RECEIVED
2004 OCT -5 PM 1:54
T.R.A. DOCKET ROOM

BEFORE THE TENNESSEE REGULATORY AUTHORITY

AT NASHVILLE, TENNESSEE

IN RE:

UNITED CITIES GAS COMPANY, a Division of ATMOS ENERGY CORPORATION COMPANY, INCENTIVE PLAN ACCOUNT (IPA) AUDIT

DOCKET NO. 01-00704

REBUTTAL TESTIMONY
OF
DANIEL W. MCCORMAC

October 5, 2004

BEFORE THE TENNESSEE REGULATORY AUTHORITY

AT NASHVILLE, TENNESSEE

IN RE:

UNITED CITIES GAS COMPANY, a Division of ATMOS ENERGY CORPORATION COMPANY, INCENTIVE PLAN ACCOUNT (IPA) AUDIT

DOCKET NO. 01-00704

AFFIDAVIT

I, Daniel W. McCormac, Coordinator of Analysts for the Consumer Advocate and Protection Division of the Attorney General's Office, hereby certify that my attached Rebuttal Testimony represents my opinion in the above-referenced case and the opinion of the Consumer Advocate Division.

Daniel W. McCormac

DANIEL W. McCORMAC

Sworn to and subscribed before me this 4th day of October, 2004.

Emily Knight

NOTARY PUBLIC

My commission expires: September 22, 2007

EMILY KNIGHT ... DAVIDSON COUNTY, TENN.

77697

My Comm... Expires SEPT. 22, 2007

Q. Would you state your name for the record, please?

A. My name is Daniel W McCormac.

Q. Are you the same Dan McCormac that previously filed testimony in this docket?

A. Yes.

Q. Would you please summarize the scope of this rebuttal testimony?

A. Yes. After examining Atmos' testimony and responses to our discovery I discovered several major contradictions with the Staff's audit report, Atmos' current tariff governing the existing Performance-Based Ratemaking Mechanism ("PBRM") and with the previous testimony presented by the CAPD. Atmos' recent filings again show that Atmos is ignoring the TRA's order, ignoring its tariffs, ignoring the TRA Staff's audit findings, and attempting to expand the PBRM to make it more profitable for Atmos while charging consumers more than the actual delivered cost of gas.

Q. What are the major remaining areas of disagreement?

A. In addition to the items discussed in the record thus far, the following major issues remain.

1. AE ignores its own tariff governing the PBRM (Tariff Sheet No. 45.7) which requires an "Incentive and Rewards Program" for Gas Supply employees as recognition for their contribution to the customers and shareholders through lower gas costs and savings.

2. AE completely ignores its own Tariff Sheet 45.2 which clearly defines the avoided transportation costs adjuster and when it should be applied. It states "For **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." (Emphasis added.)

   A. **While there is a "transportation cost adjuster" for city gate purchases, the discounts which Atmos has acquired are not on city gate purchases.**

   B. Atmos redefines "avoided transportation costs" from "**costs that would have been paid if the upstream capacity were purchased versus the demand charges actually paid**" (Emphasis added) to a definition outside the PBR's scope.

3. **The PBR was approved before transportation discounts were ever offered. Transportation discounts were not even possible when the PBR was approved.**

4. Atmos testimony reveals the fact that paying the maximum FERC transportation rate would be "relatively high transportation cost." **Atmos is thus asking to be rewarded for paying anything less than the "relatively high" costs.**

Q. The existing tariff states that "For 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." What does this mean?

A. This clearly defines the appropriate adjustment necessary to exclude the effects of transportation costs from consideration of the prices paid for natural gas to make the indices comparable to purchases of natural gas at the city gate. This adjustment is necessary to accurately compare an index based on purchase prices in Louisiana (like the NYMEX Henry Hub index price) to purchase prices in Tennessee. This is necessary for two reasons. First, there is no index price for Tennessee purchases. Second, "city gate purchases" would include all transportation costs necessary to bring the gas to Tennessee. Therefore, it is only fair to adjust the index price to exclude the effects of the transportation costs that were avoided by buying the gas **after delivery**.

