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

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| **IN RE:** | ) | |
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| **PETITION OF CHATTANOOGA GAS** | ) | |
| **FOR GENERAL RATE INCREASE,** | ) | **DOCKET NO. 09-00183** |
| **IMPLEMENTATION OF THE** | ) | |
| **ENERGY SMART CONSERVATION** | ) | |
| **PROGRAMS, AND IMPLEMENTATION OF** | ) | |
| **A REVENUE DECOUPLING MECHANISM** | ) | |

# CONSUMER ADVOCATE AND PROTECTION DIVISION'S POST-HEARING BRIEF

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Robert E. Cooper, Jr., Attorney General and Reporter for the State of Tennessee, by and through the Consumer Advocate and Protection Division of the Office of the Attorney General ("Consumer Advocate"), hereby submits its Post-Hearing brief in Tennessee Regulatory Authority ("TRA" or "Authority") Docket 09-00183.

**INTRODUCTION**

On November 16, 2009, Chattanooga Gas Company, Inc. ("CGC", "Company" or "utility") filed its petition to increase customer rates by $2,248,376 per year, after updates and revisions. CGC also sought approval for its EnergySmart conservation program and the implementation of a decoupling mechanism it calls the Alignment and Usage Adjustment ("AUA"). Subsequently, CGC's request for reimbursement of $747,743.81 in attorneys' fees from TRA Docket No. 07-00224 was also added to its other requests in this Docket by motion of Chattanooga Manufacturer's Association ("CMA").

After a careful review of the documentation accompanying CGC's petition and other supporting materials received into the record, the Consumer Advocate is of the opinion that CGC's Operations and Maintenance Expense for the attrition year must be decreased by a total amount of $939,693. Further, CGC's request for reimbursement of its attorneys' fees in a non-rate case, TRA Docket 07-00224, is not appropriate under Tennessee law, is a request for the Authority to engage in retroactive ratemaking, and is unreasonably high. In order to allow a fair and reasonable rate of return, the Consumer Advocate believes CGC's ratepayers are due a rate decrease of $189,086, rather than a rate increase. This figure assumes the Authority adopts a reallocation of CGC's book reserve consistent with the theoretical reserve in the depreciation study filed by the utility at the onset of this docket (see *Stipulation of the Consumer Advocate* filed contemporaneously herewith); should the authority reject such a reallocation, the Consumer Advocate maintains CGC's ratepayers are due a rate decrease of approximately $300,000 per year. Finally, the Consumer Advocate believes the AUA does not properly align the interests of CGC and its customers in order to encourage energy conservation, and has proposed a number of alternatives that would better align those interests, comply with the statutory mandate of the Tennessee Legislature, and better serve CGC's ratepayers. These positions are discussed in detail below.

## I. ATTRITION YEAR REVENUE REQUIREMENT

### A. OPERATION AND MAINTENANCE EXPENSE

CGC is forecasting $11,185,921 in Operation and Maintenance Expense for the attrition year.[1] The Consumer Advocate's proof demonstrated this figure must be reduced by a total of $939,693. That total consists primarily of $399,591 in Incentive Plan pay, $105,334 in annual reduction of rate case amortization in TRA Docket 09-00183, $29,902 of remaining rate case amortization from TRA Docket 06-00175, and $396,208 in Outside Legal Expense.

#### 1. CGC's forecast for Operations and Maintenance Expense should be reduced by 50% of CGC's proposed AIP Incentive Plan and by 100% of its proposed OIP and LTIP Incentive Plans.

CGC has proposed the inclusion of $421,184 in Annual Incentive Plan ("AIP") as well as $189,359 in Long Term Incentive Plan ("LTIP") and Officer Incentive Pay ("OIP") in its Operation and Maintenance Expense for the attrition year.[2] At least half of the AIP expenses, or $210,592, should be borne by shareholders, rather than ratepayers, because of the direct benefit received by shareholders, and all of the utility's $189,359 in LTIP and OIP expenses should be

[1] *Updated Exhibits Requested by the TRA at the Conclusion of Terry Buckner's Testimony on April 13, 2010,* Schedule 4, April 16, 2010.

[2] *Prepared Rebuttal Testimony of Ronald D. Hanson,* Exhibit RDH-8, April 6, 2010.

borne by shareholders because these plans are based solely upon the utility's earnings per share and, thus, benefit only CGC's shareholders.[3] Therefore, $399,951 should be removed from the utility's attrition year as this amount of the utility's incentive plans benefits shareholders, who should not be allowed to benefit at the expense of ratepayers.

It is a commonly accepted regulatory principle that those who receive the benefit of employee incentive plans should be responsible for paying the cost of these plans. This is the reason that the TRA ruled in Docket 96-00977 that incentive plans having preset financial targets should be charged equally to both shareholders and ratepayers, on a "fifty-fifty percentage (50/50) ratio."[4] Specifically, in that docket, the TRA ruled that a plan erroneously labeled the "Long-Term Incentive Plan" benefited both shareholders and ratepayers equally because it was contingent upon the utility achieving preset financial targets (as will be discussed below, this "Long-Term Incentive Plan" is an entirely different type of program than CGC's "Long-Term Incentive Plan," even though they share the same name).

With regard to CGC's AIP, the utility has taken the position that ratepayers should pay 100% of the costs associated with this incentive plan. However, CGC's proffered expert on this subject, Mr. Ronnie Hanson, admitted during cross-examination that "the benefits associated with the company's variable compensation plans, in my opinion, are a 100 percent benefit for both shareholders and customers."[5] Despite CGC's admission that both shareholders and ratepayers benefit if CGC meets the preset financial performance goals set out, CGC conveniently ignores this fact as well as longstanding TRA precedent and takes the incorrect position that only ratepayers should have to pay for those benefits. CGC discounts the fact that a

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[3] *Direct Testimony of John Hughes*, Docket 09-00183, pp. 2:20 – 7:18, March 10, 2010.

[4] *Id.; citing In Re Nashville Gas Company*, 175 P.U.R. 4th 347 (February 19, 1997).

[5] *Transcript of Proceedings*, 138:13-17, April 12, 2010.

failure to meet these goals would, in most cases, result in lowered revenues or increased expenses, and, therefore, a lower earnings per share amount.[6] By CGC's own admission, this earnings per share amount can then have an effect on either dividends and/or the utility's stock price.[7]

CGC's position on its AIP is simply illogical and inconsistent with TRA precedent. It is unjust and inequitable to allow shareholders a free-ride at the expense of ratepayers. Based on the testimony presented in this Docket, all parties agree these plans benefit both shareholders and ratepayers, yet the utility does not believe that shareholders should pay for any portion of that AIP. Clearly, CGC's proposed treatment of AIP expense would create an inequitable and unjust result for ratepayers in that it would allow CGC's shareholders to be enriched at the expense of CGC's customers. Therefore, at a minimum, one-half of the $421,184 in total AIP expenses, $210,592, should be disallowed and removed from the Operations and Maintenance Expense of CGC in the attrition year because CGC's shareholders receive at least half of the benefits from this AIP expense.

CGC also attempts to include the full amount of its $189,359 in LTIP and OIP expenses in Operations and Maintenance Expense in the attrition year. However, these LTIP and OIP expenses should not be allocated to ratepayers as they benefit only the utility's shareholders. The sole basis upon which these programs are measured is the utility's earnings per share.[8] Earnings per share is a measure designed specifically to assist shareholders in measuring the fair

[6] *Id.* at 143:8 – 144:10.

[7] *Id.*

[8] *Id.* at 138:2 – 151:10; *see also Direct Testimony of John Hughes*, at p.4:8-11, *citing TRA Docket 06-00175*, November 20, 2006.

market value of a corporation's stock.[9] The TRA and a host of other regulatory bodies throughout the nation have held incentive plans based upon earnings per share should be paid exclusively by shareholders, as it is shareholders that this measure is designed to benefit.[10]

As was briefly addressed earlier, it is important to note the "Long-Term Incentive Plan" allowed by the TRA in Docket 96-00977 is not the same type of LTIP that is at issue in 09-00183; the "Long-Term Incentive Plan" in 96-00977 was based upon preset financial targets relating to general operations.[11] CGC's LTIP in Docket 09-00183, however, is identical, in principal, to the LTIP in TRA Docket 05-00258 in that both plans are designed to compensate employees based "exclusively on earnings."[12] As a result, in TRA Docket 05-00258, the TRA adopted the Motion of Director Miller that the "LTIP provides no benefit to ratepayers" because the LTIP was a "bonus plan, strictly for [gas utility] employees, and based exclusively on earnings;" thus, the TRA denied the inclusion of any portion of this LTIP expense.[13] The LTIP and OIP proposed by CGC in Docket 09-00183 are also based exclusively on earnings per share, and, by the same logic, also provide no benefit to ratepayers.

Similarly, many other jurisdictions have adopted this approach. For example, Louisiana, Illinois, Connecticut, Idaho, Oklahoma and Kentucky have all either eliminated or recently

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[9] According to Black's Law Dictionary, Eighth Edition, 2004, "earnings per share" is defined as "a measure of corporate value by which the corporation's net income is divided by the number of outstanding shares of common stock • **Investors benefit from calculating a corporation's earnings per share, because it helps the investor determine the fair market value of the corporation's stock.** – Abbr. EPS." (emphasis added).

[10] *Entergy Louisiana, Inc., Ex Parte*, 2005 WL 372935 (May 25, 2005); *Commonwealth Edison Co. v. Illinois Commerce Commission*, 2009 WL 3048420 (September 17, 2009); *In re Public Service Co. of Oklahoma*, 270 P.U.R. 4th 205 (January 14, 2009); *In re United Water Idaho Inc.*, 2005 WL 3091674 (September 20, 2005); and *In re Kentucky-American Water Co.*, 2005 WL 1080806 (March 30, 2005).

[11] *Direct Testimony of John Hughes*, Docket 09-00183, pp. 2:20 – 7:18, March 10, 2010; *citing In Re Nashville Gas Company*, 175 P.U.R. 4th 347 (February 19, 1997).

[12] TRA Docket 05-00184, *Director Miller's Motion*, p. 4, October 25, 2006.

[13] *Id.* at 4-5.

limited similar utility incentive plans.[14] For example, the Louisiana Commission ruled that shareholders, rather than ratepayers, should bear the burden of incentive pay because those types of programs did not benefit customers in the form of rate stability, service quality, outage reductions, or minimizing length of outages, reductions in numbers of complaints, etc.[15] To cite one more specific example, the Illinois Court of Appeals ruled incentives relating to earnings per share were not proper expenses to be borne by ratepayers, and that "the very term earnings per share provided connotation of benefits for shareholders, rather than for ratepayers."[16]

Ratepayers simply should not be responsible for paying the expenses of CGC's LTIP and OIP incentive programs because these programs are designed for the benefit of shareholders, not ratepayers. CGC attempted to argue these plans also benefited ratepayers, even if accidentally, because higher revenues and lower expenses would have the effect of lowering rates.[17] However, in taking this approach, CGC ignores the fact that the payment of these bonuses would have the effect of once again increasing expenses, which would offset any gains from such an incentive plan.[18] Furthermore, CGC's position is that ratepayers should be **solely** responsible for these incentive plans, not just partially responsible. Thus, the utility believes ratepayers alone should be responsible for the payment of bonuses based solely on earnings per share and designed to benefit only shareholders, because the ratepayers receive an ancillary and unintended benefit which is offset by the payment of the bonuses they are being asked to pay. Once again,

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[14] *Entergy Louisiana, Inc., Ex Parte*, 2005 WL 372935 (May 25, 2005); *Commonwealth Edison Co. v. Illinois Commerce Commission*, 2009 WL 3048420 (September 17, 2009); *In re Public Service Co. of Oklahoma*, 270 P.U.R. 4th 205 (January 14, 2009); *In re United Water Idaho Inc.*, 2005 WL 3091674 (September 20, 2005); and *In re Kentucky-American Water Co.*, 2005 WL 1080806 (March 30, 2005).
[15] *Entergy Louisiana, Inc., Ex Parte*, 2005 WL 372935 (May 25, 2005).
[16] *Commonwealth Edison Co. v. Illinois Commerce Commission*, 2009 WL 3048420 (September 17, 2009).
[17] *Transcript of Proceedings*, 144:11 – 145:15, April 12, 2010.
[18] *Id.*

CGC is not asking its shareholders to pay any portion of these incentives even though the programs in question are designed solely for their benefit.

In summary, the Consumer Advocate is taking a very reasonable position on CGC's AIP, LTIP and OIP plans. The Consumer Advocate is simply asking that the TRA follow its well established precedent of dividing the financial responsibility of CGC's $421,184 AIP equally between shareholders and ratepayers because both parties benefit equally from this program based upon preset financial performance goals. Similarly, the Consumer Advocate is recommending the TRA again follow its own precedent, along with the recent holdings of other jurisdictions, and require CGC's shareholders to pay the $189,359 estimated for the utility's LTIP and OIP programs, as these programs are designed for the sole benefit of these shareholders. The Consumer Advocate simply asks that shareholders, and ratepayers alike, pay for the programs designed to benefit them, and believes shareholders should not obtain a free-ride at the expense of ratepayers. For all of the reasons above, $210,592, 50% of CGC's AIP, and $189,359, the cost of the utility's LTIP and OIP programs, or a total of $399,951 should be charged to CGC's shareholders and, therefore, removed from the attrition year in Docket 09-00183.

**2. The Authority should reduce CGC's proposed regulatory expenses to a just and reasonable level.**

**a. CGC's Docket 09-00183 Rate Case Expenses should be shared between shareholders and ratepayers.**

At least one-half of the total Rate Case Expenses proposed by CGC in Docket 09-00183 should be borne by shareholders and not ratepayers. CGC has asked the full amount of its rate case costs, $632,002 be included in Operation and Maintenance Expense as Rate Case Expenses amortized over a three year period and, thus, paid for exclusively by ratepayers.[19] This amount is more than double the just and reasonable Rate Case Expenses requested by CGC in TRA Docket 06-00175.[20] However, this ignores prior TRA precedent as to how rate case expenses should be distributed between shareholders and ratepayers, as well as the obvious benefits that shareholders enjoy as a result of the recent rate cases presented by CGC. Furthermore, even CGC's figure of $632,002 in total Rate Case Expenses has been amended from the utility's original estimate of $531,955.[21] Traditionally, a utility estimates its Rate Case Expenses at the onset of its rate case, just as it does all other expected costs for the attrition year; utilities do not typically amend those estimates as litigation progresses. Regardless of the propriety of CGC's amended total Rate Case Expenses, it is not proper to require ratepayers to bear the total cost of bringing this rate case. At a minimum, CGC's shareholders should be responsible for one-half of these expenses.

TRA precedent is clear that it is proper for shareholders to bear some portion of the expenses of a rate case. Just last year, in TRA Docket 08-00039, the Authority ruled that "it is appropriate for the shareholders to bear some of the expense of [a] [c]ompany's rate case."[22] Specifically, the Authority noted "in the future the Authority should closely examine the costs associated with rate case filings to determine the portions to be recovered from rate payers and shareholders."[23] In Docket 08-00039, the Authority ruled that only one-half of the utility's rate case expense should be borne by ratepayers.[24] In the present case, Docket 09-00183, the facts

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[19] *Rebuttal Testimony of Ronald D. Hanson*, Workpaper 4 Def. Rate Case Cost, April 6, 2010.
[20] *Direct Testimony of Michael J. Morley*, p.11:16-19, May 30, 2006.
[21] *Direct Testimony of Ronald D. Hanson*, Exhibit RDH-3, Schedule 2, November 16, 2009.
[22] *Order*, TRA Docket 08-00039, p. 24, January 13, 2009.
[23] *Id.*
[24] *Id.*

established at the Hearing show that no more than one-half of CGC's rate case expense should be borne by ratepayers.

The fundamental reason offered by CGC that ratepayers should bear any of the cost of bringing a rate case is that a utility must bring a rate case periodically to request a fair and reasonable return on that Company's investment.[25] Without this return, the utility would be unable to provide service to its ratepayers. Therefore, it follows that a utility has a duty to file a rate case, when necessary, which outlines the proper operating revenues and expenses which are necessary to properly run a utility and still maintain the opportunity to earn a fair and reasonable return, as determined by the Authority.

However, a review of CGC's recent rate cases shows that the utility has requested far more increases than were either granted by the Authority or agreed to by the utility itself; therefore, the rate cases presented by CGC in recent history have far exceeded what was later found to be a reasonable return on the utility's assets. For example, in TRA Docket 04-000034, CGC requested a $4.6 million rate increase.[26] However, after a full Hearing on the merits, the Authority found that only a $642,777 was "needed for the Company to earn a fair return on its investment during the attrition year."[27] Thus, CGC received approximately 14% of the amount it requested in its rate case. Further, in TRA Docket 06-00175, CGC requested a rate increase of $5,844,046.[28] Yet, CGC and the other parties in that docket settled for a net rate increase of only $1,999,097, approximately 34.2% of the total rate increase requested by CGC.[29] In total, CGC

[25] *Transcript of Proceedings*, pp. 162:14 – 164:12, April 12, 2010.
[26] *Prepared Testimony of Steve Lindsey*, TRA Docket 04-00034, p.5:15-22, January 26, 2004.
[27] *Order on Reconsideration*, TRA Docket 04-00034, p.6, ¶8, November 1, 2005.
[28] *Petition*, TRA Docket 06-00175, p.2, ¶5, June 30, 2009.
[29] *Phase I Settlement Agreement*, TRA Docket 06-00175, Settlement Exhibit A, Schedule 1, November 19, 2007.

has requested approximately $10.6 million in just its last two rate cases, but has received only about $2.6 million in rate increases.

Reviewing these figures, one can clearly determine that CGC has requested far more in each rate case than was necessary to earn a "fair return on its investment."[30] Now, it is important to determine who would have benefited if the CGC had received what was requested in its rate case. As was discussed in the preceding section of this brief on CGC's incentive pay programs, earnings per share is determined by dividing a company's net income by the number of shares outstanding.[31] Furthermore, as CGC's witness, Mr. Hanson, admitted on the stand, earnings per share will increase if CGC's estimates in a rate case turn out to be too high.[32] Thus, if CGC received the rate increases it requested in its most recent two rate cases, shareholders would have benefited in the form of an additional $8.0 million in revenues, which the Authority and/or the utility itself ultimately decided were not necessary to achieve a "fair return." This increase in revenues above what was necessary for the utility's operations and a "fair return" would have thus provided no additional value to ratepayers, but would have increased the shareholder's earnings per share. Therefore, it would appear that approximately 75% of the rate case presented by CGC in each of its last two rate cases was more for the benefit of shareholders than ratepayers.[33] In light of the Authority's comments in TRA Docket 08-00039 that "in the future the Authority should closely examine the costs associated with rate case filings to determine the

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[30] *Order on Reconsideration*, TRA Docket 04-00034, p.6, ¶8, November 1, 2005.

[31] *Transcript of Proceedings*, p.143:8-15, April 12, 2010; *See also* According to Black's Law Dictionary, Eighth Edition, 2004, "earnings per share" is defined as "a measure of corporate value by which the corporation's net income is divided by the number of outstanding shares of common stock • **Investors benefit from calculating a corporation's earnings per share, because it helps the investor determine the fair market value of the corporation's stock.** – Abbr. EPS." (emphasis added).

[32] *Transcript of Proceedings*, pp. 189:19 - 194:9, April 12, 2010.

[33] ($642,777 (Docket 04-00034) + $1,999,097 (Docket 06-00175)) ÷ ($4,600,000 (Docket 04-00034) + $5,844,046 (Docket 06-00175)) = .252955, or 25%.

portions to be recovered from rate payers and shareholders,"[34] it is proper for CGC's ratepayers to only be responsible for 25% of Rate Case Expenses, leaving the remaining 75% to be recovered from shareholders. However, the Consumer Advocate is suggesting a fifty-fifty (50%/50%) sharing of these expenses between ratepayers and shareholders would likely reach an equitable result in the aggregate of all CGC's rate cases.

