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April 23, 2019

Gwen Pinson
Executive Director
Public Service Commission
211 Sower Blvd.
Frankfort, KY 40601

Re: Atmos Energy Corporation:
Case No. 2018-00281

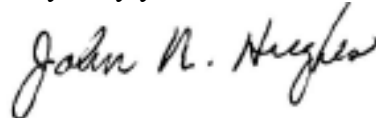
Dear Ms. Pinson:

Atmos Energy Corporation submits its Post Hearing Brief.

I certify that the electronic filing is a complete and accurate copy of the original documents to be filed in this matter, which will be filed within two days of this submission and that there are currently no parties in this proceeding that the Commission has excused from participation by electronic means.

If you have any questions about this matter, please contact me.

Very truly yours,



John N. Hughes

And

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Even if the Commission were to accept the Company's filing exactly as it was proposed in this rate proceeding, the Company would still have the lowest average gas bills in Kentucky.²

Thus, the Office of the Attorney General's ("OAG") position in this case puts the Company in an impossible position. Despite the Company managing its investment to keep customer bills at an affordable level, the OAG would have the Commission disallow prudent safety and reliability projects as being "too expensive" despite the fact that the Company offers the most affordable gas service in the commonwealth.

The record in this case is replete with evidence that the projects proposed by the Company represent prudent safety enhancements.³ No evidence was offered into the record to suggest that the Company should not replace bare steel, or low pressure systems, or Aldyl-A type plastics. No evidence was offered into the record to rebut the fact that the Company has the most affordable gas bills in the commonwealth. The total average bill impact in dispute in this proceeding specifically attributable to the Company's proposed capital projects is less than \$1.50/month per customer.⁴ These capital expenditures are proposed in order to protect human life and property. This case offers the opportunity to enhance safety and reliability while maintaining a balance with the rate impact on customers. Of Mr. Kollen's approximately \$22.5 million of recommendations from the Company's initial filed position, only approximately \$3.2 million of his recommended reduction is a result of limiting the Company's non-bare steel investment.⁵ For comparison purposes, Mr. Kollen's depreciation recommendation results in more than double the impact on the Company's revenues (approximately \$7.4 million) compared to his recommendation to limit

² Atmos Energy's Response to Staff's Second Request, Item 10, Attachment 1.

³ *See, e.g.*, Direct Testimony of Gregory W. Smith ("Smith Direct Testimony"); Rebuttal Testimony of Gregory W. Smith ("Smith Rebuttal Testimony"); Rebuttal Testimony of John S. McDill ("McDill Rebuttal Testimony").

⁴ Rebuttal Testimony of Mark A. Martin ("Martin Rebuttal Testimony") at 12.

⁵ Direct Testimony and Exhibits of Lane Kollen ("Kollen Direct Testimony") at 26; *see also* Kollen Direct Testimony at 5.

the Company's non-bare steel spending.⁶ Thus, while a small portion of the OAG's case rests on the reduction of the Company's non-bare steel spending, the Company would implore the Commission that a critical aspect to ensuring safety and reliability of the Company's system in Kentucky is dependent on the Company continuing its targeted investment for non-bare steel projects.

The OAG points to historic and projected increases in the Company's capital spending and argues that the Company's capital spending is somehow inappropriate. The Company's customers do not focus on changes in capital spending levels, they care about (1) their bills and (2) safe and reliable service. The OAG's proposal would have a minor impact on customer bills while materially impacting overall system safety and reliability.

A. History of the Case

On August 21, 2018, Atmos Energy Corporation ("Atmos Energy" or "Company") filed with the Kentucky Public Service Commission ("Commission") a notice of its intent to electronically 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 September 28, 2018, Atmos Energy filed its application for an adjustment of rates and tariff modifications, effective October 28, 2018. By its letter dated October 5, 2018, the Commission notified Atmos Energy of certain filing deficiencies. On October 12, 2018, the Commission Staff notified Atmos Energy that its application met all minimum filing requirements. On October 26, 2018, the Commission entered an Order, *inter alia*: (1) ordering that Atmos Energy's application be deemed filed as of October 9, 2018; (2) suspending Atmos Energy's proposed rates for six (6) months, up to and including May 7, 2019; and, (3) adopting a procedural schedule for this proceeding. On October

⁶ *Id.*

10, 2018, the OAG filed its motion for full intervention, which was granted by the Commission's Order of October 26, 2018. The OAG is the only intervenor in this proceeding. Following extensive discovery by and among the Company, OAG and Commission Staff, a public hearing on Atmos Energy's application for an adjustment of rates and modification to tariffs was held on April 2 and 3, 2019. By agreement of the OAG and Atmos Energy, post hearing briefs were required to be filed with the Commission by April 23, 2019.

B. Summary of Key Issues

In the order addressed in the testimony of Lane Kollen, the following are the key issues raised in Case No. 2018-00281. Many of these issues relate to matters that were included in the Company's case from last year, which were decided in the Company's favor, yet the OAG has decided to re-litigate.

1. Depreciation Expense

As has been its practice for at least the last twenty years, the Company has proposed to use the Equal Life Group ("ELG") procedure for the calculation of its depreciation expense. The OAG proposes changing to the Average Life Group ("ALG") procedure. The Company believes that the ELG procedure is more appropriate.

2. Termination of PRP Rider

Consistent with the Commission's directive from Case No. 2017-00349, the Company proposed to undertake approximately \$28 million dollars of bare steel replacement in a 12- month period. The OAG has not questioned the prudence of this proposed level of expenditure. The only issue relating to the bare-steel capital expenditures is the manner of recovery for this investment. The OAG believes that the Commission mandated that the Company must lag its recovery of this expenditure and thus be rendered incapable of having an opportunity to earn its awarded ROE on

this prudently incurred investment. The Company interprets the Commission’s prior order as requiring the recovery of this expenditure to be lagged only if the Company seeks to recover it through its permissive PRP Rider. Instead, the Company proposes to recover this investment and future bare steel replacement investment through traditional base rate proceedings. Accordingly, the Company has proposed the termination of the PRP Rider, which it does not intend to use.

3. Non-Bare Steel Capital Expenditures

The Company proposed to hold its overall planned level of capital expenditures constant but reallocate expenditures between bare steel projects and non-bare steel projects in response to the Commission’s Order in Case No. 2017-00349.⁷ Accordingly, the Company limited its bare steel replacement expenditures to \$28 million and allocated the remainder of its capital budget on prudent safety-related non-bare steel replacement work, as well as mandatory growth-related projects.⁸ The Company supported this level of expenditure as being prudent to enhance the safety and reliability of its Kentucky distribution system. The OAG instead proposes that non-bare steel capital expenditures be held at an average of the prior three years’ levels.⁹ The OAG offers no safety evaluation or engineering support for its position, and does not identify which of the projects proposed and undertaken by the Company are imprudent.

4. AFUDC/CWIP

As has been past practice for many rate cases, the Company proposed to include Construction Work in Progress (“CWIP”) as a component of rate base approved by the Commission. In the Company’s prior two fully-litigated rate proceedings, the Commission has

⁷ Atmos Energy’s Response to Staff’s Fourth Request for Information (“Staff’s Fourth Request”), Item 4.

⁸ See Atmos Energy’s Response to Staff’s Third Request for Information (“Staff’s Third Request”), Item 27, Attachment 1. Approximately 89% of the Kentucky Capital Investment outside of bare steel replacement is budgeted to System Integrity and System Improvement.

⁹ Kollen Direct Testimony at 26.

previously specifically identified CWIP as a component of rate base that it approves.¹⁰ For the first time, the OAG proposes to remove CWIP from rate base. The Company does not believe a change is warranted, however, if the Commission were to take the unprecedented step of removing CWIP from the Company's rate base, it would need to make a corresponding adjustment to remove short-term debt from the Company's capital structure. Short-term debt is primarily used to finance CWIP and seasonal gas costs. Seasonal gas costs are already not reflected in rate base. If CWIP were removed from rate base, including short-term debt in capital structure would no longer be appropriate.

5. CWC Results

The Company performed its Cash Working Capital ("CWC") study pursuant to the same methodologies it used in its prior proceeding.¹¹ The OAG has essentially repeated the same arguments that it raised last year. There is no new evidence in the record to support a change from the results of the Company's last base rate case, which the Commission found accurately reflects the working capital needs of the Company.¹²

6. Capital Structure

The Company proposed to use its actual capital structure based on its consolidated capital structure that will be in effect at the time rates are implemented in this case. The only adjustment made to actual capital structure was to reflect a long-term debt refinancing that occurred in March 2019 (this adjustment was supported by the OAG's witness). The Company's methodology for

¹⁰ *Application of Atmos Energy Corporation for an Adjustment of Rates and Tariff Modifications*, Order at 7, Case No. 2013-00148 (Ky. PSC Apr. 22, 2014); *Electronic Application of Atmos Energy Corporation for an Adjustment of Rates and Tariff Modifications*, Order at 5, Case No. 2017-00349 (Ky. PSC May 3, 2018).

¹¹ Direct Testimony of Joe T. Christian ("Christian Direct Testimony") at 4.

¹² *Electronic Application of Atmos Energy Corporation for an Adjustment of Rates and Tariff Modifications*, Order at 16-17, Case No. 2017-00349 (Ky. PSC May 3, 2018)

calculating its capital structure is the same method it used last year and there is no new evidence in the record to support a change from the methodology used in the Company's last base rate case.

7. Return on Equity

The Company, through its expert witness, initially proposed an ROE of 10.4% and the 10.4% is what is reflected in the Company's proposed revenue requirement.¹³ The OAG's witness recommends the continued use of the currently effective ROE of 9.7%.¹⁴

C. Summary of Atmos Energy's Proposed Adjustments and Other Relief

Atmos Energy originally sought Commission approval of an increase in annual revenue of \$14,455,538. Subsequently, the Company acknowledged an upward adjustment of \$54,108 as reflected in Atmos Energy's Response to Staff's Second Request, Item 64. In the course of rebuttal testimony, the Company modified OAG rate of return recommendations, as set forth in the rebuttal testimony of Atmos Energy witness Joe Christian. These modifications were to include effects of Atmos Energy's October 4, 2018 debt issuance, as well as to make a known and measurable adjustment for the Company's March 2019 debt refinance.

As a result of these adjustments, the total impact of the Staff Second Request, Item 64 corrections as well as the modifications made within rebuttal testimony is a downward adjustment of \$135,046, resulting in a request to increase annual revenue of \$14,374,606 as incorporated in Exhibit GKW-R-1 of Company witness Greg Waller's rebuttal testimony. If approved, the new rates will increase revenues sufficiently to provide an overall rate of return on rate base of 7.93% on the adjusted test year rate base of \$496,005,827¹⁵

¹³ Direct Testimony of James H. Vander Weide ("Vander Weide Direct Testimony") at 4.

¹⁴ Kollen Direct Testimony at 47.

¹⁵ Rebuttal Testimony of Gregory K. Waller ("Waller Rebuttal Testimony"), Exhibit GKW-R-1, Schedule A.

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, and mitigate depletion of revenue caused by increased operating costs and capital investments in Kentucky.

D. Legal Overview

Under Kentucky law, the Company is entitled to receive “fair, just and reasonable rates” for the services it provides.¹⁶ There is no single prescribed method for establishing rates.¹⁷ KRS 278.030 and KRS 278.040 expressly grant the PSC plenary rate-making authority. KRS 278.030 provides that “[e]very utility may demand, collect and receive fair, just and reasonable rates for the services rendered or to be rendered by it to any person.”

