Before the

TENNESSEE REGULATORY AUTHORITY

IN RE:

PETITION OF CHATTANOOGA GAS COMPANY FOR APPROVAL OF ADJUSTMENT OF ITS RATES AND CHARGES, COMPREHENSIVE RATE DESIGN PROPOSAL, AND REVISED TARIFF

DOCKET NO. 06-00175

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DIRECT TESTIMONY
OF
TERRY BUCKNER

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October 16, 2006

Q. Please state your name for the record.

A. My name is Terry Buckner.

Q. By whom are you employed and what is your position?

A. I am employed by the Consumer Advocate and Protection Division ("CAPD") in the Office of the Attorney General for the state of Tennessee ("Office") as a Regulatory Analyst.

Q. How long have you been employed in conjunction with the public utility industry?

A. I have been employed in conjunction with the public utility industry for approximately twenty-eight years. Before my current employment with the Office, I was employed by the Comptroller's Office for the state of Tennessee for nearly two years as the Assistant Director responsible for public utility audits after approximately eight years of prior employment with the Office. Formerly, I was employed with the Tennessee Public Service Commission ("Commission") in the Utility Rates Division as a financial analyst for approximately six years. My responsibilities included testifying before the Commission as to the appropriate cost of service for public utilities operating in Tennessee. Prior to my employment with the Commission, I was employed by TDS Telecom for eight years and the First Utility

District of Knox County for three years.

Q. What is your educational background and what degrees do you hold?

A. I have a Bachelors degree in Business Administration from the University of Tennessee, Knoxville with a major in Accounting. I am also a Tennessee Certified Public Accountant and a member of the American Institute of Certified Public Accountants.

Q. Would you briefly describe your responsibilities as a Regulatory Analyst with the CAPD?

A. I prepare testimony and financial exhibits in rate proceedings as an employee with the CAPD. Additionally, I review tariff filings by the Tennessee Regulatory Authority ("TRA") certificated utilities operating in Tennessee.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to address three issues with the forecasted financial exhibits prepared by Chattanooga Gas Company ("CGC") for the attrition year ended December 31, 2007. The three issues are: (1) Long Term Incentive Plans ("LTIPs"); (2) State of Tennessee Gross Receipts Tax; and (3) Depreciation Expense.

OPERATION AND MAINTENANCE EXPENSES:

Q. Explain the issue of LTIPs within Operation and Maintenance Expenses.

A. CGC has included $261,000 in its forecast of Operations and Maintenance Labor for three separate LTIP, "Incentive Plan"(s).[1] Simply put, Incentive Plans are financial awards to certain officers and employees of CGC and its parent company AGL Resources, Inc. In large part, the financial awards are based on the earnings of the companies. CGC has disclosed three separate Incentive Plans: (1) Long-Term Incentive Plan ("LTIP"); (2) Annual Incentive Plan ("AIP"); and (3) Officer Incentive Plan ("OIP"). The LTIP compensation may be based on any of twenty-three financial performance measures.[2] CGC has included $47,000 for their LTIP in the attrition year ended December 31, 2007. The AIP compensation is based on three performance components: Corporate Performance, Business Unit Performance, and Individual Performance.[3] The Corporate Performance is based solely on earnings per share goals. The Business Unit Performance is "measured by their success of their respective Business Unit. The Business Unit Performance Goals

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[1]CGC Discovery Response, FG-51.

[2]CGC Discovery Response, FG-51, LTIP Section 5.2, Page 7.

[3]CGC Discovery Response, FG-51, AIP, Page 4.

consist of specific goals with respect to their **financial performance**"[4] (Emphasis added). The Individual Performance has two measures, a "what you achieve" and a "how you achieve."[5] Based on the AIP award weighting factors, 50% of the AIP is for individual performance for non-officer employees. CGC has included $97,000 for their AIP in the attrition year ended December 31, 2007. The OIP is the granting of "Stock Options and the award of Restricted Stock."[6] The granting of an "Award" is determined by the Compensation Committee of the Board of the Directors of the Company (the "Committee"). "In making Award decisions, the Committee may take into account the nature of services to be rendered by the Eligible Employee, the Eligible Employee's potential contribution to the Company's success and such other factors as the Committee, in its sole discretion, deems relevant."[7] CGC has included $117,000 for their OIP in the attrition year ended December 31, 2007. Because there is no mechanism under the incentive plans for CGC's ratepayers to share in these increased earnings, CGC's employees and shareholders will reap all of the financial rewards of these higher

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[4]CGC Discovery Response, FG-51, AIP, Page 5.

