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June 15, 2007

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PUBLIC SERVICE  
COMMISSION

Beth O'Donnell  
Executive Director  
Public Service Commission  
211 Sower Blvd.  
Frankfort, KY 40601

Re: Atmos Energy Corporation  
Case No. 2006-00464

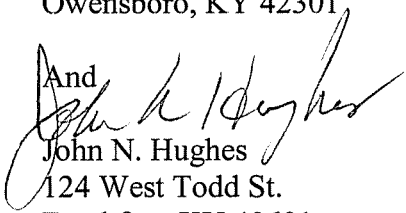
Dear Beth:

Atmos Energy Corporation submits for filing its Rebuttal Testimony consisting of an original and seven copies of bound volumes. The Attorney General has been provided three copies of the testimony.

Submitted By:

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**BEFORE THE  
KENTUCKY PUBLIC SERVICE COMMISSION  
CASE NO. 2006-00464**

**PREPARED REBUTTAL TESTIMONY  
OF  
DONALD A. MURRY, Ph.D.**

**On Behalf of  
ATMOS ENERGY CORPORATION**

**June 13, 2007**

BEFORE THE  
KENTUCKY PUBLIC SERVICE COMMISSION  
CASE NO. 2006-00464

PREPARED DIRECT TESTIMONY  
OF  
DONALD A. MURRY, Ph.D.

On Behalf of  
ATMOS ENERGY CORPORATION

1 Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS AND POSITION IN THE  
2 COMPANY.

3 A. My name is Donald A. Murry.

4 Q. ARE YOU THAT SAME DONALD A. MURRY WHO FILED DIRECT TESTIMONY  
5 PREVIOUSLY IN THIS PROCEEDING?

6 A. Yes, I am.

7 Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

8 A. I am offering testimony in rebuttal of the Direct Testimony of J. Randall Woolridge.

9 Q. WHAT IS THE NATURE OF REBUTTAL TESTIMONY OF PROFESSOR  
10 WOOLRIDGE?

11 A. Dr. Woolridge's recommended allowed return on common stock of 9.0 percent for  
12 Atmos is very low in today's markets. For example, using Dr. Woolridge's own  
13 information, (Exhibit\_\_\_(JRW-2), Atmos is relatively more risky. Yet, his  
14 recommended allowed return is lower than all of the studied companies' average

1 current returns on equity of 12.3 percent. As his Exhibit\_\_(JRW-2) shows, which I  
2 have summarized in Rebuttal Schedules DAM-1 and DAM-2, Atmos is a BBB rated  
3 company, and of the nine companies that he studied, only South Jersey Industries  
4 and Southwest Gas were not rated A- or above. Atmos' common equity ratio is 45  
5 (See Exhibit\_\_(JRW-2), percent while the average of the gas distribution utilities  
6 that he studied is 48.1 percent. Also, in Exhibit\_\_JRW-6, Dr. Woolridge reported an  
7 average return on equity for the comparable gas utilities of 12.1 percent, which he  
8 also ignored, to reach his recommended allowed return for Atmos. However, on  
9 investigation of his assumptions and analysis, it is clear that Dr. Woolridge's  
10 recommendations are not supported by his own analysis. This is not too surprising  
11 considering Dr. Woolridge's primary methodology, the Discounted Cash Flow  
12 (DCF), incorporates a DCF model that is misspecified and misapplied. Finally, I  
13 wish to respond to some of Dr. Woolridge's comments regarding my direct  
14 testimony.

15 Q. WHY DO YOU SAY THAT DR. WOOLRIDGE'S TESTIMONY IS NOT EVEN  
16 SUPPORTED BY HIS OWN ANALYSIS?

17 A. Dr. Woolridge premised his testimony on some basic misconceptions and analytical  
18 errors. He has relied on a fundamentally incorrect interpretation of current  
19 economic conditions and interest rates. He used an unorthodox regulatory standard  
20 for determining whether a utility was earning in excess of its cost of capital. He also  
21 demonstrated that his interpretation of investor risk was too narrow to be practical.

22 Q. WHAT MISCONCEPTIONS ABOUT ECONOMIC CONDITIONS AND INTEREST

1 RATES UNDERLIE DR. WOOLRIDGE'S TESTIMONY?

2 A. Dr. Woolridge describes his testimony as "consistent with the current economic  
3 environment" (Woolridge Direct, page 2, line 7), and this is not a valid statement.  
4 For example, in numerous places in his testimony Dr. Woolridge claims that interest  
5 rates are at historic lows (Woolridge Direct, pg. 2 line 8, pg. 5 line 18, pg. 6 line 3, pg.  
6 9 line 17, pg. 20 line 7, pg. 61 line 14, pg. 93 line 4). This is factually wrong. Even his  
7 own exhibits, which he ignored, show this. The chart of yields on 10-year  
8 government bonds on the top of page 6 of Dr. Woolridge's direct testimony shows  
9 rates increasing since the lows of 2003. Ten-year Treasury bonds hit a low of 3.33  
10 percent in June 2003 and, as of June 8, 2007, yielded 5.13%--more than 50% higher.  
11 Moreover, as Dr. Woolridge himself pointed out, (Woolridge Direct, page 20, line 8)  
12 A-rated utility bonds are up almost 40 percent from the low of 4.5 percent he cites in  
13 2003-2005. Current A-rated utility bonds are yielding approximately 6.24 percent.  
14 Contrary to Dr. Woolridge's assertion that interest rates are at historic lows, in fact,  
15 rates have risen. Gas utilities are capital intensive and the level of interest rates and  
16 expected interest rates are of paramount importance to investors in gas utility  
17 securities. Dr. Woolridge's insistence that he should base his recommendation on  
18 all- time low interest rates does not square with corporate interest rates, up almost  
19 40 percent, and the bellwether 10-year Treasury, up more than 50 percent, since the  
20 2003-2005 time period he cites. Furthermore, analysts forecast corporate bond rates  
21 will increase further in the remainder of 2007 and 2008. This is important because a  
22 utility's cost of capital is a forward looking concept, based on expectations. He has

1 ignored this principle as well as the facts.

2 Q. YOU REFERRED TO CURRENT INTEREST RATE FORECASTS. CAN YOU CITE  
3 SOME OF THESE CURRENT FORECASTS OF NEAR-TERM INTEREST RATE  
4 INCREASES?

5 A. Yes. As indicated in the June 1, 2007 edition of *Blue Chip Financial Forecasts*, 10-year  
6 Treasury Bonds are expected to increase from their May 18, 2007 yield of 4.74  
7 percent to 5.0 percent in the Third Quarter of 2008. However, rates have risen so  
8 much that the yield on 10-year treasuries has already exceeded the forecast amount.  
9 By comparison, AAA and BBB corporate bonds are expected to increase from 5.46  
10 percent and 6.38 percent to 5.9 percent and 6.8 percent, respectively. Market  
11 expectations are the primary consideration in this regard.

12 Q. CAN YOU IDENTIFY IF DR. WOOLRIDGE'S INACCURATE ASSESSMENT OF  
13 CURRENT AND FUTURE INTEREST RATES AFFECTED HIS RECOMMENDED  
14 ALLOWED RETURN?

15 A. He stated in his direct testimony that it did. In response to a question, at page 61,  
16 lines 11-15 of his Direct Testimony, as to whether his recommended rate of return is  
17 low by historical standards, he responded affirmatively. He explained why, as  
18 follows: "First, as discussed above, current capital costs are very low by historical  
19 standards, with interest rates at a cyclical low not seen since the 1960s."

20 Q. WHY DID YOU STATE THAT DR. WOOLRIDGE USED AN "UNORTHODOX"  
21 REGULATORY STANDARD TO DETERMINE WHETHER A UTILITY IS  
22 EARNING IN EXCESS OF ITS COST OF CAPITAL?

1 A. Dr. Woolridge falsely assumes that utilities with market-to-book ratios above one  
2 must be earning in excess of their cost of common equity. Beginning on page 16, line  
3 3, of his direct testimony, Dr. Woolridge spends a considerable amount of time  
4 discussing the relationship among the cost of equity, earned returns on equity, and  
5 the market-to-book ratio. On page 63 line 7 of his direct testimony, Dr. Woolridge  
6 claims that a market-to-book ratio above one for the group of natural gas  
7 distribution companies and Atmos indicates that these companies are earning above  
8 their equity cost rates. However, Dr. Woolridge has provided no evidence to  
9 support this claim.

10 Q. WHAT IS WRONG WITH DR. WOOLRIDGE'S ASSUMPTION THAT A MARKET-  
11 TO-BOOK RATIO IMPLIES THAT A UTILITY IS EARNING IN EXCESS OF ITS  
12 COST OF CAPITAL?

13 A. Many things, other than the returns on regulated assets exceeding the cost of equity,  
14 will cause investors to bid the prices of utility stocks above book value, and Dr.  
15 Woolridge has failed to recognize this. For example, returns on any non-regulated  
16 operation could cause the market-to-book ratio to be above one. Returns on services  
17 such as energy marketing and trading and commodity services could cause the  
18 market-to book ratio to be above one. Company assets, including real estate, which  
19 have market values above original cost, have value to investors and are likely to  
20 cause a utility's market-to-book ratio to be above one. In fact, real estate and land  
21 belonging to the regulated entity, with a market value above original cost, are likely  
22 to raise the market-to-book ratio above one if investors anticipate that those assets

1 will be freed-up through a spin-off or deregulation. Other factors, such as  
2 investment tax credits that earn a return and incentive regulation also could cause  
3 the market-to book ratio to be above one. That is, many justifiable reasons can drive  
4 the market price of a utility's common stock above book value.

5 Q. DID DR. WOOLRIDGE'S ERRONEOUS ASSUMPTION, THAT MARKET-TO-  
6 BOOK RATIOS GREATER THAN ONE IMPLY THAT UTILITIES' RETURNS  
7 EXCEED THE COST OF EQUITY, AFFECT HIS ANALYSIS?

8 A. From the data in Dr. Woolridge's Exhibit\_\_(JRW-2), this appears to be the case. He  
9 apparently ignored that all of his comparable gas distribution utilities had market-  
10 to-book ratios greater than one; they averaged 2. He must have adopted this  
11 market-to-book standard of one as an adequate return; otherwise he would have  
12 noted that the market-to-book ratio of Atmos, at 1.46, was the lowest of all of gas  
13 distribution utilities that he studied. It apparently did not concern Dr. Woolridge  
14 that Atmos' market-to-book ratio was the lowest of any of the gas distribution  
15 utilities in the group of comparable companies that he analyzed. He also ignored the  
16 simple fact that the average market-to-book ratio of Dow Jones Industrials is 3 as I  
17 show in Rebuttal Schedule DAM-3. This comparison is interesting because most of  
18 these companies in non-regulated industries face competition which would drive  
19 down their returns if they exceeded their true cost of capital for extended periods. In  
20 sum, Dr. Woolridge's based his rationale for determining a fair rate of return  
21 recommendation in this proceeding on a false economic premise.

22 Q. CAN YOU BE CERTAIN THAT DR. WOOLRIDGE APPLIES THE MARKET-TO-



1 BOOK-RATIO OF ONE AS A STANDARD WHEN DETERMINING THE  
2 ALLOWED RETURN FOR A UTILITY?

3 A. I know of at least one previous proceeding where he acknowledged that he applied  
4 that standard. For example, in the Public Service of Oklahoma rate case (PUD No.  
5 200600285), at Hearing Transcript page 117, lines 2-11, he explained his use of this  
6 standard, as follows:

7 02 REFEREE MILLER: Dr. Woolridge, I'm going  
8 03 to ask you to focus on the question. Ask the question again  
9 04 and then respond.

10 05 Q. (By Mr. Slocum) Do you believe, across the board,  
11 06 regulatory agencies have been setting return on equities that  
12 07 are too high?

13 08 A. Yes. And it's primarily related--the evidence on that  
14 09 is the fact that the market to book ratios are about 2.0,  
15 10 which clearly suggests that the allowed returns are above the  
16 11 returns that investors require.

17  
18 He further confirmed in this same proceeding that he knew that his methodology  
19 produced an unusually low return on common equity. He acknowledged that  
20 among the various cost of capital witnesses in 11 previous cases, he recommended  
21 the lowest return on common equity 10 times. In that one additional instance he was  
22 just 10 basis points higher than the lowest recommendation.

23 Q. WHY DID YOU CALL PROFESSOR WOOLRIDGE'S RISK CONCEPT TOO  
24 NARROW TO BE PRACTICAL?

25 A. At several places in Dr. Woolridge's testimony he demonstrates a very narrow  
26 concept of investment risk. This conceptual narrowness has obviously caused him to  
27 reach some illogical conclusions regarding the allowed return appropriate for this

1 proceeding. However, because of his misperceptions of investor risk he apparently  
2 fails to see the resulting inconsistencies.

3 Q. CAN YOU PROVIDE EXAMPLES OF DR. WOOLRIDGE'S OVERLY NARROW  
4 DEFINITION OF RISK AS YOU DESCRIBE IT?

5 A. Throughout his testimony, many similar definitional problems are apparent when  
6 one recognizes Dr. Woolridge's underlying risk concept. Dr. Woolridge, for  
7 example, states on page 22, line 8 of his Direct Testimony, "Exhibit JRW-5 provides  
8 an assessment of investment risk for 100 industries as measured by beta, which  
9 according to modern capital theory is the *only* relevant measure of risk that need be  
10 of concern for investors." [*Emphasis added.*] However, if one turns to Exhibit JRW-5,  
11 it is rather clear that Dr. Woolridge's risk definition and his assertion that beta is the  
12 *only* measure of risk are not adequate. For example, he reports a beta of 0.97 for the  
13 Electric Utility (West) and a beta of 0.94 for Electric Utility (Central). At the same  
14 time, he reports a lower, less risky beta of 0.88 for Petroleum (Producing). Although  
15 many oil producers and analysts, as well, would disagree with Dr. Woolridge's  
16 relative risk assessment of oil production and electric utilities, for the purposes of  
17 his testimony in this regulatory proceeding, it is his overly narrow concept of risk  
18 that is important.

19 Q. CAN YOU EXPLAIN FURTHER WHAT YOU MEAN BY PROFESSOR  
20 WOOLRIDGE'S OVERLY NARROW CONCEPT OF RISK?

21 A. Yes. In JRW-8, page 3 of 4, he presents bar charts showing the standard deviations of  
22 annual returns for common stocks and bonds for the years 1930-2006. He explains

1 on page 82, lines 2 to 5, that this variability shows the “relative riskiness of bonds  
2 and stocks.” These standard deviations, which show only the variability about a  
3 mean reveal Dr. Woolridge’s narrow risk concept. These measures show nothing  
4 more; that is, for example, they do not show whether returns are trending upward  
5 or downward.

6 Q. WHY ARE YOU STATING THAT THE STANDARD DEVIATIONS, WHICH  
7 SHOW THE VARIABILITY OF RETURNS, ARE A NARROW DEFINITION OF  
8 RISK BECAUSE THEY DO NOT SHOW TRENDS?

9 A. Let me explain by an example. Suppose in one year all of the returns sequentially  
10 decrease from high returns to low returns for a common stock. Then for another  
11 common stock all of the returns sequentially increase from low returns to high  
12 returns for the same period. Dr. Woolridge’s definition of variability about the mean  
13 as the *only* measure of risk implies and that an investor would consider these  
14 common stocks to possess equal risks. He would not even suggest that an investor  
15 need inquire as to why one common stock was trending upward and the other  
16 downward.

17 Q. DID YOU DETECT SPECIFIC INSTANCES IN WHICH PROFESSOR  
18 WOOLRIDGE’S NARROW RISK DEFINITION LED HIM TO REACH  
19 INACCURATE JUDGMENTS IN THIS CASE?