In contrast, there are no avoided costs for gas purchased at the Henry Hub and then delivered to the city gate. Avoided costs arise only in those situations when gas is delivered to the city gate. In that situation, the avoided costs are identified so that the **delivered cost** of the gas (at the city gate) may be compared to the **delivered cost** of the Henry Hub gas. The illustration in Exhibit DWM-1 attached to this testimony clearly shows what the phrase "For city gate purchases, these indexes will be **adjusted for the avoided transportation costs** that would have been paid if the upstream capacity were purchased" (emphasis added) from Sheet 45.2 of Atmos' tariff means. The only purpose of such an adjustment was to **<u>adjust the indexes</u>**

to recognize the fact that a city gate purchase is not directly comparable to indexes designed to capture market prices for purchases at the Henry Hub or other "upstream" locations. To make the indexes comparable, Atmos had to add the transportation costs that "would have been paid if the upstream capacity were purchased" instead of the city gate purchase. Exhibit DWM-1 clearly shows that without the "avoided transportation costs" adjustor of $0.50, the NYMEX index price of $5.00 would not be comparable to the $5.50 actual price paid for a city gate purchase. Without the "avoided transportation costs" adjustor, it would appear that Atmos paid $0.50 too much for the gas. The adjustor puts the two purchases on a comparable basis.

It is clear that the intent of this adjustment for the "avoided transportation costs" is to remove the transportation cost variable from the equation and focus specifically on the cost of natural gas **excluding the effects of** differing transportation charges. AE is now trying to redefine the incentive plan to **include** a transportation cost component that is not in the PBR.

Furthermore, as I will discuss below, such a component should not be added to the PBR because even Mr. Creamer concedes that the maximum FERC rate that Atmos is asking to use as a reference price is "relatively high."

Q. Is Atmos' engaging in practices consistent with its Tariff Sheet No. 45.7?

A. No. Atmos' PBR (Tariff Sheet No. 45.7) requires an "Incentive and Rewards Program" for Gas Supply employees as recognition for their contribution to the customers and shareholders through lower gas costs and savings. The details are to be supplied to the Authority on an annual basis. Atmos' response to Interrogatory #9 was that the PBR results have no effect on compensation. The TRA ordered Atmos to provide this incentive compensation to the people doing the work, not just to stockholders.

> "The Authority concludes that a feedback and reward system for those employees involved in the activities detailed in the plan must be in place as long as the Company is operating under a PBR mechanism." [Page 25, August 16, 1999 TRA Order in Docket 97-01364]

If there is no bonus for employees, the bonus to Atmos does no good.

Q. Does Atmos make "city gate" purchases?

A. Atmos' answer to interrogatory No. 12 Atmos implies that it would not make city gate purchases because city gate purchases (Option 2, Purchase point: Murfreesboro, TN) would not be the "low price option" except in my "apples to oranges caparison." Atmos stated:

> 12. Has AEC or affiliates made gas purchases similar to those illustrated in "Option 1" of Attachment A to Mr. McCormac's testimony, filed July 20, 2004, in which the total delivered cost at the "Maximum FERC Rate" would be greater than the cost of gas that could have been purchased at the city gate? Provide details of all such purchases and explain the reasoning behind these purchases.
>
> **Response:** Atmos is unaware of any purchases fitting the specifications outlined in Mr. McCormac's hypothetical. As noted in paragraph 5 of the Affidavit of Ron McDowell, previously filed in the matter, Mr. McCormac's hypothetical is overly simplistic and does not reflect the realities of the Company's gas supply purchases. The hypothetical ignores additional considerations the Company must take into account in making purchasing decisions, including operational, reliability, and safety concerns. Purchases without a separate transportation component like the "Murfreesboro" example cited in Mr. McCormac's affidavit are not generally backed by

> primary firm transportation and may not be available on critical days. In order to meet its service obligations, the Company follows a general practice of subscribing to primary firm transportation. Differences in reliability requirements directly impact pricing for transportation services. Mr. McCormac did not specify the service obligations of the two delivery hypotheticals; however, in order for the Murfreesboro example to be the low price option, the service obligation must be interruptible Consequently, Mr. McCormac is making an apples to oranges comparison that does not take into consideration that reality of the working gas market.

Atmos raises "operational, reliability, and safety concerns" as possible variables or issues to avoid discussing the real issues raised by the hypothetical transaction which I illustrated in Attachment A to my prefiled testimony. However, "operational, reliability, and safety concerns" are not considered in the PBR. Since Mr. McDowell raises operational, reliability, and safety concerns that are not considered in the PBR, the current PBR should be thoroughly audited and reviewed to assure that all appropriate factors are considered. This is consistent with my pre-filed testimony recommending an audit of all gas purchasing practices.

Also, paragraph 5 of Ron McDowell's Affidavit is cited as rebuttal to the appropriate analysis of the transaction. Atmos failed to explain how purchasing gas after delivery raises "safety concerns" when compared to the same gas that could have been purchased elsewhere and delivered through the same pipelines. I am certainly not proposing that Atmos do anything that is "unsafe." I just illustrated the possible distortion created by Atmos' proposed method of measuring savings.