In the present rate case, TRA Docket 09-00183, CGC is requesting a rate increase of $2,248,376 per year, and the Consumer Advocate has actually recommended a rate reduction of $672,896 (assuming that some form of decoupling mechanism is adopted by the Authority).[35] If the Authority adopts the proper reallocation reserves described in the Consumer Advocate's stipulation regarding CGC's proposed depreciation rates, this would reduce the rate reduction recommended by the Consumer Advocate by $111,480 to a total rate reduction of $561,416.[36] Therefore, based on the case presented by the Consumer Advocate, it would appear that practically no part of the rate case portion of Docket 09-00183 should be borne by shareholders, as no portion of the rate increase requested by CGC is necessary for CGC to earn a "fair return." Furthermore, it would appear that, once again, CGC's rate case was presented more for the benefit of its shareholders than its ratepayers.

A prime example of an expense incurred primarily for the benefit of shareholders in Docket 09-00183 is CGC's use of expert witnesses and specialized outside counsel on the issue of Cost of Capital/Rate of Return. CGC's case centers on abandoning long-held TRA precedent which would have the effect of increasing the rate of return solely for the benefit of shareholders. CGC spent a minimum of $30,000, plus expenses, for the expert testimony of Dr. Roger A.

[34] *Order*, TRA Docket 08-00039, p. 24, January 13, 2009.
[35] TRA Docket 09-00183, REVISED Consumer Advocate Exhibits, Schedule 1, April 16, 2010.
[36] *Rebuttal Testimony of Ronald D. Hanson*, p.7:16-18, April 6, 2010.

Morin, as well as an unspecified amount to bring in outside counsel from the District of Columbia, Mr. Kenneth T. Maloney, to cross-examine the Consumer Advocate's witness, Dr. Christopher C. Klein, on this issue. [37] The primary focus of the case presented by Dr. Morin and Mr. Maloney was that his so-called "stand-alone principle" must not be violated.[38] This principle dictates that CGC's capital organization and structure must be looked at alone and without taking into consideration that it is a wholly-owned subsidiary of AGL Resources, Inc.[39] As a subcomponent of this argument, Dr. Morin stresses that "double-leveraging," in which the capital structure and organization of both CGC and its parent company are taken into consideration, is never appropriate and should be abandoned by the TRA.[40] Dr. Morin and Mr. Maloney take these positions despite long-held contradictory TRA precedent employing both "double-leverage" and viewing a utility's capital structure and design in consideration of its parent company (a violation of Dr. Morin's "stand-alone principle").[41]

As is discussed in more detail in the section of this brief regarding CGC's Rate of Return, it is important to note that if CGC was viewed alone, as advocated by Dr. Morin and Mr. Maloney, this would result in a higher allowable rate of return, which would inure solely to the benefit of CGC's shareholders. Thus, if the ratemaking principles advocated by Dr. Morin and Mr. Maloney were adopted by the TRA, despite the fact that these principles have been repeatedly rejected by the Authority, it would result in higher rates being charged to CGC's customers for no improvements or additions to the services they receive. Yet, CGC argues

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[37] *Transcript of Proceedings*, pp. 749:5-25; 799:2–802:7, April 26, 2010.
[38] *Id.* at 698:25 – 699:12.
[39] *Id.*
[40] *Id.* at 745:19 - 748:16; it should be noted that the Consumer Advocate did not propose "double leveraging" in Docket 09-00183, but did argue that CGC's capital needs and structure must be viewed in consideration that it is a wholly-owned subsidiary of AGL Resources, Inc.
[41] *Id.* at 747:9 – 748:21.

ratepayers should be solely responsible for the cost of this expert witness and specialized counsel, as they comprise a part of the Rate Case Expenses in Docket 09-00183. Once again, CGC is asking that shareholders be given a free-ride at the expense of ratepayers.

Furthermore, CGC's use of Dr. Morin and Mr. Maloney in Docket 09-00183 illustrates the fact that utilities have no incentive to keep Rate Case Expenses down when they bear no responsibility for the expenses incurred in those cases. CGC has repeatedly argued that some form of "decoupling" is necessary to "align" its interests to conserve energy with ratepayers, but has ignored properly aligning the interests of CGC and ratepayers with regard to lowering the expenses incurred in rate cases. If the TRA were to adopt CGC's proposal that ratepayers be solely responsible for the expenses of Docket 09-00183, the utility would have no incentive to keep those expenses down in future rate cases or to refrain from putting forth costly arguments that have been repeatedly rejected by the Authority. However, if the Authority were to follow its own precedent and distribute these expenses equally between shareholders and ratepayers, CGC would have the proper incentive to keep Rate Case Expenses lower in the future as half of those expenses would be borne by CGC's shareholders.

In light of prior TRA precedent, CGC's most recent rate cases before the TRA, and the elements of this particular rate case, it would not be wholly unreasonable to require that CGC's shareholders be responsible for 75%, if not all, of CGC's Rate Case Expenses in Docket 09-00183. That is, if the TRA follows its precedent from the Tennessee American Water matter, Docket 08-000039, and divides Rate Case Expenses between shareholders and ratepayers based upon the benefit received by each from the presentation of that case, CGC's shareholders should be responsible for a full 75% of these costs. However, the Consumer Advocate has taken a conservative approach, and simply asks that one-half, $316,001, of CGC's total Rate Case

Expenses, $632,002, be paid by the utilities shareholders, as at least that much of the rate case in Docket 09-00183 was presented for the benefit of those shareholders. Therefore, at least $316,001 should be removed from CGC's proffered Rate Case Expense, with the remaining balance of $316,001 subject to a three year amortization period in the amount of $105,333.70 per year.[42] This approach will distribute the expenses of CGC's rate case amongst all the parties that might see some benefit from it, and would provide the minimum incentive necessary for CGC to keep these expenses down in future rate cases.

**b. CGC's proposed remaining amortization of Docket 06-00175 Rate Case Expense should be found improper and in violation of the Order issued by the Authority in that Docket.**

The $89,706 CGC has included in its rate case expense from TRA Docket 06-00175 should be excluded from the attrition year because this remaining amortization is in clear violation of the settlement agreed to by the parties and ordered by the Authority in Docket 06-00175. CGC, in the testimony of its witness, Mr. Ronnie Hanson, alleges that "the unrecovered balance [of rate case expense from Docket 06-00175] as of the beginning of the attrition period, May 1, 2010, is $89,706."[43] However, a review of the settlement agreement between the parties and the amortization schedule established in Docket 06-00175 demonstrates this figure cannot be correct. Furthermore, as will be shown below, Mr. Hanson's own testimony at the April 12, 2010 Hearing shows the utility is attempting to improperly amortize their actual rate case expenses from Docket 06-00175, rather than complying with the agreed upon settlement figure approved by the Authority at the conclusion of that docket.

[42] Alternatively, if the TRA decides not to follow the 50% shareholders and 50% ratepayers division of rate case costs used previously by the Authority, it should consider reducing the total amount of rate case costs by 50% in the event CGC receives less than 50% of the amount it requested in its rate case filing. Such an approach would help hold down rate case costs by giving companies an incentive not to file cases that cannot be supported by the proof.
[43] *Rebuttal Testimony of Ronald D. Hanson*, pp. 20:23 21:1, April 6, 2010.

In TRA Docket 06-00175, CGC's expert, Mr. Michael J. Morley, stated the utility's total rate case costs were estimated to be $300,000.[44] The parties were eventually able to settle the issues of Docket 06-00175 and specifically agreed upon a rate case expense of $300,000 to be amortized over three years.[45] A review of the Phase I Settlement Agreement, adopted and ordered by the TRA in that docket, can leave little doubt on this point. Exhibit A, Schedule 4, of that Settlement Agreement reveals a "Deferred Rate Case" expense item of $250,000 for the "12 Months Ending December 31, 2007."[46] This figure is arrived at by averaging the balance as of January 1, 2007, or $300,000, with the balance as of December 31, 2007, or $200,000, to arrive at the expense amount for the full twelve month period, $250,000.[47] This clearly creates a three year amortization of rate case expense from Docket 06-00175 in the amount of $100,000 each year.[48] Specifically, the total would be reduced from $300,000 on December 31, 2006 (or January 1, 2007, if it makes this analysis easier to follow), to $200,000 on December 31, 2007, $100,000 as of December 31, 2008, and $0 on December 31, 2009.[49] Therefore, to comply with the Authority approved Settlement Agreement, the total rate case costs of $300,000 allowed by the approved Settlement in Docket 06-00175 should have been fully amortized as of December 31, 2009.

However, CGC maintains a full $89,706 remains to be amortized as of the May 1, 2010 start of the amortization period.[50] CGC could offer no explanation as to why this amount would remain to be amortized based on the three year amortization of rate case costs agreed to in

[44] *Direct Testimony of Michael J. Morley*, p.11:16-19, May 30, 2006.
[45] *Transcript of Proceedings*, 617:15-24, April 13, 2010.
[46] *Phase I Settlement Agreement, Settlement Exhibit A, Schedule 4*, p. 18, November 19, 2007.
[47] *Transcript of Proceedings*, 152:16 – 155:18, April 13, 2010.
[48] *Id.*
[49] *Id.*
[50] *Rebuttal Testimony of Ronald D. Hanson*, pp. 20:23 21:1, April 6, 2010.

Docket 06-00175.[51] Later in the proceedings, CGC suggested this discrepancy was due to a four year, rather than three year, amortization period.[52] However, as addressed in the testimony of Consumer Advocate witness Terry Buckner, even if CGC acted in disregard of the Authoirty approved Settlement Agreement and the $300,000 were amortized over a period of four years, the amortization amount would still be improper.[53] Using the same analysis as above, a four year amortization would have left one-quarter (25%) of the $300,000, or $75,000, to be amortized as of December 31, 2009. Therefore, even if you discount the Phase I Settlement Agreement approved by the TRA in Docket 06-00175, which clearly states that a three year amortization period of rate case costs was adopted, there is no way to mathematically arrive at a figure of approximately $90,000 remaining to be amortized.

CGC's testimony in Docket 09-00183 cannot possibly be correct in light of the settlement agreement approved by the TRA. During the April 12, 2010 Hearing, Mr. Hanson admitted "**three – two days ago I saw a spreadsheet that showed $375,000 that was deferred.**"[54] (emphasis added). However, it is clear that this figure is inaccurate as the Settlement Agreement between the parties shows the 2007 Deferred Rate Case amortization was $250,000, which would have been impossible if the total amount to be amortized was $375,000.[55] In order for the 2007 Deferred Rate Case expense to equal $250,000, as it explicitly does in the *Phase I Settlement Agreement*, with a beginning total Deferred Rate Case amortization of $375,000 on January 1, 2007, the December 31, 2007 balance would have to have been $125,000.[56]

[51] *Transcript of Proceedings*, 156:6-18, April 12, 2010.
[52] *Id.* at 380:2-4, April 13, 2010.
[53] *Id.* at 617:15 - 618:3.
[54] *Id.* at 152:14-15, April 12, 2010.
[55] *Phase I Settlement Agreement*, *Settlement Exhibit A*, *Schedule 4*, p. 18, November 19, 2007.
[56] ($375,000 + $125,000)/2 = $250,000.

Obviously, this would create annual amortization of $250,000, creating a full amortization of the entire alleged balance of $375,000, by July 1, 2008.[57]

A review of the testimony of CGC's witness, Mr. Hanson, demonstrates the likely cause of CGC's improper calculation of remaining amortization. If CGC's books show the total Rate Case Expense was $375,000, as Mr. Hanson says[58], it appears CGC has disregarded the *Phase I Settlement Agreement* agreed to by the parties, and ordered by the Authority on November 19, 2007, when calculating its Deferred Rate Case expense in Docket 06-00175. If CGC does, in fact, amortize $375,000, which we have already shown to be incorrect, over four years, rather than three, this would result in total amortization of $93,750 each year.[59] While CGC's proffered figure was $89,706, as of May 1, 2010, and this calculation would result in a remaining amortization of $93,750 as of December 31, 2009, it is the only way in which the Consumer Advocate can reach a figure even remotely close to the one provided by CGC.[60] Obviously, CGC cannot be allowed to benefit from its failure to follow the Settlement Agreement approved by the Authority.

No matter how CGC reached its alleged remaining amortization of $89,706, the calculations above make clear that this figure cannot be accurate in light of the TRA's Order in Docket 06-00175. As described above, a review of the Direct Testimony provided by CGC, and the Phase I Settlement Agreement agreed to by the parties and ordered by the Authority, makes clear that CGC agreed to total Rate Case Expenses of $300,000 to be deferred over three years, beginning on January 1, 2007. That deferral resulted in a zero balance as of December 31, 2009. Therefore, any further amortization of rate case expenses from Docket 06-00175 will allow CGC

[57] $375,000 - $125,000 = $250,000.

[58] *Transcript of Proceedings*, 152:14-15, April 12, 2010.

[59] $375,000 ÷ 4 = $93,750.

[60] $375,000 - $93,750 (2007) - $93,750 (2008) - $93,750 (2009) = $93,750.

to recover more than the agreed upon $300,000 in Docket 06-00175. Thus, CGC's Operations and Maintenance Expense must be reduced by another $29,902 in the attrition period, representing the total $89,706 which CGC has inexplicably planned to amortize over an additional three year period.[61]

**3. Outside Legal Expenses**

CGC's actual legal bills from TRA Docket 07-00224 must be removed from Outside Legal Expenses, a subcomponent of Outside Services which is a line item in Operations and Maintenance Expense. CGC originally proposed an Outside Legal Expense amount of $662,437 for the test period.[62] However, in the *Prepared Rebuttal Testimony of Ronald D. Hanson*, CGC adjusted the test year figure to $578,479.[63] CGC admitted during the April 12, 2010 Hearing that it has included its actual legal bills from Docket 07-00224 in the utility's Outside Legal Expenses account for the test year - the same legal bills for which it is also seeking a dollar for dollar recovery of $744,743.81.[64] Even though counsel for CGC has admitted the expenses incurred in Docket 07-00224 are not likely to be recurring,[65] the utility is now arguing these legal bills should be included in recurring rates to CGC's customers because they will likely incur similar legal bills in the future.[66] However, a review of the record will show CGC's Outside Legal Expenses for the attrition year are grossly inflated well beyond any reasonable expectation of actual expenses for the period.

[61] *Prepared Rebuttal Testimony of Ronald D. Hanson*, p.16:4-13, April 6, 2010.

[62] *CGC's Responses to the First Set of Discovery Requests to the CAD*, Request No. 64, February 5, 2010.
[63] *Prepared Rebuttal Testimony of Ronald D. Hanson*, p.19:3, April 6, 2010.
[64] *Transcript of Proceedings*, pp.170:5 – 171:23; 172:16-23, April 12, 2010.
[65] *Transcript of Proceedings*, pp.90:18 – 98:3, January 25, 2010.
[66] *Transcript of Proceedings*, p.173:1-8, April 12, 2010.

CGC's legal expenses are comprised of two accounts: Outside Legal Expenses (No. 670402), and Miscellaneous Legal Services (670403), collectively referred to by the parties as Outside Legal Expenses.[67] The *Affidavit of Shannon Pierce*, filed in TRA Docket 07-00224, reveals all of CGC's legal expenses in that docket were billed to these two accounts.[68] Furthermore, Mr. Ronald Hanson, witness for CGC, admitted these legal bills were not removed from those accounts during the test year because CGC believed it would incur similar expenditures on an ongoing basis.[69] Throughout Docket 09-00183, CGC has taken the position that legal fees from Docket 07-00224 were not likely to recur.[70] In fact, the Consumer Advocate submitted discovery to CGC specifically asking the utility to list any non-recurring charges, such as "Outside Service Expenses," to which CGC responded that there were none.[71]

The statements of counsel for CGC during the January 25, 2010, Status Conference in Docket 09-00183 provide a clear statement of the utility's position on the subject of legal fees from Docket 07-00224. During that conference, Hearing Officer Hotvedt asked the question of all three parties (CMA, CGC, and the Consumer Advocate), "do you consider the costs associated with preparing and defending the prudence of CGC's asset management program addressed in Docket 07-00224 to be future and recurring?"[72] Counsel for CGC, Mr. J.W. Luna, under the advice of Mr. Archie Hickerson, CGC's company representative and witness on the subject of Docket 07-00224 legal fees, responded that these fees would "hopefully not" be

[67] *Id.* at 170:5-23.

[68] *Affidavit of Shannon Pierce*, Exhibit A, Legal Fees for Asset Mgmt Docket (07-00224) Matter: June 2008 – September 2009, TRA Docket 07-00224, October 6, 2010.

[69] *Transcript of Proceedings*, p.173:1-8, April 12, 2010.

[70] *Transcript of Proceedings*, pp.75:4; 90:18 – 98:3, January 25, 2010; *see also Supplemental Testimony of Terry Buckner*, p.5:1-15, March 29, 2010, *citing Consumer Advocate Discovery Request No. 46*, January 6, 2010.

[71] *Supplemental Testimony of Terry Buckner*, p.5:1-15, March 29, 2010, *citing Consumer Advocate Discovery Request No. 46*, January 6, 2010.

[72] *Transcript of Proceedings*, p.91:2-6, January 25, 2010.

recurring.[73] Following Mr. Luna's response, Hearing Officer Hotvedt stated "I'm going to take all three answers in the negative. So, if not, how can these costs be recovered in recurring rates determined in a rate case? Would basic ratemaking fundamentals require these costs to be removed from the test period?"[74] Mr. Luna responded in part that "obviously it wasn't part of a test period…because by definition that's a one-year analysis. This has been fees incurred over at least two years."[75] Finally, and most importantly, Hearing Officer Hotvedt asked the parties **"are past recurring regulatory costs included in the projected period expense?"**[76] (emphasis added). In response, Mr. Luna stated "**No,**" without any additional explanation[77] (emphasis added). Unfortunately, CGC's representatives, Mr. Luna and Mr. Hickerson, were incorrect; a portion of the legal bills from Docket 07-00224 were, in fact, already included in both the test year and projected period expense at the time that the January 25, 2010 Status Conference took place.

