BEFORE THE
TENNESSEE REGULATORY AUTHORITY

PREPARED DIRECT TESTIMONY
OF
MICHAEL J. MORLEY

IN RE:
CHATTANOOGA GAS COMPANY
DOCKET NO. 06-00175

Q. Please state your name, position and address.

A. Michael J. Morley, Director, Regulatory Accounting and Reporting, AGL Services Company. My business address is 10 Peachtree Place, Location 1180, Atlanta, Georgia 30309.

Q. Have you provided a summary of your educational background and professional experience?

A. Yes. They are included as Attachment A.

Q. Have you previously submitted testimony before the Tennessee Regulatory Authority or any other regulatory commission?

A. Yes. I provided testimony before the Tennessee Regulatory Authority ("TRA") in Docket No. 04-00034 on behalf of Chattanooga Gas Company ("CGC" or the "Company"); before the Georgia Public Service Commission in Docket No. 18638-U on behalf of Atlanta Gas Light Company; and before the Virginia State Corporation Commission in Case No. PUE–2005–00057 and Case No. PUE-2005-00062 on behalf of Virginia Natural Gas.

Q. What is the subject of your testimony?

A. I will present various financial and accounting data in support of the Company's filing in this proceeding, including (A) the proposed base revenue adjustment required for the Company's proposed rate of return, (B) CGC's cost of service, (C) the determination of rate base, and (D) the capital structure and cost of debt financing.

Q. Are you sponsoring exhibits in connection with your testimony?

A. Yes. I am sponsoring the following exhibits in support of CGC's base revenue requirement for the twelve month attrition period ending December 31, 2007:

- Exhibit MJM-1 – CGC's statement of income before and after the proposed rate adjustment and calculations of the proposed base revenue adjustment, base revenue conversion factor and Tennessee excise and federal income taxes.
- Exhibit MJM-2 – Summary of the cost of service study for the test period and attrition period.
- Exhibit MJM-3 – The elements of rate base estimated as of December 31, 2007.
- Exhibit MJM-4 – A summary of the Company's estimated cost of capital as of December 31, 2007.
- Exhibit MJM-5 – A summary of the Company's estimated cost of capital, proposed rate adjustment and rate base using the actual capital structure of AGL Resources Inc. ("AGLR") as of March 31, 2006, adjusted for known and measurable items through the end of the attrition period.

Q. What is the historic test period in support of the Company's case?

A. The Company's historic test period is the twelve months ended December 31, 2005. This represented the most recent, public financial data available when the Company began preparing its case. Additionally, the use of a consistent twelve month period for both the test period and the attrition period allows for easier analysis and comparisons.

Q. Were these exhibits and related schedules prepared by you or under your direction and supervision?

A. Yes.

A. CALCULATION OF REVENUE REQUIREMENT

Q. Would you summarize the information contained in Exhibit MJM-1, supporting the Company's calculated base revenue requirement?

A. Schedule 1 reflects the attrition period base revenue deficiency and proposed rate adjustment necessary to allow the Company the opportunity to earn a fair and reasonable return on its investment. Column 1 provides an income statement for the attrition period; Column 2 provides the Company's proposed rate adjustment; and Column 3 provides an income statement for the attrition period after the Company's proposed rate adjustment. Additionally, Line 15 of Schedule 1 includes the calculated rate of return of 5.37% before the proposed rate adjustment. Schedule 2 of Exhibit MJM-1 provides the calculation of the proposed base revenue adjustment in the amount of $5,844,046 required for the Company's proposed rate of return of 8.64%. This calculation is based on the Company's anticipated gross revenue conversion factor, as calculated on

Schedule 3 of Exhibit MJM-1. Schedule 4 of the Exhibit provides the calculation of the Tennessee excise and federal income taxes before and after the proposed rate adjustment.