20 A. Yes. On page 61, line 6 of his Direct Testimony regarding the Company’s Formula  
21 Based Rates tariff plan he revealed his narrow risk concept very clearly by stating,  
22 “... the FBR plan would reduce the risk of the Company by reducing the volatility of

1 earnings." In so stating, Dr. Woolridge has ignored that Formula Base Rates that  
2 narrow the range of expected revenues do not necessarily change investor  
3 expectations. Indeed, an FBR, which reduces both the upper revenue expectations  
4 and, at the same time, raises the lower revenue expectations, reduces in the range  
5 about the expected mean of returns. It will not reduce an investor's expected level of  
6 returns.

7 Q. IF VARIABILITY OF RETURNS IS NOT AN ADEQUATE, PRACTICAL  
8 DEFINITION OF RISK, HOW WOULD YOU DESCRIBE OVERALL RISK THAT  
9 WOULD BE USEFUL FOR DETERMINING THE COST OF COMMON EQUITY IN  
10 THIS PROCEEDING?

11 A. Because investors are interested in achieving their investment objectives, the  
12 probability of their not achieving those objectives from a particular investment is a  
13 more practical, and more involved risk concept. As Dr. Woolridge employed his  
14 inadequate, risk concept throughout his testimony, he ignored risk indicators that  
15 he analyzed and recommended an unrealistically low return on common equity.

16 Q. HOW DO YOU KNOW THAT PROFESSOR WOOLRIDGE IGNORED RISK  
17 INDICATORS THAT HE ANALYZED?

18 A. He reported indicators of relative risk of Atmos and the comparable gas utilities in  
19 the exhibits accompanying his testimony, but he did not refer to them when they  
20 might have demonstrated that his recommended allowed return was an outlier. In  
21 Exhibit (JRW-2), he reported that the Return on Equity of his comparable companies  
22 averaged 12.3 percent with a median of 11.0 percent. He did not explain how

1 Atmos' risk could be so much lower than the risk of his comparable companies,  
2 which would justify his recommended allowed return of 9.0 percent. Also, he  
3 reported, in that same exhibit, that his comparable group has an S&P bond rating of  
4 A, while Atmos has an S&P bond rating of BBB. This is just barely above a minimal  
5 "investment grade" level, and he showed no concern for setting an allowed return  
6 to at least maintain this rating.

7 Q. DID YOU DETERMINE THAT PROFESSOR WOOLRIDGE'S OVERLY NARROW  
8 RISK CONCEPT MAY HAVE PRECLUDED HIS INVESTIGATING ATMOS' RISK  
9 MEASURES MORE THOROUGHLY?

10 A. Yes. Dr. Woolridge did not even investigate the relative financial safety of his  
11 recommended allowed return. For example, he had calculated the Pre-Tax Interest  
12 Coverage of Atmos and the companies that he studied in Exhibit\_JRW-2. The  
13 average of his comparable companies was 4.2 times. For Atmos, it was only 2.8  
14 times. Only Southwest Gas, a gas distribution company that has been in financial  
15 difficulty, is lower. In this case again, Dr. Woolridge ignored his own analysis and  
16 an obvious indicator of financial risk, and he recommended an outlier rate of return.

17 Q. HAVE YOU DETERMINED WHY PROFESSOR WOOLRIDGE HAS PRODUCED  
18 SUCH A LOW EQUITY RETURN RECOMMENDATION WITHOUT  
19 RECOGNIZING THAT IT WAS AN OUTLIER?

20 A. Apparently, he accepted the low common equity return because he applied the  
21 market-to-book standard. On page 62, line 12, he stated, "To test the reasonableness  
22 of my 9.00 equity cost rate recommendation, I examine the relationship between the

1 return on common equity and the market-to-book ratios for the companies in the  
2 group of gas distribution companies and for Atmos Energy." Although he reports  
3 that the equity return and market-to-book ratio of Atmos is already significantly  
4 lower than the group of comparable companies, he is recommending a reduction in  
5 common equity return for Atmos, which will further drive down its market price  
6 and market-to-book ratio relative to the group.

7 Q. COULD YOU DETERMINE WHY HE WOULD RECOMMEND LOWERING  
8 ATMOS' RETURN, WHEN IT IS ALREADY LOWER THAN THE MARKET-TO-  
9 BOOK RATIO, IF THAT IS HIS STANDARD OF "REASONABLE?"

10 A. I believe that he revealed his dubious logic leading to this conclusion in his  
11 testimony. On page 63, lines 7-8, when referring to the market-to-book ratio of the  
12 "Gas Group" and Atmos Energy he stated, "These results clearly indicate that, on  
13 average, these companies and Atmos Energy are earning returns on equity above  
14 their equity cost rates." That is, he believes that his comparable group of gas utilities  
15 earns above their equity costs. So, he can ignore their returns and their market-to-  
16 book levels, and he recommended an outlier, low return on common equity for  
17 Atmos.

18 Q. IS HIS ASSERTION THAT HIS COMPARABLE COMPANIES' EARNINGS ARE  
19 TOO HIGH AND GIVING HIM A FALSE EARNINGS STANDARD, THE ONLY  
20 THING THAT YOU THINK IS WRONG WITH PROFESSOR WOOLRIDGE'S  
21 METHODOLOGY?

22 A. No. I believe, when he sets up a comparable group of utilities in his methodology

1 and then ignores them, this is not only bad analysis, it probably also violates the  
2 standard set in the *Hope Natural Gas* decision. As I stated in my direct testimony, this  
3 decision implies that investors in a utility's common stock are entitled to the same  
4 return as investors in equities of similar risk. Dr. Woolridge appears to have  
5 recommended a return for Atmos that is in direct conflict with this standard. For  
6 this reason alone, I believe that his recommendation has no value when determining  
7 the cost of capital in this proceeding.

8 Q. COULD YOU DETERMINE IF PROFESSOR WOOLRIDGE ATTEMPTED TO  
9 RECOMMEND AN ALLOWED RETURN THAT IS CONSISTENT WITH THE  
10 CONCEPT OF SETTING AN ALLOWED RETURN THAT IS EQUAL TO THE  
11 RETURNS EARNED BY INVESTORS IN SECURITIES OF EQUIVALENT RISKS?

12 A. No, I could not. In fact, on page 14, line 20, Dr. Woolridge refers to the need to  
13 "...provide an adequate return on capital to attract investors." This is good so far  
14 because this statement is consistent with the concept of setting returns at an  
15 equivalent margin to returns for investments of equivalent risks. However, on page  
16 16, line 4, he changes his standard. He substitutes a market-to-book ratio standard  
17 by stating, "...when a firm earns a return on equity in excess of its cost of equity,  
18 investors respond by valuing the firms' equity in *excess of book value*." [Emphasis  
19 added.] Dr. Woolridge apparently believes that all of his comparable gas companies  
20 are earning excessive regulated returns, and he has substituted his own market-to-  
21 book ratio standard for the standard of returns equivalent to the returns on similar  
22 securities.

1 Q. YOU INDICATED THAT DR. WOOLRIDGE HAD A NUMBER OF INTERNAL  
2 INCONSISTENCES AND MECHANICAL PROBLEMS IN HIS TESTIMONY THAT  
3 MAY HAVE CAUSED HIM TO RECOMMEND SUCH A LOW RETURN. COULD  
4 YOU EXPLAIN THAT FURTHER?

5 A. Yes, at least one is important. Dr. Woolridge devotes a considerable portion of his  
6 testimony, from page 42, line 6 to page 55, line 17, developing an equity-bond risk  
7 premium for use in his CAPM analysis. As Dr. Woolridge notes, at page 42, line 16,  
8 he by-passes the traditional risk premium method, which he refers to as the  
9 "Ibbotson Approach," and he calculates a much lower risk premium. His analysis  
10 includes a discussion of a variety of estimates of the equity-bond risk premium, and  
11 it is difficult to determine the weight he places on the various information sources.  
12 Nevertheless, his analysis contains a number of conceptual problems. For example,  
13 he uses the S&P 500 to represent the market, and this is a gross understatement of  
14 the alternatives available to investors. (Woolridge, page 55, line 8). Dr. Woolridge  
15 used the wrong Ibbotson equity risk premium in Exhibit\_(JRW-7), page 3 of 5. It  
16 should be 7.1 percent as I noted in Rebuttal Schedule DAM-4, an excerpt from his  
17 source. A clue that something is wrong with Dr. Woolridge's estimate of his risk  
18 premium is that his estimate of the expected return on common stock is only 1.13  
19 percent higher than the current rate for low-investment grade BBB corporate bonds.  
20 On its face, Dr. Woolridge's risk premium analysis is not credible.

21 Q. WHY DO YOU SAY THAT DR. WOOLRIDGE'S DCF MODEL IS MISSPECIFIED  
22 AND MISAPPLIED?



1 A. On page 28, line 1 of his Direct Testimony, Dr. Woolridge shows the standard,  
2 annual DCF model used in his analysis. The assumptions underlying this standard  
3 model include dividends being paid annually at the end of the year with a yearly  
4 increase in dividends starting exactly one year from the present (See Morin, R. *New*  
5 *Regulatory Finance*, pg. 343, *Public Utilities Reports, Inc. Vienna, Virginia, 2006.*).  
6 However, as shown on page 31, line 10 of his testimony, rather than multiplying the  
7 current annual dividend by the expected growth rate, Dr. Woolridge adjusts the  
8 expected growth rate of dividends by one-half for two reasons: First, because some  
9 analysts use the current quarterly dividend and multiply that dividend by 4 which  
10 could overstate the expected dividend in the coming year due to firms changing  
11 dividends at different times of the year, and second, because the overall cost of  
12 capital may be applied to a projected or end-of-test-year rate base (Woolridge  
13 Direct, page 30, line 9).

14 Q. IS THIS AN APPROPRIATE ADJUSTMENT?

15 A. No. Dr. Woolridge's adjustment is inappropriate with regard to both of these  
16 conditions. First, Dr. Woolridge obtained his dividend yields from *AUS Utility*  
17 *Reports* (Exhibit JRW-6, page 2 of 5) which uses the current annual dividend to  
18 calculate the dividend yield. Consequently, there is no overstatement of the  
19 expected dividend because of differences in expected growth between the coming  
20 quarter versus the coming year. Second, the adjustment Dr. Woolridge cites that is  
21 associated with a projected or end-of-test-year rate base only applies when a  
22 *quarterly compounded* DCF model is used to determine the cost of equity. A quarterly

1 compounded DCF model recognizes the time value of money associated with  
2 dividends being paid quarterly. Consequently, all other things being equal, a  
3 quarterly compounded model will produce a higher cost of equity.

4 Q. DO ANALYSTS UNDERSTAND THIS?

5 A. Analysts have recognized that the “DCF quarterly rate is in fact an effective market-  
6 based rate of return that, although appropriate for unregulated companies, requires  
7 modification because of the manner in which revenue requirements are set.” (See  
8 Morin, R. *New Regulatory Finance*, page. 350, Public Utilities Reports, Inc. Vienna,  
9 Virginia, 2006.) The proper adjustment to synchronize the rate base and the return  
10 on equity when using a quarterly DCF model is to adjust the effective rate to a  
11 nominal rate. Consequently, not only is Dr. Woolridge’s adjustment inappropriate  
12 for his annual DCF model, it would be inaccurate even if he had used a quarterly  
13 model. In sum, Dr. Woolridge’s primary cost of equity analysis relies on a  
14 misspecified and misapplied model that inherently underestimates the cost of  
15 equity.

16 Q. WHAT COMMENTS DO YOU HAVE REGARDING DR. WOOLRIDGE’S  
17 EVALUATION OF YOUR TESTIMONY?

18 A. I am surprised at the inconsistencies of Dr. Woolridge’s response to my direct  
19 testimony. In numerous instances, Dr. Woolridge goes to great lengths to criticize  
20 aspects of my analysis when he has incorporated the very same methods in his own  
21 work. Additionally, many of Dr. Woolridge’s criticisms contradict either his own  
22 statements, financial theory, or both. Finally, Dr. Woolridge’s criticism of the need

1 for a flotation cost adjustment and a size adjustment in his CAPM analysis are  
2 theoretically wrong. Consequently, the inconsistency and selective application of  
3 financial principles severely undermine the credibility of his responsive testimony  
4 and render it unreliable.

5 Q. YOU STATED THAT DR. WOOLRIDGE'S TESTIMONY WAS INCONSISTENT.  
6 WHAT DID YOU MEAN BY THAT STATEMENT?

7 A. The most obvious example is Dr. Woolridge's criticism of my use of analysts'  
8 forecasts. While he criticized my use of analyst's forecasts, he used them in his own  
9 analysis. For example, Dr. Woolridge spent nine pages of his Direct Testimony  
10 (Woolridge, pages 70-78) expounding on the unsuitability of analysts' forecasts for  
11 determining the DCF growth rate and criticizing academic studies supporting their  
12 use. Nevertheless, he relied on analysts' forecasts for determining his DCF growth  
13 rate (Woolridge Direct, page 31, line 4). In addition to analysts' forecasts, Dr.  
14 Woolridge "reviewed" historical growth. However, analysts also take historical  
15 growth into consideration when making forecasts. On page 76, line 8, of his  
16 testimony, regarding *Value Line*, Dr. Woolridge states, "Value Line has a decidedly  
17 positive bias to its earnings growth rate forecasts as well." Yet, Dr. Woolridge relies  
18 heavily on *Value Line's* forecasts to determine his growth rate (Woolridge Direct,  
19 page 34, line 8). Although he uses analysts' forecasts for his own analysis, he also  
20 disclaims their value. This type of internal inconsistency in his testimony is  
21 commonplace.

22 Q. HOW DID PROFESSOR WOOLRIDGE USE ANALYSTS' FORECASTS AND AT

1 THE SAME TIME DISCLAIM THEIR VALUE?

2 A. Yes. On page 61, line 16 of his direct testimony Dr. Woolridge states boldly, without  
3 any substantiation, "It seems highly unlikely that investors today would rely  
4 excessively on the forecasts of security analysts." Dr. Woolridge's unsupported  
5 opinion of whether investors are using the right information to form their  
6 expectations is not relevant. What is necessary for determining the expected growth  
7 rate in a DCF analysis is a proxy for investor expectations. Dr. Woolridge would  
8 have us believe that rather than widely circulated published forecasts by  
9 professionals, investors rely on something else. Also, Dr. Woolridge's opinion is  
10 inconsistent with academic research. As I cited in my Direct Testimony, from as  
11 early as 1982 to just recently, published academic studies have shown that analysts'  
12 forecasts are superior to historical trended growth rates as predictors of growth  
13 rates for DCF analyses.

14 Q. DID DR. WOOLRIDGE USE ANALYSTS' FORECASTS IN OTHER AREAS OF HIS  
15 TESTIMONY?

16 A. Yes. On page 46, line 1 of his testimony, Dr. Woolridge cites a study by Claus and  
17 Thomas of Columbia University to support his CAPM analysis. In citing that study,  
18 Dr. Woolridge points out, "The expected cash flows are developed using *analysts*  
19 *earnings forecasts*." [Emphasis Added.]

20 Q. DR. WOOLRIDGE CRITICIZED YOUR TESTIMONY, BUT HE APPLIED THE  
21 SAME METHODS HIMSELF. DID YOU DETERMINE WHETHER DR.  
22 WOOLRIDGE CRITICIZED OTHER AREAS OF YOUR TESTIMONY WHEN HE

1 USED THE SAME METHODS OR DATA?

2 A. Yes. Another instance occurred on page of his Direct Testimony, where Dr.  
3 Woolridge criticized my use of the historical relationship between stock and bond  
4 returns from the "Ibbotson Study." Then, on page 86, line 4, of his Direct Testimony,  
5 he stated, "Using the historical relationship between stock and bond returns to  
6 measure an ex ante risk premium is erroneous, and especially in this case, overstates  
7 the real market risk premium." However, as shown on page 56, line 11, Dr.  
8 Woolridge included the results of the Ibbotson Study in determining his CAPM cost  
9 of equity.

