

**IN THE TENNESSEE REGULATORY AUTHORITY
NASHVILLE, TENNESSEE**

IN RE: PETITION TO OPEN AN)	
INVESTIGATION TO DETERMINE)	
WHETHER ATMOS ENERGY CORP.)	
SHOULD BE REQUIRED BY THE TRA)	Docket No. 05-00258
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)	

**ATMOS ENERGY CORPORATION'S BENCH BRIEF ON APPROPRIATE TEST
YEAR AND ATTRITION PERIOD ADJUSTMENTS**

I. INTRODUCTION AND PURPOSE

This Bench Brief will discuss the standards that govern the selection of an appropriate test year and the decision whether to include forward looking attrition adjustments. In this docket, there have been inconsistent and important differences of opinion expressed on this issue by the Consumer Advocate and Protection Division ("CAPD"), the Tennessee Regulatory Authority ("TRA") Investigative Staff (the "Staff"), the Intervention Group, and Atmos Energy Corporation ("Atmos" or the "Company"). This brief will generally discuss the various positions of the parties on this critical rate-making issue and outline the legal standards to be applied. As discussed more thoroughly below, applying the legal standards to the facts of this case requires that the TRA set rates for Atmos that include forward looking attrition adjustments. As such, the TRA should follow its established practice and set the rates in this case based on a forecast test year ending September 30, 2007, which is 12 months forward from the order in this case.

II. THE PROPER TEST YEAR IN THIS CASE

A. THE TEST PERIOD MUST INCLUDE ADJUSTMENTS WHICH ARE FORWARD-LOOKING FROM THE DATE OF THE ORDER.

1. Rates Are Set Prospectively.

Rates are set prospectively. This fundamental precept of rate-making hardly requires any case citation and flows from the established construction of the statute granting the TRA's ratemaking authority, Tenn. Code Ann. § 65-5-101, which states that the TRA has the power to fix rates "which shall be imposed, observed and followed *thereafter*" (emphasis added). *South Central Bell v. Tenn. Pub. Svc. Comm'n*, 675 S.W.2d 718, 720 (Tenn. Ct. App. 1984). The prohibition against retroactive ratemaking also finds support in the statute permitting refunds only under certain prescribed circumstances, Tenn. Code Ann. § 65-5-103:

Upon a study of the applicable statutes, especially TCA [§ 65-5-103], this Court concludes that the Legislature never intended to extend retroactive rate-making power (ordering refunds) beyond that expressly stated in [§ 65-5-103]. This is supported by the maxim of *Inclusio Unius est Exclusio Alterius*. The express inclusion of one (person or thing) (implies) the exclusion of all others. The cited statute provides for narrowly circumscribed power to grant tentative rates under bond for a limited time under emergency circumstances which were not found by the Commission and are not shown in this case. It must therefore be presumed that:

- (1) the Legislature considered that the Commission had no general or inherent power to set tentative rates subject to refund, else the special grant of power would have been unnecessary;
- (2) if the Legislature had intended that the Commission have broader powers than those conferred, the statute would have been composed in broader terms.

South Central Bell Tel. Co. v. Tennessee Pub. Serv. Comm'n, 675 S.W.2d 718, 719 (Tenn. Ct. App. 1984); *American Asoc. Of Retired Persons v. Tennessee Pub. Serv. Comm'n*, 896 S.W.2d 127, 134 (Tenn. App. Ct. 718, 719) ("[T]he Commission has no statutory authority to fix rates retroactively or to order refunds except in very limited circumstances.").

2. Rates Must Take Into Account Future “Known And Measurable Changes” Regardless of the Test Year Chosen.

In setting the rates prospectively, the Commission is given broad discretion to exercise its considerable judgment and set rates that are “just and reasonable.” However, the rates set much be just and reasonable not only when first established, but also for a reasonable time following the date of the order establishing the rate:

A rate should be reasonable not only when it is first established but also for a reasonable time thereafter. *McCardle v. Indianapolis Water Co.*, 272 U.S. 400, 408-09, 47 S.Ct. 144, 148, 71 Led. 316 (1926); *Southern Bell Tel. & Tel. Co. v. Tennessee Pub. Serv. Comm’n*, 202 Tenn. At 482, 304 S.W.2d at 647. Thus, when the Commission is considering whether a rate is just and reasonable, it ‘should take into consideration the estimated effect of reasonably expected expense and investments.’ *Southern Bell Tel. Co. v. Tennessee Pub. Serv. Comm’n*, 579 S.W.2d 429, 435 (Tenn. Ct. App. 1979).

