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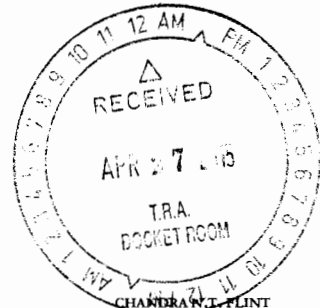
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April 27, 2015



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VIA E-MAIL AND HAND DELIVERY
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RE: Atmos Energy General Rate Case and Petition to Adopt Annual Review Mechanism and ARM Tariff, TRA Docket No. 14-00146

Dear Sharla:

Enclosed are the original and four copies of the rebuttal testimony of Atmos Energy Corporation. As per our usual practice, an electronic copy in PDF format is enclosed on the DVD to load onto the Authority's website.

Best regards.

Sincerely,

A. Scott Ross

ASR:prd

Enclosures

cc: Wayne Irvin (by email with enclosures by hand delivery)

**Atmos Energy Corporation
General Rate Case and
Petition to Adopt Annual Mechanism and ARM Tariff**

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1

2

II. PURPOSE AND SUMMARY OF REBUTTAL TESTIMONY

3

Q. PLEASE STATE THE PURPOSE OF YOUR REBUTTAL TESTIMONY.

4

A. My testimony will address the CAPD's position on (1) attrition period billing determinants and revenue calculations, (2) proposed rate design, and (3) proposed elimination of the Weather Normalization Adjustment (WNA). I will also respond to other recommendations made by Mr. Novak if the Authority were to adopt the Company's proposed ARM.

9

10

III. ATTRITION PERIOD BILLING DETERMINANTS AND REVENUE

11

12

Q. HAVE YOU REVIEWED THE TESTIMONY OF CAPD WITNESS MR.

13

HAL NOVAK?

14

A. Yes.

15

Q. PLEASE SUMMARIZE THE COMPANY'S RESPONSE TO THE CAPD'S

16

CALCULATION OF ATTRITION PERIOD BILLING DETERMINANTS.

17

A. The summary of the CAPD's Attrition Period Billing Determinants is located on page 6, lines 7-15, of Mr. Novak's pre-filed direct testimony, as well as attachment WHN-2. As stated in Mr. Novak's testimony, "the differences between the two billing determinants calculations are relatively minor" as a result of the Company using the CAPD's model from the Company's previous case in Docket No. 12-00064.¹ Both the Company and the CAPD began with test period sales and transportation volumes, bills and billing demand units, and then adjusted for the impacts of normal weather, annualized customer usage, customer growth,

24

¹ Docket No. 14-00146, Pre-Filed Direct Testimony of Hal Novak, p. 6, lines 7-9.

1 and any known changes to industrial volumes to arrive at the attrition billing
2 determinants. The Company's methodologies for attrition billing determinants
3 are proven and reliable, produce results in line with CAPD's calculations, and are
4 replicable for future filings. The Authority should adopt the Company's
5 methodologies utilized to calculate Attrition Period Billing Determinants.

6 **Q. PLEASE DISCUSS THE CAPD'S REVENUE CALCULATIONS.**

7 A. Table 3 on page 8, lines 13-15 of Mr. Novak's direct testimony as well as
8 Attachment WHN-4 shows the minor difference between the Company's
9 calculated revenues in comparison to the CAPD's calculated revenues. The
10 Authority should adopt the methodology of multiplying the attrition period billing
11 determinants by the existing base tariff rates to determine the attrition period sales
12 and transportation margin. Again, the Company's methodology is proven and
13 reliable, produces results in line with CAPD's calculations, and is replicable for
14 future filings. The Authority also should adopt the Company's methodology to
15 calculate revenues associated with forfeited discounts and miscellaneous charges.

16
17 **IV. PROPOSED RATE DESIGN**

18
19 **Q. DID MR. NOVAK MAKE ANY RECOMMENDATIONS TO THE**
20 **COMPANY REGARDING A PROPOSED RATE DESIGN?**

21 A. Yes. Mr. Novak made several recommendations, including a recommendation
22 that his proposed revenue "surplus"² be allocated evenly to all customer classes,
23 including the Company's special contract customers, based upon the ratio of

² See Docket No. 14-00146, Pre-filed Direct Testimony of Hal Novak, p. 39, lines 6-13.

1 attrition period margin to total attrition period margin. In this proceeding Mr.
2 Novak recommends on page 39, lines 16-19 of his testimony, that any revenue
3 “deficiency” be “recovered” through “decreased” commodity charges.³ Since Mr.
4 Novak’s recommendation is a reduction in revenue requirement, I believe he
5 intended to say “any revenue surplus” rather than “any revenue deficiency” and
6 also intended to say “reduced commodity charges” rather than “be recovered
7 through decreased commodity charges.”⁴

8 **Q. DO YOU AGREE WITH MR. NOVAK’S PROPOSED RATE DESIGN?**

9 A. No. I recommend that any revenue change approved by the Authority be allocated
10 based on the ratio of attrition period margin to total attrition period margin (by
11 rate schedule), and that any change in revenue further be apportioned not only by
12 rate schedule but also between the ratio of customer charges and volumetric
13 charges within each rate schedule, as proposed by the Company. The Company’s
14 proposed rate design in this proceeding is consistent with the Company’s proposal
15 in Docket No. 12-00064. Our design is proven and replicable, allows for changes
16 to both the base and volumetric charges, and has been successfully utilized by the
17 Company in previous years. I would also suggest that the Authority should
18 exclude special contracts in the calculation of any rate change. The Authority has
19 thoroughly reviewed the Company’s requests seeking approval of its special
20 contract rates for the Company’s customers.⁵ The approved rates within these
21 contracts are set for a specific term(s), some with renewal periods, and have been

³ See Docket No. 14-00146, Pre-filed Direct Testimony of Hal Novak, p. 39, lines 16-19.

⁴ See Docket No. 14-00146, Pre-filed Direct Testimony of Hal Novak, p. 39, lines 16-19.

⁵ See Docket No. 14-00146, Atmos’ Response to the First Discovery Requests by the CAD, 2/05/15, CAPD 1-006.

1 separately approved upon the premise that the contract terms will be honored. I
2 request that the Authority adopt the Company's rate design methodology for any
3 change in revenue requirement and also exclude special contracts in any revenue
4 calculation.

5
6
7 **V. WEATHER NORMALIZATION ADJUSTMENT (WNA)**
8

9 **Q. DID MR. NOVAK MAKE ANY RECOMMENDATIONS REGARDING**
10 **THE COMPANY'S WNA MECHANISM?**

11 A. Yes. On page 42, lines 8 through 10, Mr. Novak states "if the [Authority] does
12 elect to approve an ARM based on the Company's entire capital and operating
13 budget, I would recommend that the [Authority] consider terminating the
14 Company's existing WNA mechanism."⁶ According to Mr. Novak, "since the
15 ARM would true-up the Company's entire cost of service, it seems that a WNA
16 mechanism would be redundant and unneeded."⁷ Prior to commenting on Mr.
17 Novak's WNA proposal, I would point out that it seems contradictory and
18 illogical that he would recommend denying the proposed ARM because it does
19 not include a true-up (Novak page 40 lines 12-16) while simultaneously
20 recommending termination of the WNA mechanism because he argues its impact
21 would be redundant to an ARM true-up mechanism.

⁶ Docket No. 14-00146, Pre-filed Direct Testimony of Hal Novak, p.42, lines 8-10.

⁷ Docket No. 14-00146, Pre-filed Direct Testimony of Hal Novak, p.42, lines 13-15.

1 Q. DO YOU AGREE WITH MR. NOVAK'S RECOMMENDATION TO
2 ELIMINATE ITS WNA MECHANISM IN THE EVENT AN ARM IS
3 APPROVED?

4 A. No. The elimination of the WNA mechanism, even with an ARM true-up, is not
5 in the best interests of the customers for several reasons.

6 Q. BEFORE YOU EXPLAIN WHY IT IS NOT IN THE BEST INTEREST OF
7 THE CUSTOMER, PLEASE PROVIDE SOME BACKGROUND.

8 A. Certainly. The Tennessee Public Service Commission (TPSC) approved a WNA
9 mechanism for the three regulated gas utilities on an experimental basis by Order
10 dated September 26, 1991.⁸ Further, the TPSC issued an Order on June 21, 1994
11 authorizing the three regulated gas utilities to permanently implement an amended
12 version of the WNA Rider. The Company's approved WNA Rider applies to
13 Rate Schedules 210, 211, 220, 225, 221, 230 (Commercial only) and adjusts the
14 base portion of these customers' bills when actual weather is colder or warmer
15 than normal, and occurs only during the October through April period. For
16 example, if actual weather (measured by Heating Degree Days) during the
17 customer's billing cycle is colder than normal, the customer will receive a bill
18 credit on the base portion of the bill. The customer, however, pays the gas cost
19 portion (*i.e.* Purchased Gas Adjustment) of the bill based on actual usage, which
20 is typically higher in colder than normal weather. Conversely, if actual weather
21 during the customer's billing cycle is warmer than normal, the customer will
22 receive a bill surcharge on the base portion of the bill. The customer, however,
23 pays the Purchased Gas Adjustment of the bill based on actual usage, which is

⁸ See Docket No. 91-01712, Order (September 26, 1991).

1 typically less in warmer than normal weather. The WNA mechanism thus
2 protects both customers and the Company by providing real-time smoothing of
3 the volatility of both customer gas bills (at an individual customer level) and
4 Company revenues, both of which would otherwise fluctuate with weather.

5 **Q. WHAT IS THE IMPACT OF MR. NOVAK'S PROPOSAL ON REAL-**
6 **TIME BILLING?**

7 A. In essence, Mr. Novak is recommending the "real-time billing" credit and/or
8 surcharge cease and that the *aggregate* of dollars that would otherwise have been
9 credited or surcharged during those winter months not be billed, but rather be
10 included in an ARM true-up.

11 **Q. WHY IS THIS A BAD IDEA?**

12 A. I am against this idea for several reasons. First, an ARM true-up would not serve
13 a timely smoothing function on a customer level, as it would occur only in the
14 aggregate, and after a lag of up to two years, depending on the true-up
15 methodology adopted by the Authority. Because of the inherent lag, an ROE
16 true-up could greatly exacerbate gas bill variability. Assume, for example, that
17 there is an abnormally warm period in Year 1, which ultimately results in an
18 upward adjustment to rates under the ARM true-up mechanism. The upward
19 adjustment would not actually make its way into rates until Year 3, depending on
20 the true-up timing adopted. If the weather in Year 3 is abnormally cold, the
21 upward adjustment in Year 3 caused by the true-up increases gas bills when they
22 are already high due to cold weather. Whereas the WNA would have smoothed
23 the effects of weather-related variability in gas bills, the ARM true-up by itself

1 has made matters worse in this example. Attached as Rebuttal Exhibit PJC-1 is a
2 comparison of the weather's effect on WNA year-over-year for the past six years,
3 depicting the swings that would have occurred if the current WNA mechanism
4 had been eliminated and replaced with a deferral methodology, as proposed by
5 Mr. Novak.

6 Second, the WNA has worked successfully for over two decades. The
7 Authority's Staff audits the WNA of each utility annually by reviewing a
8 sampling of bills and heating degree day data used in the calculation. The dollars
9 credited or collected during those time periods have been timely applied to each
10 customer's monthly bills. Indeed, Mr. Novak himself has previously recognized
11 the correlation between weather and sales in advocating on behalf of maintaining
12 a WNA mechanism. In Docket No. 10-00189, Mr. Novak testified that "[t]he
13 [Authority] has long recognized a causal relationship between weather and sales
14 for gas utilities" while also citing his analysis of "superior correlation factors
15 [that] indicate a strong causal link between gas sales and weather."⁹

16 **Q. WHY IS THE WNA MECHANISM STILL NECESSARY EVEN WITH**
17 **MR. NOVAK'S PROPOSAL OF AN ARM TRUE-UP?**

18 A. Continuation of the WNA as a real time billing adjustment is necessary to
19 appropriately assign credit or surcharge on a customer-specific basis and avoid
20 subsidization issues through a deferral. Mr. Novak's proposal to eliminate the real
21 time WNA and defer WNA revenues to the ARM true-up disconnects the
22 assignment of revenues from the direct causal relationship for the appropriate

⁹ See Docket No. 09-00183, Response of the Consumer Advocate to the Motion of Chattanooga Gas Company to Extend the USAGE Adjustment and Conservation Programs Approved by the Authority, 5/3/13, pp. 3-4.

1 class of customers. Because the true-up adjustment would presumably be spread
2 proportionally to all classes just like each annual adjustment, Mr. Novak's
3 proposal would effectively result in weather related true-up revenue requirement
4 being spread to non-heat-load customers. For these reasons, I recommend the
5 Authority reject Mr. Novak's proposal to eliminate the WNA in the event of an
6 ARM approval.

7
8 **VI. ANNUAL REVIEW MECHANISM (ARM)**
9

10 **Q. PLEASE RESPOND TO THE CAPD'S RECOMMENDATIONS ON THE**
11 **COMPANY'S REQUEST FOR AN ANNUAL REVIEW MECHANISM?**

12 **A.** Mr. Novak makes several recommendations concerning the mechanics of an
13 annual review mechanism (ARM) under Tennessee Code Annotated §65-5-
14 103(d)(6). In his testimony, Mr. Novak states that "under the ARM, Atmos
15 Energy intends to implement its capital and operating budgets without any true-up
16 whatsoever to the actual capital amounts expended."¹⁰ While the Company did
17 not propose a true-up, as explained by Company Witness Waller, we can make a
18 true-up work with slight modifications to the proposed ARM. Mr. Waller will
19 address this recommendation in more detail in his rebuttal testimony. The CAPD
20 also recommends on page 41, lines 9-10 of Mr. Novak's testimony, that the
21 Authority consider the appropriateness of a management audit in conjunction with
22 the Company's proposed ARM.¹¹ I disagree with this recommendation because it

¹⁰ Docket No. 14-00146, Pre-Filed Direct Testimony of Hal Novak, p. 40, lines 13-14.

¹¹ See Docket No. 14-00146, Pre-Filed Direct Testimony of Hal Novak, p. 41, lines 9-10.

1 calls for a broad and undefined management audit. The annual filings under the
2 ARM, which will include a voluminous set of information comparable to what
3 has been provided in this case, should be more than sufficient to allow the CAPD,
4 Authority Staff and any intervening party an opportunity to assess the Company's
5 accounts and its compliance with the methodologies approved in this matter. Any
6 remaining questions can be addressed through the discovery process that would
7 follow, as necessary, following each ARM filing. The CAPD's recommendation
8 for a management audit is without support and would impose additional and
9 unnecessary costs on ratepayers with no promise of any concrete offsetting
10 benefit. The Authority should reject CAPD's recommendation for an undefined
11 management audit.

12 **Q. PLEASE RESPOND TO THE CAPD'S RECOMMENDATION ON PAGE**
13 **42, LINES 5-7, OF MR. NOVAK'S TESTIMONY THAT THE**
14 **AUTHORITY TERMINATE THE ANNUAL REVIEW MECHANISM IN**
15 **FIVE YEARS.**

16 A. I disagree with this recommendation, which seeks to impose a sunset provision
17 that is not part of the statutory mechanism authorized under Tennessee Code
18 Annotated section 65-5-103. The statute authorizes Atmos Energy to opt into an
19 annual review of its rates pursuant to the methodologies adopted in its most recent
20 rate case. There is no statutory time limit on the statutory right to opt for annual
21 rate review and the Authority should not attempt to create one. Subsection
22 (d)(6)(D)(ii) states: "The authority may terminate an approved annual review
23 plan only after citing the public utility to appear and show cause why the authority

1 should not take such action pursuant to the procedures in § 65-2-106.” And
2 subsection (d)(6)(D)(iii) states: “The authority or the public utility may propose a
3 modification to the approved annual review plan for consideration by the
4 authority. The authority shall determine whether any proposed modification is in
5 the public interest and should be approved within the time frame set forth in
6 subdivision (d)(6)(C). If the authority denies a modification to the approved
7 annual review plan, the authority shall set forth with specificity the reasons for its
8 denial.” The CAPD’s recommendation seeks to modify these statutory provisions
9 by imposing a set time limit where none exists. Their suggestion should not be
10 adopted.

11 **Q. PLEASE RESPOND TO MR. NOVAK’S RECOMMENDATION ON PAGE**
12 **44, LINES 15-20, OF HIS TESTIMONY RECOMMENDING THE**
13 **AUTHORITY ADOPT A MINIMUM FILING REQUIREMENT FOR THE**
14 **COMPANY**

15 A. Mr. Novak recommends that the Authority adopt wholesale the existing rate case
16 minimum filing requirements for all future ARM filings. I disagree. The
17 Company submitted this filing at the end of November, so that the filing was both
18 responsive and timely and so that it could be placed on the December 1 regularly
19 scheduled Authority Conference. Had the Company waited until the MFRs were
20 complete, the petition would not have appeared on a Conference Agenda until the
21 January 12 hearing date, unnecessarily delaying the appointment of a Hearing
22 Examiner, establishment of a procedural schedule and the discovery process. The
23 Company has supplied all necessary filings for this case, and has been responsive

1 in all follow-up questions. For this case, as in Docket No. 12-00064, the
2 Company filed its complete economic model and all associated workpapers. All
3 "relied upon" documents have been provided. These schedules and documents
4 should be familiar to the CAPD. For all future ARM filings the Company intends
5 to supply all necessary files, its economic model and workpapers and all "relied
6 upon" documents as it has done here. Multiple items that Mr. Novak
7 recommends the Company should file within its ARM requirements are not useful
8 for the CAPD's analysis and are needlessly wasteful and time-consuming as
9 explained in the Company's response to CAPD request 1-110. Any formal
10 requirements are unnecessary and the Company opposes this recommendation.
11 The Company requests that the Authority reject Mr. Novak's recommendation to
12 adopt the rate case minimum filing requirements.

13 **Q. DO YOU HAVE ANY OTHER COMMENTS TO MR. NOVAK'S**
14 **TESTIMONY.**

15 A. Yes. On page 44, lines 6-15, of his testimony Mr. Novak makes several
16 comments concerning the Company that I believe are unjustified.¹² Mr. Novak
17 leveled similar criticisms in the Company's Docket No. 12-00064. The Company
18 would refer to its previous response regarding its submission of its full economic
19 model and workpapers, along with its responsiveness to CAPD data requests and
20 willingness to participate in technical conferences, as proof that Mr. Novak's
21 criticisms are unjustified. The Company at all times in this docket has been

¹² Docket No. 14-00146, Pre-Filed Direct Testimony of Hal Novak, p. 44, lines 6-20 (e.g. "The Company's case was filed with a bare minimum amount of supporting detail and a complete lack of documentation or audit trail as to the source of that supporting information, which causes delays for all parties in analyzing the case. This same lack of support also occurred in the Company's 2012 rate case, as well as the 2014 filing that was later dismissed.")

1 committed to working in a timely and professional manner and in fact has worked
2 quite cooperatively with the CAPD and its witnesses in this case, including Mr.
3 Novak. As but one example of many, the Company is proud of the fact that, as in
4 past cases, it has been able to complete this matter without having to litigate even
5 a single discovery dispute, and I strongly disagree with Mr. Novak's criticisms.

6
7 **VII. CONCLUSION**

8
9 **Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?**

10 **A. Yes.**

BEFORE THE TENNESSEE REGULATORY AUTHORITY
NASHVILLE, TENNESSEE

IN RE:

ATMOS ENERGY CORPORATION)
GENERAL RATE CASE AND PETITION)
TO ADOPT ANNUAL REVIEW)
MECHANISM AND ARM TARIFF)

Docket No. 14-00146

VERIFICATION

STATE OF TENNESSEE)
)
COUNTY OF DAVIDSON)

I, Patricia J. Childers, being first duly sworn, state that I am the Vice President – Rates & Regulatory Affairs for Atmos Energy Corporation, that I am authorized to testify on behalf of Atmos Energy Corporation in the above-referenced docket, that the Rebuttal Testimony of Patricia J. Childers in Support of Atmos Energy Corporation's Petition and the Exhibit thereto, pre-filed in this docket, are true and correct to the best of my knowledge, information and belief.

Patricia J Childers
Patricia J. Childers

SWORN to and subscribed before me
this 27th day of April, 2015

Phillip R. Dickens
Notary Public



My Commission Expires: Nov 5, 2018

**Atmos Energy Corporation
Kentucky/Mid-States Division
Tennessee Operations
WNA Revenue (Excess) Deficiency
Rebuttal Exhibit PJC-1**

	Amount
Fiscal Year 2010	\$ (1,118,544)
Fiscal Year 2011	\$ (131,011)
Fiscal Year 2012	\$ 2,873,219
Fiscal Year 2013	\$ 43,859
Fiscal Year 2014	\$ (1,790,854)
Fiscal Year 2015 (YTD March)	\$ (1,832,139)

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

IN RE:

**ATMOS ENERGY CORPORATION)
GENERAL RATE)
CASE AND PETITION TO ADOPT)
ANNUAL REVIEW MECHANISM)
AND ARM TARIFF)**

DOCKET NO. 14-00146

**REBUTTAL TESTIMONY OF GREGORY K. WALLER
ON BEHALF OF ATMOS ENERGY CORPORATION**

I. INTRODUCTION OF WITNESS

1

2 **Q. PLEASE STATE YOUR NAME, POSITION AND BUSINESS ADDRESS.**

3 A. My name is Gregory K. Waller. I am Manager, Rates and Regulatory Affairs
4 with Atmos Energy Corporation ("Atmos Energy" or "Company"). My business
5 address is 5420 LBJ Freeway, Ste. 1600, Dallas, Texas 75240.

6 **Q. ARE YOU THE SAME GREGORY WALLER THAT FILED PRE-FILED**
7 **TESTIMONY IN THIS PROCEEDING?**

8 A. Yes.

9 **Q. HAVE YOU REVIEWED THE TESTIMONY OF THE INTERVENING**
10 **PARTIES?**

11 A. Yes. I have reviewed the testimony of the Consumer Advocate and Protection
12 Division (CAPD), including that of CAPD witness Mr. Hal Novak.

13

14 **II. PURPOSE AND SUMMARY OF REBUTTAL TESTIMONY**

15 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

16 The purpose of my testimony is to rebut certain adjustments as filed in the

1 testimony of CAPD witness Mr. Hal Novak. Specifically, I am rebutting the
2 adjustments made by Mr. Novak to the Company's O&M expenses, Taxes Other
3 Than Income Taxes, rate base and proposed methodologies for the Annual
4 Review Mechanism (ARM).

5
6 **III. ATTRITION PERIOD OPERATION & MAINTENANCE EXPENSE**

7 **Q. DO YOU AGREE WITH MR. NOVAK'S CALCULATION OF THE**
8 **COMPANY'S O&M LABOR EXPENSE AS SUMMARIZED ON PAGE 10,**
9 **LINES 13-21, OF HIS TESTIMONY?**

10 A. No. To calculate the Company's attrition period labor expense, Mr. Novak
11 attempts to analyze the previous five years of Company's expenses. He then
12 increases an amount he determines as net allowable expense by an average labor
13 growth factor over the arbitrarily-chosen last three years to calculate the
14 Company's attrition period labor expense for each division.¹

15 **Q. WHY DO YOU DISAGREE WITH MR. NOVAK'S CALCULATION OF**
16 **THE COMPANY'S O&M LABOR EXPENSE?**

17 A. I have consistently argued that the most accurate forecast of attrition period labor
18 expense (and O&M expense, in general) is the Company's budget.² Atmos
19 Energy's budget for the coming period embodies information that is ignored by a
20 purely historical trend analysis of the type utilized by Mr. Novak. When the
21 Company knows what will be spent in the coming year, there is no reason to

¹ See Docket No. 14-00146, Pre-Filed Direct Testimony of Hal Novak, p. 10, lines 13-21.

² See, e.g., Docket No. 14-00146, Pre-Filed Testimony of Gregory Waller on Behalf of Atmos Energy, pp. 20-34.

1 ignore this information. A budget-based analysis should always provide a better
2 prediction of actual expense in the coming period than Mr. Novak's backward-
3 looking approach. The Company's budget is thoroughly reviewed throughout its
4 formation and approval, and is the Company's plan for forecasted spending and
5 expenses. Mr. Novak's labor expense analysis requires several assumptions while
6 also ignoring the concepts of a test year and forward-looking components of the
7 Company's filed position. Specifically, Mr. Novak offers no support for his use
8 of a three year growth factor, explaining merely that he "felt that this rate was
9 most representative of what was likely to occur through the attrition year."³ In
10 addition, the calculation of his growth factor ignores any known or expected
11 changes that are captured in the Company's budgeting process and included in the
12 attrition year, as the factor relies purely on historical data.

13 **Q. DO YOU AGREE WITH MR. NOVAK'S CLAIM THAT HIS**
14 **METHODOLOGY PRODUCES AN O&M LABOR PROJECTION THAT**
15 **IS SIGNIFICANTLY LOWER THAN YOURS?**

16 **A.** No. Mr. Novak claims in his testimony (page 11, lines 4-6) that his labor
17 projection is \$1.7 million less than the Company's projection. That statement is
18 entirely inaccurate. In fact, if one compares Mr. Novak's claim to the Company's
19 WP 4-1 attached to my pre-filed testimony, it is clear that the number he cites for
20 comparison (\$10,665,486) is the Company's attrition year sum of labor and
21 benefits expense. When comparing labor only, Mr. Novak's projection is over \$1
22 million higher than my labor forecast (\$8,964,442 vs. \$7,915,572). The fact that

³ Docket No. 14-00146, Pre-Filed Direct Testimony of Hal Novak, p. 10, lines 17-19.

1 Mr. Novak's calculation of O&M labor expense is over \$1million more than the
2 Company's budget-based projection simply highlights the degree to which Mr.
3 Novak's poorly formed methodology can produce clearly erroneous results. The
4 Authority should reject Mr. Novak's methodology, and rather adopt the
5 methodology of calculating O&M labor expense as presented in the Company's
6 filing, which utilizes budgeting and attrition year components.

7 **Q. DO YOU AGREE WITH MR. NOVAK'S CALCULATION OF THE**
8 **COMPANY'S O&M NON-LABOR EXPENSE AS SUMMARIZED ON**
9 **PAGE 11, LINES 9-19, AND PAGE 12, LINES 1-3, OF HIS TESTIMONY?**

10 A. No. To calculate the Company's attrition period non-labor expense, Mr. Novak
11 attempts to analyze the previous five years of the Company's expenses. He then
12 increases an amount he determines as net allowable expense by an average non-
13 labor growth factor over the arbitrarily-chosen last three years to calculate the
14 Company's attrition period non-labor expense for each division.⁴

15 **Q. WHY DO YOU DISAGREE WITH MR. NOVAK'S CALCULATION OF**
16 **THE COMPANY'S O&M NON-LABOR EXPENSE?**

17 A. Similar to his calculation of Company's O&M Labor expense, Mr. Novak's
18 approach simply makes too many arbitrary assumptions, while also ignoring the
19 Company's budget and attrition year filed components. Mr. Novak's reliance on
20 historical data for the past five years and calculation of a three year growth factor
21 based on these historicals, both arbitrarily chosen by Mr. Novak, does not capture
22 known and measurable changes in the attrition year, which are reflected in the

⁴ See Docket No. 14-00146, Pre-Filed Direct Testimony of Hal Novak, p. 11 lines 9-19 and p.12 lines 1-3.

