IN THE TENNESSEE REGULATORY AUTHORITY
NASHVILLE, TENNESSEE

IN RE:	)	
	)	
PETITION TO OPEN AN INVESTIGATION TO DETERMINE WHETHER ATMOS ENERGY CORP. SHOULD BE REQUIRED BY THE TRA TO APPEAR AND SHOW CAUSE THAT ATMOS ENERGY CORP. IS NOT OVEREARNING IN VIOLATION OF TENNESSEE LAW AND THAT IT IS CHARGING RATES THAT ARE JUST AND REASONABLE	)	**DOCKET NO. 05-00258**

REPORT AND RECOMMENDATION OF INVESTIGATIVE STAFF

BACKGROUND

<u>Consumer Advocate's Petition</u>

On September 15, 2005, the Consumer Advocate and Protection Division of the Office of the Attorney General ("Consumer Advocate") filed with the Tennessee Regulatory Authority ("TRA" or "Authority") a *Petition of the Consumer Advocate to Open an Investigation to Determine Whether Atmos Energy Corporation Should be Required by the Tennessee Regulatory Authority to Appear and Show Cause that Atmos Energy Corporation is Not Overearning in Violation of Tennessee Law and that It is Charging Rates that are Just and Reasonable ("Petition").* In the *Petition*, the Consumer Advocate asserts that Atmos Energy Corporation ("Atmos" or "Company") is earning more than a fair rate of return as allowed by Tennessee law

(Tenn. Code Ann. § 65-5-101)[1] and, as relief, requests the TRA to conduct an investigation and subsequently issue an order requiring Atmos to appear and "show cause" why its rates should not be reduced a level permissible by state law.[2]

In particular, the Consumer Advocate claims that Atmos is earning approximately $10.2 million above a fair return and its rates should be reduced accordingly.[3] The Consumer Advocate calculated this amount using Atmos' September 30, 2004 twelve (12) months to date results as reported on its TRA September 2004 monthly 3.03 report and adjusting Atmos' capital structure (cost of debt and equity) to reflect a fair and reasonable return based upon current market conditions.[4]

While the Consumer Advocate's allegations are based upon its adjusted cost of debt and equity return in reaching its conclusion that Atmos is overcharging consumers, the Consumer Advocate also points out several other issues that should ultimately be reviewed in determining an appropriate level of earnings. The Consumer Advocate alleges in testimony that Atmos' merger with TXU (a natural gas company) has created the opportunity to reduce expenses, such as reduced employee levels, which are not reflected in current rates.[5] Furthermore, the Consumer Advocate contends that because customer service, accounting and corporate functions have been relocated from Tennessee to Texas since the last rate case, there needs to be an audit to verify the accuracy of costs being allocated Tennessee.[6]

Atmos' Response

On October 18, 2005, Atmos filed its response to the *Petition*, including testimony of Dr. Donald A. Murry, stating that the Consumer Advocate does not allege that Atmos is overearning

[1] *Petition*, at 1.
[2] *Petition*, at 3.
[3] *Petition*, at 1, 8.
[4] *Id*, at 7-8.

nor does the Consumer Advocate claim that Atmos is in violation of any TRA rules or orders.[7] Atmos states that the *Petition* essentially represents a challenge to the reasonableness of past TRA decisions and that the Consumer Advocate must put forth sufficient evidence to demonstrate that the existing rates are invalid.[8] Atmos rebuts the allegations contained in testimony submitted by Dr. Brown and Dan McCormac, stating:

> Dr. Brown ignored commonly accepted ratemaking methodology and disregarded overwhelming economic information from independent financial sources that clearly demonstrates his results are not credible. Dr. Murry concluded that Dr. Brown's results are simply unsupportable. As such, Dr. Brown's testimony certainly does not constitute convincing evidence of a substantial and material nature, and therefore does not come close to meeting the burden of proof required to overcome the presumption that the rates the TRA set for Atmos are just and reasonable.[9] Mr. McCormac's testimony consists mainly of gross mischaracterization of previous TRA decisions and baseless requests for full audits of everything from Atmos' gas purchasing activities to service and safety standards. As such, Mr. McCormac's testimony provides no support whatsoever for the CAPD's petition.[10]

Atmos therefore concludes that the *Petition* should be denied because the Consumer Advocate has failed to produce sufficient evidence to overcome the presumption that Atmos' rates are just and reasonable.

