BEFORE THE TENNESSEE REGULATORY AUTHORITY
NASHVILLE, TENNESSEE

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T.R.A. DOCKET ROOM

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

CONSUMER ADVOCATE AND PROTECTION DIVISION'S POSTHEARING BRIEF

The Office of the Tennessee Attorney General, by and through the Consumer Advocate and Protection Division, hereby submits its Posthearing Brief pursuant to the order of the Hearing Officer.

The Posthearing Brief is divided into three sections:

I. ACCOUNTING ISSUES AND RATE BASE

TEST PERIOD

In Atmos's Bench Brief on Appropriate Test Year and Attrition Period Adjustments, it stated the following principles:

1. Rates are set prospectively (rather than retroactively), and the test period must include forward-looking adjustments reflective of the period in which the prospective rates will be applied;

2. Rates must take into account known and measurable changes that are likely to occur in the immediate future when the prospective rates will be applied; and

3. The TRA has the discretion to choose a historical test period, a forecast test period, a combination of the two, or any other accepted method in ratemaking.

Bench Brief at 2-3. The Consumer Advocate agrees with these principles. The Consumer Advocate further agrees that Atmos's proposed definition of "immediate future" to mean the twelve months past the date of the decision is not unreasonable.

The Consumer Advocate, however, does not agree with Atmos's argument that its 2007 fiscal year is the appropriate test year to be used in this case. In particular, Atmos misapplies the one authority that it relies on for support of using a forecast test year. The case of *South Central Bell v. Tennessee Public Service Commission,* 579 S.W.2d 429 (Tenn. Ct. App. 1979), does not, as Atmos claims, stand for the proposition that a forecast test year must be used in this case. Rather, *South Central Bell* simply holds that it is an abuse of discretion for this agency to set rates without considering the impact of known and measurable changes that will affect the prospective application of rates (such as the uncontradicted evidence in *South Central Bell* of probable increases in certain expenses and investments during the effective period of the prospective rates, *see South Central Bell* at 435). It does not stand for the proposition that a forecast test period must be used to predict attrition of rates. This would defy later cases which clearly and unmistakably hold that the TRA may use a historical test period for ratemaking if it so chooses. *See C.F. Industries v. Tennessee Public Service Commission*, 599 S.W.2d 536, 542 (Tenn. 1980); *Powell Telephone Co. v. Tennessee Public Service Commission,* 660 S.W.2d 44, 46 (Tenn. 1983); *Tennessee Cable Television Association v. Tennessee Public Service*

Commission, 844 S.W.2d 151, 159 (Tenn. Ct. App. 1992); *American Association of Retired Persons v. Tennessee Public Service Commission,* 896 S.W.2d 127, 133 (Tenn. Ct. App. 1994). As the Consumer Advocate witnesses testified at the hearing, all that is required of any test period (historical, forecast, combination, or otherwise) is that it must reflect the future earnings potential of the utility. Tr. at I.79; II.23; IV.51-52.

Additionally, the Consumer Advocate does not agree with Atmos's characterization of Director Jones's comments regarding the attrition period. Bench Brief at 5; Tr. at 66. Atmos is incorrect to assume or suggest that Director Jones's comments constituted a ruling that a forecast test year must be used in this case. The meaning of Director Jones's comments is clear: the effects of attrition must be considered in setting Atmos's rates in this proceeding. In making this statement, Director Jones did not pre-select any particular test period. The Consumer Advocate agrees with Director Jones that attrition must be considered; accordingly, it has set forth a 2006 test year that has been adjusted for known and measurable attrition and, therefore, appropriately represents the future levels of Atmos's revenues, expenses, taxes, rate base, and cost of capital. Tr. at 78-79. Indeed, the soundness of the 2006 test year forecast submitted in the Consumer Advocate's direct testimony is confirmed by its 2007 test year forecast submitted as rebuttal to the company's forecast, as both the Consumer Advocate's 2006 and 2007 test years yielded about the same level of Atmos earnings.

The Consumer Advocate also disagrees with Atmos's notion that attrition will result in rates becoming too low at some point in the future. Bench Brief at 7; Tr. at I.67-68. In cases such as this, "attrition" simply refers to the concept that rates become stale over time because, due to changes in the utility's investment and cost structure and the economy as a whole, the

revenues being generated by the rates in effect do not properly match the revenue requirements needed to cover the utility's expenses, taxes, and fair rate of return on its rate base investment. But, attrition is a concept that cuts both ways -- that is, due to positive and negative attrition, rates may become either too low or too high in light of attendant circumstances. Indeed, it is due to attrition that the Consumer Advocate is requesting a reduction in Atmos's current rates to a just and reasonable level; and, if the TRA finds in this proceeding that rates should be reduced (or increased), "attrition" will be the reason why the rates set over ten years ago are no longer valid in light of Atmos's current investment and cost structure and today's economic conditions.

The Consumer Advocate urges the TRA to adopt its 2006 test year as the appropriate attrition year in this docket. While much of the Consumer Advocate's data comes from recent history, its 2006 test year has been adjusted for known and measurable changes and it properly reflects the future earnings potential of the utility. Tr. at I.78-79, II.23. As clearly demonstrated by the Consumer Advocate's 2007 test year rebuttal forecast, there is nothing on the horizon that indicates that the 2006 test year is not representative of Atmos's financial condition in the immediate future. However, should the TRA determine that Atmos's 2007 test year should be used to set rates in this case, the Consumer Advocate would urge the TRA to adopt the adjustments outlined in the Consumer Advocate's 2007 test year rebuttal forecast, because these adjustments are necessary to account for the attrition (both positive and negative) that is likely to occur during the 2007 test year.

REVENUES/GROSS MARGINS

The Consumer Advocate's and Atmos's different projections of gross margins is an important issue in this case that is worth more than $3 million. Buckner Rebuttal Work Paper

TB-1, Line 3. As Atmos stated at the hearing, this difference is due primarily to the different methods that the parties used to make their margin projections. Tr. at IV.60. The Consumer Advocate examined the primary drivers of revenues, customer growth and gas usage, as well as margin trends and test year data to form its margin forecast. Atmos's margin forecast is based on price outs. As demonstrated below, the Consumer Advocate's margin forecast should be adopted because, under the circumstances of this case, it provides the best estimate of gross margins that are likely to occur in the near future.

At the hearing on the merits, Atmos appeared confused about the Consumer Advocate's methodology, suggesting that the Consumer Advocate's margin forecast is based solely on historical trends. As Consumer Advocate witness McCormac testified, however, this is not the case. Tr. at III.39-40. The Consumer Advocate did not simply draw a trend line into the future in order to arrive at its forecast. Mr. McCormac testified that customer growth and customer usage, the two primary drivers of revenues, were also examined and considered, as well as test year data, in order to determine the Consumer Advocate's forecast. Tr. at III.41; V.22, 30. And, because the proof demonstrates that, as in the recent past, customer growth of about 3% annually will continue to outstrip declining usage (or conservation) of about 1.5% annually in the near future, the Consumer Advocate has projected that margins will continue to increase in the near future at about the same rate as margins have increased in the recent past. Tr. V.8. In other words, no substantial changes in the gross margin drivers were identified; accordingly, no substantial change in gross margin growth was predicted.

In particular, the intermediate trend in margins demonstrates that over the past four years, when customer growth has been about 3% per year and conservation has been about 1.5%,

Atmos's gross margins have increased about 1.8% per year. McCormac Direct at 2, Exhibits DM1-DM2. This intermediate trend is also confirmed by the long-term trend in margins over the past eleven years -- since the company's last rate case. Both the intermediate trend and the long-term trend show that gross margins have consistently increased about 1.8% per year over the last four years and the last eleven years, respectively. McCormac Direct at 2, Exhibits DM1-DM3; *see also* Foster Rebuttal at Chart A. Because customer growth rates (3% per year) and conservation levels (1.5% per year) -- the two primary revenue drivers -- are expected to continue at about the same levels in the near future as they have been in the past, there is no reason to anticipate that Atmos's gross margins will drop or, for that matter, level off in the near future. Rather, because the outlook for the near future looks about the same as the recent past, gross margins should perform about the same in the near future as they have in the recent past -- increasing about 1.8% per year. Indeed, the Consumer Advocate's projected customer growth of 3.0% is smaller than Atmos's own projection of 3.3% customer growth; and the Consumer Advocate has accepted Atmos's own calculation of 1.5% declining usage (conservation). Waller Direct at 4-5; McCormac Direct at DM5; MFR #22. Accordingly, the Consumer Advocate's projection that gross margins will continue to increase at 1.8% per year in the near future is reasonable because, as recent history has clearly demonstrated year after year, customer growth of about 3%, coupled with declining usage of about 1.5%, will produce a gross margin increase of about 1.8%.

Atmos suggests that use of its price-outs, as opposed to the Consumer Advocate's methodology, will produce a superior gross margin forecast in this instance. This is simply not the case because several factors call the efficacy of Atmos's price-outs into question. First,

Atmos's price-outs are unreliable because they do not agree with each other, or with the relevant 3.03 Report, by about $1 million in gross margins. The price-out at present rates for May 31, 2006, presented in Waller Direct at GW-2 shows nearly $1 million more in gross margins than the price-out at present rates for May 31, 2006, presented in Petersen/Waller Rebuttal at Schedule P/W-3 ($50.3M vs. $49.4M); additionally, the adjusted price-outs do not agree to each other by nearly $1 million ($51.6M vs. $50.8M). And, the latest adjusted price-out for May 31, 2006, presented in Petersen/Waller Rebuttal does not agree with the May 31, 2006, 3.03 Report by nearly $1 million ($50.8M vs. $51.7M). Additionally, Atmos's WNA adjusted price-out based on March 31, 2006 (*see* First Joint Discovery Response, DR# 27) does not agree to its WNA adjusted May 31, 2006 price-out presented in Petersen/Waller Rebuttal by $1.6 million ($52.5M vs. $50.9M). In summary, there are major unidentified problems in the gross margins computed in Atmos's price-outs, as well as between Atmos's latest price-out and the gross margins it reported on its 3.03 Report. As Consumer Advocate witness McCormac testified, the inputs used to produce any price-out must be reasonable in order for reasonable results to be achieved. Tr. at V.23-24. It is the Consumer Advocate's position that one should seriously question the results of price-outs that do not agree with one another, that vary significantly over a short period of time, and that do not reconcile with reported results.

Second, the price-out that Atmos computed for its 2007 forecast is not well supported. Atmos stated that it discussed usage with its large customers and that it factored the results of those discussions into its 2007 gross margins forecast. Waller Direct at 3-4; Tr. at X.12. However, the particular customers that Atmos consulted, as well as the nature of those discussions, are not included anywhere in the record. It is not known, for example, whether

Atmos talked to selected customers, its top 10 customers, or its top 100 customers. And, significantly, it is not known whether Atmos also surveyed or considered potential customers that are likely to subscribe to service in the near future. It is no secret that Atmos serves some of the fastest growing communities in Tennessee (as well as the nation). For instance, Rutherford and Williamson Counties, which Atmos serves, have exhibited huge amounts of growth, which is expected to continue. *See*, www.census.gov/Press-Release/www/2001/tables/tn_tab_6.PDF; www.tennessee.gov/tacir/Population%20Study/williamson%20_age-gender_pop.htm; www.tennessee.gov/tacir/Population%20Study/rutherford%20_age-gender_pop.htm. It is not known, however, whether Atmos also consulted real estate developers, as well as community and business leaders, to determine whether sizeable new customers, business developments, or housing developments are likely to be added to the system in the near future. Unless it did so, the results of its projected 2007 price-out are materially skewed downward. Interestingly, Atmos talks in terms of factoring in "plant closings," "planned outages," and "declining usage." Waller Direct at 4. Individual customers' usage invariably changes over time, however. In other words, plant closings, planned outages, and declining usage are not peculiar to 2007 only; they also existed in the years from 1995 to 2005 when Atmos's gross margins increased about 1.8% per year. Continually, some large customers cut back or leave the system altogether, but other large customers increase their usage or are added to the system. To be fair, a projected price-out of gross margins must also include projected increases and additions, not just projected decreases attributable to plant closings, planned outages, and declining usage. Indeed, Atmos's 2007 price-out, which projects that gross margins will remain essentially flat from May 2006 through

September 2007, defies recent history and, significantly, the company's own customer growth and declining usage projections.

Third, Atmos's use of price-outs to project gross margins is problematic in this case because they fail to account for the wide fluctuations the company experiences in gross margin levels. The record shows that Atmos's gross margins can fluctuate up or down by as much as $5 million in only a month or two. Petersen/Waller Rebuttal at Schedule P/W-2. As Consumer Advocate witness McCormac testified, such volatility makes the use of price-outs much less useful for predicting future gross margins because price-outs assume a static picture -- a snapshot in time. Tr. at V.24-25; McCormac Rebuttal at 2-3. The proof, however, demonstrates that Atmos's gross margins are not static; rather, they change significantly over a very short period of time. Accordingly, price-outs may be skewed significantly if they begin with a point in time that is not representative of the average gross margins. In other words, a price-out that is based on a month when gross margins are on a $5 million upswing will produce a gross margin forecast that is too high. On the other hand, a price-out that is based on a month when gross margins are on a $5 million downswing will produce a gross margin forecast that is too low. The Consumer Advocate's methodology, however, does not suffer from this problem. Its review of the trend in gross margins, as well as its examination of gross margin drivers, took the margin upswings, as well as the downswings, into account. As Consumer Advocate witness McCormac testified, the Consumer Advocate's forecast is built on observations and analyses of data that is representative of the fluctuating margins. Tr. at III.24-26, Tr. Exhibit No. 4. In other words, the Consumer Advocate is not projecting margins from a particularly high point or low point; rather, its gross margin projection recognizes that margins move up and down, but that the overall trend is

upward movement at about 1.8% per year. McCormac Direct at 2. Furthermore, the overall margin trend in the near future is also expected to be up by 1.8% per year because the revenue drivers that create the margins are anticipated to perform at about the same levels in the near future as they have performed in the recent past. *Id.*; Tr. at III.41-42, V.22. The Consumer Advocate's forecast, therefore, considers the whole picture.

The same is not true for Atmos's price-outs, however. Atmos begins its forecast by pricing-out May 2006. Waller Direct at GW-2. May 2006 was a downswing month for the company's gross margins. Indeed, May 2006 was abnormally low, even for a downswing month. This is proven by the fact that Atmos's booked gross margins for May 2006 was the lowest reported gross margins for the previous 15 months; and the May 2006 gross margins was the second lowest reported gross margins during the last two years. 3.03 Reports, June 2004 through May 2006. Also, Atmos booked less gross margins during May 2006 than it booked during the months of May for the last three years. Tr. at Volume III, Hearing Exhibit No. 3. As Consumer Advocate witness McCormac testified, May 2006 was more than an ordinary downswing, it was an outright anomaly that deviated far from the norm. Tr. at III.32; IV.30. Nevertheless, Atmos ignored this fact and began its projection of 2007 gross margins with a price-out of May 2006. Waller Direct at GW-2. Atmos also ignored the fact that its gross margins fluctuate both up and down, choosing instead to focus on a downswing as the basis for its gross margin forecast. It is not surprising, therefore, that Atmos is predicting that its gross margins will go down from present levels and stay down.