1 Company's budget. The Authority should reject Mr. Novak's methodology, and
2 rather adopt the Company's methodology of calculating O&M non-labor expense
3 utilizing budgeting and attrition year components, as presented in the Company's
4 filing.

5 **Q. DO YOU HAVE ANY OTHER COMMENTS REGARDING MR.**
6 **NOVAK'S METHODOLOGY IN CALCULATING O&M NON-LABOR**
7 **EXPENSE?**

8 A. Yes. In addition to disagreeing with Mr. Novak's methodology, Mr. Novak's
9 three-year methodology was calculated incorrectly, as the annualized percentage
10 used by Mr. Novak was divided based on the incorrect number of years.⁵

11 **Q. DO YOU AGREE WITH MR. NOVAK'S DISALLOWANCE OF**
12 **FINANCIAL ACCOUNTING STANDARD NO. 87 ("FAS 87") PENSION**
13 **EXPENSE AS SUMMARIZED ON PAGE 13, LINES 1-6 OF HIS**
14 **TESTIMONY?**

15 A. No.

16 **Q. WHY DO YOU DISAGREE WITH MR. NOVAK'S REMOVAL OF THE**
17 **FAS 87 PENSION EXPENSE?**

18 A. Mr. Novak's proposed adjustment is a direct contradiction of the Final Order in
19 Docket No. 12-00064.

20 **Q. HOW IS MR. NOVAK'S REMOVAL OF FAS 87 PENSION EXPENSE IN**
21 **CONTRADICTION TO THE ORDER IN THE PREVIOUS DOCKET?**

22 A. Long standing Tennessee ratemaking principles allows utilities recovery of actual

⁵ See CAPD WP E-1.5 and the CAPD's response to Atmos Energy Discovery Request 1-33.

1 cash contributions made to pension funds, rather than the FAS 87 expense
2 charged to O&M as required by generally accepted accounting principles
3 (GAAP). The Order in Docket No. 12-00064 instructed the Company to defer
4 any actual cash contributions above or below a benchmark of \$2,086,819
5 annually. By doing so, the Authority minimized the likelihood of large spikes in
6 rates caused when the Company is required to make large cash contributions to its
7 pension fund to keep the fund at required minimum funding levels.

8 **Q. PLEASE REVIEW HOW YOU ARRIVED AT YOUR ADJUSTMENT IN**
9 **THIS DOCKET?**

10 A. In this filing, an adjustment to the fixed benefit load percentage was made by the
11 Company in order to comply with long standing Tennessee rate making precedent
12 and to propose the continuation of the treatment of pension expense that was
13 prescribed in the Final Order in Docket No 12-00064. The benchmark is
14 determined by a study conducted by Towers Watson, the Company's actuary.
15 The study determines the total future pension liability of the Company, the
16 amount of that liability related to current and prior Tennessee employees
17 (including an allocation of the liability related to employees allocable to
18 Tennessee) and used that data to determine the amount of the Company's
19 minimum required contribution (also determined by Towers Watson) that is
20 allocable to Tennessee. The process to determine the amount of pension
21 contribution appropriately allocable to Tennessee was originally developed in
22 Docket No. 08-00197.

1 **IV. ATTRITION PERIOD TAXES OTHER THAN INCOME TAXES**

2 **Q. DO YOU AGREE WITH MR. NOVAK'S CALCULATIONS OF OTHER**
3 **TAXES AS SUMMARIZED ON PAGE 14, LINES 13-23, OF HIS**
4 **TESTIMONY?**

5 A. No.

6 **Q. WHY DO YOU DISAGREE WITH MR. NOVAK'S CALCULATION OF**
7 **OTHER TAXES?**

8 A. Similar to his calculations for O&M Labor and Non-Labor expense, Mr. Novak
9 once again relies on several assumptions that ignore both the Company's budget
10 and attrition year components. Mr. Novak uses five years of the Company's
11 historical Other Taxes data and ignores the Company's filed Attrition Year data.
12 From the five years of historical amounts, Mr. Novak then calculates an Other
13 Tax growth factor using an arbitrarily-chosen three year amount⁶ to arrive at his
14 Attrition Period Other Tax expense. As with other O&M expenses, I believe the
15 Company's budget process is far superior in forecasting proper Other Taxes
16 expense for the attrition year. Mr. Novak's failure to make any use of the
17 Company's budgeted amounts does not allow known and measurable changes to
18 be included, which is critical when trying to forecast spending. Indeed, Mr.
19 Novak's negative growth rate of -0.43% for Other Tax at a time of increasing
20 capital spending by the Company demonstrates the unreliable nature of Mr.

⁶ Similar to other O&M expense growth factors utilized by Mr. Novak, the only justification offered to support the use of a three year growth factor was "to be consistent with [CAPD's] O&M calculation methodology and because I felt this rate was most representative of what was likely to occur through the attrition year." Docket No. 14-00146, Direct Testimony of Hal Novak, p.14, lines 19-21.

1 Novak's methodology.⁷ The Authority should reject Mr. Novak's methodology
2 of Other Tax expense, and rather adopt the methodology proposed by the
3 Company in its filing.
4

5 **V. ATTRITION PERIOD RATE BASE**

6 **Q. DID MR. NOVAK MAKE ANY RECOMMENDATIONS ALTERING THE**
7 **COMPANY'S FILED ATTRITION PERIOD RATE BASE FORECAST?**

8 A. Yes. Specifically, Mr. Novak appears to make thirteen recommendations (from
9 page 16 through page 22 of his testimony) regarding the following components of
10 the Company's attrition period rate base: Utility Plant in Service (Line 1);
11 Construction Work in Progress (Line 2); Gas Inventory (Line 3); Materials &
12 Supplies (Line 4); Regulatory Asset (Line 5); Intercompany Leased Property
13 (Line 6); Working Capital (Line 7); Accumulated Depreciation (Line 9);
14 Accumulated Deferred Income Taxes ("ADIT") (Line 10); Operating Reserves
15 (Line 11); Customer Advances (Line 12); Customer Deposits (Line 13); and
16 Accumulated Interest on Customer Deposits (Line 14).

17 **Q. DO YOU AGREE WITH ALL THIRTEEN PROPOSED**
18 **RECOMMENDATIONS BY MR. NOVAK?**

19 A. No. I disagree with Mr. Novak's proposed adjustments regarding Utility Plant in
20 Service, Construction Work in Progress, Gas Inventory, Regulatory Asset,
21 Accumulated Depreciation, ADIT and Operating Reserves. I will address the

⁷ The Company would also point out that even though it is not agreeing to Mr. Novak's proposed methodology, he has also incorrectly calculated his Other Taxes growth rate by dividing the rate by the wrong number of years. See WP T-1.5.

1 reasons why the Company disagrees with each of these in my testimony, except
2 for ADIT. The rebuttal testimony of Company witness Pace McDonald will set
3 forth the reasons for the Company's disagreement with Mr. Novak's ADIT
4 recommendations.

5 **Q. DO YOU AGREE WITH ANY OF THE PROPOSED**
6 **RECOMMENDATIONS BY MR. NOVAK?**

7 A. Yes, I agree with Mr. Novak's proposals regarding Materials & Supplies,
8 Intercompany Leased Property, Working Capital, and Customer Advances.

9 **Q. WHY DO YOU DISAGREE WITH MR. NOVAK'S ADJUSTMENT TO**
10 **UTILITY PLANT IN SERVICE AS SUMMARIZED ON PAGE 16, LINES**
11 **8-22 OF HIS TESTIMONY?**

12 A. Similar to the Company's Attrition Period O&M Expenses, I believe that our
13 budgeting process⁸ is the best and most accurate method to forecast capital
14 investment and therefore Attrition Period Utility Plant in Service. In contrast, Mr.
15 Novak once again relies on historical spending amounts and arbitrary run rates to
16 calculate future capital investment plans for the Company. For his analysis, Mr.
17 Novak uses a four-year historical run rate⁹ on Plant and calculates an average
18 plant addition amount for the Attrition Period. Throughout his workpapers, Mr.
19 Novak makes several adjustments within his run rate calculations with little or no
20 explanation or support. For example, in his workpaper labeled RB-11-1.02A, Mr.
21 Novak arbitrarily removes approximately \$11.81 million of capital spending from

⁸ See, e.g., Docket No. 14-00146, Pre-Filed Testimony of Gregory Waller on Behalf of Atmos Energy, pp. 20-34.

⁹ As opposed to three-year growth rate for O&M.

1 Division 093 (Tennessee) Plant and his calculated run rate, based upon the
2 unsupported assertion that he believes they are somehow unjustified.¹⁰ These
3 dollars represent capital spending that the Company has directly invested in
4 Tennessee and Mr. Novak makes no claim that these investments were
5 imprudently made. The difference between Mr. Novak's methodology and the
6 Company's methodology for Utility Plant in Service is especially noticeable in
7 the calculated Division 093 additions for the Attrition Period. Mr. Novak's
8 historical growth rate method that does not incorporate the Company's budget has
9 projected only \$16,617,774 in Division 093 Additions for FY15. In contrast, the
10 Company has a FY15 capital budget for Division 093 of \$27,947,356.¹¹ This is a
11 difference of \$11,329,582 for this fiscal year alone. This large difference in FY15
12 alone clearly shows how out of touch Mr. Novak's methodology is with the actual
13 investment that the Company plans to make during the attrition period. I will also
14 note Authority precedent for the methodology used by the Company in
15 calculating its Attrition Period Utility Plant in Service. Indeed, in Docket No. 09-
16 00183 the Authority found that the same methodology the Company employs in
17 this docket, and was supported by the CAPD in that docket, "is reasonable."¹²

¹⁰ Mr. Novak claims the \$11.81M removed is due to these projects being special, rather than normal. However, Mr. Novak does not add this amount back in his workpapers when calculating his special addition run rate.

¹¹ This amount was provided to Mr. Novak as a relied upon filed labeled "KMD FY15 CapEx Projected Budget Final."

¹² Docket No. 09-00183, Order, P. 34. ("UPIS and CWIP were calculated by both parties by taking the balance at December 31, 2009, adding budgeted plant additions and retirements by month including the allocated plant of 3.12% from the parent company through April 30, 2011. The Company and the Consumer Advocate both calculated the average projected thirteen months balance for the period ending April 11, 2011 to arrive at UPIS and CWIP for the attrition period. The Company and Consumer Advocate agreed upon a net amount of \$202,527,956 for UPIS and CWIP. The panel voted unanimously to adopt the agreed-upon UPIS and CWIP of \$202,527,956 for the attrition year ending April 30, 2011, based upon the determination of the booked amounts in this case and upon finding that this amount is reasonable.")

1 The Authority should reject Mr. Novak's Utility Plant in Service methodology,
2 and rather adopt the Company's proposed methodology for Utility Plant in
3 Service as provided in the Company's filing.

4 **Q. WHY DO YOU DISAGREE WITH MR. NOVAK'S ADJUSTMENT TO**
5 **CONSTRUCTION WORK IN PROGRESS ("CWIP") AS SUMMARIZED**
6 **ON PAGE 17, LINES 21-22, AND PAGE 18, LINES 1-8, OF HIS**
7 **TESTIMONY?**

8 A. In compliance with the uniform system of accounts, when the Company makes
9 capital expenditures they are booked to projects and recorded in CWIP. When a
10 project is complete and the resulting assets are placed in service, the accumulated
11 cost of the project is removed from CWIP and added to gross plant in service. As
12 of June 30, 2014 the Company had approximately \$446.9 million of plant in
13 service in or allocated to Tennessee and approximately \$8.6 million of CWIP, for
14 a combined investment of \$455.5 million related to its Tennessee service area.
15 After June 30, 2014, as the projects in CWIP as of June 30, 2014 were completed,
16 some of the \$8.6 million of CWIP was moved to plant in service. Also after June
17 30, 2014, as additional amounts were spent on capital projects, additional
18 spending was first booked to CWIP and then, as projects were completed, was
19 moved to plant in service.

20 As I developed the projected level of plant in service and the projected level of
21 CWIP for the forecasted test year, the amount of CWIP on the Company's books
22 as of June 30, 2014, and the monthly projected capital investment were known. I
23 knew that each month as these amounts were spent and recorded to CWIP capital

1 projects would be completed and amounts would be moved from CWIP to plant
2 in service. I knew that in the normal course of business over time everything that
3 was properly recorded to CWIP would be moved to plant in service. I made the
4 reasonable assumption that each month the amount moved from CWIP to plant in
5 service would be equal to the amount of capital spending recorded to CWIP. This
6 has no effect on the combined total of CWIP and plant in service included in rate
7 base. The result of my projection was to include in the projected rate base the
8 investment in CWIP and plant in service as of June 30, 2014, and the planned
9 capital spending after June 30, 2014, through the forecasted attrition period.

10 Mr. Novak argues for a representative and normalized amount of CWIP, but never
11 address how the June 30, 2014 CWIP balance gets to that normalized amount. He
12 adjusts downward the level of CWIP from approximately \$8.6 million to his
13 number of approximately \$7.6 million with no indication of where that investment
14 went. Under his recommendation, the missing CWIP just disappears. Mr.
15 Novak's recommendation is illogical and should not be adopted by the Authority.

16 **Q. WHY DO YOU DISAGREE WITH MR. NOVAK'S ADJUSTMENT TO**
17 **GAS INVENTORY AS SUMMARIZED ON PAGE 18, LINES 9-16, OF HIS**
18 **TESTIMONY?**

19 A. Mr. Novak's adjustment for Gas Inventory once again relies on a calculated
20 historical average, in this case four years, rather than utilizing the Company's
21 anticipated withdrawals and injections from storage for the Attrition Period. Mr.
22 Novak offers no justification as to why his "normalization" of gas inventory better
23 indicates Attrition Period gas inventory than the methodology represented in my

1 pre-filed testimony. The Authority should reject Mr. Novak's proposed Gas
2 Inventory adjustment,

3 **Q. WHY DO YOU DISAGREE WITH MR. NOVAK'S REGULATORY**
4 **ASSET ADJUSTMENT AS SUMMARIZED ON PAGE 19, LINES 3-8, OF**
5 **HIS TESTIMONY?**

6 A. Mr. Novak has removed entirely, from Attrition Period rate base, a \$973,868 rate
7 base item representing the average unamortized balance of the regulatory asset
8 related to the Company's pension expense. Mr. Novak justifies the removal by
9 claiming that "no regulatory asset was ever recognized by the TRA in these cases
10 and no corresponding adjustment was made to rate base."¹³ I disagree. Authority
11 decisions in both the 2008 and 2012 Company rate cases have affirmed that a
12 regulatory asset for normalization of pension expense was recognized.¹⁴ In fact,
13 the Final Order for the Company's 2012 rate case in Docket No. 12-00064
14 explicitly states "[i]n addition, the *Stipulation and Settlement Agreement* provides
15 for a mechanism to be put in place to true-up Atmos' pension funding quarterly,
16 resulting in the establishment of a regulatory asset to be included in the rate base
17 calculation of the Company until the TRA orders new treatment."¹⁵

18 **Q. WHY DO YOU DISAGREE WITH MR. NOVAK'S ADJUSTMENT TO**
19 **ACCUMULATED DEPRECIATION AS SUMMARIZED ON PAGE 20,**
20 **LINES 3-7, OF HIS TESTIMONY?**

¹³ Docket No. 14-00146, Pre-Filed Direct Testimony of Hal Novak, p.19, lines 6-7.

¹⁴ See Docket No. 14-00146, Pre-Filed Direct Testimony of Gregory Waller, p. 7-8.

¹⁵ Docket No. 12-00064, Order Approving Settlement Agreement, p.2.

1 A. Mr. Novak's Accumulated Depreciation adjustment results from his alternate
2 methodology in calculating Utility Plant in Service. I refer back to my previous
3 response disagreeing with Mr. Novak's Utility Plant in Service adjustment in
4 arguing against the reasonableness of Mr. Novak's Accumulated Depreciation
5 adjustment. The Authority should reject this adjustment and the methodology
6 used in its calculation.

7 **Q. WHY DO YOU DISAGREE WITH MR. NOVAK'S ADJUSTMENT TO**
8 **OPERATING RESERVES AS SUMMARIZED ON PAGE 21, LINES 15-21,**
9 **OF HIS TESTIMONY?**

10 A. Mr. Novak's adjustment to operating reserves is incorrect as he relies once again
11 on historical information and refuses to utilize the attrition period budget as
12 provided by the Company. From a ratemaking perspective, it is only appropriate
13 to include Reserves (Account 2282) as a reduction to rate base if the expense that
14 was recorded to create the reserve is reflected in rates. Because the Company's
15 filing uses its O&M budget (rather than historic O&M) in calculating revenue
16 requirement, the expenses related to its reserves balances are not reflected in
17 revenue requirement. Simply put, Mr. Novak's proposed adjustment is improper
18 ratemaking. The Authority should reject Mr. Novak's proposed Operating
19 Reserves adjust, and rather adopt the methodology presented in my pre-filed
20 testimony.

21

22

23

VI. ANNUAL REVIEW MECHANISM

Q. DO YOU AGREE WITH MR. NOVAK'S OPPOSITION TO THE

PROPOSED ANNUAL REVIEW MECHANISM ("ARM") AS

SUMMARIZED ON PAGE 40, LINES 10-16, OF HIS TESTIMONY?

A. I do not agree that a true-up is necessary as part of the approval of an ARM tariff.

Q. WHY DO YOU DISAGREE WITH MR. NOVAK'S RECOMMENDATION

REGARDING DENIAL OF THE ARM TARIFF WITHOUT A TRUE-UP?

A. The Company's budgeting process and budget is the best indication of future spending and investment and therefor a true-up is not necessary. For a full review of the Company's budgeting process please see pages 20-34 of my Pre-Filed Direct Testimony. In my opinion, the utilization of the Company's methodology and budgeting process renders a true-up unnecessary.

Q. PLEASE DISCUSS THE COMPANY'S POSITION ON A POSSIBLE

TRUE-UP FOR THE ARM?

A. Although the Company did not propose a true-up for the ARM, we are not opposed to a true-up should the Authority decide that adding a true-up is a necessary condition to approval of the ARM tariff..

Q. SHOULD THE AUTHORITY IMPLEMENT A TRUE-UP, HOW WOULD

YOU PROPOSE FILING THE TRUE-UP IN RELATION TO THE ARM?

A. Should the Authority adopt a true-up, or annual reconciliation to actual return, I would propose the following process:

On or before a set date each year, the Company could submit to the Authority a reconciliation of actual results to the Authorized Return on Equity for the Forward

1 Looking Test Year immediately completed. The annual reconciliation could
2 include a calculation to determine the revenue requirement (the Annual
3 Reconciliation Revenue Requirement) necessary to adjust the actual return on
4 equity to the Authorized Return on Equity for the Forward Looking Test Year
5 immediately completed (ignoring the revenue impact of any prior year
6 reconciliation) all determined in accordance with the ratemaking methodologies
7 adopted by the Authority in this Docket. The resulting Annual Reconciliation
8 Revenue Requirement could then be netted against the revenue
9 sufficiency/deficiency that results from the Company's filing on its next annual
10 ARM filing, with the net resulting rates to be placed into effect on a fixed date
11 thereafter. All tariff rates (except special contract rates, which would not be
12 affected) would be adjusted in proportion to the relative base revenue share of
13 each class. Tariff language enacting this true-up mechanism would mirror these
14 provisions, but with the addition of specific filing dates.

15 **Q. WHEN MIGHT THE FIRST FILINGS FOR THIS RECONCILIATION**
16 **FILING OCCUR?**

17 A. As proposed, the first Annual Review Mechanism Filing would occur on or
18 before September 1, 2015 and be applicable to the Forward Looking Test Year
19 ending December 31, 2016. Given that, the first Annual Reconciliation Revenue
20 Requirement filing could occur on or before April 1, 2017, and would reconcile
21 the Forward Looking Test Year ended December 31, 2016. The resulting Annual
22 Reconciliation Revenue Requirement would then be incorporated into the
23 Company's September 1, 2017 Annual Filing.

1
2 **VII. OTHER CONSIDERATIONS**

3 **Q. DO YOU WISH TO RESPOND TO MR. NOVAK'S TESTIMONY**
4 **REGARDING "OTHER CONSIDERATIONS" (NOVAK PAGE 44, LINES**
5 **2-20)?**

6 A. Yes. Mr. Novak made comments in his testimony regarding the documentation
7 and support detail filed by the Company in this case. I completely disagree with
8 Mr. Novak's suggestion that the case was filed with insufficient documentation or
9 supporting information.

10 **Q. WHAT DID THE COMPANY FILE WITH THIS DOCKET?**

11 A. The Company filed this case with its complete economic model and all supporting
12 workpapers necessary to calculate its filed revenue requirement. In addition, the
13 Company responded to formal and informal discovery requests that far and away
14 exceeded the number of questions permitted under the Authority's rules, usually
15 ahead of schedule and beyond all deadlines established by the Procedural
16 Schedule. Company employees also spent considerable time, both in person and
17 by email and telephone, helping the CAPD and Mr. Novak understand what the
18 Company had filed and find specific pieces of information. Often, the
19 information sought was already included within the Company's model and
20 supporting workpapers. It is also worthy of note that the case has been completed
21 without having to litigate a single discovery dispute.

22 **Q. WAS THE COMPANY SUCCESSFUL IN GETTING CAPD TO CLARIFY**
23 **WHAT WAS LACKING IN TERMS OF INFORMATION?**

1 A. No. When the Company asked the CAPD in a formal data request for
2 clarification as to which and how each of the Minimum Filing Requirements and
3 data requests were utilized in connection with the case, or would be utilized in a
4 future ARM filing, the CAPD was unwilling to answer and stated that the request
5 sought "information not relevant to this case".¹⁶ It is illogical that Mr. Novak
6 would simultaneously claim that the Company's documentation in its filing was
7 inadequate, while being unwilling or unable to provide details as to how he
8 utilized the volumes of information submitted by the Company and requested by
9 the Advocate and Staff. This lack of response by Mr. Novak and the CAPD to the
10 Company's data requests allows for no clarification and underscores the CAPD's
11 baseless assertion concerning an alleged lack of support in its filing.
12

13 VIII. CONCLUSION

14 **Q. DO YOU BELIEVE THAT THE FORWARD LOOKING TEST YEAR**
15 **FORECASTS YOU HAVE PRESENTED ARE THE MOST REASONABLE**
16 **ESTIMATES OF COST OF SERVICE COMPONENTS FOR THIS**
17 **FILING AND FUTURE ANNUAL RATE REVIEW FILINGS?**

18 A. Yes. The use of the Company's budget and its budgeting process in forming the
19 forward looking test year is the best estimate we have of the Tennessee
20 jurisdiction's cost of service.

21 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

22 A. Yes.

¹⁶ See Docket No. 14-00146, Consumer Advocate and Protection Division's Responses to First Discovery Requests of Atmos Energy Corporation, 1-7 and 1-8.

BEFORE THE TENNESSEE REGULATORY AUTHORITY

NASHVILLE, TENNESSEE

IN RE:

ATMOS ENERGY CORPORATION
GENERAL RATE
CASE AND PETITION TO ADOPT
ANNUAL REVIEW MECHANISM
AND ARM TARIFF

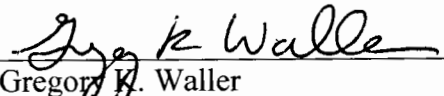
Docket No. 14-00146

VERIFICATION

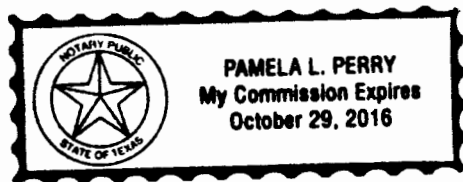
STATE OF TEXAS)

COUNTY OF DALLAS)

I, Gregory K. Waller, being first duly sworn, state that I am the Manager of Rates and Regulatory Affairs for Atmos Energy Corporation, that I am authorized to testify on behalf of Atmos Energy Corporation in the above referenced docket, that the Rebuttal Testimony of Gregory K. Waller in Support of Atmos Energy Corporation's Petition and the Exhibits thereto pre-filed in this docket on the date of filing on this Petition are true and correct to the best of my knowledge, information and belief.


Gregory K. Waller

Sworn and subscribed before me this 23rd day of April, 2015




Notary Public

My Commission Expires: 10-29-16

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

IN RE:

**ATMOS ENERGY CORPORATION)
GENERAL RATE)
CASE AND PETITION TO ADOPT)
ANNUAL REVIEW MECHANISM)
AND ARM TARIFF)**

DOCKET NO. 14-00146

**REBUTTAL TESTIMONY OF JOE T. CHRISTIAN
ON BEHALF OF ATMOS ENERGY CORPORATION**

I. INTRODUCTION OF WITNESS

1

2 **Q. PLEASE STATE YOUR NAME, POSITION AND BUSINESS ADDRESS.**

3 A. My name is Joe T. Christian. I am employed by Atmos Energy Corporation
4 ("Atmos Energy" or the "Company") as Director of Rates & Regulatory Affairs.

5 My business address is 5420 LBJ Freeway, Ste. 1600, Dallas, Texas 75240.

6 **Q. ARE YOU THE SAME JOE CHRISTIAN THAT FILED PREFILED**
7 **TESTIMONY IN THIS PROCEEDING?**

8 A. Yes.

9 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

10 A. The purpose of my testimony is to rebut the capital structure testimony of the
11 Consumer Advocate and Protection Division (CAPD) witness Dr. Christopher
12 Klein.

13 **Q. DO YOU AGREE WITH DR. KLEIN'S PROPOSED CAPITAL**
14 **STRUCTURE AS SUMMARIZED ON PAGE 2 OF HIS EXHIBIT AND**
15 **EXPLAINED ON PAGE 7, BEGINNING ON LINE 15 AND CONTINUING**
16 **TO PAGE 8, LINE 20?**

1 A. No. Specifically, I disagree with Dr. Klein's inclusion of short-term debt as part
2 of the Company capital structure and the inclusion of a short-term debt rate in
3 deriving the overall cost of capital for Atmos Energy.

4 **Q. WHAT IS DR. KLEIN'S RATIONALE FOR INCLUDING SHORT-TERM**
5 **DEBT?**

6 A. Dr. Klein proposes including 1.50% short-term debt in the Company's capital
7 structure on the logic that it is important to recognize the use of short-term debt
8 by the Company, even if it is eventually converted to long-term debt or equity at
9 some point in the future. Dr. Klein also offers that the inclusion of short-term
10 debt is appropriate because Atmos Energy included some in its previous rate case
11 (Docket No. 12-00064).

