COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ELECTRONIC APPLICATION OF ATMOS ENERGY CORPORATION FOR AN ADJUSTMENT OF RATES	)))	CASE NO. 2021-00214

ATTORNEY GENERAL'S FINAL BRIEF

Respectfully submitted,

DANIEL CAMERON
ATTORNEY GENERAL

____
LAWRENCE W. COOK
J. MICHAEL WEST
ANGELA M. GOAD
JOHN G. HORNE II
ASSISTANT ATTORNEYS GENERAL
1024 CAPITAL CENTER DR., STE. 200
FRANKFORT, KY 40601
(502) 696-5453
FAX: (502) 564-2698
Larry.Cook@ky.gov
Michael.West@ky.gov
Angela.Goad@ky.gov
John.Horne@ky.gov

TABLE OF CONTENTS

I. STATEMENT OF THE CASE …… 4

II. ARGUMENT …… 5

1. **RATE BASE ISSUES** …… 5
   - a. Remove Asset NOL ADIT Due to Winter Storm Uri …… 5
   - b. Reduce Asset NOL ADIT to Reflect Taxable Income From April 2021 Through December 2021 …… 6
   - c. SSU Division 002 ADIT …… 11
     - (1) Include SSU Division 002 T-Lock Adjustment – Unrealized Gains Liability ADIT In Allocation To The Kentucky Rate Division …… 12
     - (2) Remove Other SSU Division 002 ADIT From Allocation to Kentucky Rate Division …… 12
   - d. Remove Accounts Payable – Construction …… 13
   - e. Remove Regulatory Asset for Deferred Rate Case Expenses …… 14
   - f. Adjust Cash Working Capital Revenues, Expenses, and Expense Lag Days …… 16
     - (1) Depreciation Expense Lag Days Must Be Adjusted …… 16
     - (2) Reflect Effects Of The Company's Error Corrections And All AG Adjustments On Cash Working Capital …… 19
2. **OPERATING INCOME ISSUES** …… 19
   - a. Reduce Excessive Growth In Affiliate Outside Services Expenses …… 19
   - b. Amortize Excess Deferred Tax Regulatory Liability Over Three Years …… 21
   - c. Correct Amortization of Deferred Rate Case Expense …… 22
   - d. Reject Proposal to Defer Differences In Actual Bad Debt Writeoffs And Bad Debt Expense …… 22
   - e. Remove American Gas Association ("AGA") Dues …… 23
3. **COST OF CAPITAL ISSUES** …… 25
   - a. Modify Capital Structure to Reflect Reasonable Levels of Common Equity, Long-Term Debt, and Short-Term Debt …… 25
   - b. Reduce Commitment Fees Included In Cost of Short-Term Debt …… 30
   - c. Return on Equity …… 30
     - (1) AG Witness Baudino's Recommendation Will Lead to Fair, Just and Reasonable Rates …… 30
     - (2) Atmos' ROE Demand is Unreasonable …… 33
4. **SUMMARY OF AG ADJUSTMENTS TO ATMOS' REQUESTED BASE RATE INCREASE** …… 37
5. **PIPELINE REPLACEMENT RIDER ISSUES** …… 38

a. Reject Request for Accelerated Replacement of Aldyl-A Pipeline and Recovery of Costs Through PRP Rider……………………………38
b. Modify PRP Rider To Address Reductions In Asset Net Operating Loss ADIT……………………………………………………………….. 41

6. **TAX ACT ADJUSTMENT FACTOR ISSUES**………………………… 41

7. **ANNUAL RATE REVIEW MECHANISM ISSUES**…………………… 42

8. **RATE DESIGN**…………………………………………………………...42
a. Atmos' Proposed 26% Increase in the Residential Class Customer Charge is Unreasonable and Violates Principle of Gradualism…………………………………………………….. 43

III. **CONCLUSION**…………………………………………………………………..44

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ATTORNEY GENERAL'S FINAL BRIEF

The intervenor, the Attorney General of the Commonwealth of Kentucky, through his Office of Rate Intervention ("AG"), hereby submits his Final Brief in the above-styled matter.

I. STATEMENT OF THE CASE

On June 30, 2021 Atmos Energy Corporation ("Atmos," "AEC," or "the Company") tendered its application for an adjustment of rates, which the Kentucky Public Service Commission ("Commission") accepted for filing on July 23, 2021. On July 8, 2021 the AG filed his motion to intervene, which the Commission granted on July 16, 2021. Following the Commission's issuance of a procedural schedule, the AG and Commission Staff issued several rounds of data requests, to which Atmos filed responses into the record. On September 30, 2021 the AG filed the direct testimony and exhibits of his witnesses, Messrs. Lane Kollen and Richard A. Baudino.[1] On November 4, 2021 the AG filed responses to data requests from Atmos and Commission Staff. Atmos filed its Rebuttal Testimony on November 18, 2021,

[1] *NOTE*: Unless otherwise specified in this Brief, the AG agrees with all adjustments and recommendations of Messrs. Kollen and Baudino and recommends the Commission adopt such in their entirety. The AG also recommends an additional adjustment consistent with the Commission's Order in Case No. 2021-00183, which include the exclusion of all non-cash expenses from cash working capital calculated using the lead/lag approach. In addition to the direct effect of this additional adjustment, it has offsetting minor effects on the AG's cost of capital recommendations. The AG's final revenue recommendations are reflected in the table at pp. 37-38 of this Brief. An Excel workbook version of this table is being filed contemporaneously with this Brief.

and filed revised versions of its revenue requirement model on November 23, 2021 and December 3, 2021 to correct various errors.[2]

On December 10-11, 2021, an extreme weather event impacted portions of Atmos' service territory, causing major loss of life and property damage. As a result, Kentucky Governor Beshear on December 11, 2021 declared a state of emergency throughout the Commonwealth. On December 12, 2021, Atmos requested, and the Commission approved a postponement of the evidentiary hearing previously scheduled for December 14, 2021. Atmos subsequently requested that the case be submitted on the record with one additional round of discovery, and that final simultaneous briefs be submitted in lieu of an evidentiary hearing in this matter. On December 13, 2021, the Commission issued an order requiring the submission of simultaneous briefs, after which the Commission will determine whether this matter can be submitted upon the record as it stands, or whether the evidentiary hearing should be rescheduled.[3]

II. ARGUMENT

1. RATE BASE ISSUES

a. Reduce Asset NOL ADIT to Remove Amounts Due to Winter Storm Uri Expenses Incurred In Rate Divisions Other Than The Kentucky Rate Division

Atmos included an allocation of the AEC *utility* asset net operating loss ("NOL") accumulated deferred income taxes ("ADIT") in the Kentucky Rate Division rate base for the test year. Atmos' Texas, Oklahoma, and Kansas rate divisions incurred major expenses as a result of Winter Storm Uri in February, 2021. The Winter Storm Uri expenses reduced the

[2] *See* the Corrected Rebuttal Testimony of Atmos Witness, Joe T. Christian, filed on Dec. 3, 2021, which reduced the amount of new revenues the Company was seeking from the original as-filed amount of $16.390 million to $14.806 million.
[3] Case No. 2021-00214, Order dated Dec. 13, 2021 at 2.

AEC taxable income and significantly increased the AEC *utility* NOL ADIT and the allocation of the *utility* NOL ADIT to the Kentucky Rate Division, even though it did not incur any such expenses. The Company's application in the instant case errantly sought to include an allocation of the asset NOL ADIT due to the Winter Storm Uri expenses incurred by the other rate divisions in the Kentucky Rate Division rate base and the related return on this rate base amount in the revenue requirement. In response to AG discovery,[4] and to Mr. Kollen's testimony,[5] the Company agreed to remove the allocation of the asset NOL ADIT due to Winter Storm Uri from the Kentucky Rate Division's rate base, and from the requested revenue requirement.[6] This issue therefore is no longer disputed between the parties.

b. Reduce Asset NOL ADIT to Reflect Taxable Income From April 1, 2021 Through December 31, 2021

Atmos included an allocation of the corrected AEC *utility* asset NOL ADIT in the Kentucky Rate Division rate base for the test year. However, the Company's forecast of the AEC *utility* asset NOL ADIT is fundamentally flawed and overstated, which overstates the Kentucky Rate Division rate base and claimed revenue requirement. More specifically, Atmos failed to reduce the AEC NOL ADIT for income tax expense effects of AEC *utility* taxable income after March 31, 2021 through December 31, 2021.[7] This is a fundamental error because the Company is required to calculate rate base using a 13-month average for the test year, which includes all rate base balance sheet components at December 31, 2021.[8]

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[4] Response to AG-DR-1-17, attached as Exhibit __(LK-3) to the Direct Testimony of Lane Kollen. *See also* Excel workbook filed in Supplemental Response to PSC-DR-1-55 filed Aug. 23, 2021.
[5] Kollen Direct at 7-9.
[6] Multer Rebuttal Testimony at 11.
[7] Taxable income in a period reduces any NOL carryforward (cumulative taxable losses) from prior periods. The asset NOL ADIT is the income tax effect of the NOL carryforward at the end of each month.
[8] 807 KAR 5:001. *Rules of Procedure* § 16(6)(c): "Capitalization and net investment rate base shall be based on a thirteen (13) month average for the forecasted period."

Instead, Atmos simply used the AEC *utility* NOL ADIT at March 31, 2021 as the December 31, 2021 amount instead of an appropriate calculation of the forecast amount at December 31, 2021.

The Company offered no evidence whatsoever that the NOL ADIT at December 31, 2021 was or would be equivalent to the NOL ADIT at March 31, 2021. In response to AG discovery, the Company incredibly claimed that although it had calculated a forecast of the AEC NOL ADIT at December 31, 2021 on a consolidated basis (*utility*, non-utility, and other), it had not calculated the *utility* NOL ADIT component at December 31, 2021, the AEC amount that it allocates to the Kentucky Rate Division in the ratemaking process.[9] In its response to the AG discovery, the Company refused to make such a calculation.[10]

In the absence of a Company forecast for the *utility* NOL ADIT at December 31, 2021, Mr. Kollen developed an independent forecast by taking the first six months of actual *utility* taxable income in the base year from October 1, 2020 through March 31, 2021, extrapolating it for the nine months from April 1, 2021 through December 31, 2021, calculating the income tax expense on this taxable income, reducing the March 31, 2021 NOL ADIT by this amount to calculate the NOL ADIT at December 31, 2021, and then allocating this amount to the Kentucky Rate Division.[11] In its Rebuttal Testimony, the Company simply disagreed with Mr. Kollen's calculation, but failed to provide any specific evidence that it was inaccurate and failed to provide a forecast or an alternative calculation of the NOL ADIT at December 31, 2021.[12] The Company has therefore both failed to rebut Mr. Kollen's proposed adjustment, and failed to meet its burden of proof on this issue.

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[9] Atmos response to AG 2-18, a copy of which is attached to Mr. Kollen's Direct Testimony as Exhibit__(LK-4).
[10] *Id.*
[11] Kollen Direct at 10-13.
[12] Rebuttal Testimony of Joel Multer at 7-10.

In its Rebuttal Testimony, the Company states: "The Company, therefore, disagrees with Mr. Kollen's proposal and recommends there be no change to the Company's estimated asset NOL ADIT balances as presented in its filing."[13] However, the Company ignored its own witness' recommendation. Instead, the Company subsequently revised the NOL ADIT for the test year in its revised revenue requirement model filed on November 23, 2021 to the actual NOL ADIT at September 30, 2021, which was greater than the actual NOL ADIT at March 31, 2021.[14] The Company offered *no support* for the claimed NOL ADIT at September 30, 2021. It provided no evidence that it had properly calculated the *utility* NOL ADIT. It provided no evidence that it had excluded all NOL ADIT for unique circumstances, such as Winter Storm Uri, specifically related to its other rate divisions for taxable losses incurred in those rate divisions. The Company's failure to provide this support and evidence is particularly important given the Company's other significant errors in the NOL ADIT and other ADIT amounts in its initial filing. In other words, there is no reason for the Commission to assume that the Company correctly calculated the *utility* NOL ADIT or that it was correctly allocated to the Kentucky Rate Division even if the Commission were inclined to adopt the Company's update.

At this time, the Company still has not provided a forecast of the *utility* NOL ADIT at December 31, 2021. The NOL ADIT at September 30, 2021 included in its revised revenue requirement model filed on November 23, 2021 is not a reasonable proxy for the NOL ADIT at December 31, 2021. Nor should the Company be allowed to selectively update its forecast for the test year in this manner, solely because it benefits the Company.

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[13] Multer Rebuttal at 10.

[14] *See* Christian Rebuttal at 5, describing this revision to Atmos' revenue requirement model.

In fact, the Commission's own procedural rules prohibit such selective updates to a forecast test year. More specifically, 807 KAR 5:001 § 16(6) protects the Commission and the parties, including the AG, in general rate proceedings from the utility's procedural abuse and tactical use of such updates to revise its revenue requirement when it is based on a forecast test year. This is an especially important procedural safeguard after the parties have filed their Direct Testimony and no longer have the ability to engage in discovery. This regulation, which specifically and preemptively prohibits such updates to the forecast test year except for the correction of mathematical errors, provides the following with respect to a forecast test year:

> (6) All applications requesting a general adjustment in rates supported by a fully forecasted test period shall comply with the requirements established in this subsection.
>
> > (a) The financial data for the forecasted period shall be presented in the form of pro forma adjustments to the base period.
> >
> > (b) Forecasted adjustments shall be limited to the twelve (12) months immediately following the suspension period.
> >
> > (c) Capitalization and net investment rate base shall be based on a thirteen (13) month average for the forecasted period.
> >
> > **(d) After an application based on a forecasted test period is filed, there shall be no revisions to the forecast, except for the correction of mathematical errors, unless the revisions reflect statutory or regulatory enactments that could not, with reasonable diligence, have been included in the forecast on the date it was filed. There shall be no revisions filed within thirty (30) days of a scheduled hearing on the rate application.**[15]

In short, the Commission's procedural safeguards prohibit the Company's selective revision of the forecast NOL ADIT to the claimed actual NOL ADIT at September 30, 2021.

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[15] Emphasis added.

It also should be noted that the Company did not update its forecast for other taxable income differences in its actual accounting compared to the forecast months in the base year, nor did it update its forecast for other interrelated balance sheet amounts that affect rate base and the NOL ADIT, including plant in service, accumulated depreciation, and income statement amounts that affect depreciation expense, among other rate base and operating income components.

In any event, the Company bears the burden to meet and prove that its claimed revenue requirement is reasonable, including all rate base components for the test year. It has not met this burden for the NOL ADIT included in its original filing or the revised amount included in its revised revenue requirement model filed on November 23, 2021.

The ***only*** forecast of the *utility* NOL ADIT at December 31, 2021 in the record was developed by Mr. Kollen. Mr. Kollen utilized a reasonable methodology by extrapolating the first six months of actual *utility* taxable income in the base year through December 31, 2021. Mr. Kollen's methodology reflects the fact that AEC actually had taxable income, not taxable losses, in fiscal year 2020 and year to date in the base year as filed and the fact that the Company refused to provide any evidence that it would have no taxable income for the months April 2021 through December 2021. Atmos tactically *elected* to not provide this relevant and critical information in its application, its revisions, or even in response to specific AG discovery requesting the information.

