COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

MODIFICATION OF ATMOS ENERGY CORPORATION'S GAS COST ADJUSTMENT TO INCORPORATE PERFORMANCE BASED RATEMAKING MECHANISM (PBR)	))))	CASE NO. 2005-00321

O R D E R

On July 29, 2005, Atmos Energy Corporation ("Atmos") requested approval (1) to extend is its current gas cost performance-based ratemaking mechanism ("PBR") by 2 months, through May 31, 2006 in order to synchronize the term of the PBR with its current asset management contract and (2) to implement a revised PBR for a period of 5 years effective June 1, 2006.[1] The Commission approved the current PBR mechanism in March 2002 for 4 years expiring in March 2006.[2] The program benchmarks the following components of Atmos's gas costs: (1) commodity costs; (2) transportation costs; (3) capacity release revenues; and (4) off-system sales revenues. Actual costs and revenues are compared against benchmarks to determine how Atmos performed in its gas procurement activities.

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[1] Atmos also requested that its report on its current PBR be accepted by the Commission.

[2] Case No. 2001-00317, Modification to Western Kentucky Gas Company, a Division of Atmos Energy Corporation, Gas Cost Adjustment to Incorporate an Experimental Performance-Based Ratemaking Mechanism (PBR), Order dated March 25, 2002.

Variances between the actual costs/revenues and the benchmarks are shared between shareholders and ratepayers on a sliding scale consisting of two bands. The first band covers variances from the benchmark ranging from 0 to 2.0 percent and is shared 70:30 between ratepayers and shareholders in favor of the ratepayers. The second band covers variances greater than 2.0 percent and is shared 50:50. Since the 1998 inception of its PBR, through March 2005, Atmos realized total savings of nearly $19,600,000, with the majority of this amount going to its customers.[3]

Atmos responded to two rounds of data requests from Commission Staff and the Attorney General ("AG"), the only intervenor in this proceeding. The parties chose to file written comments in lieu of a public hearing. All comments have been filed and the case stands submitted for decision.

ISSUES

Atmos proposes to modify the current PBR mechanism by adjusting the sharing mechanism so that the 70:30 sharing in favor of customers covers variances from the benchmark ranging from 0 to 1.0 percent rather than the current range of 0 to 2.0 percent. It also proposes, within the computation of the existing Gas Acquisition Index Factor ("GAIF"), to add a new component, the Gas Acquisition Index Factor for Asset Management ("GAIFAM"). The GAIFAM would allow greater flexibility by prospective gas suppliers in structuring their bids in response to Atmos's upcoming Request for Proposals for a new asset manager. Atmos contends that increases in natural gas prices since 2002, when the current sharing mechanism was approved, have doubled

[3] Report on Performance-Based Ratemaking Report Period: April 2002-March 2005 at 10.

its hurdle for achieving the 50:50 sharing band. It claims that the GAIFAM will distinguish and recognize any supplier discounts provided for asset management rights which are fixed discounts not directly tied to per unit natural gas purchases.

The AG filed comments on December 27, 2005. He takes issue with a number of components of the PBR, namely the proposed change in the sharing mechanism, the implementation of the GAIFAM component, and the potential permanent approval of the PBR, which was discussed by Atmos in response to a Staff data request.

The AG contends that the proposed change in the sharing mechanism is not warranted because the result would allow Atmos to do less for greater reward at a time when gas prices are at all-time highs. The AG argues that Atmos should not be allowed to prosper at or above the level previously established, as if prices had not increased, while its customers are being directly affected by the high prices, which are expected to remain high for the foreseeable future.

The AG opposes the proposed GAIFAM, arguing that there is no benchmark against which to compare an asset management fee and that Atmos is merely making a one-time effort to find a new asset manager after its current asset management contract expires. The AG also contends that any asset management fee should be based on volumes rather than allowing a fee based on a fixed dollar amount. The AG contends that a fixed fee creates an inverse ratio that will result in a smaller credit per Mcf when volumes are higher and a larger per Mcf credit when volumes are smaller.

Finally, the AG objects to any permanent approval of the PBR. He argues that there is no competitive market; therefore, there is no rationale for a PBR. He claims that, if the GAIFAM is approved, it would be unwise to make an entirely new benchmark permanent given that there is no experience with that component of the PBR. The AG also repeats arguments from prior cases concerning the inability to prove, conclusively, that a PBR results in lower gas costs than would occur absent the PBR.

Atmos filed reply comments January 6, 2006. Therein, it pointed out that during the initial pilot phase of its PBR, from 1998 to 2002, all savings/costs were shared by customers and shareholders on a 50:50 basis compared to the current PBR in which the 50:50 sharing does not take place until it exceeds that 2.0 percent threshold. Atmos contends that the higher gas costs currently in effect make the 2.0 percent threshold virtually unattainable.

Atmos explained that the GAIFAM, which would allow bidders to include a fixed discount in their bids, is intended to maximize the value of the bids and lower overall gas costs to customers. The GAIFAM is merely introducing an option for an alternative bid structure. Atmos will be able to determine if it results in lower gas costs before selecting a bid with such a structure.

