COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ELECTRONIC APPLICATION OF ATMOS ENERGY CORPORATION TO ESTABLISH PRP RIDER RATES FOR THE TWELVE MONTH PERIOD BEGINNING OCTOBER 1, 2022	))))	CASE NO. 2022-00222

O R D E R

On July 29, 2022, Atmos Energy Corporation (Atmos) filed an application and tariff to revise its Pipeline Replacement Program (PRP) rates, effective October 1, 2022, based on a forecasted test period ending September 30, 2023. On August 12, 2022, the Commission suspended the rates for one day, October 1, 2022, and established a procedural schedule to ensure the orderly investigation of Atmos's application and proposed tariff. Pursuant to KRS 278.190(2), Atmos filed written notice to the Commission of its intention to place the suspended rates into effect on and after October 2, 2022, subject to refund, pending the final Order in this matter. Atmos responded to two rounds of discovery from Commission Staff. There are no intervenors in this case. Atmos gave notice waiving its opportunity for a hearing. The matter now stands submitted for a decision.

LEGAL STANDARD

KRS 278.030(1) states that "[e]very utility may demand, collect and receive fair, just and reasonable rates" for utility service. Pursuant to KRS 278.509, the Commission may allow a utility to recover costs for investment in natural gas pipeline replacement programs that are not recovered in existing rates through a rider if the costs are fair, just

and reasonable. The burden of proof to show that an increased rate or charge is just and reasonable shall be upon the utility.[1]

FINDINGS AND DISCUSSION

Revenue Requirement

Aldyl-A – In Case No. 2021-00214, Atmos's most recent rate case, the Commission found that inclusion in the PRP of future Aldyl-A pipeline replacements will be determined on a case-by-case basis and any PRP applications including Aldyl-A projects should at minimum provide safety justifications for such projects.[2] Atmos proposed to include three Aldyl-A projects in the PRP in this matter, two in Cadiz, Kentucky and one in St. Charles, Kentucky. Aldyl-A leak rates per 100 miles remain higher than coated steel and polyethylene pipe but lower than bare steel.[3] Atmos stated that the three proposed projects for Aldyl-A replacement are predominantly pre-1973 Aldyl-A pipe, which has the highest risk of failure of the Aldyl-A family, and the tracer wire has degraded to the extent that third-part damage risk is higher than bare steel.[4]

Atmos stated that it ranks pipe segments identified for replacement based on historical trends and current data from the past year.[5] This ranking list changes from year to year due to population density, new facilities being installed, or ongoing record reviews.

[1] KRS 278.190(3).

[2] Case No. 2021-00214, *Electronic Application of Atmos Energy Corporation for an Adjustment of Rates* (Ky. PSC May 19, 2022), Order at 60.

[3] Atmos's Response to Commission Staff's First Request for Information (Staff's First Request) (filed Sept. 16, 2022), Item 10(a).

[4] Direct Testimony of T. Ryan Austin (Austin Direct Testimony) at 5, Atmos's Response to Staff's First Request, Item 9(a), and Atmos's Response to Commission Staff's Second Request for Information (Staff's Second Request) (filed Oct. 14, 2022), Item 5.

[5] Atmos's Response to Staff's First Request, Item 9(d).

Atmos stated that Cadiz's rocky soil conditions increases the fracture risk for Aldyl-A pipe and the entire system is pre-1973 Aldyl-A.[6] After the proposed projects, Atmos estimated that there are approximately six to seven more projects of similar scope and scale that would be targeted in the next two to three years.[7] The proposed project in St. Charles will replace all Aldyl-A pipe in the town, which was installed in 1969.[8] Atmos stated that while St. Charles does not have the rocky soil conditions present in Cadiz, the St. Charles pipeline has shallow soil cover and its leakage and damage history have led to one of the highest risks of failure on Atmos's system.[9] The Commission finds the proposed Aldyl-A projects reasonable and therefore approves their inclusion in Atmos's PRP.

Net Operating Loss Accumulated Deferred Income Taxes

In Atmos's most recent rate case, in which its PRP rate was rolled into base rates and reset to zero, the Attorney General of the Commonwealth of Kentucky, through his Office of Rate Intervention's (Attorney General) witness argued that Atmos's net operating loss position was reversing in the forecasted test period, so it was no longer reasonable to assume that the PRP will generate incremental deferred tax assets from net operating loss carryforwards (NOL ADIT) to completely offset incremental deferred tax liabilities, or accumulated deferred income taxes (ADIT liability), arising from its accelerated tax expensing of pipeline replacement projects.[10] The Commission agreed, in part, with the Attorney General's position and stated:

[6] Atmos's Response to Staff's First Request, Item 9(d).

[7] Atmos's Response to Staff's First Request, Item 9(c).

[8] Austin Direct Testimony at 6.

[9] Austin Direct Testimony at 6.

[10] Case No. 2021-00214, May 19, 2022 Order at 61.

> [C]onsistent with the Commission's determination above that the generation and utilization of NOL ADIT included in rate base for Kentucky should be based on Kentucky operations, the PRP calculation should only reflect an incremental increase in NOL ADIT if Atmos Kentucky is able to establish that its Kentucky operations and its PRP spend actually generated NOL ADIT during the relevant period. The Commission will not accept the imputation of NOL ADIT where none was generated by Kentucky operations in the PRP period, because it would be inconsistent with ratemaking principles and federal normalization rules.[11]

In this case, Atmos projected that ADIT liability in the amount of $(3,805,097) would arise from its accelerated tax expensing of pipeline replacement projects in the program year.[12] However, Atmos also estimated that NOL ADIT in the amount of $3,502,155 would arise from net operating loss carryforwards in the PRP program year, and Atmos included that NOL ADIT in the PRP revenue requirement model as an offset to the ADIT liability.[13] The effect was that Atmos's net plant in service was only offset by net ADIT liability of $(317,361) as opposed to the full prorated ADIT liability balance of $(1,954,463) that arose from accelerated tax expensing.[14]

Atmos estimated its NOL ADIT by comparing the projected change in ADIT liability, $(3,805,097), to the projected tax expense from PRP rates during the program year,

[11] Case No. 2021-00214, May 19, 2022 Order at 62.

[12] Application, Exhibit F (indicating that the change in ADIT, excluding any change required by a net operating loss carryforward, was $(3,805,097)).