Not only does the Commission require the utility to use a 13-month average of the NOL ADIT in the forecast test year, so does the Internal Revenue Service ("IRS") pursuant to 26 C.F.R. § 1.167(l)–1, Treas. Reg. § 1.167(l) (referred to by Atmos in prior proceedings

and generally by the IRS and practitioners as the "Consistency Rule").[16] Pursuant to the Consistency Rule, the utility is required to use a 13-month average for the depreciation-related components in the test year, including plant in service, accumulated depreciation, liability ADIT, and asset ADIT, as well as the depreciation expense reflected in the accumulated depreciation and ADIT calculations.

The Company's filing violates the Consistency Rule by failing to use a 13-month average for all of these related rate base components. Instead, in its original filing, the Company averaged in the NOL ADIT at March 31, 2021, and in its rebuttal filing, at September 30, 2021, with the 12-month average of the NOL ADIT in the test year. Even the 12 months of the NOL ADIT in the test year are incorrect because the Company failed to start with the NOL ADIT at December 31, 2021, which necessarily rolls forward and affects the NOL ADIT at the end of each subsequent month.

The Company's violation of the Consistency Rule is extremely significant. More specifically, under the Consistency Rule, the failure to use a 13-month average for the ADIT components in the forecast test year is deemed a normalization violation. There will be a normalization violation if the Commission adopts the Company's actual NOL ADIT at either March 31, 2021 or September 30, 2021. A normalization violation means that the Company would be precluded from using accelerated tax depreciation. *This would be a disaster* in that it would eliminate liability ADIT due to accelerated tax depreciation as a cost-free source of capital and could result in an increase in the Company's rate base and revenue requirement absent Commission action to compensate customers for this loss.

c. <u>SSU Division 002 ADIT</u>

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[16] A copy of this IRS rule is attached hereto for reference purposes, as Exhibit 1.

(1) Include SSU Division 002 T-Lock Adjustment – Unrealized Gains Liability ADIT In Allocation To The Kentucky Rate Division

Atmos' Shared Services Unit Division 002 maintains both asset ADIT and liability ADIT amounts on its books, by FERC account and temporary difference.[17] When the Kentucky Rate Division files rate applications, the Company reviews its asset and liability ADIT amounts by temporary difference to determine which ones should be allocated to the Kentucky Rate Division.[18] In the instant case, however, while Atmos did include the ***asset*** T-Lock Adjustment – Realized Gains ADIT amounts as an addition to Kentucky rate base, the Company excluded the ***liability*** T-Lock Adjustment – Unrealized Gains ADIT amounts that should have been allocated to the Kentucky Rate Division as a subtraction to Kentucky rate base. In prior rate case proceedings, when both ADIT amounts were assets, the Company consistently added them to rate base. The Company's original and rebuttal filings now treat the two ADIT amounts inconsistently. Obviously, the failure to include and subtract this *liability* ADIT resulted in an overstated rate base and revenue requirement, which Atmos acknowledged in its rebuttal testimony,[19] although it recommends an adjustment to common equity instead of directly correcting the inconsistency.[20] Mr. Kollen's adjustment in this regard reduces the revenue requirement by $0.313 million.[21]

(2) Remove Other SSU Division 002 ADIT From Allocation to Kentucky Rate Division

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[17] Kollen Direct at 13, *citing* Excel workbook provided in Atmos' Supplemental Response to PSC-DR-1-55, "ADIT for KY 04-30-21 updated NOL for URI 8-17-21." The Company's selection of ADIT amounts is summarized on WP B.5 F and the allocations to the Kentucky Rate Division are shown on Schedule B.5 F.

[18] Kollen Direct at 13-16. The Company utilized the same adjustment in its last two rate cases, having included the asset ADIT amount in the allocation to the Kentucky Rate Division and added that allocation to the Kentucky Rate Division rate base. *Id.* at 14.

[19] Multer Rebuttal at 7.

[20] The Company's rebuttal correction merely and only slightly reduces its requested hypothetical common equity ratio, which is excessive regardless of the proposed adjustment. The better resolution is to directly correct the error and subtract the ADIT from rate base.

[21] Kollen Direct at 16.

As Mr. Kollen discusses in his testimony,[22] additional SSU Division 002 ADIT amounts must also be excluded from allocation to the Kentucky Rate Division because the temporary differences upon which the ADIT amounts are premised are not allocated to and subtracted from the Kentucky Rate Division rate base.[23] These eight additional items are:

- Self-Insurance Adjustment ADIT
- Rabbi Trust ADIT
- VEBA Trust Contribution Adjustment ADIT
- FAS106 Adjustment ADIT
- Pension Expense ADIT
- Federal and State Tax Interest ADIT
- FD-NOL Credit Carryforward – Other ADIT
- State Enterprise Zone ITC ADIT and Related Valuation Allowance ADIT

Atmos acknowledges that these items should be excluded from the allocation to the Kentucky Rate Division rate base.[24] The effect is to reduce the revenue requirement by $0.118 million.[25]

d. Remove Accounts Payable – Construction

Atmos appropriately included balance sheet ***asset*** amounts such as gas stored underground, and materials and supplies in its other working capital component of rate base. However, the Company did not subtract any balance sheet ***liability*** amounts from rate base, in particular regarding accounts payable liability balance sheet amounts.[26]

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[22] Kollen Direct at 16-19.
[23] Kollen Direct at 16, *citing* Excel workbook provided in Atmos' Supplemental Response to PSC-DR-1-55, "ADIT for KY 04-30-21 updated NOL for URI 8-17-21." The Company's selection of ADIT amounts is summarized on WP B.5 F and the allocations to the KY rate div. are shown on Schedule B.5 F.
[24] Multer Rebuttal at 4.
[25] Kollen Direct at 18.
[26] Kollen Direct at 19-20.

Atmos' accounts payable liability balance sheet amounts represent cost-free vendor financing, which allows the Company to avoid financing. This no-cost vendor financing is recognized in the Cash Working Capital ("CWC") study using the lead/lag approach as to the Company's operating expenses. For example, if a utility incurs the cost of contractors to perform vegetation management during the month, it receives an invoice at the end of that month, and then pays the invoice at the end of the next month after 30 days, that delay in payment to the contractor is cost-free vendor financing.

However, capital expenditure costs are not included within a CWC study because the lead/lag study does not include balance sheet assets and liabilities. Thus, accounts payable liability balance sheet amounts related to capital expenditures must be considered separately and subtracted directly from rate base. This is the exact same approach used in order to add materials and supplies and prepayments directly to rate base as components of the other working capital allowances.

Mr. Kollen recommends that the Commission reduce the Company's other working capital allowances for the accounts payable amounts related to capital expenditures. Such zero-cost vendor financing should be subtracted from rate base. The Commission approved a similar adjustment in Case No. 2020-00174.[27] The effect is a reduction in the revenue requirement of $0.501 million.[28]

e. <u>Remove Regulatory Asset for Deferred Rate Case Expenses</u>

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[27] *In Re:* Electronic Application of Kentucky Power Company For a General Adjustment Of Its Rates For Electric Service, etc., Case No. 2020-00174, Final Order dated Jan. 13, 2021, p. 10.
[28] Kollen Direct at 19.

In the instant case, Atmos seeks to include $0.241 million in deferred rate case expenses in rate base.[29] Mr. Kollen correctly points out that if these sums are allowed to be placed into rate base, an over-recovery would occur because the revenue recovery set in this rate case continues at the same amount regardless of the decline in the rate base and never is trued-up.[30] Additionally, if Atmos' base rates are not reset within three years, ". . . then it will continue to recover the amortization expense again and again even though the regulatory asset is fully amortized and it no longer incurs this amortization expense."[31]

In Case No. 2019-00271,[32] the Commission approved an adjustment that AG witness Kollen recommended regarding Duke Energy Kentucky, Inc.'s ("DEK") deferred rate case expenses. In that case, DEK requested that the Commission allow it to include the unamortized sums from its rate case expense regulatory asset from its prior rate case.[33] In approving Mr. Kollen's recommended adjustment in Case No. 2019-00271 and in ordering the appropriate reduction in the revenue requirement, the Commission found: "The Commission agrees that rate case expense regulatory assets should not be included in rate base, as that would allow a return on the unamortized balance of the expense. The Commission has historically excluded this item from rate base to share the cost of rate proceedings between the stockholders and ratepayers."[34]

[29] Kollen Direct at 21 (*citing* Atmos' revised regulatory asset for deferred rate case expenses and the associated amortization expense provided in Supplemental Response to PSC-DR-1-55, and to Revised Sch. F.6, line 187, Excel cell 200).
[30] Kollen Direct at 21.
[31] Kollen Direct at 22.
[32] *In Re*: Electronic Application Of Duke Energy Kentucky, Inc. For An Adjustment Of The Electric Rates, etc., Final Order dated April 27, 2020 at pp. 7-8 (*citing* Case No. 2004-00103, *In Re:* Adjustment of the Rates of Kentucky-American Water Company, Final Order dated Feb. 28, 2005, at 35).
[33] *In Re:* Electronic Application Of Duke Energy Kentucky, Inc. For: An Adjustment Of The Electric Rates, etc., Case No. 2017-00321.
[34] Case No. 2019-00271, Final Order dated April 27, 2020 at 7-8.

The Commission's precedent regarding the sharing of costs arising from rate proceedings between stockholders and ratepayers should apply just as equally to Atmos in the current case as it has applied to other jurisdictional utilities. Atmos' concern that the Company would not recover these costs is misplaced,[35] as Mr. Kollen's recommended adjustment[36] preserves the Commission's precedent for the equitable sharing of rate case expense by requiring ratepayers to continue paying the amortization expense on this expense, while allocating the return on the regulatory asset to AEC's shareholders. Mr. Kollen's recommendation allocates only 14% of the total costs to shareholders over a three-year period, while 86% would be allocated to ratepayers.[37] The effect of Mr. Kollen's adjustment yields a reduction of $0.023 million in the revenue requirement.[38]

f. <u>Adjust Cash Working Capital Revenues, Expenses, and Expense Lag Days</u>

(1) <u>Depreciation Expense Lag Days Must Be Adjusted</u>

As indicated in Mr. Kollen's testimony, the Company's lead-lag study used to determine the CWC allowance errantly included depreciation expense at zero expense lag days, which increased the CWC by a positive $1.928 million.[39] In order to cure this error, the Commission can either remove all non-cash expenses in the CWC calculation, or leave the non-cash expenses in the CWC calculation but correct the depreciation expense lag days used in the calculation. In fact, in its recent order in Case No. 2021-00183,[40] the Commission

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[35] Christian Rebuttal at 25:10-12.
[36] Kollen Direct at 21-23.
[37] Kollen Direct at 23.
[38] Kollen Direct at 23.
[39] Kollen Direct at 23-27.
[40] *In Re*: Electronic Application Of Columbia Gas Of Kentucky, Inc. For An Adjustment Of Rates; Approval Of Depreciation Study; Approval Of Tariff Revisions; Issuance Of A Certificate Of Public Convenience And Necessity; And Other Relief; Final Order dated Dec. 28, 2021, p. 14.

stated: ". . . the Commission places Columbia Kentucky and *all other* utilities on notice that in any future rate cases, a lead/lag study is to be performed and shall exclude noncash items and balance sheet adjustments." The AG and Mr. Kollen have consistently argued against including noncash items in the CWC calculation using the lead/lag approach, including in this proceeding.[41]

The underlying goal of lead-lag studies is to measure *cash* investment. Shareholder investment in lead-lag studies is identified as positive, while ratepayer-provided investment is identified as negative. The return on non-cash expenses such as depreciation expense is reflected in the return on rate base. Since depreciation is a non-cash expense, no cash disbursement will ever be made for it. Cash disbursement occurs when construction cost is incurred and capitalized as construction work in progress ("CWIP") or plant in service. Net accumulated depreciation and ADIT are subtracted from rate base, but only on a lagged basis. Doing so allows the Company to retain the carrying charge value of this non-cash expense between rate cases.

However, should the Commission decide to allow non-cash expense to be included in the lead-lag study, the Company's use of zero depreciation expense day lags is incorrect because that assumes that depreciation expense is actually paid in cash on the first day of the month in which it is recorded, regardless of whether cash is paid for an expense item. Of course, the Company *never* disburses cash for depreciation expense, let alone instantaneously. In fact, Atmos' depreciation expense is not recorded to accumulated depreciation until the end of the month.[42] Furthermore, depreciation expense is not recorded in the accounting

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[41] Kollen Direct at 24 ("I continue to disagree with the inclusion of non-cash expenses in the CWC calculation").
[42] Kollen Direct at 25.

process for each month until the end of that month. It is not recorded on the first day of the month.

The Company already includes the current month's depreciation expense in rate base because the depreciation is not recorded to accumulated depreciation until the *end* of the month. In other words, the Company earns a return on the depreciation expense each month. This lag is reflected in the use of the 13-month average of net plant (gross plant less accumulated depreciation) for the test year.

The 13-month average for each component of rate base, including accumulated depreciation, consists of twelve months of beginning balances, for the months of January 2022 through December 2022, and one month of ending balances, specifically for December 2022 only. As a result of the 13-month average methodology, the Company is allowed a full month's return on the current month depreciation expense because it is not added to accumulated depreciation and used to reduce rate base until the end of the current month, with the sole exception of the last month in the test year, which essentially negates this differential for that month only. The Company's use of zero lag days for depreciation expense in the lead/lag calculation of CWC assumes that it is paid in cash at the beginning of each month when incurred, so that it is allowed a return in the CWC calculation for the difference in the revenue lag days and the zero days depreciation expense lag days assumed in the Company's calculation. Consequently, for 11 months of the test year, the Company includes the depreciation expense in rate base twice, once through the use of the beginning balances of accumulated depreciation for each of those months and then a second time through the CWC calculation.

Therefore, if it does not exclude all noncash expenses from the CWC calculation, the Commission at least should correct the number of depreciation expense lag days to reflect the 11 months, or 335 days in the test year, during which this lag and the effect on rate base is double-counted. As Mr. Kollen points out, "[t]he Company double counted the return on depreciation expense for 27.92 days on average during the test year. There are 30.42 days each month on average in a calendar year. It was not double counted for 2.50 days each month on average in the test year (30 days divided by 12 months)."[43]

The effect of Mr. Kollen's adjustment to correct the depreciation expense lag days to 27.92 days reduces the revenue requirement by $0.153 million. The effect of the AG's adjustment to remove the remaining CWC due to depreciation expense and all other non-cash items from the CWC calculation reduces the revenue requirement by another $0.362 million.

(2) **Reflect Effects Of The Company's Error Corrections And All AG Adjustments On Cash Working Capital**

Atmos also did not modify the CWC calculation in its revised calculation of the base revenue requirement in response to Staff discovery. The revision would have resulted in a CWC reduction based on the reduction in interest expense and return on equity line items and, thus, a reduction in the claimed base revenue deficiency. The net effect is a reduction of $0.093 million, reflecting Mr. Kollen's rate base, revenues, and expense recommendations and Mr. Baudino's cost of capital recommendations.

2. OPERATING INCOME ISSUES

a. Reduce Excessive Growth in Affiliate Outside Services Expense

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[43] Kollen Direct at 26.

Although it is common for an investor-owned jurisdictional utility to receive charges from affiliates, in the instant case Atmos' Kentucky Rate Division was allocated unusually high affiliate charges for both the base period and the test period, which are grossly disproportionate to similar historic charges.