Q. Do you have any comments on Mr. Creamer's discussion about paying

"relatively high transportation cost arrangements?"

A. Yes. The unlikely and speculative example described on lines 164-166 of Mr. Creamer's testimony is unrealistic. He states that "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." (Emphasis added.)

When asked how this could be accomplished (Interrogatory No. 11), Atmos responded:

> The pipeline company may charge 'full price' for a service that it might otherwise discount, and have the affiliate offer a discount off the commodity to secure the deal. This "pass-through" of the implied transportation discount to the affiliate's commodity charge to Atmos would be captured as a benefit in the PBR plan, if transportation costs were excluded. Atmos has not to date entered into such transactions.

Close analysis of this answer reveals that there would have to be collusion between the pipeline company and its affiliate when the "pipeline company may charge 'full price' for a service that it might otherwise discount, and **have the affiliate** offer a discount off the commodity to secure the deal." (Emphasis added.) Furthermore there would be no reason to manipulate the numbers unless Atmos colluded with the pipeline company and its affiliate to do so.

When Atmos was asked to clarify how the transportation discount (losses of the transportation provider) could be recovered, Atmos answered that "Atmos does not have sufficient information to know if the gas provider and transportation provider would enter into arrangements to recoup any lost profits, or how those arrangements would be structured."

Atmos effectively admits that such pricing is unrealistic because it would require collusion between Atmos, the pipeline company and the pipeline company's affiliate.

Instead of entering a collusive agreement with the pipelines and affiliates to game the system, Atmos is now seeking a reward for not overcharging consumers for transportation. However, Atmos calls the excessive transportation charges "full price" rather than calling the excessive charges "overcharges." Atmos threatens to overcharge consumers because a "pipeline company may **charge 'full price' for a service that it might otherwise discount."** (Emphasis added.)

Mr. Creamer's description that "Atmos could increase its savings on the commodity portion, which it would share in, by entering into **relatively high transportation cost arrangements**" (emphasis added) also reveals the fact that paying the maximum FERC transportation rate would be "relatively high transportation cost." **Atmos is thus asking to be rewarded for paying anything less than the "relatively high" costs!** This underscores the deficiencies of Mr. Creamer's arguments. Mr. Creamer places himself in a contradiction. He admits that the FERC maximum rate is above the market while recommending that this "relatively high" cost be used as the standard for a new performance based reward!

Atmos management is responsible for seeking discounts on everything it purchases. When Atmos buys meters, pipes, trucks or paper, it should seek discounts. When Atmos borrows money or buys insurance, it should seek discounts. When Atmos buys transportation services, it should seek discounts.

Q. Do you have other comments on Mr. Cramer's testimony?

A. Yes. Mr. Creamer testifies that after a two-year experimental period the TRA approved a permanent PBR plan effective April 1, 1999 (pp. 3-4). Then he testified that "Atmos' **negotiated transportation discounts were intended to be captured** by the transportation cost adjuster for **city gate** purchases which is contained with[sic] the Gas Commodity Cost mechanism of the PBR." (Emphasis added.) There are several problems with this statement.

1. The PBR was approved before savings were ever offered. Transportation discounts were not even possible when the PBR was approved.

2. While there is a "transportation cost adjuster" for city gate purchases, the discounts which Atmos has acquired are not on city gate purchases.

3. The "transportation cost adjuster" in the PBR was designed for a completely different purpose. Mr. Creamer has twisted the wording of the PBR to try to make it fit something that was not even possible when the PBR was approved.

1. The PBR was approved before transportation discounts were ever offered. Transportation discounts were not even possible when the

PBR was approved.

Mr. Creamer acknowledges on page 8 of his testimony that the PBR used actual transportation costs. "During the experimental PBR time frame, 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." (Emphasis added.) He acknowledges that "Transportation discounts **first became available in the marketplace during the fall of 1999**." (Page 9, Emphasis added.) Since transportation discounts were not even available until over two years after the PBR experiment began, these savings could not have been a component of the PBR. His statement that "negotiated transportation discounts were intended to be captured" would have to be false.

2. While there is a "transportation cost adjuster" for city gate purchases, the discounts which Atmos has acquired are not on city gate purchases. When gas is purchased at the city gate, there are no transportation charges. Transportation savings could not be an issue.