[13] *See* Application, Exhibit B-1, Exhibit F.

[14] *See* Application, Exhibit B (showing ADIT of $(317,361) used to offset rate base when calculating the PRP revenue requirement); Application, Exhibit F (showing the prorated ADIT liability balances in Atmos's FXA01 and FXA02 accounts as $(1,939,063) and $(15,400), respectively, and describing the sum of those values as the "Cumulative Deferred, Inc. Taxes and Investment Tax Credits (excluding forecasted change in NOLC)").

$317,361.[15] Atmos stated in Exhibit F to its application that "[b]ecause the Company is in a [net operating loss carryforward (NOLC)] position, the total change in ADIT must equal the tax expenses included in revenue requirement."[16] Atmos explained, in part, in response to requests for information that:

> When determining total tax expense, the Company will calculate either a taxable loss or taxable income position.
>
> When the Company calculates a taxable loss position, this results in the creation or increase in NOLC and an associated NOLC-ADIT balance.
>
> When the Company calculates a taxable income position, this results in the utilization of NOLC and will therefore decrease the overall NOLC-ADIT balance as NOLC is being utilized against taxable income.[17]

However, Atmos acknowledged that its federal taxable income/(loss) in a given year is based on the current year's income and is not dependent its NOLC position in previous years.[18]

The bulk of the ADIT liability that Atmos projected would be generated during the PRP program year, $(3,749,687), was projected to arise from book-tax differences in the original cost, or basis, of pipeline projects arising from repair deductions made under 26 U.S.C.A. § 162.[19] Conversely, the ADIT liability projected to arise from accelerated

[15] *See* Application, Exhibit B (showing ADIT of $(317,361) used when calculating revenue requirement); Application, Exhibit F (showing the calculation of NOL ADIT and offset of ADIT).

[16] Application, Exhibit F.

[17] Atmos's Response to Staff's First Request, Item 13(d).

[18] Atmos's Response to Staff's First Request, Item 13(e).

[19] *See* Application, Exhibit F (showing that $(3,749,687) of the ADIT liability generated in the PRP program year was recorded in FXA01); Atmos's Response to Staff's First Request, Item 13(a) and (b) (indicating that FXA01 in Exhibit F "only includes the projection of repair deductions under [26 U.S.C.A.] §162 as these reflect the largest basis adjustments for KY PRP").

depreciation, which will accrue for a number of years after plant is placed in service before it starts reversing, accounted for only $(222,086) of the total ADIT liability accrued in the PRP program year.[20] This is important because it indicates, at minimum, that a significant portion of the change in ADIT in a given period is tied to the timing of plant additions.[21]

Atmos projected total PRP plant additions of $30,337,995 in this PRP program year.[22] In its last three fiscal years, Atmos indicated that its total plant additions, including additions for both PRP and non-PRP projects, were approximately $58 million, $57 million, and $62.5 million,[23] which means Atmos's projected PRP additions in this case would have represented about 50 percent of Atmos's total plant additions in each of the last three years. However, the projected PRP income Atmos used to calculate tax expense to compare to the PRP ADIT liability represents only a fraction of Atmos's jurisdictional income.[24] Thus, Atmos is imputing the existence of NOL ADIT in the PRP program year by comparing a significant portion of the change in ADIT liability that will

[20] *See* Application, Exhibit F (showing that $(222,086) of the ADIT liability generated in the PRP program year was recorded in FXA02); Atmos's Response to Staff's First Request, Item 13(c) (indicating that FXA02 in Exhibit F reflects the timing differences arising from accelerate tax depreciation).

[21] If there were no plant additions in a given period, then there would be no new book-tax timing differences based on original cost differences accumulated, because there is no new plant from which a difference could arise. Conversely, if there are significant plant additions, then the original book-tax cost differences are likely to be higher, because more plant is being placed in service, and therefore, a greater likelihood that original book-tax cost differences will accrue. This phenomenon is reflected in Atmos's calculation of original book-tax timing reflected in FXA01, which it projected as being tied directly total net plant additions in each month at a rate of about 61.67 percent. *See* Application, Exhibit F.

[22] Application, Exhibit F-1.

[23] Atmos's Response to Staff's Second Request, Item 11, Attachment 1.

[24] *See* Atmos's Response to Staff's First Request, Item 15, Attachment 1, Staff_1-15_Att1 - Kentucky Taxable Income (Loss) Detail.xlsx, Tab "Summary" (showing expected "Pre Tax Book Income" of $39,038,257 for the year ended December 31, 2022 and "Pre Tax Book Income" of $1,271,987 from the PRP rates in this PRP program year).

occur in the program year to tax expense on a small fraction of the taxable income it will generate in the program year.

The Commission finds that the mismatch between the change in ADIT and tax expense used to estimate Atmos's net operating loss position results in an NOL ADIT estimate that is unreasonable, because it is not reasonably connected to Atmos's actual net operating position. In fact, in *Missouri-American Water Company v. Public Service Commission of Missouri*,[25] the Missouri Court of Appeals affirmed an order rejecting a similar method used by Missouri-American Water Company in its pipeline replacement rider, in part, for that reason, stating that the method for imputing NOL ADIT, which in that case consisted of comparing incremental accelerated tax expenses to no pipeline replacement revenue in the first year,[26] "does not show whether the utility is actually generating a net operating loss associated with that investment."

Atmos was asked in a request for information in this case to provide its actual expected federal tax expense, on a standalone basis, for Atmos's Kentucky operations for its fiscal years ended September 30, 2022, and September 30, 2023, including all revenue and expenses for regulated operations.[27] In response, Atmos indicated that it did not have such standalone tax expense calculations but stated that "the overall standalone calculations for Kentucky operations as of December 31, 2022 are reflected

[25] *Missouri-American Water Company v. Public Service Commission of Missouri*, 591 S.W.3d 465, 477 (Mo. App. 2019).

[26] There was no pipeline replacement revenue in that case because it was the first year of the rider after a base rate case and it appears the rider was based on a historical period such that no rider revenue had accrued. *Missouri-American Water Company*, 591 S.W.3d at 470-477. The difference here is that Atmos has very slight incremental PRP income, because its rate is based on a single forecasted year.