TRA Actions

The Authority considered the *Petition* of the Consumer Advocate at the regularly scheduled November 7, 2005 Authority Conference and later memorialized its decision in an order issued on March 23, 2006. The Panel voted unanimously to grant the *Petition* and directed Staff of the TRA to conduct an investigation and file a report containing a recommendation for consideration by the Panel. The Panel decided that it would wait and review the results of the

[5] *Petition*, Attached Testimony of Daniel McCormac, at 5.
[6] *Petition*, Attached Testimony of Daniel McCormac, at 6.
[7] *Atmos Energy Corporation's Response to the Consumer Advocate's Petition*, p. 1 (October 18, 2005).
[8] *Atmos Energy Corporation's Response to the Consumer Advocate's Petition*, p. 5 (October 18, 2005).
[9] *Atmos Energy Corporation's Response to the Consumer Advocate's Petition*, p. 6 (October 18, 2005).
[10] *Atmos Energy Corporation's Response to the Consumer Advocate's Petition*, p. 10 (October 18, 2005).

Staff investigation before ruling on the allegations contained in the Consumer Advocate's *Petition*. Consideration of Chattanooga Gas Company's petition to intervene was also deferred until after the Staff report is filed.[11]

In light of various correspondence filed in the docket, Director Pat Miller issued a *Motion For Reconsideration* on March 23, 2006 to reconsider the decisions made at the November 7, 2005 Authority Conference. On March 28, 2006 the Consumer Advocate filed a response opposing Director Miller's *Motion For Reconsideration.* In its response, the Consumer Advocate urges the TRA not to stop the investigation because of unspecified public comments as this would serve only to deprive consumers of an inquiry. The Consumer Advocate states that it has every confidence that the investigation is on track and is the most expeditious avenue for this proceeding.[12] The Atmos Intervention Group ("AIG") filed comments in response to the *Motion For Reconsideration* on March 29, 2006. The AIG urges the Authority to allow Staff to complete its investigation and issue its recommendation, and given the time and resources already committed by the Staff, any change would only serve to delay the proceeding and hurt public interest.[13]

On March 31, 2006, Atmos filed a response to Director Miller's *Motion For Reconsideration.* In its response, Atmos argues that the Staff cannot carry out the obligations set forth under the Order and the show cause statute without making specific findings that lead to a recommended rate of return that Atmos should be entitled to earn.[14] Accordingly, Atmos proposes that the TRA amend its Order to relieve the Staff from making a recommendation as to whether sufficient evidence exists for initiating a show cause proceeding, and instead direct Staff

[11] *Order Granting Petition and Commencing Investigation*, Docket 05-00258 (March 23, 2006), pp 9-10.
[12] Consumer Advocate's Response In Opposition to Director Miller's Motion For Reconsideration of TRA Decision to Open an Investigation Into Atmos' Overearnings, p. 3.
[13] Comments of Atmos Intervention Group in Response to Motion to Reconsider, (March 29, 2006) pp 2-3.

to conduct an investigation to determine whether sufficient evidence exists to warrant the convening of a contested case proceeding.[15]

Director Miller's *Motion For Reconsideration* came before the Panel at the April 3, 2006 Authority Conference. Mr. Henry Walker, legal counsel for AIG, reaffirmed the position taken by AIG in its March 29, 2006 comments by stating that the current course of action is the best approach.[16] Mr. Russell Perkins, attorney for the Consumer Advocate, requested that their petition not be converted to a complaint as suggested by Director Miller. Instead, Mr. Perkins stated that given the time already invested by Staff in its investigation, the fact that Staff had has access to non-public information and that the matter is a top priority of the TRA, the Consumer Advocate "would very much like to see the report and let the investigation run its course."[17] Ms. Misty Kelley, legal counsel for Atmos, states that the appropriate avenue for the TRA is to dismiss the current proceeding and instruct the Consumer Advocate to file for a contested case proceeding.[18] Finally, Gary Hotvedt, Counsel for the Investigative Staff, asked that the Panel stay its course and allow the Staff to complete its report.[19]

Chairman Ron Jones clarified that the investigation, at this point, is not tantamount to that of a rate case proceeding and he would expect to see in the report whether some presumption has or has not been validated. Moreover, the Chairman pointed out that the second stage of this proceeding, if the Authority goes forward, would be to determine whether or not rates are just

