

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

**September 15, 2006**

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

Docket No. 05-00258

TRA DOCKET ROOM

SEP 15 2006

SEP 15 2006

---

**POST-HEARING BRIEF OF TRA INVESTIGATIVE STAFF  
ADDRESSING "COST OF CAPITAL"**

---

Pursuant to the Tennessee Regulatory Authority's ("Authority") directive at the close of the evidentiary hearing in this matter on August 31, 2006, in lieu of a closing argument, the TRA Investigative Staff ("Staff") files this post-hearing brief to specifically address the "cost of capital" issue testified to by Mr. Jerry Kettles. Concerning all accounting and rate base issues in Phase I of this docket, Staff adopts the arguments and conclusions set forth in the *Consumer Advocate and Protection Division's Post-Hearing Brief*, filed on September 15, 2006.

**COST OF CAPITAL**

In ratemaking, the concept of the zone of reasonableness is central. In both pre-filed and live testimony, Staff witness Kettles stated and his exhibits substantiated that Atmos Energy Corporation ("Atmos") should be allowed an overall rate of return of 7.916%, given the facts presented in this case. When analyzing and comparing the expert opinions presented by the other cost of capital witnesses, Mr. Kettles' testimony lies directly in the heart of that zone of reasonableness.

As part of his reasonable conclusion that Atmos be allowed an overall rate of return of 7.916%, Mr. Kettles calculated a capital structure comprised of 43.09% equity and 56.91% long-term debt. First,

Mr. Kettles testified that a capital structure with at 43% equity ratio is likely to exist at September 30, 2007, which is one year past his forecast.<sup>1</sup> Atmos witness Ms. Sherwood stated that the appropriate capital structure for Atmos should instead be comprised of 50% equity and 50% debt, as this more accurately reflects the desired capital structure of the company.<sup>2</sup> While Investigative Staff does not question that Atmos *desires* a 50% equity ratio, the evidence presented at the Hearing suggests that Atmos will not even reach 45% equity until approximately 2010.<sup>3</sup> Desire is one thing, feasibility is another. One aspect of sound ratemaking is the use of a capital structure that approximates the near future. In light of this standard and the improbable likelihood that Atmos will achieve a 50% equity ratio in the next several years, a 50% equity ratio should not be reflected in the capital structure for ratemaking purposes in this case. Rather, it would be more appropriate for the Authority to set rates based upon a capital structure supported by current data and reasonable forecasts, which is found throughout Mr. Kettles' testimony.

To determine required equity return, Mr. Kettles used two models: the capital asset pricing model (CAPM) and the discounted cash flow (DCF) model. With respect to the CAPM, both Mr. Kettles and Atmos' expert witness, Dr. Murry, choose the same value for the risk measure  $\beta$  and derived very similar risk premia. The difference as acknowledged by both witnesses is the imposition of an adjustment for size of the company. Mr. Kettles stated that size adjustment is not part of the standard textbook CAPM model and creates several problems when used in the context of regulatory ratemaking. Among those problems are the lack of specific industry data and the cyclical nature of size adjustment measures.<sup>4</sup> While Dr. Murry disputes this claim, on this matter reasonable minds can disagree. As Mr. Kettles notes "I think we should consider both the firm size adjustment and the standard CAPM model."<sup>5</sup> While

---

<sup>1</sup> Transcript of Proceedings, v. VI, p. 17 (August 30, 2006)

<sup>2</sup> Transcript of Proceedings, v. VIII, p. 8 (August 31, 2006)

<sup>3</sup> Jerry Kettles, Pre-Filed Rebuttal Testimony, pp.2-4 (August 18, 2006)

<sup>4</sup> Transcript of Proceedings, v. VI, pp .15-17 (August 30, 2006)

<sup>5</sup> Transcript of Proceedings, v. VI, p. 16 (August 30, 2006)

reasonable minds may disagree on size adjustment, there is no doubt that the result of Mr. Kettles' CAPM lies in the zone of reasonableness.

While testifying about the DCF model, Mr. Kettles notes the importance of acknowledging investor expectations as evidenced by market behavior. For example, Mr. Kettles directed the Authority's attention to the importance of considering both dividends flowing from stock ownership as well as capital gains resulting from stock ownership.<sup>6</sup> The DCF model utilizing dividend growth produced equity returns between 6.17% and 7.00%. When implementing the DCF model utilizing earnings per share, a proxy for anticipated capital gains, the equity return estimates increase from 11.17% to 12.00% according to Mr. Kettles.

In conclusion, Mr. Kettles selected the 10.75% result from his CAPM analysis for the allowed equity return. Combined with a long-term debt cost of 5.77% and a capital structure comprised of 43.09% equity and 56.91% long-term debt, Mr. Kettles determined the weighted cost of capital calculation for an overall fair rate of return is 7.916%. This is clearly within the zone of reasonableness, and the TRA Investigative Staff respectfully requests that the Authority so find.

Respectfully submitted,

By: 

Gary R. Hotvedt (#16468)  
Tennessee Regulatory Authority  
460 James Robertson Parkway  
Nashville, Tennessee 37243  
(615) 741-3191 x. 212

Counsel for TRA Investigative Staff

---

<sup>6</sup> Transcript of Proceedings, v. VI, pp. 18-19 (August 30, 2006)

**CERTIFICATE OF SERVICE**

I hereby certify that a true and exact copy of the foregoing has been forwarded by electronic mail to the following parties on the 15th day of September, 2006.

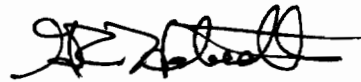
Timothy Phillips, Senior Counsel  
Vance L. Broemel, Assistant Attorney General  
Joe Shirley, Assistant Attorney General  
Office of the Attorney General  
Consumer Advocate and Protection Division  
P.O. Box 20207  
Nashville, TN 37202

Misty Smith Kelley, Esq.  
Baker, Donelson, Bearman & Caldwell  
1800 Republic Centre  
633 Chestnut Street  
Chattanooga, TN 37450

Henry Walker, Esq.  
Boult, Cummings, Conners & Berry  
1600 Division Street, Suite 700  
P.O. Box 340025  
Nashville, TN 37203

J.W. Luna, Esq.  
Jennifer Brundige, Esq.  
Farmer & Luna  
333 Union Street, Suite 300  
Nashville, TN 37201

Melvin J. Malone, Esq.  
Miller & Martin  
2300 One Nashville Place  
150 4<sup>th</sup> Avenue North  
Nashville, TN 37219



---

Gary R. Hotvedt

Electronically filed with the TRA Docket Room on September 15, 2006.