[27] Atmos's Response to Staff's First Request, Items 15 and 16.

in the order per Atmos' 2021-00214 case filing."[28] Atmos also provided an attachment and indicated that it showed the "Kentucky standalone taxable loss calculations for the 12 months ended December 31, 2022, and the Kentucky PRP taxable loss calculation for the 12 months ended September 20, 2023 based on the the (sic) revenue requirements in [this case and Case No. 2021-00214]."[29]

The attachment included Atmos's projected "Pre Tax Book Income" and the "Change in ADIT," excluding any change in NOL ADIT, for the 12-month period that ended December 31, 2022 and for this PRP program year. Atmos estimated its taxable income/(loss) for those periods by dividing the "Change in ADIT" by its tax rate to get the "Book/Tax Adjustments Other than NOL," i.e. the book-tax timing differences, or accelerated tax expensing, that would have generated the ADIT liability at issue. Atmos then offset the "Pre Tax Book Income" by the timing differences to determine its tax position in the year ended December 31, 2022, and from the PRP investment in the program year.[30] Atmos indicated that the taxable loss for the PRP program year could be determined by adding the change in ADIT and income for both periods and applying the same procedure to calculate the cumulative loss for the PRP year.[31]

There are a number of issues with Atmos's estimate of its taxable income/(loss). First, while Atmos did not provide all workpapers in this case, the $(12,245,579) change in ADIT in the year ended December 31, 2022, reflected in the spreadsheet filed in this

[28] Atmos's Response to Staff's First Request, Items 15 and 16.

[29] Atmos's Response to Staff's First Request, Items 15.

[30] *See* Atmos's Response to Staff's First Request, Item 15, Attachment 1, Staff_1-15_Att1 - Kentucky Taxable Income (Loss) Detail.xlsx, Tab "Summary".

[31] *See* Atmos's Response to Staff's First Request, Item 15.

case is the same as the change in ADIT Atmos calculated for the same period in a spreadsheet in Case No. 2021-00214, and Atmos acknowledged that it calculated the amount in the corresponding spreadsheet by subtracting the ADIT balance as of September 30, 2021 from the ADIT balance as of December 31, 2022.[32] Because the change in ADIT in the spreadsheet filed in this case is the same as the spreadsheet in the previous case, the Commission finds that the change in ADIT that Atmos used to estimate its taxable income/(loss) in this case was calculated in the same manner. This is problematic because it means that Atmos estimated its tax position in the year ended December 31, 2022, by comparing 15 months of ADIT changes, and the associated accelerated tax expenses and deductions, to 12 months of projected income. Thus, there was a mismatch in the time periods involved that would result in Atmos overestimating its taxable loss, if any, because it would be deducting 15 months of expenses from 12 months of income to determine its taxable income/(loss).

In a request for information, Atmos was provided a calculation of the actual change in ADIT, excluding any change in NOL ADIT, based on workpapers provided in Case No. 2021-00214, which appeared to show that the actual change in ADIT was $(8,575,843) in the year ended December 31, 2022.[33] Assuming that change in ADIT is accurate for the year ended December 31, 2022, Atmos would not be in a net operating loss position

[32] Atmos's response to Staff's Second Request, Item 9(b).

[33] Atmos's Response to Staff's Second Request, Item 12.

in the year ended December 31, 2022, as it claimed using its own methodology, as shown in the following table.[34]

Pre-Tax Book Income		39,038,257
Book/Tax Adjustments Other than NOL:		
Change in ADIT (B-5F)	(8,575,843)	
Tax Rate	24.95%	
Book/Tax Adjustments Other than NOL		(34,372,116)
Taxable Income (Loss		**4,666,141**

Atmos was asked to confirm that the calculation of the change in ADIT was correct, or if it could not, to explain each basis why it could not be confirmed. Atmos denied that the calculation was correct, but the only reason it gave was that the projected change in ADIT should also reflect the impact of proration.[35]

However, when ADIT liability is increasing in each month, proration, which discounts future changes in ADIT in a forecast period, will lower the projected increase in ADIT liability during the projected period.[36] Further, because Atmos is using the change in ADIT to estimate the annual book-tax timing differences to compare to annual book income and estimate annual tax income, it does not make sense to use the prorated number, because the timing differences represent differences in expenses and the full expense difference would occur in that year. In fact, Atmos actually uses the non-prorated

[34] The only change in this table and Atmos's calculation for the year ended December 31, 2022 is that a change in ADIT of $(8,575,843) is substituted for $(12,245,579). *See* Atmos's Response to Staff's First Request, Item 15, Attachment 1, Staff_1-15_Att1 - Kentucky Taxable Income (Loss) Detail.xlsx, Tab "Summary".

[35] *See* Atmos's response to Staff's Second Request, Item 12.

[36] *See* Application, Exhibit F, Line No. 10 and Line No. 11 (which shows the full change in ADIT for FXA01 and the lower prorated change); *see also* 26 C.F.R. § 1.167(l)-1 (providing an example that shows how the proration calculation is intended to work).

change in ADIT to calculate the NOL ADIT in this case.[37] Thus, Atmos's did not provide a reasonable explanation for why the calculation of the change in ADIT in the amount $(8,575,843) is incorrect.

Further, Atmos projected the effects of its PRP spending by simply adding the change in the ADIT and pre-tax income from the PRP program year—October 1, 2022 through September 30, 2022—to the change in the ADIT and pre-tax income in the test year ending December 31, 2022.[38] As noted above, the evidence indicates that the ADIT change in a given year arising from pipeline replacement spending is primarily the result of the difference between the original book cost and the original tax cost, or basis, of the property such that the bulk of the change, or at least the increase, is tied to plant additions and will only occur in the year that the plant is placed in service. Thus, by adding the full ADIT change for the PRP period to the ADIT change for the year ended December 31, 2022, Atmos projected an ADIT change based on capital spending from two separate years,[39] which will overestimate the total change in ADIT in a given year, and therefore, Atmos's net operating loss position.

For the reasons discussed above, Atmos failed to establish that including its projected NOL ADIT in rate base in this matter is reasonable. Based on that failure, it would be reasonable to include all of Atmos's projected ADIT liability in rate base with no offset for NOL ADIT. On a prorated basis, based on when Atmos projected that the ADIT

[37] *See* Application, Exhibit F, Line No. 55.

[38] *See* Atmos's Response to Staff's First Request, Item 15, Attachment 1, Staff_1-15_Att1 - Kentucky Taxable Income (Loss) Detail.xlsx, Tab "Summary".