A utility’s rates must, however, provide enough revenue to cover its operating expenses and the cost of capital.¹⁸ As our own Kentucky high court has stated, when establishing rates, the Commission must ensure the resulting rates will, *inter alia*, “...enable the utility to operate successfully, to maintain its financial integrity [and] to attract capital.”¹⁹

Kentucky law allows a utility to “receive fair, just and reasonable rates for the services rendered or to be rendered by it to any person.” KRS 278.030(1). As Kentucky courts have explained, “there is no litmus test for establishing fair, just and reasonable rates, and there is no single prescribed method for accomplishing that goal.”²⁰

Kentucky follows the rule set forth by the U.S. Supreme Court in Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 591 (1944). Hope made clear that, “[u]nder

¹⁶ KRS 278.030(1).

¹⁷ *Kentucky Industrial Utility Customers, Inc. v. Kentucky Utilities Co.*, 983 S.W.2d 493 (Ky. 1998).

¹⁸ *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

¹⁹ *Commonwealth ex rel Stephens v. South Central Bell Telephone Co.*, 545 S.W.2d 927, 930-31 (Ky. 1976).

²⁰ *Kentucky Indus. Util. Customers, Inc. v. Kentucky Utils. Co.*, 983 S.W.2d 493 (Ky. 1998). *See also National-Southwire Aluminum Co. v. Big Rivers Electric Corp.*, 785 S.W.2d 503 (Ky. Ct. App. 1990).

the statutory standard of 'just and reasonable' it is the result reached not the method employed which is controlling."²¹ This results-oriented approach has been reaffirmed several times.²²

The Hope decision gives the Commission "broad discretion in [the] factors to be considered in rate-making."²³ The Commission may consider a utility's history and development, debt retirement and operating costs.²⁴ Because of the constitutional requirement for non-confiscatory rates, the Hope Court identified "the financial integrity of the company whose rates are being regulated" as one of the major factors to be considered in ratemaking.²⁵ Ensuring financial viability would appear to be the very purpose of having fair, just, and reasonable rates. The United States Supreme Court has also suggested that rates "threatening [a utility's] 'financial integrity'" are "so unjust as to be confiscatory."²⁶ In other words, a utility's rates must provide "enough revenue not only for operating expenses but also for the capital costs of the business."²⁷ Financial integrity of a utility is reflected in the longstanding principle that a "return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate under efficient and economical management to maintain its credit and enable it to raise the money necessary for the proper discharge of its public duties."²⁸ Consequently, when setting rates that are fair, just, and reasonable, the Commission must ensure that the resulting rates will "enable the utility to operate successfully, to maintain its financial integrity, [and] to attract capital."²⁹

²¹ *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944) at 602.

²² *See, e.g., Fed. Power Comm'n v. Memphis Light, Gas & Water Division*, 411 U.S. 458, 474 (1973) ("under Hope Natural Gas rates are 'just and reasonable' only if consumer interests are protected and if the financial health of the pipeline in our economic system remains strong.")

²³ *National Southwire*, 785 S.W.2d at 512-13.

²⁴ *Id.* at 512.

²⁵ *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944) at 603.

²⁶ *Verizon Communs., Inc. v. Fed. Commun. Comm'n*, 535 U.S. 467, 524 (2002) (quoting *Duquesne Light Co.*, 488 U.S. at 307, 312).

²⁷ *Hope*, 320 U.S. at 603.

²⁸ *Bluefield Waterworks v. Public Serv. Comm'n of W Va.*, 262 U.S. 679 (1923).

²⁹ *Commonwealth ex rel Stephens v. South Central Bell Telephone Co.*, 545 S.W.2d 927, 930-31 (Ky. 1976).

Approved rates must “enable the utility to operate successfully, to maintain its financial integrity, to attract capital and to compensate its investors for the risks assumed.”³⁰

1. Future Test Year

KRS 278.190(1) establishes the procedure to be followed when a rate change is sought, referred to as a general rate case. KRS 278.192 states that for the purpose of justifying the reasonableness of a proposed general increase in rate, the commission **shall allow** a utility to utilize either an historical test period. . .or a forward-looking test period Thus, 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 a fully forecasted test period presented in the form of pro forma adjustments to the base period (emphasis added).³¹

In this case, as it has in its previous six rate cases in Kentucky, Atmos Energy elected to proceed with a fully forecasted test period because it believes this method presents a more accurate portrayal of the Company’s revenue requirement by properly aligning the Company’s cost of service with the rates borne by its customers in the same time period. Under KRS 278.190(3), “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 to those expenses, as well as the methodology used to determine its revenue requirement. An applicant in a "future test-period" case may carry its burden by providing the Commission with at least "some assurance that the expense will be incurred."³²

³⁰ *National Southwire*, 785 S.W.2d 503, 512-513 (Ky. 1976).

³¹ 807 KAR 5:001(16)(1)(a)

³² *In the Matter of Alternative Rate Filing Adjustment for Delaplain Disposal Co.*, Order at 12, Case No. 2010-00349 (Ky. PSC Jun. 29, 2011).

2. Withdrawal of PRP

The Company has proposed to withdraw its current PRP tariff as allowed by 807 KAR 5:011:

Section 6. Tariff Addition, Revision, or Withdrawal. (1) A tariff, tariff sheet, or tariff provision shall not be changed, cancelled, or withdrawn except as established by this section and Section 9 of this administrative regulation. (2) A new tariff or revised sheet of an existing tariff shall be issued and placed into effect by: (a) Order of the commission; or (b) Issuing and filing with the commission a new tariff or revised sheet of an existing tariff and providing notice to the public in accordance with Section 8 of this administrative regulation and statutory notice to the commission.

Because the statute allowing tariffs such as the PRP to be withdrawn upon notice to the Commission and the current PRP tariff itself is discretionary, the Company has opted to replace the existing tariff with recovery of the affected costs in a general rate case, consistent with the scope and authority of the applicable PRP statute and regulation. KRS 278.509 provides:

Notwithstanding any other provision of law to the contrary, upon application by a regulated utility, the commission **may allow** recovery of costs for investment in natural gas pipeline replacement programs which are not recovered in the existing rates of a regulated utility. No recovery shall be allowed unless the costs shall have been deemed by the commission to be fair, just, and reasonable (emphasis added).

Atmos Energy has chosen to file a general rate case, rather than the discretionary annual PRP application as allowed by the Company's current tariff:

The PRP Rider **may be filed** annually following the conclusion of the Company's fiscal year on September 30th and no later than January 1. The filing will reflect the impact on the Company's revenue requirements of net plant additions related to bare-steel pipe replacement as offset by operations and maintenance expense reductions during the most recently completed fiscal year ending each September as well as a balancing adjustment to reconcile collections with actual investment for the preceding program year. Such adjustment to the Rider will become effective with meter

readings on and after the first billing cycle of March. (Atmos Tariff, Sheet 38, Approved 5/03/18) (emphasis added).

The purpose of the use of the general rate case is to allow recovery of the current costs of the capital replacement projects proposed by Atmos Energy. The Final Order in Case 2017-00349, Atmos Energy's prior general rate filing, specifically limited PRP recovery of bare steel projects based on the historic cost of the prior years' projects. Such a limitation prevents the Company from earning its authorized return – generally due to regulatory lag. Moreover, such a limitation is contrary to the intent and applicability of the statute. As the Supreme Court said:

KRS 278.192 states that the Commission may allow a utility to use either a historical 12-month test period or a forward-looking 12-month test period to determine the reasonability of a general rate increase. Similarly, 807 KAR 5:001 § 10 requires that applications for general adjustment of rates must be supported by either a historical 12-month test period or a forward-looking 12-month test period. **But nothing requires that a utility can only recover costs for the previous year, rather such test periods are formulated to predict future costs when determining if proposed rates are fair, just, and reasonable.** See footnote [18] See generally 73B C.J.S. Public Utilities § 105 (2010) (" The purpose of using a test year is to establish with a reasonable degree of accuracy revenue and expenses that a public utility will experience during the period when new rates will be in effect.").³³ (Emphasis added).

Atmos Energy's use of the future test year in a general rate case rather than the current PRP tariff accomplishes the result the Court acknowledges is appropriate – the recovery of current costs and the establishment of rates that accurately reflect revenue and expenses for the period those rates will be in effect. By its nature and application, a historical test year delays recovery of current costs and prevents a utility from the opportunity to earn its allowed return – generally referred to as regulatory lag. This is exactly the purpose of the future test year as described by the Commission:

³³ *Kentucky Public Service Com'n v. Commonwealth ex rel. Conway*, 324 S.W.3d 373 (2010), Supreme Court, October 21, 2010, 324 S.W.3d 373, 381.

Theoretically, the purpose of a forecasted test year is to reduce the regulatory lag experienced in historical test period rate cases by forecasting and matching revenue requirements and rates with the actual 12-month period for which the rates will first be placed into effect.³⁴

Restricting the Company to the recovery of historic PRP costs negates the statutory option offered by KRS 278.192.

3. Credibility and Weight of Evidence

Atmos Energy 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 the Company's request.³⁵

In contrast to the evidence provided by Atmos Energy, the OAG has failed to provide credible evidence on the issues it has raised in this case. Its testimony consists solely of opinions of its one witness, who with no legal or factual support, testifies as an expert on all issues in the case. As this Commission has held, when opinions are unsupported by any "factual evidence" they must be rejected.³⁶ Kentucky courts have criticized reliance on testimony supported only on the witness's bare assertion. "Neither Daubert nor the rules of evidence require a trial court 'to admit opinion evidence that is connected to existing data only by the *ipse dixit* of the expert.'"³⁷

It is the Commission that must determine the credibility of the witnesses and the weight to be given to their testimony.³⁸ The weight of evidence is gauged by the credibility of the witnesses.³⁹ "The administrative trier of fact has the exclusive province to pass on the credibility

³⁴ *Adjustment of the Rates of Kentucky-American Water Company*, Order at 12, Case No. 2004-00103 (Ky. PSC Feb. 28, 2005).

³⁵ *Lee v. International Harvester Co.* 373 S.W.2d 418 (Ky, 1963).

³⁶ *Administrative Case No. 273*, Order ¶ 8, (Ky. PSC July 5, 1983).

³⁷ *Goodyear Tire & Rubber Co. v. Thompson*, Ky. 11 S.W.3d 575, 581 (2000).

³⁸ *Energy Regulatory Com. v. Kentucky Power Company*, 605 S.W.2d 46, 50 (Ky. App. 1980).

³⁹ *An Adjustment of Rates of Union Light and Power Company and Abandonment of Facilities*, Order, Case Nos. 8419

of the witnesses and the weight of evidence.”⁴⁰ When closely analyzed and with very limited exceptions, the unsupported opinions of the OAG’s witness as explained throughout this Brief, are insufficient to overcome the detailed factual and financial information provided by the Company.

E. Revenue and Expenses

1. Division Composite Factors

As he did in the Company’s 2017 rate case, Mr. Kollen has recommended that the Commission modify the Company’s composite allocation factor so that it is based on an equal weighing of gross direct property plant and equipment and total operating expenses.⁴¹ Laura K. Gillham, Director of Accounting Services for the Company, filed rebuttal testimony explaining why Mr. Kollen’s recommendation should not be followed by the Commission. Ms. Gillham was present at the hearing and with the exception of one question from the Commission Staff there were no questions for Ms. Gillham concerning her rebuttal testimony or concerning Mr. Kollen’s recommendation on the Company’s composite allocation factor.⁴² Mr. Kollen made the identical recommendation in the Company’s 2017 rate case, supported by the same arguments. No new or additional support was provided by Mr. Kollen in this case. The Commission declined to accept Mr. Kollen’s recommendation in the last case and should do the same in this case.