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[14] Atmos Energy Corporation's Response to Director Miller's Motion for Reconsideration (March 31, 2006) p. 11.
[15] Atmos Energy Corporation's Response to Director Miller's Motion for Reconsideration (March 31, 2006) p. 9.
[16] Transcript, Authority Conference (April 3, 2006), p. 9.
[17] Transcript, Authority Conference (April 3, 2006), pp 9-10.
[18] Transcript, Authority Conference (April 3, 2006), p. 17.
[19] Transcript, Authority Conference (April 3, 2006), p. 23.

and reasonable on a going forward basis.[20] Director Miller stated that after hearing comments from the parties, he was withdrawing his *Motion For Reconsideration*.[21]

SCOPE OF THE INVESTIGATION

The scope of this investigation is to ascertain whether Atmos' current level of earnings warrants a proceeding before the TRA for the purpose of establishing fair and reasonable rates on a going forward basis. To accomplish this task, Staff began with Atmos' monthly 3.03 report for the twelve (12) Months ended September 30, 2005, the most recent fiscal year results available. Staff verified the amounts contained on the monthly report with the Company's trial balance and in turn with the general ledger. Staff did not prepare any forecast of revenues, expenses or rate base, and did not make any adjustments to normalize the twelve (12) months ended September 30, 2005 for items that are non-recurring in nature, i.e., expenses occurring this year which will not be incurred in future years. There were also no adjustments made for known future changes.

Staff, however, made accounting/ratemaking adjustments to certain expense and rate base items from amounts contained on the Company's books in order to more accurately reflect the level of earnings for the year ended September 30, 2005. Staff utilized an appropriate capital structure for Atmos, including debt cost and a fair equity return based upon today's market, in deriving an overall just and reasonable return for Atmos.

[20] Transcript, Authority Conference (April 3, 2006), pp 26-27.
[21] Transcript, Authority Conference (April 3, 2006), p. 30.

RESULTS OF THE INVESTIGATION

The investigation, including Staff adjustments, indicates that Atmos' earned 10.53% for the twelve (12) months ended September 30, 2005 (see Exhibit 2). Staff adjustments and results are not aided by any forecast of revenues, expenses or rate base items, and Staff has not adjusted for known changes in future periods.[22] Based upon analysis of Atmos' capital structure, including debt cost and a fair equity return in the current marketplace, Staff calculates an overall just and reasonable return for Atmos to be 7.4% (see Exhibit 4). A comparison of Atmos' actual earnings for the period ended September 30, 2005 with the level of earnings determined to be fair and reasonable by Staff is shown on Exhibit 3; this calculation indicates an annual revenue surplus of $7,818,315.

Since the initial investigation indicates that Atmos is currently earning more than a just and reasonable return given today's environment, Staff concludes that a contested case proceeding should be convened for the purpose of conducting an earnings investigation to establish fair and reasonable rates for Atmos on a going forward basis.

A more detailed explanation of the investigation, including all Staff adjustments to expense and rate base items follows, together with a discussion of the overall capital structure, debt cost and return on equity utilized by Staff in developing a fair and reasonable return.

Revenues

Staff agreed and verified the twelve month-to-date regulated revenue amounts for the twelve (12) months ended September 30, 2005 (as contained in the September 30, 2005 monthly

[22] For example, Atmos' monthly 3.03 report for the period ended September 30, 2005 includes $745,581 in acquisition costs resulting from Atmos' purchase of TXU. From a rate-setting point of view, since the amortization of these costs ended December 2004, these expenses would be excluded in establishing rates in future years.

3.03 report) with Atmos' general ledger and found no discrepancies. Accordingly, there are no Staff adjustments to the regulated revenues of $170,087,139 as reported by Atmos for the twelve (12) months ended September 30, 2005.

Expenses

Initially, Staff traced various account balances per the Company's trial balance to the general ledger. Next, Staff compared amounts contained in the September 30, 2005 monthly 3.03 report with the Company's trial balance. Our review revealed no discrepancies in the total amount of regulated expenses contained in the September 30, 2005 monthly report and the Company's September 30, 2005 trial balances. Staff, however, discovered a few minor expense amounts that needed to be reclassified because they had originally been placed into an incorrect account (see Exhibit 1). These expense reclassifications do not affect the total amount of regulated expenses.