[39] The year ended December 31, 2022, and nine months of the year ended December 31, 2023.

would arise, this would result in an ADIT offset to PRP rate base of $(1,954,463) as opposed to the ADIT offset of $(317,361) Atmos included in its revenue model.

However, while the Commission does not agree that the exclusion of all NOL ADIT would result in a normalization violation,[40] the Commission acknowledges that such a violation could have negative consequences for Atmos and its customers in future rate cases.[41] Further, Atmos acknowledged that only the ADIT reflected in FXA02, which consisted of $(15,400) on a prorated basis, is subject to federal normalization rules. Because that amount is *de minimis* and the consequences of a normalization violation could be significant, the Commission will offset the ADIT reflected in FXA02 by a corresponding amount in NOL ADIT in this case only to avoid any potential normalization violation. Thus, the Commission finds that the prorated net ADIT offset reflected in Line Number 12 of Exhibit B of Atmos's revenue model should be $(1,939,063) as opposed to $(317,361) and that Atmos's PRP rates should be amended to reflect that change, though the Commission notes that it will not include any NOL ADIT in future PRP rate base absent specific, credible evidence that Atmos's Kentucky operations and its PRP spend actually generated NOL ADIT during the relevant period or that normalization rules would require it.[42]

[40] *See Matter of Missouri-American Water Company*, 637 S.W.3d 121, 127-128 (Mo. App. 2021).

[41] *See* 26 U.S.C.A. § 168(f)(2) (stating that accelerated depreciation may not be used for "public utility property" if the "taxpayer does not use a normalization method of accounting").

[42] The Commission notes that while this issue might seem small in this case it will accumulate. The imputed $3,502,155 NOL ADIT balance would be historical in the second year in which the PRP rates are in effect such that the full balance will be reflected as an increase to rate base in the second PRP year, along with any prorated NOL ADIT imputed in the second year of the PRP rates. Assuming Atmos would continue to impute ADIT at a similar rate using its method, more than $10 million of imputed NOL ADIT would likely be included in rate base in Atmos's fourth PRP years. Thus, Atmos could be recovering a return on more than $10 million from Kentucky customers in that year for net operating losses regardless of its actual income/(losses) during those periods.

Prior Period True-Up – Atmos proposed to true-up its PRP project expenditures from fiscal year 2021, October 2020 through September 2021, which includes a project cost true-up and a revenue recovery true-up.[43] In Case No. 2021-00214, the PRP was rolled into base rates and reset to $0 through September 2022.[44] The Commission has consistently prohibited true-up for amounts rolled into base rates, when explicitly addressed.[45] Further, where a specific balancing adjustment is not addressed when a PRP is rolled into base rates, it is reasonable to find that the balancing adjustment, or deferral, has been eliminated, because the existing PRP rate has been eliminated and reestablished, generally, as here, with different terms and conditions. Thus, the Commission finds that the prior-period true-up should be denied, which will reduce the revenue requirement by $337,481.[46] However, if parties conclude that existing balancing adjustments should survive a roll-in, then they can propose or raise the issue in the base rates case in which the true-up is rolled in.

Return On Equity – Atmos developed its proposed return on equity (ROE) of 10.95 percent based upon the Discounted Cash flow Model (DCF), the Capital Asset Pricing Model (CAPM) and the Risk Premium Model (RPM) (collectively, Models).[47] In its analysis, Atmos used a proxy group of six regulated natural gas companies (Utility Proxy Group) and 38 domestic non-price regulated companies that it indicated were comparable

[43] Application, Exhibits B, B-2 and B-3.

[44] Case No. 2021-00214, May 19, 2022 Order at 20.

[45] *See, e.g.,* Case No. 2021-00185, *Electronic Application of Delta Natural Gas Company, Inc. for an Adjustment of its Rates and a Certificate of Public Convenience and Necessity* (Ky. PSC Jan. 3, 2022), final Order at 21;

[46] Application, Exhibit B.

[47] Direct Testimony of Dylan W. D'Ascendis (D'Ascendis Testimony) at 4.

in total risk to the Utility Proxy Group.[48] The companies included in the Utility Proxy Group all met a set of criteria: being listed in Value Lines Standard Edition, not being involved in any major merger or acquisition, not cutting or missing a dividend payment for the last five years, have Value Line and Bloomberg Professional Services adjusted beta coefficients (betas), have five years of positive dividends per share growth and earnings per share growth rate projections.[49] Atmos's witness stated that he Utility Proxy Group of companies is representative of the risks and prospects faced by Atmos.[50]

Atmos employed the constant growth version of the DCF model. To obtain the return on equity expected by investors, Atmos added the adjusted dividend yield based on market prices to the forecast growth rate in earnings per share (EPS) for the Utility Proxy Group. The dividend yields are calculated by dividing dividends by the market stock closing prices for the 60 trading days prior to May 31, 2022.[51] The resulting dividend yields were then adjusted by multiplying the yield by one plus one half the average EPS growth rate. EPS growth rates were obtained from three sources: Value Line Investment Survey (Value Line), Zack's, and Yahoo! Finance.[52]

Atmos argued that EPS growth rates provide a better match between investors' expectations of future market price appreciation and the growth rate component of the DCF model, because since dividend growth cannot happen without growth in EPS, even

[48] D'Ascendis Testimony at 4.

[49] D'Ascendis Testimony at 13–14.

[50] D'Ascendis Testimony at 14.

[51] D'Ascendis Testimony at 17 and Exhibit DWD-2, at 1.

[52] D'Ascendis Testimony at 17 and Exhibit DWD-2, at 1.

though the DCF model is predicated on dividend yields and dividend growth rates.[53] Atmos's witness stated that:

> Investors are likely to rely on widely available financial information services, such as Value Line, Zacks, and Yahoo! Finance. Investors realize that analysts have significant insight into the dynamics of the industries and individual companies they analyze, as well as companies' ability to effectively manage the effects of changing laws and regulations, and ever-changing economic and market conditions. For these reasons, I used analysts' five-year forecasts of EPS growth in my DCF analysis.[54]

For the Risk Premium Model (RPM), Atmos employed two methods: the Predictive Risk Premium Model (PRPM) and the total market approach.[55] In the total market approach, the prospective yield on public utility bonds is added to a market equity risk premium.[56] For the prospective bond yield, Atmos adjusted the prospective yield on Aaa rated corporate bonds to obtain the prospective yield on A2 Rated Public utility bonds.[57] The prospective bond yield applicable to the utility proxy group is 5.30 percent.[58] For the risk premium, Atmos used an average of three different risk premium estimation methods: a beta adjusted total market equity risk premium, an equity risk premium based on the

[53] D'Ascendis Testimony at 18. Atmos provided a DCF calculation that included DPS growth rates in addition to the EPS growth rates. See Atmos's Response to Staff's Second Request, Item 2.

