COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:

Application of Atmos Energy Corporation for an Adjustment of Rates and Tariff Modifications	)))	Case No. 2013-0148

BRIEF OF ATMOS ENERGY CORPORATION

Submitted by:

Douglas Walther
Atmos Energy Corporation
P.0, Box 650205
Dallas. TX 75265
972-855-3102
Douglas.Walther@Atmosenergy.com

Mark R. Hutchinson
Wilson, Hutchinson, Poteat & Littlepage
611 Frederica St.
Owensboro, KY 42303
270 926 5011
Fax: 270-926-9394
Randy@whplawfirm.com

John R Hughes

John N. Hughes
124 West Todd Street
Frankfort, KY 40601
502 227 7270
Fax: none
jnhughes@fewpb.net

Attorneys for Atmos Energy Corporation

Certification:

I certify that is a true and accurate copy of the document to be filed in paper medium; that the electronic filing was transmitted to the Commission on February 25, 2014; that an original and one copy of the filing will be delivered to the Commission within two days; and that no party has been excused from participation by electronic means.

TABLE OF CONTENTS

	HISTORY OF THE CASE		p. 1
	SUMMARY OF ATMOS PROPOSED ADJUSTMENTS		p. 2
	LEGAL OVERVIEW		p. 3
	<u>ANALYSIS</u>		p. 6
I.	<u>Test Period</u>		p. 6
II.	<u>Rate Base</u>		
	• Test Year Rate Base		p. 5
	• Components of Rate Base		p. 6
	(1)	Net Utility Plan in Service	p. 7
	(2)	Construction Work in Progress	p. 7
	(3)	Cash Working Capital Allowance	p. 8
	(4)	Other Working Capital Allowances	p. 8
	(5)	Customer Advances for Construction	p. 8
	(6)	Deferred Income taxes	p. 8
	• Summary of Rate Base		p. 17
III.	<u>Revenue and Expenses</u>		
	A.	Introduction	p. 17
	B.	Background/Budgeting	p. 18
	C.	O & M Expenses	p. 22

1. Adjustment for Labor and Benefits p. 22

(i) Company's Pro Forma Adjustment p. 23

(ii) OAG's Proposed Adjustment #4 p. 24

2. Rent p. 26

3. Adjustments to "Other O & M" p. 26

(i) Company's Pro Forma Adjustment p. 26

(ii) OAG's Proposed Adjustment #2 p. 26

4. Bad Debt p. 28

(i) Company's Pro Forma Adjustment p. 28

(ii) OAG's Proposed Adjustment #8 p. 28

5. DGO & SSU Allocated Expenses p. 28

(i) Company's Pro Forma Adjustments p. 28

(ii) OAG's Proposed Adjustment #3 p. 32

6. Employee Incentive Compensation p. 33

7 CSS Costs p. 34

(i) Company's Pro Forma Adjustment p. 34

(ii) OAG's Adjustment #6 p. 35

D. REVENUES p. 38

E. Rate of Return p. 39

1. Capital Structure p. 39

2. Debt p. 39

3. Return on Equity p. 40

F. Special Contracts p. 44

G. Cost of Service p. 48

H. Depreciation p. 52

I. Other Tariff Matters p. 53

1. Margin Loss Rider p. 53

2. System Development Rider p. 53

3. NGV p. 54

4. Door Tag Fee p. 54

5. Transportation Minimum Threshold p. 54

6. Pipe Replacement Program (PRP) p. 55

7. Wireless Meter Reading (WMR) p. 56

8. Weather Normalization Adjustment (WNA) p. 59

IV. Summary of Mr. Ostranders Proposed Adjustments p. 60

A. BCO Adjustment #1. Remove Duplication Maintenance fees p. 61

B. BCO Adjustment #2: Remove 2.7% Inflation Factor p. 61

C. BCO Adjustment #3: Adjust DGO & SSU Allocated Expense p. 61

D. BCO Adjustment #4: Adjust Payroll Benefits p. 62

E. BCO Adjustment #5: Remove 50% Incentive Compensation p. 63

F. BCO Adjustment #6: Imputed CSS Cost Savings p. 63

G. BCO Adjustment #7: Remove NOLC p. 64

H. BCO Adjustment #8: Reduce Bad Debt Expense p. 65

CONCLUSION p. 66

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:

Application of Atmos Energy Corporation	)	
for an Adjustment of Rates	)	Case No. 2013-00148
and Tariff Modifications	)	

BRIEF OF ATMOS ENERGY CORPORATION

History of this Rate Case

On April 11, 2013, Atmos Energy Corporation ("Atmos" or "Company") filed with the Kentucky Public Service Commission ("Commission") a notice of its intent to file a general rate case ("Notice"). A copy of that Notice was also served on the Kentucky Attorney General's Office of Rate Intervention ("OAG"). On April 29, 2013, Atmos submitted written notice of its election to file the rate application electronically pursuant to 807 KAR 5:001(8).

On May 13, 2013, Atmos filed its application for an adjustment of rates and tariff modifications, effective June 13, 2013. By its letter dated May 28, 2013, the Commission notified Atmos of certain filing deficiencies. On June 26, 2013, the Commission Staff notified Atmos that its application met all minimum filing requirements.

On June 28, 2013, the Commission entered an Order, inter alia: (1) ordering that Atmos' application be deemed filed on June 24, 2013; (2) suspending Atmos' proposed rates for six (6) months, up to and including January 23, 2014; and, (3) adopting a procedural schedule for this proceeding.

On May 24, 2013, Stand Energy Corporation ("Stand") filed a Motion to Intervene. Atmos filed an Objection to Stand's Motion to Intervene on May 30, 2013. The Commission, on September 3, 2013, entered an Order granting Stand full intervention, but limited to participation on the issues of Atmos' transportation threshold levels and matters related thereto.

On July 2, 2013, the OAG filed its motion for full intervention, which was granted by the Commission's Order of September 11, 2013.

The Kentucky Industrial Utility Customers ("KIUC") initially filed a Petition to Intervene in this proceeding, but subsequently filed a Notice of Withdrawal of its Petition prior to the Commission's ruling.

Following extensive discovery by and among the Company, OAG and Commission Staff, a public hearing on Atmos' application for an adjustment of rates and modification to tariffs was held on January 23, 2014. By agreement of the OAG and Atmos, post hearing briefs were required to be filed with the Commission by February 25, 2014.

On January 22, 2014, Atmos gave notice of its intention to place the proposed rates into effect pursuant to KRS 278.190(2). On January 28, 2014, the Commission entered an order directing Atmos to maintain records to allow a refund resulting from any unapproved rates.

SUMMARY OF ATMOS PROPOSED ADJUSTMENTS AND OTHER RELIEF

(1) Atmos seeks Commission approval of an increase in annual revenue of $13,291,265, which reflects two adjustments acknowledged by Atmos to the original request of $13,367,575.[1] If approved, the new rates would increase revenues sufficient to provide an overall rate of return

[1] The Company originally sought an annual increase in revenue of $13,367,575. During discovery, the Company agreed with BCO Adjustment #2 (Remove duplicative CSS Maintenance Fees) of $51,262 and BCO Adjustment #8 (Reduce Bad Debt Expense) of $25,048. Both adjustments aggregate $76,310. This reduced the Company's original request of $13,367,575 to $13,291,265. *See* Rebuttal Testimony of Mark A. Martin (Martin Rebuttal) at p. 5, lines 3-5.

on rate base of 8.53% on the test year rate base of $252,914,292.[2] The actual increases by amount and percentage for each customer class are listed in FR16(4)(a)(b) and (c), Volume 3 of the Application. The average monthly charges for a residential customer increase $4.50.

(2) Atmos' application further requests the following:

(a) Permanent approval of the Company's Weather Normalization Adjustment (WNA)

(b) Establishment of a Margin Loss Rider (MLR) and a System Development Rider (SDR).

(c) Adjustment of the Company's General Firm Sales Service (Rate G-1) and Interruptible Sales Service (Rate G-2) to allow for Natural Gas Vehicle (NGV) Service.

(d) Establishment of a new service and corresponding charge for "Door Tags".

(e) Various miscellaneous tariff language revisions to incorporate changes to 807 KAR 5:006.

The relief requested in this proceeding is designed to maintain the general balance of fixed and variable elements in the distribution rates, reflect the underlying costs, characteristics of service, mitigate depletion of revenue caused by declining residential customer usage and capital investments in Kentucky.

LEGAL OVERVIEW

Under Kentucky law, the Company is entitled to receive "fair, just and reasonable rates"

[2] Direct Testimony of Gregory K. Waller (Waller Direct) at p.4, Lines 12-14.

for the services it provides.[3] There is no single prescribed method for establishing rates.[4] A utility's rates must, however, provide enough revenue to cover its operating expenses and the cost of capital.[5] As our own Kentucky high court has stated, when establishing rates, the Commission must insure the resulting rates will, inter alia, "...enable the utility to operate successfully, to maintain its financial integrity [and] to attract capital."[6]

In Kentucky, utilities have the option to file their rate cases using either:

(1) A twelve (12) month historic test period that may include adjustments for known and measurable changes; or

(2) A fully forecasted test period presented in the form of pro forma adjustments to the base period.[7]

In this case, as it has in its previous three (3) rate cases in Kentucky, Atmos elected to proceed with a fully forecasted test period because it believes this method presents a much more accurate portrayal of the Company's revenue requirement. Atmos' faith in the forecasted test period approach appears well placed, as borne out by the fact, that Atmos does not have a history of frequently seeking new rates.[8]

KRS 278.190(3) makes clear that "at any hearing involving the rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the utility . . . ." The utility must show by substantial evidence the reasonableness of its test-period expenses and any proposed adjustments

---

[3] KRS 278.030(1).
[4] *Kentucky Industrial Utility Customers, Inc. v. Kentucky Utilities Co.*, 983 S.W.2d 493 (Ky. 1998).
[5] *Federal Power Commission v. Hope Natural Gas Company*, 320 US 591 (1944).
[6] *Commonwealth ex rel Stephens v. South Central Bell Telephone Co.* 545 S.W.2d 927, 930-31 (Ky. 1976).
[7] 807 KAR 5:001(16)(6)(a).
[8] Atmos' three prior rate cases were filed in 1999, 2006, 2009.

to those expenses, as well as the methodology used to determine its revenue requirement.[9]

Atmos has provided detailed financial information which fully supports its request for rate relief in this proceeding. The written testimony, exhibits, data responses and hearing testimony more than meet the substantial evidence standard. As such, the Company believes the evidence is sufficiently probative to compel findings consistent with its stated facts.[10]

In contrast to the evidence provided by Atmos, the OAG has failed to provide credible evidence on the limited issues it has raised in this case. Its testimony generally consists of opinions of its two witnesses, with little legal or factual support. As this Commission has held, when opinions are unsupported by any "factual evidence", they must be rejected.[11]

It is the Commission that must determine the credibility of the witnesses and the weight to be given to their testimony.[12] The weight of evidence is gauged by the credibility of the witnesses.[13] Given the unsupported opinions and factual errors of the OAG's witnesses as explained throughout this Brief, the failure of Mr. Ostrander to review the case in accordance with Kentucky regulations , as well as Mr. Watkins repeated refusals to support his proposed adjustments with calculations requested by the Staff, his reliance on a cost study methodology never adopted by this Commission and his inability to justify his claims of unreasonableness of Atmos' special contracts, there can be little, if any, weight given to the testimony of the OAG's witnesses.

---

[9] *Alternative Rate Filing of Coolbrook Utility*, Case No. 2011-00433, Order of May 9, 2012.
[10] *Lee v. International Harverster Co.*, 373 S.W.2d 418 (Ky. 1963).
[11] Administrative Case No. 273, paragraph 8, Order of July 5, 1983.
[12] *Kentucky Power Company*, Ky. App., 605 S.W.2d 46, 50 (1980).
[13] *"An Adjustment of Rates of Union, Light and Power Company and Abandonment of Facilities,"* Case Nos. 8419 and 8373, Order dated May 25, 1982.

ANALYSIS

I. TEST PERIOD

Atmos' fully forecasted test period is the twelve month period ending November 30, 2014. The base period is the twelve month period ending July 30, 2013. At the time of filing, the base period consisted of seven (7) months of actuals and five (5) months of forecasted data.

II. RATE BASE

A. Introduction Atmos has calculated its test year rate base to be $252,914,292.[14] This was calculated by utilizing a thirteen month average for each component of rate base, with the limited exceptions discussed below. The OAG has proposed various adjustments to rate base. Each of those proposed adjustments are also addressed below.

The components of Atmos' rate base are:

1. Net plant in service
2. Construction work in progress (CWIP),
3. Cash working capital (calculated on the 1/8 operation and maintenance expense method)
4. Other Working Capital Allowances
    a. Materials and supplies
    b. Gas Inventory
    c. Prepayments
5. Customer Advances for Construction
6. Deferred income taxes.

B. COMPONENTS OF RATE BASE

[14] Waller Direct at p.5, Lines 4-5. *See also*, MFR 16(13)(b)(1) – (b)(6).

(1) Net Utility Plant In Service

Atmos' forecasted net utility plant in service for the test year (13 month average) is $287,487,464.[15] This was calculated by adding CWIP of $8,541,792 to gross utility plant in service of $445,835,433[16] less accumulated depreciation and amortization of $166,889,761.[17] To determine test period gross plant in service, the Company began with booked gross plant as of February 2013[18]. Budgeted or projected additions were added and projected retirements were deducted for the months of March 2013 through the end of the test period.[19]

To determine test period accumulated depreciation, the Company again began with booked accumulated depreciation as of February 2013.[20] Budgeted or projected depreciation expenses were added and projected retirements were deducted for the months of March 2013 through the end of the test period.[21]

(2) CWIP

Atmos has included $8,541,792 of CWIP in its test period rate base.[22] Company Witness Waller testified that he started with booked CWIP as of February, 2013 and deducted funds used during construction.[23] Mr. Waller concluded that February 2013 CWIP balances were reasonable estimates of future CWIP balances through November, 2014.[24] Accordingly, CWIP balances were forecasted to remain level through the test period.

---

[15] Minimum Filing Requirement (MFR) 16(13)(b)(1); Schedule B-1.
[16] MFR 16(13)(b)(1); Schedule B-1.
[17] MFR 16(13)(b)(1); Schedule B-1.
[18] Waller Direct at p.5, Lines 14-15.
[19] For detailed explanation of how the forecasted 13 month average for gross plant in service was determined, see Waller Direct at p. 5, lines 14-23 and p. 6, lines 1-5.
[20] For detailed explanation of how the forecasted 13 month average for gross plant in service was determined, see Waller Direct at p. 5, lines 14-23 and p. 6, lines 1-5.
[21] Waller Direct direct at p.6, Lines 9-12.
[22] MFR 16(13)(b)(1); Schedule B-1.
[23] Waller Direct at p.6, Lines 16-18.
[24] Waller Direct at p.6, Lines 18-21.

(3) Cash Working Capital Allowance

Atmos' forecasted test period for cash working capital allowance is $3,337,211[25] which was calculated using the 1/8 of O & M expense method.[26]

(4) Other Working Capital Allowances

In addition to Cash Working Capital, the Company's test year rate base also includes allowances based on 13 month averages for each of the following:

(a) Materials and Supplies - $58,851;

(b) Gas Stored Underground - $9,415,216;

(c) Prepayments - $1,254,362.

Accordingly, the Company's total cash and non-cash working capital allowances for the test period are $14,056,604.[27]

(5). Customer Advances for Construction

The Company's test year rate base includes a reduction to account for customer advances for construction in the sum of $2,745,576 .[28] This is based on the average of actuals included in the base period (July, 2012 to February, 2013).[29]

(6). Deferred Income Taxes and Investment Tax Credits

The Company's test year rate base includes an adjustment for net accumulated deferred income taxes and investment tax credits (collectively ADIT) in the amount of $45,893,236.[30] Embedded within the ADIT liability balance is an asset (partially offset to the liability balance) for

[25] *See* MFR 16(13)(b)(1); Schedule B-1F.
[26] Waller Direct at p.5, Lines 8-9.
[27] MFR 16(13)(b)(1), Schedule B.4F.
[28] MFR 16(13)(b)(1), Schedule B.1F.
[29] Waller Direct at p.8, Lines 3-8.
[30] MFR 16(13)(b)(1), Schedule B.1F.

Net Operating Loss Carry forward (NOLC) of $20,125,550.[31] Mr. Ostrander has suggested elimination of this asset from the Company's rate base, proposing a reduction in the amount of $22,221,329 from test period rate base.[32]

Before addressing the merits of Mr. Ostrander's NOLC adjustment, it should be noted that Mr. Ostrander's proposed dollar amount adjustment is incorrect. Mr. Ostrander proposed to remove $22,221,329 of NOLC from the ADIT rate base component, however, the correct amount of NOLC included in the test year is $20,125,550 .[33]

Based on questions from the OAG during the hearing, it was apparent that Mr. Ostrander did not believe Atmos had been responsive to his Request OAG 2-78(b) concerning Kentucky's portion of the NOLC.[34] Mr. Waller acknowledged that there was a typographical error in his response to OAG2-78(b) where he had erroneously referred to OAG DR1-47 when in fact he should have referred to Staff DR 1-47.[35] In OAG DR 2-78(b), the OAG requested the amount of NOLC included in the Company's ADIT balance, and at the hearing it became apparent it wanted the amount that was allocated to Kentucky (even though the data request did not specify this).[36] The OAG had been provided with the total company federal NOLC of $340,724,523 in response to OAG DR 2-78(a), as well as the Kentucky rate base allocation of 5.55% used throughout the case. At that point it was simply a matter of multiplying $340,724,523 by 5.55% to arrive at the

---

[31] For an explanation of the calculation of NOLC, *See* Case No. 2013-00148, *Atmos Responses to Data Requests from Hearing Held on January 23, 2014*, Hearing DR 1-08.

[32] Supplemental and Corrected Direct Testimony of Bion C. Ostrander (Ostrander Direct, Revised) p.52and Exhibit BCO-2, Schedule A-10.

[33] *See* Case No. 2013-00148, *Atmos Responses to Data Requests from Hearing Held on January 23, 2014*, Hearing DR 1-08.

[34] January 23, 2014 Hearing at VR 16:35-16:50.

[35] January 23, 2014 Hearing at VR at 16:42.

[36] January 23, 2014 Hearing at VR at 16:48.