Q. What are the primary components of the proposed revenue adjustment?

A. Comparing the operating revenues, cost of service and rate base for the attrition period and test periods as well as the Company's proposed rate of return to its currently authorized rate of return, the primary components of the proposed base revenue adjustment, in thousands, are as follows:

- Decrease in operating margin $2,200
- Change in capital structure $1,300
- Increase in rate base $1,200
- Change in ROE $1,000
- Increase in cost of service $ 100

B. COST OF SERVICE

Q. Mr. Morley, please describe the content of Exhibit MJM-2 supporting the Company's cost of service filing.

A. Schedule 1 of Exhibit MJM-2 provides comparative income statements for the test period and the attrition period. Schedule 2 of this Exhibit provides a comparative detail of operation and maintenance expenses and taxes other than income by major category for both periods.

Q. Please describe the adjustments necessary to the test period to develop the test period pro-forma income statements.

A. Schedule 3, Column 1 of Exhibit MJM-2 provides the unadjusted statements of income for the test period (as reported in the company's financial records) and includes the pro-forma adjustments that were made to arrive at the test period pro-forma income statement used in Schedule 1 of Exhibit MJM-2. Schedule 4 provides a brief explanation as to the nature and amount of the pro forma adjustments included in Schedule 3. In summary, the pro-forma adjustments were primarily rate making adjustments necessary to provide consistent regulatory treatment with previous CGC rate proceedings.

Q. What are the purposes of these schedules?

A. Schedules 1 and 2 were created to provide a clear comparison of the changes between the test period and the attrition period and Schedules 3 and 4 provide the impact of the pro-forma adjustments on the unadjusted test period.

Q. Please explain how the you developed the Company's cost of service for the attrition period.

A. The Company's response to TRA Minimum Filing Guideline No. 25 provides the detailed calculation of CGC's cost of service for the attrition period. The following provides a summary of the key assumptions and factors used in estimating the attrition period cost of service:

- Payroll was forecasted for 2007 based on information provided by CGC budget managers.

- Other post retirement benefits were estimated based on information provided by the Company's actuary.
- Pensions were based on estimated payments to participants in 2007.
- 401(k) benefits were estimated based on the average test period expense per employee. This average was then applied to the average employee count for the attrition period.
- Group health benefits were estimated based on the average test period expense per employee, which was then adjusted for an 8% increase in both 2006 and 2007. This adjusted average expense per employee was then applied to the average employee count for the attrition period.
- Bad debt expense was based on the average percent of net write-offs for 2003-2005.
- Taxes other than income were primarily based on the applicable attrition period estimates for property and revenues.
- Depreciation and amortization expense was estimated using the composite depreciation rate for the test period and the estimated utility plant in service for the attrition period.
- The remaining cost of service expense components were calculated primarily using actual results for the three months ended March 31, 2006 and the Company's approved budget for the nine months ended December 31, 2006. A growth factor of 2.8% was then applied to the sum of these two amounts to arrive at the estimated attrition period cost of service.

Q. Explain the variances between the test period and the attrition period on Schedule 2.

A. The decrease in payroll expense of $145,587 is driven primarily by a decrease in the number of employees between the test period and the attrition period. This decrease in number of employees is largely due to the Company outsourcing its meter reading functions. This outsourcing initiative began during the first quarter of 2005 and continued throughout the year, resulting in a decrease in the number of employees from 50 in January of 2005 to 34 in December 2005. This decrease in the number of employees is partially offset by the addition of three employees who previously performed certain functions (marketing and construction operations) for AGL Services Company ("AGSC") on behalf of CGC. The costs associated with the services these employees provided on behalf of CGC were then allocated to CGC though AGSC's shared service allocations. Beginning in 2006, these employees now are employed by and directly charged to CGC. The decrease in payroll expense is largely offset by an increase of $117,420 in outside services, which is primarily due to the meter reading outsourcing initiative.

Q. Please continue.

A. The increase in fleet services and facilities expense of $208,278 is primarily due to an increase in fleet services. This increase is offset by a decrease in AGSC allocated fleet services costs of approximately $350,000. Beginning in 2006, costs associated with fleet services are, for the most part, charged directly to the books and records of the applicable AGLR utility. Previously, these costs were incurred by AGSC and allocated to its affiliate utilities, primarily CGC and Atlanta Gas Light Company.

Q. What is the purpose of the Energy Conservation Plan?

A. As discussed in the direct testimonies of Steve Lindsey and Daniel Nikolich, the Energy Conservation Plan ("ECP") is a component of CGC's comprehensive rate design proposal, a proposal that encourages energy conservation while at the same time aligning the interests of CGC and its customers. The estimated cost of this program during the attrition period is $738,980.