[54] D'Ascendis Testimony at 18.

[55] D'Ascendis Testimony at 19. The Commission rejected the use of the PRPM model in Atmos's recently completed rate proceeding. See Case No. 2021-00214, May 19, 2022 Order at 47-48.

[56] D'Ascendis Testimony at 26.

[57] D'Ascendis Testimony at 26 and Exhibit DWD-3, at 3–6.

[58] D'Ascendis Testimony, Table 5 at 27.

S&P Utilities Index, and an equity risk premium based on authorized ROEs for gas distribution utilities.[59]

For the beta adjusted equity risk premium, Atmos used an average of six risk premium methods: (1) Ibbotson historical equity risk premium based on Ibbotson's SBBI Market Report and Moodys bond yields for Aaa and Aa corporate bonds for the period 1928-2021; (2) an expected risk premium based on a regression of company equity risk premiums over the period 1028-2021 and a forecast of Corporate Aaa corporate bonds; (3) an equity risk premium based on a PRPM analysis; (4) a risk premium based on the Value Line Summary and Index; (5) a risk premium using Value Line data for the S&P 500; and (6) a risk premium using Bloomberg Professional Service (Bloomberg) data for the S&P 500.[60] The average risk premium for the beta adjusted equity risk premium using the total market return is 8.52 percent and applying the beta value yields a risk premium of 6.48 percent. The equity risk premium without the inclusion of the PRPM analysis is 6.44 percent.[61]

For the equity risk premium based on the S&P Utilities Index, Atmos used average of five estimation methods: (1) a risk premium based on the monthly total returns and Moody's Public Utility Bonds from 1928-2021; (2) a risk premium based on a regression of monthly equity risk premiums and Moody's A2 rated public utility bonds from 1928-2021; (3) a risk premium based on a PRPM analysis; (4) a forecasted risk premium based on projected total return on the S&P Utility Index using Value Line data; and (5) a

[59] D'Ascendis Testimony at 26.

[60] D'Ascendis Testimony at 26-32 and Exhibit DWD-3 at 8–9.

[61] D'Ascendis Testimony at 32 and Exhibit DWD-3 at 8–9.

forecasted risk premium based on projected total return on the S&P Utility Index using Bloomberg data.[62] The average implied equity risk premium based on the S&P Utilities Index is 5.05 percent.

For the equity risk premium based on authorized ROEs for gas distribution utilities, Atmos performed a regression analysis relating awarded ROEs to Moody's A rated public utility bonds. The awarded ROEs are results 809 rate cases for gas distribution utilities over the period January 1, 1980, through May 31, 2022. The estimated risk premium based on awarded ROEs is 5.00 percent.[63]

Averaging the three methods of risk premium estimation yields 5.51 percent and when added to the prospective yield on Moody's A-2 rated public utility bonds, yields an ROE of 10.81 percent.[64] The overall estimated ROE for the RPM model is the average of Atmos's PRPM analysis (11.16 percent) and 10.81 percent to obtain 10.99 percent. Excluding the PRPM method from the analyses, yields an estimated ROE of 10.73 percent.[65]

For the equity risk premium based on the S&P Utilities Index, Atmos used the average of five estimation methods: (1) a risk premium based on the monthly total returns and Moody's Public Utility Bonds from 1928-2021; (2) a risk premium based on a regression of monthly equity risk premiums and Moody's A2 rated public utility bonds from 1928-2021; (3) a risk premium based on a PRPM analysis; (4) a forecasted risk premium

[62] D'Ascendis Testimony at 33-34 and Exhibit DWD-3 at 12.

[63] D'Ascendis Testimony at 34-35 and Exhibit DWD-3 at 12–13.

[64] D'Ascendis Testimony at 35-36 and Exhibit DWD-3 at 1.

[65] D'Ascendis Testimony at 26-32 and Exhibit DWD-3 at 1.

based on projected total return on the S&P Utility Index using Value Line data; and (5) a forecasted risk premium based on projected total return on the S&P Utility Index using Bloomberg data.[66]

For the equity risk premium based on authorized ROEs for gas distribution utilities, Atmos performed a regression analysis relating awarded ROEs to Moody's A rated public utility bonds. The awarded ROEs are results from 809 rate cases for gas distribution utilities over the period January 1, 1980, through May 31, 2022.[67]

Atmos averaged the three estimated risk premium yields and added that to the prospective yield on Moody's A-2 rated public utility bonds to obtain an ROE estimate.[68]

For the CAPM analysis, Atmos used the same average beta value used in the RPM analysis.[69] For the risk free rate, Atmos used a consensus forecast of the 30-year Treasury bond yield equal to 3.51 percent.[70] For the estimated risk premium, Atmos risk premium analysis included six methods similar to those used for the RPM analysis: (1) a historical risk premium based on the mean monthly returns on large stocks and the mean income returns on long term government bonds based on Ibbotson historical data from 1926-2021; (2) a risk premium derived from a regression analysis based on Ibbotson historical data from 2916-2021; (3) a risk premium based on a PRPM analysis; (4) a risk premium based on 3–5 years projected total market returns based on the Value Line Summary and Index and the projected risk free rate; (5) a risk premium based on

[66] D'Ascendis Testimony at 33-34 and Exhibit DWD-3 at 12.

[67] D'Ascendis Testimony at 34-35 and Exhibit DWD-3 at 12–13.

[68] D'Ascendis Testimony at 35-36 and Exhibit DWD-3 at 1.

[69] D'Ascendis Testimony at 39 and Exhibit DWD-4 at 1–2.