2. Depreciation Expense

Since at least 1999, Atmos Energy has utilized the Equal Life Group (“ELG”) procedure in all of its prior rate case filings in Kentucky.⁴³ Consistent with that practice, Atmos Energy’s depreciation rates in this case were determined by the ELG procedure. The OAG has recommended, through the testimony of Lane Kollen, that Atmos Energy be compelled by the

and 8373 (Ky. PSC May 25, 1982).

⁴⁰ *Energy Regulatory Com.*, 605 S.W.2d at 50.

⁴¹ Kollen Direct Testimony at 50.

⁴² April 2, 2019, Video Transcript of Evidence at 10:22.

⁴³ Rebuttal Testimony of Dane A. Watson (“Watson Rebuttal Testimony”) at 1.

Commission to adopt the Average Life Group (“ALG”) procedure in determining its depreciation rates. For the reasons set forth below, Atmos Energy requests the Commission to reject this recommendation.

Mr. Kollen’s arguments in support of his recommendation can be summarized as follows:

1. The ELG procedure effectively accelerates the depreciation of plant assets compared to the ALG procedure⁴⁴
2. The ELG procedure is susceptible to bias.⁴⁵
3. Under ELG over recovery of depreciation expense can occur due to regulatory lag⁴⁶
4. All other utilities in Kentucky use the ALG procedure.
5. The Commission’s Order of April 13, 2018 in Case No. 2017-00321, In Re: Application of Duke Energy Kentucky, Inc. For An Adjustment of its Electric Rates, etc.

The Company respectfully submits that Mr. Kollen’s arguments, summarized above, do not warrant the Commission compelling Atmos Energy to make such a dramatic change in the manner in which it has historically determined its depreciation rates in Kentucky.

a. The ELG Procedure Accelerates Depreciation Expense

As Mr. Watson testified at the Hearing, the notion that the ELG procedure front-loads depreciation in the early years of depreciable assets and decreases it in the later years, is a common misunderstanding.⁴⁷ A more accurate characterization would be that the ALG procedure is actually a deferral approach compared to ELG.⁴⁸ The ELG procedure simply recognizes that some assets are shorter-lived and should therefore be depreciated over a shorter period and longer-lived

⁴⁴ Kollen Direct Testimony at 11-14.

⁴⁵ *Id.*

⁴⁶ April 3, 2019, Video Transcript of Evidence at 10:43-10:47.

⁴⁷ *Id.* at 9:26.

⁴⁸ Watson Rebuttal Testimony at 11.

assets should be depreciated over their longer life.⁴⁹ The ALG procedure, on the other hand, does not recognize these varying lives of assets within the same group.⁵⁰ The ALG approach does not take into account the shorter lives of some assets within a group and when that occurs you defer the recovery of those assets to a period after the assets retire.⁵¹

Stated differently, the ELG procedure recognizes that individual assets within a group of assets have different lives and therefore should be depreciated over different periods. In contrast, the ALG procedure recognizes that individual assets within a group have different lives, yet, depreciates all assets over the “average” life.⁵² So, depreciation costs for those assets whose depreciable lives have ended prior to the time of the “average” asset will be paid for by the ratepayers who no longer have use of that asset.⁵³ Accordingly, under ALG customers will be paying for assets they did not get the use of.⁵⁴

One of the primary goals of the doctrine of Intergenerational Equity is to assure that customers should pay only for those assets they have use of. The ELG procedure accomplishes that goal. This conclusion is borne out by the opinions of preeminent authorities in the field of depreciation.⁵⁵ OAG Witness Kollen provided no authoritative text in support of ALG.

NARUC has addressed this issue: “[...]his procedure [ELG] permits accruing the full cost of the shorter lived units to the depreciation reserve while they are in service. Thus the longer lived units bear only their own costs.”⁵⁶ Put simply, the ELG procedure more closely aligns revenues and expenses than the ALG procedure.

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *Id.* at 12

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ *Id.* at 9.

⁵⁶ *Id.* at 14.

Mr. Kollen justifies this deferral of depreciation to future customers by arguing that the ALG procedure “smooths the data” by averaging.⁵⁷ But, the effect of this “averaging” is to shift depreciation expense on shorter lived assets to future customers who do not have use of such assets. Mr. Watson has testified not only as to his expert opinion, but also to authoritative text, that this is not the most accurate or preferred approach.⁵⁸

b. The ELG Procedure is Susceptible to Bias

Mr. Kollen also asserts that ALG is preferable because ELG is susceptible to bias.⁵⁹ Since both the ELG and the ALG procedures are in reality projections based on historic facts and presumptions, it would seem that the same could be said for the ALG procedure. But, according to Mr. Kollen, since ELG requires a “...more defined stratification of the data...” it can be biased by the analyst.⁶⁰

The Company respectfully submits this esoteric argument provides little, if any, support in this case for Mr. Kollen’s recommendation. Mr. Watson’s entire depreciation study, including all “stratifications of data” is part of the record in this proceeding. Mr. Kollen, as a self-proclaimed depreciation expert, has presumably analyzed the study in detail. Mr. Kollen has not pointed to one single “stratification” in Mr. Watson’s entire study that indicates bias or manipulation of the data.

⁵⁷ Kollen Direct Testimony at 13.

⁵⁸ Watson Rebuttal Testimony at 9.

⁵⁹ Kollen Direct Testimony at 11.

⁶⁰ *Id.*

c. Regulatory Lag Can Result in Over-Recovery of Depreciation Expense Under ELG

Mr. Kollen has testified that one of the reasons ELG procedures should, in all cases and under all circumstances, be rejected is because it can result in over recovery of depreciation expense due to regulatory lag. This was a topic of discussion at the hearing.⁶¹

Mr. Kollen testified that over recovery of depreciation expense can occur under ELG not only because of “front loading”, which is not an accurate characteristics as discussed above, but also because of regulatory lag.⁶² Mr. Kollen provided an example to illustrate his point. Assume you have a valve with a two year depreciable life. If you only do a depreciation study every five years, then the depreciation rate of 50% on that two year asset will remain at 50% until a new depreciation study is performed and a new rate case is filed to set new rates based on the updated depreciation schedule.⁶³ Mr. Kollen explains that regulatory lag is a result of two factors: (1) the timing of a new depreciation study; and, (2) the timing of a new rate case that sets rates based on the more recent depreciation study.⁶⁴

Is Mr. Kollen’s concern about regulatory lag relevant in this case? The Company submits it is not. The Company has repeatedly affirmed throughout this case that it will be filing annual rate cases. Annual rate filings eliminate one of the two factors referred to by Mr. Kollen. The other factor (the timing of the depreciation study) can also be resolved by requiring the Company to perform new depreciation studies on a cycle that is no longer than the shortest depreciable life of any component in its plant in service. For example, if a Company’s shortest depreciable life of

⁶¹ See, e.g., April 3, 2019, Video Transcript of Evidence at 10:43-10:47.

⁶² April 3, 2019, Video Transcript of Evidence at 10:44.

⁶³ *Id.* at 10:45. It should also be noted that when a two year asset retires at two years, and is replaced with another two year asset, the depreciation rate remains accurate. It should also be noted that the Company’s shortest long-lived asset is five years, not two.

⁶⁴ *Id.* at 10:46.

a plant asset is two years, the Company would be required to perform a new depreciation study every two years.

d. All Other Utilities in Kentucky Use ALG

With the exception of the Duke Energy case discussed below, all other utilities in Kentucky have apparently chosen to use the ALG procedure in their respective rate case filings referred to in the record in this case. Those utilities, based on their unique circumstances, have apparently determined that the ALG procedure is better suited for their purposes. For Atmos Energy, however, the ELG procedure is preferable for various reasons, including: (i) it is more accurate than the ALG procedure; (ii) because it is more accurate, it better matches revenues received from its customers with the expenses that should be borne by those customers who are benefiting from the use of those assets;⁶⁵ and (iii) switching to ALG after 20 years using ELG, would result in an immediate reduction of approximately 30% of the Company's depreciation expense, thereby reducing the Company's revenue requirement by approximately \$7.4 million, and is simply not warranted.⁶⁶

e. The Commission's Recent Decision in Duke Energy

The Company recognizes that in the recent Duke Energy rate case, this Commission addressed the ELG v ALG procedures. The Company does not know precisely why, or on what testimony or evidence contained in the Duke Energy case, the Commission relied on, in deciding that Duke Energy should use the ALG procedure. Every rate case record is different. Based on the record in this case, Atmos Energy respectfully submits that the Commission's determination in the Duke Energy case, that the ELG procedure "front-loads" depreciation expense in earlier

⁶⁵ *Id.* at 9:24.

⁶⁶ Watson Rebuttal Testimony at 8.

years and decreases it in later years, thereby creating a mismatch of revenues and expenses is not supported by the record in this case.

First, Duke Energy was an electric utility rate case which presents materially different facts and circumstances. Mr. Kollen presented no evidence as to why an electric utility case, involving a different company, with different facts and circumstances, should be directly applicable to Atmos Energy.⁶⁷ The Company, on the other hand, has substantiated, through expert testimony, why the ELG procedure should be continued.

The Company respectfully requests the Commission to reject the recommendation of the Attorney General and allow the Company to continue use of the ELG procedure, as it has done for the last twenty years. Remaining with the ELG procedure, which better matches revenues and expenses and avoids intergenerational inequity, would result in a small decrease (\$38,294) in depreciation expense in this case.⁶⁸ Compelling the Company to switch to the ALG procedure, which results in the shifting of depreciation costs to future customers on assets whose depreciable life has long ago ended, would result in an additional decrease in depreciation expense of approximately \$7.4 million.⁶⁹ Such a drastic result is not warranted. It would further hinder the Company's efforts to maintain an acceptable pace of replacement of its aged infrastructure.

3. Rate Base

As an integral part of the Company's commitment to safety, it allocates available capital to each of the eight states in which it operates in order to replace aging infrastructure and reduce risks. As stated in the Company's testimony, in every case, there is more prudent replacement work needed than capital available in any given year, both in Kentucky and in other jurisdictions.

⁶⁷ *Id.* at 2.

⁶⁸ *Id.* at 8.

⁶⁹ Kollen Direct Testimony at 14.

a. Bare Steel

As the Commission knows, the replacement of bare steel pipelines has been a nationwide priority for many years. The Company and the Commission agreed on a plan to replace bare steel pipelines in Kentucky a decade ago.⁷⁰ Company witness Gregory Smith testified that he considered the replacement of bare-steel to be his highest priority.⁷¹

While the Company had originally proposed to allocate more of its capital spending to replace bare steel than the \$28 million per year sought in this proceeding,⁷² the Commission's Order in Case No. 2017-00349 mandated a slower replacement rate for bare steel materials.⁷³ While the Company disagreed with the Commission's decision to lengthen the replacement rate for bare steel, it modified its future bare steel capital expenditures to \$28 million per year with a targeted complete date of 2027.⁷⁴ The Company has proposed removal of the Pipeline Replacement Program ("PRP") tariff to conform its non-bare steel replacement capital expenditures with the Commission's Order in Case No. 2017-00349. It transfers the ratemaking for PRP to future annual forward-looking rate case filings.⁷⁵ In the current case, the Company is seeking recovery of bare steel (formerly PRP) investment that was not a part of Case No. 2017-00349 as well as all projected capital investment during the forecasted test period.⁷⁶

The Company plans to fulfill commitments relating to the replacement of bare steel pipe and associated appurtenances previously qualifying under the former PRP, extending the original

⁷⁰ See *Application of Atmos Energy Corporation for an Adjustment of Rates*, Case No. 2009-00354, Order (Ky. PSC May 28, 2010).