12 **Q. WHY DO YOU DISAGREE WITH DR. KLEIN'S INCLUSION OF**
13 **SHORT-TERM DEBT IN HIS PROPOSED CAPITAL STRUCTURE?**

14 A. I disagree with Dr. Klein for two reasons. First, Dr. Klein cites the Company's
15 response to CAPD DR Set No. 1-38 (Page 7, Line 21) and selectively recites only
16 two years of the four years given. Combined with the capital structure provided
17 for June 30, 2014, Atmos Energy has had zero short-term debt three of the past
18 five years for the period ended June 30. Second, Dr. Klein offers no analytical
19 methodology that can be replicated in a future annual review mechanism. As
20 stated in paragraph one of the Company's petition, this docket is being filed to
21 allow implementation of the statutory Annual Review Mechanism authorized
22 under Section 65-5-103(d)(6).

1 **Q. HOW DOES A LACK OF ANALYTICAL METHODOLOGY HINDER**
2 **IMPLEMENTATION OF AN ANNUAL REVIEW MECHANISM?**

3 A. As stated above, Dr. Klein picked a short-term debt percentage using undefined
4 judgment, based upon his selective look at two recent June period end capital
5 structure figures. That method of selecting a capital structure is not rooted in any
6 methodology or analysis that allows for the Company to calculate a short term
7 debt percentage in a future Annual Review Mechanism. Dr. Klein's selection is
8 not based on analytical analysis of the data and is therefore not appropriate in
9 defining a repeatable methodology in the context of the Annual Review
10 Mechanism.

11 **Q. DO YOU BELIEVE THAT DR. KLEIN ADEQUATELY ADDRESSES THE**
12 **RATIONALE YOU OFFERED IN DIRECT TESTIMONY AS TO WHY**
13 **EXCLUDING SHORT-TERM DEBT FROM THE CAPITAL**
14 **STRUCTURE IS APPROPRIATE?**

15 A. No. Dr. Klein does give passing reference to the need to include short-term debt
16 even if it is eventually converted to long-term debt or equity at some point in the
17 future (Klein Page 8, Lines 1-2) but he does not directly refute my reasoning that
18 excluding short-term debt is appropriate because the Company's use of short-term
19 debt is seasonal in nature and is not intended to be used to finance utility plant
20 (Christian Direct Page 16, Lines 6 – 8).

21 **Q. DOES DR. KLEIN'S TESTIMONY OR SUPPORTING**
22 **DOCUMENTATION SUPPORT HOW THE CAPITAL STRUCTURE**
23 **PROVIDED IN STAFF'S MODEL WAS DERIVED?**

1 A. No. Dr. Klein does address short-term debt and the short-term debt rate, but I did
2 not see any discussion or workpapers that supported how he incorporated short-
3 term debt into the capital structure listed on page 2 of his Exhibit.

4 **Q. DID YOU ASK HIM FOR WORKPAPERS OR FURTHER**
5 **EXPLANATION?**

6 A. Yes. Those were requested in discovery. Unfortunately, Dr. Klein only provided
7 a simple methodology that allocated his proposed short-term debt level evenly
8 between long-term debt and equity to support the capital structure numbers on
9 page 2 of his exhibit. This limited response, to the Company's data request 1-29,
10 did not offer an analytical methodology that could be replicated in a future annual
11 review mechanism.¹

12 **Q. WHAT METHODOLOGY WOULD YOU PROPOSE IF INCLUDING A**
13 **SHORT-TERM DEBT AS PART OF CAPITAL STRUCTURE WERE**
14 **DEEMED NECESSARY?**

15 A. Should the Tennessee Regulatory Authority choose to adopt a methodology
16 involving short-term debt as a component of capital structure, I would propose a
17 methodology to calculate short-term debt be exactly what was provided in the
18 Company's original filing package (Schedule 9 and Workpaper 9-2).
19 Specifically, I would take the twelve month average of short-term debt during the
20 historical test period and include this along with the period-ending balances for
21 Equity and Long-Term Debt.

¹ See Docket No. 14-00146, Consumer Advocate and Protection Division's Response to First Discovery Requests of Atmos Energy Corporation. 1-29.

1 Q. DO YOU AGREE WITH DR. KLEIN'S CALCULATION OF THE
2 SHORT-TERM DEBT COST RATE?

3 A. No. Again, I believe first and foremost that short-term debt should not be
4 included as part the of Company's capital structure. However, should the TRA
5 choose to adopt a methodology including short-term debt as a component of
6 capital structure, I disagree with Dr. Klein's method of calculating the short-term
7 debt cost rate.

8 Q. WHY DO YOU DISAGREE WITH DR. KLEIN'S METHOD?

9 A. The cost of short-term debt chosen by Dr. Klein is a judgment-based comparison
10 to historical short-term debt costs rates for the Company in 2012 and 2013, but
11 again is not rooted in any methodology or analysis that would allow for the
12 Company to calculate a short-term debt percentage in a future Annual Review
13 Mechanism.

14 Q. WHAT METHODOLOGY WOULD YOU PROPOSE IF CALCULATING
15 A COST RATE FOR SHORT-TERM DEBT IS NECESSARY?

16 A. Again, I would propose a methodology to calculate the cost rate of short-term
17 debt be exactly what was provided in the Company's original filing (Schedule 9
18 and Workpaper 9-2). In this current filing, this methodology calculates a short-
19 term debt cost rate of 1.07%.

20 Q. DOES THIS CONCLUDE YOUR TESTIMONY?

21 A. Yes

BEFORE THE TENNESSEE REGULATORY AUTHORITY

NASHVILLE, TENNESSEE

IN RE:

ATMOS ENERGY CORPORATION
GENERAL RATE
CASE AND PETITION TO ADOPT
ANNUAL REVIEW MECHANISM
AND ARM TARIFF

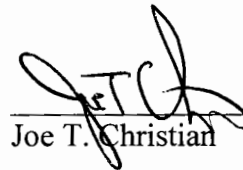
Docket No. 14-00146

VERIFICATION

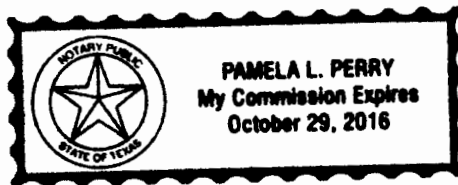
STATE OF TEXAS)

COUNTY OF DALLAS)

I, Joe T. Christian, being first duly sworn, state that I am the Director of Rates and Regulatory Affairs for Atmos Energy Corporation, that I am authorized to testify on behalf of Atmos Energy Corporation in the above referenced docket, that the Rebuttal Testimony of Joe T. Christian in Support of Atmos Energy Corporation's Petition and the Exhibits thereto pre-filed in this docket on the date of filing on this Petition are true and correct to the best of my knowledge, information and belief.


Joe T. Christian

Sworn and subscribed before me this 24th day of April, 2015




Notary Public

My Commission Expires: 10-29-16

BEFORE THE TENNESSEE REGULATORY AUTHORITY

IN RE:

**ATMOS ENERGY CORPORATION)
GENERAL RATE)
CASE AND PETITION TO ADOPT)
ANNUAL REVIEW MECHANISM)
AND ARM TARIFF)**

DOCKET NO. 14-00146

REBUTTAL TESTIMONY

OF

JAMES H. VANDER WEIDE, PH.D.

ON BEHALF OF ATMOS ENERGY CORPORATION

RATE OF RETURN

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I. WITNESS IDENTIFICATION

Q. What is your name and business address?

A. My name is James H. Vander Weide. I am President of Financial Strategy Associates, a firm that provides strategic and financial consulting services to business clients. My business address is 3606 Stoneybrook Drive, Durham, North Carolina 27705.

Q. Are you the same James Vander Weide who previously filed direct testimony in this proceeding?

A. Yes, I am.

Q. What is the purpose of your rebuttal testimony?

A. I have been asked by Atmos Energy Corporation ("Atmos Energy" or "the Company") to review the direct testimony of Dr. Christopher C. Klein and to respond to his comments and recommendations regarding the appropriate cost of equity for Atmos Energy. Dr. Klein's testimony is presented on behalf of the Tennessee Attorney General Consumer Advocate and Protection Division ("CAPD").

II. SUMMARY OF DR. KLEIN'S COST OF EQUITY RECOMMENDATION

Q. What is Dr. Klein's recommended cost of equity for Atmos Energy?

A. Dr. Klein recommends a cost of equity for Atmos Energy equal to 9.0 percent (Klein Direct at p. 5, lines 17-19).

Q. How does Dr. Klein arrive at his recommended 9.0 percent cost of equity for Atmos Energy?

A. Dr. Klein arrives at his recommended 9.0 percent cost of equity for Atmos Energy by applying the Discounted Cash Flow ("DCF") model and Capital Asset Pricing Model ("CAPM") to a proxy group of local natural gas distribution companies ("LDCs").

1 Q. What conclusions do you reach from your analysis of Dr. Klein's cost of equity
2 studies?

3 A. I conclude that Dr. Klein's DCF and CAPM analyses produce cost of equity estimates
4 that are below a reasonable range of cost of equity estimates for his proxy companies. As
5 explained below, Dr. Klein's underestimate of his proxy companies' cost of equity arises
6 from biases in his choices regarding the appropriate inputs in his DCF and CAPM
7 analyses.

8 **III. DR. KLEIN'S DCF ANALYSIS**

9 Q. What cost of equity result does Dr. Klein report from his application of his DCF
10 model to his proxy companies?

11 A. Dr. Klein reports a DCF result of 8.9 percent for his proxy group of natural gas utilities.
12 (Klein Direct p. 9, line 22).

13 Q. Do you agree with Dr. Klein's application of the DCF model to his proxy group of
14 natural gas utilities?

15 A. No. I disagree with Dr. Klein's: (1) use of an annual rather than a quarterly DCF model;
16 (2) estimate of the dividend yield component; (3) estimate of investors' growth
17 expectations; and (4) failure to include an allowance for flotation costs in his DCF
18 calculations.

19 **A. Annual DCF Model**

20 Q. What DCF model does Dr. Klein use to estimate Atmos Energy's cost of equity?

21 A. Dr. Klein uses an annual DCF model of the form, $k = D_0/P_0 + g$, where k is the cost of
22 equity, D_0 is the most recent annualized dividend, P_0 is the current stock price, and g is
23 the average expected future growth in the company's earnings and dividends (see Klein

1 Direct at p. 9, lines 8 – 10). As described in my direct testimony, this equation can only
2 be derived under the assumption that dividends are paid annually (see Vander Weide
3 Direct at pp. 17 – 18 and Appendix 2).

4 **Q. What are the basic assumptions of the annual DCF model?**

5 A. The annual DCF model is based on the assumptions that: (1) a company's stock price is
6 equal to the present value of the future dividends investors expect to receive from their
7 investment in the company; (2) dividends are paid annually; (3) dividends, earnings, and
8 book values are expected to grow at the same constant rate forever; and (4) the first
9 dividend is received one year from the date of the analysis.

10 **Q. Do you agree with Dr. Klein's use of an annual DCF model to estimate Atmos**
11 **Energy's cost of equity?**

12 A. No. Dr. Klein's annual DCF model is based on the assumption that companies pay
13 dividends only once each year. Since Dr. Klein's proxy companies all pay dividends
14 quarterly, Dr. Klein should have used the quarterly DCF model to estimate Atmos
15 Energy's cost of equity.

16 **Q. Why is it unreasonable to use an annual DCF model to estimate the cost of equity**
17 **for companies that pay dividends quarterly?**

18 A. It is unreasonable to apply an annual DCF model to companies that pay dividends
19 quarterly because: (1) the DCF model is based on the assumption that a company's stock
20 price is equal to the present value of the expected future dividends associated with
21 investing in the company's stock; (2) a company's stock price reflects both the magnitude
22 and the timing of the company's expected future dividends; and (3) the annual DCF

1 model cannot be derived from the assumption that a company's stock price is equal to the
2 present value of expected future dividends when dividends are paid quarterly.

3 **B. Estimate of Dividend Yield**

4 **Q. Recognizing your disagreement with Dr. Klein's use of an annual DCF model, did**
5 **Dr. Klein apply the annual DCF model correctly (see Klein Direct Exhibit at p. 3 of**
6 **18)?**

7 A. No. The annual DCF model is based on the assumptions that earnings and dividends are
8 paid annually at the end of the year and grow at the same constant rate forever. Under the
9 assumptions that earnings and dividends are paid annually and grow at the same constant
10 rate forever, the cost of equity is given by the equation, $k = D_0 (1 + g) / P_0 + g$, where D_0
11 is the current annualized dividend, P_0 is the stock price, and g is the expected constant
12 annual growth rate (see Vander Weide Direct at p. 18 and Appendix 2). Thus, the correct
13 first period dividend in the annual DCF model is the current annualized dividend
14 multiplied by the factor, $(1 + \text{growth rate})$. Instead, Dr. Klein simply uses the current
15 dividend in his DCF model (see Klein Direct Exhibit at p. 3 of 18).

16 **C. Estimate of Investors' Growth Expectations**

17 **Q. The DCF model requires an estimate of investors' growth expectations. How does**
18 **Dr. Klein estimate investors' growth expectations in his DCF analysis?**

19 A. Dr. Klein relies on Value Line dividend per share ("DPS") and earnings per share
20 ("EPS") growth forecasts for the three-year period 2011 – 2013 to the three-year period
21 2018 – 2020 to estimate investors' growth expectations for his proxy companies (see
22 Klein Direct Exhibit at p. 3 of 18, note 1; the forecast period for the Value Line growth
23 estimates are shown on the Value Line report pages).

1 Q. Do you agree with Dr. Klein's use of Value Line forecasts of future dividend and
2 earnings growth for the period 2011 - 2013 to the period 2018 - 2020?

3 A. No. I have several objections to Dr. Klein's use of Value Line forecasts of future
4 dividend and earnings growth for the period 2011 - 2013 to the period 2018 - 2020. First,
5 the DCF model requires growth rates that begin in the current period and end in a future
6 period. Instead, Value Line's projected growth rates begin in a three-year period, 2011 -
7 2013, that is already in the past. Because Value Line's projected growth rates begin in a
8 period that is in the past, they are not as useful as analysts' growth forecasts in a model
9 such as the DCF that requires forecast information beginning in the current period.

10 Second, as discussed below, I disagree with Dr. Klein's use of Value Line's dividend
11 growth forecasts (*see* Klein Direct Exhibit at p. 3 of 18) because Value Line's dividend
12 growth forecasts are based on Value Line's assumption that the proxy companies'
13 dividend payout ratios will decline over the forecast period. However, once the proxy
14 companies reach their long-run dividend payout target, dividends must grow at the same
15 rate as earnings.

16 Third, my studies indicate that investors use the consensus analysts' projections of
17 earnings per share growth to estimate the expected growth component of the DCF model.

18 Q. Does Value Line expect the natural gas utilities' dividends and earnings to grow at
19 the same rate over the Value Line forecast period?

20 A. No. Value Line's average earnings growth forecast for Dr. Klein's natural gas utilities is
21 5.67 percent, while the Value Line average dividend growth forecast for these natural gas
22 utilities is only 4.39 percent (*see* Klein Direct Exhibit at p. 3 of 18). Thus, Value Line

1 expects that the natural gas utilities' dividends will grow by 128 basis points less than
2 their earnings over the Value Line forecast period.

3 **Q. Does Value Line's significantly lower dividend growth forecast compared to its**
4 **earnings growth forecast for the natural gas utilities indicate that Value Line is**
5 **forecasting that the natural gas utilities' average dividend payout ratio will decline?**

6 A. Yes. A company's dividend payout ratio is equal to the percentage of earnings that is paid
7 out as dividends. If forecasted dividend growth is expected to be less than forecasted
8 earnings growth, then the forecasted dividend payout ratio is necessarily expected to
9 decline.

10 **Q. Do different dividend and earnings growth rates cause any problems in the**
11 **application of the DCF Model?**

12 A. Yes. The DCF model is based on the assumption that dividends and earnings will grow at
13 the same rate. If earnings and dividends are expected to grow at diverging rates in the
14 short run, an analyst must decide whether the dividend or earnings growth forecast is the
15 best indicator of long-run future growth.

16 **Q. Is Value Line's forecasted dividend growth rate an important indicator of long-run**
17 **future growth for natural gas utilities?**

18 A. No. Dividend growth forecasts are, in general, less accurate indicators of long-run future
19 growth than are earnings growth forecasts. When analysts forecast dividend growth, they
20 first must estimate earnings growth and then forecast the percentage of earnings that will
21 be paid out as dividends. Since the percentage of earnings that are paid out as dividends
22 is uncertain, there is an additional element of error present in dividend growth forecasts
23 than is present in earnings growth forecasts.

1 In addition, Value Line's current average dividend growth forecast for the natural
2 gas utilities is based on its assumption that natural gas utilities are in the process of
3 adjusting to a lower target dividend payout ratio. As shown below, dividends must grow
4 at the same rate as earnings once these companies have achieved their new target
5 dividend payout ratio. Thus, Value Line's forecasted earnings growth rate is a better
6 estimate of long-run dividend growth than its current forecasted dividend growth rate.

7 **Q. Suppose that analysts expect a company's dividends to grow by less than its**
8 **earnings over the next several years because of the company's transition to a new,**
9 **lower target dividend payout ratio. Does this situation imply that analysts' earnings**
10 **growth projections for this company cannot be used to estimate the "g" term in the**
11 **DCF model?**

12 **A. No. To illustrate, suppose that a company's current dividend payout ratio is**
13 **approximately 75 percent and that the company intends to adjust its dividend payout ratio**
14 **to 60 percent. Once the company achieves its new dividend payout target, dividends will**
15 **grow at the same rate as earnings. As long as the transition is relatively short, the**
16 **earnings growth forecast would still be a good estimate of long-term dividend growth in**
17 **the DCF Model.^[1]**

¹ For any one-year period of time, a company's earnings growth rate is given by the equation:

$$g_E = \frac{E_t}{E_{t-1}}$$

Assuming that the company has achieved its new dividend payout ratio of 60%, its dividend growth rate is given by the equation:

$$g_D = \frac{D_t}{D_{t-1}} = \frac{.6 E_t}{.6 E_{t-1}} = \frac{E_t}{E_{t-1}}$$

Thus, once the company achieves its new dividend payout ratio, dividends must grow at the same rate as earnings.

1 Q. How do you recommend estimating the future growth component in the DCF
2 model?

3 A. As described in my written evidence, I recommend using the analysts' forecasts
4 published by I/B/E/S Thomson Reuters.

5 Q. Why do you recommend using analysts' growth forecasts to estimate the growth
6 component of the DCF model?

7 A. I recommend using analysts' growth forecasts in the DCF model because the DCF model
8 requires the growth expectations of investors, and my studies indicate that analysts'
9 growth forecasts are the best proxy for investors' growth expectations.

10 Q. Are analysts' forecasts readily available?

11 A. Yes. An important part of the analysts' job is getting their views across to investors.
12 Major investment firms send out monthly reports with their earnings forecasts, and
13 institutional investors have direct access to analysts. Individual investors can get the same
14 forecasts through their investment advisors or online. Studies reported in the academic
15 literature indicate that recommendations based on these forecasts are relied on by
16 investors. Indeed, because analysts' forecasts are perceived by investors as being useful,
17 there are services which offer analysts' forecasts on all major stocks. I/B/E/S and Zack's
18 are some of the providers of these data. I recommend use of the I/B/E/S growth rates
19 because they have been: (1) shown to be highly correlated with stock prices; (2) widely
20 studied in the finance literature; and (3) widely available to investors for many years.

21 Q. Is it your contention that analysts make perfectly accurate predictions of future
22 earnings growth?

1 A. No. Forecasting earnings growth, for either the short-term or long-term, is very difficult.
2 This statement is consistent with the fact that stocks, unlike high-quality bonds, are risky
3 investments whose returns are highly uncertain. Though analysts' forecasts are not
4 perfectly accurate, they are better than either retention growth rates or historical growth
5 in predicting stock prices. One would expect this result, given that analysts have all the
6 past data plus current information. The important consideration is: what growth rates do
7 investors use to value a stock? Financial research suggests that the analysts' growth
8 forecasts are used by investors and therefore most related to stock prices.

9 **Q. Does the observation that analysts' growth forecasts are inherently uncertain imply**
10 **that investors should ignore analysts' growth forecasts in making stock buy and sell**
11 **decisions?**

12 A. No. Because growth forecasts have a significant influence on a company's stock price,
13 investors have a great incentive to use the best available forecasts of a company's growth
14 prospects, even if these growth forecasts are inherently uncertain. In this regard, the
15 investor's situation is similar to the situation of a pilot who is flying across the country.
16 Although the pilot recognizes that weather forecasts are inherently uncertain, he or she
17 has a strong incentive to obtain the best available forecasts of cross-country weather
18 patterns before taking off.

19 **Q. Have you done research on the appropriate use of analysts' forecasts in the DCF**
20 **model?**

21 A. Yes. As described in my direct testimony, I prepared a study with Willard T. Carleton,
22 Professor of Finance Emeritus at the University of Arizona, on why analysts' forecasts
23 are the best estimate of investors' expectations of future long-term growth. This study is

1 described in a paper entitled "Investor Growth Expectations and Stock Prices: the
2 Analysts versus History," published in the Spring 1988 edition of *The Journal of*
3 *Portfolio Management*. My studies indicate that the analysts' forecasts of future growth
4 are superior to historically-oriented growth measures and retention growth measures in
5 predicting a firm's stock price.

6 **Q. Please summarize the results of your study.**

7 A. First, we performed a correlation analysis to identify the historically oriented growth
8 rates which best described a firm's stock price. Then we did a regression study
9 comparing the historical and retention growth rates to the consensus analysts' forecasts.
10 In every case, the regression equations containing the average of analysts' forecasts
11 statistically outperformed the regression equations containing the historical and retention
12 growth estimates. These results are consistent with those found by Cragg and Malkiel, the
13 early major research in this area (John G. Cragg and Burton G. Malkiel, *Expectations and*
14 *the Structure of Share Prices*, University of Chicago Press, 1982). These results are also
15 consistent with the hypothesis that investors use analysts' forecasts, rather than
16 historically oriented growth calculations, in making stock buy and sell decisions. They
17 provide overwhelming evidence that the analysts' forecasts of future growth are superior
18 to historically oriented growth measures in predicting a firm's stock price.

19 **Q. Has your study been updated to include more recent data?**

20 A. Yes. Researchers at State Street Financial Advisors updated my study using data through
21 year-end 2003. Their results continue to confirm that analysts' growth forecasts are
22 superior to historical and retention growth measures in predicting a firm's stock price.

1 Q. What is your overall conclusion regarding the use of analysts' growth forecasts as
2 proxies for investors' growth expectations?

3 A. I find that the research literature provides strong support for the conclusion that analysts'
4 EPS growth forecasts are reasonable proxies for investor growth expectations.

5 D. Allowance for Flotation Costs

6 Q. Does Dr. Klein include an allowance for the flotation costs that Atmos Energy incurs
7 when it issues new equity?

8 A. No (*see* Klein Direct at 17, lines 5 – 20).

9 Q. Do you agree with Dr. Klein's failure to include a flotation cost allowance in his cost
10 of equity studies?

11 A. No. As I explain in my direct testimony, equity flotation costs are a legitimate cost of
12 issuing new equity in the capital markets that should be reflected in a company's cost of
13 equity (*see* Vander Weide Direct at pp. 23 – 26 and Appendix 3).

14 Q. Are equity flotation costs typically included in the operating expenses a company
15 uses to calculate its revenue requirement?

16 A. No. Equity flotation costs are typically treated as an offset to the proceeds of a new
17 equity issuance in the equity account on the balance sheet rather than as an operating
18 expense in the company's income statement.

19 Q. What is the economic basis of your recommended flotation cost allowance?

20 A. My recommended flotation cost allowance is based on the fundamental economic and
21 regulatory principles that: (1) a company should only invest in a new project if it can earn
22 a return on its investment that is equal to or greater than its cost of capital; and (2) the
23 time pattern of expense recovery should match the time pattern of benefits resulting from

1 the expense. Because equity flotation costs are a legitimate expense of raising capital, a
2 company has no incentive to invest in new capital projects if equity flotation costs are not
3 included in the cost of capital estimate. In addition, because the proceeds of an equity
4 issuance are invested in assets that provide benefits over a long time period, the costs of
5 an equity issuance should be recovered over a long period of time.

6 **Q. Has the Company experienced equity flotation costs on common stock offerings in**
7 **recent years?**

8 A. Yes. As I discuss in my direct testimony, Atmos Energy incurred flotation costs
9 associated with new equity issuances in recent years in 2014, 2006, and 2004 (*see* Vander
10 Weide Direct at p. 24, line 20 through p. 25, line 14, and Exhibit JVW-1 Schedule 2). In
11 these offerings, Atmos Energy experienced flotation costs in the range 5.4 percent to
12 10.5 percent. As also discussed in my direct testimony, Appendix 3, Atmos Energy's
13 flotation costs are similar to the flotation costs companies typically incur in issuing new
14 securities in the market place.

15 **Q. How do you determine the amount of flotation costs incurred by Atmos Energy in**
16 **its recent equity issuances?**

17 A. I determine the amount of equity flotation costs Atmos Energy incurred from information
18 contained in the prospectus documents filed by the Company with the Securities
19 Exchange Commission ("SEC"). For example, in the Company's February 2014 equity
20 offering of 9,200,000 shares, the Company's closing stock price on February 10, 2014,
21 just prior to the filing of the prospectus, was \$47.41 per share; and the public offering
22 price for this issuance was \$44.00. The Company incurred underwriting discounts,
23 commissions, and expenses equal to \$14,518,000 compared to net proceeds of

1 \$390,632,000. Thus, the Company's out-of-pocket flotation costs as a percent of net
2 proceeds to the Company are 3.7 percent, and total flotation costs as a percent of the pre-
3 issue price are 10.5 percent. As noted above, the calculation of these flotation costs for
4 the equity issuance in 2014 and for the three previous equity issuances were shown in my
5 direct testimony, Exhibit JVW-1 Schedule 1.

6 **E. DCF Results for Dr. Klein's Proxy Natural Gas Utilities Using Data through**
7 **March 31, 2015**

8 **Q. Have you calculated DCF results for Dr. Klein's proxy natural gas utilities using**
9 **data through March 2015?**

10 A. Yes. Using Dr. Klein's proxy natural gas utilities and market data through March 2015, I
11 obtain a market-weighted average result equal to 10.6 percent and a simple average DCF
12 result equal to 9.5 percent; the average of these two results is 10.1 percent (*see* Rebuttal
13 Schedule 1).

14 **IV. CAPITAL ASSET PRICING MODEL**

15 **Q. What is the CAPM?**

16 A. The CAPM is an equilibrium model of expected returns on risky securities in which the
17 expected or required return on a given risky security is equal to the risk-free rate of
18 interest plus the security's "beta" times the market risk premium:

19
$$\text{Expected return} = \text{Risk-free rate} + (\text{Security beta} \times \text{Market risk premium}).$$

20 The risk-free rate in this equation is the expected rate of return on a risk-free government
21 security, the security beta is a measure of the company's risk relative to the market as a
22 whole, and the market risk premium is the premium investors require to invest in the
23 market basket of all securities compared to the risk-free security.