Kentucky allocated portion of federal NOLC.[37] Mr. Ostrander had this information all along. Regardless of the reason, Mr. Ostrander was unable to determine the amount of NOLC allocated to Kentucky, resulting in a proposed adjustment that erroneously removed $22,221,329 of NOLC, rather than the correct amount allocated to Kentucky of $20,125,550.[38]

Regardless, removal of NOLC as a component of the Company's ADIT must be rejected on the merits for two reasons:

(1) Removal of the NOLC ADIT asset from the Company's rate base is not appropriate under general rate making principles; and,

(2) Removal of the NOLC ADIT asset from the Company's rate base would cause a violation of the Internal Revenue Code's normalization rules, thereby resulting in devastating tax consequences to the Company's customers and shareholders.

First, and most importantly, the Company believes inclusion of the NOLC ADIT asset is the appropriate adjustment to rate base based on sound ratemaking principles - a position which has been accepted by numerous commissions, including all other states in which Atmos operates.[39] This issue appears to be one of first impression for the Kentucky Public Service Commission.

A net operating loss arises when a company's tax deductions are large enough to cause the Company to report an operating loss for tax purposes. In such situations, no taxes are

[37] January 23, 2014 Hearing at VR at 16:47.

[38] *See* Case No. 2013-00148, *Atmos Responses to Data Requests from Hearing Held on January 23, 2014*, Hearing DR 1-08. Please note that $20,125,550 includes State NOLC.

[39] See e.g., *Kern River Gas Transmission Company,* FERC Docket No. RP04-274-000 (October 19, 2006); *Yankee Gas Services Company,* Conn. Docket No. 1 0-12-02REO 1, 2011 Conn. PUC Lexis 189 (September 28, *2011); Gulf States Utilities Co.,* Docket No. 8702, 17 Tex. P.u.e. Bull., 703 (P.U.e.Texas May 2, *1991); GUD No. 10170,* Statement of Intent Filed by Atmos Energy Corp., to Increase Gas Utility Rates Within the Unincorporated Areas Served by the Atmos Energy Corp., Mid-Tex Division, Final Order (Dec. 4, 2012) Available at http://www.rrc.state.tx.us/meetings/gspfd/10170-FinalOrder; *Commonwealth Edison Co.,* Docket No. 94-0065, 158 PUR4th 458 (Ill. *CC,* January 9, 1995)

payable in the current year.[40] Tax in future years will be affected by the unused deductions and are recorded as NOLC's. As explained by Company Witness Pace McDonald, a NOLC represents tax deductions that have not yet been used to offset tax.[41] To the extent these tax deductions are unused, the government has not yet extended an interest free loan to the Company and it has, therefore, not yet received the benefit of cost free capital. Therefore, the Company's rate base should not be reduced for the amount of cost free capital (ADIT) that it has not yet realized. In short, the very reason a utility is required to reduce its rate base by the amount of its ADIT does not exist to the extent it has a NOLC.

Conveniently, the OAG agrees that the Company's rate base is to be reduced by its ADIT liability balance. This balance arises when a company's tax filings reflect tax deductions in excess of its booked expenses.[42] Accelerated depreciation of plant investment is an example. These types of deductions reduce the Company's current tax liability and the Company is thereby able to retain cash that it would otherwise have paid to the government in taxes.[43] These tax savings represent, in effect, a cost free loan from the government. This represents a source of cost free capital and it has long been understood that no return should be allowed. The ADIT liability balance is therefore deducted from rate base reducing the revenue requirement.[44]

Mr. Ostrander bases his adjustment on his own interpretation of the Internal Revenue Code and the related Treasury Regulations. He claims that removal of the NOLC component from ADIT is not prohibited under the Internal Revenue Code, a position with which the Company strongly disagrees. Mr. Ostrander's testimony does not outline qualifications that

---

[40] *See* Rebuttal Testimony of Pace McDonald (McDonald Rebuttal) at p.5, lines 20-23 and at p.6 1-7.
[41] McDonald Rebuttal at p. 6, lines 3-4.
[42] McDonald Rebuttal at p.5, lines 9-23 and p.6, lines 1-7.
[43] McDonald Rebuttal at p.5, lines 9-23 and p.6, lines 1-7.
[44] McDonald Rebuttal at p.5, lines 9-23 and p.6, lines 1-7.

demonstrate either the experience or training to interpret the Internal Revenue Code. In fact, in the Potomac Electric case relied upon by Mr. Ostrander, where he personally testified concerning the NOLC and the tax normalization rules, the Maryland Public Service Commission found that neither Mr. Ostrander, nor the other witnesses in that case, were tax "experts."[45] Conversely, the Company has offered in Company Witness McDonald a tax expert that received a formal education specializing in tax and has practiced regulated utility tax for over 20 years.[46]

During his testimony, Mr. Ostrander misinterpreted the regulations numerous times. When asked whether the regulations prohibited the Company from projecting an NOLC, he responded that the Company was prohibited from projecting the NOLC by citing only the first sentence of Treas. Reg. §1.167(l)-(1)(h)(6)(ii).[47] While that first sentence does deal only with historical periods, a reading of the entirety of the section reveals that the regulation does allow projections for future periods and even hybrid methods that use historical and future periods.[48]

A second critical error is Mr. Ostrander's interpretation of Treas. Reg. §1.167(l)-(1)(h)(6)(i). After a reading of this section, Mr. Ostrander testified that a normalization method of accounting is only accomplished by the deduction of "credit" amounts from rate base. He repeatedly referenced "credits" and stated that only credits may be used to reduce rate base.[49] In fact, the regulation read by Mr. Ostrander makes no mention of credits and the word credit does not appear in the subparagraph at all. The subparagraph does however require a reduction to rate base for the amount of reserve of deferred taxes. The use of the word "reserve" in

---

[45] Order No. 85724 at p.28, filed July 12, 2013. Maryland Public Service Commission Case No. 9311, *In the Matter of the Application of Potomac Electric Power Company for an Increase in its Retail Rates for the Distribution of Electric Energy.*
[46] *See* McDonald Rebuttal at p.1, Lines 14-15 and at p.2, lines 1-17.
[47] January 23, 2014 Hearing, VR at 18:43.
[48] January 23, 2014 Hearing, VR at 18:45.
[49] January 23, 2014 Hearing, VR at 18:48.

accounting vernacular is often interchanged with credit and Mr. Ostrander has mistakenly fallen back to his accounting background while interpreting tax regulations. This is the crux of his misinterpretations. His oversight and the fallacy of this substitution is that the term “reserve” as used in the regulations is specifically defined within the regulations and not limited to just credit amounts. *(See Treas. Reg. §1.167(l)-(1)(h)(1) and (2))*

The regulations outlining the normalization requirements are complex and interpretation of them should only be done by tax professionals, such as Atmos’ witness Mr. McDonald, whose testimony regarding the regulations can be summarized as follows:

1. A taxpayer may use accelerated depreciation for public utility property if the taxpayer uses a normalized method of accounting. *(Treas. Reg. §1.167(l)-(1)(a))*
2. A taxpayer which uses accelerated depreciation is considered to use a normalized method of accounting if it makes adjustments to a **reserve** to reflect the amount of tax deferred from the use of accelerated depreciation. *(Treas. Reg. §1.167(l)-(1)(h)(1)(i)(b))*
3. The adjustment to the reserve is equal to the amount of tax deferred by the accelerated depreciation. However, if the accelerated depreciation causes the taxpayer to realize a NOLC, an adjustment for the NOLC must also be recorded to the reserve. *(Treas. Reg. §1.167(l)-(1)(h)(1)(iii))*
4. The taxpayer must record the reserve on its books and records. *(Treas. Reg. §1.167(l)-(1)(h)(2))*
5. The taxpayer does not use a normalization method of accounting if the reserve is not excluded from rate base or treated as no-cost capital. *(Treas. Reg. §1.167(l)-*

(1)(h)(6)(i))

6. For purposes of determining the reserve, a taxpayer may use periods which include historical, future or some combination thereof. *(Treas. Reg. §1.167(l)-(1)(h)(6)(ii))*

Both parties agree that the Commission should not do anything that would cause the Company to be in violation of tax normalization rules.[50] Company Witness McDonald testified as to Draconian effects that would arise from violation of those rules, including loss of the ability to take accelerated depreciation and bonus depreciation, amendment of tax returns going back to 2008 to reflect the loss of accelerated and bonus depreciation, and the loss of the ability to take accelerated and bonus depreciation in the future.[51]

Accordingly, the Company urges the Commission to take no chance on this issue. In his testimony, Mr. Ostrander repeatedly references the Mountaineer Gas case in West Virginia. While the West Virginia Commission may have been persuaded to order removal of NOLC from one of its regulated utility's ADIT, the financial consequence of that decision to that utility and its customers has not yet been determined. [52] This case has not been finalized and is still subject to further litigation. Lastly, this decision by the West Virginia Commission to remove NOLC from ADIT currently stands alone in its precedence, as opposed to decisions by other State Commissions.

In contrast, all other states that regulate Atmos have adopted the inclusion of NOLC as an adjustment to rate base, a point which Mr. Ostrander was unaware.[53] He is also unaware, as evidenced by his lack of testimony, on the impact his recommendation will have on Atmos and

[50] January 23, 2014 Hearing, VR at 18:55.
[51] January 23, 2014 Hearing, VR at 17:27, 17:36.
[52] McDonald Rebuttal at p.21, lines 7-12.
[53] January 23, 2014 Hearing, VR at 18:50.

other similarly situated utilities. As Mr. McDonald testified, Atmos would lose the benefit of accelerated depreciation, bonus depreciation and other tax adjustments.[54] Even Mr. Ostrander admits that he does not want Atmos to lose those benefits.[55] However, the harm would be unavoidable and the negative impact on rates would be long term. If the NOLC is removed from rate base and Atmos is, in turn, found to be in violation of the Internal Revenue Code's normalization rules, its entire test period ADIT balance of $45,893,236 would be at risk. Removal of that amount of rate-base offset in this proceeding would cause the Company's revenue requirement deficiency to climb $5,573,218 from $13,291,265 to $18,864,483 at the Company's filed rate of return. Furthermore, it would ensure that future rate increases would be larger than necessary as the Company's ability to take advantage of deductions like accelerated depreciation would be impacted going forward. Mr. Ostrander places the Commission in the position of making a permanent, irrevocable change to the long standing, long accepted inclusion of the ADIT adjustment without any explanation of the potential devastating financial effect on the Company and its customers as well as all other Kentucky utilities and their customers.

In an attempt to validate his questionable opinion on the issue, Mr. Ostrander suggests the Company seek a Private Letter Ruling (PLR) from the IRS. The Company is opposed to this proposal for several reasons:

(1) Removal of the NOLC from the Company's ADIT is not appropriate under generally accepted ratemaking principles and would be inconsistent with what most regulatory commissions have done in other states, including all states that regulate Atmos.[56] The

[54] January 23, 2014 Hearing VR at 17:36.
[55] January 23, 2014 Hearing, VR at 18:55.
[56] *See* McDonald Rebuttal at p.16, line 20 through p.21, line 12.

Commission is urged to consider the merits of Mr. Ostrander's proposal under generally accepted rate making principles. As stated by the Texas Public Utilities Commission, "if the Commission is going to include deferred income taxes as a reduction to rate base, which it should, the Commission should likewise include known reductions to those deferred taxes. Consequently, NOLs should be included as an offset in the calculation of the deferred income tax balance included in rate base."[57] If the Commission concurs that NOLC should remain a component of ADIT as a matter of sound ratemaking there is no need to involve the IRS.

(2) According to Mr. Ostrander, the Maryland Public Service Commission has ordered two utilities to obtain a PLR concerning this issue.[58] Although those PLRs would not be binding on Atmos, they could provide meaningful guidance. Presumably, one of them will be issued before Atmos' next rate case. One of these cases, Potomac Electric, is still on appeal.[59] In both of these cases, Mr. Ostrander was the witness – just as he is in this case. The Commission should be cautious about following untested positions from cases in another jurisdiction that are predicated on the testimony of one single witness.

(3) Preparing and processing a request for a PLR is very time consuming and expensive. The filing fee alone for a PLR is $19,000.[60] The Commission would also be required to participate in the filing process.[61] Indeed, the IRS will not ordinarily consider the PLR unless the Company states both "(1) the regulatory authority responsible for establishing or approving the taxpayer's rates has reviewed the request and believes the request is adequate and

---

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

[58] January 23, 2014 Hearing, VR at 18:55. According to Mr. Ostrander one of these cases, *Potomac Electric*, is still on appeal.

[59] January 23, 2014 Hearing, VR at 18:54.

[60] IRC Section 7121 Rev. Proc 2014-01, Section 15.05. User Fees are categorized in Appendix A. Atmos would qualify as a Category 3(c)(ii) fee.

[61] IRC Section 7121 Rev. Proc. 2014-1 Section 7. *See also*, IRC Section 7121 Rev. Proc. 2014-1 Appendix E.

complete; and (2) the taxpayer will permit the regulatory authority to participate in any Associate office conference concerning the request."[62] Given the lack of a clear need for seeking a PLR, the Company and its ratepayers should not be forced to bear the cost of obtaining one. Should the Commission require Atmos to seek a PLR, the Company would request that the Commission allow the Company to create a regulatory asset to defer those expenses and seek recovery of them in the Company's next general rate proceeding.

C. SUMMARY OF RATE BASE

As shown on Schedule B.1F to MFR 16 (13)(b), Atmos' jurisdictional rate base as of November 30, 2014, is as follows:

RATE BASE COMPONENT	FORECASTED TEST PERIOD 13 MONTH AVERAGE
Plant In Service	$445,835,433
Construction Work In Progress	$ 8,541,792
Accumulated Depreciation and Amortization	(166,889,761)
Property Plant and Equipment, Net	$287,487,464
Cash Working Capital Allowance	$ 3,337,211
Other Working Capital Allowances (Inventory & prepaids)	$ 10,728,429
Customer Advances For Construction	(2,745,576)
Deferred Income Taxes & Investment Tax Credits	(45,893,236)
Rate Base	$252,914,292

III. **REVENUE AND EXPENSES.**

A. Introduction

For its base period, Atmos records total operating revenues of $150,293,982 and total

[62] IRC Section 7121 Rev. Proc. 2014-1 Section 7. *See also*, IRC Section 7121 Rev. Proc. 2014-1 Appendix E.

operating expenses of $133,620,616, for a total net operating income of $16,673,366.[63] Atmos has proposed various adjustments to revenues and expenses for the forecasted test period, resulting in projected revenues and expenses of $155,374,969 and $141,914,890 respectively .[64] Each of the company's proposed adjustments are discussed below.

The OAG has proposed various adjustments to rate base and to operating and maintenance expenses. Each of those proposed adjustments are also addressed below.

B. Background/Budgeting

Operating and Maintenance (O & M) costs for Atmos are budgeted on a fiscal year basis, which begins October 1 of each year.[65] Budgets are approved at multiple levels beginning with supervisors/managers and extending throughout division leadership. Once approved at the division level, the senior management, who are the presiding members of the Company's Management Committee, approve the budget and it is ultimately sent to the Board of Directors for final review.[66]

As to its capital expenditures, the Company has a five (5) year plan with a focused emphasis on the first year of the five year period.[67] Like the O & M budget, the capital budget is a bottom up process beginning at the supervisor level and ultimately proceeding to the Board of Directors.[68]

Once the budget is approved, specific projects are ready for appropriation and individual project estimates are submitted by field personnel for project authorization. Each project

[63] MFR 16(13)(c)(2), Schedule C.2
[64] MFR 16(13)(c)(2), Schedule C.2
[65] Direct Testimony of Joshua Densman (Densman Direct) at p. 5, lines 11-13.
[66] Densman Direct at p.5, line 22 and at p. 6, lines 1-2.
[67] See Direct Testimony of Earnest Napier (Napier Direct) at p.5, lines 1-2.
[68] *See* Napier Direct) at p.5, lines 1-23 and p.6, lines 1-7.

estimate is separate from the budget allotment. The Company's capital budgeting system maintains projects in two broad categories:

1. Blanket Functionals which include total capital authorizations of a similar type such as new services, leak repair, short main replacements, small integrity/reliability projects, etc. and
2. Specific Projects, which are uniquely identified, such as a specific highway relocation project, replacement of work equipment, or some larger significant integrity/reliability project.[69]

Each month, budget center variance reports are generated. Each budget center manager is responsible and held accountable for managing his or her overall approved capital budget, including any approved project estimates. If during the course of a project, field management identifies that the costs of the project will exceed approved amounts, a request for supplemental funding may be submitted. All expenditures above the authorized appropriation, unbudgeted projects and variances on budgeted projects must be approved at the appropriate levels within the Company.[70]

The Kentucky operation manages the capital budget on a project basis; however, as mentioned on pages 4-6 of the Direct Testimony of Earnest Napier, the capital budget is developed beforehand when all details of the projects may not be known. The Kentucky operation also works towards managing within the overall fiscal year capital budget, per the capital categories below:

Equipment

[69] *See* Napier Direct at p.9, lines 9-23 and at p.10, lines 1-8.
[70] Napier Direct at p.9, lines 21-23 and at p.10, lines 1-8.

Growth
Information Technology
Pipeline Integrity
Public Improvements
Structures
System Improvements
System Integrity
Vehicles

The three highest priorities for capital budgeting are system integrity, pipeline integrity, and system improvement.[71] These three priorities focus on customer safety and system reliability. Other top priorities include public improvement projects, public work projects and customer growth projects. Functional projects, such as short main relocations or service line installations, fall into an annual blanket project for the fiscal year.[72]

In addition to costs related directly to Kentucky Operations, Atmos has a Division General Office ("DGO") located in Franklin, Tennessee that manages utility operations in Kentucky, Tennessee and Virginia. This division is referred to as the "Kentucky-MidStates Division". Prior to April of 2013, the Kentucky MidStates Division included the Company's utility operations in Georgia. Those assets were sold in April of 2013.[73] The Company also has a Shared Services Unit ("SSU") which is located at corporate headquarters in Dallas, Texas. SSU provides central support services to the various divisions (including KY MidStates) including services such as accounting, legal, tax, information technology, customer support (call center, billing, collections, etc.).[74] There are separate annual budgets proposed each year for expenses incurred at the Kentucky Direct, DGO, and SSU levels.

[71] Napier Direct at p.11, lines 8-10.
[72] *See* Napier Direct at p.9, lines 15-20.
[73] *See e.g.*, Company Response to OAG DR 2-02, Atmos Energy Corporation's Responses to AG's Second Data Requests.
[74] Densman Direct at p.7, lines 14-17.