10 Q. CAN YOU IDENTIFY OTHER CONTRADICTIONS BETWEEN PROFESSOR  
11 WOOLRIDGE'S CRITICISM OF YOUR TESTIMONY AND HIS OWN METHODS?

12 A. Yes. Dr. Woolridge criticizes my judgment in evaluating the data and results in my  
13 cost of equity analyses. In my analyses, I evaluated relevant market data for Atmos  
14 and a group of comparable companies and used my judgment based on these  
15 analyses to recommend an allowed return. Then, I tested this recommendation for  
16 its adequacy. Dr. Woolridge criticized this process and my judgment as "highly  
17 selective use" (Woolridge Direct, pg. 65, line 5). Nevertheless, on page 23, line 4 of  
18 his Direct Testimony, Dr. Woolridge states, "The cost of common equity, however,  
19 cannot be determined precisely and must instead be estimated from market data  
20 and informed judgment."

21 Q. WHY DID YOU STATE THAT DR. WOOLRIDGE'S CRITICISM OF THE NEED  
22 FOR A FLOTATION COST ADJUSTMENT IS MISGUIDED?

1 A. On page 79 line 10 of his testimony, Dr. Woolridge claims that I have  
2 inappropriately focused on the higher DCF results as an alternative to making a  
3 flotation or market pressure adjustment. Again, he applied his faulty market-to-  
4 book value standard as the basis for this statement. (Woolridge, page 79, line 16).  
5 However, issuance and flotation costs are inescapable investment expenses that  
6 analysts should consider in estimating an allowed return necessary for a utility to  
7 attract capital. All other things being equal, if not considered, the investor will not  
8 earn the required return.

9 Q. IS THE ALLOWANCE FOR ISSUANCE EXPENSE FOR COMMON STOCKS  
10 SIMILAR TO THE ALLOWANCE FOR BOND ISSUANCE EXPENSE?

11 A. Conceptually, the situation with common stock is similar to that of bonds and  
12 preferred stock, but the regulatory treatment differs. With bonds for example, the  
13 issuance expenses recovered over the life of the bond are reflected in the cost  
14 charged to ratepayers. The cost to the company for a specific bond issue is the  
15 interest expense plus the amortization of issuance costs divided by the principal  
16 value less the unamortized issuance costs. The result is that the cost to the utility is  
17 greater than the return to the creditor.

18 Unlike the case of bonds, however, common stock does not have a finite life.  
19 Therefore, a utility cannot amortize issuance costs and must recover them by an  
20 upward adjustment to the allowed return on equity. Studies have shown that the  
21 adjustment is necessary, even if there are no plans for future stock issuance. This  
22 adjustment reflects the utility's earned return on an equity balance that is less than

1 the actual amount paid by investors because of the issuance costs.<sup>1</sup> Historically,  
2 utility underwriting expenses associated with issuing common stock have averaged  
3 3 to 5.5 percent of gross proceeds.<sup>2</sup>

4 Q. YOU MENTIONED THAT PROFESSOR WOOLRIDGE CRITICIZED YOUR USE  
5 OF A SIZE ADJUSTMENT IN YOUR CAPM ANALYSIS. WHAT IS THE NATURE  
6 OF HIS CRITICISM?

7 A. Dr. Woolridge misrepresents an article by Ms. Annie Wong to argue that a size  
8 premium is inappropriate for a public utility. His criticism misses the point at  
9 several levels. First, Ms. Wong did not demonstrate that a size premium was  
10 inappropriate for utilities; she only reported that in the model that she used, she  
11 could not find the evidence of a size differential for utilities. Her finding, however,  
12 was contrary to the extensive work by other academics who found the size  
13 differential. Dr. Woolridge chose to ignore this extensive work. In fact, Ibbotson  
14 Associates uses an electric utility as the example in its publication when  
15 demonstrating the application of the size premium adjustment in a CAPM analysis.  
16 As Rebuttal Schedule DAM-5 shows, his CAPM understated the estimated returns  
17 of his gas utility group by an average of 158 basis points.

18 Q. ARE THESE ISSUES THAT YOU MENTIONED YOUR ONLY CONCERNS WITH  
19 PROFESSOR WOOLRIDGE'S TESTIMONY?

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1 See Brigham, E.F., Aberwald, D., and Gapenski, L.D., "Common Equity Flotation Costs and Rate Making," Public Utilities Fortnightly, May 2, 1985, pp. 28-36

2 See Lee, I., Lochead, S., Ritter, J., and Zhao, Q., "The Costs of Raising Capital." Journal of Financial Research, Vol. XIX, No. 1, Spring 1996.

1 A. No. I raised the issues mentioned at this point in my rebuttal testimony because I  
2 thought these were perhaps the significant misconceptions that led to is inordinately  
3 low recommended allowed return and his major criticisms of my Direct Testimony.

4 Q. DOES THIS COMPLETE YOUR REBUTTAL TESTIMONY?

5 A. Yes, it does.

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COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF )  
RATE APPLICATION OF ) Case No. 2006-00464  
ATMOS ENERGY CORPORATION )

CERTIFICATE AND AFFIDAVIT

The Affiant, Donald A. Murry, being duly sworn, deposes and states that the prepared testimony attached hereto and made a part hereof, constitutes the prepared rebuttal testimony of this affiant in Case No. 2006-00464, in the Matter of the Rate Application of Atmos Energy Corporation, and that if asked the questions propounded therein, this affiant would make the answers set forth in the attached prepared rebuttal pre-filed testimony.

Affiant further states that he will be present and available for cross examination and for such additional direct examination as may be appropriate at any hearing in Case No. 2006-00464 scheduled by the Commission, at which time affiant will further reaffirm the attached testimony as his rebuttal testimony in such case.

Donald A. Murry

STATE OF OKLAHOMA  
COUNTY OF OKLAHOMA

SUBSCRIBED AND SWORN to before me by Donald A. Murry on this the 13<sup>th</sup> day of June, 2007.

Carolyn S. Hanes  
Notary Public  
My Commission Expires: 12-4-2009  
CAROLYN S. HANES  
NOTARY  
#01019787  
EXP. 12/04/09  
PUBLIC  
STATE OF OKLAHOMA

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF )  
RATE APPLICATION OF ) Case No. 2006-00464  
ATMOS ENERGY CORPORATION )

CERTIFICATE AND AFFIDAVIT

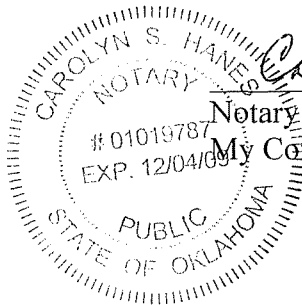
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Affiant further states that he will be present and available for cross examination and for such additional direct examination as may be appropriate at any hearing in Case No. 2006-00464 scheduled by the Commission, at which time affiant will further reaffirm the attached testimony as his rebuttal testimony in such case.

Donald A. Murry

STATE OF OKLAHOMA  
COUNTY OF OKLAHOMA

SUBSCRIBED AND SWORN to before me by Donald A. Murry on this the 13<sup>th</sup> day of June, 2007.



Carolyn S. Hanes  
Notary Public  
My Commission Expires: 12-4-2009



**BEFORE THE PUBLIC SERVICE COMMISSION  
COMMONWEALTH OF KENTUCKY**

**IN THE MATTER OF** )  
 )  
**RATE APPLICATION BY** ) **Case No. 2006-00464**  
 )  
**ATMOS ENERGY CORPORATION** )

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**REBUTTAL TESTIMONY OF STEPHEN C. HARMON**

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**I. POSITION AND QUALIFICATIONS**

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**Q. PLEASE STATE YOUR NAME, BUSINESS AFFILIATION AND BUSINESS ADDRESS.**

A. My name is Stephen C. Harmon. I am the Director of Compensation and Benefits for Atmos Energy Corporation (“Atmos” or the “Company”). My business address is Atmos Energy Corporation, 5430 LBJ Freeway, Suite 500, Dallas, Texas 75240.

**Q. PLEASE STATE YOUR EDUCATIONAL BACKGROUND AND DESCRIBE YOUR WORK EXPERIENCE.**

A. I earned a Bachelor of Science degree in Biological Sciences from Cal-State University East Bay in 1967 and a Master of Public Administration degree from the same university in 1974. I came to work for the Company in 1991 as Manager, Employee Benefits. Prior to joining the Company, I worked as the benefits manager for a restaurant chain with approximately 5,000 employees. I am also a retired naval captain and served in the U.S. Navy in both active and reserve status for over 33 years. During that time, I had command of three reserve units, one readiness unit and held senior leadership positions with a major unit that supported the U.S. Seventh Fleet.

**Q. WHAT ARE YOUR JOB RESPONSIBILITIES?**

1 A. As the Company's Director of Compensation and Benefits, I oversee the efficient  
2 operation and administration of the Company's health and welfare plans, workers'  
3 compensation program, qualified retirement/savings plans, nonqualified plans  
4 (which include incentive compensation plans) and employee compensation  
5 programs. In connection with these duties, I monitor and analyze employee and  
6 Company needs in relation to regulatory requirements and competitive trends to  
7 develop and implement compensation programs and benefit plans, as well as  
8 policy changes. I also oversee and coordinate the maintenance and accounting of  
9 benefit plans to ensure appropriate control and protection of plan assets, monitor  
10 the functional area activities to ensure compliance with required government  
11 reporting and legislative or regulatory requirements, such as ERISA. I provide  
12 guidance and formulate recommendations on matters pertaining to compensation  
13 and benefits based on Company policy, procedure and practice and keep abreast  
14 of changes in human resources related regulations and trends and apprise  
15 management of benefits issues and concerns.

16 I directly participate on the American Gas Association (AGA) Compensation and  
17 Benefits Committee and oversee the Company's participation in the Southern Gas  
18 Association (SGA) Compensation Committee. The AGA Compensation and  
19 Benefits Committee prepares the AGA's periodic Compensation Survey which is  
20 discussed later in my testimony.

21 **Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THE KENTUCKY**  
22 **PUBLIC SERVICE COMMISSION ("KPSC") OR OTHER**  
23 **REGULATORY ENTITIES?**

24 A. No.

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

26 A. The purpose of my testimony is to sponsor the Company's inclusion of certain  
27 incentive compensation costs in this rate proceeding and to explain why such  
28 costs and the inclusion thereof is reasonable and necessary. In connection  
29 therewith, my testimony is also provided in rebuttal to the direct testimony of  
30 Robert J. Henkes, who is a witness for the Kentucky Attorney General's Office in  
31 this rate proceeding.

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**II. SUMMARY**

**Q. WHAT SUBJECT AREAS DO YOU INTEND TO COVER IN YOUR TESTIMONY?**

- A. I will testify concerning the following subject areas:
- 1. Overview of the Company’s incentive compensation plans.
    - a. Variable Pay Plan (“VPP”).
    - b. Management Incentive Plan (“MIP”).
    - c. Long-Term Incentive Plan for Management (“LTIP”).
  - 2. Benefits of incentive compensation and inclusion of the cost of variable incentive compensation plans for management and non-management employees as part of the cost of service in setting rates.

**III. OVERVIEW OF THE COMPANY’S INCENTIVE COMPENSATION PLANS**

**Q. ARE YOU FAMILIAR WITH THE COMPANY’S INCENTIVE COMPENSATION PLANS?**

A. Yes. The Company has three such plans – the Variable Pay Plan, the Management Incentive Plan and the Long-Term Incentive Plan for Management.

**Q. WHAT IS THE VARIABLE PAY PLAN?**

A. The Variable Pay Plan, or “VPP”, is a broad based incentive compensation plan in which virtually all but approximately 135 employees of the Company participate (except for those included in the Management Incentive Plan or the “MIP”). The plan, which is developed around the same precepts as the MIP, provides all eligible employees with the opportunity to earn a cash-based incentive award based upon the Company’s return on equity performance which is expressed to participants as an earnings per share target (EPS).

**Q. WHAT COMPANY EMPLOYEES ARE ELIGIBLE TO PARTICIPATE IN THE VPP?**

1 A. With one exception, all Company employees that do not participate in the MIP  
2 plan participate in the VPP. The exception rests with a group of collective  
3 bargaining employees in Mississippi (Mississippi Local Union 1047C) that has  
4 not bargained to participate in the VPP. It should be noted that the Company's  
5 other bargaining unit has negotiated with management to participate in the VPP.

6 **Q. WHAT FORM OF AWARDS ARE MADE PURSUANT TO THE VPP?**

7 A. The VPP pays an annual cash award which is targeted to be 2 percent of an  
8 employee's September 30<sup>th</sup> base annual salary. For non-exempt employees in the  
9 plan compensation such as overtime and call-out pay is included in the  
10 employee's eligible earnings as required by the US Department of Labor. Should  
11 the Company attain its target level of EPS during the course of the fiscal year, the  
12 plan will pay cash awards following the September 30 close of the fiscal year.  
13 Typically, such awards are paid in November following the close of the  
14 Company's financial reporting with the Securities and Exchange Commission.  
15 The plan also pays awards based upon threshold and maximum levels of  
16 performance. The VPP provides awards equal to 1 percent of base compensation  
17 for the threshold level of performance, and the maximum level of performance  
18 results in a payment of 3 percent of base eligible compensation. Awards under  
19 the VPP are capped at 3 percent of base eligible compensation. For performance  
20 levels achieved between the stated threshold and maximum levels of performance,  
21 awards are calculated on a straight line interpolated basis.

22 **Q. HOW ARE THE APPLICABLE THRESHOLDS FOR AWARDS UNDER**  
23 **THE VPP DETERMINED?**

24 A. The range of outcomes between threshold, target, and maximum are based upon  
25 the Company's budgeted return on equity at target and moving 100 basis points  
26 below budgeted return on equity (target) for the threshold and 100 basis points  
27 above budgeted ROE (target) for setting the maximum. As an example, the  
28 following schedule sets forth the determination of the performance levels of  
29 threshold, target, and maximum performance targets for the VPP for the fiscal  
30 year 2006 plan year:

31

<b>VPP Performance Schedule – 2006 Fiscal Year</b>				
<i>Performance Level</i>	<i>Annual EPS</i>	<i>ROE</i>	<i>Basis for Performance Target</i>	<i>Payout as Percent of Base Compensation</i>
Threshold	\$1.59	8.00%	100 basis points below budget ROE	1%
Target	\$1.80	9.00%	2006 budget ROE	2%
Maximum	\$2.01	10.0%	100 basis points above budget ROE	3%

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As designed, the plan offers award opportunities only when the Company reaches or exceeds desired levels of profitability as measured by both return on equity and earnings per share. For participants, the performance targets are expressed only as levels of EPS so that participants have a clear line of sight to what they are being measured against as well as how they can influence results.

**Q. HOW CAN VPP PARTICIPANTS INFLUENCE EPS RESULTS?**

A. EPS is measured as the Company’s net income divided by total shares outstanding. Participants understand that net income is a function of both revenues and expenses, and that the best way in which they can influence EPS results is being mindful of unnecessary costs, customer service levels, safety incidents, and productivity. These actions are beneficial to all constituents of Atmos: ratepayers, shareholders, employees and the communities served by the Company. Mr. Henkes states on p. 24 of his direct testimony that the Company’s shareholders are the primary beneficiaries of these plans. This statement, however, demonstrates a lack of understanding of those factors and behaviors which have a direct bearing on EPS and who benefits therefrom.