Mr. Creamer's testimony contains several examples to illustrate the fact that the "savings" at issue are not on city gate purchases. Mr. Creamer quotes Atmos' tariff Sheet 45.2 which states that "for **city gate purchases**, these indexes will be adjusted for the avoided transportation costs that would have been paid. . . ." (Emphasis added.) He explains the reasoning for an adjuster for purchases made at the city gate on page 10 of his testimony. "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)." (Emphasis added.) Which brings us to the third and most critical point.

3. The "transportation cost adjuster" in the PBR was designed for a completely different purpose. Mr. Creamer has twisted the wording of the PBR to try to make it fit something that was not even possible when the PBR was approved.

Examining Mr. Creamer's description of the scenario where Atmos could collude with transporters and gas marketers by entering into "relatively high transportation cost arrangements" also reveals that this type of transaction would not be a "city gate" purchase. City gate purchases are the only type of purchases which require "avoided transportation cost" adjustments. The NORA purchases are city gate purchases and the avoided transportation costs are considered to recognize the fact that gas purchased at the city gate is worth more because transportation costs are avoided by buying gas at the city gate. However, there is no provision in the PBR plan for a transportation cost adjustor for purchases made anywhere other than the city gate. Prices paid for gas purchases at normal market purchase points such as the Henry Hub are compared to the reported market index prices for those purchase points such as NYMEX. Therefore, there is no need to adjust the index.

> As Mr. Creamer properly states, the real reason for the "transportation cost adjuster" is "because the basket of market indices represents only the transportation costs to get the gas from the well head to the **pipeline receipt point** . . . and not the Company's costs of transporting the gas from the receipt point to the **city gate** " (Emphasis added.) Careful analysis of this statement clearly shows that the **only time** that a "transportation cost adjuster" is needed is to reconcile the "market indices" representing prices at a "pipeline receipt point" with a price paid at the "city gate."
>
> For example, if the source is the Henry Hub, the "basket of market indices" **excludes** "the Company's costs of transporting the gas from the receipt point to the city gate" and there is no need for the "transportation cost adjuster " Conversely, a city gate purchase (with no related gas market index) such as a NORA gas purchase would require the "transportation cost adjuster." Exhibit DWM-1 illustrates the two types of purchases. A "Henry Hub" purchase needs no adjustment because the "basket of market indices" is used to estimate the market price at that purchase point. On the other hand, a NORA or city gate purchase must be compared to an adjusted index price to recognize the difference in purchase location.

The problem with Mr. Creamer's position is his extrapolation of this statement into a whole different meaning. The proper mechanics of the application of the "transportation cost adjuster" is again stated in Mr.

Creamer's quotation of Atmos' tariff Sheet 45.2. "For city gate purchases, these indexes will be adjusted for the avoided transportation costs that would have been paid. . ."

Somehow, Mr. Creamer creates a totally different definition of the "transportation cost adjuster." He wants to apply the adjustment to purchases other than city gate purchases. However, as discussed above, there is no need to adjust the index because the index already reflects the market price at the purchase location.

Another critical flaw in Mr. Creamer's reasoning is that he completely ignores the phrase "would have been paid" on Tariff Sheet 45.2 which clearly defines the avoided transportation costs adjuster. It states "For 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. (Emphasis added.)" This quote clearly shows that two **actual costs** of transportation are being compared. One is the **transportation costs that would have been paid** if the purchase was made at the Henry Hub. The second is the **demand charges actually paid** for a purchase **at the city gate** (or at NORA). These words are directly from Atmos' tariff. These words clearly define the meaning of "avoided transportation costs." The definition of "avoided transportation costs" is clear!

Somehow, Mr. Creamer totally ignores this plain language in the tariff and tries to redefine **avoided transportation costs that would have been paid**