[5]Ibid.

[6]CGC Discovery Response, FG-51, OIP Section 2.4, Page 2.

[7]CGC Discovery Response, FG-51, OIP Section 3.1(a), Page 4.

earnings. Additionally, ratepayers are the sole source of CGC's regulated earnings; therefore, the LTIP and the OIP incentive plans are circular ones whose success is built into this docket, rewarding CGC's employees and shareholders for merely increasing natural gas rates charged to ratepayers. For example, CGC has identified $2.3[8] million of their requested rate increase in this docket as directly attributable to an increase in their rate of return. As a result, the stockholders receive more return, the employees receive more LTIP, but the ratepayers receive higher bills. Also, it is a "crude"[9] method of measuring specific accomplishments of employees. Moreover, LTIP has recently been disallowed in Louisiana and Kentucky.[10] For these reasons, there is no reasonable basis to charge the cost of the LTIP and the OIP incentive plans to ratepayers, as all of the plan benefits will inure entirely to CGC's employees and shareholders and all of the plan's burden will be charged directly to ratepayers. As a result, these amounts have been excluded and should be borne solely by CGC's shareholders.

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[8]CGC direct testimony, M. Morley, page 4, Lines 11 and 13.

[9]CAPD Exhibit, Washington Utilities Commission Docket No. UT-950200, Page 49.

[10]CAPD Exhibit, Louisiana Public Service Commission Docket No, U-20925, Page 24, Order dated May 25, 2005 (WL 3729359) and Kentucky Public Service Commission Docket No. 2005-00042, Page 43, Order dated December 22, 2005 (WL 3617549) and Order dated February 2, 2006 (WL 1348489).

The TRA has found in a previous docket[11] that 50% of a LTIP should be borne by the shareholders. The AIP incentive plan meets the criteria set in TRA Docket #96-00977. However, the LTIP and OIP incentive plans do not meet the criteria threshold. For example, if CGC's employees are successful in increasing the company's earnings, even to the point of earning above the authorized rate of return set by the TRA, CGC will reward its employees for this effort through the LTIP. In such a case, ratepayers would not only be unreasonably burdened by the over-earnings, but under CGC's proposal they also would have to pay an "over earnings surcharge" in the form of the LTIP. The CAPD does not object if the company wants to reward its employees for increasing its earnings from regulated operations; however, the cost of these rewards should be charged to those that benefit from the LTIP — the company's shareholders — not the ratepayers. In essence, CGC's plan requires 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 major amount of bonuses paid in this case turns solely on the company's profits (as opposed to service quality benchmarks, etc.).

[11]TRA Docket #96-00977, dated February 19, 1997, page 12.

Therefore, in accordance with the TRA's established precedent, CGC's ratepayers should not have to pay for the LTIP and the OIP incentive plans designed to benefit only the shareholders. The TRA should disallow the proposed LTIP incentive plan costs of $47,000, the OIP costs of $117,000 and 50% of the AIP incentive plan costs of $48,500 under the circumstances of this case, resulting in a disallowance of $212,500.[12]

[12]CAPD work paper, E-LTIP.

TAXES OTHER THAN INCOME:

Q. Please explain the difference in the calculation of Gross Receipts Taxes.

A. To understand the CAPD'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, CGC paid gross receipts tax for the tax year ending June 2006, and that tax payment was based on CGC's gross receipts for the fiscal year ended September 2004. And, in August 2006, CGC paid gross receipts tax for the tax year ending June 2007, and that tax payment was based on CGC's gross receipts for its fiscal year ended September 2005. Finally, in August 2007, CGC will pay gross receipts tax for the tax year ending June 2008, and that tax payment will be based on CGC's gross receipts for its fiscal year ending September 2006.

Accordingly, the Consumer Advocate's gross receipt tax forecast for the year ending December 2006 -- which includes one-half of the tax year ending June 2006, and one half of the tax year ending June 2007 -- was based on the company's actual gross receipts for the fiscal year ended September 2005. Thus, the 2006 gross

receipts tax forecast was based on gross receipts that were actually known. Likewise, the CAPD's gross receipt tax forecast for the attrition year ending December 2007 -- which includes one-half of the tax year ending June 2007, and one-half of the tax year ending June 2008 -- was based on the company's actual gross receipts for the twelve months ended June 2006. Thus, the 2007 gross receipts tax forecast was based on three-fourths of the gross receipts that were actually known for the September 2006 fiscal year. The CAPD forecast amount recognizes an increase in gross receipts from 2005 to 2006, due primarily to higher gas prices -- from $106 million in actual September 2005 gross receipts to $129 million in twelve months to date June 2006 gross receipts. As demonstrated by the testimony of CAPD witness Dan McCormac, however, the price of natural gas futures has recently been declining. In fact, CGC's own forecast for 2007 is about $12.3 million and if updated to reflect gas prices as of October 10, 2006, revenues will be about $113 million in 2007. Even the CAPD's gross receipts tax forecast will be overstated for future years.