**Q. ARE VPP AWARDS CONSIDERED BY THE COMPANY TO BE “AT RISK” COMPENSATION?**

A. Yes. At risk compensation is employee compensation that is not part of an employee’s base pay and is contingent upon achievement of stated criteria or goals. Because the plan is discretionary, there is no guarantee that any awards nor any specific award amounts will be made under the VPP for any given year.



1 **Q. HAS THE COMPANY HISTORICALLY MADE AWARDS PURSUANT**  
 2 **TO THE VPP TO PLAN PARTICIPANTS?**

3 A. Yes. The VPP was developed in concert with the Company’s development and  
 4 adoption of a new overall compensation strategy set forth in 1998 and referred to  
 5 as “Total Rewards.” The plan was initially implemented in fiscal year 1999,  
 6 however, the plan paid no awards for that year since the Company failed to reach  
 7 its threshold level of EPS performance. The Company also failed to reach the  
 8 threshold level of EPS in fiscal year 2000, and no awards were paid for that year’s  
 9 performance. The plan paid its first awards to participants in fiscal year 2001, and  
 10 in that year the plan paid awards at 2.15 percent of eligible compensation to  
 11 approximately 2,200 participants. In the schedule below, we have reported the  
 12 payment history of the VPP from fiscal year 2001 through fiscal year 2006,  
 13 including the number of participants, the total payment, average payment per  
 14 participant, the corresponding EPS achievement for the performance period, and  
 15 the percentage of a participant’s eligible compensation for determination of the  
 16 award level.

17

<b><u>Variable Pay Plan (“VPP”) Payment History</u></b>						
	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>
Number of participants	2,217	2,108	2,475	2,362	3,846	4,161
Total payment	\$1,661,441.00	\$1,286,448.00	\$1,741,541.74	\$2,415,122.12	\$3,703,635.58	\$4,243,571.32
Average payment per participant	\$749.41	\$610.27	\$703.65	\$1,022.49	\$962.98	\$1,019.84
EPS	\$1.56	\$1.45	\$1.54	\$1.63	\$1.72	\$1.82
Award Percentage	2.15%	1.45%	1.71%	2.38%	2.12%	2.10%

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20 **Q. WHAT IS THE MANAGEMENT INCENTIVE PLAN?**

21 A. The Management Incentive Plan, or “MIP”, is an annual incentive plan and is  
 22 limited to a select group of management employees who are responsible for  
 23 directing and overseeing the day-to-day operations of the Company. In fiscal year

1 2006, 127 key management employees participated in the plan and received  
2 awards. The MIP provides the management team with the opportunity to earn a  
3 cash-based incentive award based upon the Company's return on equity  
4 performance which is expressed to participants as an EPS target.

5 **Q. WHAT AWARD OPPORTUNITIES ARE AVAILABLE TO**  
6 **PARTICIPANTS UNDER THE MIP?**

7 A. Participants in the plan receive a target award opportunity each year expressed as  
8 a percentage of base compensation. The target award opportunities vary by salary  
9 grade, and the opportunities increase with corresponding higher salary grades as  
10 management responsibility increases. These target award opportunity percentages  
11 are directly tied to the 50<sup>th</sup> percentile of competitive market survey data for  
12 positions of comparable responsibility for energy services companies of similar  
13 size. The size of target awards ranges from 20 percent of base compensation at  
14 target for salary grade 7 up to a target opportunity of 80 percent of base  
15 compensation for salary grade 13. In addition to a target incentive opportunity,  
16 there are threshold and maximum levels of payment opportunity based upon a  
17 predetermined set of performance outcomes. For the threshold level (minimum)  
18 of performance, a participant would receive 50 percent of the target award  
19 opportunity. For attainment of the maximum level of performance, a participant  
20 would receive 200 percent of the target award opportunity.

21 **Q. HOW ARE THE APPLICABLE THRESHOLDS FOR AWARDS UNDER**  
22 **THE MIP DETERMINED?**

23 A. The annual performance targets for the MIP are the same performance targets for  
24 the VPP, as determined by the return on equity target converted to an EPS target.  
25 For example, the MIP performance scale for fiscal year 2006 was essentially the  
26 same as that for the VPP, as shown in the table below:

1

<b><u>MIP Performance Schedule – 2006 Fiscal Year</u></b>				
<i>Performance Level</i>	<i>Annual EPS</i>	<i>ROE</i>	<i>Basis for Performance Target</i>	<i>Payout as Percent of Participant's Target Opportunity</i>
Threshold	\$1.59	8.00%	100 basis points below budget ROE	50%
Target	\$1.80	9.00%	2006 Budget	100%
Maximum	\$2.01	10.0%	100 basis points above budget ROE	200%

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3 **Q. CAN MIP PARTICIPANTS INFLUENCE EPS RESULTS?**

4 A. Yes. As with the VPP, the MIP pays awards only when the Company reaches or  
5 exceeds desired levels of profitability as measured by both return on equity and  
6 earnings per share. Participants in the MIP are cognizant of the EPS targets and  
7 manage for the same performance metrics that influence EPS results as with the  
8 VPP: managing unnecessary costs, being attentive to customer service levels,  
9 minimizing safety incidents, and enhancing employee productivity.

10 **Q. ARE MIP AWARDS CONSIDERED BY THE COMPANY TO BE “AT  
11 RISK” COMPENSATION?**

12 A. Yes, just the same as VPP awards. Because the plan is discretionary, there is no  
13 guarantee that any awards nor any specific award amounts will be made under the  
14 MIP for any given year.

15 **Q. HAS THE COMPANY HISTORICALLY MADE AWARDS PURSUANT  
16 TO THE MIP TO PLAN PARTICIPANTS?**

17 A. As with the VPP, the MIP was implemented at the same time that the VPP plan  
18 was implemented in fiscal year 1999 and has been an integral part of the Total  
19 Rewards program since that time. The plan did not pay incentive awards in either  
20 fiscal year 1999 or fiscal year 2000 since the Company did not achieve its  
21 threshold level of EPS performance. Since fiscal year 2001, the plan has provided  
22 payments as follows to its participants:

23

<b>Management Incentive Plan ("MIP") Payment History</b>						
	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>
Number of participants	83	85	93	92	99	127
Total payments	\$1,839,175.00	\$1,824,300.00	\$2,195,100.00	\$3,805,400.00	\$3,318,300.00	\$6,244,400.00
Average payment per participant	\$22,159	\$21,462	\$23,603	\$41,363	\$33,518	\$49,169
EPS	\$1.56	\$1.45	\$1.54	\$1.63	\$1.72	\$1.82

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3 **Q. WHAT IS THE LONG-TERM INCENTIVE PLAN FOR MANAGEMENT?**

4 A. The Long-Term Incentive Plan for Management, or "LTIP", is an equity-based  
5 incentive program which focuses upon the long-term financial strength and  
6 viability of the Company. Since 2003, the LTIP has provided long-term  
7 incentives to its management team in two forms: (1) time-lapse restricted shares;  
8 and (2) performance-based restricted share units. Long-term incentives are  
9 granted annually to participants and are based upon competitive long-term  
10 expected values awarded at the 50<sup>th</sup> percentile of competitive market practice.  
11 The long-term awards are allocated by taking 50 percent of the total award  
12 opportunity and granting that portion in time-lapse restricted shares, and taking  
13 the remaining 50 percent of the total award opportunity and granting that portion  
14 in performance-based restricted share units.

15 **Q. PLEASE EXPLAIN THE TWO FORMS OF LTIP AWARDS IN MORE  
16 DETAIL.**

17 A. The time-lapse restricted shares are subject to a three-year restricted period. The  
18 shares are paid to the participant free of restrictions following the three-year  
19 service period from the date of grant. During the restricted period, the dividends  
20 on the time-lapse restricted shares are paid at the same rate as such dividends are  
21 declared for all of the Company's common shares.

22 The performance-based restricted share units must be earned over a three-year  
23 performance period. The performance measure for determination of the number  
24 of units earned is the Company's cumulative three-year earnings per share (EPS)

1 compared to the targeted level of EPS for the same period (based on established  
2 budgets). If the Company achieves 100 percent of the EPS three-year target, the  
3 participant will receive 100 percent of the performance share units granted. If the  
4 Company achieves only the threshold level of three-year EPS performance, the  
5 participant will receive 50 percent of the performance share units granted. If the  
6 Company achieves the maximum level of three-year EPS performance, the  
7 participant will receive 150 percent of the performance share units granted.  
8 Dividends on the performance-based restricted share units are credited to the  
9 participant's notional account with the payment of such dividends not occurring  
10 until the three-year cumulative earnings per share performance targets are  
11 measured at the end of the three-year performance measurement cycle. Awards  
12 of performance-based share units under the LTIP are considered to be at risk,  
13 deferred compensation.

14 **Q. WHAT IS THE PURPOSE OF THE THREE-YEAR PERIOD ATTACHED**  
15 **TO THE TWO FORMS OF LTIP AWARDS?**

16 A. The purpose of the long-term performance incentive is to focus management's  
17 attention upon the long-term sustained results through superior earnings  
18 performance. As with the annual incentive plan, superior earnings performance  
19 comes from actions like managing excessive and unnecessary costs, driving  
20 performance through enhanced productivity, eliminating accidents and safety  
21 incidents, and managing customer service levels. These actions are the focus of  
22 an extended time period of three years with respect to long-term incentives.

23 **Q. IS THE LTIP A NECESSARY PART OF THE COMPANY'S**  
24 **COMPENSATION PACKAGE OFFERED TO ITS SENIOR**  
25 **MANAGERIAL AND EXECUTIVE EMPLOYEES?**

26 A. Yes. Atmos, like its peer companies and other companies in the competitive  
27 marketplace, must provide attractive long-term incentive opportunities to its  
28 senior management team in order to attract and retain qualified individuals critical  
29 to the Company's long-term success. Equity incentives like restricted stock and  
30 restricted share units also provide the Company with a retention vehicle to ensure  
31 that the organization retains the management talent required to lead and operate a

1 Company of the size and stature of Atmos. Atmos would be at a distinct  
2 competitive disadvantage were it not able to provide competitive long-term equity  
3 incentive opportunities to its management team.

4 **Q. AS A REFERENCE POINT, CAN YOU EXPLAIN THE COMPANY'S**  
5 **OVERALL COMPENSATION PHILOSOPHY?**

6 A. The Company aims to provide all employees with a fair, equitable and  
7 competitive total rewards program. The program is designed to help the  
8 Company attract and retain quality employees by targeting pay at the median (50<sup>th</sup>  
9 percentile) of the competitive market in which the Company competes for talent.  
10 The competitive market, for purposes of the incentive programs described above,  
11 are defined as companies in the energy services industry. The program is  
12 carefully monitored and managed to ensure that it fairly serves all of its  
13 stakeholders – employees, customers, and shareholders well.

14 **Q. HOW DOES INCENTIVE COMPENSATION FIT INTO THE**  
15 **COMPANY'S COMPENSATION PHILOSOPHY?**

16 A. The Company's compensation program is comprised of many components. One  
17 integral component is the use of variable incentive compensation plans for both  
18 management and non-management employees. Atmos' variable incentive  
19 compensation plans and the philosophy behind those plans contain a number of  
20 advantages. First, incentive compensation is a variable cost (as opposed to the  
21 fixed cost element of base salary) and the variable element of pay is awarded only  
22 when the Company can justify and afford to make such payments based upon  
23 financial performance. This is the underlying tenet of the Company's pay for  
24 performance philosophy.

25 Incentive pay also improves the Company's ability to recruit and retain talented  
26 employees since incentive compensation is widely prevalent in the labor markets  
27 in which the Company competes for key talent. Incentive compensation is  
28 viewed as pay at risk and motivates employees to achieve important performance  
29 goals in order to earn additional financial rewards. In this regard, incentive  
30 compensation is not an entitlement but instead represents the Company's  
31 willingness to pay for performance which exceeds reasonable expectations.

1 Properly designed incentive plans also encourage teamwork and the achievement  
2 of common purpose by helping employees become more engaged in their jobs,  
3 thereby benefiting customers, shareholders, other employees and the communities  
4 served by the Company.

5 Finally, incentive plans improve company communications about performance  
6 goals and other performance matters instrumental to the Company's success.

7  
8 **III. BENEFITS OF INCENTIVE COMPENSATION**

9 **Q. DO RATEPAYERS BENEFIT FROM THE COMPANY'S USE OF**  
10 **VARIABLE INCENTIVE COMPENSATION PLANS?**

11 A. Yes. Until the 1990's, utilities such as the Company were reluctant to adopt  
12 variable incentive compensation plans as a part of their overall pay strategy. Due  
13 to the many regulations imposed upon utilities by various authorities, it was  
14 commonly believed that variable pay incentive plans were an inappropriate form  
15 of compensation since shareholder and ratepayer interests could not be properly  
16 balanced. Therefore, it was easy for utilities to pay and justify high base salaries  
17 (as compared to other industries) and to add generous and expensive employee  
18 benefit plans in order to compete with other large employers.

19 The Company could easily follow this traditional path and could eliminate  
20 variable incentive compensation from its rewards program. In turn, Atmos would  
21 have to dramatically increase base salaries and employee benefit levels in order to  
22 provide a competitive rewards package in terms of total value. This would result  
23 in higher fixed costs, which would be directly borne by the ratepayers. Wisely,  
24 the Company's pay philosophy incorporates the use of at risk incentive  
25 compensation for all employees because of the many advantages that such  
26 variable compensation provides to all stakeholders of the Company.

27 **Q. ARE VARIABLE INCENTIVE COMPENSATION PLANS USED WIDELY**  
28 **IN THE UTILITY INDUSTRY TODAY?**

29 A. Yes. Many, if not the majority of, investor-owned gas and electric utilities have  
30 moved in the direction of incentive compensation as an integral component of  
31 their compensation plans. Annual incentive plans for both management and non-

1 management employees have become particularly prevalent throughout the gas  
 2 utility industry, clearly illustrating the requirement for offering competitive  
 3 compensation opportunities throughout the organization.

4 **Q. HAVE THERE BEEN ANY RECENT STUDIES WHICH SUPPORT**  
 5 **YOUR CONCLUSION?**

6 A. In 2005, the American Gas Association (AGA) undertook a major survey of  
 7 competitive compensation practices in the gas utility industry. Sixty-one (61)  
 8 companies participated in the survey, which was conducted by Effective  
 9 Compensation, Inc. I have included several highlights from the AGA survey  
 10 which clearly indicate the prominence of incentive compensation plans in U.S.  
 11 gas utilities.

12 In Table 1 below, I have reported the percentage of companies reporting the use  
 13 of incentive plans for either hourly, salaried, professional, supervisory,  
 14 managerial or executive employees. The AGA survey indicates that 90% of the  
 15 surveyed companies have one or more types of incentive plans. Such companies  
 16 also indicate their ratings of success for their incentive plans.

17 *Table 1 – Variable Plan Usage/Success by Revenue Category*

Firm Revenue	% Have	% Consider	% of Firms With Plans That Include These Employees						Success* Average Rating
			Hourly	Salary	Prof.	Supv.	Mgmt.	Exec.	
All	90%	2%	65%	60%	95%	96%	98%	98%	2.1
<\$350M	73%	0%	64%	64%	91%	100%	100%	91%	2.2
\$350M – \$1.5B	88%	6%	43%	43%	93%	93%	100%	100%	1.9
>\$1.5B	100%	0%	67%	67%	97%	97%	97%	100%	2.1

18 \* 1 = Very Successful    2 = Successful    3 = Limited Success    4 = Not Successful  
 19 Source: 2005 American Gas Association  
 20

21 Table 2 below includes competitive data regarding the type of incentive plans  
 22 deployed by gas utilities. As noted, 85% of the surveyed companies have an  
 23 organization-wide incentive plan, and that these types of plans go deep into their  
 24 respective organizations. Of importance is the survey finding that 64% of the  
 25 hourly employees, 57% of the salaried employees and 89% of the professional  
 26 employees in those companies having organization-wide incentive plans  
 27 participate in such plans. These plans are also rated as successful by the  
 28 organizations having such plans.