The legal bills incurred by CGC in Docket 07-00224 comprise a staggering 74% of CGC's total test year Outside Legal Expenses in Docket 09-00183, even by the utility's calculation.[78] CGC's witness, Mr. Ronald Hanson, testified that of a total $578,000 in legal expenses, $425,000 were legal billings from Docket 07-00224.[79] This means only $153,000 of Outside Legal Expenses in the test year did not come directly from CGC's legal bills in TRA Docket 07-00224, for which CGC has asked for a full dollar-for-dollar recovery.[80] In light of CGC's actual test year legal expense of $153,000, after removing Docket 07-00224 legal bills,

[73] *Id.* at 92:24 – 93:14.
[74] *Id.* at 93:15-20.
[75] *Id.* at 95:5-15.
[76] *Id.* at 97:4-6.
[77] *Id.* at 98:3.
[78] *Transcript of Proceedings*, p.176:9-16, April 12, 2010.
[79] *Id.*
[80] *Id.* at 172:16-23, April 12, 2010; also $578,000 - $425,000 = $153,000.

the Consumer Advocate's proposed attrition year Outside Legal Expenses of $195,000 would appear more than reasonable.[81]

A review of CGC's Outside Legal Expenses over the last four years demonstrates that its projected attrition year expense of $578,479 is grossly overstated.[82] CGC incurred $213,242 of Outside Legal Expenses in 2005, $173,976 in 2006, roughly an 18% decrease from the preceding year, $196,621 in 2007, a 13% increase over 2006, but in 2008, Outside Legal Expenses ballooned to $527,498, an inexplicable 168% increase over 2007 and a 203% increase over 2006 (the two years prior to the opening of Docket 07-00224).[83] Further, in 2009, Outside Legal Expenses increased again, this time to $578,479, a 194% increase over the 2007 figure for the same account, and a 232% increase over 2006.[84] Even Mr. Archie Hickerson, witness for CGC, admitted that Outside Legal Expenses "began to dramatically increase around the time of the filing of Docket 07-00224," when asked this question by counsel for the Consumer Advocate.[85]

Even though only $153,000 of CGC's Outside Legal Expenses in the test year came from any item other than legal bills in Docket 07-00224, CGC maintains that it expects to incur legal expenses of almost $600,000 in the attrition year and on an ongoing basis.[86] When pressed, however, the only item Mr. Hickerson could point to as likely to cause any of this anticipated expense was CGC's *Request for an RFP*, regarding CGC's asset manager.[87] In fact, Mr. Hickerson stated he believed that this CGC request for an RFP would cause the utility to incur

[81] *Supplemental Testimony of Terry Buckner*, p.6:4-19, March 29, 2010.
[82] *Prepared Rebuttal Testimony of Ronald D. Hanson*, p.19:3, April 6, 2010.
[83] *Transcript of Proceedings*, p.348:9 – 349:3, April 12, 2010.
[84] *Id.*
[85] *Id.*
[86] *Id.* at 344:7-11.
[87] *Id.*

over $600,000 in legal fees in 2010.[88] Mr. Hickerson even went so far as to state that "if you're [the Consumer Advocate] telling us that you would not object to us extending it [the current asset management agreement], I'm sure that we can withdraw our motion."[89] In response to Mr. Hickerson's statement, the Consumer Advocate demonstrated its willingness to resolve the RFP issue without causing CGC to incur any legal costs by agreeing "not to intervene in any docket opened to review the renewal of the current asset management agreement."[90] Unfortunately, following the Consumer Advocate's stipulation, CGC withdrew its offer because its affiliate asset manager, and wholly owned subsidiary of AGL Resources, Inc., Sequent Energy Services, would not agree to extend the current asset management agreement.[91]

Despite the Consumer Advocate's stipulation not to intervene in a docket in which CGC sought to extend its current asset management contract, CGC has not amended its estimate of attrition year expenses. Thus, CGC continues to believe that it will incur almost $600,000 in Outside Legal Expenses each and every year going forward, even though the Consumer Advocate has already demonstrated a willingness to work with CGC to resolve the only issue the utility expects might come up in 2010.[92] Furthermore, Director Kyle gave assurances that the TRA has already taken measures to alleviate the litigiousness between parties and would continue to do so.[93] There is simply no basis to imagine CGC will incur Outside Legal Expenses

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[88] *Id.*
[89] *Id.* at 346:23-25.
[90] *The CAD Agrees Not to Intervene in Any Docket Opened to Review the Renewal of the Current Asset Management Agreement if CGC withdraws its Proposed RFP and Extends the Existing Contract*, TRA Docket 09-00183, April 21, 2010.
[91] *Copy of Letter from Chattanooga Gas Regarding Sequent's Response to Potential Extension of Current Asset Management Agreement Filed in Docket No. 10-00049*, April 23, 2010.
[92] *The CAD Agrees Not to Intervene in Any Docket Opened to Review the Renewal of the Current Asset Management Agreement if CGC withdraws its Proposed RFP and Extends the Existing Contract*, TRA Docket 09-00183, April 21, 2010.
[93] *Transcript of Proceedings*, p.358:15 – 359:9, April 12, 2009.

of $578,479 in the 2010 attrition year. The utility's own calculations show that outside of TRA Docket 07-00224, which is now fully concluded, CGC only incurred $153,000 of Outside Legal Expenses in the 2009 test year.[94] Therefore, CGC believes it will spend almost four times that amount just on its request for an RFP.[95] Clearly, this figure is grossly overestimated.

Furthermore, if CGC is permitted to recover all that it has requested in TRA Docket 09-00183, the utility will have recovered every dollar it spent in Docket 07-00224 many times over. The Consumer Advocate's witness recommended CGC average its Outside Legal Expense for the three calendar years immediately preceding Docket 07-00224; this calculation resulted in an estimate of $194,613 in Outside Legal Expenses.[96] However, CGC argued this data was too old to be useful in making such an estimate.[97] Rather, CGC's witness, Mr. Hanson, proposed using the three most recent years, 2007-2009, to make such an estimate;[98] in making that calculation, however, he failed to remove the admittedly "unique,"[99] non-recurring[100] items included in Outside Legal Expenses, CGC's actual legal bills from Docket 07-00224. If you remove just the $744,744 in legal bills for which CGC seeks dollar for dollar reimbursement, the three year total of Outside Legal Expenses from 2007-2009 averages only $185,951.[101]

If CGC is permitted to include $578,479 of Outside Legal Expenses in its attrition year Operations and Maintenance Expense, as it has requested,[102] this would result in an

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[94] *Id.* at 176:9-16.
[95] *Id.* at 344:7-11.
[96] *Supplemental Testimony of Terry Buckner*, p.6:4-19, March 29, 2010.
[97] *Prepared Rebuttal Testimony of Ronald D. Hanson*, p.18:18-23, April 6, 2010.
[98] *Id.* at 19:4-8.
[99] *Transcript of Proceedings*, p.75:4, January 25, 2010.
[100] *Transcript of Proceedings*, pp.90:18 – 98:3, January 25, 2010.
[101] [($196,621 (2007 Expense) + $527,498 (2008 Expense) + $578,479 (2009 Expense) - $744,744 (07-00224 Legal Bills)) ÷ 3 = $185,951.
[102] *Prepared Rebuttal Testimony of Ronald D. Hanson*, p.19:3, April 6, 2010.

overstatement of Outside Legal Expenses in the amount of approximately $393,000[103] for just a single year. Therefore, if CGC waits just three years to file its next rate case, it will have recovered $1,735,437[104] in Outside Legal Expenses, and $1,177,584 of that amount is the overstatement as a result of including legal bills from Docket 07-00224 in the test year.[105] This means CGC would recover over $1.50 for every $1.00 the utility actually spent in TRA Docket 07-00224;[106] that recovery is in addition to CGC's actual Outside Legal Expense, which it would also recover in the amount of $185,951 per year, for a total of $557,853 over that same three year period. Further, if CGC's request for recovery of Docket 07-00224 legal bills is also granted, the utility would recover those legal bills a third time. Thus, if the TRA were to order the Outside Legal Expense and recovery of Docket 07-00224 legal expenses requested by CGC, the utility would receive an astounding 258% return on every dollar spent in that matter.[107]

In summary, CGC's legal bills in Docket 07-00224 were a non-recurring expense that arose in a "very unique docket," to use the words of CGC's counsel, J.W. Luna.[108] Such non-recurring legal expenses cannot be included in CGC's future rates because to do so would violate the fundamental principles of utility ratemaking. The Consumer Advocate has very reasonably suggested that the TRA adopt an Outside Legal Expense of approximately $194,613, the average Outside Legal Expense of the three years preceding Docket 07-00224.[109] This figure was selected to represent CGC's likely Outside Legal Expenses after the removal of any extraordinary items. In light of CGC's own calculation that it spent just $153,000 in Outside

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[103] $578,479 - $185,951 (using the 2007 – 2009 average as suggested in the *Prepared Rebuttal Testimony of Ronald D. Hanson*, p. 19:4-8, April 6, 2010, but removing extraordinary, non-recurring expenses) = $392,528.

[104] $578,479 x 3 = $1,735,437.

[105] $392,528 x 3 = $1,177,584.

[106] $1,177,584 ÷ $744,744 = 1.58.

[107] ($1,177,584 + $744,744) ÷ $744,744 = 2.58.

[108] *Transcript of Proceedings*, p.75:4, January 25, 2010.

[109] *Supplemental Testimony of Terry Buckner*, p.6:4-19, March 29, 2010.

Legal Expenses during the test year, it would appear the Consumer Advocate's estimate is more than fair. For all of these reasons, a minimum of $396,208[110] must be removed from CGC's Outside Legal Expenses in the attrition year.

## II. CGC'S LEGAL FEES IN TRA DOCKET 07-00224

There can be no doubt that CGC is requesting the recovery of $744,743.81 in legal bills as a result of Docket 07-00224. The first pleading it filed on this issue was titled *CGC's Motion to Accumulate and Defer Litigation Costs.*[111] Furthermore, the $744,743.81 requested by CGC is exclusively comprised of its actual legal bills in Docket 07-00224.[112] Therefore, having established that CGC is requesting the recovery of its legal bills paid in relation to TRA Docket 07-00224, the central question is whether or not CGC may recover those expenses. For all of the following reasons, CGC's request should be denied.

### A. CGC's request for recovery of legal fees from Docket 07-00224 should be dismissed as improper under TRA precedent and Tennessee law.

In its December 29, 2009 motion[113], CMA brought precedential authority to the attention of the parties and the TRA concerning the Authority's ability to award litigation costs to CGC.[114] The Consumer Advocate thoroughly reviewed the Court of Appeals' ruling in *Kingsport Power Company v. Tennessee Public Service Commission*, (hereinafter "Kingsport Power"). Following its review of the *Kingsport Power* decision, the Consumer Advocate conducted its own research

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[110] *Prepared Rebuttal Testimony of Ronald D. Hanson*, Exhibit RDH-8, April 6, 2010.

[111] *Motion to Accumulate and Defer Litigation Costs*, TRA Docket 07-00224, February 28, 2008.

[112] *Prepared Direct Testimony of Archie R. Hickerson*, p. 18:17-21, March 5, 2010.

[113] *Motion of Chattanooga Manufacturer's Association to Combine the Request of CGC for Reimbursement of Legal Fees in Docket 07-00224 With The Request Of CGC For a General Rate Increase in Docket 09-00183*, p. 6, December 29, 2009.

[114] *See Kingsport Power Company v. Tennessee Public Service Commission*, 1984 Tenn. App. LEXIS 2949.

for subsequent case law and/or statutory changes that might authorize the Commission or the TRA to award litigation costs. In conducting its research, the Consumer Advocate discovered a companion case to *Kingsport Power*, in which the Court of Appeals once again heard this issue on appeal from the remanded proceedings of the first *Kingsport Power* holding.[115] In *Kingsport Power II*, the Tennessee Public Service Commission ("the Commission") is quoted as saying that it has no "statutory authority from the Tennessee legislature to award litigation costs to **any party**."[116] (emphasis added). This position was upheld by the Court of Appeal's ruling in that case wherein the Court agreed that "the Public Service Commission has no statutory authority to award costs."[117]

CGC has attempted to argue this ruling does not bear on the present case because the specific matter at issue in *Kingsport Power* was whether or not third parties may recover fees from the Public Service Commission.[118] However, CGC was unable to provide an explanation as to why the ruling specifically stated that the Public Service Commission lacked the authority to award litigation costs to "**any party**," rather than limiting the holding to just "third parties." [119] Furthermore, in the course of conducting its own research the Consumer Advocate has been unable to find any subsequent case law which would bestow the power to award litigation costs upon the Authority. As a result of the asset management case, Docket 07-00224, CGC is attempting to obtain an "award" of legal fees at the end of a non-rate case, but such an award is simply not permissible under Tennessee law.

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[115] *Kingsport Power Company v. Tennessee Public Service Commission*, 1985 Tenn. App. LEXIS 2655 (hereinafter "Kingsport Power II")
[116] *Id.* at 3.
[117] *Id.* at 4-5.
[118] *Transcript of Proceedings*, pp. 317:15 – 318:5, April 12, 2010.
[119] *Id.* at 324:13-19.

The Consumer Advocate was also unable to find any subsequent statutory changes in the Tennessee Code Annotated ("the Code" or "T.C.A.") which would permit the TRA, as successor to the Public Service Commission, to award litigation costs under the present circumstances of Docket 07-00224. Under the Uniform Administrative Procedures Act, the general rule with regard to the expense of having counsel in a contested case is that "any party may be advised and represented **at the party's own expense** by counsel."[120] (emphasis added). As CMA addressed in its motion, T.C.A. § 4-5-325, passed in 1994, does permit for the recovery of litigation costs in proceedings before a state administrative agency, but only in very narrow circumstances. The Code requires that a state agency must first issue a "citation" for "the violation of a rule, regulation or statute and such citation results in a contested case hearing."[121] Obviously, TRA Docket 07-00224 does not meet the basic criteria of that statute as this Docket was not brought as a result of a "citation," much less a "citation alleging the violation of a rule, regulation or statute."[122]

In fact, under the principle of *expressio unius est exclusio alterius*, the legislature's passage of T.C.A. § 4-5-325 is evidence the TRA lacks the power to award litigation costs in other circumstances, not specifically enumerated by statute.[123] In *Wells v. Tennessee Board of Regents*, the Supreme Court of Tennessee describes the principal of "*expressio unius est exclusio alterius*, which translates as 'the expression of one thing implies the exclusion of … things not expressly mentioned.'"[124] Furthermore, the Supreme Court in *Limbaugh v. Coffee Med. Ctr.*,

[120] T.C.A. § 4-5-305.
[121] T.C.A. § 4-5-325(a).
[122] *Id.*
[123] *Wells v. Tennessee Board of Regents*, 231 S.W.3d 912, 917 (Tenn. 2007).
[124] *Id.*; *citing Limbaugh v. Coffee Med. Ctr.*, 59 S.W.3d 73, 84 (Tenn. 2001).

when addressing the failure of the legislature to include two specific torts in a statute dealing with exceptions to the state's immunity from suit, held that:

> we find it noteworthy that the legislature excluded the two intentional torts most likely to give rise to injury. Under the maxim '*expressio unius est exclusio alterius,*' which states the principle that the expression of one thing implies the exclusion of all things not expressly mentioned...we are unable to expand the intentional torts exception to include assault and battery.[125]

Clearly, if the legislature had intended the TRA to have the power to award litigation costs in situations other than those arising as described in T.C.A. § 4-5-325, they would have expressly provided for that power by statute. Presently, they have provided no such statute, and thus the recovery of litigation costs in a non-ratemaking docket is barred.

Further, the Tennessee Supreme Court has held that the American Rule "has been firmly established in this State" with regard to the recovery of litigation costs.[126] The American Rule provides that a party in a civil action may not recover attorney's fees absent a specific contractual or statutory provision providing for attorney's fees as part of the prevailing party's damages.[127] While the Consumer Advocate, in this case, is not seeking to re-argue the TRA's holding in Docket 08-00039 that the American Rule does not block the recovery of some regulatory expenses incurred as a result of a **ratemaking docket**, the Consumer Advocate does assert that the American Rule is applicable to bar an award of litigation costs in a **non-ratemaking docket**, such as Docket 07-00224.

The TRA itself seems acutely aware it does not have the authority to award litigation costs in a non-ratemaking docket as the Consumer Advocate cannot find a single docket in which

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[125] *Limbaugh v. Coffee Med. Ctr.*, 59 S.W.3d 73, 84 (Tenn. 2001).
[126] *House v. Estate of Edmonson*, 245 S.W.3d 372, 377 (Tenn. 2008)
[127] *Id.*

the TRA awarded litigation costs in a non-rate case.[128] Throughout the entirety of Docket 07-00224, and now Docket 09-00183, CGC has been unable to provide even a single case, docket, or statute that would grant the TRA the authority to award litigation costs in a non-rate case. In fact, during the April 12, 2010 Hearing in Docket 09-00183, CGC's witness, Mr. Archie R. Hickerson, admitted he was not aware of even a single docket "in which the Authority has awarded litigation costs in a nonrate case."[129] Therefore, CGC may not recover its litigation costs because these fees arose from a non-rate case and there is no authority authorizing the recovery of such costs in a non-ratemaking docket.

Nashville Gas Company, or "Piedmont" as it is now known, did not recover any of the expenses it incurred in Docket 05-000165, the TRA Docket most closely resembling Docket 07-00224.[130] In that Docket, just as in the present Docket, the TRA convened a contested case "to review Nashville Gas' IPA relating to asset management fees."[131] During the Hearing on the merits in Docket 09-00183, CGC admitted that Docket 05-00165 "went on for a full year; that information between the two parties [Piedmont and the Consumer Advocate] was exchanged with great frequency; and that both dockets [07-00224 and 05-00165] dealt with a variety of similar asset management issues."[132] Ultimately, in that docket the TRA ordered a triennial review of the Performance Incentive Plan of Nashville Gas Company, which it once again

[128] The Consumer Advocate reviewed all non-ratemaking dockets brought by the TRA since 2004. This review found a total of thirty-six non-ratemaking dockets brought by the TRA, including both closed and currently pending dockets: 09-00096, 09-00065, 09-00061, 09-00033, 09-00032, 08-00064, 07-00253, 07-00199, 07-00183, 07-00179, 07-00073, 07-00063, 07-00062, 07-00060, 07-00059, 07-00058, 07-00053, 06-00309, 06-00080, 05-00327, 05-00284, 05-00237, 05-00165, 05-00105, 05-00046, 05-00014, 04-00434, 04-00405, 04-00381, 04-00342, 04-00284, 04-00258, 04-00251, 04-00205, 04-00010, and 02-01274.
[129] *Transcript of Proceedings*, p.329:3-6, April 12, 2010.
[130] *Order Approving Settlement*, TRA Docket 05-00165, December 14, 2007.
[131] *Petition to Intervene*, TRA Docket 05-000165, p.2, ¶6, July 7, 2005.
[132] *Transcript of Proceedings*, p.328:10-18, April 12, 2010.

ordered, practically word-for-word, in the present Docket.[133] Furthermore, as the parties agreed during the Hearing in Docket 09-00183, Piedmont did not "attempt to recover a single cent of the costs associated with that docket [05-00165]."[134]

In light of the controlling precedent and existing statutory authority granted the TRA, the Consumer Advocate is of the opinion that CGC is unable to recover its litigation costs as a result of Docket 07-00224 because the TRA lacks the statutory authority to grant them. The motion of CMA succinctly stated that CGC's request for recovery of litigation costs "must be either (1) a rate case or (2) a request for the award of legal fees."[135] However, throughout Docket 07-00224, CGC has stated that Docket 07-00224 was not a ratemaking docket. Therefore, CGC's request for recovery of its litigation costs is just that, a request for the TRA to award the utility its legal fees in Docket 07-00224, and, as was more fully addressed above, such an award is not authorized under the existing law in the State of Tennessee, regardless of the docket or forum in which this issue is ultimately heard.

**B. CGC's request for recovery of legal fees from Docket 07-00224 should be dismissed as a request for the Authority to engage in retroactive ratemaking.**

CGC may not recover its litigation expenses in Docket 07-00224 in the same way as rate case expenses because Docket 07-00224 was not a rate case. The parties have never been in dispute that Docket 07-00224 was not a rate case; as the Vice President and General Manager of CGC recently said, in a response to an editorial printed in the *Chattanooga Times Free Press*,

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[133] *Order Approving Settlement*, Docket 05-00165, Exhibit A, p.5, December 12, 2007; see also *Handout Given at the August 24, 2009 Conference*, Docket 07-00224, August 26, 2009.

[134] *Transcript of Proceedings*, p.328:19-23, April 12, 2010.

[135] *Motion of Chattanooga Manufacturer's Association to Combine the Request of CGC for Reimbursement of Legal Fees in Docket 07-00224 With The Request Of CGC For a General Rate Increase in Docket 09-00183*, p. 9, December 29, 2009.