In response to discovery,[44] Atmos provided a breakdown of historical and projected costs. The Company's Kentucky Rate Division was allocated a total of $1.489 million in outside services by the Kentucky/Mid States Division for both the base period and the test year.[45] This sum of $1.489 million for both the base period and the test year which Atmos seeks to recover in this case is:

- 116% higher than the $0.687 million that was charged in Fiscal Year ("FY") 2018;
- 47% more than the $1.011 million charged in FY 2019;
- 25.4% higher than the $1.187 million charged in FY 2020; and
- 37% greater than the $1.087 million actually incurred on an annualized basis during FY 2021.[46]

Quite significantly, the forecasted outside services expense is $0.402 million greater than the most recent actual annualized expense in the base period.

In response to further discovery, Atmos provided a breakdown of both historical and projected costs by type, and identified two primary drivers for its projected increases:[47] (a) a *projected* increase in payment processing services due to customers' increasing usage of

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[44] Response to AG-DR-1-37, attached to Kollen Direct as Exhibit__(LK-8).
[45] Christian Direct Testimony, Exhibit JTC-2.
[46] Kollen Direct at 28 (*citing* Atmos' response to AG-DR-1-37 Attachment 1, attached to Mr. Kollen's testimony as Exhibit___(LK-8)).
[47] Atmos' Response to AG-DR-2-11, attached as Exhibit__(LK-9) to Kollen Direct.

debit/credit cards by customers; and (b) a *projected* increase in contract labor to update the Company's maps and records. However, the Company's comparisons and variance analysis provided in that discovery response[48] establishes beyond question that *neither* of the two above-referenced projected increases ever occurred during the base period. Moreover, Atmos' discovery response contained no explanation of why these projected increases did not materialize, or what differences were expected to occur during the test year.[49] Atmos has clearly failed to meet its burden of proof as to the legitimacy of this forecasted outside services expense. Accordingly, the Commission should accept Mr. Kollen's adjustment which reduces the test year affiliate outside services expense to match the annualized actual expense during the base period, which tracks closely with the actual amounts incurred in FYs 2018 and 2019. The net effect is a decrease in the revenue requirement of $0.405 million.[50]

b. Amortize Excess Deferred Tax Regulatory Liability Over Three Years

In prior years, Atmos collected income tax expense from ratepayers based on federal and state corporate income tax rates that were greater than the rates in effect today. As a result, Atmos appropriately created an unprotected excess deferred tax regulatory liability to return these sums to ratepayers. While Atmos agrees that the sums should be returned to its customers, the Company apparently neither agrees nor disagrees[51] with Mr. Kollen's recommendation to create a three-year amortization within which to effectuate the return of these sums. As Mr. Kollen states, "The refund of these unprotected amounts should be implemented as quickly as practicable. Absent an immediate refund, the refund should be

[48] Atmos' Response to AG-DR-2-11.
[49] Kollen Direct at 28-29.
[50] Kollen Direct at 29.
[51] Multer Rebuttal at 5:10, 12-13.

implemented over the estimated period between base rate cases."[52] Mr. Kollen's recommendation of a three-year amortization period is consistent with the Company's proposal to recover deferred rate case expenses over a three-year amortization period.[53] The effect is a reduction of $3.294 million in the base revenue requirement.[54]

c. Correct Amortization of Deferred Rate Case Expense

Mr. Kollen recommends that the Commission adopt an adjustment to correct an error in the amortization expense for its forecast regulatory asset for deferred rate case expense.[55] The Company incorrectly embedded the January 2022 - March 2022 amortization expense related to the prior case into the amortization expense rather than adding the remaining unamortized amount at December 31, 2021, to the Company's forecast rate case expenses for this case and then divided that sum by three years. As a result, the Company's calculation assumes that the $0.015 million in amortization expense related to the prior case is recurring. If this methodology is adopted, the Company will recover the remaining amortization expense from the prior case multiple times until base rates are reset in the next base rate case proceeding. Atmos has accepted Mr. Kollen's adjustment.[56] Accordingly, the Attorney General recommends that the Commission approve this adjustment. The effect is a reduction in the revenue requirement of $0.011 million.[57]

d. Reject Proposal to Defer Differences In Actual Bad Debt Writeoffs And Bad Debt Expense

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[52] Kollen Direct at 30.
[53] Kollen Direct at 21-23, 30.
[54] This consists of consisting of a reduction of $3.460 million due to the increase in the negative amortization expense (grossed-up from the increase in negative amortization expense of $3.436 million), and an increase of $0.166 million due to the increase in rate base from the increase in the amortization of the excess deferred tax regulatory liability. Kollen Direct at 30-31.
[55] Kollen Direct at 32-33.
[56] Christian Rebuttal at 27:14-19.
[57] Kollen Direct at 32-33.

In the instant case, Atmos seeks Commission approval to establish a regulatory asset allowing deferral of writeoffs until the next case to avoid over- and under-recovery of bad debt expense resulting due to the uncertainty of COVID-19.[58] Under the Company's proposal, the Commission would establish a baseline (benchmark) bad debt expense, in this case $363,216, which would be subject to Commission modification.[59] Actual writeoffs above or below the benchmark expense would be deferred and the amortization of any deferral amounts would be addressed in the next rate case.[60]

However, the Company already uses bad debt reserve accounting.[61] Atmos provides an estimate for bad debt expense, which generally is allowed for ratemaking purposes.[62] Bad debt expense is added to the liability balance of the bad debt reserve. The Company then records writeoffs (chargeoffs), net of recoveries, as a reduction to the liability balance of the bad debt reserve. The balance in the bad debt reserve represents the cumulative balance of the bad debt expense recorded compared to the writeoffs, net of recoveries.[63]

Atmos' proposal in this regard should be rejected for two reasons: (a) since the Company's existing bad debt reserve already tracks the difference between allowed expense and writeoffs net of recoveries, it is unnecessary and would be superfluous to adopt a second deferral mechanism atop an existing one; and (b) it would remove financial incentives to minimize writeoffs and maximize recoveries that exist under the present paradigm.

e. <u>Remove American Gas Association ("AGA") Dues</u>

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[58] *See* Direct Testimony of Joe T. Christian at 37.
[59] *Id*.
[60] *Id. See also* Atmos' Response to AG-DR-2-4, attached to Kollen Direct Testimony as Exhibit __(LK-10).
[61] Response to AG-DR-2-4.
[62] Kollen Direct at 33.
[63] *Id*. at 34.

Atmos seeks to recover from its ratepayers a net sum of $52,132 for the dues the Company pays to the American Gas Association ("AGA").[64] While Company witness, Christian, asserts that Atmos' AGA membership provides a direct benefit to ratepayers,[65] the Company provided no evidence to support that mere statement. The AGA invoice to Atmos for its annual dues fees indicates that 6.2% of these dues are allocable to the AGA's lobbying expense.[66] However, neither that invoice nor any other evidence provided by Atmos indicates what percentage of the dues go toward regulatory advocacy, and/or public relations.[67]

In prior cases, the Commission has disallowed dues expense that electric utilities pay to Edison Electric Institute ("EEI"),[68] because that organization engages in legislative advocacy, regulatory advocacy, and public relations. Atmos acknowledges that the AGA engages in lobbying activities.[69] The Commission can take administrative notice of the widely-recognized fact that the AGA also engages in two other activities, namely regulatory advocacy and public relations, which the Commission has historically excluded from recovery. The only evidence Atmos provided regarding how much of its dues are allocable to lobbying is the AGA's own single-sentence statement that 6.2% of dues go toward lobbying.[70] The provision of this one-sentence self-serving statement fails to establish anything as to lobbying activities; moreover, the record is *utterly* devoid of any information regarding how much of the ratepayer-funded dues goes toward regulatory advocacy and public relations. Since the Company has therefore failed to meet its burden of proof to establish that AGA

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[64] Response to AG-DR-1-2, Attachment 1.
[65] Christian Rebuttal at 27-29.
[66] Response to AG-DR-1-2, Attachment 3.
[67] *See* Kollen Direct at 36.
[68] *See* Kollen Direct at 35 (*citing* orders in Case Nos. 2003-00433 at 51-52; 2003-00434 at 44-45; 2020-00349 at 25-28; and 2020-00350 at 27-31).
[69] Response to AG-DR-1-2 (g).
[70] Response to AG-DR-1-2, Attachment 3.

membership provides a direct ratepayer benefit, allowing recovery of these dues would not lead to fair, just and reasonable rates.[71] Just as the Commission removed AGA dues from ratepayer recovery in three recent gas LDC rate cases,[72] it should do likewise here by excluding the full $52,132 in ratepayer-funded dues from recovery.

3. COST OF CAPITAL ISSUES

a. Modify Capital Structure to Reflect Reasonable Levels of Common Equity, Long-Term Debt, and Short-Term Debt

As the record in this matter conclusively establishes, Atmos' hypothetical proposed capital structure is so far beyond traditional norms that it unreasonably, extensively and *unnecessarily* penalizes ratepayers. Atmos' original application sought a nearly-unheard of common equity ratio of 57.05%,[73] but in rebuttal, the Company proposes to *increase* that ratio to 57.59%.[74] Atmos thus eschews traditional ratemaking principles designed to produce the least-possible cost of capital, return on rate base and taxes on the equity return in favor of a methodology that unnecessarily enhances those costs in order to unfairly maximize profits, purely at the expense of ratepayers. The Commission must emphatically reject Atmos' thinly-veiled invitation for it to abandon its legal mandate to establish fair, just and reasonable utility rates.

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[71] KRS 278.030 (1).

[72] *In Re*: Electronic Application Of Columbia Gas Of Kentucky, Inc. For An Adjustment Of Rates; Approval Of Depreciation Study; Approval Of Tariff Revisions; Issuance Of A Certificate Of Public Convenience And Necessity; And Other Relief; Final Order dated Dec. 28, 2021, p. 14; *In Re:* Electronic Application Of Duke Energy Kentucky, Inc. For: 1) An Adjustment Of The Natural Gas Rates; 2) Approval Of New Tariffs, And 3) All Other Required Approvals, Waivers, And Relief, Final Order dated Dec. 28, 2021, p. 3; and *In Re:* Electronic Application Of Delta Natural Gas Company, Inc. For An Adjustment Of Its Rates And A Certificate Of Public Convenience And Necessity; Case No. 2021-00185, Final Order Dated Jan. 3, 2022 at 8-9.

[73] Christian Direct at 53; *see also* FR 16(8)(j).

[74] Christian Rebuttal Exhibit JTC-R-1. Though the Company increased its proposed common equity ratio, its proposed return on equity remains unchanged at 10.35%. *See* D'Ascendis Rebuttal at 2.

As one objective measure of the reasonableness of Atmos' proposed capital structure, Mr. Baudino examined the common equity ratio of the utilities comprising the proxy group which he and Mr. D'Ascendis utilized in making their respective return on equity recommendations.[75] The gas proxy group's average common equity ratio was 50.3% in 2020, while the average for 2021 is expected to be 45.0%.[76] Thus Atmos has the highest common equity ratio of the companies in the gas proxy group for 2020.[77] Additionally, Atmos' proposed hypothetical common equity ratio is greatly in excess of that which was sought by Kentucky's other investor-owned gas utilities in their recent base rate cases, the average of which was only 51.7%.[78]

Moreover, Atmos' proposed hypothetical common equity ratio in the current case is only the latest manifestation of a several-years'-long-trend of increasing and increasingly excessive common equity ratios, which led the Commission in Atmos' last base rate case to caution the Company, finding:

> "Atmos's increase in common equity is concerning to the Commission, especially as compared to the proxy companies, which the Attorney General contends have a current equity ratio of 50.2 percent. Further, Atmos stated that the average debt/equity ratio for the proxy group, as reported by Value Line for 2021 - 2023, is 44 percent debt and 56 percent equity; whereas, Atmos's proposed capital structure is 40.63 percent debt and 59.37 percent equity. [footnote deleted] The Commission agrees with the Attorney General in that Atmos's common equity ratio is excessive compared to its peers, resulting in an increase in the cost of capital and base revenue requirement. However, the capital structure, including the equity component, is known and measurable. Therefore, the Commission accepts the capital structure, as filed in Atmos's rebuttal testimony and will take the excessive equity ratio into consideration in setting the

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[75] Baudino Direct at 29-32.
[76] Baudino Direct at 29.
[77] Baudino Direct at 29.
[78] Case No. 2021-00190 filed by Duke Energy Kentucky, Inc. (50.695% common equity ratio); Case No. 2021-00183 filed by Columbia Gas of Kentucky, Inc. (52.64% common equity ratio); and Case No. 2021-00185 filed by Delta Natural Gas Co. (51.76% common equity ratio).

> return on equity. Further, *the Commission cautions Atmos about the high common equity ratio and finds that in future rate filings, the Commission may make adjustments to Atmos's common equity ratio, for ratemaking purposes, to be comparable to its peers*."[79]

The Commission must determine the reasonable hypothetical capital structure for the forecast test year. The best evidence of the reasonable capital structure is the average for the gas proxy group selected by Atmos witness Mr. D'Ascendis and adopted by Mr. Baudino. Due to the magnitude of the excess common equity compared to the gas proxy group, the Commission should follow Mr. Baudino's recommendation to set in place a transition to make the adjustments necessary to bring Atmos' common equity ratio closer to the average of the gas proxy group, as well as to Kentucky's other investor-owned gas distribution utilities.[80] Specifically, Mr. Baudino recommends a common equity ratio of 53.5% in this case, which is halfway between Atmos' rebuttal requested hypothetical ratio of 57.59% and the gas proxy group 2020 ratio of 50.3%.[81] Although Mr. Baudino's recommended equity ratio is still higher than those requested by Duke Energy Kentucky, Columbia Gas of Kentucky and Delta Natural Gas, he nonetheless believes that making an immediate reduction to 50.3% would represent too large of an adjustment to make without a more graduated approach.[82]

Atmos' proposed hypothetical capital structure relies far too heavily on common equity, which is the *most* expensive capital.[83] As Mr. Kollen points out:

> "Both the common equity ratio *and* the return on equity must be reasonable because both affect the cost of capital and the rate of return applied to rate base. The Company proposes a common equity ratio of

[79] *In Re:* Electronic Application Of Atmos Energy Corporation For An Adjustment Of Rates, Case No. 2018-00281, Final Order dated May 7, 2019, at 35-36 [emphasis added].
[80] Baudino Direct at 28-32.
[81] Baudino Direct at 31.
[82] Baudino Direct at 31-32.
[83] Kollen Direct at 36-42; Baudino Direct at 28-32.

> [57.59%] and a return on equity of 10.35% in this proceeding, or 13.79% grossed up for income taxes. Both of these components are excessive and unreasonable; each component *compounds* the effect of the other in the claimed base revenue requirement." [84]

Rather than being heavily weighted toward common equity, Atmos' capital structure should be much more reliant on the least-expensive form of capital: short-term debt ("STD"), which costs Atmos only 0.57% absent commitment fees.[85] Oddly, Atmos has *abandoned* any efforts at financing capital costs through this means. Most unfortunately, doing so unnecessarily, and unreasonably, increases the cost of capital *and* the return on rate base. Legally mandated, prudent ratemaking dictates usage of least-cost financing methods. STD should thus be maintained at the highest reasonable level, rather than the virtually non-existent level [86] that Atmos proposes.