The company reported $155,101,253 of expenses for the period ended September 30, 2005. Staff made three (3) adjustments that reduced overall expenses by $78,848, resulting in adjusted expenses of $155,026,405 for the twelve (12) months ended September 30, 2005.

The first Staff adjustment was to remove $18,589 in disallowable expenses, $13,975 in donations made by Atmos and $4,614 for image advertising. While donations may be an admirable endeavor by utilities, fundamental ratemaking methodology requires them to be treated as non-operating expenses, i.e., expenses that ratepayers should not pay for in rates. In fact, the Federal Energy Regulatory Commission ("FERC") established a specific non-operating expense account (426.10) in which all donations should be booked. Staff's review, however, discovered several donation amounts that appeared in regulated accounts; accordingly, Staff appropriately removed these amounts from the regulated expense total for the year ended

September 30, 2005. It is also proper to exclude certain advertising expenses, particularly those related to enhancing the Company's image.

The second adjustment reduces Atmos' Customer Account Expense by $190,619 to appropriately reflect the actual amount of unrecovered bad debt expense incurred during the year ended September 30, 2005. The gas portion of bad debt expense is recovered through the Purchased Gas Adjustment ("PGA") mechanism while the recovery of bad debt expense related to margin is recovered through base rates.[23] Therefore, the account balance for bad debt expense for the fiscal year ended September 30 should reflect only the unrecovered gas costs related to margin. The Company booked (accrued) bad debt expenses of $265,509 during the fiscal year ended September 30, 2005. Staff, however, calculates the amount of bad debt expense related to margin at $74,890; therefore, Staff made an adjustment to reduce bad debt expense by $190,619 ($265,509 – $74,890) to reflect the actual amount of bad expense related to margin.

The third adjustment relates to taxes, both state excise and federal income. Atmos' 3.03 monthly report for the year ended September 30, 2005 calculates state excise taxes at a rate of 6.0%; this rate, however, is actually 6.5%. Staff increased the amount of state excise tax by 0.5% to reflect the correct amount of state excise tax expense. Since Staff made adjustments that reduce overall expenses, the amount of net operating income as calculated by Staff therefore increased. Accordingly, Staff incorporated additional federal income taxes (35% tax rate) due to the increased income.

[23] In Re: *Petition of Chattanooga Gas Company, Nashville Gas Company, A Division of Piedmont Natural Gas Company, Inc., and United cities Gas Company, A Division of Atmos Energy Corporation for a Declaratory Ruling Regarding the Collectibility of the Gas Cost Portion of Uncollectible Accounts Under the Purchased Gas Adjustment (PGA) Rules,* (Docket 03-00209), *Order Denying Consumer Advocate's Motion for Summary Judgment,*

Rate Base and Net Operating Income Adjustments

Rate base represents the net investment that is utilized to provide regulated gas service on which the Company is entitled to earn a fair rate of return. To test the accuracy of the reported rate base amounts contained in Atmos' September 30, 2005 monthly 3.03 report, Staff agreed and verified the September 30, 2005 ending balances for rate base amounts with Atmos' trial balances and found no discrepancies. Atmos' reports a rate base of $155,327,939 for year ended September 30, 2005 while Staff, via adjustments, calculates the Company's rate base at $151,668,273 (see Exhibit 2).

The first adjustment made by Staff is to calculate Atmos' rate base utilizing thirteen (13) months of Company data to correctly calculate a twelve (12) month average. Atmos reports its rate base amounts in 3.03 monthly reports as the average monthly balance for the previous twelve months which ignores the beginning balance of the first month used in calculating a twelve month average. For example, if you wanted a single monthly average you would not take the ending balance and call it an average for the entire month. Rather, you would take the beginning and ending monthly balances and average the two to come up with an average for the month. The same principle applies here in that thirteen (13) months of data, rather than twelve (12) as utilized by the Company, is necessary to calculate an accurate twelve (12) month average. This adjustment increases Atmos' rate base to $155,931,212.