1 **Table 2 – Variable Compensation Programs – Usage and Success by Plan Type**

Plan Type	% Have	% Consider	% of Firms With Plans That Include These Employees						Success* Average Rating
			Hourly	Salary	Prof.	Supv.	Mgmt.	Exec.	
Org-Wide Incentive	85%	0%	64%	57%	89%	89%	96%	95%	2.0
Small Group Incentive	24%	2%	46%	31%	92%	85%	85%	50%	2.0
Individual Incentive	55%	0%	50%	33%	88%	83%	93%	76%	2.1
Spot Bonuses	42%	0%	70%	61%	91%	91%	91%	48%	2.2

2 \* 1 = Very Successful 2 = Successful 3 = Limited Success 4 = Not Successful  
 3 Source: 2005 American Gas Association  
 4

5 Finally, as illustrated in Table 3 below, the AGA survey also cites the types of  
 6 performance measures found in incentive plans. As noted, the survey findings  
 7 indicate that a balance of measures are used including financial as the most  
 8 prevalent, customer satisfaction as the second most prevalent, and safety as the  
 9 third most prevalent.

10 **Table 3 – Payout Measures**

Measure	All	Small	Medium	Large
Financial	98%	100%	93%	100%
Productivity	65%	50%	57%	71%
Quality	46%	50%	50%	43%
Safety	65%	67%	57%	68%
Cost Reduction	54%	67%	50%	54%
Attendance	4%	17%	0%	4%
Project Milestone	46%	67%	36%	46%
Output/Volume	19%	33%	14%	18%
Customer Satisfaction	83%	67%	93%	82%

11 Source: 2005 American Gas Association  
 12

13 **Q. EVEN THOUGH INCENTIVE COMPENSATION PLANS ARE WIDELY**  
 14 **USED IN THE GAS UTILITY INDUSTRY, HAVE YOU FOUND THAT**  
 15 **THERE REMAINS RESISTANCE TO INCLUSION OF THESE COSTS IN**  
 16 **RATES?**

17 A. Yes. The common argument advocated by opponents is that incentive  
 18 compensation that is tied to financial performance indicators, such as earnings per  
 19 share or return on invested capital, is a cost that should be borne by a company's  
 20 shareholders and not the ratepayers. This reasoning is based upon the erroneous  
 21 assumption that such plans are designed solely to increase profit for shareholders

1 to the exclusion of more customer-oriented aims such as controlling costs and  
2 providing superior customer service. This faulty assumption leads to the  
3 misconception that incentive plans only promote results whereby the utility's  
4 shareholders and employees reap all of the financial rewards of higher earnings to  
5 the detriment of ratepayers.

6 However, earnings are derived by not only increasing revenues, but also by  
7 minimizing expenses. To the extent that Company management can minimize  
8 unnecessary costs, reduce the number of accidents and safety incidents, deliver  
9 satisfactory customer service with reasonable expense and staff levels, and  
10 improve performance by increasing productivity, the Company's bottom line (i.e.,  
11 earnings or earnings per share) will be increased and benefit all constituents.

12 **Q. ARE THE COMPANY'S EMPLOYEES THE PRINCIPAL**  
13 **BENEFICIARIES OF INCENTIVE COMPENSATION PLANS THAT**  
14 **HAVE NO UNDERLYING OBJECTIVE OF CONTROLLING COSTS OR**  
15 **EXPENSES?**

16 A. Nothing could be further from the truth. The Company's incentive compensation  
17 plans are funded based upon the key financial metric of earnings per share (EPS).  
18 This metric considers both revenues and expenses in the determination of  
19 earnings levels and performance of the Company. Maximization of EPS requires  
20 the achievement of rate-based allowed revenues while at the same time  
21 controlling expense levels. The attainment of EPS is to the benefit of both  
22 shareholders and ratepayers, not one group exclusively. Therefore, both  
23 ratepayers and shareholders should recognize the full costs of incentive  
24 compensation since it is to the mutual benefit of both constituents.

25 **Q. DO THE COMPANY'S INCENTIVE COMPENSATION PLANS ONLY**  
26 **PROMOTE HIGHER EARNINGS THAT DO NOT BENEFIT**  
27 **RATEPAYERS?**

28 A. This is a common misconception by opponents of incentive compensation and  
29 fails to consider that important customer-based considerations are key  
30 components of EPS. EPS is the Company's net income divided by total shares  
31 outstanding and is considered to be a company's quantity of earnings. Net

1 income is enhanced by both maximizing revenues and controlling expenses.  
2 Therefore, higher productivity, more careful management of operations and  
3 maintenance costs, and other customer-oriented goals improve net income. As a  
4 result, EPS is an important benchmark of the benefit provided to both customers  
5 and shareholders.

6 Variable incentive compensation is a variable expense and is tied to  
7 improvements in productivity, service, cost management, and other performance  
8 factors that drive EPS. Variable incentive compensation plans provide the  
9 management of the utility the flexibility to motivate, recognize, and reward  
10 performance of their employees. These plans are an allowable part of payroll  
11 expenses and should be recovered in a utility's cost of service, especially when  
12 such plans create a financial incentive for employees to achieve goals that are  
13 important to customers.

14 **Q. WOULD THE DISALLOWANCE OF INCENTIVE COMPENSATION**  
15 **COSTS AS PART OF THE COMPANY'S RATES PLACE IT AT A**  
16 **COMPETITIVE DISADVANTAGE?**

17 A. Yes. It is commonly understood that regulation is superimposed upon utilities  
18 such as the Company as a substitute for competition, but not to eliminate  
19 competition. In the context of recruiting and retaining valued employees, the  
20 Company faces competition not only from its own industry but also from other  
21 industries that are not regulated utilities. Those industries that are not regulated  
22 utilities are free to factor the cost of incentive compensation into the price of the  
23 products or services they sell. If the Company is not permitted to do so, then it is  
24 placed at a competitive disadvantage. Any rate that doesn't represent the amount  
25 of expense that a utility must incur to be competitive in the employment market  
26 does not meet the goal of fair and effective regulation.

27 **Q. HAVE YOU COMPARED THE COMPENSATION LEVELS OF ATMOS**  
28 **TO OTHER COMPANIES FOR WHICH ATMOS COMPETES FOR**  
29 **TALENT?**

30 A. Yes. When employee salaries and total cash compensation levels are compared to  
31 other similar positions in the applicable markets, the Company is paying at the

1 50<sup>th</sup> percentile in the market, including both base and variable incentive pay. The  
2 Company's third-party compensation consultant, Towers Perrin, periodically  
3 conducts an analysis of the competitive levels of selected benchmark positions to  
4 determine whether the compensation offered by the Company remains  
5 competitive.

6 **Q. WHY IS THIS IMPORTANT?**

7 A. As stated above, the Company's total compensation, including both base and  
8 variable incentive pay, positions its employees at the 50<sup>th</sup> percentile for the  
9 market. If the Commission were to disallow any or all of the variable incentive  
10 pay component from recovery in rates, then the Company's employee  
11 compensation costs reflected in the cost of service would be below the average for  
12 the market and would result in levels in the cost of service that are not reasonable  
13 when compared to that market.

14 **Q. Does this conclude your testimony?**

15 A. Yes.



**BEFORE THE PUBLIC SERVICE COMMISSION**

**COMMONWEALTH OF KENTUCKY**

**IN THE MATTER OF** )  
**RATE APPLICATION BY** ) **Case No 2006-00464**  
**ATMOS ENERGY CORPORATION** )

**REBUTTAL TESTIMONY OF THOMAS H. PETERSEN**

1 **Q. PLEASE STATE YOUR NAME, JOB TITLE AND BUSINESS ADDRESS.**

2 A. My name is Thomas H. Petersen. I am Director of Rates for Atmos Energy  
3 Corporation (“Atmos” or “Company”), 5430 LBJ Freeway, Dallas, Texas 75240.  
4 I am responsible for rate studies of the Company’s gas utility operations in 12  
5 states including Kentucky.

6

7 **Q. HAVE YOU PREVIOUSLY FILED TESTIMONY IN THIS CASE?**

8

9 A. Yes, I filed direct testimony on December 28, 2006.

10

11 **Q. WHAT IS THE SCOPE OF YOUR REBUTTAL TESTIMONY?**

12

13 A. My testimony addresses Mr. Majoros and Mr. Henkes testimony related to the  
14 rate base treatment of storage cushion gas.

15

16 **Q. HOW IS STORAGE CUSHION GAS TREATED BY MR. MAJOROS AND**  
17 **MR. HENKES?**

18

19 A. When the Company filed its rate application, it had inadvertently included the  
20 amount of \$1,694,833 in non-recoverable cushion gas in Account 352.3. During

1 the course of discovery, the Company determined through subsequent interviews  
2 with Company personnel that approximately 60% of the storage cushion gas is  
3 expected to be recoverable at the end of the life of the storage fields.  
4 Accordingly, in response to the Attorney General's Data Request No. 2-52(d), the  
5 Company advised the Attorney General that 60% of the storage cushion gas in  
6 Account 352.3, or \$1,016,900, should be moved to Account 117.1 to be consistent  
7 with the FERC's applicable Gas Plant instruction, which provides:

8 117.1 Gas stored-base gas.

9 This account is to include the cost of recoverable gas volumes that are necessary, in  
10 addition to those volumes for which cost are properly includable in Account 101, Gas  
11 plant in service, to maintain pressure and deliverability requirements for each storage  
12 facility. Nonrecoverable gas volumes used for this purpose are to be recorded in Account  
13 352.3, Nonrecoverable natural gas. For utilities using the fixed asset method of accounting,  
14 the cost of base gas applicable to each gas storage facility shall not be changed from the  
15 amount initially recorded except to reflect changes in volumes designated as base gas. If  
16 an inventory method is used to account for gas included herein, the utility may, at its  
17 election, price withdrawals in accordance with the instructions to Account 117.4.

18  
19 Therefore, \$677,933 of non-recoverable cushion gas would remain in Account  
20 352.3. This non-recoverable amount of cushion gas is reflected by Mr. Majoros  
21 in Account 352.3 on page 1 of his Exhibit MJM-5.

22 However, Mr. Henkes has made an adjustment to completely remove the  
23 recoverable portion of cushion gas from rate base altogether. On Henkes Exhibit  
24 RJH-3, Mr. Henkes has made an adjustment to plant in service in the amount of  
25 \$1,016,900, which is the exact amount the Company stated should be moved to  
26 Account 117. The Company never stated that this amount should be removed  
27 from rate base.

28  
29 **Q. DO YOU AGREE WITH MR. MAJOROS' AND MR. HENKES' RATE**  
30 **BASE TREATMENT OF STORAGE CUSHION GAS?**

31  
32 A. No. Mr. Majoros reduced plant in service by \$1,016,900 to reflect the transfer of  
33 the recoverable portion of storage cushion gas from account 352.3 to account 117.  
34 Mr. Henkes included Mr. Majoros' reduced plant in service in rate base but did  
35 not include the investment in recoverable cushion gas in rate base. The  
36 company's investment in recoverable cushion gas is an investment used to

1 provide service to utility customers and should be included in rate base.  
2 Moreover, just because an asset is not depreciable, such as recoverable cushion  
3 gas, does not mean that it should be excluded from the utility's rate base.  
4

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

6

7 A. Yes.



COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF )  
RATE APPLICATION OF ) Case No. 2006-00464  
ATMOS ENERGY CORPORATION )

CERTIFICATE AND AFFIDAVIT

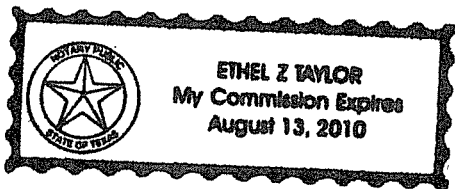
The Affiant, Thomas H. Petersen, being duly sworn, deposes and states that the prepared testimony attached hereto and made a part hereof, constitutes the prepared rebuttal testimony of this affiant in Case No. 2006-00464, in the Matter of the Rate Application of Atmos Energy Corporation, and that if asked the questions propounded therein, this affiant would make the answers set forth in the attached prepared direct pre-filed testimony.

Affiant further states that he will be present and available for cross examination and for such additional direct examination as may be appropriate at any hearing in Case No. 2006-00464 scheduled by the Commission, at which time affiant will further reaffirm the attached testimony as his direct testimony in such case.

Thomas H. Petersen

STATE OF Texas  
COUNTY OF Dallas

SUBSCRIBED AND SWORN to before me by Thomas H. Petersen on this the 13<sup>th</sup> day of June, 2007.



Ethel Z. Taylor  
Notary Public  
My Commission Expires: August 13, 2010



BEFORE THE PUBLIC SERVICE COMMISSION

COMMONWEALTH OF KENTUCKY

IN THE MATTER OF )  
 )  
RATE APPLICATION BY ) Case No. 2006-00464  
 )  
ATMOS ENERGY CORPORATION )

REBUTTAL TESTIMONY OF LAURIE M. SHERWOOD

1 Q. PLEASE STATE YOUR NAME, BUSINESS AFFILIATION AND BUSINESS  
2 ADDRESS.

3 A. My name is Laurie M. Sherwood. I am the Vice President, Corporate Development  
4 and Treasurer of Atmos Energy Corporation (“Atmos”, “Atmos Energy” or “the  
5 Company”). My business address is 5430 LBJ Freeway, Suite 700, Dallas, Texas  
6 75240.

7 Q. DID YOU PREVIOUSLY FILE TESTIMONY ON BEHALF OF THE  
8 COMPANY IN THIS RATE PROCEEDING?

9 A. Yes. My direct testimony was filed at the time of and in connection with the  
10 Company’s rate application.

11 Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

12 A. My rebuttal testimony addresses certain statements made and conclusions reached by  
13 Dr. J. Randall Woolridge, a witness for the Kentucky Attorney General, regarding the  
14 Company’s capital structure. Dr. Wooldridge’s statements and conclusions regarding  
15 recommended capital structure are set out in pp. 12-14 of his direct testimony filed in  
16 this proceeding.

17 Q. WHAT CAPITAL STRUCTURE IS PROPOSED BY DR. WOOLRIDGE?

18 A. Dr. Woolridge recommends a ratemaking capital structure of 2.86% short-term debt,  
19 50.36% long-term debt and 46.78% common equity. (Woolridge Exhibit JRW-3) In

1 contrast, the Company has proposed a projected capital structure of 51.85% long-term  
2 debt, 48.15% common equity and no short-term debt.

3 **Q. IS THE CAPITAL STRUCTURE PROPOSED BY THE ATTORNEY**  
4 **GENERAL APPROPRIATE?**

5 A. No, for several reasons. The capital structure proposed by Dr. Woolridge is based  
6 upon selected historic quarterly averages and includes a component for short-term  
7 debt. Moreover, Dr. Woolridge's proposed capital structure is not based upon the  
8 capital needs of the Company.

9 **Q. PLEASE EXPLAIN WHY THE USE OF HISTORIC QUARTERLY CAPITAL**  
10 **STRUCTURE AVERAGES IS NOT APPROPRIATE?**

11 A. The primary reason is because this rate case uses a forecasted period and a 13-month  
12 average capital structure for the period ending June 30, 2008. The use of historical  
13 averages for capital structure in a forecasted case is of limited relevance because the  
14 focus should be upon the Company's ability to forecast its capital requirements rather  
15 than comparing a forecasted capital structure to historic quarterly averages.  
16 Furthermore, when setting rates for a forecasted test period, the most current  
17 information should be used to properly match rates with the Company's cost-of-  
18 service. These precepts have been previously enunciated by the Kentucky Public  
19 Service Commission ("KPSC") in rate proceedings of Kentucky-American Water  
20 Company (Case No. 2004-00103).