"this proceeding is NOT a rate case."[136] CGC's counsel has been very clear that Docket 07-00224 was not a rate case on numerous occasions; to cite just one example, during the Pre-Hearing Conference in Docket 07-00224, Mr. Craig Dowdy, counsel for CGC stated, "now, if this were a rate-design case, if this were a cost-of-service case, a cost-study case, ... but that's not what this case is."[137] In fact, counsel for CGC expressly stated that Docket 07-00224 was not a rate case well before Mr. Dowdy was added as counsel in that docket; counsel for CGC, Farmer & Luna, PLLC, stated specifically during the March 7, 2008 Status Conference that,

> This isn't a rate case. We're not going to get into cost of service issues. We're not going to get into capital structures. We're not going to get into cost of equity, all of those issues. This is about asset management, gas costs, our capacity assets. And it's not – it's not of the complexity of a rate case.[138]

Even CGC's witness in Docket 09-00183, Mr. Archie Hickerson, admitted during the April 12, 2010 Hearing that Docket 07-00224 was not a rate case.[139]

During the Hearing on the merits, the question was asked of the Consumer Advocate's witness, Terry Buckner, "if the asset management issue had never been removed from the '06 rate case...would it have been appropriate to cover the legal fees to litigate that issue?"[140] Mr. Buckner explained that a utility would project its rate case expense for the entire rate case at the onset of litigation, just as CGC did in Docket 06-00175; however, if the utility underestimates that figure, the concept of retroactive ratemaking prevents it from coming back later and

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[136] *Editorial on Gas Inaccurate, Chattanooga Times Free Press*, December 31, 2009

[137] *Transcript of Proceedings*, TRA Docket 07-00224, p. 64:21-25, June 29, 2009.

[138] *Transcript of Proceedings*, TRA Docket 07-00224, p.32:8-17, March 7, 2008.

[139] *Transcript of Proceedings*, p352:1-3, April 12, 2010.

[140] *Id.* at 609:22 – 610:2, April 13, 2010.

attempting to recover costs that were "properly recoverable in a prior period."[141] Furthermore, CGC already recovered a full $300,000 in rate case costs as a result of Docket 06-00175.[142]

The prohibition against retroactive ratemaking is a well established rule in utility ratemaking. The United States Supreme Court has even ruled that in the absence of express statutory direction, it is unlawful for an agency to alter the past legal consequences of past actions.[143] The basic function of the prohibition against retroactive ratemaking is to protect the public by ensuring that current customers pay for their own service and not for past deficits, to prevent utilities from using future rates to protect the financial investment of their shareholders (i.e. – providing a guarantee, rather than opportunity, for a fair rate of return), and requiring utilities to bear losses and enjoy gains that depend on their own managerial efficiency.[144] Furthermore, as Mr. Buckner testified at the Hearing, the Consumer Advocate is unaware of even a single case in which the TRA has allowed a utility to engage in retroactive ratemaking.[145]

The past precedent of the TRA, the U.S. Supreme Court, and the rulings of regulatory bodies in other jurisdictions make clear that retroactive ratemaking is improper. Furthermore, we know CGC has already recovered its full projected rate case expense in TRA Docket 06-00175, the docket from which the issues litigated in Docket 07-00224 arose.[146] It is also worthy of note that Docket 07-00224 was removed from the rate case docket at the request of CGC.[147] Therefore, any attempt to recover the litigation costs of TRA Docket 07-00224 as a rate case

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[141] *Id.* at 615:24 – 616:23.

[142] *Direct Testimony of Michael J. Morley*, p.11:16-19, May 30, 2006.

[143] *Georgetown Univ. Hosp., 488 US 204 (1988); citing American Min. Congress v. U.S. Environmental Protection Agency, 956 F.2d 759 (9th Cir. 1992).*

[144] *Northern Indiana Public Service Company*, 157 PUR 4th 206, 228 (Ind. URC, 1994).

[145] *Transcript of Proceedings*, p.616:21-23, April 13, 2010.

[146] *Direct Testimony of Michael J. Morley*, p.11:16-19, May 30, 2006; *see also Order Closing Phase II of Docket*, TRA Docket 06-00175, p. 3, December 17, 2010.

[147] *Order Closing Phase II of Docket*, TRA Docket 06-00175, p. 3, December 17, 2010.

expense from Docket 06-00175, would be patent retroactive ratemaking. Effectively, this would allow CGC to recover its projected rate case costs, then move to sever issues which were originally included in that rate case, litigate those issues separately, then go back and retroactively recover the full cost of litigating those issues in a separate docket, even though the utility should have already fully recovered the cost of litigating those issues in its rate case.

As was addressed in greater detail on the section of this brief addressing Outside Legal Expenses, CGC is similarly unable to recover its litigation costs from Docket 07-00224 in the present rate making docket, Docket 09-00183, due to the extraordinary and non-recurring nature of these legal bills. During the April 12, 2010 Hearing, CGC's witness, Archie Hickerson, did not deny that there was no statutory authority allowing the TRA to award litigation costs in a non-rate case, but suggested that it might now be proper to award litigation fees because the utility's request for recovery of litigation expenses had been brought into a rate case, Docket 09-00183.[148] CGC did not, however, provide support of any kind in furtherance of this notion. In addition, and as was discussed in greater detail previously, counsel for CGC, while under the advisement of Mr. Hickerson, has previously admitted that these litigation costs are not likely to be recurring and, thus, should not be included in the test year.[149] Therefore, it would violate basic ratemaking fundamentals to allow such non-recurring litigation costs to be included in the recurring rates established in Docket 09-00183.

**C. CGC's request for recovery of legal fees from Docket 07-00224 should be dismissed as unreasonable and not incurred for the benefit of ratepayers.**

Even if the TRA disagrees with its own precedent and the statutory and judicial precedent established by other regulating entities, CGC's request for the recovery of legal fees should still

[148] *Transcript of Proceedings*, pp. 324:20 – 352:3, April 12, 2010.
[149] *Transcript of Proceedings*, pp. 91:18 – 98:3, January 25, 2010.

be denied because the amount of those fees is unreasonable and was not incurred for the benefit of ratepayers. Ratepayers should not be asked to pay legal fees far in excess of what is necessary to accomplish the goals of Docket 07-00224. They should not be asked to pay legal fees for which ratepayers saw little, if any benefit. Certainly, ratepayers are not responsible for the excessive legal fees incurred by CGC in Docket 07-00224, and therefore, it would be improper to order them to pay said fees.

CGC is requesting reimbursement of legal fees in TRA Docket 07-00224 totaling $744,743.81.[150] As was addressed in the preceding section of this brief, Docket 07-00224 arose from CGC's last rate case, TRA Docket 06-00175, and was removed from that rate case at the request of CGC.[151] The total projected cost of that entire rate case was $300,000 by CGC's own estimate.[152] CGC is now requesting an additional two and one-half times the total amount of its estimated Rate Case Expense in Docket 06-00175, in which these issues were originally set to be litigated. If the Authority grants CGC's request for reimbursement of legal expenses in Docket 07-00224, the utility will have successfully collected over $1 million[153] to litigate issues that were originally set to be heard in Docket 06-00175 for a total expense of $300,000.

The $744,743.81 reimbursement requested by CGC is far in excess of what the utility has requested in TRA Docket 09-00183, a highly complex docket involving the utility's proposal to adopt Decoupling as well as a traditional rate case. In TRA Docket 09-00183, the pending docket for which this brief is submitted, CGC has requested recovery of rate case expenses in the amount of $632,000.[154] While the Consumer Advocate does not agree with this total, as

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[150] *Prepared Direct Testimony of Archie R. Hickerson*, p. 18:17-21, March 5, 2010.
[151] *Order Closing Phase II of Docket*, TRA Docket 06-00175, p. 3, December 17, 2010.
[152] *Direct Testimony of Michael J. Morley*, p.11:16-19, May 30, 2006.
[153] $744,744 + $300,000 = $1,044,744.
[154] *Prepared Rebuttal Testimony of Ronald D. Hanson*, Workpaper 4 Def. Rate Case Cost, April 6, 2010.

explained more fully in the section of this brief addressing Rate Case Expense, it should be noted that CGC's total is $82,744 less than the amount the utility is requesting in Docket 07-00224. CGC is alleging that it is far more costly to litigate Docket 07-00224, in which it did not bear the burden of proof[155] and in which it put on a single witness, than to present a case in which it bore the ultimate burden of proof on all issues including a full traditional rate case, argument for adopting Decoupling, implementation of various conservation programs, and filed testimony from a total of nine witnesses.[156] It is hard to believe CGC would have been able to incur such a staggeringly high total of litigation costs through no fault of the utility or its counsel.

CGC has repeatedly blamed its excessive legal bills on the "stubborn litigiousness" of the Consumer Advocate,[157] and the regulatory atmosphere in place,[158] but during the Hearing on the merits, the utility's representative and witness, Mr. Archie Hickerson, stated that all parties, including CGC, share in the blame for its excessive litigation costs.[159] Throughout Dockets 06-00175 and 07-00224, CGC opposed any type of triennial review, despite the implementation of such a review in the TRA's preceding asset management case with Nashville Gas Company, Docket 05-00165,[160] from which the TRA adopted the language of the review it ultimately ordered in Docket 07-00224.[161] Surely, CGC's adamant opposition to such a triennial review,

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[155] *Transcript of Proceedings*, TRA Docket 07-00224, p.34:4-20, July 13, 2009.

[156] *In Re: Petition of Chattanooga Gas Company for a General Rate Increase, Implementation of the Energysmart Conservation Programs and Implementation of a Revenue Decoupling Mechanism,* Docket Summary, available at http://www.tennessee.gov/tra/dockets/0900183.htm.

[157] *Transcript of Proceedings*, pp.92:24 – 93:14, January 25, 2010.

[158] *Prepared Rebuttal Testimony of Archie R. Hickerson*, pp.9:14 – 10:9, April 5, 2010.

[159] *Transcript of Proceedings*, p.352:3-20, April 12, 2010.

[160] *Order Approving Settlement*, TRA Docket 05-00165, December 14, 2007.

[161] *Handout Given at the August 24, 2009 Conference: Docket 05-0016, Review of Nashville Gas Company's Incentive Plan Account Relating to Asset Management Fees, Exhibit A wherein it states: ["CGC" is substituted for "NGC" or "Company"]: Triennial Review*, TRA Docket 07-00224, August 26, 2010.

which was ultimately granted by the TRA, contributed materially to the litigiousness of Docket 07-00224 and the utility's litigation expenses incurred in that docket.

Regardless which party or parties are believed to be at fault for CGC's unreasonably high legal fees in Docket 07-00224, it is clear ratepayers are not to blame, and should, therefore, not be responsible for those legal bills. CGC's litigation costs in Docket 07-00224, in the amount of $744,743.81, represent a remarkably high expense in light of the costs incurred in other matters before the TRA. If ratepayers are required to pay these legal bills, then CGC will have no incentive to do its part to keep legal bills low in the future. If someone else is paying its legal bills, a utility has no reason not to oppose every attempt at settlement and take all matters with which it does not totally agree to a hearing on the merits.

Further, under the Tennessee Uniform Administrative Procedures Act, the general rule with regard to the expense of having counsel in a contested case is that "any party may be advised and represented **at the party's own expense**."[162] (emphasis added). Clearly, the spirit of this rule is violated when CGC pays its own expenses, only to be later reimbursed by ratepayers. If the Authority does not make CGC responsible for its own legal bills, the utility has no incentive to work toward a less litigious regulatory environment because the utility will not suffer from its own litigious conduct. Therefore, no matter how hard the Consumer Advocate and the TRA work to ensure that the regulatory environment is as amicable and efficient as possible; such a result will never be achieved. Requiring CGC to pay its own legal bills in non-rate cases before the TRA, particularly when those bills are excessively high as in Docket 07-00224, will ensure the interests of the utility, the Consumer Advocate, and the TRA are aligned

[162] T.C.A. § 4-5-305.

in creating a less litigious regulatory environment at a minimum of expense to ratepayers in the state of Tennessee.

## III. RATE OF RETURN

The next general area of contention in this Docket is the Rate of Return ("ROR") that CGC should be allowed. Included within this is the Company's allowable Return on Equity ("ROE"), cost of capital and overall capital structure. While at first glance the differences between the positions of CGC and the Consumer Advocate appear to be large, a closer analysis shows substantial agreement on many of the components of the two positions with only a few issues driving the different results.

CGC's expert witness on cost of capital issues, Dr. Roger Morin, calls for the Company to be allowed a ROE of 11.0% without approval of the AUA decoupling mechanism and a reduction to 10.75% if it is approved by the Authority. He further concludes that the appropriate capital structure to be imputed to CGC is 54% equity and 46% long term debt. He discounts any short term debt in his analysis.

On the other hand, Dr. Chris Klein, the Consumer Advocate's expert witness on the cost of capital contends that CGC should be allowed a total ROE of 9.5% without the AUA or other decoupling mechanism and that it should be reduced to 9.0% if decoupling is adopted. Dr. Klein advocates a capital structure of 48% equity, 10% short term debt and 42% long term debt which produces an overall allowable ROR of 7.29% without decoupling and 7.05% if the AUA or other similar mechanism is adopted.

The difference in the final opinions of Dr. Klein and Dr. Morin belie the many similarities in their approaches. Both use a virtually identical list of natural gas companies as part of their comparable group and both use the Capital Asset Pricing Model ("CAPM") and Discounted Cash Flow ("DCF") methodology to come up with their opinions. As will be discussed below, the primary driver of the rather wide disparity between their conclusions is the critical difference as to whether CGC should be viewed as though it were a standalone entity or whether CGC should be given the characteristics of a valued member of the AGL family of companies, which it is. The Consumer Advocate contends the Authority should follow the decisions it has made in other rate cases and find that CGC's cost of capital is greatly and directly affected by the fact it is an affiliate in the AGL Resources, Inc. ("AGL") family of companies.

### A. Should a Fictitious Standalone CGC be Created for Analysis as Suggested by CGC?

CGC is a subsidiary of AGL, and as such, enjoys the benefits of being part of a large natural gas conglomerate. This point was made by the company in its initial filings in the pre-filed direct testimony of Steve Lindsey.[163] Mr. Lindsey further reiterated that position in response to questions during the Hearing.[164] In his testimony he touts the cost savings and economies of scale that allow CGC and others in the AGL family of companies to cut costs and pass the resulting savings along to their customers.

CGC has no freely traded stock. All of its shares are owned by one entity, its parent, AGL. It issues no bonds and the only debt it has had on its books over the past years are the occasional loan to or from another AGL entity.[165] When CGC needs capital, it obtains it from

[163] *Direct Testimony of Steve Lindsey*, Docket 09-00183, pp. 13:19 – 15:15, November 16, 2009.
[164] *Transcript of Proceedings*, 57:12 – 58:21, April 12, 2010.
[165] *Transcript of Proceedings*, 703:7 – 10, April 26, 2010.

the parent company, AGL Resources, Inc., which centrally manages the sources of capital for its many subsidiaries. For these reasons, Dr. Klein used the risk profile, capital structure and other data of AGL, to evaluate CGC's cost of capital for this rate case. Dr. Morin, on the other hand, adhered to a doctrine he refers to as the "standalone principle" to make adjustments constructing a risk and capital profile for CGC as if it were a small independent company on its own in the marketplace.

This is the same approach offered by Dr. Morin in CGC's last contested rate case before the Authority, Docket No. 04-00034 and which was soundly rejected by the TRA in its Final Order in that Docket.[166] This "principle" recurs in Dr. Morin's analysis and is the basis for the vast majority of the differences between the two experts' testimony. Following the TRA precedent in Docket No. 04-00034, the Consumer Advocate believes that in arriving at the cost of capital for CGC, it is necessary to look at the cost to AGL since AGL is the entity that will actually raise any and all capital that CGC needs and uses. No rationale, other than Dr. Morin's belief that using AGL's risk and capital structure would violate the "standalone principle", is proffered to show why the TRA should come to a different conclusion on this issue than it did in Docket No. 04-00034, decided in 2005. Given the Final Order in that Docket, surely CGC must meet some burden to cause the TRA to change a view of CGC that has survived through at least two rate increase requests.

It is generally undisputed that if CGC were in fact a small independent gas company serving only 61,000 customers in the Chattanooga, Tennessee area and did not have access to the resources of AGL, investors would view putting their money in CGC as far riskier than an

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[166] *Order*, TRA Docket 04-00034, pp. 41 – 45, October 20, 2004.

investment in AGL. As such, it would, of necessity, have a higher cost of acquiring any needed new capital. Dr. Morin's search for riskier companies to use as comparators for the fictitious CGC, as well as his adjustments to create a riskier profile, drive his proposed increase over the 10.2% ROE in place for CGC since the last contested rate case and his disagreement with the 9.5% ROE suggested by Dr. Klein.

**B. Common Methods of Calculating Return on Equity**

Dr. Klein and Dr. Morin use very similar mathematical methods to calculate the appropriate allowable return for CGC, although they come to very different conclusions. Below, the Consumer Advocate will point out the many common aspects and examine more closely the key differences that lead to the different recommendations. The three methods of calculating ROE used by Dr. Morin are the Capital Asset Pricing Model ("CAPM"), the Discounted Cash Flow method ("DCF") and the Risk Premium method.

**1. CAPM.** The Capital Asset Pricing Model or CAPM was utilized by both Dr. Klein and Dr. Morin. In its simplest terms, the model takes a risk free rate of investment and adds to it the risk associated with investing in a specific company or instrument, in this case CGC. The two major components of the CAPM are the risk free rate and the risk premium. For the risk premium, it is also composed of two parts, the beta (or specific risk of the stock in question) and the general market risk premium. Although they used very different methods, Dr. Klein and Dr. Morin arrived at very similar figures for both the beta and market risk premium. Therefore, the cause of their differing opinions is their calculation of the risk free rate.

The risk free investment rate is the base rate or the floor of the CAPM. It is the rate that investors would require for an investment that is without any risk. Of course, no such investment exists in reality and it is universally accepted that US Government securities are the best proxy for a true risk free investment. Both Dr. Klein and Dr. Morin use US Government securities to calculate their risk free investment rate, but they use very different securities. Dr. Morin uses the 30 year Treasury Bond rate while Dr. Klein uses a blend of the rate for the 90 day Treasury Bill and the 5 year Treasury Note.

When questioned on cross-examination, Dr. Morin agreed that the longer the term of a security, the more risk the holder of that security is exposed to.[167] Despite this, Dr. Morin contends that the much longer 30 year Treasury Bond is the appropriate proxy for the risk free investment rate for CGC. The crux of his argument is that stocks do not expire and are held for the long term, therefore a long term US Government security is an appropriate risk proxy. On the other hand, Dr. Klein looks first to the very shortest term US Government securities, the 90 day Treasury Bill for a proxy for the true risk free rate. Recognizing that the very short term nature of the 90 day Treasury Bill may not reflect all factors affecting stocks held for a multi-year term, he also looks at the rate for 5 year Treasury Notes as well.

The CAPM uses the risk free rate of return as the base or floor for its calculation. The shorter the term of the investment, the less risk it is exposed to. 90 day and 5 year Treasury securities have lower interest rates than 30 year Treasury securities, at least partly because they expose their owners to less risk. Therefore, any analysis requiring a risk free rate should clearly

[167] *Transcript of Proceedings*, 710::5 – 16, April 26, 2010.

use shorter term US Government securities as the proxy for that rate, and not riskier long term securities.

The return rate for 30 year Treasury Bonds used by Dr. Morin is 4.3%. Adding the risk premium to this rate leads to Dr. Morin's final calculation of 9.2%, before any adjustment for flotation costs (discussed below). The return rate for 90 day Treasury Bills is 0.2% and the rate for 5 year Treasury Notes is 2.75%. Adding the risk premium to these figures leads to Dr. Klein's CAPM range of 6.13% to 8.0%, before any adjustment for flotation costs.