Although the AG addressed the issue of making the PBR permanent, Atmos did not address this issue in its reply comments. The Commission surmises that this is because making the PBR permanent was not part of Atmos's proposal contained in its July 29, 2005 application.

ANALYSIS

The AG argues that a PBR should only exist if customers are better off with it than without it. As has been noted in prior PBR reviews, it is impossible to reconstruct the purchasing decisions a utility with a PBR would have made absent its PBR. Without such a reconstruction, there is no way to determine, with exact precision, the savings or expenses realized by the PBR. Atmos has, however, structured its supplier and asset management agreements to generate savings on its purchases, compared to the benchmarks established in its PBR mechanism.

The Commission is persuaded by Atmos's argument to include a fixed supplier discount in the form of the GAIFAM. In reviewing Atmos's supply bids in past reviews of its PBR and asset management agreement, the Commission has noted that not all bidders offer a gas supply discount. The Commission believes that expanding the type of discount included in the GAIF will allow Atmos more flexibility in its selection of its next asset manager. The Commission has already approved a fixed discount from an asset manager for The Union Light, Heat and Power Company ("ULH&P").[4] The AG raised no objection to ULH&P accepting a fixed discount and the Commission is not persuaded by the AG's arguments in this case against Atmos's proposed GAIFAM.

As for Atmos's proposal to lower the savings threshold for a 50:50 sharing from 2.0 to 1.0 percent, the Commission agrees with the AG's arguments. We are not persuaded that the current high gas prices justify lowering the threshold. We recognize that, at higher prices, Atmos's opportunities to reach the 50:50 sharing threshold are limited. However, given that Atmos has the ability to pass on and fully recover these high prices from its customers, with the result being that customers bear the full brunt of those prices, the Commission finds that Atmos's proposal, which could improve the standing of its shareholders, would only do so by worsening the standing of its customers. Accordingly, under current conditions, which reflect these high prices, we

[4] Case No. 2003-00024, Application of The Union Light, Heat and Power Company for Deviation from Requirements of KRS 278.2207(1)(b), Order dated July 1, 2003.

conclude that Atmos's proposal to lower the 50:50 sharing threshold from 2.0 to 1.0 percent must be rejected.

The Commission believes that Atmos's request to continue the current PBR for 2 months, to coincide with the expiration of its current asset management agreement, is reasonable as it corrects a timing oversight from the previous PBR review. While the AG again argues against a PBR, he argues specifically against making Atmos's PBR permanent.[5] The Commission concludes that it is reasonable to continue the PBR for 5 years, at which time the mechanism should again be reviewed. With its PBR continuing for a fairly lengthy period of time, the Commission finds that some period reporting should be required of Atmos on its activity under the PBR. At this juncture, we believe that annual reports will be sufficient for the Commission to adequately monitor the PBR and find that Atmos should file annual reports containing the same information as in the report it filed in this proceeding for the period ended March of 2005.

SUMMARY

The Commission, based on the evidence of record and being otherwise sufficiently advised, finds that:

1. The current PBR should be continued for 2 months through May 31, 2006.

2. Atmos's request to modify the sharing mechanism within its PBR on a prospective basis, beginning June 1, 2006, should be denied.

3. The GAIF should be modified prospectively, beginning June 1, 2006, to include the GAIFAM factor as proposed by Atmos.

[5] Atmos did not request that the PBR be approved permanently.

4. The PBR mechanism should be approved, subject to the modifications approved herein, and extended for an additional 5 years through May 31, 2011.

5. Atmos's report on the results of its current PBR should be accepted.

6. Atmos should file annual reports of its activity under the extended PBR including the same information as contained in the report filed in this proceeding. These reports should be filed by August 31 of each calendar year, commencing in 2007.

7. Within 90 days of the end of the fourth year of the 5-year extension, Atmos should file an evaluation report on the results of the PBR for the first 4 years of the extension period for the Commission's review for purposes of determining whether the PBR should be continued, modified, or terminated.

IT IS THEREFORE ORDERED that:

1. Atmos's current PBR is extended for 2 months through May 31, 2006.

2. Atmos's request to modify the sharing mechanism within its PBR on a prospective basis, beginning June 1, 2006, is denied.

3. Atmos's GAIF shall include its proposed GAIFAM factor beginning June 1, 2006.

4. Atmos's PBR mechanism shall be extended, as modified herein, for an additional 5 years through May 31, 2011.

5. Atmos's report on the results of the current PBR mechanism is accepted.

6. Atmos shall file annual reports of its activity under the extended PBR including the same information as contained in the report filed in this proceeding. These reports shall be filed by August 31 of each calendar year, commencing in 2007.

7. Within 90 days of the end of the fourth year of the 5-year extension, Atmos shall file an evaluation report on the results of the PBR for the first 4 years of the extension period, and the Commission shall review same for purposes of determining whether the PBR should be continued, modified, or terminated.

8. Atmos shall file its revised tariff sheets setting out the revisions to its PBR tariff, approved herein, within 20 days from the date of this Order.

Done at Frankfort, Kentucky, this 8th day of February, 2006.

By the Commission

ATTEST:

Executive Director