[70] D'Ascendis Testimony at 40 and Exhibit DWD-4 at 1–2.

projected total market return based on the S&P 500 using Value Line data and the projected risk free rate; and (6) a risk premium based on projected total market return based on the S&P 500 using Bloomberg data and the projected risk free rate.[71] In addition to the traditional CAPM analysis, Atmos used an empirical CAPM (ECAPM) analysis. Atmos argues that it is necessary to correct for shortcomings in the traditional CAPM analysis.[72] Atmos's recommended CAPM ROE is based on the traditional CAPM analysis and the ECAPM analyses.[73] However, Atmos also employed analyses identical to those used for the RPM and CAPM analyses using a proxy group of 38 non-price regulated companies.[74]

Atmos's various methodologies produced estimated ROE results ranged from 9.73 percent to 12.03 percent. Atmos made further adjustments to account for its business risk through a size adjustment (0.20 percent) and its lower credit risk (-0.06 percent) relative to the Utility Proxy Group. A flotation cost adjustment of 0.05 percent was also applied. Atmos's final recommended ROE was 10.95 percent.[75] The estimated ROE results and the adjustments are shown in the table below.[76]

[71] D'Ascendis Testimony at 40-41 and Exhibit DWD-4 at 1-2.

[72] D'Ascendis Testimony at 37-39.

[73] D'Ascendis Testimony at 42 and Exhibit DWD-4 at 1.

[74] D'Ascendis Testimony at 43-46 and Exhibits DWD-5-DWD-6.

[75] D'Ascendis Testimony at 47-57 and Table 2 at 4. Notably, Atmos's estimated ROE results in this matter were not significantly different than its estimated ROE results in its most recent rate case, which was based on a test year that includes three months of the PRP period in this case. *See* Case No. 2021-00214, May 19, 2022 Order at 40.

[76] D'Ascendis Testimony, Table 2 at 4.

Atmos Kentucky
Cost of Common Equity Rates

Discounted Cash Flow Model	9.73%
Risk Premium Model	10.99%
Capital Asset Pricing Model	11.14%
Comparable Risk, Non-Price Regulated Companies	12.03%
Indicated Range of Common Equity Cost Rates	9.73% - 12.03%
Size Adjustment	0.20%
Credit Risk Adjustment	-0.06%
Flotation Cost Adjustment	0.05%
Indicated Range After Adjustments	9.92% – 12.22%
Recommended Cost of Common Equity	10.95%

When using the DCF model, Atmos's witness separately calculated the indicated return on equity for each company in the Utility Proxy Group based on an average of the projected five year growth rates in EPS from Value Line, Zack's Five, and Yahoo! Finance, which resulted in indicated returns ranging from 8.43 percent to 11.14 percent and an average of the mean and median of 9.73 percent, as reported above.[77] However, if a single DPS growth rate is added along with the three EPS growth rates to Atmos's DCF analysis (meaning the DPS growth rate is one of four rates included in an average), then the range of the indicated ROEs becomes 8.20 percent to 10.27 percent, with the average of the mean and median being reduced to 9.26 percent.[78]

The Commission notes that even though it is generally accepted that earnings per share (EPS) growth rates are used to calculate ROEs, the model is theoretically tied to

[77] D'Ascendis Testimony at Exhibit DWD-2, at 1.

[78] Atmos's Response to Staff's Second Request, Item 2, Attachment 1.

dividend per share (DPS) growth rates. Specifically, while the Commission partially agrees with Atmos's witness that security analysts' earnings expectations have a more significant influence on investors, and therefore, market prices than dividend expectations, the Commission finds that dividend expectations do have some influence on investor expectations and actions, as Atmos implicitly acknowledges,[79] and therefore, stock prices. In fact, for rate making purposes, DPS growth rates are frequently included along with multiple EPS growth rates in DCF analyses.[80] Thus, while the Commission agrees, in part, with Atmos's arguments, the Commission finds that it is useful to consider a DCF analysis based, in part, on DPS growth rates.

Regarding the RPM and CAPM models, Atmos used six different methods to estimate risk premiums using different data sources. The Commission notes that Atmos's methods for estimating a projected market risk premium begin with a large market representation and then progressively abstract away from that. There are calculations based on the Value Line Summary and Index, which is based on the New York Stock Exchange and includes 1,700 companies.[81] Other calculations are based on the smaller S&P 500 index as a market proxy.[82] Two additional risk premium estimation methods are based upon the S&P Utility Index and upon authorized ROEs for gas distribution utilities.

[79] Atmos's witness implicitly acknowledged that dividend expectations influence the market by arguing that security analyst expectations have a more significant influence.

[80] *See* Case No. 2021-00214, May 19, 2022 Order at 40–41 (in which the Attorney General's expert, among other things, argued that in addition to using earnings growth rates that dividend growth rates should have been included because dividend payments comprise a significant portion of the total return to investors).

[81] Atmos's Response to Staff's First Request, Item 8.

[82] Atmos's Response to Staff's First Request, Item 7. In addition, the SBBI-2022 market returns used in Atmos's historical risk premium analyses is based on the S&P 500 Index.

The Commission notes that there is considerable variation in the results of these risk premium and ROE estimation methods. For rate making purposes, the Commission has concerns about the applicability of equity risk premiums that are either truncations of broader market representations or are abstractions from actual markets that yield more of an implied market risk premium estimation. As estimation methods move further away from broader representations of equity markets, the Commission will accord these methods less weight.

The Commission also continues to reject the use of the PRPM model to estimate a risk premium. Though the PRPM model has been published and presented in multiple forums, as Atmos's witness again argues in this case, it has been rejected by this Commission and only been addressed by three other regulatory commissions and is not universally accepted.[83]

Regarding the beta values used in the CAPM and RPM methods, Atmos used two measures of adjusted beta, provided by Value Line and Bloomberg, respectively.[84] Value Line beta values are calculated over a five-year period using weekly data from the New York Stock Exchange as its market proxy. Bloomberg beta values are calculated over a two-year period using weekly data from the S&P 500.[85] Atmos argued that Yahoo!

[83] *See* Case No. 2021-00214, May 19, 2022 Order at 47–48; *see also* D'Ascendis Testimony at 24 ("Regarding the amount of times the model has been addressed in final orders; while it is true that only three (now four) regulatory commissions have addressed the PRPM in their final orders, the model has been presented in over 100 regulatory proceedings in over thirty U.S. regulatory jurisdictions and the Alberta Utilities Commission in Canada. This would indicate that while maybe not universally accepted, the model is widely disseminated across the U.S. regulatory landscape.").