Q. Please explain the substantial decrease in AGSC shared service allocations.

A. The decrease in shared service allocations of approximately $1.5 million is primarily the result of reduced AGSC costs ($760,000), the transfer of fleet services functions and related costs from AGSC to CGC ($350,000), and a full year impact of the acquisition of NUI ($150,000). Additionally, AGSC made some minor refinements to its allocation process in 2006, which resulted in decreased cost allocations to CGC of approximately $300,000.

Q. What were the components of the $760,000 decrease in AGSC costs?

A. The reduction in AGSC costs includes $375,000 in lower benefits costs and $200,000 in lower financial services, internal audit and executive support costs. Additionally, there is an estimated reduction of $185,000 resulting from AGSC's business process outsourcing initiative in which certain AGSC functions, including approximately 55% of AGSC's call center, will be outsourced beginning in 2006.

Q. What caused the increase in gross receipts tax?

A. The gross receipts tax increased by $389,022 million as a result of an increase in the Company's forecasted gross revenues. The increase in forecasted gross revenues is due primarily to an increase in gas costs.

C. DETERMINATION OF RATE BASE

Q. How did you determine the average rate base?

A. The average rate base, which is provided in detail in Schedule 1 of Exhibit MJM-3, was calculated as follows:

1. Utility plant in service and contributions in aid of construction were calculated using the account balances as of March 31, 2006. These balances were then projected through December 31, 2006 using the capital forecast for the nine months ended December 31, 2006. The estimated balances as of December 31, 2007 were then projected primarily by using the actual capital expenditures for January through March 2006 and the previously mentioned forecasted data for April through December 2006. For estimating the accumulated provision for depreciation, depreciation expense was calculated based on the attrition period average utility plant in service and the test period composite depreciation rate. Construction work in progress was based on the balance as of March 31, 2006, on the assumption that plant would be placed in service at a rate consistent with the monthly capital expenditures during 2006 and 2007.
2. The accumulated deferred income taxes were calculated using the account balances as of March 31, 2006 and the projected change in the deferred balance through the end of the attrition period.

3. The customer advance for construction account balance remained constant during the thirteen month period ending March 31, 2006. Therefore, the rate base amount was based on the balance of the account as of March 31, 2006.

4. The working capital requirement was calculated as follows:

   a. The requirement for lead lag was based on the lead lag study that was approved by the TRA in CGC's last rate case, Docket No. 04-00034. There have been no significant changes to the Company's operations that would materially impact the lead lag study. The requirement for lead lag is provided in Exhibit MJM-3, Schedule 3.

   b. The average stored gas inventory was calculated based on the actual storage volumes as of March 31, 2006. These balances were then projected monthly as follows:

      - For 2006, injections were forecasted based on the Company's current injection schedule. For 2007, injections were forecast ratably April through October. Injection volumes in each year are based on the Company's targeted storage levels entering the winter season. Injections are forecast and managed by AGSC's Gas Supply and Capacity Management service provider.

      - Withdrawals were forecasted based on the estimated need to utilize stored gas inventory during the winter season while maintaining an adequate level of storage to mitigate any unseen circumstances or events. Withdrawals are forecast and managed by AGSC's Gas Supply and Capacity Management service provider.

Pricing for the injections was calculated using the NYMEX futures price for natural gas as of June 15, 2006 plus the variable costs incurred to inject the gas into the Company's storage facilities. Pricing for the withdrawals was calculated using the monthly weighted average cost of gas, which was re-calculated each month based on the applicable withdrawals, injections and NYMEX futures price. Additionally, the cost of liquefaction and vaporization was included in the calculation for the LNG storage facility. The thirteen month average for the attrition period (December 2006 through December 2007) was then calculated using the monthly projected balances of the stored gas inventory.

c. The deferred rate case costs represent the average balance at the end of the attrition period for the estimated external costs that have been or will be incurred in the preparation, filing and completion of this proceeding. Total costs are estimated at $300,000.

d. The customer deposits and accrued interest on customer deposits were calculated using a regression analysis based on the average customer deposits and interest on customer deposits balances from March 2004 through February 2006.

e. The average reserve for uncollectible accounts was calculated using the ratio of the average historical reserve balance to the average historical revenues. The ratio was computed based on the three year period January 2003 through December 2005. This ratio was then applied to the estimated revenues for the attrition period.

f. The materials and supplies inventory and other accounts receivable accounts are fairly consistent. Therefore, they were based on a 13 month rolling average from March 2005 through March 2006 with no forecast assumptions.