1 **Q. How does Dr. Klein use the CAPM to estimate Atmos Energy's cost of equity?**

2 A. The CAPM requires estimates of the risk-free rate, the company-specific risk factor, or
3 beta, and either the required return on an investment in the market portfolio, or the risk
4 premium on the market portfolio compared to an investment in risk-free government
5 securities. For the risk-free rate, Dr. Klein uses the recent 1.5 percent yield on five-year
6 Treasury notes (*see* Klein Direct Exhibit at p. 6 of 18); for the company-specific risk
7 factor or beta, Dr. Klein uses the current Value Line beta for each company; and for the
8 required return or risk premium on the market portfolio, based on data from Ibbotson, Dr.
9 Klein uses the 8.6 percent difference between the average total return on common stocks
10 and the average income return on short-term Treasury bills for the period 1926 – 2014
11 (*see* Klein Direct Exhibit at p. 6 of 18).

12 **Q. Do you agree with Dr. Klein's use of the yield to maturity on five-year Treasury**
13 **notes to estimate the risk-free rate component of the CAPM (see Klein Direct at**
14 **p. 13, line 20 through p. 14 line 2)?**

15 A. No. Because utility stock prices are based on investors' expectations of cash flows over a
16 long period of time, Dr. Klein should have used the yield to maturity on long-term
17 Treasury bonds to estimate the risk-free rate component of the CAPM. The yield to
18 maturity on five-year Treasury notes is not risk free over the life of the typical utility
19 because the return on a five-year note would have to be reinvested at uncertain interest
20 rates over the life of the utility. As of the end of March 2015, the yield to maturity on
21 long-term Treasury bonds is approximately 110 basis points higher than the yield to
22 maturity on five-year Treasury notes.

23 **Q. What CAPM results does Dr. Klein report for his proxy companies?**

1 A. Dr. Klein reports CAPM results in the range 7.38 percent to 8.81 percent (*see* Klein
2 Direct at p. 12 line 20 through p. 13 line 2 and Klein Direct Exhibit at p. 6 of 18).

3 **Q. Does Dr. Klein's CAPM analysis produce a reasonable estimate of Atmos Energy's**
4 **cost of equity at this time?**

5 A. No. There are several reasons why Dr. Klein's CAPM analysis produces unreasonably
6 low cost of equity results for natural gas utilities at this time. First, the Federal Reserve
7 has kept interest rates on Treasury securities low as part of its effort to stimulate the
8 economy. However, as discussed in my direct testimony, economists are forecasting that
9 interest rates will increase over the next several years. Second, the average beta of Value
10 Line's natural gas utility group is 0.80, and the CAPM tends to underestimate the cost of
11 equity for companies whose equity beta is less than 1.0 and to overestimate the cost of
12 equity for companies whose equity beta is greater than 1.0. Third, there is considerable
13 evidence that the risk premium increases when interest rates decline. For example, my ex
14 ante risk premium analysis described in Appendix 4 at p. 3 of my direct testimony and in
15 Rebuttal Schedule 2 at p. 5 indicates that the required risk premium increases by
16 approximately 60 basis points when interest rates decline by 100 basis points. Fourth,
17 there is also considerable evidence that the risk premium is higher for small companies,
18 such as many of the companies in Dr. Klein's proxy natural gas utility group, than for
19 larger market capitalization companies (*see* Vander Weide Direct at p. 40). Dr. Klein's
20 application of the CAPM does not adequately account for any of these defects in the
21 CAPM.

22 **Q. Can you briefly summarize the evidence that the CAPM underestimates the**
23 **required returns for securities or portfolios with betas less than 1.0 and**

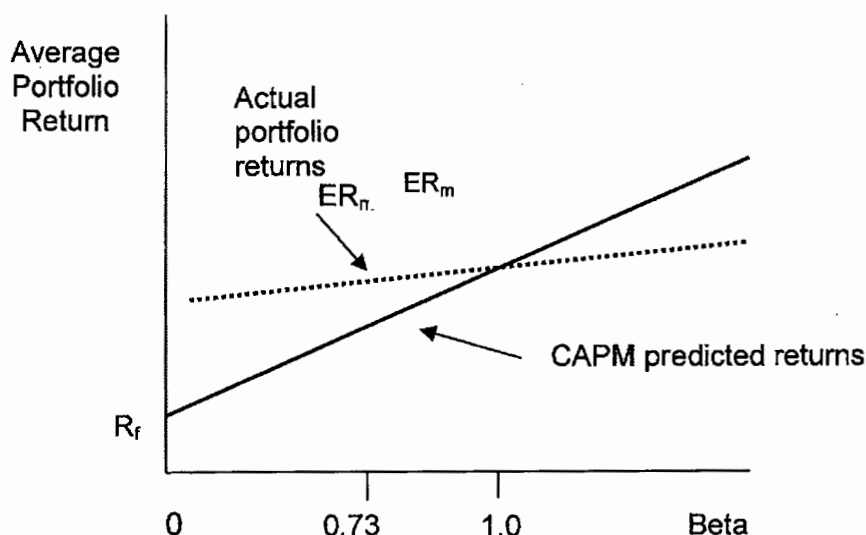
1 overestimates required returns for securities or portfolios with betas greater than
2 1.0?

3 A. Yes. As I describe in my direct testimony, the CAPM conjectures that security returns
4 increase with increases in security betas in line with the equation

$$ER_i = R_f + \beta_i [ER_m - R_f],$$

6 where ER_i is the expected return on security or portfolio i , R_f is the risk-free rate, $ER_m -$
7 R_f is the expected risk premium on the market portfolio, and β_i is a measure of the risk of
8 investing in security or portfolio i . If the CAPM correctly predicts the relationship
9 between risk and return in the marketplace, then the realized returns on portfolios of
10 securities and the corresponding portfolio betas should lie on the solid straight line with
11 intercept R_f and slope $[R_m - R_f]$ shown below.

FIGURE 1
AVERAGE RETURNS COMPARED TO BETA
FOR PORTFOLIOS FORMED ON PRIOR BETA



1 Financial scholars have found that the relationship between realized returns and betas is
2 inconsistent with the relationship posited by the CAPM. As described in Fama and
3 French (1992) and Fama and French (2004), the actual relationship between portfolio
4 betas and returns is shown by the dotted line in the figure above. Although financial
5 scholars disagree on the reasons why the return/beta relationship looks more like the
6 dotted line in the figure than the solid line, they generally agree that the dotted line lies
7 above the solid line for portfolios with betas less than 1.0 and below the solid line for
8 portfolios with betas greater than 1.0. Thus, in practice, scholars generally agree that the
9 CAPM underestimates portfolio returns for companies with betas less than 1.0, and
10 overestimates portfolio returns for portfolios with betas greater than 1.0.

11 **Q. What conclusions do you reach from your review of the literature on the CAPM to**
12 **predict the relationship between risk and return in the marketplace?**

13 A. I conclude that the financial literature strongly supports the proposition that the CAPM
14 underestimates the cost of equity for companies such as public utilities with betas less
15 than 1.0. Since the CAPM significantly underestimates the cost of equity for companies
16 with betas less than 1.0, and both Dr. Klein's and my proxy companies have betas that
17 are significantly less than 1.0, I further conclude that the Regulatory Authority should
18 give little or no weight to the results of the CAPM at this time.

19 **Q. Are there other problems with Dr. Klein's use of the CAPM to estimate the cost of**
20 **equity?**

21 A. Yes. The CAPM is based on the assumption that the investor's required risk premium
22 does not increase when interest rates decline. In contrast, the ex ante risk premium studies
23 described in my direct testimony provide strong evidence that the required risk premium

1 on utility stocks increases when interest rates decline. However, the CAPM uses a
2 constant risk premium that does not depend on the level of interest rates.

3 **Q. Have you updated your ex ante risk premium study using data through March**
4 **2015?**

5 A. Yes. Using the methodology described in my direct testimony and updating my ex ante
6 risk premium study using data through March 2015, I obtain an ex ante risk premium cost
7 of equity equal to 11.1 percent (*see* Vander Weide Rebuttal Schedule 2).

8 **V. RESPONSE TO DR. KLEIN'S REBUTTAL COMMENTS**

9 **Q. What issues does Dr. Klein have regarding your estimate of Atmos Energy's cost of**
10 **equity?**

11 A. Dr. Klein disagrees with my: (1) risk premium studies; (2) quarterly DCF model; and
12 (3) allowance for flotation costs (*see* Klein Direct at pp. 14 – 17).

13 **Q. What are Dr. Klein's comments on your risk premium analysis?**

14 A. Dr. Klein disagrees with my risk premium approach because I compare the returns on
15 utility stocks to the returns on utility bonds, and, in his opinion, returns on utility bonds
16 are subject to both inflation and default risk, but returns on utility stocks are not (*see*
17 Klein Direct at p. 16, lines 9 – 18).

18 **Q. Do you agree with Dr. Klein's opinion that returns on utility stocks are not subject**
19 **to inflation or default risk?**

20 A. No. Returns on utility stocks are subject to the risk of inflation because utility stocks
21 typically decline when inflation expectations increase and increase when inflation
22 expectations decrease. Returns on utility stocks are also subject to default risk because

1 equity values are eliminated or virtually eliminated when utilities default on the interest
2 payments on their bonds.

3 **Q. Dr. Klein also criticizes your use of the quarterly DCF model and your inclusion of**
4 **flotation costs (see Klein Direct at p. 17, line 7 through p. 18, line 9). Have you**
5 **discussed why it is appropriate to recognize the quarterly timing of dividend**
6 **payments and the existence of flotation costs in calculating the cost of equity in this**
7 **testimony above and in your direct testimony?**

8 A. Yes. I discuss the importance of recognizing the quarterly timing of dividends in my
9 direct testimony (see Vander Weide Direct at pp. 19 – 20) and also above in this rebuttal
10 testimony. I also discuss the importance of recognizing flotation costs above and in my
11 direct testimony (see Vander Weide Direct at pp. 23 – 26 and Appendix 3).

12 **Q. Dr. Klein claims that adjustments for quarterly dividend payments and flotation**
13 **costs are not required because the firm will have sufficient funds to pay quarterly**
14 **dividends when it earns profits evenly over the year, and higher profits are**
15 **sufficient to offset any adjustment for flotation costs. Do you agree with Dr. Klein's**
16 **analysis of quarterly dividend payments and flotation costs (see Klein Direct at p.**
17 **17, line 7 through p. 18, line 9)?**

18 A. No. The DCF cost of equity reflects the timing of dividend payments to investors, not the
19 timing of profits to the firm. Because dividends are paid quarterly, the stock price will
20 reflect the present value of the quarterly payment of dividends. As I discuss above, Dr.
21 Klein's annual DCF model cannot be derived from the assumption that dividends are paid
22 quarterly. Only the quarterly DCF model reflects the fact that dividends are paid
23 quarterly.

1 Q. Does this conclude your rebuttal testimony?

2 A. Yes, it does.

ATMOS ENERGY
REBUTTAL SCHEDULE 1
SUMMARY OF DISCOUNTED CASH FLOW ANALYSIS
FOR DR. KLEIN'S NATURAL GAS UTILITIES

LINE	COMPANY	MOST RECENT QUARTERLY DIVIDEND (d ₀)	STOCK PRICE (P ₀)	DIVIDEND	FORECAST OF FUTURE EARNINGS GROWTH	DCF MODEL RESULT
1	AGL Resources	0.510	52.307	2.140	4.67%	9.0%
2	Atmos Energy	0.390	55.208	1.686	7.00%	10.2%
3	New Jersey Resources	0.225	31.390	0.982	6.00%	9.3%
4	NiSource Inc.	0.260	43.141	1.192	10.40%	13.3%
5	Northwest Nat. Gas	0.465	48.538	1.983	4.00%	8.3%
6	Piedmont Natural Gas	0.330	38.240	1.398	5.00%	8.8%
7	South Jersey Inds.	0.502	57.233	2.141	6.00%	9.9%
8	Southwest Gas	0.365	59.028	1.556	4.00%	6.8%
9	WGL Holdings Inc.	0.440	55.130	1.945	6.50%	10.2%
10	Average					9.5%
11	Market-weighted Average					10.6%
12	Average Line 10, 11					10.1%

Notes:

- d₀ = Most recent quarterly dividend.
- d₁, d₂, d₃, d₄ = Next four quarterly dividends, calculated by multiplying the last four quarterly dividends per Value Line and Yahoo Finance, by the factor (1 + g).
- P₀ = average of high and low prices for the three months ending March 2015 from Thomson Reuters.
- FC = Flotation costs expressed as a percent of gross proceeds.
- g = I/B/E/S forecast of future earnings growth March 2015.
- k = Cost of equity using the quarterly version of the DCF model shown by the formula below:

$$k = \frac{d_1(1+k)^{.75} + d_2(1+k)^{.50} + d_3(1+k)^{.25} + d_4}{P_0(1-FC)} + g$$

ATMOS ENERGY
REBUTTAL SCHEDULE 2
COMPARISON OF DCF EXPECTED RETURN
ON AN EQUITY INVESTMENT IN NATURAL GAS DISTRIBUTION COMPANIES
TO THE INTEREST RATE ON A-RATED UTILITY BONDS

In this analysis, I compute a gas utility equity risk premium by comparing the DCF estimated cost of equity for a natural gas utility proxy group to the interest rate on A-rated utility bonds. For each month in my June 1998 through March 2015 study period:

DCF = Average DCF-estimated cost of equity on a portfolio of proxy companies;

Bond Yield = Yield to maturity on an investment in A-rated utility bonds; and

Risk Premium = DCF – Bond yield.

A more detailed description of my ex ante risk premium method is contained in my direct testimony, Appendix 4.

LINE	DATE	DCF	BOND YIELD	RISK PREMIUM
1	Jun-98	0.1154	0.0703	0.0451
2	Jul-98	0.1186	0.0703	0.0483
3	Aug-98	0.1234	0.0700	0.0534
4	Sep-98	0.1273	0.0693	0.0580
5	Oct-98	0.1260	0.0696	0.0564
6	Nov-98	0.1211	0.0703	0.0508
7	Dec-98	0.1185	0.0691	0.0494
8	Jan-99	0.1195	0.0697	0.0498
9	Feb-99	0.1243	0.0709	0.0534
10	Mar-99	0.1257	0.0726	0.0531
11	Apr-99	0.1260	0.0722	0.0538
12	May-99	0.1221	0.0747	0.0474
13	Jun-99	0.1208	0.0774	0.0434
14	Jul-99	0.1222	0.0771	0.0451
15	Aug-99	0.1220	0.0791	0.0429
16	Sep-99	0.1226	0.0793	0.0433
17	Oct-99	0.1233	0.0806	0.0427
18	Nov-99	0.1240	0.0794	0.0446
19	Dec-99	0.1280	0.0814	0.0466
20	Jan-00	0.1301	0.0835	0.0466
21	Feb-00	0.1344	0.0825	0.0519
22	Mar-00	0.1344	0.0828	0.0516
23	Apr-00	0.1316	0.0829	0.0487
24	May-00	0.1292	0.0870	0.0422
25	Jun-00	0.1295	0.0836	0.0459
26	Jul-00	0.1317	0.0825	0.0492
27	Aug-00	0.1290	0.0813	0.0477
28	Sep-00	0.1257	0.0823	0.0434
29	Oct-00	0.1260	0.0814	0.0446

LINE	DATE	DCF	BOND YIELD	RISK PREMIUM
30	Nov-00	0.1251	0.0811	0.0440
31	Dec-00	0.1239	0.0784	0.0455
32	Jan-01	0.1261	0.0780	0.0481
33	Feb-01	0.1261	0.0774	0.0487
34	Mar-01	0.1275	0.0768	0.0507
35	Apr-01	0.1227	0.0794	0.0433
36	May-01	0.1302	0.0799	0.0503
37	Jun-01	0.1304	0.0785	0.0519
38	Jul-01	0.1338	0.0778	0.0560
39	Aug-01	0.1327	0.0759	0.0568
40	Sep-01	0.1268	0.0775	0.0493
41	Oct-01	0.1268	0.0763	0.0505
42	Nov-01	0.1268	0.0757	0.0511
43	Dec-01	0.1254	0.0783	0.0471
44	Jan-02	0.1236	0.0766	0.0470
45	Feb-02	0.1241	0.0754	0.0487
46	Mar-02	0.1189	0.0776	0.0413
47	Apr-02	0.1159	0.0757	0.0402
48	May-02	0.1162	0.0752	0.0410
49	Jun-02	0.1170	0.0741	0.0429
50	Jul-02	0.1242	0.0731	0.0511
51	Aug-02	0.1234	0.0717	0.0517
52	Sep-02	0.1260	0.0708	0.0552
53	Oct-02	0.1250	0.0723	0.0527
54	Nov-02	0.1221	0.0714	0.0507
55	Dec-02	0.1216	0.0707	0.0509
56	Jan-03	0.1219	0.0706	0.0513
57	Feb-03	0.1232	0.0693	0.0539
58	Mar-03	0.1195	0.0679	0.0516
59	Apr-03	0.1162	0.0664	0.0498
60	May-03	0.1126	0.0636	0.0490
61	Jun-03	0.1114	0.0621	0.0493
62	Jul-03	0.1127	0.0657	0.0470
63	Aug-03	0.1139	0.0678	0.0461
64	Sep-03	0.1127	0.0656	0.0471
65	Oct-03	0.1123	0.0643	0.0480
66	Nov-03	0.1089	0.0637	0.0452
67	Dec-03	0.1071	0.0627	0.0444
68	Jan-04	0.1059	0.0615	0.0444
69	Feb-04	0.1039	0.0615	0.0424
70	Mar-04	0.1037	0.0597	0.0440
71	Apr-04	0.1041	0.0635	0.0406
72	May-04	0.1045	0.0662	0.0383
73	Jun-04	0.1036	0.0646	0.0390
74	Jul-04	0.1011	0.0627	0.0384
75	Aug-04	0.1008	0.0614	0.0394
76	Sep-04	0.0976	0.0598	0.0378
77	Oct-04	0.0974	0.0594	0.0380
78	Nov-04	0.0962	0.0597	0.0365
79	Dec-04	0.0970	0.0592	0.0378
80	Jan-05	0.0990	0.0578	0.0412
81	Feb-05	0.0979	0.0561	0.0418

LINE	DATE	DCF	BOND YIELD	RISK PREMIUM
82	Mar-05	0.0979	0.0583	0.0396
83	Apr-05	0.0988	0.0564	0.0424
84	May-05	0.0981	0.0553	0.0427
85	Jun-05	0.0976	0.0540	0.0436
86	Jul-05	0.0966	0.0551	0.0415
87	Aug-05	0.0969	0.0550	0.0419
88	Sep-05	0.0980	0.0552	0.0428
89	Oct-05	0.0990	0.0579	0.0411
90	Nov-05	0.1049	0.0588	0.0461
91	Dec-05	0.1045	0.0580	0.0465
92	Jan-06	0.0982	0.0575	0.0407
93	Feb-06	0.1124	0.0582	0.0542
94	Mar-06	0.1127	0.0598	0.0529
95	Apr-06	0.1100	0.0629	0.0471
96	May-06	0.1056	0.0642	0.0414
97	Jun-06	0.1049	0.0640	0.0409
98	Jul-06	0.1087	0.0637	0.0450
99	Aug-06	0.1041	0.0620	0.0421
100	Sep-06	0.1053	0.0600	0.0453
101	Oct-06	0.1030	0.0598	0.0432
102	Nov-06	0.1033	0.0580	0.0453
103	Dec-06	0.1035	0.0581	0.0454
104	Jan-07	0.1013	0.0596	0.0417
105	Feb-07	0.1018	0.0590	0.0428
106	Mar-07	0.1018	0.0585	0.0433
107	Apr-07	0.1007	0.0597	0.0410
108	May-07	0.0967	0.0599	0.0368
109	Jun-07	0.0970	0.0630	0.0340
110	Jul-07	0.1006	0.0625	0.0381
111	Aug-07	0.1021	0.0624	0.0397
112	Sep-07	0.1014	0.0618	0.0396
113	Oct-07	0.1080	0.0611	0.0469
114	Nov-07	0.1083	0.0597	0.0486
115	Dec-07	0.1084	0.0616	0.0468
116	Jan-08	0.1113	0.0602	0.0511
117	Feb-08	0.1139	0.0621	0.0518
118	Mar-08	0.1147	0.0621	0.0526
119	Apr-08	0.1167	0.0629	0.0538
120	May-08	0.1069	0.0627	0.0442
121	Jun-08	0.1062	0.0638	0.0424
122	Jul-08	0.1086	0.0640	0.0446
123	Aug-08	0.1123	0.0637	0.0486
124	Sep-08	0.1130	0.0649	0.0481
125	Oct-08	0.1213	0.0756	0.0457
126	Nov-08	0.1221	0.0760	0.0461
127	Dec-08	0.1162	0.0654	0.0508
128	Jan-09	0.1131	0.0639	0.0492
129	Feb-09	0.1155	0.0630	0.0524
130	Mar-09	0.1198	0.0642	0.0556
131	Apr-09	0.1146	0.0648	0.0498
132	May-09	0.1225	0.0649	0.0576
133	Jun-09	0.1208	0.0620	0.0588

LINE	DATE	DCF	BOND YIELD	RISK PREMIUM
134	Jul-09	0.1145	0.0597	0.0548
135	Aug-09	0.1109	0.0571	0.0538
136	Sep-09	0.1109	0.0553	0.0556
137	Oct-09	0.1146	0.0555	0.0592
138	Nov-09	0.1148	0.0564	0.0584
139	Dec-09	0.1123	0.0579	0.0544
140	Jan-10	0.1198	0.0577	0.0621
141	Feb-10	0.1167	0.0587	0.0580
142	Mar-10	0.1074	0.0584	0.0490
143	Apr-10	0.0934	0.0582	0.0352
144	May-10	0.0970	0.0552	0.0418
145	Jun-10	0.0953	0.0546	0.0407
146	Jul-10	0.1050	0.0526	0.0524
147	Aug-10	0.1038	0.0501	0.0537
148	Sep-10	0.1034	0.0501	0.0533
149	Oct-10	0.1050	0.0510	0.0540
150	Nov-10	0.1041	0.0536	0.0505
151	Dec-10	0.1029	0.0557	0.0472
152	Jan-11	0.1019	0.0557	0.0462
153	Feb-11	0.1004	0.0568	0.0436
154	Mar-11	0.1014	0.0556	0.0458
155	Apr-11	0.1031	0.0555	0.0476
156	May-11	0.1018	0.0532	0.0486
157	Jun-11	0.1020	0.0526	0.0494
158	Jul-11	0.1035	0.0527	0.0508
159	Aug-11	0.1179	0.0469	0.0710
160	Sep-11	0.1155	0.0448	0.0707
161	Oct-11	0.1150	0.0452	0.0698
162	Nov-11	0.1120	0.0425	0.0695
163	Dec-11	0.1092	0.0435	0.0657
164	Jan-12	0.1078	0.0434	0.0644
165	Feb-12	0.1081	0.0436	0.0645
166	Mar-12	0.1081	0.0448	0.0633
167	Apr-12	0.1131	0.0440	0.0691
168	May-12	0.1201	0.0420	0.0781
169	Jun-12	0.1011	0.0408	0.0603
170	Jul-12	0.0977	0.0393	0.0584
171	Aug-12	0.1023	0.0400	0.0623
172	Sep-12	0.1038	0.0402	0.0636
173	Oct-12	0.1011	0.0391	0.0620
174	Nov-12	0.1032	0.0384	0.0648
175	Dec-12	0.1023	0.0400	0.0623
176	Jan-13	0.1013	0.0415	0.0598
177	Feb-13	0.0982	0.0418	0.0564
178	Mar-13	0.1018	0.0420	0.0598
179	Apr-13	0.1001	0.0400	0.0601
180	May-13	0.1000	0.0417	0.0583
181	Jun-13	0.1000	0.0453	0.0547
182	Jul-13	0.0983	0.0468	0.0515
183	Aug-13	0.0982	0.0473	0.0509
184	Sep-13	0.0991	0.0480	0.0511
185	Oct-13	0.0998	0.0470	0.0528

LINE	DATE	DCF	BOND YIELD	RISK PREMIUM
186	Nov-13	0.0964	0.0477	0.0487
187	Dec-13	0.0966	0.0481	0.0485
188	Jan-14	0.0948	0.0463	0.0485
189	Feb-14	0.1019	0.0453	0.0566
190	Mar-14	0.1027	0.0451	0.0576
191	Apr-14	0.1081	0.0441	0.0640
192	May-14	0.1069	0.0426	0.0643
193	Jun-14	0.1059	0.0429	0.0630
194	Jul-14	0.1075	0.0423	0.0652
195	Aug-14	0.1069	0.0413	0.0656
196	Sep-14	0.1058	0.0424	0.0634
197	Oct-14	0.1131	0.0406	0.0725
198	Nov-14	0.1113	0.0409	0.0704
199	Dec-14	0.1105	0.0395	0.0710
200	Jan-15	0.1043	0.0358	0.0685
201	Feb-15	0.1034	0.0367	0.0667
202	Mar-15	0.1052	0.0374	0.0678

Notes: A-rated utility bond yield information from the Mergent Bond Record. DCF results are calculated using a quarterly DCF model as follows:

- d_0 = Latest quarterly dividend per *Value Line* and Yahoo Finance.
 P_0 = Average of the monthly high and low stock prices for each month from Thomson Reuters.
 FC = Flotation costs expressed as a percent of gross proceeds.
 g = I/B/E/S forecast of future earnings growth for each month.
 k = Cost of equity using the quarterly version of the DCF model shown by the formula below:

$$k = \left[\frac{d_0(1+g)^{\frac{1}{4}}}{P_0(1-FC)} + (1+g)^{\frac{1}{4}} \right]^4 - 1$$

EX ANTE RISK PREMIUM ESTIMATE OF THE COST OF EQUITY

1	Intercept Coefficient/(1-Serial Correlation Coefficient)			0.0883
2	Bond coefficient			(0.6218)
3	Bond yield =			0.0610
4	Bond coefficient * Bond yield =			(0.0379)
5	Expected Risk Premium			0.0504
6	Bond yield =			0.061
7	Ex Ante Risk Premium Cost of Equity =			11.1%

BEFORE THE TENNESSEE REGULATORY AUTHORITY

NASHVILLE, TENNESSEE

IN RE:

ATMOS ENERGY CORPORATION
GENERAL RATE
CASE AND PETITION TO ADOPT
ANNUAL REVIEW MECHANISM
AND ARM TARIFF

Docket No. 14-00146

VERIFICATION

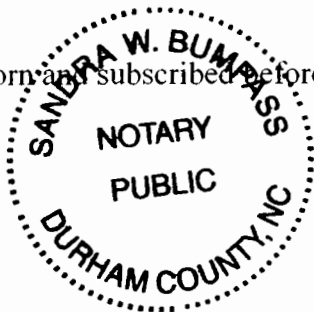
STATE OF NORTH CAROLINA)

COUNTY OF DURHAM)

I, James H. Vander Weide, being first duly sworn, state that I am President of Financial Strategy Associates, that I am authorized to testify on behalf of Atmos Energy Corporation in the above referenced docket, that the Rebuttal Testimony of James H. Vander Weide in Support of Atmos Energy Corporation's Petition and the Exhibits thereto pre-filed in this docket on the date of filing on this Petition are true and correct to the best of my knowledge, information and belief.