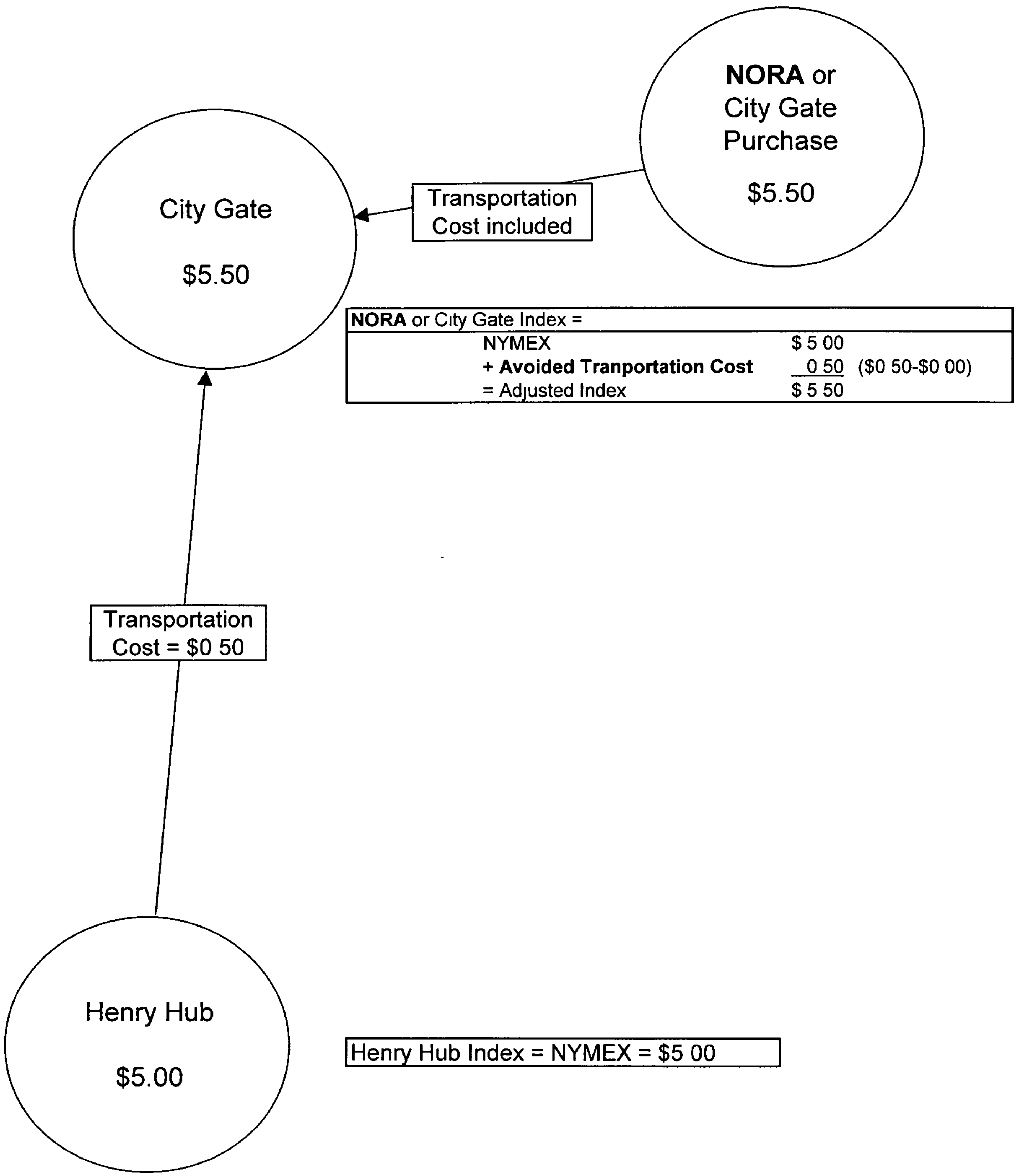
if the upstream capacity were purchased to mean **avoided transportation costs that would have been paid** ***if the maximum FERC rate were paid***

In Docket No. 97-01364, I stated:

> Since it's here close to Tennessee, even though you're paying more for it, it's still cheaper than paying less for it and getting it in Texas and having to pay to move it to Tennessee. [TR Vol. 3, page 714, lines 3-6]

Atmos stated that I "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." (Creamer, P. 7, Emphasis added.) However, I never conceded or envisioned that Atmos would somehow misinterpret **cost** to mean something other than **cost**. The avoided transportation costs are relevant only if the purchase is an actual "city gate" purchase If the gas is purchased in Tennessee, the cost of the gas will likely be higher, but the cost to transport it from the Tennessee purchase point to the city gate will likely be lower. The inverse is true for a gas purchase in Texas for delivery to Tennessee. Either way, the avoided costs are not "savings" as compared to the maximum FERC rate, but are a necessary adjustment to put the delivered costs for a Tennessee purchase on par with a Henry Hub purchase. For instance, when the purchase is made at the Henry Hub, then the **cost** for transportation is the actual **cost** to deliver to the city gate whether it be at maximum FERC or less. Again if the purchase is made at the Henry Hub, there is no reason to use the "transportation cost adjuster."

"For city gate purchases, these indexes will be adjusted for the avoided transportation costs that would have been paid if the upstream capacity were purchased"[A/]



[A/] Atmos Tariff T R A No 1, Sheet No 45 2