Atmos' O & M expenses for Kentucky fall within one of the three following categories:

1. Expenses incurred and booked directly to Kentucky (rate division 009)

2. Expenses from the DGO allocated to Kentucky (rate division 091)

3. Expenses from SSU allocated to Kentucky (rate division 002 & 012).

Expenses that are directly attributable to Kentucky are booked solely to Kentucky. Expenses for DGO and SSU are allocated to Kentucky in accordance with the allocation methods specified in the Company's cost allocation manual (CAM)[75] and discussed in the Direct Testimony of Mr. Jason Schneider. The Company has consistently applied the same allocation methods for DGO and SSU throughout this case, as it has in its three prior rate proceedings in Kentucky.[76]

As noted above, Atmos prepares its operating budgets on a fiscal year basis which commences on October 1 each year. In compiling the financial data for rate cases the Company relies extensively on its actual operating budgets. In this case, the base period extends from August 1, 2012 through July 31, 2013. For the seven months of August 2012 through February 2013, actual O & M expenses were used. For the 5 months of March 2013 through July 31, 2013, projected O & M expenses were used. These projected O & M expenses were based on the Company's FY 2013 budget.[77]

In accordance with Kentucky regulations, Atmos has filed monthly updates to its O & M expenses. By the time of the hearing, the Company had actual O & M expenses for the entirety of the base period and these numbers illustrate just how accurate the Company's budgeting process is (variance between actual amounts and budget amounts for those five months was

---

[75] A complete copy of the Company's CAM is attached as Exhibit JLS-1 to the Direct Testimony of Jason L. Schneider (Schneider Direct)

[76] *See* Schneider Direct at p.14, lines 4-14; *see also*, Densman Rebuttal, p.15 lines 13-16.

[77] Densman Direct at p.13, line 3.

minus .3%) .[78]

The accuracy of the Company's budgeting process is further illustrated by the following table which compares actual O & M expenses to budget over a five year period:[79]

($000's)

Fiscal Year	Actual $	Budget $	Over/Under $	Variance
2012	$23,540	$22,362	$1,178	5.3%
2011	$22,238	$21,635	$603	2.8%
2010	$21,311	$22,487	$(1,176)	(5.2%)
2009	$24,329	$23,445	$884	3.8%
2008	$22,334	$22,268	$66	.03%

The importance of a utility's budgeting process in a forecasted test period case has been recognized by the Commission: "When a forward-looking test period approach is used, the Commission's focus is on determining the reasonableness of the utility's budgeting and other processes used to arrive at the forward-looking test period balances. One of the methods used to determine the reasonableness of the budgeting process is a review of the utility's budget versus actual results variance analysis."[80] Atmos has a proven history of accurately projecting future O & M expenses.

C. <u>O & M EXPENSES</u>

1. <u>Adjustments for Labor and Benefits</u>

---

[78] Please see Company Hearing Exhibit #3.
[79] Densman Direct at p.12, lines 4-8.
[80] Union Light, Heat and Power, Case No. 2005-00042, Order of December 22, 2005, at pgs. 4-5.

(i) Company's Pro forma Adjustment

The Kentucky Direct total O & M Expense for the base period and forecasted test period is $13,892,232 and $13,685,601 respectively.[81] This represents a decrease of $206,631 and reflects the adjustments made for labor and benefits, rent, other O & M and bad debt as discussed below.[82]

The Company's Kentucky Direct expense payroll for the base period is $5,038,595.[83] Each year the Company adjusts base pay for employees effective October 1, and the 2012 adjustments resulted in an average increase of 3% per employee. This increase was captured as part of the FY 2013 budget.[84] An adjustment was made for the test year to account for the same average 3% increase to become effective October 1, 2013.[85] This is consistent with prior annual pay raises as well as the recommendation of the Company's compensation consultant Towers Watson.[86] Overall base payroll for Kentucky Direct was projected to increase by $300,755 from base period to the test period. [87]

Kentucky Direct employee benefits are projected as a fixed percentage of labor expenses and were adjusted $294,340 higher than base period.[88] Nationally-recognized consultants Towers Watson are used to determine the employee benefit load for the Company and its various operating divisions.[89]

---

[81] Densman Direct at p. 14, lines 1-3.
[82] Densman Direct at p. 14, lines7-8.
[83] *See* Densman Direct, Exhibit JCD-1.
[84] Densman Direct at P. 14, line 21.
[85] Densman Direct at P. 14, lines 21-23
[86] Densman Direct at p.14, line 23 and at p.15, line 1.
[87] Densman Direct at p.15, line 1-2. *See also* Exhibit JCD-1.
[88] Densman Direct at p. 15, lines 8-9.
[89] *See e.g.*, Company Response to OAG 1-119, Atmos Energy Corporation's Responses to Attorney General's First Data Requests.

Combined Kentucky Direct expense payroll and expense benefits for the base period and test period total $7,905,783 and $8,500,878 respectively.[90]

(ii) OAG Proposed Adjustment #4 (Exhibit BCO-2, Schedule A-7)

In his **original** Adjustment #4, OAG witness Ostrander proposed to reduce the Company's Kentucky Direct payroll and benefits in the test year by $2,359,107 ($1,981,253 related to the payroll reduction and $377,854 related to the benefits reduction).[91] However, this adjustment contained a significant error. Mr. Ostrander included $3,161,527 of Kentucky Direct benefits twice in his proposed Adjustment #7 causing an overstatement of Kentucky Direct payroll in the same amount. Thus, he listed the expense portion of Kentucky Direct payroll of $8,500,877 when in fact the correct amount is $5,449,350.[92]

Mr. Ostrander's **original** adjustment #4 was also flawed because he used actual 2012 payroll and benefits data rather than base period data. Based on his mathematical error and his failure to adjust from base period numbers, Mr. Ostrander alleged that Kentucky Direct payroll and benefits had increased 80%.[93] Once correct numbers and time frames are used, the proposed increase from base period to test period, a period of 16 months (rather than Mr. Ostrander's 26 month period) , is actually 5.97%.[94]

When Mr. Ostrander was notified of his error concerning the double inclusion of $3,161,527, he filed a "Revised" Schedule that utilized an entirely new methodology than his

---

[90] *See* Densman Direct, Exhibit JCD-1.

[91] Direct Testimony of Bion C. Ostrander, filed October 9, 2013 (Ostrander Direct, Original), Schedule A-7 of BCO-2

[92] Ostrander Direct, Original, Schedule A-7 of BCO-2; *see also*, Densman Rebuttal at p.7, lines 17-23 and p.8, lines 1-3.

[93] Ostrander Direct, Original, at p.37, lines 12-13. *See also* Ostrander Direct, Original, Exhibit BCO-2, Schedule A-7, line 26.

[94] Rebuttal Testimony of Joshua Densman (Densman Rebuttal) at p. 8, lines 9-14.

original schedule.[95] Mr. Ostrander then used his "revised" approach to make adjustments not only to Kentucky Direct payroll and benefits, but also to SSU/DGO payroll and benefits.[96] Under this new method for both Kentucky Direct and SSU/DGO, Mr. Ostrander again takes the difference between the Company's test year numbers and 2012 actuals (which covers a period of 26 months) and arbitrarily reduces those differences by 50%.[97]

Attached are two exhibits illustrating Mr. Ostrander's errors. Exhibit A depicts the errors and the change of methodology between Mr. Ostrander's Original Schedule A-7 and his Revised Schedule A-7. Exhibit B illustrates the improper time periods used by Mr. Ostrander in developing Exhibit BCO-2, Schedule A-7 and Revised Schedule A-7.

It is critical to note that Mr. Ostrander has provided no supporting work papers, analysis or detail for his proposed 50% reduction to payroll and benefits other than his unsupported opinion that it is a fair and reasonable thing to do.[98] He has provided no explanation as to his underlying assumptions or reasons for choosing a 50% "reducer".

In short, Mr. Ostrander's proposed adjustment to payroll and benefits (KY Direct, DGO & SSU) of $1,212,712 should be rejected in its entirely because:

(a). The arbitrary 50% reduction has not been adequately supported by Mr. Ostrander; and,

(b) The adjustment is based on adjustments to 2012 actual amounts rather than to Company's base period amounts, which is inappropriate for adjustments in a fully forecasted test

[95] *See* Densman Rebuttal at p.9, lines 9-22 and at p.10, lines 1-10. *See also,* Ostrander Direct, Revised.
[96] Densman Rebuttal at p.9, lines 12-18. *See also,* Ostrander Direct, Revised, Exhibit BCO-2, Schedule A-7.
[97] Densman Rebuttal at p.9, lines 18-22. *See also,* Ostrander Direct, Revised, Exhibit BCO-2, Schedule A-7.
[98] *See e.g.,* Ostrander Direct, Revised, at p.39 lines 4-6.

period case according to Kentucky administrative regulations.[99]

2. Rent

Rent, utilities and maintenance expenses were projected to increase by $1,303 from base period to test period.[100]

3. Adjustments to "Other O & M"

(i) Company's Pro forma Adjustment

"Other O & M" consists of all expenses except labor, benefits, rent and bad debt. "Other O & M" expenses were adjusted by a 2.7% price escalation factor.[101] One exception was insurance, which was adjusted upward by 5% from base period to test period as a result of known changes in insurance premiums.[102] The 2.7% escalation factor represents the average increases in the CPI Index for the Midwestern region over the 3 year period preceding the filing of this case.[103]

(ii) OAG Proposed Adjustment #2

OAG Adjustment #2 proposes to remove the 2.7% escalation factor, which by Mr. Ostrander's calculations would result in a downward adjustment to O & M expenses in the test period in the amount of $496,907.[104] However, one-half of that amount is attributable to Mr. Ostrander's mistaken belief that the 2.7% escalation factor had been included in the base period.[105] Mr. Ostrander conceded that if the 2.7% escalation factor was not included in base

[99] 807 KAR 5:001(16)(6)(a)
[100] Densman Direct, at p.15 lines 15-16.
[101] Densman Direct, at p.15, lines 19-21.
[102] Densman Direct, at p.15, lines 23 and at p.16, lines 1-2.
[103] Densman Direct, at p.15, lines 21-23.
[104] Revised Exhibit BCO-2, Schedule A-4, line 26.
[105] Densman Rebuttal at p.2, lines 12-17.

period, one-half of his adjustment should be removed,[106] resulting in a reduction to Mr. Ostrander Adjustment #2 in the amount of $248,454.[107] Although Mr. Ostrander complains that the Company should have simply stated there was no escalation factor applied to the base year, that information was readily discernible from various sources in the record.[108]

Mr. Ostrander also improperly applied a negative miscellaneous expense credit in his adjustment which resulted in an over statement of O & M expenses prior to his calculation of this adjustment. In his adjustment, Mr. Ostrander uses this credit to calculate an O & M subtotal, but then incorrectly adds back the credit to calculate his total O & M number which is improperly inflated as a result of the addition back. This results in an over statement of O & M in the amount of $76,648.[109] In total, Mr. Ostrander's Adjustment #2 is overstated by $325,102.[110]

Most importantly, the Company believes the use of the CPI is a reasonable proxy for estimating changes in future prices. The Commission has recognized that budgeting for a forecasted test period is an "inexact science"[111] and accordingly tools such as the CPI are useful where more precise projections are unavailable. The use of a future test year requires forecasts of future expenses and the CPI is simply a tool to estimate the projected change in prices for goods and services in the future. Had the Company merely assumed an "adder" of 2.7% based on forecasted or expected increases, the same result would have occurred but without the legitimacy or transparency that the CPI provides.

---

[106] Ostrander Direct, Original, at p.22, lines 11-15.
[107] Densman Rebuttal at p.2, lines 20-21.
[108] *See* CPI Index tab of FY13 OM Forecast workpaper in Response to Staff 1-59; *See also*, Densman Rebuttal at p.5, lines 1-23 and at p.6, lines 1-2.
[109] Densman Rebuttal at p.4, lines 18-20.
[110] Densman Rebuttal at p.4, lines 20-21.
[111] *Kentucky American Water*, DPSC 95-554, Order of September 11, 1996, p.40.

The CPI has consistently been used by the Company in its prior rate cases in Kentucky[112] and has been used by Big Rivers Electric and Columbia Gas Company in their most recent filings.[113]

However, if the Commission decides to disallow the 2.7% factor, the correct amount to remove from the Company's test period O & M expense is $171,804 simply as a result of the incorrect addition back of the miscellaneous credit expense and the error of assuming an inflation factor was applied the in base period.[114]

4. Bad Debt

(i) Company's Pro Forma Adjustment

In its original filing the Company included $327,970 and $324,479 for the base period and test period respectively related to bad debt expense.[115]

(ii) OAG's Proposed Adjustment #8.

In response to OAG DR 1-152, the Company acknowledged that it had erroneously included revenue margin associated with industrial and transportation customers in its calculation of forecasted bad debt expense. The corrected test period amount is $262,213 for an agreed upon downward adjustment of $25,048.[116]

5. DGO and SSU Allocated Expenses

(i). Company's Pro Forma Adjustments.

---

[112] Densman Rebuttal at p.5, lines 17-21.
[113] *See, In the Matter of: Application of Big Rivers Electric Corporation for a General Adjustment in Rates, KPSC Case No. 2012-00535; Application of Columbia Gas of Kentucky, Inc. for an Adjustment of Rates for Gas Service*, KPSC Case No. 2013-00167.
[114] Densman Rebuttal at p.4, lines 17-22 and at p.5, lines 1-2.
[115] Densman Direct at p.16, lines 6-10.
[116] *See* Response to 1-152 of Atmos Energy Corporation's Responses to Attorney General's First Data Request, Case No. 2013-00148, filed August 28, 2013.

The amount of DGO O & M expense allocated to Kentucky is $4,466,231 and $6,215,385 for the base period and test period respectively, or an increase of $1,749,154 .[117] For SSU, the amounts allocated to Kentucky are $6,410,613 and $6,855,965 for the base period and test period respectively, or an increase of $445,352.[118] The total forecasted test period O & M for Kentucky Direct, DGO and SSU cumulatively is $26,756,951.[119]

The primary driver for the increase in O & M expenses included in the forecasted test period is the higher percentage allocation factor for O&M expenses among the three remaining states following the sale of the Georgia operation in April 2013. Prior to the sale, 41.35% of DGO expenses and 5.33% of General SSU expenses were allocated to Kentucky.[120] Following the sale of Georgia, 50.0% of DGO expenses and 5.55% of SSU expenses were allocated to Kentucky.[121]

Atmos allocates commonly shared costs among its divisions according to the Company's cost allocation manual ("CAM"), a copy of which is attached to Mr. Schneider's Direct Testimony as Exhibit JLS-1. The CAM describes and documents the process by which various common expenses incurred for the benefit of two or more of the Company's rate divisions are allocated.

Atmos' CAM was initially filed with the Kentucky Public Service Commission in April of 2001, and it has been consistently applied and followed, both for budgeting and operation purposes, as well as for rate proceedings since first adopted.[122] The Company used the same method for allocating costs from DGO & SSU in its three prior rate cases in Kentucky.[123]

The CAM allocates SSU & DGO costs by use of a "Composite Factor". The Composite

[117] Densman Direct at p.16, lines 11-21.
[118] Densman Direct at p.17, lines 2-12.
[119] Densman Direct at p.18, line 4.
[120] See MFR 16(13) "Allocation" Tab.
[121] See MFR 16(13) "Allocation" Tab.
[122] Schneider Direct at p.14, lines 4-9.
[123] See Densman Rebuttal at p.15, lines 13-16.

Factor is the simple average of the three following percentages:

1. For SSU the average percentage of Gross Direct Property Plant and Equipment in each operating division unit (for DGO, it is each state in the division) as a percentage of the total Direct Property Plant and Equipment in all operating divisions (for DGO it is all states in the division).

2. For SSU, the average number of customers in each operating division (for DGO it is each state in the division) as a percentage of the total number of customers in all operating divisions (for DGO, it is all states in the division).

3. For SSU, the total direct O & M expenses in each operating division (for DGO, it is each state in the division) as a percentage of the total direct O & M expenses in all operating divisions (for DGO, it is all states in the division).[124]

The Company provided the detailed calculations used in this filing for both DGO & SSU in its response to OAG DR 1-082.

The sale of the Georgia operations in April of 2013 necessitated revisions to the allocation percentages used by the Company and these changes resulted in a larger share of SSU expenses being allocated to the remaining 8 states served by Atmos and a larger share of DGO expenses being allocated to Kentucky, Tennessee and Virginia in accordance with the CAM. These revised allocation percentages were used to develop the forecasted test year in this case.[125]

Testimony in this proceeding established that there have been at least two instances where Kentucky's allocation of O & M expenses for DGO and SSU **decreased** under the

[124] *See* Schneider Direct, Exhibit JLS-1.
[125] Rebuttal Testimony of Jason Schneider (Schneider Rebuttal) at p.4, lines 1-17; *See also*, Densman Rebuttal at p.15, lines 5-16; MFR 16(13) "Allocation" Tab; Schneider Direct, Exhibit JLS-1.

Company's CAM. The first resulted from the acquisition of the TXU's gas operations in October 2004. The second resulted from the merger of the Kentucky Division into the Mid-States Division in 2006.[126]

As noted above, the Company has consistently followed the CAM's allocation process in this case as it has in its three most recent rate filings with the Commission. To make a different allocation in this proceeding would be inconsistent with its prior filings with this Commission and with its prior practice in the other jurisdictions. Sometimes this methodology results in a decrease in the percentage of costs allocated to a given jurisdiction, and other times, like this case, it results in a higher percentage allocation – irrespective of the actual level of expenses. Selectively allocating expenses on an ad hoc basis defeats the purpose of the CAM.

