

**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 )  
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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**ATMOS ENERGY CORPORATION'S POST-HEARING BRIEF**

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## **I.** **INTRODUCTION**

In accordance with the Hearing Officer's August 26, 2006 Order on Motion in Limine and Motion for Permission to Seek Interlocutory Appeal and Other Matters, Atmos Energy Corporation ("Atmos") submits this Post-Hearing Brief.<sup>1</sup>

This process has involved a lot of diligent work by the Hearing Officer and the other Panel members. Atmos appreciates the time and energy that has been expended, and will continue to be expended, by the Hearing Officer and other parties to work together to bring this case to Hearing on such an extraordinary timeframe, and to decide a resolution in the coming weeks. The Directors' attention at the Hearing, and attention to the details of the voluminous evidence, is critical to a fair and reasonable outcome. In this submission, Atmos will attempt to outline the most relevant evidence and the areas in which the most significant disagreement exists.

From the beginning, the Consumer Advocate and Protection Division ("CAPD") and the TRA Investigative Staff ("Staff") advanced a consistent theme in this docket. The theme has underscored virtually every pleading, and virtually every hearing. The theme is that something is wrong. The CAPD and Staff concluded that something must be wrong because Atmos has not had a rate case for ten years.

Implications, innuendo and allegations, however, do not drive results. This case, like all contested cases, must be decided on the facts. The facts are that nothing is wrong. In fact, the lack of a rate case is something that Atmos views as a significant accomplishment. In discovery, in its data, and in its testimony Atmos has proved that through its efficiencies, growth, and advancements in technology, it has managed to maintain its 1995 rates for 10 years. Rates that

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<sup>1</sup> See 8/26/2006 Order at p. 13.

remain at consistent levels for ten years are not generally the subject of consumer complaint. To the contrary, Atmos believes this is a significant accomplishment.

In the CAPD's opening statement, for the first time in this process, the CAPD admitted that Atmos has not done anything wrong:

Now, the company, of course, can choose to file or not file a rate case, but the length of time since the last rate case really does have an impact here. ***It's not that there's anything wrong with what they did,*** but it really effects the kind of proof – the way you have to look at the proof . . . <sup>2</sup>

Atmos is not hiding from its history in Tennessee—the Company takes great pride its record of commitment to its customers, fiscal responsibility, and technological advancements. But, this is now a rate case. As this Panel knows, rate cases are not about the past. This case, like all rate cases, looks toward the future, the period when the rates will be in effect.

As the quote from the CAPD's opening statement implies, Atmos is being treated differently. The CAPD and Staff are trying to apply different standards, and treat Atmos differently than the other regulated gas companies in Tennessee. It is true that this case has somewhat of a unique procedural setting, with a unique beginning. Moreover, all parties seemingly agree that this rate case on a rocket has strained resources and presented unique proof issues. But, in this setting, the fact is that the CAPD and the Staff are asking this Panel to do something even more remarkable, with even greater implications: they are trying to revamp regulatory practice in Tennessee.

By treating Atmos differently, the CAPD and Staff have presented new and novel regulatory policy in virtually every meaningful rate-making category. These sweeping and important changes range from the choice of attrition year to revenue forecasting to expense estimates. These new and important underlying assumptions call into question years of well-

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<sup>2</sup> Transcript of Proceedings v I, p. 18 (August 29, 2006) (emphasis added).

settled regulatory practice and precedent, as well as the expectations of regulated companies. These changes must be made carefully, and with due regard for Atmos' rights to due process and other legal protections.

For the first time in recent history, the CAPD and Staff have used an historical attrition year—the 12 months ended *this month*, September 30, 2006. This request is unique to Atmos and unique to this case. None of the CAPD or Staff witnesses have pointed to a single case in recent history where a backward-looking attrition year was adopted by this Authority. Remarkably, and as shown below, the CAPD and the Staff want to use this attrition year, but also want to ignore actual results for this year (which are largely already reflected in the Company's books).

The disparate treatment of Atmos is also evident in the treatment of revenues. The CAPD witness who “forecasted” the revenues ended September 30, 2006, Daniel McCormac, eschewed the traditional and reliable method of forecasting revenues. The regulatory practice is to forecast revenues by using a forward-looking priceout of billing determinants. The priceout was ignored in favor of a new and novel “trend” of historical gross margins. This “trend” is highly speculative because it is based on very limited data (five points total) and can be easily manipulated by the subjective choices of the party doing the “trending.” Further, this methodology is fraught with analytical flaws. Perhaps that is why it has never been used before; it is unique to Atmos and unique to this case. Mr. McCormac, its principal advocate, could not point to a single case or a single utility—ever—where this methodology has been used.

The disparate treatment of Atmos also carries through to the expense adjustments advanced by Terry Buckner. As is accepted practice in rate case, Atmos relied heavily on its booked expenses and made adjustments from there. The CAPD ignored the booked expenses.

Instead, the CAPD relied on its own methodologies to predict what the booked expenses apparently should be. For instance, it made its own calculations of labor, using a “labor priceout” from payroll data, rather than the booked expenses. This labor priceout lead to significant problems with the capitalization rate and certain capital labor transferred in from other states. Moreover, the CAPD advanced a new and unique amortization for Atmos’ rate case expenses, advancing 10 years rather than the established and traditional 3 year amortization. In addition, the CAPD ignored established allocation methodologies for out-of-state assets that benefit Tennessee ratepayers, advancing a new theory that Tennessee ratepayers only pay for assets within the borders of the State. This is unique to Atmos and has not been the regulatory practice of the Agency for other gas utilities in the State. These procedures and positions, which are anomalies, have only been applied to Atmos.

Even the roles of the parties in this case have been unique to this case, and unique to the treatment of Atmos. The Staff’s role, as outlined by the Hearing Officer, is traditionally to represent all parties and to ensure just and reasonable rates. Staff witness David Foster, however, relied solely on the testimony of the CAPD margin and expense witnesses—filing his concurrence before he ever even had an opportunity to see the Atmos analysis. Moreover, Mr. Foster admitted that he was unclear as to the CAPD’s role in this case. This unique alliance between the CAPD and the Authority Staff has been reserved for Atmos.

Finally, despite the testimony of the Intervention Group that its rate design changes were intended to put Atmos on “equal footing” with Chattanooga Gas and Nashville Gas, this is clearly not the case. The Intervention Group’s proposals are unique to Atmos and have virtually no support other than the bald opinion of one expert whose credibility is seriously suspect.



These proposals are likely proposed simply to benefit some customers at the expense of others—and to make matters worse, the full implications of the proposals are unknown.

In short, the uniqueness of the way this case began, its procedural history, its expedited schedule, its simultaneous filings, and its other novel legal issues, do not justify disparate treatment for Atmos. This case is about setting rates—something the Authority and this Panel have done many times before. As Mr. Hotvedt stated in his opening: “This case is about numbers.”<sup>3</sup> It is not about treating Atmos differently. Atmos asks that this Panel simply follow established, tested and reliable procedures to set the rates of Atmos going forward.

This Post-Hearing Brief will roughly follow the itemization of amounts as contained on the spreadsheet attached hereto as Exhibit 1, which demonstrates the differences between the Consumer Advocate, Staff, and Company calculations, and includes the impact of all changes and corrections made at the Hearing in this docket.

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<sup>3</sup> Transcript of Proceedings v I, p. 38 (August 29, 2006).

## **II.**

### **ARGUMENT**

#### **A. GROSS MARGIN: CHOICE BETWEEN DETAILED BILLING DETERMINANT ANALYSIS OR A “TREND” ANALYSIS.**

The parties agree that the first step the Authority must take in setting rates for Atmos, as for any other gas utility, is to determine the amount of gross margin the Company generates under its current rates. The amount of gross margin is calculated by taking the Company’s gross operating revenues, and subtracting the cost of gas.<sup>4</sup> The gross margin represents the amount of money the Company has to pay its expenses and provide a reasonable return on its investment.<sup>5</sup> **The amount of gross margin also represents the starting point from which any reduction or increase will be determined.**

In this case, the Authority is presented with an unusual situation: there is a dispute between the parties<sup>6</sup> as to the amount of gross margin the Company generates under its current rates. For this year, the fiscal year ended September 30, 2006, the difference is approximately \$3 million: the 2006 gross margin amount used by the Consumer Advocate is approximately \$3 million higher than the amount actually reflected on the Company’s books.<sup>7</sup> For the year ended September 30, 2007, the Consumer Advocate has theorized that the Company’s current rates will generate a gross margin which is approximately \$4 million higher than the Company’s

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<sup>4</sup> Pre-Filed Direct Testimony of Greg Waller, p. 3 (July 17, 2006); Pre-Filed Direct Testimony of Dan McCormac, p. 1 (July 17, 2006).

<sup>5</sup> Transcript of Proceedings v III, at p. 23 (August 30, 2006) (McCormac) (“Gross margin is simply . . . the gross revenues minus the cost of gas. This is basically the amount of money that the company has to pay its expenses and provide a reasonable return on its investment to its investors.”).

<sup>6</sup> Only two parties, Atmos and the Consumer Advocate, presented a full analysis on the issue of gross margins. TRA Staff and the Intervention Group simply endorsed the analysis presented by the Consumer Advocate.

<sup>7</sup> Greg Waller and Tom Petersen Pre-Filed Rebuttal Testimony, p. 5 (August 18, 2006) (comparing the gross margin amount used by the Consumer Advocate of \$54.5 million to the actual amount of gross margin the Company has booked through July 31, 2006 and has budgeted for August and September 2006, the final two summer months of the fiscal year (\$51.5 million).)

projection.<sup>8</sup> Because of this dispute, the Authority must first determine what the Company's gross margin *currently is* before making a finding as to whether the Company's rates should be increased or decreased going forward. For example, if the order in this docket simply stated that the Company's current rates should be increased by \$3 million, the impact of that decision would be unclear:

- Starting from the Company's actual 2006 gross margin, the result of an order to increase current rates by \$3 million would be an increase of \$3 million from current rates;
- Starting from the Consumer Advocate's amount of 2006 gross margin (which is approximately \$3 million higher than actual amounts), the result would be an increase of approximately \$6 million to the Company's current rates; and
- Starting from the Consumer Advocate's amount of 2007 margin (which is approximately \$4 million higher than actual amounts), the result would be an increase of approximately \$7 million to the Company's current rates.

Therefore, the order in this docket must state a specific revenue requirement, rather than simply ordering an increase or decrease to current rates. To determine an appropriate revenue requirement going forward, the Authority's analysis in this docket must begin with a determination as to the amount of gross margin generated by the Company's current rates.

To determine the amount of gross margin at current rates, the Authority has before it a choice between two very different methods. The record evidence on gross margin consists of:

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<sup>8</sup> For the year ended September 30, 2007, the Consumer Advocate has projected a gross margin of \$55.5 million, compared to the Company's projection of \$51.5 million, which increases the difference between the parties' 2007 numbers to approximately \$4 million, compared to the approximate \$3 million difference for 2006. Pre-Filed Rebuttal Testimony of Dan McCormac, p. 2 (August 18, 2006) ("if the TRA chooses to use a test year ended September 30, 2007, my gross profits would change to \$55,485,148"); Pre-Filed Rebuttal Testimony of Greg Waller and Tom Petersen, p. 6 (August 18, 2006) (Atmos priceout "shows a margin for . . . the attrition period of \$51,504,553).

(1) Atmos' detailed billing determinant priceout performed by Greg Waller and Tom Petersen<sup>9</sup>; and (2) the CAPD's trending analysis performed by Daniel McCormac.<sup>10</sup>

Both the Company and CAPD have stated their gross margin results in terms of booked margins.<sup>11</sup> The following chart summarizes the dramatic differences in results:

	<b>Gross Margin Forecast</b> (12 mos. ended 9/30/2007)	<b>Method Used</b>
Greg Waller and Tom Petersen (Company)	\$51,504,553 <sup>12</sup>	Detailed Billing Determinants (Priceout)
Daniel McCormac (CAPD)	\$55,485,148 <sup>13</sup>	Trended Revenues
<b>Difference</b>	<b>(\$3,980,595)</b>	

This section will compare the methods of the Company and CAPD on this critical issue.

1. **Atmos' Detailed Billing Determinants (Priceout) of Gross Margin is the Traditional and Accepted Method of Estimating Gross Margin.**

As explained in the pre-filed testimony, Atmos calculated gross margin using a priceout; actual detailed billing determinants priced out at current rates. Atmos' analysis began with the most recent actual customer volumes (for the year ended May 2006), and adjusted those volumes by a detailed analysis to reflect:

- (1) known changes in large volume customer usage;
- (2) expected changes in customer levels through the attrition period; and
- (3) expected changes in customer usage levels through the attrition period.<sup>14</sup>

<sup>9</sup> Pre-Filed Direct Testimony of Greg Waller, pp. 2-5 (July 17, 2006).

<sup>10</sup> Pre-Filed Direct Testimony of Daniel W. McCormac, pp. 1-2 (July 17, 2006).

<sup>11</sup> 8/27/2006 Letter to Broemel and Shirley (explaining the treatment of the Barnsley Storage Fee); Transcript of Proceedings v. X, at p. 14 (Petersen) (stating that the 3.03 reports reflect "total revenues and then production costs, which would be PGA gas cost as well as the rent for the Barnsely storage facilities").

<sup>12</sup> Pre-Filed Rebuttal Testimony of Greg Waller and Tom Peterson, p. 6 (August 18, 2006) (corrected analysis).

<sup>13</sup> Pre-Filed Rebuttal Testimony of Daniel McCormac, p. 2 (August 18, 2006).

<sup>14</sup> Pre-Filed Direct Testimony of Greg Waller, p. 3 (July 17, 2006).

The WNA adjustment was applied, as was projected late/service fees and the annual Barnsley Storage fees, to arrive at the total gross margin.<sup>15</sup> Mr. Petersen summarized this process:

We started with billing units for the most recent 12 months that we had available at the time we filed our initial testimony. . . . I then made adjustments for weather consistent with our existing WNA clause, for known changes in large volume customer use that I got from Mr. Ellis, our industrial marketing representative, vice president. Also any expected changes in customer levels going forward to that period, essentially a customer growth adjustment; and expected changes in customer usage levels, essentially an adjustment to reflect declining residential use. The result in attrition for fiscal year 2007 billing units were then priced out at current rates.<sup>16</sup>

This is a rigorous process that produces dependable results.<sup>17</sup> It is based on “actual customer accounts, actual rendered bills, actual conversations with industrial and commercial customers when they told us that they’re planning to reduce load or close a plant, so forth like that.”<sup>18</sup>

The Atmos process for calculating gross margin is the typical analysis.<sup>19</sup> Priceouts are accepted, common, and tested by years of regulatory use. The testimony makes it clear that the CAPD does not have any dispute that a priceout is an acceptable method, and is in fact a common method used to determine gross margin. Mr. McCormac even testified that in “most, if not all” the gas rate cases that he has been involved in, the Authority has relied on a priceout to determine the forward-looking revenues,<sup>20</sup> and that “[i]t can be used if it’s done properly.”<sup>21</sup> In a recognized treatise on ratemaking,<sup>22</sup> a priceout is the assumed method of revenue forecasts:

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<sup>15</sup> Pre-Filed Direct Testimony of Greg Waller, p. 3-4 (July 17, 2006).