⁷¹ Smith Direct Testimony at 8.

⁷² *Id.* at 4.

⁷³ *Electronic Application of Atmos Energy Corporation for an Adjustment of Rates and Tariff Modifications*, Order at 41, Case No. 2017-00349 (Ky. PSC May 3, 2018).

⁷⁴ Smith Direct Testimony at 4.

⁷⁵ Martin Direct Testimony at 14.

⁷⁶ Atmos Energy's Response to the Office of Attorney General's First Request for Information ("AG's First Request"), Item 1.

15-year completion timeline and limiting annual capital investment to the \$28 million cap. The Company will file its annual plan for bare steel replacement on or before August 1st. The filing will reflect the names, descriptions, and estimated costs for bare steel replacement projects in the upcoming fiscal year which commences on October 1st. All these conditions reflect the direction of the Commission in Case No. 2017-00349. The total planned level of capital investment for fiscal years 2019 and 2020 are essentially the same between Case No. 2017-00349 and the pending case, Case No. 2018-00281. For fiscal years 2019 and 2020, the capital non-bare steel investment increased by approximately the same amount that the PRP spend was decreased.⁷⁷

The Commission Order in Case 2017-00349 requires the use of a historical test year for the PRP. For utilities like Atmos Energy, which employ frequent comprehensive forward-looking rate cases pursuant to KRS 278.192, integrating a historical test year rider with frequent forward-looking comprehensive cases is a significant mathematical and accounting challenge given that the PRP tariff requires investment to be rolled into comprehensive general case whenever one is filed. Timely recovery of costs associated with high levels of capital investment is financially essential. Recovery lagged for historic test year filings would strand unavoidable costs. The Company therefore has proposed to withdraw the PRP Rider and intends to recover replacements of facilities previously qualifying under the former PRP in comprehensive annual forward looking rate cases.⁷⁸

The Commission's prior order limited the PRP tariff to bare steel pipe replacements and capped these replacements at \$28 million per year through 2027. (The actual annual amount for 2019 is \$28.8M due to the allocation of the Company's overhead pool across projects in the

⁷⁷ Atmos Energy's Response to Staff's Second Request, Item 4.

⁷⁸ Atmos Energy's Response to Staff's Second Request, Item 5.

budgeting system).⁷⁹ The Company has committed to achieving the investment target for bare steel investment. However, the Commission also limited recovery of PRP investment to historical, lagged recovery as opposed to the prospective treatment previously afforded the PRP. The Company proposes to file annual plans for bare steel replacement which describes the capital projects that the Company plans to undertake in its next fiscal year.⁸⁰ KRS 278.192 allows forward looking treatment in rate proceedings. Atmos Energy's Kentucky rates have been set on a forward-looking basis since 1999 and were set on a forward-looking basis in the Company's most recent rate case, Case No. 2017-00349.⁸¹

There is no controversy over the amount of bare steel capital expenditures proposed by the Company in this rate case. The Company is proposing to do exactly the amount of bare steel work mandated by the Commission in its Order in Case No. 2017-00349. The only issue relating to bare steel capital expenditures is not the work itself, but the manner in which the Company has sought to recover those investments. Mr. Kollen's testimony interprets the Commission's decision in Case No. 2017-00349 to require the Company to invest capital to replace bare steel on a lagged basis through the required use of a PRP filing. One need look no further than the summary table on page 5 of Mr. Kollen's testimony for an estimate of the cost of lag to the Company. The additional depreciation expense alone forecasted in this case for the forward-looking test year given that level of investment is \$2.1 million.⁸²

As previously stated, the Company is seeking to recover its prudent investments in bare steel replacement in accordance with KRS 278.192. The OAG argues that the Company should

⁷⁹ Atmos Energy's Response to Staff's Third Request, Item 22.

⁸⁰ Martin Direct Testimony at 15.

⁸¹ Waller Rebuttal Testimony at 6-7.

⁸² Direct Testimony of Gregory K. Waller ("Waller Direct Testimony") at 12.

not be permitted to seek to recover its investment in accordance with KRS 278.192.⁸³ This argument is ironic considering the OAG's position submitted in its brief for Case No. 2017-00349:

Therefore, the Attorney General urges the Commission to terminate the PRP tracker, and instead require that costs for pipe replacements be recovered through base rates in the same manner as all other non-gas costs. Doing so allows the Commission to more closely scrutinize capital expenditure projects, and exercise control over costs and operating expenses by examining costs related to pipe projects together with all other costs being reviewed in the context of a base rate case.⁸⁴

The Company is seeking recovery of these investments through base rates in this case exactly as the OAG advocates for in its brief last year. Here, the OAG offers no justification as to why the Company should not be permitted to avail itself of KRS 278.192. The OAG does not argue that the proposed bare steel work is unreasonable. Rather, the OAG's arguments seem to indicate that it believes it should be permitted to determine whether or not the Company chooses to avail itself of a permissive PRP Rider. Respectfully, the OAG does not get to determine how the Company chooses to file its rate case. The statute provides that the Commission shall permit a utility to file a forward-looking case.⁸⁵ The OAG failed to offer any valid argument as to why the proposed bare steel work was inappropriate, imprudent, or otherwise should be disallowed. The proposed bare steel replacement work should be evaluated by the Commission within the context of this base rate proceeding, as would any other forecasted capital expenditure. If the forecasted work is prudent and reasonable, then the recovery of that investment should be approved.

⁸³ Kollen Direct Testimony at 14-20.

⁸⁴ *Electronic Application of Atmos Energy Corporation for an Adjustment of Rates and Tariff Modifications*, Post-Hearing Brief of the Kentucky Attorney General at 19, Case No. 2017-00349 (Ky. PSC April 23, 2018)AG Brief 2017-00349 p.19.

⁸⁵ KRS 278.192

b. Non-Bare Steel

As testified to by Company Witness Greg Smith, these non-bare steel categories of safety-related replacement also involve higher risk aged infrastructure that also need to be replaced. In addition, Company Witness John McDill rebutted Mr. Kollen's assumption that the current funding for pipeline replacement is adequate to maintain the safety and reliability of the gas system and to meet recently enacted regulatory standards.⁸⁶

The Company considers certain non-bare steel capital expenditures, such as growth-related expenditures, to be non-optional. Furthermore, such capital expenditures are largely outside of the Company's control. To the Company's knowledge, the OAG has not contested prudence to any of the Company's proposed spending relating to these expenditures.

With regard to non-bare steel and non-growth related capital expenditures, the Company testified that it reallocated its proposed expenditures from bare steel to non-bare steel as a consequence of the Commission's Order in Case No. 2017-00349. The Company's need for capital investment as a whole has not changed. In order to maintain and accelerate the pace of overall replacement of aging facilities in its Kentucky distribution system and address other non-bare steel materials, capital that would have been allocated to bare steel replacement was reallocated to non-bare steel categories.⁸⁷

The Company has approximately 210 miles of Aldyl-A Plastic and unlocatable plastic in its Kentucky system currently that needs to be replaced.⁸⁸ Atmos Energy considers Aldyl-A the most significant material risk on its system after bare steel pipe.⁸⁹ The United States Department of Transportation Pipeline and Hazardous Materials Safety Administration ("PHMSA") has issued

⁸⁶ McDill Rebuttal Testimony at 4.

⁸⁷ Waller Rebuttal Testimony at 4-5.

⁸⁸ Smith Rebuttal Testimony at 14.

⁸⁹ *Id.*

advisory bulletins warning of the risks of these materials, and the Company takes these risks seriously. Advisory Bulletin ADB-07-01 was issued for updated notification of the susceptibility of older plastic pipes to premature brittle-like cracking. The older pipes listed included Aldyl-A.

The advisory bulletin noted that:

Brittle-like cracking refers to crack initiation in the pipe wall not immediately resulting a full break followed by stable crack growth at stress levels much lower than the stress required for yielding. This results in very tight, slit-like, openings and gas leaks. Although significant cracking may occur at point of stress concentration and near improperly designed or installed fittings, small brittle-like cracks may be difficult to detect until a significant amount of gas leaks out of the pipe, and potentially migrates into an enclosed space such as a basement.⁹⁰

In the final order in Case No. 2018-00086, the Commission commented specifically on Aldyl-A replacement:

The Commission is aware of the risk associated with Aldyl-A pipe. As Delta states in its application, Aldyl-A is subject to slow crack growth that leads to eventual rupture of the pipe. Furthermore, Aldyl-A has been the subject of several PHMSA bulletins, the most recent of which is attached hereto as Appendix B. Due to the significant amount of pre-1983 Aldyl-A pipe that exists in the Delta system, the Commission finds that the Aldyl-A pipe should be replaced in a 15-year time frame. As of the date of this Order, the newest of the Aldyl-A pipe on Delta's system is at least 35 years old. At the conclusion of Delta's proposed PRP, the newest of the Aldyl-A pipe will be at least 50 years old. Given that Aldyl-A pipe was installed on Delta's system as early as 1965, and some has already been in service nearly 55 years, the Commission finds that now is an appropriate time to plan for the replacement of Aldyl-A pipe. The Commission expects Delta to continue to prioritize its PRP to replace pipe based on risk, and pipe in high-consequence areas, whether it be bare steel or Aldyl-A pipe.⁹¹

The Company's targeted investment of Aldyl-A and unlocatable plastic will enhance the safety and reliability of its Kentucky system. This investment appears in line with the

⁹⁰ Smith Rebuttal Testimony, Exhibit GWS-R-1.

⁹¹ *Electronic Adjustment of the Pipe Replacement Program Rider of Delta Natural Gas Company, Inc.*, Case No. 2018-00086, *Order* at pp. 3-4 (Ky. PSC August 21, 2018).

Commission's guidance and acknowledgement of the risk associated with Aldyl-A pipe in its Order for Case No. 2018-00086.

Company witness Greg Smith also describes other areas beyond bare steel replacement, in addition to Aldyl-A and unlocatable plastic replacement, where the Company needs to be proactive in its capital investment to maintain the safety and reliability of its system. For example, Atmos Energy has also planned replacement of all remaining low pressure systems in Kentucky (approximately 45 miles) with intermediate pressure systems including regulators with relief valves at each customer meter and renewed service lines containing excess flow and curb valves. Low pressure systems operate at less than 1 psig and may allow water to enter the system when leaks develop.⁹² Sixty percent (60%) of the materials on the Company's low-pressure systems in Kentucky are currently categorized under the Company's bare steel replacement plan. Therefore, it makes sense to target these systems for replacement and overall public risk reduction.⁹³

Other specific projects were also listed by Mr. Smith in both discovery and rebuttal testimony that will have a critical role in enhancing the safety and reliability of the Company's system. These projects include the Company's ANR Bon Harbor project, the Paducah Mall & Creek HCA project, as well as the targeted replacement of Kentucky farm taps.⁹⁴

Natural gas pipeline safety and reliability are issues of state-wide concern and Kentucky residents, regardless of where they reside or the type of pipeline system that serves them, deserve to have a natural gas system that is safe and reliable. In addition to the integrity risks associated with aging infrastructure and continued degradation of pipeline materials, many of the Company's distribution systems traverse areas with greater populations than existed when the pipes were

⁹² Smith Rebuttal Testimony at 12.