Therefore, the Commission should follow Mr. Kollen's recommendation to set in place a transition from a reasonable level of STD to be set in the current case at $100 million (approximately 1% of the Company's total capitalization), moving to a STD capitalization of $240 million in the Company's next base rate case (approximately 2% of capitalization).[87] Mr. Kollen's recommendation is more than reasonable in light of the facts that Atmos has outstanding credit facilities from which it can borrow more than $2 billion, and it has included the commitment fees for these credit facilities in its base revenue requirement.[88]

The final component of Atmos' capital structure, long-term debt ("LTD") is also unreasonably low due to the proposed extremely excessive common equity component. As

[84] Kollen Direct at 37 [emphasis added].
[85] Schedule J-2.
[86] Christian Rebuttal Exhibit JTC-R-1 indicates that the Company proposes a STD level of only 0.05%.
[87] Kollen Direct at 36-38.
[88] Kollen Direct at 38.

Mr. Kollen states, setting the LTD component at the difference between the reduction in common equity and the increase in STD, or an increase of $325 million from the Company's proposed LTD, would be reasonable.[89] Mr. Kollen recommends that the Commission set in place a two-step transition, the first of which would result in an increase in LTD of $325 million (to approximately 45.5%) in the instant case, then in the Company's next base rate case increase LTD to 48.0%.[90] This two-step transition to increase the LTD ratio is consistent with his recommendation to adopt a two-step transition to increase the STD ratio and Mr. Baudino's recommendation to adopt a two-step transition to reduce the common equity ratio.

Atmos attempts to defend its proposed hypothetical capital structure for the fully forecasted test year utilized in this case by pointing out that it is based on the Company's actual current capital structure. Yet since the Company's actual capital structure is unreasonable and results in an excessive cost of capital *for the same reasons* that the test year capital structure is unreasonable and results in an excessive cost of capital, this argument is utterly irrelevant.

The AG cautions the Commission against relying on an actual capital structure in lieu of a reasonable forecast capital structure. The fact that Atmos has chosen to utilize excessive common equity financing in lieu of significantly lower cost long-term and short-term debt in its actual financing is not proof that it is reasonable either on an actual basis or for use as the hypothetical capital structure for the forecast test year.

Moreover, the Commission is *not* bound by the actual costs in a historic base period or the bridge period between the base period and the test year any more than the Company is bound to actual costs. The impact of Messrs. Kollen and Baudinos' recommendations are

[89] Kollen Direct at 38-39.
[90] Kollen Direct at 38-39.

illustrated in the table entitled "Atmos Energy Corporation Capital Structure Comparison Company Request vs AG Recommendation," found at page 43 of Mr. Kollen's Direct Testimony, and yield a $2.511 million reduction in the base revenue requirement and base rate increase. This reduction is reduced to $2.495 million if the Commission adopts the AG's recommendation to remove all non-cash items from CWC.

a. Reduce Commitment Fees Included In Cost of Short-Term Debt

Atmos' application included $0.258 million in commitment fees for STD in the base revenue requirement, as the Kentucky Rate Division's share of the overall corporate commitment fees of $5.305 million.[91] This figure represents 24.61% of the Company's proposed cost of STD of 25.7%.[92] However, in response to discovery, the Company provided a revised corporate-wide total of $2.435 million in commitment fees, based on each source of AEC STD.[93] The revised maximum commitment fees total $2.435 million. Scaling-down the amount of commitment fees to match those provided in response to this discovery yields a reduction of $0.114 million in the claimed base revenue deficiency and base rate increase. This reduction is reduced to $0.113 million if the Commission adopts the AG's recommendation to remove all non-cash items from CWC.

b. Return on Equity

(1) AG Witness Baudino's Return on Equity Recommendation Will Lead to Fair, Just and Reasonable Rates

Based upon the testimony of Atmos' Witness Mr. D'Ascendis, the Company proposes an inflated 10.35% return on equity ("ROE"),[94] while the Attorney General's Witness Mr.

[91] Kollen Direct at 40-41.
[92] Kollen Direct at 40-41.
[93] Response to AG 1-55, attached as Exhibit__(LK-11) to Mr. Kollen's Direct Testimony.
[94] Baudino Direct at 4.

Baudino recommends a more reasonable 9.10% allowed ROE.[95] Furthermore, based upon recent Commission precedent, Mr. Baudino recommends that the Commission consider a reduction of 10 – 20 basis points, or 0.10% - 0.20%, in the allowed ROE for Atmos' Pipeline Replacement Program ("PRP") rider.[96]

The AG's recommendation to use a 9.10% ROE reduces the Company's base revenue requirement by $5.098 million. This reduction is reduced to $5.065 million if the Commission adopts the AG's recommendation to remove all non-cash items from CWC.

Mr. Baudino's recommended ROE of 9.10% is based on the results of a discounted cash flow ("DCF") analysis as applied to a proxy group of regulated gas distribution companies.[97] The DCF analysis is Mr. Baudino's standard constant growth form of the model that employs growth rate forecasts from the following three sources: dividend and earnings growth from Value Line, and earnings growth from Yahoo! Finance and Zacks.[98] Mr. Baudino also performed Capital Asset Pricing Model ("CAPM") analyses using both historical and forecasted risk premiums, but did not rely upon these results due to it being a less reliable approach.[99] It is important to note that the CAPM results were generally lower than the DCF results in this case, which further confirms the reasonableness of Mr. Baudino's DCF results.[100]

Mr. Baudino deemed the criteria used by Atmos' Witness Mr. D'Ascendis to select the companies for his proxy group as reasonable, and therefore relied on the same proxy group

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[95] *Id*. at 3.
[96] *Id*.
[97] *Id*.
[98] *Id*. at 15.
[99] *Id*. at 3 and 15.
[100] *Id*. at 3, 27, and 28. The forward-looking CAPM ROE estimated range was 8.69% to 8.73%, while the historical risk premium CAPM ROE estimated range was 7.56% to 9.07%.

for his analysis.[101] Mr. Baudino's DCF analysis as applied to the proxy group resulted in the average growth rate range of 8.42% to 10.81%, with an average of 9.49%. The DCF analysis based upon the median growth rates resulted in a range of 8.05% to 10.60%, with the average of 9.20%.[102] Hence, pursuant to the DCF analysis, Mr. Baudino recommends that the Commission adopt an ROE range of 8.40% to 9.40% for the gas distribution operations of Atmos.[103] Based upon these results, Mr. Baudino more specifically recommends an ROE for Atmos of 9.10%.[104] Mr. Baudino asserts that the 9.10% allowed ROE is reasonable given the low-risk nature of Atmos' regulated gas business and is consistent with investor expectations and requirements in the current economic environment of low interest rates.[105] Mr. Baudino also testified that his recommended ROE exceeds all of the CAPM results, which ranged from 7.56% to 8.73%.[106]

With regard to Atmos' PRP rider, Mr. Baudino recommends a lower ROE than 9.10% based upon the Commission's recent rulings applying a lower ROE to the capital costs being recovered in automatic adjustment mechanisms like the PRP rider.[107] For example, in Case No. 2020-00061,[108] the Commission approved a lower ROE for Louisville Gas and Electric Company ("LG&E") based on lower capital costs as well as lower risk of capital cost recovery through its Environmental Cost Recovery ("ECR") rider.[109] Likewise in the Commission's

[101] *Id*. at 17.
[102] *Id*. at 20.
[103] *Id*. at 28.
[104] *Id*.
[105] *Id*. at 3.
[106] Baudino Direct at 28.
[107] *Id*. at 5 and 33.
[108] *In Re:* Electronic Application of Louisville Gas and Electric Company for Approval of an Amended Environmental Compliance Plan and a Revised Environmental Surcharge, Case No. 2020-00061, Order dated Sept. 29, 2020.
[109] Baudino Direct at 33.

final Orders in Cases Nos. 2020-00349[110] and 2020-00350,[111] the Commission once again approved a lower ROE for the ECR riders for LG&E and Kentucky Utilities Company ("KU") of 9.35%.[112] Further, in the final Order in Case No. 2020-00174,[113] the Commission approved a 9.30% ROE for Kentucky Power Company and a 9.10% ROE for its ECR rider.[114]

Atmos' PRP Rider enables the Company to include qualifying investments for collection through the rider, with yearly filings that are approved by the Commission.[115] Investments included in the PRP rider are allowed to earn a return based on Atmos' approved weighted cost of capital.[116] This treatment enables the Company to collect the cost of these investments without filing yearly full rate cases,[117] which reduces shareholder risk since a return is guaranteed and any potential lag associated with recovery is virtually eliminated. Based upon the Commission's recent precedent, Mr. Baudino recommends that the Commission consider a reduction in the range of 10 – 20 basis points, or 0.10% - 0.20%, to the allowed ROE for Atmos' PRP rider.[118] Therefore, if the Commission accepts Mr. Baudino's recommended ROE of 9.10%, the ROE applied to the PRP Rider would be in the range of 8.90% - 9.00%.[119]

(2) Atmos' ROE Demand is Unreasonable

[110] *In Re:* Electronic Application of Kentucky Utilities Company for an Adjustment of its Electric Rates, etc., Case No. 2020-00349, Final Order dated June 30, 2021.
[111] *In Re*: Electronic Application of Louisville Gas and Electric Company for an Adjustment of its Electric and Gas Rates, etc., Case No. 2020-00350, Final Order dated June 30, 2021.
[112] Baudino Direct at 34.
[113] *In Re:* Electronic Application of Kentucky Power Company for A General Adjustment of its Rates for Electric Service, etc., Case No. 2020-00174, Final Order Dated Jan. 13, 2021.
[114] Baudino Direct at 34.
[115] *Id*. at 33.
[116] *Id*.
[117] *Id*. at 34.
[118] *Id*.
[119] *Id*.

Atmos witness D'Ascendis' recommended ROE of 10.35% is far beyond the zone of reasonableness that this Commission considers appropriate, and is inconsistent with today's financial markets, which continue to provide low interest rates.[120] As Mr. Baudino's testimony points out, Mr. D'Ascendis' recommendation is not due to any uncertainties arising from the effects of Covid-19, but rather are due to: (a) the unreasonable and excessively high ROE results from the application of his risk premium ("RP") and CAPM analyses (11.75%); and (b) results from the inclusion of a group of 48 domestic, non-price regulated companies (12.42%).[121] As Mr. Baudino states, Mr. D'Ascendis' RP analyses:

> ". . . are so far above recently authorized Commission-allowed returns that they cannot be seriously considered as viable estimates of the investor required ROE for a lower risk regulated gas distribution utility like Atmos. . . . [t]he extremely high ROE results from Mr. D'Ascendis' risk premium and CAPM analyses were generated by *incorrect* and *questionable* assumptions and by the data that Mr. D'Ascendis used."[122]

Mr. Baudino provided the following additional criticism of Mr. D'Ascendis' approach:

- Mr. D'Ascendis' DCF analysis should have considered Value Line's dividend growth forecast, as Mr. Baudino did;[123]
- A properly-formulated DCF model using current stock prices and growth forecasts is far more reliable and accurate than the bond yield plus RP model;[124]
- In estimating the expected RP ROE, Mr. D'Ascendis utilized both the Predictive Risk Premium Model ("PRPM") and the total market approach ("MRP").[125] Mr. D'Ascendis utilized a forecasted bond yield for the PRPM, and developed his own prospective bond yield that he utilized in the MRP approach. Mr. Baudino opines

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[120] *Id.* at 35.
[121] Baudino Direct at 35-36; 38-42.
[122] *Id.* at 36 [emphasis added].
[123] *Id.* at 37.
[124] *Id.* at 38.
[125] The results of for both of these RP models are summarized in D'Ascendis Sch. DWD-3.1.

that Mr. D'Ascendis should have considered the current Mergent average utility bond yield, which is 100 basis points lower than Mr. D'Ascendis' prospective yield.[126] Mr. Baudino further noted that current interest rates are indicative of investor expectations regarding future interest rates.[127]

- Moreover, examining Mr. D'Ascendis' analysis of Commission-allowed returns demonstrates that based on today's interest rates and bond yields, the RP ROE result is much lower than Mr. D'Ascendis recommends and is consistent with Mr. Baudino's recommended ROE of 9.10%.[128]

- Mr. D'Ascendis' risk premium models produced unreasonable results with respect to Atmos' ROE.[129]

- Mr. D'Ascendis failed to both demonstrate that his PRPM is relied upon by investors to determine the appropriate ROE for gas distribution companies, and that the PRPM is widely accepted by regulatory commissions.[130]

- Mr. D'Ascendis' mean results for the CAPM/ECAPM range from 11.73% to 11.88%. His median results range from 11.58% to 11.77%. Mr. D'Ascendis' CAPM/ECAPM results are so grossly overstated for a low risk regulated gas utility such as Atmos that they should be rejected out of hand by the Commission.[131]

- A major source of Mr. D'Ascendis' inflated CAPM/ECAPM results is his overstated expected growth rates included for the return on the market. These expected earnings growth rates range from 12.74% to 14.89%.[132] Such growth rates are totally unsustainable considering the expected nominal growth rate in the U.S. Gross Domestic Product is less than 4.0% currently.[133] As Pratt and Grabowski noted, long-term growth rates that exceed the real growth in GDP plus inflation are generally not sustainable.[134]

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[126] Baudino Direct at 39.
[127] *Id.* at 39-40.
[128] Baudino Direct at 41-42.
[129] *Id.* at 40-41.
[130] *Id.* at 42-44. Furthermore, in Case No. 2021-00183, Final Order dated Dec. 28, 2021, at 14, this Commission noted: "Even though the Commission supports the use and presentation of multiple modeling approaches, the Commission finds that Duke Kentucky's use of the Predictive Risk Premium Model (PRPM) should be rejected. The PRPM model has only been addressed by three regulatory commissions thus far and is not universally accepted. Furthermore, the Commission is concerned about the 'blackbox' aspects of the PRPM."
[131] Baudino Direct at 45.
[132] *Id.* at 47.
[133] *Id.* at 48.
[134] *Id.* at 49.

- The ECAPM adjustment is suspect because it suggests that published betas by such sources as Value Line are incorrect and that investors should not rely on them in formulating their estimates using the CAPM.[135] For his risk-free rate, Mr. D'Ascendis utilized the same forecasted 30-year Treasury Bond yield of 2.88% from the *Blue Chip Financial Forecasts* that he utilized in the PRPM RP analysis that Mr. Baudino criticized.[136] Mr. D'Ascendis' CAPM/ECAPM analysis should have instead considered current yields on 30-year Treasury Bonds, as current interest rates provide tangible evidence of investor preferences and required returns for Treasury securities. It is clear that Mr. D'Ascendis' use of a forecasted bond yield contributed to his inflated CAPM results.[137]

- Mr. D'Ascendis use of 48 non-price regulated companies in his ROE analysis is entirely inappropriate and should be rejected. The average ROE results for this group far exceeded the results that both Messrs. Baudino and D'Ascendis used in their respective gas proxy group DCF results.[138]

- It would be inappropriate to add a size adjustment of 0.20% to Atmos' ROE as Mr. D'Ascendis recommended. The companies in the Decile 8 group used by Mr. D'Ascendis in his calculation of the size premium adjustment are smaller, more risky, and many are unregulated. The beta for the Decile 8 group is 1.31 to 1.48, far higher that the gas proxy group beta of 0.90. This indicates that these unregulated companies used by Mr. D'Ascendis to calculate his size premium are far riskier than regulated gas distribution utilities like Atmos. In fact, Atmos currently has a Value Line Safety Rank of 1, the highest and least risky ranking that Value Line assigns to the companies it follows.[139]

- Flotation cost adjustments are inappropriate because they assume that the current stock price is wrong and that it must be adjusted downward to increase the dividend yield and the resulting cost of equity. Stock prices most likely already account for flotation costs.[140]

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[135] *Id.* at 50.
[136] Baudino Direct at 50-51.
[137] *Id.*
[138] *Id.* at 51-52.
[139] *Id.* at 52-53.
[140] *Id.* at 53-54.