During the hearing, Company Witness Waller was questioned about how the Company handles the financial impact of acquisitions and sales of utility assets in other states.[127] Mr. Waller explained that when a utility is acquired, the acquisition is paid for with capital that is financed at the corporate level. None of the debt related to the purchase, for example, of Georgia, would ever have been allocated to or included in Kentucky's revenue requirement. Only debt associated with Kentucky rate base is paid for by Kentucky customers.[128] None of the operating expenses or revenue from a utility in another state is allocated to Kentucky. Since acquisitions are made, booked and paid for at the corporate level, with no allocation of costs or debt related thereto being allocated to Kentucky, proceeds from the sale are also booked at the corporate level. Those funds are then utilized by the Company in a variety of ways, including

[126] Schneider Rebuttal at p.4, lines 18-23 and at p.5 lines 1-6.
[127] January 23, 2014 Hearing, VR at 17:02.
[128] January 23, 2014 Hearing, VR at 17:02.

payment of debt and capital investment for example, the investment of approximately $35.53M in capital projects in Kentucky for FY 2013.[129]

(ii). <u>OAG Proposed Adjustment #3</u>

OAG Adjustment #3 proposes to adjust SSU and DGO allocated expenses downward by $1,492,500.[130] Mr. Ostrander arrived at that number by taking the difference between the total DGO and SSU test period allocated expenses of $13,071,350 and the 2012 allocated **<u>actual amounts</u>** of $10,086,333 (a difference of $2,985,000), and then arbitrarily reducing that by 50% without any analysis or justification for a downward adjustment of $1,492,500.[131] It should be noted again that Mr. Ostrander's adjustment is to 2012 actuals instead of the base period as required by Kentucky administrative regulation.

It should also be noted that Mr. Ostrander does not question the reasonableness of the underlying numbers making up the base and test period DGO & SSU O & M expenses. To the contrary, he simply compares the DGO and SSU allocated amounts in the test year to amounts from a prior period (<u>not</u> the base period), concludes there has been an excessive increase and then reduces the increase by 50%.

Although the Company provided ample information to Mr. Ostrander concerning the effect of the sale of the Georgia operations in April 2013, he complains about the Company's "very significant and unusual" <u>increases</u> in O & M expenses.[132] The truth is the combined pool of Kentucky Direct, DGO and SSU O & M expense decreased from the base period to the test

[129] *See* Napier Direct at p.12, line 8. This number has been updated to replace the projection with actual spend.
[130] Ostrander Direct, <u>Revised</u> Exhibit BCO-2, Schedule A-5, line 20.
[131] See Ostrander Direct, <u>Revised</u> Exhibit BCO-2, Schedule A-5. *See also* Ostrander Direct, <u>Revised</u> at p.25 lines 12-18.
[132] Ostrander Direct, <u>Revised</u>, p.32 lines 11-12.

period.[133]

6. Employee Incentive Compensation.

As is true with most major corporations, including regulated utilities, Atmos has an incentive compensation program for its employees. Atmos' program has three components: Variable Pay Plan (VPP) which applies to employee grades 1 through 6 and select grade 7; Management Incentive Plan (MIP) and Long Term Incentive Plan (LTIP), both of which apply to select employee grade 7 and grades above.[134]

The Company believes that employee incentive compensation is a reasonable cost of doing business and should be allowed as normal and recurring costs. The Company acknowledges that in the two rate orders entered by the Staff at the hearing,[135] the Commission disallowed the incentive compensation plans of those utilities. The Company believes incentive compensation plans should be judged on a utility by utility basis.

Atmos acknowledges that its incentive plan provides no incentive compensation unless certain EPS goals are reached. However, the Company's customers also benefit. The primary desire of Kentucky customers is, or should be, that they receive safe, reliable gas service, from a well-qualified and trained workforce, at reasonable rates.

The Company's incentive compensation program furthers those goals. It enables the Company to attract and retain an excellent workforce by offering incentive compensation that, together with base salary and benefits, is in the 50th percentile of a competitive job market.[136]

---

[133] Densman Rebuttal at p.15, lines 9- 11; Densman Rebuttal, Exhibit JCD-2.
[134] *See* Company Response to OAG 1-131, Atmos Energy Corporation's Responses to Attorney General's First Data Requests.
[135] January 23, 2014 Hearing, PSC – Exhibit 02 and PSC – Exhibit 03.
[136] Company Response to OAG 1-133(d), Atmos Energy Corporation's Responses to Attorney General's First Data Requests.

Without that element, the Company would be competing for employees in the market place with a below average compensation package. For reasons already stated, when a Commission refuses to allow any portion of an incentive compensation plan to be recovered, there is a significant disadvantage to the utility's customers and shareholders.

It seems appropriate that rather than making a blanket disallowance of all incentive compensation plans, the Commission should consider such factors as whether the Company exemplifies excellent and safe service at rates well below industry norms and whether the incentive plan in question results in excessive or unreasonable compensation for employees.

The Company submits it is in all stakeholders' interest to pay a competitive wage and retain an excellent, well-trained workforce while providing safe and reliable service.

7. CSS Costs.

i. Company's Pro Forma Adjustments

In 2013, the Company implemented its new Customer Service System ("CSS"). The Company's prior information and billing system had been implemented in 1996. As the years advanced, more and more capital expenditures were being required to keep the system functional as it was becoming outdated and incapable of adding required new functions.[137] Accordingly, the Company began planning for a new system in 2010.[138] The Company went live with the system May 1, 2013.[139]

The total capital cost of the new CSS system that was closed to plant (Account 1010) in

[137] *See* Direct Testimony of Mark A. Martin (Martin Direct) at p.10 lines 16-23 and at p.11 lines 1-4.
[138] Martin Direct at p.10, lines 16-17.
[139] Martin Direct at p.12, lines 2-4.

May 2013 was $78,921,348.[140] Of this amount, $4,512,606 was allocated to Kentucky for ratemaking purposes.[141] For the revenue requirement filed in this proceeding, however, the estimate of the total capital cost of the system is $78,916,066, of which $4,512,304 is allocated to Kentucky for ratemaking purposes.[142]

The original cost of the CSS project was estimated to be $64 million.[143] That estimate was revised upward to $72 million when the deployment strategy was changed from a 2-stage go-live approach to single go-live approach.[144] The primary reason for the difference between the $72 million single go-live estimate and the final cost of $78.9 million was the addition of internal resources for testing the system prior to going live.[145]

ii. OAG Adjustment #6

OAG Adjustment #6 reduces the Company's O & M expense by $97,599 and rate base by $426,751 for "imputed" CSS cost savings.[146] Mr. Ostrander arrives at these amounts in a rather unique, albeit flawed, manner. He starts with the premise that internal projections of possible cost savings made to the Company's Board of Directors back in 2010[147] and filed confidentially in this case should be treated as hard numbers and binding on the Company in this rate proceeding. Inexplicably, Mr. Ostrander chose the potential savings projection provided to the Board for 2015

[140] Response to 1-096 of Atmos Energy Corporation's Responses to Attorney General's First Data Request, Case No. 2013-00148, filed August 28, 2013.
[141] Response to 1-096 of Atmos Energy Corporation's Responses to Attorney General's First Data Request, Case No. 2013-00148, filed August 28, 2013.
[142] Response to 1-096 of Atmos Energy Corporation's Responses to Attorney General's First Data Request, Case No. 2013-00148, filed August 28, 2013.
[143] Response to 1-097 of Atmos Energy Corporation's Responses to Attorney General's First Data Request, Case No. 2013-00148, filed August 28, 2013.
[144] Response to 1-097 of Atmos Energy Corporation's Responses to Attorney General's First Data Request, Case No. 2013-00148, filed August 28, 2013.
[145] Response to 1-097 of Atmos Energy Corporation's Responses to Attorney General's First Data Request, Case No. 2013-00148, filed August 28, 2013.
[146] Ostrander Direct, Revised, Exhibit BCO-2, Schedule A-2.
[147] Ostrander Direct, Revised, p.51, lines 3-6.

rather than for 2014.[148] However, neither year's projection should be deemed persuasive in this case because they are four year old estimates. Mr. Ostrander then calculates a ratio of this "savings" to the originally estimated capital cost for the CSS (which he erroneously sources from the confidential document).[149] He then applied that ratio to the updated capital spend of $78,916,066 to arrive at a "calculated" savings of $97,599 in operating costs.[150]

Mr. Ostrander's proposed adjustment should be rejected for several reasons. First, internal projections of potential savings from nearly four years ago should not be binding on the Company. They were estimates for an internal presentation - they were not prepared for budgeting or operational purposes. Secondly, Mr. Ostrander uses 2015 projected savings rather than 2014. Thirdly, he erroneously uses an incorrect figure as the original projected cost – when in fact the original cost estimate was $64M. Lastly, his adjustment is based on the assumption that an increase in the capital costs of the CSS necessarily results in greater O & M savings, an assumption he has not validated.

Mr. Ostrander uses equally illogical reasoning to justify his proposed reduction to Atmos rate base related to the CSS. His only "support" for this portion of his adjustment is that Atmos "must have" anticipated certain quantitative and qualitative benefits related to using the one-stage implementation and "these benefits" [whatever they are] should be shared with ratepayers – and on that basis he disallows 50% of the "excess costs" (which he defines as the difference between the original estimate of cost estimate of $64M and final cost of $78.9M).[151] Mr. Ostrander does not identify, explain or quantify "these benefits". Surely "must have" is not a

[148] Ostrander Direct, Revised, p.51, lines 6-10.
[149] Ostrander Direct, Revised, p.51, line 9
[150] Ostrander Direct, Revised, Confidential Exhibit BCO-2, Schedule A-9
[151] Ostrander Direct, Revised, p.50 lines 19-24.

sufficient basis to support his proposed Adjustment #6.

In the Kentucky American Water Company Case, No. 2012-00520, Order dated October 25, 2013, one of the Interveners opposed inclusion of a new system, similar to Atmos' CSS program, into rate base for ratemaking purposes. It argued that Kentucky-American Water Company (KAWC) had failed to meet its burden of proof that the program was reasonable based on the absence of any Kentucky-American specific study regarding the program and the lack of any study of possible alternatives to the Program.[152] These objections are similar to those of the OAG in this case. However, the Commission found sufficient evidence to approve the new system. The similarity of the KAWC situation and Atmos is clear from the following Commission statement:

> "Our review of the evidence indicates sufficient evidence to support inclusion of the BT Program costs into UPIS. The evidence of record indicates that Kentucky-American's information infrastructure was approaching the end of its useful life and a need to replace the system existed. Most of Kentucky-American's information system had been in service since the 1990s or the early part of the last decade. These systems were not integrated and had limited functionality. They could not perform many of the customer-service technology functions that the public has come to expect. Some supporting software for these systems was no longer available. Moreover, while the lives of some systems could be extended through system customizations, numerous customizations would be required and would be expensive..."Order of October 25, 2013, p. 10.

The Commission also found that a reasonable and thorough review process was used to determine the needs of the company and to procure the information technology systems. The company performed a comprehensive study of its needs. It used a competitive bidding and evaluation process to select its information systems and system integrator. The Commission

[152] Order dated October 25, 2013, p.9, KPSC Case No. 2012-00520, *Application of Kentucky American Water Company for an Adjustment of Rates Supported by a Fully Forecasted Test Year.*

then listed some benefits of the KAWC program, which are very similar to the benefits described by Mr. Martin in his Direct Testimony at page 12.

Given the similarity of the programs and the qualitative benefits to the ratepayers, Atmos' CSS program should be approved as filed.

D. REVENUES

Based on present rates, the Company's projected gross profit for the test year ending November 30, 2014 is $65,109,725.[153] Company witness Martin testified as to the method used by the Company to determine base period and test period revenues.[154] Exhibit MAM-2 to Mr. Martin's Direct Testimony shows actual volumes metered by customer class for the twelve months ending December 31, 2012, which totaled 40,386,931 Mcf. A pro forma adjustment for changes in volume due to expected contract changes, load changes, new plant and plant closings of 165,435 Mcf was made. Lastly, a weather adjustment to volumes of 2,189,876 Mcf was made, resulting in total weather adjusted volumes for the reference period of 42,742,242 Mcf.[155]

To arrive at the test period volume, adjustments of 427,287 Mcf were made, resulting in test year volumes of 42,314,955 Mcf.[156] At these projected volumes, under current rates, the Company would earn a 4.51% return on shareholder equity.[157] The rate of return on equity proposed by Company witness Vander Weide is 10.6%.[158] In order to achieve that return,

[153] Martin Direct at p.22, lines 17-18.
[154] *See* Martin Direct.
[155] Martin Direct, Exhibit MAM-2
[156] Martin Direct, Exhibit MAM-2
[157] Martin Direct at p.22, lines 18-19.
[158] Company Updated Response to Staff 2-48, Case No. 2013-00148, *Atmos Energy Corporation's Supplemental Response to Staff's Second Request for Information*, filed November 15, 2013.

additional revenue of $13,291,265 is required.[159]

The OAG proposed no adjustments to the Company's test period tariff revenues, however, as discussed in Section F, an adjustment was proposed for special contract revenues. The Company has submitted detailed analysis showing expected volumes, by class, in the test period. No evidence has been presented questioning those volumes and the Commission is respectfully requested to accept the Company's projected test year revenues.

E. Rate of Return

1. Capital Structure

Atmos conducts its utility operations in eight states through unincorporated operating divisions. Kentucky is in the Kentucky/Midstates operating division. These are not subsidiaries. These operating divisions collectively make up the corporate entity of Atmos Energy Corporation.[160] Atmos provides the debt and equity capital for all of the operating divisions. Accordingly, the consolidated capital structure of Atmos is the appropriate capital structure for all the operating divisions, including Kentucky.[161] Long term debt is projected to comprise 48.2% and equity to comprise 51.8% of Atmos' 13 month average capital structure for the forecasted test period.[162]

2. Debt

Although the Company's projected average cost of long term debt for the base period is 6.39%, the Company anticipates the cost of debt will actually be lower as of November 30,

[159] Martin Direct at p. 22, lines 20-22.
[160] Waller Direct at p.10 lines 8-18.
[161] Waller Direct at p.10, lines 14-23 and at p.11 lines 1-3.
[162] Waller Direct at p.11 lines 5-7.

2014.[163] The Company anticipates the average cost of long term debt for the forecasted test period will be 6.19%.[164] The Company accordingly recommends that 6.19% be adopted in this proceeding.

During the hearing, questions were propounded by the Staff concerning the Company's use of short term debt (STD) to finance gas stored underground.[165] The Company does not use STD to finance gas stored underground on average throughout its normal annual cycle. Please see Attachment 1 to Hearing DR 1-09 for an analysis of the Company's consolidated short term debt, cash, and gas stored underground balances. As shown in this Attachment, the Company's STD (net of cash) balance was less than its gas stored balance on 71% of the days comprising the base period in this case.[166] If STD net of cash is not large enough to finance gas storage, it follows that gas stored is financed with something other than STD (a combination of long term debt (LTD) and equity). Furthermore, the average balance of STD minus cash and minus gas stored underground is $(85,205,258) for the base period which is further proof that, on average, gas stored underground is financed by a combination of LTD and equity.[167] For these reasons, the Company believes that the appropriate capital structure to use in calculating the revenue requirement in this case is the capital structure presented on the top half of Schedule J-1 labeled "Proposed Capital Structure".[168]

3. Return on Equity

[163] Waller Direct at p.12, lines 7-19.
[164] Waller Direct at p.12, lines 7-19.
[165] January 23, 2014 Hearing, VR 16:51-16:57.
[166] *See* Response 1-09 in *Atmos Responses to Data Request from Hearing Held on January 23, 2014*. Case No. 2013-00148, filed February 3, 2014.
[167] *See* Response 1-09 in *Atmos Responses to Data Request from Hearing Held on January 23, 2014*. Case No. 2013-00148, filed February 3, 2014.
[168] Minimum Filing Requirement 16(13)(j); Schedule J-1. *See also,* Response 1-09 in *Atmos Responses to Data Request from Hearing Held on January 23, 2014*, Case No. 2013-00148, filed February 3, 2014.

Company witness Dr. James H. Vander Weide testified concerning the cost of equity for Atmos. Dr. Vander Weide calculated Atmos' cost of equity by applying several generally accepted cost of equity estimate techniques, including the Discounted Cash Flow (DCF), the Risk Premium Method (RPM), and the Capital Asset Pricing Model (CAPM) and applied these to proxy groups of comparable risks.[169] Based on his analysis, Dr. Vander Weide recommended that Atmos be allowed a fair rate of return on equity (ROE) equal to 10.6%.[170] Dr. Vander Weide further testified that his recommended return on equity was conservative because the financial risk of the proxy companies he used (financial risk being based on the equity ratio resulting from the market values of their equity and debt) is <u>less</u> than the financial risk implied by the lower equity ratio in Atmos capital structure and which is based on book values of equity and debt.[171]

The OAG did not offer any cost of equity expert, although Mr. Ostrander did include in his testimony reference to a return of 7.63% as a "benchmark."[172] Mr. Ostrander expressly disavowed being a qualified expert in this field[173] and his "benchmark" return is not appropriate in this proceeding. In the recent Columbia Gas rate proceeding, for its PRP purposes, the Commission approved a 10.125% return on equity.[174]

At the hearing the Staff introduced Staff Exhibit 1 which reported the average allowed returns on equity ("ROE") for all electric and gas utility rate case outcomes nationwide for 2013.[175] The implication was that the average allowed return on equity should serve as a guide to

---

169 Direct Testimony of James Vander Weide (Vander Weide Direct) at p.3 lines 2-5.
170 Company Updated Response to Staff 2-48,Case No. 2013-00148, *Atmos Energy Corporation's Supplemental Response to Staff's Second Request for Information*, filed November 15, 2013
171 Vander Weide Direct at p. 4 lines 13-17.
172 Ostrander Direct, <u>Revised</u>, at p.10, lines 1-5.
173 Ostrander Direct, <u>Revised</u>, at p.9, lines 21-23 and at p.10, lines 1-3.
174 PSC Final Order, Case No. 2013-00167 at P.4.
175 *See* PSC – Exhibit 01, Regulatory Research Associates – Regulatory Focus – January 15, 2014 – Major Rate Case

the Commission. The Company submits there are several problems with using a generic return for all utilities. First, the use of a simple average of all rate case outcomes does not account for differences in the underlying analysis used to arrive at the ROE outcome (DCF, CAPM, Comparable Earnings, etc.), the regulatory treatment, such as the treatment of rate base items or test year options, the treatment of various revenue and expense components and the applicable test periods. The use of nationwide 2013 rate case outcomes also precludes an analysis of comparability of the companies and differences in the size, operations and financial stability of the group of companies. For example, the list of Gas Utility Decisions for 2013 includes only four (of twenty-one) utilities included in Dr. Vander Weide's peer group. The selection of a fixed time period (calendar 2013) of allowed returns does not account for changes in the capital markets that occurred between the time cases were filed and the recorded outcome, and thus not reflective of more recent capital market conditions.

