commodity)[22]	$1,696,509	387,393		$4.3793	
Total Purchased Volumes[23]		1,270,798			
Actual Pipeline Invoice Cost (transportation) for entire state of Tenn.[24]	$1,957,357				
Actual Transportation Cost Allocation Factor[25]				$1.5403	
Totaled Bundled Actual Cost[26]				$5.9196	
Benchmark FERC Approved Max Rate (all transportation contracts)	$2,199,570				
Transportation Cost Adjuster			$1.7309		
Average of Commodity Only Indexes			$4.4670		
Bundled Index (commodity and transportation)			$6.1979		
97.7% of Bundled Index (Gains)				$6.0553	$0.1357
102% of Bundled Index (Losses)				$6.3219	

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22 Invoiced volumes -- MMBTU

23 Excluding NORA, so as to not double count

24 Invoiced actual costs.

25 Actual, total transportation costs for Tennessee divided by the purchased volumes for Tennessee.

26 Sum of actual commodity cost and allocated actual transportation cost.

Note: Above values are representative of actuals for a single month for a single supplier during the audit year. A similar calculation, using the above methodology for the remaining supplier contracts would be conducted, as well for the remaining months of the plan year.

In summary, the cost to deliver the gas from the pipeline receipt point to the city gate can be captured by the PBR mechanism:

a) The total bundled cost at the city gate, e g. commodity and transportation, is compared to a market index that includes both commodity and transportation costs;

b) The FERC approved rate is used as the benchmark to adjust the commodity indices and therefore, bundle both the commodity and transportation cost into a single market index, and

c) The 97 7% - 102% deadband is applied to calculate gains and losses. Benefits are shared 50/50 between the ratepayer and Atmos.

Q: How should savings under the Company's NORA contract be treated under the current PBR plan?

A: Atmos' gas supply contract covering the East Tennessee-NORA Gas Pipeline was included in the two-year experimental PBR period, but was initially excluded from the permanent PBR plan because it pre-dated the plan. The TRA ruled that if the NORA contract was renewed or renegotiated, Atmos could petition for inclusion of the contract in the PBR plan. Atmos negotiated a new NORA contract in April 2000, with an effective date of November 1, 2000. On September 26, 2000, Atmos filed a petition with the TRA requesting permission to include the new NORA contract in the PBR plan. The TRA granted Atmos' request at the June 12, 2001 agenda conference.

Unlike the negotiated discount contracts discussed above, which are transportation-only contracts, the NORA contract contains both commodity and transportation purchases. During the PBR experimental period, the savings generated from the NORA contract were calculated through the use of the transportation cost adjuster. Purchases made under the NORA contract avoid or reduce Atmos' transportation costs This transportation cost savings was calculated by comparing the actual transportation costs to the approved FERC

maximum rate. The difference between the actual transportation costs and the maximum FERC rates was labeled as avoided costs and is a key element of the formula used to determine the benchmark to apply to the total NORA purchase.

Although the NORA contract was initially excluded from the permanent PBR program, the Authority, on November 8, 2001, entered an order granting permission to include the newly renegotiated NORA contract in the PBR.[27] The Authority held:

> Upon a careful review of the petition, and of the entire record in this matter, the Authority approved United Cities' request to include transactions under the new NORA contract in its Incentive Plan.

The NORA contract is a long-term contract. The Avoided Costs (maximum FERC rate minus actual transportation rate) are added to the average of the three indexes (FERC, NGI, and NYMEX) to arrive at an "Average Index" price. This Average Index price is a bundled index with both commodity and transportation components. Gains/penalties are then calculated if the invoiced price is 97.7% or less than the Average Index price (Gains) or 102% or more than the Average Index price (Penalties).

The table below demonstrates these calculations.

27 Order, Docket No 00-00844

Category	Index ($/MMBTU)	Cost ($/MMBTU)	Gains/losses ($/MMBTU)
Supplier Invoice Price (commodity) [28]		N/A	
Pipeline Invoice Price (transportation) [29]		N/A	
Total Bundled Invoice Price (commodity and transportation)		$6.3050	
Average of Commodity Only Indexes	$6 1893		
Plus Transportation Cost Adjuster from the Benchmark FERC Approved Max. Demand Rate	$0.3522		
Bundled Index (commodity and transportation)	$6.5415		
97.7% of Bundled Index (Gains)		$6 3910	$0.086
102% of Bundled Index (Losses)		$6.6723	

Note: Above values are hypothetical but are representative of actuals during the audit year.

The above methodology correctly outlines the manner in which the PBR plan envisioned the treatment of the NORA benefits, and recognizes that:

a) To make an accurate comparison, the NORA purchases (which is a bundled cost which includes both commodity and transportation components) must be compared to a market index that includes both commodity and transportation costs;

28 Invoiced volumes -- MMBTU

29 Demand rate based on MDQ, not actual throughput

b) The FERC maximum approved rate is the appropriate benchmark to adjust the commodity indices and therefore, bundle both the commodity and transportation cost into a single market index; and

c) Benefits should then be calculated by applying the 97.7% - 102% deadband to the benchmark and determining whether Atmos' purchases were less than 97.7% of the benchmark (such that savings would be split equally between the Company and the consumers); or, more than 102% of the benchmark (such that penalties are shared equally between the Company and the consumers); or, fell within the deadband (such that no penalties or savings were shared).

Q: Please describe how the new tariff proposed in Docket No. 02-00850 would operate if approved?