Staff adjusted Atmos' rate base calculation to include the thirteen (13) month average of unamortized tax credit. Although Atmos reported an amount for unamortized tax credit on the front page of its year ended September 30, 2005 monthly 3.03 report, the Company did not carry

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Granting, in Part, and Denying, in Part, Petitioner's Motion for Summary Judgment, Denying Petition for a Declaratory Ruling and Modifying Refund Adjustment Formula, (February 9, 2005), pp 8 – 12.

the balance to its rate base calculation. Accordingly, Staff made an adjustment for the unamortized tax credit which reduces rate base by $624,507.

Staff made an adjustment to increase deferred federal income taxes by $3,638,432 to recognize the deferred portion of taxes relating to shared services which was inadvertently omitted from the Company's September 30, 2005 monthly 3.03 report. The adjustment decreases rate base by $3,638,432 and was derived from information contained on Company books.

Staff also adjusted the amount of interest on customer deposits to reflect the revised thirteen (13) month average. The Company reported interest on customer deposits at 6% of $5,587,211, or $335,233. The thirteen (13) month average for customer deposits, per the Company's books, is $5,453,656; accordingly, at a 6% interest rate Staff calculated interest customer deposits at $327,219 – $8,013 lower than Atmos. The proper mechanism to account for the decreased interest on customer deposits is to increase net operating income by $8,013.

Finally, Staff made an adjustment for allowance for funds used during construction ("AFUDC"). AFUDC is a component of construction costs representing the net cost of borrowed funds and a reasonable rate on other funds used during the period of plant construction. AFUDC is capitalized until a construction project is placed into operation by concurrent credits to the income statement and charges to utility plant and is based generally upon the amount expended to date on a particular project. Atmos' September 30, 2005 monthly 3.03 report contains no adjustment for AFUDC. Staff made an adjustment for AFUDC based upon amounts booked for AFUDC by Atmos as required by FERC. An adjustment of $115,075 to net operating income is necessary to remove any premium, discount or expense on debt or other funds included in the cost of construction or acquisition of property from the rate base.

Capital Structure, Return on Equity & Rate of Return

The TRA has broad discretion in establishing a fair and reasonable return for utilities and therefore must exercise sound judgment in making the appropriate determination. The Authority, however, is not without guidance in exercising its judgment. The principle factors that should be used in establishing a rate were set forth by the U.S. Supreme Court in *Bluefield Waterworks & Improvement Company v. Public Serv. Comm. of West Virginia:*

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.[24]

In *Federal Power Commission v. Hope Natural Gas Company,* the U.S. Supreme Court determined that regulated firms are entitled to a return that is "just and reasonable."[25] The rate a firm is permitted to charge should enable it "to operate successfully, to maintain its financial integrity, to attract capital, and to compensate investors for the risks assumed."[26] According to the *Hope* Court, the general standards to be considered in establishing the fair rate of return for a public utility are financial integrity, capital attraction and setting a return on equity that is commensurate with returns investors could achieve by investing in other enterprises of corresponding risk. The utility's fair rate of return is the minimum return investors expect, or require, in order to make an investment in the utility. The proper level of return on the

[24] *Bluefield,* 262 U.S. 679, 692-93 (1923); see also *Duquesne Light Company v. Barasch*, 488 U.S. 299, 310 (1989).
[25] *Hope,* 320 U.S. 591, 605 (1944).
[26] Id.

Company's capital, including equity capital, must allow a return on capital that is commensurate with returns on investment in other enterprises having corresponding risk.

Additionally, a utility is only entitled to a return on plant that is actually serving ratepayers. This principle was stated by the U.S. Supreme Court in *Denver Union Stock Yard Co. v. United States*:

> The utility is entitled to rates, not per se excessive and extortionate, sufficient to yield a reasonable rate of return upon the value of property used, at the time it is being used, to render the service. But it is not entitled to have included any property not used and useful for that purpose.[27]

Thus, pursuant to the *Hope, Bluefield* and *Denver Union* decisions, the general standards to be considered in establishing a fair rate of return for a public utility are financial integrity, capital attraction and setting a return on equity that is commensurate with returns investors could achieve by investing in other enterprises of corresponding risk. The utility's fair rate of return is the minimum return investors expect, or require, in order to make an investment in the utility.

There are three steps to establishing the fair rate of return: (1) determine an appropriate capital structure; (2) determine the cost rates of each component of the capital structure: (i) short-term debt, (ii) long-term debt and (iii) equity; and (3) compute the overall cost of capital using a weighted average of the component rates to account for the proportion of each component.