Staff Exhibit 1 selectively uses information from Regulatory Research Associates (RRA). This Exhibit does not include two important reference points published by RRA. The first is how RRA views the overall result of each rate case outcome. Following the completion of each rate case, RRA publishes a summary of the case and offers both qualitative and quantitative analysis regarding the rate case. On an ongoing basis RRA also evaluates each regulatory commission and on a quarterly basis publishes State Regulatory Evaluations, attached as Exhibit C. As shown on page 2 of the report, the Kentucky commission has an "Average 1" ranking which is on the upper end of RRA's ranking's scale. As can also be seen in comparing page 2 to Staff Exhibit 1, eight of the reported cases are from commissions with "Below Average" rankings. With these two

Decisions – Calendar 2014. January 23, 2014 Hearing; Case No. 2013-00148.

additional points in mind, the Staff Exhibit 1 can be put in a fuller context. To pull the simple average from the 2013 rate case outcomes and apply it as a meaningful reference point in this case would allow commissions that are viewed negatively by RRA to have too much of an influence because these commissions make up eight of the twenty-one points in the yearly average. Illinois, for example, takes a formulaic approach to determining ROE that uses 10-yr U.S. Treasuries as a key input. With interest rates at near-historic lows, the Illinois Commission's formula results in inappropriately low outcomes. Confining the 2013 outcomes to commissions viewed as "Average" or "Above Average" by RRA would result in a simple average ROE of 9.80% for 2013.

Over reliance on a simple average return based on a fluid group of companies would be to eliminate the need for a detailed analysis of a company's specific financial condition and its appropriate return. The Commission's traditional review of ROE, predicated on an extensive financial analysis of a particular company and other comparable companies, supported by expert testimony, will be eliminated and ROE will simply be the lowest common average of all utilities reported for the period closest to the issuance of a final rate order. The quality of the ROE analysis will be greatly diminished and the allowed ROE will likely result in inadequate earnings and more frequent rate filings.

The Company was requested during the hearing to provide the average allowed ROE for all states in which it operates. This information has been provided in the Company's Response to Hearing DR 1-01. As stated in the DR Response, the weighted ROE for the Company is 10.33%. The current ROE of 10.5%, which is utilized for determining the PRP surcharge, has permitted the Company to make the investment in infrastructure that is necessary to support the operation of a safe and reliable system. The Company was also ordered during the hearing to provide the ROE for the Company's Mississippi operation. That ROE is 10.2% for baseline investments and 12.0% for Supplemental Growth Rider tariff.[176]

F. Special Contracts

OAG witness Watkins raised issues in this proceeding concerning the special contracts the Company has with seventeen industrial customers.[177] Mr. Watkins argues that the reasonableness of these special contracts should be determined in this rate proceeding. The Company does not concur with Mr. Watkins that the treatment of revenue generated, or which might have been generated, under these previously approved contracts should be determined in this rate case. Mr. Watkins' testimony related to the special contracts can only be classified as unsubstantiated. There are three broad issues he deals with related to the contracts: (1) the alleged lack of information Atmos provided; (2) the validity of the process of the review and acceptance of those contracts by the Commission; and, (3) the allocation of 50% of the "discounted" revenue to shareholders.

As to the first issue, Mr. Watkins claims repeatedly that Atmos failed to provide information related to the contracts. That allegation was totally refuted by Mr. Smith's rebuttal and surrebuttal testimony. Mr. Smith testified on page 2 of his surrebuttal testimony: "Mr. Watkins has essentially had all current special contracts in hand since the Company provided its initial response to OAG DR 1-212 on August 28, 2013". He goes on to say on the next page that the Company's supplemental response filed on November 18, 2013 merely included the

[176] *See* Response 1-01, *Atmos Responses to Data Requests from Hearing Held on January 23, 2014*, Case No. 2013-00148, filed February 3, 2014; *see also* Response 1-11, *Atmos Responses to Data Request from Hearing Held on January 23, 2014*, Case No. 2013-00148, filed February 3, 2014.
[177] *See* Direct Testimony of Glenn Watkins (Watkins Direct) at p.32, line 12.

Commission-stamped copy of those same contracts. Mr. Watkins complained about the Company's responses to his data requests concerning special contracts being insufficient or untimely. Copies of all special contracts were in Mr. Watkins possession on August 28, 2013, which was the due date for responses to the Attorney General's Initial Data Requests. He had the name of the customer, the date of the initial contract and the terms of the agreement. This was all that could be located by the Company at that time. Upon additional searching, copies of the Commission "stamped" contracts, along with supporting financial data was located and promptly provided to Mr. Watson.[178]

The second major point of contention raised by Mr. Watkins is that the special contracts Atmos has executed with a small group of its industrial customers (17 out of approximately 400 industrial customers), have not been thoroughly analyzed by the Commission. For example, on page 36 of his Direct Testimony, Mr. Watkins says he could find no indication that these discounted rates were either contested, questioned, or fully evaluated. He repeated that belief at the hearing, emphasizing that no supporting information had been supplied to the Commission to justify the contracts.[179] Had Mr. Watkins made even a passing effort to verify his statements, he would have seen on page 8 of Mr. Smith's Rebuttal Testimony, references from two Commission cases that specifically detail the information filed by Atmos to justify the need for and the reasonableness of the contracts.

In Case No. 95-010, the Commission, in its review of the special contracts, discussed the specific revenue impact in an order dated June 13, 1995 where it stated:

[178] *See* Atmos Energy Corporation's Supplemental Response to AGs First Data Requests, Case No. 2013-00148, Filed November 18, 2013.

[179] January 23, 2014 Hearing, VR 19:28.

> In its Summary of Revenue at Present Rates (Schedule 2, pare 1 of 2) at Tab 25 in the application, Western included an adjustment to reduce revenues by $700,000 for "Additional Contract Reformation". On page 2 of that schedule Western provided an analysis of test year revenues from special contracts which includes sales and transportation volumes and the contract rates in effect. . . .
>
> In a subsequent case cited by Mr. Smith, the Commission said:
>
> Special contracts are reviewed by the Commission to ensure that they are not subsidized by the general customers. In each of these cases (of review of the special contracts) each customer has an interstate pipeline in close proximity to its premises, and, therefore easy access to competing sources of natural gas. The special contracts were used to retain the customers' load on the WKG system. Case Nos. 96-096; 96-113; 96-185; 96-278; 96-295; and 96-424, Order dated July 17, 1997.

In Item 30 of Atmos' data requests to the OAG, Mr. Watkins was asked if Atmos' Special Contracts in Kentucky have been reviewed and accepted by the Kentucky Public Service Commission. His response was: "I have insufficient information to respond to this question". In Item 31, he was asked to confirm that he is aware that each of the Company's contracts for negotiated gas service and rates has been accepted by the Kentucky PSC. His response was: "Unknown". Yet, at the hearing, he admitted that the "tariff" [the contract] had been approved and that Atmos was legally entitled to charge the contract rates.[180] These contradictions between his testimony and his data responses not only undermine the credibility of his allegations, they are prime examples of the lack of substance and credibility of Mr. Watkins' testimony generally.

The third issue relates to the 50% allocation of the "discounted" contract rate. Mr. Watkins was asked to provide the reference to cases where he had recommended a portion of

[180] January 23, 2014 Hearing at 19:26.

special contract "discounts" be allocated to shareholders.[181] He referred to another response and his testimony. Neither of those referenced items provides any indication of the case citations requested.[182] His testimony at the hearing was also unresponsive. He said he did not recall recommendations related to a 50% allocation of revenue "discounts" to shareholders.[183] His only justification for the allocation is that it is "fair".[184]

In his response to Atmos' DR1-37, Mr. Watkins, was asked to validate his statement:

"To the extent that Atmos negotiates rate discounts in its distribution rates and affiliate also provides gas supply to the same customer, the potential for mischief exists."

His response was: "See response to 36 (a), (b) and (c). With respect to the relevance of Mr. Watkins testimony on page 38, lines 18 through 20, the statement is self-explanatory and a matter of common sense". None of the referenced items validated his unsupported allegation. Yet, in his response to Atmos' DR1-73 data requests, Mr. Watkins said that he was **unaware of any instance** where a special contract customer of Atmos was solicited by Atmos to purchase gas through its affiliate. Again, Mr. Watkins has made an allegation that he ultimately admits is unsupported by any facts.

It is crucial to emphasize that all of the existing special contracts: (1) were filed with the Commission in accordance with applicable law and the Commission's prior orders; (2) were supported by a financial analysis that established the revenue generated by the special contract rates covered all variable costs and contributed to the Company's fixed costs (3) were reviewed

[181] See Response 1-74, *Attorney General's Responses to Data Requests of Atmos Energy Corporation*, Case No. 2013-00148.
[182] See Response 1-74, *Attorney General's Responses to Data Requests of Atmos Energy Corporation*, Case No. 2013-00148.
[183] January 23, 2014 Hearing at 19:14.
[184] January 23, 2014 Hearing at 19:17.

and accepted by the Commission; (4) were stamped by the Commission Staff's Tariff Department; and, (5) the revenues generated by these special contracts were included in each of the Company's subsequent rate cases before the Commission.

To accept Mr. Watkins recommendation that in this proceeding, the Commission should effectively "disallow" these previously approved contracts by allocating to the shareholders 50% of the difference between the special contract rates and the Company's filed general tariff rates, would be manifestly unwarranted and unjust. Mr. Watkins erroneously views these special contracts as a source of "lost revenue", when in fact these contracts provide revenue benefiting the ratepayer that would otherwise be lost without the Company's endeavors to keep these loads by negotiating rates that avoided bypass.

Mr. Watkins has repeatedly claimed both in his pre-filed testimony and at the hearing, that Atmos has not provided, to use his words, a "shred of evidence" to support these contracts.[185] Mr. Watkins claims are without merit. The Company provided copies of each special contract to Mr. Watkins; provided copies of the financial analysis previously submitted to the Commission with each contract; and compiled documentation and maps not maintained by the Company in its ordinary course of business in an attempt to satisfy Mr. Watkins' requests. Company witness Gary Smith, who was personally involved in the negotiations of these contracts, and personally prepared the supporting financial data, testified that bypass remains a viable option for each of these customers.[186] Neither Mr. Watkins, nor any other witness brought forth credible evidence that bypass is no longer a viable option for these customers.

G. Cost of Service.

[185] January 23, 2014 Hearing, VR at 19:16; Watkins Direct, p.36, lines 11-16.
[186] January 23, 2014 Hearing, VR at 17:58 – 18:01

The Company's allocation of the proposed revenue requirement by class is based on the Cost of Service (COS) study performed by Paul H. Raab. Mr. Raab testified that while all classes are making positive contributions to rate of return, the residential class is providing less than the system average return.[187] All other classes are providing a return greater than the system average return. Mr. Raab's study clearly indicates that the residential class should receive a larger increase than the other customers on Atmos' system.[188] The Company's proposed allocation moves the classes closer to an equalized rate of return, but not all the way.[189] This partial movement is in recognition of gradualism.

The Company's proposed allocation of the revenue requirement among classes of customers as a percentage of total revenue, changes only slightly from the current allocation. For example, under current rates, the Residential class is contributing approximately 60% of total revenue. Under the new proposed rates, the residential class continues to contribute approximately 60% to total revenue.[190] The same holds true for the remaining classes.

Mr. Raab's cost of service study reflects the traditional manner of determining what it actually costs for the Company to service its various classes of customers. His model is not designed to allocate the revenue requirements in any particular fashion. His model is to track and determine costs based on well-defined and well established methods. Mr. Watkins' methods, on the other hand, appear to be designed more to allocate the burden of the revenue requirement among the customer classes than to assign costs.

Mr. Raab testified, as did Mr. Watkins, that the fundamental difference in their cost

187 Direct Testimony of Paul Raab (Raab Direct) at p.16, lines 15-19.
188 Raab Direct, p.17, lines 10-13.
189 Raab Direct, p.17, lines 17-20.
190 Raab Direct, Exhibit PHR-2, p.1.

studies is the treatment of distribution mains. Mr. Raab allocates those costs based on customers and demand.[191] Mr. Watkins allocates costs based on commodity and demand.[192] Mr. Raab's methodology focuses on the demand customers place on the distribution system. Mr. Watkins' methodology focuses on the volume each class of customers places on the system. The result is that Mr. Watkins places more of the cost on non-residential customer classes. Mr.Raab's methodology, generally referred to as a zero intercept method, has been used by many cost study experts and has been widely accepted, including by this Commission. For example, in Application of Delta Natural Gas Company for an Adjustment of Rates the Commission accepted its cost study, which utilized the zero intercept method.[193]

In his testimony related to the Cost of Service Study, Mr. Watkins has provided misleading responses or uninformative responses. For example, in Atmos DR 1-63 to Mr. Watkins, he was asked to provide all analysis as well as regulatory orders that supported his claim that: "[t]he Peak and Average approach is the most fair and equitable method to assign natural gas distribution mains costs to the various customer classes." His response was: "Please refer to Mr. Watkins' Direct Testimony, page 11, line 11 through page 19, line 7". A review of the referenced pages shows no regulatory orders adopting his assumption.

At the hearing, Mr. Watkins was asked to provide any orders supporting his position. His response was that he has testified in over 500 rate cases, yet with that number of cases, he still could not provide one situation supporting his position.[194] Again contradicting his Direct Testimony, Mr. Watkins testified at the hearing that methods other than the Peak and Average

---

[191] January 23, 2014 Hearing, VR at 14:38.
[192] January 23, 2014 Hearing, VR at 14:39.
[193] Order, p.24, dated October 21, 2010, KPSC Case No. 2010-00116, *Application of Delta Natural Gas Company, Inc. for an Adjustment of Rates*.
[194] January 23, 2014 Hearing, VR at 19:11.

can be equitable.[195]

In addition to the lack of evidence and contradictory testimony, Mr. Watkins in several instances refused to verify or validate his testimony. For example, in response to Staff DRs 12 and 13, Mr. Watkins refused to provide supporting calculations.[196] He did so again at the hearing when asked by the staff to provide a revised cost study.[197]

Mr. Watkins did not cite any case indicating that his methodology has been adopted by this Commission.[198] When asked at the hearing by the Staff to support his methodology by providing certain additional calculations and schedules, he refused, just as he refused to provide the Staff with calculations in his response to Staff DRs 12 and 13.[199] This refusal to participate in the evidentiary verification of the case should justify the outright rejection of his proposed Cost of Service Study. Selectively providing some data while refusing to provide possibly damning data, is not the choice of the witness. Without a complete record, the staff and Commission cannot reach a decision supported by substantial evidence. The only conclusion that can be drawn from Mr. Watkins' testimony is contradictory and unsupported by facts. The Commission should disregard his proposals and give his testimony the weight and credibility it deserves – none.

Even though the Company's proposed allocation of the revenue requirement among the customer classes, assigns more cost to the residential class than Mr. Watkins proposes, it should be noted that Mr. Raab's cost of service study shows that the proposed monthly base residential

---

[195] January 23, 2014 Hearing, VR at 19:09-19:10.
[196] *See* Responses to Staff 1-12 and Staff 1-13. *OAG Response to Atmos Requests for Information*, Case No. 2013-00148, filed November 6, 2013.
[197] January 23, 2014 Hearing, VR 19:32 – 19:33.
[198] January 23, 2014 Hearing, VR at 19:11.
[199] January 23, 2014 Hearing VR 19:32 – 19:33.

charge of $16.00 per month would need to be increased to approximately $31.00 per month to cover their part of the Company's fixed costs.[200]

H. Depreciation

Atmos requests the Commission to approve the depreciation study performed by Dane A. Watson, PE CDP. Mr. Watson's study is composed of three components: (1) Atmos Energy Corporation – Kentucky Depreciation Rate Study at September 30, 2012, attached as DAW-1 to Mr. Watson's Direct Testimony; (2) Atmos Energy Corporation – Kentucky Mid-States General Office Depreciation study at September 30, 2012, attached as DAW-2 to Mr. Watson's Direct Testimony; and, (3) Shared Services Unit Depreciation Rate Study at September 30, 2010, attached as DAW-3 to Mr. Watson's Direct Testimony.[201]

Mr. Watson also sponsored and supported Atmos' request to implement Vintage Group Amortization for its Kentucky General Amortized Plan Assets in FERC Accounts 391-399 (excludes Accounts 390, 392 & 396).[202]

Consistent with the FERC Rule AR-15, Mr. Watkins' depreciation expense for Vintage Group Amortization in the above stated accounts, provides for the amortization of general plant over the same life as recommended in his study (with a separate amortization to allocate deficit or excess reserve). At the end of the amortized life, property will be retired from the books.[203] Implementation of the Vintage Group Amortization will not affect the total annual expense accrued by the Company, but simply provides for the timely retirement of assets and simplifies

[200] January 23, 2014 Hearing VR 14:47 -14:49; *see also*, Rebuttal Testimony of Paul Raab (Raab Rebuttal), Exhibit PHR-3, page 2 of 7.
[201] Direct Testimony of Dane A. Watson ("Watson Direct") at p.5, lines 6-9.
[202] Watson Direct at p.5, lines 9-12.
[203] Watson Direct at p.9, lines 4-5.

accounting for general plant property.[204] Both FERC and several state public utility commissions have approved this approach, including Colorado and Louisiana for Atmos in particular.[205]

The depreciation study performed by Mr. Watson analyzed and developed depreciation recommendations at an account level. The resulting annual depreciation accrual amounts and depreciation rates are at the account level and should be approved by the Commission. Neither the Company's depreciation studies, nor its recommended depreciation rates, were contested in this case.

I. <u>Other Tariff matters</u>.

1. <u>Margin Loss Rider (MLR)</u>

The MLR will allow the Company to recover, between rate cases, 50% of any lost margin related to: (1) future economic development contracts under the Company's existing Economic Development Rider; (2) future discounts pursuant to the Alternative Fuel Responsive Flex provisions of T-3 and T-4 service; and, (3) new special contracts related to industrial by-pass candidates. The Company has not entered into any economic development contracts or special contracts since 2009.[206] The Company did utilize the Flex Provision in February 2010. The revenue lost was $3,543 of which $1771.50 would have passed through the MLR if it had been in effect.[207] The EDR is designed as an economic development tool; whereas special contracts are limited to industrial customers to avoid bypass.[208]

2. <u>System Development Rider (SDR)</u>

---

[204] Watson Direct at p.9, lines 9-11.
[205] Watson Direct at p.9, lines 15-19.
[206] Hearing Response 1-03, *Atmos Energy Corporation's Responses to Data Requests from Hearing Held on January 23, 2014*, Case No. 2013-00148.
[207] Hearing Response 1-03, *Atmos Energy Corporation's Responses to Data Requests from Hearing Held on January 23, 2014*, Case No. 2013-00148.
[208] January 23, 2014 Hearing, VR 12:16.