21 **Q. DOES THE CAPITAL STRUCTURE PROPOSED BY DR. WOOLRIDGE**  
22 **COMPORT WITH KPSC PRECEDENT?**

23 A. No. Additionally, the KPSC has previously stated that rate setting in a forecasted  
24 case should be based upon the most current information, including changes to capital  
25 structure that have occurred since the filing of the rate application (Kentucky-  
26 American Water Company Case No. 2000-120).

27 **Q. DOES DR. WOOLRIDGE'S TESTIMONY ACCOUNT FOR CHANGES TO**  
28 **THE COMPANY'S CAPITAL STRUCTURE SINCE THE FILING OF THE**  
29 **RATE APPLICATION IN DECEMBER 2006?**

1 A. No. As described more particularly in my direct testimony previously filed herein,  
2 the Company, pursuant to an equity offering made in December 2006, substantially  
3 reduced the level of its then outstanding short-term debt. Since the filing of its rate  
4 application, and as reported by the Company in its Form 10-Q filed with the  
5 Securities and Exchange Commission for the fiscal quarter ended March 31, 2007, the  
6 Company has reduced its level of short-term debt to zero.

7 **Q. WHY IS THIS SIGNIFICANT?**

8 A. As I explained in my direct testimony, the Company's prior elevated levels of short-  
9 term debt were primarily attributable to the unprecedented spike in natural gas prices  
10 in late 2005 combined with much warmer than normal winter weather during the  
11 2005-2006 heating season. Even though the 2004-2005 winter heating season was  
12 also much warmer than normal, the Company's short-term debt levels returned to  
13 zero as usual in the spring and summer of 2005; interestingly, Dr. Woolridge ignores  
14 this and chooses to focus solely on 2006 short-term debt in his testimony. However,  
15 for the reasons I have just noted, the elevated levels of short-term debt in 2006 were  
16 not truly reflective of the Company's historical use of short-term debt to seasonally  
17 fund natural gas purchases, at which times short-term debt levels have typically fallen  
18 to zero once the heating season ends. The Company's reduction of its short-term debt  
19 level to zero as of March 31, 2007 is indicative of the Company's historical use of  
20 short-term debt.

21 **Q. WHY DOES DR. WOOLRIDGE INCLUDE A SHORT-TERM DEBT**  
22 **COMPONENT IN HIS PROPOSED CAPITAL STRUCTURE?**

23 A. Dr. Wooldridge states that the Company's purchased gas costs are included in its test  
24 period operating expenses and that the average gas stored underground balance is  
25 included in the test period rate base. Dr. Woolridge therefore concludes that a  
26 component of short-term debt should be included in the Company's capital structure  
27 for consistency purposes.

28 **Q. HAS THE COMPANY INCLUDED PURCHASED GAS COSTS IN ITS TEST**  
29 **PERIOD OPERATING EXPENSES?**

1 A. Not for purposes of Operating and Maintenance (O&M) expense. As the Company  
2 informed the Attorney General during discovery in its response to the Attorney  
3 General's data request No. 1-189, the Company recovers zero percent of its purchased  
4 gas costs in rates and instead recovers those costs through its gas cost adjustment  
5 rider. Purchased gas costs are included in the Company's *Summary of Utility*  
6 *Jurisdictional Adjustments to Operating Income by Major Accounts* as Filing  
7 Requirement 10(10)(b), but that is to properly account for and reflect total operating  
8 revenue, total plant revenue and net operating income which do factor into calculating  
9 other rate items (such as the KPSC assessment), and not as a component of O&M  
10 expense that is used for purposes of setting rates for the Company. The Company is  
11 unaware of any major gas utility in Kentucky that does not use a gas cost adjustment  
12 rider to recover its purchased gas costs.

13 **Q. DO YOU AGREE WITH DR. WOOLRIDGE'S CONCLUSION THAT THE**  
14 **COMPANY'S USE OF SHORT-TERM DEBT TO FUND GAS STORED**  
15 **UNDERGROUND JUSTIFIES THE INCLUSION OF A COMPONENT OF**  
16 **SHORT-TERM DEBT IN THE CAPITAL STRUCTURE?**

17 A. No. During discovery, the Company advised the Attorney General that the Company  
18 uses cash from all sources, including short-term debt, to fund its natural gas purchases  
19 (Response to AG Data Request No. 1-5). This response, however, does not  
20 automatically presume that the Company borrows short-term funds every time its  
21 pays for storage gas. Such payments could just as well come from cash flow from  
22 operations, which is the Company's typical first source of funding in order to avoid  
23 incurring borrowing costs. If payment from cash flow from operations is not  
24 practicable at the time, then such purchases may be funded through short-term  
25 borrowings.

26 Even assuming, however, that the KPSC were to accept Dr. Woolridge's rationale  
27 concerning storage gas, the level he has proposed for short-term debt does not  
28 correspond to the Company's projected rate base level of storage gas as of June 30,  
29 2008. In Filing Requirement 10(8)(f) sponsored by Company witness Mr. Thomas  
30 Petersen, the Company's projected level of rate base storage gas at June 30, 2008 is

1 approximately \$23.6 million. This is drastically less than the level of approximately  
2 \$124 million in short-term debt that Dr. Wooldridge proposes to be included in the  
3 Company's capital structure. If inclusion of storage gas in rate base justifies  
4 inclusion of a component of short-term debt in capital structure, then the Company's  
5 adjusted capital structure would appear as follows (in thousands):

<u>L-T Debt</u>	<u>S-T Debt</u>	<u>Total Debt</u>	<u>Shareholder Equity</u>	<u>Total</u>
\$2,183,548	\$23,598	\$2,207,146	\$2,006,916	\$4,214,062
51.85%	0.005%	51.8505%	48.1495%	100.0%

9 As shown above, there is no noticeable change in the Company's projected capital  
10 structure of 51.85% long-term debt and 48.15% common equity.

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

12 A. Yes.

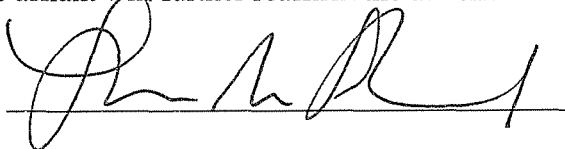
COMMONWEALTH OF KENTUCKY  
BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF )  
RATE APPLICATION OF ) Case No. 2006-00464  
ATMOS ENERGY CORPORATION )

CERTIFICATE AND AFFIDAVIT

The Affiant, Laurie M. Sherwood, being duly sworn, deposes and states that the prepared testimony attached hereto and made a part hereof, constitutes the prepared rebuttal testimony of this affiant in Case No. 2006-00464, in the Matter of the Rate Application of Atmos Energy Corporation, and that if asked the questions propounded therein, this affiant would make the answers set forth in the attached prepared direct pre-filed testimony.

Affiant further states that she will be present and available for cross examination and for such additional direct examination as may be appropriate at any hearing in Case No. 2006-00464 scheduled by the Commission, at which time affiant will further reaffirm the attached testimony as her direct testimony in such case.

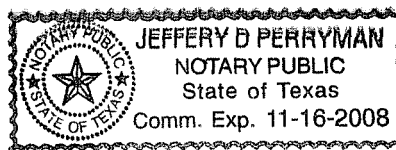


STATE OF Texas  
COUNTY OF Dallas

SUBSCRIBED AND SWORN to before me by Laurie M. Sherwood on this the \_\_\_\_ day of June, 2007.



Notary Public  
My Commission Expires: \_\_\_\_\_







**BEFORE THE PUBLIC SERVICE COMMISSION**

**COMMONWEALTH OF KENTUCKY**

**IN THE MATTER OF**

)

**RATE APPLICATION BY**

)

**Case No. 2006-00464**

)

**ATMOS ENERGY CORPORATION**

)

)

**REBUTTAL TESTIMONY OF GREGORY K. WALLER**

1 **Q. PLEASE STATE YOUR NAME, JOB TITLE AND BUSINESS ADDRESS.**

2 A. My name is Gregory K. Waller. I am Vice President of Finance for the Kentucky/Mid-  
3 States Division of Atmos Energy Corporation (“Atmos” or the “Company”). My  
4 business address is 810 Crescent Centre Drive, Suite 600, Franklin, TN 37067.

5

6 **Q. HAVE YOU PREVIOUSLY FILED TESTIMONY IN THIS CASE?**

7 A. Yes, I filed direct testimony on December 28, 2006.

8

9 **Q. WHAT IS THE SCOPE OF YOUR REBUTTAL TESTIMONY?**

10 A. My testimony addresses Mr. Henkes’ testimony related to ad valorem taxes, public and  
11 community relations expenses and certain miscellaneous expenses.

12

13 **Q. DO YOU AGREE WITH THE TREATMENT OF AD VALOREM TAXES IN**  
14 **THE TESTIMONY OF MR. HENKES?**

15 A. Yes. His analysis is based on the Company’s response to KPSC DR 3- 8 and continues  
16 to be the most current reasonable estimate for the Company’s 2006 Kentucky ad  
17 valorem tax assessment. That estimate is \$2,632,247 for 2006. Mr. Henkes applied the  
18 Company’s methodology for forecasting the appropriate amount for the forecasted test  
19 period of \$2,684,892 which is \$1,406,756 lower than the amount in the Company’s  
20 original filing.

21

1 **Q. DID THE COMPANY INCUR ADDITIONAL EXPENSES TO ACHIEVE THE**  
2 **SAVINGS DOCUMENTED ABOVE?**

3 A. Yes. To achieve these results, the Company hired an outside consultant to assist in the  
4 formal protest of the original property valuation and resulting assessment. A change in  
5 the appeal process has moved responsibility for formal protests from the Department of  
6 Property Tax Valuation to the Protest Resolution Group. Due to this change in process,  
7 the Company anticipates the annual need for an outside consultant to assist in formal  
8 protests, whereas negotiations could be handled more informally in the past. In  
9 appealing the 2006 assessment, the company will incur expenses of \$70,000 in outside  
10 services (payable once final resolution is reached). These expenses directly benefited  
11 ratepayers as they were instrumental in lowering the recoverable property tax  
12 assessment by over \$1.4 million. Thus, the Company's Outside Services expense  
13 category (a component of O&M) should be increased by \$70,000 in the forecasted test  
14 period.

15  
16 **Q. DO YOU AGREE WITH HENKES' ADJUSTMENT FOR PUBLIC AND**  
17 **COMMUNITY RELATIONS EXPENSES?**

18 A. No. Mr. Henkes has removed the sum of \$178,809 related to public and community  
19 relations. In response to KPSC DR 6 and Atmos DR 6, Mr. Henkes agrees that every  
20 example given by the company in response to AG DR 2-32(b) (with one exception)  
21 should be recoverable in rates. Because rates will be set using a forecasted test year in  
22 this case, it is impossible to quantify specific examples of expenses that, by definition,  
23 will occur in the future. Based on our list of historical examples and Mr. Henkes'  
24 response to above referenced data requests, the Company believes that 90% of the  
25 \$178,809 of expenses in question should be recoverable. This changes Henkes'  
26 expense adjustment from \$178,809 to \$17,881 and his adjustment to after tax operating  
27 income from \$109,252 to \$10,925.

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**Q. DO YOU AGREE WITH MR. HENKES' MISCELLANEOUS EXPENSE ADJUSTMENTS?**

A. No. Mr. Henkes has excluded the sum of \$64,769 for gas supply services and \$5,344 for donations. During the course of discovery, the Company clarified in response to the Attorney General's Data Request No. 1-48 that the gas supply services costs are now allocated to Kentucky as part of the Company's shared services costs instead of part of Kentucky's direct O&M expense, and that the Company's fiscal year 2007 budgeting process reflected this change. Also in discovery, the Company clarified in response to the Attorney General's Data Request No. 1-49 that donations are below the line and were excluded in the Company's fiscal year 2007 budgeting process. The gas supply services cost have not been included twice and the donations costs have already been removed by the Company. Mr. Henkes apparently misunderstood and has improperly removed the gas supply services costs altogether and the donation costs a second time.

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

A. Yes.

COMMONWEALTH OF KENTUCKY  
BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF )  
RATE APPLICATION OF ) Case No. 2006-00464  
ATMOS ENERGY CORPORATION )

CERTIFICATE AND AFFIDAVIT


The Affiant, Gregory K. Waller, being duly sworn, deposes and states that the prepared testimony attached hereto and made a part hereof, constitutes the prepared rebuttal testimony of this affiant in Case No. 2006-00464, in the Matter of the Rate Application of Atmos Energy Corporation, and that if asked the questions propounded therein, this affiant would make the answers set forth in the attached prepared direct pre-filed testimony.

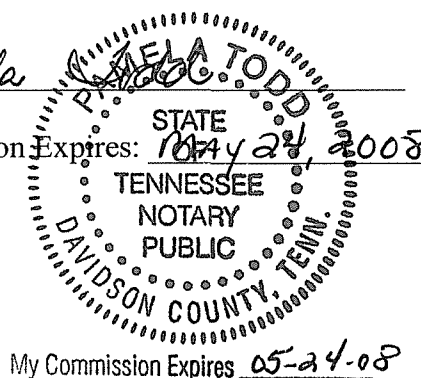
Affiant further states that he will be present and available for cross examination and for such additional direct examination as may be appropriate at any hearing in Case No. 2006-00464 scheduled by the Commission, at which time affiant will further reaffirm the attached testimony as his direct testimony in such case.

  
\_\_\_\_\_

STATE OF Tennessee  
COUNTY OF Williamson

SUBSCRIBED AND SWORN to before me by Gregory K. Waller on this the 13<sup>th</sup> day of June, 2007.

  
\_\_\_\_\_  
Notary Public  
My Commission Expires: May 24, 2008





**BEFORE THE PUBLIC SERVICE COMMISSION**

**COMMONWEALTH OF KENTUCKY**

**IN THE MATTER OF** )

**RATE APPLICATION BY** )

**Case No 2006-00464**

**ATMOS ENERGY CORPORATION** )

**REBUTTAL TESTIMONY OF DONALD S. ROFF**

1           **Q.   PLEASE STATE YOUR NAME, TITLE AND COMPANY.**

2

3           A.   My name is Donald S. Roff and I am President of Depreciation Specialty  
4           Resources (“DSR”).

5

6           **Q.   ARE YOU THE SAME DONALD S. ROFF WHO SUBMITTED**  
7           **DIRECT TESTIMONY IN THIS PROCEEDING?**

8

9           A.   Yes.

10

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

12

13          A.   The purpose of my testimony is to address the position taken by Attorney  
14          General witness Mr. Michael J. Majoros, Jr. My rebuttal testimony deals  
15          with the topics of net salvage (salvage less cost of removal) and  
16          depreciation rates.

17

18          **Q.   HAVE YOU PREPARED ANY EXHIBITS?**

19

20          A.   Yes. I have prepared Exhibit \_\_\_\_ (DSR-1R) which provides the  
21          development of the annual cost of removal accrual.

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**Q. PLEASE SUMMARIZE YOUR REBUTTAL TESTIMONY.**

A. Mr. Majoros was asked by the Attorney General to review the Company’s gas and shared services depreciation rates and proposals and to express an opinion regarding their reasonableness. He was further asked to make alternative recommendations if warranted. My rebuttal testimony will demonstrate that the Company’s depreciation proposals are reasonable and are predicated on sound analysis techniques and principles. I will further show that Mr. Majoros has made several incorrect and unsubstantiated statements, and therefore his recommendations must be rejected.

**Q. WHAT IS NET SALVAGE?**

A. Net salvage is the difference between gross salvage and cost of removal. When cost of removal exceeds gross salvage, the result is referred to as negative net salvage.