Dr. Morin also uses a variant of the CAPM, the Empirical CAPM, to measure the CAPM against empirical data. Using this method, Dr. Morin calculates the Empirical CAPM at 9.7%, again before flotation costs. Dr. Klein did not utilize the Empirical CAPM, but did recognize that the current historical lows in short term interest rates could cause the CAPM to slightly underestimate the current cost of equity.[168] He gave the CAPM less weight in his final analysis and this approach was shared by Dr. Morin who also testified that the CAPM should be given less weight than other methods.[169]

While they have a large difference in the base or risk free rate they use in the CAPM, (4.3% for Dr. Morin and 0.2% to 2.75% for Dr. Klein), and a difference in their final calculation (9.2% for the standard CAPM and 9.7% for the Empirical CAPM for Dr. Morin and 6.13% to 8.0% for Dr. Klein), that is not the driver for their final disagreement. Both give the CAPM less weight because of various factors caused by the current unprecedented economic turmoil. Even with these considerations, it is still instructive that Dr. Morin's final calculations using the

[168] *Direct Testimony of Dr. Christopher C. Klein,* Docket 09-00183, pp. 13:20 – 14:2, March 10, 2010.
[169] *Transcript of Proceedings,* pp. 712:7 – 713:4, April 26, 2010.

CAPM compare favorably with Dr. Klein's final recommended ROE of 9.5% rather than his own final recommended ROE of 11.0%.

**2. DCF.** Both Dr. Klein and Dr. Morin also use the DCF method to calculate the appropriate ROE for CGC. The DCF is a measure of the value of a company's cash flow discounted for its present value. The formula for the DCF shows the rate of return an investor would expect on stock ownership by calculating the dividend yield (the expected dividend divided by the current price of the stock) plus the expected growth rate in that dividend.[170]

Both Dr. Klein and Dr. Morin run their DCF analysis on a group of comparable natural gas companies. Seven of the eight companies included by the experts are identical. The only difference is Dr. Morin's list included Nicor while Dr. Klein's list included New Jersey Resources.[171] Both lists include AGL. Both Dr. Morin and Dr. Klein used the service Value Line in calculating the dividend yield. They also used both Value Line and another service, Zack's, to evaluate the growth rate. They applied those common figures to the agreed DCF formula.

Despite some differences in their approach to the DCF (discussed below), the analysis of the natural gas only comparator group produces remarkably similar results. Dr. Klein's analysis with Value Line and Zack's shows a range solely for AGL of 7.5% to 9.7%, with a midpoint of 8.6%. His analysis of the whole group shows an average range of 9.1% to 10.87%, with a midpoint of 9.99%.[172] Dr. Morin calculated one figure for Value Line and a separate figure for

[170] *Direct Testimony of Dr. Christopher C. Klein*, Docket 09-00183, pp. 9:23 – 10:7, March 10, 2010.

[171] *Direct Testimony of Dr. Roger A. Morin*, Docket 09-00183, Exhibit RAM-2, page 1 of 2, November 16, 2009; *Direct Testimony of Dr. Christopher C. Klein*, Docket no 09-00183, Klein Direct Exhibit 3, March 10, 2010.

[172] *Direct Testimony of Dr. Christopher C. Klein*, Docket 09-00183, p. 11:11 – 13, March 10, 2010.

Zack's rather than presenting a range. His DCF calculation using Value Line's figures for the growth rate produced a rate of 9.1% before flotation costs, after eliminating the results for Nicor (the company not used by Dr. Klein as a comparable) as an outlier.[173] When applying the Zack's growth rate, and after eliminating Nicor, Dr. Morin calculated a DCF of 10.6%.

Going back to the central dispute in their approaches, Dr. Klein used the analysis of the comparable natural gas companies to test his results solely for AGL, as Dr. Klein concluded AGL was the proper company for calculating the cost of capital and return for CGC. Dr. Morin used the comparable companies only as part of his analysis to construct the profile of a fictitious standalone CGC. Because Dr. Morin also felt that the standalone CGC would be smaller and more risky than the natural gas group, he also performed the DCF analysis on a large group of combination gas and electric utility companies. Dr. Klein did not perform any analysis on these gas electric hybrid companies as he felt they faced different risks and were not comparable to CGC or AGL.[174] Given the higher risk levels associated with the gas electric hybrid companies, not surprisingly, Dr. Morin's analysis produced significantly higher DCF estimates for this group, averaging 11.5% to 11.8%.[175]

Even within their analysis of common companies, Dr. Morin still had three major differences with how Dr. Klein performed his calculations. The first was Dr. Morin's complaint that Dr. Klein erroneously used the "spot" dividend yield rather than the expected dividend yield, which would understate the DCF. To compensate he multiplied the dividend yield by one plus

[173] *Direct Testimony of Dr. Roger A. Morin*, Docket 09-00183, pp. 38:16 – 39:12, November 16, 2009.
[174] *Direct Testimony of Dr. Christopher C. Klein*, Docket 09-00183, p. 15:5 – 14, March 10, 2010.
[175] *Direct Testimony of Dr. Roger A. Morin*, Docket 09-00183, p. 40:6 – 13, November 16, 2009.

the expected growth rate.[176] Dr. Klein responded by explaining that both he and Dr. Morin used the Value Line expected dividend yield chart which shows Value Line's expectations for the dividend yield in the future and not just the yield at the point the chart is published.[177] To further multiply this expected rate by a growth factor would in effect "double dip" on the growth of the dividend yield.

The second major difference listed by Dr. Morin was his assertion Dr. Klein ignores the fact that dividends are paid quarterly rather than annually, thereby ignoring the time value of money factor in receiving the quarterly components of the dividend rather than one lump sum at year-end. But as Dr. Klein pointed out, part of this has to do with the way that dividends are accounted for in a rate setting environment.[178] Additionally, Dr. Morin also does not account for the fact that the company's profits are also received throughout the year rather than in a lump sum at the end of the year. The fact that the company gets these profits periodically and can invest them prior to year-end generates income which offsets the time value of money costs of issuing the dividends quarterly.

The final major difference with Dr. Klein's approach is Dr. Morin's assertion that Dr. Klein has used a stale growth rate. Both Dr. Morin in his original direct testimony and Dr. Klein in his direct testimony used the most current data available at the time. In his rebuttal where he raises this criticism, Dr. Morin uses the most current data as of that date. However, as Dr. Klein responded at the Hearing, Dr. Morin failed to also update his dividend yield with this newer data, which would have offset any higher outcomes based on the newer growth rate. In short, if you

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[176] *Rebuttal Testimony of Dr. Roger A. Morin*, Docket 09-00183, p. 8:11 – 15, April 6, 2010.
[177] *Transcript of Proceedings*, 775:10 – 22, April 26, 2010.
[178] *Transcript of Proceedings*, Docket 09-00183, pp. 776:3 – 777:7, April 26, 2010.

update part of the analysis, you must update all to get a true picture of the correct outcome. Updating all components produces a wash to the final outcome.[179]

**3. Risk Premium Method**. Dr. Morin also performed an analysis using the Risk Premium method. This method analyzes the relationship between the risk for utility bonds and utility stocks. Dr. Klein did not feel that this approach was warranted in this instance. As he pointed out in his direct testimony, the returns on utility stocks and bonds are not independent.[180] This means that changes in risk affect both utility stocks and bonds which could lead to the clearly erroneous result of a higher risk premium under this method if the risks faced by a particular company actually decrease. The rationale for this is that if the interest rate a utility pays on its bonds decreases because of a lower perceived risk to that utility, its stock price will presumably increase because of its lower borrowing costs, all other things being constant. This would lead to a higher risk premium spread between the bond and stock prices even with a lower risk portfolio. This would produce higher than anticipated cost of equity with lower risk and therefore, in Dr. Klein's expert opinion, he felt this method was unreliable for this case.

**C. Adjustments Made by Dr. Morin.**

Dr. Morin made certain additional adjustments to his recommended ROE figure while Dr. Klein did not. While none of the adjustments in and of themselves make a truly significant difference in the final ROE, taken together they do.

[179] *Transcript of Proceedings*, Docket 09-00183, p. 778:6 – 15, April 26, 2010.
[180] *Direct Testimony of Dr. Christopher C. Klein*, Docket 09-00183, pp. 15:15 – 16:5, March 10, 2010.

**1. Flotation Costs.** The first adjustment at issue is in regards to flotation costs. Flotation costs are the costs of issuing the stock or bond used by the company to raise capital. Both experts agree that flotation costs exist, but they disagree on the size of the costs in this instance and how they should be accounted for. Dr. Morin estimates issuance costs for his constructed standalone CGC at 4% for a new stock sale with an additional 1% due to market pressure, for a total flotation cost of 5%. This causes him to recommend a 30 basis point increase in the cost of equity.[181] Dr. Klein, again using AGL actual figures as his guide, does not agree.

AGL's most recent actual stock sale issuance costs, according to the filings in this Docket, were only 2.99% to 3.5%.[182] Additionally, Dr. Klein stated that since most of AGL's equity funding comes from retained earnings and other non-public sources, flotation cost adjustments shouldn't be applied to all of AGL's equity sources. According to Dr. Klein, this reduces the adjustment for flotation costs for AGL to only about 10 basis points.[183] Because offsetting adjustments, including one for the quarterly payment of dividends which allows AGL to reduce the cost of equity, are not also made by Dr. Morin, Dr. Klein recommends no adjustment for flotation costs to AGL. So while both experts recognize the existence of flotation costs generally, their cost and size to AGL and whether they have any true effect on the cost of equity are in dispute.

**2. Risk Premium.** Dr. Morin in his testimony proposed an additional adjustment for the risk premium that CGC would bring due to its small size as a standalone company. He

[181] *Rebuttal Testimony of Dr. Roger A. Morin*, Docket 09-00183, p. 7:1 – 15, April 6, 2010.
[182] *Minimum Filing Guidelines*, Docket 09-00183, Item 84-3, November 16, 2009.
[183] *Direct Testimony of Dr. Christopher C. Klein*, Docket 09-00183, p. 16:6 – 21, March 10, 2010.

calculates this risk adjustment to be an additional 50 basis points to its ROE. That is composed of 25 basis points because of CGC's size and an additional 25 basis points due to the particular risk profile CGC would have as a standalone company. Obviously, Dr. Klein did not make a special risk premium adjustment because he uses AGL as the company he looks to when calculating allowable returns.

Dr. Morin's proposed 50 basis point increase in the suggested return for CGC is predicated entirely on his incorrect position that the standalone principle requires that CGC be evaluated as though it were an independent small natural gas company. This is the same position presented to the TRA in the last contested rate case brought by CGC and rejected by the TRA in its Final Order. Nothing new has been presented to suggest that CGC should be so treated. Most importantly, it simply isn't factually true, as CGC is just one company in the AGL family of companies. This fact is touted by CGC in its filings in this case and was reiterated in testimony before the Authority.[184]

CGC enjoys cost savings and economies of scale by having AGL, as a centralized entity, perform common functions for it and the other natural gas companies in the AGL family. This includes providing capital to CGC as needed. It is undisputed that if and when CGC needs access to capital, it is AGL that acquires that capital and allocates it to CGC. There is no testimony in the record that CGC ever had any difficulty in obtaining needed capital from AGL. CGC witnesses were asked about any such difficulties by Director Roberson but could cite no

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[184] *Direct Testimony of Steve Lindsey*, Docket 09-00183, pp. 13:19 – 15:15, November 16, 2009; *Transcript of Proceedings*, 57:12 – 58:21, April 12, 2010.

instances where capital was denied.[185] Therefore, it is AGL's cost structure that determines the cost of any capital that CGC needs. It does not need to be adjusted upward because any investment to raise that capital is an investment in AGL as recognized by Dr. Klein.

Simply put, if the Authority continues to hold that it will look to the capital structure and risk profile of AGL when evaluating the cost of capital to CGC as a member of the AGL family of companies, then Dr. Morin's additional 50 basis points added to the cost is clearly unwarranted. It serves no purpose other than to reflect the added costs that the fictitious CGC constructed by Dr. Morin would face if it really existed.

### C. Decoupling and the Reduction of Risk.

The final major adjustment to CGC's allowable Rate of Return is one based on the presence or absence of a decoupling or other similar mechanism which would decrease the risk CGC would face due to volumetric fluctuations. Both Dr. Morin and Dr. Klein agree that decoupling reduces the risk that a utility faces; they disagree on the size of the reduction in risk and in one instance, whether the reduction has already been made.

The decoupling adjustment is a reflection of the fact that companies which have in place a decoupling mechanism, straight fixed variable rate design, or other similar rate design model face a reduced risk that they will not achieve their allowable return due to fluctuations in the volume of gas consumed by their customers. If more of the company's costs are covered by a fixed, rather than variable charge, then the risk of not covering those costs is reduced. This reality is accepted by both experts and all parties.

[185] *Transcript of Proceedings*, Docket 09-00183, pp. 74:7 – 75:24, April 12, 2010; p. 207:16 – 22, April 12, 2010; pp. 761:17 – 762:6, April 26, 2010.

The first disagreement on the issue is the size of the needed adjustment to ROE because of the reduced risk faced by CGC if the Authority approves the AUA or other decoupling or similar rate design. Dr. Morin quantifies the adjustment at 25 basis points and Dr. Klein calculates it at 50 basis points.[186] In order to isolate the risk reduction caused by the implementation of the AUA, Dr. Klein uses a statistical analysis showing the expected returns with risk reductions of 5%, 10% and 15%, risk premiums of 7.0% and 5.0%, and beta values of 0.5, 0.75 and 1.0. This analysis yields a wide range of results, from 12.5 to 105 basis points as the indicated correction. Dr. Klein chose the mid range numbers of a 10% risk reduction applied to a 7.0% risk premium and a beta value of 0.75 which yields a 52.5 basis point reduction.[187] He conservatively rounds this to 50 basis points and recommends a reduction in CGC's allowable ROE if the AUA or other similar mechanism is adopted. At the Hearing, Dr. Klein also testified that a straight fixed variable rate design would yield a required reduction in ROE of at least the same 50 basis points.[188]

Dr. Morin does not provide any independent analysis of his figure of 25 basis points. Rather, it seems to be the 25 basis points that is the second half of his 50 basis point adjustment for a risk premium described above.[189] While the Consumer Advocate believes that Dr. Klein's detailed analysis of the effects of the AUA on CGC's return provide a much better and more persuasive view, it is significant that both experts agree that an adjustment of at least 25 basis points is needed to CGC's ROE if the Authority adopts the AUA, a straight fixed variable rate

[186] *Direct Testimony of Dr. Roger A. Morin,* Docket 09-00183, p. 50; 6 – 14, November 16, 2009; *Direct Testimony of Dr. Christopher C. Klein,* Docket 09-00183, p. 21:3 – 11, March 10, 2010.

[187] *Direct Testimony of Dr. Christopher C. Klein,* Docket 09-00183, p. 21:7 – 11, March 10, 2010.

[188] *Transcript of Proceedings,* 780:9 – 781:3, April 26, 2010.

[189] *Direct Testimony of Dr. Roger A. Morin,* Docket 09-00183, pp. 46:10 – 47:6, November 16, 2009.

design or other similar decoupling mechanism. But perhaps more important to the final outcome of this rate case is the question of in which direction the adjustment should be made.

Dr. Klein calculates the change in return associated with the reduction in risk that a natural gas company faces if it has a decoupling mechanism. He quantifies that at 50 basis points, and since CGC does not now have a decoupling mechanism, he reduces its allowable ROE by those 50 basis points should the Authority see fit to order implementation of the AUA or other similar policy. Dr. Morin views it differently. As discussed above, both he and Dr. Klein use virtually the same set of natural gas companies in their comparator group when calculating the ROE CGC should be allowed in this case. However, in looking at the appropriate decoupling adjustment, Dr. Morin asserts that most, if not all, natural gas companies in the comparator group and all gas companies generally, already have some form of decoupling or straight fixed variable rate design.[190] Dr. Morin, therefore, wrongly concludes that the adjustment for decoupling is already "baked in" to the allowable return so that CGC's rate must be increased if the Authority does not approve the AUA.

Dr. Morin's position, however, is simply not supported by any evidence in the record in this Docket. Nowhere in any of his testimony, either direct or rebuttal, pre-filed or live, does he provide any evidence as to which of his comparable companies have a decoupling mechanism in place and for which of their operating entities. Further weakening his position, when questioned about this issue on cross examination, Dr. Morin conceded in the state of Virginia, where at least two of his seven comparable companies operate, state law prohibits any adjustment to ROE because of the presence or absence of decoupling. He also conceded that he did not do any

[190] *Rebuttal Testimony of Dr. Roger A. Morin*, Docket 09-00183, p. 19:13 – 19, April 6, 2010.

specific analysis on his comparable companies but just asserts that decoupling is mainstream policy in the industry.[191]

If CGC wants the Authority to increase its allowable rate of return if the AUA is not adopted, rather than decrease the rate of return if it is, then it is incumbent upon CGC to prove the universally accepted adjustment for decoupling is already "baked in" to its calculations. It has provided no evidence other than Dr. Morin's mere assertion that decoupling is mainstream policy and that it would, therefore, already be imbedded in available financial data. On the contrary, as was testified to at some length by Dr. David Dismukes, decoupling is not mainstream policy and should not be accepted as such by this Authority. To allow an upward adjustment in ROE if the AUA is rejected and deny a downward adjustment in ROE if it is approved flies in the face of Dr. Klein's empirical analysis. There is simply no proof in the record in this Docket that the agreed upon ROE adjustment is already "baked in" to the results.

**D. Capital Structure.**

The final issue in dispute between the parties' respective positions is CGC's capital structure. Once again, the difference comes down to whether a capital structure for a standalone CGC needs to be constructed by comparing it to other companies and making size and other adjustments or whether a simple analysis of AGL's capital structure is all that is needed. Dr. Morin looks to the capital structure of his comparator natural gas utilities and their average equity ratio. Interestingly, he does not do a similar analysis on his hybrid gas and electric comparator group. Based on the averages for his comparator group, he then concludes that a

[191] *Transcript of Proceedings*, 732:7 – 734:18, April 26, 2010.

capital structure of 54% equity is called for, after excluding short term debt.[192] The balance of 46% is, presumably, long term debt.

Dr. Klein, on the other hand, recognizes that AGL operates as a consolidated company and that any funds needed by affiliates are raised by AGL. Further, CGC has only one shareholder and no debt other than the occasional intra-company loan. Accordingly, Dr. Klein looked to AGL to arrive at the appropriate capital structure for the Authority to adopt in this Docket. Dr. Klein then did a review of AGL's capital structure for the most recent three years (2007 – 2009) and concluded that a capital structure of 48% equity, 42% long term debt and 10% short-term debt is appropriate.[193] CGC witness Ronnie Hanson disagreed in his rebuttal testimony when he testified that the current capital structure of AGL is 51% equity, 42% long-term debt and 7% short-term debt (rounded) because of the recent issuance of $300 Million in long term notes to retire some of the short-term borrowing.[194]

Dr. Klein responded in his oral testimony that it is not unexpected that the capital structure would change, especially the given ebb and flow of short-term debt.[195] Because the rates adopted by the Authority in this Docket will be in effect until the Company seeks to have them adjusted again, an historical view of the debt structure is most appropriate rather than the "spot" structure that AGL has right now. This is consistent with Dr. Morin's own argument about not looking at the "spot" dividend yield when calculating rates. It is not disputed that over the past three years the average proportions of AGL's capital structure are reflected in Dr. Klein's proposed version.

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[192] *Direct Testimony of Dr. Roger A. Morin*, Docket 09-00183, p. 48:5 – 9, November 16, 2009.
[193] *Direct Testimony of Dr. Christopher C. Klein*, Docket 09-00183, Klein Direct Exhibits 1 and 2, March 10, 2010.
[194] *Rebuttal Testimony of Ronald D. Hanson*, Docket No. 09-00183, pp. 22:2 – 23:5, April 6, 2010.
[195] *Transcript of Proceedings*, 793:6 – 794:14, April 26, 2010.

Two simple questions govern the proper allocation of equity and debt to CGC's capital structure. The first is whether you need to construct a hypothetical standalone CGC or whether you use the actual capital structure of AGL. Clearly, the evidence supports using the capital structure of AGL. That leads to the second question, do you use the actual structure of AGL at the point of filing the rate case, a date solely controlled by CGC who also controls what the structure looks like on that day, or do you use the average structure of a period of years? Once again, clearly the better and more reliable answer is to look to how the ever changing ratio of debt to equity has been managed over time and not on any given day. This leads to the inevitable conclusion that Dr. Klein's historical average of AGL's capital structure of 48% equity, 42% long term debt and 10% short term debt is the sounder strategy.