Tennessee Cable Tel. Ass’n v. Tennessee Pub. Serv. Comm’n, 844 S.W.2d 151, 159-60 (Tenn. Ct. App. 1992) (emphasis added).

Staff and CAPD correctly reference the principle that the TRA has the discretion to “choose a historical test period, a forecast period, a combination of the two, or any other accepted method in rate making,” *American Assoc. of Retired Persons*, 896 S.W.2d at 133; see also *Powell Tel. Co. v. Tennessee Public Serv. Comm’n*, 660 S.W.2d 44, 46 (Tenn. 1983). However, what the CAPD and Staff omit is the second part of that principle, that is regardless of which test period is selected, the TRA must make adjustments to that test period to take into account “known changes that are likely to occur in the immediate future.” *S. Central Bell Telephone v. Tenn. Pub. Serv. Comm’n*, 579 S.W.2d 429, 434-35 (Tenn. App. Ct. 1979).

In the *South Central Bell* case, the Court of Appeals agreed with the Chancellor’s finding that “reasonable time in the immediate future” means 12 months forward *from the date of the order* setting rates. *Id.* In rejecting the Commission’s argument that “the test period need only

be adjusted to take into account changes *up until the date of the order*, the Court quoted approvingly from the Chancellor's opinion:

A rate order which only takes into account the changes that have taken place before the effective date of the order and ignores changes reasonably certain to occur after the date of the order is *looking backward and not to the future*.

Id. at 435. However, In the *South Central Bell* case, the Court was careful to point out the distinction between selection of a test year and the need for attrition adjustments:

Where the order of the Commission entered on December 30, 1977 sets the rate for the company, the Court is of the opinion that the year 1978 is a "reasonable time in the immediate future" which must be taken into account in the Commission's order. This does not mean that the year 1978 must be the test period; it simply means that the test period results must be adjusted to take into account known changes that are likely to occur in the immediate future.

Id. at 435. As the *South Central Bell* case and the other authorities cited above demonstrate, Tennessee law is clear that while the TRA has discretion to use choose a historical test period, a forecast period, or a combination of the two, the test year results must be adjusted to take into account all changes which are known or which are fairly and reasonably anticipated to occur in a reasonable time (which the Court of Appeals has interpreted as 12 months) following the date of the order. *Powell Tel. Co.*, 660 S.W.2d at 45-46; *See also American Assoc. of Retired Persons*, 896 S.W.2d at 133 (holding that "*all* reasonably expected changes affecting the rate of return should be taken into account.") (emphasis in original). Further, the TRA cannot avoid its duty to consider attrition adjustments, including rising expenses and increased investment, in the name of efficiency. *South Central Bell*, 579 S.W.2d at 437-38 (rejecting as unreasonable "the expressed policy of the Commission to 'squeeze' efficiency and economy out of the Company by maintaining existing rates in the face of rising costs.")

Indeed, Director Jones, sitting as Hearing Officer in this docket, recognized that, as discussed in the *South Central Bell* case, the “attrition” adjustments that must be included in the ratemaking analysis are those changes which are likely to occur in the 12 months following the order. Specifically, Director Jones ruled as follows:

Before deciding on this, I considered many different modes in which to proceed. The Advocate’s office thought that the investigative report alone was sufficient with which to go forward to actually fix the rates.¹ Atmos Energy Corporation, of course, in its response to the staff’s – investigative staff’s report suggested that there had to be some considerations of some attrition period adjustments and submitted a case² in support of that. After reviewing that case and making a determination, I’ve determined that in order to go forward the most prudent course in which to go forward is one in which there is consideration of attrition period adjustments.”³

Director Jones’ ruling clearly finds that the TRA should consider attrition period adjustments in this case, as required by the opinion in *South Central Bell*.

B. THE ATTRITION ADJUSTMENT IS AN ESTABLISHED ECONOMIC PRINCIPLE THAT EQUALLY AFFECTS UTILITIES.

1. The TRA’s Use of Historical Test Periods, Attrition Adjustments and the Forecasted Test Year.

As set forth above, there is no doubt that Tennessee law requires that, regardless of the test period selection, the TRA must make adjustments for known or reasonably anticipated changes that will occur looking forward from the date of the order. Mr. McCormac testified for the CAPD that these changes led the TRA to abandon a strictly historical test year:

In my work experience, I have prepared rate cases using historical test periods, historical test periods adjusted for ‘attrition,’ and forecasted test periods. In the

¹ The Report and Recommendation of Investigative Staff states that Staff analyzed Atmos’ earnings as reported on the 3.03 report for the year ended September 30, 2005, but made no adjustments to account for known future changes. *Report and Recommendation of Investigative Staff*, p. 6.

