COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ELECTRONIC APPLICATION OF ATMOS ENERGY CORPORATION FOR AN ADJUSTMENT OF RATES AND TARIFF MODIFICATIONS	)))	CASE NO. 2017-00349

ORDER

Atmos Energy Corporation ("Atmos") is a gas distribution company that operates in eight states and serves roughly 3 million customers. Its Kentucky/Mid-States division is one of six operating divisions that provides natural gas service in Kentucky, Tennessee, and Virginia. In Kentucky, Atmos serves approximately 176,000 customers in 38 central and western counties. The most recent adjustment of Atmos's base rates was in August 2016 in Case No. 2015-00343.[1]

BACKGROUND

On August 25, 2017, Atmos filed a notice of intent to file an application for a general rate case based upon a forecasted test period. On September 28, 2017, Atmos submitted its application based on a forecasted test period ending March 31, 2019, seeking an increase in revenues of $10,416,024, or 6.10 percent, with a proposed effective date of October 28, 2017.[2]

A review of the application revealed that it did not meet the minimum filing requirements of 807 KAR 5:001, Sections 16 and 17, and a notice of filing deficiencies

[1] Case No. 2015-00343, *Application of Atmos Energy Corporation for an Adjustment of Rates and Tariff Modifications* (Ky. PSC Aug. 4, 2016).

[2] Application, Volume 1, at 3.

was issued. Atmos filed information on both October 4, 2017, and October 5, 2017, to cure the noted filing deficiencies and to request a deviation from certain filing requirements. A notice that Atmos's deficiencies had been cured was issued October 6, 2017, stating that the application met the minimum filing requirements as of October 5, 2017. The Commission's October 11, 2017 Order granted Atmos a deviation from the public notice requirements of 807 KAR 5:011, Section 8(2)(b)(3) with regard to publishing its corrected notice of the rate adjustment to the Research and Development rider ("R&D Rider") twice rather than three times. Based on an October 5, 2017 filing date, the earliest possible date Atmos's proposed rates could become effective was November 4, 2017.

The Commission found that an investigation would be necessary to determine the reasonableness of Atmos's proposed rates and therefore suspended them for six months, from November 4, 2017, up to and including May 3, 2018, pursuant to KRS 278.190(2). The October 17, 2017 Suspension Order included a procedural schedule, which provided for discovery to both Atmos and any intervenors, intervenor testimony, discovery on any intervenor testimony, rebuttal testimony by Atmos, a public hearing, and an opportunity to file post-hearing briefs.

A petition to intervene was filed by the Attorney General of the Commonwealth of Kentucky, by and through the Office of Rate Intervention ("Attorney General"). The Attorney General was granted full intervention. Discovery was conducted on Atmos's application by the Attorney General and Commission Staff ("Staff"). The Attorney General filed testimony on which discovery was conducted by Atmos and Staff, and

Atmos filed rebuttal testimony. In Atmos's rebuttal testimony, after certain adjustments were made, the revenue increase request was updated to $1,764,082.[3]

The Commission held an information session and public meeting for the purpose of taking public comments on February 22, 2018, at Daviess County Courthouse in Owensboro, Kentucky. The Commission held an evidentiary hearing on the proposed rate adjustment on March 22, 2018, at its offices in Frankfort, Kentucky. Both Atmos and the Attorney General filed responses to post-hearing requests for information. Post-hearing briefs were filed by both Atmos and the Attorney General, and Atmos filed a reply brief as permitted by the Commission in an April 19, 2018 Order. The case now stands submitted for a decision.

TEST PERIOD

Atmos proposed the 12 months ending March 31, 2019, as its forecasted test period to determine the reasonableness of its proposed rates. The Attorney General did not object to the proposed test period or suggest an alternative test period; it did, however, criticize Atmos's development of certain items contained in the proposed test period, as discussed herein. Atmos stated that its development of a forecasted test period begins with its budget, which it prepares annually for its October 1 to September 30 fiscal year. It described the numerous approvals to which its budgets are subjected, including the final review by the Atmos Board of Directors. Atmos noted that, along with its Kentucky operations, Atmos maintains a Division General Office ("DGO") that manages utility operations in the states, including Kentucky, which comprises the Kentucky/Mid-States division. It further noted that Atmos has a Shared Services Unit

[3] Atmos Rebuttal Testimony, Waller Exhibit GKW-R-1, Overall Financial Summary.

("SSU") which provides support services such as accounting, billing, tax, call center, collections, etc. to the various operating divisions. Atmos stated that separate budgets are developed each year at the Kentucky, DGO, and SSU levels.

The Commission finds Atmos's forecasted test period to be reasonable and consistent with the provisions of KRS 278.192 and Kentucky Administrative Regulation 5:001, Section 16 (6), (7), and (8). Therefore, we will accept the forecasted test period proposed by Atmos for use in this proceeding.

VALUATION

Rate Base

Atmos proposed a net investment rate base for its forecasted test period of $430,095,330 based on the 13-month average for that period.[4] In response to errors identified in discovery, Atmos revised this amount to $430,063,026.[5] In its rebuttal testimony, Atmos further revised its proposed rate base to $427,151,221 to remove prepayments and certain deferred tax assets not associated with the cost of service, as proposed by the Attorney General.[6]

The Attorney General proposed to reduce Atmos's rate base to $375,511,070.[7] The Attorney General proposed to 1) eliminate Net Operating Loss Carry-forwards

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[4] Application, Volume 7, FR 16(8)(b).

[5] Atmos's response to Commission Staff's Second Request for Information ("Staff's Second Request"), Item 37, Attachment 1, Schedule A.

[6] Rebuttal Testimony of Joe T. Christian ("Christian Rebuttal Testimony") at 15, Rebuttal Testimony of Jennifer K. Story ("Story Rebuttal Testimony") at 4–5, and Rebuttal Testimony of Gregory K. Waller ("Waller Rebuttal Testimony"), Exhibit GKW-R-1, Schedule A-1.

[7] Direct Testimony of Lane Kollen ("Kollen Testimony"), Attachment Atmos_Rev_Req_-_AG_Recommendation.xlsx, Tab COC.

("NOLC") resulting from the losses reported by Atmos's regulated operations for tax purposes;[8] 2) remove certain deferred tax assets not associated with the cost of service and include temporary differences associated with deferred tax assets included in the cost of service;[9] 4) remove a 12 percent escalation factor from Atmos's non-PRP capital additions from October 2018 through March 2019;[10] 5) reduce cash working capital to reflect the Attorney General's adjustments to Atmos's as-filed lead/lag study;[11] 6) remove prepayments,[12] and; 7) reflect the effects on accumulated depreciation of the Attorney General's recommendation to remove net salvage values from depreciation rates.[13]

As discussed later in this order, the Commission has determined that Atmos's net investment rate base is $427,646,252 as shown below. Cash working capital has been reduced to reflect the lead/lag study Atmos filed with its application.

Utility Plant in Service	$ 656,927,449
Construction Work In Progress	27,493,203
Total Utility Plant	$ 684,420,652
LESS:	
Accumulated Depreciation	$ 191,908,970
Net Utility Plant	$ 492,511,682
ADD:	
Cash Working Capital Allowance	$ 2,400,429
Inventory and Prepayments	8,469,206

[8] Kollen Testimony at 18–29.

[9] *Id.* at 11–13.

[10] *Id.* at 6–8.

[11] *Id.* at 30–36.

[12] *Id.* at 36.

[13] *Id.* at 59.

Subtotal	$	10,869,635
DEDUCT:		
Customers Advances for Construction	$	1,437,537
Regulatory Assets/Liabilities		34,312,410
Accumulated Deferred Income Taxes And Investment Tax Credits		39,985,118
Subtotal	$	75,735,065
NET INVESTMENT RATE BASE	$	427,646,252

Capitalization

Atmos's proposed capitalization represents the end of year balances of the thirteen-month average for the test period ending March 31, 2019. Atmos conducts utility operations in eight states through unincorporated operating divisions, which are not separate legal entities, and comprise the Atmos Corporation. All debt or equity funding of each division is issued by Atmos as a whole.[14] Atmos states that this consolidated capital structure is appropriate for ratemaking in Kentucky because Atmos provides the debt and equity capital that supports the assets serving Kentucky customers.[15] The total capitalization for the forecasted test period is $6,977,465,606.[16] The Attorney General did not recommend any adjustments to the proposed capitalization amount. The Commission accepts the proposed capitalization amount.

REVENUES AND EXPENSES

Atmos developed an operating statement for its forecasted test period based on its budgets for the 2018 fiscal year. As required by 807 KAR 5:001, Section 16(6)(a),

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[14] Direct Testimony of Joe T. Christian ("Christian Testimony") at 5.