Indeed, Atmos's projected gross margins for September 2007 is <u>less than</u> its actual gross margins it reported for 22 of the last 24 months. *Compare* Waller Direct at GW-2 *with* 3.03

Reports, June 2004 through May 2006. But, because Atmos failed to consider the whole picture of fluctuating margins, its gross margin forecast is skewed downward since its starting point -- May 2006 -- was unusually low and, therefore, not representative of a normal reporting period. Although gross margins do fluctuate, the past 11 years of history demonstrates that every single downturn in gross margins is soon followed by an upturn. Tr. at V.32. Gross margins simply do not go down and stay down, as Atmos has assumed in this docket. Moreover, because the parties agree that the rate of customer growth (3%) is not expected to decline and because the rate of declining usage (1.5%) is not expected to increase, there is absolutely no reason to project, as Atmos does, that the May 2006 downturn in gross margins is permanent. As Mr. McCormac testified, the TRA should not set rates in this docket based on data outliers and anomalies. Tr. at IV.53. Because Atmos's forecast is not representative of a normal reporting period, it should be rejected.

EXPENSES

Direct Labor Expense

Direct labor expense is an issue worth about $280 thousand for the 2006 test period, and about $416 thousand for the 2007 test period. Buckner Rebuttal Work Paper TB-1, Line 4. The TRA should adopt the Consumer Advocate's calculation of direct labor expense because it assumes a reasonable labor growth rate of about 3.5% per year, which was provided by Atmos, and because it is based on a detailed labor price-out that was reconciled to the company's own books. On the other hand, Atmos's direct labor expense should be rejected because: it assumes a fantastic labor growth rate, it assumes a labor capitalization rate that is too low, and it is not supported by any detailed calculations. Additionally, the TRA should not be confused by

Atmos's attempt to cloud the direct labor expense issue by discussing capital labor transfers to Tennessee from other jurisdictions.

According to Atmos, employee levels have remained relatively flat since September 30, 2005, and it does not anticipate any material changes in employee levels. Waller Direct at 8. Atmos also projected that the labor budget will increase at 3.5% annually. Waller Direct at Schedule GW-3, Line 1. Atmos's labor capitalization rate for the 2005 fiscal year -- the latest whole year of data -- was 60%. Based on these assumptions, as well as overtime hours worked for the 2005 fiscal year -- again, the latest whole year of data -- the Consumer Advocate projected direct labor expense by completing a labor price-out of actual employees at normalized levels and pay rates. Buckner Direct at Work Papers E-PAY-1 - E-PAY-5; Buckner Rebuttal at Rebuttal Work Papers E-PAY-1 - E-PAY-5. Significantly, the beginning point of the Consumer Advocate's labor price-out was reconciled to the company's books to assure proper results. Buckner Direct at 5. This methodology produced a direct labor expense for the 2006 test year that is 3.67% greater than the actual direct labor expense for the 2005 fiscal year; and a direct labor expense for the 2007 test year that is 7.29% greater than the actual expense for 2005. *See* attached **Exhibit 1**. These results are reasonable based on the direct labor assumptions used (importantly, all of the Consumer Advocate's direct labor assumptions were taken directly from Atmos's discovery responses and reported data).

Atmos, on the other hand, projected a direct labor expense that is unreasonable in relation to its own forecast assumptions. Indeed, Atmos's forecast that 2007 direct labor expense will increase by more than 22% over 2005 is incredible in light of Mr. Waller's testimony that employee levels will remain flat and that pay will increase by only 3.5% annually. *See* attached

Exhibit 1. In short, Atmos's direct labor expense forecast simply does not add up and, moreover, the company has not provided any detailed calculations that would support such a hefty increase in labor expense over such a short period of time. At the hearing on the merits, however, Atmos suggested that its lower capitalization rate, as well as additional direct labor transfers to Tennessee from other jurisdictions, supply the missing pieces. Tr. at X.24-29. But, as explained below, neither the capitalization rate nor the direct labor transfers can explain a nearly one-quarter jump in direct labor expense in a mere two years.

With respect to the capitalization rate, even if it is declining from 60% in 2005 to 57% in 2007, as Atmos claims, direct labor expense is still increasing by 22.29% in two years. *See* attached **Exhibit 1**. Thus, a declining capitalization rate does not explain this large increase in expense. Additionally, the Consumer Advocate does not accept Atmos's prediction that the capitalization rate will decline for two reasons. First, as Consumer Advocate witness Buckner testified, there should be a consistent relationship between capital additions and the capitalization rate. Tr. at II.86. In other words, as plant additions rise, one would expect the capitalization rate to also rise as more labor is committed to capital projects. Because Atmos's forecasted plant additions -- which the Consumer Advocate also incorporated into its forecast -- are increasing significantly, the labor capitalization rate should also increase -- not decrease. In 2005, Atmos's capitalization rate was 60% on plant additions of $14.2 million, but for 2007 Atmos unreasonably projects that the capitalization rate will decrease to 57% while net plant additions will increase to $17.8 million. Second Joint Discovery Response, DR#2. This inverse relationship between the capitalization rate and plant additions makes little sense. The second reason for rejecting Atmos's capitalization rate is that its calculation of a 57% rate is based on

incomplete data. At the hearing, Atmos introduced an exhibit that purportedly supports its 57% capitalization rate. Tr. at Volume II, Hearing Exhibit No. 1. As Consumer Advocate witness Buckner testified, however, an examination of Atmos's computation reveals that the budgeted capital labor for the months of August and September of 2006 is omitted from the calculation (*see* Hearing Exhibit No. 1, Budgeted 2006 August Capital Labor Transfer = 0, Budgeted 2006 September Capital Labor Transfer = 0). Accordingly, the computed capitalization rate is based on two months of missing data that, when supplied, will increase the capitalization rate. Indeed, Mr. Buckner testified that if the missing August and September capital labor is incorporated into Atmos's calculation, its capitalization rate may be near the Consumer Advocate's 60% capitalization rate. Tr. at I.88.

Finally, the TRA should not be confused by Atmos's attempt to cloud the direct labor expense issue by discussing the capital labor transferred to Tennessee from other jurisdictions. In particular, Atmos tried to explain its higher direct labor expense by suggesting that Mr. Buckner overlooked $620,999 in capital labor transfers from other jurisdictions. Hearing Exhibit No. 1. Mr. Buckner, however, did not overlook anything. Such transfers cannot impact Mr. Buckner's direct labor expense forecast because capital labor transfers to Tennessee are wholly accounted for as plant additions, as opposed to operations and maintenance expenses. Thus, the "Reconciliation to Buckner" calculation shown on Hearing Exhibit No. 1 is erroneous. The $620,999 capital labor transferred to Tennessee should be appropriately accounted for as 100% capitalized to the Tennessee plant accounts; thus, Atmos's calculation, which places 42% of the capitalized labor into direct labor expense, mistakenly accounts for a significant portion (42%) of the capital labor transfers twice -- once in rate base and again in direct labor expense. Moreover,

because the Consumer Advocate accepted Atmos's own projected plant additions for 2006 and 2007 without any adjustments, it has appropriately accounted for any capital labor transfers to Tennessee in its forecasts. Accordingly, the $620,999 in capital labor transfers cannot explain why Atmos is requesting more than a 22% increase in direct labor expense for 2006 and 2007. The Consumer Advocate submits that such an increase is unreasonable and unsupported and, therefore, should be rejected.

Long Term Incentive Plan (LTIP)

LTIP is an issue worth in excess of $318 thousand for the 2006 test year and $444 thousand for the 2007 test year. Buckner Rebuttal Work Paper TB-1, Line 5. As Consumer Advocate witness Buckner testified, the sole performance measure (or benchmark) associated with the payout of employee bonuses under the LTIP is company earnings. Buckner Rebuttal at 5; MFR #38. Additionally, there is no mechanism under the LTIP for ratepayers to share in the increased earnings produced by the plan. *Id.* Thus, it is Atmos's shareholders, not its ratepayers, that will receive all of the benefits created by the LTIP. Indeed, the LTIP program in this case is so onerous to ratepayers that, under the company's proposal, ratepayers would have to pay Atmos's employees bonuses for increasing Atmos's earnings, even if it resulted in the utility earning more than the fair rate of return set by this Authority. In essence, then, Atmos's plan would require ratepayers to pay bonuses to the company's employees for collecting windfall profits for the shareholders. It is not reasonable to ask ratepayers to pay the costs of such a plan.

The Consumer Advocate is not against incentive plans *per se*. But, as the Authority has previously recognized, the bonuses should be charged to those that benefit from the incentive plan. In dealing with Nashville Gas's LTIP, the TRA found that one-half of the incentives

should be charged to ratepayers and one-half to shareholders because, under Nashville's plan, "both the shareholders and ratepayers equally share in the benefits derived from the LTIP." *See* Nashville Gas Rate Case Order issued on February 19, 1997, TRA Docket No. 96-00977, page 12. In this case, however, the uncontradicted proof shows clearly that ratepayers do not share in the benefits of Atmos's LTIP at all. The amount of bonuses paid in this case turns solely on the company's profits (as opposed to service quality benchmarks, etc.) Therefore, in accordance with the TRA's established precedent, Atmos's ratepayers should not have to pay for an LTIP designed to benefit only the shareholders. The TRA should disallow the proposed LTIP costs under the circumstances of this case.

Pension Expense

Pension expense is an issue worth $205 thousand for the 2006 test year, and $417 thousand for the 2007 test year. Buckner Rebuttal Work Paper TB-1, Line 6. In accordance with ratemaking practice, as well as the TRA's precedent, the Consumer Advocate excluded pension expense from its forecast because Atmos's pension plan is fully funded under both financial accounting standards (FAS 87) and governmental regulations (ERISA) and, thus, no minimum contribution is required. Buckner Direct at 9-10. Atmos, however, includes its FAS 87 pension accrual as pension expense to be recovered through utility rates. Petersen/Waller Rebuttal at 12. While FAS 87 is the appropriate treatment for financial accounting purposes, the Financial Accounting Standards Board itself recognizes, in FAS 71, that regulated entities may be subject to accounting practices for ratemaking purposes that do not conform with financial accounting standards. *See* FAS 71, ¶¶ 1-3.

Indeed, this Authority has consistently held that appropriate ratemaking policy dictates that only actual pension contributions (as opposed to the FAS 87 accrual) should be recovered through the utility's rates. Buckner Direct at 9. In Docket No. 96-00997, for instance, this Authority stated "that to appropriately match the Company's current pension expense with its current ratepayers, the minimum required contribution should be adopted as the current pension expense. Since the pension plan is fully funded, the Company's minimum required contribution for this case is zero dollars ($0.00), therefore the Authority adopts this dollar amount for the Company's pension expense." Nashville Gas Rate Case Order issued on February 19, 1997, TRA Docket No. 96-00977, page 14. In fact, this case presents the exact same pension situation as existed in TRA Docket No. 96-00997. The uncontradicted proof demonstrates clearly that Atmos's pension plan is fully funded. MFR #37, Actuarial Report page MS-1. Since the pension plan is fully funded, Atmos's minimum required contribution for this case is zero dollars ($0.00), therefore, the Authority should adopt this dollar amount for Atmos's pension expense.

At the hearing, Atmos witness Petersen stated that the company made pension contributions during the test period. Tr. at X.16. Mr. Petersen's testimony, however, is potentially misleading and irrelevant. Mr. Petersen did not state that Atmos has two pension plans -- the Pension Account Plan (PAP) and the Retirement Plan for Mississippi Valley Gas Union Employees (MVG Plan). *See* Atmos Form 10-K for the fiscal year ended September 30, 2005, pages 91-92 (Consolidated Financial Statement Note No. 9 -- Retirement and Post-Retirement Employee Benefit Plans). Mr. Petersen did not state that, with the exception of about $300 thousand, the pension contributions were <u>voluntary</u>. *Id.* Mr. Petersen did not state that the contributions were made to the MVG Plan, not the PAP. *Id.* Mr. Petersen did not state that

Atmos's employees in Tennessee are participants of the PAP, not the MVG Plan. *Id.*; First Discovery Requests DR#27. Mr. Petersen did not state that Atmos is not required to make any minimum contributions to the PAP, and that Atmos does not plan to make any voluntary contributions to the PAP during the 2006 or 2007 fiscal years. *Id.* In summary, the pension contributions that Atmos mentions at the hearing are, for the most part, voluntary contributions to a pension plan in which its Tennessee employees do not participate. Tennessee ratepayers should not be required to fund pension contributions of employees in other jurisdictions, nor should they be required to fund voluntary contributions that are not required to keep the pension plan financially viable. The TRA's long-standing policy on recovery of pension costs should continue to be applied in this case -- that is, the recovery of the minimum required contribution should be allowed. As the TRA has found, this policy appropriately matches current pension expenses with current ratepayers. Moreover, it simply would not be fair to grant Atmos preferential treatment over the other utilities regulated by this agency. Accordingly, the Consumer Advocate's treatment of pension expense in this case, which merely applies the TRA's precedent, should be adopted.

Uncollectible Accounts Expense

Uncollectible accounts expense is an issue worth $249 thousand in the 2006 test year, and $112 thousand in the 2007 test year. At the hearing, Atmos reduced its 2007 uncollectible expense forecast from $351,679 to $207,848. Tr. at X.30. The reduced amount, however, is still too high in light of the record in this case. At the hearing, Atmos suggested that high gas costs increased the amount of uncollectibles; and it further suggested that last Winter's gas costs were

near record highs. Tr. at I.93. Even assuming that Atmos's suggestions are true, however, the amount of uncollectibles that it is seeking in this docket is not reasonable.

In particular, Atmos is seeking to recover in this case uncollectible expenses of more than $207 thousand annually. The record clearly shows, however, that Atmos's uncollectibles do not come close to approaching this amount. Even during last Winter's heating season -- when, according to Atmos, gas costs were near record highs -- Atmos's uncollectibles remained well below $100 thousand annually. *See* attached **Exhibit 2**. In fact, during the last year, Atmos's uncollectibles exceeded $100 thousand annually only once -- about $110 thousand for the twelve months ended June 2005 -- and the latest data shows that Atmos's current level of uncollectibles is about $96 thousand annually for the twelve months ended May 2006. *See* attached **Exhibit 2**.

Moreover, Atmos witness Swain testified that the company has had a big response in Tennessee for budget billing, which mitigates spikes in the customer's bills due to high gas costs. Tr. at IX.79. As Consumer Advocate witness Buckner testified, however, placing more customers on budget billing should have the effect of controlling uncollectible accounts, as opposed to significantly increasing them. Tr. at II.70. Additionally, the TRA's decision to allow recovery of the gas portion of uncollectibles through the PGA mechanism will allow Atmos to flow through the uncollectibles associated with higher gas costs directly to ratepayers. Accordingly, as the recent data from the last heating season indicates, higher gas costs should not cause the non-gas uncollectibles to rise exponentially, as Atmos has assumed with its fantastic 100%-plus growth rate. Atmos's forecast, therefore, should be rejected. On the other hand, the Consumer Advocate's uncollectibles forecast should be adopted because it is in line with recent

data, which includes the effects, if any, that higher gas costs may have on the uncollectibles recovered through base rates.