There is no single recipe for the appropriate capital structure. Regulators have to keep in mind that a utility is simply operating in the same environment and market as other comparable companies and that a capital structure for a given company does not necessarily fit the needs of another similar company. Atmos' capital structure as of September 30, 2005 was:

Long term debt: 55.49%
Short term debt: 3.69%
Equity: 40.82%

[27] *Denver Union Stock Yard Co. v. United States*, 304 U.S. 470, 475, 58 S.Ct. 990 (1938).

The company described its debt costs as:

Long term debt: 5.57%
Short term debt: 4.02%

Given the capital structure and debt costs described above, determination of a fair rate of return for Atmos requires setting an appropriate return on equity. It is appropriate to look to recent cost rates used by the Authority in setting a just and reasonable return. In the rate case for Chattanooga Gas (Docket No. 04-00034), the Authority set a fair return on equity of 10.2%.

The use of the equity return determination from Chattanooga Gas is appropriate for several reasons. First, the Chattanooga Gas equity return was used in setting an overall rate of return deemed just and reasonable by the Authority. Second, the return on equity statistic is taken from another gas company operating in Tennessee that is also a subsidiary of a larger company operating over a diverse geographic footprint. Given the similarities of the companies, it is reasonable to believe that the same equity return will appropriately compensate shareholders of each company. Third, the equity return for Chattanooga Gas was finalized in the *Reconsideration Order* issued on November 1, 2005 in Docket No. 04-00034. Although economic conditions are continually evolving, it is unlikely that the required equity return has changed since the issuance of the *Reconsideration Order*. Finally, the equity return set for Chattanooga Gas was set to reflect future economic conditions. Once again, since the return is set to reflect going forward equity returns coupled with the recent reaffirmation of the rate, it is appropriate to use the rate for Atmos.

Given the capital structure and debt and equity costs, Staff calculates the fair rate of return for Atmos at 7.40% (see Exhibit 4).

Other Noted Items/Issues

There are several items/issues that fell outside of our investigation that could have a major impact on the establishment of consumer rates in future years and, therefore, warrant additional examination.

Certain aspects of Atmos' operations have not been audited in more than ten (10) years in which time the Company has been through two major mergers or acquisitions. Subsequent to rates being approved in 1995, Atmos purchased United Cities Gas Company in 1996 and in 2004 Atmos purchased the natural gas facilities of TXU. As a result of these changes, factors utilized to allocate certain expenses and investment amounts to Tennessee have changed. The TRA has not reviewed the underlying calculations for these revised factors to ensure that Tennessee consumers are paying for their reasonable share of allocated costs. The purchase of TXU should also create efficiencies through reduced employee levels and future rates should in turn reflect this expense reduction.

Since Staff's charge was not to forecast or normalize the company's earnings to exclude non-recurring items, there would certainly be a need for additional examination of certain amounts contained on the Company's books in the context of an earnings investigation. In other words, there are several areas that could have a major impact on consumer rates depending upon a more detailed forward-looking review and analysis. Some of these items include the consideration/audit of deferred credits and debits relating to deferred income taxes, a review of pension costs to determine if an appropriate level of funding has been included in regulated expenses, and calculating an appropriate level of working capital.

Investigative Staff Results vs. Consumer Advocate's Claim

This Staff investigation does not verify the Consumer Advocate's claim that Atmos is overcharging consumers by approximately $10.2 annually. Rather, Staff conducted our own analysis to determine whether the allegations presented by the Consumer Advocate are valid enough to warrant the convening of a contested case. Nevertheless, Staff presents the following comparison of results between the Consumer Advocate's claim and Staff's investigation.

The Consumer Advocate claims that Atmos is overcharging its consumers by approximately $10.2 million annually. The Consumer Advocate calculates this amount by taking Atmos' earnings as reported on its year ended September 30, 2004 monthly 3.03 report and adjusting the Company's overall return to 6.89% (8.2%, cost of equity), a level the Consumer Advocate claims is fair and reasonable. The Consumer Advocate then compares the level of Atmos' earnings reported in its September 30, 2004 monthly 3.03 report with the level of earnings adjusted to reflect the 6.89% return. This comparison yields a revenue surplus of $10.2 million annually.