The SDR is intended to allow the Company to recover specific investment related to economic development initiatives that cannot be assigned to a specific customer or group of customers. It is designed to be an economic development tool. The SDR would be applicable to all tariff sales service to the Company's G-1 and G-2 customers. There are no projects currently that the Company would intend to use the SDR.[209] The primary difference between the EDR and the SDR is that the former would normally be customer specific and the later would be area specific.[210]

3. NGV

This tariff revision is designed to enable sales customers that do not qualify for transportation service to be able to offer CNG as an alternative fuel for vehicles.

4. Door Tag Fee

The Company is proposing to implement a new "door tag" procedure for which a $10.00 fee will be charged. The purpose of this new procedure is to lower the number of service disconnects by providing the customer an extra notice as well as the avoidance of the higher cost of reconnection.[211] This procedure has been used successfully in the Company's West Texas division since 2003.[212]

5. Changes to the Company's Transportation Services Minimum Threshold

The Company proposes no changes to its current threshold of 9,000 Mcf per year. Although Stand Energy was permitted to intervene concerning this issue, it provided no testimony. The Company believes that the threshold is at an appropriate level and is line with

[209] January 23, 2014 Hearing, VR 11:44.
[210] January 23, 2014 Hearing, VR 13:40.
[211] January 23, 2014 Hearing, VR 11:50 – 11:51.
[212] January 23, 2014 Hearing , VR 11:54; *see also*, Hearing Response 1-04, *Atmos Energy Corporation's Responses to Data Requests from Hearing Held on January 23, 2014*, Case No. 2013-00148.

other LDCs in Kentucky.

6. Pipeline Replacement Program

Since beginning the bare steel replacement program in mid-2011, Atmos has completed replacement of 12 miles of high pressure main, 28 miles of distribution main and associated appurtenances.[213] Additionally, Atmos Energy has retired or replaced over 2000 service lines and associated meter sets.[214] These replacements target aging bare steel infrastructure and enhance the safety and reliability of gas supply for the communities Atmos Energy serves. The meter sets have been replaced with new meters or regulators and relocated to accessible location for meter reading or emergency response. The new service lines have been installed with excess-flow devices which add an enhanced level of safety for the customers. In several instances, entire low pressure systems have been eliminated which improves service reliability.[215] Atmos has invested in new technology that allows detailed mapping of these replacement projects showing service detail and ensuring locatability using wireless devices. Atmos has completed infrastructure renewal in many of its service territories including: Bowling Green, Russellville, Horse Cave, Cave City, Glasgow, Mayfield, Hopkinsville, Owensboro, Marion, Madisonville, Princeton, Campbellsville, Harrodsburg and Lancaster.[216]

The Company makes annual filings that project the anticipated PRP related capital investment and recovers the return and related cost of service components on that investment through the PRP Rider. The annual investment forecast is the best forecast available for the amount the Company plans to invest at the time each filing is made. In each PRP filing following a

[213] Napier Direct, p.15, lines 1-4.
[214] Napier Direct, p.15, lines 3-6.
[215] Napier Direct, p.15, lines 10-11
[216] Napier Direct, p.15, lines 13-17.

completed fiscal year of PRP investment, the Company trues-up the revenue requirement and recoveries associated with the most recently completed fiscal year. The difference between the actual and filed for revenue requirement is included in the PRP Rider rates of the current year's PRP filing to protect customers and the Company from variances in levels of anticipated investment.

The revenue requirement in this proceeding includes PRP investment only through September 30, 2014 (FY 2014).[217] The level of PRP investment for FY 2014 is projected to be $20 million.[218] PRP investment for October 2014 through September 2015 will be addressed in the Company's 2014 PRP filing to be made on or before August 1, 2014.[219] The amount included in the test year is $15,779,792, which is the portion of that $20 million budgeted for December 1, 2013 - Sept 30, 2014.[220] While the Company will plan to make PRP investments in October and November of calendar 2014, those amounts will be budgeted and included in the Company's annual PRP filing which will be made in August of 2014.[221] The PRP expenditures for those two months are not included in the test period of this case.[222]

7. Wireless Meter Reading (WMR)

Atmos has proposed a capital project that is not part of the 2013 Kentucky direct capital budget - the Wireless Meter Reading project (WMR). Rate base is forecasted to include

[217] Waller Direct, p.9, lines 6-12; *see also*, Company Response to Staff 2-34, *Atmos Responses to Staff's Second Request for Information*
[218] Napier Direct, p.16, lines 4-5
[219] Waller Direct at p.9, lines 13-23 and p.10 lines 1-4.
[220] Waller Direct at p.9, lines 13-23 and p.10 lines 1-4; *see also*, Company Response to Staff 3-15, *Atmos Energy Corporation's Responses to Staff's Third Request for Information*.
[221] Waller Direct at p.9, lines 13-23 and p.10 lines 1-4; *see also*, Company Response to Staff 2-38, *Atmos Responses to Staff's Second Request for Information*.
[222] Waller Direct at p.9, lines 13-23 and p.10 lines 1-4; *see also*, Company Response to Staff 2-38, *Atmos Responses to Staff's Second Request for Information*.

$2,117,328 for the WMR program.[223]

The WMR project involves the installation of 20,000 end points in various Atmos locations within Kentucky. Atmos will implement installation targeting locations where the Company utilizes contract meter readers, locations where there will be a reduction in work force due to retirements and relocation, and areas where meter reading is costly due to time per read. By targeting these high-cost locations Atmos Energy aims to reduce O&M expenses over time in several ways through the WMR project. The automated process of WMR allows the human error factor to be removed and the more accurate readings result in fewer calls to the call center, fewer re-read requests and fewer billing adjustments resulting from manual meter reading errors.[224]

The devices will be installed on all classes of customers. One exception would be for large volume commercial, industrial or transportation customers, who may already have electronic flow measurement installed. That equipment will not be replaced with WMR devices.[225] No timeframe has been established at this time for full implementation in Kentucky.[226]

The WMR transmitting devices will be attached to selected meter reading routes in the Atmos service area. Once the devices are installed and programmed, each configuration will be validated for accuracy. Once the WMR device is validated, Atmos will begin to bill customers with the WMR reading each month thereafter.[227]

---

[223] Company Response to OAG 1-054, *Atmos Energy Corporation's Responses to Attorney General's First Data Requests.*
[224] *See* Napier Direct, p.13.
[225] Company Response to OAG 1-056, *Atmos Energy Corporation's Responses to Attorney General's First Data Requests.*
[226] Company Response to OAG 1-057, *Atmos Energy Corporation's Responses to Attorney General's First Data Requests.*
[227] Company Response to Staff DR 2-59(a), *Atmos Responses to Staff's Second Request for Information.*

The WMR device is installed by removing the existing meter reading index, installing the transmitter on the meter, then reinstalling the original index to the WMR device. Devices exist for virtually all models of meters in the Kentucky service area. In the event that a meter is not compatible with the WMR device, then that meter would be changed. Any disruption of service for the customer would be scheduled to accommodate the customer.[228]

The WMR system being utilized by Atmos is the FlexNet System by Sensus. The system operates on private FCC licensed frequencies reserved for the Company's use. The WMR device, base station systems, over the air protocol, and head end systems are all proprietary to Sensus and is a complete system end-to-end. The system was selected due to its long range transmitting capability and limited infrastructure needed to collect the data from the meters. In 2006, a thorough evaluation of various vendors and technology was conducted and the FlexNet system was selected.[229]

The device on the meter transmits only limited data: 1) the device serial number 2) a stream of approximately two weeks of meter readings 3) **no** personal data, account number or other identifying data about the customer and 4) the system is coded in a proprietary format and transmitted across private FCC licensed frequencies.[230] The device is battery operated and has a manufacturer warranty of 20 years. During the first 10 years, the device replacement is at 100%. Then beginning in year 11 through year 20, Atmos Energy will pay a gradually increasing percentage of the replacement value, i.e., year 11 - 40%. This increases 5% per year until the end of the 20 year warranty period. The service life of the device is projected to be at least 20 years,

[228] Company Response to Staff DR 2-59(b), *Atmos Responses to Staff's Second Request for Information.*
[229] Company Response to Staff DR 2-59(c), *Atmos Responses to Staff's Second Request for Information.*
[230] Company Response to Staff DR 2-59(d), *Atmos Responses to Staff's Second Request for Information.*

but likely longer.[231]

The device installed is not a meter. The WMR device simply collects and counts the revolutions of the meter electronically and duplicates the readings that are captured mechanically by the meter index.[232]

Once the device is programmed, a thorough verification process is performed over a two month period to assure that the WMR data being transmitted matches the physical reading on the meter. Since the meter index remains on the meter, it can always be used to verify that the WMR reading matches the index reading by a simple audit of the device with a programming tool. Manual and visual inspections of the gas meter will be conducted every three years, to verify integrity of the meter set and complete Atmospheric Corrosion surveys as required.[233]

The WMR project will result in savings, primarily from the reduction of labor costs from manual reading processes; however, the Company's experience in other WMR implementations has been to only reduce meter reading staff through attrition rather than forced reduction. This approach allows meter reading personnel to transition to other service related activity and ensures a good quality of service to customers. Given this approach, no net WMR related savings are anticipated during the test period because it will take some time after the installation to realize these labor savings. Over time, labor will be reduced and net WMR savings will be removed from future O&M costs in future rate proceedings.[234]

8. Weather Normalization Adjustment (WNA)

[231] January 23, 2014 Hearing, VR at 15:15; *see also* Company Response to OAG DR 1-047(e), *Atmos Energy Corporation's Responses to Attorney General's First Data Request.*
[232] January 23, 2014 Hearing, VR at 14:55; *see also* Company Response to OAG DR 1-047(f), *Atmos Energy Corporation's Responses to Attorney General's First Data Request.*
[233] Company Response to Staff 2-59(h), *Atmos Responses to Staff's Second Request for Information.*
[234] January 23, 2014 Hearing, VR 14:57; *see also* Company Response to Staff 2-59(e), *Atmos Responses to Staff's Second Request for Information.*

The Company's current weather normalization adjustment was last approved for a three (3) year period by the Commission in 2011.[235] The Company has requested the Commission to make its WNA permanent, as the Commission has done with other distribution companies.[236]

The Company uses the 30 year NOAA for its WNA. Several questions were propounded by Staff as to other data sets that could be used for the WNA.[237] Company Witness Martin testified that the Company was amendable to using a different data set. The Company's main concern is that whatever data set the Commission decides Atmos should use, that it be same for both rate making purposes and for the Company's WNA tariff purposes.[238]

IV. SUMMARY OF MR. OSTRANDER'S PROPOSED ADJUSTMENTS

Mr. Ostrander has proposed seven (7) O & M adjustments, and three (3) rate base adjustments. The basic flaw in Mr. Ostrander's testimony related to the O&M adjustments is his failure to apply the correct standard of review. He admits that the application should be reviewed according to applicable Commission regulations.[239] This case was filed according to the future test year regulations. However, throughout his testimony, Mr. Ostrander refers to the use of historical data and known and measurable adjustments. He also consistently makes his adjustments from 2012 actuals, rather than the base period as required by Kentucky administrative regulations. Historical data may be useful for comparison purposes, but not for making adjustments to a fully forecasted period. Although Mr. Ostrander certainly has the right to disdain fully forecasted test period rate cases, he doesn't have the right to ignore Kentucky regulations which require pro forma adjustments to the base period. Because of his improper

[235] KPSC Case No. 2011-00205
[236] *See* Martin Direct, p.26, lines 3-17
[237] January 23, 2014 Hearing, VR at 11:28 – 11:32.
[238] January 23, 2014 Hearing, VR at 11:29.
[239] January 23, 2014 Hearing, VR at 18:27.

starting point and his improper future test year analysis, his adjustments are not valid and cannot be used as a basis for modifying Atmos' proposed adjustments.

The following is a summary of each of his adjustments and a summary of the Company's response to each.

A. BCO Adjustment #1:. Remove Duplicative CSS Maintenance Fees.

(1) Mr. Ostrander proposes to remove $51,262 of duplicative CSS maintenance fees.

(2) Atmos concurs with this adjustment.

B. BCO Adjustment #2: Remove 2.7% Inflation Factor

(1) Mr. Ostrander recommends that the 2.7% escalation factor utilized by the Company as part of Atmos' calculation of its forecasted test period adjustments to "Other O & M Expenses" be disallowed, resulting in a downward adjustment to the Company's O & M expense in the forecasted test year of $496,907.

(2) The Company believes that the 2.7% CPI adjustment is a valid and widely accepted method of forecasting future increases in prices and has specific applicability to Atmos. However, if the Commission determines otherwise, after correcting for Mr. Ostrander's admitted errors, the appropriate adjustment would be $171,804.

C. BCO Adjustment #3: Adjust DGO and SSU Allocated Expense

(1) Mr. Ostrander alleges that Atmos' forecasted DGO and SSU expenses are excessive and 50% should be disallowed, resulting in a downward adjustment of $1,492,500.

(2) Atmos disagrees with this proposed adjustment for the following reasons: (i) the increase in DGO and SSU O & M costs for test year do **not** represent "significant and

unusual" increases in underlying O & M costs as alleged by Mr. Ostrander. To the contrary, the increase in DGO and SSU allocated costs resulted from the re-allocation of these costs following the sale by Atmos of its Georgia operations. This re-allocation was calculated and applied in accordance with Atmos Cost Allocation Manual (CAM), which has been on file with the Commission since 2001. The re-allocation is also consistent with Atmos' treatment of allocated costs in prior Kentucky rate cases where the percentage of DGO and SSU of O & M expenses allocated to Kentucky was **reduced** by reason of an acquisition or merger; (ii) no portion of the debt attributable to the purchase of the Georgia assets has been borne by the Kentucky ratepayers; (iii) Mr. Ostrander has provided no support or evidence to contradict any of the above; and, (iv) Mr. Ostrander's selection of a 50% reducer is arbitrary and unsupported by credible evidence.

D. BCO Adjustment #4: Adjust Payroll Benefits and Taxes

(1) Mr. Ostrander proposes an adjustment to the Company's payroll and benefits expense for the test period to remove $1,212,712. Mr. Ostrander's primary justification is that the increase in the test period payroll and benefits is considerably higher than actuals for the period ending December 31, 2012. As he has done with several other of his adjustments, Mr. Ostrander then arbitrarily selects 50% as the magic number to use in reducing the Company's payroll and benefits expense without supporting data or evidence to explain or justify 50%. He applies his 50% "reducer" to the amount of increase of test year payroll and benefits over 2012 **actuals**.

(2) Mr. Ostrander's proposed Adjustment was and is riddled with errors and inconsistencies. When the Company pointed out to Mr. Ostrander that he had erroneously

included $3,171,527 of benefits expense twice, he acknowledged his error. But rather than simply making the mathematical correction to remove the "double dip", he completely changed the method for calculating his proposed adjustment to come up with a "new and improved" revised adjustment. Mr. Ostrander's proposed adjustment to payroll and benefits should be rejected in full because: (a) it is based on adjustments to 2012 **actuals** rather than to the base period; and (b) it is based on an arbitrary "reducer" of 50%, which is not supported by any substantive evidence in the record.

E. BCO Adjustment #5: Remove 50% of employee incentive compensation.

(1) In this adjustment, Mr. Ostrander proposes to reduce employee incentive compensation by 50%, resulting in a downward adjustment to O & M expense for the test year of $582,228.

(2) Atmos believes that the level of employee incentive compensation included in this case is fair and reasonable and should be allowed by the Commission as a legitimate cost of doing business.

F. BCO Adjustment #6: Imputed CCS Cost Savings.

(1) Mr. Ostrander's Adjustment #6 proposes to impute $97,599 of cost savings related to the CSS, as well as remove $426,251 from Atmos' rate base related to the CSS.

(2) As to the imputing of cost savings, Mr. Ostrander relies on preliminary internal estimates made to the Company's Board of Directors back in 2010 as "proof" that the CSS would produce operational cost savings in the test year ending November 30, 2014. The CSS implementation just occurred in May, 2013, and it is therefore too early to be able to reasonably identify and quantify cost savings. Mr. Ostrander does not, and cannot, refute this testimony. To

the contrary, he relies on preliminary projections from a 2010 Board of Directors presentation as his proof. Mr. Ostrander further confounds this adjustment by making the assumption that since the system ended up costing more, there should be more savings. Mr. Ostrander has provided no credible justification for this assumption.

As to the reduction in rate base of $426,751, Mr. Ostrander theorized that 50% of the increase in costs from the originally proposed 2-stage implementation to a one stage implementation should be disallowed. There is no sound ratemaking principle that requires the Company to reduce rate base and corresponding depreciation expense when a prudent investment costs more than originally estimated. The increase in investment in this instance enhanced, rather than detracted from the prudency of the overall CSS investment. Failure to make the additional investments necessary to ensure a successful implementation once it was evident that the additional investments were needed would have in fact been an imprudent decision by the Company.

G. BCO Adjustment #7: Remove NOLC ADIT

(1) Mr. Ostrander proposes to remove $22,221,329 of net operating loss carry forward from Atmos' rate base.

(2) Mr. Ostrander's primary justification for his adjustment is his opinion that removal of NOLC will not cause a violation of the tax normalization rules for utilities. The Company urges the Commission to reject this OAG Adjustment for two primary reasons:

(i) Inclusion of NOLC in the Company's ADIT is consistent with widely accepted, sound rate making principles; and, (ii) removal of the NOLC would violate the tax normalization rules which would have a devastating financial impact on the Company and its ratepayers.

H. BCO ADJUSTMENT #8: Reduce Bad Debt Expense

(1) Mr. Ostrander recommends in this adjustment to remove $25,048 from the Company's operating expenses in the test year relating to bad debt expenses.

(2) The Company agrees with this adjustment.

As has previously been referenced, the credibility of witnesses and the weight to be given to their testimony is the province of the Commission.[240] Atmos believes that the testimony of the OAG's witnesses lacks the degree of credibility needed to support a factual conclusion. In rejecting the testimony of expert witnesses in Administrative Case 273, Order of July 5, 1984 at page 8, the Commission said that the statements of the witnesses "...**are opinions which are unsupported by any "factual evidence."** That same standard should be applied in this case and the testimony of Mr. Watkins and Mr. Ostrander rejected for purposes of supporting the OAG's positions on the issues they have raised.

