

**BEFORE THE TENNESSEE REGULATORY AUTHORITY  
NASHVILLE, TENNESSEE**

**August 7, 2006**

*In re: Petition to Open an Investigation to )  
Determine Whether Atmos Energy Corp. Should be )  
Required by the TRA to Appear and Show Cause )  
That Atmos Energy Corp. is Not Overearning in )  
Violation of Tennessee Law and That it is Charging )  
Rates That are Just and Reasonable )*

Docket No. 05-00258

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**TRA INVESTIGATIVE STAFF RESPONSES TO ATMOS ENERGY CORPORATION'S FIRST  
REQUESTS FOR INFORMATION FROM THE STAFF**

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The TRA Investigative Staff ("Staff") responds to Atmos Energy Corporation's First Request for Information from the Staff as follows.

**QUESTION 1.      PRODUCE all DOCUMENTS related to the ATMOS Show Cause Petition, the Staff investigative report, or to these proceedings which were exchanged by and between any member of one or more of the following: (i) the CAPD, (ii) the STAFF, and/or the INTERVENTION GROUP. This request includes all DOCUMENTS, as defined above, including e-mails, correspondence, notes, memoranda, drafts, edits, and other COMMUNICATIONS between or among the foregoing PERSONS.**

**RESPONSE:**      While complying with the Hearing Officer's oral directive of July 27, 2006, the TRA Investigative Staff continues its objection to this Question 1, and specifically reserves the right to appeal the written order to the full panel of Directors, both to prevent the use at hearing of the following supplied documents and so that such directive does not become precedent for the Authority. To wit, TRA Investigative Staff reiterates its objection as follows. Atmos has requested the production of all documents and communications related to the Atmos Show Cause Petition, to the TRA Staff investigative report, or to these proceedings that were exchanged between any member of one or more of the following: the Consumer Advocate; the TRA Investigative Staff;

and/or the Atmos Intervention Group (AIG). The TRA Investigative Staff objects to these requests on the grounds of the Common Interest Privilege and the Work Product Doctrine.

The Attorney-Client Privilege encourages full and frank communications between attorneys and their clients by sheltering their communications from compulsory disclosure. Tenn. Code Ann. §23-3-105; *see also Boyd v. Comdata Network, Inc.*, 88 S.W.3d 203, 212-213 (Tenn. Ct. App. 2002). The Common Interest Privilege extends the Attorney-Client Privilege to a litigation group by permitting participants of the group “to communicate among themselves and with their attorneys on matters of common legal interest for purposes of coordinating their legal strategy.” *Boyd*, 88 S.W.3d at 214; *see also Gibson v. Richardson*, 2003 WL 135054 at \*5 (Tenn. Ct. App. Jan 17, 2003). The Common Interest Privilege protects all such communications from disclosure. *Id.* The Work Product Doctrine also shields from disclosure information prepared or assembled by lawyers in anticipation of litigation. Tenn. R. Civ. P. 26.02(3).

The documents and communications exchanged between or among the Consumer Advocate, the TRA Investigative Staff, and AIG were done so in connection with anticipated litigation and in furtherance of a common interest or legal strategy in actual or anticipated litigation. These documents and communications were not distributed outside that group. Therefore these documents and communications are protected from disclosure under the Common Interest Privilege.

This requested information is also protected from discovery by the Work Product Doctrine which “prevents litigants from taking a free ride on the research and thinking of their adversary’s lawyer.” *Boyd*, 88 S.W.3d at 219. The materials sought were prepared in anticipation of litigation and were prepared with and under the supervision of Staff’s counsel. The information reflects the mental impressions, conclusions, opinions or legal theories of Staff’s counsel. *Id.*, at 221.

Subject to this continuing objection, the requested documents are Bates numbered 1-2484 and 3486-3488.

**QUESTION 2.** Please produce all documents that you (Jerry Kettles) relied upon, referenced, created, or otherwise reviewed in preparation of your testimony. This request includes all work papers, reference sources, financial information, discovery responses, e-mails and other materials. Please produce working Excel files for all work papers and exhibits.

**RESPONSE:** During preparation of testimony, I viewed information from the Wall Street Journal, Yahoo! Finance, Value Line, Standard and Poor's and other outlets for information on the gas industry and other economic variables. No attempt was made to track or record the information viewed and such tracking would not occur as part of normal work.