A. If the tariff proposed in Docket No. 02-00850 is approved, the PBR program will be amended to include a slightly different and more detailed formula for the calculation of transportation cost savings that will more explicitly reflect current market conditions. The proposed tariff adds a third incentive mechanism to the two existing mechanisms (Gas Commodity Cost or "GCC" and Capacity Release Sales or "CRS"). This third mechanism would be a separate mechanism solely for transportation costs and would be labeled a Transportation Index Factor ("TIF").

With the addition of the new TIF, the PBR formula would be represented as follows:

PBR Benefits = GCC + CRS + TIF

where GCC = Gas Commodity Cost, CRS = Capacity Release Sales, and TIF = Transportation Index Factor.

Q: Please describe the TIF component.

A: The recommended TIF component of the PBR would be comprised of four (4) basic elements:

1. Actual discounted transportation costs ("Actuals");

2. Transportation cost standards of performance (SOP);

3 Savings calculation; and

4 Savings sharing formula.

Actuals would represent the amount of transportation discounts received on Atmos' pipeline contracts. Actuals would be compared to the SOP, the maximum FERC-approved transportation rates, in order to determine the amount of savings earned. Savings would be calculated on a monthly basis. The monthly savings would then be allocated between the consumers and the Company based on the recommended three tiered sharing formula.

a) When the savings are greater than 0% but less than 10% of the standard of performance, the Company is entitled to 30% of the savings, with the consumers retaining the remaining 70% of the savings,

b) When the savings are greater than or equal to 10% but less than 20% of the standard of performance, the Company is entitled to 40% of the savings, with the consumers retaining the remaining 60% of the savings; and

c) When the savings are greater than or equal to 20% of the standard of performance, the savings are shared equally between the consumers and the Company.

Atmos' total earning under the entire PBR plan would be its portion of TIF benefits in addition to its portion of the GCC and CRS components, subject to the earnings cap.

Q: Please explain the calculation of the elements of the TIF component.

A: A SOP for each pipeline contract would be calculated by multiplying the maximum FERC rate by the volumes contracted for and delivered to the Company. The TIF Savings would then be calculated by subtracting the Company's actual discounted transportation costs from the maximum FERC rate for each pipeline. The savings for each pipeline would then be allocated between the Company and the consumers according to the three tier sharing formula described above.

453 Q: Please provide an example of the TIF calculation if Docket No. 02-00850 were
454 approved.

455 A. A brief summary is as follows :

Pipeline	Actuals City gate Invoice Price	Actuals Reservation City gate Invoice Value	SOP [1] FERC Maximum Rate	SOP FERC Demand Value	Benefits Avoided Costs Rate	Benefits Avoided Costs Demand	Consumer's Share of Benefits (%)	Company's [2] Share of Benefits (%)
Tennessee/ETNG #30774	$7 11	$374,324	$7 16	$376,957	$0 05	$2,632	70%	30%
Tennessee/ETNG #33254	$0 4227	$89,424	$0 5988	$126,678	$0 1761	$37,255	70%	30%
Tennessee /Storage A	$1 92	$17,925	$2 02	$18,859	$0 10	$934	70%	30%
Total		$481,673		$522,494		$40,821	70%	30%

456
457 1) SOP would be the maximum FERC rate
458 2) Company's Share of Benefits subject to earnings cap
459

460 As demonstrated in the example above, the Company outperformed the market; however,
461 only at a level to share in 30% of the benefits due to the three tiered sharing mechanism.

462 Q: In your opinion is the tariff proposed in Docket No. 02-00850 just and reasonable
463 and in the best interest of the Company and the ratepayers?

464 A: Yes. As noted above, the purpose of the PBR program is to incent proper business
465 decisions and do so in a manner that is not detrimental to the consumer. It was designed to
466 create an incentive for the Company to out-perform the market in its acquisition of gas
467 supplies by allowing the Company to share in savings obtained and help absorb excess costs.
468 In order to satisfy this design principle, a PBR program must span all gas purchasing and
469 transportation activities, and must be flexible enough to allow innovation with regard to
470 types of savings obtained. Without such flexibility, I believe the plan to have a material
471 defect. If the Company is permitted to recover savings for only a portion of its gas
472 purchasing and transportation activities, the incentives will be skewed and will not result in
473 the most beneficial decisions for the Company and the ratepayers.

The tariff proposed in Docket No. 02-00850 unbundles the transportation cost component of the total delivered cost of gas to the city gate and provides a more detailed and specific method for calculation of the transportation savings that have become available since the PBR plan was implemented. Transportation costs can be then be monitored on a pipeline by pipeline contract basis, thereby simplifying the transportation cost process.

The proposed tariff replaces the reasonableness or prudence review of the Company's gas purchasing activities overseen by the TRA. This replacement results in a reduction in regulatory costs. This reduction of costs corresponds to a reduced cost-of-service, which directly benefits the consumer by reducing the corresponding amount of revenue requirements and therefore, consumer rates. It also benefits the Company and the TRA by freeing up scare resources to focus on other regulatory and business issues.

The proposed tariff, which would span the entire spectrum of gas procurement, storage, and capacity activities, including transportation costs, also provides the Company with a set of visible and measurable standards against which its performance on the cost of the delivered city-gate gas would be determined. These standards would serve as the basis, based on Company performance, from which savings or costs would be shared between the consumer and the Company.

The proposed tariff also ensures that the consumer's cost-of-gas is based fairly on market-based pricing and that the Company is incented to beat that market price.

Lastly, the proposed tariff ensures that the Company's gas purchasing activities are focused on reducing the total cost of gas delivered to the city-gate, as opposed to maximizing benefits in one component of the PBR at the expense of another.

Q: Does this conclude your direct testimony?

A Yes it does.

499

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing has been served via U S. Mail, postage prepaid, upon the following this the 30th day of July, 2004:

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