V. SUMMARY OF RELIEF REQUESTED

Overall Financial Summary

Line No.	Description	Supporting Schedule Reference	Base Jurisdictional Revenue Requirement	Forecasted Jurisdictional Revenue Requirement
	(a)	(b)	(c)	(d)
1	Rate Base	B-1	$222,461,642	$252,914,292
2	Adjusted Operating Income	C-1	$ 16,673,366	$ 13,460.079

[240] *Energy Regulatory Commission v. Ky. Power Company*, 605 S.W.2d 46, 50 (Ky. App. 1980).

3	Earned Rate of Return (line 2 divided by line 1)	J-1.1	7.49%	5.32%
4	Required Rate of Return	J-1	8.64%	8.53%
5	Required Operating Income (line 1 times line 4)	C-1	$ 19,220.686	$ 21,573.589
6	Operating Income Deficiency (line 5 minus line 2)	C-1	$ 2,547,320$	8,113,510
7	Gross Revenue Conversion Factor	H	1.64757	1.64757
8	Revenue Deficiency (line 6 times line 7)		$ 4,196,888	$ 13,367,575
9	Revenue Increase Requested	C-1		$ 13,367,575
10	Adjusted Operating Revenues	C-1		$ 155,374,969
11	Revenue Requirements (line 9 plus line 10)	C-1		$ 168,742,544

CONCLUSION

The Company filed its application for an adjustment of rates pursuant to the Commission's regulations and in conformity with prior rate applications. Given the over-whelming evidence supporting the application, the consistency of the application with Commission regulations and precedent and the credibility of the Company's witnesses, it cannot be questioned that it has met its burden of proof. In stark contrast, the OAG's lack of evidence, the error riddled adjustments proposed by his witnesses and their contradictory testimony offered to justify his positions cannot be the basis of a finding supported by substantial evidence.

For these reasons, Atmos requests that the Commission find that its proposed rates are fair, just and reasonable and that the proposed tariff changes be approved.

Submitted by:

Douglas Walther
Atmos Energy Corporation
P.O. Box 650205
Dallas, TX 75265
972-855-3102

Mark. R. Hutchinson
Wilson, Hutchinson, Poteat & Littlepage
611 Frederica St.
Owensboro, KY 42303
270-926-5011
Fax: 270-926-9394
Randy@whplawfirm.com

John N. Hughes
124 West Todd Street
Frankfort, KY 40601
Fax: None
jnhughes@fewpb.net

Attorneys for Atmos Energy Corporation

\ATMOS\RATE CASE 2013\BRIEF02172014

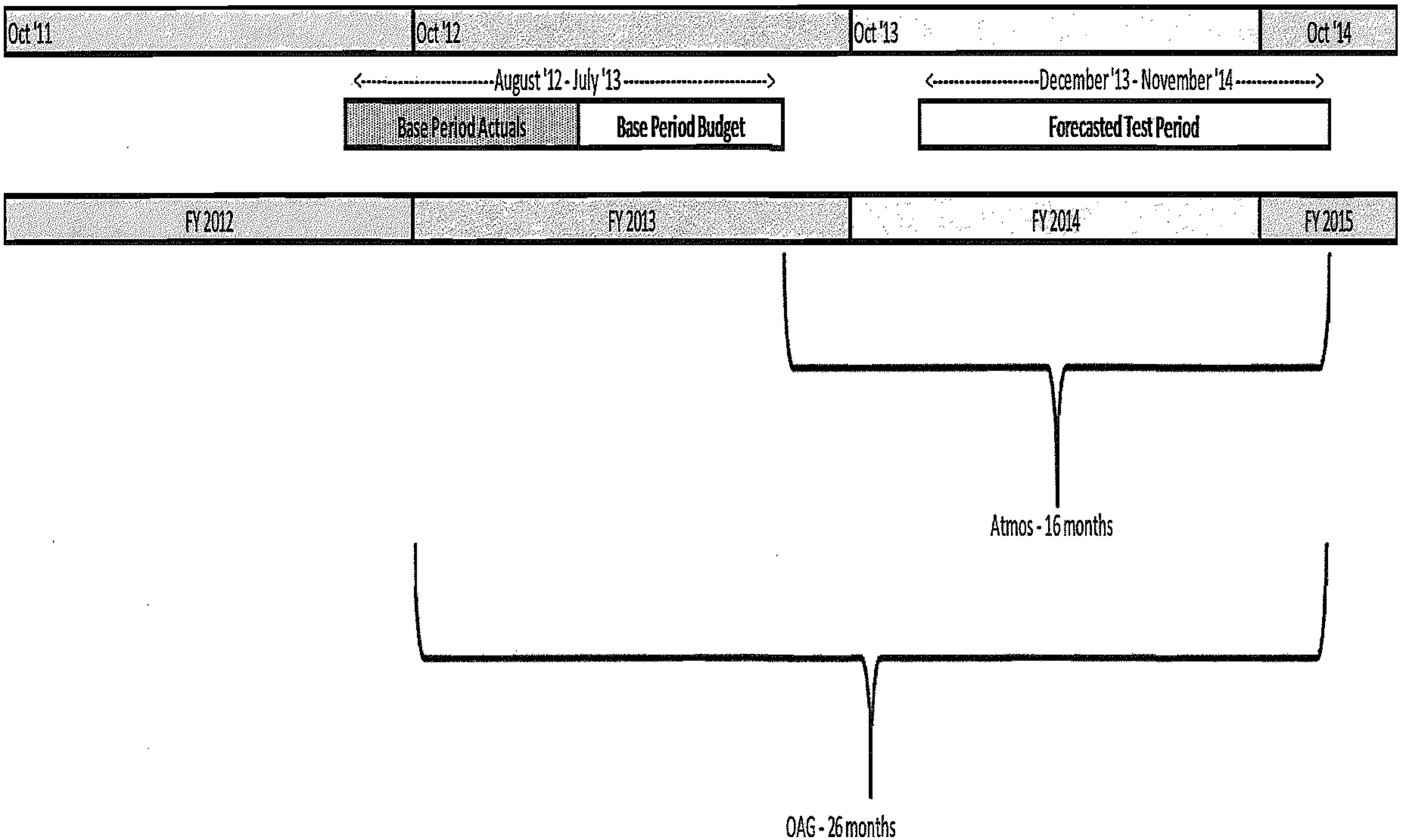
Kentucky Office of Attorney General
Adjust Payroll and Benefits
Atmos Electric Corporations
Forecasted Test Period November 30, 2014

A	B	C	D	E
	ORIGINAL EXHIBIT BCO-2 Schedule A-7			
Line	Description	Expense		Total Expense & Capital
1	**Kentucky Direct - OAG Adjustment**			
2	OAG Payroll	$6,519,624		$10,866,041
3	Atmos Payroll	$8,500,877		$11,478,317
4	OAG Adjustment - Payroll	($1,981,253)		
5				
6	OAG Benefits	$2,783,674		$5,567,348
7	Atmos Benefits	$3,161,528		$6,796,500
8	OAG Adjustment - Benefits	($377,854)		
9	OAG Total Adjustment - Kentucky Direct	($2,359,107)		
10				
11	**SSU & DGO - OAG Adjustment**			
12	OAG Payroll	$4,688,394		$6,794,774
13	Atmos Payroll	$4,815,551		$6,801,742
14	OAG Adjustment - Payroll	($127,157)		
15				
16	OAG Benefits	$2,281,930		$4,563,860
17	Atmos Benefits	$2,364,456		$5,118,967
18	OAG Adjustment - Benefits	[illegible]		
19	OAG Total Adjustment - SSU & OAG	($209,683)		
20				
21	**OAG Total Adjustment - Kentucky & S**	($2,568,790)		
22				
23		Total Proposed Expense Increase for			
24		Base and Forecasted Test Period			
25	Type of Payroll	Atmos $	Atmos %	OAG $	OAG %
26	Kentucky Direct - Payroll	$3,772,630	80%	$1,791,377	38%
27	Kentucky Direct - Benefits	$1,003,687	47%	$625,833	29%
28	SSU & DGO - Payroll	$519,373	12%	$392,216	
29	SSU & DGO - Benefits	$206,419	10%	$123,884	6%
30	Total Expense Increase Proposed	$5,502,109	41%	$2,933,310	22%

Kentucky Office of Attorney General
Adjust Payroll, Benefits & Taxes
Atmos Energy Corporation
Forecasted Test Period November 30, 2014

Revised Exhibit BCO-2
Revised Schedule A-7

A	B	C	D	E	F	G	H
	REVISED EXHIBIT BCO-2 SCHEDULE A-7						
Line	Description	Expense	Capital	Total Expense & Capital	% Increase Expense	% Increase Total	Reference
1	**Kentucky Direct - OAG Adjustment**						
2	***PAYROLL (with payroll taxes)***						
3	Atmos Payroll - Forecasted Test Period	$5,339,350	$6,138,968	$11,478,318			OAG 117 & 120
4	OAG Actual 2012 Payroll	$4,728,247	$5,719,869	$10,448,116			OAG 120
5	Increase from Actual 2012 to Nov. 2014 Forecasted	$611,103	$419,099	$1,030,202	12.92%	9.86%	
6	Disallow 50% of Atmos Forecasted Increase	50%					
7	**OAG Adjustment - Payroll**	$305,552					
8	**OAG Payroll Increase Allowed for Base and Forecasted Test Period**		6.46%				
9							
10	***BENEFITS***						
11	Atmos Benefits - Forecasted Test Period	$3,161,528	$3,634,972	$6,796,500			OAG 117 & 120
12	OAG Actual 2012 Benefits	$2,157,841	$2,296,037	$4,453,878			OAG 120
13	Increase from 2012 Actual to Nov. 2014 Forecasted	$1,003,687	$1,338,935	$2,342,622	46.51%	52.60%	
14	Disallow 50% of Atmos Forecasted Increase	50%					
15	**OAG Adjustment - Benefits**	$501,844					
16	**OAG Benefit Increase Allowed for Base and Forecasted Test Period**		23.26%				
17							
18	***PAYROLL TAXES***						
19	Atmos Payroll Taxes - Forecasted Test Period	$364,805	$419,434	$784,239			OAG 120
20	OAG Actual 2012 Payroll Taxes	$338,313	$550,944	$889,257			OAG 120
21	Increase from 2012 Actual to Nov. 2014 Forecasted	$26,492	-$131,510	-$105,018	7.83%	-11.81%	
22	Disallow 50% of Atmos Forecasted Increase	50%					
23	**OAG Adjustment - Payroll Taxes**	$13,246					
24	**OAG Payroll Tax Increase Allowed for Base and Forecasted Test Period**		3.92%				
25							
26	**SSU & DGO - OAG Adjustment**						
27	***PAYROLL***						
28	SSU/DGO Payroll - Forecasted Test Period	$4,815,551	$1,986,191	$6,801,742			OAG 120
29	OAG Actual 2012 Payroll	$4,296,178	$2,300,690	$6,596,868			OAG 120
30	Increase from Actual 2012 to Nov. 2014 Forecasted	$519,373	-$314,499	$204,874	12.09%	3.11%	
31	Disallow 50% of Atmos Forecasted Increase	50%					
32	**OAG Adjustment - Payroll**	$259,687					
33	**OAG Payroll Increase Allowed for Base and Forecasted Test Period**		6.04%				
34							
35	***BENEFITS***						
36	SSU/DGO Benefits - Forecasted Test Period	$2,364,465	$2,754,502	$5,118,967			OAG 120
37	OAG Actual 2012 Benefits	$2,158,046	$1,493,042	$3,651,088			OAG 120
38	Increase from 2012 Actual to Nov. 2014 Forecasted	$206,419	$1,261,460	$1,467,879	9.57%	40.20%	
39	Disallow 50% of Atmos Forecasted Increase	50%					
40	**OAG Adjustment - Benefits**	[illegible]					
41	**OAG Benefit Increase Allowed for Base and Forecasted Test Period**		4.78%				
42							
43	***PAYROLL TAXES***						
44	SSU/DGO Payroll Taxes - Forecasted Test Period	$390,787	$117,298	$508,085			OAG 120
45	OAG Actual 2012 Payroll Taxes	$332,437	$172,224	$504,661			OAG 120
46	Increase from 2012 Actual to Nov. 2014 Forecasted	$58,350	-$54,926	$3,424	17.55%	0.68%	
47	Disallow 50% of Atmos Forecasted Increase	50%					
48	**OAG Adjustment - Payroll Taxes**	$29,175					
49	**OAG Payroll Tax Increase Allowed for Base and Forecasted Test Period**		8.78%				
50							
52	**OAG Total Adjustment - Payroll, Benefits & Payrol**	$1,212,712					


Oct '11
Oct '12
Oct '13
Oct '14
<----August '12 - July '13---->
Base Period Actuals
Base Period Budget
<----December '13 - November '14---->
Forecasted Test Period
FY 2012
FY 2013
FY 2014
FY 2015
Atmos - 16 months
OAG - 26 months

Regulatory Research Associates
REGULATORY FOCUS

Jan. 27, 2014

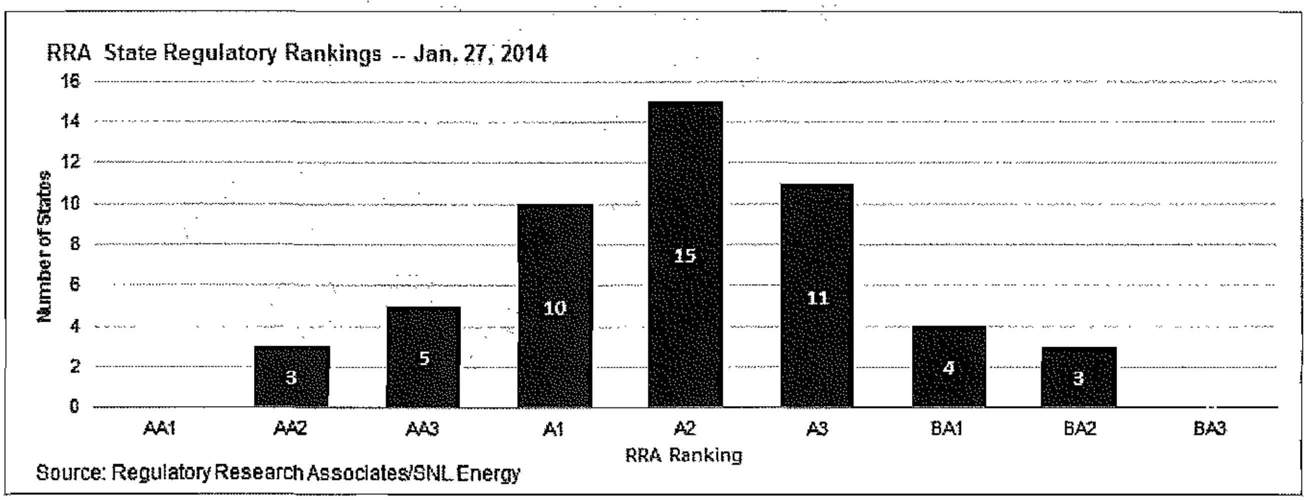
STATE REGULATORY EVALUATIONS

~ Including an Overview of RRA's ranking process ~

As part of RRA's regulatory research effort, we evaluate the regulatory climates of the 50 states and the District of Columbia on an ongoing basis. The evaluations are assigned from an investor perspective and indicate the relative regulatory risk associated with the ownership of securities issued by each jurisdiction's electric and gas utilities. Each evaluation is based upon our consideration of the numerous factors affecting the regulatory process in the state, and is changed as major events occur that cause us to modify our view of the regulatory risk accruing to the ownership of utility securities in that individual jurisdiction.

We also review our evaluations when we update our Commission Profiles, and when we publish this quarterly comparative evaluations report. The majority of factors that we consider are discussed in Focus Notes articles, Commission Profiles, or Final Reports. We also consider information obtained from contacts with commission, company, and government personnel in the course of our research. The final evaluation reflects our assessment of the probable level and quality of the earnings to be realized by the state's utilities as a result of regulatory, legislative, and court actions.

RRA maintains three principal rating categories, Above Average, Average, and Below Average, with Above Average indicating a relatively more-constructive, lower-risk regulatory environment from an investor viewpoint, and Below Average indicating a less-constructive, higher-risk regulatory climate from an investor viewpoint. Within the three principal rating categories, the numbers 1, 2, and 3 indicate relative position. The designation 1 indicates a stronger (more constructive) rating; 2, a mid-range rating; and, 3, a weaker (less constructive) rating. We endeavor to maintain about an equal number of ratings above the average and below the average. The graph below depicts the current distribution of our rankings. (***A more detailed explanation of our ratings process can be found in the Appendix that begins on page 3***.)



Our previous "State Regulatory Evaluations" report was published Oct. 22, 2013, at which time we noted four ratings changes that followed our periodic audit of our ranking framework. Specifically, we: raised our ranking of Connecticut regulation to Below Average/2 from Below Average/3; lowered our ranking of the District of Columbia to Average/3 from Average/2; raised our ranking of Georgia regulation to Above Average/3 from Average/1; and, lowered our ranking of North Carolina to Average/1 from Above Average/3. Please note that these adjustments were not triggered by a specific regulatory event, but arose from a need to realign our rankings to more accurately reflect each jurisdiction's comparative risk. We are making no further ratings changes at this time.