Finally, the Commission has recently noted that ". . . it continues to reject the use of flotation cost adjustments, financial risk adjustments and size adjustments in the ROE analyses." [141]

4. SUMMARY OF AG ADJUSTMENTS TO ATMOS' REQUESTED BASE RATE INCREASE

The following table summarizes the evolution of the Company's requested base rate increase from its direct to its rebuttal and final corrected calculations and the AG recommendations. Some of the AG adjustments on the table[142] have been updated from the amounts in Mr. Kollen's testimony due to the AG's additional adjustment to CWC to remove all non-cash items in addition to its adjustment to reduce the depreciation expense lag days. This additional adjustment reduces rate base and the base revenue requirement and deficiency. This reduction in rate base requires revisions to slightly reduce all three of the AG's cost of capital recommendations:

[141] *In Re:* Electronic Application Of Columbia Gas Of Kentucky, Inc. For An Adjustment Of Rates, etc., Case No. 2021-00183, Final Order dated Dec. 28, 2021 at 33.

[142] Contemporaneous with the filing of this brief, the AG is also filing a version of this same table in an updated Excel workbook in live format with all formulas intact depicting the table's derivation, and which also reconciles the table with the table in the Summary section of Mr. Kollen's testimony.

Atmos Energy Corporation - Kentucky Division Summary of Attorney General Recommendations KPSC Case No. 2021-00214 Test Year Ended December 31, 2022 $ Millions	Adjustment Amount	Rate Increase Amount
Atmos Requested Base Revenue Increase		
Atmos Requested Base Rate Increase	$ 16.390	
Atmos Revision in Calculated Base Revenue Deficiency	(1.338)	
Atmos Revised Base Rate Revenue Deficiency	$ 15.052	
Less: Temporary Reduction Due to Amortization of COS and Depreciation Regulatory Liabilities		$ (9.862)
Atmos Net Increase in First Year		$ 5.189
Effects of AG Rate Base Recommendations on Revenue Requirement		
Reduce Asset NOL ADIT to Reflect Taxable Income from April 2021 through December 2021	(0.514)	
Include SSU Division 002 T-Lock Adjustment-Unrealized Gains Liability ADIT	(0.313)	
Remove Other SSU Division 002 ADIT	(0.118)	
Remove Accounts Payable - Construction	(0.501)	
Remove Regulatory Asset for Rate Case Expenses	(0.023)	
Correct Depreciation Expense Lag Days in CWC	(0.153)	
Adjust CWC to Reflect Changes in Expenses Recommended by AG	(0.093)	
Adjust CWC to Remove Non-Cash Items From Lead/Lag Study	(0.362)	
Reflect Effects from Amortization of Unprotected EDIT Over Three Years	0.166	
Effects on AG Operating Income Recommendations on Revenue Requirement		
Reduce Outside Services Expense Allocated from KY/Mid States Division	(0.405)	
Amortize Unprotected EDIT Over Three Years Instead of Five Years	(3.460)	
Amortize Remaining Rate Case Expense from Case 2018-00281 Over Three Years	(0.011)	
Remove AGA Dues	(0.052)	
Effects of AG Rate of Return Recommendations on Revenue Requirement		
Reflect Changes in Capital Structure	(2.495)	
Correct STD Commitment Fees	(0.113)	
Reflect Return on Equity of 9.10%	(5.065)	
Total AG Recommendations to Annual Revenue Requirement	$(13.512)	
AG Recommended Maximum Base Rate Increase - Before Amort of COS and Depr Reg Liab	$ 1.540	
Less: Temporary Reduction Due to Amortization of COS and Depreciation Reserves *		$ (1.540)
AG Recommended Maximum Base Rate Increase - Prior to Utilization of All COS and Depr Reg Liab		$ -

* Temporary reductions will continue until COS and depreciation reserve regulatory liabilities are fully amortized.

5. PIPELINE REPLACEMENT RIDER ISSUES

a. Reject Request for Accelerated Replacement of Aldyl-A Pipeline and Recovery of Costs Through PRP Rider

Atmos' application proposes to modify the Pipeline Replacement Rider ("PRP") to include accelerated replacement of early-generation plastic pipes known as Aldyl-A, despite the fact that the Company acknowledges there is no immediate need to replace these pipes.[143] The Company included what it terms an "incremental" sum of $2.736 million in proposed

[143] Austin Direct Testimony at 27: 9-17.

PRP Rider rates in this case. Consistent with the Company's plan to roll-over the entirety of its PRP rate base and operating expenses into base rates, those sums have been placed into base rates in this case at the cost of $2.794 million.[144] Atmos proposes to recover all incremental Aldyl-A pipeline replacement costs incurred after September 2022 through the PRP Rider. Atmos has another PRP docket currently pending in Case No. 2021-00304, in which the Commission has suspended rates "to await the outcome of Case No. 2021-00214, Atmos's pending base rate case, regarding the appropriate Return on Equity and the proposed inclusion of Aldyl-A plastic pipe replacements in the PRP."[145]

The Company's current accelerated bare steel replacement program has not been completed, and will not be completed until 2027. Atmos is on track to continue spending between $28.1 million to $28.6 million annually for its bare steel replacement program alone.[146] Yet now, the Company proposes additional accelerated spending of between $2.8 million to $17.1 million annually for the new Aldyl-A replacement program.[147] Not only has the Company acknowledged that the Aldyl-A replacement program is unnecessary,[148] but it also acknowledges that its system is experiencing minimal customer and usage growth.[149] Moreover, since the Company has provided no schedule, no cost estimate, and no annual or aggregate limits to the costs that would be, or could be, included in the PRP Rider for this new program, approving it would obviously increase spending, potentially in an unchecked manner. Several times in the recent past, the Commission has had to caution Atmos regarding

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[144] Kollen Direct at 39-40.
[145] *In Re*: Electronic Application Of Atmos Energy Corporation To Establish PRP Rider Rates For The Twelve Month Period Beginning October 1, 2021, Order dated Sept. 15, 2021 denying rehearing request, at 1.
[146] Response to AG-DR-1-24, attached as Exhibit__(LK-13) to Kollen Direct Testimony.
[147] Response to AG-DR-1-24, attached as Exhibit__(LK-13) to Kollen Direct Testimony.
[148] Austin Direct at 27.
[149] Response to AG-DR-1-13. In subpart (a) of that response, the Company acknowledges its customer count will grow less than 1% from 2023 – 2025. In subpart (b), Atmos acknowledges that its Mcf sales will grow only 0.24% from 2023 – 2025.

its PRP spending.[150] Allowing the program to embark on a new accelerated recovery program under these circumstances simply makes no sense.[151]

Just as the Commission recently rejected Columbia Gas of Kentucky's accelerated replacement and cost recovery of Aldyl-A pipes,[152] it should likewise reject Atmos' efforts at accelerated recovery for Aldyl-A pipes until the Company completes its bare steel pipe replacement program. Atmos cites no compelling reason to accelerate replacement of these pipes, such as an excessive leak rate.[153] The Company is already replacing Aldyl-A if and when necessary, a practice with which the AG agrees and supports through the Company's base revenue requirement. Additionally, since the Company has provided no schedule, cost estimates or scope of work to replace its Aldyl-A pipes, any Commission approval would leave the program open-ended as to scope, cost and timelines.[154]

In the interim, the Commission should: (a) allow the Company's proposed incremental accelerated Aldyl-A replacement costs that it included in the base revenue requirement, but condition this recovery on a clawback of the related base revenues if the Company does not complete the projects that comprise the costs in the test year and limit the recovery to the forecast costs to complete the projects included in the base revenue requirement, regardless of the actual costs incurred; (b) require Atmos to submit periodic reporting upon the completion of these projects, which should demonstrate to the Commission that the Company has complied with these requirements, and if it did not, to

[150] *See, e.g.*, Case No. 2017-00349, Order dated May 3, 2018 at 40; Case No. 2018-00281, Order dated May 7, 2019 at 8-16.
[151] Kollen Direct at 46.
[152] *In Re:* Electronic Application Of Columbia Gas Of Kentucky, Inc. For An Adjustment Of Rates, etc., Final Order dated Dec. 23, 2021 at 39-41.
[153] Austin Direct at 27.
[154] Kollen Direct at 46.

provide a calculation of the base revenue sums that should be clawed back; and (c) in the event the reporting indicates revenues should be clawed back, the Commission should direct Atmos to record these revenues as a regulatory liability to be addressed in its next base rate case proceeding.[155]

b. Modify PRP Rider To Address Reductions In Asset Net Operating Loss ADIT

Atmos adds an incremental asset NOL ADIT to rate base in the PRP rate base formula.[156] The Company inappropriately offsets and reduces the incremental *liability* ADIT due to accelerated tax depreciation subtracted from rate base by the incremental asset NOL ADIT. The addition of this incremental asset NOL ADIT to rate base assumes that there are no other changes to the AEC *utility* NOL ADIT. This assumption is erroneous because AEC's *utility* NOL ADIT has declined substantially due to taxable income in each fiscal year since base rates were last reset in Case No. 2018-00281.[157] The Company's approach is inequitable and does not accurately reflect the changes in the asset NOL ADIT.

The Commission should therefore: (a) remove the asset NOL ADIT from the PRP rate base formula, unless it incorporates reductions in AEC's *utility* NOL ADIT due to taxable income after the test year in this proceeding and subtracts the allocation of these amounts to the Kentucky Rate Division from the PRP rate base formula; and (b) exclude amounts from AEC's *utility* NOL ADIT that are specifically identified and directly assignable to other rate divisions, such as the NOL ADIT due to Winter Storm Uri.

6. TAX ACT ADJUSTMENT FACTOR ISSUES

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[155] Kollen Direct at 46-47.
[156] *Id*. at 48-49.
[157] *Id*. at 48.

Atmos seeks permission to implement a new Tax Act Adjustment Factor ("TAAF") rider, ostensibly to enable the Company to implement and respond to changes in federal and/or state income tax rates.[158] Such a rider is not necessary to address changes in tax rates. The Commission will recall that fairly recent changes to both federal and state tax rates brought about by the Tax Cuts and Jobs Act ("TCJA") did not require a TAAF rider, nor is such a tariff necessary for future changes.[159] As Mr. Kollen points out:

> "In addition, there often are changes in the federal and state income tax code that do not affect income tax rates, but do affect income tax expense, including deductions and tax credits. If and when there are changes in the federal and state income tax code, whether income tax rates or other changes, then the Commission's historic approach is sufficient, *and indeed, superior*, to the Company's proposed TAAF rider."[160]

Accordingly, the Commission should reject Atmos' request for the TAAF rider.

7. ANNUAL RATE REVIEW MECHANISM ISSUES

Although the Company does not appear to be actively pursuing an annual rate review mechanism ("ARM") in the instant case, its testimony does encourage the Commission to "continue to consider" an ARM.[161] In Case No. 2017-00349, the Company did formally pursue an ARM, which the Commission rejected.[162] The Attorney General maintains his opposition to any such ARM, for the reasons set forth in the three resources cited in the footnote below.[163]

8. RATE DESIGN

[158] Taylor Direct Testimony at 16, and 23-24.
[159] Kollen Direct at 49-50.
[160] Kollen Direct at 50 [emphasis added].
[161] Taylor Direct at 24.
[162] Case No. 2017-00349, Final Order dated May 3, 2018 at 33-37.
[163] *See, e.g.*, Case No. 2017-00349: (i) Final Order dated May 3, 2018 at 33-37; (ii) Attorney General's Post-Hearing Brief at 5-16; and (iii) Kollen Direct at 66-73.

a. Atmos' Proposed 26% Increase in the Residential Class Customer Charge is Unreasonable and Violates Principle of Gradualism

Atmos proposes to increase its residential customer charge from the current $19.30 per month to $24.40 monthly, which if approved would constitute a 26% increase. Atmos has not presented any evidence which demonstrates that the current residential customer charge is insufficient for the Company in meeting its revenue requirement. The Attorney General believes this increase would not comport with principles of rate gradualism. In Case No. 2018-00281, the Commission approved a 10.2% increase in the residential customer charge from $17.50 to $19.30.

Additionally, this significant hike in the flat monthly charge comes at a time when Atmos' customers are trying to recover from powerful, devastating and indeed deadly tornadoes. Many thousands of customers have sustained significant property damage, with many structures utterly destroyed. Moreover, the increase would come on top of a 23% increase in the gas commodity cost that Atmos passes on to all customers.[164] Although the gas commodity charge is not before the Commission in the instant case, the Commission can and should take administrative notice of the totality of the all-in rates Atmos' customers are facing. Given these facts and circumstances, the Attorney General respectfully requests that the Commission place as much of any potential base rate increase through the volumetric charge as opposed to the flat monthly charge. Doing so will incentivize customers to conserve and will provide much-needed savings.

[164] *In Re*: Electronic Purchased Gas Adjustment Filing Of Atmos Energy Corporation, Case No. 2021-00366, Final Order dated Oct. 22, 2021. Atmos has another GCA case pending in Docket No. 2021-00453 which should provide a decrease in gas commodity cost.

III. Conclusion

With regard to any adjustments which the Attorney General may not have specifically addressed herein, he supports the recommendations put forward by his witnesses Messrs. Kollen and Baudino. Furthermore, the Attorney General would welcome any other adjustments the Commission may deem necessary that will lead to fair, just and reasonable rates in this matter.

Wherefore, the Attorney General respectfully requests that the Commission deny Atmos' requested rates, reduce Atmos' revised rates by the adjustments discussed above, deny the proposed increase in the residential customer charge, and grant any and all further relief as he may be entitled.

Respectfully submitted,

DANIEL CAMERON
ATTORNEY GENERAL

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LAWRENCE W. COOK
J. MICHAEL WEST
ANGELA M. GOAD
JOHN G. HORNE II
ASSISTANT ATTORNEYS GENERAL
1024 CAPITAL CENTER DR., STE. 200
FRANKFORT, KY 40601
(502) 696-5453
FAX: (502) 564-2698
Larry.Cook@ky.gov
Michael.West@ky.gov
Angela.Goad@ky.gov
John.Horne@ky.gov

Certificate of Service

Pursuant to the Commission's Order dated July 22, 2021 in Case No. 2020-00085, and in accord with all other applicable law, Counsel certifies that an electronic copy of the forgoing was served and filed by e-mail to the parties of record.

This 14th day of January, 2022

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Assistant Attorney General

EXHIBIT 1

26 C.F.R. § 1.167(l)–1, Treas. Reg. § 1.167(l)–1

§ 1.167(l)–1 Limitations on reasonable allowance in case of property of certain public utilities.