Q. Did the average rate base change between the test period and the attrition period?

A. Yes. The average rate base is expected to increase approximately $12.5 million as follows:

1. The working capital requirement increased approximately $8.0 million, primarily due to an increase in the average balance of stored gas inventory.

2. Increase in net utility plant in service of approximately $5.6 million, primarily due to the bare steel/cast iron pipeline replacement program, improvements to the Company's LNG facility, normal expansion of the Company's system and increased plant allocations from AGSC, which are primarily the result of investments in technology.

3. The above two increases were offset partly by a $1.0 million increase in deferred income taxes.

Q. What will be the impact to rate base and the Company's base revenue requirement if the proposed bare steel and cast iron replacement program tracker is approved?

A. The average rate base will decrease by approximately $2.0 million, and the base revenue requirement will decrease by approximately $303,000 if the Company is allowed to recover these costs through the proposed rider.

D. COST OF CAPITAL

Q. Please explain Exhibit MJM-4 supporting the Company's capital structure and proposed rate of return.

A. Schedule 1 of the exhibit provides a summary of the Company's ratio of debt components and common equity to total capitalization and Schedule 2 supports the Company's long-term debt and common equity ratios to total capitalization at 46.38%.

Q. How was the cost rate for short-term debt determined in Exhibit MJM-4, Schedule 1?

A. The estimated cost of short-term debt is based on AGLR's projected short-term debt cost on its commercial paper program. The projected short-term debt cost includes the quarterly average of the forward curve for the London Inter-Bank Offering Rate ("LIBOR") from December 2006 through December 2007, plus the estimated spread between LIBOR and the commercial paper rate and the estimated rate on bank facility fees and other short-term debt related costs. The average LIBOR rate is projected to be 5.34%, the estimated commercial paper spread is 0.05% and the estimated rate on bank facility fees and other short-term debt related costs is 0.05%, resulting in a total estimated short-term debt cost of 5.44%.

Q. How was the cost of long-term debt determined in Exhibit MJM-4, Schedule 1?

A. The cost of long-term debt includes the cost of senior notes, medium-term notes and preferred stock within the consolidated capital structure of AGLR as of March 31, 2006, adjusted for the retirement of $150 million in preferred stock in May 2006 and for the issuance of $175 million in long-term debt in June of 2006. A detailed calculation of the estimated long-term debt cost rates is included in the Company's response to TRA Minimum Filing Guideline No. 81.

Q. Does AGLR still have preferred stock outstanding after the previously mentioned retirement of $150 million in preferred stock?

A. Yes. AGLR still has $75 million in preferred stock still outstanding, the cost of which has been incorporated in the overall cost of long-term debt described above.

Q. How was the cost of common equity determined?

A. The calculation of the cost of common equity of 11.5% is discussed in the pre-filed direct testimony of Dr. Roger Morin. As described further by Dr. Morin, the recommended cost of common equity decreases 50 basis points to 11% if CGC's proposed rate design plan and PRP are adopted.

Q. What is the impact of an 11% ROE to the Company's revenue requirement if both proposals are adopted?

A. The Company's base revenue requirement would decrease by approximately $420,000 using an ROE of 11%.

Q. How did the Company determine a 7.23% short-term debt capital structure?

A. The Company based its short-term debt capital structure on the average short-term debt of AGLR based on the twelve month daily average short-term debt balances through March 31, 2006. This balance was applied to the long-term debt balance calculated in the determination of the long-term debt costs and the common equity of AGLR as of March 31, 2006, adjusted to exclude the impact of other comprehensive income ("OCI").