[15] *Id.*

[16] Application, FR 16(8)(j).

the financial data for the forecasted test period was presented by Atmos in the form of pro forma adjustments to its base period, the 12 months ending December 31, 2017.[17] Based on the assumptions built into its budgets, Atmos calculated its test year revenues and operating and maintenance ("O&M") expenses to be $170,729,276 and $143,802,790, respectively.[18]

Based on the adjusted revenues and O&M expenses stated above, Atmos's test period operating income was $26,926,486, which, based on its proposed rate base, results in a 6.26 percent overall rate of return.[19] Based on a proposed return on equity ("ROE") of 10.30 percent, Atmos determined that it required a revenue increase of $10,416,375, which would produce an overall return on rate base of 7.73 percent.[20]

The Attorney General, based on a number of proposed adjustments to Atmos's test period results and an 8.80 percent return on equity, recommended a decrease in revenues of $16,937,397.[21]

The Commission will accept most components of Atmos's test period and many of its proposed adjustments, and will also accept some of the Attorney General's proposed adjustments. A discussion of the individual adjustments accepted, modified

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[17] Application, Volume 7, Schedules D.1 and D.2.

[18] Application, Volume 7, Schedule C.1. Through rebuttal testimony, Atmos revised its O&M expense projections to $140,138,939. *See* Waller Rebuttal Testimony, Exhibit GKW-R-1, Schedule C.1.

[19] Application, Volume 7, Schedule C.1. Atmos's revised O&M expense result in a test period net income of $30,590,337 and 7.16 percent overall rate of return. *See* Waller Rebuttal Testimony, Exhibit GKW-R-1, Schedule C.1.

[20] Application, Volume 7, Schedule C.1. Based on Atmos's revised O&M expense, Atmos determined that it required a revenue increase of $1,764,082 to produce a 7.72 percent overall rate of return. *See* Waller Rebuttal Testimony, Exhibit GKW-R-1, Schedule A.

[21] Kollen Testimony at 5.

or rejected by the Commission, and the impact of those adjustments on Atmos's revenue requirement, follows.[22]

Escalation Factor for Non-PRP Capital Additions

Atmos prepares its budget on a fiscal year basis, for the year ended September 30.[23] Atmos's fiscal year 2018 budget ends September 30, 2018, while its forecasted test period in this proceeding ends March 31, 2019. To forecast the Kentucky division, non-PRP capital additions for the test-year months outside of Atmos's 2018 budget, Atmos applied an escalation factor of 12 percent using the approved expense levels in its fiscal year 2018 as the starting point.[24] This escalation factor of 12 percent "reflects expected growth in investment needs consistent with [Atmos]'s five-year plan."[25]

The Attorney General opposed Atmos's use of an escalation factor to forecast test period capital additions and proposed to include the same level of capital expense for the last six months of the test year as Atmos's 2018 budget.[26] The Attorney General stated that Atmos has neither identified any specific projects in support of the proposed increase in capital spending nor explained the 12 percent escalation factor.[27] The

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[22] The Attorney General adjustments to which Atmos wholly agreed on rebuttal are: revenue requirement reduction of $53,216 to correct filing errors in response to Staff's Second Request, Item 37; removal from rate base of prepayments in the amount of $1,729,944, which reduces the revenue requirement by $167,053; and reduction of federal income tax rate included in the gross-revenue conversion factor ("GRCF") to 21 percent, for a reduction in the revenue requirement of $6,796,256. The Commission accepts these adjustments as well.

[23] Direct Testimony of Gregory K. Waller ("Waller Testimony") at 21.

[24] Waller Testimony at 14.

[25] Waller Testimony at 12 and Atmos's response to Staff's Second Request, Item 16.

[26] Kollen Testimony at 8.

[27] *Id.*

Attorney General proposed revenue requirement reductions of $53,890 to remove the impact of escalation on rate base and $21,450 to reduce the depreciation expense.

On rebuttal, Atmos stated that the escalation factor projects increases in direct investment that reflect actual and expected capital expenditure growth consistent with the operational needs of Atmos's jurisdictional property and that Atmos has experienced minimal budget variances, which confirms that the increased investment is need-based.[28] However, Atmos failed to provide any explanation of how the 12 percent escalation factor was developed other than that the factor is utilized in Atmos's budget process.[29]

Finding no persuasive reason to base capital spending increases on a generic escalation factor, the Commission accepts the Attorney General's proposed adjustment. The result is a $75,360 reduction in the test-year revenue requirement.

Escalation Factor for Ad Valorem Tax Expense

Atmos included in its test-year operating expenses a provision for ad valorem taxes that applies an 8 percent escalation factor to 2017 estimated tax expense.[30] Atmos stated that the 8 percent escalation factor is "a standard estimated tax increase from year to year" based on "a 3% tax rate and 5% valuation increase."[31]

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[28] Waller Rebuttal Testimony at 4.

[29] *See* Atmos's responses to Staff's Second Request, Item 16; Attorney General's First Request for Information ("Attorney General's First Request"), Item 15; and Commission Staff's Third Request for Information ("Staff's Third Request"), Item 8.

[30] Post-Hearing Brief of Atmos at 25.

[31] Atmos's response to Attorney General's First Request, Item 24.

The Attorney General recommended that the Commission reject the forecasted ad valorem tax expense and instead include just the fiscal year 2017 estimates.[32] The effect of this recommendation is a decrease to revenue requirements of $543,158.[33]

Finding no persuasive reason to base ad valorem tax expense increases on a generic escalation factor, the Commission accepts the Attorney General's proposed adjustment. The result is a $543,158 reduction in the test-year revenue requirement.

Net Operating Loss Carryforward

Atmos included in rate base an accumulated deferred income tax ("ADIT") asset that it attributed to federal NOLC arising from its regulated operations ("NOLC ADIT"), which offset corresponding ADIT liabilities included in rate base. The Attorney General proposed to remove the NOLC ADIT from rate base, which would result in a revenue requirement reduction of $3,741,762.[34] In support of its recommendation, the Attorney General cited Private Ruling Letter ("PRL") 2014-18024 in which the Internal Revenue Service ("IRS") determined that a state utility commission's decision to exclude an ADIT asset attributable to NOLC from rate base would not result in a violation of normalization requirements imposed by federal tax law.[35] Based on that PLR, the Attorney General

[32] Kollen Testimony at 52.

[33] *Id.*

[34] *Id.* at 19.

[35] *Id.* at 55; *see also* Private Letter Ruling 201418024, 2014 WL 1743212 (issued May 2, 2014)(in which IRS determined that it was not a normalization violation to exclude NOLC ADIT while including the ADIT liabilities arising from book-tax depreciation timing differences).

argued that removing the NOLC ADIT from rate base here would not cause a tax normalization violation.[36]

Atmos claimed that removing the NOLC ADIT from rate base while allowing corresponding ADIT liabilities to reduce rate base would result in a tax normalization violation.[37] It stated that a violation would cause it to lose accelerated tax depreciation in future years and require amended returns for any affected tax years that recalculate its tax liability.[38] Atmos also claimed that removing the NOLC ADIT from its rate base is inappropriate and inconsistent with sound ratemaking principles and that the facts presented in PLR 2014-18024 are not comparable to the instant case.[39]

While there is some ambiguity in the relevant provisions of the Internal Revenue Code, and related Treasury regulations cited by the Attorney General and Atmos on the subject of NOLCs, the Commission is unable to agree with the Attorney General that a tax normalization violation would not result from a decision to remove NOLC ADIT attributable to tax-book timing differences for the depreciation of public utility property from Atmos's rate base while allowing corresponding ADIT liabilities attributable to those tax-book timing differences to reduce rate base. In Case No. 2013-00148,[40] the Commission ordered Atmos to seek a PLR from the IRS on the ADIT/NOLC issue. On August 21, 2015, the IRS issued PLR 2015-534001, in which it stated, based on the

[36] *Id.* at 24.

[37] Story Rebuttal Testimony at 40.

[38] *Id.*

[39] *Id.* at 31–34.

[40] Case No. 2013-00148, *Application of Atmos Energy Corporation for an Adjustment of Rates and Tariff Modifications* (Ky. PSC Apr. 22, 2014).

facts and circumstances presented by Atmos to the IRS, that Atmos's NOLC ADIT attributable to tax-book timing differences for the depreciation of public utility property should be included in rate base if the corresponding ADIT liabilities attributable to those tax-book timing differences are included to reduce rate base. The PLR is applicable to Atmos's specific tax situation in Kentucky. Therefore, the Commission finds that NOLC ADIT attributable to tax-book timing differences for the depreciation of public utility property jurisdictional to Kentucky should be included in rate base, since the corresponding ADIT liabilities attributable to those tax-book timing differences are included to reduce rate base (with the net affect being an overall reduction in rate base); however, the amount included in rate base has been based on changes to the NOLC resulting from changes to the taxable income during the test year and removal of ADIT derived from items not included in the cost of service. Accordingly, the Commission will increase the revenue requirement by $215,454.

Amortization of Excess Accumulated Deferred Income Taxes

On December 22, 2017, the Tax Cuts and Jobs Act ("TCJA") was signed into law and, among other things, reduced the federal corporate income tax rate from 35 percent to 21 percent. Through rebuttal testimony, Atmos proposed a reduction in its revenue requirement of $1,471,233 to reflect the estimated impact of the TCJA on its ADIT.[41] Atmos proposed a 24-year amortization period for estimated excess ADIT of $35,309,597, using the alternative method provided by the TCJA for utilities that do not keep vintage depreciation records necessary to utilize the Average Rate Assumption

[41] Waller Rebuttal Testimony, Exhibit GKW-R-1, page 4 of 123.