⁹³ *Id.*

⁹⁴ *Id.* at 16-17; *see also* Atmos Energy's Response to Staff's Third Request, Item 22.

initially constructed, potentially resulting in an increased risk of injury and property damage should an incident occur. Addressing these issues and concerns directly results in a significant increase in the capital investment and O&M needed to comply with federal requirements.⁹⁵

Atmos Energy realizes that balancing safety and financial cost is an important policy objective. However, the Company believes that the goal of maintaining low-cost service should not be allowed to jeopardize initiatives that are required to maintain a safe and reliable system.⁹⁶ Results of the Company's capital investment, in particular the replacement of bare steel, has resulted in a reduction of leaks as well as Lost and Unaccountable ("L&U") gas on the Atmos Energy Kentucky system as the Company responded to the AG's First Request, Item 12, as well as Table GWS-R-3 and Table GWS-R-4 in Gregory Smith's rebuttal testimony. The January 2019 amount reinforces the continued trend that the Company's targeted projects are having a noticeable effect in reducing leaks and enhancing safety.⁹⁷

However, in balancing these competing considerations, it is critical that neither Atmos Energy nor this Commission allow the goal of providing low-cost service to jeopardize the undertaking of initiatives to maintain a safe and reliable system. Federal regulations and directives have necessitated the systematic and proactive assessment and replacement of pipelines. In turn, this systematic and proactive approach now requires the commitment of capital investment at higher levels than have been previously included in our rate structure. This is a nationwide phenomenon and is not limited to either Atmos Energy or the Commonwealth of Kentucky.⁹⁸

This Commission understands the vital importance of having a regulatory structure in place for utilities to mitigate pipeline safety risks. In Atmos Energy's last rate case, the Commission

⁹⁵ McDill Rebuttal Testimony at 16.

⁹⁶ *Id.* at 1.

⁹⁷ Smith Rebuttal Testimony at 6.

⁹⁸ McDill Rebuttal Testimony at 10.

reiterated “[t]o the extent that the pipeline eligible for recovery poses a safety risk to the utility’s customers, service areas, and employees, the Commission has proven itself to be in favor of accelerated replacement.”⁹⁹

The Administrator for PHMSA specifically highlighted the public interest in infrastructure replacement programs in a letter to the President of the National Association of Regulatory Utility Commissioners (“NARUC”). The White Paper referenced in the letter then offered the following conclusion:

“[Pipeline infrastructure replacement] programs play a vital role in protecting the public by ensuring the prompt rehabilitation, repair, or replacement of high-risk gas distribution infrastructure.”¹⁰⁰

FERC and NARUC each have adopted policies recognizing the need for aggressive pipeline replacement programs and cost recovery. For example, the NARUC resolution of July 24, 2013 provides that states should: “consider adopting alternative rate recovery mechanisms as necessary to accelerate the modernization, replacement and expansion of the nation’s natural gas pipeline systems.”¹⁰¹

In 2006, Congress passed the Pipeline Inspection, Protection, Enforcement and Safety Act (“PIPES Act”). Pursuant to the PIPES Act, in 2009 PHMSA published the Integrity Management Program for Gas Distribution Pipelines Rule (49 CFR Part 192, Subpart P) (“2009 Final Rule”) requires each operator, including Atmos Energy, to create and maintain a written distribution pipeline safety and integrity management program or “DIMP”, which specifies how the utility will identify, assess, prioritize, and evaluate risks to the integrity of distribution lines and the manner in which those risks will be mitigated or eliminated.¹⁰² The integrity management approach is

⁹⁹ *Id.* at 11.

¹⁰⁰ McDill Rebuttal Testimony, Attachment JSM-R-1 at 17.

¹⁰¹ *See* McDill Rebuttal Testimony, Exhibit JSM-R-3.

¹⁰² McDill Rebuttal Testimony at 18.

“designed to promote continuous improvement in pipeline safety by requiring operators to identify and invest in risk control measures beyond core regulatory requirements.” Indeed, the “basic principle underlying integrity management” is that “operators should identify and understand the threats to their pipelines and apply their safety resources commensurate with the importance of each threat.”¹⁰³ Atmos Energy has submitted its DIMP analysis as part of its response to Staff’s First PH-DR Request, Item 12.

PHMSA’s 2009 Final Rule (74 Fed. Reg. 63906) notes:

IM provides for a more systematic and comprehensive approach to preventing failures. Accordingly, PHMSA considers this the most effective means to effect further reductions in the number of pipeline incidents. The regulatory analysis supporting this rule considers the improvement in safety that is expected to result and explicitly recognizes the current low frequency of serious accidents.”

PHMSA stated specifically:

“States must implement the minimum standards established by PHMSA but have a variety of ways in which they can oversee distribution pipeline safety. They can simply mirror the Federal pipeline safety program; they can impose additional requirements, beyond the Federal minimum; they can engage in special oversight programs with individual operators or groups of operators; or finally, they can provide incentives for safety improvements, often through their rate-setting authority. (emphasis added) Notice of Proposed Rulemaking, 73 Fed. Reg. 36015 at 36017.¹⁰⁴

Former U.S. Transportation Secretary LaHood provided additional information on the 2009 Final Rule DIMP regulations:

“require operators of local gas distribution pipelines to evaluate the risks on their pipeline systems to determine their fitness for service and take action to address those risks. For older gas distribution systems, the appropriate mitigation measures could involve major pipe rehabilitation, repair, and replacement programs. At a minimum, these measures are needed to requalify those systems as being fit for service. While these measures may be costly, they are

¹⁰³ *Id.* at 18-19.

¹⁰⁴ *Id.* at 21.

necessary to address the threat to human life, property, and the environment.

We ask you to urge your staff to encourage companies and the State utility commission to accelerate pipeline repair, rehabilitation, and replacement programs for systems whose integrity cannot be positively confirmed. This is one of the best ways to help protect your citizens from accidents like those in Allentown, Marshall, and San Bruno.”¹⁰⁵ (emphasis added).

Atmos Energy desires a proactive approach to pipeline safety. Atmos Energy’s intention is not only to repair identified leaks but also to proactively identify pipes where the risks of leaks developing are unacceptably high and to then design and implement a plan to mitigate those risks. As pipe ages, the likelihood of pipeline failure increases, also increasing the likelihood of an occurrence of pipeline failure. For this reason, delaying pipe replacement until there is an imminent threat to public safety is not good policy. The continuance of the Company’s accelerated replacement plan will facilitate the complete retirement or replacement of the specific pipe materials posing an increased risk to safety and reliability because they are prone to failure over time from the threat of corrosion (for bare steel), brittle cracking (Aldyl-A, and legacy plastic as advised by PHMSA Advisory Bulletin (FR Doc. 07-4309) and included as Exhibit GWS-R-1) and third party damage (unlocatable plastic).

Utilities need to have appropriate replacement cycles for all of their pipeline infrastructure. Atmos Energy has approximately 4,200 miles of natural gas distribution and transmission pipeline (plus associated service lines) in Kentucky. If we were to replace 42 miles of pipe per year (1% per year), it would take 100 years to renew the entire system...and future generations would be left

¹⁰⁵ McDill Rebuttal Testimony, Exhibits JSM-R-5 and JSM-R-6.

with a pipeline system with 100-years-old segments. A prudent pipeline operator must consider the overall replacement cycle of its system to ensure future customer safety.¹⁰⁶

As a result, Atmos Energy must invest capital into its system at a much higher annual rate than it has historically done to address safety and integrity issues identified through the risk assessment process.¹⁰⁷ The proposed proactive approach to accelerated pipeline replacement is intended to fund and implement programs and capital investments that will continue to improve the safety and reliability of Kentucky's natural gas system rather than doing so reactively. It also will mitigate against the types of infrastructure problems confronting this Commission that result from delayed or inadequate replacements that are plaguing water utilities.

Of Mr. Kollen's approximately \$22.5 million of recommendations from the Company's initial filed position, only approximately \$3.2 million of his recommended reduction is a result of limiting the Company's non-bare steel investment.¹⁰⁸ Mr. Kollen's recommendation is based solely on the simple analysis of using a three-year historical average, compared to the Company's detailed record presented regarding the prudence of its projects. For comparison purposes, Mr. Kollen's depreciation recommendation results in more than double the impact on the Company's revenues (approximately \$7.4 million) compared to his recommendation to limit the Company's non-bare steel spending.¹⁰⁹ Thus, while a small portion of the OAG's case rests on the reduction of the Company's non-bare steel spending, the Company would implore the Commission that a critical aspect to ensuring safety and reliability of the Company's system in Kentucky is dependent on the Company continuing its targeted investment for non-bare steel projects.

¹⁰⁶ Smith Rebuttal Testimony at 13.

¹⁰⁷ McDill Rebuttal Testimony at 25.

¹⁰⁸ Kollen Direct Testimony at 26; *see also* Kollen Direct Testimony at 5.

¹⁰⁹ *Id.*

c. Cash Working Capital

As it did in last year's rate case, the OAG asserts that the Company's cash working capital is overstated and should be reduced, based on certain "corrections" it proposes to the Company's lead/lag study.¹¹⁰ The quantitative effect of the OAG's proposed changes to the Company's cash working capital included in rate base is a reduction of \$0.821 million to the Company's revenue requirement.¹¹¹

The OAG asserts that "[t]he Company incorrectly included depreciation expense, deferred income tax expense, and the non-dividend component of the return on equity."¹¹² The OAG also states that "[t]he Company also failed to correctly include the dividend component of the return on equity with the correct number of expense lag days."¹¹³ What the OAG fails to mention is that the Company prepared its cash working capital study in exactly the same manner as it was approved in last year's case.¹¹⁴

The Commission heard the arguments made by the OAG relating to the inclusion of these non-cash items in cash working capital in the Company's last rate case. The Company sees no reason to burden its brief with the identical rebuttal arguments made in the prior case.¹¹⁵ The Company believes that inclusion of these non-cash items is appropriate and Mr. Kollen argues they are not. The Company asks the Commission to reach the same decision on this issue as it did last year.

¹¹⁰ Kollen Direct Testimony at 36.

¹¹¹ *Id.* at 39.

¹¹² *Id.* at 36.

¹¹³ *Id.*

¹¹⁴ Christian Direct Testimony at 12; *see also* Rebuttal Testimony of Joe T. Christian ("Christian Rebuttal Testimony") at 15 (which is the identical methodology is used in the Company's approved cash working capital calculation in Tennessee)

¹¹⁵ The Company incorporates its prior year arguments on Cash Working Capital from Section F.1. of its post-hearing brief in Case No. 2017-00349 by reference.