<sup>16</sup> Transcript of Proceedings, v X, p. 12 (August 31, 2006).

<sup>17</sup> Pre-Filed Rebuttal Testimony of Tom Petersen and Greg Waller, p. 6 (August 18, 2006).

<sup>18</sup> Transcript of Proceedings v X, p. 24 (August 31, 2006).

<sup>19</sup> Pre-Filed Rebuttal Testimony of Greg Waller and Tom Peterson at p. 5 (August 18, 2006) (“Typically, margins used in ratemaking are not based on trends in past margins, as Mr. McCormac has done. Rather, they are based on an analysis of billing determinants for a recent 12 month period and current prices.”). This approach is so typical that Mr. McCormac included the following question in his pre-filed direct: “Why have you not filed a ‘priceout’ of revenues?” Pre-Filed Direct Testimony of Daniel McCormac, p. 2 (July 17, 2006).

<sup>20</sup> Transcript of Proceedings, v III, p. 38-39 (August 30, 2006).

<sup>21</sup> Transcript of Proceedings, v III, p. 42 (August 30, 2006).

<sup>22</sup> See Pre-Filed Direct Testimony of Terry Buckner, p. 4 (July 17, 2006) (citing the Hahne treatise).

The use of forecasted sales data effectively eliminates the abnormality problem, since forecasts generally are based on expectations of normal conditions (e.g., normal weather) and expected events (e.g. reduced usage due to successful conservation efforts). **The forecasted data should express the best available measure of events as they will occur under normal operating conditions, and pro forma adjustments thereto should not be required.**<sup>23</sup>

As the treatise implies, historical per books margin amounts will include fluctuations and other variations; Mr. McCormac admitted in his testimony that these fluctuations and variations in per books margin amounts occur due to the data not being “pure” for several reasons, including out-of-period adjustments.<sup>24</sup> Authority Staff witness Foster agreed, and added that because the Company cannot read every meter by the end of the month, per books margin data includes estimates of unbilled amounts which can also cause anomalies.<sup>25</sup> Mr. McCormac admitted that these fluctuations and other anomalies present in per book margin amounts is precisely the reason that regulatory commissions, including this Authority, use priceouts, and not per books information, to determine gross margins for ratemaking purposes.<sup>26</sup> The Atmos priceout approach is the recognized approach which neutralizes historical and per books anomalies.

2. **Mr. McCormac’s “Trend” Gross Margin Approach is Unreliable and Speculative and Should be Rejected by this Authority.**

Mr. McCormac used the straight linear trend function in Microsoft Excel to calculate an annual growth rate which he added to the per books margin for year ending March 2006 to calculate gross margin for his attrition period. Mr. McCormac’s statistical analysis accounts for one variable—the passage of time—and assumes Atmos’ gross margin grows in a linear manner annually. Mr. McCormac suggested that he judged by his “experience” that other variables

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<sup>23</sup> Robert L. Hahne, Gregory E. Aliff, Deloitte & Touche, LLP, *Accounting for Public Utilities* § 7.07 (Lexis-Nexis 2005).

<sup>24</sup> Transcript of Proceedings, v IV, p. 34 (August 30, 2006).

<sup>25</sup> Transcript of Proceedings, v VI, p. 55 (August 30, 2006).

<sup>26</sup> Transcript of Proceedings, v IV, p. 34 (August 30, 2006).

would not have impacted his analysis, cautioning that “nothing is exact.”<sup>27</sup> However, Mr. McCormac plainly and clearly indicated that he just chose not to do anything more by way of testing his assumptions:

This is not the only case I’ve worked on the last few months. . . . and you’re limited to how much you can do with the data you have. And it sometimes gives you overconfidence I guess in the output. . . . We’re just trying to get a good estimate and *you can add some degree of confidence or certainty, if you will, by plugging in some more variables, but in my experience it just doesn’t pay to spend the extra time.*<sup>28</sup>

In response to a follow-up question by Director Miller, Mr. McCormac indicated his uncertainty as to whether those additional variables may be important because he stated that he “look[s] forward” to spending more time in the pending Chattanooga docket “to analyze that more to see if it does pay.”<sup>29</sup>

The Authority may not set rates upon information which is unsubstantiated or speculative. *South Central Bell v. Tennessee Pub. Serv. Comm’n*, 579 S.W.2d 429, 438 (Tenn. Ct. App. 1979). In this case, Mr. McCormac agreed that Atmos’ gross margins show “significant fluctuation,” and that the forecast of the margins is a “hard prediction” and a “tough job.”<sup>30</sup> As Mr. McCormac’s response shows, however, he could have done additional work to add to the reliability of his results—he just decided it was not worth his time. This Authority may not jettison reliability in the name of simplicity. As discussed more thoroughly below, the McCormac analysis is not reliable and is speculative of the future based on a past which showed significant fluctuation.

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<sup>27</sup> Transcript of Proceedings, v V, pp. 34-35 (August 30, 2006) (“I try to do my best with what information, time, and tools I have to project it, but I can’t put a number on those, if you will, experience factors that I used.”).

<sup>28</sup> Transcript of Proceedings, v V, p. 35 (August 30, 2006).

<sup>29</sup> Transcript of Proceedings, v V, pp. 35-36 (August 30, 2006).

<sup>30</sup> Transcript of Proceedings, v IV, pp. 54-55 (August 30, 2006); v V, p. 25 (August 30, 2006).

**(a) Mr. McCormac's "Analysis" was Limited to a Mathematical and Statistical Trend Which Considered Only One Factor: the Passage of Time.**

Mr. McCormac's testimony and discovery responses clearly demonstrate that the CAPD's gross margin analysis is the function of a command in Microsoft Excel applied to 5 data points – the year ended gross margin per books for March 2002, 2003, 2004, 2005, and 2006. The following "detailed description" of Mr. McCormac's analysis was set forth in his direct testimony:

As shown on Exhibit DM1, I examined the gross margins reported on the TRA 3.03 reports for each of the years ended March 31, 2002, 2003, 2004, 2005, and 2006. The gross margins have grown at a rate of \$993,352 per year or \$496,676 every six months. The \$54,491,796 estimate for the year ended September 30, 2006 is based on one half year's growth of \$496,676 added to the \$53,995,120 recorded for the 12 months ended March 31, 2006.<sup>31</sup> This equates to an annual revenue growth rate of 1.82%.<sup>32</sup>

Mr. McCormac's entire "trend" analysis is set forth in two columns of DM1<sup>33</sup> as follows:

	McCormac Column "A"	McCormac Column "E"
		Total Margin:
90	3/31/2002	50,862,547
91	3/31/2003	48,643,849
92	3/31/2004	53,444,043
93	3/31/2005	52,317,057
94	3/31/2006	53,995,120
95	9/30/2006	54,491,796
96	9/30/2007	55,485,148
97		
98		
99	3/31/2006	53,840,316
100	3/31/2007	54,833,668

<sup>31</sup> Transcript of Proceedings, v III, p. 24 (August 30, 2006).

<sup>32</sup> Mr. McCormac's data points (the range of years ended March 31, 2002 through March 31, 2006) represent the twelve months ended that year. Pre-Filed Direct Testimony of Daniel W. McCormac, p. 2 (July 17, 2006) (stating that "each one of these five points represents 12 months of data").

<sup>33</sup> This Spreadsheet is taken from the Discovery Response of Mr. McCormac in the file labeled "Exh DM1and2 DR #7,8,0.xls" and is exactly as set forth in DM1. See Pre-Filed Direct Testimony of Daniel W. McCormac, Ex. DM1 (July 17, 2006).



From this information, Mr. McCormac mathematically calculated a growth rate of **1.845%**, or **\$993,352 per year** (or \$496,676 for a half year's growth). In discovery, the CAPD provided the following "detailed calculation and explanation of the \$496,676 for 6 months growth":

The specific Excel formula used to compute the straight line trend is "**=TREND(E\$90:E\$94,A\$90:A\$94,\$A99)**" where[:]

- **E\$90:E\$94** represents the actual total margin reported by Atmos each year ended March 31, 2002 through 2006;
- **A\$90:A\$94** is the range of years ended March 31, 2002 through March 31, 2006; and
- **\$A99** represents the trend line time period(s).
- **The difference between any two trend line years will produce the slope of the trend line.** In this case the trend of reported gross margins yields \$993,352 per year or \$496,676 every six months.<sup>34</sup>

Mr. McCormac admitted that the "trend line"<sup>35</sup> that he then extrapolated is "simply a formula within Microsoft Excel that calculates a best fit line between the [five data] points that [he] plotted"<sup>36</sup> The chart solely demonstrates the "relationship between the passage of time [over the last few years] and the change in margins."<sup>37</sup> His gross margin "growth" is the monetary calculation of the slope of that trend line:

Q. But the conclusion is reached based on the trend. That's how you figure out how much you're going to add to the March, 2006 to go forward?

A. That's how we projected the reasonable level of growth going out into the future where rates are set for the future, yes.<sup>38</sup>

To finish his 9/30/2006 and 9/30/2007 forecast, Mr. McCormac added his calculated "growth" to the actual per books 3/31/2006 gross margin. The math is **actual** per books March 2006, plus the calculated **trended** growth:

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<sup>34</sup> Consumer Advocate and Protection Division's Responses to Atmos Energy Corporation's First Requests for Information at Response 41, pp. 21-22 (Aug. 4, 2006) (emphasis and bullets added).

<sup>35</sup> Mr. McCormac's "trend" is graphed on DM2. Pre-Filed Direct Testimony of Daniel W. McCormac, Ex. DM2 (July 17, 2006).

<sup>36</sup> Transcript of Proceedings, v IV, p. 14 (August 30, 2006).

<sup>37</sup> Transcript of Proceedings, v IV, pp. 15-16 (August 30, 2006).

<sup>38</sup> Transcript of Proceedings, v III, pp. 39-40 (August 30, 2006).

	12 months ending...	Gross Margin	McCormac Explanation/Calculation	Ref. on DM1
1	March 31, 2006	\$53,995,120	= <b>Starting Point</b> Actual March 31, 2006	D94
2	September 30, 2006	\$54,491,796	= <b>\$53,995,120 + \$496,696</b> actual March 31, 2006 plus McCormac's trended ½ year's growth	D95
3	September 30, 2007	\$55,485,148	= <b>\$54,491,796 + \$993,352</b> calculated September 30, 2006 plus McCormac's trended full year's growth	D96

McCormac's forecasted gross margin is "a pure mathematical calculation from [McCormac's calculated] trend line."<sup>39</sup> This approach is not standard regulatory practice. Mr. Petersen testified that in his 26 years of regulatory experience, as both commission Staff and utility analyst,<sup>40</sup> he had never seen the "novel" approach of Mr. McCormac.<sup>41</sup> In Mr. McCormac's own testimony, he admitted that "historically the TRA does not determine gross margins based solely on trend analysis."<sup>42</sup> More important than its novelty, however, is that the approach is riddled with statistical problems and common sense limitations.

**(b) Mr. McCormac's Starting Point of March is Unreliable (an Update to More Current Data Produces Remarkably Different Results).**

Mr. McCormac used the month of March 2006 as his starting point for one identified reason: "that was the most recent information [he] had at the time that [the CAPD] began this phase of this investigation."<sup>43</sup> But, as Mr. Petersen testified, the use of the twelve months ending March 2006 is unreliable:

<sup>39</sup> Transcript of Proceedings, v X, pp. 58-59 (August 31, 2006) (Waller).

<sup>40</sup> Mr. Petersen's extensive experience is set forth in his direct testimony: "[f]rom July 1980 through March 1989, I was employed in Rates and Tariffs Division of the Kentucky Public Service Commission. I was Manager of Rates and Revenue Requirements for Atmos from 1989 through 1997. I was Director of Price Policy and Administration from October 1997 through September 1998. I have been in my current position [Director of Rates] since October 1998." Thomas H. Petersen Pre-filed Direct Testimony, p. 1 (July 17, 2006).

<sup>41</sup> Transcript of Proceedings, v X, p. 13-14 (August 31, 2006) (Petersen).

<sup>42</sup> Transcript of Proceedings, v II, p. 39 (August 29, 2006) (McCormac).

<sup>43</sup> Transcript of Proceedings, v III, p. 24 (August 30, 2006) (McCormac). *See also* Consumer Advocate and

the 12-month period ending that month is a period in which the amount of *unbilled revenues was quite large*. Because of cycle billing for booking purposes at the end of each month, you have to make an estimate of unbilled revenues and put them on the books. . . . [I]n this case, the amount of unbilled that was estimated in March of '06 was 1.7 million higher than the amount of unbilled that was estimated at the end of March '05. So, unless we would presume that amount of unbilled would continue to grow, that would tend to overstate as a base for looking forward the amount of revenue that you can get there.<sup>44</sup>

The CAPD had no answer for this criticism at the Hearing. In fact, Authority Staff witness Foster agreed that the estimates of unbilled can cause significant variation in the margins reported per books.<sup>45</sup>

Moreover, as demonstrated at the Hearing, the use of the 12 months-ended March 2006 as a starting point because it was the “most recent information” that the CAPD had should not justify this Authority’s use of that period. Mr. McCormac’s own testimony was that “[u]sually your most current data is most relevant.”<sup>46</sup> At the hearing, Atmos demonstrated that the most recent data, using the year ended June 2006, resulted in a “trend” that was significantly lower than Mr. McCormac’s March analysis:

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Protection Division’s Responses to Atmos Energy Corporation’s First Requests for Information at Response 42, p. 23 (August 4, 2006) (“We did not use April 2006 numbers because our testimony was due only six business days after we received the April 2006 report. The March 2006 data was the latest data available at the time of our analysis.”).

<sup>44</sup> Transcript of Proceedings v X, p. 12-13 (August 30, 2006) (Petersen) (emphasis added).