Method.[42] Atmos will not have finalized data for the correct amount of excess ADIT or the amortization period until it completes accounting for its 2018 fiscal year, which ends September 30, 2018.[43] The record of Case No. 2018-00039[44] will remain open to determine any additional rate adjustments necessary when finalized data is available.

The Attorney General estimated Atmos's excess ADIT to be $46,372,101 and amortization of this amount to be $2,318,605 based on a proposed 20-year amortization period.[45] Accordingly, the Attorney General proposed to reduce the revenue requirement by $2,934,943 to reflect the amortization of excess ADIT.[46]

The Commission accepts Atmos's proposed amortization of estimated excess ADIT. Accordingly, the Commission will reduce the test-year federal income tax expense by $1,471,233, which reduces the revenue requirement by $1,981,192.

<u>Depreciation Rates – Net Salvage</u>

The Attorney General recommended an adjustment to the test-year depreciation and accumulated depreciation to reflect the removal of net salvage from depreciation rates, which would reduce the revenue requirement by $3,430,385.[47] The Attorney General stated that including net salvage in depreciation rates "front-loads forecasted

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[42] Story Rebuttal Testimony at 42–43.

[43] *Id.* at 47.

[44] Case No. 20118-00039, *Electronic Investigation of the Impact of the Tax Cuts and Job Act on the Rates of Atmos Energy Corporation* (Ky. PSC Mar. 19, 2018).

[45] Kollen Testimony at 49 and Atmos_Rev_Req_-_AG_Recommendation.xlsx, Tab Tax Rate Change 21%.

[46] Kollen Testimony, Atmos_Rev_Req_-_AG_Recommendation.xlsx, Tab Summ Rev Req.

[47] Kollen Testimony at 59.

costs based on limited data" and "preemptively recovers costs that have not and may not be incurred."[48]

Atmos did not propose changes to its depreciation rates in this proceeding and included depreciation studies in its application that were submitted and approved in Case No. 2015-00343.[49] Atmos contended that its current depreciation rates were approved in Case No. 2015-00343 and include net salvage according to the customary methodology accepted by the Commission.[50] Atmos avers that the Attorney General's recommendation would violate "traditional depreciation theory, this Commission's precedent, intergenerational equity between generations of customers and the Federal Energy Regulatory Commissions ("FERC") guidance on accrual accounting."[51]

The Commission finds the Attorney General's recommendation on the treatment of net salvage in computing Atmos's depreciation rates unreasonable in that it opposes customary depreciation conventions and creates intergenerational inequity, and should, therefore, be rejected. Atmos's depreciation rates, as approved in Case No. 2015-00343, should remain in effect until a new depreciation study is filed and accepted by the Commission. The Commission also finds that Atmos should prepare a new depreciation rate study for Commission review by the earlier of five years from the date of this Order or the filing of Atmos's next general rate case.

Accumulated Deferred Income Taxes and Temporary Differences

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[48] *Id.* at 58.

[49] Application, Volume 6, Tab FR 16(7)(s).

[50] Rebuttal Testimony of Dane A. Watson, at 4.

[51] *Id.* at 6.

The Attorney General recommended a total revenue requirement reduction of $727,927 to 1) exclude from rate base ADIT associated with expenses that the Attorney General contends were not included in the test year, and; 2) include in rate base liabilities for the temporary tax difference associated with expenses that were included in the test year.[52] The Attorney General contended that its recommendation is necessary to properly reflect rate base and revenue requirement.[53]

Through discovery and rebuttal, Atmos agreed to remove ADIT associated with five expenses excluded from the test year, and refused two items because the expenses were in fact included in the test year.[54] Through rebuttal, Atmos asserted that it should not reduce rate base for liabilities associated with expenses that were included in the test year because the net result of timing differences between expense and revenue is accounted for in the cash working capital allowance that is included in rate base.

The Commission concurs with Atmos and the Attorney General that rate base should be reduced to exclude ADIT associated with expenses that were not included in the test year. As discussed below, the Commission accepts the Attorney General's recommendation to exclude restricted stock expense for directors and accepts this additional item above those accepted by Atmos. The Commission also concurs with Atmos that liabilities resulting from timing differences are reflected in rate base through the cash working capital allowance and, therefore, rejects the Attorney General's

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[52] Kollen Testimony at 17–18.

[53] *Id.* at 9.

[54] Story Rebuttal Testimony at 7.

recommended adjustment for those items. Accordingly, the Commission will reduce Atmos's revenue requirement by $173,960.

Cash Working Capital Allowance

As a result of the settlement agreement accepted in Case No. 2015-00343, Atmos filed a lead/lag study with its application in this proceeding. Atmos proposed to determine cash working capital in rate base based upon the one-eighth O&M methodology. It stated that this methodology recognizes that lead/lag studies are burdensome and time-consuming and produces a reasonable estimate of cash working capital.[55] Atmos proposed to include $3,270,504 of cash working capital in the test-year rate base.[56]

The Attorney General proposed a reduction to the revenue requirement of $658,905 to reflect cash working capital based on "corrections" to the lead/lag to remove non-cash items.[57] The Attorney General also stated that the one-eighth O&M methodology is outdated, simplistic, and does not measure the timing of cash receipts or disbursements for revenues or expenses.[58]

The Commission finds that the cash working capital allowance included in Atmos's rate base should be based upon the lead/lag study as filed. While the one-eighth O&M methodology is a reasonable estimate of cash working capital absent a lead/lag study, Atmos's lead/lag study is part of the record of this proceeding and more

[55] Waller Testimony at 18.

[56] Application, Volume 7, Schedule B.1 F.

[57] Kollen Testimony, Atmos_Rev_Req_-_AG_Recommendation.xlsx, Tab Summ Rev Req.

[58] *Id.* at 36–37.

accurately reflects the working capital needs of Atmos. Accordingly, the Commission will reduce Atmos's revenue requirement by $84,049.

Rate Case Regulatory Asset and Amortization

Atmos proposed to include $235,413 in rate base for the 13-month average of a regulatory asset for its expenses related to this proceeding.[59] Atmos also proposed a 2-year amortization period for this regulatory asset, resulting in amortization expense of $156,942.[60]

The Attorney General recommends denying the establishment of this regulatory asset or recovery of amortization expense because he contends that Atmos's test-year results show that a decrease in base rates are warranted and thus Atmos did not require an increase in base rates and should not have incurred rate case expense.[61] The Attorney General contends that denying recovery of rate case expense will incentivize Atmos to file rate cases only when necessary.[62]

The Commission finds that rate case expenses should only be denied when the expenses themselves are found unreasonable. However, the Commission rejects Atmos's proposed 2-year amortization period and will use the customary 3-year period. The increased regulatory asset balance included in rate base and the decreased amortization expense together result in a decrease in revenue requirements of $50,156.

Test-Year O&M Expense

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[59] Application, Volume 7, Schedule F.6.

[60] *Id.*

[61] Kollen Testimony at 38 and Post-Hearing Brief of the Attorney General at 16.

[62] Post-Hearing Brief of the Attorney General at 16.

The Attorney General recommended adjustments to test-year O&M expense for direct costs of Atmos and those expenses allocated from the Kentucky/Mid-States division.[63] To support and quantify the proposed adjustment, the Attorney General compared the forecast test-year level of these expenses to Atmos's 2016 actual expenses.[64] The Attorney General contended that he identified "unusual increases compared to actual expense levels incurred in prior years."[65] These two adjustments together would reduce the revenue requirement by $1,404,322.

On rebuttal, Atmos asserted that these adjustments should be rejected on the basis that they do not include cost categories that decreased from 2016 actuals and ignore the base-period expense levels, which would result in a smaller reduction.[66]

The Commission concurs with Atmos that any adjustments to the forecast test year O&M expense should have included both increases and decreases in cost components. The Attorney General's decision to adjust only those costs that increased from 2016 to the test-period is unreasonable. The Commission, therefore, finds that the Attorney General's recommended adjustment to test-year O&M expense should be denied.

Directors' Stock Expense

Atmos included $181,683 in its revenue requirements for restricted stock expense for its Board of Directors.[67] The Attorney General proposed to remove this

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[63] Kollen Testimony at 40 and 44.

[64] *Id.* at 39-40.

[65] *Id.* at 39 and 41.

[66] Post-Hearing Brief of Atmos at 18–19.

expense from the test year as it is compensation directly tied to Atmos's financial performance.[68] The Commission accepts the Attorney General's recommended adjustment and will reduce the revenue requirement by $182,963.

Retirement Plan Expenses

Atmos incurs direct and allocated retirement plan expense related to employees who are covered by both a defined benefit plan and a defined contribution plan. The Attorney General recommended reducing Atmos's retirement plan expense by $575,076[69] based on recent decisions in which the Commission denied recovery of retirement expenses where a utility made contributions to both defined benefit and defined contribution plans for certain employees.[70]

Atmos contended that the Attorney General has offered no justification as to why its test-year retirement plan expense is unreasonable or assessed the market competitiveness of its retirement plans.[71] Atmos stated that all 145 employees currently participating in the defined benefit plan also participate in the defined contribution plan.[72]

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[67] Atmos's response to Commission Staff's Post-Hearing Request for Information, Item 7.

[68] Kollen Testimony at 44–45. *See* Attorney General's response to Atmos's Request for Information, Item 20.