Environmental Costs

Environmental costs is an issue worth almost $638 thousand for the 2007 test year. Buckner Rebuttal Work Paper TB-1, Line 8. Consistent with the 1994 order of this agency, the Consumer Advocate did not include the recovery of any environmental costs in present rates. Buckner Rebuttal at 9-10. In particular, the order authorized the accumulation of certain environmental cleanup costs in a deferred account, but it did not authorize that any of the costs be included in rates or otherwise billed to ratepayers. Environmental Cost Order issued on October 4, 1994, Docket No. 94-02529, page 3. Although Atmos has identified some deferred environmental costs that have been incurred, the Consumer Advocate has not included any amortization of these costs in its forecast because, just as in 1994, many questions still remain about the nature and amount of the costs, as well as the appropriate ratemaking treatment.

Atmos admitted that, even after twelve years, its environmental cleanup program remains substantially incomplete. Tr. at X.41. According to Atmos's own projections, over one-third of the costs have not been incurred yet. Since 1994, Atmos has identified $1.2 million in environmental cost deferrals, but it claims that additional costs of $680 thousand will be incurred in 2007 alone (interestingly, during the last four years combined, Atmos has incurred just $29 thousand in environmental costs). Second Joint Discovery Request, DR #16; Tr. at X.41. Atmos then requests that these $1.9 million in projected costs -- which will accumulate over thirteen years -- be amortized over just three years. With respect to insurance payments, government or third-party reimbursements, or other offsets to the cost of its environmental cleanup program,

Atmos can provide no detailed information. Tr. at X.42. The 1994 order, however, requires an accounting of such payments and reimbursements. Environmental Cost Order issued on October 4, 1994, Docket No. 94-02529, page 2. Also, it is not known if the environmental cleanup program is being performed internally by Atmos's own employees or externally by contractors. Tr. at II.75; Buckner Rebuttal at 9-10. As Consumer Advocate witness Buckner testified, if the environmental cleanup is being done, either in whole or in part, by Atmos's own employees, then some or all of the environmental costs are already built into the forecast in the form of salaries, wages, and benefits. *Id.* Additionally, it is unknown whether Atmos's proposed treatment of environmental costs is consistent with Piedmont's treatment of its environmental costs in Docket No. 92-16160. Environmental Cost Order issued on October 4, 1994, Docket No. 94-02529, page 2. Accordingly, there are simply too many unknowns in the amount and nature of the environmental costs for the TRA to authorize amortization at this time. Indeed, the purpose of the 1994 order was to accumulate and account for the costs before any decision is made on their recovery in rates, and it is clear from the record that the accumulation and accounting of the costs are ongoing. Consistent with the 1994 order, the Consumer Advocate recommends that no action be taken until the environmental cleanup program is complete and the costs are known and verified.

However, if the TRA authorizes the amortization of environmental costs in this docket, even before the program is complete, then it should do so very carefully. Atmos's proposed amortization of nearly $638 thousand annually is problematic because, if the company does not have a rate proceeding for another 10 years, it will have recovered over $6.3 million in environmental costs rather than its own estimate of $1.9 million in total costs (even a five-year

gap in cases will provide Atmos with recovery of $3.9 million rather than the estimated $1.9 million total costs). Also, over one-third of the proposed amortized costs is an estimate that may or may not be actually incurred. Finally, it is simply too burdensome to ask ratepayers to bear thirteen years of environmental cost deferrals over just three years. While, for the reasons stated above, the Consumer Advocate does not recommend any amortization at this time, the maximum that should be allowed in any case is $120 thousand annually, which represents a ten-year amortization of the $1.2 million in identified (but unverified) environmental cost deferrals.

Rate Case Expense

Rate case expense is an issue worth $38,500 in the 2007 test year. Buckner Rebuttal Work Paper TB-1, Line 9. The Consumer Advocate has amortized the $165 thousand in rate case expenses over ten years, whereas Atmos has amortized this amount over three years. Buckner Rebuttal at 10-11. Utility rates should not be set to recover rate case expenses at a faster pace than the frequency of the rate cases themselves. Otherwise, the utility will be allowed to over-recover rate case expenses. The proven track record of this company in Tennessee is that it does not file rate cases with any frequency at all. Indeed, it has been over ten years since the company's last rate case. Accordingly, the Consumer Advocate's proposed ten year amortization period is much more reasonable than Atmos's proposed three years.

Additionally, the TRA may want to consider disallowing the rate case expenses altogether, given the particular circumstances of this case. There is no reason why ratepayers should have to pay for a rate reduction that they justly deserve. When it comes to a meritorious petition to increase rates, for instance, the amount of the utility's costs associated with obtaining the rate increase is routinely built into the rates and recovered from ratepayers. This is sound

ratemaking policy as it is the ratepayers who have benefitted from the deficient rates. However, if the Authority should find in this docket that rates should be reduced to a just and reasonable level, it is the shareholders, not the ratepayers, that have benefitted from the excessive rates. In this instance, then, the utility's rate case costs will have gone toward continuing the stream of windfall profits that are flowing to shareholders. It cannot be said that such costs are just and reasonable expenses that should be borne by ratepayers.

Operations and Maintenance (O&M) Expense

Other operations and maintenance (O&M) expense is an issue worth over $410 thousand for the 2006 test period and about $340 thousand for the 2007 test period. Buckner Rebuttal Work Paper TB-1, Lines 10 and 11. The TRA should adopt the Consumer Advocate's projection for other O&M expense because it grows this basket of general expenses by the traditionally-accepted method of using inflation and customer growth. Buckner Rebuttal at 11. Using this method, the Consumer Advocate projects that other O&M will grow at a rate of 4.4% annually (or 9.0% for two years). Buckner Direct at 6. On the other hand, Atmos has projected an increase in O&M expense that far exceeds a reasonable growth rate. Atmos claims that it is increasing O&M expense from $14.04 million in 2005 to only $14.31 million in 2007, asserting a low two-year growth rate of only 2%. Waller Direct at 5. An apples-to-apples comparison, however, reveals that Atmos's true two-year growth rate for O&M expense is over 23% if Atmos's proposed adjustments to O&M are included, and 16% excluding these proposed adjustments. *See* attached **Exhibit 3**. These growth rates (either with or without Atmos's proposed adjustments) are unreasonable, unsupported, and out-of-line with traditional ratemaking practice.

To understand Atmos's true two-year growth rate in O&M, one must understand Atmos's presentation of its O&M forecast presented in Waller Direct at 5 and Petersen Direct at Schedule THP-4. In Atmos's 3.03 Report, O&M is computed by adding the following line items: Storage Transportation and Distribution-Operation + Storage Transportation and Distribution-Maintenance + Customer Accounts Expense + Sales Expense + Administrative and General Expense (these are lines 7-11 on the first page of the 3.03 Report). *See* Petersen Direct at Schedule THP-4; 3.03 Report for September 2005. A separate issue involves the lease and sale of Atmos's Maryland Way Property, which is accounted for in Atmos's 3.03 Report as an NOI adjustment on page 3. *See* 3.03 Report for September 2005, page 3. Thus, for an apples-to-apples comparison between 2005 and 2007, the O&M expense and the NOI adjustment must be accounted for separately in both years (which is done on the 3.03 Report) or, alternatively, they must be lumped together in both years. For its presentation, however, Atmos has compared the reported September 2005 O&M expense of $14.04 million, which excludes the NOI adjustment, with the forecasted September 2007 O&M expense of $14.31 million, which includes the NOI adjustment. *Compare* 3.03 Report for September 2005 *with* Petersen Direct at Schedule THP-4 (lines 15 and 16 on Schedule THP-4 is the NOI adjustment presented on page 3 of the 3.03 Report, as opposed to O&M expense). As the attached **Exhibit 3** demonstrates, Atmos's mixed treatment of the NOI adjustment in its O&M forecast presentation is inappropriate and potentially misleading.

First, Atmos's September 2005 O&M expense includes $750,000 in nonrecurring merger costs charged to Tennessee. First Joint Discovery Response, DR #14. As attached **Exhibit 3** shows, when these nonrecurring costs are excluded, Atmos's recurring O&M expense for

September 2005 was $13.29 million, excluding the NOI adjustment related to the lease and sale of Atmos's Maryland Way Property. Second, as demonstrated on Schedule THP-4, Atmos's unadjusted 2007 O&M forecast is actually $15.39 million, excluding the NOI adjustment. Schedule THP-4 at line 12. When an apples-to-apples comparison is made, one can see that Atmos's true two-year growth rate for O&M is nearly 16%, based on the unadjusted 2007 O&M forecast of $15.39 million, excluding the NOI adjustment, and the recurring 2005 O&M expense of $13.29 million, excluding the NOI adjustment. *See* attached **Exhibit 3**. Third, when Atmos's proposed O&M adjustments related to rate case expense, environmental costs, and reorganization costs are added, Atmos's total 2007 O&M forecast is actually $16.41 million, excluding the NOI adjustment. Petersen Direct at Schedule THP-4 (addition of lines 12, 17, 18, and 19). Finally, when Atmos's total 2007 O&M forecast of $16.41 million, excluding the NOI adjustment, is compared to the recurring 2005 O&M expense of $13.29 million, excluding the NOI adjustment, one can plainly see that Atmos is projecting a two-year jump in O&M of 23.5%. *See* attached **Exhibit 3**. Thus, a proper presentation, which places both 2007 and 2005 on the same footing, reveals that Atmos is projecting a fantastic amount of growth in O&M, which growth is both unsupported and far beyond the growth computed in accordance with established ratemaking practice. Indeed, the record in this case shows that Atmos's O&M is actually declining. Foster Rebuttal at Chart B.

In separate sections of this brief, the Consumer Advocate sets forth its arguments for exclusion or reduction of the rate case expense and environmental cost amortizations included in Atmos's O&M forecast. Petersen Direct at Schedule THP-4, Lines 17 (rate case expense) and 18 (environmental costs). The Consumer Advocate will not repeat these arguments here, except to

say that Atmos's treatment of these items makes an already unreasonable O&M forecast even more unreasonable. With respect to the $320 thousand in reorganization costs due to the consolidation of the Midstates and Kentucky Divisions (Schedule THP-4, Line 19), the Consumer Advocate contends that this amount is unreasonable and should be excluded because, as Atmos admitted, it has put only a conservative amount of the reorganization savings in its forecast. Atmos witness Waller stated that the "level of savings represents only the labor and benefits associated with key management positions, . . . [t]herefore the level of savings included [in the forecast] is conservative." Waller Direct at 12. Additionally, Mr. Waller testified that other efficiencies and cost savings could be generated from combining the two Divisions. Waller Direct at 9-10. It therefore seems unfair to ratepayers to include all of the costs associated with the reorganization in rates while including only a portion of the savings generated from the reorganization. This is especially true in light of the fact that these reorganization costs significantly contribute to raising Atmos's projected two-year O&M growth rate from an already unreasonable 16% to an even more unreasonable 23.5%. *See* attached **Exhibit 3**.

Depreciation Expense

Depreciation expense is an issue worth $547 thousand for the 2006 test year and $813 thousand for the 2007 test year. Buckner Rebuttal Work Paper TB-1, Line 12. The majority of this issue -- $782 thousand of the $813 thousand 2007 difference -- is attributable to the parties' different procedures for calculation of depreciation for Atmos's shared services unit (SSU) assets. As Atmos witness Roff testified, Atmos has employed the Equal Life Group (ELG) method of depreciating the company's SSU assets. Roff Direct at 2. Atmos used the Average Life Group (ALG) depreciation method for the company's Tennessee jurisdictional assets. The

Consumer Advocate, however, employed ALG for both the shared services and Tennessee jurisdictional assets. The Consumer Advocate submits that the TRA should reject Atmos's ELG depreciation of its SSU assets because: (1) as proposed in the case, Atmos's ELG depreciation proposal is flawed, and (2) ELG is not a sound depreciation convention for ratemaking purposes.

Atmos's ELG depreciation proposal is flawed and, therefore, should be rejected because: (1) Atmos's ELG depreciation study is too old to be useful for ratesetting purposes; and (2) its ELG depreciation study is not comprehensive (the study included only Atmos's shared services assets and excluded Atmos's Tennessee jurisdictional assets). First, Atmos's ELG depreciation study is based on the shared services assets as of September 30, 2002. Roff Direct at 2. Atmos witness Roff testified about a number of study parameters that affect an ELG depreciation recommendation, such as average service lives, plant retirements, net salvage values, and existing depreciation reserves. Roff Direct at 3-5, Schedule DSR-4. Many of these study parameters have surely changed during the last four years, which could have a significant impact on the study's conclusions and recommendations. Atmos's 2002 depreciation study is simply too old to be used for setting rates prospectively.

Second, and more importantly, Atmos's ELG depreciation proposal is not comprehensive. Its ELG study was done for only part of Atmos's assets -- the common shared services assets, a portion of which is allocated to Tennessee. Tr. at VIII.35. In this case, Atmos did not present an ELG study for its Tennessee jurisdictional assets. Tr. at VIII.35-36. As Atmos's recent Georgia rate case demonstrates, however, a comprehensive study would likely reduce depreciation expense in this case rather than increasing it. In particular, Mr. Roff testified that, because ELG is a remaining life depreciation technique, if existing depreciation reserves are

greater than the depreciation reserves computed under an ELG study, then a reduction in depreciation rates would be recommended for that position, and vice-versa. Tr. at VIII.35. Thus, a stronger depreciation reserve position tends to drive down ELG depreciation rates whereas a weaker depreciation reserve position tends to drive up ELG depreciation rates. In Atmos's 2005 Georgia rate case, Mr. Roff presented a comprehensive ELG depreciation study that included Georgia jurisdictional assets. Tr. at VIII.37. Unlike the partial study submitted in this case, however, the comprehensive ELG study submitted in Georgia last year recommended a reduction in Atmos's depreciation expense. Tr. at VIII.38. In the Georgia case, the ELG depreciation study produced a decrease in rates based on a composite depreciation reserve of 35.21% of Georgia jurisdictional assets. Buckner Rebuttal at Rebuttal Work Paper E-DEPCOMP. In Tennessee, the composite depreciation reserve is 42.81% of Tennessee jurisdictional assets. *Id.* Thus, Tennessee's depreciation reserve position is stronger than Georgia's. So, it stands to reason that if Atmos had presented a comprehensive ELG depreciation study in this case that included the Tennessee jurisdictional assets, as it did in Georgia, Atmos could well be recommending a decrease in depreciation rates in this case, as it did in Georgia. Accordingly, Atmos's ELG depreciation proposal should be rejected because it is based on dated and incomplete information that may not reflect the current situation. Atmos simply should not be allowed to maximize its depreciation expense by cherry-picking ELG depreciation rates for shared services assets while retaining ALG depreciation rates for the Tennessee jurisdictional assets.