<sup>45</sup> Transcript of Proceedings, v VI, p. 55 (August 30, 2006).

<sup>46</sup> Transcript of Proceedings v X, p. 12-13 (August 30, 2006) (Petersen) (emphasis added).

	June Column "A"	June Column "E"
		Total Margin:
90	6/30/2001	51,905,873
91	6/30/2002	51,847,264
92	6/30/2003	48,828,264
93	6/30/2004	53,577,466
94	6/30/2005	52,627,050
95	6/30/2006	51,781,585
96	9/30/2006	51,827,819
97	6/30/2007	51,966,522
98	9/30/2007	52,012,756
99		
100	6/30/2006	52,223,847
101	6/30/2007	52,408,784

Mr. McCormac verified that the data inputs and formulas were correct and same explanations from DM1 would apply to this analysis.<sup>47</sup> Like Mr. McCormac's March analysis, the June comparison used 6 year-ended data points, all the same month. A comparison showing the difference in result when the March numbers are replaced with June numbers is striking:

	March Analysis	June Analysis	Difference
Growth Rate	1.845%	0.354%	1.491%
Margin Growth Per Year	\$ 993,352	\$ 184,937	\$ 808,415
9/30/2006 Forecast	\$ 52,491,796	\$ 51,827,819	\$ 663,977
9/30/2007 Forecast	\$ 55,485,148	\$ 52,012,756	\$ 3,472,392

As demonstrated by this chart, if the March numbers in Mr. McCormac's analysis are simply replaced with June numbers, the result all but eliminates the \$3 million gap between the parties' conclusions regarding gross margin. This analysis is not intended as an alternate forecast. Rather, it is intended to show the extreme limitations of Mr. McCormac's "trend" theory—which is far too subjective and easily manipulated to provide any meaningful rate guidance.

<sup>47</sup> Transcript of Proceedings v IV, pp. 37-41 (August 30, 2006).

**(c) Mr. McCormac Ignores His Own Admission that the More Data That is Inputted, the Better and More Accurate the Result Will Be.**

Mr. McCormac generally agreed that the more information and data that is inputted, the more accurate the results will be.<sup>48</sup> To be clear, and regardless of any implication in Mr. McCormac's summary testimony, Atmos has not based any forecast of gross margin on a trend analysis. Rather, as Mr. McCormac admitted at the Hearing, Atmos' forecast was based on the priceout.<sup>49</sup> In the rebuttal testimony, Atmos did show another meaningful flaw in Mr. McCormac's "trend" analysis.<sup>50</sup> As explained by Company witnesses Waller and Peterson:

In order to provide the Authority with a complete comparison, we reviewed 12 month ended margins for all monthly 3.03 reports since the beginning of fiscal 1999. Schedule P/W-2 shows the data, a graph of the data and a simple least squares regression of the margins over time. Visual inspection of the data shows some significant fluctuations from October 1998 through October 2003 with smaller fluctuations since then. **In short, there is no discernable trend, contrary to the assertions that Mr. McCormac has made based on his use of very selective and limited data.** The regression analysis slopes slightly upward with a margin growth of about \$400,000 per year but has a low R Square of approximately 0.18.<sup>51</sup>

A copy of the demonstrative board used at the Hearing is attached as Exhibit 2 to this Post-Hearing Brief. The Atmos demonstrative board plotted all reported monthly 3.03 reports starting in October 1998, with each monthly point representing twelve months of data.<sup>52</sup> This graph plotted information equivalent to Mr. McCormac's five March data points, it is just that Atmos "had more of them."<sup>53</sup>

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<sup>48</sup> Transcript of Proceedings v IV, p. 25 (August 30, 2006).

<sup>49</sup> Transcript of Proceedings v IV, p. 4 (August 30, 2006) (Q. "Now, Atmos didn't present any forecast based on a trend in this case, did it? A. I don't think they did . . . that's correct."); p. 9 (admitting that Atmos has done a priceout).

<sup>50</sup> Transcript of Proceedings v IV, p. 13-14 (August 30, 2006) ("Q. And the purpose of Mr. Peterson's taking your method and just backing it up to '98 was not reach a conclusion on margin but rather to show what he contends are the flaws in your conclusion on margin. A. Yes, he tried to show the flaws in my analysis. I think he – he tried.").

<sup>51</sup> Pre-Filed Rebuttal Testimony of Greg Waller and Tom Peterson, p. 5 (August 18, 2006).

<sup>52</sup> Transcript of Proceedings v IV, p. 13 (August 30, 2006).

<sup>53</sup> Transcript of Proceedings v IV, p. 12 (August 30, 2006).

This chart of all the 3.03 data, when you look at it on any objective level, demonstrates that the Atmos margins fluctuate to such a degree that it cannot be relied upon for any “trend,” much less a trend of linear growth annually. It shows significant fluctuation. Mr. McCormac chose five data points out of several hundred candidates. The result is a “trend” that is irreconcilable with the overall group. As discussed more thoroughly below, the statistical evidence confirms this intuitive result which is evident from a simple examination of the fluctuating per book margin amounts on the chart: there is no trend.

**(d) The Statistical Evidence Demonstrates a Minimal Correlation  
Between the Passage of Time and the Change in Gross Revenue.**

Mr. McCormac’s approach statistically and mathematically does not account for any factor other than the passage of time.<sup>54</sup> The trend line can be calculated from any data inputs in Microsoft Excel. As Mr. McCormac’s analysis simply used the Microsoft “TREND” function to calculate the growth, Microsoft’s own caution should be accounted for: “whether that straight line is a good predictor of the future will depend on an analysis of how good a fit it is.”<sup>55</sup> Mr. McCormac agrees that in statistics, an R Square coefficient “tell[s] you how good the relationship is between the passage of time and the change in Atmos margins.”<sup>56</sup> An R square coefficient closer to “1” indicates a strong correlation between the passage of time and the change in gross margins.<sup>57</sup> Mr. McCormac’s selected data points (the range of years ended March 31, 2002 through March 31, 2006) showed an R Square coefficient of .44 that he described as only “fairly good,” correlation and only “[f]or this type of data analysis.”<sup>58</sup> As Mr. McCormac admitted at the Hearing, an R Square coefficient of .44 indicates that 44% of the

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<sup>54</sup> Transcript of Proceedings v IV, p. 26 (August 30, 2006) (McCormac).

<sup>55</sup> Transcript of Proceedings v IV, p. 21 (August 30, 2006) (McCormac).

<sup>56</sup> Transcript of Proceedings v IV, pp. 22-23 (August 30, 2006).

<sup>57</sup> Transcript of Proceedings v IV, p. 22 (August 30, 2006).

<sup>58</sup> Transcript of Proceedings v IV, pp. 24-25 (August 30, 2006).

variation in gross margins is due to the passage of time, whereas the remaining 56% of the variation is due to other factors not taken into account in Mr. McCormac's analysis.<sup>59</sup>

Mr. McCormac's own analysis shows the vast disparity in the R square coefficients that depend solely on what date range is used. During his summary, Mr. McCormac handed out a chart entitled "*Annual Margin Forecasts Using Atmos' Data Analysis Methodology Forecast [sic] Depends Greatly on Starting Point Atmos Chose Period with Low R Square (Poor Curve Fit)*" which Mr. McCormac submitted "shows how critical it is to select a proper period of data."<sup>60</sup> On that chart, Mr. McCormac used various data from the same data set (the monthly 3.03 reports) which show R Square coefficients anywhere from zero (or "no correlation at all") to .58.<sup>61</sup> What this chart shows is that the result is "subjective to the period of time that you choose to plot"<sup>62</sup> and that the analysis itself is flawed.

Moreover, Mr. McCormac acknowledged that statistically, you can also judge the "fit" of a trend by using the "standard error," which is the standard variation between the trend line and actual results.<sup>63</sup> Mr. McCormac conceded that the "margin fluctuation shown [on the Atmos 3.03 reports] is significant."<sup>64</sup> Mr. McCormac testified as follows to the standard variation in his analysis:

Q. And here you have a – for your period that you chose, March '02 to March '06, you have a standard error of \$1.6 million; correct?

A. Yes.

Q. So that means a standard difference between a trend line – between your trend line and actual results is going to vary up or down \$1.6 million.

A. Up or down.

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<sup>59</sup> Transcript of Proceedings v IV, pp. 33-34 (August 30, 2006).

<sup>60</sup> Transcript of Proceedings v III, p. 29 (August 30, 2006).

<sup>61</sup> Transcript of Proceedings v IV, pp. 24-25 (August 30, 2006).

<sup>62</sup> Transcript of Proceedings v IV, p. 32 (August 30, 2006).

<sup>63</sup> Transcript of Proceedings v IV, p. 36 (August 30, 2006).

<sup>64</sup> Transcript of Proceedings v IV p. 54 (August 30, 2006).

**Q. So if you set rates based on this trend, then the standard amount you're going to be off is 1.6 million.**

**A. That's what that statistic shows.<sup>65</sup>**

This type of speculative analysis, which can best be characterized by its proponent as "fairly good" and with a standard error of \$1.6 million (up or down) should not be adopted by this Authority and used to set rates.

**(e) The McCormac Analysis Does Not Line Up With Actual Results.**

Mr. McCormac's trended analysis also cannot be justified based on the actual booked results that Atmos has had this fiscal year. As was reported in Mr. Petersen and Mr. Waller's rebuttal, "for the first 10 months of fiscal year 2006 (October 1, 2005 – July 31, 2006), the Company booked gross margin of \$47,006,746. The budgeted amount for the remaining two months of fiscal 2006 (August and September 2006) is \$4,535,066. Thus, by simply combining the actual amounts for fiscal 2006 to date with budgeted amounts as projections for the final two months of fiscal 2006, the result in total projected gross margins for year ended September 30, 2006 is \$51,541,812."<sup>66</sup> In other words, to make up the difference between Mr. McCormac's trended amount and the actual amounts, the margin would have to exceed budget (in two summer months) by \$2.7 million. At the Hearing, Mr. McCormac implied that might be the case.<sup>67</sup> However, the actual gross margin booked for August was \$2,285,949, just \$30,422 different than the budgeted amount.

At the Hearing, Mr. McCormac insisted that the Authority should disregard for ratemaking purposes the gross margin amounts booked for April, May, and June 2006 because those amounts are "outliers" when compared to what Mr. McCormac described as the "trend"

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<sup>65</sup> Transcript of Proceedings v IV, p. 36 (August 30, 2006).

<sup>66</sup> Pre-filed Rebuttal Testimony of Thomas H. Peterson and Greg Waller, pp. 4-5 (August 18, 2006).

<sup>67</sup> Transcript of Proceedings, v IV, p. 47 (August 30, 2006).



from the most recent previous years.<sup>68</sup> Presumably, Mr. McCormac would also argue the Authority should disregard July and August 2006 per books margins for the same reason. What Mr. McCormac's argument ignores is the fact that the actual per books amounts for April, May, June, July and August are "outliers" only if you accept his hypothesis that there is a trend evident in the fluctuations of gross margin over time. All evidence in this docket points to the contrary; there is no trend. Instead, per books gross margins fluctuate significantly over the years due to numerous factors other than the passage of time, none of which are accounted for in Mr. McCormac's analysis.

Mr. McCormac attempts to bolster his analysis by comparing the annual growth rate calculated from his March trend analysis to an overall annual growth rate calculated by comparing the total change in margins over the past ten years, which Mr. McCormac claims demonstrates margins have grown 1.8% annually.<sup>69</sup> The fundamental flaws in Mr. McCormac's observation regarding the total difference in per books margin in 1995 and 2006 and the annual growth rate conclusion he extrapolates from that observation is demonstrated with the following example:

Jane weighed 120 lbs in college 10 years ago, and now weighs 160 lbs, so Jane's weight has gone up 4 lbs per year in the last 10 years. It is reasonable to conclude that Jane will continue to gain 4 lbs per year in the future.

That conclusion seems reasonable at first glance, until you consider the fact that Jane lost 20 lbs after starting her first job after college, and is currently 8 months pregnant with twins. An annual growth rate is a relevant predictor of the future only if the variable, in the example, Jane's weight, changes in a linear manner with the passage of time. Clearly, Jane's weight has historically fluctuated a significant amount over time due to numerous variables (job stress,

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<sup>68</sup> Transcript of Proceedings, vol IV, pp. 42-43 (August 30, 2006).

<sup>69</sup> Pre-filed Direct Testimony of Daniel McCormac, p. 2 (July 17, 2006).

pregnancy) that are not included in simple linear analysis. Adding 4 lbs per year to Jane's current weight at 8 months pregnant is in no way a reasonable method to predict her future weight. Just as the assumptions applied to Jane's weight in the example above, Mr. McCormac has assumed that margin growth is linear and changes with the passage of time. All of the evidence in this docket has demonstrated that margin growth is not linear, but fluctuates significantly due to numerous variables other than the passage of time, none of which have been taken into account in the linear analysis.

In short, the actual booked amounts demonstrate that the McCormac analysis is wholly speculative and unreliable. As such, it should be rejected by this Authority.

**3. Atmos' Priceout Conclusion is Reliable and Should be Adopted by the Authority as the Appropriate Amount of Gross Margin.**

As discussed above, Atmos projected gross margins using a detailed priceout, which is a rigorous process that relies on actual customer accounts, actual rendered bills, and actual conversations with industrial and commercial customers regarding future usage. The Atmos process for calculating gross margin is the standard, accepted practice for projecting gross margins. At the Hearing, Mr. McCormac testified that he neglected to do a priceout, not because the method is flawed, but rather because he did not have the time to complete such an analysis.<sup>70</sup>

In pre-filed testimony, the CAPD raised only two criticisms of Atmos' priceout: (1) Mr. McCormac criticized the priceout results because they were inconsistent with per books amounts; and (2) Mr. McCormac implied in pre-filed testimony that Atmos' had improperly adjusted margins to account for the \$1.8 million Barnsley storage fee.<sup>71</sup> At the close of the

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<sup>70</sup> Transcript of Proceedings, vol V, pp. 35-36 (August 30, 2006); Transcript of Proceedings, vol III, p. 42 (August 30, 2006).

<sup>71</sup> Pre-filed Rebuttal Testimony of Daniel McCormac, p. 2 (August 18, 2006).

Hearing in this docket, both of those criticisms had been withdrawn or refuted through Mr. McCormac's own testimony.