**E. Out of the Mainstream.**

In his rebuttal testimony, Dr. Morin criticizes Dr. Klein's recommendations as "out of the zone of reasonableness and well outside the zone of currently authorized rates of return for natural gas utilities in the United States" and "difficult to take seriously".[196] He also characterizes Dr. Klein's recommended ROE as "outside the mainstream".[197] Interestingly, an examination of the facts presented in this Docket shows that perhaps it is Dr. Morin and his constant refrain of an 11.0% ROE that is not consistent with mainstream thinking and economic principles.

First, examine Dr. Morin's final conclusion that CGC should be allowed an ROE of 11.0% without decoupling and 10.75% with the AUA. His own analysis delivers an unadjusted

[196] *Rebuttal Testimony of Dr. Roger A. Morin*, Docket 09-00183, p. 2:1 – 13, April 6, 2010.
[197] *Rebuttal Testimony of Dr. Roger A. Morin*, Docket 09-00183, p. 6:8 – 11, April 6, 2010.

allowable ROE of 9.2% for his CAPM analysis and 9.7% for his Empirical CAPM. His DCF analysis on natural gas companies shows an unadjusted ROE of 9.1% using Value Line for the growth rate and 10.6% using Zack's. Discounting the higher ROE's called for by his more risky gas electric hybrid comparable group clearly shows Dr. Klein's suggested ROE of 9.5% is more in line with Dr. Morin's own analysis than is Dr. Morin's final conclusion of an 11.0% ROE.

Second, Dr. Morin's testimony about his recent experience in other rate cases illustrates even more clearly that his constant refrain of a 10.75% ROE with decoupling and 11.0% without decoupling is not gaining any traction. On cross examination, Dr. Morin readily admitted in three states where Commissions recently issued final orders, his 10.75/11.0% testimony was not accepted. In the Maryland case of Delmarva Power & Light, he conceded that he testified in favor of an ROE of 10.75% to 11.0% and the Maryland Commission on December 30, 2009 awarded only 10.0% and kept in place the 50 basis point reduction for reduced risk due to a revenue stability adjustment.[198] He further admitted that in the District of Columbia case of Potomac Electric Power Company, he again recommended 10.75% to 11.0% as the ROE yet the DC Commission on March 2, 2010 ordered a rate of 9.625%, again after a 50 basis point revenue stability adjustment.[199] Finally, he agreed that in the Washington State case of Puget Sound, he recommended 10.3% to 11.3% and the Commission just this month on April 2, 2010 awarded 10.1% where there was no decoupling.[200]

It should be stressed here that none of these very recent examples of regulatory action are being offered to show what the ROE should be in this Docket. Each rate case rises and falls on

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[198] *Transcript of Proceedings*, 739:10 – 740:3, April 26, 2010.
[199] *Transcript of Proceedings*, 740:4 – 13, April 26, 2010.
[200] *Transcript of Proceedings*, 740:14 – 18, April 26, 2010.

its own merits. Rather, they are being offered to rebut Dr. Morin's accusation that Dr. Klein's recommended ROE is somehow outside of the mainstream of current regulatory thought. As is detailed above, Dr. Morin's consistent recommendation of a ROE of 10.75% to 11.0% is not only inconsistent with what is currently being awarded by other Commissions, it is not even consistent with his own relevant calculations. Dr. Klein's expert testimony is clearly the more consistent with current mainstream utility regulation and should be afforded significant weight by the Authority.

Finally, CGC has been allowed a ROE of 10.2% since the conclusion of its last contested rate case in 2005. Dr. Morin admitted that the economy is in significantly poorer shape today than it was in 2005, 2006 or 2007.[201] His recommended ROE of 11.0% without the AUA, in today's economic environment is just not supported by the weight of the evidence. Accordingly, Dr. Klein's recommended ROE of 9.5% without the AUA (adjusted to 9.0% if the AUA or other risk mitigation mechanism is adopted), overall return of 7.29% (adjusted to 7.05% if the AUA is adopted) and capital structure of 48% equity, 42% long term debt and 10% short term debt is appropriate for this Docket.[202] The current economic conditions in Tennessee and the rest of the country further validate this conclusion.

## IV. Implementing the State's Energy Conservation Policy

### A. Introduction to Energy Conservation Policy & the Concept of Decoupling

Energy conservation is an important part of this rate case. Both the Consumer Advocate and the Company have made proposals for the Authority to consider. With exceptions, the

[201] *Transcript of Proceedings*, 741:5 – 21, April 26, 2010.

[202] *Direct Testimony of Dr. Christopher C. Klein*, Docket 09-00183, p. 22:11 – 16 and *Klein Direct* Exhibit 1, March 10, 2010.

parties are in agreement on many facets of the conservation programs proposed by the Company. There is sharp disagreement between the parties regarding the alignment of a financial incentive for CGC to help consumers use less energy. The Consumer Advocate frames its position in the context of the State of Tennessee's new conservation policy enumerated in Section 53 of Public Chapter 531 enacted in 2009 ("conservation policy").

> The general assembly declares that the policy of this state is that the Tennessee regulatory authority will seek to implement, in appropriate proceedings for each electric and gas utility, with respect to which the authority has rate making authority, a general policy that ensures that utility financial incentives are aligned with helping their customers use energy more efficiently and that provides timely cost recovery and a timely earnings opportunity for utilities associated with cost-effective measurable and verifiable efficiency savings, in a way that sustains or enhances utility customers' incentives to use energy more efficiently.

T.C.A. § 65-4-126. The conservation policy is broad and malleable in that it does not endorse or require any specific rate design mechanism. In fact, there is no mandate requiring an absolutist, sweeping or radical shift in rate design. While the Company claims the options of the Authority are limited to decoupling and variations of straight fixed variable ("SFV") rate design, Senator Andy Berke made the following comment at the hearing in this matter which did not endorse any specific approach or rate design.

> I encourage you today to fully align the interests of the utility with conservation *whether doing so is through decoupling, a straight-fixed variable, or some other design is beyond my knowledge.* What I do know, however, is that there is a way to align these interests better, and you have the ability to find it. (emphasis added).

Transcript Vol., I, p.119. Had the Legislature intended to mandate decoupling mechanisms, annual rate reviews or SFV rate designs, it would have enacted, rather than defer for study, HB 1349/SB 1375 during the $106^{th}$ session which mandated these specific options.[203] However, CGC's position in this matter is that the state policy gives the Authority only two real options; a full revenue decoupling mechanism or a variation of SFV.

Clearly the Legislature was not convinced a radical change in rate design was necessary. Rather, the Legislature enacted T.C.A. § 65-4-126 which is broadly composed and grants the Authority wide policy discretion. The conservation policy therein has three essential elements, all of which are dependent upon one another. The general policy established by the Authority must be one that:

> **(1)** ensures financial incentives are aligned with helping consumers use less energy;
>
> **(2)** provides timely cost recovery and earning opportunity for utilities associated with cost-effective and measureable and verifiable efficiency savings;
>
> **(3)** sustains or enhances utility customer's incentives to conserve energy.

The general conservation policy the Authority determines for CGC in this matter must take into account how each facet and element of the policy effects and impacts each of the others. In other words, the general policy adopted by the Authority must meet and comply with all three elements. The Consumer Advocate submits that of all three elements, the critical caveat of the State's conservation policy is the third element, which requires that any policy

[203] Given the definitions of "decoupling mechanism" and "fixed costs" of HB 1349/SB 1375, a utility would have had the option to implement a straight fixed variable rate design. Section 4 (9) (B) of HB 1349/SB 1375 specifically defines "decoupling mechanism" as including rate design changes that substantially align the percentage of fixed charge revenue recovery with the percentage of the utility's fixed costs. Section 4 (10) defines fixed costs as all non-gas costs incurred by the utility in the provision of service to customers within this state, including the allowed return on common equity approved by the authority.

implemented will sustain or enhance the incentive of consumers to conserve. If a policy intended to encourage energy conservation actually weakens the incentive of consumers to conserve to the benefit of a utility's revenues and margins, then such a policy must be viewed as a failure, as consumers are already the driving force behind lower energy usage.

The focus of CGC in this matter has been on the first element of the policy statement, the aligning of utility financial incentives. The Company's position in this matter has been an all or nothing proposition wherein CGC claims that only the implementation of a full revenue decoupling mechanism or a variation of SFV rate design will align its financial interests; no consideration is given to the role of consumers in saving energy or with providing financial incentives to consumers to conserve. However, as discussed herein, full revenue decoupling and SFV rate designs do not sustain or enhance consumer incentives to conserve energy, which is the most important element in the State's conservation policy. Moreover, far from encouraging energy conservation, CGC's proposals would, in practice, force consumers into the role of an insurance company protecting the revenues and profits of the utility. This proposition is all the more unreasonable given the economic conditions the households and small businesses of Chattanooga continue to face.

CGC admits encouraging energy conservation is a policy question and that there is more than one way or means to achieve a particular policy goal.[204] CGC avers that it is committed to exploring other means to implement this policy.[205] However, for all its talk of open discussion, the Company's stance is stubbornly tied to rate designs that would insulate revenues from all factors and would transfer all economic risks and business burdens for revenues to consumers in

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[204] *Rebuttal Testimony of Daniel Yardley* (April 5, 2010), p. 11.
[205] *Id.*,6.

the name of energy conservation. The Consumer Advocate realizes the Company has a natural drive to maximize profits and earnings by all means. However, consumers are the biggest consideration of, and driver for, energy conservation. Any change in rate design must first take into account the interests of consumers along with a number of other factors and regulatory considerations. In implementing the State's conservation policy, there must be a balancing of interests.

Rate design and rate-making are complex matters, but the basic disagreement between CGC and the Consumer Advocate can be broken down into simple terms. The Consumer Advocate supports mechanisms, including modified decoupling mechanisms described herein if the need for one is established, which make the Company whole from revenue lost as a result of its energy programs. Moreover, the Consumer Advocate supports giving the Company a financial stake in the success of energy conservation programs to provide financial incentives for the cost-effective, measurable and verifiable results that help consumers use less energy.

In exchange for *paying* for CGC's guaranteed financial benefit, residential and commercial consumers would also *pay* an additional $800,000 a year to fund the energy conservation programs offered by the Company. These programs would provide weatherization, programmable thermostats, and appliance rebates to only a fraction CGC's customers. Moreover, there is no guarantee such programs would be successful or meet expectations.[206] Although the Company is spending the funds of consumers under its proposal, CGC has no financial stake in the success or failure of the programs (i.e. cost effectiveness, verifiable and

[206] *Tr. Vol. I,* p. 105; *Direct Testimony of Dr. Dismukes*, p. 29-32 (March 10, 2010); *Rebuttal Testimony of Daniel Nikolich*, p. 3 (April 5, 2010).

measurable savings), which contradicts the second element of the State's conservation policy.[207] While CGC's receives a significant financial guarantee, the vast majority of consumers are left with only speculative benefits and higher bills to prop up the Company's revenues.

**B. The "Through-put Incentive" of CGC is no Barrier to Energy Conservation**

The Company claims it is currently subject to a "through-put incentive" which allegedly discourages the Company from encouraging energy conservation since a portion of revenues is tied to the volume of natural gas it sells. On the surface, this appears to be a reasonable statement; however, it is unsupportable given the nature of the industry, the impact of energy conservation programs and the stark results of the rate designs CGC seeks to implement. Utilities simply do not have control over the usage patterns of consumers. The commodity price of natural gas and the state of the economy experienced by consumers are the factors that control usage, not actions by utilities.[208] There is simply nothing a utility can do to actively incent a consumer to use *more* natural gas and no such proof was offered in this case.

The Company also asserts that while it is in a unique position to interact with and educate consumers, it cannot because encouraging energy conservation will lead to lost revenue. However, energy conservation programs actually have little impact on utility revenues.[209] On the contrary, certain aspects of energy conservation programs actually provide the opportunity to increase the amount of natural gas consumer's use. For example, rebates provided to consumers

[207] T.C.A. § 65-4-126: "and that provides timely cost recovery and earning opportunity for utilities associated with cost-effective and measureable and verifiable efficiency savings;"

[208] *Direct Testimony of Dr. Dismukes*, (March 10, 2010), p. 44, 46.
[209] *Id.*, 48

can specifically be used to replace electric water heaters with natural gas powered water heaters, an outcome that is not undesirable.

The Consumer Advocate recognizes CGC may lose revenues if it encourages energy conservation. However, this dilemma can be readily reversed with reasonable alternatives designed to make a utility whole while providing financial incentives for successful programs. Instead, the Company has proposed rate designs that go far beyond merely providing compensation for any financial harm from or incentive to encourage energy conservation. Under the Company's plan, the business risks of commodity prices and economic conditions on customer usage are completely removed from shareholders and placed squarely on the shoulders of consumers in a fashion that has nothing to do with energy conservation.

The Consumer Advocate is not alone in this position of questioning the so-called "through-put incentive." In fact, the theory that removing the perceived disincentive of utilities is a necessity to promote conservation has been called into question in a number of states. In rejecting the concept of decoupling for the natural gas operations of Narragansett Electric Company d/b/a National Grid, the Rhode Island Public Utilities Commission measured the perceived "disincentive" versus the benefits decoupling grants to utilities.

> The fact that decoupling may eliminate a disincentive for the Company to promote conservation, even if true, does not necessarily translate into any significant reduction in consumption above what would have been achieved as a result of local and national economic pressures, technology improvements, and other extrinsic factors. Regardless of decoupling, most customers will have an incentive to conserve because reduced usage translates into lower commodity charges for the customer, and commodity costs currently account for two thirds of the average residential bill.

> Revenue decoupling would protect the Company from revenue declines attributable to any cause, not only energy conservation and efficiency efforts. Decoupling would reduce the Company's revenue risk to zero, and shift the risk of revenue variations to ratepayers. While the record includes substantial evidence of the benefits of decoupling to the Company, the evidence that decoupling will benefit ratepayers is largely speculative. (internal commission order citations omitted).

State of Rhode Island and Providence Plantations Public Utilities Commission, Decision and Order, p. 69-70 (January 29, 2009).

In Iowa, decoupling rate designs have been rejected on the grounds that the financial performance of natural gas utilities in that state did not show a direct correlation between net operating income and declining customer usage as a result of energy efficiency programs.[210] This finding is especially relevant in that Iowa's natural gas utilities have been required to implement conservation programs since 1990. Iowa's Board of Utilities ("Board") has concluded that since 1990, the financial performance of its gas utilities has not been harmed by the effects of encouraging conservation.[211] The theory that a "through-put" incentive is an obstacle to promoting energy conservation was simply unsupported:

> Based upon the information reviewed by the Board in this docket, the tension between energy efficiency and Iowa natural gas utilities' opportunity to earn their authorized rate of return does not appear to be a substantial problem in Iowa.

Iowa Utilities Board, Docket No. NOI-0601, *Order Addressing Issues and Closing Docket*, p. 3 (December 18, 2006). These are examples of state public service commissions which had delved

[210] *Iowa Utilities Board*, Docket NO. NOI-0601, *Order Addressing Issues and Closing Docket*, p. 6 (December 18, 2006).
[211] *Id.*, 3-4.

into the facts behind the claims of the "through-put disincentive" and associated decoupling proposals.

## ISSUE 1. The Appropriate Financial Incentive to Align the Interests of CGC and Consumers Under the State's New Conservation Policy

### A. Consumer Advocate's Primary Proposal: Lost Base Revenue Mechanism

The Consumer Advocate submits a performance based mechanism that allows CGC the ability to recover its costs for energy conservation programs, recover non-gas revenues lost due to such programs, and allows the award of financial incentives for successful energy conservation programs, would align the financial interests of the Company with promoting energy conservation and fully comply with all elements of Tennessee's new conservation policy. The symmetry of this proposal is that it aligns the financial interests of CGC with those of consumers by making the utility whole for lost revenue attributable to the utility's energy conservation efforts and provides an incentive for such efforts if they are successful in producing cost-effective and measurable results.[212] In short, the higher the level of energy savings achieved, the greater the financial award for the utility. Tying an explicit incentive to the promotion of energy efficiency goals gives a regulated utility the critically needed financial stake in maximizing efficiency opportunities for its customers.[213] Likewise, if consumer funded conservation programs are inefficient and wasteful, there will be stiffer penalties for poor performance.

By requiring a lost base revenue mechanism with performance based incentives and penalties for conservation program efforts, the Authority would create a clear-cut financial

[212] *Direct Testimony of Dr. Dismukes*, p. 73-74 (March 10, 2010).
[213] *Id.*, 24.

incentive for the utility to aggressively encourage and engage in cost-effective and measurable conservation efforts. Under this framework, the Company is insulated from both the costs of conservation programs and lost revenue attributable from its conservation efforts, thereby making CGC effectively revenue neutral in the context of promoting energy efficiency. The financial interests are further aligned in that the Company receives a financial incentive for successful conservation programs and corresponding penalties for wasteful and unsuccessful efforts. This financial incentive approach is not new, but rather is offered by several states in a variety of performance based mechanisms.[214] Finally, the mechanism sustains and enhances the ability of consumers to continue to reap the benefit of their own conservation efforts as required by the State's new policy.

This relatively straight-forward approach has the vitally important benefit of fully maintaining the incentive of CGC to control and manage costs. Moreover, such a proposal does not eliminate or shift to consumers a significant amount of business risk, which would require an adjustment to the utility's return on equity. Arbitrary levels of fixed revenue are not guaranteed and the positive effects of regulatory lag remain in place. Furthermore, unlike CGCs proposed AUA or SFV proposals, such a performance based mechanism does not create circumstances that allow utility revenues and reported returns to grow beyond that which the TRA has authorized nor require a rate case prior to implementation.

**B. Consumer Advocate's First Alternative Proposal: The "Washington Model" Decoupling Mechanism**

The Washington Utilities and Transportation Commission ("Washington Commission") has experimented with decoupling for a number of years. Following a pilot program established

[214] *Id.*, Exhibit DED-20

in 2007 for Avista Corporation ("Avista"), a natural gas utility, consisting of a decoupling mechanism which allowed recovery of 90% of weather-normalized lost margins, the Washington Commission reconsidered decoupling in 2009.[215] During this rate case for Avista, the Commission Staff and other intervening parties noted the decoupling mechanism had recovered revenue four times greater than the estimated financial impact of the conservation programs on the company's revenues.[216] Given its experience with decoupling and energy conservation, the Washington Commission was wary of continuing a mechanism that allowed for recovery of revenues far beyond that resulting from energy conservation.

The Washington Commission concluded that while the decoupling mechanism appeared to have enhanced the energy conservation efforts of the utility, additional modifications were needed in order to balance the interests of consumers and stockholders:

> However, its initial design should be modified to better align the Company's interests with that of its customers. We believe this is accomplished by allowing the Company the opportunity to recover lost margins related to its programmatic and non-programmatic conservation efforts.

*Washington Utilities and Transportation Commission v. Avista,* Order (December 22, 2009). 2009 WL 5061998*65. The chief modification made by the Washington Commission was to reduce the permitted lost margin recovery permitted of 90% to 45%. The rationale for lowering the level for recovery of lost margin was that 45% of lost weather normalized revenues was more proportional to the results of the energy conservations, both programmatic (i.e., weatherization) and non-programmatic (i.e., conservation education). This modification was not made as a result of failed conservation program(s), but rather the recognition of the financial benefit full revenue

[215] *Washington Utilities and Transportation Commission v. Avista, Order* (December 22, 2009). 2009 WL 5061998
[216] *Id.*, *64.

decoupling grants a utility verses the impact of energy conservation efforts. The Washington Commission concluded that decoupling, with the aforementioned modifications, aligned the interests of the utility and the consumer for promotion of energy conservation.