James H. Vander Weide
James H. Vander Weide

Sworn and subscribed before me this 22ND day of April, 2015



Sandra W. Bumpass
Notary Public

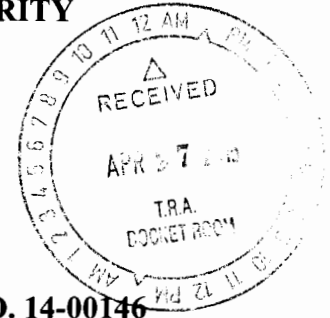
My Commission Expires: 05-30-2018

BEFORE THE TENNESSEE REGULATORY AUTHORITY
NASHVILLE, TENNESSEE

IN RE:

ATMOS ENERGY CORPORATION)
GENERAL RATE)
CASE AND PETITION TO ADOPT)
ANNUAL REVIEW MECHANISM)
AND ARM TARIFF)

DOCKET NO. 14-00146



REBUTTAL TESTIMONY OF PACE MCDONALD
ON BEHALF OF ATMOS ENERGY CORPORATION

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME, POSITION AND BUSINESS ADDRESS.

A. My name is Pace McDonald. I am Vice President of Taxes for the Atmos Energy Corporation and Subsidiaries ("Atmos Energy" or the "Company"). My business address is 5430 LBJ Freeway, Suite 700, Dallas, Texas 75240.

Q. WHAT ARE YOUR JOB RESPONSIBILITIES?

A. I am responsible for oversight and management of all income, property and sales tax matters for the Company. This oversight includes ensuring that the tax accounts recorded on the books and records accurately reflect the Company's tax filings and positions. I oversee a group of 23 tax professionals and clerical staff which undertake tax planning to minimize taxes, prepare the Company's tax filings, and defend those filings under audit. I am also responsible for the establishment and compliance with the Company's tax policies and controls.

1 Q. PLEASE OUTLINE YOUR EDUCATIONAL AND PROFESSIONAL
2 QUALIFICATIONS.

3 A. I received my education at the University of Texas at Austin. In 1993, I concurrently
4 received a Bachelor of Business Administration degree with a major in accounting and a
5 Master of Professional Accounting degree with a specialization in tax. I am a licensed
6 certified public accountant in the State of Texas.

7 I began working for the public accounting firm of Deloitte & Touche LLP in
8 August 1993. In 1997, I left Deloitte & Touche LLP and joined the public accounting
9 firm of Ernst and Young LLP. At both firms, I provided tax planning and compliance
10 services to a client base of primarily large public companies. My client base was equally
11 divided between large multinational manufacturers and regulated public utilities. One of
12 my key responsibilities included reviewing and consulting with clients regarding the
13 appropriate amount and manner in which to record accumulated deferred income taxes.

14 In April 2002, I joined Atmos Energy Corporation and assumed the oversight and
15 management of all income, property and sales tax matters for the Company. I also serve
16 as the Company's representative on the American Gas Association's Tax Committee.

17 Q. HAVE YOU TESTIFIED BEFORE ANY OTHER REGULATORY
18 COMMISSIONS?

19 A. Yes. I testified before the Railroad Commission of Texas in GUD Nos. 9670, 9762, 9869,
20 10000 and 10170. I have also testified before the Public Service Commission of
21 Mississippi in Docket No. 92 UN 0230 and the Public Service Commission of Kentucky
22 in Case No. 2013-00148.

1 **Q. WHAT WAS THE SCOPE OF YOUR TESTIMONY IN THOSE PROCEEDING?**

2 A. I provided rebuttal testimony regarding the Company's accumulated deferred income
3 taxes ("ADIT") and the appropriateness of including specific ADIT items within rate
4 base as filed in those proceedings.

5 **Q. HAVE YOU REVIEWED THE INTERVENOR TESTIMONY FILED IN THIS**
6 **CASE?**

7 A. Yes, I have reviewed the testimony as noted in the response to the next question.
8

9 **II. PURPOSE AND SUMMARY**

10 **Q WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

11 A. I rebut the arguments raised in the direct testimony of Consumer Advocate and Protection
12 Division witness William H. Novak regarding his proposed adjustments to the
13 accumulated deferred income tax ("ADIT") resulting from tax net operating loss
14 carryforwards ("NOLC") as summarized on page 20 line 8 through page 21 line 14, and
15 also page 23 line 3 through page 38 line 2 of his testimony. Throughout my testimony I
16 will refer to this ADIT asset as NOLC ADIT. I will address what gives rise to NOLC
17 ADITs, the proper regulatory treatment of this item and explain the normalization
18 requirements of the Internal Revenue Code ("IRC").

19 **Q. PLEASE SUMMARIZE YOUR IMPRESSIONS OF MR. NOVAK'S**
20 **TESTIMONY.**

21 A. Mr. Novak has proposed to eliminate from rate base the NOLC ADIT created by NOLCs.
22 There are two significant flaws in Mr. Novak's testimony. First, he incorrectly concludes
23 that the NOLC ADIT is not a well-accepted rate base item under general ratemaking

1 principles (*see* Novak Direct, page 21, lines 4-8). His second significant error is
2 concluding that if the Authority were to remove the NOLC ADIT from rate base, the
3 Company would not violate the normalization provisions of the IRC (*see* Novak Direct,
4 page 36, lines 5-21). His analysis is further clouded by overlapping and mingling the
5 normalization requirements of the Internal Revenue Code, sound ratemaking principles,
6 regulatory commission decisions and IRS rulings. He draws conclusions about rate
7 making based on IRS decisions and, likewise, draws conclusions about normalization
8 based on commission decisions in rate proceedings. His testimony on these matters is
9 confused and misguided.

10 Despite numerous rulings by regulatory commissions in support of the inclusion
11 of an NOLC ADIT, Mr. Novak testifies that that the ADIT asset from NOLCs is not a
12 well-accepted rate base item under general ratemaking principles. He clouds the issue by
13 referring to the ADIT asset from NOLCs as simply NOLCs as if it were not an ADIT
14 asset but instead some sort of separate and distinct type of asset. It seems Mr. Novak does
15 not understand that a NOLC creates an ADIT asset for the Company. Not understanding
16 or possibly ignoring that the NOLCs create a well-accepted ADIT asset, his testimony
17 suggests that recovery of a NOLC ADIT should be pursued as some sort of unique
18 regulatory asset. Such an approach is confusing and without precedence. He also
19 incorrectly argues that including the NOLC ADIT would be tantamount to including prior
20 period losses in rate base.

21 His testimony does not describe ADIT assets and liabilities and why they are
22 included in rate base. He fails to establish that rate base will be more accurately reflected
23 by its removal. In fact, he offers no such opinion. He does however spend a considerable

1 amount of testimony opining incorrectly that its removal would not be a normalization
2 violation under the IRC and that the TRA has the authority to declare its removal would
3 not be a normalization violation.

4 With respect to normalization, Mr. Novak maintains that if the Authority were to
5 adopt his recommendations the Company would not sustain a normalization violation
6 under the IRC. His analysis is based on a singular ruling for which he has failed to grasp
7 a critical fact. A fact that, as I will explain, is not present in this case. His testimony
8 ignores numerous recent IRS rulings with facts consistent with this case which did
9 conclude if a commission excludes the NOLC ADIT from rate base a normalization
10 violation would occur. He also errs in suggesting that a regulatory commission has the
11 standing to rule whether a normalization violation occurs (see Novak Direct page 34 line
12 19 through page 35 line 2).

13 **Q. PLEASE SUMMARIZE YOUR TESTIMONY.**

14 A. It will be my testimony that the NOLC ADIT is an appropriate rate base item, accepted
15 by numerous commissions and is based first and foremost on sound ratemaking
16 principles. Failure to include the NOLC ADIT would result in a rate base and an
17 associated return requested from rate payers that would not be reflective of the economic
18 realities embodied in the Company's tax filings and associated cash flow. It will be my
19 testimony that if the Authority adopts well established rate making treatment for the
20 NOLC ADIT, the discussion of potential a normalization violation under the IRC is a
21 moot point.

22 However, I will also address the normalization issue raised by Mr. Novak. It will
23 be my testimony that removal of the NOLC ADIT would violate the normalizations

1 provisions of the IRC. My testimony will outline the proper cause and effect relationship
2 between regulatory commission actions and the resulting tax effects under the IRC. My
3 testimony will demonstrate that failure to include the NOLC ADIT would in fact result in
4 a normalization violation and I will explain the roles of regulatory commissions and the
5 IRS in making this determination. I will also explain why Mr. Novak's suggestion that
6 the Company seek a second private letter ruling from the IRS is unnecessary (*see* Novak
7 Direct page 37 line 8 through page 38 line 2).

8 **Q. PLEASE SUMMARIZE YOUR TESTIMONY REGARDING THE PROPER**
9 **RATEMAKING TREATMENT OF NOLC ADIT.**

10 A. In this filing, the Company's requested rate base has been reduced by its net ADIT
11 liability balance. Embedded within the ADIT liability balance is an asset (increase to rate
12 base) for NOLCs.

13 ADIT liabilities are realized because the Company's tax filings reflect tax
14 deductions in excess of its book deductions, for example accelerated tax depreciation.
15 These tax deductions offset the Company's current tax liability, which allows the
16 Company to retain cash that would have otherwise been paid to the government. As more
17 fully explained in my testimony, this cash tax savings allowed by the government
18 represents an interest free loan from the government to the Company. The loan is paid
19 back over time as the Company's book deductions exceed its tax deduction. Essentially
20 an ADIT liability represents an obligation to pay this interest free loan back to the
21 government in the future. These loans are therefore appropriately reflected as a reduction
22 to rate base to account for this cost free capital provided to the Company.

1 In certain situations, the Company's tax deductions can produce a tax net
2 operating loss. A tax net operating loss is realized when the Company's tax deductions
3 exceed its earned income and all tax has been offset. Tax in future periods will be offset
4 by the unused deductions. These unused tax deductions are reflected on the Company's
5 tax returns and books and records as a carryforward of the net operating loss. These
6 carryforwards (NOLC) are used in future periods to offset tax. In effect, a NOLC
7 represents tax deductions that have not yet been used to offset tax. Since those deductions
8 have not yet been used to offset tax, the government has not yet extended an interest-free
9 loan to the Company. It follows that the Company's rate base should not be reduced for
10 cost free capital that it has not yet realized.

11 It is my testimony that all of the ADIT balances, assets and liabilities, must be
12 included in the calculation of the ADIT rate base reduction. The NOLC ADIT must be
13 included, otherwise the Company's rate base does not reflect the true quantity of interest
14 free cash made available to the Company by the government.

15 **Q. PLEASE SUMMARIZE YOUR TESTIMONY AS TO WHETHER**
16 **NORMALIZATION OF NOLC ADIT IS REQUIRED BY THE IRC.**

17 A. A violation of the tax depreciation normalization provisions is a serious matter under the
18 IRC and a violation would have devastating financial implications. Mr. Novak's
19 arguments are misguided and financially dangerous. There is no doubt NOLCs must be
20 taken into account in order to avoid a normalization violation. In reaching his conclusion
21 that a normalization violation would not occur in this case, Mr. Novak relies exclusively
22 on a singular private letter ruling. This letter ruling was issued to Mountaineer Gas
23 Company ("Mountaineer") and as I will testify, its facts are distinguishable from those of

1 this case. In that ruling, the IRS ruled that the West Virginia Public Service
2 Commission's ("WVPSC") failure to adjust rate base by the NOLC ADIT would not
3 result in a normalization violation because in setting rates the WVPSC had already *taken*
4 *into account* the NOLC. The key requirement to avoid triggering a normalization
5 violation is to "take into account" the NOLC. How it was taken into account for purposes
6 of Mountaineer is distinguishable from this case.

7 It will be my testimony that Mr. Novak has not proposed to "take into account"
8 the NOLC in this case. In fact, he has proposed to exclude it in its entirety (*see* Novak
9 Direct page 37 lines 4-5). He has also failed to discuss several recent factually similar
10 IRS rulings in which a normalization violation was deemed not to occur because of the
11 regulator's allowed inclusion of the NOLC ADIT in rate base. To avoid the IRS asserting
12 a normalization violation against the Company, the Authority must take into account the
13 NOLC in establishing rates. The widely accepted manner of accomplishing this is to
14 include the entire ADIT balance which includes the NOLC ADIT in rate base. Mr.
15 Novak's suggestion to include the ADIT liability, but to exclude the corresponding
16 NOLC ADIT asset, would result in a normalization violation.

17 **Q. PLEASE SUMMARIZE YOUR TESTIMONY REGARDING THE**
18 **RELATIONSHIP BETWEEN SETTING RATES AND NORMALIZATION AND**
19 **THE ROLES OF THE IRS AND REGULATORY COMMISSIONS.**

20 A. It will be my testimony that rates and the inclusion or exclusion of items in setting rates is
21 obviously solely within the purview of the regulatory commission that has jurisdiction.
22 Likewise, the determination of whether a company incurs a normalization violation is
23 solely within the purview of the IRS. The IRS cannot require that a commission include

1 an item in rate base, just as a commission cannot rule on the proper reporting of an item
2 on a company's tax returns. As I will explain, the relationship between setting rates and
3 normalization is a linear, one-way step process that begins with the rate setting process.

4 A commission and company establish rates through rate proceedings. The tax
5 expense and inclusion or exclusion of ADIT items in rate base used to set rates either
6 complies or does not comply with the normalization provisions. If the established rates
7 comply with the normalization provision, the company is allowed to retain the benefits
8 and the use of accelerated depreciation in its tax filings. If the established rates do not,
9 then the company is deemed to be in violation of the normalization provision and is
10 prohibited from claiming the benefits and use of accelerated depreciation on its tax
11 filings.

12 Companies, interveners and advisors have cautioned commissions against setting
13 rates which would violate the normalization provisions because of the draconian effects
14 of incurring a violation. So draconian in fact that the mere threat of them has the practical
15 effect and appearance of "requiring" utilities and commissions abide by them. Certainly a
16 commission could choose to violate the normalization provisions by setting rates which
17 knowingly do not comply with the IRC. It is well within their regulatory authority to do
18 so. However, a utility or commission that knowingly violated the IRC normalization
19 provisions would cause the utility to lose its accelerated depreciation deductions, and
20 thereby remove the incentive for investment in new plant that Congress intended to
21 provide. The loss of these deductions and the intended "savings" would be a detriment to
22 the ratepayers. Indeed, the normalization rules are intended precisely to prevent

1 accelerated depreciation deductions from being passed along to ratepayers, as a means to
2 preserve the tax incentives to additional investment that Congress intended to create.

3 **Q. ARE YOU SPONSORING ANY EXHIBITS?**

4 A. Yes, I am sponsoring Exhibit PM-1 and Exhibit PM-2.

5 **Q. WERE THESE EXHIBITS PREPARED BY YOU OR UNDER YOUR DIRECT**
6 **SUPERVISION?**

7 A. Yes.

8
9 **III. RATEMAKING TREATMENT OF ACCUMULATED DEFERRED INCOME**
10 **TAXES**

11 **Q. WHY IS AN UNDERSTANDING OF ACCUMULATED DEFERRED TAXES**
12 **IMPORTANT IN THIS PROCEEDING?**

13 A. Knowing what accumulated deferred taxes represent is critical to understanding the
14 impact of accumulated deferred taxes on a Company's financing and how that should be
15 accounted for in ratemaking.

16 **Q. PLEASE DESCRIBE WHAT ACCUMULATED DEFERRED INCOME TAXES**
17 **ARE.**

18 A. Deferred taxes represent the balance of tax that is due or receivable in the future,
19 resulting from items of income and expense being recognized for tax purposes in a period
20 different than they are recognized for financial reporting purposes. Accumulated deferred
21 taxes simply represent the accumulated tax for all items deferred to future periods. More
22 importantly, for a regulated utility, deferred taxes represent a source of cost-free
23 financing provided by the government.

1 **Q. PLEASE DESCRIBE WHAT GIVES RISE TO ACCUMULATED DEFERRED**
2 **INCOME TAXES.**

3 A. Deferred taxes arise from the interaction of the IRC, the Company's accounting practices
4 under United States ("US") generally accepted accounting principles ("GAAP"), and the
5 Company's operations. Deferred taxes are created because of differences between the
6 IRC and the Company's accounting under US GAAP. In addition to FERC rules, the
7 Company's records are maintained according to US GAAP, which provide guiding
8 principles and requirements as to when and how the Company records its financial
9 results. Likewise, the IRC and related regulations provide the rules and requirements the
10 Company follows when completing its tax filings. There are a myriad of differences
11 between US GAAP and the IRC.

12 Examples include but are not limited to differences in the recognition of income
13 or expense, time period or methods by which assets are depreciated, and the
14 capitalization of costs. Many of these differences are temporary in nature, meaning the
15 total amount of income or expense recognized for an item is the same under US GAAP
16 and the IRC, but the time period over which it is recognized is different. For example, an
17 item purchased by the Company for \$100 may be capitalized and depreciated over a 30
18 year period under US GAAP. The IRC may permit that same item to be depreciated over
19 a 15 year period. There is no difference in the total depreciation deductions, in that US
20 GAAP and the IRC permit the Company a \$100 depreciation deduction. However, that
21 deduction is realized over different time periods. It is this difference in timing between
22 the US GAAP and the IRC that gives rise to deferred taxes. Due to the difference in

1 timing required by the IRC, the Company has deferred recognition of tax liabilities or
2 benefits to a future period.

3 **Q. WHAT IS THE MOST SIGNIFICANT DRIVER OF UTILITY ACCUMULATED**
4 **DEFERRED TAXES?**

5 A. Timing differences between book and tax depreciation associated with utility property
6 and plant. Notably, the difference between much slower book depreciation versus the
7 accelerated or bonus tax depreciation allowed under the IRC.

8 **Q. HOW DO DEFERRED TAXES IMPACT A REGULATED UTILITY?**

9 A. A utility earns its allowed rate of return and cost of service from its rate payers. A
10 component earned includes the tax liability the utility will owe on its earnings. From its
11 earning, the utility has cash funds available to pay its tax obligations to the government.
12 The federal government by way of accelerated and bonus depreciation rules grants the
13 utility tax depreciation in excess of its book depreciation. These favorable depreciation
14 deductions lower the utility's current tax liability and provide funds to the utility in the
15 current period. However, its future tax liability will be increased and those funds will be
16 remitted to the government in the future. The net effect is that the government has
17 provided an interest-free loan to the utility by virtue of a lower current tax bill due to the
18 accelerated and bonus depreciation provisions. That interest-free loan will be repaid by
19 higher tax bills in the future.

20 **Q. HOW IS THIS LOAN REFLECTED ON A UTILITY'S BOOKS AND RECORDS?**

21 A. Essentially, the balance of the interest-free loan is reflected as the net ADIT credit
22 recorded on the Company's books and records. An ADIT credit is quite simply the
23 amount of interest-free capital that the government loaned to the Company.

1 **Q. HOW IS AN ADIT CREDIT TREATED FOR RATEMAKING PURPOSES?**

2 A. Given that an ADIT credit represents an interest free loan or cost-free capital, rate base
3 should be reduced for the amount of the ADIT credit. This allows rate payers to receive
4 the benefit of the interest-free loan and not pay a rate of return on rate base financed at no
5 cost.

6 **Q. IS THE REDUCTION OF RATE BASE FOR ADIT CREDITS A STANDARD**
7 **REGULATORY RATEMAKING PRACTICE?**

8 A. Yes. This is the widely accepted treatment of ADIT credits.
9

10 **IV. NET OPERATING LOSS CARRYFORWARDS**

11 **Q. WHAT IS A NET OPERATING LOSS (“NOL”)?**

12 A. The Company computes its taxable income in accordance with the IRC. Depending on the
13 income and deductions reported on the Company’s tax return, either positive or negative
14 taxable income is reported on the tax return. Positive taxable income will result in the
15 imposition of tax at the applicable tax rate. Negative taxable income creates an income
16 tax net operating loss (“NOL”).

17 **Q. WHAT IS AN INCOME TAX NET OPERATING LOSS CARRYFORWARD?**

18 A. Under §172 of the IRC, a tax NOL may first be carried back to offset taxable income
19 (generally to the two preceding years). Any loss remaining after the carryback is
20 available to carry forward for up to 20 years and reduce taxable income in a future
21 period.

22 **Q. WHAT ARE THE CONSEQUENCES OF CARRYING A NOL FORWARD?**

1 A. A NOL carryforward (NOLC) simply represents deductions that were claimed on tax
2 returns but not used to offset the tax liability in the period claimed. An NOL carryforward
3 therefore has the effect of moving those unused deductions forward to a subsequent year
4 to offset the tax liability of the future period.

5 **Q. HAVE ATMOS ENERGY CORPORATION'S REGULATED UTILITY**
6 **OPERATIONS RESULTED IN TAXABLE LOSSES?**

7 A. Yes. For the past six fiscal years, the taxable income computations for the utility
8 operations have reflected large taxable losses.

9 **Q. HAVE THESE LOSSES RESULTED IN A NOL CARRYFORWARD FOR THE**
10 **COMPANY?**

11 A. Yes. As of the filing of this case, the Company had federal and state NOL carryforwards
12 of \$444,334,650 (unallocated) and \$1,936,633, respectively, from its utility operations.

13 **Q. HAS THE COMPANY PROPOSED TO INCREASE RATE BASE FOR THESE**
14 **AS NOLC ADIT?**

15 A. Yes. NOLC ADIT is a component of ADIT. It is included as part of net ADIT subtracted
16 from rate base.

17 **Q. PLEASE EXPLAIN WHAT CAUSED THE TAX LOSSES AND NOL**
18 **CARRYFORWARD.**

19 A. The Company has realized significant deductions associated with bonus depreciation,
20 accelerated depreciation and the deduction of capital expenditures as repairs for tax
21 purposes.

22 Bonus depreciation is a stimulus measure passed by Congress that allows
23 taxpayers to immediately expense a portion of costs that would normally be capital

1 expenditures subject to recovery over an extended period through depreciation
2 deductions. The percentage of capital expenditures deductible for calendar years 2009-
3 2014 has either been 50% or 100%, depending on the time period and type of assets.
4 Effectively, bonus depreciation has allowed the Company to expense immediately either
5 50% or 100% of most capital investment since 2009.

6 Accelerated depreciation is another depreciation methodology allowed under the
7 IRC whereby taxpayers are allowed to depreciate assets on a much faster basis than that
8 allowed for financial accounting or regulatory purposes. In the early years of an asset's
9 life, tax depreciation (accelerated depreciation) is typically higher than book depreciation
10 (straight-line). This difference in depreciation methodologies produces more tax
11 depreciation in the early years of an asset's life and less in future years. For that portion
12 of capital investments not expensed as bonus depreciation, the Company was permitted to
13 claim depreciation deductions under the accelerated depreciation provisions.

14 The Company is allowed for tax purposes to treat certain types of otherwise
15 capital costs as deductible repairs and maintenance costs. Rather than recording these
16 expenditures as capital additions to plant in service for tax purposes, the Company
17 expenses these costs immediately. The amount of costs eligible for immediate expensing
18 as a repair has been substantial in recent years.

19 **Q. DID THESE DEDUCTIONS HAVE AN IMPACT ON THE COMPANY'S ADIT**
20 **BALANCE?**

21 A. Yes. These accelerated deductions resulted in a deferral of the Company's tax liability.
22 Therefore, an ADIT credit was recorded on the Company's books and records to reflect
23 this future obligation to the government.

1 **Q. WHAT THEN IS THE SIGNIFICANCE OF THE NOL CARRYFORWARD**
2 **GENERATED BY THESE DEDUCTIONS?**

3 A. To the extent that these deductions gave rise to an NOL carryforward, the deductions are
4 not generating current tax savings. Therefore, in terms of the loan analogy described in
5 my testimony, the government has not yet extended a loan because the underlying
6 deductions have not yet reduced the Company's tax liability.

7 **Q. HOW IS A NOLC REFLECTED IN THE COMPANY'S BOOKS AND**
8 **RECORDS?**

9 A. A NOLC is recorded as an ADIT asset. This asset represents a future cash flow from the
10 government which will be realized when the Company has sufficient taxable income and
11 a tax liability to reduce. Until that time, the tax deductions which have given rise to the
12 NOL have not produced any tax saving for the Company.

13 **Q. HOW DOES THE RECORDING OF THE NOLC ADIT INTERACT WITH THE**
14 **ADIT CREDIT RECORDED FOR ACCELERATED DEDUCTIONS?**

15 A. This asset effectively reduces the ADIT liability recorded for accelerated deductions to
16 the amount that has been loaned to the Company in the form of current tax savings.

17 **Q. WHAT IS THE SIGNIFICANCE OF THE NOLC FOR RATEMAKING?**

18 A. The Company's ADIT credit balance represents the tax benefit of its favorable tax
19 deductions regardless of whether or not they actually produced cash. A NOLC represents
20 unused tax deductions (beyond what is necessary to reduce current year taxable income
21 to zero) and taxes that the Company has on deposit with the government. There is no
22 current cost-free capital associated with the NOLC, and thus, from a ratemaking
23 perspective, it is inappropriate to have a reduction of rate base for the unused deferred

1 taxes. Thus, the offset against rate base of accumulated deferred taxes must be limited to
2 the amount of current benefit. The proper ratemaking treatment of including NOLC
3 ADIT in rate base achieves this by accurately reflecting the cash tax savings obtained by
4 the Company when these savings are realized.

5 **Q. IS THERE ANY JUSTIFICATION FOR IGNORING THE IMPACT OF THE**
6 **NOLC ADIT?**

7 **A.** No, there is not. If the effect of the Company's NOLC ADIT is ignored, then every dollar
8 of accelerated depreciation and other favorable tax deductions claimed by the Company
9 on its tax returns would reduce its rate base - even though, to the extent the deductions
10 simply produced a NOLC (no actual tax deduction), they would not yet have deferred any
11 tax and, therefore, would not have produced any incremental cash for the Company. If,
12 instead, the Company had claimed fewer such deductions - only enough to eliminate its
13 taxable income but not enough to produce a NOLC - then it would be in the same cash
14 position (that is, the Company still would have paid \$0 tax) but the amount by which its
15 rate base is reduced would be diminished. Rate treatment that ignores the impact of the
16 Company's NOLC would disadvantage the Company more so if it claimed favorable tax
17 deductions than if it did not claim them.

18
19 **V. NOLC REGULATORY PRECEDENT**

20 **Q. HAVE OTHER JURISIDICCTIONS CONSIDERED THE NOLC ADIT ISSUE AND**
21 **AGREED TO REGULATORY TREATMENT CONSISTENT WITH THAT**
22 **PROPOSED BY THE COMPANY?**

1 A. Yes. I am aware of decisions issued by the Federal Energy Regulatory Commission
2 (FERC) and several state public utility commissions. These commissions include
3 Connecticut, Texas, Illinois, Washington, Colorado and New Mexico.¹

4 **Q. ARE THE FACTS IN THESE DECISIONS SIMILAR TO THIS CASE?**

5 A. Yes. In all of these decisions the Companies proposed to increase rate base by including a
6 NOLC ADIT in the overall balance of deferred taxes.