Above Average

1

2

Alabama
Virginia
Wisconsin

3

Florida
Georgia
Indiana
Iowa
Mississippi

Average

1

California
Colorado
Hawaii
Kentucky
Louisiana
Michigan
North Carolina
North Dakota
South Carolina
Tennessee

2

Alaska
Delaware
Idaho
Kansas
Maine
Minnesota
Missouri
Nebraska
Nevada
New York
Ohio
Oklahoma
Utah
Washington
Wyoming

3

Arizona
Arkansas
District of Columbia
Massachusetts
New Hampshire
New Jersey
Oregon
Pennsylvania
Rhode Island
South Dakota
Vermont

Below Average

1

Montana
New Mexico
Texas
West Virginia

2

Illinois
Connecticut
Maryland

3

ALPHABETICAL LISTING

Alabama - AA/2
Alaska – A/2
Arizona - A/3
Arkansas –A/3
California – A/1
Colorado - A/1
Connecticut – BA/2
Delaware - A/2
Dist. of Col. - A/3
Florida – AA/3
Georgia – AA/3
Hawaii - A/1
Idaho - A/2
Illinois - BA/2
Indiana - AA/3
Iowa - AA/3
Kansas – A/2
Kentucky - A/1
Louisiana – A/1
Maine - A/2
Maryland – BA/2
Massachusetts – A/3
Michigan - A/1
Minnesota - A/2
Mississippi - AA/3
Missouri - A/2
Montana - BA/1
Nebraska – A/2
Nevada – A/2
New Hampshire – A/3
New Jersey - A/3
New Mexico - BA/1
New York – A/2
North Carolina - A/1
North Dakota - A/1
Ohio - A/2
Oklahoma - A/2
Oregon - A/3
Pennsylvania - A/3
Rhode Island - A/3
South Carolina - A/1
South Dakota - A/3
Tennessee - A/1
Texas - BA/1
Utah - A/2
Vermont - A/3
Virginia - AA/2
Washington - A/2
West Virginia – BA/1
Wisconsin - AA/2
Wyoming - A/2

Appendix: Explanation of RRA ratings process

As noted above, RRA maintains three principal rating categories, Above Average, Average, and Below Average, with Above Average indicating a relatively more constructive, lower-risk regulatory environment from an investor viewpoint, and Below Average indicating a less constructive, higher-risk regulatory climate. Within the three principal rating categories, the numbers 1, 2, and 3 indicate relative position. The designation 1 indicates a stronger (more constructive) rating; 2, a mid-range rating; and, 3, a weaker (less constructive) rating within each higher-level category. Hence, if you were to assign numeric values to each of the nine resulting categories, with a "1" being the most constructive from an investor viewpoint and a "9" being the least constructive from an investor viewpoint, then Above Average/1 would be a "1" and Below Average/3 would be a "9."

The rankings are subjective and are intended to be comparative in nature. Consequently, we do not use a mathematical model to determine each state's ranking. However, we endeavor to maintain a "normal distribution" with an approximately equal number of rankings above and below the average. The variables that RRA considers in determining each state's ranking are largely the broad issues addressed in our State Regulatory Reviews/Commission Profiles and those that arise in the context of rate cases and are discussed in RRA Rate Case Final Reports. Keep in mind that the rankings reflect not only the decisions rendered by the state regulatory commission, but also take into account the impact of the actions taken by the governor, the legislature, the courts, and the consumer advocacy groups. The summaries below are intended to provide an overview of these variables and how each can impact a given regulatory environment.

Commissioner Selection Process/Membership--RRA looks at how commissioners are selected in each state. All else being equal, RRA attributes a greater level of investor risk to states in which commissioners are elected rather than appointed. Generally, energy regulatory issues are less politicized when they are not subject to debate in the context of an election. Realistically, a commissioner candidate who indicates sympathy for utilities and appears to be amenable to rate increases is not likely to be popular with the voting public. Of course, in recent years there have been some notable instances in which energy issues in appointed-commission states have become gubernatorial/senatorial election issues, with detrimental consequences for the utilities (e.g., Illinois, Florida, and Maryland, all of which were downgraded by RRA when increased politicization of the regulatory process became apparent.)

In addition, RRA looks at the commissioners themselves and their backgrounds. Experience in economics and finance and/or energy issues is generally seen as a positive sign. Previous employment by the commission or a consumer advocacy group is sometimes viewed as a negative indicator. In some instances, new commissioners have very little experience or exposure to utility issues, and in some respects, these individuals represent the highest level of risk, simply because there is no way to foresee what they will do or how long it will take them to "get up to speed."

Commission Staff/Consumer Interest--Most commissions have a staff that participates in rate proceedings. In some instances the Staff has a responsibility to represent the consumer interest and in others the Staff's statutory role is less defined. In addition, there may or may not be: additional state-level organizations that are charged with representing the interests of a certain class or classes of customers; private consortia that represent certain customer groups; and/or, large-volume customers that intervene directly in rate cases. Generally speaking, the greater the number of consumer intervenors, the greater the level of uncertainty for investors. The level of risk for investors also depends on the caliber and influence (political and otherwise) of the intervening parties and the level of contentiousness in the rate case process. RRA's opinion on these issues is largely based on past experience and observations.

Rate Case Timing/Interim Procedures--For each state commission, RRA considers whether there is a set time frame within which a rate case must be decided, the length of any such statutory time frame, the degree to which the commission adheres to that time frame, and whether interim increases are permitted. Generally speaking, we view a set time frame as preferable, as it provides a degree of certainty as to when any new revenue may begin to be collected. In addition, shorter time frames for a decision generally reduce the likelihood that the actual conditions during the first year the new rates will be in effect will vary markedly from the test period utilized (a discussion of test periods is provided below) to set new rates. In addition, the ability to implement all or a portion of a proposed rate increase on an interim basis prior to a final decision in a rate case is viewed as constructive.

Return on Equity--Return on equity (ROE) is perhaps the single most litigated issue in any rate case. There are two aspects RRA considers when evaluating an individual rate case and the overall regulatory environment: (1) how the authorized ROE compares to the average of returns authorized for energy utilities nationwide over the 12 months, or so, immediately preceding the decision; and, (2) whether the company has been accorded a reasonable opportunity to earn the authorized return in the first year of the new rates. (It is important to note that even if a utility is accorded a "reasonable opportunity" to earn its authorized ROE, there is no guarantee that the utility will do so.)

With regard to the first criteria, RRA looks at the ROEs historically authorized for utilities in a given state and compares them to utility industry averages (the benchmark statistics are available in *RRA's Major Rate Case Decisions Quarterly Updates*). Intuitively, authorized ROEs that meet or exceed the prevailing averages at the time established are viewed as more constructive than those that fall short of these averages.

With regard to the second consideration, in the context of a rate case, a utility may be authorized a relatively high ROE, but factors, e.g., capital structure changes, the age or "staleness" of the test period, rate base and expense disallowances, the manner in which the commission chooses to calculate test year revenue, and other adjustments, may render it unlikely that the company will earn the authorized return on a financial basis. Hence, the overall decision may be negative from an investor viewpoint, even though the authorized ROE is equal to or above the average. (RRA's *Rate Case Final Reports* provide a detailed analysis of each fully-litigated commission decision.)

Rate Base and Test Period--As noted above, a commission's policies regarding rate base and test year can impact the ability of a utility to earn its authorized ROE. These policies are often outlined in state statutes and the commission usually does not have much latitude with respect to these overall policies. With regard to rate base, commissions employ either a year-end or average valuation (some also use a date-certain). In general, assuming rate bases are rising, i.e., new investment is outpacing depreciation, a year-end valuation is preferable from an investor viewpoint. Again this relates to how well the parameters used to set rates reflect actual conditions that will exist during the rate-effective period; hence, the more recent the valuation, the more likely it is to approximate the actual level of rate base being employed to serve customers once the new rates are placed into effect. Some commissions permit post-test-year adjustments to rate base for "known and measurable" items, and, in general, this practice is beneficial to the utilities.

Another key consideration is whether state law and/or the commission generally permits the inclusion in rate base of construction work in progress (CWIP), i.e., assets that are not yet, but ultimately will be, operational in serving customers. Generally, investors view inclusion of CWIP in rate base for a cash return as constructive, since it helps to maintain cash flow metrics during a large construction phase. Alternatively, the utilities accrue allowance for funds used during construction (AFUDC), which is essentially booking a return on the construction investment as a regulatory asset that is recoverable from ratepayers once the project in question becomes operational. While this method bolsters earnings, it does not augment cash flow.

With regard to test periods, there are a number of different practices employed, with the extremes being fully-forecasted (most constructive) on the one hand and fully historical (least constructive) on the other. Some states utilize a combination of the two, in which a utility is permitted to file a rate case that is based on data that is fully or partially forecast at the time of filing, and is later updated to reflect actual data that becomes known during the course of the proceeding.

Accounting--RRA looks at whether a state commission has permitted unique or innovative accounting practices designed to bolster earnings. Such treatment may be approved in response to extraordinary events such as storms, or for volatile expenses such as pension costs. Generally, such treatment involves deferral of expenditures that exceed the level of such costs reflected in base rates. In some instances the commission may approve an accounting adjustment to temporarily bolster certain financial metrics during the construction of new generation capacity. From time-to-time commissions have approved frameworks under which companies were permitted to, at their own discretion, adjust depreciation in order to mitigate under-earnings or eliminate an over-earnings situation without reducing rates. These types of practices are generally considered to be constructive from an investor viewpoint.

Alternative Regulation--Generally, RRA views as constructive the adoption of alternative regulation plans that: allow a company or companies to retain a portion of cost savings (e.g. fuel, purchased power, pension, etc.) versus benchmark levels; permit a company to retain for shareholders a portion of off-system sales revenues; or, provide a company an enhanced ROE for achieving operational performance and/or customer service metrics or for investing in certain types of projects (e.g., demand-side management programs, renewable resources, new traditional plant investment). The use of ROE-based earnings sharing plans is, for the most part, considered to be constructive, but it depends upon the level of the ROE benchmarks specified in the plan, and whether there is symmetrical sharing of earnings outside the specified range.

Court Actions--This aspect of state regulation is particularly difficult to evaluate. Common sense would dictate that a court action that overturns restrictive commission rulings is a positive. However, the tendency for commission rulings to come before the courts, and for extensive litigation as appeals go through several layers of court review, may add an untenable degree of uncertainty to the regulatory process. Also, similar to commissioners, RRA looks at whether judges are appointed or elected.

Legislation--While *RRA's Commission Profiles* provide statistics regarding the make-up of each state legislature, RRA has not found there to be any specific correlation between the quality of energy legislation enacted and which political party controls the legislature. Of course, in a situation where the governor and legislature are of the same political party, generally speaking, it is easier for the governor to implement key policy initiatives, which may or may not be focused on energy issues. Key considerations with respect to legislation include: how prescriptive newly enacted laws are; whether the bill is clear or ambiguous and open to varied interpretations; whether it balances ratepayer and shareholder interests rather than merely "protecting" the consumer; and, whether the legislation takes a long-term view or is it a "knee-jerk" reaction to a specific set of circumstances.

Corporate Governance--This term generally refers to a commission's ability to intervene in a utility's financial decision-making process through required pre-approval of all securities issuances, limitations on leverage in utility capital structures, dividend payout limitations, ring-fencing, and authority over mergers (discussed below). Corporate governance may also include oversight of affiliate transactions. In general, RRA views a modest level of corporate governance provisions to be the norm, and in some circumstances these provisions (such as ring-fencing) have protected utility investors as well as ratepayers. However, a degree of oversight that would allow the commission to "micromanage" the utility's operations and limit the company's financial flexibility would be viewed as restrictive.

Merger Activity--In cases where the state commission has authority over mergers, RRA reviews the conditions, if any, placed on the commission's approval of these transactions, specifically: whether the company will be permitted to retain a portion of any merger-related cost savings; if guaranteed rate reductions or credits were required; whether certain assets were required to be divested; and, whether the commission placed stringent limitations on capital structure and/or dividend policy.

Electric Regulatory Reform/Industry Restructuring--RRA generally does not view a state's decision to implement retail competition as either positive or negative from an investor viewpoint. However, for those states that have implemented retail competition, RRA considers: whether up-front guaranteed rate reductions were required; how stranded costs were quantified and whether the utilities were accorded a reasonable opportunity to recover stranded costs; the length of the transition period and whether utilities were at risk for power price fluctuations associated with their default service responsibilities during the transition period; how default service is procured following the end of the transition period; and, how any price volatility issues that arose as the transition period expired were addressed.

Gas Regulatory Reform/Industry Restructuring--Retail competition for gas supply is more widespread than is electric retail competition, and the transition was far less contentious, as the magnitude of potential stranded asset costs was much smaller. Similar to the electric retail competition, RRA generally does not view a state's decision to implement retail competition for gas service as either positive or negative from an investor viewpoint. RRA primarily considers the manner in which stranded costs were addressed and how default service obligation-related costs are recovered.

Securitization--Securitization refers to the issuance of bonds backed by a specific existing revenue stream that has been "guaranteed" by regulators. State commissions have used securitization to allow utilities to recover demand-side management costs, electric-restructuring-related stranded costs, environmental compliance costs, and storm costs. RRA views the use of this mechanism as generally constructive from an investor viewpoint, as it virtually eliminates the recovery risk for the utility.

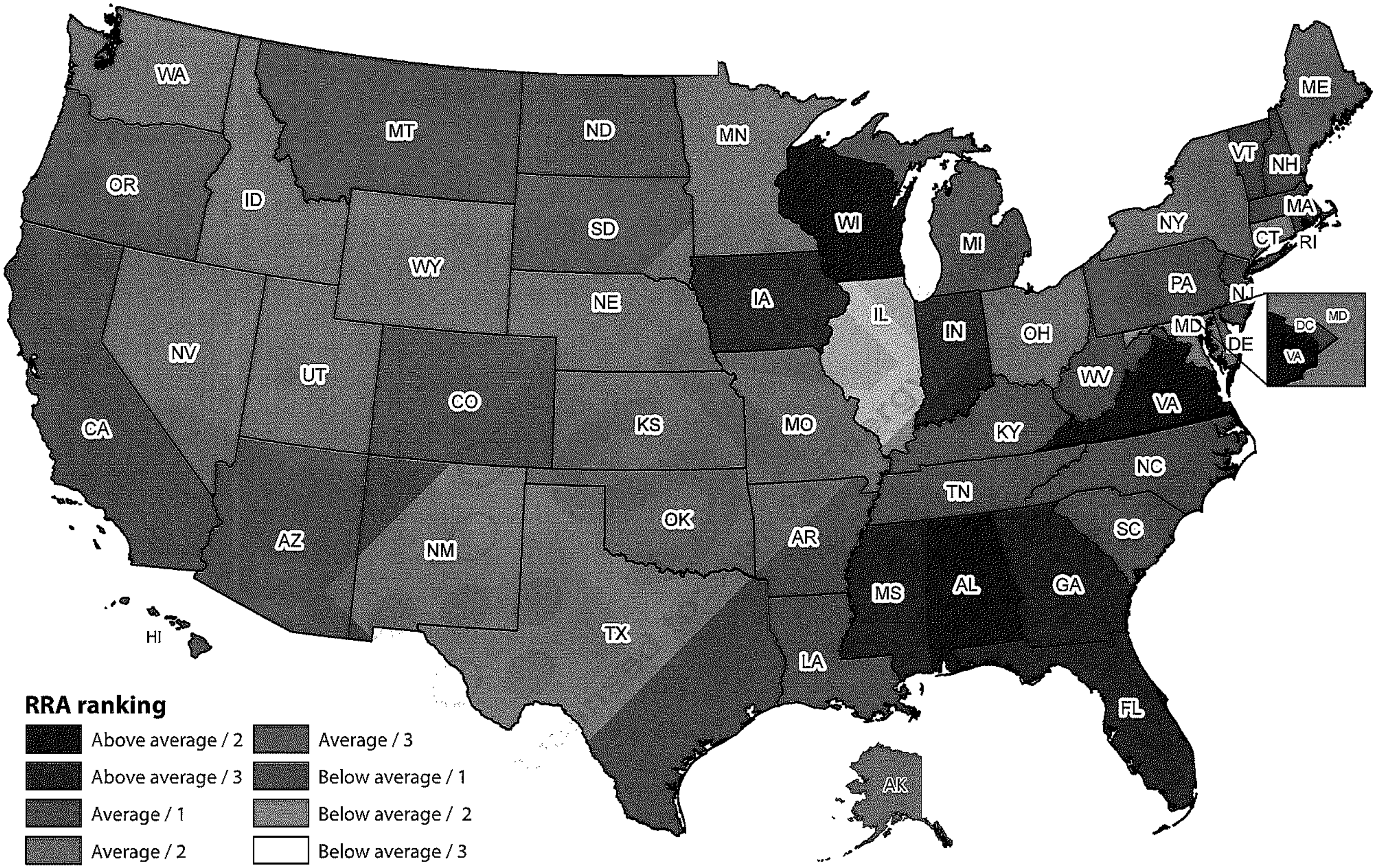
Adjustment Clauses--For many years adjustment clauses have been widely utilized to allow utilities to recover fuel and purchased power costs outside a general rate case, as these costs are generally subject to a high degree of variability. In some instances a base amount is reflected in base rates, with the clause used to reflect variations from the base level, and in others, the entire annual fuel/purchased power cost amount is reflected in the clause. More recently, the types of costs recovered through these mechanisms has been expanded in some jurisdictions to include such items as pension and healthcare costs, demand-side management program costs, FERC-approved transmission costs, and new generation plant investment. Generally, RRA views the use of these types of mechanisms as constructive, but also looks at the frequency with which the adjustments occur, whether there is a true-up mechanism, and whether adjustments are forward-looking in nature. Other mechanisms that RRA views as constructive are weather normalization clauses that are designed to remove the impact of weather on a utility's revenue and decoupling mechanisms that may remove not only the impact of weather, but also the earnings impacts of customer participation in energy efficiency programs. Generally, an adjustment mechanism would be viewed as less constructive if there are provisions that limit the utility's ability to fully implement revenue requirement changes under certain circumstances, e.g., if the utility is earning in excess of its authorized return.

Integrated Resource Planning--RRA generally considers the existence of a resource planning process as constructive from an investor viewpoint, as it may provide the utility at least some measure of protection from hindsight prudence reviews of its resource acquisition decisions. In some cases, the process may also provide for pre-approval of the ratemaking parameters and/or a specific cost for the new facility. RRA views these types of provisions as constructive, as the utility can make more informed decisions as to whether it will proceed with a proposed project.

Renewable Energy/Emissions Requirements--As with retail competition, RRA does not take a stand as to whether the existence of renewable portfolio standards or an emissions reduction mandate is positive or negative from an investor viewpoint. However, RRA considers whether there is a defined pre-approval and/or cost-recovery mechanism for investments in projects designed to comply with these standards. RRA also reviews whether there is a mechanism (e.g., a percent rate increase cap) that ensures that meeting the standards does not impede the utility's ability to pursue other investments and/or recover increased costs related to other facets of its business. RRA also looks at whether incentives, such as an enhanced ROE, are available for these types of projects.

Rate Structure--RRA looks at whether there are economic development or load-retention rate structures in place, and if so, how any associated revenue shortfall is recovered. RRA also looks at whether there have been steps taken over recent years to reduce/eliminate inter-class rate subsidies, i.e., equalize rates of return across customer classes. In addition, RRA considers whether the commission has adopted or moved towards a straight-fixed-variable rate design, under which a greater portion (or all) of a company's fixed costs are recovered through the monthly customer charge, thus according the utility greater certainty of recovering its fixed costs.

RRA state regulatory rankings



Source: SNL Energy/RRA
As of Jan. 27, 2014
Map credit: Jesse Bellavance

SNL Financial