[84] D'Ascendis Testimony at 39.

[85] D'Ascendis Testimony at 39; Atmos's Response to Staff's First Request, Item 8a.

Finance beta values are based on five years of monthly data and are not adjusted and, therefore, are not suitable for cost of capital calculations.[86]

Atmos provided updates to its RPM and CAPM analyses by including adjusted Yahoo! Finance beta values in addition to the Value Line and Bloomberg beta values.[87] The results of the updated analyses, excluding PRMP, are an average RPM ROE of 10.59 percent[88] and an average traditional CAPM ROE of 10.41 percent.[89]

The Commission recognizes the shortcomings of using Yahoo! Finance unadjusted monthly beta values, especially if no other beta values were used in the analyses. However, relative to Value Line beta values, which are based on five years of weekly market observations, Bloomberg beta values provide a skewed picture as well. Specifically, Bloomberg beta values emphasize more recent market volatility as compared to Value Line beta values, because the Bloomberg beta values are only based on two years of weekly observations. Thus, both Bloomberg and Yahoo! Finance betas omit market observations that are captured in the Value Line beta values.[90]

[86] Atmos's Response to Staff's First Request, Item 8 at 5 and Item 8b at 1-7. Atmos argued that using monthly data as opposed to weekly data provides fewer market observations, which is of particular concern for higher dividend stocks. Stock price behavior on ex-dividend dates and other price movements could skew the calculation of both the relative volatility of market returns and the correlation of market returns, which determine beta values In the response, Atmos provided the rationale and formula used to transform historical raw beta values to forward looking values more suitable for cost of capital calculations. The Commission notes that both the Value Line and Bloomberg beta values are adjusted values.

[87] *See* Atmos's Response to Staff's Second Request, Item 3.

[88] *See* Atmos's Response to Staff's Second Request, Item 3, Attachment 1.

[89] *See* Atmos's Response to Staff's Second Request, Item 3, Attachment 2 (showing the average of the mean and the median to be 10.40%).

[90] As discussed earlier, the Commission notes that Atmos's RPM and CAPM analyses are replete with multiple alternative estimation methods of calculating ROE and ROE model components.

The Commission reiterates that it continues to reject the use of non-price regulated proxy groups and the use of size adjustments, credit risk adjustments, and flotation cost adjustments for rate making purposes.[91] Both the DCF and CAPM are long standing, well accepted models that model risk and returns both implicitly and explicitly. The Commission will continue to evaluate all models, but will accord most weight to DCF and CAPM analyses based upon regulated company proxy groups using historical and forecast data. After consideration of the evidence of record, the Commission finds that an ROE of 9.55 percent for Atmos' base rates and an ROE of 9.45 percent for its natural gas capital rider (pipeline replacement program) is fair, just and reasonable.[92]

The Commission notes that Atmos proposed an ROE and filed ROE testimony in this matter because the Commission indicated Atmos should do so in Case No. 2020-00229.[93] Prior to that case, Atmos's PRP revenue requirement was calculated based on the ROE approved in the most recent base rate case. However, the Commission found no public purpose is served by the continuation of a previously approved ROE without regard to the reasonableness of the rate and indicated that going forward the overall PRP return would be established in each PRP case. The Commission further stated that it

[91] *See* Case No. 2021-00214, May 19, 2022 Order at 39–48 (in which the Commission found that ROEs of 9.23% for Atmos Kentucky's base rates and 9.13% for its natural gas capital riders were fair, just and reasonable, while rejecting the use of the PRPM analysis as well as flotation cost adjustments, financial risk adjustments, and size adjustments in the ROE analyses); *see also* Case No. 2022-00147, *Electronic Application of Water Service Corporation of Kentucky for a General Adjustment in Existing Rates and a Certificate of Public Convenience and Necessity to Deploy Advanced Metering Infrastructure* (Ky. PSC April 12, 2023), final Order (rejecting specific flotation cost, financial risk, and size adjustments proposed by Mr. D'Ascendis separate from the ROE calculation using accepted methodologies).

[92] *See* Case No. 2021-00214, May 19, 2022 Order at 47–48 (adopting a lower rider ROE); *see also* Case No. 2020-00174, *Electronic Application of Kentucky Power Company* (Ky. PSC. Jan. 13, 2021) (setting a lower rider ROE based on a finding that ROEs for riders are generally lower and noting that there is less risk associated rider recovery).

[93] Case No. 2020-00229, *Electronic Application of Atmos Energy Corporation for PRP Rider Rates* (Ky. PSC Sept. 30, 2020) at 8, and ordering paragraph 4.

"strongly recommends that Atmos file adequate testimony to support its proposed rate of return, including a reasonable ROE."[94]

It has been necessary to suspend Atmos's PRP rates in both PRP cases since the Order in Case No. 2020-00229 due to the complex nature of ROE testimony.[95] Further, changes to the ROE in the first couple years of a PRP rate will have limited effect on the revenue requirement.[96] In fact, the revenue requirement effect of changing the ROE in this case was likely less than the cost of Atmos's ROE expert in this case.[97] Further, the Commission recognizes that Atmos will make its next annual PRP filing in approximately two months. Thus, the Commission finds that it would be reasonable for Atmos to use the PRP ROE approved herein in its next PRP filing, and therefore, finds that Atmos may rely on the PRP ROE approved herein in its next PRP filing without filing ROE testimony.[98]

With the adjustments discussed above, the Commission finds that Atmos's PRP net rate base is $16,313,779 and its PRP revenue requirement is $1,587,695 as shown in Appendix A.

[94] Case No. 2020-00229, Sept. 30, 2020 Order at 8, and ordering paragraph 4.

[95] *See* Case No. 2021-00304, *Electronic Application of Atmos Energy Corporation to Establish PRP Rider Rates for the Twelve Month Period Beginning October 1, 2021* (Ky. PSC Aug. 20, 2021), Order.

[96] The ROE of 9.45% approved herein increased the weighted average cost of capital by 0.18% as compared to the PRP ROE approved in the last base rate case. This would result in a revenue requirement change of about $25,644.49 ($14,374,716 x 0.18 %).