In this matter, the concept inherent in the Washington Commission model can be applied to CGC's proposed AUA mechanism by retaining the WNA mechanism and simply imposing a limit on the amount of weather-normalized revenue that can be recovered by the Company. The limit should bear a proportional relationship to the efforts of CGC's proposed energy conservation programs. Based on the calculations of Dr. Dismukes, the Consumer Advocate submits CGC's AUA could be modified with a 24% limit of recovery of weather-normalized lost margins.[217] This limit of recovery of AUA revenues is proportional to the estimated impacts of CGC's energy conservation programs.[218]

CGC's opposition to the Washington Commission model is the blanket assertion that the design does not align the utility's financial interest with energy conservation because it does not remove the "through-put incentive." However, Mr. Yardley, testifying on behalf of CGC, did not review the order of the Washington Commission laying out the design or the rationale for the decision although the order was cited, quoted and discussed in Dr. Dismukes's Pre-Filed Direct Testimony.[219] Moreover, the state of Washington, with specific reference to the utility Avista, is among those jurisdictions Mr. Yardley claims has "successfully implemented decoupling."[220] In addition, Dr. Dismukes was not cross-examined by the Company regarding the Washington Commission model, an option that was developed after years of experience.

[217] *Direct Testimony of Dr. Dismukes* (March 10, 2010), p. 80-81.
[218] *Id.*
[219] *Id.*, p.82-86.
[220] *Rebuttal Testimony of Daniel Yardley*, p. 11; DPY-4, page 2 of 2.

### C. Consumer Advocate's Second Alternative Proposal: The New Jersey Model Decoupling Mechanism

In 2007, the New Jersey Board of Regulators ("New Jersey Board") approved a settlement agreement that implemented an innovative form of decoupling, the Consumer Incentive Program ("CIP"). The CIP is unique in that it is a revenue decoupling mechanism that ties weather-normalized margin recovery to upstream natural gas savings.[221] The CIP starts with a base level of usage per customer and revenue per customer, similar to CGC's proposed AUA mechanism. However, the New Jersey Board's approach limits lost margin recovery to the amount of "upstream savings" (defined below) the utility and the conservation programs achieve through natural gas procurement in the PGA.

"Upstream savings" are (a) capacity release; (b) reductions in capacity purchases; and (c) reductions in the average cost of purchased gas. This approach, in effect, ties the amount of decoupling revenue margin that can be collected to the utility's performance as a promoter of energy conservation as measured by upstream savings. Margin recovery is limited to the amount of savings the utility achieves in the PGA. Recently, the New Jersey Board accepted the recommendation of the utilities and consumer groups to continue the CIP for an additional three years.[222] The New Jersey Board concluded that the CIP had allowed both South Jersey Gas Company and New Jersey Natural Gas Company to be successful in helping consumers use less energy while allowing both utilities to maintain sufficient earnings.[223]

[221] *Direct Testimony of Dr. Dismukes*, p. 79-81 (March 10, 2010).
[222] *New Jersey Board of Regulatory Commissioners, In the Matter of the Petition of South Jersey Gas Company, et al.* Docket No. GR05121019 (January 21, 2010), 2010 WL 333120.
[223] *Id*,. *3.

The Consumer Advocate submits the New Jersey Board model, which has a proven track record of experience, is a viable option for the Authority to consider. Contrary to Mr. Yardley's assertion, the existing framework and regulatory experience for implementing the model is already in place. Moreover, this model embraces the resource and supply planning process contained in the PURPA standard with regard to gas supply and procurement, the same standard CGC has endorsed in this proceeding.[224] By tying decoupling margin recovery to upstream savings, CGC would have an even greater financial incentive to generate such savings, benefiting both consumers and stockholders.

The majority of CGC's rather brief discussion and criticism of the New Jersey Board model is limited to the fact the mechanism was the result of a settlement between the utilities and consumer groups rather than a litigated decision.[225] Mr. Yardley's implication is that a fully litigated decision is somehow more valid than one that arises out of a compromise between parties and adopted by a regulatory commission. However, the fact the New Jersey Board implemented the model in 2007 and renewed it again in 2010, all at the behest of utilities and consumer groups, speaks to its balanced nature and successful results. The Consumer Advocate would also note the National Action Plan for Energy Efficiency ("National Action Plan"), which highlights the New Jersey Board model, among others, makes no criticism of its origins in a settlement.[226]

While Mr. Yardley and the Company rely upon executive summaries encompassing the extremely broad policy pronouncements of the National Action Plan in support of their position,

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[224] *Direct Testimony of Archie Hickerson,* (March 5, 2010) p. 22.
[225] *Rebuttal Testimony of Daniel Yardley,* (April 5, 2010), p. 26-27.
[226] *National Action Plan for Energy Efficiency (2007). Aligning Utility Incentives with Investment in Energy Efficiency. Val R. Jensen, ICF International.,* p.5-6 through 5-8

the resource publications of the National Action Plan note that the New Jersey Board model is novel, innovative and produces value for consumers and utilities.[227] In fact, the New Jersey Board model has been spotlighted and used as a case study by the National Action Plan in a publication regarding the aligning of utility interests for energy conservation investment.[228] Moreover, the state of New Jersey, with specific reference to New Jersey Natural Gas and South Jersey Gas, is among those jurisdictions Mr. Yardley claims have successfully implemented decoupling mechanisms.[229] The Consumer Advocate would further note that at the hearing, Dr. Dismukes was not asked a single question during cross-examination by the Company regarding this valuable regulatory option with a proven track record of success.

**D. The Company's Modified Demand Charge SFV is Administratively Burdensome and Does Not Promote Energy Conservation**

In response to TRA data requests 29-31, CGC proposed a modified demand charge straight fixed variable ("Modified Demand SFV") rate design. Descriptions of this proposal were also provided in Mr. Yardley's rebuttal testimony.[230] However, for the first time at the hearing, the Company actually explained the details of how the Modified Demand SFV would function, revealing just how administratively complicated and anti-energy conservation the measure is. While this proposal is presented as something akin to a softer, kinder version of traditional SFV, the Consumer Advocate can only conclude, based on the record, the Modified Demand SFV is counter-productive to encouraging energy conservation.

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[227] *Id.*
[228] *Id.*
[229] *Rebuttal Testimony of Daniel Yardley*, p. 11; DPY-4, page 2 of 2.
[230] *Id.*, 29-31.

First, in order to calculate the demand charge, the Company would look at every household and eligible business and determine the individual customer's peak usage in order to determine the demand charge.[231] Each individual customer would have a different demand charge and pay a different amount.[232] Each year there would be a true-up process in which individual customer demand charges would be recalculated.[233] While CGC claims this is not a revenue true-up, consumer demand charges would be increased for class wide declines in usage, thus guaranteeing set revenue levels.[234] Moreover, there is some question, under CGC's proposal as to whether the Authority would be involved in the annual reallocation of demand charges or whether the Company simply reports the results to the TRA.[235] While rates could be changed annually, additional and offsetting revenue from customer growth would be excluded from such calculations.[236] Because the Modified Demand SFV would provide the ability for CGC to change rates on consumers every year in order to meet a specific revenue requirement, the resulting effect would be shifting CGC from a regulated public utility to non-regulated public utility.

While the conversion of a public utility to a non-regulated entity is of great concern to the Consumer Advocate, an additional drawback regarding the proposed Modified Demand SFV is how it would weaken a consumer's incentive to use less natural gas. Under the Company's proposal, an individual customer is saddled with a demand charge calculated by the Company based on peak usage, presumably for a 12 month period. Today, when a consumer uses less, it is

[231] *Tr. Vol.* I, 295.
[232] *Id.*, 298.
[233] *Id.*, 298-299.
[234] *Id.*, 306.
[235] *Id.*, 307.
[236] *Id,. 290.*

reflected fully on their monthly bill. However, under the Modified Demand SFV, if he or she uses less during this period, they will theoretically pay a lower demand charge at some point in the future after CGC's reallocation process. In other words, a portion of the savings as a result of the consumer's conservation efforts they hope to receive will be subject to an extended delay. Curiously enough, it is as if their financial reward for conserving would be subject to regulatory lag, which hardly has the effect of encouraging lower usage. Consumers cannot be expected to understand a billing process that does not produce any potential savings benefit in the year in which they conserve nor will it provide incentive for consumers to save.

Moreover, the assignment of individual demand charges will impact those with intangible circumstances which do not reflect principles of equity. For example, a household might have fairly low consumption until medical circumstances require an elderly parent or relative to stay temporarily for extended periods, resulting in the use of more natural gas for heating and cooking than usual. The next year, the very same household will have a higher demand charge even through the cause of using more natural gas may no longer be present. Another example would be a new tenant that is using less gas than the previous tenant, yet the higher demand charge remains.

In addition to the above factors, price elasticity is another significant factor affecting a household's usage of gas. It is undeniable that the commodity price of natural gas can be volatile. In one year, consumers may be less inclined to conserve when commodity prices are low and incur higher demand charges the next year after the true-up that may come into effect when the commodity prices rise dramatically. Again, some rate designs may appear to be solid investments on paper, yet the reality in which they are applied does not exist in a vacuum.

CGC's proposal fails to recognize these circumstances affecting a household's usage of natural gas.

Finally, the Consumer Advocate questions the administrative complexity of annually assessing the individual customer demand charges of tens of thousands of ratepayers. From an administrative point of view, the level and danger for billing mistakes is tantamount. Given the recent instances before the Authority of the over-billing by consumers of AT&T and alleged under-billing of consumers by Piedmont Natural Gas Company, even large and sophisticated utilities make mistakes which they struggle to correct for months and perhaps years.[237] Of course, this assumes consumers of CGC would realize a mistake has been made. Depending on whether consumers could understand having a different demand charge from year to year, very few if any may even realize a mistake has been made on their bill. Depending on the format of the actual bills consumers pay, there may never be a correction for assessing the wrong demand charge as consumers may never discover the possible error.

### E. SFV and Variations of SFV Do Not Encourage Energy Conservation

In this proceeding, a variation of SFV rate design has been presented as a means of aligning the financial interest of a utility to encourage energy conservation. However, SFV is not an appropriate rate design for purposes of encouraging energy conservation, but rather a blunt instrument for purposes of implementing cost causation principles. In any event, very few states have implemented a complete or variation of SFV rate design.[238] The consensus on a national level is that such rate designs weaken the incentive of consumers to conserve energy.

[237] *Transcript of Authority Conference*, April 26, 2010, p. 4-25; *Transcript of Authority Conference*, April 12, 2010, p. 11-24.
[238] *Tr. Vol. I,* 268; Tr. Vol. II, 530.

Indeed, follow-up resource publications to the National Action Plan have specifically concluded that shifting costs from volumetric to fixed charges through rate designs such as SFV *does not encourage* customer energy efficiency.[239] In fact, the National Action Plan states volumetric rates are more favorable for energy efficiency promotion.[240] There has been no endorsement of SFV within the National Action Plan. Rather, variations of SFV are discussed as convenient for utilities yet counter-productive for encouraging energy conservation:

> However, such rates significantly reduce a consumer's incentive to undertake efficiency investments, since energy use reductions would produce much lower customer bill savings relative to a situation under a rate design that included fixed costs in volumetric charges. In addition, fixed variable rates are criticized as being regressive (the lower the use, the higher the average cost per unit consumed) and unfair to low-income customers.

National Action Plan for Energy Efficiency (2007). *Aligning Utility Incentives with Investment in Energy Efficiency*. Prepared by Val. R. Jensen, ICF International. p. 2-11, footnote 9. Likewise, state public service commissions have concluded SFV rate designs are not tools to encourage energy conservation. In rejecting variations of SFV and large shifts toward SFV, the Washington Utilities and Transportation Commission expressly noted that decreasing the variable charges paid by consumers decreases the incentive of consumers to conserve his or her own usage and the impact of such designs on low-income and fixed income households.[241]

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239 *National Action Plan for Energy Efficiency (2009). Customer Incentives for Energy Efficiency Through Electric and Natural Gas Rate Design.*, p.2. *Prepared by William Prindle, ICF International, Inc.* <www.epa.gov/eeactionplan>.

240 *National Action Plan for Energy Efficiency* (2006), *Chapter 5: Rate Design*, p. 5-8.

241 *Washington Utilities and Transportation Commission v. Avista Corporation*, 2009 WL 5061998 (December 22, 2009), * 69.

Indeed, the issues of rate shock, energy conservation and the impact on low or fixed income households have been fixtures in the commission decisions rejecting variations of SFV rate design. The state of Kansas is but one example:

> Although straight fixed variable rates are attractive for their relative simplicity and lesser administrative burden, the Commission is concerned about their effect on customer inclination to save energy. The Commission is also concerned with the potential impact such rate structures may have on lower-income and fixed-income customers. (internal commission citations omitted).

State Corporation Commission of Kansas, *In the Matter of a General Investigation Regarding Cost Recovery and Incentives For Energy Efficiency Programs*, Docket 08-GIMX-441-GIV, Final Order, p. 22-23 (November 14, 2008).

When faced with a proposal for large shifts toward fixed costs, the Arizona Corporation Commission also noted these concerns:

> As discussed by Staff's witness, movement towards cost-based rates is just one of the many factors that must be considered in designing rates. The goal of moving closer to cost-based rates must be balanced with competing principles such as gradualism, fairness, and encouragement ***of*** conservation. (Emphasis added by Commission).

Arizona Corporation Commission, *In the Matter of Application of UNS Gas, Inc. for Establishment of Just and Reasonable Rates*, Docket No. G-04204A-08-0571, Opinion and Order, 2010 WL 1634233*36 (April 14, 2010).

Even those states, such as Indiana, that find the concept of SFV persuading have not endorsed an immediate radical change, but rather the need for a gradual and steady transition of raising the fixed charge and lowering the volumetric rate on a rate case by rate case basis:

> Going forward, the Commission finds that straight-fixed variable rate designs are attractive because they align basic cost causation principles of rate-making. However, these designs do present concerns regarding *rate shock* and *conservation efforts*. Issues of rate shock could be tempered in a phased manner through a steady transition, reducing volumetric rate design by a fixed percentage in each rate case. (Emphasis added).

Indiana Utility Regulatory Commission, *Joint Petition of Northern Indiana Fuel and Light Company, et al.* Cause No. 43745 (March 31, 2010), 2010 WL 1368630, *8.

Moreover, consumer interest groups, such as the American Association of Retired Persons ("AARP"), on behalf of 700,000 Tennesseans, strongly oppose SFV and SFV variations of rate design due to their inherent effects on energy conservation and rate shock.

> Imposing a hefty customer charge while reducing volumetric rates is contrary to the goals of energy affordability and energy conservation. Indeed, such a rate design discourages conservation, as additional usage becomes less expensive on a per unit basis. Shifting costs currently recovered on a usage basis to the fixed charge is especially harmful to low usage customers, who are often older households and low-income households...

Comments of AARP, TRA Docket 09-00183 (April 13, 2010), p. 3. The fact SFV rate designs hamper the encouragement of energy conservation is not new, nor is the concept of SFV being proposed to fulfill one public policy or another. Utilities, at various times and for various purposes, have advocated SFV rate designs as a means of achieving various policy objectives. Whether it be cost-causation principles, implementing a competitive market, or as now, encouraging energy conservation, a variety of reasons have been put forward in support of SFV rate designs over the years. For example, in this matter, CGC has pointed to Georgia for implementing a SFV.

The Georgia Legislature allowed for regulated natural gas utilities to elect to become unregulated in a competitive market. Ga. Code Ann. §46-4-151, *et seq*. The deregulation law allowed Atlanta Gas Light Company, which remains the only natural gas utility in Georgia that elected for deregulation, to implement a straight fixed variable rate design upon commission approval for purposes of promoting market competition rather than energy conservation. *Id.* In 1998, a SFV rate design was implemented for Atlanta Gas Light to act as the facilitator for a market of competitive marketers. Indeed, consumers pay a SFV in essence as a pass through via gas marketers who vive for customers with commodity discounts. Practically all of the 1.5 million natural consumers within Atlanta Gas Light's service area are actually customers of competitive gas marketers. Energy conservation had no connection to the implementation of SFV in Georgia.

While SFV has little to do with promoting energy conservation, the traditional volumetric rate design does. In this very docket, the Company itself has acknowledged that volumetric rates encourage energy conservation. With regard to recovery of the costs of the proposed energy conservation programs, CGC has proposed a volumetric rate:

> The overall goal of energySMART program is energy conservation. As such, a charge per therm will serve as an incentive to customers to further energy conservation.

Direct Testimony of Daniel Nikolich (November 16, 2009), p. 17.; Tr. Vol. I, p. 108-109.

While the Company views a volumetric charge for approximately $800,000 annually as encouraging energy conservation, one has to consider that consumers already have a powerful incentive through the volumetric rate design, which accounts for, and collects millions of dollars, to use less and reap substantial savings.[242]

### F. The Company's Proposed AUA is Unjust and Unreasonable

CGC's proposed AUA is a revenue per customer decoupling mechanism which will provide the Company with recovery of lost revenue for any reduction in customer usage, regardless of the cause. Energy conservation is the cloth decoupling mechanisms are draped in, yet the actual financial benefits they yield for utilities at the expense of consumers far outweigh the impact of conservation programs. Moreover, they weaken the incentive of consumers to conserve. Currently, when consumers use less, they save on the commodity cost and on the volumetric charge. The AUA will recapture any savings on the volumetric charge consumers as a whole make. As noted by the Virginia Commission Staff when considering the decoupling mechanism of CGC's affiliate, Virginia Natural Gas ("VNG"), it is questionable whether decoupling meets the goal of preserving bill savings to consumers who conserve.[243] In fact, decoupling would, in effect, eliminate some customer savings associated with individual conservation efforts.[244]

Regardless of whether an individual consumer is conserving through his or her own efforts while another consumer does little to conserve, both households, indeed all residential consumers, pay the same rate increase under the AUA. Thus, the AUA is not a mechanism which "sustains or enhances" utility customers incentives to use energy more efficiently" as

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[242] *Tr. Vol. I,* 110-111.
[243] *Virginia State Corporation Commission,* Case No. PUE-2008-00060, *Pre-filed Direct Testimony of Cody Walker,* p. 17 (September 25, 2008).
[244] *Id.*

required by the new conservation policy. Rather, it weakens the financial reward individual consumers reap when they conserve. As recognized by the Authority and the Company, volumetric charges are important to encourage consumers to conserve.[245]

Decoupling mechanisms have little to do with energy conservation. Practical experience shows decoupling mechanisms can produce extremely large rate increases and insulate a utility from economic and business risk while utility conservation programs have little, if any, measurable impact on utility revenues. VNG, an affiliate of CGC, has reaped millions of dollars in exchange for modest estimates of savings achieved by its energy conservation programs.[246] Part of this lop-sided result was due to the fact that legislation, supported by the gas industry, enacted in Virginia allowed for the use of stale data without a rate case at the discretion of the electing utility. However, such results are not out of norm for revenue decoupling mechanisms due to the fact the very concept is not related to the actual impact of energy conservation programs.

Based on Piedmont Natural Gas Company's most recent 10-K filings, Piedmont's decoupling mechanism in North Carolina has increased the Company's overall margin by $6 million in 2009, $25.6 million in 2008 and $32.7 million in 2007.[247] In a 2008 report from the North Carolina Legislature, the North Carolina Public Utilities Commission ("North Carolina Commission") calculated Piedmont's Customer Utilization Tracker ("CUT") produced $99.1 million in additional revenue from 2005, when the mechanism was implemented, up to mid-

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[245] *Transcript of Authority Conference*, p. 37 (May 18, 2009); *Direct Testimony of Daniel Nikolich*, (November 17, 2009) p. 17

[246] *Tr. Vol. II*, p. 398.