7 **Q. PLEASE DESCRIBE THE FERC ORDER.**

8 A. In its Kern River decision, the FERC stated:

9 229. There is a second type of timing [difference] that can have the opposite
10 effect. It is possible that some accounting entries will decrease expenses or
11 increase income for IRS purposes faster than would be the case for
12 accounting purposes. In this case the cash flow from the tax allowance
13 embedded in the regulated entity's rates is less than the income tax payments
14 that are generated by the higher income. When the regulated entity pays for
15 an expense earlier than would be under the Commission's regulatory
16 accounting system, it is in essence committing more funds to the business.
17 The difference is therefore capitalized and added to the rate base. The
18 difference in the timing that results is capitalized and added to the rate base to
19 allow a somewhat higher return on the additional funds that have been
20 committed to the enterprise. As the accounting entries for these expenses are
21 entered (usually allowance for funds used during construction), the difference
22 in timing is reversed, the short term addition to the rate base decreases, and
23 return drops. This timing difference is reflected as an ADIT debit, or
24 regulatory asset, in Account No. 190.

25
26 230. In the instant case the NOL was properly included in Account No. 190.
27 The large depreciation deduction for the "bonus" depreciation was properly
28 reflected as a credit in Account No. 282 and served to reduce rate base to
29 reflect the difference in timing previously described. However, the impact of

¹ *Kern River Gas Transmission Company*, FERC Docket No. RP04-274-000 (October 19, 2006); *Yankee Gas Services Company*, Conn. Docket No. 10-12-02REO 1, 2011 Conn. PUC Lexis 189 (September 28, 2011); *Gulf States Utilities Co.*, Docket No. 8702, 17 Tex. P.u.e. Bull., 703 (P.U.e.Texas May 2, 1991); *GUD No. 10170*, Statement of Intent Filed by Atmos Energy Corp., to Increase Gas Utility Rates Within the Unincorporated Areas Served by the Atmos Energy Corp., Mid-Tex Division, Final Order (Dec. 4, 2012) Available at <http://www.rrc.state.tx.us/meetings/gspfd/10170-FinalOrder>; *Commonwealth Edison Co.*, Docket No. 94-0065, 158 PUR4th 458 (Ill. CC, January 9, 1995); *WUTC v. Puget Sound Energy Inc.*, Dockets UE-111048 and UG-111049 (consolidated) Order 08, (May 7, 2012); *In re Public Service Co. of Colorado*, Docket No. 10AL-963G, Decision No C11-0946, Order on Exceptions and Request for Clarification (Sept. 1, 2011); *In the Matter of the Application of Public Service Company of New Mexico for a Revision of Its Retail Electric Rates Pursuant to Advice Notice Nos. 397 and 32 (Former TNMP Services)*, *Public Service Company of New Mexico*, Case No. 10-00086-UT, New Mexico Public Regulation Commission, 2011 N.M PUC LEXIS 35 at 259 (July 28, 2011). {Legal/02831/18422/01454298.DOCX }

1 this deduction was so great that it exceeded the taxable cash that would have
2 been generated under the straight line regulatory method. Thus, Kern River
3 was not able to use the full extent of the deduction in the first year it was
4 available. However, as discussed, the full accelerated depreciation amount is
5 included in the credit ADIT in Account No. 282. Without a corresponding
6 debit in Account No. 190, Kern River's rate base would be reduced even
7 though it did not achieve the tax savings, and additional cash flow, that a
8 credit entry in Account No. 282 is intended to offset. Therefore the NOL is
9 carried forward as a regulatory asset in future years and is reduced as the tax
10 savings actually accrue to Kern River.²
11

12 **Q. PLEASE DESCRIBE THE CONNECTICUT ORDER.**

13 A. The Connecticut Commission recognized that NOLC ADIT is properly reflected as an
14 increase to rate base. The Connecticut Commission stated in its Yankee Gas Services
15 decision:

16 In the instant proceeding, the Authority finds that the NOL generated during
17 rate year 1 ending June 30, 2012 (RY1) diminished the cash flow available to
18 Yankee as a result of the tax effect of the timing differences between straight
19 line book depreciation and accelerated tax depreciation deductions.³
20

21 **Q. PLEASE DESCRIBE THE TEXAS ORDERS.**

22 A. Both the Texas Public Utilities Commission (PUC) and the Texas Railroad Commission
23 have provided clear instructions on the inclusion of NOLC ADITs. The PUC ruled the
24 following:

25 Deferred accumulated federal income taxes are properly included as a credit
26 to GSU's rate base because deferred federal income taxes represent cost free
27 capital to the Company. However, this cost free capital is appropriately
28 reduced to the extent that GSU has NOL carry forwards, which the utility is
29 currently unable to use. Just as deferred income taxes represent future taxes
30 which the utility has not yet been required to pay, NOLs represent deductions
31 to the utility's tax liability which the Company has not yet realized. To the
32 extent that a utility has unutilized NOL carry forwards, its tax liability will be
33 reduced in the future. Therefore, if the Commission is going to include
34 deferred income taxes as a reduction to rate base, which it should, the

² *Kern River Gas Transmission Company*, FERC Docket No. RP04-274-000 (October 19, 2006)

³ *Yankee Gas Services Company*, Conn. Docket No. 1 0-12-02REO 1, 2011 Conn. PUC Lexis 189 (September 28, 2011)
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Commission should likewise include known reductions to those deferred taxes. Consequently, NOLs should be included as an offset in the calculation of the deferred income tax balance included in rate base.⁴

The Texas Railroad Commission ruled likewise:

The Examiners find that the company has established that its calculation of the ADIT asset related to NOLs was just and reasonable...The company's approach matches the ADIT liabilities to the ADIT NOL asset created by those deductions.⁵

Q. PLEASE DESCRIBE THE ILLINOIS ORDER.

A. The Illinois Commerce Commission ruled as follows:

We believe, in this instance, Edison's rate base should include a deferred tax asset offsetting the deduction for deferred taxes, so that deferred tax accounting items will be treated consistently. If we were to make this rate base adjustment, the Company well might forfeit its federal deferred income tax benefits. This would be inequitable.⁶

Q. PLEASE DESCRIBE THE WASHINGTON ORDER.

A. The Washington order has this succinct discussion:

Since the beginning of the current recession Congress has tried different approaches to revitalize the economy. One approach has been the use of "bonus depreciation" to allow rapid recovery of investment that it is assumed will be reinvested. Bonus depreciation allows companies, including PSE, to deduct from taxable income 50 percent to 100 percent of the cost of a new asset in the year the asset is acquired. The bonus depreciation greatly reduces the taxable income of the company and the amount of income taxes the Company must actually pay. For regulatory purposes the rapid recovery creates: (1) a Net Operating Loss (NOL) resulting in zero income taxes payable and (2) large deferred taxes caused by the bonus depreciation maximizing cash flow. Cash flow is maximized because the related deferred income tax expense created by the timing differences is still recovered in rates.

⁴ *Gulf States Utilities Co.*, Docket No. 8702, 17 Tex. P.u.e. Bull., 703 (Tex. PUC May 2, 1991)

⁵ *GUD No. 10170*, Statement of Intent Filed by Atmos Energy Corp., to Increase Gas Utility Rates Within the Unincorporated Areas Served by the Atmos Energy Corp., Mid-Tex Division, Final Order (Dec. 4, 2012) Available at <http://www.rrc.state.tx.us/meetings/gspfd/10170-FinalOrder>

⁶ *Commonwealth Edison Co.*, Docket No. 94-0065, 158 PUR4th 458 (Ill. CC, January 9, 1995)
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1 In the Company's case, the tax basis NOL created by bonus depreciation must
2 be carried forward to future years. NOLs act as additional tax deduction on
3 future tax returns, reducing future taxes payable to zero until the carryforward
4 no longer is large enough to reduce operating income to zero.
5

6 The Company observes that as a practical matter, any tax benefits associated
7 with the NOL will be delayed until a future tax year. According to the
8 Company, PSE has claimed bonus depreciation on its taxes but has not
9 received a cash benefit. The cash benefit is the amount of income taxes the
10 Company would have paid had it not been for the accelerated recovery
11 reflected in the bonus depreciation. The Company observes that "[a] NOL
12 carryforward is similar to a tax receivable from the IRS except that it can only
13 be used on future tax returns...."
14

15 Since the NOL carryforward cannot be used by the Company to reduce a
16 current liability, the Company argues that the deferred taxes associated with
17 the assets that created the NOL should also be offset by a NOL carryforward
18 deferred tax asset. The reduction in the net deferred tax amount increases rate
19 base by the amount of the tax-affected NOL
20

21 Based on this analysis, the Washington Commission ruled the following:

22 We agree with the treatment of PSE's current NOL proposed by PSE and
23 agreed to by Staff.⁷
24

25 **Q. PLEASE DESCRIBE THE COLORADO ORDER.**

26 A. In the matter before the Colorado Public Utilities Commission, the parties reached a
27 settlement. The following language in the settlement agreement illustrates how the NOLC
28 ADIT was treated:

29 The Settling Parties agree that the Company shall calculate the revenue
30 deficiency using full tax normalization, allowing the Company to provide for
31 deferred taxes on all book/tax timing differences, including the Company's
32 proposed offset to accumulated deferred income taxes ("ADIT") for the net
33 operating loss carryforward applicable to the Company's gas department for
34 income tax purposes for calendar year 2010.⁸
35

36 **Q. PLEASE DESCRIBE THE NEW MEXICO ORDER.**

⁷ WUTC v. *Puget Sound Energy Inc.*, Dockets UE-111048 and UG-111049 (consolidated) Order 08, (May 7, 2012), 2012 Wash. UTC LEXIS 423; 297 P.U.R.4th 135-138.

⁸ *In re Public Service Co. of Colorado*, Docket No. 10AL-963G, Decision No C11-0946, Order on Exceptions and Request for Clarification (Sept. 1, 2011), 2011 WL 4825894 at 9 (2011).
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1 A. The New Mexico Regulation Commission ruled as follows:

2 The revenue requirement in the Illustrative Cost of Service should be adjusted
3 to incorporate the effects of bonus depreciation for property placed in service
4 through June 30, 2010. The adjustment should reflect not only the ADIT
5 liability created through using bonus depreciation but the ADIT asset created
6 as a result of the NOL and the loss of the DPAD.⁹
7

8 **Q. PLEASE SUMMARIZE THESE DECISIONS.**

9 A. All of these commissions ruled that the NOLC ADIT should be included as an increase to
10 rate base. Each commission recognized that failure to do would understate rate base and
11 ignore the true ADIT related cash flow realized by the petitioners.

12 **Q. HAS THE COMPANY REPORTED ADIT IN THIS FILING CONSISTENT**
13 **WITH THESE DECISIONS AND WITH THESE WIDELY ACCEPTED**
14 **PRINCIPLES?**

15 A. Yes.

16 **Q. PLEASE EXPLAIN.**

17 A. In its tax filings, the Company has realized significant timing differences associated with
18 accelerated depreciation, bonus depreciation on plant investment and other timing items.
19 Between the Company's investment in plant over recent years and the favorable tax laws
20 enacted by Congress through bonus and accelerated depreciation, the Company has
21 realized favorable timing differences that exceed its earned income and all tax has been
22 offset. The excess timing differences not utilized to offset current tax have created a
23 NOLC that will be used in future periods to offset tax.

⁹ *In the Matter of the Application of Public Service Company of New Mexico for a Revision of Its Retail Electric Rates Pursuant to Advice Notice Nos. 397 and 32 (Former TNMP Services), Public Service Company of New Mexico*, Case No. 10-00086-UT, New Mexico Public Regulation Commission, 2011 N.M PUC LEXIS 35 at 259 (July 28, 2011).
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1 In establishing rates in this case and prior filings before this Authority, the
2 Company has recorded tax expense in Cost of Service at the current statutory rates. The
3 timing differences have allowed the Company to retain, as an interest free loan from the
4 government, the taxes collected in Cost of Service at statutory rates. The Company has
5 recorded an ADIT credit which equals the full amount of the favorable tax deductions
6 regardless of whether they produced cash in the current period. The ADIT credit
7 recorded exceeds the interest free loan extended from the government and a portion of the
8 liability represents unused tax deductions. The Company has also recorded a NOLC
9 ADIT for the NOLC generated by those same unused tax deductions.

10 In this case and in prior filings before this Authority, the Company has included
11 both the ADIT credit and the NOLC ADIT in rate base. This ratemaking treatment of
12 including both ADIT items accurately reduces rate base for the true cost free capital
13 realized by the Company.

14 **Q. DOES MR. NOVAK AGREE WITH THIS TREATMENT?**

15 **A.** He has expressed agreement with all but one key item.

16 On page 21, line 5 of his testimony he acknowledges that income tax expense
17 within the Cost of Service is set at statutory rates.

18 On page 26, lines 15-16, he also acknowledges that under generally accepted
19 ratemaking principles rate base is reduced by ADIT.

20 On page 21, line 4 of his testimony he expresses agreement with the Company's
21 accounting for the NOLC ADIT.

1 However, on page 21, lines 4-14, Mr. Novak opposes including the NOLC ADIT
2 as an increase to rate base despite including the full amount of the ADIT credit as a
3 reduction to rate base.

4 **Q. DOES MR. NOVAK OFFER ANY JUSTIFICATION BASED ON SOUND**
5 **RATEMAKING PRINCIPLES FOR IGNORING THE IMPACT OF THE NOLC**
6 **ADIT?**

7 A. None, whatsoever.

8 **Q. HAS MR. NOVAK OFFERED ANY PRECEDENTIAL SUPPORT FOR HIS**
9 **PROPOSED ADJUSTMENT?**

10 A. Mr. Novak cites a singular case filed by Mountaineer Gas Company before the West
11 Virginia Public Service Commission on page 31, lines 6-7, of his testimony.¹⁰

12 **Q. WHAT IS YOUR IMPRESSION OF THE WEST VIRGINIA RULING AS**
13 **PRECEDENTIAL SUPPORT?**

14 A. The West Virginia order is an outlier among jurisdictions that have dealt with this issue.
15 As I demonstrated, overwhelming precedent from a wide range of jurisdictions supports
16 the Company's proposed treatment of the NOLC ADIT. West Virginia is the only
17 jurisdiction that I am aware of that has reached a different conclusion and, as I will
18 explain, it appears there were distinguishing facts in that case upon which the WVPSC
19 found justification for departure from precedent. Those facts are not present in this case.

20 **Q. WHAT OTHER ARGUMENTS OR POSITIONS DOES MR. NOVAK ADVANCE**
21 **IN SUPPORT OF EXCLUSION OF THE NOLC ADIT?**

¹⁰ Public Service Commission of West Virginia at Charleston, Case No. 11-1627-G-42T, Commission Order on Rule 42T
Tariff Filing to Increase Rates and Charges (October 31 , 2012).
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1 A. Besides not offering any sound ratemaking policy reasons for excluding the NOLC
2 ADIT, Mr. Novak offers several other flawed opinions:

3 He opines on page 34 lines 3-5 of his testimony that the Company would not be in
4 violation of the normalization provision of the IRC if the NOLC ADIT were excluded
5 from rate base. He again references the Mountaineer case and bases this opinion on what
6 appears to be an incomplete understanding of an IRS private letter ruling issued in
7 relation to the Mountaineer proceedings.

8 He argues on page 29 lines 10-18 of his testimony that recovery of the NOLC
9 ADIT should be sought as some sort of regulatory asset and presumably not ADIT.

10 He calls into question on page 28 lines 7-15 of his testimony the Company's
11 ability to realize a benefit from an NOLC ADIT and suggests it is a "potentially risky
12 financing alternative".

13 Finally, he suggests on page 28 line 20 through page 29 line 5 of his testimony
14 that the NOLC ADIT represents an attempt by the Company to capitalize prior period
15 losses into rate base and should be denied.

16 **Q. HAS MR. NOVAK OFFERED TESTIMONY REGARDING THE TAX**
17 **NORMALIZATION RULES AND NOLCS?**

18 A. Yes.

19
20 **VI. NORMALIZATION REQUIREMENTS AND NOLCS**

21 **Q. WHAT IS MEANT BY TAX NORMALIZATION IN THE RATEMAKING**
22 **CONTEXT?**

1 A. There are a myriad of differences between the rules governing the recognition of income
2 and expense for tax purposes versus the recognition of those same items for financial
3 statement purposes. These differences result in both the acceleration and deferral of
4 income tax payments when compared to the income tax expense recorded on a
5 company's financial statements. However, in the context of a utility, the difference
6 between tax expense per the financial statements and the tax paid to the taxing authorities
7 generally results in a deferral of tax. Said differently, current taxes paid to the
8 government are less than the tax expense on the books and records. This is true for both
9 the financial statement tax expense and the tax expense for rate purposes in cost of
10 service. To use the previous loan analogy, the government has loaned money to the utility
11 by the enactment of favorable tax provisions.

12 A normalization method of accounting for taxes in its simplest terms strives to
13 keep this incremental cash received from the interest-free loan at the utility level where
14 Congress intended. Tax expense in its cost of service and rate filings are normalized and
15 not artificially lowered for the cash tax savings. In return, a reserve is recorded against
16 rate base in the amount of the accumulated tax deferred. Such an approach is mutually
17 beneficial both for rate payers and the utility. Rate payers are not paying a return on rate
18 base financed with the cost-free loan that the utility receives from the government.

19 **Q. WHAT IS FULL NORMALIZATION OF TAXES?**

20 A. Full normalization of taxes refers to treating all tax differences as normalized thereby
21 reducing the requested rate base for all taxes deferred. In other words, full normalization
22 reduces rate base by the loan advanced to the company for all differences between taxes
23 paid versus the tax expense realized in cost of service.

1 **Q. DOES THE COMPANY'S FILING IN THIS PROCEEDING REFLECT A FULL**
2 **NORMALIZATION APPROACH?**

3 A. Yes. The Company has filed utilizing a fully normalized approach.

4 **Q. WHY IS A FULLY NORMALIZED APPROACH APPROPRIATE?**

5 A. A fully normalized approach takes into account all tax deferrals and treats all of them as a
6 reduction to rate base. It is the simplest approach yet also the most balanced between the
7 interests of the rate payer and the utility. Essentially all interest-free loans the Company
8 has received from all taxing authorities are accounted for. The Company is able to use
9 those loans to build utility property infrastructure with cost-free financing and rate payers
10 do not pay a return on that investment.

11 **Q. DOES THE INTERNAL REVENUE CODE REQUIRE NORMALIZATION?**

12 A. As I will explain, the IRC and related regulations provide consequences to those utilities
13 and commissions that do not normalize certain tax benefits. These consequences are
14 draconian. So draconian in fact that the mere threat of them has the effect of "requiring"
15 utilities and commissions abide by them. Certainly a commission could choose to violate
16 the normalization provisions. However, a utility or commission that knowingly violated
17 the IRC normalization provisions would arguably be negligent in looking out for the best
18 interests of its rate payers.

19 **Q. WHICH TAX BENEFITS ARE REQUIRED TO BE NORMALIZED UNDER THE**
20 **IRC?**

21 A. The IRC requires that the deferral of tax associated with tax depreciation be normalized.

22 **Q. WHAT ARE THE TAX DEPRECIATION NORMALIZATION RULES?**

1 A. Accelerated depreciation was enacted by Congress as an investment incentive for
2 businesses. In a regulated environment, Congress was concerned that the tax savings
3 from accelerated depreciation would be flowed through to rate payers thereby negating
4 the incentive it sought to create. To discourage utilities and commissions from flowing
5 the incentive through to rate payers, Congress enacted the depreciation normalization
6 rules. The tax depreciation normalization rules mandate the normalization process I
7 previously described for all items associated with tax depreciation. In other words,
8 deferred accounting must be utilized and the balance of deferred taxes must be adjusted
9 out of rate base.

10 **Q. HOW DOES TAX DEPRECIATION NORMALIZATION WORK?**

11 A. As defined under Treas. Reg. §1.167(l)-1(h), in order to use a normalization method of
12 accounting, the public utility must use the “same method” of depreciation to compute
13 both its tax expense and its depreciation expense for purposes of establishing its cost of
14 service for ratemaking purposes and for reflecting operating results in its regulated books
15 of account. Further, if in computing its allowance for tax depreciation for purpose of
16 filing its tax returns, it uses a method other than that used for establishing its cost of
17 service for ratemaking purposes and for reflecting operating results in its regulated books
18 of account, the utility must make adjustments to an accumulated deferred federal income
19 tax reserve to reflect the deferral of taxes resulting from the use of the different methods
20 of depreciation. (Treas. Reg. §1.167(l)-1(h)(1)(i)(a) and (b)).

21 The established reserve must be used in ratemaking proceedings to reduce the
22 utility’s rate base upon which the rate of return is applied. A taxpayer DOES NOT use
23 a normalization method if, for ratemaking purposes, the amount of the accumulated

1 deferred federal income tax reserve which is excluded from rate base exceeds the amount
2 in the reserve for deferred taxes for the period used in determining the taxpayer's cost of
3 service. (Treas. Reg. §1.167(l)-1(h)(6)(i))

4 **Q. WHAT IS THE IMPACT TO A PUBLIC UTILITY IF IT DOES NOT MAINTAIN**
5 **A NORMALIZED METHOD OF ACCOUNTING?**

6 A. If a public utility believes its method of accounting is not a normalized method or is
7 compelled by a regulatory body to adopt a method which is not normalized, the utility
8 must notify the Service's District Director within 90 days and file amended returns which
9 recompute its tax liability for any affected taxable years. Prospectively, the utility
10 would lose the ability to claim accelerated tax depreciation on future tax returns.

11 **Q. DO THE TAX DEPRECIATION NORMALIZATION RULES TAKE INTO**
12 **ACCOUNT A NOLC?**

13 A. They absolutely do. The normalization rules apply to any portion of the NOLC that is
14 attributable to the accelerated tax depreciation.

15 **Q. HOW DO YOU REACH THIS CONCLUSION?**

16 A. Treasury Regulation §1.167(l)-1(h)(1)(iii) addresses the situation specifically. It provides
17 that if by use of accelerated depreciation, the taxpayer generates a NOLC which would
18 have otherwise not arisen, then the amount and time of tax depreciation deferral shall be
19 taken into account for rate base in an appropriate time and manner as is satisfactory to the
20 Service's District Director.

21 **Q. EFFECTIVELY WHAT DOES THIS MEAN?**

22 A. A taxpayer in computing the amount of ADIT credit by which to reduce rate base must
23 take into account a NOLC ADIT. A NOLC ADIT, to the extent created by depreciation

1 deductions, represents depreciation deductions that have not yet resulted in a tax deferral.
2 To use the loan analogy, if a NOLC has been created by the accelerated tax depreciation,
3 then a loan HAS NOT yet been extended to the company. To reduce a utility's rate base
4 for the full amount of deferred tax generated by the accelerated depreciation and not take
5 into account the generation of a NOLC would essentially impute a loan that has not
6 occurred and more importantly violate the normalization provisions.

7 **Q. IF A TAXPAYER DOES NOT TAKE INTO ACCOUNT ITS NOLC, WHAT**
8 **HAPPENS?**

9 A. The taxpayer would be in violation of this provision and would have a "normalization
10 violation" under the IRC. It would be required to notify the IRS of such a violation and it
11 would be prohibited from using accelerated depreciation. It would be required to file
12 amended returns reversing the use of accelerated depreciation. In short it would have an
13 immediate and negative cash flow impact on the taxpayer. It would be catastrophic from
14 a tax standpoint.

15 **Q. IN THIS CASE, HAS THE COMPANY TAKEN INTO ACCOUNT ITS NOLC BY**
16 **INCLUDING THE NOLC ADIT ASSET INTO ITS DEFERRED TAXES**
17 **APPLIED TO RATE BASE AND COMPLIED WITH TREASURY**
18 **REGULATION §1.167(L)-1(H)(1)(III)?**

19 A. Yes.

20 **Q. HAS MR. NOVAK OPINED THAT A NORMALIZATION VIOLATION WOULD**
21 **NOT OCCUR IF THE NOLC ADIT IS NOT INCLUDED IN RATE BASE?**

22 A. Yes (*See Novak Direct, page 36, lines 19-21*).

23 **Q. ON WHAT DOES HE BASE THIS OPINION?**

1 A. Mr. Novak believes the ruling in the Mountaineer case and an IRS private letter ruling
2 (“PLR”) issued to Mountaineer, PLR 201418024, support his position.

3 **Q. ARE YOU FAMILIAR WITH THE WEST VIRGINIA RULING AND THE**
4 **RELATED PLR 201418024 THAT MR. NOVAK CITES IN SUPPORT OF HIS**
5 **POSITION?**

6 A. Yes.

7 **Q. WITH RESPECT TO NOLC ADIT, PLEASE DESCRIBE THE WEST VIRGINIA**
8 **PUBLIC SERVICE COMMISSION’S RULING IN THE MOUNTAINEER CASE.**

9 A. Mountaineer filed a rate case before the WVPSC. The inclusion of on an NOLC ADIT in
10 rate base was a significant component of the case. Also at issue in the case was the level
11 of deferred tax expense recovered in Cost of Service both within the current case before
12 the commission and in prior cases. Through a series of final orders and motions for
13 reconsideration, the WVPSC ruled that Mountaineer was not allowed to include the
14 NOLC ADIT in rate base. There were also several adjustments made to tax expense
15 included within Cost of Service, such that the tax expense authorized in the case did not
16 equal statutory rates.

17 **Q. PLEASE DESCRIBE PLR 201418024.**

18 A. In PLR 201418024, issued on May 2, 2014, the Service addressed the implications under
19 the normalization rules of Mountaineer’s NOLC ADIT in light of the West Virginia
20 ruling. In setting rates, Mountaineer’s regulators reduced the utility's rate base by its
21 ADIT balance excluding the NOLC ADIT asset. Mountaineer had an NOLC ADIT
22 deferred tax asset (DTA) that was attributable to accelerated depreciation deductions.
23 Mountaineer argued that the normalization rules required that its DTA be factored into

1 the ADIT computation for this purpose. The regulators asserted that their process for
2 setting rates already recognized the effects of the utility's NOLC insofar as it included "a
3 provision for deferred taxes based on the entire difference between accelerated tax and
4 regulatory depreciation, including situations in which a utility has an NOLC. . . ." ¹¹ The
5 Service concluded that, if the regulators took the effect of the NOLC into account when
6 establishing the tax expense element of Cost of Service, as they asserted they did, then
7 the normalization rules did not require that the DTA also be considered in the
8 determination of rate base.

9 **Q. WHAT IS THE DISTINGUISHING FACT PRESENT IN THE MOUNTAINEER**
10 **CASE?**

11 A. Upon issuance of the PLR in May 2014 a critical fact in the Mountaineer case became
12 apparent. The PLR clearly states that the WVPSC and Mountaineer appear to have
13 adjusted the level of tax expense in Cost of Service to account for NOLs as they arose.
14 The following sentences from the PLR are clear.