CGC, however, has forecasted their gross receipts tax on estimated revenues of $128 million including a rate increase of $5.8 million for the entire tax year. As a result, the CGC forecast of Gross Receipts Tax has three problems: (1) the assumption that the TRA

will grant the full $5.8 million in increased rates; (2) the assumption that higher gas prices will continue in the unforeseen future; and (3) a mismatch of revenues subject to the gross receipts tax for the tax period ending December 31, 2007. As a result, CGC's gross receipts tax calculation for the attrition year ended December 31, 2007 should be reduced by $225,666. [13]

[13]CAPD work paper, T-OTAX.

DEPRECIATION EXPENSE

Q. Please discuss your calculation of Depreciation Expense for the attrition year.

A. In our calculation of depreciation expense, the CAPD applied the current Average Life Group ("ALG") depreciation rates for Atlanta Gas Light ("AGL") by account category for Tennessee plant balances as a surrogate for the attrition year ended December 2007 for CGC.[14] However, the currently authorized Equal Life Group ("ELG") depreciation rates, which were adopted ten years ago, were applied to the previous monthly CGC Plant in Service balances for the remaining forecasted six months of 2006. The attrition year 2007 forecasted amount results in total Depreciation Expense of $4,114,106.[15] CGC calculated a Depreciation Expense amount of $5,812,351[16] for the attrition year ended December 31, 2007, a difference of $1,698,245. However, $57,869[17] of this difference is directly attributable to differences in average monthly plant balances between the CAPD and CGC using current ELG depreciations rates. The remaining difference is attributable to the CAPD's use of ALG

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[14]CAPD work paper, E-DEP GA.

[15]CAPD work paper, E-DEP.

[16]CGC Discovery Response, FG-69, CGC Schedule 69-1-(a).

[17]CAPD work paper E-DEP1.

depreciation rates for the attrition year 2007 and CGC's use of ELG depreciation rates for the period. Also, a comparison of the current depreciation rates for CGC in Tennessee and their affiliated company Virginia Natural Gas ("VNG") depreciation rates for Virginia, using actual and forecasted Tennessee plant in service balances is provided.[18] Additionally, a comparison of state specific plant in service, state specific accumulated depreciation balances and book values is provided.[19] By simply applying the approved depreciation rates in Virginia to Tennessee's forecasted Plant in Service balance as of December 31, 2007 results in decreasing annual depreciation expense by nearly $1.6 million. In both Georgia and Virginia, however, ALG depreciation rates are employed for rate making purposes, whereas CGC uses ELG depreciation rates in Tennessee. For the reasons explained later, the CAPD used the ALG depreciation convention rather than ELG because ALG is better suited for rate making purposes.

[18]CAPD work paper, E-DEP VA, VNG depreciation rates approved in 2002.

[19]CAPD work paper, RB-ACC DEP COMP.

Q. Please explain the ALG and ELG depreciation conventions.

A. There are two predominant depreciation conventions used in the utility industry. They are the ALG and the ELG depreciation procedures. The ALG depreciation procedure assumes that all property within a group have a life equal to that of the group. The ELG depreciation procedure assumes that only a small portion of the property group has a life equal to that of the group. Consequently, the main difference in the two procedures is the assumption of the existence of retirement dispersion. Under ELG theory, accumulated depreciation reserve will remain relatively stable assuming retirement dispersion. In order to arrive at the distinct service lives within the group, ELG requires the computation of survivor curves, whereas ALG does not. Many assumptions, based on the experience and judgment of the depreciation analyst, are used to determine the shape of these curves. Thus, the calculation of ELG depreciation rates is more art than science.

As a general principle, however, the ELG depreciation convention produces higher annual depreciation expense in the earlier years of the group's life and less annual depreciation expense in the later years of the group's life, whereas the ALG depreciation convention produces a more constant annual depreciation expense over the entire life of the group. Both ALG and ELG, if properly

applied, will theoretically recover the same amount of depreciation expense over the plant's entire service life.

Q. Has the TRA ever affirmatively approved the ELG convention over the ALG convention for rate making purposes in Tennessee?