As to the criticism concerning the Barnsley storage fee, at the Hearing, Mr. McCormac acknowledged there was some confusion initially surrounding the treatment of the Barnsley storage fee, but confirmed on the stand that the letter and additional information Atmos sent and filed in the docket on August 27, 2006 clarified the appropriate ratemaking treatment of the fee.<sup>72</sup> As a result, Mr. McCormac agreed that both the Consumer Advocate and the Company had treated the fee in an identical manner for ratemaking purposes, and confirmed that treatment was appropriate.<sup>73</sup> As a result, Mr. McCormac withdrew any implied criticism of Atmos' priceout with regard to the Barnsley storage.

As for Mr. McCormac's remaining criticism of Atmos' priceout, which implied the priceout was unreliable because the priceout margin amounts were not identical to per books margin amounts, the testimony from both the CAPD and Authority Staff at the Hearing is also instructive. At the Hearing, Mr. McCormac and Mr. Foster both gave numerous reasons why per books margin amounts differ from actual results, including the presence of out of period adjustments and variations due to estimates of unbilled amounts.<sup>74</sup> In fact, at the Hearing, Mr. Petersen explained that the differences cited by Mr. McCormac between per books and priceout amounts consisted almost entirely of estimates for unbilled amounts.<sup>75</sup> Mr. Petersen also explained that the rolling amounts for unbilled estimates, which cycle throughout the year, were at a high point in March 2006, almost \$1.7 million higher than the same date the year before. By using March 2006 as his starting point, Mr. McCormac overstated margins by the amount of the

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<sup>72</sup> Transcript of Proceedings, vol IV, pp. 59-61 (August 30, 2006).

<sup>73</sup> *Id.*

<sup>74</sup> Transcript of Proceedings, vol IV, p. 34 (August 30, 2006); Transcript of Proceedings, vol VI, p. 55 (August 30, 2006).

<sup>75</sup> Transcript of Proceedings, v X, pp. 12-13 (August 31, 2006).

unbilled that his analysis failed to account for.<sup>76</sup> Therefore, neither of Mr. McCormac's criticisms of Atmos' priceout survived the testimony offered at the Hearing.

No party has raised any serious challenge to the conclusions presented through Atmos' priceout analysis. As this analysis is uncontradicted, the Authority should adopt the conclusions set forth therein.

**4. Given the Large Variance in the Conclusions Presented by the Parties in this Docket as to Gross Margins, the Authority Should Consider Implementing an Annual Mechanism to Refund or Surcharge the Difference Between the Forecasts and Actual Margins.**

The unusual progress of this docket and the widely divergent positions of the parties as to the appropriate amount of gross margins to use as a starting point in the ratemaking analysis place the Authority in a difficult position. On one hand, the Authority has been presented with a detailed billing determinant priceout from the Company which has not been seriously challenged. On the other hand, the only other party presenting an analysis of gross margins, the CAPD, has presented a trending analysis which, by the CAPD's own admission is only "fairly good" and which will vary from actual experience by a standard amount of more than \$1.6 million. The approximate \$4 million difference between the positions of the parties makes the gross margin analysis one of the single biggest issues in the case. As the directors have acknowledged, adding to the difficulty is the limited number of knowledgeable staff available to serve in an advisory capacity to the directors, and the limited amount of time advisory staff has had to complete its analysis. In light of these factors, Atmos proposes that the Authority consider setting rates based on the Company's billing determinant priceout, but implementing an annual mechanism by which the Authority will review the actual booked margins at the end of the fiscal year. Upon that review, the Authority could adjust rates through surcharge or refund to

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<sup>76</sup> *Id.*

account for any differences between the amount of gross margins set in this case and the amount of gross margins actually experienced by the Company. Essentially, gross margins would be annually trued-up to actual results, much like the ACA audit process governing gas costs. Such a mechanism would correct for fluctuations in gross margins either above or below the levels set in this case. If, as the CAPD alleges, gross margins climb dramatically throughout the next fiscal year, the ratepayers will receive a refund. An annual mechanism to true up gross margins to actual booked amounts would correct one of the traditional shortcomings of ratemaking – the inability to return to the past to correct mistakes in projections.

**B. THE DIFFERENCE IN THE METHODOLOGY USED BY THE COMPANY AND THE CAPD IN FORECASTING EXPENSES.**

The major differences with Atmos' projections for expenses (presented by Mr. Waller and Mr. Petersen), and the CAPD's projections for expenses (presented by Mr. Buckner) is the source of the numbers, and the methodology ultimately used to calculate those numbers. This brief will not cover every issue, but rather will address the expenses where there is the greatest disparity between the Company and the CAPD.

**1. Atmos Has Provided Ample Support for all of its Figures and Has Fully and Completely Answered All Outstanding Discovery.**

On several occasions Mr. Buckner implied that Atmos has not provided adequate support for its expenses and, because of this alleged fact, the CAPD's number should be accepted. This was a clear enough strategy that Director Kyle actually asked if Atmos intended to file a late-filed exhibit to address it.<sup>77</sup> To be clear, this implication of incompleteness is just wrong. In fact, Atmos has provided ample support for all its calculations. Its witnesses testified and were available for cross-examination on their methods; data and schedules supporting the calculations

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<sup>77</sup> Transcript of Proceedings vol IV, pp. 4-5 (August 30, 2006).

were provided. For the most part, the CAPD and the Staff simply failed to ask any questions at the Hearing from these Company witnesses and the testimony was admitted unopposed.

This is a rate case on a rocket. There were only thirty-seven days from the simultaneous filing of all parties' direct testimony to the first day of the rate case hearing. As was made clear in the testimony at the Hearing, the simultaneous filings created unique problems with proof and presentation. For instance, it was not until the filing of the direct testimony that Atmos learned the CAPD and Staff intended to rely on an attrition year of the 12 months ended September 30, 2006. As a result, Atmos did not receive the CAPD's financial projections for the 12 months ended September 30, 2007 until August 18, 2006, 11 days before the hearing. This is coupled with the fact that Atmos responded to over 300 different discovery requests (including a full set of MFRs) and did not object to any discovery request of the CAPD and the Staff seeking financial information. In addition to formal discovery, Atmos gave the CAPD and Staff unfettered access to ask its employees informal questions. Mr. Buckner himself testified:

Q. Mr. Buckner, we've talked a bit today about how many data requests the Company has answered.

A. Yes.

Q. And you will agree that the Company worked diligently to provide as much information as possible to the Consumer Advocate on the financial issues; wouldn't you?

A. I would like to particularly compliment Al Ashburn. He had the patience of Job in this case and was so cooperative and helpful and we – I really appreciate that speaking for myself.<sup>78</sup>

Atmos has been responsive, diligent, accessible and comprehensive. If Mr. Buckner or Mr. McCormac needed additional supporting data or explanations that they could not locate, they just had to ask. In this accelerated setting, with Atmos' significant legal interests at stake, this Authority should not reward the CAPD hiding the ball, not asking for support, and then simply

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<sup>78</sup> Transcript of Proceedings, vol II, pp. 50-51 (August 29, 2006).

claiming it is not there. Such a result would create a significant incentive in future cases for similar conduct. This would be an unjust result, and a violation of Atmos' rights to due process.

**2. The Differences in the CAPD and Company Estimates of Expenses.**

**(a) Mr. Buckner's Labor Priceout Fails to Account for the Actual Booked Amounts for Labor Transferred Into Tennessee and Uses an Incorrect Capitalization Rate.**

The difference between the CAPD and the Company on the forecasted labor amount starts with the source of the 2006 numbers. The "[C]ompany's 2007 labor expense is based on *actual booked amounts* for '06".<sup>79</sup> Conversely, Mr. Buckner did "a price-out of employee by employee pay rates — actual pay rates, the overtime rates that were per the last fiscal year, [and a] pay increase of three and a half percent per year."<sup>80</sup> The Company's is the booked amounts; Mr. Buckner's is a build-up or priceout of labor. Ironically, the CAPD steadfastly refuses the priceout methodology for gross margin (where priceouts are traditionally used) in favor of a trend of booked revenues, while at the same time steadfastly refusing to look at Atmos' booked expenses for labor (where booked amounts are traditionally used) in favor of a priceout.

The Company's forecast begins with its booked labor expense amount. Mr. Buckner's begins with payroll data. As a result, he failed to account for capital labor "transferred into" Tennessee from other states (such as Virginia, Missouri, Illinois, and Mississippi).<sup>81</sup> As explained by Mr. Waller, the error in Mr. Buckner's testimony derives from the fact that he did a "bottoms-up forecast of total labor" without consideration of the labor which is not reflected on the Tennessee payroll:

When you do that, you do in fact capture all the labor of the people who are again directly living in and directly coding time to Tennessee for people who are based in Tennessee who are on the Tennessee payroll permanently. What you do not

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<sup>79</sup> Transcript of Proceedings v I, pp. 76-77 (August 29, 2006).

<sup>80</sup> *Id.* v I, p. 76-77.

<sup>81</sup> *Id.* v I, p. 81-82, 90.

pick up when you do that type of forecast. . . is the capital labor transferred in and transferred out.<sup>82</sup>

This situation arises when employees from a neighboring state “come in to the State of Tennessee and work on capital projects. This happens somewhat regularly for employees from Missouri, from Illinois, and from Mississippi and Virginia.”<sup>83</sup> This information is generated on the general ledger, but is not accounted for in the Tennessee payroll information.<sup>84</sup> This would add approximately \$620,999 as “net labor transferred in.”<sup>85</sup>

Compounding the problem with failing to account for labor transferred into Tennessee, Mr. Buckner used the wrong capitalization rate. He used the average capitalization rate for 2005 of 60%, rather than the actual 2006 capitalization rate of 58%.<sup>86</sup> This would increase Mr. Buckner’s labor expense by about \$45,000.<sup>87</sup>

The corrections to Mr. Buckner’s 2006 labor expense were demonstrated on Exhibit No. 1, introduced at the hearing:

RECONCILIATION TO BUCKNER		ATMOS FORECAST
Buckner '06 Labor Expense	2,877,636	
Buckner '06 Cap Rate	60%	
Buckner '06 Total Labor	7,194,090	
Add net labor transferred YTD '06	620,999	
Corrected Total Labor	7,815,089	
Corrected Cap Rate	58%	
Corrected Labor Expense for '06	3,282,337	3,165,841

As can be seen above, if Mr. Buckner’s analysis is corrected to (i) include labor transferred in and (ii) the correct capitalization rate, it is actually **higher** than Atmos’ forecast by \$116,497.

<sup>82</sup> Transcript of Proceedings v X, pp. 25-26 (August 31, 2006).

<sup>83</sup> *Id.* v X, p. 26.

<sup>84</sup> *Id.* v X, p. 26-27.

<sup>85</sup> *Id.* v I, p. 90.

<sup>86</sup> Transcript of Proceedings v I, pp. 86-87 (August 29, 2006).

<sup>87</sup> *Id.* v. I, p. 88.



After the adjustments are made to correct the 2006 numbers, both the Company and the CAPD use the same growth rate to project total labor to 2007: 3.5%.<sup>88</sup> Therefore, to reach the 2007 forecast, the 2006 forecast is grown at 3.5%.<sup>89</sup>

	<b>CAPD</b>	<b>Atmos</b>
Corrected Labor Expense	3,282,337	3,165,841
Grow Corrected Labor Expense by 3.5%	3,397,219	3,394,765 <sup>90</sup>
<b>Difference</b>	<b>2,454 (Corrected CAPD is Higher)</b>	

Mr. Buckner's explanation that the transferred labor would likely appear in the "other O&M" category does not remedy the problem because this is "capital labor transferred in and out. In no instance should capital labor ever appear in O&M."<sup>91</sup>

**(b) The Long-Term Incentive Pay Plan ("LTIP") is Part of the Total Compensation Package of Atmos, is Necessary to Meet Market Rates, and Should Be Included as a Proper Expense.**

Atmos included the following expense associated with its LTIP for employees:

	<b>Company</b>	<b>CAPD</b>
<b>LTIP Expense</b>	\$444,447	\$0

The essence of the Mr. Buckner's criticism is that the LTIP should be excluded because "all of the plan benefits will inure entirely to Atmos' employees and shareholders and all of the plan's burden will be charged directly to ratepayers."<sup>92</sup> This, however, is simply a function of Mr. Buckner ignoring the market realities of the Atmos compensation package. Mr. Waller provided the following explanation for why the LTIP expense should be properly recoverable:

Those dollar amounts that we pay as part of a long-term incentive plan are part of a total compensation package that we pay our employees. We strive to pay

<sup>88</sup> Id. v X p. 29 ("I think we both agreed that the appropriate growth rate for labor – regardless of the starting the point, the appropriate growth rate is 3 and a half percent growth.").

<sup>89</sup> Hearing Ex. 1.

<sup>90</sup> This number also includes the impact of the difference between the 2006 capitalization rate of 58% and the 2007 capitalization rate of 57%.

<sup>91</sup> Transcript of Proceedings v X, pp. 29 (August 31, 2006).

<sup>92</sup> Direct Testimony of Terry Buckner, pp. 7-8 (July 17, 2006).

market fair wage for every job that we employ in Atmos. The long-term incentive plan is part of that market competitive wage.

The other thing I want to point out is the target payout for that plan is in fact what is widely considered a fair rate of return in our jurisdiction. So, you know, we make our – we make our target payout if we earn exactly what we hope to and expect to earn in our jurisdictions.<sup>93</sup>

As Mr. Waller testified, the inclusion of the LTIP payments brings the compensation payments up to the target payout for each position. The LTIP expense is properly recoverable in this case.

**(c) The Pension Contributions, Which are “Lumpy,” Should be Included as Proper Expense.**

The CAPD and the Company agree that pension expenses are a legitimate expense. Mr. Buckner stated: “The contributions should be recovered. The ratepayers pay the contributions.”<sup>94</sup> However, the CAPD has excluded Atmos’ estimated pension contribution:

	<b>Company</b>	<b>CAPD</b>
<b>Pension Expense</b>	\$417,131	\$0

The stated reason for Mr. Buckner’s exclusion is that “in Tennessee, only *actual pension contributions* have been recognized for setting rates.”<sup>95</sup> Mr. Buckner correctly cites the Form 10-K of Atmos as reporting that currently the pension fund is fully funded.<sup>96</sup> This is because of the many and expensive contributions that Atmos has made:

- \$ 77,000,000 in the summer of 2003;
- \$ 3,000,000 in the summer of 2005; and
- \$ 350,000 in the summer of 2006.<sup>97</sup>

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<sup>93</sup> Transcript of Proceedings, vol X, pp. 33-34 (August 31, 2006).