**Q. CAN YOU CITE ANY AUTHORITATIVE SOURCE THAT DESCRIBES HOW A NET SALVAGE ANALYSIS SHOULD BE CONDUCTED?**

A. Yes. One source is a text referred to by Mr. Majoros, the National Association of Regulatory Utility Commissioners (“NARUC”) publication: *Public Utility Depreciation Practices*. Mr. Majoros correctly points out that this text, which was originally published in 1968, was later updated in 1996. At page 18 of the 1996 edition, the following appears:  
“Net salvage is expressed as a percentage of plant retired by dividing the dollars of net salvage by the dollars of original cost of plant retired”.

My depreciation study was conducted using exactly this analysis process.



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**Q. WHAT IS THE ISSUE RAISED BY MR. MAJOROS?**

A. Essentially, Mr. Majoros is proposing to utilize a “cash basis” for the depreciation of cost of removal. His proposal is based on the annual average cost of removal expenditure for the past five years. He also claims to have corrected my interpretation of depreciable cushion gas. Finally, he spends a great deal of his testimony discussing topics unrelated to his conclusions and proposals.

**Q. DO YOU AGREE WITH MR. MAJOROS’ PROPOSALS?**

A. No. First and foremost, Atmos is required to practice accrual accounting.<sup>1</sup> The cash basis proposed by Mr. Majoros is not accrual accounting. Secondly, the cash basis results in serious intergenerational inequity. The proper allocation of the total cost of fixed assets (investment plus net salvage) should be assigned to the customers benefiting from the service of those assets and not delayed to burden future customers. The cash basis for cost of removal results in the last generation of customers providing the full cost of removal. Treating cost of removal differently from the investment is not only inconsistent, it is improper and unfair. This topic will be expanded further later in my rebuttal testimony. With respect to the issue of recoverable cushion gas, Atmos revised its estimate of the balance in that account during discovery. I agree with Mr. Majoros’ determination of that balance as revised by Atmos.

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<sup>1</sup> Federal Energy Regulatory Commission Uniform System of Accounts, CFR 18, Part 201, General Instruction 11. *Accounting to be on accrual basis.* A. The utility is required to keep its accounts on the accrual basis. This requires the inclusion in its accounts of all known transactions of appreciable amount which affect the accounts. If bills covering such transactions have not been received or rendered, the amounts shall be estimated and appropriate adjustments made when the bills are received.

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**Q. HOW DOES THE CASH BASIS CREATE INTERGENERATIONAL INEQUITIES?**

A. Quite simply, the cash basis creates intergenerational inequities by charging the wrong generation of customers for cost of removal. Consider a small building installed in 1962 for \$250,000. In 2007, the Company retires and demolishes the building for a cost of \$50,000. Under the cash basis proposed by Mr. Majoros, the only customers who are charged for the \$50,000 cost of removal are those on the system in 2007. Every generation of customers between 1962 and 2006 are charged nothing. Clearly, this is inequitable. The accrual accounting approach that I have utilized would allocate the entire cost of this asset (\$250,000 + \$50,000) over the 45 year life of the building, thus correctly charging each and every generation of customers its fair share of depreciation expense.

**Q. AT PAGE 7, LINE 3 OF HIS TESTIMONY, MR. MAJOROS STATES: “THE COMMISSION SHOULD DISALLOW ATMOS’S INCLUSION OF EXCESSIVE COST OF REMOVAL IN ITS DEPRECIATION EXPENSE. ATMOS’S PROPOSED GAS DEPRECIATION RATES RESULT IN THE COLLECTION OF \$2.2 MILLION ANNUALLY FOR COST OF REMOVAL EVEN THOUGH IT IS ONLY INCURRING \$975 THOUSAND OF ACTUAL COST OF REMOVAL ON AVERAGE.” DO YOU AGREE WITH HIS RECOMMENDATION?**

A. No. It is unclear what Atmos is actually collecting for cost of removal. Mr. Majoros admits in the response to Atmos Data request Question No. 26 that he “has not conducted any studies comparing the Company’s charges to depreciation expense to any specific recoveries for depreciation expense.” It is true that the proposed depreciation rates will result in the recording of \$2.2 million annually of depreciation expense related to cost

1 of removal. This is entirely different from the cost of removal Atmos  
2 incurs.

3  
4 **Q. PLEASE EXPLAIN.**

5  
6 A. Under accrual accounting, an allocation of cost is made recognizing the  
7 components of depreciation expense, including cost of removal, over the  
8 entire life of the associated assets. In this case, that cost of removal  
9 component of depreciation expense of \$2.2 million is the annual accrual  
10 which relates to the entire Atmos asset base which will, over time, be  
11 retired. The \$975 thousand of cost of removal incurred on an annual basis  
12 relates only to **those assets retired in one year**, which amounts to only a  
13 fraction of the entire Atmos asset base. On average, the annual  
14 retirements total \$4.26 million.<sup>2</sup> So the comparison made by Mr. Majoros,  
15 while reflecting the correct dollar amounts for unrelated items, is  
16 comparing an amount for one year to an amount for the total life of long  
17 lived assets which provides an “apples to oranges” comparison.

18  
19 **Q. CAN YOU PROVIDE A MORE APPROPRIATE COMPARISON?**

20  
21 A. Yes. Exhibit \_\_\_ (DSR-1R) has been prepared to show the development  
22 of the annual cost of removal accrual. Exhibit \_\_\_ (DSR-1R) provides a  
23 table of only those accounts for which a cost of removal allowance is  
24 recommended. This Exhibit shows that, based upon recent experience, the  
25 total cost of removal for Atmos’ assets in service at the time of the study  
26 would be \$95.4 million and the annual component of this total is roughly  
27 \$2.2 million. Thus the fact that Atmos only incurs \$975 thousand  
28 annually is somewhat irrelevant, as it does not account for the accrual of  
29 amounts to be incurred for cost of removal over the life of the assets as is

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<sup>2</sup> Majoros Exhibit MJM-3, Page 4.

1 required by regulatory GAAP. The testimony of Mr. Majoros is  
2 misleading.

3  
4 **Q. ARE THERE OTHER PARTS OF MR. MAJOROS' TESIMONY**  
5 **WITH WHICH YOU DISAGREE?**

6  
7 A. Yes. For example, at page 6, lines 15 through 17 Mr. Majoros asserts that  
8 he disagrees “with charging ratepayers for estimated future cost of  
9 removal, unless the utility has a legal obligation to incur those costs.”  
10 Clearly, Atmos is entitled to the recovery of legitimate and reasonable  
11 costs, including cost of removal. Further, Mr. Majoros was asked in  
12 discovery<sup>3</sup> to provide specific references to SFAS No. 143 and FERC  
13 Order No. 631 wherein excess collections of cost of removal are  
14 addressed. His response referred to paragraphs B22 and B73 of SFAS No.  
15 143 and is implied by reading paragraphs 33 and 36 of Order No. 631.  
16 My reading of SFAS No. 143, paragraph B22 indicates that an asset  
17 retirement obligation must be offset by increasing the carrying amount of  
18 the asset. There is absolutely no reference to “excess collections”.  
19 Similarly, paragraph B73 provides an excellent description of the  
20 objective of depreciation accounting, that being “to allocate costs to  
21 customers over the lives of the assets”. Nowhere is the term “excess  
22 collections” addressed.  
23 With respect to Order No. 631, paragraph 33 merely states that “The  
24 Commission did not propose to change its accounting under Parts 101, 201  
25 and 352 for the cost of removal for amounts that result from other than  
26 asset retirement obligations”. In effect, this paragraph did not change  
27 depreciation accounting for cost of removal. Again, there is no reference  
28 whatsoever to “excess collections”. In the same way, paragraph 36  
29 reaffirms traditional accounting. The interpretation expressed by Mr.  
30 Majoros is completely incorrect.

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<sup>3</sup> Response to Atmos Request for Information, Question 29.

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**Q. MR. MAJOROS ASSERTS AT PAGE 6, LINE 19 THAT “CHARGES TO TODAY’S RATEPAYERS SHOULD NOT INCLUDE FUTURE INFLATION OUT FOR THIRTY TO FORTY YEARS”. DID YOUR STUDY DEVELOP NET SALVAGE FACTORS PROJECTING INFLATION OUT FOR THIRTY TO FORTY YEARS?**

A. No. My recommended net salvage factors were developed on the basis of history (specifically recent history) and conducted under the analysis process described previously in my rebuttal testimony. When asked to provide specific information or calculations demonstrating such projection, Mr. Majoros could only respond that “this is a generalization based upon Mr. Roff’s proposed lives”.<sup>4</sup> His claims must be dismissed.

**Q. AT PAGE 7, LINE 7 OF HIS TESTIMONY, MR. MAJOROS ASSERTS THAT “THE COMPANY HAD ALREADY COLLECTED \$23.9 MILLION OVER AND ABOVE WHAT IT HAS ACTUALLY SPENT FOR GAS AND COMMON PLANT COST OF REMOVAL”. IS THIS AN ACCURATE STATEMENT?**

A. It is true that the Company reported a regulatory liability of \$23.9 million which represents the reclassification of accumulated cost of removal recorded in the accumulated depreciation balance. It is untrue that the Company has collected more in cost of removal than it has spent. Mr. Majoros admits in his response to Company data request No. 26 that he “has not conducted any studies comparing the Company’s charges to depreciation expense to any specific recoveries for depreciation expense”. Nor could he, as revenues on are not segregated on that basis. Atmos has collected precisely what it has been allowed by regulators, but there is no

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<sup>4</sup> Ibid, Question 24.

1 way to determine what specific recoveries relate to cost of removal. This  
2 assertion is unfounded and unsupported.

3  
4 **Q. MR. MAJOROS STATES AT PAGE 10, LINE 14 OF HIS**  
5 **TESTIMONY THAT “I DO NOT OBJECT TO INCLUDING**  
6 **FUTURE COST OF REMOVAL ESTIMATES IN DEPRECIATION**  
7 **RATES AS LONG AS THE RESULTING CHARGES ARE JUST**  
8 **AND REASONABLE AND REFLECT CURRENT ACTIVITY”?**  
9 **WAS YOUR ANALYSIS OF COST OF REMOVAL BASED UPON**  
10 **CURRENT ACTIVITY?**

11  
12 A. Yes. My analysis reflected historical experience from the years 1996  
13 through 2005. This was the most recent current activity available at the  
14 time of the study. Further, nowhere in his testimony does Mr. Majoros  
15 assert that my proposed depreciation rates produce a level of charges that  
16 is not just and reasonable. In fact, the proposed composite depreciation  
17 rate is within four basis points of the existing approved depreciation rate.  
18 By any standard, that recommendation would seem to be reasonable.

19  
20 **Q. AT PAGE 15, LINES 19 AND 20 OF HIS TESTIMONY, MR.**  
21 **MAJOROS CLAIMS THAT “ATMOS’S NET SALVAGE STUDIES**  
22 **RELATE REMOVAL COSTS IN CURRENT DOLLARS TO ASSET**  
23 **RETIREMENTS EXPRESSED IN VERY OLD HISTORICAL**  
24 **ORIGINAL COST DOLLARS”. DO YOU AGREE WITH HIS**  
25 **CLAIM?**

26  
27 A. No. It is one thing to make such a statement and it is quite another to  
28 provide documentation of such a statement. There is no place in his  
29 testimony or workpapers where Mr. Majoros definitively quantifies and  
30 verifies this statement. In fact, in response to Commission Request No.  
31 12, Mr. Majoros states: “because the minimum amount of missing

1 statistics is the average age of the retirements included in the net salvage  
2 data. This is not available, and since Mr. Roff relied solely upon SPR to  
3 study lives, it appears the Company does not maintain the data necessary  
4 to conduct the requested analysis.” Such an analysis can be made, and my  
5 calculations show that the projected age of retirements for Mains and  
6 Services for the year 2006 is approximately 21 years, making the average  
7 vintage year 1985. This is not the very old historical original cost dollars  
8 claimed by Mr. Majoros.

9  
10 **Q. MR. MAJOROS, AT PAGES 17 AND 18 OF HIS TESTIMONY**  
11 **SEEMS QUITE TROUBLED REGARDING A QUOTATION THAT**  
12 **YOU REFERRED TO IN YOUR TESTIMONY. HE GOES ON TO**  
13 **ASSERT THAT GAAP DEPRECIATION RATES HAVE NEVER**  
14 **ALLOWED COST OF REMOVAL FACTORS. DO YOU AGREE?**

15  
16 **A.** Despite his assertions, there was no intent on my part to favor one  
17 edition’s quotation over the other. The more important point is his  
18 erroneous statement that GAAP depreciation rates have never allowed cost  
19 of removal factors. This is absolutely incorrect, as utilities have been  
20 applying depreciation rates including cost of removal factors for decades.  
21 I could find no reference in GAAP precluding such depreciation treatment.  
22 Certainly SFAS No. 71 (*Accounting for the Effects of Certain Types of*  
23 *Regulation*), a portion of GAAP, would permit these depreciation rates if  
24 approved by regulators. Mr. Majoros is simply wrong.

25  
26 **Q. MR. MAJOROS ASSERTS, AT PAGE 20, LINE 14 OF HIS**  
27 **TESTIMONY THAT “ATMOS DOES NOT HAVE ANY**  
28 **PROBABLE OBLIGATION TO MAKE THESE EXPENDITURES”**  
29 **(COST OF REMOVAL). IS THIS A CORRECT STATMENT?**

30

1 A. No. In response to AG DR 1-171, the following was stated: “The  
2 Company will continue to remove assets that need to be removed in the  
3 course of providing gas utility service”. Not only is such activity  
4 probable, it is a virtual certainty. Mr. Majoros has tried to alter the  
5 accounting guidance to fit his needs. There is no support for his  
6 assertions.

7

8 **Q. PLEASE SUMMARIZE YOUR TESTIMONY.**

9

10 A. Mr. Majoros’ cash basis treatment of cost of removal, which, in addition  
11 to being contrary to regulatory accounting requirements, is unfair to both  
12 Atmos and its customers. It results in artificially lowering depreciation  
13 expense and creates intergenerational inequity. His testimony contains  
14 many erroneous or unsubstantiated statements and therefore should be  
15 rejected by this Commission. My depreciation studies produce a fair  
16 and reasonable level of depreciation expense were conducted using sound  
17 analytical principles and should be adopted in this proceeding.

18

19 **Q. DOES THIS COMPLETE YOUR REBUTTAL TESTIMONY?**

20

21 A. Yes.

22

23

24

25

26



ATMOS ENERGY CORPORATION - KENTUCKY      **EXHIBIT \_\_\_ DSR-1R**  
DEVELOPMENT OF ANNUAL COST OF REMOVAL ACCRUAL

[1] Account Number	[2] Description	[3] 12/31/2005 Balance	[4] Cost of Removal %	[5] Cost of Removal \$	[6] ASL yrs	[7] Annual Amount \$
336.0	Purification Equipment	44,369	5.0	2,218	50.0	44
352.0	Well Construction & Equipment	2,176,341	40.0	870,536	50.0	17,411
367.0	Transm - Mains	22,044,698	25.0	5,511,175	55.0	100,203
369.0	Transm - M & R Equipment	288,851	2.0	5,777	45.0	128
375.0	Distr - Structures	468,328	10.0	46,833	50.0	937
376.0	Distr - Mains	95,924,845	25.0	23,981,211	55.0	436,022
378.0	Distr - M & R Equipment	2,617,970	5.0	130,899	50.0	2,618
379.0	City Gate Equipment	2,804,310	15.0	420,647	50.0	8,413
380.0	Services	69,190,312	75.0	51,892,734	40.0	1,297,318
381.0	Meters	13,775,723	25.0	3,443,931	25.0	137,757
382.0	Meter Installations	33,358,910	25.0	8,339,728	40.0	208,493
385.0	Industrial M & R Equipment	4,433,322	17.0	753,665	40.0	18,842
		<u>247,127,979</u>	<u>38.6</u>	<u>95,399,352</u>		<u>2,228,187</u>

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF )  
RATE APPLICATION OF ) Case No. 2006-00464  
ATMOS ENERGY CORPORATION )

CERTIFICATE AND AFFIDAVIT

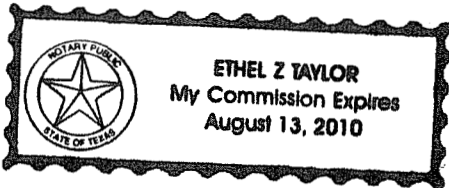
The Affiant, Donald S. Roff, being duly sworn, deposes and states that the prepared testimony attached hereto and made a part hereof, constitutes the prepared rebuttal testimony of this affiant in Case No. 2006-00464, in the Matter of the Rate Application of Atmos Energy Corporation, and that if asked the questions propounded therein, this affiant would make the answers set forth in the attached prepared direct pre-filed testimony.