Additionally, the Authority should reject ELG depreciation altogether because it is not a sound depreciation convention for ratemaking purposes. Although Atmos suggested that the

TRA has adopted ELG depreciation for Chattanooga Gas (Tr. at II.39), a review of the TRA's orders reveals that this agency has never explicitly decided whether ELG or ALG is the better depreciation method for ratemaking purposes, nor has the TRA affirmatively approved ELG depreciation on the basis that it is the best depreciation convention for ratemaking. Rather, a review of Chattanooga Gas's rate case orders reveals that, in TRA Docket No. 97-00982, the TRA approved Chattanooga Gas's depreciation proposal due to the particular circumstances presented in that case. Chattanooga Gas Rate Case Order issued on October 7, 1998, TRA Docket No. 97-00982, page 44. Apparently, Chattanooga's proposal included ELG depreciation rates; however, the Authority's order did not discuss (or even mention) ELG depreciation or ELG depreciation rates anywhere within it. The Authority, therefore, has not made a decision that affirmatively approves the ELG depreciation convention over the ALG depreciation convention. The Consumer Advocate is asking the TRA to consider this issue for the first time here.

As Atmos witness Roff testified, there are two methods of group depreciation -- Average Life Group (ALG) and Equal Life Group (ELG). Roff Direct at 14-18. Atmos currently uses the ALG method; but, as discussed above, it is asking the Authority to approve ELG depreciation for its shared services assets. One principle difference in these two methods is that ALG assumes that assets within a group will be retired at the average service life whereas ELG assumes that distinct assets within the group have different service lives. Roff Direct at 14. In order to arrive at the distinct service lives within the group, ELG requires the computation of survivor curves, whereas ALG does not. Roff Direct at 10-11. Many assumptions, based on the experience and judgment of the depreciation analyst, are used to determine the shape of these curves. Roff Direct at 11-12. Thus, the calculation of ELG depreciation rates is more art than science.

As Mr. Roff acknowledged, ELG depreciation expense is generally more in earlier years than ALG depreciation expense. Roff Direct at 17. As argued above, however, an ELG depreciation study of existing Tennessee jurisdictional assets could actually produce a decrease in annual depreciation expense because of the strong depreciation reserve position of these particular assets. But, for any new vintage groups placed in service, the ELG method would produce higher annual depreciation expense. *Id.* Thus, ELG depreciation starts higher in earlier years and trends lower in later years whereas ALG depreciation remains more constant. This is illustrated by the hypothetical presented in the attached **Exhibit 4**, as well as Mr. Roff's hypothetical presented in Roff Direct at 15. As Mr. Roff illustrates, both ALG and ELG, if properly applied, will theoretically recover the same amount of depreciation expense. Roff Direct at 15. While ELG theory may be fine for financial accounting and reporting, it breaks down when it comes to utility ratemaking. In particular, ELG depreciation, when coupled with the passage of time between rate cases, will assure the utility an over-recovery of its depreciation expense on vintage groups in each and every case. As attached **Exhibit 4** demonstrates, the reality is that customer rates, which are set to recover ELG depreciation expense, remain constant between rate cases; however, the theory is that a utility's ELG depreciation expense will decline during the passage of time between rate cases. Although the ELG depreciation rates can be re-set at the correct level during the next rate case, the utility will again continue its over-recovery of depreciation expense from that point in time, albeit at a less egregious level. *See* attached **Exhibit 4** (the over-recovery of depreciation expense under ELG is represented by the shaded areas). This mismatch between reality and theory allows a series of depreciation expense premiums to be built in to customer rates. Thus, when all is said and done, ELG depreciation

will actually recover far more depreciation expense on existing assets than ALG, which is due to the mismatch between the reality of constant customer rates between rate cases and the theory of declining depreciation expense between rate cases. Moreover, the longer the utility goes between rate cases, the bigger the over-recovery becomes. Because ALG depreciation assumes that all assets within the group will be retired at the average service life of the group, ALG poses no such problem. *See* attached **Exhibit 4**. Furthermore, not only does ELG essentially guarantee an over-recovery of depreciation expense, but it also poorly matches current expenses with current ratepayers, which is a primary goal of any regulatory policy. There is no good reason why current ratepayers should have to shoulder more depreciation expense on the same vintage group of assets than future ratepayers -- as ELG would require them to do.

As Atmos witness Roff testified, one common criticism of ELG is that it is not widely accepted in most jurisdictions. Roff Direct at 17. The problems discussed above -- concerning the over-recovery of depreciation expense, the mismatch between current expenses and current ratepayers, and the level of subjectivity associated with the calculation of ELG rates -- are often cited as the reasons why ELG is rejected in most jurisdictions. *See, e.g.,* Order No. 16 at page 51 issued by the Arkansas Public Service Commission in Docket No. 04-121-U on September 19, 2005 (2005 WL 3354346); Order at page 3 issued by the Michigan Public Service Commission in Case No. U-12999 on October 14, 2004 (2004 WL 2381069); Order at pages 20-21 issued by the Colorado Public Utilities Commission in Docket No. 00S-422G on March 15, 2001 (2001 WL 574577); Order at page 39 issued by the Connecticut Department of Public Utility Control in Docket No. 99-09-03 on May 25, 2000 (2000 WL 944956). For these same reasons, the Consumer Advocate urges the TRA to also reject ELG in favor of the widely-accepted ALG depreciation convention.

One final note that should be discussed is the Federal Communication Commission's use of ELG depreciation. The FCC approved ELG on a going forward basis from 1981. *See* Report and Order at paragraphs 89-97 issued by the FCC in Docket No. 20188 on December 5, 1980 (1980 WL 121421). The FCC adopted this remaining life procedure due in part to the absence of depreciation reserve records (a problem that does not exist here). *Id.* As members of the Authority and Staff may recall, however, the FCC also required a continuing series of depreciation dockets to correct for the decline in ELG depreciation rates. *Id.* If the Authority believes that ELG depreciation should be approved for ratemaking purposes in Tennessee, it should also be prepared to convene regular depreciation dockets to correct for declining depreciation rates, just as the FCC did.

Taxes Other Than Income Tax

Taxes other than income is an issue worth about $684 thousand for the 2007 test year. Buckner Rebuttal Work Paper TB-1, Line 13; Tr. at II.4. At the hearing, Consumer Advocate witness Buckner corrected the Consumer Advocate's payroll tax calculation by adding approximately $80 thousand to the original forecast. Tr. at I.72. This correction essentially resolved any differences between the parties with respect to payroll taxes. Tr. at II.9; X.16.

Most of the remaining difference between the parties is attributable to the gross receipts tax and allocated shared services taxes. With respect to gross receipts tax, Atmos does not have any real difference with the Consumer Advocate's calculation for 2006. Tr. at X.17. However, Atmos disagrees with the Consumer Advocate's calculation of gross receipts tax for 2007. *Id.* The gross receipts tax issue is worth about $339 thousand. Buckner Rebuttal at Exhibit Schedule 5, Line 2. According to Atmos, the Consumer Advocate's 2007 tax calculation is too low

because it fails to account for the effects of rising gas costs. Tr. at X.17. As demonstrated below, however, the Consumer Advocate has correctly computed gross receipts tax for 2007.

To understand the Consumer Advocate's forecast of gross receipts tax, one must also understand the basis of the gross receipts tax and the timing of the tax payments. In August of each year, the company pays a tax on gross receipts for the tax year ending the next June 30, which is based on the receipts from the company's prior fiscal year ended September 30. Thus, for instance, in August 2005, Atmos paid gross receipts tax for the tax year ending June 2006, and that tax payment was based on Atmos's gross receipts for its fiscal year ended September 2004. MFR #47(a). And, in August 2006, Atmos will likewise pay gross receipts tax for the tax year ending June 2007, and that tax payment will be based on Atmos's gross receipts for its fiscal year ended September 2005. Finally, in August 2007, Atmos will pay gross receipts tax for the tax year ending June 2008, and that tax payment will be based on Atmos's gross receipts for its fiscal year ending September 2006.

Accordingly, the Consumer Advocate's gross receipt tax forecast for the test year ending September 2006 -- which includes three quarters of the tax year ending June 2006, and one quarter of the tax year ending June 2007 -- was based on the company's actual gross receipts for three quarters of the fiscal year ended September 2004 and one quarter of the fiscal year ended September 2005. Buckner Direct at Work Paper T-OTAX7. Thus, the 2006 gross receipts tax forecast was based on gross receipts that were actually known. Likewise, the Consumer Advocate's gross receipt tax forecast for the test year ending September 2007 -- which includes three quarters of the tax year ending June 2007, and one quarter of the tax year ending June 2008 -- was based on the company's actual gross receipts for three quarters of the fiscal year ended September 2005 and one quarter of the fiscal year ending September 2006. Buckner Rebuttal at

Rebuttal Work Paper T-OTAX7. Thus, the 2007 gross receipts tax forecast was based on three quarters of gross receipts that were actually known from the 2005 fiscal year, with only one quarter of the gross receipts being forecasted from the 2006 fiscal year. Contrary to Atmos's claim, however, the Consumer Advocate's projection of 2006 gross receipts recognized the effects of rising gas prices. Indeed, the Consumer Advocate projected a 51% increase in gross receipts from 2005 to 2006, due primarily to rising gas prices -- from $161 million in actual 2005 gross receipts to $243 million in projected 2006 gross receipts. Buckner Rebuttal at Rebuttal Work Paper T-OTAX7. Atmos is simply incorrect in its assertion that the Consumer Advocate ignored the effects of rising gas prices in its gross receipts tax calculation. As demonstrated above, the Consumer Advocate's gross receipts tax forecast is well supported, whereas Atmos's is not; therefore, the TRA should adopt the Consumer Advocate's gross receipts tax amount.

With regard to the allocation of shared services taxes, the Consumer Advocate did not include these taxes in its forecast because they are without any support. As a general principle, taxes in Tennessee are predicated on the revenues, wages, and investment within the jurisdiction. Consequently, the Consumer Advocate's forecast of taxes is based on empirical calculations, whereas Atmos did not provide any calculations in support of its projected taxes. Additionally, special allocations of shared services taxes are not typically done in a rate case proceeding. Tr. at II.13. Despite the Consumer Advocate's request for Atmos to provide support for its proposed taxes, Atmos failed to do so. Second Joint Discovery Response, DR#11. Rather, the company simply listed on a page the amount of shared services taxes that it claims Tennessee ratepayers should cover -- about $300 thousand -- without providing any information about the particular taxes themselves or how they were calculated. Petersen/Waller Rebuttal at Schedule P/W-8 (Account 4081-9344). Thus, unlike every other single tax calculation presented in this case, the

Consumer Advocate had absolutely no information about the purpose, identity, tax base, or tax rate of Atmos's purported shared services taxes. Accordingly, as Consumer Advocate witness Buckner testified, the shared services taxes were excluded because there was no way to substantiate whether the proposed taxes and amounts are proper or not. Tr. at II.12. The TRA, therefore, should disallow the proposed shared services taxes under these circumstances.

Income Tax Expense

Errors in Atmos's calculation of income tax expense is an issue worth $125 thousand in the 2007 test year. In particular, Atmos failed to include the tax effect of both the Investment Tax Credit (ITC) amortization of $104 thousand and net permanent tax differences of $52 thousand in its federal income tax and Tennessee excise tax calculations for 2007. Buckner Rebuttal at 19. These ITC and net permanent tax difference amounts were disclosed by Atmos in the First Joint Discovery Request, DR #30b (permanent tax differences) and 30f (ITC). As the attached **Exhibit 5** demonstrates, Atmos's failure to include these amounts in its federal income tax and state excise tax calculations caused its 2007 income tax expense to be overstated by $125 thousand. *See* attached **Exhibit 5**, Buckner Rebuttal at 19. Atmos never rebutted the Consumer Advocate's income tax treatment of ITC and net permanent tax differences in its pre-filed testimony or during the hearing on the merits.

Because the income tax effect of ITC and net permanent tax differences change from year-to-year, appropriate treatment of these items for the 2006 test year would produce a slightly different calculation. As demonstrated in attached **Exhibit 5**, the Consumer Advocate reduced its 2006 income tax expense by $139 thousand as a result of ITC amortization and net permanent tax differences. Thus, regardless of whether the TRA adopts a 2006 test year or 2007 test year, it is important for the Authority's federal income tax and state excise tax calculations to

recognize Atmos's reported ITC amortization and net permanent tax differences. For the 2006 test year, the tax effect of these items would reduce income tax expense by $139 thousand; and for the 2007 test year, the tax effect of these items would reduce income tax expense by $125 thousand. *See* attached **Exhibit 5.**

NOI Adjustments

There are two NOI adjustments that the parties treated differently -- (1) accrued interest on customer deposits and (2) allowance for funds used during construction (AFUDC). Buckner Rebuttal Work Paper TB-1, Lines 18 and 19. At the hearing, Atmos corrected its NOI adjustment for accrued interest on customer deposits. Atmos witness Petersen testified that, using the tariffed rate of 6% for interest on customer deposits instead of the 7.74% rate designated for PGA refunds due to ratepayers, its NOI adjustment for customer deposits should be reduced from $471 thousand to $365 thousand. Tr. at X.7-8. Atmos's corrected $365 thousand figure compares favorably to the Consumer Advocate's NOI adjustment of $368 thousand for the 2006 test year and $391 thousand for the 2007 test year. Buckner Rebuttal Work Paper TB-1, Lines 18 and 19. Accordingly, the issue concerning the NOI adjustment for accrued interest on customer deposits should be essentially resolved by Atmos's correction at the hearing. Tr. at X.7-8.

The NOI adjustment regarding AFUDC, however, has not been resolved. As Consumer Advocate witness Buckner testified, ratemaking practice requires an AFUDC adjustment to NOI in order to prevent the utility from recovering the cost of certain capitalized funds twice. Buckner Rebuttal at 25. Based on Atmos's general ledger for Tennessee, Mr. Buckner computed an AFUDC adjustment to NOI of $235 thousand for both the 2006 and 2007 test years. Buckner Direct at Work Paper NOI-AFUDC; Buckner Rebuttal at Rebuttal Work Paper NOI-AFUDC.

Atmos failed to make any NOI adjustment for AFUDC; however, it did not rebut the Consumer Advocate's NOI adjustment for AFUDC in its pre-filed testimony or during the hearing on the merits. In accordance with established ratemaking practice, the TRA should include a $235 thousand addition to NOI in order to properly account for the allowance for funds used during construction.

RATE BASE

Plant In Service

Plant in service is an issue worth $2.7 million for the 2007 test year. Buckner Rebuttal Work Paper TB-1, Line 25. There are three sub-issues that make up the differences between the Consumer Advocate's and Atmos's rate base forecasts in this area -- a beginning balance problem, an allocation factor problem, and capitalized LTIP salaries. Atmos witness Petersen testified to an approximate $2 million rate base difference for 2007. Tr. at X.18-19. Mr. Petersen is referring to the fact that Atmos failed to reconcile the beginning plant balances in its forecast with Atmos's own books. As attached **Exhibit 6** clearly demonstrates, the May 31, 2006, beginning point for gas plant in service in Atmos's forecast is $1.9 million greater than the May 31, 2006, balance for gas plant in service per Atmos's own books. On the other hand, the Consumer Advocate reconciled the beginning March 31, 2006, plant balances in its forecast to Atmos's books. *Compare* Buckner Rebuttal at Rebuttal Work Paper RB-PLANT93, page 16 of 30 *with* Second Joint Discovery Response, DR# 1. This accounts for $1.9 million of the parties' gas plant in service differences. Furthermore, Atmos's plant additions for its 2006 fiscal year that were disclosed in discovery to the Consumer Advocate do not agree to the 2006 plant additions that Atmos uses to build its 2007 forecast. In its last discovery response to the Consumer Advocate on this issue, Atmos projected 2006 plant additions of $14.6 million. MFR

#52 (supplemental and amended response filed on August 17, 2006). However, Atmos included $17.1 million in 2006 plant additions in order to calculate the beginning balances for its 2007 forecast. Petersen Direct at WP THP 7-5 (compare monthly beginning and ending plant and accumulated depreciation balances for the 2006 fiscal year). The TRA should adopt the Consumer Advocate's beginning plant balances because they reconcile to the company's books, whereas Atmos's balances do not. Thus, Atmos's beginning plant balances are unsupported and should be disallowed.