<sup>94</sup> Transcript of Proceedings, vol II, p. 30 (August 29, 1006).

<sup>95</sup> Pre-Filed Testimony of Terry Buckner, p. 9 (July 17, 2006).

<sup>96</sup> *Id.*

<sup>97</sup> Transcript of Proceedings, vol X, pp. 15-16 (August 31, 2006).

Because these contributions are “lumpy”—they can come in different amounts at different times—Atmos calculated the typical amount which would be contributed in a typical year.<sup>98</sup> This was used then as the forecast of pension contributions in the attrition year.

Mr. Buckner’s suggestion ignores the realities of pension funding. Under Mr. Buckner’s method, the Company would have to time a rate case to be filed the year prior to making a pension fund contribution. Such predictions are impossible. Moreover, Mr. Buckner was only minimally prepared on the legal authority that he cited, stating that he did not know “of any language whatsoever addressing the issue of pension expense.”<sup>99</sup> That is because each of those orders cited by Mr. Buckner in his pre-filed testimony were stipulations that included the standard language that the stipulations are for those proceedings only and are not intended to bind other parties as precedent.

Finally, and for the first time in cross-examination, Mr. Buckner first stated on cross that “you can put [the pension contributions] in a deferred asset and recover it in future rates.”<sup>100</sup> This was the procedure that was used for the environmental costs (see below), which the CAPD also excluded. In any event, the Atmos approach is appropriate and these expenses should be allowed.

**(d) Mr. Buckner’s Uncollectible Expenses Fail to Account for the Increased Exposure from the High Winter Gas Prices and the Effects of Budget Billing.**

The CAPD and the Company differ by \$112,088 in the amount of uncollectible expenses:

	<b>Company</b>	<b>CAPD</b>
<b>Uncollectible Expense</b>	\$207,848	\$95,760

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<sup>98</sup> Transcript of Proceedings, vol X, p. 16 (August 31, 2006)..

<sup>99</sup> Transcript of Proceedings, vol II, p. 32 (August 29, 2006). *See also* Pre-Filed Testimony of Terry Buckner at p. 9 (July 17, 2006) (citing several orders from 1988 through 1992).

<sup>100</sup> Transcript of Proceedings, vol II, p. 26 (August 29, 2006).

These are simply expenses that cannot be collected because the customer does not pay. Atmos calculates uncollectible or bad debt as follows:

The way we calculate our projection for bad debt and the way we budget our bad debt in most jurisdictions where we do total bad debt, we predict and budget to have bad debt of .5 percent of residential and commercial, and public authority revenues. In the State of Tennessee and a couple of other jurisdictions, . . . the gas cost portion of that bad debt [is recovered] through the PGA. So therefore our bad debt calculation expectation should be .5 percent of residential, commercial, and public authority margin as opposed to revenues.<sup>101</sup>

Conversely, Mr. Buckner simply used the “actual net write-offs for the company for the 12 months ended May 2006.”<sup>102</sup>

There are two major issues with Mr. Buckner’s use of the May 2006 uncollectible expense number. First, by using 12 months ended May 2006, Mr. Buckner’s analysis would not account for the higher gas costs incurred just this past winter. Mr. Buckner testified:

Q. Do more people fail to pay their bill when the gas costs are higher and the bills are higher?

A. I don’t know.

Q. Okay. Would you agree that last winter’s gas prices were some of the highest in recent history.

A. I know they were high.

Q. Would you also agree that there’s some amount of lag between the time the customer fails to pay the bill and the time the company actually writes off the amount as bad debt?

A. Yes, normally.

Q. And are you aware of what that lag time is with Atmos?

A. No, I’m not.

Q. Does 90 days sound about right?

A. I think depending upon the policies of the company that could be normal and how you determine the history of the write-offs it could be.<sup>103</sup>

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<sup>101</sup> Transcript of Proceedings, vol X, p. 30 (August 31, 2006).

<sup>102</sup> Transcript of Proceedings, vol I, p. 91 (August 29, 2006).

<sup>103</sup> Transcript of Proceedings, vol I, p. 93 (August 29, 2006).

There can be no question that the gas prices in the winter of 2005-2006 are the highest in recent history. The Intervention Group's Late Filed Exhibit shows that the winter prices from 2000 through 2004 were far less than the winter prices from November 2005 through February 2006.<sup>104</sup> If you have a lag time of 90 days, and high winter prices, common sense tells you that using the 12 months May 2006 would understate the uncollectible expenses by excluding some of the uncollectible expenses from the winter. Mr. Buckner admitted this fact:

Q. Isn't it true that your \$95,000 number does not allow for the increased bad debt from this past winter?

A. To the extent of the lag, it may not for a little bit.<sup>105</sup>

The second critical error is Mr. Buckner's failure to consider the impact of the budget billing plan. The budget billing plan can greatly increase the Company's bad debt exposure. The example Mr. Waller gave is instructive. If you have a customer who owes \$200 in January and that customer goes on budget billing, he simply has to make a payment equal to the average of the last 12 months of his bills—which can be assumed to be \$50. So, in January the customer pays \$50, and the Company's exposure is \$150; in February, the customer pays \$50, but the exposure increases to \$300. At the end, the Company is more exposed and, if the customer chooses not to pay after the winter months pass, the Company has a higher uncollectible expense.<sup>106</sup> As budget billing was vastly increased last year per Authority order, Mr. Buckner's analysis does not account for this increased exposure.

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<sup>104</sup> Intervention Group Late Filed Exhibit at Nymex Closes 2000 (Sept. 8, 2006).

<sup>105</sup> Transcript of Proceedings, vol I, p. 95 (August 29, 2006).

<sup>106</sup> Transcript of Proceedings, vol X, pp. 31-32 (August 31, 2006).

**(e) Mr. Buckner Unreasonably Excluded the Environmental Clean-Up Costs.**

Atmos included certain environmental clean-up costs in its expenses that the CAPD excluded. The CAPD agrees that these fees were (i) approved by the Authority in 1994 for deferred accounting and treatment, and (ii) well within the estimate given to the Authority at that time.<sup>107</sup> These costs were as follows:

	<b>Company</b>	<b>CAPD</b>
<b>Environmental Expense</b>	\$ 637,802	\$ 0

Mr. Waller explained these expenses in his direct testimony:

Pursuant to Docket No. 94-02529, the Company received Commission authorization in 1994 to defer all costs related to environmental control requirements that were mandated by various federal and state agencies. The order specified that there would be no ratemaking treatment at that time, but the appropriate disposition of these costs would be determined in the Company's next rate proceeding. Since that order, Atmos has worked to clean up a Manufactured Gas Plant (MGP) site in Bristol, and has met requirements concerning five underground storage tank sites in Tennessee. These costs have been deferred as specified in that order, and have accumulated a total of \$1,233,407. In addition, Atmos is in the final phases of the clean up of a Johnson City MGP site, and projects to spend approximately \$680,000 on the project during the attrition period in this case. The Company believes it is entitled to full recovery of the historical and projected FY07 expenses totaling \$1,913,407, and is seeking to include this expense in this case. Atmos is flexible concerning the treatment of this expense, but would recommend a three year amortization beginning Oct 1, 2006.<sup>108</sup>

The CAPD excluded these costs, and cited as its bases (i) that the costs have not been "audited for veracity;" (ii) that it is unclear if whether the costs were "internally born"; and (iii) the CAPD believes that the period should be ten years, as opposed to the three proposed by Atmos. None of these bases should cause these expenses to be excluded.<sup>109</sup>

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<sup>107</sup> Transcript of Proceedings, vol. II, pp 33-34 (August 29, 2006).

<sup>108</sup> Pre-Filed Direct Testimony of Greg Waller, p. 6 (July 17, 2006).

<sup>109</sup> Pre-Filed Direct Testimony of Terry Buckner, pp. 9-10 (July 17, 2006).

The CAPD has taken no steps to audit these fees and, apparently, did not issue sufficient discovery to become satisfied with them. If the CAPD's position were accepted, it could forestall these fees ever being recovered by simply not auditing them. Moreover, these costs have been audited, in a sense, because the "have been incurred under the authority and oversight of the Tennessee Department of Environmental Control. The work is approved by them before its done."<sup>110</sup> Attached as collective Exhibit 3 to this brief are copies of various orders and agreements from the Tennessee Department of Environment and Conservation detailing the work to be performed by the Company. The Company finds it ironic that a state agency responsible for protecting the interests of the public can justify excluding costs incurred by the Company under the legal mandate, supervision and oversight of another state agency for the sole purpose of remediating the environment in Tennessee.

As to Mr. Buckner being unsure if the costs were "internally born", he could have asked. He admitted that he "didn't ask whether it's internally or externally borne."<sup>111</sup> By choosing to hold his uncertainty until the simultaneous rebuttal, Mr. Buckner demonstrated that he did not know because he did not want to know. As to the final criticism that three years is too short, Atmos already indicated that it was "flexible" as to the period of time that it is amortized. However, if the recovery is spread over that extended of a period of time, "it would be appropriate to allow for some carrying costs; in other words, to allow the unrecovered balance in rate base."<sup>112</sup> These costs should be included in the attrition year and the CAPD's position should be rejected.

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<sup>110</sup> Transcript of Proceedings, vol. X, p. 15 (Petersen); p. 33 (Waller) ("the plans for the work that is itemized by that \$680,000, have already been approved by the Tennessee environmental group that does that approval.").

<sup>111</sup> Transcript of Proceedings, vol II, p. 35 (August 29, 2006).

<sup>112</sup> Transcript of Proceedings, vol X, p. 15 (August 31, 2006) (Petersen).

**(f) The CAPD's Treatment of the Rate Case Expenses is Inappropriate.**

The CAPD and the Company agree to the amount of rate case expense (\$165,000), but differ in the period over which the expense should be amortized:

	<b>Company</b>	<b>CAPD</b>
<b>Rate Case Expense</b>	\$ 55,000 (3-year amortization)	\$ 16,500 (10-year amortization)

The sole justification for the CAPD's departure from established regulatory practice is that "the company has not had a rate case in ten years."<sup>113</sup> Atmos is proud that it has not "been before [the TRA] in this capacity in over ten years," and is "proud of the fact that we've been able to keep our prices the same for ten years."<sup>114</sup> However, it is obvious that this is the exception, not the rule. Mr. Buckner himself testified that he has seen three years, and five years, and relies solely on the rate case history of Atmos for his ten year amortization.<sup>115</sup> This is an insufficient basis on which to so far deviate from the standard practice; Atmos' three year amortization should be adopted by this Authority.

**(g) Mr. Buckner's Adjustment to Remove Approximately \$340,000 From the Amount of O&M Expense the Company Has Booked is Unsupported and Inappropriate.**

Although the CAPD asserted that it made the necessary adjustments to incorporate the impact of the consolidation of the Company's Mid-States and Kentucky Divisions, including the approximately \$320,000 increase in Operations and Maintenance ("O&M") expense, Mr. Buckner then proceeded to remove approximately that same amount as part of an overall adjustment to what he categorized as "other O&M."<sup>116</sup> As Mr. Waller explained, the overall impact of the consolidation to Tennessee was essentially a wash: O&M expense increased, but

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<sup>113</sup> Pre-Filed Direct Testimony of Terry Buckner, p. 10 (July 17, 2006); Transcript of Proceedings, vol II, pp. 37-38 (August 29, 2006).

<sup>114</sup> Transcript of Proceedings, vol IX, p. 99 (August 31, 2006).

<sup>115</sup> Transcript of Proceedings, vol II, P. 38 (August 29, 2006).

<sup>116</sup> Pre-filed Rebuttal Testimony of T. Buckner, pp. 11-2 (August 18, 2006).



that increase was offset by corresponding adjustments which reduced other taxes expense, depreciation expense, and rate base amounts.<sup>117</sup> The effect of Mr. Buckner's overall "other O&M" adjustment was that the CAPD accepted the benefits of the consolidation in the form of reduced expenses and reduced rate base, but rejected the increase in O&M expense necessitated by that same consolidation. As discussed more thoroughly below, Mr. Buckner's "other O&M" overall adjustment is unsupported and inappropriate.

Mr. Buckner's approximately \$340,000 overall adjustment to what he calls "other O&M" does not stem from a dispute concerning calculation methodology, and is not the result of differing positions as to whether costs have been prudently incurred, or whether costs should be included for ratemaking purposes.<sup>118</sup> Instead, Mr. Buckner reduces the Company's 2006 O&M expense by approximately \$340,000 to make the total expense number reflect what Mr. Buckner contends is a more reasonable growth rate than actually reflected in the Company's books.<sup>119</sup> Mr. Buckner does not contest the growth rate the Company has used to grow expenses from 2006 to 2007; rather, Mr. Buckner contends that the change in booked expenses from 2005 to 2006 and the increase in booked expenses within 2006 is somehow unreasonable. The basis for Mr. Buckner's criticism is the difference between the growth rate he contends is reflected in the Company's booked amounts, and what he contends a reasonable growth rate should be.

At the Hearing, some questions were raised as to Mr. Buckner's growth rate conclusions. For example, Mr. Buckner acknowledged that he assumed the Company used a 58% capitalization rate in calculating what he contended was a 7.23% growth rate in the labor portion of O&M expenses for 2007. Mr. Buckner admitted he failed to ask the Company what

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<sup>117</sup> Transcript of Proceedings v X, pp. 34-35 (August 31, 2006).

<sup>118</sup> Transcript of Proceedings, vol X, pp. 53-54 (August 31, 2006).

<sup>119</sup> Pre-filed Rebuttal Testimony of T. Buckner, pp. 11-2 (August 18, 2006).

capitalization rate was used. The Company actually used a 57% capitalization rate in calculating 2007 labor expense, which Mr. Buckner confirmed would lower his calculated growth rate from 7.23% to approximately 4.8%.<sup>120</sup>

Mr. Buckner's growth rate assumptions aside, by focusing his criticism on the actual booked expenses for 2005 and 2006, rather than the rate at which the Company grew projected expenses from 2006 to 2007, Mr. Buckner is not disputing the Company's projection methodology, but is instead challenging the amount of O&M expense reflected on the Company's books. Mr. Buckner has absolutely no basis on which to raise such a challenge. According to the uncontroverted evidence of Company witness Daniel Meziere, the Company's books and records are in full compliance with the FERC Uniform System of Accounts and Generally Accepted Accounting Principles, and are audited quarterly and annually by the independent public accounting firm of Ernst & Young.<sup>121</sup> The Company's books are accurate and complete, and the increase in expenses reflected in those books must be taken into account in setting the Company rates going forward.