Affiant further states that he will be present and available for cross examination and for such additional direct examination as may be appropriate at any hearing in Case No. 2006-00464 scheduled by the Commission, at which time affiant will further reaffirm the attached testimony as his direct testimony in such case.

Donald S. Roff

STATE OF TEXAS  
COUNTY OF DALLAS

SUBSCRIBED AND SWORN to before me by Donald S. Roff on this the 14th day of June, 2007.



Ethel Z. Taylor  
Notary Public  
My Commission Expires: August 13, 2010



**BEFORE THE PUBLIC SERVICE COMMISSION  
COMMONWEALTH OF KENTUCKY**

**IN THE MATTER OF:** )  
 )  
**RATE APPLICATION BY** ) **Case No. 2006-00464**  
 )  
**ATMOS ENERGY CORPORATION** )

**REBUTTAL TESTIMONY OF GARY L. SMITH**

**I. INTRODUCTION**

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

A. My name is Gary L. Smith. I have served as Vice President – Marketing and Regulatory Affairs for Atmos Energy Corporation’s (the “Company”) Kentucky/Mid-States operations until only recently. Effective June 1, 2007, my position is Director of Customer Revenue Management. My current business address is 2401 New Hartford Road, Owensboro, Kentucky 42303.

**Q. DID YOU PREVIOUSLY FILE TESTIMONY ON BEHALF OF THE COMPANY IN THIS RATE PROCEEDING?**

A. Yes. My direct testimony was filed at the time of and in connection with the Company’s rate application.

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

A. My rebuttal testimony addresses certain statements made and conclusions reached by Mr. Robert J. Henkes and Mr. Charles W. King, witnesses for the Commonwealth of Kentucky’s Office of the Attorney General, regarding the Company’s proposed Customer Rate Stabilization (CRS) mechanism and other rate design matters.

1 **II. CUSTOMER RATE STABILIZATION MECHANISM**

2  
3 **Q. PLEASE BRIEFLY DESCRIBE THE RECOMMENDATIONS OF MR.**  
4 **HENKES AND MR. KING REGARDING THE COMPANY’S PROPOSED**  
5 **CRS MECHANISM.**

6 A. In their respective testimonies dated April 27, 2007, both Mr. Henkes and Mr.  
7 King recommend that the proposed CRS mechanism be rejected by the Kentucky  
8 Public Service Commission. Mr. Henkes believes the CRS should be denied due  
9 to its departure from “traditional” ratemaking, concerns that the mechanism  
10 reduces the incentives for the Company to manage its business in an efficient  
11 manner, and his belief that the mechanism shifts virtually all risks from  
12 stockholders to the ratepayers. Similarly, Mr. King suggests denial of CRS as the  
13 mechanism, in his opinion, is not justified, removes incentives for Atmos Energy  
14 to control its costs, and is not necessary due to other existing “risk-reducing” rate  
15 mechanisms.

16 **Q. IS THE CRS A DEPARTURE FROM “TRADITIONAL” RATEMAKING?**  
17 **AND, IF SO, WHY IS THE CRS NECESSARY?**

18 A. Now common rate mechanisms, such as those addressing Gas Cost Adjustments  
19 and Weather Normalization Adjustments, were not always “traditional”  
20 ratemaking practices and were at one time “experimental”.

21 The CRS mechanism is the first proposed by Atmos Energy for its Kentucky  
22 operations, and therefore, may represent a departure from “traditional”  
23 ratemaking. However, revenue stabilization mechanisms are not unprecedented.  
24 Louisville Gas & Electric possessed an Earning Stabilization Clause in Kentucky,  
25 and Atmos Energy operates under revenue stabilization mechanisms in  
26 Mississippi and Louisiana, and similar mechanisms exist in 5 states for 11 gas  
27 utilities.

28 The Company has provided extensive evidence that its business has undergone  
29 profound changes in recent years, primarily due to unprecedented gas cost  
30 increases. These price increases have escalated customer declining gas usage  
31 trends and resulted in greater customer retention challenges. Mr. King

1 acknowledges that numerous changes have occurred in the industry over the past  
2 twenty years. Although Atmos Energy wishes to align interests of shareholders  
3 and customers, “traditional” ratemaking pits the Company’s recovery of the  
4 Company’s costs and investments performance at odds with customer  
5 conservation efforts. Thus, “traditional” ratemaking should be reassessed. The  
6 CRS proposal provides for a streamlined annual regulatory review of the  
7 Company’s earnings levels and provides the assurance, to customers and  
8 shareholders, that earnings are appropriate.

9 **Q. DO YOU BELIEVE THE CRS MECHANISM WILL REMOVE OR**  
10 **REDUCE THE INCENTIVES FOR THE COMPANY TO OPERATE**  
11 **EFFICIENTLY?**

12 A. That is certainly not the intention of the Company. Atmos Energy’s history of  
13 efficient operations is a legacy for which the Company is very proud. Based upon  
14 2006 data found on the Commission’s website, both Atmos Energy’s Net Utility  
15 Plant per customer and annual O&M expense per customer was lowest among the  
16 five major gas utilities in the state, and less than ½ the average of the other four  
17 utilities.

18 Although AG witness Henkes first claimed in testimony that the CRS would  
19 result in “bloated budgets with little prospect for management attention to cost  
20 containment”, he later clarified that he meant the “adoption of the CRS will  
21 remove or reduce the incentives for the Company to operate in the most efficient  
22 manner and at the lowest possible cost”. Mr. Henkes also acknowledges that  
23 “other than the expense items for which Mr. Henkes has recommended  
24 adjustments in this case, it is not Mr. Henkes’ position that Atmos’ proposed  
25 expense budget underlying the forecasted test period in this case is “larger than  
26 warranted for operating efficiently and at the lowest possible cost.” Interestingly,  
27 Mr. Henkes’ recommended expense adjustments are primarily due to a belief that  
28 certain expenses should not be recovered from customers; no adjustments were  
29 proposed due to the fact that expenses were “larger than warranted for operating  
30 efficiently and at the lowest possible cost”.

1 Mr. Henkes and Mr. King apparently believe that Atmos Energy can offset the  
2 affects of declining usage or inflation through limitless productivity and  
3 efficiency improvements. However, neither Mr. King nor Mr. Henkes offered  
4 tangible recommendations in that regard. Mr. Henkes points out that the  
5 Company managed through declining usage trends for the past seven years  
6 without seeking a rate increase; but, he fails to recognize that efficiencies were  
7 realized with Atmos Energy's corporate growth by a factor of more than three  
8 times during the period due to acquisitions. With more than 3 million customers  
9 at this time, such proportionate growth in the future is very unlikely.

10 The CRS mechanism proposed by the Company will provide specified schedules  
11 identifying and deducting expenses consistent with the Commission's Order in  
12 this Case to be non-recoverable from customers. Discovery by the Commission  
13 and AG regarding the expenses proposed for regulatory recovery is afforded by  
14 the CRS tariff proposal. Thus, in addition to the Company's ongoing  
15 commitment to management of expenses, increased regulatory review of Atmos  
16 Energy's costs and earnings levels will provide assurances that our rates are  
17 reasonable on an ongoing basis.

18 **Q. PLEASE ADDRESS MR. HENKES' BELIEF THAT THE CRS SHIFTS**  
19 **VIRTUALLY ALL RISKS FROM SHAREHOLDERS TO CUSTOMERS.**

20 A. Atmos Energy acknowledges that the CRS mechanism does better enable the  
21 Company to earn its authorized rate of return, and no more. CRS provides  
22 customers a greater assurance that their rates are appropriate on an ongoing basis.  
23 The CRS mechanism is designed to retain some of the features of a forward-  
24 looking test year, as utilized in this Case, and incorporates the true-up feature  
25 merely to ensure dependable forecasts. In the event forecasted billing  
26 determinants or costs vary from the actual results, the true-up feature will correct  
27 for those variances. Perhaps this combination of forward-looking and past review  
28 calculations leads to the unintended appearance that earnings levels are  
29 "guaranteed". We encourage the Commission to consider appropriate  
30 modifications to this mechanism to address any such concerns they may have, in

1 order to gain experience with a “non-traditional”, experimental model that can  
2 prove beneficial for all stakeholders.

3 **Q. PLEASE ADDRESS MR. KING’S STATEMENT THAT CRS IS NOT**  
4 **NECESSARY DUE TO OTHER, EXISTING “RISK-REDUCING” RATE**  
5 **MECHANISMS.**

6 A. The GCA, WNA, PBR, MLR, DSM and GTI mechanisms Mr. King refers to  
7 address discrete issues and achieve their intended purposes, but even in aggregate,  
8 do not address the comprehensive scope of the proposed CRS mechanism. For  
9 example, changes in residential and commercial customer usage, changes in non-  
10 gas O&M expenses and changes in rate base are not addressed in any of the cited  
11 mechanisms. The CRS will complement these existing mechanisms and serve its  
12 purpose as a comprehensive monitor of bottom-line earnings by the Company.

13 **III. RECOVERY OF BAD DEBT GAS COSTS THROUGH THE GAS COST**  
14 **ADJUSTMENT (GCA) MECHANISM**  
15

16 **Q. PLEASE EXPLAIN MR. HENKES’ RECOMMENDATION**  
17 **CONCERNING THE PROPOSAL TO RECOVER BAD DEBT GAS**  
18 **COSTS THROUGH THE GCA.**

19 A. Mr. Henkes does not agree with the Company’s proposed treatment of bad debt  
20 gas costs due, once again, to its departure from traditional ratemaking treatment.  
21 Also, Mr. Henkes does not believe “that the uncollectible expense at issue is  
22 sufficiently material to warrant inclusion in a tracker such as the GCA.”

23 **Q. DO YOU AGREE WITH MR. HENKES’ RECOMMENDATION?**

24 A. No. Mr. Henkes acknowledges that he has not directly participated in any rate  
25 cases dealing with either this proposal or a rate stabilization mechanism, as  
26 addressed previously in this Rebuttal Testimony. This absence of direct  
27 experience could explain his dismissal of both of these proposals on the basis of  
28 departing from “traditional” ratemaking practices. Atmos Energy already  
29 recovers bad debt gas costs through the GCA in four jurisdictions, so this manner  
30 of treatment is not uncommon.



1 In regard to Mr. Henkes' claim that the expense is not sufficiently material to  
2 warrant a tracker, it is noteworthy that only two of the 11 recommended  
3 adjustments to Atmos Energy's operating income summarized on Mr. Henkes'  
4 schedule RJH-5 are greater than, or more "material" than the \$815,000  
5 represented by bad debt gas costs.

6 Atmos Energy should be afforded recovery of prudently incurred gas costs.  
7 Under traditional ratemaking practices of recovering these costs through base  
8 rates, customers bear unnecessary risks that bad debt gas costs may be over-  
9 recovered by the Company. The proposed mechanism removes risk from both  
10 ratepayers and our shareholders. It is an appropriate treatment in today's more  
11 volatile gas supply pricing environment.

#### 12 IV. OTHER ISSUES

13  
14 **Q. ARE THERE OTHER POSITIONS OFFERED BY THE OFFICE OF THE**  
15 **ATTORNEY GENERAL YOU WISH TO ADDRESS AT THIS TIME?**

16 A. Yes, the proposal by Mr. Henkes to include the Late Payment Fee ratio in the  
17 derivation of the Gross Revenue Conversion Factor and Mr. King's suggested rate  
18 design with respect to fixed and variable billing components.

19 **Q. PLEASE EXPLAIN YOUR POSITION REGARDING THE INCLUSION**  
20 **OF LATE PAYMENT FEES IN THE GROSS REVENUE CONVERSION**  
21 **FACTOR.**

22 A. The company believes that the best approach to incorporating incremental Late  
23 Payment Fee revenues associated with the rate adjustment in this case is to  
24 include the 0.87% factor in the proof of revenues in the process of rate design,  
25 applicable only to the firm sales classes of Residential, Commercial and Public  
26 Authority. As noted in Mr. Henkes' response to PSC DR #1, there is no known  
27 precedent in Kentucky to include Late Payment Fees in the Gross Revenue  
28 Conversion Factor.

1 **Q. PLEASE EXPLAIN YOUR POSITION RELATING TO MR. KING'S**  
2 **SUGGESTED RATE DESIGN WITH RESPECT TO FIXED AND**  
3 **VARIABLE BILLING COMPONENTS.**

4 A. The Company believes that allocating a proportionately larger amount of the  
5 adjustment awarded by the Commission in this Case to the fixed customer charge  
6 improves the alignment of interests between customers and shareholders, and  
7 sends more accurate pricing signals to customers. Mr. King argues that “a rate  
8 design that concentrates pricing in the volumetric portion of the charge gives  
9 ratepayers choices as to how to control their costs” and “encourages  
10 conservation”. Clearly, although such an approach would magnify the consumer  
11 incentives to cut natural gas usage, it also does not afford the Company a  
12 reasonable opportunity to recover its costs; and provides a clear example of  
13 misalignment of interests between shareholders and customers. Atmos Energy’s  
14 current volumetric distribution rates represent only approximately 12% of the  
15 total volumetric rate for a firm sales customer. The predominant component of  
16 the customer’s volumetric rate is for the recovery of gas costs. Using the  
17 relatively small distribution component as an encouragement for customer  
18 conservation seems unrealistic and imbalanced.

19 **Q. DOES THIS CONCLUDE MATTERS YOU WISH TO ADDRESS IN**  
20 **REBUTTAL TESTIMONY AT THIS TIME?**

21 A. Yes.

22

COMMONWEALTH OF KENTUCKY  
BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF )  
RATE APPLICATION OF ) Case No. 2006-00464  
ATMOS ENERGY CORPORATION )

CERTIFICATE AND AFFIDAVIT

The Affiant, Gary L. Smith, being duly sworn, deposes and states that the prepared testimony attached hereto and made a part hereof, constitutes the prepared rebuttal testimony of this affiant in Case No. 2006-00464, in the Matter of the Rate Application of Atmos Energy Corporation, and that if asked the questions propounded therein, this affiant would make the answers set forth in the attached prepared direct pre-filed testimony.

Affiant further states that he will be present and available for cross examination and for such additional direct examination as may be appropriate at any hearing in Case No. 2006-00464 scheduled by the Commission, at which time affiant will further reaffirm the attached testimony as his direct testimony in such case.

Gary L. Smith

STATE OF Kentucky  
COUNTY OF Daviess

SUBSCRIBED AND SWORN to before me by Gary L. Smith on this the 14<sup>th</sup> day of June, 2007.

Jacqueline Sturck  
Notary Public  
My Commission Expires: 11/15/2007