² The case Atmos submitted was the 1979 *South Central Bell* case referenced above. *Resp. of Atmos Energy to Report and Recommendation of Investigative Staff*, p. 4.

³ 5/22/2006 Hearing Trans. at p. 2-3.

early years of my career⁴, the Public Service Commission used an historical test period in all rate cases. As high inflation, high toll revenue growth rates, and other factors made the historical test year approach less reliable, the use of a historical test periods adjusted for 'attrition' or forecast periods became more prevalent. Now that inflation and growth rates are more subdued, the historical test period again seems to produce a reasonable measure of earnings.

8/18/2006 McCormac Rebuttal at p. 3. Mr. McCormac's statement generally tracks the progression of TRA's treatment of the test period before and after the 1979 *South Central Bell* opinion. It appears from a review of the TRA orders following the 1979 *South Central Bell* opinion that in the years immediately following the opinion, the TRA generally used a historic test year, and then separately calculated the attrition adjustments necessary to account for changes going forward 12 months from the date of the order. At some point, the TRA discarded the two step approach and began employing a forecast test. This change in practice is reflected in the Minimum Filing Requirements, which require projections through the "attrition year," which is defined as 18 months from the date of the filing, i.e., 12 months forward from the date of the order.⁵ For instance, in *In re: Petition of South Central Bell Telephone Company to Change and Increase Certain Rates and Charges for Intrastate Telephone Service*, Docket No. U-83-7248 (1/18/1984)⁶, the TRA recognized that future changes to organization of the telephone company mitigated in favor of using a forecast test period rather than a historical test year with forward looking attrition adjustments.

The TRA's shift to the use of a forecast test year is supported by the Commentators. In *Accounting for Public Utilities*, the treatise cited by Mr. Buckner as support for his use of an historic test period, the text states:

The idea that historic data express factual conditions has sometimes led to the conclusion that those data are the most reliable data available for estimating future

⁴ Mr. McCormac stated in his direct testimony that he has "30 years of experience in the field of utility ratemaking and regulatory accounting." (McCormac Direct at App. A, p. 1.) Presumably, the "early years" would refer to the years preceding the 1979 *South Central Bell* opinion.

⁵ CITE

⁶ This Order is attached to the Rebuttal testimony of David Foster.

conditions. The factual nature of the events as recorded has apparently imbued the data with a degree of soundness and quality that appears to exceed a forecast approach for test year purposes. When conditions are in a state of change, historic results are likely to be the most unreliable of the sources of test period data as a basis for measuring future rate needs. While projected data, using standard forecasting techniques, may miss the mark, historic data, with a patchwork of updating, will surely miss the mark. As imprecise as forecasting may be, projected test year data based on reasonable forecasts should consistently come closer to expressing future conditions than will historic data as traditionally used.

Robert L. Hahne, Gregory E. Aliff, Deloitte & Touche, LLP, *Accounting for Public Utilities* § 7.03 (Lexis-Nexis 2005). The TRA should follow the established practice in this case and set rates based on the forecast test year, the year ended September 30, 2007.

2. There Will Be Attrition ... The Only Question is "How Much"?

Attrition is a reality, not a concept. The same treatise cited by Mr. Buckner recognizes the fact of attrition.

The reality of attrition and its debilitating impact on rates, and ultimately on the financial standing of regulated utilities, is quite apparent. The issue is not whether, but how much. With hindsight, it will be known what was needed, but that will be too late. The luxury of hindsight is not available in fixing prospective rates. Foresight must be used in making the most reasonable assumptions possible in looking to prospective conditions to fix prospective rates.

Robert L. Hahne, Gregory E. Aliff, Deloitte & Touche, LLP, *Accounting for Public Utilities* § 8.02 (Lexis-Nexis 2005). The test period chosen by this agency in setting rates is critical. It is foundational question in this case and it affects whether the rates actually set are just and reasonable at the date they are set and for the reasonable period following the order.

III. CONCLUSION

Tennessee law requires that the TRA set rates which include attrition adjustments which are forward looking from the date of the order. While this can be accomplished through the use of a historic test year adjusted for known or reasonably anticipated changes from the date of the order, the authoritative literature and past TRA practice recognizes that a forecast test year is a better method for setting prospective rates. As such, the TRA should follow its established

practice and set the rates in this case based on a forecast test year ending September 30, 2007,
which is 12 months forward from the order in this case.

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CERTIFICATE OF SERVICE

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