15 Commission has stated that, in setting rates it includes a provision for deferred
16 taxes based on the entire difference between accelerated tax and regulatory
17 depreciation, including situations in which a utility has an NOLC or MTCC. Such
18 a provision allows a utility to collect amounts from ratepayers equal to income
19 taxes that would have been due absent the NOLC and MTCC. ¹²
20

21 From these statements, it would follow that West Virginia rate payers paid higher
22 rates in prior periods as the effect of the NOL was absent in calculating income taxes in
23 Cost of Service. This fact is also supported by the controversy surrounding the level of
24 tax expense included within Cost of Service in the Mountaineer case before the WVPSC.

¹¹ I.R.S. Priv. Ltr. Rul. 201418024 (May 2, 2014), 2014 WL 1743212 at 3. (A copy of the PLR is also attached to Mr. Novak's pre-filed direct testimony as attachment WHN-10).

¹² I.R.S. Priv. Ltr. Rul. 201418024 (May 2, 2014), 2014 WL 1743212 at 5
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1 A review of the final order shows that tax expense in that case was not set at statutory tax
2 expense but rather an adjusted tax expense.¹³

3 **Q. IS THE WEST VIRGINIA RULING OR THE PLR SUPPORTIVE OF MR.**
4 **NOVAK'S POSITION THAT THE NOLC ADIT SHOULD NOT BE INCLUDED**
5 **IN RATE BASE IN THIS CASE?**

6 A. No. The distinguishing fact I described is not present in this case. Mr. Novak appears to
7 miss that the Mountaineer case and the resulting PLR hinged on the manner in which the
8 NOLs were accounted for in Cost of Service. The IRS held that the normalization rules
9 required that the utility's NOLC be "taken into account" by the utility's regulators in
10 establishing rates.¹⁴ The way in which the regulators asserted that they "took it into
11 account" was by imposing on customers a deferred tax charge on the entire difference
12 between book and tax depreciation whether or not the deduction created an NOLC.¹⁵
13 Under those circumstances, the Service ruled that the NOLC ADIT did not have to be
14 included in the ADIT calculation because the NOLC had already been "taken into
15 account" in computing tax expense.¹⁶ The type of ratemaking for the NOLC claimed by
16 the regulators in PLR 201418024 is not practiced in Tennessee. In the context of this
17 proceeding, if the NOLC ADIT is not included in the calculation of rate base, then it is
18 not "taken into account" at all, a consequence of which is that the treatment will be
19 inconsistent with the normalization rules.

20 **Q. HOW IS PLR 201418024 SUPPORTIVE OF THE COMPANY'S TREATMENT**
21 **OF THE NOLC IN THIS CASE?**

¹³ See Public Service Commission of West Virginia at Charleston, Case No. 11-1627-G-42T, Commission Order on Rule 42T Tariff Filing to Increase Rates and Charges, (October 31, 2012) at pp. 44 – 47.

¹⁴ I.R.S. Priv. Ltr. Rul. 201418024 (May 2, 2014), 2014 WL 1743212 at 5

¹⁵ See I.R.S. Priv. Ltr. Rul. 201418024 (May 2, 2014), 2014 WL 1743212 at 5.

¹⁶ I.R.S. Priv. Ltr. Rul. 201418024 (May 2, 2014), 2014 WL 1743212 at 5.

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1 A. The PLR is unambiguous in its ruling that the normalization rules require the utility's
2 NOLC be "taken into account" by the utility's regulators in establishing rates.¹⁷

3 **Q. HAS THE COMPANY "TAKEN INTO ACCOUNT" THE NOLC IN**
4 **ESTABLISHING RATES IN THIS CASE?**

5 A. Yes. Including the NOLC ADIT in rate base, as the Company has in this proceeding,
6 would satisfy this requirement and comply with the normalization rules.

7 **Q. DOES MR. NOVAK PROPOSE TO "TAKE INTO ACCOUNT" THE NOLC IN**
8 **ESTABLISHING RATES IN THIS CASE?**

9 A. No. He proposes to exclude the NOLC and not take it into account in establishing rates in
10 this proceeding (*See Novak Direct*, page 21, line 12-14).

11 **Q. ARE YOU AWARE OF OTHER PRIVATE LETTER RULINGS ISSUED THAT**
12 **ADDRESS THE IMPLICATIONS OF THE NOLC ADIT ON THE**
13 **NORMALIZATION PROVISIONS?**

14 A. Yes. I am aware of four other PLRs that address the issue of tax normalization rules for a
15 NOLC ADIT. The IRS issued PLR 8818040 on February 9, 1988. In addition, the IRS
16 issued two rulings on September 5, 2014; PLRs 201436037 and 201436038. The IRS also
17 issued PLR 201438003 on September 19, 2014. A copy of the four rulings is attached as
18 Exhibit PM – 1.

19 **Q. PLEASE DESCRIBE THESE RULINGS.**

20 A. PLR 8818040 - A utility in 1985 and 1986 incurred substantial accelerated tax
21 depreciation deductions. Not all of those deductions could be used and as a result the
22 utility reported a NOLC on its tax returns. The utility proposed to reflect the deferred tax

¹⁷ I.R.S. Priv. Ltr. Rul. 201418024 (May 2, 2014), 2014 WL 1743212 at 5.
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1 from tax depreciation in rate base in 1987, which is the year the NOLC would be used.
2 The PLR held this approach would be consistent with the normalization rules.¹⁸ One
3 factor that was also addressed in the PLR was the difference in tax rates between 1987
4 and the earlier years. The IRS also ruled which rate should be used to calculate the
5 deferred taxes given the change in tax rate.¹⁹ Regardless of the tax rate issue, the fact
6 remains that the IRS ruled a NOLC ADIT asset should be considered when determining
7 the proper amount of ADIT to apply to rate base.

8 In PLRs 201436037, 201436038 and 201438003 issued in September 2014, the
9 Service addressed the treatment of NOLC ADIT in ratemaking. In each of those rulings
10 the Service concluded that (1) to the extent that the taxpayer's NOLC-related DTA is
11 attributable to accelerated depreciation, it must reduce the ADIT balance by which rate
12 base is reduced and (2) the NOLC is attributable to accelerated depreciation to the extent
13 that the claiming of accelerated depreciation created or increased the NOLC in the
14 taxable year (i.e., a "last dollars deducted" computation).²⁰

15 In each of these cases, the NOLC had not been taken into account in calculating
16 tax expense and therefore, the NOLC ADIT was required to be included in rate base to
17 comply with the normalization provisions.

18 **Q. ARE THESE RULINGS SUPPORTIVE OF MR. NOVAK'S POSITION THAT A**
19 **NORMALIZATION VIOLATION WOULD NOT OCCUR IF THE NOLC ADIT**
20 **IS REMOVED FROM RATE BASE?**

¹⁸ Exhibit PM-1, p. 28

¹⁹ See Exhibit PM-1, p.28

²⁰ See Exhibit PM-1, pp. 23-24; Exhibit PM-1, pp. 15-16; Exhibit PM-1, pp. 7-8.

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1 A. No. On the contrary, these rulings support the Company's position that exclusion of the
2 NOLC ADIT from rate base would result in a normalization violation.

3 **Q. WOULD MR. NOVAK HAVE REASON TO BE AWARE OF THESE PRIVATE**
4 **LETTER RULINGS?**

5 A. Yes. They were described in the Company's private letter ruling request Mr. Novak
6 references in his direct testimony.²¹

7 **Q. WHAT IS YOUR OPINION REGARDING MR. NOVAK'S RELIANCE ON PLR**
8 **201418024 VERSUS OTHER PLRS YOU HAVE DESCRIBED?**

9 A. Mr. Novak demonstrates a lack of understanding about NOLC ADITs in general, as well
10 as confusion about the private letter rulings issued. It appears that Mr. Novak believes
11 that PLR 201418024 supports his position that excluding the NOLC ADIT from rate base
12 would not violate normalization provisions (*See* Novak Direct, page 34, line 3-5). While
13 the Service did rule that the exclusion of the NOLC ADIT from rate base would not result
14 in a normalization violation in that case, Mr. Novak does not appear to understand or to
15 acknowledge that the ruling hinged on the fact that tax expense for rates is calculated
16 differently than in Tennessee. Therefore, that case and PLR 201418024 are not
17 supportive of Mr. Novak's position. The other PLRs I have discussed clearly indicate that
18 the NOLC ADIT must be included in rate base in order to comply with the normalization
19 provisions.

20 **Q. ARE YOU AWARE OF ANY PRIVATE LETTER RULINGS THAT ARE**
21 **SUPPORTIVE OF MR. NOVAK'S POSITION?**

22 A. No.

²¹ See e.g., Novak Direct page 8 – 12 (citing Exhibit A, at pages 14-15, to the Attachments to Informal Discovery request of the Consumer Advocate, filed March 23, 2015, in this TRA Docket 14-00146).
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1 **Q. HAS ATMOS REQUESTED A PRIVATE LETTER RULING FROM THE IRS**
2 **REGARDING THE APPLICATION OF THE NORMALIZATION RULES TO**
3 **THE NOLC?**

4 A. Yes. Atmos filed a private letter ruling request on January 9, 2015 to comply with
5 Kentucky Public Service Commission Order in Case No. 2013-00148.

6 **Q. HAVE THE FACTS CHANGED WITH REGARD TO NOLC ADITS SINCE THE**
7 **KENTUCKY RATE CASE OR THE FILING OF THE PRIVATE LETTER**
8 **RULING REQUEST?**

9 A. No. The Company's treatment of NOLC ADITs and the Company's computation of tax
10 expense for Cost of Service in this case are consistent with the Kentucky case and the
11 facts as stated in the private ruling request.

12 **Q. HAS MR. NOVAK SUGGESTED THAT THE COMPANY FILE ANOTHER**
13 **PRIVATE LETTER RULING REQUEST?**

14 A. Yes, on page 37, lines 5 through 10 of Mr. Novak's direct testimony, he suggests that if
15 the Authority does not agree with his position that the NOLC ADIT should be excluded
16 from rate base, the Company should be required to seek a private letter ruling on the
17 issue.

18 **Q. WOULD THERE BE ANY BENEFIT TO THE COMPANY OR THE**
19 **AUTHORITY IF ATMOS FILED A SECOND PRIVATE LETTER RULING**
20 **REQUEST?**

21 A. No. The facts as stated in the filed private ruling request have not changed. The only
22 distinction is the regulatory jurisdiction. The facts were stated completely and accurately
23 and the Company complied with all provisions of the revenue procedure that dictates the

1 requirements for a PLR request. The Company believes that the IRS will rule that the
2 Company's interpretation of the normalization provisions with regard to NOLC ADITs is
3 correct. A PLR is a statement regarding the application of tax laws to a taxpayer's set of
4 circumstances. Since neither the tax laws nor the stated circumstances have changed
5 since the filing of the PLR, there would be no benefit to requesting a second PLR.

6 **Q. DID THE KENTUCKY PUBLIC SERVICE COMMISSION AGREE THAT THE**
7 **FACTS IN THE PRIVATE LETTER RULING REQUEST WERE COMPLETE**
8 **AND ACCURATE?**

9 A. Yes they did. The letter by the Kentucky Public Service Commission is attached as
10 Exhibit PM-2.
11

12 **VII. REGULATORY AUTHORITY REGARDING RATES AND NORMALIZATION**

13 **Q. IN THE MOUNTAINEER CASE THAT MR. NOVAK CITES, DID THE PUBLIC**
14 **SERVICE COMMISSION OF WEST VIRGINIA RULE ON WHETHER THE**
15 **EXCLUSION OF THE NOLC FROM RATE BASE WOULD RESULT IN A**
16 **NORMALIZATION VIOLATION?**

17 A. No. The Commission stated a belief or opinion, not a ruling. In fact, in the order denying
18 Mountaineer Gas Company's Petition to Reconsider, the WVPSC stated, "The
19 Commission stated in the November 2012 Order and continues to believe that its
20 historical method of determining the level of deferred income tax expense for rate
21 recovery meets the normalization requirements of the IRS."²²

²² Public Service Commission of West Virginia at Charleston, Case No. 11-1627-G-42T (REOPENED),
Commission Final Order rejecting the Limited Petition for Consideration (February 11, 2013) at page 3.
{Legal/02831/18422/01454298.DOCX }

1 **Q. DID THE INTERNAL REVENUE SERVICE RULE AS TO WHETHER THE**
2 **EXCLUSION OF THE NOLC FROM RATE BASE WAS PROPER RATE**
3 **MAKING TREATMENT?**

4 A. No. The Internal Revenue Service only ruled on whether a normalization violation had
5 occurred. The Internal Revenue Service does not have the authority or desire to rule
6 about rate making.

7 **Q. WHERE ARE THE NORMALIZATION PROVISIONS FOUND?**

8 A. The Internal Revenue Code and related regulations.

9 **Q. WHO HAS AUTHORITY FOR INTERPRETING THE IRC AND RELATED**
10 **REGULATIONS?**

11 A. The Internal Revenue Service does.

12 **Q. DOES MR. NOVAK STATE THAT THE TRA HAS THE AUTHORITY TO**
13 **DETERMINE WHETHER A NORMALIZATION VIOLATION WILL OCCUR?**

14 A. Yes. Mr. Novak states in his direct testimony, page 34, lines 15-22 and on page 35, lines
15 1-2 that he does believe the TRA has the authority to determine whether a normalization
16 violation would occur.

17 **Q. IS MR. NOVAK'S CONCLUSION CORRECT THAT THE TRA HAS THE**
18 **AUTHORITY TO RULE AS TO WHETHER A NORMALIZATION VIOLATION**
19 **WILL OCCUR?**

20 A. No. While the Authority can offer an opinion or a belief regarding whether a
21 normalization violation has occurred, only the IRS has the authority to determine whether
22 the Company is in compliance with provisions of the IRC. Likewise, only the IRS can
23 assess penalties if it is determined that a normalization violation has occurred. Mr. Novak

1 draws an incorrect and illogical conclusion that because the IRS ruled that a
2 normalization violation had not occurred in the Mountaineer case, the TRA has authority
3 to make such a determination.

4 **Q. HAS MR. NOVAK MADE SUGGESTIONS REGARDING THE PREPARATION,**
5 **CONTENT AND PARTICIPATION BY THE CONSUMER ADVOCATE IN A**
6 **PRIVATE LETTER RULING REQUEST IF THE COMPANY IS ORDERED TO**
7 **FILE A REQUEST?**

8 A. Yes (See Novak Direct, page 37, lines 5-22 and page 38, lines 1-2).

9 **Q. ARE THESE REQUESTS CONSISTENT WITH THE IRS PROCEDURES FOR**
10 **REQUESTING A RULING?**

11 A. No. Revenue Procedure 2015-1 outlines the requirements for requesting a private letter
12 ruling from the IRS. It is specific and straight forward. The request is not made jointly by
13 the Company and a consumer advocate or a commission. Instead, the request is made by
14 the taxpayer alone. The taxpayer is required to submit the request to the commission for
15 agreement that the facts are accurate and complete. Comments from a consumer
16 advocate or any other party are permissible but the avenue to submit those comments is
17 well defined and specified within the Revenue Procedure. If ordered to seek a private
18 letter ruling, the Company would welcome the Authority and Consumer Advocate's
19 participation in the process consistent with those procedures outlined in the Revenue
20 Procedure.

1 **VIII. PROPER UNDERSTANDING OF NOLC ADIT**

2 **Q. DOES THE NOLC ADIT REPRESENT PRIOR PERIOD LOSSES AS MR.**
3 **NOVAK SUGGESTS?**

4 A. No. The NOLC ADIT represents unused deductions available to offset taxable income in
5 a future period.

6 **Q. DOES MR. NOVAK ALSO ARGUE THAT THE DEDUCTIONS TAKEN IN**
7 **PRIOR YEARS THAT GENERATED THE NOLC ADIT BE TREATED AS**
8 **PRIOR PERIOD ITEMS AND EXCLUDED FROM RATE BASE?**

9 A. No. Mr. Novak is very inconsistent in this respect. He acknowledges that including
10 deferred tax liabilities in rate base is proper rate making treatment (*See* Novak Direct,
11 page 26, lines 15-16). What he fails to acknowledge is that a portion of the deductions
12 generating these deferred tax liabilities included in rate base have not yet been used to
13 offset taxable income. These unused deductions are recorded as the NOLC ADIT and do
14 not represent prior period losses. The NOLC ADIT is no different than any other ADIT
15 recorded on the books.

16 **Q. DOES THE NOLC ADIT REPRESENT A REGULATORY ASSET AS MR.**
17 **NOVAK SUGGESTS?**

18 A. No. The NOLC ADIT is a deferred tax asset representing unused deductions that will be
19 used to offset taxable income in a future period.

20 **Q. DOES MR. NOVAK OFFER AN OPINION ABOUT THE COMPANY'S**
21 **ACCOUNTING METHODOLOGIES?**

22 A. Yes, on page 36, lines 5-7, Mr. Novak states that the Company's accounting
23 methodologies are correct.

1 **Q. WHERE IS THE NOLC ADIT RECORDED ON THE COMPANY'S BOOKS?**

2 A. The NOLC ADIT is recorded to deferred taxes, account 190.

3 **Q. ARE YOU AWARE OF ANY PRECEDENT FOR TREATING THE NOLC ADIT**
4 **AS A REGULATORY ASSET?**

5 A. No, I am not.

6 **Q. DOES MR. NOVAK CITE PRECEDENT FOR TREATING THE NOLC ADIT AS**
7 **A REGULATORY ASSET?**

8 A. Mr. Novak suggests in his testimony on page 29, lines 12-14, that Piedmont Natural
9 Gas's ("Piedmont") petition to amortize and refund excess deferred taxes to customers is
10 similar to the Company's NOLC ADIT.

11 **Q. WHAT ARE EXCESS DEFERRED TAXES?**

12 A. Deferred taxes on the books of a company that the company does not believe will be
13 realized. In other words, excess deferred taxes are deferred taxes on the books that a
14 company cannot support.

15 **Q. WHAT IS THE PROPER RATE MAKING TREATMENT FOR EXCESS**
16 **DEFERRED TAXES?**

17 A. Excess deferred tax liabilities are typically refunded to customers. Piedmont has proposed
18 to do this by establishing a regulatory liability and amortizing the refund to customers
19 over three years.

20 **Q. HOW IS THIS DIFFERENT FROM THE NOLC ADIT?**

21 A. The NOLC ADIT is in no way similar to excess deferred taxes. Mr. Novak's comparison
22 is very misguided. To start, the NOLC ADIT is an asset, whereas, contrary to Mr.
23 Novak's direct testimony on page 29, lines 12-14, the regulatory item Piedmont has

1 petitioned to create is a liability.²³ Further, the NOLC ADIT is a deferred tax asset that
2 Atmos Energy can support and has confidence that it will utilize. Excess deferred taxes
3 by definition are ADIT amounts that cannot be supported and are not expected to be
4 realized.

5 **Q. WHAT IS YOUR IMPRESSION OF MR. NOVAK'S TESTIMONY ON PAGE 28,**
6 **LINES 7-15, THAT THE NOLC ADIT REPRESENTS RISKY FINANCING FOR**
7 **THE BENEFIT OF SHAREHOLDERS?**

8 A. Mr. Novak's argument lacks merit. The NOLC ADIT is not a financing alternative. It is a
9 deferred tax asset that will reduce future tax liability by offsetting future taxable income.

10 **Q. DO YOU BELIEVE, AS MR. NOVAK SUGGESTS, THAT THE NOLC MAY**
11 **EXPIRE UNUSED?**

12 A. No. The Company believes that the NOLC will be fully utilized.

13 **Q. WHY DO YOU BELIEVE THIS?**

14 A. The Company is required to follow US GAAP for all items recorded on the financial
15 statements, including deferred tax items such as the NOLC ADIT. The Company is
16 audited to determine compliance with US GAAP.

17 **Q. WHAT DOES US GAAP REQUIRE WITH REGARD TO THE NOLC ADIT?**

18 A. Credit carryforwards and net operating loss carryforwards, such as the NOLC ADIT, are
19 audited to determine the likelihood they will be utilized before expiring. The Company is
20 required to prepare taxable income projections that are reviewed by external auditors to
21 support the future realization of these assets. If any amount is at risk for not being utilized
22 prior to expiring, a valuation allowance must be established.

²³ Petition of Piedmont Natural Gas Company, Inc. for Authorization to Amortize and Refund to Customers Excess Accumulation Deferred Income Taxes, TRA Docket No. 14-00017, 2/21/14, page 3.
{Legal/02831/18422/01454298.DOCX }

1 **Q. HAS THE COMPANY PREPARED THESE TAXABLE INCOME**
2 **PROJECTIONS?**

3 **A. Yes.** The Company computes high-level taxable income projections annually for external
4 audit review. These projections are prepared for consolidated operations and include both
5 regulated and non-regulated amounts. When the projections were prepared in September,
6 2014, they indicated that the Company will have future taxable income sufficient to offset
7 all NOLCs.

8 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

9 **A. Yes.**

BEFORE THE TENNESSEE REGULATORY AUTHORITY

NASHVILLE, TENNESSEE

IN RE:

ATMOS ENERGY CORPORATION
GENERAL RATE
CASE AND PETITION TO ADOPT
ANNUAL REVIEW MECHANISM
AND ARM TARIFF

Docket No. 14-00146

VERIFICATION

STATE OF TEXAS)

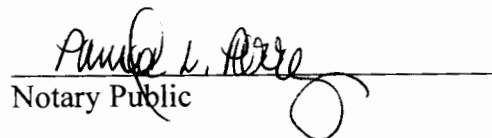
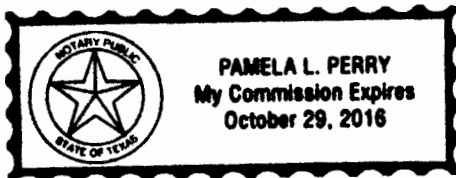
COUNTY OF DALLAS)

I, Pace McDonald, being first duly sworn, state that I am the Vice President of Taxes for Atmos Energy Corporation, that I am authorized to testify on behalf of Atmos Energy Corporation in the above referenced docket, that the Rebuttal Testimony of Pace McDonald in Support of Atmos Energy Corporation's Petition and the Exhibits thereto pre-filed in this docket on the date of filing on this Petition are true and correct to the best of my knowledge, information and belief.



Pace McDonald

Sworn and subscribed before me this 23rd day of April, 2015



Notary Public

My Commission Expires: 10-29-16

PLR 201438003 -- IRC Sec(s). 167; 168, 09/19/2014

Private Letter Rulings & Technical Advice Memoranda (1953 - Present) (RIA)

Private Letter Rulings

Private Letter Ruling 201438003, 09/19/2014, IRC Sec(s). 168

UIL No. 167.22-01

Accelerated depreciation-accumulated deferred income tax-net operating loss carryover-normalization-limitations on reasonable allowance in case of property of public utilities.

Headnote:

Reduction of taxpayer/regulated electric utility's rate base by full amount of its ADIT account balance unreduced by balance of NOLC-related account balance would be inconsistent with **Code Sec. 168(i)(9)**; and **Reg § 1.167(l)-1** requirements.

Reference(s): Code Sec. 168; Code Sec. 167;

Full Text:

Number: **201438003**

Release Date: 9/19/2014

Index Number: 167.22-01

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact: [Redacted Text]

[Redacted Text], ID No.

Telephone Number: [Redacted Text]

Refer Reply To:

CC:PSI:B06

PLR-104157-14

Date:

June 12, 2014

LEGEND:

Taxpayer =

Parent =

State A =

Commission A =

Commission B =

Year A =

Year B =

Year C =

Year D =

Date A =

Date B =

Date C =

Date D =

Case =

Director =

Dear [Redacted Text]:

This letter responds to the request, dated January 24, 2014, and additional submission dated May 19, 2014, submitted on behalf of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer is a regulated, investor-owned public utility incorporated under the laws of State A primarily engaged in the business of supplying electricity in State A. Taxpayer is subject to the regulatory jurisdiction of Commission A and Commission B with respect to terms and conditions of service and particularly the rates it may charge for the provision of service. Taxpayer's rates are established on a rate of return basis.

Taxpayer is wholly owned by Parent, and Taxpayer is included in a consolidated federal income tax return of which Parent is the common parent. Taxpayer employs the accrual method of accounting and reports on a calendar year basis.

Taxpayer filed a rate case application on Date A (Case). In its filing, Taxpayer used as its starting point actual data from the historic test period, calendar Year A. It then projected data for Year B through Year C. Taxpayer updated, amended, and supplemented its data several times during the course of the proceedings. Rates in this proceeding were intended to, and did, go into effect for the period Date B through Date C.

In computing its income tax expense element of cost of service, the tax benefits attributable to accelerated depreciation were normalized and were not flowed thru to ratepayers.

In its rate case filing, Taxpayer anticipated that it would claim accelerated depreciation, including "bonus depreciation" on its tax returns to the extent that such depreciation was available in all years for which data was provided. Additionally, Taxpayer forecasted that it would incur a net operating loss (NOL) in Year D. Taxpayer anticipated that it had the capacity to carry back a portion of this NOL with the remainder producing a net operating loss carryover (NOLC) as of the end of Year D.







On its regulatory books of account, Taxpayer "normalizes" the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute "cost-free capital" to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account. In addition, Taxpayer maintains an offsetting series of entries - a "deferred tax asset" and a "deferred tax expense" - that reflect that portion of those 'tax losses' which, while due to accelerated depreciation, did not actually defer tax because of the existence of an NOLC.

In the setting of utility rates in State, a utility's rate base is offset by its ADIT balance. In its rate case filing and throughout the proceeding, Taxpayer maintained that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of the NOLC, as represented in the deferred tax asset account. Thus, Taxpayer argued that the rate base should be reduced as of the end of Year D by its federal ADIT balance net of the deferred tax asset account




attributable to the federal NOLC. It based this position on its determination that this net amount represented the true measure of federal income taxes deferred on account of its claiming accelerated tax depreciation deductions and, consequently, the actual quantity of "cost-free" capital available to it. It also asserted that the failure to reduce its rate base offset by the deferred tax asset attributable to the federal NOLC would be inconsistent with the normalization rules. Testimony by another participant in Case argued against Taxpayer's proposed calculation of ADIT.


Commission A, in an order issued on Date D, held that it is inappropriate to include the NOL in rate base for ratemaking purposes. Commission A further stated that it is the intent of the Commission that Taxpayer comply with the normalization method of accounting and tax normalization regulations. Commission noted that if Taxpayer later obtains a ruling from the IRS which affirms Taxpayer's position, Taxpayer may file seeking an adjustment. Commission A also held that to the extent tax normalization rules require recording the NOL to rate base in the specified years, no rate of return is authorized.