As stated previously, the result of Staff's investigation indicates that Atmos earned surplus revenues of approximately $7.8 million during the twelve (12) months ended September 30, 2005 based upon current market conditions. There are, however, some major differences between the numbers reported by the Consumer Advocate and the Staff. First, the Consumer Advocate used Atmos' year ended September 30, 2004 monthly 3.03 report as its base for computing earnings whereas Staff used the more recent fiscal year ended September 30, 2005. Atmos reported its rate of return for the period ended September 30, 2005 (used by Staff) at 10.16% compared to Atmos' reported rate of return of 11.02% for the year ended September 30, 2004 (used by Consumer Advocate). Also, the Consumer Advocate calculated an overall fair and reasonable return of 6.89% (8.2% equity) compared with the Staff's calculated return of 7.4% (10.2% equity). Exhibit 5 compares the calculations of the Consumer Advocate with those of the Staff.

CONCLUSION AND RECOMMENDATION

Based upon our investigation, Staff concludes that Atmos' current level of earnings warrants the TRA to convene a contested case proceeding for the purpose of establishing a fair and reasonable rate of return for Atmos Energy Corporation. Staff is of the opinion that the most efficient and expeditious avenue to take is to proceed with an earnings review in which Investigative Staff as a party, along with any intervenors, will have the opportunity to present its forecasted level of earnings for Atmos along with a recommended rate of return. This approach is consistent with the TRA's Order issued on March 23, 2006 in which the Panel voted to consider Staff's investigation and recommendation regarding the allegations made by the Consumer Advocate in determining how to proceed in the docket.[28]

As an alternative to a contested case, Staff contends that prior to issuing a show cause order against Atmos, additional discovery and investigation would be required in order to forecast future earnings levels and legally establish an appropriate fair rate of return. Accordingly, Staff recommends that the Authority convene a contested case proceeding for the purpose of conducting an earnings investigation for Atmos Energy Corporation.

For the Investigative Staff

Gary Hotvedt, Counsel

[28] *Order Granting Petition and Commencing Investigation*, Docket 05-00258 (March 23, 2006), pp 9-10.

Atmos
05-00258
Net Operating Income
As Reported, Corrected and Adjusted

Exhibit 1

Line No.		Company Reported FYE 9/30/2005	Corrected FYE 9/30/05 per Company Books	Staff Adjustments	FYE 9/30/2005 As Adjusted
1	Residental Sales	161,682,418	161,682,418		161,682,418
2	Comm and Ind Sales	0	0		0
3	Other Sales	8,404,721	8,404,721		8,404,721
5	Total Op Rev	170,087,139	170,087,139		170,087,139
6	Production	117,231,462	117,231,462		117,231,462
7	Storage, Trans & Dist - Oth	4,060,732	4,061,049	(7,965) 1/	4,053,084
8	Storage, Trans & Dist - Mtnce	433,176	432,860		432,860
9	Cust Acct Exp	2,133,618	2,133,619	(190,719) 2/	1,942,900
10	Sales Expense	158,612	161,891	(1,603) 1/	160,288
11	Adm. & Gen. Exp.	7,258,088	7,254,805	(8,921) 1/	7,245,884
12	Dep and Amort	11,521,370	11,521,371		11,521,371
13	Other Taxes	6,044,532	6,044,533		6,044,533
14	Inc Tax	6,259,662	6,259,663	134,359 3/	6,394,022
15	Total Op Exp	155,101,253	155,101,253	(74,848)	155,026,405
16	Net Op Inc	14,985,886	14,985,886		15,060,734

1/ Adjustment to remove donations from regulated expenses.
2/ Adjusted to reflect only the unrecovered gas costs related to margin. (This amount also includes $100 in donations removed from regulated expesnes.)
3/ To reflect 6.5% Excise Tax Rate and an increase in federal income taxes resulting from increased net operating income due to expense reductions.