As Mr. Waller pointed out at the Hearing, the fact that the Company's expenses have continued to increase demonstrates that the Company has been experiencing traditional attrition of its rate of return in the past, and will continue to experience such attrition in the future.<sup>122</sup> This is entirely consistent with Mr. Paris' pre-filed testimony, in which he explained while the Company's return in Tennessee started healthy, and remained steady for a period of years following the last rate case, around 2001, the Company began to experience the natural effects of attrition:

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<sup>120</sup> Transcript of Proceedings, vol III, pp. 8-12.

<sup>121</sup> Transcript of Proceedings, vol VII at p. 43 (August 31, 2006).

<sup>122</sup> Transcript of Proceedings, vol X, pp. 53-54 (August 31, 2006.)

Due in large part to plant improvements and system reinforcements necessitated by strong economic growth in our region, and steadily rising inflation, Atmos has no longer been able to increase efficiencies at a level sufficient to counteract the natural effects of attrition. This is natural and has occurred despite the best efforts of Atmos.<sup>123</sup>

The CAPD has steadfastly refused to accept this reality of attrition reflected in the audited books and records of the Company, insisting instead that Atmos' experience going forward will mirror that of the Company immediately following the last rate case over a decade ago. The CAPD's position is unsupported, and should be rejected. The Authority has no evidence before it upon which to reject the expenses reflected in the Company's books and records. As such, the Authority should reject the arbitrary \$340,000 overall adjustment Mr. Buckner made to the Company's 2006 O&M expense amounts.

### **3. Depreciation and Taxes are Understated by Mr. Buckner.**

The Company and the CAPD's forecast for depreciation and taxes are set forth below:

	<b>Company</b>	<b>Difference</b>	<b>CAPD</b>
Depr. & Amort. Expense	\$ 12,519,876	(\$ 813,111)	\$ 11,706,765
Taxes Other than Income Taxes	\$ 6,090,833	(\$ 686,882)	\$ 5,403,951
Income Taxes <sup>124</sup>	\$ 5,230,057	\$ 3,094,384	\$ 8,324,441

This section will discuss the differences between Atmos and the CAPD on these issues.

#### **(a) The Depreciation and Amortization Expense, Based on the Depreciation Calculated by Don Roff, are Proper and Should be Included.**

The difference of \$813,111 between Atmos' depreciation and amortization expense largely lies in the depreciation rates used by Atmos, which are based on a study conducted by Donald Roff. Mr. Roff is an eminently qualified expert who prepared the depreciation study for

<sup>123</sup> Pre-filed Rebuttal Testimony of J. Paris, pp. 5-6 (August 18, 2006).

<sup>124</sup> The difference between the parties' calculation of income taxes is, of course, due in large part to the parties' vastly different positions on net operating income and debt costs.

Atmos while he was employed by Deloitte & Touche LLP.<sup>125</sup> The primary driving forces behind the recommended change in annual depreciation expense are as follows: “by changes in retirement dispersion; by the depreciation procedure utilized; by changes in net salvage allowances; and the respective reserve position for each asset category. The General Plant functional category is impacted by a combination of these factors.”<sup>126</sup> The Roff Study recommends an Equal Life Group (“ELG”) procedure and the attached study amply supports the depreciation rates supplied by the Company used by the Company.

The CAPD rejects the Roff Study and depreciation rates for only one identifiable reason: in a recent case the Georgia Public Service Commission did not accept the Roff recommendation.<sup>127</sup> Obviously, the TRA should not depend on the Georgia Public Service Commission to set depreciation policy and/or depreciation rates for Tennessee. In fact, in the past the TRA has done just the opposite. The ELG procedure has been approved by the TRA for Chattanooga Gas (a fact of which Mr. Buckner was not aware).<sup>128</sup> Moreover, Mr. Buckner was simply unaware that the study was accepted in Virginia, Louisiana and parts of Texas.<sup>129</sup> While Mr. Buckner recommends “an independent depreciation study,” he made no efforts to accomplish such a study in this case. The depreciation is reasonable; it has not been substantively challenged in this docket; and it should be accepted in this docket.

#### **(b) Taxes Other Than Income Taxes**

In this category, there are six different taxes: (1) Property Taxes; (2) the TRA Inspection fee; (3) Payroll Taxes (FICA, FUTA, and SUTA); (4) State Franchise Tax; (5) State Gross

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<sup>125</sup> Pre-Filed Direct Testimony of Donald Roff at p. 2 (July 17, 2006).

<sup>126</sup> Pre-Filed Direct Testimony of Donald Roff at pp. 2-3 (July 17, 2006).

<sup>127</sup> Pre-Filed Rebuttal Testimony of Terry Buckner at p. 13 (August 23, 2006).

<sup>128</sup> Transcript of Proceedings v II, p. 39 (August 23, 2006).

<sup>129</sup> Transcript of Proceedings v II, p. 39 (August 23, 2006).

Receipts Taxes; and (6) Other General Taxes.<sup>130</sup> The CAPD number reflected above is slightly higher than was listed on TB-1 because Mr. Buckner corrected his testimony to increase his estimate of payroll taxes.<sup>131</sup> This correction effectively eliminated any dispute between the parties on payroll taxes,<sup>132</sup> and closed the gap on other taxes to \$686,882. As discussed more thoroughly below, this difference is due to: (1) Mr. Buckner disregarding all amounts for allocated taxes for assets located outside Tennessee, based on the CAPD's contention that the ratepayers should not be subject to taxes on assets or revenues located outside the state, regardless of whether they benefit from those assets or not; and (2) Mr. Buckner understating 2007 gross receipts tax expense by assuming gas costs will be equivalent to those incurred in September 2005, before the rise in gas costs following the 2005 hurricanes. Correcting for these fundamental flaws in the CAPD's analysis eliminates the difference between the parties' calculation of other taxes.

(i) **Allocated Taxes for the SSU in Texas Should Be Included in Other Taxes.**

A large portion of this difference is in "allocated taxes", which includes taxes allocated from outside the State of Tennessee.<sup>133</sup> These are taxes which are allocated from the shared services unit ("SSU") located in Texas,<sup>134</sup> and would include things such as property taxes for the buildings and facilities in Texas and payroll taxes for all of the employees that work at the call center.<sup>135</sup> The shared services unit in Texas provides **management services**, including accounting, human resources, legal, rate support, risk management, information technology, and

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<sup>130</sup> Pre-Filed Rebuttal Testimony of Terry Buckner at p. 15 (August 23, 2006).

<sup>131</sup> I, p. 72 (increasing payroll taxes by 79,206 for 2006)

<sup>132</sup> II, p. 9

<sup>133</sup> II, p. 9.

<sup>134</sup> II, p 9.

<sup>135</sup> II at p. 15

the call center.<sup>136</sup> These management services are not free—it costs money for Tom Petersen to prepare the 3.03 reports and the testimony in this case; it costs money for Dan Meziere and Jim Cagle to perform accounting for Tennessee and Mid-States;<sup>137</sup> and it costs money to run the call centers. This is common sense and is not in dispute.

Importantly, there has been no dispute in this case regarding the allocation methodology of the Company.<sup>138</sup> The CAPD has not challenged the allocation factors of the Company in any way, in any of its testimony. Equally important, there is no dispute as to how the Company keeps its books and records. Mr. Meziere confirmed the following:

[W]e do use the FERC Uniform Systems of Accounts, and we follow Generally Accepted Accounting Principles. And our books and records are audited quarterly and annually by the independent public accounting firm of Ernst & Young.<sup>139</sup>

No evidence from the CAPD would call this into any question.

The substance of Mr. Buckner's logic for excluding the shared services taxes is found in his Rebuttal Testimony:

Atmos has included a net \$153,789 in Other General Taxes. Much of this amount is attributable to an allocation of SSU taxes. [1] It is the CAPD's contention that, ratepayers should be subject to taxes on assets and or revenues derived solely within the jurisdiction of Tennessee. [2] Once more, there is no empirical calculations to document support for this amount.<sup>140</sup>

Mr. Buckner's jurisdictional limitation question ignores the realities of the marketplace, ignores the realities of the efficiencies of centralized management, and ignores the realities of the world in which we live. The only reason that Tennessee ratepayers would not have to pay for the services would be if they derived no benefit from them. Clearly, Atmos has shown that it does

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<sup>136</sup> II pp. 9-10

<sup>137</sup> VIII, pp. 40-41. Mr. Meziere is director of accounting services for Atmos; Mr. Cagle is manager of rates for Atmos.

<sup>138</sup> VII at p. 42 (Cagle) ("the allocation methodology is not really at issue").

<sup>139</sup> VII at p. 43 (Meziere)

<sup>140</sup> Rebuttal Testimony of Terry Buckner at p. 18 (August 24, 2006).

benefit Tennessee ratepayers with its SSU. At the hearing, Atmos asked him to confirm his testimony:

Q. Are you withdrawing the statement that Tennessee ratepayers should not have to pay for things that are not located within the state of Tennessee?

A. Not really.<sup>141</sup>

While it is unclear, Mr. Buckner appeared to rely on his allegation that there is no empirical calculations to support the calculation. Again, if Mr. Buckner needed more support, he should have asked in this docket, and had the opportunity to do so after the testimony was filed.<sup>142</sup>

It is an incredible allegation to state that solely because the assets are located in Texas, and Mr. Buckner did no follow-up discovery, that the SSU allocated taxes should be excluded. This result would be inconsistent with the TRA's established practice, as indicated by its treatment of Chattanooga (who has assets outside Tennessee that are allocated). In short, these allocated taxes should be permitted.

## **(ii) Gross Receipts Taxes**

The remainder of the approximate \$700,000 difference between the amounts used by the CAPD and the Company for other taxes is in the different calculations of gross receipts taxes. Atmos pays a gross receipts tax on the total amounts collected from ratepayers in Tennessee, which includes both the amounts collected as margin and those amounts collected to reimburse Atmos for its cost of gas.<sup>143</sup> The Company explained its methodology for projecting other tax expense, which includes gross receipts tax, in the pre-filed direct testimony of Mr. Waller.<sup>144</sup> As Mr. Petersen explained at the Hearing, the CAPD and Company gross receipts numbers for 2006

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<sup>141</sup> Transcript of Proceedings v II, p. 13 (August 29, 2006).

<sup>142</sup> Transcript of Proceedings v II, p. 17 (August 29, 2006).

<sup>143</sup> Transcript of Proceedings, v II, pp. 20-21 (August 29, 2006).

<sup>144</sup> Pre-Filed Direct Testimony of Greg Waller, p. 8 (July 17, 2006).

were substantially the same; the difference arises between the parties' 2007 numbers.<sup>145</sup> Specifically, Mr. Buckner shows the Company's gross receipts tax expense declining sharply from 2006 to 2007.<sup>146</sup> At the Hearing, Mr. Buckner admitted that the sharp decline in his calculation was due to two factors: (1) he had assumed in his calculation that the Company's rates would be lowered by the full \$12 million recommended by the CAPD; and (2) he had assumed in his calculation that gas costs would be equivalent to those reflected on the September 2005 3.03, before the sharp rise in gas costs due to the hurricanes of 2005.<sup>147</sup> Mr. Buckner had no knowledge of what gas costs were at September 2005, or what they are predicted to be in the future, and he admitted he had no basis to support his assumption that gas costs would return this winter to pre-hurricane levels.<sup>148</sup> Although Mr. Buckner implied at the hearing that adjusting his gross receipts tax to reflect a higher cost of gas would also result in a change to excise tax that would somehow lessen the total rate impact, Director Miller correctly recognized that excise taxes are taxes on net earnings, or profits, which do not rise correspondingly with increased gas costs.<sup>149</sup> Mr. Buckner conceded Director Miller's point, and acknowledged his understatement of gross receipts tax was not rendered immaterial by any necessary adjustment to excise tax.<sup>150</sup> Therefore, the evidence at the Hearing clearly demonstrated that Mr. Buckner's gross receipts calculation was patently incorrect. Given that the only criticism Mr. Buckner raised to the Company's calculation was that it was not the same as his, the Company's number is uncontradicted, and should be adopted by the Authority for ratemaking purposes.

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<sup>145</sup> Transcript of Proceedings, v X, pp. 17-18 (August 31, 2006).

<sup>146</sup> Transcript of Proceedings, v II, p. 17 (August 29, 2006).

<sup>147</sup> *Id.* at pp. 20-23; Transcript of Proceedings, v X, pp. 17-18 (August 29, 2006).

<sup>148</sup> Transcript of Proceedings, v II, p. 22 (August 29, 2006).

<sup>149</sup> Transcript of Proceedings, v III, p. 20 (August 30, 2006).

<sup>150</sup> *Id.*



Correcting Mr. Buckner's other tax calculation to remove the impact of the errors discussed above in his gross receipts and allocated tax numbers eliminates the approximate \$700,000 difference between the parties' calculation of other taxes.

**4. Mr. Buckner's Rate Base Calculation Contains Several Fundamental Errors Which Result in a Rate Base Conclusion Which is Significantly Understated.**

Mr. Buckner's rate base calculations contain several fundamental errors, the most significant of which are discussed separately below. As demonstrated in the following sections, adjusting Mr. Buckner's calculations to remove these fundamental errors results in a rate base calculation which is substantially equivalent to the Company's rate base amount.

**(a) The Disappearing Construction Work in Progress (CWIP) – Error of Approximately \$2 million.**

One of the most significant errors in Mr. Buckner's rate base calculation was referenced in the Company's rebuttal testimony and at the Hearing as the "disappearing CWIP." This refers to the fact that by projecting Gross Plant and CWIP independently, Mr. Buckner ignored the process by which capital spending goes through CWIP to become Gross Plant, and by doing so, "lost" almost \$200,000 of capital additions to Gross Plant for the 2006 fiscal year. This disappearing CWIP error was described in detail in the pre-filed rebuttal testimony of Tom Petersen and Greg Waller.<sup>151</sup> Mr. Buckner acknowledged his error. In revised schedules filed August 28, 2006, the day before the Hearing, Mr. Buckner included a correction to his 2006 rate base calculation to remove the impact of the disappearing CWIP.<sup>152</sup> However, Mr. Buckner inexplicably made no correction to his 2007 rate base calculation, which contained the same disappearing CWIP error. Of course, because the CAPD did not present any 2007 numbers until their rebuttal testimony, filed the same day as the Atmos rebuttal testimony, Atmos was unable

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<sup>151</sup> Pre-filed Rebuttal Testimony of Tom Petersen and Greg Waller, pp. 8-9 (August 18, 2006).