A. No, it has not. 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 rate making purposes, nor has the TRA affirmatively approved ELG depreciation on the basis that it is the best depreciation convention for rate making. CGC's rate case order in TRA Docket #97-00982 reveals that the TRA approved CGC's depreciation proposal due to the particular circumstances presented in that case.[20] CGC's proposal in Docket #97-00982 included ELG depreciation rates; however, the Authority's order did not discuss (or even mention) the ELG depreciation convention or ELG depreciation rates.

The TRA, therefore, has not made a decision that affirmatively approves the ELG depreciation convention over the ALG depreciation convention for rate making purposes. Although this issue has been raised in the recent Atmos Energy Corporation rate

[20] Chattanooga Gas Rate Case Order issued on October 7, 1998, TRA Docket #97-00982, page 44.

case, TRA Docket #05-00258, the TRA has not yet ruled in that docket at the time of the filing of this testimony. The CAPD is also asking the TRA to consider this issue in this docket.

Q. Do you have an opinion on whether the ELG convention or ALG convention should be used for rate making purposes?

A. Yes, I do. The ALG depreciation convention should be used to establish customer rates for regulated natural gas services.

Q. Why should customer rates be based on the ALG depreciation convention rather than the ELG convention?

A. While ELG theory may be fine for financial accounting and reporting, it breaks down when it comes to utility rate making. 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. In theory, ELG depreciation expense will decline during the passage of time between rate cases. In reality, however, customer rates will not decline during the passage of time between rate cases to reflect the theoretical decline in ELG depreciation expense.

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. 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.

Q. Are there other reasons for rejecting the ELG depreciation convention for rate making purposes?

A. Yes. 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.

Also, the ELG depreciation convention is much harder to administer in the regulatory environment than is ALG. The Federal Communications Commission ("FCC"), for example, approved ELG for the regulated telephone industry on a going forward basis from 1981.[21] The FCC adopted this remaining life procedure due in part to the absence of depreciation reserve records (a problem that does not exist here). 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. If the Authority believes that ELG depreciation should be approved for rate making purposes in Tennessee, it should also be prepared to convene regular depreciation dockets to correct for declining depreciation rates, just as the FCC did.

Q. Is the ELG depreciation convention accepted by most jurisdictions for rate making purposes?

A. No, it is not 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

[21] Report and Order at paragraphs 89-97 issued by the FCC in Docket No. 20188 on December 5, 1980 (1980 WL 121421).

reasons why ELG is rejected in most jurisdictions.[22] Also, as previously mentioned, both Georgia and Virginia use the ALG depreciation convention, as opposed to ELG, for CGC's affiliates in those jurisdictions.

For these reasons, the Consumer Advocate recommends that the TRA also reject ELG in favor of the widely-accepted ALG depreciation convention.

Q. Even if the ELG depreciation convention is approved in this docket for rate making purposes, should the Authority adopt CGC's current ELG depreciation rates?

A. No, the current ELG depreciation rates should not be approved because they are too high, which is clearly demonstrated by CGC's significant increase in depreciation reserves since the rates were first adopted ten years ago. The current ELG rates were adopted for CGC in TRA Docket #97-00982[23] based on a depreciation study dated March 1997 or the study period September 1996. Although

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[22]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).

[23]TRA Order dated October 7, 1998, Pages 43-44,

ELG depreciation rates theoretically decline over time, the ten-year old ELG rates adopted in Docket #97-00982 have never been corrected to reflect ELG theory. Moreover, CGC compounds this error by proposing these same ten-year old ELG rates again in this docket.

After nearly ten years of ELG experience, the accumulated depreciation is approximately 46%[24] of total plant in service at June 30, 2006, as compared to 33%[25] at September 30, 1996. This increase in accumulated depreciation is due to the failure of the assumption of retirement dispersion under ELG theory and/or the failure to actually correct for declining depreciation rates under ELG theory. Unless corrective action is taken in this docket, CGC will continue to over-depreciate its gas plant in service, as is evidenced by the substantial increase in its accumulated depreciation since ELG was adopted.

CGC's current ELG depreciation rates are flawed and, therefore, should be rejected because they are too old to be useful for rate setting purposes. Under ELG's remaining life theory, a stronger accumulated depreciation position tends to drive down ELG depreciation rates whereas a weaker accumulated depreciation position tends to drive up ELG depreciation rates. As demonstrated

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[24]CAPD work paper, RB-ACC DEP COMP.