[69] *See* Atmos's response to Staff's Second Request, Item 24 and Attorney General's Second Request for Information ("Attorney General's Second Request"), Item 25.

[70] Kollen Testimony at 45–46.

[71] Waller Rebuttal Testimony at 10.

[72] Atmos's response to Attorney General's Second Request, Item 25 and Post-Hearing Brief of Atmos at 24.

The Commission finds that, for ratemaking purposes, it is not reasonable to include both Atmos's defined benefit plan expense and matching contributions to employees' defined contribution plans. Accordingly, the Commission will accept the Attorney General's adjustment and reduce Atmos's revenue requirement by $579,127.

PRO FORMA ADJUSTMENTS SUMMARY

The effect of the Commission's adjustments on Atmos's pro forma test-period operations is as follows:

	Atmos Forecasted Test Period	Commission Accepted Adjustments	Commission Adjusted Test Period
Operating Revenues	$170,729,276	$ -0-	$ 170,729,276
Operating Expenses	143,802,790	(6,156,380)	137,646,410
Net Operating Income	$ 26,926,486	$ 6,156,380	$ 33,082,866

RATE OF RETURN

Capital Structure and Cost of Debt

Atmos proposed a test-year-end capital structure consisting of 43.95 percent long-term debt at a cost of 5.11 percent; 3.48 percent short-term debt at a cost of 1.99 percent; and 52.57 percent common equity with a proposed ROE of 10.30 percent.[73] The Attorney General recommended two adjustments to Atmos's proposed debt cost. The first was to adjust the cost of short-term debt downward to 0.92 percent to reflect the exclusion of $2.604 million in commitment fees and to reflect these fees through O&M expenses.[74] Atmos disagreed with this adjustment, stating that commitment fees

[73] Application, FR 16(8)(j).

[74] Direct Testimony of Richard A. Baudino ("Baudino Testimony") at 29.

are part of the cost of debt and are up-front interest payments which are properly accounted for as interest costs. The Commission agrees that commitment fees are a component of the short-term interest rate and should be included in the short-term interest rate calculation.

The second recommendation from the Attorney General regarding debt cost was to update the cost of long-term debt to reflect the maturation of a $450 million debt issuance during the last month of the forecasted test period.[75] This debt instrument currently has a coupon rate of 8.5 percent and will be refinanced at an interest rate reflective of the interest rate environment at the time of refinancing. The Attorney General recommended applying a coupon rate of 4.0 percent for the entirety of the debt, deferring the greater interest expense between the maturing issue and the new debt issuance, and recovering the interest rate differential over a ten-year amortization period.[76] In its Rebuttal Testimony, Atmos disagreed with this adjustment, stating that the terms of the refinancing are not known and the recording of the interest rate differential as an O&M expense is inappropriate.[77] Atmos notes that the debt instrument is maturing on March 15, 2019, so only one half of a month of the future test year will be affected by the interest rate decrease. Atmos countered that in the absence of the approval of the proposed ARM, a more accurate way to reflect the refinancing is to weigh the issuance at 11 and one-half months at the current rate and one-half month at a forecasted rate. Irrespective of the treatment of the ARM proposal, the Commission

[75] *Id.* at 30.

[76] Kollen Testimony at 61.

[77] Christian Rebuttal Testimony at 4.

believes that a blended rate is a more accurate representation of the cost of the long-term debt. The Attorney General stated that its estimated rate was based on the average yield on utility bond yields and that as of March 29, 2018, this bond yield was 4.15 percent.[78] The Commission finds a 4 percent cost rate should be used for the refinancing of the $450 million debt for one-half of a month, resulting in a blended rate of 8.31 percent for the debt instrument, and 5.09 percent for the cost of long-term debt.[79] The effect of the adjustment is a reduction to the revenue requirement of $43,010.

Return on Equity

In its Application, Atmos developed its proposed ROE using the Discounted Cash Flow ("DCF") method, two Risk Premium ("RP") methods, and two Capital Asset Pricing Model ("CAPM") methods. Derived from the cost of capital evaluations, Atmos recommended an ROE range, adjusted for flotation costs, of 9.4 percent to 11.0 percent and proposed an ROE of 10.3 percent based on the average of the model outputs. Atmos maintained that an ROE of 10.3 percent is conservative because the financial risk of the comparable companies used in the models is less than the financial risk associated with the lower equity ratio used in Atmos's ratemaking capital structure.[80] The table below summarizes Atmos's ROE estimates:[81]

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[78] Attorney General's responses to Commission Staff's Post-Hearing Request for Information, Item 1.

[79] Christian Rebuttal Testimony, Exhibit JTC-R-2 Updated Long-term Debt Rate.

[80] Direct Testimony of James H. Vander Weide, Ph.D. ("Vander Weide Testimony") at 4.

[81] *Id.* at 44.

STUDY	ROE
DCF	9.4%
Ex Ante Risk Premium	11.0%
Ex Post Risk Premium	10.2%
CAPM – Historical	10.2%
CAPM - DCF Based	10.7%
Average	10.3%

The Attorney General provided direct testimony and analysis regarding ROE which employed the DCF and CAPM models but based its recommendation on the results of the DCF model.[82] The Attorney General examined the proxy groups used by Atmos and found them to be reasonable, but noted that in the time between the filing of Atmos's direct testimony and the filing of the Attorney General's testimony, South Jersey Industries ("South Jersey") had announced acquisition activity, causing this company to be excluded from the Attorney General's proxy group.[83] In the DCF model, the Attorney General employed both the average and the median values for the expected growth rates. The model results indicated equity cost rates ranging from 8.13 percent to 9.01 percent using average growth rates, and using median growth rates, 7.68 percent to 9.20 percent. The Attorney General recommended removing the low end of the average growth range, stating that the 8.13 percent and 7.68 percent appeared to be understated. The remaining DCF estimates reflect a range of

[82] Baudino Testimony at 3.

[83] *Id.* at 17–18.

approximately 8.24 percent to 9.2 percent. The Attorney General recommended an ROE near the midpoint or 8.80 percent.[84]

The Attorney General stated that Atmos's analysis produced an overstated ROE and that it did not reflect the return requirement of investors in today's marketplace.[85] He disagreed with Atmos's DCF analysis, specifically noting that the use of quarterly compounding produced overstated results and that Atmos confined its growth rate analysis to earnings forecasts from only Institutional Brokers' Estimate System ("IBES").[86]

In regard to Atmos's RP models, the Attorney General stated that these model results are also overstated and should not be relied upon.[87] The Attorney General took issue with the use of forecasted bond yields and specifically noted that the use of a forecasted bond yield in any RP analysis should be rejected in favor of current, observable bond yields, as these reflect current market information including expectations about future interest rates.[88] The Attorney General criticized Atmos's use of historical returns of stocks over bonds for the Ex-Post RP analysis, noting that gas distribution utility stock returns are lower than those of unregulated companies in the Standard & Poor's ("S&P") 500, and stating this further supports its argument that the RP models are overstated. The Attorney General observed that focus on historical S&P

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[84] *Id.* at 28.

[85] *Id.* at 32.

[86] *Id.* at 33.

[87] *Id.* at 34.

[88] *Id.* at 35.

returns does not capture what investors require today, as today's requirements may be quite different from a long-term historical perspective.[89]

The Attorney General's CAPM results range from 7.29 percent to 7.49 percent for the forward-looking CAPM return on equity estimates and 6.21 percent to 7.66 percent using historical risk premiums.[90] The Attorney General stated that Atmos's CAPM analysis employed inflated projected interest rates, and that it was not appropriate to use forecasted interest rates for the same reasons that projected interest rates should be rejected in the RP models.[91] The Attorney General further argued that the use of an adjustment factor to "correct" the CAPM results for smaller sized gas distribution companies as measured by market capitalization and for those companies whose betas are less than 1.0 is an inappropriate adjustment, as there is no evidence supporting a CAPM bias towards underestimating the cost of equity for companies with these characteristics.[92] Also, the Attorney General questioned Atmos using a beta of 0.90 in its analysis as opposed to a proxy group beta of 0.74.

Finally, the Attorney General disagreed with Atmos's inclusion of an upward adjustment for flotation costs. The Attorney General noted that flotation costs attempt to collect the costs of issuing common stock, which are already accounted for in current stock prices, and that adding an adjustment for floatation costs amounts to double

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[89] *Id.* at 37.

[90] *Id.* at 27.

[91] *Id.* at 38.

[92] *Id.* at 39.

counting.[93] The Attorney General observed that if flotation costs are excluded from Atmos's DCF analysis, the cost of equity results fall in the range of 8.80 percent to 9.30 percent.[94]

In its rebuttal testimony, Atmos disagreed with the methods used in the Attorney General's ROE analysis. Specifically, Atmos disagreed with the use of an annual versus a quarterly DCF model, stating that since the proxy companies pay dividends quarterly, a quarterly model should be employed.[95] Atmos further disagreed with the Attorney General's inclusion of forecasted dividends per share as an input to the DCF analysis. In regard to the CAPM analysis, Atmos disagreed with the Attorney General's use of current yields, the use of geometric and arithmetic means for historical returns on the S&P 500 to estimate the market risk premium, failure to recognize that the CAPM underestimates the cost of equity for companies with betas less than 1.0 and with small market capitalization.[96] Finally, Atmos reiterated its position regarding flotation costs, stating that flotation costs are deducted from the proceeds of a stock issuance prior to the distribution of the net proceeds and thus are not included in the stock price.[97] Atmos believes that it will not be able to earn a fair ROE if flotation costs are not included.