I relied on both print and electronic information within the MFR responses provided by the company. I also consulted Ibbotson Associates 2004 Yearbook and 2002 Valuation Guide as found in the Nashville Public library. Both texts are reference materials that cannot be removed from the library. Photocopies of pages containing data used in my analysis are provided, however. See documents Bates numbered 2485-3464.

**QUESTION 3.** On page 1, line 12 on Staff Witness Kettles Prefiled Direct Testimony, he mentions the completion of his dissertation "for a Ph.D. in Economics. Please provide the following information:

- (i) The topic of Mr. Kettles' dissertation**
- (ii) A prospectus of the dissertation topic, if one exists.**
- (iii) A list of Finance and Industrial Organization courses that Mr. Kettles satisfactorily completed during the course work phase of his Ph.D. program.**
- (iv) The date at which Mr. Kettles completed the course work phase of his Ph.D. program.**

**RESPONSE:** (i) Competition in Schooling Markets: An Industrial Organization Perspective  
(ii) A draft of my dissertation proposal is provided and is Bates numbered 3465-3485.  
(iii) Economics 631 – Industrial Organization and Public Policy

(iv) 1997-1998 school year

**QUESTION 4.** On page 2, lines 8-12, you stated that you “chose September 30, 2006 as the end-point of [your] forecast.” Explain why you believe the use of 12 months ended September 30, 2006 is appropriate for these proceedings. Please produce all facts and other evidence that supports the appropriateness of this attrition year, as well as any pages and specific references of any treatise, textbooks, articles, case law, published studies or other authoritative texts that support use of this attrition year.

**RESPONSE:** See Response to Request #14 to David Foster.

**QUESTION 5.** You “joined the TRA in June 2000 [and] have held the position of TRA Economist since 2002.” During the time you have been at the TRA, please identify:

- (i) The TRA’s policies and procedures during that time with regard to the appropriate attrition year to be used in setting rates; and
- (ii) Any case in which the TRA use an attrition year that was not forward looking from the date of the order.

**RESPONSE:** (i) I am not aware of any written policies and procedures regarding the appropriate attrition year to be used in setting rates.

(ii) I am not aware of any cases in which the TRA has not used an attrition year that was not forward looking from the date of the order.

**QUESTION 6.** For each gas rate case in Tennessee which you have been involved in any capacity, please identify:

- (i) The date of the Order; and
- (ii) The attrition year used.

**RESPONSE:** I have not been involved in a gas rate case in an advisory capacity.

**QUESTION 7.** On page 11, lines 8 and 9 of the Prefiled Direct Testimony of Staff Witness Jerry Kettles, he determined that “a risk premium of 7% is appropriate based upon a prevailing market return of 12.5%”

- (i) Did Staff Witness Kettles calculate the value of the “prevailing market return of 12.5%”?**
- (ii) If the response to (i) is “yes,” then please note the work papers where Mr. Kettles made this calculation and explain all of the calculations that he used to determine the “the “prevailing market return of 12.5%”?**
- (iii) If the response to (i) is “no,” then please identify Mr. Kettles’ source and explain how he used this source to make this determination.**

**RESPONSE:** (i) No.

(ii) N/A

(iii) I used the Ibbotson’s 2004 Stock, Bond, Bills and Inflation Yearbook. Data through 2003 are included in the calculations provided. The 2004 Yearbook was the most recent edition available to the analyst. The 12.5% return statistic is derived by looking at the central tendency several long term measures of market returns. All data are provided in the attached sheets from the Ibbotson’s publication referenced above. First, I looked at arithmetic mean of large company stock returns for 1926 to 2003. This return is reported as 12.4%.

I reviewed the returns for holding investments 20 years as detailed in Table 2.11. Over the most recent time period reported, 1984 to 2003, large company stocks grew 12.99 percent. Over the same time frame, small company stocks grew 12.35%. Averaging the two returns provides a broader measure of long term growth across both large and small companies which should be indicative of the growth in the market as a whole. The average return of large and small company stocks held over the twenty year period 1984 to 2003 yields a 12.67% return. I adjusted the long term (1926 – 2003) large company stock return upwards by simply averaging the 12.4% large

stock return with the 12.67% return figure described above. The resulting figure of 12.53% was rounded downward to 12.5% for use in the analysis.