Atmos
05-00258
Rate of Return
As Reported and Adjusted

Exhibit 2

Line No.		Company Reported Average for 12 Months to Date 9/30/2005	Adjusted to Reflect 13 End of Month Average Balances	Staff Adjustments	13 End of Month Average at 9/30/2005 with Staff Adjustments
1	Gas plant in service	297,394,905	297,024,015		297,024,015
2	Construction work in progress	7,577,859	7,314,938		7,314,938
3	Materials and supplies/Storage gas	5,118,665	5,395,860		5,395,860
4	Working capital	1,176,346	1,176,346		1,176,346
5	Net elimination of intercompany leased property	7,669,534	7,679,761		7,679,761
6	Unamoritized Maryland Way Gain	(68,353)	(69,196)		(69,196)
7	Total (L1 thru L6)	318,868,956	318,521,724		318,521,724
	Deductions:				
8	Depreciation reserve	127,335,678	126,895,387		126,895,387
9	Unpaid for portion of materials and supplies	106,768	106,768		106,768
10	Customer deposits	5,587,211	5,453,656		5,453,656
11	Contributions and advances in aid of construction	29,720	29,741		29,741
12	Accumulated deferred tax-accelerated depreciation	30,481,640	30,104,960	3,638,432 4/	33,743,392
13	Unamortized investment tax credit	0	0	624,507 3/	624,507
14	Total (L8 thru L13)	163,541,017	162,590,512		166,853,451
15	Rate Base (L7-L14)	155,327,939	155,931,212		151,668,273
16	Net Operating Income	14,985,886	14,985,886		15,060,734
17	Accrued interest on customer deposits	(335,233)	(335,233)	8,013 1/	(327,219)
18	Allowance for funds used during construction	0	0	115,075 2/	115,075
19	Gain on sale of Maryland Way Property	20,244	20,244		20,244
20	Elimination of leased property: Decreased rent	2,005,132	2,005,132		2,005,132
21	Elimination of leased property: Increased depr exp	(238,564)	(238,564)		(238,564)
22	Elimination of leased property: Tax effect	(662,461)	(662,461)		(662,461)
23	Total Adjusted Net Operating Income (L16 thru L22)	15,775,005	15,775,004		15,972,941
24	Rate of Return (L23 by L15)	10.16%	10.12%		10.53%

1/ To adjust interest based on thirteen (13) month average customer ($5,453,656 * 6%)
2/ To reflect AFUDC amounts booked and allocated to Tennessee, net of taxes.
3/ To reflect the 13 month average Unamortized ITC reported on page 1 of the monthly 3.03 report.
4/ To adjust 13 month average balance per company books to recognize the portion of deferred income taxes relating to Shared Services.

Atmos
05-00258
Revenues Earned Above Staff Calculated ROR

Exhibit 3

Line No.		Staff Calculated 12 Months Ended September 30, 2005	
1	Rate Base	151,668,273	1/
2	Total Adjusted Net Operating Income at Present Rates	15,972,941	2/
3	Earned Rate of Return (L2/L1)	10.53%	
4	Fair Rate of Return	7.40%	3/
5	Required Operating Income (L1xL4)	11,223,452	
6	Operating Income Surplus (L2-L5)	4,749,489	
7	Gross Revenue Conversion Factor	1.646138213	4/
8	Revenue Surplus (L6xL7)	7,818,315	

1/ Exhibit 2, Line 15.
2/ Exhibit 2, Line 23.
3/ Exhibit 4.
4/ Calculated using an uncollectible factor of .044%, state excise tax rate of 6.5% and federal income tax rate of 35%.

Atmos
05-00258
Cost of Capital - Fair Rate of Return

Exhibit 4

Line No.		Ratio	Cost	Weighted Cost
1	Short Term Debt	3.69%	4.02%	0.15%
2	Long Term Debt	55.49%	5.57%	3.09%
3	Equity	40.82%	10.20%	4.16%
4	Total	100.00%		7.40%

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05-00258
Comparison of CAPD-DM Schedule 1
To Staff Investigation

Exhibit 5

Line No.		A/ 12 Months Ended September 30, 2004	B/ 12 Months Ended September 30, 2005
1	Rate Base	150,905,600	151,668,273
2	Operating Income at Present Rates	16,636,326	15,972,941
3	Earned Rate of Return (L2/L1)	11.02%	10.53%
4	Fair Rate of Return	6.89%	7.40%
5	Required Operating Income (L1xL4)	10,397,396	11,223,452
6	Operating Income Surplus (L2-L5)	6,238,930	4,749,489
7	Gross Revenue Conversion Factor	1.63	1.646138213
8	Revenue Surplus (L6xL7)	10,169,456	7,818,315

A/ Exhibit CAPD-DM Schedule 1 of CAPD Petition.
B/ Staff Exhibits.