Q. What is the OCI included in AGLR's common equity?

A. OCI, which in this case reduces total equity, is primarily the result of a substantial increase in the pension liability of AGLR. In accordance with Statement of Financial Accounting Standard No. 87, "Employer's Accounting for Pensions" ("SFAS 87"), AGLR is required to recognize as a pension liability the difference between the accumulated benefit obligation ("ABO") and the fair value of pension plan assets. SFAS 87 also requires the offsetting debit to be recorded to OCI, which is included in the equity section of the balance sheet.

Q. What caused the large increase in the pension liability for the Company?

A. The reason for the large increase is due to a substantial increase in the ABO of the pension plan combined with a minimal increase in pension plan assets from October 2000 through December 2003. Equity market performance and corporate bond rates have a significant effect on the reported unfunded ABO, as the primary assumptions that drive the value of the unfunded ABO are the discount rate and actual return on pension plan assets. Currently, a one-percentage-point increase or decrease in the assumed discount rate could have a negative or positive impact to the ABO of approximately $40 million. From October 2000 through December 2003, the discount rate decreased 1.7%.

Q. Why should the OCI be excluded from common equity for regulatory purposes?

A. As discussed above, treatment of the increase in the pension liability as OCI is an accounting requirement under SFAS 87. As it relates to regulated entities, this amount represents the future costs that will be recovered from customers through base rates. Excluding the OCI from common equity for regulatory purposes is appropriate for CGC because the OCI represents future contribution requirements to the pension plan. CGC's recovery from rate payers is based on pension plan contributions. In other words, for CGC, the OCI represents the future funding requirements to the pension plan that will be recovered from ratepayers in the future, assuming there are no changes. This also assumes that there are no changes in the ABO or plan asset amounts. Any changes in the ABO or plan asset amounts would adjust the OCI accordingly, but the regulatory treatment to exclude the OCI balance from common equity would remain the same. The regulatory treatment would be the same if CGC were recovering its pension costs through the SFAS 87 expense calculation.

Q. How did the Company determine a 46.38% long-term debt and common equity capital structure?

A. The 46.38% long-term debt and common equity capital structure is based on Dr. Morin's comparable group capital structure in which the long-term financing portion of the capital structure (long-term debt and common equity) is a 50/50 ratio. When the short-term debt ratio of 7.23% is considered, the remaining portion of the capital structure to be split 50/50 is 92.76%, resulting in a long-term debt and common equity ratio of 46.38%.

Q. How did the Company determine a 50% long-term debt and 50% common equity capital structure?

A. Based on an analysis against its peers, the Dr. Morin determined that a 50% long-term debt and 50% common equity capital structure is both reasonable and appropriate. Additionally, as is discussed later in my testimony, his recommended capital structure is consistent with the actual capital structure of AGLR.

Q. Has the Company proposed a hypothetical capital structure in previous rate cases before the TRA?

A. Yes. In its most recent rate case filed in 2004 (Docket 04-00034), the Company also proposed a hypothetical capital structure. This proposal, however, was not adopted by the TRA. Rather, a capital structure based on a three year historical average of AGLR was adopted.

Q. What is AGLR's actual capital structure?

A. AGLR's actual capital structure as of March 31, 2006, adjusted for known and measurable items, is 7.23% short-term debt, 45.98% long-term debt and 46.79% common equity. Exhibit MJM-5 provides the actual capital structure and the resulting rate of return, base revenue requirement and rate increase.

Q. How was the actual capital structure derived?

A. The actual capital structure included in Exhibit MJM-5 is based on the actual capital structure of AGLR as of March 31, 2006, adjusted to exclude the impact of OCI from common equity, to include the retirement of $150 million in preferred stock in May 2006 and to include the issuance of long-term debt in June of 2006. The short-term debt component of the actual capital structure is the same amount used to derive the short-term debt percentage of Dr. Morin's recommended capital structure, which is the average short-term debt of AGLR based on the twelve month daily average short-term debt balances through March 31, 2006.

Q. Please explain why you used the average twelve month daily short-term debt balances rather than the short-term debt balance at March 31, 2006.