Taxpayer requests that we rule as follows:





1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balance unreduced by the balance of its NOLC-related account balance would be inconsistent with (and, hence, violative of) the requirements of  § 168(i)(9) and  § 1.167(l)-1 of the Income Tax regulations.
2. For purposes of Ruling 1 above, the use of a balance of Taxpayer's NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with and without" basis would be inconsistent with (and, hence, violative of) the requirements of  § 168(i)(9) and  § 1.167(l)-1 of the Income Tax regulations.
3. Under the circumstances described above, the assignment of a zero rate of return to the balance of Taxpayer's NOLC-related account balance would be inconsistent with (and, hence, violative of) the requirements of  § 168(i)(9) and  § 1.167(l)-1.






Law and Analysis


 Section 168(f)(2) of the Code provides that the depreciation deduction determined under  section 168 shall not apply to any public utility property (within the meaning of  section 168(i)(10)) if the taxpayer does not use a normalization method of accounting.


In order to use a normalization method of accounting,  section 168(i)(9)(A)(i) of the Code requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter

than, the method and period used to compute its depreciation expense for such purposes. Under  section 168(i)(9)(A)(ii), if the amount allowable as a deduction under  section 168 differs from the amount that would be allowable as a deduction under  section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under  section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

 Section 168(i)(9)(B)(i) of the Code provides that one way the requirements of  section 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under  section 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under  section 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.

Former  section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former  section 167(l)(3)(G) in a manner consistent with that found in  section 168(i)(9)(A).  Section 1.167(l)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under  section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

 Section 1.167(l)-1(h)(1)(i) provides that the reserve established for public utility property should reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.

 Section 1.167(l)-1(h)(1)(iii) provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used. If, however, in



respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.


Section 1.167(l)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that, with respect to any account, the aggregate amount allocable to deferred tax under section 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation. That section also notes that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under section 1.167(l)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under section 167(a).



Section 1.167(l)-1(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

Section 1.167(l)-1(h)(6)(ii) provides that, for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under section 1.167(l)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period.

Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting the total amount of the

deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes. Taxpayer has done so.  Section 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.  Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

Regarding the first issue,  § 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Because the ADIT account, the reserve account for deferred taxes, reduces rate base, it is clear that the portion of an NOLC that is attributable to accelerated depreciation must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT). Thus, the order by Commission A is not in accord with the normalization requirements.

Regarding the second issue,  § 1.167(l)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes.  Section 1.167(l)-1(h)(1)(iii) provides generally that, if, in respect of any year, the use of other than regulatory depreciation for tax purposes results in an NOLC carryover (or an increase in an NOLC which would not have arisen had the taxpayer claimed only regulatory depreciation for tax purposes), then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director. While that section provides no specific mandate on methods, it does provide that the Service has discretion to determine whether a particular method satisfies the normalization requirements. The "with or without" methodology employed by Taxpayer is specifically designed to ensure that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated depreciation to ratepayers. Under these facts, any method other than the "with and without" method would not provide the same level of certainty and therefore the use of any other methodology is inconsistent with the normalization rules.

Regarding the third issue, assignment of a zero rate of return to the balance of Taxpayer's NOLC-related account balance would, in effect, flow the tax benefits of accelerated depreciation deductions through to rate payers. This would violate the normalization provisions.

We rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balance unreduced by the balance of its NOLC-related account balance would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

2. For purposes of Ruling 1 above, the use of a balance of Taxpayer's NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with and without" basis would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

3. Under the circumstances described above, the assignment of a zero rate of return to the balance of Taxpayer's NOLC-related account balance would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely,

Peter C. Friedman

Senior Technician Reviewer, Branch 6

(Passthroughs & Special Industries)

cc: [Redacted Text]

PLR 201436038 -- IRC Sec(s). 167; 168, 09/05/14

Private Letter Rulings & Technical Advice Memoranda (1953 - Present) (RIA)

Private Letter Rulings

Private Letter Ruling 201436038, 09/05/14, IRC Sec(s). 167

UIL No. 167.22-01

Accelerated depreciation-accumulated deferred income tax-net operating loss carryover-computation based on "with or without" basis-normalization-limitations on reasonable allowance in case of property of public utilities.

Headnote:

Reduction of taxpayer/regulator electric utility's rate base by full amount of its ADIT account balances offset by portion of its NOLC-related account that is less than amount attributable to accelerated depreciation computed on "with or without" basis would be inconsistent with **Code Sec. 168(l)(9)**; and **Reg § 1.167(l)-1** requirements.

Reference(s): Code Sec. 167; Code Sec. 168;

Full Text:

Number: **201436038**

Release Date: 9/5/2014

Index Number: 167.22-01

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact: [Redacted Text]

[Redacted Text], ID No.

Telephone Number: [Redacted Text]

Refer Reply To:

CC:PSI:B06

PLR-148311-13

Date:

May 22, 2014

LEGEND:

Taxpayer =

Parent =

State A =

State B =

State C =

Commission A =

Commission B =

Commission C =

Year A =

Year B =

Date A =

Date B =

Date C =

Date D =

Date E =

Case =

Director =

Dear .[Redacted Text]:

This letter responds to the request, dated November 25, 2013, of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer is a regulated public utility incorporated in State A and State B. It is wholly owned, through a limited liability company, by Parent. Taxpayer is engaged in the transmission, distribution, and supply of electricity in State A and State C. Taxpayer also provides natural gas and natural gas transmission services in State A. Taxpayer is subject to the regulatory jurisdiction of Commission A, Commission B, and Commission C with respect to terms and conditions of service and particularly the rates it may charge for the provision of service. Taxpayer's rates are established on a rate of return basis. Taxpayer takes accelerated depreciation, including "bonus depreciation" where available and, for each year beginning in Year A and ending in Year B, Taxpayer individually (as well as the consolidated return filed by Parent) has or expects to, produce a net operating loss (NOL). On its regulatory books of account, Taxpayer "normalizes" the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute "cost-free capital" to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account. In addition, Taxpayer maintains an offsetting series of entries - a "deferred tax asset" and a "deferred tax expense" - that reflect that portion of those 'tax losses' which, while due to accelerated depreciation, did not actually defer tax because of the existence of an net operating loss carryover (NOLC). Taxpayer, for normalization purposes, calculates the portion of the NOLC attributable to accelerated depreciation using a "with or without" methodology, meaning that an NOLC is attributable to accelerated depreciation to the extent of the lesser of the accelerated depreciation or the NOLC.

Taxpayer filed a general rate case with Commission B on Date A (Case). The test year used in the Case was the 12 month period ending on Date B. In computing its income tax expense element of cost of service, the tax benefits attributable to accelerated depreciation were normalized in accordance with Commission B policy and were not flowed thru to ratepayers. The data originally filed in Case was updated in the course of proceedings. In establishing the rate base on which Taxpayer was to be allowed to earn a return Commission B offset rate base by Taxpayer's ADIT balance, using a 13-month average of the month-end balances of the relevant accounts. Taxpayer argued that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of the NOLC, as represented in the deferred tax asset account. Testimony by various other participants in Case argued against Taxpayer's proposed calculation of ADIT.

On Date C, a settlement agreement was filed with Commission B, incorporating the Taxpayer's proposed treatment of the tax consequences of its NOLC. In an order issued on Date D, Commission B issued an order approving the settlement agreement and also ordered Taxpayer to seek a ruling on the effects of an NOLC on ADIT. Rates went into effect on Date E.

Taxpayer proposed, and Commission B accepted, that it be permitted to annualize, rather than average, its reliability plant additions and to extend the period of anticipated reliability plant additions to be included in rate base for an additional eight months. Taxpayer also proposed, and Commission B accepted, that no additional ADIT be reflected as a result of these adjustments inasmuch as any additional book and tax depreciation produced by considering these assets would simply increase Taxpayer's NOLC and thus there would be no net impact on ADIT.

Taxpayer requests that we rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balances offset by a portion of its NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with or without" basis would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.
2. The imputation of incremental ADIT on account of the reliability plant addition adjustments described above would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

Law and Analysis

Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, section 168(i)(9)(A)(i) of the Code requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting

from such difference.

Section 168(i)(9)(B)(i) of the Code provides that one way the requirements of section 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under section 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under section 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.

Former section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(l)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

Section 1.167(l)-1(h)(1)(i) provides that the reserve established for public utility property should reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.

Section 1.167(l)-1(h)(1)(iii) provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory

to the district director.

Section 1.167(1)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that, with respect to any account, the aggregate amount allocable to deferred tax under section 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation. That section also notes that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under section 1.167(1)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under section 167(a).

Section 1.167(1)-(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

Section 1.167(1)-(h)(6)(ii) provides that, for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under section 1.167(1)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period.

Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes. Taxpayer has done so. Section 1.167(1)-(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used



in determining the taxpayer's expense in computing cost of service in such ratemaking. [REDACTED] Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

In Case, Commission B has reduced rate base by Taxpayer's ADIT account, as modified by the account which Taxpayer has designed to calculate the effects of the NOLC. [REDACTED] Section 1.167(1)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes. Further, while that section provides no specific mandate on methods, it does provide that the Service has discretion to determine whether a particular method satisfies the normalization requirements. [REDACTED] Section 1.167(1)-(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Because the ADIT account, the reserve account for deferred taxes, reduces rate base, it is clear that the portion of an NOLC that is attributable to accelerated depreciation must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT). Thus, the order by Commission B is in accord with the normalization requirements. The "with or without" methodology employed by Taxpayer is specifically designed to ensure that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated depreciation to ratepayers. Under these facts, any method other than the "with and without" method would not provide the same level of certainty and therefore the use of any other methodology is inconsistent with the normalization rules.

Regarding the second issue, [REDACTED] § 1.167(1)-(h)(6)(i) provides, as noted above, that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Increasing Taxpayer's ADIT account by an amount representing those taxes that would have been deferred absent the NOLC increases the ADIT reserve account (which will then reduce rate base) beyond the permissible amount.


We rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balances offset by a portion of its NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with or without" basis would be inconsistent with the requirements of [REDACTED] § 168(i)(9) and [REDACTED] § 1.167(l)-1 of the Income Tax regulations.

2. The imputation of incremental ADIT on account of the reliability plant addition adjustments described above would be inconsistent with the requirements of  § 168(i)(9) and  § 1.167(l)-1.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

This ruling is directed only to the taxpayer who requested it.  Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely,

Peter C. Friedman

Senior Technician Reviewer, Branch 6

(Passthroughs & Special Industries)

cc: [Redacted Text]

PLR 201436037 -- IRC Sec(s). 167; 168, 09/05/14

Private Letter Rulings & Technical Advice Memoranda (1953 - Present) (RIA)

Private Letter Rulings

Private Letter Ruling 201436037, 09/05/14, IRC Sec(s). 167

UIL No. 167.22-01

Accelerated depreciation-accumulated deferred income tax-net operating loss carryover-computation based on with or without basis-normalization-limitations on reasonable allowance in case of property of public utilities.

Headnote:

Reduction of regulated electric utility's rate base by full amount of its ADIT account balances offset by portion of its NOLC-related account that is less than amount attributable to accelerated depreciation computed on "with or without" basis would be inconsistent with **Code Sec. 168(i)(9)**; and **Reg § 1.167(l)-1** requirements.

Reference(s): Code Sec. 167; Code Sec. 168;

Full Text:

Number: **201436037**

Release Date: 9/5/2014

Index Number: 167.22-01

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact: [Redacted Text]

[Redacted Text], ID No.

Telephone Number: [Redacted Text]

Refer Reply To:

CC:PSI:B06

PLR-148310-13

Date:

May 22, 2014

LEGEND:

Taxpayer =

Parent =

State A =

State B =

State C =

Commission A =

Commission B =

Commission C =

Year A =

Year B =

Date A =

Date B =

Date C =

Case =

Director =

Dear [Redacted Text]:

This letter responds to the request, dated November 25, 2013, of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures,

described below.

The representations set out in your letter follow.

Taxpayer is a regulated public utility incorporated in State A and State B. It is wholly owned by Parent. Taxpayer is engaged in the transmission, distribution, and supply of electricity in State A and State C. Taxpayer is subject to the regulatory jurisdiction of Commission A, Commission B, and Commission C with respect to terms and conditions of service and particularly the rates it may charge for the provision of service. Taxpayer's rates are established on a rate of return basis. Taxpayer takes accelerated depreciation, including "bonus depreciation" where available and, for each year beginning in Year A and ending in Year B, Taxpayer individually (as well as the consolidated return filed by Parent) has or expects to, produce a net operating loss (NOL). On its regulatory books of account, Taxpayer "normalizes" the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute "cost-free capital" to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account. In addition, Taxpayer maintains an offsetting series of entries - a "deferred tax asset" and a "deferred tax expense" - that reflect that portion of those 'tax losses' which, while due to accelerated depreciation, did not actually defer tax because of the existence of an net operating loss carryover (NOLC). Taxpayer, for normalization purposes, calculates the portion of the NOLC attributable to accelerated depreciation using a "with or without" methodology, meaning that an NOLC is attributable to accelerated depreciation to the extent of the lesser of the accelerated depreciation or the NOLC.

Taxpayer filed a general rate case with Commission B on Date A (Case). The test year used in the Case was the 12 month period ending on Date B. In computing its income tax expense element of cost of service, the tax benefits attributable to accelerated depreciation were normalized in accordance with Commission B policy and were not flowed thru to ratepayers. The data originally filed in Case included six months of forecast data, which the Taxpayer updated with actual data in the course of proceedings. In establishing the rate base on which Taxpayer was to be allowed to earn a return Commission B offset rate base by Taxpayer's ADIT balance, using a 13-month average of the month-end balances of the relevant accounts. Taxpayer argued that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of the NOLC, as represented in the deferred tax asset account. Testimony by various other participants in Case argued against Taxpayer's proposed calculation of ADIT. One proposal made to Commission B was, if Commission B allowed Taxpayer to reduce the ADIT balance as Taxpayer proposed, then Taxpayer's income tax expense element of service should be reduced by that same amount.

Commission B, in an order issued on Date C, allowed Taxpayer to reduce ADIT by the amount that Taxpayer calculates did not actually defer tax due to the presence of the NOLC and ordered Taxpayer to seek a ruling on the effects of an NOLC on ADIT. Rates went into effect on Date C.

Taxpayer proposed, and Commission B accepted, that it be permitted to annualize, rather than average, its reliability plant additions and to extend the period of anticipated reliability plant additions to be included in rate base for an additional quarter. Taxpayer also proposed, and Commission B accepted, that no additional ADIT be reflected as a result of these adjustments inasmuch as any additional book and tax depreciation produced by considering these assets would simply increase Taxpayer's NOLC and thus there would be no net impact on ADIT.

Taxpayer requests that we rule as follows:



1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balances offset by a portion of its NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with or without" basis would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.
2. The imputation of incremental ADIT on account of the reliability plant addition adjustments described above would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.
3. Under the circumstances described above, any reduction in Taxpayer's tax expense element of cost of service to reflect the tax benefit of its NOLC would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.






Law and Analysis


Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) if the taxpayer does not use a normalization method of accounting.




In order to use a normalization method of accounting, section 168(i)(9)(A)(i) of the Code requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.


Section 168(i)(9)(B)(i) of the Code provides that one way the requirements of section 168(i)(9)(A)




will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under  section 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under  section 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.



Former  section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former  section 167(l)(3)(G) in a manner consistent with that found in  section 168(i)(9)(A).  Section 1.167(1)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under  section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.



 Section 1.167(l)-1(h)(1)(i) provides that the reserve established for public utility property should reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.




 Section 1.167(1)-1(h)(1)(iii) provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's reasonable allowance under  section 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under  section 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.


 Section 1.167(1)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a


reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that, with respect to any account, the aggregate amount allocable to deferred tax under  section 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation. That section also notes that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under  section 1.167(1)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under  section 167(a).


 Section 1.167(1)-(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under  section 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

 Section 1.167(1)-(h)(6)(ii) provides that, for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under  section 1.167(1)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period.

 Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes. Taxpayer has done so.  Section 1.167(1)-(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.  Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.



In Case, Commission B has reduced rate base by Taxpayer's ADIT account, as modified by the account which Taxpayer has designed to calculate the effects of the NOLC.  Section 1.167(1)-1(h)(1)(iii)

makes clear that the effects of an NOLC must be taken into account for normalization purposes. Further, while that section provides no specific mandate on methods, it does provide that the Service has discretion to determine whether a particular method satisfies the normalization requirements.  Section 1.167(1)-(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Because the ADIT account, the reserve account for deferred taxes, reduces rate base, it is clear that the portion of an NOLC that is attributable to accelerated depreciation must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT). Thus, the order by Commission B is in accord with the normalization requirements. The "with or without" methodology employed by Taxpayer is specifically designed to ensure that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated depreciation to ratepayers. Under these facts, any method other than the "with and without" method would not provide the same level of certainty and therefore the use of any other methodology is inconsistent with the normalization rules.

Regarding the second issue,  § 1.167(1)-(h)(6)(i) provides, as noted above, that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Increasing Taxpayer's ADIT account by an amount representing those taxes that would have been deferred absent the NOLC increases the ADIT reserve account (which will then reduce rate base) beyond the permissible amount.

Regarding the third issue, reduction of Taxpayer's tax expense element of cost of service, we believe that such reduction would, in effect, flow through the tax benefits of accelerated depreciation deductions through to rate payers even though the Taxpayer has not yet realized such benefits. This would violate the normalization provisions.

We rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balances offset by a portion of its NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with or without" basis would be inconsistent with the requirements of  § 168(i)(9) and  § 1.167(l)-1 of the Income Tax

regulations.

2. The imputation of incremental ADIT on account of the reliability plant addition adjustments described above would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

3. Under the circumstances described above, any reduction in Taxpayer's tax expense element of cost of service to reflect the tax benefit of its NOLC would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely,

Peter C. Friedman

Senior Technician Reviewer, Branch 6

(Passthroughs & Special Industries)

cc: [Redacted Text]

PLR 8818040 -- IRC Sec(s). 167, 2/09/1988

Private Letter Rulings & Technical Advice Memoranda (1953 - Present) (RIA)

Private Letter Rulings

Private Letter Ruling 8818040, 2/09/1988, IRC Sec(s). 167

UIL No. 0168.08-02

Headnote:

Reference(s): Code Sec. 167;

Private Letter Ruling 8818040

Code Sec. 167 DEPRECIATION -- special situations -- public utility property -- carryover of NOL .

Taxpayer (T) is regulated public electric utility. T is required to use normalization method of accounting as condition to its use of accelerated depreciation methods. T wishes to carryover NOL from 1986 to 1987. RULED: To extent use of ACRS depreciation in 1986 and prior years in determining depreciation expense for tax purposes contributed to NOL carryover from 1986 to 1987, T's use of 1987 tax rate in computing deferred tax expense on its regulated books of account will be consistent with normalization requirements.

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Full Text:

Feb. 9, 1988

This is in response to your request for a letter ruling dated November 23, 1987, submitted on your behalf by your authorized representative. You have asked us to rule whether, to the extent that the use of the Accelerated Cost Recovery System (ACRS) in 1986 and prior years in determining the taxpayer's depreciation expense for Federal income tax purposes contributed to a net operating loss (NOL) carryover from 1985 and 1986 to 1987, the taxpayer's use of the Federal statutory income tax rate in effect in 1987 for purposes of computing the deferred tax expense in its regulated books of account for the year 1987 will be consistent with the normalization requirements under sections 167 and 168 of the Internal Revenue Code and the Income Tax Regulations promulgated thereunder.


The taxpayer is incorporated under the laws of the State of . . . , has its principal executive offices at . . . , and files its returns with the Internal Revenue Service in The taxpayer files its returns using a calendar year. The Internal Revenue Service (IRS) district office in . . . has examination jurisdiction over the taxpayer's return.


The taxpayer is a regulated public utility transmitting and distributing electric power. It has been represented under penalty of perjury that the Commission has been apprised of the taxpayer's ruling request and has no objection to the issuance of a ruling on the request.

As a public utility, the taxpayer is required to use the normalization method of accounting as a condition to its use of accelerated depreciation methods, including ACRS, for Federal income tax purposes. Accordingly, the taxpayer records deferred tax expense for financial statement and regulatory purposes pursuant to the provisions of sections 167 and 168 of the Code and the regulations thereunder. Hereinafter, the accelerated depreciation that the taxpayer is required to normalize is referred to as ACRS.

The amount of Federal income tax expense that the taxpayer recorded for financial statement purposes for 1986 and prior years was greater than the Federal income taxes actually paid. The additional recorded Federal income taxes (deferred taxes) resulted, in part, from a significant amount of property placed in service in 1985, which increased the depreciation deduction for Federal income tax purposes. However, the taxpayer did not realize the entire tax benefit from the ACRS depreciation claimed in 1985 and 1986 because the depreciation resulted in a NOL carryover to 1987. Therefore, in order to reflect the tax benefit of the NOL carryover to 1987, the taxpayer reduced its deferred Federal income tax expense and liability for 1985 and 1986 for financial reporting purposes. The net effect of this accounting in 1985 and 1986 was to record no deferred taxes applicable to the amount of ACRS depreciation that produced no current tax savings but rather caused or increased taxpayer's NOL carryover to 1987. The taxpayer only recorded deferred taxes applicable to ACRS when and to the extent that the use of ACRS produced an actual tax deferral.

The taxpayer will have taxable income in 1987 in excess of the NOL carryover from 1986. Consequently, the ACRS depreciation that was claimed in 1985 and 1986, but did not then produce a tax benefit, will produce a benefit in 1987 when the NOL is utilized. Accordingly, for 1987 the taxpayer proposes to record the deferred Federal income tax expense resulting from the use of the NOL carryover from 1986 at the rate of 39.95%, the effective income tax rate for 1987. This rate is lower than the 46 percent rate in effect during 1986 and the prior years when the ACRS depreciation was originally deducted on the taxpayer's Federal income tax return.

 Section 168(f)(2) of the Code generally requires the use of the normalization method of accounting with respect to regulated public utility property in order for the public utility to be allowed to use ACRS depreciation for Federal income tax purposes.

 Section 168(i)(9)(A) of the Code sets forth the normalization accounting requirements. This section

provides that the taxpayer must, in computing its tax expense for purposes of establishing its cost of service for rate making purposes and reflecting operating results in its regulated books of account, use a method of depreciation with respect to such property that is the same as, and a depreciation period for such property that is no shorter than, the method and period used to compute its depreciation expense for such purposes. In addition, if the amount allowable as a deduction under this section with respect to such property differs from the amount that would be allowable as a deduction under section 167 (determined without regard to section 167(1)) using the method (including the period, first and last year convention, and salvage value) used to compute regulated tax expense under clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 1.167(1)-1(h)(1)(i) of the regulations provides that a taxpayer uses a normalization method of regulated accounting if the taxpayer makes adjustments to a reserve to reflect the total amount of the deferral of Federal income tax liability resulting from the use with respect to all of its public utility property of such different methods of depreciation.

Section 1.167(1)-1(h)(1)(iii) of the regulations provides that, except as provided in this subparagraph, the amount of Federal income tax liability deferred as a result of the use of different methods of depreciation under subdivision (i) of this subparagraph is the excess (computed without regard to credits) of the amount the tax liability would have been had a subsection (1) method been used over the amount of the actual tax liability. Such amount shall be taken into account for the taxable year in which such different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a section (1) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover (as determined under section 172) to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.


Under the regulations, the amount of deferred taxes is computed using a "with and without" methodology. (That is, deferred taxes equal the excess of taxes due without ACRS over the taxes due with ACRS). Where taxes computed with ACRS produce a NOL carryover, the amount and time of the deferral is left to the discretion of the Internal Revenue Service.

The taxpayer maintains that where the computation utilizing ACRS results in a NOL, the deferral is appropriately made at the time the taxpayer realizes an actual tax benefit from the use of ACRS. The taxpayer will realize the benefit of the NOL attributable to the accelerated depreciation in 1987. Therefore, the taxpayer should record the deferred taxes in 1987. We conclude that this approach is consistent with the normalization requirements under sections 167 and 168 of the Code.

With respect to the amount of the deferral, the Federal statutory income tax rates in effect in 1987 for calendar year taxpayers, pursuant to the Tax Reform Act of 1986, can reasonably be combined to result in an effective rate of 39.95 percent. See section 3 of Rev. Proc. 88-12, 1988-8 I.R.B. . . . This is lower

than the 46 percent rate in effect when the NOL was incurred. Because the deferred taxes are being recorded in 1987, it is appropriate to utilize the effective tax rate for that year. We note that this approach is consistent with generally accepted accounting principles as set forth in APB Opinion No. 11, ACCOUNTING FOR INCOME TAXES. Regarding NOL's, the APB Opinion provides that if loss carryforwards are realized in periods subsequent to the loss period, the amounts eliminated from the deferred tax credit account should be reinstated at the then current tax rates. We conclude that the taxpayer's methodology satisfies the normalization requirements of sections 167 and 168 of the Code.

Accordingly, to the extent that the use of ACRS depreciation in 1986 and prior years in determining depreciation expense for Federal income tax purposes contributed to a NOL carryover from 1986 to 1987, the taxpayer's use of the effective tax rate for 1987 (39.95 percent for calendar year taxpayers) in computing the deferred Federal income tax expense on its regulated books of account for the year 1987 will be consistent with the normalization requirements of sections 167 and 168 of the Code and the regulations thereunder.

This ruling is directed only to the taxpayer who requested it.  Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this private letter ruling is being sent to your authorized representative in accordance with the power of attorney on file with this office.

A copy of this ruling letter should be filed with the income tax return for the taxable year or years in which the transaction covered by this ruling is consummated.

Steven L. Beshear
Governor

Leonard K. Peters
Secretary
Energy and Environment Cabinet



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December 15, 2014

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Pace McDonald
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Re: Ruling Request for Atmos Energy Corporation (EIN# 75-1743247)

Dear Sir or Madam:

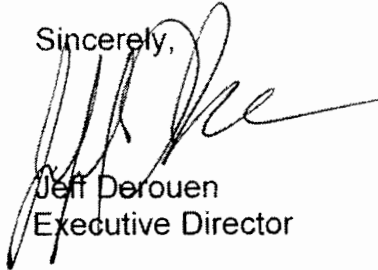
By letter dated November 7, 2014, Atmos Energy Corporation ("Atmos Energy") furnished to the Kentucky Public Service Commission ("KPSC") a copy of a request for a private letter ruling from the National Office of the Internal Revenue Service which seeks guidance regarding the application of the depreciation normalization rules of §168(i)(9) of the Internal Revenue Code of 1986, as amended, and Treas. Reg. §1.167(1)-1 (together, "Normalization Rules") to the regulatory treatment of net operating loss carryovers.

We have reviewed the ruling request and believe that the Statement of Facts and Rulings Requested sections of the letter are adequate and complete. We are unable to agree or disagree with Atmos Energy's Statement Of the Law section. Further, Atmos

Energy has indicated that it will permit the KPSC to participate in any associate office conference concerning the ruling request. The KPSC does wish to be notified of such a conference.

If additional information is desired, please feel free to contact the undersigned.

Sincerely,

A handwritten signature in black ink, appearing to read "Jeff Derouen", written over the typed name and title.

Jeff Derouen
Executive Director

cc: Jennifer Hans, Kentucky Attorney General's Office

VG