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[93] *Id.* at 34.

[94] *Id.*

[95] Rebuttal Testimony of James H. Vander Weide, Ph.D. at 3.

[96] *Id.* at 11-12.

[97] *Id.* at 6.

Atmos provided an update of its ROE analysis in its rebuttal testimony and responses to post-hearing requests for information, which resulted in an increase in its estimated ROE to 10.4 percent and 10.6 percent, respectively, further supporting its request of a 10.3 percent ROE.[98]

In its Post-Hearing Brief ("Brief"), Atmos stated that the updated ROE of 10.6 percent is based on the most current financial information available. Atmos noted that the Attorney General's witness stated during the hearing that the rising interest rate environment leads to upward pressure on ROE rates and that he admitted that no Commission has recently adopted an ROE of its recommended 8.8 percent.[99] Atmos contends that given this acknowledgment, a continued recommendation of an 8.8 percent ROE is unexplained and unwarranted.[100] Atmos further discounts reliance on Regulatory Research Associates ("RRA") allowed returns because they only reflect regulatory commission decisions, not market forces, and that market forces relevant to each particular case should be assessed to determine ROE, not RRA results.[101]

In its Post-Hearing Brief ("Brief"), the Attorney General stated that Atmos's ROE recommendations were anything but conservative, that the analysis was unnecessarily inflated and overstated for a regulated utility such as Atmos, and thus that it is improper for Commission consideration.[102] The Attorney General did not question the models

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[98] *Id.* at 27 and Atmos's Response to Staff's Post-Hearing Request for Information, Item 10.

[99] Post-Hearing Brief of Atmos at 7.

[100] *Id.* at 60.

[101] *Id.*

[102] Post-Hearing Brief of the Attorney General at 20.

used for ROE valuation, but rather the modifications of the methods. The Attorney General stressed its position regarding flotation costs and emphasized the low-interest rate environment of the current U.S. economy, proposing that the Commission give more weight to models that depend on current market rates rather than forecasted rates as these rates may never come to fruition.

The Commission agrees with the Attorney General that flotation costs should be excluded from the analysis as they are already accounted for in the current stock prices and therefore overstate the results. The Commission further agrees that including South Jersey as a proxy company in the DCF model results in an overstated ROE. Making adjustments for flotation and removing South Jersey from the DCF model causes the lower end of Atmos's proposed ROE range to decrease to 9.1 percent.[103]

Economic data indicates a healthy outlook for steady growth, low unemployment, and inflation at the Federal Reserve's ("FED") target level. Citing a solid economic outlook, the FED increased the federal funds' interest rate to 1.75 percent this past March, the highest level in a decade, and signaled that two to three more rate hikes are possible in 2018. Increased government spending, the possible impact of the current tariff policy on net imports, and the Tax Cut and Jobs Act of 2017 all contribute to a healthier economy. These macroeconomic inputs point to a robust outlook and an economy that has recovered from the Great Recession. However, notwithstanding these improvements, interest rates are still historically low, the impact of interest rate changes is unpredictable, and increases in the federal funds rate are not guaranteed.

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[103] Staff removed 5 percent from each DCF model result, eliminated South Jersey, and calculated the average.

For 2017, the average authorized ROE in the gas utility industry as reported in the RRA's quarterly review was 9.72 percent and absent an outlier, 9.63 percent.[104] In addition, the average earned ROE for Atmos's proxy group is 9.23.[105] The Commission believes that both the ROE reports and average proxy group returns are benchmarks worthy of consideration but are not the only determining factors. The Commission notes the economy has shown quantifiable signs of improvement and responded as such with an award to Duke Energy Kentucky, Inc. of 9.725 for its electric division.[106] The Commission agrees with Atmos that one must not only look at other regulatory decisions but also at capital markets and expected returns from similar utilities. Therefore the Commission awards Atmos an ROE of 9.7 percent. An ROE of 9.7 percent will best allow Atmos to attract capital at a reasonable cost, maintain its financial integrity to ensure continued service, provide for necessary expansion to meet future requirements, and result in the lowest possible cost to ratepayers. This ROE lies within Atmos's proposed range, is greater than the proxy group's current return, therefore, taking into consideration capital markets and current economic improvements, and is within the range of authorized approved ROEs. The effect of this adjustment is a reduction in the revenue requirement of $1,808,091.

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[104] Hearing Log at 11:39:56.

[105] Atmos's Response to Staff's Second Request, Item 48.

[106] Case No. 2017-00321, *Electronic Application of Duke Energy Kentucky, Inc., for 1) an Adjustment of the Electric Rates; 2) Approval of an Environmental Compliance Plan and Surcharge Mechanism; 3) Approval of New tariffs; 4) Approval of Accounting Practices to Establish Regulatory Assets and Liabilities; and 5) All Other Required Approvals and Relief* (Ky. PSC Apr. 13, 2018).

Rate-of-Return Summary

Applying the cost rates of 1.66 percent for short-term debt, 5.09 percent for long-term debt, and 9.70 for common equity to the proposed capital structure percentages consisting of 3.48 percent, 43.95 percent, and 52.57 percent, respectively, produces an overall cost of capital of 7.41 percent.

REVENUE REQUIREMENTS

Based upon Atmos's rate base of $427,646,252 and an overall cost of capital of 7.41 percent, the net operating income that is justified for Atmos by the evidence of record is $31,688,587. Recognizing the adjustments found reasonable herein,[107] Atmos's pro forma net operating income for the test year is $33,082,866. Based on the difference in these two amounts, Atmos's annual operating income should be reduced by $1,394,279. After recognizing the provision for uncollectible accounts, state and federal income taxes, and the Commission Assessment, Atmos's revenue sufficiency is $1,890,792.

PRICING AND TARIFF ISSUES

Cost-of-Service Study

Atmos filed three fully allocated cost-of-service studies ("COSS") as required by Case No. 2013-00148.[108] The Attorney General's testimony did not address Atmos's COSSs and did not include any alternate COSSs. Having reviewed the three COSSs,

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[107] See Appendix A to this Order for a summary of adjustments.

[108] Atmos filed a Customer/Demand study, a Demand/Commodity study, and a Demand-only study.

the Commission finds that the COSSs are acceptable to use as a guide in setting rates for Atmos.

Revenue Allocation

According to Atmos, while the results of its COSS show that all customer classes except the residential class contribute adequately to its cost of service, it chose to allocate a portion of the requested revenue increase to each customer class. It proposed to slightly increase the customer charges of all classes, and allocated the remainder of each class's increase to volumetric rates.[109] As previously mentioned, the Attorney General submitted no COSS and made no recommendation regarding revenue allocations in its direct testimony. In its Brief, however, the Attorney General urged the Commission to use the same or similar methodology to reduce base rate revenues, if any reductions were required in this proceeding, as was used in Case No. 2018-00039[110], to apply interim reductions to base rates and the PRP mechanism that resulted from the decrease in the federal corporate tax rate. The Attorney General further requested that if the Commission awards a base rate revenue increase to Atmos that any increase in revenue allocated to residential customers be collected through an increase to the volumetric delivery charge and the residential customer charge not be increased.[111]

The Commission's allocation of the required revenue decrease as reflected in the rates found reasonable herein preserves the base monthly customer charges approved

[109] Direct Testimony of Mark A. Martin ("Martin Testimony") at 18.

[110] Case No. 2018-00039, *Electronic Investigation of the Impact of the Tax Cuts and Job Act on the Rates of Atmos Energy Corporation* (Ky. PSC Mar. 19, 2018).

[111] Post-Hearing Brief of the Attorney General at 47–48.

in Atmos's last rate case, as discussed below, with the remainder of the revenue requirement allocated to volumetric rates in a manner that approximately preserves the existing base rate revenue responsibility among the customer classes.

Rate Design

Atmos proposed no change in rate design, maintaining a monthly base customer charge and declining block volumetric rates for all rate schedules. It proposed to increase the G-1 Firm Sales Service base customer charge to $20.50 for residential customers and to $52.50 for non-residential customers. It also proposed to increase the base customer charge for G-2 Interruptible Sales Service and for T-4 and T-3 Firm and Interruptible Transportation Service customers to $400.00. Atmos proposed to increase volumetric rates for all customer classes. As previously mentioned, the Attorney General made no recommendation with regard to rate design in direct testimony, but in its Brief, the Attorney General made specific recommendations as to rates resulting from any decrease or increase in revenues approved by the Commission, as previously discussed.

The Commission finds that Atmos's currently approved monthly base customer charges of $17.50 and $44.50 for the G-1 Firm Sales Service base residential and non-residential customer charges, respectively, continue to be reasonable based on the COSSs submitted by Atmos. Likewise, the $375.00 G-2 Interruptible Sales Service and T-4 and T-3 Firm and Interruptible Transportation Service monthly base customer charges should not be increased, as indicated by the COSS.[112] As discussed herein, Atmos's monthly base customer charges should, therefore, remain at their current levels

[112] Direct Testimony of Paul H. Raab, Exhibit PHR-5, page 1.

for all customer classes, and the revenue decrease required herein should be allocated to volumetric rates. Because the customer charges are maintained at their current levels, the remainder of the revenue requirement has been allocated to the volumetric charges. In order to retain the approximate class contributions to total revenues, an increase in the 1-300 Mcf block for firm sales and transportation customers is required. The remainder of the volumetric rates have been only slightly changed from the current rates.