4. Capital Structure

a. Long-Term Debt

The OAG recommends through Mr. Kollen the inclusion of a projected October 2018 long-term debt issuance rate of 4.392%.¹¹⁶ Mr. Kollen calculated a projected long-term debt capital ratio of 42.47% with a long-term debt cost at 4.66% once the October 2018 debt issuance was included, resulting in a reduction of \$1.256 million to the Company's base revenue requirement.¹¹⁷ In his rebuttal testimony, Mr. Christian agreed to the modification to the long-term debt provide that all components of the capital structure, including the impact of the October 2018 debt refinancing, be updated to reflect all known financing activity.¹¹⁸ Only updating for the October financing would ignore the impact of the incremental equity financing activities that have also occurred since the Company filed its case.¹¹⁹ Accordingly, the Company has updated its submitted long-term debt to include the actual known amounts of the issuance of its March 2019 long-term debt financing.¹²⁰ This modification reflects the actual rate of the March 2019 refinancing, as opposed to Mr. Kollen's calculation which is a hypothetical rate.¹²¹ The Company's requested capital structure following this modification to include both long-term debt and equity updates is reflected on Schedule J-1 in its submitted Exhibit GKW-R-1 filed in Company witness Greg Waller's rebuttal testimony.¹²²

¹¹⁶ Kollen Direct Testimony at 44.

¹¹⁷ *Id.* at 43.

¹¹⁸ Christian Rebuttal Testimony at 8.

¹¹⁹ Christian Rebuttal Testimony at 8.

¹²⁰ Waller Rebuttal Testimony, Exhibit GKW-R-1, Schedule J; *see also* Christian Rebuttal Testimony, Exhibit JTC-R-4 Prospectus Supplement February 25, 2019 for Atmos Energy Corporation \$450,000,000 4.125% Senior Notes due 2049.

¹²¹ Christian Rebuttal Testimony at 8.

¹²² Waller Rebuttal Testimony, Exhibit GKW-R-1, Schedule J; *see also* Christian Rebuttal Testimony at 11.

b. Actual Capital Structure

The OAG also recommends through Mr. Kollen to alter the Company's proposed capital structure and cap the common equity at 54.3%.¹²³ Mr. Kollen's recommendation is based solely on a simple comparison to what was approved in the Company's last case and a comparison to a proxy group.¹²⁴ The Company rejects Mr. Kollen's recommendation and has proposed its actual capital structure, with agreed upon modifications to its long-term debt rate, in a manner similar to previous rate case filings. Mr. Kollen's equity cap recommendation ignores the impact of incremental equity financing but includes incremental long-term debt issuances.¹²⁵ The Company's capital structure presented in GKW-R-1 reflects actual capital structure through December 2018 with a known and measurable adjustment for the March 2019 debt refinancing.¹²⁶ As stated by Mr. Christian at the hearing, Atmos Energy is managing its capital structure at the upper end as compared to the proxy group, but every utility has its unique reasons for the choices it makes in regards to its debt / equity ratio.¹²⁷ Furthermore, Atmos Energy's need to currently manage in the upper end of its SEC guidance of 50% - 60% is driven by its capital investment today. As the Company increases its capital investment, it puts pressure on credit metrics, which has resulted in the increased amount of equity reflected in the Company's capitalization.¹²⁸ Mr. Kollen provides no substantial evidence that the Company's proposed capital structure should not be based on its actual costs and should not allow the establishment of a capital structure to be cast as a simple analytical exercise of averaging the proxy company results as the Attorney General's Hearing Exhibit 7 implies. Development of an actual capital structure for each utility's own books

¹²³ Kollen Direct Testimony at 41.

¹²⁴ Christian Rebuttal Testimony at 3

¹²⁵ *Id.* at 8.

¹²⁶ *Id.* at 10.

¹²⁷ April 3, 2019, Video Transcript of Evidence at 10:11.

¹²⁸ *Id.* at 10:19.

and records is possible; therefore, the use of a group average is inappropriate because a group average would not be based on the utility's actual cost incurred.

The Company's capital structure is based on its actual costs, which is reflective of what is necessary to maintain its current credit metrics, and is not out of line as compared to its peer companies' debt / equity ratios.¹²⁹ Safe and reliable service cannot be maintained at a reasonable cost if the Company does not have the financial flexibility and strength to access the competitive capital markets on reasonable terms. As the factors used by the credit rating agencies¹³⁰ to evaluate utilities demonstrate, relying too heavily on long-term debt financing creates risk, as does a regulatory environment that is not supportive of utilities' ability to recover their actual costs and to have the opportunity to earn a fair return on their investments. The Company has strengthened the equity component of its capital structure as a result of increased investment and in order to improve its credit metrics to accomplish its anticipated five-year financing needs.¹³¹ The Company's actual capital structure is necessary in order to maintain a strong balance sheet and credit rating, which in turn will enable the Company to access the capital markets under more favorable conditions than if the Company's credit metrics were arbitrarily diminished by having less equity in the capital structure.¹³² If the Commission were to adopt Mr. Kollen's recommendation of capping our equity at 54.3% it would put downward pressure on and possibly downgrade our debt rating.¹³³ Any downgrade would make future debt financing more costly.¹³⁴ Atmos Energy's consolidated capital structure is appropriate for use in setting rates for the

¹²⁹ Christian Rebuttal Testimony at 7; *see also* Atmos Energy's Response to Attorney General's Post-Hearing Data Requests ("AG's PH-DRs"), Item 3, Attachment 1.

¹³⁰ Moody's Investor Service and Standard and Poor's ("S&P"). S&P utilizes Core Ratios (FFO/Debt and Debt/EBITDA).

¹³¹ Christian Rebuttal Testimony at 5; *see also* Atmos Energy's Response to AG's First Request, Item 16.

¹³² Christian Rebuttal Testimony at 5-6.

¹³³ *Id.* at 11-12.

¹³⁴ *Id.* at 12.

Company's Kentucky customers because Atmos Energy provides the debt and equity capital that supports the assets serving those customers.¹³⁵ The actual equity portion of the Company's capital structure has been accepted by the Commission in its last two fully-litigated cases.¹³⁶ Based on these facts, the Company respectfully requests approval of its filed capital structure, with agreed-upon modifications, as presented in Exhibit GKW-R-1.

F. Rate of Return

Atmos Energy, through its expert witness, Dr. James Vander Weide, Ph.D., presented the only evidence related to return on equity in his detailed, analytically thorough and extensively documented testimony. In contrast, the witness for the OAG, who lists no cases in which he testified as an expert on the subject of return on equity or cost of capital in his exhibit LK-1, merely concludes without any supporting study or analysis that a previously determined ROE in other cases should be applied to Atmos Energy.

Dr. Vander Weide initially recommended a return on equity of 10.4 percent¹³⁷, which was confirmed by his updated analysis of market trends.¹³⁸ This conclusion was based on the results of the application of standard cost of equity estimation techniques, including the DCF model, the ex ante risk premium approach, the ex post risk premium approach and the CAPM, to a broad group of utilities of comparable business risk.¹³⁹ His initial recommendation of 10.4 percent was considered conservative because the financial risk of the comparable companies he analyzed, which is based on the equity ratio resulting from the market values of their equity and debt, is less

¹³⁵ Atmos Energy Response to AG's First Request, Item 25.

¹³⁶ *Electronic Application of Atmos Energy Corporation for an Adjustment of Rates and Tariff Modifications*, Order at 30, Case No. 2017-00349 (Ky. PSC May 3, 2018); *Application of Atmos Energy Corporation for an Adjustment of Rates and Tariff Modifications*, Order at 9-10, Case No. 2013-00148 (Ky. PSC Apr. 22, 2014).

¹³⁷ Vander Weide Direct Testimony at 4.

¹³⁸ April 2, 2019, Video Transcript of Evidence at 9:38.

¹³⁹ Vander Weide Direct Testimony at 4.

than the financial risk of the lower equity ratio in Atmos Energy's ratemaking capital structure, which is based on its book values of equity and debt.¹⁴⁰

Dr. Vander Weide relied on the principles stated in *Bluefield Water Works and Improvement Co. v. Public Service Comm.*, 262 U.S. 679, 692 (1923), 262 U.S. 679, 692 and *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603(1944).

A public utility is entitled to such rates as will permit it to earn a return upon the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility, and should be adequate, under efficient and economical management, to maintain and support its credit, and enable it to raise the money necessary for the proper discharge of its public duties. *Bluefield Water Works*, 692¹⁴¹

The Court recognizes that: (1) a regulated firm cannot remain financially sound unless the return it is allowed to earn on the value of its property is at least equal to the cost of capital (the principle relating to the demand for capital); and (2) a regulated firm will not be able to attract capital if it does not offer investors an opportunity to earn a return on their investment equal to the return they expect to earn on other investments of the same risk (the principle relating to the supply of capital).¹⁴²

In *Hope Natural Gas*, *supra*, the Court reiterates the financial soundness and capital attraction principles of *Bluefield Water Works*, *supra*:

“From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for

¹⁴⁰ *Id.*

¹⁴¹ *Id.* at 9.

¹⁴² *Id.* at 9.

the capital costs of the business. These include service on the debt and dividends on the stock... By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.”¹⁴³

The Court clearly recognizes that the fair rate of return on equity should be: (1) comparable to returns investors expect to earn on other investments of similar risk; (2) sufficient to assure confidence in the company's financial integrity; and (3) adequate to maintain and support the company's credit and to attract capital.¹⁴⁴

Rates for natural gas distribution services are generally set by state regulatory authorities in a manner that provides natural gas distribution companies an opportunity to recover prudently incurred operating expenses and earn a fair rate of return on their prudently incurred investment in property, plant, and equipment. Investors’ perceptions of the business and financial risks of natural gas utilities are strongly influenced by their views of the quality of regulation. Investors are aware that regulators in some jurisdictions may be unwilling at times to set rates that allow companies an opportunity to recover their cost of service in a timely manner and earn a fair and reasonable return on investment. Moody’s and Investor Service and Standard and Poor’s utilize both financial metrics (40%) as well as qualitative factors such as “Regulatory Framework” (25%) and “Ability to Recover Costs and Earn Returns” (25%) when evaluating a utility’s rating.¹⁴⁵

Investors are also aware that, even if a company presently has an opportunity to earn a fair return on its investment in property, plant, and equipment, there is no assurance that they will continue to have such an opportunity in the future. If investors perceive that regulators may not provide an opportunity to earn a fair rate of return on investment, investors may demand a higher

¹⁴³ *Hope* at 603; *see also* Vander Weide Direct Testimony at 9-10.

¹⁴⁴ Vander Weide Direct Testimony at 10.

¹⁴⁵ Atmos Energy’s Response to AG’s First PH-DR, Item 3.

rate of return for natural gas utilities operating in such jurisdictions. If investors perceive that regulators are likely to continue to provide an opportunity for a company to earn a fair rate of return on investment, investors will view the risk of earning a less than fair return as minimal.¹⁴⁶ Also affecting investors' assessment of risk is regulatory lag. Dr. Vander Weide testified that when calculating the required ROE, he considers regulatory lag because that affects risk.¹⁴⁷

Dr. Vander Weide used several generally accepted methods to arrive at his recommended return on equity. These are the DCF, the ex ante risk premium, the ex post risk premium, and the CAPM. The DCF method assumes that the current market price of a firm's stock is equal to the discounted value of all expected future cash flows. The ex ante risk premium method assumes that an investor's expectations regarding the equity risk premium can be estimated from data on the DCF expected rate of return on equity compared to the interest rate on long-term bonds. The ex post risk premium method assumes that an investor's expectations regarding the equity-debt return differential are influenced by the historical record of comparable returns on stock and bond investments. The cost of equity under both risk premium methods is then equal to the expected interest rate on bond investments plus the expected risk premium. The CAPM assumes that the investor's required rate of return on equity is equal to an expected risk-free rate of interest plus the product of a company-specific risk factor, beta, and the expected risk premium on the market portfolio.¹⁴⁸

The annual DCF model is only a correct expression for the present value of future dividends if dividends are paid annually at the end of each year. Because the companies in Dr. Vander Weide's comparable group all pay dividends quarterly, the current market price that investors are

¹⁴⁶ *Id.*

¹⁴⁷ April 2, 2019, Video Transcript of Evidence at 9:50.