[247] *2009 Form 10-K of Piedmont Natural Gas Company, Inc.*, p. 32 (filed with the Securities and Exchange Commission on December 23, 2009).

2008.[248] Given the CUT also accounted for weather adjustments, roughly $50 million of the CUT adjustments to consumer's bills were the result of reduced usage on 'per customer' basis due to all other factors beyond weather.[249] The North Carolina Commission attributed the CUT's significant financial results to high natural gas prices and the effects of hurricanes impacting the Gulf region.[250] Piedmont's energy conservation programs had no significant impact in reducing consumer usage or in reducing the Company's revenues.[251] Such results, which illustrate the ever tenuous link between decoupling and energy conservation, demonstrate the weakness of standard decoupling mechanisms.

Part of the argument in support of the AUA and other decoupling mechanisms is the concept that all of a utility's costs are fixed. Indeed, for regulatory purposes, some costs are fixed, such as depreciation expense on underground pipes. However, not all costs are fixed in nature. Utility "costs" or expenses can go up and down in the period between rate cases while impacting the Company's reported return.[252] While some costs are indeed fixed, others are variable. Indeed, if all costs were fixed, public utilities would be filing rate cases practically every other year throughout the history of rate of return regulation to the present.

Rate-making recognizes that expenses and revenues are dynamic and subject to change. Rates are set using the matching principle, a concept that matches expenses, revenues and authorized return for a test year with adjustments for the attrition year moving forward to allow a

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[248] *Report of the North Carolina Utilities Commission to the Joint Legislative Utility Review Committee*, p. 6 (October 2, 2008). The Consumer Advocate would note that Piedmont's service area and customer base in North Carolina is much larger than the CGC's service area and customer base in Tennessee which greatly skews the financial results of the CUT in North Carolina when compared to smaller company like CGC.
[249] *Id.*
[250] *Id.*
[251] *Id.*
[252] *Transcript of Hearing*, Docket 09-00104, p. 58-62 (December 17, 2009).

utility the opportunity, rather than the guarantee of a return. Some revenues and expenses will go up or down as they are not static. Thus, the concept of employing a decoupling mechanism rests on the notion that all costs are static and utilities are *entitled* to a set return rather than the *opportunity* to make a return. In 2006, the Nebraska Commission recognized the possibilities of increased rates and risk shifting from decoupling:

> Automatic rate mechanisms raise concerns of piecemeal rate making by adjusting for only one element of cost without accounting for other increases and decreases in costs incurred by the utility. Such automatic mechanisms can lead to excessive rates, an inappropriate shifting of risks from stockholders to ratepayers, and decreased incentives to operate efficiently. Therefore, their use should be limited."[253]

Nebraska Public Service Commission, Application No. NG-0041. (July 24, 2007). The shift of business and economic risk from shareholders to utilities under decoupling is apparent. Indeed, if utilities are relieved of the burdens of revenue risk, then consumers must bear it alone. This was a major concern of the Colorado Commission when it considered decoupling and the incentives to encourage energy conservation. The Colorado Commission also stressed the need, as a rate-making policy, to maintain the incentive of the utility to control costs. Indeed, these concerns were the primary drivers of that Commission to substantially modify the proposed decoupling mechanism:

> We find that the entire risk associated with declining per customer use should not be assigned entirely to Public Service's residential customers. We expect that Public Service is aware of this decline in use per customer, and should be undertaking its own internal cost reduction, becoming more efficient through process re-designs and seeking more productive uses of its labor and capital

[253] In the matter of *Aquila, Inc. d/b/a Aquila Networks (Aquila) Omaha*, seeking individual rate increases for Aquila's Rate Area One, Rate Area Two, and Rate Area Three. Before the Nebraska Public Service Commission. Application No. NG-0041. July 24, 2007.

> resources. Becoming more efficient in the face of declining demand for an enterprise's product is rational economic behavior for a firm.

Colorado Public Utilities Commission, No. 690-Gas, 06S-65G,CO7-0568, *Commission Order Approving Settlement Agreement with Modifications*, Paragraph 56 (June 18, 2007). In order to mitigate these concerns, on its own volition, the Colorado Commission modified the decoupling mechanism by limiting the potential revenue the company could recover.[254] This same concern has been voiced in this State by the Authority in prior dockets.[255]

In this matter, the Consumer Advocate recommends mechanisms featuring balanced safeguards to protect consumers and regulatory interests, while at the same time provide the Company with financial incentives. These models, such as those from New Jersey and Washington, are from states with years of experience with decoupling and energy conservation. In fact, they are listed as "decoupled" in Mr. Yardley's DPY-4 exhibit, and are listed as members of the leadership of the National Action Plan.[256] Yet, in Mr. Yardley's opinion, these models fail to "make any progress toward aligning economic interests of the company and its customers" and simply don't comply with Tennessee's conservation policy.[257]

The Company makes a sweeping and broad argument relying on policy statements in an executive summary of the National Action Plan and the twenty states that have adopted decoupling in some form. Company specific facts, analysis or circumstances are missing from

[254] *Id.*, The Colorado Commission was considering a settlement agreement that would have allowed a full decoupling mechanism. The Commission modified the settlement agreement on its own volition to satisfy its concerns.

[255] *Transcript of Authority Conference*, January 25, 2010, Docket 09-00104, p. 26; *Transcript of Proceeding*, October 26, 2006, Docket 05-00258, p. 13 referencing Director Miller's written motion, attached to the transcript (p. 15 of Director Miller's motion addresses the denial of the decoupling mechanism).

[256] *Tr. Vol. II*, p. 531-532.

[257] *Tr. Vol. I*, p. 262, 311.

the record. Again, it is an all or nothing proposition which begins to breakdown when one goes beyond the broad argument. For example, the Company sees no need for decoupling safeguards despite the fact such modifications are common. Eight of the sixteen states listed in DPY-4 as having adopted some form of decoupling mechanism have done so with caps and other modifications to limit the amount of revenue that can be collected and assessed to consumers. Colorado, Illinois, Indiana, Massachusetts, New Jersey, Oregon, Washington and Wisconsin have all adopted a form of revenue decoupling for natural gas utilities with various designs and safeguards to limit margin recovery and protect consumers.[258] Mr. Yardley's reliance on these states in support of his general position, while at the same time dismissing the various consumer protections implemented, is simply inconsistent. The fact that a considerable number of "decoupling" states have adopted one form or another of decoupling safeguards, many of which Dr. Dismukes has proposed or discussed, is a fact the Company has chosen to dismiss out of hand or mischaracterize completely.

For example, when questioned about the various states with forms of decoupling safeguards, Mr. Yardley insisted generally that such safeguards had been adopted because the mechanisms were implemented outside of a rate case.[259] However, contrary to Mr. Yardley's assertion, these states all instituted decoupling mechanisms with design modifications during rate proceedings, with the exception of Northwest Gas in Oregon, which was specifically required to

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[258] *Colorado Public Utilities Commission*, No. 690-Gas, 06S-65G,CO7-0568, *Commission Order Approving Settlement Agreement with Modifications*, (June 18, 2007); Illinois Commerce Commission, No. 07-0241, No. 07-242, Commission Order, (February 5, 2008); Indiana Regulatory Commission, Cause No. 42943, 43046, Order (December 1, 2006); Massachusetts Department of Public Utilities, *Re: Bay State Gas Company*, DPU-09-30 (October 30, 2009); New Jersey Regulatory Board, No. GR05121120 (January 21, 2010).; Oregon Public Utility Commission, Re: Northwest Natural Gas Company, UG 143, Order No. 02-634 (September 12, 2002); Wisconsin Public Service Commission, Re: Wisconsin Public Service Corporation 6690-UR-119 (December 30, 2008).
[259] Tr. Vol. I, p. 267.

file a rate case within two months of the decision.[260] Assuming decoupling is a growing national trend, the facts suggest many states cited by Mr. Yardley have not committed to full decoupling thereby eliminating the alleged "through-put incentive."

No Company specific facts supporting the notion of eliminating the "through-put incentive" have been presented. The only facts CGC relies upon in support of the implementation of full decoupling are the words contained within the State's new policy itself.[261] For many public service commissions broad policy statements do not necessarily translate into adopting revenue decoupling without safeguards or even adopting revenue decoupling at all. An additional and fairly recent state not listed in Mr. Yardley's exhibit DPY-4, Minnesota, has been required by legislation specifically to implement decoupling and break the link between sales and revenue, yet the commission in that state still subjects the financial results of the decoupling mechanism to an earnings cap.[262]

An example which is relatively on point in terms of interpreting legislative conservation policy statements is from New Mexico. Following the passage of the Efficient Use of Energy Act ("EUE") by New Mexico's State Legislature, the New Mexico Public Regulation Commission considered a decoupling mechanism. The EUE policy statement is far more detailed than Tennessee's new conservation policy in that it discusses utility disincentives:

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[260] *Colorado Public Utilities Commission,* No. 690-Gas, 06S-65G,CO7-0568, *Commission Order Approving Settlement Agreement with Modifications,* (June 18, 2007); Illinois Commerce Commission, No. 07-0241, No. 07-242, Commission Order, (February 5, 2008); Indiana Regulatory Commission, Cause No. 42943, 43046, Order (December 1, 2006); Massachusetts Department of Public Utilities, *Re: Bay State Gas Company,* DPU-09-30 (October 30, 2009); New Jersey Regulatory Board, No. GR0512120 (January 21, 2010).; Oregon Public Utility Commission, Re: Northwest Natural Gas Company, UG 143, Order No. 02-634 (September 12, 2002); Wisconsin Public Service Commission, Re: Wisconsin Public Service Corporation 6690-UR-119 (December 30, 2008).
[261] *Tr. Vol. I,* p. 264.
[262] *In the Matter of the Application of CenterPoint Energy, Minnesota Public Utilities Commission* (January 11, 2010), 2010 WL 149133*15.

> It is the policy of the Efficient Use of Energy Act that public utilities, distribution cooperative utilities and municipal utilities include all cost-effective energy efficiency and load management programs in their energy resource portfolios, that regulatory disincentives to public utility development of cost-effective energy efficiency and load management be removed in a manner that balances the public interest, consumers' interests and investors' interests and that the commission provide public utilities an opportunity to earn a profit on cost-effective energy efficiency and load management resources that, with satisfactory program performance, is financially more attractive to the utility than supply-side resources.

NMSA 1978, Section 62-17-3 (2005). The New Mexico policy statement is explicit in that it requires the removal of regulatory disincentives for public utilities to engage in conservation. Public Service Company of New Mexico ("PNM"), which proposed a decoupling mechanism to comply with EUE policy, claimed the policy statement required the removal of the "through-put" incentive through a decoupling rate design. While the EUE policy does specifically require "regulatory disincentives" to public utility development of conservation measures to be removed in a manner that balances the interests of consumers, the New Mexico Commission rejected the notion that the EUE requires decoupling to remove the "through-put incentive:"

> The single-minded focus on use per customer ignores PNM's overall economic picture and has negative consequences for consumers. The EUE requires that a utility be made *financially neutral*. PNM's decoupling mechanism is designed to be a *financial windfall* instead. (emphasis added).

New Mexico Public Regulation Commission, Case No. 06-00210-UT, Hearing Examiner's Recommended Decision p. 116 (May 23, 2007). The Consumer Advocate submits a serious policy discussion and decision regarding the implementation of a rate design which grants a utility a significant financial benefit at the expense of consumers requires much more than an unsupported interpretation of a broad legislative policy statement.

## G. Any Modification to CGC's Rate Design Must Fully Maintain The Incentives to Control Costs

Any change in rate design for a regulated public utility should fully maintain the incentive of utilities to control costs. The incentive to control costs is essential to control the rates paid by captive customers of monopolies. In a competitive free market, there is a rational incentive for a business to control the price of a product and the cost of production in order to maximize earning potential and to survive in the struggle for the market.[263] A regulated public utility, on the other hand, serves as a monopoly without direct competition in which regulation is the substitute to maintain the relationship between prices and costs.[264]

An essential consideration before the Authority is that allowing an arbitrary recovery of a fixed level of revenue on a per customer basis, whether through a straight fixed variable design or through a decoupling mechanism, will weaken the incentive of a utility to control costs. It is a basic economic fact that rational utility management has little incentive to control costs (operational and capital) if controlling costs has no effect on the utility's profits.[265] Indeed, in 2006 the Authority concluded decoupling mechanisms remove the incentive to control costs.[266]

A major cornerstone of rate-making is the concept of "regulatory lag", which in layman's terms is the natural mismatch between utility profits going above or below the authorized level

[263] Bonbright, James C., *Principles of Public Utility Rates*, Inc. 2d Edition, p. 53 (1988).
[264] *Id.*
[265] *Direct Testimony of Dr. Dismukes*, p. 38 (March 10, 2010).
[266] Docket 05-00258, *Transcript of Proceeding,* October 26, 2006, p. 13 referencing Director Miller's written motion, attached to the transcript (p. 15 of Director Miller's motion addresses the denial of the decoupling mechanism).

and the time of an offsetting rate increase or decrease. As a regulated monopoly with fixed rates, public utilities cannot increase rates during those periods between rate cases. As their return is not guaranteed, public utilities have an incentive to control costs which increases or helps maintain profitability:

> In the regulation of public utility monopolies, the principle that rates should be set at levels designed to yield revenues covering cost including or plus a "fair rate of return" may be regarded as a substitute, though not a close substitute, for the tendency of prices and costs to come into accord under the forces of market competition. *But where is the efficiency-incentive counterpart?*
>
> Under prevailing methods of rate regulation, such incentives are, indeed, provided to a limited degree. First, private companies *receive no guaranty* of their ability to enjoy a "fair rate of return," with the result that they may be under more or less severe pressure to practice operating economies and to stimulate growth of demand for service in order to earn the officially sanctioned rate. Second the standards of a commission-fixed "fair rate of return" are themselves somewhat flexible, and some commissions, in setting these rates, try to make allowance for supposed relative efficiency or inefficiency of operation and of financial planning. *And third, there is the so-called "regulatory lag"* – the quite usual delay between the time when reported rates of profit are above or below standard and the time when an offsetting rate decrease or rate increase may be put into effect by commission order or otherwise. (emphasis added).

Bonbright, James C., *Principles of Public Utility Rates*, Inc. 2d Edition, p. 53 (1988). Thus, regulatory lag *and* the fact a utility's return is not guaranteed are indeed a positive incentive for regulated utilities to control costs in the absence of market competition.[267]

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[267] James C. Bonbright, *Principles of Public Utility Rates*, p. 53 (2.ed 1988). This is the same edition cited by Mr. Yardley in his rebuttal testimony.

Economic theory holds that the longer the period of regulatory lag, the greater the incentive a utility has to control costs.[268] Regulatory lag is also an element of the risk associated with investment in a utility. *Railroad Commission of Texas v. Lone Star Gas Co.*, 656 S.W. 2d 421, 425 (Tex.1983) (citing *Garfield and Lovejoy*, Public Utility Economics, pp.122-23 (1964); Bonbright, Principles of Public Utility Rates, p. 242 (1961)). As such, given the benefits of regulatory lag, the incentives to control costs must be maintained.

**ISSUE 2. The Implementation of a Decoupling Mechanism or SFV Shifts Business Risk from CGC to Consumers Which Requires Adjustments to the Company's Return on Equity**

As addressed earlier in this brief, decoupling mechanisms and variations of SFV reduce the risk of a utility. Under CGC's proposals, the risk is shifted to consumers to act as an insurance company for Company. The issue of whether such designs reduce risk is not contested. Dr. Morin explicitly agrees decoupling mechanisms reduce Company risk. Mr. Yardley admits SFV similarly reduces the risk.[269] The question before the Authority is not whether to make an adjustment to the return on equity if a decoupling mechanism or variation of SFV is implemented, but rather how much. The Consumer Advocate submits Dr. Klein's analysis is the appropriate methodology, given ROE adjustments have not been made for many comparable companies that actually have revenue decoupling. For example, the state of Virginia, which regulates affiliates of AGL and WGL and which have decoupling, was forbidden by statute from making an adjustment to the ROE for both respective companies when

[268] *Tr. Vol., II*, p. 394-395.

[269] *Tr. Vol. I, 290.*

implementing decoupling.[270] It is worth noting that Dr. Morin considered the prohibition in Virginia on adjusting the ROE for decoupling a misguided policy.[271]

**ISSUE 3. Tennessee's Energy Conservation Policy Requires Cost-Effective, Measurable and Verifiable Energy Conservation Programs**

As a required element of the State's energy conservation policy, the Consumer Advocate submits CGC may receive timely recovery and earnings opportunities for energy conservation programs that are cost-effective, and provide measureable and verifiable results. The Consumer Advocate welcomes the agreement of the Company with the need for an independent third party with the appropriate expertise to assess Company conservation programs. However, the core problem with meeting the State's conservation policy requirement is that at the outset of a new policy, both CGC and the Consumer Advocate can only provide projections and estimates of savings. There is some common ground between Dr. Dismukes and Mr. Nikolich on some estimates and programs.[272]

Be that as it may, the actual results of the programs will invariably differ from the initial estimates.[273] Measuring and verifying results for cost effective efforts may, for an initial period, be a post facto exercise while the Company would already be recovering funds from consumers.[274] At this time, the Consumer Advocate does not oppose the method of cost recovery for CGC given the need to initially implement the programs prior to knowing whether the

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[270] Virginia Code Ann. 56-602 (G).

[271] *Tr. Vol. III*, 733.

[272] *Tr. Vol. I*, p. 105; *Vol. II, Rebuttal Testimony of Daniel Nikolich*, p. 6, 9 (April 5, 2010).

[273] *Tr. Vol. I*, p. 105; *Direct Testimony of Dr. Dismukes*, p. 29-32 (March 10, 2010); *Rebuttal Testimony of Daniel Nikolich*, p. 3 (April 5, 2010).

[274] The state policy allows for timely recovery for conservation efforts which are cost-effective and provide verifiable and measurable results.

programs will actually result in cost effective initiatives with verifiable and measurable results. However, the Consumer Advocate is not foreclosing the possibility of opposing such method of recovery in future matters with regard to CGC or other public utilities.

With regard to the conservation education proposal, the Consumer Advocate would note that no firm program plan currently exists. No consumer funding for this program should be allowed. Other than a budget and a flyer or bill insert from an affiliate's conservation program, there is simply nothing in the record supporting consumer funding other than a promise to establish a vague program of sorts.[275] Moreover, the flyer or bill insert example provided is strictly limited to promoting the existence of a rebate program. While reasonable promotional costs for advising consumers of the availability of any offered conservation programs are presumably prudent, costs for an undefined education program that CGC claims will educate consumers on new ways to conserve beyond the offered programs is simply unwarranted.

The Consumer Advocate supports CMA's suggestion that conservation programs be made available to industrial customers. However, the Consumer Advocate submits that any customer class that participates in any energy conservation programs offered by CGC must also share the burden of funding such programs.

## CONCLUSION

For the foregoing reasons, the Authority should find that CGC's request to increase the rates of its customers is without merit and that implementation of the AUA or another, similar decoupling mechanism as proposed by CGC, is neither necessary to align the energy conservation interests of CGC and its customers nor is it in the best interest of those customers.

[275] *Direct Testimony of Dr. Dismukes*, (March 10, 2010), p. 10-12: *Rebuttal Testimony of Donna Peeples*, (April 5, 2010), DP-2.

The Authority should, therefore, decrease CGC's proposed Operations and Maintenance Expense by a minimum of $939,693, reject the utility's request to recover litigation fees from TRA Docket 07-00224, and deny CGC's request to implement such a decoupling rate design mechanism. If any decoupling rate design is to be adopted by the Authority, it should include the safeguards and an adjustment to the return on equity as proposed by the Consumer Advocate.

RESPECTFULLY SUBMITTED,

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## CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing was served via U.S. Mail or electronic mail upon:

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This the 7th day of May, 2010.

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