Annual Rate Mechanism

Atmos proposed an Annual Review Mechanism ("ARM") and associated tariff to implement a formula rate mechanism similar to that approved by the Tennessee Public Utility Commission for Atmos's operations in Tennessee.[113] The Martin Direct Testimony described formula rate mechanisms that were approved for Atmos in other jurisdictions as successful, with the process having become largely formulaic with prescribed information filed and reviewed on an annual basis. According to Atmos, the regularly scheduled rate review would cost less, and the timelier annual rate adjustments would achieve the result contemplated by the Commission's rate orders.[114]

The Waller Direct Testimony elaborated that the proposed ARM is designed to create a more efficient and less costly process to review rates annually, resulting in customer rates that more accurately reflect the current costs. Atmos further argued that the ARM would appropriately reflect current cost of service through transparent rate

[113] Atmos stated in response to Staff's Second Request, Item 10, that in 2013 Tennessee adopted legislation concerning annual rate formula mechanisms.

[114] Martin Testimony at 20.

reviews that ensure the Company earns only its authorized return, in a timelier and less costly manner than in traditional ratemaking.[115] Atmos proposes that the ARM replace the Pipeline Replacement Program ("PRP") mechanism and process, with plant investment and recovery pursuant to KRS 278.509 being included in the annual comprehensive review of Atmos's financial performance. Atmos states that the ARM creates a streamlined, lower cost, and more rational process that annually adjusts rates to reflect current operations. It further alleges that it would benefit customers by avoiding the costly and resource-intensive traditional rate case process, and would eliminate concerns that its earnings are too high.[116] Atmos states that the PRP addresses only investment in eligible pipeline replacement programs and that it does not adjust for other changes in revenues and expenses or in its capital structure or cost of debt.

Details of the proposed ARM are set out in the proposed new Annual Review Mechanism tariff, Sheet Nos. 42 through 42.5, and in Exhibit GKW-3 of the Waller Direct Testimony. Atmos indicated that it would make annual ARM filings based on the forward-looking test year revenue requirements on or before December 1 of each year, starting this year, with rates effective the following April 1.[117] Revenues and certain costs would be subject to true-up based on actual costs as filed in an annual

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[115] Waller Testimony at 5.

[116] *Id.* at 6.

[117] In order to address an expressed concern of Attorney General witness Kollen regarding the inflation factor proposed to be applied to Atmos's capital budget, the Waller Rebuttal Testimony on page 12 proposes a modification to align the forward-looking test year with Atmos's fiscal year, and change the ARM filing date to June 1, for rates to be effective October 1, with a resulting forward-looking test year of October 1 to September 30.

reconciliation filing. All customer classes are proposed to be subject to ARM rate changes except special contract customers.

The Attorney General's opposition to the proposed ARM is set out in the Kollen Direct Testimony and was addressed in its Brief. The Attorney General recommends that the ARM be rejected because 1) it is not necessary to achieve annual or more frequent rate increases; 2) it is not necessary to eliminate regulatory lag due to Atmos's ability to use a forecasted test year; 3) it will harm customers by forcing the incurrence of more frequent and larger increases without the traditional rate case process review; 4) there is no support for Atmos's claim that the ARM will result in savings due to reduction in ratemaking cost, and; 5) the ARM removes the utility's incentive to exercise management control to maintain its authorized return between rate cases.[118] Atmos responded to the Attorney General's criticism of the ARM in rebuttal testimony by reiterating that the traditional rate case process is burdensome and expensive when compared to the proposed ARM, and referenced other state regulatory commissions that have found annual mechanisms to be a preferable alternative. Atmos stated that streamlining the ratemaking process through the proposed ARM would assist both the Commission and Commission Staff during a time of severe budget cuts by reducing the time and resources currently required to process traditional rate cases. Atmos countered the Attorney General's position that the ARM would harm customers, stating that the ARM has necessary safeguards to ensure customers are not harmed, and that the true-up component provides that customers pay no more than the cost of service plus the Commission-approved return. Atmos further contended that the proposed

[118] Kollen Testimony at 68–70.

ARM would result in stable and gradual increases or decreases in rates, and reduce or prevent rate shock that stems from traditional rate cases. Atmos states that the ARM mechanism provides more regulatory oversight of its expenses and investments through the annual review and reconciliation process by the Commission as well as third parties such as the Attorney General.[119] In response to the Attorney General's concern regarding decreased review and oversight in comparison to the traditional ratemaking process, Atmos offered to modify its proposed ARM process to develop a procedural schedule for each filing, which would include multiple rounds of discovery and the opportunity for intervenor testimony.[120]

In his Brief, the Attorney General claims that neither KRS Chapter 278 nor the Commission's administrative regulations contemplate or permit a ratemaking scheme such as the proposed ARM, and that in general, the Commission should continue to deny formula base ratemaking mechanisms.[121]

The Commission finds that the current ratemaking process is aligned with Kentucky statutes and regulations, ensures the public interest is served, and that it is fair to Atmos and its shareholders. The proposed ARM, while it may meet the needs of commissions in other jurisdictions, is not attractive in its offer of expediency or its relative guarantee of return. The Commission shares some of the concerns of the Attorney General with regard to lack of clear benefit to customers beyond that of a decrease in regulatory expense, and a predictable and possibly gradual annual increase

[119] Martin Rebuttal Testimony at 3–6.

[120] Waller Rebuttal Testimony at 13.

[121] Attorney General Brief at 6.

in rates, the possibility of rate decreases notwithstanding. Moreover, to approve an annual ratemaking mechanism that could subsequently, and perhaps inevitably, be requested by and approved for 42 other gas and electric utilities and dozens of regulated water and sewer utilities, does not appear to provide benefits to the Commission, Commission Staff, intervenors, or consumers in terms of using scarce resources to produce reasonable outcomes. The Commission, therefore, finds that the proposed ARM tariff and mechanism should be denied.

Pipeline Replacement Program

In Case No. 2017-00308,[122] the Commission found in its October 27, 2017 Final Order that the significant increase in the cost of Atmos's PRP Rider since it was approved in Case No. 2009-00354[123] warranted a more detailed review in this case. The Commission noted that "when Atmos's PRP Rider was approved in 2010, the 15-year program included the replacement of 250 miles of bare steel pipe and services at a cost estimated to be $124 million. Atmos subsequently discovered that there was an additional 100 miles of bare steel pipe to be replaced, and then added the replacement of the Shelbyville Line at a cost of $21.7 million and the Lake City Line at a cost of $5.7 million, both due to safety and reliability concerns. Atmos now estimates the cost of the pipeline replacement program to be $438 million for 350 miles of bare steel pipes and services and the two additional projects. Thus, the cost per mile for replacing the bare steel pipe and services has more than doubled, from just under $500,000 per mile to

[122] Case No. 2017-00308, *Electronic Application of Atmos Energy Corporation for PRP Rider Rates* (Ky. PSC Oct. 27, 2017).

[123] Case No. 2009-00354, *Application of Atmos Energy Corporation for an Adjustment of Rates* (Ky. PSC May 28, 2010).

just over $1.17 million per mile." Atmos affirmed in that case and reiterated during the course of this proceeding, its intent to complete the PRP within the 15-year time period originally approved in Case No. 2009-00354.

The Attorney General recommends that the Commission terminate the PRP and PRP Rider, or in the alternative cap, the annual PRP Rider increases. The Attorney General considers the PRP and associated Rider to be a growth vehicle for earnings, with customer rates steadily increasing between base rate increases.[124] In the Attorney General's Post-Hearing Brief, it cited the fact that most of the PRP cost increases that have been projected by Atmos are expected to occur beginning with the end of fiscal year 2017.[125] The Attorney General states that if the Commission approves the continuation of the PRP, it would be reasonable for the Commission to establish a total PRP rate increase cap of 5 percent, to protect customers from increases that the Attorney General terms "wild" and "open-ended."[126]

In its Reply Brief, Atmos countered the Attorney General's assertions that the PRP is excessively costly because Atmos's growth rate is relatively flat, that there are virtually no savings associated with the program, and that the PRP is specifically designed to minimize Commission oversight over PRP projects. Atmos emphasized that the focus of the PRP is safety, which is not a growth-driven factor and therefore makes miles of pipeline replaced and the cost of replacement irrelevant.[127] According

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[124] Kollen Testimony at 73–74.

[125] Attorney General's Brief at 17.

[126] *Id.* at 20.