Atmos's use of the wrong allocation factors overstated the 13-month average for allocated plant. Petersen Direct at WP THP 7-5, page 1, line 1, columns h-k. At the hearing, Atmos witness Petersen testified that the allocation factors used by the Consumer Advocate were appropriate, and that Atmos did not disagree with the Consumer Advocate's allocation factors for allocated plant. Tr. at X.57-58. As a result, Atmos's allocated plant is overstated by $111 thousand in its 2007 test year forecast.

Finally, Atmos capitalized in its rate base nearly $628 thousand in LTIP salaries. Buckner Rebuttal at Rebuttal Work Paper RB-LTIP. For the same reasons discussed earlier in this brief concerning the exclusion of LTIP expenses, the Consumer Advocate also excluded the rate base portion attributable to capitalized LTIP salaries. The TRA should treat both the LTIP expense issue and the LTIP rate base issue in a consistent manner. As argued in this brief under the LTIP expense issue, ratepayers do not receive any benefits from Atmos's LTIP; accordingly, both the expense and rate base portions of LTIP should be disallowed.

Working Capital/Prepaids

Working capital is an issue worth about $723 thousand. Second Joint Discovery Response, DR# 15. Atmos arrives at its working capital addition to rate base by including

prepaid expenses -- such as insurance, postage and maintenance contracts -- existing as of May 2006. *Id.* Atmos did not perform or submit a lead/lag study. The Consumer Advocate excluded these prepaid expense items because, in the absence of a lead/lag study, there is no assurance that this working capital addition is correct. Buckner Rebuttal at 21. First, Atmos's inclusion of only the leads attributable to prepaid expenses fails to recognize the effects of offsetting expense lags. *Id.* While some expense items are paid before the goods or services are received (such as Atmos's prepaids), other expense items are paid after the goods or services are received. *Id.* For example, payroll is not paid until after the associated services are performed by employees. *Id.* In addition, many vendors bill for goods or services in arrears on terms such as net in 30 days or net in 60 days. Atmos's inclusion of prepaid expense leads, without recognizing any expense lags, overstates its working capital requirement. *Id.*

Atmos's inclusion of prepaids existing as of May 2006 is also problematic because there is no assurance that this one point in time is truly representative of normal prepaid balances. As Atmos witness Buckner stated during the hearing, traditional ratemaking practice would require an average of several observations, as opposed to the single observation that Atmos used. Tr. at II.47.

Accordingly, Atmos's addition to rate base for prepaids should be disallowed or, in the alternative, reduced to recognize the effects of offsetting expense lags.

Accumulated Depreciation

Accumulated depreciation is an issue worth $645 thousand in the 2007 test year. Tr. at X.19. Atmos witness Petersen testified that the Consumer Advocate overstated accumulated depreciation and, thus, understated rate base, because it failed to properly account for retirements in its starting point. *Id.* Atmos's argument is without merit. The Consumer Advocate's starting

points for its forecast of both plant in service and accumulated depreciation were balances as of March 31, 2006. Moreover, the Consumer Advocate used the same source for both its plant in service and accumulated depreciation beginning balances -- that source being Atmos's own balances for its plant in service and accumulated depreciation subaccounts. Second Joint Discovery Response, DR #1.

Accordingly, retirement work in process could not possibly cause either an understatement or overstatement in the Consumer Advocate's rate base forecast. This is so because retirements reduce both plant in service and accumulated depreciation by equal amounts (the balancing journal entry for retirements is a debit to accumulated depreciation and a credit to plant in service). In other words, retirements do not affect the rate base balance at all since the same amount is deducted from both the asset account (plant in service) and the contra-asset account (accumulated depreciation). Therefore, by using the same data source for plant in service and accumulated depreciation -- that source being the company's own reported numbers by subaccount in Second Joint Discovery Response, DR #1 -- and by starting from the same point in time for plant in service and accumulated depreciation -- that point being the balances as of March 31, 2006 -- there is no conceivable way that retirement work in process could have any affect on the Consumer Advocate's rate base forecast. Accordingly, the TRA should adopt the Consumer Advocate's beginning balances for plant in service and accumulated depreciation because they tie directly to Atmos's own accounting records.

Accumulated Deferred Federal Income Taxes (ADFIT)

ADFIT is an issue worth $6.9 million in the 2007 test year. Buckner Rebuttal Work Paper TB-1, Line 36. The Consumer Advocate's ADFIT forecast is based on the ADFIT beginning balances taken straight from Atmos's books, and then grown by the federal income tax

effect on the ADFIT timing differences reported by Atmos in discovery. Curiously, Atmos's ADFIT forecast does not reconcile with its own ADFIT records.

The bulk of the ADFIT difference -- about $6.7 million of the $6.9 million total difference -- lies in the parties different forecasts for Company 093 (Tennessee). The remaining $0.2 million stems from similar differences in allocated ADFIT. For Company 093, Atmos records ADFIT only at fiscal year end; thus, the latest ADFIT actual is the balance as of September 30, 2005. (The Consumer Advocate would note that annual accrual of ADFIT inappropriately understates the ADFIT 13-month average because ADFIT -- which is primarily driven by differences in tax depreciation and book depreciation -- should be recorded monthly, just as book depreciation is recorded monthly.) The Company 093 ADFIT balance at September 30, 2005, was $34.5 million. MFR #10 (summation of accounts 190, 282, and 283); *see also* Second Joint Discovery Response, DR #18. The Consumer Advocate used this number as its starting point for its ADFIT forecast. Buckner Rebuttal at Replacement Work Paper RB-DEFTAX. In discovery, Atmos reported ADFIT timing differences of $7.8 million for fiscal year 2006 and $1.8 million for fiscal year 2007. First Joint Discovery Response, DR #30c. Applying the statutory federal income tax rate of 35% to Atmos's projection of $7.8 million in ADFIT timing differences for 2006, the Consumer Advocate projected ADFIT accruals of $2.7 million for 2006. Buckner Rebuttal at Replacement Work Paper RB-DEFTAX. Thus, the ADFIT ending balance for the 2006 test year was computed to be $37.2 million (34.5 + 2.7) *Id.* And, applying the statutory federal income tax rate of 35% to Atmos's projection of $1.8 million in ADFIT timing differences for 2007, the Consumer Advocate projected ADFIT accruals of $0.6 million for 2007. Thus, the ADFIT ending balance for the 2007 test year was computed to be $37.9 million (37.2 + 0.6 (rounded)). Buckner Rebuttal at Rebuttal Work Paper RB-DEFTAX.

From these balances, the Consumer Advocate computed an ADFIT 13-month average balance of $37.6 million for Company 093 for the 2007 test year. *Id.*

On the other hand, for Atmos's 2007 test year, it inexplicably computed an ADFIT beginning balance of $30.7 million for Company 093 (as opposed to the Consumer Advocate's $37.2 million), an ADFIT ending balance of $31.1 million for Company 093 (as opposed to the Consumer Advocate's $37.9 million), and an ADFIT 13-month average balance of $30.9 million for Company 093 (as opposed to the Consumer Advocate's $37.6 million). Petersen Direct at WP THP 7-5, page 19 of 27. Atmos's ADFIT forecast is simply irreconcilable with its own accounting records and projected timing differences. Given the amount of ADFIT timing differences that Atmos forecasts for 2006 and 2007 (which increase ADFIT), it is mathematically and theoretically impossible for Atmos's projected ADFIT ending balance of $31.1 million at September 2007 to be less than its actual ADFIT ending balance of $34.5 million at September 2005. As demonstrated above, the ADFIT calculations are straightforward, and the Consumer Advocate's calculations are both mathematically and theoretically correct. Indeed, Atmos never rebutted the Consumer Advocate's ADFIT forecast in its pre-filed testimony or during the live hearing. Accordingly, the Consumer Advocate's ADFIT reduction from rate base should be adopted by the TRA.

Unamortized Rate Case Expense

Unamortized rate case expense is an issue worth $137 thousand in the 2007 test year. Peterson Direct at WP THP 7-4, Line 11. For the same reasons discussed earlier in this brief concerning the reduction or exclusion of amortized rate case expense, the Consumer Advocate excluded the rate base portion attributable to unamortized rate case expense. The TRA should treat both the amortized rate case expense issue and the unamortized rate case expense rate base

issue in a consistent manner. As argued in this brief under the amortized rate case expense issue, unamortized rate case expense should be excluded from rate base.

II. COST OF CAPITAL ISSUES

RATEPAYERS SHOULD PAY A REASONABLE COST OF CAPITAL NOT ONE BASED ON CAPITAL GAINS SPECULATION

INTRODUCTION

Consumer Advocate witness Dr. Steve Brown testified as to the cost of capital in this case. In his testimony, Dr. Brown explained that he first determined that Atmos rewarded its shareholders through the payment of dividends rather than capital gains speculation. Brown Direct Testimony at 2:9-15 and 5:9-13. Accordingly, Dr. Brown set out to consistently use data from dividend paying companies where applicable.

Dr. Brown's focus on dividend paying companies and his decision to exclude or limit data from non-dividend paying companies (also referred to as capital gains companies) contrasts sharply with the other two cost of capital witnesses, Dr. Murry of Atmos and Mr. Kettles of the TRA Investigative Staff. The Consumer Advocate maintains that Dr. Brown's approach of focusing on dividend paying companies is the proper one and should be followed by the agency. Otherwise ratepayers will be forced to fund a rate of return that is more appropriate for speculative capital gains companies rather than a relatively low-risk utility like Atmos. Brown Direct Testimony at 2:9-15 and 2:24-32.

The Consumer Advocate's point that there is a great difference between equity returns achieved through capital gains speculation versus wealth achieved through dividend payments was, ironically, most tellingly made by Atmos's witness Dr. Murry as he explained why he, unlike Dr. Brown, included capital gains companies such as Microsoft in his analysis of the cost of equity for Atmos:

> . . .Microsoft at that time was one of the largest companies in the world, and Bill Gates was one of the richest people in the world as a result of growth of Microsoft without ever paying a dividend to Mr. Gates or to any other Stockholders.

Hearing Transcript ("Tr.") at VIII.20:15-21(August 31, 2006) (emphasis added).

We can all, of course, be glad for Microsoft's success. But surely the wild swings of the "dot.com" market are not what we want in the regulated gas business. When it comes to determining the cost of equity for Atmos it is necessary to concentrate on similar companies, not companies who are far outside the profile of a dividend-paying natural gas distribution company.

In addition to the issues related to the cost of each type of capital (equity and debt), there were also issues about the precise percentage of each kind of capital in Atmos's capital structure. As just stated, Consumer Advocate witness Dr. Brown began his cost of capital analysis by first determining what kind of company Atmos actually was with respect to the payment of dividends. Similarly, Dr. Brown based his capital structure analysis on a determination of what mix of debt and equity Atmos actually had in the past. Brown Direct Testimony at 2: 9-22 and Schedule 1. Dr. Murry, on the other hand, based his equity percentage in the capital structure on a forecast or target set by Atmos. Murry Direct at 13:9-21. Mr. Kettles came to nearly the same equity figure as Dr. Brown, but Mr. Kettles disregarded Atmos's prior use of short term debt and concluded that Atmos should have no short term debt in its capital structure. Kettles Direct at 3:16-6:10. Dr. Brown, looking at the actual audited figures over a ten year period, found that Atmos should have a significant amount of short term debt.

In this section on the Cost of Capital, the Consumer Advocate will discuss five main subjects: (A) the choice of comparable companies; (B) the use of the Discounted Cash Flow (DCF) model to compute the cost of equity; (C) the use of the Capital Asset Pricing Model

(CAPM) to compute the cost of equity; (D) the cost of debt; and (E) the capital structure of Atmos, i.e., the amount of Atmos's debt and equity.

Following is a brief summary of each of these five subjects with particular attention to where the Consumer Advocate's position differs from that of Atmos and the TRA Investigative Staff.

Comparable Companies

All three experts used fairly similar comparable companies to begin their analyses. Thus, the choice of comparable companies is not a major issue in this case.

DCF Model

With regard to the DCF model, the three experts differed markedly. As a result of his decision to concentrate on dividends and limit the influence of data from non-dividend companies, Dr. Brown used the DCF model containing a factor for dividend growth as opposed to earnings growth. Brown Direct Testimony at 8 and Brown Rebuttal at 24-28. The other two experts, Mr. Kettles and Dr. Murry, used the DCF model for both dividend and earnings growth, but both experts virtually disregarded the results of the dividend growth model, apparently because it didn't meet their preconceived notion of a high enough rate of return. Kettles Direct at 12-14; and Murry Direct at 26:7-27:2.

CAPM Model

The three experts differed most sharply in their use of the CAPM model. Unlike Dr. Brown, Mr. Kettles and Dr. Murry did not attempt to limit the influence of data from non-dividend companies in their CAPM calculations. In particular, the three experts differed in their choice of data used to form the betas, the Risk Free Return, and the overall Market Return in the CAPM formula. The use of data from non-dividend companies caused Mr. Kettles and Dr.

Murry to have a much higher cost of equity based on the CAPM model: Brown CAPM: 8.0%; Kettles CAPM:10.75%; and Murry CAPM: 11.70/12.44%. Brown Direct at 16:25 and Schedule 14; Kettles Direct at 11:14-16; and Murry Direct at 31:5-6.

Cost of Debt

Dr. Brown calculated Atmos's cost of long-term debt cost as 5.523% at September 30, 2005, and his data source is the SEC's Form 10-K, an audited financial report which Atmos completed for its fiscal year of September 30, 2005. Brown Direct at 8:1-6.

Mr. Kettles is in close agreement with Dr. Brown on Atmos's debt cost. Mr. Kettles stated in his direct testimony page 6, line 15: "Atmos reported an effective cost of long-term debt of 5.58%" as of Sept. 30, 2005.

In contrast, Dr. Murry claims a debt cost one-half percent higher, nearly 50 basis points higher than the audited figure of 5.52 percent: ". . . the embedded cost of long-term debt of Atmos Energy [is] 6.03 percent." Murry Direct at 4:20-21. In order to come up with this figure, Dr. Murry stated that he looked at "financial statistics " of Atmos and statistics for other comparable companies. Murry Direct at 4:21-23. No adequate reason was given for departing from the audited figures in computing debt cost; the effect, obviously, was to increase the cost of debt.