[25]Roff Exhibit No. 7, Schedule 3, TRA Docket #97-00982.

above, Tennessee's accumulated depreciation position is much stronger than it was ten years ago when the ELG rates were first adopted. Tennessee's accumulated depreciation position is also much stronger than Georgia's and Virginia's.[26] Thus, if CGC had presented a new ELG depreciation study in this case, CGC would be recommending a decrease in depreciation rates for their current reserve position. Accordingly, CGC's ELG depreciation rates should be rejected because they are based on dated and incomplete information that does not reflect the current situation.

Q. Why did the CAPD use Georgia's ALG depreciation rates as a surrogate?

A. Because there is no current Tennessee-specific depreciation study, the CAPD used the currently approved ALG depreciation rates for Georgia as a surrogate for Tennessee. The reasonableness of using the Georgia ALG rates was tested by applying both the currently approved Georgia depreciation rates for AGL and the currently approved Virginia depreciations rates for VNG to Tennessee's gas plant in service balances. Both AGL and VNG are affiliates of CGC, and the ALG depreciation convention is used for rate making purposes in both Georgia and Virginia. The results of

[26]CAPD work paper, DEP RES COMP.

these comparisons are remarkably similar. A comparison of CGC's current Tennessee ELG depreciation rates to the current Georgia ALG depreciation rates resulted in a decline in annual depreciation expense of $1.7 million; and a comparison of CGC's current Tennessee ELG rates to the current Virginia ALG depreciation results in a decline in annual depreciation expense of nearly $1.6 million.[27] All comparisons were done by applying the three sets of depreciation rates (CGC's Tennessee ELG rates, AGL's Georgia ALG rates, and VNG's Virginia ALG rates) to the forecasted Tennessee plant in service balances.

In my opinion, Georgia's ALG depreciation rates should be used in this docket because: (1) ALG is better suited for rate making and adoption of Georgia's ALG rates would allow the earliest implementation of this preferred convention; (2) adoption of ALG rates would help correct the over depreciation of CGC's plant in service, which is evident by the state accumulated depreciation comparisons; (3) the current ELG rates, which CGC proposes to continue applying in the future, are outdated ten year old rates and have not been corrected to reflect the decline in depreciation expense under ELG theory; (4) Tennessee's depreciation rates will be comparable to Georgia and Virginia; (5) the Georgia depreciation

[27]CAPD work papers, E-DEP GA and E-DEP VA.

rates were adopted in 2002 and therefore are much more current than the outdated rates CGC proposes; and (6) the same categories of depreciable plant in service are used in Georgia and Tennessee.

Q. Please summarize your depreciation recommendation.

A. The TRA should approve the ALG depreciation convention for rate making purposes. The TRA should adopt the Georgia ALG depreciation rates for Tennessee and order CGC to file a Tennessee specific ALG depreciation study in its next rate proceeding. Adoption of the Georgia ALG depreciation rates will bring CGC's depreciation expense in line with the expense allowed in both Georgia and Virginia, both of which use the ALG depreciation convention for rate making. This will also help correct the over depreciation of CGC's gas plant in service, which is evidenced by the significant jump in accumulated depreciation since CGC's depreciation rates were adopted ten years ago.

If, however, the TRA approves ELG depreciation for rate making purposes, the TRA should order CGC to immediately correct its outdated ELG depreciation rates, which should immediately reduce customer rates. Without such correction in the ELG rates ratepayers could be charged $5 to $6 million in excessive depreciation rates to cover the over depreciation of CGC's plant in

service if another rate proceeding is not held for three to four years. Also, the TRA should convene annual depreciation dockets in the future to correct for the decline in depreciation expense under ELG theory.

Q. Does this conclude your testimony?

A. Yes, it does.

BEFORE THE TENNESSEE REGULATORY AUTHORITY
AT NASHVILLE, TENNESSEE

IN RE:

PETITION OF CHATTANOOGA GAS COMPANY FOR APPROVAL OF ADJUSTMENT OF ITS RATES AND CHARGES, COMPREHENSIVE RATE DESIGN PROPOSAL, AND REVISED TARIFF

DOCKET NO. 06-00175

AFFIDAVIT

I, Terry Buckner, Regulatory Analyst, for the Consumer Advocate Division of the Attorney General's Office, hereby certify that the attached Direct Testimony represents my opinion in the above-referenced case and the opinion of the Consumer Advocate Division.

Terry Buckner
TERRY BUCKNER

Sworn to and subscribed before me
this 11th day of October, 2006.

Emily Knight
NOTARY PUBLIC

My commission expires: Sept. 29, 2007

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