[127] Atmos Reply Brief at 1.

to Atmos, the Attorney General's argument fails to recognize that the fundamental purpose of infrastructure mechanisms such as the PRP is to accelerate replacement of aging infrastructure that poses safety and reliability concerns. Atmos states that KRS 278.509 was enacted to encourage, and not discourage, safety-related investment. Atmos maintains that the Attorney General's analysis of the PRP has provided no evidence that costs incurred to date are not fair, just, and reasonable, and thus properly recoverable.[128] Atmos further claims that the Attorney General's analysis fails to consider that its cost projections beginning in 2023 include other types of pipe including early generation and un-locatable plastic pipe.[129] With regard to the argument concerning Commission oversight, Atmos states that the Commission reviews and scrutinizes each project and expenditure annually, with opportunity for the Attorney General to intervene in PRP proceedings. Atmos further claims that if the Commission were to accept the Attorney General's recommendation to terminate the PRP and instead review PRP projects and expenditures in base rate proceedings, it will necessarily limit the time and depth of analysis currently afforded to the Commission.[130]

The Commission has consistently found that the public interest is served by pipeline replacement programs that have been approved as being fair, just, and reasonable. To the extent that the pipeline eligible for recovery poses a safety risk to the utility's customers, service areas, and employees, the Commission has proven itself to be in favor of accelerated replacement. Having considered the record with regard to

[128] *Id.* at 2.

[129] *Id.* at 3.

[130] *Id.* at 6.

Atmos's PRP, the Commission finds that up to this point Atmos has operated within the parameters of the Commission's prior approval with regard to the pace of replacements. The eligible bare steel pipeline replacements for which Atmos's PRP is approved, however, cannot reasonably be made and funded by ratepayers at the levels estimated by Atmos for the PRP program years of 2019 through 2022.[131] The Commission trusts that Atmos replaced the highest-risk pipeline on its system first and that it will continue to risk categorize the remaining pipeline to be replaced. Responses to requests for information filed by Atmos in this proceeding show that the annual number of leaks on its system has decreased significantly since the inception of the PRP,[132] and that its system's lost and unaccounted for gas percentage ("L&U") has been in a range of .84 percent to 2.32 percent since 2009 when its L&U was 3.45 percent.[133]

Atmos's direct and rebuttal testimony, responses to requests for information, witness testimony at the hearing, and post-hearing brief have assured the Commission that Atmos will make any necessary effort or investment to ensure the safety of its customers and the integrity of its system. The Commission agrees with the Attorney General, however, that Atmos's annual recovery of investment should be limited, and that it can be limited without risk to public safety. Information provided by Atmos was sufficient to show that extending its program by an additional 10 years would

[131] Atmos indicated in response to Post-Hearing Request for Information 3, Item 3, page 2, that it anticipates the replacement of bare steel pipeline in its system will be complete in 2022, with estimated investment totaling $234.3 million, consisting of $51.1 million in 2019 to replace 63 miles of bare steel pipe; $56.9 million in 2020 to replace 70 miles of bare steel pipe; $63.2 million in 2021 to replace 78 miles of bare steel pipe; and $63.1 million in 2022 to replace 78 miles of bare steel pipe.

[132] Atmos's response to Staff's Second Request, Item 18.d.

[133] Atmos's response to Staff Post-Hearing Request for Information, Item 9.

necessitate estimated annual PRP investment of $28 million.[134] The Commission finds that Atmos's PRP and associated Rider should be approved. We find, however, that the original 15-year PRP time period should be extended and that annual ratepayer-funded PRP investment should be limited to $28 million, barring the identification of a PRP eligible pipeline-related hazard that could not have been reasonably foreseen. $28 million in annual investment should cause the remaining PRP for bare steel replacement to be complete in 8 - 9 years beginning in 2019 with estimated completion in 2027, adding two years to the originally approved 15-year timeframe. The Commission finds the annual investment amount of $28 million to be reasonable based on Atmos's average actual annual PRP investment from 2012 through 2017.[135]

Commission Staff propounded multiple post-hearing requests for information to Atmos in an effort to reconcile conflicting information concerning its 2018 PRP activities, its replacement completion rate, and most importantly its budget estimates representing millions of dollars of future ratepayer investment. Atmos's inconsistent and unsupported estimates for PRP-eligible projects that it states are necessary to complete the program is of great concern to the Commission. Atmos's projections based on a 12 percent future annual escalation rate resulted in an estimated $517.8 million remaining investment amount that caused the Commission to question the reliability of the

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[134] Atmos's response to Staff's Fourth Request, Item 9. The Commission notes that Atmos provided this information in the context of investment required to replace all at-risk pipeline, both bare steel, which is eligible for replacement, and plastic for which it has not requested or received Commission approval, as further explained in response to Post-Hearing Request for Information 3, Item 3.

[135] Atmos's response in Case No. 2017-00308 to the Attorney General's First Request for Information, Item 1(b)iv. provided a table summarizing annual actual and projected PRP capital investment for 2011 through 2022. The amounts provided in the table produced a six-year actual average PRP investment of $27.4 million. Actual PRP investment for 2011, the first year of PRP spending, was $3.7 million and is not considered representative.

estimates and the reasonableness of the program as currently structured. Atmos stated in its April 20, 2018 response that the PRP estimates for 2023 through 2025 that it provided in Case No. 2017-00308, and which it has continued to support in this case ($70.7 million in 2023; $79.2 million in 2024; and $88.7 million in 2025), are actually cost of "estimated miles of early generation and un-locatable plastic" pipe,[136] which are not currently eligible for replacement through the PRP. The Commission, therefore, finds these future cost estimates to be speculative despite Atmos's reliance on past Commission decisions concerning eligibility of projects beyond bare steel,[137] and no conclusions can be reached about the appropriate timeframe for their recovery in this proceeding.

KRS 278.509 authorizes the recovery of PRP investment costs only when the Commission has deemed the costs to be fair, just, and reasonable. In order to remove any question as to the reasonableness of the ratepayer-funded PRP, we therefore, find that Atmos's recovery of PRP investment should be based on actual spending subject to the $28 million cap in a historic 12-month period, and that budget estimates for funding a future PRP period will no longer be accepted as the basis for calculating the PRP Rider rate.

Atmos should file a revision to Sheet No. 38 of its tariff to state that its annual PRP filing will reflect the impact on the company's revenue requirements of net plant additions during the most recent 12 months ended September 30, with adjustment to the Rider becoming effective March 1. Annual PRP applications should be filed no later

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[136] Atmos's response to Staff's Third Post Hearing Request for Information, Item 3.

[137] *Id.*

than January 1. Atmos may include with its tariff revisions a provision for a balancing adjustment to reconcile collections with actual investment for the preceding program year. Applications should include sufficient detail with regard to individual projects completed to support the annual PRP revenue requirements. Atmos should also include in its annual PRP filing details concerning planned projects for the upcoming year similar to what it currently files for its future PRP investment approval.

<u>Research and Development Rider</u>

Atmos proposed to increase its R&D Rider rate from $.0035 per Mcf to $.0174 per Mcf. Collections through the R&D Rider support the research of the Gas Technology Institute ("GTI"). Atmos explained in testimony and in its Post-Hearing Brief that the R&D Rider charge has remained at the level of $.0035 per Mcf since it was first approved by the Commission in its final Order in Case No. 1999-00070.[138] The R&D Rider is a standalone rate that is designed to recover only Atmos's contributions in support of the research of GTI. No revenues or expenses related to the R&D Rider are included in, or otherwise affect, base rates. Atmos currently recovers approximately $56,000 through the Rider, and proposes to increase that amount to $278,000 annually. Atmos states that the proposed $.0174 per Mcf R&D Rider charge is equal to the interstate pipeline charge it paid prior to the phase-out of that charge in 2004.[139]

In support of its request to increase funding to GTI through the R&D Rider, Atmos states that technologies developed by GTI, and supported by Atmos and its

[138] Case No. 1999-00070, *Application of Western Kentucky Gas Company for an Adjustment of Rates* (Ky. PSC Dec. 21, 1999).

[139] Martin Direct Testimony at 20.

ratepayers, have benefited gas consumers. Benefits cited by Atmos are increased safety, enhanced deliverability, contained costs for distribution O&M, enhanced environmental quality, and greater system integrity through the development of distribution operations technologies.[140] Atmos states that its proposed increase in GTI funding to $278,000 is in line with the funding approved by the Commission for Columbia Gas of Kentucky, Inc. ("Columbia"), which collects $300,000 annually for remittance to GTI pursuant to its Rider for Natural Gas Research and Development.[141]

The Attorney General recommends in testimony and in its Brief that the Commission either terminate the R&D Rider or reject the proposed increase to Atmos's funding to GTI, arguing that Atmos has not shown any direct benefit to Kentucky customers resulting from the funding. The Attorney General points out that the funding is discretionary and states that the ratepayers' sponsorship of GTI through the Rider ultimately benefits industry vendors and manufacturers by subsidizing their product development research.[142]

The Commission finds that Atmos's request to increase the R&D Rider rate to the level it paid through the 2004 interstate pipeline charge is reasonable and should be approved. The Commission further finds that the value of benefits received by Atmos's customers and gas consumers, in general, outweighs the bill increase to its

[140] Martin Rebuttal Testimony at 11.

[141] Martin Direct Testimony at 22 and Atmos Brief at 85.