Capital Structure

Dr. Brown and Mr. Kettles were in fairly close agreement as to the percentage of equity in the capital structure; Dr. Brown proposed an equity figure of 44.3% and Mr. Kettles proposed an equity figure of 43.09%. Brown Direct at 2:21; Kettles Direct at Exhibit 1, Schedule JLK-1. Dr. Murry, however, proposed an equity figure of 50%. Murry Direct at 13:20-21. Dr. Brown also had a figure 12.6% short term debt, while Mr. Kettles and Dr. Murry had no short term debt.

Brown Direct at 2:22; Kettles Direct at 7:14-17; and Murry Direct at 12:21-13:8. The Consumer Advocate maintains that Dr. Brown's short term debt figure more accurately reflects Atmos's actual history.

Dr. Brown's Final Figures

The Consumer Advocate urges the TRA to adopt Dr. Brown's cost of capital and capital structure as follows:

> The capital-cost components are 8% to equity, 5.52% to long term debt, and 5.09% to short term debt. These capital costs apply to a capital structure composed of 44.3% equity, 43.1% long term debt, and 12.6% short term debt, which sum to 100%.

Brown Direct at 2:17-22

A. Comparable Companies

As stated above, all three experts used fairly similar comparable companies to begin their analyses. Brown Direct at 5:25-6:31; Kettles Direct at 8:12-9:6; and Murry Direct at 11:8-12:12. Thus, the choice of comparable companies is not a major issue in this case.

It is important to note, however, that both Dr. Murry and Mr. Kettles recognized the importance of focusing on dividend paying companies in their selection of comparable companies. Thus, Mr. Kettles stated that he ". . . removed SEMCO Energy and Southern Union [from the list of comparable companies] because they have an inconsistent history of dividend payments." Kettles Direct at 9:3-4. Similarly, Dr. Murry stated that he "excluded companies that do not pay a dividend . . . ." Murry Direct at 11:16. As will be seen below, however, Mr. Kettles and Dr. Murry did not carry through on this principle of focusing on dividend paying companies when it came to other parts of their work, particularly their CAPM analysis.

B. DCF Model

The three experts differed greatly in their use of the DCF model. As a result of his decision to concentrate on dividends and limit the influence of data from non-dividend companies, Dr. Brown used the DCF model containing a factor for dividend growth as opposed to earnings growth. Brown Direct Testimony at 8 and Brown Rebuttal at 24-28. The other two experts, Mr. Kettles and Dr. Murry, used the DCF model for both dividend and earnings growth, but both experts virtually disregarded the results of the dividend growth model, apparently on the ground that it somehow was too low. Kettles Direct at 13:1-7, 14; and Murry Direct at 20:5-27:2.

The DCF formula is as follows:

$K=D/P+g$

Where: K=cost of equity
D=dividend per share
P=price per share
g=growth rate

The expression D/P is the dividend yield. The measure of the growth rate, g, is measured as dividend growth (as used by all three experts), but often earnings per share growth are used (as used by Mr. Kettles and Dr. Murry but not by Dr. Brown). Kettles Direct at 12:2-10.

Dr. Brown explained his reliance on the DCF model as follows:

> In my opinion the DCF is a sound model, not easily construed to give results far from the mainstream. Dividends and dividend yields are well tracked by web sites, newspapers, newsletters, and other forms of the popular press. In my opinion the public availability of the inputs and the ease with which they can be applied explain why the model appears in every rate case and in every jurisdiction.

Brown Direct at 8:21-32.

Using the DCF model, Dr. Brown found that 8% was a reasonable return on equity. Brown Direct at 8:14-19. As previously stated, Dr. Brown only used the DCF model for dividend growth because he had determined that Atmos was a dividend paying company. He did not compute the DCF using earnings growth since this would be more appropriate for capital gains companies.

Mr. Kettles computed the DCF for both dividend and earnings growth:

> The DCF calculation using the long-term forecast of earnings per share supports an equity return between 11.17% and 12% based upon the lowest and highest dividend yield in the past 52 weeks. The DCF calculation using dividend growth provided much lower equity returns of 6.17% to 7% per the low and high ranges of dividend yields.

Kettles Direct at 13:11-14.

Mr. Kettles, however, then proceeded to nullify the effect of the relatively lower DCF dividend figure by using it to compute a so-called "midpoint" within which to frame the much higher CAPM equity figure:

> The results of my CAPM and DCF analysis are found in schedule JLK-8. The results of the CAPM and the DCF analysis using forecasted earnings per share are very similar. However, the DCF results using the forecast dividends yields a substantially lower equity return. I chose the CAPM result of 10.75% equity return as it represents a loose midpoint between the DCF estimates.

Kettles Direct at 14:3-7 (emphasis added).

Clearly, this use of a "midpoint" lessens the impact of the DCF dividend model. But the "midpoint" of the DCF figures that Mr. Kettles claimed was a kind of verification of his CAPM equity figure was nothing of the sort. The actual midpoint between the DCF figures is **9.085%** as shown by the following calculation based on figures taken from Mr. Kettles Direct Testimony at 13:

1. Discounted Cash Flow Using Earnings per Share Growth Rate:

11.17%	12.00%
LOW	HIGH

2. Discounted Cash Flow Using Dividend Growth Rate:

6.17%	7.00%
LOW	HIGH

3. Average of Each:

(a) 11.17% + 12.00% = 23.17% 23.17% / 2 = 11.585%

(b) 6.17% + 7.00% = 13.17% 13.17% / 2 = 6.585%

4. Average of Average of Dividends Growth and Earnings Growth:

(a) 11.585% + (b) 6.585% = 18.17% 18.17% / 2 = 9.085%

5. Midpoint Between DCF Dividends Growth and DCF Earnings Growth:

9.085%

If this actual midpoint of 9.085% is compared to the CAPM of 10.75%, which also served as Mr. Kettles' final proposed return on equity in this case, it is obvious that the final figure must be reduced.

Accordingly, the Consumer Advocate proposes the following adjustment to Mr. Kettles final figure of 10.75% for the return on equity. The CAPM of 10.75% should be averaged with the "midpoint" of 9.085% to yield a return on equity of 9.917% (10.75% + 9.085% ÷ 2 = 19.835% ÷ 2 = 9.917%).

Like Mr. Kettles, Dr. Murry's DCF methodology also had the effect of nullifying the implications of his DCF dividend calculations. Using the DCF dividend model, Dr. Murry found an equity cost of 5.90/6.74% (high/low for the year). Murry Direct at 26:16. Dr. Murry, however, concluded that these figures were not credible mainly because they conflicted with the

much higher DCF earnings figure of 11.59/12.42% (high/low for the year). Murry Direct at 26:19-20. The obvious question, of course, is why not throw out the higher DCF earnings figure because it is too high in light of the much lower DCF dividend figure?

Significantly, as was the case with Mr. Kettles' DCF figures, the calculation of a true midpoint of Dr. Murry's DCF figures yields a more reasonable cost of equity. The midpoint for Dr. Murry's DCF results are calculated in the same way as the midpoint for Mr. Kettles' results. The average of Dr. Murry's DCF dividends model is: (5.90% +6.74%)/2 =6.32%. The average of Dr. Murry's DCF earnings growth model is: (11.59% + 12.42%)/2=12.00%. Thus, the midpoint of 6.32% and 12.00% is 9.16%.

As Dr. Brown said in his summary, calculating a DCF return using earnings growth will not lead to just and reasonable rates in Tennessee:

> Finally -- I don't want to run over -- I simply point out that we also rebutted -- I also rebutted the use of earnings growth rates and discounted cash flow. My opinion is that when you use earnings growth rates to pump up the return from a discounted cash flow that essentially it's easily manipulated, that you can pump the rates up to what you would like to see and it's -- it doesn't follow standard procedure, because when investors and companies get their returns, it's the dividend and the dividend growth. They're not getting earnings per se.

Tr. at V:91:15-25 (August 30, 2006)

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This point about manipulating the DCF results was tellingly made by Atmos's witness Dr. Murry, in his rebuttal testimony, page 14 lines 7 -15:

> As my Rebuttal Schedule DAM-R5 shows, the historical earnings growth rate... produces an estimated...return...of 14.98 percent.

This figure is obviously ridiculously high and shows how far results can be manipulated.

Finally, Dr. Murry's and Mr. Kettles' emphasis on earnings growth does not comport with the company's emphasis on its dividend as the source of attraction to investors. In discovery Atmos provided minutes of its Board of Directors meeting for the June 16, 2003, meeting. Those minutes show the following: "there appears to be strong retail interest in the Company stock, primarily due to the dividend tax cut." Atmos's Discovery Reply, sent by e-mail in PDF format entitled "Documents Responsive To CAPD Request No. 2 (Page 8)," at page 11 of the Reply. Clearly, dividends, not earnings, are what Atmos believes its investors are interested in.

In conclusion, Dr. Murry and Mr. Kettles both, in effect, disregarded the clear findings of their DCF dividend model. Accordingly, the TRA should reject their DCF finding or adjust them downward.

C. CAPM Model

Unlike Dr. Brown, Mr. Kettles and Dr. Murry did not attempt to limit the influence of data from non-dividend companies in their CAPM calculations. In particular, the three experts differed in their choice of data used to form the betas, the Risk Free Return, and the overall Market Return in the CAPM formula. As will be shown below, the figures for betas and Market Return chosen by Mr. Kettles and Dr. Murry were heavily influenced by companies relying on capital gains speculation for their value. The use of data from non-dividend companies caused Mr. Kettles and Dr. Murry to have a much higher cost of equity based on the CAPM model: Brown CAPM: 8.0%; Kettles CAPM:10.75%; and Murry CAPM: 11.70/12.44%. Brown Direct at 16:25 and Schedule 14; Kettles Direct at 11:14-16; and Murry Direct at 31:5-6 and 28:19-23.

Dr. Murry's dual CAPM number is somewhat unusual; he explained it as follows:

> I applied two different, but complementary, approaches to estimate a CAPM cost of capital. One of these methods examines the historical risk premium of common stock over high grade

> corporate bonds. The other integrates the risk premium of common stocks to long-term bonds in recent markets. This second method requires an adjustment for the bias because of company size I mentioned previously.

Murry Direct at 28:19-23. It should be noted that the second higher number contains an "adjustment" for so-called size bias which Dr. Murry claims affects large companies like Atmos but this adjustment has not been recognized by the TRA and should be rejected here.

The CAPM model is expressed as follows:

$K = R_f + \beta(R_m - R_f)$

Where: K = expected return

R_f = risk free return

R_m = overall market return

β = measure of asset risk relative to market risk.

Portions of the CAPM formula will be referred to in the following analysis.

1. <u>Choice of Betas</u>

Dr. Brown's beta was deliberately chosen to lessen the impact of capital gains speculation on rates paid by Tennessee consumers. Dr. Brown did this by choosing a beta that tracked the S&P index where only one-fourth of the companies are capital gains companies, as opposed to the New York Stock Exchange (NYSE) where one-half of the companies are capital gains companies. Brown Rebuttal at 17:7-15. The beta chosen by Dr. Brown was a "NASDAQ" beta because it was listed on a NASDAQ web site but it tracked the S&P 500. Brown Rebuttal at 16:17-18. Dr. Brown's beta was .33. Brown Rebuttal at 16:19-20.

Mr. Kettles and Dr. Murry, on the other hand, used betas derived from the NYSE. Brown Rebuttal at 15:16-26. Their betas came from Value Line, and were .91 for Dr. Murry and .87 for

Mr. Kettles. Brown rebuttal at 16:21-25; and Hearing Transcript ("Tr.") at V.88:12-90:9 (August 30, 2006) . Obviously, these higher betas led to a higher return on equity when plugged into the CAPM formula as a multiplier of the difference between the overall Market Return minus the Risk-free Return.

Dr. Brown explained the impact of the different choice of betas in his summary during the hearing:

> Now, the betas that I took are from the NASDAQ website, and those betas do not track the NASDAQ exchange. Those betas track the S&P 500 index. That's why I chose it. In contrast, the other witnesses use the value line beta. The value line beta is derived from the New York Stock Exchange composite index approximately 1,800 to 2,000 companies. That's the second way that they have reintroduced capital gains considerations into the calculation of their equity return.
>
> It's my opinion that that is a mistake, that what they [ought to] have done was to have used a beta based on the S&P 500. What they have done in their Cap-M is to switch indexes - - indexes right in the middle of the stream. . . So if in fact, they had used an S&P 500 index such as from NASDAQ.com that I know of, their calculated returns they wouldn't be up around 12 or 11. They would be down to 8, which is where I am approximately.

Hearing Transcript ("Tr.") at V.89:16-90:9 (August 30, 2006) (emphasis added).

Dr. Murry's and Mr. Kettles' reliance on a beta drawn from the New York Stock Exchange Index is inappropriate because the overall market return is calculated on the basis of on the S&P 500 index; Brown Direct at 17:26-33 and Hearing Transcript ("Tr.") at V.85:1-6 (August 30, 2006). Obviously, Dr. Murry and Mr. Kettles switch indexes in mid-stream and provide no justification for such a change.

In conclusion, the betas chosen by Mr. Kettles and Dr. Brown introduced capital gains speculation into Tennessee rates. Accordingly, the TRA should use the beta chosen by Dr. Brown.

2. Risk Free Return

In essence, the CAPM method determines the cost of equity by finding the cost of a "Risk Free" investment and then adding to that the cost of the "Risk Premium" which is the product of the beta times the difference between the Market Return and the Risk Free Return. In the present case, the three experts used the following Risk Free figures: Dr. Brown-3.72%; Mr. Kettles-5.50%; and Dr. Murry-5.35%. Brown Rebuttal at 8; Kettles Direct at 10; and Murry Direct at DAM-23.

Dr. Brown based his Risk Free figure on the three-month Treasury bill. Brown Direct at 21:18-20. Mr. Kettles based his Risk Free return on long-term treasury bills. Kettles Direct at 10:19-20. Similarly, Dr. Murry based his 5.35% return on a 20-year Treasury bond. Brown Rebuttal at 23:17-18 (citing a discovery response from Atmos/Dr. Murry). As Dr. Brown shows in his Rebuttal, however, neither Mr. Kettles nor Dr. Murry offered any reason to use long-term debt over short-term debt. Brown Rebuttal at 21-24. In particular, neither Mr. Kettles nor Dr. Murry showed that there is any less risk in long-term debt. On the contrary, it is clear that tying up your money in a long-term investment has the obvious risk of being subject to swings in the economy while being unable to remove your investment. Accordingly, the most reasonable choice is to use the least expensive and more controllable form of investment, short-term debt.

3. Market Return Calculation

As shown in the CAPM formula set forth above, a key component of the CAPM return on equity is derived by multiplying the beta times the difference between the overall Market Return minus the Risk Free Return. Accordingly, if the Market Return is overstated, the resulting equity return will also be overstated. In the present case, Dr. Murry and Mr. Kettles overstated the Market Return by including many capital gains companies in it. The Market Return figures used

by the three experts were as follows: Dr. Brown- 9.93%; Mr. Kettles-12.50%; and Dr. Murry-12.45%. Brown Rebuttal at 8 (setting forth a comparative analysis of each witness's CAPM calculations); Kettles Direct at 11:8-9; Dr. Murry Direct at 27:12 and Schedule DAM-23 (where 12.45%= 5.35% (risk free return) + 7.10 (equity risk premium)) .