While long-term growth rates are relatively stable and do not vary substantially from year to year, I reserve the right to incorporate more recent data on market returns in my analysis. See documents Bates numbered 3461-3464.

**QUESTION 8.** Please identify each and every reason why your testimony differs from the testimony on CAPD in this case on the issue of the revenue surplus. For instance, please identify why:

- (i) Your calculated rate of return for Atmos of 7.916% (with a Rate of Equity of 10.75% and Long Term Debt Rate of 5.77%) is more appropriate than the rate of return calculated by Mr. Brown of 6.564% (with a Rate of Equity of 8%, a Long Term Debt Rate of 5.52%, and Short Term Debt Rate of 5.09%);**
- (ii) Your capital structure (56.91 Equity, 43.09% Long Term Debt, and no Short Term Debt) is more appropriate than the capital structure used by Mr. Brown (44.3% Equity, 43.1% Long Term Debt, and 12.6% Short Term Debt).**

**RESPONSE:** (i) With respect to each cost element used to calculate weighed cost of capital, my testimony differs in the following fashion:

Short-term debt cost – I do not propose the inclusion of short term debt in capital structure, while Dr. Brown assigns both non-zero values.

Long-term debt cost – Dr. Brown takes the long-term debt cost for 2005 reported in the most recent Atmos 10-K as his debt cost figure. I utilize the 2005 debt cost from the 10-K and perform adjustments to project to September 30, 2006 as described in my testimony.

Equity cost – Dr. Brown utilizes two models for equity valuation: DCF and a Risk Premium Model. By contrast, I provide cost of equity figures derived from the DCF and CAPM models.

Dr. Brown's Risk Premium Model appears to be a standard CAPM model where the risk free investment is set as the company's debt cost and proxied by the average Moody's AAA Corporate Bond Rate. The market risk premium is determined as it in a standard CAPM implementation by differencing the overall market return from a low risk return. Dr. Brown uses data from Ibbotson's to find a market return of 9.93%. The risk-free return selected by Dr. Brown is a three-month T-bill rate of 3.72 % derived by averaging data from 1925 to 2004. The measure  $\beta$  is taken from NASDAQ data and represents an average of  $\beta$  measures from comparable companies.

By contrast, I use a  $\beta$  measure from Value Line that is specific to Atmos rather than an average of similar companies. I utilize a forecast based on long-term interest rate for my risk-free return. My market return is taken from Ibbotson's Associates and is described in the response to Request 7. My CAPM model results are more appropriate because they reflect a long-term prospective approach to asset valuation. For example, Value Line  $\beta$  are adjusted to reflect long-term trends in the stock market, thus making the more appropriate for prospective rate making. The use of historical averages for the short-term interest rates for the risk-free return produces a result that is far below existing rates. While Dr. Brown uses a historical rate of 3.72%, as of May 2006, the three month T-Bill had a 4.82% rate. The use of a historical rate does not reflect a prospective view on the risk free returns available to investors. I choose to use current 20 year T-Bill rates to reflect a longer investment horizon and reflect prospective economic conditions.

With respect to equity costs determined by use of the DCF model, Dr. Brown provides estimates used by using only dividend growth factors. No DCF valuation result is provided for Atmos, rather results are presented from comparable companies. By contrast, I provide two DCF models. One model utilizes forecasted dividend growth rates and the second uses forecasted earnings per share. My DCF models present estimates for Atmos and a group of companies in a similar line of business. My approach is preferable because the use of forecasted results leads to prospective equity cost projections. Further, the calculation of Atmos specific DCF results is preferable to reliance on comparable companies.

(ii) Dr. Brown utilizes a "comparable companies" methodology. A description of his methodology can be found on pages 5- 6 of his testimony. It is my understanding that he determines the capital structure for Atmos by

first determining the average capital structure for his comparable companies for each of the last three years. He then takes the average capital structure for each of the past three years and averages those figures to develop his capital structure for Atmos. My approach is to use data specific to Atmos to determine its capital structure. I contend that it is more appropriate to use Atmos company specific data for the purpose of ratemaking for Atmos than utilizing a comparable company's approach, which excludes Atmos specific data. As a general rule, company specific information will represent the company's financial position more accurately than a composite measure developed from other company's data. That is not to say that Dr. Brown approach will not inform decision makers about the relative performance of Atmos to its industry peer and thus be relevant and useful in ratemaking decisions.