A. Use of an average short-term debt balance is consistent with basic ratemaking principles and procedures in that it takes into consideration the seasonality of a utility. The operations of utilities, which are the primary component of AGLR's business, are very seasonal in nature and require more short-term debt financing during the heating season as compared to the injection season. This seasonality normally results in larger short-term debt balances at December and March but smaller short-term debt balances in June and September. If the short-term debt balance as of March 31, 2006 was used, the short-term debt component of the Company's hypothetical and actual capital structures would not be reflective of the Company's operations and working capital requirements on an annual basis. Additionally, and equally important, use of a twelve month average for short-term debt is consistent with the manner in which the Company computes its rate base.

Q. Please explain.

A. The primary components of the Company's rate base that cause short-term debt to fluctuate are stored gas inventory and the lead lag portions of CGC's working capital requirement. These two components are heavily impacted by the seasonality of CGC's business. In the case of stored gas inventory, a thirteen month average is used to compute its portion of rate base, and for the lead lag requirement, twelve months of revenues, cost of revenues and operating expenses are used in the computation. In summary, both calculations take into consideration the seasonality of CGC's operations.

Q. How does the actual capital structure compare to the Company's proposed capital structure?

A. The actual capital structure results in a rate of return of 8.66%, which is slightly higher than the 8.64% rate of return resulting from the hypothetical capital structure.

On a base revenue requirement basis, the actual capital structure results in an additional base revenue requirement of approximately $50,000. In summary, AGLR's actual capital structure, when computed properly, is consistent with the capital structure recommended by Dr. Morin.

Q. Has the Company calculated an actual capital structure using a three year historical average?

A. No. The Company believes the methods it has proposed provide a reasonable basis for estimating the attrition period capital structure. In the preparation of a rate case, it is common for jurisdictions to allow and use forward looking test years, or, as Tennessee refers to them, attrition periods. Such forward looking periods are used to forecast operating revenues, cost of service and rate base. Additionally, the use of forward looking test periods are used to estimate the cost of long-term debt and short-term debt. The use of forward looking estimates are proper because new rates, if authorized, are set for a future point in time. Therefore, when estimating capital structures, a forward looking period should also be used.

Q. How are forward looking estimates for rate cases generally forecast?

A. There are a number of methods that are used when forecasting a forward looking period. Forecasting methods include, but are not limited to, the use of an approved annual budget or a forecast developed for internal purposes or specifically for a rate case; the use of a recent historical period, unadjusted; and the use of a historical period adjusted for known and measurable or reasonably anticipated items and/or growth factors.

Q. Does this also apply to capital structures?

A. Yes. Dr. Morin's proposed capital structure is based on the actual capital structures of AGLR's peer group as of December 31, 2005, the most recent available period at the time of his testimony. This also represents the ending date of the Company's test period. As discussed previously, the Company's actual capital structure provided in Exhibit MJM-5, Schedule 1, is based on the actual capital structure of AGLR as of March 31, 2006 (a historic period), updated for the retirement of debt and new issuances of debt (known and measurable items). These two capital structures are the best estimates of the attrition period capital structure of AGLR.

Q. Does this conclude your testimony?

A. Yes.

Attachment A

MICHAEL J. MORLEY

Educational Background and Professional Experience

Mr. Michael J. Morley, as Director, Regulatory Accounting and Reporting of AGL Resources Inc. (AGLR) and as and an employee of AGLR's wholly-owned subsidiary, AGL Services Company, has responsibility for the preparation and coordination of financial information for rate cases and for the monthly and annual reporting requirements of AGLR's regulated subsidiaries. Mr. Morley is also responsible for directing and coordinating responses to various requests of state and federal regulatory agencies and provides various analyses and regulatory interpretations and consulting to senior management.

Mr. Morley received a B.B.A. from the University of Georgia in June 1991 with a major in accounting.

The following is a summary and timeline of Mr. Morley's professional experience:

- **AGL Resources Inc., Atlanta, Georgia**
  - Director, Regulatory Accounting and Reporting, May 2005 to Present
  - Director, Financial Accounting, January 2002 – May 2005
  - Manager of Financial Accounting, September 2000 – January 2002
- **Nevins Marketing Group, Inc., Atlanta, Georgia**
  - Controller, July 1997 – May 2000
- **Moore Colson and Company, P.C., Atlanta, Georgia**
  - Senior Auditor, January 1993 to July 1997
  - Staff Auditor, June 1991 to December 1992