The source for Dr. Brown's figure of 9.93% is "the actual historical returns to the S&P 500 since 1925 . . . . taken from the Ibbotson Associates Yearbook--Stocks, Bonds, Bills and Inflation for 2005 . . . " Brown Direct at 17:17-22. Dr. Brown used what has been referred to as the "geometric" average to measure growth over that period, as opposed to "arithmetic" average; as will be explained below, the arithmetic average yields a higher return over time. Brown Direct at 19:6-16. As Dr. Brown acknowledges in his Direct Testimony, the arithmetic figure for the same period is 12.39%, which he referred to as the "fool's gold" figure. Brown Direct at 19:18-22.

According to Mr. Kettles's testimony, the source for his figure of 12.50% Market Return is the Ibbotson Yearbook, starting with the 2004 edition and also referring to the 2006 edition. Tr. at VI.11:3-7 and 12:2-8. Mr. Kettles used the arithmetic average which, as stated above, yields a higher return over time than the method used by Dr. Brown.

The source for Dr. Murry's Market return of 12.45% is, according to his testimony, the Ibbotson Yearbook. Tr. VIII.26:17-25.

Even though both Mr. Kettles and Dr. Murry relied on the Ibbotson Yearbook, neither witness took into account Mr. Ibbotson's position on declining market returns set forth in a December 14, 2005 "Fortune" magazine article referred to by Dr. Brown in his Rebuttal Testimony. Brown Rebuttal at 4-6. In that article Mr. Ibbotson "dialed down" his predicted growth rate to 9.27%, a figure consistent with Dr. Brown's figure of 9.93%.

Both Dr. Murry and Mr. Kettles compiled their figure for Market Return by taking the simple average of a sum of the return of large companies and small companies. Brown Rebuttal at 9 (referring to discovery responses by Mr. Kettles and Mr. Murry in which they described the averaging process).

Consumer Advocate witness Dr. Brown testified that such a combination of large and small companies reintroduced capital gains speculation into the determination of just and reasonable rates:

> . . . . They have picked to add to that [large company returns] returns from one small mutual fund which is the DFA Microcap Fund which happens to be under the advisory umbrella of the same man who wrote their yearbook, Mr. Ibbotson. So I have substantial rebuttal of what they have done. It's in my Schedules 2 in my rebuttal. I won't go into that, but what I discovered is that 70 percent of the companies in that fund don't pay dividends. It's a capital gains operation for the most part. So that's an example of how they have reintroduced the capital gains consideration of nondividend paying companies into the calculation of their return.

Tr. at V.87:17-88:6 (August 30, 2006).

Dr. Murry's and Mr. Kettles' Market Return was also overstated by their use of the "arithmetic" average of percentage changes in the market as opposed to the "geometric" average used by Dr. Brown. Dr. Brown referred to the use of the "arithmetic" average as "fool's gold" and explained why as follows:

> The figure is a "fool's gold" calculation because it overstates the true percentage increase when percentage increases are averaged with percentage decreases.
>
> Here is an example of the "fool's gold" calculation. If I bought a stock two years ago for $1000 and the market price declined to $500, I would have a loss of 50% in that year. If by a miracle the stock climbed back to $1000 the next year, I would have a 100% gain even though I have the same amount of money I started with.

> If I took that to a bank and asked for a loan on the basis of my percent gain, I think I would be turned down. The average gain over two years is the "arithmetic" mean, which is 25%, i.e., (-50% + 100%) /2. Any historical record averaging percentage losses and percentage gains to get an average percent increase always overestimates the true gain.

Brown Direct at 19:27-20:20. Obviously, the more accurate picture of gains and losses here is the "geometric" average use by Dr. Brown which, in this example, shows no gain or loss.

Accordingly, the TRA should not adopt the Market Returns of Mr. Kettles and Dr. Murry as used in their CAPM model.

In conclusion, the TRA should accept Dr. Brown's CAPM figure of 8.0%. If, however, the TRA considers using the CAPM analysis of Mr. Kettles or Dr. Murry, it should do so only after making certain adjustments.

As discussed above in the section on the DCF analysis, Mr. Kettles' CAPM figure of 10.75% should only be used if it is adjusted in light of the true DCF "midpoint" of 9.085% to yield an overall equity cost of no more than 9.917% under Mr. Kettles' analysis.

Dr. Murry's CAPM of 11.70/12.44% should first be adjusted by disregarding his so-called size adjustment for large company bias (neither Mr. Kettles nor Dr. Brown used this approach and it has not been recognized in Tennessee). Furthermore, Dr. Murry's high CAPM should be examined in light of his own reporting of the recent decisions of other commissions where out of some 25 decisions there is no reported equity return above 11.00% except for one figure of 11.50%. Murry Rebuttal at DAM R-4. Clearly, Dr. Murry's recommendation is out of step with current regulatory policy.

D. Cost of Debt

Dr. Brown calculated Atmos's cost of long-term debt cost as 5.523% at September 30, 2005, and his data source is the SEC's Form 10-K, an audited financial report which Atmos completed for its fiscal year of September 30, 2005. Brown Direct at 8:1-6.

Mr. Kettles is in close agreement with Dr. Brown on Atmos's debt cost. Mr. Kettles stated in his direct testimony page 6, line 15: "Atmos reported an effective cost of long-term debt of 5.58%" as of Sept. 30, 2005.

In contrast, Dr. Murry claims a debt cost one-half percent higher, nearly 50 basis points higher than the audited figure of 5.52 percent: ". . . the embedded cost of long-term debt of Atmos Energy [is] 6.03 percent." Murry Direct at 4:20-21. In order to come up with this figure, Dr. Murry stated that he looked at "financial statistics " of Atmos and statistics for other comparable companies. Murry Direct at 4:21-23. Obviously, the effect of departing from the verified figure was to increase the cost of debt.

Dr. Murry is repeating the same pattern he established in the 1995 case of United Cities/Atmos, Docket No. 95-02258, where his estimated debt cost was more than a half-percent higher than what the Company actually incurred. Brown Direct at 4. The Consumer Advocate urges the TRA to use the figure of 5.52% as Atmos's cost of long term debt. The Consumer Advocate urges the TRA to use the figure of 5.52% as Atmos's cost of long term debt because this figure is derived directly from Atmos's 10-K, a verified source.

E. Capital Structure

Dr. Brown and Mr. Kettles were in fairly close agreement as to the percentage of equity in the capital structure; Dr. Brown proposed an equity figure of 44.3% and Mr. Kettles proposed an equity figure of 43.09%. Brown Direct at 2:21; Kettles Direct Testimony at Exhibit 1,

Schedule JLK-1. Dr. Murry, however, proposed an equity figure of 50%. Murry Direct at 13:20-21. Dr. Brown also had a figure 12.6% short term debt, while Mr. Kettles and Dr. Murry had no short term debt. Brown Direct at 2:22; Kettles Direct at 7:14-17; and Murry Direct at 12:21-13:8.

Where possible, Dr. Brown used verified (audited) information in analyzing the Atmos capital structure. Brown Direct at 7:1-17. Dr. Murry, on the other hand, was content to rely on a mere "target" set by Atmos itself in determining the percentage of equity in the capital structure. Murry Direct at 13:20-23. Dr. Brown's is obviously the more reliable figure.

With regard to short term debt, Dr. Brown again looked at the historical record. In his Rebuttal Testimony, Dr. Brown laid out the record of Atmos's short term debt from 1996 through 2005, establishing that in every year except one Atmos had a significant percentage of short term debt.

Accordingly, the TRA should adopt Dr. Brown's proposed capital structure.

III. OTHER ISSUES (PIPELINE TRACKER, CONSERVATION, AND SERVICE QUALITY)

PROPOSED CUSTOMER UTILIZATION ADJUSTMENT TARIFF

The CUA and Proposed Tariff Changes Will Not Encourage Conservation

ATMOS has proposed a Customer Utilization Adjustment ("CUA") mechanism that adjusts rates upward in order to compensate for an annual decline in the amount of gas consumed due to conservation. Childers Direct at 3. It is the Consumer Advocate's position that this mechanism is simply a request for an automatic rate increase under the guise of "conservation". McCormac Rebuttal at 4. In essence, under the CUA the company could charge consumers for gas that is not delivered or consumed collectively by consumers. It is the position of the Company that this mechanism will encourage conservation while allowing ATMOS the opportunity to earn the authorized rate of return set by the Authority. Childers Direct. at 4. However, the CUA would in effect function as a surcharge on all consumers that would neither reward nor encourage conservation. McCormac Rebuttal at 4-7.

Whether an individual consumer, influenced by high gas bills, went to great lengths and sacrifice to conserve the amount of gas consumed would be irrelevant under the Company's proposal. A consumer that practices and invests in conservation would suffer the same collective surcharge as a neighbor that did not attempt to conserve. In light of the acknowledged trend in the decline in usage attributed to conservation the proposed mechanism would consistently raise consumer rates. Thus the end result would solely benefit the company by providing for an annual rate increase while leaving consumer conservation efforts out in the cold. Such a proposal will not encourage conservation.

In addition to the CUA, the company has proposed doubling the customer service charge consumers pay during the winter months. Childers Direct at 15. This change would also discourage conservation. Consumer Advocate expert Dan McCormac showed that instead of raising the fixed customer charge, the elimination or zeroing out of the fixed charge should be considered as an example of a possible alternative to benefit consumers and the company. McCormac Rebuttal at 7-8. As to one alternative example, completely eliminating the fixed customer charge would change the rate to an estimated $3.80 charge per MCF for all customers, thus rewarding consumers that use less gas with a lower transportation charge. McCormac Rebuttal at 6.

The CUA is Not a Necessity for Purposes of Setting Just & Reasonable Rates

In their respective forecasts, both the Consumer Advocate and the Company have taken into consideration and accounted for a 1.5% annual decline in the usage of gas due to conservation efforts. Tr. at V. 9, 22-23; McCormac Direct DM-5; Waller Direct at 4-5; Peterson-Waller Rebuttal at P/W-3. There is no need for a mechanism to counter a trend that has already been accounted for within authorized revenues. Furthermore the record in this docket contains the uncontradicted fact that the Company's revenues since 1995 have grown from the authorized amount of $44 million per year to nearly $54 million as of the 12 months ended March 31, 2006. Thus ATMOS has enjoyed a steady increase in revenue without the need for an annual rate adjustment to account for the decline in annual usage. McCormac Rebuttal at p. 5. In addition, ATMOS has not in the past "eaten the cost" of the 1.5% annual decline in usage trend due to countering affect of the annual trend of a 3% growth in new customers. Tr. at V.19-20; McCormac Direct at 2, Exhibits DM1-DM3. Revenue from new customers more than compensates for the decreased sales per customer attributed to consumers using less gas. Tr. at

V.18-20, 22-23. Thus, there is simply no need for the Company to benefit from a yearly automatic rate increase.

The Proper Forum for Conservation Policy is within the framework of the Authority's Home Energy Conservation Task Force

The Consumer Advocate submits that the consideration and approval of this measure within this proceeding is premature. The merits of the company's CUA proposal or other alternatives that concern conservation would be better probed and debated within the format of the Authority's Home Energy Conservation Task Force. Only after the Task Force has completed its work should the mechanics and application of policy be tested in subsequent contested proceedings or within the confines of a rule-making docket.

While the Consumer Advocate supports conservation efforts, this office submits that studied and learned exchanges between the industry, regulators and consumers are the proper method of forming policy proposals that would encourage and reward conservation among Tennesseans and gas providers. More time, data and reflection is needed to consider the advantages and disadvantages of proposals such as the CUA and alternate proposals that might better serve the goals of conservation. Thus, the Authority's Home Energy Conservation Task Force is a more appropriate forum for considering a broad policy rather than a rush to judgment regarding the proposal of one gas company.

PROPOSED PIPELINE REPLACEMENT TRACKER

The Consumer Advocate's consistent opposition to pipeline trackers and the Authority's prior denial of such trackers is rooted in the principal that cost recovery through the rate-base methodology is a policy more conducive to motivating the control of costs rather than a tracker. Put simply, recovery via the rate base method provides a reasonable and prudent budget for such

expenditures while a tracker presents a company with a blank check. The Authority has in the past denied proposed bare steel replacement trackers basing the decision in part on the sound policy of allowing recovery of pipeline expenses through a rate case rather than through a separate surcharge. TRA Docket 04-00034, ORDER, 10/20/2004, p. 22.

In addition, the Authority noted the additional strain placed on resources and staff that would monitor such a tracker. *Id.* In pre-filed Direct and Rebuttal testimony the Company did not provide a general over-view or specifics of how the Authority would monitor and audit expenses attributed to the proposed tracker. However, ATMOS insisted during the hearing that the regulation of pipeline trackers already in place in Georgia results in a "stream lined" procedure in which the Georgia Public Service Commission Staff arrive on site and audit for three to four days. Tr. at IX. 61. Yet a cursory review of publicly available Commission orders reveals that the practice in Georgia is not as streamlined as advertised. Annual audits of companies using pipeline replacement mechanisms have resulted in on-going proceedings between Staff and companies. In one instance the Georgia Commission Staff revealed the inappropriate inclusion of anticipated rate-base items through the pipeline mechanism in amounts totaling $6.5 million. Georgia Public Service Commission Docket No. 8516-U, ORDER, p.4, 8/19/2003.

The Consumer Advocate has serious reservations regarding pipeline trackers in general and the ability of a company to use a tracker inappropriately when the lines of demarcation for recovery can be blurred and the company can be incented to make decisions, not based on financial and engineering prudence, but based on the mechanism of cost recovery. The Company, since this proceeding began, has already raised the projected expenditures for pipeline replacement this year from $1.3 million agreement with the Pipeline Safety Division of the

Authority in April of this year to nearly $1.5 million in the Company's proposed rate-base in this proceeding. Chrysler Direct at Exhibit BS-2; MFR 56.

Furthermore, the ambiguity of the proposed tracker's stated purpose reveals even more potential for the lines of demarcation to blur. In Direct, Rebuttal and in testimony before the hearing panel, the proposed tracker has been characterized and explained as a mechanism to recover the cost of replacing pipeline. Childers Direct at 18; Childers-Swain at 6; Tr. at IX. 60-61. However, in response to data requests, the Company has indicated that the mechanism could be applied to "All Capital investments as a means of avoiding regulatory lag". Atmos Response to CAPD Data Request #2, Part IV, Question #4. This would indicate that Company may envision that the tracker can encompass recovery of costs not only for bare steel replacement but also as a means to recover costs for new business plant. This is a considerably bolder proposal than the tracker proposed by Chattanooga Gas in its prior rate case and would provide little motivation to keep costs reasonable and under control. As with the CUA, this proposal would also permit the Company the luxury of an annual rate increase.