Currentness

(a) In general—(1) Scope. Section 167(*l*) in general provides limitations on the use of certain methods of computing a reasonable allowance for depreciation under section 167(a) with respect to "public utility property" (see paragraph (b) of this section) for all taxable years for which a Federal income tax return was not filed before August 1, 1969. The limitations are set forth in paragraph (c) of this section for "pre–1970 public utility property" and in paragraph (d) of this section for "post–1969 public utility property." Under section 167(*l*), a taxpayer may always use a straight line method (or other "subsection (l) method" as defined in paragraph (f) of this section). In general, the use of a method of depreciation other than a subsection (l) method is not prohibited by section 167(l) for any taxpayer if the taxpayer uses a "normalization method of regulated accounting" (described in paragraph (h) of this section). In certain cases, the use of a method of depreciation other than a subsection (l) method is not prohibited by section 167(*l*) if the taxpayer used a "flow-through method of regulated accounting" (described in paragraph (i) of this section) for its "July 1969 regulated accounting period" (described in paragraph (g) of this section) whether or not the taxpayer uses either a normalization or a flow-through method of regulated accounting after its July 1969 regulated accounting period. However, in no event may a method of depreciation other than a subsection (l) method be used in the case of pre–1970 public utility property unless such method of depreciation is the "applicable 1968 method" (within the meaning of paragraph (e) of this section). The normalization requirements of section 167(l) with respect to public utility property defined in section 167(l)(3)(A) pertain only to the deferral of Federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 and the use of straight line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. Regulations under section 167(l) do not pertain to other book-tax timing differences with respect to State income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items. The rules provided in paragraph (h)(6) of this section are to insure that the same time period is used to determine the deferred tax reserve amount resulting from the use of an accelerated method of depreciation for cost of service purposes and the reserve amount that may be excluded from the rate base or included in no-cost capital in determining such cost of services. The formula provided in paragraph (h)(6)(ii) of this section is to be used in conjunction with the method of accounting for the reserve for deferred taxes (otherwise proper under paragraph (h)(2) of this section) in accordance with the accounting requirements prescribed or approved, if applicable, by the regulatory body having jurisdiction over the taxpayer's regulated books of account. The formula provides a method to determine the period of time during which the taxpayer will be treated as having received amounts credited or charged to the reserve account so that the disallowance of earnings with respect to such amounts through rate base exclusion or treatment as no-cost capital will take into account the factor of time for which such amounts are held by the taxpayer. The formula serves to limit the amount of such disallowance.

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(2) Methods of depreciation. For purposes of section 167(*l*), in the case of a declining balance method each different uniform rate applied to the unrecovered cost or other basis of the property is a different method of depreciation. For purposes of section 167(*l*), a change in a uniform rate of depreciation due to a change in the useful life of the property or a change in the taxpayer's unrecovered cost or other basis for the property is not a change in the method of depreciation. The use of "guideline lives" or "class lives" for Federal income tax purposes and different lives on the taxpayer's regulated books of account is not treated for purposes of section 167(*l*) as a different method of depreciation. Further, the use of an unrecovered cost or other basis or salvage value for Federal income tax purposes different from the basis or salvage value used on the taxpayer's regulated books of account is not treated as a different method of depreciation.

(3) Application of certain other provisions to public utility property. For rules with respect to application of the investment credit to public utility property, see section 46(e). For rules with respect to the application of the class life asset depreciation range system, including the treatment of the use of "class lives" for Federal income tax purposes and different lives on the taxpayer's regulated books of account, see § 1.167(a)–11 and § 1.167(a)–12.

(4) Effect on agreements under section 167(d). If the taxpayer has entered into an agreement under section 167(d) as to any public utility property and such agreement requires the use of a method of depreciation prohibited by section 167(*l*), such agreement shall terminate as to such property. The termination, in accordance with this subparagraph, shall not affect any other property (whether or not public utility property) covered by the agreement.

(5) Effect of change in method of depreciation. If, because the method of depreciation used by the taxpayer with respect to public utility property is prohibited by section 167(l), the taxpayer changes to a method of depreciation not prohibited by section 167(l), then when the change is made the unrecovered cost or other basis shall be recovered through annual allowances over the estimated remaining useful life determined in accordance with the circumstances existing at that time.

(b) Public utility property—(1) In general. Under section 167(l)(3)(A), property is "public utility property" during any period in which it is used predominantly in a "section 167(l) public utility activity". The term "section 167(l) public utility activity" means the trade or business of the furnishing or sale of—

(i) Electrical energy, water, or sewage disposal services,

(ii) Gas or steam through a local distribution system,

(iii) Telephone services,

(iv) Other communication services (whether or not telephone services) if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U.S.C. 701), or

(v) Transportation of gas or steam by pipeline,

if the rates for such furnishing or sale, as the case may be, are regulated, *i.e.,* have been established or approved by a regulatory body described in section 167(*l*)(3)(A). The term "regulatory body described in section 167(l)(3)(A)" means a State (including the District of Columbia) or political subdivision thereof, any agency or instrumentality of the United

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States, or a public service or public utility commission or other body of any State or political subdivision thereof similar to such a commission. The term "established or approved" includes the filing of a schedule of rates with a regulatory body which has the power to approve such rates, even though such body has taken no action on the filed schedule or generally leaves undisturbed rates filed by the taxpayer involved.

(2) Classification of property. If property is not used solely in a section 167(*l*) public utility activity, such property shall be public utility property if its predominant use is in a section 167(*l*) public utility activity. The predominant use of property for any period shall be determined by reference to the proper accounts to which expenditures for such property are chargeable under the system of regulated accounts required to be used for the period for which the determination is made and in accordance with the principles of § 1.46–3(g)(4) (relating to credit for investment in certain depreciable property). Thus, for example, for purposes of determining whether property is used predominantly in the trade or business of the furnishing or sale of transportation of gas by pipeline, or furnishing or sale of gas through a local distribution system, or both, the rules prescribed in § 1.46–3(g)(4) apply, except that accounts 365 through 371, inclusive (Transmission Plant), shall be added to the accounts enumerated in subdivision (i) of such paragraph (g)(4).

(c) Pre–1970 public utility property—(1) Definition. (i) Under section 167(*l*)(3)(B), the term "pre–1970 public utility property" means property which was public utility property at any time before January 1, 1970. If a taxpayer acquires pre–1970 public utility property, such property shall be pre–1970 public utility property in the hands of the taxpayer even though such property may have been acquired by the taxpayer in an arm's-length cash sale at fair market value or in a tax-free exchange. Thus, for example, if corporation X which is a member of the same controlled group of corporations (within the meaning of section 1563(a)) as corporation Y sells pre–1970 public utility property to Y, such property is pre–1970 public utility property in the hands of Y. The result would be the same if X and Y were not members of the same controlled group of corporations.

(ii) If the basis of public utility property acquired by the taxpayer in a transaction is determined in whole or in part by reference to the basis of any of the taxpayer's pre–1970 public utility property by reason of the application of any provision of the code, and if immediately after the transaction the adjusted basis of the property acquired is less than 200 percent of the adjusted basis of such pre–1970 public utility property immediately before the transaction, the property acquired is pre–1970 public utility property.

(2) Methods of depreciation not prohibited. Under section 167(l)(1), in the case of pre–1970 public utility property, the term "reasonable allowance" as used in section 167(a) means, for a taxable year for which a Federal income tax return was not filed before August 1, 1969, and in which such property is public utility property, an allowance (allowable without regard to section 167(l)) computed under—

(i) A subsection (l) method, or

(ii) The applicable 1968 method (other than a subsection (l) method) used by the taxpayer for such property, but only if—

(a) The taxpayer uses in respect of such taxable year a normalization method of regulated accounting for such property,

(b) The taxpayer used a flow-through method of regulated accounting for such property for its July 1969 regulated accounting period, or

(c) The taxpayer's first regulated accounting period with respect to such property is after the taxpayer's July 1969 regulated accounting period and the taxpayer used a flow-through method of regulated accounting for its July 1969 regulated accounting period for public utility property of the same kind (or if there is no property of the same kind, property of the most similar kind) most recently placed in service. See paragraph (e)(5) of this section for determination of same (or similar) kind.

(3) Flow-through method of regulated accounting in certain cases. See paragraph (e)(6) of this section for treatment of certain taxpayers with pending applications for change in method of accounting as being deemed to have used a flow-through method of regulated accounting for the July 1969 regulated accounting period.

(4) Examples. The provisions of this paragraph may be illustrated by the following examples:

Example 1. Corporation X, a calendar-year taxpayer subject to the jurisdiction of a regulatory body described in section 167(l)(3)(A), used the straight line method of depreciation (a subsection (l) method) for all of its public utility property for which depreciation was allowable on its Federal income tax return for 1967 (the latest taxable year for which X, prior to August 1, 1969, filed a return). Assume that under paragraph (e) of this section, X's applicable 1968 method is a subsection (l) method with respect to all of its public utility property. Thus, with respect to its pre–1970 public utility property, X may only use a straight line method (or any other subsection (l) method) of depreciation for all taxable years after 1967.

Example 2. Corporation Y, a calendar-year taxpayer subject to the jurisdiction of the Federal Power Commission, is engaged exclusively in the transportation of gas by pipeline. On its Federal income tax return for 1967 (the latest taxable year for which Y, prior to August 1, 1969, filed a return), Y used the declining balance method of depreciation using a rate of 150 percent of the straight line rate for all of its nonsection 1250 public utility property with respect to which depreciation was allowable. Assume that with respect to all of such property, Y's applicable 1968 method under paragraph (e) of this section is such 150 percent declining balance method. Assume that Y used a normalization method of regulated accounting for all relevant regulated accounting periods. If Y continues to use a normalization method of regulated accounting, Y may compute its reasonable allowance for purposes of section 167(a) using such 150 percent declining balance method for its nonsection 1250 pre–1970 public utility property for all taxable years beginning with 1968, provided the use of such method is allowable without regard to section 167(l). Y may also use a subsection (l) method for any of such pre–1970 public utility property for all taxable years beginning after 1967. However, because each different uniform rate applied to the basis of the property is a different method of depreciation, Y may not use a declining balance method of depreciation using a rate of twice the straight line rate for any of such pre–1970 public utility property for any taxable year beginning after 1967.

Example 3. Assume the same facts as in example (2) except that with respect to all of its nonsection 1250 pre–1970 public utility property accounted for in its July 1969 regulated accounting period Y used a flow-through method of regulated accounting for such period. Assume further that such property is the property on the basis of which the applicable 1968 method is established for pre–1970 public utility property of the same kind, but having a first regulated accounting period after the taxpayer's July 1969 regulated accounting period. Beginning with 1968, with respect to such property Y may compute its reasonable allowance for purposes of section 167(a) using the declining balance method of depreciation and a rate of 150 percent of the straight line rate, whether it uses a normalization or flow-through method of regulated accounting after its July 1969 regulated accounting period, provided the use of such method is allowable without regard to section 167(l).

(d) Post–1969 public utility property—(1) In general. Under section 167(l)(3)(C), the term “post–1969 public utility property” means any public utility property which is not pre–1970 public utility property.

(2) Methods of depreciation not prohibited. Under section 167(l)(2), in the case of post–1969 public utility property, the term “reasonable allowance” as used in section 167(a) means, for a taxable year, an allowance (allowable without regard to section 167(l)) computed under—

(i) A subsection (l) method,

(ii) A method of depreciation otherwise allowable under section 167 if, with respect to the property, the taxpayer uses in respect of such taxable year a normalization method of regulated accounting, or

(iii) The taxpayer's applicable 1968 method (other than a subsection (l) method) with respect to the property in question, if the taxpayer used a flow-through method of regulated accounting for its July 1969 regulated accounting period for the property of the same (or similar) kind most recently placed in service, provided that the property in question is not property to which an election under section 167(l)(4)(A) applies. See § 1.167(l)(2) for rules with respect to an election under section 167(l)(4)(A). See paragraph (e)(5) of this section for definition of same (or similar) kind.

(3) Examples. The provisions of this paragraph may be illustrated by the following examples:

Example 1. Corporation X is engaged exclusively in the trade or business of the transportation of gas by pipeline and is subject to the jurisdiction of the Federal Power Commission. With respect to all its public utility property, X's applicable 1968 method (as determined under paragraph (e) of this section) is the straight line method of depreciation. X may determine its reasonable allowance for depreciation under section 167(a) with respect to its post–1969 public utility property under a straight line method (or other subsection (l) method) or, if X uses a normalization method of regulated accounting, any other method of depreciation, provided that the use of such other method is allowable under section 167 without regard to section 167(l).

Example 2. Assume the same facts as in example (1) except that with respect to all of X's post–1969 public utility property the applicable 1968 method (as determined under paragraph (e) of this section) is the declining balance method using a rate of 150 percent of the straight line rate. Assume further that all of X's pre–1970 public utility property was accounted for in its July 1969 regulated accounting period, and that X used a flow-through method of regulated accounting for such period. X may determine its reasonable allowance for depreciation under section 167 with respect to its post–1969 public utility property by using the straight line method of depreciation (or any other subsection (l) method), by using any method otherwise allowable under section 167 (such as a declining balance method) if X uses a normalization method of regulated accounting, or, by using the declining balance method using a rate of 150 percent of the straight line rate, whether or not X uses a normalization or a flow-through method of regulated accounting.

(e) Applicable 1968 method—(1) In general. Under section 167(l)(3)(D), except as provided in subparagraphs (3) and (4) of this paragraph, the term “applicable 1968 method” means with respect to any public utility property—

(i) The method of depreciation properly used by the taxpayer in its Federal income tax return with respect to such property for the latest taxable year for which a return was filed before August 1, 1969,

(ii) If subdivision (i) of this subparagraph does not apply, the method of depreciation properly used by the taxpayer in its Federal income tax return for the latest taxable year for which a return was filed before August 1, 1969, with respect to

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public utility property of the same kind (or if there is no property of the same kind, property of the most similar kind) most recently placed in service before the end of such latest taxable year, or

(iii) If neither subdivision (i) nor (ii) of this subparagraph applies, a subsection (l) method.

If, on or after August 1, 1969, the taxpayer files an amended return for the taxable year referred to in subdivisions (i) and (ii) of this subparagraph, such amended return shall not be taken into consideration in determining the applicable 1968 method. The term "applicable 1968 method" if such new method results to any public utility property, for the year of change and subsequent years, a method of depreciation otherwise allowable under section 167 to which the taxpayer changes from an applicable 1968 method if such new method results in a lesser allowance for depreciation for such property under section 167 in the year of change and the taxpayer secures the Commissioner's consent to the change in accordance with the procedures of section 446(e) and § 1.446–1.

(2) Placed in service. For purposes of this section, property is placed in service on the date on which the period for depreciation begins under section 167. See, for example, § 1.167(a)–10(b) and § 1.167(a)–11(c)(2). If under an averaging convention property which is placed in service (as defined in § 1.46–3(d)(ii)) by the taxpayer on different dates is treated as placed in service on the same date, then for purposes of section 167(l) the property shall be treated as having been placed in service on the date the period for depreciation with respect to such property would begin under section 167 absent such averaging convention. Thus, for example, if, except for the fact that the averaging convention used assumes that all additions and retirements made during the first half of the year were made on the first day of the year, the period of depreciation for two items of public utility property would begin on January 10 and March 15, respectively, then for purposes of determining the property of the same (or similar) kind most recently placed in service, such items of property shall be treated as placed in service on January 10 and March 15, respectively.

(3) Certain section 1250 property. If a taxpayer is required under section 167(j) to use a method of depreciation other than its applicable 1968 method with respect to any section 1250 property, the term "applicable 1968 method" means the method of depreciation allowable under section 167(j) which is the most nearly comparable method to the applicable 1968 method determined under subparagraph (1) of this paragraph. For example, if the applicable 1968 method on new section 1250 property is the declining balance method using 200 percent of the straight line rate, the most nearly comparable method allowable for new section 1250 property under section 167(j) would be the declining balance method using 150 percent of the straight line rate. If the applicable 1968 method determined under subparagraph (1) of this paragraph is the sum of the years-digits method, the term "most nearly comparable method" refers to any method of depreciation allowable under section 167(j).