[97] Case No. 2021-00214, *Electronic Application of Atmos Energy Corporation for an Adjustment of Rates* (filed Feb. 17, 2022), Atmos Energy Supplemental Response to Staff's DR 1-12 (showing costs for the initial preparation of ROE testimony and workpapers in the range of about $25,000 with tens of thousands more being charged throughout the a base rate case that went to an evidentiary hearing).

[98] This should not be construed as preventing Atmos from filing PRP ROE testimony if it determines it is appropriate to do so.

Rate Design

Atmos's most recent base rate case was approved by the Commission in Case No. 2021-00214.[99] Pursuant to Atmos's PRP Rider tariff, the rate class allocation of the PRP revenue requirement will be in proportion to the relative base revenue share approved in Atmos's most recently concluded base rate case.[100] The rates in the Appendix B attached to this Order should produce PRP revenue requirement, with the adjustments discussed above, of approximately $1,587,695. Thus, the Commission finds that those rates should approved effective October 2, 2022.

However, the Commission notes that Atmos placed its proposed rates in this matter in effect, subject to refund, on October 2, 2022, while this case was pending. The Commission finds that Atmos should refund each of its customers all amounts collected for service rendered from October 2, 2022 through the date of entry of this Order that are in excess of the rates set forth in Appendix B attached to this Order. Atmos should also file a written report into the case record that describes its efforts to refund all monies collected in excess of the rates that are set forth in the Appendix B to this Order. Furthermore, following the filing of the written report, the Commission reserves its right to initiate an investigation to determine whether Atmos reasonably refunded all monies collected in excess of the rates that are set forth in the Appendix B to this Order.

[99] Case No. 2021-00214, May 19, 2022 Order.

[100] PSC KY No. 2, Second Revised Sheet No. 38.

IT IS THEREFORE ORDERED that:

1. The PRP rates proposed by Atmos are denied.

2. The PRP rates in Appendix B to this Order are approved for service rendered by Atmos on and after the date of entry of this Order.

3. Atmos may use the PRP ROE approved in this Order in its next PRP filing without filing ROE testimony.

4. Within 20 days of the date of service of this Order, Atmos shall file with this Commission, using the Commission's electronic Tariff Filing System, revised tariff sheets setting out the rates approved herein and reflecting that they were approved pursuant to this Order.

5. Within 60 days of the date of service of this Order, Atmos shall refund to its customers all amounts collected for service rendered from October 2, 2022, through the date of entry of this Order that are in excess of the rates set forth in the Appendix B herein attached to this Order.

6. Within 75 days of the date of service of this Order, Atmos shall submit a written report to the Commission in which it describes its efforts to refund all monies collected in excess of the rates that are set forth in the Appendix B to this Order.

7. The Commission reserves its right to initiate an investigation to determine whether Atmos reasonably refunded all monies collected in excess of the rates that are set forth in the Appendix B to this Order should the Commission deem it necessary.

8. This case is closed and removed from the Commission's docket.

PUBLIC SERVICE COMMISSION

Chairman

Vice Chairman

Commissioner

Aff with permission

ENTERED

MAY 25 2023

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KENTUCKY PUBLIC SERVICE COMMISSION

ATTEST:

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2022-00222 DATED MAY 25 2023

Atmos Energy Corporation
Pipe Replacement Program
October 2022 - September 2023

Line Number	Description	Total	As filed	Difference
1	Project Additions	$ 15,586,559	$ 15,586,559	$ -
2	Project Retirements	$ (3,039,583)	$ (3,039,583)	$ -
3	**Net Change to Gross Plant**	$ 12,546,976	$ 12,546,976	$ -
4				
5	Cost of Removal to Accumulated Depr.	$ 790,841	$ 790,841	$ -
6	Retirements from Accumulated Depr.	3,039,583	3,039,583	-
7	Depreciation Accrual to Accumulated Depr.	(63,621)	(63,621)	-
8	**Net Change to Accumulated Depreciation**	3,766,802	3,766,802	-
9				
10	**Net Change to Net Plant**	$ 16,313,779	$ 16,313,779	$ -
11				
12	Accumulated Deferred Income Taxes	(1,939,063)	(317,361)	1,621,702
13	**Net Change to Rate Base**	$ 14,374,716	$ 15,996,418	$ 1,621,702
14				
15	Rate of Return	6.94%	7.75%	0.82%
16	**Required Operating Income**	$ 997,030	$ 1,240,282	$ 243,252
17				
18	Depreciation & Amortization Expense	216,445	216,445	-
19	O&M Savings	(4,474)	(4,474)	-
20	Ad Valorem Tax Increase	122,265	122,265	-
21	Income Taxes on Cost of Service Items	(83,392)	(83,392)	-
22	Income Taxes on Adjusted Interest Expense	(64,046)	(71,271)	(7,225)
23	**Operating Income at Present Rates**	$ 186,798	$ 179,573	$ (7,225)
24				
25	Deficiency	$ 1,183,828	$ 1,419,855	$ 236,027
26	Tax Factor	74.56%	74.56%	0.00%
27	**Total Rate Adjustment**	$ 1,587,695	$ 1,904,243	$ 316,548
28				
29	Project Cost True-up	$ -	$ 237,735	$ 237,735
30	Revenue Recovery True-up	-	99,746	99,746
31	**Total True-up**	$ -	$ 337,481	$ 337,481
32				
33	**Total Rate Adjustment**	$ 1,587,695	$ 2,241,724	$ 654,029

APPENDIX B

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2022-00222 DATED MAY 25 2023

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

Pipeline Replacement Program Rider Rates

	Monthly Customer Charge		Distribution Charge per Mcf
Rate G-1 (Residential)	$ 0.00	1-300 Mcf	$0.0883
		301-15,000 Mcf	$0.0883
		Over 15,000 Mcf	$0.0883
Rate G-1 (Non-Residential)	$ 0.00	1-300 Mcf	$0.0645
		301-15,000 Mcf	$0.0449
		Over 15,000 Mcf	$0.0449
Rate G-2	$ 0.00	1-15,000 Mcf	$0.0215
		Over 15,000 Mcf	$0.0177
Rate T-3	$ 0.00	1-15,000 Mcf	$0.0158
		Over 15,000 Mcf	$0.0132
Rate T-4	$ 0.00	1-300 Mcf	$0.0260
		301-15,000 Mcf	$0.0179
		Over 15,000 Mcf	$0.0148

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