<sup>152</sup> Exhibit: *Consumer Advocate and Protection Division, 2006 Forecast Comparative*, filed August 28, 2006, at fn. A.

to reference the 2007 disappearing CWIP in pre-filed rebuttal testimony. At the hearing, Mr. Petersen explained that the impact of the disappearing CWIP on Mr. Buckner's 2007 rate base amount is approximately \$2 million.<sup>153</sup>

**(b) Prepayments – Error of Approximately \$800,000.**

As Atmos witness Tom Petersen explained in pre-filed and hearing testimony, the Company was unable to perform a lead lag study under the time constraints of this docket.<sup>154</sup> Therefore, the Company has requested no amounts for cash working capital be included in rate base.<sup>155</sup> However, pursuant to standard regulatory practice followed by numerous state commissions, the Company requested the amount of prepayments reflected on its books, \$861,072, be included in rate base.<sup>156</sup>

Mr. Buckner excluded the amount of prepayments from rate base, citing to orders from Atmos rate cases in Virginia and Georgia awarding the Company \$0 in cash working capital in the absence of a lead lag study.<sup>157</sup> At the Hearing, Mr. Buckner had no response when it was pointed out that both of those orders also permitted the Company to include the amount of booked prepayments in rate base, just as the Company is requesting in this docket.<sup>158</sup> Mr. Buckner also admitted at the Hearing that the treatise he cited in his pre-filed testimony, and confirmed was an authoritative ratemaking treatise, expressly recognized that as a general rule, prepayments are treated separately from cash working capital, and are generally included in rate base.<sup>159</sup> They should be included in this case as well.

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<sup>153</sup> Transcript of Proceedings, vol. X, pp. 18-19 (August 31, 2006).

<sup>154</sup> Transcript of Proceedings, vol X, pp. 19-20 (August 31, 2006).

<sup>155</sup> Transcript of Proceedings, vol II, p. 48 (August 29, 2006).

<sup>156</sup> *Id.* at p. 44.

<sup>157</sup> Pre-filed Rebuttal Testimony of T. Buckner, pp. 21-22 (August 18, 2006).

<sup>158</sup> Transcript of Proceedings, vol II, p. 45.

<sup>159</sup> Transcript of Proceedings, vol II, pp. 45-47.

**(c) Accumulated Depreciation Reserve – Error of Approximately \$645,000.**

As Mr. Petersen explained at the hearing, in calculating the accumulated depreciation to be deducted from rate base, Mr. Buckner used amounts from a schedule including no offsetting retirement work in progress costs, rather than trial balance amounts for the total account.<sup>160</sup> In doing so, Mr. Buckner overstated the accumulated depreciation deduction from rate base by approximately \$645,000.

**(d) Accumulated Deferred Tax – Error of Approximately \$6.9 million**

Mr. Buckner has contended Atmos' projected amount of accumulated deferred tax (approximately \$33 million) to be deducted from rate base should be increased by approximately \$6.9 million (to the CAPD amount of approximately \$40 million) to correct for what he claims are contradictions between Atmos' projection and actual reported amounts.<sup>161</sup> However, the amounts included in Mr. Buckner's pre-filed testimony as "reported amounts," are simply incorrect. It appears that the amounts Mr. Buckner is presenting as "reported amounts" are actually fully allocated reported amounts *plus* additional amounts he derived from the Company's data responses. That error aside, the amount of fully allocated accumulated deferred tax per books reported on the June 2006 3.03 report is \$32,806,983. Therefore, it is evident that Atmos' projection of approximately \$33 million is much more in line with reported per books amount than the CAPD amount of approximately \$40 million. Atmos' projection is the correct number, and should be adopted by the Authority.

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<sup>160</sup> Transcript of Proceedings, vol X, pp. 18-19 (August 31, 2006).

<sup>161</sup> Pre-filed Rebuttal Testimony of T. Buckner, pp. 22-25 (August 18, 2006).

**C. THE COMPANY'S CAPITAL STRUCTURE AND COST OF CAPITAL RECOMMENDATIONS SHOULD BE ADOPTED BY THE AUTHORITY.**

The following chart summarizes the different rate of return recommendations set forth by the Company, Authority Staff, and the CAPD:

	<b>Company</b>	<b>Authority Staff</b>	<b>CAPD</b>
<b>Capital Structure</b>	50% debt 50% equity (Target Capital Structure)	56.91% debt 43.09% equity (Actual Capital Structure at September 30, 2005 with Projections to September 30, 2006 from 10-K Reports)	43.1% long-term debt 12.6% short-term debt 44.3% equity (Comparable Company Capital Structure)
<b>Cost of Debt</b>	6.03% (Actual Atmos Cost of Debt ending April 30, 2006)	5.77% (Projected Average Cost of Debt for September 30, 2006)	long-term debt 5.52% short-term debt 5.09% (Comparable Company Cost of Debt)
<b>Cost of Equity</b>	12% (DCF and CAPM Analyses)	10.75% (DCF and CAPM Analyses)	8% (Modified DCF Ignoring Capital Gains and Modified CAPM Using Raw Calculated Beta)

Each of these differences is discussed at length in both the pre-filed and live testimony presented by Staff and Company cost of capital witnesses. The discussion below highlights some of the more significant disparities.

**1. Capital Structure**

Both the Company and Authority Staff witnesses agree that Atmos does not use short-term debt as permanent capital to support physical utility assets, and therefore short-term debt should be excluded from the Company's capital structure for ratemaking purposes.<sup>162</sup> Therefore, the Authority should not include short-term debt in Atmos' capital structure.

<sup>162</sup> Pre-filed Direct Testimony of J. Kettles, pp. 4-5 (July 17, 2006) (noting that "[a]s a general rule, only permanent financing elements should be included in the capital structure."); Pre-filed Direct Testimony of D. Murry, pp. 12-13 (July 17, 2006) (noting that "Atmos Energy's short term debt fluctuates greatly, and even disappears for periods of time.").

As for the overall percentage of long-term debt versus equity, Staff witness Mr. Kettles projected a capital structure consisting of 56.91% debt based on his determination of the debt level that will exist as of September 30, 2006.<sup>163</sup> However, Mr. Kettles recognized that the Company's current debt level is higher than normal due to the recent TXU acquisition, among other things, and that the Company has a committed publicly to work toward returning to its target capital structure of no more than 50% debt, and that it intends to be within 5% of that goal in the next three to five years.<sup>164</sup> Mr. Kettles also stated that his own analysis confirmed that the Company is taking the required steps to reach its target capital structure.<sup>165</sup> Therefore, Mr. Kettles' testimony confirms that the Company is moving towards its stated target capital structure. Mr. Kettles' conclusion that the Company would not reach its goal was based on his assumption that September 30, 2006 is the appropriate test period for setting rates in this docket. As such, if the Authority follows the previous ruling of Director Jones and finds that the agency must consider attrition adjustments which are forward looking from the date of the order, by Mr. Kettles' own acknowledgement, the equity percentage should increase.

In addition, Mr. Kettles' conclusions regarding the appropriate equity percentage were based in part on a data response the Company provided in this docket which asked for any projections the Company had with respect to future equity percentages.<sup>166</sup> As Dr. Murry explained, the response provided by the Company was from the only equity percentage projections the Company had, an internal budgeting and planning document. For internal budgeting and planning purposes, the Company assumes no issuances of common stock will occur. Therefore, the numbers presented in the Company's data response represent project

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<sup>163</sup> Pre-filed Direct Testimony of J. Kettles, p. 5.

<sup>164</sup> *Id.* at pp. 4-5.

<sup>165</sup> *Id.* at p. 6.

<sup>166</sup> *Id.*

equity percentages, assuming that the Company does not issue any common stock.<sup>167</sup> It appears that Mr. Kettles may have misinterpreted the data response, which is certainly understandable given the amount of data responses that have been provided and the unprecedented pace of this docket.

Therefore, the Authority should adopt the Company's proposed capital structure presented by Atmos Treasurer Laurie Sherwood, 50% debt and 50% equity.

## **2. Cost of Debt**

The cost of debt calculated by both Staff witness Kettles and CAPD witness Brown is substantially lower than the Company's current actual cost of debt.<sup>168</sup> At the hearing, a question was raised as to why the actual cost of debt used by Company witness Dr. Murry included amounts for Account 4270. Dr. Murry's cost of debt is calculated in Schedule DAM-7. Included in that schedule is Account 4270, which is the amortization of debt expense and debt discount account. This Account represents the annualized amortization of the Treasury lock hedges expense (labeled "T-lock" on Schedule PW-10). The Company entered into these hedges in 2004, after agreeing to acquire TXU Gas, in order to mitigate the risk that long-term interest rates could rise significantly between then and the anticipated closing date. These Treasury lock agreements effectively locked in the Treasury yield component of the interest rate associated with the anticipated issuance of \$875 million of long-term debt to partially fund the acquisition. For accounting purposes, these Treasury locks were treated as cash flow hedges of an anticipated transaction. When Atmos issued the long-term debt in October 2004 after closing the acquisition, long-term interest rates had fallen instead of risen, and the Company was required to settle the hedges by paying a net \$43.8 million to the hedge counterparties. This

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<sup>167</sup> Transcript of Proceedings, vol VIII, p. 22 (August 31, 2006).

<sup>168</sup> Pre-filed Rebuttal Testimony of Tom Petersen and Greg Waller, p. 13; Transcript of Proceedings, vol X, pp. 20-21 (August 31, 2006).

realized loss is being amortized over the life of the associated securities and is recognized as a component of interest expense, just as debt issuance premiums or discounts are.

Mr. Kettles and Dr. Brown's computations of the cost of long-term debt should be adjusted to reflect the Company's actual cost of debt.

### **3. Cost of Equity**

As Dr. Murry and Mr. Kettles explained in pre-filed and live testimony, Dr. Brown's cost of equity analysis advances an entirely new theory of finance and economics which is not a generally accepted method within the field.<sup>169</sup> As such, the Authority must reject Dr. Brown's analysis, as it has in previous gas rate cases.<sup>170</sup>

As Dr. Murry explained in his pre-filed and live testimony, one of the more significant differences between his analysis and that of Mr. Kettles is the fact that Mr. Kettles did not consider the Ibbotson Associates' recommended size adjustment, which corrects for a statistical bias within the CAPM analysis that understates the cost of capital of smaller firms like Atmos.<sup>171</sup> At the Hearing, Mr. Kettles acknowledged that the statistical bias within the CAPM analysis exists, and that it results in an understatement of the cost of capital for smaller firms like Atmos.<sup>172</sup> Mr. Kettles also acknowledged that Ibbotson's, which Mr. Kettles recognizes as an authoritative source and relies on for his conclusions elsewhere in his analyses, recommends that the fix to correct for this statistical bias is to apply the size adjustment, as Dr. Murry has done.<sup>173</sup> Mr. Kettles questioned whether the size adjustment is "granular" enough to be used, but in the end concludes that "until we get something more definitive about industry size, I think we should

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<sup>169</sup> Transcript of Proceedings, vol VI, pp. 18-19 (August 30, 2006).

<sup>170</sup> See Chattanooga Gas Company rate case Docket No. 04-0034.

<sup>171</sup> Pre-filed Rebuttal Testimony of D. Murry, pp. 2-4 (August 18, 2006).

<sup>172</sup> Transcript of Proceedings, vol VI, pp. 15-16 (August 30, 2006).

<sup>173</sup> *Id.* at pp. 15-16.

consider both the firm size adjustment and the standard CAPM model.”<sup>174</sup> Dr. Murry was the only cost of capital witness in this docket that included in his CAPM analysis the size adjustment that Mr. Kettles agrees this Authority should consider in addition to the standard CAPM analysis. As Dr. Murry explained, if Mr. Kettles’ analysis were adjusted to account for his omission of the size adjustment, the corrected analysis would produce a result very similar to Dr. Murry’s recommended rate of equity of 12%.<sup>175</sup> Therefore, the Authority should adopt Dr. Murry’s recommended rate of equity of 12%.

**D. WHATEVER TEST YEAR IS CHOSEN IN THIS DOCKET MUST INCLUDE ATTRITION ADJUSTMENTS WHICH ARE FORWARD LOOKING FROM THE DATE OF THE ORDER.**

Atmos has already presented the law governing the selection of the test year in this case and the consideration of forward looking attrition adjustments. (*See generally* 8/28/2006 Atmos Bench Br. on Appropriate Test Year and Attrition Period Adjustments (“Bench Brief”).) Authority Staff and the CAPD have urged the Authority to deviate from established TRA practice and set rates for Atmos based on the historic test year ended September 30, 2006, with no forward looking adjustments. In support of this argument, 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

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<sup>174</sup> *Id.* at p. 16.

<sup>175</sup> Pre-filed Rebuttal Testimony of D. Murry, pp. 3-4 (August 18, 2006).



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.<sup>176</sup> 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 case<sup>177</sup> 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.”<sup>178</sup>

Director Jones’ ruling clearly finds that the TRA must consider attrition period adjustments in this case which are forward looking from the order, as required by the opinion in *South Central Bell*.

This is simply a recognition of established Tennessee law. In the *South Central Bell* case, the Appellate Court quoted approvingly from the Chancellor’s opinion, stating: “A rate order which only takes into account the changes that have taken place before the effective date of

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<sup>176</sup> 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.

<sup>177</sup> 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.

<sup>178</sup> 5/22/2006 Hearing Trans. at p. 2-3.

the order and ignores changes reasonably certain to occur after the date of the order is looking backward and not to the future.” *South Central Bell*, 579 S.W.2d at 435.

**E. THE TARIFF PROPOSALS OF THE INTERVENTION GROUP SHOULD BE REJECTED BECAUSE THE FULL IMPACT ON BOTH THE WINNERS AND THE LOSERS IS NOT FULLY KNOWN**

Throughout this expedited rate case, there have been a number of conflicts regarding the Intervention Group. These disputes range from the Intervention Group’s initial refusal to even identify who its clients were;<sup>179</sup> to Earl Burton’s membership in the Group when he is an undisputed competitor of Atmos Energy Marketing (“AEM”);<sup>180</sup> to the questionable tactics the Intervention Group has used in recruiting new clients;<sup>181</sup> to the Intervention Group’s claim that it has a common interest with the CAPD and TRA Staff when it represents from 2 to 5 commercial and industrial customers;<sup>182</sup> to the ethically questionable compensation arrangements of the “team of three [Novak, Burton, and Walker] working toward serving the clients in this case”.<sup>183</sup> These background disputes are amply argued in the record of this case and that record speaks for itself.