(4) Applicable 1968 method in certain cases. (i)(a) Under section 167(l)(3)(E), if the taxpayer evidenced within the time and manner specified in (b) of this subdivision (i) the intent to use a method of depreciation under section 167 (other than its applicable 1968 method as determined under subparagraph (1) or (3) of this paragraph or a subsection (l) method) with respect to any public utility property, such method of depreciation shall be deemed to be the taxpayer's applicable 1968 method with respect to such public utility property and public utility property of the same (or most similar) kind subsequently placed in service.

(b) Under this subdivision (i), the intent to use a method of depreciation under section 167 is evidenced—

(1) By a timely application for permission for a change in method of accounting filed by the taxpayer before August 1, 1969, or

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(2) By the use of such method of depreciation in the computation by the taxpayer of its tax expense for purposes of reflecting operating results in its regulated books of account for its July 1969 regulated accounting period, as established in the manner prescribed in paragraph (g)(1)(i), (ii), or (iii) of this section.

(ii)(a) If public utility property is acquired in a transaction in which its basis in the hands of the transferee is determined in whole or in part by reference to its basis in the hands of the transferor by reason of the application of any provision of the Code, or in a transfer (including any purchase for cash or in exchange) from a related person, then in the hands of the transferee the applicable 1968 method with respect to such property shall be determined by reference to the treatment in respect of such property in the hands of the transferor.

(b) For purposes of this subdivision (ii), the term "related person" means a person who is related to another person if either immediately before or after the transfer—

(1) The relationship between such persons would result in a disallowance of losses under section 267 (relating to disallowance of losses, etc., between related taxpayers) or section 707(b) (relating to losses disallowed, etc., between partners and controlled partnerships) and the regulations thereunder, or

(2) Such persons are members of the same controlled group of corporations, as defined in section 1563(a) (relating to definition of controlled group of corporations), except that "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears in section 1563(a) and the regulations thereunder.

(5) Same or similar. The classification of property as being of the same (or similar) kind shall be made by reference to the function of the public utility to which the primary use of the property relates. Property which performs the identical function in the identical manner shall be treated as property of the same kind. The determination that property is of a similar kind shall be made by reference to the proper account to which expenditures for the property are chargeable under the system of regulated accounts required to be used by the taxpayer for the period in which the property in question was acquired. Property, the expenditure for which is chargeable to the same account, is property of the most similar kind. Property, the expenditure for which is chargeable to an account for property which serves the same general function, is property of a similar kind. Thus, for example, if corporation X, a natural gas company, subject to the jurisdiction of the Federal Power Commission, had property properly chargeable to account 366 (relating to transmission plant structures and improvements) acquired an additional structure properly chargeable to account 366, under the uniform system of accounts prescribed for natural gas companies (class A and class B) by the Federal Power Commission, effective September 1, 1968, the addition would constitute property of the same kind if it performed the identical function in the identical manner. If, however, the addition did not perform the identical function in the identical manner, it would be property of the most similar kind.

(6) Regulated method of accounting in certain cases. Under section 167(l)(4)(B), if with respect to any pre–1970 public utility property the taxpayer filed a timely application for change in method of accounting referred to in subparagraph (4)(i)(b)(1) of this paragraph and with respect to property of the same (or similar) kind most recently placed in service the taxpayer used a flow-through method of regulated accounting for its July 1969 regulated accounting period, then for purposes of section 167(l)(1)(B) and paragraph (c) of this section the

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taxpayer shall be deemed to have used a flow-through method of regulated accounting with respect to such pre–1970 public utility property.

(7) Examples. The provisions of this paragraph may be illustrated by the following examples:

Example 1. Corporation X is a calendar-year taxpayer. On its Federal income tax return for 1967 (the latest taxable year for which X, prior to August 1, 1969, filed a return) X used a straight line method of depreciation with respect to certain public utility property placed in service before 1965 and used the declining balance method of depreciation using 200 percent of the straight line rate (double declining balance) with respect to the same kind of public utility property placed in service after 1964. In 1968 and 1970, X placed in service additional public utility property of the same kind. The applicable 1968 method with respect to the above described public utility property is shown in the following chart:

Property held in 1970	Placed in service	Method on 1967 return	Applicable 1968 method
Group 1..............................	Before 1965	Straight line	Straight line.
Group 2..............................	After 1964 and before 1968.	Double declining balance.	Double declining balance.
Group 3..............................	After 1967 and before 1969.	....	Do.
Group 4..............................	After 1968	....	Do.

Example 2. Corporation Y is a calendar-year taxpayer engaged exclusively in the trade or business of the furnishing of electrical energy. In 1954, Y placed in service hydroelectric generators and for all purposes Y has taken straight line depreciation with respect to such generators. In 1960, Y placed in service fossil fuel generators and for all purposes since 1960 has used the declining balance method of depreciation using a rate of 150 percent of the straight line rate (computed without reduction for salvage) with respect to such generators. After 1960 and before 1970 Y did not place in service any generators. In 1970, Y placed in service additional hydroelectric generators. The applicable 1968 method with respect to the hydroelectric generators placed in service in 1970 would be the straight line method because it was the method used by Y on its return for the latest taxable year for which Y filed a return before August 1, 1969, with respect to property of the same kind (*i.e.,* hydroelectric generators) most recently placed in service.

Example 3. Assume the same facts as in example (2), except that the generators placed in service in 1970 were nuclear generators. The applicable 1968 method with respect to such generators is the declining balance method using a rate of 150 percent of the straight line rate because, with respect to property of the most similar kind (fossil fuel generators) most recently placed in service, Y used such declining balance method on its return for the latest taxable year for which it filed a return before August 1, 1969.

(f) Subsection (l) method. Under section 167(l)(3)(F), the term “subsection (l) method” means a reasonable and consistently applied ratable method of computing depreciation which is allowable under section 167(a), such as, for example, the straight

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line method or a unit of production method or machine-hour method. The term “subsection (l) method” does not include any declining balance method (regardless of the uniform rate applied), sum of the years-digits method, or method of depreciation which is allowable solely by reason of section 167(b)(4) or (j)(1)(C).

(g) July 1969 regulated accounting period—(1) In general. Under section 167(l)(3)(I), the term “July 1969 regulated accounting period” means the taxpayer's latest accounting period ending before August 1, 1969, for which the taxpayer regularly computed, before January 1, 1970, its tax expense for purposes of reflecting operating results in its regulated books of account. The computation by the taxpayer of such tax expense may be established by reference to the following:

(i) The most recent periodic report of a period ending before August 1, 1969, required by a regulatory body described in section 167(l)(3)(A) having jurisdiction over the taxpayer's regulated books of account which was filed with such body before January 1, 1970 (whether or not such body has jurisdiction over rates).

(ii) If subdivision (i) of this subparagraph does not apply, the taxpayer's most recent report to its shareholders for a period ending before August 1, 1969, but only if such report was distributed to the shareholders before January 1, 1970, and if the taxpayer's stocks or securities are traded in an established securities market during such period. For purposes of this subdivision, the term “established securities market” has the meaning assigned to such term in § 1.453–3(d)(4).

(iii) If subdivisions (i) and (ii) of this subparagraph do not apply, entries made to the satisfaction of the district director before January 1, 1970, in its regulated books of account for its most recent accounting period ending before August 1, 1969.

(2) July 1969 method of regulated accounting in certain acquisitions. If public utility property is acquired in a transaction in which its basis in the hands of the transferee is determined in whole or in part by reference to its basis in the hands of the transferor by reason of the application of any provision of the Code, or in a transfer (including any purchase for cash or in exchange) from a related person, then in the hands of the transferee the method of regulated accounting for such property's July 1969 regulated accounting period shall be determined by reference to the treatment in respect of such property in the hands of the transferor. See paragraph (e)(4)(ii) of this section for definition of “related person”.

(3) Determination date. For purposes of section 167(l), any reference to a method of depreciation under section 167(a), or a method of regulated accounting, taken into account by the taxpayer in computing its tax expense for its July 1969 regulated accounting period shall be a reference to such tax expense as shown on the periodic report or report to shareholders to which subparagraph (1)(i) or (ii) of this paragraph applies or the entries made on the taxpayer's regulated books of account to which subparagraph (1)(iii) of this paragraph applies. Thus, for example, assume that regulatory body A having jurisdiction over public utility property with respect to X's regulated books of account requires X to reflect its tax expense in such books using the same method of depreciation which regulatory body B uses for determining X's cost of service for ratemaking purposes. If in 1971, in the course of approving a rate change for X, B retroactively determines X's cost of service for ratemaking purposes for X's July 1969 regulated accounting period using a method of depreciation different from the method reflected in X's regulated books of account as of January 1, 1970, the method of depreciation used by X for its July 1969 regulated accounting period would be determined without reference to the method retroactively used by B in 1971.

(h) Normalization method of accounting—(1) In general. (i) Under section 167(l), a taxpayer uses a normalization method of regulated accounting with respect to public utility property—

(a) If the same method of depreciation (whether or not a subsection (l) method) is used to compute both its tax expense and its depreciation expense for purposes of establishing cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and

(b) If to compute its allowance for depreciation under section 167 it uses a method of depreciation other than the method it used for purposes described in (a) of this subdivision, the taxpayer makes adjustments consistent with subparagraph (2) of this paragraph to a reserve to reflect the total amount of the deferral of Federal income tax liability resulting from the use with respect to all of its public utility property of such different methods of depreciation.

(ii) In the case of a taxpayer described in section 167(l)(1)(B) or (2)(C), the reference in subdivision (i) of this subparagraph shall be a reference only to such taxpayer's "qualified public utility property". See § 1.167(l)–2(b) for definition of "qualified public utility property".

(iii) Except as provided in this subparagraph, the amount of Federal income tax liability deferred as a result of the use of a different method of depreciation under subdivision (i) of this subparagraph is the excess (computed without regard to credits) of the amount the tax liability would have been had a subsection (l) method been used over the amount of the actual tax liability. Such amount shall be taken into account for the taxable year in which such different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (l) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover (as determined under section 172) to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (l) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

(2) Adjustments to reserve. (i) The taxpayer must credit the amount of deferred Federal income tax determined under subparagraph (1)(i) of this paragraph for any taxable year to a reserve for deferred taxes, a depreciation reserve, or other reserve account. The taxpayer need not establish a separate reserve account for such amount but the amount of deferred tax determined under subparagraph (1)(i) of this paragraph must be accounted for in such a manner so as to be readily identifiable. With respect to any account, the aggregate amount allocable to deferred tax under section 167(l) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation under subparagraph (1)(i) of this paragraph. An additional exception is that the aggregate amount allocable to deferred tax under section 167(l) may be properly adjusted to reflect asset retirements or the expiration of the period for depreciation used in determining the allowance for depreciation under section 167(a).

(ii) The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Corporation X is exclusively engaged in the transportation of gas by pipeline subject to the jurisdiction of the Federal Power Commission. With respect to its post–1969 public utility property, X is entitled under section 167(l)(2)(B) to use a method of depreciation other than a subsection (l) method if it uses a normalization method of regulated accounting. With respect to such property, X has not made any election under § 1.167(a)–11 (relating to depreciation based on class lives and asset depreciation ranges). In 1972, X places in service public utility property with an unadjusted basis of $2 million, and an estimated useful life of 20 years. X uses the declining balance method of depreciation with a rate twice the straight line rate. If X uses a normalization method of regulated accounting, the amount of depreciation allowable under section 167(a) with respect to such property for 1972 computed under the double declining balance method would be $200,000. X computes its tax

expense and depreciation expense for purposes of determining its cost of service for rate-making purposes and for reflecting operating results in its regulated books of account using the straight line method of depreciation (a subsection (l) method). A depreciation allowance computed in this manner is $100,000. The excess of the depreciation allowance determined under the double declining balance method ($200,000) over the depreciation expense computed using the straight line method ($100,000) is $100,000. Thus, assuming a tax rate of 48 percent, X used a normalization method of regulated accounting for 1972 with respect to property placed in service that year if for 1972 it added to a reserve $48,000 as taxes deferred as a result of the use by X of a method of depreciation for Federal income tax purposes different from that used for establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account.

Example 2. Assume the same facts as in example (1), except that X elects to apply § 1.167(a)–11 with respect to all eligible property placed in service in 1972. Assume further that all property X placed in service in 1972 is eligible property. One hundred percent of the asset guideline period for such property is 22 years and the asset depreciation range is from 17.5 years to 26.5 years. X uses the double declining balance method of depreciation, selects an asset depreciation period of 17.5 years, and applies the half-year convention (described in § 1.167(a)–11(c)(2)(iii)). In 1972, the depreciation allowable under section 167(a) with respect to property placed in service in 1972 is $114,285 (determined without regard to the normalization requirements in § 1.167(a)–11(b)(6) and in section 167(l)). X computes its tax expense for purposes of determining its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account using the straight line method of depreciation (a subsection (l) method), an estimated useful life of 22 years (that is, 100 percent of the asset guideline period), and the half-year convention. A depreciation allowance computed in this manner is $45,454. Assuming a tax rate of 48 percent, the amount that X must add to a reserve for 1972 with respect to property placed in service that year in order to qualify as using a normalization method of regulated accounting under section 167(l)(3)(G) is $27,429 and the amount in order to satisfy the normalization requirements of § 1.167(a)–11(b)(6) is $5,610. X determined such amounts as follows:

(1) Depreciation allowance on tax return (determined without regard to section 167(l) and § 1.167(a)–11(b)(6))	$114,285
(2) Line (1), recomputed using a straight line method	57,142
(3) Difference in depreciation allowance attributable to different methods (line (1) minus line (2))	$57,143
(4) Amount to add to reserve under this paragraph (48 percent of line (3))	27,429
(5) Amount in line (2)	$57,142
(6) Line (5), recomputed by using an estimated useful life of 22 years and the half-year convention	45,454
(7) Difference in depreciation allowance attributable to difference in depreciation periods	$11,688
(8) Amount to add to reserve under § 1.167(a)–11(b)(6)(ii) (48 percent of line (7))	5,610

If, for its depreciation expense for purposes of determining its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, X had used a period in excess of the asset guideline period of 22 years, the total amount in lines (4) and (8) in this example would not be changed.

Example 3. Corporation Y, a calendar-year taxpayer which is engaged in furnishing electrical energy, made the election provided by section 167(l)(4)(a) with respect to its “qualified public utility property” (as defined in § 1.167(l)–2(b)). In 1971, Y placed in service qualified public utility property which had an adjusted basis of $2 million, estimated useful life of 20 years, and no salvage value. With respect to property of the same kind most recently placed in service, Y used a flow-through method of regulated accounting for its July 1969 regulated accounting period and the applicable 1968 method is the declining balance

method of depreciation using 200 percent of the straight line rate. The amount of depreciation allowable under the double declining balance method with respect to the qualified public utility property would be $200,000. Y computes its tax expense and depreciation expense for purposes of determining its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account using the straight line method of depreciation. A depreciation allowance with respect to the qualified public utility property determined in this manner is $100,000. The excess of the depreciation allowance determined under the double declining balance method ($200,000) over the depreciation expense computed using the straight line method ($100,000) is $100,000. Thus, assuming a tax rate of 48 percent, Y used a normalization method of regulated accounting for 1971 if for 1971 it added to a reserve $48,000 as tax deferred as a result of the use by Y of a method of depreciation for Federal income tax purposes with respect to its qualified public utility property which method was different from that used for establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account for such property.