**QUESTION 9.**            **In regard to Exhibit 1, Schedule JLK-1 of the Prefiled Direct Testimony of Staff Witness Kettles, please identify:**

- (i) All adjustments that Mr. Kettles performed to ATMOS Energy's Year-End 2005 capital structure to develop his projected 2006 capital structure;**
- (ii) And explain any calculations that Mr. Kettles performed to develop these adjustments.**
- (iii) And provide and note all source documents and work papers Mr. Kettles used in making these adjustments in (a) to ATMOS Energy's capital structure.**

**RESPONSE:**    (i) All adjustments to equity and debt levels are described in direct testimony and detailed in the attached spreadsheets.

(ii) Data to support the equity addition due to common stock issuance originates with MFR 82. The equity adjustment is performed on the capital structure exhibit.

The debt level calculations are performed on a copy of the spreadsheet detailing debt found in MFR 68. The adjustment to unamortized debt discount is calculated by taking the September 30, 2005 balance reported in the spreadsheet and subtracting of one years worth of monthly amortization. The monthly amortization amount of

\$37,011 is found in the spreadsheet corresponding to MFR 73. When using MFR 68 as a template, a broken link is present for the September 30, 2005 unamortized debt discount. I did not remove or repair the broken link, however, I verified that the value for unamortized debt discount in MFR 68 was the same as the September 30, 2005 balance reported in MFR 73.

(iii) All calculations are found in the attached Excel spreadsheets.

**QUESTION 10.** On page 12, at lines 9-10, of your testimony, you note that a DCF model will approximate the “marginal cost of equity for a firm. That is, it represents the minimum equity return required to attract investment in common stock.” Please identify

- (i) An estimate of what percentage of the time a DCF based estimate will be below the “minimum equity return required to attract investment in common stock?”;
- (ii) And provide all citations and research results upon which Mr. Kettles bases his opinion.

**RESPONSE:** (i) I am unaware of statistical estimates of the percentage of time DCF calculations of equity cost for regulated gas utilities are insufficient to attract common stock investment.

(ii) I am unaware of research that contains statistical estimates of the percentage of time DCF calculations of equity cost for regulated gas utilities are insufficient to attract common stock investment.

**QUESTION 11.** Please produce all DOCUMENTS that you (David Foster) relied upon, referenced, created, or otherwise reviewed in preparation of your testimony. This request includes all work papers, reference sources, financial information, discovery responses, e-mails and other materials. Please produce working Microsoft Excel files for all work papers and exhibits.

**RESPONSE:** I relied upon the discovery responses of Atmos and Atmos' monthly and annual reports on file with the Authority. I also relied upon and reviewed exhibits and work papers developed by the Consumer Advocate and Protection Division ("CAPD"), a copy of which was served on all parties in this docket. Attached is correspondence between myself, Paul Greene (member of the TRA Investigative Staff) and the CAPD which was utilized in developing Investigative Staff's position in this case. The attached Excel spreadsheets contain Staff Exhibit 1.

**QUESTION 12.** On page 2 of your testimony, you IDENTIFY your purpose is to "support the calculations and exhibits provided by the Consumer Advocate and Protective Division (CAPD) relating to net operating income and rate base." Please IDENTIFY exactly what you did to independently to verify the CAPD's calculation and Exhibits.

**RESPONSE:** Rather than preparing a separate position from the CAPD, the Investigative Staff worked closely with the CAPD in developing CAPD exhibits and schedules relating to net operating income and rate base amounts. This included discussing ratemaking theories, assisting in the preparation of certain schedules, and reviewing CAPD exhibits and schedules.

**QUESTION 13.** Produce copies of DOCUMENTS constituting any testimony (whether prefiled or transcripts of live testimony) which you have given before the Tennessee Regulatory Authority.

**RESPONSE:** I have not submitted prefiled testimony or given live testimony as a party since the TRA was established in 1996.