Investigation of Shut-Offs from the Winter of 2005-2006

Over the prior Winter and as result of the industry and Authority's mitigation efforts, Chattanooga Gas Company and Nashville Gas Company actually reduced their shut offs (compared with the previous year) by 31% and 46.5% percent respectively; however, shut-offs of ATMOS customers actually increased by 14.1%. Chrysler Direct at 10; Exhibit MDC S01. When asked by the Consumer Advocate to explain how those numbers increased in light of the mitigation efforts, ATMOS was unable to provide a explanation other than the fact that winter heating bills were high. Childers-Swain Rebuttal at 13-14. The explanation of the company that high winter heating bills were an obvious factor. While this explanation is grounded in fact, it is

also true that customers of Nashville Gas and Chattanooga Gas were equally subject to high winter heating bills. The latter respective companies were able to limit and decrease the number of shut-offs under the same circumstances. Tr. at V. 70-73. This is a concern in light of the potential that this coming winter heating season may produce winter heating bills on the same scale as the prior winter. That is precisely why the Consumer Advocate has asked the TRA to conduct an investigation and assist the Company with appropriate management shutoff modifications in an effort towards achieving a reduction in the number of shut-offs in the coming heating season.

Service Metrics Reporting

The Consumer Advocate has requested that ATMOS begin compiling and regularly reporting service metrics in the same comprehensive categories as Nashville Gas currently reports to the Consumer Advocate. Chrysler Direct, 7; Exhibits CS, SD, CD, and MS. The Company can benefit from reporting such metrics. ATMOS representatives have testified that there have been negative perceptions in the media regarding the level of customer service the company provides. Paris Direct at 11. Comprehensive service metric reporting would represent an important measurement and documentation of the level of customer service that would help dispel such negative perceptions. In addition, metrics reporting would allow the Authority and the Consumer Advocate to have a more accurate picture of service quality provided to consumers.

The reporting of comprehensive service metrics will aid the Company in terms of record keeping and in detecting potentially troubling trends in service. During the course of this proceeding, the Company went to great lengths in an effort to correct erroneous information it had provided and in producing more accurate figures for such important categories as average

emergency response time. Childers-Swain Rebuttal, at 10-11. Whereas if ATMOS were regularly reporting such statistics, there would be little doubt or delay in producing such information. Comprehensive metrics reporting would represent a commitment to being transparent about the level of service provided. In accordance with the Company's frequent expressions of pride in the level of customer service, the documentation of the level of service can only benefit the company and its relationship with consumers. While the Company does report data concerning the number of consumer calls answered, it remains puzzling as to why ATMOS would not voluntarily submit the same level of metrics as those provided by Nashville Gas.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing is being forwarded via electronic mail and U.S. mail, to:

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on this the 15th day of September, 2006.

Vance L. Broemel

99264

ATMOS ENERGY CORPORATION
DOCKET NO. 05-00258
TOTAL WAGES COMPARATIVE SUMMARY
FOR FISCAL YEARS ENDING 9/30/05-07

Exhibit 1

	Atmos				CAPD			
	Total	**Capitalized**	**Labor Expensed**	**Expense Growth**	**Total**	**Capitalized**	**Labor Expensed**	**Expense Growth**
Actual September 2005	$ 6,915,102 A/	$4,139,206	$ 2,775,896		$6,915,102	$ 4,139,206	$ 2,775,896	
Capitalized Percentage		60%				60%		
Forecasted September 2006	7,531,618 B/	4,365,777	3,165,841	14.05%	7,194,091 C/	4,316,455	2,877,636	3.67%
Capitalized Percentage		58%				60%		
Forecasted September 2007	7,894,802 D/	4,500,037	3,394,765	7.23%	7,445,884 E/	4,467,531	2,978,354	3.50%
Capitalized Percentage		57%				60%		
Two year growth				22.29%				7.29%

A/ Atmos response to Dr #11, #18, #19, and MFR #31.
B/ Atmos rebuttal testimony, Schedule P/W-9.
C/ CAPD workpaper E-PAY-5, Index of Direct Workpapers, P12.
D/ Atmos direct testimony, Line #1, Column C divided by 1 minus .57.
E/ CAPD workpaper E-PAY-5, Index of Rebuttal Workpapers, page 12.

ATMOS ENERGY CORPORATION
TRA DOCKET #05-00258
UNCOLLECTIBLE EXPENSE
FOR THE ATTRITION YEAR ENDED SEPTEMBER 30, 2006
Monthly Totals of Charge-Offs and Payment Credits:

E-UNCOL

Exhibit 2

		No. of Accts. Chg.'d Off	Total Chg. Off	PGA Chg. Off	Average %	No. of Payments	Tot.Acct. Payments	PGA Amount	Average %	Net Charge-Offs	Unrecovered Margin	12 MTD Amount
March 2004	A/		32,771.87	22,290.13	68.02%		711.23	154.26	21.69%	22,135.87	9,924.77	
April 2004			42,426.69	30,641.48	72.22%		3,930.79	2,832.68	72.06%	27,808.80	10,687.10	
May 2004			60,189.41	44,781.19	74.40%		353.69	228.79	64.69%	44,552.40	15,283.32	
June 2004			115,745.63	88,229.30	76.23%		2,425.51	1,857.68	76.59%	86,371.62	26,948.50	
July 2004			166,100.21	124,803.77	75.14%		5,302.28	3,792.17	71.52%	121,011.60	39,786.33	
August 2004			112,331.44	82,665.87	73.59%		13,574.47	9,448.06	69.60%	73,217.81	25,539.16	
September 2004			75,476.55	53,905.89	71.42%		19,189.30	14,456.58	75.34%	39,449.31	16,837.94	
October 2004			16,733.63	11,277.95	67.40%		30,400.28	22,299.71	73.35%	(11,021.76)	(2,644.89)	
November 2004			14,080.41	9,988.52	70.94%		42,029.42	30,281.80	72.05%	(20,293.28)	(7,655.73)	
December 2004			9,524.18	6,728.68	70.65%		35,862.92	27,653.13	77.11%	(20,924.45)	(5,414.29)	
January 2005			6,506.84	4,366.82	67.11%		7,339.70	5,333.51	72.67%	(966.69)	133.83	
February 2005			80,252.86	68,508.26	85.37%		6,977.78	4,890.76	70.09%	63,617.50	9,657.58	139,083.62
March 2005			13,824.69	10,619.35	76.81%		9,834.12	7,512.32	76.39%	3,107.03	883.54	130,042.39
April 2005			16,058.80	11,818.63	73.60%		3,402.96	2,501.29	73.50%	9,317.34	3,338.50	122,693.79
May 2005			35,421.18	26,556.05	74.97%		5,537.61	3,998.20	72.20%	22,557.85	7,325.72	114,736.19
June 2005			93,202.58	70,060.02	75.17%		4,195.32	3,027.47	72.16%	67,032.55	21,974.71	109,762.40
July 2005			86,833.70	64,520.02	74.30%		6,160.05	4,769.96	77.43%	59,750.06	20,923.59	90,899.66
August 2005			63,263.88	45,939.06	72.61%		10,312.93	7,464.07	72.38%	38,474.99	14,475.96	79,836.46
September 2005			51,257.10	36,732.67	71.66%		9,424.15	6,791.45	72.06%	29,941.22	11,891.73	74,890.25
October 2005			38,549.83	28,233.06	73.24%		34,134.81	25,936.04	75.98%	2,297.02	2,118.00	79,653.14
November 2005			14,588.08	9,834.23	67.41%		32,530.77	25,166.97	77.36%	(15,332.74)	(2,609.95)	84,698.92
December 2005			5,733.89	4,067.60	70.94%		15,179.33	10,204.80	67.23%	(6,137.20)	(3,308.24)	86,804.97
January 2006			18,847.44	14,573.05	77.32%		9,096.55	6,650.46	73.11%	7,922.59	1,828.30	88,499.44
February 2006			9,050.20	6,524.97	72.10%		7,568.96	5,551.74	73.35%	973.23	508.01	79,349.87
March 2006			22,257.75	17,392.52	78.14%		3,184.53	2,211.78	69.45%	15,180.74	3,892.48	82,358.81
April 2006			43,429.50	34,445.69	79.31%		3,875.96	2,845.20	73.41%	31,600.49	7,953.05	86,973.36
May 2006			92,479.06	72,417.24	78.31%		17,426.51	13,476.95	77.34%	58,940.29	16,112.26	12MTD 5/06 95,759.90

ATMOS ENERGY CORPORATION
TRA DOCKET #05-00258
O&M EXPENSE SUMMARY
FOR FISCAL YEARS ENDING 9/30/05-07

Exhibit 3

Line #		("Millions") Atmos
1	Total 2005 Operations and Maintenance Expense	$ 14.04 A/
2	Non-Recurring Expense	0.75 B/
3	Adjusted 2005 Operations and Maintenance Expense	$ 13.29
4	Atmos 2007 Operations and Maintenance Expense	$ 16.41 C/
5	Two year growth rate including adjustments (Line 4 minus Line 3)/Line 3))	23.48%
	Adjustments:	
6	Reorganization Costs	$ 0.3 D/
7	Environmental Costs	0.6 D/
8	Rate Case Costs	0.1 D/
9	Atmos 2007 Net Operations and Maintenance Expense (Line 4 minus Lines 6-8)	$ 15.41
10	Two year growth rate excluding adjustments (Line 9 minus Line 3)/Line 3))	15.95%

A/ Per Lines 7-11 of September 2005 12 MTD 3.03 TRA surveillance report.
B/ Atmos 1st Joint Discovery Response, DR #14.
C/ Atmos direct testimony, Schedule THP-4, Sum of Lines 12, 17-19.
D/ Atmos direct testimony, Schedule THP-4, Lines 17-19.

Exhibit 4

Atmos ELG-ALG Comparison

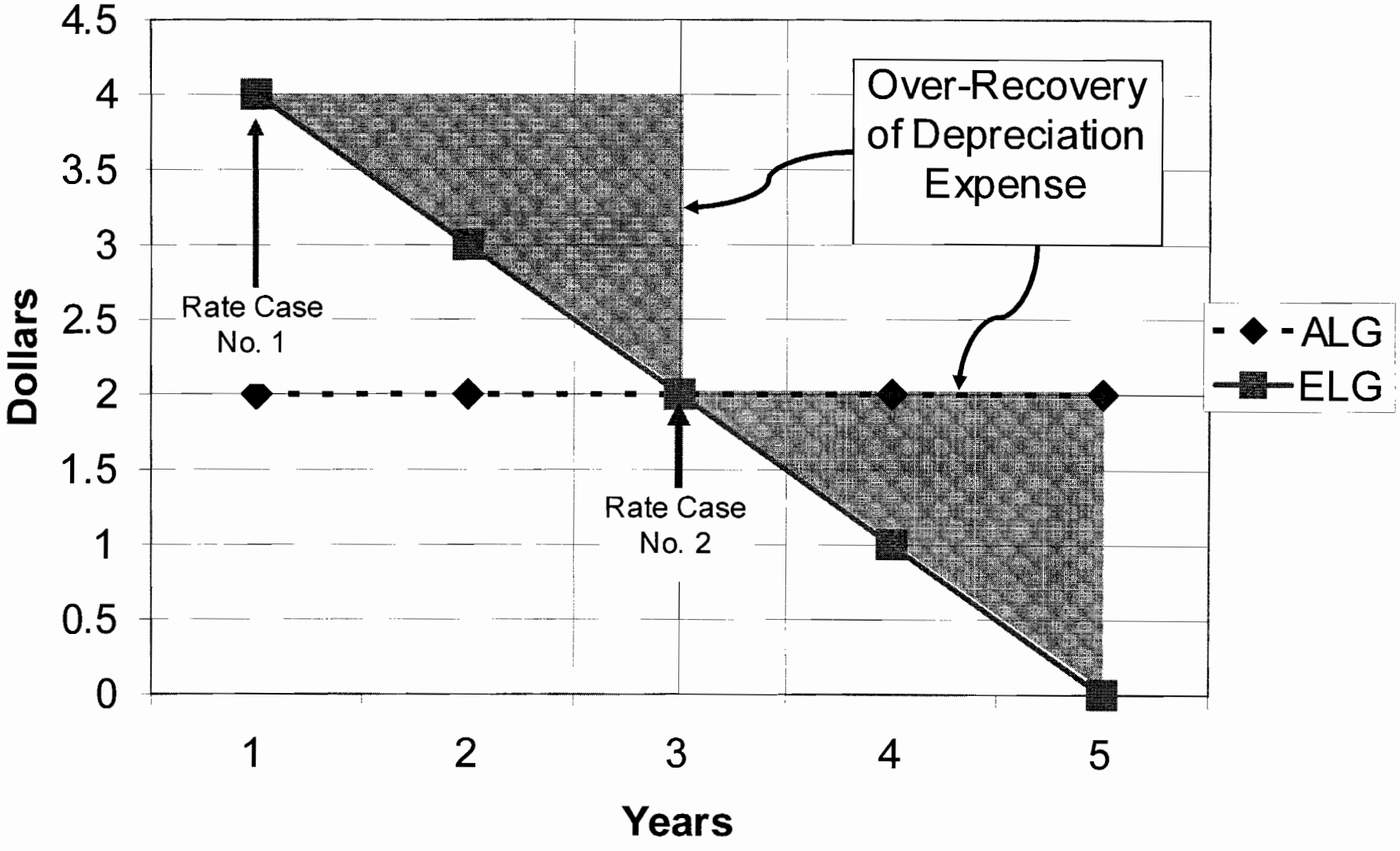

Exhibit 5

CONSUMER ADVOCATE AND PROTECTION DIVISION
ANALYSIS OF STATE EXCISE AND FEDERAL INCOME TAXES
ATMOS ENERGY CORPORATION TRA DOCKET #05-00258
FOR THE ATTRITION YEARS ENDED SEPTEMBER 30, 2006-2007

Line #		2006	2007
1	ITC Amortization	$ (118,834) A/	$ (104,319) A/
2	Permanent Tax Differences	(52,394) B/	(52,394) B/
3	Statutory State Tax Rate	6.50%	6.50%
4	Reduced State Excise Taxes	(3,406)	(3,406)
5	Permanent Tax Differences	(52,394)	(52,394)
6	Reduced State Excise Taxes	(3,406)	(3,406)
7	Statutory State Tax Rate	35.00%	35.00%
8	Reduced Federal Income Taxes (Line 5 minus Line 6 times Line 7)	(17,146)	(17,146)
9	Total Reduced Federal and State Taxes (Sum of Line 1, Line 4, and Line 8)	$ (139,386)	$ (124,871) C/

A/ Atmos 1st Joint Discovery Response, DR #30f.
B/ Atmos 1st Joint Discovery Response, DR #30b.
C/ Buckner Rebuttal Testimony, Page 19, Line 10.

Exhibit 6

CONSUMER ADVOCATE AND PROTECTION DIVISION
ATMOS - COMPANY 93 PLANT IN SERVICE FORECAST/ACTUAL COMPARISON
ATMOS ENERGY CORPORATION TRA DOCKET #05-00258
FOR THE MONTH ENDED MAY 31, 2006

	A/ ATMOS FORECAST	B/ ATMOS ACTUAL BOOK BALANCE	DIFFERENCE
PLANT IN SERVICE	$ 291,221,119	$ 291,221,119	$ -
CONSTRUCTION WORK IN PROGRESS	6,053,003	4,166,938	1,886,065
ACCUMULATED DEPRECIATION	(123,729,671)	(123,729,671)	0
NET PLANT	$ 173,544,451	$ 171,658,386	$ 1,886,065

A/ May 2006 Ending Balance amounts per Atmos 1st Joint Discovery, DR #36.
B/ May 2006 Ending Balance amounts per Atmos 2nd Joint Discovery, DR #18.