Example 4. Corporation Z, exclusively engaged in a public utility activity did not use a flow-through method of regulated accounting for its July 1969 regulated accounting period. In 1971, a regulatory body having jurisdiction over all of Z's property issued an order applicable to all years beginning with 1968 which provided, in effect, that Z use an accelerated method of depreciation for purposes of section 167 and for determining its tax expenses for purposes of reflecting operating results in its regulated books of account. The order further provided that Z normalize 50 percent of the tax deferral resulting from the use of the accelerated method of depreciation and that Z flow-through 50 percent of the tax deferral resulting therefrom. Under section 167(l), the method of accounting provided in the order would not be a normalization method of regulated accounting because Z would not be permitted to normalize 100 percent of the tax deferral resulting from the use of an accelerated method of depreciation. Thus, with respect to its public utility property for purposes of section 167, Z may only use a subsection (l) method of depreciation.

Example 5. Assume the same facts as in example (4) except that the order of the regulatory body provided, in effect, that Z normalize 100 percent of the tax deferral with respect to 50 percent of its public utility property and flow-through the tax savings with respect to the other 50 percent of its property. Because the effect of such an order would allow Z to flow-through a portion of the tax savings resulting from the use of an accelerated method of depreciation, Z would not be using a normalization method of regulated accounting with respect to any of its properties. Thus, with respect to its public utility property for purposes of section 167, Z may only use a subsection (l) method of depreciation.

(3) Establishing compliance with normalization requirements in respect of operating books of account. The taxpayer may establish compliance with the requirement in subparagraph (l)(i) of this paragraph in respect of reflecting operating results, and adjustments to a reserve, in its operating books of account by reference to the following:

(i) The most recent periodic report for a period beginning before the end of the taxable year, required by a regulatory body described in section 167(l)(3)(A) having jurisdiction over the taxpayer's regulated operating books of account which was filed with such body before the due date (determined with regard to extensions) of the taxpayer's Federal income tax return for such taxable year (whether or not such body has jurisdiction over rates).

(ii) If subdivision (i) of this subparagraph does not apply, the taxpayer's most recent report to its shareholders for the taxable year but only if (a) such report was distributed to the shareholders before the due date (determined with regard to extensions) of the taxpayer's Federal income tax return for the taxable year and (b) the taxpayer's stocks or securities are traded in an established securities market during such taxable year. For purposes of this subdivision, the term "established securities market" has the meaning assigned to such term in § 1.453–3(d)(4).

(iii) If neither subdivision (i) nor (ii) of this subparagraph applies, entries made to the satisfaction of the district director before the due date (determined with regard to extensions) of the taxpayer's Federal income tax return for the taxable year in its regulated books of account for its most recent period beginning before the end of such taxable year.

(4) Establishing compliance with normalization requirements in computing cost of service for ratemaking purposes. **(i)** In the case of a taxpayer which used a flow-through method of regulated accounting for its July 1969 regulated accounting period or thereafter, with respect to all or a portion of its pre–1970 public utility property, if a regulatory body having jurisdiction to establish the rates of such taxpayer as to such property (or a court which has jurisdiction over such body) issues an order of general application (or an order of specific application to the taxpayer) which states that such regulatory body (or court) will permit a class of taxpayers of which such taxpayer is a member (or such taxpayer) to use the normalization method of regulated accounting to establish cost of service for ratemaking purposes with respect to all or a portion of its public utility property, the taxpayer will be presumed to be using the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes with respect to the public utility property to which such order applies. In the event that such order is in any way conditional, the preceding sentence shall not apply until all of the conditions contained in such order which are applicable to the taxpayer have been fulfilled. The taxpayer shall establish to the satisfaction of the Commissioner or his delegate that such conditions have been fulfilled.

(ii) In the case of a taxpayer which did not use the flow-through method of regulated accounting for its July 1969 regulated accounting period or thereafter (including a taxpayer which used a subsection (l) method of depreciation to compute its allowance for depreciation under section 167(a) and to compute its tax expense for purposes of reflecting operating results in its regulated books of account), with respect to any of its public utility property, it will be presumed that such taxpayer is using the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes with respect to its post–1969 public utility property. The presumption described in the preceding sentence shall not apply in any case where there is (a) an expression of intent (regardless of the manner in which such expression of intent is indicated) by the regulatory body (or bodies), having jurisdiction to establish the rates of such taxpayer, which indicates that the policy of such regulatory body is in any way inconsistent with the use of the normalization method of regulated accounting by such taxpayer or by a class of taxpayers of which such taxpayer is a member, or (b) a decision by a court having jurisdiction over such regulatory body which decision is in any way inconsistent with the use of the normalization method of regulated accounting by such taxpayer or a class of taxpayers of which such taxpayer is a member. The presumption shall be applicable on January 1, 1970, and shall, unless rebutted, be effective until an inconsistent expression of intent is indicated by such regulatory body or by such court. An example of such an inconsistent expression of intent is the case of a regulatory body which has, after the July 1969 regulated accounting period and before January 1, 1970, directed public utilities subject to its ratemaking jurisdiction to use a flow-through method of regulated accounting, or has issued an order of general application which states that such agency will direct a class of public utilities of which the taxpayer is a member to use a flow-through method of regulated accounting. The presumption described in this subdivision may be rebutted by evidence that the flow-through method of regulated accounting is being used by the taxpayer with respect to such property.

(iii) The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Corporation X is a calendar-year taxpayer and its “applicable 1968 method” is a straight line method of depreciation. Effective January 1, 1970, X began collecting rates which were based on a sum of the years-digits method of depreciation and a normalization method of regulated accounting which rates had been approved by a regulatory body having jurisdiction over X. On October 1, 1971, a court of proper jurisdiction annulled the rate order prospectively, which annulment was not appealed, on the basis that the regulatory body had abused its discretion by determining the rates on the basis of a normalization method

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of regulated accounting. As there was no inconsistent expression of intent during 1970 or prior to the due date of X's return for 1970, X's use of the sum of the years-digits method of depreciation for purposes of section 167 on such return was proper. For 1971, the presumption is in effect through September 30. During 1971, X may use the sum of the years-digits method of depreciation for purposes of section 167 from January 1 through September 30, 1971. After September 30, 1971, and for taxable years after 1971, X must use a straight line method of depreciation until the inconsistent court decision is no longer in effect.

Example 2. Assume the same facts as in example (1), except that pursuant to the order of annulment, X was required to refund the portion of the rates attributable to the use of the normalization method of regulated accounting. As there was no inconsistent expression of intent during 1970 or prior to the due date of X's return for 1970, X has the benefit of the presumption with respect to its use of the sum of the years-digits method of depreciation for purposes of section 167, but because of the retroactive nature of the rate order X must file an amended return for 1970 using a straight line method of depreciation. As the inconsistent decision by the court was handed down prior to the due date of X's Federal income tax return for 1971, for 1971 and thereafter the presumption of subdivision (ii) of this subparagraph does not apply. X must file its Federal income tax returns for such years using a straight line method of depreciation.

Example 3. Assume the same facts as in example (2), except that the annulment order was stayed pending appeal of the decision to a court of proper appellate jurisdiction, X has the benefit of the presumption as described in example (2) for the year 1970, but for 1971 and thereafter the presumption of subdivision (ii) of this subparagraph does not apply. Further, X must file an amended return for 1970 using a straight line method of depreciation and for 1971 and thereafter X must file its returns using a straight line method of depreciation unless X and the district director have consented in writing to extend the time for assessment of tax for 1970 and thereafter with respect to the issue of normalization method of regulated accounting for as long as may be necessary to allow for resolution of the appeal with respect to the annulment of the rate order.

(5) Change in method of regulated accounting. The taxpayer shall notify the district director of a change in its method of regulated accounting, an order by a regulatory body or court that such method be changed, or an interim or final rate determination by a regulatory body which determination is inconsistent with the method of regulated accounting used by the taxpayer immediately prior to the effective date of such rate determination. Such notification shall be made within 90 days of the date that the change in method, the order, or the determination is effective. In the case of a change in the method of regulated accounting, the taxpayer shall recompute its tax liability for any affected taxable year and such recomputation shall be made in the form of an amended return where necessary unless the taxpayer and the district director have consented in writing to extend the time for assessment of tax with respect to the issue of normalization method of regulated accounting.

(6) Exclusion of normalization reserve from rate base. (i) Notwithstanding the provisions of subparagraph (1) of this paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's tax expense in computing cost of service in such ratemaking.

(ii) For the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i) of this subparagraph, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for the period is the amount of the reserve (determined under subparagraph (2) of this paragraph) at the end of the historical period. If solely a future period is used for such determination, the amount of the reserve account for the period is the amount of the reserve at the beginning of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during such period. If such determination is made by reference both to an historical portion

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and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period. The pro rata portion of any increase to be credited or decrease to be charged during a future period (or the future portion of a part-historical and part-future period) shall be determined by multiplying any such increase or decrease by a fraction, the numerator of which is the number of days remaining in the period at the time such increase or decrease is to be accrued, and the denominator of which is the total number of days in the period (or future portion).

(iii) The provisions of subdivision (i) of this subparagraph shall not apply in the case of a final determination of a rate case entered on or before May 31, 1973. For this purpose, a determination is final if all rights to request a review, a rehearing, or a redetermination by the regulatory body which makes such determination have been exhausted or have lapsed. The provisions of subdivision (ii) of this subparagraph shall not apply in the case of a rate case filed prior to June 7, 1974 for which a rate order is entered by a regulatory body having jurisdiction to establish the rates of the taxpayer prior to September 5, 1974, whether or not such order is final, appealable, or subject to further review or reconsideration.

(iv) The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Corporation X is exclusively engaged in the transportation of gas by pipeline subject to the jurisdiction of the Z Power Commission. With respect to its post–1969 public utility property, X is entitled under section 167(l)(2)(B) to use a method of depreciation other than a subsection (l) method if it uses a normalization method of regulated accounting. With respect to X the Z Power Commission for purposes of establishing cost of service uses a recent consecutive 12–month period ending not more than 4 months prior to the date of filing a rate case adjusted for certain known changes occurring within a 9–month period subsequent to the base period. X's rate case is filed on January 1, 1975. The year 1974 is the recorded test period for X's rate case and is the period used in determining X's tax expense in computing cost of service. The rates are contemplated to be in effect for the years 1975, 1976, and 1977. The adjustments for known changes relate only to wages and salaries. X's rate base at the end of 1974 is $145,000,000. The amount of the reserve for deferred taxes under section 167(l) at the end of 1974 is $1,300,000, and the reserve is projected to be $4,400,000 at the end of 1975, $6,500,000 at the end of 1976, and $9,800,000 at the end of 1977. X does not use a normalization method of regulated accounting if the Z Power Commission excludes more than $1,300,000 from the rate base to which X's rate of return is applied. Similarly, X does not use a normalization method of regulated accounting if, instead of the above, the Z Power Commission, in determining X's rate of return which is applied to the rate base, assigns to no-cost capital an amount that represents the reserve account for deferred tax that is greater than $1,300,000.

Example 2. Assume the same facts as in example (1) except that the adjustments for known changes in cost of service made by the Z Power Commission include an additional depreciation expense that reflects the installation of new equipment put into service on January 1, 1975. Assume further that the reserve for deferred taxes under section 167(1)[1] at the end of 1974 is $1,300,000 and that the monthly net increases for the first 9 months of 1975 are projected to be:

January 1–31	$310,000
February 1–28	300,000
March 1–31	300,000
April 1–30	280,000
May 1–31	270,000
June 1–30	260,000

July 1–31	260,000
August 1–31	250,000
September 1–30	240,000
	$2,470,000

For its regulated books of account X accrues such increases as of the last day of the month but as a matter of convenience credits increases or charges decreases to the reserve account on the 15th day of the month following the whole month for which such increase or decrease is accrued. The maximum amount that may be excluded from the rate base is $2,470,879 (the amount in the reserve at the end of the historical portion of the period ($1,300,000) and a pro rata portion of the amount of any projected increase for the future portion of the period to be credited to the reserve ($1,170,879)). Such pro rata portion is computed (without regard to the date such increase will actually be posted to the account) as follows:

$310,000 x 243/273 =	$275,934
300,000 x 215/273 =	236,264
300,000 x 184/273 =	202,198
280,000 x 154/273 =	157,949
270,000 x 123/273 =	121,648
260,000 x 93/273 =	88,571
260,000 x 62/273 =	59,048
250,000 x 31/273 =	28,388
240,000 x 1/273 =	879
	$1,170,879

Example 3. Assume the same facts as in example (1) except that for purposes of establishing cost of service the Z Power Commission uses a future test year (1975). The rates are contemplated to be in effect for 1975, 1976, and 1977. Assume further that plant additions, depreciation expense, and taxes are projected to the end of 1975 and that the reserve for deferred taxes under section 167(l) is $1,300,000 for 1974 and is projected to be $4,400,000 at the end of 1975. Assume also that the Z Power Commission applies the rate of return to X's 1974 rate base of $145,000,000. X and the Z Power Commission through negotiation arrive at the level of approved rates. X uses a normalization method of regulated accounting only if the settlement agreement, the rate order, or record of the proceedings of the Z Power Commission indicates that the Z Power Commission did not exclude an amount representing the reserve for deferred taxes from X's rate base ($145,000,000) greater than $1,300,000 plus a pro rata portion of the projected increases and decreases that are to be credited or charged to the reserve account for 1975. Assume that for 1975 quarterly net increases are projected to be:

1st quarter	$910,000
2nd quarter	810,000
3rd quarter	750,000
4th quarter	630,000

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Total	$3,100,000

For its regulated books of account X will accrue such increases as of the last day of the quarter but as a matter of convenience will credit increases or charge decreases to the reserve account on the 15th day of the month following the last month of the quarter for which such increase or decrease will be accrued. The maximum amount that may be excluded from the rate base is $2,591,480 (the amount of the reserve at the beginning of the period ($1,300,000) plus a pro rata portion ($1,291,480) of the $3,100,000 projected increase to be credited to the reserve during the period). Such portion is computed (without regard to the date such increase will actually be posted to the account) as follows:

$910,000 x 276/365 =	$688,110
810,000 x 185/365 =	410,548
750,000 x 93/365 =	191,096
630,000 x 1/365 =	1,726
	$1,291,480

(i) Flow-through method of regulated accounting. Under section 167(l)(3)(H), a taxpayer uses a flow-through method of regulated accounting with respect to public utility property if it uses the same method of depreciation (other than a subsection (l) method) to compute its allowance for depreciation under section 167 and to compute its tax expense for purposes of reflecting operating results in its regulated books of account unless such method is the same method used by the taxpayer to determine its depreciation expense for purposes of reflecting operating results in its regulated books of account. Except as provided in the preceding sentence, the method of depreciation used by a taxpayer with respect to public utility property for purposes of determining cost of service for ratemaking purposes or rate base for ratemaking purposes shall not be considered in determining whether the taxpayer used a flow-through method of regulated accounting. A taxpayer may establish use of a flow-through method of regulated accounting in the same manner that compliance with normalization requirements in respect of operating books of account may be established under paragraph (h)(4) of this section.

Credits

[T.D. 7315, 39 FR 20195, June 7, 1974]

SOURCE: T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960, unless otherwise noted.

Notes of Decisions (1)

Current through December 9, 2021; 86 FR 70314.

Footnotes

1 So in original; probably should read “167(l)”.

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