¹⁴⁸ Vander Weide Direct Testimony at 17.

willing to pay reflects the expected quarterly receipt of dividends. Therefore, a quarterly DCF model should be used to estimate the cost of equity for these firms. The quarterly DCF model differs from the annual DCF model in that it expresses a company's price as the present value of a quarterly stream of dividend payments. A complete analysis of the implications of the quarterly payment of dividends on the DCF model is provided in Exhibit JVW-1, Appendix 1. The results of the quarterly DCF model are approximately equal to the results of a properly applied annual DCF model (in which the end-of-year dividend is estimated by multiplying the current annual dividend by the factor one plus the growth rate).¹⁴⁹ The proxy group consists of all the natural gas utilities followed by Value Line that: (1) paid dividends during every quarter of the last two years; (2) did not decrease dividends during any quarter of the past two years; (3) have an available positive I/B/E/S long-term growth forecast; (4) have an investment grade bond rating and a Value Line Safety Rank of 1, 2, or 3; and (5) are not the subject of a merger offer that has not been completed.¹⁵⁰

The risk premium method is based on the principle that investors expect to earn a return on an equity investment that reflects a "premium" above the interest rate they expect to earn on an investment in bonds. This equity risk premium compensates equity investors for the additional risk they bear in making equity investments versus bond investments.¹⁵¹ Dr. Vander Weide used two methods to estimate the required risk premium on an equity investment in publicly-traded natural gas utilities. The first is called the ex ante risk premium method and the second is called the ex post risk premium method.¹⁵² With this analysis, the expected return on equity is in the range 9.7 percent to 10.4 percent, with a midpoint of 10.1 percent. Adding a 15 basis-point allowance

¹⁴⁹ *Id.* at 20.

¹⁵⁰ *Id.* at 27.

¹⁵¹ *Id.* at 28.

¹⁵² *Id.* at 30.

for flotation costs, the estimate is 10.2 percent as the ex post risk premium cost of equity.¹⁵³

The CAPM is an equilibrium model of the security markets in which the expected or required return on a given security is equal to the risk-free rate of interest, plus the company equity “beta,” times the market risk premium.¹⁵⁴ The CAPM requires an estimate of the risk-free rate, the company-specific risk factor or beta, and the expected return on the market portfolio. For the estimate of the expected risk premium on the market portfolio, Dr. Vander Weide used two approaches. First, an estimate of the risk premium on the market portfolio using historical risk premium data reported in the *2018 valuation handbook* for the years 1926 through 2017, data which are consistent with the data previously reported by Ibbotson[®] SBBI[®]. Second, an estimate of the risk premium on the market portfolio from the difference between the DCF cost of equity for the S&P 500 and the forecasted yield to maturity on 20-year treasury bonds.¹⁵⁵

Questioned about the inclusion of flotation costs, Dr. Vander Weide referring to pages 4-5 of his rebuttal testimony, reaffirmed that such costs are recognized in generally accepted financial analysis as a cost of stock issuance.¹⁵⁶ Regardless of the Commission’s prior regulatory policy of disregarding these costs, they are nonetheless appropriate costs based on a recognized economic proposition.¹⁵⁷ His direct testimony provides the analysis disproving this mistaken notion of exclusion of flotation costs. Flotation costs are an expense that is deducted from the proceeds associated with a stock issuance before the proceeds are distributed to the issuing company. Because the stock price reflects the return on the amount of cash invested by the company and flotation costs are deducted from the proceeds of a stock issuance prior to the

¹⁵³ *Id.* at 36.

¹⁵⁴ *Id.*

¹⁵⁵ *Id.* at 37.

¹⁵⁶ April 2, 2019, Video Transcript of Evidence at 9:25.

¹⁵⁷ *Id.*

distribution of the net proceeds to the company, flotation costs are not included in the stock price. Dr. Vander Weide includes flotation costs in his calculation of the company's cost of equity because the company will not be able to earn a fair return on equity if flotation costs are not included in the estimate of the cost of equity. His recommended flotation cost allowance is based on the fundamental economic and regulatory principles that: (1) a company should only invest in a new project if it can earn a return on its investment that is equal to or greater than its cost of capital; and (2) the time pattern of expense recovery should match the time pattern of benefits resulting from the expense. Because equity flotation costs are a legitimate expense of raising capital, a company has no incentive to invest in new capital projects if equity flotation costs are not included in the cost of capital estimate. In addition, because the proceeds of an equity issuance are invested in assets that provide benefits over a long time period, the costs of an equity issuance should be recovered over a long period of time.¹⁵⁸

All firms that have sold securities in the capital markets have incurred some level of flotation costs, including the costs of underwriters' commissions, legal fees, and printing expense, for example. These costs are withheld from the proceeds of the stock sale or are paid separately and must be recovered over the life of the equity issue. Costs vary depending upon the size of the issue and the type of registration. Previously incurred flotation costs have not been recovered in previous rate cases; rather, they are a permanent cost associated with past issues of common stock. Just as an adjustment is made to the embedded cost of debt to reflect previously incurred debt issuance costs (regardless of whether additional bond issuances were made in the test year), so should an adjustment be made to the cost of equity regardless of whether additional stock was issued during the test year.¹⁵⁹

¹⁵⁸ Vander Weide Direct Testimony at 25-26.

¹⁵⁹ *Id.* at 25-27, *see also id.* at 5.

Another factor in the development of Dr. Vander Weide's updated recommendation is the current trend in interest rates. Economists project that future interest rates will be higher than current interest rates as the Federal Reserve allows interest rates to rise in order to prevent inflation. Thus, the use of forecasted interest rates is consistent with the fair rate of return standard, whereas the use of current interest rates at this time is not.¹⁶⁰

Dr. Vander Weide was asked by the Commission Staff to explain why current interest rates, which are often believed to be the most accurate in the short-term, should not be used given the fact that annual rate cases will be filed. His response explained that long-term interest rates forecasts support the equity models in the case where there may be annual rate cases because at each point in time the cost of equity reflects the investor's expected return over the long-term life of the investment, and current long-term interest rates may not reflect investors' estimates of the expected return over the life of the investment.¹⁶¹ Dr. Vander Weide used forecasted interest rates in: (1) his ex ante and his ex post risk premium analyses¹⁶²; and (2) his historical and DCF-based CAPM methods¹⁶³. Dr. Vander Weide did not use forecasted interest rates in his DCF analysis because interest rates are not an input variable in the DCF analysis.¹⁶⁴ The interest rate forecasts used in Dr. Vander Weide's direct and rebuttal testimonies were the most recent Value Line and Energy Information Administration ("EIA") long-term interest rate forecasts available at the time of his direct and rebuttal testimonies. The June 1, 2018, and November 30, 2018, Value Line

¹⁶⁰ *Id.* at 10; *see also* April 2, 2019 Video Transcript of Evidence at 9:14.

¹⁶¹ Atmos Energy's Response to Staff's Second Request, Item 51.

¹⁶² *See* Vander Weide Direct Testimony at 32, 36.

¹⁶³ *See* Vander Weide Direct Testimony at 39; Vander Weide Rebuttal Testimony at 6; Vander Weide Rebuttal Testimony at 45, Schedule 8.

¹⁶⁴ Atmos Energy's Response to Commission Staff's First Post-Hearing Data Request ("Staff's First PH-DR"), Item 15.

Selection & Opinion forecasts that Dr. Vander Weide refers to in his direct and rebuttal testimonies are higher for the period 2019 than for the period 2018.¹⁶⁵

If investors always expected forecasted interest rates to be equal to current interest rates, they would be unwilling to pay for economic forecasts from firms such as Consensus Economics, Blue Chip, and others. The fact that numerous firms and individuals spend considerable sums to obtain forecasts of interest rates is sufficient evidence that they do not believe that current interest rates are the best forecast of future interest rates.

The fair rate of return on equity is a forward-looking return on equity that provides the regulated company with an opportunity to earn a return on its investment over the period in which rates are in effect that is commensurate with returns that investors expect to earn on other investments of similar risk. Because the fair rate of return is a forward-looking return, the estimate of the fair return requires consideration of investors' expectations for a reasonably long period into the future. The proposed cost of equity analyses reflect the financial risk of the proxy companies as measured by their average market value capital structure, which has more than 67 percent equity. If Atmos Energy's ratemaking, or book value capital structure, is used to set rates, the cost of equity for Atmos Energy will necessarily be higher than the cost of equity for the proxy group because the financial risk associated with Atmos Energy's book value capital structure is significantly higher than the financial risk reflected in the cost of equity estimate for the proxy companies.

Dr. Vander Weide updated his estimated cost of equity for Atmos to 10.5%, but his recommended return remains 10.4%.¹⁶⁶ This is consistent with current investor expectations, even

¹⁶⁵ Atmos Energy's Response to Staff's First PH-DR, Item 16; *see also* Atmos Energy's Response to Staff's First PH-DR, Item 17, Table 1 (showing an upward trend in rates).

¹⁶⁶ April 2, 2019, Video Transcript of Evidence at 9:38.

with the Company's announced intention to file annual rate cases and the potential reduction in regulatory lag.¹⁶⁷

G. Class Cost of Service

Atmos Energy proposed rates to be implemented based on a fully allocated cost of service study ("COSS") prepared by Paul Raab, a consulting economist with extensive experience. No other testimony about cost of service was presented. The proposed cost of service study uses the same methodology as the study approved in the prior case.¹⁶⁸ It is a generally accepted utility ratemaking principle that rates should be based on costs, not only the overall level of costs incurred by the utility, but also the costs that the utility incurs to serve individual services, classes of customers, and segments of the utility's business. Adherence to this principle is complicated by the fact that many of the costs incurred to provide different types of service are "joint" costs and many are "common" costs, neither of which has a theoretically precise method by which they can be assigned to the different products produced as a result of the incurrence of these costs.¹⁶⁹ Thus, class cost of service studies are the primary method used to allocate the common and joint costs incurred by the utility in serving different customer classes. They are used for five purposes:

1. To attribute costs to different categories of customers based on how those customers cause costs to be incurred;
2. To determine how costs will be recovered from customers within each customer class;
3. To calculate the costs of individual types of service based on the costs each service requires the utility to expend;

¹⁶⁷ April 2, 2019, Video Transcript of Evidence at 9:45; 9:50.

¹⁶⁸ Atmos Energy's Response to Staff's Second Request, Item 60.

¹⁶⁹ Direct Testimony of Paul H. Raab ("Raab Direct Testimony") at 6.

4. To determine the revenue requirement for the monopoly services offered by a utility operating in both monopoly and competitive markets; and

5. To separate costs between different regulatory jurisdictions.¹⁷⁰

The development of multiple COSS studies in this case is in direct response to Commission directives in its Order in Case No. 2013-00148. The primary directive from that Order is that, “the Commission strongly encourages Atmos-Ky. to file multiple-methodology COSSs in future rate cases in order to give the Commission a range of reasonable results for use in determining revenue allocation and rate design.”¹⁷¹

In addition, the Commission also stated that, “With this Order, the Commission puts all parties to future rate proceedings on notice that we cannot give full consideration to a COSS that does not show separately each of the typical individual COSS steps of functionalization, classification, and allocation.”¹⁷²

As recognized by the Commission in its Order in Case No. 2013-00148, the treatment of distribution mains in the COSS has a significant impact on the class results: “Although certain minor differences exist between the two COSSes, [Atmos Energy] and the AG agree that the primary difference lies in the treatment of distribution mains.”¹⁷³ As a result, Mr. Raab developed three COSS studies for this case that differ based on the treatment of distribution mains.