**QUESTION 14.** Do you believe that the use of 12 months ended September 30, 2006 is appropriate for these proceedings? If so, please explain why. Please produce all facts and other evidence that supports the

**appropriateness of this attrition year, as well as any pages and specific references of any treatises, textbooks, articles, case law, published studies or other authoritative texts that support use of this attrition year.**

**RESPONSE:** I believe that the use of 12 months ended September 30, 2006 is an appropriate attrition period in this case. The TRA has broad discretion in choosing an attrition period; it can choose past, current or future periods on which to establish rates and this position is supported by past orders of the TPSC as well as the Tennessee Court of Appeals and the Tennessee Supreme Court. In this particular case, the Investigative Staff initially issued a report on April 24, 2006 based upon a twelve month period ending September 30, 2005; the prefiled testimony submitted by the CAPD utilized an attrition period of the twelve months ended September 30, 2006. In my opinion, utilizing September 30, 2006 as an attrition period takes a lot of guesswork out of the equation because we have six to seven months of actual data within the attrition period to review and base results upon. The TRA should establish rates going forward based upon on the best information available – in this case it is the actual results (earnings) of Atmos.

Orders which support my contention that the TRA has the authority to utilize the twelve months ended September 30, 2006 as an appropriate attrition period are Bates numbered 3489-3591.

**QUESTION 15.** On page 1 of your testimony, you state that you have “twenty plus years experience in the field of utility ratemaking and regulatory accounting with the TRA and its predecessor agency, the Tennessee Public Service Commission (“TPSC”). Further, you state that you “have participated in numerous rate cases and earnings reviews, which have included the development of financial exhibits and rate design proposals presented before the TRA and the TPSC to aid in establishing just and reasonable rates.” Please IDENTIFY:

- (i) The TRA’s policies and procedures with regard to the appropriate attrition year to be used in setting rates;

- (ii) Any case in which the TRA used an attrition year that was not forward looking from the date of the order; and
- (iii) Provide copies of any testimony which you presented during your years in the field of utility ratemaking and regulatory accounting where you have testified on an attrition year.

**RESPONSE:** (i) I am not aware of any written policies and procedures regarding the appropriate attrition year to be used in setting rates.

(ii) I am not aware of any cases in which the TRA has not used an attrition year that was not forward looking from the date of the order.

(iii) I have not provided testimony regarding the specific issue of what constitutes an appropriate attrition year.

**QUESTION 16.** For each gas rate case in which you have been involved in any capacity, please identify:

- (i) The date of the Order; and
- (ii) The attrition year used.

**RESPONSE:** **Docket No. U-86-7442**, *Petition of United Cities Gas Company To Place Into Effect Revised Natural Gas Tariffs For The Tennessee Properties Served By United Cities Gas Company and Tennessee-Virginia Energy Corporation*. The attrition period utilized was the twelve months ending February 29, 1988.

**Docket No. 04-00034**, *Petition of Chattanooga Gas Company For Approval of Adjustment Of Its Rates And Charges And Revised Tariff*. The attrition period utilized was October 1, 2003 through June 30, 2005.

**QUESTION 17.** On page 1 of your testimony, you state that you are an “active member on the National Association of Regulatory Accounting and Finance, Gas and Telecommunications.” Do you disagree with the NARUC resolutions referenced on pages 7 and 8 the testimony of Patricia J. Childers that

**encouraged regulators to approve decoupling mechanisms for the utilities they regulate? Did you have any participation in discussing those resolutions? Please produce all DOCUMENTS that you have which reference NARUC and decoupling.**

RESPONSE: I agree that NARUC has encouraged State Commissions to explore programs relating to energy efficiency, winterization and high-efficiency appliances. NARUC has also encouraged innovative rate designs that will encourage energy conservation and energy efficiency. While this could include the implementation of a decoupling mechanism, NARUC also concluded that “the best approach toward promoting energy efficiency programs for any utility, State, or region may likely depend on local issues, preferences, and conditions”.<sup>1</sup>

I have been present in subcommittee meetings where these resolutions have been discussed and agree that energy efficiency and energy conservation programs, including those related to rate design, should be considered and evaluated by state commissions.

Two resolutions, one adopted on July 14, 2004 and one adopted November 16, 2005, are Bates numbered 3588-3591. Any other NARUC information that I may have read can be found at NARUC’s website, “NARUC.org.”

Respectfully submitted,

By: 

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Counsel for TRA Investigative Staff

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<sup>1</sup> NARUC Resolution adopted by the NARUC on November 16, 2005 (copy attached).

**CERTIFICATE OF SERVICE**

I hereby certify that a true and exact copy of the foregoing has been forwarded by electronic mail to the following parties on the 7th day of August, 2006.

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Electronically filed with the TRA Docket Room on August 7, 2006.