Because of the compensation arrangements and other indicia of unreliability of Mr. Novak’s testimony, Atmos filed a Motion in Limine to Exclude the Testimony of Hal Novak.<sup>184</sup> While the Hearing Officer denied the Motion in Limine, it was clear that this was competent

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<sup>179</sup> Early in this case, Director Miller sent a letter requesting that all parties in the proceeding identify who their clients were. Letter from Director Miller to Ron Jones (June 8, 2005). The Intervention Group objected and sought to convince Director Jones to “decline to grant Director Miller’s request,” and to keep the identities of the clients of the Group a mystery. Letter from Henry Walker to Ron Jones at p. 4 (June 16, 2006).

<sup>180</sup> See Affidavit of Earl Burton, attached to Letter from Henry Walker (June 19, 2006); Order Resolving Discovery and Protective Order Disputes and Requiring Filings at p. 19 (June 14, 2006) (“Mr. Burton is without question associated with the marketing of services in competition with AEM”).

<sup>181</sup> See Letter from Misty Kelley at pp. 1-2 (5/12/2006).

<sup>182</sup> See Order Resolving Second Round of Discovery Disputes at pp. 3-12 (August 11, 2006) (setting forth the positions of the Intervention Group, the Staff and the CAPD on the common interest privilege and overruling the same).

<sup>183</sup> Transcript of Proceedings v VI, pp. 69-70 (August 30, 2006); see Atmos Motion in Limine to Exclude the Testimony of Hal Novak at p. 4 (August 11, 2006).

<sup>184</sup> Atmos Motion in Limine to Exclude the Testimony of Hal Novak at p. 4 (August 11, 2006).

evidence to consider in weighing the credibility of Mr. Novak's testimony: "The panel may consider the facts brought forth through the arguments on the motion in the course of evaluating the weight and credibility to be afforded Mr. Novak's testimony."<sup>185</sup> In light of that Order, this discussion will focus on two broad subjects: (1) the questionable motives and bias of Mr. Novak (and, by implication, the Intervention Group), the only witness offered by the Intervention Group; and (2) the merits of the proposals of the Intervention Group, including the late-filed exhibit of Hal Novak.

**1. Hal Novak, who is the Mouthpiece of the Intervention Group, is Biased and His Testimony Should be Given No Weight.**

When asked to identify the current "members" of the Intervention Group, Mr. Novak made clear that Mr. Burton (a competitor of AEM) was a principal member, stating that "[t]here is a team of three [Mr. Burton, Mr. Walker and Mr. Novak] working towards serving the clients in this case".<sup>186</sup> Under the original fee agreement of the Intervention Group (which was altered after Atmos filed its Motion in Limine), Mr. Burton, Mr. Walker and Mr. Novak agreed to an "even split" of any proceeds of the Intervention Group from its clients in this case: "initially we were to receive one-third of the proceeds from the [ ] Intervention Group clients between Mr. Walker [1/3], Mr. Burton [1/3] and myself [1/3], an even split."<sup>187</sup> Incredibly, Mr. Novak testified that when he entered into this fee arrangement he did not have an understanding about much money he would be paid.<sup>188</sup> Mr. Novak would have this Panel hold that he accepted 1/3 of a contingency question mark.

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<sup>185</sup> Order on Motions in Limine, Motion for Permission to Seek Interlocutory Appeal and Other Matters, p. 9 (August 23, 2006).

<sup>186</sup> Transcript of Proceedings v VI, pp. 69-70 (August 30, 2006). Mr. Novak, Mr. Burton and Mr. Walker are collectively referred to as the "Principal Members" of the Intervention Group to distinguish them from customers.

<sup>187</sup> Transcript of Proceedings v VII, pp. 4-5 (August 31, 2006).

<sup>188</sup> Transcript of Proceedings v VII, p. 4 (August 31, 2006).

When he filed his testimony on July 17, 2006, this contingency fee arrangement was in place.<sup>189</sup> In that testimony, Mr. Novak gave a three-line endorsement to the ultimate revenue requirement conclusions of the CAPD in this case in the pre-filed testimony in this case.<sup>190</sup> This endorsement came after, at most, a five day review,<sup>191</sup> and came after Mr. Walker sent an e-mail to the CAPD witnesses stating: “As soon as you can, please send Hal a draft of your testimony so he can review it. *I want him to say in his testimony he agrees with your analysis and numbers.*”<sup>192</sup> It was also shown that based on the customer agreement of the Intervention Group, that Mr. Walker, Mr. Novak and Mr. Burton would benefit from this endorsement by collecting a contingency fee of 1/3 of each client’s base rate reduction:

Q. Have you seen this exhibit before that outlines the terms of a proposed contingency fee agreement?<sup>193</sup>

A. Not that I recall.

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Q. This schedule shows that the intervention group will be paid for years one through three for clients choosing a contingency fee arrangement 33 percent of the reduction in Atmos base rates. Is that correct?

A. That is what that agreement shows.

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Q. [Y]our only testimony as to a reduction in base rates is on the bottom of page 12 of your direct testimony. Isn’t that right?

A. That’s correct.

Q. Those three lines?

A. Yes.<sup>194</sup>

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<sup>189</sup> Transcript of Proceedings v VII, p. 5 (August 31, 2006).

<sup>190</sup> Pre-Filed Direct Testimony of Hal Novak at p. 12 (July 17, 2006) (“[The Intervention Group] agrees with the CAPD’s calculation of revenue surplus for this case and recommends that it be adopted by the TRA.”).

<sup>191</sup> Transcript of Proceedings v VI pp. 80 (August 30, 2006). Moreover, it appears from Mr. Novak’s testimony that he either did not produce all of his workpapers, or that he actually only spent one weekend with the CAPD’s testimony prior to making his recommendation. *Id.* at pp. 81-85.

<sup>192</sup> Transcript of Proceedings v VI pp. 79 (August 30, 2006).

<sup>193</sup> See Letter from Earl Burton soliciting customers for the Intervention Group, at the Customer Agreement Ex. A (4/20/2006), attached to the Letter from Misty Kelley (May 12, 2006).

Mr. Novak’s “endorsement” of the CAPD’s testimony should be given no weight by this Panel because it is tainted by his own questionable financial motivations.<sup>195</sup>

While Mr. Novak made clear that “Mr. Burton does discuss issues with the clients of Atmos Intervention Group,”<sup>196</sup> it was also shown that the principal members of the Intervention Group have not followed through on their promises to the customers that they represent:

EARL BURTON’S PROMISE TO THE CUSTOMERS IN THE GROUP	MR. NOVAK’S ADMISSION
<p><u>“Every effort will be made during this intervention to ensure that the value of our efforts flow to the customers that support the intervention.”<sup>197</sup></u></p>	<p>“Q. But you haven’t made any effort to ensure that the value of your efforts flows through [to] the customers that support the intervention, have you?</p> <p>A. There is no way to work within the existing framework of a tariff to say this rate reduction flows only to a select number of customers.</p> <p>Q. So the answer is no?</p> <p>A. So the answer is no.”<sup>198</sup></p>

Obviously, such promises are improper if there is “no way to” accomplish them, and calls into question the motives of Mr. Burton and the understandings of the clients of the Intervention Group.

Finally, the testimony is unreliable based on Mr. Novak’s methodology and Earl Burton’s participation in preparing it. He did not have any direct discussions with the clients of the

<sup>194</sup> Transcript of Proceedings v VI, pp. 86-88 (August 30, 2006).

<sup>195</sup> In order that this is made clear to the clients of the Intervention Group, the Panel should make clear that it is not relying on this testimony for its findings.

<sup>196</sup> Transcript of Proceedings v VI, pp. 72 (August 30, 2006).

<sup>197</sup> Transcript of Proceedings v VI, pp. 76 (August 30, 2006) (*See* Letter from Earl Burton soliciting customers for the Intervention Group (4/20/2006), attached to the Letter from Misty Kelley (May 12, 2006) (emphasis in original).)

<sup>198</sup> Transcript of Proceedings v VI pp. 75-76 (August 30, 2006).

Intervention Group.<sup>199</sup> All the information that Mr. Novak had regarding the clients of the Intervention Group was received from Mr. Burton.<sup>200</sup> Mr. Novak testified that even though he has known Mr. Burton for 20 years, and talked to him “practically every day” in preparing for the hearing, Mr. Novak did not know whether Mr. Burton was a competitor with AEM (a fact which should have been relevant to the expert who is relying on the information).<sup>201</sup> Furthermore, Mr. Burton approved the filing of the testimony and was given drafts in which Mr. Novak told him that he would “have some heavy editing to do on certain sections of [Mr. Novak’s] testimony.”<sup>202</sup>

On the whole, Mr. Novak’s testimony is unreliable and should be rejected by this Panel.

**2. Hal Novak’s Proposals Should be Rejected by this Commission.**

Atmos has made it clear in this proceeding that it is not opposed to rate design changes in this case. As stated by the Atmos witnesses, Gary L. Smith and Danny Bertotti, on the subject: “if a rate design restructuring would better meet the needs of its customers, Atmos is open to it.”<sup>203</sup> However, Atmos’ commitment to all of its customers means that “the Company moves forward with rate design changes that are thoughtful and deliberate and take into consideration all customers’ interests.”<sup>204</sup> Mr. Novak’s proposals are neither thoughtful, nor deliberate. First of all, Mr. Novak did not prepare a class cost of service study, and without it, “it’s impossible to know if the rate for one class of customers is too high, thereby resulting in a subsidy to other

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<sup>199</sup> Transcript of Proceedings v VII, p. 11 (August 31, 2006).

<sup>200</sup> *Id.*

<sup>201</sup> Transcript of Proceedings v VII, p. 11-13 (August 31, 2006).

<sup>202</sup> Transcript of Proceedings v VII, p. 15 (August 31, 2006).

<sup>203</sup> Pre-Filed Rebuttal Testimony of at p. 6 (August 23, 2006).

<sup>204</sup> *Id.* at p. 7.

customer classes.”<sup>205</sup> Second, if adopted, there will be winners and losers within the class, with some customers benefiting at the detriment of other customers.<sup>206</sup>

In his opening statement, Mr. Novak testified that the changes he is proposing to “move [Atmos’] commercial and industrial rate structure closer to what [the TRA] has approved for Chattanooga Gas and Nashville gas.”<sup>207</sup> Similarly, Mr. Novak stated in his pre-filed testimony that his changes were “designed solely to put Atmos on equal footing with Chattanooga.”<sup>208</sup> However, despite Mr. Novak’s representation, there are numerous and significant differences between Mr. Novak’s proposals and the existing tariffs of Chattanooga and Nashville.<sup>209</sup>

Finally, at the hearing Director Jones asked Mr. Novak to submit a late-filed exhibit supporting his analysis that “there may be instances where winter gas may be cheaper than summer gas.”<sup>210</sup> This late filed exhibit was made on September 8, 2006.<sup>211</sup> However, there are both obvious and subtle problems with Mr. Novak’s comparison. One critical flaw is Mr. Novak’s “analysis” is based on comparison of summer and winter prices within a calendar year. Typically, gas is stored at average summer prices then withdrawn the following winter. For instance, gas bought in the summer of 2006 will be used in the winter of 2006 to 2007. Therefore, using AIG’s definition of summer average and the winter low, except comparing the summer average with the lowest NYMEX price during the subsequent winter:

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<sup>205</sup> Transcript of Proceedings v VII, pp. 16-17 (August 31, 2006).

<sup>206</sup> Transcript of Proceedings v VII, pp. 19-20, 46-47, 49 (August 31, 2006).

<sup>207</sup> Transcript of Proceedings v VI, p. 59 (August 30, 2006).

<sup>208</sup> Pre-filed Rebuttal Testimony of Hal Novak, p. 2 (August 23, 2006).

<sup>209</sup> Transcript of Proceedings v VI, pp. 23-39 (August 31, 2006).

<sup>210</sup> Transcript of Proceedings v VII, p. 53-54 (August 31, 2006).

<sup>211</sup> See Late-Filed Exhibit of Intervention Group (September 8, 2006).



SUMMER AVERAGE	WINTER LOW
2000 at \$ 4.20	2000-2001 at \$ 5.00
2001 at \$ 3.36	2001-2002 at \$ 2.01 <sup>212</sup>
2002 at \$ 3.23	2002-2003 at \$ 4.14
2003 at \$ 5.31	2003-2004 at \$ 4.86 <sup>213</sup>
2004 at \$ 6.29	2004-2005 at \$ 6.21
2005 at \$ 6.92	2005-2006 at \$ 7.11 <sup>214</sup>

It is patently misleading to say that “in 6 of the last 7 years there were months during the winter where actual the NYMEX close was lower than the summer average.” Instead, the data supports that the summer average is higher than the winter low in three out of the last seven years. Moreover, in these exceptional cases where the winter price falls below the preceding summer average, the softer market is due to improved supply versus demand balance (warmer than normal weather, high storage levels, etc.). Thus the likelihood of Atmos needing to obtain market supply during those periods would be very low. Conversely, the periods in which we would be shopping for market supply to accommodate the release of storage would be peak periods, when the price would most likely be highest.

In short, all of Mr. Novak’s proposals should be rejected at this time.

### **III. CONCLUSION**

The evidence contained in the full record of these proceedings clearly demonstrates that the only way this Authority may conclude Atmos’ rates should be significantly reduced is by jettisoning years of well-settled regulatory practice and precedent and treating Atmos differently. The unique manner in which this case was initiated and has progressed to date does not justify such disparate treatment for Atmos. The Authority has defined the task

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<sup>212</sup> Market lower all 4 winter months.

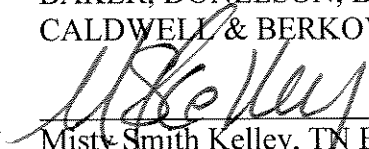
<sup>213</sup> Market lower in 2 winter months.

<sup>214</sup> Market lower in 1 winter month.

before it as setting the rates for Atmos going forward, just as the agency does for any utility. In setting Atmos' rates for the future, the Authority should follow the well-established, tested and reliable ratemaking precedent and procedures the agency has applied numerous times before. If the Authority does so in this case, the result is clear: Atmos' current rates should be increased, not decreased. Therefore, Atmos respectfully requests that the increase it has proposed be granted.

Respectfully Submitted,

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**CERTIFICATE OF SERVICE**

I hereby certify that a true and correct copy of the foregoing has been hand-delivered, e-mailed or faxed and mailed to the following parties of interest this 15th day of September, 2006.

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