[142] Kollen Testimony at 75–76.

customers.[143] While the R&D Riders of both Atmos and Columbia were initially approved as a result of rate case settlements in which the Attorney General was a participant, the Commission approved a GTI Rider for Delta Natural Gas Company, Inc. ("Delta") in a contested rate proceeding in Case No. 2004-00067.[144] Despite the opposition of the Attorney General, the Commission stated in its final Order that:

> The Commission agrees with Delta's proposal to recover monies to voluntarily fund GTI research through a tariff rider. The Commission has provided a clear signal to jurisdictional gas utilities in the past that it supports research and development efforts in the gas industry. Allowing recovery via a rider is consistent with Commission decisions for two other gas utilities, Atmos Energy and Columbia Gas of Kentucky.[145]

This decision is also consistent with a resolution issued by the National Association of Regulatory Utility Commissioners ("NARUC") in support of research and development funded by gas and electric utilities and performed by institutions such as GTI.[146]

The Commission notes that not all states in which Atmos operates have approved ratepayer contributions to research and development. This arguably creates a "free rider" issue because consumers that do not contribute to the efforts of entities such as GTI share in benefits in which they have no investment. The Commission

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[143] According to the Notice Atmos provided to its customers, the average residential bill will increase $.07 per month and the average commercial bill will increase $.36 per month as a result of the increase in research and development funding through the Rider.

[144] Case No. 2004-00067, *Application of Delta Natural Gas Company, Inc. for an Adjustment of Rates* (Ky. PSC Nov. 10, 2004).

[145] Case No. 2004-00067, final Order at 59.

[146] NARUC Resolution on Public Purpose Research & Development in the Electricity and Natural Gas Industries, adopted November 12, 1997.

finds, however, that all gas consumers including the customers of Atmos, the utility itself, and the general public, benefit sufficiently from the relatively small investment that it is reasonable for an average residential customer's annual bill to be increased less than a dollar. While private firms may benefit as well, their investment in research and development may not adequately fund science and technology activities that produce important health and safety benefits. With pipeline safety concerns often at the forefront on a national level, R&D Rider funding appears to be a natural accompaniment to pipeline replacement programs approved pursuant to KRS 278.509.

Demand-Side Management Cost Recovery Mechanism, Demand-Side Management

The Commission finds that, upon the implementation of new base rates, the demand-side management ("DSM") Lost Sales Adjustment component of Atmos's DSM cost-recovery mechanism should be reset to zero. Atmos's compliance tariff should reflect this revision to the DSM Cost Recovery Mechanism.

SUMMARY

The Commission, after consideration of the evidence of record and being otherwise sufficiently advised, finds that:

1. The rates set forth in Appendix B to this Order are the fair, just, and reasonable rates for Atmos to charge for service rendered on and after May 3, 2018.

2. The rate of return granted herein is fair, just, and reasonable and will provide sufficient revenue for Atmos to meet its financial obligations with a reasonable amount remaining for equity growth.

3. The rates proposed by Atmos would produce revenue in excess of that found reasonable herein and should be denied.

4. Atmos's depreciation rates, as approved in Case No. 2015-00343, should remain in effect until a new depreciation study is filed and accepted by the Commission.

5. Atmos should file a new depreciation study for Commission review by the earlier of five years from the date of this Order or the filing of its next general rate application.

6. The proposed ARM and associated tariffs should be denied.

7. The PRP and associated tariffs should be modified as discussed herein.

8. Atmos's request to increase its R&D Rider Rate should be approved.

IT IS THEREFORE ORDERED that:

1. The rates and charges proposed by Atmos are denied.

2. The rates in Appendix B to this Order are approved for service rendered by Atmos on and after May 3, 2018.

3. Atmos's depreciation rates, as approved in Case No. 2015-00343, shall remain in effect until a new depreciation study is filed and accepted by the Commission.

4. Atmos shall submit a new depreciation study for Commission review by the earlier of five years from the date of this Order or the filing of its next general rate case.

5. The proposed ARM is denied.

6. Atmos's future recovery of PRP investment is limited to $28 million annually and shall be recovered based on a historic 12-month period as described herein.

7. Within 20 days of the date of this Order, Atmos shall file with the Commission, using the Commission's Electronic Tariff Filing System, new tariff sheets

setting forth the rates, charges, and revisions approved herein, including those required for the PRP, and reflecting their effective date and that they were authorized by this Order.

8. Absent a request for rehearing, this case will be closed and removed from the Commission's docket upon expiration of the statutory time period to request rehearing.

Partial Dissenting Opinion of Vice Chairman Robert Cicero in Case No. 2017-00349

The majority approves the R&D Rider and rate increase from $.0035 per Mcf to $.0174 per Mcf, finding it to have sufficient public interest value to justify the additional charge to the customers of Atmos; however, I do not agree. Although funding for GTI is discretionary for the utility, once the Commission approves the rate it is mandatory for Atmos's sales customers. The current $.0035 per Mcf rate was approved almost 20 years ago, and while I do not believe ratepayers receive a direct benefit from the R&D Rider, at least the rate charged represented a *de minimis* and familiar portion of the customers' bills. Increasing the amount remitted to GTI annually is not reasonable given the very general benefits that *may* accrue to not only Atmos's customers, but also to customers of utilities that do not charge such rates, or whose regulatory Commissions will not approve them, and to private industry. Atmos's ratepayers are already investing a sufficient monetary amount through the PRP surcharge to ensure the safety of the system and the communities served; therefore, additional funding charged through the R&D rate appears burdensome.

Thus, while I join the rest of the Commission with respect to the final order, I respectfully dissent only to the decision regarding the R&D Rider rate increase.

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By the Commission

ENTERED

MAY 03 2018

KENTUCKY PUBLIC
SERVICE COMMISSION

Vice Chairman Robert J. Cicero
dissenting in part.

ATTEST:

Gwen R. Pinson

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2017-00349 DATED MAY 03 2018

Adjustment		**Amount**
Atmos Request Based on Original Filing	$	10.416
Atmos Modification of Request to Correct Filing Errors	$	(0.053)
Atmos Modified Request Amount to Correct Filing Errors	$	10.363
Remove Forecast 12% Escalation on Capital Additions for Kentucky Non-PRP Oct 2018-Mar 2019	$	(0.054)
Remove Account 190 ADIT Not Associated With Cost of Service	$	(0.174)
Reflect Cash Working Capital Based on Lead/Lag Study	$	(0.084)
Remove Prepayments from Rate Base	$	(0.167)
Reflect 3-Year Amortization Period for Rate Case Regulatory Asset	$	0.003
NOLC Balancing Adjustment	$	0.230
Reduce Amortization Expense for Rate Case Regulatory Asset	$	(0.053)
Remove Directors Stock Expense	$	(0.183)
Reduce Retirement Plan Expenses	$	(0.579)
Reduce Income Tax Expense to Reflect Reduction in Federal Income Tax Rate	$	(6.796)
Reduce Income Tax Expense to Amortize Excess ADIT	$	(1.981)
Remove Escalation in Ad Valorem Taxes	$	(0.543)
Adjust Depreciation Expense to Remove Forecast 12% Escalation on Non-PRP Capital Additions	$	(0.021)
Reduce Long Term Debt Rate by Reflecting Redemption and Reissue of High Interest Debt	$	(0.043)
Reflect Return on Equity of 9.70%	$	(1.808)
Total Adjustments	$	(12.254)
Total Increase/(Decrease)	$	(1.891)

Dollar amounts shown are in millions.

APPENDIX B

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2017-00349 DATED MAY 0 3 2018

The following rates and charges are prescribed for the customers served by Atmos Energy Corporation. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under the authority of this Commission prior to the effective date of this Order.

RATE G-1
GENERAL FIRM SALES SERVICE

Base Charge

$17.50	per meter per month for residential service
$44.50	per meter per month for non-residential service

Distribution Charge

First	300	Mcf	$ 1.7250 per Mcf
Next	14, 700	Mcf	$ .9600 per Mcf
Over	15, 000	Mcf	$ .7700 per Mcf

RATE G-2
INTERRUPTIBLE SALES SERVICE

Base Charge

$375.00 per delivery point per month

Distribution Charge

First	15, 000	Mcf	$ .8550 per Mcf
Over	15, 000	Mcf	$ .6350 per Mcf

RATE T-3
INTERRUPTIBLE TRANSPORTATION SERVICE

Base Charge

$375.00 per delivery point per month

Distribution Charge for Interruptible Service

First	15, 000 Mcf	$ .8550 per Mcf
Over	15, 000 Mcf	$ .6350 per Mcf

RATE T-4
FIRM TRANSPORTATON SERVICE

Base Charge

$375.00 per delivery point per month

Distribution Charge for Firm Service

First	300 Mcf	$ 1.7250 per Mcf
Next	14, 700 Mcf	$ .9600 per Mcf
Over	15, 000 Mcf	$ .7700 per Mcf

Research and Development Rider

$.0174 per Mcf

Pipeline Replacement Program Rider Rates

	Monthly Customer Charge		Distribution Charge per Mcf
Rate G-1 (Residential)	$ 0.00		$0.00
Rate G-1 (Non-Residential)	$ 0.00		$0.0000
Rate G-2	$ 0.00	1-15,000 Mcf	$0.0000
		Over 15,000 Mcf	$0.0000
Rate T-3	$ 0.00	1-15,000 Mcf	$0.0000
		Over 15,000 Mcf	$0.0000
Rate T-4	$ 0.00	1-300 Mcf	$0.0000
		301-15,000 Mcf	$0.0000
		Over 15,000 Mcf	$0.0000

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