The first study, termed the “customer/demand” study, classifies investments in distribution mains as both customer- and demand-related using the “minimum system” approach. Such a classification reflects the fact that the Company’s level of investment in distribution mains is

¹⁷⁰ *Id.* at 5-6.

¹⁷¹ *Application of Atmos Energy Corporation for an Adjustment of Rates and Tariff Modifications*, Order at 34, Case No. 2013-00148 (Ky. PSC Apr. 22, 2014).

¹⁷² *Id.* at 35.

¹⁷³ *Id.* at 32.

driven by the maximum demand that customers place on the system, but that there is also a minimum level of investments in distribution mains that would be necessary regardless of the level of such demands.¹⁷⁴

In response to the Commission Staff, Mr. Raab explained that as in the previous case, the mains data that were used to develop the customer/demand classification of distribution mains were through June of 2017. When the zero-intercept approach was applied to these data, it produced a nonsensical result. Specifically, as can be seen in the “analysis” tab of the file provided in Attachment 5 "Staff_1-64_Att5 - Raab WP - KY Mains Data as of 201706.xlsx" to the Company's response to Staff DR No. 1-64, the zero-intercept approach resulted in a negative demand component of distribution mains, implying a customer-related component of greater than 100%. By applying judgment to the dataset and omitting some apparent outliers, a more realistic answer can be developed. However, the application of such judgments to underlying data is not without controversy and Mr. Raab believed that a preferred approach was to rely on a minimum system approach, rather than apply judgments to the dataset to produce a reasonable zero-intercept result.¹⁷⁵ In Mr. Raab’s opinion, the relative benefit of adopting the minimum system approach, which can be applied without judgment and is also recognized by NARUC as an appropriate method to determine customer-related distribution mains costs, is a more reliable COSS.

A second COSS study, termed the “demand-only” study, classifies investments in distribution mains as only demand-related. The third study, entitled the “demand/commodity” study, reflects the Commission’s 1987 guidance that, “cost-of-service methodologies should give some consideration to volume of use.” While Mr. Raab disagrees that such an approach reflects distribution mains investment cost incurrence, and therefore is a results-driven choice of

¹⁷⁴ Raab Direct Testimony at 4.

¹⁷⁵ Atmos Energy Response to Staff’s Second Request, Item 61.

classification methodologies, the study has been prepared for the Commission's consideration.¹⁷⁶ These three studies are filed in this case as Exhibits PHR-2, PHR-3 and PHR-4, respectively, the Direct Testimony of Paul H. Raab.

The summary results of Mr. Raab's allocation studies are provided on Exhibit PHR-5. Page 1 of Exhibit PHR-5 shows actual and relative returns at present rates, the increases needed for an equalized proposed return by class and the estimated customer-related costs for the Company and for each of the cost of service classes for each of the studies developed. Exhibit PHR-5 identifies for the Commission the extent to which rates need to be adjusted so that all identified subsidies can be eliminated under a range of reasonable allocation assumptions. While this exhibit shows that all classes are making positive contributions to rate of return, the residential class is generally providing less than the system average rate of return. All other classes, except Interruptible Transport are generally providing a return greater than the system average return, as indicated by at least one of the alternative allocation schemes.¹⁷⁷

The issue of subsidization of the Non-Residential Interruptible Sales Class was raised during the cross examination of Mr. Raab. He testified that there is no subsidy.¹⁷⁸

The Company was asked why only 10.72 percent of the average increase needed for an equalized return is allocated to the Non-Residential Interruptible Sales Class. The Non-Residential Interruptible Sales Class consists of only 10 customers consuming approximately 330,000 Mcf in the test year. A balanced view of class costs would warrant combining the Interruptible Sales group with the much larger Interruptible Transportation class consisting of 122 customers consuming

¹⁷⁶ Raab Direct Testimony at 4.

¹⁷⁷ *Id.* at 20.

¹⁷⁸ April 2, 2019, Video Transcript of Evidence at 10:02; *see also* Atmos Energy Response to Staff's First PH-DR ("The Company does not believe the Residential Class is contributing to 'the subsidization of the Non-Residential Interruptible Sales Class'.")

approximately 7,560,000 Mcf in the Test Year. With that context, it is debatable whether Interruptible Services are being subsidized. For example, if the Customer/Demand study is used as a reference, Atmos Energy's residential class is being subsidized and therefore not contributing to the subsidization of any other classes. Further, based on the difference between the “Average Revenue Increase Indicated” and the “Proposed Revenue Increase,” shown on Exhibit PHR-5, Page 2 of 2, the Residential Sales class is on average not providing a subsidy to any class, but is instead being subsidized by other classes.

On a combined basis, the “Customer/Demand” study would produce an average class Rate of Return of 11.54%, a 1.45 Relative Rate of Return. By this viewpoint, the Non-Residential Interruptible Sales & Transportation classes are not being subsidized. While Mr. Raab sponsored the three versions of the COSS models filed in this Case, Mr. Martin that is sponsoring the proposed rate design. As noted in Mr. Martin’s Direct Testimony (on pages 12-13), in the design of proposed customer charges and distribution rates, Mr. Raab’s CCOS was only one point of reference, other factors were considered. Mr. Raab’s Direct Testimony explains that the filing of multiple COSS complies with a previous request by the Kentucky Public Service Commission (on page 3). Mr. Raab also notes his preference for the “Customer/Demand” study among the three he filed.¹⁷⁹

Also note that Atmos Energy’s rate structure applies the same customer charges and distribution rates for both the Interruptible Sales and Interruptible Transportation classes. Any adjustment to these rates will affect both of those classes. The Company’s proposed rates did not isolate the small set of customers in the Non-Residential Interruptible Sales group, but rather the

¹⁷⁹ Atmos Energy’s Response to Staff’s First PH-DR, Item 23.

total Interruptible Sales and Transportation classes. And, the Company's overall recommendation sought a generally uniform percentage increase to current rates (excluding gas costs) for all classes.

Based on the revenue increase allocation advocated by Company witness Mark Martin, the rate classes move closer to an equalized rate of return. This can be seen by comparing the class relative rates of return at proposed rates (line 56 of page 1 of Exhibits PHR-2, PHR-3 and PHR-4) to the class relative rates of return at existing rates (line 35 of page 1 of those same exhibits). If the class relative rates of return at proposed rates move closer to 1.0, the proposed revenue increase is a movement toward parity of class returns and a reduction of interclass subsidies. As this condition prevails across all classes and studies, Mr. Raab concludes that the Company's proposed revenue distribution is a reasonable movement toward reducing interclass subsidies. The Company's proposals therefore appear to be reasonable and reflect gradualism in the assignment of the revenue increase.¹⁸⁰

H. Conclusion

The Commission has over the last few years recognized the need for structured, long-term pipeline replacement mechanisms to address the aging infrastructure of the gas industry as well as the growing concern for the safe, reliable operation of those systems. As this case demonstrates, the Commission's stated concerns with bare steel pipe is well founded. Atmos Energy is aggressively attempting to replace the most potentially dangerous segments of its system. However, the physical and financial limitations imposed on that effort in the prior rate case has placed the Company in a difficult position. A Commission limit on non-bare steel expenditures, combined with a limit on bare steel expenditures, force Atmos Energy to defer a significant portion

¹⁸⁰ Raab Direct Testimony at 20.

of prudent, currently needed replacements of undisputedly unsafe pipe – Aldyl-A and low-pressure pipelines.

To address this irreconcilable constraint, the Company is proposing to accept the bare steel pipeline replacement schedule and monetary cap as directed in the prior case as it has detailed in this brief. To continue to fulfill its obligation to the public to provide safe reliable service, it is proposing to address non-bare steel pipe replacements through its capital budgeting. The additional funds committed to the replacement program are fully explained in the five year and annual budgets presented in this case. Based on historic expenditures and annual pipeline replacement projects, the Company's efforts are fully disclosed – the projects have been completed as proposed and the funds expended as budgeted. The Company has done what it said it was going to do.

The need and prudence of the projects is unchallenged. The testimony of the Company's witnesses describes the condition of the portions of the system to be replaced, the standards for determining replacement and the applicable state and national safety standards applicable to Atmos Energy. The only objection from the Attorney General is one of timing, not prudence. Yet, he has not provided any evidence to support his demand for deferral of unquestioned safety upgrades to protect the public – his clients. His only objection is to keep rates lower than proposed. He fails to respond to the fact that even with the proposed capital projects, Atmos Energy's average customer bill is only increased by approximately \$1.50 per month. Of the Attorney General's approximately \$22.5 million of recommendations from the Company's initial filed position, only approximately \$3.2 million of his recommended reduction is a result of limiting the Company's non-bare steel investment.

The longer the replacement of aging infrastructure is delayed, the more expensive it becomes to replace and the greater the risk to the public. The Commission has recently dealt with

situations of deferred replacement – one a gas system and one a water system – Kentucky Frontier Gas Company and Martin County Water District. Each of those utilities is addressing delayed pipe replacement with significantly higher rate impact on their customers than Atmos Energy is proposing. Deferring a current expense to a future customer base is not sound public policy. Yet, as with his position on depreciation rates, the Attorney General wants to get the benefit of unjustifiably low current rates and leave the burden of future higher than necessary rates to his successors.

The Commission should continue its current policy of encouraging replacement of aging, leaking, unreliable pipelines. The Company's proposal sets out a well-defined, fiscally responsible program to address the safety of its system, not only in Kentucky but in its other operating jurisdictions. Each of those situations is distinguishable based on needs, operational factors, regulatory mandates and project specific requirements. Kentucky must be judged on its needs, not on the needs or activities in other jurisdictions. The issue is whether based on the evidence in this record, Atmos Energy has demonstrated that its replacement proposal, its budgeting reliability and its efforts to maintain a safe pipeline system in Kentucky is reasonable. Failing to actively address the known safety issues now will only increase the cost and customer rates in the future and may jeopardize public safety to an unnecessary degree. The practice of delaying expenditures to future ratepayers has unfortunately occurred for many years in other scenarios in Kentucky, such as public infrastructure like roads and bridges. The Commission is urged to reject the Attorney General's recommendation to defer needed pipe replacement, and allow, indeed encourage, the Company's need to invest capital into the Commonwealth to enhance the safety and reliability of its system.

Modest rate adjustments in alignment with responsible infrastructure replacement is a much more justifiable regulatory policy than continually deferring rate increases and safety projects to the next case as the Attorney General demands. That deferral creates a never-ending cycle resulting in situations needing extensive immediate system reconstruction and the associated spike in rates and surcharges, such as those the Commission is facing with many of its water systems. Prudent management of current system needs is preferable to crisis management of foreseeable but unaddressed incidents in the future.

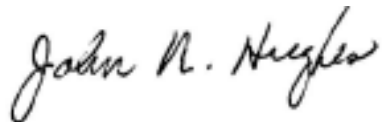
Atmos Energy requests that its proposed rates, PRP tariff withdrawal, capital expenditures and safety replacement proposals be approved.

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Certification: I certify that this is a true and accurate copy of the documents to be filed in paper medium; that the electronic filing was transmitted to the Commission on April 23, 2019; 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.

